
Costs for School Trust Lands Management: Current Approaches, Issues, and Potential Alternatives

Office of School Trust Lands
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Executive summary

At the request of the Minnesota Office of School Trust Lands (OSTL) and with support from the Minnesota Department of Natural Resources (DNR), Management Analysis and Development (MAD) researched how the DNR assigns and recovers its costs for managing school trust lands (STL), examined uncompensated costs to DNR, and explored potential areas for improvement. Given the broad research focus for this study, MAD in this report presents detailed information on a variety of relevant STL topics and also offer recommendations where appropriate.

School trust lands are held in trust by the state to generate revenue for the state's Permanent School Fund (PSF). The investment earnings from that fund, expected to have reached \$31.3 million in fiscal year 2018, are distributed to school districts statewide to support public education. STL revenues flow primarily from mineral leases and royalties, timber sales, and real estate transactions.

Recommendations

Based on extensive research, MAD offers the following recommendations for actions, steps, and approaches relevant to STL management and costs. Some of these recommendations would require changes to state law, but others would not.

Establish clear and distinct guidelines for management of school trust lands. MAD recommends that the DNR establish clear and distinct guidelines and practices that are both aligned with the goal of maximizing long-term economic returns using sound conservation and management principles, and also differentiated from what the DNR uses to manage state lands for public benefit and other purposes. Along these lines, the DNR recently issued an interim policy on site-level forest management for school trust lands using benchmarks from the Minnesota Forest Resources Council. The agency is also working toward forest management guidelines for 11 specific topics of concern. In addition, the DNR has outlined how to approach landscape-level forest management guidelines through planning processes, including use of a pilot project to define sound natural resource and management principles and to evaluate instances when the DNR needs to compensate the trust for the agency's approach to forest management on school trust lands. Beyond forest management, the DNR recognizes the need for real estate and minerals management guidelines specific to school trust lands. Further progress on STL-specific guidelines and practices has the potential to increase STL revenues and reduce STL costs. (See more on page 16.)

Increase involvement from the Office of School Trust Lands. MAD recommends that the DNR and OSTL cooperative more fully on trust land management and operations. Grounded in state statute, OSTL has a fiduciary role to play in decisions, policies, and approaches relating to STL management. As operational manager, DNR ultimately determines what is done on the lands and how. Despite a common fiduciary responsibility and focus on STL revenue, DNR and OSTL have fallen short when it comes to communication and collaboration for much of the period from 2015 when an OSTL director was hired up until recently. An operating agreement signed in April 2018 by the OSTL director, the DNR commissioner, and the governor's chief of staff has helped address this challenge. The agreement lays out duties for these key players and commits them to meaningful consultation and specific channels for the exchange of information. (See more on page 17.)

Consider service level agreements for DNR work on school trust lands. MAD recommends that the DNR and OSTL explore the possibility of using service level agreements (SLAs) instead of cost-based accounting for work on school trust lands. SLAs could clarify parameters, expectations, and charges for STL work. They could also lead to greater understanding and agreement about how school trust lands are managed and at what costs. But a move to SLAs would require DNR to carry out significant advanced planning and budgeting for work on school trust lands. Legislative changes would be required. MAD also cautions that SLAs might increase the DNR costs charged against STL revenues if the DNR uses SLAs to secure STL revenues for the uncompensated work it carries out now on school trust lands. (See more on page 18.)

Use state bonding to fund STL reforestation. MAD recommends that the Legislature use bonding to pay most reforestation costs for school trust lands, even if the DNR uses a different mix of funds for reforestation on the other state lands it manages. This proposed change would return to a long-held practice in the state, reduce forestry costs to the trust, and boost net forestry revenues from school trust lands. (See more on page 19.)

Consider results-oriented performance measures for school trust forest lands. Outside experts said it is important to tie performance measures to desired results for trust lands. With respect to Minnesota's school trust lands, MAD recommends that the DNR present more performance measures focused on the goal of maximizing economic returns – in the context of sound conservation and management principles. The Forestry division already presents data-based financial comparisons with a focus on costs, in keeping with statutory provisions. (See more on page 20.)

Alternatives to also consider

In addition to the recommendations cited above, MAD presents two other notable ideas for OSTL and DNR to consider. While not recommendations, the following alternatives may warrant addition research and analysis.

Cap costs to school trust lands. Some states limit trust land management costs by law to a set percentage of revenues as a way to cap costs. MAD urges OSTL and DNR to explore the appropriateness of this capped approach to costs for school trust lands in Minnesota. In the case of caps put into place by law, once expenditures hit the cap, funding ends for work on trust lands. (See more on page 22.)

Move from shares of costs to shares of revenues for Forestry. Forestry could guarantee a set percentage of gross timber revenues for school trust lands each year and abandon the current practice of identifying allowable costs and assigning appropriate shares to the trust. A set rate of return for the trust from STL timber sales would provide a strong incentive for Forestry to control and reduce the costs of its forestry operations. It would also end worries and disputes about DNR costs, including those related to public benefits. However, a shift away from costs to revenue might mean less accountability and transparency for Forestry's costs to the trust. (See more on page 22.)

Models, measures, and practices

MAD compiled information on a number of notable models, measures, and practices relevant to school trust lands in Minnesota, based on research and interviews. Here are some points of note.

Promising practices and ideas for land management:

- Trust lands must be managed in the interests of their beneficiaries. This means state-owned trust lands different from other state lands managed for public purposes. Trustees for school trust lands need to focus on economic returns from those lands, as distinct from land-related public purposes and benefits.
- Managers of public trust land should listen to stakeholders but not allow them undue influence over decisions that restrict income generation unless the trust is compensated for that lost income.
- Those responsible for land trusts should continually re-evaluate assets that in the past offered only limited potential revenue, as the value of those assets may shift over time.
- Land trust managers should reassess royalty and lease arrangements for assets and update them to match changing market conditions. All parties using the trust lands should pay some type of fee.
- There may be opportunities for increased collaboration on forest sales and forest management between county and DNR staff, according to some county land commissioners in Minnesota.
- Most experts agreed that sealed timber bids generate greater revenue than oral bids and recommended that the DNR use sealed bids rather than oral bids for sales of STL timber.

Separate state government teams to manage trust lands. Some states have established separate land trust units or offices within state government that are accountable for the single-purpose mission of the trust lands and responsible for managing the land and staffing around that purpose. MAD believes that separate management for STL operations, apart from DNR management of other state lands, might not significantly reduce costs or improve cost containment here and could in fact lead to duplication and inefficiencies. MAD research didn't examine the potential impacts that separate STL management might have on trust revenues.

Two notable findings

Based on its research, MAD calls out the following two notable findings as points important for understanding DNR's management of school trust lands, the resulting costs, and potential areas for improvement.

Current Forestry division practices cut costs and boost returns for school trust lands. MAD calculations using Forestry division data show that Forestry's conservative approach to identifying and allocating costs to school trust lands keeps forestry costs to the trust relatively low and the STL operating margin relatively high. STL revenues cover a smaller share of Forestry's SLFM costs under current cost calculations than the trust would cover if Forestry used reasonable alternatives. Furthermore, Forestry's approach leaves the trust with a much higher operating margin than the margin for all other timber acres that the DNR manages. In fiscal 2016 and 2017, this meant a positive operating margin for STL forest lands and a negative one for other lands.

It would be ill-advised for DNR to track forestry and mineral costs by land type. DNR doesn't currently track staff time by land type to calculate forestry and mineral costs for the school trust. MAD concludes that time tracking in most cases would be complicated, administratively burdensome, and potentially inaccurate.

STL cost and revenue challenges

State law allows the DNR to use STL revenues to pay for some—but not all—of its costs for managing those trust lands. STL net revenue for the Permanent School Fund depends on both these management costs and also earnings from STL assets. MAD identified several key challenges related to STL costs and earnings:

- **Limited control and predictability of revenues and costs.** STL revenues can vary significantly based on market-driven price fluctuations for minerals and timber, fluctuations that are beyond the control of the DNR and STL stakeholders. Consequently, costs for those commodities may be steady or rising when revenues are in decline, squeezing net income for the trust.
- **Poor returns from timber, and from school trust timber lands in particular:** In Minnesota in general and on school trust lands in particular, timber operations earn only limited economic returns, if any, because of the dominance of low-value trees and the high cost of timber operations.
- **Policy choices and STL forestry costs:** State government spending and investment aimed at increasing the health and diversity of its forests raise DNR's costs to manage school trust forest lands and consequently reduce STL net revenues from timber.
- **Different goals for different types of land managed by the DNR:** The DNR is charged with managing state land for multiple purposes and public benefit, but also managing school trust lands solely for maximum long-term economic returns using sound natural resource conservation and management principles. Some see this difference in DNR goals as problematic for the school trust.
- **Reforestation costs for school trust lands:** By law, the DNR must plant in areas where timber has been harvested, including on trust lands. Recently, policymakers changed how the state funds reforestation, greatly increasing the reforestation costs that the Forestry division covers using STL revenues.

DNR costs for school trust forest management

The DNR's Forestry division uses appropriated funds to carry out state land forest management (SLFM) activities for both school and university trust lands. Forestry then estimates its expenditures for trust land forest management after the fiscal year ends, submits those expenditures for certification, and receives a transfer of funds from the Forest Suspense Account (FSA) to cover those outlays retroactively. In fiscal year 2017, school trust lands earned \$11.20 million in gross revenues from forestry activities, against \$9.26 million in certified Forestry costs, resulting in \$1.94 million in STL net income.

Under state law, Forestry can allocate costs to the school trust only for SLFM work linked to current or future revenue generation from forestry activities on school trust lands. There are four types of qualifying expenditures: forest management, forest improvement, forest roads, and administration.

To estimate its certifiable costs within those qualifying categories, the Forestry division first determines its overall costs for the appropriate SLFM activities and then calculates the share of those costs to be covered using trust revenues in the FSA. The DNR uses three approaches to allocate costs to the school trust:

- For forest management and improvement costs, Forestry uses acres of trust land subject to cost certification as a percentage of the DNR's total SLFM acres subject to cost certification.

- For indirect costs, Forestry uses its totals for administration and general operations expenditures, reduced first based on the percentage of Forestry's overall direct costs associated specifically with SLFM work and then reduced again by the percentage of its direct costs related specifically to the trust lands.
- For forest road costs, Forestry uses acres of trust land within one-half mile of the state's forest system roads as a percentage of all SLFM acres subject to cost certification.

While there is general agreement about Forestry's direct SLFM costs for school trust lands, some STL stakeholders expressed unease about indirect costs for administration and general operations. Indirect costs in any agency or business are necessary for ongoing operations but are difficult to assign to specific production, projects, or operating units. Based on MAD calculations using Forestry data for fiscal 2017, administration amounted to 12.0 percent of Forestry's cost to school trust lands, and general operations accounted for 30.4 percent. These levels for the two types of spending are difficult to discern from published Forestry data because of statutorily required accounting procedures. The issue when it comes to indirect costs to school trust lands is not that they are assessed but if and how they can be reduced.

Tight margins from timber operations intensify interest in cost containment. This is compounded by the fact that Forestry has a high degree of discretion to decide what and how much work it will carry out when managing trust land forests. Use of STL forestry revenues to cover Forestry's qualifying costs, as set forth in state law, creates an open-ended cost to the school trust every year.

DNR costs for minerals management

The minerals program of the DNR's Lands and Minerals (LAM) division identifies its minerals management costs each fiscal year and covers those costs as it incurs them. The minerals program uses about \$3 million per year that the Legislature appropriates from the state's Minerals Management Account (MMA). A share of the mineral receipts from school trust lands and all other DNR-managed mineral lands flows into the MMA, so in this way mineral receipts are used to cover mineral program costs. For fiscal years 2014-17, school trust lands accounted for about three-fourths of the mineral receipts, an indication of STL's share of minerals program costs. STL mineral receipts over that period fluctuated significantly, from \$53.58 million in fiscal year 2014 to \$12.34 million in fiscal year 2017.

LAM categorizes the types of minerals management work it carries out for the benefit of the state's minerals lands and then estimates what share of those costs should be covered using MMA appropriations. LAM estimates its total minerals management expenditures overall for school trust lands and all other DNR-administered minerals lands. For the most part, LAM uses annual work plans and estimates of required staff time to identify appropriate salary expenditures, which account for the largest share of relevant costs for the minerals program. LAM also uses annual work plans to estimate shares of other costs for specific projects involving mineral potential, mineral title research, and mineral engineering. In addition, LAM has identified several other minerals management expenditures to cover using MMA funds, including a share of costs for the state's new land record system and part of its environmental research costs.

LAM also taps MMA funds to cover a portion of administration and general operations costs. MAD used LAM budget data to roughly estimate these costs as shares of expected overall fiscal year 2018 minerals management costs: 6.9 percent for administration and somewhere between 18.5 and 23.3 percent for general operations.

Because of differences in methods and definitions, these indirect costs for minerals management cannot be compared directly to those same types of costs for forestry work. However, indirect costs may constitute a higher percentage of the Forestry division's costs because Forestry is a larger division than LAM, and DNR allocates agency-level indirect costs based on staffing and budget levels for the different divisions.

DNR costs for real estate work

The lands program within LAM handles real estate transactions and land-related work that benefits the school trust, including leasing, land sales, land exchanges, easements, and licensing. Since fiscal year 2012, the Legislature has approved annual transfers of about \$200,000 from the FSA to cover a limited share of the lands program work of benefit to the school trust. About half of that total covers a share of personnel costs, and the remaining half is available to fund other land program real estate work.

In their annual budget meetings, LAM officials compile spending priorities overall and include planned spending that benefits the school trust, with input from the DNR's STL administrator. LAM sets up project codes for STL real estate work that can be paid for using available FSA funds, and staff for the lands program then bill time to the appropriate project codes. The annual FSA funding only covers some of the lands program's STL work, so the lands program pays for much of that work using the fees paid by other DNR divisions under service level agreements with LAM.

Significant uncompensated costs for STL management

The current approach to school trust land management in Minnesota fails to compensate the DNR and state government more broadly for all STL-related costs. State laws and protocols limit the types of forestry, mineral, and real estate expenses to be paid for with STL revenues. In addition, the DNR and the state incur STL-related costs for activities beyond real estate, forestry, and minerals activities. The following provides a general sense of the scope and amounts for the major uncompensated costs.

State government other than the DNR. The state of Minnesota broadly, rather than the DNR more narrowly, covers payments in lieu of taxes (PILT) made to local governments for acres of school trust land, at a cost of \$3.75 million in fiscal year 2017 and an expected cost of about \$5 million for fiscal 2018. In addition, until recently, the Legislature issued state bonds to cover most costs for reforestation of school trust lands after timber harvests, a cost that the state would again incur without STL compensation if bonding is used in the future. STL's reforestation costs totaled \$817,800 in fiscal year 2017.

Forestry division. The Forestry division can use STL revenues from the FSA to pay for qualifying STL costs, but available FSA dollars are constrained by the level of trust revenues earned from forestry-related activities. The last time costs exceeded revenues was in fiscal year 2013, when the DNR had to secure other funds to cover an \$861,500 shortfall for school trust lands. In addition, the legislature halted Forestry's practice of certifying its fire prevention and suppression costs and charging a share to school trust lands—\$1.76 million annually on average to the school trust in fiscal years 2009-13. The division now offers these services on school trust lands at no charge, as it does on all other forests in Minnesota regardless of who owns the land, except for federal forests.

LAM's land program. The Legislature makes limited STL revenues available from the FSA to cover some costs for real estate work that benefits the school trust. However, because those funds are limited, they fail to fully cover even the land program's allowable STL expenditures. In addition, LAM's categories for allowable STL land work miss some activities that benefit the school trust, including lease transactions, land title actions, trespass issues, staff time spent on PILT, and preparation for the land exchanges and sales. A LAM official roughly estimated that the lands program will incur about \$920,000 in uncompensated costs for STL work in fiscal year 2018.

LAM's minerals program. The minerals program uses MMA funds to cover all minerals management costs on state lands, including school trust lands. However, minerals program staff also work on STL leases for surface extraction of peat, gravel, and other aggregates—work it cannot cover using MMA funds because surface extraction isn't mineral mining. A LAM official roughly estimated the cost of this uncompensated STL work at \$100,000 per year.

Parks and Trails (PAT) division. PAT manages school trust lands used for recreational purposes without reimbursement from STL revenues. Under state law, PAT must deposit all revenues collected for the school trust from recreational uses into the FSA for transfer to the Permanent School Fund. PAT data show that campground fees earned \$216,200 annually on average for the school trust in fiscal years 2013-17. PAT staff recently began tracking time spent managing school trust lands used for recreational purposes, as well as STL-related expenditures. PAT data show STL costs of well under \$200,000 for fiscal year 2017, although this new system may have missed some costs. In addition, the division operates the Knife River Marina on school trust lands, which PAT officials report needs millions of dollars in repairs and restoration work.

Trust land management in other states

MAD contacted officials in Alaska, Idaho, Montana, Oregon, and Washington to learn more about how they manage trust lands and allocate costs to school trusts and other trusts. The full report includes information on each of these states. Applicability in Minnesota may be limited, however, by differences from state to state with regard to laws, types of trust land acreage, the asset base of that land, and the value of those assets.

Costs, purpose, governance for school trust lands

Minnesota’s Office of School Trust Lands (OSTL) asked Management Analysis and Development (MAD) to research how the Minnesota Department of Natural Resources (DNR) assigns and recovers costs for managing school trust land assets and examine what might be missed in that process.¹ At the request of the DNR, MAD also examined uncompensated costs to the agency for STL management. In addition, MAD explored potentially useful models and alternative approaches to trust land management and costs.

MAD used reference research, data analysis, and extensive interviews with more than 40 people to understand and document the current approaches to costs for school trust land management and to explore potential areas for improvement. (For a list of interviewees, see Appendix A on page 63.) Given the broad research focus for this study and the varied issues of interest to trust land stakeholders, MAD compiled useful information, findings, and ideas across many subject areas. MAD paid particular attention to pressing and potentially contentious trust land topics. Consequently, this resulting study presents detailed information on a variety of topics relevant to cost issues for the school trust lands (STL) and also offers recommendations where appropriate.

