

MINUTE ITEM

This Calendar Item No. C74 was approved as Minute Item No. 74 by the California State Lands Commission by a vote of 3 to 0 at its 5/12/97 meeting.

**INFORMATIONAL
CALENDAR ITEM
C74**

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) Statewide
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05/12/97
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ANNUAL STAFF REPORT ON THE MANAGEMENT OF STATE SCHOOL LANDS

PARTY:

California State Lands Commission
100 Howe Avenue, Suite 100-South
Sacramento, California 95825-8202

California Public Resources Code section 6477 provides for the submittal of an annual report to the State Teachers' Retirement Board, the Legislature and the Governor on the management of State School Lands by the Commission.

The report addresses the State School Lands asset which comprises approximately 570,000 acres of land and 760,000 acres of reserved mineral interest in previously sold land. Revenues from these lands are dedicated to the California State Teachers' Retirement Fund (CSTRF). Proceeds from land sales are deposited in the School Land Bank Fund (SLBF) for reinvestment.

In Fiscal Year 1995-96, surface and mineral leases produced a net revenue of \$2,399,346.29 to the CSTRF. Land sales produced a net income of \$1,466,721.08 for the SLBF on which accrued interest for the year was \$749,902.55.

The report has been submitted to the State Teachers' Retirement Board, 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 the Management of State School Lands

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EXHIBIT A

CALIFORNIA STATE LANDS COMMISSION

**ANNUAL STAFF REPORT ON THE MANAGEMENT
OF STATE SCHOOL LANDS**

Fiscal Year 1995-96

CALIFORNIA STATE LANDS COMMISSION

Gray Davis, Lieutenant Governor
Kathleen Connell, State Controller
Craig L. Brown, Director of Finance

Robert C. Hight, Executive Officer

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

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INTRODUCTION

The California State Lands Commission (CSLC), 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 entitlement under the State's original grant.

Management of the Program is divided among three staff divisions within the CSLC. 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 CSLC's Geothermal Program and the Mineral Program under which the School Lands geothermal, oil and gas leasing, and mining activities are administered.

During 1995-96, the Program's twofold emphases were: 1) consolidation of capital resources, acquisition of additional long-term revenue producing properties, sale of School Land parcels with marginal revenue potential; and 2) implementation of the California Desert Protection Act of 1994 (CDPA). The CSLC's management costs for the Program, \$1,045,339.94 in Fiscal Year (FY) 1995-96, reflect this additional responsibility. Net revenues of the program to the California State Teachers' Retirement System (CSTRS) were \$2,399,346.29.

Major activities for each of these program components for FY 1995-96 and FY 1996-97 are described in the following pages.

NOTE: Assembly Bill No. 116 (Chap. 970, Stats. of 1996) suspended the statutory mandate for preparation of this report through October 1, 1999. The staff of the Commission elected to prepare a report for FY 1995-96 because of the ongoing implementation of the CDPA.

UPDATE: CALIFORNIA DESERT PROTECTION ACT OF 1994

On October 31, 1994, the CDPA was signed into law by the President (Public Law 103-433). 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.

The process to compensate the State for the monetary impact of the CDPA on School Land parcels is clearly defined. The CSLC 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, e.g., 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 CSLC 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. The increase in management costs from FY 1994-95 attributed to CDPA activities is reflected in the Financial Summary on Page 12. In FY 1995-96, three person-years were allocated to this process. This allocation has been increased to three and one-half person-years for FY 1996-97 to help offset the increased and intensified mineral appraisal workload.

Ownership of nine School Land parcels totaling 5,646.13 acres with an appraised value of \$992,686 has been transferred to BLM pursuant to the CDPA. The \$992,686 has been deposited in the School Land Bank Fund.

Ownership of two School Land parcels totaling 800 acres with an appraised value of \$144,000 is being proposed for transfer to the BLM, in consideration for monies generated from the sale of surplus properties by the General Services Administration (GSA), which will be used to compensate the CSLC for said lands as provided for in the CDPA.

Negotiations are continuing on a proposed four-party exchange between the BLM, GSA, CSLC, and the City of Pomona. CSLC will take title to a 100± acre parcel of Federal surplus land in exchange for comparable value of School Land in accordance with the CDPA. The City of Pomona will purchase the acquired parcel from the CSLC pursuant to the School Land Bank Act for \$11 to \$13 million.

