

State Trust Land Management: An Evaluation of Effectiveness and Efficiency

A report from the
Independent Review Committee
to the Commissioner of Public Lands

December 2004



WASHINGTON STATE DEPARTMENT OF
Natural Resources
Doug Sutherland - Commissioner of Public Lands

Acknowledgements

This report was prepared by the Independent Review Committee at the request of the Commissioner of Public Lands, Doug Sutherland.

Published by the Department of Natural Resources – December 2004

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Trisha Bennett
Charley Bingham
Ted Bottiger
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See Appendix A for committee credentials

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The Independent Review Committee
Chartered to evaluate the effectiveness and efficiency of state trust land management

December 10, 2004

Honorable Doug Sutherland
Commissioner of Public Lands
1111 Washington St SE
Olympia, WA 98504

Dear Commissioner Sutherland:

In accordance with your request, we, the Independent Review Committee, have completed the charge you laid out for us several months ago.

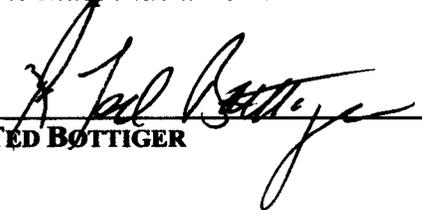
We are pleased to transmit our findings and unanimous recommendations relating to management of State trust lands and implementation of the new sustainable harvest levels approved by the Board of Natural Resources.

We have received all of the information requested of the Department and our deliberations have been completely open to the public. The trust beneficiaries have submitted their concerns and recommendations and commented in depth as our work progressed.

It has been a privilege to work together on this task. We are prepared to answer any questions or concerns you may have.

Respectfully,

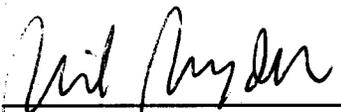
The Independent Review Committee



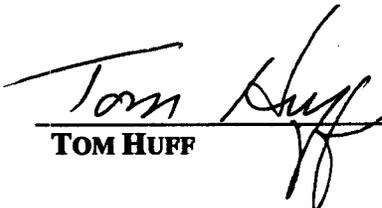
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Contents

Page	Title
1	1. Introduction
4	2. Findings and Facts
8	3. Recommendations
	Appendices
	A. Appointment Letter and List
	B. Committee Charter
	C. Briefing Material – Volumes 1-5
	D. Beneficiary Responses to Report

1. Introduction

In October 2004, Washington State Commissioner of Public Lands Doug Sutherland convened an advisory committee of individuals from outside the state Department of Natural Resources to evaluate the agency's effectiveness and efficiency concerning trust land management costs and benefits. (See Appendix A.) The Commissioner asked this Independent Review Committee to report back to him with findings and recommendations by early December 2004. This report fulfills that request.

Context

The Department of Natural Resources (DNR) manages nearly 3 million acres of upland state trust lands to benefit specific public institutions (e.g., public schools, state universities) and to support county services. About 2 million of those acres are forestland. The rest are largely agricultural and commercial lands. About 85 percent of the revenue generated from the lands comes from timber harvests.

Although DNR is the trust manager, the Legislature is the trustee. Management of the trust lands is guided not only by agency policy and direction from the Board of Natural Resources, but also by law, including the State Constitution and Washington State's 1889 Federal Enabling Act.

State law¹ also establishes the funding for management of the lands. With one exception (the Agricultural School trust), funding for management of the trust lands comes from a portion of the revenue generated from the lands. As revenue is generated, up to 25 percent² goes to the appropriate management account (Resource Management Cost Account and the Forest Development Account), the remainder goes to the appropriate beneficiary account. The legislature allocates money from the management accounts to DNR for trust land management expenses.

State law³ also requires periodic updates of the sustainable harvest level (for forested state trust lands). In September 2004, the Board of Natural Resources, adopted a new sustainable harvest level for Westside trust forests. DNR has concluded that stewardship investments are needed to ensure healthy forest ecosystems and increased timber productivity to generate increased trust revenue. Without such investments, financial and environmental benefits that accrue from trust land would likely be eroded over time. Further, DNR has concluded that, due to a variety of factors and despite three years of cost reductions, current funding is inadequate to meet investment needs. The net result is that the management funds are at risk of becoming depleted and becoming unable to support trust land management.

¹ Chapter 79.64 RCW

² There is one exception, the State Forest Purchased; for this trust, the legislature fixed the percentage at 50 percent.

³ Chapter 79.10 RCW

Before seeking new management funds, Commissioner Sutherland asked the Independent Review Committee to determine whether these conclusions are warranted.

Charge

The Charter for the committee (see Appendix B) charges it with the following:

Under the assumption that the current legal and contractual framework remains constant, the focus of the Independent Review Committee is to evaluate the effectiveness and efficiency of trust land management.

Are there changes that would result in improved revenues or cost savings sufficient to fund current management and the implementation of the Board of Natural Resources' directions?

To answer this question the Independent Review Committee will need to evaluate revenues and expenditures.

Revenues: Are there additional actions that could be taken to further expand net revenues?

Expenditures: Are there significant changes that should be made to reduce expenditures while maintaining legal mandates, other trust duties, while meeting the Board of Natural Resource' policy direction?

The Charter also established key principles and assumptions to guide the committee in its work:

- The trust concept of support of named beneficiaries will continue to govern upland trust lands.
- The upland trust lands will remain in state ownership for management.
- Only upland Trust expenditures and revenue will be reviewed.
- All existing legal requirements (laws, contracts, agreements) remain in place.

Review Process

Over the course of two months, the committee met three times in Olympia—October 6 and 22, and November 17. The meetings were open to the public, although public comment was not taken.

Prior to each meeting, DNR prepared briefing materials for the committee (see Appendix C), first to introduce the committee to the subject of its review, and then to answer questions it posed and provide information it requested. Prior to the first committee meeting, DNR had met with beneficiary groups to describe the review process and to invite them to voice the questions and concerns they thought the committee should address. Questions from the beneficiaries and answers to those questions were included in the briefing materials (see Appendix C).

During the meetings, the committee members evaluated the some 160 pages of briefing materials, including specific analyses that members requested, to increase their understanding of the issues.

The briefing material provided foundational information, that when coupled with the Committee Charter, led to a series of Findings. The Findings are the Committee's understandings of current circumstances. These also include some assumptions about population dynamics, future markets and market uncertainties.

The Findings and Facts provide a context for the Recommendations.

2. Findings and Facts

The Independent Review Committee adopts the following findings:⁴

Overview

1. For the past several years, the department has drawn down management fund balances to support land management activities. During this period the beneficiaries have continued to receive 75 or 78 percent of total revenue. Therefore, the management fund⁵ balances have declined and are projected to be depleted within two years for the Resource Management Cost Account and six years for the Forest Development Account. (*Vol. 4, Question 21, Pages 24-305; Vol. 1, Pages 35-41; Vol. 2, Pages 31-33*)
2. The trust beneficiaries wish to maintain or increase revenue compared to current levels. (*Vol. 4, Pages 29-33*)
3. Projected increases in revenue to beneficiaries are dependent on sufficient funds for trust land management. Based on available information, it appears the Department needs an average of an additional \$10 million per year to arrest the fund balance decline, to implement the Board's sustainable harvest plan, and to fund legislated salary and benefit increases. (*Vol. 3, Pages 16 and 13*)

Management of Trust Lands

4. The state trust land base DNR manages is one of the largest and most complex in the nation. (*Vol. 1, Page 11-21; Vol. 2, pages 38-41, Volume 4, Question 1, Pages 7-9*)
5. Population growth in Washington State has:
 - Created an increased demand for open space, housing and school construction;
 - Resulted in population centers becoming closer to state trust lands especially in Western Washington with many new neighbors adjacent to resource lands; and
 - Created a tension between public expectations for revenue production and public expectations for recreation/aesthetic/habitat use.

All projections indicate that these trends will increase. (*Volume 1, Pages 28-30*)

⁴ Note: Findings are based on combinations of information from the attached Briefing Materials - Vol. 1-5 (Appendix C) and from the knowledge and understandings for the Independent Review Committee members. Findings based on Briefing Materials are followed by italicized citations identifying significant supportive data. Citations refer to the key sources, not all potential sources in Appendix C.

⁵ Collectively, the Resource Management Cost Account and the Forest Development Account are called the management funds; created by statute, these accounts are for costs and expenses necessarily incurred by the department in managing and administering state lands.

6. The state trust lands are complex and diverse in terms of their distribution, value and public expectations. These lands come in various asset types, e.g., commercial, agricultural and forest. The forested acreage accounts for the largest revenue-generating asset. The sale of timber accounts for about 85 percent of total annual revenue. *(Volume 2, Pages 48-51)*
7. Trust forest resources vary in their productivity, current age, and degree of management constraints. In general, trust timber resources are very productive and contain a relatively healthy mix of different ages. *(Volume 2, Pages 15-20)*
8. The DNR has incurred increased costs in trust land management since the 1970's due to such events as tribal lawsuit settlements, the Clean Water Act, the Endangered Species Act, State Forest Practices Act, Habitat Conservation Plan, etc. Significant trust forestland and timber inventory are dedicated in part to meeting legal and contractual obligations related to these federal and state environmental laws. *(See Vol. 4, Question 17, page 22)*
9. For Western Washington, forestlands are classified such that about 30 percent of the forest area is providing a majority, about 55 percent, of the economic return.
10. The Board has chosen an approach to management of trust forestlands, which allows for an increase in the western Washington sustainable harvest level. *(Vol. 1, Pages 41-42)*
11. The Board-approved harvest plan for western Washington for the first decade will sell 3.8 percent (597 mmbf compared to 575 mmbf) more timber than the last sustainable harvest calculation in 1996. *(Vol. 3, Page 4)*
 - Compared to the western Washington sales for 2004, the first decade average annual harvest will increase 157 million board feet, a 36 percent increase.
 - The plan will produce a 45 percent increase of western Washington forest inventory by 2067, which will also contain a large increase of older age forests to meet Endangered Species Act requirements. *(Vol. 4, Page 22)*

Market Trends

12. World market trends are uncertain, creating similar uncertainty around future timber prices. If timber prices were to change 10 percent, then total revenue would increase or decrease \$170 million over a 10-year period; such a change would increase or decrease the management fund balance by \$50 million. *(Vol. 1, Page 38)*
13. Faced with this uncertainty, the timber market forecasts used by the DNR seem reasonable. The forecast predicts relatively flat prices which means a continued decline in real timber prices. *(Vol. 3, Pages 5-7)*

14. As the population has grown, so too has the market value of certain lands, especially small parcels located near rapidly growing populations centers and agricultural lands in irrigated agriculture areas. *(Vol. 5, Pages 1-4)*
15. There are markets for wind resources, communication sites, mitigation banks and carbon sequestering needs. *(Vol. 2, Page 48)*
16. The amount of private capital available to set lands aside for conservation, or to provide mitigation for development elsewhere, is increasing, providing the Department opportunities to gain additional revenue from trust lands.
17. There has been a conscious effort by the DNR to increase the competition for trust timber. *(Vol. 2, Page 47)*

Cost Control

18. Comparing FY 2001 to FY2003, the DNR reduced management fund operating expenditures from \$58.9 million to \$41.9 million, a 29 percent reduction.
19. DNR has specific costs associated with the 1997 Habitat Conservation Plan, which is a reasonable approach to managing risk related to uncertainty in the requirements of federal Endangered Species Act. *(Vol. 2, Pages 16-19, Pages 42-43)*
20. With the information currently available, it appears that the cost to manage the forest trust lands is reasonable, given public expectations. Benchmarking business functions against other land managers, on a per unit cost, not percentage basis, may indicate opportunities for more cost controls. *(Vol. 3, Pages 9-12; Vol. 4, Question 4, Page 10 and Question 19, Page 23; Vol. 2, Pages 35-41)*
21. The DNR has been using new technology for timber inventory and to develop the sustainable harvest calculation. DNR has outstanding timber inventory data for western Washington. *(Volume 2, Pages 16-20)*

Revenues

22. Revenues to the trusts are dependent on the following factors:
 - Market price fluctuations: revenues will fluctuate as the market dictates. *(Vol. 3, Page 6; Vol. 4, Figure 5, Page 15)*
 - Timber sales: harvest/income fluctuates by trust depending on timber species, volume and quality that are sold and removed. *(Vol. 2, Page 12)*
23. Those beneficiaries receiving trust revenue primarily from permanent funds are buffered from short-term trust land revenue fluctuations. *(Vol. 2 page 6)*
24. DNR has increased statewide sold timber volume from 461 mmbf in 2001 to 535 mmbf in 2004.

25. There is potential for increased total revenues and net revenues to beneficiaries resulting from the recent Board-decision on sustainable timber harvest levels. *(Vol. 3 Pages 16-20, Vol. 2, Page 14)*
26. The highest available price for trust land timber or other resources is achieved by active, targeted, and customer-oriented marketing.
27. Non-timber revenues, from sources such as agricultural and commercial properties, gravel sales, plus telecommunication sites, represent a small (about 15 percent) but increasing portion of trust land revenue. *(Vol. 4, Figure 1, Page 11)*
28. For some trust lands, especially isolated parcels in populated areas, returns are not commensurate with land value. *(Vol. 5, Pages 1-4)*
29. DNR will continue working to diversify holdings of trust land assets guided by Board-adopted plans such as the Transitions Lands Plan, Asset Stewardship Plan, and Agriculture and Grazing Plan. There are opportunities to continue and increase these diversification efforts in the future. *(Vol. 5, Pages 1-4)*

3. Recommendations

The Independent Review Committee adopts the following recommendations:

1. As far as the Independent Review Committee can determine, given the amount of time to study the issue, the department will have to increase management expenditures approximately \$10 million per year during the first decade, in order to accomplish the environmental and economic objectives of the State Board of Natural Resources' sustainable forestry timber harvest plan.
2. Currently,⁶ the beneficiaries receive 75 percent to 78 percent of gross receipts from most revenue sources. There is a need to increase the departmental Management Funds by an amount equal to 5 percent to 8 percent of gross revenue in order to implement the sustainable harvest calculation and likewise increase total gross revenues and total net revenue to the beneficiaries. We make no recommendation as to the source of the additional management funds.
3. We recommend the department continuously examine the particular mixes of timber to be marketed as well as the nature of the competition for its timber. Through time, the department should also plan to bring more timber to market when the prices are relatively high and less timber when the prices are low—within the constraints of providing a reasonably stable flow of income to the trust accounts through an economic cycle.
4. We recommend the department evaluate the niche market potential of red cedar and red alder.

⁶ Existing statutory authority creates a 25 percent ceiling for the Management Funds, the Resource Management Cost Account and Forest Development Account. The Board of Natural Resources has been granted the authority to lower the percentage to increase revenue to the beneficiaries when there are sufficient minimum fund balances in Management Funds. The Board of Natural Resources has adjusted the current Forest Development Account to 22 percent, resulting in a 78 percent return of gross revenues to the beneficiaries. By RCW, the State Forest Purchase Trust is fixed at 50 percent.

5. We recommend the department engage in a sustained effort to benchmark both the forest management and total costs of the department to ascertain whether departmental costs or charges can be further reduced.
 - a. Compare both unit costs and costs as a percent of gross revenue.
 - b. Include a zero budgeting approach and an evaluation of other similar functions in and outside of the State of Washington, including the private sector.
 - c. Evaluate benchmark data for both production and environmental compliance costs found within the public and private sectors.
 - d. Include benchmark comparisons in the DNR annual report to include, for example, the silvicultural costs, timber sale preparation costs, and HCP implementation costs.
6. We recommend the department convene a broad-based task force, including private industry, to review DNR's field procedures for the purpose of finding efficiencies to reduce costs and improve revenue.
7. We recommend the department identify 1 or 2 additional independent forecasting services or sources to help forecast the longer-term timber prices for the region. Too often, long-term prices are forecast from the peaks of the commodity cycle or from the valley—neither of which turn out to be accurate.
8. We recommend the department aggressively pursue asset repositioning and asset diversification.
 - a. Given the current diversity, location, size, and type of land managed by the Department, over 85 percent of current revenue is from timber. Increasing the non-timber revenues through exchange or sale of small or isolated parcels which are not earning a reasonable return on their fair market value can substantially increase economic performance.
 - b. Many of these parcels are located near I-5, I-90 and numerous other locations that limit or preclude revenue production but may have other important values best realized by other owners.
 - c. The department should develop a multi-year plan with clear goals to accomplish this recommendation.
 - d. Since the value of the non- or under-performing assets are in the hundreds of million dollars, the plan should include an internal organization that is solely dedicated to asset repositioning/diversification and funded at levels substantially in excess of current levels.
9. We recommend the department explore partnerships/joint ventures in land development in order to increase revenue. Coordination with local, state and federal economic development councils can reduce costs.

10. We recommend the department seek to streamline the processes for all land transactions.
11. We recommend that the department seek legislative authority for:
 - a. non-appropriated status for accounts into which revenue from trust land transactions is deposited for reinvestment;
 - b. significantly higher appropriation authority to accommodate revenue from trust land transactions.
12. We recommend that markets for wind power, mitigation banking, communication sites, and carbon sequestering be aggressively pursued, alone or through public-private partnerships or public-private-non-profit avenues. The department should develop a multi-year plan to accomplish this recommendation.
13. The Committee recognizes that there are a number of RCWs and WACs that create excessive costs and recommends that the department analyze the costs of certain legal requirements and recommend legislative changes.

Appendix A. – Appointment letter and list



September 29, 1004

Dear Independent Review Committee

Thank you very much for your willingness to look at the effectiveness and efficiency of state trust fund investments. While that assignment may sound rather mundane at first blush, your work and recommendations will, in fact, shape the future of state lands for decades to come. The potential of these nearly three million acres is incredible. The benefits are both real and significant. They include economic, social and ecological components such as money for schools, counties and other beneficiaries, clean water, wildlife habitat jobs, and nine million annual recreational visits to state trust lands.

These are benefits to all the people of Washington. Our working landscapes can provide over \$2.3 billion in gross revenues over the next decade but it takes investments to yield such returns. Without sufficient levels of investments, the productive capacities of the trusts cannot be realized.

Our best analysis of business costs and revenue projections indicate that we will not have the necessary management fund cash flow to support the levels of revenue the beneficiaries are entitled to. As overall revenue declines, so does the management fund. Without a dramatic increase in timber prices – and that is not predicted any time soon - the management funds, and consequently trust revenue, both spiral downward through the foreseeable future. We can't let that happen --- the future hangs in a delicate balance.

Prior to my term, the department had proposed legislation that would have increased the amount withheld for management by 40%. I asked the Legislature in 2001 to not act on the proposal, committing to a full evaluation to verify if there were alternatives.

Since that time, I have continuously evaluated our trust expenditures and made significant changes. Since that time, I have reduced expenditures to the lowest level since 1971, reduced employment by over two hundred positions and increased agency efficiencies, including the productivity of timber sales by over 40%. Nevertheless, there are macro-economic forces that have reduced revenue and create a future revenue picture unlike the long-term historical patterns. The results are a continued decline in the management fund balances. As you will see in the accompanying briefing material, without a solution the funds are predicted to go below prudent reserves and create "deficit spending", something not possible in state government.

*Over the next three months, I am asking that you evaluate how I am spending trust assets. To provide a focus, I have developed the attached "Charter for an Independent Evaluation of the Effectiveness and Efficiency of State Trust Fund Investment." As noted in the Charter, the central question is: **Are there changes that would result in improved revenues or cost savings sufficient to fund current management and the implementation of the Board of Natural Resources' directions?***

I do not presume that an increase in the management fund percentage must occur. If there are opportunities that I have missed to make material changes in our daily operations or if there are other paths that can fund the necessary investments, I welcome your ideas.



The enclosed briefing material is a first step to providing you with important information. This and other information that you or the trust beneficiaries may request should assist you in your deliberations. After your review, I am asking for a Final Independent Review Committee Report by early December that outlines your findings and recommendations. This becomes your "answer" to the central question that I posed. While ambitious, I sense that we can do this with three Committee meetings.

The first meeting will be in Olympia at the Olympia Center at 222 Columbia St NW, Room 101 and 102 on October 6 from 10:00 am - 3:00 pm. Lunch will be provided. The remaining two meetings will be in the Natural Resources Building, Room 172 from 10:00 am - 3:00 pm on October 22 and November 17.

I have asked Jack Hulsey, Operations Manager for the Department of Natural Resources, to work full-time on the Independent Review. He will be your primary contact to answer process or substantive questions. Jack can be reached at 360-902-1401 or email at jack.hulsey@wadnr.gov.

For your reference, I am also enclosing the following:

1. Independent Review Committee Charter;
2. Briefing Material, Volume I;
3. Initial questions from the beneficiaries on this topic; and
4. 2003 DNR Annual Report

Washington State is blessed with an endowment of nearly three million acres of state trust lands. These lands sustain our schools and institutions, our waters and wildlife habitat, and our culture and community viability across the state. These precious benefits can continue indefinitely with the right care and appropriate management.

I need your help in creating a new future.

Sincerely,
Doug Sutherland
Commissioner of Public Lands

Enclosures

Independent Review Committee Members

Patricia Bennett

Vice President, Government Affairs, Bennett Forest Industries, Grangeville, ID
Former Director, Legislative Affairs, Burlington Northern, Inc.
Former transition team member for Idaho Governor Kempthorne, with responsibility to review and make recommendations regarding the management of Idaho's trust lands.
Chair, American Forest Resource Council
Former Board member, Seattle League of Women Voters
Emeritus Board member, Olympic View Republican Womens Club

Charley Bingham

Retired Chairman, National Forest Products Board of Directors—The Weyerhaeuser Company
Visiting Fellow, Yale Graduate School of Environment and Forestry
Puget Energy Board member
Mountains to Sound Greenway Board member and former Vice President
Advisory Council member, Cascade Land Conservancy

Ted Bottiger

Vice President, Port Commission, Port of Tacoma
Former Washington State Senate Democratic Majority Leader
Former member, Governor's Blue Ribbon Commission on Transportation

Tom Huff

Former Chairman, Washington State House of Representatives Appropriations Committee
Former member, Washington State Joint Legislative Audit and Review Committee
Saint Martin's College Board member

Sid Snyder

Former Washington State Senate Democratic Majority Leader
Former member, Senate Natural Resources, Parks and Recreation Committee and Agriculture and Rural Economic Development Committee
Owner and operator, Sid's Supermarket of Seaview
State Grocer of the Year, 1974

Appendix B. – Committee charter

Charter for an Independent Evaluation of the Effectiveness and Efficiency of State Trust Fund Investments

**Department of Natural Resources
August 31, 2004**

Legal Context

The Washington State Department of Natural Resources (DNR) is the trust manager of some three million acres of upland trust lands. The DNR has a clear legal duty of undivided loyalty to each separate trust and is subject to the common law duties of a trustee. Providing financial support is one of the several trust land management responsibilities.

The Legislature is the trustee.

DNR management of trust lands is conducted within the framework of state and federal laws, various policy plans for specific resources such as forest, the 1997 Habitat Conservation Plan, the 2001 Washington State Forest Practices Rules, the state constitution and Enabling Act and with oversight and policy direction provided by the Board of Natural Resources. The Board of Natural Resources was created by the Legislature to provide strategic direction and to serve various statutory and constitutional duties regarding the fiduciary management of these trusts; one of their duties is a responsibility to set sustainable timber harvest levels for the forested trust lands.

Introduction

After the most extensive technical and public review ever accomplished, the Board of Natural Resources is ready to set a path for the stewardship of state trust forests, including a sustainable timber harvest level.

As a result of this work, there is a growing understanding that good stewardship will require increased investment to ensure healthy forest ecosystems and increased productivity. Without this investment, the financial and environmental benefits that accrue from the trust land will likely be eroded over time.

In addition to the Board of Natural Resources' extensive technical analysis of sustainable harvest levels, the department has studied global timber market conditions, conducted quarterly revenue projections, and has made major reductions in costs over the past three years. As a result of these analyses, the department has come to the conclusion that the significant financial and environmental benefits that are achievable with sustainable forest management cannot be obtained without an increase in the level of retainage for investment and operating expense currently available (25% of revenue generated from sales and leases).

During the past three years, Department of Natural Resources has cut overhead by 16%, reduced management fund expenditures by \$47 million, implemented new ways to market and sell timber to optimize price, found ways to improve revenue and bring revenue forward through land diversification and shortened contract lengths. However, these efficiency measures have not kept pace with increasing costs. In addition, timber prices have remained low in recent years and are projected to continue at lower than historical levels.

In 1971 the Legislature set the trust management funds at 25% of gross trust revenue from the lands. That percentage has not been updated since, despite the growing complexities of modern trust land management.

Need

Before seeking new management funds, Commissioner of Public Lands Doug Sutherland has chosen to undertake an independent examination, to determine whether this conclusion is warranted, or whether there are opportunities for further savings that would avoid the need for a funding increase. Commissioner Sutherland will appoint an Independent Review Committee of individuals from outside the Department of Natural Resources to review the Department's trust land operations, expenditures and revenues, and report their findings to him. This work is expected to be completed by mid December 2004.

Role of the members of the Independent Review Committee

Members of the Independent Review Committee have been chosen for their expertise and experience regarding governmental or private sector financing and organizational management. Their role on the committee will be to use their knowledge and expertise to challenge or verify the Department's conclusion that *the substantial benefits achievable from sustainable forest management are not obtainable without an increase in investment beyond what is possible with current level funds*. Because the Department of Natural Resources' conclusion was based on the legal and contractual framework, and the reality that timber price is largely determined by market forces beyond the agency's sphere of influence, the review committee will necessarily focus on the elements of cost and revenue as variables over which the agency maintains some management control. Their final report will be findings and recommendations to the Commissioner of Public Lands.

The Department will provide staff to the Independent Review Committee, and committee members will be compensated for their time and travel expenses in accordance with state law.

Independent Review Committee – Scope of Work

Under the assumption that the current legal and contractual framework remains constant, the focus of the Independent Review Committee is to evaluate the effectiveness and efficiency of trust land management.

Are there changes that would result in improved revenues or cost savings sufficient to fund current management and the implementation of the Board of Natural Resources' directions?

To answer this question the Independent Review Committee will need to evaluate revenues and expenditures.

Revenues: Are there additional actions that could be taken to further expand net revenues?

Expenditures: Are there significant changes that should be made to reduce expenditures while maintaining legal mandates, other trust duties, while meeting Board of Natural Resources' policy direction?

Key Principles and Assumptions

- *The trust concept of support of named beneficiaries will continue to govern upland trust lands.*
- *The upland trust lands will remain in state ownership for management.*
- *Only upland Trust expenditures and revenues will be reviewed.*
- *All existing legal requirements (laws, contracts, agreements) remain in place.*

Role of the Trust Beneficiaries

Department of Natural Resources will consult with beneficiary groups representing the various trusts before the Independent Review Committee convenes for its first meeting. The purpose of the beneficiary discussions will be to describe the review process and provide beneficiaries with a chance to voice the questions and concerns that the beneficiaries believe the Independent Review Committee should address. They will be invited to submit any additional questions in writing following this initial meeting.

Department of Natural Resources staff will compile all of the beneficiary questions and provide the complete list of questions to all beneficiaries. The questions will be included in briefing materials prepared for the Independent Review Committee members so they can be well informed about the beneficiaries' interests from the beginning of the review.

At the first meeting of the Independent Review Committee, a representative for each of the beneficiary trust groups will be given the opportunity to make a five to ten minute presentation to the Independent Review Committee. The purpose is to allow the beneficiary to elaborate or expand on the information previously provided in the briefing materials. The beneficiary trust groups are as follows:

- Common School Trust
- Normal School Trust
- WSU Agricultural and Scientific School Trusts
- UW Transferred and Original Trusts
- Community and Technical College Forest Reserve Trust
- CEP&RI Trust
- Capital Building Trust
- Forest Board Counties

The preliminary report of the Independent Review Committee will be distributed to the beneficiaries for review and comment. Comments will be reviewed by the Independent Review Committee prior to preparing the final report. The comments and responses will be included in an appendix to the final report.

Appendix C. – Briefing material, volumes 1-5

DNR Briefing Material - Volume 1

October 2004

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Contents

EXECUTIVE SUMMARY	5
Introduction/Purpose.....	5
Public Policy Context	5
Costs of business.....	7
Management Fund Balances Continue to Decline.....	7
Conclusion	8
1. BASIS OF THE INDEPENDENT REVIEW	9
2. TRUST LANDS – A REFLECTION OF PUBLIC POLICY.....	11
2.1 Origin of the trusts.....	11
2.1.1. Federal Grant Lands.....	11
2.1.2. State Forest Lands.....	12
2.2 The trust framework.....	13
2.2.1 Legal Construction of the Federal Grant Lands.....	13
2.2.2 Legal Construction of the State Forest Lands.....	14
2.2.3. State Trust Land Management Compared to Other Lands and Trusts.....	15
2.3. The trust manager – DNR.....	16
2.4 Funding Trust Land Management	17
2.4.1. Benefits of Dedicated, Revolving Accounts.....	17
2.4.2 Use of the Management Accounts	18
3. ASSETS, COSTS AND BENEFITS	19
3.1 Trust assets – the land base.....	19
3.1.1. The Deloitte & Touche Study – a Snapshot in Time of Asset Value	19
3.1.2 Repositioning Assets.....	22
3.2 Revenue, Expenditures & Fund Balances	22
3.2.1 Management Revenues and Fund Balance	22
3.2.2 Historical Patterns of Revenue and Expenditure	23
3.3 Expenditure Controls	26
3.4 The Cost of Doing Business.....	27
3.4.1 Multiple Use Trust Land Management	28
3.4.2 Societal Changes.....	29

4. THE FUTURE OF TRUST FOREST MANAGEMENT	31
4.1 Western Washington Sustainable Harvest Level Recalculation	31
4.1.1 Sustainable Forest Management Policy	32
4.2. Volume and Value from Timber – Statewide.....	33
4.3 Projections: Revenue, Expenditures and Fund Balance	35
4.3.1 The Funding Gap	36
4.4 Conclusions.....	41
4.4.1 What’s at Stake	41
4.4.2 The Central Issue	42
4.4.3 Consequences.....	42
APPENDIX A	43
Appendix B	47
Questions Raised by Trust Beneficiaries in Meetings Regarding the Independent Review Committee	47

Executive Summary

Introduction/Purpose

The purpose of the Report is to provide foundational information to assist the Independent Review Committee understand the history and the potential of trust land management in this century. History has given us much. Land...Laws...Institutional capacity. And the trusts have produced billions of non-tax dollars used to build elementary schools, institutions of higher learning and help fund counties over the years. This incredible endowment of productive lands can provide such direct and many indirect benefits well into the future. But the costs to obtain those benefits will be greater relative to the revenue they produce than in the past.

Given our best projections of revenue, and our best analysis of future costs to manage the trusts, the Department of Natural Resources has reached the conclusion that it will take additional resources beyond what will be available under the current funding mechanism to achieve the full potential benefits expected from our State Trust Lands. Under the assumption that the current legal and contractual framework for land management remains constant, the focus of the Independent Review Committee is to test that hypothesis, and evaluate the effectiveness and efficiency of trust land management.

The expected outcome is a December 2004 Final Report to the Commissioner of Public Lands. It is anticipated that the Report will contain both findings of fact and recommendations on effectiveness and efficiency and alternative funding mechanism that will help the Commissioner of Public Lands in framing options for the trustee, the Legislature.

Public Policy Context

When Washington entered the Union as a state in 1889, it was granted 3.2 million acres of land by the federal government to help establish and maintain institutions important for the new state. Unlike most states, Washington public policy fairly quickly evolved into “retain the land in trust ownership.” This forward-looking stance preserved options for today and future generations to provide sustainable benefits from these lands.

The State’s underlying policy of “retain the land in trust ownership” remains the fundamental policy today. However, much has changed since statehood. Our population has substantially increased. Science and technology have increased our understanding of what it takes to provide the important economic benefits, while ensuring good stewardship of the lands and resources well into the future.

As our knowledge has grown, the concept of stewardship has evolved in our laws and public policies. The concept of harvesting a sustained yield of timber became law for the trusts in 1971, but was preceded by public concerns in the 1920’s as increasingly cut-over lands were left unproductive and became tax delinquent. In 1957, the Department of

Natural Resources was created to provide professional forestry management on trust lands, and focus on providing school construction financing for the growing population. The State Environmental Policy Act (SEPA) was passed in 1971. Later in the 1970's the SEPA process was applied to state timber sales, adding a public process to analyze environmental impacts in timber sales design. The Multiple Use Act was also passed in 1971, ensuring access to trust lands for a variety of recreational uses when consistent with the underlying trust responsibility. In 1974 the modern Forest Practices Act was adopted, and the balance between state, tribal, and environmental interests has been continued to be debated during the following three decades. More recently, endangered species listings led to the State's Forest and Fish Agreement which became law for all forest landowners, and DNR adopted its Habitat Conservation Plan (HCP) on trust lands. The HCP is an "insurance policy" to provide certainty and predictability for maintaining revenue flow to the beneficiaries while meeting important conservation objectives required under the Endangered Species Act.

Public policy regarding trust land management has evolved in complexity throughout its 115-year history. The results are now substantial financial and environmental benefits from active trust land management. We now have a better understanding of the connections between our past practices and what we need to do today. Today, we know that thinning overstocked stands improves forest health while accelerating useable habitat and reduces fire danger. And the Forest Practices Act requires investments to fix roads and replace culverts that limit fish passage.

As science and technology have given us new knowledge and tools to meet a variety of important goals for our trust lands, the complexity of management and cost of production have increased significantly.

Costs and Benefits

Scientifically based, active land management has substantial benefits, but also costs. The central question of this report is how to pay for the benefits while continuing to provide substantial financial support to the beneficiaries. This is an ongoing question.

The information that follows is shown in real (2003) dollars; this means, that the values are adjusted to the purchasing power of today's dollar. This is relevant in that both costs and revenues vary due to inflationary pressures. Much of the data will show trends over three plus decades to help understand macro-economic and other trends that strongly influence land management.

Benefits for the Trusts

Macro-economic forces of supply and demand have converged to change the long-term trends in commodities, both timber and agricultural. Until the mid 1990s, real timber prices have shown real price appreciation over time, despite numerous ups and downs. During the past 10 years, real prices have trended downward, and starting at this new lower level they are forecast to remain stable in real terms for the foreseeable future. Increases in demand are offset by increases in supply due to expanding supply from

forests around the world. Timber prices averaged \$273 MMBF in the last biennium. That average sales price was 56% lower than 1993-95 and 41% lower than the 1971-73 timber sales prices, in real terms. While the department has consistently increased revenue from non-timber sources, revenue from timber still represents about 85% of the total revenue. Timber is expected to continue to be the major revenue source for the foreseeable future.

The department has made many changes in how timber is marketed; including shortening sales contract length, increased pole sales, managing the timing of wood flow to the market, and contract harvesting a different product mix. The result is about a twenty percent higher sales prices for timber. The department has also increased efforts to diversify trust assets into commercial and agricultural lands, seeking to sell or transfer unproductive land assets, and acquire immediate revenue and long-term value improvement. In the past year alone, real revenue to the common schools was improved through specific land transactions. Prior to asset re-positioning, \$16.6 million worth of property returned only \$3,000; after re-investing \$10.4 million of the original \$16.6 million, annual returns were of \$771,000. Through these transactions, returns are increased from less than 1 percent on the properties disposed to 7.4 percent return on the newly acquired properties.

Costs of business

Recognizing the significance of long-term revenue trends and the concurrently significant increases in costs for staffing, fuel, and infrastructure, the department has taken dramatic steps to reduce costs and increase productivity over the past four years. DNR has eliminated more than two hundred positions since 2001, and reduced administrative services FTEs by 14 percent. By organizing to focus staff on specific tasks with measurable goals, we have increased timber sales labor productivity by 40%. Even with the today's increased complexity of forest management and the increased cost of doing business, DNR's expenditures last biennium (2001-03) are at the lowest point since 1971-73 biennium, in real terms. In spite of these dramatic reductions, costs have continued to exceed revenue into the management funds (Resource Management Cost Account (RMCA) and Forest Development Account (FDA)). Since the 1991-93 biennium, costs have exceeded revenue in 5 of the past 6 biennial periods.

Management Fund Balances Continue to Decline

Despite the department's efforts to reduce costs and enhance revenues, management fund have declined faster than the department has been able to reduce costs. Since 1997, trust land management costs were 28% of gross revenue while management fund revenues are generated at 24%. Without further action, expenditures are expected to continue to exceed revenues for the foreseeable future. If left unchecked, fund balances will soon evaporate.

On September 6, 2004, the Board of Natural Resources selected a decadal sustainable harvest level that included new forest management strategies, which would realize higher net revenue to the beneficiaries while improving forest health. Given the current trends

in revenue, cost, and management fund balance, it will take an additional investment to realize the full ecological and revenue potential. Gross revenue could increase to some \$2.3 billion over the decade. In addition, older forest habitat could increase five-fold, acres of unhealthy forests could decrease by 10%, standing forest inventory could increase by 45%, and about 2,000 jobs could be created. These gains in revenue, ecological and other benefits cannot be achieved unless the funding problem is addressed.

Conclusion

In early 2001, Commissioner Sutherland promised the legislature that he would exhaust all options for efficiency and effectiveness in the agency, before he would consider asking for help. Throughout the ensuing four years, significant cost savings, substantial productivity gains and numerous revenue enhancements have been achieved throughout the agency. Despite these efforts, the department's analysis shows that without some source of additional investment dollars, the funds will be exhausted within a two and six years for the RMCA and FDA, respectively.

This report launches an independent review of that analysis and asks for your recommendations regarding the issues.

1. Basis of the Independent Review

The Washington State Department of Natural Resources (DNR) manages about three million acres of (upland¹) state trust lands that are worth several billion dollars. These working lands—forests, agricultural lands, mineral sites and urban properties—provide substantial revenue to specific public beneficiaries and benefits to all the people of Washington. Such lands provide needed revenue to schools, hospitals, fire departments and other public institutions. Importantly, they also provide jobs, commodities, clean water, wildlife habitat and increasingly scarce recreational opportunities.

The Legislature (as trustee), the beneficiaries and the public have long had an interest in state trust land management. Historically, there have been a number of studies to evaluate the management of these assets. The importance of and the costs of managing this fixed asset base suggest that a new and current review of the effectiveness and efficiency of state trust fund investments is essential.

DNR manages the state trust lands within the framework of state and federal laws, various policy plans for specific resources (for example, agricultural lands and forest lands), the 1997 Habitat Conservation Plan, the 2001 Washington State Forest Practices Rules, the State Constitution and Enabling Act; and with oversight and policy direction provided by the Board of Natural Resources.

The Legislature created the Board of Natural Resources (Board) to provide strategic direction and to serve various statutory and constitutional duties regarding the fiduciary management of these trusts. One of the Board's duties is to set sustainable timber harvest levels for the forested trust lands. Recently, after the most extensive technical and public review ever applied to the task, the Board of Natural Resources set a new path for the stewardship of state trust forests, including a sustainable timber harvest level.

As a result of this work, there is a growing understanding that good stewardship will require increased investment to ensure healthy forest ecosystems and increased productivity. Without this investment, the financial and environmental benefits that accrue from the trust land will likely be eroded over time.

Before seeking new funds for this investment, Commissioner of Public Lands Doug Sutherland has chosen to initiate an independent examination to determine whether this conclusion is warranted, or whether there are opportunities for further savings that would avoid the need for a funding increase. Commissioner Sutherland has appointed an Independent Review Committee of individuals from outside DNR to review the

¹ The subject of the Independent Review is limited to the upland trusts. While the DNR manages some 2.6 million acres of aquatic lands, that is, the beds of navigable water, tidelands, shorelands and harbor areas, their legal construction and management issues are materially different. Due to the distinct differences, aquatic lands are excluded from the Independent Review.

department's trust land operations, expenditures and revenues, and report their findings to him. This work is expected to be completed by mid-December 2004.

Under the assumption that the current legal and contractual framework remains constant, the focus of the Independent Review Committee is to evaluate the effectiveness and efficiency of DNR's management of state trust lands.

2. Trust Lands – a Reflection of Public Policy

Washington's state trust lands, and DNR's trust management, are a reflection of public policy. Public policy created the trusts. Public policy defines the trust framework. And public policy directs DNR as the trust manager. As public policy evolves, at both state and federal levels, so does DNR's management of the trusts and their assets.

2.1 Origin of the trusts

DNR manages two major categories of upland state trust lands: Federal Grant Lands and State Forest Lands. These categories have separate origins, which are reflected in both the nature of the lands and how they are managed.

2.1.1. Federal Grant Lands

When Washington entered the Union as a state in 1889, it was granted 3.2 million acres of land by the federal government to help establish and maintain institutions that would be important for the new state. The lands were to be managed in trust for the public educational and institutional beneficiaries.

Washington received seven land grants for the support of educational (Common Schools, State University, Agricultural, Normal, and Scientific) and other state institutions (Capitol and Charitable Educational Penal & Reform Institutions). Direction and authority for management of these lands was given to the state legislature in the new state's Enabling Act.

In 1889, on behalf of the people of Washington, the delegates to the state's constitutional convention accepted the terms offered by Congress for Washington to enter the Union. In Article XVI School and Granted Lands, the people accepted the Federal Grant Lands and agreed to the terms and conditions under which all the trusts were to be managed.

The federally granted lands were widely dispersed and contained a variety of land types, including productive forest land or agricultural lands as well as rocky lands, both suitable and unsuitable for natural resource products.

Unlike most other states, Washington has retained most of the granted trust assets in land. Of the original Educational Federal Grant Lands of 2.8 million acres, the state has retained 2.0 million acres or more than 71 percent. Of the original Institutional Federal Grant Lands of 432,000 acres, the state has retained more than 262,000 acres or 61 percent. (See Table 1 for detail.)

This pattern of trust land retention was not uniform. The University of Washington's original grant was almost depleted before statehood. Of the original University grant of 46,080 acres only 2,937 acres or 6 percent remains.

After statehood, an additional 931,000 acres were sold from the other trusts' holdings, most prior to 1930. Since 1930 the state has had a policy of retaining trust lands rather than disposing of them.

Table 2-1 Granted Trust Lands Managed by the Department of Natural Resources

Grant	Designated Beneficiary	Original Acreage	Sold Acreage [3]	Current Acreage [1]	Percent Retained	Permanent Fund Balance
Educational						
Common School	Common School	2,432,564	686,544	1,746,020	72%	\$163,486,502
Agricultural School	Washington State University	90,000	19,267	70,733	79%	\$140,810,235
Scientific School	Washington State University	100,000	19,545	80,455	80%	\$154,847,124
Normal School	EWU, CWU, WWU, & TESC	100,000	35,696	64,304	64%	\$201,486,521
University Original	University of Washington	46,080	43,143	2,937	6%	\$23,769,889
Total Educational		2,768,644	804,195	1,964,449	71%	\$684,400,271
Institutional						
Capitol	Capitol Buildings	132,000	23,719	108,281	82%	NA
Charitable, Educational, Penal and Reformatory Institutions (CEP&RI)	CEP&RI - as directed by legislature	200,000	130,109	69,891	35%	NA
	Dedicated for support of University of Washington [2]	100,000	16,131	83,896	84%	
Total Institutional		432,000	169,959	262,041	61%	NA

[1] As of July 1, 2001. Some trust lands have been temporarily liquidated with the funds from those transactions being held to purchase replacement lands. These funds are temporarily held in the RPR account, Land Bank, and State Park Transfer account. The majority of these funds involve the common school trust. Actual areas will increase as replacement properties are purchased. "Actual Acres" were not adjusted for anticipated purchases.

[2] In 1893 the legislature designated 100,000 acres of the CEP&RI Federal Grant Lands for the support of the University of Washington. See Laws of 1893, Chapter 122, Section 9 (uncodified amended by Laws of 1903, Chapter 91, Section 1 (uncodified)).

[3] Sold acreage is calculated by subtracting the current acres from the original acres

2.1.2. State Forest Lands

The approximately 626 thousand acres of State Forest Lands (formerly known as Forest Board lands), represent about thirty percent of the 2.1 million acres of forested state trust lands that DNR manages.

Most of the State Forest Lands are *State Forest Transfer* lands. These are lands that were acquired by 21 counties in the 1920s and 1930s through tax foreclosures. Many of the lands had been recently harvested, and a number of private landowners elected not to pay taxes on forestlands, resulting in tax foreclosure. The lands were ultimately deeded to DNR as State Forest Transfer Lands and placed in trust status. In exchange for the deed transfer, the county and junior taxing districts in which the land is located are given a portion of the revenue from timber sales and other activities on these lands. In addition, a portion is forwarded to the State General Fund for support of public schools.

