July 31, 2014

2014-501
(Letter Report)

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

Dear Governor and Legislative Leaders:

This letter report presents the results of a follow-up review of the State Lands Commission (commission) subsequent to recommendations made in 2011 by the California State Auditor (state auditor). In August 2011 the state auditor issued a report titled *State Lands Commission: Because It Has Not Managed Public Lands Effectively, the State Has Lost Millions in Revenue for the General Fund*, Report 2010-125. The 2011 audit report included recommendations aimed at improving how the commission manages its revenue-generating leases by developing policies that commission staff should follow when a lessee fails to pay rent owed to the State, conducting timely rent reviews to ensure that it collects fair values for the State's properties under its charge, and using audits of its oil and gas leases to track recoveries and develop a risk-based audit plan. As shown in the Table on the following page, the commission has yet to fully implement certain key recommendations from the 2011 audit report—particularly in the areas of collecting past-due amounts from delinquent lessees and conducting timely rent reviews.

Background

The commission is responsible for managing the lands that the State acquired upon its admission to the union, including the beds of navigable rivers and lakes, and submerged land along the State's coast. The commission is also responsible for managing school lands granted to the State for the benefit of public education. The commission's management of the lands under its jurisdiction provides the State with revenues. The majority of this revenue comes from net profits and royalty payments, such as for oil and gas production on state lands, which generally accounted for more than 90 percent of the total revenue—ranging between roughly $400 million and $500 million annually. Other revenue earned by the commission includes rental revenue that is earned by leasing state property under its jurisdiction. In addition to negotiating leases and assessing rents, the commission's activities also include monitoring ongoing leases, performing timely rent reviews and lease renewals, and auditing the State's oil and gas leases and contracts.

Our 2011 audit report made numerous recommendations to the commission and in this letter report we discuss certain key recommendations that have not been fully implemented. As noted in the table, we have changed our conclusion on the status for all of these recommendations from what we reported previously in *Implementation of State Auditor's Recommendations*, Report 2013-406 (February 2013 report). In that February 2013 report, we had concluded that the commission had *fully implemented* these recommendations based on information the commission provided at that time. However, based on the results of our follow-up review and related testing, we now conclude that the commission has only *partially implemented* the recommendations shown in the table.

Table

Certain Key Recommendations From the California State Auditor's Report #2010-125 That Have Not Been Fully Implemented (as of June 2014)

RECOMMENDATION	STATUS BASED ON FOLLOW-UP REVIEW	AUDITOR'S ANALYSIS
To ensure that it manages delinquent leases in an effective and timely manner and collects all the amounts owed to it, the State Lands Commission (commission) should develop and adhere to policies and procedures that incorporate the *State Administrative Manual's* (administrative manual) 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.	Partially implemented*	Although the commission has developed guidelines, our review found that the commission's practices are inconsistent with these guidelines and with the administrative manual. (See page 3 for further discussion of this issue.)
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.	Partially implemented*	Although the commission has developed guidelines that establish holdover reduction procedures, our review found that these procedures were not followed in practice. Further, we noted that the commission does not consistently raise the rent for certain lessees when lease terms require it to do so. (See page 6 for further discussion of this issue.)
• Consistently assess the 25 percent penalty on expired leases.	Partially implemented*	
To complete its rent reviews promptly and obtain a fair rental amount for its leases, the commission should conduct rent reviews on each fifth anniversary as specified in the lease agreements or consider including provisions in its leases that allow for the use of other strategies, such as adjusting rents annually using an inflation indicator.	Partially Implemented*	We found that the commission still has difficulty performing rent reviews on the fifth anniversary of each lease agreement. (See page 7 for further discussion of this issue.)
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.	Partially implemented*	We found that although the commission has established guidelines for conducting appraisals, it does not consistently follow these guidelines and appraise the value of properties that its management defines as financially significant. (See pages 7 and 8 for further discussion of this issue.)
• 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.	Partially implemented*	
To adequately monitor its revenue-generating oil and gas leases, the commission should track the recoveries and findings identified in its audits and use this information to develop an audit plan that would focus on leases that have historically generated the most revenue and recoveries for the State, as well as those that historically have had the most problems.	Partially implemented*	The commission created an audit plan and began tracking its findings and recoveries; however, it has been unable to complete the proposed number of audits and anticipates further revising its audit plan. (See page 9 for further discussion of this issue.)

Sources: Selected recommendations made in the report by the California State Auditor (state auditor) titled *State Lands Commission: Because It Has Not Managed Public Lands Effectively, the State Has Lost Millions in Revenue for the General Fund*, Report 2010-125 (issued in August 2011) and the state auditor's analysis of the commission's actions related to these recommendations.

* In the state auditor's report titled *Implementation of State Auditor's Recommendations*, Report 2013-406 (February 2013), we had originally concluded that the commission had fully implemented these recommendations based on the commission's responses. However, our follow-up review found that the commission has not fully implemented these recommendations, which we discuss in this letter report.

