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
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PROCEEDINGS

MALE VOICE: The State Controller

COMMISSIONER CONNELL: Here.

MALE VOICE: Lieutenant Governor.

COMMISSION CHAIRMAN DAVIS: Present.

MALE VOICE: Director of Finance.

ACTING COMMISSIONER PARKER: Theresa Parker for Russell Gould.

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

(Asides.)

MALE VOICE: We have a consent calendar, Mr. Chairman, that is Items 1 through 52. Items C18 and C44 have been pulled from the agenda and will be considered at a later time.

MALE VOICE: And a small change in 21.

Item 21 we have a small change. In the calendar item and in the summary there's an authorization for an incumbrance in an amount not to exceed $1,500,000. It should be $1,590,000. The calendar item is right in one place and wrong in another. In approving the consent calendar we just ask you to note that difference.

MALE VOICE: And Item C7, Mr. Chairman, we would like to take off of the consent calendar and deal with it separate -- last, I think.

COMMISSION CHAIRMAN DAVIS: Might note in that,
that isn't that the matter that involves General Services
and SMUD?

MALE VOICE: Yes.

COMMISSION CHAIRMAN DAVIS: Then if there are
representatives from those two agencies they might want to
use the time allowed in this meeting to see if there's some
accommodation they can --

MALE VOICE: They're in the hallway doing that
right now, Mr. Chairman.

COMMISSION CHAIRMAN DAVIS: They're ahead of us.

All right.

Don't we have to approve the minutes?

MALE VOICE: A minor detail. Yes, sir.

COMMISSION CHAIRMAN DAVIS: The controller moves.

COMMISSIONER CONNELL: Yes.

COMMISSION CHAIRMAN DAVIS: Finance Director
seconds.

Submitted. So approved unanimously.

MALE VOICE: Thank you, Mr. Chairman.

COMMISSION CHAIRMAN DAVIS: Do I have a motion for
the consent calendar as amended?

COMMISSIONER CONNELL: I move the consent calendar
as amended.

COMMISSION CHAIRMAN DAVIS: Controller so moves.

ACTING COMMISSIONER PARKER: Second.
COMMISSION CHAIRMAN DAVIS: It's unanimous.

We'll move to the first item of regular business.

MALE VOICE: That's item number 53, Mr. Chairman, which is the request by a subsidiary of Shell Oil Company to modify the royalty provisions that Shell pays on its leases at Huntington Beach.

And I would like to ask Mr. Paul Mount of the Commission Staff -- Paul is manager of the Commission's mineral operation -- to present this item.

MR. MOUNT: Good afternoon, Commissioners.

These leases that we're talking about for modifying the royalties were first leased in 1938, and since then the royalties have not changed. In other words, the royalty formulas they used in 1938 are the same royalty formulas we use today.

As you know, the world has changed, the economics have changed, the oil fields have been in a great state of depletion and the oil companies have been struggling to get some profits out of these leases. There's competition from Alaska north slope crude, there's competition from Mid-East crude, and so they've been struggling with these leases here.

Shell recently took assignment of these leases and invested a considerable sum of money into these leases. That first graph you show there, that you see there, that
was just handed out, shows the accumulative investment to date. The cash flow to date has been negative $54 million and they purchased these leases for $100 million. So they've had a negative cash flow of $154 million since they --

COMMISSION CHAIRMAN DAVIS: Who did they purchase the leases from?

MR. MOUNT: They took them from Phillips Petroleum in 1986.

A lot of this was due to the fact that they had to bring the leases up to a good condition. They've done a lot of work on the platforms, they've done a lot of work on the facilities, and they've really invested a lot of time and effort in these leases trying to make them profitable. They've developed cost-cutting programs to try to reduce their costs on the lease. And over the years, because of the oil price and because of the competition, the heavy pressure from overseas crude, it's been very difficult for them to turn a profit. In fact, impossible.

They came to us and asked if there's a way that we could modify the royalty formula, first to make the leases profitable, and, secondly, so they could invest some money into the leases to do a water flood.

As a personal note, I worked on this field in 1981 as an engineer for Enamen Oil, and these water flood that
they're talking about has been in the development stage since the 1960s but yet to be implemented. This new royalty formula that we're talking about providing for will give them an incentive to make investment into a water flood that will increase the ultimate recovery of the oil for the State of California. Without that, without a royalty modification, they would not be able to make the investments that it would require to do this water flood.

Without that investment and without the water flood these leases could go uneconomic -- well, in fact, are uneconomic today. Although we have gotten a little release from oil price because right now the oil price is $14.40 a barrel. Pretty good price and they're just breaking even right now at this price.

COMMISSION CHAIRMAN DAVIS: What is the price average for the last five years?