School Trust Land acres

School Trust Lands are acres that were granted by the federal government to the state of Minnesota and set aside under the Minnesota Constitution to generate revenues in support of the state’s public schools. Today, Minnesota has 2.5 million acres of school trust lands, most of them in Northeast Minnesota. In addition, the state holds rights for the trust to minerals below the surface on 1 million additional acres. Total school trust holdings include the remaining lands from 2.9 million acres granted by the federal government when Minnesota became a state, plus grants in the 1860s of 4.7 million acres classified as swampland and other acreage given to the state to foster economic and railroad development. Initially, the state of Minnesota sought to quickly sell the best of parts of this land to generate income for the school trust. Consequently, the state sold much of the best timber, agricultural, and mineral lands to private land holders by 1900, including most of the STL acres in the southern part of the state.²

Revenue generation and STL earnings

Under Minnesota’s constitution, revenues generated from school trust lands are credited to the state’s Permanent School Fund (PSF). The state distributes earnings from the fund’s principle to all school districts in Minnesota twice per year. The PSF paid out \$30.1 million to school districts from investment earnings in fiscal

¹ At the same time, the OSTL asked MAD to research how the state of Minnesota manages the flow of revenues from School Trust Lands through its funds and accounts. Information on that topic is included in a separate June 2018 report on “School Trust Lands Funds and Accounts,” available from the OSTL.

² For more on School Trust Lands, see <https://mn.gov/school-trust-lands/lands/overview/>.

year 2017 and was projected to distribute another \$31.3 million in fiscal year 2018. The PSF consolidated funds balance was estimated to be \$887.1 million at the start of fiscal 2018, while the market value of the fund, including investments, was \$1.39 billion at the end of 2017.³

Minerals and timber account for the vast majority of STL revenues each year, with more limited revenues flowing from land sales and real estate transactions, campground fees, and other economic activity. Mineral receipts amounted to \$24.81 million per year on average for fiscal years 2008-17. Average net STL revenues from timber and other forest-related activities totaled \$1.93 million on average for that same 10-year period. DNR officials report that STL revenues from minerals could triple if non-ferrous mining moves forward in Minnesota.

The trust status of these state lands for schools sets them apart from most public lands owned and managed by the state of Minnesota. The state has an enforceable fiduciary responsibility to manage these trust lands in the interests of the public schools. For this reason, school trust lands are managed with the goal of revenue generation, unlike most other state lands. The Legislature makes this clear in language found in Minnesota Statutes 2017, section 127A.31:

The legislature intends that it is the goal of the permanent school fund to secure the maximum long-term economic return from the school trust lands consistent with the fiduciary responsibilities imposed by the trust relationship established in the Minnesota Constitution, with sound natural resource conservation and management principles, and with other specific policy provided in state law.

Office of School Trust Lands

The Legislature established a director of school trust lands in 2012 to focus on STL management and advise other key players involved in STL plans, management, and operations. The director is housed in the Office of School Trust Lands (OSTL) under Minnesota’s Department of Education, and OSTL is located at DNR headquarters. The OSTL director offers advice specifically to the DNR, the governor, the state’s executive council, the land exchange board, and the legislative commission for the Permanent School Fund. State statute instructs the director to advise these other parties on STL management matters, including land management plans, STL leases and royalty agreements, land sales and exchanges, cost certification, and revenue generation options. The OSTL is also responsible for proposing legislative changes to the PSF legislative commission on ways to improve STL asset allocation.⁴ The OSTL mission is to “[a]dvocate for sustainable asset management strategies that maximize revenue for Minnesota’s public schools.”⁵

³ Data from the DNR’s Office of Management and Budget Services on “Consolidated Endowment & Permanent School Funds 3800 (860),” printed November 9, 2017, p. 1; and from State Street, “Comprehensive Performance Report” to the Minnesota State Board of Investment for the quarter ending December 31, 2017, p. 84 (available at <http://mn.gov/sbi/performance/MSBI%20Comprehensive%20Performance%20Report%20Quarter%20Ending%20December%2031,%202017.pdf>).

⁴ Minnesota Statutes 2017, section 127A.353.

⁵ Minnesota Office of School Trust Lands. “2018-2028 Strategic Plan: Advancing the School Trust Legacy through Strategic Innovation,” 2018, p. 6. (Available at https://mn.gov/school-trust-lands/assets/2018-OSTL-Strategic-Plan_tcm1107-339630.pdf.)

OSTL recently developed a 2018-2028 strategic plan for advancing the school trust legacy, one that includes strategies relating to STL’s operating environment, fiduciary integrity, future direction, and education and communication about trust lands. OSTL is working on 2018 priorities from the plan. Several relate directly to topics noted in this report, including clarification of roles and responsibilities, guidance on maximizing long-term revenue for the trust using sound natural resource conservation and management principles, and planning for comprehensive asset management.⁶

Department of Natural Resources

The Department of Natural Resources manages the school trust lands. DNR staff carry out the work involved in minerals management, timber production and harvest, real estate efforts, and other STL-related initiatives. The DNR is allowed to use STL revenues from mineral receipts, timber sales, and other forestry activities to cover some of its STL costs. State statute spells out the DNR’s authority and responsibility for STL management. The DNR’s goals align with the following statutory requirements:

1. “manage the school trust lands efficiently and in a manner that reflects the undivided loyalty to the beneficiaries consistent with the commissioner's fiduciary duties;
2. reduce the management expenditures of school trust lands and maximize the revenues deposited in the permanent school trust fund;
3. manage the sale, exchange, and commercial leasing of school trust lands, requiring returns of not less than fair market value, to maximize the revenues deposited in the permanent school trust fund and retain the value from the long-term appreciation of the school trust lands;
4. manage the school trust lands to maximize the long-term economic return for the permanent school trust fund while maintaining sound natural resource conservation and management principles;
5. optimize school trust land revenues and maximize the value of the trust consistent with the balancing of short-term and long-term interests, so that long-term benefits are not lost in an effort to maximize short-term gains; and
6. maintain the integrity of the trust and prevent the misapplication of its lands and its revenues.”⁷

Legislative Permanent School Fund Commission

The Legislative Permanent School Fund Commission, made up of 12 state legislators, advises the DNR and the OSTL director on the management of school trust lands. Established in 2012, the commission reviews STL- and PSF-related statutes and reports annually to the Legislature on recommendations for how best to manage school trust lands for long-term economic returns.⁸

⁶ Minnesota Office of School Trust Lands. “2018-2028 Strategic Plan: Advancing the School Trust Legacy through Strategic Innovation,” 2018, pp. 8-10. (Available at https://mn.gov/school-trust-lands/assets/2018-OSTL-Strategic-Plan_tcm1107-339630.pdf.)

⁷ Minnesota Statutes 2017, section 84.027, subdivision 18.

⁸ Minnesota Statutes 2017, section 127A.19.

MAD recommendations

Based on extensive research into how DNR assigns and recovers costs for managing STL assets, MAD presents the following five recommendations. The state of Minnesota's current approaches to STL management and costs are shaped by provisions in the state constitution, state statutory language, the structure of the SWIFT accounting system, and DNR policies and practices. Some of these recommendations would require changes to state law, the existing accounting frameworks, or DNR policies.

Establish clear and separate guidelines for management of school trust lands

MAD recommends that the DNR establish clear and distinct guidelines and practices that are both aligned with the goal of maximizing long-term economic returns using sound conservation and management principles, and also differentiated from what the DNR uses to manage state lands for public benefit and other purposes. The DNR made progress on this front in the summer of 2018 and has committed to additional positive action in the future.

Since 2016, the DNR's cross-divisional working group on strategic land asset management and school trust lands has met to examine a number of critical issues, including land management guidance specifically for school trust forest lands. In late June 2018, the DNR issued an interim policy on site-level forest management guidelines for school trust lands based on work by this group and intended to provide initial DNR guidance for STL management practices, based on the goal of securing maximum long-term economic return from the lands using sound natural resource conservation and management principles.

Under the interim policy, the DNR manages forests on school trust lands at the site level using forest management guidelines from the Minnesota Forest Resource Council (MFRC) when no federal or state law directs its activities. The interim policy further defines the MFRC benchmarks in some cases to provide additional clarity and direction.⁹ Separately, a DNR memo cites this interim policy as Phase 1, commits the DNR's working group to supplemental forest management guidelines for 11 specific topics (Phase 2), and outlines working group plans for a pilot project to assess the feasibility of using landscape-level section forest resource management planning to define "sound natural resource and management principles" and evaluate instances when the DNR needs to compensate the trust for the agency's approach to forest management on school trust lands (Phase 3).¹⁰ Beyond forest management, the DNR recognizes the need for real estate and minerals management guidelines specific to school trust lands. The DNR should move forward and complete these useful and important initiatives as soon as possible.

As noted elsewhere in this report, some unease and even skepticism about the DNR's costs for school trust land management likely stem from the Legislature's explicit goal for school trust lands: "to secure the maximum long-

⁹ Minnesota Department of Natural Resources. "Interim DNR Policy: Forest Management Guidelines for School Trust Lands," June 28, 2018, p. 2.

¹⁰ Bob Meier. "Internal Memo RE: Forest Management Guidelines on School Trust Lands," July 16, 2018.

term economic return from the school trust lands consistent with the fiduciary responsibilities imposed by the trust relationship established in the Minnesota Constitution, with sound natural resource conservation and management principles, and with other specific policy provided in state law.”¹¹ This purpose differs from purposes central to the DNR’s management of most other state lands, for which revenue generation is not the primary consideration. Several DNR officials reported that the agency strives to completely fulfill its fiduciary responsibility to manage school trust lands for revenue generation in support of the state’s public schools.

Some stakeholders argue that the DNR’s costs for school trust land management would be lower absent activities that the DNR carries out for reasons other than long-term economic returns. Some DNR officials acknowledge that the required focus on economic returns from school trust lands conflicts at times with important goals appropriate to the DNR’s management of other land types, potentially affecting STL costs as well as revenues. Other DNR officials argue the agency is able to manage school trust lands for revenue generation while managing other state lands for other purposes, even in cases where the acreage is intermixed.

MAD recognizes that the DNR manages different natural resources for different purposes but suggests in the case of school trust lands that doing so is difficult without clear and established guidelines. DNR officials readily acknowledge the need to manage school trust lands differently for revenue generation. But clear and agreed-to guidelines will eliminate or minimize situations where interpretations vary among DNR divisions and staff when it comes to appropriate conservation and management principles for school trust lands. Without guidelines, discussions and decisions about STL costs have to be worked out, often on a case-by-case basis.

Continued progress on STL-specific practices and guidelines—ones framed around the revenue focus for STL acres and different from practices and guidelines followed for other DNR-managed forests— have the potential to reduce costs for the trust. One potential cost savings could come from interdisciplinary forest management coordination. As a part of this coordination, forestry staff spend time engaged with other DNR divisions on trust-related, site-level forest management issues and bill their time as a certified costs for the trust. In fiscal year 2017, forestry’s costs to the trust for interdisciplinary forest management coordination amounted to an estimated at \$156,400.

Increase involvement from the Office of School Trust Lands

MAD recommends the DNR and OSTL cooperative more fully on school trust land management and operations. MAD found that the relationship between DNR and OSTL in the past was marked by notable disconnects, limited information sharing, and a lack of trust among DNR officials and school trust stakeholders. Based on MAD’s research interviews, this seems to contrast with situations in other states where natural resources agencies carry out trust land management. Despite a common fiduciary responsibility and focus on STL revenue, DNR and OSTL have fallen short when it comes to communication and collaboration for much of the period from 2015 when an OSTL director was hired—after significant delay—up until recently.

The OSTL and its director have an important role to play in the long-range planning and direction for the lands. Grounded in state statute, OSTL also has a fiduciary role to play in decisions, policies, and approaches relating to

¹¹ Minnesota Statutes 2017, section 127A.31.

STL management.¹² The DNR, as the operational manager of the lands, ultimately determines what is done on the lands and how. Consequently, DNR and OSTL need to cooperate for the good of the trust.

A new operating agreement signed in April 2018 by the OSTL director, the DNR commissioner, and the governor's chief of staff likely will help address this challenge. The agreement lays out duties for the players and commits them to meaningful consultation and specific channels for the exchange of information. The agreement states that "[the] relationship between OSTL and DNR is an agency-to-agency relationship."¹³ MAD suggests that one added and clear area where improved communications and greater OSTL involvement could advance progress is with the DNR's strategic land asset management and school trust lands working group. The OSTL could contribute to that group's effort to develop STL-specific land management practices and guidelines.

Consider service level agreements for DNR work on school trust lands

MAD recommends that the DNR and OSTL explore the possibility of using service level agreements (SLAs) instead of cost-based accounting for work on school trust lands, examining both the potential benefits and downsides to SLAs for the school trust and the agency. Using SLAs could clarify parameters, expectations, and charges for needed STL work by the DNR. Forestry, Lands and Minerals (LAM), Parks and Trails (PAT), and other DNR divisions regularly use intra-agency service level agreements to contract with each other for work and set the terms of reimbursement. A change in statutory requirements would be needed if the DNR were to use SLAs for management of school trust lands. State lawmakers would need to determine, among other considerations, which two parties would enter into the agreements and also what funds would be used to pay for the services because currently STL revenues go into funds located within DNR.

Use of SLAs will likely lead to greater understanding and agreement about how school trust lands are managed and at what cost. A move to SLAs will also require complex, advance planning and budgeting for DNR work on school trust lands because that work crosses many different cost codes and involves many different staff, something that several DNR officials cited as potentially problematic. This is especially true in the case of the Forestry division. Several DNR officials also raised questions about how the DNR would work out the details for STL-related SLAs and with whom. In addition, a move to SLAs would require legislative changes.

A number of DNR officials said they would be open to exploring the use of SLAs for school trust land work if they were able to cover the agency's STL costs under such agreements. SLAs might lead to a reduction in some types of work that the DNR carries out now when managing school trust lands, and in this way SLAs might reduce costs to the trust, one DNR official said. Another noted that fees under an SLA arrangement are easier to figure out and manage than the costs that are used now to determine the DNR's reimbursement from STL revenues.

An SLA for the Forestry division's work on school trust lands would involve agreement on work scope and cost at the start of a year. This would address unease among some outside of the DNR that the open-ended nature of current arrangements may result in higher or unexpected STL costs. At present, forestry tracks allowable

¹² Minnesota Statutes 2017, section 127A.353.

¹³ "Operating Agreement," April 24, 2018.

management expenditures for school trust forests throughout the fiscal year, tallies the costs at the end of the year, and allocates a share of those costs to be covered using revenues from school trust lands.

With a move to SLAs, the DNR could and would seek reimbursement from STL revenues for uncompensated work carried out now on school trust lands, several agency officials said. For example, right now the LAM division incurs STL-related costs for real estate transactions and other land work but is able to cover only a share of its expenditures by tapping into limited funds from STL revenues. Similarly, the PAT division cannot use STL revenues to pay its costs for campground maintenance and management on school trust lands, even though the campgrounds produce revenue for the school trust.

As noted later in this report's section on trust land management costs in other states (see page 49), MAD gathered information from several states that use upfront service agreements for trust land work. In both Alaska and Oregon, the government units that manage trust lands use agreements with other state government divisions to secure and pay for needed work. This allows the state office or agency responsible for the trust lands to set parameters in advance for the work to be done and for the costs, although adjustments are made if unexpected costs arise. Because in these instances the trust land officials work out the details in advance, after-the-fact cost accounting is not required, although front-end work is needed to estimate the costs of the work to be performed.

MAD also talked to an Oklahoma state official who said his state used SLAs for school trust management in the 1980s but moved away from them because SLAs resulted in battles over which costs to include and which to leave out. A Minnesota DNR official expressed related concerns about use of SLAs for school trust lands, saying negotiations over scopes of work and costs would heighten political tensions and adversely affect management decisions for school trust lands. This would result in risks that outweigh any gains, he said.

MAD also cautions that SLAs might increase the DNR costs charged against STL revenues, depending upon negotiations, and consequently reduce net STL income for the Permanent School Fund. The DNR officials who expressed interest in SLAs said their agency would benefit from such agreements because the DNR could incorporate more costs into such agreements. They suggested that SLAs could include an array of expenditures not currently eligible to be reimbursed from STL revenues, including capital expenditures on DNR facilities and STL-related costs for millions of dollars annually in fire protection and payments in lieu of taxes. One DNR official cited "sticker shock" to the school trust as one potential drawback of a switch to SLAs. Consequently, MAD suggests that STL stakeholders weigh potential disadvantages as well as potential advantages when considering if service level agreements might be of interest.

Use state bonding to fund STL reforestation

MAD recommends that the Legislature use bonding to pay most reforestation costs for school trust lands, even if the DNR uses a different mix of funds for reforestation on the other state lands that it manages. This proposed change for STL reforestation would return to a long-held practice in the state, reduce forestry costs to the trust, and boost net forestry revenues from school trust lands.

Historically, the Minnesota Legislature has issued bonds to pay for reforestation on state forest lands after timber harvests. State law requires reforestation on DNR-managed timber acres, including school trust holdings.

But starting in fiscal year 2017, the Legislature shifted most all of the reforestation costs to the Forest Management Investment Account, dramatically increasing the reforestation costs that the DNR charges to the school trust, as noted in a later section of this report on reforestation costs for school trust lands (see page 31). The reforestation costs that the DNR now covers using STL forestry revenues more than doubled from fiscal year 2016 to fiscal year 2017 (\$817,800) and jumped again for fiscal year 2018.

The DNR certifies state land forest management activities paid for with FMIA funding and taps STL revenues to cover the share allocated to the trust. The reforestation costs covered with bond funding cannot be passed along to the school trust. So if the Legislature once again uses bonding for STL reforestation, the forestry costs allocated to the school trust will decline. It is reasonable for the state to take responsibility for the costs of reforestation on school trust lands because state law requires reforestation. In addition, timber constitutes a high-risk investment for the school trust, with no economic return earned from reforestation for decades until the timber is ready to harvest. Plus, the harvest itself is uncertain due to many uncontrollable and unpredictable factors, including insect infestations, strong wind storms, and climate change.

