

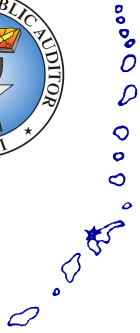


**Office of the Public Auditor**  
Commonwealth of the Northern Mariana Islands

**Division of Public Lands  
Audit of Collection of Rentals  
on Land Leases with Quarries  
For Six Lease Years from 1990 to 1995**



**Audit Report**  
**AR-00-04**



# Office of the Public Auditor

Commonwealth of the Northern Mariana Islands

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November 22, 2000

Mr. Manuel P. Villagomez  
Chairman  
Board of Public Lands  
P. O. Box 500380  
Saipan, MP 96950

Dear Mr. Villagomez:

**Subject: Final Report on the Audit of the Division of Public Lands' Collection of Rentals on Land Leases with Quarries for Six Lease Years from 1990 to 1995 (Report No. AR-00-04)**

The enclosed audit report presents the results of our audit of the Division of Public Lands' (DPL) collection of rentals on land leases with quarries during the six lease years from 1990 to 1995. The objective of our audit was to determine whether collection of lease rentals due on land leases with quarries was in accordance with the terms set forth in their quarry lease agreements, quarry permits, and/or commercial permits (mining).

Our audit showed that DPL failed to collect substantial amounts of lease rentals and interest during the six lease years from 1990 to 1995. Specifically, (1) five quarry operators incurred back rentals amounting to \$2.89 million, (2) four quarry operators underpaid lease rentals by \$261,311 due to misinterpretation of lease agreement/permit provisions and incorrect rental computations, and (3) the eight quarry operators owed about \$1.1 million in interest as of lease year ending 1995 because of late and nonpayment of rentals. DPL also (4) failed to collect rental underpayments of \$570,061 disclosed in a previous audit. As of December 31, 1998, (5) additional interest of \$1.28 million was owed DPL computed on the balance of outstanding rentals and interest as of lease year ending 1995. After deducting subsequent collections and offsetting arrangements of \$1.4 million, the net uncollected rentals and interest totaled \$4.69 million.

Accordingly, we recommend that the Board of Public Lands (BPL) require the DPL Director to (1) record in the lessees' subsidiary ledgers maintained by DPL the adjustments to effect the under/overpayments of rentals and interest, including underpayments identified in OPA's prior audit. DPL should prepare documents to make the offset arrangements binding on all of the affected parties so they will have a basis for updating financial records. DPL should record the correct amounts of offset in the lessees' subsidiary ledgers it maintains, and should also record

the amount due from the CNMI general fund in payment for SMO and DPW; (2) take steps to collect the \$4.69 million in underpayment of rentals (including interest) on land leases with quarries, and refer those lessees who refuse to pay to the Attorney General's office for legal action; (3) review the effect of the additional revenues identified in this audit on each affected year's operation in order to determine if there will be surplus funds due to the Marianas Public Land Trust (MPLT); (4) develop and implement written policies and procedures to ensure that all rental amounts payable under the lease agreements or permits are assessed, collection of all lease amounts payable is pursued, and timely action against erring lessees is taken; (5) send letters to lessees who misinterpreted certain provisions of the lease agreements/permits and incorrectly computed required rentals, clarifying for them the proper interpretation of material subject to royalty or gross receipts rent, and the common errors noted such as not implementing rate increases on the anniversary dates of lease agreements; (6) stop awarding contracts (*e.g.*, construction) mainly for offset purposes without using the competitive selection procedures required by the procurement regulations; (7) require lessees to submit a certification of no quarry operations during periods when they claim no quarry operations. This should be signed by an official of the quarry operator and should indicate the reason for non-operation; (8) develop and implement written policies and procedures to ensure that all quarry operators who remain in possession of the leased area are holding valid quarry permits; and (9) amend the conditions for quarry lease agreements/permits to include (and include in future agreements/permits) a provision that any government agency will be exempt from paying any cost for material extracted from a government-owned quarry site because the sites are government properties and the lessees/permit holders are making substantial profits in their quarry operations. In return, the lessee should be exempt from paying a royalty for the quantity of material quarried by a government agency. The suggested provision can help reduce CNMI government costs.

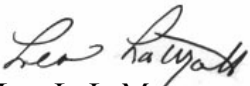
Additionally, we recommend that BPL, the Governor, and the Secretary of Finance (10) review the average yearly government cost for coral purchased by agencies such as SMO and DPW. It appears that the cost (of coral) now incurred by the two agencies was not included in the annual budgets. The only reason why the unbudgeted costs went unnoticed was because the agencies were not making direct cash payments and their costs were being offset against DPL revenues.

In the joint letter response dated July 13, 2000, the BPL Chairman and the DPL Director generally concurred with the recommendations, and provided OPA copies of DPL's computation of lessees' under/overpayments of rentals and interest, adjusted subsidiary ledgers of quarry operators that DPL maintains, and billings sent to quarry operators, to address some of the recommendations.

In his letter response dated May 18, 2000, the Governor concurred with the recommendation addressed to him (Recommendation 10), and provided OPA a copy of his May 18, 2000 letter to the BPL Chairman requesting a full accounting of the annual cost for the coral purchased on behalf of SMO and DPW, and directing BPL to stop the practice of offsetting costs to purchase coral against DPL revenues. The Secretary of Finance has not provided a response to the draft report.

Based on the joint response of the Board and the Division of Public Lands and the response of the Governor, we consider Recommendations 6 and 10 closed, Recommendations 1 and 2 resolved, and Recommendations 3 to 5 and 7 to 9 open. The additional information or action required to close the recommendations is presented in **Appendix H**.

Sincerely,



Leo L. LaMotte  
Public Auditor, CNMI

xc: Governor  
Lt. Governor  
Twelfth CNMI Legislature (27 copies)  
Secretary of Finance  
Secretary of Lands and Natural Resources  
Director of Public Lands  
Attorney General  
Special Assistant for Management and Budget  
Press Secretary  
Press

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# EXECUTIVE SUMMARY

**O**ur audit showed that the Division of Public Lands (DPL) failed to collect substantial amounts of lease rentals and interest during the six lease years from 1990 to 1995. Specifically, (1) five quarry operators incurred back rentals amounting to \$2.89 million, (2) four quarry operators underpaid lease rentals by \$261,311 due to misinterpretation of lease agreement/permit provisions and incorrect rental computations, and (3) the eight quarry operators owed about \$1.1 million in interest as of lease year ending 1995 because of late and nonpayment of rentals. DPL also (4) failed to collect rental underpayments of \$570,061 disclosed in a previous audit. As of December 31, 1998, (5) additional interest of \$1.28 million was owed DPL computed on the balance of outstanding rentals and interest as of lease year ending 1995. After deducting subsequent collections and offsetting arrangements of \$1.4 million, the net uncollected rentals and interest totaled \$4.69 million. This occurred because DPL had inadequate collection procedures. Quarry operators also misinterpreted the agreed rental terms and conditions, and DPL failed to verify the quarry operators' rental computations. Interest was also either incorrectly computed by DPL or not computed at all. As a result, DPL stands at risk of losing a significant amount of rental and interest revenues totaling \$4.69 million unless appropriate measures are taken. Also, benefits from the potential use of these uncollected public funds were not realized.

## Background

Article XI, Section 4 of the Commonwealth of the Northern Mariana Islands (CNMI) Constitution established the Marianas Public Land Corporation (MPLC) to manage public lands in the CNMI. The CNMI Constitution also set forth the fundamental policies for managing public lands to be followed by MPLC and any successor agency.

On August 23, 1994, Executive Order 94-3 (a government reorganization plan) dissolved MPLC and transferred all its functions to DPL in the Department of Lands and Natural Resources (DLNR). The dissolution of MPLC by the executive order resulted in direct control of public

land management by the executive branch.

On April 18, 1997, Public Law 10-57, the Public Lands and Natural Resources Administration Act of 1997, took effect. The act established a Board of Public Lands (BPL) to direct the affairs of DPL. With respect to matters concerning public land management, the Secretary of DLNR and the Director of DPL were to be under the jurisdiction of the Board.

The law also required DPL to strictly enforce all terms of every public land lease and all requirements imposed as a condition of legislative approval of a lease or lease extension. DPL was to develop management policies, procedures, and controls related to

public land which would ensure, among others, that: (1) all rental amounts payable under all lease agreements are fully assessed; (2) all financial documents required under lease agreements are provided and all rental calculations by lessees are checked for accuracy; and (3) lease rental payments are collected or pursued in timely fashion under default provisions of the lease agreements. DPL was directed to maintain records documenting the basis of rental computations for public land leases.

For the purpose of this report, both the previous MPLC and the current DPL will be referred to only as “DPL”.

### **Quarry Leases**

Through the years, private companies and individuals have been allowed to use public lands for quarry operations through lease and permit arrangements, as follows:

1. Quarry Lease Agreement - This arrangement requires payment of a fixed rent, a guaranteed annual minimum royalty, and an additional royalty based on the quantity actually removed over and above the annual minimum royalty. Lease terms covered periods of five to twenty-five years beginning on the date of the lease or on the first day of the month of execution of the agreement.
2. Quarry permit - This arrangement requires the payment of a guaranteed annual minimum royalty, and an

additional royalty based on the quantity actually removed over and above the annual minimum royalty. Permits were usually for a one-year period beginning on the date of the lease or on the first day of the month of execution of the permit.

3. Commercial permits (mining) - This arrangement requires the payment of a permit fee, a guaranteed annual minimum royalty, and an additional royalty based on the quantity of material actually removed over and above the annual minimum royalty. Permits were usually for a one-year period beginning on the date of the lease or on the first day of the month of execution of the permit.

For the purpose of this report, we shall refer to the fixed rent, permit fee, and royalty fee as lease rentals.

During the six lease years from 1990 to 1995, DPL had existing leases or entered into lease arrangements with eight private companies for rock quarry operations on Saipan. Two of the companies were also allowed to perform quarry operations on Pagan Island and on Tinian.

### **Objective and Scope**

The objective of the audit was to determine whether collection of lease rentals due on land leases with quarries was in accordance with the terms set forth in their quarry lease agreements, quarry permits, and/or commercial permits (mining).

The scope of the audit covered the lease rentals due from the eight quarry operators during the six lease years from 1990 to 1995. To accomplish our objectives, we (1) examined available accounting records such as production reports, quarry tally sheets, sales reports, and other documents having financial implications; (2) independently computed rentals due based on provisions of lease agreements and permits and compared with the lessees' rental payments to DPL; (3) computed the imputed interest on the unpaid rent and royalty from due date to December 31, 1998; and (4) interviewed knowledgeable officials and personnel from DPL and the lessees.

**DPL Failed to Collect \$4.69 Million in Rentals and Interest**

DPL should collect lease rentals from the eight quarry operators in accordance with the agreed terms and conditions of the leases and permits, and should ensure that all lease rentals are billed and collected in a timely manner. Interest should also be computed and collected on late rental payments and unpaid rentals. Our audit showed, however, that DPL failed to collect substantial amounts of lease rentals and interest during the six lease years 1990 to 1995. Specifically, (1) five quarry operators incurred back rentals amounting to \$2.89 million, (2) four quarry operators underpaid lease rentals by \$261,311 due to misinterpretation of lease agreement/permit provisions and incorrect rental computations, and (3) the eight quarry operators owed about \$1.1 million in interest as of lease year ending 1995 because of late and

nonpayment of rentals. DPL also (4) failed to collect rental underpayments of \$570,061 disclosed in a previous audit. As of December 31, 1998, (5) additional interest of \$1.28 million was owed DPL computed on the balance of outstanding rentals and interest as of lease year ending 1995. After deducting subsequent collections and offsetting arrangements of \$1.4 million, the net uncollected rentals and interest totaled \$4.69 million. This occurred because DPL had inadequate collection procedures. Quarry operators also misinterpreted the agreed rental terms and conditions, and DPL failed to verify the quarry operators' rental computations. Interest was also either incorrectly computed by DPL or not computed at all. As a result, DPL stands at risk of losing a significant amount of rental and interest revenues totaling \$4.69 million unless appropriate measures are taken. Also, benefits from the potential use of these uncollected public funds were not realized.

Accordingly, we recommend that BPL require the DPL Director to:

1. Record in the lessees' subsidiary ledgers maintained by DPL the adjustments to effect the under/overpayments of rentals and interest, including underpayments identified in OPA's prior audit. The report already shows the correct amounts for the offset between the lessees and affected CNMI government agencies as of the lease year ending in 1995. DPL should prepare documents to make the offset arrangements binding on all of the affected



parties so they will have a basis for updating financial records. DPL should record the correct amounts of offset in the lessees' subsidiary ledgers it maintains, and should also record the amount due from the CNMI general fund in payment for SMO and DPW.

2. Take steps to collect the \$4.69 million in underpayment of rentals (including interest) on land leases with quarries, and refer those lessees who refuse to pay to the Attorney General's office for legal action.
3. Review the effect of the additional revenues identified in this audit on each affected year's operation in order to determine if there will be surplus funds due to the Marianas Public Land Trust (MPLT).
4. Develop and implement written policies and procedures to ensure that all rental amounts payable under the lease agreements or permits are assessed, collection of all lease amounts payable is pursued, and timely action against erring lessees is taken. Include in the policies and procedures to be developed the following: (a) monitoring the submission of required financial documents by the lessees; (b) checking whether the report of material extracted is complete and accurate, and whether the royalty computations have complied with the terms of the lease and are accurate; and (c) scheduling periodic on-site inspections of quarry sites.
5. Send letters to lessees who misinterpreted certain provisions of the lease agreements/permits and incorrectly computed required rentals, clarifying for them the proper interpretation of material subject to royalty or gross receipts rent, and the common errors noted such as not implementing rate increases on the anniversary dates of lease agreements.
6. Stop awarding contracts (e.g., construction) mainly for offset purposes without using the competitive selection procedures required by the procurement regulations.
7. Require lessees to submit a certification of no quarry operations during periods when they claim no quarry operations. This should be signed by an official of the quarry operator and should indicate the reason for non-operation.
8. Develop and implement written policies and procedures to ensure that all quarry operators who remain in possession of the leased area are holding valid quarry permits. Include in the policies and procedures to be developed the monitoring of contract renewals.
9. Amend the conditions for quarry lease agreements/permits to include (and include in future agreements/permits) a provision that any government agency will be exempt from paying any cost for material extracted from a

government-owned quarry site because the sites are government properties and the lessees/permit holders are making substantial profits in their quarry operations. In return, the lessee should be exempt from paying a royalty for the quantity of material quarried by a government agency. The suggested provision can help reduce CNMI government costs.

Additionally, we recommend that BPL, the Governor, and the Secretary of Finance:

10. Review the average yearly government cost for coral purchased by agencies such as SMO and DPW. It appears that the cost (of coral) now incurred by the two agencies was not included in the annual budgets. The only reason why the unbudgeted costs went unnoticed was because the agencies were not making direct cash payments and their costs were being offset against DPL revenues.

#### **Joint Response of the Board and the Division of Public Lands**

In the joint letter response dated July 13, 2000 (**Appendix E**), the BPL Chairman and the DPL Director generally concurred with the recommendations, and provided OPA copies of DPL's computation of lessees' under/overpayments of rentals and interest, adjusted subsidiary

ledgers of quarry operators maintained by DPL, and billings sent to quarry operators, to address some of the recommendations.

#### **Response to Recommendation 10 by the Office of the Governor and Department of Finance**

In his letter response dated May 18, 2000 (**Appendix F**), the Governor concurred with the recommendation addressed to him (Recommendation 10), and provided OPA a copy of his May 18, 2000 letter to the BPL Chairman requesting a full accounting of the annual cost for the coral purchased by SMO and DPW, and directing BPL to stop the practice of offsetting costs to purchase coral against DPL revenues.

The Secretary of Finance has not provided a response to the draft report.

