March 3, 1998

Members
Legislative Audit Commission

When Minnesota joined the Union in 1858, the federal government granted the state millions of acres of land to be held in trust for the “benefit of schools.” Today, the state still owns 2.5 million acres of school trust land, which is managed by the Department of Natural Resources (DNR). Income produced from the land is invested by the State Board of Investment (SBI), and the proceeds ($30 million in 1997) are distributed each year to public schools.

In May 1997, the Legislative Audit Commission directed us to evaluate the performance of DNR and SBI relative to school trust land. We found that DNR generally manages school trust land the same way it manages all land under its jurisdiction. While in many cases that is appropriate, given DNR’s overall natural resource management responsibilities, in some instances it may inappropriately result in less income being generated for schools. We urge DNR to reconsider some of its internal management policies and report to the Legislature regularly on the status of its management activities. The Legislature, which has not always given consistent direction to DNR on trust fund issues, could benefit from better information and analysis from DNR. We also recommend that the Commissioner of Finance be added to the Permanent School Fund Advisory Committee to provide better oversight of DNR.

We also found that the past policy of investing school trust fund dollars in fixed-income securities instead of stocks seriously limited the growth of the principal of the fund over the past decade. We support SBI’s current policy of investing more of the fund in stocks and recommend that the Legislature consider statutory and constitutional changes to maximize the fund’s future growth.

This report was researched and written by Susan Von Mosch (project manager), Tom Walstrom, and Mary Jackson. We received the full cooperation of the staff of the Department of Natural Resources, the Department of Finance, and the State Board of Investment.

Sincerely,

James Nobles
Legislative Auditor

Roger Brooks
Deputy Legislative Auditor
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School Trust Land

SUMMARY

When Minnesota became a state in 1858, the federal government granted it sections 16 and 36 of every township, or their equivalent, for the benefit of schools. 1 The Minnesota Constitution established the Permanent School Fund (PSF) to ensure a long-term source of funds for public education in the state. The PSF consists of the accumulated revenues generated from the land. The state holds the land and accumulated revenues from the land in trust for the benefit of public schools in Minnesota.

The Department of Natural Resources (DNR) is responsible for managing school trust land, much of which had been sold by the mid-1880s. DNR currently manages about 2.5 million acres of school trust land.

The principal of the Permanent School Fund consists of cash generated from the trust land. 2 Income is primarily earned from land and timber sales, land leases, and mineral royalties. The State Board of Investment (SBI) is responsible for investing the PSF principal, which had a market value of about $437 million on June 30, 1997. Interest and dividend earnings are distributed to school districts each year. During the 1995-96 school year, nearly $31 million (less than 1 percent of all state revenues to K-12 schools) was distributed to schools.

In May 1997, the Legislative Audit Commission directed our office to study the state’s management of school trust land and the Permanent School Fund. We asked the following questions:

- How has DNR managed the school trust land given its fiduciary responsibilities related to the Minnesota Constitution and state laws?
- How does DNR balance its fiduciary responsibilities to the Permanent School Fund with its natural resource management responsibilities?
- What returns have timber sales, mining rents and royalties, lakeshore and other leases, and land sales realized for the principal of the PSF?
- Do DNR’s administrative costs reflect the actual costs of managing school trust land?

---

1 The original federal school land grant consisted of 2.9 million acres of land. The state later added swampland and other land grants to the original grant for a total of 8.1 million acres.

2 The principal of the PSF does not include the value of the trust land.
• How does Minnesota’s oversight of school trust land management compare with other states? Could another unit of government manage Minnesota’s school trust land more cost-effectively than DNR?

• How has the State Board of Investment invested the PSF principal? What rates of return have been earned?

To answer these questions, we used several different DNR databases to examine the characteristics of Minnesota school trust land, estimate the value of timber on commercial forest trust land, and analyze timber sales. We interviewed staff from the Department of Natural Resources, the State Board of Investment, Minnesota county land departments, and land management and fund investment agencies in other states, and members of the Permanent School Fund Advisory Committee. We reviewed literature, state laws, and case law related to management of school trust land.

BACKGROUND

The federal government’s grant of land to Minnesota “for the use of schools” and the state’s acceptance of the grant created a trust. When the State of Minnesota accepted the terms and conditions of the federal land grant, it accepted the position of trustee for public schools in Minnesota. The trustee relationship extends to the Minnesota Legislature, DNR, SBI, and other state officials who make decisions affecting the trust. DNR officials told us that their actions as land management trustees are often constrained by conflicting legislative direction and limited funding.

We recognize that the interests of the trust can coincide with the general interests of the state, and that state actions are often consistent with the interests of both the trust and the general public. Nevertheless, state officials need to be mindful that when their actions affect school trust land, they have special obligations. According to our interpretation of case law, the trust status of the federal school grant land imposes obligations and constraints on how the state may manage school trust land that would not apply if the state held the land outright. The same fiduciary principles that govern the administration of private trusts apply to trustees of school trust land and funds. Case law emphasizes that the trustee’s primary responsibilities are to manage the trust in the interests of current and future beneficiaries. The basic long-term objective of the trust should be to generate as much revenue as possible to aid public education.

The state has a fiduciary responsibility for Minnesota’s school trust land and the PSF.

---

3 A trust is a right of property held by one party, a trustee, for the benefit of another.
4 There have not been any court cases on the nature of the trust relationship in Minnesota. We examined cases from federal district courts and circuit courts of appeals that would be applicable to Minnesota.
SCHOOL TRUST LAND

Minnesota’s 2.5 million acres of school trust land are located primarily in the northern part of the state, as shown in Figure 1. More than 92 percent of school trust land is located in 10 counties: Koochiching, St. Louis, Itasca, Lake, Cass, Aitkin, Cook, Beltrami, Roseau, and Hubbard. School trust land represents 46 percent of the 5.4 million acres of state-owned, DNR-administered land in Minnesota.

Table 1 shows that about 1.9 million acres of trust land are in state forests, state parks, wildlife management areas, and other DNR management units. The Division of Forestry manages 94 percent of the school trust land: 67 percent of the trust land that is in state forests and another 27 percent that is not located in any management unit.

Minnesota has about 2.5 million acres of mineral rights on school trust land and about 1 million acres where the state has “severed mineral rights.” Severed mineral rights occur when the state sells the land but retains the subsurface rights. Since 1901, the state has reserved mineral rights when state-owned land is sold.

The PSF principal receives income from economic activities on trust land—mining rents and royalties, land sales, and forest management activities, which include timber sales and leasing of trust land. We found that:

- Since 1986, mining rents and royalties and land sales accounted for 84 percent of the land management revenues added to the PSF principal, while timber sales and leasing of trust land accounted for 16 percent of the revenues. In 1996 and 1997, these three sources each accounted for about one-third of revenues added to the PSF.

Figure 2 shows the revenues from land management activities added to the PSF principal since 1986. Management of school trust land contributed about $41 million to the PSF between 1986 and 1997, or an average of $3.4 million per year. Mining rents and royalties have provided the most stable source of revenue, generating an average of $1.4 million in revenues each year. Net revenues to the PSF from timber sales and land leases increased from zero in 1991 to nearly $1.7 million in 1997. The lack of net revenues from timber sales prior to 1992 was the planned result of DNR implementing a reforestation policy. Trust land sales, most notably the legislatively-initiated sale of lakeshore lots, represented an increasing revenue stream starting in 1988 and will continue for 20 years as payments are received.

DNR’S MANAGEMENT OF SCHOOL TRUST LAND

In 1985, the Legislature adopted the following goal for management of school trust land:
Figure 1: School Trust Land in Minnesota, 1997
Table 1: Estimated School Trust Acres by DNR Management Unit

<table>
<thead>
<tr>
<th>Management Unit</th>
<th>Trust Land Acres</th>
<th>Percent of Trust Land</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Forests and Campgrounds</td>
<td>1,737,123</td>
<td>67%</td>
</tr>
<tr>
<td>Wildlife Management Areas</td>
<td>85,681</td>
<td>3</td>
</tr>
<tr>
<td>Scientific and Natural Areas</td>
<td>51,000</td>
<td>2</td>
</tr>
<tr>
<td>State Parks</td>
<td>5,745</td>
<td>**</td>
</tr>
<tr>
<td>Riverways</td>
<td>756</td>
<td>**</td>
</tr>
<tr>
<td>Water Access</td>
<td>2,880</td>
<td>**</td>
</tr>
<tr>
<td>** Subtotal</td>
<td>1,883,185</td>
<td>73</td>
</tr>
<tr>
<td>** Outside of Management Units</td>
<td>706,800</td>
<td>27</td>
</tr>
<tr>
<td>** Total</td>
<td>2,589,985</td>
<td>100</td>
</tr>
</tbody>
</table>

NOTES: Data represent DNR’s estimate of total school trust land acres in each management unit. The total acres add to a number greater than the total acres of school trust land because some parcels are in more than one management unit.

** = Less than 1 percent.

SOURCES: Department of Natural Resources, MIS/GIS Section, unpublished data, June 1996; Division of Parks and Recreation; Scientific and Natural Areas Program.

Most school trust land is located in northern Minnesota.

Figure 2: Permanent School Fund Net Income from Land Management, 1986-97

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

In addition to maximizing the long-term economic return, this goal allows DNR to manage school trust land to serve the public benefit by providing recreational opportunities, wildlife habitat, and other values consistent with natural resource management principles. If trust land is used for purposes that either restrict or prohibit revenue generation, DNR has recognized that it should seek a method of compensating the trust for the foregone revenues.

Our review of DNR policies shows that:

- DNR applies the same broad natural resource management policies contained in state law to all types of state-owned land, including school trust land. Consequently, some trust land is managed to secure a maximum long-term economic return, while other trust land is managed for natural resource purposes that do not generate revenues.

State laws governing the management of forestry, minerals, parks and recreation, and other resources generally apply to all state-owned land, including school trust land. School trust land is managed according to the plans for the management unit in which it is located. In some cases (timber sales and mineral leasing), the plans are consistent with the goal of securing the maximum long-term economic return from trust lands. In other situations (state parks and wildlife management areas), managing for natural resource considerations has the potential to restrict or prohibit economic activities on trust land.

We also found that:

- In some instances, DNR applies more rigorous standards for revenue generation on trust land than on other state-owned land.

For example, DNR requires that all leases on trust land be charged a cash rental. This means that some contracts allowed on other types of land are excluded from trust land.

**Forest Management**

All school trust land is not of equal value and does not have the same capacity to generate revenue for the trust. The Division of Forestry maintains a forest inventory database that we used to describe the characteristics and estimate the value of timber on commercial forest trust land. We found that:

5 Minn. Stat. §124.079.
• About 1.5 million acres (67 percent) of the 2.2 million acres of trust land in the timber inventory are classified as commercial forest available for timber harvest.

About two-thirds of the commercial forest trust land (963,000 acres) has an “excellent/good” timber productivity and one-third (528,000 acres) has “medium/poor” timber productivity. The remaining forest trust land (746,000 acres) is unlikely to yield commercially viable timber harvests because it is: (1) commercial forest land that is not available for harvest because of policy considerations (shoreline setbacks, old growth timber); (2) unproductive because it is inaccessible and swampy; (3) not stocked as forest land; or (4) used for agricultural, industrial, or recreational purposes.

The Minnesota Constitution and state law allow DNR to deduct the costs of managing school trust forest land from the revenues earned by this land. Timber sales from trust land represent the bulk (about 85 percent) of the forest management revenues, but 50 percent of the revenues from lakeshore lot leases and revenues from other leases of school trust land are also used to finance forest management costs.

From 1983 until 1992, forestry management costs for school trust forest land exceeded revenues earned from that land and no income was deposited in the Permanent School Fund. According to DNR, prior to 1983 funding did not permit the department to reforest trust land located outside of state forests. This created a large backlog of forest improvement work (such as reforestation) for subsequent years. In 1992 and thereafter, revenues from managing school trust forest land have exceeded costs (see Figure 3).

DNR’s forestry management costs charged to the trust exceeded revenues for many years.

**Figure 3: Forestry Management Revenues, Costs, and Deposits to the PSF, 1986-97**

<table>
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<th>Dollars (in millions)</th>
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<tr>
<td>---</td>
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<tr>
<td>Revenues</td>
</tr>
<tr>
<td>Costs</td>
</tr>
<tr>
<td>Deposits</td>
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</table>

SOURCE: Department of Natural Resources, Division of Forestry, Trust Fund Transfer Certification Reports, 1986-97.
Forestry management costs eligible for reimbursement include fire protection, improvement, administration, management, and forest road construction and improvement. We examined how DNR determines its costs for managing trust forestry land and we concluded that:

- Overall, the methods used to allocate forestry management costs to trust land are reasonable, but DNR should consider alternative methods of allocating costs for fire protection and recreation management.

DNR uses a number of methods to allocate its forest management costs to the trust. The bulk of the costs—managing timber sales and reforestation—are allocated based on the percentage of total timber sale revenues that are generated from trust land. We think using the trust’s proportion of timber sale revenues is a reasonable way to allocate the actual forest management and improvement costs incurred.

DNR provides fire protection services on over 22 million acres of land—about 2.5 million acres of school trust land, 2.9 million acres of other state-owned land, and more than 17 million acres of other public and private land. The costs of fire protection are allocated on a per acre basis. Since school trust forest land represents about 10 percent of the land receiving fire protection, DNR allocates 10 percent of its total fire protection costs to school trust land. However, only about 7 percent of the fires over the past 10 years occurred on all state-owned land. Since school trust land represents about half of state-owned land, it could be assumed that roughly 3.5 percent of all fires (or about half of what occurred on all state-owned land) occurred on trust land. Probably fewer than 3.5 percent of fires occurred on trust land because only 2 percent of the all fires occurred in the counties where trust land is concentrated. Some fire costs are associated with the number of fires, however, DNR believes that the costs of fire prevention and suppression on trust land may be greater than the number of fires would suggest. We recommend that:

- DNR should reexamine its cost allocation for fire protection to determine if a different method could more closely reflect the actual cost of protecting trust land.

DNR currently include the revenues and associated management costs from recreation management (primarily state campgrounds) in the Forest Suspense Account. From 1992 to 1997, the costs charged for recreation management have exceeded the revenues. The Legislature and DNR should consider whether costs for recreation management should continue to be paid from trust revenues.

With DNR’s assistance, we estimated the net income likely to be produced from commercial forest trust land over the next 40 years. Like any model, our estimate of timber value relies on a number of simplified assumptions. For example, we assumed that the state and the trust’s share of the total timber harvest would remain the same over the 40-year period as it is today. We estimate that:

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6 Minn. Stat. §16A.25, subd. 5.
• If DNR forestry management costs do not grow faster than inflation, the estimated accumulated net income from timber on trust forest land over the next 40 years will be between $186 million and $305 million in 1998 dollars.

These estimates are sensitive to assumptions about DNR’s forestry management costs. If DNR management costs increase at a rate of 2 percent more than inflation over the next 40 years, then the estimated present value of net income from timber decreases to between $93 million and $213 million. These estimates of the timber harvest for trust land are similar to rough estimates of the value of commercial forest trust land provided by DNR. Valuing trust commercial forest land at $300 million, the return on asset value from timber sales on school trust land has been less than 1 percent in recent years. DNR hopes past investments in reforestation and forest management will increase future returns.

We also examined what portion of timber sale activity is generated from school trust land. Timber sales on trust land accounted for over 50 percent of both the volume and value of state-owned timber sold between 1986 and 1996. Between 1955 and 1980 the state sold 67 percent of its timber by volume through noncompetitive sales. An earlier study found that this was a less effective way to sell timber and generate revenue than auction sales. 7 Our analysis shows that:

• Between 1986 and 1996, DNR sold the majority of state-owned timber through auctions.

The volume (in cords) of state-owned timber sold by auction increased from about 44 percent in 1986 to 97 percent in 1996. DNR increased its use of auctions for timber sales on both trust and other state-owned land. Although research indicates that sealed bid auctions generate higher sale prices than oral bid auctions, we found that:

• Sealed bid auctions comprised a very small proportion of total auctions between 1986 and 1996.

DNR conducted 7,696 timber auctions between 1986 and 1996, but only 116 (less than 2 percent) were sealed bid auctions. Although few in number, a higher percentage of sealed bid auctions (89 percent) sold above the appraised value than oral auctions (56 percent). DNR does not use explicit criteria to select what tracts will be sold using sealed bids. The department has been reluctant to use sealed bids because they are perceived to involve higher administrative costs. To potentially receive higher prices for state-owned timber, we recommend that:

• DNR should analyze the costs and benefits of increasing the use of sealed bid auctions.

We did not evaluate the Division of Forestry’s overall management of Minnesota’s timber resources, but we think that a study of DNR’s timber management policies and practices, management costs, and timber appraisal and stumpage pricing methods may be timely.

Minerals Management

The Division of Minerals administered about 3.4 million acres of school trust mineral rights in 1997. Trust land mineral rights represented 28 percent of the 12.4 million acres of state-owned mineral rights. In addition to iron ore and taconite leases, which have dominated Minnesota’s mining activities, DNR administers metallic minerals, peat, and industrial mineral leases. We found that:

- School trust land accounted for about one-third of all acres of state-owned mineral rights leased and about one-fifth of all revenues from state mineral leases in 1997.

School trust land accounted for about 11,300 acres (35 percent) of the 31,837 acres of leased state mineral rights in 1997. Mineral revenues from school trust land generated about $1.6 million, or 22 percent of total revenues from mineral leases on state-owned land. The cost of mineral management on school trust land is financed with a General Fund appropriation, not from trust land mineral revenues.

The exact nature and location of Minnesota’s mineral resources is unknown, so it is not possible to develop an estimate of the value of those resources. Without knowing the estimated value of the minerals, we are not able to calculate a return on asset value for DNR’s mineral leasing activity on school trust land.

Other Management Units and Areas

School trust land is located in state parks, wildlife management areas, scientific and natural areas (SNAs), and other DNR units that manage land to provide recreational opportunities and protect critical habitats. Management policies of these units have the potential to restrict or prohibit economic activities on trust land. Both the Minnesota Legislature and DNR have generally recognized the need to compensate the PSF for the lost revenue potential of this land.

In the past, DNR has compensated the trust for lands that could not generate income by purchasing trust land, exchanging trust land for other state-owned land, or paying lease fees for the use of trust land. For instance, in 1992 DNR exchanged over 5,300 acres of trust land in state parks valued at $1.1 million for other state-owned land of similar value. DNR has also used some of its land acquisition money to acquire trust land in SNAs and wildlife management areas. In spite of these efforts, we estimate that:

- In 1997, there were about 150,000 acres of trust land in DNR management units or uses that prohibited revenue generation.

Table 2 summarizes the distribution of these acres, representing about 6 percent of all school trust land. In addition, between 85,000 and 95,000 acres of trust land are located in wildlife management areas (WMAs), which may limit the revenue generating potential of the land. While DNR policies acknowledge the idea of compensating the PSF when revenues are diminished, we found that:

About six percent of trust land is in areas that prohibit revenue generation for the trust.
DNR has not given a high priority to compensating the trust fund for the trust land in state parks and scientific and natural areas. Since the early 1990s, the Legislature and DNR have added about 550 acres of school trust land to state parks without compensating the trust. Legislation creating the peatland SNAs in 1991 specifically required the Commissioner of DNR to acquire the trust land in these areas. However, DNR does not have any immediate plans to remove the remaining acres of trust land from state parks, SNAs, or other management units. In past years, DNR has given higher priority to acquiring private land in imminent danger of development. Since school trust land is already state-owned and administered, it is not in danger of being developed.

Our analysis also shows that:

- Aside from lakeshore lot sales and state park land exchanges in the late 1980s and early 1990s, DNR has initiated few sales, condemnations, or exchanges of school trust land in recent years.

In addition to the sale of over 1,000 lakeshore lots and the exchange of trust land in state parks in the late 1980s and early 1990s, there were 39 land sales, 19 land condemnations, and 29 land exchanges involving school trust land between 1987 and 1997.

DNR is faced with a dilemma as it tries to balance its fiduciary responsibilities to the PSF with its natural resource management responsibilities. Given the choice of using limited capital bonding and land acquisition money to acquire trust land versus private land, the department has chosen the latter. In these instances, the department has emphasized its natural resource responsibilities over its fiduciary responsibilities to trust beneficiaries.

Table 2 also shows that approximately 93,000 acres of school trust land valued at approximately $35 million are located in the Boundary Waters Canoe Area Wilderness (BWCAW). Development activities in the BWCAW are severely restricted; this land does not generate revenue for the trust. Recently state and

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**Table 2: School Trust Land in Uses That Prohibit the Generation of Revenue, 1997**

<table>
<thead>
<tr>
<th>Use</th>
<th>Estimated Acres</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Parks</td>
<td>5,060</td>
</tr>
<tr>
<td>Peatland Scientific and Natural Areas</td>
<td>51,000</td>
</tr>
<tr>
<td>Boundary Waters Canoe Area Wilderness</td>
<td>93,260</td>
</tr>
<tr>
<td>Estimated Total</td>
<td>149,320</td>
</tr>
</tbody>
</table>

SOURCES: Department of Natural Resources, Divisions of Parks and Recreation, Fish and Wildlife, and Forestry.
federal officials have discussed the federal government’s purchase of this land. We recommend that:

- DNR should continue to pursue compensation for the PSF for trust land in the BWCAW. If the federal government’s purchase of some or all of the trust land is the most realistic option, then it should be pursued.

**Lakeshore Lots on School Trust Land**

Between 1986 and 1995, the state sold 1,060 lakeshore lots on school trust land. These sales generated over $14 million in revenues for the Permanent School Fund, mostly (93 percent) financed with annual payments over 20 years.

DNR currently manages 546 lakeshore lot leases on school trust land. Lakeshore leases receive a great deal of public scrutiny, but they account for a small fraction of all trust land. These lots are located on 76 lakes in 12 counties and account for a total of 426 acres of school trust land. The leased lots had an appraised value of $11.6 million as of January 1, 1997. Table 3 shows that based on these appraised values, the lakeshore leases on trust land generated $319,000 in revenues in 1997, the first year of the three-year phase-in of 1997 annual lease rates. Total revenues will increase to $578,000 in 2000.

Some provisions in the initial lakeshore sale laws of 1986 and 1987 benefited lessees instead of trust beneficiaries, such as allowing the lessee to decide if a leased lakeshore lot was to be sold and to cancel the sale after the appraisal was completed. Laws providing for the sale of lakeshore lots have been repealed. However, some provisions in current lakeshore lease laws (1985, 1990) also benefit lessees. Specifically, the three-year phase-in of increases to lease rates reduces revenues for the trust fund. The five-year cycle for adjusting the lease rates based on appraised value is one year longer than the four-year period used to reevaluate the values of other property, including other lakeshore property, for property tax purposes in Minnesota. DNR has argued that some of the lakeshore leasing and sale provisions were not in the interest of trust beneficiaries.

We also examined whether the state should continue to lease the existing lakeshore lots on school trust land or sell them. The analysis rests on a number of assumptions, the most critical of which involve: (1) the rate at which land values will appreciate; (2) the rate of return earned on investment of lease or sale receipts; and (3) how sale costs will be financed. Depending on what assumptions are used, the results of our analysis could support either the continued leasing or the sale of the lakeshore lots. For example, the higher the assumed rate of land value appreciation, the less attractive the option of selling the lots becomes. In considering this issue, policy makers should carefully examine the assumptions used to estimate the costs and benefits of leasing versus selling. Our analysis does not lead to a definitive conclusion, suggesting that any decision about whether to continue leasing or to sell lakeshore lots should not rest on economic analysis alone.
OVERSIGHT OF TRUST LAND MANAGEMENT

The Minnesota Legislature established the Permanent School Fund Advisory Committee (PSFAC) in 1982 to review DNR land management policies, advise DNR on the management of trust land, and recommend necessary changes in policy and implementation. The advisory committee consists of the chairs of the House Education and Ways and Means committees; the Senate Finance and Children, Families, and Learning committees; the Commissioner of Children, Families, and Learning; and two superintendents, one from a nonmetropolitan school district and one from a metropolitan area school district. Our review of the committee and its activities has led us to conclude that:

- Minnesota’s structure for overseeing the management of school trust land needs improvement.

The PSFAC has met irregularly, usually at the call of DNR. Between 1987 and 1997, the committee met 11 times; between December 1991 and April 1994, the...
committee did not meet. The committee has focused most of its attention on the leasing and sale of lakeshore lots, the state park land exchange program, and forestry management costs. A legislative staff member who has other significant responsibilities assists the committee.

Through PSFAC is partly composed of legislators who are chairs of major education and finance committees, revenues from the PSF are a small proportion of education finance. Therefore, it is difficult for school trust land issues to capture the attention of these policy makers consistently.

One result of Minnesota’s oversight structure is that no single agency or entity has been responsible for compiling and presenting comprehensive information related to both the school trust land and PSF investments. To address these concerns, we recommend that:

- **The Legislature should improve oversight of school trust land management by expanding the Permanent School Fund Advisory Committee and assigning a more explicit oversight role to the Department of Finance.**

We believe that the Legislature should add the Commissioner of Finance to the PSFAC to serve as chair of the committee and to be responsible for calling regular meetings. The Commissioner of Finance could add financial expertise, a statewide perspective, continuity, and another voice for the interests of the trust to the committee. The committee would retain its current advisory responsibilities of reviewing DNR policies on trust land management, providing advice and guidance to the department, and making recommendations for changes in policy and implementation when necessary. We also recommend that:

- **The Legislature should use Permanent School Fund resources to fund a position, full- or part-time, in the Department of Finance to staff the Permanent School Fund Advisory Committee.**

Staff support for the PSFAC could assist with the regular review of land management policies and practices and development of a comprehensive annual financial statement on land management proceeds, management costs, deposits to the PSF, and distributions from the PSF. We also think that:

- **The Legislature should require DNR to develop a biennial report on the management of school trust land.**

Of the 13 states we examined, Minnesota is one of only two states that use the same structure and staff to manage both trust and other state-owned land. In most other states independent agencies or separate divisions within land management agencies are responsible for trust land management. Typically, an independent agency that deals exclusively with trust land issues is likely to be focused on trust goals and beneficiaries.³ We do not recommend that Minnesota’s DNR reorganize.

its administration of trust land to be consistent with the organizations in other states. We suggest, however, that:

- **DNR should consider having specific staff within the department assume responsibility for coordinating school trust land management activities.**

DNR could assign a specific staff person responsibility for writing a biennial report, training department staff on the nature of trust land, working as liaison with the PSFAC, and monitoring trust land management activities within the department. We also suggest that the staff person be independent of other DNR functions.

**Options for Financing Management Costs**

In Minnesota, DNR’s trust land management costs are financed with a combination of land management revenues for forestry management and lakeshore leasing/sales activities and General Fund appropriations for minerals management and other land sales. A national study and our survey of other states show that there are three options for financing the costs of trust land management: (1) general fund appropriations; (2) revenues from trust land management activities; and (3) a combination of land management revenues and general fund appropriations.

Of the states we surveyed, we found that:

- **Minnesota, Montana, and Idaho use a combination of revenues from land management activities and general fund appropriations to finance trust land management costs.**

Most of the other states we examined use revenues from land management activities to finance management costs. However, these states also have independent agencies or divisions responsible for managing school trust land and are able to identify actual management costs. While forest management costs appear to be reasonably allocated in Minnesota, the allocation of mineral management costs is more complicated. These management costs are not associated with the mineral potential of the land and mineral revenues are not necessarily related to management costs or activities. Based on these considerations, we recommend that:

- **No change should be made in how Minnesota finances the costs of school trust land management at this time.**

Regardless of how management costs are financed, it is unlikely to have an impact on how Minnesota finances education.
Other Management Issues

We contacted representatives from Minnesota counties with land departments to determine if another unit of government could manage Minnesota’s school trust land more cost-effectively than DNR. After reviewing county land department annual financial reports, we concluded that:

- Minnesota counties should not be recruited to manage school trust land.

It does not appear that county land departments are equipped to provide the land management services currently provided by DNR, such as minerals management and fire protection and suppression. Decentralizing trust land management could further disperse decision making and complicate the state’s ability to provide comprehensive and consistent oversight.

INVESTMENT OF THE PERMANENT SCHOOL FUND

Proceeds from the sale, use, and management of trust land are added to the Permanent School Fund principal. SBI’s investment of the PSF principal is constrained by constitutional, statutory, and political factors. The Constitution requires that the principal of the fund not be spent. Interest and dividend earnings from the investment of the principal must be distributed to school districts each year. Political and budgetary factors dictate the level of income the PSF is expected to generate for the public schools.

Budget constraints during the 1980s and early 1990s led SBI to invest the PSF principal exclusively in fixed-income securities (bonds) in order to generate the maximum current income for public schools. We found that:

- The PSF portfolio’s investment performance has been typical of fixed-income portfolios over the last ten years.

However, this fixed-income investment strategy earned less than alternative portfolio strategies incorporating equities (stocks). In addition, we found that:

- The PSF has distributed a relatively high percentage of its assets (7 to 9 percent) to public schools over the last ten years.

Two factors—a lower than possible rate of return and a high distribution percentage—have resulted in slow growth in the fund’s market value. We found:

- The returns from the PSF portfolio of bonds have not kept pace with inflation over the last ten years.

The Governor, the Legislature, and SBI recognized this trend and took action in 1997, adopting a budget that expected a reduced contribution from PSF
investment income to public education. This has allowed SBI to shift assets from
bonds to stocks. In July and August 1997, SBI implemented this initiative by
purchasing $212 million of Standard and Poor’s 500 indexed stock portfolio. We
support this action, which we recommended in a 1991 report, because it will
increase the potential of the PSF principal to grow over the long term.

We examined school trust funds in other states and found that:

- School trust fund managers in other states are investing a portion of
  their portfolios in stocks and have changed or are evaluating their
  funds’ distribution policies.