Nearly 80 thousand acres of State Forest Lands are *State Forest Purchase* lands that were either purchased or acquired as a gift by the state.

As their nomenclature suggests, these lands are distinguished by how they were acquired.

2.2 The trust framework

The legal framework that establishes Washington's state trust lands also provides constraints and direction for their management. It is this framework that makes DNR's legal duties regarding forests and other trust lands different from the obligations of most federal and state land management agencies.

Our state's Enabling Act, Constitution, state statutes and resulting case law describe a legally binding duty to manage the lands in trust to provide financial support for specific, named beneficiaries, perpetually. The trusts are managed by a public agency and are subject to many of the same federal and state laws as private lands. In addition to the laws of general applicability, the trusts are subject to specific state law governing the management of the trusts, and are subject to the common law trust responsibilities.²

2.2.1 Legal Construction of the Federal Grant Lands

In 1889, Washington joined the Union under the terms and conditions of the Enabling Act. These conditions included a grant of sections 16 and 36 of every township within the state "for the support of common schools." Additional grants of land for capitol buildings, for a university, for a penitentiary, for an agricultural college, for a scientific school, for normal schools, and for charitable, educational, penal, and reformatory institutions were made.

The 1889 Enabling Act placed conditions on the grants. For example, Federal Grant Lands cannot be disposed of except at public sale and for a minimum price of \$10 per acre. The proceeds from the sale or permanent disposal of the education Federal Grant Lands are to be placed in permanent funds, the corpus of which cannot be diminished,

² For example, the Washington State Constitution specified that the lands are held in trust for all the people of the state. In the area of forest resources, RCW 79.15.010 provides that "the best interest of the state" must be considered before timber or fallen timber is to be sold. RCW 79.11.175 further requires that the state find "that the best interests of the state may be subserved" before a timber sale contract is confirmed.

and the interest from the permanent funds can only be used to support the named beneficiary. The lands may be leased and timber sold separate from the lands, but only under regulations promulgated by the state legislature.³ The state accepted the grants together with all the terms and conditions under which they were conveyed on behalf of all the people of the state in Article XVI of the state constitution. The Washington State Constitution placed additional constraints on the management and disposal of the trust lands.

The grantor of the trust is the federal government. The primary terms of the trust are contained in the Enabling Act. The trustee is the State of Washington with the State Legislature being identified as having specific responsibilities under those terms, and the beneficiaries are those named in the Enabling Act. While the trust terms in the Enabling Act and state constitution give considerable discretion to the state, the courts have ruled on numerous occasions, that where the terms of the federal grants are silent, certain common law duties apply.

2.2.2 Legal Construction of the State Forest Lands

The State Forest Lands—State Forest Transfer and State Forest Purchase lands—were created by the state legislature. State Forest Transfer lands are held in trust, and the trust terms are contained in state statute. Uniquely, the State of Washington is both the grantor and the trustee. State Forest Purchase lands are not held in trust.⁴ However, these lands are managed similarly to State Forest Transfer lands.

The creation of the State Forest Lands was a response to one of the first environmental and public policy problems that faced Washington State—what to do with the deforested lands that were being created by the rapid development of the forest products industry.⁵

State Forest Transfer Lands

In the early 1900s, many landowners did not pay the taxes on their forestlands, particularly after harvesting the trees, resulting in tax foreclosure. The 1935 Legislature passed legislation requiring the counties to transfer tax delinquent land suitable for forestry uses to the state for the creation of a state forest.

The Legislature created the trust in statute (RCW 79.22.010).⁶ The legislature directed that these lands be held in trust, forever reserved from sale and managed as forestland, with the intent at the time to support long-term forest production in Washington.

The grantor of the State Forest Transfer Trust is the state of Washington. The primary terms of the Trust are contained in statute; the trustee is also the state of Washington, and the beneficiaries are the junior taxing districts, the counties, and State General Fund. Because the state is both the grantor and trustee, the state has considerable flexibility to

³ 1889 Enabling Act, § 11, 17.

⁴ AGO 1996, No. 11 at 60.

⁵ Forest Board Transfer Lands, Joint Legislative Audit and Review committee Report 96-5 December 16, 1996 (on the web at <http://jlarc.leg.wa.gov/Reports/96-5.pdf>)

⁶ Hence this trust is referred to at “statutory trusts”.

change the terms of the trust through statutory direction. The legislature has directed that the State Forest Transfer Lands are to be managed in the same way and purposes as the federally granted trust lands. Unless the state legislature has specifically directed otherwise, common law trust responsibilities apply.⁷

State Forest Purchase Lands

The State Forest Purchase lands were acquired under the 1923 Reforestation Act. Under the act the State Forest Board was given the power to acquire any lands that were chiefly valuable for developing and growing timber, and to designate these lands as State Forest Lands. All State Forest Lands were to be used primarily for forestry, forever reserved from sale. However, the timber could be sold and lands leased in the same way as for the same purposes as state Federal Grant Lands. The nature of the trust is very similar to the State Forest Transfer Lands.

2.2.3. State Trust Land Management Compared to Other Lands and Trusts

The core characteristics of the state land trusts create major differences in how these lands are managed when compared to private lands, other public lands and private trusts. However, there are also some similarities.

As trust manager, DNR is required to comply with all laws of general applicability, including the omnibus Enabling Act of 1889, state Multiple Use Act, state Forest Practices Act, state Shorelines Management Act, State Environmental Policy Act, the federal Endangered Species Act and Clean Water Act, the state Growth Management Act, and others.

The courts have ruled that the state land trusts constitute real and enforceable trusts⁸, and where the documents that created the trust are silent, the courts have ruled that some of the common law principles governing the administration of private trusts apply⁹.

The Restatement (Second) of Trusts (1959) and Restatement (Third) of Trusts (1990)¹⁰ identify and discuss the following relevant common law duties of a trustee:

- a duty to administer the trust,
- a duty to manage trust assets with undivided loyalty,

⁷ AGO 1996, No. 11, at 62-65.

⁸ Viewing the land grants as trusts has evolved over time, the strongest language is in the -New Mexico and Arizona accession (1910) and this strong language (through case law) has been applied retrospectively and with increasing clarity to all the grants. Sec. 10 of New Mexico and Arizona's Enabling Act specifically provided that lands granted to the state were to be held "in trust" and declared that it was the duty of the attorney general of the United States to enforce in court the provisions relating to the application and disposition of the lands, the products thereof, and the funds derived there from. (Souder p.26) This may partially explain why key U.S. Supreme Court decisions are unusually likely to involve cases about those two states. The general trust rule is that, once a trust is established, the settlor has a very limited role in its administration. However, the U.S. government is not a typical settlor. (Souder p. 307)

⁹ *County of Skamania v. State*, 102 Wn.2d 127, 132-33, 685 P.2d 576 (1984).

¹⁰ Restatement (Second) of Trusts §§ 169-185; Restatement (Third) of Trusts §§ 170-171, 181, 183-185.

- a duty to delegate trustee duties only when reasonable,
- a duty to keep and render accounts,
- a duty to furnish information to beneficiaries,
- a duty to exercise reasonable care and skill in managing the trust,
- a duty to take and keep control of trust property,
- a duty to preserve trust property,
- a duty to enforce claims held by the trust,
- a duty to defend actions that may result in loss to the trust,
- a duty to keep trust property separate from other property,
- a duty to use reasonable care regarding bank deposits,
- a duty to make the trust property productive,
- a duty to pay income to the beneficiaries,
- a duty to deal impartially with beneficiaries,
- a duty to use reasonable care to prevent breach of the trust by co-trustees, and
- a duty to follow the direction of persons given control over the trustee.

What makes the State Land Trusts unique is not the specific duties which the trust managers are responsible for, but rather, how the duties may need to be applied given the nature of the trusts.¹¹

2.3. The trust manager – DNR

DNR was formed in 1957 by consolidating portions of several state agencies and boards— including the Commissioner of Public Lands, the Division of Forestry and the State Forest Board—to reduce costs, improve land management consistency, and apply professional management principles to trust management. As part of creating DNR, the legislature also created the Board of Natural Resources. The Board, made up of representatives of the trust beneficiaries, develops policy guidance for DNR’s land management and approves sales of valuable materials, such as timber, from the trust lands.

The formation of DNR provided a focus on trust lands management that resulted in a number of initiatives, such as sustained yield, application of intensive forest management, and the creation of the Resource Management Cost Account (see section 2.4). These innovations have resulted in a substantial increase in sustainable revenues to the beneficiaries that could not have been accomplished under the pre-1957 organization. It allowed resources to be shared and fixed costs to be spread over a larger organization thus reducing the costs and increasing net returns to the beneficiaries.

¹¹ See AGO 1996, No. 11, at 13-18 for a discussion on application of a trustee’s duties to state land trusts. This opinion is available at: http://www.atg.wa.gov/opinions/opinion_1996_11.html.

In addition to being the state trust land manager, DNR has other responsibilities, including service, resource protection and other General Fund responsibilities. DNR's variety of responsibilities reflects the agency's origins.

2.4 Funding Trust Land Management

Management of the Granted Lands and State Forest Lands is funded through two dedicated accounts—the Resource Management Cost Account (RMCA) and Forest Development Account (FDA), respectively. Collectively, they are referred to as the “management accounts.” The Legislature established the management accounts and appropriates monies from them to DNR through the state's biennial (and supplemental) budget processes.

The RMCA and FDA are revolving funds, in which a portion of gross revenue from the lands is deposited in the respective account. The expenditures from each account are used to pay for the costs of land management activities and investments to produce future revenues.

Both funds have built in checks and balances in that:

- (1) The Board of Natural Resources sets deductions up to the statutory ceiling, currently 25 percent (except for State Forest Purchase, which is 50 percent);
- (2) The Legislature sets maximum appropriation authority for each account; and
- (3) All monies appropriated for trust management must be spent solely for the benefit of the trust lands.

2.4.1. Benefits of Dedicated, Revolving Accounts

The dedicated, revolving accounts provide cash flow for ongoing management and long-term investments. Although both the RMCA and FDA expenditures must be appropriated, the availability of dedicated management funds gives DNR somewhat greater discretion in establishing long-range management programs for the lands because the legislature is not being asked to fund management from general state revenues. This was not always the case.

Prior to the 1957 creation of the Department of Natural Resources, all funds to manage federally granted lands were appropriated out of the state general fund. Reforestation and silvicultural investments for trust lands had to compete with the state's other needs for funding. To address the need for funding such investments, the legislature created the Resources Management Cost Account (RMCA) as a dedicated fund for managing the Granted Lands. The legislature directed that a percentage of the gross receipts from the lands (originally a maximum of 20 percent and increased to 25 percent in 1971) be placed in the RMCA to be used for “defraying the costs and expenses necessarily incurred in managing and administering all of the trust lands . . .”¹² The FDA serves a similar function for the State Forest Lands.

¹² RCW 79.64.030

RMCA and FDA funds are dedicated to the management and administration of the trust lands and are considered a trust asset and cannot be used for any other purpose unless the trust is compensated.

Beginning in the 1960s, Forest Development Fund (FDF – the precursor to the Forest Development Account) funds weren't adequate to meet the management needs of the State Forest Lands, while RMCA funds were in excess of those needed to manage Granted lands. The legislature authorized DNR to expend the two funds on the management of all State Trust Lands. RMCA funds expended on FDA lands were to be considered a debt against the FDA and FDA funds expended against the RMCA were considered a reduction in that debt. This debt together with interest has been repaid to the granted trusts.

2.4.2 Use of the Management Accounts

Management fund expenditures cover more than current management activities such as preparing and complying timber sales. They also cover an investment in the future that includes capital investments and long-term land management investments such as tree planting, thinning, fertilization and tree improvement.

Trust beneficiaries, both now and in the future, benefit from investments made in various land management activities, including timber sales, road access, forest inventory, irrigation development, asset repositioning, forest management practices, research, etc. Adequate management funds are needed to make new investments and protect the investments that already have been made.

3. Assets, Costs and Benefits

Much about trust land management has changed since statehood. Support for the beneficiaries of the Granted Lands now comes not from the sale of those lands but largely from timber sales, with some additional income increasingly coming from agricultural and grazing uses, mineral development, commercial leasing and the Trust Land Transfer Program¹³. Most State Forest lands, virtually stripped of trees when originally obtained, are producing valuable harvests of timber once again, providing revenues to the counties in which they are located. Some original trust assets have been exchanged for new ones. Changes to public policy have created new requirements, benefits and costs.

3.1 Trust assets – the land base

Most of the land DNR manages were originally acquired on a “where is, as is” basis. Washington State took title to assets that were identified by General Land Office coordinates, irrespective of their value or future use. Today, DNR-managed trust lands include mountaintops that are leased for use as telecommunication tower sites, agricultural lands, forestlands, commercial property and grazing lands. This size and diversity of this portfolio of lands is unlike the Federal Grant Trust assets managed by other states.

Upland trust assets are typically categorized as forest, agriculture or commercial properties. The commercial category includes both leased properties (including communication sites) and undeveloped lands in commercial or residential areas.

The following chart, Chart 3.1: Trust Acres by Asset Class shows the current (July 2004) distribution of the upland trusts, nearly 2.9 million acres.

3.1.1. The Deloitte & Touche Study – a Snapshot in Time of Asset Value

There has been only one comprehensive and systematic study of the trust asset value. Deloitte & Touche, LLP, was commissioned in 1995 to address concerns about the management and economic returns from trust lands. The study’s first phase assessment of DNR-managed lands and assets was a high-level economic overview designed to assess value and rates of return by various asset classes.

The assessment was created using existing DNR data from fiscal year 1995. It is a snapshot of fiscal year 1995 and should not be considered a trend indicator. Chart 3.2 –

¹³ For more information on the Trust Land Transfer Program see the 2003 Report to the Legislature available on the department’s web site at:

<http://www.dnr.wa.gov/htdocs/obe/reporttoleg/reportleghome.htm>

Trust Value by Asset Class, 1995 shows the summary values from the Deloitte and Touche study.

The Deloitte & Touche assessment is limited by conditions and assumptions that were necessary to complete the study. This study was general in nature, and was not based on an appraisal or financial audit. Return on investment was calculated on to the sum of both land appreciation and cash return. Also, rounded estimates and approximations were used.

Since 1995, the market in all asset classes has changed—most notably the timber market, which has dropped significantly since that time period. Also, the land base has continuously changed through a relatively active sale, exchange and purchase program. The report is a snapshot in time and does not show the long-term performance of each trust.

Major Findings of the Study – based on 1995 data

However, even as a snapshot, the study produced some major findings:

- 5 million acres of DNR-managed lands make up about 8.1 percent of the state's total land base (including nearly 2.6 million acres of submerged lands, more than 670,000 acres of retained mineral rights on lands no longer owned by the state and nearly 3 million acres of uplands).
- Natural Areas (these are not trust lands), some of the state's most ecologically significant lands, were estimated to be worth \$1.3 billion, based on *existence value*—just because the lands are there.
- Total return on investments for all trust assets, combining current income and land appreciation, was estimated to be 8.6 percent for fiscal year 1995. The Forest Resources asset class alone had an estimated return of 8.6 percent.
- Active non-market benefits from recreation opportunities and related activities were estimated to provide \$248 million of benefits to the state during 1995.
- Deloitte & Touche concluded that the value of all trust assets in 1995 was \$6.965 billion. The federally granted trusts and the State Forest together were valued at \$6.231 billion for 2.9 million acres.

Chart 3.1 Trust Acres by Asset Class as of July 1, 2004

Total 2,869 acres - Numbers in Thousands
 Data Source: DNR Transactions Section Data

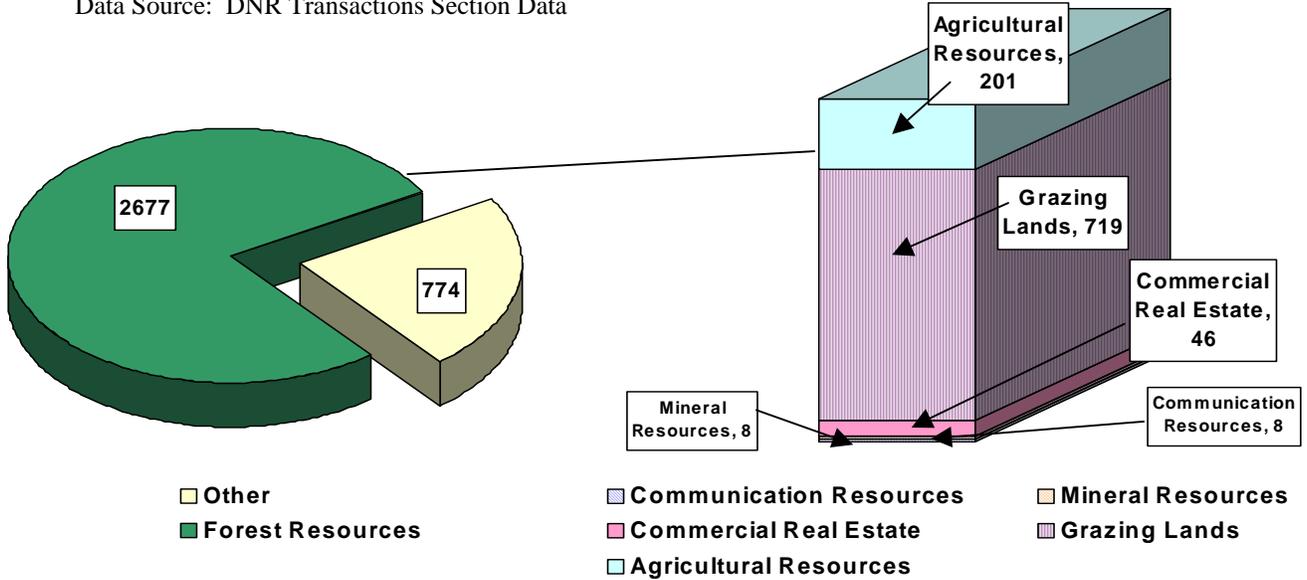
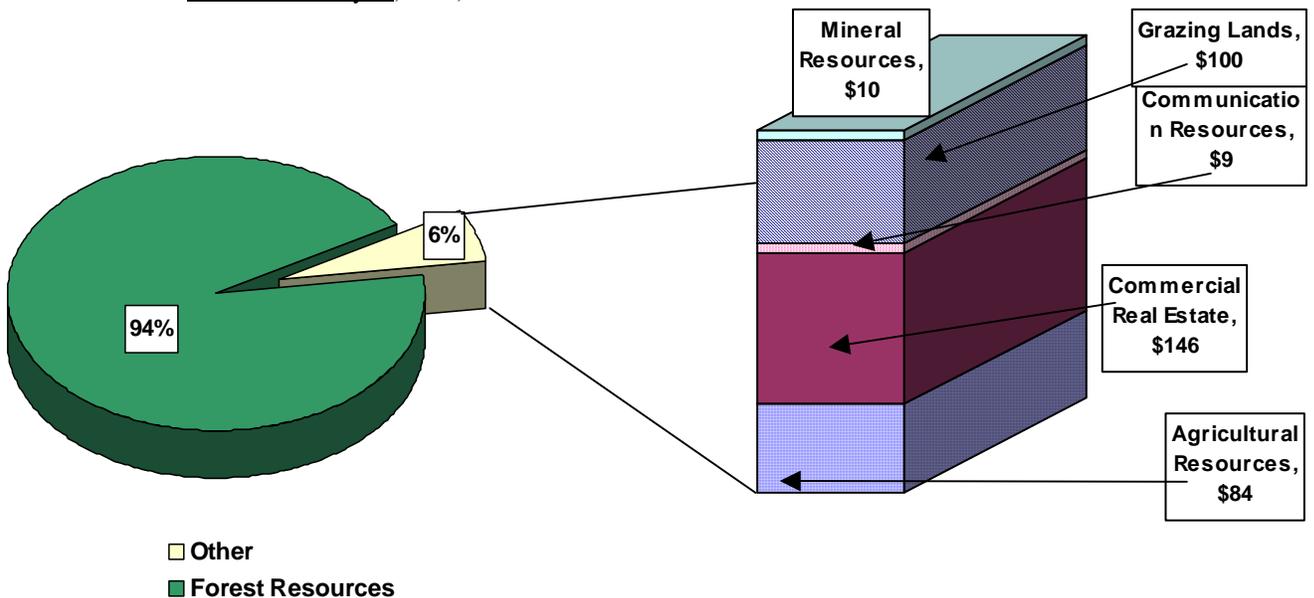


Chart. 3.2 Trust Value by Asset Class in \$\$ as of July 1, 1995

Total \$6,231 - Dollars in Millions
 Data Source: Economic Analysis, June, 1996 Deloitte & Touche



3.1.2 Repositioning Assets

Since the early 1960s DNR has actively sought to reposition trust assets through land exchanges. The chief purpose was to block up forestlands for more efficient management. The result was the creation of major forest blocks in western Washington, and the elimination of many scattered tracts.

In the late 1970's, the Land Bank was created, which provided a method to sell and replace trust land. In 1989, the Trust Land Transfer program was created, in which trust properties with significant ecologic, open space or recreation values are transferred to either natural area status or to other suitable governmental bodies; subsequently, productive replacement properties are purchased. This was followed by the Direct Transfer legislation in 1992, allowing for direct transfer to public entities for fair market value or direct sales to private individuals in the resolution of a real property trespass.

The original land base was scattered throughout the 16th and 36th Sections of the state. Since statehood, land exchanges and other land transactions have consolidated many of the trust lands into more manageable holdings. Since 1957, DNR has repositioned more than one million acres, resulting in better asset performance and reduced management costs.

3.2 Revenue, Expenditures & Fund Balances

Revenues, expenditures and management fund balances are tied together. The gross revenues from trust lands are appropriately distributed among the specific trust beneficiaries and the management funds. Fund balance depends on management fund revenues and expenditures. Expenditures provide for current and future revenue production, that supports current and future beneficiaries and trust management.

3.2.1 Management Revenues and Fund Balance

Since 1971, the maximum deduction for both the RMCA and FDA (except State Forest Purchase) has been at 25 percent. This amount was intended for long-term trust land management investments and to increase long-term trust revenues as well as to generate current revenue.. Management of these funds has been done on a cash flow basis.

DNR manages the fund balances of both the RMCA and FDA to maintain an operating reserve as a buffer against fluctuations in cash flows. This operating reserve has varied depending upon economic conditions (specifically timber markets), timing of major capital and/or operating expenditures, or other considerations. Expenditure from both management funds is fairly steady throughout each fiscal year, but revenue flows are relatively volatile given the nature of timber harvest activities on state trust lands and the timing of harvest and revenues there from.

The legislative biennial appropriations set the ceiling for DNR spending. However, the appropriations are not spending targets; DNR expenditures are frequently below appropriation levels due to fund balance and/or other considerations.

Resource Management Cost Account (RMCA)

WAC 332-100-040 governs RMCA revenue deductions and allows the Board of Natural Resources to set the deduction at any level up to a maximum of 25% of revenue from Federal Grant Lands. Board policy is to maintain a balance of at least 3-month operating expenditures. During the period 1978 through 1983 and in fiscal year 1988 the Board suspended deductions for some trusts for parts of or all these years due to RMCA fund balances in excess of those needed for operating expenses. In addition, the department has passed on excess balances in RMCA to trust beneficiary accounts. During the 1989, 1990 and 1993 legislative sessions, the Legislature authorized DNR to transfer \$50 million to selected beneficiaries direct from RMCA.

Forest Development Account (FDA)

During the 1990s, there was excess FDA fund balance. Options to reduce the fund balance were presented to the Board of Natural Resources, legislative staff and county beneficiary representatives during the mid-1990s. In February 1997, the Board adopted resolution #97-919 to reduce the deduction on forest board transfer lands to 22 percent effective July 1, 1997. When the Board made its decision, it was anticipated that revenues would gradually decline so that the fund balance would reach a level equal to six months operating expenses, at which time the percent deduction would be increased to the statutory maximum of 25 percent. During the 1998 legislative session there was a \$12 million transfer out of the FDA to the counties and other state funds to fund salmon restoration efforts.

3.2.2 Historical Patterns of Revenue and Expenditure

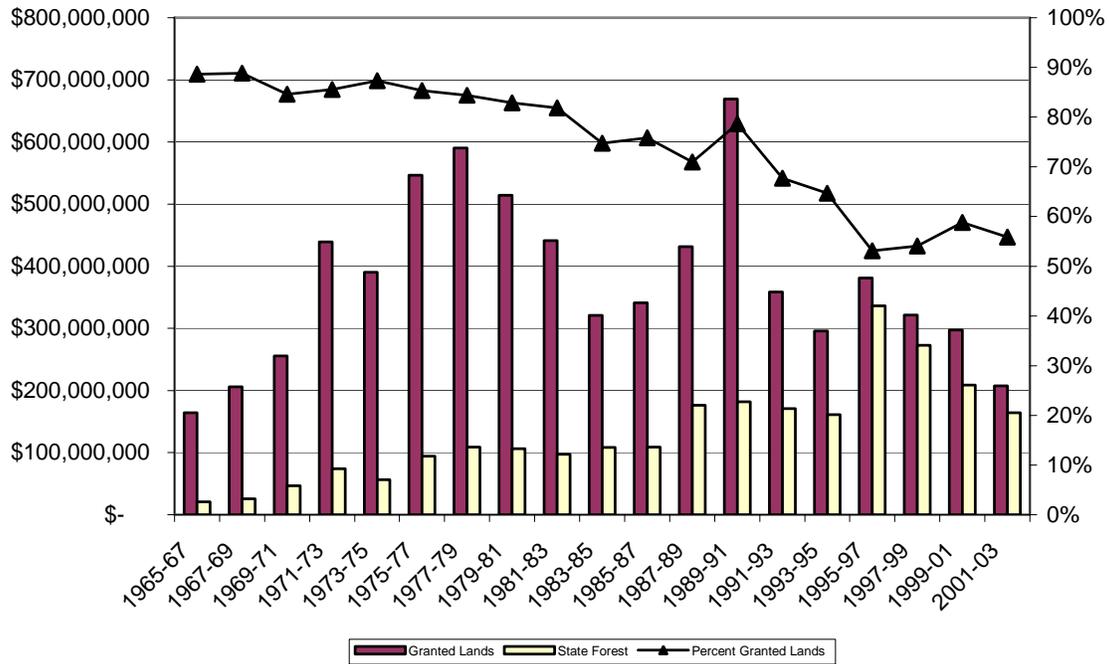
The graphs that follow (graphs 3.1-3.4) are based on data from DNR's Annual Reports.¹⁴ The data is grouped on a biennial basis to reflect the department's biennial planning budget.¹⁵ The graphs cover the 19 biennial periods from FY 1965-67 to FY 2001-03 or 38 years. All of the monetary data is shown in real terms, adjusted for inflation to 2003 dollars, allowing comparisons over time utilizing "real" costs and the current purchasing power of revenues.¹⁶

¹⁴ The department's Annual Reports are available on line for Fiscal Years 2000 through 2003 on line at: <http://www.dnr.wa.gov/base/publications/list.html>

¹⁵ The department's planning biennia is a 24-month period beginning on July 1 of odd numbered years through June 30 of the following odd numbered year. For example, the 2001-03 biennia covers the period from July 1, 2001 through June 30, 2003.

¹⁶ Fiscal Year Data from the annual reports was adjusted for inflation on a fiscal year bases to 2003 using the Consumer Price Index – All urban consumers (CPI-U - U.S. All items, 1982-84=100 - CUUR0000SA0) as published by the U.S. Department of Labor Bureau of Labor Statistics before the biennial numbers were compiled. <http://data.bls.gov/cgi-bin/surveymost?cu>

Graph 3.1 Real Revenue from DNR-Managed Trust Lands 2003 \$'s and Percentage of Revenues that Came from Federal Grant Lands 1965-2003

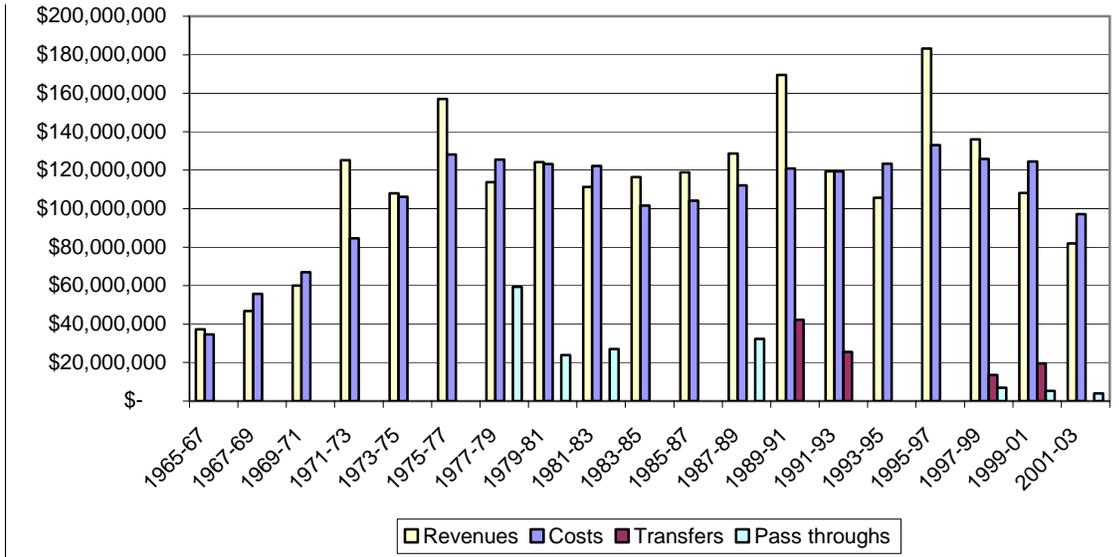


Real Revenues from Federal Grant Lands and State Forest Lands

Graph 3.1 shows total (real) revenue for 19 biennial periods. During this time, the state trust lands produced a total of \$9.7 billion dollars in 2003 purchasing power. Granted lands produced \$7.2 billion, an average of \$377 million per biennium, while State Forest Lands produced \$2.5 billion average of \$133 million per biennium. At the beginning of the period 90 percent of the revenue came from Federal Granted Lands. As the timber on State Forest lands has matured, the proportion of revenue from Federal Granted lands has fallen to about 65% and is anticipated to be 50% this biennium, 03-05.

- 2001-03 revenue reflects the lowest timber revenue since 1969-71.

Graph 3.2 Management Funds (RMCA & FDA) Revenue and Costs from all Trust Lands (in 2003 \$'s)



Management Fund Revenues and Expenditures

Graph 3.2 shows management funds (RMCA & FDA) Revenues and Costs from all Trust lands. It also shows transfers from the management funds to beneficiaries and pass-throughs (when the management fund deductions was suspended or reduced).

Total real revenues to the management funds for the 19-year period were \$2.2 billion, while costs were \$2.0 billion. The total difference for the period was \$142 million. The legislature transferred \$101 million out of the management funds to the beneficiaries. The remaining \$41 million represents the current fund balance and accumulated loss in purchasing power of holding the fund balance.¹⁷ In addition the department passed through to beneficiaries a total of \$159 million in real revenue by suspending or reducing the management fund deduction.

Expenditures for Management Funds

During the past three biennia, DNR has reduced real management fund costs by \$36 million (27 percent), from \$133 million in 1995-97 to 97.2 million in 2001-03. Had expenditures remained at the 1995-97 level, an additional \$51 million would have been spent. Over this same period real revenues fell by 101 million, or 55 percent.

In real terms: 2001-03 management fund revenue is the lowest since 1969-71. Costs are at the lowest levels since 1971-73. Costs have exceeded revenue in the last two biennia, despite recent cost reduction efforts, starting in 2001.

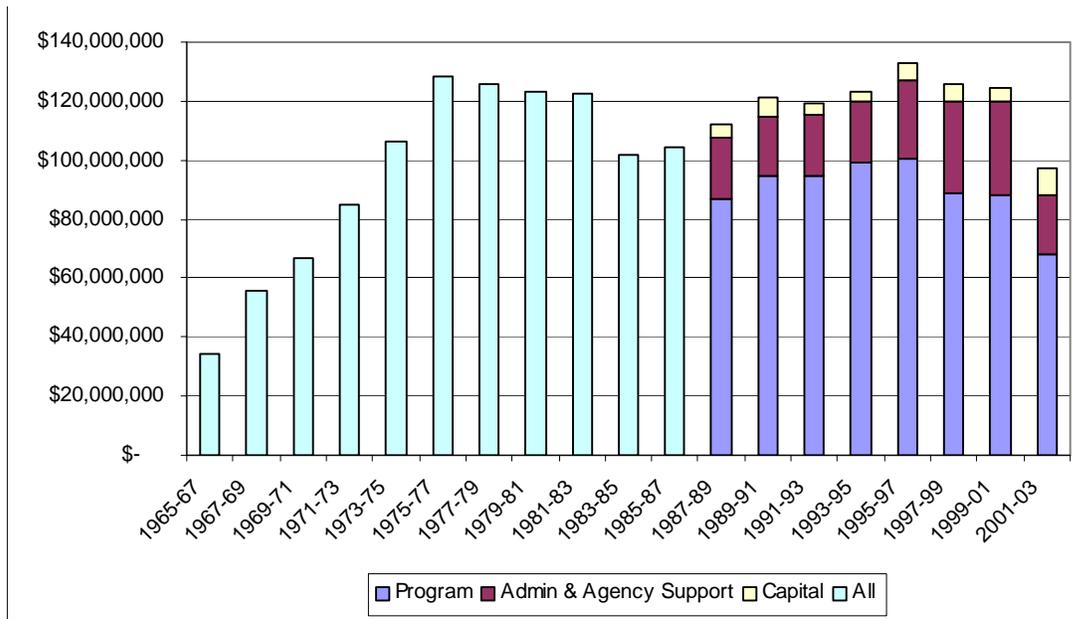
¹⁷ There has also been a cost in real terms due to the loss in purchasing power of the fund balance each year due to inflation.

Agency Allocation of Expenditures

Graph 3.3 shows the actual and percent of total management costs broken down by Administration & Agency Support, Capital Investments and Program costs. For 1987-89 through 2001-03 administration and agency support averaged 20 percent; capital, 4 percent; and program costs, 75 percent.

In 2001-03, expenditures for Administration & Agency Support were less than two-thirds what they were in 1999-0.

Graph 3.3 Management Funds (RMCA & FDA) Real Cost in 2003 \$s



3.3 Expenditure Controls

DNR's management fund costs remained well below 25 percent of gross revenues from 1972 through 1991-93. In 1993-95, costs reached 30 percent. Costs declined to below 20 percent in 1995-97 (due to a brief period of high timber prices), but increased markedly in each subsequent biennium.

In 2001-03, management costs exceeded revenues by five percent, despite the fact that DNR has focused significant attention since 2001 on reducing costs, through staff reductions, organizational changes, and performance goals, with the following results:

- RMCA expenditures in real dollar term, adjusted for inflation, are at the lowest level since 1969-71.
- Total state land management expenditures—sales, silviculture, leasing, etc.—are 26 percent below the level in 2001.
- Sales and leasing expenditures alone are 22 percent below the 2001 level.

- Total state land management staff numbers are 24 percent less than in 2001, down from 458 full time equivalents (FTEs) in 2001 to 339 in 2004.
- Timber sales productivity has increased 41 percent over the same period.
- Administrative services FTE expenditures have been reduced 14 percent since 2002, down from \$171 Million in 2001 to \$147 Million in 2004.
- Merged two Regional Offices, biennially saving about \$1 ½ million.

3.4 The Cost of Doing Business

The following table presents a comparison between the previous biennium (01-03) and the current biennium (03-05) for major categories of trust land management expenditures. It shows the direct programs for managing timber trust assets, the programs providing direct support, and the administrative and agency support program costs for both RMCA and FDA.

Table 7-1: FY 01-03 through 03-05 Comparison of Management Fund Expenditures (All values expressed to the nearest thousands of dollars and converted to 2003 dollars.)

	FDA	RMCA	01-03 Total	FDA	RMCA	03-05 Total
Direct Programs	\$17,992	\$20,604	\$38,596	\$19,322	\$18,967	\$38,289
Direct Support	\$11,177	\$16,316	\$27,493	\$11,935	\$15,389	\$27,324
Admin & Agency Support	\$8,701	\$13,521	\$22,222	\$10,487	\$13,041	\$23,528
Total Expenditures	\$37,869	\$50,441	\$88,310	\$41,744	\$47,397	\$89,141

The direct programs are timber sales, silviculture and science/HCP. The direct support programs include data stewardship, leasing & right-of-way, granting and acquisition, silviculture investment provided by inmates camps, land survey, agricultural management, asset management & transactions, seed orchard & seed plant, law enforcement, state lands support operations, natural heritage, public access management and forest roads. The administrative and agency support programs include commissioner’s office, budget and economic services, communications, human resources, financial management, information technology, region administration, geographic information services, facilities, interagency payments, environmental and legal strategies, and a mainframe system replacement to manage revenue and agreements. Interagency payments include DNR’s contribution to the state’s self-insurance revolving funds, rent on the capitol campus, and other government services shared by all agencies (i.e., legal services, audit services, archive services, telecommunication and information services, etc.). Administrative and agency support costs are shared by all funds managed by DNR, on a pro-rata basis, based on actual program expenditures

During the 01-03 biennium, fire suppression funds (from state general fund) were used to pay a proportionate share of administrative and agency support expenditures. The use of these monies for the same during the 03-05 biennium has not been allowed by the legislature, as reflected in agency appropriations. This has the effect of increased

administrative and agency support expenditures across all funds in 03-05 relative to 01-03.

3.4.1 Multiple Use Trust Land Management

DNR provides public access opportunities on State Trust lands as directed by the Multiple Use Act. Every year an estimated 9 million visits are paid to trust lands by hikers, hunters, trail riders, campers and others enjoy who recreating outdoors on DNR-managed lands. Public access on trust lands can be generally characterized as:

- *Land-based recreation* that is
- *Dispersed in nature* with
- *Primitive support facilities*, and an
- *Emphasis on trails*, within
- *Remote forested settings*.

On trust lands, there are 143 recreational sites and over 1100 miles of recognized trails. In addition there are countless dispersed opportunities (including an unknown amount of user-built trails in certain settings). In addition to campgrounds, picnic areas, and trails, the agency provides considerable public access along 13,000 miles of its forest road system. Most sites dedicated for recreational use are leased from the trust using GFS dollars or off road vehicle gas tax monies to compensate the trust. Maintenance and operational investments are made through grants, direct appropriation of nontrust moneys, and volunteer contributions.

The recreational use of trust lands has increased for many years. This has been particularly true as more private industrial forestland is closed to the public due to concerns about increased illegal activities and liability. Below are some statewide trends:

- State population doubled since 1950 and is expected to double again by 2050.
- ORV use is expected to increase by 20% over the next 20 years, and, the amount of available ORV trails is expected to stay static¹⁸.
- Equestrian use is expected to grow by 29% over the next 20 years.
- Hiking use is expected to grow by 34% over the next 20 years.
- Rapid growth of motorcycle and all-terrain-vehicle use.
- Annual expenditures of two billion dollars for hiking, fishing and viewing wildlife¹⁹.
- 1.1 million²⁰ people in Washington participated in wildlife viewing at least one mile from their home for 11.3 million days of viewing, feeding or photographing wildlife.
- 938,000 people fished for a total of 12.8 million days of fishing
- 227,000 people hunted for a total of 3 million days of hunting

Forestlands, especially, provide a unique experience of the outdoors that is rapidly disappearing from around urban and urbanizing areas. Any large landowner close to

¹⁸ State Comprehensive Outdoor Recreation Plan, or SCORP (IAC, 2002)

¹⁹ According to a study, “Adding it up – Washington communities profit from fish, wildlife recreation” (WDFW, 2002).

²⁰ “Survey of Fishing, Hunting and Wildlife Associated Recreation in Washington” (USFWS 2001).

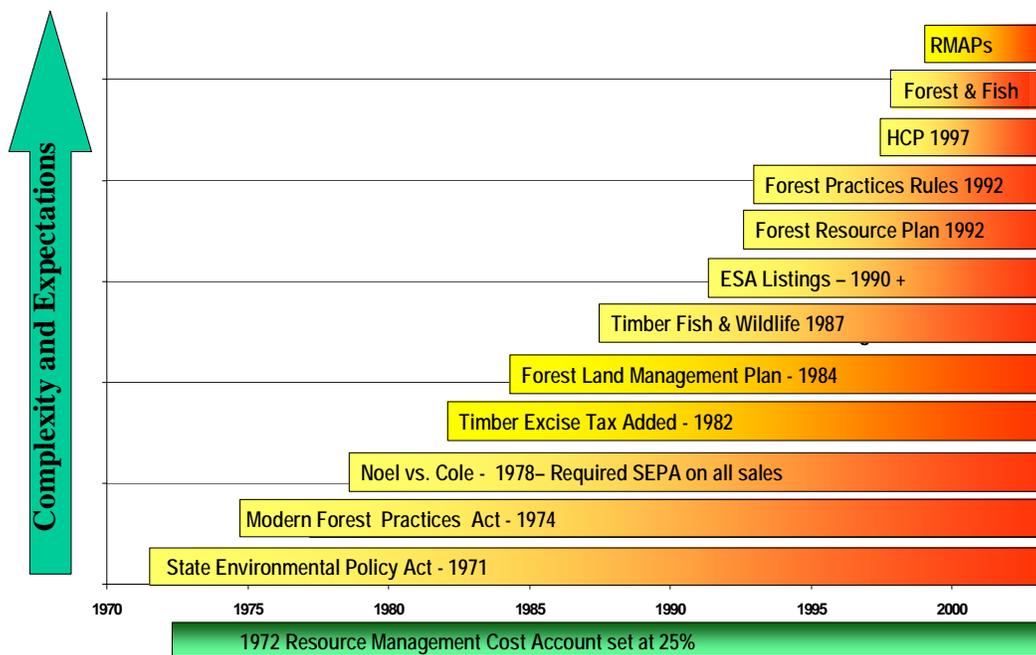
population, with easy access will experience heavy use, or illegal use that have both ecological and direct economic impacts to the land and timber. The cost of managing those impacts can be significant (gates, signs, garbage, meth labs, enforcement, etc.).

Public expectations of trust lands are not limited to their value as recreational lands. There are substantial expectations for scenic values, aesthetics, wildlife habitat and ecological services (such as watershed protection, flood abatement, clean air enhancement, noise abatement, etc.). The Multiple Use Act directs the trust lands to provide these services so long as they are not inconsistent with trust purposes.

As the state’s population increases and development has an impact on more of the natural environment, land managed for natural resources will become more critical to the health and maintenance of many native plant and animal communities.

Chart 3.3 Historical Evolution – Public Policy for Washington’s Trust Land Management

Changes in the Legal and Policy Environment



DRAFT: Subject to changes and amendments over time 08/26/02



3.4.2 Societal Changes

The Legislature comprehensively evaluated trust land investment needs in 1971. The Legislature concluded that increasing the investment rate from 20 percent to 25 percent was in the best interests of the trusts. The anticipated and realized result was an increase in net returns to the beneficiaries.

In the following three plus decades, a number of changes have occurred that affect the cost of doing business in Washington State. Some of the changes are due to differences in national and international macro-economic forces, such as timber prices. Other changes were made as public policy relating to trust lands and forest management evolved in Washington.

In spite of dramatic improvements in expenditure control and productivity gains over this period, and because of the reduced revenue and increased costs, the 25 percent deduction appears to be insufficient to fund necessary investments to realize the trust lands' full potential, either financially or ecologically, in the future.

4. The Future of Trust Forest Management

During the past half century, DNR's management of the forested state trust lands has evolved in an effort to develop productive forest resources for today and tomorrow.

The Washington State Legislature, as trustee, has directed that the forested trust lands be managed on a sustainable basis. Periodically, the Board of Natural Resources sets timber harvest levels to create what was envisioned as "sustained yield plans" as contained in RCW 79.10.310; here, the Legislature specified that the objective of the plan is "management of the forest to provide for harvesting on a continuing basis without major prolonged curtailment or cessation of harvest."

"The department shall manage the state-owned lands under its jurisdiction which are primarily valuable for the purpose of growing forest crops on a sustained yield basis insofar as compatible with other statutory directives. To this end, the department shall periodically adjust the acreages designated for inclusion in the sustained yield management program and calculate a sustainable harvest level." RCW 79.10.320

Timber sales are the chief source of trust revenue, providing on average about 85 percent of total revenue. Because most of the trust forests are located in western Washington (1.4 million of the 2.1 million acres), the sustainable harvest level for Westside trust forests is the key element in shaping future revenue, expenditures and fund balances.

