Appendix C. – Briefing material, volumes 1-5

DNR Briefing Material - Volume 1

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Executive Summary

Introduction/Purpose

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

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

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

Public Policy Context

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

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

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

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

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

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

Costs and Benefits

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

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

Benefits for the Trusts

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

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

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

Costs of business

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

Management Fund Balances Continue to Decline

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

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

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

Conclusion

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

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

1. Basis of the Independent Review

The Washington State Department of Natural Resources (DNR) manages about three million acres of (upland[1]) state trust lands that are worth several billion dollars. These working lands—forests, agricultural lands, mineral sites and urban properties—provide substantial revenue to specific public beneficiaries and benefits to all the people of Washington. Such lands provide needed revenue to schools, hospitals, fire departments and other public institutions. Importantly, they also provide jobs, commodities, clean water, wildlife habitat and increasingly scarce recreational opportunities.

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

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

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

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

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

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

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

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

2. Trust Lands – a Reflection of Public Policy

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

2.1 Origin of the trusts

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

2.1.1. Federal Grant Lands

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

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

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

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

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

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

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

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

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

[1] As of July 1, 2001. Some trust lands have been temporarily liquidated with the funds from those transactions being held to purchase replacement lands. These funds are temporarily held in the RPR account, Land Bank, and State Park Transfer account. The majority of these funds involve the common school trust. Actual areas will increase as replacement properties are purchased. "Actual Acres" were not adjusted for anticipated purchases.
[2] In 1893 the legislature designated 100,000 acres of the CEP&RI Federal Grant Lands for the support of the University of Washington. See Laws of 1893, Chapter 122, Section 9 (uncodified amended by Laws of 1903, Chapter 91, Section 1 (uncodified).
[3] Sold acreage is calculated by subtracting the current acres from the original acres

2.1.2. State Forest Lands

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

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

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

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

2.2 The trust framework

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

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

2.2.1 Legal Construction of the Federal Grant Lands

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

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

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

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

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

2.2.2 Legal Construction of the State Forest Lands

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

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

State Forest Transfer Lands

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

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

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

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[3] 1889 Enabling Act, § 11, 17.
[4] AGO 1996, No. 11 at 60.
[5] Forest Board Transfer Lands, Joint Legislative Audit and Review committee Report 96-5 December 16, 1996 (on the web at http://jlarc.leg.wa.gov/Reports/96-5.pdf)
[6] Hence this trust is referred to at “statutory trusts”.

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

State Forest Purchase Lands

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

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

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

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

The courts have ruled that the state land trusts constitute real and enforceable trusts[8], and where the documents that created the trust are silent, the courts have ruled that some of the common law principles governing the administration of private trusts apply[9].

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

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

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[7] AGO 1996, No. 11, at 62-65.

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

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

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

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

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

2.3. The trust manager – DNR

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

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

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

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

2.4 Funding Trust Land Management

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

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

Both funds have built in checks and balances in that:

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

2.4.1. Benefits of Dedicated, Revolving Accounts

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

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

[12] RCW 79.64.030

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

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

2.4.2 Use of the Management Accounts

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

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

3. Assets, Costs and Benefits

Much about trust land management has changed since statehood. Support for the beneficiaries of the Granted Lands now comes not from the sale of those lands but largely from timber sales, with some additional income increasingly coming from agricultural and grazing uses, mineral development, commercial leasing and the Trust Land Transfer Program[13]. Most State Forest lands, virtually stripped of trees when originally obtained, are producing valuable harvests of timber once again, providing revenues to the counties in which they are located. Some original trust assets have been exchanged for new ones. Changes to public policy have created new requirements, benefits and costs.

