MEETING

STATE OF CALIFORNIA

STATE LANDS COMMISSION

STATE CAPITOL

ROOM 2040

SACRAMENTO, CALIFORNIA

WEDNESDAY, MARCH 1, 1995

1:07 P.M.

COMMISSIONERS IN ATTENDANCE

Gray Davis, Lieutenant Governor, Chairman

Kathleen Connell, State Controller

Russell S. Gould, Director of Finance
represented by Theresa Parker

STATE LANDS COMMISSION STAFF

Robert C. Hight, Executive Officer

James F. Trout, Assistant Executive Officer

Jack E. Rump, Chief Counsel

Paul B. Mount, Chief, Land Management Division

ATTORNEY GENERAL'S OFFICE

Jan Stevens, Assistant Attorney General, Land Law Division

SPEAKERS

Paul B. Mount, Chief, Land Management Division

Tom Christenson, Asset Manager, California Resources

Tony Lansor, Staff Engineer, California Resources

Dr. Shirley Anders, Professor, School of Business & Economics, California State University, Northridge

Robert Davis, Board of Directors, Huntington Beach Chamber of Commerce

Steven Cohn, Senior Attorney, Legal Counsel for SMUD

I N D E X

1 P R O C E E D I N G S

2 MALE VOICE: The State Controller

3 COMMISSIONER CONNELL: Here.

4 MALE VOICE: Lieutenant Governor.

5 COMMISSION CHAIRMAN DAVIS: Present.

6 MALE VOICE: Director of Finance.

7 ACTING COMMISSIONER PARKER: Theresa Parker for

8 Russell Gould.

9 MALE VOICE: We have a quorum, Mr. Chairman.

10 (Asides.)

11 MALE VOICE: We have a consent calendar, Mr.

12 Chairman, that is Items 1 through 52. Items C18 and C44

13 have been pulled from the agenda and will be considered at a

14 later time.

15 MALE VOICE: And a small change in 21.

16 Item 21 we have a small change. In the calendar

17 item and in the summary there's an authorization for an

18 incumbrance in an amount not to exceed $1,500,000. It

19 should be $1,590,000. The calendar item is right in one

20 place and wrong in another. In approving the consent

21 calendar we just ask you to note that difference.

22 MALE VOICE: And Item C7, Mr. Chairman, we would

23 like to take off of the consent calendar and deal with it

24 separate -- last, I think.

25 COMMISSION CHAIRMAN DAVIS: Might note in that,

1 that isn't that the matter that involves General Services
2 and SMUD?
3 MALE VOICE: Yes.
4 COMMISSION CHAIRMAN DAVIS: Then if there are
5 representatives from those two agencies they might want to
6 use the time allowed in this meeting to see if there's some
7 accommodation they can --
8 MALE VOICE: They're in the hallway doing that
9 right now, Mr. Chairman.
10 COMMISSION CHAIRMAN DAVIS: They're ahead of us.
11 All right.
12 Don't we have to approve the minutes?
13 MALE VOICE: A minor detail. Yes, sir.
14 COMMISSION CHAIRMAN DAVIS: The controller moves.
15 COMMISSIONER CONNELL: Yes.
16 COMMISSION CHAIRMAN DAVIS: Finance Director
17 seconds.
18 Submitted. So approved unanimously.
19 MALE VOICE: Thank you, Mr. Chairman.
20 COMMISSION CHAIRMAN DAVIS: Do I have a motion for
21 the consent calendar as amended?
22 COMMISSIONER CONNELL: I move the consent calendar
23 as amended.
24 COMMISSION CHAIRMAN DAVIS: Controller so moves.
25 ACTING COMMISSIONER PARKER: Second.

1 COMMISSION CHAIRMAN DAVIS: It's unanimous.
2 We'll move to the first item of regular business.
3 MALE VOICE: That's item number 53, Mr. Chairman,
4 which is the request by a subsidiary of Shell Oil Company to
5 modify the royalty provisions that Shell pays on its leases
6 at Huntington Beach.
7 And I would like to ask Mr. Paul Mount of the
8 Commission Staff -- Paul is manager of the Commission's
9 mineral operation -- to present this item.
10 MR. MOUNT: Good afternoon, Commissioners.
11 These leases that we're talking about for
12 modifying the royalties were first leased in 1938, and since
13 then the royalties have not changed. In other words, the
14 royalty formulas they used in 1938 are the same royalty
15 formulas we use today.
16 As you know, the world has changed, the economics
17 have changed, the oil fields have been in a great state of
18 depletion and the oil companies have been struggling to get
19 some profits out of these leases. There's competition from
20 Alaska north slope crude, there's competition from Mid-East
21 crude, and so they've been struggling with these leases
22 here.
23 Shell recently took assignment of these leases and
24 invested a considerable sum of money into these leases.
25 That first graph you show there, that you see there, that

1 was just handed out, shows the accumulative investment to
2 date. The cash flow to date has been negative $54 million
3 and they purchased these leases for $100 million. So
4 they've had a negative cash flow of $154 million since
5 they --
6 COMMISSION CHAIRMAN DAVIS: Who did they purchase
7 the leases from?
8 MR. MOUNT: They took them from Phillips Petroleum
9 in 1986.
10 A lot of this was due to the fact that they had to
11 bring the leases up to a good condition. They've done a lot
12 of work on the platforms, they've done a lot of work on the
13 facilities, and they've really invested a lot of time and
14 effort in these leases trying to make them profitable.
15 They've developed cost-cutting programs to try to reduce
16 their costs on the lease. And over the years, because of
17 the oil price and because of the competition, the heavy
18 pressure from overseas crude, it's been very difficult for
19 them to turn a profit. In fact, impossible.
20 They came to us and asked if there's a way that we
21 could modify the royalty formula, first to make the leases
22 profitable, and, secondly, so they could invest some money
23 into the leases to do a water flood.
24 As a personal note, I worked on this field in 1981
25 as an engineer for Enamen Oil, and these water flood that