SBI is recommending further modification of statutory and constitutional
restrictions on the way the income and dividends from the PSF are handled. Our
analysis indicates that the SBI staff recommendations have considerable merit.
Eliminating the restriction on how capital gains are treated would allow SBI to
even the cash distribution over time and provide predictable levels of income to
the schools. Adopting a distribution policy based on a percentage of market value
also would allow the fund to keep up with inflation and ensure that future policies
will be consistent with the state’s fiduciary responsibility to the PSF. As a result,
we recommend:

- The Legislature should consider constitutional and statutory changes
to the distribution of income and to the treatment of capital gains from
the Permanent School Fund.

Another option that could be explored involves using distributions from the
Permanent School Fund for special projects within public education instead of
offsetting the general fund education appropriation. For example, the annual PSF
distribution might be used to finance capital projects or classroom technology
improvements in Minnesota’s public school districts. The PSF could be used for
education much like the Environmental Trust Fund is used to finance
environmental projects. Under this option, the Legislature would decide how to
appropriate the PSF distribution, perhaps with assistance from an advisory group
or other body.

Using the PSF distribution for special projects could increase the visibility of the
fund, generating more interest in how the PSF principal is invested and how
school trust lands are managed. If the PSF distributions were used for specific
education projects, school districts around the state would probably become more
aware of the trust. Of the states we contacted, Wisconsin and Iowa distribute PSF
interest earnings to specific programs.

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INTRODUCTION

When Minnesota became a state in 1858, the federal government granted it sections 16 and 36 of every township, or their equivalent, for the benefit of schools. The Minnesota Constitution established the Permanent School Fund (PSF) to ensure a long-term source of funds for public education in the state. The PSF consists of the accumulated revenues generated from the land. The state holds the land and accumulated revenues in trust for the benefit of public schools in Minnesota.

The Department of Natural Resources (DNR) is responsible for managing the school trust land, much of which had been sold by the mid-1880s. DNR currently manages about 2.5 million acres of school trust land and retains an additional 1 million acres of “severed” mineral rights. Severed mineral rights occur when the state sells the land but retains the subsurface rights. School trust land represents 46 percent of the 5.4 million acres of state-owned, DNR-administered land in Minnesota.

The principal of the Permanent School Fund consists of cash and investments generated from the trust land. Income is primarily earned from land and timber sales, land leases, and mineral royalties. The State Board of Investment (SBI) is responsible for investing the PSF principal, which had a market value of about $437 million as of June 30, 1997. The Minnesota Constitution requires that the principal of the fund remain perpetual and inviolate forever. Interest and dividend earnings are distributed to school districts each year.

In May 1997, the Legislative Audit Commission directed our office to study the state’s management of school trust land and the Permanent School Fund. We addressed the following questions:

- How has DNR managed the school trust land given its fiduciary responsibilities related to the Minnesota Constitution and state laws?

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1 The original federal grant consisted of 2.9 million acres of land. The state later added swampland and other land grants to the original grant for a total of 8.1 million acres.

2 Since 1901, state law has required that the mineral rights to state-owned land be retained when the surface rights to the land are sold.

3 The principal does not include the value of the trust land.
• How does DNR balance its fiduciary responsibilities to the Permanent School Fund with its natural resource management and conservation responsibilities?

• What returns have timber sales, mining rents and royalties, lakeshore and other leases, and land sales realized for the principal of the PSF?

• Do DNR administrative costs reflect the actual costs of managing school trust land?

• How does Minnesota’s oversight of school trust land management compare with other states? Could another unit of government manage Minnesota’s school trust land more cost-effectively than DNR?

• How has the State Board of Investment invested the PSF principal? What rates of return have been earned?

To answer these questions we reviewed national literature and previous reports about Minnesota’s school trust land, along with the Minnesota Constitution, state statutes, and case law relating to the management of school trust land. We discussed trust land, timber, mining, and other management policies and practices with DNR program staff responsible for administering these policies and practices. We used several different databases maintained by DNR to: (1) determine the nature and estimate the value of timber on trust land; (2) analyze timber sales on trust land; and (3) examine the number of leases and contracts and the frequency of land sales and exchanges. We also talked with staff from county land management departments in northern Minnesota, and conducted telephone interviews with trust land and investment fund managers from a sample of other states. We interviewed members of the Permanent School Fund Advisory Committee. Finally, we evaluated the SBI’s past and future investment strategies and past performance related to the PSF principal.

We did not examine DNR’s management of the 26,000 acres of University trust land given by the federal government to Minnesota to support a public university. This evaluation also does not examine DNR’s forestry and minerals resource management policies and practices in detail.

This report has five chapters. Chapter 1 provides background information on the origin and nature of the federal school land grant, including a summary of Minnesota’s current management structure for school trust land and the PSF principal. Chapter 2 contains detailed information on Minnesota’s land management policies and presents our analysis of how DNR manages school trust land. Chapter 3 examines lakeshore and other leases on trust land and trust land sales and exchanges. Chapter 4 discusses oversight of school trust land management and options for financing the costs of land management. Chapter 5 examines the State Board of Investment’s strategies for investing the PSF principal and rates of return.

The Permanent School Fund has a market value of $437 million.
The policy of granting federally owned land for the support of schools was common throughout the American colonial period, beginning before the federal Constitution was adopted. The General Land Ordinance of 1785 began the program of land grants for schools, providing that section 16 in every township would be reserved “for the maintenance of public schools.” The Northwest Ordinance, enacted in 1787, provided a system for establishing a territorial government and organizing for statehood that applied specifically to Ohio, Indiana, Illinois, Michigan, Wisconsin, and Minnesota east of the Mississippi. As the Northwest Ordinance was implemented, its procedures for statehood and its commitment to grant land for schools were applied to other states.\(^1\) The U.S. Congress granted school land to the states at the time each state joined the Union, beginning with Ohio in 1803 and ending with Alaska in 1959. \(^2\)

Throughout this time period, the nature of the land grants varied from state to state. The land grants increased from one to four sections of each township and general language was replaced with more complex and specific provisions. What is consistent, however, is that the federal government made grants of land in support of public schools and that states, in accepting the grants, entered into an “irrevocable compact” with the federal government. The states made clear and specific promises in return for the granted land. States agreed to use the proceeds from initial land sales to establish permanent school funds, the principal of which would be inviolate and undiminished forever. The income earned from the investment of the fund’s principal would be used to support public schools in each state.

To provide a context for our discussion of the management of Minnesota’s school trust land and Permanent School Fund principal in later chapters, this chapter provides background information on the history and key components of Minnesota’s school land grant. This chapter addresses the following questions:

- What was the origin and purpose of Minnesota’s school land grant?

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\(^2\) The thirteen original colonies and three other states (Vermont, Tennessee, and Kentucky) did not receive school land grants when they became states. See Souder and Fairfax, *State Trust Lands*, 19.
To answer these questions, we reviewed national literature and previous reports about Minnesota’s school trust land, along with the Minnesota Constitution, state statutes, and case law relating to school trust land. We also analyzed state financial information on revenues deposited in the principal of the Permanent School Fund (PSF), and we conducted telephone interviews with managers of school trust land in 15 other states.

The land granted to the state by the federal government is held in trust for the support of schools. According to our analysis, the trust is governed by the same fiduciary principles that apply to private trusts. A trustee’s primary responsibilities are to the trust, not to other considerations. While the trust land can be used for any public purpose, if other uses result in decreased or foregone income to the trust, then the trust fund should be reimbursed.

Mining, forest management, and land sales added $4.8 million in 1996 and $4.4 million in 1997 to the PSF principal. Each of these land management activities accounted for about one-third of the revenues added to the PSF principal during these years. Between 1986 and 1997, these land management activities contributed a total of $41 million to the principal of the PSF. The sale of assets including mining rents and royalties and land sales accounted for about 84 percent of all deposits into the PSF principal during this time period, while net revenues from forest management activities accounted for 16 percent of total deposits.

HISTORY OF MINNESOTA’S SCHOOL LAND GRANT

The State of Minnesota entered the Union on May 11, 1858. Minnesota’s grant of school trust land and the conditions attached to the grant were contained in a series of federal congressional acts that were part of the process of Minnesota becoming a state. The Organic Act of 1849, which created the territory of Minnesota, reserved sections 16 and 36 in each township “for the purpose of being applied to the schools in said territory.” ³ The Enabling Act of 1857, which authorized the people of the territory to write a constitution and prepare for statehood, actually granted this land to the state. The Enabling Act stipulated:

³ An Act to Establish the Territorial Government of Minnesota, March 3, 1849, sec. 18, in Minn. Stat., volume 1, xli. This act is commonly called the Organic Act of 1849. A section is one square mile, or 640 acres.
That the following propositions be and the same are hereby offered to the said convention of the people of Minnesota for their free acceptance or rejection, which, if accepted by the convention, shall be obligatory on the United States, and upon the said State of Minnesota to-wit:

First - That sections numbered sixteen and thirty-six in every township of public lands in said State, and where either of said sections, or any part thereof, has been sold or otherwise disposed of, other lands, equivalent thereto, and as contiguous as may be, shall be granted to said state for the use of schools. [Emphasis added.]

The citizens of Minnesota accepted the land grant for the use of schools on October 13, 1857, when they voted to adopt a state constitution. The constitution stated that “the propositions contained in [the Enabling Act] are hereby accepted, ratified, and confirmed and shall remain irrevocable without the consent of the United States.” [Emphasis added.]

The Enabling Act and the Minnesota Constitution of 1857 established a legal framework for the school trust land. In addition to authorizing the establishment and maintenance of public schools, the Constitution contained additional conditions relating to the school land grant. The language relating to school trust land in the current Minnesota Constitution remains substantially unchanged from the original language, requiring that:

1. Income from the sale or other disposition of the land is to be deposited in the Permanent School Fund, the principal of which “shall be perpetual and inviolate forever;”

2. The “net interest and dividends arising from the [permanent school] fund shall be distributed to the different school districts of the state in a manner prescribed by law;” and

3. School trust land shall be sold only “at public sale, and in a manner provided by law.”

There are some distinctions among states in the restrictions contained in federal enabling acts and state constitutions accepting the school land grant. Minnesota illustrates the simple conditions attached to the federal land grant in states admitted to the Union before the mid-1880s. The federal government simply provided the land “for the use of schools.” In contrast, the federal government attached detailed restrictions on school land grants made after the 1880s. Arizona’s Enabling Act, for instance, requires that land may be sold only at public sale, after advertising, and at not less than the fair market value, and rental revenues from trust land must be deposited into the permanent fund.

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4 Act Authorizing A State Government, February 26, 1857, sec. 5, para. 1, in Minn. Stat., volume 1, xlii. This act is commonly called the Enabling Act of 1857.
5 Minn. Const. 1857, art. II, sec. 3. Currently, this provision is found in Minn. Const., art. II, sec. 1.
6 Minn. Const., art. XI, sec. 8.
Minnesota was one of the first states entering the Union to receive a school land grant of two sections per township instead of one. 8 Minnesota’s original school trust land grant consisted of approximately 2.9 million acres. 9

Minnesota added other federal land grants to the school trust land. Minnesota received internal improvement land to foster railroad and other economic development. It also received swampland, the proceeds of which were to be used for the construction of dams, levees, and drainage systems. Over time, the state combined these lands with the original school trust land. 10

As a result of these changes, since 1974 school trust land in Minnesota has consisted of a combination of lands granted to the state for school, drainage, and internal improvement purposes. The current Minnesota Constitution defines the Permanent School Fund as:

(a) the proceeds of lands granted by the United States for the use of schools within each township, (b) the proceeds derived from swamp lands granted to the state, (c) all cash and investments credited to the permanent school fund and to the swamp land fund, and (d) all cash and investments credited to the internal improvement land fund and the lands therein.11

Other constitutional amendments relating to the management of school trust land have been adopted over the years. In 1914 an amendment authorized the state to designate and manage certain timber on school trust land as state forests. The amendment permitted the state to use the net revenue from forest activities on the land to finance forest management costs. 12

Two constitutional amendments, in 1938 and 1984, authorized the state to exchange school trust land for other public or private land, contingent upon the unanimous approval of the Land Exchange Board, consisting of the Governor, Attorney General, and State Auditor. 13 Finally, in 1984 a constitutional amendment vested the responsibility for “administering and directing the investments of all state funds,” including the Permanent School Fund principal, with the State Board of Investment. 14

8 Ohio, Wisconsin, and other states entering the Union in 1848 or earlier received one section per township. After 1896, the federal government granted new states four sections per township. Utah, Nevada, New Mexico, and Arizona were given four sections because the land was arid and more of it was needed to support schools. Souder and Fairfax, State Trust Lands, 27.

9 Samuel T. Dana, et al, Minnesota Lands: Ownership, Use and Management of Forest and Related Lands (Washington, D.C.: American Forestry Association, 1962), 92. Some sources list the number of school trust land acres granted as 2,888,608. Because some land located in sections 16 and 36 was underwater, or had already been homesteaded, Minnesota was allowed to select other land in lieu of those sections that were not available. These lands are referred to as “indemnity” lands.

10 For a detailed discussion of this topic see: Minnesota Department of Natural Resources, School Trust Land Management Report (St. Paul, 1983), 7-8; and Office of the Legislative Auditor, Evaluation of State Land Acquisition and Disposal (St. Paul, 1983), 9, 83-84.

11 Minn. Const., art. XI, sec. 8.

12 Minn. Const., art. XI, sec. 11.

13 Minn. Const., art. XI, sec. 10.

14 Minn. Const., art. XI, sec. 8.
DIFFERENCE BETWEEN SCHOOL TRUST LAND AND OTHER STATE-OWNED LAND

A trust relationship that governs school trust land was created when the federal government granted specific land to the state and the state accepted the land for the use of schools. Minnesota’s school trust land and the principal of the Permanent School Fund are held in trust for public school districts pursuant to the federal enabling act and the state constitution.

Although the Minnesota Constitution does not specifically identify a trustee, when the state accepted the terms and conditions of the federal land grant, it accepted the position of trustee for public schools in Minnesota. The U.S. Supreme Court has recognized the State of Minnesota as trustee of the federal land grant and acknowledged that “the legislature was the body representing the state.” 15 A broader legal interpretation might hold that, in Minnesota, entities of government with authority to make management decisions affecting the school trust land and fund should also be considered trustees. Since the Minnesota Legislature has delegated such responsibilities to the Department of Natural Resources and the State Board of Investment, these agencies also serve as trustees. 16 In contrast, the constitutions in many other states provide for the creation of state land boards, composed of various combinations of constitutional and executive branch officers, to serve as trustees of school trust land. 17

The trust status of the federal land grant imposes constraints and obligations on the trustees that would not apply if the state owned the land outright. There have not been any court cases on the nature of the trust relationship related to school trust land in Minnesota. We examined cases from federal district courts and circuit courts of appeals that could be applicable to Minnesota. A great deal of case law and commentary have emphasized that:

- The trust is a real trust that should be governed by the same fiduciary principles that apply to the management of private trusts.

The Washington Supreme Court in 1984 noted that the federal land grant trusts were created to benefit certain beneficiaries and that “[e]very court that has considered the issue has concluded that these are real enforceable trusts.” 18 For further support of this interpretation, the court cited the U.S. Supreme Court, which concluded:

16 Interview with Assistant Attorney General Andrew Tourville, June 18, 1997.
17 Of the states we examined, Colorado, Idaho, Montana, Nebraska, Oregon, South Dakota, and Wisconsin have constitutionally created state land boards.
There have been intimations that school land trusts are merely honorary, that there is a “sacred obligation imposed on (the state’s) public faith,” but no legal obligation. These intimations have been dispelled by Lassen v. Arizona . . . . This trust is real, not illusory. 19

As a result, the state has several responsibilities in managing school trust land. First, the state must manage the land according to the terms of the trust as established in the enabling act and the state constitution. In Minnesota these conditions are fairly simple to: sell school trust land at public auction, deposit income from the land sales in the Permanent School Fund, and distribute interest from the fund to school districts.

Second, common law principles governing the administration of private trusts must be applied to the state in managing the school trust land. The Washington Supreme Court, in County of Skamania v. State, concluded that fiduciary principles apply to state actions regarding federal land grants. The opinion stated that the federal grant land trusts “impose upon the State the same fiduciary duties applicable to private trustees.” 20 As a practical result, a legislature may be constrained with respect to enactments affecting school trust land.

The duties of a trustee are summarized in Figure 1.1. A trustee is required to act prudently in managing a trust. 21 The trustee should manage the trust to serve the interests of the trust beneficiaries. Cases from other states that address trustee duties have concluded that “undivided loyalty” to the trust beneficiaries is a trustee’s chief duty. In other words, the trustee’s primary responsibilities are to the trust, not to other considerations.

For instance, in Skamania the court ruled that the state as trustee may not use trust assets to pursue other state goals. The court held that the state had violated its duty of undivided loyalty to trust beneficiaries and its duty to act prudently by enacting a law aimed at benefiting the timber industry and the state economy in general at the expense of trust beneficiaries. The Nebraska Supreme Court (in State ex rel. Ebke v. Board of Education Lands and Funds) ruled that the state may not enact legislation for the benefit of lessees of public school land at the expense of the beneficiaries of the trust. In State v. University of Alaska, the Alaska Supreme Court ruled that the state had breached its duty to administer the trust solely in the interests of beneficiaries by failing to compensate the trust for the value of university land included in a state park. 22


20 County of Skamania v. State, 102 Wn.2d 129, 132, (1984) as cited in Washington Opinion, 4, 11-12. The state must comply with common law duties in administering the federal trust lands. However, the state’s management decisions are given deference not granted a private trustee because of the presumption of constitutionality that applies to state legislative authority.


Some duties of a trustee, such as making the trust productive, or maximizing its economic returns, have different standards for application than others. The trustees of a perpetual trust, such as the school trust land, must reasonably balance the short- and long-term interests of the current and future trust beneficiaries. While a trustee must make the trust economically productive at the present time, a trustee must also protect the productivity of the trust in the long run. In other words, a trustee cannot simply be concerned with maximizing current income. The conflict between maximizing economic returns and preserving the trust property may be more pronounced with trust land because of its perpetual nature.

Washington State statutes adopting a sustained yield policy for the state-owned forested land reflect consideration of the common law duty of making the trust productive over time. Sustained yield requires managing the forest to provide for harvesting a specific amount on a continuing basis so that there is not a major prolonged curtailment of harvest.

Some beneficiaries of federal grant land have suggested that the trust need only comply with general laws if the laws serve the beneficiaries’ economic interest. The courts have held, however, that state legislatures may pass laws that apply

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generally, such as environmental laws, and that those laws apply to trust land just as they apply to all other land in the state. This same argument applies to federal laws of general application. 24

The Minnesota Constitutional Study Commission in 1972 discussed some of these issues and concluded that school trust land should be managed in the interest of the trust beneficiaries, not for other purposes. Outside interest groups suggested that the Natural Resources Committee of the Study Commission endorse a constitutional amendment to authorize the use of school trust land for strictly non-income producing purposes (such as scientific and natural areas) without compensating the trust. The Committee rejected the suggestion in its November 1972 report to the Constitutional Study Commission. While noting that school trust land is included in state forests and thus is available for many recreational and scientific purposes, the Committee concluded in its report that:

The trust fund lands should be managed for income, although ecological considerations are important in the minds of those responsible for their administration. A scientific or natural area is probably not income producing. Hence, trust administrators would consider such use of trust fund lands a violation of their obligations.

While the state forests are, in one sense, investments of the public in the natural resources of the state, they can also serve to provide other uses to the citizens. . . . Since the state committed itself, when accepting these lands, to use the proceeds for school purposes, the principal objective must be sound management for income consistent with overriding public concerns. . . .

There are very good arguments for preserving and protecting wilderness areas, scientific areas, and parks. The Legislature can accomplish this by appropriating the necessary funds for the purchase of land. In proper circumstances it ought to do so. The stream of future finance for the schools, which the trust fund lands represent, ought to be protected too. 25 [Emphasis added]

According to our interpretation, the state is constrained in how it may manage the school trust land and revenues from the land in a way that it would not be if the state held the land outright. Most important, the state should manage the trust in the interest of the beneficiaries of the trust, current and future, and should not sacrifice the economic interests of the beneficiaries of the trust by using trust assets to serve other purposes. The long-term objective should be to receive as much revenue as possible to aid public education for both current and future beneficiaries.

MANAGEMENT OF MINNESOTA’S SCHOOL TRUST LAND AND FUND

Between 1861 and 1969, the administration of Minnesota’s school trust land shifted from the State Board of Commissioners of School Lands (1861), to the State Land Office with the State Auditor serving as commissioner ex officio (1862-1931), and then to the Department of Conservation (1931-1969). In 1969, the Department of Conservation was reorganized into the Department of Natural Resources which maintains responsibility for managing the trust land.  

The original policy of the state was the speedy survey and sale of the best school trust land to generate income for the trust fund and to support public schools. The Permanent School Fund principal was established in 1862, when the first 38,000 acres of school land were sold for approximately $243,000, an average price of $6.35 per acre. Land good for farming or near populated areas was sold first and was largely disposed of by the 1880s. The remainder of the trust land was never sold, leaving large tracts of school trust land in the northern part of the state.

The early actions of the state to liquidate school trust land were consistent with the popular conviction that private enterprise would drive economic development. The Legislature began placing limitations on the sale of state-owned land, including school trust land, in the early 20th century. Limitations included reserving mineral rights when state-owned land was sold (which passed in 1901), prohibiting the sale of state-owned land bordering or adjacent to public waters (1923), and removing land containing commercial peat deposits from sale (1935). This shift to retaining state land occurred for three reasons: (1) the most productive and valuable land had already been sold for development; (2) there was a growing recognition that the PSF would have fewer future opportunities for growth if more of the school and swamplands were sold; and (3) there were growing pressures on the state to reserve some land for public use and enjoyment and to increase its own role as a land manager in the public interest.

Current Management Structure

The responsibility for managing Minnesota’s school trust land and investing assets of the Permanent School Fund is currently divided among several state agencies. Figure 1.2 illustrates the current structure for administering Minnesota’s school trust land and PSF principal. As noted above, the Minnesota Department of Natural Resources is responsible for managing school trust land. The Commissioner of the Department of Natural Resources “shall have charge and control of all the public lands, parks, timber, waters, minerals . . . of the state

26 Office of the Legislative Auditor, A Review, 4-5.
27 Dana, Minnesota Lands, 134.
28 Minn. Stat. §§93.01, 93.02, 93.04, 92.45, and 92.461, subd. 1.
29 Office of the Legislative Auditor, Evaluation of State Land Acquisition, 12.
and of the use, sale, leasing, or other disposition” of those lands. The State Board of Investment (SBI) is responsible for investing the PSF principal, while the Department of Finance is responsible for managing the PSF.

In 1981, the Financial Audit Division of the Office of the Legislative Auditor reviewed DNR’s management of school trust land and found, among other things, that the department had not established objectives for the overall management and use of the land. The report also concluded that DNR “should not have the sole decision-making authority over the use of school trust land” and it recommended that “some management oversight be established outside of the organizational structure of the [DNR].”

In response, the 1982 Legislature established the seven-member Permanent School Fund Advisory Committee to “advise the Department of Natural Resources on management of permanent school fund land, which is held in trust for school districts of the state.” The advisory committee was directed to “review the policies of the Department of Natural Resources on management of school trust fund lands” and to “recommend necessary changes in policy and

30 Minn. Stat. §84.027, subd. 2.
31 Minn. Const. 1988, art. XI, sec. 8; and Minn. Stat. §11A.16, subs. 3 and 4.
32 Office of the Legislative Auditor, A Review, 6-7, 15-16.
implementation in order to ensure provident utilization of the permanent school fund lands.”

In 1985, the Legislature adopted the following goal for management of the school trust land:

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

Based on this goal, DNR is supposed to maximize the long-term economic return from the school trust land to the trust. In addition, this goal provides that school trust land may be managed according to “sound natural resource conservation and management principles.” This means managing trust land to preserve unique characteristics or values (such as wildlife habitat), or to serve the public benefit by providing recreational opportunities. While trust land can be used for public purposes, DNR has acknowledged that if such uses result in decreased or foregone income to the trust, then it should seek a method of compensating the trust. DNR policies and practices on compensating the trust for the value of diminished or lost revenues are examined in Chapter 2.

Flow of Funds

The principal of the Permanent School Fund includes cash and investments generated from mining rents and royalties, land sales, timber sales, and lakeshore and other leases on school trust land. Figure 1.3 illustrates the flow of funds within the Permanent School Fund.

Based on constitutional language, revenues from the sale of school trust land and royalties and rents from mining should be deposited in the Permanent School Fund. Revenues from forestry management activities, such as timber sales and land leasing, are deposited in a special account called the Forest Suspense Account. The Minnesota Constitution and state law allow DNR to deduct the costs of protection, improvement, management, and administration of state forest trust land and construction and improvement of forest roads from the revenues earned by this land. Any balance in the Forest Suspense Account after deducting forestry management costs is deposited in the PSF. Since 1988, up to 50 percent of the revenues from lakeshore leases have been deposited in another special account, called the Lakeshore Account, to finance the costs of appraising, selling, and leasing lakeshore lots. The remainder of revenues from lakeshore leases are deposited in the Forest Suspense Account.

33 Minn. Stat. §124.078.
34 Minn. Stat. §124.079.
36 Minn. Const., art. XI, sec. 11, and Minn. Stat. §16A.125, subd. 5.
37 Minn. Stat. §92.46, subd. 1 (c).
At the end of each fiscal year, the income earned from investment of the PSF principal is distributed by the Commissioner of Children, Families, and Learning to school districts as part of the state’s general education aid payments. This income is distributed twice a year, on the first Monday in March and September, based on average daily membership during the preceding year.

38 Minn. Stat. §§124.08 and 124.09. The revenue from the PSF is transferred to the Endowment School Fund, an expendable trust fund, and then distributed to school districts.
Existing Trust Assets

The primary assets of Minnesota’s school trust consist of the trust land and the Permanent School Fund principal. As noted earlier, Minnesota’s school trust land totaled about 2.5 million acres in July 1997.

Sixty-two percent of the remaining 2.5 million acres of school trust land was from the swampland grant, as shown in Table 1.1. Minnesota has retained about one-third each of the original school trust and swampland grant acres, while few internal improvement lands remain. In 1997, Minnesota’s school trust land was concentrated in the northern part of the state; more than 92 percent of the school trust land was located in ten northern Minnesota counties as shown in Table 1.2 and Figure 1.4. Minnesota has about 2.5 million acres of mineral rights on school trust land, including about 1 million acres of “severed mineral rights”

### Table 1.1: Distribution of School Trust Land by Type of Grant

<table>
<thead>
<tr>
<th>Type of Grant</th>
<th>Acres Granted</th>
<th>Acres Retained in 1997</th>
<th>Percent Retained</th>
</tr>
</thead>
<tbody>
<tr>
<td>School</td>
<td>2,900,000</td>
<td>950,264</td>
<td>33%</td>
</tr>
<tr>
<td>Swampland</td>
<td>4,706,503</td>
<td>1,552,989</td>
<td>33</td>
</tr>
<tr>
<td>Internal Improvement</td>
<td>500,000</td>
<td>6,688</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>8,106,503</strong></td>
<td><strong>2,509,921</strong></td>
<td><strong>31</strong></td>
</tr>
</tbody>
</table>

SOURCES: Office of the Legislative Auditor, *Evaluation of State Land Acquisition and Disposal* (St. Paul, 1983), and Department of Natural Resources, unpublished data.

### Table 1.2: Distribution of School Trust Land by County, 1997

<table>
<thead>
<tr>
<th>County</th>
<th>Acres of Trust Land</th>
<th>Percent of Total</th>
<th>Cumulative Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Koochiching</td>
<td>853,771</td>
<td>34.0%</td>
<td>34.0%</td>
</tr>
<tr>
<td>St. Louis</td>
<td>481,666</td>
<td>19.2</td>
<td>53.2</td>
</tr>
<tr>
<td>Itasca</td>
<td>292,364</td>
<td>11.6</td>
<td>64.8</td>
</tr>
<tr>
<td>Lake</td>
<td>159,346</td>
<td>6.3</td>
<td>71.1</td>
</tr>
<tr>
<td>Cass</td>
<td>140,182</td>
<td>5.6</td>
<td>76.7</td>
</tr>
<tr>
<td>Aitkin</td>
<td>138,025</td>
<td>5.5</td>
<td>82.2</td>
</tr>
<tr>
<td>Cook</td>
<td>120,066</td>
<td>4.8</td>
<td>87.0</td>
</tr>
<tr>
<td>Beltrami</td>
<td>60,576</td>
<td>2.4</td>
<td>89.4</td>
</tr>
<tr>
<td>Roseau</td>
<td>46,649</td>
<td>1.9</td>
<td>91.3</td>
</tr>
<tr>
<td>Hubbard</td>
<td>29,163</td>
<td>1.2</td>
<td>92.5</td>
</tr>
<tr>
<td><strong>Remaining Counties</strong></td>
<td><strong>188,113</strong></td>
<td><strong>7.5</strong></td>
<td><strong>100.0</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,509,921</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

SOURCE: Department of Natural Resources, unpublished data.
Figure 1.4: School Trust Land in Minnesota, 1997
on school trust land that has been sold. Severed mineral rights occur when the state sells the land but retains subsurface rights.

Of the 2.5 million acres of school trust land, 1.9 million acres are in DNR management units, as shown in Table 1.3. The Division of Forestry manages approximately 94 percent of school trust land: 67 percent of the school trust land that is in state forests and another 27 percent that is not located in any management unit. About 3 percent of the school trust land is in wildlife management areas, 2 percent is in scientific and natural areas, and less than 1 percent is in state parks and other recreational units.

