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State Land Board

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Secretary of State

Ted Wheeler
State Treasurer

MEMORANDUM

April 12, 2016

To: Governor Kate Brown
Secretary of State Jeane Atkins
State Treasurer Ted Wheeler

From: James T. Paul, Director

Subject: Annual Report on Common School Fund Real Property for Fiscal Year 2015 (July 1, 2014 to June 30, 2015).

The purpose of this report is to provide the State Land Board a year-end summary of the financial performance of the Common School Fund trust lands under the Department of State Lands oversight. Included in the summary are the overall revenues and expenditures associated with these lands, which are the result of a broad range of real property management activities including leases, easements, licenses, special uses and land sales and exchanges. This annual report presents outcomes from the 2015 fiscal year (July 1, 2014 to June 30, 2015), and includes some discussion of future real property management direction and priorities.

Status of Real Property Asset Classes

Under the direction of the 2012 Real Estate Asset Management Plan, DSL manages approximately 2.8 million acres of state-owned lands, which includes both "trust" and "statutory" lands. These lands are further categorized into seven different real property land classifications: Forestlands; Agricultural Lands; Rangelands; Industrial, Commercial, Residential (ICR) Lands; Mineral and Energy Resource Lands; Waterways; and Special Stewardship Lands (Appendix A shows a map of the distribution of these across the state):

Table 1. Summary of total acres of state land ownership administered by DSL, by land classification and land type (trust vs. statutory lands), as of January 2015.

	Trust Lands (acres)	Statutory Lands (acres)	Total
Forestlands	121,973	119	**122,092**
Agricultural Lands	5,726	111	**5,837**
Rangelands	601,031	23,569	**624,600**
Industrial/Commercial/Residential	6,668	369	**7,037**
Mineral and Energy Resources	767,092		**767,092**
Waterways		1,264,558	**1,264,558**
Special Stewardship Lands	5,526	7,686	**13,212**
Total	1,508,016	1,296,412	**2,804,428**

Trust Lands

Trust lands (Table 1) are those lands granted by the federal government to Oregon "for the use of schools" upon its admission into the Union – also known as "Admission Act" lands. Trust lands make up 96% of all the uplands managed by DSL for the Land Board, and also include sub-surface minerals and energy resources. The Land Board is directed by Oregon's Constitution to manage these lands for the primary purpose of generating revenues for K-12 public education. This mandate places a trust obligation on the Board to maximize revenue to benefit multiple generations of K-12 students, and requires obtaining market value from the sale, rental or use of Admission Act lands.

Statutory Lands

Statutory lands (Table 1) – also referred to as "non-trust" lands – includes 1,263,650 acres of waterways (navigable waters, tidally influenced waters, and the territorial sea). These lands are held and managed by the Land Board for the greatest benefit of all Oregonians. The Land Board has considerably more latitude in managing statutory lands than it does in managing trust lands. Neither the Oregon Constitution nor statutes require that statutory lands be managed principally for generating revenue for the Common School Fund, and allows such lands to be used for a variety of purposes. Revenues produced from statutory lands, however, are used to protect the public trust values on these lands, in accordance with the Oregon Public Use Doctrine. Additionally, the state's management of these waterways is conducted so as to avoid unreasonable interference with public navigation, recreation, fisheries and commerce[1].

FY 2015 Revenue and Expenditures By Land Class from Authorizations

Appendix B includes a summary of revenues and expenditures organized by land classification for Fiscal Year 2015 (FY2015).

FY 2015 Land Sales and Exchanges

In FY2015, the Department conducted a total of five land sale/exchange transactions, generating a total of $1,179,746 in gross revenues. These transactions resulted in a total net divestment of 459 acres of Common School Fund trust lands.

2012 REAMP Asset Management Performance Measures

Summarized below are the four different financial performance measures identified in the 2012 Real Estate Asset Management Plan (REAMP). The stated aim of the REAMP is to show improvement in these measures over the ten-year timeframe of the plan. In addition, the REAMP recognizes that year-to-year fluctuations will likely occur that may deviate from a long-term positive trend for these measures:

[1] DSL's Aquatic Resource Management Program is responsible for managing all authorizations in the "statutory" category of state-owned lands, and for updating the State Land Board regarding activities on these lands separate from this report.