4.1 Western Washington Sustainable Harvest Level Recalculation

For western Washington, the harvest levels have changed over time. The different levels are due to fundamental changes over time in how the forests in Washington State are managed. Since the 1970's forest management has undergone dramatic changes, incorporating the lessons of science and the ecological connectivity of forest habitat with water quality, species diversity and forest health regulations.²¹ The Board of Natural Resources has shifted policies to reflect these fundamental factors.

DNR recently recalculated the sustainable forest management harvest levels in western Washington. The process provided for unprecedented levels of public involvement, a Technical Review Committee and sophisticated computer simulations. It was supported by an Environmental Impact Statement, the first ever for a sustainable harvest calculation. The Final Environmental Impact Statement was published July 2004. Previous calculations used limited data and did not benefit from the computer simulations

²¹ Among the many laws of general applicability that govern state land management, of particular impact is the Washington Forest Practices Act/Rules and federal laws such as the Endangered Species Act.

and an environmental impact statement (EIS). The computer simulations were used to understand how different policies change forests over time and space; they also showed how forest ecology and forest revenues would change for the EIS alternatives.

Acting in their fiduciary capacity, the Board of Natural Resources carefully considered the following:

- Public comments on the Draft EIS;
- Public comments offered at regular monthly Board meetings;
- Public comments on the selection of a Preferred Alternative;
- Additional analyses provided by the DNR staff at board request; and
- The Draft and Final EIS analysis.

The Board adopted a harvest level that had a number of economic and ecological outcomes. However, funding the activities needed to implement the harvest level is at issue. Without adequate investments, to fund the projected activities, the prospective economic and ecological objectives will not be met. DNR’s analysis shows that given the current fund balances and revenue projections, there is not sufficient funding to support the needed investments.

4.1.1 Sustainable Forest Management Policy

The following are some of the major outcomes associated with a full implementation of Sustainable Forest Management, recently adopted by the Board.

Table 4.1 Economic and Ecological Outcomes for Sustainable Forest Management

Economic Outcomes	Ecological Outcomes
<ul style="list-style-type: none"> ▪ Marginal increase in net revenue returned to the beneficiaries by 2067: \$2.4 billion ▪ Marginal increase in net revenue returned to the beneficiaries first decade: \$0.3 billion ▪ Increase of two thousand jobs, first decade ▪ Forest inventory increase of 45% by 2067 ▪ ½ million acre increase “on-base” acres by the end of the first decade 	<ul style="list-style-type: none"> ▪ Old-growth habitat increases five-fold ▪ Spotted owl habitat increases 20% ▪ Improved stream ecology due to more fully functional trees in riparian management zones ▪ More watersheds with significant deer and elk foraging habit ▪ Ten percent reduction of unhealthy forests

Table Notes

1. All comparisons are against Alternative 1 (current practices).
2. Time comparisons generally reference today versus 2067, the nominal end of the HCP.
3. The net revenue assumes that 30% of gross revenue is required to produce the net revenue. The net revenue reflects all modeled activities necessary to produce the gross revenue.
4. What is commonly referred to as “old-growth” is referred to in the Final EIS as “fully functional”
5. “On-base” acres are actively managed to meet a variety of economic and conservation objectives as compared to “off-base” acres that are essentially unmanaged.

Table 4.2 summarizes and compares net revenue, volume of projected sales and harvest acres over a seven-decade period.

Table 4.2 Average annual net revenue (\$ millions), volume (millions of board feet, MBF) and harvested acres

All Trusts, All Revenue Sources	Decades						
	1	2	3	4	5	6	7
Net Revenue: Implementation	151	153	144	148	148	142	129
Westside Harvest (MBF): Implementation	597	574	531	539	547	543	499
Westside Area (1000s of acres): Implementation	20	18	16	18	18	20	19

Table Notes:

1. Revenues and Costs are based on 2003-04 values
2. These numbers are net returns to the beneficiaries. All management costs have been subtracted from gross revenues. Estimated management costs are about 30%.
3. Decade 7 is represented by four years, rather than a full 10 years. The analyses are focused on the initial life of the Habitat Conservation Plan (2067). While summary analyses are run beyond 2067, the data contained within this report is based on the more detailed analyses run through 2067. The first four years of decade 7 are annualized and projected for the remainder of decade 7.
4. The data is for all trusts.

For a more complete understanding of the environmental and economic outcomes, refer to the EIS and key DNR documents developed for the Board of Natural Resources. Go to www.dnr.wa.gov/htdocs/fr/sales/sustainharvest/sustainharvest.html for source documents.

4.2. Volume and Value from Timber – Statewide

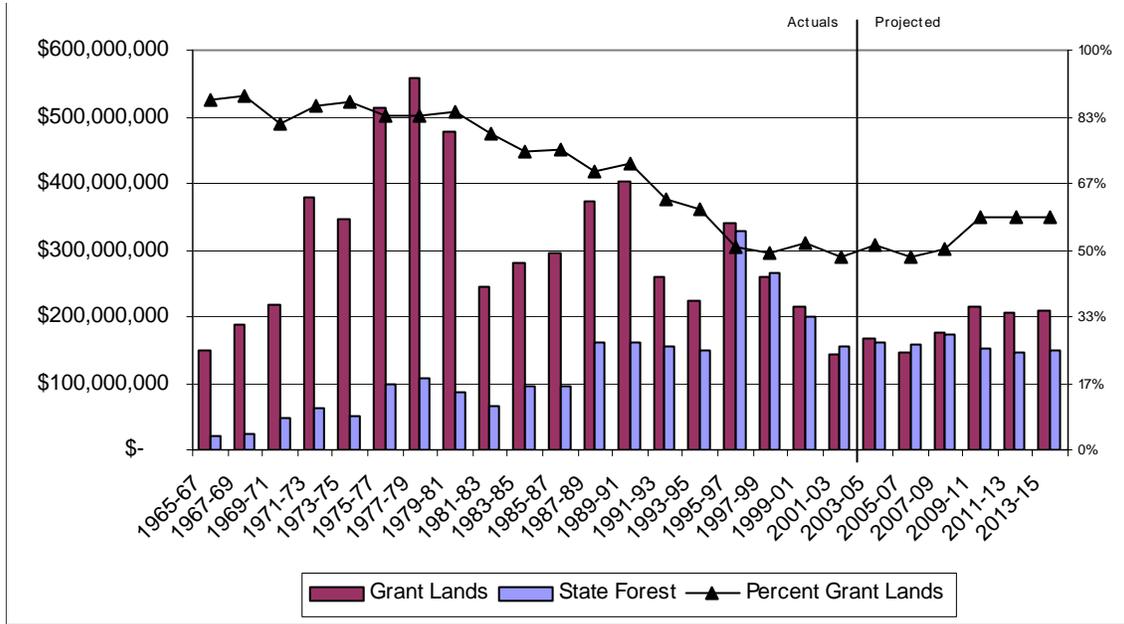
Timber harvested under the new Westside sustainable harvest level will become part of the larger, statewide picture of trust forest management. The following graphs are based on data from DNR's Timber Sales Management System, and provide both a historic view and projections for the future. The monetary values have been adjusted to 2003 dollars using the previously referenced Consumer Price Index.

Trends in Revenue from Timber (actual/projected)

Graph 4.1 shows actual and projected real revenue from timber removed from Granted and State Forest Lands. Real revenues from timber harvest are projected to increase as the new sustainable harvest is phased in, but still remain lower than level since the early 1970s.

- Total Revenues lowest since 1967-69
- Proportion of Federal Grant Land revenues falls from 88 percent to less than 50 percent.

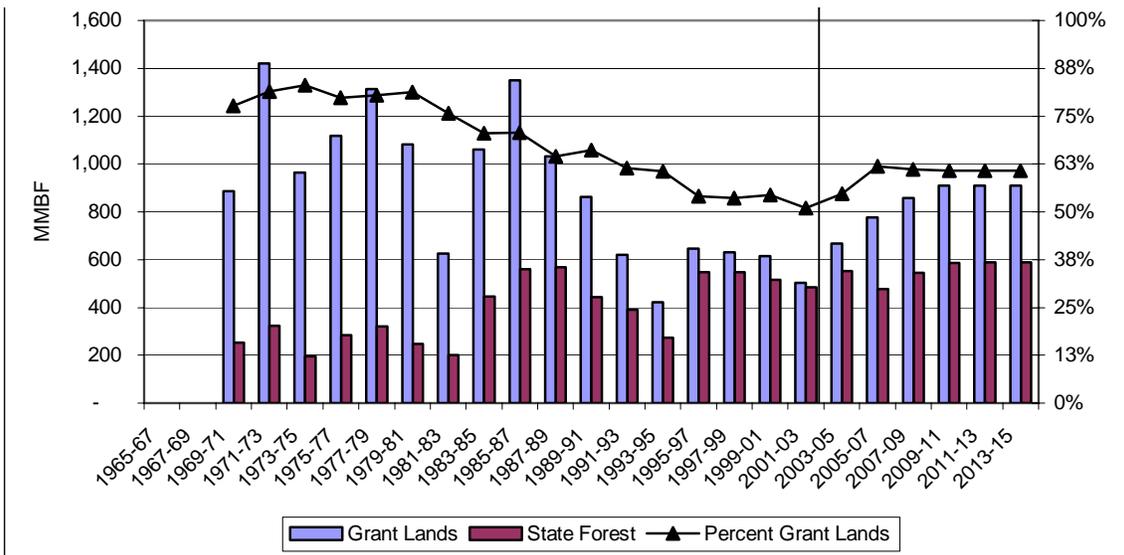
Graph 4.1 Revenue from Timber Removed from all Trust Lands Managed by DNR in 2003 \$'s



Graph 4.2 shows the volume of timber removed from Federal Granted and State Forest lands, and the percentage of the harvest that was from Federal Granted lands.

- 2001-03 harvest was second lowest in the last 19 biennia

Graph 4.2 Volume Removed from Federal Granted and State Forest

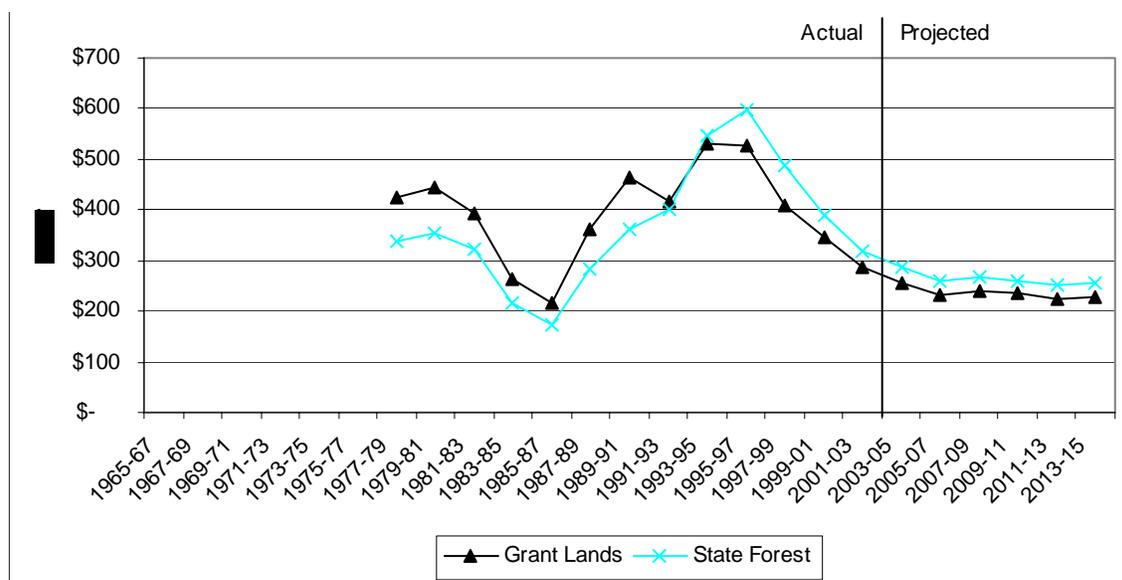


Graph 4.3 shows real removal prices (\$/mbf) from Granted and State Forest land.

- 44 percent drop in removal price since 2001-03
- Additional 20 percent drop by the end of the projection period

Removal prices from Federal Grant Lands were higher than those from State Forest lands prior to the 1993-95 biennia by about 20 percent because of the higher quality logs from older stands. Since the 1993-95 the prices from State Forest lands have been higher than those from Granted lands by about 12 percent. This price relationship is expected to continue in the forecast period.

Graph 4.3 Removal Value (\$/mbf) Federal Granted and State Forest in 2003 \$'s



4.3 Projections: Revenue, Expenditures and Fund Balance

The Resource Management Cost Account (RMCA) and the Forest Development Account (FDA) are the principal source of funds for trust land investments. The balance in these accounts serve as a “shock absorber” that offsets revenue volatility. Cash flows (timing of revenue into the accounts) are determined by a series of independent business decisions made by purchases on some 400-500 timber sales contracts over the two year life of the contract.

In 2001, Commissioner of Public Lands Doug Sutherland committed to carefully evaluate all options before considering an increase in funding. Subsequently, the DNR reduced expenditures and increased efficiencies; see sections 3.3.2 and 3.3 for more details. Since

1997, expenditures out of these funds to support trust management have exceeded revenue into the funds, and the fund balances continued to decline. The department has wrestled with the implications of a declining fund balance. Through cost control and skillful marketing – the point of exhaustion for the fund balances has been forestalled. However, despite those efforts, the costs and revenues have continued to work at cross-purposes, and fund balances are now projected to be depleted during the 2005-2007 biennium for the RMCA and 2011-2013 biennium for the FDA.

As DNR developed the new Sustainable Forestry EIS and evaluated the costs of the various alternatives, several issues became clear:

- Even without any changes to current policies or harvest levels, the costs of business were in excess of the revenue at 25 percent.
- Under any of the EIS Alternatives, the fund balances would decline and quickly go negative, something not permissible in state government.
- To prevent a negative fund balance, DNR would need to summarily curtail investments, causing a very large drop in revenue to the beneficiaries, including the State General Fund.
- As revenues collapsed, the ability to generate revenue would be significantly eroded; starting a “death spiral” as shrinking revenues provided less and less revenue for the beneficiaries.
- As an alternative to ever decreasing revenue, we found that significant increases in net revenue to the beneficiaries could be obtained from investment levels equivalent to a management percentage of about 30 percent of gross revenue.
- However, we also found that by investing at a level of cost equivalent to 30 percent of gross revenue, the beneficiaries would actually receive more revenue, even with a 5 percent increase in the management deductions. The ability to make those investments today is a critical component of sustainable harvest implementation.

4.3.1 The Funding Gap

There is a well-identified difference between the costs of doing business in this century and the revenue to fund investments that bring benefits both today and tomorrow. The magnitude of the gap will continue to increase unless one or more elements change.

The data in Table 4.3 shows the amount of money necessary to fund projected agency operations, both operating and capital budgets along with what is necessary to maintain minimum fund balances. Minimum fund balances are “prudent reserves”, set at 3 months average expenditures; these prudent reserves are minimum amounts necessary due to revenue-timing variability. The data are based on the current statutory authority that sets the RMCA and FDA rates at a maximum of 25 percent. The “Net Effect” columns identify the differences between management fund income and expenditures; this is a measure of cash flow in and out of the accounts and resultant fund balances. When the “Net Effect” is negative the result is a reduction in fund balance, creating a gap that, ultimately, can become quite large.

There are a number of possibilities to close the gap. They are not mutually exclusive and could include, but are not limited to the following:

- **Increase Land Management Revenue** – This could come from developing new market products or increased revenue from timber sales, leases or new revenue from commercial or agricultural lands;
- **Reduce Costs** – Further reductions in costs through increased efficiencies, staff reductions, process re-engineering or contracting; or
- **Increase the Management Fund Percentage** – Legislative action could increase the investment rates beyond their 1971 levels of 25 percent. Such a change could be of specific duration, subject to various reviews or other conditions.

Table 4.3 Biennial Cash Flow with the current Management Fund Percentage

Cash Flow based on the Sustainable Harvest Fund Balance Analyses	RMCA Expenditures	RMCA Revenue	Net Effect RMCA (Shortfall)	FDA Expenditures	FDA Revenue	Net Effect FDA Surplus/ (Shortfall)
6-30-03	(54,399.0)	52,533.5	(1,865.5)	(47,151.7)	59,301.7	12,150.0
6-30-05	(79,343.2)	54,051.2	(25,292.0)	(45,711.1)	53,050.0	7,339.0
6-30-07	(85,322.5)	66,000.0	(19,322.5)	(56,902.8)	59,850.5	2,947.7
6-30-09	(91,599.9)	79,381.4	(12,218.6)	(60,698.8)	54,284.5	(6,414.4)
6-30-11	(94,362.0)	81,756.5	(12,605.5)	(63,198.4)	52,596.7	(10,601.6)
6-30-13	(100,003.6)	87,462.0	(12,541.6)	(66,957.4)	56,371.4	(10,586.0)
6-30-15						

Assumptions:

1. Revenue assumes a 18 month contract period starting FY05. Effective removal rate; 1st yr = 41.7%, 2nd year = 54.2% and 3rd year = 4.1%.
2. Revenue estimates updated using September 2004 forecast (9/21/04).
3. RMCA revenue adjusted in FY04 to CAS Rpt and in FY05 to FB Rpt. In outlying years revenue fund split is 58.4%.
4. FDA revenue adjusted in FY04 to CAS Rpt and in FY05 to FB Rpt. In outlying years revenue fund split is 41.6%.
5. FYs 06, 07, 08 and 09 have been reconciled to the 5th quarter 2004 FB report for transition to model estimates.
6. Non-timber revenue average over period = \$27.7M per year, estimated using trend line analysis.
7. Non-timber revenue fund split = 92.6% RMCA and 7.4% FDA.

To help answer the question of what percentage would be necessary to fund the identified investments, two tables have been prepared. The Table 4.4 and Table 4.5 show projected fund balances, using a number of specific assumptions, including different percentages, identified with each table. All tables assume that the new sustainable harvest level 5.97 billion board feet of timber will be sold over the next decade. The DNR analyses show that the fund balance model to be very sensitive to timber prices. A change in timber prices by only 10 percent, something that is historically moderate and often have been larger (see Graph 4.3), can change the overall management fund balance in 2015 by about plus or minus \$ 50+ million.

Table 4.4 assumes that the management fund percentage stays at 25 percent. Under the assumptions listed, the fund balance in the RMCA drops into the negative by the end of the 05-07 biennium, and the FDA is negative three biennia later. This calculation assumes the FDA percentage deduction automatically increases to the statutory ceiling of 25 percent in when the fund balance falls below the three-month operating minimum. Negative fund balances of any amount are not permissible legally, suggesting that some combination of the following must happen:

- New cost savings or substantial increase in efficiency;
- Increase in revenue into the management funds, not associated with a percent increase; and/or
- Increase the management fund percentage.

Table 4.5 shows the assumed management fund percentage necessary to stabilize the fund balance. It is a variable rate for both RMCA and FDA and stages the management fund deduction carefully to allow for the necessary investments through time. If the management fund percentage is increased as part of the solution, these numbers should be considered a ceiling only and could be changed within that level by the Board of Natural Resources if unforeseen events occur.

In this example, RMCA deduction is 35 percent for the 05-07 biennium only, dropping to 30% in the outlying years. The FDA is stable at 30 percent from the 05-07 biennium forward. For the purposes of this review, however, the management fund balance percentage should be seen as a surrogate for the amount of cash or efficiencies necessary to produce the 5.97 billion board feet of timber sales and perform the other major statutory duties and meet the major Board policy objectives.

Table 4.4 Sustainable Harvest (dollars in thousands)

Sustainable Harvest Fund Balance Report	RMCA: 25%		FDA: 22-25%	
Actual Balance @ 6-30-03	9,151.7		25,805.0	
<i>minimum fund balance (operating 3-mo RMCA and 6-mo FDA)</i>	<i>6,058.2</i>		<i>9,370.3</i>	
Revenue 03-05 (FY04 CAS Rpt + FY05 FB Rpt)	49,783.0		42,867.0	
Operating Expenditures 03-05 (Adjusted for FY04 phase 2)	(51,210.0)		(44,556.0)	
Capital Expenditures 03-05	(3,189.0)		(827.0)	
Transfers (included in FY04 actual revenue)				
Projected Balance @ 6-30-05	4,535.7		23,289.0	
<i>minimum fund balance (operating 3-mo RMCA and 6-mo FDA)</i>	<i>6,401.3</i>		<i>11,139.0</i>	
Revenue 05-07	54,051.2		40,900.0	
Operating Expenditures 05-07	(72,927.5)		(49,812.5)	
Capital Expenditures 05-07	(3,701.0)		(811.0)	
Projected Balance @ 6-30-07	(18,041.5)		13,565.5	
<i>minimum fund balance (operating 3-mo RMCA and 6-mo FDA)</i>	<i>9,115.9</i>		<i>12,453.1</i>	
Revenue 07-09	66,000.0		52,511.5	
Operating Expenditures 07-09	(80,742.6)		(55,463.4)	
Capital Expenditures 07-09	(3,603.0)		(733.0)	
Projected Balance @ 6-30-09	(36,387.2)		9,880.7	
<i>minimum fund balance (3-month operating)</i>	<i>10,092.8</i>		<i>6,932.9</i>	
Revenue 09-11	79,381.4		51,336.7	
Operating Expenditures 09-11	(85,374.0)		(58,502.0)	
Capital Expenditures 09-11	(5,647.0)		(1,817.0)	
Projected Balance @ 6-30-11	(48,026.8)		898.4	
<i>minimum fund balance (3-month operating)</i>	<i>10,671.8</i>		<i>7,312.8</i>	
Revenue 11-13	81,756.5		52,596.7	
Operating Expenditures 11-13	(90,631.8)		(62,007.2)	
Capital Expenditures 11-13	(3,073.0)		(753.0)	
Projected Balance @ 6-30-13	(59,975.1)		(9,265.1)	
<i>minimum fund balance (3-month operating)</i>	<i>11,329.0</i>		<i>7,750.9</i>	
Revenue 13-15	87,462.0		56,371.4	
Operating Expenditures 13-15	(96,209.4)		(65,725.6)	
Capital Expenditures 13-15	(3,097.0)		(767.0)	
Projected Balance @ 6-30-15	(71,819.5)		(19,386.2)	
<i>minimum fund balance (3-month operating)</i>	<i>12,026.2</i>		<i>8,215.7</i>	

Assumptions:

1. Revenue assumes a 18 month contract period starting FY05. Effective removal rate; 1st yr = 41.7%, 2nd year = 54.2% and 3rd year = 4.1%.
2. Revenue estimates updated using September 2004 forecast (9/21/04).
3. RMCA revenue adjusted in FY04 to CAS Rpt and in FY05 to FB Rpt. In outlying years revenue fund split is 58.4%.
4. FDA revenue adjusted in FY04 to CAS Rpt and in FY05 to FB Rpt. In outlying years revenue fund split is 41.6%.
5. FYs 06, 07, 08 and 09 have been reconciled to the 5th quarter 2004 FB report for transition to model estimates.
6. Non-timber revenue average over period = \$27.7M per year, estimated using trendline analysis.
7. Non-timber revenue fund split = 92.6% RMCA and 7.4% FDA.
8. Expenditure fund split is 55% RMCA and 45% FDA for sustainable harvest transition costs.
9. Expenditure fund split is 60% RMCA and 40% FDA for current base operating and inflation.
10. Management rates for the decade are: RMCA = 25% and FDA = 22% thru FY07 and 25% the rest of the decade.
(The contribution from forest board purchase to FDA is approximately 1.5% annually.
For model purposes the 1.5% is added to the management rates for forest board transfer as mentioned above).
11. FTE 5-year ramp-up as follows: FY05 = 21.4, FY06 = 14.6, FY07 = 30, FY08 = 29.4 (per SL Div's).
12. Capital per recommended 10 year capital plan (05-07 thru 13-15).
13. Includes negotiated COLA rate of 3.2% in FY06 and 1.6% in FY07.

**Table 4.5 Sustainable Harvest Level Variable Management Rate (see table note #10)
(dollars in thousands)**

Sustainable Harvest Fund Balance Report		
	RMCA	FDA
Actual Balance @ 6-30-03	9,151.7	25,805.0
<i>minimum fund balance (operating 3-mo RMCA and 6-mo FDA)</i>	<i>6,058.2</i>	<i>9,370.3</i>
Revenue 03-05 (FY04 CAS Rpt + FY05 FB Rpt)	49,783.0	42,867.0
Operating Expenditures 03-05 (Adjusted for FY04 phase 2)	(51,210.0)	(44,556.0)
Capital Expenditures 03-05	(3,189.0)	(827.0)
Transfers (included in FY04 actual revenue)		
Projected Balance @ 6-30-05	4,535.7	23,289.0
<i>minimum fund balance (operating 3-mo RMCA and 6-mo FDA)</i>	<i>6,401.3</i>	<i>11,139.0</i>
Revenue 05-07	78,350.2	40,900.0
Operating Expenditures 05-07	(72,927.5)	(49,812.5)
Capital Expenditures 05-07	(3,701.0)	(811.0)
Projected Balance @ 6-30-07	6,257.5	13,565.5
<i>minimum fund balance (operating 3-mo RMCA and 6-mo FDA)</i>	<i>9,115.9</i>	<i>12,453.1</i>
Revenue 07-09	86,063.0	52,511.5
Operating Expenditures 07-09	(80,742.6)	(55,463.4)
Capital Expenditures 07-09	(3,603.0)	(733.0)
Projected Balance @ 6-30-09	7,974.8	9,880.7
<i>minimum fund balance (3-month operating)</i>	<i>10,092.8</i>	<i>6,932.9</i>
Revenue 09-11	92,082.4	61,022.9
Operating Expenditures 09-11	(85,374.0)	(58,502.0)
Capital Expenditures 09-11	(5,647.0)	(1,817.0)
Projected Balance @ 6-30-11	9,036.2	10,584.6
<i>minimum fund balance (3-month operating)</i>	<i>10,671.8</i>	<i>7,312.8</i>
Revenue 11-13	94,837.5	62,520.6
Operating Expenditures 11-13	(90,631.8)	(62,007.2)
Capital Expenditures 11-13	(3,073.0)	(753.0)
Projected Balance @ 6-30-13	10,169.0	10,345.0
<i>minimum fund balance (3-month operating)</i>	<i>11,329.0</i>	<i>7,750.9</i>
Revenue 13-15	101,456.0	67,007.6
Operating Expenditures 13-15	(96,209.4)	(65,725.6)
Capital Expenditures 13-15	(3,097.0)	(767.0)
Projected Balance @ 6-30-15	12,318.5	10,860.0
<i>minimum fund balance (3-month operating)</i>	<i>12,026.2</i>	<i>8,215.7</i>

Assumptions:

- Revenue assumes a 18 month contract period starting FY05. Effective removal rate; 1st yr = 41.7%, 2nd year = 54.2% and 3rd year = 4.1%.
- Revenue estimates updated using September 2004 forecast (9/21/04).
- RMCA revenue adjusted in FY04 to CAS Rpt and in FY05 to FB Rpt. In outlying years revenue fund split is 58.4%.
- FDA revenue adjusted in FY04 to CAS Rpt and in FY05 to FB Rpt. In outlying years revenue fund split is 41.6%.
- FYs 06, 07, 08 and 09 have been reconciled to the 5th quarter 2004 FB report for transition to model estimates.
- Non-timber revenue average over period = \$27.7M per year, estimated using trendline analysis.
- Non-timber revenue fund split = 92.6% RMCA and 7.4% FDA.
- Expenditure fund split is 55% RMCA and 45% FDA for sustainable harvest transition costs.
- Expenditure fund split is 60% RMCA and 40% FDA for current base operating and inflation.
- *Management rates for 03-05 biennium: RMCA = 25% and FDA = 22%, for outlying years RMCA as follows; 05-07 biennium 35%, 07-09 biennium 32%, FY10 thru FY15 = 29%. For outlying years FDA as follows; 05-07 biennium 22%, 07-09 biennium 25%, FY10 thru FY15 = 30%.
(The contribution from forest board purchase to FDA is approximately 1.5% annually.
For model purposes 1.5% is added to the management rates for forest board transfer as mentioned above).
- FTE 5-year ramp-up as follows: FY05 = 21.4, FY06 = 14.6, FY07 = 30, FY08 = 29.4 (per SL Div's).
- Capital per recommended 10 year capital plan (05-07 thru 13-15).
- Includes negotiated COLA rate of 3.2% in FY06 and 1.6% in FY07.

DNR performed a number of sensitivity analyses on key assumptions. While differing reasonable assumptions on salaries and rates of inflation did have some impact on the fund balance, it was found that the timber price assumptions are the most important. The timber price assumptions are based upon the September 2004 DNR Revenue Forecast. The forecast uses outside specialists to analyze price trends. In 2015, the management fund balance would drop \$55 million if timber prices were consistently 10 percent below forecast assumptions; correspondingly, if the timber prices were to increase 10 percent, the management fund balance would be \$50 million higher than that calculated using the (control) assumptions in the September 2004 Revenue Forecast.

Understanding how the management fund balance can change is an important consideration, strongly supporting its historical role as “shock absorber”. The Board of Natural Resources has the authority to adjust the percentage withheld, up to the statutory ceiling; this discretionary authority is critical, allowing investments to either increase or decrease depending on actual market phenomena.

4.4 Conclusions

4.4.1 What’s at Stake

In September 2004, the Board of Natural Resources adopted a new sustainable harvest level, and directed an active management approach to developing healthy habitat in order to achieve the following benefits for the beneficiaries, for the public, and for the environmental health of the state.

- Increase in revenue to the beneficiaries, see table 4.6, below;
- Five-fold increase in older forest habitat;
- 20 percent increase in northern spotted owl habitat; and
- Improved stream ecology that provides better habitat for salmon and other fish.

Table 4.6 Comparison of Total Revenue at two different time periods

Gross Revenue	No Action	Board Action September 2004	Difference: Board - No Action
First Decade Total Revenue	\$ 1.66 billion	\$ 2.08 billion	+ \$ 0.42 billion
Total Revenue through 2057	\$ 9.85 billion	\$ 12.84 billion	+ \$ 2.99 billion

The Board’s action is a balance that generates revenue for schools and counties, creates healthy ecosystems and provides benefits for all the people of Washington. Collectively, the action meets the important goal of leaving state forest ecosystems healthier and more diverse than they are today.

These benefits are substantial. As noted by Dr. Bruce Bare, University of Washington Dean of the College of Forest Resources and Board member, “Guided by environmentally and economically sustainable forest policies and practices, we initiate a new style of active stewardship to meet the needs of society today as well as generations to follow.” While some would believe that increasing environmental

protection and increasing net revenue are mutually exclusive, DNR's experience and analyses show that both are simultaneously possible.

This forward looking approach to stewardship and its many benefits that can sustain our state for decades to come, will only be realized if we invest in achieving them today. We will not realize that sustainable future unless we take the steps necessary to secure it now.

4.4.2 The Central Issue

DNR's objective is to increase net returns to the beneficiaries while providing the environmental benefits identified in the Habitat Conservation Plan, the Forest Resource Plan and the newer policies and directions established by Board's sustainable harvest decision. As identified in Section 4.3, the nature and amount of activities for "active stewardship" will cost more than current operations. Even with the additional timber sales, the costs exceed the revenue into the Resource Management Cost Account (RMCA) and the Forest Development Account (FDA).

The analyses show that our costs, on a real dollar basis, are the lowest since 1971, the date when the Legislature last adjusted the percentage rates (to a maximum of 25 percent for the RMCA and FDA). In 1971, timber sales prices were more than 70 percent greater than they were for the last biennium. The central tension is that we are experiencing a market driven phenomenon where timber, the dominant revenue source that represents 85 percent of upland revenue is not following the previous long-term price appreciation patterns. The forecast²² is for flat or declining prices with increased production costs.

4.4.3 Consequences

The outcome is that the fund balances will drop dramatically. Recently, the fund balances have declined. Even with the previously identified substantial increases in efficiencies and reductions in costs, the costs of doing business in this century are in excess of the cash flow at the 25% rate. Because deficit spending is not permitted in state government, expenditures would have to be materially reduced. The very direct result is an accelerated reduction in revenue to the beneficiaries. The downward spiral would be abrupt, disrupting the productive capacity of the trusts, both from economic and ecological viewpoints.

²² See Appendix A – Analysis of Current and Expected Stumpage Trends

Appendix A

Analysis of Current and Expected Stumpage Trends

Department of Natural Resources
Jon J. Tweedale

Executive Summary

The sale of timber provides the single largest return²³ from trust land management. Understanding the anticipated price trends is key to evaluating what is a market driven phenomenon and how land management options rise or fall with the market. Over the next decade the trend in DNR real (adjusted for inflation) timber prices (stumpage) is expected to be flat with nominal prices increasing at about the rate of inflation. Actual prices in any given year are expected to deviate around this trend, as it has historically, based on demand and supply conditions. Fewer supply shocks are expected than have occurred in the past two decades, as world supply is dominated more by plantation and second growth sources rather than natural and old growth sources of supply.

The fundamental drivers of price include supply, and demand. Demand is driven by housing starts, which in turn is driven by interest rates and demographics. Although housing starts are expected to moderate from current levels they are not expected to drop significantly, as the echo-generation and continued high immigration levels provide the need and low interest rates by historic standards provide affordability.

Supply will be the moderating factor on stumpage price over the next decade. Supply is expected to be in balance with higher demand as increased areas of plantation and second growth forests reach harvestable ages. With demand and supply in balance, no structural changes are foreseen that would materially change or disrupt the current price structure.

Given the reasonably anticipated market dynamics, the DNR concludes that prices will likely remain stable in real terms unless there is some unforeseen market shock that materially alters supply or demand.

²³ In real 2003 dollars, timber has returned \$8.5 billion during the period fiscal years 1966 through 2003; this is 88% of total upland trust revenue for this period.

Global and Economic Influences on DNR Stumpage

The global and U.S. economy are in recovery from a short but relatively stagnate recessionary period. This recovery has been bolstered by an extraordinarily loose monetary and fiscal policy resulting in record low interest rates. Growth has been broad-based with increased business investment, manufacturing base improvements and consumer spending increasing. At the same time employment has improved significantly from a year ago. Historically low interest rates have helped fuel both new housing investment and re-investment into the forest products sector. While current historically low rates are expected to rise, average interest rates during the next decade are expected to be below average levels experienced over the past two decades, both in real and nominal terms.

Forest Products Demand Influences

China and Japan (second highest forest products consuming region) and Western Europe (third highest) have all shown signs of improvement, with Western Europe lagging China and Japan. Improvement in these regions has caused a shift in foreign exchange favoring imports of forest products into Japan, China, and Western Europe. While products from Scandinavian countries and Canada have flowed into the US in recent years, the near-term foreign currency valuations favoring Japan and Western Europe have dampened these flows.

U.S. housing starts have lowered somewhat but are expected to remain well above baseline levels during the next decade. Average square footage of new homes is expected to continue to increase over the decade while substitution of non-wood products for wood products is expected to slow, although the substitution of composite wood products for solid wood products is expected to continue. The resulting growth in US lumber demand is expected to exceed growth in the overall economy.

In the last decade, the forest product industry has been plagued by low product prices and oversupply of raw material, thus depressing profits and timber prices. Recent economic improvement, demand improvement and a balancing of supply with demand have all contributed to an increase in lumber, log and stumpage prices from years past. Prices have improved on DNR nominal stumpage by 4% per year for the last two years²⁴.

Although the forest products industry is currently enjoying strong base economic price support with adequate supplies, recent reports by Resource Information System, Inc.²⁵ and Clear Vision both expect the industry fundamentals of low interest rates and robust housing to turn negative briefly in 2005. Current low product prices have bolstered mills to increase productivity and increase supply and capacity, thus dampening any upward volatility in lumber prices that have traditionally dominated these markets.

²⁴ FY 02 \$264, FY 03 \$276, FY 04 \$288 Source DNR timber sales reporting system average sales price statewide.

²⁵ Either in footnote or the text, note what these two companies are so that a less informed reader can understand their “standing”

Structurally, no major stresses on supply or demand warrant any fundamental shifts in anticipated pricing over the next decade. Although the recent increases are welcomed, they are more likely an upward correction from artificially low stumpage prices due to excess supply and do not signal any upward trend in real stumpage prices.

Region Marketing (Supply and Demand)

Timber markets in Washington State have seen dramatic increases and decreases due to the influx of both lumber and logs from British Columbia. Although B.C. logs have historically been seen as an unreliable source, questions remain as to the long-term impacts from both the lumber trade dispute and B.C.'s focus to harvest insect damaged timber exceeding current mill capacity in the interior B.C. The volume made available for export is Douglas fir but is characterized as Rocky mountain Douglas-fir which has different wood properties than West Coast Douglas-fir. Most of this production will be going into North Idaho and Northwestern Montana where severe shortages are already taking their toll on available mill capacity.

Lumber prices have moved from their high position and are expected to trend lower due to seasonal influences².

The DNR enjoys a market reputation of providing a stable supply of high quality timber from trust lands that produces high value end use products.

Stumpage prices for timber from trust lands is constrained by the inability to compete in the open market; current federal law eliminates direct access to export log markets, but indirect participation comes in the form of end-users exporting some manufactured product over-seas. This indirect access to overseas markets is shrinking as U.S. lumber exports have fallen significantly over the past two decades and are not expected to recover. The log export restrictions also prohibit firms that export logs from bidding on trust timber for domestic production.

Recent DNR Timber Stumpage Trends

Average DNR timber sales prices, for Fiscal Year 2005 to date, are up (10%) over prices during the same period last year. This follows a two-year period, in which nominal DNR sales prices have increased by 4% per year. The current plateau of prices is not expected to increase or decrease significantly in the near-term and over the next decade in real terms.

The five-year outlook for Coastal saw-timber demand has improved. Saw-timber demand is not expected to decline to the lows of the last five years. Sawmills have invested heavily in new and improved capacity, making producers in this region more competitive with their rivals in other regions².

RISI reports that a large portion of the western saw-timber resource is now composed of younger, smaller-diameter timber. Much of the older second-growth forests on private ownership in the west have been harvested, while those on federal lands are unavailable

for harvest. Increased levels of growth in Western Douglas-fir plantations will be seeded in the next 5 years bring additional small-diameter timber volume to the market.

Finally, RISI reports that regulatory influences will reduce the operable inventory by approximately 3 percent over the next five years.

References

Clear Vision Associates, Timber and Wood Products Outlook, June 2004

Resource Information Systems, INC. (RISI), North American Timber Forecast,
April 2004S

Appendix B

Questions Raised by Trust Beneficiaries in Meetings Regarding the Independent Review Committee²⁶

Washington State School Directors Association (WSSDA)

- How do other state land offices manage trust lands for their beneficiaries without a management fee?

Higher Ed — University of Washington; Washington State University; The Evergreen State College; Eastern, Western, and Central Washington universities; and the Council of Presidents

- What is the volume that would need to be harvested to avoid further budget reductions?
- What are the environmental benefits? Are the trusts paying for these? Should the trust be funding benefits that exceed the trust benefits?
- Comment: we're bothered by an increase above the 25% management fee.
- How does the 25% rate compare with how forest-lands are managed elsewhere around the country?
- Will the timber inventory be increasing during the sustainable harvest period?
- What is the plan for how the additional management funding would be spent?
- What does status quo look like?
- What is the increased expense needed to produce increased revenue?
- How will costs to produce other benefits beyond regulatory requirements be covered?
- Community college trust—What new lands have been purchased? How was the money spent? Where did it go? What happened to the management fund?
- Would it be better to just “take the money and run?”

Capitol Building Trust

- What is the additional increment of work that causes the costs to go up? What is the cost driver?

²⁶ Note: These are preliminary and partial. It is anticipated that the beneficiaries will pose additional questions.

DNR Briefing Material - Volume 2

October 2004

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Contents

INTRODUCTION.....	5
1. REVENUE TO BENEFICIARIES	6
1.1 Distribution of trust land revenue to beneficiary accounts.....	6
1.1.1 Permanent Fund Distribution.....	6
1.1.2 Capital Fund Distribution	7
1.1.3 County Taxing Districts Distribution.....	8
1.1.4 Permanent Funds.....	10
1.2 Trends of trust land revenues to the beneficiaries.....	10
1.3 Proposed increase in management funds compared to annual beneficiary funding from trust accounts.....	13
2. LANDS AND RESOURCES	15
2.1 Total trust land inventory	15
2.1.1 Forest Inventory	16
2.1.2 Use of an Appropriate Land Classification.....	16
2.2 Forest productivity – a measurement of tree growth potential.....	19
2.3 Diversification – trust land transactions and improvements to the asset base	20
3. DNR MANAGEMENT COSTS	23
3.1.1 Legislative Allocation.....	23
3.1.3 Allocation of Management Funds Within DNR	26
3.1.4 The “Trust Land Management” Component of the Management Fund Allocation	27
3.1.5 The “Administration” and “Payment to Other Agencies” Component of the Management Fund Allocation.....	28
3.1.6 Allocation of Management Funds for Public Access and Recreation	29
3.2 How the proposed increase in management funds would be spent to carry out the Board of Natural Resources' direction	30
3.3.....	31
The relation of fund balance trends to volume trends projected for the future	31
3.4 Reductions already made	33
3.4.1 Impact of Cost Savings	34
4. OTHERS' COSTS	35
4.1 Comparability and data availability	35
4.2 Private sector comparisons	36

4.3 Comparisons with other states.....	38
4.4 Comparison with Grays Harbor County.....	40
5. COST CENTERS FOR ENVIRONMENTAL COMPLIANCE	42
5.1 Comparing DNR to other landowners	42
5.2 Estimated results.....	43
6. POSSIBLE COST SAVINGS	44
6.1 Savings and technology improvements.....	44
6.2 Savings and merging trusts.....	45
6.3 Other major barriers to realizing significant savings	45
7. INFLUENCES ON TIMBER PRICE	46
7.1 Effects from imports of Canadian wood.....	46
7.2 Effects from changes in wood processing technology.....	46
7.3 Effects from more active, targeted marketing of timber products from trust lands... 47	
Customer Outreach	47
Internal Training and Scheduling.....	47
Contract Harvesting Program	47
8. OTHER REVENUE SOURCES.....	48
8.1 Potential from lands near the I-5 corridor	48
8.2 Potential for wind farms and other revenue sources DNR is pursuing	48
8.3 Potential for further reductions in rotation age.....	51
8.4 Potential for short rotation hardwoods.....	52
8.5 Potential for seeking voluntary payment of some management costs by private companies.....	52

Introduction

This volume (Vol. 2) of briefing materials for the Independent Review Committee focuses on information that answers questions and requests from the trust beneficiaries. Related information is grouped together in the following sections:

1. Revenue to Beneficiaries
2. Lands and Resources
3. DNR Management Costs
4. Others' Costs
5. Cost Centers for Environmental Compliance
6. Possible Cost Savings
7. Influences on Timber Prices
8. Other Revenue Sources

Some of the information is presented as text, but much of it is in charts, tables and diagrams (all labeled as "figures"). To assure readability of these figures in limited space, the following abbreviations have been used.

Ag. School	Agricultural School Trust
CEP& RI	Charitable, Educational, Penal and Reformatory Institution Trust
Univ.	University Trust
EWU	Eastern Washington University
WWU	Western Washington University
CWU	Central Washington University
TESC	The Evergreen State College
UW	University of Washington
WSU	Washington State University

1. Revenue to Beneficiaries

This section focuses on information to help answer the following questions and requests:

- Provide detail on how trust land revenue is distributed to the various beneficiary accounts.
- What have been the trends of the trust land revenues to the beneficiaries? Particularly what has been the trend of the trust land revenue to the common school construction account in comparison with the total state share of school construction funding?
- What is the size of the proposed increase in management funds in comparison to annual beneficiary funding from trust accounts?

1.1 Distribution of trust land revenue to beneficiary accounts.

The Department of Natural Resources (DNR) manages eight granted trusts and the state forestlands (two classifications). Revenue earned from the management of these lands is, in general, distributed in three different ways: a) to permanent funds, b) to capital funds, and c) to county taxing districts. Individual variations by trust, directed by law, add to the complexity of distributing and reporting revenue activity to the trust beneficiaries.