### Table 1.3: Estimated School Trust Acres by DNR Management Unit

<table>
<thead>
<tr>
<th>Management Unit</th>
<th>Trust Land Acres</th>
<th>Percent of Trust Land</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Forests and Campgrounds</td>
<td>1,737,123</td>
<td>67%</td>
</tr>
<tr>
<td>Wildlife Management Areas</td>
<td>85,681</td>
<td>3</td>
</tr>
<tr>
<td>Scientific and Natural Areas</td>
<td>51,000</td>
<td>2</td>
</tr>
<tr>
<td>State Parks</td>
<td>5,745</td>
<td>**</td>
</tr>
<tr>
<td>Riverways</td>
<td>756</td>
<td>**</td>
</tr>
<tr>
<td>Water Access</td>
<td>2,880</td>
<td>**</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>1,883,185</td>
<td>73</td>
</tr>
<tr>
<td><strong>Outside of Management Units</strong></td>
<td>706,800</td>
<td>27</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2,589,985</td>
<td>100</td>
</tr>
</tbody>
</table>

**NOTES:** Data represent DNR’s estimate of total school trust land acres in each management unit. The total acres add to a number greater than the total acres of school trust land because some parcels are in more than one management unit.

** = Less than 1 percent.

**SOURCES:** Department of Natural Resources, MIS/GIS Section, unpublished data, June 1996; Division of Parks and Recreation; Scientific and Natural Areas Program.

We compared the original federal land grant and acres of school trust land retained in Minnesota with selected other states and found:

- **Minnesota has retained more of its school trust land than surrounding states, but less than most western states.**

Table 1.4 illustrates that Minnesota currently retains 31 percent of the 8.1 million acres of original school trust land, swampland, and internal improvement land granted by the federal government. In contrast, Iowa, Michigan, Wisconsin, and Ohio have little or no school trust land left, while South and North Dakota have

39 It is not possible to accurately identify how many acres of school trust land are located within each DNR management unit because this information is not maintained in the department’s main land records database. We obtained information on acres from various divisions and programs in DNR.
24 to 25 percent of their original trust land grants. Most of the western states we examined, however, have retained between 60 and 98 percent of the federal school land grant.

From Minnesota’s remaining school trust land, the PSF principal continues to receive revenue from mining rents and royalties, forestry management activities, and land sales. Forestry management activities include both timber sales and leasing of trust land. Our analysis of revenues from land management activities shows that:

- Since 1986, the sale of assets including mining rents and royalties and land sales accounted for 84 percent of the deposits into the PSF principal, while net revenues from timber sales and trust land leases accounted for 16 percent of deposits.

Figure 1.5 shows the net revenues from land management activities added to the PSF principal since 1986. Management of trust land contributed about $41 million to the principal of the Permanent School Fund between 1986 and 1997, or

### Table 1.4: Original and Current Surface Acres of School Trust Land

<table>
<thead>
<tr>
<th>State</th>
<th>Original Trust Land</th>
<th>Current Surface Land</th>
<th>Acres as a Percentage of Original Grant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arizona</td>
<td>8,400,000</td>
<td>8,191,711</td>
<td>98%</td>
</tr>
<tr>
<td>Montana</td>
<td>5,188,000</td>
<td>4,620,487</td>
<td>89</td>
</tr>
<tr>
<td>New Mexico</td>
<td>8,600,000</td>
<td>6,765,000</td>
<td>79</td>
</tr>
<tr>
<td>Washington</td>
<td>2,376,391</td>
<td>1,783,000</td>
<td>75</td>
</tr>
<tr>
<td>Idaho</td>
<td>2,982,683</td>
<td>2,095,944</td>
<td>70</td>
</tr>
<tr>
<td>Colorado</td>
<td>4,382,240</td>
<td>2,640,368</td>
<td>60</td>
</tr>
<tr>
<td>Utah</td>
<td>6,000,000</td>
<td>3,573,978</td>
<td>60</td>
</tr>
<tr>
<td>Nebraska</td>
<td>2,894,000</td>
<td>1,509,000</td>
<td>52</td>
</tr>
<tr>
<td>MINNESOTA</td>
<td>8,106,503(^a)</td>
<td>2,509,921</td>
<td>31</td>
</tr>
<tr>
<td>North Dakota</td>
<td>2,500,000</td>
<td>635,469</td>
<td>25</td>
</tr>
<tr>
<td>South Dakota</td>
<td>2,733,084</td>
<td>652,448</td>
<td>24</td>
</tr>
<tr>
<td>Oregon</td>
<td>3,399,360</td>
<td>772,000</td>
<td>23</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>1,243,721(^b)</td>
<td>4,068</td>
<td>&lt;1</td>
</tr>
<tr>
<td>Ohio</td>
<td>704,204</td>
<td>1,232</td>
<td>&lt;1</td>
</tr>
<tr>
<td>Iowa</td>
<td>1,000,679</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Michigan</td>
<td>1,021,867</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

\(^a\)Acres include swamp land and internal improvement land grants that were added to the original school trust land grant of 2.9 million acres.

\(^b\)Acres include swamp land grant.

SOURCE: Office of Legislative Auditor telephone surveys and interviews, July-August 1997; and various annual reports from other states on file in the Office of the Legislative Auditor.

Minnesota still has more school trust land than most neighboring states.
Mining, land sales, and timber sales each accounted for about one-third of income in 1997. An average of $3.4 million per year. Mining activities and land sales, predominantly the sale of lakeshore lots, accounted for the majority of deposits into the Permanent School Fund, with the remainder coming from forestry management activities, primarily timber sales.

There was considerable variation in the source of revenues deposited in the PSF between 1986 and 1997. Mining rents and royalties have provided the most stable source of revenue to the PSF, generating an average of $1.4 million in revenues each year. Net revenues from forestry management activities, including timber sales and land leases, increased from zero in 1991 and preceding years to nearly $1.7 million in 1997. Trust land sales, most notably the sale of lakeshore lots in the late 1980s and early 1990s, represented an increasing revenue stream for the PSF beginning in 1988.

Revenues from mining, land sales, and forestry management activities added $4.8 million and $4.4 million to the Permanent School Fund principal in 1996 and 1997 respectively. These revenues were nearly evenly divided between mining, land sales, and forestry management activities, with each accounting for about one-third of all revenues, as illustrated in Figure 1.5.

The market value of the PSF principal was about $437 million as of June 30, 1997. Over the past 12 years, the distribution to school districts has been between $29 million and $36 million each school year. During the 1995-96 school year, nearly $31 million was distributed to schools, comprising less than one percent of all state revenues to K-12 schools.
This chapter has shown that the federal government’s grant of land to Minnesota for the use of schools and the state’s acceptance of the grant created a real, enforceable trust. The trust consists of both the school land and the Permanent School Fund principal arising from the proceeds of this land. When the State of Minnesota accepted the terms and conditions of the federal land grant, it accepted the position of trustee for public schools in Minnesota. The trustee relationship extends to the Minnesota Legislature, which has delegated responsibilities to the Department of Natural Resources for managing the trust land and the State Board of Investment for investing the assets of the Permanent School Fund.

According to our research, the trust status of the federal grant lands imposes obligations and constraints on how the state may manage school trust land that would not apply if the state held the land outright. The same fiduciary principles that govern the administration of private trusts apply to trustees of school trust land and the Permanent School Fund principal. Case law emphasizes that the trustee’s primary responsibilities are to the trust, not to other state goals, policies, or considerations.

The Minnesota Legislature, DNR, SBI, and other trustees manage the school trust land and PSF in the interest of the current and future beneficiaries. According to our understanding, the trustees should not sacrifice the economic interests of the trust beneficiaries by using trust assets to serve other purposes. The trust concept that applies to grant land establishes a recognition of the cost of withdrawing the land from income production. While granted land can be used for any public purpose, if such use decreases income to the PSF principal, then methods should be sought to compensate the trust. Chapter 2 analyzes how DNR has managed the school trust land in light of the above trust principles.
The Minnesota Legislature has delegated responsibility for managing most state-owned lands to the Department of Natural Resources (DNR). In 1997, DNR managed a total of 5.4 million acres of land in state forests and parks, wildlife areas, scientific and natural areas, state trails, and public water accesses. A significant portion of this land, 2.5 million acres or 46 percent, was school trust land. The department also administered over 12 million acres of mineral rights in 1997, of which 3.4 million acres or 28 percent was school trust land.

Our evaluation focused primarily on DNR’s role as a trustee responsible for managing school trust land. We asked the following questions:

- How has DNR managed school trust land, including forest and mineral resources, lakeshore and other leases, and land sales?
- How does DNR determine its forestry management costs? Are the assumptions used to determine forestry management costs reasonable and appropriate?
- How do timber sales from trust land compare with those from other state-owned land?
- How does DNR reimburse the Permanent School Fund for the use of school trust land for purposes that do not produce revenue? What options are available for compensating the trust?

To answer these questions, we used the Division of Forestry’s inventory of forest land to determine the nature and estimate the value of timber on commercial forest trust land. We also used the timber sales database to examine timber sales on trust land. We talked with DNR staff about trust land, forestry, minerals, and other management policies and practices, as well as forestry management costs.

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1 Minn. Stat. §84.027, subd. 2.
POLICY OVERVIEW

While common law fiduciary obligations apply to DNR in exercising its management responsibilities for school trust land, the department must also comply with state law. Our review of DNR policies shows that:

- DNR applies the same broad natural resource management policies contained in state law to all types of state-owned land, including school trust land. Consequently, some trust land is managed to secure a maximum long-term economic return, while other trust land is managed for natural resource purposes that do not generate revenues.

Laws governing management of state forests, minerals, wildlife, state parks, and other resources generally apply to all state-owned land, including school trust land. For example, state law defines state forests as “all land and waters owned by the state within state forests, including all lands set apart under the Constitution.” The department conducts annual timber sales on “all state lands,” including school trust land. Similarly, state laws authorizing mineral leasing activities apply to “any lands owned by the state, including trust fund lands,” or “land belonging to the state or lands in minerals of which the state has an interest, in trust or otherwise.” The Commissioner of DNR is authorized to “establish, develop, maintain, and operate recreational areas [such as wildlife management areas] . . . on any state-owned land under the commissioner’s jurisdiction.”

School trust land is managed in accordance with the management plans for the DNR unit in which it is situated. In most cases, the plans are consistent with the statutory goal of securing the maximum long-term economic return from trust land consistent with sound environmental and natural resource conservation principles.

In other situations, natural resource management considerations have the potential to restrict or prohibit economic activities on trust land. By law, some DNR units manage land, including trust land, to preserve and protect unique characteristics or to provide public recreational and educational opportunities. However, these goals do not emphasize an economic return to the trust.

DNR distinguishes between school trust land and other state-owned land when state law contains specific procedures to exchange school trust land, separate income for deposit into the Permanent School Fund, determine forestry management costs for the trust land, or appraise, lease, and sell trust land. We also found that:

2 Minn. Stat. §89.001, subd. 6.
3 Minn. Stat. §90.041, subd. 1.
4 Minn. Stat. §§93.25 and 93.283, subd. 3.
5 Minn. Stat. §84.029.
6 Minn. Stat. §§16A.125, 92.28, 93.07, and 94.341 to 94.347.
In some instances, DNR applies more rigorous standards for revenue generation on trust land than other DNR-managed land.

For example, DNR requires cash returns for the use of trust land and excludes “payment-in-kind” arrangements on trust land that are allowed on other land types. It also requires cash payments for “reciprocal access” agreements which are used with other units of government for trails and right-of-way leases on trust land.

The remainder of this chapter examines DNR’s management of school trust land in forestry, minerals, state parks, and other management units. It estimates the amount of trust land that does not produce revenue and discusses options for compensating the trust for the use of this land.

FORESTRY MANAGEMENT

The Department of Natural Resources’ Division of Forestry manages almost all (about 2.4 of the 2.5 million acres) school trust land. Timber sales is one of the largest sources of revenue from trust land, with about $5.2 million in revenues in 1997. The Division of Forestry is allowed to charge costs to the trust for its management of forest land; it charged the trust about $4.4 million in 1997. In this section we discuss the characteristics of the trust forest land, DNR’s management costs for trust land, the likely value and returns from timber management on trust land, and the proportion of timber sales from trust land.

Characteristics of School Trust Forest Land

The federal government gave school trust land to the state at different times for a variety of purposes. In addition to the original school land grant, Minnesota received internal improvement land grants to foster railroad and other economic development, and lands categorized as swamp land. Not all school trust land is of equal value or has an equal capacity to generate revenue for the trust. In this section, we describe the characteristics of school trust forest land and estimate its capacity to generate revenue.

DNR’s Bureau of Real Estate Management maintains records on the ownership and administration of over 2.5 million acres of trust land, but the data are of limited value in describing the land’s current and potential uses. However, the Division of Forestry maintains a database, the Cooperative Stand Assessment (CSA) inventory, that does capture information on most (2.2 million acres) of the trust fund land.

The CSA inventory categorizes land by four major types: commercial forest, non-forest, non-stocked forest, and unproductive forest. The inventory also contains the timber harvest status of the lands, such as whether and under what circumstances timber harvesting is allowed.

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7 The Division of Forestry also administers about 93,000 acres of trust land in the Boundary Waters Canoe Area Wilderness that are not included in the CSA inventory.
The major source of revenue on DNR-managed trust land is timber sales. In examining the inventory for trust land we found that:

- More than 30 percent of school trust forest land is unlikely to generate timber revenue.

As Table 2.1 shows, commercial forest makes up about 68 percent (1.5 million acres) of all trust land in the CSA inventory. About 98 percent of the trust land classified as commercial forest is available for timber harvest. The other 2 percent of commercial forest trust land (about 29,000 acres) is unavailable to harvest for forest policy reasons (for example, it might be old growth forest), or because it is restricted by county, state, or federal laws or ordinances (for example, shoreline restrictions). It is possible that additional lands might become restricted as the result of the planning process now being undertaken by the Forest Resources Council, which is developing guidelines that address riparian, soil productivity, cultural/historic, and site specific wildlife habitat concerns.

Table 2.1: Trust Land by Forest Type and Timber Harvest Status, 1997

<table>
<thead>
<tr>
<th>Forest Type</th>
<th>Trust Land Acres Available</th>
<th>Trust Land Acres Unavailable</th>
<th>Total</th>
<th>Percent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>For Timber Harvest</td>
<td>For Timber Harvest</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commercial Forest</td>
<td>1,491,117</td>
<td>29,175</td>
<td>1,520,292</td>
<td>68.0%</td>
</tr>
<tr>
<td>Non-Forest</td>
<td>11,288</td>
<td>956</td>
<td>12,244</td>
<td>5</td>
</tr>
<tr>
<td>Non-Stocked Forest</td>
<td>272,417</td>
<td>1,891</td>
<td>274,308</td>
<td>12.3</td>
</tr>
<tr>
<td>Unproductive</td>
<td>415,090</td>
<td>10,999</td>
<td>426,089</td>
<td>19.0</td>
</tr>
<tr>
<td>Undecided</td>
<td>4,189</td>
<td>62</td>
<td>4,251</td>
<td>.2</td>
</tr>
<tr>
<td>Total</td>
<td>2,194,101</td>
<td>43,083</td>
<td>2,237,184</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

SOURCE: Office of the Legislative Auditor analysis of Department of Natural Resources Cooperative Stand Assessment database.

An additional 426,000 acres (19 percent) of trust land are unproductive and are unlikely to yield commercially viable timber harvests. Much of this land is low lying, inaccessible, and swampy. Another 274,000 acres (12.3 percent) of trust land are categorized as non-stocked forest lands. Very little of the non-stocked land will produce an economically productive timber harvest. The non-stocked commercial forest type includes a category of “cutover area,” some portion of which will eventually regenerate. DNR officials told us that perhaps 10 percent of the non-stocked forest lands could eventually yield a commercial timber harvest. In addition, about 12,000 acres are on non-forest land, such as water, marsh, or muskeg cover types. A small portion of trust land (about 700 acres) is used for agricultural, industrial, or recreational purposes and is not expected to produce timber sales.

---

8 The Legislature established the Forest Resources Council in 1995 to serve as a forum to discuss forest resources issues and provide forest management recommendations to the Governor and to federal, state, county, and local governments. Minn. Stat. §89A.
With DNR’s assistance, we categorized the productivity of the 1.5 million acres of commercial forest trust land that are available for timber harvest. We used a site index for each timber species. The site index is a common indicator of site quality and potential timber volume that is based on tree height and age. DNR’s CSA Forestry Manual distinguishes between “excellent/good” timber sites and “medium/poor” timber sites. Table 2.2 shows that 65 percent of the commercial forest trust land available for harvest is in the “excellent/good” category.

In summary, although the Division of Forestry administers the majority of trust land, only about 1.5 million acres are managed as commercial forest land. About two-thirds of the 1.5 million acres are excellent/good timber producing land. About 30 percent of forestry-administered land is unlikely to generate timber revenue because it is unsuitable for timber production or unavailable for timber harvest for policy reasons.

### Table 2.2: Acres of Commercial Forest by Cover Type and Site Productivity

<table>
<thead>
<tr>
<th>Cover Type</th>
<th>Site Productivity for Trust Land Available for Harvest</th>
<th>Total Acres</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Medium/Poor</td>
<td>Excellent/Good</td>
</tr>
<tr>
<td>Ash</td>
<td>38,599</td>
<td>22,370</td>
</tr>
<tr>
<td>Aspen</td>
<td>67,314</td>
<td>403,613</td>
</tr>
<tr>
<td>Balm of Gilead</td>
<td>9,039</td>
<td>13,223</td>
</tr>
<tr>
<td>Balsam Fir</td>
<td>22,691</td>
<td>51,683</td>
</tr>
<tr>
<td>Birch</td>
<td>3,561</td>
<td>53,452</td>
</tr>
<tr>
<td>Black Spruce, Upland</td>
<td>5,328</td>
<td>4,764</td>
</tr>
<tr>
<td>Black Spruce, Lowland</td>
<td>142,133</td>
<td>207,239</td>
</tr>
<tr>
<td>Central Hardwoods</td>
<td>0</td>
<td>458</td>
</tr>
<tr>
<td>Cottonwoods</td>
<td>5</td>
<td>9</td>
</tr>
<tr>
<td>Jack Pine</td>
<td>2,496</td>
<td>37,008</td>
</tr>
<tr>
<td>Lowland Hardwoods</td>
<td>6,685</td>
<td>11,401</td>
</tr>
<tr>
<td>N. White Cedar</td>
<td>80,774</td>
<td>15,105</td>
</tr>
<tr>
<td>Northern Hardwoods</td>
<td>22,509</td>
<td>15,227</td>
</tr>
<tr>
<td>Norway Pine</td>
<td>1,327</td>
<td>46,534</td>
</tr>
<tr>
<td>Oak</td>
<td>4,050</td>
<td>11,811</td>
</tr>
<tr>
<td>Scotch Pine</td>
<td>0</td>
<td>29</td>
</tr>
<tr>
<td>Tamarack</td>
<td>114,242</td>
<td>40,078</td>
</tr>
<tr>
<td>Unknown Code</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Walnut</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>White Pine</td>
<td>3,211</td>
<td>1,758</td>
</tr>
<tr>
<td>White Spruce</td>
<td>3,888</td>
<td>27,466</td>
</tr>
<tr>
<td>Willow</td>
<td>20</td>
<td>0</td>
</tr>
<tr>
<td>Total Acres</td>
<td>527,878</td>
<td>963,239</td>
</tr>
<tr>
<td>Percent of Total</td>
<td>35%</td>
<td>65%</td>
</tr>
</tbody>
</table>

SOURCE: Department of Natural Resources, Division of Forestry.

---


Forestry Management Revenues and Costs

The Minnesota Constitution allows DNR to charge its costs of managing trust forest resources against the gross revenue produced from the trust land it manages. In this section we examine how DNR determines its trust land forestry management revenues and costs.

Historically, expenses incurred for the management of school trust forest land were paid from the General Fund. Beginning in 1953, however, the Legislature allowed forestry management costs to be subtracted from the revenues generated from school trust forest land. Since 1982, all revenues from school trust forest land are placed in a special account, the Forest Suspense Account. The costs of managing school trust forest land are paid out of that account to the General Fund, and the remaining balance is transferred to the Permanent School Fund. Figure 2.1 shows forest management revenues and costs, and the net income deposited into the PSF from forest management activities. We found that:

DNR charges forestry management costs to the trust.

Forestry management costs exceeded revenues for many years.

Figure 2.1: Forestry Management Revenues, Costs, and Deposits to the PSF, 1986-97

![Chart showing forestry management revenues, costs, and deposits from 1986 to 1997]

SOURCE: Department of Natural Resources, Division of Forestry, Trust Fund Transfer Certification Reports, 1986-97.

11 Minn. Const., art. XI, sec. 11. The Constitution provides that trust lands “may be set aside as state school forests” and that “the Legislature may also provide for their management on forestry principles.” The Constitution also provides that the net revenues shall be used for the purposes for which the lands were granted to the state. [Emphasis added.]

12 Minn. Laws (1953), ch. 741, sec. 60. Between 1953 and 1982, the reimbursement of forestry management costs from trust revenues was limited to $500,000 a year.
From 1983 until 1992, management costs for school trust forest land exceeded revenues earned from that land. As a result, no revenues from forestry management activities on trust land were deposited into the Permanent School Fund.

In 1982, the Legislature passed the Forest Resource Management Act authorizing payments for forest management costs on trust land out of the Forest Suspense Account up to the amount of gross revenue. According to DNR, prior to 1983 the department did not practice intensive management on trust land which created a large backlog of forest improvement activities (such as reforestation) for subsequent years. Part of the purpose of the Forest Resource Management Act was to reforest the backlog of trust land. DNR estimated in 1983 that, due to investment in forest improvements on trust land, net income to the trust would be limited until 1998. As Figure 2.1 shows, school trust forest land revenues have exceeded DNR forest management costs since 1992.

As Table 2.3 shows, income from timber sales represents the predominant source of revenue (76 to 85 percent) to the Forest Suspense Account. Other revenues deposited into the suspense account include: state campground fees, sand and gravel lease fees, 50 percent of lakeshore lease payments, and other lease payments.

There is some question about whether revenues from sand and gravel leases on trust land should be used to pay forestry management costs. According to DNR officials, sand and gravel revenues are included in the Forest Suspense Account for “historical reasons.” Legally, sand and gravel can be sold and are not mineral rights subject to the reservation of mineral rights for the state. Based on this interpretation, DNR considers the removal of sand and gravel a land-related use and its management a forestry management activity. Statutes are in conflict about whether the removal of sand and gravel should be considered an extractive use (and, therefore, not part of the Forest Suspense Account revenues) or a land-related use that might be considered a part of forestry activities.

There is some rationale for including the sand and gravel revenues in the Forest Suspense Account: Division of Forestry personnel inspect the lease sites to ensure compliance with the lease terms and conditions, although the leases are negotiated and administered by DNR’s Bureau of Real Estate Management. Staff from the Division of Minerals also assist with the planning and management of sand and gravel leases on trust land. Given the ambiguity of statutes, DNR has chosen to consider the costs of managing sand and gravel leases to be forestry-related costs.

By law, DNR can charge forestry costs to the Forest Suspense Account in five different areas: protection, improvement, administration, management of state forest trust land, and construction and improvement of forest roads. DNR uses a

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13 Minn. Laws (1982), ch. 511, sec. 3, subd. 2, and sec. 11.
15 Minn. Stat. §16A.25, subd. 5.
### Table 2.3: Forest Suspense Account Revenues, Costs, and Deposits to the Permanent School Fund, 1986-97 (in thousands)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Timber</td>
<td>$2,146</td>
<td>$2,151</td>
<td>$1,929</td>
<td>$2,354</td>
<td>$2,433</td>
<td>$2,773</td>
<td>$3,236</td>
<td>$3,200</td>
<td>$4,000</td>
<td>$3,809</td>
<td>$4,768</td>
<td>$5,185</td>
</tr>
<tr>
<td>Campgrounds</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>94</td>
<td>109</td>
<td>125</td>
<td>121</td>
<td>138</td>
<td></td>
</tr>
<tr>
<td>Sand and gravel</td>
<td>64</td>
<td>109</td>
<td>80</td>
<td>77</td>
<td>122</td>
<td>80</td>
<td>154</td>
<td>217</td>
<td>304</td>
<td>243</td>
<td>274</td>
<td>304</td>
</tr>
<tr>
<td>Leases(^a)</td>
<td>324</td>
<td>414</td>
<td>517</td>
<td>896</td>
<td>550</td>
<td>492</td>
<td>550</td>
<td>481</td>
<td>419</td>
<td>419</td>
<td>435</td>
<td>467</td>
</tr>
<tr>
<td><strong>Total Revenues</strong></td>
<td>$2,534</td>
<td>$2,675</td>
<td>$2,526</td>
<td>$3,017</td>
<td>$3,345</td>
<td>$3,939</td>
<td>$3,992</td>
<td>$4,832</td>
<td>$4,596</td>
<td>$5,599</td>
<td>$6,094</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Costs</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Protection</td>
<td>$231</td>
<td>$511</td>
<td>$676</td>
<td>$794</td>
<td>$653</td>
<td>$579</td>
<td>$507</td>
<td>$528</td>
<td>$443</td>
<td>$496</td>
<td>$644</td>
<td>$758</td>
</tr>
<tr>
<td>Improvement</td>
<td>1,465</td>
<td>1,872</td>
<td>2,121</td>
<td>2,133</td>
<td>723</td>
<td>788</td>
<td>749</td>
<td>1,192</td>
<td>1,199</td>
<td>1,084</td>
<td>929</td>
<td>930</td>
</tr>
<tr>
<td>Administration</td>
<td>551</td>
<td>1,073</td>
<td>924</td>
<td>1,168</td>
<td>895</td>
<td>962</td>
<td>989</td>
<td>580</td>
<td>529</td>
<td>539</td>
<td>573</td>
<td>701</td>
</tr>
<tr>
<td>Management</td>
<td>1,899</td>
<td>1,017</td>
<td>1,043</td>
<td>1,126</td>
<td>1,350</td>
<td>1,419</td>
<td>1,403</td>
<td>1,392</td>
<td>1,319</td>
<td>1,299</td>
<td>1,827</td>
<td>2,048</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>4,146</td>
<td>4,473</td>
<td>4,764</td>
<td>5,221</td>
<td>3,621</td>
<td>3,749</td>
<td>3,648</td>
<td>3,693</td>
<td>3,491</td>
<td>3,417</td>
<td>3,972</td>
<td>4,438</td>
</tr>
<tr>
<td>Other Costs(^b)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>-67</td>
<td>-9</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total Costs</strong></td>
<td>$4,146</td>
<td>$4,473</td>
<td>$4,764</td>
<td>$5,221</td>
<td>$3,621</td>
<td>$3,749</td>
<td>$3,647</td>
<td>$3,693</td>
<td>$3,424</td>
<td>$3,408</td>
<td>$3,972</td>
<td>$4,438</td>
</tr>
<tr>
<td>Deposits to PSF Principal (^c)</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$292</td>
<td>$299</td>
<td>$1,409</td>
<td>$1,188</td>
<td>$1,639</td>
<td>$1,694</td>
</tr>
</tbody>
</table>

**Note:** Numbers may not sum due to rounding.

\(^a\) Lease revenues include 50 percent of the lakeshore lease revenues since 1988 and revenues from other land leases.

\(^b\) Costs not eligible for reimbursement.

\(^c\) For fiscal years 1996 and 1997, deposits to the Permanent School Fund were increased to include revenues deposited in the Forest Suspense Account that were not eligible for the account.

**SOURCE:** Department of Natural Resources, Division of Forestry, Trust Fund Transfer Certification Reports, fiscal years 1986 to 1997.
number of methods to allocate a portion of the forestry division’s costs to the trust. Each year the department prepares a report that summarizes the allocation of costs to the five allowed areas and submits the costs to the Department of Finance, which approves the costs before they are charged against the Forest Suspense Account.

We examined the cost allocation system that the Division of Forestry uses to calculate the costs charged to the Forest Suspense Account, and we conclude that:

- **Overall, the methods used to allocate forestry management costs to trust land are reasonable, but DNR should consider improving the way it allocates costs for fire protection and recreation management activities.**

The major DNR costs are those associated with timber sales and reforestation. These costs are allocated based on the percentage of total timber sale revenues that are generated from trust land. We think using the trust’s proportion of timber sale revenues is a reasonable way to allocate the actual forest management and improvement costs incurred. However, improvements that DNR might consider in allocating costs for fire protection and recreation management are discussed below.

DNR is responsible for fire protection (fire prevention and suppression) on over 5 million acres of state-owned lands (including school trust lands) and more than 17 million acres of other public and private lands. The costs of fire protection are allocated to the trust on a per acre basis, although private landowners and local governments are not charged for fire costs. DNR’s cost allocation method apportions a full 10 percent of its total fire protection costs to the trust land’s Forestry Suspense Account. This amounted to about $758,000 in fiscal year 1997. This apportionment is based on the fact that school trust land represents about 10 percent of the total land for which DNR provides fire protection services. However, about 7 percent of the fires over the last 10 years occurred on state-owned lands and the rest were on other lands. Since about half of state-owned lands are school trust lands, it could be surmised that roughly 3.5 percent of fires on DNR-protected land occurred on school trust land. Some fire costs are clearly associated with the number of fires, however, DNR believes that the costs of fire suppression and prevention on trust land may be greater than the number of fires would suggest.

DNR has chosen a reasonable method of apportioning fire protection costs, but we think that a per acre allocation for fire protection may overstate the actual fire protection costs incurred on trust lands. We recommend that:

- **DNR should reexamine its cost allocation for fire protection to determine if a different method could more closely reflect the actual cost of protecting trust acres.**

---

16 Since much school trust land acreage is concentrated in swampy areas, the percent of fires on trust land is likely to be even less than this estimate.
DNR also charges recreation management costs (mostly related to campground activities) to the trust’s Forest Suspense Account. Recreation management costs charged to the trust have exceeded revenues generated from campgrounds on trust lands for fiscal years 1992-97. In 1997, $264,000 in costs were charged to the trust compared to $138,000 in revenues. DNR has interpreted statutes to require it to include recreation management revenues and costs as part of “forestry management.” However, we are uncertain whether the Legislature wanted the trust to subsidize the General Fund by over $100,000 per year for recreation management. We recommend that:

- The Legislature and DNR should consider whether costs for recreation management should continue to be paid from trust revenues.