The Commission Can Do More to Collect Additional Revenue for the State

Our follow-up review of a small number of lease agreements found that the commission is not consistently following its guidelines as per our recommendation; as a result, we believe the commission can do more to ensure that the State receives all the rental revenue to which it is entitled. For example, we noted that the commission's staff did not always fully pursue past-due payments from delinquent lessees by sending timely collection letters and they did not document an analysis of whether additional collection efforts, such as using a collection agency or pursuing legal action, would be worthwhile financially. Consequently, we believe the commission's collection practices are inconsistent with both the *State Administrative Manual* (administrative manual) and with its own guidelines. At times, our follow-up review also found that the commission did not charge higher rents when it was required to do so under the terms of its lease agreements. Finally, we noted that the commission does not perform rent reviews of the State's property as frequently as called for in its lease agreements and does not ensure that appraisals are performed on property it deems to have *significant* financial value. As a result, our testing found that the commission is missing opportunities to charge higher rental amounts to its lessees. It also lacks reliable data in its new computer system to identify when rent reviews should be performed. The commission transitioned to its new computer system beginning in February 2014 and acknowledges that it is working on improving the quality of the data that it had imported from its previous system. Nevertheless, based on the results of our follow-up review, we believe the commission can do more to effectively manage the State's lease agreements.

The Commission Does Not Consistently Follow State Criteria and Its Own Guidelines for Pursuing Payment From Delinquent Lessees

To ensure that the commission manages delinquent leases in an effective and timely manner and collects all the amounts owed to the State, we recommended in our 2011 audit report that the commission develop and adhere to policies and procedures that incorporate the administrative manual's guidance for the steps its staff should take when a lessee is delinquent in payment to the State. In response to this recommendation, the commission provided us with a confidential memo addressed to the commission's staff from its chief counsel. The memo was intended to provide staff with direction for addressing lease compliance issues, such as how to follow-up on delinquent payments that are due from lessees, along with other lease management issues. According to the commission's chief counsel, while the memo provides some recommended time frames informing the decision-making and notification process leading up to an enforcement action, it was never intended to establish "hard and fast deadlines" for the staff to meet. The chief counsel also commented that the memo clearly acknowledged the need for flexibility in the face of specific circumstances. As a result, in this follow-up report, we refer to the direction contained in the confidential memo as the commission's *guidelines* and do not cite the specific processes or time frames the memo outlines.

Although we can appreciate the commission's desire for flexibility in certain cases, we noted deviations from both the commission's guidelines and from the guidance contained in the administrative manual, and it was not clear to us what specific or unique circumstances warrant the commission's staff failure to follow these criteria. We noted two general areas of concern. First, the commission was often significantly late in sending collection letters to delinquent lessees for four of the five leases we reviewed. Second, the commission's staff informed us that

it no longer consistently follows its guidelines to document and explain whether it will pursue additional collection efforts once its collection letters have proved ineffective at securing payment. The lack of timely collection letters to delinquent lessees may unnecessarily delay the State's receipt of payment, and the lack of an analysis explaining why additional collection efforts—subsequent to the mailing of the collection letters—was or was not pursued prevents the commission from demonstrating that it has considered all reasonable and cost‑effective steps to obtain the funds owed to the State. We note that the administrative manual discusses both of these steps as required collection activities.

Sending timely collection letters to delinquent lessees is a necessary and reasonable step to ensure that the State ultimately receives all due amounts. However, for four of the five delinquent lessees we reviewed, the commission did not send timely collection letters in a manner consistent with the administrative manual. The administrative manual states that departments are to send a sequence of three collection letters at a minimum of 30‑day intervals. If a reply or payment is not received within 30 days after sending the first letter, the administrative manual requires a second letter, which must reference the original request for payment and must be stated in a stronger tone. Finally, the administrative manual states that if a response is still not received from the lessee, a third letter is to be sent 30 days later. The third collection letter is to include reference to the prior two letters and is to state what further actions may be taken in the collection process.

For four of the five delinquent lessees we reviewed, the commission did not send its first collection letters in a timely manner when measured against the criteria in the administrative manual. The commission's first letters were late by an average of nearly 70 days, with two collection letters mailed to lessees more than 130 days late. When four of the five delinquent lessees still had not remitted their payments after 90 days, the commission sent them the third letter but with delays of 57 to 333 days. In fact, the commission sent the third letter more than 200 days later than it should have for three of the four delinquent lessees. The lateness of the commission's third collection letter is of particular concern because this notice contains the clearest articulation that payment is past due and that failure to pay will result in default and referral to the commission's legal office. A member of the commission's accounting staff, who is responsible for identifying overdue invoices and sending the collection letters, indicated that the recent implementation of the commission's new computer system has disrupted some of her duties, such as mailing past due notices. She also stated that the loss of significant personnel in the accounting department played a role, causing other tasks to take a higher priority. Nevertheless, the commission is hopeful that its new computer system will allow its staff to better manage the timely notification of its delinquent lessees. Because of the recent implementation of the computer system, which it began using within the last few months, it is too early to tell whether its use will lead to more timely collection letters to delinquent lessees.

Once collection letters prove ineffective at securing payment, the administrative manual requires departments to determine what additional collection efforts, if any, they should make. According to the administrative manual, this analysis should include an assessment of the cost versus the benefit of using one or more different collection options such as seeking a court judgment or using a collection agency, among others. Without disclosing the commission's specific processes or approach as articulated in its guidelines, we noted that those guidelines similarly discuss how staff should decide whether to proceed if collection letters are ineffective and how staff should then document that decision. Based on the criteria contained in the administrative manual and the commission's own guidelines, we expected the commission to

have performed such an analysis by the time delinquent lessees were more than six months (or roughly 180 days) late in submitting their payments to the State. However, we did not find any evidence of this type of analysis or documentation for four of the five leases that we reviewed. When we asked for an explanation for the missing analyses, the commission's executive officer stated that her staff generally follow the steps contained in the guidelines and perform an analysis that weighs the costs and benefits of pursuing a delinquent lease; however, she acknowledged that her staff have not been consistent in documenting that analysis. Nevertheless, we believe it is a prudent business practice, and one required by the administrative manual, to perform and document a cost-benefit analysis—or a similar approach—to determine what additional collection efforts are warranted. The aggregate past-due amount for the four lessees receiving late notices exceeded $22,000. Until the commission adheres to the requirements in the administrative manual regarding collections in such cases, it remains unclear if the commission has done all it reasonably can to obtain these funds for the State.