#### **OPA Comments**

Based on the joint response of the Board and the Division of Public Lands and the response of the Governor, we consider Recommendations 6 and 10 closed, Recommendations 1 and 2 resolved, and Recommendations 3 to 5 and 7 to 9 open.

The additional information or action required to close the recommendations is presented in **Appendix H**.

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# Introduction

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## Background

**A**rticle XI, Section 4 of the Commonwealth of the Northern Mariana Islands (CNMI) Constitution established the Marianas Public Land Corporation (MPLC) to manage public lands in the CNMI. The CNMI Constitution also set forth the fundamental policies for managing public lands to be followed by MPLC and any successor agency.

On August 23, 1994, Executive Order 94-3 (a government reorganization plan) dissolved MPLC and transferred all its functions to the Division of Public Lands (DPL) in the Department of Lands and Natural Resources (DLNR). The dissolution of MPLC by the executive order resulted in direct control of public land management by the executive branch.

On April 18, 1997, Public Law 10-57, the Public Lands and Natural Resources Administration Act of 1997, took effect. The act established a Board of Public Lands (BPL) to direct the affairs of DPL. With respect to matters concerning public land management, the Secretary of DLNR and the Director of DPL were to be under the jurisdiction of the Board.

The law also required DPL to strictly enforce all terms of every public land lease and all requirements imposed as a condition of legislative approval of a lease or lease extension. DPL was to develop management policies, procedures, and controls related to public land which would ensure, among others, that: (1) all rental amounts payable under all lease agreements are fully assessed; (2) all financial documents required under lease agreements are provided and all rental calculations by lessees are checked for accuracy; and (3) lease rental payments are collected or pursued in timely fashion under default provisions of the lease agreements. DPL was directed to maintain records documenting the basis of rental computations for public land leases.

For the purpose of this report, both the previous MPLC and the current DPL will be referred to only as “DPL”.

## Quarry Leases

Through the years, private companies and individuals have been allowed to use public lands for quarry operations through lease and permit arrangements, as follows:

1. *Quarry Lease Agreement* - This arrangement requires payment of a fixed rent, a guaranteed annual minimum royalty, and an additional royalty based on the quantity actually removed over and above the annual minimum royalty. Lease terms covered periods of five to twenty-five years beginning on the date of the lease or on the first day of the month of execution of the agreement.
2. *Quarry permit* - This arrangement requires the payment of a guaranteed annual minimum royalty, and an additional royalty based on the quantity actually

removed over and above the annual minimum royalty. Permits were usually for a one-year period beginning on the date of the lease or on the first day of the month of execution of the permit.

3. *Commercial permits (mining)* - This arrangement requires the payment of a permit fee, a guaranteed annual minimum royalty, and an additional royalty based on the quantity of material actually removed over and above the annual minimum royalty. Permits were usually for a one-year period beginning on the date of the lease or on the first day of the month of execution of the permit.

For the purpose of this report, we shall refer to the fixed rent, permit fee, and royalty fee as lease rentals.

During the six lease years from 1990 to 1995, DPL had existing leases or entered into lease arrangements with eight private companies for rock quarry operations on Saipan. Two of the companies were also allowed to perform quarry operations on Pagan Island and on Tinian. The details are presented in **Table 1** below. A map of Saipan showing the quarry sites is presented in **Appendix A**.

Quarry Operators	Quarry Site	Land Area (in square meter)	----- Arrangement -----			
			Type	Period Term	From	To
1 Black Micro Corporation	Marpi, Saipan	83,313	Quarry Lease Agreement	15 years	09/11/79	09/10/94
2 Camacho Equipment Co. and Rock Quarry	Marpi, Saipan	50,000	Quarry Permit	1 year	10/03/89	10/02/92*
3 J.C. Tenorio Enterprises, Inc.  Construction & Material Supply, Inc. (CMS)	Dandan, Saipan	45,135	Quarry Lease Agreement	5 years	03/21/80	03/20/90**
			Quarry Permit	10 years	04/01/90	03/31/2000
	Dandan, Saipan	15,358	Quarry Lease Agreement	25 years	01/18/89	01/17/2014
4 Juan T. Sablan  J.G. Sablan Construction & Quarry Company	Marpi, Saipan	40,000	Quarry Permit	1 year	12/01/89	11/30/90
	Pagan Island	unsurveyed	Commercial Permit (Mining)	1 year 5 years	09/10/92 08/01/93	07/31/93 09/07/95***
5 Marianas Trading & Development Corporation (MTDC)	Dandan, Saipan	50,000	Quarry Permit	1 year month to month	07/12/88 07/12/89	07/11/89 07/31/92
			Quarry Lease Agreement	5 years	08/01/92	07/31/97
6 Sablan Corporation	Sadog Tasi, Saipan	49,297	Quarry Lease Agreement	10 years	03/05/82	03/04/92
	Naftan, Saipan	49,999	Quarry Lease Agreement	25 years	03/01/90	07/12/91****
7 Benigno T. Fejeran (d.b.a. Solid Builders)	Kagman, Saipan	not stated	Quarry Permit	1 year	12/04/91	12/03/92
	Capitol Hill, Saipan	48,171	Quarry Permit	1 year	04/01/93	03/31/94
8 Western Equipment, Inc.	Dandan, Saipan	40,000	Quarry Lease Agreement	25 years	07/20/84	07/19/2009
	Marpo Heights, Tinian	49,900	Lease Agreement	25 years	06/03/86	06/02/2011

\* Renewal for lease years 1991 and 1992 was documented on the last page of the original permit.  
\*\* The agreement granted the lessee the option to extend the lease for another 5 years. The lessee exercised this option.  
\*\*\* Revoked on 09/08/95.  
\*\*\*\* The period of the lease was cut short to 07/12/91 because DPL approved the exchange of the property on this date.

**Table 1 - Lease Arrangement**

**Objective, Scope,  
and  
Methodology**

**T**he objective of the audit was to determine whether collection of lease rentals due on land leases with quarries was in accordance with the terms set forth in their quarry lease agreements, quarry permits, and/or commercial permits (mining).

The scope of the audit covered the lease rentals due from the eight quarry operators during the six lease years from 1990 to 1995.<sup>1</sup> To accomplish our objectives, we (1) examined available accounting records such as production reports, quarry tally sheets, sales reports, and other documents having financial implications;<sup>2</sup> (2) independently computed rentals due based on provisions of lease agreements and permits<sup>3</sup> and compared with the lessees' rental payments to DPL; (3) computed the imputed interest on the unpaid rent and royalty from due date to December 31, 1998; and (4) interviewed knowledgeable officials and personnel from DPL and the lessees.

We performed our audit at the DPL and lessees' offices on Saipan from April 1996 to November 1997. The audit was made, where applicable, in accordance with Government Auditing Standards issued by the Comptroller General of the United States. Accordingly, we included such tests of records and other auditing procedures as were considered necessary under the circumstances.

As part of our audit, we evaluated DPL's internal controls over collection of lease rental. We found internal control weaknesses in these areas, which are discussed in the Findings and Recommendations section of this report. Our recommendations when implemented should improve controls in these areas.

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<sup>1</sup> Lease year represents one-year period from anniversary date of the agreement or permit, *e.g.*, if the lease has an anniversary date of November 22, lease year 1995 represents period from November 23, 1994 to November 22, 1995. In three leases, the audit scope was extended to 12/31/95, which was beyond the ending dates for lease year 1995, because of the following: (1) CMS Quarry Permit - to coincide with the audit cut-off date of another lease agreement with the lessee on adjacent property; (2) MTDC Lease Agreement - because of an offsetting agreement between DPL and the lessee where the settlement covers the period ending 12/31/95; and (3) Solid Builders Quarry Permit - because accounting records were readily available at the time of audit. The audit scope for Sablan Corporation's two lease agreements was cut short to 8/14/94 and 7/12/91, respectively, because DPL approved the exchange of the properties on these dates.

<sup>2</sup> Information in the lessees' reports was test-checked against source documents such as quarry slips, delivery receipts, and sales invoices, if available. In those periods where no lessee's reports were available, other documents such as financial statements, Business Gross Receipts (BGR) tax returns, and source documents were used as a basis.

<sup>3</sup> The provisions of the expired quarry permits were applied to those lessees whose permits had expired but who still had quarry operations on the premises or had not vacated the premises during the period covered by the audit (see page 26).

**Prior Audit  
Coverage**

**I**n 1993, OPA conducted an audit of lease payments made by quarry and nonquarry operators in lease years 1988 and 1989. The major finding noted was underpayment of rentals to DPL totaling \$244,369 due mainly to DPL's lack of policies and procedures to monitor collection of lease payments and verify the accuracy of rental computations provided by the lessees. In 1996, we conducted an audit of lease payments received from hotel lessees for lease years 1990 to 1994. The major finding noted was underpayment of rentals to MPLC totaling \$772,363, again due mainly to DPL's control weaknesses regarding collection of lease rental payments.

# Findings and Recommendations

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## DPL Failed to Collect \$4.69 Million in Rentals and Interest

DPL stands at risk of losing \$4.69 million in uncollected rental and interest revenues because of its inadequate collection procedures

**D**PL should collect lease rentals from the eight quarry operators in accordance with the agreed terms and conditions of the leases and permits, and should ensure that all lease rentals are billed and collected in a timely manner. Interest should also be computed and collected on late rental payments and unpaid rentals. Our audit showed, however, that DPL failed to collect substantial amounts of lease rentals and interest during the six lease years from 1990 to 1995. Specifically, (1) five quarry operators incurred back rentals amounting to \$2.89 million, (2) four quarry operators<sup>4</sup> underpaid lease rentals by \$261,311 due to misinterpretation of lease agreement/permit provisions and incorrect rental computations, and (3) the eight quarry operators owed about \$1.1 million in interest as of lease year ending 1995 because of late and nonpayment of rentals. DPL also (4) failed to collect rental underpayments of \$570,061 disclosed in a previous audit. As of December 31, 1998, (5) additional interest of \$1.28 million was owed DPL computed on the balance of outstanding rentals and interest as of lease year ending 1995. After deducting subsequent collections and offsetting arrangements of \$1.4 million, the net uncollected rentals and interest totaled \$4.69 million. This occurred because DPL had inadequate collection procedures. Quarry operators also misinterpreted the agreed rental terms and conditions, and DPL failed to verify the quarry operators' rental computations. Interest was also either incorrectly computed by DPL or not computed at all. As a result, DPL stands at risk of losing a significant amount of rental and interest revenues totaling \$4.69 million unless appropriate measures are taken. Also, benefits from the potential use of these uncollected public funds were not realized.

### Collection of Lease Rental Due

Quarry lease agreements and permits provided terms and conditions such as rental amount, due date, financial reporting, interest, lease period, and renewal. DPL should collect lease rentals and interest, if any, from the quarry operators in accordance with the agreed terms and conditions, and should ensure that all lease rentals are billed and collected in a timely manner.

Lease agreements and permits specify the required financial documents and other information to be submitted by the lessee. Most agreements and permits require the submission of royalty reports showing the computation of royalty in relation

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<sup>4</sup> One of which (Sablan Corporation) was also included among those five who failed to pay required rentals.



to the quantity of material extracted and removed from the quarry premises. Even without actual extraction and/or removal of material, most of the agreements and permits require fixed periodic lease rentals.

DPL should check whether the information in the royalty reports (e.g., summary of quantity of material extracted), is complete and accurate by (1) accounting for the numerical sequence of the source documents as summarized in the report; (2) checking mathematical accuracy of the summary; (3) comparing the reported information with the lessee’s annual certified financial statements and Commonwealth business gross revenue quarterly tax returns; and (4) performing on-site inspections to become familiar with the lessee’s operations so as to detect previously undeclared material extracted. DPL should also check whether royalty computations are in accordance with the terms of the lease and are mathematically accurate. To facilitate review of compliance with provisions of the lease, DPL should maintain a tabulated summary of relevant information for each lease such as rental amount, due date, financial reporting, interest, lease period, and renewal.

Lease provisions specify when lease payments are to be made, when a default occurs, and what actions are available to DPL if the lessee defaults. DPL should ensure that lease rental payments are collected, or default provisions of the lease agreements/permits are enforced, in a timely manner such as by termination of the lease agreements/permits.

**Uncollected Lease Rentals Totaled \$4.69 Million**

Our audit showed that DPL failed to collect substantial amounts of lease rentals and interest during the six lease years from 1990 to 1995. Specifically, (1) five quarry operators incurred back rentals amounting to \$2.89 million, (2) four quarry operators underpaid lease rentals by \$261,310.89 due to misinterpretation of lease agreement/permit provisions and incorrect rental computations, and (3) the eight quarry operators owed about \$1.1 million in interest as of lease year ending 1995 because of late and nonpayment of rentals. DPL also (4) failed to collect rental underpayments of 570,060.95 disclosed in a previous audit. As of December 31, 1998, (5) additional interest of \$1.28 million was owed DPL computed on the balance of outstanding rentals and interest as of lease year ending 1995. After deducting subsequent collections and offsetting arrangements of \$1.4 million, the net uncollected rentals and interest totaled \$4.69 million (see below for summary and **Appendices B and C** for details specific to each quarry operator).

Back Rentals .....	\$2,887,664.68
Underpayments Due to Misinterpretation and Incorrect Rental Computations .....	261,310.89
Unpaid Interest as of Lease Year Ending 1995 because of Late Payments and Nonpayments .....	<u>1,096,268.32</u>
Net Underpayments - Lease Years 1990 - 1995 .....	4,245,243.89
Underpayments Identified in OPA’s Prior Audit .....	570,060.95
Additional Interest after Lease Year Ending 1995 up to 12/31/98 .....	1,275,676.31
Deduct: Subsequent Collections/Offsetting Arrangements .....	<u>(1,400,273.34)</u>
Total .....	<u>\$4,690,707.81</u>

## Back Rentals

Our audit showed that five quarry operators incurred back rentals amounting to \$2.89 million from lease years 1990 to 1995. A breakdown of the unpaid rentals is shown below:

Lessee	Fixed Rent	Minimum Royalty	Additional Royalty	Total Unpaid Rentals
1. J.G. Sablan		\$201,120.00	\$1,098,104.24	\$1,299,224.24
2. MTDC	\$100,000.00	27,708.34	559,105.24	686,813.58
3. Camacho Equipment		54,720.00	447,779.73	502,499.73
4. Solid Builders	18,059.64	21,437.50	244,419.88	283,917.02
5. Sablan Corporation	28,264.18	79,465.50	7,480.43	115,210.11
Total	\$146,323.82	\$384,451.34	\$2,356,889.52	\$2,887,664.68

### *J.G. Sablan Construction & Quarry Company - \$1,299,224.24*

The lessee did not pay the required minimum and additional royalties totaling \$1.3 million on the two quarry sites as follows:

Rental Type	Marpi Quarry	Pagan Quarry	Total Unpaid Rentals
Minimum Royalty	\$9,120.00	\$192,000.00	\$201,120.00
Additional Royalty	1,098,104.24	0.00	1,098,104.24
Total	\$1,107,224.24	\$192,000.00	\$1,299,224.24

### Marpi Quarry

The quarry permit required the lessee to pay a guaranteed annual minimum royalty of \$9,120, (computed based on 6,000 cubic yards (cy) at \$1.52 per cy). Additional royalty was due at the rate of \$1.52 per cy based on the quantity of material actually removed in excess of 6,000 cy. Minimum royalty was payable semi-annually in advance while the additional royalty was payable within five days after the end of each one-month period. Past due fees were to bear interest at one percent per month compounded monthly.

Our audit showed that during the six-year period from December 1, 1989 to November 30, 1995, the lessee did not pay the \$9,120 minimum royalty for one lease year (1995) and \$1,098,104.24 in additional royalties for all six years. The lessee only paid the minimum royalties for five lease years totaling \$45,600, plus \$3,416.92 interest.