1 they're talking about has been in the development stage
2 since the 1960s but yet to be implemented. This new royalty
3 formula that we're talking about providing for will give
4 them an incentive to make investment into a water flood that
5 will increase the ultimate recovery of the oil for the State
6 of California. Without that, without a royalty
7 modification, they would not be able to make the investments
8 that it would require to do this water flood.
9 Without that investment and without the water
10 flood these leases could go uneconomic -- well, in fact, are
11 uneconomic today. Although we have gotten a little release
12 from oil price because right now the oil price is $14.40 a
13 barrel. Pretty good price and they're just breaking even
14 right now at this price.
15 COMMISSION CHAIRMAN DAVIS: What is the price
16 average for the last five years?
17 MR. MOUNT: For the last five years it's ranged
18 from about nine dollars, was the low, and the highest we got
19 in that period was about fifteen and a half. Now, during
20 the Gulf War the price went up for a few months to over
21 twenty-two dollars a barrel.
22 COMMISSIONER CONNELL: What was the mean average?
23 MR. MOUNT: The mean average was -- I don't
24 have that number right in front of me, but it's on the
25 order of about fifteen -- well, about -- take that back,

1 thirteen dollars a barrel. I don't have the exact number in
2 front of me, but I can get that.
3 We have in your packet there, however, a chart,
4 and it's several back, showing what the royalty rate would
5 have been with the oil price. It's a proposed price base
6 sliding scale royalty, and it's about halfway through your
7 packet and it looks similar to this. And had this royalty
8 formula been in effect during all these years this shows
9 what our royalty rate would have been.
10 Now currently the royalty rate average for the
11 leases is 15.5 percent. As you can see from this chart, in
12 1979 had this royalty formula been in place our royalties
13 would have gone to 25 percent because of the oil price. And
14 during that period the oil price went well over $30 a
15 barrel. In 1985, as you can see by this chart, the oil
16 price went down, but the royalty then went down to fifteen
17 and a half percent and would have stayed at fifteen and a
18 half percent under the current -- under the new royalty
19 formula until 1989.
20 In 1989 the Gulf War happened. Had we been using
21 this royalty formula the royalty would have gone to 21
22 percent, and then after the Gulf War the oil price went down
23 and our royalty would have gone back down to sixteen and two
24 thirds.
25 Now, there's a short period here you see after

1993 in which the oil prices went down to $9 a barrel in Huntington Beach. At that time Shell Oil took a big loss. And you might say, well, this is more of what you would expect an oil company to do, to take a risk in developing this lease. But let me remind you the profit margin was very slim to begin with, and, secondly, that loss that Shell took during that period was almost totally royalty. In other words, had there been a smaller royalty rate they would have not taken a loss, they would have broken even.

But essentially over these years we've been getting fifteen and a half percent royalty since 1975. Our evaluation shows that had we had this royalty formula in place the state would have benefitted by over $100 million incremental revenue above what we got.

Now --

COMMISSION CHAIRMAN DAVIS: What would it have been if you started the calculation in, say, 1986?

MR. MOUNT: 1986, let's see. I think I've got a graph on that.

COMMISSION CHAIRMAN DAVIS: That's about the time they purchased it.

MR. MOUNT: Yeah. It would have been -- I think we did an estimate on that, I don't have that right in front of me, but it's about $20 million because of the Gulf War. Now, keep in mind the royalty rate today is

1 fifteen point five percent. We are proposing a sixteen and
2 two thirds. Had this been in place back in '86 we would
3 have gotten sixteen and two thirds plus we'd have gone up to
4 twenty-one percent during the Gulf War. So it'd be about
5 $20 million or so that we would have gotten since 1986.
6 Now, we had this downturn here, but that's really small
7 compared to what we would have gained over the long haul.
8 So we want to bring this back to a sixteen and two
9 thirds royalty not a fifteen and a half percent. And during
10 the upturn when the oil prices are high we want to benefit
11 by two things, getting a higher royalty rate, and, number
12 two, getting the higher price. So the price goes up, the
13 royalty rate goes up, we get a double-whammy; we get an
14 increase in royalty rate, we get an increase in price.
15 The other advantage we have in this proposal is
16 that we don't rely on posted prices any longer. Right now
17 the way our lease is structured we are paid on posted
18 prices. What we're proposing in this modification is that
19 we are paid on the highest price that we obtain for any oil
20 sold in that field. The state has the option to take its
21 oil in kind. We can then market that crude and we will be
22 paid royalty based on the price that we get for that crude.
23 Current evaluations are, and we've had an
24 independent evaluation, of between 40 and 50 cents a barrel
25 more than what we're getting now, which could amount to

about $500,000 a year increase in our revenue just because of the fact we'd be allowed to market our own crude and do it and not pay the royalty based on posted price but be paid based on market price.

COMMISSIONER CONNELL: Mr. Chair?

COMMISSION CHAIRMAN DAVIS: Yes.

COMMISSIONER CONNELL: I have some questions.

First of all, I think that the way the deal is being structured it has some attractive components to it. Coming from the private sector I always like to see contracts that reward competition, and in this case particularly incentive-based pricing versus fixed. So I'm totally in agreement with it.

I should disclose that I am not trained in commodities and -- or commodity futures so I don't know anything about pricing of oil historically. But I am concerned that when we give downside protection to a contract that we should be knowledgeable about the likelihood or probability of that downside protection being drawn on. And I guess I am not as informed as I need to be to feel comfortable with what you're recommending.