Consider results-oriented performance measures for school trust forest lands

In interviews with outside experts, MAD learned it is important to tie performance measures to desired results for trust lands, especially forests held in trust and managed for revenue generation. With respect to Minnesota's school trust lands, MAD recommends that the DNR compile and present performance measures tied to the goal of generating and maximizing economic returns— in the context of sound conservation and management principles.

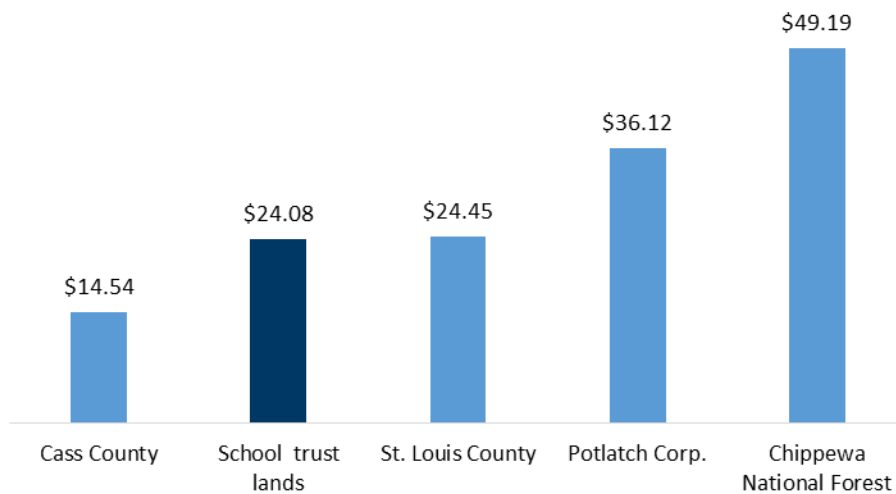
The Forestry division already presents financial comparisons in its annual reports on STL costs and revenues, in keeping with statutory provisions.¹⁴ Forestry compiles and analyzes comparable cost and revenue measures for school trust lands and selected county, federal, and private forest land management operations. The data include gross revenues per management acre, operating margins, and operating profit or loss per cord harvested, as well as other useful data points. Forestry staff said that comparisons are difficult because no other land management organization has strictly comparable forest land assets, revenue potential, and management objectives to those of the school trust lands. Nonetheless, Forestry strives to ensure its financial comparisons present reasonable data on a range of timber operations and returns. Forestry officials report that St. Louis County offers the closest comparison to school trust lands in terms of assets, objectives, and geographical location.

Data for fiscal year 2017 show the following:

¹⁴ For example, see "Division of Forestry, "M.S. 16A.125 Transfer Certification Report," Department of Natural Resources, March 5, 2018, Table 3: Minn. Stat. 16A.125, Subd. 5.c – Financial Performance Comparisons., pp. 11-12. (Available at <https://files.dnr.state.mn.us/aboutdnr/reports/legislative/2017-transfer-certification-report.pdf>.)

- The DNR’s costs per cord for STL timber (\$24.08) was lower than for St. Louis County (\$24.45), the Potlatch Timber Real Estate Investment Trust (\$36.12), and the Chippewa National Forest (\$49.19), but higher than the cost per cord for Cass County (\$14.54).
- The DNR’s gross revenue per management acre for STL timber (\$8.30) was lower than for St. Louis County (\$8.66), Cass County (\$11.00), and Potlatch (\$102.65), but higher than the gross revenue per management acre for the Chippewa National Forest (\$7.48).
- The DNR’s operating profit per cord harvested was lower for school trust lands (\$5.79) than what was earned by St. Louis County (\$8.27), Cass County (\$12.77), and Potlatch (\$52.22). However school trust lands did better than the Chippewa National Forest, which recorded an operating loss per cord harvested (negative \$11.84).

Figure 4: Example financial performance comparison of costs per cord between the DNR’s STL forestry operations and the forestry operations of other land management entities for 2017¹⁵



Given the focus in Minnesota on forestry costs and cost certification, the Forestry division presents financial performance data framed around costs, not assets. In fact, statutory language directs the DNR to use costs as the defining element for financial performance comparisons, calling for “an analysis that compares costs certified [for school trust lands]... with costs incurred on other public and private lands with similar land assets.”¹⁶ A focus instead on revenue generation and economic returns from school trust forest land would better align with the goals for the trust. No annual performance measures are produced for minerals management, which generates the bulk of net revenues to the school trust.

Outside experts interviewed for this study suggested a number of measures to track and assess internal performance of forestry operations on school trust lands. Many of the metrics they mentioned are included already in the Forestry division’s annual financial performance comparisons. However, the DNR doesn’t compile

¹⁵ Data for School Trust Lands and the Chippewa National Forest are from fiscal year 2017, while data for the others are from calendar year 2017.

¹⁶ Minnesota Statutes 2017, section 16A.125, subdivision 5c.

and present that STL data over time to show trends and progress. Experts also suggested that for internal comparisons over time, Forestry should present data related to staffing, including gross revenue per employee, cost per staff member based on full-time equivalents, and staff costs per unit of timber harvested. Many of the outside experts also suggested that Forestry use data from the National Council of Real Estate Investment Fiduciaries to compare returns from school trust forest lands to forest land returns in the region that includes Minnesota.

Alternatives to also consider

In addition to the recommendations cited above, MAD presents two other notable ideas for OSTL and DNR to consider. While not recommendations, the following alternatives may warrant addition research and analysis.

Cap costs to school trust lands

In the interests of the school trust, DNR needs to contain its costs for managing School Trust Lands. One way that some states contain costs for trust land management is to cap those costs by law at a set percentage of revenues, as noted later in this report's section on trust land management costs in other states (see page 49). For example, the overall costs for Montana's trust land management division cannot exceed 25 percent of the revenues earned from those trust lands. The state of Washington effectively caps overall expenditures for all types of DNR work on federally granted trust lands by transferring a set percentage of trust land revenues into its Resource Management Cost Account and then using appropriations from the RMCA to fund its trust lands work. Similar to this, Minnesota's Minerals Management Account in effect sets a limit on costs for the DNR's mineral work, including minerals management for school trust lands. MAD urges OSTL and DNR to explore the appropriateness of this capped approach to costs for school trust lands in Minnesota.

This overarching cap on costs differs from the cap imposed by a negotiated service level agreement tied to specific work. Unlike SLAs, caps put into place by law cannot be reopened in the case of unexpected costs; once expenditures hit the cap, funding ends for work on trust lands.

Move from share of costs to share of revenues for forestry

One idea suggested during MAD's interviews was to have Forestry guarantee a set percentage of gross timber revenues for school trust lands each year and abandon the current practice of identifying allowable costs and assigning an appropriate share to the trust. Under this scenario, the school trust would earn a set rate of return from its timber operations, based perhaps on historical operating margins and reasonable earnings expectations. MAD cites this idea of shifting from a share of forestry costs to a share of forestry revenues as another one worth exploring for school trust lands.

The DNR takes this approach now for low-value consolidated conservation lands, also known as Con-Con lands, which are state-owned properties held in trust for conservation purposes. Forestry transfers 50 percent of its gross timber revenues from Con-Con lands to counties, although the DNR officials who cited this model as a

possibility for school trust lands suggested a much smaller percentage of revenues for the trust based on historical returns.

Use of a set rate of return for STL timber sales offers several advantages, DNR officials said. Forestry would have a strong incentive to reduce and control the cost of forestry operations because those costs will reduce the return to the DNR from STL timber sales under this suggested approach. At present, forestry usually isn't at risk because the division passes all relevant forestry costs on to the school trust unless STL costs exceed STL revenues.

Timber revenues for STL based on a set share of gross STL timber sales and other forestry-related receipts would end worries and disputes about DNR costs, including those related to public benefits. As a result, Forestry would be freer to manage forests for public benefit because those costs wouldn't be passed on to the trust. Still, public benefit decisions by the DNR could reduce STL timber harvests and in this way adversely affect STL revenues. Consequently, these types of public benefit decisions would need to be constrained, in keeping with the legislative goals for school trust lands.

DNR officials also pointed out what would be lost if the agency were to use a set share of gross revenues to determine STL earnings each year, instead of subtracting costs from gross revenues to calculate net returns from school trust lands. A shift in focus to revenue would mean less accountability and transparency when it comes to DNR forestry costs, some said. The current focus on costs means that forestry and school trust officials know what costs occur and can look for ways to reduce them.

Models, measures, and practices

MAD compiled information on a number of notable models, measures, and practices relevant to school trust lands in Minnesota. MAD staff gathered the examples presented below from research and interviews with leaders at departments of natural resources in other states, officials at timber investment management organizations (TIMOs), county land commissioners in Minnesota, trust fiduciaries, and natural resource consultants.

Many of the general approaches noted in this section are ones used to manage land and trust holdings in other states. (For information on specific states, see later section on page 49.) Government practices in other states provide useful examples for Minnesota officials to consider.

However, some state officials urged caution when it comes to one state adopting or adapting trust land management policies and systems from another state, and the same might be true for approaches used by other government entities and private-sector land managers. The state of Oregon explored how other states handle trust land holdings and revenues, said Nancy Pustis, the real estate program manager for the Oregon Department of State Lands (DLS). Asked about lessons learned from other states, Pustis said she had none to offer because while Oregon's circumstances are similar in many ways to those in other states, the differences among states are significant. For example, the DSL pursued commercial real estate as a trust investment based

in large part on practices in Arizona, but commercial real estate hasn't earned strong returns for Oregon's trust and the DSL is rethinking this investment option.

Separate state government teams to manage trust lands

Some states have established separate land trust units or offices within state government that are accountable for the single-purpose mission of the trust lands and responsible for managing the land and staffing around that purpose. MAD spoke with officials in a number of other states where responsibility for trust land management lies with separate units housed within state natural resources agencies, including the Trust Land Management division of the Montana DNR and the Trust Land Office within the Alaska DNR. The land management staff at Oregon's Department of State Lands focuses on trust lands. And the state of Utah's School and Institutional Trust Lands Administration handles trust lands there.

In Minnesota, the DNR manages trust lands and other state land holdings. No separate unit or office is responsible for operations on trust lands, although the director of the state's Office of School Trust Lands plays an advisory role in STL management plans, leases, royalty agreements, land sales and exchanges, cost certification, and revenue generation options.¹⁷

MAD believes that separate management for School Trust Lands operations in Minnesota, apart from DNR management of other state lands, might not significantly reduce costs or improve cost containment. Separate management could lead to duplication and inefficiencies, particularly when it comes to forest lands where some school trust acreage is intermixed with the other state lands managed by the DNR. To some extent, duplication and inefficiencies could be reduced if a separate STL unit contracted with the DNR for land management services. But a separate state government unit to manage operations for school trust lands would add administrative costs. In addition, some officials said, the DNR and state government more broadly might be inclined to pass on some costs to a separate STL entity that the DNR or the state pay for now, including a share of capital costs for maintenance, renovation, and construction of DNR facilities.

While completely separate management of school trust lands may not result in lower costs, greater involvement in land management decisions by OSTL could lead to improvements, including increased understanding and acceptance of DNR's costs to the school trust.

MAD research didn't examine the potential impacts that separate STL management might have on school trust revenues because that topic lies beyond the scope of this study. DNR officials suggested, however, that separate management of mineral lands would decrease the DNR's market power when it comes to negotiating with mining companies on lease and royalty agreements. On the forestry side, any potential gains from a separate STL unit would be significantly restricted by asset values and market factors that limit economic returns from timber operations in Minnesota, DNR officials said.

¹⁷ Minnesota Statutes 2017, section 127A.353.

Management practices

Based on research for this report, MAD notes the following considerations and promising practices for entities involved in land management:

- **Trust lands, not public lands:** Trust lands must be managed in the interests of their beneficiaries. For this reason, even state-owned trust lands differ from other state lands managed for public purposes. Trustees of school trust lands need to focus on economic returns from those lands, as distinct from land-related public purposes and benefits.
- **Decision making:** Managers of public trust land should seek input from stakeholders on land decisions and on the revenue potential of those land assets, but they shouldn't allow stakeholders undue influence over decisions that restrict income generation unless the trust is compensated for that lost income.
- **Asset valuation:** Those responsible for land trusts should continually re-evaluate assets that in the past offered only limited potential revenue. Those assets may become valuable as technology and markets change over time. This may be true for holdings of sphagnum moss and peat, for example. Responsible parties should look at when assets were last valued and ensure they are re-evaluated on a timely schedule. The recently released strategic plan from the Office of School Trust Lands calls for development of "a comprehensive asset management plan to provide long-term strategic direction" for the trust lands.¹⁸
- **Royalties and leases:** Land trust managers should reassess royalty and lease arrangements for assets and update them to match changing market conditions. They should make sure, too, that all parties using the trust lands pay some type of fee or royalty to the trust. In addition, those responsible should consider if the traditional escalator clauses that set royalty levels in the out years of a contract remain appropriate or could be strengthened to increase gains for the trust.
- **Increased state-county intergovernmental collaboration:** There may be opportunities for increased collaboration on forest sales and forest management between county and DNR staff, according to some county land commissioners. An example of where such intergovernmental cooperation is already being practiced is through the federal Good Neighbor Authority program, wherein the DNR collaborates and shares services with the U.S. Forest Service.
- **Bidding for timber:** Most experts agreed that sealed timber bids generate greater revenue than oral bids and recommended that the DNR use sealed bids rather than oral bids for sales of STL timber. Their opinion is supported by the findings of Office of the Legislative Auditor in 1998,¹⁹ and more recently in a

¹⁸ Minnesota Office of School Trust Lands. "2018-2028 Strategic Plan: Advancing the School Trust Legacy through Strategic Innovation," 2018, p. 9. (Available at https://mn.gov/school-trust-lands/assets/2018-OSTL-Strategic-Plan_tcm1107-339630.pdf.)

¹⁹ Office of the Legislative Auditor. "School Trust Land Report: A Program Evaluation Report," report #98-05, State of Minnesota, March 1998, pp. 38-39. (Available at <https://www.auditor.leg.state.mn.us/ped/pedrep/9805-all.pdf>.)

2010 research study conducted by the University of Minnesota.²⁰ Those interviewed for this OSTL study who were familiar with timber sales practices further recommended that intermediate bids be avoided in the case of STL timber sales—intermediate bids being those limited to companies with 30 or fewer workers. While intermediate bids provide business opportunities for small logging companies, they generally resulted in reduced revenues.

Business models

Experts noted features of their business models that help make their particular organization effective and efficient and therefore may be relevant to school trust land management in Minnesota, including the following:

- **Timber investment management organizations:** TIMOs are configured as two-sided businesses—a management unit responsible for day-to-day management of TIMO assets, and an investor unit that represents the interests of the TIMO investors by establishing and monitoring target performance requirements for the management unit.
- **County land commissions:** County land commissions seek to optimize returns from tax-forfeited lands for the net benefit of their counties, schools, cities, and townships. To maximize revenue, the commissions generally engage experts on an as-needed basis for issues that arise infrequently, instead of hiring these experts. For example, county land commissions in Minnesota don't have wildlife biologists or hydrologists on staff. That said, some Minnesota land commissions plan to hire or contract with mineral development specialists because mineral and gravel revenues provide more significant returns than timber. As a staffing practice to increase efficiency, many have also assigned foresters and land personnel to a specific geographic area, rather than assigning them by function or specialization. County land commissions reported that they measure the effectiveness of their organizations using information from the National Council of Real Estate Investment Fiduciaries.

Two notable findings

Based on its research for this report, MAD calls out the following two findings as points important for understanding DNR's management of school trust lands, the resulting costs, and potential areas for improvement. Both are useful background for exploration and discussion of possible changes.

²⁰ Michael Kilgore, Ross Brown, Charlie Blinn, Jay Coggins and Catherine Pfender. "A National Review of State Timber Sale Programs and an Analysis of Factors Influencing Minnesota State Stumpage Prices," May 2010, p. 27. (Available at https://mn.gov/frc/docs/MFRC_TimberSale_Stumpageprices_Report_2010-05-01.pdf.)

Current Forestry division practices cut costs and boost returns for school trust lands

The Forestry division takes a conservative approach when identifying school trust forest management costs and allocating them to school trust lands. As a result, the DNR keeps STL forestry costs relatively low and its operating margin for forestry operations higher on school trust lands than for other DNR-managed forest lands, as noted in this report's later section on advantages to school trust lands from the Forestry division's approach (see page 39). These lower costs and higher returns benefit the school trust and Minnesota's public schools.

Specifically, MAD calculations using Forestry division data MAD found that STL revenues cover a smaller share of Forestry's state land forest management (SLFM) costs under current cost calculations than the trust would cover if Forestry used reasonable alternatives. In addition, MAD found that the STL operating margin was 17.3 percent in fiscal year 2017, compared to an operating margin of negative (-) 31.5 percent for DNR forest land other than school trust acreage. In fiscal year 2016, the STL operating margin was 30.2 percent, compared to an operating margin of negative (-) 2.3 percent for the remainder of the forest land managed by DNR.

MAD also determined that the STL advantage for fiscal 2016 stemmed from lower costs for school trust lands, not higher revenues: gross revenue per timber management acre, at \$7.83, was lower for school trust lands than all other DNR-managed timber lands (\$8.23) that year. This pattern of lower costs driving higher STL returns likely holds for other fiscal years, but MAD was unable to calculate this comparison of gross revenue per timber management acre for fiscal years other than 2016 and of operating margins for fiscal years other than 2016 and 2017 using existing Forestry data.

It would be ill-advised to track forestry and minerals management costs by land type

To determine what share of costs the DNR should allocate to the school trust for important forest and mineral resource management work, the agency uses percentages based on proxy measures, such as acreage and revenues, rather than tracking specific DNR work on specific STL parcels of land. MAD concludes that time tracking in most cases would be complicated, administratively burdensome, and potentially inaccurate.

As noted in a later section of this report on forestry costs (see page 32), STL's share of costs for most qualifying Forestry division expenditures is based on STL's share of the total state-administered forest acres that the DNR manages. In the case of minerals resource management, funding to cover costs incurred by the DNR's Lands and Minerals division flows into a Minerals Management Account (MMA) based on shares of minerals-related revenue derived from the different types of land, including school trust lands, as noted in the later section of this report on minerals management costs (see page 42).