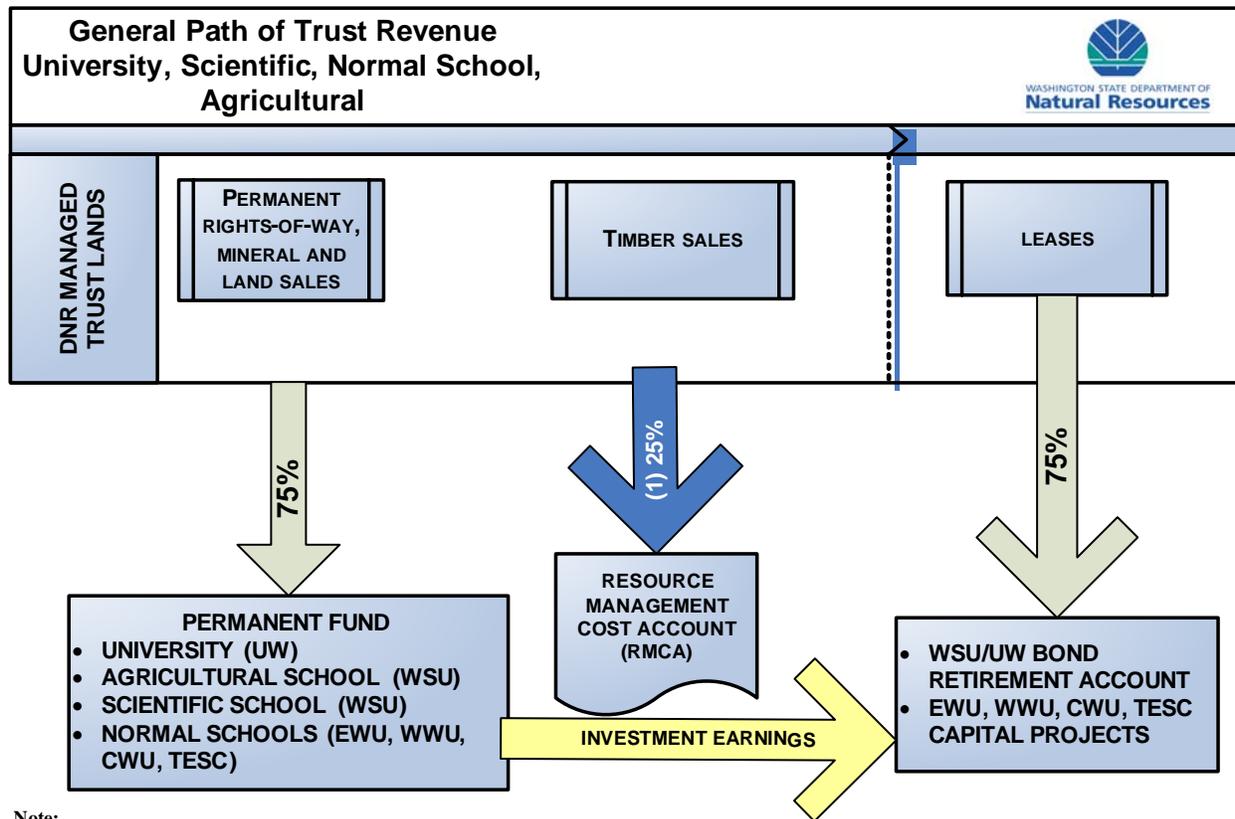
1.1.1 Permanent Fund Distribution

Seventy-five percent (75%) of revenue earned on the four permanent fund trusts (University-UW; Scientific-WSU; Agricultural-WSU; Normal Schools-EWU, WWU, CWU, TESC) generally is distributed to the four permanent funds (see section 1.1.4). The State Investment Board (SIB) invests the permanent funds and distributes investment earnings revenue to the UW and WSU Bond Retirement Accounts and to the four normal (regional) schools capital projects accounts. Revenue from leases on these trust lands goes directly to the bond retirement and capital project accounts. One notable exception is that mineral lease revenue is distributed to the respective bond retirement or capital project accounts, while mineral royalties are distributed to the respective permanent funds.

Generally, twenty-five percent (25%) of earned revenue goes into the Resource Management Cost Account (RMCA) to manage these trust lands. None of the gross revenue of the Agricultural trust is deducted for management. Therefore, it does **not** contribute to the RMCA. The state general fund, through the Agricultural College Trust Management Account, covers the costs of managing the Agricultural college trust lands.

See figure 1.1, next page.

Figure 1.1 General Path of Trust Revenue – University, Scientific, Normal School, and Agricultural



Note:

- (1) 100% of the agricultural school trust revenue goes directly to the permanent fund or the WSU bond retirement account; management costs are paid by the general fund.
- (2) Revenue from university transfer lands (formerly CEP&RI) are distributed in the same manner as CEP &RI with the UW bond retirement account as the receiving fund.

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Subject to changes and amendments overtime.

October 15, 2004

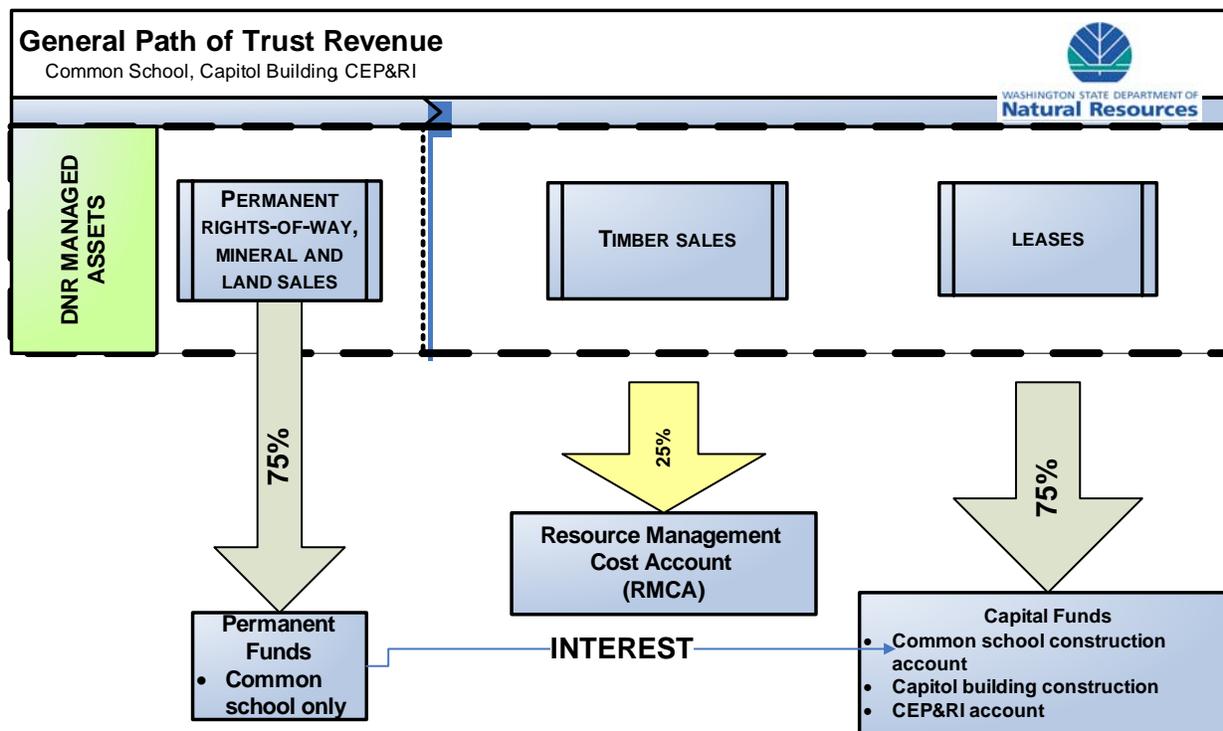
1.1.2 Capital Fund Distribution

The three capital fund trusts are the Common School, Capitol Building, and Charitable, Educational, Penal and Reformatory Institutions (CEP&RI) trusts.

Seventy-five (75%) of the timber and lease revenue earned on these three trusts goes directly to the capital construction budget accounts associated with the trust. The exception is the Common School trust where revenue earned from the sales of minerals, permanent rights-of-way, or land goes into the Common School permanent fund. This is a minimal amount: \$525,000 in FY03 or less than one percent.

Twenty-five percent (25%) of revenue earned from these trusts goes into the RMCA for the management of the trusts.

Figure 1.2 Non-University Trusts



Note:
 Capitol Building trust and CEP & RI do not have a permanent fund; revenue is distributed directly to their capital accounts .
 Subject to changes and amendments over time.

October 15, 2004

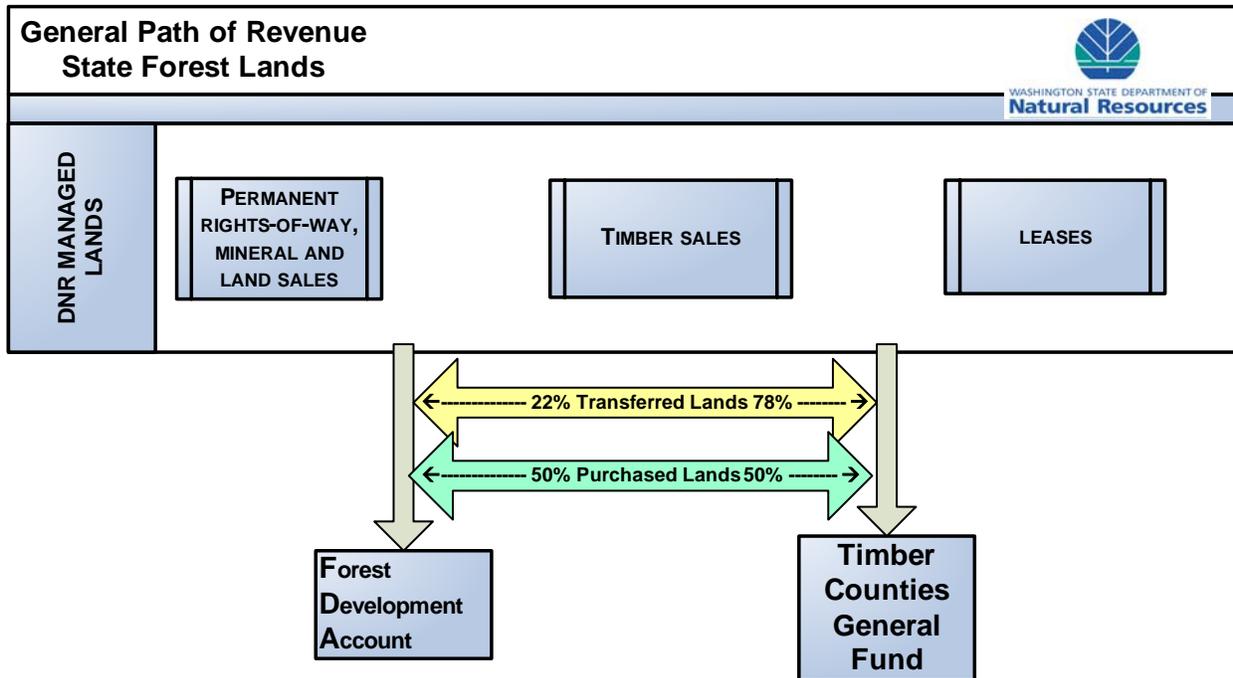
1.1.3 County Taxing Districts Distribution

There are two categories of state forestlands – forest board transferred and forest board purchased. In fiscal year 2003 nearly 71 percent of revenue earned on state forestlands went to county government and junior taxing districts in the counties in which the forest was located. Five percent went directly to the state general fund and 24 percent went to the Forest Development Account (FDA) for the management of these lands. The state general fund portion on purchase lands is distributed directly by DNR, while the county receives the state general fund share from transfer lands initially (per statute), and re-distributes this amount back to the state twice each year.

Forest board transfer: 78% to counties; 22% to FDA. The amount going to FDA will increase to 25% when the fund balance drops below six month operating expenses. Revenue to the Forest Development Account is currently 22% for Forest Board Transfer lands. Per BNR resolution #97-919 it will increase to 25% when the fund balance falls below the 6 month operating level.

Forest board purchase: 26.5% goes to counties; 23.5% to the state general fund; and 50% to the FDA (per statute).

Figure 1.3 General Path of Revenue – State Forest Lands



Note:

Revenue to the management fund, FDA, is currently 22% of forest board transfer lands. It will automatically increase to 25% when the fund balance drops below the 6-month operating reserve.

Subject to changes and amendments overtime.

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October 15, 2004

1.1.4 Permanent Funds

As figures 1.1 and 1.2 show, some revenue generated from the granted lands goes into permanent accounts.

There are five permanent funds managed by the State Investment Board for the benefit of the trustees. The SIB distributes investment earning from the permanent funds to the UW and WSU Bond Retirement Accounts, the EWU, WWU, CWU, and TESC capital project accounts, and the Common School Construction Account.

The five permanent funds and their market value as of June 30, 2004 are:

- Agricultural Fund (WSU) \$148 million
- Scientific Permanent Fund (WSU) \$162 million
- State University Fund (UW) \$ 25 million
- Normal School Fund \$208 million
- Common School Fund \$168 million

1.2 Trends of trust land revenues to the beneficiaries

Total revenue of the trust has varied over time, especially as timber prices and volume have fluctuated. The following two figures show total revenues earned by the trusts and their distribution over time.

Figure 1.4 Total Trust Revenues: 1972 - 2004

Table 1. Total Trust Revenues for Fiscal Years 1972 through 2003.

Fiscal Year	Total Granted Trusts Revenues wo/TLT	Total Forest Board Revenues	Total Upland & Aquatic Revenues	
			Total Forest Board Revenues wo/TLT	Total Upland & Aquatic Revenues wo/TLT
1972	42,167	6,741	48,908	49,761
1973	61,372	10,739	72,111	72,930
1974	57,681	7,651	65,331	66,186
1975	51,957	8,257	60,214	61,152
1976	62,307	11,831	74,138	75,284
1977	114,833	18,546	133,379	134,796
1978 2/	96,401	17,821	114,222	116,301
1979 2/	127,188	23,542	150,730	153,273
1980 2/	144,319	28,890	173,209	175,454
1981 2/	93,167	20,869	114,035	116,997
1982 2/	140,453	24,096	164,550	168,220
1983 2/	96,121	27,670	123,791	126,490
1984	89,246	25,687	114,932	118,263
1985	95,835	33,369	129,204	132,161
1986	98,525	29,007	127,532	130,991
1987	109,203	35,709	144,912	148,776
1988 2/	129,110	52,283	181,393	186,446
1989	157,617	59,764	217,380	223,047
1990 4/	261,081	65,898	326,979	333,205
1991 4/	219,552	59,817	279,369	285,739
1992 4/	131,238	58,470	189,708	197,015
1993 3/, 4/	146,726	70,364	217,090	227,274
1994 4/	93,614	48,517	142,131	155,361
1995 4/	150,397	75,514	225,911	235,949
1996 5/	159,592	132,019	291,611	303,731
1997 5/	171,416	142,643	314,059	328,036
1998 2A/, 4/, 5/	138,026	104,410	242,436	255,971
1999 2A/, 4/, 5/	152,563	128,135	280,698	294,345
2000 2A/, 4/, 5/	152,040	103,799	255,839	272,611
2001 2A/, 4/, 5/	130,682	83,888	214,570	227,725
2002 2A/, 4/, 5/	100,162	75,869	176,032	191,944
2003 2A/, 4/, 5/	106,972	78,248	185,219	203,548
2004 2A/, 4/, 5/	115,832	94,236	210,068	227,806

2004 values are preliminary and subject to change!

Notes: Values expressed in thousands of dollars.

Source: DNR Annual Financial Reports (without any CPI-U inflationary adjustments)

Uplands RMCA excludes Aquatic Lands and Land Bank; FDA excludes Land Bank.

2/ Deduction suspended from some trusts for all or parts of these years.

2A/ Per BNR resolution 97-919 the deduction on forest board transfer revenues was reduced to 22% effective July 1, 1997 (fiscal year 1998)

3/ Uplands RMCA Excludes \$5.9 million transfer from Park Land Trust Revolving Account to repay Land Bank.

4/ Beginning in fiscal year 1990, the Legislature has provided for the transfer of Common School trust lands for special lands protection and for transfer to State Parks.

5/ Includes pro rata share for TESC Capital Projects account effective fiscal year 1996.

Figure 1.5 Distribution of Revenues from Trust Lands – 1972-2004

Revenues for Management Funds (FDA, RMCA) and for Current and Permanent Funds within each upland Trust for Fiscal Years 1972 through 2004.

Fiscal Year	Management Funds 1/		Common School, Indemnity and Escheat Trusts		Agricultural and Scientific Trusts			University Trust		Normal School Trust		C.E.P. & Trust Account	Capitol Building Trust Construction	Forest Board Counties	Total Granted Trusts Revenue wo/TLT
	Forest Development Account	Resource Management Cost Account	Common School Construction	Common School Permanent	S.U. Bon Retiremen	College Permanent	Scientific Permanent	J.W. BonC Retirement	University Permanent	EWU, CWU, WU, TESC, Normal School Permanent	Capitol Projects Permanent				
1972	1,750	10,289	19,833	733	69	791	216	3,595	365	59	3,900	575	1,743	4,991	42,167
1973	2,804	15,020	30,668	518	100	2,011	1,481	3,981	64	88	3,453	789	3,199	7,935	61,372
1974	2,003	14,086	29,288	777	121	1,772	3,061	4,295	12	81	2,055	614	1,519	5,647	57,681
1975	2,144	12,670	29,208	522	174	542	605	3,015	74	155	1,537	468	2,987	6,113	51,957
1976	3,065	15,153	31,785	1,144	184	238	1,510	6,227	113	122	2,414	984	2,434	8,766	62,307
1977	4,795	28,420	60,655	770	147	788	1,906	9,988	240	118	6,672	1,730	3,399	13,750	114,833
1978	4,655	21,502 2/	51,383	606	136	1,924	4,953	7,095	217	97	4,709	1,015	2,764	13,166	96,401
1979	6,082	10,517 2/	83,280	541	204	3,099	2,670	10,428	126	134	7,653	2,157	6,379	17,460	127,188
1980	7,238	28,079 2/	84,864	823	427	3,531	1,820	12,080	93	345	3,480	970	7,806	21,652	144,319
1981	4,988	13,864 2/	60,062	1,161	673	2,815	1,713	5,807	62	551	3,147	814	2,498	15,881	93,167
1982	8,524	20,472 2/	93,374	1,120	1,125	4,350	3,531	5,726	124	858	4,385	862	4,527	15,573	140,453
1983	8,163	21,326 2/	48,435	898	304	3,638	3,238	8,063	83	188	5,003	3,021	1,923	19,507	96,121
1984	8,116	22,576	43,321	810	238	2,166	2,569	3,871	425	57	7,784	1,820	3,608	17,571	89,246
1985	11,339	23,541	50,030	1,013	193	1,037	417	6,483	90	45	5,563	2,688	4,735	22,030	95,835
1986	8,216	24,635	54,837	998	184	1,937	1,500	3,396	472	35	4,790	1,476	4,266	20,791	98,525
1987	12,498	27,282	54,126	919	301	951	2,512	8,909	129	132	8,275	2,541	3,128	23,211	109,203
1988	16,772	12,609 2/	84,741	1,081	342	3,402	3,526	11,951	17	156	5,144	2,352	3,789	35,511	129,110
1989	18,840	37,932	86,090	1,172	281	3,882	3,484	6,410	1,387	120	6,480	3,270	7,108	40,924	157,617
1990	20,014	49,841	160,609 4/	1,073	390	6,239	6,754	7,934	-140	100	8,464	9,274	10,543	45,884	261,081
1991	17,791	33,456	147,444 4/	476	870	1,872	4,152	13,471	-456	588	5,773	5,571	6,334	42,026	219,552
1992	16,565	31,639	69,328 4/	534	335	4,335	2,898	4,435	849	49	7,226	4,614	4,996	41,905	131,238
1993	19,256	31,057 3/	90,457 4/	505	413	1,625	3,600	3,755	641	83	5,504	3,365	5,720	51,108	146,726
1994	13,971	24,630	50,927 4/	552	476	943	2,367	2,384	387	82	3,478	5,020	2,368	34,546	93,614
1995	23,130	30,681	95,486 4/	587	242	1,882	6,225	4,525	1,029	115	2,265	2,583	4,776	52,385	150,397
1996	36,061	42,097	84,824	787	471	5,484	6,961	1,810	2,139	107 5/	4,495	5,455	4,962	95,958	159,592
1997	38,879	43,870	84,408	992	452	4,445	7,950	2,534	2,790	95 5/	3,658	12,907	7,315	103,764	171,416
1998	25,728 2A/	34,284	70,790 4/	3,548	549	3,800	7,137	1,454	1,206	69 5/	3,316	5,547	6,327	78,682	138,026
1999	30,751 2A/	34,097	86,631 4/	817	525	3,832	7,549	1,829	1,982	74 5/	3,439	4,461	7,327	97,384	152,563
2000	25,023 2A/	31,896	90,179 4/	1,054	476	2,871	5,218	288	844	64 5/	5,397	5,386	8,369	78,776	152,040
2001	19,717 2A/	24,276	83,469 4/	743	580	1,400	4,517	1,147	573	101 5/	4,331	3,321	6,224	64,171	130,682
2002	18,737 2A/	22,476	52,897 4/	124	1,120	1,556	4,092	514	857	62 5/	4,102	4,602	7,759	57,133	100,162
2003	20,060 2A/	19,622	67,350 4/	525	643	2,628	3,348	780	85	58 5/	2,544	4,075	5,313	58,188	106,972
2004	23,554 2A/	23,471	68,260 4/	506	835	3,643	3,250	572	435	65 5/	3,211	5,981	5,604	70,681	115,832

2004 values are preliminary and subject to change!

Notes: Values expressed in thousands of dollars.

Source: DNR Annual Financial Reports (without any CPI-U inflationary adjustments)

1/ RMCA excludes Aquatic Lands and Land Bank; FDA excludes Land Bank.

2/ Deduction suspended from some trusts for all or parts of these years.

2A/ Per BNR resolution 97-919 the deduction on forest board transfer revenues was reduced to 22% effective July 1, 1997 (fiscal year 1998)

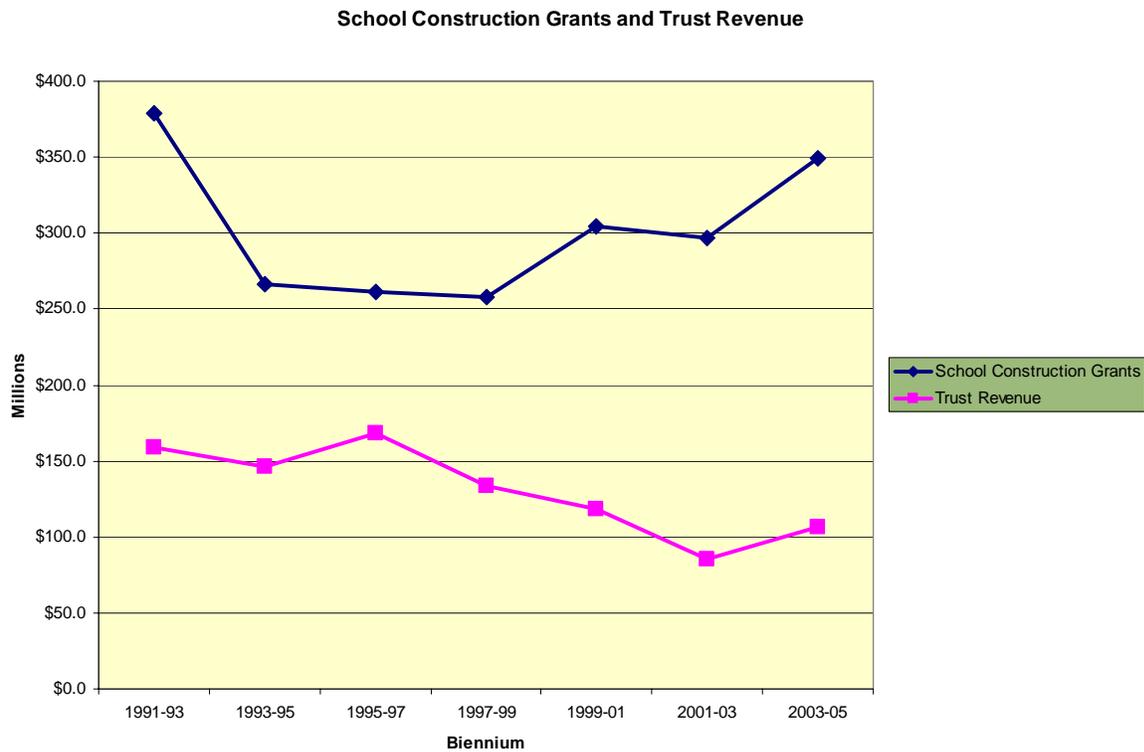
3/ Excludes \$5.9 million transfer from Park Land Trust Revolving Account to repay Land Bank.

4/ Beginning in fiscal year 1990, the Legislature has provided for the transfer of Common School trust lands for special lands protection and for transfer to State Parks.

5/ Includes pro rata share for TESC Capital Projects account effective fiscal year 1996.

Figure 1.6 shows how the capital needs have varied over the last 14 years. The revenue from trust lands has provided significant offset of tax dollars for school construction that would have otherwise come from the general fund. During this period trust lands have contributed between 28 and 64 percent of the state funding for school construction.

Fig. 1.6 Revenue to the common school construction account compared with the total state share of school construction funding grants.

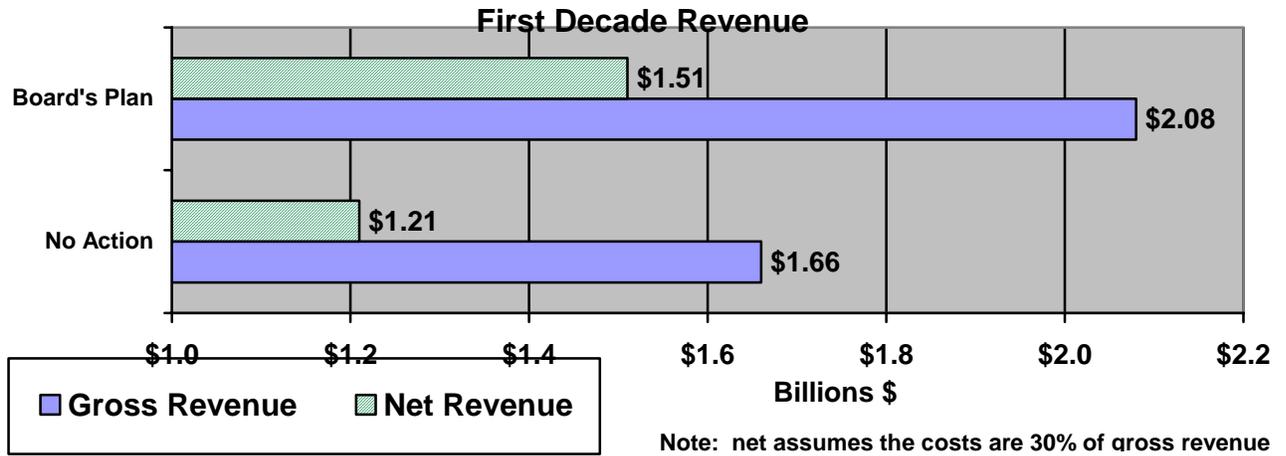


1.3 Proposed increase in management funds compared to annual beneficiary funding from trust accounts

DNR estimates it needs an additional \$10 million per year to carry out the Board of Natural Resources direction to meet the sustainable timber harvest level. If that additional management funding were to be raised by raising the statutory management fee (only one possibility to be considered), the beneficiaries would receive a net increase in funding from implementing the Board’s adopted plan. For instance, going from the 25 % deduction to the 30 % deduction would allow the department to implement the new sustainable harvest which when fully implemented would increase state wide harvest by 157 mmbf per year, mean annual for the first decade, compared to the 2004 sales level. Other funding solutions that supplement the current management fund are possible.

As shown in figure 1.7, under the new sustainable harvest level, beneficiaries will receive an additional \$300 million in net revenue over the next decade.

Figure 1.7 First Decade Revenue Projected Under 2004 Sustainable Harvest Calculation for Western Washington State Trust Forests



2. Lands and Resources

This section provides information to help answer the following questions and requests:

- Provide a breakdown of the trust lands in a way that provides a sense of the various categories of land value. (This might include forest site class, forest age class, forest diversification by management restriction, and forest and other asset classes.).
- What is the reason for the projected 45 percent growth in standing timber inventory over the life of the sustainable harvest calculation?
- Provide information about DNR's efforts to diversify the trust land assets, and the gains in value and/or return that result.

2.1 Total trust land inventory

The trust lands can be categorized according to land use. Using a geographical information system (GIS), DNR maintains a high quality inventory of the trust assets. Rather than present the more than 100 sub-categories for the upland trusts, a simplified scheme is used in Figure 2.1 to show how many acres of each trust are in each major land use group. Forests make up about 75 percent of the total acres of trust lands.

Figure 2.1 – All Upland Trust Acres by Land Use

	Forest Board Transfer	Forest Board Purchase	Common School and Indemnity	Agricultural School	University - Transferred	CEP &RI	Capitol Grant	Normal School	Escheat	Scientific School	University - Original	Total
Land Use Category: Derived from DNR GIS data												
Agricultural	284	0	139,800	7,855	10,934	18,013	3,761	3,265	1,048	6,196	64	191,220
Grazing	95	0	402,632	4,557	17,105	9,724	1,106	2,782	969	3,965	30	442,964
Forest	520,074	76,854	1,095,529	56,734	55,137	40,108	99,811	57,125	4,066	68,711	1,742	2,075,891
Commercial Real Estate	13,298	99	37,797	817	3	996	667	74	488	500	1,045	55,784
Miscellaneous	12,370	2,428	66,167	774	623	1,042	3,426	978	280	1,737	14	89,839
Total	546,121	79,381	1,741,925	70,738	83,803	69,883	108,770	64,225	6,851	81,109	2,893	2,855,698

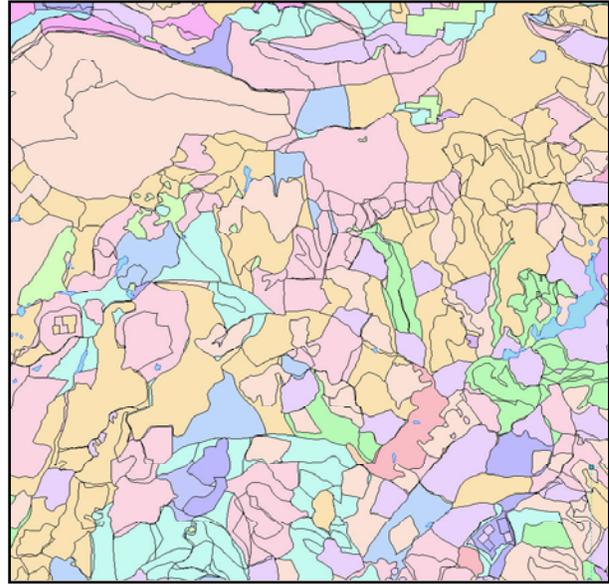
NOTE: *Miscellaneous* includes lands that may be in a variety of uses that includes rights of ways, roads, rock pits, and water bodies or recently acquired and not assigned a land use.

2.1.1 Forest Inventory

Understanding forest inventory is key to understanding the financial opportunities and ecological opportunities on forested state trust lands. Since the early 1990's, DNR has been collecting forest data in a detailed form, the Forest Resource Inventory System (FRIS). The FRIS data has replaced several decades of earlier, more generalized information and provides information on tree quality, quantities by grade and selected ecological data.

Figure 2.2 Representative FRIS Inventory Map

The major focus of the following information related to forest inventory focuses on western Washington trust lands and their relationship to the September 2004 Board of Natural Resources' decision for Sustainable Forest Management. However, about 0.7 million acres of the 2.1 million acres of forested trust lands are located in eastern Washington. Currently, there are about 8.5 billion board feet on eastern Washington trust lands. Relatively soon, DNR will start a process to calculate the Sustainable Forest Management harvest levels for lands east of the Cascade Mountains. Using previous calculations, eastern Washington harvest levels have been at the 80- 100 million board feet per year; the annual sales level varies due to significant forest health problems.



2.1.2 Use of an Appropriate Land Classification

A land classification scheme for the western Washington Sustainable Forestry calculation was developed to represent DNR policy goals and constraints. The classification places all trust forestlands into one of three classes based upon resource sensitivity and likely level of management intensity. The three classes in order of decreasing resource sensitivity and increasing level of management are:

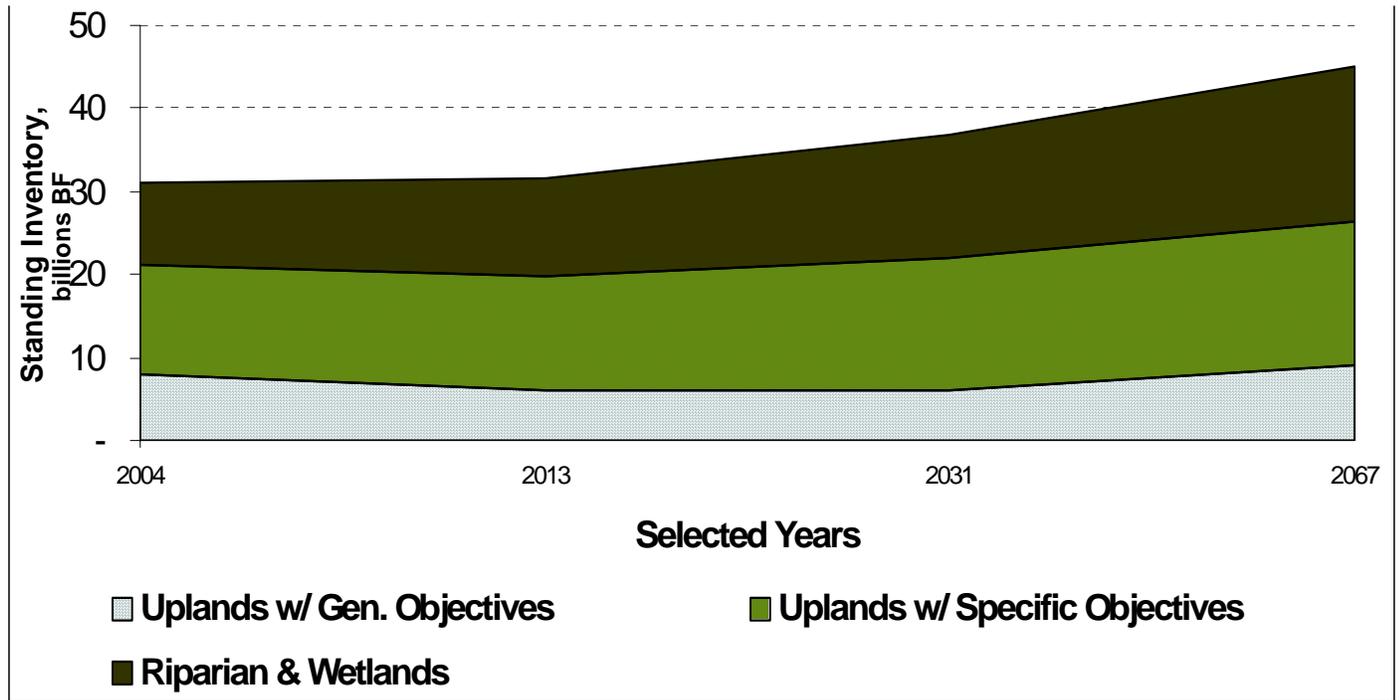
- 1) Riparian and Wetlands** – Riparian and wetland areas.
- 2) Uplands w/ Specific Objectives** – Upland areas with location-specific resource sensitivities and/or operational management. Includes areas such as unstable slopes, rain-on-snow areas, and Northern spotted owl nesting roosting foraging and dispersal habitat;
- 3) Uplands w/ General Objectives** – Upland areas where DNR practices general ecological management practices such as legacy and reserve trees and green-up.

The current forest inventory has been placed into these same categories. These categories are useful in understanding how the HCP strategies change the landscapes over time. The terms of the contract (the HCP) specify certain habitat contributions in exchange for certainty, both certainty from the “take” penalties under the Endangered Species Act and operational certainty. The operational certainty and the ability to plan and budget brings predictability. In particular, the HCP has a “no surprises” policy that protects the trusts from many types of regulatory changes. Also, with the HCP, millions of dollars of survey costs for northern spotted owls are avoided every year.

Special management strategies for northern spotted owls apply to about 400,000 acres. The net result, over time, is to increase the amount of older forest habitat in these acres; the increase in older forest habitat corresponds to an increase in standing volume.

Improving stream ecology and functioning is also a major HCP objective. Lands in the riparian (stream) management zones have lower levels of harvests that, over time, result in higher standing volumes.

Figure 2.3 Standing Inventory by Land Class, Preferred Alternative



The current western Washington inventory is 31 billion board feet. It will increase 45 percent (45%) by 2067 to 45 billion board feet. Essentially, all the increase in volume comes in the land classes necessary to meet the HCP contractual responsibilities or to meet the requirements of the State Forest Practices Act. The volume in the uplands with general management objectives stays fairly constant.

The Board of Natural Resources' Sustainable Forestry Plan specifies the nature and types of harvests. Figure 2.4 shows the projected harvests by land classification for the first decade.

Figure 2.4 First Decade, Western Washington Sustainable Harvests by Land Class

Land Classification	Mean Annual Volume, millions BF	Percentage
Riparian & Wetlands	48	8
Uplands w/ Specific Objectives	248	42
Uplands w/ General Objectives	301	50
Totals	597	100

The following figures show how the detailed land classifications apply to each specific trust. Figure 2.5 shows the distribution of the current inventory by trust and land class, and Figure 2.6 shows the current western Washington acres by trust by land class.

Figure 2.5 Current Western Washington Inventory Volumes by Trust and Land Class

	Data	LAND CLASS		
	Million Board Feet			
TRUST	Riparian and Wetland Area	Uplands with Specific Objectives	Uplands with General Objectives	Total Million Board Feet
Agricultural School	218	272	171	660
Capitol Grant	788	928	398	2,114
Charitable/Educational/Penal & Reformatory Institutions	209	216	237	662
Common School and Indemnity	3,358	4,354	1,998	9,710
Community College Forest Reserve	11	0	41	52
Escheat	15	27	21	63
Normal School	241	300	91	632
Scientific School	472	538	378	1,389
State Forest Board Purchase	563	521	773	1,856
State Forest Board Transfer	3,396	4,814	3,117	11,326
University — Original	16	33	6	56
University — Transferred	319	363	142	824
Administrative Site	1	10	1	11
C.E.P. & R.I. Transferred	0	3		3
Land Bank	1	0	0	1
Natural Area Preserve	63	131	34	228
Natural Resources Conservation Area	276	640	35	950
Water Pollution Control Division Trust Land	7	21	22	50
Grand Total	9,953	13,171	7,465	30,588

Figure 2.6 Current Western Washington Acres by Trust and Land Class

	AREA			Total AREA
	Riparian and Wetland Area	Uplands with Specific Objectives	Uplands with General Objectives	
TRUST				
Agricultural School	8,644	11,148	6,418	26,210
Capitol Grant	29,766	37,885	17,809	85,460
Charitable/Educational/Penal & Reformatory Instit.	7,635	8,326	10,849	26,810
Common School and Indemnity	171,673	229,317	103,726	504,716
Community College Forest Reserve	650	14	2,414	3,079
Escheat	994	1,484	1,114	3,592
Normal School	11,539	16,630	4,379	32,549
Scientific School	16,623	21,013	15,359	52,995
State Forest Board Purchase	20,102	16,954	36,244	73,300
State Forest Board Transfer	131,743	203,628	154,935	490,306
University -- Original	603	1,617	357	2,576
University - Transferred	13,673	20,202	4,679	38,554
Administrative Site	37	370	31	438
C.E.P.& R.I. Transferred	3	233		236
Land Bank	38	8	30	76
Natural Area Preserve	2,240	3,598	1,447	7,286
Natural Resources Conservation Area	10,210	26,891	1,501	38,601
Water Pollution Control Division Trust Land	552	1,930	1,414	3,896
Grand Total	426,726	601,248	362,706	1,390,680

2.2 Forest productivity – a measurement of tree growth potential

Forest productivity is traditionally measured by what is called “site class.” Site classes are labeled I, II, III, IV and V—the smaller the number, the greater the productivity. In western Washington, a tree on Site I will grow to greater than 135 feet tall in 50 years while a site V tree will be less than 75 feet in 50 years. Not only are the trees taller on better sites, they also will be larger in diameter; the net result is that better sites have considerably more merchantable volume than poorer sites.

Figure 2.7 shows the distribution of site classes by trust for western Washington. Eastern Washington is not shown but the sites there are substantially less productive than the trust lands in western Washington.

Figure 2.7 Site Class Distribution for Western Washington Trust Lands

TRUST	ACRES BY SITE CLASS					Grand Total
	I	II	III	IV	V	
Agricultural School	854	8,029	12,147	4,832	348	26,210
Capitol Grant	4,867	23,390	43,406	11,786	2,011	85,460
Charitable/Educational/Penal & Reformatory Institutions.	1,456	11,947	9,305	3,162	941	26,810
Common School and Indemnity	14,187	124,433	220,420	115,918	29,758	504,716
Community College Forest Reserve	896	1,856	304	23		3,079
Escheat	103	1,179	1,316	858	136	3,592
Normal School	630	6,984	14,562	6,395	3,978	32,549
Scientific School	907	15,270	27,294	8,623	901	52,995
State Forest Board Purchase	3,367	43,689	22,508	3,545	192	73,300
State Forest Board Transfer	24,891	156,696	216,183	78,973	13,563	490,306
University -- Original	118	1,043	1,168	243	5	2,576
University -- Transferred	1,384	13,097	22,163	826	1,084	38,554
C.E.P.& R.I. Transferred		11	55	170		236
Natural Area Preserve	9	536	3,576	2,822	343	7,286
Natural Resources Conservation Area	3	2,469	11,036	10,075	15,019	38,601
Water Pollution Control Division Trust Land	19	742	1,534	1,409	191	3,896
Grand Total	53,690	411,371	606,976	249,657	68,471	1,390,166

2.3 Diversification – trust land transactions and improvements to the asset base

DNR uses land transactions – sales, transfers, purchases, and exchanges – to maintain and improve the quality, value, and productive capability of the state trust land assets. In general, the goal is to dispose of properties that are unproductive or underperforming and replace them with others of higher quality and better capacity to produce income for trust beneficiaries for both the short and long term. Many of the properties identified for disposal have attained higher-and-better-use characteristics, which may increase their value but render them unsuitable for resource management by DNR. The Trust Land Transfer program funds the transfer of lands with special ecological values out of trust ownership and funds their replacement with assets that are income-producing.

The trust land base is strongly dominated by forestry holdings (both in terms of acreage and value), so diversifying over time into other asset classes is a key goal in selecting replacement properties. DNR’s repositioning strategy aims to reduce risk and increase prospects for immediate income, typically through agricultural and commercial property leases. The internal DNR Asset Management Council directed that for FY 2003-2005, one third of acquisition funds should be used to purchase commercial agriculture properties, one third for commercial properties, and one third for protecting and enhancing existing assets (by purchasing in-holdings within forest blocks, making infrastructure investments, etc.).

In addition to diversifying into non-forestry asset classes, DNR uses transactions to upgrade holdings within asset classes to subclasses with higher rates of return. For example, low value/low return agricultural and grazing lands have been sold, and vineyards and farms producing high value crops have been acquired.

DNR has sought and achieved improvements in planning and executing transactions. Within the past three years DNR Regions conducted inventories and assessments of the lands within their borders, identifying possible areas for property disposals and acquisitions. This input has been consolidated into a statewide view which, when finalized, will contribute to setting transaction priorities. DNR makes extensive use of its Internet web site to market trust lands, including commercial properties. It achieved wider outreach and cost efficiency in marketing and auctioning a number of scattered properties in Grant County through a single “batch sale” process, and is applying this approach in other geographic areas.

Figure 2.8 Trust Land Transactions by Asset Class – FY 1984 to FY 2004

	Acres Disposed	Value Disposed ***	Timber Value to Common Schools	Acres Acquired	Value Acquired
Ag/Grazing Management	17,495	\$3,610,335		11,331	\$15,746,477
Grazing to Conservation Use	5,227	728,900			
Commercial *	360	21,601,215		37	57,600,000
Forest Management	21,935	162,438,424		70,456	214,187,546
Forest to Conservation Use **	45,361	32,241,300	137,144,500		
Higher & Better Use	9,440	53,402,725	31,812,000	364	27,400
Total	99,818	274,022,899	168,956,500	82,189	\$287,561,423

* Disposals are primarily undeveloped commercial acreage; acquisitions are developed commercial properties.

** Forest to Conservation Use value disposed includes Trust Land Transfer timber value deposited in Common School Construction Account.

*** Monies received from disposal of trust land are used to purchase replacement properties, which may be in any of the asset classes. Disposal from a particular asset class are not necessarily reinvested in the same asset class.

