MINUTE ITEM
This Calendar Item No. C66 was approved as Minute Item No. 66 by the California State Lands Commission by a vote of 2 to ~~0~~ at its 2/27/96 meeting.

INFORMATIONAL CALENDAR ITEM
C66

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ANNUAL REPORT ON MANAGEMENT OF STATE SCHOOL LANDS

PARTY:

State Lands Commission
1807 - 13th Street
Sacramento, California 95814

Public Resources Code Section 6477 provides for the submittal of an annual report on the management of school lands by the Commission to the State Teachers' Retirement Board, the Legislature, and the Governor.

The report addresses the school lands asset composed of approximately 570,000 acres of school land and 760,000 acres of reserved mineral interest. Current revenues from these lands are dedicated to the State Teachers' Retirement Fund (STRF). Proceeds from land sales are deposited in the School Land Bank Fund (SLBF) for reinvestment. In Fiscal Year 1994-95, surface and mineral leases produced a net revenue of $2,631,188.62 to the STRF. Land sales produced a net income of $301,651.00 for the SLBF. The accrued interest on this fund for the year was $672,700.64.

The report will be submitted to the State Teachers' Retirement Board, to the Legislature, and the Governor.

A copy of the report is attached as Exhibit "A".

AB 884:

N/A

EXHIBIT:

A. Annual Staff Report on Management of School Lands

NO TEXT ON THIS PAGE

EXHIBIT "A"

CALIFORNIA STATE LANDS COMMISSION

ANNUAL STAFF REPORT

ON

STATE SCHOOL LANDS MANAGEMENT

Fiscal Year 1994-95

CALIFORNIA STATE LANDS COMMISSION
Gray Davis, Lieutenant Governor
Kathleen Connell, Ph.D., State Controller
Russell S. Gould, Director of Finance

EXECUTIVE OFFICER
Robert C. Hight

Submitted to the State Teachers' Retirement System,
the California Legislature, and the Governor

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INTRODUCTION

The State Lands Commission (SLC), through its State School Lands' Management Program (Program), manages approximately 570,000 acres of School Lands held in fee ownership by the State and the reserved mineral interests on another 760,000 acres of School Lands which have been sold by the State. In addition, approximately 52,000 acres of lieu lands are still owed to California by the federal government to satisfy the entitlements under the State's original grant.

Management of the Program is divided among three staff divisions within the SLC. The Divisions of Environmental Planning and Management and Land Management share responsibilities for the Surface Management Program under which all surface resources on School Lands are managed. The Mineral Resources Management Division oversees both the SLC's Geothermal Program and the Mineral Programs under which the School Lands geothermal oil and gas leasing and mining activities are administered.

During 1994-95 the program's emphasis continued to be on the consolidation of capital resources, acquisition of additional long-term revenue producing properties, and the sale of School Land parcels with marginal revenue potential. The SLC's management costs for the Program were $835,337.36 in Fiscal Year (FY) 1994-95. Net revenues of the program were $2,631,188.62.

Major activities for each of these program components for the 1994/95 and 1995/96 Fiscal Years are described in the following pages.

CALIFORNIA DESERT PROTECTION ACT OF 1994

On October 31, 1994, the California Desert Protection Act of 1994 (CDPA) was signed into law by the President. The CDPA designates 3.6 million acres in Southern California as wilderness to be administered primarily by the Bureau of Land Management (BLM), and 4 million acres as additions to the National Park Service (NPS) system.

The purpose of the CDPA is to set aside areas in the California Desert to protect the desert's natural, cultural, scenic, and historical values and to provide for public enjoyment. Of the 3.6 million acres, 266,000 acres (462 parcels) are State School Land parcels owned in fee and an additional 65,000 acres (168 parcels) are encumbered by the State's reserved mineral interests. The fee and mineral School Land interests are both administered by the SLC for the State Teachers Retirement System (STRS).

The monetary impact of the CDPA on the State School Land parcels is clearly defined. The SLC will receive compensation for the "taking" of its fee and mineral interests on a value for value basis determined by fair market value appraisals. Compensation for the State's assets may be made in various forms - cash, exchange for other lands, and/or by periodic payments of identified income streams. There are no provisions in the CDPA, however, to compensate the SLC for the staff time or contracts needed to implement the Act. State funds allocated for the management of the Program are being expended for this process.

SLC staff (Staff) is working with the BLM and the General Services Administration (GSA) to finalize agreements to identify value and exchange parcels and income streams which will be used to clear the State's interests as described above. One of the most time consuming tasks to implement the Act is the listing and review of the impacted SLC parcels and review of the BLM/GSA parcels offered for exchange or sale. Currently, three person years are allocated to this process.

