

# LEGISLATIVE AUDIT DIVISION

Tori Hunthausen, Legislative Auditor  
Deborah F. Butler, Legal Counsel



Deputy Legislative Auditors:  
Cindy Jorgenson  
Angus Maciver

## MEMORANDUM

**TO:** Legislative Audit Committee Members  
**FROM:** William Soller, Senior Performance Auditor  
**CC:** John Tubbs, Director, Department of Natural Resources and Conservation  
Shawn Thomas, Administrator, Trust Land Management Division  
**DATE:** September 2015  
**RE:** Performance Audit Follow-up (15SP-15): Management of Oil and Gas and  
Commercial Leasing on State Trust Lands (orig. 13P-03)  
**ATTACHMENTS:** Original Performance Audit Summary

### Introduction

In October 2013, we presented our performance audit of the *Management of Oil and Gas and Commercial Leasing on State Trust Lands*. The audit included seven recommendations to the Department of Natural Resources and Conservation (department). We gathered information from the department to assess their progress in implementing the audit's recommendations. This memorandum summarizes the results of our follow-up work in addition to presenting background information on oil and gas and commercial leasing on state trust lands.

### **Overview**

Audit work determined that the department had controls in place to ensure oil and gas lease bid information is not used to inappropriately influence the sale process at public auction. However, audit work also determined the department should strengthen commercial leasing activities. Audit recommendations addressed the need for the department to proactively identify commercial leasing opportunities and strengthen the identification, issuance, and monitoring of commercial leasing activities on state trust lands. Our performance audit report contained seven recommendations to the department. Based on our follow-up work, the department has implemented two recommendations, and partially implemented three recommendations. The remaining two recommendations are in the process of being implemented.

### Background

The mission of the Trust Land Management Division within the department is to manage the State of Montana's trust land resources to produce revenue for trust beneficiaries while considering environmental factors and protecting future income-generating capacity of the land. Trust beneficiaries include public education institutions such as K-12 schools and universities, which receive trust revenue to support education. The department manages about 11 million acres (surface and mineral acres) of state trust land, including forest, agricultural, grazing, residential, mineral, and commercial properties. Revenue from trust

land is typically generated by leasing the land for some productive purpose, such as agricultural, grazing, residential, mineral, or commercial uses. According to the department's fiscal year 2014 annual report, state trust land generated over \$114 million in gross revenue for trust beneficiaries, which includes leasing activities. In fiscal year 2014, the department generated over \$21 million in gross revenue from oil and gas leases and nearly \$6 million in gross revenue from commercial leases. Oil and gas leasing has occurred on state trust land at a high volume for many years; however, commercial leasing on state trust land is a fairly new concept. In fiscal year 2014, there were 5,160 oil and gas leases, of which 685 were productive, on state trust land, while there were 136 active commercial leases on state trust land.

### **Audit Follow-up Results**

Our performance audit report contained seven recommendations to the department. As part of follow-up work, we examined program materials, interviewed staff from the department, and reviewed two commercial leases recently issued by the department. The following summarizes information relating to follow-up audit work and the implementation status of recommendations.

### **RECOMMENDATION #1**

**We recommend the Department of Natural Resources and Conservation proactively identify and develop commercial leases on state trust land by establishing:**

- A. Identification and development goals, including long-term targets and milestones for commercial leasing activities.**
- B. A resource allocation plan to enhance long-term revenue for trust land beneficiaries.**

### **Implementation Status – Partially Implemented**

In response to the audit, the department implemented a centralized filter process called the Developmental Economic Site Index (DESI) which was used to identify trust land parcels with potential for real estate development, including commercial leases. Based on several factors, including public road access, population density, and adjacent private property values, trust land parcels were weighted to assess their potential for real estate development. Based on this DESI analysis, the department identified 128 trust land parcels statewide that had a high potential for real estate development, which were then subsequently reviewed by department field staff to evaluate any additional factors to be considered as part of any potential development. While the department assessed trust land parcels for potential development, they determined at their most recent annual real estate project identification meeting in 2014 that no new projects should be considered for real estate development, with department resources focused on existing real estate projects to increase revenues for trust beneficiaries. As part of our review of our follow-up work, a review of two recently issued commercial leases indicated that one of the leases issued was part of the department's current real estate project management list, with another lease not currently included as part of that list. Aside from the DESI analysis which the department proactively conducted to identify potential commercial leases on state trust land, the department has not yet established any specific targets or timeframes for commercial leasing activities. And relative to the development of a resource allocation plan to enhance the long-term revenue for beneficiaries, the department requested funding from the 2015 Legislature for one full-time equivalent to conduct commercial leasing and marketing activities. However, the funding was not appropriated by the legislature. Department staff reported that they will likely request additional funding from the 2017 Legislature. However, at this point in time, the department has not developed a resource allocation plan regarding developing commercial leases on state trust land.