Recreation management costs could be considered an expenditure that benefits the public as a whole and thus an appropriate General Fund expense. Alternately, the Legislature and DNR may want to consider whether the amount of forestry management recreation costs charged to the trust should exceed the revenues from recreation activities (campground fees).

DNR charges the trust for its costs of conducting forest management activities, primarily timber sales, based on the proportion of timber sales revenue generated from trust lands. Costs for forest improvement activities (such as reforestation) also are charged to the trust based on the trust’s proportion of total timber sales revenue. In our opinion, using the school trust’s proportion of total timber sales revenue is probably a reasonable approximation of the actual forest improvement management costs incurred.

The administrative costs paid by the trust are based on the proportion of costs from “other categories” (such as fiscal/personnel management and clerical support) expended from the General Fund by the forestry division. To the extent that the department has over- or under-estimated the trust’s share of other cost categories, the administrative charges will not reflect the true costs. In fiscal year 1997, the trust paid $702,000 of the Division of Forestry’s administrative costs.

In 1995, the Legislature expanded the allowable categories of costs that could be recovered from the trust to include forest road construction and improvement. DNR determines the trust land acres within 1/4 mile of a forest road as a proportion of the total acres served by forest roads and multiplies that percentage times the total state forest road costs. In fiscal year 1997, the department determined that the trust’s share of road construction and improvement was about 5.7 percent of the total or $51,000. We believe the department’s allocation basis for road costs is reasonable.

### The Value of and Return on Asset Value for Timber on School Trust Land

The largest sources of revenue from school trust land are mining royalties, land sales, and timber sales. Timber sales on school trust land managed by DNR are

one of the largest sources of trust land revenues because timber, unlike minerals payments and land sales, can continue to produce revenue in perpetuity. As a result, we looked at how much income timber was likely to contribute to the trust.

With DNR’s assistance, we estimated the net income likely to be produced from trust timber land over the next 40 years. A relatively simple timber income model was produced with the assistance of DNR and represents the best judgments of a number of experts on Minnesota forestry. Nonetheless, like any model, it relies on a number of simplifying assumptions and cannot take into account many potential external factors. The model projects the amount of timber harvested from trust land and the harvest value after DNR’s management costs. We modeled several different scenarios to obtain a range for the results. We found that:

- If DNR forestry management costs do not grow faster than inflation, the estimated accumulated net income from timber on trust forest land over the next 40 years will be between $186 million and $305 million, with a midpoint estimate of $245 million in 1998 dollars.

These estimates are sensitive to assumptions about the level of DNR forestry management costs. For example, if DNR costs increase at a rate of 1 percent more than inflation, the estimated present value of net timber income over the 40-year period decreases to between $146 million and $265 million with a midpoint of $205 million. If DNR forestry costs were to increase at a rate of 2 percent more than the inflation rate over the 40-year period, the estimated present value of net timber income would decline to between $94 million and $213 million with a midpoint of $153 million.

---

18 DNR estimated the average annual growth and growing stock volume of timber on trust land by species from 1990 federal forest timber inventory data. The resulting timber growth estimates were applied to a base volume species table derived from DNR’s Cooperative Stand Assessment (CSA) inventory. In essence, the amount of timber available for each species of trees was increased each year between 1998 and 2037 to account for growth and then adjusted downward to account for projected harvest. Changes were made in assumptions about the harvest of aspen acreage on CSA trust land in 2007, 2017, and 2027 based on the growing stock volume composition available on trust land.

The projected harvest of trust land timber was estimated as a simple percentage of the amount of total timber harvest in the state. About 20 percent of Minnesota’s total timber harvest has historically come from state land and about 56 percent of that timber is harvested from trust lands. DNR officials expect these average percentages to continue. The total statewide timber harvest was based on current projections from DNR timber marketing officials and are in line with recent trends. Total statewide harvest is estimated to be 3.82 million cords in 1998 and 2000, 4.1 million cords in 2000, 4.34 million cords in 2001-09, 4.34 million cords in 2010-25, and 4.7 million cords in 2026-2037. These estimates take into account currently known production capacity increases and estimates of technology effects as well as the species-age composition of Minnesota timber resources. The estimates are in the middle range of harvest scenarios evaluated by the forest Generic Environmental Impact Statement. Also see Minnesota Forest Resources, (St. Paul: Minnesota Department of Natural Resources, September 1997).

The value of the timber harvest was based on current timber stumpage prices by species, advanced into the future based on the 30 year average annual percentage increase by species. The value of the projected timber harvest on trust land by species was accumulated and discounted at a 7.5 percent rate to put the values in 1998 dollars.

19 Revenues were estimated based on increases in prices over the last 30 years plus/minus one standard deviation.
Figure 2.2 presents three scenarios of the value of timber income from trust land. Because income is expected to grow more rapidly than costs, the net present value of timber revenues will be greater several years from now. In other words, the present value of trust timber income is dependent on DNR keeping its increase in costs less than the growth in revenues.

DNR informally has estimated the average value of trust land at between $100 and $250 per acre. Estimates of trust land value vary with its characteristics: upland timber acres in northern Minnesota are generally valued at about $250 per acre; land in the Boundary Waters Canoe Area Wilderness is estimated to be worth between $300-350 per acre; and some swampy land in Koochiching County may be worth as little as $50-75 per acre. A more exact valuation of trust land depends on land appraisals that DNR has not conducted. A very rough estimate of forest trust land value is probably in the range of $300 million. This estimate is similar to the value derived above from looking at timber harvest value.

As discussed in the previous sections, the trust fund has not generated significant net earnings from timber sales on trust land. The net return on asset value from timber sales has been less than 1 percent in recent years, and for many years was zero.

---

**Figure 2.2: Estimated Value of Trust Land Timber Harvest, 1998-2037**

Dollars (in millions)

- Inflation
- Inflation + 1%
- Inflation + 2%

SOURCE: Office of the Legislative Auditor analysis of Department of Natural Resources model results.

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20 DNR officials note that such appraisals would be expensive to conduct.
Timber Sales

State laws and policies for timber sales generally apply equally to both school trust and other state-owned land. 21 The Division of Forestry is responsible for administering the sale of timber from state-owned land, including: identifying tracts to harvest, estimating the appraised value of timber to be sold, selling timber, and supervising the timber harvest. 22 DNR’s timber sale procedures are contained in state law and described in DNR timber sale manuals. 23

We examined what proportion of timber sale activity is generated from school trust land and how timber sale activities on trust land compared with similar activity on other state-owned land. 24 We analyzed timber sales data from fiscal years 1986 to 1996, reviewed statutes and policies, and interviewed forestry management staff.

Our analysis is based on timber sale activity by type of land ownership (school trust and other state-owned land), referred to as “land type.” During the timber appraisal process, a forester determines the volume and value of timber on each 40-acre tract. 25 The forester also estimates the percentage of the total sale value within each 40-acre tract assigned to the owners of the tract, such as school or University trust. The estimated percentage value of the timber for each land type depends on how much of the total sale value on a specific tract comes from each land type. Our analysis of timber sales data divides timber sale permits into three categories based on land type: (1) a “trust” timber sale involves only school trust land; (2) a “nontrust” timber sale involves other state-owned land, but no school trust land; and (3) a “partial” trust timber sale involves a combination of school trust and other state-owned land.

Timber Sales Activity

In 1996, DNR accounted for about 44 percent of all timber (excluding fuel wood) sold by public agencies in Minnesota. 26 School trust land timber sales accounted for more than half of that volume, making the school trust land the single largest source of timber from Minnesota public lands.

The volume of state-owned timber sold in 1996 represented a 100 percent increase over 1986. Although it fluctuated from year to year, the volume of state-owned

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21 Minn. Stat. §89.001, subd. 6.
24 This evaluation did not focus on the overall management of the timber sale program or timber appraisal procedures.
25 Minn. Stat. §90.061, subd. 4. Timber appraisers use land ownership information from the Bureau of Land Management, along with aerial photographs and maps, to determine the land ownership for each tract.
26 Minnesota Department of Natural Resources, Division of Forestry, Public Stumpage Price Review (St. Paul, 1996).
timber sold increased from 377,000 cords in 1986 to over 757,000 cords in 1996. The volume sold peaked in 1989, when approximately 814,200 cords were sold.

Minnesota has benefited from a national increase in timber prices over the past 12 years. Although timberland in Minnesota may be isolated, the market for timber resources has become global. An index of stumpage prices for common species in Minnesota increased over 300 percent between 1985 and 1996; after adjusting for inflation, the index value increased 193 percent.

We analyzed Minnesota timber sale activities based on the volume and value of timber sold, and the number of timber sale permits, and found:

- **Timber sales on school trust land accounted for one half of the total volume and value of state-owned timber sold in Minnesota between 1986 and 1996.**

The volume of state-owned timber sold from school trust land represented an average of 53 percent of total timber volume in cords sold annually between 1986 and 1996. Figure 2.3 shows that timber sales on school trust land represented the largest share of timber volume (in cords) sold every year except 1994. During that same time period, the volume of timber sold from nontrust land averaged 39 percent of all timber sold while the volume from partial trust land types averaged 8 percent of the volume sold.

We found a similar pattern in the dollar value of timber sales by land type. Timber sales on school trust land accounted for an average of 54 percent of the total value of timber sold between 1986 and 1996. As Figure 2.4 shows, timber sales from trust land generated the greatest share of total sale value for every year examined. Nontrust land timber sales averaged 39 percent of total timber sales and partial trust land timber sales averaged 7 percent of the value of timber sold, during the same period. Timber sale values reflect the actual value of timber sold in a fiscal year. Sale values do not reflect timber sale revenues because a timber buyer has from 2 to 5 years to harvest the timber purchased. Revenues are recognized when the timber is harvested. Therefore, revenues for a specific fiscal year are generated from earlier timber sales.

**Timber Sale Methods**

DNR uses three primary methods to sell timber from state-owned lands: regular auction, intermediate auction, and informal sale. Prior to 1996, timber sale

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27 We calculated the volume of timber sold using the DNR’s timber sales database. The DNR converted all timber volumes to cords if they were not already measured in cords. The conversion rate for board feet was 500 board feet per cord for products measured in board feet. Other conversion rates were used for products measured by the piece, in linear feet, or in other units.

28 Sources we interviewed told us that timber prices in Minnesota are influenced by conditions that affect the worldwide markets for paper, lumber, and other forest products. For instance, a reduction in the supply of timber from the Pacific Northwest has contributed to increased demand and higher prices for timber resources in Minnesota.

**Figure 2.3: Volume of Timber Sold by Land Type, 1986-96**

Cords (in thousands)

SOURCE: Office of the Legislative Auditor analysis of Department of Natural Resources timber sale data.

**Figure 2.4: Value of Timber Sold by Land Type, 1986-96**

Dollars (in millions)

SOURCE: Office of the Legislative Auditor analysis of Department of Natural Resources timber sale data.
methods were defined using dollar values. In 1996, the state started using volume limits in response to the rapid timber price increases in the past decade. The timber sale methods are distinguished by the volume of timber that can be sold in one tract, as summarized below.  

1. Under the regular auction method, stands of timber not exceeding 6,000 cords are sold to the highest bidder at public auction. The minimum price is the appraised value. Regular auctions are the least restrictive method of selling timber. According to DNR, regular auctions should provide the truest indication of stumpage value because logging operations of all sizes are able to bid.  

2. The intermediate auction method, which is used for sales not exceeding 3,000 cords, allows DNR to auction smaller tracts to small businesses and independent timber operators. Businesses with more than 20 employees are excluded from bidding. Intermediate auctions enable independent timber operators to compete more successfully in the auction process and reduce their dependence on informal permits.  

3. The informal method can be used for any sale not exceeding 500 cords. This method allows DNR to sell timber in small tracts without public auction. Under this method timber is sold at the appraised price.  

Figure 2.5 highlights other distinguishing characteristics of each sale method. Auctions are more effective at generating revenue than informal sale methods. Auctions allow for competition between or among potential buyers, and therefore, are more likely to result in a competitive price. An earlier study by the Office of the Legislative Auditor found that between 1955 and 1980 the state had sold approximately 67 percent of its timber by volume using the informal method and 33 percent using the auction method. Over the past 11 years, DNR has changed its timber sale methods. Our analysis of state timber sales shows that:  

- Between 1986 and 1997, DNR sold the majority of state timber through regular and intermediate auctions.  

Figure 2.6 shows that the volume (in cords) of state-owned timber sold by regular and intermediate auctions increased from about 45 percent in 1986 to 97 percent
in 1996. During the same period, the value (in dollars) of timber sold by auction increased from about 50 percent to 98 percent. DNR increased its use of auctions for timber sales on both trust and other state-owned land.

Since 1986, DNR has increased its use of auctions for timber sales.
Bid Method

The state may use two bid methods to conduct auctions: oral and sealed bids. Either bid method may be used with regular and intermediate auctions. Whether the auction is by sealed bid or oral bid, DNR is required to sell timber at not less than the appraised value, also called the minimum allowable price. The appraised value is the starting point for bidding in oral auctions.

Research demonstrates that sealed bid auctions generate higher sale prices than oral bid auctions. According to a national study on U.S. Forest Service timber sales, sealed bid auctions were “significantly related to higher bid premiums.” A “bid premium” is the amount the winning bidder paid over the appraised price. In sealed bid sales, individual bidders assess the likelihood of competing bidders and determine their bid accordingly. With a sealed bid auction, even if a tract of timber receives only one bid, the bidder does not know this. There is a greater potential that bidders will bid according to what they think the timber is worth rather than basing it on the minimum price, which is the appraised value. In oral auction sales, however, bidders know if anyone else is competing against them. When there is only one bidder, that bidder can win the sale by bidding the appraised price. Our analysis of DNR timber sales data shows that:

- Sealed bid auctions comprised a very small proportion of DNR’s total auctions between 1986 and 1996.

DNR conducted 7,696 regular and intermediate auctions of Minnesota timber between 1986 and 1996. About 98 percent of these auctions were oral bid auctions. Only 116 timber auctions (less than 2 percent) used sealed bids during this time period, and in 1988, 1995 and 1996 no auctions were conducted using sealed bids.

Auctions that sold above the appraised value are a reflection of increased competition. The percentage of oral bid auction sales that sold above the appraised value increased from about 26 percent in 1986 to 72 percent in 1994, before declining to 61 percent in 1996. Between 1986 and 1996, an average of 56 percent of oral bid auctions sold above the appraised value. There is no significant difference in the distribution of oral bid auctions between trust and nontrust land. Of the 116 sealed bid auctions for all land types between 1986 and

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36 Minn. Stat. §§90.101 and 90.191.
38 U.S. GAO, Forest Service, 2. Sealed bid auctions are used almost exclusively for timber sales on the Chippewa and Superior National Forests, according to U.S. Forest Service staff.
39 Gorte, Forest Service Timber, 11
40 We calculated the percentage above the appraised value for each timber sale using the following formula: \((\text{total sale value minus total appraised value}/\text{total appraised value}) \times 100\). Several changes in timber stumpage pricing and appraisal method in the past ten years make it difficult to compare the final sale prices and percentages on a year-to-year basis.
1996, 89 percent sold above the appraised value. The limited number of sealed bid auctions precluded our analysis of sealed bid auctions by land type.

According to DNR staff, the department does not have explicit criteria to determine when to use sealed- versus oral-bid auction procedures. The department has been reluctant to use sealed bids because they are perceived to involve higher administrative costs. To facilitate more competition and possibly receive higher prices for state-owned timber, we suggest that:

- DNR should analyze the costs and benefits of increasing the use of sealed bid auctions.

In 1996, DNR implemented a new method for establishing the list value of timber from which appraised values are determined based on sale-specific conditions. The list value used on auction sales has been determined by taking 67 percent of the volume weighted mean auction sales price for the preceding 12 months for each species and product. This is done to take into account timber markets that can be volatile and state law requiring that timber may not be sold for less than the appraised price. Of the 376 auction timber sales conducted between March 1 and June 30, 1996, 55 percent sold above the appraised value. DNR recently changed its timber stumpage pricing methods for auction sales, changing the bid allowance from 33 percent to 17 percent. 41

We did not evaluate the Division of Forestry’s overall management of Minnesota’s timber resources. We think that a future study of the Division of Forestry may be timely. Such a study could focus on timber management policies and practices, management costs, the timber appraisal process, and stumpage pricing methods. 42

MINERALS MANAGEMENT

The Division of Minerals administered about 3.4 million acres of mineral rights on school trust land, which included about 1 million acres of “severed” mineral rights in 1997. Severed mineral rights occur when the state owns the subsurface rights but not the surface rights to a parcel of land. School trust mineral rights represented 28 percent of the 12.4 million acres of state-owned mineral rights. Most of the school trust land mineral rights are in the northeastern part of the state; 80 percent are located in 8 northeastern counties. 43

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42 The timber appraisal and stumpage pricing methods are important because: (1) DNR is the largest seller of timber in the state; (2) prices established by DNR serve as the minimum price in auction sales; and (3) prices ultimately determine what value will be received for timber sold by DNR.

43 These counties are Koochiching, St. Louis, Itasca, Roseau, Aitkin, Cass, Lake, and Cook.
Minnesota leads the nation in the quantity and value of iron ore produced. 44 Iron ore has dominated Minnesota’s mining activities. In addition to iron ore and taconite leases, DNR’s Division of Minerals administers metallic minerals, peat, and industrial minerals leases. There were no active industrial mineral leases in 1997.

Like other DNR divisions, the minerals division does not distinguish between school trust and other state-owned lands in its management of mineral resources. State law authorizing mineral resource management applies to “any lands owned by the state, including trust fund lands.” 45 Unlike other DNR divisions, however, we found that:

- The Division of Minerals is the only DNR division that explicitly acknowledges its role as a trust agent with a fiduciary responsibility to generate income for the Permanent School Fund in the division’s budget and performance report.

The division’s budget and performance reports specifically state:

The Division of Minerals, as the trust agent for mineral rights and interests of the Permanent School Fund lands[and other lands], manages mineral exploration, mine development, and mine operation to generate income and maintain job growth for the state. As such, it has the fiduciary responsibility to obtain equitable rental and royalty income for the state trust funds through leasing of lands for exploration and mining. Equally important is the division’s stewardship of state lands for future generations. 46 [Emphasis added.]

The Division of Minerals obtains rental and royalty income for school trust and other land by comparing its rental and royalty rates with those provided by other landowners. 47 As the mineral leases are renegotiated, the division analyzes the royalty rates received by private owners of mineral rights. 48 This results in negotiated royalty rates for state-owned iron ore and taconite ore comparable with those received by the private sector. If a mining operation involves a 40-acre section with split land ownership, then the negotiation process requires that the state receive at least the same royalty rate that private owners of mineral rights in that section are paid.

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45 Minn. Stat. §§93.14, 93.15, and 93.25.


47 Other owners of Minnesota’s minerals include the federal government, local government s, mining companies, and other private owners. Private parties hold the bulk of mineral rights in Minnesota. Rents are a flat charge per acre leased. Royalties are a charge per ton of material mined. Minnesota uses a schedule of minimum royalties and an additional royalty which companies offer in competitive sealed bids.

48 This report did not evaluate Minnesota’s mineral leasing procedures or the Division of Minerals performance in administering the mineral leasing process.
Recent Mining Activity

Although Minnesota has a large amount of state-owned mineral rights, only a small percentage of the state-owned or school trust lands are currently leased for mining activities. We found that:

- School trust land accounted for about one-third of all acres of state-owned mineral rights leased and about one-fifth of all revenues from state mineral leases in 1997.

School trust land accounted for about 11,300 acres (35 percent) of the total 31,837 acres of leased state mineral rights in 1997, as shown in Figure 2.7. School trust land accounted for 52 percent of the acres leased for iron ore and taconite mining; 28 percent of the acres leased for metallic minerals explorations; and 35 percent of the acres for peat leases.

![Figure 2.7: Percentage of Acres of Mineral Rights by Lease Category, 1997](image)

NOTE: Percentages shown indicate the percent of land within each lease category.

SOURCE: Department of Natural Resources, Division of Minerals, unpublished data, August 1997.

Of the $7.6 million in total state revenues generated from mineral leasing activities in 1996, $1.6 million, or 22 percent, was deposited in the Permanent School Fund. Revenues from iron ore and taconite leases represented an average of 94 percent of all mineral revenues added to the Permanent School Fund principal between 1986 and 1997.

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49 Minnesota’s mineral leases occurred on school trust, University trust, tax-forfeited, and other DNR-owned land.

50 Seventy-three percent of mineral revenues were deposited in the University trust and the remaining 5 percent were distributed to local units of government pursuant to Minn. Stat. §93.335, subd. 4.
The cost of mineral management on school trust land is financed with a General Fund appropriation. Revenues from state mineral leases on trust land do not finance management costs.

OTHER MANAGEMENT UNITS AND AREAS

DNR’s Divisions of Forestry and Minerals administer operations that are designed to generate revenues. The Divisions of Parks and Recreation and Fish and Wildlife manage land to preserve and protect unique characteristics and provide public recreational and educational opportunities for the enjoyment of the general public. The inclusion of trust land in these areas has the potential to prohibit revenue generating activity on the land. We estimate that:

- In 1997, there were about 150,000 acres of trust land in DNR management units or uses that prohibited the generation of revenue.

School trust land is located in state parks, scientific and natural areas (SNAs), and the Boundary Waters Canoe Area Wilderness (BWCAW), as shown in Table 2.4. In addition, between 85,000 and 95,000 acres of trust land are located in wildlife management areas (WMAs), which may limit the revenue generating potential of the land.

The Minnesota Legislature and DNR recognize the need to compensate the Permanent School Fund when revenues are diminished. In the past, DNR has compensated the trust by purchasing trust land and exchanging trust land for other state-owned land. However, we found that:

- In recent years, DNR has not given a high priority to compensating the trust fund for the use of trust land.

### Table 2.4: School Trust Land in Uses That Prohibit the Generation of Revenue, 1997

<table>
<thead>
<tr>
<th>Use</th>
<th>Estimated Acres</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Parks</td>
<td>5,060</td>
</tr>
<tr>
<td>Peatland Scientific and Natural Areas</td>
<td>51,000</td>
</tr>
<tr>
<td>Boundary Waters Canoe Area Wilderness</td>
<td>93,260</td>
</tr>
<tr>
<td>Estimated Total</td>
<td>149,320</td>
</tr>
</tbody>
</table>

**Sources:** Department of Natural Resources, Divisions of Parks and Recreation, Fish and Wildlife, and Forestry.

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51 Commissioner Joseph N. Alexander to Legislative Auditor Eldon Stoehr, June 17, 1981, letter; Minn. Stat. §84.035, subs. 4 and subd. 9; Minnesota Department of Natural Resources, Recommendations for the Protection of Ecologically Significant Peatlands in Minnesota (St. Paul, 1984), 27-30; and Minnesota Department of Natural Resources, Operational Order 1961: Wildlife Management Areas (St. Paul, June 10, 1983).
DNR does not have any immediate plans to remove the remaining acres of trust land from state parks, SNAs, or other management units. As discussed below, DNR has given priority to acquiring privately-held land in state parks and other management units that is threatened with development. Since school trust lands are already under state control they are not in danger of being developed. In past years, DNR has given higher priority to other private land acquisition projects.

The DNR is faced with a dilemma as it tries to balance its fiduciary responsibilities to the PSF with its natural resource management and conservation responsibilities. Given the choice of using limited capital bonding and land acquisition resources to acquire trust land versus acquiring private inholdings threatened with subdivision and development, the department has chosen to emphasize the latter. In these instances, the department has chosen to emphasize its natural resource responsibilities over its fiduciary responsibilities to the PSF.

The remainder of this section discusses trust land located in SNAs, state parks, the BWCAW, and WMAs. It also reviews DNR’s efforts to compensate the PSF for use of school trust land for purposes other than maximizing long-term economic returns to the trust beneficiaries.

**Scientific and Natural Areas**

Scientific and natural areas (SNAs) are established to protect critical habitats or rare species and natural communities, and to ensure the perpetuation of natural features possessing exceptional scientific and educational value in an undisturbed natural state. Examples of these features include stands of old growth timber, geological and fossil formations, flora or fauna from an earlier period, or habitat supporting a vanishing, rare, endangered or restricted species of plant or animal. SNAs currently encompass about 29,000 acres and do not contain any school trust land. However, the 146,200 acres of peatland SNAs include about 51,000 acres of school trust land, or about 35 percent of the peatland SNAs. This acreage represents 2 percent of all acres of school trust land.

State law requires that the department acquire land before establishing a SNA. A 1984 DNR report recommending protection of ecologically significant peatlands identified school trust land as an area of concern because the area proposed for peatland protection contained trust land. The report stated:

> The DNR goal for management of School Trust Lands is to secure the maximum long-term economic return from the lands consistent with sound natural resource conservation and management principles and specific policy guidance as provided in state law. When economic activities that would provide income to the Permanent School Fund are restricted or prohibited, the DNR’s policy is to compensate the fund for economic value foregone.

52 Minn. Stat. §86A.05, subd. 5.

53 Minn. Stat. §84.033. The law provides that land may be acquired by purchase, lease, or easement.
For these reasons, it became clear that any School Trust Lands within units of peatland protection areas in which economic activities were restricted would require compensation of the Permanent School Fund for the loss of revenue potential. There was nearly unanimous agreement by members of the [Task Force on Peatlands of Special Interest] about this issue.  

Legislation creating peatland SNAs in 1991 specifically stated, “the commissioner shall acquire by exchange or eminent domain the surface interest, including peat, on trust fund lands contained in peatland scientific and natural areas.”  

We found that:

- The DNR has not assigned a high priority to transferring school trust land in peatland scientific and natural areas to a non-trust status.

Although the Legislature directed the commissioner of DNR to acquire the school trust land in these areas in 1991, the agency has not yet taken action on this issue. DNR staff told us that since the Legislature did not set a time frame or appropriate specific funding for the trust land acquisition, the department did not consider it a mandate.

The department has estimated the value of school trust land in peatland SNAs at $3.8 million, an average of about $75 per acre based on county assessor valuations. The SNA program’s 1996 land acquisition priorities included 73,813 acres of land valued at $15.9 million. Actual appropriations for land acquisition from all sources totaled $1.95 million between 1994 and 1997. In its efforts to acquire and preserve pristine natural areas, DNR has used its limited resources to acquire privately-held lands that are in imminent danger of development. School trust land is already under state control and is not in danger of being developed.

In the past, the SNA program has used some of its land acquisition budget to acquire trust land. In 1990, the SNA program acquired 40 acres of trust land valued at $13,000. The program has also initiated some land exchanges. In 1994, the SNA program exchanged 46 acres of trust land valued at $54,000 for other DNR-acquired land to preserve an old growth forest in the Lost Forty SNA. In 1996, 80 acres of school trust land valued at $36,600 were exchanged for 200 acres of state-owned land to preserve a stand of old growth pine in the Kawishiwi Pines SNA.

State Parks

There were about 5,750 acres of school trust land within the statutory boundaries of Minnesota state parks and recreational areas administered by the Divisions of

55 Minn. Stat. §84.035, subds. 4 and subd. 9.
56 According to DNR staff, most of school trust land in peatland SNAs is not of commercial value because it is not readily accessible or close to commercial markets. About 84 percent of this land is located in Koochiching County.
57 Minnesota Department of Natural Resources, Scientific and Natural Areas Acquisition and Betterment documents, January 26, 1996.
Parks and Recreation in 1997. The trust land in state parks comprise 0.2 percent of all the school trust land and 2.4 percent of the 240,000 acres in state park boundaries.

Like other units, DNR’s goals and policies for management of Minnesota’s state park system do not differentiate between school trust land and other state land in parks and recreation areas. Minnesota’s state parks, recreation areas, and waysides were created to conserve “scenery, natural and historical objects and wildlife” and to provide for the general public’s enjoyment of these resources in a manner that will “leave them unimpaired for the enjoyment of future generations.”

As part of Minnesota’s outdoor recreation system, state parks are designed to protect and perpetuate natural areas and to provide recreational and educational opportunities in natural settings consistent with ecological concerns.

The above natural resource management goals and policies limit the potential for revenue generation from school trust lands located in the state parks and recreation system. Some timber may be harvested within state parks. However, when these lands are logged it is to address land management goals other than income generation. The revenues and associated management costs from selected timber harvesting on trust land in state parks are included in timber sale revenues and costs in the Forest Suspense Account for the Division of Forestry. DNR also compensates the trust for the 633 acres of trust land in the Hill-Annex Mine State Park by paying an annual lease fee of $3,000 (or about $5 per acre).

In the 1980s, there were over 10,000 acres of school trust land in state parks. A report by the Office of the Legislative Auditor expressed concern that these trust lands were not generating revenue for trust beneficiaries.

During the late 1980s and early 1990s, DNR addressed this issue by exchanging 5,357 acres of school trust land in state parks valued at $1.2 million for other DNR-acquired land of similar value. The Legislative Commission on Minnesota Resources financed the state park land exchange, which was finalized in 1992. The land exchange program left school trust land in four parks for the following reasons:

1. Nerstrand Big Woods State Park. The 460 acres of trust land in this park contain valuable stands of timber that were appraised at a value in excess of $1 million in 1989. There were no DNR-acquired lands in Rice County with which to exchange the trust land.

2. Savanna Portage State Park. The 3,050 acres of trust land are located in the northern portion of this park. In the late 1980s the department considered changing the park’s boundary to eliminate the trust land from the park. The boundary was not changed.

3. Hill-Annex Mine State Park. In the late 1980s, when the park land exchange program began, this area had not yet been designated as a state park. Given limited resources, and the fact that park designation would

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58 Minn. Stat. §85.011.
59 Minn. Stat. §86A.05, subd. 2.
not preclude mineral lease revenues, it was not included in the exchange program.

4. Itasca State Park. Approximately 613 acres of school trust land in Becker and Itasca counties were exchanged. However, the department was not able to reach an agreement with Clearwater County on the exchange of an additional 1,000 acres valued at approximately $528,000 in 1989.