DNR staff in the Forestry division and LAM's minerals program do not track staff time by land type to calculate costs for the trust. Previously, Forestry did track time by land type but abandoned this practice as impractical. DNR officials argue that adding land type to time tracking requirements significantly complicates the task for Forestry staff, leading to guess-work, inaccuracies, and increased administrative costs for time-keeping. Both the

Idaho and Washington State DNRs have staff track time by land type, but officials from both states noted that time tracking is difficult for forestry staff and is not used for all types of forestry work.

Minnesota DNR officials cited another issue that would complicate time tracking by Forestry staff: the different types of state-administered land—DNR land, school trust lands, University Trust holdings, tax-forfeited land managed for the counties, Con-Con lands, and others—are mixed together in some locations. This makes it difficult for Forestry staff to determine what shares of time spent managing an area would match with which types of land, although it is unclear how widespread this problem might be. Forestry data on timber permits from fiscal years 2015 and 2016 indicate a mix of lands for only about 10 percent of the permits from those years. This is based on data showing that about half of the permits involved areas with at least some STL timber but only one in five of those permits included timber from lands aside from school trust lands. The mix might be different, however, for other years.

For the state’s minerals program, tracking staff time by land type also would be impractical and potentially inaccurate, according to officials from the Lands and Minerals division. As with Forestry staff, minerals staff would have a hard time determining precisely which land type they are working on. In addition, work carried out in one location may be work that in fact benefits land in another location, such as when staff exploring mineral potential find promising signs in one spot that ultimately lead to minerals located in another spot.

In contrast to the Forestry division and the minerals program, the lands program is able to trace its costs for real estate work directly to the different types of land, including school trust lands. This happens by default because costs are coded to real estate and land-related projects, and those projects relate to specific land parcels with specific ownership or beneficiaries. So the staff time and other costs that can be identified for any given real estate project necessarily relate to the land type and can be assigned accordingly. That said, STL revenues appropriated to cover some lands program costs also pay half-shares for two DNR staff members whose work isn’t tied to real estate projects or tracked by land type.

Cost and revenue challenges for school trust lands

The DNR’s costs for school trust land management attract and warrant attention because of the Minnesota Legislature’s explicit goal that the lands “secure the maximum long-term economic return” consistent with sound conservation and management principles.²¹ Economic returns hinge on costs but also revenues, with both affecting the flow of net income from school trust lands into the state’s Permanent School Fund. MAD identified several key challenges related to economic returns from school trust lands and to the school trust’s interest in cost containment.

²¹ Minnesota Statutes 2017, section 127A.31.

Limited control and predictability for revenues and costs

Almost all the net revenues from school trust lands depend upon gross revenues driven by market conditions for minerals and timber and also the DNR's costs in managing those lands and their assets. The DNR and other school trust stakeholders have very little influence over the factors that determine the prices paid for STL mineral and timber output. Those prices fluctuate significantly based on factors ranging from regional weather patterns to the worldwide economic outlook. STL production and sales may sometimes fluctuate, too, in response to market conditions. This means STL revenues can vary significantly. For example, mineral receipts from school trust lands swung from \$10.49 million in fiscal year 2010 to \$53.58 million in fiscal year 2014 and then down again to \$12.34 million in fiscal year 2017.

These strong and volatile market factors may reduce STL revenues but without reducing the DNR's land management costs. The DNR may have limited control over production costs, particularly when managing school trust lands for long-term returns despite unfavorable short-term market circumstances. As a result, the DNR's expenditures for salaries and other costs may not decline significantly even when prices and revenues do, thus squeezing net revenues for the trust.

Poor returns from timber and school trust timber lands

In Minnesota in general and on school trust lands in particular, timber operations earn only limited economic returns, if any, according to DNR officials and other forestry experts. Located on the edge of the nation's prairie lands, forests in Minnesota compared to many other states have low timber productivity and yield low-value timber primarily used as pulpwood for paper production, rather than high-value hardwoods. A 2014 report on the competitiveness of Minnesota's forest products industry found that the state lagged behind seven other states with significant forest lands on almost every measure for the productivity of forests and the quality of wood fiber.²² "We're sitting in a state that has really low value timber," a DNR official said.

It is difficult to generate adequate cash flow and positive earnings from timber operations in Minnesota, said Michael Kilgore, professor and department head at the University of Minnesota's Department of Forest Resources. "You can't do it..., not if you're managing just for timber." DNR officials agreed, noting that the Potlatch forest products company has been selling its land holdings in the state. The costs are high for any entity raising and selling timber. When it comes to timber operations in Minnesota, "there's no money to be made, or very little," a DNR Forestry division official said. "If we had to live off of our timber sales, we wouldn't make it... We don't make any money [from timber], and then we are supposed to make money for the trust." Another forestry official said, "Forestry is the stewardship activity [for the school trust] that takes place while you are waiting for a mine or real estate transaction."

²² Minnesota Forest Resources Council. "Report on the Competitiveness of Minnesota's Primary Forest Products Industry," December 2014, Table 6. Wood Fiber Availability and Cost, p. 18. (Available at http://mn.gov/frc/documents/council/Forest_Industry_Competitiveness_Report.pdf.)

The challenge is even greater when it comes to school trust lands specifically because the federal land grants to the state of Minnesota consisted primarily of acres unwanted by lumber and other interests, and most of the more valuable and productive trust land holdings from those acres were sold by the early 1900s.

Policy choices and forestry costs for school trust lands

Minnesota’s policymakers agree to fund state forest management based on expected costs for forestry operations but also their assessment of needed investments in the state’s forest lands. Policy choices led the Legislature and the governor to increase forestry appropriations from the Forest Management Investment Account and the General Fund by 60 percent from fiscal year 2013 (\$22.5 million) to fiscal year 2018 (\$36.1 million). Some of the state spending on forests is for expenditures aimed at increasing the health and diversity of the forests, a DNR official said. “People want to improve the forests.”

FMIA dollars pay for the state land forest management activities that the DNR allocates in part to the school trust lands, using STL forestry revenues to cover the trust’s share of the costs. Consequently, policy-related decisions about forestry spending and forest investment increase the DNR’s costs for management of the school trust’s forest lands and consequently reduce STL net revenues from timber. So if legislators and the governor agree to increase spending on and investments in Minnesota’s forests, forestry management costs for the school trust lands go up and net revenues for STL forestry go down. Appropriations for the Forestry division from the FMIA and the General Fund almost always exceed potential state land forest revenue, a DNR official said. Current levels of forest management spending, combined with expected flat revenues from timber, will push returns from school trust forest lands to zero or near zero unless the DNR’s costs for management of the school trust’s forest lands are reduced, the official said.

Different goals for different types of land

For school trust lands, the DNR is statutorily required to maximize long-term economic returns using sound natural resource conservation principles,²³ which differs from the agency’s priorities for many other types of the state land that it manages, often for multiple purposes and public benefit. Those other management priorities may involve costs not required for STL acreage. In fact, the DNR strives to manage school trust lands differently than its other holdings in keeping with the STL emphasis on long-term economic returns—an issue beyond the scope of this study. The DNR regularly manages different types of land for different purposes, including recreational lands, timber lands, and wildlife management areas. Consequently, the agency is able to manage school trust lands for revenue generation, DNR officials argue.

But the DNR has lacked clear and differentiated guidelines for the management of school trust lands, leading to case-by-case decisions about what constitutes sound conservation and management principles on STL acreage compared to other DNR holdings, according to DNR and OSTL officials. A lack of clear land management guidelines for school trust lands has led to unease and in some cases even skepticism from STL stakeholders about DNR costs to the trust. This split in purposes for school trust lands compared to other DNR forest acres

²³ Minnesota Statutes 2017, section 127A.31.

may be more complicated because in some cases the same DNR forestry staff are managing both school trust and other DNR lands intermixed across parcels and areas.

Fortunately, the DNR's cross-divisional working group on strategic land asset management and school trust lands is making progress toward clear and consistent guidelines for management of school trust acreage. Based on that progress, the DNR recently issued an interim policy on Phase 1 forest management guidelines for school trust lands based on benchmarks from the Minnesota Forest Resources Council. The DNR also laid out its plans for more site-level guidelines and further definition of the "sound natural resource and management principles" that the agency uses for school trust land management.

Reforestation costs for school trust lands

The DNR's forest management costs for school trust lands significantly increased recently because the allowable expenditures now include much greater certified costs for reforestation to replace harvested trees. In fiscal year 2017, the Forestry division certified site preparation and reforestation costs that amounted to \$817,800 for school trust lands, up by \$463,000 from fiscal year 2016. This means reforestation costs more than doubled for the school trust, increasing by 130.5 percent from fiscal year 2016 to 2017. Importantly starting in fiscal 2017 and at least through fiscal year 2019, STL's forestry revenues cover the trust's full share of these costs, reducing the net income flowing to the Permanent School Fund.

By law, DNR Forestry must plant in areas where timber was harvested, including on school trust lands. Without reforestation, of course, DNR-managed forest lands wouldn't earn timber revenues in the future for the school trust, the state of Minnesota, or other beneficiaries of land that the agency manages. In the past, the Legislature has approved the sale of state bonds to cover most reforestation costs for DNR-managed lands. Even with bonding, the DNR still covered some reforestation costs using appropriations from the Forest Management Investment Account and the General Fund because only small shares of bonding funds may be used for salaries.

But when 2016-17 bonding funds for reforestation fell short of what was needed in fiscal year 2017, the Legislature issued a separate appropriation from the FMIA to cover those costs. The Legislature again chose to use FMIA funds rather than bonding dollars for reforestation in fiscal years 2018 and 2019, in part to ensure adequate dollars for reforestation. The amount provided for reforestation also increased by \$1.00 million per year for each of those years. Use of FMIA funds for reforestation means all reforestation expenditures are certifiable costs and can be passed along to the trust, increasing STL's forestry costs at least until fiscal year 2020 and perhaps longer if FMIA funds continue to be used. This is significantly reducing net school trust income from timber operations.

Overview: DNR costs for School Trust Land management

Based on state statute and interpretations of state constitutional language regarding school trust lands, the Minnesota Department of Natural Resources uses STL revenues from forestry operations and minerals management to cover costs for activities that produce those STL revenues or support that revenue generation.²⁴ The DNR's divisions of Forestry and Lands and Minerals determine overall costs for the types of work that benefit the school trust and allocate shares of those costs to funds derived from school trust land revenues. These methods of cost accounting and cost recovery are complicated, in part because of statutory requirements. These methods also leave the DNR without compensation for significant work it carries out in managing school trust lands—work beyond the DNR activities that fit with forestry and minerals management. (For information about DNR's uncompensated, STL-related costs, see section on page 54.)

Several DNR officials said the current approaches that the agency uses to track qualifying STL-related expenditures and cover them with STL revenues are good ones, despite their complexity and limitations. The existing setup secures significant STL revenues to fund the DNR's management of school trust lands. "The only way to make it work better is to make it more complicated," said one DNR official. "The real challenge is that we don't get to make the rules. They are made by the Legislature."

A number of DNR officials said, too, that the agency takes a conservative approach when estimating what costs to charge against STL revenues. This is done to ensure that the DNR stays within the bounds of the qualifying expenditures set by legislators. It also helps balance out added costs that stem from land management by a public agency constrained by laws and public pressures, compared to the costs of a private company, said another DNR official. "We're committed as an agency and an administration to make sure our costs are dependable, transparent, and market rate."

Forestry costs

The DNR manages school trust forests, as well as forests on university trust lands, tax-forfeited land from the counties, state land held in trust for conservation purposes (Con-Con lands), and other state land. The DNR's Forestry division estimates its expenditures for managing 2.37 million forested acres of school and university trust land and covers these qualifying expenditures using forestry-related revenue generated from those trust lands, as allowed under the state's constitution and state statute.²⁵ In this way, Forestry taps gross revenues to the trusts from timber and forestry-related land uses to cover trust land forest management expenditures. The Forestry division identifies the qualifying expenditures and allowable costs to allocate to the trusts and submits

²⁴ For statutes and constitutional language related to school trust lands, see Minnesota Statutes 2017, sections 16A.125 and 93.2236, and the Constitution of the State of Minnesota, article XI, sections 8 and 11.

²⁵ Minnesota Constitution, article XI, section 11; and Minnesota Statutes 2017, section 16A.125, subdivision 5.

them to Minnesota Management and Budget for certification each fiscal year. Since fiscal year 2014, Forestry has been deliberately improving upon documentation and certification of those qualifying costs, which are restricted to forest management expenditures by the Forestry division that generate revenue for the trust or support revenue generation.²⁶

In fiscal year 2017, school trust lands earned \$11.20 million in gross revenues related to forestry's qualifying expenditures for state land forest management, against \$9.26 million in Forestry division costs certified for the school trust, resulting in \$1.94 million in STL net income from qualifying forestry revenues. Comparing net revenues to gross revenues, the margin for qualifying forestry operations on school trust lands stood at 17.3 percent in fiscal year 2017. In fiscal year 2016, the levels were \$11.79 million in qualifying forestry revenues and \$8.24 million in certified forestry costs, resulting in \$3.56 million in net income and an operating margin of 30.2 percent.

Trust revenues cover the Forestry division's qualifying costs

Revenues from timber sales and other forestry-related activities flow into the state's Forest Suspense Account (FSA) and are transferred to both the Forest Management Investment Account and the state's General Fund to pay for the Forestry division's qualifying costs to the trust.²⁷ Based on the shares of forestry-related revenues flowing into the FSA from school trust lands and university trust lands, forestry officials estimate that just more than 99 percent of the qualifying costs are covered using STL revenues, with the remainder covered by revenue from the university's lands.²⁸ For both trusts, only revenues from Forestry division activities are used to cover allowable and certified forest management costs, while mineral royalties, forest campground receipts, lake shore leases, and other non-forestry revenues are excluded.²⁹

²⁶ DNR's annual "M.S. 16A.125 Transfer Certification Report" states: "Qualifying expenditures are limited to SLFM activities that directly generate forestry related revenue and the activities that support forestry related revenue." Excluded from qualifying expenditures are Forestry division expenditures on work aside from state forest land management, including activities related to private forest management, urban and community forests, education and outreach, and others. These non-SLFM activities account for between 25 percent and 30 percent of the division's expenditures.

²⁷ In actuality, the Forest Suspense Account is an appropriation in the state's SWIFT accounting system, rather than an account. (SWIFT stands for StateWide Integrated Financial Tools.) Because appropriations cannot be made from an appropriation, the DNR transfers funds out of the FSA to then spend them for allowable trust land costs.

²⁸ Based on shares of revenue, the DNR's Forestry division estimates that STL's portion of the certified costs that Forestry covers using trust land revenues amounts to 99.23 percent of the total costs allocated to both the school and university trusts, with the remaining 0.77 percent coming from University Trust land revenues. This estimate of 99.23 percent is used throughout this report to estimate the share and amounts of certified costs covered using STL revenues.

²⁹ Division of Forestry. "M.S. 16A.125 Transfer Certification Report," Department of Natural Resources, March 5, 2018, p. 2. (Available at <https://files.dnr.state.mn.us/aboutdnr/reports/legislative/2017-transfer-certification-report.pdf>.)

Qualifying forestry costs

Not all types of Forestry division costs qualify as costs to be passed along to the school and university trusts. For forestry costs allocated to the trusts, the focus is limited to state land forest management work linked to current or future revenue generation from forest lands, although they also include indirect costs for administration and shared general operations tied to this work.³⁰ (For information about DNR’s uncompensated, STL-related forestry costs, see section on page 55.)

As noted in the Forestry division’s annual *M.S. 16A.125 Transfer Certification Report*, “Qualifying expenditures are limited to SLFM activities that generate state forestry revenue and activities required to facilitate state forestry revenue. Work activities such as private land forest management assistance, urban forestry, education and outreach, and the [U.S. Forest Service] Good Neighbor Agreements are excluded from the cost certification process.”³¹ Only costs paid from the FMIA and the state’s General Fund qualify for cost certification, so costs charged to dedicated funds, federal funds, and capital budgets are excluded.³² As required under state law, the DNR also excludes fire protection costs from the trust land cost certification process. Costs from all other DNR divisions are excluded, as well.

In accordance with state statute, the Forestry division certifies its costs and taps into school and university trust land revenues for the following types of qualifying expenditures:

- **Forest management** includes timber sales activities and the forest resource management activities related to future revenue generation from the trusts’ forest lands, notably planning, harvest scheduling, forest inventory, and policy development.
- **Forest improvement** includes Forestry division efforts to “establish and improve forests for future revenue,” for example, site preparation and reforestation, regeneration surveys, and timber stand improvement.
- **Forest roads** include cost for construction and improvements that provide access to timber for harvest and increase the forest value of the lands, with the Forestry division allocating less than 10 percent of its costs for forest roads to trust lands because “[s]tate forest roads provide direct access to a relatively small portion of trust lands.”
- **Administration** includes both the DNR administrative services that the agency provides for its Forestry division and also the Forestry division’s own administrative activities. The certification process allows the DNR and the Forestry division to use FSA funds from trust land revenues to cover costs for

³⁰ In this report, the phrase “indirect costs” is used in the general accounting sense to identify costs related to multiple activities or purposes and therefore not directly traceable to a specific project, work task, or other cost object. As a result, what this report labels indirect costs may differ from how costs are defined under the DNR’s accounting protocols.

³¹ Division of Forestry. “M.S. 16A.125 Transfer Certification Report,” Department of Natural Resources, March 5, 2018, p. 5. (Available at <https://files.dnr.state.mn.us/aboutdnr/reports/legislative/2017-transfer-certification-report.pdf>.)

³² Division of Forestry. “M.S. 16A.125 Transfer Certification Report,” Department of Natural Resources, March 5, 2018, p. 2. (Available at <https://files.dnr.state.mn.us/aboutdnr/reports/legislative/2017-transfer-certification-report.pdf>.)

leadership services, general office and clerical, human resources, accounting, and other support activities for staff who generate revenue.³³

Tracking forestry’s qualifying SLFM costs and allocating shares to the trusts

To certify its qualifying costs and allocate them to the school and university trusts, the Forestry division first determines its overall costs for the qualifying SLFM activities and then calculates the share of those costs to be covered using Forest Suspense Account funds. (Again, forestry-related trust fund revenues flow into the FSA.) The DNR is responsible for identifying which forestry activities and tasks fit within the four qualifying categories—forest management, forest improvement, forest roads, and administration—and therefore are allowed as certifiable costs.

