

CALIFORNIA STATE LANDS COMMISSION

ANNUAL STAFF REPORT ON THE MANAGEMENT OF STATE SCHOOL LANDS

Fiscal Year 2003-04

CALIFORNIA STATE LANDS COMMISSION

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

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INTRODUCTION

The California State Lands Commission (CSLC), through its State School Lands Management Program (Program) manages approximately 473,000 acres of school lands held in fee ownership by the State, and the reserved mineral interests on another 790,000± acres of school lands where the surface estate has been previously sold. Management of the Program is split between two CSLC divisions, the Land Management Division (LMD) and the Mineral Resources Management Division (MRMD). The LMD is responsible for the Surface Management Program under which all surface resources on school lands, with the exception of mineral activities, are administered. The MRMD is responsible for the Geothermal, Mineral, and Oil & Gas Programs, which involve the leasing of school lands for geothermal resources development, mining activities, and oil and gas development.

School lands were placed into statutory trust in 1984 when the State Legislature approved the School Land Bank Act (Act), created the School Land Bank Fund (SLBF), and designated the CSLC as trustee of this fund. The Act added Sections 8700 through 8716 to the Public Resources Code (PRC), which set forth the management guidelines for the Program. The Act directs that school lands be proactively managed and enhanced to provide for an economic base in support of the public school system. PRC Section 8702 spells out specific findings and declarations made by the Legislature, emphasizing the development of school lands into a permanent and productive resource base and requiring that all transactions, including exchanges, sales, and acquisitions, be implemented for revenue generating purposes.

Pursuant to PRC Section 6217.7, all net revenues, monies, and remittances from the sale of school lands are directed to be deposited in the State Treasury to the credit of the School Land Bank Fund. PRC Section 6217.5 directs all net revenues derived from the use of school lands (for example, royalties, rents, and interest generated from promissory notes) be deposited into the State Treasury to the credit of the Teachers' Retirement Fund, which benefits the State Teachers' Retirement System (STRS). With the CSLC serving as trustee for the SLBF, a fiduciary relationship exists between the CSLC (trustee) and STRS (beneficiary), and obligates the CSLC to make school lands productive, primarily in financial terms, for the beneficiaries of STRS. This fiduciary responsibility includes protection of trust assets as well as the generation of revenue.

The CSLC's emphasis in administering the Program has been: 1) the maximization of revenues from school lands assets, 2) the continued implementation of the California Desert Protection Act Exchange Program, and 3) protecting the corpus of the trust. Net revenue transferred to STRS during Fiscal Year 2003-04 was \$3,672,836.86. Net revenue deposited to the SLBF was \$1,249,353.44, resulting in a fiscal year end balance of \$48,346,522.19. Management expenses for the Program in FY 2003-04 were \$1,188,278.59, which represented a 16% decrease from FY 2002-03 expenses. For a summary, see the table entitled "Financial Summary: Fiscal Year 2003-04" (page 29).

The *Annual Staff Report on the Management of State School Lands* is prepared pursuant to PRC Section 6477. The major activities for each of the Program components for FY 2003-04 are described in the following pages.

SURFACE MANAGEMENT PROGRAM

The Land Management Division is responsible for the Surface Management Program, which oversees all surface activities on school lands with the exception of mineral activities. These activities include land exchanges and sales of school lands parcels to public and private entities, acquisitions of lands to enhance the resource base, and issuance of leases for various purposes such as agricultural, grazing, and rights of way for roads, oil pipelines, gas pipelines, and electrical transmission lines. Activities also include the management of approximately 36,500 acres of commercially harvestable timberland. The objectives of the program are to manage surface uses to generate revenue, assure ongoing viability of the resource, protect the corpus of the trust, enhance local economies, and protect the environment. These goals are accomplished through management and development techniques that maximize the economic return to STRS and the SLBF. For a summary of the revenues generated to STRS and the SLBF through this program, see the table entitled "Summary of Revenue Generated From Surface Management Program: Fiscal Year 2003-04" (page 9).

UPDATE: CALIFORNIA DESERT PROTECTION ACT OF 1994

On October 31, 1994, the California Desert Protection Act (CDPA) was signed into law by the President of the United States (Public Law 103-433). The CDPA designates 3.6 million acres in southern California as wilderness to be administered primarily by the Bureau of Land Management (BLM), and designates an additional 4 million acres in southern California to be included in the national park system.

The purpose of the CDPA is to set aside areas in the California desert to protect its natural, cultural, scenic, and historical values, and to provide for public enjoyment. 442 parcels (approximately 251,000 acres) of fee-owned school lands and over 100 parcels encumbered by the State's reservation of mineral interests were identified within the boundaries of the CDPA.

Section 707 of the CDPA provides for the exchange of the school lands located within these designated areas for other federal lands located outside of these areas. The CSLC receives compensation for the exchange of its fee and mineral interests on a value-for-value basis as determined by fair market appraisals. Compensation for the State's assets may be made in various forms including cash or exchange for other lands.

To date, there have been five CDPA land exchange transactions completed with the BLM. In the first transaction, completed in September 1996, 5,646 acres of school lands were transferred to the BLM. The value of these lands, \$992,686, was deposited into the SLBF. In June 1997 a second transaction resulted in \$144,000 being deposited into the SLBF after 800 acres was transferred to the BLM. The third transaction, valued at \$13,155,120, was completed in November 1997 and involved 57,309 acres of school lands that were transferred to the BLM. In exchange, the CSLC acquired a 100-acre federal surplus parcel in Pomona and immediately sold the acquired land to the city of Pomona. While the previous two transactions were all cash, and resulted in deposits to the SLBF, the Pomona sale was accomplished by the CSLC carrying a note secured by a deed of trust. Principal reduction payments were made on the note and deposited to the SLBF while interest payments were transferred to the STRS Fund. A total of \$1,563,622.60 in interest was earned and credited to STRS before the note was paid off in December 2001. The fourth transaction resulted in the CSLC acquiring 658 acres of federal lands located within the Chocolate Mountains area of San Bernardino County. The lands were acquired with the intent of potentially generating revenue to STRS through gold mining activities. The CSLC has not yet compensated the BLM for the value of these lands. During FY 2003-04, a fifth CDPA land exchange involving the CSLC, the BLM, and the Metropolitan Water District of Southern California (MWD) was completed, whereby 2,560 acres of school lands were transferred to the BLM in consideration for a cash payment of \$456,900.

