Assembly Budget Committee
Subcommittee No. 3 on Resources and Transportation
Assemblymember Richard S. Gordon, Chair
November 1, 2011
State Capitol, Room 437
1:30 p.m.

OVERSIGHT HEARING

SUBJECT:	State Lands Commission's Management of Public Land Leases
1:30 – 1:40	Introductions/Opening remarks from Assemblymember Richard S. Gordon and Assemblymember Ricardo Lara
1:40 – 2:10	**Summary of State Lands Commission Audit, Bureau of State Audits** Doug Cordiner, Chief Deputy State Auditor
2:10 – 2:40	**State Lands Commission Response to Audit** David Brown, Chief of Administration and Information Services Division Brian Bugsch, Chief of Land Management Division Jennifer Lucchesi, Chief Counsel Alan Gordon, Deputy State Controller, Environmental Policy
2:40 – 3:10	Questions & Answers of State Lands Commission regarding audit findings and proposed action plan
3:10 – 3:30	Public Comment
3:30	Adjournment

BACKGROUND

The State Lands Commission (commission) is responsible for managing the lands that the State acquired from the federal government at statehood, including the beds of navigable rivers and lakes, submerged land along the State's coast, and school lands granted to the State for the benefit of public education. The commission's management of these lands provides the State with revenues from leases and from the State's share of net profits derived from activities conducted on state lands. While most of the revenue generated by these lands is deposited in the State's General Fund, revenue from school lands must be used to benefit the State Teacher's Retirement System.

The commission is principally a land and resource management agency, not a regulatory agency. A primary function of commission staff is to negotiate leases and contracts for the use of the State's property and resources. The commission manages the State's sovereign public trust lands, which include approximately 120 rivers and sloughs, 40 lakes, and lands along over 1000 miles of coastline underlying the Pacific Ocean out three miles, together encompassing approximately four million acres. The commission also manages 489,000+ acres of school lands and another 790,000+ acres of state-owned mineral rights.

The commission consists of three members (commissioners): the lieutenant governor, who is chair; the state controller; and the director of the Department of Finance. The commissioners appoint an executive officer who manages the commission's daily operations and more than 200 employees who support the commissioners. The commission has six divisions: Legal; Marine Facilities; Mineral Resources Management; Land Management; Environmental Planning and Management; and Administrative and Information Services.

The commission's budget is $29.9 million for fiscal year 2011-12, including $9.9 million from the General Fund. According to the commission's financial statements, the commission collected roughly $400 million in rents and royalties during fiscal year 2010-2011. The majority of these revenues were generated by oil leases and deposited into the General Fund. Of the 4,000 leases the commission manages: 85 are oil and gas, geothermal, and mineral leases; 900 are agricultural, commercial, industrial, right-of-way, and recreational; 3,200 are rent-free leases (private recreational piers and public agency use permits). Three divisions at the commission have a role in managing leases: Land Management; Mineral Resources; and Legal. Since 1990, the land management and legal divisions have experienced staffing reductions of 50%, while the resources division has been reduced by 32%.

In August 2010, the Joint Legislative Audit Committee requested the Bureau of State Auditor to perform an audit of the commission's management of leases. The findings of the August 2011 Auditor's report, as well as the commission's response, are discussed below. Attached is a chart which details the Auditor's recommendations and the commission's response and proposed audit action plan.

STATE AUDITOR REPORT CONCLUSION:

The commission has not always managed its more than 4,000 leases in the State's best interest with the result that it has missed opportunities to generate millions of dollars in revenues for the State's General Fund.

REPORT HIGHLIGHTS:

Review of the commission's management of leases disclosed that the commission:

- Does not have policies and procedures specifying steps needed for managing leases and is ineffective or inconsistent in seeking payment from or evicting lessees whose rent is past due.

- Has missed opportunities to generate millions of dollars in revenues for the State's General Fund - estimated to be as much as $8.2 million for just some of the leases reviewed (35 of the commission's nearly 1,000 revenue-generating leases reviewed).

