REPORT BY THE
AUDITOR GENERAL
OF CALIFORNIA

REVIEW OF THE STATE LANDS COMMISSION'S MANAGEMENT OF STATE LAND

P-344

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REPORT BY THE

OFFICE OF THE AUDITOR GENERAL

TO THE

JOINT LEGISLATIVE AUDIT COMMITTEE

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MARCH 1984

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Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the State Lands Commission's management of state land. The report indicates the need for the commission to develop procedures to ensure that it sells the State's royalty oil even when royalty disputes arise and to perform rent reviews promptly.

Respectfully submitted,

THOMAS W. HAYES
Auditor General

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SUMMARY

Our review of the State Lands Commission (commission) indicates that the commission has effectively managed the state land under its jurisdiction. This land includes the beds of navigable rivers and lakes, submerged land along the State's coast, and school land granted to the State for the support of public education. In fiscal year 1982-83, the commission collected revenues from these lands totaling approximately $464 million. However, the State has not derived as much revenue as possible from all of the leases of state land. The commission has not sold the oil that the State received as a royalty from one oil lease, and it has not promptly reviewed rents on some leases.

When the State leases land to oil companies, the State receives royalties for the oil that is produced. The commission can elect to receive these royalties either in cash or in crude oil. When the commission receives royalties in cash, it receives the current price for the oil. However, when the commission takes the royalty in oil ("royalty oil"), the commission can sell the oil and receive the current price plus a bonus for each barrel. The commission's policy has been to sell the State's royalty oil to the highest bidder. However, on one lease, the commission and the lessee have disagreed for several years about the correct method of calculating royalties. As a result, a portion of the royalty oil produced on the lease had been in dispute. Nevertheless, the commission could have sold the undisputed portion of the oil and the State could have earned at least $340,000 in bonus revenues.

In addition, the State may not have derived as much revenue as possible from other leases of state land. For example, most commercial and some recreational leases managed by the commission allow the commission to increase the rent every five years. However, because the commission failed to properly notify the lessee of the dates when new

rents were to become effective, the commission could not increase rents for at least eight leases on the fifth anniversary of those leases. As a result, the State lost at least $15,450 between 1981 and 1983 because the commission did not raise rents as soon as it could have.

Despite the shortcomings discussed above, the commission has increased revenues from the State's school land in the last seven years. Revenues from school land increased from approximately $126,000 in fiscal year 1975-76 to approximately $8 million in fiscal year 1982-83. However, federal encumbrances, unresolved legal problems, and environmental restrictions limit the commission's control of unsold school land. The commission is actively pursuing policies that would provide for more effective management of unsold school land, thus producing the highest economic return to the State.

INTRODUCTION

In 1938, the State established the State Lands Commission (commission) as the successor to the Office of the Surveyor General and the Division of State Lands in the Department of Finance. The commission supervises lands that the State acquired from the federal government at statehood and in subsequent land grants. This land is referred to as "statutory land."

The commission consists of three members: the State Controller, who is the chairperson, the Lieutenant Governor, and the Director of the Department of Finance. The commission staff includes specialists in mineral resources, land management, state boundary determination, petroleum engineering, and natural science. The staff, which is supervised by an executive officer appointed by the commission members, oversees the development of state land for the extraction of minerals and manages state land to ensure that its use is consistent with prudent land use practices.

Statutory Land Received from the Federal Government

In the 1850's, California acquired nearly nine million acres of land from the federal government. Part of this "statutory land" consisted of approximately four million acres of sovereign land, including the beds of navigable rivers and lakes and the three-mile wide strip of tide and submerged land along the State's coast and along the

coasts of islands belonging to the State. Sovereign land, which may not be sold, is held for the benefit of the people of California. Statutory land also included more than five million acres of school land that the federal government granted to the State to support public education. Although the State has sold most school land, the commission has prohibited the sale of the remaining school land except for use by public agencies and utility company rights-of-way. The State currently holds approximately 715,700 acres of unsold school land and manages mineral interests on nearly 717,000 acres of land that the State sold. The commission manages this land for the support of the State's public schools.