Figure 2.9 Improved Revenue – Transactions Completed July 1, 2003-June 30, 2004

	Disposals	Acquisitions
Market value	\$16,654,220	\$10,367,222
Average annual return	\$3,100	\$711,000
Rate of return	<1%	\$6.9%

Figure 2.10 Trust Land Transfer Summary – 1989-2005

Total appropriation	\$422,352,000	100%
Common School Construction Account deposits (timber value)	\$348,496,720	82.5%
Land transferred:		
• Value	\$65,402,000	
• Acres	75,139	
• Value/acre	\$870	
Replacement land:		
• Value	\$58,413,636	
• Acres	34,632	15.5%
• Value/acre	\$1,687	
Administrative costs	\$8,453,280	2%

In a 2003 Report to the Legislature, DNR compared returns to trust beneficiaries from permanent fund investments with those from investing in replacement trust lands. Adjustments were made to account for differences in the department’s investment analysis for forest, agriculture and commercial properties and inflation, and to remove the management fund deduction from beneficiary returns to allow proper comparison to the permanent fund returns. The average real return on replacement property was weighted to reflect the actual proportionate dollar investments since 1998 in forestland (44%), agricultural land (2%) and commercial properties (54%).

The projected real return to beneficiaries of 5.0 percent from purchase of replacement trust properties since 1989 is 32 percent greater than the comparable real return to beneficiaries of 3.7 percent from the permanent fund.

Figure 2.11 Comparison of Returns on Investments

	Gross Nominal Return	Loss in Purchasing Power	Gross Real Return	Less 25% RMCA	Net Real Return
Real Property Purchases					
Forestry			6.0%	1.5%	4.5%
Agriculture			10.5%	2.6%	7.8%
Commercial	10.1%	-3.1%	7.1%	1.8%	5.3%
Weighted Average			6.7%	1.7%	5.0%
Permanent Fund	6.8%	-3.1%			3.7%

This table originally appeared in the Department of Natural Resources Report to the Legislature: “Options for Increasing Revenues to the Trusts: Comparison of Returns from Investing in Real Property and in Permanent Funds,” Table 16, p. 51

3. DNR Management Costs

This section provides information to help answer the following questions and requests:

- Provide detail on what categories of expenditures are made from the trust management funds.
- Provide detail on how the proposed increase in management funds would be spent to carry out the Board of Natural Resources' direction.
- What is the relation of fund balance trends to volume trends projected for the future?
- Provide details on reductions already made.
- Provide information on the time period during which expenditures are projected to exceed revenues.
- Relate management fund expenditures to targets of expenditure also funded by non-management funds.

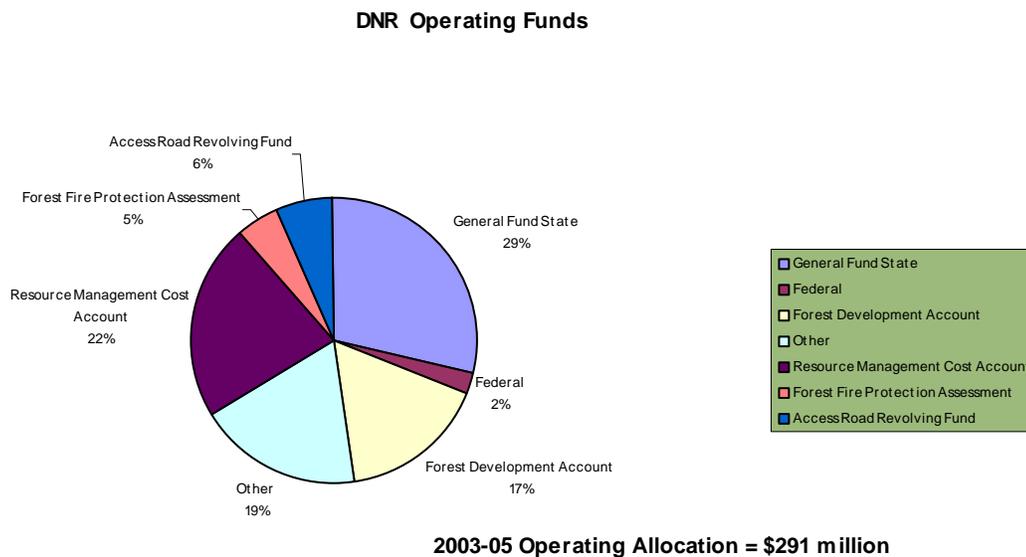
3.1 Budget overview and use of management funds

3.1.1 Legislative Allocation

DNR operates from more than 20 operating and capital accounts. For the 2003-2005 Biennium, the department's operating budget allocation was \$291 million.

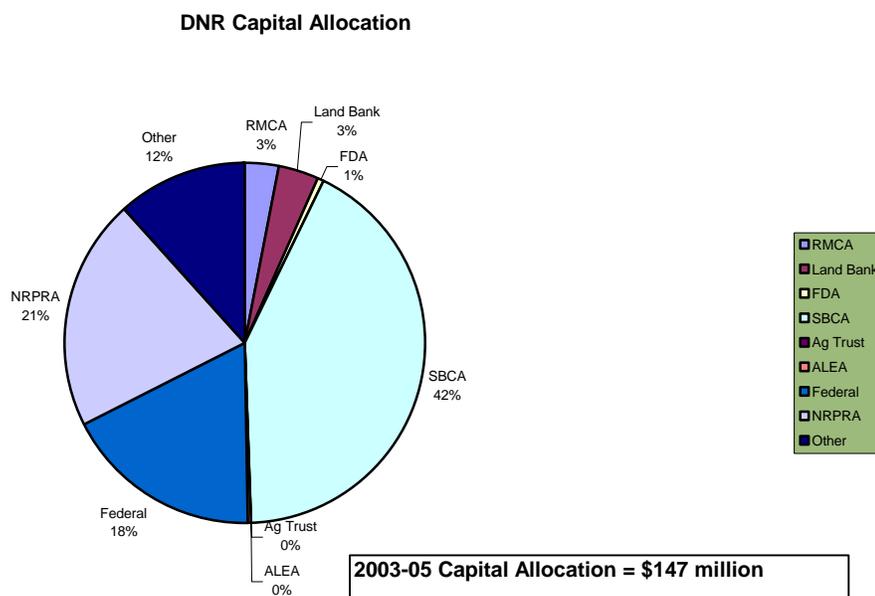
The use of all of these funds, except the state General Fund is restricted by statute. Some of the state General Fund appropriation is restricted by legislative proviso for specific purposes.

Figure 3.1 Source and Proportion of DNR Operating Funds



DNR also receives a Capital Budget allocation totaling \$147 million. The largest source of Capital funds is general fund bond money from the State Building Construction Account (SBCA). Most of the SBCA funds, \$55 of \$62 million, are for the Trust Land Transfer program. Federal funds account for \$26 million or 18%. The Natural Resources Real Property Replacement Account (\$31 million or 21%) and the Land Bank (\$5 million or 3%) are funds into which DNR deposits the value of trust lands sold. These funds are used to purchase new trust assets.

Figure: 3.2 Source and proportion of DNR Capital Allocation

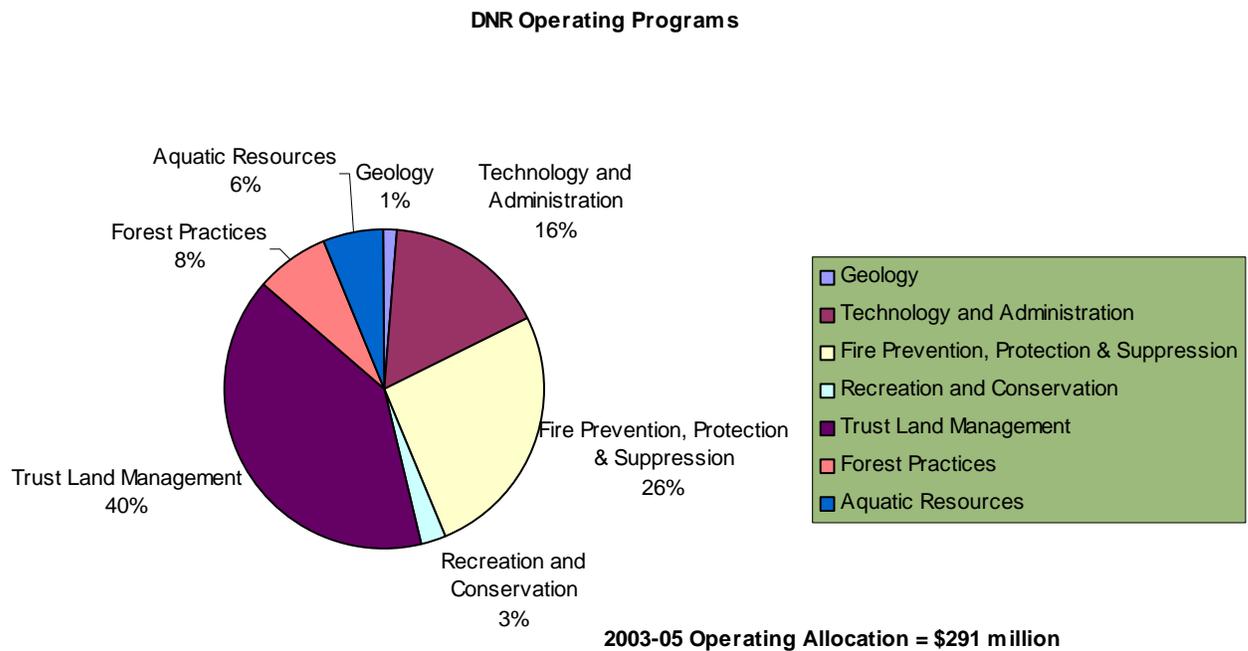


3.1.2 DNR Operating Programs

DNR has operates within seven basic function (program) areas. Each of these program areas is uniquely funded.

The largest program is Trust Land Management, which includes parts of four operating divisions and six regions. Trust Land Management is primarily funded from the distribution of revenue earned on granted trust lands and state forestlands. The management funds used are the Resource Management Cost Account (RMCA) and the Forest Development Account (FDA), respectively. In addition, the State General Fund pays for the management of the Agricultural Trust, though the Agricultural College Trust Management Account.

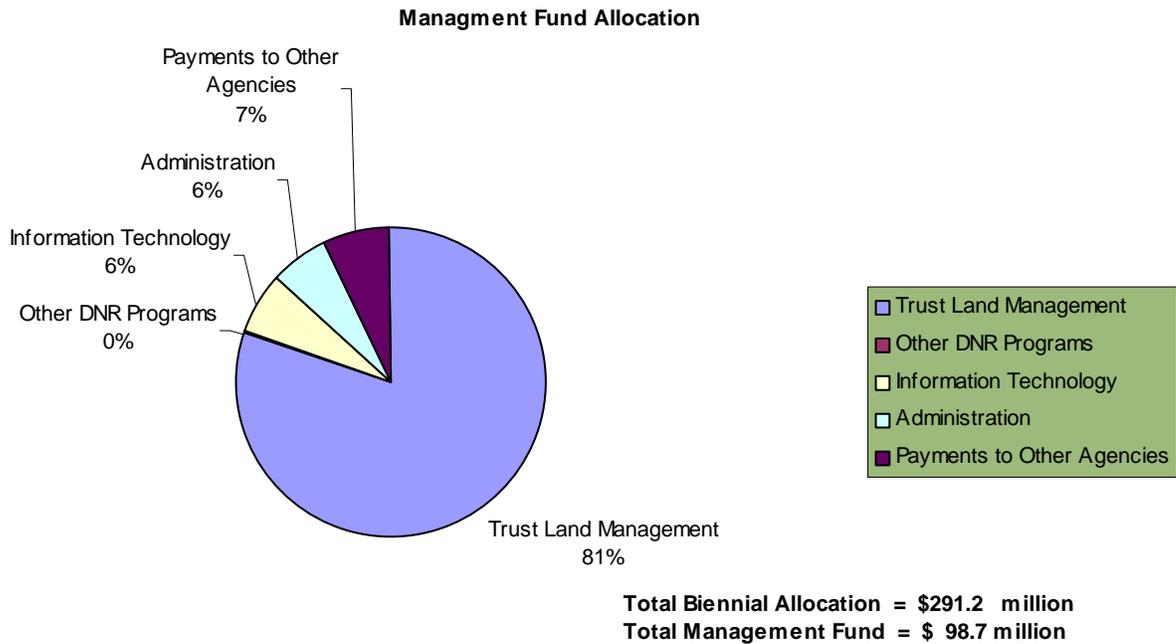
Figure 3.3 Distribution of 2003-05 Operating Allocation to DNR Programs



3.1.3 Allocation of Management Funds Within DNR

Of DNR's \$291 million 2003-2005 biennial allocation, \$98.7 million is from the RMCA and FDA management funds. This biennium, 81 percent of the management funds are allocated to the direct service Trust Land Management programs. The three overhead areas receive 19 percent. The other DNR Programs are allocated less than \$400,000 in management funds, or 0.4 percent.

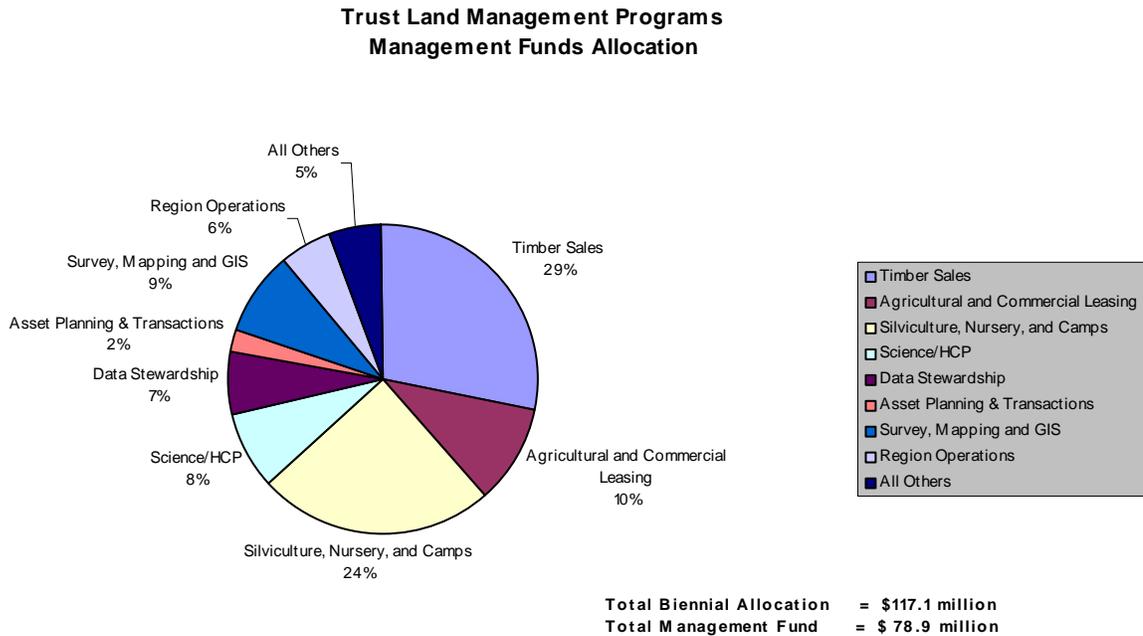
Figure 3.4 Allocation of Management Funds within DNR



3.1.4 The “Trust Land Management” Component of the Management Fund Allocation

Trust Land Management is a \$117 million program. Management funds account for \$79 million. The two largest programs in terms of the management fund allocation are Timber Sales (29 percent) and Silvicultural activities (24 percent). The management of Agricultural and Commercial Leases accounts for 10 percent.

Figure 3.5 Trust Land Management Programs Management Funds Allocation



Several of the programs within the Trust Land Management program operate from dedicated funds such as the Nursery Account, Access Road Revolving Fund, and Survey and Maps Account.

3.1.5 The “Administration” and “Payment to Other Agencies” Component of the Management Fund Allocation

The “Administration” component includes what many organizations would call “overhead” services— departments such as human resources, finance and budget, executive offices and communications and facilities. DNR’s overhead also includes the Environmental and Legal Services office, which responds to public disclosure requests and monitors and assists in SEPA compliance and EIS development.

DNR is also billed by a number of other agencies for their services. These include the departments of Personnel, General Administration, Information Services and offices such as Minority and Business Enterprises and Office of Financial Management. This “Payment to Other Agencies” component also includes the allocation for rent and attorney general services.

Figure 3.6 Administrative Functions

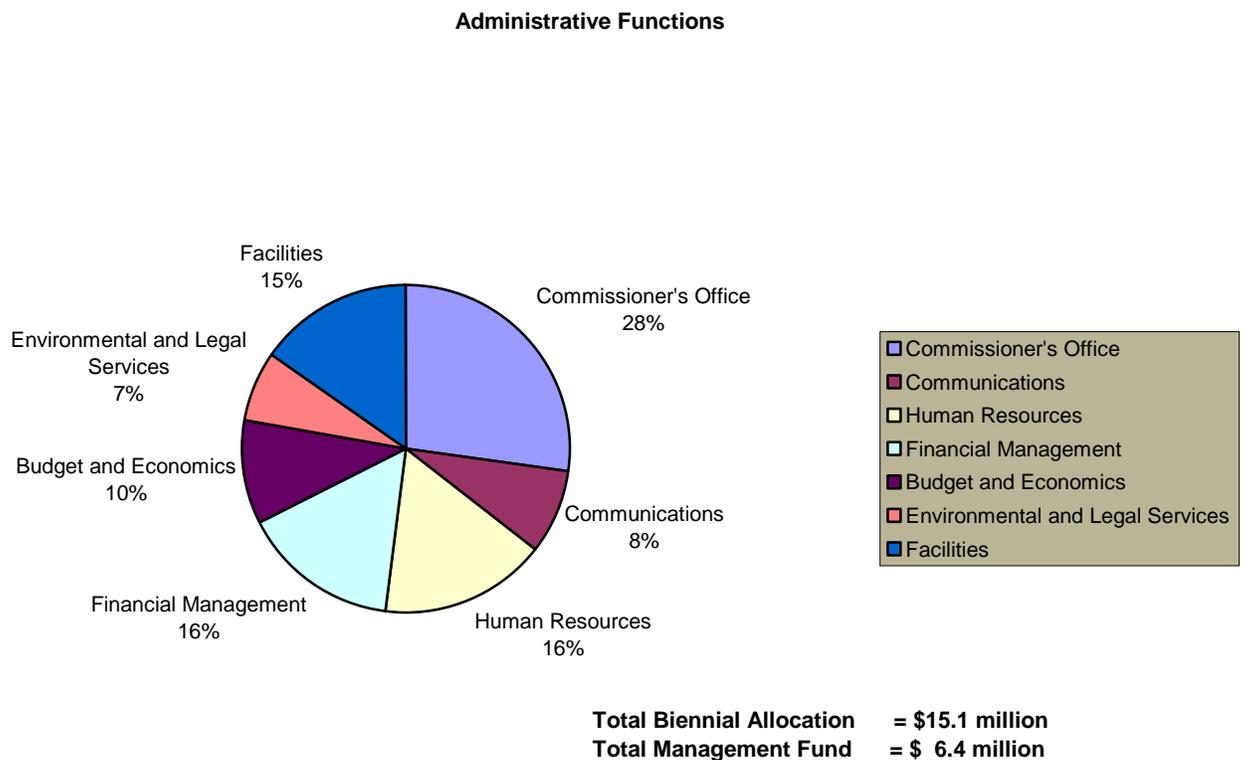
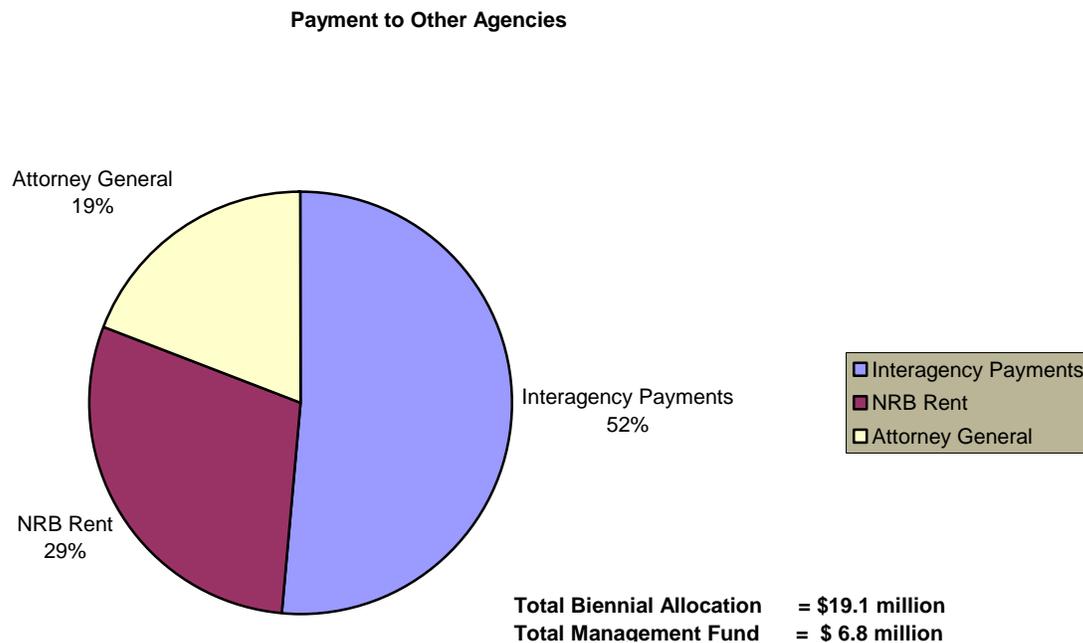


Figure 3.7 Payment to Other Agencies



3.1.6 Allocation of Management Funds for Public Access and Recreation

Figure 3.3 shows “Other DNR Programs” as 0 percent of the management fund allocation but shows a small sliver on the pie chart. These other programs include aquatics resources, resource protection (fire), forest practices, geology, and natural areas and recreation. There is no management fund allocation in any of these programs except for natural areas and recreation.

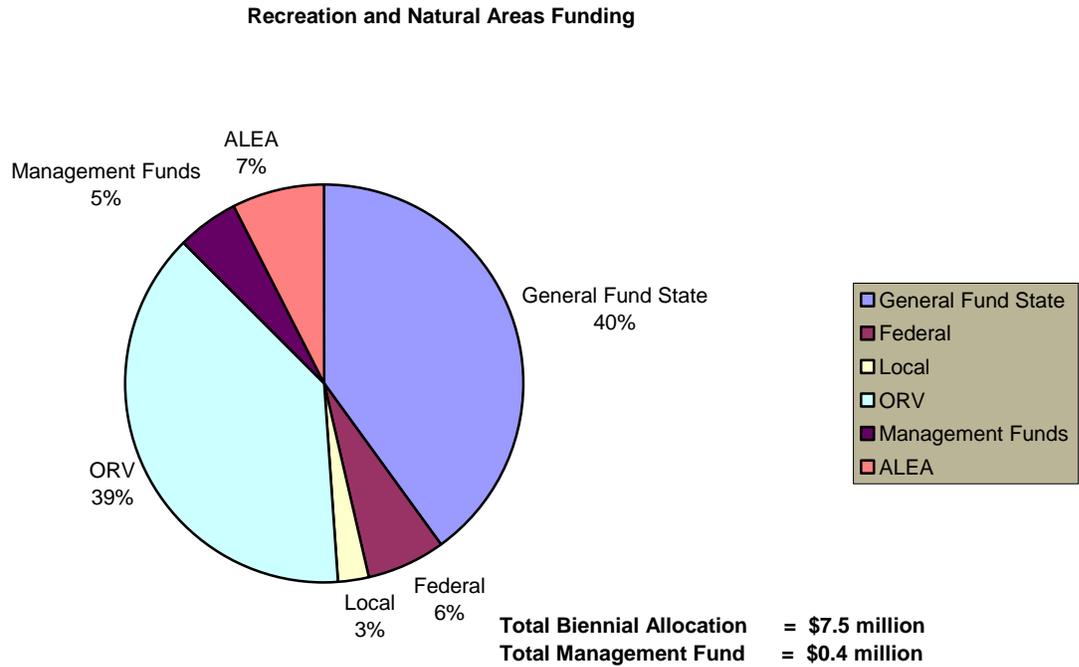
Natural Areas and Recreation programs have a small, \$381,000, management fund allocation. This allocation is 0.4 percent of the total management fund allocation.

- The Natural Heritage program receives \$200,000 for services it provides to the trusts —identifying unique animal and plants species on state lands.
- The Recreation program is allocated \$181,000 to manage the typical landowner costs from deleterious public impacts such as hazardous waste and meth lab clean up; abandoned vehicles; and garbage removal. No trust dollars are allocated to support public access under the Multiple Use Act. Incidental costs are incurred. Incidental costs for roads maintenance stemming from general public driving on trust roads may be borne by the trust, but this assumed cost has not been quantified.
- The Natural Areas program does not receive a management fund allocation.

The Natural Areas and Recreation programs are primarily funded from the state general fund (40 percent) and the Off Road Vehicle Account (ORV) (39 percent). In addition, the Recreation program receives roughly \$3 million biennially from grants from the Non-highway Off Road Vehicle Account (NOVA) administered by the Interagency Committee for

Outdoor Recreation (IAC). These grants provide for education, enforcement, maintenance and operations of recreation sites and 110 miles of trails across the state.

Figure 3.8 Recreation and Natural Areas Funding



3.2 How the proposed increase in management funds would be spent to carry out the Board of Natural Resources' direction

DNR has begun the process to bring on staff to implement the board action for sustainable harvest. In FY05, 26 additional staff will be added in our six upland regions. Additional staff will be phased-in each of the next three fiscal years until 95 new FTE have been added by FY08. Of these staff, 75 will be in the regions. The remaining staff will be allocated agency support, Financial Management, and Information Technology, GIS support.

3.3 The relation of fund balance trends to volume trends projected for the future

The RMCA and FDA expenditures will exceed revenues in the current biennium and in each of the following five biennia. The follow charts assume that DNR will meet the expectations set forth by the board action for sustainable harvest and also assume that the management fund share will remain at 25%. This information is also available in Table 4.4, Page 39, in Volume 1 of the Briefing Materials for the Independent Review Committee.

The impact on the fund balance for the RMCA and FDA are shown in the figure 3.11

Figure 3.9 RMCA Revenue Vs. Expenditure

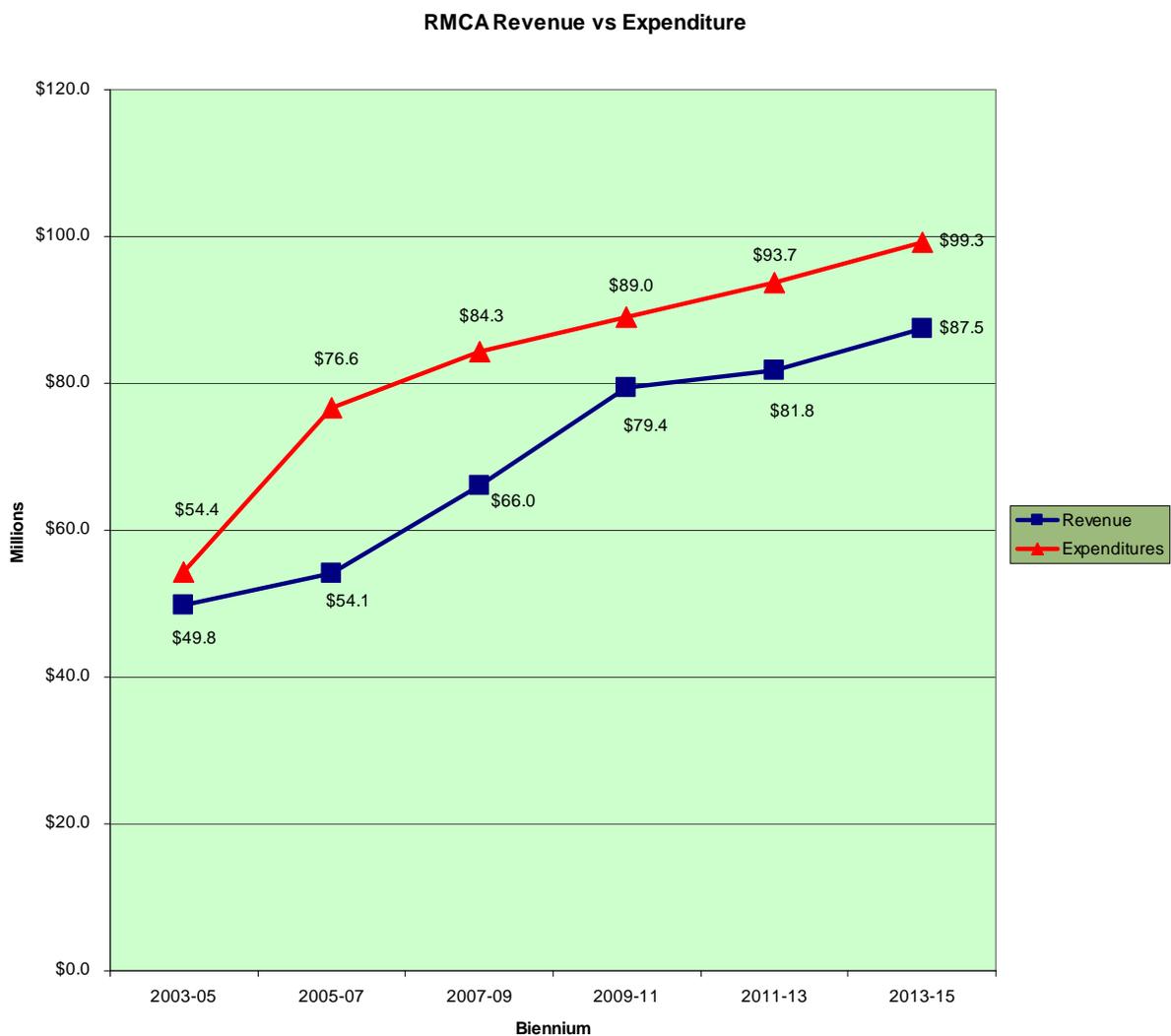


Figure 3.10 FDA Revenue Vs. Expenditure

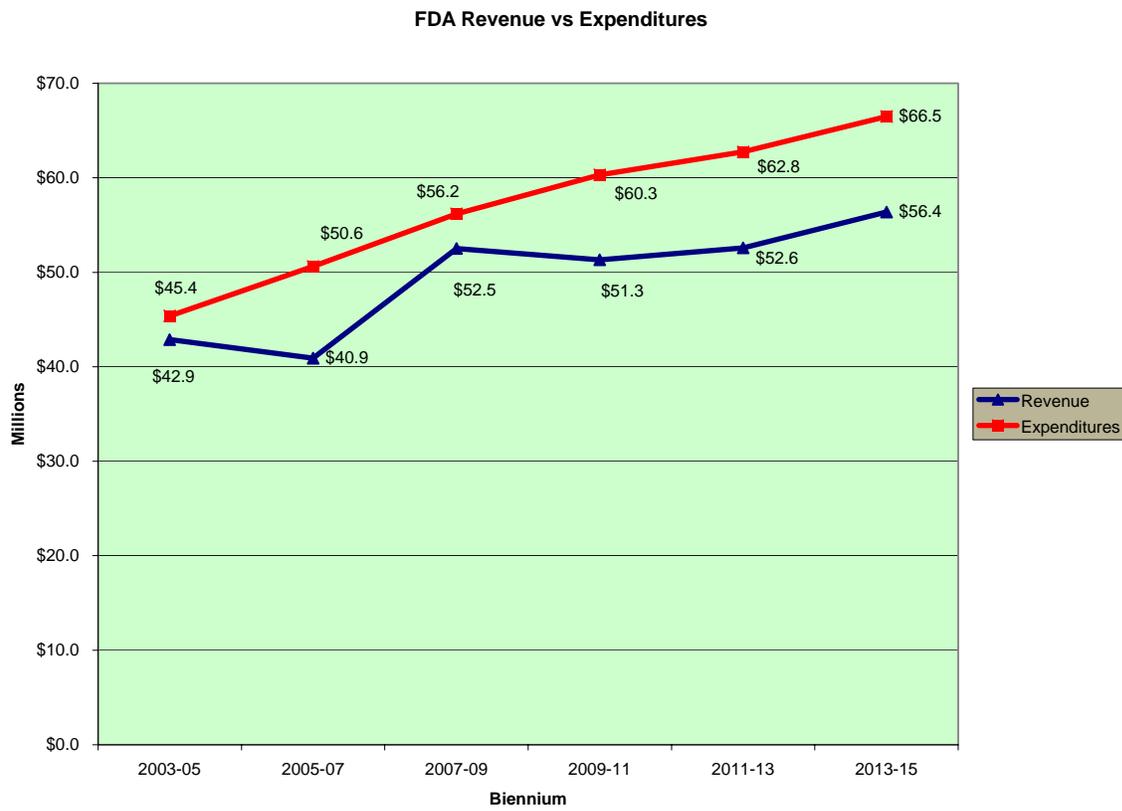
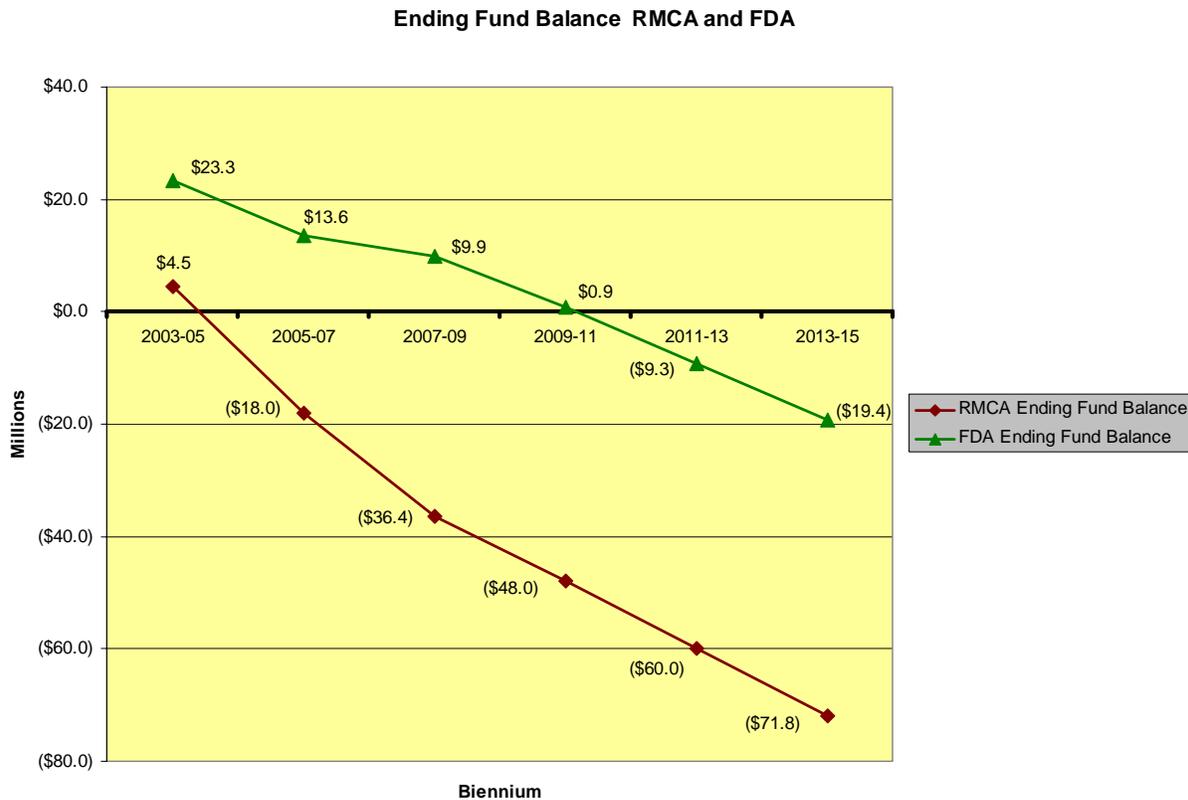


Figure 3.11 Ending Fund Balance RMCA and FDA



3.4 Reductions already made

The 01-03 biennial operating and capital budgets assumed the following:

- Management fund expenditures \$165.8 million
- Management fund revenues \$175.5 million
- Beginning fund balance (7/1/01) \$ 47.3 million
- Ending fund balance (6/30/03) \$ 40.7 million

In early spring 2001, DNR was spending at a rate that would have resulted in \$144.7 million operating expenditures during the forthcoming 2001-2003 biennium. The revenue estimate was reduced in the March 2001 forecast to \$100.9 million for the upland management funds. The draw down on the fund balance would have exceeded \$43 million. The adjusted ending fund balance would have been negative.

In May 2001, DNR set a target biennial operating expenditure level at \$110.2 million, reducing the expenditure rate by \$34 million.

In July 2001, the department set the allotments at \$112.9 million, or roughly \$32 million below the previously identified expenditure levels.

In November 2001, DNR eliminated approximately 200 positions. Fortunately, due to earlier management actions to slow down hiring, many of these positions were vacant. Management

intervention to help place individuals at risk of reduction-in-force (RIF) significantly reduced the number of employees actually laid off to nine.

In the 2002 supplemental budget, DNR voluntarily reduced its management fund appropriation by \$10 million. The supplemental budget also directed that the department reduce its General Fund-State (GFS) appropriation by \$6.5 million. The General Fund reductions in the administrative programs resulted in additional management fund savings.

In April 2002, DNR continued its efforts to reduce management fund expenditures, particularly from the RMCA. At this point the projected ending fund balance for the RMCA at June 30, 2005 was negative at (\$13.2) million. The department took actions to:

- Reduce RMCA operating expenditures by \$3.6 million over three years.
- Reduce RMCA capital expenditures by \$3.0 million in FY2004-2005.
- Administrative services reductions reduced management fund expenditures roughly \$1.0 million per year.

3.4.1 Impact of Cost Savings

- RMCA expenditures in real dollar terms, adjusted for inflation, are at the lowest level since 1970.
- Total state land management expenditures are 26 percent below the level in 2001.
- Product sales expenditures are 22 percent below the 2001 level.
- Total state land management Full Time Equivalents (FTEs -staffing level) are down from 458 in 2001 to 339 in 2004, or 24 percent.
- Product sales FTEs are down for 231 in 2001 to 176 in 2004, or 24 percent.
- Timber sales productivity (volume of sales per FTE) has increased 57 percent since 2001.
- Administrative services FTEs are down from 171 in 2001 to 147 in 2004, or 14 percent.

4. Others' Costs

This section provides information to help answer the following questions and requests:

- What information is available on cost of other organizations?
- What information is available on costs of private forest management companies for forestland management? How comparable are these costs to DNR costs?
- What information is available on costs of similar states for forest land management? How comparable are these costs to DNR costs?
- What information is available on costs of Grays Harbor County for forest land management? How comparable are these costs to DNR costs?

4.1 Comparability and data availability

The ability to compare or benchmark costs is an important element in the Independent Review. Comparative data is not always available. Particularly in the private sector, problems associated with proprietary data that create competitive advantages are very real. Concerns associated with anti-trust prosecution by the federal Department of Justice are additional realities not found in comparisons of costs associated with public sector land management.

A common problem with any comparison or benchmark, private or public sector, is comparability. There are three elements of comparability. The first element is cost accounting practices. This does not imply impropriety. All entities account for costs in various ways and use different cost allocation strategies. Federal or state taxes can substantially influence accounting objectives. As a public entity, DNR has no distortions due to taxes. Allocation of indirect and administrative/corporate costs are done in a variety of ways. If an entity has multiple functions, then millions of dollars of annual costs would have to be allocated to those various functions in some fashion.

The second element of comparability can be summarized as management objectives. Assets that are managed for near-term cash flow have different objectives than those managed for long-term goals. Correspondingly, assets held in a long-term fiduciary trust will not be managed the same as where quarterly returns dominate land management and accounting practices. The ability to quickly dispose of under performing assets and to creatively reinvest in high performance assets is a common tool for many private assets managers but it is not routinely available for publicly held assets.

The third, and final, element of compatibility can be important—access to markets. Many landowners operate in the full open market. Some landowners, including the trust lands, restrict their markets; this restriction can be voluntary or as a result of federal and/or state law. In particular, trust lands can only sell timber in the domestic market due to federal and state laws that do not directly apply to the private sector. The ability to receive a higher price in certain markets can increase revenue while reducing percent costs and improving the calculated rates of return.

4.2 Private sector comparisons

Given the previous discussions, it is hard to get direct or comparable data. DNR has discussed benchmarking with PWC, PricewaterhouseCoopers LLP. As noted on the company's web-site, "PricewaterhouseCoopers provides industry-focused assurance, tax and advisory services for public and private clients..."

Their *Global Forest and Paper Industry Survey*. 2004 edition based on 2003 results is available on the web: www.pwc.com/gx/eng/about/ind/forest/pwc_gfp_survey_2004.pdf. Because DNR did not participate in the 2003 survey with its associated confidentiality stipulations, we do not have access to the full set of data. However, the following information was provided by PWC: The information provides a picture that helps us understand some of the DNR costs while simultaneously demonstrating the complications of data comparability and availability.

Figure 4.1 Benchmark Comparisons of Certain Forest Management Costs

Western US Wood Cost Benchmarking Survey (2001 and 2002 data) Special Report for US Department of Natural Resources

	Washington	Oregon
Average site preparation costs (\$/ac)	\$124.15	\$122.66
Average planting costs (\$/ac)	\$259.54	\$278.51
Pre-commercial thinning - manual (\$/ac)	\$109.99	\$90.65
Forest inventory personnel (acres/fte)	32,003	21,196
Forest inventory costs fully loaded (\$/ac)	\$2.01	\$1.23
Overhead costs (excluding forest inventory) (\$/ac)	\$6.30	\$10.47

Notes:

1. Results are the simple averages of respondents' responses to the 2001 and 2002 questionnaires, except for forest inventory personnel data, which was not collected in 2001.
2. Extreme results have been excluded to avoid skewing the averages

PRICEWATERHOUSECOOPERS

The following table takes the same categories, uses DNR costs and extends them to our scale¹ of operations.

Figure 4.2 Benchmark Costs versus DNR Costs

Cost Comparisons using PricewaterhouseCoopers data and DNR data

Activity	PWC Unit Costs	Average annual	Projected costs using PWC as a base	DNR unit costs	Projected costs using DNR as a base	Cost Differences between PWC- DNR calculation
		DNR Activity levels, acres 4 yr. Aver.				
Site Preparation, \$/ac	\$124.15	4,350	\$540,053	\$104.92	\$456,402	\$83,651
Planting, \$/ac	\$259.54	15,520	\$4,028,061	\$140.00	\$2,172,800	\$1,855,261
Precommercial Thinning, \$/ac	\$109.99	10,390	\$1,142,796	\$140.43	\$1,459,068	-\$316,272
Inventory Costs, fully loaded, \$/ac	\$2.01	2,100,000	\$4,221,000	\$0.80	\$1,680,000	\$2,541,000
Overhead costs, w/o forest inventory, \$/ac	\$6.30	2,100,000	\$13,230,000	\$5.60	\$11,760,000	\$1,470,000
Totals			\$23,161,909		\$17,528,270	\$5,633,640

As Figure 4.2 shows, the benchmark differs from actual DNR data. DNR site preparation, planting, inventory and overhead costs are lower, while DNR precommercial thinning costs are higher. Assuming data comparability for these activities, overall DNR costs are 24 percent lower than the benchmark data when applied to DNR's scale of operation. To place this in context of the total annual DNR operating budget, \$49.35 million, the \$17.5 million is about one-third of the total. Benchmark data for the remaining two-thirds does not exist.

DNR believes that benchmarking can provide very useful information and is pursuing two benchmarking efforts. DNR plans to participate in the upcoming PWC 2004 benchmark study, and anticipates that it will enter into a contract early next year that will generate a report by the end of May 2005. The other effort DNR is pursuing is with Atterbury Consultants, Inc., Portland, Oregon is a well-respected forestry consultant. They intend to conduct a benchmark study of forest land management costs. While the study will be similar to PricewaterhouseCoopers' concepts, its design will be different. The Atterbury benchmark study will focus on some of the aspects that are regionally specific (Pacific Region, including Idaho and British Columbia). Importantly, their report should be completed by the end of this calendar year.

¹ The number of trust land acres and acres treated are then used to make comparisons.

Important Information

DNR discussed operating costs with one of the larger private Washington forest landowners. In some regards, their management objectives have some important similarities to trust land management. For reasons of confidentiality, the name of the company cannot be disclosed. The company is focused on forestland management for the long run, and is willing to have a longer-range view that recognizes that land management costs, expressed as percentage of gross revenue, vary substantially. Adjusted for a domestic-market-only percentage, their recent experiences are most informative.