UPDATE: ELK HILLS NAVAL PETROLEUM RESERVE NO. 1

Staff, in concert with the staff of STRS, continues to work aggressively toward compensation for the two School Land sections within the Elk Hills Naval Petroleum Reserve No. 1. During the 104th Congress the issue of compensation has been addressed in five congressional bills. At this time the revised Defense Authorization Bill offers the greatest opportunity to resolve this long standing claim. The Defense Authorization Conference Report contains the following provisions to settle California's claim:

> Within 30 days of the sale of Elk Hills, the Department of Energy (DOE) will offer "proper compensation" for the fair market value of the State's claim, including the mineral estate. If a settlement is not reached, the claim will be resolved in a court of competent jurisdiction.
>
> A contingent fund for the California Teachers' Retirement Fund will last 10 years and will be available to the State, if appropriated. This fund will equal 9 percent of the proceeds of the sale of Elk Hills after deducting the costs of the sale.

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California must release its claim as a condition of accepting the settlement offer.

This language was developed by Congressman Bill Thomas, Bob Winters (staff to Congressman Thomas), John Stanton and Elinor Schwartz. This bill passed the House on January 24, 1996. If it passes the Senate and is not vetoed, DOE and the Office of Management and Budget could still stop the sale pursuant to provisions contained in the conference report. In addition, the Defense Authorization Bill would require a separate appropriation.

SURFACE MANAGEMENT PROGRAM

The Surface Management Program oversees all surface activities on School Lands. This includes surface leasing for various purposes, such as rights-of-way for transmission lines and grazing. The Surface Management Program is also responsible for the sale of parcels to public and private interests, and the management of 25,000 acres of timberland. In FY 1994-95, surface rentals and timber harvests generated $686,365.99 of gross revenues. Land sales produced revenue of $301,651.00. Accrued interest on the School Land Bank Fund for FY 1994-95 was $672,700.64.

FISCAL YEAR 1994-95 ACTIVITIES

SCHOOL LAND BANK FUND REVENUES

Revenue from the sale of School Land parcels totaled $301,651.00 from the following transactions.

Mendocino County

Six parcels of School Land in Mendocino County totaling 480 ± acres were sold to various individuals. The proposed uses for the parcels range from ranching and grazing, to a building site for a single family residence. Revenue from the transactions totaled $129,841.00.

Pergola Properties

This sale involved a 640 acre parcel of School Land in San Bernardino County. The acquisition may be used as mitigation, specifically to provide replacement habitat, for impacts that may be caused to certain threatened and endangered species (e.g., the desert tortoise) by the purchaser's future development plans. Revenue from this transaction totaled $65,210.00.

Metropolitan Water District of Southern California (MWD)

This transaction conveyed approximately 281 acres in Riverside County to the MWD to provide controlled access and additional protection to the Colorado River Aqueduct and water system of the MWD. The purchase price was $105,600.00.

MWD v. Scott Vaughn, et al., Riverside County Superior Court Case No. 226917

The Metropolitan Water District of Southern California brought an action to condemn Lot 2 of the Northwest 1/4 of the Southeast 1/4 of Section 36, T5S, R2W, San Bernardino Base and Meridian, in connection with construction of Domenigoni Reservoir. The State retained a 1/16 mineral reservation in the subject land. A consulting Registered Geologist concluded that the parcel at issue contained no significant potential for the occurrence of any economic mineral resource, and the Commission, acting as School Land Bank Trustee accepted the sum of $1,000, to be deposited into the School Land Bank Fund, as full compensation for the value of the reserved interest.

STRS REVENUES

Salvage Timber Sales

The Commission authorized Staff to enter into emergency agreements (Title 2, C.C.R., Section 2034) to harvest insect killed and infested timber on parcels of School Land. Costs of the salvage operation were offset by the revenue derived from the sale of the salvaged timber. Net revenues received totaled $541,222.23.

FISCAL YEAR 1995-96 PLANNED ACTIVITIES

POTENTIAL SCHOOL LAND BANK FUND REVENUES

Northern California

Staff has identified parcels of land that may be marketed for sale to various timber companies. Contract appraisers have been retained to provide a valuation of land and timber on all of these parcels.

Department of Transportation

The sale of an additional three parcels of land to the State Department of Transportation to allow modification of I-15 and State Route 247 in San Bernardino County will be completed this year. Revenue from the transaction will total $46,000.

Pergola Properties

The sale of an additional two parcels of land in San Bernardino County to Pergola Properties for the same purpose as described on the previous page for the 1994-95 Pergola Properties transaction have been approved by the Commission and will be completed this year. Revenue from the transaction will total $250,000.

