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August 1, 2011

Elaine M. Howle, CPA
State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Dear Ms. Howle:

Initially, I want to acknowledge that the Bureau of State Audits (Bureau) has provided the staff of the California State Lands Commission (Commission) a valuable review and analyses of the policies, practices and past incidents involving Commission business over the last 20 plus years. We agree with many of the Bureau's recommendations and, in fact, are implementing or plan to implement most of them. 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. The enclosed response to the Bureau of State Audits report is the staff's response and has not been approved by the Commission.

We do appreciate the efforts of the Bureau in providing constructive criticism and analyses of past and present practices, as well as its recommendations, which we look forward to implementing where feasible and appropriate. Many of the recommendations suggested by the Bureau are practical and achievable if the Commission is provided the opportunity to acquire and retain adequate staff to address these areas.

Finally, I would like to say that Commission staff is a relatively small, hardworking, and professional group dedicated to acting in the State's best interest and I am very proud of all that they have been able to accomplish with such limited resources.

Sincerely,

CURTIS L. FOSSUM
Executive Officer

Enclosure

cc: Honorable Gavin Newsom, Lt. Governor and Chair, CSLC
Honorable John Chiang, State Controller and Member, CSLC
Ana J. Matosantos, Director of Finance and Member, CSLC
John Laird, Secretary, Natural Resources Agency

State Lands Commission: response to August 2011 Audit

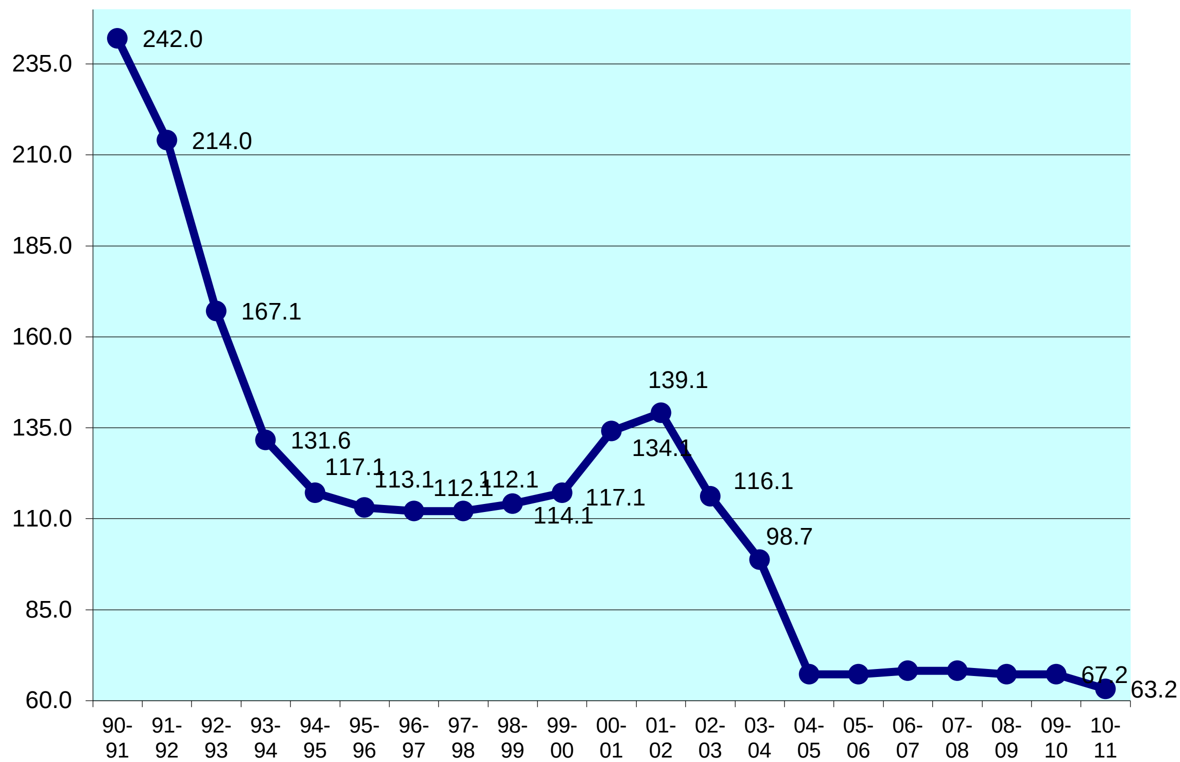
Despite Significant Staff Reductions in the Last 20 Years, the Commission Has Managed Public Lands Resourcefully to Generate Billions in Non-Tax Revenue for the General Fund

In July 2010, the Joint Legislative Audit Committee, at the request of former State Senator Dave Cogdill (R-14), scheduled a hearing to discuss whether "the state receives fair market value for its properties." The August 4, 2010 hearing included eight areas of investigation proposed by the Bureau of State Audits (Bureau). The audit report discusses each of these areas and also describes recommended actions to address and improve Commission practices. We believe many of these recommendations are ones that would enhance the ability of the Commission and its staff to carry out its duties. We also believe 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.