Their percent of gross revenue used in land management ranged from a high of nearly forty percent down to just under thirty percent.

These were actual costs compared to fluctuating market revenues. This landowner does not deal with any costs that may be associated with the social obligations of the State Multiple Use Act or other laws that govern state land operations differently than the private sector. Further, it did not include the costs of managing nearly half-a-million acres of grazing lands or extensive eastern Washington timberlands. The private land managers have the opportunity to broadly and quickly reposition under-performing assets without the public policy obligations found in state government.

4.3 Comparisons with other states

Comparable data is often difficult to find. However, the Oregon Department of Forestry has published data regarding management expenditures for their Common School Forest Lands. As shown in their *Status of Common School Forest Land Management Fiscal Year 2004*, the percentage of revenue to expenditure was calculated. In FY 2004 it was 32.31 percent, while FY 2003 was 53.10 percent. Fiscal year 2002 and 2001 showed 30.93 percent and 24.30 percent respectively.

Figure 4.3 Comparison of Selected Western State's Trust Land Management Activities and Functions

	Wash. 1/	Oregon 2a/	Oregon 2b/	Idaho 3/	Montana 4/	Utah 5/	New Mexico 6/	Arizona 7/	Wyoming 8/
Trust Acres Managed	2,862,290 acres (upland only)	763,200 acres - State Lands (uplands only)	780,000 acres - Board of Forestry	2,463,863 acres	5,163,000 acres	3,445,000 acres	8,868,000 acres	9,279,243 acres	3,565,669 acres
Forest Acres	2,113,760 acres	133,000 acres (managed by ODF)	Same as above	1,019,816 acres					
No. of Trust Beneficiari	10	1 – Common school lands	1 - Co. Forest Trust Lands	9	10	12	22	13	17
Total Trust Revenues	\$195,561,000	\$30.5 million		\$64,303,000	\$62,595,000	\$50,267,000	\$263,135,000	\$103,378,000	\$66,310,900
Timber Sales Revenue	\$143,393,000	\$8,550,000	\$86,816,831	\$41,696,500	\$6,915,000	\$713,000	Mineral Royalties = \$220,417,000		\$797,600
Timber Harvest	494,266 MBF	24,310,MBF	253,637 MBF	170,191 MBF	44,500 MBF (42,200 annual sales level)				4,705 MBF
Funding Sources for Trust Mgmt	RMCA (federal grants); FDA (forest board); ACTMA – Ag. School Trust Mgmt. Acct. (GF-S)	Capital Imp. & Maint. Costs; Constitutional Expenses	Forest development fund	GF 29%; dedicated funds (5) 18%, federal funds 13%; endowment funds 40%	GF, Res.; Dev. Acct. 3%; For. Imp. Acct. (fees); Trust Admin. Acct. 5%	Self funded	Maintenance fund	GF	GF (78%), federal funds (15%), other state funds (7%)
Percent Retained by Mgmt	25% - RMCA; 22% - FDA	Cost reimbursable \$4,423,336	29.36% (FY03)	10% - Forest Imp. Acct.	2.5% Res. Dev. Account except timber sales			0%	0%
Major Revenue Sources	Timber sales, leasing – agric., commercial, communication sites, other	Timber sales, grazing, ag. & misc. uses; property sales	Timber sales, rights-of-way, permits	Timber sales, leasing – agric., commercial, mineral, other	Ag/grazing; minerals, timber sales	Oil & gas, commercial, minerals, surface leases	Oil & gas rentals and royalties, grazing rents, misc. leases	Coal, oil, gas and mineral royalties & rents; agric. and grazing	Coal, oil, gas and mineral royalties & rents; agric. and grazing

	Wash. 1/ Oregon 2a/ Oregon 2b/ Idaho 3/ Montana 4/ Utah 5/ New Mexico 6/ Arizona 7/ Wyoming 8/								
Costs of Land Management	\$48,965,000	\$10.3 million	\$21,256,459	\$13,373,700	\$3,900,000	\$9,397,000	\$11,336,493		\$6,839,160
Budget cycle	Biennial	Biennial	Biennial	Annual	Biennial				
Board involvement in budget	No review or approval prior to submittal to Legislature	Review and approved prior to submittal to Legislature	Review and approved prior to submittal to Legislature	Review and approved prior to submittal to Legislature	No review or approval prior to submittal to Legislature				

1/ Upland acres from Lands Managed by DNR Chart – July 2003. Percent retained on forest board transfer lands currently equals 22 percent, while on forest board purchase lands FDA retains 50 percent per statute. The deduction on forest board transfer lands could be increased to 25 percent per Board of Natural Resources action.

2a/ Source: Oregon Dept of State Lands Biennial Report and Status of Common School Forest Management Report for FY03 by the Oregon Dept. of Forestry (ODF), which manages approximately 133,000 CSL acres under contract for the Dept. of State Lands.

2b/ Source: Oregon Dept. of Forestry – State Forester’s Report for Council of Forest Trust Land Counties. During FY03 \$49,801,650 was distributed to the counties with forest trust lands.

3/ Source: Idaho Department of Lands Annual Report 2003.

4/ Source: Montana Department of Natural Resources and Conservation 2003 annual report for the Trust Land Management Division.

5/ Source: Utah School and Institutional Trust Lands Administration, Fiscal Year 2003 Report.

6/ Source: New Mexico State Land Office, Fiscal Year 2003 Report.

7/ Source: Arizona State Land Department, Annual Report 2003.

8/ Source: Wyoming Office of State Lands and Investments, Annual Report 2003.

The DNR is continuing to research this data and anticipates updating this section for the third Independent Review Committee meeting.

4.4 Comparison with Grays Harbor County

Discussions with representatives from the County have indicated that the *JLARC² Report 96-5 1996 Forest Board Transfer Lands* is considered the most current analysis of costs. By the time of the next meeting, we anticipate supplemental County information that may update this data.

The following material is copied from the cited JLARC Report.

² The Joint Legislative Audit and Review Committee (JLARC) was established by Chapter 44.28 RCW, to provide oversight of state funded programs and activity. Under the direction of the Legislative Auditor, JLARC conducts performance audits, program evaluations, sunset reviews, and other types of policy studies. Study reports typically focus on the efficiency and effectiveness of agency operations.

**DNR's
management
fee percent-
age is
similar to
other public
forestry
agencies**

We compared the percentage of DNR's management fee with Grays Harbor County and the states of Oregon and Idaho. The two states were selected for their proximity to Washington State, and also because besides Washington, they are the largest (in terms of revenue generated) managers of state timber trust lands. Grays Harbor County was selected because of the study mandate to compare DNR with to this county.² The following table illustrates these percentages:

State/County	Revenue Percent Retained as Management Fee³
Grays Harbor County	25%
Idaho	10%
Oregon	36.25%
Washington	25+%

The relative productivity of the land that is managed and the intensity of management efforts needed to make the land productive *limit the usefulness of the comparison*. For example, if the timberland in Oregon is only half as productive as Washington timberland, Oregon could have a higher management fee percentage, yet receive less revenue per acre in management fees.

²Grays Harbor County was the only county holder of timberland that did not convey their timberlands to the state.

³Information on the percentage management fee from Idaho and Oregon is from Souder and Fairfax, *State Trust Lands*, 1996, p.46. Information on the Grays Harbor County management fee provided by the Grays Harbor County Department of Forestry.

5. Cost Centers for Environmental Compliance

This section provides information to help answer the following questions and requests:

- What information is available to help understand the costs of compliance with environmental and other regulatory laws? In what way are these costs similar to or different from the costs of other commercial forest management organizations?

5.1 Comparing DNR to other landowners

As part of the Sustainable Forestry Calculation, the DNR analyzed various costs and management strategies. In August 2002 the DNR presented the Board of Natural Resources with an assessment of the revenue differences between various management strategies for western Washington trust lands. The DNR evaluated three different tiers.

The first tier was to assess the potential of the western Washington lands to grow timber. This is a baseline to evaluate how much of the productive capacity of the forest estate is dedicated to various policy or regulatory objectives.

The second was the Forest Practices tier. The objective was to assess how the trust lands could be managed under Forest Practices Rules and Law, without a HCP. In some ways, this approximates how a private landowner might manage forests under Forest Practices without a HCP. This should not be interpreted as an estimate of a realistic trust land management prescription due to distinct Endangered Species Act compliance obligations for trust lands. A comparison with the costs of others is difficult as noted elsewhere in this report. Above and beyond the issues of comparability and differences in management objectives, there are some unique geographical and forest habitat issues.

The proximity of DNR older forests to the federal lands designated for northern spotted owl management changes the patterns of northern spotted owl use on state lands. Northern spotted owl use of such trust lands is much higher than the average forestlands in Washington. The results are increased uncertainty as to where the owls may be from year to year. The regulatory response is to require repeated and costly northern spotted owl surveys. The movement of the owl in this habitat and the higher cost of surveys introduce a high degree of uncertainty and call for alternative strategies for risk management and predictability. A similar situation exists concerning another species. Almost no private forestlands were designated as federal critical habitat for the marbled murrelet; however, a disproportionate amount of state forestlands were given that destination.

Finally, the third tier valued the forest estate under the HCP, the Forest Resource Plan³ and the applicable Forest Practices Rules and Law.

Net present value is a measure of today's value for the 1.4 million acres of land. All future costs and future revenues are discounted to a common point in time, 2002. The numbers

³ The Forest Resource Plan is the current suite of Board policies that govern forest management on 2.1 million acres of forested trust lands.

should be seen as relatively accurate and do not constitute a formal appraisal. The numbers were valid in 2002. The purpose is helping understand the relative differences in the costs, assuming no changes in species listing or regulatory requirements occur in the 200-year period that would affect Forest Practices Rules. In contrast, the HCP has incidental take permits for species not yet listed but expected in the 70-year plan's lifespan.

The analyses do not attempt to quantify the benefits of either the Forest Practices Rules/Law or the Habitat Conservation Plan. The use of the timber growth potential calculation is not to assert that it is legally feasible to manage trust lands without regard to federal and state environmental laws. Rather, the purpose was to help the Board of Natural Resources understand the magnitude of resources allocated to non-revenue functions.

A number of assumptions were necessary to evaluate the tiers. More complete information is available upon request.

5.2 Estimated results⁴

The difference between growing potential value and current management under the HCP is about \$1.6 billion over a 200-year calculation period. This can be viewed as a proxy for the unavoidable costs of complying with state and federal environmental laws.

As a further comparison, the estimated difference is \$0.7 billion over a 200 year calculation period between hypothetical management of trust lands under only Forest Practice rules (which would possibly not meet trust lands' obligations under the federal Endangered Species Act) and current management under the HCP. This could be viewed as the cost of the State's compliance with the federal ESA for state trust lands. See the closing paragraph of this section for a discussion on the benefits of having a HCP for trust lands.

⁴ Information excerpted from a Board of Natural Resources Retreat presentation on August 28, 2002.

Figure 5.3 Estimated Results

	Tier 1: Timber Growth Potential	Tier 2: Forest Practices	Tier 3: DNR w/ FRP & HCP
Net Present Value (over 200 years @ 5% discount rate, in \$ Billions)	\$4.4	\$3.5	\$2.8

Given the advantages of the “no surprises” policy in the HCP, there are a number of benefits that are difficult to quantify. Included is incidental take coverage for any future listings during the term⁵ of the HCP. It is clear that the HCP brings additional environmental benefits that will reduce costs of future Endangered Species Act compliance. The HCP provides certainty and predictability not found in management simply based on the Forest Practices Rules and Law. The value of predictability and certainty is quite real but hard to quantify. Prior to the HCP the DNR spent millions of dollars per year for surveys. Finally, the cost of an ESA “take” can be quite large. One of the major objectives of the HCP is to reduce the risk of violating the ESA. There is no ESA coverage under Forest Practices. This section provides information to help answer the following questions and requests:

- What savings might be possible with greater technology improvements?
- What savings might be possible by merging trusts?
- What other major barriers exist to realizing significant savings?

6. Possible Cost Savings

6.1 Savings and technology improvements

DNR business systems are currently heavily dependent on computer technology, particularly geographic information system (GIS) technology, in which DNR is a state leader. The agency is constantly seeking ways to improve efficiency through improved application of technology. Recent examples include:

The consolidation of two DNR regional organizations, predicated on the assumption that field staff with greater technology access in the field can work in larger geographic areas. The current project to revamp the Revenue Management System, Timber Sales Contract System, and Asset Performance System, switching from older mainframe systems to a more easily supported Web-based technology.

The current request for a budget increase, to allow the agency to keep pace with our GIS vendor’s planned transition to Windows-based software, which will place GIS data in the hands of the user and significantly decrease dependence on technical experts to feed information requests.

While all these efforts will result in a more efficient and effective organization, all take an initial investment, which generally must be approved by the Office of Financial Management

⁵ The term of the HCP contract is through 2067 with the option of three 10-year extensions.

(OFM) and the legislature. DNR welcomes the Independent Review Committee's interest in discussing ways the agency can improve its business through technology improvements.

6.2 Savings and merging trusts

If it serves the interest of each trust, federally granted trust lands may be managed collectively as long as DNR maintains separate allocation and accounting of costs and expenses to each trust. See AGO 1996 No. 11, pp. 21-25. A complete "merger" that did not maintain separate trust funds would require a change in Washington State's Constitution and the federal Enabling Act, which set up the federally granted trusts as separate and distinct.

The State Forest Transfer lands, created by state statute, are a single trust that can be managed as a whole. See AGO 1996 No. 11, pp. 69, 70. However, under RCW 79.66.110, revenues are distributed to the county in which the land that produced the revenue is located. The county beneficiaries have generally not supported proposals to treat these "county trust" lands as a unified trust, due to the complexity of dividing up their respective "shares."

In the recently completed Sustainable Harvest EIS, one alternative was to combine all trusts into one unit for purposes of calculating a sustainable harvest level. This allows greater flexibility in assigning a given year's harvest among the various trusts' forest lands. The harvest level and economic performance of that alternative compared to the Board's selected approach is one proxy for this suggested savings measure. The Board's selected approach generally combines all federally granted trusts into one calculation unit, separates each county as a separate unit, and sets up two geographically separate calculation units.

The combined trust alternative was estimated to produce 663 MMBF of timber volume per year in the first decade, compared with the Board's selected approach, which will produce an average of 597 MMBF per year. This translates into approximately \$165 million per year in trust revenue in decade one for the combined trust approach, compared to approximately \$151 million per year for the selected approach. The Board did not select the combined trust approach because of its much greater timber volume and revenue fluctuations from year to year and from decade to decade, both in aggregate for all trusts and especially for individual trusts. For example, over the seven-decade planning period, the combined trust alternative shows decade harvest levels ranging from 4.79 billion board feet to 8.83 billion board feet, an 84% swing. This could produce severe revenue flow problems for some beneficiaries. The Board's selected alternative shows inter-decade variations of 4.99 bbf to 5.97 bbf, a 20% change which is consistent with the Board's policy.

6.3 Other major barriers to realizing significant savings

In general, the scope of the Committee's work in making recommendations to Commissioner Sutherland is intended to be limited by the existing legal and contractual framework. However, Commissioner Sutherland agreed at the first Committee meeting that where there are obvious barriers that are feasible to overcome in the near term, the Committee may make that suggestion to the Commissioner. The Commissioner may then consider making appropriate policy proposals to the legislature. An obvious statutory barrier is the limit of the RMCA and FDA management fees to 25 percent of gross revenues. DNR's intention in bringing information to the Committee is to stimulate creative discussion related to its

management efficiency and effectiveness. If the Committee identifies barriers that significantly harm efficiency and effectiveness, and that the Committee believes can feasibly be eliminated, the department welcomes those recommendations.

7. Influences on Timber Price

This section provides information to help answer the following questions and requests:

- What effects are occurring from imports of Canadian wood?
- What effects are occurring or possible from changes in processing technology?
- What effects are occurring or possible from more active, targeted marketing of timber products from trust lands?

7.1 Effects from imports of Canadian wood

Canada currently exports a significant percentage of logs and lumber to the US log and lumber supply (approximately 30 percent). This dramatically affects the balance of supply and demand in the US domestic log market. Nowhere is the effect of this greater than here in the Pacific Northwest, which is located adjacent to British Columbia, Canada's most productive log source. Because the stumpage rates for timber from trust lands depends upon the strength of the domestic market, DNR timber revenues will rise or fall in accordance with the level of supply of Canadian logs in the US domestic log market.

New forecasts (for 2005-2006) by the Western Wood Products Association, as presented in Portland on October 13, 2005, indicate lumber production to decline very slightly with declining housing starts into 2005 and 2006. One prediction is that log supply and "cheap" logs in Canada may be a thing of the past. This potentially could hold stumpage even with slight declines in lumber prices.

7.2 Effects from changes in wood processing technology

The log supply picture has changed. Once dominated by large logs, today the market is dominated by smaller second and third rotation forests. Simultaneously, forest health issues, primarily on the east side of the Cascade Mountains, mean additional smaller logs in the market. Trust land management strategies will generally increase the log size, which may place us in tension with most mills. DNR is a player in the market, not a market maker; trust lands provide 10-15 percent of the domestically produce logs in Washington.

The wood processing industry is responding to this broad change in future log supply by investing heavily in new sophisticated equipment designed to maximize the merchantability of the smaller material that was once considered to be of very low value or useless. Innovation by industry is erasing the old paradigm that bigger logs are better.

A response to log supply quality shifts appears to be influencing new mill capacity to address these increased small wood increases. In the last few years, one significant change in the manufacturing picture is logs moving from Washington to less supplied regions in Oregon and California. These log supplies have influenced manufacturers to look seriously at

reallocating production capacity into Washington. The result is that more logs stay in Washington but with little or no impact on stumpage pricing structures.

7.3 Effects from more active, targeted marketing of timber products from trust lands

Over the past year and a half, DNR has instituted an aggressive marketing strategy. This strategy reaches out to customers as well as teaches staff how to better market sales.

Customer Outreach

- E-mailing Purchasers – Monthly e-mails of appraisal packets
- Purchaser conferences
- Internet – Appraisal Packets of sales, developing sale query
- Personal contacts with Purchasers, developing new markets
 - Contract Harvesting sales
 - Spruce house log sales

Internal Training and Scheduling

- Product Finder query system – Identifies stands with high value products and species
- Processor Database – Identifies what processors want, when they want it, how far they will go, and what size they want
- Timing Chart – When species specific sales should be sold
- Statewide marketing area map – Identifies areas that have similar purchasers
- Pre-Sales Planning training in spring of 2004
- Division and Region scheduling of sales utilizing marketing tools

Contract Harvesting Program

- Increased revenue from adjustments during sales
 - Wiehl Ridge – Peeler Douglas fir
 - Hungry Bug – Red cedar poles
 - Cougar Mountain – Engleman spruce house logs

8. Other Revenue Sources

This section provides information to help answer the following questions and requests:

- What is the potential from lands near the I-5 corridor?
- What is the potential for Wind farms and other revenue sources?
- What is the potential for further reductions in rotation age?
- What is the potential for short rotation hardwoods
- What is the potential for seeking voluntary payment of some management costs by private companies?

8.1 Potential from lands near the I-5 corridor

- About 16,000 acres of trust lands along the I-5 corridor have been identified for potential disposal. At an estimated average value of \$10,000/acre they are worth approximately \$160 million (land value only –timber not included).
- There are also an estimated 50,000 acres of transition lands, lands that are unlikely to remain in resource production due to their zoning or the nature of adjacent land uses. . At an estimated average value of \$5,000/acre they are worth an additional \$250 million (land value only –timber not included).
- The current income potential is very low in most instances.
- Potential reinvestment of the prospective \$0.4 billion assets in the I-5 corridor and transition lands would yield annual gross revenue of some \$20-30 million, assuming a minimum annual return of 5-7 percent.

8.2 Potential for wind farms and other revenue sources DNR is pursuing

Wind Power

New sources and methods of generating power are constantly under development in the energy sector. Wind power generation is becoming an increasingly viable resource to plug into the energy mix in the Northwest.

Wind power generation on public lands offers potentially significant revenues from leasing of land and ongoing payment of royalties. DNR currently manages about 20,000 acres of state trust land that meet criteria set forth by the industry as attractive to wind power developers.

DNR has been active since 1999 in considering wind power opportunities on state parcels. The department contracted with a specialist from Portland, Oregon, for technical and practical advice on developing a solid wind power development lease and how to go about negotiating with industrial proponents of wind power. DNR has developed a close working relationship with the National Renewable Energy Laboratory in Boulder, Colorado and local folks at Washington State University's Energy Office in Olympia. NREL facilitates the Western States Land Commissioners "Virtual Workgroup on Wind Power on State Lands". We have developed a model Wind Power lease now shared with other Land Grant States to help them as they develop their programs.

To date, DNR has issued 8 land use licenses (for wind power exploration) across the state for the purpose of obtaining wind data from selected DNR-managed parcels. The department has 4 active wind power development leases, and is negotiating on more.

New Communication Technology

The DNR communication site leasing program manages more than 500 leases at mountain top sites and other appropriate locations around the state. Current uses at these sites include cellular phone relays, microwave links, TV and FM broadcasters, and two-way radio transmitters. Some of the newest technologies of interest to the department are WiFi and WiMax, which are used for wireless internet and data transmission networks.

Oil and Gas Leasing

Interest by the petroleum industry, due to improved technologies and high petroleum prices, continues to motivate DNR to auction nominated lands for exploration. DNR recently (April 2004) held such an auction; there were 8 bidders. The department received bids on 601 Oil & Gas Leases. All lease areas are located in Eastern Washington, and the leases cover more than 320,000 acres. Inquires are already being received regarding interest in another oil and gas lease auction.

Vineyards and Wineries

DNR leases more than 3,500 acres of vineyard. The department is working with multiple stakeholders as we move forward to develop opportunities within the Red Mountain American Viticultural Area near Benton City.

Turn-key Orchards

The department bought an operating orchard earlier this year including investment in the current infrastructure such as the river pump station and fruit trees. This is the first project of its kind for state trust investment, and this property has shown itself to be an excellent producer. As this property demonstrates its return on investment, it is expected that the department may make similar investments in the future.

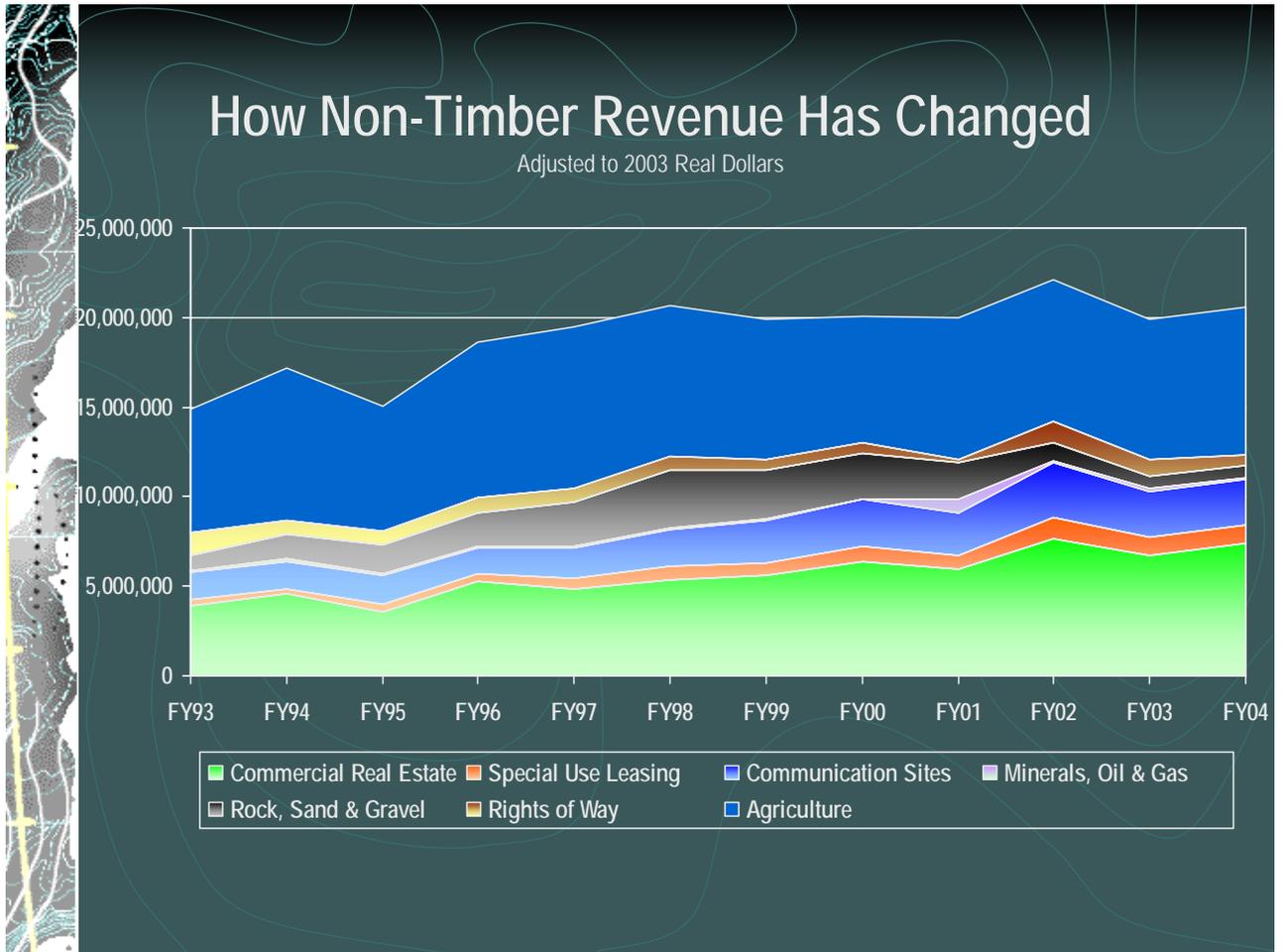
Balanced Agricultural Holdings

Dry land sharecrop revenue is 42 percent of trust agricultural revenue; irrigated crop revenue is 29 percent; and, orchard/vineyard revenue is 29 percent.

Direct Seeding on Dry Land Sharecrop Leases

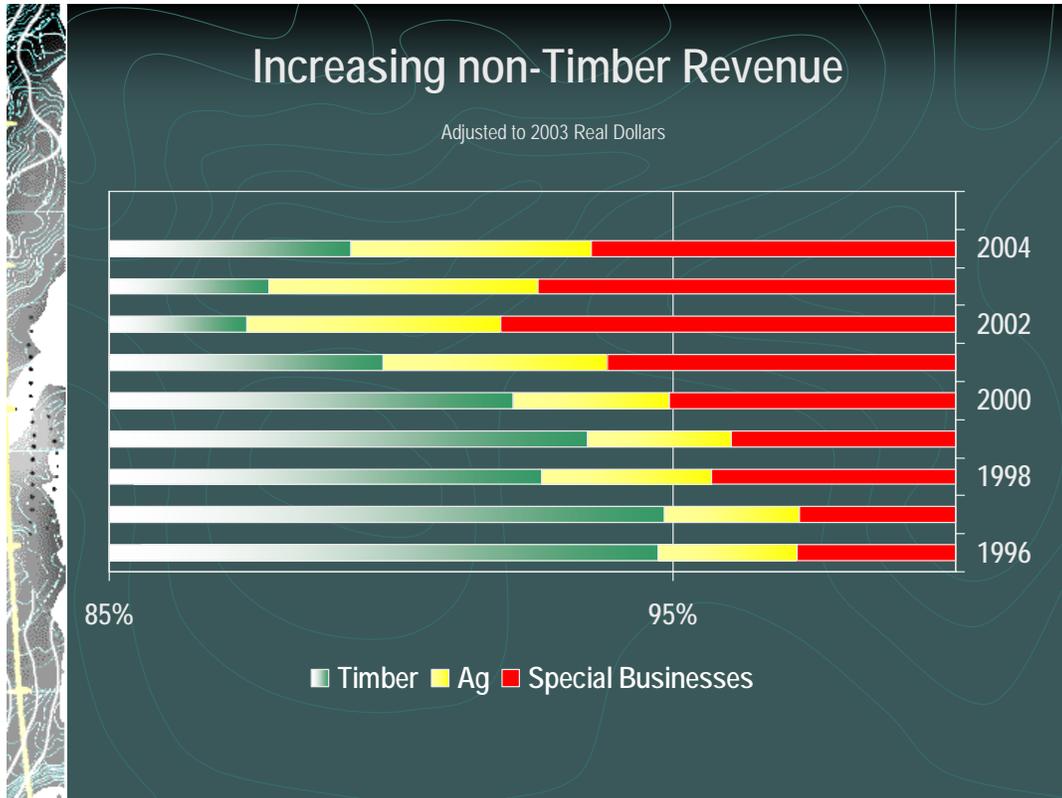
Through an incentive program, DNR has entered into agreements with 36 lessees to grow crops using direct seed or "no-till" methods. Direct seed is a cropping system, which leaves most of the crop and plant residue undisturbed on the soil surface, from harvest through to the next planting.

Figure 8-1 How Non-Timber Revenue Has Changed



While the objective has been to improve the portfolio through asset diversification, the following chart shows the dominance of timber. In this chart, the term “Special Businesses” is used; this is a catch-all category that bundles all the revenue sources identified in the previous chart, except agriculture.

Figure 8.2 Increasing Non-Timber Revenue



8.3 Potential for further reductions in rotation age

In the recently completed Sustainable Harvest EIS, one alternative considered was to apply more traditional industrial management practices, including shorter rotations to those trust lands not constrained by other legal obligations. For example, under that alternative an average rotation age for Douglas fir on average sites would be 50 years. In the alternative the Board selected, there are a variety of rotation ages, depending on management objectives.

The alternative with shorter rotation ages was estimated to have a first decade average annual timber harvest volume of 648 MMBF, compared to 597 MMBF for the Board’s selected alternative. That translates into approximately \$162 million per year in trust revenue, compared to approximately \$150 million per year for the Board’s selected alternative. The alternative with the shorter rotations did not meet the Board’s objective to employ innovative silviculture which is intended to simultaneously increase production of both complex habitat and trust income, thereby accelerating department compliance with its contractual HCP commitments for habitat creation. Meeting HCP habitat goals more quickly will increase management flexibility over the long term, which benefits the trusts.

8.4 Potential for short rotation hardwoods

The largest factor that affects DNR's presence or role in the future hardwood market is the shift to focusing on marketing strategies, "Value Based," aimed at increasing revenues through better product merchandising and improved targeting of customers' niche product demands. This includes hardwoods.

DNR currently has no plans for large-scale conversion of trust lands forests to short rotation hardwood-dominated stands. There are significant supply and price problems with hybrid cottonwood stands; such stands, grown on agricultural rotations of less than ten years, may never be harvested.

However there are a few factors that will contribute to an anticipated increase in the amount of hardwoods grown under conventional rotations, from existing stands on trust lands.

- **Westside Sustainable Harvest** – An increase in the amount of wood available for harvest annually translates into additional hardwood volumes.
- **Riparian Strategy Update** – The plan enabling harvest activities within riparian areas is in the final stages of negotiations and approval by federal agencies... More riparian harvest activity = more hardwoods.
- The shift to '**Value-Based**' marketing strategies aimed at increasing revenues through better product merchandising and improved targeting of all our customer's niche product demands (including hardwoods).

8.5 Potential for seeking voluntary payment of some management costs by private companies

RCW 43.30.490 authorizes DNR to enter into voluntary cost-reimbursement agreements with applicants for "permits" or "leases" in order to recover the costs of processing the permits and leases. However, that statute does not apply to many management activities conducted by DNR, such as timber sales. The state legislature would need to expand DNR's existing cost recovery authority in order for DNR to accept payment of those operating costs from private companies.

DNR Briefing Material - Volume 3

November 2004

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Introduction

This volume of briefing materials (Volume 3) provides responses to the following questions raised by the Independent Review Committee at Meeting # 2 (October 22, 2004):

1. Can DNR increase net revenue by harvesting more timber?
2. Is DNR's timber price forecast reasonable?
3. How have recent expenditures been reduced?
4. What are the detailed management expenditures currently made with DNR's 25 percent share of gross revenues?
5. How, in detail, does DNR proposed to spend the projected \$10 million dollar annual increase in management expenditures it says is needed to implement the Board of Natural Resources direction to increase harvests?
6. What would be the financial impact on trust beneficiary revenue and management fund balance from increasing the harvest level to the board-approved level while increasing the maximum management fee deduction to 30 percent?

1. Can DNR increase net revenue by harvesting more timber?

On September 2004, the Board of Natural Resources, after over three years of analysis, technical review, and public participation, reached a unanimous decision to increase Western Washington's sustainable timber sales volume to 597 mmbf per year over the 2005-14 decade. This is a 3.8 percent increase from the last scientifically analyzed harvest calculation done in 1996. This also compares to the 2004 sales level for western Washington of 440 mmbf.

The Board decided this is the most prudent harvest level, in the interest of trust beneficiaries, which meets trust obligations, is sustainable over the long term, meets DNR's contractual HCP commitments under the Federal Endangered Species Act and Clean Water Act, and can be accomplished by the department through aggressive implementation schedules. The Board's rationale for selecting this level, rather than alternatives with higher average annual harvest volumes, included several considerations:

1. avoiding large annual or decadal swings in volume which would be disruptive for some beneficiaries;
2. employing active innovative forestry techniques which will accelerate development of structurally complex forests (an HCP requirement) while increasing trust revenue, thereby providing more management flexibility; and
3. incorporating aggressive but reasonable expectations about DNR's implementation of higher levels. Under the Board's decision, to employ active management over a larger portion of the landscape, average harvest levels in the second decade will be 574 mmbf/yr.

Because of the nature of DNR's variable and fixed costs, expenditures exceed management fund revenues at the current volume, price, and current statutory ceiling. DNR's projections show that simply increasing volume alone, to the new level set by the Board, will not reverse this trend. Therefore, at higher volumes, total expenditures continue to exceed total management fund revenues, leading to a rapid depletion of the management funds. See tables in the section addressing question #6.

2. Is DNR's Timber Price Forecast Reasonable?

About 85 percent of total trust revenue is from timber sales. As a result, changes in timber prices have immediate and dramatic impact on total trust land revenue. For example, if timber prices were to be 10 percent higher for the next 10 years, total revenue would increase about \$170 million; similarly, a sustained drop would reduce total revenue by the same amount. For the management funds, such changes would increase or decrease the FY 2015 fund balance by about \$50 million.

Macro-economic forces control prices of goods produced on trust lands. These forces include but are not limited to

- Supply: international, national and regional;
- Demand: international, national and regional;
- Relative strength of currency: the value of the US dollar versus the Canadian dollar versus other currencies; and
- Economic growth: differential rates by nations ultimately influence the previous factors.

Long-term historical timber price trends appear to have changed. Real price appreciation for timber in the U.S. was a trend for nearly a century. Today, the trend is more toward stable prices. When combined with the effects of inflation, this means a reduction in *real* prices.

Certain historical patterns may no longer be valid:

To meet the increasing demand, new sources of wood fiber have been developed over the past twenty years, as well as more efficient utilization of existing sources and increased recycling. As a result, the world supply of timber is moving from an era of relative scarcity to one of relative abundance and from regional markets to global markets.¹

This trend is clearly demonstrated by the following excerpted data (Figure 2.1), which shows actual and forecasted prices for delivered logs. Trust land timber revenue directly follows delivered-log prices. While not all trust timber is Douglas fir, this species represents the majority of the total sales value, making this chart representative of possible revenue trends. The DNR revenue forecasts are based on this underlying data, and in turn, the financial analyses we have prepared are based on our revenue forecasts.

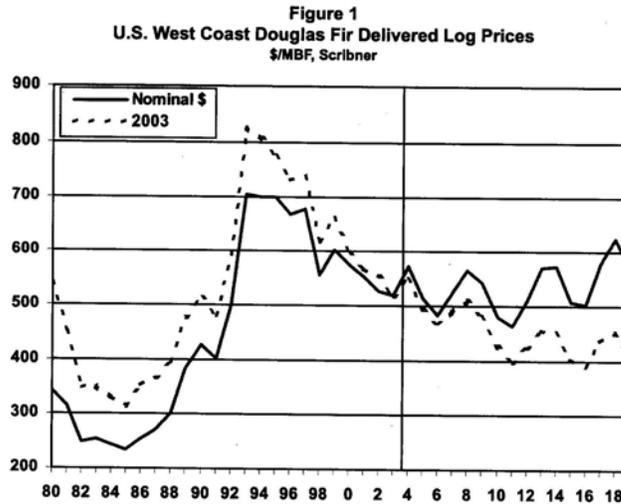
The department subscribes to two forecasting services: Resource Information Systems, Inc. (RISI) and Clear Vision & Associates (CV). In addition to their forecasts, these organizations provide consulting services to the department. The department also subscribes to a number of industry publications including Log Lines, Random Lengths, Western Wood Products, Midman's Market Barometer, and the Wall Street Journal that provide information on current and projected market conditions. The department also uses internal tracking and reporting systems to provide information on historical timber sales and removal volumes, timber sales and removal prices, the volume and value of timber under contract and timber, and non-timber revenues.

¹ Economic Research, The Campbell Group, LLC, James Stevens, Ph. D, Forest Economist, June 2002

Figure 2.1 – Delivered Log Prices

RISI North American Timber Forecast

Timber Prices



- Over the 15-year forecast period, West Coast sawlog prices will trend lower on an inflation-adjusted basis. A healthy expansion in the inventory of second-growth timber on the region's private forests will be a key factor in restraining upward movements in West Coast softwood sawtimber prices. In addition, growing competition from lumber and panel producers in other supply regions in North America and offshore will limit the expansion of demand for West Coast softwood sawtimber. Inflation-adjusted delivered log prices for Douglas Fir sawtimber will slip 25% between the periods 2000–2004 and 2015–2019 (Table 1).

Table 1
Western Washington and Oregon Delivered Log Prices
Dollars per MBF, Scribner

	1990- 1994	1995- 1999	2000- 2004	2005- 2009	2010- 2014	2015- 2019
Nominal Dollars						
Douglas Fir	547	642	550	526	519	557
White Woods	427	490	395	404	398	427
Adjusted for Inflation 2003 \$						
Douglas Fir	646	706	557	487	432	419
White Woods	504	540	400	374	332	321

Note: Prices include costs of harvest and delivery to mill.

October 2004 - Long-Term

Note: This data is abstracted from RISI North American Timber Forecast in an article titled "Timber Prices" by Balter & Barynin

179

Although timber prices may increase, they may also decline to levels below what has been forecasted. If timber prices outperform the forecast, then the amount of money returned to the beneficiaries would be increased.

At present, real revenue available to manage trust assets is declining. This decline in real revenue is driven by the decline in real prices of timber over time. For example in the 2001–03 biennium, timber revenue was the lowest since 1969-71.

Influence of timber prices on management fund share

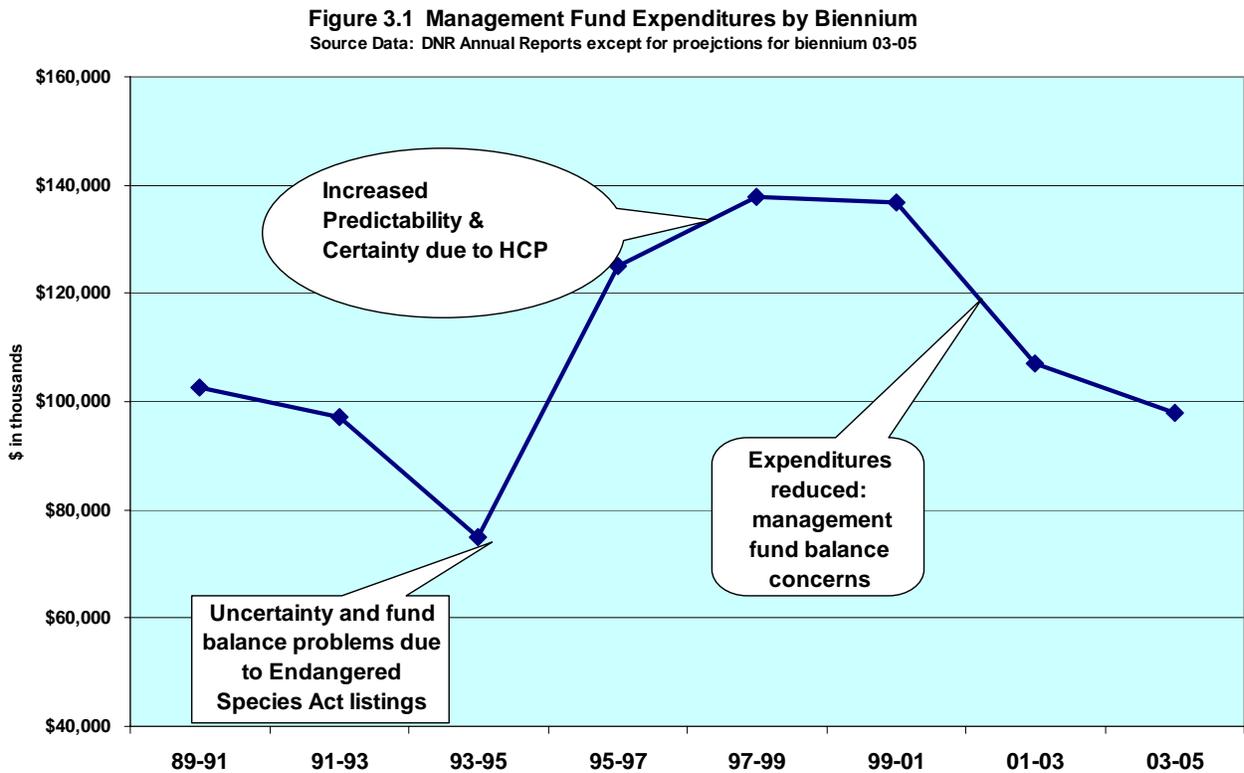
Subject to the ceiling in current law, the Board of Natural Resources has the authority to adjust the cash flow necessary to maintain appropriate management fund balances. The Board has a history of adjusting the percentage of revenue allocated to the management funds, sometimes equal to the statutory ceiling or at other times, below the ceiling. For example, the Forest Development Account now receives 22 percent of revenue from State Forest Transfer lands, but the statutory ceiling is 25 percent.

To address price uncertainty and operating cycles, DNR takes the approach that some fund balance is necessary as a shock absorber.

3. How have recent expenditures been reduced?

Management fund (RMCA and FDA) expenditures have increased or been reduced to fit then current circumstances. Figure 3.1 shows the actual expenditures from the management funds for the previous seven biennia and projections for the current biennium.

Figure 3.1



4. What are the detailed management expenditures currently made with DNR's 25 percent share of gross revenues?

While meeting increased expectations, DNR has substantially reduced expenditures to reflect the realities of lowered revenues. The Resource Management Cost Account expenditures are the lowest since 1970, when expressed in real 2003 dollars.

Yet, to manage these multi-billion dollar trust lands, money from the Resource Management Cost Account and Forest Development Account—the “management funds”—must be spent. The majority of the trust land management expenditures are for personnel—the DNR employees that provide the scientific, professional, managerial and administrative resources to manage 2.9 million acres of trust lands spread across the nearly 43 million acres of the state. Other costs are for goods and services; interagency payments for building rent, audit services and Attorney General legal help; and payment for fire protection services.

The state trust lands have a high quality forest inventory that needs to be maintained to make forest management and forest marketing effective. Expenditures cover capital improvements and long-term land management investments such as tree planting, thinning, fertilization and tree improvement.

The size of the agency and its responsibilities allow for economies of scale. DNR's total budget for the current biennium, fiscal years 2004 & 2005, is \$291 million. Of that, \$98.7 million is from the “management funds.” See Figure 4.1. Overhead costs are equitably distributed to all programs with trust land management benefiting from the existence of the agency-wide computer networks and other administrative systems. All programs, whether they are trust land or general fund (such as fire protection and forest practices) pay equitable shares that are subject to ongoing evaluation by the State Auditor.

Allocation of Management Funds within the DNR

As identified in the Briefing Material for the Independent Review Committee Volume 2, about 80 percent of the management funds goes directly to the Trust Land Management programs. The other roughly 20 percent goes to overhead costs and programs that benefit trust land management indirectly. See Figure 4.1, following.

