

**CALENDAR ITEM
C35**

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PRC 2839.1
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**CONSIDER ISSUANCE OF REPLACEMENT LEASE FOR
GAS STORAGE LEASE PRC 2839.1,
MCDONALD ISLAND GAS FIELD,
SAN JOAQUIN**

OPERATOR:

Pacific Gas and Electric Company
Attn.: Mr. Wayman Pon
77 Beale Street, Room 1612
San Francisco, CA 94105

SUMMARY:

McDonald Island is located about ten miles west of the City of Stockton in San Joaquin County. Pacific Gas and Electric Company (PG&E) has been storing natural gas in a storage reservoir under McDonald Island since 1962. The storage reservoir, which is approximately one (1) mile deep, is called the McDonald Island Sand. The State's ownership share of this reservoir has been determined to be 9.6 percent (9.6%) as provided in Gas Storage Lease PRC 2839.1. Under Gas Storage Lease PRC 2839.1, PG&E pays the State the higher of (1) an annual rental or (2) an incremental gas fee to inject and store its gas in the State's ownership share of the storage reservoir during the lease year (March through February). Each year the annual rental and incremental gas fee are increased by five percent (5%). For the lease year beginning March 1, 2009, the annual rental will be \$318,887.31. Staff is requesting that the California State Lands Commission (Commission) approve the issuance of a lease to replace Gas Storage Lease PRC 2839.1 which by law cannot extend beyond 2011. The new replacement lease will continue PG&E's use of the State's ownership share of the reservoir for another 15 years under essentially the same terms and conditions as Gas Storage Lease PRC 2839.1, and will allow the State to continue to collect annual rentals and fees from PG&E for the use of the State's ownership share (pore space) of the storage reservoir.

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BACKGROUND:

In the 1930s, the McDonald Island Gas Field was discovered by Standard Oil of California. On March 1, 1940, the Commission entered into Compensatory Agreement Easement 412.1 with Standard Oil Company of California for the payment of royalty on natural gas removed (drained) from beneath sovereign State lands (a portion of Whiskey Slough) located on McDonald Island. Compensatory Agreement Easement 412.1 only allows for the payment of royalty on the State's share of native gas withdrawn from the McDonald Island Gas Field. It does not allow for any use of the State lands (surface or subsurface), nor does it allow for any mineral development of or entitlement to the State lands.

In March 1958, after producing over 150 billion cubic feet of natural gas, the reservoir pressure of the McDonald Island Gas Field declined to a point where wells no longer could be produced without compression. Consequently, the McDonald Island Gas Field was shut-in and no more native gas was produced. In April 1958, PG&E began injecting natural gas into the McDonald Island Sand (Eocene series gas sand located within the McDonald Island Gas Field) to test its capability as an underground gas storage reservoir. After determining that the partially depleted formation could be used to store gas, PG&E proceeded to acquire all of the properties in the McDonald Island Gas Field and acquired Compensatory Agreement Easement 412.1 through an assignment approved by the Commission on March 17, 1960.

Because Compensatory Agreement Easement 412.1 only allowed for the payment of royalty on native gas and does not allow for any use of State lands, the Commission and PG&E entered into Gas Storage Lease PRC 2839.1 McDonald Island Gas Field on January 25, 1961. The purpose of the lease was to allow PG&E to store gas in and withdraw gas from the State's share (pore space) of the underground reservoir or McDonald Island Sand. Gas Storage Lease PRC 2839.1 was issued for the 15-year period from March 1, 1962 to March 1, 1977, and provided PG&E with a preferential right of renewal for two successive periods of 15 years each upon reasonable terms and conditions as prescribed by the Commission. Gas Storage Lease PRC 2839.1 covers only the State's share of the McDonald Island Sand in the McDonald Island Gas Field and requires PG&E to pay the State the higher of an annual rental or incremental gas fee. Gas Storage Lease PRC 2839.1 also required PG&E to pay the sum of \$127,420.74 as full compensation for all in-place native gas.

Gas Storage Lease PRC 2839.1 has been renewed and amended twice over the years. The last (second) amendment (March 1, 1992 to March 1, 2007) granted

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PG&E the preferential right to renew the lease for one additional 15-year period upon reasonable terms and conditions as prescribed by the State. However, Title 2, California Code of Regulations, Section 2004 limits the terms for general leases and permits, including any optional renewal periods, to no longer than necessary to accomplish the intended use or purpose, and not to exceed forty-nine (49) years. In accordance with this provision, the third renewal of Gas Storage Lease PRC 2839.1, would have expired by law on March 1, 2011, and the lease would terminate. Therefore, staff is proposing that a new replacement lease be issued in place of extending Gas Storage Lease PRC 2839.1 for the third time. Since March 1, 2007, PG&E has continued to make escalated rental and incremental gas fees payments as if Gas Storage Lease PRC 2839.1 had been extended.