Staff time accounts for a major share of forestry’s qualifying costs. Whenever possible, Forestry staff use cost codes in the DNR’s accounting system to track time spent on forestry activities. The Forestry division identifies 25 of these staff-time cost codes as activities that match the four qualifying cost categories, with 13 of those codes linked solely to forest management and timber sales and another one partially matched to forest management. Forestry staff track time by type of activity but not by type of land because, DNR officials argue, Forestry staff may not know if they are working on trust land or not. In addition, DNR officials say, adding land type into the mix would make time tracking considerably more onerous and as a result both undermine accuracy and increase the administrative cost of carrying it out. (See more on time tracking below in section on page 27.)

Forestry also uses its coding system to identify qualifying costs other than staff time, such as fleet costs and professional services arrangements.³⁴ The cost code data for staff time and other expenditures provide Forestry with breakdowns and totals for forestry expenditures on qualifying SLFM activities for all DNR-managed forests, so this identifies expenditures tied to management of both trust lands and other land types. The Forestry division then allocates a share of those totals to the school and university trusts.

The Forestry division uses several methods to determine what share of qualifying SLFM costs to allocate to the trust lands and then cover using trust revenues. For each of the methods, DNR Forestry uses percentages as proxies for actual costs. The methods are as follows:

- **For forest management and improvement costs, Forestry uses acres of trust land subject to cost certification as a percentage of total SLFM acres subject to cost certification.** The Forestry division uses this percentage to calculate trust land amounts for the qualifying expenditure categories of (1) forest management, including timber sales, and (2) forest improvement. With this method, Forestry employs

³³ Division of Forestry. “M.S. 16A.125 Transfer Certification Report,” Department of Natural Resources, March 5, 2018, p. 6. (Available at <https://files.dnr.state.mn.us/aboutdnr/reports/legislative/2017-transfer-certification-report.pdf>.)

³⁴ Forestry incurs fleet costs as a part of its work on forest management, forest improvement, and forest roads. For this reason, forestry distributes the fleet expenditures allocated to trust lands across those three categories of qualifying expenditures. Fleet costs for School Trust Lands amounted to \$461,700 in fiscal year 2017.

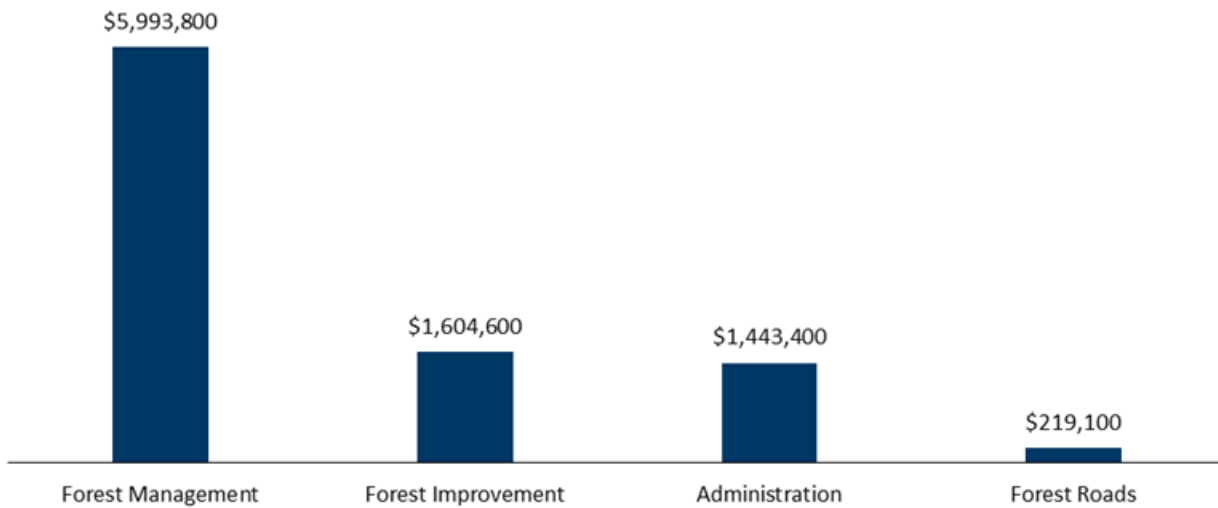
shares of land as a reasonable proxy for determining shares of its state land forest management work and thus its costs. Trust lands account for 45.2 percent of the 5.29 million acres that the state manages as forest land, subject to cost certification. STL acres amount to 44.8 percent of that total, and STL revenues thus cover that same percentage of the certified forest management and improvement costs.

- **For indirect costs, Forestry uses its totals for administration and general operations expenditures reduced first based on the percentage of Forestry’s overall direct costs associated specifically with SLFM work and then reduced again by the percentage of Forestry’s direct costs related specifically to the trust lands.** These administrative and general operations costs are difficult to assign to specific work activities and projects. Consequently, Forestry allocates them to the trust lands based on the share of forestry costs aligned with state land forest management work in order to tie the allocation only to Forestry’s qualifying expenditures. The Forestry division then determines what share of these SLFM-related administration and general operations costs to assign to the trusts based on the trusts’ share of Forestry’s direct costs, thus spreading these indirect costs out over the relevant direct costs. For fiscal year 2017, Forestry estimated that direct SLFM costs accounted for 73.5 percent of the division’s overall direct costs and that the trusts accounted for 40.8 percent of Forestry’s direct costs. As a result, 30 percent of Forestry’s fiscal year 2017 indirect costs were allocated to the trusts ($0.735 \times 0.408 = 0.300$). STL’s share alone was just less than the 30 percent.³⁵ (For more on administrative and general operations costs, see section below on page 46.)
- **For forest road costs, Forestry uses acres of trust land within one-half mile of state forest system roads as a percentage of all SLFM acres subject to cost certification.** Rather than attempt to determine what share of road construction and improvement work directly benefits the trusts in any fiscal year, Forestry uses this proxy share to allocate forest road costs to the trusts. The one-half mile cutoff resulted in Forestry allocating 9.4 percent of its forest road costs to the school and university trusts in fiscal years 2016 and 2017, at a time when the trusts accounted for 45.2 percent of the total acres subject to state land forest management activities. MAD estimates that 9.3 percent of the 9.4 percent in qualifying forest road costs (\$220,800) fell to school trust lands rather university trust lands. DNR officials cited this low allocation as a significant discount to the school and university trusts and an important reason why the trusts account for a lower share of Forestry’s direct, certifiable SLFM costs (40.8 percent in fiscal year 2017) than their share of SLFM acres subject to cost certification (45.2 percent).

An executive budget officer at Minnesota Management and Budget reviews and certifies Forestry’s cost each year before trust revenues are transferred from the Forest Suspense Account to the FMIA and the General Fund in order to cover Forestry’s allowable trust land management costs.

³⁵ The Forestry division’s “M.S. 16A.125 Transfer Certification Report” for fiscal year 2017 notes on p. 6 that the trust’s allocation for administration expenses was “40.8 percent of the \$3,561,784 qualifying administration expenditures,” rather than the 30 percent cited here in this report. This is true because the transfer certification report references only the SLFM share of Forestry’s administration expenses (73.5 percent of forestry’s overall administration costs), 40.8 percent of which Forestry allocated to the trusts based on the trusts’ share of Forestry’s direct costs. The text above in this report references Forestry’s overall administration costs for both SLFM and non-SLFM work as a starting point, resulting in the 30 percent level.

Figure 1: Certified Forestry division costs to school trust lands by qualifying category, fiscal year 2017³⁶



Review of qualifying expenditures and certifiable costs

MAD analyzed forestry’s qualifying expenditures and certifiable costs to the trusts and reviewed all questions and concerns with DNR officials, who provided clarifications and additional information that resolved almost all of the potential issues MAD identified. However, MAD recommends the following to Forestry with regard to cost codes used for qualifying expenditures:

- **Cost code 23999: Miscellaneous Forestry Transactions.** The Forestry division should further differentiate the expenditures now included in this miscellaneous cost code, estimated at \$682,500 for school trust lands in fiscal year 2017.³⁷ Forestry has dramatically reduced the expenditures previously lumped into this cost code—down from \$6.86 million allocated to both the school and university trusts in fiscal year 2014. But even the fiscal year 2017 total remains high for a miscellaneous category. Forestry officials recognize this and expect to further improve transparency for what’s now included in cost code 23999, perhaps by separating out some information technology costs and other types of expenditures.
- **Cost code 23214: Timber Program Administration.** This cost type, which totaled \$701,800 in STL expenses in fiscal year 2017, matches up with the qualifying expenditure category of forest management and relates to direct costs for timber sales. However, use of the word “administration” in the code’s label unfortunately brings to mind the labels “administration and general operations” that DNR gives to indirect costs. Consequently “timber program administration” gives the false impression that the expense is an administrative one. The DNR should relabel this cost code as “Timber Program Support” or

³⁶ Amounts include the general operations costs that the DNR assigns to School Trust Lands but then divides among these four qualifying categories. Data are from the Forestry division’s annual M.S. 16A.125 transfer certification reports.

³⁷ Throughout this report, amounts in the thousands are rounded to the nearest hundred.

some other alternative to clarify that this expenditure is not an administrative one. The code includes compensation costs for the time that regional staff and supervisors spend on timber sales.

Current approach to forestry costs: advantages and misgivings

Officials at Forestry, the Office of School Trust Lands, and the DNR dedicate considerable time and attention to the state's costs for managing school trust land forests, as do policymakers. Questions and misgivings about those costs have led to a well-documented approach for defining allowable Forestry division costs within the qualifying expenditure categories identified in state statute and a thorough process for certifying those costs before they are covered retroactively using trust land revenues from the Forest Suspense Account.

Sources of misgivings

In all likelihood, the high degree of care and scrutiny regarding Forestry's trust land management costs stems in large part from the statutory discretion Forestry has to decide what and how much work it should carry out when managing trust land forests.³⁸ Under the current approach described above, the Forestry division determines the allowable forest management costs and the extent to which it incurs those costs.

Consequently, the current practice of covering Forestry's qualifying costs using STL forestry revenues, as set forth in state law, creates an open-ended cost to the school trust every year.³⁹ The more staff time and other expenses forestry incurs for state land forest management, the more funds it draws from the FSA to cover those costs. While the DNR's diligence and commitment to fiscal responsibility serve as a check on these costs, the open-ended nature of the arrangement draws attention.⁴⁰

Beyond this, OSTL and the DNR have a fiduciary responsibility to maximize long-term economic returns from school trust lands consistent with sound conservation principles. When it comes to forest land, factors ranging from market demand to weather conditions may adversely affect timber revenues without reducing land management costs. This potential disconnect between costs and revenues—particularly notable in the short-term—can intensify interest in cost levels and cost containment.

³⁸ Minnesota Statutes 2017, section 16A.125, subdivision 5c notes the cost certification process.

³⁹ For state land forest management activities in any given fiscal year, DNR's Forestry division spends appropriations from the Forest Management Investment Account and the state's General Fund. Forestry uses these funding sources to carry out forest management for the school and university trusts and then calculates its expenditures on trust land forest management after the fiscal year ends, estimates and certifies those expenditures, and receives a transfer of funds from the Forest Suspense Account that are deposited into the FMIA and the General Fund to cover those outlays retroactively. From a practical standpoint, the FMIA and General Fund appropriations provide a budgetary cap to what forestry can spend on trust land management in any given fiscal year.

⁴⁰ The annual appropriation to the Forest Suspense Account, the Legislature's oversight, and review of Forestry's costs and certification by staff at Minnesota Management and Budget provide additional checks on STL costs.

Advantages to school trust lands from the Forestry division's approach

DNR officials report that Forestry's current approach to tracking and certifying SLFM costs to the trusts accurately estimates those costs, compiles detailed information about those costs, and even favors the trusts when it comes to allocating the share of costs to be covered using trust revenues in the Forest Suspense Account. MAD's review and analysis confirmed that Forestry has taken a conservative approach to assigning qualifying costs and uses proxy measures that benefit the trusts when it calculates their share of Forestry's SLFM expenditures.

Forestry actions in the last few years have significantly improved the breakout of SLFM costs, as well as the alignment of allowable costs to the trusts with the Legislature's qualifying expenditure categories, DNR officials said. Forestry staff have made a concerted effort since fiscal year 2014 to improve the transparency of and the rationale for the cost structure. Since the fiscal year 2015 version, Forestry's annual *M.S. 16A.125 Transfer Certification Report* has offered improved data about land management costs to the trusts and provided comparable financial performance data for generally assessing the DNR's management of school trust forest land against forest management by other entities. Although some DNR officials expressed concerns about the time and effort now required to carry out the cost certification process and produce the annual report, others cited benefits. They said the cost certification makes clear what Forestry is charging against trust revenues and puts the focus on costs in a way that opens up discussions for how to reduce them. They also tout the transparency of and detailed information from forestry's current cost certification process.

A number of DNR officials emphasized that Forestry's approach to cost calculations and allocations actually favors school trust lands over other DNR-managed forest acres. The Forestry division errs on the side of caution when assigning costs to trust revenues. Given the attention and unease surrounding Forestry's costs for management of school trust forest lands, DNR officials said Forestry uses conservative estimates to avoid overcharging the school trust. "The safest number is the lowest number," said one DNR official. "If we billed everything we spent, the school trust lands would not get a dime..., and zero is not the right number." Another DNR official said, "I think the goal at our end ultimately is to provide a return comparable to the alternatives that are available [for land management].... Any decision point that we come to is going to be on the conservative side."

One example of this conservative approach is Forestry's allocation of qualifying expenditures for forest management and forest improvement. For this allocation, the division uses trust acres subject to cost certification as a percentage of total acres of state forest land subject to cost certification. This results in STL revenues covering 44.8 percent of Forestry's SLFM costs, with another 0.4 percent covered by revenues from University Trust lands. It makes sense for the Forestry division to take into account all the school trust forest acres it manages when determining the trusts share of costs, rather than using a narrower measure of trust holdings, such as only acres harvested, according to Kilgore from the University of Minnesota's Department of Forest Resources. This is because DNR must manage all the acres for timber harvests that occur both now but also in the future.

From a cost allocation standpoint, the split based on acres managed is more advantageous than other measures, DNR officials said. Using data from Forestry, MAD confirmed that cost allocations based on the school trust's share of DNR-managed forest acres result in lower costs to the trust than would be the case using the following

alternative measures: acres of commercial forest cover type, acres of timber sold, scaled volume of timber sold, cords scaled, and scaled value of timber sold (see Table 1). In most cases, these alternative measures are also less appropriate for determining school trust lands’ share of Forestry’s work and costs, according to DNR officials.

Table 1: STL’s share of state forest acres subject to cost certification compared to other alternative percentages for allocating DNR’s forest management and improvement costs to school trust lands

	STL percentage
Acres subject to cost certification (FY17; actual measure used)	44.8%
Scaled value timber sold (annual avg FY13-17)	46.8%
Scaled volume of timber sold (annual avg FY13-17)	47.7%
Cords scaled (annual avg FY13-17)	48.3%
Acres of timber sold (annual avg FY13-17)	49.6%
Acres of commercial forest cover type (FY17)	52.0%

As another example of favorable treatment for the trusts, Forestry officials cited the small share of forest road construction and improvement costs allocated to the trusts. As noted above, Forestry uses a proxy share to allocate forest road costs to the trusts. The proxy measure is based on acres of trust forest land within one-half mile of state forest system roads, calculated as a percentage of all acres subject to SLFM activities and cost certification. As a result, trust revenues covered just 9.4 percent of the forest road costs in fiscal years 2016 and 2017, a percentage almost five times smaller than the trusts’ share of the DNR’s state land forest management acres (45.2 percent). The small share of road costs allocated to the school trust makes sense, DNR officials say, because STL acres include significant swamp areas where road construction is impossible.

It is still possible—but unlikely over the long term, perhaps—that the share of forest road costs allocated to school and university trust lands might be lower in any given fiscal year if Forestry were to allocate STL costs based on which specific road improvement projects benefit the trust lands compared to other DNR land. It would be difficult and subjective, however, for forestry to attempt to assign shares of road costs to the trusts based on how much the trusts benefit from those road projects.

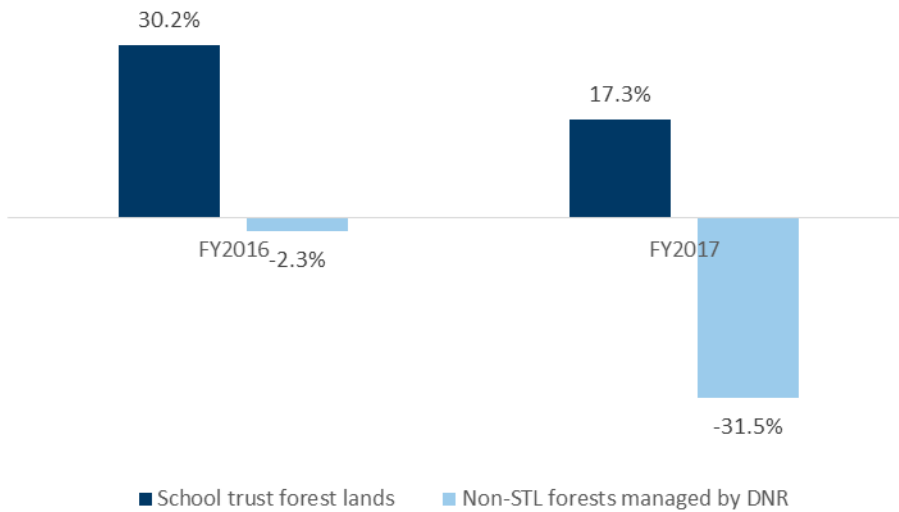
The low share of road costs allocated to the trusts also affects the trust’s share of direct, certifiable SLFM costs, which at 40.8 percent in fiscal year 2017 was much lower than their share of DNR-managed forest land acres subject to cost certification (45.2 percent). Furthermore, this limited share of direct costs lowers the share of Forestry’s administration and general operations costs allocated to the trusts.