The commission's assistant executive officer stated that since 2011 his staff have made significant progress on delinquent accounts, citing a reduction in the delinquent portion of accounts receivable from the $689,000 that was outstanding and past due in November 2011 to the roughly $165,000 outstanding and past due in April 2014. However, for further context, the commission's total accounts receivable for revenue at the end of the fiscal year—for fiscal years 2010–11 through 2013–14—have substantially increased. The commission reported roughly $1.7 million in total accounts receivable for revenue at the end of fiscal year 2010–11, which later increased to $1.9 million at the end of fiscal year 2012–13. Preliminary data for fiscal year 2013–14 shows the commission's accounts receivable amount further increasing to nearly $2.2 million. Although the assistant executive officer indicated that roughly $124,000 of the $2.2 million was delinquent, the point of our critique is that the commission's staff should be evaluating and documenting what actions, if any, they plan to take when collection letters are unsuccessful at obtaining payment from lessees.

The Commission Can Do More to Notify Lessees of Their Expiring Agreements and Increase Rents When Agreements Expire

In our 2011 audit report we found that the commission did not take advantage of its lease terms that allow it to raise rents when lease agreements expire and go into a status called holdover, a status where the lessee's tenancy converts to a month-to-month basis. To reduce the number of lessees operating with an agreement in a holdover status, the commission developed procedures in 2010—which we recommended in our 2011 audit report that the commission continue to follow—that direct staff to send reminder letters to lessees regarding their soon-to-expire lease agreements and to encourage lessees to submit applications for new leases. The commission's procedures classify leases with an annual rent of $10,000 or more as significant and directed staff to begin the renewal process for these leases 27 months before the lease agreement is due to expire. For the remaining leases—those with an annual rent of less than $10,000—the commission's procedures require its staff to notify lessees at intervals of 12, nine, and six months before the lease agreement expires. Finally, the commission has the ability—based on terms and provisions that are contained in its lease agreements since 1991—to increase the rent by 25 percent after the lessee's agreement has expired. Our 2011 audit report recommended

that the commission consistently take advantage of this option because doing so may encourage lessees to renegotiate their agreements more promptly and result in higher revenue for the State.

When it developed its policies in November 2010 for reducing the number of revenue-generating leases in holdover, the commission noted that it had 130 such leases at the time. According to preliminary data the commission provided during our follow-up review, roughly 50 leases are currently identified as either expired, expired but in negotiations, or in holdover. However, this number is subject to change since the commission's staff are updating some leases labeled expired that were imported from its old computer system, according to the commission's assistant executive officer. Furthermore, most of these 50 leases are associated with relatively low annual rental amounts of $3,000 or less.

We reviewed 10 lease agreements—five leases that were approaching the end of their term (ranging between $3,000 and $70,000 in annual rent) and five that had already expired since the issuance of our 2011 audit report (ranging between $900 and $8,000 in annual rent)—to determine whether the commission had notified the lessees in accordance with its policies. We found that for seven of the 10 leases we reviewed, the commission did not provide timely notification to the lessee that its lease was expiring—notification letters were sent from five to 10 months late—and in one case, the commission only sent the notification after the lease agreement had already expired. When we spoke with commission staff about the late notifications we observed, they indicated that in one case the notifications were unnecessary, asserting that they had already been in contact with the lessee through other means such as the telephone or e-mail. In the other cases, commission staff acknowledged that the notices were late but stated that the lessees have committed to renewing their leases or have already submitted applications to renew their agreements. Nevertheless, sending late notices to lessees raises the risk that a lease agreement will not be renewed before expiration which, as we discuss below, may ultimately lead to the commission not collecting all the revenue that it otherwise would for the State.

Since 1991 the commission has included certain terms in its lease agreements that discuss how the lessee can continue using state property, but must pay a higher rental amount once the current lease agreement has expired. When these holdover terms are included in lease agreements, the lessee's tenancy in the property converts to a month-to-month basis and the lease agreement states that the annual rental amount shall increase by 25 percent. These holdover provisions remain in place until the lessee successfully executes a new lease agreement. In our 2011 audit report, we found that the commission did not consistently apply these provisions and we recommended that it do so. We believe that by applying these terms, the commission would not only secure additional revenue for the State but it might provide lessees with more incentive to promptly renegotiate their lease agreements. For the five leases we reviewed that had expired and gone into holdover, we noted that four agreements contained terms calling for the commission to increase the expired rent by 25 percent. However, in three of the four cases the commission did not do so. In the fourth case, the lease agreement expired in July 2012 and the commission did increase the annual rent by 25 percent (an additional $968) to roughly $4,800; however, beginning in 2013, the rent billed to that lessee was the original annual amount of roughly $3,800 without a new negotiated lease. When we brought this matter to the commission's attention, it subsequently billed the lessee for the additional amounts due.