  - Does not always evict delinquent lessees - estimated losses totaling $1.6 million for 10 delinquent leases (more than $600,000 in principal and $1 million in penalties and interest) reviewed. More than 10% of the revenue-generating leases were past due on rent and yet some of the lessees have remained on state land without paying rent for up to 22 years.
    - Crockett Marine Services, Incorporated has not paid rent since 1989, costing the state up to $622,000 for this one lease alone. The commission found out only after the Auditor inquired about the lease that Crockett had been subleasing the land to another party and collecting rent.
    - The commission states that it does not consistently take action against delinquent lessees because litigation is too costly and staff intensive, yet has not conducted a cost benefit analysis to determine when it would be beneficial to pursue such delinquent lessees.
  - Does not take timely action to renew its expired leases, conduct rent reviews, or appraise properties.
    - As of December 2010, about 140 of its nearly 1,000 revenue-generating leases had expired and are in holdover - leases that have not been extended or renewed. While in holdover, lessees continue to pay the rental amount from the expired lease.
    - The commission lost up to an estimated $269,000 for 10 leases reviewed that are currently in holdover.
    - The commission has failed to enforce a general provision in most leases that allows it to charge the lessee an additional 25% until the commission and the lessee agree to a new lease.

- However, since November 2010, the commission has developed a procedure for "significant" leases (annual rent of more than $10,000) whereby it begins the renewal process for these leases up to 27 months before the lease is due to expire.

- Lost $6.3 million in increased rent that it may have been able to receive on a sample of leases (18 of the 35 leases in the sample) because it failed to promptly conduct rent reviews, which frequently result in increased rent amounts.
  - Nearly all leases contain language that allows the commission to increase the rental amount through a rental review every 5 years. The Auditor found that several of the leases reviewed had not had appraisals conducted in more than 15 years.
  - For example, the commission did not perform a rent review from 2000 through 2010 for one of its leases with Pacific Gas and Electric Company. The State Auditor estimates that during those 10 years, the commission could have collected an additional $1.1 million from this lessee if it had conducted its rent review every 5 years. The report also estimates that the commission could have collected an additional $2.4 million from Chevron had it conducted the rent review earlier.
  - The State Auditor's 1984 audit report titled "Review of the State Lands commission's Management of State Land," identified similar problems with the commission's rent review process.
  - The commission states that it failed to perform timely reviews due to staffing shortages.

- May be losing up to $174,000 each year for a sample of seven pipeline leases reviewed because it has not updated the rate in regulations to use when calculating rent for such leases in 30 years.
  - The commission currently charges an average of 50 cents per linear foot as the annual rental for pipeline and conduit leases.
  - Three comparison states reviewed by the audit revealed the other states charged an average of $1.90 per linear foot.

- Does not have a plan for monitoring its nearly 1,000 revenue-generating leases, in particular those leases that are potentially the most profitable, because they involve the extraction of oil and gas from state properties.
  - The commission has completed only two audits since 2008, neither of which were for oil and gas leases. Thus, the commission is not ensuring that the State is receiving the appropriate amount of revenue from its revenue-generating leases.

- Is not appropriately tracking the status of some of its leases. Its Application Lease Information Database has inaccurate and incomplete data that staff does not always use to track lease information.
    - The report documents one lease with an incorrect rental amount, one lease with an incorrect lease expiration date, three leases with a blank or incorrect review date, three leases with outdate lease terms even though each lease had been renegotiated, and five lease with blank or incorrect lease tickler dates. Further, the commission tracking methods had no controls to ensure the information's accuracy.
    - The audit found that each division has developed its own method of tracking leases, resulting in the commission not appropriately tracking the status of some leases.
    - The audit found that the commission had 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.

- Has not taken sufficient steps to quantify its need for additional staff.
    - The commission has not developed any analyses to determine an appropriate workload nor has it developed a succession plan to address its future workforce needs.

- Does not consistently audit its 85 oil, gas, minerals, and other natural resources leases—even though these audits can result in millions of dollars in revenue for the state.
    - In 2008, the commission reported that it recovered or saved nearly $22 million between 2004 and 2007 as a result of audits and reviews for oil and gas leases, yet it has completed only two audits since 2008, neither of which were for oil and gas leases.
    - The Mineral Resources Management Division acknowledged that due to insufficient staff, the commission has conducted monitoring activities only in reaction to discovered problems rather than based on any proactive monitoring schedule.

- Does not conduct any audits of properties granted to local governments to ensure that they spend the funds generated from those lands in accordance with applicable laws and doctrines.
    - The commission indicated that it does not have the staff to ensure that grantees are expending funds appropriately and does not direct limited resources toward auditing granted lands because these audits do not generate revenue for the State.
    - However, without oversight of granted lands, the commission is neglecting its responsibility to protect the public trust.