In other words, I'm not sure how many times it's going to drop below $14 a barrel. I think that we ought to do some trend analysis, particularly -- I have enough knowledge about oil trading to know that there is a

1 different value range depending on the way other commodity
2 prices are trading in the world markets and importantly the
3 quality of the oil that is being taken out of the ground.
4 So that the oil that is represented in this particular
5 transaction is not the highest quality oil, it will trade at
6 a different level to par than would be true of the highest
7 quality oil that it available.
8 So I guess when I look at what you're proposing --
9 and I was intrigued by I think it's chart number 16.
10 MR. MOUNT: Okay.
11 COMMISSIONER CONNELL: Chart number 16, which is a
12 Shell Huntington Beach field chart.
13 MR. MOUNT: Right.
14 COMMISSIONER CONNELL: When I looked at this I
15 guess what I was trying to decide, you know, the gap that
16 you have here is our downside --
17 MR. MOUNT: Correct.
18 COMMISSIONER CONNELL: -- and really our upside
19 starts from 16.67 out. Now, as I understand it, this is a
20 12-year contract, is that right?
21 MR. MOUNT: Well, it will go on as long as the
22 field is economically feasible. It is estimated to be 12
23 years.
24 COMMISSIONER CONNELL: All right. Well, assuming
25 a base economic model of 12 years, then what you need to

1 determine is what is the state's ability to gain the upside
2 of the additional royalty percentage that would kick in
3 after the 17.50 level is reached. And if indeed we go out
4 to infinity, which is the other possibility, that it's
5 longer than 12 years, so it's x plus some number of years,
6 then that upside would kick in for a longer period of time.
7 What I am concerned about in reading this
8 material, Mr. Chair, is that I don't think we have those
9 answers here today, and I would be concerned that we do not
10 offer downside protection without understanding what the
11 probability is of our upside revenue potential. Because
12 when we offer downside protection we're offering an
13 insurance policy, it seems to me, to Shell.
14 And I can understand that, I don't have a problem
15 with the state offering downside protection if there is a
16 likelihood -- the same probability that we're going to get
17 the upside advantage that Shell gets on the insurance
18 package on the downside.
19 Just looking at it casually as an economist, I
20 would think that that cutoff point might be somewhere closer
21 to 15.50 or $16 a barrel rather than 17.50, but I haven't
22 done an econometric analysis and I would really like to
23 share -- or have Shell share with us their analysis of
24 probabilities as it relates to, I'm sure, the investment
25 analysis that they've done.

1 I guess, Mr. Chair, where I am on this matter
2 is that I think we ought to ask, unless there's a
3 time-sensitive component on this, I would like to ask that
4 we table this to our next meeting because I am not opposed
5 to the way we're trying to structure this contract, I think
6 we want to encourage Shell to develop a resource which has
7 economic value to the state, but I'm not certain that we
8 have assurance that we're cutting the right deal given the
9 lack of information we have.
10 MR. MOUNT: Well, let me say that maybe we have a
11 lack of information to give to you at the moment, although
12 we have analyzed those things you talk about.
13 Our analysis shows that, you know, we will not
14 reasonably -- and statistically it shows it's a very small
15 chance that we will ever get up into the 20 percent to 25
16 percent royalty range lacking a war or some big economic
17 upset that would increase the price of oil, such as the Gulf
18 War or such as the early eighties. So the likelihood that
19 we get up there is very small. But again on the other hand,
20 the likelihood that we go below the $14 a barrel for any
21 extended period of time is also very small.
22 And if you want to compare the two, I don't have
23 that analysis right here, but what we're seeing is that flat
24 part of the line is where we anticipate being a great
25 majority of the time and that the upside to this deal is

1 twofold. One is that we increase our royalty to sixteen and
2 two thirds from fifteen and a half. Secondly, we market the
3 crude and we get forty to fifty cents a barrel more. And
4 there's really a third advantage in that they come in and
5 invest a million dollars a year, two million dollars a year
6 for the first couple of years, then five million dollars a
7 year thereafter and do the upper main zone water flood,
8 recover us more oil and make us more money that way.
9 So we're not banking on the fact that the oil
10 price is going to go up to make money. That's not what this
11 deal's intended to do. But they wanted some protection on
12 the downside and so we said, "Okay, if you want protection
13 on the downside then we want to reap the benefits on the
14 upside."
15 COMMISSIONER CONNELL: My point is you may never
16 reap the benefits on the upside.
17 MR. MOUNT: That's true.
18 COMMISSIONER CONNELL: And that's what I have to
19 be assured.
20 MR. MOUNT: That's true.
21 COMMISSIONER CONNELL: And, in fact, this is a
22 very simple probability analysis and statistical and
23 economic analysis and it can be quickly done.
24 MR. MOUNT: Correct.
25 COMMISSIONER CONNELL: And if I had all that

1 myself, historically, you could draw it up in literally a
2 half hour.
3 MR. MOUNT: Correct.
4 COMMISSIONER CONNELL: It's not a magical analysis
5 here. And I think that we ought to share that kind of
6 information with the Board --
7 MR. MOUNT: Okay.
8 COMMISSIONER CONNELL: -- so that we can justify
9 being willing to provide an insurance opportunity to Shell
10 and that we have done so at a price which is fair given our
11 judgment of the probabilities of market activity in
12 relationship to oil.
13 MR. MOUNT: One other thing I wanted to point out,
14 Commissioners, was the chart number 25. It's a couple back
15 from the previous one. It shows our State Lands proposed
16 royalty. And along with that are two others that are
17 working, one is the N&S royalty modification they recently
18 made with POI, which is an offshore producer, and the other
19 one is an Alaska British Petroleum model that they're
20 working on in Alaska. And in each of those cases our
21 royalty exceeds either one of those.
22 MALE VOICE: Thank you, Paul.
23 MR. MOUNT: Yeah.
24 COMMISSION CHAIRMAN DAVIS: Do you have any
25 questions?

