



How the Ministry of Agriculture Manages National Property – Mineral Resources?

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Dear Reader,

During a financial audit of the Annual Report of the Ministry of Agriculture for 2018, the State Audit Office of Latvia has established that the Ministry has not recorded and disclosed state-owned mineral resources (peat, sand, gravel, etc.) in its possession by the end of 2018, which it has transferred to state-owned joint stock company “Latvijas valsts meži” for management. To put it in other words, the audit has found that an owner does not know what he owns. When one does not account for all the properties and has not estimated their value, the risk increases that the property will be squandered fraudulently. To remedy this situation, the Ministry of Agriculture included the state-owned mineral resources entrusted to it in its report by the end of 2018 and declared them at the value of 3.8 billion euros (Peat deposits - 3.7 billion euros, sand and gravel deposits - 102 million euros). The state owns 58% of the available peatlands in Latvia; hence, the State Audit Office of Latvia asked a question, “What is the state’s revenue from the sale of its own peat reserves if the residual value of peat is still 3.7 billion euros after approximately 20 years of active peat extraction?” Three months later, the Ministry of Agriculture reduced the value of mineral resources 58 times to 57.3 million euros for peat and 8.4 million euros for sand and gravel deposits.

Therefore, the State Audit Office decided to conduct an in-depth investigation of the situation and to initiate a regularity (compliance) audit “Activities of the Ministry of Agriculture in the Management of State-Owned Mineral Resources”. We have finalised this audit and drafted an audit report.

The findings are distressful, especially concerning the management of peat resources.

Neither the Ministry of Agriculture nor JSC “Latvijas valsts meži” has tracked and identified the extent to which one has extracted and expropriated state-owned peat up to now. The State Audit Office requested the State Environmental Service to collect those data for the period starting from 2013. More than 60% of the peat that commercial companies extract in Latvia are extracted on the property transferred to the management of JSC “Latvijas valsts meži” every year, and more than 95% of the Latvian peat are exported. In 2018, peat was exported for 178 million euros, while the revenue of JSC “Latvijas valsts meži” from peat was only 2.47 million euros (1.8 million euros in 2017). One can explain such disproportionately low revenues not only with the contracts signed in the 1990s under the laws and regulations and understanding of the value of natural resources and national property existing then but also with the very slow pace of regulatory change and the fact that JSC “Latvijas valsts meži” did not begin the indexation of peat extraction rents in due time.

The Ministry of Agriculture also holds about one-fifth of the sand and gravel deposits in the country. When aligning its accounting system, the Ministry of Agriculture will ensure the disclosure of those changes in resources after their sale or commencement of new extraction in the accounting.

All in all, one can conclude that the actions of the Ministry of Agriculture and JSC “Latvijas valsts meži” in the management of mineral resources are not appropriate for a caring and responsible proprietor.

In addition, the insufficient care of the national interests on behalf of the Ministry of Agriculture has also been observed previously. The State

Audit Office concluded during the audit on the actions of JSC “Latvijas valsts meži” concerning the state forest property transferred into its possession and management and the actions of the Ministry of Agriculture for the supervision of the company already in 2008 that “the Ministry of Agriculture has not protected the national interest for the state to benefit properly from the use and sale of its property when determining unreasonably small payments by JSC “Latvijas valsts meži” to the state budget for the use of state capital.”

Managing the state-owned mineral resources is not the main activity of JSC “Latvijas valsts meži” because the extensive forest management has overshadowed the area of mineral resources. But would the fact that it is not the main direction of activity for the joint stock company be an explanation for neither the Ministry of Agriculture nor the joint stock company has a future vision of state-owned mineral resources on the land property occupying a huge part of the territory of Latvia they are entrusted with? One has also established the fact that the information provided to the public on the management of mineral resources, especially peat, has been sparse so far.

The audit raised the question whether the performance indicators published by JSC “Latvijas valsts meži” reflect actual achievements. For example, a company has stood out with a high return on assets because it has not

used the value of state-owned assets (forest stands) (on the balance of the Ministry of Agriculture) when calculating the indicator and has not known the value of some assets (peat, sand, and gravel) at all, for which income was received and which had not been recorded. The calculations that the State Audit Office made show a less successful performance than the company has reported in its reports.

The state budget receives nothing directly from the expropriation of its mineral resources in proportion to the amount of the expropriated resources, as the only payments are dividends or a portion of what remains from all expenses of the capital company, including administration, public relations, renting, and other expenditure. The results above in new additional questions that should be asked to the Ministry of Agriculture and JSC “Latvijas valsts meži”.