During FY 2003-04, work continued on a sixth CDPA land exchange, which will entail school lands worth approximately \$8.5 million. This exchange is scheduled for completion in late FY 2004-05 or early FY 2005-06. For more information see "Potential School Land Bank Fund Revenues, Bureau of Land Management" (page 11).

Due to a complex review and revision by the Bureau of Land Management of the federal standards and guidelines involving federal lands transactions, progress on the sixth proposed CDPA/CSLC land exchange was slowed substantially during FY 2003-04. All transactions involving federal lands now require review by the Department of the Interior in Washington, D.C. As a consequence, the time necessary to complete exchanges with the BLM has been extended.

At the close of FY 2003-04, there were 326 parcels of school lands containing a total of approximately 185,400 acres within the designated national parks, monuments, preserves, and wilderness areas available to exchange with the BLM.

FISCAL YEAR 2003-04 ACTIVITIES

STATE TEACHERS' RETIREMENT SYSTEM FUND REVENUES

Total revenue deposited into the STRS Fund from surface management activities in FY 2003-04 was \$241,025.92. This money was generated from the following transactions:

Surface Rental Income and Revenues

Most of the 473,000± acres of school lands are isolated, landlocked parcels, with the majority being non-productive desert lands. However, close to a quarter of the total school land acreage is leased for revenue generating purposes. Rent received during FY 2003-04 from approximately 140 revenue-generating leases totaled \$232,673.66. General surface leasing involves ongoing activities, including processing new applications, re-issuing expired leases, processing lease assignments and amendments, conducting rent reviews, terminating old leases, and conducting other surface management activities. Income from the prosecution of a trespass on timbered school lands in Mendocino County generated \$544.00. An additional \$970 plus interest is still owed on this account and is expected to be collected in FY 2004-05. Income from investments provided an additional \$7,808.26, the amount of interest collected during FY 2003-04 from the City of Shasta Lake pursuant to their purchase of school lands in FY 1999-00.

SCHOOL LAND BANK FUND REVENUES

Principal revenue from three school lands transactions (described in the following three paragraphs) totaled \$500,119.26. The total accrued interest earned on the SLBF during FY 2003-04 was \$723,024.51. A total of \$1,223,143.77 in revenue was generated to the SLBF during FY 2003-04. In addition, \$28,189.47 was received from the Department of General Services as a refund on the Eureka/Arcata Office Building Feasibility Study contract. The Commission in 2001 authorized this contract, which had an original amount of \$30,000.

City of Shasta Lake Land Sale (SA 5752)

The City of Shasta Lake made two principal payments totaling \$37,519.26 on its loan from CSLC for the purchase of a school lands parcel that occurred in FY 1999-00.

Caltrans State Highway 247 Land Sale (SA 5757)

The California Department of Transportation (Caltrans) purchased 7.15 acres of school lands for a road improvement project for State Highway 247 in San Bernardino County. The completion of this sale resulted in a deposit of \$5,700 into the SLBF.

BLM/Metropolitan Water District Land Sale (AD 384)

Staff completed a three-party land exchange between the CSLC, the BLM and the Metropolitan Water District of Southern California (MWD). The CSLC transferred title to four school lands parcels totaling 2,560 acres to the BLM in consideration for a cash payment from MWD. The parcels are located within federal wilderness areas. In return for this cash payment, MWD received title to federal lands to include in its aqueduct facility. \$456,900 was deposited into the SLBF from this transaction.

Accrued Interest on the SLBF

The total accrued interest earned on the SLBF during FY 2003-04 was \$723,024.51. Accrued interest earnings declined from the previous year due to the lower interest rates that resulted from the general downturn in economic conditions.

Refund from Eureka/Arcata Office Building Feasibility Study

In April 2001, the CSLC authorized staff to contract with the Department of General Services (DGS) for a feasibility study to investigate a potential investment in an office building in the Eureka/Arcata area. The proposal involved a plan that would consolidate several State agencies in one building, with the ends of increasing the operating efficiency of the agencies while providing a long-term rental income to the SLBF. The project was terminated in FY 2003-04 when it was determined that the plan was not financially feasible. A refund of \$28,189.47 from the original contact of \$30,000 was received from DGS in March 2004 and re-deposited in the SLBF.

Other SLBF Activities - Downey/CDPA Land Transaction (W 24480/AD 385)

Over the last several years, staff has been participating in a complex five-party land exchange involving the BLM, General Services Administration (GSA), National Aeronautics Space Administration (NASA), CSLC, and the City of Downey (City). As originally proposed, the CSLC was to take title to approximately 96 acres of federal surplus land (a former NASA site) located in Downey, in exchange for comparable value of school lands, in accordance with the provisions of the CDPA. The City then was to purchase the acquired land from the CSLC pursuant to the School Land Bank Act. However, during

FY 2002-03 the transaction was re-negotiated when the CSLC withdrew from the transaction because of liability issues related to the cleanup of environmental pollution associated with the property. Under the new sales agreement that closed in FY 2003-04, the GSA transferred the surplus lands directly to the City, thereby eliminating the CSLC from the chain of title and minimizing the CSLC's liability. Although this transaction did not result in a direct deposit into the SLBF, the CSLC's CDPA program benefited from the GSA's sale of the property because \$500,000 from the sale was credited to the SLBF to be used for future land exchanges with the BLM.