Commission staff strives to balance the goals of maximizing the return on the use of State 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 has some regulatory functions, principally it is 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 3 miles, together encompassing approximately 4 million acres. The Commission also manages 489,000+ acres of school lands and another 790,000+ acres of state-owned mineral rights. With adequate staffing, the Commission is in a position to assist in reaching the State's alternative energy goals and generate substantial non-tax revenues at the same time. Commission staff is already working on geothermal, solar, wind and wave energy projects. While many of these projects are in their infancy, the staff members monitoring these projects spend the majority of their time also assigned to and processing other unrelated matters.

Since 1990, the Commission has been subjected to a continual erosion of its General Fund positions. Regulatory programs have been added regarding Oil Spill Prevention and Marine Invasive Species accompanied by special fund appropriations, however, the core revenue producing and resource management programs that existed in 1990 have been continually reduced. Of 242 General Fund positions that existed in 1990, only 63.2 remain. These losses are principally those positions that performed much of the workload that we are now being criticized for failing to perform. These were positions involved in revenue generation. These 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 ejectments. These positions were responsible for protecting the public's interest in the State's lands and resources consistent with the Commission's Public Trust responsibilities. Some of the losses have been offset by obtaining cost recovery for the processing of lease applications. However, those functions where there is no application being processed must be supported by General Fund appropriations and the loss of those staff resources has had a significant impact on the Commission's ability to carry out its core program objectives to increase non-tax revenues to the General Fund and protect the public's interest in these lands and resources consistent with the Public Trust.

3560: California State Lands Commission
Trend of General Fund Authorized Positions



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. 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.

We believe that the subtitle to the report and titles to Chapters 1 and 2 do not fairly represent the Commission's past or ongoing efforts and successes in managing the public lands and resources in the State's best interest. The "sound bite" impact of those titles is likely to create an indelible first impression with the reader that the Commission is improperly and incompetently managing the public lands entrusted to it. In fact, the underlying circumstances which have resulted in the inability of the Commission staff to keep up with the workload in a highly efficient manner have been clearly stated within the report, but the "headlines" reflected in these titles do not. The Commission staff has been resourceful in adjusting to circumstances beyond its control that have impacted the ability to employ many methods and practices which Commission staff had followed in the past. These adjustments, which were forced by declining staff resources, were designed to achieve optimal lease revenues by making accommodation for and realignment of lease management priorities. The return the State receives in generating non-tax revenue we believe is a remarkable achievement and neither a failure nor a sign of ineffectiveness in light of these declining staff resources.

We also have some concerns about some of the methodology used to produce the report. The report states that the auditors "judgmentally selected a sample of 35 leases from the commission's approximately 1,000 revenue-generating leases." The report does not provide a definition of what "judgmentally selected" means nor does it provide any explanation as to how the leases were selected in the sample. What is clear is that this was not a representative sample of State Lands Commission leases, but rather a subjectively selected list of leases chosen to highlight specific problem areas. The report proceeds to use this subjectively selected sample as a basis for making additional assumptions about the Commission's operations.

Generally speaking, while the report describes examples of mistakes and failures to take action on leases in holdover or delinquent in rent payments, the examples we believe distort the bigger picture of Commission successes. One example is the sample of leases in holdover analyzed by the report. The Commission administers approximately 4,000 leases, including 15 marine oil terminal leases (3 of which are in caretaker status), 85 oil and gas leases, 61 industrial leases, 146 commercial leases, 904 public agency leases, and 1,149 recreational pier leases. The "judgmentally selected" sample of 35 leases used throughout the report included 4 marine terminal leases, yet marine terminal leases represent a miniscule fraction of the Commission's total leases.

