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A Performance Audit of the School & Institutional Trust Land Administration (SITLA)

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Digest of A Performance Audit of The School and Institutional Trust Land Administration

Since separation from state controls, the School and Institutional Trust Lands Administration (SITLA) has focused on increasing revenues and growing the permanent fund dedicated to support the fund beneficiaries. Revenue and fund growth have become the overriding measures of the organization's success and are the basis of the compensation and bonus programs. We believe the agency's desire to increase revenues and grow the fund has also resulted in their redirection toward land sales and land development.

The organization's revenues have increased in recent years due primarily to increases in natural gas and oil prices and an aggressive land sales program. Changes in investment policies of the permanent fund have been positive but can be furthered with greater flexibility. Fund contributions credited to the Development Group's land transaction activities have increased but are concerning because the group's success has been overstated and lacks acceptable levels of control for a public trust. Revenue and fund growth are the basis for SITLA's compensation program that has resulted in senior management receiving higher compensation than any of the organizations surveyed for this report and individual bonuses ranging from $20,000 to $40,000 per year.

Chapter I: Introduction

SITLA is the organization currently entrusted with the management of 3.4 million acres of land granted by the federal government to Utah's beneficiaries. SITLA's seven-member Board of Trustees oversees the statutorily-established operations of the organization. The Legislature is responsible for statutory oversight and for appropriating, from the revenue generated from the land, funding for SITLA's annual operations.

Chapter II: External Market Forces and Internal Policy Changes Shape SITLA

Revenue Growth Correlates with Market Trends. Revenues earned by SITLA have increased due to strong oil and gas prices beyond SITLA's control. The agency prior to SITLA also earned high revenues when oil and gas prices were just as strong in the early 1980s. SITLA revenues have also increased from an aggressive land sales program of prime trust land and appreciation in land values as they sell and trade land.

A substantial amount of SITLA's recent revenue increases can be attributed to a $50 million federal government land exchange and a $12.5 million lawsuit settlement.

Distribution Policy Change Has Resulted in Permanent Fund Growth. When SITLA was created, the ***Utah Constitution*** was changed to require all net revenue earned by SITLA go into the permanent school fund and not be distributed to the Uniform School Fund. This major change in distribution policy—from spending revenues for education to saving the revenues—allowed the fund to grow from $95 million in fiscal year 1994 to $569 million in fiscal year 2005. SITLA's goal is to reach $1 billion in the permanent fund by the year 2010, at which point interest and dividends generated from the fund may provide a 2-percent supplement to the annual state budget for public education.

1. We recommend that the Legislature revisit the distribution policy of trust lands to see if it is still meeting the needs of public education—particularly the distribution of renewable resources.

2. We recommend that the Legislature require SITLA to publish a comprehensive annual report.

Chapter III: Investment Policies Can Be Improved

Current Investment Practices Follow State Law. The ***Utah Constitution*** and state statute provide that the State Treasurer is the custodian of all permanent and public funds, including the permanent fund of SITLA, and is also given the authority for setting investment policy for the permanent fund. Oversight is provided at least quarterly by the State Money Management Council. In addition, an Investment Advisory Committee meets at least quarterly to give suggestions, advice, and opinions to the State Treasurer in regard to how the fund is invested within the parameters of the MMA.

Investment Policies Have Changed, but More Can Be Done Within Existing Laws. In 1995, the MMA was modified to allow investments in equities, up to 80 percent of the value of the fund. By

investing a portion of the fund in stocks, the state can take advantage of the opportunity to earn higher returns. Historically, funds invested in stocks have earned more through appreciation than funds invested in fixed-income securities. This change allowed the Treasurer to diversify the portfolio. ***Utah Code*** 51-7-12 specifies the type of investments the State Treasurer can make with trust funds.

1.	We recommend that the Legislature consider changing the Money Management Act to allow the Treasurer more flexibility in investing the permanent trust funds.

Chapter IV: Land Development Emphasis Raises Concerns

The Development Group Lacks Necessary Controls. When capital improvement expenditures are included, the Development Group spends more money per dollar earned than any other SITLA group and, by design, has the fewest controls governing its operation. The Development Group has been given charge of selected prime lands with the ability to independently negotiate land transactions. The Development Group's negotiated sales, with the exception of their presentation to the board, are not public and receive little oversight.

Development Group Success Is Overstated. The Development Group's stated success is overstated by attributing too much revenue to developed land sales and recognizing too few of SITLA's costs. Revenue is overstated because half of the Development Group's reported earnings can be attributed to land sales that required minimal efforts to prepare for sale. Costs are understated because the group has not fully accounted for staff time and agency overhead. The overstatement of revenue and understatement of costs are concerning given the additional capital improvement funding requests scheduled for the coming years.

Increased Development Activity Is Concerning. To date, several development projects have underperformed projections. Strong market conditions have offset project delays and problems which otherwise would have resulted in less than acceptable returns. SITLA believes that a number of current multi-year projects, including some that have underperformed to date, have high potential and will exceed current expectations in the near future.

1. We recommend that SITLA establish a uniform method of selling land requiring appraisals and market competition for all properties.

2. We recommend that the Legislature consider providing direction to SITLA regarding land sales and development including the level of risk appropriate for SITLA's development opportunities.

3. We recommend that if the Legislature elects to allow development past basic planning and infrastructure, the Legislature consider funding staff with sufficient experience in real estate planning.

4. We recommend that the Development Group use the system in place to track their work on a project-by-project basis to adequately establish true cost calculations and net revenues of projects and that SITLA use this information to adjust the overhead allocation accordingly.

5. We recommend that the Legislature consider allocating funds for the purpose of hiring additional audit staff for the monitoring of development projects.

Chapter V: SITLA Administrative Compensation Appears High

Much of Bonus Program Is Based on Market-Driven Factors. Since 1997, SITLA has paid out almost $2 million in bonuses. Current bonuses are paid to the entire full-time permanent staff and range from $2,000 to $40,000 per person. No surveyed organization paid bonuses that approach those of SITLA. The majority of the bonus program is based on reaching unrealistically low net revenue goals, which are more tied to increases in natural gas and oil prices and an expanded land sales program than to employee performance.

SITLA Total Compensation Appears High. Selected SITLA administrative and support staff job compensation is generally higher than that of comparable jobs in other states and organizations. It appears that neither span of control nor job responsibilities provide justification for the increased compensation. SITLA did not conduct compensation surveys when setting compensation levels. SITLA's jobs are generally equivalent to those of the surveyed organizations.

1. We recommend that if bonuses continue, they be based on appropriate and measurable goals.

2. We recommend that the Legislature provide SITLA with guidelines for salaries and bonuses.

Chapter I
Introduction

The School and Institutional Trust Lands Administration (SITLA) was created as an independent state agency on July 1, 1994 by enactment of ***Utah Code*** 53C, and its functions were moved out of the Department of Natural Resources (DNR). Since separation from state controls, some of SITLA's general methods of operations have raised concerns. Primarily, the focus is on maximizing revenues and growing the permanent fund rather than distributing revenues to education. Contributing to concerns has been SITLA's development emphasis, with questionable policies and profitability, and SITLA's salary and bonus program, which is higher than similar trust land agencies in other Western states.

Trust Lands Procedures Governed by Federal and State Statutes

The federal government granted the state 7.4 million acres of land in 1896 to be held in trust for the benefit of public education and 11 specific state institutions such as universities, schools for the deaf and blind, and the state hospital. These lands were federally granted to support public education because states were not able to tax the federal lands. Today, the state still owns 3.4 million surface acres and 4.3 million subsurface acres across the state, and SITLA manages the lands. (See Appendix A for the original surface trust land grant acreage and current holdings.)

Revenue from the Permanent School Fund is a small portion of the state's K-12 education budget.

Public education is the largest beneficiary. The majority of revenues generated from SITLA activities are placed in the Permanent State School Fund (permanent fund) and invested by the State Treasurer. The interest and dividends earned on the permanent fund are distributed by the School Learning and Nurturing Development (LAND) Trust Program housed within the Utah State Office of Education. During the 2004-2005 school year, LAND distributed $9.7 million (less than one-half of 1 percent of all state revenues for K-12 schools) to school districts and charter schools, based on the number of students. SITLA distributed $2.5 million to the other 11 beneficiaries.

Land Management Has Been A State Function Since Statehood

Trust land operations was an independent agency of the state, prior to its 1967 incorporation in the Division of State Lands and Forestry within the Department of Natural Resources. In 1994, the operation was again given independent status as SITLA. All activities affecting trust lands, including the issuance and administration of mineral leases, grazing and agricultural leases, special use leases, easements, temporary use permits, and the sale, exchange, and development of trust lands currently rests with SITLA.

According to SITLA's 10-year report published in 2004, trust lands management was removed from the DNR and established as an independent state agency in 1994. The report states that "Utah's education community believed trust lands operations were treated as a small and insignificant part of the Department's total operations and that the results of trust lands management would improve if administered by those whose only responsibility was the financial performance of trust lands. They fostered the legislation to create the new agency and its mission."

Board Provides Oversight

A seven-member Board of Trustees (Board) oversees the operations of SITLA as established in ***Utah Code***. The Governor, with consent of the Senate, appoints seven members for nonconsecutive six-year terms. The Governor makes six of the seven Board appointments from a list of nominees supplied to him from a nominating committee consisting of representatives from public education, higher education, and user groups, namely the livestock industry, Petroleum Association, Mining Association, and the DNR; he also appoints one at-large member.

By statute, members of the Board represent specific areas of expertise, including nonrenewable resource management or development, renewable resource management, and real estate. The Board meets monthly. The agency must obtain Board approval for certain types of decisions, primarily other business arrangements and development land sales and exchanges.

Legislature Establishes Funding

The Legislature sets the level of funding for SITLA. This funding comes from a portion of the revenue generated from the lands, which goes into an enterprise fund known as the Land Grant Management Fund (LGM). The director may expend funds from the LGM in accordance with the legislatively-approved budget for support of the director and administrative activities. Although general fund dollars are not appropriated from the Legislature for SITLA's support, legislative oversight is a primary system control.

Agency Mission

The majority of state-owned lands in Utah are trust lands, which are managed to produce revenue for public education and 11 other specific beneficiaries from uses such as leasing land for oil and gas production, grazing, mining, and land sales and development. The agency's mission is "To administer the trust lands prudently and profitably for Utah's schoolchildren." The vision reads: "The trust is an increasingly significant source of funding for Utah's schools."

The management objectives for state trust lands are detailed in *Administrative Rule* R850-2-200 that implements the Enabling Act, constitutional and statutory provisions regarding state trust lands. The general land management objective is to "optimize and maximize trust land uses for the beneficiaries over time." Specific goals require SITLA to do the following:

- Maximize the commercial gain from trust land uses for school and institutional trust lands consistent with long-term support of beneficiaries.

- Manage school and institutional trust lands for their highest and best trust land uses.

- Ensure that no less than fair-market value is received for the use, sale, or exchange of school and institutional trust lands.

- Reduce risk of loss by reasonable trust land use diversification of school and institutional trust lands.

- Upgrade school and institutional trust land assets where prudent by exchange.

- Permit other land uses or activities not prohibited by law which do not constitute a loss of trust assets or loss of economic opportunity.

SITLA's activities are divided into three groups: Minerals, Surface, and Planning and Development. The Minerals Group manages leases on mineral properties for mineral production including gas and oil, coal, gold, and sand and gravel. The Surface Group leases property for uses such as telecommunication towers, commercial and industrial enterprises, cabin sites, farming, and grazing. One of Surface's major responsibilities is selling lands. The Planning and Development Group is involved in planning, zoning, and the development of infrastructure on trust lands considered to be of highest value. They have identified 60,000 acres for future development and privatization.

Audit Scope and Objectives

This audit is the product of a joint effort by the Office of the Legislative Auditor General (OLAG) and the Legislative Fiscal Analyst. The audit was requested in response to legislative interest that came after a Legislative audit on **Statewide Employee Incentives** (Report 2004-04). That audit report showed that SITLA senior management received bonuses up to $25,000, and most of the remaining employees received about $2,600 in annual bonuses. The Natural Resources Appropriations Subcommittee co-chairs requested OLAG conduct a performance audit of the incentive awards program of SITLA. According to the request letter, the audit should accomplish the following tasks:

- Review and determine if SITLA's incentives have been appropriate in relation to the salary structure.

- Report on the economy and efficiency of the agency.

Chapter II
External Market Forces and Internal Policy Changes Shape SITLA

Since SITLA's creation in 1994, historically high natural gas and oil prices, in combination with aggressive land sales, have resulted in earnings of over $500 million. Over this same period, SITLA's distributions of these earnings to public education, the largest beneficiary, have been minimized to allow growth of the permanent school fund. As a result, the permanent school fund has grown from $83.5 million in fiscal year 1994 to $569 million in fiscal year 2005. SITLA and the school beneficiaries cite the increase in revenues and the growth of the permanent fund as evidence of SITLA's success.

Most other states do not sell their trust lands and, on average, provide greater distributions to beneficiaries. The relationship of revenues to distribution and fund balance growth is the key element of SITLA's strategic change. Revenue and fund growth have become SITLA's major emphases and key performance measures. Neither measure alone gives a complete picture of the organization's success.

Revenue Growth Correlates with Market Trends

Revenues have increased because of land sales and mineral lease royalties.

SITLA's revenues have increased because of aggressive land sales, a federal land exchange, and increasing natural gas and oil prices. The largest revenue increase came in fiscal year 2005 because of historically high mineral lease royalties. SITLA has also benefitted from appreciation in land values as they sell and trade land. SITLA's annual operating revenues increased from $15.5 million in 1995 to $93.9 million in 2005, a six-fold increase. In 1999, the agency revenues were augmented by $62.5 million of extraordinary income—$50 million in a land exchange with the Federal Government when they created the Grand Staircase Escalante National Monument, and $12.5 million from the settlement of a coal audit lawsuit.

Since beginning its operation as an independent state agency, SITLA has earned $520.6 million in operating revenue from the following sources:

- Mineral leasing: $306.5 million (59 percent of total)
- Land sales: $104.2 million (20 percent of total)
- Land exchange & lawsuit settlement: $62.5 million (12 percent of total)
- Other activities, including surface and development leases, grazing, interest earned: $47.3 million (9 percent of total)

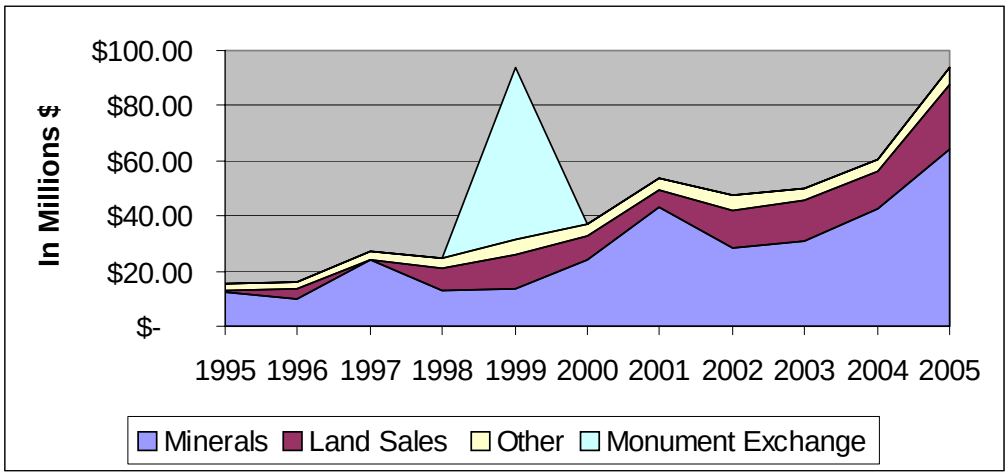
Mineral Leases Have Been the Major Revenue Source

Revenues from natural gas, oil, and minerals provide the majority of annual revenues.

Revenues from natural gas, oil, and minerals consistently provide the majority of SITLA's operating revenue. Since becoming an independent state agency, SITLA has earned $306.5 million in gross revenues from minerals (59 percent of total operating revenue). Figure 2.1 shows that minerals have provided the majority of revenue for all years except 1999.

Figure 2.1. SITLA Revenue by Activity, Fiscal Years 1995-2005. The majority of SITLA's revenue comes from minerals and land sales.

SITLA is seeing increased revenues due to higher prices for natural gas and oil and land sales.



SITLA earns a constant amount of revenue from leasing lands for oil, gas, and coal exploration. When the prices for oil and gas are high, revenues increase because royalties, simultaneous bids, and bonus bids all increase. Royalty revenue is based on price and production. Simultaneous bids are additional sums of money a lessee pays above the

stated rental rate for the right to hold a mineral lease. Bonus payments, similar to simultaneous bids, are one-time payments for the right to hold the lease for exploration. In 2005, SITLA earned a total of $64 million from minerals—$45 million in royalties, $14.5 million in simultaneous bids, and $1.8 million in bonus bids.

Natural Gas and Oil Prices Have Increased in the Past 10 Years. According to information from the Utah Division of Oil, Gas and Mining, from July 1995 to June 2005 natural gas prices increased from $1.00 per MMBtu (a thousand thousand British Thermal Units, a standard unit of measurement for natural gas) to $5.46 per MMBtu, a 446-percent increase. Similar increases occurred with crude oil, where prices for Black Wax (a type of crude oil found in Utah) increased from $16.83 per barrel to $53.25 per barrel, a 216-percent increase. Natural gas and crude oil prices continue to climb through 2005.

Trust land mineral earnings fluctuate with oil and gas price, exploration, and production.

High Mineral Earnings Are Not Unique to the Last Five Years. Historically, trust land revenues have benefitted, at times, from elevated natural gas and oil prices, exploration, and production. As an example, current prices have resulted in mineral earnings from rentals and royalties that have averaged about $40 million per year (in 2005 dollars) for the last six years. This value is more than double the average of $17 million per year (in 2005 dollars) for the previous five years. The current high is, however, not unique in either earning value or duration. For the six-year period beginning in 1980, comparable mineral earnings averaged about $38 million per year (in 2005 dollars). In 2005, SITLA earned almost $15 million in simultaneous bids, which was a historical high. If the historically unique $15 million in simultaneous bids is not included in the comparison, minerals provided about the same amount of revenue in the 2000s as in the 1980s. See Appendix B for the historical patterns of mineral revenue, total revenue, and distributions to beneficiaries.

Land Sales Have Increased

Selling trust lands has increased since SITLA became an independent state entity.

SITLA's operating revenues also reflect an increase in land sales: $104 million (20 percent of total operating revenue) over the past 11 years. In 2005, SITLA earned $23 million from selling land both through negotiated sales and at public auctions.

Trust land sales have increased since SITLA became an independent state agency. SITLA sells trust lands twice a year at auctions and at other

times during the year in direct sales. Prior to the creation of SITLA, the policy of the Board of State Lands was to encourage the lease, rather than the sale, of trust lands. Sales were only made when there was an overriding need for private or local ownership of the lands.