SCHOOL LAND BANK FUND INVESTMENTS AND OTHER ACTIVITIES

With the enactment of the School Land Bank Fund Act in 1984, the CSLC was given the authority, as trustee for the SLBF, to select and acquire real property or any interest in real property with funds contained in the SLBF with the objective of facilitating management of school lands for the purpose of generating revenue (Public Resources Code Sections 8705, 8711, and 8712). To accomplish this objective, staff has undertaken several investment studies to review and analyze potential investment alternatives for the SLBF monies.

Agricultural Property Investment (W 25759)

In 2001, staff received a consultant's report entitled "Planning for Agricultural Land Investments in California". The report concluded that agricultural properties could be suitable investments for SLBF monies and developed a set of investment criteria that would minimize risk while maximizing long-term returns. The contract with the consultant, Agland Investment Services, Inc., was extended during FY 2002-03 to provide assistance to staff in the identification and selection of potential agricultural investments.

In June 2003, staff received authorization from the Commission to issue a Request for Proposals (RFP) for the purposes of awarding and executing a new contract for an agricultural investment consultant to assist staff with the identification, purchase, and long-term management of suitable agricultural properties. The contract was awarded in October 2003 to Agland Investment Services, Inc.

With the professional assistance of the consultant, staff expects to make purchase(s) of one or more agricultural properties during FY 2004-05. For further details on the progress of investment in agricultural properties, see the discussion under "Fiscal Year 2004-05 Planned Activities, Potential Land Bank Fund Investments – Agricultural Investments" (page 13).

Barstow Property Development (SA 5760)

One of the prime properties in the school lands portfolio is a $33.49\pm$ acre parcel of vacant commercial land located at the northwest corner of L Street and Interstate 15 in Barstow, San Bernardino County. In March 2004, staff received an application from Home Depot, U.S.A., Inc. (Home Depot), for the purchase of a portion of the property. After reviewing the application, staff proposed to the applicant that the proposed sale be offered to the public through an open bidding procedure as an RFP. As FY 2003-04 came to a close, Home Depot agreed to act as the Project Nominator for the RFP, which is expected to be released in FY 2004-05.

For further details on the progress of the Barstow property RFP, see the discussion under "Fiscal Year 2004-05 Planned Activities, Potential School Land Bank Fund Investments - Barstow Property Development" (page 13).

SUMMARY OF REVENUE GENERATED FROM SURFACE MANAGEMENT PROGRAM: FISCAL YEAR 2003-04

STRS FUND

Surface Rentals:

Surface Rentals:	\$ 232,673.66
Timber	\$ 544.00
Miscellaneous Income	\$ 7,808.26
TOTAL GROSS REVENUE GENERATED TO STRS FUND:	\$ 241,025.92

SCHOOL LAND BANK FUND

Land Sales:

City of Shasta Lake (SA 5752)	
Principal Reduction Payments	\$ 37,519.26
Caltrans Highway 247 (SA 5757)	\$ 5,700.00
BLM – Metropolitan Water District (AD 384)	\$ 456,900.00
Total:	\$ 500,119.26
Refund from Eureka Office Building Study – DGS	\$ 28,189.47
Accrued Interest on the School Land Bank Fund:	\$ 723,024.51
TOTAL GROSS REVENUE GENERATED TO SCHOOL LAND BANK FUND:	\$ 1,251,333.24

FISCAL YEAR 2004-05 PLANNED ACTIVITIES

POTENTIAL STATE TEACHERS' RETIREMENT SYSTEM FUND REVENUES

Surface Rentals Income

Staff will continue to receive income from existing surface use leases and new leases (when appropriate) on school lands parcels.

Interest Income

Staff anticipates receiving income from interest on the promissory note secured by the deed of trust that the CSLC is holding for the City of Shasta Lake. At the end of FY 2003-04, the note had a remaining principal of \$90,665.04. The note has four scheduled payments remaining and is scheduled to be paid off by July 2006.

Income from Timber Harvests

There is the potential for timber income in the upcoming year from timber salvage and sanitation operations. These operations are conducted periodically and result from inevitable losses from natural causes, such as fire, high winds, insect infestation and diseases. Because of the sporadic and irregular nature of these operations, the amount of any additional income from these sources during the coming fiscal year is impossible to predict.

POTENTIAL SCHOOL LAND BANK FUND REVENUES

Staff anticipates that new requests for land exchanges and land sales will be received throughout the coming fiscal year. Applications on the following projects from prior years currently are under consideration or are being actively processed.

CDPA/Bureau of Land Management Land Exchanges

Staff anticipates the land exchanges with the BLM mandated by the California Desert Protection Act (CDPA) will continue for several more years. Staff will be working on the following CDPA exchanges in FY 2004-05:

Bureau of Land Management (W 24480/AD 407)

Prior CDPA land exchanges between the CSLC and the BLM have resulted in an unequal balance between the value of the lands previously exchanged. Currently, the CSLC owes the BLM \$2,081,775. Additionally, the BLM has available, through the General Services Administration, approximately \$6,500,000 from surplus federal land sales that is designated for CDPA land purchases from the CSLC. The CSLC has been working actively with the BLM on a new proposed "Ledger Balancing Land Exchange", whereby the CSLC will transfer school lands of approximately \$8,500,000 in value to the federal government in order to eliminate the outstanding balance and facilitate the completion of the terms of the original CDPA legislation. When completed as proposed, approximately \$6,500,000 will be generated to the SBLF from this transaction.

44+ Parcel Exchange (W 24480 & W 40157.3)

Efforts between the CSLC and the BLM continue in identifying federal lands with mineral potential to be exchanged for CSLC inholdings with mineral potential that are located within wilderness areas and national parks. One proposed exchange would consist of more than 44 federally owned parcels in the San Joaquin Valley that possess oil and gas mineral potential. These BLM-administered parcels would be exchanged for CSLC inholdings of comparable value contained within certain national parks, a national preserve, and/or BLM wilderness areas. Staff plans to continue negotiating with the BLM to facilitate this land exchange.