3.1 Trust assets – the land base

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

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

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

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

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

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

[13] For more information on the Trust Land Transfer Program see the 2003 Report to the Legislature available on the department's web site at: http://www.dnr.wa.gov/htdocs/obe/reporttoleg/reportleghome.htm

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

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

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

Major Findings of the Study – based on 1995 data

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

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

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

Total 2,869 acres - Numbers in Thousands

Data Source: DNR Transactions Section Data

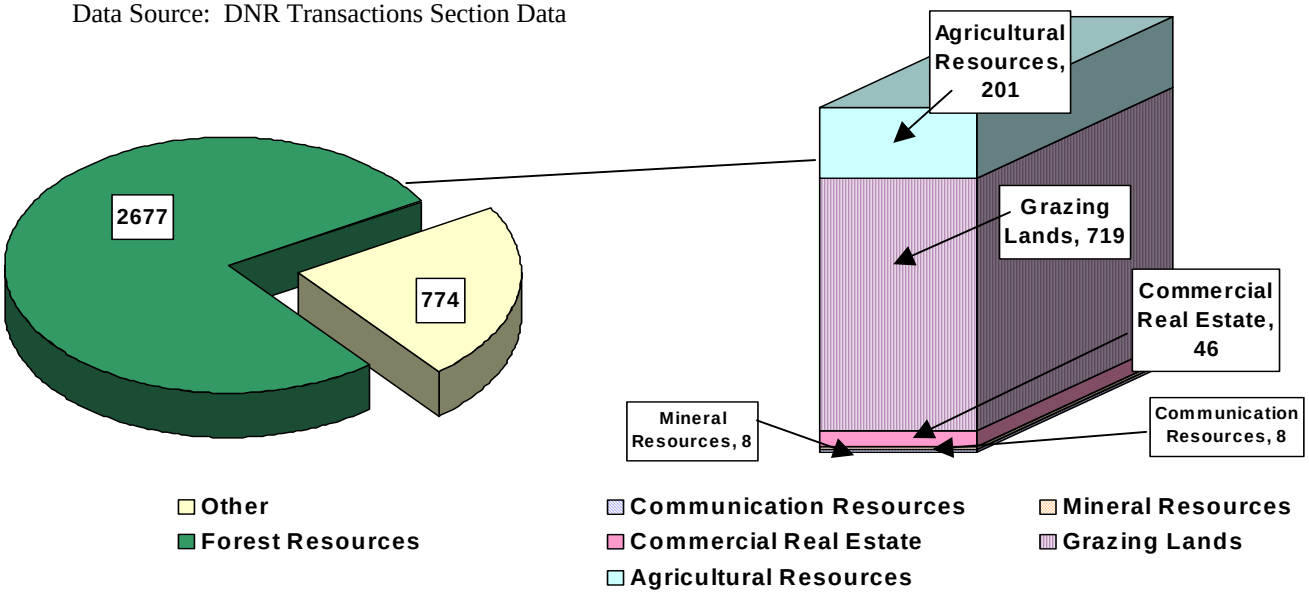
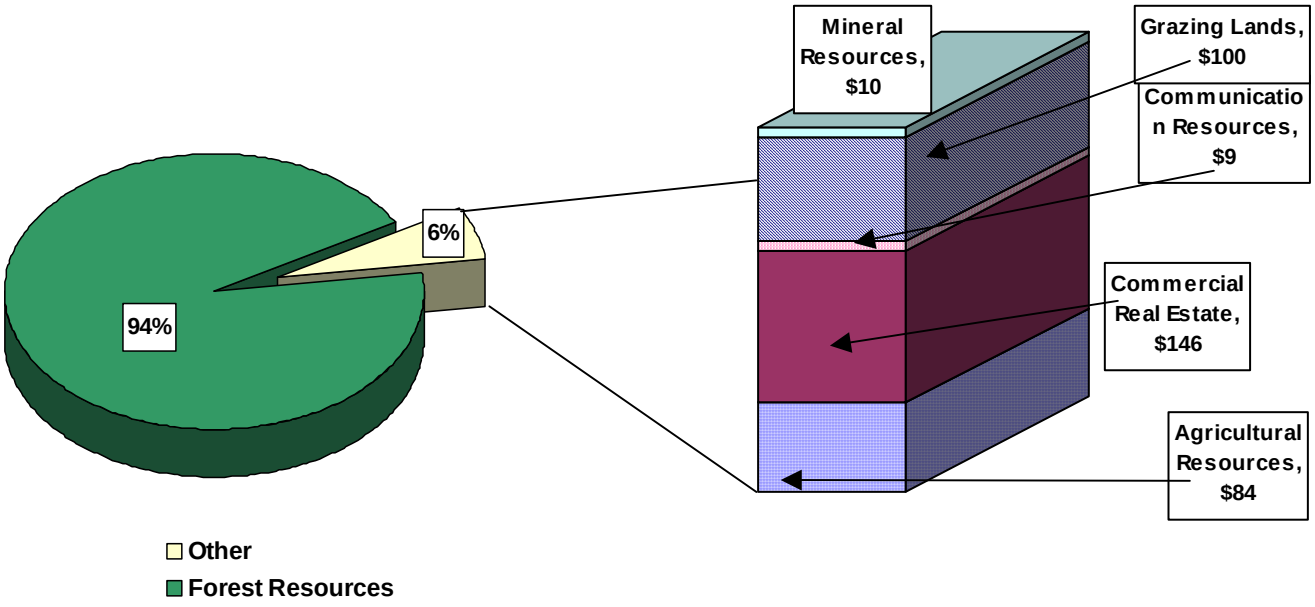