Revenues Received from the Use of State Land

The commission's management of statutory land 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. The Public Resources Code authorizes the commission to lease state land for a variety of activities. For example, the commission leases land for the extraction of oil, gas, geothermal resources, and minerals. The law also provides for the leasing of land for agricultural, commercial, industrial, and recreational purposes such as docks, wharfs, pipelines, and marinas. The major revenue-producing leases that the commission manages include 156 oil, gas, geothermal, and mineral leases and 576 agricultural, commercial, industrial, and recreational leases. In fiscal year 1982-83, the State received almost $118 million in rents and royalties from leasing state land.

Since 1851, the State has made grants of sovereign land to cities and counties to promote commerce, fishing, navigation, and recreation. Currently, 72 trustees have primary responsibility for managing this granted land. Some grant statutes, however, give the commission the responsibility for managing particular elements of a grant. For example, the commission controls the development and operation of oil and gas production on sovereign land granted to the City of Long Beach. In fiscal year 1982-83, the State received over $346 million as its share of the profits from oil and gas operations at Long Beach. Table 1 below summarizes the sources of revenues from the State's land.

TABLE 1

SOURCES OF REVENUES FROM STATE LAND
FISCAL YEAR 1982-83

Source	Amount
Oil and Gas Revenues	
Profits from Long Beach oil and gas operations	$346,014,995
Royalties from oil and gas leases	106,980,885
Geothermal Leasing Royalties	7,230,788
Mineral Leasing Royalties	758,551
Revenues from Land Rentals	
Oil, gas, agricultural, commercial, industrial, and recreational leases	2,943,189
Sales of School Land	115,600
Permits, Filing Fees, Penalties, and Interest	429,065
Total	$464,473,073

Source: State Lands Commission. We did not audit these figures.

SCOPE AND METHODOLOGY

We conducted this review to determine if the State Lands Commission's management of state land ensures that the State receives maximum revenues from its statutory land. We focused our review on the commission's administration of leases for the extraction of oil and for commercial and recreational operations conducted on state land. We also reviewed the commission's efforts to obtain all of the land due the State under the federal school land grant.

To determine whether the state receives all of the revenues due from leases for oil operations, we interviewed commission officials responsible for administering leases and for selling crude oil taken as royalties from leases. We also interviewed staff responsible for calculating the royalties due from leases. In addition, we reviewed lease agreement documents, contracts for oil sales, royalty statements from lessees, and correspondence between lessees and commission staff.

To evaluate the adequacy of the commission's rent review process, we reviewed commercial and recreational lease files and interviewed commission staff responsible for administering these leases. In addition, we examined the commission's rent review procedures.

Finally, to determine whether the commission is receiving a fair economic return for the school land under its control, we reviewed school land lease files, documents, and correspondence, and we interviewed commission officials and staff. We also spoke with an official at the U.S. Bureau of Land Management. In addition, we evaluated the commission's policies for administering school land.

CHAPTER I

THE STATE LANDS COMMISSION COULD HAVE INCREASED STATE REVENUES BY SELLING ROYALTY OIL

When the State leases land to oil companies, the companies pay the State a royalty for the oil they produce. The State may choose to receive this royalty either in cash or in crude oil. When the State takes its royalty in cash, it receives the current price for each barrel of oil. However, when the State takes its royalty in crude oil ("royalty oil"), it can sell the oil to the highest bidder and receive the current price plus a bonus on each barrel. From 1981 through 1983, the State Lands Commission (commission) took most of the State's royalty in oil. However, if the commission had taken the royalty in oil instead of in cash for one of the leases, the State could have earned at least $340,000 in bonus revenues.

The State's Program To Sell Royalty Oil

Since the 1930's, the State has leased to oil companies tracts of state land off the California coast. For the oil they produce on this land, the oil companies pay the State a percentage of the oil's value as a royalty. Lessees who produce oil on State land pay royalties to the State based on the gross amount of oil produced each month. In some cases, the royalty is a fixed percentage of the monthly production, while in others, the royalty rate increases with increases in oil production. For example, the monthly royalties from some leases are fixed at 12.5 percent of the gross production. For other leases, however, average

monthly royalties can reach as high as 50 percent of the monthly production; in these cases, the commission uses a sliding production scale to calculate royalties. According to this scale, the State is assured a minimum royalty of 16-2/3 percent on production rates averaging up to 100 barrels a day for each well on the leased land and a maximum royalty of 50 percent on production of 500 or more barrels a day for each well.