Figure 4.1 Allocations of Management Funds within DNR: Total = \$98.7 million

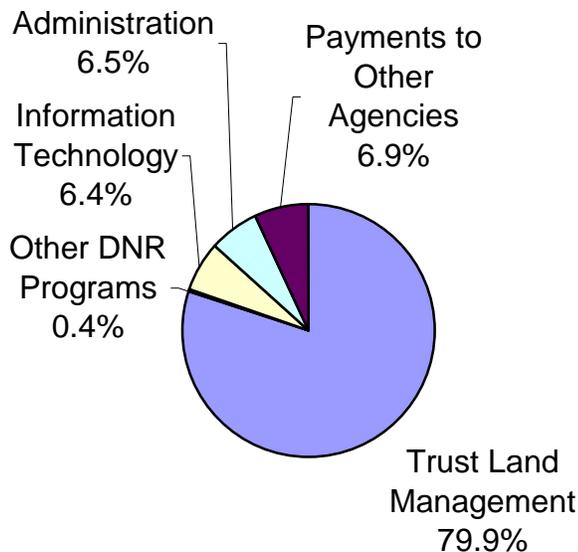
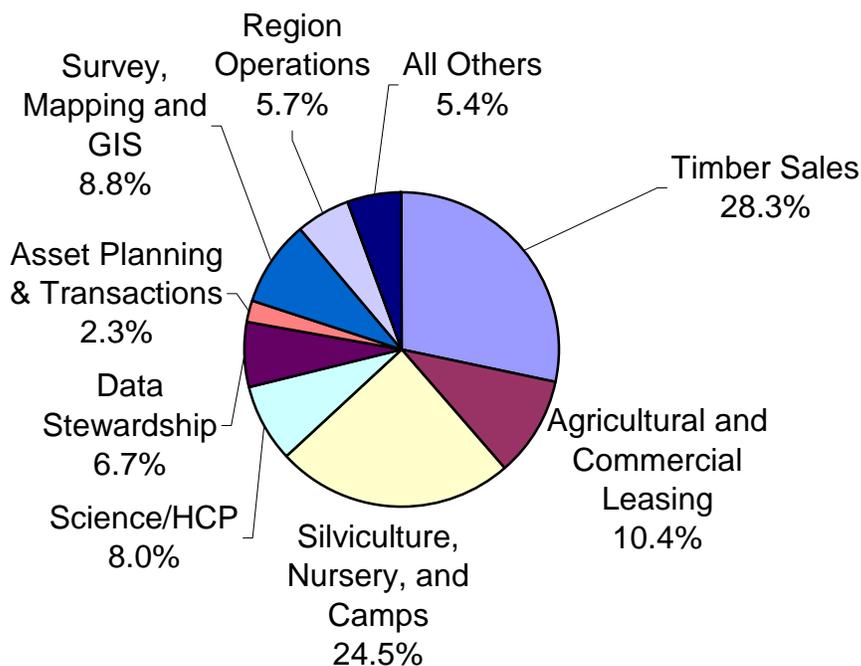


Figure 4.2 identifies how money is used within the large category of Trust Land Management identified in Figure 4.1. The total expenditures for this category are \$78.9 million. The two largest elements, Timber Sales (field work necessary to prepare, market and administer timber sale contracts) and Silvicultural activities (for example, tree planting and thinning young stands to improve health and growth) are 53 percent of the Trust Land Management Program expenditures.

Figure 4.2 Management Funds Allocation to Trust Land Management Programs by Category: Total = \$78.9 million



Description of trust land management program categories

Each program category shown in Figure 4.2 includes various activities. Major trust land management activities for each category are listed below.

- **Timber Sales:**
 - Identifying areas for timber harvest
 - Reconnaissance of the ground to identify logical harvest boundaries, road locations, environmental concerns
 - Survey of boundaries
 - Determination of timber volume and appraisal value
 - Develop timber sale contract and road engineering plan
 - Prepare a SEPA checklist and Forest Practices application
 - Post public notice of sale and respond to public comments
 - Market and advertise timber sale, hold public auction
 - Contract administration
 - Forest fire protection assessment

- **Agriculture and Commercial Leasing**
 - Identification of trust land suitable for agriculture and commercial leasing
 - Market and advertise properties
 - Appraise properties
 - Negotiate leases and determine lease rates
 - Conduct public auctions
 - Lease administration and re-appraisals
 - Capital improvements such as: wells, irrigation systems, commercial buildings

- **Siviculture, Nursery, and Camps**
 - Planting trees
 - Site preparation
 - Thinning of non-commercially sized trees
 - Vegetation control
 - Fertilization
 - Growing of seedlings
 - Genetic improvement of seedlings
 - Preparation and transportation of seedlings for planting

- **Science and HCP**
 - Scientific support for land management including Hydrologists, Wildlife Biologists, Forest Pathologists, Entomologists, Geologists, Silviculturalists, Plant Ecologists, and Fisheries Biologists
 - Implementation, research and monitoring of conservation objective specified in the HCP to comply with the Endangered Species Act obligations

- **Data Stewardship**
 - Inventory of Forest stands using GIS
 - Growth and yield modeling
 - Sustainable harvest analysis
 - Sustainable Harvest implementation

- **Asset planning and transaction**
 - Land use assessments of trust land parcels
 - Buy, sell, and trade trust assets to improve economic and ecological performance while diversifying the asset base
 - Law enforcement activities to protect trust assets

- **Survey, Mapping, and GIS**
 - Land surveys to establish legal boundaries
 - Resource photography; aerial photography
 - Development and maintenance of geographic information systems (GIS)
 - Development and support of multiple data layers to permit spatial analyses

- **Region Operations**
 - Six region offices and associated satellite work centers
 - Telecommunications, rent, and other charges
 - State lands support for vehicle and facilities operations
 - State lands support of administrative support personnel such as:
 - human resources
 - payroll
 - accounts payable/accounts receivable

5. How, in detail, does DNR propose to spend the projected 10 million dollar annual increase in management expenditures it says is need to implement the Board of Natural Resources' direction to increase harvests?

In September 2004, the Board of Natural Resources adopted a new sustainable harvest level, and directed an active management approach to increase revenue while developing healthy habitat, benefiting all of the people of the state of Washington.

The Board-approved Sustainable Management of Western Washington Trust Lands plan requires that an additional half- million acres would be more actively managed to bring important economic and ecological benefits.

Currently, DNR anticipates the need for some 95 additional employees over the next four years. Based upon the initial estimates approximately 85 percent would be hired for direct timber sales operations and 15 percent would be hired for related agency administrative activities. There are some fixed start-up costs for vehicles and other equipment. Most positions are field-level professionals necessary to make the complex decisions to capture the potential of the trust lands. The Board of Natural Resources was briefed on our hiring strategies. The following chart gives a preliminary breakdown of the various new positions planned for the next four years.

Figure 5.1

Figure 5.1 - NEW Board Action Implementation - New FTE and Management Fund Costs

	New FTE	%	FY05		FY06		FY07		FY08	
			FTE	Total \$						
Operating Programs										
Product Sales	53.3	55.9%	11.2	691,800	5.7	360,900	16.0	1,005,900	20.5	1,284,900
Silviculture	7.4	7.8%	3.5	216,200	3.9	246,900				
Science/HCP	3.7	3.9%	2.0	123,500	1.7	107,600				
Data Stewardship	4.8	5.0%					4.8	301,800		
Leasing & Right of Way	2.0	2.1%	2.3	142,100	0.7	44,300				
Correctional Camps										
Land Survey	4.0	4.2%	2.5	154,400	0.5	31,700				
GIS	6.0	6.3%			1.0	63,300			5.0	313,400
Agricultural Resources										
Resource Mapping										
Asset Planning & Transactions										
Seed Orchard & Seed Plant										
Law Enforcement										
State Lands Operations										
Natural Heritage										
Recreation										
Forest Roads										
Total Operating Expenditures	81.2	85.1%	21.5	1,328,000	13.5	854,700	20.8	1,307,700	25.5	1,598,300
Administration & Agency Support										
Financial Management	3.7	3.9%					3.7	232,600		
Information Technology	1.5	1.6%					1.5	94,300		
Region Administration	5.0	5.2%			1.0	63,300	4.0	251,400		
Commissioner's Office										
RTA System										
Attorney General	1.5	1.6%							1.5	94,000
Human Resources	1.5	1.6%							1.5	94,000
Facilities										
Budget & Economics										
Communications										
Environmental & Legal Strategies	1.0	1.0%							1.0	62,700
Total A&AS Expenditures	14.2	14.9%	0.0	0	1.0	63,300	9.2	578,300	4.0	250,700
FTE Totals by Year	95.4	100.0%	21.5	1,328,000	14.5	918,000	30.0	1,886,000	29.5	1,849,000
One-Time Equipment Costs				539,000		294,000		588,000		588,000
Forest Investment (PCT, Fertilization, Reforestation, etc.)						2,766,000				
Overall Board Action Implementation				1,867,000		3,978,000		2,474,000		2,437,000

6. What would be the financial impact on trust beneficiary revenue and management fund balance from increasing the harvest level to the Board-approved level while increasing the maximum management fee deduction to 30 percent?

The following information is provided to help answer the above question. While there are references to the management funds deduction increasing to 30 percent, the number is used as a financial and policy placeholder. It stands for a sum of money that comes from possible combinations of any of the following:

- Increased efficiencies within the DNR;
- Additional revenue into the management funds from any source; or
- An increase in the actual percentage of gross revenue going to management funds.

The tables are designed to quantify the financial impacts under differing sets of assumptions unique to each table. Note that the numbers used here are expressed in real terms; that is, the numbers are expressed in constant 2003 dollars (adjusted by the Consumer Price Index-Urban). Note also that there is a lag between when increased expenditures are made and when actual revenues are received.

Current Harvest level with 25 percent deduction

The table below shows real revenues in constant 2003 dollars for beneficiaries and management funds, assuming the current harvest level and a maximum deduction of 25 percent for the management funds. Real revenues to beneficiaries fall from \$279.3 during the current biennium to \$224.8 million during the 2013-15 biennium. Management fund revenues fall from \$88.7 million to \$74.8 million over the same period.

Figure 6.1

Real Revenues, Expenditures and Management Fund Balances - Current Harvest level with 25% Deduction

In Million of Real (2003) Dollars

		2003-05	2005-07	2007-09	2009-11	2011-13	2013-15
Revenue to Beneficiaries	\$ -	\$ 279.3	\$ 257.2	\$ 233.4	\$ 247.2	\$ 236.5	\$ 224.8
Management Funds Total							
Revenue		\$ 88.7	\$ 81.1	\$ 78.6	\$ 82.3	\$ 78.7	\$ 74.8
Expenditure		\$ 95.5	\$ 101.7	\$ 102.0	\$ 104.3	\$ 101.2	\$ 95.3
Ending Fund Balance	\$ 35.0	\$ 28.1	\$ 7.5	\$ (15.9)	\$ (38.0)	\$ (60.6)	\$ (81.1)

To continue the same level of harvest, management fund expenditures are projected to need to be increased next biennium by \$6.2 million due to anticipated salary and benefit increases beyond the control of the department. Department-wide expenditures needed to maintain the current harvest level are projected to average over \$10 million more per year than anticipated revenues. As a result, the combined management fund balance (RMCA & FDA) falls from a positive \$35.0 million to a negative \$81.1 million by June 30, 2015.

This means that, at current level of harvest with a 25 percent deduction, the department would not have the financial capacity solely from management funds to generate trust revenue beyond 2009.

Board-Approved Harvest level with 25 percent deduction

The table below shows the impact on real revenues to beneficiaries, management fund revenues, expenditures, and ending fund balances of increasing harvest to the Board-approved harvest level while retaining the 25 percent deduction.

Figure 6.2

Real Revenues, Expenditures and Management Fund Balances

- Board Approved Harvest level with 25% deduction

In Million of Real (2003) Dollars

		2003-05	2005-07	2007-09	2009-11	2011-13	2013-15
Revenue to Beneficiaries	\$ -	\$ 279.4	\$ 274.7	\$ 299.9	\$ 314.0	\$ 304.1	\$ 289.3
Management Funds Total							
Revenue		\$ 88.7	\$ 86.6	\$ 101.5	\$ 104.7	\$ 101.4	\$ 96.5
Expenditure		\$ 95.5	\$ 114.6	\$ 119.4	\$ 121.3	\$ 118.1	\$ 111.2
Ending Fund Balance	\$ 35.0	\$ 28.1	\$ 0.0	\$ (17.9)	\$ (34.4)	\$ (51.1)	\$ (65.8)

When the new harvest level is fully implemented, revenue to beneficiaries increases by more than \$65 million per biennium over that projected under the current harvest level. Management fund revenue increases as well, by over \$20 million per biennium.

Generating the higher sales level requires increasing real expenditures by an estimated \$16 million per biennium. The result is about a \$6 million dollar per biennium increase when the new harvest is fully implemented. The resulting fund balance, while improved, is still a negative \$65.8 million at the end of the projection period.

This means that, at the Board-approved harvest with a 25 percent deduction; the department would still not have the financial capacity solely from management funds to generate trust revenue at this level.

Board-Approved Harvest with 30 percent deduction

The table below shows the same information for the Board-approved harvest and a maximum deduction of 30 percent for the management funds. Because the RMCA fund balance falls below the minimum sooner than does the FDA, the RMCA deduction is assumed to increase to 30 percent at the beginning of 2005-07, while the FDA deduction from transfer lands increase to 25 percent at the beginning of the 2007-09 biennium and doesn't increase to 30 percent until the beginning of the 2009-11 biennium.

Figure 6.3

Real Revenues, Expenditures and Management Fund Balances - Board Approved Harvest level with 30% deduction

In Million of Real (2003) Dollars

		2003-05	2005-07	2007-09	2009-11	2011-13	2013-15
Revenue to Beneficiaries	\$ -	\$ 279.4	\$ 264.8	\$ 288.5	\$ 293.5	\$ 284.3	\$ 270.5
Management Funds Total							
Revenue		\$ 88.7	\$ 96.5	\$ 112.8	\$ 125.2	\$ 121.3	\$ 115.4
Expenditure		\$ 95.5	\$ 114.6	\$ 119.4	\$ 121.3	\$ 118.1	\$ 111.2
Ending Fund Balance	\$ 35.0	\$ 28.1	\$ 10.0	\$ 3.4	\$ 7.4	\$ 10.5	\$ 14.7

When the new harvest level is fully implemented with a 30 percent management fund level, revenue to beneficiaries will still increase by more than \$45 million per biennium over that projected under the current harvest level. Management fund revenue increases as well, by over \$40 million per biennium.

Real revenues to beneficiaries remain relatively stable over the projection period rather than falling as they do under the current harvest level, as increased harvest volume offsets both the reduction in real timber prices and the increase in the management fund deduction.

The combined Management Fund balance fall during the first two biennia as the department makes additional expenditures to increase the harvest level. Fund balances fall to near zero in the end of 2007-09 but then increase slightly as harvest increases in subsequent biennia to \$14.7 million at the end of the projection period.

This means that at the Board-approved harvest level with a 30 percent deduction, the department would have the financial capability to continue to generate trust revenue at this higher level.

Summary – Financial impact of increasing the harvest level and increasing the maximum management fund deduction to 30percent.

The table below shows the change in real revenues to the beneficiaries and management funds over the projection period from increasing the harvest to the Board-approved level and increasing the maximum management fund deduction to 30 percent. By the end of the decade revenues from trust lands are \$86.2 million higher under the board approved harvest level than under the current harvest level. Revenues to beneficiaries are \$45.6 million higher than under the current harvest with the 25 percent maximum deduction.

With the 30 percent maximum management fund deduction, management funds increase by \$40.6 million. As a result, management fund balances rather than being a negative \$81 million at the end of the projection period are a positive \$14.7 million, a net improvement of \$95.7 million.

Figure 6.4

Change in Real Revenues, Expenditures and Management Fund Balances - From Current Harvest and 25% Deduction - To Board Approved Harvest level with 30% deduction

In Million of Real (2003) Dollars

		2003-05	2005-07	2007-09	2009-11	2011-13	2013-15
Revenue to Beneficiaries	\$	0.1	\$ 7.6	\$ 55.1	\$ 46.3	\$ 47.8	\$ 45.6
Management Funds Total							
Revenue	\$	-	\$ 15.4	\$ 34.3	\$ 43.0	\$ 42.6	\$ 40.6
Expenditure	\$	-	\$ 12.9	\$ 17.4	\$ 16.9	\$ 16.9	\$ 15.9
Ending Fund Balance	\$	-	\$ 2.5	\$ 19.4	\$ 45.4	\$ 71.1	\$ 95.7

The graphs in Figure 6.5, 6.6 and 6.7 show how the three previously described combinations (see Figures 6.2, 6.3 and 6.4) of harvest level and management fund deduction compare. Five past biennia are also shown on each graph for reference, and reflect actual data (hence they are the same on each graph) or a common projection for 2003-05 biennium. The 2003-05 biennium is also the same on each graph, it is projected; a change in the harvest level or management fund deduction could not be implemented in time to make a significant change in the 2003-05 biennium.

Figure 6.5 Comparison of Harvest Level and Management Fund Deduction Scenarios

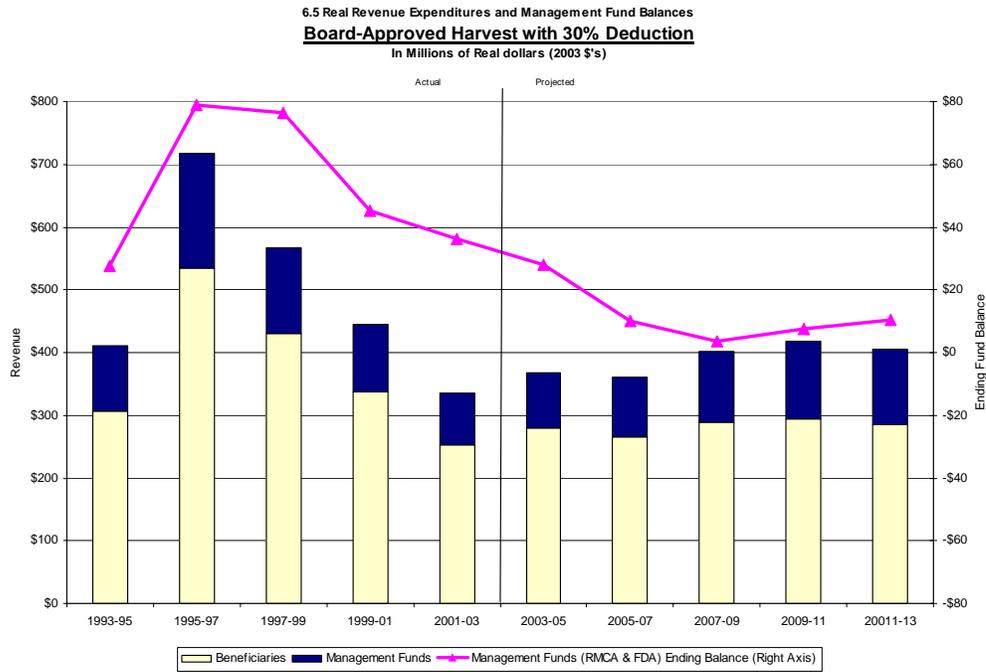


Figure 6.6

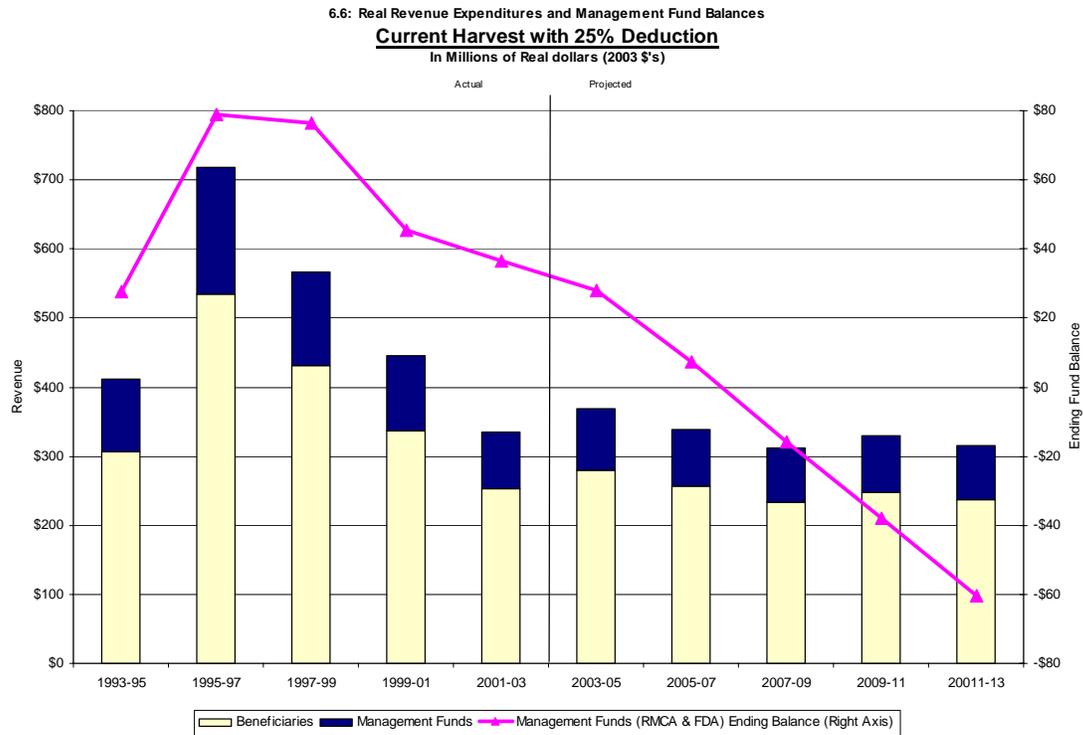
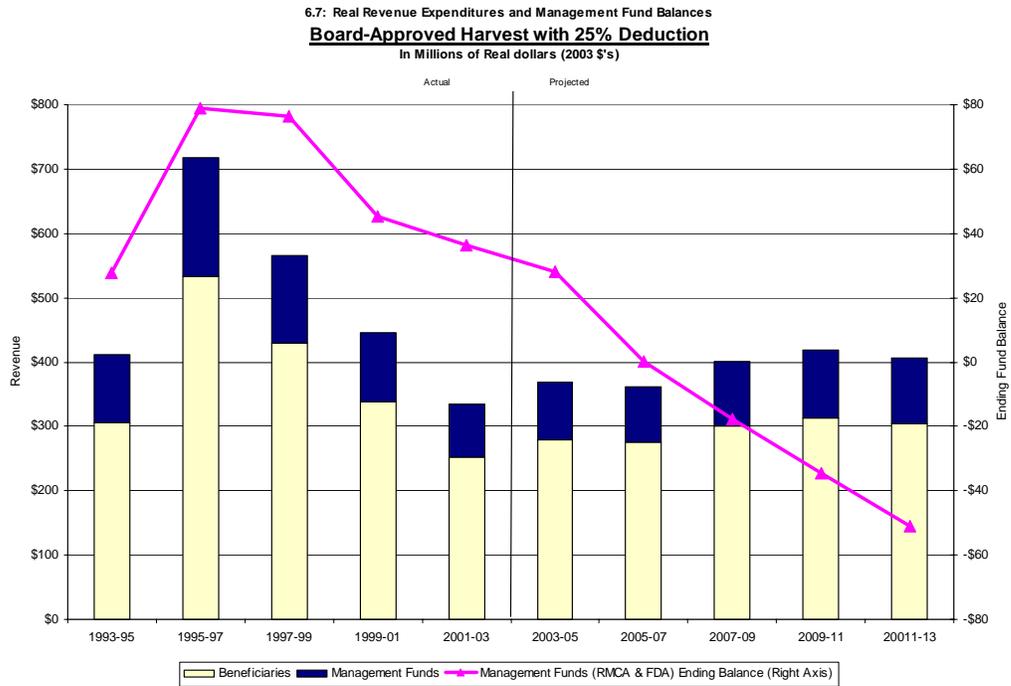


Figure 6.7



DNR Briefing Material - Volume 4

November 10, 2004

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Contents

Page	Section title
5	Introduction
7	Questions about Comparability
10	Questions about History and Current Status
19	Questions about the Future and Projections General Timber Harvest, Prices and Revenues Management Costs and Funds Beneficiary Revenues
29	Appendix Original Questions from Beneficiaries

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Introduction

This volume of the Briefing Materials (Volume 4) provides responses to questions and requests from the trust beneficiaries.

The questions and requests are grouped into three major categories:

- *Questions about Comparability*
- *Questions about History and Current Status*
- *Questions about the Future and Projections*

A number of the questions were very similar and have been consolidated. Other questions were re-stated to clarify the question to facilitate a more precise answer. Within these changes, we have tried to preserve the essential nature of the original questions. (For reference, the original questions submitted to the department are included as an appendix.)

Many of the questions were submitted early in the Independent Review Committee's process, and were then essentially answered in material prepared in volumes 1-3 of *Briefing Material for the Independent Review Committee*. The answers in this volume may refer to those earlier volumes of "Briefing Material."

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Questions about comparability

- 1. How do other state land offices manage trust lands for their beneficiaries without a management fee?
How does the 25 percent management fund share compare with how forestlands are managed elsewhere?
How does DNR's cost structure compare to that of outside land managers?**

Idaho

Nine beneficiaries — 2,464,000 total acres, including 1,020,000 acres of forestlands.

Starting with fiscal year 2001, Idaho changed its accounting system for trust land management expenses. Prior to that year, the Department of Lands was funded from a portion of dedicated "improvement" funds and state general funds. Since FY2001, the management of endowment lands has been 100 percent self-supporting. The Department of Lands distributes 100 percent of all endowment land revenues to the Endowment Fund Investment Board, which in turn reimburses the department for its actual expenses on a quarterly basis.

The ratio of expenses to revenues has ranged from 16.8 percent in FY2001 to 26.4 percent in FY03. The Department of Lands maintains a "float" of \$1-2 million per year to cover operating expenses as they occur. Administrative and overhead costs are allocated between the endowment land management activities and other department activities (fire fighting, forest practices, etc.), which are funded by dedicated funds and the state general fund. These dedicated funds and state general fund are not available for managing the endowment lands. The Department of Lands tracks management costs by asset class (forest, agriculture, commercial) and by endowment ownership.

Oregon

*Common School trust — 763,000 acres, including 133,000 acres of forestlands
Board of Forestry — 780,000 acres of forestlands*

Although all non-forested trust lands are managed by the State Lands Department, state trust forests are managed under an agreement between the Department of State Lands (DSL) and Department of Forestry (ODF). The Common School trust forestlands are intermingled with the Board of Forestry lands managed by ODF in five state forests, located mostly on the west side of the state, and with the vast majority of common school acres in one state forest.

For the Common School trust lands, the ODF transfers 100 percent of revenues earned as they are received and invoices DSL for costs of management. Administrative and overhead costs are prorated based on acres for site-specific costs, or on statewide acres for agency-wide activities. The six-year average (1998 through 2003) for reimbursable costs between ODF and DSL was 25.65 percent, and ranged from 17.13 percent in fiscal

year 2000 to 51.73 percent in fiscal year 2003. Preliminary numbers for FY2004 reimbursable costs are 32.31 percent. The two departments are currently negotiating a target funding level for fiscal year 2005 and beyond for reimbursable costs in managing the Common School lands. The Oregon Legislature has directed DSL to develop a system to separate expenses by revenue stream (cost accounting by asset class) starting with their next biennium.

For the Board of Forestry (1 beneficiary/15 counties) lands, during the last five years (fiscal years 1999 through 2003), the amount of revenue withheld to cover the costs of management has ranged from 22.24 percent to 29.36 percent.

Montana

Ten trusts — 5,163,000 acres, including 727,000 acres of forestland, with the Common School trust having 4,633,000 acres, or 90 percent of total trust acres

The Trust Land Management Division of the Montana Department of Natural Resources and Conservation (DNRC) manages these lands. The division is funded by a combination of state general funds and dedicated revenues from trust management activities. The funding formulas (revenue distribution and expenditures) are different for the common school trust lands and all other trust lands managed by DNRC. Montana's funding scheme is complex and utilizes a combination of dedicated fee-based revenues, retention of a small percentage of trust activity revenues (generally 5 percent or less), and state general fund monies to fund the Trust Land Management Division.

On Common School lands and from distributable receipt activities, a small percentage is allocated to the Resource Development Account and Timber Sale Account. No money is distributed to the timber sale account from non-common school trust lands. The remainder of the distributable receipt revenue is distributed to the Guarantee Account for use by the public schools. Fees assessed on individual timber sales are distributed to the Forest Improvement Account. Public access and use activities are funded by fees paid for a general recreational use license to access state trust lands. In 1999, the Montana Legislature created the Trust Administration Account, which is funded from a small percentage of revenues from land sales, mineral royalties, rights-of-ways and other activities from which the majority of revenue is distributed to the non-distributable permanent funds. The 1999 Legislature required the Board of Land Commissioners, which oversees the Trust Land Management Division, to provide annual reports regarding the average return of revenue on asset value to trust beneficiaries of forested lands, by land office location.

Grays Harbor County , Washington

The County manages 37,436 acres of formally tax delinquent lands, 35,644 acres of which are forested. Total revenues for calendar year 2003 were \$608,385, with \$448,803 from timber sales. Timber sales revenue is distributed 78 percent to the tax districts based on the current levy rates (similar to forest board transfer lands in other counties). The remainder (22 percent) is retained to fund the operations of the Department of Forestry. The County has deducted up to 25 percent in past years from timber sales to fund its

management activities. Other revenue sources (road use permits, facility rentals, special forest products permits, tideland leases) are distributed based on other funding formulas. The amount retained (22 percent) to fund department operations does not include costs for administrative or overhead services provided by the county (payroll, revenue receipts, legal services, etc.) with the minor exception of janitorial services on the department's own building, equipment/vehicle rentals from the county motor pool, and GIS/computer services.

2. Will the private sector be surveyed to obtain management cost data and, where applicable, be compared to DNR management costs to ascertain opportunities for further management efficiencies and savings?

Yes. Please see Briefing Material, Volume 2, Section 4. DNR has evaluated limited information from PricewaterhouseCoopers LLP and plans to participate in a fuller benchmark study early next calendar year. Similarly, there is a planned benchmark study that will start later this year, to be conducted by Atterbury Consultants, Inc.; similarly, DNR plans to participate in the Atterbury benchmark study.

As noted in Section 4.2 of Volume 2, DNR did talk with a larger private forest landowner in western Washington. Their percent of gross revenue used in land management ranged from a high of nearly forty percent down to just under thirty percent.

**3. How do the current land treatments and “on the ground” management practices compare to the most economically efficient land treatments?
Are similar treatments and practices used by outside land managers?
If there is a difference, what is the impact on revenue, related RMCA revenue and associated management costs?
What economic analyses indicate how the trusts were impacted (either positively or negatively) by the recent sustainable harvest calculation?**

Management practices are largely set by objectives. Other land managers may have similar or dissimilar objectives. Please see Briefing Material, Volume 2, Section 4.1.

The investment horizons and risk tolerance are significant factors that control on-the-ground practices. As a trust manager, DNR's objectives are tempered by the common law duties of a trustee and express laws that either created or govern the trust. Similarly, the existence of a Habitat Conservation Plan provides benefits and responsibilities that change our practices, making direct comparisons with other managers difficult.

Different alternatives were analyzed in the *Alternatives for Sustainable Forest Management of State Trust Lands in Western Washington Environmental Impact Statement*. The Final EIS document may be found at www.dnr.wa.gov.sepa. Some alternatives produced increased revenue in the near-term but had other consequences that were seen as unacceptable by the Board. These consequences included substantial inter-decadal variability in revenue levels or not achieving the desired mix of stand structures.

Questions about history and current status

4. What does status quo look like? Where is the 25 percent being spent today?

DNR has substantially reduced expenditures to reflect the realities of lowered revenues due to historically low timber prices. The Resource Management Cost Account expenditures are the lowest since 1970, when expressed in real 2003 dollars. Nevertheless, the actual expenditure rates are presently close to 30 percent. The net result is that we continue to spend and therefore draw down the fund balance. This answer assumes that the underlying question is about how the DNR is spending the management funds today. Briefing Material, Volume 3, directly answers the question in some detail (see pages 9-12).

Management of these multi-billion dollar trust lands requires investments. Investment money comes from the Resource Management Cost Account and Forest Development Account—the “management funds”. The majority of the trust land management expenditures are for personnel—the DNR employees that provide the scientific, professional, managerial and administrative resources to manage 2.9 million acres of trust lands spread across the nearly 43 million acres of the state. Other costs are for goods and services; interagency payments for building rent, audit services and Attorney General legal help; and payment for fire protection services, like any other forest land owner.

See also answer to question 16.

5. Community College Trust – What new lands have been purchased? How was the money spent? Where did it go? What happened to the management fund?

There are four parcels of lands which make up the current Community College Forest Reserve Trust. The first two parcels were acquired in June 1991, the third was acquired in February 2000 and the fourth parcel in August 2003. The following table summarizes the transactions to acquire these lands.

Parcel Name	Acres	County	Land Value	Timber Value	Total Value
Forest Glade	2,741	Snohomish	\$4,985,860	\$261,140	\$5,250,000
TAT	482	Snohomish	767,000	433,000	1,200,000
Phillips	26	King	200,000	0	200,000
Big Lake	120	Skagit	110,000	83,000	193,000
TOTAL	3,369		\$6,062,860	\$780,140	\$6,843,000

Since fiscal year 1997 there has been \$724,096 of revenue produced from these lands, with 75 percent being distributed to the Community and Technical College Forest Reserve Account and 25 percent to the Forest Development Account, per RCW 79.02.420 (5).

6. **What has the gross trust revenue amount been each year since 1971 adjusted to current dollars using a common state inflation adjuster? What have been the expenses in a similar fashion? What is the percent of expenditures by general object of expenditure historically (e.g., salaries & benefits, contractual services, etc.)? This object of expenditure information will provide a glimpse regarding how the allocation of resources might have changed over time. What are the total FTE supporting the Trust over time, and what is the average salary (not adjusted for inflation) of that FTE?**

Part 1

What has the gross trust revenue amount been each year since 1971 adjusted to current dollars using a common state inflation adjuster?

Real (adjusted for inflation) gross trust revenues from granted and state forest lands managed by the department since 1965 are shown in Figure 1.

Figure 1 **Real Revenues from Trust Lands Managed by The Department of Natural Resources In million of Real (FY 2003) Dollars**

Biennium	Timber	Leases	Trust Land Transfer (TLT)	Other	Total
1965-67	\$ 169.2	\$ 15.1	\$ -	\$ 0.9	\$ 185.2
1967-69	\$ 212.7	\$ 17.4	\$ -	\$ 1.8	\$ 231.9
1969-71	\$ 274.0	\$ 20.1	\$ -	\$ 8.2	\$ 302.4
1971-73	\$ 470.8	\$ 23.8	\$ -	\$ 18.6	\$ 513.2
1973-75	\$ 395.9	\$ 24.7	\$ -	\$ 26.5	\$ 447.1
1975-77	\$ 585.3	\$ 25.2	\$ -	\$ 30.2	\$ 640.7
1977-79	\$ 652.2	\$ 20.3	\$ -	\$ 27.0	\$ 699.6
1979-81	\$ 545.5	\$ 25.2	\$ -	\$ 49.5	\$ 620.2
1981-83	\$ 462.7	\$ 30.3	\$ -	\$ 46.2	\$ 539.2
1983-85	\$ 375.4	\$ 24.8	\$ -	\$ 29.2	\$ 429.4
1985-87	\$ 391.7	\$ 21.5	\$ -	\$ 36.8	\$ 450.0
1987-89	\$ 561.9	\$ 26.6	\$ -	\$ 19.6	\$ 608.1
1989-91	\$ 610.0	\$ 26.3	\$ 191.7	\$ 22.8	\$ 850.8
1991-93	\$ 428.5	\$ 29.6	\$ 59.6	\$ 11.7	\$ 529.4
1993-95	\$ 372.9	\$ 31.6	\$ 45.1	\$ 7.1	\$ 456.7
1995-97	\$ 671.8	\$ 38.1	\$ -	\$ 7.5	\$ 717.5
1997-99	\$ 517.0	\$ 39.5	\$ 24.2	\$ 13.2	\$ 593.8
1999-01	\$ 401.4	\$ 40.7	\$ 59.3	\$ 4.5	\$ 505.9
2001-03	\$ 290.9	\$ 41.3	\$ 34.2	\$ 5.4	\$ 371.8
Total	\$ 8,389.8	\$ 522.4	\$ 414.0	\$ 366.7	\$ 9,692.9

The US Consumer Price Index, for All Urban consumers (CPI-U) was used to adjust for inflation. For the period shown, the department generated \$9.7 billion dollars. Of this \$8.4 billion was from timber sales, \$0.5 billion came from leases, \$0.4 from Trust Land Transfer, and \$0.4 from “Other” Sources.¹ See Briefing Material, Volume 1, page 24 for more detail on historical revenues.

Part 2

What have been the expenses in a similar fashion?

Figure 2 shows real expenditures from management funds for the same time period.

Figure 2 **Real Management Fund Costs
RMCA & FDA
In Millions of Real (FY 2003) Dollars**

Biennium	Program	Administration and Agency Support	Capital	Total
1965-67				\$ 34.7
1967-69				\$ 55.7
1969-71				\$ 67.0
1971-73				\$ 84.6
1973-75				\$ 106.1
1975-77				\$ 128.2
1977-79				\$ 125.5
1979-81				\$ 123.3
1981-83				\$ 122.2
1983-85				\$ 101.7
1985-87				\$ 104.2
1987-89	\$ 87.1	\$ 20.7	\$ 4.3	\$ 112.1
1989-91	\$ 94.4	\$ 20.6	\$ 5.9	\$ 120.9
1991-93	\$ 94.6	\$ 20.7	\$ 4.1	\$ 119.4
1993-95	\$ 99.3	\$ 20.7	\$ 3.5	\$ 123.5
1995-97	\$ 100.8	\$ 26.0	\$ 6.2	\$ 133.0
1997-99	\$ 88.8	\$ 31.2	\$ 5.8	\$ 125.8
1999-01	\$ 88.0	\$ 32.2	\$ 4.4	\$ 124.6
2001-03	\$ 68.0	\$ 20.5	\$ 8.7	\$ 97.2
2001-05	\$ -	\$ -	\$ -	\$ 2,009.4

¹ “Other” Sources include timber default payments and other timber related sources (\$123 million), land sales (\$54 million) and interest on contracts and fund balances (\$189 million).

During the past three biennia, DNR has reduced real management fund costs by \$36 million (27 percent, from \$133 million in 1995-97 to \$97.2 million in 2001-03). Real management costs in the 2001-03 biennium are the lowest they have been since 1971-73. From 1987-89 through 2001-03 administration and agency support averaged 20 percent; capital, 4 percent; and program costs, 75 percent. In 2001-03, expenditures for Administration & Agency Support were less than two thirds what they were in 1999-00. These data were taken from the department's annual reports and adjusted for inflation to FY 2003 purchasing power using the CPI-U.

Part 3

What is the percent of expenditures by general object of expenditure historically (e.g., salaries & benefits, contractual services, etc.). This object of expenditure information will provide a glimpse regarding how the allocation of resources might have changed over time. What are the total FTE supporting the Trust over time and what is the average salary (not adjusted for inflation) of that FTE?

Historical objects of expenditure: See Figures 3 and 4, which follow.

Total FTE supporting Trust Land Management: DNR does not have readily historic data due to organizational shifts that have changed labels.

Average Salary: The DNR average salary in tFY2004 was \$41,700.

Figure 3. Comparison of Selected Program Expenditures by Management Fund and Object of Expenditure from the 2001-03 Biennium

Program Activity	Forest Development		Resource Management		Ag. College Trust Mgmt.		Totals by Fund
	Account FDA - 014	% of Program Activity	Cost Account RMCA - 041	% of Program Activity	Account ACTMA - 830	% of Program Activity	
Timber Sales	11,072,284	45%	13,201,793	54%	309,131	1%	24,583,208
Agriculture	19,290	1%	2,683,886	97%	58,012	2%	2,761,188
Leasing and Rights-of-Way	1,340,592	27%	3,569,057	71%	98,238	2%	5,007,887
Silviculture, Nursery and Camps	7,855,698	52%	7,083,130	47%	115,159	1%	15,053,987
Science and HCP	2,069,566	39%	3,141,886	59%	138,807	3%	5,350,259
Data Stewardship	1,565,735	38%	2,427,972	59%	102,964	3%	4,096,671
Roads	2,160,897	100%	5,025	0%	0	0%	2,165,922
Asset Planning & Transactions	861,578	30%	1,936,217	68%	63,941	2%	2,861,736
Survey, Resource Mapping & GIS	2,469,065	31%	5,422,562	67%	155,506	2%	8,047,133
State Lands & Regions Operations	2,664,700	41%	3,787,704	58%	63,657	1%	6,516,061
Law Enforcement	328,806	36%	566,593	62%	15,859	2%	911,258
Information Technology Support	579,082	39%	900,888	60%	17,606	1%	1,497,576
Total	32,987,293	42%	44,726,713	57%	1,138,880	1%	78,852,886

NOTE This table only shows the funding for the three trust land funds. Several of the program activities listed above receive monies from other funding sources (GF-S, federal grants, etc.), which are not shown in this table. This table also does not show all program activities which spend from the three funds (i.e., primarily administrative programs).

Figure 4 Comparison of Selected Program Expenditures by Management Fund and Object of Expenditure from the 2001-03 Biennium

Program Activity	Salaries and	% of	Goods and	% of	all other	% of	Totals	% of
	Benefits	Program	Services,	Program	expenditure	Program		
	(obj. A, B)	Activity	Travel	Activity	objects	Activity	by Objects	Grand
			(obj. E, G)					Total
Timber Sales	20,285,586	83%	4,269,745	17%	27,877	0%	24,583,209	31.2%
Agriculture	2,204,518	80%	534,988	19%	21,682	1%	2,761,189	3.5%
Leasing and Rights-of-Way	3,057,142	61%	1,902,486	38%	48,259	1%	5,007,888	6.4%
Silviculture, Nursery and Camps	7,051,005	47%	7,651,628	51%	351,354	2%	15,053,988	19.1%
Science and HCP	3,501,502	65%	593,591	11%	1,255,166	23%	5,350,260	6.8%
Data Stewardship	2,130,766	52%	1,332,362	33%	633,543	15%	4,096,672	5.2%
Roads	931,179	43%	1,190,984	55%	43,759	2%	2,165,923	2.7%
Asset Planning & Transactions	2,108,020	74%	235,677	8%	518,039	18%	2,861,737	3.6%
Survey, Resource Mapping & GIS	5,136,235	64%	2,143,900	27%	766,998	10%	8,047,134	10.2%
State Lands & Regions Operations	4,659,122	72%	1,842,584	28%	14,355	0%	6,516,062	8.3%
Law Enforcement	610,649	67%	256,675	28%	43,934	5%	911,259	1.2%
Information Technology Support	555,684	37%	604,180	40%	337,723	23%	1,497,588	1.9%
Total	52,231,408	66%	22,558,800	29%	4,062,689	5%	78,852,908	100.0%

NOTE: This table only shows the funding for the three trust land funds. Several of the program activities listed above receive monies from other funding sources (GF-S, federal grants, etc.), which are not shown in this table. This table also does not show all program activities which spend from the three funds (i.e., primarily administrative programs).

- The summary notes “timber prices have remained low in recent years and re projected to continue at lower than historical levels.” Please provide a history and projection of those “timber prices” (actual and adjusted for inflation) historically and on a pro forma basis. We will want to compare the pro forma forecast of timber prices against our forecasted revenue as shown on the Excel spreadsheet entitled Revenue by Fund V14 w_o TLT.xls 8/17/2004.

Real Removal Value (\$/mbf) was presented in Graph 4.3 in Briefing Material, Volume 1, page 35. (This graph is reproduced in the answer to question 21 as Figure 8.) Both the actual and projected (pro forma forecast) timber prices for Granted and Forest Board lands are shown in Figure 5.