We extend our gratitude to the Ministry of Agriculture and JSC “Latvijas valsts meži”, the State Environmental Service, Association “Latvian Association of Property Appraisers”, and the Latvian Peat Association for their cooperation during the audit.

Respectfully yours,
Ms Inga Vilka
Department Director



BASIC INFORMATION

The Ministry of Agriculture has transferred to JSC “Latvijas valsts meži” for management

Revenue of JSC “Latvijas valsts meži” in 2018

25%

of the territory of Latvia or state-owned forest land of 16,300 km²

339.38 million €

From total economic activity

58%

of entire peat resource extraction area in Latvia

2.47 million €

from peatland

19%

of all sand and sand-gravel quarries in the territory of Latvia

1.72 million €

from the extraction of sand, sand-gravel, and clay

77.2 million €

Dividends that JSC “Latvijas valsts meži” paid to the state budget in 2019 (for reporting year 2018)

178 million €

Value of total Latvian peat exports in 2018

Summary

Motivation

The Ministry of Agriculture possesses state-owned or community-owned land in more than a quarter of Latvia's territory, with the resources under the jurisdiction of the State consisting of both forest stands and various mineral resources such as peat, sand, gravel, etc. Since 2000, the Ministry of Agriculture has transferred the management of the state-owned forestland in its possession, which includes mineral resources as well, to the state-owned joint stock company "Latvijas valsts meži".

Peatland is one of the most valuable natural resources of Latvia. Latvia holds 0.4% of the global peat reserves, and Latvia has the seventh-highest share of peat bogs in the world.

Although peat is a natural resource that regenerates, the regeneration process is very slow and takes 400 years or more. Therefore, the prudent use of this valuable resource to support the country's economic growth is crucial. When using this resource, it is essential to strike a balance between environmental protection requirements and the development of the national economy.

The State owns more than half of Latvia's peat resources, id est, 58%, which has been transferred to the possession of the Ministry of Agriculture and JSC "Latvijas valsts meži" for management. JSC "Latvijas valsts meži" has also been delegated to manage one-fifth of all sand and sand-gravel quarries in the territory of Latvia.

Unfortunately, there is no strategy elaborated for the use of the entrails of the earth in state and municipal land, which is why there is no planned and systematic exploration of new resources of the entrails of the earth, as well as the additional exploration of known mineral deposits to ensure their use as rational as possible.

The State Audit Office has stated during a previous audit that the Ministry of Agriculture has not declared state-owned mineral resources under its responsibility that were transferred to JSC "Latvijas valsts meži" for management either in the pecuniary expression of value nor in amounts in its annual report until 2018. Hence, they were not disclosed in the annual report of the State until the drafting of the annual report 2018. Mineral resources were included in the accounting records of the Ministry of Agriculture for the first time by the end of the reporting period (31 Dec 2018) with a book value of 3.8 billion euros. That was done during the preparation of the annual report 2018 only after the State Audit Office had established that this state property had not been recorded anywhere.

In a situation where all state-owned mineral resources are not or are not fully accounted for at their fair value, there is a high risk of squandering them.

The Cabinet Regulations stipulating that public entities are obliged to take into account the value of mineral resources as well when determining the rent for mineral deposits were approved only in 2014, although the State Audit Office had pointed out the problem that one had not charged the payment for the extracted mineral resources owned by the state or municipality frequently already in 2007.

Therefore, the State Audit Office has carried out an audit aimed at establishing whether the activities of the Ministry of Agriculture in the management of mineral resources complied with the laws and regulations and the principles of good governance.

Main Conclusions

The audit revealed significant deficiencies in the activities of the Ministry of Agriculture and JSC “Latvijas valsts meži” in operating and managing state-owned mineral resources, that is, more than a half of all peat resources in Latvia and one-fifth of all sand and sand-gravel quarries in Latvia:

- The Ministry does not have reliable information on the fair value, extracted amounts, and actual balances of the mineral resources in its possession, thus not complying with the requirements of laws regulating accounting. Without identifying the fair value of the mineral resources, determination of the highest possible price for the mineral resources to be extracted is impossible;
- The Ministry has violated the Law on the State Administration Structure while failing to supervise the lawful performance of the delegated task by JSC “Latvijas valsts meži” properly, id est, the management of mineral resources, as JSC “Latvijas valsts meži” began the indexation of peat extraction rent only in 2018, that is, three years later than the Law provided for;
- Opposite to the principles of good governance¹, the Ministry, as the manager of state-owned forest land, including entrails of the earth, is neither taken interest nor is aware, and has not informed the public about the value of state-owned mineral resources, their management, and results. Besides, the Ministry has no future vision on the sustainable management of mineral resources.