Selling trust lands is a policy decision that has been discussed since the implementation of the Enabling Act. Approximately 4 million acres of land have been sold since statehood. Most of these sales took place in the first 34 years of statehood, when the philosophy of the Land Board and the Utah Legislature was that trust lands should be disposed of to the citizens of the state and the lands placed on the tax rolls.

Other than Utah and Arizona, most western states do not sell trust lands. In fact, at the 2005 Western States Land Commissioners Association Conference, the executive director of the Colorado Department of Natural Resources addressed the group and talked about not going down the path of liquidation. He noted that not every parcel needed to be maintained, but that the best protection for the next generation was to keep the land.

Other Revenue Sources Have Increased

SITLA earned $62.5 million (12 percent of operating revenue) in fiscal year 1999 because of two extraordinary transactions—$50 million from the land exchange that created the Grand Staircase Escalante National Monument, and $12.5 million from the settlement of a coal audit lawsuit.

SITLA received $50 million from a federal land exchange.

The Federal Government pursued the national monument designation, and it was initially fought by SITLA. However, after negotiations between the State and the Federal Government, an exchange of land and money occurred. In the exchange, SITLA received $50 million, 120,000 acres of developable surface and mineral properties, and 29,675 acres of mineral-only properties. The Federal Government received 187,000 acres in national parks, forests, recreational areas, and Indian Reservations, and 176,000 acres of land within the Grand Staircase Escalante National Monument.

An example of the mineral properties acquired in the trade is the Drunkards Wash area in Carbon County. SITLA staff identified known oil and gas lands, and the Federal Government allowed it to be part of the

trade. SITLA acquired valuable land that was the exact footprint of the oil and gas fields. This area has been written up in professional journals because it was so productive. More than 400 producing wells are in this area, which provides 60 percent of all the revenues of the oil and gas group.

Distribution Policy Change Has Resulted in Permanent Fund Growth

When SITLA was created, the ***Utah Constitution*** was changed to require that all net revenue earned by SITLA go into the permanent school fund and not be distributed to the Uniform School Fund. This major change in distribution policy—from spending revenues for education to saving the revenues—allowed the fund to grow from $83.5 million in fiscal year 1994 to $569 million in fiscal year 2005. Prior to SITLA becoming an independent state agency, schools received a larger portion of the annual trust revenues.

According to SITLA's annual report, a primary goal is to grow the permanent fund so that the investment earnings from the fund become a major source of public school funding. SITLA's goal is to reach $1 billion in the permanent fund by 2010. The annual state budget for public education is over $2.5 billion per year. Upon reaching the $1-billion goal, interest and dividends generated from the fund may provide a 2-percent supplement to the annual state budget for public education.

Change in Statute Allowed Fund to Grow But Limited Distributions

School beneficiaries believe that SITLA's new distribution system is consistent with Section 10 of Utah's Enabling Act which provides that ". . . the interest of [the permanent fund] shall be expended for the support of said schools." However, other states, some with similar enabling acts, distribute all revenues from renewable resources.

A review of historical revenues and distributions shows that trust lands distributed, on average, 50 percent of gross annual revenues to the beneficiaries. When the distribution policy was changed, operating revenue was no longer distributed to the schools; only investment earnings were distributed. On average they now distribute about 14

percent of gross revenues. This change in the distribution policy was designed to allow the fund to grow.

Distributions to Schools Have Decreased, but Distributions to Institutional Beneficiaries Have Not Changed. As a result of the change in statute, distributions to schools have decreased. For example, in fiscal year 1976, 52 percent of gross revenue was distributed to beneficiaries. In that year, trust lands generated $44 million in gross revenues (in 2005 dollars) and distributed $23 million (in 2005 dollars) to beneficiaries. The remaining revenues were deposited to the permanent fund or used in support of the agency. In contrast, in fiscal year 2005, trust lands and the State Treasurer's investments generated $108.9 million in gross revenues and distributed $16.6 million (15.2 percent), $13.9 million of which will be distributed to school districts by LAND in fiscal year 2006.

Institutional beneficiaries receive distributions of all operating revenue except the proceeds from land sales. Only the proceeds from land sales are deposited in their permanent trust funds with the State Treasurer. (See Appendix C for a flowchart showing how revenues are distributed.)

A major portion of the permanent fund was distributed to beneficiaries in 1983.

Beneficiaries Received Majority of Trust Fund Between 1983 and 1987. In 1983, $37.6 million in accumulated royalties from the permanent fund was distributed to public schools and the other beneficiaries. In addition, mineral royalties earned from 1983 to 1987 were distributed directly to the beneficiaries. These disbursements were deemed acceptable by the Utah Supreme Court, who held that lands of a mineral character did not fall within the provisions of the Enabling Act and Constitution and that, while proceeds for their leases and royalties must be used for the support of the designated purposes (public schools and institutions), all net revenues should be distributed directly to the beneficiaries. The ***Utah Constitution*** was amended in 1988 to stop this practice.

The net result of these distributions is that the trust lands permanent fund decreased from $68.9 million to $22 million. To put the effect of these distributions in context, leaving the earnings in the fund rather than distributing them would have increased the fund by an additional $232 million by fiscal year 2005 at a 6.5-percent annual return.

Because SITLA's and the school beneficiaries' goal is to increase the permanent fund and not distribute any operating revenue to public education, the large distributions in the 1980s with the resulting decrease in the permanent fund are seen as negative by some at SITLA and some beneficiary representatives. It should be remembered, however, that distributions for current public education students are just as much investments as placing the funds in the instruments used by the permanent fund.

Other States Distribute Renewable Resource Revenues to Schools

Other states distribute renewable resource revenues to public education.

SITLA's operation differs from that of most other trust land states in that SITLA does not annually distribute renewable resource revenues (sales interest, grazing, telecommunications site leasing, and development leases). From fiscal years 1995 to 2005, SITLA earned $47.3 million from renewable resources, and in compliance with the current statute, deposited the funds into the permanent school fund. If SITLA's operation mirrored that of other states, the permanent fund would be less, but public education would have received an additional $47.3 million in the last 11 years.

A permanent fund mechanism is intended to retain the proceeds from nonrenewable resources.

Prior to SITLA's creation, renewable resource revenues were distributed to public education as they were earned. The legislation that changed this distribution was fostered by the school beneficiary representative who believed the Enabling Act required all proceeds from the land to be placed into the permanent fund.

Other states appear to use a permanent fund mechanism to retain the proceeds from permanent disposals of trust lands (sales) or earnings from their nonrenewable natural resources (oil, gas and minerals) and thus protect the "corpus" of their trusts. As an example, in fiscal year 2004, Arizona distributed $77 million to its beneficiaries—$51 million of which was from renewable resources including: sales interest, $25 million; commercial leasing, $14.9 million; agriculture, $3.6 million; and natural products (such as sand, gravel, and fuel wood), $3.6 million.

Distributions of revenue earned from renewable resources are supported by an Oklahoma court decision that states:

> Income issuing from the land on an annual basis, such as annual rentals on a grazing lease, would not be deposited in the

permanent fund, since this type of income would be similar to the interest from the fund, which could be expended annually for the support of the schools.

Although depositing renewable resources into the permanent trust fund allows the fund to grow, distribution of renewable resource revenue is allowable and is a policy decision.

State Distribution Policies Differ

Utah does not distribute any operating revenues to public education, only the interest and dividends earned by the State Treasurer.

Utah has the fourth-lowest annual distribution to its beneficiaries in terms of comparison with the permanent fund balance. Like most other states, revenues from trust lands in Utah do not significantly contribute to overall funding for public education. Figure 2.2 shows how small these revenues are compared to the common school budgets in each state.

Trust lands revenues do not significantly contribute to overall public education funding.

Figure 2.2 Comparison of Selected States' Distributions to All Beneficiaries to Total K-12 Education Budget, Fiscal Year 2004. Trust land revenues are very small compared to overall funding for public education.

State	Annual Distribution to Trust Beneficiaries	Annual K-12 School Budget	Percent of Distributed Trust Dollars to Overall School Budget	Permanent Fund Balance	Distribution as a Percent of Fund Balance
MT	$ 55,262,861	$ 1,208,058,000	4.7%	$ 411,173,416	13.7%
WA	89,000,000	8,788,224,000	1.0	709,029,452	12.6
NE	28,730,430	2,594,892,000	1.1	289,867,635	9.9
CO	31,100,000	6,644,305,000	0.5	369,000,000	8.4
ID	55,105,000	1,726,941,000	3.2	755,348,948	7.3
SD	7,909,091	982,450,000	0.8	133,102,291	5.9
AZ	77,077,140	6,210,287,000	1.2	1,311,567,000	5.8
OK	63,299,796	4,371,189,000	1.5	1,104,068,453	5.7
ND	31,991,376	839,780,000	3.8	566,490,000	5.6
NM	381,007,171	2,658,140,000	14.3	7,600,000,000	5.0
WI	25,000,000	9,039,211,000	0.3	536,000,000	4.7
TX	880,000,000	37,207,366,000	2.4	19,900,000,000	4.4
MN	14,000,000	8,662,366,000	0.3	527,000,000	2.7
UT	**11,543,545**	**2,557,874,000**	**0.5**	**469,000,000**	**2.5**
NV	3,937,227	3,008,639,000	0.2	172,485,155	2.3
OR	13,300,000	4,960,253,000	0.3	908,000,000	1.5
WY	14,010,146	910,319,000	1.5	1,129,000,000	1.2

Figure 2.2 shows that for fiscal year 2004, SITLA distributed $11.5 million to beneficiaries, approximately 2.5 percent of the value of the permanent fund. In contrast to SITLA, Texas and New Mexico each earn hundreds of millions of dollars annually from oil and gas royalties and interest earned from the largest permanent funds in the western states. Growth of these permanent funds is due to decades of oil and gas revenues earned by these state trust lands. New Mexico's fund is worth more than $7.6 billion, and Texas' fund totals nearly $20 billion; both distribute earnings in the hundreds of millions of dollars. Arizona generates most of their revenue from selling prime lands in high-growth urban areas. In fiscal year 2004, the Arizona Land Department completed 24 auctions

resulting in gross sales of $310 million, and in fiscal year 2005, they completed nine major auctions resulting in gross sales of $514 million.

New Mexico got a congressional waiver to distribute more than the interest earnings on the permanent fund.

A few states distribute a set portion of the value of their permanent funds, regardless of the annual interest and dividend earnings. For example, New Mexico distributes 5.8 percent of the five-year average of the market value of the fund and renewables to beneficiaries regardless of the amount of interest or dividends earned by the Treasurer. Although its Enabling Act was similar to Utah's, New Mexico got a congressional waiver of its Enabling Act to distribute more than the interest earnings on the permanent fund. North Dakota is in the process of working to change its constitution to allow a similar distribution method and will then ask for a congressional waiver of its Enabling Act.

The percent-of-value distribution model started when endowment fund managers moved away from investing primarily in fixed-income securities. Wanting both higher returns and some annual income, endowment funds moved toward policies that distribute a portion of the fund's market value each year without regard as to whether the source was interest or capital gains.

Better Information Flow Could Reduce Concerns

Arizona statutes require comprehensive annual reports.

Although not required, SITLA publishes an annual report with little financial information. SITLA's financial information reporting is not as extensive as that of other states. For example, the Arizona State Land Department publishes an extensive annual report with revenues earned by division, beneficiary information, financial schedules, and fund distributions. (For further information see: www.land.state.az.us/report/report_full.pdf)

The only reporting requirement applicable to Utah's trust lands is in the Money Management Act (***Utah Code*** 51–7-9.5) that requires the State Treasurer to prepare an annual report for the Education Interim Committee detailing the investment returns on the permanent fund by October 1 of each year.

Distributions to schools are reported, on a limited basis, on the LAND website by the School Learning and Nurturing Development (LAND) Trust Program, not by SITLA. Figure 2.3 summarizes LAND maintained information on distributions.

Figure 2.3 Distributions to Individual Schools Reported by LAND Program, Fiscal Years 2000-2005. LAND receives the investment proceeds earned by the State Treasurer and distributes some funds to individual public schools the following school year.

Fiscal Year	Available to Distribute	Distributions to Schools	USOE Expenses	Expenses as a % of Fund Balance
2000		0		
2001	$ 9,166,377	$ 4,950,000	0	0.0
2002	9,300,899	6,000,000	$ 70,000	1.2%
2003	8,428,069	7,443,575	0	0.9
2004	9,577,454	8,308,000	80,000	1.0
2005	14,066,147	9,701,304	80,000	0.8
2006	Unknown	13,986,147	Unknown	Unknown

LAND distributes funds to school districts.

According to the State Treasurer and the school beneficiary representative, there was a two-year transition period (2000 and 2001) where LAND disbursed less to the school districts so they could get to a point where they were distributing funds after they were earned. The process has now been worked out so that all interest and dividends available for distribution are distributed to public education. Prior to the creation of the LAND program, funds were distributed directly to the Uniform School Fund and apportioned to school districts at no cost.

Recommendations

1. We recommend that the Legislature revisit the distribution policy of trust lands to see if it is still meeting the needs of public education—particularly the distribution of renewable resources.

2. We recommend that the Legislature require SITLA to publish a comprehensive annual report.

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Chapter III
Investment Policies Can Be Improved

Investing SITLA's permanent funds using passive investment practices and following Utah's Money Management Act (MMA) may be too restrictive to maximize the permanent fund's earnings. While the MMA has been modified in recent years, further changes in the MMA may provide higher returns to the beneficiaries within acceptable levels of risk.

The State Treasurer has the expertise and authority to determine what specific investment strategies to use to achieve the ultimate goals of the fund. Some of the decisions the Treasurer makes include the asset allocation mix, the use of active managers or passive indexed funds, the use of internal or external money managers, and the inclusion of alternative investments such as real estate and private equity. The Treasurer bases his decisions, in part, on input from an independent investment consultant and two advisory groups.

Current Investment Practices Follow State Law

The State Treasurer has statutory authority for investing the permanent fund.

The ***Utah Constitution*** and state statute provide that the State Treasurer is the custodian of all permanent and public funds, including the permanent fund, and is given the authority for setting investment policy for the permanent school fund. Oversight is provided at least quarterly by the State Money Management Council. In addition, an Investment Advisory Committee meets at least quarterly to give suggestions, advice, and opinions to the State Treasurer in regard to how the permanent fund is invested within the parameters of the MMA.

The Treasurer hired an investment consulting firm to conduct an asset allocation review and to develop the best strategic plan for allocating the permanent fund. Using the advice from the report dated January 21, 2002, and from his advisory groups, the Treasurer established long-range goals and objectives for the fund and developed the current investment practices.

The Treasurer has developed a long-term investment strategy.

The investment policy statement of June 2004 has the following objectives:

- Maintain the purchasing power of the current assets and all future contributions.
- Maximize return within reasonable and prudent levels of risk.
- Maintain an appropriate asset allocation policy that is compatible with the objectives of the fund, while still having the potential to produce positive real returns.
- Minimize and control costs of administering the fund's assets and managing the investments.

The majority of states give state treasurers the responsibility to invest trust land funds. In three of the 10 states reviewed, investment responsibility is granted to a separate group, not to the state treasurer. North Dakota, Idaho, and Oklahoma each have a small one- or two-person staff that hires money managers to invest the permanent fund. In New Mexico, the State Investment Officer actively manages the $7.6-billion permanent fund and other long-term trust funds with a staff of about 20 employees, including portfolio managers, financial analysts, and an equity trader. Figure 3.1 shows who is responsible for investing each state's permanent fund.

Figure 3.1 Investment Responsibility in a Selection of Other States. The investment responsibility in most of the states reviewed rests with the state treasurer and an oversight board.

State	Investment Responsibility	Standard of Investment	Investment Oversight
Arizona	State Treasurer	Prudent Investor	Five-member board
Colorado	State Treasurer		State Treasurer
Idaho	Two staff with the Endowment Fund Investment Board and oversee outside money managers.	Uniform Prudent Investor Act	Nine-member Endowment Fund Investment Board
Montana	Executive Director or Chief Investment Office of Montana Board of Investments	Prudent Expert Principle	Montana Board of Investments
New Mexico	State Investment Officer	Prudent Investor	Nine-member State Investment Council
North Dakota	Investment Division in Land Office and external manager	Prudent Investor	Board of University and School Lands
Oklahoma	Investment Division in Land Office and external manager	Prudent Person	Three-member investment committee
Oregon	State Treasurer	Prudent Investor	Investment Council
Utah	State Treasurer	Prudent Man	Investment Advisory committee
Washington	State Treasurer	Prudent Person	Five nonvoting Investment Board members
Wyoming	State Treasurer	Uniform Prudent Investor Act	Nine-member State Loan and Investment Board

Figure 3.1 shows that the investment responsibility in a selection of other states generally rests with the state treasurer under the oversight of an investment board and typically uses variations of the Prudent Person standard of investment.

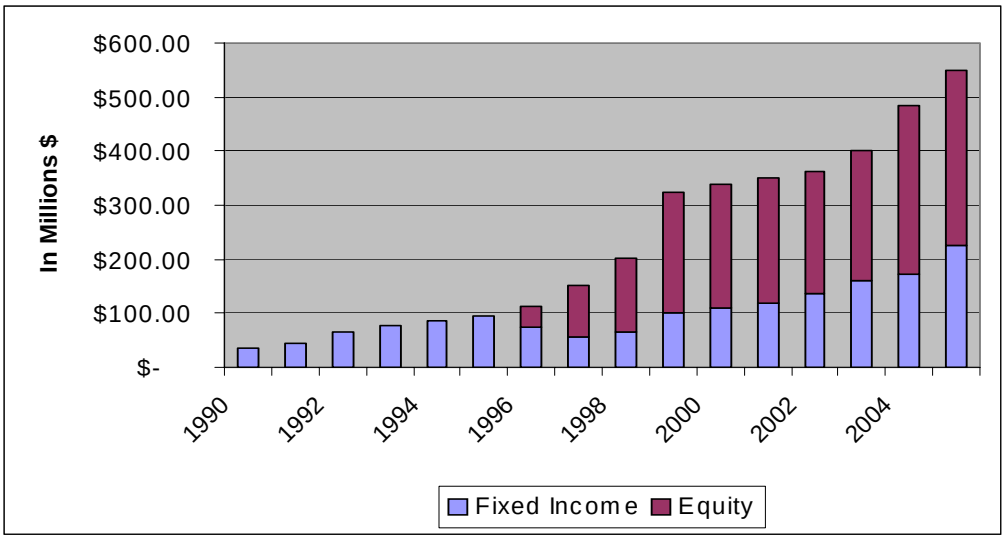
As in Utah, most state treasurers have the responsibility to invest the permanent funds.