We also found that the lessee did not submit monthly reports to DPL which should have shown the quantity of material extracted from the quarry and amount of royalty due. Our verification of the lessee's records revealed that the lessee did not account for the monthly extractions of material, and therefore had no basis for computing royalty and reporting to DPL. To calculate the materials extracted for assessment of royalty, OPA used as a basis the lessee's sales documents such as sales records

and/or invoices. For those periods when no sales documents were available, OPA used as a basis the Business Gross Receipts (BGR) tax returns where amounts were divided by the average selling price derived from available previous sales documents.

#### Pagan Quarry

The commercial (mining) permit which became effective in September 1992 required the lessee to pay a permit fee of \$4,000 per annum, a guaranteed annual minimum royalty of \$62,500 (computed based on 250,000 tons of pozzolan<sup>5</sup> at \$.25 per ton) and \$1,500 (computed based on 2,000 cy of basalt<sup>6</sup> at \$.75 per cy), and additional royalty based on quantity of material actually removed that exceeded the quantity covered by the minimum royalty. Payments were as follows: Permit fee was payable annually in advance; minimum royalty was payable semi-annually in advance; and the additional royalty was payable on or before the 15<sup>th</sup> of the month immediately after receipt of payment for pozzolan or basalt shipped by the lessee. Past due fees were to bear interest at one-half percent per month compounded monthly. On August 1, 1993, a month before the first permit expired, a second permit was executed for a term of five years with almost the same provisions as the first permit. On September 8, 1995, a third permit was executed which revoked the second permit. This has a term of 20 years.

The lessee did not pay the minimum royalties of \$192,000 ( $[\$62,500 + \$1,500] \times 3$  years) for lease years 1993 to 1995. The lessee only paid the \$12,000 permit fees plus \$269.49 interest for the three-year lease period.

We found that the lessee did not submit any monthly reports to show DPL the quantity of material extracted from the quarry. An official of the company stated that no reports were submitted because there were no commercial quarry operations during the period covered by the audit. The lessee, however, has never informed DPL about the absence of commercial operations.

In November 1998, OPA staff members visited Pagan island and found no conclusive evidence to establish that there were ongoing quarry operations or that material was mined in commercial quantities. OPA saw only about 12,000<sup>7</sup> tons of pozzolan stockpiled near the shore, which the lessee's employee stated were quarried during the last quarter of 1996. Nevertheless, the lessee should have paid the minimum royalties as required in the conditions for granting the permit.

A DPL official informed OPA that the issue of nonpayment from 1993 to 1995 was rendered moot by the issuance of the third permit. The third permit provided that

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<sup>5</sup> Pozzolan is a volcanic rock, powdered and used in making a hydraulic cement. The minimum royalty per ton of \$.25 is increased by \$.25 for every additional 500,000 tons extracted.

<sup>6</sup> Basalt is a dark, tough, fine-grained to dense, extrusive volcanic rock commonly occurring in sheet-like lava flows. The minimum royalty per cy of \$.75 is increased by \$.25 for every additional 500 cy extracted.

<sup>7</sup> This estimate was given by the lessee's employee assigned on Pagan.

the permit fee would be increased to \$20,000 per annum, and royalties would be based only on actual extraction with no guaranteed minimum. The third permit, however, also provided that nothing in the revocation should act to release the lessee from any responsibilities lawfully accrued under the second permit, including responsibility for paying rental accrued and past due. Thus, the lessee should not be relieved from paying the past due amounts for lease years 1993 to 1995.

### **Marianas Trading & Development Corporation (MTDC) - \$686,813.58**

During the six-year period covered by the audit, the first three years of the lessee's quarry operations were covered by a quarry permit while the other three years were covered by a lease agreement.

The quarry permit required the lessee to pay a guaranteed annual minimum royalty of \$3,040.00 (based on 2,000 cy at \$1.52 per cy), and additional royalty at \$1.52 per cy computed based on the quantity of material actually removed in excess of 2,000 cy.

The lease agreement required the lessee to pay the following: (1) a guaranteed annual minimum rent of \$40,000, (2) additional rent equivalent to three percent of gross receipts from any business activity conducted within the leased premises less the \$40,000 minimum rent, (3) guaranteed annual minimum royalty of \$8,750 (based on 5,000 cy at \$1.75 per cy), and (4) additional royalty of \$1.75 per cy of materials actually removed in excess of 5,000 cy.

Our audit showed that lease rentals due for the first three years (August 1, 1989 to July 31, 1992) were paid in full. However, lease rentals due for the next three-year period (August 1, 1992 to December 31, 1995), those covered by the lease agreement, were only partially paid, leaving an unpaid balance of \$686,813.58 as follows:

Lease Years 1993- 1995 (up to 12/31/95)	Fixed Rent	Minimum Royalty	Additional Royalty	Total
Amount Due*	\$136,666.00	\$29,895.84**	\$583,394.16**	\$749,956.00
Payments	(36,666.00)	(2,187.50)	(24,288.92)	(63,142.42)
Unpaid Rentals	\$100,000.00	\$27,708.34	\$559,105.24	\$686,813.58

\* Fixed rent and minimum royalty were computed at 3 years and 5 months.

\*\* Royalties due, which totaled \$613,290, consist of \$330,302.75 for material extracted by the lessee and \$282,987.25 for material extracted by the Office of the Mayor of Saipan and the Department of Public Works.

During the second three-year period, the lessee only paid the fixed rent due for 11 months (*i.e.*, from August 1992 to March 1993 and from July to September 1993), and royalties due for 3 months (August, October, and November 1992). Also, starting January 1993, the lessee did not submit to DPL any monthly reports to show the quantity of material extracted from the quarry. Our verification revealed that the lessee did not have records of royalty computations based on material extracted from the quarry. To estimate the quantity of material extracted, OPA used as a basis the lessee's delivery receipts. The royalties due on material extracted were \$330,302.75.

We also found that from September 1992 to January 1995, both the Saipan Mayor's Office (SMO) and the Department of Public Works (DPW) removed coral from the MTDC site. The direct removal of material by the two government entities was authorized by the former MPLC Executive Director. Those entities were also charged by MTDC for coral extractions at the rate of \$3.50 per cy (which was later reduced to \$2.65). Our review showed that material extracted by SMO and DPW totaled 161,707 cy. The equivalent royalty for that quantity was \$282,987.25 but no royalty payment was made. The lessee claimed that it should not be charged royalties for what SMO and DPW extracted because the two government entities were charged a lower rate. OPA believes that in determining the quantity of material subject to royalty, coral extracted by government entities from the lessee's quarry should also be included because the written agreement did not have a provision for any such exemption. It was also reasonable for SMO and DPW to be charged a lower rate because the removal and delivery of material was done by government personnel, not MTDC's.

#### ***Camacho Equipment Co. and Rock Quarry - \$502,499.73***

The quarry permit required the lessee to pay a guaranteed annual minimum royalty of \$9,120 (computed based on 6,000 cy at \$1.52 per cy) and an additional royalty of \$1.52 per cy on the quantity of material actually removed which exceeded 6,000 cy. The minimum royalty was payable semi-annually in advance while the additional royalty was payable within five days after the end of each one-month period. Past due fees were to bear interest at one percent per month compounded monthly.

Our audit showed that during the six-year period covered by the audit (October 1, 1989 to September 30, 1995), the lessee did not pay the required minimum and additional royalties totaling \$54,720 and \$447,779.73, respectively. Although the lessee had submitted monthly reports to DPL showing the volume of material extracted from the quarry, no payments accompanied the reports. The lessee paid \$25,000 and \$15,000 in October and November 1992, respectively, but those amounts were applied, as required, only to interest on past due accounts.

#### ***Solid Builders - \$283,917.02***

The lessee was first granted a one year quarry permit at a site in Kagman. The permit was from December 1991 to November 1992 but DPL records showed that the lessee occupied the site until March 1993. On April 1, 1993, a second quarry permit was granted for another site on Capitol Hill. That quarry permit had a provision for yearly renewal. The first permit required the lessee to pay a guaranteed annual minimum royalty of \$5,250 (computed based on 3,000 cy at \$1.75 per cy), and an additional royalty of \$1.75 per cy on the quantity of material actually removed in excess of 3,000 cy.

The second permit required the lessee to pay a fixed rent of \$12,039.75 per annum, a guaranteed annual minimum royalty of \$5,250 (computed based on 3,000 cy at

\$1.75 per cy) and an additional royalty of \$1.75 per cy on the quantity of material actually removed in excess of 3,000 cy.

The lessee did not pay the required fixed rent, minimum royalties, and additional royalties totaling \$283,917.02 for the two quarry sites as follows:

Rental Type	Kagman Quarry	Capitol Hill Quarry	Total Unpaid Rentals
Fixed Rent	\$0.00	\$18,059.64	\$18,059.64
Minimum Royalty	7,000.00	14,437.50	21,437.50
Additional Royalty	0.00	244,419.88	244,419.88
<b>Total</b>	<b>\$7,000.00</b>	<b>\$276,917.02</b>	<b>\$283,917.02</b>

#### Kagman Quarry

Our audit showed that from December 1991 to March 1993, the lessee did not pay the required minimum royalty of \$7,000. The lessee also did not submit any royalty reports to DPL to show the quantity of material extracted from the quarry. An official of the lessee stated that no quarry operations were performed at the site due to the substandard quality of the coral found. The lessee, however, did not request permit cancellation and did not ask DPL to inspect the quarry site so that inspectors could validate the claim of inactivity. Nevertheless, it was clear in the permit that the minimum royalty had to be paid, with or without quarry operations.

#### Capitol Hill Quarry

Our audit showed that from April 1993 to December 1995, the lessee paid only \$18,059.64<sup>8</sup> or 50 percent of the fixed rent, leaving the same amount unpaid, and did not pay any of the required minimum and additional royalties of \$14,437.50 and \$244,419.88, respectively.

The lessee did not submit any royalty reports to DPL to show the quantity of material extracted from the quarry. To estimate the quantity of material extracted, OPA used copies of the delivery receipts issued by the lessee.

#### **Sablan Corporation - \$115,210.11**

The lessee did not pay the required fixed rent, or the minimum and additional royalties totaling \$115,210.11 on the two quarry sites (see next page for breakdown).

<sup>8</sup> In addition to the \$18,059.64 payment, the lessee remitted \$1,577.97 interest on past due accounts.

Rental Type	Sadog Tasi Quarry	Naftan Quarry	Total Unpaid Rentals
Fixed Rent	\$28,264.18	\$0.00	\$28,264.18
Minimum Royalty	67,739.30	11,726.20	79,465.50
Additional Royalty	7,070.93	409.50	7,480.43
Total	\$103,074.41	\$12,135.70	\$115,210.11

### Sadog Tasi Quarry

The lease agreement was for a ten-year period which expired on March 4, 1992. The agreement required the lessee to pay a fixed rent of \$8,592.09 for lease year 1990, with an eight percent increase annually. In addition, the lessee was required to pay a guaranteed annual minimum royalty of \$20,565 (computed based on 30,000 cy at \$.6855 per cy) for lease year 1990, with an eight percent rate increase annually. Additional royalty was also to be paid, at the rate of \$.6855 per cy (also with an eight percent rate increase annually) based on the quantity of material actually removed in excess of 30,000 cy. Fixed rent and royalty were payable on or before the 20<sup>th</sup> day of the 1<sup>st</sup> month of each calendar quarter. On August 14, 1994, DPL approved an exchange of the leased land with land owned by the lessee.<sup>9</sup>

Our audit showed that from March 1, 1990 to August 14, 1994, the lessee paid only partial lease rentals (fixed rent, minimum and additional royalties), leaving an unpaid balance of \$103,074.41. The unpaid rentals represented those due from March 1, 1992 to August 14, 1994. The lessee stopped payments when the lease agreement expired on March 4, 1992, but continued quarry operations until August 14, 1994.

### Naftan Quarry

The lease agreement was for 25 years beginning March 1, 1990, and required the lessee to pay a fixed rent of \$43,999.12 (for the first five-year period). In addition, the lessee was required to pay a guaranteed annual minimum royalty of \$8,750 (computed based on 5,000 cy at \$1.75 per cy), and an additional royalty of \$1.75 per cy on the quantity of material actually removed in excess of 5,000 cy. The lease agreement, however, was terminated on July 12, 1991 because DPL approved an exchange of the leased land with land owned by the lessee.

Our audit showed that from March 1, 1990 to July 12, 1991, the lessee did not pay the minimum and additional royalties of \$11,726.20 and \$409.50, respectively. The lessee paid only the fixed rent.

<sup>9</sup> A DPL Official informed us that to date, the approved land exchange has not yet been completed.

## Underpayments Due to Misinterpretation and Incorrect Rental Computations

Four quarry operators<sup>10</sup> underpaid lease rentals by \$261,310.89 (see breakdown below) due to misinterpretation of lease agreement/permit provisions and incorrect rental computations.

Lessee	Misinterpretation	Incorrect Computation	Total Under (Over) payments
1. CMS	\$264,938.31	(\$14,075.86)	\$250,862.45
2. Black Micro		13,099.37	13,099.37
3. Sablan Corporation		(2,340.65)	(2,340.65)
4. Western Equipment		(310.28)	(310.28)
Total	\$264,938.31	(\$3,627.42)	\$261,310.89

### Misinterpretation of Lease Agreement/Permit Provisions - \$264,938.31

CMS leased two adjacent parcels of land located in Dandan, Saipan for rock quarrying and other related operations. Under the lease agreements, the two parcels of adjacent land were called H 01 and H 02. Quarrying was restricted to area H 01 where quarried rocks were processed into sand and aggregates, while area H 02 was used for manufacturing concrete-masonry-units (CMU). However both sites had batch plants for preparing ready-mix-concrete (RMC), to be sold or used in the lessee's construction projects.

The H 01 area was covered by a five-year lease agreement with an option to extend for another 5 years. The extension expired on March 20, 1990. A new ten-year quarry permit was signed on August 14, 1996 but was made to take effect retroactively on April 1, 1990, or more than 6 years prior to its actual issuance.

The H 02 area was covered by a 25-year lease agreement from January 18, 1989 to January 17, 2014.

Our audit showed that during the period January 1, 1989 to December 31, 1995, the lessee had a different interpretation of how to apply the provisions on lease rentals which resulted in underpaid lease rentals of \$264,938.31 (see next page for breakdown).

<sup>10</sup> One of which (Sablan Corporation) was also included among the five lessees who failed to pay required rentals as previously discussed.



Difference in Interpreting Material Subject to Royalty or Gross Receipts Rent	Under Payments
H 01 Old Lease Agreement	
- Lessee excluded inventory	\$16,473.04
H 01 New Quarry Permit	
- Lessee excluded material:	
1. Used in construction projects	175,463.05
2. Used in the production of RMC and CMU	80,906.66
- Adjustment - Change in wording of the new permit - from material "removed" to "sold"	(20,083.93)
H 02 Lease Agreement	
- Lessee excluded RMC and CMU used in construction projects	12,179.49
Total	\$264,938.31

## H 01 Area

### ***Old Lease Agreement (from January 1, 1989 to March 31, 1990)***

In the final year (lease year 1990) of this lease agreement, the lessee was required to pay a fixed rent of \$9,175.43. The lessee was also required to pay a guaranteed annual minimum royalty of \$4,198 (computed based on 6,000 cy at \$.6997 per cy) and an additional royalty of \$0.6997 per cy on the quantity of material actually removed in excess of 6,000 cy. Lease rentals were payable on or before the 20<sup>th</sup> day of the 1<sup>st</sup> month of each quarter.

*Exclusion of material inventory in royalty computation.* In its computation, the lessee interpreted that "material actually removed" excluded material stockpiled at the quarry site (material inventory), even though it had been established in prior audits (Review of Rental Payments from Quarry & Non Quarry Operations for Lease Years 1988 & 1989) that "material actually removed" included material quarried and held as material inventory. Both OPA and DPL's legal counsel agreed to the inclusion of inventory as part of material actually removed.

