



April 18, 2008

Ms. Bridget Luther, Director
Department of Conservation
801 K Street, MS 24-01
Sacramento, CA 95814

Dear Ms. Luther:

Final Report—Audit of Department of Conservation's Bond Funds Proposition 12, 13, 40, and 50

Enclosed is the final audit report of the Department of Conservation's (Department) Propositions 12, 13, 40, and 50 bond funds as of June 30, 2007. The Department of Finance, Office of State Audits and Evaluations, performed this review in accordance with the Department of Finance's bond oversight responsibilities.

Our audit concludes that the Department generally awarded and expended bond funds in accordance with applicable legal requirements. However, we noted that monitoring procedures to protect the state's long-term interest in bond funded conservation easements were inadequate and efforts to monitor bond funded projects could be improved. The Department's response is included in the enclosed report.

In accordance with the Department of Finance's policy of increased transparency, this report will be published on our website. We appreciate the Department's cooperation and assistance during our review. If you have any questions, please contact Diana Antony, Manager, or Jennifer Arbis, Supervisor, at (916) 322-2985.

Sincerely,

Original signed by:

David Botelho, Chief
Office of State Audits and Evaluations

Enclosure

cc: Mr. Bryan Cash, Deputy Assistant Secretary, Resources Agency
Mr. Tom Gibbs, Deputy Director, Department of Conservation.
Mr. Brian Leahy, Assistant Director, Division of Land Resources Protection, Department of Conservation.
Mr. Gregory Lee, Accounting Administrator II, Department of Conservation

AN AUDIT OF BOND FUNDS

Department of Conservation
Audit of Propositions
12, 13, 40, and 50

Prepared By:
Office of State Audits and Evaluations
Department of Finance

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EXECUTIVE SUMMARY

In response to Department of Finance's (Finance) bond oversight responsibilities, we have audited the Department of Conservation's (Department) funding under Propositions 12, 13, 40, and 50 as of June 30, 2007. The primary objectives of this audit were to determine whether bond funds were awarded and expended in compliance with applicable legal requirements and established criteria, and to determine if the Department had adequate project monitoring processes.

In general, the Department awarded and expended funds in compliance with applicable legal requirements and established criteria. In addition, the Department has adequate project monitoring processes through the final payment phase, but needs to implement a long-term monitoring process for conservation easement grants.

The Department lacks policies or procedures for periodic verifications of easement conditions by Department staff and periodic reviews of the grantee's fiscal capacity to monitor and manage the easement throughout the easement term. Although the easement deeds include a clause allowing the Department recourse for grantee noncompliance, the Department relies on grantee self certification on annual reports to determine the status of easement conditions without an independent verification. Without independent verification of the easement conditions, the Department may not be able to protect the state's long-term interest in agricultural conservation easements.

As the administrator of bond funds, the Department should develop a risk-based monitoring process to proactively identify easement violations or potential issues in a timely manner. With proper ongoing monitoring in place, prompt corrective actions can be taken and costly legal expenses may be avoided.

BACKGROUND, SCOPE AND METHODOLOGY

Background

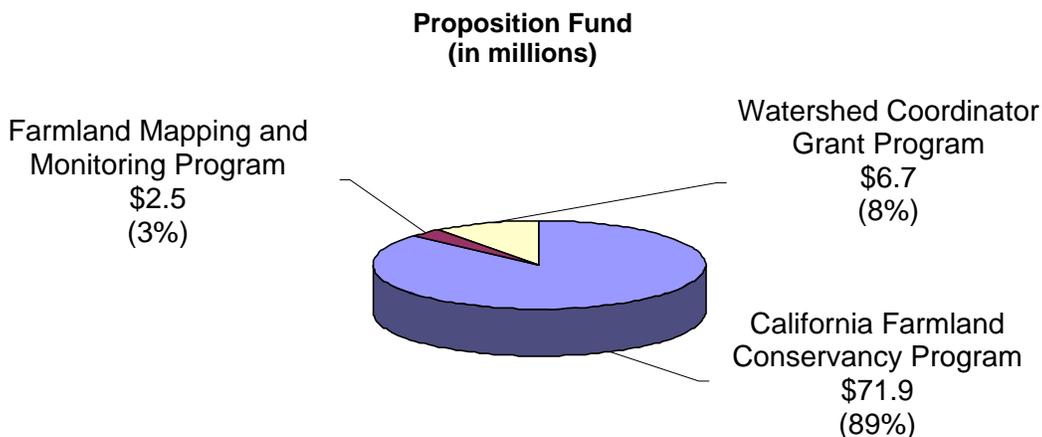
Between March 2000 and November 2002, California voters passed four bond measures totaling \$10.1 billion. The Safe Neighborhood Parks, Clean Water, Clean Air, and Coastal Protection Bond Act of 2000 (Proposition 12) and the Safe Drinking Water, Clean Water, Watershed Protection, and Flood Protection Act (Proposition 13) were passed on the March 2000 ballot. The California Clean Water, Clean Air, Safe Neighborhood Parks, and Coastal Protection Act of 2002 (Proposition 40), and the Water Security, Clean Drinking Water, Coastal and Beach Protection Act of 2002 (Proposition 50) were passed on the March and November 2002 ballots, respectively. These propositions authorized the sale of bonds to finance a variety of resource programs. Administered by a number of state departments, agencies, boards, and conservancies, the proceeds from these bonds support a broad range of programs that protect, preserve, and improve California's water and air quality, open space, public parks, wildlife habitats, and historical and cultural resources. Bond proceeds are expended directly by the administering departments on various capital outlay projects, and are also disbursed to federal, state, local, and non-profit entities in the form of grants, contracts, and loans.