UPDATE: ELK HILLS NAVAL PETROLEUM RESERVE NO. 1

The U.S. Department of Energy (DOE), as part of the FY 1996 Budget, proposed to privatize the Elk Hills Naval Petroleum Reserve No. 1 (NPR-1). That proposal was a part of the National Defense Authorization Act which was signed by the President

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on February 10, 1996. The Act provides a mechanism for compensating California for its School Land interest within NPR-1. In order to provide greater certainty that California's retired teachers would receive compensation under the Act, negotiations occurred with the DOE in April.

It was not until October 10, 1996, after two months of intense negotiations between the CSLC, the CSTRS, and the Office of the California Attorney General, that Secretary of Energy, Hazel O'Leary, agreed to the terms of a "Settlement Agreement."

The Settlement Agreement provides for compensation to California for the two affected Elk Hills School Land sections. At the same time, it will maximize sale revenues to the Federal Government and to the State by removing the State's cloud on title, by removing purchasers' exposure to treble damages for conversion under California statutory law, and by prohibiting the State from enjoining the sale of Elk Hills. The key provisions of the "Settlement Agreement" are:

- DOE will pay nine (9) percent of the net proceeds from the sale of Elk Hills to California in five (5) equal installments, without interest, beginning in FY 1999 and ending in FY 2003. If the amount exceeds \$180 million, the balance over \$180 million would be paid in two (2) equal installments in years six and seven (FYs 2004 and 2005).
- The obligation to pay is contingent on sale, and the obligation to pay each installment is subject to an appropriation for the purpose of making the payment.

With the signing of the "Settlement Agreement," the focus now is to ensure that the 105th Congress appropriates settlement funds to California.

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 1995-96, surface rentals and timber harvests generated \$341,701.56 of gross revenues. Land sales produced revenue of \$1,466,721.08. Accrued interest on the School Land Bank Fund for FY 1995-96 was \$749,902.55.

FISCAL YEAR 1995-96 ACTIVITIES

SCHOOL LAND BANK FUND REVENUES

Revenue from the sale of School Land parcels totaled \$1,466,721.08 from the following transactions.

Mendocino County

Three parcels of School Land in Mendocino County were sold to various individuals. The proposed use for the parcels is ranching and grazing. Revenue from the transactions totaled \$75,310.

Pergola Properties

This sale involved two 640-acre parcels of School Land in San Bernardino County. The acquisition may be used as mitigation, specifically to provide replacement habitat for impacts to certain threatened and endangered species, e.g., the desert tortoise, by the purchaser's future development plans. Revenue from this transaction totaled \$252,021.

Department of Transportation

This transaction conveyed three parcels of land to the California Department of Transportation to allow modification of I-15 and State Route 247 in San Bernardino County. The purchase price was \$50,419.18.

Bureau of Land Management

Ownership of nine School Land parcels totaling 5,646.13 acres with an appraised value of \$992,686 have been transferred to BLM, pursuant to the CDPA. The \$992,686 has been deposited in the School Land Bank Fund.

Miscellaneous Revenue

The Commission approved the sale of two parcels of land in Kern and Imperial Counties. Pursuant to the terms and conditions delineated in the "Bid to Purchase State Land" packages, the successful bidder agreed that failure to complete the purchase of the property would result in the deposit being retained by the State as liquidated damages. Therefore, due to the inability of the successful bidders to complete the sales, their deposits of \$79,524 and \$16,400 have been forfeited and deposited into the School Land Bank Fund. Miscellaneous processing and patent fees in the amount of \$361 were received and deposited into the School Land Bank Fund.

STRS REVENUES

Salvage Timber Sales

In 1994, the Commission authorized staff to enter into emergency agreements (Title 2, C.C.R., Section 2034) to salvage insect and disease killed and infested timber on School Land parcels. Costs of the salvage operation were offset by the revenue derived from the sale of the salvaged timber. Net revenues received totaled \$119,753.49.

Right-of-Way Timber Sales

In 1995, the Commission authorized staff to enter into three road access use agreements and receive revenue from the trees removed from the road right-of-way during construction. Net revenues received totaled \$9,300.50.

FISCAL YEAR 1996-97 PLANNED ACTIVITIES

POTENTIAL SCHOOL LAND BANK FUND REVENUES

California Department of Parks and Recreation (CDPR)

The sale of 160 acres in Imperial County within the Ocotillo Wells State Vehicular Recreation Area will be completed this year. The purchase price is \$18,000.

CDPR continues to market surplus land in order to purchase a parcel of School Land in Santa Cruz County. CDPR is optimistic that surplus land sales will enable them to raise approximately \$4 million needed to close this project.

Southern California Public Power Authority

This sale of 12.38 acres will be used as a portion of the right-of-way corridor needed for the Mead-Adelanto Project (MAP). The MAP is a 1,200-megawatt transmission system being jointly developed by the Western Area Power Administration, ten Southern California municipal utilities, and a joint agency representing three Northern California municipal utilities. The purchase price is \$8,400.