Investment Policies Have Changed, But More Can Be Done Within Existing Laws

In 1995, the MMA was modified to allow investments in equities, up to 80 percent of the value of the fund. By investing a portion of the fund in stocks, the state can take advantage of the opportunity to earn higher

returns. Historically, funds invested in stocks have earned more through appreciation than funds invested in fixed-income securities. This change allowed the Treasurer to diversify the portfolio. ***Utah Code*** 51-7-12 specifies the type of investment the State Treasurer can make with trust funds. Figure 3.2 demonstrates the asset allocation move from fixed income to equities.

Figure 3.2 State Treasurer Asset Allocation, Fiscal Year 1990-March 2005. Prior to 1997, the permanent fund was solely invested in fixed-income securities. After 1997, funds have also been invested in equities.



According to the State Treasurer, based on the recommendations of the consultant and in an effort to reduce costs to SITLA and to maximize returns, he has carefully selected indexed funds that cover a broad spectrum of the market.

The Money Management Act allows equity investments up to 80 percent, yet investment policy limits equities to 65 percent.

One of the primary fiduciary duties is to balance the needs of current and future beneficiaries through distribution policy and investment asset allocation. Distribution policy is set in the Constitution and only allows the distribution of the interest and dividends earned. Consequently, asset allocation, how those funds are invested, and what type of returns are earned is critical.

Altering Investment Practices Is Possible

Although the MMA allows equity investments up to 80 percent of the total fund assets, the Treasurer's Investment Policy Guidelines state that no more than 65 percent of the total fund may be invested in common stocks. The State Treasurer has not gone to this higher level of equity investment.

The Money Management Act allows money managers, but the cost is higher.

The Money Management Act (MMA) allows the Treasurer to hire money managers to actively invest the funds. According to the consultant's report, active management usually produces higher investment returns for higher fees. The State Treasurer uses index funds that keep costs low, and over the long term, the fund does as well as the overall market.

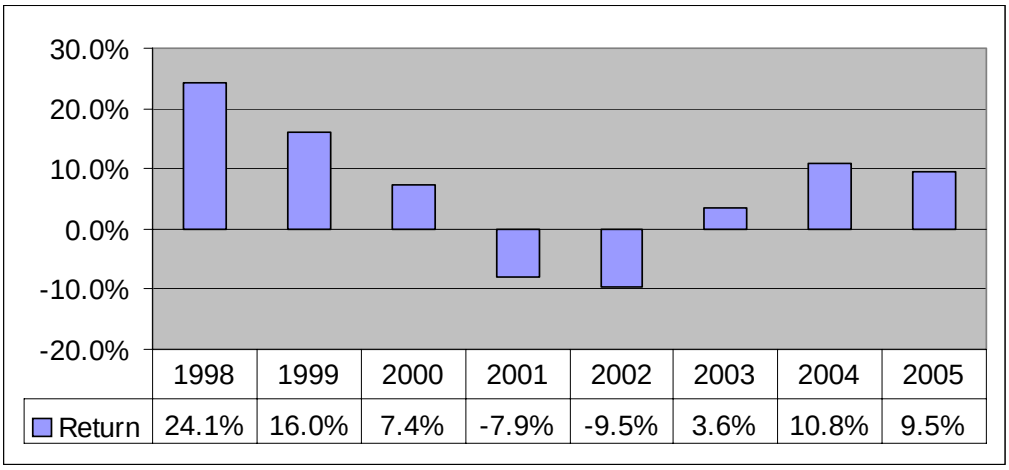
Investment Goals Have Been Met

The long-term goal of the Consumer Price Index plus 5 percent has been met.

The goal of the fund's investment management program established in 2004 is to produce growth and income sufficient to support a long-term total return equal to the rate of change of the Consumer Price Index (CPI) plus 5 percent. Total return is the sum of the earned interest and dividends and the realized and unrealized gains and losses less all investment management costs.

Investment returns are detailed in Figure 3.3. The calculated rate of return was prepared by the State Treasurer and is an internal rate of return (IRR), or a return which assumes the interest is not reinvested. Interest earned on the investments is distributed directly to the beneficiaries. This figure only reflects the permanent school fund investments, which make up about 93 percent of the total fund.

Figure 3.3 Total Investment Returns on Permanent School Fund Earned by State Treasurer, Fiscal Years 1998-2005. Investment returns are not compounded because all interest and dividends are distributed to beneficiaries.



	1998	1999	2000	2001	2002	2003	2004	2005
Return	24.1%	16.0%	7.4%	-7.9%	-9.5%	3.6%	10.8%	9.5%

Note: The negative returns are not actual losses because equities were not sold.

Figure 3.3 shows that investment returns are volatile and vary by year. A review of the actual returns compared to the target goal of the rate of change of the Consumer Price Index plus 5 percent shows that the goal has been achieved. Over the past eight years, we calculate the overall goal to be 6.09 percent and the average actual return to be 6.75 percent. Consequently, the overall established goal was met even though the returns were low in 2001, 2002, and 2003.

Money Management Act May Hinder Investments

The Money Management Act does not allow investments in REITs, Hedge Funds, or Private Equity.

The Treasurer and the Investment Advisory Committee have expressed concerns that the MMA does not allow the Treasurer to invest in Real Estate Investment Trusts (REITs), Hedge Funds, and Private Equities. The Investment Advisory Committee is working to alter the MMA to allow more flexibility of investment options. Modifying the MMA to allow more aggressive types of investments may allow the State Treasurer to earn higher returns for trust beneficiaries.

The consultant hired by the Treasurer discussed diversification into private equities and equity real estate as methods to offer risk reductions. The potentially higher return of these investments is offset by higher risk. For example, New Mexico has only invested 1.5 percent of the book value of its portfolio in private equity through limited partnerships. Private

equity investment returns can swing wildly from year to year, demonstrating how volatile and risky this asset class can be. This is also why only a small percentage of the assets are committed to private equity.

Recommendations

1. We recommend that the Legislature consider changing the Money Management Act to allow the Treasurer more flexibility in investing the permanent trust funds.

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Chapter IV
Land Development Emphasis Raises Concerns

SITLA's Development Group lacks the administrative and operating controls usually required of public organizations to prevent possible abuses. The Development Group's lack of controls allows revenue to be overstated and project costs to be understated. The lack of controls also leads to a general concern over the increased development activity. SITLA's Development Group plans to request nearly $60 million in capital improvement funding over the next six years.

SITLA is currently involved in many facets of land development. This emphasis on land development is a policy decision supported by SITLA's administration and Board, who believe that involvement in self-development will ultimately generate greater revenue than the sale or lease of raw land. While SITLA and its Board have increased controls over the last year, there is a continued belief that current controls are sufficient. We, however, do not believe that the current level of control is appropriate for an organization with authority over public property or funds.

Development Group Controls Are Insufficient

The Development Group spends more money per dollar earned and has the fewest controls of all SITLA groups.

When capital expenditures are included, the Development Group currently spends more per dollar earned than any other SITLA group and, by design, has minimal controls governing its operation. The Development Group operates under rules that we believe are contrary to good public management and do not provide sufficient controls to prevent fraud, waste, and abuse. Additional controls are necessary to decrease the possibility of improper management.

The Board has given the Development Group charge of selected prime lands and the ability to independently negotiate land sales with interested parties with only Board oversight governing its decisions. The director can sell property as long as he meets only four requirements:

- Bring transactions to the Board or director for approval.
- Do not sell below fair market value as determined by appraisal or by the director.
- Market properties to solicit interested parties.
- Get cultural clearances before sale.

Currently, the Development Group director has plans to expand the group to address the growing number of development projects and augment what he sees as SITLA's lack of experienced staff. In his opinion, if the Development Group is to move toward self-development, the group will have to hire additional staff with specific real estate and construction expertise. If the Development group expands the need for appropriate controls increases.

Development Group Controls Are Insufficient for Public Programs

In 1996, when the Development Group was created, the director selected 80,000 acres of prime land for development, primarily in Southern Utah. The Board waived the surface rules governing land transactions to allow for flexibility. However, as currently written, the rules allow freedoms which are not appropriate for a state institution which is selling land in greater volume and is ultimately accountable to the people and beneficiaries of the state. The frequency and ability of sales through negotiated means and the lack of accountability apart from the initial presentation to the Board are concerning.

Accountability of Land Transactions Needs Improvement. We believe that the Development Group should seek competitive bids through auction or a widespread Request For Proposal (RFP) process in its land dealings. Unlike the Surface Group, which sells the majority of its land through auction, the Development Group negotiates most of their transactions where there is little competition between prospective buyers. There is no requirement for a wide distribution of proposals or inquiries.

Of the 72 development land transactions from fiscal years 1996 through 2005, seven were transacted with RFPs and four were transacted at public auction. The remaining 60 transactions were negotiated. When Development sells land at the semi-annual Surface auction, development land has sold for considerably more than the appraised value. An example of this occurred in May 2005 when 35.6 acres of raw land, expected to

sell for $3.5 million or $98,000 an acre, sold for $5.8 million or $163,000 an acre.

In lieu of auctions, an RFP method can be used for complex development properties to ensure competition and market-driven values for properties. More recently, SITLA has recognized the importance of RFPs. They hired an employee who understands the RFP process and have committed themselves to using more RFPs. SITLA reports that since the close of audit fieldwork eight additional RFPs have been issued on a master planned community in Washington County. It appears the move to RFPs has been valuable as the new contracts give SITLA a higher share of gross project revenues.

There are occasions when a RFP or auction are not viable such as smaller, land-locked parcels that only have value to a neighboring parcel owner. However, we are concerned that there is a continuing belief within the Development Group that some larger parcels which could go through a RFP or auction process should still be sold through limited party negotiations. In these cases the director believes that for land-use planning and infrastructure purposes a single, large developer is necessary.

Some land developers have alleged that the SITLA Development Group have consistently favored certain developers and alienated others. While we found no evidence of inappropriate dealings, we also found no established control, beyond Board oversight. Partnering is commonplace in the industry when private funds are involved but can be problematic with the introduction of public assets. SITLA's management believes that its partnerships are a helpful business practice, but they are not the norm for public organizations that must maintain transparency to hold the public trust.

Contracting Can Also Benefit From Competitive Bidding. There have been concerns over sole-source contracts among consultants used by the Development Group. A limited number of consultants get a large share of SITLA's business. We believe that, as a public agency, SITLA should conduct business through a competitive bid process ensuring transparency and accountability. State business should be conducted in a manner that minimizes, to the fullest extent possible, the existence of improper business practices through adequate and appropriate controls. SITLA, through their own internal audit, is now discussing changes in their controls governing sole sourcing of contracts.

Other SITLA Groups and Other States Have Controls

When selling raw land, the Development Group should provide continuity by adhering to Surface rules.

The Surface Group's rules contain very detailed requirements concerning the sale of raw land. The Surface Group has 14 separate requirements compared to Development's four requirements for sale. These requirements make up a process which forces a certain chain of events to occur. Development's lack of sequential steps has created some problems. As an example, cultural clearances have been rushed at the last minute due to the development property not following a standard process and the clearances being overlooked.

The Surface Group was given a goal to sell $3 million of land per year. The Board issued this goal for two reasons: first, to ensure that land is being offered to the public for sale; and second, to safeguard against the Surface Group selling SITLA's prime land too quickly. Additionally, the dollar limit prevents the Surface Group from simply selling land to meet the revenue and bonus goals. In contrast, the Development Group has none of these safeguards or monitoring mechanisms regarding the amount of land they sell.

Arizona's State Land Department has the most successful sales program and requires that all properties go through public auction. Other states sell minimal amounts of land. For example, Colorado requires public advertising and appraisals for all land sales.

Specifically, the Trust could benefit from development land sales following the structured Surface schedule in obtaining appraisals, print and media advertising, and a schedule for obtaining cultural, archeological, and easement clearances. Following these rules would ensure propriety in land prices and advertising as well as better scheduling for clearances, thus allowing clearances to be completed well before the land sale.

Internal Oversight May Be Insufficient

Development provides the Board with project details and revenue forecasts at the beginning of each new project. However, they do not provide follow-up information as the project progresses. As the Development Group continues to engage in larger projects, continued monitoring of Development projects is necessary. SITLA's Board receives little information on how a project is doing unless they are asked to make additional decisions. This lack of ongoing information is concerning

because the Board has a great deal of institutional knowledge but may not always get full information. The Board should be informed formally about the revenue goals and changes in the revenue stream on projects, that they may use their institutional and business knowledge to adequately make governing decisions. A regular review of projects would also provide additional controls over the decisions of the Development Group, ensuring that all decisions are in the best interest of the Trust.

Increased internal oversight is also necessary as the Development Group continues to grow and spend a larger part of the SITLA budget. SITLA already has a small auditing staff that reports to the SITLA director and receives assignments from the director. The auditing staff devotes most of their efforts to monitoring oil and gas projects that produce the most revenue for SITLA. They do not currently have the staff to expand their audits to include development contracts and project monitoring. Little auditing has been done on the Development Group to ensure that financial goals are being met or that deals are appropriate. SITLA has begun a limited internal audit program, and they found that purchasing rules were often overlooked by the Development Group, and the same consultants are used with properties in the area. SITLA's director believes that controls have been tightened since the results of their internal audit.

In conclusion, we are not suggesting that fraud or abuse has occurred within the Development Group, simply that a lack of program controls allow for the possibility. Increased internal oversight is necessary for a public organization with stewardship over land, provided to the state at statehood. The Development Group should have the kind of control and oversight over its operation expected by Utah's citizens.

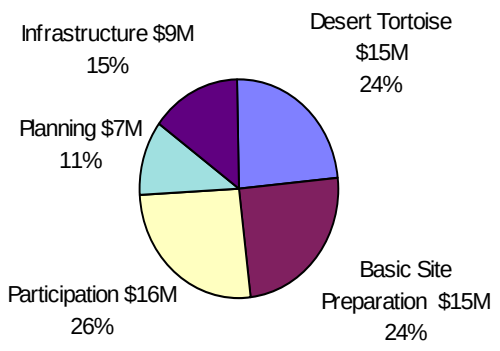
Development Group Success Is Overstated

The Development Group's success in creating returns has been overstated by attributing too much revenue to developed land sales and recognizing too few of SITLA's direct and indirect costs. The end result is that Development's contribution to the overall success of the organization is overstated, and the contribution of other groups within the agency has been understated. This overstatement is concerning, as the Development Group has yet to show the success which warrants the increased capital improvement funding requested in the coming years.

Development Earnings Are Overstated

Since 1995, SITLA's Development Group has spent over $28 million in salaries and capital improvement money and reported $62 million in revenue. Of this $62 million, $30 million was generated by selling land on which SITLA has done minimal work to prepare for sale to either private developers or the Federal Government. Additionally, $16 million was generated through development leases in which SITLA provides the land and the developer prepares the land for sale—$15 million was generated from selling land to the Federal Government for Desert Tortoise Habitat. The Development Group generated $7 million through sales of property where significant planning has taken place, and another $9 million through sales of self-developed properties. Currently, development land transactions can be divided into the five categories shown in Figure 4.1.

Figure 4.1 Development Land Transactions Revenue for Fiscal Years 1996-2005 Totals $62 Million. Development's land transactions can be classified into five categories. Transactions with minimal preparation includes Desert Tortoise and basic site preparation.



- **Desert Tortoise Sales**—Nearly $15 million (24 percent of total) of the Development Group's revenue was generated through land sales to the Federal Government for protected Desert Tortoise habitat. According to SITLA, the sales revenue did not fit any specific group so it was assigned to the Development group as they

were involved in the negotiations and legal work. The land was separated into smaller parcels, thereby driving up the value, and sold to the federal government. The Federal Government prevented SITLA from developing this land because of the endangered Desert Tortoise habitat and forced the sale.

- **Basic Site Preparation**—(22 projects) The Development Group generated $15 million (24 percent of total) from the sale of land, which is land where SITLA spent minimal money in preparing it for sale. Depending on the property, funds were spent obtaining appraisals, sectioning the land, changing the zoning, etc. Some of the properties may include preexisting improvements which SITLA did not install.

- **Participation Leases**—(19 projects) The Development Group generated $16 million (26 percent of total) from lands where the developer paid for and built the infrastructure, and SITLA provided the land. SITLA participates in a percentage of the final sale of the lots or the homes when the lots are sold.

- **Development (Planning)**—(18 projects) The Development Group generated $7 million (11 percent of total) on lands where the Development Group spent significant time planning, platting, and parceling out for development options (obtaining entitlements) without the addition of infrastructure.

- **Development (Infrastructure)**—(12 projects) The Development Group generated $9 million (15 percent of total) on projects where the Development Group spent significant time and funds planning, installing infrastructure, clearing easements, and developing the land for sale or lease.

Although the Development Group generated $62 million, only $16 million was earned on projects where they themselves spent significant time and money improving the land. These properties were hand selected by the Development director for their value and are located in a high appreciation market. A portion of the earnings can be attributed to land appreciation rather than improvements. The remaining $46 million was generated from selling land to others for development or conservation. It is difficult to determine how much effort was required by the Development Group in negotiating sales to developers or the federal government.

We do not feel the Development Group has shown the success to warrant the nearly $60 million in capital improvement funding requested over the next six years.

The Desert Tortoise land should not be considered as revenue when the Development Group is making the case for more capital money allocations because the revenue is not the result of land development. We do not doubt that additional revenue can be obtained through improving the land before sale. We do not feel that the Development Group has shown enough proficiency in development with infrastructure and planning to warrant the nearly $60 million of capital improvement funding requested over the next six years.

Development Project Costs Are Incomplete

Unlike the Surface Group, the Development Group does not record its direct and indirect costs on a project-by-project basis. Thus, staff time spent working directly on an individual project and staff time spent indirectly supporting a project is not attributed to that project. Rather, the cost is distributed throughout SITLA, forcing other projects and even other divisions to absorb the costs.

The lack of project-cost accounting in fiscal year 2005 resulted in approximately $137,000 in misallocated overhead costs.

The lack of project-cost accounting in fiscal year 2005 resulted in approximately $137,000 in misallocated overhead costs. Accounting of the other divisions is more complete and does not mirror this problem, as the ability to track staff time exists through SITLA's business system. The Development Group believes that accounting for their time, by project, is too time consuming and provides little benefit.

When staffing is not tracked by project, a project's success can be overstated. In these cases, the determination of internal rates of return cannot be correctly stated, as administrative costs are not declared. This misstatement becomes proportionally larger as project size and development intensity increase.

Development staff time and effort are not figured into project cost.

An example of the overstatement of success is the first completed development project thus far, Leigh Hills in Cedar City. Leigh Hills was begun before the Development Group existed and was completed as the first Development Group project. Leigh Hills had a reported gross revenue of $3 million, expenses of $1.3 million, and a net revenue to the fund of $1.6 million. This value does not, however, reflect the estimated $370,000 of development staff and overhead cost spent on the project. A more realistic value for revenue would be about $1.2 million.