Furthermore, Commission staff acknowledges that negotiating new leases for these marine terminals has not gone as quickly as desired. The delay in finalizing these negotiations illustrates the balancing between maximizing revenues to the State and providing the highest level of environmental and resource protection. Specifically, the primary reason for the delay 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. While this took time, we view the resulting negotiated leases as a success because the Commission was able to convince the oil companies to invest in an environmental review and commit to significant mitigation measures. Staff strongly believes any delays resulting from its efforts to ensure this review occurred were in the State's best long-term interest.

Another example outlined in the report is the failure to collect rent for a five year period on holdover leases with Southern California Gas Company. The case involved four prior 49-year leases with a total rent of $2,343, paid up front in 1957. Pursuant to law, in the five year holdover, the uncollected rent due totaled $234 or approximately $46 per year for all four leases combined. Rather than focus on bringing this small amount current, the staff focused on consolidating these leases with two other leases held by the same lessee, to create efficiency benefits for both the state and private lessee, and bring all the leases to a current fair market rent of $16,794 per year. So, in this case, staff chose to forego the short-term minor rental gain in order to improve efficiency in long-term lease management. In fact, in several of the samples cited in the audit, there are unique circumstances relating to the specific property and proposed use of that property that influenced the negotiation strategy and approach staff ultimately took.

The report describes a number of leases that have expired or are failing to pay rent. While the California economy has recently begun to stabilize, the number of failed business, empty offices, foreclosures and bankruptcies in the general population over the last few years are likewise replicated in many of the Commission's leases. While the Commission may and has taken action to evict trespassers and lessees whose leases have expired, it does so after all other approaches to work cooperatively with the lessees have failed. In these difficult times, the Commission staff prefers to work with lessees, especially individuals and small businesses. Sometimes this may mean collecting less rent, or not imposing penalties, in the short term. We believe this is preferable to evicting a lessee and not collecting any rent and then being exposed to financial responsibility for any liability involving the lease premises. Furthermore, the Commission is not resourced to actively manage improved properties, such as marinas. So if the Commission did evict a lessee, such as a marina operator for failure to pay rent, the Commission would not be in a position to step into a management role and collect the slip rentals and pay the operating expenses.

Furthermore, many of the innovations and benefits developed in lease royalty structure were a result of refocusing existing staff functions toward enhancement of existing practices. An example of an outcome from this effort is the broader use of comprehensive economic analysis for determining oil and gas royalty lease terms for new leases. The benefits of this practice, and one example, which was brought to the attention of the Bureau, is evident in the Huntington Beach field's application of a "price based sliding scale" royalty, that has provided over $50 million in additional state royalties over the past 15 years.

Responses to each of the Bureau's specific recommendations are listed below:

<u>Bureau of State Audits Recommendations and Staff of the State Lands Commission Response</u>

Summary

To ensure that it manages delinquent leases in a timely manner, the commission should do the following:

- Develop and adhere to policies and procedures that include the steps staff should take when a lessee is delinquent, time standards for performing those steps, and a process for tracking the status of delinquent leases between divisions.

  Commission Staff Response:
  Commission staff agrees and has already begun taking measures to implement to this recommendation. While accounting procedures for 30, 60, and 90-day dunning letters are in place, there is a recognized need to better coordinate Accounting, Land Management and Legal divisions in disposition of delinquent leases should those initial steps fail.

- Conduct cost-benefit analyses when it contemplates either referring a delinquent lessee to the attorney general of pursuing the delinquent lessee through other means.

  Commission Staff Response:
  While no formal written process exists, Commission staff conducts an extensive, informal cost-benefit analysis, including consideration of statewide policy implications, through coordination with senior management, the Executive Officer and the Attorney General's Office, when deciding whether to recommend pursuing litigation to the Commission.

To ensure that as few leases as possible are in 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 Staff Response:
Commission staff agrees and has already implemented this recommendation. The report states that our new holdover procedures "appear reasonable [however], because the commission only recently implemented them, we were unable at the time of our audit fieldwork to determine whether they would be

effective. In August 2010, there were 32 leases in holdover status with annual rent greater than or equal to $10,000. As of July 2011, there are only 8 leases in holdover status with annual rent greater than or equal to $10,000. That is a 75% reduction in significant holdovers in an 11 month period. One of these leases (Selby Slag) is an ongoing environmental obligation and will remain in holdover status indefinitely. Four of these leases are marine oil terminals (Tesoro Avon, Tesoro Amorco, NuStar and Chevron Estero). One (NuStar) will be renewed in 2011, one (Chevron Estero) is in caretaker status (non-operational), and rent reviews were conducted on all three active terminal leases in 2011. The other three leases (PG&E pipeline master lease, Kinder Morgan pipeline master lease, GP Gypsum) are in negotiations and we anticipate taking them to the Commission for new lease agreements within the next six to twelve months.