We found that:

- Since the early 1990s, DNR has added school trust land to state parks without making provisions to compensate the trust by either acquiring the trust land or exchanging the trust land for other state-owned land.

Table 2.5 lists the seven state parks and recreational areas which currently contain trust land. Since 1991, 601 acres of school trust land have been added to three state parks through the creation of new parks, boundary extensions, or survey adjustments. Mining activities are permitted in the Cuyana County Recreation Area and may provide revenue to the trust. DNR staff have estimated the value of school trust land remaining in state parks at between $4 million and $5 million. According to DNR staff,

- The department has no immediate plans to either acquire or exchange school trust land in state parks.

In addition to school trust land, the statutory boundaries of state parks contain approximately 24,000 acres of privately-owned land, called “inholdings.” To prevent uncontrolled development within state park statutory boundaries, the division’s top priority is acquiring private inholdings that are threatened with subdivision and development. While this may be a reasonable strategy in the short run, we think that DNR should make specific plans to compensate the trust for land within state parks over the next 10 years.

**Boundary Waters Canoe Area Wilderness**

The state owns approximately 112,000 acres of the Boundary Waters Canoe Area Wilderness (BWCAW), most of which (93,260 acres) is school trust land. The BWCAW is remote, pristine, and unique. Development in what is now the BWCAW has been restricted to some extent since 1926, when the Secretary of Agriculture declared most of it a roadless area. Federal laws and wilderness regulations and state laws have prohibited revenue generating activities, such as

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61 These values are not based on formal appraisals, but are estimates developed by DNR Division of Parks and Recreation staff.

timber sales, minerals exploration, and mining in the BWCAW since 1978 when it was designated a wilderness area. 63

Although the Boundary Waters Canoe Area is a unique natural resource, the state’s responsibility to the school trust should not be forgotten. Trust land in the BWCAW has generated little revenue since 1926 and no revenue in the last 20 years.

Several options exist for dealing with school trust land within the BWCAW. DNR has been interested in an exchange of school trust land in the BWCAW for U.S. Forest Service (USFS) land in Minnesota’s national forests since 1978. The USFS, however, has not been interested in a land exchange because a large scale exchange of land would severely disrupt the Forest Service’s timber harvest plan for federal timberland in northern Minnesota. USFS forest plans assign a priority to exchanging county lands within the BWCAW, but not state lands. According to federal officials, USFS regards the state as a partner in the BWCAW regulation because of the state’s jurisdiction over the waters in the BWCA, and, therefore, land exchange with the state has been a low priority.

Recent discussions between state and federal officials indicate that federal purchase of state land, and particularly school trust land, in the BWCAW may be feasible. Preliminary discussions between DNR and federal officials have estimated the value of trust land in the BWCAW at approximately $35 million. More precise estimates would require appraisals. DNR officials are supportive of a purchase option, and have made efforts to obtain a “down payment” of $10 million from federal Land and Water Conservation funds. While the state

63 The 1978 BWCA Wilderness Act (P.L. 95-495); and Minn. Stat. §84.523.
congressional delegation has been supportive of this request, some Minnesota state legislators continue to prefer a land exchange to a cash purchase. The Permanent School Fund is the predominant owner of state land within the BWCAW and has not benefited from the stalemate between the state and federal government over how to deal with state inholdings in the BWCAW. We recommend that:

- **DNR should continue to pursue compensation to the PSF for the trust land in the BWCAW.** If the federal government’s cash purchase of some or all of the trust land in the BWCAW is the most practical option, then it should be pursued.

User fees could be another option for compensating the trust. The USFS has recently instituted user fees for the BWCA of $10 per trip beginning in 1998. Additional user fees to compensate the Permanent School Fund for the use of trust land in the BWCA are a possibility, although the details of how a state-imposed user fee might work are unclear.

**Wildlife Management Areas**

DNR’s Fish and Wildlife Division administers wildlife management areas (WMAs) to protect lands and waters with a high potential for wildlife production and to develop and manage these lands and waters for the production of wildlife, opportunities for public hunting, fishing, and trapping, and other compatible outdoor recreational activities.

A DNR policy document first adopted in 1983, and currently in the process of being revised, states that trust land within an approved WMA project boundary will be managed in accordance with the WMA’s management plan. In addition:

> Management activities will be evaluated to determine whether they preclude or limit income producing uses of the trust fund land.

> To the extent that management activities preclude all income producing uses of trust fund land, the department will initiate condemnation procedures.

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65 Minn. Stat. §86A.05, subd. 7.

In 1997, the department managed 1,288 WMAs containing 753,000 acres of DNR-acquired land. Approved WMA project boundaries contained another 797,400 acres. Approved WMA project boundaries include a variety of land ownership, such as privately-held, trust, and tax-forfeited lands. Until the department begins acquiring title to land within a project boundary designation as a proposed WMA does not affect land use.

The department estimates that approved WMA project boundaries contained 109,000 acres of school trust land in 1983. About 15,800 acres were in proposed projects where DNR had not acquired any land; therefore, these acres were not managed as WMAs. Between 85,000 and 95,000 acres of trust land were in WMA project areas where the department had acquired title to some land. About 65 percent of trust land in WMAs was located in Kittson, Marshall, and Roseau counties and was managed according to WMA policies, which may restrict the revenue generating potential of the trust land. While there are some agricultural and sand and gravel leases on WMA land, there are only selective timber harvests to meet wildlife management purposes, not to generate income.

In 1983, DNR stated that “it will eventually acquire by condemnation all remaining school trust land in WMAs as funding and acquisition priorities permit.” DNR staff told us that if WMA management decisions remove trust land from revenue producing status, such as flooding land to create a wildlife habitat, then the department condemns the land and compensates the trust fund. Since 1986, however, the WMA program has initiated only six condemnations involving 2,037 acres valued at $288,640, and one land exchange. In addition, three condemnations initiated in 1995 and 1997 are pending.

**Options for Compensating the PSF**

There are many different ways of compensating the PSF for uses of trust land that result in decreased or foregone income. DNR can purchase the trust land or exchange it for other DNR-owned land that generates revenue. User fees and lease payments are other options for compensating the PSF. For example, DNR could lease the acres of trust land in a management unit or it could pay a share of the public access fees to the trust fund. These payments could be determined a number of different ways. For instance, lease fees could be calculated on a per-acre basis or public access fees could be shared based on the share of trust land acres in a park. In most situations, however, the lost revenues for DNR divisions would have to be balanced with General Fund appropriations made by the Legislature.

Another approach could involve special legislative appropriations for the specific purpose of acquiring the trust land and compensating the trust fund. For example, the Legislature may want to consider specific appropriations for any trust land affected by the creation of new state parks or boundary changes that add trust land to existing state parks.

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67 The 1983 acreage data was the most current information available from DNR’s Fish and Wildlife Division. The DNR’s GIS/MIS system reports about 85,000 acres of trust land in WMAs.

SUMMARY

The DNR manages some trust land to secure an economic return. In this chapter we found that 1.5 million acres of the 2.2 million acres of trust land managed by the Division of Forestry was classified as commercial forest and was available for timber harvest in 1997. We estimated that the accumulated net income of timber from forest trust land over the next 40 years will be between $186 million and $305 million in 1998 dollars.

Timber sales on school trust land accounted for one half of the total volume and value of timber sold in Minnesota between 1986 and 1996. Because DNR is allowed to use revenues from forestry management activities (including timber sales and leases) to finance its trust land management costs, forestry management has not generated significant net earnings for the trust fund. From 1982 to 1992, nothing was deposited into the PSF principal from forestry management activities on trust land. Since 1992, forestry management activities have added $6.5 million to PSF principal. Forestry management costs have averaged 70 percent of revenues, however, resulting in a net return on asset value of less than 1 percent.

The department uses a number of methods to allocate a portion of its fire protection, forest improvement and management, administration, and road improvement and construction costs to school trust land. We found that the per acre allocation of fire protection and suppression costs may overstate the actual costs incurred on trust land. We suggest that DNR review whether specific components, such as sand and gravel and recreation management activities, should be included with other forestry management revenues and costs.

We did not examine the Division of Forestry’s overall management of Minnesota’s timber resources. We think that a study of Minnesota’s timber management policies and practices, management costs, and timber appraisal and stumpage pricing methods may be timely.

Between 1986 and 1997, mineral revenues from school trust land accounted for $17.1 million or about 40 percent of revenues from all school trust land proceeds added to the PSF principal. Revenues from iron ore and taconite leases represented about 94 percent of all mineral revenues. Because the value of Minnesota’s mineral resources is unknown, it is not possible to estimate a return on asset value for mineral leasing on school trust land.

We estimate that about 150,000 acres of school trust land are included in areas that prohibit revenue generating activities, such as state parks, peatland scientific and natural areas, and the Boundary Waters Canoe Area Wilderness. Given the choice of using limited capital bonding and land acquisition money to compensate the trust versus acquiring private inholdings threatened with development, DNR has chosen to emphasize the latter. In these instances, the department’s natural resource responsibilities have predominated over its fiduciary responsibilities to the PSF. If the Legislature wants to compensate the PSF for the trust land that does not generate revenue, then it could consider authorizing specific appropriations for that purpose.
The Department of Natural Resources (DNR) leases school trust land for lakeshore cabins, as well as for agricultural, commercial, governmental, recreational, and other purposes. DNR also administers the sale of trust land. Trust land may be exchanged for other public or private land. This chapter examines the leasing, sale, and exchange of school trust land. We asked:

- What revenues have been realized from the leasing and sale of school trust land?

- Should the state continue to lease lakeshore lots on school trust land or to sell them?

Overall we found that while the management of lakeshore lot leases have generated both visibility and controversy in recent years, the existing 546 leases on trust land accounted for less than one hundredth of a percent of all trust land. The leased lots had an appraised value of $11.6 million and generated $319,000 in revenues as of July 1997. A portion of these revenues are used to finance lakeshore lease and trust land management costs.

Between 1986 and 1995, the state sold 1,060 lakeshore lots on school trust land, generating over $14 million in revenues for the Permanent School Fund (PSF), mostly financed with annual payments over 20 years. Aside from the sale of lakeshore lots and the 1992 exchange of school trust land in state parks, there have been few sales or exchanges of trust land in the past decade.

LAKESHORE AND OTHER LEASES

Minnesota’s lakeshore leasing of state-owned land has an 80-year history, beginning in 1917 on Lake Vermilion. In 1923, the Legislature passed a law that withdrew all state land on meandered lakes and other public waters from sale and designated these lands as “public campgrounds” to be leased as cottages and camps. New lakeshore lots were platted until 1964, when the Commissioner of Natural Resources, Lakeshore Disposal Report (St. Paul, February 24, 1987); Christopher J. Klyza, A Study of the State Lakeshore Leasing Program in Minnesota (St. Paul, September 1984), 9–14; and Minnesota House of Representatives Research Department, Lakeshore Leasing (St. Paul, February 9, 1971).

1 Minn. Stat. §§92.45 and 92.46.
Conservation (predecessor to the Commissioner of Natural Resources) ordered the platting of new lots to be stopped. Since 1974, the DNR’s Bureau of Real Estate Management has been responsible for administering the leases (annual billings, receipts, and renewals) and the department’s Division of Forestry has been in charge of making site inspections and performing other field duties.

The fees for lakeshore leases cover rental of the land, not private improvements on the land. Originally, the annual lease rate was $10 for most lakeshore lots. Between 1957 and 1975, the department charged lease rates of $25 annually. In 1975, the department started implementing a new lease rate based on 5 percent of the appraised value of the unimproved lakeshore lots. The new lease rate was incorporated into each lease as it expired and was renewed. Beginning on January 1, 1981, DNR established a standard 10-year term for all lakeshore leases. The new leases contained a clause allowing the state to readjust the lease rate after five years, or as of January 1, 1986.

In the meantime, the Office of the Legislative Auditor issued a report in June, 1981, that was critical of DNR management of lakeshore leases on school trust land. The report found that the annual lease rates were too low because DNR had been appraising the lots every ten years instead of every five years, like the U.S. Forest Service. At the time, the annual lease rates averaged $150.

In January 1985, in preparation for lease rate adjustment the following year, the department sent letters to lessees informing them that the new appraised values would be three and a half times higher on average than the 1975 values. The lakeshore lessees, most of whom had opposed the change from a flat annual lease rate to a rate based on a percentage of appraised value, expressed opposition to the increased values. Some lessees approached legislators with their concerns. In response to constituent concerns, the 1985 Legislature passed a law phasing in the increased lease rates over three years. The Legislature also directed DNR to inventory the lakeshore leases and prepare a report with recommendations on lots that should be sold.

Law relating to the sale of lakeshore lots have changed numerous times.

**History of Lakeshore Lot Sales**

In 1986, the Legislature lifted a 63-year ban on the sale of state-owned lakeshore when it directed the Commissioner of DNR to begin the process of selling the leased lakeshore lots at public auction in the summer of 1987. At the time the state owned 1,782 leased lots, of which about 90 percent were on school trust land. The 1986 law required DNR to sell lakeshore lots if the lessee requested the sale and if a DNR inventory requested by the Legislature in 1985 recommended that a lot be sold. Provisions of the 1986 and later laws relating to lakeshore sales and leases are summarized in the Appendix.

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Legislative amendments in 1987 changed the appraisal process. It also repealed the request for a DNR inventory and recommendation on which leased lots should be sold, leaving the decision on whether to sell a lot to the discretion of the lessee.

The first public auction of leased lakeshore lots was scheduled for August 26, 1987. On August 20, 1987, Adam C. Segner, a public grade school student, and his mother filed a lawsuit to stop the sale of lakeshore lots. The lawsuit alleged that state law allowing the sale of lakeshore lots was unconstitutional because it allowed the lessee to request the sale, use up to $500 of the annual lease fee as part of the down payment, select an appraiser, and stop the sale of a lot after the appraisal. The district court judge temporarily delayed the August and September sales of lakeshore lots, and, on January 14, 1988, denied the plaintiffs’ motion to certify the case as a class action.

The 1988 Legislature amended the lakeshore sales law, repealing those provisions that the plaintiffs claimed were unconstitutional. For instance, the 1988 law:

- Changed the appraisal process;
- Did not allow annual lease payments to be applied to the down payment; and
- Required that all lakeshore lots be offered for sale eventually, whether or not a lessee opposed the sale.

On August 11, 1988, the district court concluded that the lakeshore lot sales statutes of 1986, 1987, and 1988 were constitutional and dismissed the case for lack of standing and failure to state a claim.

Other legislative changes between 1986 and 1996 focused on management costs for the leasing and sale of lakeshore lots. In 1986 an amendment allowed up to 50 percent of lease revenues from lakeshore lots on school trust land to be deposited in a “Lakeshore Account” and used to finance the state’s costs to survey these lots. Later amendments added appraisal and other sale costs (1987) and leasing costs (1996) as eligible administrative costs for reimbursement from the lakeshore account. DNR anticipates that management costs for lakeshore leases will decline starting in 1998 and be less than half of the revenues generated from those leases.

Legislation also provided for the recovery of appraisal costs. In 1987 the Legislature directed the commissioner to add up to $700 to the appraised value of the lots offered for sale for the costs of surveying and appraising. The Legislature required that the recovered costs be deposited directly in the PSF.

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7 Minn. Laws (1988), ch. 718, art. 7. See the Appendix.
9 The remaining 50 percent of lakeshore lease revenues are deposited in the Forest Suspense Account to pay for forest management costs on school trust land.
Provisions for Lakeshore Lot Sales and Leasing

In 1985, the Legislature directed the Commissioner of Natural Resources to adopt rules to address the method of appraising property, determination of lease rates, and an appeal procedure by July 1, 1986. On November 25, 1996, DNR adopted the lakeshore lease rules. On January 1, 1997, DNR implemented new cabin site leases. Key provisions of the current lakeshore leases are summarized in Figure 3.1.

DNR has argued that certain lakeshore leasing and sale provisions were not in the interest of trust beneficiaries. At various times, for instance, DNR has indicated that it was to the state’s disadvantage that lot sales were initiated by the lessee and that the lessee had control over the appraiser selection.

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**Figure 3.1: Key Provisions of the Current Lakeshore Leases**

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease term:</td>
<td>20 years--January 1, 1997 to December 31, 2016</td>
</tr>
<tr>
<td>Lease rate (rent):</td>
<td>5 percent of the appraised value of the leased land</td>
</tr>
<tr>
<td>Adjustments to rent:</td>
<td>Lease fees shall be adjusted at the fifth, tenth, and fifteenth anniversary of the lease</td>
</tr>
<tr>
<td></td>
<td>Increases in lease fees will be phased in by three equal annual increments</td>
</tr>
<tr>
<td>Appraisal method:</td>
<td>The Commissioner of Natural Resources shall determine the appropriate method to use to appraise leased lots and when the appraised value shall be based on new appraisals</td>
</tr>
<tr>
<td></td>
<td>The commissioner’s decision to appraise will depend on staffing, the degree of fluctuation in real estate values, and fiscal constraints</td>
</tr>
<tr>
<td></td>
<td>The commissioner shall use mass appraisal of leased lots rather than individual appraisals, whenever practicable</td>
</tr>
<tr>
<td></td>
<td>All appraisals and appraisal reviews shall be conducted by appraisers licensed under state law</td>
</tr>
<tr>
<td>Taxes:</td>
<td>Lessee pays any taxes levied on the premises and improvements</td>
</tr>
</tbody>
</table>

SOURCES: Department of Natural Resources, Cabin Site Lease, and *Minn. Rules*, 6122.0100 - 6122.0400.

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10 *Minn. Laws* (1985 First Special Session), ch. 14, art. 17, sec. 1, subd. 1(c).
11 *Minn. Rules*, 6122.0100 - 6122.0400.
Some provisions in lakeshore sales of 1986 and 1997 and current lakeshore lease laws benefited lessees instead of trust beneficiaries. Examples of these sale provisions in the initial 1986 lakeshore lot sales law include allowing the lessee to decide if a leased lakeshore lot was to be sold and allowing the lessee to cancel the sale after the appraisal was completed. Some sale provisions, such as those allowing the lessee to select an appraiser, were amended by the Legislature during the sales process. All laws related to the sale of lakeshore lots have been repealed.

Some provisions in current lakeshore lease laws also benefit the lakeshore lessees. The three-year phase in of increases in lease rate reduces revenues for the trust fund. The five-year cycle for adjusting the lease rates based on appraised value is one year longer than the four-year period used to reevaluate the values of other property, including other lakeshore property, for property tax purposes in Minnesota.

Sale of Lakeshore Lots

Following resolution of the Segner lawsuit, DNR held the first sale of lakeshore lots in October 1988, with subsequent sales in August of each year between 1989 and 1993. A total of 1,153 lakeshore leased lots have been sold since 1988, of which about 92 percent were on school trust land. DNR data show that:

- The sale of 1,060 lakeshore lots on trust land generated about $14 million for the Permanent School Fund, mostly financed with annual payments over 20 years.

Table 3.1 shows the number and sale price of lakeshore lots sold each year since 1988. The lots sold for an average of about $13,400 per lot. The revenue realized

<table>
<thead>
<tr>
<th>Year</th>
<th>Lots Sold</th>
<th>Sale Price</th>
<th>Amount Paid at Sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>91</td>
<td>$1,373,200</td>
<td>$267,720</td>
</tr>
<tr>
<td>1989</td>
<td>117</td>
<td>1,603,250</td>
<td>343,535</td>
</tr>
<tr>
<td>1990</td>
<td>263</td>
<td>3,688,317</td>
<td>838,672</td>
</tr>
<tr>
<td>1991</td>
<td>128</td>
<td>1,312,256</td>
<td>298,041</td>
</tr>
<tr>
<td>1992</td>
<td>189</td>
<td>2,197,700</td>
<td>480,135</td>
</tr>
<tr>
<td>1993</td>
<td>271</td>
<td>3,955,100</td>
<td>1,054,696</td>
</tr>
<tr>
<td>1995</td>
<td>1</td>
<td>26,500</td>
<td>11,000</td>
</tr>
<tr>
<td>Total</td>
<td>1,060</td>
<td>$14,156,323</td>
<td>$3,293,799</td>
</tr>
</tbody>
</table>

*The amount paid at sale includes both down payments and lump sum payments.

SOURCE: Department of Natural Resources.

About two-thirds of the lakeshore lots were sold in the late 1980s and early 1990s.

13 Minn. Stat. §92.46, subd. 3.
14 Minn. Stat. §94.46, subd. 1 (b).
by the PSF from the sale of lots is spread out over 20 years because approximately 93 percent of the buyers opted to finance the purchase at interest rates of between 5 percent and 8 percent.\(^\text{15}\) The PSF received annual revenues from down payments, cash sales, and the assessment of appraisal, survey, and sale costs. The fund continues to receive annual principal payments with interest from these sales. As discussed in Chapter 1, proceeds from all land sales (mostly lakeshore lots) accounted for 42 percent of all revenues deposited in the PSF between 1986 and 1997.

The lakeshore lots were sold at public auction, but anecdotal information indicates that bidding competition was limited. Of the lots sold between 1988 and 1997, 7 percent sold for more than the appraised value.

## Existing Lakeshore Leases

DNR managed 582 lakeshore leases in 1997, of which 546 (or 94 percent) were on school trust land.\(^\text{16}\) Table 3.2 shows that the 546 lakeshore lots on school trust land are located on 76 lakes in 12 counties. Most (45 percent) of the lots are in St. Louis County, followed by Itasca County with 17 percent and Cass County with 15 percent. Lakeshore lot lessees are predominantly from Minnesota, but

### Table 3.2: Lakeshore Leases by County, 1997

<table>
<thead>
<tr>
<th>County</th>
<th>Number of Leases</th>
<th>Percent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aitkin</td>
<td>16</td>
<td>3%</td>
</tr>
<tr>
<td>Beltrami</td>
<td>6</td>
<td>1</td>
</tr>
<tr>
<td>Carlton</td>
<td>1</td>
<td>&lt;1</td>
</tr>
<tr>
<td>Cass</td>
<td>80</td>
<td>15</td>
</tr>
<tr>
<td>Cook</td>
<td>30</td>
<td>5</td>
</tr>
<tr>
<td>Crow Wing</td>
<td>22</td>
<td>4</td>
</tr>
<tr>
<td>Hubbard</td>
<td>23</td>
<td>4</td>
</tr>
<tr>
<td>Itasca</td>
<td>95</td>
<td>17</td>
</tr>
<tr>
<td>Koochiching</td>
<td>6</td>
<td>1</td>
</tr>
<tr>
<td>Lake</td>
<td>15</td>
<td>3</td>
</tr>
<tr>
<td>Polk</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>St. Louis</td>
<td>248</td>
<td>45</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>546</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

**NOTE:** Percentages may not sum due to rounding.

**SOURCE:** Department of Natural Resources.

\(^{15}\) The interest rates vary depending on the year a lot was purchased. The interest rate was 8 percent in 1988, 1989, and 1993, 7 percent in 1990 and 1991, and 5 percent in 1992.

\(^{16}\) Previously, DNR had reported that there were 541 lakeshore lots on trust land. Our evaluation uncovered a coding error in DNR’s database. Correction of this error changed the number of lakeshore lots on trust land to 546.
12 percent are from other states. Most of the out-of-state lease holders are from Illinois (10), Wisconsin (8), and Iowa (7). Our analysis shows that:

- Lakeshore leases on school trust land accounted for a small amount of school trust land acres and a small share of land management revenues deposited into the Permanent School Fund in 1997.

The existing lakeshore leases average about three-fourths of an acre in size and account for a total 426 acres of school trust land, or less than two-tenths of 1 percent of all school trust land. The leased lots have an average of 151 feet of lakeshore frontage, with approximately 15 percent of the lots having over 200 feet of frontage.

Table 3.3 shows that the 546 leased lakeshore lots had an appraised value of $11.6 million in 1997. Appraised values averaged about $21,180 per lot and ranged from $4,100 to $180,000. Between 1986 and 1996, the total appraised values of the lakeshore leases increased $6.6 million, an average increase of 6.8 percent compounded annually.

### Table 3.3: Summary of Lakeshore Leases on School Trust Land

<table>
<thead>
<tr>
<th></th>
<th>Minimum</th>
<th>Maximum</th>
<th>Average</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Appraised Values:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1986</td>
<td>$1,800</td>
<td>$34,200</td>
<td>$9,030</td>
<td>$4,929,755</td>
</tr>
<tr>
<td>1997&lt;sup&gt;a&lt;/sup&gt;</td>
<td>4,100</td>
<td>180,000</td>
<td>21,180</td>
<td>11,562,200</td>
</tr>
<tr>
<td><strong>Change in Appraised Values, 1986-97&lt;sup&gt;b&lt;/sup&gt;</strong></td>
<td></td>
<td></td>
<td></td>
<td>6.8%</td>
</tr>
<tr>
<td><strong>Annual Lease Fees:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1986</td>
<td>90</td>
<td>1,710</td>
<td>451</td>
<td>$246,500</td>
</tr>
<tr>
<td>1997&lt;sup&gt;c&lt;/sup&gt;</td>
<td>208</td>
<td>3,833</td>
<td>653</td>
<td>319,500</td>
</tr>
<tr>
<td>2000&lt;sup&gt;d&lt;/sup&gt;</td>
<td>225</td>
<td>9,000</td>
<td>1,060</td>
<td>578,000</td>
</tr>
<tr>
<td>1997 Lot Size (acres)</td>
<td>.15</td>
<td>4.71</td>
<td>.78</td>
<td>426</td>
</tr>
<tr>
<td>1997 Frontage (feet)</td>
<td>41</td>
<td>1,117</td>
<td>151</td>
<td>82,707</td>
</tr>
</tbody>
</table>

<sup>a</sup>The 1997 appraised values were based on appraisals conducted in 1996.

<sup>b</sup>Compounded annual percent change based on appraisals completed in 1983 and 1996.

<sup>c</sup>First year of three-year phase-in of the 1997 increased lease rate, as provided for in Minn. Stat. §92.46, subd. 3.

<sup>d</sup>Lease fees at the end of the three-year phase-in.

SOURCE: Office of the Legislative Auditor analysis of Department of Natural Resources data. Number of leases = 546.

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17 Data on appraised values are as of July 1997. About 93 lakeshore lessees appealed the 1996 appraised values for their leased lots. The appraised values reflect the results of 54 appeals that were resolved by July 1997.
Based on these appraised values, the lakeshore leases on trust land generated $319,000 in revenues in 1997, the first year of the three-year phase-in of 1997 increased annual lease rates. Total revenues will increase to $578,000 in 2000, based on the 1997 appraised values. Half of the 1997 lakeshore lease revenues were deposited in the Lakeshore Account and used to finance the costs of managing the lakeshore leases. The other half, approximately $159,000, were deposited in the Forest Suspense Account (discussed in Chapter 2) to finance forestry management costs. The lakeshore lease revenues represented about 9 percent of the $1.7 million transferred from the Forest Suspense Account to the PSF and about 4 percent of the $4.5 million from all land management activities deposited into the PSF in 1997.

We also examined whether the state should continue to lease the existing lakeshore lots on school trust land or sell them. We analyzed various lease versus sell options using a discounted cash flow model. As with any model, the analysis is based on a number of assumptions. Depending on what assumptions are used, the results could support either the continued leasing or the sale of the lots.

The most critical assumptions involve: (1) the rate at which land values will appreciate; (2) the rate of return earned on investment of lease or sale receipts; and (3) how sale costs will be financed. If the lots appreciate at a rate of 7 percent annually, the interest rate for investing net lease revenues or sale proceeds is 9.75 percent, and the sale costs will be financed from proceeds of the sale, then the analysis would support continued leasing. However, if the lots appreciate at 5 percent annually instead of 7 percent and sale costs are financed from proceeds of the sale, then the analysis would support selling the lots. Similarly, if other assumptions are the same and the reinvestment rate increases 1 percent, then the analysis would support selling the lots.

Analysis of whether to continue leasing or to sell the lakeshore lots depends on what will happen to land values, investment rates, and other factors in the future. In considering this issue, policy makers should carefully examine the assumptions used to estimate the costs and benefits of leasing versus selling. Our analysis does not lead to a definitive conclusion, suggesting that any decision about whether to continue leasing or to sell lakeshore lots should not rest on economic analysis alone.

Other Leases and Contracts

In addition to lakeshore lot leases, DNR also administered other leases, easements, and utility licenses on school trust land. The DNR’s Bureau of Real Estate Management determines the terms and conditions of the leases, conducts real estate appraisals, and executes the contracts. The department’s Division of Forestry is responsible for timber appraisals, inspections, enforcement, and other

18 Examples of other assumptions used in our analysis include: a portion of lakeshore lease revenues would be used to finance management costs, other lakeshore lease revenues would be added in the Permanent School Fund, all lots would be sold in 1998, and 93 percent of the sales would be financed over 20 years with a 7.5 percent interest rate. All lease options examined assume that the land would be sold at the end of the 20-year period used in our analysis.

19 Minn. Stat. §§84.153, 89.17, 92.50.
field work related to these contracts. Because the Division of Forestry manages these contracts, the revenues generated are deposited in the Forest Suspense Account.

Table 3.4 summarizes the number of contracts by type, the acres leased, and revenues generated in 1997. The table illustrates that leases are issued for a variety of purposes, including: sand, gravel, and black dirt operations; agriculture (hay, pasture, cultivation); commercial enterprises such as resorts, youth camps, and restaurants; governmental activities including trails, parks, public portages, and storage facilities; hunting cabins; and home sites to rectify squatter situations.

DNR requires cash returns for all uses of school trust land. DNR leasing policies specify that “all leases on trust fund lands must be charged the full cash rental. No deductions are allowed.” This means that cooperative farming agreements, which do not involve a cash payment, are not allowed on trust land. Departmental policies also require cash payment for grant-in-aid trails and right-of-way access permits. The financial data show that this policy resulted in a negligible benefit to the PSF.