In the computation of royalty (in the prior audit) for lease year 1989, 4,646 cy of material inventory was included, but the same quantity was again included in royalty computation and payment (by lessee) for lease year 1990. However, the lessee excluded 28,189 cy of material inventory in the 1990 royalty computation. That resulted in 23,543 (28,189 less 4,646) cy of material inventory excluded from royalty computation in 1990. The unpaid royalty (at \$0.6997/cy) was \$16,473.04.

### ***New Quarry Permit (April 1, 1990 to December 31, 1995)***

There was actually no existing permit when quarry operations were ongoing from March 21, 1990 to December 31, 1995. Negotiation for and signing of a new permit were not completed until August 14, 1996. The terms of the new permit were made to take effect retroactively on April 1, 1990, except for the assessment of three percent of gross receipts. The terms covering lease rentals were as follows:

- guaranteed annual minimum royalty of \$9,590 for lease years 1991 to 1994 and \$23,975 for lease year 1995. Those amounts were for the equivalent minimum extraction of 13,700 cy at the rates of \$0.70 per cy (from 1991 to 1994) and \$1.75 per cy (in 1995).
- additional royalty on the quantity of “material actually sold” in excess of 13,700 cy at the same rate minimum royalty would be calculated for each particular year.
- payment of three percent of gross receipts derived from the sale of *cement and rock products (such as RMC and CMU)* produced on the premises (H 01 area), except that quarried material (such as coral, sand, aggregates) used in the products on which the three percent charge was imposed were to be exempt from the assessment of royalty. However, this provision (three percent of gross receipts) was to take effect only after the permit’s execution date (*i.e.*, August 14, 1996), and would not be retroactive like the provisions for minimum and additional royalties.

*Royalties were not paid on material used in lessee’s construction projects.* In the computation of royalties, the lessee included only rock material *directly sold* to customers and excluded those issued to its contracted construction projects. OPA believes that rock material issued to construction projects should also have been assessed royalties because both transactions (direct sales and issuance to construction projects) were for the same objective, to earn revenue from the quarried material. The difference in the form and the method by which material was sold for profit should not affect the computation of the correct amount of royalty due to the government. Rock material issued to lessee’s construction projects during the period totaled 146,080 cy, and the equivalent unpaid royalty was \$175,463.05.

*Royalty was not paid on material used in the production of RMC and CMU.* The lessee excluded (1) material manufactured and sold as RMC, and (2) material transferred to H 02 area, manufactured, and sold as CMU in the computation of royalty for the H 01 area. The lessee’s interpretation was that all rock material used in the production of RMC and CMU, *whether manufactured in the H 01 or H 02 area*, was exempted from royalty charges because the sale of those products was charged the three percent of gross sales of these products, and that the exemption was *retroactive to the effective date of the permit*, on April 1, 1990.

OPA believes that the above described material was subject to royalty computations under the terms of the permit for the H 01 area because:

- The manufacturing of material (on H 01) for RMC did not exclude it from being part of the quantity of “material actually sold.” It was merely a change in the appearance of the material when the sale was conducted.
- The provisions in the two agreements/permits should be applied only to the specific area stated in the agreements/permits.

- The permit for H 01 stated that the quarried material used in the products on which the three percent charge was imposed was to be exempt from the assessment of royalty, except that the three percent charge was to take effect only after the permit's execution date (August 14, 1996). From April 1, 1990 to December 31, 1995, the lessee did not pay the three percent charge (pursuant to the terms of the permit for H 01) on RMC sold on H 01. It is therefore clear that material used for the RMC should have been included for royalty computations.
- The lessee also transferred material to the adjacent H 02 area where the material was sold as part of manufactured CMUs and RMCs. Again, the lessee excluded such (transferred and sold) material in the royalty computations for H 01 because it claimed that the three percent charge (based on gross receipts) was paid. The lessee cannot claim payment of the three percent charge on the H-02 area as a basis for not paying royalty due under the H 01 permit because the exclusion was to take effect only after August 14, 1996. In addition, the three percent charge that was actually paid pertains to the lease rental due under the terms of another lease agreement for the H 02 area. The lessee, therefore, should pay the royalty due under the H 01 permit for quarrying and selling the material, and at the same time should pay the three percent charge based on gross receipts because that was the manner in which the lease rental was to be computed for the H 02 area. The issue would have been seen more clearly if the two areas had been leased by different lessees. If material transferred to H 02 were not to be subjected to royalty payment and the lessee of H 02 were only to pay a three percent charge based on gross receipts, then DPL would end up collecting only the minimum royalty for the quarry operations on H 01.

The material included in directly sold RMC and CMU, and RMC and CMU issued to lessee's construction projects during the period, totaled 89,387.82 cy. The equivalent unpaid royalty was \$80,906.66.

*Adjustment due to Change in the basis of computing royalty from material "removed" to "sold."* Under the new quarry permit, royalty was based on rock material "sold," where previously it was based on rock material "removed." Under the old permit, royalty was computed on ending inventory of rock material as of March 31, 1990. However, that material became the beginning inventory under the new permit, and was eventually sold and again assessed royalty under the new permit provisions. In order to be consistent with the permit provisions and to correct the double computation of royalty on the material inventory, the lessee's royalty account was credited \$20,083.93. That credit represented royalty charged on the March 31, 1990 ending inventory of 28,189 cy. This procedure fairly charged the lessee with royalty due in line with the wording of the lease.

## H 02 Area

***Lease Agreement (from January 18, 1989 to December 31, 1995)***

The lessee was required to pay three percent of the gross receipts from whatever business activities were conducted within the premises. However, in the absence of any business activity, the lessee was required to pay an annual guaranteed minimum rent of \$7,688.50 from 1990 to 1993 and \$8,303.58 for 1994 and 1995.

*Gross Receipts rent was not paid for material issued to lessee's contracted construction projects.* The lessee excluded the selling price of RMC and CMU issued to its construction projects from the total gross receipts that were used as the basis for computing the three percent gross receipts rent. The lessee included only the selling price of RMC and CMU *sold directly* to customers. RMC and CMU that were issued to a construction project formed part of the total construction cost to be used as the basis for computing mark-up or net revenue. Any activity performed to generate revenue should be considered a business activity, and the RMC and CMU issuances to contracted construction projects must therefore be considered part of the gross revenue used for the three percent rent computation.<sup>11</sup>

The lessee's records showed that the cost of RMC and CMU issued to lessee's construction projects during the period totaled \$414,268.24, and the equivalent unpaid three percent gross receipts rent was \$12,179.49.

***Incorrect Computation - (\$3,627.42)***

Our audit showed that the quarry operators made various accounting errors in the computation of required rentals resulting in net overpayments of \$3,627.42 as follows:

Nature of Errors	CMS	Sablan Corporation	Black Micro	Western Equipment	Under (Over) Payment
1. Rate increase not implemented on anniversary date of lease agreement		(\$187.04)	\$3,733.01	(\$374.24)	\$3,171.73
2. Error in computing fixed rent in certain period	\$298.65	(2,311.53)			(2,012.88)
3. Gross receipts rent computed based on sales from another leased area	(13,765.82)				(13,765.82)
4. Paid only minimum royalties instead of actual		157.92			157.92
5. Error in accounting for the quantity of quarry material	(866.67)		9,366.36		8,499.69
6. Others	257.98			63.96	321.94
<b>Total</b>	<b>(\$14,075.86)</b>	<b>(\$2,340.65)</b>	<b>\$13,099.37</b>	<b>(\$310.28)</b>	<b>(\$3,627.42)</b>

<sup>11</sup> Quarried material was also used for purposes other than generating revenue such as repairs and leasehold improvements on the lessee's property. These were described in CMS' records as "Other Jobs". Material issued to other jobs from April 1, 1990 to December 31, 1995 totaled 6,822 cy. No royalty was computed on this type of issuances because these were not in the nature of sales.

***Rate increase not implemented on anniversary date of lease agreement***

Sablan Corporation's lease agreement for Sadog Tasi provided for rate increases effective on the anniversary dates of the lease agreement, *i.e.*, every March. In computing the fixed rent, the lessee recognized the rate increase in December 1990 instead of March 1991. This resulted in a \$187.04 overpayment of the required rentals.

Black Micro's lease agreement provided for rate increases effective on the anniversary dates of the lease agreement. In computing fixed rent and royalties, the lessee recognized the rate increases in the month following the anniversary dates of the lease agreement. This resulted in \$3,733.01 underpayment of the required rentals.

Western Equipment's lease agreement for the Dandan quarry provided for rate increases for each subsequent five-year period of the term of the lease, *i.e.*, in July 1989, July 1994, and so on. In computing the royalties, the lessee recognized the rate increase in April 1989 instead of July 1989, and in October 1993 instead of July 1994. In computing the fixed rent, the lessee recognized the rate increase in January 1994 instead of July 1994. This resulted in a \$374.24 overpayment of the required rentals.

***Error in computing fixed rent for certain periods***

CMS' extended five-year lease agreement on H 01 area expired on March 20, 1990. A ten-year quarry permit was executed on August 14, 1996 which was made effective retroactively on April 1, 1990. Because there was no existing contract during the period March 21 to 31, 1990, the lessee did not compute and pay the fixed rent of \$298.65 during that period. OPA believes, however, that the lessee should have paid the fixed rent during that period because it continuously used the area.

The expiration of Sablan Corporation's lease term on Naftan quarry was shortened to July 12, 1991 because on that date, DPL approved an exchange of the leased land with land owned by the lessee. The lessee did not prorate the computation of fixed rent for July 1991 (should be for 12 days only), resulting in a \$2,311.53 overpayment.

***Gross receipts rent computed based on sales from another leased area***

CMS' lease agreement on H 02 area required payment of gross receipts rent based on the lessee's gross receipts from any business activity conducted within the H 02 area. The lessee erroneously computed the gross receipts rent based on the gross receipts from sale and issuances of products manufactured in the H 01 area instead of the H 02 area during the period April 1990 to March 1991. Sales and issuance of RMC manufactured in the H 01 area were more than those produced in the H 02 area, resulting in a \$13,765.82 overpayment.

***Paid only minimum royalties instead of actual***

Sablan Corporation’s lease agreement required the payment of an annual guaranteed minimum royalty of \$20,565 (computed based on 30,000 cy at \$.6855 per cy for 1990, with an eight percent rate increase annually). Additional royalty was due at the same rate based on the quantity of material actually removed in excess of 30,000 cy. In lease year 1992, the lessee paid only the minimum royalty on 30,000 cy although material extracted totaled 30,197.50 cy. This resulted in a \$157.92 underpayment.

***Error in accounting for the quantity of quarry material***

In CMS’ computation of royalties in the *H 01 area under the old lease agreement*, the lessee arrived at 92,212 cy of material subject to royalty, *i.e.*, excluding inventory.<sup>12</sup> For comparison purpose, OPA also excluded inventory, and the amount of material arrived at was 94,476.09 cy. This means that the material subject to royalty reported by the lessee was short by 2,264.09 cy which was equivalent to a \$1,584.18 underpayment. In CMS’ computation of royalties in the *H 01 area under the new quarry permit*, the lessee arrived at 268,976.25 cy of material subject to royalty, *i.e.*, excluding material used in construction projects and in the production of RMC and CMU.<sup>12</sup> For comparison purpose, OPA also excluded the material not included by the lessee in its accounting of material, and the amount of material arrived at was 266,981.79 cy. This means that the reported material subject to royalty was over by 1,994.46 cy, which was equivalent to a \$2,450.85 overpayment. OPA and the lessee based the above volume on the same source document, *i.e.*, the cost of production report. The discrepancies noted, however, could not be explained, resulting in lessee’s net overpayment to DPL of \$866.67.

In Black Micro’s computation of royalties, the lessee arrived at 509,678 cy of material subject to royalty. The amount of material arrived at by OPA was 511,587 cy. OPA

Aggregates and manufactured sand produced
Add: Blasted rocks used for job MTRs (means material transfers - for further processing)
Blasted rocks sold per delivery tags
Boulders extracted and sold
Deduct: Processed products used for production of MTRs
Month-end production subject to royalty
Add (Deduct): Black Micro’s adjustments
Errors noted in Black Micro’s summary (addition error, omission, etc.)
= Actual material extracted

and the lessee used the same source document, *i.e.*, production reports, in arriving at the volume of quarry material extracted. However, the lessee obtained only the number of cy to produce aggregates and manufactured sand as summarized in the “Purchase or Produce” column of the report. OPA, on the other hand, took into consideration the movement of the quarry material to arrive at the actual material extracted. The formula used by OPA is shown in **Figure 1**. This resulted in a 1,909 cy difference (lessee under) which was equivalent to a \$9,366.36 underpayment.

**Figure 1** - Computation used by OPA

<sup>12</sup> This matter was included in our finding on misinterpretation of agreement/permit provisions on pages 13 to 16 of this report.

**Others**

In our audit of CMS’ and Western Equipment’s rental due, immaterial discrepancies were noted between OPA’s and lessees’ rental computations resulting in underpayment of \$257.98 and \$63.96, respectively. The discrepancies were mainly due to a rounding difference.

**Unpaid Interest due to Late Payments and Nonpayments**

Seven quarry operators owed a total of about \$1.1 million in interest as of lease year ending 1995 because of late and nonpayments of rentals from lease years 1990 to 1995, as follows:

1. J.G. Sablan .....	\$658,165.21
2. MTDC .....	161,869.89
3. Camacho Equipment .....	185,409.93
4. Solid Builders .....	37,990.38
5. CMS .....	10,601.55
6. Sablan Corporation .....	36,496.89
7. Black Micro .....	5,734.47
Total .....	<u>\$1,096,268.32</u>

Most of the executed lease and permit arrangements between DPL and the lessee required that past due rental would bear interest at either one percent per month compounded monthly, or eight percent per year, from the due date until paid. For lease years 1990 to 1995, the seven lessees incurred interest on past due accounts totaling \$1,141,798.45. DPL collections, however, totaled only \$45,530.13. This resulted in a \$1,096,268.32 interest underpayment.

**Underpayments Identified in OPA’s Prior Audit**

DPL also failed to collect rental underpayments of \$570,060.95 disclosed in a previous audit.

Our previous audit of DPL’s quarry land leases showed that for lease years 1988 and 1989, five lessees underpaid the required rentals to DPL, totaling \$231,893.16. Two lessees (MTDC and Camacho Equipment), failed to pay the required rentals totaling \$193,296.04, while the other three lessees (CMS, Sablan Corporation, and Western Equipment) underpaid the required rentals totaling \$38,597.12 due to misinterpretation of certain provisions of the lease agreements/permits, and incorrect computations.

Our audit showed that except for Camacho Equipment whose rental due was offset against the cost of services it provided under its agreement with DPL to do a homestead site clearing, each lessee has not paid the underpayments reported in our previous audit totaling \$207,479.74.<sup>13</sup> As of December 31, 1998, additional interest

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<sup>13</sup> This amount comprises unpaid rental of \$178,959.50 and unpaid interest of \$28,520.24.

on uncollected rentals amounted to \$362,581.21, resulting in net uncollected rentals and interest of \$570,060.95.

1. MTDC .....	\$519,876.46
2. CMS .....	46,992.51
3. Sablan Corporation .....	2,091.83
4. Western Equipment .....	1,100.15
Total .....	<u>\$570,060.95</u>

Our review of DPL's ledgers showed that the lessees' accounts were not charged for the underpayment of rentals. Consequently, DPL did not bill the lessees for the amounts owed.