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 it to use other strategies, such as adjusting rents annually using an inflation indicator.

Commission Staff Response:
Commission staff agrees with this recommendation and will be exploring alternatives that are manageable with existing staff resources available.

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 once every five years.

Commission Staff Response:
Commission staff agrees with this recommendation in those specific situations of high revenue-generating leases where the benefits are likely to exceed the costs.

To ensure that it does not undervalue certain types of properties, the commission should do the following:

- Amend its regulations for establishing pipeline rents on state land to reflect a more current method.

Commission Staff Response:
Commission staff agrees with this recommendation and was awaiting input from this audit before moving forward with the extensive regulatory process to implement this change.

- Periodically analyze whether collecting oil royalties in cash or in kind would maximize revenues to the State, and collect its oil royalties in the most profitable way.

  Commission Staff Response:
  Commission staff agrees with this recommendation. The report correctly describes the current practice of receiving its oil royalties in cash. This was a result of an analysis performed by staff from 2002 through 2005, and further supported by subsequent annual spreadsheet analyses of area oil sales supplied by a consultant. The staff analysis, and those subsequent annual reports, showed receiving royalty in crude oil in-kind and then selling the oil through sell-off contracts, was not in the State's best interest. The report, however, asserts that the current practice of receiving cash for royalty oil is based on the "outdated" analysis of 2002-2005 and may not maximize revenue. Although we agree that the analysis is a few years old, the factors and circumstances upon which those conclusions were based have not changed. We do agree however, as recommended in the report, that those previous conclusions should be periodically retested for confirmation. It should be noted that due to significant reductions to the General Fund-supported Mineral Management Division staff (which is tasked with monitoring and managing a program that generated over $400,000,000 of non-tax revenue to the General Fund in 2010/11) the Commission no longer has the staff resources to accommodate a sell-off program. Should the circumstances indicate that such an effort would be favorable to the State, additional staff resources would be required.

To improve its monitoring of leases, the commission should do the following:

- Create and implement a policy, including provisions for supervisory review, to ensure that the information in ALID is complete, accurate, and consistently entered to allow for the retrieval of reliable lease information.

  Commission Staff Response:
  Commission staff agrees and has already implemented this recommendation.

- Require all of its divisions to use ALID as its centralized lease-tracking database.

  Commission Staff Response:
  The three divisions (Land Management, Accounting and Legal) involved in lease-tracking do use ALID. Staff recognizes that regular management reports from

ALID need to be developed to reduce dependency on division only lists and spreadsheets tracking similar information.

To adequately monitor its revenue-generating oil and gas leases, the commission should do the following:

- Develop an audit schedule that focuses on leases that have historically generated the most revenue and recoveries for the State, as well as those that have historically had the most problems.

  Commission Staff Response:
  Commission staff agrees with this recommendation. The report accurately points out the Commission staff's need to plan formalized and scheduled audits. However, it does not recognize that (in addition to responding to issues raised and/or lease assignments audits) the approach used by the Commission staff to select/choose potential audits has been risk-based. As such, Commission staff has been selective in assigning its limited resources to audits where potential substantial recoveries exist. "Developing" an audit plan will assist in a more structured approach to conducting audits. However, without addressing the staffing requirements Commission staff will have difficulty implementing any such plan.

- 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 Staff Response:
  Commission staff agrees to further explore this recommendation. There are concerns regarding civil service rules regarding contracting out as well as the use of contingency as the basis for payment in extending this practice beyond this isolated instance.

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 Staff Response:
Commission staff has and will continue to develop workload analyses and does submit this information in conjunction with requests for additional staffing.

To better address current and potential future staffing shortages, the commission should create a succession plan.

> ***Commission Staff Response:***
> *Commission staff agrees with this recommendation and recognizes its value. In fact, all but one of the current division chief positions have turned over in the past two years bringing the need for a succession plan into sharp focus. However, given current budget dynamics regarding hiring freezes, continual staff reductions and limited staff resources, it is difficult to create and implement any such a plan.*

Chapter 1

To ensure that it manages delinquent leases in a timely manner and collects all the amounts owed to it, the commission should do the following:

- Determine the amount of past-due rent that should be included in its accounts receivable account.