Northern California

Staff plans to market two parcels of timberland in early 1997. If successful, this venture will result in approximately \$1 million to the School Land Bank Fund.

U. S. Bureau of Land Management

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Negotiations are continuing on a proposed four-party exchange between the BLM, GSA, CSLC, and the City of Pomona. CSLC will take title to a 100± acre parcel of Federal surplus land in exchange for comparable value of School Land in accordance with the CDPA. The City of Pomona will purchase the acquired parcel from the CSLC pursuant to the School Land Bank Act for \$11 to \$13 million.

POTENTIAL STRS REVENUES

Salvage Timber Harvests

Under Title 2, C.C.R., Section 2034, staff has concluded two emergency blowdown salvage sales, a result of the December 1995 windstorm, in Shasta and Tehama Counties. Staff has prepared and contracted an emergency fire salvage sale, a result of the August 1996 Forks Fire in Lake County, and is preparing another salvage sale in Lassen County.

GEOHERMAL, MINERAL, AND OIL AND GAS PROGRAMS

The objective of these programs is to manage development of geothermal, mineral, and oil and gas resources on School Land to maximize revenue, protect the environment and the public, and further the best interests of the State. Revenue from these programs totaled approximately \$3.1 million for 1995-96.

FISCAL YEAR 1995-96 ACTIVITIES

Geothermal Leases at The Geysers

More than 7,500 acres of reserved mineral interest School Land are under lease to Unocal Geothermal, Central California Power Agency (CCPA), Calpine Corporation, and Santa Fe Geothermal at The Geysers, the largest geothermal development in the world, in Sonoma and Lake Counties. Revenue from these leases increased to \$3.0 million during 1995-96, from the previous year's \$2.7 million, despite a decrease in both steam production and steam prices that caused a \$278,000 reduction in regular royalty. This reduction was offset by a \$61,400 royalty adjustment from Unocal, and \$515,900 in net profit revenue from Calpine. These payments were derived from staff efforts to obtain the highest possible prices from Unocal and in detecting discrepancies in Calpine's net profit accounting. Staff efforts, that led to a negotiated lease with Santa Fe last year, paid off this year in the drilling of two new State wells on that lease. Royalty of about \$3,500 per month is now being generated from the Santa Fe lease.

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Unocal's steam production was again curtailed by PG&E during the year. PG&E can curtail up to 60 percent of the field's capacity on an annual basis, but Unocal was able to persuade them to take additional steam so that curtailment for the year was only 45 percent of capacity. PG&E increased electrical generation above the minimum because Unocal offered the incremental steam at prices comparable to the competing sources of electrical power available to PG&E on the open market. This strategy increased the State's royalty revenue beyond that which would have been derived at the contract minimum because it enabled Unocal to increase steam production and prevent the steam from migrating to adjacent non-State leases.

PG&E's plans to retire many of their powerplants at The Geysers over the next five years, as noted in last year's report, have been put on hold. These retirements would have forced the premature abandonment of many steam wells, reducing future royalty revenue from School Land leases and jeopardized Unocal's involvement in potential water injection projects that may extend the life of the field. Staff met with both PG&E and Unocal during the year regarding: 1) the importance of keeping the plants operating; and 2) the tremendous heat potential believed to be still present in the reservoir. PG&E has now put these retirement plans on hold indefinitely, partly because the plants may be valuable when the electric power industry is deregulated in the next few years.

CCPA took their powerplant off-line and shut-in their steam wells on May 31, 1996. CCPA later informed staff that unless they can sell the facilities, they will abandon the wells and dismantle the plant. They made this decision because the cost to produce electricity at the plant was far higher than the cost of purchasing power. Unocal subsequently offered to buy the facilities, including the State leases, but requested a drastic reduction in the steam price to help make the project economic. At the end of 1995-96, staff initiated discussions with Unocal, and with owners of the adjacent private leases, toward a goal of getting the plant back on-line, either with Unocal as the owner/operator, or some other company in that role.

Geothermal Water Injection Projects

During 1995-96, construction began on a pipeline to transport 5,400 gallons per minute of treated wastewater from Lake County to The Geysers. The water from this Lake County Wastewater Project (LCWP) will be injected on Federal and private leases in the southeast part of the field, possibly as early as 1997. Adjacent State leases should also see some benefit in terms of higher reservoir pressures, reduced decline rates, and improved steam quality. Staff has closely followed the progress of this project because it may lead to a larger water injection project that would involve primarily State leases.