Amargosa Canyon Land Exchange (W 25843)

To equalize a land exchange between the BLM, the National Park Service (NPS) and a private party who owns land within the Death Valley National Park, the BLM requested the CSLC to consider making available a school lands property located within the federal Amargosa Canyon Natural Area in Inyo County. The BLM wants to acquire the parcel because of its valuable habitat and highly valued recreational areas. As a result of the exchange, the CSLC will receive cash for the fair market value of the school lands parcel from the private party. The private party will receive title to federal land; the BLM will receive title to the school lands parcel to be administered as part of the Amargosa Canyon Natural Area; and the NPS will receive title to the private party's property within Death Valley National Park. This project has been substantially delayed due to a complete review of BLM appraisal practices and land exchange procedures. Upon BLM's request, the CSLC staff will continue negotiations with the BLM, NPS, and private party on this transaction.

United States Forest Service Land Exchange (W 23390)

In June 1987, the CSLC authorized a Memorandum of Understanding between the CSLC and the Pacific Southwest Region of the U.S. Forest Service (USFS). The purpose of this agreement is to facilitate the exchange of CSLC lands located within national forest boundaries (inholdings) for forested lands outside of national forest boundaries. The proposal consolidates the respective inholdings and benefits both agencies. Phase 1 of the exchange, which included CSLC inholdings primarily in southern California, was completed in 1990. Phase 2 of the exchange was delayed due to required federal cultural and archaeological studies. In Phase 2, the CSLC would exchange its remaining national forest inholdings for approximately 1,640 acres of land containing an estimated 55 million board feet of timber in Butte County. Staff has placed this exchange on inactive status pending further notifications from the USFS.

EI Centro 80-Acre Land Exchange (W 26004)

Among the parcels of school lands under the authority of the CSLC is an 80-acre tract of vacant desert land located near EI Centro. The parcel is landlocked and is estimated to be of relatively low value due to poor soil quality, uneven topography, and lack of legal access. Late in FY 2003-04, staff received an application from Raceland Property Holding, LLC that proposed a land exchange between the CSLC and the applicant that would involve the 80-acre parcel. Under the terms of the proposed exchange, the CSLC would transfer fee title to parcel to the applicant. In exchange, the applicant would purchase and transfer a parcel of agricultural land of equal or greater value to the CSLC. The parcel to be acquired by the CSLC would be suitable for long term leasing and would provide income that would be deposited into the STRS account to the benefit of the state's retired teachers.

POTENTIAL SCHOOL LAND BANK FUND INVESTMENTS

Staff has identified several property types as prime targets for the investment of SLBF monies. The property types include agricultural investments, ground leasing of a commercial parcel in Barstow, San Bernardino County, and other ground leasing possibilities throughout California. In addition to these primary areas, other investment alternatives also will continue to be considered as possible investment avenues for SLBF monies.

Agricultural Investments

Incorporating the guidelines and property selection screening criteria developed in the report "Planning for Agricultural Land Investments in California", staff plans to continue analyzing available agricultural investment opportunities throughout California. During FY 2003-04, staff prepared and circulated a Request For Proposals (RFP) for a Farmland Advisor/Manager to assist staff in obtaining and analyzing information on specific agricultural investments and assist staff in the purchase and long-term management of the properties. In October 2003, the contract was awarded to Agland Investment Services, Incorporated (Agland). With the assistance of Agland, staff anticipates completing one or more investments of from \$1 million to \$6 million in California agricultural land during FY 2004-05.

Barstow Property Development

In September 2001, CSLC staff circulated an RFP to locate a consultant to study the feasibility of ground leasing a $33.49\pm$ acre school lands property located at the northwesterly corner of L Street and Interstate 15 in Barstow. A contract to complete the study was awarded to the firm of Wallace and Steichen, Inc. in December 2001. The consultant's final report, entitled "Feasibility Study for NWC Interstate 15 at Avenue L, Barstow, CA", was completed in March 2002. The report was very positive as to the prospects for a successful ground-leasing program for the property, and several development options were presented. Due to the large property size and the nearly twenty year forecast absorption period, it was determined that the best option was for the CSLC to act as master developer of the property (design an overall site plan, construct infrastructure improvements and lease individual pad sites).

In March 2004, staff received an application from Home Depot, U.S.A., Inc. (Home Depot), for the purchase of a portion of the property. After reviewing the application, staff proposed to the applicant that the proposed sale be offered to the public through an open bidding procedure as a Request for Proposals (RFP). As FY 2003-04 came to a close, Home Depot agreed to act as the Project Nominator for the RFP, which is expected to be released in FY 2004-05. In addition to paying the CSLC for the market value of the land, the RFP will specify that the winning bidder will be responsible for installing all of the infrastructure improvements to service the entire 33.5 acres and will be required to process and pay for a new parcel map to subdivide the property. Upon the conclusion of this project, staff expects to have approximately 19.79 acres of commercially zoned land that will be available for long-term leasing. Pursuant to PRC section 6217.5, income from this leasing activity will be depositing into the State Treasury to the credit of the State Teachers Retirement Fund.

Ground Leasing Investments

In April 2003, pursuant to a CSLC consulting contract awarded in March 2002, staff received a report from Wallace & Steichen, Inc. entitled "Analysis of Ground Leases as an Investment Alternative". The report indicated that there are positive prospects for this type of investment. Staff proposes to continue pursuing the possibility of investing SLBF funds into long-term ground leases. Staff will research specific commercial, industrial, and/or retail land purchases where the resulting development would produce a stable, long-term income stream with low management expenses, relatively low risk, and the benefits of asset appreciation.

GEOTHERMAL, SOLID MINERALS, AND OIL & GAS PROGRAMS

The Mineral Resources Management Division is responsible for the Geothermal, Solid Minerals, and Oil & Gas Programs, which involve the leasing of school lands for geothermal resources development, mining activities, and oil and gas development. The objectives of these programs are to maximize royalty revenues, while protecting the environment and assuring public safety. All monies generated from these programs benefit the State Teachers Retirement System (STRS).