1. Return on Asset Value (ROAV)
Appendix C includes an estimate (by land class) of total asset value for the Common School trust Lands. This market value estimate allows a Return on Asset Value (ROAV) to be calculated for four trust land classes (forestlands, agricultural lands, rangelands, and ICR Lands), and for these land classes combined.

In FY2015, the ROAV for all trust lands averaged 0.10% (see Appendix C). This measure was significantly affected this year by continued negative revenues from forestlands within the Elliott State Forest, as well as negative revenues from rangelands this year. For the forestlands, this reduced performance reflects adjustments in timber harvest plans on the Elliott State Forest that resulted from litigation concluded in January 2014, concerning lands managed for DSL by the Oregon Department of Forestry. For the rangelands, this reduced performance reflects FY2015 costs associated with fire protection that totaled $211,976, as well as reductions in lease revenues related to eastern Oregon drought conditions during this year.

2. Annual Increase in Net Operating Income (NOI)
The total NOI for FY2015 was $645,896, an increase of $229,208 (or 55%) from FY2014. This increase was primarily due to a single timber sale on the “other” forestlands (trust lands not on the Elliott) that generated approximately $1.3 million, which more than offset reduced performance from range, industrial-commercial-residential, and mineral & energy resource lands as compared to FY2014. When considering land classifications other than forestland, the NOI for FY2015 decreased by $596,737, or –57%, as compared to FY2014. (Appendix B)

3. Annual Increase in Gross Annual Revenue (AR) 5% to 7%
The FY2015 Gross Annual Revenue was approximately $6.5 million, an increase of about $0.4 million as compared to FY2014. A decrease of $0.3 million, or –11%, occurred for all land classifications when excluding forestlands. (Appendix B)

4. Annual Land Value Appreciation (LVA) 3% to 5%
This performance measure is not reported for FY2015 due to the uncertainty of forestland values for Common School Forestlands within the Elliott State Forest (ESF), and also due to the general nature of the methodology used by DSL in the past to assess land values for other land classifications. Within the ESF, land values are believed to have been negatively affected in recent years by the presence of federally listed threatened and endangered species. However, the absolute degree of this reduction and resulting market value remains speculative. In December 2014, DSL contracted a report from Evergreen Economics (see December 2014 State Land Board agenda), that provided an estimated market value of those Common School Lands within the Elliott State Forest. Land values for other land classes were last reported in FY2014, based on general market assessments in the recent past by DSL (Appendix C).

2012 Real Estate Asset Management Plan (REAMP) Implementation

Information on the general implementation categories defined in the 2012 REAMP, or asset performance categories, and the distribution of the trust lands across these categories are summarized in Table 2 (excludes waterways and sub-surface mineral rights).

As of January 2015, approximately 120,000 acres of trust lands (or 16%) were generating minimal or no revenues for the Common School Fund, and its estimated these acres make up at least 60% of the total asset value of the Common School Fund trust lands. The large majority of these acres are forestlands managed for DSL by the Oregon Department of Forestry, also referred to as “certified” forestlands. Current projections do not anticipate a change in this low performance in the future. The 2012 REAMP Implementation Outcomes include “a rebalanced portfolio through acquisition of assets with high performance potential and the strategic disposal of selected non- or lower-performing assets.” Therefore, moving forward, DSL will continue to be evaluating all of these non-performing lands in the “none/minimal” category for potential sale. Net proceeds from trust land sales are deposited into the land revolving account (a sub-account of the Common School Fund).

In the near-term, however, the focus for DSL land sale efforts will be on the 5,536 acres in this category classified as agriculture, rangelands, and ICR land. For the approximately 84,000 acres of lands within the Elliott State Forest, the Department continues to move forward with the Elliott Protocol and the potential transfer of ownership of these forestlands by December 2017. The remaining acres of forestlands in the “none/minimal” revenue category will generally not be actively considered for sale until DSL has adequately examined the potential to increase revenues through alternative approaches to managing those lands.

Table 2. Summary of trust lands administered by DSL, by land classification type and asset performance category (APC), excluding mineral and energy resources and waterways ownership (as of January 2015).

