

# State Lands Commission

## Because It Has Not Managed Public Lands Effectively, the State Has Lost Millions in Revenue for the General Fund

### REPORT NUMBER 2010-125, ISSUED AUGUST 2011

This report concludes the State Lands Commission (commission) has not always managed its more than 4,000 leases in the State's best interest with the result that it has missed opportunities to generate millions of dollars in revenues for the State's General Fund. For example, the commission has allowed lessees whose rent is past due to remain on state land for years without paying rent. In fact, we estimated losses totaling \$1.6 million for a sample of 10 delinquent leases we reviewed. Additionally, about 140 of the commission's 1,000 revenue-generating leases are currently expired. We estimate the commission has lost \$269,000 for 10 expired leases because lessees continue to pay the rent established by an old appraisal that may not be indicative of the property's current value. Further, although the commission has a mechanism in place to periodically review—and potentially increase—rental amounts, we found that it generally failed to promptly conduct rent reviews, causing it to lose \$6.3 million in increased rent it may have been able to collect. Moreover, the commission does not appraise its leased properties as frequently as the lease agreements allow, and when it does conduct appraisals, it sometimes undervalues its properties because it uses outdated methods, some of which were established more than 18 years ago.

We also found that the commission does not adequately monitor its leases. Specifically, the database used by the commission to store lease information is both inaccurate and incomplete, and is not used by staff to monitor the status of its leases. As a result, the commission is not appropriately tracking the status of some of its leases. For example, the commission apparently lost track of one of its leases, and as a result failed to bill the lessee for 12 years while the lessee remained on state property. Additionally, the commission does not regularly audit its revenue-generating leases, nor does it adequately oversee granted lands.

Finally, although the commission has undergone a series of staff reductions since 1990 and has made attempts to replace these lost positions, it has not taken sufficient steps to quantify its need for additional staff. Specifically, the commission has not developed any analyses to determine an appropriate workload and the number of staff needed to address such a workload.

In the report, the California State Auditor (state auditor) made the following recommendations to the commission. The state auditor's determination regarding the current status of recommendations is based on the commission's response to the state auditor as of October 2011.

#### **Recommendation 1.1.a—See pages 16 and 17 of the audit report for information on the related finding.**

To ensure that it manages delinquent leases in an effective and timely manner and collects all the amounts owed to it, the commission should determine the amount of past due rent that should be included in its accounts receivable account.

#### ***Commission's Action: Fully implemented.***

The commission asserted that it identified the amount of past-due rent that should be included in its accounts receivable account and it provided us the list of accounts receivable that included those receivables identified as contingent receivables.

**Recommendation 1.1.b—See page 18 of the audit report for information on the related finding.**

To ensure that it manages delinquent leases in an effective and timely manner and collects all the amounts owed to it, the commission should develop and adhere to policies and procedures that incorporate the administrative manual's guidance, including the steps staff should take when a lessee is delinquent, time standards for performing those steps, and a process for consistently tracking the status of delinquent leases between divisions.

***Commission's Action: Fully implemented.***

The commission provided draft policies and procedures that specified the steps staff should take when a lessee is delinquent, including time standards and a process for tracking the status of delinquent leases between divisions. The commission also plans to convene a team of senior management that will meet at least quarterly to discuss delinquent leases. According to the commission, the new process will be in place by November 1, 2011.

**Recommendation 1.1.c—See page 19 of the audit report for information on the related finding.**

To ensure that it manages delinquent leases in an effective and timely manner and collects all the amounts owed to it, the commission should conduct and document cost-benefit analyses when it contemplates either referring a delinquent lessee to the attorney general or pursuing the delinquent lessee through other means.

***Commission's Action: Fully implemented.***

The commission's draft procedures regarding delinquent lessees specify that a management team will make a determination regarding pursuing a delinquent lessee after weighing available resources. According to the commission's chief counsel, while its draft procedures did not use the phrase "cost-benefit analysis," the analysis of whether to pursue a trespass or lease compliance issue includes the elements of a cost-benefit analysis in addition to policy and legal considerations.

**Recommendation 1.2—See pages 19 and 20 of the audit report for information on the related finding.**

When the commission determines that it will pursue delinquent lessees itself, it should use a collection agency or a program such as the Franchise Tax Board's Interagency Intercept Collections Program.

***Commission's Action: Pending.***

The commission stated that it is conducting an analysis to determine if it is currently authorized to use a collection agency or if it can participate in the Franchise Tax Board's Interagency Intercept Collections Program.

**Recommendation 1.3.a—See page 22 of the audit report for information on the related finding.**

To ensure that as few leases as possible go into holdover, the commission should continue to implement its newly established holdover reduction procedures and periodically evaluate whether its new procedures are having their intended effect of reducing the number of leases in holdover.

***Commission's Action: Fully implemented.***

The commission believes that its new holdover reduction procedures are effective with the result that the number of leases in holdover has decreased by 75 percent.

**Recommendation 1.3.b—See pages 21 and 22 of the audit report for information on the related finding.**

To ensure that as few leases as possible go into holdover, the commission should consistently assess the 25 percent penalty on expired leases.

***Commission's Action: Fully implemented.***

The commission stated that its new holdover reduction policies include a provision to assess the 25 percent penalty.

**Recommendation 1.4.a—See pages 22 and 23 of the audit report for information on the related finding.**

To complete its rent reviews promptly and obtain a fair rental amount for its leases, the commission should consistently notify lessees of impending rent reviews or rental increases within established timelines.

***Commission's Action: Partially implemented.***

The commission stated that it updated a rent review checklist and now requires staff to pull lease files one year in advance of the rent review date rather than nine months. Further, the commission requested additional staff to accommodate the rent review workload. According to the commission, these changes have helped staff to complete rent reviews in a timely manner.

**Recommendation 1.4.b—See page 25 of the audit report for information on the related finding.**

To complete its rent reviews promptly and obtain a fair rental amount for its leases, the commission should establish time standards for each step of the rent review process and ensure that all staff adhere to those time standards.

***Commission's Action: Partially implemented.***

The commission provided its rent review policies and procedures; however, none of these include time standards for each step in the rent review process, including appraisals.

**Recommendation 1.4.c—See pages 25 and 26 of the audit report for information on the related finding.**

To complete its rent reviews promptly and obtain a fair rental amount for its leases, the commission should develop a methodology for prioritizing its workload that focuses its staff on managing the higher revenue generating leases until such time as it addresses its workload needs.

***Commission's Action: No action taken.***

The commission provided policies and procedures that instructed staff to focus on significant leases—those with rent over \$10,000—to reduce the number of leases in holdover. Although the commission provided evidence that it requested additional staff to perform rent reviews, it did not provide a methodology for prioritizing its workload that focuses its staff on managing the higher revenue generating leases for rent reviews.

**Recommendation 1.4.d—See page 26 of the audit report for information on the related finding.**

To complete its rent reviews promptly and obtain a fair rental amount for its leases, the commission should conduct rent reviews on each fifth anniversary as specified in the lease agreements or consider including provisions in its leases that allow for the use of other strategies, such as adjusting rents annually using an inflation indicator.



***Commission's Action: Pending.***

The commission stated that it is exploring the use of an inflation indicator to streamline the rent review process. Additionally, as we indicated under recommendation 1.4.c, the commission is requesting additional staff to perform rent reviews.

**Recommendation 1.5—See pages 26 and 27 of the audit report for information on the related finding.**

To ensure that it receives rent from the lessee that reflects the approximate value for the State's property at those times when a lessee disputes a modification to the rental amount after the commission exercises its right to perform a rent review or because the lease expired, the commission should include in its lease agreements a provision that requires lessees to pay the commission's proposed increased rental amount, which would be deposited into an account within the Special Deposit Fund. The increased rental amounts deposited, plus the corresponding interest accrued in the account, should then be liquidated in accordance with the amount agreed to in the final lease agreement.

***Commission's Action: Pending.***

The commission stated that other strategies such as enforcing the 25 percent rental increase for holdover leases should negate the need to establish an account within the Special Deposit Fund. However, during our review we identified several circumstances in which a lessee disputed the rental amount after a rent review, rather than after a lease had expired. The commission does not address this situation and we believe the commission should still explore the use of the Special Deposit Fund when lessees dispute a modification to the rental amount after a rent review.

**Recommendation 1.6.a—See page 28 of the audit report for information on the related finding.**

To ensure that it is charging rent based on the most current value of its properties, the commission should appraise its properties as frequently as the lease provisions allow—generally every five years.

***Commission's Action: Pending.***

The commission stated that it requested additional staff to accommodate the appraisal workload. Additionally, the commission is exploring the use of an inflation indicator to appraise its properties.

**Recommendation 1.6.b—See pages 28—31 of the audit report for information on the related finding.**

To ensure that it is charging rent based on the most current value of its properties, the commission should use the sales comparison method when it establishes values for leases having the greatest revenue potential, and develop policies that specify when and how often it is appropriate to use the other methods of appraising properties. These policies should address the coordination of leasing staff with appraisal staff as part of the process for determining which appraisal method should be used.

***Commission's Action: Partially implemented.***

The commission indicated that Land Management has directed staff to request sales comparison appraisals for all high value leases. However, the commission did not address whether it has developed a policy that specifies when and how often it is appropriate to use the other methods of appraising properties, or coordinates leasing and appraisal staff.

**Recommendation 1.7.a—See pages 31 and 32 of the audit report for information on the related finding.**

To ensure that it does not undervalue certain types of leases, the commission should amend its regulations for establishing pipeline rents on state land as staff recommended in the 2010 survey of methods used by agencies in other states to establish pipeline rents.

***Commission's Action: Pending.***

The commission stated that it is moving forward with the regulatory process to revise and update the regulations regarding rents, including those for pipelines.

**Recommendation 1.7.b—See pages 33 and 34 of the audit report for information on the related finding.**

To ensure that it does not undervalue certain types of leases, the commission should implement and follow its plan to regularly update its benchmarks for determining rental amounts.

***Commission's Action: Partially implemented.***

The commission provided an updated benchmark for San Francisco County. The commission asserted that it is progressing on the scheduled periodic updates of the other benchmarks.

**Recommendation 1.7.c—See page 34 of the audit report for information on the related finding.**

To ensure that it does not undervalue certain types of leases, the commission should periodically analyze whether collecting oil royalties in cash or in kind would maximize revenues to the State, and use that method to collect its oil royalties.

***Commission's Action: Fully implemented.***

The commission requested the city of Long Beach to perform an analysis of the sale of oil from the Long Beach leases. The city of Long Beach determined that it will not collect royalties in kind as such sales would be detrimental to the State. Commission staff conducted an analysis of its non-Long Beach leases and made a similar determination.

**Recommendation 2.1.a—See pages 38—40 of the audit report for information on the related finding.**

To improve its monitoring of leases, the commission should create and implement a policy, including provisions for supervisory review, to ensure that the information in the Application Lease Information Database (ALID) is complete, accurate, and consistently entered to allow for the retrieval of reliable lease information. To do so, the commission should consult another public lands leasing entity, such as the Department of General Services, to obtain best practices for a lease tracking database.

***Commission's Action: Partially implemented.***

The commission asserts that all income-producing leases have been verified for data elements related to rent review dates, lease term, and expiration dates. Further, commission staff is developing management reports that, according to the commission, will allow access to data in a format that will be useful for decision making. Finally, the commission is pursuing an off-the-shelf software program that could potentially replace ALID. However, the commission has not implemented a policy that includes provisions for a supervisory review of the data entered into ALID. Further, the commission has not yet consulted with other public lands leasing agencies to obtain best practices for a lease tracking-database.

**Recommendation 2.1.b—See page 39 of the audit report for information on the related finding.**

To improve its monitoring of leases, the commission should require all of its divisions to use ALID as its one centralized lease-tracking database.

***Commission's Action: Partially implemented.***

The commission stated that the steps it has taken should reduce the need for staff to use multiple data sources.

**Recommendation 2.2.a—See page 42 of the audit report for information on the related finding.**

To adequately monitor its revenue generating oil and gas leases, the commission should track the recoveries and findings identified in its audits and use this information to develop an audit plan that would focus on leases that have historically generated the most revenue and recoveries for the State, as well as those that historically have had the most problems.

***Commission's Action: Partially implemented.***

The commission developed an audit plan for all mineral leases that considers a combination of factors, including risk and specifies that the commission will track the recoveries and findings identified in its audits. However, the commission does not believe that it can implement the plan without additional staff but has recently requested several staff to accommodate the workload.

**Recommendation 2.2.b—See page 43 of the audit report for information on the related finding.**

To adequately monitor its revenue generating oil and gas leases, the commission should work with lessees that entered into a lease with the commission before 1977 to put in place a reasonable time period within which lessees must resolve other types of deduction claims similar to the regulations already in place for dehydration costs.

***Commission's Action: Partially implemented.***

The commission stated that staff will continue to work with lessee when the opportunity arises to implement the recommendation where appropriate and when it is in the best interests of the State. However, we believe the commission should implement a policy that demonstrates that the commission intends to make this a regular practice.

**Recommendation 2.2.c—See pages 43 and 44 of the audit report for information on the related finding.**

To adequately monitor its revenue generating oil and gas leases, the commission should explore and take advantage of other approaches to fulfill its auditing responsibilities, such as contracting with an outside consulting firm that could conduct some of its audits on a contingency basis.

***Commission's Action: Pending.***

The commission is withholding consideration of this approach until after the completion of a project for which the commission is currently contracting with an outside consulting firm.

**Recommendation 2.3—See pages 44 and 45 of the audit report for information on the related finding.**

The commission should establish a monitoring program to ensure that the funds generated from granted lands are expended in accordance with the public trust.

***Commission's Action: Pending.***

The commission is requesting additional staff to establish this monitoring program.

**Recommendation 2.4—See pages 46 and 47 of the audit report for information on the related finding.**

To ensure that all of its oil and gas leases have current surety bonds and liability insurance, as required by law and certain lease agreements, the commission should require lessees to provide documentation of their surety bonds and liability insurance. If the commission believes that assessing a monetary penalty will be effective in encouraging lessees to obtain surety bonds or liability insurance, it should seek legislation to provide this authority. Finally, if it obtains this authority, the commission should enforce it.

***Commission's Action: Partially implemented.***

The commission is requesting additional staff to establish a lease compliance program that would ensure lessees maintain current surety bonds and liability insurance, and is exploring regulations that would give it authority to penalize non-compliance.

***Legislative Action: Unknown.***

The state auditor is not aware of any action taken by the Legislature as of January 5, 2012.

**Recommendation 3.1.a—See pages 52 and 53 of the audit report for information on the related finding.**

To better demonstrate its need for additional staff, the commission should conduct a workload analysis to identify a reasonable workload for its staff and use this analysis to quantify the need for additional staff.

***Commission's Action: Fully implemented.***

The commission conducted workload analyses that it included as part of its request for additional staff.

**Recommendation 3.1.b—See pages 53—55 of the audit report for information on the related finding.**

To better demonstrate its need for additional staff, the commission should quantify the monetary benefits of its staff's duties other than processing lease applications, and consider billing lessees for those activities.

***Commission's Action: Pending.***

The commission asserts that it is incorporating management fees into larger leases and is exploring legislative and regulatory changes necessary to address this issue.

**Recommendation 3.1.c—See page 55 of the audit report for information on the related finding.**

To better demonstrate its need for additional staff, the commission should ensure that the workload analysis takes into consideration the additional responsibilities and staffing needs that the commission will receive if the section of the state law that provides for rent free leases is repealed.

***Commission's Action: Fully implemented.***

The section of the state law that provided for rent-free leases was repealed during this past legislative session. The commission stated that it identified additional staffing needs in its enrolled bill report.

**Recommendation 3.2—See pages 55—57 of the audit report for information on the related finding.**

To better address current and potential future staffing shortages, as well as the impending loss of institutional knowledge, the commission should create a succession plan.

***Commission's Action: No action taken.***

➡ Although the commission agrees with this recommendation, it indicated that it does not plan to address this recommendation until it has sufficient staff to do so.