The commission has the option of taking the royalties from oil leases either in cash or in crude oil. When the commission takes the royalty in cash, the lessee calculates the royalty due and forwards a statement of monthly production and a royalty payment to the commission. The commission also calculates the royalty due, and if its calculations differ from the lessee's, the commission notifies the lessee that adjustments for over- or underpayments are to be made on the subsequent month's statement. For royalties paid in cash, the royalty payment is calculated by multiplying the total amount of oil produced by the royalty rate and the current price per barrel of crude oil posted for oil of similar quality in the nearest California oil field.

When the commission determines that the State is likely to earn higher revenues by selling royalty oil than by taking royalties in cash, the commission takes the royalty in crude oil. Sales contracts for the State's oil are competitively bid, and they provide the State with revenues that are greater than those it receives when it takes royalties in cash because the State receives a bonus for each barrel of royalty oil

it sells. Thus, if the commission determines that prospective purchasers are likely to pay a bonus in addition to the current price for each barrel of royalty oil, the commission takes the royalties in oil and sells the oil to the purchaser offering the highest bonus. Some leases allow the commission to begin taking royalties in oil as soon as the commission notifies the lessee of the commission's intention to do so. Other leases require that the commission notify the lessee of its intention to take royalties in oil 30, 60, or 180 days in advance of such action.

The commission's current policy is to take the State's royalties in crude oil and to sell that oil. Title 2 of the California Administrative Code requires the commission to select, in advance of any particular oil sale, the lease from which the oil will be taken and to adopt specific bidding and contract award procedures. After receiving all bids, the commission determines the winner and, with the approval of the commission members, awards the sales contract. In some cases, the commission combines the royalty oil from two or more leases to make the quantity of oil more attractive to potential bidders.

Since 1973, when the commission began selling royalty oil, the commission has approved 37 contracts for the sale of royalty oil. The contracts have ranged from 6 months to 18 months and, in some cases, have been extended. The volume of royalty oil sold under these contracts ranges from 4,400 barrels to almost 90,000 barrels per month. Since the commission began this practice, bidders have won sales contracts offering

bonuses as low as $.05 above the current price per barrel and as high as $3.56 above the current price per barrel.

The Commission Did Not Sell Some Royalty Oil

On January 28, 1981, the federal government lifted the price controls on crude oil. Those controls had prohibited the State from selling much of the royalty oil from its leases, and after the controls were lifted, the State was entitled to sell all of the royalty oil from its leases. From February 1, 1981, to December 31, 1983, the commission sold most of the State's royalty oil under several sales contracts. However, the commission did not begin the process to sell the royalty oil from one lease until September 1983. As a result, we calculate that the State could have lost approximately $340,000 in bonus revenues. The commission, however, has recently begun the process to take the royalty in oil from this lease, and it will receive bonuses beginning on July 1, 1984.

From August 1, 1980, to February 1, 1981, the commission sold only a portion of the royalty oil from one of the State's leases. In this case, the lessee and the commission disagreed on the method for calculating the royalty rate applicable to the lease, and they disagreed on the amount of royalty oil available for sale. In fact, in 1974, the commission notified the lessee that the lessee was incorrectly calculating royalties. In October 1978, the commission demanded that the lessee pay royalties based on the commission's calculations. As a

result, from October 1978 through October 1982, the lessee paid a monthly cash royalty based on the commission's calculations. The commission allocated to a special state account that portion of each payment applicable to the royalty oil being disputed; the amount in the special account would be held in trust until the dispute was settled. After October 1983, the commission and the lessee agreed on the royalty due the State, and royalties were no longer allocated to the special account.

The commission's supervising mineral resources engineer told us that the commission should not sell any of the royalty oil from the lease in question until the lessee and the commission agreed on the amount of royalty oil that was due the State. Furthermore, he said that the commission continually believed that the dispute would be settled in "the near future" and, as a result, the amount of royalty oil available for sale would be equal to the total royalty oil produced from the lease. The lessee and the commission agreed on settlement terms in December 1982. Even so, the commission did not attempt to sell the royalty oil from this lease until September 1983.