To receive the revenue from Leigh Hills, SITLA accepted the risk and problems associated with development for what was, in effect, a 9-percent

annual appreciation of raw land. This property is located in Cedar City in the path of growth on the mountainside overlooking Cedar City. Raw land value in this area has appreciated significantly during the development period.

In addition to not tracking internal group personnel costs by project, the Development Group does not adequately account for its external overhead costs. As examples:

- The Development Group uses more legal services than it pays for through the current overhead allocation. SITLA legal staff report that the four attorneys average about 40 percent of their time on development issues. However, the Development Group is charged with less than one-third of the total office legal costs, roughly $573,000 per year. A more precise percentage division would allocate an additional $50,000 for the Development Group's share of the legal department.

- The Development Group does not receive its full cost assignment of the Accounting Group. That group estimates that, on average, the four accounting professionals spend about 40 percent of their time on Development work, yet Development's allocation is still one-third of overhead costs. This allocation shifts almost $41,000 in expenses from the Development Group to the other two groups.

In conclusion, $137,000 was misallocated to other SITLA groups that did not use the services. The Development Group has overstated their earnings through claiming revenue generated through little to no development, such as Desert Tortoise properties and land sales. The group has also underestimated their costs as they have not accounted for their time on projects and have operated under an incorrect overhead allocation. If the whole agency used a system which tracked time on a project-by-project basis, accurate adjustments could be made annually to the overhead allocation based on the previous year's actual use.

Development's 10-Year Plan Raises Questions

$59 million is requested by the Development Group over the next six years for capital improvement.

The new Development Group business plan was developed for $86,000 by an out-of-state consultant at the request of the Board of Trustees and the Development Group director. Establishing this business plan was important enough to the Board that it was a condition of the senior management receiving a bonus. The business plan calls for

additional staffing for deeper involvement in development and new accounting system software to track development projects in-house. The business plan calls for nearly $60-million in non-lapsing capital improvement funds from fiscal years 2006 through 2011 to fund both current and future projects.

As part of the Development Group's 10-year business plan, additional capital funding is requested for current and future projects as development becomes more involved. The Development Group spent $24 million from 1995 through 2005 for capital improvements and is now asking for between $7 million and $13 million a year for the next six years. The purpose for the increase is that the Development Group wants to be more aggressive in managing development projects.

While some changes have occurred, there is still a question surrounding the powers given the Development director. Some developers believe the Development director can act as a gatekeeper during the bidding process. The Development director believes that gatekeeping is a necessary part of his job which keeps projects on track. We believe that such actions can be problematic without proper oversight controls. SITLA's Board does admit that it does not participate in the selection process and that once a project is approved it has limited knowledge of the operational decisions.

Increased Development Activity Is Concerning

Utah and Arizona are the only two states of the 23 states with significant trust holdings who are actively pursuing land sales as a revenue source.

In 1996, SITLA determined that they could get more value out of some of their land by developing it. We do not argue that improving land before sale is a sound policy decision by SITLA and the Board. So far, this practice has met with mixed results as some projects have not met expectations and some have sold more quickly than expected. Prior to this, the agency primarily sold raw land, allowing developers to take the risks in developing and then profiting from the land. The decision of whether to sell raw land or develop it and then sell it is a policy decision. Other states generally provide long-term leases for development and focus on managing their renewable and oil and gas resources to obtain revenue. Selling land at the rate of Utah and Arizona is concerning to some states as they see land as a one-time resource, and leasing it provides a recurring revenue stream.

However, selling lands that are in the path of growth is beneficial for public education in two ways. First, the sales revenue is placed in the permanent fund and school districts annually receive the interest and dividends from the land. More importantly, the property taxes generated from the homes and businesses built on the lands provide direct funding to public education, which is the overall mission of SITLA.

Other States Are Not Developing Land

Other states in the West with significant trust holdings find Utah's type of land development risky and difficult. Arizona sells the land to developers, allowing the buyers to take the development risk. Some are not allowed by their constitutions to encumber the land in any way, thus preventing many development opportunities. A majority of the Western states, like South Dakota and, to some extent, Colorado, believe that their constitutions or enabling acts, which dictate that they balance the benefit of the beneficiaries now with those in the future, prevent them from disposing of a great deal of land because disposal violates the mandate to provide for the beneficiaries in the future. Colorado is just starting to think about developing land and has received $1 million a year from its Legislature for the next five years to begin to increase the value of its land before sales or leases.

Arizona's state land office has made the policy decision to not develop the land but to sell it to developers. In the past two years, the Arizona State Lands Office has sold over $800 million of land in high-growth areas at public auction. They do not develop land. The Arizona State Lands Office has declined to develop land even though a legislative audit in 1997 recommended that in some cases the agency fund and install infrastructure prior to a land auction. The Arizona State Land Commissioner, at the time, did not implement the recommendation, noting "The true margin of profit is, on average, fairly narrow, and in some cases the developer may lose money if property values drop over time." Instead, Arizona has sold development land to developers, giving them the risk and the possibility of higher profit.

Development Projects Have Mixed Results

Several of the development projects have not been as successful as originally projected.

To date, several of the development projects have not been as successful as originally projected. Development projects are risky by nature. Within the projects we reviewed, SITLA has some projects that have been moderately successful and others that have not met expectations

or have generally underperformed initial projections. SITLA does believe that a number of current projects, including some that have underperformed to date, have high potential and will exceed current expectations in the near future.

The Development Group has performed Internal Rates of Return (IRR) analysis on some of their projects. For example, they do IRRs to determine whether to sell the land or to engage in an development lease with a developer, or to determine whether to invest capital improvement funds into a project. To do this analysis, the director estimates an initial value for the land. Future revenue flows are projected by the SITLA selected developer and SITLA staff. Project IRRs are considered acceptable if the projected return is greater than a given anticipated return by the State Treasurer's investments. It is not based on projected growth rates for land values for the region. The two most critical components of this review are the original estimated land value and the timing of revenue flows.

We believe that often the initial estimated value of the property was too low and failed to adequately account for property appreciation if not developed. Additionally, projects have been delayed further altering SITLA's IRR calculations. The IRRs we reviewed could easily have resulted in unacceptable returns had land appreciation not far exceeded SITLA's projections. We question why land values were not appraised more thoroughly at the project's initiation.

The Request for Proposal process is an important component of development as project earnings can be affected by the development agreement. For instance, the limited party negotiated agreement for developing Coral Canyon, in Washington County, allows SITLA to participate in up to 20 percent of the lot price, which is figured to be 25 percent of the home price. Therefore a $300,000 dollar home would allow SITLA to receive up to 20 percent of $75,000 lot price, or roughly $15,000. A more recent RFP agreement in a nearby area allows SITLA to earn 18 percent of the gross sales price of home and lot. So, in the same scenario, a $300,000 home will earn SITLA nearly $54,000. We believe that SITLA is correct in doing more business through the RFP process.

The Coral Canyon development is just beginning to meet annual revenue expectations.

The initial earnings forecast has not been met. Coral Canyon has been a moderate success for generating $4.6 million in revenue through fiscal year 2005. It has not performed up to the initial projections of $12

million by fiscal year 2005, but it remains a success for the Development Group. This project is a 2,000-acre master planned community. A Phoenix-based company is developing the land and constructing homes. SITLA shares in the profits as lots are sold. Figure 4.2 shows the projected revenue and the actual revenue generated by the project through fiscal year 2005.

Figure 4.2. Coral Canyon Actual and Projected Revenue, Fiscal Years 2000-2005. Actual revenues have been delayed and are less than projected.

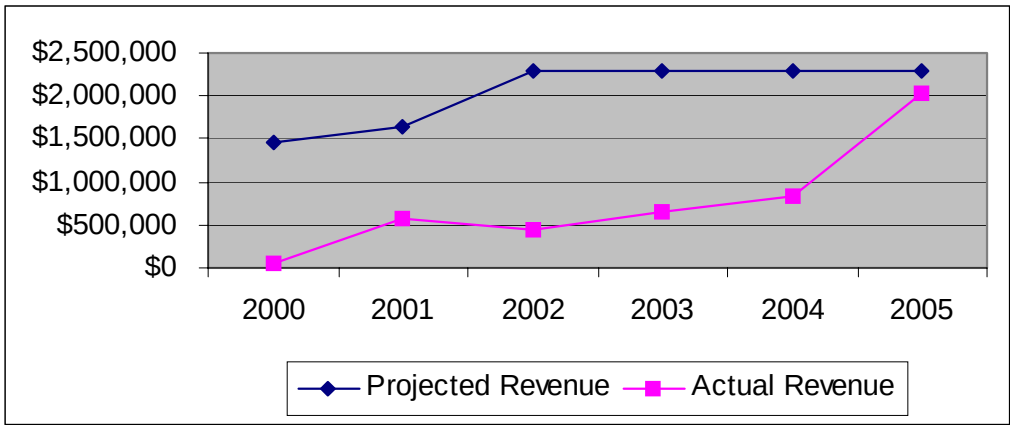


Figure 4.2 shows that the Development Group projected revenues of $1.5 to $2.5 million per year beginning in 2000 for a total of $12 million by fiscal year 2005. Actual revenues have been delayed and are less than projected. This delay in the building of the project has caused the initial internal rate of return to decrease. Through fiscal year 2005, $4.8 million was generated. Overall, revenues are $7.2 million behind what was projected. The earnings are increasing due to increased interest in Washington County property and will likely increase for the next few years as more building takes place in the Coral Canyon area. The Development Group claims they have received another $700,000 in revenue in fiscal year 2006, and they estimate an additional $3 million by the fiscal year's end.

The developments at Big Water in Kane County began in 2000, and through fiscal year 2005, SITLA has spent $983,000 on the residential development parcels, including $233,000 for the purchase of blighted property near the entrance of one of SITLA's developments. The projected earnings for fiscal year 2005 were $1.1 million, but the actual

revenue was $4,000. Four lots were sold through fiscal year 2005. The trust earned a total of $308,000 through fiscal year 2005. The Development director states that the remaining 15 lots were sold in fiscal year 2006 for a gross sales price of $631,000. Overall, revenues are $939,000 on this project. When the project started, it was expected to earn a 13-percent Internal Rate of Return. Lot sales were originally delayed but then sold faster than anticipated; the return to the trust was greater than originally expected at a modified IRR of 14 percent. The director believes that they entered the Big Water market at the right time and that the revenues will increase, while others within the agency believe that the timing for entering the Big Water market was poor.

Future SITLA Revenue Sources

SITLA believes that their greatest successes are in the near future with their large multi-year projects. Through fiscal year 2005, SITLA has spent $5.4 million on two major projects—Eagle Mountain in Utah County ($3.2 million) and Sienna Hills near St. George ($2.2 million)—and has only recovered a total of $816,000 through fiscal year 2005. The Eagle Mountain project was started in 1998 and has not yet generated any significant revenue.

The Sienna Hills project was started in 1999 and marks new ground for SITLA, as it is taking on greater risk financially by self-developing sections, installing roads and utilities, and contracting with a fiber-optic network provider who is providing the hardware. SITLA's participation in the residential and commercial parcels will be determined through an RFP process for each parcel. SITLA forecasts receiving $4 million in gross revenue for the sale of two parcels by calendar year-end. These projects have great projected revenues and continued capital investment, but when considering land values it may still be several years before SITLA will receive a return on their infrastructure investment. However, SITLA has used RFPs in selling the parcels of Sienna Hills property. SITLA has sent RFPs for six separate parcels, the use of RFPs has already provided desirable results for the property thus far.

Recommendations

1. We recommend that SITLA establish a uniform method of selling land requiring appraisals and market competition for all properties.

2. We recommend that the Legislature consider providing direction to SITLA regarding land sales and development including the level of risk appropriate for SITLA's development opportunities.

3. We recommend that if the Legislature elects to allow development past basic planning and infrastructure, the Legislature consider funding staff with sufficient experience in real estate planning.

4. We recommend that the Development Group use the system in place to track their work on a project-by-project basis to adequately establish true cost calculations and net revenues of projects and that SITLA use this information to adjust the overhead allocation accordingly.

5. We recommend that the Legislature consider allocating funds for the purpose of hiring additional audit staff for the monitoring of development projects.

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Chapter V
SITLA's Administrative Compensation Appears High

School and Institutional Trust Land Administration (SITLA) administrators are well compensated compared to their peers in state government and other Western states' trust land organizations. A key element of their compensation and a legislative concern has been SITLA's bonus program, which since 1997 has paid out almost $2 million in bonuses. Annual bonuses are paid to the entire permanent staff and range from $2,000 to $40,000 per person, per year. SITLA's Board created the bonus program as a staff inducement to create value for the organization. With these bonuses, SITLA's administrators are compensated, on average, 26 percent higher than their counterparts in Utah state government and trust land management organizations in other states. Few of the surveyed organizations pay bonuses, and none approach the bonus levels of SITLA.

SITLA cites, in defense of the bonus program, the organization's outstanding financial performance, specifically, increases in annual revenues. However, we believe that SITLA's increased revenues are not due to organizational performance as much as increases in natural gas and oil prices as well as an expanded land sales program—most recently selling prime trust land. Further, based on a review of historical revenues earned, we believe that revenue goals are set unrealistically low, making them easily attainable. Revenue goals are set lower than the prior year's earned net revenue and as a result, SITLA has always met its revenue goals. See Appendix B for the historical patterns of mineral revenue, total revenue, and distributions to beneficiaries.

Much of Bonus Program Is Based on Market-Driven Factors

SITLA has paid nearly $2 million in bonuses since they became an independent state agency.

The majority of SITLA's bonus program is based on reaching net revenue goals that are primarily based on natural gas and oil prices and an expanded land sales program. Often revenue goals are set lower than the prior year's earned net revenue, and as a result, SITLA's administrators have always met the revenue goals. In addition to monetary goals, the Board also sets annual non-monetary goals for senior management. When

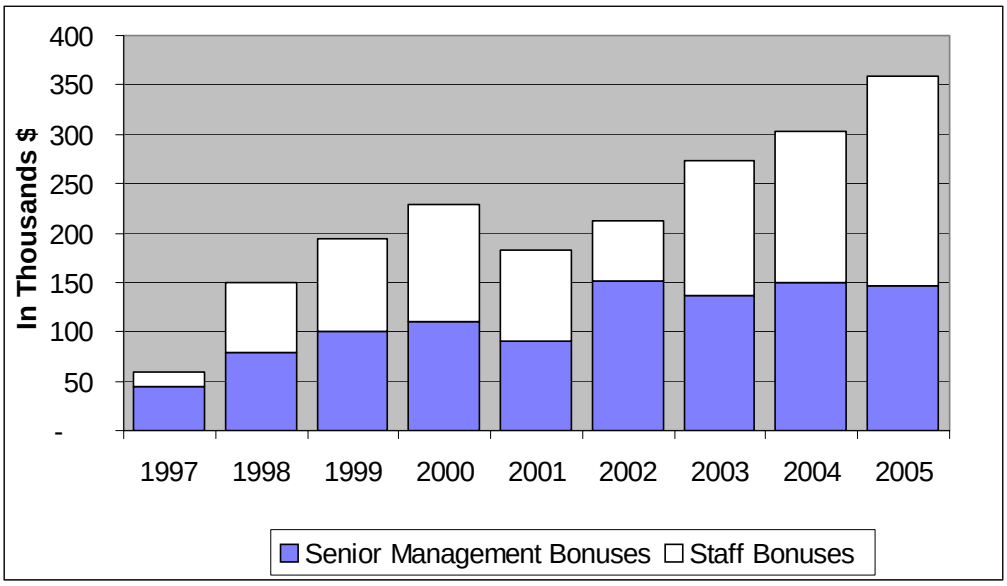
SITLA was created, ***Utah Code*** 53C-1-201(3)(d)(v) allowed the Board to create an annual incentive and bonus plan for the director and other administration employees based upon the attainment of financial performance goals and other measurable criteria defined and budgeted in advance by the Board.

Revenues from natural gas, oil, and minerals produced on state lands consistently provide the majority of SITLA's operating revenues. A 446 percent increase in natural gas prices, from 1995 to 2005, significantly increased SITLA's revenues. SITLA's increased revenues also reflect an increase in land sales from $600,000 in 1995 to $23 million in 2005. As a result of increased revenues, the agency has paid out almost $2 million in bonuses—with $1 million going to senior management and the other million distributed in a second bonus program to the remaining agency staff.

Both Bonus Programs Have Grown

SITLA's two bonus programs are primarily based on revenue growth. Half of the bonus program for senior management and all of the agency staff bonus is based on SITLA achieving revenue goals established by the Board each year. SITLA has achieved the revenue goals each year, and all senior management and staff have been rewarded with available bonus money as a result. Figure 5.1 demonstrates the growth in the bonus program.

Figure 5.1 SITLA's Bonus Program Has Grown Over Time. Since fiscal year 1997, total bonuses have increased from $59,000 per year to $359,000 per year for a total of almost $2 million.



The bonus program was created when SITLA was created.

Legislation allowed, and SITLA's board established, the bonus program when SITLA separated from state controls in 1994. The program's objective was to reward senior management for achieving revenue goals and becoming more efficient and effective, thus adding value to the organization. The first bonus payments were made to five senior managers in 1997. One year later, a second bonus program was created to reward the remaining SITLA staff.

Senior Management Bonuses Have Grown. The board rewards senior managers for exceeding specific board-established goals. One-half of the bonus is based on reaching a net revenue goal, and the other half is based on specific non-monetary goals established in conjunction with SITLA's director. Since the board bonus started in 1997, SITLA's senior managers have received a total of $1 million in bonuses, ranging from $4,500 to $40,000 per person per year. Some of these amounts are higher than the $8,000 annual cap currently allowed by Utah's Department of Human Resources Management rules. However, since SITLA's senior management is exempt from DHRM rules and SITLA is an independent state agency, these bonuses do not violate any rules or state laws.

Staff Bonuses Have Grown. Under this director-administered plan, all permanent employees are eligible for $2,000 per year or a portion thereof based on full-time status. Additional bonuses are given to select

employees, with a few employees receiving bonuses as high as $10,500 per year. The plan was started as a result of complaints by the staff for not being rewarded for their contributions to reaching the overall revenue goal. This plan grew from $70,750 in fiscal year 1998 to $212,700 in fiscal year 2005, for a total payout of $952,000. Prior to fiscal year 1998 a few select employees received bonuses.

Although SITLA pays large bonuses to senior management and bonuses to all permanent staff, few of the surveyed organizations reported paying bonuses. Only one other state trust land organization paid bonuses to five of the surveyed jobs. The bonuses ranged from $139 to $1,000 per year and averaged about $400. One of the two independent entities paid bonuses to three of the surveyed jobs ranging from $750 to $10,000 and averaging $3,833. Lastly, the BLM paid bonuses to two of the surveyed jobs. Awards ranged from $364 to $4,500. BLM noted that awards higher that $4,500 were rare.