LAND CLASSIFICATION	PROPERTY REVENUE POTETNIAL (acres)				
	Long-term[1] Potential	Short-term[2] Potential	Current[3]	None/ Minimal[4]	**Total Acres**
Forestlands		458	19,021	102,615	**122,094**
Agricultural Lands		275	5,368	193	**5,836**
Rangelands	716	3,556	616,503	3,825	**624,600**
Industrial/Commercial /Residential	476	1,911	3,132	1,518	**7,037**
Special Stewardship Lands			891	12,321	**13,212**
Total Acres	1,192	6,200	644,912	120,472	**772,776**

[1] Not currently producing revenue, but with strong potential to produce revenue within 10 years.
[2] A strong potential to produce revenue within two years, but not presently generating revenue.
[3] Currently producing annual revenues for the Common School Fund.
[4] Generating minimal or no annual revenue, and low potential for generating revenue in the future.

About 7,400 acres across four of the five upland land classes are currently classified as having either short- or long-term potential to generate revenues. DSL will continue to actively pursue opportunities to manage those lands in the future to convert them to higher-performing assets. If at a future point in time it's determined these acres are unlikely to be able to generate revenues, they would then be reclassified as "none/minimal" category lands and shifted into the pool of acres to be evaluated for possible divestment.

The balance of the remaining lands—about 645,000 acres—are currently generating revenue, and DSL will continue to manage these lands accordingly (also see Appendix B, and 3-year average net revenues). DSL will look for opportunities to increase revenues and decrease expenditures from these lands, consistent with the REAMP Implementation Outcome for "a more aggressively managed portfolio, including evaluation of all lands, with a focus on ICR and agricultural lands and mineral and energy resources to generate new revenues." A current example of this is the Eastern Region's continued efforts to identify opportunities to develop rangelands into irrigated agricultural production, which can result in as much as a 30-fold increase in per-acre income.

The primary factors affecting the reduced performance in FY2015 of the rangelands that make up the large majority of these 645,000 acres are leasing rates, drought conditions, and fire protection costs. Depending on how future conditions change relative to these three factors, rangelands have the potential to see improved performance in the future. Fire protection costs are unique in that there are potential steps that can be taken to reduce such costs in the future, and thereby improve the performance of these lands. The Department will be exploring various options towards reducing fire protection costs where prudent and feasible, in order to improve the net revenues generated by these lands in the future.

Finally, DSL will continuously re-evaluate the entire portfolio of trust lands to ensure the revenue generating status is properly categorized (Table 2). The Real Property unit will make on-going adjustments as needed to reflect changes in our knowledge of the lands, any physical changes to the lands (ex. infrastructure investments), and any changes to potential revenue-generating opportunities.

Current and Future Real Propety Management Priorities

Moving forward, the Department will continue implementing the 2012 REAMP's General Management Principles, which include the following (pp.17-18):

1. The Land Board and Department will continue to meet their obligations on Trust Lands.
2. The Land Board and Department will continue to manage CSF lands to create a sustained and consistent stream of revenue to assist in building the principal of the CSF, thereby increasing annual distributions to schools.
3. The plan balances revenue enhancement and resource stewardship.

4. Consistent with the legacy of the Admission Act, the Land Board will maintain a real property asset portfolio of CSF lands. The allocation of land among land classifications may change over time based on management, reinvestment and disposal [i.e. divestment] strategies.
5. The Land Board and Department will actively strive to increase the total annual revenues from the real property asset portion of the CSF portfolio through the disposal of Trust lands that are not actively managed or are low revenue producers.

The Common School Fund's real property portfolio, with an estimated value of approximately $678 million (Appendix C), is a substantial asset of the Common School Fund as a whole. This asset has historically generated hundreds of millions of dollars in revenue for the Common School Fund, and continues to be a very significant portion of the total asset value of the Fund portfolio (equivalent in value to almost half of the Common School Fund investment holdings, currently valued at approximately $1.42 billion).

That said, the trust-land portion of this real property asset holds a unique position in its primary role of providing revenue for Oregon's public schools. A key element of ensuring the mandate of these trust lands is maintaining an accurate and comprehensive inventory of all real property assets and asset values, and continually evaluating their current and potential revenue-generating status. The primary framework for this will be the regular asset performance category (APC) review as discussed in the previous section of this report. These reviews are intended to further fine-tune the evaluation of the various APCs for these lands.

