

## State Lands Commission

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

August 2011 Report 2010-125



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August 23, 2011

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The Governor of California  
President pro Tempore of the Senate  
Speaker of the Assembly  
State Capitol  
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report concerning the State Lands Commission's (commission) management of leases of state property. This report concludes the 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lease agreements allow, and when it does conduct appraisals, it sometimes undervalues its properties because it uses outdated methods, some of which were established more than 18 years ago.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.

Respectfully submitted,



ELAINE M. HOWLE, CPA  
State Auditor

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## Summary

### Results in Brief

The State Lands Commission (commission) is responsible for managing the lands that the State acquired from the federal government at statehood, including the beds of navigable rivers and lakes, submerged land along the State's coast, and school lands granted to the State for the benefit of public education. The commission's management of these lands provides the State with revenues from leases and from the State's share of net profits derived from activities conducted on state lands. However, we found that the commission has not always managed its more than 4,000 leases in the State's best interest. As a result, it has missed opportunities to generate millions of dollars in revenues for the State's General Fund—estimated to be as much as \$8.2 million for just some of the leases in the sample of 35 we reviewed.

Specifically, the commission is not effective or consistent in seeking payment from lessees whose rent is past due—known as delinquent lessees—in part because it does not have policies and procedures specifying the steps it needs to take to appropriately manage these leases. Furthermore, it does not consistently take any other actions, such as evicting delinquent lessees, to ensure that it is protecting the State's interest in its properties. In fact, we found that 130 of the commission's nearly 1,000 revenue-generating leases were past due on rent and that the commission has allowed some of the delinquent lessees whose leases we reviewed to remain on state land for up to 22 years without paying rent. For example, Crockett Marine Services, Incorporated (Crockett) has not paid any rent since 1989; however, the commission has not actively sought to remove or otherwise penalize Crockett at any time since it stopped paying its rent. In fact, it was only after we inquired about this lease that the commission found that Crockett is subleasing the land to another party from whom Crockett is collecting rent. We estimate that the commission may have lost as much as \$662,000 for this one lease alone, with estimated losses totaling \$1.6 million for a sample of 10 delinquent leases we reviewed, including the Crockett lease.

According to the chief of the commission's Administrative and Information Services Division, part of the reason that the commission does not consistently take action against delinquent lessees is because actions such as eviction require litigation, which is costly and staff intensive. Nonetheless, although state law prohibits the commission from taking formal legal action against a lessee unless it retains the services of the Office of the Attorney General (attorney general), state law allows the commission to recover the costs of the legal action. Further, state law does not

### Audit Highlights . . .

*Our review of the State Lands Commission's (commission) management of leases disclosed that the commission:*

- » *Does not have policies and procedures specifying steps needed for managing leases and is ineffective or inconsistent in seeking payment from or evicting lessees whose rent is past due.*
- » *Has missed opportunities to generate millions of dollars in revenues for the State's General Fund—estimated to be as much as \$8.2 million for just some of the leases we reviewed.*
  - *Does not always evict delinquent lessees—we estimated losses totaling \$1.6 million for 10 delinquent leases we reviewed. More than 10 percent of the revenue-generating leases were past due on rent and yet some of the lessees have remained on state land without paying rent for up to 22 years.*
  - *Does not take timely action to renew its expired leases, conduct rent reviews, or appraise properties. The commission lost up to an estimated \$269,000 for the leases we reviewed that are currently in holdover—leases that have not been extended or renewed.*
  - *Lost \$6.3 million in increased rent that it may have been able to receive on a sample of leases because it failed to promptly conduct rent reviews, which frequently result in increased rent amounts.*
  - *May be losing up to \$174,000 each year for a sample of pipeline leases we reviewed because it has not updated the rate—established in 1981—in regulations, to use when calculating rent for such leases.*

*continued on the next page . . .*

- » *Is not appropriately tracking the status of some of its leases. Its Application Lease Information Database has inaccurate and incomplete data and staff do not always use it to track lease information.*
- » *Does not have a plan for monitoring its revenue-generating leases, in particular those leases that are potentially the most profitable because they involve the extraction of oil and gas from state properties.*
- » *Has not taken sufficient steps to quantify its need for additional staff.*

prohibit the commission from using a collection agency to collect past-due rent. Thus, we expected that the commission would have conducted a cost-benefit analysis to determine when it would be beneficial to either seek a court judgment through the attorney general or pursue the case in another manner, such as using a collection agency. However, according to its chief counsel, the commission has not conducted a formal analysis of this type. Therefore, we question how the commission determined that litigation was too costly to pursue.

Moreover, the commission has not always taken timely action to renew its expired leases, conduct rent reviews, or consistently appraise its properties. For example, about 140 of the commission's revenue-generating leases are currently expired and are in *holdover*—the term the commission uses when referring to leases that have not been extended or renewed. During the time their leases are in holdover, lessees continue to pay the amounts stipulated by their expired leases. As a result, the commission loses the rent it could have collected if it had promptly renegotiated the leases using a recent appraised value. Because of this, we estimate the commission lost up to \$269,000 for 10 leases we reviewed that are currently in holdover. The commission has recently implemented procedures it believes will prevent leases from going into holdover. Although these new procedures appear reasonable, because the commission only recently implemented them, we were unable at the time of our audit fieldwork to determine whether they would be effective.

Rent reviews can result in modifications to the rental amounts the commission charges lessees—frequently resulting in increased rental amounts—but the commission has failed to promptly conduct rent reviews, causing it to lose \$6.3 million<sup>1</sup> in increased rent that it may have been able to collect on 18 of the 35 leases in our sample. Nearly all leases contain language that allows the commission to increase the rental amount by conducting a rent review on the fifth anniversary of the lease. However, the commission failed to perform timely rent reviews for these 18 leases, in part, according to the chief of the Land Management Division (land management), because of staffing shortages.

The commission also does not appraise its leased properties as frequently as the lease agreements allow, which generally is at least once every five years in preparation for a rent review. For example,

<sup>1</sup> After we completed our fieldwork, the commission ultimately negotiated and the commissioners approved a new lease with Shell Oil Company on June 23, 2011, which is one of the leases included in our sample that resulted in our estimate of \$6.3 million in lost revenues. As part of its negotiations, Shell Oil Company agreed to pay \$2.5 million for the period from August 1999 to July 2011.

we found that the commission appraised the value of the properties related to the sample of leases we reviewed an average of only three times over the period during which the commission could have performed a rent review, which ranged from five to 41 years, and it has not conducted an appraisal for several leases in more than 15 years. Because these properties increased in value over time, the commission missed opportunities to increase their related rent. Furthermore, when it did perform these periodic appraisals, it used methods that may have resulted in values that were lower than they might have been using other methods, again missing opportunities to increase the State's revenues. For example, the regulations that specify the rate that the commission should use to calculate rent for its pipeline leases were established in 1981. We estimate that, as a result of using this outdated rate, the commission may be losing up to \$174,000 for a sample of seven pipeline leases we reviewed for each year it fails to update the rate. Additionally, the commission may be losing revenue because it has not performed an analysis to determine whether it is more profitable to receive royalties on oil extracted from state land in the form of cash or crude oil.

In order for the commission to meet its responsibilities, we expected to find that it uses a database that would allow it to manage its leases effectively, assisting the commission in performing timely rent reviews and lease renewals and in accurately invoicing lessees. Instead, we found that the data in the commission's Application Lease Information Database (ALID) are both inaccurate and incomplete, and staff do not use the database to track lease information. Further, we found that each division has developed its own method of tracking leases, but the information is not consistent among the divisions. 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.

The commission is also not effectively performing two other key functions: auditing the funds generated from its revenue-producing leases or granted lands and ensuring that lessees maintain current surety bonds and liability insurance. With respect to its auditing program, the commission has not developed a plan for monitoring its nearly 1,000 revenue-generating leases and, in particular, about 85 leases that are potentially the most profitable because they include leases that involve the extraction of oil and gas from state properties. In fact, the commission has completed only two audits since 2008, neither of which were for oil or gas leases. Thus, the commission is not ensuring that the State is receiving the appropriate amount of revenues from its revenue-generating leases.



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. In fact, the commission's land management and Mineral Resources Management divisions—the divisions with the most responsibility for managing its leases—have experienced staffing reductions of 50 percent and 32 percent, respectively. We found that although commission managers expressed a need for more staff to adequately perform critical duties such as rent reviews, they had not developed any analyses to determine an appropriate workload and the number of staff needed to address such a workload. In addition, the commission has not developed a succession plan to address its future workforce needs, exposing it to the further loss of knowledgeable staff and a continuation of the problems it currently has with effectively managing its leases.

### Recommendations

To ensure that it manages delinquent leases in an effective and timely manner, the commission should do the following:

- Develop and adhere to policies and procedures that include the steps staff should take when a lessee is delinquent, time standards for performing those steps, and a process for tracking the status of delinquent leases between divisions.
- 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.

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

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 it to use other strategies, such as adjusting rents annually using an inflation indicator.

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 once every five years.

To ensure that it does not undervalue certain types of properties, the commission should do the following:

- Amend its regulations for establishing pipeline rents on state land to reflect a more current method.
- Periodically analyze whether collecting oil royalties in cash or in kind would maximize revenues to the State, and collect its oil royalties in the most profitable way.

To improve its monitoring of leases, the commission should do the following:

- Create and implement a policy, including provisions for supervisory review, to ensure that the information in ALID is complete, accurate, and consistently entered to allow for the retrieval of reliable lease information.
- Require all of its divisions to use ALID as its centralized lease-tracking database.

To adequately monitor its revenue-generating oil and gas leases, the commission should do the following:

- Develop an audit schedule that focuses on leases that have historically generated the most revenue and recoveries for the State, as well as those that have historically had the most problems.
- 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.

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.

To better address current and potential future staffing shortages, the commission should create a succession plan.

### **Agency Comments**

The commission agrees with many of our recommendations and states that it is implementing or is planning to implement most of them.

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# Introduction

## Background

When California achieved statehood in the 1850s, the federal government granted approximately 9 million acres of land to the newly formed state. This included approximately 4 million acres of tidelands and submerged lands—essentially those lands that lie underwater along the California coast as well as the beds of navigable rivers and lakes. By law, these tidelands and submerged lands are held in trust for the people of California and may be used only for certain purposes, including commerce, navigation, fisheries, and other uses that the courts have found consistent with the public trust. In addition, the federal government granted more than 5 million acres of *school lands* to California. These school lands were granted to be used for the benefit of public education. School lands are not required to be used to site school facilities; rather, the revenue generated by those lands, many of which are located in desert areas, must be used to benefit public education and, more specifically, the State Teachers' Retirement System.

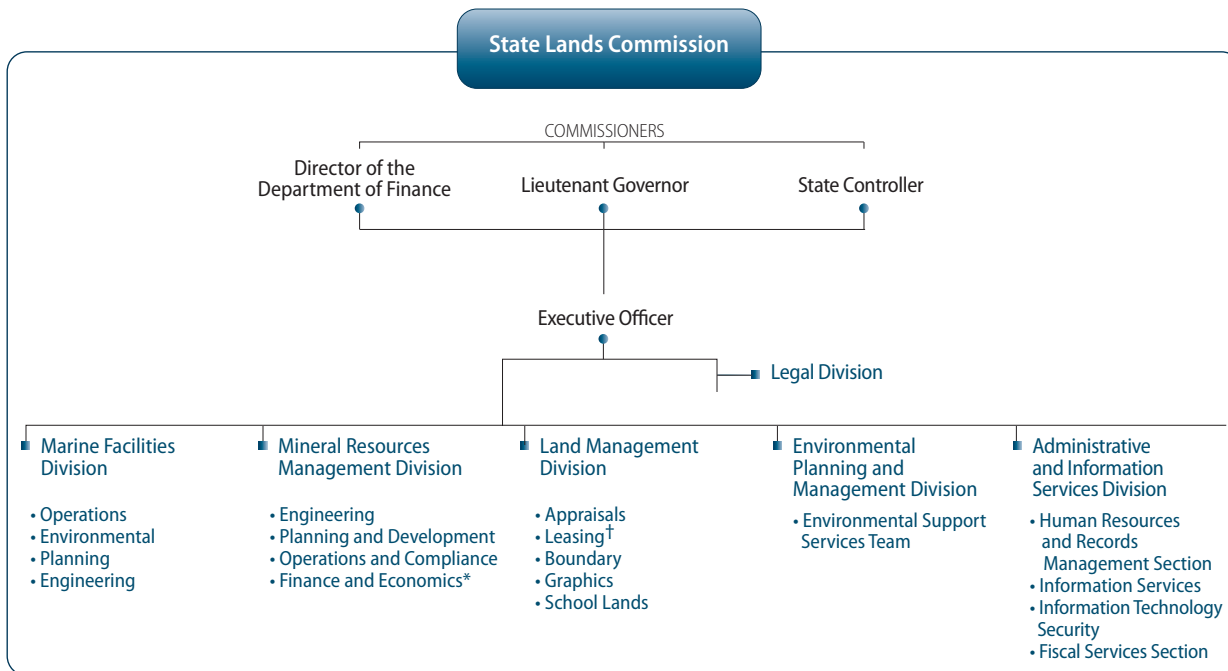
Since 1938 the State Lands Commission (commission), within the Natural Resources Agency, has been charged with the responsibility of managing these state lands in a manner consistent with the public trust. Although the commission generally acts as the trustee over state lands, with the responsibility for managing them in keeping with permissible purposes, the Legislature has the power to delegate the responsibility for managing tidelands and submerged lands to local governments. When it does so, these lands are known as *granted lands*, and the local governments that manage them must ensure that they are used in ways that are consistent with the public trust and with any other conditions the Legislature imposes. This includes ensuring that revenue generated from the use of these lands is used for purposes that further the public trust. The commission, however, remains responsible for overseeing these granted lands and for ensuring that they are properly managed. Currently, according to the commission, the Legislature has made 85 grants of state land to various local governments. Examples of granted lands include the Port of Long Beach, the Port of San Francisco, and other areas along the California coast.

## Organization of the Commission

The commission consists of three members (commissioners): the lieutenant governor, who is the chair; the state controller; and the director of the Department of Finance. The commissioners meet periodically to make decisions regarding leases and other matters. In 2010 the commissioners met six times. The commissioners also

appoint an executive officer who manages the commission's daily operations and the more than 200 employees who provide support to the commissioners. The commission is organized into six divisions, as shown in Figure 1.

**Figure 1**  
Organization of the State Lands Commission



Source: Organization chart provided by the State Lands Commission.

\* The Mineral and Land Audit Program, which we refer to as the audit section in Chapter 2 of the report, is under Finance and Economics.

† Leasing staff within the Land Management Division process lease applications.

The Land Management Division (land management) has the responsibility of managing the leasing of the State's properties that are under the commission's authority. Land management's responsibilities include receiving and processing applications, appraising property, conducting rent reviews, and renegotiating leases. The Mineral Resources Management Division (mineral resources) manages the use of energy and resources on more than 85 revenue-generating oil and gas, geothermal, and mineral leases. Mineral resources also conducts inspections and safety audits of equipment and facilities to ensure safe and environmentally friendly operations.

The Marine Facilities Division has certain regulatory responsibilities related to oil transfer operations and to the prevention of invasive species in state waters. Additionally, the Environmental Planning and Management Division is responsible for ensuring that the commission complies with the requirements of the California Environmental Quality Act. Finally, the Legal Division and Administrative and Information Services Division (administrative services) assist the other divisions in carrying out their duties. The fiscal services section within administrative services is responsible for billing and receiving payments from lessees.

The commission's budget was \$29.8 million for fiscal year 2009–10, including \$9.4 million from the State's General Fund, \$11.5 million from the Oil Spill Prevention and Administration Fund, \$3.5 million from the Marine Invasive Species Control Fund, and \$4.6 million in reimbursements. The commission's management of lands provides the State with revenues from leases of state land and revenues from the State's share of the net profits derived from activities conducted on state land. According to the commission's unaudited financial statements, the commission collected roughly \$400 million in rents and royalties during fiscal year 2010–11, and the majority of these revenues were generated by the commission's oil leases. The commission deposits most of the revenues it collects into the General Fund.

### **Types of Leases Managed by the Commission**

The commission's regulations provide for the leasing of state property for a variety of purposes, including agricultural, commercial, industrial, right-of-way, and recreational purposes. According to the commission's database, it manages more than 4,000 leases, including approximately:

- 85 oil and gas, geothermal, and mineral leases.
- 900 agricultural, commercial, industrial, right-of-way, and recreational leases.
- 3,200 rent-free leases.

Recreational leases include boat docks, buoys, and buoy fields. By law, rent-free leases include private recreational piers and public agency use permits that the commission has deemed provide a public benefit.

## The Commission's Leasing Processes

Public and private entities may apply to the commission for a new lease or for the renewal of an existing lease of state property. The commission requires that the application include an outline of the proposed project, supporting environmental data, and payment of appropriate fees. Commission staff then review the application and make a recommendation to the commissioners for action.

### Methods Used by the State Lands Commission to Establish Rental Amounts

- **Sales comparison:** Uses recent sales of similar property to estimate the value of state property. The California Code of Regulations requires the annual rental amount to be 9 percent of the estimated value.
- **Benchmarks:** Establishes a representative value and rental for a certain use or property type within a certain geographic area, which is similar to the amount an individual would pay for a comparable property within that area.
- **Consumer Price Index adjustments:** Uses the Consumer Price Index (CPI) to adjust the rental amount. The commission uses the CPI only for five-year rent reviews and annual adjustments.
- **Pipeline diameter:** Multiplies 2 cents times the outside diameter of the pipe multiplied by the length of the pipeline within the lease area.
- **Percentage of gross income:** Uses either actual or estimated gross income received from the activities or facilities on the lease premises. This method is used primarily for commercial leases.

Sources: The California Code of Regulations and interviews with staff of the State Lands Commission.

To determine the amount of rent a lessee will pay for leasing state property, the commission appraises the value of the property, using the methods described in the text box. The type of lease influences the type of appraisal method that the commission will use when establishing the rent. For example, if the commission is appraising the value of a lease for a pipeline, it will generally calculate the rent using the sales comparison or pipeline diameter method.

The commission's current regulations indicate that when it calculates the rent to be charged for commercial or industrial uses, such as for an oil terminal and related structures, it must use any one or a combination of specified methods, including basing the rent on the volume of commodities passing over the land—known as the volumetric method.<sup>2</sup>

The commission's regulations allow it to collect other types of payments from lessees in addition to or in lieu of an annual rent based on the appraised value of the land. Specifically, some lessees pay the commission a percentage of the profits generated from commercial business on state property. Additionally, when the State leases land to oil companies, it receives royalties for the oil or natural gas that is extracted from state land.

The commission can elect to collect the oil royalties either in cash or in crude oil. When the commission collects royalties in cash, it receives an amount for each barrel of oil that is based on the market value of oil extracted from that area. However, when there is a sufficient quantity of oil, and there are local buyers with an interest in buying the oil such that a cash pricing bonus

<sup>2</sup> These specific provisions were challenged in court, and in a 1984 decision the Ninth Circuit Court of Appeals found that they violate the Commerce Clause of the United States Constitution (*Western Oil and Gas Association v. Cory* (9<sup>th</sup> Cir. 1984, 726 F.2d 1340), construing U.S. Const., art. 1, § 8, cl. 3.) because of the burden they place on interstate commerce. As a result, the commission no longer uses the volumetric method to appraise its properties.

could be added to the selling price, the commission's practice is to take the royalty in crude oil and then sell the oil to the highest bidder, using 12- to 18-month contracts.