The chief of land management stated that instead of automatically assessing the 25 percent penalty on all expired leases, management determines whether to apply the penalty on a case-by-case basis, and it typically applies the penalty as a punitive measure when the lessee does not appear to be negotiating in good faith or is otherwise being uncooperative or unresponsive to the commission. Nevertheless, we believe the commission should enforce the terms of its lease agreements because doing so encourages lessees with expired leases to renegotiate and best protects the State's financial interests. Finally, to the extent that the commission charges 25 percent higher rent on certain lessees who are in holdover, but does not do so for others, the commission exposes itself to criticism that it is selectively enforcing the terms of its lease agreements.

The Commission Does Not Consistently Perform Timely Rent Reviews or Perform Appraisals to Update Rental Amounts to Market Value

The lease agreements we reviewed contain provisions that generally allow the commission to review and modify the rental amount it charges lessees on the fifth anniversary of the lease agreement, and every five years thereafter, in a process the commission calls a rent review. During a rent review, the commission may choose one of several methods to determine a new rental amount, including performing an appraisal on the value of the land or adjusting the rental amount using the Consumer Price Index (CPI). In our 2011 audit report, we recommended that the commission conduct rent reviews every five years and appraise its properties or use other methods to adjust rents to reflect market values as frequently as the lease provisions allow. Performing periodic rent reviews—which are informed by appraisals or other analyses of a property's value—provides the commission with a better understanding of what it might reasonably charge lessees and can help maximize the amount of rent it collects for the State.

Our follow-up review found that the commission still has difficulty performing rent reviews in a timely manner, thus limiting its ability to maximize the rent it collects for the State. For three of the five leases we reviewed, the commission failed to perform rent reviews on the fifth anniversary of the lease agreement. In one of the five leases, nearly 12 years passed between the commission's establishment of the rental amount in August 2001 and its reconsideration of the rental rate in March 2013. From 2001 to the next five-year lease anniversary in August 2015, the commission will collect more than $2.8 million from the lessee. However, had the commission modified rent on the five-year lease anniversaries occurring in 2005 and 2010 using a simple CPI adjustment, we estimate that the commission could have collected roughly an additional $200,000 in rent for the State's General Fund. For the other two leases where the commission did not perform timely rent reviews, we project that the commission will miss collecting nearly $3,000 in additional revenue for lease payments scheduled from 2007 through 2016. Although $3,000 may not be a significant amount of money, the time and effort required for commission staff to apply an inflationary rate—such as the CPI—to estimate the value of low-rent properties is minimal and may be worth the effort. Moreover, if the commission is not consistent in conducting timely rent reviews, it could be passing up opportunities to adjust the rents on leases having much higher annual lease payments.

Separate from the commission's difficulty with performing timely rent reviews is its inability to consistently appraise the value of properties that the commission's management defines as significant. The commission's guidelines for its land management staff are intended to help them not only complete rent reviews in a timely manner but also to help clarify when a property

is sufficiently valuable that staff should perform an appraisal during the rent review process. Specifically, these guidelines state that staff should perform appraisals on leases that generate, or have the potential to generate, $10,000 or more in annual rent; however, we found that the commission did not perform such appraisals for four of the five leases we reviewed that had rent reviews in 2013 and 2014. The annual rent amounts for these four leases were between approximately $32,000 and $196,000 before rent review, and between five years and 12 years had passed since their last appraisal. In these four leases, the commission decided to apply the CPI to adjust its rental amounts, sometimes citing a lack of appraisal staff as its justification.

When we asked a public land manager (manager) why the commission did not perform timely rent reviews and appraisals, the manager explained that in one case the commission had to resolve a boundary issue for the leased parcel of land before it could perform a rent review on the lease. For the other two lease files with rent reviews that were not timely, the manager stated that the commission did not pull the lease file in time to complete the rent review for one of the leases, but the manager could not explain how staff missed the rent review date on the other file. With respect to not performing appraisals, the public land manager stated that the commission has not been able to perform appraisals because it lacks appraisal staff. The assistant chief of land management (assistant chief) added that the commission needs at least two full-time appraisers to perform appraisals for all leases with annual rents greater than $10,000, but it has only been able to hire one appraiser who started with the commission in May 2014. The commission plans to continue its efforts to hire at least one more appraiser. Because of this shortage, according to the assistant chief, he has had to make decisions about which leases should have an appraisal based on factors such as the complexity of the lease, the cost of doing an appraisal compared to the additional rent likely to be received, and the availability of appraisal staff. Nevertheless, until the commission can hire a sufficient number of appraisers to perform periodic appraisals of its significant leases, it likely will miss opportunities to increase rental revenues.

The commission also lacks reliable data on the timing of the respective lease agreement's five-year interval for rent reviews, which complicates its ability to perform rent reviews as frequently as its lease agreements allow. Our review of data in the commission's new database revealed inaccurate rent review dates for three of the five leases we reviewed. For example, although one lease should have its next five-year anniversary in August 2015, the commission's database shows the next rent review date as July 2018. When we raised concerns regarding the accuracy of the rent review data in the new computer system, the public land manager agreed that the rent review date should be in August 2015. To address our concern, the manager stated that the next rent review date for the lease has been corrected, and that an e-mail has been sent to staff reminding them that they are to conduct rent reviews at five-year intervals based on the effective date of the lease. Although we saw notes in the commission's database showing corrections for the rent review dates for the three leases we identified, the database still generated a report showing the incorrect dates. We note that the commission only recently began using its new computer system in February 2014 and it recognizes the need to take additional steps to correct the data that was imported from its previous system. As part of this process, the commission should review the database lease entries to ensure that the rent review dates for its more than 1,200 revenue-generating leases are accurate.

The Commission Has Not Performed All of the Audits It Had Anticipated and Is Considering Further Changes to Its Audit Plan

In our 2011 audit report, we found that the commission did not regularly audit its revenue‑generating oil and gas leases and contracts. Since that report, the commission began tracking its ongoing audits, findings, and recoveries and it created an audit plan in 2011 (2011 audit plan) that focuses on oil and gas leases generating significant royalty income for the State. The 2011 audit plan suggests that a fully staffed audit unit of seven auditors would be able to perform annual audits of its largest revenue‑generating entities. In addition, the 2011 audit plan includes audits of other revenue‑generating leases on a cyclical basis, such as once every three years. Our review of the 2011 audit plan found that it adequately accounted for the commission's largest revenue‑generating oil and gas leases.

Although the commission has created an audit plan to monitor its largest revenue‑generating oil and gas leases, it has not been able to adhere to that plan and perform the expected number of audits. Specifically, the commission's audit plan indicates an intention to complete 14 audits between fiscal years 2011–12 and 2013–14. However, the commission has completed only six audits in that time frame, one of which was completed by a contractor who found that the lessee had underpaid the State. After reviewing the contractor's audit findings, the commission ultimately settled with the lessee resulting in the State recovering $450,000. The commission's inability to complete its expected audits is unfortunate since these efforts appear to have successfully identified funds due from lessees. In another example, the commission completed an audit in May 2014 that identified disallowed expenses, potentially resulting in recovering $440,000 for the State. The commission's management is reviewing this audit to determine how best to proceed.

Performing audits can be a long process for the commission's auditors. For five of the six audits that the commission completed, they often spanned multiple years and were not completed until roughly two years after the audit period. For example, the commission completed an audit of a lessee in November 2011 with the audit period covering more than 12 years between August 1997 and September 2009. Similarly, another audit of one of the commission's most significant lessees covered fiscal years 2007–08 through 2008–09, but the audit was not completed until more than two years later in December 2011. With the significant passage of time between the end of a multi‑year audit period and the completion of the audit, the commission increases the risk that lessees will dispute the results of the audit and the commission will lose its opportunity to obtain unpaid funds due to the State. In a January 2008 report submitted to the Legislature, the commission's staff stated that there is a four‑year statute of limitations for the recovery of unpaid royalties and that the statute of limitations furthermore drives the need to have an appropriately staffed auditing program that will ensure all leases are reviewed on a timely basis within the period of recovery. As revenues continue to increase, according to the commission, the risk of losing recoveries due to a lack of audits also increases. This equates to potential loss of revenue owed to the General Fund.

According to its audit supervisor (supervisor), the commission has not been able to follow its 2011 audit plan because of a lack of staff, litigation issues with its lessees, and an increased audit scope for one of its larger audits. The supervisor told us that most of her staff are now focused on auditing one of its larger revenue‑generating entities because the audit scope was expanded

to include what she considered to be a high risk area for misallocated costs. While we agree that it is appropriate to allocate the commission's audit staff towards the highest revenue and highest risk areas, the commission's ability to complete its other audits is now further limited.

The audit supervisor stated that the commission would likely change its audit plan going forward, especially as the commission begins to perform more monthly desk reviews of royalty payments. We noted that the supervisor has scheduled audits for two larger revenue-generating entities and has decided to not audit others that the commission had planned to review on a cyclical basis in fiscal year 2014–15. The commission's change in approach appears to be based, in part, on the results of the commission's monthly desk reviews of royalty payments made to the State which, according to the supervisor, entail a review of how these payments were calculated and their supporting documentation. According to a May 2014 internal commission report, its desk reviews have resulted in more than $1.1 million in recoveries from lessees. As of January 2014 the commission was staffed with four auditors and an audit supervisor. In June 2014 the supervisor stated she was in the process of trying to fill the final vacancy for her audit staff. Nevertheless, if the commission is going to change its approach for how it audits or otherwise monitors its revenue-generating lessees, it should formalize its new processes so that it can better demonstrate adherence to our 2011 audit report's recommendation while also allowing it to solidify staffing requirements for its audit unit.

Conclusion

This follow-up review focused on relevant actions the commission has taken related to recommendations that we made in our 2011 audit report. We determined that the commission has not fully implemented certain key recommendations that we believe will lead to better management of the State's numerous leases.

Recommendations

To more effectively manage its revenue-generating leases, the commission should take steps to fully implement the recommendations identified in the table on page 2 of this follow-up review.

To ensure that the commission is performing rent reviews in a timely manner, it should review its database and correct the *Next Rent Review* date so that rent reviews are scheduled to take place every five years.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code. We limited our review to those areas specified in the letter report.

Respectfully submitted,

ELAINE M. HOWLE, CPA
State Auditor

Staff: Grant Parks, Audit Principal
Tram Thao Truong
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Brett Noble, MPA

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

STATE OF CALIFORNIA EDMUND G. BROWN JR., *Governor*

CALIFORNIA STATE LANDS COMMISSION

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JOHN CHIANG, *Controller*
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July 25, 2014

Elaine M. Howle, CPA*
California State Auditor
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Dear Ms. Howle,

I would like to thank the California State Auditor and her staff for this review of the Commission staff's operations. I believe the numbers reveal that we have made significant progress since the initial audit in all areas of lease management and audits. We also acknowledge the need to continuously maintain and review our processes. Some of those processes put in place as a result of the 2011 audit have helped improve performance while others require updating to reflect experience, current staffing, and other necessary changes resulting from the conversion to a new lease management database and workflow software. Issues tied to appraisals and audits have been significantly hampered by recruiting difficulties as noted in the report and our response.

(1) We agree that we can always do more to collect revenue for the State. However, generating revenue is not our only objective. As Trustees of more than 4 million acres of California's sovereign Public Trust land, the Commission is entrusted with the long-term management and sustainability of this valuable, yet limited resource and the responsibility of ensuring that these lands and resources are utilized consistent with the Public Trust Doctrine and preserved and protected for all the people of California and future generations. These sometimes competing goals of maximizing revenue and preserving Public Trust lands and resources, along with the limited staff resources of the Commission, often require a balancing of priorities and workload, to ensure that the use and development of these lands and resources are in the best interest of the State.

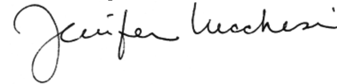
My management team and I are committed to continuous improvement and will be working to address those issues identified the report. We are confident that our new lease management software will facilitate these improvements. Additionally, we believe we are well on our way to establishing a more robust royalty accountability and audit process that ensures the State is fairly compensated for the use of its resources.

The enclosed response, taken in the order of the sections in the report, addresses some of the observations identified in the Auditor's report and our responses are meant to provide a context for those findings. We accept the overall analysis of the

* California State Auditor's comments appear on page 20.

audit and will be working toward implementation of the recommendations except where noted.

Sincerely,



JENNIFER LUCCHESI
Executive Officer

Enclosure

cc: State Controller John Chiang, Chair
Lt. Governor Gavin Newsom, Commissioner
Michael Cohen, Director of Finance, Commissioner
John Laird, Secretary, California Natural Resources Agency

CALIFORNIA STATE LANDS COMMISSION
Response to Audit Findings
2014-501

The Commission Can Do More to Collect Additional Revenue for the State

We would be remiss if we did not respond to the general tone of this review regarding criticisms that the Commission staff has not maximized revenues to the State through its leasing practices. While the Commission generally seeks to maximize revenue derived from lands under its jurisdiction, revenue is by no means the Commission's sole objective or consideration. ① Existing law, including Division 6 of the Public Resources Code and the State Constitution, require that the Commission receive consideration for use and development of state lands and resources, while at the same time allowing the Commission to consider factors other than rent if doing so is in the best interests of the State.

In some cases, the Commission authorizes leases for which the consideration is the public benefit. Leases to other public entities, such as cities, counties, water and reclamation districts and other State agencies are generally rent-free to support projects that benefit the general public. Private entities may in some instances also be given rent-free leases, such as for protective structures along river banks, insofar as these structures benefit the people of the State as much as they do the adjacent private land owner.

The Commission has clearly and consistently directed staff that it is in the ② State's best interest to pursue a fair return on the use of State land that does not unduly burden the lessee, especially small businesses. Many marinas and waterfront visitor-serving enterprises would not be able to remain in operation if the Commission were to impose the highest rent possible. Nine percent of appraised land value may be unbearable in some regions for many small businesses. The result could be losses in both jobs and taxes; significant staff and Attorney General costs to bring such lessees into compliance; and ultimately derelict and abandoned facilities on State land that create both a navigational hazard and legal tort liability for the State. In other instances, an area may have a lack of adequate visitor-serving commercial operations. ② Assessing a fair and reasonable rent in these situations is in the State's best interest as it can preempt all these negative implications while complying with the gift clause of the State Constitution.

The Commission Does Not Consistently Follow State Criteria and Its Own Guidelines For Pursuing Payment From Delinquent Lessees

The chief counsel memo referred to in the report is in need of updating. Although the memo's protocols were appropriate, since that time, the universe of chronic delinquent accounts has been greatly reduced. We recognize the need to document the notices and the decisions made as to whether to pursue a delinquent account. Staff will be formalizing the requirement to document

through the Accounting, Land Management and Legal procedures. It should be noted that the results of our efforts since the initial audit have reduced delinquent accounts from $689,000 in 2011 to $165,000 in 2014, a 76% reduction. This recent review also correctly noted that overall accounts receivables increased in that same period from $1.6 million to $2.2 million, thus reducing the proportion of delinquent amounts from 43% of total receivables to 7.5%. The increased value in the overall revenue receivables is due to bringing holdover lease rent and past due rent reviews current, processing new lease applications, conversion of private recreational pier leases to revenue generating status and an acceleration of billing notices. All rentals are now billed 75 to 90 days in advance of the due date to ensure timely payment, resulting in timelier lease payments.

The systems in place during the period of review were primarily manual systems. A new State Lease Information Center (SLIC) database has been implemented, being released to program staff a mere three weeks before the Auditor's staff arrived. We are hopeful that ready access to lease information will ameliorate many of the deficiencies that were noted in this most recent review. Many of the recent delays in sending out past due notices were the result of redirecting of limited staff to engage in the development of the system as well as significant turnover in the Accounting section. The old method was a dual entry system prone to information gaps that did not facilitate timely notices. The SLIC database has the capability to more efficiently facilitate these processes. We are in agreement that these letters are more effective when issued in a timely manner and will be working toward implementation of a more reliable system within SLIC.

The Commission Can Do More to Notify Lessees of Their Expiring Agreements and Increase Rents When Agreements Expire.

In the summary, the report states: "Although the commission has developed guidelines that establish holdover reduction procedures, our review found that these procedures were not followed in practice."

The primary critique is that the notification letters were not consistently sent out in the timeframes identified in the holdover reduction procedures. We agree that letters for all leases are not always sent out in the timeframes identified in the holdover reduction procedures. We will work to rectify this and, as the new SLIC database is implemented and refined, we believe it will improve. While we agree that prompt notice to lessees is important to initiate the renewal process, these timelines were never meant to be hard deadlines. Rather, they were intended as general guidelines meant to achieve the ultimate goal of getting lessees to submit applications so leases are renewed in a timely manner, thus preventing leases from going into holdover. Although this has always been understood internally, we will revise the holdover procedure memo to clarify this matter.

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As far as the larger purpose of the memo – to prevent leases expiring and going into holdover - we believe the holdover procedure process, in combination with recent funding for positions for lease compliance and enforcement, has been extremely effective and produced excellent results. In the first two years since receiving funding for lease compliance and enforcement positions, the number of expired rent-generating leases has been reduced from 122 to 33. Over this same period, the number of long-term expired rent-generating leases (more than 10 years past due) has declined from 41 leases to 4 leases. As noted in the report, the overwhelming majority (29 out of 33) of these expired rent-generating leases have annual rents of less than $3,000 with combined revenue of less than $50,000. In almost every case, when an expired lease is renewed, the lease start date is either backdated to be continuous with the expired lease or back rent is collected, thus ensuring that no revenue is lost to the State.

The summary goes on to state: "Further, we noted that the commission does not consistently raise the rent for certain leases when lease terms require it to do so."

(4) This issue refers to the application of the 25% holdover increase to rents. Language was inserted in leases several years ago to increase rents by 25% if the lease lapsed into holdover to provide an incentive to lessees to promptly renew their leases. In practice, it has become leverage that, in most cases, is not necessary and, in other cases, is perceived as punitive. Most lessees are cooperative with staff and willingly participate in the renewal application process. Delays can occur due to permitting by other agencies or even the timing of the State Lands Commission public meetings. Staff does not believe it would serve the public to assess these higher rents for circumstances beyond the lessee's control.

(5) Beginning in May, staff instituted a process for each billing cycle where expiring leases are noted on a prebilling report from SLIC. With billings occurring 75 to 90 days in advance of the due date, a significant number of expiring leases may be due. A listing of those leases is sent to Land Management staff for consideration as to whether the holdover "penalty" should be assessed. Division management, based on the facts of that particular lease, determines whether to assess the holdover penalty. Such facts include whether an application and processing fees have been received, if the lessee is working cooperatively with staff to provide the required information, or if other permitting agencies are delaying the process. To assess a punitive rent to a cooperating lessee would not serve any useful purpose. Whether or not the holdover penalty is assessed, all leases are "trued up" upon the State Lands Commission's authorization of the lease renewal application. Any additional amounts due are billed immediately after the Commission's authorization of a lease renewal. If the 25% is in excess of the new rent, billings are adjusted and any excess rent paid refunded. No actual revenue is being lost, only the marginal time value of money.

We do recognize the point made by the Auditor regarding consistency in applying specific lease provisions and are continuing to improve standard lease language to add clarity and to reflect the various factors influencing the lease renewal process.

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The Commission Does Not Consistently Perform Timely Rent Reviews or Perform Appraisals to Update Rental Amounts to Market Value

We acknowledge the Auditor's finding that the Commission staff continues to have difficulties performing some rent reviews in a timely manner. We are currently formalizing this workflow in the SLIC database, which will provide more prompt notification when rent reviews are due and document assignments and timeliness of staff work for closer management scrutiny. Procedures under development will have managers review currently available SLIC reports for rent reviews due within six months and assign to staff through the system. Reports under development will be used to track assignments and ensure work is completed in a timely manner.

Additionally, staff has been assigned to confirm current rent review dates within the database to ensure accuracy. Data quality assurance continues as a result of the conversion from ALID to SLIC. Rent review dates will be given priority for verification.

Furthermore, over time we are moving away from rent reviews and toward a fixed rent with annual CPI adjustments. We are doing this with all General Lease – Recreational Use leases going forward with the August 2014 Commission meeting. These leases make up the majority of our rent-generating leases. Not only will this allow us to collect more revenue earlier, but, over time, it will allow us to save staff resources expended on rent reviews. This option has only recently been made feasible through the adoption and implementation of our new SLIC database.

Commission staff concurs with the Auditor's recommendation to appraise its significant properties as described in its February 2012 Rent Review Prioritization memo as frequently as the lease provisions allow. As noted in discussions with the Auditor's staff, the Commission's ability to follow the guidelines outlined in the memo has been significantly impacted by the lack of appraisal staff and the difficulty in recruiting, hiring, and retaining qualified appraisers due to the disparity in financial incentives between the public and private sectors. Despite receiving two appraiser positions in FY 2012, we have had difficulty attracting qualified applicants to hire. The exam for Public Land Management Specialist, the classification previously used, did not result in any qualified appraiser candidates. The Commission received permission to employ a class of land appraiser used by another department to finally recruit qualified staff and then only one was found. The Commission's appraisal staff currently now consists of the one full-time appraiser, hired in May 2014, and one part-time retired annuitant. The Commission plans to try again to recruit for an additional appraiser in either August or September 2014. Any inability to find qualified candidates will continue to have detrimental effect on appraising significant properties.