Figure 5

Removal Price (\$/mbf)

	Biennium	Grants		State Forest		Total	
		Nominal Removal Price \$/mbf	Real Removal Price 2003 \$/mbf	Nominal Removal Price \$/mbf	Removal Price 2003 \$/mbf	Nominal Removal Price \$/mbf	Removal Price 2003 \$/mbf
Actual	1965-67					\$ 29	\$ 162
	1967-69					\$ 35	\$ 177
	1969-71					\$ 50	\$ 233
	1971-73					\$ 59	\$ 253
	1973-75					\$ 96	\$ 341
	1975-77					\$ 142	\$ 436
	1977-79	\$ 162	\$ 426	\$ 128	\$ 338	\$ 155	\$ 409
	1979-81	\$ 205	\$ 443	\$ 165	\$ 353	\$ 198	\$ 426
	1981-83	\$ 210	\$ 393	\$ 172	\$ 321	\$ 201	\$ 376
	1983-85	\$ 152	\$ 265	\$ 124	\$ 215	\$ 144	\$ 250
	1985-87	\$ 132	\$ 218	\$ 105	\$ 172	\$ 124	\$ 205
	1987-89	\$ 239	\$ 360	\$ 188	\$ 285	\$ 221	\$ 334
	1989-91	\$ 336	\$ 466	\$ 261	\$ 360	\$ 310	\$ 430
	1991-93	\$ 324	\$ 419	\$ 310	\$ 400	\$ 319	\$ 412
	1993-95	\$ 437	\$ 533	\$ 447	\$ 545	\$ 441	\$ 538
	1995-97	\$ 454	\$ 526	\$ 517	\$ 599	\$ 483	\$ 559
	1997-99	\$ 368	\$ 410	\$ 438	\$ 488	\$ 400	\$ 446
1999-01	\$ 331	\$ 348	\$ 369	\$ 388	\$ 348	\$ 366	
2001-03	\$ 282	\$ 285	\$ 317	\$ 320	\$ 299	\$ 302	
Projected	2003-05	\$ 269	\$ 257	\$ 299	\$ 286	\$ 280	\$ 268
	2005-07	\$ 269	\$ 234	\$ 300	\$ 260	\$ 281	\$ 244
	2007-09	\$ 289	\$ 239	\$ 321	\$ 266	\$ 301	\$ 249
	2009-11	\$ 293	\$ 235	\$ 326	\$ 261	\$ 305	\$ 245
	2011-13	\$ 299	\$ 226	\$ 333	\$ 251	\$ 312	\$ 235
	2013-15	\$ 321	\$ 228	\$ 357	\$ 254	\$ 334	\$ 238

The Excel spreadsheet entitled Revenue by Fund V14 w o TLT.xls 8/17/2004 was prepared by the department as a part of the sustainable harvest evaluation and used different assumptions than those used in the analysis prepared for the Independent Review Committee. The assumption used in the sustainable harvest analysis and that underlies the Excel spreadsheet is constant real timber prices over the 120-year projection period. The average price for Western Washington during the first decade was \$280/mbf. The Excel spreadsheet included Eastern Washington (price in eastern Washington are about 80 percent less than those in western Washington) and non-timber revenues, as did the analysis done for the IRC. In the spreadsheet, average projected net revenue for the “Implement” Alternative were \$150.7 million. The projection done for the IRC and shown on page 17 of Volume 3 shows average biennial revenues of \$280.2 million or \$140.1 million per Year or 7 percent less. These estimates were arrived at independently

and the major difference is due primarily to the lower real prices used in the IRC projection.

For more information on the real prices used in the IRC projections see Briefing Material, Volume 1, page 35.

8. What are the efficiency measures initiated over the last three years, and how much real savings did they generate? What have been the contributors to increased costs over the past three years and how did those contributors help with the effectiveness of the management of the Trust?

The department has been continually implementing efficiency measures in recent years as falling timber prices have reduced revenue into the management funds, necessitating staff layoffs. It has not been possible to precisely measure savings in all cases. However, examples of efficiency efforts since 2001 include the following:

- Timber sale program expenditures have been reduced by 41 percent while increasing revenue by \$15 million.
- Leasing program expenditures have been reduced by 13 percent while increasing revenue 19 percent.
- Two operating regions were combined with savings expected to be near \$1 million per year beginning in July 2005.
- A regional office has been co-located with a US Forest Service office, bringing in tenant revenue.
- DNR programs have made much greater use of the agency internet website to interact with the public and customers, saving both employees and the public hundreds of hours previously spent processing paper and phone requests.
- DNR's photo and map sales function has been merged with a similar function at the State Department of Transportation.

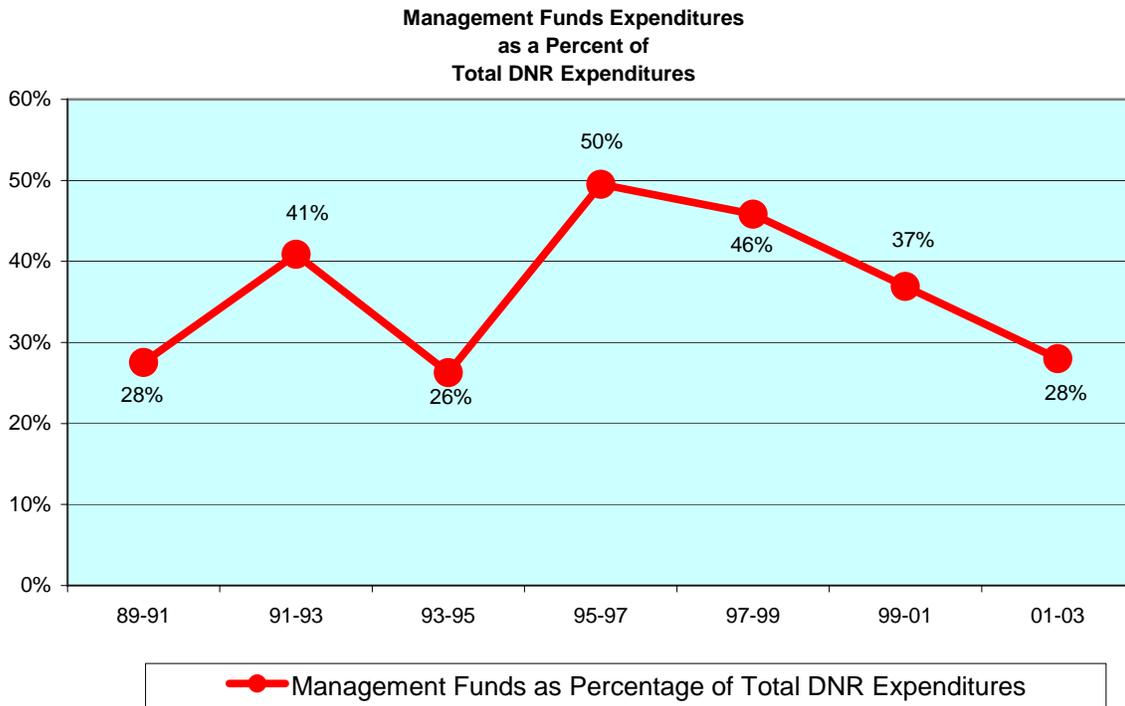
Costs have decreased not increased over the past three years, even though timber sales volume has been increasing over this same period.

9. Please provide a historical comparison of the percent of the total DNR budget supported by revenue generated from the Trust Funds. Is revenue from Trust Funds used to support functions (e.g., Departmental Direction, overhead, etc.) that are not 100% in support of the Trust Fund function? If so, how has that diversion of revenue changed over history?

Comparison of management fund expenditures to total DNR expenditures: The percent of management fund expenditures to total DNR expenditures is not necessarily a meaningful comparison. During the past seven biennia, the State has experienced two recessionary periods where general fund allocation significantly dropped. During these periods, management fund expenditures have remained stable, thereby, increasing the percentage of management fund to total expenditures. Over this period, several of the

DNR programs not funded by management funds such as Forest Practices and Aquatic Resources, have grown. This growth would drive the percentage down. Fire Suppression is also a variable. Fire Suppression cost has significantly increased in the past decade. These are general fund costs that would also change the percentage. Consequently, the relationship between management fund expenditures and total expenditures has little meaning without a great deal of biennium-to-biennium explanation.

Figure 6



Management Fund revenue in other DNR programs: See Briefing Material, Volume 2, page 26.

Eighty-one percent of management funds are charged directly or allocated to trust land management functions. Nearly 19 percent is allocated to agency-wide administrative functions based upon DNR’s approved cost methodology. Less than 1 percent is used to manage public access to trust lands.

- 10. How are direct and indirect costs being allocated for each of the asset classes?
How do RMCA revenues generated for each asset class (e.g. timber, agriculture, aquatic, commercial, etc.) match up to related expenditures (both direct and indirect)?
If costs & revenues are managed in aggregate at the trust level, will changes be considered to better match management costs to RMCA revenues generated on an asset class basis (e.g. cost accounting)? For example, management of timber lands is certainly more time consuming than a commercial building with a long term lease.**

Costs are not allocated to asset classes.

The Department of Natural Resources follows the legal mandates of Governmental Accounting Standards Board, Generally Accepted Accounting Principles, Office of Financial Management and State Auditor's Office. This is based on actual costs being charged to the separate funds. Also, individual trusts are charged for direct costs.

Other charges, which cannot be assigned directly to the benefiting fund or trust, are allocated based on a number of allocation methods (actual FTE time, acres, etc.) based on the benefit derived for the activity.

The chart of accounts is structured to match revenues to expenditures based on the Fund and Program Index (activity).

- 11. Why is the present 25% of revenue inadequate to fund the Department's management expenses?
What are the specific costs being paid with this revenue, and which of those costs have increased (or been incurred) within the last decade to require an increase in the RMCA percentage?
What portion of these increased costs, if any, are associated with environmental mandates (e.g. the HCP and the ESA)?**

Please see answers to questions 4 and 19. Also, see Briefing Material, Volume 3, page 9.

Questions about the future and projections

General

- 12. What are the environmental benefits?
Are the trusts paying for these?
Should the trust be funding benefits that exceed the trust benefits?
How will costs to produce other benefits beyond regulatory requirements be covered?**

The principle environmental benefits of trust land management are provided as a direct byproduct of managing the trust lands for sustainable natural resource production. Additionally, trust lands are subject to the requirements of federal and state environmental regulatory laws. Compliance with these laws, thereby avoiding damage to publicly owned environmental resources, is an integral aspect of trust land ownership. These requirements include the department's federally approved Habitat Conservation Plan, which, in the judgment of the department, best controls present and future regulatory risks to the beneficiaries resulting from the state's legal obligations under the federal Endangered Species Act.

Legally required regulatory compliance is a normal land management expense, appropriately born by the trusts, in this case. Alternative ways for the state to cover these land management expenses would be a question for the state legislature. The Department believes it is not incurring costs to produce benefits beyond regulatory requirements or prudent trust land management. See also question 14.

It is beyond the scope of the Independent Review Committee's charter to determine how to fund legitimate expenses of trust land management. However, see the answer to question 22.

- 13. Would it be better to just "take the money and run?"**

Current primary methods to convert trust lands and resources to trust funds are sales of valuable materials like timber and sale of land. In the case of timber sales, common law trustee duties as well as state law require that harvests be sustainable over the long term, and not favor present beneficiaries over future ones. Land sales are substantially limited both by the department's staff capacity and by longstanding legislative policy to maintain the publicly owned land base.

Nevertheless, the Department's sustainable harvest program does consider the substantial current inventory of timber on trust lands, within overall sustainability constraints.

Subject to budgetary considerations the department continues to diversify and reposition assets to increase net return on trust asset values.

- 14. Will the Committee review the segregation of costs tied to the federal/state legal requirements versus public benefit targets? The trusts need to bear the cost of the federal/state requirements but arguably should be exempt from any non-federal/state requirements that increase costs and decrease revenues.**

Information previously provided to the Independent Review Committee demonstrates that the department spends much less than 1 percent of management account funds on expenses related to public use of trust lands. These expenses are for risk avoidance or response to actual problems, such as cleaning up methamphetamine labs and other hazardous wastes, abandoned vehicles, and garbage removal. The department also engages in planning and public involvement at levels that are prudent for a large public landowner, so as to continue the overall trust land management program in the face of community interest. All these expenses enhance the revenue potential of trust lands .

- 15. What would the cost structure be if the trusts did not have timberlands as the principal holdings?
Will the Committee evaluate whether it is proper under DNR trust responsibilities to keep the trusts so heavily invested in upland forests if the cost structure for doing so is unduly burdensome?**

Currently, more than 90 percent of trust land value is in timberland. As stated in the answer to question 13, the department repositions and diversifies trust assets. As part of the asset allocation strategy, the department acquires other revenue-producing land assets, such as irrigated agriculture and commercial properties. These efforts are limited by department budget and staffing. Further, there are the realities of the real estate market and public response to major transactions involving public land. Therefore, it would not be fruitful, nor is it within the Independent Review Committee's scope to plan for wholesale conversion of 2.1 million acres of forestland.

The Committee may consider recommendations related to these issues.

Timber harvest, prices and revenues

- 16. What volume would need to be harvested to produce the necessary revenue at the 25% rate to meet associated costs and avoid further budget reductions?
How does this required amount of harvesting compare to the sustainable harvest calculation?**

This question is essentially the same as one addressed in Briefing Material, Volume 3; please see page 4 of that document.

The Board's rationale for selecting their Plan with the associated harvest level, rather than alternatives with higher average annual harvest volumes, included several considerations:

1. Avoiding large annual or decadal swings in volume which would be disruptive for some beneficiaries;
2. Employing active innovative forestry techniques which will accelerate development of structurally complex forests (an HCP requirement) while increasing trust revenue, thereby providing more management flexibility; and
3. Incorporating aggressive but reasonable expectations about DNR's implementation of higher levels. Under the Board's decision, to employ active management over a larger portion of the landscape, average harvest levels in the second decade will be 574 mmbf/yr, compared to 597 mmbf/yr for the first decade.

Because of the nature of DNR's variable and fixed costs, expenditures exceed management fund revenues at the current volume, price, and current statutory ceiling. DNR's projections show that simply increasing volume alone, to the new level set by the Board, will not reverse this trend. Therefore, at higher volumes, total expenditures continue to exceed total management fund revenues, leading to a rapid depletion of the management funds.

As DNR developed the new Sustainable Forestry EIS and evaluated the costs of the various alternatives, several issues became clear:

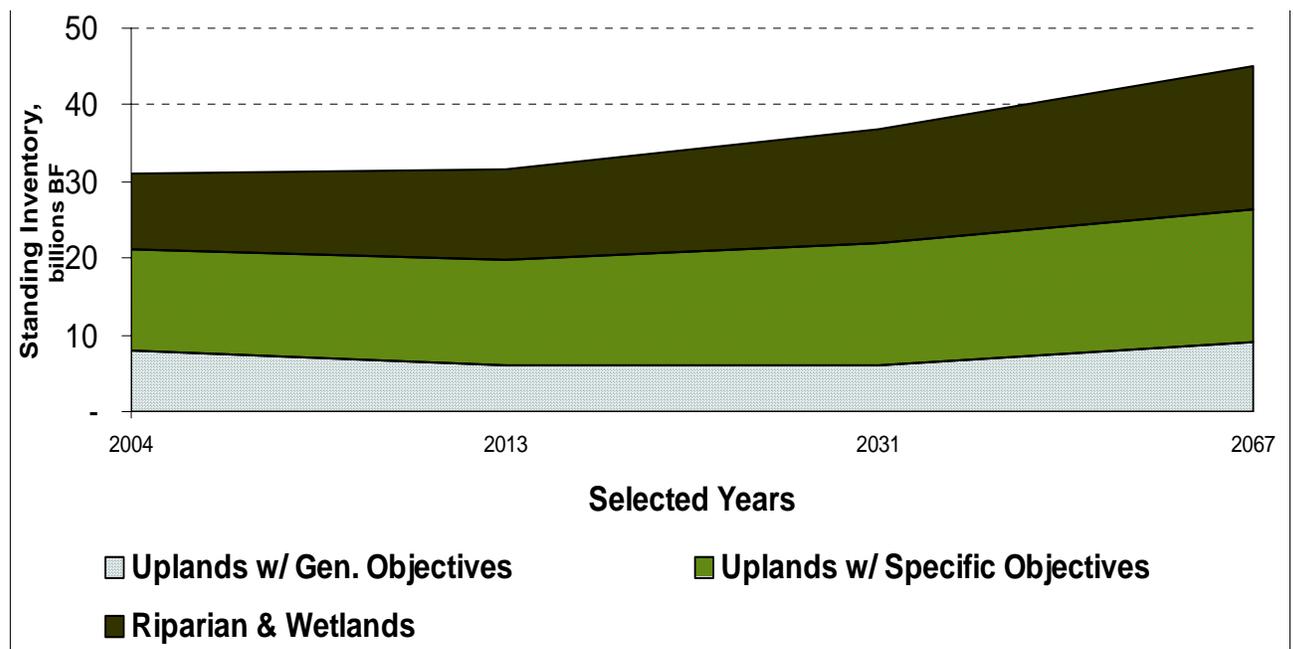
- Even without any changes to current policies or harvest levels, the costs of business were in excess of the revenue at 25 percent.
- Under any of the EIS Alternatives, the fund balances would decline and quickly go negative, something not permissible in state government.
- To prevent a negative fund balance, DNR would need to summarily curtail investments, causing a very large drop in revenue to the beneficiaries, including the State General Fund.
- As revenues collapsed, the ability to generate revenue would be significantly eroded, starting a "death spiral" as shrinking revenues provided less and less revenue for the beneficiaries.

- As an alternative to ever decreasing revenue, we found that significant increases in net revenue to the beneficiaries could be obtained from investment levels equivalent to a management percentage of about 30 percent of gross revenue.
- However, we also found that by investing at a cost-equivalent of 30 percent of gross revenue, the beneficiaries would actually receive more revenue, even with a 5 percent increase in the management deductions. The ability to make those investments today is a critical component of sustainable harvest implementation.

17. Will the timber inventory be increasing during the sustainable harvest period?

Yes. This is discussed in some length in Briefing Material, Volume 2, Section 2.1.1, starting on page 16. The following graph is reproduced from that section.

Figure 7 Standing Inventory by Land Class, Preferred Alternative



The current western Washington inventory is 31 billion board feet. It will increase 45 percent by 2067 to 45 billion board feet. Essentially, all the increase in volume comes in the land classes (e.g., riparian and wetland) necessary to meet the requirements of the Federal Endangered Species Act and the State Forest Practices Act. The volume in the uplands with general management objectives stays fairly constant.

- 18. What are the market expectations and DNR projections for real timber price increases over the next couple decades? How have these real price increases, if any and the timber age-class schedule been factored into the harvesting plans and projected management deficits?**

The Projected nominal and real (adjusted for inflation to FY2003 purchasing power) prices are shown in the answer to question 7 above. For information on the reasoning behind those projections see Briefing Material, Volume 3, page 5, “Is DNR’s Timber Price Forecast Reasonable?”

Sustainable harvest planning is primarily driven by economic and biological factors. As indicated in question 7 the assumption used in the sustainable harvest projections was no real price increase or decrease over the projection period.

The department matches timber sales to predicted markets to maximize expected returns. For example, stands that have a higher percentage of hardwoods would be identified for sale when hardwood prices are relatively high. Once sales are identified, they are marketed to take advantage of seasonal variations in species prices.

Management costs and funds

- 19. What is the increased expense needed to produce increased revenue? What is the plan for how the additional management funding would be spent? Are there specific targeted expenses that will be covered by this increase?**

Briefing Material, Volume 3, directly answers the question in some detail (please see page 13). In summary, DNR anticipates the need for some 95 additional employees over the next four years. Based upon the initial estimates approximately 85 percent would be hired for direct timber sales operations. Most positions are field-level professionals necessary to make the complex decisions to capture the potential of the trust lands. The remaining 15 percent would be hired for related agency administrative activities. There are some fixed start-up costs for vehicles and other equipment.

See also answer to questions 20 and 25.

- 20. What is the additional increment of work that causes the costs to go up? What is the cost driver?**

There are two primary cost drivers:

1. The cost of additional staff to meet the sales volume expectations, and
2. Increased salary and benefit costs and other inflationary pressures.

The planned increase in the number/volume of timber sales is the primary cost driver. The implementation plan calls for a sales volume increase in western Washington, incrementally rising from 453 mmbf in FY2005 to 636 mmbf in FY2011 and continuing at that level through FY2016.

In addition to the increased sales volume, a half-million acres in western Washington will be more actively managed to deliver important economic and ecological benefits.

The Department has initially determined that 95 additional FTE will need to be added incrementally during the first four years of implementation. Staffing will continue at this increased level for the remainder of the first decade. The phasing-in of the additional staff will allow the Department to more accurately gauge the level of actual staffing required. Eighty-five percent of the new staff will be assigned to the direct operating programs. Additional staffing for Financial Management, Human Resources, Information Technology and Attorney General will be added in the third and fourth year. This administrative staff represents 15 percent of the total new staffing.

The State has just finished negotiating a new collective bargaining agreement. The agreement will increase employees' salaries by 3.2 percent in the first year and 1.6 percent in second. Health benefit and pension costs have also increased. Changes in salary and health benefit costs will increase Management Fund expenditures by \$5.4 million at current staffing levels in the next biennium. Our projections have increased these and other costs by a standard inflationary rate (3%) for the remainder of the decade.

See the Briefing Material, Volume 3, page 14.

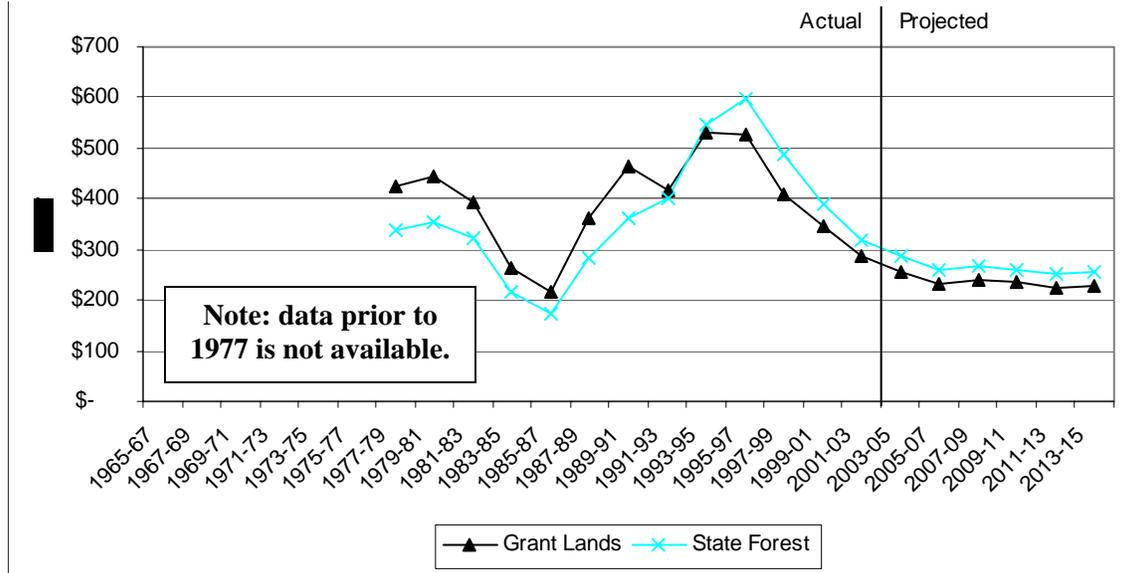
21. What change has occurred that has resulted in the need for this “rate” increase? Please be specific.

There are two primary factors. The first is the decline in real timber prices. Some 85 percent of land management revenue comes from timber sales. The decline in timber sales values shown in Figure 8 has been substantial and shows no sign of recovery in the next decade.

The second major factor is the cost of business has increased since 1971, the date the Legislature last adjusted the funding of trust land management. In the following three plus decades, a number of changes have occurred that affect the cost of doing business in Washington State. Other changes were made as public policy relating to trust lands and forest management evolved in Washington. Briefing Material, Volume 1, Section 3.4 outlines a number of legal, social and policy changes that have materially increased costs.

Despite these increased costs, the department's management fund expenditures, when adjusted for inflation, are the lowest they have been since 1974.

Figure 8 Removal Value (\$/mbf) Federal Granted and State Forest in 2003 \$'s



- 22. What alternatives to this rate increase were reviewed and why were they rejected?
 If this rate increase is not forthcoming, what alternative actions are proposed that will have the least impact on the Trusts, and what is that impact?
 Are there other sources of revenues that can be examined to meet the needs for managing the timber trusts?**

The alternative to increasing management account revenue would be to substantially reduce activities not directly linked to trust revenue. Because major cuts in these areas have already been implemented, further cuts will inevitably have consequences for trust beneficiary revenue. These consequences include such things as an inadequate information base upon which to base timber sales, procedural failures in the timber sales program, risk of being out of legal compliance with federal and state laws, risk of active public opposition to revenue-generating activities, etc. To the extent that these consequences reduced timber sales levels, revenue to both beneficiaries and the management accounts would be reduced, triggering repeated cycles of revenue reductions.

One alternative is a statutory change that modifies, in some way, the percent ceiling set in 1971. The department has not specifically proposed a statutory change. Other ways of increasing management funds might include issuing bonds, receiving loans, or receiving direct legislative appropriations of non-trust funds. Although these alternatives each have advantages and disadvantages, none have been ruled out.

- 23. Please share the portions of the “thorough technical and economic analyses” that show environmental benefits and sustainable forest management cannot be obtained without an increase in rates. On what will the money be spent?**

The *Final EIS on Alternatives for Sustainable Forest Management of State Trust Lands in Washington July 2004* contains substantial information that helps understand and quantify the gains due to the Board’s Plan for Sustainable Forest Management; the document may be found at www.dnr.wa.gov.sepa. The Board directed DNR in Resolution 1110, Section 5 to identify “implementation timelines and the cash flow necessary” to implement the Plan (See <http://www.dnr.wa.gov/htdocs/fr/sales/sustainharvest/030204resolution1110.pdf>).

Subsequent to Resolution 1110 in March 2004, the DNR presented cash flow analyses and fund balance projections to the Board, including summaries of both gross and net revenues for each Alternative. For a summary of volume and revenue modeled for the planning decade, see www.dnr.wa.gov/htdocs/fr/sales/sustainharvest/597_636fin_sum8_3104.pdf

Some of this information has been updated and is contained within the Independent Review Committee Briefing Materials.

In particular, please see the answers to questions 4 and 19 of this document.

- 24. The focus of this Committee appears to be primarily on trust land management and RMCA. Yet, there are other DNR-Administered Funds that presumably share in the overhead to support DNR operations. Are those funds being reviewed as well? If an increase to RMCA percentage is recommended, will the other DNR-Administered Funds have corresponding increases in overhead to support DNR administration and agency functions?**

DNR allocates administrative costs across 22 funds based upon a cost allocation methodology reviewed annually by the Office of the State Auditor. Administrative costs are allocated based upon actual FTE’s charged to each fund. The allocation of administrative costs is adjusted monthly based upon the actual staff month expenditures charged to each of the program’s 22 funds.

The fund balance in a number of DNR funds has caused the Department to review several program expenditures during the past four years. Faced with declining fund balances and general fund reductions, DNR has intensively reviewed all programs including the administrative programs. As a result, DNR has reduced administrative FTE from 171 to 146 since FY2001. Any reduction in administrative costs benefits all 22 funds

25. What elements of the management of the trust lands can be effectively outsourced at a cost savings?

Under new civil service reform laws, agencies may outsource certain functions when not displacing or reassigning current employees, or where contracting for that function has been ongoing since 1977. In other cases, outsourcing can occur, although existing employees are given certain rights to compete for contracts. The department is assessing opportunities for contracting that may be associated with implementing the Board's direction on harvest levels, considering feasibility, legal requirements, and potential net savings.

Beneficiary revenues

- 26. What is the incremental benefit that the trust beneficiaries will in fact derive from the increased management cost?
When and how will that benefit be realized?
Is the increased benefit adequate to justify the increased cost?
Will the benefit be realized in the form of increased revenues to the Universities?
For any recommended changes, please prepare an economic analysis detailing the impact of a proposed RMCA fee adjustment on the trust beneficiaries.**

Briefing Material, Volume 3 answers this question and has an extensive analysis of this issue starting on page 15. The change in real revenues to the beneficiaries going from the current harvest and a 25 percent deduction to the board-approved harvest with a 30 percent deduction is shown in figure 6.4 (Volume 3).

The analyses show that even if the percentage is raised to 30 percent, the beneficiaries would still receive more net revenue.

This is due to the interaction of several factors.

- Production expenditures occur two plus years in advance of the actual revenue due to the time to engineer a timber sales, sell a sale and actually log a sale. These facts, by themselves, would seemingly be impossible to overcome without some other changes.
- Revenue to the beneficiaries was accelerated by reducing the timber sales contract duration. This produces a near-term surge in cash that offsets a potential change in percentage.
- Those trusts with revenue that largely comes from permanent funds have few or no perceptible changes to revenue to the beneficiaries; see Briefing Material, Volume 2, Section 1, for a more complete discussion of revenue flows to the beneficiaries.
- Compared to today's harvest levels, sold volume will increase.

Appendix – original questions from beneficiaries

A. Questions raised by Trust Beneficiaries in meetings regarding the Independent Review Committee

Washington State School Directors Association (WSSDA)

- How do other state land offices manage trust lands for their beneficiaries without a management fee?

Higher Ed — University of Washington; Washington State University; The Evergreen State College; Eastern, Western, and Central Washington universities; and the Council of Presidents

- What is the volume that would need to be harvested to avoid further budget reductions?
- What are the environmental benefits? Are the trusts paying for these? Should the trust be funding benefits that exceed the trust benefits?
- Comment: we're bothered by an increase above the 25% management fee.
- How does the 25% rate compare with how forest-lands are managed elsewhere around the country?
- Will the timber inventory be increasing during the sustainable harvest period?
- What is the plan for how the additional management funding would be spent?
- What does status quo look like?
- What is the increased expense needed to produce increased revenue?
- How will costs to produce other benefits beyond regulatory requirements be covered?
- Community college trust—What new lands have been purchased? How was the money spent? Where did it go? What happened to the management fund?
- Would it be better to just “take the money and run?”

Capitol Building Trust

- What is the additional increment of work that causes the costs to go up? What is the cost driver?

B. Questions submitted by the University of Washington

1. The focus of this Committee appears to be primarily on trust land management and RMCA. Yet, there are other DNR-Administered Funds that presumably share in the overhead to support DNR operations. Are those funds being reviewed as well? If an increase to RMCA % is recommended, will the other DNR-Administered Funds have corresponding increases in overhead to support DNR administration and agency functions?
2. Will the Committee review the segregation of costs tied to the federal/state legal requirements versus public benefit targets? The trusts need to bear the cost of the federal/state requirements but arguably should be exempt from any non-federal/state requirements that increase costs and decrease revenues.
3. How are direct and indirect costs being allocated for each of the asset classes? How do RMCA revenues generated for each asset class (e.g. timber, agriculture, aquatic, commercial etc.) match up to related expenditures (both direct and indirect)? If costs & revenues are managed in aggregate at the trust level, will changes be considered to better match management costs to RMCA revenues generated on an asset class basis (e.g. cost accounting)? For example, management of timber lands is certainly more time consuming than a commercial building with a long term lease. Please note we are not suggesting for a specific review of non-upland trust revenues and expenditures, only a comparison.
4. Will the private sector be surveyed to obtain management cost data and, where applicable, compare to DNR management costs (by asset class per #3 above) to ascertain opportunities for further management efficiencies and savings?
5. Inventory of standing timber is expected to increase by 45% over the next 64 years up to 45 billion bf. What would be the required increase in timber harvested to produce the necessary RMCA revenue at the 25% rate to meet associated costs? How does this required amount of harvesting compare to the sustainable harvest calculation?
6. What are the market expectations and DNR projections for real timber price increases over the next couple decades? How have these real price increases, if any, and the timber age-class schedule been factored into the harvesting plans?
7. How do the current land treatments compare to the most economically efficient land treatments? If there is a difference, what is the impact on revenue, related RMCA revenue and associated management costs? Please share with the Committee and the beneficiaries the economic analyses performed that indicate

8. how the trusts were impacted (either positively or negatively) by the recent sustainable harvest calculation.
9. Are there other sources of revenues that can be examined to meet the needs for managing the timber trusts?
10. Finally, for any recommended changes, please prepare an economic analysis detailing the impact of a proposed RMCA fee adjustment on the trust beneficiaries.

C. Questions submitted by Washington State University

1. Why is the present 25% of revenue inadequate to fund the Department's management expenses? What are the specific costs being paid with this revenue, and which of those costs have increased (or been incurred) within the last decade to require an increase in the RMCA percentage? What portion of these increased costs, if any, are associated with environmental mandates (e.g. the HCP and the ESA)?
2. How will the increased management expense be used? Are there specific targeted expenses that will be covered by this increase?
3. What is the incremental benefit that the trust beneficiaries will in fact derive from the increased management cost? When and how will that benefit be realized? Is the increased benefit adequate to justify the increased cost? Will the benefit be realized in the form of increased revenues to the Universities?
4. In evaluating the propriety and effect of the proposed management fee increase, are other Department administered funds also being reviewed? If an increase to the RMCA percentage is recommended, will the other Department administered funds have corresponding increases in overhead to support Department administration and agency functions?
5. Will the Independent Review Committee review the segregation of costs tied to the federal and state legal requirements versus "public benefit" targets?
6. How are direct and indirect costs being allocated for each of the asset classes? How do revenues generated for each asset class (e.g. timber, agriculture, aquatic, commercial) match up to related expenditures (both direct and indirect)?
7. What would the cost structure be if the trusts did not have timber lands as the principal holdings? Will the Committee evaluate whether it is proper under the Department's trust responsibilities to keep the trusts so heavily invested in upland forest lands if the cost structure for doing so is unduly burdensome?

8. If costs and revenues are aggregated at the trust level, will changes be considered to better match management costs to revenues generated on an asset class basis? For example, management of timber lands is certainly more time consuming than a commercial building with a long term lease. Please note that we are not suggesting that a specific review of non-upland trust revenues and expenditures be made, but we do want a comparison of the costs by asset class to be considered.
9. Will the private sector be surveyed to obtain management cost data and, where applicable, compare those figures to the Department's management costs (by asset class) to ascertain opportunities for further management efficiencies and savings?
10. How does 25% of revenue compare to the fee that would be charged by outside land managers, and how does the Department's cost structure compare to that of outside land managers?
11. Inventory of standing timber is expected to increase by 45% over the next 64 years up to 45 billion board feet. What would be the required increase in timber harvest to produce the necessary revenue to meet associated costs at the current 25% rate? How does this required harvest figure compare to the sustainable harvest calculation?
12. What are the market expectations and Department projections for real timber price increases over the next twenty years? How have these price increases, if any, and the timber age-class schedule been factored into the harvesting plans and projected management deficits?
13. How do the current land treatments and "on the ground" management practices compare to the most economically efficient land treatments? Are similar treatments and practices used by outside land managers? If there is a difference, what is the impact on revenue, related RMCA revenue and associated management costs? Please share with the Independent Review Committee and the other beneficiaries the economic analyses performed that indicate how the trusts were impacted (either positively or negatively) by the recent sustainable harvest calculation.
14. What other sources of revenue have been examined to meet the needs for managing the timber trusts?
15. What elements of the management of the trust lands can be effectively outsourced at a cost savings?
16. Finally, for any recommended changes, please prepare an economic analysis detailing the impact of a proposed fee adjustment on the trust beneficiaries.

D. Additional questions submitted to the committee

1. What change has occurred that has resulted in the need for this “rate” increase? Please be specific.
2. What has the gross trust revenue amount been each year since 1971 adjusted to current dollars using a common state inflation adjuster? What have been the expenses in a similar fashion? What is the percent of expenditures by general object of expenditure historically (e.g., salaries & benefits, contractual services, etc.). This object of expenditure information will provide a glimpse regarding how the allocation of resources might have changed over time. What are the total FTE supporting the Trust over time and what is the average salary (not adjusted for inflation) of that FTE.
3. The summary notes “timber prices have remained low in recent years and are projected to continue at lower than historical levels.” Please provide a history and projection of those “timber prices” (actual and adjusted for inflation) historically and on a pro forma basis. We will want to compare the pro forma forecast of timber prices against our forecasted revenue as shown on the Excel spreadsheet entitled Revenue by Fund V14 w o TLT.xls 8/17/2004.
4. What are the efficiency measures initiated over the last three years and how much real savings did they generate? What have been the contributors to increased costs over the past three years and how did those contributors help with the effectiveness of the management of the Trust?
5. Please provide a historical comparison of the percent of the total DNR budget supported by revenue generated from the Trust Funds. Is revenue from Trust Funds used to support functions (e.g., Departmental Direction, overhead, etc.) that are not 100% in support of the Trust Fund function? If so, how has that diversion of revenue changed over history?
6. What alternatives to this rate increase were reviewed and why were they rejected? If this rate increase is not forthcoming what alternative actions are proposed that will have the least impact on the Trusts and what is that impact?
7. Please share the portions of the “thorough technical and economic analyses” that shows environmental benefits and sustainable forest management cannot be obtained without an increase in rates. On what will the money be spent?

DNR Briefing Material - Volume 5

November 15, 2004

Revenue Potential from Trust Lands Transactions

What is the near- and long-term revenue potential from repositioning trust land parcels in the I-5 corridor to improve financial performance?

Candidate Properties for Disposal

There are some 200 parcels (totaling 26,000) acres of under-performing trust lands in the I-5 corridor. The department is currently preparing to dispose of some of these. The primary goal is to improve net returns to the beneficiaries by acquiring higher performing assets. The replacement properties could be any asset class (agriculture, forest, commercial) and be located anywhere in the state.

Properties are selected for disposal if they:

- have appreciated in value due to higher and better use (HBU) characteristics, and are no longer suitable for resource production;
- generate little or no income;
- are too small or isolated to manage efficiently; and/or
- are costly to manage, relative to revenue.

Property Value and Revenue Potential

The estimated value of the 26,000 acres is about \$219 million. DNR's current policy sets a target range for minimum return on investment of 5-7 percent or better, for forest, agricultural and commercial properties. If the \$219 million were invested in a mix of properties, the anticipated gross returns would be about \$14 million per year once the subject properties are disposed and replaced with higher yield land. The department's general re-investment strategy has been to invest two-thirds of the re-investment funds into commercial and agricultural properties, which return annual lease revenues. The remaining one-third of the funds is targeted for forestland acquisitions, the revenue from which is generated over time, because it is not practical to buy significant amounts of mature timber.

Generally, the lands under discussion are federal grant lands. As such, 25 percent of the revenue from the reinvested lands is returned to the Resource Management Cost Account (RMCA), 75 percent is distributed to the trust beneficiaries. Using long-term averages, the RMCA would receive \$3.5 million and the beneficiaries would receive \$10.5 million in new revenue not available today.

Timing and Capacity

Typically, a sale or transfer with few issues takes about a year; a land exchange takes from two to four years; and a purchase takes from six to nine months. The appraisal process can be lengthy due to technical and social issues, public processes and negotiating the terms of the transaction.

Over the past two years with an active program, the department has repositioned about 9,000 acres per year through sales, transfers, and purchases. Exchanges, which usually

take 18 months – 2 years, can increase the acres repositioned dramatically in a given year. At 9,000 acres per year, hypothetically, it could take about three years to completely dispose of and replace the I-5 properties, assuming:

- all 26,000 acres were repositioned;
- there were no controversial issues or public concerns;
- this was the department’s sole transaction focus; and
- General Fund support for the Trust Land Transfer Program was available.

Realistically, a time frame of ten years or more is more likely. The less controversial parcels could be transferred more quickly; others would take substantial time. Assuming 20 percent of the properties could be auctioned or transferred in the first one to two years, with 30 percent transferred in two to four years, the remaining 50 percent would take five to ten years to complete. The General Fund appropriation for Trust Land Transfer is a key factor in repositioning the Common School Trust. Without it, the capacity for transactions would shrink to about 3,000 acres per year, and take 9-30 years to accomplish.

Approximate Cost

At a cost of about \$1.85 million per year, the cost of repositioning the 26,000 acres would be roughly \$5 million.

Once the parcels were transferred or sold, the cash would be reinvested into trust-grade properties. The re-investment period can range from 6 to 12 months, or longer, depending on the nature of the negotiations. In summary, the mean annual first decade net cash flows would be less than the \$14 million previously identified.

Factors Affecting Land Transactions

Legal Constraints (See Table)

Most of the legal constraints found in the State Constitution, Enabling Act, and Revised Code of Washington have been identified in a previous report. (See attachment.) One additional legal constraint is found in the Land Bank statute (RCW 79.66) that limits the amount of land that can be held in the Land Bank at any one time to 1,500 acres.

Appropriation

DNR is currently limited in purchasing power by the legislative appropriation process. No matter how much money is derived from land sales in a given biennium, the Legislature sets the amount of money available for replacement acquisitions at the outset of a biennium.

Over the last several biennia, biennial appropriations have been in the \$20 million - \$30 million-dollar range. If the department could participate in the market for properties of \$40 million or more, large blocks of forestland or large commercial developments could be acquired.

As long as the department can only operate in the \$1 million to \$10 million property value range, transactions costs will be higher because more properties need to be acquired in order to reach revenue goals.

Internal Practices to Protect the Corpus of the Trusts

The department has long been reluctant to pay for transaction costs through the transactions themselves, reasoning that any diminution in land value to pay for operating costs is a diminution of the corpus of the trust. Instead, the agency has chosen to allocate a portion of the management funds to pay for this work.

In the past, The Board of Natural Resources has given limited authority to the department in some situations to pay for transaction costs up to a maximum of 5 percent, but the agency has rarely exercised this authority. In the 2003-2005 legislative session, the department was given the authority in a budget proviso to fold transaction costs for land exchanges into the value of the exchange, when the trust's position after the exchange (including costs) was improved over the pre-exchange position.

Public Concerns

Political and social concerns are present in both disposing of and acquiring properties. Some local governments view state acquisition of private land as an unacceptable negative impact to their tax revenues. Other governmental organizations and conservation interests may not support the sale of forested or other public land to private owners, and counting on undeveloped trust lands to fulfill their future open space, local park or other needs. Private landowners may view the state as an inappropriate competitor in their business arena. Neighbors often do not want the state to dispose of the last undeveloped property in their neighborhood.

Legal Constraints For Transactions	Source	Programs Affected
160 acre limit to lands sold at auction	RCW 79.11.010 State Constitution	Land Bank Sales
Oral auctions only for land sales	RCW 79.11.090	Land Bank Sales
No direct sales to public entities	RCW 79.11.090	Land Bank Sales
Sale at auction limited to within 90 days of Board approval	RCW 79.11.110	Land Bank Sales
Disposal of mineral rights not allowed except to US government	RCW 79.11.210 RCW 79.11.220	Land Bank Sales, Direct Transfers, Trust Land Transfers, Exchanges
Platting requirement for lands within two miles of towns	RCW 79.11.250 State Constitution	This provision does not technically apply to “buy first” Land Bank Sales or to Transfers, but it is a consideration in “sell first” Land Bank Sales
Exchange land as nearly as possible on an acre for acre basis	Enabling Act	Exchanges
Requirement to not reduce the forest land base	79.17.010 79.17.010	Exchanges, Land Bank Sales
Sales of Forest Board Land not allowed	79.22.050	Land Bank Sales, Direct Transfers, Trust Land Transfers
TLT program available only to common school trust	Biennial capital budget	Trust Land Transfers
Intergrant exchanges required for non-school TLT properties	Biennial capital budget proviso	Trust Land Transfer
Public hearing requirement for exchanges.	RCW 79.17.050	Exchanges
Lack of express authority to cover transaction costs within value of transaction (land and timber) beyond authority to do so for land exchanges for current biennium only	03-05 biennial budget proviso	Exchanges, Sales, Direct Transfers
Can deduct up to five percent of proceeds from sales and transfers for the management fund	Board of Natural Resources Resolution #768	Land Bank Sales, Direct Transfers, Trust Land Transfers

Appendix D – Beneficiary responses to report

From: Rich Heath <heath@wsu.edu>
To: <jana.greer@wadnr.gov>
Date: 12/06/2004 12:05:36 PM
Subject: WSU Comments to IRC Re: Findings

Patty Henson requested that I send you WSU's comments on the IRC findings. Please see below.

It would be helpful if the IRC could expand on Finding number 8 in the report. Washington State University concurs with this finding that aggressive measures should be taken by DNR to diversify the assets that are held in the trusts. We believe the IRC's findings demonstrate that keeping a large percentage of the trust assets in timber land is not in the long-term best interests of the trust beneficiaries. WSU has advocated for some time that the lands in its Agricultural and Scientific trusts be diversified by trading timber lands for more productive commercial or irrigated agriculture properties. We also continue to advocate selling lands in the trust and having the proceeds placed in our Permanent Fund in order to achieve a better rate of return.

It would be helpful if the IRC could expand on Finding 8 as to the type of diversification it would recommend. Also, does the IRC have any recommendations on how quickly the trust assets should be diversified? In addition, what level of resources is the IRC recommending that DNR devote to the diversification effort?

WSU appreciates the opportunity to provide input on the IRC's findings, and also appreciates the efforts and work of the members of the IRC in studying the important issues that have been presented to them.

Rich

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