MR. MOUNT: For the last five years it's ranged from about nine dollars, was the low, and the highest we got in that period was about fifteen and a half. Now, during the Gulf War the price went up for a few months to over twenty-two dollars a barrel.

COMMISSIONER CONNELL: What was the mean average?

MR. MOUNT: The mean average was -- I don't have that number right in front of me, but it's on the order of about fifteen -- well, about -- take that back,
thirteen dollars a barrel. I don't have the exact number in front of me, but I can get that.

We have in your packet there, however, a chart, and it's several back, showing what the royalty rate would have been with the oil price. It's a proposed price base sliding scale royalty, and it's about halfway through your packet and it looks similar to this. And had this royalty formula been in effect during all these years this shows what our royalty rate would have been.

Now currently the royalty rate average for the leases is 15.5 percent. As you can see from this chart, in 1979 had this royalty formula been in place our royalties would have gone to 25 percent because of the oil price. And during that period the oil price went well over $30 a barrel. In 1985, as you can see by this chart, the oil price went down, but the royalty then went down to fifteen and a half percent and would have stayed at fifteen and a half percent under the current -- under the new royalty formula until 1989.

In 1989 the Gulf War happened. Had we been using this royalty formula the royalty would have gone to 21 percent, and then after the Gulf War the oil price went down and our royalty would have gone back down to sixteen and two thirds.

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
fifteen point five percent. We are proposing a sixteen and two thirds. Had this been in place back in '86 we would have gotten sixteen and two thirds plus we'd have gone up to twenty-one percent during the Gulf War. So it'd be about $20 million or so that we would have gotten since 1986.

Now, we had this downturn here, but that's really small compared to what we would have gained over the long haul.

So we want to bring this back to a sixteen and two thirds royalty not a fifteen and a half percent. And during the upturn when the oil prices are high we want to benefit by two things, getting a higher royalty rate, and, number two, getting the higher price. So the price goes up, the royalty rate goes up, we get a double-whammy; we get an increase in royalty rate, we get an increase in price.

The other advantage we have in this proposal is that we don't rely on posted prices any longer. Right now the way our lease is structured we are paid on posted prices. What we're proposing in this modification is that we are paid on the highest price that we obtain for any oil sold in that field. The state has the option to take its oil in kind. We can then market that crude and we will be paid royalty based on the price that we get for that crude.

Current evaluations are, and we've had an independent evaluation, of between 40 and 50 cents a barrel 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
different value range depending on the way other commodity
prices are trading in the world markets and importantly the
quality of the oil that is being taken out of the ground.
So that the oil that is represented in this particular
transaction is not the highest quality oil, it will trade at
a different level to par than would be true of the highest
quality oil that it available.

So I guess when I look at what you're proposing --
and I was intrigued by I think it's chart number 16.

MR. MOUNT: Okay.

COMMISSIONER CONNELL: Chart number 16, which is a
Shell Huntington Beach field chart.

MR. MOUNT: Right.

COMMISSIONER CONNELL: When I looked at this I
guess what I was trying to decide, you know, the gap that
you have here is our downside --

MR. MOUNT: Correct.

COMMISSIONER CONNELL: -- and really our upside
starts from 16.67 out. Now, as I understand it, this is a
12-year contract, is that right?

MR. MOUNT: Well, it will go on as long as the
field is economically feasible. It is estimated to be 12
years.

COMMISSIONER CONNELL: All right. Well, assuming
a base economic model of 12 years, then what you need to
determine is what is the state's ability to gain the upside of the additional royalty percentage that would kick in after the 17.50 level is reached. And if indeed we go out to infinity, which is the other possibility, that it's longer than 12 years, so it's x plus some number of years, then that upside would kick in for a longer period of time.

What I am concerned about in reading this material, Mr. Chair, is that I don't think we have those answers here today, and I would be concerned that we do not offer downside protection without understanding what the probability is of our upside revenue potential. Because when we offer downside protection we're offering an insurance policy, it seems to me, to Shell.

And I can understand that, I don't have a problem with the state offering downside protection if there is a likelihood -- the same probability that we're going to get the upside advantage that Shell gets on the insurance package on the downside.

Just looking at it casually as an economist, I would think that that cutoff point might be somewhere closer to 15.50 or $16 a barrel rather than 17.50, but I haven't done an econometric analysis and I would really like to share -- or have Shell share with us their analysis of probabilities as it relates to, I'm sure, the investment analysis that they've done.
I guess, Mr. Chair, where I am on this matter is that I think we ought to ask, unless there's a
time-sensitive component on this, I would like to ask that we table this to our next meeting because I am not opposed
to the way we're trying to structure this contract, I think we want to encourage Shell to develop a resource which has
economic value to the state, but I'm not certain that we have assurance that we're cutting the right deal given the lack of information we have.