The general provisions included in the commission's standard lease agreements allow it to periodically modify the method, amount, or rate used to determine the annual rent agreed to in the lease. The commission refers to this as a rent review. These rent reviews are intended to ensure that the amount of rent the commission charges is commensurate with any increase or decrease in land value. Thus, rent reviews may result in the commission increasing or decreasing a lessee's rent. To determine whether the rent should be adjusted since the rental amount was last established, the commission performs a more current appraisal of the property, using one of the methods mentioned in the previous text box. The lease provisions generally stipulate that the commission can perform rent reviews on each fifth anniversary of the lease, or on any of the next four anniversaries thereafter if the commission fails to perform the rent review on the fifth anniversary. The commission is required to inform the lessee of the rent review at least 30 days before the new rental amount becomes effective.

The commission designates leases that have expired as being in *holdover*. Lease provisions and state law allow the commission to collect the rent specified by the expired lease while the lease is in holdover. Additionally, according to the lease provisions, the commission can assess a 25 percent penalty on the annual rent in effect. As of December 2010, according to documents provided by the commission, there were approximately 140 leases in holdover. When the commission executes a new lease with a lessee, ending the holdover period, the commission generally has the option of charging the lessee back rent, which is an estimate of the additional rent the lessee should have paid during the period that the lease was in holdover.

The commission uses the Application Lease Information Database (ALID) to store its lease information. Specifically, ALID contains lease information, including the lessee name, lease term and type, lease location, rental amount, lease history, and bond and insurance information. The commission also uses tickler dates within ALID to remind staff when leases are eligible for a five-year rent review. ALID is not used to track appraisal frequency, appraisal types, or rental payment status.



### Scope and Methodology

The Joint Legislative Audit Committee (audit committee) requested the Bureau of State Audits (bureau) to perform an audit of the commission's management of leases. Specifically, the audit committee asked the bureau to do the following:

- Determine the changes the commission made to its process for reviewing leases to address the findings in the Office of the Auditor General's 1984 report (discussed later).
- Examine the current process used by the commission to review leases and determine whether the process includes steps to calculate and revise rents based on property appraisals and other relevant factors. In addition, the bureau was asked to determine how frequently the commission appraises the value of its leased properties.
- Determine the time standards established for completing each step in the rent review process and whether the commission notifies lessees of potential changes to leases in a timely manner.
- Determine the commission's process for managing leases that are in holdover, including how it sets payments during the holdover period.
- For a sample of leases, determine whether the commission is adequately managing its leases with respect to the lease-related processes identified in the three previous objectives.
- Identify the price per linear foot of pipelines and conduits that the commission currently uses in developing rents and determine whether this price should be revised to reflect changes in a relevant price index.
- Review and assess any other issues that are significant to the effective and efficient management of leases of state lands.

In 1984 the Office of the Auditor General, the predecessor to the bureau, issued a report titled *Review of the State Lands Commission's Management of State Land*, Report P-344. The report concluded that the commission did not have an adequate rent review process and recommended that the commission establish a systematic rent review process to ensure that staff conduct timely rent reviews. To determine the changes the commission made to its process for reviewing leases in response to the 1984 report, we interviewed key personnel in the commission's land management and administrative services divisions and reviewed the commission's policies and procedures to assess whether

the commission had made changes to its process. Because the 1984 report also contained a recommendation to the commission regarding its process for determining whether to receive oil royalties in cash or in oil, we also spoke with personnel in mineral resources to determine whether it regularly assesses which method is most beneficial to the State.

The U.S. Government Accountability Office, whose standards we follow, requires us to assess the sufficiency and appropriateness of computer-processed information. When our initial review of the data included in ALID found significant errors, we determined that we would not be able to make conclusions based on these data. For example, we would have liked to have used information from ALID to determine how frequently the commission appraises the value of all of its lease properties, how much time it spends in each step of the rent review process, the total number of leases in holdover, and the total number of leases based on the price per diameter inch per linear foot of pipeline. Because we could not use ALID for these purposes, we judgmentally selected a sample of 35 leases from the commission's approximately 1,000 revenue-generating leases to obtain some of this information. To select the sample, we took into consideration the status of the leases, rental amount, and type. Of the 35 leases, 10 were in holdover and 11 were delinquent on rent.

To understand the process the commission currently uses to review leases, and to determine whether the process includes steps to calculate and revise rents based on property appraisals, in addition to any time standards established for completing each step in the rent review process, we reviewed the commission's policies and procedures and interviewed key staff in land management. We used the sample of 35 leases to determine whether the commission is adequately managing its leases in areas relevant to the processes we identified through our discussions with commission staff. We reviewed the commission's lease files related to the sample of 35 leases and obtained information such as the lease history, rental payment status, frequency and notification of rent reviews, appraisal frequency and appraisal method, any actions the commissioners may have taken related to the lease, renewals or amendments, status of surety bonds and liability insurance, and accuracy of information in the commission's ALID. As part of this review, we also determined how frequently the commission appraises the value of its leased properties.

To determine how the commission manages leases that are in holdover, we interviewed key staff in the commission's land management and administrative services divisions to understand how it identifies and tracks leases in holdover, how the commission sets payments during the holdover period, and what efforts it takes to notify lessees of leases that will be expiring soon. We also

reviewed the commission's options for penalizing lessees whose leases have expired, and calculated the potential lost revenue as a result of the commission's inconsistent application of these options. Finally, we calculated the potential revenues lost as a result of the commission's failure to appropriately manage its delinquent leases and holdover leases and to conduct timely rent reviews, as well as the revenues potentially lost due to the commission's use of outdated methods to appraise its properties. We consulted the California Department of Industrial Relations' California Consumer Price Index when calculating some of these lost revenues.

To identify the price per diameter inch per linear foot of pipelines and conduits that the commission currently uses in developing rents, and to determine whether this price should be revised to reflect changes in a relevant price index, we interviewed key staff in land management. Further, we calculated the amount of revenue the commission could receive if it charged an average price based on its survey of other states' prices.

To review and assess any other issues significant to the effective and efficient management of leases and state lands, we reviewed some of the commission's other key functions, including auditing leases and ensuring that proper surety bonds and insurance are in place. To assess its auditing function, we interviewed staff in mineral resources, obtained a list of audits performed since 2008, and reviewed a sample of audits to determine the amounts recovered as a result of those audits. To determine whether the commission ensures that lessees maintain current surety bonds and liability insurance, we interviewed land management staff and reviewed the lease files of our sample of 35 leases to ascertain whether they included evidence of current surety bonds and liability insurance. Because the commission attributes many of its difficulties with managing leases to staffing shortages, we determined the changes in staffing that had occurred at the commission over time and reviewed the commission's efforts to request and to justify additional staff and to plan for its future workforce needs through succession planning.

## Chapter 1

### THE STATE LANDS COMMISSION'S POOR MANAGEMENT OF LEASES HAS CAUSED THE STATE TO LOSE MILLIONS OF DOLLARS IN REVENUE

#### Chapter Summary

The State Lands Commission (commission) is not effectively managing its leases, and as a result it has failed to collect or generate millions of dollars in potential revenue for the State's General Fund. Our review of a sample of 35 of the commission's nearly 1,000 revenue-generating leases found that the commission could have collected an additional \$8.2 million for some of these leases had it more effectively managed them. For example, we found that the commission has allowed lessees whose rent is past due—referred to as delinquent lessees—to remain on state land for years without paying rent.

Moreover, the commission does not always promptly negotiate new leases for those that have expired, which the commission refers to as leases in *holdover*, nor does it always conduct rent reviews in a timely manner. Both of these situations allow lessees to remain on state land for a rental amount that may not be reflective of the land's current value. In fact, at the time of our review, according to the commission's records, about 140 of its leases had expired. When we reviewed a sample of 10 of these expired leases, we estimated that the commission could have collected an additional \$269,000 during the years they have been in holdover. Additionally, because the commission did not perform timely rent reviews for 18 of the 35 leases we reviewed, we estimated that the commission failed to collect more than \$6.3 million.

We also found that the commission is missing opportunities to increase the State's revenues related to its leases because it does not regularly appraise the value of its leased properties. Thus, as the land increased in value over time, the commission missed opportunities to increase the rent on its properties. Additionally, when it establishes the rental amounts for certain properties, the commission sometimes uses outdated methods, some of which were established more than 18 years ago.

#### The Commission Is Not Effectively Managing Its Delinquent Leases

The commission has allowed delinquent lessees to remain on state land for years, sometimes decades, without paying rent. The commission has not developed and implemented policies and

***The commission's listing of accounts receivable contained just over \$1.2 million in past-due rent for 130 leases—of this total about \$370,000 has been delinquent for at least three years.***

procedures that specify the steps it needs to take to appropriately manage its delinquent lessees. By failing to collect the revenue related to these delinquent payments, as well as the applicable penalties and interest, the commission is failing to derive all the revenues it could from the state property that is leased under its authority.

The commission's listing of accounts receivable contained just over \$1.2 million in past-due rent for 130 leases as of December 31, 2010, and of this total about \$370,000 has been delinquent for at least three years. However, the \$1.2 million in delinquent rent does not represent the total revenue the commission has lost, as it includes only the base annual rental amount stipulated by the original lease agreement and not the penalties and interest that the commission could apply to the late payments. In addition, we found that the commission's accounts receivable account is not accurate. For example, the \$1.2 million account balance does not include at least \$190,000 in past-due rent we identified when we reviewed a sample of 10 delinquent leases. We originally attempted to determine the total amount of the past-due rent that the commission's accounts receivable account should include. However, we received conflicting information as to what this amount should be from the fiscal services supervisor and the chief of the Administrative and Information Services Division (administrative services). Until the commission determines the past-due amounts that should be included in its accounts receivable account, it will not be able to take appropriate action to collect all the amounts owed to it.

To provide some perspective on the actual amount of lost revenue related to delinquent leases, we selected a sample of 10 leases for which the lessee had not paid rent for between five and 22 years as of December 2010. As shown in Table 1, we estimate that the commission has lost more than \$1.6 million on these 10 leases—more than \$600,000 in principal that these lessees failed to pay over the years and about \$1 million in penalties and interest. This amount will continue to increase for as long as the commission delays taking action. Further, if the remaining 120 leases that we did not analyze reflect similar amounts, the actual amount lost will be significantly higher than \$1.6 million.

As an example, Crockett Marine Services, Incorporated (Crockett) has not paid its \$10,170 annual rent since 1989. We calculated that as a result, the commission has lost \$662,000 in principal, penalties, and interest for that one lease alone. According to the commission's lease file for Crockett, the Land Management Division (land management) concluded in 1998 that Crockett did not have a valid reason for not paying its rent; however, the commission has not taken much action to force Crockett to make its lease payments since that date. Furthermore, after we inquired about the

**Table 1**  
**Lost Revenues Related to a Sample of 10 Delinquent Leases**

LEASE	CURRENT ANNUAL RENT	YEARS PAST DUE	TOTAL PRINCIPAL DUE	PENALTIES AND INTEREST	TOTAL LOST REVENUE
Crockett Marine Services, Inc.*	\$10,170	22	\$221,670	\$440,429	\$662,099
Ramos Oil Company, Inc.	2,907	18	52,326	86,537	138,863
AERA Energy, LLC	7,605	11	83,655	91,813	175,468
AERA Energy, LLC	6,210	11	68,310	74,972	143,282
AERA Energy, LLC	4,725	5	23,625	39,031	62,656
AERA Energy, LLC	5,193	11	57,123	62,694	119,817
Ship Ashore Resort	1,200	22	26,400	52,805	79,205
Thousand Trails, Inc.	3,075	8	24,600	30,766	55,366
R.J. Naylor†	1,700	17	3,400	10,786	14,186
The Dow Chemical Company	2,712	21	56,952	109,042	165,994
<b>Totals</b>			<b>\$618,061</b>	<b>\$998,875</b>	<b>\$1,616,936</b>

Source: State Lands Commission's lease files.

\* The rent amount for the first year of the 22 years was \$8,100.

† This lessee did not pay for only the years 1993 and 1994.

Crockett lease, a manager in land management determined that, as of February 2011, Crockett was subleasing the land to another party from whom Crockett was collecting rent. The chief of land management could not tell us, nor could we determine from the lease file, specifically why Crockett was not evicted or otherwise penalized for not making its lease payments. After we began questioning various staff at the commission in February 2011 as to why they had not taken any substantive action related to this delinquent lease, staff took the matter to the commissioners. When the commissioners met in April 2011, they authorized the commission to take all steps necessary, including litigation, to collect the amounts owed by Crockett.

In another example that is not included in Table 1 because the commission finally did take action, Southern California Gas Company was allowed to remain on state property for five years after its lease expired without paying any rent, and was not penalized for doing so. Although the commission sent letters to this gas company requesting a new lease application before and after the lease expired, our review of the lease file showed that Southern California Gas Company repeatedly neglected to send in all of the required application documentation. According to the chief of land management, although the commission could have charged rent for the five years that the lease was expired, it elected not to do so because it was focused on consolidating this lease with several others and getting them current. Ultimately, the commission increased the annual rent for this lease from \$420 to \$16,794 when

the lease was consolidated with five others. Although we recognize that state law requires the commission to follow specific procedures, including providing written notice to a nonpaying lessee, we question why the commission thought it was appropriate to forfeit rent that was due during the five years that the lease was expired, especially given the fact that this gas company continued to occupy the property and repeatedly failed to submit the required documentation for a new lease application.

We believe that the commission is failing to appropriately manage its delinquent leases, in part because it does not have policies and procedures specifying the steps it needs to take to manage these leases, including a formal process for coordinating among land management, the fiscal services section (fiscal services), and the legal division, all of which play a role in managing delinquent leases. In fact, we question whether each of these entities is even aware of which specific lessees are delinquent in their payments. Further, although the *State Administrative Manual* (administrative manual) provides state entities guidance for managing delinquent accounts, we found that the commission does not always follow this guidance. The administrative manual delineates the collection procedures that state entities should develop to assure prompt management of delinquent accounts. These procedures include locating the debtor, sending collection letters, charging a collection fee, and performing a cost-benefit analysis to determine whether additional efforts should be taken, such as using a collection agency to assist in collecting the debt or seeking a court judgment against the debtor.

***Other than sending out past-due notices when lessees are 30, 60, and 90 days late in their payments, the commission does not take consistent action to either collect amounts due or evict delinquent lessees.***

The fiscal services supervisor stated that fiscal services adheres to the first portion of the administrative manual's guidance by sending out past-due notices when lessees are 30, 60, and 90 days late in their payments. After that point, however, the commission does not take consistent action to either collect amounts due or evict delinquent lessees. For instance, the fiscal services supervisor indicated that after it sends the 90-day past-due notification to the lessee, fiscal services notifies land management that it now considers the lease delinquent and typically does not make any more attempts to collect the past-due payments. She also stated that when fiscal services is advised by the legal division or through other means that there is an issue regarding the validity of a receivable related to a lease, the receivable is reclassified as a contingency and fiscal services discontinues attempting to collect payments from the lessee until advised otherwise. According to its chief, land management may also make attempts to contact delinquent lessees by sending two letters in addition to the letters sent by fiscal services. The chief explained that the second letter informs the lessee that land management will take the issue of delinquency

to the commissioners for action to terminate the lease. After the commissioners approve the termination of the lease, the chief stated that land management asks the legal division to take eviction action.

Given this description, we expected to find most, if not all, of the leases on fiscal services' contingency list on the legal division's workload list. However, according to the commission's chief counsel, the legal division is not made aware of the contingency list on a continual basis and, in fact, appears to be processing only two of the 17 leases on the contingency list. As we discuss in Chapter 2, the commission does not reconcile its various workload-tracking lists, which further contributes to its inability to identify and properly manage its delinquent leases.

The commission does not evict or pursue other remedies against lessees who do not pay rent. According to the chief of administrative services, part of the reason that the commission does not consistently take action against delinquent lessees is that actions such as an eviction require litigation, which is costly and staff intensive. Although state law prohibits the commission from taking formal legal action against a lessee unless it retains the services of the Office of the Attorney General (attorney general), it allows the commission to recover the costs of the legal action. Further, state law does not prohibit the commission from using a collection agency to collect past-due rent. Thus, in keeping with the administrative manual's guidance, we expected that the commission would have conducted a cost-benefit analysis to determine when it would be beneficial to either seek a court judgment through the attorney general or pursue the case in another manner, such as using a collection agency. However, according to its chief counsel, the commission has not conducted a formal analysis of this type. Therefore, we question how the commission determined that litigation was too costly to pursue.

The commission might want to consider modeling its policies for collecting rent from delinquent lessees after those followed by the federal Department of the Interior, U.S. Bureau of Land Management (Bureau of Land Management). According to the state lead realty specialist (realty specialist), the Bureau of Land Management issues mineral, recreational, grazing, agricultural, and commercial leases, and it is currently managing leases related to about 150 properties in California. The realty specialist indicated that the Bureau of Land Management's billing system automatically generates delinquent notices that include penalties and interest. Further, after approximately four to six months of nonpayment, according to the realty specialist, the Bureau of Land Management will refer the lessee to the U.S. Treasury for collection or begin proceedings to terminate the lease. Similarly, the commission could use the

***The commission does not evict or pursue other remedies against lessees who do not pay rent.***



Interagency Intercept Collections Program, which is operated by the California Franchise Tax Board and is available to state entities to recover costs from certain individuals at a nominal fee.

### **The Commission Is Losing Revenue by Allowing the State's Leases to Expire**

As of December 2010, according to the commission's records, about 140 of its nearly 1,000 revenue-generating leases had expired and were in holdover. While a lease is in holdover, lessees continue to pay the rental amount stipulated by the expired lease, and as a result the commission loses the rent it would have collected if it had renegotiated the lease more promptly using a reappraised value.

To determine the estimated amount of revenue the commission lost by allowing expired leases to remain in holdover, we selected a sample of 10 of the 140 expired leases that had been in holdover for between two and 15 years. After consulting the Consumer Price Index (CPI)<sup>3</sup> to obtain the average rate of inflation from each lease's inception through December 31, 2010, we applied those rates to the rents the lessees are currently paying. We then subtracted the amount the lessees are continuing to pay as stipulated in the expired lease. We did not include in our calculation the 25 percent penalty that we discuss later, because most of the 10 leases were executed before 1990, when the commission began including this provision in its leases. As Table 2 demonstrates, if the commission had adjusted the leases to reflect the CPI, it could have collected an additional \$269,000 in rent for these 10 leases during the years they have been in holdover.

*If the commission had adjusted the leases to reflect the Consumer Price Index, it could have collected an additional \$269,000 in rent for 10 leases during the years they have been in holdover.*

Moreover, as we explain later, the commission likely lost even more revenue than we estimated because the CPI may not reflect the land value as accurately as an appraisal that is performed using the sales comparison method—a process used by the commission's appraiser to estimate the current value of a property by comparing it to the value of recently sold property within the same area. For example, as shown in Table 2, after adjusting the rent by the CPI, we estimated an annual rental amount of \$32,854 for the NuStar Energy, L.P. lease. However, when the commission performed an appraisal on this property in 2010 using the sales comparison method, it determined that it should be charging a rent of between \$148,485 and \$168,285 annually—a much greater amount than we calculated based simply on inflation. Using the value of the property based on the higher appraisal, we estimate that the commission lost as much as \$672,000 during the time this one lease was in holdover.