FISCAL YEAR 2003-04 ACTIVITIES

GEOTHERMAL PROGRAM

Revenue from the geothermal program totaled \$4,242,068.07 for FY 2003-04, a 6% reduction from the total for FY 2002-03. However, last year's total included revenue released from a disputed royalty account related to past production. Royalty and net profit revenue derived from the current year's production was actually 11% higher than for the prior year. All program revenue was attributable to The Geysers geothermal field.

The Geysers

The Geysers field in Sonoma and Lake Counties is the site of the world's largest geothermal development. At the end of FY 2002-03, the geothermal program had 5,204 acres of 100% reserved mineral interest school lands under lease there, plus another 360 acres of 1/16th reserved mineral interest. The State acreage supplies about 25% of the subterranean steam that is used to generate 1,000 megawatts of electricity. The balance of the steam is produced from Federal and private leases. Calpine Corporation, through its Geysers Power Co., LLC, and Silverado Geothermal Resources, Inc., subsidiaries, owns and operates most of the steam field and generating facilities, and is the lessee of all seven of the State's active geothermal leases.

There are an additional 4,000 acres of school lands northwest of the developed part of The Geysers. Some of this unleased acreage was once productive, but other portions have yet to be explored. Staff continued processing an application from Calpine for a negotiated lease in this area. The lease would cover 1,657 acres of reserved mineral interest school lands. The surface owner of those lands, WHR, Inc., submitted its own application, as is its right under PRC Section 6912. Staff was able to process the two applications in tandem because WHR entered into a lease agreement with Calpine for WHR's private lands and the surface of the State's 1,657 acres of reserved mineral interest lands, and WHR agreed to assign the new State lease to Calpine once that lease is issued by the Commission. Both applications were deemed complete, and staff successfully negotiated lease terms with Calpine. The lease will be presented to

the Commission for consideration early in FY 2004-05. The California Division of Oil, Gas, and Geothermal Resources (CDOGGR), as Lead Agency under the California Environmental Quality Act (CEQA), began the required documentation for Calpine's proposed exploratory drilling on the leased land. Should that drilling prove successful, Calpine will need to request Commission approval for developing and utilizing the lease's geothermal resources. The State lease would likely be developed along with adjacent private lands as part of a project involving one or more new 25-megawatt generating facilities.

Staff continued to work with Calpine concerning the utilization of injection water at The Geysers, and it approved the conversion of one idle producing well to injection. Calpine injects water to enhance steam productivity and extend the life of the field. The water is obtained from condensed steam at the generating facilities, from local creeks as permitted by State and local water agencies, and from tertiary-treated wastewater via two large pipeline projects. The Southeast Geysers Effluent Project (SEGEP) is a 29-mile pipeline that transports 8 million gallons per day of reclaimed water from Lake County. The SEGEP was completed in 1997. The Santa Rosa Geysers Recharge Project (SRGRP) is a 41-mile pipeline that transports 12 million gallons per day of reclaimed water from the city of Santa Rosa. The SRGRP was completed in December 2003. Calpine has a system of smaller pipelines to distribute water throughout The Geysers for injection into more than 45 wells, at least ten of which are on State leases.

Geothermal Prospecting Permit Applications

Staff was unable to make progress on two applications for geothermal prospecting permits on school lands parcels in the vicinity of Truckhaven near the western shore of the Salton Sea in Imperial County. Applications submitted by Mack Energy Company and Layman Energy Associates (LEA) totaling 3,840 acres remain incomplete pending submittal of viable prospecting programs and evaluation of potential environmental impacts associated with exploration. The applicants must apply for use permits from the County's Planning Department, which would be Lead Agency under the CEQA. Only LEA has applied for a use permit, but it is for an exploratory well on a parcel of private land, not on school lands. LEA has obtained grants from the Department of Energy and the California Energy Commission to help fund its exploration efforts.

Staff continued processing an application from Deep Rose, LLC, for a geothermal prospecting permit on a 640-acre school lands parcel in Inyo County several miles north of the Coso geothermal field. Staff deemed Deep Rose's application complete in February 2004, but a recommendation to the Commission could not be made until an analysis of potential environmental impacts has been completed. Deep Rose has proposed an exploratory well that would be one of the deepest geothermal wells ever drilled.

The environmental analysis would be undertaken by the CDOGGR, as Lead Agency under the CEQA. However, that work will not begin until Deep Rose secures the funding and locates a drilling contractor for the proposed well.

SOLID MINERALS PROGRAM

Revenue from the solid minerals program totaled \$183,162.65 for FY 2003-04, a 39% reduction from the total for FY 2002-03. The decrease was due to the curtailment of sand and gravel production following completion work on interstate highways in San Bernardino County, and because last year's total included a significant amount attributable to production that occurred in a prior year.

The solid minerals program currently has six active mineral extraction leases totaling 1,188 acres, and two active 1/16th reserved mineral interest agreements totaling 605 acres. In addition to managing these mineral properties, staff continued processing applications for new solid mineral development projects on school lands parcels.

Mineral Lease Management

U.S. Borax (PRC 736)

U.S. Borax holds a 160-acre lease at the Gerstley Borate Mine, an underground mine operating in eastern Inyo County since the 1920's. The mine contains a unique blend of calcium and sodium borates, but because the mine workings do not comply with federal Mine Safety and Health Administration regulations, it cannot be legally operated. The mine openings have been sealed, and prior surface disturbance reclaimed in accordance with a plan approved by the County. U.S. Borax is consulting with engineering firms on the viability of reopening the mine as a small open pit. In the interim, U.S. Borax continues to pay a minimum annual royalty on 600 tons of production. The royalty totaled \$21,182.00 for the year, a 10% increase from last year. The lease will be up for renewal in May 2007.

Hanson Aggregates (PRC 7301)

Hanson Aggregates operates a 120-acre lease for the extraction of rock, sand, and gravel previously held by Nelson and Sloan at the Lakeside Quarry in northern San Diego County. Royalty from this lease totaled \$77,096.01 for the year, a 29% decrease from last year due to Hanson shifting some of its mining operations to private land adjacent to the State lease. Staff's processing of Hanson's application to extend, amend, and transfer the lease from Nelson and Sloan awaits the completion of a financial audit and settlement of final lease terms.

