

INFORMATIONAL

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**THE COMMISSION STAFF'S REPORT
ON ITS AUDIT ACTION PLAN IN RESPONSE
TO THE COMMISSION'S DIRECTION**

PARTY:

California State Lands Commission
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BACKGROUND:

At its meeting on September 1, 2011, the Commission directed staff to prepare an action plan to address the findings of the Bureau of State Audits August 2011 Report 2010-125 regarding the Commission's management of leases of state property. The enclosed report is in response to that direction.

EXHIBIT:

- A. 2011 Audit Action Plan; "A Report by the Staff of the California State Lands Commission"

EXHIBIT A
2011 Audit Action Plan
A Report by the Staff of the California State Lands Commission

At the request of the Joint Legislative Audit Committee in July 2010, the California Bureau of State Audits (Bureau) conducted an audit and prepared a report concerning the State Lands Commission's (Commission) management of leases of State property. In response to the Bureau's recommendations and the Commission's direction, the Commission's staff has prepared this Audit Action Plan to address the various deficiencies and recommendations included in the Bureau's August 2011 Report 2010-125.

Background

The Commission was created by the California Legislature in 1938 as an independent body, composed of three members - the Lieutenant Governor and State Controller, both statewide elected officials, and the Director of Finance, an appointee of the Governor. The Commission was given the authority and responsibility to manage and protect the important natural and cultural resources on public lands within the State and the public's rights to access such lands. The Commission was created in response to disclosures of corruption and fraudulent practices in the management of oil, gas, and other mineral resources belonging to the State. After extensive investigation, it was determined that the abuse in the management of those resources was so great that there should be greater political accountability. Hence the three-member Commission was created. Since its inception, the Commission has managed the resources of the State without a hint of malfeasance or scandal. In its 73-year history, the Commission has generated revenues for the public benefit approaching \$10 billion.

Commission staff strives to balance the goals of maximizing the return on the use of State sovereign and school lands and resources entrusted to its care with providing the highest possible level of environmental and resource enhancement and protection of these lands for current and future generations. While the Commission was granted some regulatory functions in the last twenty years, principally it is a land and resource management agency, not a regulatory agency. A primary function of the 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 tide and submerged lands within bays, estuaries (including the Sacramento/San Joaquin Delta) and lands along over 1,000 miles of coastline underlying the Pacific out 3 miles, together encompassing approximately 4 million acres. The Commission also manages 489,000+ acres of school lands and another 790,000+ of state-owned mineral rights. For context, the land area under the management control of the Commission is greater than the combined areas of the states of Connecticut and Delaware combined, including their water covered lands.

The lands and resources managed by the Commission are diverse and range from commercially valuable minerals such as oil, natural gas, hard rock minerals, sand, gravel, and geothermal steam to unique natural resources such as forests, grazing lands, wetlands, riparian vegetation,

and fish and wildlife habitat. Enactment of the Lempert-Keene-Seastrand Oil Spill Prevention and Response Act of 1990 expanded the Commission's jurisdiction over marine oil facilities. Additional responsibilities were added in 1999 for ballast water management to control introduction of non-indigenous species by marine vessels from foreign waters.

The Commission's staff is organized into six divisions, including the Land Management Division (LMD), the Mineral Resources Management (MRMD), the Marine Facilities Division (MFD), the Division of Environmental and Planning Management (DEPM), the Administrative and Information Services Division (AISD) and the Legal Division, all of which are under the leadership of the Executive Officer. While the Commission is the ultimate decision maker on proposed actions, including leases brought before it, it is the staff that has the day-to-day responsibility to make recommendations to the Commission and carry out the Commission's directives.

Staffing

Since 1990, the Commission's staff has been subjected to a continual erosion of its General Fund positions. Regulatory programs have been added to the Commission's responsibilities, as described above, accompanied by special fund appropriations, however the core revenue producing and resource management programs that existed in 1990 have been continually reduced. Of the 242 General Fund positions that existed in 1990, only 63.2 remain today. These lost positions performed royalty accounting, lease rental billings, revenue receipts, auditing and oil field management. These also included positions that were responsible for appraisals, lease management and compliance, enforcement, trespass investigations, litigation and ejections. These lost positions are those which performed those activities for which the Commission is now being criticized for not performing effectively. However, over this same period, through careful prioritization of activities to maintain its income stream, the Commission has continued to earn revenues of over \$3.8 billion.