The commission could have initiated the process to sell the undisputed royalty oil from the one lease on February 1, 1981. Had the commission begun the process on that date, it could have begun selling the oil on approximately November 1, 1981. The royalty oil from three other leases in the same oil field had been sold in 1981. In March and April 1981, bidders won contracts to purchase the royalty oil from these three leases; the bonuses averaged $1.53 per barrel. Purchasers may have

also offered bonus bids for the oil from the lease in question during the same period. Moreover, in 1982 the commission again sold the royalty oil from the three other leases on bids received in March and April of that year. The bonus per barrel of oil averaged $.09 for these three leases. Thus, if the commission had sold the royalty oil from the lease in question at the same time that it sold the royalty oil from three other leases in the same oil field, the State could have received at least $340,000 in bonus revenues between November 1981 and October 1983, the period for which production data were available.*

Commission officials told us that when the commission and the lessee settled the dispute over calculating royalties, the commission initiated the process to sell the royalty oil from this lease. On September 29, 1983, commission staff took steps to obtain authorization from the commission members to sell the royalty oil from this lease. The sales contract is to become effective on July 1, 1984, at a bonus price of $2.57 per barrel. Commission officials also informed us that the commission and the lessee still do not fully agree on how to determine royalties. However, if this disagreement leads to disputed royalties, the commission will sell the royalty oil that is not subject to dispute.

*The contracts awarded in 1982 covered an 18-month period; however, because only 12 months of production data were available for the lease in question, we based our calculations on those data.

We believe that the commission could have implemented procedures that would have allowed the sale of at least some of the royalty oil from the one lease despite the disputes over calculating the royalty. The commission could have sold that portion of the royalty oil that was not under dispute and reserved the right to receive from the lessee a cash royalty equal to the current price of each disputed barrel when the dispute was resolved.

CONCLUSION

The policy of the State Lands Commission is to sell the crude oil received as a royalty from oil companies that produce oil on state land. However, the commission did not sell any royalty oil from one lease for over two years, even though it could have sold a portion of that oil. Consequently, the State lost as much as $340,000 in potential bonus revenues.

RECOMMENDATIONS

To ensure that the State maximizes its revenues by receiving the current price and a bonus for the royalty oil produced on state land, the State Lands Commission should attempt to sell all of the royalty oil produced from its leases when doing so is in the best interest of the State. Furthermore, the commission should develop procedures to ensure that royalty oil is offered for sale even if disputes about royalties arise.

CHAPTER II

THE STATE LANDS COMMISSION COULD INCREASE STATE REVENUES BY IMPROVING THE RENT REVIEW PROCESS

The State receives revenues from rents paid on commercial, recreational, and other leases. However, the State has not earned all potential rental revenue because the State Lands Commission does not have an adequate rent review process. Many leases allow the commission to modify the rent on each fifth anniversary of the lease, and these leases require the commission to notify the lessee before that date that the rent will or may be modified. In our sample of leases, we found eight of twelve cases between 1981 and 1983 in which the commission failed to notify the lessee in advance and, thus, could not increase the rent on the fifth anniversary. The commission eventually raised the rent on six of the leases but not until some time after the fifth anniversary of the lease. Consequently, lessees paid rent that was less than what the State could have been receiving. For these six leases, the State lost at least $15,450; the losses ranged from $110 to $6,148.

The Commission Did Not Notify Lessees On Time

Most commercial and some recreational leases of state land have provisions allowing the commission to modify the rent on each fifth anniversary of the lease. These modifications are intended to reflect increases in land value and volume of business. Some of these leases require that the commission complete its review of the rent and notify

the lessee of the new rent at least 90 days before the fifth anniversary of the lease. Other commercial and recreational leases require that the commission notify the lessee at least 60 days in advance that the rent may be modified. If the commission fails to notify the lessee of the review and, when appropriate, the new rent, the commission may modify the rent only on one of the four anniversaries following the fifth anniversary of the lease. For the commission to raise the rent on a subsequent anniversary, the commission must still notify the lessee either 60 or 90 days in advance, depending upon the lease agreement. The commission members must approve each new rent rate before it becomes effective.

During our assessment of the commission's rent review process, we examined 19 commercial and recreational leases. Of these 19 leases, 12 leases were eligible for rent review because the five-year rent review provision had been included in the lease agreement and because the fifth anniversary of the lease had arrived. However, in 8 of the 12 cases, the commission failed to notify the lessees by the date specified in the lease agreements. In 6 cases, the commission did not notify the lessee at least 90 days in advance that the rent would be increased. In the other 2 cases, the commission did not notify the lessee at least 60 days in advance that the commission would be reviewing the rent.