<sup>3</sup> For our estimates throughout this chapter, we consulted the California Consumer Price Index published by the California Department of Industrial Relations, rather than the U.S. Bureau of Labor Statistics' Consumer Price Index.

**Table 2**  
**Estimated Lost Revenues Related to a Sample of 10 Leases in Holdover**

LEASE	CURRENT ANNUAL RENT	LEASE EXPIRATION DATE	YEARS IN HOLDOVER AS OF DECEMBER 31, 2010	2010 LEASE VALUE USING CALIFORNIA CONSUMER PRICE INDEX	ESTIMATED LOST REVENUE
Hanson Marine Operations, Inc.	\$1,800	June 2008	3	\$1,903	\$220
Cabrillo Power I LLC*	70,000	March 2002	8	70,000	
Georgia-Pacific Gypsum LLC	54,000	November 2000	10	71,028	97,299
Tesoro Refining and Marketing Company	11,442	December 1995	15	17,083	42,912
Tesoro Refining and Marketing Company <sup>†</sup>	260,300	December 2008	2	266,219	5,112
Tesoro Refining and Marketing Company <sup>†‡</sup>	143,200	December 1999	11	151,429	17,496
Roy Hunter	500	December 1997	13	716	1,496
Pacific Gas and Electric Company	30,400	December 1997	13	43,549	91,571
NuStar Energy, L.P. <sup>†</sup>	29,333	December 2005	5	32,854	13,140
Red Wolf Lakeside Lodge, L.P.	588	March 2007	4	622	91
<b>Totals</b>	<b>\$601,563</b>			<b>\$655,403</b>	<b>\$269,337</b>

Sources: State Lands Commission's (commission) lease files and the California Department of Industrial Relations' California Consumer Price Index (California CPI).

Methodology: We consulted the California CPI to obtain the average rate of inflation from each lease's inception through December 31, 2010, and applied those rates to the rents the lessees are currently paying. We then subtracted the amount the lessees are continuing to pay as stipulated in the expired lease.

\* Although this lease was in holdover from 2002 to 2011, the commission applied the new rent amount retroactively in 2011.

† In June 2011, after we completed our fieldwork, the commission executed new leases with these lessees, increasing the rent for each to an amount greater than the amount we estimated in this table. For example, the commission increased the rent for the NuStar Energy, L.P. (NuStar) lease from \$29,333 to \$168,285. If we had used this new rental amount to calculate the total lost revenue, the amount would have been \$672,000 rather than the \$13,140 we calculated. According to the chief of the Land Management Division, the commission is going to attempt to collect back rent from NuStar.

‡ Although this lease expired in 1999, the commission performed a rent review in 2007 and increased the rent amount from \$66,169 to \$143,200, which the lessee paid retroactively starting in 2003. We estimated the lost revenue by applying the average rate of inflation to the \$143,200 for the years 2008 through 2010.

According to the chief of land management, many factors, both external and internal, contribute to leases going into holdover, but the main internal factor is a shortage of staff, particularly leasing and appraisal staff. He indicated that external factors include whether lessees respond to notification letters from the commission on time and whether the lease negotiations and environmental review processes are lengthy. For instance, the chief indicated that the negotiation process for renewing a lease with Chevron U.S.A. Inc. (Chevron) included beginning the environmental review process twice, with the last review taking more than three years to complete.

We also found that the commission does not take advantage of a mechanism it has available to it that, if used, may encourage lessees to more quickly renegotiate leases that have expired. Specifically, according to the chief of land management, in about 1990 the commission began including a general provision in most leases that allows it to charge the lessee the annual rental in effect plus an additional 25 percent until the commission and the lessee agree to and execute a new lease. However, the chief of land management told us that the commission seldom, if ever, enforces this penalty

because he believes doing so would hinder the negotiation process. Further, the chief of administrative services indicated that while he believes the commission has the legal authority to enforce the provision, it has done so in only a few instances. If this provision is so onerous as to hinder the lease negotiation process, we fail to understand why the commission and lessees have agreed to include it in their leases. Additionally, because the commission has seldom enforced this provision, we question how it knows that charging this penalty would hinder the negotiation process. Given the fact that more than 140 leases are in holdover, we believe the monetary loss to the State could be substantially reduced if the commission were to consistently apply this penalty to its holdover leases.

In November 2010 the commission developed procedures that it believes will prevent leases from going into holdover at the end of their lease terms. Specifically, according to a procedures memo, the commission has classified leases with an annual rent of more than \$10,000 as *significant* and directed staff to begin the renewal process for these leases up to 27 months before the lease is due to expire. For the remaining leases—those with an annual rent of less than \$10,000—the commission plans to notify lessees at intervals of 12, nine, and six months prior to their respective expiration dates that their lease will soon be expiring. The new procedures also require that staff complete a checklist that includes the dates staff should be sending the notification letters and the dates the letters were actually sent. Although these new procedures appear reasonable, because the commission only recently implemented these procedures and the checklist, we were unable, at the time of our fieldwork, to determine whether they would be effective in reducing the number of leases in holdover.

### **The Commission Does Not Always Promptly Conduct Rent Reviews**

*The commission failed to promptly perform rent reviews for 18 of a sample of 35 leases we reviewed.*

Our review of a sample of leases found that the commission often failed to perform timely rent reviews. Specifically, the commission failed to promptly perform rent reviews for 18 of a sample of 35 leases we reviewed. Because these rent reviews frequently result in increases in the rental amounts, by not performing these reviews as soon as it is able to, the commission is missing opportunities to increase the revenues it receives from its leases.

The commission includes in many of its lease agreements provisions that allow it to review and modify the rental amount effective on the fifth anniversary of the lease and every five years thereafter, or if the commission does not perform the rent review to take effect on the fifth anniversary, it may do so on any of the next four anniversaries. The commission intends for these modifications to the rental amount to reflect increases in the land's value and the

volume of business, if applicable. The lease agreements also require that the commission complete this rent review process and notify the lessee no less than 30 days before the effective date of the new rental amount. If the commission fails to notify the lessee of the review and the new rental amount by the deadline included in the lease agreement, it cannot increase the rental amount during that year and must wait until the next year to do so.

Our review of a sample of 35 leases found that land management did not consistently notify the lessees of its impending rent reviews or rental increases. Specifically, we found that land management failed to give lessees the required notice of a fifth-year rent review 22 times for 15 of the leases we reviewed. Thus, land management could not adjust the rent on the fifth anniversary, and instead had to wait at least another year before doing so.

Moreover, as shown in Table 3 on the following page, we found that land management failed to perform timely rent reviews for 18 of the 35 leases we reviewed. For example, the commission did not perform a rent review from 2000 through 2010 for one of its leases with Pacific Gas and Electric Company. We estimated that during those 10 years, the commission could have collected an additional \$1.1 million from this lessee if it had conducted its rent reviews to take effect on each fifth anniversary. In fact, as shown in Table 3, we estimated that for the 18 leases we identified, the commission could have collected an additional \$6.3 million.<sup>4</sup>

***We estimated that for the 18 leases we identified, the commission could have collected an additional \$6.3 million if it had performed timely rent reviews.***

By performing timely rent reviews, the commission can ensure that it receives an appropriate amount of rent that reflects the current value of the property, even during the time a lease is in holdover. For example, the Chevron lease was in holdover for 16 years, from 1992 to 2008, because Chevron and the commission could not reach agreement on a number of issues, including an adjustment to the rental amount. We did not include the amount of revenue the commission potentially lost related to this lease in Table 3 because the commission renewed the lease and received compensation from Chevron before we began our fieldwork. During the holdover period, Chevron continued to pay \$319,140 annually, which the commission and Chevron had agreed to in 1993. Although the commission could have exercised its right to perform a rent review for this lease in 1997, it did not do so until 2008, after which Chevron ultimately agreed to pay \$1.3 million annually. When we asked the chief of land management why the commission did not

<sup>4</sup> After we completed our fieldwork, the commission ultimately negotiated and the commissioners approved a new lease with Shell Oil Company on June 23, 2011, which is one of the leases included in our sample that resulted in our estimate of \$6.3 million in lost revenues. As part of its negotiations, Shell Oil Company agreed to pay \$2.5 million for the period from August 1999 to July 2011.

**Table 3**  
**Sampled Leases for Which the State Lands Commission Failed to Perform Timely Rent Reviews**

LEASE*	TIME PERIOD OVER WHICH REVIEWS WERE MISSED	INITIAL RENT AMOUNT	NEW RENT ESTABLISHED BY RENT REVIEW OR APPRAISAL	ESTIMATED LOST REVENUE
Pacific Gas and Electric Company	1/01/93 through 12/31/95	\$24,292	\$30,400	\$18,324
Pacific Gas and Electric Company	8/28/74 through 8/27/80	4,860	10,640	28,900
	8/28/94 through 8/27/95	30,000	35,000	5,000
	8/28/00 through 8/27/10	35,000	260,000	1,125,000
NuStar Energy, L.P.	1/01/96 through 1/01/10	29,333	168,283	694,750
Southern California Edison	9/24/94 through 9/23/96	17,964	21,727	7,526
	9/24/99 through 9/23/04	21,727	23,334	8,035
	9/24/04 through 9/23/09	23,334	44,910	107,880
Ramos Oil Company, Inc.	8/29/87 through 8/28/88	1,584	2,907	1,323
	8/29/92 through 8/29/10	2,907	4,311	7,020
Crockett Marine Services, Inc.	8/20/89 through 8/19/90	8,100	10,170	2,070
	8/20/94 through 8/19/09	10,170	not yet established	unknown
AERA Energy, LLC	4/01/90 through 3/31/91	3,555	7,605	4,050
	4/01/95 through 4/01/11	7,605	not yet established	unknown
AERA Energy, LLC	4/01/90 through 3/31/91	2,905	6,210	3,305
	4/01/95 through 4/01/11	6,210	not yet established	unknown
AERA Energy, LLC	4/01/90 through 3/31/91	966	4,725	3,759
	4/01/95 through 4/01/04	4,725	not yet established	unknown
AERA Energy, LLC	4/01/90 through 3/31/91	2,019	5,193	3,174
	4/01/95 through 4/01/11	5,193	not yet established	unknown
Ship Ashore Resort	10/01/81 through 9/31/82	800	1,200	400
	10/01/86 through 4/29/10	1,200	5,400	21,000
Tesoro Refining and Marketing Company	1/01/99 through 12/31/07	75,000	260,300	926,500
Tesoro Refining and Marketing Company	1/01/85 through 1/01/86	30,000	43,840	13,840
	1/01/95 through 5/09/97	51,046	66,169	30,246
Shell Oil Company <sup>†</sup>	8/01/84 through 7/31/89	60,000	73,062	65,310
	7/31/99 through 7/31/04	85,212	288,150	1,014,690
	8/01/04 through 7/31/09	85,212	326,570	1,206,790
	8/01/09 through 7/31/10	85,212	326,570	241,358
Georgia-Pacific Gypsum LLC	12/01/85 through 11/30/90	18,000	54,000	180,000
	12/01/95 through 11/30/00	54,000	102,775	243,875
Point Arguello Pipeline Company	2/01/01 through 2/09/11	27,048	66,450	197,010
Chevron U.S.A. Inc.	10/01/82 through 9/30/83	175,000	270,504	95,504
Thousand Trails, Inc.	9/01/90 through 7/31/91	1,068	2,681	1,613
	8/01/95 through 7/31/97	2,681	3,075	788
<b>Total</b>				<b>\$6,259,040</b>

Source: State Lands Commission's (commission) lease files.

Note: The lightly shaded items are leases for which the commission conducted an appraisal, but the new rental amount was not approved by the commissioners.

Methodology: To calculate the estimated lost revenue, we subtracted the initial rent amount from the new rent amount and multiplied the result by the number of years the commission failed to perform a rent review. In cases for which the commission missed more than five years of rent reviews, we calculated the estimated lost revenue for the last five years. We believe this approach is appropriate because to use a longer period of time may not result in a reasonable estimate.

\* The lessee indicated is the most current lessee associated with this lease. However, some lessees changed names or transferred the leases during the earlier years indicated.

<sup>†</sup> After we completed our fieldwork, the commission ultimately negotiated and the commissioners approved a new lease with Shell Oil Company on June 23, 2011, which is one of the leases included in our sample that resulted in our estimate of \$6.3 million in lost revenues. As part of its negotiations, Shell Oil Company agreed to pay \$2.5 million for the period from August 1999 to July 2011.

perform a rent review sooner, he noted that staff were unsure whether they could implement the rent review provision, but in the end they decided that the rent review provision could be implemented because it was stipulated by the original lease. Even though Chevron agreed to pay an additional \$2.4 million when it executed the new lease to compensate the commission for what it should have paid during the 16 years of negotiation, we estimated, using the same method we used in Table 3, that the commission could have collected an additional \$2.4 million had it conducted the rent review earlier.

In our 1984 audit report titled *Review of the State Lands Commission's Management of State Land*, we identified similar problems with the commission's rent review process. At that time, we found that the commission did not always notify lessees in advance and thus could not increase the rent on the fifth anniversary for those leases, resulting in lost revenues to the State. We recommended that the commission establish a systematic rent review process, including provisions for supervisory review to ensure that staff meet specific deadlines as stated in each lease agreement, as well as establishing time standards for each step of the review process, such as for appraising property. The commission was unable to provide us with evidence of specific changes it had made to its processes that would indicate it had implemented our recommendations. However, a procedures memo requires clerical staff to obtain the lease file nine months before a rent review is due to allow the staff to notify the lessee that the annual rental amount may be adjusted within the specified time frame.

After they take these initial steps in the rent review process, according to the chief of land management, the commission's procedures do not specify how long it should take staff to complete subsequent steps, such as the appraisal. As an example, on June 3, 1999, land management staff notified Shore Terminals, LLC, which is now known as NuStar Energy, L.P., that it was beginning its rent review process. However, land management failed to complete the appraisal until 2010, more than 10 years later, and as of March 2011 had yet to establish a new rental amount for this lease. Thus, although land management notified the lessee of the impending rent review, it could not complete the rent review because it did not perform a timely appraisal. Establishing time standards—not only for when the rent review process should begin, but for all the steps in the process—would assist the commission in completing its rent reviews more promptly.

The chief of land management attributed the commission's inability to perform timely rent reviews to other reasons. The chief believes that the rent reviews are not always performed on time due to shortages of staff. He also believes that other activities, such as processing lease applications, take precedence over staff performing

***We estimated the commission could have collected an additional \$2.4 million from Chevron had it conducted the rent review earlier.***

rent reviews. Although staffing shortages may contribute to the commission's inability to perform timely rent reviews, as we discuss further in Chapter 3, the commission has not performed a workload analysis to substantiate this claim. Until the commission addresses its workload needs, it should include, as part of the development of a rent review process, a methodology for prioritizing its workload that focuses its staff on managing the higher revenue-generating leases.

To address its concerns regarding a staff shortage, the commission might want to consider adopting other practices that could help it reduce the number of rent reviews or appraisals that its staff are currently required to perform, in order to ensure that rental amounts associated with its leases are adjusted on a more timely and consistent basis. For example, one lease agreement contained provisions allowing the commission to adjust the rent annually based on the CPI. When conducting each five-year rent review, these provisions also allow land management to simply compare the fourth-year rental amount with a predetermined amount stipulated in the lease agreement for the fifth year. Land management could then establish the new rental amount as the higher of the two. The advantage of this type of agreement is that it requires minimal staff time and simply involves annually calculating the increase to the lease amount based on the current CPI. Another strategy that the commission could consider would be to use the model just discussed but build provisions into the lease agreements requiring the commission's appraiser to perform a sales comparison appraisal at certain points during the lease term to ensure that the automatic increases fairly reflect current property values.

Finally, we found that, at times, lessees disputed a modification to the rental amount after the commission had determined that it should increase the rent, whether because the commission exercised its right to perform a rent review or because the lease had expired. In situations such as these, the commission might want to consider using a mechanism that ensures that, while the lease is being renegotiated, it receives rent from the lessee that reflects the approximate value of the land. Specifically, the commission could require lessees to pay the proposed increased rental amount during the negotiation process, which it would deposit into a special account, such as one set up within the State's Special Deposit Fund. To accrue interest, this account would need to be included in the Surplus Money Investment Fund, for which the State Controller's Office publishes interest rates on a quarterly basis. After the negotiation process is complete, the funds deposited into this account, along with the interest earned, would be either retained by the commission or provided to the lessee, depending on the final results of the negotiation process. For instance, if a lessee disagreed with the commission's proposed rental increase from \$30,000 to \$50,000 annually, the commission could require the lessee to pay the proposed new rental amount of \$50,000 into the Special Deposit Fund. After negotiating for three years, if the

***The commission could require lessees to pay the proposed increased rental amount during the negotiation process, which it would deposit into a special account to accrue interest.***

commission and the lessee agree to the \$50,000, the commission would retain \$150,000 plus the corresponding interest. Alternatively, if the negotiations resulted in a decrease in the amount originally proposed, the commission would remit the applicable amount plus interest to the lessee. We believe that if the commission establishes such an account for its high-dollar leases, it could probably generate more than enough revenue to outweigh the costs of administering the account.

According to the assistant chief of land management, the commission's management has some concerns with establishing a fund into which a lessee would deposit an increased rental amount until such a time as the rent negotiations were concluded. He indicated that the commission believes this recommendation is impractical and that the commission already has a procedure in place that should provide the lessee an incentive to complete the negotiation process, which includes a new annual rental amount, by the time the lease expires. More specifically, he indicated that in each of the three written notices included in the commission's holdover procedures, the lessee is informed that if a lease expires before negotiations are completed, then under the terms of the existing lease, the lessee's next annual billing may include a 25 percent increase in the rent. According to the assistant chief, the commission's management believes this procedure should eliminate the need to establish a fund to deposit an increased rental amount during the time a lease is in holdover.

We agree that if the threat of a 25 percent increase in the rent provides the necessary incentive for a lessee to renegotiate a lease before it expires, there is no need to establish a special fund. However, we have two concerns. First, as discussed earlier, according to the chief of land management, the 25 percent penalty is seldom enforced because he believes doing so would hinder the negotiation process. As such, if the commission believes the 25 percent penalty will best address its problem with leases that expire before negotiations are complete, it needs to consistently enforce this penalty. Second, we are suggesting that the commission establish a fund not only to deposit rental amounts for expired leases, but to also deposit the proposed increase in the rental amounts when a lessee fails to agree to a new amount as the result of the commission exercising its right to perform a rent review.

### **The Commission's Failure to Appraise Its Properties Regularly May Cause Them to Be Undervalued**

Because the commission did not regularly appraise the value of its leased properties as the land increased in value over time, it missed opportunities to increase the related rent on those properties.

*If the commission believes the 25 percent penalty will best address its problem with leases that expire before negotiations are complete, it needs to consistently enforce this penalty.*



***The commission is not performing appraisals as often as is allowed and adjusting rental amounts accordingly and cannot collect the additional revenue that would result when the value of the property increases over time—one appraisal resulted in an increase in rent from \$319,000 to \$1.3 million annually.***

Additionally, when the commission did perform appraisals, at times it used methods that may have resulted in its leased properties being valued at lower amounts than it otherwise might have obtained, again missing opportunities to renegotiate a higher rent for these leased properties.