> ***Commission Staff Response:***
> *Staff is aware of past due amounts maintained in its receivable accounts. The report describes $1.2 million in past due rents as of December 31, 2010. The correct amount of past due revenue receivables reported to the auditor was $209,389.27 for 210 invoices. Of these, 146 invoices for $121,433.68 were in excess of 180 days, delinquent as defined by the State Controller's standards. Other invoices included in the total reported past due amount include contingent receivables. These are invoices for which there is some question as to their validity, usually boundary or jurisdiction related. These totaled $484,189.30 and are purposefully kept, as prescribed by State procedures, in a separate account due to their contingent nature. The remainder of the amount asserted as past due were invoices that were not yet due, based on their actual due dates.*
>
> *Additionally, Table 1 asserts that the Commission has "lost" $1,616,936 in delinquent rents. It is unclear how it relates to the $1.2 million above. Regarding those accounts, the table includes 4 leases to AERA that are to be quitclaimed representing $501,223. These are pipeline leases associated with the "Molino" lease in the Santa Barbara Channel. While the oil & gas lease was quitclaimed in 1997, these associated pipeline leases were not similarly processed by staff and will be closed out as of that same date. While this does illustrate a process failure, the associated revenues are not valid and should not be considered "lost" due to their not being collected. All 4 accounts have been placed in Contingent*

Receivables pending completion of the transaction. Also, Ramos Oil Company and Ship A Shore have both been placed into Contingent Receivables until outstanding issues are resolved.

- Develop and adhere to policies and procedures that incorporate the *State 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 Staff Response:
  Commission staff agrees and has already begun taking measures to implement this recommendation. While accounting procedures for 30, 60, and 90-day dunning letters are in place, there is a recognized need to better coordinate between Accounting, Land Management and Legal in disposition of delinquent leases should those initial steps fail.

- Conduct cost-benefit analyses when it contemplates either referring a delinquent lessee to the attorney general or pursuing the delinquent lessee through other means.

  Commission Staff Response:
  While no formal written process exists, Commission staff conducts an extensive, informal cost-benefit analysis, including consideration of statewide policy implications, through coordination with senior management, the Executive Officer and the Attorney General's Office, when deciding whether to recommend pursuing litigation to the Commission.

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 Staff Response:
Commission currently does not have the authority to request a taxpayer ID from individuals, which is necessary for participation in the intercept program. As it expands to include Employer ID for businesses, this may become an option. Staff will continue to explore better ways to pursue delinquent accounts including possible legislation or regulation to allow collection of such information.

To ensure that as few leases as possible go into holdover status, 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.

  Commission Staff Response:
  Commission staff agrees and has already implemented this recommendation.

- Consistently assess the 25 percent penalty on expired leases.

  Commission Staff Response:
  Commission staff agrees and has already implemented this recommendation.

To complete its rent reviews promptly and obtain a fair rental amount for its leases, the commission should do the following:

- Consistently notify the lessee of impending rent review or rental increases within established timelines.

  Commission Staff Response:
  Commission staff agrees with this recommendation. However, in triaging the total lease workload, a prioritization approach has been implemented for high revenue-generating leases. Additional review and increases could be implemented with additional staff.

- Establish time standards for each step of the rent review process and ensure that all staff adhere to those time standards.

  Commission Staff Response:
  Commission staff will explore this recommendation. Staff has already prioritized the rent review process for high revenue-generating leases.

- Develop a methodology for its workload that focuses its staff on managing the higher revenue-generating leases until such time as it addresses its workload needs.

  Commission Staff Response:
  Commission staff agrees and has already implemented this recommendation.

- 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 Staff Response:
  Commission staff agrees with this recommendation and will be exploring alternatives that are manageable with existing staff resources available.

To ensure 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 rent amount that would be deposited into an account within the Special Deposit Fund. The increased rent 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 Staff Response:
Commission staff is investigating this recommendation.

To ensure that it is charging rent for 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.

  Commission Staff Response:
  Commission staff agrees with this recommendation as to those specific situations, such as high revenue-generating leases, where the benefits are likely to exceed the costs of preparing such an appraisal.

- 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 Staff Response:
  Commission staff agrees with this recommendation and is currently developing a procedure to implement this recommendation.

To ensure that it does not undervalue certain types of leases, the commission should do the following:

- 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 Staff Response:
  Commission staff agrees with this recommendation and was awaiting input from this audit before moving forward with the extensive regulatory process to implement this change.

- Implement and follow its plan to regularly update its benchmarks for determining rental amounts.