**Subsequent Collections**

Our audit showed that subsequent to the period covered by the audit, Solid Builders and Sablan Corporation paid \$26,455 and \$34,442.10, respectively. After paying \$26,455, Solid Builders still owes DPL \$295,452.40. On February 5, 1997, AGO sent Solid Builders a notice of eviction from the Capitol Hill quarry. On September 30, 1997, AGO ordered the enforcement of the eviction notice, *i.e.*, the quarry site was chained and padlocked. On October 6, 1997, DPL filed a lawsuit to collect the unpaid rent, royalties and late charges/interest from Solid Builders, which totaled \$1.14 million. The unpaid balance per audit was less than \$.8 million according to DPL records, mainly due to different cut-off dates, *i.e.*, December 1995 for OPA and November 1997<sup>14</sup> for DPL.

**Subsequent Offsetting Arrangements**

Subsequent to the period covered by the audit, DPL resorted to offsetting arrangements with three lessees in an amount totaling \$1.34 million in order to collect all or a portion of the receivables. The most significant of the three arrangements was the one with Camacho Equipment Co. DPL awarded an \$873,350 construction contract to Camacho Equipment Co. on the condition that 90 percent of the contract price would be offset against the company's liability to DPL.

J.G. Sablan - \$21,177.41

In 1993, J.G. Sablan was contracted (Contract No. HSTDRDC93-2S) by DPL to construct streetways and a ponding basin in specified areas of the Kagman III Village Homestead Project. On September 10, 1996, the lessee requested an offset of what it was supposed to collect for the contract against whatever amount it owed DPL. DPL accepted the request on November 5, 1996. On that date, DPL's obligation to the lessee for the Kagman III Homestead Project was \$90,936.17, while DPL's records showed a \$73,460.93 receivable from the lessee, \$21,177.41 (\$20,965.62 for Marpi and \$211.79 Pagan) of which was for quarry leases. Our computation showed

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<sup>14</sup> The date the quarry site was sequestered.



that the lessee actually owed DPL more than \$2 million in quarry rental and interest. However, because DPL had not recorded the correct amount of receivables from the lessee, only \$21,177.41 was settled through the offset arrangement for quarry leases.

MTDC - \$550,178.83

As previously mentioned in this report, the Saipan Mayor's Office (SMO) and the Department of Public Works (DPW) also extracted and bought coral from the MTDC quarry. In a letter to the Governor dated February 12, 1996, the DPL Director discussed an offset arrangement wherein MTDC would release SMO and DPW from an estimated \$535,000 debt if DPL would agree to discharge MTDC's estimated \$484,554.66 liability. However, the proposed offset arrangement did not happen as planned for several reasons. Among those reasons were:

1. DPL was not able to provide any basis for how the \$535,000 owed to MTDC was computed. Also, DPL could not accurately compute the amount of monthly royalty due from MTDC at the time because MTDC had stopped submitting the required monthly extraction and royalty computation reports as of December 1992. The estimated receivable from MTDC of \$484,554.66 as of December 1995 was computed based on the average royalty from previously submitted royalty reports.
2. As of December 31, 1995, the amount of the receivable from MTDC that was recorded in DPL's subsidiary ledger was only \$274,554.66. Therefore, on March 7, 1996, DPL was only able to credit MTDC's account by the same amount, and OPA had not been furnished any information about how MTDC adjusted its records.
3. MTDC knew that the offset arrangement did not happen as planned. In an August 1, 1996 letter to DPL, the MTDC president stated that the offset did not materialize because of an Attorney General's (AG) decision (except that the details were not stated in the letter and no copy of the AG decision has been provided to OPA). He stated further that since OPA was conducting an audit of MTDC's quarry operations, MTDC should be allowed to make all necessary payments after the audit. The audit will show to both MTDC and DPL the actual amounts for offset purposes.

Because of the MTDC president's statement about relying on the results of the OPA audit as the basis for making its (MTDC) final settlement with DPL, OPA also computed the estimated liability (for cost of coral and interest) of SMO and DPW to MTDC. The total amount due to MTDC from SMO and DPW as of December 31, 1995 was \$550,178.83 (see details in **Appendix D**).

Our audit showed that for the period August 1, 1989 to December 31, 1995, the lessee had an unpaid balance of \$848,683.47 (including underpaid interest of \$161,869.89). On the other hand, SMO and DPW owed the lessee \$550,178.83 for

coral extractions in the lessee's quarry (161,707 cy at \$2.65 per cy, plus interest of \$121,655.28). Therefore, MTDC still owes the CNMI government \$298,504.64.

Camacho Equipment - \$768,020

On November 21, 1995, DPL (through a contract signed by the former governor) contracted Camacho Equipment for a road development project in Kagman III Homestead Subdivision. DPL and the lessee also agreed that 90 percent of the \$873,350 contract cost, or \$786,015, would be offset against any amount owed by the lessee to DPL. There was also a 25 percent change order that increased the contract cost by \$218,337.50, thus resulting in a total contract cost of \$1,091,687.50.

DPL records showed that when the contract was finished, only \$553,747.57, and not the \$786,015 stipulated in the contract, was offset against the lessee's debt to DPL. According to DPL, the balance of \$232,267.50 will be applied once the OPA audit is completed and the correct amount of receivables from the lessee is determined. The audit showed that as of the April 22, 1997 contract completion date, the lessee owed DPL \$773,404.25 in unpaid lease rentals (as of LY 1995) and interest (up to April 22, 1997). In accordance with the provisions of the contract, we believe that the offset of accounts should have taken effect on the completion date. The settlement of accounts should have been accomplished by offsetting the \$773,404.25 the lessee owed to DPL against the \$786,015 representing 90 percent of the original contract price. However, in paying the remaining 10 percent, DPL overpaid the lessee by \$17,995 decreasing the amount available for offset with Camacho Equipment to \$768,020. That would result in lessee still owing DPL \$5,384.25.

The offset arrangement may have been a practical way to collect unpaid lease rentals, but it also may have resulted in losses to the government due to improprieties in awarding the construction contract. First, the contract was awarded without complying with the CNMI procurement regulations. All government contracts are to be awarded by competitive sealed bids except when authorized under other methods of procurement such as sole source, emergency procurement, expedited procurement, and small purchases. Nothing in DPL records showed which authorized procurement method was used, and there was no justification for the alternative method selected. Second, the contract and attachments did not clearly show the scope of work or services needed by DPL, and thus there was no basis for reviewing or ascertaining that periodic billings received were valid claims of the lessee. Third, the use of technical experts to ensure quality and cost control was not evident during the period of the project. There was no reference to any architectural and engineering (A & E) study. There was no evidence that progress billings were reviewed by an independent construction manager or a qualified in-house technical person. In addition, the 25 percent change order further raised the risk of improprieties in the transactions. There was no clear and documented justification (such as the explanation of engineers or other technical personnel), yet the contract price was increased by 25 percent.

It appears that the delinquent lessee benefitted more from the result of the offset arrangement than did DPL. Aside from settling a large amount of debt, the lessee who was delinquent and not complying with the provisions of the lease agreement was able to immediately collect a cash benefit of about \$250,000 (total of change order cost and DPL’s remaining liability after the offset) from a highly questionable construction contract. Because of the lessee’s history of not making timely payment, it would have been more prudent for DPL to withhold any payment due for the contract until the lessee had complied with all the terms of the lease and was making timely payments.

### Inadequate Collection Procedures

DPL’s failure to collect \$4.69 million in rentals and interest occurred because DPL had inadequate collection procedures. Quarry operators also misinterpreted the agreed rental terms and conditions, and DPL failed to verify the quarry operators’ rental computations. Interest was also incorrectly computed by DPL or not computed at all.

DPL did not employ control procedures that would assess all rental amounts payable under the lease agreements or permits, and pursue the collection of all lease amounts payable. In addition, DPL officials did not take timely action against erring lessees.

During the period covered by the audit, DPL did not have written policies and procedures to ensure that (1) required financial documents were provided and lessee rental calculations were accurate, and (2) lease rental payments were collected or default provisions of the lease agreements or permits were enforced in a timely manner.

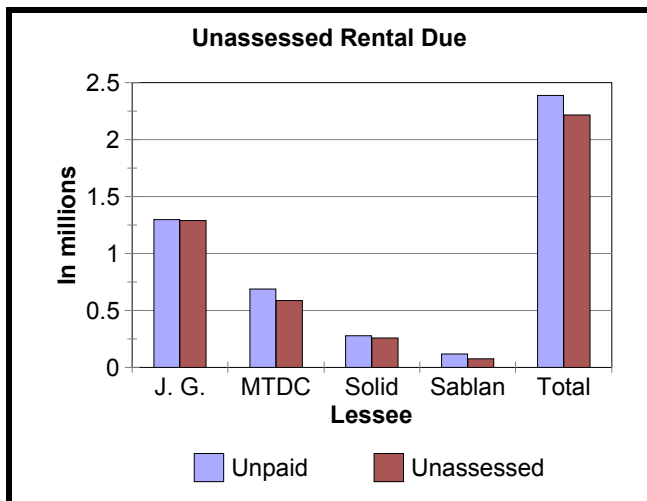


Figure 2- Comparison of Unpaid and Unassessed Rentals

DPL did not ensure that lessees were assessed the required rentals when due. Our review of DPL’s ledgers showed that four lessees (J.G. Sablan, MTDC, Solid Builders, and Sablan Corporation) who failed to pay the required rentals to DPL for certain periods, were not assessed and billed the required royalties. Amounts not assessed totaled \$2.22 million, which represented 93 percent of the \$2.38 million uncollected lease rentals from the four lessees (excluding interest; see Figure 2). This occurred because DPL did not ensure lessees’ submission of monthly detailed reports and royalty computations that would have been the basis of assessment. Most of the lease agreements and permits provide that fixed rent and royalty payments is to be paid when due without demand or notice. Therefore, DPL should immediately take action if a lessee has failed to pay and submit monthly reports. DPL

personnel should be familiar with the lease terms and not claim they are unaware of the rental requirement. As in the case of J.G. Sablan’s lease, DPL claimed it was not aware that the lessee should be charged additional royalties because the requirement was omitted in the lessee’s manual ledger maintained by DPL.<sup>15</sup> For CMS, DPL was not able to detect undeclared material extracted because it did not perform site inspections to become familiar with the lessee’s operations, resulting in an approximate \$265,000 underpayment by the lessee (excluding interest). Furthermore, because the unassessed rentals totaled as much as \$2.22 million, the interest on past due accounts charged to the lessees was materially understated.

DPL also failed to take appropriate action when a lessee defaulted. For example, even with sufficient quarry operation information provided by Camacho Equipment, DPL allowed about \$700,000 (including interest) in receivables to accumulate for six years. Consequently, a questionable construction contract was awarded to the lessee in order that contract payments could be offset against the unpaid rent.

As a result, DPL stands at risk of losing a significant amount of rental and interest revenues totaling \$4.69 million unless appropriate measures are taken. Also, benefits from the potential use of these uncollected public funds were not realized. (see below for breakdown, and **Appendices B** and **C** for details).

1. J.G. Sablan	\$2,753,839.88
2. MTDC	946,967.58
3. Camacho Equipment	5,384.25
4. Solid Builders	424,083.85
5. CMS	379,486.51
6. Sablan Corporation	152,570.13
7. Black Micro	27,585.74
8. Western Equipment	789.87
Total	<u>\$4,690,707.81</u>

**Subsequent Events**

In response to OPA’s recommendations in the previous audit conducted on DPL’s collection of rentals on land leases with hotels, resorts, and golf courses from lease years 1990 to 1994, DPL established written procedures detailing the functions of program activities on leases, contracts, and permits, which became effective in December 1996. The finalized procedures did not address, however, our recommendations relating to verification of rental computations in accordance with the terms of the lease and the mathematical accuracy of the computations, or the comparison of lessee’s reported information with its annual certified financial statements and business gross revenue tax returns. Effective July 1995, the DLNR Secretary created the Account Compliance Section, headed by an Account Compliance Supervisor, to monitor receivables for collection and review whether lessees were in compliance with the lease agreements/permits. Also, DPL established

<sup>15</sup> DPL used to maintain a manual subsidiary ledger for each lessee where relevant information about the lease was noted on the left side of the ledger. Starting in fiscal year 1996, DPL computerized the subsidiary ledgers, and the relevant information about the lease was no longer noted.

written procedures under which the Technical Enforcement Officer would perform regular visual site inspections to ensure that all income from the leased premises would be reported to DPL. The procedures did not address, however, the frequency and extent of inspection. DPL’s letter dated February 25, 1999 stated that the Account Compliance function was recently transferred back under the supervision of the Division’s Comptroller.

**Other Matter - Quarry Operators Remain in Possession of the Leased Area without Valid Quarry Permits**

Our audit also showed that three quarry operators had performed quarry operations or had not vacated the quarry sites although their permits had already expired two to five years ago. (Details are shown below). This occurred because DPL was inadequately monitoring contract renewals.

	Quarry Operators	Quarry Site	Period Without Valid Permit		
1.	Camacho Equipment Co. and Rock Quarry	Marpi, Saipan	10/01/92	09/30/95	3 yrs.
2.	J.G. Sablan Construction & Quarry Company	Marpi, Saipan	12/01/90	11/30/95	5 yrs.
3.	Solid Builders	Capitol Hill, Saipan	04/01/94	12/31/95	1 yr. & 9 mos.

Although most of the quarry permits provided that renewal should be initiated by the quarry operator (thru written notice to DPL not less than 30 days before the expiration of the permit), DPL should take action in cases where the operator fails to send notice but remains in possession of the leased area after the expiration of the term of the permit.

**Conclusion and Recommendations**

Because DPL failed to establish and implement adequate policies and procedures to ensure that all rental amounts payable under the lease agreement/permit provisions were assessed, that collection of all lease amounts payable was pursued, and that timely action against erring lessees was taken, uncollected rental revenues on land leases with quarry operators totaled \$4.69 million (including \$2.37 million interest). Accordingly, we recommend that BPL require the DPL Director to:

1. Record in the lessees’ subsidiary ledgers maintained by DPL the adjustments to effect the under/overpayments of rentals and interest, including underpayments identified in OPA’s prior audit. The report already shows the correct amounts for the offset between the lessees and affected CNMI government agencies as of the lease year ending in 1995. DPL should prepare documents to make the offset arrangements binding on all of the affected parties so they will have a basis for updating financial records. DPL should record the correct amounts of offset in the lessees’ subsidiary ledgers it maintains (see **Appendix C** for details), and should also record the amount due from the CNMI general fund for what it paid on behalf of SMO and DPW.

2. Take steps to collect the \$4.69 million in underpayment of rentals (including interest) on land leases with quarries ( see **Appendices B and C** for details), and refer those lessees who refuse to pay to the Attorney General’s office for legal action.
3. Review the effect of the additional revenues identified in this audit on each affected year’s operation in order to determine if there will be surplus funds due to the Marianas Public Land Trust (MPLT).<sup>16</sup>
4. Develop and implement written policies and procedures to ensure that all rental amounts payable under the lease agreements or permits are assessed, collection of all lease amounts payable is pursued, and timely action against erring lessees is taken. Include in the policies and procedures to be developed the following: (a) monitoring the submission of required financial documents by the lessees; (b) checking whether the report of material extracted is complete and accurate, and whether the royalty computations have complied with the terms of the lease and are accurate; and (c) scheduling periodic on-site inspections of quarry sites. In developing such policies, the Director should be guided by our discussion of the collection of lease rental due on pages 5 and 6 of this report.
5. Send letters to lessees who misinterpreted certain provisions of the lease agreements/permits and incorrectly computed required rentals, clarifying for them the proper interpretation of material subject to royalty or gross receipts rent, and the common errors noted such as not implementing rate increases on the anniversary dates of lease agreements (see discussion on pages 13 to 19 of this report).
6. Stop awarding contracts (*e.g.*, construction) mainly for offset purposes without using the competitive selection procedures required by the procurement regulations.
7. Require lessees to submit a certification of no quarry operations during periods when they claim no quarry operations. This should be signed by an official of the quarry operator and should indicate the reason for non-operation.
8. Develop and implement written policies and procedures to ensure that all quarry operators who remain in possession of the leased area are holding valid quarry permits. Include in the policies and procedures to be developed the monitoring of contract renewals.
9. Amend the conditions for quarry lease agreements/permits to include (and include in future agreements/permits) a provision that any government agency will be exempt from paying any cost for material extracted from a government-owned quarry site because the sites are government properties and the

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<sup>16</sup> DPL is required by constitutional mandate (2 CMC §4115 (g)) to remit its net revenue to MPLT

lessees/permit holders are making substantial profits in their quarry operations. In return, the lessee should be exempt from paying a royalty for the quantity of material quarried by a government agency. The suggested provision can help reduce CNMI government costs.