The commission can select from several different appraisal methods when appraising its properties, as mentioned in the Introduction. Generally, the commission's appraiser is responsible for performing appraisals using the sales comparison method, while other land management staff who are not appraisers, such as lease negotiators, use the other methods. Despite the various appraisal options that the commission can use, the commission did not appraise its properties as frequently as the lease agreements allowed, which is generally once every five years. Specifically, we found that the commission appraised each property for the sample of 35 leases we reviewed an average of only three times over the period of time during which a rent review could have been performed, which varied in duration from five to 41 years. As shown in Table 4, the commission has not conducted an appraisal for several leases in more than 15 years.

Because the commission is not performing appraisals as often as is allowed and adjusting rental amounts accordingly, it cannot collect the additional revenue that would result when the value of the property increases over time. As an example of appraisals that were conducted at appropriate intervals, the commission appraised one property leased to several refining and marketing companies three times during a 13-year period, each time recommending an increase in annual rent from an initial \$51,046 to the current amount of \$143,200. Some appraisals result in significant increases in rent. For example, the commission conducted an appraisal of a Chevron lease that resulted in an increase in rent from \$319,000 to \$1.3 million annually.

The commission at times adjusts the rental amount of its leases using methods other than the sales comparison method, such as CPI adjustments and benchmark methods. In doing so, it can cause the State to lose revenue if these other methods do not accurately estimate the value of the land. As shown in Table 5 on page 30, we found that the commission conducted 101 appraisals of its properties related to the sample of 35 leases we reviewed. It used the sales comparison method for 56 of these appraisals. Although it most often used the sales comparison method, as Table 5 shows, it used the CPI, benchmark, or pipeline diameter method for a total of 32 leases. We discuss our concerns with the benchmark and pipeline diameter methods in the next section.

**Table 4**  
**History of Appraisals for the Sampled Leases**

LEASE*	FIRST YEAR IN WHICH THE STATE LANDS COMMISSION (COMMISSION) COULD HAVE CONDUCTED AN APPRAISAL	YEARS APPRAISALS WERE CONDUCTED	NUMBER OF YEARS BETWEEN THE FIRST YEAR THE COMMISSION COULD HAVE CONDUCTED AN APPRAISAL AND 2010	NUMBER OF APPRAISALS CONDUCTED	NUMBER OF YEARS SINCE LAST APPRAISAL
R.J. Naylor†	1946		NA	NA	NA
The Dow Chemical Company	1989		21	0	21
Ramos Oil Company, Inc.	1982	1988, 1992	28	2	18
Crockett Marine Services, Inc.	1984	1990	26	1	20
AERA Energy, LLC	1985	1985, 1991	25	2	19
AERA Energy, LLC	1985	1985, 1991	25	2	19
AERA Energy, LLC	1985	1985, 1991	25	2	19
AERA Energy, LLC	1985	1985, 1991	25	2	19
Ship Ashore Resort	1976	1977, 1982, 1986	34	3	24
Thousand Trails, Inc.	1985	1991, 1997	25	2	13
ConocoPhillips Company	1999	1999, 2003	11	2	7
Southern California Edison	1969	1984, 1989, 1996, 2000, 2005	41	5	5
Crockett Cogeneration	1993	1993, 1998, 2003, 2008	17	4	2
Southern California Gas Company	2005	2010	5	1	0
Pacific Gas and Electric Company	1969	1980, 1984, 1989, 1994, 2003, 2006	41	6	4
Chevron U.S.A. Inc.	1984	1984, 1989, 1993, 1999	26	4	11
SFPP L.P.	1978	1978, 1987	32	2	23
Pacific Gas and Electric Company	1978	1978, 1982, 1988, 1992, 1994, 1998, 2003	32	7	7
Venoco Incorporated	2005	2005	5	1	5
USS POSCO Industries	1974	1975, 1984, 1989, 1998, 2006	36	5	4
ConocoPhillips Company	1989	1991, 2001	21	2	9
Coscol Petroleum Corporation	1985	1993, 2009	25	2	1
Point Arguello Pipeline Company	1986	1986, 1988, 1991, 1996, 2001, 2010	24	6	0
Cabrillo Power I LLC	1982	1981, 1988, 2003	28	3	7
Tesoro Refining and Marketing Company	1984	1984, 1994, 2007	26	3	3
Tesoro Refining and Marketing Company	1980	1981, 1994, 1997, 2007	30	4	3
Tesoro Refining and Marketing Company	1975	1981, 1994, 2005	35	3	5
Shell Oil Company	1974	1974, 1979, 1980, 1996, 1999, 2006, 2010	36	7	0
Georgia-Pacific Gypsum LLC	1980	1980, 1991, 2006, 2010	30	4	0
NuStar Energy, L.P.	1980	1981, 1994, 2010	30	3	0
Hanson Marine Operations, Inc.	1998	1998	12	1	12
Red Wolf Lakeside Lodge, L.P.	1997	1997, 2001, 2007	13	3	3
Roy Hunter	1995	1995	15	1	15
Chevron U.S.A. Inc.	1977	1977, 1983, 1987, 1993, 2009	33	5	1
El Segundo Power LLC and El Segundo Power II LLC	2002	2004	8	1	6
<b>Averages</b>			<b>24.9</b>	<b>3.0</b>	<b>9.0</b>

Source: Commission's lease files.

NA = Not applicable.

\* The lessee indicated is the most current lessee associated with this lease. However, some lessees changed names or transferred the lease during the years indicated.

† This lease does not contain a provision that allows the commission to modify the rent. Thus, the commission would not conduct an appraisal. We do not include this lease in our averages.

**Table 5**  
**Appraisal Methods for Sampled Leases**

LEASE*	APPRAISAL TYPES					TOTALS
	SALES COMPARISON <sup>†</sup>	BENCHMARK <sup>‡</sup>	CONSUMER PRICE INDEX <sup>§</sup>	PIPELINE DIAMETER <sup>  </sup>	VOLUMETRIC <sup>#</sup>	
R.J. Naylor**						0
The Dow Chemical Company						0
Ramos Oil Company, Inc.	● ●					2
Crockett Marine Services, Inc.	●					1
AERA Energy, LLC	●			●		2
AERA Energy, LLC	●			●		2
AERA Energy, LLC	●			●		2
AERA Energy, LLC	●			●		2
Ship Ashore Resort	● ● ●					3
Thousand Trails, Inc.		● ●				2
ConocoPhillips Company	●		●			2
Southern California Edison	● ●		● ●	●		5
Crockett Cogeneration	●		● ● ●			4
Southern California Gas Company				●		1
Pacific Gas and Electric Company	● ● ● ● ●		●			6
Chevron U.S.A. Inc.	● ●		●		●	4
SFPP LP	●				●	2
Pacific Gas and Electric Company	● ● ●		●	●	● ●	7
Venoco Incorporated			●			1
USS POSCO Industries	● ● ● ●		●			5
ConocoPhillips Company	●		●			2
Coscol Petroleum Corporation	● ●					2
Point Arguello Pipeline Company	● ● ● ● ● ●					6
Cabrillo Power I LLC	● ●				●	3
Tesoro Refining and Marketing Company	●		●		●	3
Tesoro Refining and Marketing Company	●		● ●		●	4
Tesoro Refining and Marketing Company	●		●		●	3
Shell Oil Company	● ● ●		● ●		● ●	7
Georgia-Pacific Gypsum LLC	● ● ● ●					4
NuStar Energy, L.P.	●		●		●	3
Hanson Marine Operations, Inc.	●					1
Red Wolf Lakeside Lodge, L.P.		● ● ●				3
Roy Hunter	●					1
Chevron U.S.A. Inc.	● ●		●		● ●	5
El Segundo Power LLC and El Segundo Power II LLC	●					1
<b>Totals</b>	<b>56</b>	<b>5</b>	<b>20</b>	<b>7</b>	<b>13</b>	<b>101</b>

Source: State Lands Commission's (commission) lease files.

● = An appraisal the commission conducted.

\* The lessee indicated is the most current lessee associated with this lease. However, some lessees changed names or transferred the lease during the years appraisals were conducted.

† Uses recent sales of similar property to estimate the value of the state property.

‡ Establishes a representative value and rental amount for a certain use or property type within a certain geographic area, which is similar to the amount an individual would pay for a comparable property within that area.

§ Uses the Consumer Price Index to adjust the rent amount.

|| Multiplies 2 cents times the outside diameter of the pipe multiplied by the length of the pipeline within the lease area.

# Uses the volume of the commodity passed through the pipeline. In 1985 the U.S. Supreme Court ruled that this method is unconstitutional, and it is no longer used by the commission.

\*\* This lease does not contain a provision that allows the commission to modify the rent. Thus, the commission would not conduct an appraisal.

The only appraiser currently employed by the commission believes that using the sales comparison method provides a more precise estimate of land value, which might generate more revenue. In fact, when we estimated the value of one lease using the CPI method, we found that it resulted in a much lower value when compared to an appraisal performed using the sales comparison method. Specifically, using the CPI to adjust the annual rent of \$54,000 that was established in 1990 for the Georgia-Pacific Gypsum LLC lease, we calculated that the annual rent could have been \$67,168 annually beginning in 2007. However, the commission conducted an appraisal of the property using the sales comparison method in 2007 and determined that the rental amount should be \$146,820—or \$79,652 more than our calculation.

The chief of land management stated that staffing shortages, in particular a shortage of appraisers, explains why the commission does not conduct more sales comparison appraisals. However, the commission's appraiser stated that he does not have a backlog of appraisal requests, perhaps because land management staff are using the other methods of valuing properties. In fact, a manager in land management noted that her staff explore alternative ways of valuing property because she believes that the appraiser has a large backlog of appraisal requests. Based on these two somewhat contradictory statements by the appraiser and the manager, it appears that the land management staff do not effectively coordinate with the appraiser and thus may be missing opportunities to conduct more sales comparison appraisals.

### **The Commission Is Undervaluing Certain Types of Leases**

The commission uses a rate to establish rent for pipelines on state property that is more than 30 years old. In addition, it uses benchmarks that are more than 18 years old to establish rent for some types of leases. Further, the commission uses an outdated analysis to determine whether receiving its oil royalties in cash or crude oil is more profitable to the State. As a result, it is again missing opportunities to increase the State's revenues.

We found that the commission is charging a rate for its pipeline leases that was last updated 30 years ago, in 1981. According to the commission, in 1968 a bulletin was issued directing staff to charge a rate of 1 cent per diameter inch per linear foot as the annual rental for pipeline and conduit leases. In 1981 the rate was increased to 2 cents, and it has not been updated since. In 2010 the commission conducted a survey to determine which methods agencies in other states use when establishing an annual rental amount for pipelines located on state property. Although the commission concluded that no other agencies use exactly the same method as California,

*The commission is charging a rate for its pipeline leases that was last updated 30 years ago, in 1981.*

when we reviewed the survey we found that Delaware, Louisiana, and New Mexico use a somewhat similar method by charging an amount per linear foot. Using a sample of seven of the commission's leases, we converted the pipeline diameter rate to the rate used by these three states and found that the commission was charging between 16 cents and 78 cents per linear foot, with an average of about 50 cents per linear foot. This is significantly less than the average of \$1.90 per linear foot charged by the three comparison states. In fact, as shown in Table 6, we determined that the commission could charge an additional \$174,000 annually for these seven leases by using a rate of \$1.90 per linear foot.

**Table 6**  
**Revenues for Sample Leases Using the State Lands Commission's Rate Compared to an Average Based on Rates Charged by Three States**

LEASE	ANNUAL RENT CHARGED USING STATE LANDS COMMISSION'S PIPELINE DIAMETER METHOD	ANNUAL RENT USING THE THREE-STATE* AVERAGE RATE	DIFFERENCE
El Paso Natural Gas Company	\$3,685	\$11,669	\$7,984
SFPP L.P.	2,420	19,162	16,742
Geysers Power Company, LLC	451	5,360	4,909
Kern River Gas Transmission Company	3,384	8,930	5,546
Kern River Gas Transmission Company	3,827	10,099	6,272
Pacific Gas and Electric Company	30,400	129,407	99,007
Southern California Gas Company	16,794	50,416	33,622
<b>Totals</b>	<b>\$60,961</b>	<b>\$235,043</b>	<b>\$174,082</b>

Sources: State Lands Commission lease files and its report on pipeline prices, which includes a survey.

\* Delaware, Louisiana, and New Mexico.

Increasing the rate could result in the commission collecting higher rents for pipelines on state land. The chief of land management was unable to provide an explanation as to why the commission had not proposed an increase to this rate in the past. However, he indicated that currently the commission primarily uses land appraisals to set rental amounts, because the pipeline diameter method is outdated. Additionally, the commission's staff are still determining the best method for updating the rate. Specifically, as part of the commission's analysis of the survey results, staff recommended that the commission discontinue using the pipeline diameter method entirely. Commission staff further recommended that the commission continue to use the appraised land value, since it is reflective of true land values, but they also recommended that the commission implement a second method based upon linear feet, as used by other states, thereby giving the commission a greater range

of values when determining the amount to charge for its pipeline leases. To implement the method of charging by the linear foot, commission staff stated that it would be necessary to create benchmark appraisals and recommended benchmarks for locations throughout the State.

However, some of the benchmarks the commission is using to value property when determining the amount a lessee should pay are outdated. The commission uses benchmarks to value property leased for recreational use, such as boat docks and buoy fields. A *benchmark* is a dollar amount that is based upon what an individual would pay for a comparable property within the region. Currently, the commission uses 11 benchmarks to value property. As shown in the text box, the commission has not updated four of the 11 benchmarks since 1992. Additionally, although the text box shows that the commission last updated seven of the benchmarks between 2005 and 2010, before that time four of the benchmarks—for the Southern California area, Lake Tahoe, Sacramento River area, and Delta area—had not been updated since 1992.

The assistant chief of land management was unable to provide an explanation as to why the commission had not updated the benchmarks more frequently, but indicated that the commission plans to update its benchmarks that are older than four years by the end of 2011 and then update all the benchmarks on a more regular basis. However, the assistant chief also stated that because the commission has only one appraiser available to update benchmarks and perform other appraisal functions for the land management division, management has to weigh the costs and benefits of committing the appraiser to updating benchmarks. As shown in Table 7 on the following page, when adjusted using the CPI, the commission's four benchmarks that have not been updated for 18 years would each increase by 56 percent, or an average of 12 cents per square foot.

We were unable to provide a perspective on how much the commission may have lost by using outdated benchmarks because it does not track how often it uses this method. However, using a theoretical example, if a 50,000-square-foot property located in the Black Point–Marin County area were to be appraised using the benchmark rate adjusted using the CPI, it would result in an annual rent of \$27,500 rather than the \$17,500 annual rent that would result using the current benchmark rate. According to the chief of land management, the loss is likely insignificant because

**Most Recent Updates of the  
 State Lands Commission's Benchmarks**

- Black Point (Marin County)—1992
- San Francisco Bay Area—1992
- Marin County area—1992
- Wingo (Sonoma County) —1992
- Southern California area—2005
- Lake Tahoe—2007
- Monterey area —2008
- Sandy Beach (Solano County) —2008
- Sacramento River area—2009
- Delta area—2009
- Tomales Bay—2010

Source: State Lands Commission's benchmark updates.

these benchmarks are used for only a small number of its leases. Nonetheless, the commission is unable to provide any evidence to support this claim.

**Table 7**  
**Four Outdated Benchmarks, Updated Using the California Consumer Price Index**

BENCHMARK	YEAR BENCHMARK WAS LAST UPDATED	CURRENT BENCHMARK RATE PER SQUARE FOOT	BENCHMARK RATE PER SQUARE FOOT USING CALIFORNIA CONSUMER PRICE INDEX	DIFFERENCE PER SQUARE FOOT
Black Point, Marin County	1992	\$0.35	\$0.55	\$0.20
San Francisco Bay Area	1992	0.11	0.18	0.06
Marin County Area	1992	0.16	0.25	0.09
Wingo, Sonoma County	1992	0.24	0.37	0.13
<b>Averages</b>		<b>\$0.22</b>	<b>\$0.34</b>	<b>\$0.12</b>

Sources: State Lands Commission's benchmark data and the California Department of Industrial Relations' California Consumer Price Index.

Finally, the commission may also be losing revenue because it has not performed an analysis to determine whether it is more profitable to receive royalties from oil extracted from state land in the form of cash or crude oil. As we describe in the Introduction, when the State leases land to oil companies, it receives royalties for the oil or natural gas that is extracted. In our 1984 report, we found that even though the commission's policy was to collect the State's royalty in crude oil, the commission received royalties in cash from one lease for more than two years, and as a result lost as much as \$340,000 in bonus revenue. At that time, we recommended that the commission accept oil royalties in crude oil instead of cash when doing so was in the best interest of the State.

According to the chief in the Mineral Resources Management Division (mineral resources), the commission does not currently receive any royalties in crude oil, but instead receives them in cash. The commission conducted an analysis of the sell-off of oil from 2002 through 2005 with one of its oil-producing leases and determined that it received a greater amount of revenue when accepting the royalties in cash rather than in crude oil. However, according to the chief of mineral resources, the commission has not taken any steps since 2005 to determine whether it is still beneficial to receive royalties in cash. He also stated that he believes it would be in the commission's best interest to periodically analyze which method provides the greater amount of revenue to the State. However, the chief also indicated that the commission does not have any current plans to perform such an analysis, due to staffing shortages.

## Recommendations

To ensure that it manages delinquent leases in an effective and timely manner and collects all the amounts owed to it, the commission should do the following:

- Determine the amount of past-due rent that should be included in its accounts receivable account.
- 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.
- 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.

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.

To ensure that as few leases as possible go into holdover, the commission should do the following:

- 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.
- Consistently assess the 25 percent penalty on expired leases.

To complete its rent reviews promptly and obtain a fair rental amount for its leases, the commission should do the following:

- Consistently notify lessees of impending rent reviews or rental increases within established timelines.
- Establish time standards for each step of the rent review process and ensure that all staff adhere to those time standards.
- 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.



- 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.

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.

To ensure that it is charging rent based on the most current value of its properties, the commission should do the following:

- Appraise its properties as frequently as the lease provisions allow—generally every five years.
- 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.

To ensure that it does not undervalue certain types of leases, the commission should do the following:

- 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.
- Implement and follow its plan to regularly update its benchmarks for determining rental amounts.
- 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.

## Chapter 2

### THE STATE LANDS COMMISSION DOES NOT ADEQUATELY MONITOR ITS LEASES

#### Chapter Summary

During our review, we found that the Application Lease Information Database (ALID) used by the State Lands Commission (commission) is both inaccurate and incomplete and is not used by staff to monitor the status of its leases. Further, we found that of the three divisions that have a role in managing leases, each has developed its own method of tracking leases, but none of these divisions compare their information as a means of ensuring accuracy. 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 failed to bill a lessee for 12 years while the lessee remained on state property.

In addition we found that the commission is not effectively performing two key functions related to monitoring leases. Specifically, it does not consistently audit its oil and gas leases—even though these audits can result in millions of dollars in revenue for the State—nor does it conduct any audits of 85 properties granted to local governments to ensure that they spend the funds generated from those lands in accordance with applicable laws and doctrines. Finally, the commission does not ensure that its lessees maintain current surety bonds and liability insurance, putting the State at risk of financial loss should a claim result from an accident that occurs on state property.