Commission staff also concurs with the Auditor's recommendation to use the sales comparison approach, whenever possible, in appraisals of those leases having the greatest revenue potential. Commission staff will prepare a procedures memo expanding on its February 2012 Rent Review Prioritization memo to reflect this

recommendation. The additional text will address when to use other rent setting methods and the coordination of leasing staff with appraisal staff. It should be noted, however, that management will continue to take into account the overall best interest of the State in making its recommendations to the State Lands Commission on rental amounts.

The Commission Has Not Performed All of the Audits It Had Anticipated and Is Considering Further Changes to Its Audit Plan

The Auditor's report correctly states that the 2011 audit plan suggested that "a fully staffed audit unit of seven auditors" would be able to perform" the maximum number of 14 audits proposed by the plan. As discussed with the Auditor's staff, the number of audits planned was contingent on the number of auditors on staff. The Commission was fortunate, as a result of the risk to the State identified in the 2011 audit, to be granted approval to hire an additional four positions in the 2012 budget cycle. However, due to recruitment challenges, the audit unit has been staffed with only three auditors through January 2013 and five auditors since February 2013. Since that time, the Commission has completed eight audits, which is well within the 2011 audit plan when adjusted for the number of auditors available.

The lack of staffing, also cited in the report as a major factor in the findings, was not due to a lack of effort to fill vacancies. Finding qualified candidates for the "Mineral and Land" audit series proved difficult. An initial recruitment after approval of the additional four positions in 2012 yielded only one qualified candidate and that individual filled an existing position of a recently retired auditor. Subsequent efforts resulted in hiring two individuals through use of a temporary authorization (TAU) until another exam could be scheduled. A recruitment in 2013 resulted in only three qualified candidates, all of who were already working for the Commission. These included the auditor hired in 2012, who was eligible for promotion and the two TAU individuals that were eligible to be appointed to the positions. Due to the recruiting challenges the decision was made to recruit basic entry-level auditors to fill the remaining two positions with the goal of training them to specialize in mineral and land audits. This approach has ultimately proved successful in terms of hiring qualified although inexperienced individuals and, as of July 2014, all auditor positions are now filled. We will be revising the audit plan accordingly.

The outcome of a recent litigation settlement clarified allowable deductions in determining the ultimate price of oil (market price) used to value the State's share royalties and will have a significant impact on how future royalties due to the State from lessees are determined. The effect has been a simplification resulting in the ability to perform a more accurate "desk audits" on a monthly basis, thus facilitating the verification of the oil price paid as soon as payments are received. Not only has this increased the efficiency in confirming the accuracy of the payments received, but lessees are now aware that the Commission staff is monitoring the revenue generated more closely. This will reduce the risk of loss or opportunity to obtain unpaid revenues

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in future audits. The increased use of desk audits will also be factored into any future audit plans.

Recommendations:

To more effectively manage its revenue-generating leases, the commission should take steps to fully implement the recommendations identified in the table on page 3 of this follow-up review.

We concur. As noted in the discussion above, we generally concur with this assessment by the auditors and are taking steps to implement those recommendations.

To ensure that the commission is performing rent reviews in a timely manner, it should review its database and correct the Next Rent Review date so that rent reviews are scheduled to take place every five years.

We concur. Staff assigned to data verification will be tasked to review rent review dates as a priority to ensure no rent reviews are missed due to data errors.

Comments

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

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

① The commission states that generating revenue is not its only objective, attempting to downplay our letter report's general conclusion that the commission can do more to maximize revenue owed to the State. We recognize that the commission manages many leases that do not generate revenue. However, our letter report focused specifically on revenue-generating leases and the commission's policies for managing such leases. We believe the commission has a responsibility to the State and its taxpayers to follow its own policies and take reasonable steps to maximize revenue when it is able to do so.

② The commission states that it pursues a fair return on the use of state land that does not unduly burden the lessee, especially small businesses. We are unclear how the commission can make such a claim when, as our letter report points out, it does not consistently appraise the value of its land to determine what a fair rental amount would be. As noted on page 8 of our letter report, the commission did not perform appraisals on four of the five leases we reviewed. These four leases generated annual rents between $32,000 and $196,000. Further, between five and 12 years had passed since their previous appraisal.

③ The commission claims that issuing timely notices to lessees about their expiring lease agreements are important, but then seems to distance itself from this statement by explaining that its related procedures were never meant to establish hard deadlines for when notices were to be mailed. We question this explanation and the value of the commission's procedures if, in general, commission staff need not follow them. As we indicate on page 6 of our letter report, the commission's letters were between five and 10 months late. In one instance, the commission notified the lessee only after the lease agreement had expired.

④ The commission misses our point. As we state on page 7, the commission's current practices exposes it to criticism that it is selectively enforcing the terms of its lease agreements. The commission either needs to consistently follow the terms of its lease agreements and increase rent by 25 percent once the lease has expired until it is renegotiated, or it needs to reconsider the lease terms it places it its agreements.

⑤ The commission's response downplays our critique on page 6 that the State both loses revenue and does not provide any incentive for a lessee to promptly renegotiate their expired lease until, as the commission states in its response, all amounts due are "trued up" upon the authorization of a new lease agreement.