State Lands Commission

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

REPORT NUMBER 2010-125, ISSUED AUGUST 2011

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lease agreements allow, and when it does conduct appraisals, it sometimes undervalues its properties because it uses outdated methods, some of which were established more than 18 years ago.

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

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

In the report, the California State Auditor (state auditor) made the following recommendations to the commission. The state auditor's determination regarding the current status of recommendations is based on the commission's response to the state auditor as of August 2012.

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

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

Commission's Action: Fully implemented.

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

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

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

Commission's Action: Fully implemented.

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

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

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

Commission's Action: Fully implemented.

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

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

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

Commission's Action: Partially implemented.

The commission determined that it would need special legislation to obtain individual lessee social security numbers in order to participate in the Franchise Tax Board Interagency Intercept Collections program. It also stated that it determined that the liability risks, legal requirements, and obligations to keep such private information safe from disclosure outweigh the potential benefits of obtaining such authority to request that kind of information. However, the commission indicated that it has intensified the collection efforts currently available and it has reduced outstanding past due account receivable significantly. According to the commission, the June 2012 total is $868,000 compared to the $1.2 million identified in the state auditor's report and recent actions will reduce the total by another $225,000. The commission stated that it is confident this trend will continue and that the addition of the lease compliance positions in the fiscal year 2012–13 budget will further enhance these efforts.

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

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

Commission's Action: Fully implemented.

The commission believes that its new holdover reduction procedures are effective with the result that the number of leases in holdover has decreased by 75 percent. As of August 2012 the commission indicated that 27 of the 32 holdover leases identified in the state auditor's report have been eliminated from holdover status.

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

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

Commission's Action: Fully implemented.

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

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

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

Commission's Action: Fully implemented.

The commission stated that it updated a rent review checklist and now requires staff to pull lease files one year in advance of the rent review date rather than nine months. It also indicated that it has a process in place that prioritizes rent reviews for high value or otherwise significant issues. Further, the commission requested and received five additional staff for lease compliance purposes and to accommodate the rent review workload.

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

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

Commission's Action: Fully implemented.

The commission provided its rent review policies and procedures that include time standards for each step in the rent review process, including appraisals.

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

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

Commission's Action: Fully implemented.

The commission provided policies and procedures that instructed staff to focus on managing the higher revenue-generating leases.

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

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

Commission's Action: Fully implemented.

The commission stated that it is moving forward with a more expanded use of the Consumer Price Index (CPI) in calculating annual rent revisions. In November 2011, according to the commission, it consolidated and simplified the CPI process by using the California CPI as the sole index where feasible on a going-forward basis. Additionally, as indicated for recommendation 1.4.a, the commission received additional staffing that will ensure the five-year rent reviews and appraisals are completed on schedule.

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

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

Commission's Action: No action taken.

➲ The commission indicated that the aggressive strategies it has implemented should preclude the need for the use of a special deposit fund. Additionally, the commission stated that implementing this recommendation would undermine the leverage achieved by the 25 percent rental increase for holdover leases.

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

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

Commission's Action: Fully implemented.

The commission stated that it reorganized its structure to provide for more direct management of appraisal staff. As part of this, the commission updated it appraisal request form and it was released with a memo from management on how to complete the form. The memo also instructed staff to submit an appraisal request, even in areas where a benchmark is available, if there is reason to believe that a land value appraisal would result in a higher rent than the benchmark. The commission believes that these steps have and will continue to improve the coordination and communication between leasing staff and appraisal staff and ensure that appraisals are completed as frequently as the lease provisions allow (generally every five years). However, according to the commission, implementation of these measures will be temporarily affected by the current lack of appraisal staff, although it hopes to fill two appraisal positions by late summer or early fall of 2012.

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

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

Commission's Action: Fully implemented.

The commission indicated that the Land Management Division (land management) has directed staff to request sales comparison appraisals for all high value leases. Additionally, it indicated that to improve the coordination of leasing and appraisal staff, land management has reorganized its structure to provide for more direct supervision and management of appraisal staff. In December 2011, the commission issued a memo revising the appraisal process.

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

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

Commission's Action: Partially implemented.

The commission stated that it is moving forward with the regulatory process to revise and update the regulations regarding rents, including those for pipelines. The commission plans to submit its regulatory package to the Office of Administrative Law in September 2012. As part of these regulations, the commission is recommending an increase in pipeline rent from 2 cents per diameter inch per linear foot of pipeline to 5 cents.

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

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

Commission's Action: Partially implemented.

The commission asserted that it updated all benchmarks other than the Black Point and the Lake Tahoe residential benchmarks. The commission indicated that it plans to complete these benchmarks when the appraisal unit is fully staffed.

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

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

Commission's Action: Fully implemented.

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

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

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

Commission's Action: Fully implemented.