For example, consider the overall performance of lands in the "current" category (see Table 2). Although they are presently providing a net positive benefit to the Common School Fund, the relative performance of these lands is currently low. In FY2015, the three-year average return on asset value for agricultural, rangelands and ICR lands is 0.81%, 0.02% and 0.31%, respectively. Given this is an average, there are parcels performing both at a higher and lower level than this, and others possibly even at a net deficit to the Common School Fund. To the extent that DSL can develop a more sophisticated approach to the asset performance category review of these lands in the future, there is the potential to parse out sub-categories within land classification categories to allow for a more refined assessment of specific lands that are higher- versus lower-performing. This would better inform future Department and Land Board decision-making concerning land retention and divestment.

A major focus and timely issue for the Land Board and the Department over the past few years has been the net deficit to the Common School Fund resulting from forestland management activities. Over the past three fiscal years (FY2013 thru FY2015), the forestlands category of the trust lands portfolio has cost the Common School Fund about $3.28 million. Revenue projections are currently showing a likelihood of deficits from these lands continuing into the future, although the magnitude of those deficits is uncertain.

These deficits have occurred primarily as a result of federal Endangered Species Act litigation involving Common School Fund trust lands on the Elliott State Forest. Forest management changes made in the course of managing the litigation led to drastically reduced timber sales and a continued net revenue deficit on the Elliott in FY2015. The management constraints on these lands has raised the question of their compatibility – now and in the future – with the primary trust obligations of the Land Board to maximize revenues to benefit multiple generations of K-12 students.

Addressing this issue in the near term and for the foreseeable future is a high priority for DSL. In August of 2015, the State Land Board approved the Elliott Opportunity Protocol, directing the Department to move forward with an approach towards the potential transfer of ownership of the Elliott State Forest (ESF) out of the Common School Fund by December 2017.

Also, in light of the continued low return on asset value (ROAV) – nearly a decade after the adoption of the prior 2006 Asset Management Plan – it may be appropriate to evaluate the need for a change in approach towards managing the Common School Fund real property portfolio as a whole. This could be in the form of a substantive revision to the Real Estate Asset Management Plan aimed towards an alternative approach with a higher likelihood of improved financial performance in the future.