Additionally, we recommend that BPL, the Governor, and the Secretary of Finance:

10. Review the average yearly government cost for coral purchased by agencies such as SMO and DPW. It appears that the cost (of coral) now incurred by the two agencies was not included in the annual budgets. The only reason why the unbudgeted costs went unnoticed was because the agencies were not making direct cash payments and their costs were being offset against DPL revenues.

From a financial management standpoint, SMO and DPW are reporting understated costs and not preparing accurate budgets, while DPL may be reporting understated amounts of revenue. If DPL is not reporting the correct amount of revenue and not recording a receivable for the amount it paid on behalf of SMO and DPW, then DPL may not be in compliance with the constitutional mandate to remit net revenue to MPLT.

#### ***Joint Response of the Board and the Division of Public Lands***

The BPL Chairman and the DPL Director generally concurred with the recommendations, and provided OPA copies of DPL's computation of lessees' under/overpayments of rentals and interest, adjusted subsidiary ledgers of quarry operators maintained by DPL, and billings sent to quarry operators, to address some of the recommendations, as follows:

Recommendations 1 and 2 - DPL assessed the uncollected lease rentals and interest of the quarry operators, including underpayments identified in OPA's prior audit and offsetting arrangements; recorded in its subsidiary ledgers of quarry operators adjustments to effect the unrecorded lease rentals and interest; and sent billings to quarry operators to collect the unpaid lease rentals and interest. However, the ledgers were not adjusted and billings were not made either for MTDC due to its pending bankruptcy proceeding or for Sablan Corporation due to its land exchange issues, which require further review and clarification.

DPL's assessment of unpaid lease rentals and interest during the six lease years from 1990 to 1995 totaled \$7.04 million which included additional interest as of May 31, 2000. For comparison purpose, DPL also determined the unpaid lease rentals with additional interest up to December 31, 1998 only (same cut-off date as OPA), and this totaled \$4.75 million.

Five of the six quarry operators responded to the billing, as follows: (1) one had fully paid its underpayments; (2) one had paid only the amount which it considered to be the undisputed portion and requested a further discussion to clarify some discrepancies; (3) one had proposed a schedule of installment payments; (4) one

had disagreements on certain interpretations of the lease agreement and requested a further discussion of the issues; and (5) one asked to waive a large portion of the underpayment because of its inability to check the validity of the billing due to nonavailability of the financial records.

With regards to the recommendation to record the amount due from the CNMI general fund for what it paid on behalf of SMO and DPW (which was offset against MTDC's underpayment), DPL stated that it does not intend to request reimbursement from DOF for the amount because it believed that the offset was justified because the extraction made by SMO and DPW from the MTDC site was for a public purpose.

Recommendation 3 - The response expressed concurrence with the recommendation and stated that DPL is currently reviewing the effect of the foregoing unrealized revenues on each affected year's operation to determine whether there are surplus funds due to MPLT.

Recommendation 4 - The response expressed concurrence with the recommendation and stated that DPL will update its existing policies and procedures to ensure that rentals due under the lease agreements or permits are accurately assessed and collected in a timely manner, and that submission of all required reports are consistently monitored.

Recommendation 5 - The response expressed concurrence with the recommendation and stated that DPL will ask respective lessees to clarify the proper interpretation of certain rental provisions of the lease agreement/permits on material subject to royalty or gross receipts rent, as well as other errors committed in the computations of rentals.

Recommendation 6 - The response expressed concurrence with the recommendation and stated that DPL no longer awarded contracts mainly for offset purposes without using the competitive selection procedures required by the procurement regulations.

Recommendations 7 and 8 - The response did not address the recommendations.

Recommendation 9 - The response expressed concurrence with the recommendation and stated that DPL will consider adding in its future quarry lease agreements/permits a provision that exempts any government agency from paying any cost/fee for material extractions from a designated government quarry site. Further consideration will be given to exempting quarry operators from paying royalty fees for any quantity of quarry materials taken by government agencies from quarry sites, more specifically if the extractions are for public purposes.

Recommendation 10 - The response did not address the recommendation.



### **Office of the Governor Response to Recommendation 10**

The Governor concurred with Recommendation 10 and provided OPA a copy of his May 18, 2000 letter to the BPL Chairman requesting a full accounting of the annual cost for the coral purchased on behalf of SMO and DPW and directing BPL to stop the practice of offsetting costs to purchase coral against DPL revenues.

### **Department of Finance Response to Recommendation 10**

The Secretary of Finance has not provided a response to the draft report.

### **OPA Comments**

Based on the joint response of the Board and the Division of Public Lands and the response of the Governor, we consider Recommendations 6 and 10 closed. Recommendations 1 and 2 resolved, and Recommendations 3 to 5 and 7 to 9 open because of the following:

Recommendations 1 and 2 - Pending receipt of the adjusted ledgers and billings for MTDC and Sablan Corporation.

Recommendations 3, 4, 5, and 9 - The response did not provide a time frame for action.

Recommendations 7 and 8 - The response did not address the recommendation.

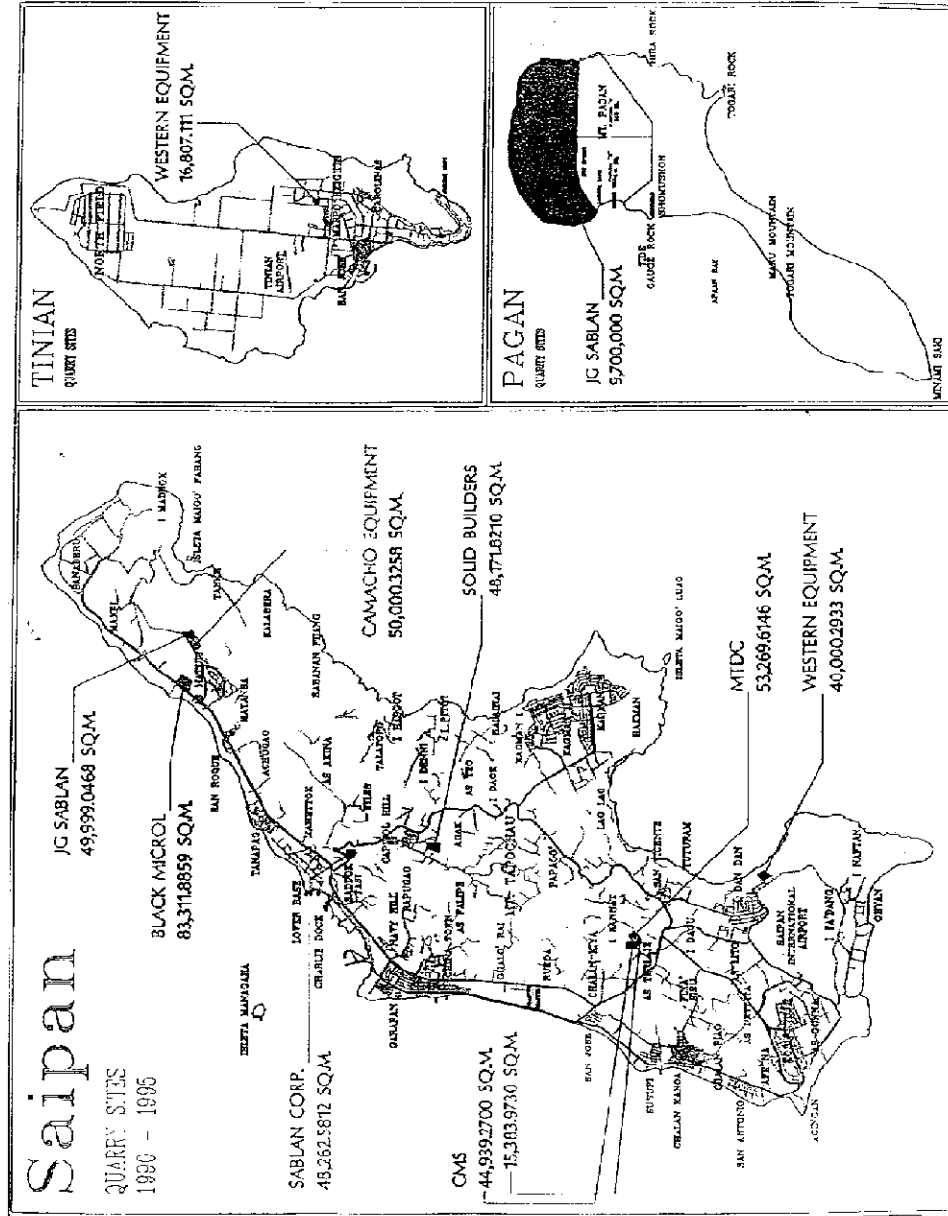
Although BPL and DOF did not address Recommendation 10, the Governor instructed BPL to disallow any future offsetting of accounts between quarry operators and government agencies. We also agree with DPL (based on oral discussion) that it is not practical for DPL to monitor the coral usage of other government agencies. DPL's compliance with the Governor's instruction will ensure the proper reporting of quarry revenues, and therefore we will drop the part of that recommendation which requires the monitoring of coral usage, and consider Recommendation 10 closed.

OPA's final calculation of uncollected lease rentals, with additional interest as of December 31, 1998, totaled \$4.69 million. Compared with DPL's computation of \$4.75 million, OPA's computation was less by \$60,000. This was mainly because OPA's computation of royalty for Solid Builders was less by \$37,000 (with corresponding interest of \$19,000). Although OPA and DPL both used the delivery receipts submitted by the lessee as the basis for computing quantity of materials extracted, the quantity computed by OPA perhaps was less because the documents which were made available to OPA during the audit were incomplete. DPL may have accurately computed the quantity, however, and because OPA does not intend to perform recomputation, the difference was not considered in OPA's final calculation.

Also, if DPL decided not to request reimbursement from DOF for the amount due from the CNMI general fund for what it paid on behalf of SMO and DPW (which were offset against MTDC's underpayment), we accept DPL's decision and consider the recommendation closed. OPA questioned, however, the reason cited in the response justifying the offset, *i.e.*, extraction was for a public purpose, because even if the extraction was for a public purpose, the cost incurred by SMO and DPW should not have been offset against DPL revenues. From a financial management standpoint, SMO and DPW are reporting understated costs and not preparing accurate budgets, while DPL may be reporting understated amounts of revenue. If DPL is not reporting the correct amount of revenue and not recording a receivable for the amount it paid on behalf of SMO and DPW, then DPL may not be in compliance with the constitutional mandate to remit net revenue to MPLT.

The additional information or action required to close the recommendations is presented in **Appendix H**.

Appendix A



**SCHEDULE OF UNDER/OVERPAYMENTS (BY REASON)  
LEASE YEARS 1990 TO 1995**

Particulars	J. G. Sablan	MTDC	Camacho Equipment	Solid Builders	CMS	Sablan Corporation	Black Micro	Western Equipment	Total
A. Back rentals	\$1,299,224.24	\$686,813.58	\$502,499.73	\$283,917.02		\$115,210.11			\$2,887,664.68
B. Underpayments due to misinterpretation					\$264,938.31				264,938.31
C. Underpayments due to incorrect computations:									
Rate increase not implemented on anniversary date of lease agreement						(187.04)	3,733.01	(374.24)	3,171.73
Error in computing fixed rent in certain period					298.65	(2,311.53)			(2,012.88)
Gross receipts rent computed based on sales from another leased area					(13,765.82)				(13,765.82)
Paid only minimum royalties instead of actual						157.92			157.92
Error in accounting for volume of quarry material					(866.67)		9,366.36		8,499.69
Others					257.98			63.96	321.94
Subtotal - Incorrect computation	0.00	0.00	0.00	0.00	(14,075.86)	(2,340.65)	13,099.37	(310.28)	(3,627.42)
Under(Over) Payments (A+B+C)	\$1,299,224.24	\$686,813.58	\$502,499.73	\$283,917.02	\$250,862.45	\$112,869.46	\$13,099.37	(\$310.28)	\$3,148,975.57
Add: Unpaid interest as of LY ending 1995 because of late and nonpayments	658,165.21	161,869.89	185,409.93	37,990.38	10,601.55	36,496.89	5,734.47	0.00	1,096,268.32
Net Under(Over) Payments for Lease Years 1990 to 1995	\$1,957,389.45	\$848,683.47	\$687,909.66	\$321,907.40	\$261,464.00	\$149,366.35	\$18,833.84	(\$310.28)	\$4,245,243.89
Add: Underpayments from OPA's prior audit		519,876.46			46,992.51	2,091.83		1,100.15	570,060.95
Additional interest after LY ending 1995 up to 12/31/98	817,627.84	128,586.48	85,494.59 <sup>a</sup>	128,631.45	71,030.00	35,554.05	8,751.90	0.00	1,275,676.31
Deduct: Subsequent Payments/Offsetting Arrangements	(21,177.41)	(550,178.83)	(768,020.00) <sup>b</sup>	(26,455.00)		(34,442.10)			(1,400,273.34)
Total Amount Due as of Lease year 1995	\$2,753,839.88	\$946,967.58	\$5,384.25	\$424,083.85	\$379,486.51	\$152,570.13	\$27,585.74	\$789.87	\$4,690,707.81

a Interest was computed earlier than 12/31/98, i.e., up to 4/30/97 (offset date).

b Represents total amount available for offset with Camacho Equipment.