#### The Commission Uses an Inaccurate, Incomplete Database to Track Leases and Bill Lessees

We expected to find that the commission uses a database that would allow it to effectively manage its leases, perform timely rent reviews and lease renewals, and accurately invoice lessees. Such a database would need to reflect relevant lease information accurately and completely, including impending rent review dates, lease expiration dates, and current rental amounts. Further, the database would be accessible to, and used by, each of the three divisions that manage leases. Instead, we found that ALID is inaccurate, incomplete, and underutilized. In fact, we found that each of the three divisions responsible for managing leases have developed their own method of tracking lease information, with no controls to ensure the information's accuracy. As a result, the commission

*The lease information included in the commission's Application Lease Information Database contained erroneous information for several of the sample of 35 leases we reviewed.*

is not appropriately tracking the status of some of its leases and, in more than one circumstance, allowed lessees to remain on state land for years without paying rent.

Currently, the commission uses ALID to record information that its staff can access related to all of its leases, including the lessee, the terms of the lease, important review dates, rental amounts, and lease expiration dates, as well as narrative comments specific to each lease. The type of information contained in this database would suggest that employees could use it to assist them in managing their lease workload. However, our review of the lease information included in ALID found that it contained erroneous information for several of the sample of 35 leases we reviewed. As a result, we could not use it to evaluate lease information or determine whether the commission was managing its leases effectively. For example, we found one lease with an incorrect rental amount, one lease with an incorrect lease expiration date, three leases with a blank or incorrect review date, three leases with outdated lease terms even though each lease had been renegotiated, and five leases with blank or incorrect lease tickler dates. As mentioned in the Introduction, the commission uses the tickler-date field in ALID to initiate the rent review process.

The following problems we identified exemplify the need for the commission to ensure that the lease information included in ALID is complete, accurate, and consistently entered if it expects employees to use the database to effectively manage their lease workload:

- ALID contained a tickler date of February 2031 to initiate the next rent review for a lease with USS-POSCO Industries (POSCO), when it should contain the date February 2011. If the commission were to rely on this date to initiate the rent review process for this lease, it would be approximately 20 years late.
- Although the commission updated the annual rental amount in ALID for this same lease with POSCO as the result of a rent review it performed in 2006—12 years after the lease expired in 1994—the document used to update ALID reflected an annual rental amount of \$0. Therefore, we have reason to believe that the annual rental amount shown in ALID was \$0, rather than the correct amount of \$5,565. This likely caused the commission to fail to bill POSCO the \$5,565 annual rental amount for the 12-year period during which the lease had expired and was in holdover. Although according to the minutes from a commissioner's meeting, it eventually collected the total amount of \$66,800 owed by POSCO for the 12 years before it renegotiated the lease in 2006, the commission did not collect any interest or penalties related to these late payments.

- The commission failed to update ALID to reflect that Dow Chemical had taken over a lease related to state land in 1989. Although the commission sent a letter to Dow Chemical in 1990 indicating that it would need to transfer the lease for this property from the United States Steel Corporation to Dow Chemical, since that time it has not transferred the lease. The commission's failure to update ALID likely caused it to lose track of this change in the lease, with the result that Dow Chemical has used state land for 17 years rent-free.

Further, as part of our testing, we found that the commission could not readily provide us a current list of leases in holdover. Specifically, the commission gave us a list of holdover leases that it generated during August 2010 from its accounting records rather than from ALID. Additionally, it could not provide us a more updated list until two months after we requested it in March 2011, and then only by making manual adjustments to the original list it generated in August 2010. The chief of the Land Management Division (land management) confirmed that ALID does not always reflect the current status of leases and thus cannot be used to produce an accurate list of those in holdover. Not having a database that allows it to efficiently generate an accurate and complete list of the leases that are in holdover makes the commission's task of tracking and resolving these leases even more difficult.

Moreover, land management, the fiscal services section (fiscal services) within the Administrative and Information Services Division (administrative services), and the legal division all separately track their workload on two Microsoft Excel spreadsheets and one Microsoft Word document, and the staff involved do not reconcile these various spreadsheets and documents to each other or to ALID. Currently, it appears that only land management uses ALID to generate its workload spreadsheet, from which it makes staff assignments. During our review of 35 lease files, we found that the spreadsheets and the Word document did not contain 11 leases that required some type of processing on the part of the commission's staff. For example, these documents contained no reference to the Dow Chemical lease we previously discussed. We question the commission's need to have three separate means to track leases when its staff should be using the database—ALID—that ostensibly provides this function. Additionally, using three separate means of tracking leases, two of which are manually populated, can add to and compound errors, such as those we noted that are already present in ALID, and is duplicative and an inefficient use of staff's time.

The commission may want to communicate with other entities that successfully lease property and manage their leases and consider modeling its database and some of its lease-tracking

***We question the commission's need to have three separate means to track leases when its staff should be using the database that ostensibly provides this function.***

practices after them. For example, the State-Owned Leasing and Development Unit (leasing unit) in the Department of General Services (General Services) manages the leases for the State's underutilized property. According to the chief of real property services, which houses the leasing unit, these leases include agricultural land for grazing, hilltops for telecommunications facilities, parking lots, office buildings, and retail space. The chief also indicated that the leasing unit issues approximately 80 different types of leases for about 1,100 state properties and uses several different tools, including databases, to manage its leases.

The chief of administrative services admitted that the lease information in ALID has not been updated promptly or precisely, and that it contains many inconsistencies and stale data. According to the chief, in April 2011 the commission completed a special project to update ALID with current information from fiscal services for the leases that generate revenue. The chief also indicated that the commission has no immediate plans to update the remaining leases included in ALID. However, the commission has not developed any policies to ensure that it enters information into ALID completely and accurately, nor has it established a process to ensure that the various divisions that manage leases all use the same database. Although it may be appropriate for fiscal services to use a second database to generate invoices, it would seem that the accounting database could be integrated to some degree with the lease-tracking database. The commission's failure to ensure that the information in ALID is complete and accurate and that its staff are using the same system to track its leases increases the risk that the errors and omissions in the commission's management of leases that we discussed earlier in this chapter and in Chapter 1 will continue to occur.

*The commission's failure to ensure that the information in the database is complete and accurate and that its staff are using the same system to track its leases increases the risk of errors and omissions.*

### **The Commission Does Not Regularly Audit Its Revenue-Generating Leases, nor Does It Adequately Oversee Granted Lands**

The commission has not developed a plan for monitoring its nearly 1,000 revenue-generating leases—in particular, about 85 leases that involve the extraction of oil, gas, minerals, and other natural resources from state properties. Furthermore, according to the chief of the Mineral Resources Management Division (mineral resources), because of an insufficient number of staff, the commission has conducted its monitoring activities only in reaction to discovered problems or relating to actions taken by lessees to transfer their leases to other entities, rather than based on any proactive monitoring schedule. Additionally, we found that the commission does not ensure that funds generated on lands granted to local governments are spent in accordance with the

public trust, because it only responds to allegations of improper use of funds rather than identifying and preventing the misuse through periodic monitoring.

According to a 2008 report by the commission to the Legislature, the audit section within mineral resources conducts financial and compliance audits to ensure that the State receives appropriate royalties, rents, and other compensation due under the commission's leases and that the lessees comply with applicable laws and the terms of their leases. The report also indicates that most of the audit section's effort is focused on the royalty revenues the commission receives from its approximately 85 oil and gas, geothermal, and mineral leases. The State received roughly \$400 million in revenues for fiscal year 2010–11 from these leases, according to the commission's unaudited financial statements. The report states that the audit section ensures that lessees accurately deduct only allowable costs from their royalty payments. Additionally, as required in the provisions of the commission's oil and gas leases, the lessees are required to produce accurate monthly statements; to maintain full, complete, and accurate records related to the costs of development and production of resources on state property; and to make these records available at all times for inspection by the State. The commission's audit manual indicates that through its audits the commission determines whether a lessee has accurately calculated the royalty revenues remitted to the State and whether it has complied with its lease contract. The 2008 report to the Legislature asserts that the commission recovered or saved nearly \$22 million between 2004 and August 2007 as a result of these audits and reviews.

However, the commission has completed only two audits since 2008, neither of which were for oil and gas leases. Additionally, although the audit supervisor indicated that the commission focuses its monitoring on those leases that generate more than \$10,000 each month, its 2008 report to the Legislature indicates that the commission had not audited several of these leases in many years. Furthermore, although the 2008 report also indicates that the commission believes it should be auditing some of its leases on a more consistent basis, the audit supervisor noted that the commission has not developed nor followed any type of monitoring schedule to audit its revenue-generating leases since the late 1990s. In fact, in the 2008 report, the commission stated that it conducts audits only in reaction to a discovered problem or actions taken by lessees to transfer their leases to other entities, rather than following any type of audit schedule.

Ultimately, the 2008 report to the Legislature concludes that the commission needs an additional three staff to ensure that audits are conducted on a timely basis. According to the 2008 report, the

*The commission reported that it recovered or saved nearly \$22 million between 2004 and August 2007 as a result of audits and reviews for oil and gas leases, yet it has completed only two audits since 2008, neither of which were for oil and gas leases.*

commission employed seven auditors in the mid-1990s; however, at the time we completed our fieldwork, the commission had three auditors. Of these three staff, one is the audit supervisor and another performs royalty accounting duties in addition to audit tasks. Although we acknowledge that the commission has experienced staff reductions, which we discuss further in Chapter 3, we believe it could do a better job of prioritizing its audit activities to ensure that it adequately monitors its revenue-generating leases. In fact, we expected that the commission would track its audit recoveries and other audit findings as it performed these audits over the years, so that it could use this information to develop an audit plan that uses a risk-based approach and provides appropriate follow-up actions. For example, such an audit plan could indicate that the audit section planned to focus its resources on the larger revenue-generating leases as well as those that historically have had the most problems, such as errors in the lessees' royalty payments.

In its 2008 report to the Legislature, the commission provides a list of the benefits it derived from the 14 audits it conducted from 2004 through August 2007. This list includes the lessee's name, the amount of staff time taken to perform the audit, and the amounts recovered or saved as a result of the audit. However, when we asked the audit supervisor whether the commission had maintained a similar tracking spreadsheet for the audits it conducted prior to 2004, he indicated that no such list exists prior to 2004 and that the commission does not consistently track this information. Without consistently tracking this information, the commission will not be able to develop a plan that focuses staff time on monitoring the leases that are the most risky or that provide the highest return.

***The chief told us that the two audit section staff have spent roughly 6,500 hours since 2008 reviewing nine years of one lessee's records and that the lessee owes the State for underpaid royalties.***

Although the chief of the audit section agreed that an audit plan might be beneficial, she indicated that currently her audit resources are fully occupied in performing reviews prompted by disputes related to some of the 85 leases involving royalty payments. For example, the chief told us that the two audit section staff have spent roughly 6,500 hours since 2008 conducting a review of one lessee's records and that the lessee owes the State for underpaid royalties. According to the chief, this effort required that staff review nine years of the lessee's records, and the commission hopes to recoup several million dollars in underpaid royalties. In a second example, the commission conducted two audits in response to a lessee's claim that it had overpaid royalties by \$5.9 million by failing to take appropriate deductions for various costs associated with oil and gas production—such as transportation, dehydration,<sup>5</sup> and administrative costs. To assess the lessee's claim, audit staff had to review records covering a period of more than eight years.

<sup>5</sup> Dehydration costs consist of the facilities and equipment required to separate water from oil.

Eventually, the State provided a refund of nearly \$2.3 million to the lessee rather than the \$5.9 million the lessee had claimed—a savings of about \$3.6 million.

Although we understand the commission's need to audit the lessee's records to determine the accuracy of its claim that the State owed it \$5.9 million, we believe it is not reasonable for the lessee to wait eight years before making this type of claim, especially when it was the one responsible for failing to take the appropriate deductions. To avoid having to perform similar types of reviews in the future, which appears to have consumed a significant amount of the audit section's time since 2008, we believe the commission should put in place a reasonable time period during which those lessees who claim these deductions can do so. In fact, existing commission regulations require a lessee that intends to take deductions for dehydration costs incurred when extracting oil and gas, to take those deductions within 10 days of the end of the month to which the deduction applies. This requirement is designed to ensure the timely resolution of deduction claims related to dehydration costs. Although no similar regulatory provision currently exists for other types of deduction claims, we asked the commission whether it believes it has legal authority to impose a similar requirement on other types of deduction claims, such as transportation costs. The commission indicated that it does believe that it generally possesses this authority, but that its ability to enforce this requirement on existing leases entered into before 1977 is limited and would require the mutual consent of the lessee and the commission. Although it may be difficult for the commission to obtain this consent for existing leases, we believe that it is well worth the effort to work with lessees to put such a mechanism in place.

According to the chief of the audit section, some of the audit section's resources have been directed to assist a software contractor in the development of a royalty accounting system that should streamline the receipt of royalty payments and help the commission more quickly identify issues with royalty payments for the purpose of audits, as well as facilitating faster recoveries by the State. However, the chief also stated that, although the agreement to develop this system has been in place since 2005, and one auditor spends 40 percent of his time and the other audit staff have spent roughly 700 hours assisting in its implementation, work remains to be done. Given these challenges, the commission may want to consider contracting some of its auditing workload to an outside entity on a contingency basis—with payment based on the percentage of any amounts recovered or saved.

***We believe it is not reasonable for the lessee to wait eight years before making a claim that it had overpaid royalties by \$5.9 million by failing to take appropriate deductions for various costs associated with oil and gas production.***



In fact, in June 2011 commission staff used a similar approach to ensure that the State receives all revenues it is due from one of its lessees. Specifically, commission staff requested and received authority from the commissioners to solicit proposals for a third-party auditor or firm to conduct a review of a lessee's records in response to the lessee's intention to transfer a lease to another entity. According to the commission, the lessee agreed to enter into a reimbursement agreement for \$150,000 to cover the costs of the audit. Further, to expedite the transfer, the commission also requested that the lessee post a surety bond of \$4 million to cover the potential recoveries resulting from the audit. If the chief of mineral resources believes that current staffing levels impede the audit section's ability to conduct audits on a regular basis, he should consider exploring and taking advantage of other approaches, such as contracting with third parties to fulfill its auditing responsibilities and, in so doing, provide the commission the time it needs to implement the royalty accounting system and establish an audit plan.

Finally, the audit supervisor told us that the commission has not formalized a plan for overseeing the State's granted lands. As mentioned in the Introduction, the Legislature has the power to delegate the management responsibility of tidelands and submerged lands to local governments. When it does so, these lands are known as granted lands, and the grantees that manage them must ensure that they are used in ways that are consistent with the public trust and with any other conditions the Legislature imposes. This includes ensuring that revenue generated from the use of these lands is used for public trust purposes. The commission, however, remains responsible for overseeing these granted lands and ensuring that they are properly managed.

In a Public Trust Policy formally adopted in September 2001, the commission describes its role in overseeing these granted lands, stating:

[T]he commission carries out this responsibility by working cooperatively with grantees to assure that requirements of the legislative grants and the Public Trust Doctrine are carried out and to achieve trust uses. The commission monitors and audits the activities of the grantees to insure that they are complying with the terms of their statutory grants and with the public trust. With a few exceptions, grantees are not required to secure approval from the commission before embarking on development projects on their trust lands or before expending revenues generated from activities on these lands. However, where an abuse of the Public Trust Doctrine or violation of a legislative grant occurs, the commission can advise the grantee of the abuse or violation; if necessary,

report to the Legislature, which may revoke or modify the grant; or file a lawsuit against the grantee to halt the project or expenditure.

The commission appears to have taken a reactive approach to carrying out its oversight responsibilities of granted lands by only responding to allegations of improper use of funds rather than proactively identifying and preventing misuse through periodic monitoring. According to the commission's executive officer, in the past, the cities of Los Angeles, Long Beach, and San Diego, as well as Orange County, were alleged to have improperly used funds generated from granted lands. For example, in the case of Los Angeles, the executive officer indicated that the commission was alerted to the potential misuse of public trust funds by the Steamship Association of Southern California, which alleged that the city of Los Angeles was using funds generated by the Port of Los Angeles for projects unrelated to the port. According to the commission's legal counsel, the investigations and litigation related to this case occurred during the period from 1995 to 2001. Ultimately, the commission sued the city and settled for \$60 million plus interest, which is being paid to the Port of Los Angeles. In another example, the executive officer also told us that in 2004 the commission investigated certain allegations regarding the city of Redondo Beach that were deemed unfounded, but that it discovered other problems during its investigation that were subsequently resolved in 2006. Currently, the commission is investigating more recent allegations related to the city of Long Beach.

The commission has not developed an audit plan designed to ensure that the revenues generated on these granted lands are used properly. Instead, according to the chief of administrative services, one individual in land management responds to grantee questions and requests regarding appropriate activities on granted lands. This individual also receives financial statements of granted land revenues from the grantees. However, the chief indicated that the commission lacks the expertise to conduct a review of these financial statements. The chief also stated that the commission cannot regularly conduct audits of granted lands because of staffing constraints. According to him, the commission does not have the staff to ensure that grantees are expending funds appropriately and does not direct its limited resources toward auditing granted lands because these audits do not generate revenue for the State. However, without oversight of granted lands, the commission is neglecting its responsibility to protect the public trust and risks having to address additional ongoing abuses of funds dedicated for public trust uses.

*The chief indicated that the commission lacks the expertise to conduct a review of these financial statements and that it cannot regularly conduct audits of granted lands because of staffing constraints.*

*We found that for 21 of the 35 leases we reviewed, either the surety bond or the liability insurance or both had expired.*

### **The Commission Does Not Always Ensure That Lessees Have Current Surety Bonds or Liability Insurance**

The commission is not consistently ensuring that lessees maintain a surety bond and liability insurance to mitigate a potential financial claim resulting from an accident occurring on state land. A surety bond guarantees that the lessee will observe all the terms, covenants, and conditions of the lease and remains in effect until all the lease premises have been either accepted as improved by the State or restored by the lessee in accordance with the lease.

State law requires that lessees maintain a surety bond and liability insurance for all oil and gas pipeline leases, and according to the chief of land management, most of the commission's other leases contain a provision requiring lessees to acquire and maintain surety bonds and liability insurance. However, according to the chief of land management, the commission does not proactively ensure that lessees have a current surety bond and liability insurance. In fact, we found that for 21 of the 35 leases we reviewed, either the surety bond or the liability insurance or both had expired.

In 2000 the commission created the State Land Compliance Program (compliance program), in part to ensure that lessees maintain a current surety bond and liability insurance. In a description of the compliance program, the commission explains that failure to have adequate liability insurance and bonds places the State at risk of financial loss resulting from claims of personal injuries or property damage caused by accidents on its lands. Further, the program description states that damages and injury awards could be extremely high and therefore, adequate liability coverage for each lease is of paramount importance. However, despite identifying that some of its pipeline leases did not have current liability insurance and surety bonds, according to the chief of administrative services, the commission ended the compliance program in 2006.

The chief of administrative services indicated that as the result of staffing reductions and the commission's decision to emphasize its revenue-generating functions, its efforts to maintain any semblance of a dedicated compliance program were minimal, with enforcement actions taken in only the most egregious instances. Although the commission can terminate a lease if the insurance or bond has lapsed, the chief of land management noted that it has not been the commission's practice to do so, because by evicting the lessee the State is solely liable for any accidents that occur on its lands. Further, although it would like to, the commission believes that it does not have the statutory authority to impose monetary penalties on lessees when they fail to maintain a surety bond or liability insurance. Although we agree that assessing a monetary

penalty may be effective to encourage a lessee to obtain the required surety bond or liability insurance, it is only effective if enforced. Up to this point the commission has not obtained legislative authority to assess penalties, nor has it shown an inclination to take any punitive actions against these lessees.

### **Recommendations**

To improve its monitoring of leases, the commission should do the following:

- Create and implement a policy, including provisions for supervisory review, to ensure that the information in 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 General Services, to obtain best practices for a lease-tracking database.
- Require all of its divisions to use ALID as its one centralized lease-tracking database.

To adequately monitor its revenue-generating oil and gas leases, the commission should do the following:

- 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.
- 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.
- 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.

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

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.

## Chapter 3

### **STAFFING REDUCTIONS HAVE AFFECTED THE ABILITY OF THE STATE LANDS COMMISSION TO PERFORM MANY OF ITS FUNCTIONS, YET IT HAS NOT ADEQUATELY QUANTIFIED ITS STAFFING NEEDS**

#### **Chapter Summary**

The State Lands Commission (commission) attributes its inability to perform many of its duties to a series of staff reductions it has experienced since 1990. In particular, the commission's Land Management (land management) and Mineral Resources Management (mineral resources) divisions—the divisions with the most responsibility for managing its leases—have experienced staffing reductions of 50 percent and 32 percent, respectively. Although the commission has made attempts to replace these lost positions, it has not taken sufficient steps to quantify its need for additional staff. Furthermore, although the commission receives fees for processing lease applications, it has not implemented other approaches that would allow it to be reimbursed for some of its other leasing activities.

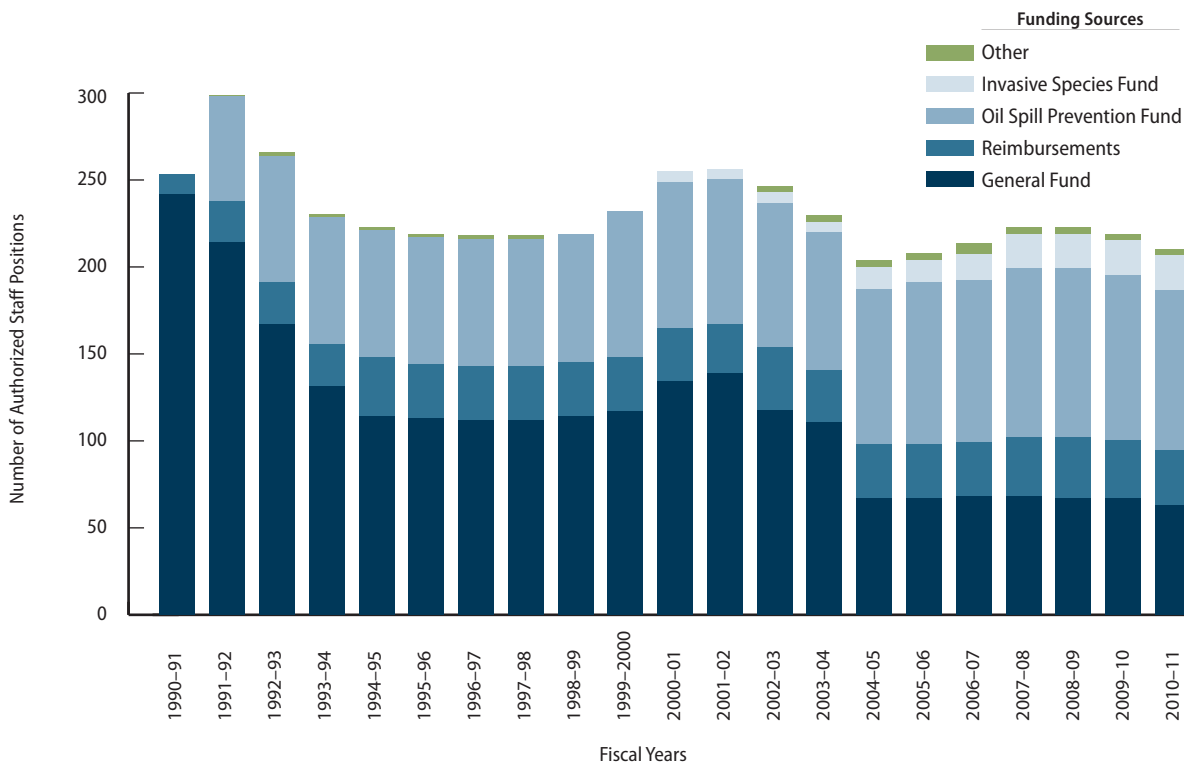
The commission also has not developed a succession plan, despite significant reliance on retired annuitants and staff nearing retirement to perform much of its work. Although the commission has taken some steps to train the staff it currently has and to attract additional staff, the lack of a succession plan leaves it vulnerable to a loss of institutional knowledge and the continuation of many of the problems we have already identified associated with its failure to effectively manage its leases.

#### **The Divisions That Generate Revenues Have Experienced Significant Staff Reductions**

Significant reductions in staff have hindered the commission's ability to conduct activities necessary to ensure that the State receives appropriate revenues and that lessees comply with lease terms. To meet its objectives, the commission employs staff with expertise in land appraisal, lease negotiation, boundary determination, engineering, financial auditing, and safety inspections. However, many of the activities performed by land management are not conducted in a timely manner or are simply not performed at all. In addition, as previously discussed, the commission does not regularly audit its oil and gas leases—a key function performed by mineral resources. Furthermore, the chief of mineral resources indicated that the commission is facing difficulty fulfilling its duties with respect to oil and gas safety inspections.

The commission attributed this decline in work performed in both the land management and mineral resources divisions to a steep decrease in staff. Although the commission's total staff declined from 253 in 1990 to 210 in 2010, this overall decline has been accompanied by significant changes in the total workload and overall staff distribution of the commission. Since 1990 the commission's duties have grown in the areas of oil spill prevention and the control of invasive marine species. These functions have been accompanied by dedicated funding sources and new program responsibilities. At the same time, the commission's General Fund budget has decreased by 35 percent since fiscal year 2001-02, accompanied, according to the commission's records, by a significant reduction in the number of staff that perform duties paid for by the General Fund. Figure 2 demonstrates the change in staffing with respect to total number of staff as well as funding source. In 1990, according to documents provided by the commission, it was funded primarily through the General Fund, but by 2010 the portion of General Fund positions had dropped to roughly 30 percent of the commission's total positions.

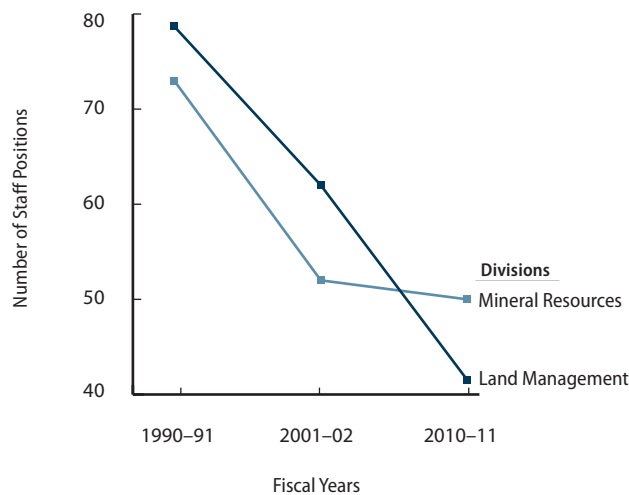
**Figure 2**  
**State Lands Commission Staff and Their Funding Sources**  
**Fiscal Years 1990-91 Through 2010-11**



Sources: The salaries and wages supplements to the Governor's budget for numbers of authorized positions and State Lands Commission (commission) staffing records for funding source. We did not verify the accuracy of the commission's staffing records for funding source.

At the same time that funding sources have shifted within the commission, the divisions that perform several of the commission’s core revenue-producing functions—processing lease applications, ensuring lease compliance, and auditing oil and gas royalty payments—have experienced a net decline of 111 positions since fiscal year 1990–91. As shown in Figure 3, land management has lost 37 positions, a reduction of almost 50 percent, while mineral resources has lost 23 positions, amounting to a 32 percent reduction during this same period.

**Figure 3**  
**Decrease in Total Staff Positions for the Land Management and Mineral Resources Management Divisions Since Fiscal Year 1990–91**



Sources: Salaries and wages supplements to the Governor’s budgets, fiscal years 1990–91 through 2010–11.

According to the chief of the Administrative and Information Services Division (administrative services), since fiscal year 2000–01, the commission has developed numerous budget change proposals requesting additional positions to perform oil and gas financial audits and conduct land appraisals and lease compliance activities related to surface leases for the land management and mineral resources divisions. Most of these requests were related to positions the commission had lost in previous across-the-board budget reductions. Although prior administrations approved two of these proposals—for positions to conduct limited-term oil and gas audits and to staff a lease compliance program, including pipeline and surface lease inspections that were lost in subsequent budget cuts—the majority of these proposals requesting additional positions were not approved. The chief of administrative services told us that



the explanation given for not approving these positions was that positions funded by the General Fund that the commission had lost in the past could not be restored, due to the administration's policies regarding ongoing budget constraints. Given the size and scope of the reductions to these divisions, the commission's claim that its ability to conduct its work has been affected appears to be reasonable.

### **The Commission Has Not Adequately Quantified Its Staffing Needs**

The commission has not performed workload analyses for several of its key functions. Without such analyses, it is difficult for the commission to accurately quantify the number of staff it needs to meet its obligations. Furthermore, for various reasons the commission has not always been able to fill its open positions. In addition, although the commission receives fees for processing lease applications, it has not implemented other approaches that would allow it to be reimbursed for some other lease activities. As a result, the commission may be missing the opportunity to increase revenue from other activities.

*The commission has not adequately analyzed its staff's workload for many important functions, which makes it difficult to both understand and justify its staffing needs.*

The commission has not adequately analyzed the workload of its staff for many important functions, which makes it difficult to both understand and justify its staffing needs. For example, two managers in land management noted that the workload for staff who process leases is not manageable and that as a result, staff cannot meet all of their obligations. The managers indicated that they would need an additional 10 staff to sufficiently address the existing workload in their unit. However, the managers told us that they had not performed any type of workload analysis that would justify the staffing levels they believe are necessary to accommodate their workload. One of the managers indicated that the complexity of the leases makes the workload difficult to analyze, noting that the lease negotiators do not have a typical workload of routine lease files. In addition, the manager cited the difficulty of anticipating the additional workload generated by changes to lease files, such as amendments, lease transfers, and defaults. Nonetheless, as we discussed in Chapter 1, the commission has lost revenue due to its failure to perform rent reviews and other lease management activities. Therefore, it should make an effort to develop a workload analysis that accurately reflects the work generated as a result of its responsibilities.

In the past, the commission's requests for additional appraisal staff have not been approved. Although a manager in land management indicated that the commission has a shortage of appraisal staff, the chief of administrative services told us that the commission has not taken the steps necessary to analyze the appraiser's

workload since the late 1980s or early 1990s. The assistant chief of land management also confirmed that the commission has not developed a method for determining the number of appraisals it should be performing based on upcoming rent reviews and other considerations. In fact, as we mentioned in Chapter 1, the appraiser asserted that he has no backlog and estimated that appraisals take anywhere from a few hours to a few weeks to complete. Similarly, aside from the 2008 report to the Legislature on the audit section, which we discussed in Chapter 2, the chief of mineral resources indicated that his division has not conducted a comprehensive review of its workload and staffing needs. This systemic lack of workload analysis may make it difficult for decision makers to evaluate the commission's requests for staff.

Moreover, the commission has not always filled its open positions. As Figure 4 on the following page demonstrates, the commission has experienced a persistent gap between its filled positions and authorized positions. The chief of mineral resources attributed the vacancy rate in his division in part to a lack of a competitive salary structure, which has led to ongoing difficulty finding and hiring qualified candidates during times when the commission was authorized to hire new staff. Furthermore, he indicated that although proposals for some positions may have been approved, they have not always been funded, making it difficult or impossible for the commission to hire individuals to fill these open positions. According to the chief of administrative services, some of the commission's positions likely were not filled because of hiring freezes, or, in the event of a credible threat of layoffs, the commission may have held positions vacant in anticipation of budget reductions. Additionally, the chief of administrative services asserted that some of the commission's vacancies are due to a requirement that departments budget 5 percent in salary savings each year, and that this savings is built into the commission's base budget. Finally, according to the chief of administrative services, because the commission charges fees for lease applications, which it then uses to fund several lease negotiator positions, it must receive sufficient reimbursements from processing applications to pay for these positions. Because the commission has not collected enough revenue from application fees in recent years to pay for all of its reimbursed lease negotiator positions, some of these positions have been held vacant.

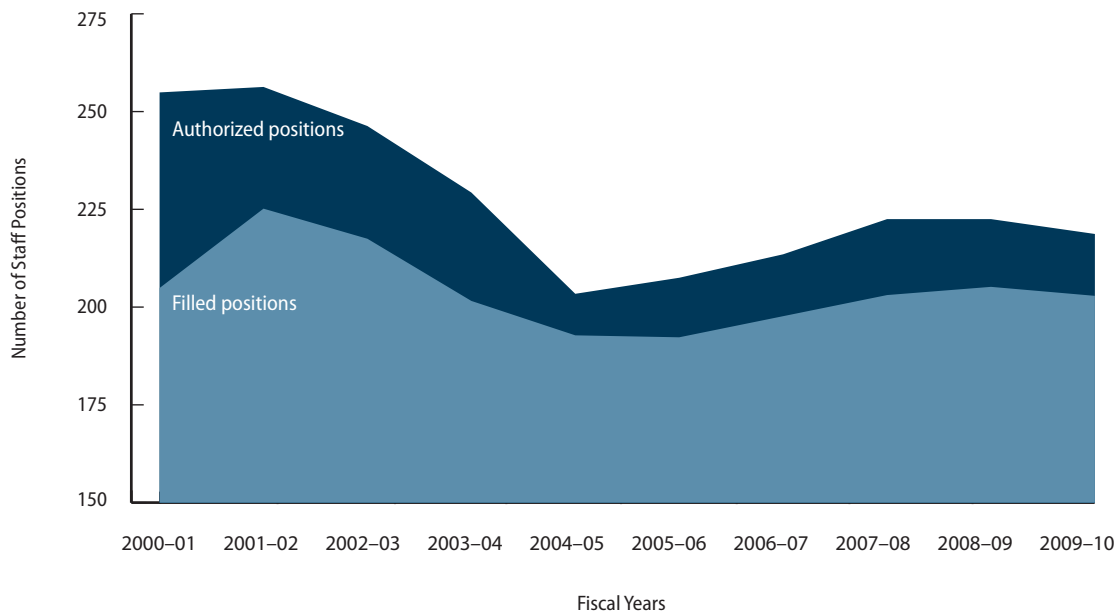
Despite its inability to perform many of its duties, the commission has not requested additional staff to address its challenges in processing rent reviews and other lease management activities, according to the chief of administrative services. The chief indicated that since application processing is the only leasing activity conducted by the commission for which it receives fees, the commission must rely on the State's General Fund to pay for all other lease management

*Despite its inability to perform many of its duties, the commission has not requested additional staff to address its challenges in processing rent reviews and other lease management activities.*

activities, including rent reviews, responding to public inquiries, and conducting lease appraisals. The commission has not requested additional lease management staff to conduct rent reviews and other activities because it perceives requests for other positions paid from the General Fund to be a higher priority. For instance, the chief stated that appraiser positions represent a greater potential revenue return to the commission because a rent review based on an appraisal or current benchmark is more favorable to the State than one without current information. Nonetheless, if the commission believes it needs additional staff to conduct these other leasing activities, it should perform the workload analysis already discussed or find other approaches to fund its activities.

**Figure 4**

**Differences Between the State Lands Commission's Number of Authorized Positions and Its Filled Positions**



Sources: Salaries and wages supplements to the Governor's budgets, fiscal years 2001-02 through 2010-11.

In fact, according to the chief of administrative services, the commission has considered other approaches that would allow it to be reimbursed for its activities, including charging lease maintenance and public inquiry fees. The chief of administrative services expressed concern that lease maintenance fees may exceed the lease rental amount and that members of the public may be less willing to make inquiries if they had to pay a fee and would instead proceed with projects without appropriate advice. However, the state lead realty specialist at the federal Department of the Interior, U.S. Bureau of Land Management (Bureau of Land

Management), with whom we spoke noted that the Bureau of Land Management charges lease maintenance fees. By considering other reimbursement categories to fund staff positions, rather than focusing solely on processing applications, the commission may be able to fund some of its other activities, such as performing rent reviews, and thus increase the revenues it receives as the result of these activities.

Finally, the commission is seeking to repeal the section of state law that provides for rent-free leases related to recreational piers.<sup>6</sup> The commission estimates that by doing so it could collect an additional \$2 million annually at the end of 10 years from the conversion of about 1,285 rent-free leases to revenue-generating leases. If this law is repealed, the number of revenue-generating leases that the commission manages would more than double, increasing the workload for what the commission asserts is its already overtaxed land management staff. However, according to the chief of administrative services, the commission will require only two positions to implement this change—one in year three and another in year four after implementing the legislation if passed. Although the commission asserts that it will not need additional staff in the near future to manage this increase in workload, we believe it is important that, as part of its workload analysis, the commission take into consideration the impact that this additional responsibility will have on its staffing needs.

### **The Commission Has Not Undertaken a Succession Planning Effort**

The commission has not developed a succession plan to address its ongoing and future workforce needs, exposing it to further depletion of knowledgeable staff and the continuation of many of the problems associated with the ineffective lease management mentioned throughout this report. Specifically, of the 20 staff in the leasing unit within land management, only eight are under age 50. According to the chief of administrative services, six of the remaining 12 are working as retired annuitants—retired state employees who continue to work for the State on a part-time basis. The problem is equally severe in mineral resources, which, according to the chief of mineral resources, relies on highly experienced engineering, finance, and safety audit personnel, one-third of whom are anticipating retirement in the next six years.

Although land management appears to rely heavily on retired annuitants to fill its more experienced positions, according to the chief of mineral resources, his division is unable to do the same.

*The commission estimates that by repealing the section of state law that provides for rent-free leases, it could collect an additional \$2 million annually at the end of 10 years from the conversion of about 1,285 rent-free leases to revenue-generating leases.*

<sup>6</sup> As of August 11, 2011, this legislation was pending.

*Land management appears to have taken some steps to address the unequal distribution of experience among its staff.*

The chief indicated that mineral resources has experienced a large number of retirements during the past two to three years, during which time the use of retired annuitants was discouraged or eliminated. The chief of the audit section within mineral resources told us that the analyst responsible for royalty accounting and the audit supervisor are retiring within the next year. According to a request for a hiring freeze exemption, dated February 2011, the analyst position is a critical revenue-generating position responsible for verifying the accuracy of lessee royalty payments, the timeliness of these payments, follow-up, and billing for penalty and interest and provides extensive support to the audit staff in financial audits.