Commission staff appreciates the Bureau report's findings regarding staffing and the significant impact of the severe General Fund position reductions. As noted in Chapter 3 of the report:

“Significant reductions in staff have hindered the commission's ability to conduct activities necessary to ensure that the State receives appropriate revenues and that lessees comply with lease terms.”

Across-the-board staff reductions by prior administrations in response to General Fund deficits have reduced positions responsible for programs of revenue production and lease compliance to only 26% of what it was twenty years ago. Repeated requests for additional staffing have gone unheeded. Several past budget requests have been submitted directly addressing those deficiencies that have now been identified in the Bureau's audit findings. The Commission staff also identified this loss of staffing as major risks in its 2009 biennial Financial Integrity and State Managers Accountability Act (FISMA) Report in regards to both the erosion of General Fund positions and the depletion of the Audit program.

The procedural and process improvement recommendations in the Bureau's report can only impact the deficiencies noted to the extent that adequate staff resources are available to implement and carry out the work. The simple fact is that a program cannot sustain staff reductions on the scale experienced by the Commission with the expectation that there will be no adverse impact on the activities necessary to carry out those program responsibilities, including the generation of non-tax revenues to the General Fund. The requests outlined below are the beginning of the Commission identifying where additional resources are necessary and where those resources are most urgently needed.

- **Royalty Recovery and Revenue Assurance** –The report criticizes the Commission's audit program for not having a plan in place to regularly review the various revenue producing oil and gas leases. While there is some disagreement with the audit's findings as to the existence of such planning, the simple fact is that given the current level of audit staffing any such plan is virtually impossible to carry out. The report is correct in observing that current activities address only the most urgent lease and royalty issues and leave little time for routine audits. Commission Staff has submitted a request for four Auditors and a Staff Services Analyst to re-staff the Commission's audit program. This level of staffing will result in a regular audit cycle with sufficient staffing to address urgent lease royalty matters while ensuring that all major revenue producing leases are audited at least once every 5 years with the more significant leases being reviewed every 3 years. Commission staff feels confident that with additional staffing, the Commission's audit program will be effective, as exemplified by a single limited term position from 2006 to 2008 which resulted in a 10:1 return ratio (over \$1 Million) as reported in a 2008 Supplemental Report to the Legislature entitled "Mineral and Land Audit Report". Without additional staffing, remaining resources will be reactive and devoted to urgent issues as they arise with little remedy to the situation described in the audit report.
- **Lease Compliance and Revenue Enhancement** – The Bureau's report was critical of Commission staff's inability to provide current appraisals for rent reviews as well as conducting those rent reviews in a timely manner. Additionally, the report observed that bonding and insurance certificates were not routinely reviewed to ensure that they were currently in force or of adequate amount to protect the State's interests. Many positions responsible for these activities were eliminated in the early part of the prior decade. A budget augmentation did occur to specifically address these issues in 2003-04, but were eliminated within two years of the augmentation by an across-the-board reduction. Over this same period appraisal staff was reduced to one position for the entire organization.

Commission staff has requested to reestablish positions to specifically address those deficiencies. One position will supplement current appraisal capabilities ensuring that appraisals are available for timely rent reviews. Four Public Land Management Specialist positions were requested to ensure that leases are in compliance with terms and conditions, including that improvements on state property are in a safe condition and good repair. These positions will also be responsible to determine appropriate uses of the State's property, provide timely review of rents pursuant to lease terms and ensure that bonds and insurance policies are maintained at appropriate levels to protect the State

from liability. To support these efforts, an additional Accounting staff position was requested to pursue delinquent lessees, as well as request for a Staff Counsel position to provide legal support, advice and enforcement.

- **Tidelands Trust Compliance Program (Statutory Trust Grants)** – At present, the Commission has only one full-time dedicated position to oversee the compliance of 85 local government entities (trustees) with the terms of their statutory trust grants and the common law Public Trust Doctrine. These trustees, includes some of the State’s major ports of San Diego, Long Beach, Los Angeles, San Francisco and Oakland, which were given the day to day management over state sovereign lands to develop and manage the lands on behalf of the State.