MR. MOUNT: Well, let me say that maybe we have a lack of information to give to you at the moment, although we have analyzed those things you talk about.

Our analysis shows that, you know, we will not reasonably -- and statistically it shows it's a very small chance that we will ever get up into the 20 percent to 25 percent royalty range lacking a war or some big economic upset that would increase the price of oil, such as the Gulf War or such as the early eighties. So the likelihood that we get up there is very small. But again on the other hand, the likelihood that we go below the $14 a barrel for any extended period of time is also very small.

And if you want to compare the two, I don't have that analysis right here, but what we're seeing is that flat part of the line is where we anticipate being a great majority of the time and that the upside to this deal is
twofold. One is that we increase our royalty to sixteen and
two thirds from fifteen and a half. Secondly, we market the
 crude and we get forty to fifty cents a barrel more. And
there's really a third advantage in that they come in and
invest a million dollars a year, two million dollars a year
for the first couple of years, then five million dollars a
year thereafter and do the upper main zone water flood,
recover us more oil and make us more money that way.
So we're not banking on the fact that the oil
price is going to go up to make money. That's not what this
deal's intended to do. But they wanted some protection on
the downside and so we said, "Okay, if you want protection
on the downside then we want to reap the benefits on the
upside."

COMMISSIONER CONNELL: My point is you may never
reap the benefits on the upside.
MR. MOUNT: That's true.
COMMISSIONER CONNELL: And that's what I have to
be assured.
MR. MOUNT: That's true.
COMMISSIONER CONNELL: And, in fact, this is a
very simple probability analysis and statistical and
economic analysis and it can be quickly done.
MR. MOUNT: Correct.
COMMISSIONER CONNELL: And if I had all that
myself, historically, you could draw it up in literally a
half hour.

MR. MOUNT: Correct.

COMMISSIONER CONNELL: It's not a magical analysis
here. And I think that we ought to share that kind of
information with the Board --

MR. MOUNT: Okay.

COMMISSIONER CONNELL: -- so that we can justify
being willing to provide an insurance opportunity to Shell
and that we have done so at a price which is fair given our
judgment of the probabilities of market activity in
relationship to oil.

MR. MOUNT: One other thing I wanted to point out,
Commissioners, was the chart number 25. It's a couple back
from the previous one. It shows our State Lands proposed
royalty. And along with that are two others that are
working, one is the N&S royalty modification they recently
made with POI, which is an offshore producer, and the other
one is an Alaska British Petroleum model that they're
working on in Alaska. And in each of those cases our
royalty exceeds either one of those.

MALE VOICE: Thank you, Paul.

MR. MOUNT: Yeah.

COMMISSION CHAIRMAN DAVIS: Do you have any
questions?
I share some of the Controller's concerns, although I would note that there are economic benefits to the state beyond simple royalties. I gather there's a number of people who would continue to work over a sustained period of time if this well is not abandoned and if the water flooding proceeds?

MR. MOUNT: Correct.

COMMISSION CHAIRMAN DAVIS: Would you speak to that for a moment?

MR. MOUNT: Yes. There's been an economic analysis done on the impact on the local economy and on the State of California.

COMMISSION CHAIRMAN DAVIS: Who did that analysis?

MR. MOUNT: That was done by Dr. Anderson, and she's here in the audience to speak to that.

COMMISSIONER CONNELL: Who is she employed by?

MR. MOUNT: Dr. Anderson.

DR. ANDERSON: Cal State Northridge.

COMMISSIONER CONNELL: No. But who paid for the analysis?

MR. MOUNT: I believe Shell did. Is that correct?

COMMISSIONER CONNELL: Okay. I think we should always disclose who --

COMMISSION CHAIRMAN DAVIS: I would like to hear from her when you're --
MR. MOUNT: Sure. But, yes, there has been
analysis done, and, actually, she's better qualified to
speak than I am on that. If you don't mind I'll have her
come up.

COMMISSION CHAIRMAN DAVIS: All right. One thing
that occurred to me, and I mentioned this to our Executive
Officer when he was briefing me, you know -- first of all,
for the record, I, too, think that it's appropriate for the
state to kind of ride the tiger of oil prices. I mean I
don't -- I'm not philosophically opposed.

As a matter of fact, at some earlier Commission
hearings some of the attendees may recall my asking some of
the companies that wanted us to give permission to reduce
their royalties if they would, for fear that oil prices
would go down, if they would raise their royalties if prices
went up. So they've sort of called my bluff on this, and I
appreciate that and I think that's a risk that we should be
willing to accept.