Table 3.4: Contracts on School Trust Land by Type, 1997

<table>
<thead>
<tr>
<th>Contract Type</th>
<th>Number of Leases</th>
<th>Acres Leased</th>
<th>Estimated Lease Receipts 1997</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gravel Leases</td>
<td>56</td>
<td>737</td>
<td>$303,700</td>
</tr>
<tr>
<td>Agricultural Leases</td>
<td>82</td>
<td>3,152</td>
<td>16,000</td>
</tr>
<tr>
<td>Misc. Commercial Leases</td>
<td>89</td>
<td>1,125</td>
<td>145,600</td>
</tr>
<tr>
<td>Misc. Governmental Leases</td>
<td>70</td>
<td>1,667</td>
<td>19,900</td>
</tr>
<tr>
<td>Misc. Private Leases</td>
<td>125</td>
<td>440</td>
<td>3,800</td>
</tr>
<tr>
<td>Grant-in-Aid Permits</td>
<td>85</td>
<td>727</td>
<td>6,300</td>
</tr>
<tr>
<td>Access Permits</td>
<td>50</td>
<td>92</td>
<td>400</td>
</tr>
<tr>
<td>Hunting Cabin Leases</td>
<td>53</td>
<td>30</td>
<td>12,600</td>
</tr>
<tr>
<td>Home Site Leases</td>
<td>22</td>
<td>13</td>
<td>5,600</td>
</tr>
<tr>
<td>Easements</td>
<td>601</td>
<td>3,825</td>
<td>9,600</td>
</tr>
<tr>
<td>Land Crossing Licenses</td>
<td>380</td>
<td>6,194</td>
<td>9,800</td>
</tr>
<tr>
<td>Water Crossing Licenses</td>
<td>3,697</td>
<td>0</td>
<td>69,600</td>
</tr>
</tbody>
</table>

Total 5,310 18,002 $602,900

*Estimated acreages based on the number of trust land 40-acre sections crossed by permits.

*Water crossing licenses do not involve acreage, but receipts are dedicated to the Permanent School Fund via the Forest Suspense Account.


20 Minnesota Department of Natural Resources, Real Estate Management Manual, 15.
21 See for example, Minnesota Department of Natural Resources, Commissioner’s Delegation Order No. 830 dated August 20, 1993, 2, and Delegation Order No. 831 dated September 30, 1993.
The department also uses different lease rates depending on the type of lease. While the lease rate for lakeshore lots is 5 percent of appraised values, the rates are 6 percent for governmental and miscellaneous leases and 9 percent for commercial leases.  

Payments for easements and licenses are made once for the life of the contract. Easements granting access to, but not ownership of, trust land are provided for highways, roads and trails, flowage for development of wildlife resources, flood control, and other purposes. Easements may be temporary, lasting several months or years, or permanent. Revenues from easements are lump sum payments, usually equal to 90 percent of the appraised value of the land.

**LAND SALES, CONDEMNATIONS, AND EXCHANGES**

The Minnesota Constitution requires that trust land be sold at public auction. For public agencies with the authority to use eminent domain, acquiring school trust land by condemnation is equivalent to a public sale. Acquiring trust land by condemnation is one method used to compensate the Permanent School Fund when trust land is used for purposes that restrict or prohibit revenue generation. Land exchanges are another method used to compensate the PSF. Land exchanges typically remove school trust land from DNR management areas where the potential for revenue generation is limited or nonexistent and transfer the trust designation to land with potential to produce revenue. Our analysis shows that:

- Aside from lakeshore lot sales and state park land exchanges in the late 1980s and early 1990s, DNR has initiated few sales, condemnations, or exchanges of school trust land in recent years.

In addition to the sale of lakeshore lots between 1988 and 1992 and the exchange of 5,357 acres of trust land in state parks in 1992, there were 39 land sales, 19 land condemnations, and 29 land exchanges between 1987 and 1997. These transactions are discussed below.

**Land Sales**

Since 1923, state law has directed the Commissioner of DNR to “hold frequent sales of school and other state lands.” Nevertheless, in more recent times, DNR’s policy has been to retain and manage, not sell, school trust and other state-owned land. State law requires that trust land be sold at public sale for not less than the appraised value and that sale proceeds be deposited in the Permanent.

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22 We did not evaluate the procedures used to appraise leased trust land.

23 *Minn. Stat.* §92.11, subd. 4.
The minimum price for trust land was set at $5 per acre in 1907, although current land values are much higher than the minimum. No more than 100,000 acres may be sold in one year.

Purchasers may pay cash for the land or make a down payment of at least 15 percent of the purchase price of the land, with the balance paid in equal installment payments over 20 years. Interest on the unpaid balance is based on the average effective interest rates on mortgage loans, which was 8 percent in 1993.

Sales of school trust lands are usually initiated by interested individuals, frequently people who already lease the land, or by DNR to correct trespass situations. The department reviews and approves the requests for land sales. Public sales of trust land may be held “when it is advantageous to the state and to intending buyers.” Consequently, the department tries to group land sale requests and conduct the sales together.

Table 3.5 shows that between 1987 and July 1997, there were a total of 39 land sales involving 1,143 acres of trust land providing $331,400 to the PSF. The average price was about $290 per acre for the land sold during this time. About 91 percent of the buyers opted for 20-year financing agreements, with the remainder purchasing the land outright.

Land Condemnations

In 1924, the Minnesota Supreme Court ruled that acquiring fee title by condemning school trust land was equivalent to the public auction requirements of the Minnesota Constitution. In the case of Independent School District of Virginia v. State, where the Virginia school district wanted some school trust land for public educational purposes, the court upheld the school district’s authority to condemn the trust land. The court stated that the value of the trust land, as determined in the court supervised condemnation proceeding, is paid into and becomes part of the Permanent School Fund, benefiting all school districts in the state.
Condemnation authority was also used to acquire school trust land for park use in 1971 when over 24,000 acres of trust land was condemned prior to its donation by the state to the federal government for Voyageurs National Park. The federal district and circuit courts concluded that this transfer did not breach the trust agreement between the state and federal government in regard to school trust land. Other state agencies, counties, cities, and school districts, with the authority to use eminent domain, may also initiate condemnation proceedings to acquire school trust land. In these situations DNR, as manager of the trust land, reviews and consents to the condemnation.

When DNR initiates a condemnation of trust land, representatives from separate divisions of the Minnesota Attorney General’s Office represent the opposing sides. Land condemnations are court supervised procedures, involving the appointment of three commissioners who gather information, have the land

Table 3.5: Sales of School Trust Land, Excluding Lakeshore Lots, 1987-97

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Sales</th>
<th>Acres Sold</th>
<th>Estimated Value of Land Sold</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>7</td>
<td>297</td>
<td>$32,900</td>
</tr>
<tr>
<td>1988</td>
<td>2</td>
<td>81</td>
<td>7,700</td>
</tr>
<tr>
<td>1989</td>
<td>5</td>
<td>224</td>
<td>54,800</td>
</tr>
<tr>
<td>1990</td>
<td>2</td>
<td>10</td>
<td>59,700</td>
</tr>
<tr>
<td>1991</td>
<td>1</td>
<td>40</td>
<td>10,700</td>
</tr>
<tr>
<td>1992</td>
<td>5</td>
<td>84</td>
<td>15,000</td>
</tr>
<tr>
<td>1993</td>
<td>4</td>
<td>21</td>
<td>40,450</td>
</tr>
<tr>
<td>1994</td>
<td>8</td>
<td>363</td>
<td>70,600</td>
</tr>
<tr>
<td>1995</td>
<td>4</td>
<td>23</td>
<td>32,500</td>
</tr>
<tr>
<td>1996</td>
<td>1</td>
<td>&lt;1</td>
<td>7,090</td>
</tr>
<tr>
<td>1997</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>39</td>
<td>1,143</td>
<td>$331,440</td>
</tr>
</tbody>
</table>

*Does not include state-owned improvements valued at $35,100.

The sales data for 1995 exclude two condemnations of trust land by other public entities involving 37 acres valued at $275,800.

Partial year, January to July 1997.

SOURCE: Office of the Legislative Auditor analysis of Department of Natural Resources, Bureau of Real Estate Management land records data.

Condemnation authority was also used to acquire school trust land for park use in 1971 when over 24,000 acres of trust land was condemned prior to its donation by the state to the federal government for Voyageurs National Park. The federal district and circuit courts concluded that this transfer did not breach the trust agreement between the state and federal government in regard to school trust land. Acquiring trust land by condemnation is one method used to compensate the trust when trust land is used for purposes that do not produce revenue for the trust. Other state agencies, counties, cities, and school districts, with the authority to use eminent domain, may also initiate condemnation proceedings to acquire school trust land. In these situations DNR, as manager of the trust land, reviews and consents to the condemnation.

When DNR initiates a condemnation of trust land, representatives from separate divisions of the Minnesota Attorney General’s Office represent the opposing sides. Land condemnations are court supervised procedures, involving the appointment of three commissioners who gather information, have the land

28 Minn. Laws (1971), ch. 852. Currently coded as Minn. Stat. §84B.


30 Minn. Stat. §117.
When trust land is condemned, a lump sum payment for the appraised value is made to the PSF.

appraised, and file a report with the court. The court procedures involve public notice of the condemnation and an appeal process. When school trust land is condemned, a lump sum payment for the appraised value is made to the PSF.

DNR initiated a total of 19 land condemnations involving 2,435 acres of school trust land valued at $674,000, between 1990 and July 1997 (see Table 3.6). The condemnations varied in size from less than half an acre to 960 acres. Various DNR programs initiated the condemnations including trails and waterways, wildlife management, parks and recreation, and minerals. DNR acquired the trust land for boat ramps and other public water accesses, dams, administrative offices, preservation of ecological areas, and other uses.

Our examination of condemnations was limited to DNR-initiated condemnations because DNR has not consistently maintained computerized records of school trust land condemnations by other public entities. Paper copies of condemnations by other entities are maintained and computerized land ownership files are updated when a condemnation is completed. DNR staff told us about some condemnations initiated by other public entities, and while probably few in number, it is not possible to determine the nature of these condemnations. We suggest that:

Table 3.6: DNR-Initiated Condemnations of School Trust Land, 1990-97

<table>
<thead>
<tr>
<th>Year</th>
<th>Number</th>
<th>Acres</th>
<th>Appraised Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>2</td>
<td>40</td>
<td>$13,000</td>
</tr>
<tr>
<td>1991</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1992</td>
<td>6</td>
<td>967</td>
<td>168,600</td>
</tr>
<tr>
<td>1993</td>
<td>2</td>
<td>2</td>
<td>33,000</td>
</tr>
<tr>
<td>1994</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1995</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1996</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1997*</td>
<td>4</td>
<td>8</td>
<td>80,000</td>
</tr>
</tbody>
</table>

Condemnations Pending

| Pending | 5 | 1,418 | 379,500 |

Total

| Total   | 19 | 2,435 | $674,100 |

*Partial year, January through July 1997.

*The Department of Natural Resources initiated these condemnations between 1994 and 1997 but they have not been completed. The acres acquired may change before the purchases are completed.

SOURCE: Department of Natural Resources, unpublished data.

31 We found two condemnations—one by the Minnesota Department of Transportation and one by a city—recorded as land sales.
• In the future all condemnations of trust land should be consistently recorded in the Bureau of Real Estate Management’s computerized land record databases.

Land Exchanges

The goal of land exchanges involving school trust land is to remove school trust land from DNR management areas when the potential for revenue generation is restricted or prohibited. School trust land may be exchanged for other public or private land, as provided for in the Minnesota Constitution and state law. All exchanges of school trust land must be unanimously approved by the Land Exchange Board, consisting of the Governor, Attorney General, and State Auditor. The Permanent School Fund Advisory Committee, serving as temporary trustee of the school trust land for land exchanges, reviews and makes recommendations to the Land Exchange Board on proposed exchanges of school trust land. Independent legal counsel reviews proposed land exchanges for the committee.

State law also requires that: (1) school trust land be exchanged only for land of at least “substantially equal value;” (2) a qualified state appraiser must examine the trust land and the land to be exchanged to determine the fair market value of the lands; (3) all mineral and water rights of exchanged land are reserved for the state; and (4) all land received in exchange for school trust land must assume the school trust designation. Land exchanges may be initiated by DNR, other public agencies, or private land owners. Within DNR, proposals for school trust land exchanges may originate at any level within the department.

DNR guidelines for land exchanges emphasize the department’s policy to use land exchanges as a tool to improve the pattern of public land ownership for management of natural resources, which may involve both consolidated and dispersed land holdings. The 1988 guidelines assign the highest priority for land exchanges to:

- Exchange of state school trust land located in the Boundary Waters Canoe Area Wilderness (BWCAW) for federally-owned lands outside the BWCAW.

- Exchange of school trust lands located in DNR management units precluded from generating revenue for the Trust for DNR-administered non-Trust lands capable of generating revenue for the Trust.

32 Minn. Const. 1988, art. XI, sec. 10. Minn. Stat. §§94.341 to 94.347. A 1984 constitutional amendment allowed the DNR to exchange school trust land for other state-owned lands. Before that, trust land could only be exchanged for federal or private land.

33 Minn. Stat. §94.343, subd. 3 (a), 4, and 11. Subd. 3 (b) defines “substantially equal value” to mean (1) where the lands being exchanged are both over 100 acres, their values do not differ by more than 10 percent; and (2) in other cases, the values of the exchanged lands do not differ by more than 20 percent. Minn. Stat. §94.343, subs. 5 and 6 make provisions for when school trust land may be exchanged for land of greater or lesser value.

34 Minnesota Department of Natural Resources, Operational Order No. 89: Guidelines for Land Exchanges (St. Paul, December 1988), 4-6.
The guidelines also acknowledge that exchanges involving “school trust land should generally not be traded into an area or management unit where the potential for the production of income is substantially reduced or eliminated, with the possible consequence that the Trust may be frustrated.”

A total of 29 land exchanges involving school trust land occurred between 1988 and 1997. Nearly 16,000 acres of school trust land valued at $2.8 million have been exchanged for 13,500 acres of land with an equivalent value, as illustrated in Table 3.7. DNR initiated about one-quarter of the land exchanges during this time period, while private landowners requested one-half of the exchanges, and other governmental units accounted for the remainder.

Table 3.7: School Trust Land Exchanges, 1988-97

<table>
<thead>
<tr>
<th>Year</th>
<th>Number</th>
<th>Acquired</th>
<th>Relinquished</th>
<th>Acquired</th>
<th>Relinquished</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>2</td>
<td>166</td>
<td>291</td>
<td>$47,600</td>
<td>$44,540</td>
</tr>
<tr>
<td>1989</td>
<td>3</td>
<td>149</td>
<td>55</td>
<td>75,450</td>
<td>75,200</td>
</tr>
<tr>
<td>1990</td>
<td>4</td>
<td>3,154</td>
<td>4,133</td>
<td>490,688</td>
<td>489,250</td>
</tr>
<tr>
<td>1991</td>
<td>4</td>
<td>1,059</td>
<td>960</td>
<td>174,900</td>
<td>171,500</td>
</tr>
<tr>
<td>1992a</td>
<td>5</td>
<td>6,464</td>
<td>8,022</td>
<td>1,349,400</td>
<td>1,349,400</td>
</tr>
<tr>
<td>1993</td>
<td>2</td>
<td>455</td>
<td>460</td>
<td>73,400</td>
<td>71,100</td>
</tr>
<tr>
<td>1994</td>
<td>3</td>
<td>699</td>
<td>880</td>
<td>150,800</td>
<td>149,425</td>
</tr>
<tr>
<td>1995</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1996</td>
<td>1</td>
<td>40</td>
<td>40</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>1997b</td>
<td>5</td>
<td>1,361</td>
<td>1,145</td>
<td>419,600</td>
<td>412,600</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>13,546</td>
<td>15,986</td>
<td>$2,786,838</td>
<td>$2,768,015</td>
</tr>
<tr>
<td></td>
<td>State Park Land Exchange, 1992</td>
<td>4,543</td>
<td>5,357</td>
<td>$1,119,800</td>
<td>$1,119,800</td>
</tr>
<tr>
<td></td>
<td>Percent of Total</td>
<td>33.5%</td>
<td>33.5%</td>
<td>40.2%</td>
<td>40.4%</td>
</tr>
</tbody>
</table>

NOTE: Totals may not sum due to rounding.

aIncludes the state park land exchange.

bPartial year, January through September 1997.

SOURCE: Department of Natural Resources, unpublished data.

DNR completed the largest exchange of school trust land when it facilitated the exchange of 5,357 acres of school trust land in 15 state parks valued at $1.1 million for state land outside parks between 1988 and 1992 (see Table 3.8). The state park land exchange represented 33 percent of the land and 40 percent of the value of all trust land exchanged since 1987. The objective of the state park school trust land exchange program was to remove trust land from the parks.
The largest land exchange involved removing school trust land from state parks.

### Table 3.8: Minnesota State Park Land Exchange Program, 1992

<table>
<thead>
<tr>
<th>State Parks</th>
<th>County</th>
<th>Trust Acres Relinquished</th>
<th>Trust Acres Remaining</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bearhead Lake</td>
<td>St. Louis</td>
<td>749</td>
<td>0</td>
</tr>
<tr>
<td>Caribou Falls</td>
<td>Lake</td>
<td>40</td>
<td>0</td>
</tr>
<tr>
<td>Crosby-Manitou</td>
<td>Lake</td>
<td>280</td>
<td>0</td>
</tr>
<tr>
<td>Cross River</td>
<td>Cook</td>
<td>600</td>
<td>0</td>
</tr>
<tr>
<td>Father Hennepin</td>
<td>Mille Lacs</td>
<td>7</td>
<td>0</td>
</tr>
<tr>
<td>Glacial Lakes</td>
<td>Pope</td>
<td>35</td>
<td>0</td>
</tr>
<tr>
<td>Gooseberry</td>
<td>Lake</td>
<td>40</td>
<td>0</td>
</tr>
<tr>
<td>Itasca</td>
<td>Becker/Clearwater</td>
<td>613</td>
<td>1,000</td>
</tr>
<tr>
<td>Jay Cook</td>
<td>Carlton</td>
<td>80</td>
<td>0</td>
</tr>
<tr>
<td>Judge Magney</td>
<td>Cook</td>
<td>800</td>
<td>0</td>
</tr>
<tr>
<td>Lake Bemidji</td>
<td>Beltrami</td>
<td>287</td>
<td>0</td>
</tr>
<tr>
<td>McCarthy Beach</td>
<td>St. Louis</td>
<td>130</td>
<td>0</td>
</tr>
<tr>
<td>Mille Lacs Kathio</td>
<td>Mille Lacs</td>
<td>400</td>
<td>0</td>
</tr>
<tr>
<td>Scenic</td>
<td>Itasca</td>
<td>1,204</td>
<td>0</td>
</tr>
<tr>
<td>Schoolcraft</td>
<td>Itasca/Cass</td>
<td>92</td>
<td>0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>State Parks Not In Land Exchange Program</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nerstrand Big Woods</td>
</tr>
<tr>
<td>Savanna Portage</td>
</tr>
<tr>
<td>Hill-Annex Mine</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>


because these lands are severely limited in their opportunity to produce revenue for the trust.

The Division of Forestry has initiated or participated in several land exchanges to consolidate scattered forestry land. As mentioned earlier, the Fish and Wildlife Division has initiated several land exchanges to preserve stands of old growth timber in scientific and natural areas and to protect critical wildlife habitat in wildlife management areas.

In Chapter 2 we estimated that about 150,000 acres of school trust land are in DNR management units that prohibit economic returns to trust beneficiaries. DNR acknowledges the need to compensate the Permanent School Fund for the loss of revenue potential on this land. However, the department has initiated relatively few trust land sales and exchanges in recent years. The reasons why DNR has not pursued the purchase or exchange of school trust land more aggressively are discussed in Chapter 2. DNR has used its limited land acquisition resources to acquire privately-held land in state parks, scientific and
natural areas, and other units rather than trust land. We were told that these privately-held lands are frequently threatened with subdivision and development. In contrast, the school trust land is already state-owned and administered and is not subject to the same development pressure.

**SUMMARY**

DNR leases school trust land for a variety of purposes—lakeshore cabins, sand and gravel, agriculture, commercial, governmental, and other uses. DNR currently manages 546 leased lakeshore lot on school trust land with an appraised value of $11.6 million. The lakeshore leases generated about $319,000 in revenues in 1997, the first year of the three year phase-in of 1997 annual lease rates. These revenues will increase to $578,000 in 2000. Other leases, easements, and licenses on school trust land generated about $600,000 in revenues in 1997.

A portion of the revenues generated from leases and contracts on trust land are used to finance management costs. Half of the lakeshore lease revenues are deposited in the Lakeshore Account to finance lease management costs and the other half are deposited in the Forest Suspense Account. Revenues from other leases go to the Forest Suspense Account.

Between 1986 and 1997, the state sold 1,060 lakeshore lots on school trust land, generating over $14 million in revenues for the Permanent School Fund, mostly financed with annual payments over 20 years. Aside from the sale of lakeshore lots and an exchange of over 5,000 acres of state park trust land in 1992, DNR has initiated few sales, condemnations, or exchanges of school trust land in recent years.
As discussed in Chapter 1, the responsibility for managing Minnesota’s school trust land and Permanent School Fund (PSF) is divided among several agencies. The Minnesota Legislature has delegated responsibility for managing the school trust land to the Department of Natural Resources, with oversight provided by the Permanent School Fund Advisory Committee (PSFAC). The State Board of Investment is responsible for investing the PSF principal and the Department of Finance is responsible for managing the PSF.

This chapter reviews Minnesota’s oversight of school trust land management and discusses options for financing the costs of land management. We asked the following questions:

- **How does Minnesota’s oversight of school trust land management compare with that in other states?**
- **Is Minnesota’s existing oversight structure adequate?**
- **Could another unit of government manage school trust land more cost-effectively than DNR?**
- **What options are available for financing DNR’s costs of managing the school trust land?**

To answer these questions, we reviewed national literature and conducted telephone interviews with trust land managers from a sample of states. We interviewed members of the Permanent School Fund Advisory Committee and reviewed the minutes of the committee’s meetings. We also talked with county staff and reviewed annual financial statements from county land management departments in northeastern Minnesota.

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3. We conducted telephone interviews with trust land and trust fund investment managers, or other state representatives, in Arizona, Colorado, Idaho, Iowa, Michigan, Montana, Nebraska, New Mexico, North Dakota, Ohio, Oregon, South Dakota, Utah, Washington, and Wisconsin. Of these states, Iowa and Michigan do not have any school trust land remaining, and Ohio and Wisconsin each have less than 5,000 acres of school trust land remaining.
This chapter compares Minnesota with other states in three areas: (1) the structure used to oversee trust land management; (2) the administrative structure of the state trust land management agency and the agency’s location within the state’s natural resources bureaucracy; and (3) funding for land management activities.

Oversight of school trust land management varies among the states we examined. We found that Minnesota’s oversight of trust land management, which is primarily the responsibility of a legislative advisory committee, needs to be improved to provide more comprehensive or consistent oversight. We also found that of the 13 states we examined only Minnesota and, to some extent, Washington use the same structure and staff within DNR to manage both trust and other state-owned land. In most other states independent trust land management agencies or separate trust land divisions within their land management agencies manage school trust land. Finally, three states we reviewed—Minnesota, Montana, and Idaho—use a combination of revenues from land management activities and general fund appropriations to finance trust land management costs.

OVERSIGHT STRUCTURE

Oversight of school trust land management varies from state to state. The basic model involves a state board of land commissioners that serves as trustee and oversees the operations of a state land management agency. In some states, the board of land commissioners is composed of an assortment of constitutional officers (such as the governor, lieutenant governor, state auditor, and superintendent of education). In other states, the board of land commissioners consists of members of the public who are appointed in a variety of ways. Some states do not have a board of land commissioners, but instead delegate authority to either an elected land commissioner or an executive director appointed by the governor.

Figure 4.1 shows that 9 of the 13 states we surveyed have boards of land commissioners and 3 have commissioners of public lands overseeing a state land management agency. In most of the states we examined, the state constitution provides for a board of land commissioners. Two states without boards of land commissioners—New Mexico and South Dakota—have land commissioners who are elected officials. These two states also have advisory boards that provide advice to the elected land commissioner. In Arizona, the land commissioner is appointed by the governor. In contrast, the Minnesota Legislature established the Permanent School Fund Advisory Committee in 1982 to oversee DNR’s management of school trust land. Prior to 1982, Minnesota did not have an entity charged with oversight of the DNR’s school trust land management activities.

The Permanent School Fund Advisory Committee (PSFAC) is supposed to oversee DNR’s management of school trust land.

The most important issue for Minnesota is not whether there is a constitutionally created board of land commissioners but whether the existing oversight structure and procedures are adequate. 5 A 1981 report by the Office of the Legislative Auditor concluded that DNR “should not have the sole decision-making authority over the use of school trust land.” The report recommended that “some management oversight be established outside of the organizational structure of the [DNR].” 6 In response, the Legislature created the PSFAC in 1982 to “advise the Department of Natural Resources on management of permanent school fund land,” “review the policies of the Department of Natural Resources on management of school trust fund lands,” and “recommend necessary changes in policy and implementation in order to ensure provident utilization of the permanent school fund lands.” 7

By law, the advisory committee consists of the chairs of the House Education and Ways and Means committees; the Senate Finance and Children, Families and

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**Figure 4.1: Oversight of School Trust Land Management**

<table>
<thead>
<tr>
<th>State</th>
<th>Oversight Entity</th>
<th>Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minnesota</td>
<td>Permanent School Fund Advisory Committee</td>
<td>Statutory</td>
</tr>
<tr>
<td>Arizona</td>
<td>Land Commissioner (appointed by governor)</td>
<td>Statutory</td>
</tr>
<tr>
<td>Colorado</td>
<td>State Board of Land Commissioners</td>
<td>Constitutional</td>
</tr>
<tr>
<td>Idaho</td>
<td>Board of Land Commissioners</td>
<td>Constitutional</td>
</tr>
<tr>
<td>Montana</td>
<td>State Land Board</td>
<td>Constitutional</td>
</tr>
<tr>
<td>Nebraska</td>
<td>Board of Educational Lands and Funds</td>
<td>Constitutional</td>
</tr>
<tr>
<td>New Mexico</td>
<td>Commissioner of Public Lands (elected official)</td>
<td>Constitutional</td>
</tr>
<tr>
<td></td>
<td>Land Trust Advisory Board</td>
<td>Statutory</td>
</tr>
<tr>
<td>North Dakota</td>
<td>Board of University and School Lands</td>
<td>Constitutional</td>
</tr>
<tr>
<td>Oregon</td>
<td>State Land Board</td>
<td>Constitutional</td>
</tr>
<tr>
<td>South Dakota</td>
<td>Commissioner of the Office of School and Public Lands (elected official)</td>
<td>Constitutional</td>
</tr>
<tr>
<td></td>
<td>Advisory Board</td>
<td>Statutory</td>
</tr>
<tr>
<td>Utah</td>
<td>Board of Trustees (as of 1995)</td>
<td>Statutory</td>
</tr>
<tr>
<td>Washington</td>
<td>Board of Natural Resources, which includes Commissioner of Public Lands (elected official)</td>
<td>Statutory</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wisconsin</td>
<td>Board of Commissioners of Public Lands</td>
<td>Constitutional</td>
</tr>
</tbody>
</table>

**Sources:** Office of the Legislative Auditor telephone surveys and interviews, July-August, 1997; and various annual reports from other states on file in the Office of the Legislative Auditor.

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5 A recent national study “found it difficult to relate patterns of management decisions to particular institutional arrangements” involving the composition and role of state land boards. The study also concluded that “it is difficult to trace particular outcomes to particular methods of selecting commissioners.” Souder and Fairfax, *State Trust Lands*, 40-41.


7 Minn. Stat. §124.078.
Learning committees; the Commissioner of Children, Families, and Learning; and two superintendents, one from a nonmetropolitan school district and one from a metropolitan area school district.  

Our review of Minnesota’s Permanent School Fund Advisory Committee and its activities has led us to conclude that:

- Minnesota’s structure for overseeing the management of school trust land needs improvement because it does not provide comprehensive or consistent oversight.

The Permanent School Fund Advisory Committee has met irregularly, usually at the call of DNR. Between 1987 and 1997, the committee met 11 times. It held several meetings each year from 1989 to 1991 to address lakeshore sales and state park land exchange items. The committee did not meet between December 1991 and April 1994. Two meetings, dealing with specific land exchanges in 1994 and 1996, lasted less than 15 minutes. When the PSFAC examined financial information recently it focused on forestry management costs.

Some PSFAC members told us that their role on the committee is a “sidelight” and that they do not feel connected to or engaged in school trust land issues because the committee seldom meets or because they lack background information. The PSFAC is partly composed of legislators who are chairs of major education and finance committees, but revenues from the PSF are a small proportion of education finance. Therefore, it is difficult for school trust land issues to capture the attention of these policy makers consistently.

Our review of PSFAC minutes revealed that the committee has focused most of its attention on the leasing and sale of lakeshore lots, the state park land exchange program, and forestry management costs. At its most recent meeting in March 1997, committee members had extensive discussions about forestry management costs. However, the committee has not requested, and DNR has not provided, comprehensive information on revenues generated from all land proceeds, including mineral lease revenues. The committee has one legislative staff member who has significant other responsibilities, and does not have the resources to conduct detailed, independent reviews of land management activities.

Finally, the Commissioner of Finance is responsible for managing the Permanent School Fund. Minnesota laws do not clearly define the management role assigned to the commissioner and there is no specific language clearly articulating the Department of Finance’s responsibilities. Traditionally, the term “Permanent School Fund” has been used to refer to the money in the fund, not the school trust land. The department’s activities have involved transferring funds between DNR, SBI, and PSF, and reviewing and signing off on the forest management cost reports.

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8 The Commissioner of the Minnesota Department of Children, Families, and Learning appoints the school district superintendents to the advisory committee. Members of the committee may appoint a designee to serve in their place.