## SCHEDULE OF UNDER/OVERPAYMENTS (BY AMOUNT DUE LESS PAYMENTS) LEASE YEARS 1990 TO 1995

	J. G. Sablan	MTDC	Camacho Equipment	Solid Builders	CMS	Sablan Corporation	Black Micro	Western Equipment	Total
Per Audit:									
Fixed Rent or Permit Fee	\$12,000.00	\$136,666.66	\$0.00	\$36,119.28	\$63,802.21	\$116,178.09	\$144,278.66	\$77,576.33	\$586,621.23
Royalty	1,344,824.24	947,218.90	502,499.73	265,857.38	582,739.61	203,056.07	524,414.40	43,889.72	4,414,500.05
Gross Receipts Rent	0.00	0.00	0.00	0.00	92,335.36	0.00	0.00	0.00	92,335.36
<b>Total Due</b>	<b>\$1,356,824.24</b>	<b>\$1,083,885.56</b>	<b>\$502,499.73</b>	<b>\$301,976.66</b>	<b>\$738,877.18</b>	<b>\$319,234.16</b>	<b>\$668,693.06</b>	<b>\$121,466.05</b>	<b>\$5,093,456.64</b>
Less: Payments of Principal	57,600.00	397,071.98	0.00	18,059.64	488,014.73	206,364.70	655,593.69	121,776.33	1,944,481.07
<b>Under (Over) Payments</b>	<b>\$1,299,224.24</b>	<b>\$686,813.58</b>	<b>\$502,499.73</b>	<b>\$283,917.02</b>	<b>\$250,862.45</b>	<b>\$112,869.46</b>	<b>\$13,099.37</b>	<b>(\$310.28)</b>	<b>\$3,148,975.57</b>
Add: Interest Due on Late and Nonpayments	661,851.62	161,936.56	225,409.93	39,568.35	10,616.92	36,680.60	5,734.47	0.00	1,141,798.45
Less: Payments of Interest	3,686.41	66.67	40,000.00	1,577.97	15.37	183.71	0.00	0.00	45,530.13
Unpaid Interest as of LY ending 1995	658,165.21	161,869.89	185,409.93	37,990.38	10,601.55	36,496.89	5,734.47	0.00	1,096,268.32
<b>Net Under (Over) Payments</b>	<b>\$1,957,389.45</b>	<b>\$848,683.47</b>	<b>\$687,909.66</b>	<b>\$321,907.40</b>	<b>\$261,464.00</b>	<b>\$149,366.35</b>	<b>\$18,833.84</b>	<b>(\$310.28)</b>	<b>\$4,245,243.89</b>
Deduct: Subsequent Payments/Offsetting Arrangements	21,177.41	550,178.83	768,020.00	26,455.00	0.00	34,442.10	0.00	0.00	1,400,273.34
<b>Total</b>	<b>\$1,936,212.04</b>	<b>\$298,504.64</b>	<b>(\$80,110.34)</b>	<b>\$295,452.40</b>	<b>\$261,464.00</b>	<b>\$114,924.25</b>	<b>\$18,833.84</b>	<b>(\$310.28)</b>	<b>\$2,844,970.55</b>
Add: Additional Interest After LY Ending 1995 up to 12/31/98	817,627.84	128,586.48	85,494.59	128,631.45	71,030.00	35,554.05	8,751.90	0.00	1,275,676.31
<b>Total Amount Due (Overpayments) - Lease Years 1990 to 1995</b>	<b>\$2,753,839.88</b>	<b>\$427,091.12</b>	<b>\$5,384.25</b>	<b>\$424,083.85</b>	<b>\$332,494.00</b>	<b>\$150,478.30</b>	<b>\$27,585.74</b>	<b>(\$310.28)</b>	<b>\$4,120,646.86</b>
Add: Underpayments In OPA's Prior Audit	0.00	519,876.46	0.00	0.00	46,992.51	2,091.83	0.00	1,100.15	570,060.95
<b>Total Amount Due - As of 12/31/98 (covering up to lease year 1995)</b>	<b>\$2,753,839.88</b>	<b>\$946,967.58</b>	<b>\$5,384.25</b>	<b>\$424,083.85</b>	<b>\$379,486.51</b>	<b>\$152,570.13</b>	<b>\$27,585.74</b>	<b>\$789.87</b>	<b>\$4,690,707.81</b>

Note: Footnotes in Appendix B also apply in this worksheet.

**COMPUTATION OF MTDC'S RECEIVABLE FROM SMO AND DPW  
AS OF DECEMBER 31, 1995**

Year/ Month	Issuances to SMO at \$2.65/cy			Receivable from SMO	Issuances to DPW at \$2.65/cy			Receivable from DPW	TOTAL ISSUANCES		Accrued Interest	TOTAL RECEIVABLE
	In CY	In Dollars	Accrued Interest		In CY	In Dollars	Accrued Interest		In CY	In Dollars		
<b>1992</b>												
Sep.	5,410	\$14,336.50		\$14,336.50	140	\$371.00		\$371.00	5,550	\$14,707.50		\$14,707.50
Oct.	11,440	30,316.00	\$143.36	44,795.86	1,210	3,206.50	\$3.71	3,581.21	12,650	33,522.50	\$147.07	48,377.07
Nov.	3,460	9,169.00	447.96	54,412.82	980	2,597.00	35.81	6,214.02	4,440	11,766.00	483.77	60,626.84
Dec.	4,470	11,845.50	544.13	66,802.45	2,390	6,333.50	62.14	12,609.66	6,860	18,179.00	606.27	79,412.11
	<u>24,780</u>	<u>\$65,667.00</u>	<u>\$1,135.45</u>		<u>4,720</u>	<u>\$12,508.00</u>	<u>\$101.66</u>		<u>29,500</u>	<u>\$78,175.00</u>	<u>\$1,237.11</u>	
<b>1993</b>												
Jan.	2,920	\$7,738.00	\$668.02	75,208.47	260	\$689.00	\$126.10	13,424.76	3,180	\$8,427.00	\$794.12	88,633.23
Feb.	3,320	8,798.00	752.08	84,758.55	1,310	3,471.50	134.25	17,030.51	4,630	12,269.50	886.33	101,789.06
Mar.	2,820	7,473.00	847.59	93,079.14	500	1,325.00	170.31	18,525.82	3,320	8,798.00	1,017.90	111,604.96
Apr.	3,600	9,540.00	930.79	103,549.93	0	0.00	185.26	18,711.08	3,600	9,540.00	1,116.05	122,261.01
May	2,470	6,545.50	1,035.50	111,130.93	480	1,272.00	187.11	20,170.19	2,950	7,817.50	1,222.61	131,301.12
Jun.	3,560	9,434.00	1,111.31	121,676.24	2,020	5,353.00	201.70	25,724.89	5,580	14,787.00	1,313.01	147,401.13
Jul.	3,530	9,354.50	1,216.76	132,247.50	2,150	5,697.50	257.25	31,679.64	5,680	15,052.00	1,474.01	163,927.14
Aug.	4,340	11,501.00	1,322.48	145,070.98	1,985	5,260.25	316.80	37,256.69	6,325	16,761.25	1,639.28	182,327.67
Sep.	5,600	14,840.00	1,450.71	161,361.69	1,685	4,465.25	372.57	42,094.51	7,285	19,305.25	1,823.28	203,456.20
Oct.	6,145	16,284.25	1,613.62	179,259.56	675	1,788.75	420.94	44,304.20	6,820	18,073.00	2,034.56	223,563.76
Nov.	3,570	9,460.50	1,792.60	190,512.66	630	1,669.50	443.04	46,416.74	4,200	11,130.00	2,235.64	236,929.40
Dec.	2,455	6,505.75	1,905.13	198,923.54	525	1,391.25	464.17	48,272.16	2,980	7,897.00	2,369.30	247,195.70
	<u>44,330</u>	<u>\$117,474.50</u>	<u>\$14,646.59</u>		<u>12,220</u>	<u>\$32,383.00</u>	<u>\$3,279.50</u>		<u>56,550</u>	<u>\$149,857.50</u>	<u>\$17,926.09</u>	
<b>1994</b>												
Jan.	2,070	\$5,485.50	\$1,989.23	206,398.27	540	\$1,431.00	\$482.72	50,185.88	2,610	\$6,916.50	\$2,471.95	256,584.15
Feb.	3,290	8,718.50	2,063.98	217,180.75	580	1,537.00	501.86	52,224.74	3,870	10,255.50	2,565.84	269,405.49
Mar.	3,919	10,385.35	2,171.81	229,737.91	1,920	5,088.00	522.25	57,834.99	5,839	15,473.35	2,694.06	287,572.90
Apr.	4,690	12,428.50	2,297.38	244,463.79	1,700	4,505.00	578.35	62,918.34	6,390	16,933.50	2,875.73	307,382.13
May	3,110	8,241.50	2,444.64	255,149.93	660	1,749.00	629.18	65,296.52	3,770	9,990.50	3,073.82	320,446.45
Jun.	5,130	13,594.50	2,551.50	271,295.93	3,410	9,036.50	652.96	74,985.98	8,540	22,631.00	3,204.46	346,281.91
Jul.	3,280	8,692.00	2,712.96	282,700.89	2,430	6,439.50	749.86	82,175.34	5,710	15,131.50	3,462.82	364,876.23
Aug.	5,235	13,872.75	2,827.01	299,400.65	2,650	7,022.50	821.75	90,019.59	7,885	20,895.25	3,648.76	389,420.24
Sep.	3,687	9,770.55	2,994.01	312,165.21	1,560	4,134.00	900.19	95,053.78	5,247	13,904.55	3,894.20	407,218.99
Oct.	2,912	7,716.80	3,121.65	323,003.66	3,130	8,294.50	950.54	104,298.82	6,042	16,011.30	4,072.19	427,302.48
Nov.	4,196	11,119.40	3,230.04	337,353.10	4,030	10,679.50	1,042.99	116,021.31	8,226	21,798.90	4,273.03	453,374.41
Dec.	2,826	7,488.90	3,373.53	348,215.53	1,970	5,220.50	1,160.21	122,402.02	4,796	12,709.40	4,533.74	470,617.55
	<u>44,345</u>	<u>\$117,514.25</u>	<u>\$31,777.74</u>		<u>24,580</u>	<u>\$65,137.00</u>	<u>\$8,992.86</u>		<u>68,925</u>	<u>\$182,651.25</u>	<u>\$40,770.60</u>	

### COMPUTATION OF MTDC'S RECEIVABLE FROM SMO AND DPW AS OF DECEMBER 31, 1995

Year/ Month	Issuances to SMO at \$2.65/cy		Accrued Interest	Receivable from SMO	Issuances to DPW at \$2.65/cy		Accrued Interest	Receivable from DPW	TOTAL ISSUANCES		Accrued Interest	TOTAL RECEIVABLE
	In CY	In Dollars			In CY	In Dollars			In CY	In Dollars		
<b>1995</b>												
Jan.	3,562	\$9,439.30	\$3,482.15	361,136.98	2,210	\$5,856.50	\$1,224.02	129,482.54	5,772	\$15,295.80	\$4,706.17	490,619.52
Feb.	960	2,544.00	3,611.37	367,292.35	0	0.00	1,294.82	130,777.36	960	2,544.00	4,906.19	498,069.71
	4,522	\$11,983.30	\$7,093.52		2,210	\$5,856.50	\$2,518.84		6,732	\$17,839.80	\$9,612.36	
<b>Totals</b>	117,977	\$312,639.05	\$54,653.30	\$367,292.35	43,730	\$115,884.50	\$14,892.86	\$130,777.36	161,707	\$428,523.55	\$69,546.16	
Add: Additional Interest as of December 31, 1995 (at 1 percent compounded monthly)											52,109.12	52,109.12
<b>TOTAL AMOUNT DUE</b>										\$428,523.55	\$121,655.28	<b>\$550,178.83</b>



Commonwealth of the Northern Mariana Islands  
Office of the Governor  
Department of Lands & Natural Resources

07/19

P.O. Box 390  
Saipan, Mariana Islands 96950

**BOARD OF PUBLIC LANDS**

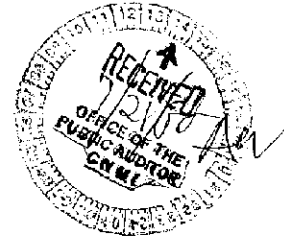
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Mr. Leo L. LaMotte  
Public Auditor, CNMI  
Office of the Public Auditor  
P. O. Box 501399  
Saipan, MP 96950

**Subject: Audit of Division of Public Lands' Collection of Rentals on Land Leases with Quarries for Six Lease Years from 1990 to 1995**

Dear Mr. LaMotte:

This letter is concerning your most recent audit on DPL's collection of rentals on land leases with eight quarry operators on public lands for lease years 1990 to 1995. According to your report, DPL failed to collect \$4.43 million in rentals and interest.

The amount represents 1.) back rentals, 2.) underpayment of lease rentals due to misinterpretation of lease agreement/permit provisions and incorrect rental computations, 3.) unpaid interest due to late and nonpayment of rentals, and 4.) underpayment from prior year's audit and additional interest assessed as of December 31, 1998, computed based on the balance of outstanding rentals as of lease year ending 1995. Similarly, the report indicated that the foregoing occurred because DPL had inadequate collection procedures, failed to verify quarry operators' rental computation and their misinterpretation of rental terms and conditions. You also reported that interest was either incorrectly computed or not computed at all.

About a year ago, DPL made an internal assessment of its Compliance Section, which was tasked to manage the account receivables. Its findings were communicated to the Office of the Public Auditor. Therefore, based on our review of your preliminary report, we concur with your audit findings and recommendations, except the manner how the late fees were assessed. Be advised that the Division will not attempt to request from the Department of Finance a reimbursement for charges made by SMO and DPW, which were offset against MTDC's underpayment. We believe there was a public purpose when the quarry materials were extracted by SMO and DPW, therefore, the offset was justified.

**OPA Note:** The DPL's computation of lessees' under/overpayments of rentals and interest, adjusted subsidiary ledgers of quarry operators maintained by DPL, and billings sent to quarry operators are no longer attached to the report.



In addition to OPA's findings, DPL made its own assessment and included in the report, dated April 19, 2000, the following, which were discussed with the Office of the Public Auditor.

**CAMACHO EQUIPMENT**

- 1.) The first offsetting of account made on July 1996 for \$353,706.75, which represents 45% completion of the homestead project was applied on December 1995 based on OPA's findings, hence, assessment of late fees was affected due to timing difference;
- 2.) Upon completion of the project on April 22, 1997, amount subject for offsetting was \$214,272.43, however, audit report reflected an amount of \$232,267.43. The difference was due to overpayment committed by DPL when the payment schedule was erroneously revised;
- 3.) Since the project was completed on 4/22/97, final offsetting of accounts should have been recorded as of that date. As such, assessment of late fees should be as of March 1997 only, however, OPA made an assessment until April 1997;
- 4.) The Office of the Public Auditor's assessment of late fees was based on prior month's balance and did not consider the payment made within the month. However, since late fee was charged compounded monthly, DPL based its assessment after the application of payment.

With the foregoing, the amount assessed was understated by \$35,237.15 as of 12/31/98, which was further included in the billing sent to Camacho Equipment.

**SOLID BUILDERS**

- 1.) OPA's assessment of royalty for the period from 6/93 to 12/95 was understated by \$37,313.50 as compared to assessment made by DPL, which was based on the delivery receipt submitted by Solid Builders;
- 2.) The Office of the Public Auditor assessed late fees as of 11/97 only, when the quarry was padlocked and chained. However, DPL continued the assessment of late fees, since there was no provision to cease the assessment upon closure of the quarry;
- 3.) On February 7, 1996, DPL offset the amount of \$455.00 against Solid Builders' lease rental, which represents DPL's account due to permittee. OPA missed this offsetting arrangement in the report;
- 4.) The Office of the Public Auditor's assessment of late fees was based on prior month's balance and did not consider the payment made within the month. However, since late fee was charged compounded monthly, DPL based its assessment after the application of payment.

The net effect of the foregoing, amount assessed was understated by \$109,244.23 as of 12/31/98, which DPL included in the billing sent to Solid Builders.

## Appendix E

Page 3 of 5

### MTDC

- 1.) The Office of the Public Auditor did not assess late fees after 12/31/95 for the underpayment of rental as reported on the prior year's audit, due to offset arrangement. Therefore, late fee assessed as of December 31, 1998 was understated;
- 2.) The Office of the Public Auditor assessed late fees based on prior month's balance and did not consider the payment made within the month. However, since late fee was charged compounded monthly, DPL based its assessment after the application of payment.

Consequently, the assessed late fee was understated by \$156,323.80 as of 12/31/98, which will be included in the billing to MTDC.

### WESTERN EQUIPMENT

- 1.) The Office of the Public Auditor effected the increase in rental rate a day after. For Marpo quarry (L8638T), rate should have been increased effective June 3, but OPA applied the new rate on June 4; Dandan quarry (L8660S) rate should increased effective July 20, however, OPA reflected the increase on July 21;
- 2.) The Office of the Public Auditor assessed late fees on late payments made by Western Equipment for Marpo quarry, however, DPL did not consider such assessment, due to the fact the Western Equipment made an overpayment for Dandan quarry. DPL based its assessment of late fees on the net balance of the two leases.

The foregoing resulted in an over-assessment of \$35.41 as of 12/31/98, which was excluded from the billing to Western Equipment.

### BLACK MICRO CORPORATION

The over-assessment in the minimum rent of \$73.44 was due to the increase in rental rate during the anniversary, which is September 11. OPA effects the rate increase at the beginning of September, however, rent should have been calculated proportionately.