Department of Parks and Recreation

The Department of Parks and Recreation would like to purchase a parcel of School Land in Santa Cruz County for $4,300,000. The Department intends to sell three parcels of land under its control to finance the desired purchase. One of the surplus parcels has been sold, one is in escrow, and the third is going to be advertised again this year.

The Department of Parks and Recreation received an appropriation for the FY 1995-96 to expand the Ocotillo Wells State Vehicular Recreation Area (SVRA) in Imperial County. The expansion will include the purchase of approximately 2,100 acres of School Land, the value of which has not yet been established by appraisal. Monies from the sale of this acreage will be deposited in the School Land Bank Fund.

POTENTIAL STRS REVENUES

Salvage Timber Harvests

Revenue from continuing salvage timber harvests necessitated by insect killed and infested timber should net in excess of $150,000 during the 1995-96 Fiscal Year. Additional School Lands timber lands are being surveyed to determine the extent of insect infestations and the need for additional salvage operations.

LAND EXCHANGES

Forest Preserves and Production

Negotiations are continuing on two, three-way exchanges involving timber land in Mendocino County. The exchanges are designed to protect specific sensitive watershed resource lands that are currently managed for timber production and harvest, while allowing a comparable level of timber harvest activities to occur on State School Lands that are less sensitive. The STRS would receive fair market value for the stumpage taken from the State's parcel.

GEOTHERMAL, MINERAL, AND OIL AND GAS PROGRAMS

The objective of the Geothermal, Mineral, and Oil and Gas Programs is to prudently manage the development of geothermal, hardrock mineral, and oil & gas resources on School Lands. The SLC issues lease agreements and prospecting permits, approves all operations conducted on the leases, verifies conformance with lease provisions, calculates proper royalty payment, and promotes programs and research that enhance resource recovery or its value. These actions are designed to maximize revenue generated from the resources, protect the environment and public safety, and further the best interests of the State.

Royalty revenue generated by these School Lands mineral resource programs is derived from three sources -- production of geothermal energy, hardrock mineral extraction, and oil & gas production. The development and use of geothermal energy is, by far, the largest revenue source. Royalty revenue from these three programs for 1994-95 totaled nearly $2.8 million. This is, however, significantly less than the previous year's total of over $5.3 million of which over $1.6 million were adjustments and settlements that were discussed in the 1993-94 Fiscal Year report. The circumstances affecting such revenues are discussed below.

FISCAL YEAR 1994-95 ACTIVITIES

The Geysers

The Geysers Geothermal Field in Lake and Sonoma Counties remains the largest geothermal operation in the world. The 7,329 acres of School Lands leased to Unocal Geothermal, Central California Power Agency (CCPA), and Calpine Corporation represent about 33% of the total producing acreage, and about 25% of the electrical generating capacity of the Geysers. Drilling activity during 1994-95 continued to be slow because of lack of economic incentive and a limited supply of steam. One new well and six redrills were completed. No new wells were drilled on State leases. Most of the redrilled wells are older, single-bore wells from which new secondary bores are being forked. These are less costly to drill than two individual wells, and if any future drilling occurs on existing State leases, it will likely be from a forked hole redrill.

Events Affecting 1994-95 Revenue

Net geothermal revenue declined during 1994-1995. In the late 1980's and early 1990's Unocal and PG&E litigated a prior pricing and production agreement for the Geysers. A settlement agreement was entered into in 1992. Under the terms of the agreement a new pricing structure was agreed upon and PG&E was given a right to curtail its steam purchases. The most significant event affecting revenue during 1994-1995 was a severe curtailment of electrical generation by PG&E under this agreement. Beginning in February 1995, PG&E's demand for steam from Unocal was reduced by about 75%. PG&E based its action on their access to an abundance of less expensive hydroelectric power and extremely low prices for natural gas. PG&E's operating agreement with Unocal allows this reduction, but the agreement also requires that PG&E must produce electricity at a level equal to an average of 40% of field capacity on an annual basis. To lessen the severity of curtailment, Unocal negotiated a temporary pricing agreement with PG&E, effective August 1995, that gives PG&E incentive to generate power beyond the 40% contract minimum. The agreement calls for steam used to generate power up to 40% of field capacity to be sold at the original contract price, but all steam used to generate power beyond the minimum sold at a reduced price, competitive with natural gas. This means additional royalty revenue to the State beyond that which would be derived at the contract minimum.

