commit onshore parcels to the unit." Does he?

MR. SHAVELSON: The agreement would never go into effect, of course, unless sixty per cent of the Town Lot owners consented to it; and if an owner of more than forty per cent, or combination of owners of more than forty per cent, in the Town Lot area should do this, the Unit Agreement and the Field Contractor's Agreement would never go into effect.

SENATOR O'SULLIVAN: Have you been asked by anyone for an opinion as to whether this was true or not?

MR. SHAVELSON: Well, we considered this question very carefully. Of course, if the agreement never went into effect, the owners of the Town Lot would never get any production from their area; and yet, legally, it is required to have Town Lot participation in the Unit -- so this is a difficult problem to avoid.

SENATOR O'SULLIVAN: May I ask this - - I don't want to monopolize all the time here, but I take it that this entire transaction has been taken up and examined by the Trust Section of the Attorney General's Office?

MR. SHAVELSON: Yes, we have consulted with them, and in our opinion to the State Lands Commission that aspect has been gone into in some detail.

SENATOR O'SULLIVAN: Let me ask you: Do you have an opinion as to whether or not the statement here that the letting of this bid under the facts and circumstances of the oil industry may be a monopoly?

MR. SHAVELSON: We have asked the State Lands Division staff to prepare, and they did prepare, a statement as to the percentage of total production from California and from District Five, the producing marketing area in which California is located, and we also inquired as to the factors that went into

1 those estimates; and, actually, we concluded that it is unknown
2 and unknowable at this point to what extent the successful bidder
3 would have monopolistic control. There are so many imponderables
4 entering into that determination. Whether or not he would ac-
5 quire monopolistic control is a question -- and even if that
6 control were gained, there would not necessarily be illegality
7 unless it was either improperly acquired or there was an inten-
8 tion to exercise it.

9 We don't think acquiring it by open competitive bidding
10 would be an improper way to acquire it, and we further believe
11 the fact that the City Manager is going to have such a high de-
12 gree of control over these operations would certainly militate
13 against any finding that there was any intention to exercise any
14 monopoly.

15 MR. LINGLE: Could I inject one thing?

16 MR. CRANSTON: Yes.

17 MR. LINGLE: If I could have your permission, Senator --
18 With reference to this expansion east and west, we could not ex-
19 pand east. There is an existing contract with Richfield Oil Com-
20 pany adjacent here and before that contract could be modified,
21 before you could come into the Unit, we would have to come in to
22 the State Lands Commission. Similarly, on the L.B.O.D. parcels
23 to the west of it, the ones that we spoke of that will run out a
24 year from tomorrow, before those contracts could be amended in
25 any way, before we could put them in -- maybe there were some
26 terms to expand this way if you were willing, but the question is
27 the existing contract on this area; and this existing contract
28 would also have to be amended and we are required to come back
29 to the State Lands Commission and get consent before we can do
30 that. I think you agree with me?

31 MR. SHAVELSON: Yes, I do. I was thinking in terms

of whether or not in an expansion, the State Lands' consent would be required for the expansion of this particular Unit. I think you are correct as far as the inclusion of those.

SENATOR O'SULLIVAN: Yes, but the permission of the Commission having been granted for the first question, the matter being brought before the Commission would be limited to the second question which you bring up, isn't that correct?

MR. SHAVELSON: In a practical sense, since this would involve an amendment of the other fault block agreements, and since they would require the consent of the State Lands Commission, the State Lands Commission could withhold that consent for any policy reason it desired. It wouldn't be limited as to what policy matters were taken into consideration.

MR. CHAMPION: Could it be limited in the restrictions it could place on that with respect to this unitization?

MR. SHAVELSON: You mean the conditions?

MR. CHAMPION: Yes, the conditions.

MR. SHAVELSON: Well, it could just continue to withhold its consent until those conditions were inserted. I think it could require conditions to be put in.

SENATOR ARNOLD: I have a question of Mr. Scott. I believe you heard the discussion on repressuring -- as to whether you could put this in one parcel or more. Do you wish to comment on that?

MR. SCOTT: No, I believe it can be repressured without any trouble. I have never known sixty-five hundred acres or sixty-three hundred to be repressured off one island or one injection well, but I believe it can be - - it would require further hearings and you would have to have competent experts to answer that.