The Ministry of Agriculture has not been a responsible and diligent proprietor when managing state-owned mineral resources

The Ministry of Agriculture has transferred the management of the state-owned forestland in its possession, which also contains mineral resources, to JSC “Latvijas valsts meži” in 2000.

Mineral resources accounting

The Ministry of Agriculture still does not have reliable information on the fair value, extracted amounts, and actual balances of the state-owned mineral resources it holds. Multiple changes in the value of mineral resources included in the annual report of the Ministry call into question its accuracy. When operating with the mineral resources in its possession, the Ministry of Agriculture has not complied with the requirements of the law and regulations governing accounting and hence has not acted as a responsible and diligent proprietor, taking care of the identification, recognition, accounting, and preservation of the public resources it was entrusted with.

By 2018, the Ministry of Agriculture had neither identified, evaluated nor reported the mineral resources assigned to it in more than a half of the total peat extraction area in Latvia and one fifth of all sand and sand-gravel quarries in Latvia in its annual report.

¹ Section 10.5 of the Law on State Administration Structure; European Governance. A White Paper. Brussels 25.07.2001 COM (2001) 428 final. Available at: https://ec.europa.eu/europeaid/european-governance-white-paper_en [Viewed on 3 Oct 2019].

In its 2018 report, the Ministry of Agriculture included mineral resources (peat, sand, and sand-gravel) in its possession of 3.8 billion euros, but the Ministry reduced the value of those assets 58 times to 65.7 million euros three months later. Such value is also included in the annual report of the State.

However, the audit has revealed discrepancies, which also make one doubt the updated value of the mineral resources, that is, 65.7 million euros. That refers to the discrepancies that reduce the value of mineral resources by at least 1.6 million euros. At the same time, one has identified irregularities, which increase the value of mineral resources by at least 2.1 million euros and others. The aforementioned leads to the conclusion that the Ministry of Agriculture has not complied with the requirements of the Law on Accounting stipulating that the information provided by the accountancy must be true and complete.

In a situation where the Ministry's accounting records do not contain information on state-owned mineral resources in its possession or the latter is not declared at their fair values, there is a risk of their fraudulent use, such as expropriation of mineral resources for lower price and loss of income to meet other public needs.

In addition, the value of the mineral resources in the entrails of the earth for sand-gravel in the balance sheet of the Ministry of Agriculture exceeds the value of the mineral resources in the entrails of the earth included in the sale price of mineral resources of JSC "Latvijas valsts meži". The auditors believe that the market values of the mineral resources in the entrails of the earth for both prime cost calculations and balance sheet purposes should be interlinked and may be viewed in isolation. Therefore, this situation begs the question:

- Has JSC "Latvijas valsts meži" set a sale price of sand-gravel lower than its actual value?
- Is the value of sand-gravel included in the balance sheet of the Ministry of Agriculture fair and is not its book value increased?

Most of the rent agreements on peat deposits managed by JSC "Latvijas valsts meži" have been taken over from other institutions that had concluded those agreements before 2000 following the laws and regulations of that time, and the peat deposit rent fee set therein is significantly lower than the market value of peat deposit rent payment. The auditors pay attention to the fact that the updated book value of peat deposits has been determined based on the rent payment of peat deposits stipulated in the "historically" signed land lease agreements. Therefore, the balance sheet of the Ministry of Agriculture does not indicate the actual market value of the peat deposits, but the present value of the rent payment set in the concluded peat deposit rent agreements, which is significantly lower than the actual market value of the peat deposits.

Revenue from the mineral resources in possession of the Ministry of Agriculture

Peat, as an essential state-owned resource, has been expropriated for years at a price significantly lower than the actual market value of the peat. Such a situation has developed because of the following:

- The laws and regulations valid until 19 May 2014 allowed the rent for the land lease be determined solely based on the land survey value of the land, which did not include the value



The Ministry of Agriculture had included the mineral resources of 3.8 billion euros initially in its annual report, but the Ministry reduced the value of those assets to 65.7 million euros only three months later.

of the entrails of the earth. Consequently, the rent for the extraction of mineral resources did not depend on the amount of mineral resources extracted or to be extracted;

- Although the law stipulated that the indexation of the payments determined in the agreements on mineral resource extraction should be started from 2015, JSC “Latvijas valsts meži” started indexing three years later, only from 2018.