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The City of Santa Rosa in Sonoma County must soon decide on a long-term solution to its wastewater disposal problem. The Santa Rosa Wastewater Project (SRWP) will involve about 9,000-10,000 gallons per minute, roughly twice as much as the LCWP. The alternatives being considered for use of the wastewater include reclamation for agricultural irrigation, discharge into the Russian River, and injection at The Geysers to recharge the steam reservoir. The environmental impacts and the costs of these alternatives are currently being examined. The City will select an alternative in 1997 or 1998.

Injection of SRWP water at The Geysers could guarantee the continued operation of PG&E's powerplants, allowing Unocal to produce steam that otherwise would have been abandoned had PG&E retired those powerplants, and actually increase steam production throughout the field from the conversion of injected water to steam. Because most of the injection would be on State leases, an additional \$15 to \$20 million in School Lands royalty revenue is possible between 2000 and 2015.

Due to the importance of the SRWP on the future of the field, staff continued working with Unocal, PG&E, and the City of Santa Rosa during 1995-96 to promote The Geysers alternative. Staff provided input on ways to reduce the estimated costs for the alternative, pointed out its economic benefits and advantages over the other alternatives, and offered to help locate outside funding sources. If costs for The Geysers alternative can be split between the City and those who stand to benefit from the project, rather than by the City alone, then the project has a distinct advantage over the other alternatives. This concept was crucial in the decision to build the LCWP, where funding is being provided by various local, State, and Federal agencies, and the geothermal industry itself. Staff efforts to promote The Geysers alternative for the SRWP were ongoing at the end of 1995-96, and will likely increase next year.

Mineral Leases and Mineral Prospecting Permits

At the end of 1995-96, there were five active mineral extraction leases. The most recent was approved by the Commission in June 1996, for Baldwin Contracting Company of Chico, California. During the year, these leases generated \$69,119 in revenue from extraction of sand and gravel, borates, and from lease rentals.

At the end of 1995-96, there was one active mineral prospecting permit. This is a permit for precious metals exploration on approximately 640 acres of School Land in the Cargo Muchacho Mountains in southeast Imperial County. The parcel is adjacent to a gold-producing operation at the site of the American Girl Mine.

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Mineral Trespass Settlement

During 1995-96, staff continued negotiations for settlement of a mineral trespass by Granite Construction Company of Palm Desert, California on a School Land parcel at the Indio Quarry in central Riverside County. Granite has paid a total of \$81,489 for past and current production of sand and gravel at Indio Quarry, and staff is negotiating with them on a continuing basis regarding additional revenue. Legal action is being considered to recover the full value of the State's one-sixteenth reserved mineral interest in this property. Granite's payment of \$81,489 has been placed in suspense, pending the outcome of settlement negotiations.

Therefore, total revenue received from School Land mineral leases, including the payment from Granite, is \$150,608 for 1995-96.

Oil and Gas Revenues

Revenue from two School Land oil and gas leases totaled \$20,641 for 1995-96. One parcel, located at the Round Mountain oil field in Kern County, produced about 22,000 barrels of oil generating \$19,952 in revenue. It has been producing oil since the 1920s. MacPherson Oil Company of Los Angeles is the current operator. The lease was pooled with other leases in the area in 1994 and has since shown an increase in revenue.

A second parcel, located in the Sulfur Crest area of the Santa Paula oil field in Ventura County, produced \$689 in revenue. The Termo Company of Long Beach is the current operator of that parcel.

FISCAL YEAR 1996-97 PLANNED ACTIVITIES

Geothermal Leases at The Geysers

Geothermal revenue for 1996-97 is estimated at \$3.1 million. This is slightly higher than 1995-96 because of a \$508,300 disputed royalty payment, plus interest, from CCPA and a \$500,000 increase in regular royalty from Unocal, Calpine, and Santa Fe. These revenues will more than offset an expected \$461,900 reduction in net profit revenue from Calpine, and an expected \$420,900 reduction in royalty from CCPA leases.

Royalty revenue should be higher from Unocal, Calpine, and Santa Fe during 1996-97 because steam production and prices are expected to increase. Curtailment of Unocal production by PG&E should be less severe than last year, and Calpine production will increase due to a new well being drilled on the State lease.

However, royalty from the CCPA leases is uncertain at this time because CCPA has yet to sell the facilities to another operator. Staff plans to continue efforts to help locate a buyer, and to negotiate a pricing arrangement which makes the project economic for the operator and assures the State adequate compensation for use of the resource. Staff will also explore other options for the CCPA leases. If a buyer is found, it will still take several months to get the steam wells and powerplant back in operation. Therefore, no royalty is expected from CCPA leases in 1996-97.