MR. CHAMPION: Mr. Scott, at one point, page 7, your

1 testimony says: "It is requested that the companies who wrote
2 this contract explain ...." and Long Beach has taken the position
3 that companies did not write the contract. What is the basis of
4 the statement?
5 MR. SCOTT: Well, to my knowledge several companies
6 participated in that and if they said they didn't, I would accept
7 their statement; but to my knowledge many people participated in
8 the preparation of the Field Contractor's Agreement. They can
9 answer that better than I.
10 MR. CHAMPION: Do you accept Mr. Lingle's statement
11 that he wrote the contract?
12 MR. SCOTT: From what I heard today, I won't accept it
13 completely but I just won't belabor the point.
14 MR. CHAMPION: You won't, however, assert flatly to
15 the contrary?
16 MR. SCOTT: No. If we can get involved to where we can
17 get under oath and under subpenas, maybe we can appear from that
18 point out.
19 MR. CHAMPION: I have another question based on Mr.
20 Scott's testimony and it goes to the City of Long Beach, and
21 that's this question of the payment of interest. On what deter-
22 mination was that based -- this 3.75 percentage, as against no
23 interest at all?
24 MR. LINGLE: Under Internal Revenue statutes, there are
25 some ways - - When they pay a bonus such as the State requires,
26 this usually is required to be capitalized. Another method, which
27 nobody knows, but if you can get close to the Internal Revenue
28 Code or the Federal statutes -- which I am not an expert on - -
29 if you can have some of the elements of production payments in
30 one of those, a production payment is an advance payment and pro-
31 duction payments will be treated differently, and it will be

treated as though there was a loss. Therefore, we did put the interest on it.

Now, one thing I want to be clear with Mr. Scott on: Any time Mr. Scott wants to question me under oath, I am perfectly willing. As I said, we have consulted and I have asked all those that I possibly could for suggestions; and there was a suggestion that this was a way under which the production payments could be handled -- whereby there could be benefit to the State and to the City, so that if these production payments, the advance payments, could be framed under a certain framework, the potential bidder could bid a higher figure and thus the State and the City would be able to reap the benefit of a better tax basis; and to get the benefits of that tax basis when we are paid we would have to pay interest on it; and that's why the interest rate is in it.

MR. CHAMPION: Why was the interest rate set at 3.75? Presumably, any interest at all could have made this available.

MR. MANSELL: Mr. Champion, I can answer that question.

MR. CRANSTON: John Mansell, the City Manager.

MR. MANSELL: That was the average interest rate we had been paying on bonds and the average we had on securities on deposit, so we thought if we had this money to invest over a period of time it would be a washout. I might say that we need a million and a half for a new bus company. If Mr. Scott wants to lend that to us, we will be happy to take it.

SENATOR O'SULLIVAN: Is this 3.75 chargeable to the interest of the State of California?

MR. SHAVELSON: Yes, it is.

SENATOR O'SULLIVAN: Does anyone know what our interest rate is now that we are paying?

MR. CHAMPION: On bonds?

SENATOR O'SULLIVAN: Any kind of money.

MR. CHAMPION: Well, the last time we sold, our bond cost has been between 3 and 3.2; large amounts of bonds, around 3.2. I think the last hundred million sale was in that area, general obligation bonds.

SENATOR O'SULLIVAN. And we would be paying 3.75 compounded every month under this agreement?

MR. CHAMPION: I think there is a serious question about this.

SENATOR O'SULLIVAN: I don't know what 3.75 compounded monthly would amount to, but it would be substantial to what we are paid.

MR. CRANSTON: If there are no further questions, thank you very much. I assure you all of your remarks will be given the utmost care and attention.

MR. SHAVELSON: Just one more thing before we leave Mr. Scott's statement. I think there is possibly a misunderstanding that has risen that I should mention; and that is the remark on page 11 here that "The State Lands Commission cannot put up Tract Number 2 under the Long Beach formula because it is not permitted by the statutes."

Actually, the purpose of the pending legislation is merely to give the State Lands Commission the alternative, should it choose to exercise it, of putting Tract Number 2 into the Unit as the owner of a working interest without executing a lease.

I believe under present law and as specifically provided in Section 6832 of the Public Resources Code, the State's lessee of Tract Number 2, should it be put out for lease, there is no necessity for further legislation to authorize going into Tract Number 2.

One thing, Senator, if I may get back to my other correction. That took me sort of unawares -- on the joinder of these lands. Since on these areas to the extent that they are tide and submerged lands, already the State is getting fifty per cent of the revenues, the detriment insofar as the State's interest in Tract Number 1 wouldn't be significant at all; and so I presume that you were talking about the detriment to the State in Tract Number 2.