For example, according to the estimates of the auditors, the amount of rent for peat extraction in state-owned peat deposits (including those taken over from other institutions) accounted for approximately 19% of the market value of rent according to the laws and regulations existing then in 2013, where the difference between the rent received and its market value was approximately 3 million euros. This estimate is approximate considering that the market value of the peat extraction in peat bogs was determined only in 2017-2019.

Already in 2007, the State Audit Office pointed out a similar situation during the audit in local governments that the local governments actually did not charge any payment for the extraction of mineral resources belonging to them. There was a law adopted only in 2014, which established the procedure for calculating the rent for a public land plot leased for the use of entrails of the earth by stipulating that the rent for such land plot should be determined pursuant to the land lease fee determined by a certified appraiser. That principle should ensure that the rent for a land plot leased for the use of entrails of the earth corresponds to fair remuneration for the use of that land and ensures adequate payment for the mineral resources extracted.

The slow pace of the law-drafting process has prevented drawing adequate revenue from the expropriation of state-owned mineral resources.

The law provided that the indexation of the rents determined in the agreements signed in the past should begin from 2015. JSC “Latvijas valsts meži” started indexing three years later, only from 2018. If JSC “Latvijas valsts meži” had begun the indexation of the rent for peat deposits in 2015, then, according to estimates of the auditors by using the valuations of certified appraisers on the market value of peat deposits in 2017-2019 and the maximum indexation increase of 20% per annum, leasing of state-owned peat deposits could have generated revenue of 1.6 million euros (incl. VAT 21%) more during the rent period from 2015 to 2019 than was actually received during this period.

JSC “Latvijas valsts meži” explained the situation by the time needed to reach an agreement:

- *Due to the dominance of JSC “Latvijas valsts meži” in the peat extraction market, renegotiating the rent with the peat deposit tenants unilaterally was impossible because such provision was included only in some agreements and one could not apply different terms and conditions to equivalent transactions due to the dominant position;*
- *There was no common methodology for certified appraisers to determine the market valuation of peat extraction rents in the event of the use of entrails of the earth.*

The methodology was approved on 30 June 2016, whereas JSC “Latvijas valsts meži” started ordering the evaluations of certified appraisers only in the second half of 2017 because the methodology was explained and discussed with the parties involved in the peat industry during all that period. The long



In 2013, the revenue from the peat extraction accounted for less than one fifth of the market value of the rent of peat deposits in accordance with the requirements of the laws and regulations valid at that time, hence the difference between the rent payment received and its market value constituted approximately three million euros.

period of discussing the methodology reaching one year raises concerns that one might have delayed the start of indexing the rents for peat extraction and generated more revenue from the expropriation of state-owned peat.

In relation to the above, the Ministry of Agriculture has stated,

The fact that indexation has been applied to 41 peat deposits from 1 Jan 2018 and the tenants have not initiated any legal proceedings regarding this process, confirms that the preparatory work performed by JSC “Latvijas valsts meži” has been of high quality and has justified itself.

Organising and coordinating the implementation of laws and regulations in forestry policy is among the functions of the Ministry of Agriculture. After the law took legal effect, the Ministry of Agriculture did not inform the Ministry of Finance as a drafter of the relevant chapter of the draft law that JSC “Latvijas valsts meži” could not fulfil the requirement of the law to index the rent every year starting from 1 Jan 2015 until the rent reaches the land lease payment stated in a market valuation of the land plot rent by a certified appraiser and allowed a situation of non-compliance with the law for three years, which also had a financial impact on the state budget by reducing the relevant part of the profit (dividend) owed to the State from the profit obtained from peat expropriation.

One should note that the valuations that various certified appraisers have carried out according to the methodology developed by the Latvian Association of Property Appraisers had changed significantly for the same peat deposit without the actual circumstances changing over the past six months in several cases when the value of peat deposits increased from ‘worthless’ even to 102 euros per hectare². This situation indicates that one can interpret the developed methodology widely and the methodology does not ensure its purpose, that is, a single approach to the determination of the market value of peat deposit rent, which allows doubting the validity of the market valuations of peat deposit rent as well as the book value of peat.

Administration of the management of mineral resources

Neither the Ministry of Agriculture nor JSC “Latvijas valsts meži” has ensured proper management of mineral resources compliant to good governance³ so far.

Although the Boards and Councils of JSC “Latvijas valsts meži”, as well as shareholders have met regularly, the meetings have not addressed the issue of the value of state-owned mineral resources transferred to the management of JSC “Latvijas valsts meži” and the amount of peat extracted.