Department of Conservation

The Department of Conservation (Department) administers programs to preserve agricultural and open space lands, promote beverage container recycling, evaluate geology and seismology, and regulate mineral, oil, and gas development activities. Propositions 12, 13, 40 and 50 provided the Department with a total of \$81.1 million in bond funds to support its resource preservation programs under the Division of Land Resource Protection. As of June 30, 2007, a total of \$43 million was expended. See Figures 1 and 2 for detail regarding allocations and expenditures. In November 2006, voters approved an additional bond measure, the Safe Drinking Water Quality and Supply, Flood Control, River and Coastal Protection Bond Act of 2006 (Proposition 84). This will provide the Department with an additional \$10 million in bond funds; however, as of June 30, 2007, no Proposition 84 funds had been appropriated or expended.

FIGURE 1

Proposition Funds Allocated by Program

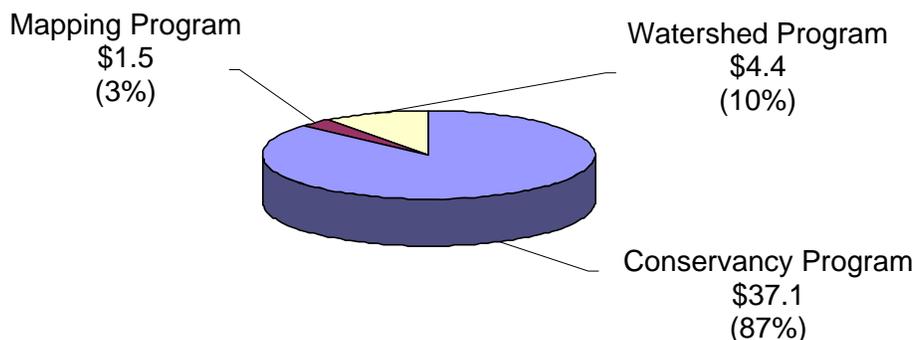


Source: Department of Conservation financial statements for fiscal years 2000-01 to 2006-07.

FIGURE 2

Proposition Expenditures by Program

As of June 30, 2007
(in millions)



Source: Department of Conservation financial statements for fiscal years 2000-01 to 2006-07.

The Division of Land Resource Protection administers three types of agricultural and open space land programs: farmland conservation, watershed coordinator grants, and farmland mapping and monitoring.

The California Farmland Conservancy Program (Conservancy Program) provides grants to local governments and qualified nonprofit organizations to purchase conservation easements placed on agricultural lands. The easements protect agricultural land from conversion into a residential, commercial, or industrial real estate development. These easements allow for restoration of and other types of improvements to the agricultural

land. Also, with the easements in place, the Department can plan and develop land use policy and projects. The Conservancy Program is designed to work in concert with local planning and zoning strategies to conserve agricultural land. Using Proposition 12 grant funds, the Conservancy Program placed 39 individual agricultural conservation easements preserving approximately 11,000 acres of strategic farmland. In addition, the planning/technical assistance grants awarded further facilitated local efforts in developing and expanding farmland conservation strategies, including facilitating strategic easement acquisitions. The Conservancy Program continues to complete additional agricultural land conservation projects utilizing bond grant funding.

The Watershed Coordinator Grant Program (Watershed Program) funds watershed coordinator positions in order to facilitate collaboration among diverse stakeholders, build coalitions for watershed work, secure additional funding for watershed projects, and initiate watershed improvement projects within the CALFED Solution Area. The CALFED Solution Area includes watersheds that contribute to or import water through the Bay-Delta system. The Watershed Program uses a coordinated approach to planning and management to improve and sustain watersheds throughout the state, offering organizations a unique opportunity to work cooperatively with other organizations.