The report observed that the Commission’s staff “has taken a reactive approach to carrying out its oversight responsibilities of granted lands by only responding to allegations of improper use of funds rather than proactively identifying and preventing misuse through periodic monitoring.” Even this ability has been severely hampered by elimination of positions. The present situation evolved in response to diminishing staff resources and an emphasis by Commission management on direct revenue producing activities for its General Fund staff. The continual across the board reductions in the 1990’s eroded the ability of staff to address granted lands issues to near non-existence. A budget augmentation in 1999 (2 positions) resulted in a brief period of activity and the effort was beginning to develop a plan to ensure that the required financial statements were submitted by all trustees and that trustees were made aware of their management obligations pursuant to their statutory trust grants and the common law Public Trust Doctrine. This period of staffing however was short-lived and subsequent across the board reductions resulted in the current one staff position dedicated to overseeing all 85 statutory trust grants.

Commission staff have requested seven positions including two Auditor positions to review and audit a trustee’s trust fund accounts and financial statements, as provided for in Public Resources Code §6306, two Public Land Management Specialist positions, an Associate Boundary Officer position and a Staff Counsel position to provide oversight and assistance to trustees to ensure compliance with their statutory trust grants.

It is critical to the economic revitalization of California that Public Trust revenues generated by some of the most valuable assets of the State are appropriately devoted to those lands from which they were generated and to thereby facilitate waterfront redevelopment projects and trade and commerce infrastructure necessary for the State’s future economic needs. Without such augmentation, the efforts of the Commission staff will continue to be in reaction only to those most egregious trust violation accusations brought to its attention.

The foregoing requests represent to most urgent staffing needs necessary to address those areas deficient in resources necessary to sustain effective program levels as delineated in the Bureau’s report. Staff also recognizes the need to effectively quantify its overall staffing needs and will continue to analyze workload and program outputs and results as suggested in the report.

Audit Report Recommendations

In addition to determination of the adequacy of Commission staffing, the recommendations provided in the Bureau's report addressed six general areas of concern. These areas include:

- Delinquent Leases and General Lease Compliance
- Holdovers
- Missed Rent Reviews
- Audit Cycles for Leases
- Statutory Trust Grants Oversight
- Lease Database

Below is a brief discussion of how each area has and is being addressed, as well as a summary of the current status.

Delinquent Leases/General Lease Compliance

A comprehensive review of the aged Accounts Receivable is being conducted. Leases identified as being chronically past due (several years in arrears) have been identified by AISD and LMD staff. Additionally, LMD staff is identifying those leases that are known to be out of compliance with their lease terms and conditions. These identified non-compliant leases will be prioritized by a management group comprised of the Executive Officer, Chief of AISD, Chief of LMD and the Chief Counsel. Each delinquent or non-compliant lease will be addressed until resolved, as resources and staffing allows. On a going forward basis, AISD staff will continue to send out 30, 60, 90 day past due letters for any lease for which rent payments are overdue.

For future delinquent and non-compliant leases, a procedure is under development to address coordination between LMD, AISD and the Legal Division when the lease delinquency goes beyond 90 days or where there are other lease compliance concerns. This will include an analysis as to whether the particular lessee is in compliance with its lease terms and conditions and will be considered by the aforementioned management group for prioritization. Their recommendations will then result in taking whatever action will be deemed appropriate, including requesting Commission authorization to litigate as appropriate, and referring the case to the Attorney General's Office. This procedure is expected to be in place by November 1, 2011. Additionally, Commission staff is currently pursuing other possible remedies or practices for resolving delinquent leases such as participation in the State Intercept Program, as well as outside collection agencies, and, for lease compliance issues, options such as penalties for failure to maintain adequate insurance.

Holdovers

As the Bureau's report points out, in a November 2010 memo, the Commission staff implemented a holdover reduction procedure aimed at reducing the number of leases that go into holdover and the length of time those leases remain in holdover, as well as to prevent new leases from going into holdover status. The Bureau's report stated that "these new procedures appear reasonable" and recommended staff continue to implement them. The report went on to caveat that because it was such a new process the Bureau was unable to determine if the new process

would be effective. This process has now been in place nearly one year and has proven its success.

Since November 2010, staff has continued to build upon its holdover reduction process. In March 2011, staff: (1) finalized the language for the holdover notification letters for both significant and routine leases as laid out in its holdover reduction procedure; (2) finalized language and formalized the practice of including '2-year lease renewal notification provisions in the more significant leases; and (3) finalized the holdover checklist, which identifies the steps and timeframes to be followed by staff. LMD management also continues to hold monthly meetings to discuss the status of holdovers and those leases assigned to contingent receivables. All of these items were discussed in the November 2010 holdover reduction procedures.