Revenue Goals May Be Inappropriate

One-half of the bonus for senior management and all of the bonuses for agency staff are based on reaching a net revenue goal set by the board. Net revenue is affected by the market prices of natural gas and oil and selling land–most recently selling prime trust land. Further, based on a review of historical revenues earned, the incentive program goal thresholds have been easily attainable. There are concerns by some within the agency that the bonus is tied to the market prices of oil and gas, which they cannot control. Legislators have raised concerns questioning the difficulty in attaining SITLA's goals that leads to such sizeable bonuses.

Revenue Goals Are Unrealistically Low. SITLA's board began the bonus program with a revenue goal of $12 million and has increased the goal each year. However, the revenue increases have not reflected the actual net earnings of the agency. Although the board has increased the revenue goal each year, the annual increase has not always met the actual revenues earned by the agency in the previous year. This is due largely to the market-driven price fluctuations of natural gas and oil, and land sales.

Figure 5.2 Revenue Goals for Monetary Portion of Board Bonus and Actual Revenue Earned by SITLA, Fiscal Years 1997-2005. SITLA's revenue goals have increased each year; however, they have not kept up with actual earnings by the agency.

Revenue goals for the bonus program are often set lower than the prior year's net earnings.

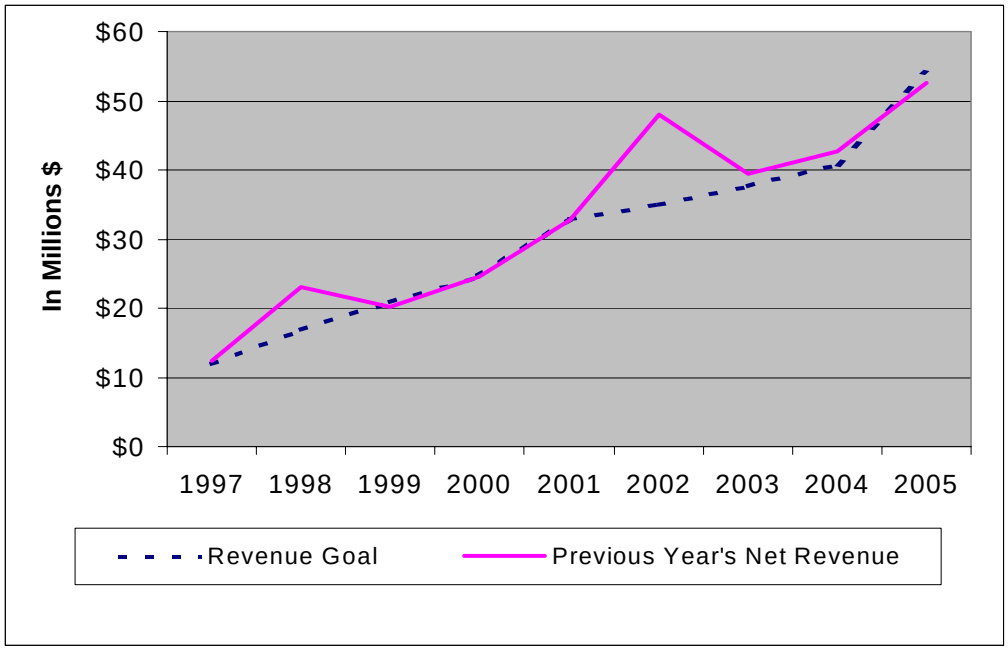


Figure 5.2 shows that revenue goal are often set lower than the prior year's earned revenue. As a result, SITLA has always met its revenue goals. It is concerning that the board-established revenue goals are usually lower than the prior year's generated revenue. This practice seems contrary to business principles of setting goals beyond the previous year's achievement. According to the Board chair and vice chair, the board bonuses focus the entire organization on forward thinking goals that are not easily attainable but are realistic.

Board Also Sets Non-Monetary Goals

In addition to revenue goals, SITLA's board sets annual non-monetary goals that allow senior management to share up to $75,000 if the goals are realized. The board determines goals, bonus values, and agency priorities. At the end of the fiscal year, the board determines what percentage of the goal was attained and generates an associated bonus value. The 2005 objectives included:

- Implement a tactical plan for coal resources.
- Identify and rank for acquisition all producing and prospective federal oil and gas areas.

- Develop a forward looking business plan to govern the Planning/ Development Group's real estate activities over the next 10 years.
- Develop and implement a pilot biological management strategy on a selected block.
- Develop a plan for the prudent expenditure of monies received from the appropriation of OHV registration fees.
- Address outstanding in-lieu selection issues of concern to the beneficiaries.
- Take necessary steps to position Administration to pursue exchange opportunities.
- Merge the two ownership databases managed by the Administration so that "real-time" map making can be performed.

In fiscal year 2005, each non-monetary objective was worth $10,000, except merging the databases, which was worth $5,000.

The board has awarded additional bonuses to employees. The reasons vary widely as to why these bonuses were awarded. Some staff have received $2,000 for completing a special project, while others were awarded $1,000 each for a well-planned 10th anniversary party.

SITLA Total Compensation Appears High

Selected SITLA administrative and support staff job compensation is generally higher than that of comparable jobs in other states and organizations. It appears that neither span of control nor job responsibilities provide justification for the increased compensation. SITLA's jobs are generally equivalent to those of the surveyed organizations. Since SITLA was created, personnel expenditures have nearly doubled, while the number of new employees has increased by 37 percent. Personnel expense is the largest component of total expenses.

Administrative compensation has increased since 1994, when SITLA became an independent agency. At that time, ***Utah Code*** 53C-1-201(3)(d)(iv) provided:

> "Salaries for exempted positions, except for the director, shall be set by the director, after consultation with the Director of the Department of Human Resource Management, within ranges approved by the board. The board and director shall consider salaries for similar positions in private enterprise and other public employment when setting salary ranges."

We found no evidence that SITLA had considered salaries in the public sector or had any consultation with the Department of Human Resource Management. SITLA had only conducted compensation surveys for two staff positions–lands coordinator and resource specialist.

Since SITLA had only conducted compensation surveys for two jobs, we conducted a compensation survey for 10 jobs. We used a job-content-benchmark methodology, commonly used by human resource management, where one group provides job descriptions to other groups and allows them to determine if they have similar positions in their organizations. Working closely with Utah's Department of Human Resource Management, SITLA's Human Resource Director and DNR's Human Resource Director specific jobs were selected in similar organizations for a comparative compensation survey.

The survey was extensive and included questions regarding salary rates, annual bonuses, years of experience, number of employees supervised, level of education, and pay ranges. The survey was sent to 17 organizations, including trust land organizations in other states, the Federal Government's Bureau of Land Management (BLM), two independent agencies in Utah, and the Department of Natural Resources (DNR). Thirteen of the 17 organizations responded with sufficient data. Data from two state land offices were not used because of their small size. See Appendix D for statistics from the surveyed organizations including original and current surface trust land grant acreage, number of FTEs, revenues, and operating budgets.

SITLA's compensation is higher than that of some comparable jobs in similar organizations.

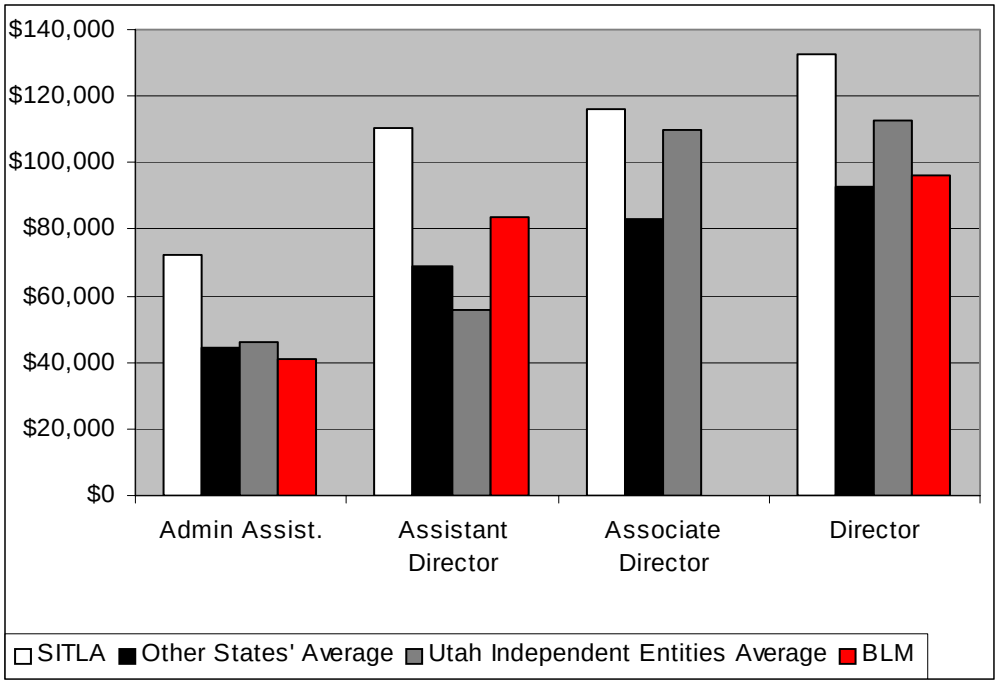
Administrative Compensation Is Higher than Comparable Organizations

SITLA's compensation measured higher than the compensation of comparable organizations in each of four administrative job categories:

director, assistant director, associate director, and administrative assistant. In part, the higher SITLA compensation is due to higher board-set salary ranges. Additionally, other organizations give their employees little or no bonuses, while SITLA employees receive large bonuses.

The two independent entities were compared to SITLA, based on their similar staff sizes and operating budgets. Independent entities are created by the state and have a public purpose relating to the state or its citizens. SITLA's human resource specialist agreed with the use of these organizations. In addition, comparisons with other states' land trust organizations were based on benchmarked jobs developed with SITLA. Figure 5.3 graphically demonstrates the compensation for SITLA, seven other western trust land offices, the U.S. Bureau of Land Management (BLM) in Utah, and two comparably sized independent entities in Utah.

Figure 5.3 Actual Administrative Compensation Comparison (Salary & Bonus), Fiscal Year 2004. State trust land offices in seven Western states, the BLM, and two independent entities in Utah report lower compensation than SITLA.



SITLA's administrators receive greater compensation than any of their respective counterparts.

With the exception of one independent entity director, SITLA's administrators receive greater compensation than any of their respective counterparts in all of the organizations that responded to the survey.

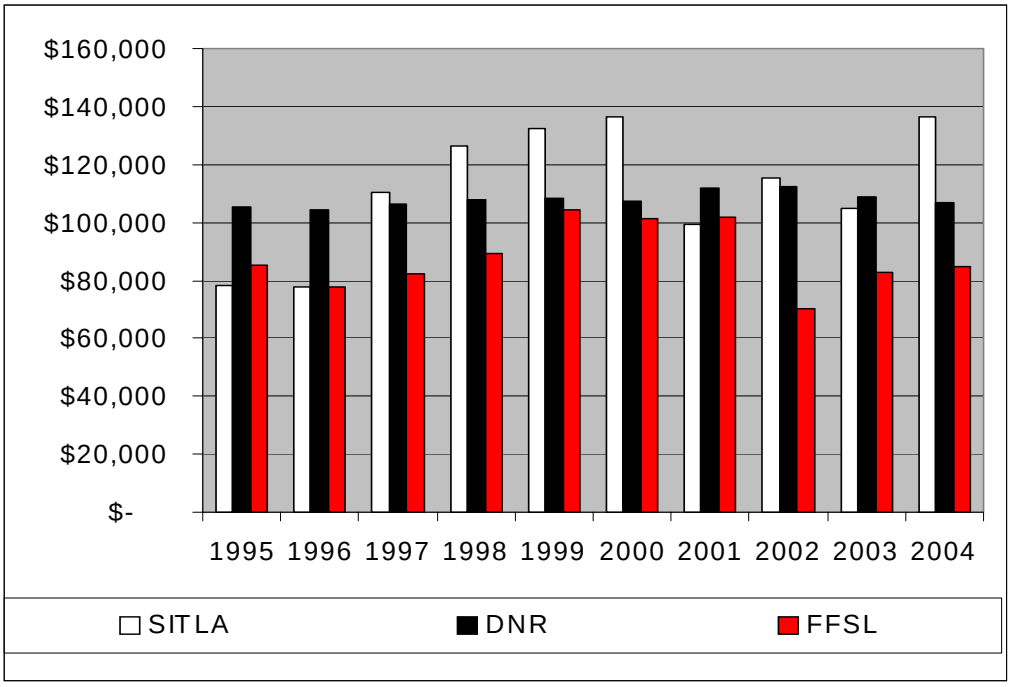
While SITLA's director is the highest paid trust land director, his experience level is not significantly different than some of his counterparts. The directors of other land management offices have significant work experience that they believe correlates well to the experience level necessary for an agency director. The deputy director of the BLM in Utah (whose job the BLM benchmarked with the SITLA director) has nearly as much experience, at 21 years, and makes about $96,000. Some of the other states did not report years of experience because the equivalent job is an elected position. The BLM's benchmarked job manages 22.9 million acres of land in Utah, 6.5 times more land than SITLA's director. Yet the SITLA director's compensation is 38 percent more ($36,000) than the BLM-benchmarked job in the Utah division.

SITLA Compensation Surpasses the DNR

SITLA's compensation has grown and surpassed rates of state government counterparts.

Compensation for SITLA's administration have surpassed the rates of their counterparts in the Department of Natural Resources (DNR), which was SITLA's previous departmental supervisor, and the Division of Forestry, Fire, and State Lands, (FFSL), which was SITLA's previous co-division member within the DNR. Figure 5.4 compares the directors' total compensation histories for each of these organizations.

Figure 5.4 Director Compensation Comparison (Inflation Adjusted), Fiscal Years 1995-2004. The total compensation of SITLA's director has increased much more rapidly than those of the executive director of the Department of Natural Resources and the division director of FFSL.



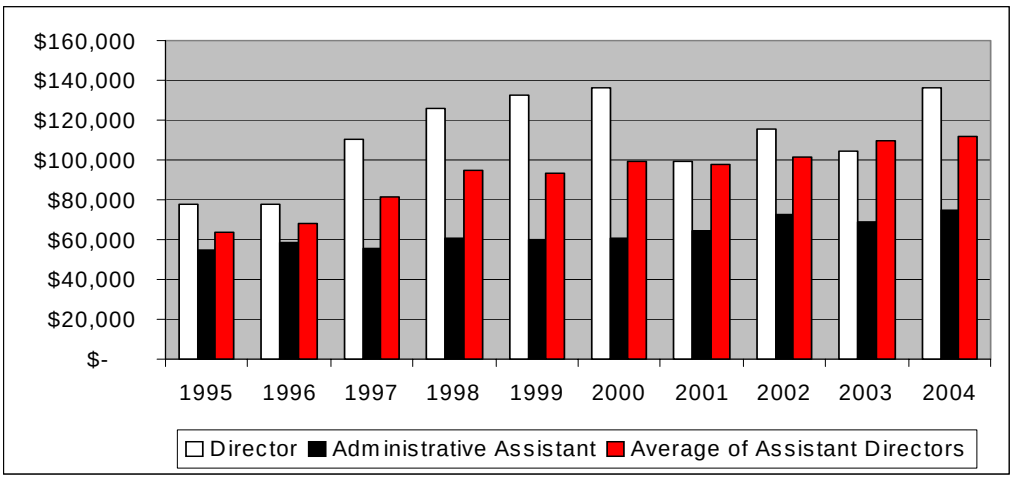
Beginning in 1997, the compensation for SITLA's director surpassed the level of compensation for DNR's executive director and continued to increase in subsequent years. In the years 2001-2003, a change in SITLA directors affected compensation. In 2004, the SITLA director's compensation was 28 percent higher than the compensation of DNR's executive director and 61 percent higher than the FFSL division director. The DNR executive director's salary includes a $3,000 car allowance.

Compensation Increases Occurred After Separation from the State

Since SITLA's creation, total compensation for senior management has grown by 75 percent.

SITLA became an independent state agency in 1994. Since that time, total compensation for SITLA's senior administrators has grown, mostly due to the annual bonuses. Figure 5.5 shows total administrative compensation growth over the last 10 years.

Figure 5.5 Administrative Compensation Growth (Inflation Adjusted), Fiscal Years 1995-2004. Administrative compensation has grown steadily since separation.

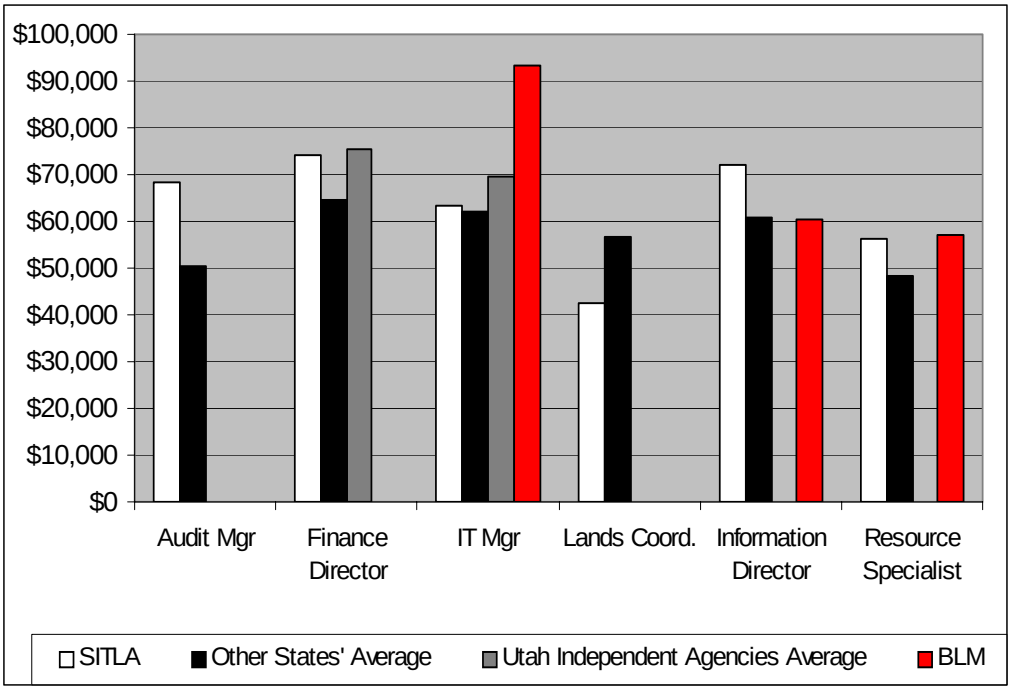


The director's and assistant directors' total compensation has grown by 76 percent since 1995. The administrative assistant's total compensation has grown by 36 percent. Several management changes from 2001-2003 resulted in a lower director's compensation during this period.