To test the DNR’s assertion that school trust lands benefit from its cost allocation methods, MAD calculated the DNR’s operating margins for forestry operations in fiscal years 2017 and 2016 on acreage other than school trust lands and compared it to operating margins for forestry operations on school trust lands, using net income from operations as a percentage of total revenues. The results show much higher operating margins for school trust lands, despite lower revenues per acre, affirming the claims of DNR officials.

MAD found that the operating margin for school trust lands was 17.3 percent in fiscal year 2017, compared to an operating margin of negative (-) 31.5 percent for DNR forest land other than school trust lands. The

comparable operating margin for all DNR forest land including school trust lands was negative (-) 6.1 percent for that year. In fiscal year 2016, STL’s operating margin was 30.2 percent, compared to an operating margin of negative (-) 2.3 percent for DNR forest land other than school trust lands. The operating margin for DNR forest land including school trust lands was 14.3 percent for fiscal year 2016. (See Figure 2.)

Figure 2: Difference in operating margins (“profit”) for forestry activities between school trust lands and other DNR-managed forest land⁴¹



While differences in operating margins may stem from either lower costs or higher revenues, MAD calculations of Forestry division data for fiscal year 2016 found that forestry revenues were lower, not higher, for school trust lands compared to other DNR-managed forest land. Specifically, gross revenue per timber management acre was \$7.83 on school trust lands, compared to \$8.23 on all other DNR-managed timber acres in fiscal year 2016. Officials with both the DNR and the Office of School Trust Lands said timber on school trust lands is not of higher value than other timber on other DNR-managed acres, as this data indicates.

The comments and data in this section of the report support claims by DNR officials that Forestry’s current approach to cost allocation and certification works well for school trust lands and likely favors the school and university trusts over other land types when it comes to net income earned from forestry operations. That said, DNR and STL stakeholders may still wish to consider alternative approaches or changes to how school trust lands are managed compared to the DNR’s other state lands if such changes would yield comparable benefits to the trust.

⁴¹ MAD calculation based on published data for School Trust Lands and unpublished data for other DNR-managed forest lands. Fiscal year 2017 DNR operating margin was adversely affected by low harvest volumes.

Minerals management costs

The DNR's Lands and Minerals division is responsible for minerals work on state-managed mineral lands, including school and university trust lands, tax-forfeited land from the counties, state land held in trust for conservation purposes (the Con-Con lands), and other types. The minerals program of the DNR's Lands and Minerals division identifies its minerals management costs each fiscal year and covers those costs, as it incurs them, using dollars appropriated from the state's Minerals Management Account. (For information about the DNR's very limited uncompensated, STL-related minerals management costs, see section below on page 55.)

Funding minerals management from the Minerals Management Account

Established by the Legislature in 2005, the Minerals Management Account (MMA) is funded by minerals receipts earned for all types of state mineral lands. To fund the MMA, 20 percent of the mineral receipts from school trust lands and all other land types is deposited into that account, with amounts distributed back to the income funds for these different land types when the MMA balance exceeds \$3.0 million.⁴² The Legislature biennially appropriates MMA dollars, at about \$3 million per year, to fund DNR minerals management work and projects. Under this arrangement, LAM has a consistent and available source of funds to draw upon for both immediate and long-term minerals management work. "The important thing is to have a dedicated fund for minerals management," a DNR official said, one that protects LAM's minerals management work and staffing from funding swings that occurred in the past when funding came from the state's General Fund.

The minerals management costs that LAM covers using MMA appropriations fall to the school trust lands and other land types based on their proportions of mineral receipts flowing into the MMA. STL mineral receipts for the four fiscal years from 2014 to 2017 accounted for 73.8 percent of the total receipts on average, indicating the approximate share of LAM's minerals management costs covered using STL minerals revenues in recent years.⁴³ For fiscal year 2017, STL accounted for 72.8 percent of the \$17.00 million in total gross mineral receipts from state land, based on data provided by LAM. LAM expected to incur \$3.09 million in minerals management expenses in fiscal year 2018, the same level of spending as the MMA appropriations by the Legislature for fiscal year 2018. Mineral receipts from school trust lands have fluctuated significantly over the last 10 years,

⁴² Based on statute, the state of Minnesota distributes MMA amounts of more than \$3 million on a quarterly basis. The distributions are based on shares of mineral receipts in the previous biennium generated from the different types of land. Therefore, distributions in fiscal year 2018 from the MMA for School Trust Lands go into the Permanent School Fund based on the share of mineral receipts earned on School Trust Lands in the 2016-17 biennium. For more on the MMA, see the separate June 2018 report on "School Trust Lands Funds and Accounts," available from the OSTL.

⁴³ The other major sources of minerals receipts for the four-year period from fiscal years 2014 through 2017 on average were University Trust lands (14.4 percent of the \$155 million total) and tax forfeited county lands (11.4 percent).

registering at a high for the period of \$53.56 million in fiscal year 2014 and at a low of \$10.49 million in fiscal year 2010.⁴⁴

Estimating minerals management costs

LAM estimates its total minerals management expenditures for all DNR-administered minerals land together, rather than attempting to estimate discreet costs for minerals work carried on the different types of state land. Because relevant costs are covered using appropriations from the Minerals Management Account, those costs in effect are allocated to the school trust lands and other land types in proportion to the mineral revenues earned from each type of land, as noted above. DNR officials report that strict tracking of minerals management costs by land type is impractical because of time lags and uncertainties for mineral revenues, and it may even be inappropriate because LAM cannot always determine which type of land benefits from its immediate minerals management work. (See more on tracking costs in section above on page 27.)

LAM's process for estimating minerals management costs is less complicated than Forestry's cost certification process in part because the minerals management expenditures are less complicated. LAM categorizes the types of minerals management work it carries out to the benefit of the state minerals lands and estimates what share of those costs should be covered using mineral receipts deposited to the MMA.

Salaries for the minerals program account for the majority of LAM's minerals management costs—\$1.88 million of the estimated \$3.09 million in expected minerals management expenses to be covered by MMA appropriations for fiscal year 2018. For minerals program salaries, LAM uses annual work plans and estimates of required staff time to determine what share of work hours and employee compensation relates to minerals management and is therefore of benefit to the school trust and other state minerals lands. Staff who explore the minerals potential of state lands are included in this tally. Depending upon the type of minerals work they carry out, some LAM staff may have part of their compensation covered by MMA dollars and part by other LAM sources or general fund dollars.

Separately, LAM estimates shares of other costs related to projects involving mineral potential, mineral title research, and mineral engineering. Here again, LAM also uses annual work plans to estimate the share these expenditures it covers using MMA appropriations, with the finalized amount expected to be \$142,200 for fiscal year 2018.

In addition, LAM has identified several other minerals management costs to cover using mineral receipts deposited to the MMA. The MMA funds are used to cover 27 percent of the costs for the state's new land record system (\$270,000 in fiscal year 2018). That system is used to compile, process, and share information on real estate transactions, including those related to mineral mining. LAM also uses MMA funds to cover environmental research costs— expected to have totaled \$200,000 in fiscal 2018. Environmental research work relates directly to minerals management because it includes research aimed at diversification and at solutions

⁴⁴ LAM's data on gross mineral receipts include the 20 percent in mineral receipts diverted to the MMA. They include all revenue from iron ore and taconite, metallic minerals, peat, industrial minerals, M-Leases, stockpile leases, and interest.

for mining materials not mined now because of concerns about environmental impacts, DNR officials said. Other state funds, including the General Fund, also are used to pay for LAM environmental research and the land record system.

LAM also taps MMA funds to cover a portion of indirect and shared administration and general operations costs, including part of the DNR's agency-level expenditures for central services, leadership services, information technology services, and facilities. These administrative and general operations costs are difficult to assign to specific work activities and projects. Consequently, LAM determines what share of these indirect costs to cover using appropriations from the Minerals Management Account based on LAM staffing for the minerals program as a percentage of total LAM staff, calculated as full-time equivalents.

Based on measures related to usage, LAM also uses MMA appropriations to cover agency costs for computers, fleet services, workstation and software support, cell phones and network connectivity, mail and postage, and worker's compensation (an expected \$83,700 all totaled in fiscal 2018), as well as research and mining-related facilities in Hibbing (an expected \$110,100). In addition, LAM also assigns some travel expenses to MMA appropriations—an estimated \$21,700 in fiscal year 2018.

Land and real estate costs

While mineral receipts and timber sales account for the majority of revenues from school trust lands, the trust also earns revenue from real estate transactions and land-related work, which are handled by the lands program within the DNR's Lands and Minerals division. This land work includes leases, sales through public auctions, easements, and licenses. The lands program also enters into land exchanges designed to reposition school trust holdings, consolidate ownership, improve land management, and increase future revenue potential. Based on data in the available STL biennial reports, net real estate revenues to the trust for the period from fiscal year 2012 to 2015 ranged from a high of \$706,400 in fiscal year 2013 to a low of \$205,200 in 2015.⁴⁵

Forest Suspense Account appropriations for some real estate costs

Staff for LAM's lands program carry out a range of real estate transactions and land-related work of benefit to the school trust, including survey work, appraisals, legal work, and advertising. To cover some of the lands program's costs for STL-related real estate transactions, the Lands and Minerals division is able to use funds from a legislative appropriation of FSA dollars. LAM officials report that this funding from the FSA provides a predictable baseline that the division can use to support ongoing real estate work by staff.

⁴⁵ See recent biennial reports on Minnesota's School Trust from the Minnesota Department of Natural Resources, Table 1. (Reports are available at https://www.dnr.state.mn.us/aboutdnr/school_lands/reports.html.)

In 2011, the Minnesota Legislature approved this draw down of FSA funds for real estate and other work, set initially at \$200,000 for fiscal year 2012. Prior to fiscal year 2012, LAM’s lands program received no funds from school trust revenues to support its STL real estate work. This was the case because trust-related costs for lands program work don’t fit within the cost categories for qualifying state land forest management expenditures and therefore cannot be covered under the Forestry division’s cost certification process, nor do the lands program costs fit with LAM’s minerals management expenditures.

The STL revenues from the FSA funds cover some but not all of the lands program expenditures for real estate transactions and land-related work of benefit to the school trust. The annual FSA amount—\$206,000 for fiscal year 2017 and \$212,000 for fiscal year 2018—also funds half the costs for the DNR’s STL administrator position, housed within the commissioner’s office and not within LAM.⁴⁶ Of the remaining dollars available, LAM uses some to fund half the staffing costs for its industrial minerals specialist, whose work is integral to many of the aggregate leasing efforts of benefit to the school trust. These two specific employee compensation expenditures amount to about \$100,000 of the total FSA funding available each year for use by the lands program. The lands program uses the rest to cover some of its STL-related real estate work, if approved to do so by the DNR’s STL administrator based on the available FSA dollars.

Using the FSA appropriations to cover limited costs

As criteria for spending the funding from the Forest Suspense Account, the lands program looks for real estate work that aligns with the broad legislative language used to appropriate funds, specifically that the funds “are from the state forest suspense account in the permanent school fund to secure maximum long-term economic return from the school trust lands consistent with fiduciary responsibilities and sound natural resources conservation and management principles.”⁴⁷

LAM, with input from the STL administrator, has identified a range of specific real estate transactions and land-related work that can be paid for with FSA funds, including survey work, appraisals, land exchanges, land sales, data reporting from the DNR’s land records system, and strategic land asset management. In their annual budgeting meetings, LAM officials compile spending priorities overall and include planned spending for the benefit of the school trust, with input from the STL administrator. “It’s a project-by-project decision” when it comes to the STL-related real estate work to be funded with available FSA dollars, a LAM official said.

Once the LAM budget is approved and in place as a part of the overall DNR budget, LAM’s business manager sets up project codes for real estate transactions of benefit to STL and approved as projects to be paid for using the available FSA funds. Lands program staff then bill their time using the appropriate project codes. In this way, the available FSA dollars cover some of the real estate work of benefit to school trust lands.

Lands program staff are able to identify what work matches LAM’s STL-related project codes because real estate work is tied to specific transactions for specific types of land, LAM officials said. Consequently, if a real estate transaction is carried out for school trust lands, staff know the work is for STL alone. Even if a broad effort for,

⁴⁶ DNR’s STL administrator reports to the agency’s assistant commissioner for policy and government. This is a separate position from that of director for the Office of School Trust Lands.

⁴⁷ Minnesota Laws of 2017, Chapter 93, Article 1, Section 3.

say, land leasing involves different types of land, the work will involve discreet transactions for each type of land.

The annual FSA funding offers limited support for a range of real estate transactions and land-related work of benefit to the school trust. As a result, the FSA dollars only cover some of the lands program's STL work, so the lands program pays for much of that work using other sources. (For information about DNR's uncompensated, STL-related lands program costs, see section below on page 56.)

The limited STL land work that the DNR covers using the FSA, then, is of clear and notable benefit to the school trust, DNR officials said. For this reason, the lands program and the DNR's STL administrator have been able to use the Legislature's broad language about the FSA funding as criteria for allowable STL projects, rather than developing granular and targeted criteria. This situation contrasts with that of the Forestry division, where all costs for state land forest management work on trust lands are funded using dollars that trace back to trust land forestry revenue and the division uses distinct categories for qualifying expenditures and then cost codes to identify allowable work.

To cover the costs of STL real estate work not paid for using the FSA funds, the lands program taps into payments made to LAM by other DNR divisions for real estate work carried out under intra-agency service level agreements. Those SLAs pay for most of the land transactions and land-related work that the lands program carries out, with the SLAs totally \$2.13 million for fiscal year 2018.

Separately, the lands program handles three lakeshore leases on school trust lands. LAM holds in reserve \$300,000 in revenues from these leases for improvements that the DNR will need to make when these lakeshore properties are eventually sold.

Indirect administration and general operations costs

OSTL and DNR officials recognize revenue generation as the goal for the DNR's management of school trust lands, given the clear legislative intent to "secure long-term economic return from the school trust lands" in alignment with fiduciary responsibilities, conservation principles, and state law.⁴⁸ The strong focus on net returns from school trust lands brings attention to DNR costs, as noted earlier. While there is general agreement about the reasonableness of DNR costs tied directly to STL management and of direct benefit to the trust, there is unease and even skepticism among some STL stakeholders about administration and shared general

⁴⁸ Minnesota Statutes 2017, section 127A.31 states, "The legislature intends that it is the goal of the permanent school fund to secure the maximum long-term economic return from the School Trust Lands consistent with the fiduciary responsibilities imposed by the trust relationship established in the Minnesota Constitution, with sound natural resource conservation and management principles, and with other specific policy provided in state law."

operations expenditures covered using STL revenues. OSTL officials noted that these indirect expenditures impact the financial returns to the trust.

Expenditures for administration and shared general operations in any agency or business are indirect costs—ones difficult to assign to specific production, projects, functions, programs, or operating units. These costs are indirect but also necessary for ongoing operations. Direct costs can be traced to specific output or outcomes, while indirect activities may provide shared benefits across the broad operations of a company or agency, as is often the case with information technology services or supervisory staff, for example. In addition, there are indirect expenses that are difficult or impossible to assign to specific production, such as paid employee leave time.

In the case of the DNR and trust land management, shared administration and general operations expenses are legitimate, as they are for other government units and private businesses. The notable concern is about the level of those shared costs and what they entail, not that indirect costs are incurred and shared. DNR officials and STL stakeholders need to ensure that costs to the trust for administration and general operations are kept in check at a reasonable level suitable to support revenue generation from school trust lands. Unfortunately, at present, it is somewhat difficult to sort out the DNR's level of spending on these indirect activities and functions.

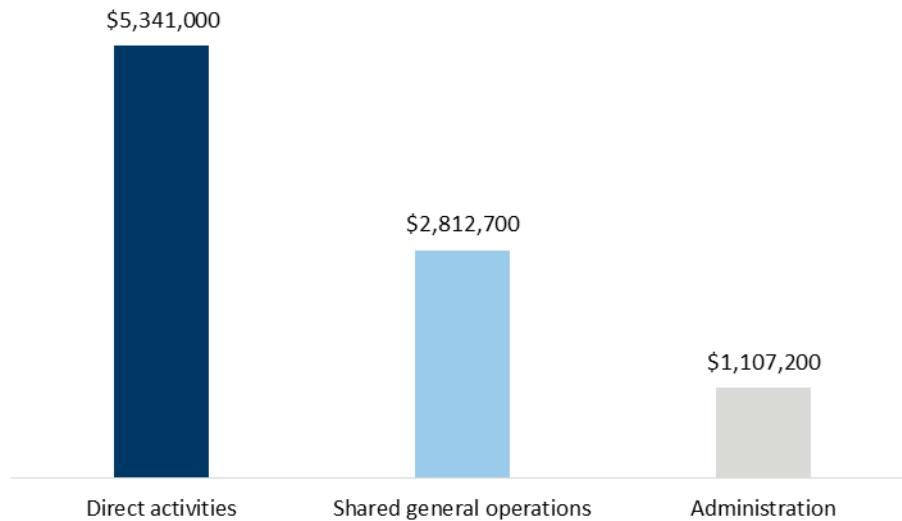
For the Forestry division, state statutory requirements obfuscate what share of STL expenses fall into the categories of administration and general operations. To calculate trust land forestry costs that it can cover using trust land forest revenues, the Forestry division follows state statute and distributes allowable general operations expenditures among the four qualifying expenditure categories—forest management, forest improvement, forest roads, and administration. This is necessary to ensure that the share of general operations expenditures distributed to administration is then included in what the DNR pays back to the General Fund in order to reimburse the state for Forestry's administrative costs. The Forestry division uses revenues from the school and university trust lands, transferred from the Forest Suspense Account, to cover the trusts' share of these administrative costs. While this approach works well for that purpose, it obscures the share of forestry's qualifying administrative and general operations costs allocated to School Trust Lands.

The issue for the school trust and the DNR is if and how costs for administration and general operations can be reduced. MAD worked with Forestry officials to split out STL's shares of costs as follows for direct activities, shared general operations, and administration in fiscal year 2017, based on forestry's certified costs for STL of \$9.26 million (see Figure 3):

- 57.7 percent, or \$5.34 million, for direct activities (includes timber sales, forest improvement, forest management, and forest roads).
- 30.4 percent, or \$2.81 million, for shared general operations (includes information systems hardware and support, facilities, equipment, maintenance, leave time off, training, safety, and assessments such as those for ditches and waste management).
- 12 percent, or \$1.11 million, for administration but excluding the share of general operations allotted to administration (includes Forestry management, Forestry specialists, Forestry area supervisors and

clerical support, Forestry accounting staff, DNR financial and budgets services, DNR human resources, DNR payroll, and DNR leadership).⁴⁹

Figure 3: Forestry division costs for school trust lands management by type (without general operations costs allotted to administration), fiscal year 2017



The percentage and dollar amounts noted here for administration are significantly less than what forestry presents in its *M.S. 16A.125 Transfer Certification Report* for fiscal year 2017 (\$1.27 million, or 15.9 percent of the certified costs).⁵⁰ The difference occurs because the transfer certification report uses administration totals that add a share of forestry’s general operations expenditures to the administration costs as required by state statute. The transfer certification report doesn’t split out overall general operations expenditures separately from the categories of qualifying expenditures, again because of the statutory requirements for how administration and general operation costs should be handled.

MAD also roughly calculated administration costs, general operations costs, and their shares of total costs for minerals management. MAD used Lands and Minerals data for expected fiscal year 2018 minerals management expenses for all types of land (\$3.09 million), rather than costs applicable to the school trust separately. These less detailed data are available for minerals management expenditures and none are available for separate costs to the school trust because of the MMA accounting structure, the difficulties of tracking costs by land types, and the fact that less trust-related reporting is required for minerals management costs than for forestry expenditures. MAD estimates the following for fiscal year 2018, based on expected minerals management costs of \$3.09 million:⁵¹

⁴⁹ MAD calculations using unpublished data from Forestry division.

⁵⁰ Division of Forestry. “M.S. 16A.125 Transfer Certification Report,” Department of Natural Resources, March 5, 2018, p. 1. (Available at <https://files.dnr.state.mn.us/aboutdnr/reports/legislative/2017-transfer-certification-report.pdf>.)

⁵¹ From unpublished data provided by the Lands and Minerals division.

- Somewhere between 69.8 percent and 74.6 percent—that is, between \$2.15 million and \$2.30 million—for direct costs, including staff, project spending, and travel expenses (assumed here to be related to direct minerals management work), with the range reflecting that some but not all work by top managers ties directly to minerals management operations.
- Somewhere between 18.5 percent and 23.3 percent—that is, between \$570,800 and \$718,100—for general operations tied to minerals management, with the range again reflecting that some but not all work by top managers ties directly to minerals management operations.
- 6.9 percent (\$213,700) for administration expenses tied to minerals management.

Because of differences in methods and definitions, the administration and general operations costs for minerals management cannot be directly compared to those same types of costs for forestry work, presented earlier in this section. Both the available data and the estimation methods used differ for indirect costs for minerals management work on all land types compared to indirect costs for school trust lands from forestry activities. Nonetheless, it is likely that administration and general operations costs for minerals management are a smaller share of total costs in part because the minerals program is much smaller than the Forestry division. This matters because the DNR allocates shared costs across the organization based 70 percent on the relative size of program area budgets and 30 percent based on the relative number of employees in each program area using full-time equivalents. As a result, a much larger portion of the DNR’s shared costs fall to the larger Forestry division than to the smaller minerals program.

Trust land management costs in other states

Management Analysis and Development contacted officials in other states to learn more about how they manage trust lands and allocate costs to specific trusts, including school trusts. MAD interviewed officials from Alaska, Idaho, Montana, Oregon, and Washington based on the advice from OSTL and DNR officials, the size of trust land holdings in those states, and the presence of significant timber acreage. Information from those states may be useful as STL and DNR officials consider alternatives to current trust land management approaches in Minnesota. As the same time, some state officials—both inside and outside of Minnesota—warned that when it comes to trust lands, successful adoption or adaptation of one state’s approach in another state may prove difficult because of differences in state law, the mix of timber, minerals, oil and gas, grazing acreage, and other assets found on the land, and the value of those assets.

Alaska: Reimbursable service contracts

Alaska’s Mental Health Trust Land Office (TLO) manages land assets of a trust established to generate revenues used to ensure that Alaska has a comprehensive integrated mental health program. The TLO offers a better comparison for Minnesota’s school trust lands because only a very small portion of land in Alaska had been surveyed at the time of statehood, so the small portion of federal lands granted to Alaska as school trust lands

aren't treated separately from Alaska DNR general state lands. While Alaska's trust land for mental health offers a better comparison, those trust lands do differ from Minnesota's school trust lands in a number of important ways. For example, the land managed by the TLO is completely separate from general state lands held by Alaska's DNR, whereas some Minnesota STL acres are mixed in with acres held by Minnesota's DNR.

The TLO is an office within the Alaska DNR, with a staff of about 20. The state's Alaska Mental Health Trust Authority (AMHTA) contracts with the TLO to manage trust owned lands through a reimbursable services agreement. The TLO also contracts with DNR for certain land management activities from other divisions to accomplish its responsibilities to the AMHTA. Each service contract between the TLO and its parent agency spells out what work is to be done by Alaska DNR staff, at what cost, based on the expected number of hours the TLO work will require and the Alaska DNR's costs for that work. Alaska DNR staff bill time spent on that TLO work to the service contract. Wyn Menefee, TLO executive director, said this arrangement increases the accountability for work done to serve the interests of the trust.

The service contracts allow the TLO to push the Alaska DNR on the work agreed to in the service contracts and to challenge charges from the Alaska DNR if they are for work that wasn't agreed to in advance. This matters, in part, because the interest of the trust in generating revenue may not align with the interests of the Alaska DNR in managing its lands for public benefit or other purposes. The trust benefits from the arrangement, too, because the Alaska DNR has experts and experienced staff that the TLO can draw upon through the service agreements, Menefee said.

If unexpected circumstances mean that the Alaska DNR underestimated its costs for trust land work, the TLO and its parent agency can revisit the service contract and adjust the payment, Menefee said. The trust office has the ability to move funds within its budget from the AMHTA in order to cover unexpected costs or take advantage of new revenue opportunities, and the office can also request additional funding from the AMHTA to handle these situations.

The TLO's reimbursable service contracts with the Alaska DNR generally exclude indirect costs, but as an office within that department, the TLO is still responsible for a portion of those costs for administration and shared services, Menefee said. The TLO pays the commissioner's office to cover a share of expenses for such services as human resources, IT and telecommunications, mail, and travel.

Oregon: Management agreement for timberlands

Oregon's Department of State Lands (DSL) is responsible for the state's trust lands, all of which are school trust lands. About 15 DSL staff are responsible for all of the trust land holdings managed for lease revenues tied to uses such as grazing, agriculture, minerals, and energy, as well as industrial, commercial, and residential real estate. Most of the school trust's 741,000 acres is rangeland leased for grazing.

The Oregon trust lands include over 121,000 acres of forest land that has required active management for timber operations, although most of this land won't be managed for timber going forward. Up until July 2017, the DSL partnered with Oregon's Department of Forestry (ODF) to manage the trust's consolidated timber holdings in Elliot State Forest, as well as scattered forest holdings mostly in the southwestern portion of the state. While the ODF continues to manage the trust's scattered forest sites, the DSL itself has taken over

management of Elliott State Forest with the sole aim of generating revenue for the trust through the sale of those acres, according to Nancy Pustis, the DSL's real property program manager.

The DSL and ODF use a management agreement to set the ODF's costs to manage forest lands for the trust. The management agreement is amended from time to time as necessary to reflect current conditions and actual costs. The costs to the DSL depend in part upon the amount that the ODF needs to pay for its staff who manage the trust's forest land, Pustis said. In addition, the DSL must cover other non-salary ODF costs, including the costs of vehicles, training, sales contracts, and other miscellaneous and other equipment items, which are determined and included in the management agreement based on the trust's share of total forest acres managed by the ODF.

Until the DSL moved away from managing the trust's Elliot State Forest acreage for timber revenues, that forest accounted for most of the timber land managed for the DSL by the ODF. Oregon's departments of State Lands and Forestry continue to use provisions of the management agreement to arrange for the ODF's management of the trust's other forest lands based on estimated costs. It has been difficult to track the ODF's costs for forest management activities, including the overhead costs that accounted for about half of the total costs from the ODF for forest management, Pustis said. She said the DSL is moving out of timber as an interest for the school trust because timber operations have generated low net positive revenues.

Idaho: Project-based time tracking and shares of acreage and revenue⁵²

The Idaho Department of Lands (IDL) recently adopted a hybrid system to identify and allocate costs, one that uses time tracking, shares of acres for timber land costs, and shares of revenues for other land management costs. The IDL starts with staff tracking their time whenever possible, according to an Idaho official. Codes for time tracking indicate asset classes, with most land classified as rangeland (1.43 million acres) or timberland (994,500 acres). The codes also tie to projects and endowment types, including the Idaho Public Schools endowment as well as eight others ranging in purpose from college and university endowments to an endowment for the juvenile corrections system.

Whereas the cost accounting system of the Minnesota DNR's Forestry division emphasizes work activities matched to statutory language about qualifying trust expenditures, Idaho's system focuses on projects, using project codes to tally program totals for the time that staff are able to track. A few years ago, IDL leaders decided they would have staff track time for major projects, the Idaho official said. Since then, the effort has been expanded to projects in general, with staff tracking time on most IDL projects. When IDL staff set up project codes, they decide what endowments will pay the expenses and what asset class matches up with the project.

⁵² This section about Idaho's approach to trust land costs is based on a MAD interviewed with an Idaho official. Unlike sections about other states, the Idaho description was not reviewed by someone from that state before publication of this report.

In many cases, staff are unable to track their time by project codes. This is particularly true for timber activities for a number of reasons, the Idaho official said. IDL forestry staff have a hard time determining the type of land they are working on out in the field, for example, and the work they carry out may relate to future rather than current projects, as is the case when work is done years in advance of a timber sales project, for example. “It’s hard to really know... what you’re working on when you are working on land,” said the official. Consequently, no codes exist for most timber work. Indeed, unpublished state of Idaho data for most of fiscal year 2017 indicate that more than 90 percent of the personnel costs related to work categories for the IDL’s forestry program didn’t match with project codes.

When staff are unable to code time for timber work using project codes, the cost of that staff time is allocated to Idaho’s different land endowments based on each endowment’s share of total timber acres—similar to how Minnesota’s DNR allocates most of its forestry costs for the school trust. Real estate staff time is also difficult to track by project code, the Idaho official said, because current work might relate to projects in future years and expert staff spend significant time on work not tied to one specific project. When real estate and other non-timber staff time isn’t assigned to project codes, the IDL allocates those staff costs among the land types based on each land type’s share of total revenues. The IDL also uses this revenue-based split for management overhead and administrative costs not billed to project codes.

Washington: Time tracking by project

Like Idaho Department of Lands, the Washington State DNR also uses time tracking to allocate the costs of field staff work among a variety of trust lands, including the Common School trust, according to Angus Brodie, the deputy supervisor for State Uplands, and Lisa Anderson, trust outreach specialist. Staff track time and are responsible for determining what share of that time was spent on what types of land, they said. This direct cost of field staff time is divided up based on the time worked on the different types of land. Staff know the areas where they work and can use geographic information systems technology to view slices of that land by trust type. Washington DNR uses the totals for direct staff time that can be tracked in order to allocate staff time that cannot be tracked to the trusts, such as work performed at DNR headquarters or regional offices that supports the associated field management activities. For other work—including forest inventory, planning, and research—Washington DNR uses its data on overall acres managed or treated to allocate costs among the different trusts over a biennium, Brodie and Anderson said.

Administrative and general operations costs—including human resources, information technology, and executive management—are applied using a rate that Washington DNR calculates at the beginning of every month based on the numbers of staff actually employed in each of the programs. This process, used for Washington DNR as a whole, has resulted in an agency-wide administrative cost rate of about 27 percent for the last six years.

Washington’s DNR uses a portion of the trust land revenues to cover its trust land management costs. The state has a number of accounts, including the Resource Management Cost Account (RMCA). About 30 percent of the revenues earned from federally granted trust lands each year flows to the RMCA account for trust land operating expenditures. The maximum percentage of revenues transferred to the RMCA is established by the legislature. The state’s Board of Natural Resources sets the actual percentage used for management costs consistent with the legislatively set limits, which act as a cap on those costs. RMCA management costs have

ranged from 27 percent to 31 percent over the last 10 years, Brodie and Anderson said. As is the case in here in Minnesota for the Mineral Management Account, the Washington Legislature appropriates funds from the RMCA to the DNR for the agency to spend.

In fiscal year 2016, timber sales contributed more than half of the revenues generated on Common School trust lands in Washington State—\$53.32 million of \$94.33 million—with mineral and hydrocarbon leases accounting for less than 10 percent of the revenue. Notably, tree types in Washington’s forests produce much higher value timber than the trees in Minnesota, with the National Association of State Foresters reporting 2016 timber revenues per managed acre of \$40.26 for the Washington DNR, compared to \$4.88 for Minnesota’s DNR.⁵³

Montana: Work planning as basis for costs

The Trust Lands Management (TLM) division of Montana’s Department of Natural Resources and Conservation allocates costs to the state’s common school trust and other trust land holdings based on work planning, projects, and trust acreage. “It’s a planning activity,” said Connie Daruk, budget analyst for TLM division. The division’s leaders meet quarterly to review revenues, costs, projects, and impacts to trust beneficiaries. This process is used to handle administrative costs as well as direct costs, she said.

Prior to fiscal year 2010, Montana allocated costs among the trusts based on a percentage of revenues generated by each trust, Daruk said. However an audit review posed a question about the reasonableness of allocating expenses based on revenues. The TLM division evaluated other possible approaches, and the Montana legislature amended state law in its 2009 session, which made it feasible for the division to base cost allocation on work plans⁵⁴—a process the TLM calls Accounting by Trust. The Legislature also established an earnings reserve account to be used in the event trust revenues are insufficient to fund expenditures and an appropriation ceiling—up to 25 percent of trust revenues may be used to fund expenses.

The TLM division has a staff of 125, based on full-time equivalents, managing land for 14 trust beneficiaries, including the common schools trust for k-12 education. The common schools trust lands account for about 90 percent of the state’s total trust acres. Montana trust lands include 5.2 million surface acres and 6.2 million acres of mineral rights. Land management activities on school trust lands include leasing activities for agriculture and grazing, oil and gas, metal and coal mining, and commercial and residential real estate. Other trust land revenue-generating activities are timber sales, land banking, land sales for cabins and homes, recreational use, and easements.⁵⁵

⁵³ Data exported by Forestry division from a 2016 report by the National Association of State Foresters and shared with MAD.

⁵⁴ In the 2009 legislative session, amendments were made to 77-1-108, Montana Code Annotated, which made the Accounting by Trust (ABT) process based on work plans feasible. Legislation established the Trust Administration Account, which is funded by a portion of the distributable revenues from land management activities and interest earned from the permanent fund.

⁵⁵ “Trust Land Management,” Montana Department of Natural Resources & Conservation, <http://dnrc.mt.gov/divisions/trust>. Accessed April 2018.

Uncompensated DNR and State of Minnesota costs for STL management

The current approach to school trust land management in Minnesota fails to compensate the Department of Natural Resources and state government more broadly for all STL-related costs. State laws and the agency protocols based upon them limit the types of forestry, mineral, and real estate expenses to be paid for with STL revenues. In addition, the DNR and the state incur STL-related costs for activities beyond real estate, forestry, and minerals activities. Both OSTL officials and DNR leaders acknowledge that these unreimbursed costs are significant. This section of the report provides a sense for the types of uncompensated costs incurred by each of the DNR's divisions and the magnitude of those costs. A strict accounting for these costs was beyond the scope of this study.

State government other than the DNR

All the DNR divisions reported uncompensated costs for school trust land work, but two of the largest uncompensated expenditures fall not to the DNR but to the state of Minnesota overall. First, the state covers payments in lieu of taxes (PILT) that state government makes to local governments for acres of school trust land. Second, the state often issues bonds to cover the costs of reforestation on school trust lands and other DNR-managed forests, although, at present, the DNR is using Forest Management Investment Account funding for reforestation costs.

The state of Minnesota's total for PILT on school trust lands was \$3.75 million in 2017 (calendar year) and will rise to \$5 million in 2018 because of the Legislature's decision to increase payments to \$2 an acre from \$1.50. State lawmakers choose to issue payments in lieu of taxes to counties and other local governments because those local governments may not tax state-owned land, including school trust land. This means school trust lands and other state land are off the property tax rolls, which creates a fiscal challenge for local governments, especially counties that include large state land holdings.⁵⁶ The Legislature appropriates the state's PILT amount to the DNR from the General Fund as a pass-through for transfer to the Department of Revenue, which then handles the payments to the local governments. Because of this state practice regarding PILT, DNR officials identify those payments for school trust acreage as an uncompensated cost.

Historically but not currently, reforestation costs have been another large expenditure by the state of Minnesota for school trust lands. As noted earlier, the DNR's Forestry division must plant in areas where timber was harvested, including on school trust lands. In the past, no reforestation costs were passed along to the school trust because state policymakers used bonding to pay for reforestation on DNR-managed timber lands. This created an uncompensated cost to the state for reforestation on school trust lands. Currently, however, the Legislature is using an appropriation from the Forest Management Investment Account to pay for reforestation,

⁵⁶ For more about PILT, see the DNR's "Understanding Payment in Lieu of Taxes: Frequently Asked Questions" available at http://files.dnr.state.mn.us/lands_minerals/pilt/pilt_faq.pdf.

making this expenditure one that is certified against STL revenues. If in the future Minnesota returns to bonding for all or some reforestation costs, this will again become an uncompensated cost to the state.