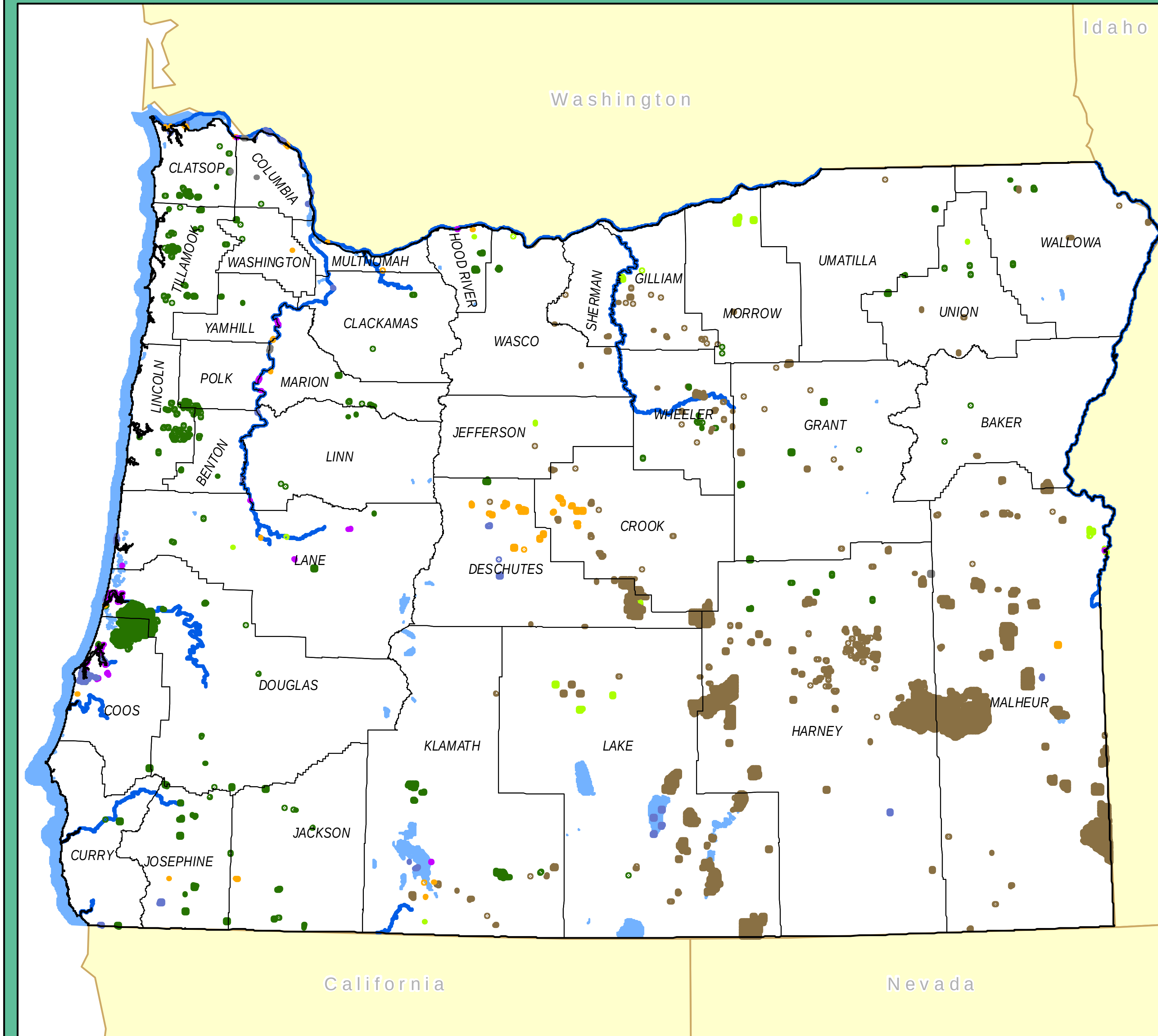
Summary

In FY2015, Common School Fund forestlands on the Elliott continued to produce a net loss to the Common School Fund (CSF), with only modest relative returns being generated by other forestlands and the other categories of trust lands (rangeland, industrial-commercial-residential, agriculture, and mineral & energy resources). Depressed forestland revenues are projected to continue given the current management constraints intended to protect federally listed threatened and endangered species on forestland lands. Given the primary mandate of trust lands to produce revenue for Oregon's public schools, and the fact that a majority of forestlands are currently a liability to the CSF, the Department will continue with the careful evaluation of alternative approaches to this category of trust land assets. The implementation of the Elliott Protocol adopted by the Land Board in August 2015 is a central piece of this work. This effort, in addition to the continuous evaluation of the entire real property asset portfolio and the potential revisiting of the 2012 REAMP, will be important to ensuring prudent financial practices in support of the State Land Board's trust obligations.

APPENDICES

A. Map of all lands under the authority of the Department of State Lands, by Land Use Class
B. FY 2013 – 2015 Real Property Revenue, Expenditures, and Net Operating Income by Land Class
C. FY 2015 Financial Performance by Land Class

APPENDIX A



State of Oregon Department of State Lands

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Land Use Class

- Agriculture
- Forest
- ICR
- Mineral & Energy
- Rangeland
- Special Stewardship
- Waterway
- Navigable Rivers
- Territorial Sea & Meandered Lakes

N W E S

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Oregon Lambert Conformal Conic
Datum NAD83
International Feet

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APPENDIX B

FY2013-FY2015 Real Property Revenues, Expenditures (Direct only) and Net Operating Income by Land Class

(Does not include land sales/exchanges, South Slough expenditures/revenues, or capital expenditures.)

	Fiscal Year 2013			Fiscal Year 2014			Fiscal Year 2015			***3-Year Avg.***
Land Classification	Gross Revenue ($)	Expenditures ($)	Net Operating Income ($)	Gross Revenue ($)	Expenditures ($)	Net Operating Income ($)	Gross Revenue ($)	Expenditures ($)	Net Operating Income ($)	***Annual Net Operating Income ($)***
Agricultural Land	220,363	106,000	114,363	$ 225,398	$ 119,772	$ 105,626	$ 237,244	$ 127,229	$ 110,015	***$ 110,001***
Rangeland	668,994	616,764	52,230	$ 578,940	$ 420,391	$ 158,549	$ 586,907	$ 716,223	$ (129,316)	***$ 27,154***
ICR	999,038	820,062	178,976	$ 1,139,053	$ 826,819	$ 312,234	$ 1,037,108	$ 849,944	$ 187,164	***$ 226,125***
Forestland	2,305,411	5,142,914	(2,837,503)	$ 3,573,368	4,208,891	$ (635,523)	$ 4,270,904	4,080,482	$ 190,422	***$ (1,094,201)***
Mineral & Energy Resource	477,239	131,832	345,407	$ 559,291	$ 86,650	$ 472,641	$ 352,726	$ 70,509	$ 282,217	***$ 366,755***
Special Stewardship	12,403	10,575	1,828	$ 13,672	$ 10,511	$ 3,161	$ 14,875	$ 9,481	$ 5,394	***$ 3,461***
		Revenues do not include land sales or mineral releases.								
Totals	**4,683,448**	**6,828,147**	**(2,144,699)**	**6,089,722**	**5,673,034**	**416,688**	**6,499,764**	**5,853,868**	**645,896**	***$ (360,705)***
Totals without Forestlands	***2,378,037***	***1,685,233***	***692,804***	***2,516,354***	***1,464,143***	***1,052,211***	***2,228,860***	***1,773,386***	***455,474***	***$ 733,496***