1 I share some of the Controller's concerns,
2 although I would note that there are economic benefits to
3 the state beyond simple royalties. I gather there's a
4 number of people who would continue to work over a sustained
5 period of time if this well is not abandoned and if the
6 water flooding proceeds?
7 MR. MOUNT: Correct.
8 COMMISSION CHAIRMAN DAVIS: Would you speak to
9 that for a moment?
10 MR. MOUNT: Yes. There's been an economic
11 analysis done on the impact on the local economy and on the
12 State of California.
13 COMMISSION CHAIRMAN DAVIS: Who did that analysis?
14 MR. MOUNT: That was done by Dr. Anderson, and
15 she's here in the audience to speak to that.
16 COMMISSIONER CONNELL: Who is she employed by?
17 MR. MOUNT: Dr. Anderson.
18 DR. ANDERSON: Cal State Northridge.
19 COMMISSIONER CONNELL: No. But who paid for the
20 analysis?
21 MR. MOUNT: I believe Shell did. Is that correct?
22 COMMISSIONER CONNELL: Okay. I think we should
23 always disclose who --
24 COMMISSION CHAIRMAN DAVIS: I would like to hear
25 from her when you're --

1 MR. MOUNT: Sure. But, yes, there has been
2 analysis done, and, actually, she's better qualified to
3 speak than I am on that. If you don't mind I'll have her
4 come up.
5 COMMISSION CHAIRMAN DAVIS: All right. One thing
6 that occurred to me, and I mentioned this to our Executive
7 Officer when he was briefing me, you know -- first of all,
8 for the record, I, too, think that it's appropriate for the
9 state to kind of ride the tiger of oil prices. I mean I
10 don't -- I'm not philosophically opposed.
11 As a matter of fact, at some earlier Commission
12 hearings some of the attendees may recall my asking some of
13 the companies that wanted us to give permission to reduce
14 their royalties if they would, for fear that oil prices
15 would go down, if they would raise their royalties if prices
16 went up. So they've sort of called my bluff on this, and I
17 appreciate that and I think that's a risk that we should be
18 willing to accept.
19 My only concern is that the Commission have an
20 independent analysis, maybe from the UC system, and maybe
21 there's some other arbiter on this subject that could give
22 us his or her analysis as to whether the particular formula
23 that we've had presented to us today makes the most sense.
24 And it may well. I'm not saying it doesn't. I don't have a
25 bias for or against it. I was hoping the Attorney General

1 would opine on that, but Jan was unwilling to opine on the
2 business efficacy of such a move.
3 (Inaudible comments from the floor.)
4 COMMISSIONER CONNELL: What an appropriate answer.
5 (Laughter.)
6 COMMISSION CHAIRMAN DAVIS: You'll pay for dinner
7 next time.
8 (Laughter.)
9 COMMISSION CHAIRMAN DAVIS: If you'll recall, the
10 one time we have done this since I've been on this
11 Commission, which is eight years, at least one time I recall
12 doing it, is when we reduced the prices for ARCO when it was
13 investing $100 million to water flood the leases in Long
14 Beach.
15 MR. MOUNT: Correct.
16 COMMISSION CHAIRMAN DAVIS: Now, there we did
17 not -- we had no upside potential, just the assurance that
18 if more oil was developed then we'd have more royalties.
19 However, that was reviewed by the Attorney General and he
20 opined specifically on the formula. The Legislature passed
21 a bill validating the formula and the Governor signed it.
22 So we had a lot of people concurring in the wisp of that
23 transaction. That's effectively what I'd like to recreate
24 here to the best we can. I'm not conceptually opposed to
25 it.

1 Does the staff or the Commission members have any
2 thoughts as to who might be an appropriate -- you look so
3 worried over there -- who might be an appropriate --
4 MR. MOUNT: Mr. Chairman, we have what we think
5 are some independent economists who we think would -- could
6 help us and whose expertise is in the oil industry.
7 ACTING COMMISSIONER PARKER: What time frame for
8 doing that?
9 MR. MOUNT: I think we could do that in a month.
10 COMMISSION CHAIRMAN DAVIS: That they could just
11 come present their findings.
12 MR. MOUNT: Yes.
13 COMMISSIONER CONNELL: Do we competitively bid
14 these contracts?
15 MR. MOUNT: No, this would be sufficiently low
16 that it would not require competitively bidding.
17 (Cross conversation.)
18 COMMISSION CHAIRMAN DAVIS: Anybody in the UC
19 system.
20 MR. MOUNT: Yes, yes. Definitely.
21 COMMISSIONER CONNELL: A couple of people at UCLA.
22 MR. MOUNT: Yes.
23 COMMISSION CHAIRMAN DAVIS: Well, my concern is do
24 other states use formula's like this?
25 MR. MOUNT: They're working on them. Like I

1 showed you, Alaska's working on a very similar formula.
2 You know, we have the authority to modify the
3 royalty on a lease given, one, that you don't reduce the
4 ultimate revenue you would have gotten from the primary
5 recovery. And generally that's done for a water flood or
6 something to enhance the recovery on a lease, and the
7 Commission has done that fairly routinely in the past.
8 Long Beach was a special deal and very
9 complicated, and it was very successful, I might add. And
10 this is also different from the norm. So scrutiny by a
11 third party would probably be well worth our effort.
12 COMMISSIONER CONNELL: Well, Mr. Chair, may I
13 modify my proposal then, or my motion? I move that we table
14 this agenda item to our next meeting and that we request
15 that staff retain a proper advisor to perform the economic
16 analysis.
17 COMMISSION CHAIRMAN DAVIS: Do you have any
18 thoughts on that?
19 ACTING COMMISSIONER PARKER: I think the (tape
20 cuts out) what oil prices may be (tape cuts out) if there
21 are not, future investments may not, and I think that's an
22 important consideration in the overall analysis.
23 MR. MOUNT: And we will do that. And with that
24 motion we'll --
25 COMMISSION CHAIRMAN DAVIS: I would like you to at