- Does not ensure that its leases maintain current surety bonds and liability insurance, putting the State at risk of financial loss should a claim result from an accident that occurs on state property.
  - The audit found that for 21 of the 35 leases reviewed, either the surety bond or liability insurance or both had expired

COMMISSION RESPONSE TO AUDIT

The commission has stated that it believes many of the recommendations would enhance the ability of the commission and its staff to carry out its duties. It also believes that the restoration of a number of positions cut by prior administrations from the commission's staff would result in substantially higher returns to the State's General Fund and State Teachers' Retirement System.

Since 1990, the commission's core revenue producing and resource management programs have been continually reduced, of 242 General Fund positions that existed in 1990, only 63.2 remain. According to the commission, those losses included positions that performed royalty accounting, lease rental billings, revenue receipts, auditing and oil field management. They also included positions that were responsible for appraisals, lease management and compliance, enforcement, trespass investigations, litigation and ejectments.

Further, the commission states that despite losing 74% of its General Fund-supported positions since 1991 (from 242 to 63.2), the commission has earned revenues over $3.8 billion, increasing annual revenues by 135%, from $181 million (1990-91) to more than $426 million (2010-11). In particular, over the same period (1990-2010), the Land Management Division has increased its annual surface rental revenue 384% from $3.8 million to $18.4 million.

According to the commission, staff was able to achieve these increases despite a 47% reduction (37 positions lost) by effectively managing and triaging its many responsibilities, focusing on improving revenues, while still fulfilling its responsibilities to protect the Public Trust. During this same time period, the Legal Division has been reduced by over 50% and currently has only eight attorneys, seven of which are dedicated to supporting the management and enforcement of the commission's 4,000 leases, as well as, investigating and litigating incidences of trespass, in addition to their other responsibilities.

The commission argues that the audit report does "not fairly represent the commission's past or ongoing efforts in managing the public lands and resources in the state's best interest." It states that "staff has been resourceful in adjusting to circumstances beyond its control (declining staff) that have impacted the ability to employ many methods and practices which commission staff had followed in the past. These adjustments… were designed to achieve optimal lease revenues by making accommodation for and realignment of lease management priorities."

The commission also argues that the sample 35 leases reviewed are not a representative sample of State Lands Commission leases, but rather a subjectively selected list of leases chosen to highlight specific problem areas. The commission believes the examples of mistakes and failures to take action on leases in holdover or delinquent in rent payments from the 35 leases distort the bigger picture of commission successes. For example, the report included 4 marine terminal leases, yet such leases represent a miniscule fraction of the commission's total leases. The delay in finalizing negotiations on these leases was to ensure that the marine oil terminal facilities were required to undergo detailed environmental review to evaluate the potential of significant impacts from an oil spill. Thus, the delay resulted in state's best long-term interest.

Auditor's Comments on the Response from State Lands Commission

The Auditor believes the report accurately reflects the commission's past and ongoing difficulties with effectively managing and monitoring its leases. Further, the Auditor states that while it would have liked to have used information from the ALID system instead of the 35 sample leases, a review of the data included in ALID found significant errors, thus it was determined it could not be used. The Auditor disagrees with the commission's belief that leases were selected to highlight specific problem areas because it could not have known what would be found before examining the lease files. Ultimately, the Auditor's review of these files identified that the commission appropriately performed timely rent renewals, rent reviews, appraisals, and collected rent for only one of the 35 leases reviewed. Thus, the Auditor believes that the fact that systemic problems were found related to 34 of these various types of leases (commercial, marine terminal, and recreational leases) provides evidence that these problems are not isolated to the 35 samples.

Comments

The Auditor's report revealed the commission has seriously mismanaged some of it leases, resulting in lost revenues for the State's General Fund. While there is debate over how much revenue has been lost and whether the cause of the deficiencies are due to procedural or inadequate staff, the commission has agreed and is working toward implementing most of the Auditor's recommendations.

Reductions to commission staffing have undoubtedly contributed to the problem. The commission's core revenue producing and resource management programs have been cut by 74% since 1990. However, given the current state of the General Fund, it would be prudent of the commission to heed the Auditor's recommendation to focus on the high-value leases to maximize revenue returns within existing resources for the balance of this year. This will allow the Committee to consider SLC’s staffing for this function in next year’s budget deliberations. The Committee may consider directing the SLC to work with the Legislative Analyst's Office on developing its workload analysis as it relates to the deficiencies identified in the Auditor's report.

Given that the restoration of a number of positions cut by prior administrations from the commission’s staff would result in substantially higher returns to the State’s General Fund and State Teachers’ Retirement System, the Committee may also wish to treat SLC as a revenue generating agency.