As was detailed in the Commission staff's response to the Bureau's report, in August 2010 there were 32 leases in holdover status with annual rent greater than \$10,000. As of today, 24 of these 32 holdover leases (75 percent) have been eliminated with only 8 leases remaining in holdover status with annual rent greater than \$10,000. One lease (Selby Slag) involves an ongoing environmental clean-up obligation and will remain in its holdover status indefinitely. Another lease (Chevron Estero) is in non-operational caretaker status and should be taken off the holdover list once a determination is made as to its final disposition. Four of the remaining six are expected to go to the Commission for consideration in the next eight months. The GP Gypsum lease is scheduled to be considered by the Commission at its October 27, 2011 meeting. The PG&E pipeline master lease is expected to be considered by the Commission in December 2011, and the NuStar Marine Oil Terminal is expected to be considered in early 2012. The Kinder Morgan pipeline master lease is expected to be considered by the Commission in mid-2012. Staff recently received the applications for the two Tesoro marine oil terminals. With the environmental review required to process these applications, it will likely be a few years before these leases can be considered by the Commission. However, rent reviews were conducted in June 2011 and rent rates and payments are up to date for those two leases.

Rent Reviews

Commission staff has continued to develop and refine its rent review process. In late 2010, leases due for rent reviews began being pulled one year in advance as opposed to 9 months in advance. In April 2011, the rent review checklist, which identifies steps and timeframes for staff to adhere to, was updated. These changes have been effective in helping staff complete rent reviews in a timely fashion.

Commission staff is moving forward with the regulatory process to thoroughly revise and update § 2003 of Title 2 of the California Code of regulations dealing with rent. Commission staff had delayed progress on this action in hopes that the Bureau's report would provide additional insight and recommendations, but the report only reiterated the information staff provided the Bureau based on staff's own research and analysis at the time.

Staff continues to move forward with a more expanded use of the consumer price index (CPI) in calculating annual rent revisions. Staff will be recommending to the Commission the expanded use of the CPI in most high-value commercial use, industrial use, and right-of-way use leases on a going-forward basis. Staff is also exploring the use of the CPI in lower value leases to assist in

streamlining the rent review process. Also, in December 2010, staff developed an LMD-AISD procedure to facilitate and ensure CPI-indexed rent changes are updated to the Commission staff's lease database (ALID). Staff has also updated and consolidated the San Francisco and Marin County Benchmarks and is progressing on the scheduled periodic updates of the other Benchmarks.

Audit Cycles for Leases

MRMD staff is responsible for auditing oil and gas, geothermal and solid mineral leases. Over the past several years, due to significant reduction in auditor positions, staff has not been able to implement an audit schedule/plan. Instead, most of staff's efforts have been focused on auditing leases with an identified problem in royalty payments or in response to assignments or other changes requested by lessees. As a result of the Bureau's report, Commission staff has developed a proposed audit schedule. The audit schedule places the oil, gas, mineral, geothermal and dredging leases on a rotating audit schedule based on the following criteria:

- Mandated through Regulation
- Revenue generated from the lease
- Date and Findings of Last Audit
- Applicable Statute of Limitations
- Identified issues in royalty payments by staff
- Lease Assignments
- Notification/request by Lessee of pending changes
- Commercial/ Surface Leases

As a result, staff has developed a go-forward plan based on four categories of audit cycles. This plan will also include planning for routine activities performed by audit staff in addition to audits. It should be noted that any planned auditing frequency can only be carried out if the number of auditors requested as part of the Budget Proposal is maintained at that level. The four proposed categories are as follows:

1. Yearly
2. Every 3-3 ½ years
3. Complete first audit cycle by 2015 and then determine future audit frequency
4. Complete one audit cycle 2-3 years after start of production

Mineral Lease	Current Audit cycle (3 Auditors)	Proposed Audit cycle (7 Auditors)
Tidelands Oil Revenues: Long Beach Unit (LBU) & West Wilmington	LBU: 2 yr. period every other year w reduced scope West Wilmington: None	Yearly
High revenue generating oil and gas leases	Only as necessary for Lease Assignments or identified issues	Every 3 - 3 ½ years
LBU major capital investment projects & yearly oil price adjustments	None	Every 3 - 3 ½ years (For major projects, audit will cover multiyear project based costs)

Northern CA gas leases, low revenue generating oil, gas, solid minerals, dredging, geothermal	None - As needed for Lease Assignments or identified issues	Complete one cycle by 2015 and then determine future audit cycle based on risk
Commercial Leases	None – only most egregious high income if discrepancies identified	Perform risk assessment and determine schedule