The Farmland Mapping and Monitoring Program (Mapping Program) was established in 1982 in response to a critical need for assessing the location, quality, and quantity of agricultural lands and conversion of these lands over time. The Mapping Program is a non-regulatory program and provides a consistent and impartial analysis of agricultural land use and land use changes throughout California. Agricultural and urban land use on nearly 96 percent of the state's privately held land is mapped. The coverage area is 47.9 million acres in 49 counties and is the only statewide land use inventory conducted on a two-year basis that identifies agricultural and urban land conversions.

SCOPE

The audit was conducted to determine whether bond funds were awarded and expended in compliance with applicable legal requirements and established criteria and to determine if the Department had adequate project monitoring processes in place.

The audit did not include an assessment of the bond authorization, issuance, and sale processes, or an examination of the efficiency or effectiveness of program operations. Further, no assessment for the reasonableness of the land acquisition costs or the conservation value of the land acquired or projects completed was performed.

METHODOLOGY

To assess whether the Department awarded and expended bond funds in compliance with applicable legal requirements and established criteria, we selected the Conservancy Program because it administered the majority, 89 percent, of the Department's total bond allocation and awarded the majority, 59 percent, of the Department's total bond projects. To gain an initial understanding of key legal provisions and awarding criteria established, we reviewed the program's legal requirements and program guidelines, written grant management policies and procedures, and goals and objectives were reviewed. We also interviewed executive management and key staff that administered the bond funds to determine how legal provisions and criteria were implemented.

To gain an understanding of the agriculture conservation easement industry, internet resources including the Land Trust Alliance's website and other state and federal department easement policies and procedures were researched.

In addition, the Department's bond project tracking database was reviewed to assess the completeness and reliability of the project data. Based on our review, we determined the data to be sufficiently reliable for audit purposes. Using the database, we judgmentally selected and examined 12 out of 121 (10 percent) of the Department's total bond projects to document the Department's legal compliance efforts.

To assess whether the Department had adequate project monitoring processes, documented grant management policies and procedures pertaining to disbursements, grant close-out, and on-going monitoring were reviewed. Using the same sample noted above, we reviewed project files that documented the Department's monitoring efforts. Project files reviewed included documents such as appraisals of fair market value, preliminary title reports, pro forma title insurance policies, subordination agreements, escrow instructions, escrow closing statements, and recorded easements were reviewed. We also reviewed fiscal records that relate to the project monitoring processes.

Recommendations were developed based on our review of documentation made available to us, and interviews with the Department's management and key staff directly responsible for administering bond funds. This review was conducted during the period August 2007 through November 2007.

An audit was performed to determine whether the Department of Conservation's (Department) bond funds awarded and expended were consistent with the applicable legal requirements and established criteria, and whether the Department had adequate project monitoring processes. The following observation was identified:

The Department Lacks Long-Term Monitoring Procedures for Agriculture Conservation Easement Grants

The Department lacks monitoring procedures to protect the state's long-term interest in the agricultural conservation easements. Currently, the Department, via an easement deed, requires the easement holder (grantee) to annually monitor the real property to ensure compliance with the easement terms and conditions. The grantees are required to provide the Department with a one-page annual report describing the monitoring efforts over the property, such as a statement of the site visit performed, the condition of the property, any violations found during the period, corrective actions taken, and resolution of any violations. The easement deed also includes a clause allowing the Department recourse for grantee noncompliance with easement terms and conditions. The Department relies on these annual reports to determine the status of easement conditions. According to the Department on an informal basis, it may also observe the easement properties when visiting neighboring properties and/or have ongoing direct communications with grantees. Although the easement deed articulates the grantee's annual monitoring responsibilities and the Department's right to enforce the easement in non-compliance situations, the Department has no policies or procedures for independent verifications of easement conditions.

Additionally, the Department does not review or require the grantee to report on its ongoing fiscal capacity. According to The Nature Conservancy's Easement Working Group¹, sufficient funding and resources must be available to ensure perpetual active monitoring, management, and if necessary enforcement, which can be very expensive, particularly where court action is required. The Department's required one-page annual report consists of only four items:

- Describe the method of monitoring.
- What is the current land use and condition of the property?
- Were any questionable uses or potential violations of the easement identified? If yes, what corrective actions are being taken?
- Has there been a transfer of interest in the property during the past year? If yes, please identify the type of transfer and name/address of new interest holder.

¹ The Nature Conservancy: Final Report Conservation Easement Working Group, April 29, 2004.

An initial long-term financial plan and/or annual reporting of available monitoring funds may be an additional grantee oversight mechanism for the Department.

With over \$37 million in conservation easement expenditures as of June 30, 2007, and costs of individual easement acquisitions ranging from \$160,000 to \$2.8 million, the Department may face an increasingly high risk of easement violations. An article by the Land Trust Alliance² reported on twelve different types of easement violations observed, including construction of prohibited or unauthorized structures, dumping of waste or debris, and prohibited surface alteration. With the long-term easement terms, normally "in perpetuity", one of the greatest inherent risks in agricultural conservation easements is the potential for conversion of these lands into non-agricultural use, especially as more time passes beyond the initial easement acquisition due to subsequent sales.

Although the Department performs pre-award site visits of potential easement grants, periodic on-site monitoring by Department staff and annual reporting of the grantee's fiscal capacity could mitigate risk. Site visits to all easements may not be feasible given the number of easements acquired; however, the Department can implement a risk-based approach to identify and prioritize potential at-risk grantees and to determine the necessity or frequency of site visits. For example, using a risk-based approach the Department can identify easements subject to intensive pressure for change from either development or other conditions.

One state department has taken proactive steps by adopting policies governing conservation easements. On August 17, 2006, the Wildlife Conservation Board adopted policies allowing it access to protected property once every three years to assess compliance with terms and conditions of conservation easements.

The State Coastal Conservancy (SCC) has also been proactive in easement monitoring. The SCC performs periodic inspections of accessway easements to evaluate its management. If the easement is not managed according to the management plan, SCC either takes title to the easement or designates another acceptable entity to do so.³

As the administrator of bond funds, the Department should develop a risk-based monitoring process to proactively identify easement violations or potential issues in a timely manner. With proper ongoing monitoring in place, prompt corrective actions can be taken and costly legal expenses may be avoided.

² "Conservation Easement Violations: Results from a study of Land Trusts", *Exchange*, Winter 2000. Volume 19 No. 1. The Land Trust Alliance a 501(c)3 charitable organization, is a national organization that provides coordination among 1,600 land trusts across the United States. As part of its mission, the Land Trust Alliance provides leadership, information, skills, and resources land trusts needed to conserve land for the benefit of communities and natural systems.

³ Brenda Buxton, *Happy Trails to You*. How to Accept and Manage Offers to Dedicate Access Easements, California Coastal Commission, 1997.

Recommendations:

- Develop and implement conservation easement monitoring policies and procedures to identify easement violations or potential issues in a timely manner. The monitoring plan should include a risk-based approach to identify and prioritize potential at-risk grantees and to determine the necessity or frequency of site visits.
- Review grantee's fiscal capacity to monitor and manage the easement throughout the easement term. An initial long-term financial plan and/or annual reporting of available monitoring funds may be employed.

This audit was conducted in accordance with *Generally Accepted Government Auditing Standards* (GAGAS), issued by the Comptroller General of the United States.

In connection with this audit, there are certain disclosures required by GAGAS. Finance is not independent of the Department. Both the Department and Finance are part of the Executive Branch, which GAGAS considers an impairment to independence. Also, as required by various statutes within the California Government Code, Finance's other units are mandated to perform certain management and accounting functions. These activities impair independence. Although Finance is statutorily obligated to perform these activities, there are sufficient safeguards and divisions of responsibility in existence to enable the users to rely on the audit work performed and reported.

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March 4, 2008

Mr. David Botelho, Chief
Department of Finance
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300 Capitol Mall, Suite 801
Sacramento, CA 95814

Dear Mr. Botelho:

DRAFT REPORT – AUDIT OF DEPARTMENT OF CONSERVATION'S BOND FUNDS PROPOSITION 12, 13, 40, AND 50

Thank you for the opportunity to review and comment on the draft audit report of the bond management practices in place at the Division of Land Resource Protection (DLRP) of the Department of Conservation (DOC). We take our responsibility to manage the \$81.1 million in bond funds very seriously, and welcome the audit process and findings developed by your auditors.

The DOC accepts and appreciates the audit finding regarding the lack of long-term monitoring procedures for conservation easements. In keeping with the audit recommendations, DLRP will review existing policies and procedures in order to improve our processes to best address the report's findings.

In addition to the steps that are taken when grants are initially awarded, DLRP will establish a risk-based monitoring process to focus the review efforts of our conservation easement grants. We will also add a component to the grantee's annual reporting format that can better assess the financial capacity of an easement holder's ability to adequately monitor and manage the easement through the term of the agreement.

Should you have questions or require additional information, please contact Scott Limpach, Deputy Chief of the Division of Land Resource Protection, at (916) 324-0868.

Sincerely,

Original signed by:

Bridgett Luther
Director