PROPOSED ACTION:

A new replacement Lease for Gas Storage Lease PRC 2839.1 will continue Gas Storage Lease PRC 2839.1 terms with the following modifications:

1. PG&E or the Company (as referred to in the replacement lease) shall pay to the State the higher of (1) an annual rental or (2) an incremental gas fee on all gas injected into the State's ownership share of the storage reservoir during the lease year (March through February).
 - (a) The annual rental shall be based on the State's ownership share of the storage reservoir. Beginning March 1, 2007, the annual rental shall be \$289,240.19 and shall be increased each year by five percent (5%) of the previous year's annual rental.
 - (b) The incremental gas fee shall be based on the total gas injected for storage (Mcf) into the State's ownership share of the storage reservoir during the lease year. Beginning March 1, 2007, the incremental gas fee factor shall be \$0.08646 per Mcf and shall be increased each year by five percent (5%) of the previous year's incremental gas fee factor. The Company shall pay to the State the difference between the incremental gas fee and the annual rental for the previous lease year if the former exceeds the latter.
2. The State's ownership share of the storage reservoir shall be 9.6 percent (9.6%). The ownership share of the storage reservoir has been determined according to the best judgment of the State and the Company based upon currently available geological data.
3. The lease shall be effective as if 7:00 a.m. on March 1, 2007, for a term of

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15 years until 7:00 a.m., March 1, 2022. The Company shall have the right to renew the lease for two (2) successive terms of 15 years each upon such reasonable terms and conditions as may be prescribed by the State, unless applicable law in effect at the time of the expiration of the lease prevents such renewal.

4. Within 60 days after full execution of this lease, the Company shall provide to the State a quitclaim of all of its rights in Compensatory Agreement Easement 412.1 issued March 1, 1940, as amended by agreement effective June 1, 1950. The acceptance of this quitclaim by the State shall constitute a termination of Compensatory Agreement Easement 412.1 pursuant to paragraph 15 of that Agreement. Acceptance of this quitclaim will be addressed in a separate calendar item at a later Commission meeting.

OTHER PERTINENT INFORMATION

1. PG&E has recently undergone corporate restructuring and has relocated some of its offices. PG&E failed to notify the State of their address change therefore the State sent the 2006 annual rental bill to the old address. As a result, PG&E's payment of the 2006 annual rental was late. The State assessed PG&E a late payment penalty of \$13,773.34 and interest of \$30,837.19 for a total of \$44,610.53. Pursuant to Commission regulations, penalties and interest on late payments are to be punitive and are set at five percent (5%) penalty and 18 percent (18%) annualized interest. PG&E has requested that the Commission waive the late payment penalty and interest charges of \$44,610.53. Staff recommends that the Commission waive the penalty charge and reduce the interest to five percent (5%) annual rate, equivalent to the Pooled Money Investment Fund return for that period. This will recoup the time value of those revenues in the amount of \$8,565.89. Currently, all expected rentals and incremental gas fee payments have been paid.

Authority: Title 2, California Code of Regulations, section 1911.

2. Pursuant to the Commission's delegation of authority and the State CEQA Guidelines (Title 14, California Code of Regulations, section 15061), the staff has determined that this activity is exempt from the requirements of the CEQA as a categorically exempt project. The project is exempt under Class 1, Existing Facilities; Title 14, California Code of Regulations, section 15301(b).

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Authority: Public Resources Code section 21084 and Title 14,
California Code of Regulations, section 15300.

3. This activity involves lands identified as possessing significant environmental values pursuant to Public Resources Code sections 6370, et seq. Based upon the staff's consultation with the persons nominating such lands and through the CEQA review process, it is the staff's opinion that the project, as proposed, is consistent with its use classification.

EXHIBITS:

- A. Location Map
- B. Replacement Lease for Gas Storage Lease PRC 2839.1, McDonald Island Gas Field, San Joaquin County, California

PERMIT STREAMLINING ACT DEADLINE:

N/A (not a "development project" subject to the Act)

RECOMMEND ACTION:

IT IS RECOMMENDED THAT THE COMMISSION:

CEQA FINDINGS:

1. FIND THAT THIS ACTIVITY IS EXEMPT FROM THE REQUIREMENTS OF THE CEQA PURSUANT TO TITLE 14, CALIFORNIA CODE OF REGULATIONS, SECTION 15061 AS A CATEGORICALLY EXEMPT PROJECT, CLASS 1, EXISTING FACILITIES; TITLE 14, CALIFORNIA CODE OF REGULATIONS, SECTION 15301(b).
2. FIND THAT THIS ACTIVITY IS CONSISTENT WITH THE USE CLASSIFICATION DESIGNATED BY THE COMMISSION FOR THE LAND PURSUANT TO PUBLIC RESOURCES CODE SECTIONS 6370, ET SEQ.

AUTHORIZATION:

1. APPROVE THE ISSUANCE OF A NEW REPLACEMENT LEASE FOR GAS STORAGE LEASE PRC 2839.1, MCDONALD ISLAND GAS FIELD, SAN JOAQUIN COUNTY, CALIFORNIA, TO PACIFIC GAS AND ELECTRIC COMPANY FOR A TERM OF 15 YEARS BEGINNING MARCH 1, 2007, UPON SUCH REASONABLE

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TERMS AND CONDITIONS AS THE STATE MAY PRESCRIBE,
AS MORE PARTICULARLY SET FORTH IN EXHIBIT B,
ATTACHED HERETO.

2. WAIVE THE LATE PAYMENT PENALTY AND ADJUST INTEREST CHARGES, WHICH WERE ASSESSED ON THE 2006 ANNUAL RENTAL PAYMENT FOR LEASE PRC 2839.1, TO \$8,565.89.
3. AUTHORIZE THE EXECUTIVE OFFICER OR HIS DESIGNEE TO EXECUTE ANY DOCUMENTS NECESSARY TO IMPLEMENT THE COMMISSION'S ACTION.