SENATOR O'SULLIVAN: Yes, 2 -- not Tract 1.

MR. SHAVELSON: I just wanted to get that clear.

MR. CRANSTON: Do you wish to appear now?

MR. CLARK: Please. Gentlemen, it is late and I will try to be brief. I am Durland Clark, Shell Oil Company, Los Angeles. Our views on the proposed contracts, briefly stated, fall into three general headings: Operations, State of California interest, and the industry at large.

Now, for the operations: These contracts adequately cover the operating requirement for producing a known oil reserve by well-known production techniques understood by any competent operator. The size of the undertaking should not be equated to any inherent difficulty of accomplishment. The contract language relating to operations is well known to us and the scriveners demonstrate considerable familiarity with oil and gas operations. The observed omissions are generally most favorable to the industry.

Now, as to the State: These comments are directed to the interest of the State of California in adopting the proposed contracts. You appreciate that under a net profits format the items covered under this heading are of only indirect concern to an operator who merely charges them off against the value of produced oil. They can, however, be of substantial monetary

significance to the State.

Now, as to Federal tax -- The Proposed field contract provides that the so-called production payments constitute installments which must be paid by the contractor in all events and cannot be avoided. This will require the contractor to advance approximately $51,000,000 to the City over the first three years.

The Internal Revenue Service has informally advised us and others that as now drawn these payments constitute a bonus. However, a comparison of projected profitabilities based on Federal income tax consequences to the Field Contract, that is, advance payments treated (1) as a bonus or (2) as a bona fide production payment, clearly demonstrates that a substantial monetary difference exists in favor of a true production payment approach. This difference arises from the Federal income tax treatment of the income received by the Field Contractor and is in the magnitude of two digit millions of dollars over the thirty five-year life of the contract. A higher percentage bid to the City would result if the contract was recast to reflect both intent and actual creation of a production payment.

2. Ad valorem or property taxes: In considering the influence of property taxes it had been indicated to us by the Los Angeles County Assessor's Office that an assessment might be made against undeveloped oil reserves. The Los Angeles County Assessor held a conference with representatives of the oil industry on February 20, presumably to discuss this possibility. Actually, the specific question was never answered, as an issue of much greater significance developed.

The Assessor indicated that he is now giving consideration under the De Luz Homes case to assessing the entire one hundred per cent interest in the tidelands property rather than

only the net profits interest of the contractor. The De Luz case -- now that is in the California Supreme Court 1955, confirmed in 1959 by the Supreme Court in Texas Company versus County of Los Angeles -- the De Luz case held that in determining full cash value of a lease for property tax purposes by the capitalization of income method, the rent specified in the lease could not be deducted from gross income from the property. It is the Assessor's view that there is no difference between rental and the retained interest of the City; therefore, no deduction should be made from gross income with respect to the governmental interest.

If assessments are to be made against undeveloped oil reserves and would be applicable to the full cash value of future net operating income, then the impact of property taxes would substantially increase the cash expenditures of the contractor and the time of his payout. Consequently, the return to the City and State would be appreciably reduced, since under the field contract taxes are a chargeable expense.

We estimate that on a recovery of only 800 million barrels of oil in a 35-year period at a per barrel rate of 20 cents, which appears to be the current minimum rate of tax in the Wilmington Field, the property taxes would total $160,000,000. This is a substantial diversion of income from the State and the tidelands trust fund to local governmental jurisdictions. Anyone urging a contrary view should, of course, be prepared to indemnify the City and State against this contingency in writing.

Now, Industry at Large: Without attempting to categorize the following comments, we list a number of observations resulting from the contract format.

1. The successful bidder must advance $51,000,000 over the first three years as an absolute obligation even in the face

of litigation striking at the very validity of the field contract. This is an open invitation to specious law suits by taxpayers -- essentially blackmail in nature. One needs but a cursory glance at the considerable history of Long Beach tidelands litigation to conclude that our concern is hardly illusory. This inflexible demand for advances suggests motives for employment of such funds foreign to the subject at hand and is a cynical disregard of common business practice, where the seller is presumed to produce the thing bargained for as consideration for payment. Clearly these payments should be impounded in the event litigation arises. Failure to so provide will reduce bid offers by some measurable degree dependent upon the risk assessment of the individual bidder.

2. The contract contains three elements providing for its own nullifcation.

First, we refer to the requirement of the commitment of sixty per cent or more of the Town Lot tracts to the Unit for it to become effective. We must have the advance written assurance from those companies holding Town Lot leases that they will commit their lands to the Unit irrespective of whether any one or more of them qualifies as a successful bidder. Otherwise, they hold an absolute veto power on legitimate bidders, a matter we must assume escaped the attention of the drafters of this provision.

Secondly, we have serious reservations as to the provisions in Article 16 of the Unit Agreement relating to relief from unit obligations. As applied to the City, we question whether these provisions may not involve a violation of the prohibition against alienation contained in the trust under which its tide and submerged lands are held.

Lastly, what of the rule against perpetuities, which in effect directs that twenty-one years shall be the maximum permissible period for the vesting of future property rights? The

option rights contained in the Unit Agreement (whereby continuing participants may elect to acquire the working interest of a withdrawing participant) must become suspect under the perpetuities rule, since there is no express limitation on the period within which such options become exercisable.

3. We are opposed to such provisions of Article 6.3 of the Unit Agreement as provide for the addition of public lands to the Unit by resolution of the City Council of the City of Long Beach. Such a procedure is in reality an amendment of the term of existing contracts covering lands that would otherwise be subject to future competitive bidding and substitutes the closed negotiation process for the independent bidding evaluation of the entire industry. This clause, if left unchanged, could deprive the City and State of substantial future income and favors certain operators over others. Again, the drafters of these papers must be presumed to have overlooked this potential windfall.

4. The crude oil pricing provisions are most interesting. Unlike competitive State of California oil and gas leases, the price of crude oil is tied to the average of posted prices rather than the highest posted price. This usually results in the State receiving less for its oil and has an unusual side effect. Consider the case of the three companies presently posting prices in the Wilmington Field. Could all or any two safetly become joint bidders without incurring the accusation of price collusion irrespective of whether the prices posted by them are identical or dissimilar? Further, does not a similar risk attach to any Field Contractor who attempts to post prices in the Wilmington Field?

5. Time permits just the briefest mention of certain collateral effects growing out of the contracts. The situation

at hand is far removed from the casual offering of a relatively small piece of land under competitive conditions. You are being asked to place under development the largest uncommitted oil reserve in the world. The development of this reserve will trigger a series of complex events which will have regional, national and international force. This stems from the economic power that will result from the acquisition of a one and one-half billion barrel reserve in a single parcel by a single operator or even a combination thereof.

The problem that concerns us is the anti-trust implications of this offering in a single contract. We agree that the proposal before us differs markedly from the usual private transactions which are so subject to attack by the Department of Justice in that here the City and State by their own actions are making an offer to the industry. The aspect of this that is so bothersome is whether or not the City and State make this decision independently.

If this cannot be demonstrated, we have no assurance that the offered contract will not be the subject of immediate anti-trust investigation by the Department of Justice or even the State itself. We should note that demands for such an investigation could emanate from this or any of forty-nine other jurisdictions far beyond the control of forces within this State. It seems to us almost elementary that this Commission, after full investigation, must make a finding to the effect that the ultimate format will encourage maximum participation in a free and open bidding competition, thereby minimizing any suggestion that it is designed to effect a concentration of economic power.

To avoid any aspect of the above problem, to offer wider participation to the industry in the offered oil reserve and to afford the City and State the opportunity for greater

return, we strongly recommend that the offshore tract be subdivided into several parcels. Such an approach was recommended by the Harbor Department of the City of Long Beach and appears to have been endorsed by your own staff. This in no way would interfere with the unit plan of operation, as such offerings could be made fully subject thereto.

We further recommend that prior to any offering, the so-called pre-unit expense agreement, which Article 9.1 of the Unit Operating Agreement describes as an agreement between the City and certain unidentified working interest owners, be made public. This is one of the most unusual provisions we have ever encountered for it clearly implies that prior private investments offering economic advantage in this bidding situation are to be charged against the efforts of the successful bidder with consequent reimbursement out of public funds. Even if this almost ludicrous provision is allowed to remain, the State and all potential bidders should be fully informed as to the extent to which their own efforts and public funds are being committed to reimbursement of private risk. This provision suggests a pork barrel of potentially significant proportions and distorts the equality of opportunity that is inherent in a truly competitive offering.

In summary, we can state our opinion as to the contracts very briefly: First, we find them acceptable as to operating features. Secondly, we find them unpalatable as to a number of features related to equality of bidding opportunity and exposure to excessive legal risks. And, finally, while actually not of direct concern to us, we would suggest that this Commission must necessarily consider whether the present posture of the proposed offering is such as to reasonably assure the maximum economic return to the State.

We will make no decision as to whether we will even offer a bid until we have had a chance to evaluate further action by the State Lands Commission. We can say without any equivocation that the contract in its present form prevents our offering the maximum bid that we might otherwise make.

We urge the Commission to hold further hearings on the contracts with a view toward offering these lands on a more advantageous basis to all concerned. Once this is accomplished, we would expect to be a highly competitive bidder for the operating contract.

MR. CRANSTON: Thank you very much.

MR. CHAMPION: Are copies of this statement going to be available?

MR. CLARK: They will be. I don't have any now.

GOV. ANDERSON: I take it from your opening remark that if any contracts are entered into, the upland areas, or sixty per cent, should be signed up, so they couldn't hold it up?

MR. CLARK: Yes.

GOV. ANDERSON: I think it was reported earlier that one operator had fifty-three per cent, so that one operator could hold everything up.

MR. CLARK: That's right. There is an absolute veto.

MR. SHAVELSON: I might point out that the obligation of the successful bidder would not arise until the Unit Agreement became effective, because the Contractor Agreement does not become effective until the Unit Agreement becomes effective -- in case anybody has the idea that the successful bidder would be compelled to make production payments even while someone was holding up the agreement.

MR. CLARK: That's our least concern. We are exposed to all sorts of things. I think this is absolutely terrible --

to launch a contract which could only work at the choice of certain people that are also competitive bidders.

MR. CHAMPION: May I ask , Mr. Shavelson, at what point do you interpret this agreement - - or was there any point that these agreements would be in writing, or was it your understanding there would not be any agreement until bids had been made?

MR. SHAVELSON: It is my understanding thatuntil the Unit Agreements had been approved by the Lands Commission, there would be no attempt to execute them.

MR. CHAMPION: Would you offer for bid before that point? At what point would you insist on the commitment and what relation would that have to this problem?

MR. SHAVELSON: The way the agreement is drawn up, there is no necessity of the Unit Agreements being effective before the date of offering. Now, as to exactly what has been contemplated by the parties, I do not know.

MR. CHAMPION: Would there be any bar to any commitments?

MR. SHAVELSON: No.

MR. CRANSTON: Any other questions at this time? (No response) We would all like a copy of your comments. We would deeply appreciate it. I assure you we will give your statement most careful consideration.

I believe there is one more person here who wished to testify. (No response)

I think that we will at this time take this matter under advisement. I remind you that there are other matters pending on our calendar.

MR. HORTIG: Mr. Chairman, may I note for the record another telegram addressed to Alan Cranston, State Lands

Commission:

"Jade Oil and Gas Co. is prepared to execute the unit operating agreement and all other agreements immediately after approval by the State Lands Commission.

Delays in approval of this unit will automatically cause a loss of income to my company, my royalty owners, the City of Long Beach, and the State of California. The unit is presently being drained by off-set operators and we feel it is imperative that action be taken to approve this unit as soon as possible.

Jade Oil Co., a small independent, chartered in California in 1908, attended all unit agreement meetings and I can assure the State Land Commission that the final conclusions to these agreements were accepted as the best possible measures to operate efficiently in this Wilmington pool.

Jade Oil Co. owns more than 800 leases in the onshore unit comprising of approximately 150 acres. We feel that the presentplans to unitize the offshore and onshore units into one unit is the only logical method to properly develop this reservoir. I feel sure that the other owners of the onshore leases will agree that this unit should be one large, properly-developed unit.

I understand that there are other disinterested companies who, through their lack of ability were unable to secure onshore leases when the opportunity to secure them was available. It is my understanding that these companies want to divide the offshore into several parcels. It is my firm conviction that to be included in the unit of an incompetent operator if the offshore is divided and if so, not only is Jade Oil Co. affected, but so are my royalty owners.

We sincerely hope that the State Land Commission uses its best judgment and requires that the Wilmington unit remain as one big major unit, properly drilled, properly engineered and one which will earn the State of California and other interested parties maximum recovery at a minimum of cost, which is vitally essential to all of us.

Johnny Mitchell, President
Jade Oil and Gas Co. "

MR. CRANSTON: (To Senators and Assemblymen present) We will be in touch with each of you and thank you very much.

(End of Long Beach Wilmington Oil Field item)