Another proposal by PG&E has even more serious consequences to the future of the field. PG&E plans to retire several power plants much sooner than previously planned, including eight of the twelve Unocal-supplied PG&E units which would be retired by 2001. Such action could force the premature abandonment of many steam wells on Unocal's State leases, significantly reduce future royalty revenue, and preclude future use of the resource. Unocal's involvement in two major water injection projects would also be placed in jeopardy. The *Lake County Wastewater Project* and the *Santa Rosa Wastewater Project* are considered essential to enhancing the field's generating capacity and extending the life of the resource. Without a guarantee that the PG&E plants will continue to operate, Unocal cannot commit funds to the projects. Unocal has informed Staff that they and PG&E will go to mediation concerning the plant retirement schedule and curtailment. Staff is actively working on potential solutions to this situation and will appraise STRS of further developments.

Staff has also been assessing the implications and impacts that two injection projects may have on the future revenue from The Geysers. The first injection project is the Lake County Wastewater Project (Project), which has already been approved and partially funded. The Project will pipe treated wastewater, together with water extracted from Clear Lake, to the southeast part of The Geysers where it will be injected on Federal and private leases owned by Unocal, Calpine, and the Northern California Power Agency. About 30-50% of the injected water should be converted to producible steam within the reservoir, resulting in an additional 40-70 mega- watts of power. Though the injection will not occur on State leases, it may be close enough to cause some positive benefits, such as higher reservoir pressures and lower decline rates for the State's resource. Construction of the pipeline could be completed in 1997.

A second project, similar to the Lake County project, but significantly larger, is one being considered by the City of Santa Rosa to dispose of the City's wastewater. Other options are being considered by the City, but a pipeline project would have many economic advantages. Much of the water would be injected on State leases where it would significantly enhance future School Lands royalty revenue by facilitating additional steam production. Because of this, Staff met with City officials to voice support for the *pipeline-to-The Geysers* option. Large scale water injection would turn the field into a true heat mining operation, and provide monetary benefits to the entire region through the additional power generated and jobs created. Within the reservoir, injection will help maintain reservoir pressure and control non-condensable gases and corrosive elements in the steam. However, uncertainty regarding PG&E's final plans for its power plants could affect the economic feasibility of the Santa Rosa pipeline project. An estimated $23 million in future royalty over the next 15 years, about 50% of the total royalty revenue expected from Unocal's State leases during that period, will be realized if the pipeline project is completed.

Geysers Royalty Revenue and Steam Prices

Royalty from CCPA and Calpine leases increased by 23% due to relatively steady production, significantly higher prices from CCPA, and application of a higher royalty rate for Calpine. The higher price from CCPA was the result of a favored nations provision negotiated by Staff in 1992, and the higher Calpine royalty rate from negotiations by Staff in 1994. Unfortunately, these gains were overshadowed by a 33% reduction in royalty from Unocal leases, where the vast majority of School Lands royalty is derived. Average steam prices during 1994-95 were $0.82 per thousand pounds for Unocal, $1.08 and $0.66 for CCPA, and $1.74 for Calpine. In January 1995, the two CCPA prices were replaced by a single price of $1.15. Each of these prices is expected to rise slightly in 1996.

Additional Leasing in The Geysers

During 1994-95, Staff negotiated a new lease with Calpine in the northwest part of the field, with a 12.5% royalty rate and a $10,000 per year reimbursement agreement paid by the lessee for field inspection by Staff. Calpine plans to drill a well in the next two years. Staff also negotiated a new lease with Santa Fe Geothermal on a parcel in the southeast part of the field, with a 12.5% royalty and a $5,000 per year reimbursement agreement. The lease agreement was effective as of July 1, 1995, and Santa Fe plans to drill a well this year.

Mineral Extraction Leases

At the end of FY 1994-95, there were four active mineral extraction leases. The most recent one, approved by the Commission in November 1994, with Homestake Mining Company, is for the extraction of precious metals. However, royalty revenue during FY 1994-95 generated by the remaining three active mineral leases during the year was for the extraction of industrial minerals, including sand, gravel, and borates.

Mineral Prospecting Permits

At the end of FY 1994-95, there were five active mineral prospecting permits. They are all for precious metal mineral extraction on School Lands in San Bernardino, Imperial, Tehama, and Inyo Counties. Two are adjacent to gold-producing mine operations.

Mineral Trespass Settlements

During FY 1994-95, Staff continued negotiations for mineral trespass settlements with Granite Construction Company, for the State mineral interest at the Indio Quarry in

Riverside County, and with Kasler Corporation, for the State mineral interest at the Ludlow Pit in San Bernardino County. Granite has sent the State a total of $59,022 to date, for past production of minerals at the Indio Quarry. Staff is continuing its negotiations with Granite in this regard, as additional monies may be required to compensate the State. Kasler sent the State $4,000 for past production from the Ludlow Pit.