Chart. 3.2 Trust Value by Asset Class in $$ as of July 1, 1995

Total $6,231 - Dollars in Millions

Data Source: Economic Analysis, June, 1996 Deloitte & Touche



3.1.2 Repositioning Assets

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

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

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

3.2 Revenue, Expenditures & Fund Balances

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

3.2.1 Management Revenues and Fund Balance

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

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

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

Resource Management Cost Account (RMCA)

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

Forest Development Account (FDA)

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

3.2.2 Historical Patterns of Revenue and Expenditure

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

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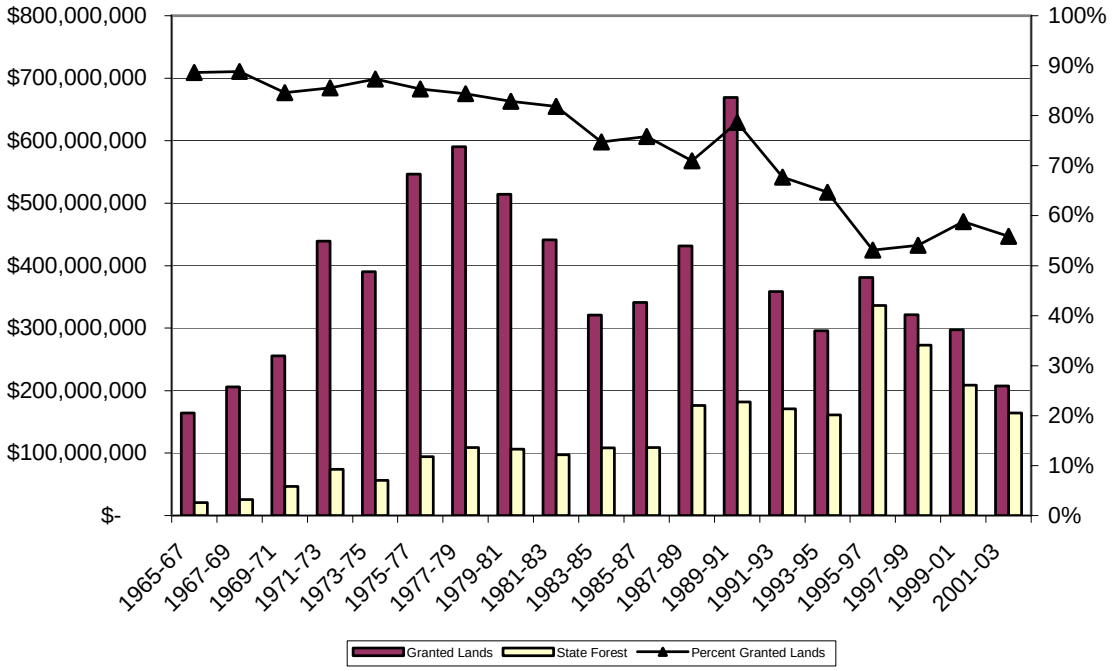
[14] The department's Annual Reports are available on line for Fiscal Years 2000 through 2003 on line at: http://www.dnr.wa.gov/base/publications/list.html