The commission indicated that the accuracy of the information included in its database continues to improve. According to the commission, as part of its quality control process, the two staff entering data into ALID verify and validate the other's data entry. In addition, the commission stated that other staff have been assigned to audit and validate the information in ALID and management within land management review all input and routinely access the database. The commission also indicated that it participated in a round table discussion with numerous other state agencies that manage significant land holdings and that part of the discussion was devoted to best practices for tracking state properties. Finally, the commission stated that it is currently upgrading the database from MS Access to a net web interface to improve accessibility by all staff.

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

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

Commission's Action: Fully implemented.

The commission created five new management reports from information contained in ALID, including four specific reports related to rent reviews, expiring leases, holdover leases, and bond/insurance status, in addition to one master report containing general lease information. It believes that these types of reports should preclude the need for multiple lists and data sources that were kept by staff in the past. The commission asserted that these reports will better assist management in tracking leases and prioritizing lease compliance issues. The commission believes that such a reporting capability should preclude the need for multiple lists and data sources.

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

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

Commission's Action: Fully implemented.

The commission developed an audit plan for all mineral leases that considers a combination of factors, including risk. In addition, the commission tracks and submits quarterly reports to the executive officer on the status of findings for the completed audits. It believes that this process will help staff track its findings identified in audits and any associated recoveries. Finally, the commission indicated that it is in the process of hiring auditors and training them in oil and gas operations and the audit process.

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

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

Commission's Action: Fully implemented.

The commission stated that staff will continue to work with lessees when the opportunity arises to implement the recommendation where appropriate and when it is in the best interests of the State.

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

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

Commission's Action: Fully implemented.

The commission is currently contracting with an outside consulting firm to audit one of its oil and gas leases. The commission believes that because this approach has proven to be successful, it will continue to be an option.

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

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

Commission's Action: Partially implemented.

State law approved in August 2012 requires the commission to prepare a workload analysis to ensure that it is fulfilling its oversight responsibilities over public trust lands. In addition, according to the commission, it is exploring potential funding sources for its granted lands program pursuant to a request by the Senate and Assembly Budget committees. The commission also indicated that the executive officer has directed a reorganization of those currently working on granted lands issues within a new External Affairs Division. This reorganization is intended to focus attention to this area and result in closer coordination between all divisions on granted lands issues. Finally, the commission asserted that on a limited basis given its constrained resources, it is improving outreach to local trustees and to assist them with their waterfront revitalization programs.

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

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

Commission's Action: Partially implemented.

The commission indicated that, in accordance with the specific language of the recommendation, it has already implemented the recommendation as it relates to the commission's offshore oil and gas leases and that bondsmen are required to give at least a 90-day notice (some are longer) before they can terminate a bond. According to the commission, it also requires that the offshore lessees show evidence of current bonding and insurance or a replacement bond for any expiring or terminating bond at the annual meetings with all lessees. For its surface leases, the commission stated that it has contacted federal, state, and local agencies with leasing responsibilities, both in California and in other states, and found that many agencies do not require insurance of any kind when leasing to private individuals. The commission also indicated that those that do require insurance communicated significant difficulty in obtaining insurance compliance. In addition, according to the commission, its communications with the insurance industry indicate there is no stand-alone product available that covers recreational piers.

The commission indicated that it has researched the availability of insurance in the California market and found that insurance companies are reluctant to name the State as an additional insured and to provide notice of cancellation to the State. According to the commission, in some instances lessees can obtain insurance, but this appears to be an exception that the companies make to retain clients with large insurance portfolios. However, the commission stated it is exploring other options including strengthening the indemnity provisions in the lease language, contacting the insurance industry and educating them on the market for an insurance product that covers recreational piers, and contacting various insurance companies and attempting to create a pilot program providing insurance coverage.

Legislative Action: Unknown.

The state auditor is not aware of any action taken by the Legislature as of December 18, 2012.

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

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

Commission's Action: Fully implemented.

The commission conducted workload analyses that it included as part of its request for additional staff. Moreover, Chapter 206, Statutes of 2012 (Assembly Bill 2620), among other things, requires the commission, on or before September 1, 2013, to prepare a workload analysis that summarizes the resources necessary for the commission to fulfill its oversight responsibilities related to legislatively granted public trust lands.

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

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

Commission's Action: Fully implemented.

The commission asserted that it has been able to secure a management fee in certain oil, gas, and geothermal producers as well as larger industrial leases to recoup actual costs. It also stated that it is conducting a workload analysis to quantify staff duties as part of its foundational research to establish new minimum rent levels. The commission indicated that the goal in establishing minimum rents based on this methodology is to ensure that most of the lease maintenance costs not currently captured would at least be offset by annual rents and make administration of these leases cost neutral to the State's General Fund.

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

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

Commission's Action: Fully implemented.

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

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

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

Commission's Action: Fully implemented.

The commission has developed a draft succession plan and it stated that the succession plan will be updated upon completion of its strategic plan by the end of the year.