Granite Construction Company (PRC 7945)

Granite Construction Co. operates a large aggregate mine in Riverside County near Palm Desert that includes a 560-acre school lands parcel with a 1/16th reserved mineral interest. The State's royalty is \$0.04 per ton. Revenue totaled \$63,584.64 for the year, 20% less than last year because of curtailed production.

Western Mesquite Mines (PRC 8039)

Western Mesquite Mines, Inc., acquired this 658-acre lease at the Mesquite Gold Mine in Imperial County from Newmont Mining in April 2004 through an assignment approved by the Commission. The mine first operated in 1985 but was idled in 2001 due to low gold prices and depletion of permitted reserves. Since then, the County approved an expansion that includes the leased land, and gold prices increased by about 33% to over \$400 per troy ounce. Western is now studying the reactivation of mining operations.

Sigma Stone (PRC 8253)

Sigma Stone holds a 160-acre lease at the Black Angel Mine in San Bernardino County. The mine was idle during the year due to loss of the contract miner operating Sigma's facility. Although a competitor has seized a large share of the market for road construction materials due to a superior location adjacent to Interstate 15, Sigma hopes to resume mining next year as the greater Victorville and Barstow region continues to grow and thrive as a result of its more economical housing compared to Los Angeles and Orange Counties, and the San Bernardino-Riverside area. Sigma's rock material is marketable not only for road construction but as decorative stone due to its lavender hue.

Washington Group International (PRC 8272)

Washington Group International's (WGI) 80-acre lease in San Bernardino County yielded only \$14,700.00 in royalty this year compared to more than \$80,000 last year. The State's royalty is \$0.47 for each ton of rock, sand, and gravel extracted from the leased land. WGI completed its work on a large Caltrans project to resurface a portion of Interstate 40 between Ludlow and Needles.

Protech Minerals (PRC 8322)

Protech Minerals' 10-acre lease at the Pioneer Talc Mine in San Bernardino County near the Nevada border remained idle, with activity limited to pre-development work. A minimum royalty of \$6,600.00 was received during the year. In August 2003, the Commission approved a

reduction in the minimum annual royalty to \$3,300.00. The reduction was granted to help Protech develop and market domestic talc that must compete against relatively inexpensive talc from China. Protech owns other talc mines near the Pioneer Mine, and its processing plant in Victorville is the only such facility in the California Desert region.

Pacific Coast Minerals (W 9694)

Pacific Coast Minerals, Inc., (PCM) of Spokane, WA, has an active 1/16th reserved mineral agreement in San Bernardino County covering approximately 40 acres at the Calspar Mine in the Ord Mountains southeast of Barstow. The mine produces feldspathic quartzite (calspar ore), but the 1/16th agreement parcel has not yielded royalty revenue since the early 1980s. PCM advised staff it continues to seek a market for the calspar ore. One possibility is to use the high-white calspar sand as a replacement for silica sand for golf course bunkers.

MolyCorp (W 40646)

Molycorp extracts rare earth elements at the Mountain Pass Mine in San Bernardino County, near the Nevada border. During the environmental review process for a proposed expansion of that operation, staff found that Molycorp's proposed expansion area contains approximately 400 acres of 100% reserved mineral interest school lands. Staff has asserted the State's leasable mineral interest via correspondence with Molycorp's legal counsel. It has also requested more information from Molycorp on the mineral material within the project area and its final disposition.

Mineral Lease Applications

Bureau of Reclamation (PRC 6735)

Staff continued processing an application from the Bureau of Reclamation (BOR) to resume mining at the Manchester Quarry in the Dead Mountains area of San Bernardino County. The BOR proposes to quarry 2.8 million tons of rock over a 25-year period for riverbank stabilization along the Colorado River. Staff continued its coordination with the BOR, the San Bernardino County Planning Department, the State Department of Conservation's Office of Mine Reclamation (OMR), and the BLM to resolve outstanding issues. The OMR has been granted a contract to prepare a Mining and Reclamation Plan and conduct biologic studies for the project. BOR is expected to submit an application in January 2005 to San Bernardino County, lead agency for mining activities.

Jacobson Construction (W 40783)

Staff continued negotiating with Jacobson Construction regarding sand and gravel extraction on a 45-acre 1/16th mineral interest parcel in San Bernardino County. The material would be used to resurface and widen portions of Interstate 15 from Baker to the Nevada border and for local construction needs. Staff continued its efforts to ensure appropriate payment for the State's portion of the aggregate resource.

Hi-Grade Materials (W 40842)

Staff received a letter from Hi-Grade Materials in November 2003 withdrawing its application for a mineral extraction lease in San Bernardino County. Hi-Grade withdrew the application because the portion of its proposed project area containing the school lands parcel was eliminated from the use permit application being processed by San Bernardino County. The school lands parcel was originally included because the County's typical grading requirement would have necessitated the slope extending into the State parcel. The County will allow Hi-Grade to buttress the toe of the slope instead.

Cima Cinders Company (W 40880)

Staff awaited completion by Cima Cinders Co. of an application for a lease to extract material from a volcanic cinder deposit in the East Mojave Preserve in San Bernardino County. Cima's parent company extracted cinders from the school lands parcel in the 1950s, developed cinder block markets in the Las Vegas area, and provided road-surfacing materials for local county roads and State highways. Cima maintains mining claims on adjacent Federal lands within the CDPA area containing similar cinder deposits.