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

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

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

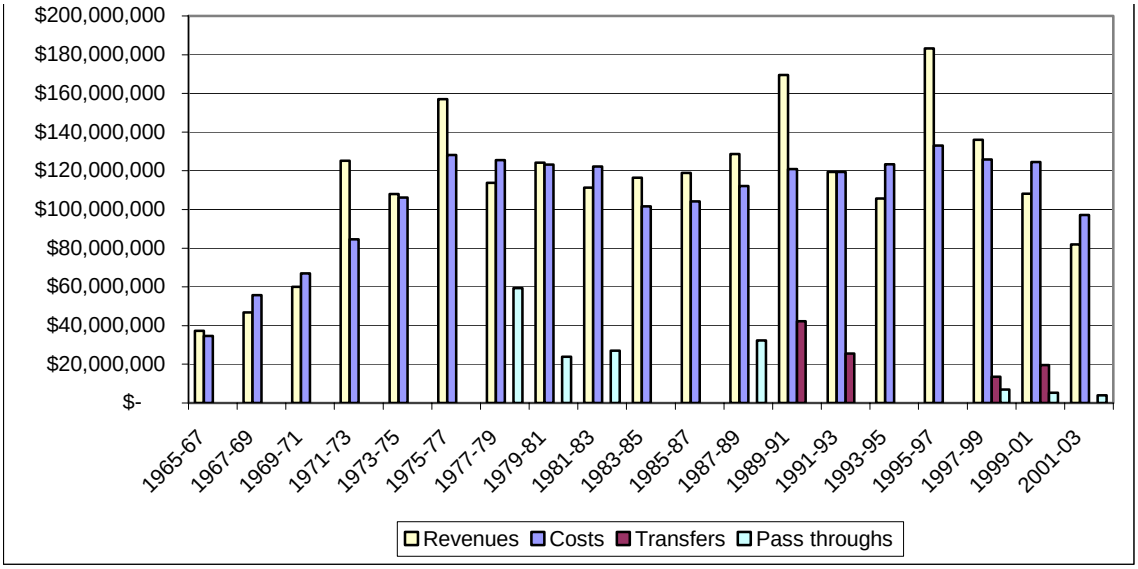


Real Revenues from Federal Grant Lands and State Forest Lands

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

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

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



Management Fund Revenues and Expenditures

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

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

Expenditures for Management Funds

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

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

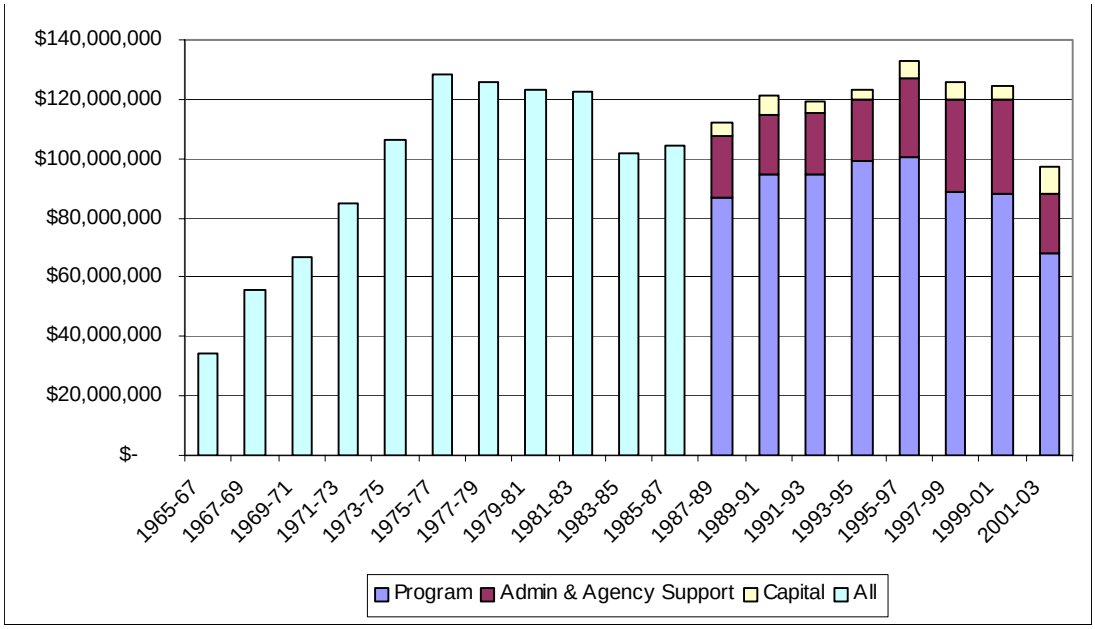
[17] There has also been a cost in real terms due to the loss in purchasing power of the fund balance each year due to inflation.