APPENDIX C: FY2015 Financial Performance by Land Classification

Land Classification	*Total Acres*	Approximate Market Value (millions)	% of Total Market Value	Annual Net Operating Income (NOI)	*3-year Average Annual Net Operating Income (NOI)*	Annual Return on Asset Value (ROAV	*3-year Average Return on Asset Value (ROAV)*
Forestlands: Elliott State Forest	*84,000*	$285.0 – 442.6 (1)	54%	($820,109) (2)	*($1,094,201)*	-0.23%	*-0.23%*
Forestlands: Other	*38,000*	$103.3 – 113.9 (3)	16%	$1,010,531 (4)		0.93%	
Agricultural Lands	*5,800*	$13.4 – 13.9 (3)	2%	$110,015	*$110,001*	0.81%	*0.81%*
Rangelands	*624,600*	$109.5 – 125.1 (3)	17%	($129,316)	*$27,154*	-0.11%	*0.02%*
ICR Lands	*7,000*	$72.2 – 75.2 (3)	10%	$187,164	*$226,125*	0.25%	*0.31%*
Special Stewardship Lands	*13,200*	(5)	(5)	$5,394	*$3,461*	(5)	*(5)*
Mineral and Energy Resources (sub-surface ownership)	*767,100*	(5)	(5)	$282,217	*$366,755*	(5)	*(5)*
Totals	***1,540,000***	**$678**	**100% (6)**	**$645,896**	***($360,705)***	**0.10% (7)**	***-0.05% (8)***

Notes:

(1) Based on values reported in the November 19, 2014 "Elliot State Forest—Analysis of Alternatives" report, submitted to the State Land Board at their December 9, 2014 meeting.

(2) The "Forestlands: Elliott State Forest" NOI value listed here was calculated using the "Coos District/Elliott" revenue and expenditure numbers from the FY2015 ODF Annual Report to the State Land Board (see February 2016 Board agenda item); 70% of the ODF "Fire Protection Assessment" costs listed in that report; and $394,727 in DSL expenditures associated with the Elliott Alternatives project work in FY2015.

(3) These are values reported in the FY 2011 Annual Report, with the exception of ICR Lands. For the ICR value range, $2.9 million was added to the value reported in FY 2011 to account for the Helvetia property purchased after FY 2011. In the case of "Forestlands: Other", per acre-equivalent is used. (These are the most recent estimated values with reported DSL methodology.)

(4) The "Forestlands: Other" NOI value listed here was calculated using the combined revenue and expenditure numbers from the eight remaining ODF districts (excluding the Elliott) listed in the FY2015 ODF Annual Report to the State Land Board (see February 2016 Board agenda item); and 30% of the ODF "Fire Protection Assessment" costs listed in that report.

(5) Data unavailable.

(6) Total of individual Land Classification % of Total Market Value may not total 100% due to rounding.

(7) The total ROAV does *not* include NOI derived from special stewardship lands, since the asset value of those lands are not reported here. The NOI for mineral and energy resources is included here because those revenues are derived from parcels in one of the other surface land classifications. Excluding forestlands, the total ROAV increases to 0.2 %.

(8) The total ROAV does *not* include NOI derived from special stewardship lands, since the asset value of those lands are not reported here. The NOI for mineral and energy resources is included here because those revenues are derived from parcels in one of the other surface land classifications. Excluding forestlands, the total ROAV increases to 0.1 %.