Net profit revenue from Calpine will be reduced from \$515,900 in 1995-96 to about \$54,000 in 1996-97 because it will take about 12 months for the net profit account to become positive again following the expected \$3 million expenditure by the lessee to drill the new State well. Higher levels of royalty revenue are anticipated immediately after completion of the new well, but higher levels of net profit revenue, on the order of \$600,000 annually, are not expected until after 1996-97. Staff will monitor the drilling of the Calpine well and verify all charges applied to the net profit account.

Geothermal Water Injection Projects

Staff will continue to monitor the construction and implementation of the Lake County Wastewater Project because of its possible benefit to adjacent State leases and its role as a model for the larger Santa Rosa Wastewater Project. More importantly, staff plans to continue its efforts to promote The Geysers alternative for the SRWP because of its potential impact on the future of the field, particularly State leases. Staff plans to review and comment on the EIR/EIS prepared for the SRWP, and work with a coalition of geothermal interests -- Unocal, PG&E, other geothermal operators, the U. S. Department of Energy, and others -- to provide to the City of Santa Rosa the best possible estimate of the costs and benefits of The Geysers alternative. In this regard, staff plans to assist with a Department of Energy funded study of the feasibility of specific cost reduction options for The Geysers alternative and to assist in securing outside funding sources to offset the overall project costs. The City will need accurate cost and benefit information before it makes its final decision on a disposal solution in 1997 or 1998.

Mineral Extraction Leases, Prospecting Permits, and Mineral Inquiries

Staff continues its commitment to increase revenue from School Lands parcels with mineral resources through the pursuit of leasing and permitting opportunities, and follow-up on the 50 to 60 mineral inquiries received each year. Staff plans to negotiate an extension of the mineral prospecting permit at the American Girl Mine and process a permit application submitted by Viceroy Gold Corporation of Vancouver, Canada, for precious metal exploration on School Land adjacent to the site of Viceroy's Castle Mountain

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Mine in eastern San Bernardino County. These transactions could lead to more precious metal leasing on School Lands.

In addition, negotiations are underway to renew a mineral extraction lease to U. S. Borax for the continued mining of borates at their Gerstley Mine. Staff is currently reviewing the draft Environmental Impact Report for the U. S. Army's land acquisition project for the expansion of the Fort Irwin National Training Center to analyze the effects on some 15,773 acres of State lands. Staff also plans to pursue a recent mineral inquiry from the Salt River Sand & Gravel Company of Phoenix, Arizona. This inquiry may lead to a long-term industrial minerals lease on School Land at the Manchester Quarry in eastern San Bernardino County.

Revenue from mineral leases is expected to exceed \$150,000 during the 1996-97 period. Revenue should show a moderate increase with additional revenue from Baldwin Contracting and from mineral trespass settlement negotiations with Granite Construction.

FINANCIAL SUMMARY

REVENUES AND EXPENSES/FISCAL YEAR 95/96

Revenues:

Surface Rentals	\$ 212,647.57
Geothermal	3,020,839.43
Oil and Gas	20,641.42
Minerals	69,119.47
Timber	129,053.99
TOTAL:	\$3,452,301.88

Less: Geothermal Resources Development

Account Deposits	<u><\$7,615.65></u>
(Public Resources Code Section 3826)	
TOTAL: School Lands Revenues Subject to PRC 6217.5	\$3,444,686.23

Expenses: Net Management Costs

Land Management	\$593,191.42
Geothermal	281,735.66
Oil and Gas (includes Elk Hills evaluation and legal services)	97,964.45
Minerals	91,679.51
Ownership Determination	<u>20,175.42</u>
TOTAL:	\$1,084,746.46¹

Less: Reimbursement Recovery	<u><\$39,406.52></u>
TOTAL: Net Management Expenses	\$1,045,339.94

NET REVENUES TO STATE TEACHERS RETIREMENT FUND \$2,399,346.29

SCHOOL LAND BANK FUND

Balance as of September 30, 1995	\$13,692,221.51
SMIF Interest Fiscal Year 1995-96	749,902.55
Adjustment From Prior Year SMIF Interest	<28.00>
Revenue From Land Sales	1,466,721.08
Adjustment From Prior Year Sales Interest	89,934.61
Less: Real Estate Consultant Contract	<11,648.21>

BALANCE AS OF SEPTEMBER 30, 1996 \$15,987,103.54

¹ Approximately \$250,000 of this amount is attributed to staff costs for the implementation of the California Desert Protection Act.