Mineral Exchange Applications

Kaiser Resources (W 40871)

Staff continued processing an application from Kaiser Resources to exchange a 467-acre parcel of 100% reserved mineral interest school lands for an interest in a nearby mineral estate owned by Kaiser and believed valuable for aggregate. Staff reviewed an appraisal report prepared to support the value of the exchange, and continued directing a contractor to compile and assess data to determine that the property does not pose an environmental risk. The lands involved are near Eagle Mountain in Riverside County where Kaiser once held a State mineral extraction lease. The lease was issued in 1978 and covered 145 acres of the 467-acre school lands parcel. The lease was within an open pit area covering more than 5,000 acres that was mined for iron ore for over 30

years. Operations at the mine ceased in 1982 when air quality laws and foreign competition rendered it uneconomic. The lease expired in 1998. Kaiser has since permitted a landfill at the Eagle Mountain complex, and plans to sell the property to the Los Angeles County Sanitation District. Kaiser has been requested to extinguish the State's mineral interest to eliminate conflict with the landfill operation, but because the State may not sell its minerals and future iron ore mining is unlikely, an exchange has been proposed. Staff is negotiating to obtain mineral property with equal or higher mineral development potential.

Mineral Prospecting Permit Applications

There has been little interest in prospecting for precious and base metals since passage of regulations that require backfilling of such mines and a tax on all precious metals to fund closure of abandoned mines. The 1994 CDPA and management policies on Federal lands have reduced the availability of areas open to all types of mineral exploration and development. Staff has adopted a proactive role in promoting the exploration and development of school lands that can help meet Caltrans' and society's need for aggregate.

Glamis Imperial Gold (W 40588 and W 40589)

Staff received a letter from Glamis Imperial Gold Corporation withdrawing its two applications for permits covering school lands parcels in eastern Imperial County. The project became uneconomic after the backfilling regulation went into effect. Staff subsequently closed both applications.

Southern Clay Products (W 40851)

Staff continued processing an application from Southern Clay Products for a permit covering school lands east of Highway 126 in Inyo County, near the Nevada border. Valuable clay minerals are mined in the region, and Southern Clay wants to determine the extent and economic viability of developing a clay resource believed to underlie the parcel. Although the application remained incomplete at year's end, staff anticipates it will be deemed complete and ready for consideration by the Commission early in FY 2004-05.

NDT Ventures (W 40870)

Staff closed the file on NDT Ventures' application for a permit in Mono County near the ghost town of Bodie due to NDT's lack of interest in completing the application process.

Jaxon Baker (W 40882, W 40883, and W 40884)

Jaxon Baker, Inc., withdrew applications for mineral prospecting permits on three school lands parcels in Inyo County. Jaxon Baker wanted to conduct sampling of sand and gravel from established roads near Highway 395 between the towns of Cartago and Big Pine. One proposed parcel was adjacent to the Manzanar National Historic Site operated by the National Park Service. That application was withdrawn due to concerns over the environmental impacts that could have resulted from mining operations. The other two applications were withdrawn because Jaxon Baker would not agree to reimburse staff for processing. Staff is considering contracting out the prospecting work because aggregate deposits, if present in this area and subsequently developed, would be valuable for road maintenance by Caltrans and the County, and would benefit the school lands program.

Abandoned Mine Reclamation Partnership

Staff continued cooperative efforts with the OMR to close mines located on school lands which may pose a threat to humans or wildlife. After addressing biological and historical resources, fences were installed on eight mineshafts and adits at three sites in San Bernardino County. The OMR funded the cost of the fence materials, which is modest compared to other closure methods such as foam plugs, with staff assisting the OMR with the actual installation. Plans to install two steel "bat gates" at the Crown Uranium Mine in Imperial County were postponed due to the presence of a breeding colony of bats. The gates are designed to allow bats to enter and exit the mine while keeping humans and most wildlife out. The work will be performed during the winter when the bats are not present.

OIL & GAS PROGRAM

Revenue from the oil & gas program totaled \$244,806.15 for FY 2003-04, a 2% reduction from the total for FY 2002-03. Oil production fell by nearly 14% on the two school lands parcels where the State has a 1/16th reserved mineral interest. However, oil prices increased by 13%. The higher prices reflect higher prices for crude oil worldwide.

Round Mountain (VA 5310)

This 160-acre school lands parcel in the Round Mountain oil field northeast of Bakersfield in Kern County produced almost all of the total oil & gas royalty revenue, more than \$244,000. The parcel is part of a 2,363-acre unit organized in 1994 and operated by MacPherson Oil Company.

Sulfur Crest (LA 9252)

This seven-acre school lands parcel in the Sulfur Crest area of the Santa Paula oil field in Ventura County produced the balance of the oil & gas royalty revenue, less than \$500.

**REFERENCE MAP FOR GEOTHERMAL, SOLID
MINERALS, AND OIL & GAS:**



**SUMMARY OF REVENUE GENERATED FROM GEOTHERMAL,
SOLID MINERALS, AND OIL & GAS PROGRAMS: FISCAL YEAR 2003-04**

STRS FUND

Geothermal Royalties and Net Profits:

Royalties from leases at The Geysers:	\$ 3,448,352.65
Net Profits from lease at The Geysers:	\$ 793,715.42
Geothermal Total:	\$ 4,242,068.07

Solid Minerals Royalties:

Royalties from leases and 1/16th agreements:	\$ 119,578.01
Adjustment	\$ 63,584.64
Solid Minerals Total:	\$ 183,162.65

Oil & Gas Royalties:

Total:	\$ 244,806.15
TOTAL GROSS REVENUE:	\$ 4,670,036.87

FISCAL YEAR 2004-05 PLANNED ACTIVITIES

GEOTHERMAL PROGRAM

The Geysers

Staff estimates that royalty and net profit revenue from school lands geothermal leases at The Geysers will reach \$4.0 million in FY 2004-05. This is nearly the same as in FY 2003-04. Steam production and steam prices are expected to remain fairly stable.

Staff anticipates the issuance of a new geothermal lease to WHR, Inc., with the immediate assignment of that lease to Calpine's Geysers Power Company subsidiary. Once a commercial well has been drilled on the lease, even if such well is not immediately produced, the State will collect a minimum of \$33,160 per year. Development of the lease and royalty revenue from steam production may not be realized for several years. Calpine must obtain a power sales contract, secure project financing, satisfy CEQA requirements, and then drill wells and construct new generating facilities. Such activities typically take five to seven years.