## **RECOMMENDATION #2**

**We recommend the Department of Natural Resources and Conservation:**

- A. Set the annual rental for commercial leases based on the appraised value of the land, or**
- B. Seek the statutory authority to establish annual rentals for commercial leases based on alternative valuation methodologies.**

### **Implementation Status – Partially Implemented**

Presently, state law requires of any commercial lease on state trust land an annual rental equal to the full market rental value of the land. The annual rent for a commercial lease may not be less than the product of the appraised value of the land multiplied by a rate that is 2 percentage points a year less than the rate of return of the unified investment program administered by the board of investments. At the time of the original audit, the department was also establishing rental rates based on alternative valuation methodologies, due to the fact that in some circumstances an annual rental based on the appraised value of the land may result in a rental rate not equal to the full market rental value of the land. However, the department was unable to support how alternative valuation methods were in the best interest of beneficiaries. In an effort to more clearly define and support how the department sets rental rates for commercial leases, the department established a Commercial Leasing Procedure which outlines how commercial lease rental rates are developed and comply with the requirements set forth in state law.

As part of our follow-up work, we reviewed two commercial leases recently issued by the department and determined the department is setting the annual rental rate for commercial leases based on the appraised value of the land, as currently required by state law. The department also proposed HB46 in the 2015 Legislature to provide them the authority of use alternative valuation methodologies in lieu of an appraisal; however, the bill died in standing committee. Despite the fact the department has established a formal procedure for analyzing rental rates when alternative valuation methodologies are used, it is unclear how the department can compare the rental rates from an alternative methodology and an appraisal of the land when a land appraisal has not been conducted. While audit and follow-up work supports the argument that in some circumstances an appraisal value of the land may not result in the full market rental value of the land, current state law requires a land appraisal. Alternative methodologies are not permitted. We believe the department should continue to seek the statutory authority to establish annual rentals for commercial leases based on alternative valuation methodologies.

## **RECOMMENDATION #3**

**We recommend the Department of Natural Resources and Conservation:**

- A. Review and approve land appraisals used to determine annual rentals for commercial leases.**
- B. Develop and implement policies and procedures for documenting appraisal reviews for land appraisals**

### **Implementation Status –Implemented**

Per department staff, they conduct internally or contract for review and approval all land appraisals and complete a formal appraisal review report prior to accepting any appraisals used to determine annual rentals for commercial leases. Department staff reported they have historically conducted these formal appraisal reviews, but were unable to locate the reviews at the time of the audit, due to staff attrition. Consequently, in response to the audit, the department has established the Commercial Leasing Procedure, which requires that all appraisals are reviewed and be documented within the department's Trust Lands Management System (TLMS) if the lease is executed. The procedure outlines how the department will conduct a review of the appraisal, develop an appraisal review report, and details on the

electronic storage of the appraisal and appraisal review. As part of our follow-up work, we reviewed two commercial leases recently issued by the department and determined that the department reviewed and approved the appraisals per their current policy, including documenting those reviews electronically.

**RECOMMENDATION #4**

**We recommend the Department of Natural Resources and Conservation consistently issue commercial leases to the highest and best bidder responding to a department request for proposals.**

**Implementation Status –Implemented**

State law currently authorizes commercial leases on state trust land to the highest and best bidder responding to a department request for proposals (RFP) for commercial uses of a specified tract. At the time of the original audit, the department had issued several commercial leases for an existing use on state trust land historically authorized under a land use license (LUL) which were likely more appropriately authorized under a commercial lease. According to the department, a LUL is a short-term temporary use with no permanent surface improvements or facilities. Examples of converted LULs identified during the original audit included communication sites on state trust land where a decision was made to better align the use of the property to the appropriate type of agreement as those LULs expired. During the follow-up, department staff reported that administrative rules provide them the authority to convert a LUL to a lease with an RFP only required for new commercial leases. However, state law does not limit the use of an RFP for only new commercial leases. At the time of the original audit, the department's legal staff indicated there are no exceptions in the law to the department issuing an RFP for a commercial lease on state trust land. As part of our follow-up work, we reviewed two commercial leases recently issued by the department and determined that the department had issued those leases via an RFP process as currently required by the law. While the department believes it has the authority to issue a commercial lease without an RFP in limited circumstances, audit work determined there are no exceptions to the use of an RFP. The department would need to seek the statutory authority to issue a commercial lease without the use of an RFP when converting LULs to leases on state trust land. However, at the time of our follow-up work, the department has not issued any additional commercial leases without an RFP.