  Commission Staff Response:
  Commission staff agrees and has already begun implementing this recommendation.

- 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 Staff Response:
  Commission staff agrees with this recommendation. The report correctly describes the current practice of receiving its oil royalties in cash. This was a result of an analysis performed by staff from 2002 through 2005, and further supported by subsequent annual spreadsheet analyses of area oil sales supplied by a consultant. The staff analysis, and those subsequent annual reports, showed receiving royalty in crude oil in-kind and then selling the oil through sell-off contracts, was not in the State's best interest. The report, however, asserts that the current practice of receiving cash for royalty oil is based on the "outdated" analysis of 2002-2005 and may not maximize revenue. Although we agree that the analysis is a few years old, the factors and circumstances upon which those conclusions were based have not changed. We do agree however, as recommended in the report, that those previous conclusions should be periodically retested for confirmation. It should be noted that due to significant reductions to the General Fund-supported Mineral Management Division staff (which is tasked with monitoring and managing a program that generated over $400,000,000 of non-tax revenue to the General Fund in 2010/11) the Commission no longer has the staff resources to accommodate a sell-off

program. Should the circumstances indicate that such an effort would be favorable to the State, additional staff resources would be required.

Chapter 2

To improve its monitoring of leases, the commission should do the following:

- Create and implement a policy, including provisions for supervisory review, to ensure that the information in 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 Staff Response:
  Commission staff agrees and has already implemented portions of this recommendation.

- Require all of its divisions to use ALID as its one centralized lease-tracking database.

  Commission Staff Response:
  The three divisions (Land Management, Accounting and Legal) involved in lease-tracking do use ALID. Staff recognizes that regular management reports from ALID need to be developed to reduce dependency on division lists and spreadsheets tracking similar information.

To adequately monitor its revenue generating oil and gas leases, the commission should do the following:

- Track the recoveries and findings identified in its audits and use this information to develop an audit plan that would focus on leases to audit that have historically generated the most revenue and recoveries for the State, as well as those that historically have had the most problems.

  Commission Staff Response:
  Commission staff agrees with this recommendation. The report accurately points out the Commission staff's need to plan formalized and scheduled audits. However, it does not recognize that (in addition to responding to specific issues that arise and/or lease assignment audits) the approach used by Commission staff to select/choose potential audits has been risk-based. As such, Commission staff has been selective in assigning its limited resources to audits where identified potential substantial recoveries exist. "Developing" an audit plan could assist in a more structured approach to conducting audits. However,

without addressing staffing requirements it is almost certain that Commission staff would not be able to implement any such plan.

- Develop and implement regulations that would apply to any new lease by putting 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 Staff Response:
  Since 1977 Public Resources Code §6827 prohibits any deductions for treatment, dehydration, or transportation of royalty oil on new leases. Therefore, a regulation as recommended above is not necessary for new leases.

- 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 Staff Response:
  Commission staff agrees to further explore this recommendation. There are concerns regarding civil service rules involving contracting out as well as the use of contingency as the basis for payment in extending this practice beyond this isolated instance.

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 Staff Response:
Commission staff agrees with this recommendation, however, Commission staff currently lacks the staff resources necessary to establish and implement such a program. There are more than 300 statutes granting public trust lands to approximately 85 local governments throughout the State. These statutory trust grants include some of 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. The Commission currently has one staff position assigned to overseeing the management of these state lands and revenues by these local entities.

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 Staff Response:
This is already done on the Commission's offshore oil and gas leases and the bondsmen are required to give at least 90 day notice (some are longer) before they can terminate a bond. Further, staff 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.

Chapter 3

To better demonstrate its need for additional staff, the commission should do the following:

- Conduct a workload analysis to identify a reasonable workload for its staff and use this analysis to quantify the need for additional staff.

  Commission Staff Response:
  Commission staff has and will continue to develop workload analyses and does submit this information in conjunction with requests for additional staffing.

- Quantify the monetary benefits of its staff's duties other than processing lease applications, and consider billing lessees for those activities.

  Commission Staff Response:
  Commission staff agrees to explore the expansion of lease management fees.

- 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 Staff Response:
  Commission staff has already addressed this issue and additional staffing needs have been identified.

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 Staff Response:
Commission staff agrees with this recommendation and recognizes its value. In fact, all but one of the current division chief positions have turned over in the past two years bringing the need for a succession plan into sharp focus. However,

given current budget dynamics regarding hiring freezes, continual staff reductions and limited staff resources, it is difficult to create and implement any such plan.