Support Staff Compensation Is More in Line with the Market

The compensation of most SITLA support staff are, for the most part, in line with compensation of their counterparts in other organizations. While some SITLA staff receive somewhat higher compensation, others receive less compensation than the other organizations. Figure 5.6 demonstrates key support staff compensation in greater detail.

Figure 5.6 Support Staff Compensation Comparison, Fiscal Year 2004. Some SITLA support staff compensation is greater than that of comparable organizations, while other compensation is similar or lower.



Note: Not all jobs were available in other state land organizations, independent entities, or the BLM.

When compared to positions in other state trust land organizations, some SITLA support staff positions receive higher-than-average compensation. However, when compared to other independent entities in Utah and the BLM, they receive similar or lower compensation. This analysis shows wide variations in the compensation for these support staff positions.

SITLA Has Similar Functions to Trust Land Organizations in Other Western States

The majority of trust land organizations appear to be as independent as SITLA.

SITLA, as an independent state agency, is thought by its board and administrators to have a unique status that justifies its salary and bonus structure. They believe that their salaries and bonuses should be compared to private trusts and major land developers. In our opinion, SITLA manages a public trust and not a private trust. There are major differences between private and public trusts according to the Western States Land Commissioners Association.

The majority of trust land organizations appear to be as independent as SITLA. We define an independent agency as one that deals exclusively with trust land issues and goals of its beneficiaries and is free from management from another agency. Furthermore, SITLA is an organization that manages lands that are more commensurate with other trust land organizations than with private land developers. Figure 5.7 lists the seven states used in the survey, their oversight entities and their management structures. For further information, see Appendix D.

Figure 5.7 Oversight of Trust Land Organizations in a Selection of Western States. The majority of trust land organizations in other states are also independent.

State	Land Management Agency	Oversight Entity	Management Structure
Colorado	State Land Board	State Board of Land Commissioners	Division of DNR
Idaho	Idaho Department of Lands	Board of Land Commissioners	Independent
Montana	Trust Land Management Division	State Board of Land Commissioners	Division of DNR
New Mexico	State Land Office	State Land Office Advisory Board	Independent
Oregon	Department of State Lands	State Land Board	Independent
Utah	**SITLA**	**Board of Trustees**	**Independent**
Washington	Department of Natural Resources	Board of Natural Resources	Division of DNR
Wyoming	Office of State Lands and Investments	Board of Land Commissioners	Independent

The duty of virtually all state trust land organizations is to provide revenue for current and future beneficiaries with the resources given the state at statehood. All land organizations face similar obstacles and challenges as they determine the best ways to utilize their resources within their fiduciary responsibilities.

Recommendations

1. We recommend that if bonuses continue, they be based on appropriate and measurable goals.

2. We recommend that the Legislature provide SITLA with guidelines for salaries and bonuses.

Appendices

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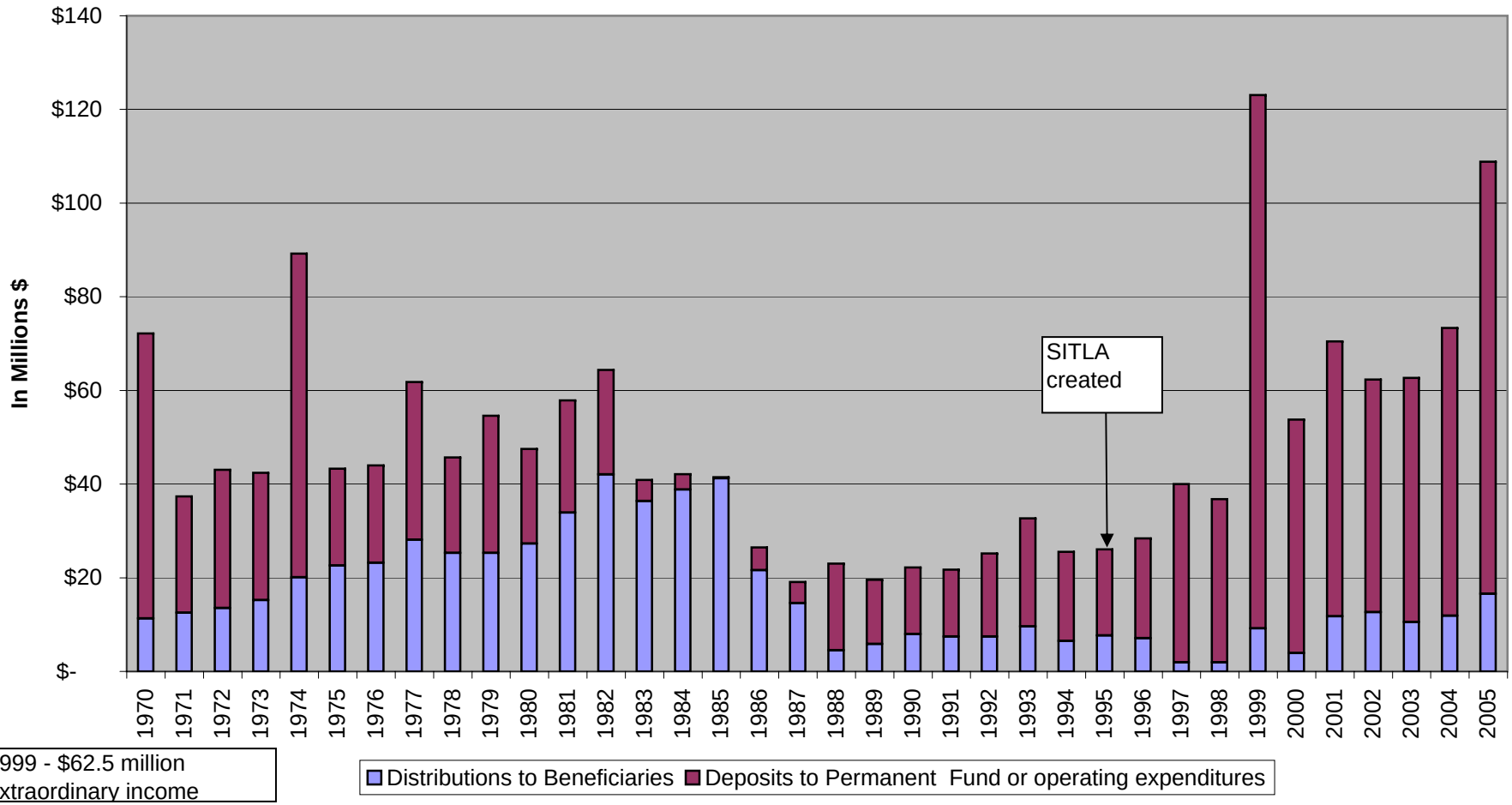
Appendix A

Original Land Grant and Current Holdings of the 12 Beneficiaries

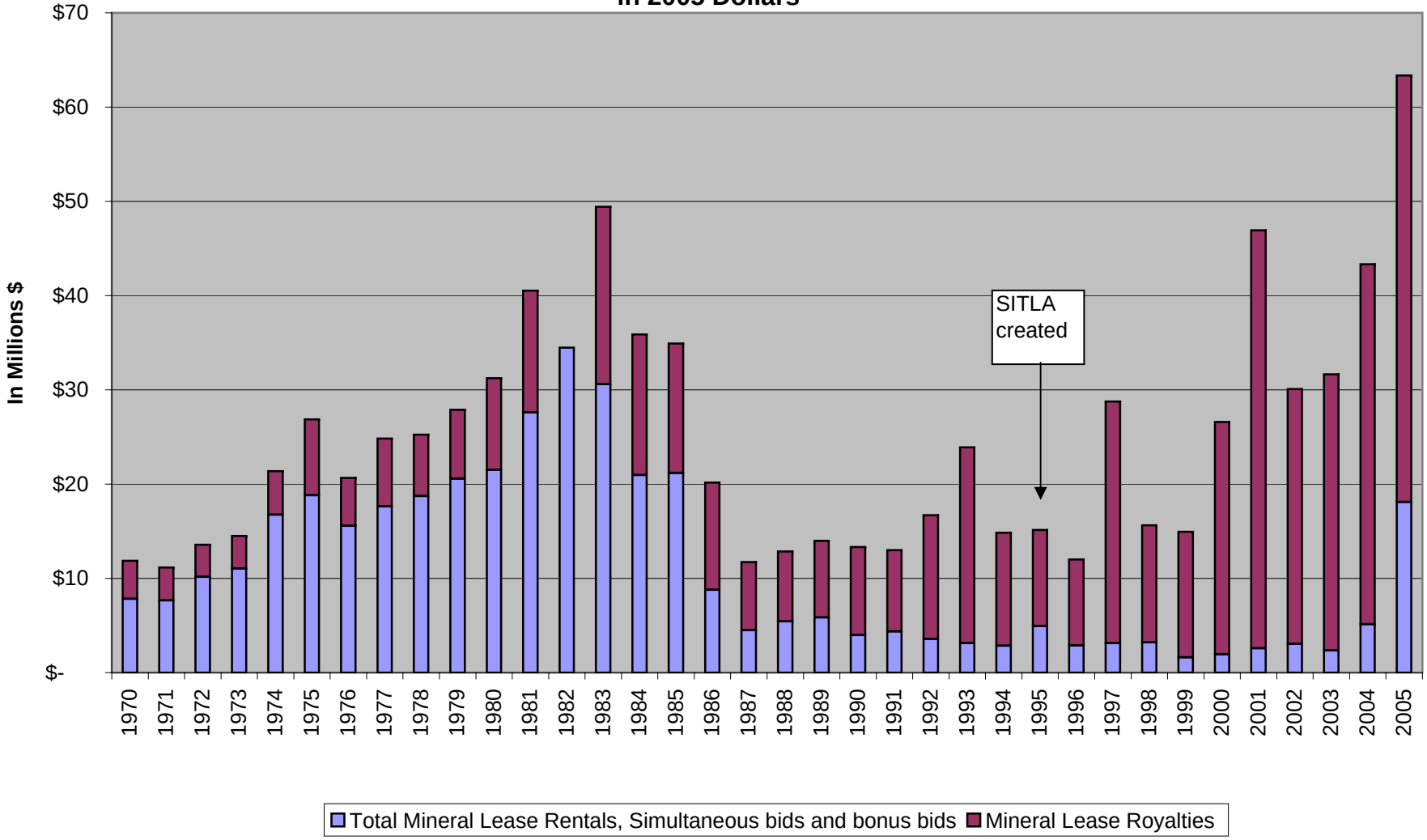
By the Enabling Act approved July 16, 1894, Congress granted to the State of Utah, for common school support, sections 2, 16, 32 and 36 in every township within the state. The Enabling Act also granted acreage to 11 other educational and state institutions.

Beneficiary	Original Surface Trust Land Grant Acreage	Trust Lands Sold Since Statehood	FY 2005 Trust Land Holdings
Public Schools	5,855,217.00	2,539,408.13	3,315,808.87
Reservoir Fund	500,000.00	455,915.10	44,084.90
Utah State University	200,000.00	171,978.19	28,021.81
University of Utah	156,080.00	139,519.73	16,560.27
School of Mines	100,000.00	92,773.17	7,226.83
Miners Hospital	100,000.00	93,390.94	6,609.06
Normal School	100,000.00	93,717.11	6,282.89
School for the Deaf	100,000.00	94,422.00	5,578.00
Public Buildings	64,000.00	63,999.73	0.27
State Hospital	100,000.00	99,574.80	425.20
School for the Blind	100,000.00	99,544.45	455.55
Youth Development Center	100,000.00	99,980.82	19.18
Total All Beneficiaries:	**7,475,297.00**	**4,044,224.17**	**3,431,072.83**

Appendix B-1
Gross Revenues (Agency Earnings and Investment Earnings)
and Distributions to Beneficiaries
Fiscal Years 1970-2005
in 2005 Dollars

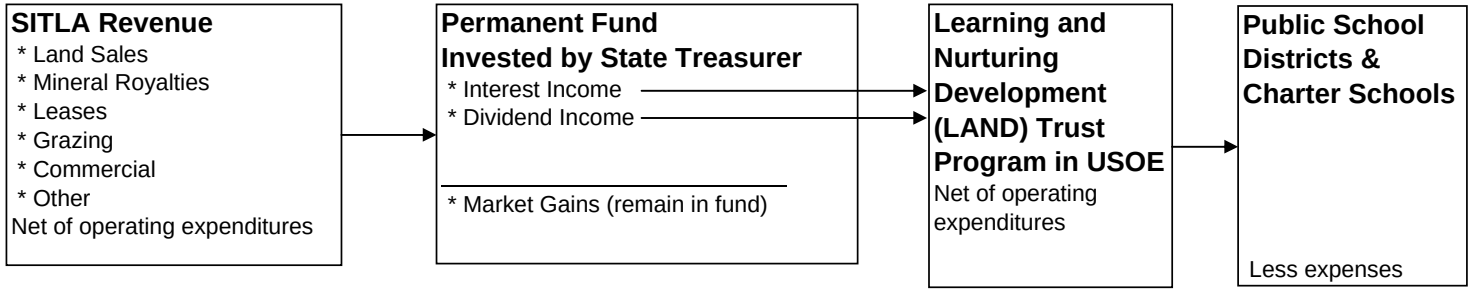


Appendix B-2
Mineral Lease Rentals and Royalties
Fiscal Years 1970-2005
in 2005 Dollars

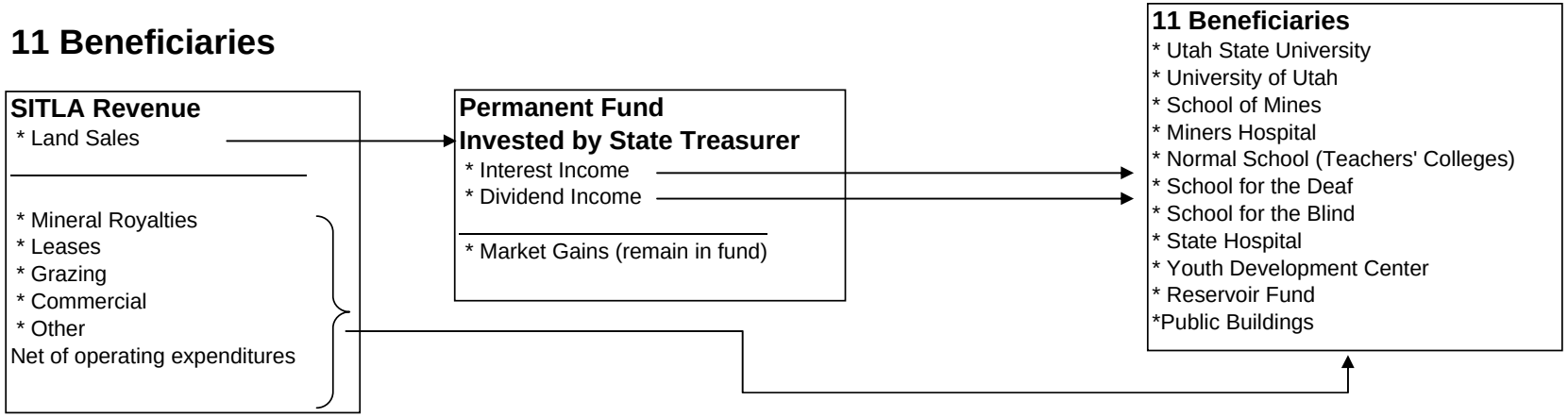


Appendix C
Trust Land Revenue Flow Chart for Beneficiaries

Public Schools Beneficiary



11 Beneficiaries



Appendix D
Statistics from Surveyed Organizations

Surveyed Organizations	Original Surface Trust Land Grant Acreage	FY 2004 Trust Land Holdings	FY 2004 Number of FTE's	FY 2004 Agency Revenues In Millions	FY 2004 Operating Budget in Millions
State Trust Land Organizations:					
New Mexico State Land Office	8.7	9.0	155	$278.7	$ 14.0
Washington DNR – Trust Lands Management Activities	2.4	2.8	770	215.9	23.6
Wyoming Office of State Lands and Investments	3.5	3.5	97	93.0	10.0
Idaho Department of Lands	3.0	2.2	29	65.6	4.6
Utah – SITLA	5.8	3.4	62	60.4	7.5
Montana Trust Land Management Division	5.2	5.1	108	46.3	5.2
Colorado Land Board	3.7	2.8	34	36.4	3.5
Oregon Department of State Lands	3.4	0.7	86	15.8	6.9
Other Organizations:					
Utah BLM, Lands & Minerals Division		22.0	38		
Utah Department of Natural Resources (DNR)			1,230		115.0
Utah Division of Forestry, Fire and State Lands (FFSL)			138		15.0
Utah Housing Corp. (Independent Entity)			55		3.5
Utah State Fair (Independent Entity)			50		3.5

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Agency Response

Utah!

State of Utah

School and Institutional
TRUST LANDS ADMINISTRATION

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Jon M. Huntsman, Jr.
Governor

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Director

January 18, 2006

Mr. John M. Schaff
Legislative Auditor General
W315 State Capitol Complex
Salt Lake City, Utah 84114

Mr. John E. Massey, Director
Office of the Legislative Fiscal Analyst
W310 State Capitol Complex
Salt Lake City, Utah 84114

Re: Performance Audit of the School and Institutional Trust Lands Administration

Dear Mr. Schaff and Mr. Massey:

On behalf of the School and Institutional Trust Lands Administration ("SITLA"), thank you for the opportunity to respond to the above-referenced performance audit. We particularly appreciate your office's willingness to share preliminary draft materials and work with us to resolve problem issues.

SITLA welcomes input and guidance from the Legislative Auditor General and the Utah legislature, in light of the legislature's role as the ultimate trustee over management of trust lands. While SITLA does disagree with several conclusions reached by the Audit Report, we share your goal that Utah's trust lands be managed prudently for the long-term benefit of the trust beneficiaries, and we look forward to working with the Legislature to address any concerns raised by the review. We specifically plan, in light of the concerns raised by the review, to take specific actions as more fully described below.

Summary of SITLA Response to Audit Recommendations

Chapter II: SITLA agrees that it is appropriate for the Legislature to revisit the policy of what proportion of funds generated from state school trust lands are distributed annually, in light of the major growth in the Permanent School Fund since SITLA was established. The policy of retaining renewable resource income in the fund, rather than distributing it annually, was established by Constitutional amendment in 1992 as a response to past diversions of funds that left Utah's Permanent School Fund depleted to almost zero. Since creation of SITLA, the fund has grown to over $600 million. While

SITLA disagrees with the audit report's inference that this growth has occurred largely due to external factors (SITLA has substantially outpaced other similarly-situated states in annual revenue growth, as set forth in **Figure 1**), there can be legitimate debate as to the proper balance between distributions to current beneficiaries, and growing the endowment for future generations of Utah schoolchildren by investing rather than distributing current revenue. Since any change in the distribution policy would require a Constitutional amendment, this issue is appropriate for the Legislature and the voters to decide.