An executive order issued by the governor in February 2011 prohibits agencies from filling vacant positions with individuals currently employed by the State or retired annuitants. The commission requested several exemptions from the governor's hiring freeze to address these impending vacancies and, in July 2011, it received approval to fill these vacancies, including the royalty accounting analyst position previously discussed. On the other hand, the chief of administrative services indicated that the commission has not been able to augment its staff with younger staff very often, which has increased its reliance on older staff and retired annuitants. Land management appears to have taken some steps to address the unequal distribution of experience among its staff. For instance, according to managers within land management, they develop skills in younger staff by assigning them to more complex leasing projects along with a retired annuitant, and allow staff to gain the experience necessary to qualify for promotional exams, which they believe will help address the shortage of staff in the middle ranks. Despite these actions, the managers within land management asserted that the division will need to rely on retired annuitants for the foreseeable future.

The commission is cognizant of these difficulties and, in one instance, has attempted to address its challenges through collaboration with the Department of Personnel Administration (Personnel Administration) by attempting to increase salaries and reclassifying inspector positions in mineral resources. According to the chief of administrative services, the inspection program—which is responsible for safety inspections on offshore platforms as well as for testing oil samples for the purpose of royalty verification—was significantly understaffed because of a loss of inspectors to retirement and private sector hiring and the difficulty of filling vacancies, including a supervisor's position, despite holding several examinations. In 2007 the commission conducted a salary analysis that proposed reclassifying its mineral resources inspectors at a higher salary range because, according to the chief, these positions were underpaid. Despite these efforts, the commission was unable to obtain approval from Personnel Administration to revise the

classification structure. According to the chief of administrative services, the commission was eventually able to fill the supervisor position with an individual who was willing to accept the salary.

According to the chief of administrative services, the commission began reviewing succession planning in 2006, at which time it noted that about half of its workforce was eligible for or approaching eligibility for retirement. At that time, the chief indicated that the commission did not pursue the development of a succession plan due to staffing constraints in its personnel office and anticipated difficulties in successfully implementing any plan the commission might develop because of its small size, its small number of incumbents per class, the elimination of all of its unfilled authorized positions, and hiring freezes. In addition to personnel office staffing constraints, the chief of administrative services cited several factors contributing to the commission's difficulty in retaining existing staff and replacing retiring staff. These factors include the length of the State's hiring process, salary disparities between the State and the private sector, the difficulties in hiring staff when the State faces fiscal challenges, and the need for extensive experience or specialized degrees for many of the positions the commission is seeking to fill.

Given the extent to which the commission relies on the specialized knowledge of staff to perform the bulk of its work, the lack of a succession plan may leave it vulnerable to a loss of productivity and institutional knowledge as a result of retirements. For example, according to the manager of two of the leasing teams in land management, she is planning to retire within the next two years, and the other team's manager only recently took over the position. Without significant support from other staff members, many of whom are nearing retirement themselves, the new manager may experience difficulty managing the unit. Further, the chief of administrative services noted that not replacing retirees could pose a risk to public health and safety, as the commission is responsible for inspecting high-risk facilities and activities, including offshore oil platforms and abandoned mines. Failure to perform these duties increases the risks to the environment and public safety.

### Recommendations

To better demonstrate its need for additional staff, the commission should do the following:

- Conduct a workload analysis to identify a reasonable workload for its staff and use this analysis to quantify the need for additional staff.
- Quantify the monetary benefits of its staff's duties other than processing lease applications, and consider billing lessees for those activities.
- 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.

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.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives specified in the scope section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,



ELAINE M. HOWLE, CPA  
State Auditor

Date: August 23, 2011

Staff: Denise L. Vose, CPA, Audit Deputy  
Kathleen Klein Fullerton, MPA  
Jason Beckstrom, MPA  
Genti Droboniku, MPP  
Maya Wallace, MPPA

Legal Counsel: Donna L. Neville, Associate Chief Counsel

For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

*(Agency response provided as text only.)*

California State Lands Commission  
100 Howe Avenue, Suite 100-South  
Sacramento, CA 95825-8202

August 1, 2011

Elaine M. Howle, CPA\*  
Bureau of State Audits  
555 Capitol Mall, Suite 300  
Sacramento, CA 95814

Dear Ms. Howle:

Initially, I want to acknowledge that the Bureau of State Audits (Bureau) has provided the staff of the California State Lands Commission (Commission) a valuable review and analyses of the policies, practices and past incidents involving Commission business over the last 20 plus years. We agree with many of the Bureau's recommendations and, in fact, are implementing or plan to implement most of them. While the Commission is the ultimate decision maker on proposed actions, including leases brought before it, it is the staff that has the day-to-day responsibility to make recommendations to the Commission and carry out the Commission's directives. The enclosed response to the Bureau of State Audits report is the staff's response and has not been approved by the Commission.

We do appreciate the efforts of the Bureau in providing constructive criticism and analyses of past and present practices, as well as its recommendations, which we look forward to implementing where feasible and appropriate. Many of the recommendations suggested by the Bureau are practical and achievable if the Commission is provided the opportunity to acquire and retain adequate staff to address these areas.

Finally, I would like to say that Commission staff is a relatively small, hardworking, and professional group dedicated to acting in the State's best interest and I am very proud of all that they have been able to accomplish with such limited resources.

Sincerely,

*(Signed by: Curtis L. Fossum)*

CURTIS L. FOSSUM  
Executive Officer

Enclosure

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\* California State Auditor's comments begin on page 73.



## State Lands Commission: response to August 2011 Audit

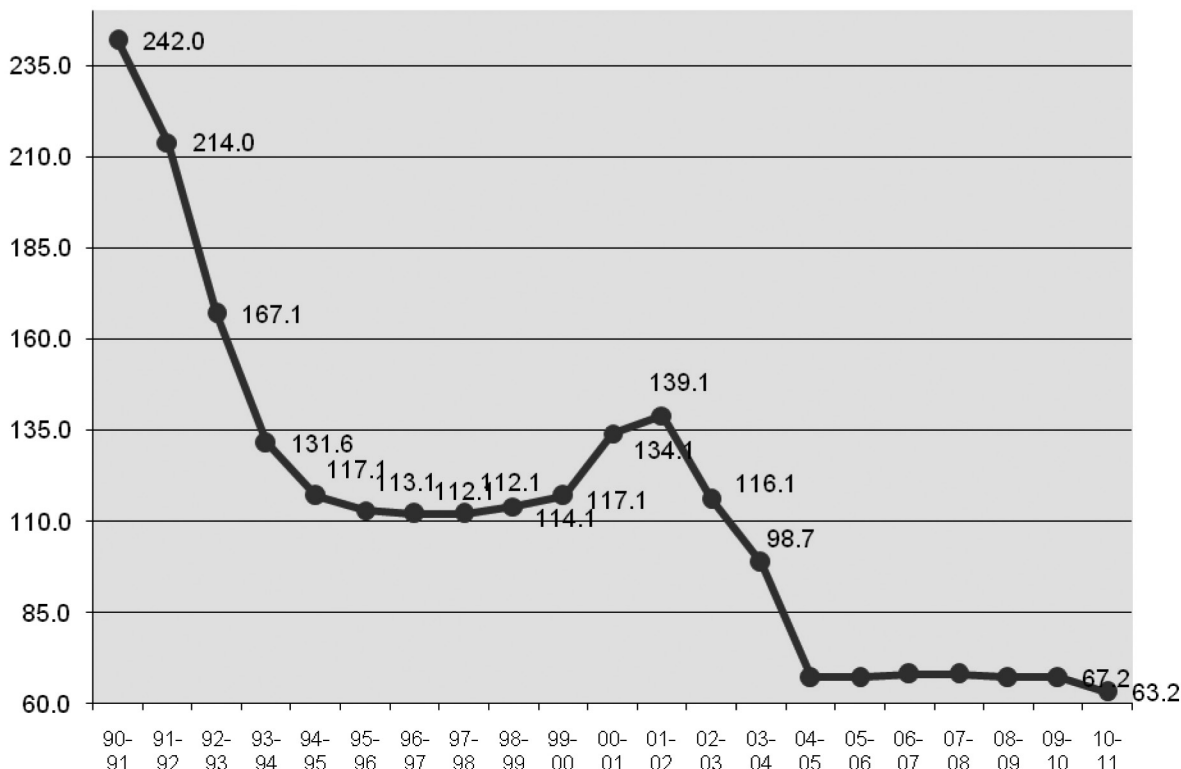
*Despite Significant Staff Reductions in the Last 20 Years, the Commission Has Managed Public Lands Resourcefully to Generate Billions in Non-Tax Revenue for the General Fund*

In July 2010, the Joint Legislative Audit Committee, at the request of former State Senator Dave Cogdill (R-14), scheduled a hearing to discuss whether “the state receives fair market value for its properties.” The August 4, 2010 hearing included eight areas of investigation proposed by the Bureau of State Audits (Bureau). The audit report discusses each of these areas and also describes recommended actions to address and improve Commission practices. We believe many of these recommendations are ones that would enhance the ability of the Commission and its staff to carry out its duties. We also believe that the restoration of a number of positions cut by prior administrations from the Commission’s staff would result in substantially higher returns to the State’s General Fund and State Teachers’ Retirement System.

Commission staff strives to balance the goals of maximizing the return on the use of State lands and resources entrusted to its care with providing the highest possible level of environmental and resource enhancement and protection of these lands for current and future generations. While the Commission has some regulatory functions, principally it is a land and resource management agency, not a regulatory agency. A primary function of Commission staff is to negotiate leases and contracts for the use of the State’s property and resources. The Commission manages the State’s sovereign public trust lands, which include approximately 120 rivers and sloughs, 40 lakes, and lands along over 1000 miles of coastline underlying the Pacific Ocean out 3 miles, together encompassing approximately 4 million acres. The Commission also manages 489,000+ acres of school lands and another 790,000+ acres of state-owned mineral rights. With adequate staffing, the Commission is in a position to assist in reaching the State’s alternative energy goals and generate substantial non-tax revenues at the same time. Commission staff is already working on geothermal, solar, wind and wave energy projects. While many of these projects are in their infancy, the staff members monitoring these projects spend the majority of their time also assigned to and processing other unrelated matters.

Since 1990, the Commission has been subjected to a continual erosion of its General Fund positions. Regulatory programs have been added regarding Oil Spill Prevention and Marine Invasive Species accompanied by special fund appropriations, however, the core revenue producing and resource management programs that existed in 1990 have been continually reduced. Of 242 General Fund positions that existed in 1990, only 63.2 remain. These losses are principally those positions that performed much of the workload that we are now being criticized for failing to perform. These were positions involved in revenue generation. These positions performed royalty accounting, lease rental billings, revenue receipts, auditing and oil field management. These also included positions that were responsible for appraisals, lease management and compliance, enforcement, trespass investigations, litigation and ejectments. These positions were responsible for protecting the public’s interest in the State’s lands and resources consistent with the Commission’s Public Trust responsibilities. Some of the losses have been offset by obtaining cost recovery for the processing of lease applications. However, those functions where there is no application being processed must be supported by General Fund appropriations and the loss of those staff resources has had a significant impact on the Commission’s ability to carry out its core program objectives to increase non-tax revenues to the General Fund and protect the public’s interest in these lands and resources consistent with the Public Trust.

### 3560: California State Lands Commission Trend of General Fund Authorized Positions



Despite losing 74% of its General Fund-supported positions since 1991 (from 242 to 63.2), the Commission has earned revenues over \$3.8 billion, increasing annual revenues by 135%, from \$181 million (1990-91) to more than \$426 million (2010-11). In particular, over the same period (1990-2010), the Land Management Division has increased its annual surface rental revenue 384% from \$3.8 million to \$18.4 million. Staff was able to achieve these increases despite a 47% reduction (37 positions lost) by effectively managing and triaging its many responsibilities, focusing on improving revenues, while still fulfilling its responsibilities to protect the Public Trust. During this same time period, the Legal Division has been reduced by over 50% and currently has only eight attorneys, seven of which are dedicated to supporting the management and enforcement of the Commission’s 4,000 leases, as well as, investigating and litigating incidences of trespass, in addition to their other responsibilities.

We believe that the subtitle to the report and titles to Chapters 1 and 2 do not fairly represent the Commission’s past or ongoing efforts and successes in managing the public lands and resources in the State’s best interest. The “sound bite” impact of those titles is likely to create an indelible first impression with the reader that the Commission is improperly and incompetently managing the public lands entrusted to it. In fact, the underlying circumstances which have resulted in the inability of the Commission staff to

①

keep up with the workload in a highly efficient manner have been clearly stated within the report, but the “headlines” reflected in these titles do not. The Commission staff has been resourceful in adjusting to circumstances beyond its control that have impacted the ability to employ many methods and practices which Commission staff had followed in the past. These adjustments, which were forced by declining staff resources, were designed to achieve optimal lease revenues by making accommodation for and realignment of lease management priorities. The return the State receives in generating non-tax revenue we believe is a remarkable achievement and neither a failure nor a sign of ineffectiveness in light of these declining staff resources.

② We also have some concerns about some of the methodology used to produce the report. The report states that the auditors “judgmentally selected a sample of 35 leases from the commission’s approximately 1,000 revenue-generating leases.” The report does not provide a definition of what “judgmentally selected” means nor does it provide any explanation as to how the leases were selected in the sample. What is clear is that this was not a representative sample of State Lands Commission leases, but rather a subjectively selected list of leases chosen to highlight specific problem areas. The report proceeds to use this subjectively selected sample as a basis for making additional assumptions about the Commission’s operations.

② Generally speaking, while the report describes examples of mistakes and failures to take action on leases in holdover or delinquent in rent payments, the examples we believe distort the bigger picture of Commission successes. One example is the sample of leases in holdover analyzed by the report. The Commission administers approximately 4,000 leases, including 15 marine oil terminal leases (3 of which are in caretaker status), 85 oil and gas leases, 61 industrial leases, 146 commercial leases, 904 public agency leases, and 1,149 recreational pier leases. The “judgmentally selected” sample of 35 leases used throughout the report included 4 marine terminal leases, yet marine terminal leases represent a miniscule fraction of the Commission’s total leases.

Furthermore, Commission staff acknowledges that negotiating new leases for these marine terminals has not gone as quickly as desired. The delay in finalizing these negotiations illustrates the balancing between maximizing revenues to the State and providing the highest level of environmental and resource protection. Specifically, the primary reason for the delay was to ensure that the marine oil terminal facilities were required to undergo detailed environmental review to evaluate the potential of significant impacts from an oil spill. While this took time, we view the resulting negotiated leases as a success because the Commission was able to convince the oil companies to invest in an environmental review and commit to significant mitigation measures. Staff strongly believes any delays resulting from its efforts to ensure this review occurred were in the State’s best long-term interest.

Another example outlined in the report is the failure to collect rent for a five year period on holdover leases with Southern California Gas Company. The case involved four prior 49-year leases with a total rent of \$2,343, paid up front in 1957. Pursuant to law, in the five year holdover, the uncollected rent due totaled \$234 or approximately \$46 per year for all four leases combined. Rather than focus on bringing this small amount current, the staff focused on consolidating these leases with two other leases held by the same lessee, to create efficiency benefits for both the state and private lessee, and bring all the leases to a current fair market rent of \$16,794 per year. So, in this case, staff chose to forego the short-term minor rental gain in order to improve efficiency in long-term lease management. In fact, in several of the samples cited in the audit, there are unique circumstances relating to the specific property and proposed use of that property that influenced the negotiation strategy and approach staff ultimately took.

The report describes a number of leases that have expired or are failing to pay rent. While the California economy has recently begun to stabilize, the number of failed business, empty offices, foreclosures and bankruptcies in the general population over the last few years are likewise replicated in many of the Commission's leases. While the Commission may and has taken action to evict trespassers and lessees whose leases have expired, it does so after all other approaches to work cooperatively with the lessees have failed. In these difficult times, the Commission staff prefers to work with lessees, especially individuals and small businesses. Sometimes this may mean collecting less rent, or not imposing penalties, in the short term. We believe this is preferable to evicting a lessee and not collecting any rent and then being exposed to financial responsibility for any liability involving the lease premises. Furthermore, the Commission is not resourced to actively manage improved properties, such as marinas. So if the Commission did evict a lessee, such as a marina operator for failure to pay rent, the Commission would not be in a position to step into a management role and collect the slip rentals and pay the operating expenses. ③

Furthermore, many of the innovations and benefits developed in lease royalty structure were a result of refocusing existing staff functions toward enhancement of existing practices. An example of an outcome from this effort is the broader use of comprehensive economic analysis for determining oil and gas royalty lease terms for new leases. The benefits of this practice, and one example, which was brought to the attention of the Bureau, is evident in the Huntington Beach field's application of a "price based sliding scale" royalty, that has provided over \$50 million in additional state royalties over the past 15 years. ④

Responses to each of the Bureau's specific recommendations are listed below:

#### **Bureau of State Audits Recommendations and Staff of the State Lands Commission Response**

##### **Summary**

To ensure that it manages delinquent leases in a timely manner, the commission should do the following:

- Develop and adhere to policies and procedures that include the steps staff should take when a lessee is delinquent, time standards for performing those steps, and a process for tracking the status of delinquent leases between divisions.

##### ***Commission Staff Response:***

*Commission staff agrees and has already begun taking measures to implement to this recommendation. While accounting procedures for 30, 60, and 90-day dunning letters are in place, there is a recognized need to better coordinate Accounting, Land Management and Legal divisions in disposition of delinquent leases should those initial steps fail.*

- Conduct cost-benefit analyses when it contemplates either referring a delinquent lessee to the attorney general of pursuing the delinquent lessee through other means.

##### ***Commission Staff Response:***

*While no formal written process exists, Commission staff conducts an extensive, informal cost-benefit analysis, including consideration of statewide policy implications, through coordination with senior management, the Executive Officer and the Attorney General's Office, when deciding whether to recommend pursuing litigation to the Commission.* ⑤

To ensure that as few leases as possible are in 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 Staff Response:**

Commission staff agrees and has already implemented this recommendation. The report states that our new holdover procedures “appear reasonable [however], because the commission only recently implemented them, we were unable at the time of our audit fieldwork to determine whether they would be effective. In August 2010, there were 32 leases in holdover status with annual rent greater than or equal to \$10,000. As of July 2011, there are only 8 leases in holdover status with annual rent greater than or equal to \$10,000. That is a 75% reduction in significant holdovers in an 11 month period. One of these leases (Selby Slag) is an ongoing environmental obligation and will remain in holdover status indefinitely. Four of these leases are marine oil terminals (Tesoro Avon, Tesoro Amorco, NuStar and Chevron Estero). One (NuStar) will be renewed in 2011, one (Chevron Estero) is in caretaker status (non-operational), and rent reviews were conducted on all three active terminal leases in 2011. The other three leases (PG&E pipeline master lease, Kinder Morgan pipeline master lease, GP Gypsum) are in negotiations and we anticipate taking them to the Commission for new lease agreements within the next six to twelve months.

⑥

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 it to use other strategies, such as adjusting rents annually using an inflation indicator.

**Commission Staff Response:**

Commission staff agrees with this recommendation and will be exploring alternatives that are manageable with existing staff resources available.

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 once every five years.

**Commission Staff Response:**

Commission staff agrees with this recommendation in those specific situations of high revenue-generating leases where the benefits are likely to exceed the costs.