Because the commission did not notify lessees by the date specified in the lease, the higher rent could not become effective on the fifth anniversary. In one case, for example, the commission did not give

the lessee 90-days' notice that the rent would be increased from $1,412 a year to $7,560 a year. Consequently, the new rent could not take effect until the sixth anniversary of the lease. We estimate that the State lost $6,148 on this one lease because the commission was forced to wait at least an additional year before raising the rent. In another case, the commission could not increase the rent until the seventh anniversary of the lease because it failed to notify the lessee in sufficient time. For six of the eight leases in our sample, the State lost $15,450 in rent because the commission did not notify lessees in advance. (Rent modifications for two of the eight leases in our sample were pending at the time of our review.)

The commission failed to notify lessees in advance of possible rent modifications for two reasons. First, the commission has no provision for supervisors to review staff work during the rent review process to ensure that the staff complete the process on time. Second, the commission's procedures for rent reviews do not include time standards for completing the rent review process. For example, the commission's procedures do not specify how long it should take to complete particular steps in the process, such as appraising property.

CONCLUSION

The State Lands Commission does not always complete the rent review process promptly enough for a higher rent to become effective on the fifth anniversary of a lease. We found eight

instances in which the State was precluded from charging a higher rent because the commission did not notify the lessee sufficiently in advance of the fifth anniversary of the lease. In one case, we estimate that the State lost $6,148 because the commission failed to notify the lessee in sufficient time to raise the rent on the fifth anniversary. For six of the leases in our sample, the State lost at least $15,450 between the fifth anniversary and the dates the new rents became effective.

RECOMMENDATIONS

To ensure that it completes its rent reviews promptly and to ensure that it notifies lessees by the dates specified in the leases, the State Lands Commission should establish a systematic rent review process. The commission should include provisions for supervisory review during the rent review process to see that staff meet specific deadlines, as stated in each lease agreement. In addition, the commission should include time standards for completing each step in the rent review process.

CHAPTER III

THE STATE LANDS COMMISSION'S MANAGEMENT OF UNSOLD SCHOOL LAND IS LIMITED BY FACTORS OUTSIDE OF ITS CONTROL

In fiscal year 1982-83, the State received approximately $8 million in revenues from the lease and sale of school land. This is a considerable increase over the approximate $126,000 in revenue earned in fiscal year 1975-76. We reviewed the State Lands Commission's management of school land to determine whether the State is receiving a fair economic return for the school land under the commission's control. We found that the commission's control of school land is limited by a number of factors: federal encumbrances, unresolved legal problems, and environmental restrictions all limit the alternative uses that the commission can make of school land. However, the commission has been actively pursuing ways to manage more effectively the unsold school land under its jurisdiction and to bring a greater economic return to the State.

Federal School Land Grant

In the 1850's, the federal government intended to provide the western states with land that could be used for the benefit of public schools. In 1853, under the school land grant, the federal government granted to California over 5 million acres of land. Title to this land passed to the State upon approval of the survey map by the U.S. Bureau of

Land Management (BLM), which administers the school land grant. Most of the land acquired since 1853 has been sold; however, approximately 715,700 acres of school land remain unsold.

In 1970, the commission members imposed a moratorium on the sale of most of the remaining school land so that the commission could better plan the use of this land before it was sold. (The only land excluded from the moratorium was land that could be used by public agencies or land that was needed for utility company rights-of-way.) The commission members directed staff to inventory and classify all of the unsold school land and to work with the BLM in coordinating school land grant records. In 1975, the commission staff completed the "Inventory of Unconveyed State School Lands and Tide and Submerged Lands Possessing Significant Environmental Values." In 1978, the commission completed a listing of the school land under its jurisdiction.

Status of Unsold School Land

Based on its inventories, the commission determined the status of about 715,700 acres of unsold school land remaining under its jurisdiction. Table 2 below shows the status of approximately 608,000 acres for which the State has already received title from the federal government and the status of approximately 107,700 acres for which the State has not yet received title.