9 Minn. Stat. §11A.16, subd. 3.

10 Income from investment of the PSF principal is transferred to the Endowment School Fund, an expendable trust fund, before it is distributed to school districts.
One result of Minnesota’s oversight structure is that no single agency or entity has been responsible for compiling and presenting comprehensive information related to both the school trust land and PSF investment. In the past, no single entity has routinely compiled comprehensive annual financial information related to the PSF, such as the amount of annual deposits to the PSF principal from land management activities.  

Our evaluation uncovered a number of problems with DNR’s main data files that are used to manage school trust and other state-owned land. For instance, the trust status for parcels that were part of the state park land exchange in 1992 had never been transferred, resulting in a total of 546 instead of 541 lakeshore lots on school trust land. While the data problems appear to be minor, they raise questions about the accuracy of the information that is used to manage trust assets. With more regular review and oversight of trust land management activities these problems could have been identified and corrected earlier.

To address these concerns, we recommend that:

• The Legislature should improve oversight of school trust land management by expanding the Permanent School Fund Advisory Committee and assigning a more explicit oversight role to the Department of Finance.

We believe that oversight of school trust land management should be improved to ensure that the oversight provided is consistent and comprehensive. These objectives could be achieved by having the Department of Finance play a stronger oversight role. One option would be to have the Commissioner of Finance serve as chair of the PSFAC and assume responsibility for calling regular meetings. The committee would retain its current responsibilities of reviewing DNR policies on trust land management, providing guidance and advice, and making recommendations to the Legislature and to DNR for changes in policy or implementation when necessary. We think that the Commissioner of Finance could add financial expertise, a statewide perspective, continuity, and another voice for the interests of the trust to the committee. We also believe the Commissioner of Finance could help ensure that the PSFAC regularly review financial aspects of land management policies and practices, such as the appropriateness of management costs and policies related to land leases, exchanges, and sales. Such reviews could help bring attention to policy questions regarding the state’s fiduciary responsibility to the trust that could be discussed and acted on by the PSFAC and ultimately DNR and the Legislature. We also recommend that:

• The Legislature should use Permanent School Fund resources to fund a position, full- or part-time, in the Department of Finance to staff the Permanent School Fund Advisory Committee.

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11 The Minnesota Accounting and Procurement System (MAPS), which contains financial data from fiscal year 1996 to present, greatly expedited our analysis of PSF financial information for the more recent years.
Staff supporting the PSFAC could regularly review the financial aspects of land management policies and practices. With assistance from DNR and SBI, staff could also compile a comprehensive annual financial statement of land management proceeds, management costs, deposits to the Permanent School Fund, and investment earnings and distributions. Also, we think that:

- The Legislature should require DNR to develop a biennial report on the management of school trust land.

The report could summarize past land management activities, including revenues raised from mining, timber sales, land leases and sales and management costs paid. It also could better inform the Legislature about land management issues and policy choices.

**ADMINISTRATIVE STRUCTURE OF LAND MANAGEMENT AGENCY**

This section examines the administrative structure of the state trust land management agencies, which in Minnesota’s case is DNR. Our survey of other states identified three administrative patterns that are common for state land management agencies responsible for trust land management. The trust land management agency could be:

1. Totally independent of other state agencies;

2. Independent, but with a larger agency providing administrative oversight; or

3. Integrated into another agency, sharing facilities and staff with that agency.

Typically, an independent agency that deals exclusively with trust land issues is likely to be focused on trust goals and beneficiaries. In contrast, a trustee’s emphasis on trust land may be diffused if the agency also manages other state-owned land and has other responsibilities. Attention to trust and beneficiary goals may be diverted when another activity that the land management agency manages requires a significant commitment of personnel who would otherwise be contributing to trust management activities. More importantly the goals and objectives for the agency’s other responsibilities may conflict with those of trust land management.

We found that:

- Of the 13 states we examined, only Minnesota and, to some extent, Washington use the same staff and facilities within the Department of Natural Resources to manage both trust and other state-owned land.

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Figure 4.2 shows land management organizations for the states we surveyed. In Minnesota the staff and facilities used for trust land management are fully integrated with other land and natural resource management responsibilities within the DNR. The Minnesota DNR does not have designated staff or a separate division responsible for trust land management. As discussed in Chapter 2, most DNR divisions do not distinguish between trust land and other state-owned land when accounting for staff time or land management activities.

In Minnesota, the same DNR staff manage both trust land and other state-owned land.

In the state of Washington, three divisions in DNR are responsible for the majority of trust land management: (1) the Forest Resources Division manages 3 million acres of land, two-thirds of which is trust land; (2) the Agricultural Resources Division manages 1 million acres, all of which is trust land; and (3) the Resource Planning and Asset Management Division manages all commercial properties, the majority of which are trust land. Some support divisions also assist trust management but do not exclusively serve trust land. While Washington does combine trust and nontrust functions within some divisions, staff maintain separate records for time and resources spent on trust and other land.

Two states—Colorado and Montana—have trust land management divisions located in their state departments of natural resources. Montana recently changed the administrative structure of its trust land management. Prior to 1995, Montana had an independent trust land department. On July 1, 1995, a government reorganization established the current Montana Department of Natural Resources.
and Conservation (DNRC) by combining several different functions, including the trust land department. As a result, the Trust Land Management Division is located in DNRC. Similarly, in Colorado the State Land Board is a separate division located within DNR.

Nine of the 13 states we surveyed have independent land management departments whose primary responsibility is to manage school and other trust land: Arizona, Idaho, Nebraska, New Mexico, North Dakota, Oregon, South Dakota, Utah, and Wisconsin. Some of these state agencies may also manage private land, provide fire protection services for all state land, or fulfill other nontrust related duties.

Utah recently reorganized its trust land management structure as a result of initiatives proposed by beneficiary groups led by the state parent-teachers association. In 1994, the Utah Legislature established the School and Institutional Trust Lands Administration as a separate and independent agency to remove potential conflicts of interest with other state land management agencies. Prior to this, the school trust land department also managed other state-owned land.

We were not able to evaluate the effectiveness of trust land management for each of the above organizational structures. However, responsibility for school trust land management in other states usually rests with a single independent agency or a specific division within an agency. Specific trust land agencies and staff are responsible for managing trust land and are accountable to the state land board or commissioner. Separating responsibility for trust land management from other land management responsibilities removes potential conflicts of interest. The trust land agency or division focuses on trust goals, eliminating other competing goals and objectives.

Although we stop short of recommending that Minnesota’s DNR reorganize its administration of school trust land to be consistent with the organizations of other states, we suggest that:

- **DNR should consider having specific staff within the department assume responsibility for coordinating school trust land management activities.**

We think that DNR should assign specific staff to serve as a voice on behalf of the school trust within the department. We also suggest that the staff person be independent of other DNR functions. Staff responsibilities could include writing a biennial report on school trust land management, training department staff on the nature of trust land, working as liaison with the PSFAC, and monitoring land management activities within the department. The Bureau of Real Estate Management may be an appropriate division to house this function because the...
bureau currently maintains land records for trust land and administers leases on trust land.

Other Management Issues

We were asked to consider whether another unit of government could manage Minnesota’s school trust land more cost-effectively than DNR. To address this question we contacted representatives from Minnesota counties with land departments and reviewed their annual financial reports.

In Minnesota, the state holds title to tax-forfeited land, but counties manage this land. Fifteen counties have land management departments responsible for tax-forfeited land. Most of the county tax-forfeited land is forest land; it represents about 17 percent of the state’s timberland. The county land departments vary considerably in the amount and type of land they administer. St. Louis County manages the most land (approximately 745,000 acres), while Lake of the Woods County manages the least (1,600 acres). Five counties—St. Louis, Koochiching, Itasca, Cass, and Aitkin—manage about 70 percent of the commercial timberland managed by all county land departments.

County land departments get revenues from a variety of sources, such as timber sales, leases, and intergovernmental grants. Sources of revenue vary depending on the amount of tax-forfeited land in a county and the resources on that land. Some county land departments depend primarily on timber sale revenues for funding. Some county land departments are also expected to return a portion of timber sale revenues to the county general fund. In addition to forestry management, county land departments have a variety of other responsibilities, including administering land leases and sales, enhancing recreational opportunities, improving wildlife habitat, and maintaining roads and public accesses.

Our examination of annual financial statements highlighted the wide variation in county land department operations. The land departments in each county have different responsibilities and use different categories and levels of detail to report expenses. Given this lack of uniformity, we were unable to aggregate management expenses, make quantitative comparisons among different counties or between the counties and DNR, or reach conclusions about the relative cost-effectiveness of managing school trust land.

Another issue is whether the county land departments could provide all of the land management functions that DNR provides. DNR provides minerals management, exploration and leasing activities, and fire suppression services for all land types. The county land departments are not equipped to provide these services. If responsibility for managing trust land were delegated to another level of

15 The land departments are located in the following counties: Aitkin, Becker, Beltrami, Carlton, Cass, Clearwater, Cook, Crow Wing, Hubbard, Itasca, Koochiching, Lake, Lake of the Woods, Pine, and St. Louis.

government, the state would need to continue to articulate consistent policies for management of timber harvesting, lakeshore lot leases and sales, and land exchanges. Decentralizing trust land management could further disperse decision making and complicate the state’s ability to provide comprehensive and consistent oversight. We conclude that:

- **Minnesota counties should not be recruited to manage school trust land.**

An improved oversight structure, as recommended above, could be used to address issues of cost effectiveness and the appropriate allocation of management costs in the future.

A final management concern raised during our evaluation is DNR’s move toward decentralized decision making, for all functions including school trust land management. For the past 5 to 6 years, DNR has been working with teams, giving more authority to field staff, and focusing on decision making at the regional level. Depending on the issue, team members consist of representatives from various DNR divisions—forestry, parks and recreation, fish and wildlife—that are required to represent the goals of their respective divisions as well as to promote the best interests of trust beneficiaries. Some DNR staff told us this should not affect the department’s management of trust land. Other DNR staff, however, told us it might have a detrimental effect because some staff may not adequately understand the revenue-generation goals of the trust.

We were not able to thoroughly evaluate the effect of DNR’s decentralized decision making on trust land management. This type of decision making, however, requires everyone to be aware of the fiduciary responsibilities related to school trust land management, otherwise there is a risk that the fiduciary responsibilities will not be carried out. We do not know the extent to which DNR field staff are aware of these responsibilities. DNR staff need to be informed about the unique nature of school trust land to carry out these responsibilities. We suggest that DNR improve staff training that focuses on the unique nature of school trust land.

**MANAGEMENT COSTS**

The last organizational issue addressed in this chapter is funding for land management activities. States use variations of three basic models to finance school trust land management activities:

1. General fund appropriations from the state legislature;
2. Revenues from trust land management activities; or
3. A combination of land management revenues and general fund appropriations.
In Minnesota, DNR’s trust land management costs are financed with a combination of land management revenues for forestry management and lakeshore leasing/sales and General Fund appropriations for minerals management and other land sales. As discussed in Chapter 2, revenues from forestry management activities on school trust land are used to reimburse the General Fund for forest management costs. Revenues in excess of costs are deposited in the PSF.

The cost of minerals management activities on school trust land is financed with DNR’s General Fund appropriation. Revenues from state mineral leases on trust land are not used to finance minerals management costs.  

The Minnesota Constitution requires that income from the sale or disposition of school trust land be deposited in the Permanent School Fund, but the constitution does not contain language relating to lease revenues. In 1987, the Legislature authorized the use of lakeshore lease revenues to finance part of DNR’s school trust land management costs. Since 1988, 50 percent of the revenues from lakeshore leases have been deposited in a special Lakeshore Account to finance the costs of appraising, selling, and leasing lakeshore lots, with the other 50 percent being deposited in the Forest Suspense Account.

Of the states we surveyed, we found that:

- Minnesota, Montana, and Idaho use a combination of revenues from land management activities and general fund appropriations to finance school trust land management costs.

As Figure 4.3 shows, in Montana and Idaho, one-half of management costs are financed with general fund appropriations and one-half are financed with timber sale revenues. The independent state land management departments in Arizona and South Dakota receive general fund appropriations to finance their operations. In the remaining states—Colorado, Idaho, Nebraska, New Mexico, North Dakota, Utah, and Washington—revenues from land management activities are used to finance the management costs. In Oregon, the Division of State Lands is financed from investment earnings of the permanent school fund. And in Wisconsin, management costs for the Board of Commissioners of Public Lands are financed from interest earnings on municipal and school loans made with Permanent School Fund assets.

Because most of the other states have independent agencies or divisions responsible for managing school trust land, they are able to identify actual management costs. This is not always the case in Minnesota. Because management of trust land is fully integrated with other DNR responsibilities, the allocation of management costs to different types of land, such as trust land, is usually made using a variety of assumptions.

17 A minerals suspense account, similar to the Forest Suspense Account, was created in 1955 to allow management costs to be applied against mineral lease revenues from school trust land. Minn. Stat. §16A.125, subd. 5. An Attorney General’s Opinion maintained that this law was unconstitutional and that the costs of managing minerals could not be paid out of school trust land proceeds. Minnesota Attorney General’s Opinion #454E, October 11, 1955. The Legislature repealed the law in 1995. Minn. Laws (1995) ch. 220, sec. 26 repealed Minn. Stat. §16A.125, subd. 6.
While forest management costs appear to be reasonably allocated (see our discussion in Chapter 2), the allocation of mineral management costs is more complicated. Mineral management costs are not associated with the mineral potential of the land. Exploration activities may not result in the discovery of economically-viable mineral deposits. Mineral revenues are not necessarily related to management costs or activities. Usually, there is a long lead time between issuance of a lease and revenue generation. This means that the revenue received in one year is not necessarily related to that year’s management activities or costs. Based on these considerations, we recommend that:

- No changes should be made to how Minnesota finances the costs of school trust land management.

Regardless of how management costs are financed, it is unlikely to have an impact on how Minnesota finances education. Minnesota policy makers will maintain their commitment to education and are not likely to change the total amount appropriated to K-12 education based on the amount of revenues that are generated from the Permanent School Fund for the support of public education.
Mineral Management Costs

Recently, some policy makers have expressed an interest in using mineral revenues from school trust land to finance DNR’s costs for minerals management on that land. In similar efforts related to University land, a 1996 Attorney General’s memorandum reversed a 1955 opinion that minerals management revenues from school trust land could not be used to finance DNR’s management costs.  

In 1995, land management costs related to minerals management activities on University trust land became an issue when the Minnesota Legislature created the “University lands and minerals suspense account.”  

In 1995, the Minnesota Legislature made a one-time appropriation of $500,000 for fiscal year 1997 to reimburse the General Fund for DNR’s management of minerals on University trust land. The Legislature directed the University board of regents to discuss options for calculating reasonable costs for DNR to maintain the university trust land. The negotiated figure of $250,000 was not based on actual mineral management costs. 

We were asked to examine mineral management costs for school trust land and to determine how these costs could be estimated. The Division of Minerals, like other DNR divisions, does not record or allocate management costs based on land type. Therefore, any estimate of mineral management costs for school trust land needs to be based on an allocation of existing management costs. 

The Division of Minerals had a total budget of $4.7 million in FY 1996, of which about $4.0 million was for mineral management costs and about $700,000 was passed through to fund three research programs. Using these figures as a base, we determined that:

- **Estimates of mineral management costs allocated to school trust land could range from $202,000 to $848,000 annually.** 

Table 4.1 summarizes the options used for estimating mineral revenues that could be used to finance mineral management costs for school trust land. The Division of Minerals is responsible for managing mining activities on various types of land—school and University trust land, as well as DNR-acquired, tax-forfeited,

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21 Minn. Laws (1996), ch. 395, secs. 17 (a) and 19 repeal the University lands and minerals suspense account effective June 30, 1997. Minn. Laws (1996), ch. 407, sec. 3 reduced the FY 1997 appropriation to $250,000 from the University lands and minerals suspense account.
Table 4.1: Estimates of Mineral Management Costs for School Trust Land, 1996

<table>
<thead>
<tr>
<th>Description</th>
<th>Estimated Management Costs</th>
<th>Percent of School Trust Mineral Revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Option 1 - Allocates 23 percent (the state’s share of total mineral rights) of mineral management costs based on percentage of revenues from each land type</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Option 1.a. Total mineral costs, including research</td>
<td>$239,500</td>
<td>15%</td>
</tr>
<tr>
<td>Option 1.b. Mineral management costs only</td>
<td>202,400</td>
<td>12</td>
</tr>
<tr>
<td>Option 2 - Bases management fee on 20 percent of mineral revenues generated</td>
<td>328,700</td>
<td>20</td>
</tr>
<tr>
<td>Option 3 - Estimates management costs by calculating the percent of acres leased and applying that percentage to mineral revenues generated</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Option 3.a. Portion of acres leased by type of lease</td>
<td>$847,700</td>
<td>52</td>
</tr>
<tr>
<td>Option 3.b. Portion of total acres leased</td>
<td>$247,800</td>
<td>15</td>
</tr>
</tbody>
</table>

SOURCE: Office of the Legislative Auditor estimates based on mineral leasing costs and revenues for fiscal year 1996.

and consolidation conservation land. While management costs are allocated to each land type, the material presented focuses on school trust land.

Option 1 estimates management costs using the state’s share (23 percent) of total mineral ownership as the basis for recovering management costs. This option takes 23 percent of mineral management costs in fiscal year 1996 and allocates it based on the percentage of mineral revenues generated from each land type. Option 1.a. uses total mineral costs including the pass through research funds. Option 1.b. uses mineral management costs only.

Option 2 estimates management costs by taking 20 percent of mineral revenues generated from each land type. This is based on statutory language requiring that 20 percent of mining revenues from tax-forfeited land be deposited in the General Fund.  

Option 3 estimates management costs by applying the percent of acres leased to the mineral revenues generated. Option 3.a. uses the portion of acres leased by each lease category—iron ore/taconite, metallic minerals, and peat leases. Option 3.b. uses the portion of total acres leased.

Since it is extremely difficult to assess management costs to a particular type of land, such as trust land, the process of estimating mineral management costs

22 Minn. Stat. §93.335, subd. 4. This language was authorized in 1949.
attributed to trust land is dependent on assumptions. Several sets of assumptions could be used to estimate the minerals management costs that might be attributed to school trust land.

SUMMARY

In Minnesota, the Permanent School Fund Advisory Committee, consisting of legislators and educators, oversees DNR’s management of school trust land. In this chapter, we conclude that Minnesota’s structure for providing oversight needs to be improved because it does not provide comprehensive or consistent oversight. We suggest that the Commissioner of Finance be added to the advisory committee and serve as the committee’s chair. We also recommend that the Legislature appropriate resources from the PSF to fund a position to staff the PSFAC and that DNR’s Bureau of Real Estate Management be required to develop a biennial report on trust land management.

Of the 13 states we examined, Minnesota is one of only two states that use the same staff and facilities within its land management agency (DNR) to manage both trust and other state-owned land. In most other states independent trust land management agencies or separate trust land divisions within larger land management agencies manage school trust land. We do not recommend that Minnesota’s DNR reorganize its administration of school trust land to be consistent with the organizations in other states, but we think that DNR should consider the possibility of assigning specific staff responsibility for coordinating school trust land activities within the department.

Finally, we reviewed the options for financing land management costs. Currently Minnesota uses a combination of revenues from land management activities and General Fund appropriations to finance trust land management costs. Other options include financing these costs totally with General Fund appropriations or totally from revenues from land management activities. Since it is difficult to allocate mineral management costs to specific types of land, we do not recommend changing the current financing arrangements at this time.
The Minnesota Constitution and statutes delegate management of the Permanent School Fund (PSF) principal to the State Board of Investment (SBI) which consists of the Governor, the State Auditor, the Secretary of State, the Attorney General, and the State Treasurer. The board is assisted by a professional investment staff that invests trust fund assets according to board guidelines. The PSF principal amounted to over $437 million on June 30, 1997.

In this chapter we discuss the investments made on behalf of the trust and issues that may face the trust in the future. We asked:

- How has the State Board of Investment invested the principal of the fund? What rates of return have been achieved?
- How have other states structured their investment and distribution of permanent school trust funds?

To answer these questions, we reviewed SBI investment policy and investment returns, interviewed other state investment managers, and reviewed relevant investment literature.

INVESTMENT RESTRICTIONS

SBI’s investment of the PSF principal is restricted by the Minnesota Constitution and statutes. Figure 5.1 shows the key provisions that limit SBI investment strategies. The major provisions include:

- The Constitution requires that the principal of the Permanent School Fund cannot be spent; it must remain perpetual and inviolate.
- The fund must annually distribute all income and dividends received (net of capital losses) to public school districts.
- Minnesota Statutes require that capital gains from the sale of securities be added to the fund’s principal.
- Net realized capital losses must be subtracted in equal installments from capital gains and interest and dividends received over a 10-year period.
**Figure 5.1: Restrictions on the Permanent School Fund**

<table>
<thead>
<tr>
<th>Type of Restriction</th>
<th>Constitution</th>
<th>Statutes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditure of the Fund’s Principal</td>
<td>Prohibits expenditure of the principal.</td>
<td>NA</td>
</tr>
<tr>
<td>Definition of the Fund’s Principal</td>
<td>NA</td>
<td>The principal consists of the proceeds from land sales and leases plus the net realized capital gains derived from the investment of these proceeds.</td>
</tr>
<tr>
<td>Income Distribution</td>
<td>Net interest and dividends must be distributed to school districts in a manner prescribed by statutes.</td>
<td>Each fiscal year’s net income and dividends are transferred to the Endowment School Fund, from which they are distributed to school districts in proportion to the number of students in average daily membership.</td>
</tr>
<tr>
<td>Net Capital Losses</td>
<td>Net realized capital losses must be subtracted from the interest and dividends earned thereafter.</td>
<td>Net realized capital losses must be recovered from capital gains apportioned for that year or in equal installments from interest and dividends over a ten-year period.</td>
</tr>
<tr>
<td>Net Capital Gains</td>
<td>NA</td>
<td>Capital gains shall be apportioned in equal installments over the next ten fiscal years to offset net losses. Any capital gains not needed to offset losses should be added to the principal of the fund.</td>
</tr>
<tr>
<td>Investment Goals</td>
<td>Secure the maximum return consistent with the maintenance of the perpetuity of the fund.</td>
<td>NA</td>
</tr>
<tr>
<td>Investment Restrictions</td>
<td>NA***</td>
<td>Same as for retirement funds. (Stocks, bonds, cash equivalents, and alternative investments, including some foreign securities, are permitted.)</td>
</tr>
</tbody>
</table>

***Prior to passage of the constitutional amendment in November 1984, the fund could not have more than 20 percent stocks and 40 percent corporate bonds. In addition, the Constitution imposed certain financial quality restrictions on the stocks and bonds held by the fund. The remainder of the fund had to be invested in the United States Treasury or agency United States, or the bonds of Minnesota or other states. These restrictions were removed by the 1984 amendment.

Net capital gains are apportioned to the fund’s principal in equal installments over ten fiscal years and are first used to offset any security sale losses in that fiscal year. Net losses from the sale of securities are recovered from the portion of capital gains apportioned to that fiscal year and if the gains are insufficient, the losses are recovered from interest and dividend income in equal installments over the following ten fiscal years. SBI’s investment of the fund is also constrained by the general statutory restrictions on allowable investments contained in Minn. Stat. §11A.24. Prior to a 1984 constitutional amendment, the investment of the PSF portfolio was also limited to 20 percent equities (stocks) and 40 percent corporate bonds.

SBI INVESTMENT STRATEGY FOR THE PSF PORTFOLIO

SBI’s investment of the PSF portfolio has also been limited by political constraints. Legislators expected relatively high income from the fund because of state budget pressures in the 1980s and early 1990s. As a result of these pressures, SBI has invested exclusively in fixed-income securities (bonds) to maximize current income. Although the constitutional restriction on equity (stock) investments was removed by the 1984 constitutional amendment:

- The amount invested in equities actually declined from over 20 percent of the PSF portfolio in the mid-1980s to no equities by 1986.

In general, over the long-term, total returns from equity investments are higher than from fixed-income investments. Because dividends on equities usually average a return on investment between 2 and 3 percent, and returns on fixed-income securities usually average several percentage points higher, the current income for any fund is maximized in the short term by a portfolio holding only bonds.

The allocation of assets only to bonds has profound effects on a portfolio’s ability to grow in the longer run, especially when inflation is considered. This is because stocks have consistently outperformed bonds over time. For example, Figure 5.2 shows the relative nominal returns of stocks, bonds, and cash since 1960. Figure 5.3 shows that the same pattern of returns has held true during the bull market for stocks of the last 15 years, with stocks outperforming bonds by between 6 and 8 percent annually. Although, in general, stocks consistently outperform bonds over longer time periods, in any one year stock returns can be more volatile than bonds.

SBI Investment Policy 1986-97

How has SBI responded to the trade-off between long-term returns and short-term income? SBI’s investment policy since 1986 has been to produce the maximum

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1 Minn. Stat. §11A.16, subd. 5 (a)(b).
amount of current income while maintaining portfolio quality. The board adopted this policy because the Legislature expected a certain amount of income to be

Figure 5.2: Compound Returns on Stocks, Bonds, and Cash, 1960-96

![Graph showing compound returns on stocks, bonds, and cash from 1960 to 1996.]

SOURCES: Standard & Poor’s 500 Stock Index, Lehman Aggregate Composite Bond Index, and Treasury Bills.

Figure 5.3: Stock and Bond Returns for Periods Ending 1996

![Graph showing stock and bond returns for 5, 10, and 15-year periods ending in 1996.]

SOURCES: Standard and Poor’s 500 Stock Index and Lehman Aggregate Composite Bond Index.
transferred annually to offset state school aid payments. The board felt that the need for current income, and the requirement that capital gains become part of the fund principal and therefore not be available to reduce potential losses attributable to equity price fluctuations, necessitated a fixed-income security portfolio.

As a result of the need for current income, beginning in 1986 the PSF’s relatively small (approximately 20 percent) equity portfolio was eliminated. The board has followed a “laddered” fixed-income security investment approach from 1986 to 1996, purchasing bonds of varying terms and almost always holding them until the bonds’ maturity date. This results in a staggered or “laddered” maturity of the bonds over time.

SBI’s short-term investment policy arguably has maximized predictable current spendable income at the expense of long-term principal growth. The board recognized this dilemma in 1986:

The Board believes that the Fund’s needs could better be met by a longer-term outlook. Under the current asset allocation, spendable income cannot grow over time. As a result, the value of income produced by the fund, in inflation-adjusted terms, will gradually decline. On the other hand, a longer-term outlook that includes investments in equity assets could allow the Fund’s principal, and hence spendable income, to grow.

Since 1986, SBI staff have recommended consistently that the PSF portfolio contain equity securities. However, because of the state budget crisis in the early 1980s, the need for current annual income led the board to continue with a bond investment strategy in order to maintain higher current income.

In 1991 our office also recommended that:

SBI, along with the administration and the Legislature, should review the accounting restrictions placed on the fund and the desirability of changing the statutes and/or the Constitution so that stocks could be added to the portfolio once the budget crisis is over.

At that time we estimated that the PSF was losing from $3 to $9 million per year over the long term by not holding 50 percent stocks in the portfolio. We reported that investment of a portion of the portfolio in stocks, although requiring an initial drop in distributed income, would likely allow the PSF portfolio to grow over the longer term.

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4 State Board of Investment Annual Reports 1986-1996.
6 Ibid., xx. The report compared a 50 percent equity/50 percent bond portfolio to the SBI 100 percent bond approach.
PSF Investment Performance

Figure 5.4 shows the annual percentage returns since fiscal year 1987 resulting from SBI’s bond asset allocation strategy. We found that:

- The investment performance of the PSF portfolio has been comparable to that of similar investments over the last ten years.

Over the ten year time period between fiscal years 1988 and 1997 the portfolio has had a compound annual total return of 9.4 percent, comparable to the Lehman Aggregate Composite Bond Index return of 8.8 percent during that period. However, over the same period of time the Standard and Poor’s 500 Stock Index grew at a 15 percent compound rate.

The Permanent School Fund’s investment performance has been comparable to similar portfolios but less than stocks.

The investment management of the PSF portfolio, combined with $37 million in deposits from DNR management of trust lands, has resulted in an increase in the portfolio’s market value from $358 million to $437 million over the last ten years. Figure 5.5 shows the PSF portfolio’s market value at the end of each fiscal year since 1987. During the same period the Permanent School Fund paid out $325.6 million to the Endowment School Fund. Although $325.6 million is a large sum, it is a small percentage of the total amount of state and local government education funding paid over the last ten years.

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7 Morningstar Fixed Income Annuity Performance Report, July 1997, 5. The Lehman Aggregate Bond Index is a composite of the performance of a portfolio of 6,500 publicly traded bonds.
SBI has managed an investment portfolio with an equity component for the Environmental Trust Fund since 1994. SBI has managed the portfolio with an asset allocation of approximately 50 percent stocks and 50 percent bonds. Figure 5.6 shows a comparison of the returns from the Environmental Trust Fund’s partial stock portfolio with the returns from the Permanent School Fund bond portfolio between 1994 and 1997. The figure shows that the partial stock allocation used for the Environmental Trust Fund earned a higher return than the PSF portfolio over that period.

Minnesota’s PSF Investments and Distributions

According to investment managers we consulted, permanent school trust fund investment strategy and distribution policy are interrelated. The PSF’s distribution policy is dictated by the constitutional requirement to pay all dividends and interest proceeds to public school districts. ⁸ We found that as a result of this requirement:

- The PSF has paid out a relatively high percentage of its assets to public school districts.

Table 5.1 shows that over the last ten years, the PSF has distributed income and dividends of between 7 and 9 percent of the trust’s market value each year to

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⁸ Minn. Stat. §§11A.16, subds. 5 and 6, and 124.08; Minn. Const. art. XI, sec. 8. Revenue from the Permanent School Fund is transferred to the Endowment School Fund, an expendable trust fund, and then distributed to school districts. Minn. Stat. §§124.08 and 124.09.
schools. Such a high payout ratio makes it unlikely that the fund will grow relative to inflation. The fund cannot keep pace with inflation unless the additions to the fund’s principal from land management proceeds make up the difference.