Chapter III: SITLA enthusiastically concurs with the conclusion of Chapter III that the Legislature consider changing the state Money Management Act to allow the State Treasurer more flexibility in investing the permanent trust funds. As the Audit Report notes, investment of funds generated from Utah state trust lands is constitutionally delegated to the State Treasurer rather than SITLA. Other states have allowed the custodians of their permanent funds substantial investment flexibility within the bounds of the prudent investor rule and principles of sound endowment management, with good results. Utah's Treasurer should be given similar flexibility.

Chapter IV: Chapter IV of the Audit Report expresses concerns that internal controls within SITLA are not sufficient to prevent potential waste or abuse in connection with the agency's real estate development activities. SITLA recognizes that the rapid growth of its development program, from virtually zero revenue a few years ago to a projected $30+ million in the current fiscal year, requires more formal controls than have been in place. To that end, SITLA has: (1) begun revision of its administrative rules governing development to take into account procurement and RFP issues raised by the audit; (2) requested funds for increasing internal audit and construction management capacity; and (3) begun development of an improved project accounting system that will address the audit's recommendations concerning allocation of overhead and performance reporting. That said, SITLA disagrees with the audit's inference that agency development activities should be constrained by the legislature, or that capital funding requested by the agency for future projects should be limited. SITLA's past capital investments (which come from trust funds rather than tax dollars) have positioned the agency to reap very significant financial gains in the next several years, with close to $500 million in development revenue projected over the next 10 years. Maintaining sufficient capital to support these projects through planning and infrastructure development is critical both to growing the Permanent School Fund and to supporting local communities – particularly in Washington and Iron Counties – in funding critical planning and infrastructure for community growth.

Chapter V: Chapter V of the Audit Report addresses SITLA management compensation. The School and Institutional Trust Lands Administration Board of Trustees is responsible by statute for setting salary ranges for SITLA management and developing the annual incentive and bonus plan. The Board has responded to this portion of the Audit Report by letter dated January 4, 2006, which we hereby incorporate by reference, and request that you append to this response. By way of summary, the Board principally noted that SITLA's governing statute provides that management salaries at SITLA are to be set with regard to private as well as public sector salaries, in keeping with the business mission of the agency. The salary survey undertaken by the audit staff did not consider private sector salaries as provided by the statute. The Board has responded that, at the time that it considers compensation for the upcoming fiscal year, it will seek independent professional examination of both the incentive program and SITLA management salaries to ensure a fair compensation package that promotes hiring and retention of the best possible management team, while protecting the interests of the trust beneficiaries.

Discussion

Chapter II – Distribution of Income from SITLA Land.

SITLA was created by the Utah legislature in 1994 to apply businesslike management practices to the state's trust lands. Prior to that time, Utah had consistently underperformed the other western states in using its trust lands to build permanent endowments for the support of the state's public schools and other public institutions. In a survey of the western states' permanent funds and trust lands revenues in 1990, Utah ranked dead last among the public lands states in its accumulated permanent funds, and in the bottom three in annual income.[1] Based in part on this underperformance, the Utah legislature created the School and Institutional Trust Lands Advisory Board in 1993 to undertake a comprehensive review of trust lands management and policy. The Trust Lands Advisory Board determined that a wholesale change in trust lands management was warranted. The Advisory Board concluded the appropriate policy for trust lands was for the management agency to operate like a business, with reasonable independence from the state's bureaucratic structures, so that it could respond in a timely fashion to

[1] J. Souder & S. Fairfax, *State Trust Lands* (University Press of Kansas 1990), Tables 2.5, 2.6.

business opportunities.[2] The Legislature adopted the Advisory Board's conclusions when it created SITLA in 1994.

Concurrently with its review of trust lands management, the Legislature adopted (and the voters subsequently approved) amendments to Article X, Section 5 of the Utah constitution to govern the investment and distribution of funds generated from school trust lands. Section 5(1)(d) of Article X was amended to require that only interest and dividends from investment of the Permanent School Fund would be distributed annually to fund current education needs. The Audit Report correctly points out that this distribution policy is more restrictive than other western states, which typically distribute revenue from "renewable" resources (grazing, commercial rentals, etc.) annually. One motivating reason for this amendment was that Utah, in contrast to other western states, had chosen in the 1980s to distribute virtually all assets in its "permanent" school fund to fund current education needs, with the result that assets accumulated since statehood were spent down to virtually zero. By adopting a more conservative distribution standard, the Legislature allowed Utah's Permanent School Fund to begin to catch up to other states that had not raided their permanent funds.

SITLA believes that it is entirely appropriate for the Legislature to review the current distribution policy, as recommended by the Audit Report (although such review should probably be undertaken by the Constitutional Review Commission in light of the constitutional nature of the investment requirements). On one hand, Utah has increased its Permanent School Fund almost tenfold since SITLA was created. On the other hand, continuing to aggressively build the fund in the future would make it more likely that meaningful distributions could be made in future years when K-12 student populations are much higher, as projected. SITLA concurs with the Legislative Auditor that these issues are appropriate for legislative study.

SITLA does disagree with inferences in Chapter II that all growth in both the Permanent School Fund and annual revenues from trust lands has been the result of external factors rather than any effort by SITLA management and staff. The audit concludes that agency revenue growth is primarily linked to increased natural gas and oil prices and sales of "prime" trust land. In fact, during much of the period in question, natural resources prices were flat or down, but the agency was still able to significantly increase revenue year over year. In more recent years, when natural gas prices have risen greatly, SITLA's revenue growth has exceeded gas price growth by significant margins.

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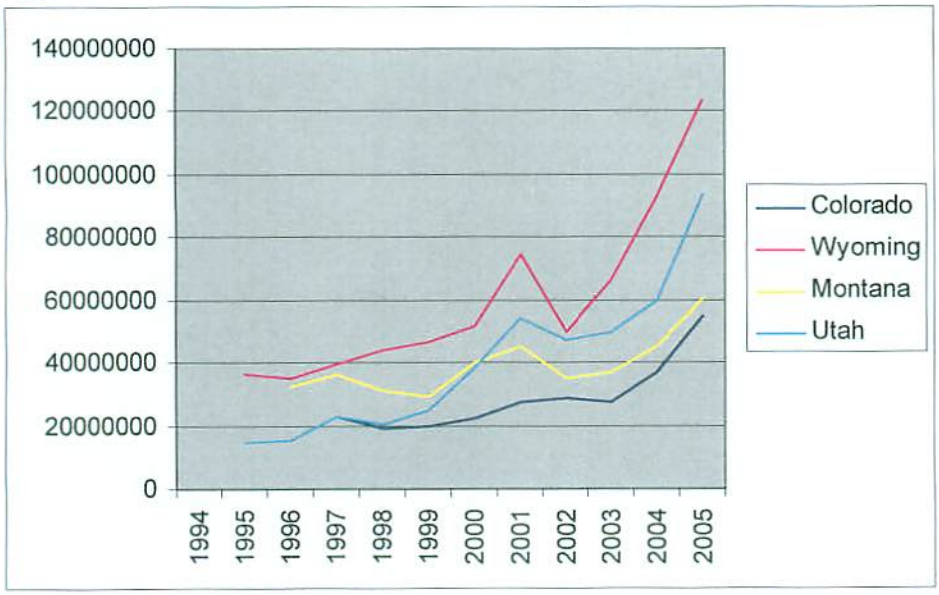
[2] *Statement of Intent for Management of School and Institutional Trust Lands*, School and Institutional Trust Lands Advisory Board (December 13, 1993) at 2.

In the 11 years since SITLA was created, Utah's Permanent School Fund has increased from $85.6 million in 1994 (the entire amount accrued in the 98 years since statehood) to approximately $600 million today. Instead of being dead last among the 23 public lands states, Utah is now solidly in the middle in terms of permanent fund size. Total trust assets (including the assets of other beneficiaries, but excluding the market value of trust lands) exceed $680 million. Annual income has increased from slightly over $14 million in 1994 to $93.9 million in 2005, with over $100 million in net revenues expected from SITLA operations in the current fiscal year.

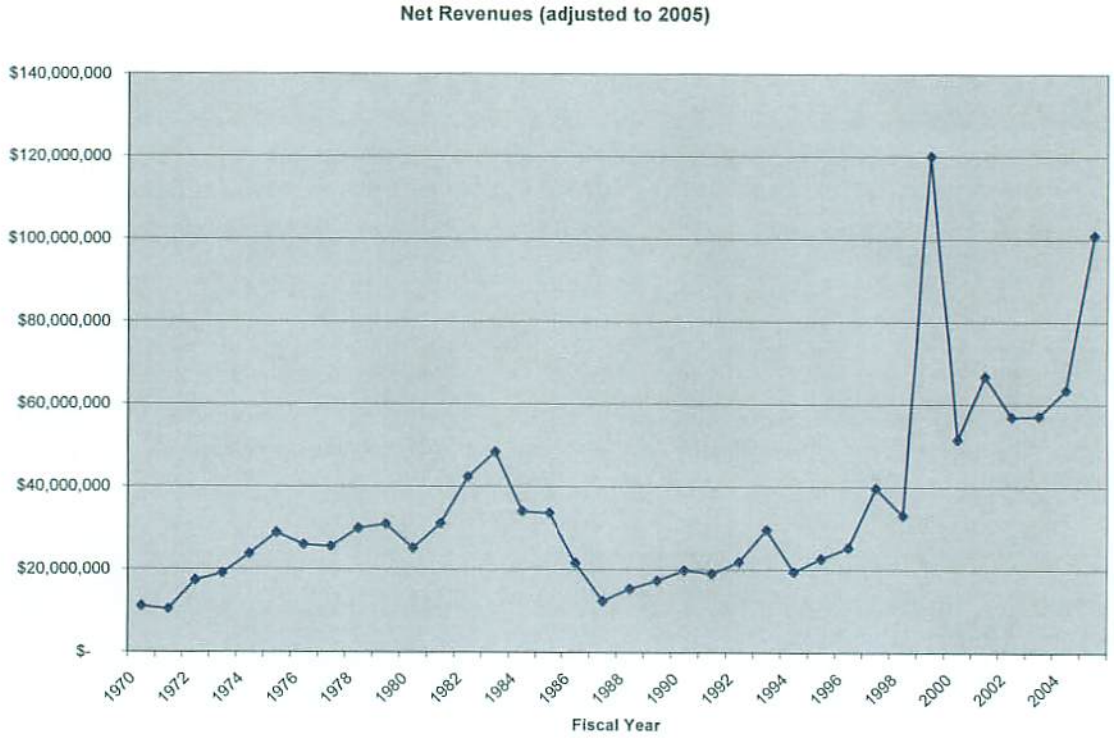
A useful point of comparison is to look at other western states where commodity production forms a large portion of revenues, as depicted in Figure 1. Since 1994, Montana trust land revenues have increased 85%; Colorado revenues have increased 136%; and Wyoming revenues have increased 240%. During this same period, Utah trust land revenues increased 531%.

Figure 1: SITLA Revenue Growth vs. Comparable States



Similarly, SITLA net revenues (which reflect amounts actually available for investment or distribution after the agency's expenses) have exceeded the historic high achieved by all prior agencies in every year since 2000, as depicted in Figure 2.

Figure 2: SITLA Net Revenues



The audit also states that SITLA's revenue growth was based in part on the sale of "prime" trust lands. In fact, the agency's primary land sale program seeks to identify trust lands for sale where the returns that can be generated from investing the sales proceeds in financial assets demonstrably exceed the income-generating potential of the property. Most of these lands are remote and rural rather than "prime" lands, where long-term data shows that land appreciation is typically much less than SITLA's Board of Trustees carefully watches to ensure that SITLA does not place property onto the market solely to meet revenue goals, and has by policy capped annual sales at $3 million in appraised value to avoid any perception that the agency is liquidating lands. Other significant sale revenues were generated from selling lands trapped within desert tortoise habitat which had no potential for future development. In most sales, we believe that value-added activities by the agency such as planning and marketing significantly increased values obtained. We similarly disagree with the statement that Permanent School Fund growth was because of the 1992 change in distribution policies; in fact, less than 10% of growth in the Permanent School Fund can be attributed to retaining renewable resources revenues in the fund.

One additional recommendation made by the Audit Report was for SITLA to publish a consolidated annual financial report. SITLA generally concurs in this recommendation, although we note that financial information regarding investment returns and the exact use of distributions is compiled and maintained, respectively, by the State Treasurer and the Utah State Office of Education. Historically, timely financial information from these entities has not been available in a format that is consistent with SITLA's financial reporting format, so consolidated financial reporting on an annual basis will require better coordination between the three entities. SITLA believes that the best way of meeting the Audit Report's recommendations is for SITLA to maintain these data on its web site so that the information can be updated when appropriate.

Chapter III – Investment of Trust Lands Proceeds

Investment of proceeds generated from Utah's trust lands is the constitutional responsibility of Utah's State Treasurer; SITLA does not manage or control trust land funds once the funds have been collected and paid to the Treasurer. The Treasurer invests the funds under the constraints of the state Money Management Act.

SITLA concurs with the recommendation of Chapter III that the Legislature consider changing the state Money Management Act to allow the State Treasurer more flexibility in investing the permanent trust funds. Other states have allowed the custodians of their permanent funds substantial investment flexibility within the bounds of the prudent investor rule and principles of sound endowment management, with good results. Utah's Treasurer should be given similar flexibility. SITLA also supports giving the Treasurer additional funding to permit better oversight of trust fund investment activity.

Chapter IV – Land Development Emphasis

Chapter IV of the Audit Report expresses concerns that internal controls within SITLA are not sufficient to prevent potential waste or abuse in connection with the agency's real estate development activities. SITLA recognizes that the rapid growth of its development program, from virtually zero revenue a few years ago to a projected $30+ million in the current fiscal year, requires more formal controls than have been in place. To that end, SITLA has: (1) begun revision of its administrative rules governing development to take into account procurement and RFP issues raised by the audit; (2) requested funds in the current budget cycle for increasing internal audit and construction management capacity; and (3) begun development of an improved project accounting system that will address the audit's recommendations concerning allocation of overhead and periodic performance reporting of transactions. The latter two steps had been

identified as key issues by SITLA's staff and Board of Trustees in the Planning and Development Group's June 2005 business plan, and are being implemented now.

The principal focus of the Planning and Development Group's activities has been and will continue to be Washington County. SITLA manages four large Washington County parcels ranging from 1,000 to 8,000 acres, in addition to numerous smaller tracts. The larger parcels are critical to economic development in Washington County. A large portion of the capital requested by the agency will be used on these parcels to support UDOT and local cities in the planning/development of important new transportation corridors, including a new interchange on I-15 at Milepost 2, the Southern Corridor, and roads serving the area around the proposed regional airport. Funding also will be used for water, sewer and other key infrastructure improvements necessary to the orderly privatization of this land. The availability of capital to move these important projects forward and to work with other local communities throughout the state is critical not only to the projected growth of agency revenues, but also to the communities themselves, which are strapped for funding to accommodate rapid population growth.

Investment in transportation and utility infrastructure is also fundamental to SITLA's ability to break larger parcels into smaller sizes prior to privatization. Proper sizing helps ensure that land offerings are competitive to a larger group of potential developers (not just large developers), thereby improving competition and enhancing pricing. SITLA's past capital investments (which come from trust funds rather than tax dollars) have positioned the agency to reap very significant financial gains in the next several years, with close to $500 million in development revenue projected over the next 10 years.

As noted in the summary above, SITLA recognizes the need for additional internal controls in its disposition of development lands given the greater scale at which it is currently operating. The agency, with the guidance of its Board, is revising the administrative rules governing real estate development activities, and will take into account the Audit Report's recommendations in doing so. SITLA does believe that some of the concerns expressed in the Audit Report with respect to negotiated sales are overstated. We note the following in this regard:

- Negotiated sale transactions include sales to UDOT, the BLM, the City of St. George, Washington City, the Washington County School District, the Washington County Conservancy District, the Grand County Water District, the Department of Natural Resources and other governmental agencies. In each instance, the parcels were necessary for purposes of the other governmental entity and were sold at values equal or greater than fair market value, as supported by

- appraisals. The all-RFP approach advocated by the Audit Report would preclude the agency from addressing local government needs to support community growth.
- Several of the transactions mentioned (Coral Canyon, Leigh Hills) were originally encumbered by failed transactions inherited from the former Division of State Lands & Forestry, and SITLA's ability to generate full returns was limited by that legacy.
- Selling land by advertisement and subsequent negotiation with interested parties is the predominant practice in the private sector, and does not necessarily reduce values obtained. SITLA has regularly run extensive advertising in local and regional markets (St. George, Wasatch front, Denver, Las Vegas) for development land opportunities, and has consistently sought competition for its offerings.

Over the last three years, the Planning and Development Group has increased its use of both a formal Request for Proposal process (followed by negotiation) and auctions and intends to increase use of these practices. However, we believe that direct negotiated sales remain an appropriate business practice in certain circumstances, such as sales to local governmental institutions or where properties are landlocked within an existing development. It may also be in the best interest of the beneficiaries in certain circumstances to ensure that the developer has the capacity to complete a project in a manner which enhances or facilitates development of adjoining lands that have been retained by the agency.

SITLA has also undertaken, in connection with its June 2005 Business Plan for Real Estate Development, the development of an updated project accounting system for tracking project costs (including overhead allocations) and revenues of development projects, as recommended by the Audit Report. This will enable SITLA's Board of Trustees to review performance of existing and future projects beyond its initial review at the time transactions are entered.

In response to the specific recommendations of the Audit Report concerning real estate development, SITLA responds as follows:

Recommendation #1: SITLA intends to revise its development rules to clarify and strengthen its internal controls for disposing of properties. We recognize that an RFP/auction process is a key and increasingly important tool in transacting the more valuable trust properties. At the same time, the availability of a negotiated sale process for special circumstance properties and inter-government transactions remains necessary and appropriate. Additional efforts to increase competition and broaden markets will be

undertaken. Reliance upon appraisals for guidance in valuation decisions will continue as an important practice.

Recommendation #2: Investment of capital into land planning and key infrastructure development is critical if the trust beneficiaries are to achieve the potential returns offered by key land holdings. This is particularly true in Washington County, where SITLA's ability to cooperate and partner with local governments is dependent on capital authorization. Opportunities to create recurring long-term revenues through ground and building leases are dependent upon the agency's capital plan. Risk/return analysis is the key responsibility of SITLA management and the professional board overseeing the program. The agency believes that disciplined investment in its key assets will lead to outstanding returns.

Recommendation #3: SITLA's investment program is focused upon planning and infrastructure development (e.g. key roads and utility trunk lines), not retail land development. This program, as articulated in the Development Business Plan, requires modest increases in staffing to improve project execution and increase accounting and reporting on the project level basis.

Recommendation #4: SITLA has requested FY2006/FY2007 funding to develop and implement a more sophisticated project accounting system. The agency will continue its current practice of reviewing overhead allocations regularly to ensure that each business group receives a fair overhead charge.