My only concern is that the Commission have an
independent analysis, maybe from the UC system, and maybe
there's some other arbiter on this subject that could give
us his or her analysis as to whether the particular formula
that we've had presented to us today makes the most sense.
And it may well. I'm not saying it doesn't. I don't have a
bias for or against it. I was hoping the Attorney General
would opine on that, but Jan was unwilling to opine on the
business efficacy of such a move.

(Inaudible comments from the floor.)

COMMISSIONER CONNELL: What an appropriate answer.

(Laughter.)

COMMISSION CHAIRMAN DAVIS: You'll pay for dinner
next time.

(Laughter.)

COMMISSION CHAIRMAN DAVIS: If you'll recall, the
one time we have done this since I've been on this
Commission, which is eight years, at least one time I recall
doing it, is when we reduced the prices for ARCO when it was
investing $100 million to water flood the leases in Long
Beach.

MR. MOUNT: Correct.

COMMISSION CHAIRMAN DAVIS: Now, there we did
not -- we had no upside potential, just the assurance that
if more oil was developed then we'd have more royalties.
However, that was reviewed by the Attorney General and he
opined specifically on the formula. The Legislature passed
a bill validating the formula and the Governor signed it.
So we had a lot of people concurring in the wisp of that
transaction. That's effectively what I'd like to recreate
here to the best we can. I'm not conceptually opposed to
it.
Does the staff or the Commission members have any thoughts as to who might be an appropriate -- you look so worried over there -- who might be an appropriate --

MR. MOUNT: Mr. Chairman, we have what we think are some independent economists who we think would -- could help us and whose expertise is in the oil industry.

ACTING COMMISSIONER PARKER: What time frame for doing that?

MR. MOUNT: I think we could do that in a month.

COMMISSION CHAIRMAN DAVIS: That they could just come present their findings.

MR. MOUNT: Yes.

COMMISSIONER CONNELL: Do we competitively bid these contracts?

MR. MOUNT: No, this would be sufficiently low that it would not require competitively bidding.

(Cross conversation.)

COMMISSION CHAIRMAN DAVIS: Anybody in the UC system.

MR. MOUNT: Yes, yes. Definitely.

COMMISSIONER CONNELL: A couple of people at UCLA.

MR. MOUNT: Yes.

COMMISSION CHAIRMAN DAVIS: Well, my concern is do other states use formula's like this?

MR. MOUNT: They're working on them. Like I
showed you, Alaska's working on a very similar formula.

You know, we have the authority to modify the royalty on a lease given, one, that you don't reduce the ultimate revenue you would have gotten from the primary recovery. And generally that's done for a water flood or something to enhance the recovery on a lease, and the Commission has done that fairly routinely in the past.

Long Beach was a special deal and very complicated, and it was very successful, I might add. And this is also different from the norm. So scrutiny by a third party would probably be well worth our effort.

COMMISSIONER CONNELL: Well, Mr. Chair, may I modify my proposal then, or my motion? I move that we table this agenda item to our next meeting and that we request that staff retain a proper advisor to perform the economic analysis.

COMMISSION CHAIRMAN DAVIS: Do you have any thoughts on that?

ACTING COMMISSIONER PARKER: I think the (tape cuts out) what oil prices may be (tape cuts out) if there are not, future investments may not, and I think that's an important consideration in the overall analysis.

MR. MOUNT: And we will do that. And with that motion we'll --

COMMISSION CHAIRMAN DAVIS: I would like you to at
least exhaust efforts at the UC system to see if there's --

MR. MOUNT: We will.

COMMISSION CHAIRMAN DAVIS: -- a department or a
department head or consultants that they've used on this
issue.

MR. MOUNT: We'll find somebody.

COMMISSION CHAIRMAN DAVIS: And, again, I'm
inclined to be supportive of this formula if I'm assured
that this is a reasonable approach. But just from a
layman's perspective, you'd have to conclude that Shell is
betting that the price of oil will fall.

COMMISSIONER CONNELL: Well, one does not buy an
insurance policy unless there's some probability that you're
going to need to use it. I don't think we have to worry
about what level of probability that is, but I'd just like
to know that we have a probability of winning on the upside
as well.

COMMISSION CHAIRMAN DAVIS: No. But, I mean, just
to be specific here, they're willing to pay an increased
royalty of sixteen and two thirds if the price of oil
remains where it is.

COMMISSIONER CONNELL: That's what evoked my
original concern, Mr. Chair.

COMMISSION CHAIRMAN DAVIS: It's quite possible, I
usually accord this to the private sector, that they know
more than we do.

MR. MOUNT: Well, let me point out that the current royalty formula is one -- there are different royalties on different leases, and in your package it shows that. And it's very complicated for the oil company and the State Lands because we have people that have to verify each one of these royalties by lease and it actually is a problem with bureaucracy, and the companies don't like it and we don't like it because we have to spend money to monitor these royalties.