Agency Allocation of Expenditures

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

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

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



3.3 Expenditure Controls

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

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

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

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

3.4 The Cost of Doing Business

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

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

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

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

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

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

3.4.1 Multiple Use Trust Land Management

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

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

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

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

- State population doubled since 1950 and is expected to double again by 2050.
- ORV use is expected to increase by 20% over the next 20 years, and, the amount of available ORV trails is expected to stay static[18].
- Equestrian use is expected to grow by 29% over the next 20 years.
- Hiking use is expected to grow by 34% over the next 20 years.
- Rapid growth of motorcycle and all-terrain-vehicle use.
- Annual expenditures of two billion dollars for hiking, fishing and viewing wildlife[19].
- 1.1 million[20] people in Washington participated in wildlife viewing at least one mile from their home for 11.3 million days of viewing, feeding or photographing wildlife.
- 938,000 people fished for a total of 12.8 million days of fishing
- 227,000 people hunted for a total of 3 million days of hunting

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

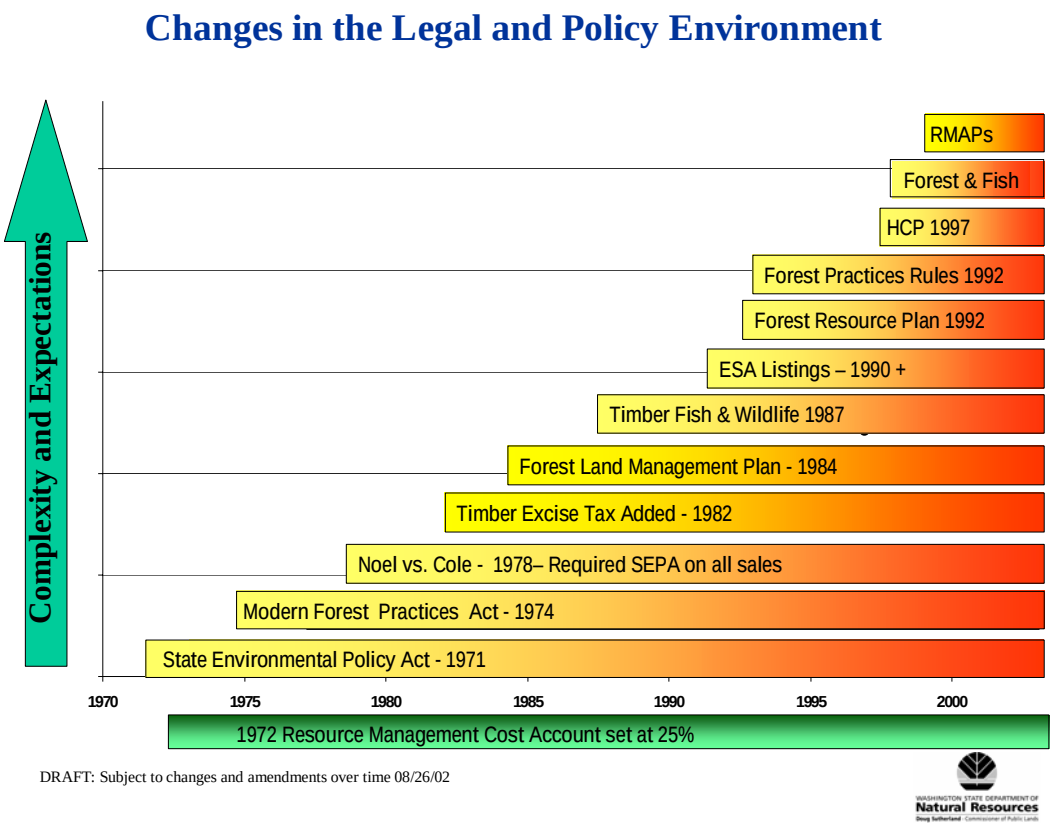
[18] State Comprehensive Outdoor Recreation Plan, or SCORP (IAC, 2002)
[19] According to a study, "Adding it up – Washington communities profit from fish, wildlife recreation" (WDFW, 2002).
[20] "Survey of Fishing, Hunting and Wildlife Associated Recreation in Washington" (USFWS 2001).