⑦

To ensure that it does not undervalue certain types of properties, the commission should do the following:

- Amend its regulations for establishing pipeline rents on state land to reflect a more current method.

**Commission Staff Response:**

Commission staff agrees with this recommendation and was awaiting input from this audit before moving forward with the extensive regulatory process to implement this change.

- Periodically analyze whether collecting oil royalties in cash or in kind would maximize revenues to the State, and collect its oil royalties in the most profitable way.

**Commission Staff Response:**

*Commission staff agrees with this recommendation. The report correctly describes the current practice of receiving its oil royalties in cash. This was a result of an analysis performed by staff from 2002 through 2005, and further supported by subsequent annual spreadsheet analyses of area oil sales supplied by a consultant. The staff analysis, and those subsequent annual reports, showed receiving royalty in crude oil in-kind and then selling the oil through sell-off contracts, was not in the State's best interest. The report, however, asserts that the current practice of receiving cash for royalty oil is based on the "outdated" analysis of 2002-2005 and may not maximize revenue. Although we agree that the analysis is a few years old, the factors and circumstances upon which those conclusions were based have not changed. We do agree however, as recommended in the report, that those previous conclusions should be periodically retested for confirmation. It should be noted that due to significant reductions to the General Fund-supported Mineral Management Division staff (which is tasked with monitoring and managing a program that generated over \$400,000,000 of non-tax revenue to the General Fund in 2010/11) the Commission no longer has the staff resources to accommodate a sell-off program. Should the circumstances indicate that such an effort would be favorable to the State, additional staff resources would be required.*

8

To improve its monitoring of leases, the commission should do the following:

- Create and implement a policy, including provisions for supervisory review, to ensure that the information in ALID is complete, accurate, and consistently entered to allow for the retrieval of reliable lease information.

**Commission Staff Response:**

*Commission staff agrees and has already implemented this recommendation.*

- Require all of its divisions to use ALID as its centralized lease-tracking database.

**Commission Staff Response:**

*The three divisions (Land Management, Accounting and Legal) involved in lease-tracking do use ALID. Staff recognizes that regular management reports from ALID need to be developed to reduce dependency on division only lists and spreadsheets tracking similar information.*

9

To adequately monitor its revenue-generating oil and gas leases, the commission should do the following:

- Develop an audit schedule that focuses on leases that have historically generated the most revenue and recoveries for the State, as well as those that have historically had the most problems.

**Commission Staff Response:**

*Commission staff agrees with this recommendation. The report accurately points out the Commission staff's need to plan formalized and scheduled audits. However, it does not recognize that (in addition to responding to issues raised and/or lease assignments audits) the approach used by the Commission staff to select/choose potential audits has been risk-based. As such, Commission staff has been selective in assigning its limited resources to audits where potential substantial recoveries exist. "Developing" an audit plan will assist in a more structured approach to conducting audits. However, without addressing the staffing requirements Commission staff will have difficulty implementing any such plan.*

10

- 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 Staff Response:**

- ⑪ *Commission staff agrees to further explore this recommendation. There are concerns regarding civil service rules regarding contracting out as well as the use of contingency as the basis for payment in extending this practice beyond this isolated instance.*

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 Staff Response:**

- ⑫ *Commission staff has and will continue to develop workload analyses and does submit this information in conjunction with requests for additional staffing.*

To better address current and potential future staffing shortages, the commission should create a succession plan.

**Commission Staff Response:**

- ⑬ *Commission staff agrees with this recommendation and recognizes its value. In fact, all but one of the current division chief positions have turned over in the past two years bringing the need for a succession plan into sharp focus. However, given current budget dynamics regarding hiring freezes, continual staff reductions and limited staff resources, it is difficult to create and implement any such a plan.*

## Chapter 1

To ensure that it manages delinquent leases in a timely manner and collects all the amounts owed to it, the commission should do the following:

- Determine the amount of past-due rent that should be included in its accounts receivable account.

**Commission Staff Response:**

- ⑭ *Staff is aware of past due amounts maintained in its receivable accounts. The report describes \$1.2 million in past due rents as of December 31, 2010. The correct amount of past due revenue receivables reported to the auditor was \$209,389.27 for 210 invoices. Of these, 146 invoices for \$121,433.68 were in excess of 180 days, delinquent as defined by the State Controller's standards. Other invoices included in the total reported past due amount include contingent receivables. These are invoices for which there is some question as to their validity, usually boundary or jurisdiction related. These totaled \$484,189.30 and are purposefully kept, as prescribed by State procedures, in a separate account due to their contingent nature. The remainder of the amount asserted as past due were invoices that were not yet due, based on their actual due dates.*

*Additionally, Table 1 asserts that the Commission has "lost" \$1,616,936 in delinquent rents. It is unclear how it relates to the \$1.2 million above. Regarding those accounts, the table includes 4 leases to AERA that are*

to be quitclaimed representing \$501,223. These are pipeline leases associated with the "Molino" lease in the Santa Barbara Channel. While the oil & gas lease was quitclaimed in 1997, these associated pipeline leases were not similarly processed by staff and will be closed out as of that same date. While this does illustrate a process failure, the associated revenues are not valid and should not be considered "lost" due to their not being collected. All 4 accounts have been placed in Contingent Receivables pending completion of the transaction. Also, Ramos Oil Company and Ship A Shore have both been placed into Contingent Receivables until outstanding issues are resolved.

15

- Develop and adhere to policies and procedures that incorporate the *State 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 Staff Response:**

Commission staff agrees and has already begun taking measures to implement this recommendation. While accounting procedures for 30, 60, and 90-day dunning letters are in place, there is a recognized need to better coordinate between Accounting, Land Management and Legal in disposition of delinquent leases should those initial steps fail.

- Conduct cost-benefit analyses when it contemplates either referring a delinquent lessee to the attorney general or pursuing the delinquent lessee through other means.

**Commission Staff Response:**

While no formal written process exists, Commission staff conducts an extensive, informal cost-benefit analysis, including consideration of statewide policy implications, through coordination with senior management, the Executive Officer and the Attorney General's Office, when deciding whether to recommend pursuing litigation to the Commission.

5

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 Staff Response:**

Commission currently does not have the authority to request a taxpayer ID from individuals, which is necessary for participation in the intercept program. As it expands to include Employer ID for businesses, this may become an option. Staff will continue to explore better ways to pursue delinquent accounts including possible legislation or regulation to allow collection of such information.

16

To ensure that as few leases as possible go into holdover status, the commission should do the following:

- 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 Staff Response:**

Commission staff agrees and has already implemented this recommendation.



- Consistently assess the 25 percent penalty on expired leases.

**Commission Staff Response:**

*Commission staff agrees and has already implemented this recommendation.*

To complete its rent reviews promptly and obtain a fair rental amount for its leases, the commission should do the following:

- Consistently notify the lessee of impending rent review or rental increases within established timelines.

**Commission Staff Response:**

*Commission staff agrees with this recommendation. However, in triaging the total lease workload, a prioritization approach has been implemented for high revenue-generating leases. Additional review and increases could be implemented with additional staff.*

- Establish time standards for each step of the rent review process and ensure that all staff adhere to those time standards.

**Commission Staff Response:**

*Commission staff will explore this recommendation. Staff has already prioritized the rent review process for high revenue-generating leases.*

17

- Develop a methodology for its workload that focuses its staff on managing the higher revenue-generating leases until such time as it addresses its workload needs.

**Commission Staff Response:**

*Commission staff agrees and has already implemented this recommendation.*

- 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 Staff Response:**

*Commission staff agrees with this recommendation and will be exploring alternatives that are manageable with existing staff resources available.*

To ensure 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 rent amount that would be deposited into an account within the Special Deposit Fund. The increased rent 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 Staff Response:**

*Commission staff is investigating this recommendation.*

To ensure that it is charging rent for the most current value of its properties, the commission should do the following:

- Appraise its properties as frequently as the lease provisions allow — generally every five years.

**Commission Staff Response:**

*Commission staff agrees with this recommendation as to those specific situations, such as high revenue-generating leases, where the benefits are likely to exceed the costs of preparing such an appraisal.*

⑦

- 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 Staff Response:**

*Commission staff agrees with this recommendation and is currently developing a procedure to implement this recommendation.*

To ensure that it does not undervalue certain types of leases, the commission should do the following:

- 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 Staff Response:**

*Commission staff agrees with this recommendation and was awaiting input from this audit before moving forward with the extensive regulatory process to implement this change.*

- Implement and follow its plan to regularly update its benchmarks for determining rental amounts.

**Commission Staff Response:**

*Commission staff agrees and has already begun implementing this recommendation.*

- 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 Staff Response:**

*Commission staff agrees with this recommendation. The report correctly describes the current practice of receiving its oil royalties in cash. This was a result of an analysis performed by staff from 2002 through 2005, and further supported by subsequent annual spreadsheet analyses of area oil sales supplied by a consultant. The staff analysis, and those subsequent annual reports, showed receiving royalty in crude oil in-kind and then selling the oil through sell-off contracts, was not in the State's best interest. The report, however, asserts that the current practice of receiving cash for royalty oil is based on the "outdated" analysis of 2002-2005 and may not maximize revenue. Although we agree that the analysis is a few years old, the*

- ⑧ *factors and circumstances upon which those conclusions were based have not changed. We do agree however, as recommended in the report, that those previous conclusions should be periodically retested for confirmation. It should be noted that due to significant reductions to the General Fund-supported Mineral Management Division staff (which is tasked with monitoring and managing a program that generated over \$400,000,000 of non-tax revenue to the General Fund in 2010/11) the Commission no longer has the staff resources to accommodate a sell-off program. Should the circumstances indicate that such an effort would be favorable to the State, additional staff resources would be required.*

## Chapter 2

To improve its monitoring of leases, the commission should do the following:

- Create and implement a policy, including provisions for supervisory review, to ensure that the information in 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 Staff Response:**

*Commission staff agrees and has already implemented portions of this recommendation.*

- Require all of its divisions to use ALID as its one centralized lease-tracking database.

**Commission Staff Response:**

- ⑨ *The three divisions (Land Management, Accounting and Legal) involved in lease-tracking do use ALID. Staff recognizes that regular management reports from ALID need to be developed to reduce dependency on division lists and spreadsheets tracking similar information.*

To adequately monitor its revenue generating oil and gas leases, the commission should do the following:

- Track the recoveries and findings identified in its audits and use this information to develop an audit plan that would focus on leases to audit that have historically generated the most revenue and recoveries for the State, as well as those that historically have had the most problems.

**Commission Staff Response:**

- ⑩ *Commission staff agrees with this recommendation. The report accurately points out the Commission staff's need to plan formalized and scheduled audits. However, it does not recognize that (in addition to responding to specific issues that arise and/or lease assignment audits) the approach used by Commission staff to select/choose potential audits has been risk-based. As such, Commission staff has been selective in assigning its limited resources to audits where identified potential substantial recoveries exist. "Developing" an audit plan could assist in a more structured approach to conducting audits. However, without addressing staffing requirements it is almost certain that Commission staff would not be able to implement any such plan.*

- Develop and implement regulations that would apply to any new lease by putting 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 Staff Response:**

*Since 1977 Public Resources Code §6827 prohibits any deductions for treatment, dehydration, or transportation of royalty oil on new leases. Therefore, a regulation as recommended above is not necessary for new leases.*

18

- 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 Staff Response:**

*Commission staff agrees to further explore this recommendation. There are concerns regarding civil service rules involving contracting out as well as the use of contingency as the basis for payment in extending this practice beyond this isolated instance.*

11

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 Staff Response:**

*Commission staff agrees with this recommendation, however, Commission staff currently lacks the staff resources necessary to establish and implement such a program. There are more than 300 statutes granting public trust lands to approximately 85 local governments throughout the State. These statutory trust grants include some of the State's most important major contributors to the local, state and national economies, including the Ports of Long Beach, Los Angeles, Oakland, San Francisco and San Diego. The Commission currently has one staff position assigned to overseeing the management of these state lands and revenues by these local entities.*

19

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 Staff Response:**

*This is already done on the Commission's offshore oil and gas leases and the bondsmen are required to give at least 90 day notice (some are longer) before they can terminate a bond. Further, staff requires that the offshore lessees show evidence of current bonding and insurance or a replacement bond for any expiring or terminating bond at the annual meetings with all lessees.*

20

### Chapter 3

To better demonstrate its need for additional staff, the commission should do the following:

- Conduct a workload analysis to identify a reasonable workload for its staff and use this analysis to quantify the need for additional staff.

⑫

**Commission Staff Response:**

*Commission staff has and will continue to develop workload analyses and does submit this information in conjunction with requests for additional staffing.*

- Quantify the monetary benefits of its staff's duties other than processing lease applications, and consider billing lessees for those activities.

**Commission Staff Response:**

*Commission staff agrees to explore the expansion of lease management fees.*

- 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 Staff Response:**

*Commission staff has already addressed this issue and additional staffing needs have been identified.*

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 Staff Response:**

*Commission staff agrees with this recommendation and recognizes its value. In fact, all but one of the current division chief positions have turned over in the past two years bringing the need for a succession plan into sharp focus. However, given current budget dynamics regarding hiring freezes, continual staff reductions and limited staff resources, it is difficult to create and implement any such plan.*

⑬

## Comments

### CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE STATE LANDS COMMISSION

To provide clarity and perspective, we are commenting on the State Lands Commission's (commission) response to our audit report. The numbers below correspond to the numbers we have placed in the margins of the commission's response.

We believe that the report title and the titles of chapters 1 and 2 accurately reflect the commission's past and ongoing difficulties with effectively managing and monitoring its leases.

①

As we discuss on page 13, we would have liked to have used information from the Application Lease Information Database (ALID) to determine how frequently the commission appraises the value of all of its lease properties, how much time it spends in each step of the rent review process, the total number of leases in holdover, and the total number of leases based on the price per diameter inch per linear foot of pipeline. However, when our initial review of the data included in ALID found significant errors, we determined that we could not use ALID for these purposes. Thus, we judgmentally selected a sample of 35 leases from the commission's approximately 1,000 revenue-generating leases, taking into consideration the status of the lease, the rent amount, and type. We disagree with the commission's belief that we selected the leases to highlight specific problem areas because we could not have known what we would find before examining the lease files. In fact, our sample included commercial, marine terminal, and recreational leases with annual rental amounts between \$800 and \$1.3 million. Ultimately, our review of the lease files identified that the commission appropriately performed timely renewals, rent reviews, appraisals, and collected rent for only one of the 35 leases we reviewed. Thus, we believe the fact that we found systemic problems related to 34 of these various types of leases provides evidence that these problems are not isolated to our sample.

②

Although the commission indicates it has taken action to evict lessees whose leases have expired, it did not do so for any of the leases we reviewed.

③

We are not sure in what context the commission is providing this information. We did not review the Huntington Beach field's application of a price-based sliding scale royalty as part of our audit.

④

- ⑤ As we point out on page 19, the commission's chief counsel stated that the commission has not conducted a formal analysis when it contemplates pursuing litigation. Additionally, the commission did not provide us with any documentation of an extensive informal cost-benefit analysis, which is why we recommend on page 35 that it conduct and document such an analysis.
- ⑥ The list of leases in holdover that the commission provided to us in December 2010 that we used to select leases in holdover contained 26 leases with rent amounts of \$10,000 or more. As we state on page 20, we selected a sample of 10 of the expired leases that had been in holdover for between two and 15 years. We look forward to the commission's 60-day, six-month, and one-year updates on whether it is continuing to make progress in decreasing the number of leases in holdover.
- ⑦ While we agree that the commission could use a cost-benefit approach when determining when to conduct appraisals, the commission needs to develop and implement such an approach.
- ⑧ As we point out on page 34, the chief of the Mineral Resources Management Division stated that the commission has not taken any steps since 2005 to determine whether it is still beneficial to receive royalties in cash. Because the commission has not conducted an analysis of the sell-off of oil since 2005, we question how it can assert that the factors and circumstances have not changed.
- ⑨ As we point out on page 39, the Land Management Division (land management), the fiscal services section within the Administrative and Information Services Division, and the legal division all separately track their workload on two Microsoft Excel spreadsheets and one Microsoft Word document, and the staff involved do not reconcile these various spreadsheets and documents to each other or to ALID. Of these three divisions, only land management uses ALID to generate its workload spreadsheet to facilitate making staff assignments. Thus, we are perplexed by the commission's statement that all of its divisions use ALID.
- ⑩ The commission's assertion contradicts earlier statements it made. As it acknowledged on page 41, the commission has not developed nor followed any type of monitoring schedule to audit its revenue-generating leases since the late 1990s and it conducts audits only in reaction to a discovered problem or actions taken by lessees to transfer their leases to other entities. In fact, since 2008 the commission has completed only two audits, and neither were for oil and gas leases.

The rules the commission refers to in its response generally apply to all state agencies. Given the commission was successful in hiring a third party to review one lessee's records, as stated on page 44, we believe it should be able to implement our recommendation, consistent with civil service rules.

⑪

Contrary to the commission's assertion that it has developed workload analyses, as stated on pages 52 and 53, the commission has not performed workload analyses for lease management activities, such as conducting rent reviews or appraisals.

⑫

We do not believe that limited resources should preclude the commission from, at a minimum, creating a succession plan.

⑬

We disagree that the commission staff is aware of the past due amounts maintained in its receivable accounts. As discussed on page 16, we received conflicting information as to what the accounts receivable account should contain and, in fact, confirmed that the account omitted \$190,000 of past-due rent we had identified from reviewing just 10 delinquent leases.

⑭

The lease files for the four AERA Energy, LLC (AERA) leases indicated that, although in 2004 the commission received some information that the lessee may have abandoned the property, it did not take any action at that time for three of the four leases. As a result, these leases are still considered active in the commission's database. Additionally, AERA did not pay any rent to the commission from 1999 through 2004 for any of these leases, thus, the State is owed at least the principal rent amounts, plus penalty and interest, for the years AERA did not pay rent. As such, without further evidence, we considered these amounts to be lost revenues to the State.

⑮

We stand by our recommendation. Additionally, if the commission believes it does not have the authority to request a taxpayer ID from individuals, it should seek the authority to do so.

⑯

Regardless of whether the commission prioritizes rent reviews for high revenue-generating leases, it still needs time standards to ensure it conducts such rent reviews promptly.

⑰

We modified the text on page 43 and the related recommendation on page 47 to refer to leases entered into prior to 1977 that do allow for these types of deductions. As we point out on page 43, when we asked the commission whether it believes it has legal authority to impose a similar requirement on other types of deduction claims, such as transportation costs, the commission indicated that it believes it generally possesses this authority, but that its ability to

⑱



enforce this requirement on existing leases entered into before 1977 is limited and would require the mutual consent of the lessee and the commission.

- ①9 Nevertheless, the commission should perform a workload analysis that includes granted lands to determine the staffing levels it needs to fulfill its oversight responsibilities.
- ②0 The commission addresses only its offshore oil and gas leases and does not address its surface leases. Thus, we anticipate that when the commission provides us with its 60-day, six-month, and one-year responses that it will respond to our recommendation related to all its leases that contain surety bonds and liability insurance requirements.

cc: Members of the Legislature  
Office of the Lieutenant Governor  
Milton Marks Commission on California State  
Government Organization and Economy  
Department of Finance  
Attorney General  
State Controller  
State Treasurer  
Legislative Analyst  
Senate Office of Research  
California Research Bureau  
Capitol Press