### J.G. SABLAN

The Office of the Public Auditor assessed late fees based on prior month's balance and did not consider the payment made within the month. However, DPL assessed late fees after payments have been applied, because a late fee is charged compounded monthly. Therefore, the amount assessed per audit was overstated by \$1,416.86, which was omitted in the billings to J.G. Sablan.

### EXPLANATIONS:

The foregoing occurred because in the past and during the audit period, DPL (formerly MPLC) maintained its account receivables using manual ledgers. Billings were also handled manually.

There was no tracking system to determine whether public land tenants were in compliance with their rental lease/permit provisions. Similarly, aside from being understaffed, personnel in-charge did not possess the appropriate work experience/training and had no proper supervision. Additionally, Enforcement Section did not have enough manpower to conduct regular field inspections to determine whether lessees'/permittees' permit were valid.

**ACTIONS TAKEN:**

The following are the actions taken by the Division in order to address OPA's audit findings and recommendations:

1. Procured an accounting software to implement a more adequate collection procedure and to monitor timely billing to lessees/permittees; as well as, to minimize human errors, if not eliminate them totally.
2. Compliance Section was merged with Accounting, which is under the supervision of the Comptroller. Similarly, two new staffs with appropriate education and proper work experience in the field of accounting were recently hired to perform various reconciliation and to properly manage the receivables.
3. Underpaid rentals and its corresponding late fees have been recorded to the respective lessees'/permittees' subsidiary ledgers. Likewise, all concerned quarry operators were billed and given thirty days to respond. However, billing for MTDC is being withheld due to its pending bankruptcy proceeding. Likewise, Sabian Constructions has not been billed yet due to land exchange issues, which requires further review and clarification.
4. Enforcement Section is now manned with diligent staffs and supervisor to ensure field inspections are done on a regular basis and to monitor that all public land tenants are operating with valid permits.
5. The Division ceased to enter into offsetting arrangement with any of its public land tenants without using the competitive selection procedures required by the procurement regulations.

**FURTHER ACTIONS TO BE TAKEN:**

1. The Division is currently reviewing the effect of the foregoing unrealized revenues on each affected year's operation to determine whether there are surplus funds due to MPLT.
2. To conform with OPA's recommendation, we will update our existing policies and procedures to ensure that rentals due under the lease agreements or permits are accurately assessed and collected on a timely manner, in addition, to consistently monitoring that the lessees submit all required reports


**Appendix E**  
Page 5 of 5

3. The Division will communicate to respective lessees to clarify the proper interpretation of certain rental provisions of the lease/permits on materials subject to royalty or gross receipts rent and other errors committed in the computations of rentals.
4. The Division will consider adding in its future quarry lease agreements/permits a provision that exempts any government agency from paying any cost/fee for material extractions from any designated government quarry site. Further consideration will be made to exempt quarry operators (permittees/lessees) from paying royalty fees for any quantity of quarry materials taken by government agencies from quarry sites, more specifically if the extractions are for public purposes.

With the foregoing, it is hoped that the Division had addressed all concerns in your audit report. Should you need further clarifications, please do not hesitate to contact our office.

Sincerely,

  
MANUEL P. VILLAGOMEZ  
Chairman, BPL

  
BERTHA C. LEON GUERRERO  
Director

cc: Governor  
Secretary, DLNR  
Secretary, DOF  
Comptroller, DPL  
Enforcement, DPL



**COMMONWEALTH OF THE NORTHERN MARIANA ISLANDS**

Pedro P. Tenorio  
Governor  
Jesus R. Sablan  
Lt. Governor

Caller Box 10007  
Saipan, MP 96950  
Telephone: (670) 664-2200  
Fax: (670) 664-2211

18 MAY 2000

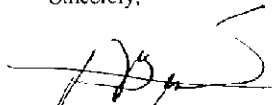
Mr. Leo L. LaMotte  
Public Auditor  
Post Office Box 1399  
Saipan, MP 96950

Dear Mr. LaMotte:

Re: Your Draft Report on Audit of Division of Public Lands (DPL)  
Collection of Rentals on Land Leases with Quarries for Six Lease  
Years, from 1990-95

I have reviewed the draft report. As a result, I have asked the Board of Public Lands for a full accounting of annual cost for coral purchased by the Saipan Mayor's Office and the Department of Public Works. I have also asked that the procedure of offsetting costs against Division of Public Lands' revenues be stopped so that the Division may comply with its constitutional mandate to remit net revenues to the Marianas Public Land Trust. Please see enclosed copy of my letter to the Chairman of the Board of Public Lands dated this date.

Sincerely,

  
PEDRO P. TENORIO

Enclosure

CC: Chairman, Board of Public Lands  
Mayor of Saipan  
Secretary of Public Works

**Appendix F**  
Page 2 of 2



**COMMONWEALTH OF THE NORTHERN MARIANA ISLANDS**

Pedro P. Tenorio  
Governor  
Jesus R. Sablan  
Lt. Governor

18 MAY 2000

Caller Box 10007  
Saipan, MP 96950  
Telephone: (670) 664-2200  
Fax: (670) 664-2211

Mr. Manuel P. Villagomez  
Chairman, Board of Public Lands  
c/o Division of Public Lands  
Department of Lands and Natural Resources  
Saipan, MP 96950

Dear Mr. Villagomez:

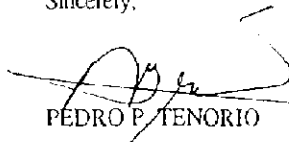
Re: Public Auditor's Draft Report on Audit of Division of Public Lands'  
(DPL) Collection of Rentals on Land Leases with Quarries for Six Lease  
Years, from 1990-95

I have reviewed the subject draft report. Aside from the recommendations addressed to the Director of Public Lands, the Public Auditor did bring attention to the concern that the Saipan Mayor's Office and the Department of Public Works (DPW) may be understating their operational costs by not budgeting and not paying for the purchase of coral. Concurrently, DPL may be understating their revenue by not collecting payments from the Mayor's Office and DPW.

Because DPL handles all its financial transactions, I am requesting that a full accounting of the annual cost for coral purchased by the Saipan Mayor's Office and DPW be made. The procedure of offsetting costs against DPL revenues must cease in order for DPL to comply with its constitutional mandate to remit net revenues to the Marianas Public Land Trust. Likewise, the information will enable the Saipan Mayor's Office and DPW to properly include in their budgets the cost to purchase coral required to comply with what is required to deliver services to the community.

Thank you very much for your attention. I look forward to receiving this information.

Sincerely,



PEDRO P. TENORIO

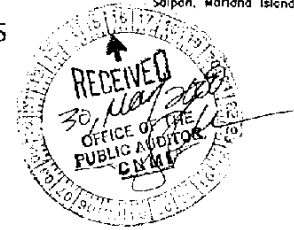
CC: / Public Auditor  
Mayor of Saipan  
Secretary of Public Works



Commonwealth of the Northern Mariana Islands  
Office of the Governor  
Department of Lands & Natural Resources

P.O. Box 380  
Saipan, Mariana Islands 96950

BOARD OF PUBLIC LANDS



Manuel P. Villagomez  
Chairman  
May 24, 2000  
Pedro M. Alalig  
Vice Chairman

Ana Demapan-Castro  
Member  
The Honorable Pedro P. Tenorio  
Governor  
Commonwealth of the Northern Mariana Islands  
Capitol Hill, Saipan MP 96950  
Pedro L. Igitol  
Member  
Tomas B. Aldan  
Member

Re: Public Auditor's Draft Report on Audit of Division of Public Lands Collection of Rentals on Land Leases with Quarries for Six Lease Years, from 1990-95

Dear Governor:

Thank you for your letter of 18 May 2000, in reference to the above-captioned subject matter.

I would like to assure you that the Board of Public Lands and the Division of Public Lands will diligently address the concerns raised by the Office of the Public Auditor with regards to its audit findings of quarry leases and permits on public lands. You will be provided a written report at a later date on actions to be taken to correct any deficiencies with respect to the subject matter therein.

Again, thank you for bringing our attention to this important matter.

Sincerely,

  
MANUEL P. VILLAGOMEZ  
Chairman, Board of Public Lands

cc: Board of Public Lands  
Public Auditor  
Mayor of Saipan  
Secretary, DPW

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## Appendix H

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### STATUS OF RECOMMENDATIONS

Recommendations	Agency to Act	Status	Agency Response/ Additional Information or Action Required
<p>1. Record in the lessees' subsidiary ledgers maintained by DPL the adjustments to effect the under/overpayments of rentals and interest, including underpayments identified in OPA's prior audit. The report already shows the correct amounts for the offset between the lessees and affected CNMI government agencies as of the lease year ending in 1995. DPL should prepare documents to make the offset arrangements binding on all of the affected parties so they will have a basis for updating financial records. DPL should record the correct amounts of offset in the lessees' subsidiary ledgers it maintains, and should also record the amount due from the CNMI general fund for what it paid on behalf of SMO and DPW.</p>	BPL	Resolved	<p>DPL assessed the uncollected lease rentals and interest of the quarry operators, including underpayments identified in OPA's prior audit and offsetting arrangements; recorded in its subsidiary ledgers of quarry operators adjustments to effect the unrecorded lease rentals and interest; and sent billings to quarry operators to collect the unpaid lease rentals and interest. However, the ledgers were not adjusted and billings were not made either for MTDC due to its pending bankruptcy proceeding or for Sablan Corporation due to its land exchange issues, which require further review and clarification.</p> <p>Five of the six quarry operators responded to the billing, as follows: (1) one had fully paid its underpayments; (2) one had paid only the amount which it considered to be the undisputed portion and requested a further discussion to clarify some discrepancies; (3) one had proposed a schedule of installment payments; (4) one had disagreements on certain interpretations of the lease agreement and requested a further discussion of the issues; and (5) one asked to waive a large portion of the underpayment because of its inability to check the validity of the billing due to nonavailability of the financial records.</p>
<p>2. Take steps to collect the \$4.69 million in underpayment of rentals (including interest) on land leases with quarries, and refer those lessees who refuse to pay to the Attorney General's office for legal action.</p>	BPL	Resolved	<p>With regards to the recommendation to record the amount due from the CNMI general fund for what it paid on behalf of SMO and DPW (which was offset against MTDC's underpayment), DPL stated that it does not intend to request reimbursement from DOF for the amount because it believed that the offset was justified because the extraction made by SMO and DPW from the MTDC site was for a public purpose.</p> <p><i>Further Action Required</i></p> <p>Provide OPA copies of adjusted subsidiary ledgers of MTDC and Sablan Corporation, and documents evidencing recovery of unpaid lease rental and interest from the quarry operators.</p>
<p>3. Review the effect of the additional revenues identified in this audit on each affected year's operation in order to determine if there will be surplus funds due to the Marianas Public Land Trust (MPLT).</p>	BPL	Open	<p>The response expressed concurrence with the recommendation and stated that DPL is currently reviewing the effect of the foregoing unrealized revenues on each affected year's operation to determine whether there are surplus funds due to MPLT.</p> <p><i>Further Action Required</i></p> <p>Provide OPA copies of the results of the review and supporting documents.</p>
<p>4. Develop and implement written policies and procedures to ensure that all rental amounts payable under the lease agreements or permits are assessed, collection of all lease amounts payable is pursued, and timely</p>	BPL	Open	<p>The response expressed concurrence with the recommendation and stated that DPL will update its existing policies and procedures to ensure that rentals due under the lease agreements or permits are accurately assessed</p>



## STATUS OF RECOMMENDATIONS

Recommendations	Agency to Act	Status	Agency Response/ Additional Information or Action Required
action against erring lessees is taken. Include in the policies and procedures to be developed the following: (a) monitoring the submission of required financial documents by the lessees; (b) checking whether the report of material extracted is complete and accurate, and whether the royalty computations have complied with the terms of the lease and are accurate; and (c) scheduling periodic on-site inspections of quarry sites.			and collected in a timely manner, and that submission of all required reports are consistently monitored.  <i>Further Action Required</i>  Provide OPA a copy of the revised policies and procedures.
5. Send letters to lessees who misinterpreted certain provisions of the lease agreements/permits and incorrectly computed required rentals, clarifying for them the proper interpretation of material subject to royalty or gross receipts rent, and the common errors noted such as not implementing rate increases on the anniversary dates of lease agreements.	BPL	Open	The response expressed concurrence with the recommendation and stated that DPL will ask respective lessees to clarify the proper interpretation of certain rental provisions of the lease agreement/permits on material subject to royalty or gross receipts rent, as well as other errors committed in the computations of rentals.  <i>Further Action Required</i>  Provide OPA copies of documents evidencing communications made with the lessees.
6. Stop awarding contracts (e.g., construction) mainly for offset purposes without using the competitive selection procedures required by the procurement regulations.	BPL	Closed	The response expressed concurrence with the recommendation and stated that DPL no longer awarded contracts mainly for offset purposes without using the competitive selection procedures required by the procurement regulations.  <i>Further Action Required</i>  None.
7. Require lessees to submit a certification of no quarry operations during periods when they claim no quarry operations. This should be signed by an official of the quarry operator and should indicate the reason for non-operation.	BPL	Open	The response did not address the recommendations.  <i>Further Action Required</i>  Provide OPA a copy of the written policies and procedures on the certification requirement when lessees claim no quarry operations and on contract renewal monitoring.
8. Develop and implement written policies and procedures to ensure that all quarry operators who remain in possession of the leased area are holding valid quarry permits. Include in the policies and procedures to be developed the monitoring of contract renewals.	BPL	Open	
9. Amend the conditions for quarry lease agreements/permits to include (and include in future agreements/permits) a provision that any government agency will be exempt from paying any cost for material extracted from a government-owned quarry site because the sites are government properties and the lessees/permit holders are making substantial profits in their quarry operations. In return, the lessee should be exempt from paying a royalty for the quantity of material quarried by a government agency. The suggested provision can help reduce CNMI government costs.	BPL	Open	The response expressed concurrence with the recommendation and stated that DPL will consider adding in its future quarry lease agreements/permits a provision that exempts any government agency from paying any cost/fee for material extractions from a designated government quarry site. Further consideration will be given to exempting quarry operators from paying royalty fees for any quantity of quarry materials taken by government agencies from quarry sites, more specifically if the extractions are for public purposes.  <i>Further Action Required</i>  Provide OPA a copy of sample quarry lease agreements/permits including the recommended provision.

**Appendix H**  
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**STATUS OF RECOMMENDATIONS**

Recommendations	Agency to Act	Status	Agency Response/ Additional Information or Action Required
<p>Additionally, we recommend that BPL, the Governor, and the Secretary of Finance:</p> <p>10. Review the average yearly government cost for coral purchased by agencies such as SMO and DPW. It appears that the cost (of coral) now incurred by the two agencies was not included in the annual budgets. The only reason why the unbudgeted costs went unnoticed was because the agencies were not making direct cash payments and their costs were being offset against DPL revenues.</p>	<p>Office of the Governor BPL DOF</p>	<p>Closed</p>	<p>The Governor concurred with the recommendation and provided OPA a copy of his May 18, 2000 letter to the BPL Chairman requesting a full accounting of the annual cost for the coral purchased on behalf of SMO and DPW and directing BPL to stop the practice of offsetting costs to purchase coral against DPL revenues.</p> <p>Although BPL and DOF did not address the recommendation, the Governor instructed BPL to disallow any future offsetting of accounts between quarry operators and government agencies. We also agree with DPL (based on oral discussion) that it is not practical for DPL to monitor the coral usage of other government agencies. DPL's compliance with the Governor's instruction will ensure the proper reporting of quarry revenues, and therefore we will drop that part of the recommendation which requires the monitoring of coral usage.</p> <p><i>Further Action Required</i></p> <p>None.</p>