TABLE 2

STATUS OF UNSOLD SCHOOL LAND
AS OF SEPTEMBER 1983

	Number of Acres (Rounded)	
Land to Which the State Has Received Title		
Available for Lease		
Under lease with the commission	152,900	
Unleased	56,000	208,900
Restricted by Federal Encumbrances		
National parks, forests, monuments, and military areas	59,500	
Legal problems with the BLM	26,300	
BLM Desert Conservation Area and Wilderness Study Areas	207,300	293,100
Designated "Environmentally Significant"		106,000
Subtotal		608,000
Land to Which the State Has Not Received Title		
Surveyed	55,000	
Unsurveyed*	52,700	107,700
Total		715,700

*The State will acquire this land through exchange with the U.S. Bureau of Land Management.

Source: Estimates from the State Lands Commission. We did not audit these figures.

The commission is restricted in how it uses much of the 608,000 acres of school land to which the State received title. For example, some school land parcels are located within national parks, forests, and monuments, or within military and wilderness areas. The commission is

trying to exchange some of this land for federal land that would bring more revenue to the State, such as timberland or agricultural land.

The remaining 107,700 acres of unsold school land is land to which the State never received title from the federal government either because encumbrances existed when the land was surveyed or because the land was never surveyed. In place of this land, the commission is attempting to select federal land that will produce revenue for the State.

Land to Which the State Has Received Title

From the 1853 federal land grant, there remain approximately 608,000 acres of unsold school land to which the State received title. Almost half of the land is in the California desert located in San Bernardino County. Although this land remains unsold, federal encumbrances, unresolved legal problems, and environmental restrictions hamper the State's management of it.

The commission leases about 152,900 acres of the 208,900 acres of school land available for lease. In fiscal year 1982-83, the State received approximately $129,000 in rent for grazing, agricultural, military, and other leases, and over $7.7 million in royalties from mineral leases, from the sale of timber, and from geothermal leases on land to which the State has retained mineral rights. Another 56,000 acres of unsold school land are unleased and are considered

"unencumbered." A commission official stated that there has been no public interest in leasing or purchasing these parcels primarily because they are located in remote areas or because the terrain is unsuitable for development.

Federal encumbrances restrict the commission's use of about 293,100 acres of unsold school land. Approximately 59,500 acres are located in national parks, forests, and monuments, and in federal military areas. The State received title to this land but cannot use it because the land is used for public recreational purposes. Land located in the military areas was used for munitions practice during World War II and still contains live ammunition. The use of approximately 26,300 acres of unsold school land is restricted because of legal problems between the State and the BLM. According to a commission supervisor, most of these problems concern inaccurate surveys. Clarifying the survey problems is not a priority for either the commission or the BLM until someone shows an interest in leasing the land. Finally, the commission's use of another 207,300 acres of unsold school land is restricted because much of the land is surrounded by BLM land or is subject to BLM policies. This land lies within or is affected by the BLM's California Desert Conservation Area Plan and the BLM's Wilderness Study Areas. The federal government will be conducting environmental studies in these areas to maintain a balance between the sensitive ecology and the needs of the public.

The third category of land to which the State has received title is land that is considered "environmentally significant." Section 6370 et seq. of the Public Resources Code restricts the State's use of 106,000 acres of unsold school land because of various environmental and cultural factors. For example, one parcel of land in Riverside County supports a bighorn sheep habitat and is considered "environmentally significant." Consequently, the commission was precluded from leasing part of this land to a person who wanted to install a dirt access road.

Because of the many restrictions that inhibit the commission from more effectively managing the remaining unsold school land, the commission has sought to exchange some of this land for land held by the BLM and other federal agencies. In 1981, the commission and the BLM signed a Memorandum of Understanding that established procedures for exchanges between the State and the BLM. The commission and the BLM are presently working to exchange "scattered parcels" of unsold school land for approximately 8,000 acres of BLM land in Lassen County. The commission believes that this land may be suitable for agricultural leases. The commission and the BLM also prepared an exchange proposal for approximately 20,000 acres of unsold school land located in the California Desert Conservation Area. According to the commission's assistant executive officer, the commission's current policy is to exchange school land surrounded by BLM Wilderness Study Areas so that the State will have access to its land. The commission will exchange land in these wilderness areas for land that will generate revenue for the State.