1 least exhaust efforts at the UC system to see if there's --
2 MR. MOUNT: We will.
3 COMMISSION CHAIRMAN DAVIS: -- a department or a
4 department head or consultants that they've used on this
5 issue.
6 MR. MOUNT: We'll find somebody.
7 COMMISSION CHAIRMAN DAVIS: And, again, I'm
8 inclined to be supportive of this formula if I'm assured
9 that this is a reasonable approach. But just from a
10 layman's perspective, you'd have to conclude that Shell is
11 betting that the price of oil will fall.
12 COMMISSIONER CONNELL: Well, one does not buy an
13 insurance policy unless there's some probability that you're
14 going to need to use it. I don't think we have to worry
15 about what level of probability that is, but I'd just like
16 to know that we have a probability of winning on the upside
17 as well.
18 COMMISSION CHAIRMAN DAVIS: No. But, I mean, just
19 to be specific here, they're willing to pay an increased
20 royalty of sixteen and two thirds if the price of oil
21 remains where it is.
22 COMMISSIONER CONNELL: That's what evoked my
23 original concern, Mr. Chair.
24 COMMISSION CHAIRMAN DAVIS: It's quite possible, I
25 usually accord this to the private sector, that they know

1 more than we do.

2 MR. MOUNT: Well, let me point out that the

3 current royalty formula is one -- there are different

4 royalties on different leases, and in your package it shows

5 that. And it's very complicated for the oil company and the

6 State Lands because we have people that have to verify each

7 one of these royalties by lease and it actually is a problem

8 with bureaucracy, and the companies don't like it and we

9 don't like it because we have to spend money to monitor

10 these royalties.

11 If we consolidate, make it one royalty on all the

12 leases, they're willing to give us sixteen and two thirds

13 just to get rid of the headache for accounting for all this

14 oil. And we have the same problem. In fact, this will

15 allow us to reduce the scrutiny on this so that the

16 accounting and the accounting requirements are much less

17 than they are today.

18 ACTING COMMISSIONER PARKER: But they're not

19 willing to do that essentially as trade for the elimination

20 of the bureaucracy for increasing the current royalties from

21 fifteen and a half to sixteen and two thirds and just let it

22 go at that as opposed --

23 MR. MOUNT: They might be, but then they might not

24 be willing to make the investment either. They probably

25 would be, you're right.

1 COMMISSIONER CONNELL: Well, I think this is what
2 the -- the analysis should clearly be multivariate in nature
3 and you want to look at alternative scenarios. I mean you
4 don't want a singular analysis.
5 MR. MOUNT: Okay.
6 COMMISSION CHAIRMAN DAVIS: Why don't we use this
7 opportunity to have them offer any guidance they want our
8 current royalty system with everybody? Because if there's a
9 way in which we can simplify the lives of our lessees and
10 generate more revenue for the state, obviously, we should
11 explore that. I would also like the analysis to try and
12 quantify the value of our being able to market the oil
13 ourselves.
14 MR. MOUNT: Mr. Chairman, I think, depending upon
15 your pleasure, Shell would like to say just a few words.
16 COMMISSION CHAIRMAN DAVIS: And, again, not to
17 repeat the obvious, but I applaud the lessee for making a
18 proposal that may well have merit and that this Commission
19 may well adopt. I don't anticipate the process we're going
20 through to unduly delay the decision. Hopefully we can make
21 a decision at the next meeting. But you'll understand our
22 caution never having gone down this path before. And
23 believe me, if the price of oil drops they're not going to
24 be blaming Bob Hight, they'll be blaming Kathleen Connell
25 and Gray Davis. So --

1 COMMISSIONER CONNELL: This is correct.

2 COMMISSION CHAIRMAN DAVIS: -- if it goes up, you

3 know, nobody knows from us either.

4 (Cross conversation.)

5 COMMISSION CHAIRMAN DAVIS: Now, who wanted to be

6 heard from Shell? And then we'll hear from the professor

7 from Cal State Northridge.

8 MR. CHRISTENSON: My name's Tom Christenson. I'm

9 an asset manager with Cal Resources, operator of Huntington

10 Beach, on behalf of Shell.

11 I understand the economic concerns of the

12 Commission, and, you know, rather than trying to get into

13 economic principals and probabilities, I'd just like to make

14 a few points for the Commission to ponder on while the

15 number crunching goes on.

16 If you look at the current state of Huntington

17 Beach as it stands right now, you know, we're making no

18 money. The state's royalty revenues are at risk, as Ms.

19 Parker pointed out. And we do have an imperatibility to

20 develop and recover both the developed and undeveloped

21 reserves. That's as it stands today.

22 If you look at what this agreement has the

23 potential to do for us, if we come to agreement on the

24 specifics of it, is a classic win/win between the industry

25 and the state and the governments and the community. It

1 specifically addresses some of the concerns around the
2 sixteen and two thirds. I think what the state gets clearly
3 is a little over a one percent increase in royalty right off
4 the bat.
5 Countering that, the concern that, you know,
6 Shell's willing to give that up, that they must be -- there
7 must be something that we don't know. And, you know, I
8 would offer what we get out of that I think is essentially a
9 wash. Because, in fact, our operating costs and
10 administrative costs will probably go down by about the
11 amount that the royalty goes up. So that part of it to us
12 is essentially a wash.
13 But going on, I think that the government then,
14 the state, continues to get the sixteen and two thirds
15 percent royalty under most probable price scenarios. They
16 have a much higher probability of enjoying the revenues from
17 future development of the upper main zone, as Mr. Mount
18 pointed out. Lower administrative costs. They can direct
19 their staff to a number of things that add a lot more value
20 than counting the barrels that go across the Shell lease.
21 They can look at some of these issues of marketing crude and
22 that kind of thing that will really bring the state an
23 unquantified enhanced value.
24 The state does enjoy participation in a higher
25 price world. You know, if we're all fortunate enough to be

1 in that environment, both ourselves and the state will enjoy
2 some of the benefits. Socioeconomic impacts, which you'll
3 hear much more about from a much more authoritative source
4 than myself so I won't try to dip into that, but we do have
5 considerable community support. I think that the mayor and
6 the chamber of commerce have sent in letters on our behalf.
7 And, finally, I think the state gets some
8 assurance that Cal Resource -- there's a high probability
9 that Cal Resources and Shell will be there as a continued
10 operator, and I think we have a good record and we're a
11 responsible operator.
12 What we get, we get one leg of I think a three-
13 legged stool for Huntington Beach. Royalty modification is
14 one of those legs. We're actively looking at cost structure
15 improvements. We've engaged McKenzie & Associates to help
16 us do that. They're on the lease now. We're hopeful that
17 our basic cost structure will be helped. And we also need
18 to make sure that we spend our capital as efficiently as we
19 can. And all those are things that we're looking at
20 actively.
21 As I said, offsetting what we're giving to the
22 sixteen and two thirds, we are getting something for that,
23 irrespective of what we do at the upper main zone, and
24 that's reduced operating and administrative costs that we
25 think are probably going to offset that. So that alone, in

1 my mind, is a win/win for both of us.

2 We do have an incentive, then, to go on with

3 development of reserves. We do have a hedge in insurance

4 policy against lower prices. I think the counter to that

5 goes a little bit beyond the probabilities of a high price

6 environment. But the state's real upside, the real win for

7 the state, is that they do get -- that this scheme does not

8 kick into place unless the upper main zone is developed and

9 the state then reaps the increased volumes and the royalties

10 that go with that.

11 And the final thing that it gives us is a way to

12 weather the bad times. A year ago we found ourselves in a

13 $9 world losing considerable money. Our premises and

14 industry projections said better times are ahead and we just

15 kind of had to hold our breaths for about six or nine

16 months. So that was a difficult time for us, we weathered

17 that, but, you know, this sliding scale will kind of balance

18 the scales on that.

19 So that was the extent of my remarks.

20 COMMISSIONER CONNELL: Do you have any problem

21 with our moving forward with undertaking an economic

22 analysis and engaging an outside advisor to assist us in

23 that?

24 MR. CHRISTENSON: No, I don't have any problem at

25 all if that would make the Commission more comfortable with

1 the recommended proposal. Yeah, that's fine. And we'd be
2 happy to provide any information or support that we could to
3 help that and expedite it.
4 COMMISSIONER CONNELL: I appreciate that. I think
5 it will make it an easier analysis for us.
6 COMMISSION CHAIRMAN DAVIS: There's even the
7 possibility that the independent analysis may suggest
8 another royalty scale that you find to your liking. I
9 notice under this one there's a big swing if the price of
10 oil goes from $14 down to $13. But there may be a way to
11 ensure you against the downside of declining oil prices
12 other than the formula you've presented, or this formula may
13 be absolutely perfect and we have a third party so indicate.
14 MR. CHRISTENSON: I think we're willing to engage
15 in discussion over any scheme. I don't think we're proud
16 enough to claim that we got the only scheme that'll work.
17 I'm sure there's lots of ways to skin the cat.
18 COMMISSION CHAIRMAN DAVIS: That's a good
19 attitude. Thank you.
20 Do you have any questions?
21 ACTING COMMISSIONER PARKER: No.
22 COMMISSION CHAIRMAN DAVIS: Did you have some
23 further comments you want to make?
24 MR. CHRISTENSON: No. That was all the comments.
25 COMMISSION CHAIRMAN DAVIS: No further questions

1 from the members. Thank you very much.
2 Let's see. We also had --
3 COMMISSIONER CONNELL: Have we voted on the
4 motion, Mr. Chair?
5 COMMISSION CHAIRMAN DAVIS: Well, the Executive
6 Officer asked us to allow the people who'd come here to
7 testify to testify, so --
8 COMMISSIONER CONNELL: Oh, all right. We have
9 more people?
10 COMMISSION CHAIRMAN DAVIS: -- we'll give him the
11 courtesy of two more.
12 Tony Lansor, who is a staff engineer.
13 (Inaudible comments from the floor.)
14 COMMISSION CHAIRMAN DAVIS: Thank you, sir.
15 And then, finally, Dr. Anderson, who performed
16 this analysis. She's with the School of Business and
17 Economics at Cal State University.
18 Would you mind just sharing with us, Doctor, some
19 of your comments about the other economic benefits
20 associated with this undertaking in terms of employment and
21 job retention and anything else you care to share with us?
22 DR. ANDERSON: (Tape cuts out) quantitative
23 outputs from the input/output analysis that --
24 FEMALE VOICE: It's the last page.
25 DR. ANDERSON: Yeah. Exhibit B, and it's the last

1 page.

2 COMMISSION CHAIRMAN DAVIS: Okay. This is loss of

3 407 jobs?

4 DR. ANDERSON: That's right. So while you're

5 looking at that, what I wanted to tell you was about the

6 background of that study which had the purpose of showing

7 the impact on the Huntington -- well, on the Orange

8 County/Los Angeles County area. On the local area, not on

9 the State of California. And that was using Shell data and

10 measuring the output on jobs, wages, taxes, output,

11 et cetera, using an input/output method which will measure

12 direct and indirect effects.

13 That results were the high employment multiplier

14 of five, for example, meaning that every job that Shell

15 would -- additional job that would be -- Shell would have in

16 Huntington Beach would employ a total of five people in that

17 LA/Orange County area. That's a high employment multiplier

18 and it goes along (tape cuts out).

19 COMMISSIONER CONNELL: Okay. Can you explain the

20 multiplier to me? Five is a very high multiplier. How did

21 you get to that number?

22 DR. ANDERSON: All right. As you probably are

23 aware of, Kathleen, the input/output process is one of

24 relating industries to each other as customers and suppliers

25 to each other, and the technical purchase coefficients are

1 available by county so that you can figure out the average.
2 That if Shell, for example, spent a million dollars in the
3 Huntington Beach area it would be purchasing, say, material
4 from tool makers and the tool makers would themselves then
5 have money to spend in that local area. In the same way
6 that when they employed additional people, that those tool
7 pushers would be spending money in the grocery stores and
8 drug stores of the area.
9 So when you take those indirect effects and add
10 them to the direct impact of that initial million dollar
11 impact, you're coming up with, in this example, something
12 like one and half million dollar impact on the local area.
13 And in terms of additional job -- of direct Shell
14 employment, that high paid Shell employee would stimulate
15 enough additional spending in the local area that it would
16 employ a total of five other people -- or four other people,
17 five including himself. That's a very high --
18 COMMISSIONER CONNELL: But most of it in the
19 retail community.
20 DR. ANDERSON: No, actually it affects almost
21 every sector in the economy, but construction, transport,
22 retail trade, yes, and services, but much blue collar and
23 professional employment. And I think for this -- this is an
24 unusual industry in the sense that it does kind of impact
25 the blue collar and professional and managerial class as

1 much as it does. It pays good taxes and produces a (tape
2 cuts out) reason my own feeling is that you're -- you've got
3 a good bet here on this horse in the sense that this is not
4 a declining demand industry. This is an industry that's
5 temporarily beset by competition.
6 The prediction of future prices may be very
7 difficult by trend, as we noted in 1974 when the price
8 temporarily crashed because of a breakdown of a cartel
9 agreement. And of course the many uses of oil in war and so
10 forth make the price fluctuations I think serious in this
11 industry and difficult I think to predict by trend,
12 although --
13 COMMISSIONER CONNELL: Surely Shell must have made
14 some prediction or they wouldn't be asking for a downside
15 protection, though. I mean I have to assume --
16 DR. ANDERSON: (Cross conversation) -- lived
17 through a history of downside long enough that they have
18 decided they better do something about it.
19 COMMISSIONER CONNELL: That is my whole point,
20 that if they obviously did the rigors of economic analysis
21 to determine what their probability was for downside
22 production to a point where they felt it was necessary to
23 have downside protection insurance to move this deal
24 forward, then we need to understand how likely it is that
25 the downside will occur and what is the likelihood that we

1 will benefit from the upside.

2 Obviously somebody did an economic analysis at

3 Shell to come to that conclusion, so they must have used

4 some kind of historical trend information that they're

5 comfortable with.

6 DR. ANDERSON: Yeah. Historical trends, however,

7 have broken down in this industry in the past. That was my

8 point about 1974. But at any rate, what is very good here

9 and that you can't lose on unless there's an abandonment, is

10 the fact that things are being done efficiently by having

11 that Huntington Beach field open and close to the market.

12 The fact that you've got a field that can pump its

13 oil into a refinery close to the market using a safe and

14 low-cost means of transportation in an industry in which

15 transportation costs are serious is a very efficient set-up

16 and one that I would think you would probably want to

17 preserve. It is probably also more environmentally sound

18 for the local economy to use those pipelines going from the

19 field to the refinery than to have to import foreign or oil

20 from other states either by ship through our port or by tank

21 truck over our -- the California roads and streets.

22 COMMISSION CHAIRMAN DAVIS: Let me interrupt you

23 for a second. Isn't the well currently -- aren't the wells

24 currently being worked?

25 DR. ANDERSON: They are being worked, right. So

1 I'm talking in terms of the continued production of these
2 wells, are doing -- are using those scarce resources as
3 efficiently as could possibly be done. An alternative, I
4 don't think you could find a more efficient or effective
5 set-up.
6 COMMISSION CHAIRMAN DAVIS: I agree with that.
7 DR. ANDERSON: And, in fact, I would say just the
8 benefits of the Shell lease operation, of maintaining that
9 operation and encouraging the continued investment in that
10 field, are not only these state taxes of around $7 million a
11 year and local taxes, direct and indirect, of over
12 $3 million a year an efficient and safe production of an
13 essential base product, which is an import to many other
14 industries in California, but also the high wage scale, the
15 support for a weak local economy in a high unemployment area
16 -- this area has really suffered -- and the preservation of
17 that blue collar upward mobility ladder that we like to talk
18 about but that California's seen a big drain on.
19 So I would bet on the lease royalty modification
20 as being a good investment for the citizens of California,
21 even without having a forecast in what the petroleum price
22 is going to be.
23 COMMISSION CHAIRMAN DAVIS: Thank you.
24 MALE VOICE: There's one other individual who's
25 indicated they desire to speak.

1 COMMISSION CHAIRMAN DAVIS: Are there any
2 questions from the members?
3 ACTING COMMISSIONER PARKER: Nothing.
4 COMMISSION CHAIRMAN DAVIS: No. Thank you.
5 MALE VOICE: And I don't know whether Mr. Davis
6 desires to speak.
7 COMMISSION CHAIRMAN DAVIS: Mr. Davis of the
8 Huntington Beach Chamber of Commerce.
9 Great last name.
10 (Laughter.)
11 MR. DAVIS: I was going to say, no relation to the
12 Chairman.
13 COMMISSIONER CONNELL: I was just going to ask
14 that question.
15 (Laughter.)
16 (Cross conversation.)
17 MR. DAVIS: I just wanted to throw a quick comment
18 in on behalf of the business community and the Chamber of
19 Commerce, and, in fact, the City of Huntington Beach. I'm
20 very active in all those areas.
21 And being past president of the chamber and
22 presently on the board of directors, at our February 23rd
23 meeting, I won't bore you with reading it, it's in the file,
24 but the Chamber after lengthy discussion very, very strongly
25 recommend that something be worked out. And we're not

1 getting into the numbers on that.

2 What we're saying is that it's very important in

3 several areas, and I think the preceding speaker mentioned

4 the blue collar employment, which is very important to us.