To maximize the State's future royalty revenue, staff plans to continue working on the following goals: 1) develop school lands already under lease but not fully developed; 2) negotiate terms for the leasing and development of unleased school lands; 3) improve the utilization of available steam resources through optimization of steam field and power generating facility operations; and 4) select well conversion candidates for optimal injection benefits. Staff will continue to monitor all production operations and engineering projects on State leases and adjacent lands, verify all pricing and royalty calculations, and look for new opportunities to increase royalty revenue from school lands at The Geysers.

Geothermal Permit Applications

Staff will continue working with Mack Energy and LEA, the two applicants for prospecting permits in Imperial County, to further the exploration for geothermal resources near Truckhaven. Staff will also continue working with Deep Rose with the goal of issuing a geothermal prospecting permit for the school lands parcel in Inyo County north of the Coso geothermal field.

SOLID MINERALS PROGRAM

Mineral Lease Management

Staff estimates that royalty revenue from school lands solid minerals leases in FY 2004-05 will remain near the current level of \$180,000. An increase could occur from leases coming into full production, the amendment of an existing aggregate lease, a lessee securing a large aggregate contract for a road construction job, and a new 1/16th agreement with Jacobson. Additionally, staff hopes revenue can be realized from successful prospecting for clay resources by Southern Clay Products, and the subsequent issuance of a preferential mineral extraction lease.

Staff anticipates approval of the amendment, extension, and transfer of Hanson's mineral lease in San Diego County. The amendment should provide for a doubling of revenue as a result of a higher royalty rate and higher minimum annual production, but the revenue would not be expected before FY 2005-06.

Staff plans to continue efforts to resolve issues related to the re-issuance of a mineral extraction lease to the BOR for the excavation of rock in San Bernardino County. Resolution of the financial assurance issue is anticipated during the first half of FY 2004-05, with the issuance of a lease early in FY 2005-06. Potential revenue over the 25-year life of the lease could exceed \$3 million, making it a prominent income stream for the solid minerals program.

Staff plans to meet with Molycorp and discuss further the State's assertion of a leasable mineral interest.

Mineral Exchange Applications

Staff plans to continue negotiations with Kaiser Resources to exchange approximately 467 acres of reserved mineral interest school lands for an interest in a mineral estate owned by Kaiser in Riverside County. The exchange is not expected to occur until FY 2005-06.

Mineral Prospecting Permits

Staff anticipates the Commission will consider the issuance of a mineral prospecting permit to Southern Clay in Inyo County. It expects additional prospecting permits will be issued by the Commission as Caltrans' sand and gravel needs are further defined.

Mineral Inquiries

Staff will continue to investigate and respond to inquiries it receives concerning the availability of school land parcels for solid minerals prospecting and leasing.

Abandoned Mine Reclamation Partnership

Staff plans to continue cooperative efforts with the OMR to identify and close additional mines on school lands that may present a hazard to the public or wildlife. A survey is scheduled for late summer 2004 to identify mines for the FY 2004-05 closure program. The installation of bat gates at the Crown Uranium Mine is scheduled for December 2004.

OIL & GAS PROGRAM

Staff estimates that royalty revenue from the two school lands oil & gas leases will total around \$250,000 during FY 2004-05. This assumes that strong crude oil prices will continue to offset declining production rates.

FINANCIAL SUMMARY: FISCAL YEAR 2003-04

STRS FUND

REVENUES AND EXPENSES

Revenues:

Surface Rentals	\$ 232,673.66
Timber.....	\$ 544.00
Miscellaneous Income	\$ 7,808.26
Geothermal	\$ 4,242,068.07
Solid Minerals	\$ 183,162.65
Oil and Gas.....	\$ 244,806.15
GROSS REVENUES	\$ 4,911,062.79

Less: Geothermal Resource Development	
Account (GRDA) Deposits.....	\$ <49,947.34>
(Public Resources Code Section 3826)	
TOTAL	\$ 4,861,115.45

EXPENSES: Net Management Costs

Land Management.....	\$ 311,213.82
Geothermal	\$ 357,867.02
Solid Minerals	\$ 459,838.48
Oil and Gas.....	\$ 118,346.17
Ownership Determination	\$ 62,521.41
GROSS EXPENSES	\$ 1,309,786.90

Less: Reimbursement Recovery	\$ <121,508.31>
TOTAL EXPENSES	\$ 1,188,278.59

NET REVENUE TO STRS \$ **3,672,836.86**

SCHOOL LAND BANK FUND

Balance as of July 1, 2003.....	\$ 47,097,168.75
SMIF Interest Earned Fiscal Year 2003-04.....	\$ 723,024.51
Revenue from Land Sales	\$ 500,119.26
Contract Refund - Eureka Office Feasibility Study	\$ 28,189.47
Less: Contracts for Investment Services.....	\$ <1,979.80>

BALANCE OF SLBF AS OF JUNE 30, 2004 \$ **48,346,522.19**

ABBREVIATIONS

BLM	U.S. Bureau of Land Management
BOR	U.S. Bureau of Reclamation
Caltrans	California Department of Transportation
CDOGGR	California Division of Oil, Gas, and Geothermal Resources
CDPA	California Desert Protection Act
CEQA	California Environmental Quality Act
CSLC	California State Lands Commission
DGS	California Department of General Services
FY	Fiscal Year
GSA	General Services Administration
LEA	Layman Energy Associates
LLC	Limited Liability Corporation
LMD	Land Management Division
MRMD	Mineral Resources Management Division
MWD	Metropolitan Water District of Southern California
NASA	National Aeronautics Space Administration
NPS	National Park Service
OMR	State Office of Mine Reclamation
PCM	Pacific Coast Minerals
PRC	Public Resources Code
RFP	Request for Proposals
SEGEP	Southeast Geysers Effluent Project
SLBF	School Land Bank Fund
SRGRP	Santa Rosa Geysers Recharge Project
STRS	State Teachers' Retirement System
USFS	U.S. Forest Service
WGI	Washington Group International