Land to Which the State
Has Not Received Title

There are approximately 107,700 acres of school land to which the State has not received title from the federal government. Over half of this land was encumbered before the federal government granted the land to the State in 1853; the remaining land was never surveyed. Encumbered land includes homesteads, Indian reservations, and land known to contain minerals. Because this land is encumbered, the State has the right to select and receive other federal land as a replacement. The federal government requires the State to choose federal land that is of "rough equivalent value" to the land for which the State did not receive title. The BLM must approve the State's selection and title to the land.

The commission's highest priority is to select federal land in exchange for the 55,000 acres of unsold school land to which the State has not received title. Included in this 55,000 acres are two parcels of school land, worth an estimated $1.7 billion, in the Elk Hills Naval Petroleum Reserve located east of San Luis Obispo. Presently, the BLM and the U.S. Department of Energy are responsible for administering the land at Elk Hills.

Despite the federal provisions, the commission has been hampered in its efforts to select land of equivalent value in exchange for the land at Elk Hills. According to a BLM official, the BLM believes that a federal statute prohibits the State from selecting land that is producing oil. Furthermore, the Department of the Interior may require

the State to select land that is of "rough equivalent value" to land for which the State never received title. According to the BLM official, the BLM does not have land in California that is of equal value to the land at Elk Hills and that is not already producing oil. The commission, however, disagrees with the BLM's interpretation of the federal statute.

Because of the extraordinary value of the Elk Hills land and the legal restrictions on selecting land in exchange, the resolution to this problem rests either with the Secretary of the Interior or with the Congress. The commission has been actively working to complete its selection of federal land in exchange for land to which the State never received title, including the land at Elk Hills. Commission executives met with officials from the Department of the Interior in January and May 1983 and with congressional members in November 1983. The commission plans to meet with the Secretary of the Interior in early 1984. Moreover, the commission frequently corresponds with federal agencies and congressional members about completing its selection of federal land. The commission is currently waiting for a response from the federal government to conclude negotiations on Elk Hills and to complete its selection of federal land.

The commission has, however, successfully exchanged some school land. For example, in March 1983, the commission received title to two selections of land in exchange for land to which the State never received title. One selection included 1,536 acres at The Geysers located north of San Francisco. Before the State acquired this land, the federal

government had leased it for the development of the geothermal resources. Lessees have drilled wells on the land, but it has not yet produced any revenue. The other selection included approximately 6,500 acres in Mendocino County. In 1983, the State received over $70,000 from the sale of timber produced on this land, and the commission expects to receive an additional $400,000 from timber sales over the next three years. The commission filed another application with the BLM to select an additional 2,900 acres at The Geysers and the commission plans to apply for an additional 24,000 acres of timberland in Humboldt, Trinity, and Mendocino counties within the next year.

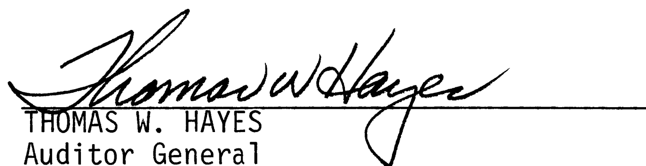
The remaining 52,700 acres of land to which the State did not receive title are unsurveyed. Most of the parcels are in Death Valley and are not readily accessible. Even if this land had been surveyed and the State granted title, the commission believes that the land would be of little use. Therefore, the commission will eventually exchange this land with the BLM for land that will bring more revenue to the State.

CONCLUSION

Based on our review of the State Lands Commission's management of unsold school land, we conclude that the commission is actively attempting to produce the highest economic return to the State for the school land under its jurisdiction. However, the commission's efforts are somewhat limited by factors over which it has no control.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



THOMAS W. HAYES
Auditor General

Date: February 27, 1984

Staff: Robert E. Christophel
Steven M. Hendrickson
Anthony F. Majewski
Karen S. Schwager
Scott Downer

State of California | THE RESOURCES AGENCY

Memorandum

To : Honorable Claire T. Dedrick
Executive Officer
State Lands Commission
1807 -13th Street

Date : [illegible]

File No.:

Subject: Auditor General Report

From : Office of the Secretary

Attached is a copy of a draft report from the Auditor General entitled "Review of the State Lands Commission's Management of State Land".

In order to meet the deadline for comments of February 21, 1984, please provide your written response directly to the Auditor General with a copy to this office. The Resources Agency will not be commenting independently on the report.