Oversight of Statutory Trust Grants

As described previously, the Legislature has legislatively granted, in trust, much of the state’s prime waterfront lands to local governmental entities (trustees) to manage on behalf of the state. These statutory trust grants include some the state’s most important major contributors to the local, state and national economies, including the Ports of Long Beach, Los Angeles, Oakland, San Francisco and San Diego. There is currently one staff position dedicated to overseeing the management of these state lands, as well as the revenues derived from these lands, by approximately 85 local government trustees pursuant to over 300 statutes. While the trustee has the primary responsibility of administering the statutory trust grant pursuant to its terms and the common law Public Trust Doctrine on a day-to-day basis, the Commission has the statutory oversight responsibility and authority on issues relating to the management of these state trust lands and assets and the expenditures of funds derived from the use of these lands.

The Bureau’s report stated, “the commission should establish a monitoring program to ensure that the funds generated from granted lands are expended in accordance with the public trust.” Staff agrees with the report’s recommendation. However, due to the lack of resources, Commission staff has had to take a reactive approach to carrying out its oversight responsibilities by responding to allegations of improper use of lands and funds rather than proactively identifying and preventing misuse through periodic monitoring. Even in this reactive environment, Commission staff is unable investigate all allegations.

While staff is currently in the process of working with trustees to submit their annual financial reports, as required by Public Resources Code §6306, in a format that readily identifies the trustee’s trust fund and details its income and expenditures, the fact that the Commission still only has one dedicated staff position to review these reports, as well as process authorizations for expenditures of trust funds, review project proposals and respond to requests from trustees, the public and the Legislature concerning issues of appropriate uses of trust lands and revenues, prevents this program from functioning effectively. As described previously, staff has submitted a request for six positions to restore the Commission’s statutory trust grant compliance program, which will include implementing a monitoring program and developing and maintaining a close relationship with the trustees to help facilitate the appropriate management of these State trust lands and assets.

Lease Database (ALID)

Action has been taken to improve the accuracy and reliability of the data in the ALID system. Staff has been instructed to complete entry of all Commission actions into the system within 30 days of the meetings. All income-producing leases will be verified for data elements relating to rent amounts, rent review dates, lease term, and lease expiration dates. Non-income leases will be verified upon availability of staff to do so. A programmer has been assigned to work with

LMD management to develop management reports and ad hoc reporting capability that will allow ready access to data in a form and format that will be useful for decision making. This should ameliorate the need for and use of local data sources. In addition to this, investigations have begun into the availability of off-the-shelf lease/asset management software packages, either commercially available or from other governmental agencies as suggested in the report, that could provide more extensive and flexible reporting and inquiry capabilities. Particularly intriguing are cloud solutions or Software-as-a-Service (SaaS) that would require minimal development time and tremendous flexibility and are currently being used by educational institutions and local governments. Such SaaS systems provide web access and may improve public transparency as well as operational effectiveness.

Legislation/Regulation Changes

Commission staff is currently exploring and analyzing potential legislative and regulation changes as appropriate to give the Commission and its staff ample authority to implement some of the activities proposed above, including:

- Updates to the Commission's regulations (Title 2, of California Code of Regulations), beginning with § 2003 (rent)
- Imposition of a lease management fee for surface leasing
- Participation in the State Intercept Program
- Use of private collection agencies
- Penalties for failure to secure required insurance
- Administrative remedies for trespass actions

Conclusion

Even in the face of these continual staff reductions, as described throughout this Action Plan, Commission staff continues to seek opportunities to generate revenue for the State for the private or commercial use of the State's property. For example, this past legislative session was very successful given staff's resources. Three bills, two of which were sponsored by the Commission and the other supported by the Commission, SB 152 (Pavley, Fair Rent for Private Piers), AB 595 (Wolk, Abandoned Vessel Removal), and AB 982 (Skinner, Renewable Energy Program – School Lands Exchange), were recently signed into law. These three bills together will assist the Commission in generating additional revenue to the State for the use of State property, while also assisting the Commission in cleaning up the State's waterways by streamlining the process for removing abandoned vessels.

As Commission staff expressed in its response to the Bureau's report, staff appreciates the recommendations detailed in the Bureau's report. Many of the recommendations are practical and achievable if the Commission is provided the opportunity to acquire and retain adequate staff. Commission staff looks forward to further implementing the Bureau's recommendations as outlined in this Audit Action Plan.