Forestry

The DNR's Forestry division is able to tap STL forestry revenues to cover qualifying expenditure categories, as allowed by state law and noted in this report's previous section on forestry costs. (See section on page 32.) DNR officials argue that the division's conservative approach both to identifying allowable costs and allocating the share of those allowable costs to school trust lands favors the trust.

Even though the Forestry division can secure STL revenues from the Forest Suspense Account to pay for qualifying STL management activities, the FSA funds available are limited each year to the forest-related revenues earned from school and university trust lands. As a result, the DNR must secure other funds to cover STL-related forestry expenditures in years when its trust-land forestry costs exceed trust revenues from forest lands. The last time this shortfall was an issue was in fiscal year 2013, when Forestry's certified costs for management of school trust lands exceeded STL forestry revenues by \$861,500.

More significantly, the Forestry division is responsible for wildfire protection and emergency response throughout Minnesota, including on school trust lands. The Legislature provides General Fund dollars for the Forestry division to use each year in preventing and suppressing wildfires on almost all forests throughout the state. While the Forestry division carries out fire protection and suppression across a wide range of land types without seeking reimbursement, DNR officials cite its fire protection costs for school trust lands as an uncompensated expenditure by the state.

Up until fiscal year 2014, Forestry identified and certified its fire prevention and suppression costs for school and university trust lands and used trust land revenues to cover those costs. In the years just prior to fiscal year 2014, the DNR allocated fire protection costs to the trust based on the trust land acres affected by actual fires and suppression efforts and also based on the trust's share of total statewide forest acreage for costs related to prevention and other fire protection. These costs were passed onto the trusts even though DNR provided fire protection and suppression at no charge on other forests owned by individuals, companies, and all other governmental units aside from the federal government. For the five fiscal years from 2009 through 2013, STL revenues covered \$1.76 million annually in Forestry division fire costs on average, with the actual fiscal year costs to the school trust ranging from a high of \$2.33 million in fiscal year 2013 to a low of \$1.16 million in fiscal year 2011.

LAM's minerals program

The minerals program uses funds from the Minerals Management Account to cover all its costs for work on minerals management for the school trust lands and other types of state land. However, professional staff with the minerals program also performs some work on trust lands leased out for extraction of peat, gravel, and other aggregates. DNR cannot use MMA funds to cover those costs because peat and aggregates are extracted from surface land, rather than mined from below the surface, and therefore cannot be classified as mining costs. While an appropriation from the legislature of more than \$200,000 annually from the Forest Suspense Account

may be used to cover these costs as well as real estate work, DNR officials note that this funding falls short of what's needed for real estate work alone. As a very rough estimate, a Lands and Minerals official said this uncompensated cost to the minerals program for work on lands leased for extraction might amount to \$100,000 per year.

LAM's lands program

As noted in this report's previous section on land and real estate costs (see page 44), the Minnesota Legislature makes limited STL revenues available from the Forest Suspense Account to cover some but not all expenses that the lands program incurs to the benefit of the school trust. Because those funds are limited, they fail to fully cover even the types of lands program expenditures allowed. In addition, officials with the Lands and Minerals division report that the allowed categories of real estate work miss some important lands program activities carried out to the benefit of school trust lands. Notable uncompensated STL costs for the lands program include work on the following:

- Preparing for the exchange of school trust lands, including appraisals and surveying;
- Preparing for the sale of school trust lands, including appraisals and surveying;
- Lease transactions;
- Land title actions;
- Trespass issues;
- Lands program staff time spent on payments in lieu of taxes for school trust land acreage, including communication with affected counties and townships, calculation of PILT amounts, and coordination of the payments—although the actual PILT amounts paid out for school trust lands are covered using legislative appropriations from the state's General Fund; and
- Allowable costs related to public auction of school trust lands in cases where the land is offered but not sold because no buyers come forward with acceptable bids.

The lands program doesn't use STL revenues to pay its costs for easements and utility licensing that involve school trust acreage, although the program does charge application fees that help cover those costs and also receives appropriations from the state's General Fund to pay for some of its utility licensing work. One way to boost revenues in support of lands program work for school trust lands would be to increase or expand application fees, according to OSTL officials.

As noted previously, the lands program covers most of the uncompensated costs for its STL real estate work through the service level agreements it has with other DNR divisions. The Lands and Minerals division establishes those SLAs to pay for real estate work that the lands program carries out for the other divisions beyond its real estate work billed directly to the other divisions. In this way, the lands program secures adequate funding to cover its total costs. The dollar amounts for those SLAs include what's necessary to cover the lands program's budget deficit for professional services, including the costs of uncompensated STL work.

A LAM official roughly estimated that for fiscal year 2018, the lands program will incur about \$920,000 in costs tied to school trust lands, above and beyond what the lands program receives in FSA funds to cover some of its STL-related work. For this rough estimate, the LAM official assigned a share of the land program's costs to school trust lands based on what percentage of the DNR's state land forest management acres are STL acres (about 45

percent). The uncompensated estimate (\$919,000) includes 45 percent of the land program's total for its SLAs, less the professional services deficit (0.45 x \$1.59 million), 45 percent of the lands program's utility licensing costs covered using dollars from the state's General Fund (0.45 x \$416,200), and 45 percent of the total professional services deficit related to land exchanges and sales, which account for most of the STL-related professional services carried out by lands program staff (0.45 x \$38,400).

Parks and Trails

The DNR's Parks and Trails division manages school trust lands used for recreational purposes, including campgrounds, hiking and snowmobile trails, and public sites for access to bodies of water. However, this work by PAT relates to recreation rather than forestry or minerals, so no STL revenues are available to cover the division's costs. In most cases, any revenue generated from recreational use of school trust lands is deposited to the Forest Suspense Account for transfer to the Permanent School Fund. The DNR pays for PAT's management of those school trust lands mostly using appropriations from the General Fund—appropriations the division cannot then use for other recreational purposes.

With regard to campgrounds on school trust lands, PAT budget data for fiscal years 2013 through 2017 show that campground fees brought in \$216,200 annually on average over that five-year period, for deposit to the FSA.⁵⁷ PAT officials said that staff recently began tracking time spent managing recreational lands for the school trust as a way for the division to identify most of its operational costs for STL work. In addition, PAT assigns costs to the STL recreational areas for supplies, materials, utilities, and some other expenditures. For fiscal year 2017, the totals for staff time and other operational expenses totaled well under \$200,000, but PAT officials said it is likely that not all staff are fully coding time and costs using this new system. PAT also has administrative costs and general operations expenditures not included in the fiscal year 2017 totals. PAT officials said capital investment costs haven't been a concern because the state hasn't made capital investments in campgrounds as of late.

Uncompensated STL costs for the campground sites that PAT manages on school trust lands are a problem, PAT officials said. They would like to be able to tap into the revenues earned from recreational sites on school trust lands to cover operational expenditures. PAT officials suggested that the division could track its costs for campground sites on trust lands and then the trust could cover those costs using fees that now go into the FSA for transfer to the Permanent School Fund. Current state law doesn't allow this.⁵⁸ Another idea would be for PAT to lease campground sites from the trust and keep the fees that campers pay to use those sites, similar to what has been done with the Hill Annex Mine site and state park fees paid there. PAT officials said the viability of this approach would depend on whether or not revenues from camping fees would be higher than the combined costs of leasing the land from the trust and managing the land as active campgrounds. This might prove problematic for sites where campground revenues are low or camping is free.

⁵⁷ Unpublished data from the Parks and Trails division.

⁵⁸ Minnesota Statutes 2017, section 16A.25, subdivision 5(c).

PAT also manages recreational use of some school trust lands that currently present significant challenges regarding future costs for the division and perhaps for school trust lands, according to division officials. These two cases, both of which involve leased land, are as follows:

- **Knife River Marina:** The DNR took over management of this marina on Lake Superior as a part of a land exchange with Lake County for the school trust lands. PAT leases the marina out to a commercial company that operates it, with the revenues from that lease going to the school trust, not Parks and Trails. The commercial company paid \$60,800 for in lease fees in fiscal year 2017, based on set shares of revenues from dockage and storage fees and from boat service and repairs offered at the marina. PAT incurs only minor costs to administer the lease, but the marina is in need of major repairs and restorations, which PAT officials said could total as much as \$15 million. Such repairs and restorations would constitute significant uncompensated costs to either the DNR or the state. Given the relatively low lease income earned from the marina, MAD concludes it be unlikely that marina repairs and restoration would be a reasonable investment for the trust.
- **Hill Annex Mine:** PAT leases an historic mining site from the school trust and has operated this site as the Hill Annex Mine State Park since 1988. Under this arrangement, PAT is allowed to keep revenues earned from park fees and pay only the lease costs to the school trust. The Hill Annex Mine is on the National Registry of Historical Places, so the buildings on the site are historic. PAT has paid for maintenance of these historic facilities, but PAT and the DNR are now exploring possible closure for the state park. If that happens, PAT will drop its lease with the school trust and no longer pay for upkeep of the old facilities. Under state law, the Iron Range Rehabilitation and Resources Board has responsibility for managing the Hill Annex Mine and others from that era, but PAT officials wonder if high maintenance costs for the buildings on the site might fall to the school trust. The school trust holds the mineral rights to the now-closed mine.

Ecological and Water Resources

The DNR's Ecological and Water Resources division (EWR) collects, analyzes, and shares ecological information and offers expertise about relations between living organisms and their environment in Minnesota, with a focus on rare plants and animals, old growth forests, native plant communities, and landscape diversity both in the short- and long-terms. With regard to school trust lands, EWR officials said the division ensures compliance with state laws for species that are endangered, threatened, or of special concern. EWR staff examine what sound conservation principles entail for trust lands at the site level, the officials said. EWR staff are involved with forestry staff in site-level coordination and in setting up timber harvests. In addition, EWR staff carry out the Minnesota Biological Survey on plant and animal distribution across the Minnesota landscape and are involved in environmental assessments and environmental impact statements.

EWR officials said it would be difficult to estimate costs incurred on work carried out for the school trust lands. They argued, however, that such work should be covered using trust land revenues, especially when it involves efforts to keep the trust operating within state conservation laws and to assess the environmental impacts of activities on trust lands. The costs for such work vary depending on the issues and circumstances involved. OSTL officials said much of the STL work that EWR staff carry out involves restrictions on activities that would otherwise generate revenues for the trust. EWR officials noted that DNR's recently released STL-specific

guidelines for land management will help clarify what practices are appropriate on trust lands when it comes to protecting ecological and water resources, although they said that gray areas will remain.

The Ecological and Water Resources division receives no payments or funds from other DNR divisions for work it carries out related to the activities of those other divisions.

Fish and Wildlife

The DNR's Fish and Wildlife (FAW) division manages and protects Minnesota's fish and wildlife resources. FAW is involved when school trust lands are designated as wildlife management areas (WMAs) or aquatic management areas (AMAs), but no STL revenues are used to compensate the division for its work on trust lands. FAW officials said the division's work, like that of EWR, matches with the Legislature's goal that school trust lands be managed using "sound natural resource conservation and management principles, and with specific policies provided by state law."⁵⁹

Most often, FAW staff are involved in leases for gravel extraction, agriculture production, and native seeds on school trust lands located in WMAs. FAW officials provided a rough estimate of \$14,000 to \$26,000 per year in staff time required for leases of school trust lands in wildlife management areas, based on several years of data for agriculture and gravel leases but excluding native seed leases because of data issues. The work involved includes contacting the leasing entity, negotiating the terms of the lease, compiling land appraisal documents, and reviewing the leased land to assess compliance with lease terms.

In addition, FAW is involved with timber sales on trust lands in wildlife management areas, but FAW officials said staff work much less on STL timber sales than on STL leases. In the case of these timber sales, FAW staff coordinate with Forestry staff on whether an area should be harvested and on the design for that harvest. FAW officials said the division flags far fewer design issues for timber harvests on trust lands, compared to other DNR-managed acres, because of the revenue-focused mission of the trust. Harvest issues might include impact on trout streams, wintering areas for deer, or threatened plant and animal species.

Invasive species work by FAW staff on school trust lands is another uncompensated cost to the division, FAW officials said. FAW also incurs costs for leases of school trust lands or STL timber harvests in AMAs, although FAW officials said not many AMAs are located within school trust lands. There may be rare occasions, too, when FAW staff work on encroachment issues involving school trust lands.

As is the case for the EWR, the Fish and Wildlife division receives no payments or funds from other DNR divisions for work it carries out related to the activities of those other divisions.

Enforcement

The DNR's Enforcement division, which enforces the state's natural resource laws, carries out the same type of work on school trust lands that it does on any type of land that the DNR manages, according to a DNR official. Most notable in the context of school trust forests is timber theft. When people cut timber illegally, including

⁵⁹ Minnesota Statutes 2017, section 127A.31.

cuts for spruce tops and birch poles, DNR enforcement officers document the violation, investigate it, identify and pursue suspects, and charge them. The number of timber thefts varies by time of year but average about one per month across all DNR-managed land, the DNR official said. The Enforcement division estimated staff time costs for thefts on school trust at \$4,000 per year on average for the five fiscal years from 2013 through 2017. The estimated cost for fiscal year 2017 was \$6,100. To estimate the costs, Enforcement identified staff time coded to timber theft case work and decorative tree and bough regulations work for each of those five fiscal years and allocated a share of the total to school trust lands based on STL acreage as a percentage of the DNR's total state land forest management acreage (44.8 percent).

Enforcement also conducts work on school trust lands that it conducts on all other forest lands in the state owned by entities other than the federal government. Enforcement officers handle trespassing complaints, garbage dumping, and illegal activities in forests. In some of these cases, those reporting the incidents might contact other law enforcement agencies to respond, but DNR enforcement will respond when called upon and assist other law enforcement agencies when asked. The division does not charge counties, private land holders, or others for these activities.

STL not compensated for public water access

A number of DNR officials noted that while divisions within the agency incur uncompensated costs for STL activities, the DNR offers water access sites for the public on school trust lands without compensating the trust for this use of trust land. At the direction of the Minnesota Legislature, the DNR has created water access sites for the public on DNR-managed land to ensure quality recreational opportunities and public use. DNR established about 200 of these sites on school trust lands, all prior to 2012.⁶⁰

The DNR takes an approach to trails on school trust lands that might be useful in addressing the situation with water access sites for the public and compensating the trust. The DNR's Parks and Trails division manages trails on school trust lands, laid out for hiking, mountain biking, snowmobile, and all-terrain vehicles. PAT leases the land from the school trust, compensating the trust for land use of public benefit. The DNR collects registration fees from owners of snowmobile and all-terrain vehicles to fund trail maintenance and management, but the fees are general ones, not tied to specific trails. The fees go to PAT, not to the school trust. PAT also handles the DNR's water access sites on school trust lands—and pays for the development of that public access—but does not lease the sites from School Trust Lands. Several officials interviewed for this report said it likely makes sense to use the current approach to trails for public water access sites, too, with PAT leasing the land from the trust.

⁶⁰ Minnesota Department of Natural Resources. "Minnesota's School Trust Lands Valuation Report," December 31, 2016, p. 4. (Available at http://files.dnr.state.mn.us/aboutdnr/legislativeinfo/psfac/minnesota_school_trust_land_valuation_report_fy_17.pdf.)

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Appendix A: Interviewees

MAD interviewed the following people for this report:

Anderson, Lisa. Trust Lands Outreach Specialist, Washington Department of Natural Resources.

Beimborn, Doug. Senior Accounting Officer, Parks and Trails, Minnesota Department of Natural Resources.

Boe, Forrest. Forestry Director, Minnesota Department of Natural Resources.

Bird, Margaret. Executive Director, Children's Land Alliance Supporting Schools.

Brodie, Angus. Deputy Supervisor for State Uplands, Washington Department of Natural Resources.

Melvin Brown, former State of Utah Representative.

Clevenstine, Peter. Assistant Director for Minerals, Lands and Minerals, Minnesota Department of Natural Resources.

Damon, Susan. Assistant Director for Lands, Lands and Minerals, Minnesota Department of Natural Resources.

Daruk, Connie. Budget Analyst, Trust Land Management Division, Montana Department of Natural Resources and Conservation.

Deckard, Don. Forest Economist, Minnesota Department of Natural Resources.

Erickson-Eastwood, Linda. Administrative Services Manager, Parks and Trails, Minnesota Department of Natural Resources.

Engel, Emily. Budget Director, Minnesota Department of Natural Resources.

Goodrum, Brent. Director of Mining, Land & Water, Alaska Department of Natural Resources.

Haworth, Brooke. Environmental Assessment Ecologist, Northwest Region, Ecological and Water Resources, Minnesota Department of Natural Resources.

Heibel, Nathan. Koochiching County Land Commissioner, Koochiching County Land & Forestry.

Hittle, Tom. Senior Vice President, Steigerwaldt Land Services.

Jensen, Nicholas. Assistant Regional Plant Ecologist, Northwest Region, Ecological and Water Resources, Minnesota Department of Natural Resources.

Juelich, Barb. Chief Financial Officer (now former), Office of Management and Budget Services, Minnesota Department of Natural Resources.

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Appendix B: Abbreviations

AMHT – Alaska Mental Health Trust Authority
AMA – Aquatic management areas
Con-Con lands – Consolidated Conservation lands
DNR – Department of Natural Resources
DSL – Oregon’s Department of State Lands
EWR – Ecological and Water Resources (DNR)
FAW – Fish and Wildlife (FAW)
FMIA – Forest Management Investment Account
FSA – Forest Suspense Account
IDL – Idaho Department of Lands
LAM – Land and Minerals (DNR)
MAD – Management Analysis and Development
MDE – Minnesota Department of Education
MMA – Minerals Management Account
ODF – Oregon Department of Forestry
OMBS – Office of Management and Budget Services (DNR)
OSTL – Office of School Trust Lands
PAT – Parks and Trails (DNR)
PILT – Payment in lieu of taxes
PSF – Permanent School Fund
RMCA – Resource Management Cost Account
SBI – State Board of Investments
SLAs – Service level agreements
SLFM – State land forest management
STL – School trust lands
SWIFT – StateWide Integrated Financial Tools
TIMOs – Timber investment management organizations
TLM – Montana’s Trust Land Management division
TLO – Alaska’s Trust Land Office
WMA – Wildlife management areas