If we consolidate, make it one royalty on all the leases, they're willing to give us sixteen and two thirds just to get rid of the headache for accounting for all this oil. And we have the same problem. In fact, this will allow us to reduce the scrutiny on this so that the accounting and the accounting requirements are much less than they are today.

ACTING COMMISSIONER PARKER: But they're not willing to do that essentially as trade for the elimination of the bureaucracy for increasing the current royalties from fifteen and a half to sixteen and two thirds and just let it go at that as opposed --

MR. MOUNT: They might be, but then they might not be willing to make the investment either. They probably would be, you're right.
COMMISSIONER CONNELL: Well, I think this is what the -- the analysis should clearly be multivariate in nature and you want to look at alternative scenarios. I mean you don't want a singular analysis.

MR. MOUNT: Okay.

COMMISSION CHAIRMAN DAVIS: Why don't we use this opportunity to have them offer any guidance they want our current royalty system with everybody? Because if there's a way in which we can simplify the lives of our lessees and generate more revenue for the state, obviously, we should explore that. I would also like the analysis to try and quantify the value of our being able to market the oil ourselves.

MR. MOUNT: Mr. Chairman, I think, depending upon your pleasure, Shell would like to say just a few words.

COMMISSION CHAIRMAN DAVIS: And, again, not to repeat the obvious, but I applaud the lessee for making a proposal that may well have merit and that this Commission may well adopt. I don't anticipate the process we're going through to unduly delay the decision. Hopefully we can make a decision at the next meeting. But you'll understand our caution never having gone down this path before. And believe me, if the price of oil drops they're not going to be blaming Bob Hight, they'll be blaming Kathleen Connell and Gray Davis. So --
COMMISSIONER CONNELL: This is correct.

COMMISSION CHAIRMAN DAVIS: -- if it goes up, you know, nobody knows from us either.

(Cross conversation.)

COMMISSION CHAIRMAN DAVIS: Now, who wanted to be heard from Shell? And then we'll hear from the professor from Cal State Northridge.

MR. CHRISTENSON: My name's Tom Christenson. I'm an asset manager with Cal Resources, operator of Huntington Beach, on behalf of Shell.

I understand the economic concerns of the Commission, and, you know, rather than trying to get into economic principals and probabilities, I'd just like to make a few points for the Commission to ponder on while the number crunching goes on.

If you look at the current state of Huntington Beach as it stands right now, you know, we're making no money. The state's royalty revenues are at risk, as Ms. Parker pointed out. And we do have an imperatibility to develop and recover both the developed and undeveloped reserves. That's as it stands today.

If you look at what this agreement has the potential to do for us, if we come to agreement on the specifics of it, is a classic win/win between the industry and the state and the governments and the community. It
specifically addresses some of the concerns around the sixteen and two thirds. I think what the state gets clearly is a little over a one percent increase in royalty right off the bat.

Countering that, the concern that, you know, Shell's willing to give that up, that they must be -- there must be something that we don't know. And, you know, I would offer what we get out of that I think is essentially a wash. Because, in fact, our operating costs and administrative costs will probably go down by about the amount that the royalty goes up. So that part of it to us is essentially a wash.

But going on, I think that the government then, the state, continues to get the sixteen and two thirds percent royalty under most probable price scenarios. They have a much higher probability of enjoying the revenues from future development of the upper main zone, as Mr. Mount pointed out. Lower administrative costs. They can direct their staff to a number of things that add a lot more value than counting the barrels that go across the Shell lease. They can look at some of these issues of marketing crude and that kind of thing that will really bring the state an unquantified enhanced value.

The state does enjoy participation in a higher price world. You know, if we're all fortunate enough to be
in that environment, both ourselves and the state will enjoy some of the benefits. Socioeconomic impacts, which you'll hear much more about from a much more authoritative source than myself so I won't try to dip into that, but we do have considerable community support. I think that the mayor and the chamber of commerce have sent in letters on our behalf.

And, finally, I think the state gets some assurance that Cal Resource -- there's a high probability that Cal Resources and Shell will be there as a continued operator, and I think we have a good record and we're a responsible operator.

What we get, we get one leg of I think a three-legged stool for Huntington Beach. Royalty modification is one of those legs. We're actively looking at cost structure improvements. We've engaged McKenzie & Associates to help us do that. They're on the lease now. We're hopeful that our basic cost structure will be helped. And we also need to make sure that we spend our capital as efficiently as we can. And all those are things that we're looking at actively.

As I said, offsetting what we're giving to the sixteen and two thirds, we are getting something for that, irrespective of what we do at the upper main zone, and that's reduced operating and administrative costs that we think are probably going to offset that. So that alone, in
my mind, is a win/win for both of us.

We do have an incentive, then, to go on with development of reserves. We do have a hedge in insurance policy against lower prices. I think the counter to that goes a little bit beyond the probabilities of a high price environment. But the state's real upside, the real win for the state, is that they do get -- that this scheme does not kick into place unless the upper main zone is developed and the state then reaps the increased volumes and the royalties that go with that.

And the final thing that it gives us is a way to weather the bad times. A year ago we found ourselves in a $9 world losing considerable money. Our premises and industry projections said better times are ahead and we just kind of had to hold our breaths for about six or nine months. So that was a difficult time for us, we weathered that, but, you know, this sliding scale will kind of balance the scales on that.

So that was the extent of my remarks.

COMMISSIONER CONNELL: Do you have any problem with our moving forward with undertaking an economic analysis and engaging an outside advisor to assist us in that?

MR. CHRISTENSON: No, I don't have any problem at all if that would make the Commission more comfortable with
the recommended proposal. Yeah, that's fine. And we'd be
happy to provide any information or support that we could to
help that and expedite it.

COMMISSIONER CONNELL: I appreciate that. I think
it will make it an easier analysis for us.

COMMISSION CHAIRMAN DAVIS: There's even the
possibility that the independent analysis may suggest
another royalty scale that you find to your liking. I
notice under this one there's a big swing if the price of
oil goes from $14 down to $13. But there may be a way to
ensure you against the downside of declining oil prices
other than the formula you've presented, or this formula may
be absolutely perfect and we have a third party so indicate.

MR. CHRISTENSON: I think we're willing to engage
in discussion over any scheme. I don't think we're proud
enough to claim that we got the only scheme that'll work.
I'm sure there's lots of ways to skin the cat.

COMMISSION CHAIRMAN DAVIS: That's a good
attitude. Thank you.

Do you have any questions?

ACTING COMMISSIONER PARKER: No.

COMMISSION CHAIRMAN DAVIS: Did you have some
further comments you want to make?

MR. CHRISTENSON: No. That was all the comments.

COMMISSION CHAIRMAN DAVIS: No further questions
from the members. Thank you very much.

    Let's see. We also had --

COMMISSIONER CONNELL: Have we voted on the
motion, Mr. Chair?

COMMISSION CHAIRMAN DAVIS: Well, the Executive
Officer asked us to allow the people who'd come here to
testify to testify, so --

COMMISSIONER CONNELL: Oh, all right. We have
more people?

COMMISSION CHAIRMAN DAVIS: -- we'll give him the
courtesy of two more.

Tony Lansor, who is a staff engineer.

(Inaudible comments from the floor.)

COMMISSION CHAIRMAN DAVIS: Thank you, sir.

And then, finally, Dr. Anderson, who performed
this analysis. She's with the School of Business and
Economics at Cal State University.

Would you mind just sharing with us, Doctor, some
of your comments about the other economic benefits
associated with this undertaking in terms of employment and
job retention and anything else you care to share with us?

DR. ANDERSON: (Tape cuts out) quantitative
outputs from the input/output analysis that --

FEMALE VOICE: It's the last page.

DR. ANDERSON: Yeah. Exhibit B, and it's the last
COMMISSION CHAIRMAN DAVIS: Okay. This is loss of 407 jobs?

DR. ANDERSON: That's right. So while you're looking at that, what I wanted to tell you was about the background of that study which had the purpose of showing the impact on the Huntington -- well, on the Orange County/Los Angeles County area. On the local area, not on the State of California. And that was using Shell data and measuring the output on jobs, wages, taxes, output, et cetera, using an input/output method which will measure direct and indirect effects.

That results were the high employment multiplier of five, for example, meaning that every job that Shell would -- additional job that would be -- Shell would have in Huntington Beach would employ a total of five people in that LA/Orange County area. That's a high employment multiplier and it goes along (tape cuts out).

COMMISSIONER CONNELL: Okay. Can you explain the multiplier to me? Five is a very high multiplier. How did you get to that number?

DR. ANDERSON: All right. As you probably are aware of, Kathleen, the input/output process is one of relating industries to each other as customers and suppliers to each other, and the technical purchase coefficients are
available by county so that you can figure out the average. That if Shell, for example, spent a million dollars in the Huntington Beach area it would be purchasing, say, material from tool makers and the tool makers would themselves then have money to spend in that local area. In the same way that when they employed additional people, that those tool pushers would be spending money in the grocery stores and drug stores of the area.

So when you take those indirect effects and add them to the direct impact of that initial million dollar impact, you're coming up with, in this example, something like one and half million dollar impact on the local area.

And in terms of additional job -- of direct Shell employment, that high paid Shell employee would stimulate enough additional spending in the local area that it would employ a total of five other people -- or four other people, five including himself. That's a very high --

COMMISSIONER CONNELL: But most of it in the retail community.

DR. ANDERSON: No, actually it affects almost every sector in the economy, but construction, transport, retail trade, yes, and services, but much blue collar and professional employment. And I think for this -- this is an unusual industry in the sense that it does kind of impact the blue collar and professional and managerial class as
much as it does. It pays good taxes and produces a (tape cuts out) reason my own feeling is that you're -- you've got a good bet here on this horse in the sense that this is not a declining demand industry. This is an industry that's temporarily beset by competition.

The prediction of future prices may be very difficult by trend, as we noted in 1974 when the price temporarily crashed because of a breakdown of a cartel agreement. And of course the many uses of oil in war and so forth make the price fluctuations I think serious in this industry and difficult I think to predict by trend, although --

COMMISSIONER CONNELL: Surely Shell must have made some prediction or they wouldn't be asking for a downside protection, though. I mean I have to assume --

DR. ANDERSON: (Cross conversation) -- lived through a history of downside long enough that they have decided they better do something about it.

COMMISSIONER CONNELL: That is my whole point, that if they obviously did the rigors of economic analysis to determine what their probability was for downside production to a point where they felt it was necessary to have downside protection insurance to move this deal forward, then we need to understand how likely it is that the downside will occur and what is the likelihood that we
will benefit from the upside.

Obviously somebody did an economic analysis at Shell to come to that conclusion, so they must have used some kind of historical trend information that they're comfortable with.

DR. ANDERSON: Yeah. Historical trends, however, have broken down in this industry in the past. That was my point about 1974. But at any rate, what is very good here and that you can't lose on unless there's an abandonment, is the fact that things are being done efficiently by having that Huntington Beach field open and close to the market.

The fact that you've got a field that can pump its oil into a refinery close to the market using a safe and low-cost means of transportation in an industry in which transportation costs are serious is a very efficient set-up and one that I would think you would probably want to preserve. It is probably also more environmentally sound for the local economy to use those pipelines going from the field to the refinery than to have to import foreign or oil from other states either by ship through our port or by tank truck over our -- the California roads and streets.

COMMISSION CHAIRMAN DAVIS: Let me interrupt you for a second. Isn't the well currently -- aren't the wells currently being worked?

DR. ANDERSON: They are being worked, right. So
I'm talking in terms of the continued production of these wells, are doing -- are using those scarce resources as efficiently as could possibly be done. An alternative, I don't think you could find a more efficient or effective set-up.

COMMISSION CHAIRMAN DAVIS: I agree with that.

DR. ANDERSON: And, in fact, I would say just the benefits of the Shell lease operation, of maintaining that operation and encouraging the continued investment in that field, are not only these state taxes of around $7 million a year and local taxes, direct and indirect, of over $3 million a year an efficient and safe production of an essential base product, which is an import to many other industries in California, but also the high wage scale, the support for a weak local economy in a high unemployment area -- this area has really suffered -- and the preservation of that blue collar upward mobility ladder that we like to talk about but that California's seen a big drain on.

So I would bet on the lease royalty modification as being a good investment for the citizens of California, even without having a forecast in what the petroleum price is going to be.

COMMISSION CHAIRMAN DAVIS: Thank you.

MALE VOICE: There's one other individual who's indicated they desire to speak.
COMMISSION CHAIRMAN DAVIS: Are there any questions from the members?

ACTING COMMISSIONER PARKER: Nothing.

COMMISSION CHAIRMAN DAVIS: No. Thank you.

MALE VOICE: And I don't know whether Mr. Davis desires to speak.

COMMISSION CHAIRMAN DAVIS: Mr. Davis of the Huntington Beach Chamber of Commerce.

Great last name.

(Laughter.)

MR. DAVIS: I was going to say, no relation to the Chairman.

COMMISSIONER CONNELL: I was just going to ask that question.

(Laughter.)

(Cross conversation.)

MR. DAVIS: I just wanted to throw a quick comment in on behalf of the business community and the Chamber of Commerce, and, in fact, the City of Huntington Beach. I'm very active in all those areas.

And being past president of the chamber and presently on the board of directors, at our February 23rd meeting, I won't bore you with reading it, it's in the file, but the Chamber after lengthy discussion very, very strongly recommend that something be worked out. And we're not
getting into the numbers on that.

What we're saying is that it's very important in several areas, and I think the preceding speaker mentioned the blue collar employment, which is very important to us.

And really the gist of what I wanted to say, Mr. Chairman, is that in Huntington Beach, as in most cities, we have an economic support program through the Chamber, city staff and so forth, and we're very interested in some objectives to retain and attract businesses, number one, and believe me, we want to retain this business in the City of Huntington Beach. It's economically very important to us.