**RECOMMENDATION #5**

**We recommend the Department of Natural Resources and Conservation develop and implement policies and procedures for the request for proposals process for commercial leases, including:**

- A. Highest and best use scope,**
- B. Evaluation committee composition and responsibilities,**
- C. Proposal scoring, and**
- D. Final selection.**

**Implementation Status – Partially Implemented**

At the time of the original audit, in addition to not always using an RFP to issue a commercial lease, we determined the manner in which the department issued and awarded commercial lease RFPs was conducted inconsistently, including solicitation, scoring, and selection activities. Consequently, the department developed and implemented a Commercial Leasing Procedure which outlines the development, release, and evaluation of an RFP for a potential commercial lease. This procedure provides direction to the department regarding the RFP process, including the use of standard templates for solicitation and selection activities based on the evaluation criteria in the RFP. The procedure also outlines the composition of the evaluation committee. As part of our follow-up work, we reviewed two commercial leases recently issued by the department and determined that while the department had issued those leases via an RFP process as currently required by the law, there were inconsistencies in the way the

two RFPs solicited proposals. In one circumstance, the RFP broadly requested proposals for commercial development for the highest and best use of state trust land, with descriptions of the trust land and adjacent land use. In contrast, the other RFP very specifically solicited a developer to lease a commercial parcel of state trust land in Helena, and redevelop the site to provide an office building that meets the state's needs, with the primary objective of the RFP to secure a ground lessee and lease back office space to the department. The second RFP was also issued in conjunction with the Department of Administration (DOA), with both DOA and the department staff involved in the evaluation process. At the time of the original audit, we noted circumstances with the intended use of the state trust land explicitly stated in the RFP, rather than as a competitive solicitation to identify the highest and best commercial use of the parcel of trust land. Based on our follow-up work, we determined that while the department has developed policies and procedures for the RFP process, questions still remain regarding the integrity and defensibility of how the department issues commercial leases in the best interest of state trust land beneficiaries.

#### **RECOMMENDATION #6**

**We recommend the Department of Natural Resources and Conservation develop and implement policies and procedures for the financial and physical monitoring of commercial leases, including content relative to lease stipulations, monitoring frequency, and enforcement.**

#### **Implementation Status – Being Implemented**

In an effort to monitor commercial leases, the department drafted a Contract Monitoring Procedure for Lease and Licenses. This purpose of this procedure is to establish a standard process and schedule for monitoring surface leases and licenses under the Real Estate Management Bureau. Per the procedure, monitoring is necessary to ensure the leases and licenses are obtaining full market value, the contract terms are being met by the lessee or licensee, and to monitor expiring contracts for either renewal or discontinuation of use. The procedure outlines the process for both the financial and physically monitoring of commercial leases, including compliance for lease terms, regulations, and the lease rental fee. The procedure also outlines the use of standardized templates for monitoring activities, but those templates are still under development by department staff. Commercial leases require a physical inspection every five years and one financial review during the term of the lease. As part of our follow-up work, we reviewed two commercial leases recently issued by the department and determined due to the fact that the leases were recently issued, there were no monitoring activities conducted to date. However, department staff reported they are also currently in the process of developing standard management reports which can be generated from TLMS to track the various monitoring activities and obligations. Overall, monitoring for commercial leases is still a work-in-progress and not fully developed.

#### **RECOMMENDATION #7**

**We recommend the Department of Natural Resources and Conservation develop and implement documentation policies and procedures for real estate projects and commercial leasing activities.**

#### **Implementation Status – Being Implemented**

Overall, department staff reported the original audit helped them recognized the fact that the commercial leasing process was poorly and inconsistently documented. Consequently, they developed and implemented the Commercial Leasing Procedure, which outlines documentation requirements, including where documents are to be located, both in hardcopy and electronic formats. As part of that procedure, the official lease file is stored and centrally maintained in Helena. The department has also developed and implemented a Commercial Lease Development Worksheet which functions as a checklist to ensure commercial lease files are complete, with all required documentation. Currently, the department is also in

the process of drafting a specific procedure to document real estate management projects and associated commercial leasing activities, which will clarify required forms, participant roles, and documentation location. As part of our follow-up work, we reviewed two commercial leases recently issued by the department and determined the department has made significant progress in documenting commercial leases, with lease documentation consistently organized and available.

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