Recommendation #5: SITLA currently is funded to retain outside auditors to review development transactions. Several audits under this program have been completed and others are ongoing. SITLA has requested funding in the FY2006/FY2007 budget cycle for a financial analyst to work with the new project accounting system and improve project reporting to the Board of Trustees and senior management. Additionally, the budget request includes funding for additional outside audit help to review development transactions.

Chapter V – Administrative Compensation of SITLA Staff

Chapter V of the Audit Report addresses SITLA management compensation. The School and Institutional Trust Lands Administration Board of Trustees is responsible by statute for setting salary ranges for SITLA management and developing the annual incentive and bonus plan. The Board has responded to this portion of the Audit Report by letter dated January 4, 2006, which we hereby incorporate by reference, and request

that you append to this response. By way of summary, the Board principally noted that SITLA's governing statute provides that management salaries at SITLA are to be set with regard to private as well as public sector salaries, in keeping with the business mission of the agency. The salary survey undertaken by the audit staff did not consider private sector salaries as provided by the statute. The Board has committed that, at the time that it considers compensation for the upcoming fiscal year, it will seek independent professional examination of both the incentive program and SITLA management salaries to ensure a fair compensation package that promotes hiring and retention of the best possible management team, while protecting the interests of the trust beneficiaries.

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SITLA appreciates the opportunity for comment in connection with the review, and shares with you the common goal of causing Utah's trust lands to be managed prudently and profitably for the benefit of the trust beneficiaries. In the meantime, please feel free to contact us if you have any questions or comments, and thank you for your input.

Sincerely,

Kevin S. Carter
Director

Cc: SITLA Board of Trustees

Utah!

State of Utah

School and Institutional
TRUST LANDS ADMINISTRATION

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Mr. John E. Massey, Director
Office of the Legislative Fiscal Analyst
W310 State Capitol Complex
Salt Lake City, Utah 84114

Re: Review of Administrative Compensation -- School and Institutional Trust Lands Administration

Dear Mr. Schaff:

On behalf of the Board of Trustees of the School and Institutional Trust Lands Administration ("SITLA"), thank you for the opportunity to respond to the above-referenced report concerning the compensation of SITLA management and staff. The Board of Trustees is responsible by statute for setting policies for the effective and profitable management of Utah's trust lands, including setting salary ranges for SITLA management and creating an annual incentive and bonus plan. The Board welcomes input and guidance from the Legislative Auditor General and the Utah legislature, in light of the legislature's role as the ultimate trustee over management of trust lands. While the Board does disagree with several conclusions reached by the review, as described below, we share your goal that Utah's trust lands be managed prudently for the long-term benefit of the trust beneficiaries, and we look forward to working with the Legislature to address any concerns raised by the review. We specifically plan, in light of the concerns raised by the review, to undertake an independent professional review of SITLA management compensation prior to finalizing such compensation for the upcoming fiscal year.

Summary of Board Response

(1) The salary review compares SITLA management salaries only to those of other government employees. This fails to take into account the Utah legislature's express directive in *Utah Code Ann.* § 53C-1-201(3)(d)(iv) that compensation for SITLA management should be based upon compensation for similar positions in private enterprise as well as in other public employment. The Board of Trustees, in keeping with

the legislature's directive, has applied its best business judgment in setting compensation for SITLA management, based upon the need to retain qualified staff in competition with the private sector, and upon the value added by their activities for the benefit of the trust beneficiaries.

(2) The report contends that SITLA's increased revenues were the result of higher mineral prices in recent years, rather than any particular actions by SITLA managers. The Board believes that SITLA's actions have played a large role in creating opportunities to capitalize on higher mineral prices, including through acquisition of federal lands with major energy resources through land exchanges. We note that SITLA has substantially outperformed state land management agencies in other western states that also rely upon mineral revenues for substantial portions of their income, and we believe that value added by SITLA management has substantially contributed to this outperformance.

(3) In the Board's business judgment, the revenue goals upon which a portion of SITLA's management bonuses were based have not been set unrealistically low. During the initial portion of the period in question, the goals were based upon compounded annual operating income growth of 15%, and the goals have subsequently been increased substantially. We believe that this type of benchmarking is consistent with practice in the private sector. Bonuses paid to SITLA management constitute less than 2/10 of 1% of agency revenues since inception, and the Board believes that these amounts are reasonable under the circumstances.

Background

SITLA was created by the Utah legislature in 1994 to apply businesslike management practices to the management of the state's trust lands. Prior to that time, Utah had consistently underperformed the other western states in using its trust lands to build permanent endowments for the support of the state's public schools and other public institutions. In a survey of the western states' permanent funds and trust lands revenues in 1990, Utah ranked dead last among the public lands states in its accumulated permanent funds, and in the bottom three in annual income.[1] Based in part on this underperformance, the Utah legislature created the School and Institutional Trust Lands Advisory Board in 1993 to undertake a comprehensive review of trust lands management and policy.

The Trust Lands Advisory Board determined that the appropriate policy for trust lands was for the management agency to operate like a business, with reasonable

[1] J. Souder & S. Fairfax, *State Trust Lands* (University Press of Kansas 1990), Tables 2.5, 2.6.

independence from the state's bureaucratic structures, so that it could respond in a timely fashion to business opportunities.[2] The Advisory Board recommended that compensation for the trust land manager should be market-based, with reference to similar private and public positions, and should include bonuses based upon factors similar to those used for private sector executives, as the Board found appropriate.[3]

These concepts were expressly adopted by the Utah legislature when it adopted the Utah Trust Lands Management Act in 1994. The Board of Trustees, each member of which is required to have outstanding professional qualifications in areas of business, real estate and asset management, acts as the equivalent of a corporate board in directing management of SITLA, including the hiring and compensation of the director. The Board of Trustees and the director are expressly directed by the Act to consider similar positions in private enterprise in setting management salaries.[4] An annual incentive and bonus plan is authorized for the director and other SITLA employees based upon attainment of financial performance goals and other measurable criteria defined and budgeted in advance.[5]

The Board of Trustees believes that SITLA has fulfilled the intent of the legislature to bring competent, focused and businesslike management to the management of Utah's trust lands. In the 11 years since SITLA was created, Utah's permanent school fund has increased from $85.6 million in 1994 (the entire amount accrued in the 98 years since statehood) to over $580 million today. Instead of being dead last among the 23 public lands states, Utah is now solidly in the middle in terms of permanent fund size. Total trust assets (including the assets of other beneficiaries, but excluding the market value of trust lands) exceed $680 million. Annual income has increased from slightly over $14 million in 1994 to $93.9 million in 2005, with over $100 million in net revenues expected from SITLA operations in the current fiscal year.

Response to Review

1. Introduction.

The Board is composed of seven members, all of whom have lengthy experience in the business world, including the hiring and compensation of professional business

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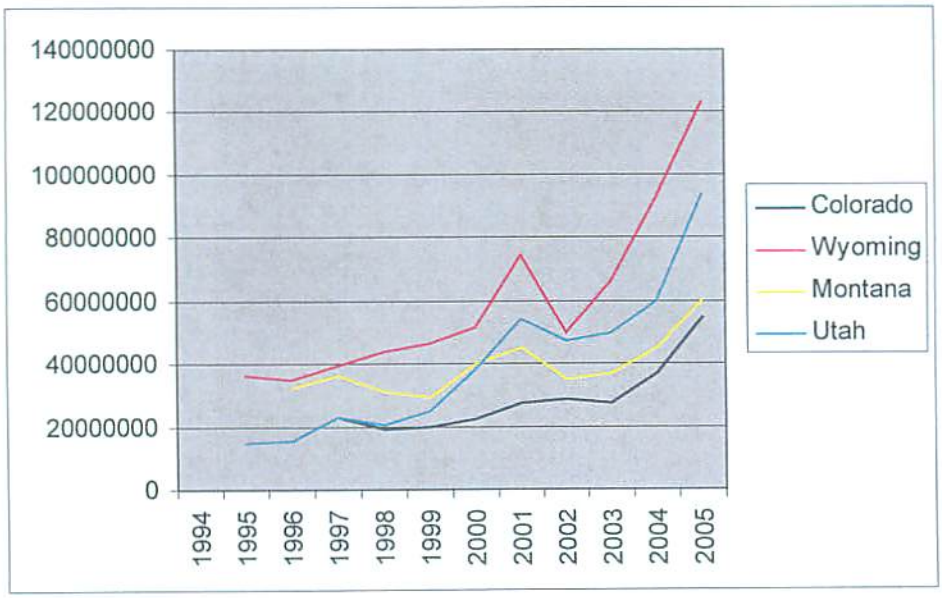
[2] *Statement of Intent for Management of School and Institutional Trust Lands*, School and Institutional Trust Lands Advisory Board (December 13, 1993) at 2.
[3] Proposed H.B. 350 at 17-18.
[4] *Utah Code Ann.* §53C-1-201(3)(d)(iv).
[5] *Utah Code Ann.* §53C-1-201(3)(d)(v).

managers. In fulfilling the Legislature's guidance that the state's trust lands be managed profitably for the financial benefit of the trust beneficiaries, the Board has sought to hire and retain management for SITLA who have the skills, motivation and experience to add value to the state's land portfolio, rather than passively managing the lands as was the practice of land management agencies prior to SITLA.

2. The Salary Review Understates SITLA's Efforts In Increasing Revenue.

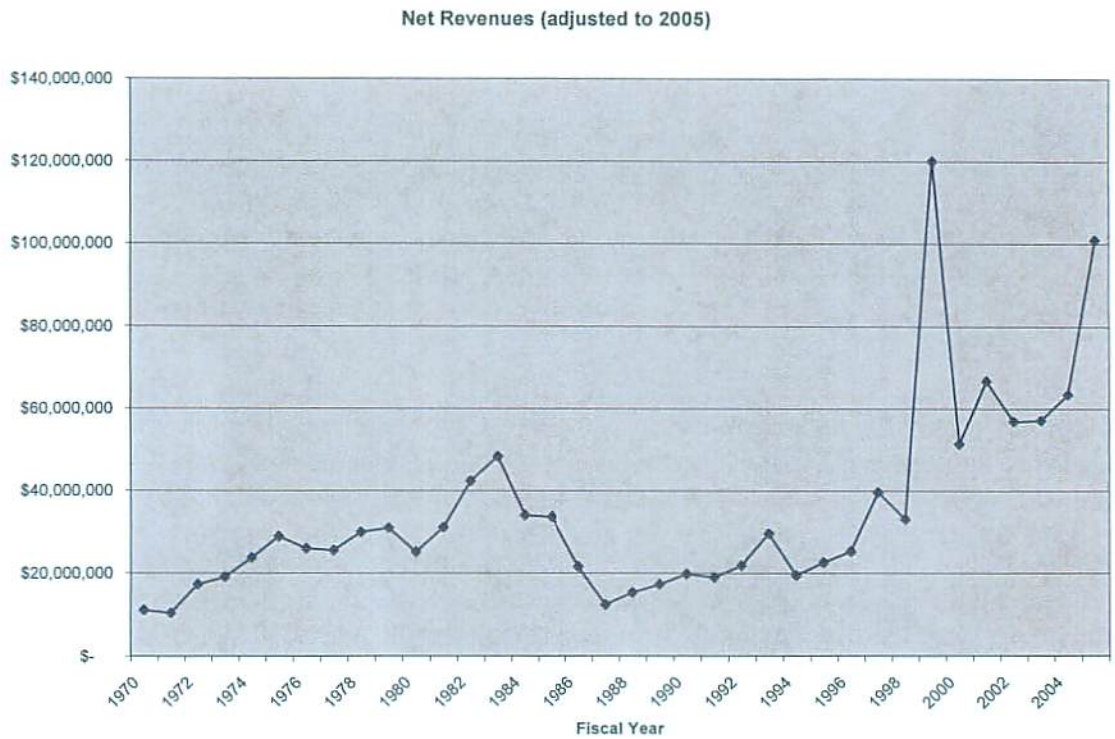
The Board of Trustees believes that the salary review incorrectly infers that increases in SITLA revenues, upon which the Board's incentive program was partially based, were mainly or solely the result of external forces rather than the efforts of agency staff. In particular, the review concludes that the bonus program is primarily linked to increased natural gas and oil prices and sales of "prime" trust land. In fact, during much of the period in question, natural resources prices were flat or down, but the agency was still able to significantly increase revenue year over year. In more recent years, when natural gas prices have risen greatly, SITLA's revenue growth has exceeded gas price growth by significant margins. A useful point of comparison is to look at other western states where commodity production forms a large portion of revenues, as depicted in Figure 1. Since 1994, Montana trust land revenues have increased 85%; Colorado revenues have increased 136%; and Wyoming revenues have increased 240%. During this same period, Utah trust land revenues increased 531%.

Figure 1:



Similarly, SITLA net revenues (which reflect amounts actually available for investment or distribution after the agency's expenses) have exceeded the historic high achieved by all prior agencies in every year since 2000, as depicted in Figure 2.

Figure 2.



The review also states that SITLA's revenue growth was based in part on the sale of "prime" trust lands. In fact, the agency's primary land sale program seeks to identify trust lands for sale where the returns that can be generated from investing the sales proceeds in financial assets exceed the income-generating potential of the property. Most of these lands are remote and rural rather than "prime" lands. The Board carefully watches to ensure that SITLA does not place property onto the market solely to meet revenue goals, and has by policy capped annual sales at $3 million in appraised value to avoid any perception that the agency is liquidating lands. The $50 million in cash received in the Grand Staircase Exchange was not counted toward income goals in the year received, and revenues received from any decision to market a large, valuable property would similarly be excluded from bonus calculations. Other significant sale revenues were generated from selling lands trapped within desert tortoise habitat which had no potential for future development. In most sales, we believe that value-added

activities by the agency such as planning and marketing significantly increased values obtained.

3. The Review Does Not Mention the Small Relative Size of Bonus Compensation.

The Board of Trustees is concerned that the review creates a misleading impression by reporting the total bonuses paid to staff without reference to the total amount of revenue generated by the agency. Bonuses awarded by the Board to SITLA management total approximately $1 million to date, with staff bonuses awarded by the director adding approximately $952,000. Over the period in question, SITLA direct revenues were over $520 million. In context, total bonuses paid to management comprised less than 2/10 of 1 percent of revenues, and staff bonuses a similarly small percentage. In light of the significant increases in trust revenues during this period, the Board believes that bonuses of this size are not excessive. The Board further notes that the primary criterion set by *Utah Code* Ann. § 53C-1-201(d)(v) for the award of bonuses is attainment of financial performance goals, which were in fact met. It might have been more informative to report these incentive amounts in context rather than standing alone.

4. Incentives for Performance Were Based Upon the Board's Business Judgment.

The Board's incentive bonuses for SITLA management have been based upon the agency's meeting both operating profit (i.e. revenue less operating expenses) goals, and non-monetary performance goals. With respect to the operating profit goals, the Board originally based its incentives on the goal of increasing net revenues by 15% per year, compounded annually, over a multi-year period, which the Board felt was a significantly difficult hurdle for management to reach, and a goal that would be deemed significant in the private sector. As the review notes, this policy resulted in the goal being below actual revenues for the prior year in some years. With increases in mineral revenue in the last several years as a result not only of increased resource prices but also because of the successful completion of two large land exchanges, the Board has increased the revenue goals by much more than a 15% compounded annual rate, but still at a level that the Board deemed achievable if management worked hard to achieve the goal, taking into account reasonable projections for agency revenues.

The Board of Trustees also believes that non-monetary performance objectives, which have comprised 50% of the management bonus program, are a worthy tool in guiding management performance in accordance with the Board's statutory role in setting policy to guide the agency. Our goal has been to use the non-monetary portion of the objectives to put SITLA in a position to capture future value through positioning the agency to take advantage of emerging opportunities. As an example, one Board priority

in recent years has been to encourage SITLA management to prepare aggressively to pursue land exchanges with the United States. In furtherance of this policy, the Board directed the agency to take specific actions in preparation for an exchange of lands in the West Desert area. Lands identified as part of the incentive objective were ultimately acquired, and have since been included in a transaction for a solid waste facility that is expected to provide many millions of dollars for the school trust from one small portion of the exchange lands.

The Board of Trustees believes that the incentive program, properly managed, can be and is a valuable means to incentivize SITLA management to find new ways to generate revenue for the school trust, and to set the stage for future revenue growth. The goals set by the Board in past years have been carefully examined during the years in question, and reflect the Board's business judgment.

5. The Salary Review Does Not Consider Comparable Private Sector Positions.

The Utah legislature's intent in creating SITLA was for the agency to act in a businesslike manner in managing trust assets. In doing so, the legislature expressly directed that the Board and director consider similar positions in the private sector, as well as comparable public sector positions, in setting management salaries. *Utah Code Ann.* § 53C-1-201(3)(iv). The same statute provides for SITLA's director to consult with the director of the Division of Human Resource Management in setting salaries for exempt positions in the agency. The director in fact has done so, without adverse comment from the director of DHRM.

The Board of Trustees has attempted to follow all legislative directives in managing SITLA, and, more specifically, in compensating SITLA management. The Board has sought to retain management staff with significant private sector experience, who can add value to trust lands and assets rather than simply managing the lands in a custodial capacity. In contrast, the auditors considered only public sector jobs in their survey of "comparable" positions, and did not consider even public sector entities with a business focus (e.g. the Salt Lake Airport Authority, the Utah Transit Authority, etc.). While the data in the review is relevant, we feel it should take into account the legislature's direction that SITLA salaries be based upon both public and private salaries.

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With respect to the first of the review's recommendations, the Board of Trustees concurs that any SITLA management bonuses should be based on appropriate and measurable goals. Prior to the commencement of the legislative audit, the Board

appointed a subcommittee to examine bonus issues. This subcommittee is currently addressing issues such as the non-financial goals and modifying the financial goals so that more emphasis is given to achieving premiums over fair market value and other benchmarks rather than gross revenue.

With respect to the second of the review's recommendations, the Board looks forward to working with you, the Legislative Audit Committee, and the relevant appropriations committees to ensure that our compensation practices are open and appropriate. At the time that it is considers compensation for the upcoming fiscal year, the Board will seek independent professional examination of both the incentive program and SITLA management salaries to ensure a fair compensation package that promotes hiring and retention of the best possible management team, while protecting the interests of the trust beneficiaries.

The Board of Trustees appreciates the opportunity for comment in connection with the review, and shares with you the common goal of causing Utah's trust lands to be managed prudently and profitably for the benefit of the trust beneficiaries. In the meantime, please feel free to contact any of us if you have any questions or comments, and thank you for your hard work.

FOR THE BOARD:

James B Lee

James B. Lee
SITLA Board Chair

SITLA Board Members:

James B. Lee, Chair
Michael P. Morris, Vice-Chair
Vernal J. Mortenson
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