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

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

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

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



3.4.2 Societal Changes

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

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

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

4. The Future of Trust Forest Management

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

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

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

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

4.1 Western Washington Sustainable Harvest Level Recalculation

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

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

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

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

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

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

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

4.1.1 Sustainable Forest Management Policy

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

Table 4.1 Economic and Ecological Outcomes for Sustainable Forest Management

Economic Outcomes	Ecological Outcomes
▪ Marginal increase in net revenue returned to the beneficiaries by 2067: $2.4 billion ▪ Marginal increase in net revenue returned to the beneficiaries first decade: $0.3 billion ▪ Increase of two thousand jobs, first decade ▪ Forest inventory increase of 45% by 2067 ▪ ½ million acre increase "on-base" acres by the end of the first decade	▪ Old-growth habitat increases five-fold ▪ Spotted owl habitat increases 20% ▪ Improved stream ecology due to more fully functional trees in riparian management zones ▪ More watersheds with significant deer and elk foraging habit ▪ Ten percent reduction of unhealthy forests

Table Notes

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

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

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

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

Table Notes:

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

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

4.2. Volume and Value from Timber – Statewide

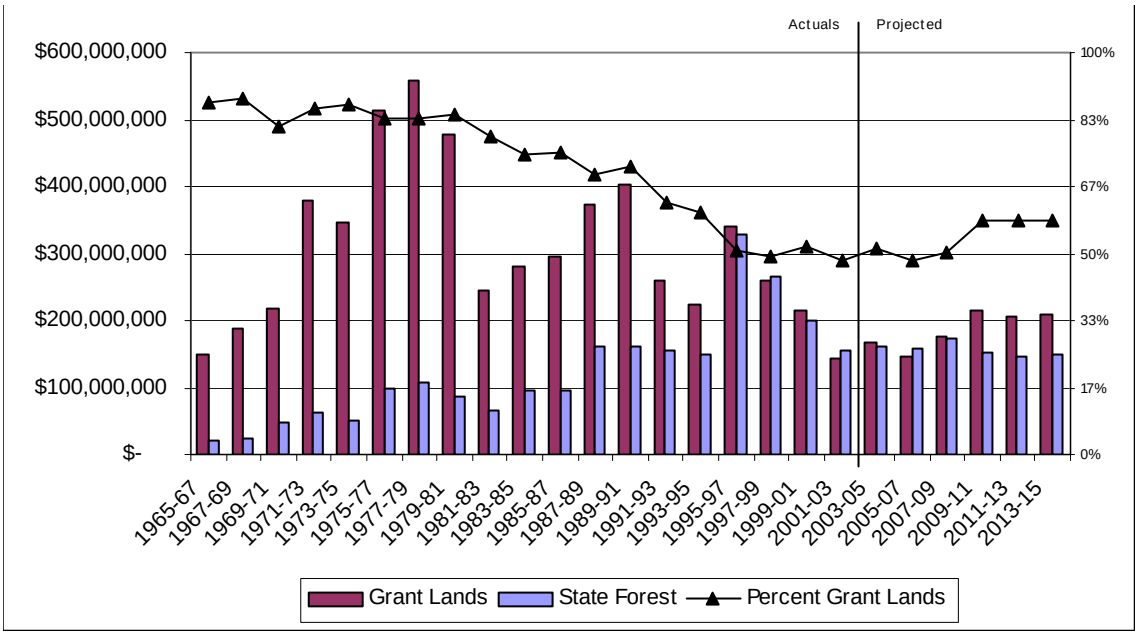
Timber harvested under the new Westside sustainable harvest level will become part of the larger, statewide picture of trust forest management. The following graphs are based on data from DNR's Timber Sales Management System, and provide both a historic view and projections for the future. The monetary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

Trends in Revenue from Timber (actual/projected)

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

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

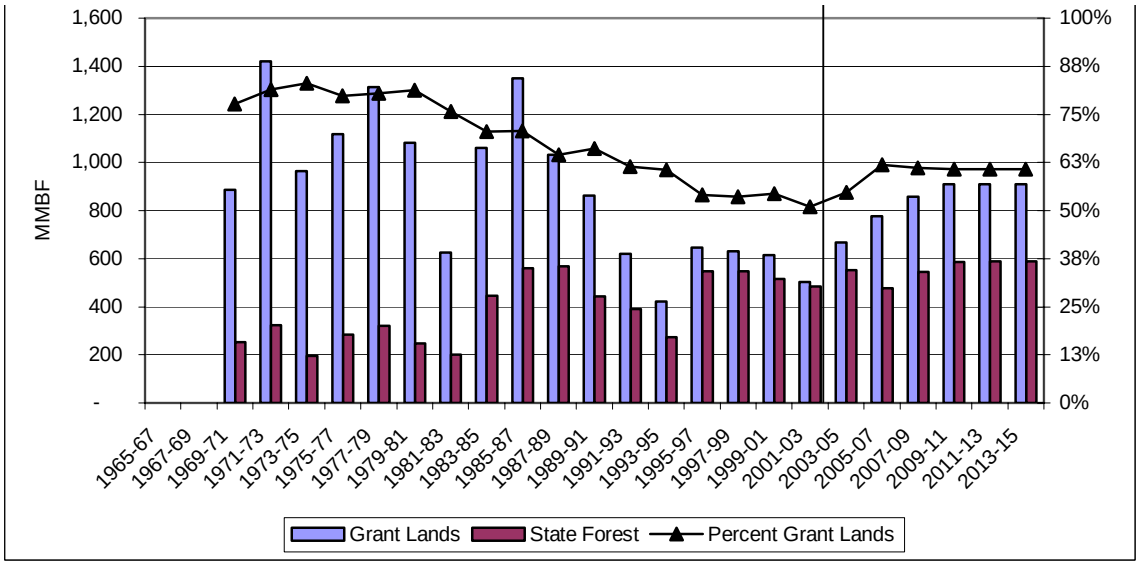
Graph 4.1 Revenue from Timber Removed from all Trust Lands Managed by DNR in 2003 $'s



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

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

Graph 4.2 Volume Removed from Federal Granted and State Forest

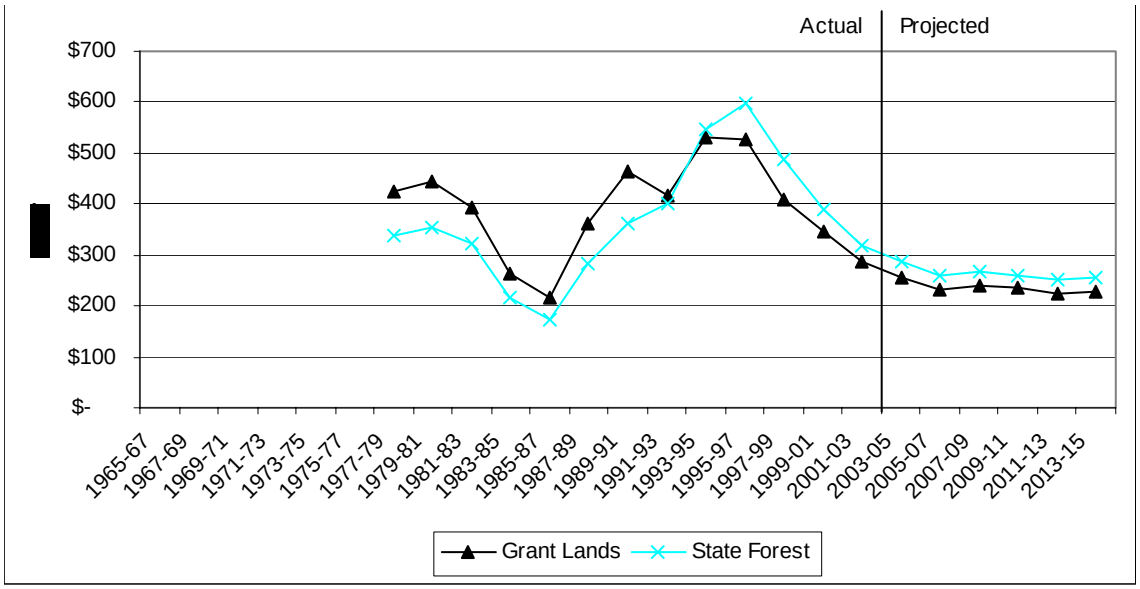


Graph 4.3 shows real removal prices ($/mbf) from Granted and State Forest land.

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

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

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



4.3 Projections: Revenue, Expenditures and Fund Balance

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

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

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

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

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

4.3.1 The Funding Gap

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

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

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

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

Table 4.3 Biennial Cash Flow with the current Management Fund Percentage

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

Assumptions:

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

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

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

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

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

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

Table 4.4 Sustainable Harvest (dollars in thousands)

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

Assumptions:

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

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

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

Assumptions:

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

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

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

4.4 Conclusions

4.4.1 What's at Stake

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

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

Table 4.6 Comparison of Total Revenue at two different time periods

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

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

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

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

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

4.4.2 The Central Issue

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

The analyses show that our costs, on a real dollar basis, are the lowest since 1971, the date when the Legislature last adjusted the percentage rates (to a maximum of 25 percent for the RMCA and FDA). In 1971, timber sales prices were more than 70 percent greater than they were for the last biennium. The central tension is that we are experiencing a market driven phenomenon where timber, the dominant revenue source that represents 85 percent of upland revenue is not following the previous long-term price appreciation patterns. The forecast[22] is for flat or declining prices with increased production costs.

4.4.3 Consequences

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

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

Appendix A

Analysis of Current and Expected Stumpage Trends

Department of Natural Resources
Jon J. Tweedale

Executive Summary

The sale of timber provides the single largest return[23] from trust land management. Understanding the anticipated price trends is key to evaluating what is a market driven phenomenon and how land management options rise or fall with the market. Over the next decade the trend in DNR real (adjusted for inflation) timber prices (stumpage) is expected to be flat with nominal prices increasing at about the rate of inflation. Actual prices in any given year are expected to deviate around this trend, as it has historically, based on demand and supply conditions. Fewer supply shocks are expected than have occurred in the past two decades, as world supply is dominated more by plantation and second growth sources rather than natural and old growth sources of supply.

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

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

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

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

Global and Economic Influences on DNR Stumpage

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

Forest Products Demand Influences

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

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

In the last decade, the forest product industry has been plagued by low product prices and oversupply of raw material, thus depressing profits and timber prices. Recent economic improvement, demand improvement and a balancing of supply with demand have all contributed to an increase in lumber, log and stumpage prices from years past. Prices have improved on DNR nominal stumpage by 4% per year for the last two years[24].

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

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

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

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

Region Marketing (Supply and Demand)

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

Lumber prices have moved from their high position and are expected to trend lower due to seasonal influences[2].

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

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

Recent DNR Timber Stumpage Trends

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

The five-year outlook for Coastal saw-timber demand has improved. Saw-timber demand in not expected to decline to the lows of the last five years. Sawmills have invested heavily in new and improved capacity, making producers in this region more competitive with their rivals in other regions[2].

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

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

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

References

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

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

Appendix B

Questions Raised by Trust Beneficiaries in Meetings Regarding the Independent Review Committee[26]

Washington State School Directors Association (WSSDA)

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

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

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

Capitol Building Trust

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

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