Oil and Gas Revenues

Revenue from a reserved mineral interest parcel of School Land in Kern County at the Round Mountain Oil Field was $19,628 for FY 1994-95. This parcel first produced oil in 1928.

Hardrock Mineral Leasing Revenues

Revenue from hardrock mineral leasing totaled $66,758 for FY 1994-95.

Total Mineral and Oil & Gas Revenues

The revenues for these two activities totaled $86,386.

FISCAL YEAR 1995-96 PLANNED ACTIVITIES

Geysers Royalty Revenue and Prices

Royalty revenue from existing leases is expected to total about $3.3 million for 1995-96. About $100,000 of that will be due to the additional production caused by the temporary pricing agreement between Unocal and PG&E. The estimate assumes Unocal production during the remainder of 1995 and early 1996 will not be curtailed to the extent it was during February through July 1995, because excess hydroelectric power is not expected to be as abundant in 1996 as it was in 1995. The estimate also includes $508,000 in additional royalty from CCPA for settlement of a pricing issue based on production during 1992-94. Net profit revenue is not included in the above estimate, but there is a distinct possibility that one of the State's two leases with net profit-sharing provisions will begin generating net profit revenue in 1996. This is partly the result of Staff efforts in discovering and correcting a number of discrepancies in the lessee's net profit accounting, and establishing equitable allocations for development and operating costs.

Geysers Leasing

Staff will continue to evaluate prospects for negotiated leases at The Geysers. For example, a few parcels that have never been leased, or were leased and later quitclaimed, could be utilized by an operator to supplement steam supplies for existing plants.

Geysers Reservoir Studies

Staff will continue to expand and improve its in-house computer database and reservoir simulation capabilities in FY 1995-96. The primary purpose of this effort is to monitor and project the reservoir's response to increased water injection. Although field operators will try to avoid detrimental reservoir management practices, in-house studies are vital in protecting the State's interests. An independent study performed by Staff will be essential in guiding future injection projects that involve School Lands.

Staff will also investigate the benefits of participating in Stanford University's Geothermal Industrial Affiliates Program. Stanford is a pioneer and leader in geothermal research. It is currently conducting extensive research on water injection in geothermal fields. Stanford's research is aimed at better understanding this process so that it can be conducted in the most efficient and cost-effective manner. By participating in this program, Staff will gain quicker access to their research results, better ensure that their work is relevant, and stay abreast of new ideas that may improve the performance of geothermal reservoirs on School Lands.

Mineral Revenue

Revenue from active leases is expected to remain at about $65,000 for FY 1995-96. Revenue should begin to show a moderate increase when negotiations are completed on pending transactions with Granite Construction Company and Kasler Corporation and Resources.

Mineral Extraction Leases, Prospecting Permits, and Mineral Inquiries

Staff will continue its commitment to increase School Lands revenue through the pursuit of opportunities to issue mineral leases and prospecting permits and expeditious follow-up of all mineral inquiries. During FY 1995-96, Staff will also continue negotiations with Granite for current and future mineral extraction at Indio Quarry. Staff will also endeavor to clarify the State's mineral interest and develop a plan of action for unresponsive parties in possible mineral trespass situations.

FINANCIAL SUMMARY

REVENUES AND EXPENSES/FISCAL YEAR 94/95

Revenues:	
Surface Rentals	$ 145,143.76
Geothermal	2,704,697.97
Oil and Gas	19,628.67
Minerals	66,758.54
Timber	541,222.23
TOTAL:	$3,477,451.17
Less: Geothermal Resources Development Account Deposits (Public Resources Code Section 3826)	<$10,925.19>
TOTAL: School Lands Revenues Subject to PRC 6217.5	$3,466,525.98
Expenses: Net Management Costs	
Land Management	$ 438,727.54
Geothermal	351,295.93
Oil and Gas (includes Elk Hills evaluation and legal services)	49,065.46
Minerals	66,751.68
Ownership Determination	29,704.72
TOTAL:	$ 935,565.63
Less: Reimbursement Recovery	<$100,227.97>
TOTAL: Net Management Expenses	$835,337.36
NET REVENUES TO STATE TEACHERS RETIREMENT FUND	**$2,631,188.62**

SCHOOL LAND BANK FUND

Balance as of September 30, 1994	$12,696,671.04
SMIF Interest Fiscal Year 1994-95	672,700.64
Adjustment From Prior Year SMIF Interest	(346.76)
Revenue From Land Sales	301,651.00
Adjustment From Prior Year Sales Interest	21,545.59
BALANCE AS OF SEPTEMBER 30, 1995	$13,692,221.51