The Ministry of Agriculture while holding the state-owned mineral resources and JSC “Latvijas valsts meži” while managing the state-owned mineral resources do not provide compliance with the principle of good governance, openness to the public, enshrined by the Law on State Administration Structure. The Ministry of Agriculture as the manager of state-owned forest lands, including the entrails of the earth has not interested or known, or informed the public about the value of state-owned mineral resources, their management and results even though the strategy of the Ministry of Agriculture also envisages the following direction of activity, “Preservation of sustainability of natural resources aimed at ensuring rational use of natural resources and sustainability of their management.” Information

² Rent for peat deposits is set for a hectare including rent payment for land and payment for peat extraction.

³ Section 10.5 of the Law on State Administration Structure;

European Governance. A White Paper. Brussels 25.07.2001 COM (2001) 428 final. Available at: https://ec.europa.eu/europeaid/european-governance-white-paper_en [Viewed on 3 Oct 2019].

published by JSC “Latvijas valsts meži” regarding the management of entrails of the earth, especially peat, and its results have been minimal before the auditing.

The Ministry of Agriculture could not evaluate the profitability and efficiency, return on assets, and economic viability of the activity of JSC “Latvijas valsts meži” related with mineral resources impartially without identifying the amount of extraction and the value of the state-owned mineral resources transferred to it.

To ensure the efficient and sustainable management of state-owned mineral resources in line with the principles of good governance⁴ in the European Union, one requires drafting a policy document such as a mineral resources management plan with a clear national vision for sustainable management of mineral resources, goals, economic estimates and projected potential revenue embodied. Nobody has drafted such a plan for the management of mineral resources held by the Ministry of Agriculture yet.

JSC “Latvijas valsts meži” uses the profitability of assets as one of its performance indicators that shows how efficiently the corporate assets are used and what the competitiveness of the company in the market is.

One calculates the profitability ratio of JSC “Latvijas valsts meži” only formally, without taking into account the specifics of its activities, that income is mainly derived from state-owned assets that are not on the balance sheet of the company. For example, the profitability of assets that JSC “Latvijas valsts meži” reported in 2017 is 16.9%, which exceeds the average value in the forestry/ logging sector (7.1%) more than twice. In its turn, according to the calculation of the auditors, the actual return on assets of JSC “Latvijas valsts meži” is only 6.6% taking into consideration the book value of all the assets used. Hence, one can conclude that every euro of the assets used in the economic activity of the company has actually generated less profit than JSC “Latvijas valsts meži” has indicated.

Major Recommendations

The audit resulted in six recommendations issued to both the Ministry of Agriculture as the responsible institution for the preservation of state resources, mineral resources in particular, and JSC “Latvijas valsts meži” as the manager of state-owned mineral resources. To improve the accounting and management of mineral resources held by the Ministry of Agriculture, the State Audit Office of Latvia considers it essential to carry out the following actions:

The Ministry of Agriculture:

- To develop a plan for sustainable management of mineral resources in possession of the Ministry of Agriculture in cooperation with the Ministry of Environmental Protection and Regional Development and JSC “Latvijas valsts meži”;
- To evaluate the return on assets and economic viability of mineral resources regularly as a manager of state-owned forest land, including the mineral resources deposited there, as well as inform the public about the activities and results of the Ministry of Agriculture and JSC “Latvijas valsts meži” in managing state-owned mineral resources.

The Ministry of Agriculture shall provide that JSC “Latvijas valsts meži”:

⁴ European Governance. A White Paper. Brussels 25.07.2001 COM (2001) 428 final. Available at: https://ec.europa.eu/europeaid/european-governance-white-paper_en [Viewed on 3 Oct 2019].

- Performs regular comparisons of mineral deposit balances with the data from the Mineral Resources Deposit Register;
- Informs the Latvian Association of Property Appraisers to assess the reasons for the differences in rents indicated by various certified appraisers in market valuations for the same peat deposits;
- Elaborate procedures and principles for determining the selling price of sand and sand-gravel for each specific deposit;
- Assess the reasons for the difference between the average market price of mineral resources in entrails of the earth included in the prime cost of mineral resource extraction and the price indicated in the valuations of certified appraisers about the book value of the mineral resources.

After the audit, the State Audit Office sent a letter to the Treasury with a call for improving the accounting methodology of budget institutions in cooperation with ministries and local governments by defining common principles for the presentation of mineral resources in the accounts.