Since, as Table 5.2 shows, DNR’s management of the land assets have been contributing approximately 1 percent of the PSF portfolio’s market value each year, land management proceeds are unlikely to make up the difference between investment returns and inflation.
We found that:

- The PSF portfolio has not kept pace with inflation over the last ten years.

The result of a bond investment strategy, combined with a high distribution ratio and relatively small contributions to the fund’s principal from DNR land management activities, has been a decline in the fund’s market value after considering inflation. Figure 5.7 shows that the market value of the PSF principal, even with additions from DNR land management, has not kept pace with inflation over the last ten years. Figure 5.8 shows that the value of the distributions from the PSF to public school districts has also lost ground to inflation over the same time period.

### 1997 Change in PSF Investment Policy

As noted earlier, SBI staff along with the Legislative Auditor had recommended that the PSF portfolio contain some portion of equities. An initiative to change the portfolio’s asset mix to 50 percent equities was included in the Governor’s recommendations for the 1998-99 budget and was approved by the 1997 Legislature.

- **Actions by the Governor and the 1997 Legislature have allowed SBI to change the PSF portfolio asset allocation to include equities.**

The addition of equities to the PSF portfolio will mean a short-term decrease in distributable income to public education. That reduction is estimated to be $18 million less in interest income over the 1998-99 biennium. SBI modeling of the effect of changing the portfolio asset mix to 50 percent equity-50 percent bonds projected that interest income might be back to 1997 levels by 2008. Capital

### Table 5.2 PSF Deposits from Land Proceeds as a Percent of PSF Market Value, 1988-97

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>PSF Market Value (Millions)</th>
<th>Land Proceeds as a Percent of PSF Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>358</td>
<td>.4%</td>
</tr>
<tr>
<td>1989</td>
<td>385</td>
<td>.6</td>
</tr>
<tr>
<td>1990</td>
<td>377</td>
<td>.7</td>
</tr>
<tr>
<td>1991</td>
<td>392</td>
<td>.9</td>
</tr>
<tr>
<td>1992</td>
<td>419</td>
<td>.8</td>
</tr>
<tr>
<td>1993</td>
<td>456</td>
<td>1.0</td>
</tr>
<tr>
<td>1994</td>
<td>416</td>
<td>1.5</td>
</tr>
<tr>
<td>1995</td>
<td>439</td>
<td>.9</td>
</tr>
<tr>
<td>1996</td>
<td>419</td>
<td>1.1</td>
</tr>
<tr>
<td>1997</td>
<td>437</td>
<td>1.0</td>
</tr>
</tbody>
</table>

**SOURCE:** Office of the Legislative Auditor analysis of Department of Finance and State Board of Investment data.
Figure 5.7: PSF Market Value Compared to Inflation, 1988-97

Dollars (in millions)


Consumer Price Index


Figure 5.8: PSF Distribution to Schools Compared to Inflation, 1988-97

Dollars (in millions)


Consumer Price Index

appreciation between 1998 and 2008 was projected to add over $200 million to the total market value of the portfolio. SBI modeling is based on average historical returns and may not occur exactly as projected; nonetheless, it is a reasonable estimate of future investment results.

SBI implemented the initiative by selling $210 million in bonds in July 1997 (approximately one-half of the PSF market value on June 30, 1997) and purchasing $212 million of Standard and Poor’s 500 index portfolio in July and August 1997. The portfolio is passively managed internally by SBI.

**ENDOWMENT FUND INVESTMENT POLICY**

Trust funds, like the Permanent School Fund and its counterparts in other states, have much in common with endowment funds. The principle similarity is that the funds are to be held in perpetuity while generating a stream of income for some group or beneficiary. Endowment funds typically manage assets for charitable institutions, such as the Ford or McKnight Foundations, and for universities. In reviewing endowment fund investment management we found:

- University endowment funds have increasingly moved into equity investments and have begun to consider capital gains as part of the expendable portion of the endowment.

Endowment funds face the same conflicts as perpetual trusts, such as the PSF, between maximizing predictable short-term revenue and long-term growth in assets and revenues. For both there is a tradeoff between the short term and the longer term. How that tradeoff is balanced depends on the fund’s tolerance for risk.

An endowment fund’s tolerance for risk is determined by how it trades off short-term versus long-run objectives. In turn, the emphasis on short-run versus long-run objectives is primarily a function of the importance of the endowment fund’s spendable income stream compared to the sponsor’s total revenue. Where the spendable income stream is a relatively small percentage of total revenues, the risk tolerance of the sponsor will tend to be higher than in a situation where the fund’s spendable income stream is a large percentage of the sponsor’s total revenue picture. In the latter case, the sponsor must be more cautious. A protracted period of poor investment results could have a serious impact on the various projects that the endowment fund is supposed to finance.

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9 Passively managed portfolios are not actively traded and typically have low management and transaction costs.

Endowment fund management underwent a fundamental change as the result of two influential reports sponsored by the Ford Foundation in 1969. The first report found that:

The record of endowment management by most colleges and universities in the United States has not been good. We believe the fundamental reason is that the primary emphasis has been given to avoiding losses and sustaining income. In our opinion, the most important present responsibility of the trustees of these institutions with respect to endowments is to shift their objective to maximizing the long-term total return. We believe the total return can be increased significantly to permit both a larger annual contribution to operations and greater long-term growth. [Emphasis added]

The second Ford report found that there was no legal impediment to trustees considering total return of the endowment portfolio to be a proper objective. The report challenged the widely held view of the time, that the realized gains of endowment funds can never be spent and must be added to the principal.

The result of these two influential reports was a significant shift during the 1970s in the philosophy of endowment trustees about proper investment objectives. By 1975, a Twentieth Century Fund report found that:

There is fairly wide agreement that total return as an investment objective is a good thing. The investment manager is expected to make the endowment fund as profitable as possible, within reasonable risk limitations, without regard for whether the profit takes the form of income yield (dividends, interest, and the like) or appreciation in market value.

Over the last two decades, university endowment funds have increasingly moved into equities and have considered capital gains as a part of the expendable portion of the endowment.

Endowment Fund Distribution Policy

When endowment fund managers moved away from the notion of investing mostly in fixed-income securities and distributing the interest earnings, they had to develop new strategies for managing the endowments’ investment proceeds. The first Ford Foundation report recommended that endowments transfer to operating funds “an aggregate amount equal to 5% of the three-year, moving average, market value of the fund—whether or not that amount is provided by interest and dividends.” The idea behind this recommendation was that by

Endowment funds have begun to consider capital gains as expendable assets.

12 Managing Educational Endowments, 45.
13 Cary and Bright, The Law and the Lore, 66.
15 Managing Educational Endowments, 21.
averaging the distribution over three years, some of the effect of equity investments volatility would be “averaged out” of the distribution, thereby stabilizing the distribution to some extent from the fluctuations of the stock market. Likewise, the ability to distribute capital gains in a planned way lessens the volatility of distributions.

We found that:

- **Endowment funds have moved toward policies that distribute a portion of the fund’s market value each year without regard to whether the source was interest or capital gains.**

With endowment funds’ shift to “total-return” investing has come a shift toward spending rules that emphasize distribution of a percentage of the endowment market value each year. The National Association of College and University Budget Officers (NACUBO) conducts an endowment study every two years. The study found that many endowment funds distribute a percentage of market value with mechanisms often included to smooth out the distributions over time. NACUBO’s 1996 study found that:

- 64 percent of responding universities distributed a pre-arranged percentage of the moving average market value;
- 6 percent distributed a pre-specified percent of the beginning year’s market value;
- 12 percent used some sort of spending policy relating to the distribution of all or a part of income (interest and dividends); and
- the remaining 18 percent used some other method of distribution, such as a pre-determined increase over the previous year, or a trustee-decided amount.

The average institution’s endowment spending rate was 5.7 percent. But the largest endowments distributed an average of 4.8 percent of market value. The NACUBO study noted that the spending policies of all but the largest endowments were not consistent with preserving their purchasing power. So, the NACUBO study shows that despite two decades of movement toward total-return investing by endowment funds, concern remains about fund balances keeping pace with inflation. In order to preserve endowment fund purchasing power, withdrawals must be closely balanced against investment gains.

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17 Ibid., 56.
OTHER STATES’ SCHOOL TRUST FUND
INVESTMENT POLICIES

State school trust fund investment management in the 1990s is in the same position that endowment fund management was in the late 1960s and early 1970s. The primary investment instruments used by state school trust fund managers are fixed-income securities and most states distribute all of the dividends and interest earned annually. Officials in several states are concerned that their trust funds are losing value to inflation because they do not invest enough in stocks. There is a great deal of interest in expanding investments into equities and several states have already changed their asset allocations to include stocks.

We found that:

- Other state school trust funds are increasingly moving a portion of their investments into equities and several states have changed, or are in the process of changing, their distribution policies.

Our survey and interviews with other states managing permanent school funds showed seven states (Utah, North Dakota, Oregon, New Mexico, Wyoming, Oklahoma, and Nebraska), in addition to Minnesota, had authority to directly invest in stocks. An earlier 1995 study of 14 western states found that several states had moved to equity investments, but it concluded that most (13 of 14) of the western states did not have “appropriate constitutional and/or statutory provisions that will protect their permanent funds against the effects of inflation.”18 Since 1995, several states, including Minnesota, have either begun to invest in equities or increased the amount of equities in their portfolios.

Fourteen western states have permanent school or university trust funds derived from federal land grants. New Mexico, the largest ($4 billion) permanent land fund devoted to public schools and universities, has been studying changing the investment of trust fund principal for the last several years. 19 Officials there were concerned that the fund had been distributing too large a percentage of its principal (between 6.6 and 9.2 percent of market value annually over the previous ten years) and that investment restrictions have limited earning power. In 1996, New Mexico passed a constitutional amendment to loosen restrictions on allowable investments for its permanent school fund and to change its distribution requirement from paying out all income to paying out up to 4.7 percent of the five-year average market value. 20

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19 Ibid., 4. Four other states have school funds not derived from or restricted by federal land grants: Alaska ($15 billion), Texas ($12 billion Common School Fund), California ($12 million), and Kansas.
20 New Mexico currently is awaiting Congressional approval of the modification of its enabling act. If approved, New Mexico will be able to invest up to 15 percent of market value in foreign securities, up to 65 percent in stocks, and purchase stocks that do not pay dividends and are not listed on national stock exchanges. New Mexico will use an average of the previous five year’s market value to determine the annual distribution.
Several other states have invested permanent school funds in equities. Oklahoma, although prohibited from investing in foreign securities, may invest up to 40 percent in domestic stocks and by mid-1997 had moved 28 percent of its portfolio into equities. Oregon began investing in equities in 1989 and between 1989 and 1997 returns have averaged 15 percent while bond yields have averaged 8 percent over the same period. Wyoming passed a constitutional amendment in November 1996 allowing for equity investments. Nebraska began investing in equities in the early 1980s, maintaining a roughly 50 percent split between stocks and bonds. All income is distributed in Nebraska, but there is an explicit objective of managing the portfolio asset allocation to grow the fund at least by the inflation rate.

North Dakota began investing in stocks in 1990 and currently has 30 percent of its Permanent School Fund invested in equities. In North Dakota, because of the necessity of meeting income distribution goals set by the Legislature, the State Land Department has a longer term strategy of moving to a 60 percent equity allocation over a 10 to 15 year period and decreasing the rate of asset distribution from 6.5 percent to 5 percent of market value. North Dakota adopted this strategy because of concerns that its fund was not keeping up with inflation and its distribution ratio was unsustainable in the longer term.

Although several states have begun to invest in equities, and others are interested in equity investments, there has been only slow change in trust fund distribution policy among states. Minnesota has several choices available to consider for its trust distribution policy.

**POLICY OPTIONS FOR MINNESOTA**

Compared with other states, Minnesota has dealt, or is dealing, with some of the problems inherent in managing permanent trust funds. School funds are facing similar problems to those endowments faced in the 1970s: a failure of the funds’ value to keep pace with inflation and policies of distributing untenable percentages of market value to beneficiaries.

As noted earlier, in 1984, Minnesota loosened investment restrictions that made it difficult for SBI to invest in a diversified portfolio of stocks, bonds, and other investments that might help keep pace with inflation. At that time, budget constraints and legislative expectations of income distribution made it difficult to change PSF investment policy. In 1997, the Legislature modified its income expectations from the PSF and SBI changed the asset allocation policy of the Permanent School Fund to include equities. This will result in a lower distribution of roughly 4.3 percent of the PSF market value in 1998 compared with distributions ranging from 7 to 9 percent over the last ten years.

Although Minnesota has partially addressed the issue of investment restrictions, legislative expectations about the level of income to be distributed from the PSF

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21 History of Oregon Common School Fund Investments. Presentation by Paul Cleary, Director, Oregon Division of State Lands, at the Western States Land Commissioners Investment Conference, July 1997, 18.
could change, as could the policy of SBI on asset allocation. Regardless, the long-term ability of the PSF to keep up with inflation is affected by the fund’s distribution policy. The PSF distribution policy is currently set by constitution and statute; all income must be distributed annually. The difficulty with distributing all income annually is that the income reflects both an inflation component and a real return. So, if all income is distributed, the market value may not keep pace with inflation. Some states and many university endowments have addressed this dilemma by adopting an endowment approach to trust distributions, limiting distributions to a maximum of some percentage of the fund’s market value.

The State Board of Investment staff have recommended that: “the PSF adopt a policy of spending a set percentage of the PSF, instead of spending only the net dividend and interest income generated.” SBI staff advocate having a fixed percentage of market value as the distribution at the beginning of each biennium, with the spending amount being the same for each year of the biennium. This strategy is similar to that adopted by large endowment funds, and has the advantage of eliminating uncertainty about the amount available for school aid during the biennium. In addition, SBI staff have recommended eliminating the constitutional requirement that net capital losses earned from the fund be repaid from spendable income. This would allow the fund to be invested on a total return basis with capital gains available for distribution. In essence, SBI is recommending that the PSF be treated as a typical endowment fund. Income from capital gains under SBI’s proposal could be considered when adopting a distribution policy.

We believe that the SBI staff recommendations have considerable merit. Eliminating the restriction on how capital gains are treated would allow SBI to even the cash distribution and provide predictable levels of income to public schools. Adopting a percentage of market value distribution policy (like most endowment funds) in the Constitution also would ensure that future policies will abide by the state’s fiduciary responsibility to the permanent school trust. As a result, we recommend:

- The Legislature should consider Constitutional and statutory changes to the distribution of income and to the treatment of capital gains from the Permanent School Fund.

Other options exist. If the state does nothing, and SBI policy on asset allocation does not change, it is possible the PSF portfolio will keep up with inflation. It is more likely that the PSF portfolio will keep up with inflation if the Legislature were to change the requirement that net income and dividends be distributed to the schools annually, and that capital gains become part of the fund principal. We believe that on balance the state’s school children would be best served, in the long run, by a total return investment policy that distributes a fixed percentage of fund assets annually. In our opinion, distributing a limited percentage of fund assets annually will maximize the distribution to schools and allow the fund to grow in real terms.

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23 State Board of Investment, The Permanent School Fund Needs, 12.
Another option that could be explored involves using distributions from the Permanent School Fund for special projects within public education instead of offsetting the general fund education appropriation. For example, the annual PSF distribution might be used to finance capital projects or classroom technology improvements in Minnesota’s public school districts. The PSF could be used for education much like the Environmental Trust Fund is used to finance environmental projects. Under this option, the Legislature would decide how to appropriate the PSF distribution, perhaps with assistance from an advisory group or other body.

Using the PSF distribution for special projects could increase the visibility of the fund, generating more interest in how the PSF principal is invested and how school trust land is managed. If the PSF distributions were used for specific education projects, school districts around the state would probably become more aware of the trust.

Of the states we contacted, Wisconsin and Iowa distribute PSF interest earnings to specific programs. In Wisconsin, school districts receive an annual allocation for library materials from the PSF. In Iowa, two education programs related to teaching talented and gifted students and encouraging innovative teaching practices receive annual PSF distributions. These programs are required to match the distribution with other funds.

**SUMMARY**

Over the last ten years the Permanent School Fund portfolio has not kept pace with inflation because it has paid out a relatively high proportion of the fund’s principal and because the fund’s investments have been largely in bonds. Recent policy changes by the Legislature and SBI have changed the fund’s asset allocation to include stocks. The current asset allocation strategy has the prospect of keeping pace with inflation although the fund is still vulnerable to inflation effects. The prospects for the PSF portfolio might be improved by moving toward an endowment trust management strategy. The Legislature should consider statutory and constitutional changes to maximize the chances that the PSF portfolio will continue to grow in the future.
# Appendix: Legislative History of Lakeshore Leasing and Sales, 1985 to 1997

<table>
<thead>
<tr>
<th>Year</th>
<th>Minnesota Laws for Lakeshore Leasing and Sales</th>
</tr>
</thead>
</table>
| 1985 | • Established a lease term of not longer than 20 years with a lease rate based on the appraised value of the land without any private improvements.  
• Directed DNR to adopt rules by July 1, 1986 to address the method of appraising the property, determination of lease rates, and an appeal procedure.  
• Required that increased lease rates effective on or after Jan. 1, 1986 be phased in over three years.  
• Directed DNR to inventory the lakeshore leases and prepare a report by Jan. 1, 1987 on lease lots that should be sold.  

*Minn. Laws* (1985 First Special Session), ch. 14, art. 17, secs. 1, 3, and 4. |
| 1986 | • Authorized DNR to sell lakeshore lots at a lessee’s request if DNR recommended a lot be sold in the inventory requested in 1985.  
• Required requests for sale be made before July 1, 1991 and all sales be completed by July 1, 1992.  
• Required that requests for sale received before Jan. 1, 1987 be sold in June, July, or August 1987.  
• Required that requests for sale received each calendar year after Dec. 31, 1986 be sold in June, July, or August of the year after the request was made.  
• Directed the commissioner to provide a list of appraisers approved by the Commissioner of Administration to the lessee. The lessee may select a person from the list to appraise the property to be sold.  
• Allocated the appraisal costs to the lots offered for sale, and required the successful bidder to reimburse the commissioner for appraisal costs.  
• Required DNR to survey lots before offering them for sale.  
• Allowed the lesser of $500 or the annual lease fee to be used as part of the down payment for the lot.  
• Required the purchaser to pay 10 percent down with no more than 20 equal installments with an interest rate of 8 percent.  
• Allowed the lessee to stop the sale process after the appraisal and before the sale but required the lessee to reimburse DNR for the appraisal costs if the sale is stopped.  
• Required a purchaser who outbids the lessee to pay the lessee the appraised value of any improvements in full at the time of the sale.  

Management costs:  
• Allowed up to 50 percent of lease revenues in fiscal years 1986 to 1989 to be used to pay for the survey of lots. (This established the lakeshore account.) Any money that is not needed to survey lots must be deposited in the PSF.  


1987 | • Changed the list of appraisers from which the lessee can select to do appraisals to include people who meet the minimum appraisal standards established by the FHA or VA.  
• Allowed the commissioner to offer lots for sale the same year as requested.  
• Repealed the request for DNR inventory of lakeshore leases with recommendations on leased lots to be sold. |
Management costs:

- Extended the lakeshore account to fiscal year 1992, and allowed funds to be used to finance appraisal and associated sales costs.
- Required the commissioner to add to the appraised value of lots offered for sale the costs of surveying, appraising, and selling the lot. Required that costs recovered be deposited in the PSF.
- Stipulated that in no case may the commissioner add more than $700 to the appraised value of any lot for the costs of surveying and appraising the lot.

Minn. Laws (1987), ch. 404, secs. 110-114. ²

1988

- Changed requirements on purchase of improvements--owner of improvements should be paid within 15 days of the auction sale in cash or on terms agreeable to the owner. If not done in 15 days, the commissioner may sell the lot to the second highest qualified bidder.
- Required the Commissioner of DNR to publicize land sales in Minnesota and elsewhere to the greatest extent possible.
- Repealed the provision allowing lessee to use up to $500 of the annual lease payment as part of the down payment.
- Set sales request deadline at Dec. 31, 1992, with the last sale date set at Dec. 31, 1993.
- Changed the appraisal process. Provided that appraisals made by FHA or VA approved appraisers before the effective date of the act be reviewed and approved by an appraiser selected by the Commissioner of DNR from appraisers on a list approved by the Commissioner of Administration.
  - Appraisals made after the effective date of the law must be performed by appraisers selected by the Commissioner of DNR from the list maintained by the Commissioner of Administration.
  - A lessee may recommend to the commissioner a person from the approved list to appraise the property to be sold.
- Allowed the lessee to select an appraiser if the lessee disagreed with the appraisal of the improvements. If the lessee and the commissioner do not agree on the value within 180 days, then the commissioner shall set the value at the county assessor’s estimated market value.
- If more than 50 percent of the lessees in a plat request sale, required the commissioner to put the entire plat up for sale, unless a specific request for removal is received. The commissioner may not offer the withdrawn lots for sale until 1993.
- Required the commissioner to offer for sale over a 5-year period beginning in 1994 any lakeshore lots that are unsold at the end of 1993. Lots that are unsold at the end of 1998 must be offered for sale in 1999 and each year thereafter until sold.
- Changed the interest rate to the rate in effect for other state land (in Minn. Stat. §549.09, the Supreme Court interest rate on judgments).

Management costs:

- Required the commissioner to first deposit the money recovered for surveying, appraising, and selling costs in the PSF, then in other funds.

1990  
- Allowed the lease rate to be adjusted in the fifth, tenth, and fifteenth year of the 20-year lease.  
- Established a lease rate of 5 percent of the appraised value of the leased land.  
- Allowed lessee to withdraw from the sale process anytime up to 10 days before the sale, and prohibited the sale of the withdrawn leased properties until the lessee makes another sale request.  
- Deleted language requiring the sale of all leased lots.  
  *Minn. Laws* (1990), ch. 452, secs. 1-3.

1991  
- Allowed the sale of lands to be held in counties adjacent to the county in which the lot is located.  
- Allowed the commissioner to sell other state property not needed for public access that has been included in the plats of state property by Dec. 31, 1993.  
- Repealed *Minn. Stat.* §§92.67 and 92.68 as of Jan. 1, 1994. This sunsets all sale provisions for leased lakeshore lots.  
- Changed the last sale date to Dec. 31, 1994.  
  *Minn. Laws* (1991), ch. 219, secs. 1-6, and ch. 254, art. 2, sec. 23.

1992  
- Correction extends the sale window until Dec. 31, 1994 is of no effect.  

1993  
- Changed the interest rate charged on school trust land sale contracts to a statutory formula.  

**Management costs:**  
- Extended the lakeshore account to fiscal year 1995, and subject to an appropriation the account may be used to finance survey, appraisal, and associated selling costs.  

1995  
**Management costs:**  
- Allowed the use of lakeshore account to finance lot sales and leasing costs. Limitation to a specific fiscal year is removed.  
  *Emphasis added.*  

1This law also stipulated that the shoreline of sold lots is not reserved for public travel, road access in place at the time of sale may not be terminated, and for purposes of local zoning, the land sold shall be treated as if purchased at the time the state first leased the sites.

2This law also allowed the commissioner to add land to a lot offered for sale whenever possible to provide compliance with zoning requirements.

February 23, 1998

Mr. James R. Nobles, Legislative Auditor
Centennial Building, First Floor South
658 Cedar Street
St. Paul, Minnesota 55155

Dear Mr. Nobles:

Thank you for the opportunity to provide written comment on your evaluation of the management of Permanent School Trust Fund lands. First, let me commend your staff on their hard work and professionalism in evaluating this complex subject.

The focus of your evaluation was DNR’s management of trust fund lands. Both the executive and legislative branches share this responsibility. The larger question is: has the legislature provided an effective and consistent policy framework for the management of trust lands? My letter to you dated January 7, 1998, expands on this issue and gives examples. I was pleased to see that your report states our view that in our management of trust fund lands we are “constrained by conflicting legislative direction and limited funding.”

The evaluation acknowledges that the goal of the Permanent School Fund is not just to maximize revenues, but includes managing for the public benefit such as recreation, wildlife habitat and other values. Additionally, we support your premise that we must not attempt to maximize short-term revenues at the expense of the long-term economic productivity of the trust lands.

The evaluation contains measures of net income and rates of return on assets projected to be generated from these lands. The report cautions readers that the estimates are based on a number of simplified assumptions. It should be pointed out that the income figures do not reflect the portion of revenues that, by statute, are transferred to the General Fund nor do they reflect the non-monetary returns such as wildlife habitat, wetlands and recreation that these lands provide. Based on these very rough estimates, the report gives the return on net asset valuation at less than 1%. Readers need to know that this is not the same thing as rate of return on investment. My staff can document that the rate of return on asset value for Minnesota banks with less that one billion dollars in assets for 1997 was 1.31%. The rate of return on assets for trust fund lands is probably excellent for natural resource management.
The report cites the lack of net revenues between FY1983 and FY1992. This requires further clarification. Prior to FY1983, legislation prohibited investment in reforestation on lands outside statutory state forests and limited funding for reforestation within state forests. We must emphasize that during this time the DNR did practice intensive forest management to the degree allowed by the legislature. These statutory and funding restrictions created a backlog of investment needs for reforestation. Since 1983 and the enactment of the Forest Management Act, the DNR has invested heavily in reforestation with the concurrence and guidance of the legislature. This investment has, of course, resulted in less net revenues to the trust fund in the short term. Long term, our foresters are confident that these investments will generate greatly-increased revenues in the future for the trust fund.

The evaluation recommends changes to the oversight of trust lands, but supports current DNR administrative and management practices. By integrating management of trust lands with other lands, the DNR has created a structure of management efficiencies resulting in lower administrative costs to the trust fund. More importantly, it is a more effective way to manage natural resources.

The DNR has legislation currently pending that expands the Permanent School Fund Advisory Committee by five members. These members include: chairs of both the House and Senate Environmental and Natural Resources Committees, the chair of the House Environment and Natural Resources and Agriculture Finance Committee, the chair of the Senate Environment and Agriculture Budget Division and the commissioner of the DNR as an ex-officio member.

The evaluation contains a number of recommendations that we will examine and implement if they improve the management of the trust lands. Some of them may require legislative authorization.

Thank you again for this opportunity. I believe that overall the evaluation is a fair and accurate assessment. It can provide the basis for discussions and changes that can result in even better management of trust fund lands.

Your truly,

Rodney W. Sando
Commissioner
February 20, 1998

James R. Nobles
Legislative Auditor
Office of the Legislative Auditor
1st Floor South, Centennial Building
658 Cedar Street
St. Paul, MN 55155

Dear Mr. Nobles:

State Board of Investment staff have read the final draft of your office’s report, “School Trust Land.” We concur with your findings and recommendations in Chapter 5, “Investment of the Permanent School Fund.”

We suggest your office consider an additional item. As your report points out on page 5 of Chapter 5, the amount of money paid out of the Permanent School Fund is a small percentage of the total amount of state and local government education funding. We suggest you consider recommending to the Legislature that Permanent School Fund moneys not be used to offset school aid payments. Rather, the moneys could be invested in educational projects identified on a legislatively determined basis.

We draw a parallel between the project funding by the Legislative Commission on Minnesota Resources and the investment opportunity we see for the Permanent School Fund. We envision the Permanent School Fund supporting projects like investment in computers or being a source of financing for a district’s need to bring their school buildings up to code or for many other worthy projects that would have a direct benefit to school children. Our suggestion is that you recommend use of the Permanent School Fund to better serve the children of Minnesota.

Again, we concur with the findings and recommendations in Chapter 5 of your report. We are available to discuss these issues at your convenience.

Sincerely,

[Signature]

Howard Bicker
Executive Director
February 23, 1998

Roger Brooks  
Deputy Legislative Auditor  
1st Floor South - Centennial Building  
658 Cedar Street  
St. Paul, MN 55155

Dear Mr. Brooks:

Thank you for the opportunity to review and comment on your report evaluating school trust fund management, and for the opportunity to discuss our concerns with you.

We reviewed the report with particular emphasis on Chapter 4, which contains certain recommendations pertaining to the Department of Finance.

In that chapter, the report asserts that oversight of the trust fund is neither comprehensive nor consistent, largely because no single entity has been responsible for compiling and presenting comprehensive information related to both the school trust land management and the investment of the Permanent School Fund financial resources. The report then offers the following three specific recommendations:

1. that the Commissioner of Finance be added to the Permanent School Fund Advisory Committee, possibly as the committee chair;

2. that a "more explicit" oversight role be assigned to the Department of Finance; and

3. that the Legislature should authorize the department to employ permanent staff for the Advisory Committee using Permanent School Fund resources.

While we support an increased role for the Department of Finance, we are concerned that the recommendations will raise certain expectations for change in the management of the lands and financial resources, but not necessarily provide the impetus for such change to occur. While we believe that there may be occasions when our other statewide responsibilities could place the department in a situation of conflicting interests, on balance we believe that the department's representation on the committee would be appropriate.
We also agree that the department can improve the performance of the Advisory Committee by assuming certain administrative responsibilities and providing greater administrative structure, including the convening of regular meetings. We can also raise issues of balance and performance in a broad context. We would expect the department’s role to be that of reporting on activities of those entities with direct responsibilities (DNR for land/resource management and SBI for investment performance) and raising issues to the attention of the Legislature for ultimate disposition.

We believe it is premature for the department to employ permanent staff to support the committee. We think it may be more appropriate to consider an on-going role for the department at a later time, when specific functions could be identified. We think consideration could be given to a broader restructuring of the Advisory Committee. Perhaps the committee could include other legislators, the Commissioner of Natural Resources and the Executive Director of the State Board of Investment, bringing their special expertise and interest.

Thank you again for the opportunity to review your draft.

Sincerely,

Wayne Simoneau
Commissioner
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