To add jobs, it does that, and, of course, we're interested in our existing business increasing their productivity, and that's kind of part of what the plan is.

We believe it's a win/win situation. And I won't take anymore of your time except to say that we feel that it's real easy to support a fine corporate citizen like Shell. We really don't want to have to break anybody else in in the City of Huntington Beach.

Thank you.

COMMISSION CHAIRMAN DAVIS: Does anyone else care to offer any comments on this proposal from the public?

And we have a motion before us, which is to postpone this decision to the next meeting, at which time we'll have an independent analysis, hopefully from the
UC system, but at least from a reputable third party who
will advise the Commission whether the particular formula
before us is appropriate, and if not what if any changes
would make, and among other things would quantify the value
of having a right to market oil ourselves as part and parcel
of this contractual adjustment.

Have I stated the motion correctly?

MALE VOICE: I think you got all the elements.

COMMISSION CHAIRMAN DAVIS: Close enough?

COMMISSIONER CONNELL: That's good. That's fine.

COMMISSION CHAIRMAN DAVIS: All right.

Everybody's for it. It's unanimous. So the motion passes.

MALE VOICE: Thank you, Mr. Chairman.

The last item then is Item C7, which is the SMUD
issue. And Mr. Trout has been out in the hall negotiating
as we've been here.

ASSISTANT EXECUTIVE TROUT: Mr. Chairman, we've
reached agreement on the language in the calendar item and
in the lease regarding the SMUD lease. We have agreed that
the two amendments to the calendar item should be approved
as submitted. One of the amendments is to change the land
use and purpose so that the gas line could be used to supply
any of SMUD's power plants, and, second, that it could be
used for plants or facilities of the State of California.

Second, SMUD has agreed to an additional clause
which would provide that unless they are prohibited by law, they will negotiate with the state to allow the state to use excess capacity on terms and conditions that are market based. And with that, subject to final approval by the Commission and by SMUD of the agreement, we would ask your approval of this lease and this calendar item.

The representative of SMUD here is to I hope agree with that analysis. And this would allow SMUD to proceed with their leasing and their acquisition of the pipes and it gives the state the access that it needs unless there is some specific prohibition in law, which has been the concern of SMUD.

ACTING COMMISSIONER PARKER: Jim, you said final agreement between SMUD and General Services?

ASSISTANT EXECUTIVE OFFICER TROUT: And us.

ACTING COMMISSIONER PARKER: And State Lands. All three?

ASSISTANT EXECUTIVE OFFICER TROUT: Yes. Right. We will act for General Services.

Mr. Steve Cohn with SMUD.

MR. COHN: Thank you. Mr. Chairman, members of the Commission, my name is Steve Cohn, I'm an attorney for SMUD. I did have with me a letter from our General Manager, Jan Shori, that I wanted to distribute.

Since Ms. Shori signed the letter, we've had the
subsequent discussions that Mr. Trout referred to. And I am
prepared to recommend these changes to the General Manager
and my board. The one caveat I have to tell you, it is
subject to their approval because it's on the agenda for
this afternoon's meeting and, you know, they would not have
seen this language previously. But I will certainly
recommend it to our board as outlined by Mr. Trout.
I might add, this came as sort of a last minute
item and that's why it wasn't noticed in our SMUD Board
agenda.

So I'd be happy to answer any questions.
COMMISSION CHAIRMAN DAVIS: Do you think it's
appropriate the Commission act first or --
MALE VOICE: Yes, Mr. Chairman. I think that
there's adequate grounds to do that and that the conditions
are appropriate.
COMMISSION CHAIRMAN DAVIS: Any questions,
Commission members?
COMMISSIONER CONNELL: No. I'm delighted we've
been able to so quickly negotiate the conditions,
surprising, in the couple of hours that they've had. I'm
ready to move forward if staff and SMUD and others are
comfortable with it.
ACTING COMMISSIONER PARKER: Is that a motion?
COMMISSIONER CONNELL: Yes, that is my motion. I
move that we approve this with the conditions now indicated by staff in the staff presentation.

COMMISSION CHAIRMAN DAVIS: Before we vote, is there anyone here present that would care to oppose this matter?

ACTING COMMISSIONER PARKER: I concur.

COMMISSION CHAIRMAN DAVIS: All right. Then it's unanimously approved.

MALE VOICE: Thank you, Mr. Chairman. That concludes the agenda for today.

COMMISSION CHAIRMAN DAVIS: Any matters any members want to bring up?

We stand adjourned.

(Thereupon, at 2:00 p.m., the meeting was concluded.)
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: Lum Wellman

DATED: 3/17/95