5 And really the gist of what I wanted to say, Mr.

6 Chairman, is that in Huntington Beach, as in most cities, we

7 have an economic support program through the Chamber, city

8 staff and so forth, and we're very interested in some

9 objectives to retain and attract businesses, number one, and

10 believe me, we want to retain this business in the City of

11 Huntington Beach. It's economically very important to us.

12 To add jobs, it does that, and, of course, we're interested

13 in our existing business increasing their productivity, and

14 that's kind of part of what the plan is.

15 We believe it's a win/win situation. And I won't

16 take anymore of your time except to say that we feel that

17 it's real easy to support a fine corporate citizen like

18 Shell. We really don't want to have to break anybody else

19 in in the City of Huntington Beach.

20 Thank you.

21 COMMISSION CHAIRMAN DAVIS: Does anyone else care

22 to offer any comments on this proposal from the public?

23 And we have a motion before us, which is to

24 postpone this decision to the next meeting, at which time

25 we'll have an independent analysis, hopefully from the

1 UC system, but at least from a reputable third party who
2 will advise the Commission whether the particular formula
3 before us is appropriate, and if not what if any changes
4 would make, and among other things would quantify the value
5 of having a right to market oil ourselves as part and parcel
6 of this contractual adjustment.
7 Have I stated the motion correctly?
8 MALE VOICE: I think you got all the elements.
9 COMMISSION CHAIRMAN DAVIS: Close enough?
10 COMMISSIONER CONNELL: That's good. That's fine.
11 COMMISSION CHAIRMAN DAVIS: All right.
12 Everybody's for it. It's unanimous. So the motion passes.
13 MALE VOICE: Thank you, Mr. Chairman.
14 The last item then is Item C7, which is the SMUD
15 issue. And Mr. Trout has been out in the hall negotiating
16 as we've been here.
17 ASSISTANT EXECUTIVE TROUT: Mr. Chairman, we've
18 reached agreement on the language in the calendar item and
19 in the lease regarding the SMUD lease. We have agreed that
20 the two amendments to the calendar item should be approved
21 as submitted. One of the amendments is to change the land
22 use and purpose so that the gas line could be used to supply
23 any of SMUD's power plants, and, second, that it could be
24 used for plants or facilities of the State of California.
25 Second, SMUD has agreed to an additional clause

1 which would provide that unless they are prohibited by law,
2 they will negotiate with the state to allow the state to use
3 excess capacity on terms and conditions that are market
4 based. And with that, subject to final approval by the
5 Commission and by SMUD of the agreement, we would ask your
6 approval of this lease and this calendar item.
7 The representative of SMUD here is to I hope agree
8 with that analysis. And this would allow SMUD to proceed
9 with their leasing and their acquisition of the pipes and it
10 gives the state the access that it needs unless there is
11 some specific prohibition in law, which has been the concern
12 of SMUD.
13 ACTING COMMISSIONER PARKER: Jim, you said final
14 agreement between SMUD and General Services?
15 ASSISTANT EXECUTIVE OFFICER TROUT: And us.
16 ACTING COMMISSIONER PARKER: And State Lands. All
17 three?
18 ASSISTANT EXECUTIVE OFFICER TROUT: Yes. Right.
19 We will act for General Services.
20 Mr. Steve Cohn with SMUD.
21 MR. COHN: Thank you. Mr. Chairman, members of
22 the Commission, my name is Steve Cohn, I'm an attorney for
23 SMUD. I did have with me a letter from our General Manager,
24 Jan Shori, that I wanted to distribute.
25 Since Ms. Shori signed the letter, we've had the

1 subsequent discussions that Mr. Trout referred to. And I am
2 prepared to recommend these changes to the General Manager
3 and my board. The one caveat I have to tell you, it is
4 subject to their approval because it's on the agenda for
5 this afternoon's meeting and, you know, they would not have
6 seen this language previously. But I will certainly
7 recommend it to our board as outlined by Mr. Trout.
8 I might add, this came as sort of a last minute
9 item and that's why it wasn't noticed in our SMUD Board
10 agenda.
11 So I'd be happy to answer any questions.
12 COMMISSION CHAIRMAN DAVIS: Do you think it's
13 appropriate the Commission act first or --
14 MALE VOICE: Yes, Mr. Chairman. I think that
15 there's adequate grounds to do that and that the conditions
16 are appropriate.
17 COMMISSION CHAIRMAN DAVIS: Any questions,
18 Commission members?
19 COMMISSIONER CONNELL: No. I'm delighted we've
20 been able to so quickly negotiate the conditions,
21 surprising, in the couple of hours that they've had. I'm
22 ready to move forward if staff and SMUD and others are
23 comfortable with it.
24 ACTING COMMISSIONER PARKER: Is that a motion?
25 COMMISSIONER CONNELL: Yes, that is my motion. I

1 move that we approve this with the conditions now indicated
2 by staff in the staff presentation.
3 COMMISSION CHAIRMAN DAVIS: Before we vote, is
4 there anyone here present that would care to oppose this
5 matter?
6 ACTING COMMISSIONER PARKER: I concur.
7 COMMISSION CHAIRMAN DAVIS: All right. Then it's
8 unanimously approved.
9 MALE VOICE: Thank you, Mr. Chairman. That
10 concludes the agenda for today.
11 COMMISSION CHAIRMAN DAVIS: Any matters any
12 members want to bring up?
13 We stand adjourned.
14 (Thereupon, at 2:00 p.m., the meeting was
15 concluded.)
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CERTIFICATION OF TRANSCRIPT

TITLE: State of California, State Lands Commission Meeting

NO. OF TAPES: 1

MEETING DATE: March 1, 1995

I certify that the above-described electronic recording was accurately transcribed by me and constitutes a true, complete and accurate transcription of the aforementioned proceedings.

SIGNED: Kim L Wellman

DATED: 3/17/95