Harold F. Waraas
Assistant Deputy Secretary

Attachment

cc: ✓ Office of the Auditor General
660 J Street, Suite 300
Sacramento, CA 95814

STATE OF CALIFORNIA GEORGE DEUKMEJIAN, *Governor*

STATE LANDS COMMISSION

KENNETH CORY, *Controller*
LEO T. McCARTHY, *Lieutenant Governor*
MICHAEL FRANCHETTI, *Director of Finance*

EXECUTIVE OFFICE
1807 - 13th Street
Sacramento, California 95814

CLAIRE T. DEDRICK
Executive Officer

February 17, 1984

Mr. Thomas W. Hayes
Auditor General
660 J Street, Suite 300
Sacramento, California 95814

Dear Mr. Hayes:

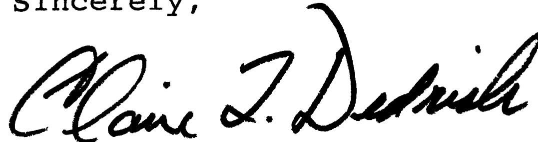
Secretary Van Vleck has asked us to respond directly to your draft report "Review of the State Lands Commission's Management of State Land." Our reaction is that the report is factually accurate and that we concur with the conclusions. The recommendations of Chapters I and II have already been acted upon as a result of the exit briefings we had with your staff.

Attached is our analysis of the circumstances which led to the conclusions in the report. Our feeling is that the steps we have taken will avoid any recurrence of these problems.

I want to congratulate your staff (particularly Steve Hendrickson, Tony Majewski and Karen Schwager) for the professional approach and consideration given us while working at our offices. It is at best difficult to review

the amount of material they did without disrupting office routine. We found their efforts cooperative and designed to have minimal adverse impact. We appreciated their diplomacy.

Sincerely,



CLAIRE T. DEDRICK
Executive Officer

Enclosures

cc: Gordon Van Vleck

Analysis of Draft Report P-344

Office of the Auditor General
"Review of the State Lands Commission's
Management of State Land"

February, 1984

This analysis covers Chapters I and II of the subject report. It is not the intent of the State Lands Commission to quarrel with details of the report. Instead the analysis is to provide management and the Auditor General with some expanded material beyond that which could be covered in the report.

Chapter I
Selling Royalty Oil

The report covers the unsold royalty oil which was the subject of a dispute with Union Oil Company. Two leases are actually involved (PRC's 3033 and 3413). While a partial settlement was reached with Union in 1982 as to back royalties, there still is not full agreement on royalty terms for the future.

We do not dispute that the State could have received $340,000 if the royalty oil was sold at the same bonus price as the three other leases in the field. However, because potential buyers' ability (or desire) to take larger quantities is by no means certain, we cannot say that in fact the oil would have sold at that average price. As pointed out, the Commission now has sold the undisputed amount of royalty oil.

One problem with attempting to sell royalty oil while involved in a dispute with the lessee is that a successful sale requires cooperation on the part of the lessee. Without such cooperation the purchaser may find it most difficult to take the oil or exchange it for oil at some other location. We do not imply that Union would have deliberately made a sale difficult for a royalty oil purchaser, only that this is a consideration in deciding whether a royalty oil sale would be advisable.

Chapter II
Rent Review Process

The Auditor General's staff investigation helped focus Commission attention on this area of operation. Problems with the rent review process were recognized in 1978 by the then newly appointed manager of the Land Management Section. Corrective action began immediately. The process has continuously been reviewed and improved; however, we recognize that problems persist and further improvements are warranted.

A "Lease Review Report by Date" was created in September, 1981. This print-out was updated on September 1, 1982, and September 1, 1983. This report is the backbone of the current rent review process. It is superior to the previous system but could be improved upon. The major deficiency is that the system does not accommodate anything other than five-year intervals from the starting date of the lease. This is being corrected.

In November of 1981 a new control system was developed to monitor the flow of appraisal requests. The

system was developed specifically to negate the possibility of missing rent reviews due to the appraisal process. The new system included the following major procedural changes: a) A new detailed appraisal request form was developed and implemented; b) New estimated time frames for completion of appraisals were developed; c) Control log review dates were developed and implemented; d) Appraisal forwarding process was simplified.

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Director of Finance
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps