DEPARTMENT OF NATURAL RESOURCES

FY 2013-14 Funding Request
November 1, 2012

John W. Hickenlooper
Governor

Mike King
Executive Director

Signature

8-1-12
Date

Department Priority: R-7
Strategic Business Initiatives

Summary of Incremental Funding Change for FY 2013-14	Total Funds	Cash Fund	FTE
Strategic Business Initiatives	$399,881	$399,881	2.0

Request Summary:
The State Land Board requests an increase of $399,881 in Cash Fund spending authority and 2.0 FTE to allow it to expand existing, and develop new, lines of business that both diversify state trust revenues and make those more sustainable over the long-term.

Problem or Opportunity:
The State Land Board experienced tremendous recent growth, with revenues more than doubling in the past three years ($66M in FY 2009-10 to $145M in FY 2011-12). The revenue increase has primarily been the result of non-renewable, highly variable mineral sales (largely oil and gas bonus and royalty payments) which grew 109% between FY 2009-10 and FY 2011-12. This contrasts sharply with State Land Board non-mineral revenues such as commercial and agricultural rents which as a group only grew five percent over the same time period.

The State Land Board seeks to pursue a more diversified and proactive investment strategy in order to make its revenues more broad based and sustainable. This goal is outlined in the Board's 2011 Strategic Plan. To be clear, this Strategic Plan is different than the DNR Strategic Plan included each year in the annual budget request for compliance with the SMART Act although the overall goals are generally the same. This request will allow the State Land Board to focus on growing revenues associated with ecosystem services, recreation, renewable energy, and solid minerals.

Brief Background:
The State Land Board was established in 1876 to manage more than 3 million acres of land and 4 million acres of mineral rights that the federal government gave to Colorado to generate revenue for public education and some of the state's institutions The Board is the trustee for the beneficiaries and is charged with the duties to generate reasonable and consistent income and preserve the long-term asset value through strong stewardship. Its earnings support not only the operations of the board, but several State school programs including the Building Excellent Schools Today (BEST) Program, the School Finance Act, and the Colorado Early Literacy Act.

The State Land Board's 2011 Strategic Plan calls for the creation of a diversified portfolio that produces reasonable and consistent revenues over time.

However, over the past ten years, mineral revenues, which are highly variable and non-

recurring grew from 50 percent to 87 percent of total trust revenues. At the same time, surface and commercial revenues, which are consistent and recurring dropped from 50 percent to 12 percent of total trust revenues.

The State Land Board seeks to pursue a more diversified and proactive investment strategy (as outlined in the Board's 2011 Strategic Plan) in order to make its revenues more broader based and sustainable. The State Land Board's current approach to nontraditional lines of business is at best reactionary and at worst, nonexistent. In many cases lease applications and other business opportunities are never considered because the State Land Board lacks the resources, infrastructure, and support to adequately evaluate and manage new revenue earning opportunities.

Proposed Solution:
The State Land Board has begun to organize around a "lines of business" approach where an emphasis is placed on developing and proactively pursuing leasing opportunities while at the same time ensuring the long term value of trust assets. This new strategy involves both expanding current lines of business as well as developing new lines which will lead to more consistent and diversified revenues.

The State Land Board believes that it could vastly expand its recreation, solid mineral, and renewable energy lease revenues. These represent established lines of business that have not had dedicated staff or contract resources. Dedicated resources would allow the State Land Board to address an existing backlog of lease inquiries and lease applications and more importantly indentify and market new leasing opportunities.

There is also an opportunity to develop a new line of business in the area of ecosystem services. Given the State Land Board's land holdings and associated ecological resources, there are both established and emerging markets for ecosystem services that could generate new revenue. The intensive and specialized nature of these markets requires dedicated staff or contract resources.

Both new and expanded leasing opportunities are detailed below:

Ecosystem Services
Ecosystem services are all of the benefits people derive from nature, ranging from clean water to nutrient cycling to regulating climate. While nature provides these services for free, new opportunities exist for land owners to receive payments for providing certain ecosystem services. These include offset or mitigation for development impact to wetlands, streams, and wildlife habitat.

There are both established and emerging markets for ecosystem services. The most established markets, like wetlands or watershed mitigation and banking, are organized around federal, state, or local regulatory requirements. There are also emerging ecosystem service markets aimed at encouraging voluntary or pre-regulatory transactions.

The State Land Board commissioned a study of ecosystem service opportunities in Colorado (http://www.sonoraninstitute.org/analysis-of-ecosystem-services-potential-on-colorado-state-trust-lands.html) and subsequently developed a wetlands mitigation banking project plan in Park County. The State Land Board expects to earn a net $1.6 million (25 wetlands banking credits) from one project on one property in Park County at the end of the next 5 years. The study also identified additional strategies and revenue generating projects which could be developed to increase revenues to the Land Board.

The Board strongly believes that ecosystem services projects are real and significant opportunities for state trust lands. The 2011 Strategic Plan indentifies a target of earning $10 million in ecosystem services project revenue by the end of 2020-21.

Using the already completed study as a guide, staff will develop an inventory of land holdings, establish policies to guide the application of appropriate real estate instruments, and pursue the best and most marketable opportunities. The State Land Board believes that it could create three additional ecosystem services projects over the next five years if it had additional staff and contract resources. These three ecosystem services project would produce an estimated $4.8 million in new revenue over the next five years.

Recreation

Currently, recreation leases cover approximately 650,000 acres or one-quarter of the Board's total surface ownership. 450,000 acres are leased to Colorado Parks and Wildlife under the "Public Access Program" and 200,000 acres are private recreational leases. In total these leases generate about $900,000 each year.

There are many opportunities to increase recreation lease revenues which include new hunting and fishing properties, snowmobiling, wildlife viewing, cycling, cultural and heritage trails, rock climbing, and other outdoor recreational sports.

The State Land Board developed a recreation business plan which summarizes a new recreation leasing strategy. The strategy focuses on three areas:

- Increasing the total acreage leased for recreational uses
- Increase rates charged for recreational uses
- Developing and leasing land for new recreational uses

The Board's goal is to double its recreational revenues by FY 2017-18. The Board believes that increasing revenues from recreation requires a proactive, engaged approach to leasing and it does not currently have dedicated staff or contract resources for recreation.

Renewable Energy

The State Land Board has 13,700 acres of producing renewable energy leases which generate approximately $500,000 per year.

These leases are utility-scale wind energy and are entirely the result of reactive leasing. In fact, because renewable energy leasing does not have dedicated staff resources, applications for renewable energy leases are processed slowly and the Board has missed leasing opportunities in southeast and south central (San Luis Valley) Colorado.

The State Land Board believes that there are both existing and future renewable energy leasing opportunities on which the Board can capitalize. These include additional and/or expanded utility-scale wind energy projects in northern Colorado, geothermal projects near Buena Vista, solar energy projects in the San Luis Valley, and community or small scale renewable energy projects for towns and schools on the eastern plains.

Based on statewide renewable energy maps produced by the Governor's Energy Office, there are about 500,000 acres of the state trust land that provide good wind and/or solar renewable energy resources. We estimate there are approximately an additional 20,000 acres that could provide good geothermal resources for renewable energy projects.

The State Land Board's goal for renewable energy leasing is to double the current annual revenue level to by FY 2017-18. Assuming current renewable lease rates, this increase would require the State Land Board to lease 14,000 acres for renewable energy projects. 14,000 acres represent about 2.7% of the State Land Board's 520,000 acres of good renewable energy potential.

The Board believes it needs additional dedicated staff and contract resources to take a proactive approach to identifying and pursuing renewable energy development opportunities for state trust land.

Solid Minerals

Both the number of solid mineral leases and the associated royalties declined by more than 40%[1] over the past 5 years. While there are macroeconomic market trends that contributed to this decline, the lack of clear strategies, lack of knowledge of opportunities and lack of proper market expertise have also contributed.

The State Land Board identified the following opportunities for new mineral development on State Trust Land:

- Gold – Box Creek
- Frac Sand – El Paso County
- Metallurgical Coal – Las Animas County
- Uranium/Thorium – Multiple Locations
- Coal Gasification – Moffat County
- Rare Earths – Multiple Locations

There is strong market demand for the products produced from the new mineral development opportunities listed above.

As noted above, the Board's inability to increase solid mineral leasing is due to a lack of dedicated staff and contract resources. If these resources were available, the State Land Board believes that it could generate a minimum of $430,000 in new annual royalty revenue. In fact several of the opportunities identified above specifically gold, frac sand, and coal gasification have the potential to produce several million dollars in annual royalties each.

Alternatives:

Preferred Alternative:

Hire 2 FTE and contractors

Each of the new business opportunities described above require specific and dedicated resources to be successfully developed. At this point, the State Land Board does not know if a particular opportunity will require an FTE or contractor.

Alternative 1:

Hire only contractors

Contractors are best for developing and establishing new lines of business or line of business expansions in areas where there is limited institutional experience.

Alternative 2:

Hire only FTEs

See Alternative 1. Once the line of business is fully established, the State Land Board may consider converting contractors to FTE, if it is more cost effective and the State Land Board anticipates better outcomes.

Anticipated Outcomes:

In addition to expected increases in asset values, these strategic business initiatives are estimated to increase revenues by $7.4 million in net revenues at the end of five years (Exhibit 1). The following are the anticipated revenue increases by line of business:

Ecosystem Services

- $4.8 million from ecosystem services projects

Recreation

- $900,000 million (100%) increase in annual recreational revenues

Renewable Energy

- $560,000 (100%) increase in annual renewable revenue.

Solid Mineral

- $430,000 (100%) increase in non coal, non limestone solid mineral revenue

Exhibit 1:
Projected annual revenues and expenditures
FY 2013-14 to FY 2018-19

	FY 2013-14	FY 2014-15	FY 2015-16	FY 2016-17	FY 2017-18	FY 2018-19
Solid Mineral Revenues	$0	$86,393	$215,982	$323,972	$431,963	$475,159
Renewable Energy Revenue	$0	$112,997	$282,492	$423,737	$564,983	$621,481
Recreation	$0	$173,358	$433,395	$650,093	$866,790	$953,469
Ecosystem Services	$0	$0	$0	$1,645,000	$3,290,000	$0
TOTAL REVENUES	$0	$372,747	$931,868	$3,042,802	$5,153,736	$2,050,110
Strategic Business Initiatives	($426,673)	($418,712)	($418,712)	($418,712)	($418,712)	($418,711)
TOTAL COSTS	($426,673)	($418,712)	($418,712)	($418,712)	($418,712)	($418,711)
CUMLATIVE TOTAL	($426,673)	($472,638)	$40,518	$2,664,608	$7,399,633	$9,031,032
NPV (FY14 ro FY 18)	$4,500,663					
DISCOUNT RATE	15%					

At the end of five years, we believe the State Land Board would have generated $9.5 million in revenue based on $2.1 million in expenditures.

Assumptions for Calculations:

The State Land Board believes that it will need 2 FTE to manage and expand these new business

[1] Excludes coal and limestone. These have unique circumstances and would skew the amount.

opportunities. Please see attached detail. We also estimate $180,000 in contract services funding to assist with project management, technical due diligence, and marketing. Though the use of, and hourly rate for, contractors can vary greatly, based on the work involved and the knowledge required, the Board's recent experience indicates that $75 an hour is an appropriate rate for the expertise that would be needed in developing these new lines of business. Assuming 1,200 billable hours annually to research or develop a program and two contractors, (75 * 1,200 * 2) the State Land Board is requesting $180,000 for contract services.

Consequences if not Funded:
State Land Board earnings that support several State school programs including BEST, the School Finance Act, and the Colorado Early Literacy Act will continue to rely on non-recurring, unsustainable, highly variable revenues to support annual programs. The state trust lands will lose business opportunities.

Impact to Other State Government Agency:
DPA - This request includes 4 new vehicles.

Cash Fund Projections:
See the Schedule 9 for the State Land Board's Trust Administration Cash Fund (Fund #162).

Relation to Performance Measures:

Current Statutory Authority or Needed Statutory Change:
No

APPENDIX A
STATE LAND BOARD ORGANIZATIONAL REALIGNMENT

SUMMARY

The Strategic Business Initiatives FY 2013-14 budget request is part of a broad reorganization effort directed toward making the State Land Board more efficient and business-focused, forward looking, and proactive. The reorganizational effort is aimed at generating additional revenue from existing operations and developing new lines of business that will diversify state trust revenues and make them more sustainable over the long-term.

The State Land Board believes that the best way to accomplish this goal is to consolidate administrative operations, implement a new IT system, task existing program staff with value-added business development activities and hire FTE's and/or contract staff in areas where existing staff do not have expertise or capacity.

This appendix details the State Land Board's reorganizational efforts. The sections are as follows:

- Problem Statement
- Traditional Organizational Structure
- Recent Growth
- New Organizational Approach
- Organizational Strategies
    - Efficiency Strategies
    - Business Strategies

The realignment process described in this appendix began toward the end of FY 2011-12 and is expected to continue through FY 2013-14.

PROBLEM STATEMENT

The State Land Board has historically focused its efforts on leasing its mineral estate for oil and gas exploration/production and its surface estate for agricultural uses. In both areas, the leasing process is mostly reactive. That is, the State Land Board primarily responds to leasing requests and does not develop and/or market its resources. Due to limitations in staff resources, an inefficient organizational structure, and inferior IT systems, there has been very little ability to identify and proactively pursue new business opportunities.

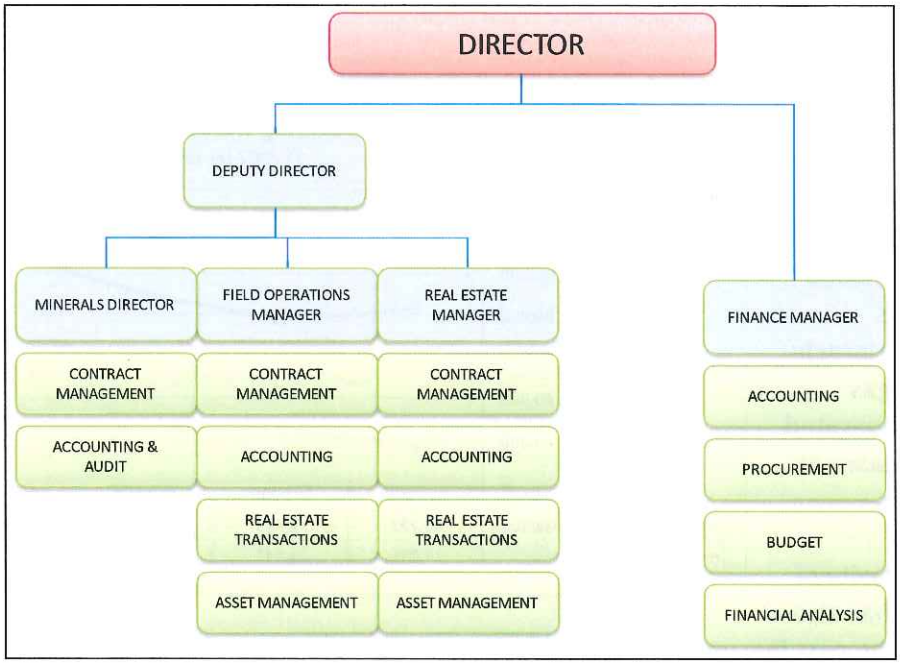
TRADITIONAL ORGANIZATION STRUCTURE

The State Land Board's organization structure has existed since mid 1990s, shortly after the passage of Amendment 16. In fact, the State Land Board has been principally organized around leasing agriculture and minerals since the 1950s. The traditional organizational structure was organized to process leases.

The graphic on the following page is the State Land Board's traditional organization chart depicting the section managers and the associated business functions.

STATE LAND BOARD ORGANIZATIONAL REALIGNMENT

Traditional Organizational Structure



The State Land Board's traditional organizational structure is vertically segregated. Each section has been responsible for the lease processing and accounting associated with its own transactions. The result has been a lack of consistency in lease processes and documentation, a lack of opportunity to cross-train administrative staff, and an inability to efficiently manage staff workloads across sections. More importantly, the current organizational structure is not conducive to expanding beyond the traditional lines of business.

RECENT GROWTH: FY 2007-08 to FY 2011-12

The State Land Board experienced tremendous recent revenue growth. Revenues more than doubled in the past five years ($69M in FY 2007-08 to $145M in FY 2011-12). The State Land Board produces a net of $20 per ownership acre (mineral estate and surface estate).[1] The State Land Board covers its operating costs 15 times over.

The revenue increase over the past five years has resulted in a corresponding increase in lease and payment processing. The number of accounting transactions entered into SAMS[2] grew steadily over the past five years at approximately 8 percent per annum. The accounting transactions are handled by three staff members and the State Land Board has also assigned non-accounting staff and DNR Accounting to assist with the workload and to maintain proper accounting (GAAP) procedures. A recent request to add commercial property accounting to the State Land Board's SAMS system will increase this workload.

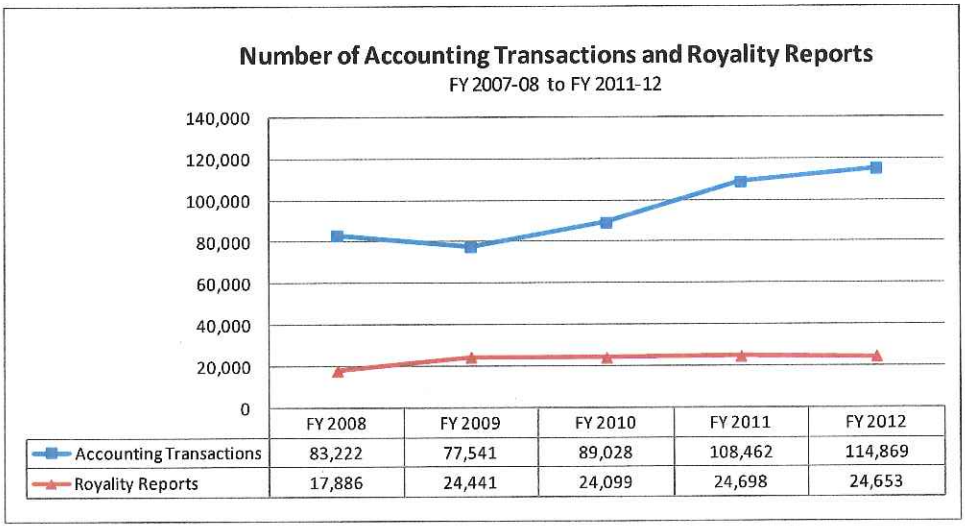
The number of royalty reports submitted by lessees and entered into SAMS increased significantly between FY 2007-08 and FY 2008-09 and has remained consistent at approximately 24,000 per year. Royalty reports have historically been processed by one staff member. The State Land Board recently reassigned two additional staff to assist with royalty report input and also consolidated and simplified

[1] $21.32 revenue per ownership acre minus $1.36 cost per ownership acre. Ownership is 4.0 million acres of mineral estate and 2.8 million of surface estate.

[2] SAMS is the State Land Board lease management system that tracks all leases and payments. This is reconciled each month with COFRS.

the royalty reports. This simplification has kept the total number of royalty reports constant in the face of significant new oil and gas drilling on state trust land.

Over the past five years, the number of average annual active leases increased by 10%. The State Land Board now manages around 13,600 active leases. The increase has been largely driven by oil and gas auctions which generated over 1,000 new leases in the past five years.



	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Accounting Transactions	83,222	77,541	89,028	108,462	114,869
Royality Reports	17,886	24,441	24,099	24,698	24,653

Finally, the complexity of leasing decisions has also increased. Over the past five years over 40% (50% over the past 3 years) of all new oil and gas leases issued by the State Land Board contain specific environmental stipulations developed in partnership with Colorado Parks and Wildlife and the Colorado Natural Heritage Program. Starting in FY 2012-13, all new oil and gas leases will contain similar stipulations. All lease stipulations need to be tracked by State Land Board staff to ensure compliance.

NEW ORGANIZATIONAL APPROACH

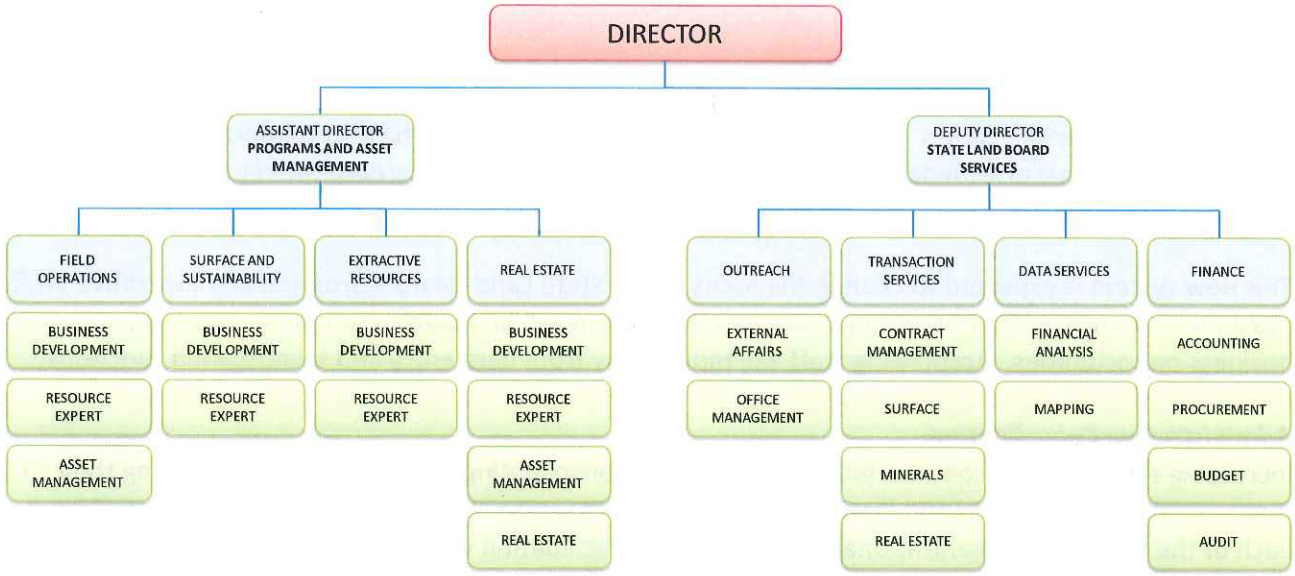
To address the issues and challenges described above, the State Land Board is restructuring its organization to accomplish three key outcomes:

1) Consistent lease processes and tools used by all sections.
2) More efficient organization/use of administrative resources.
3) Dedicated staff and contract resources responsible for expanding existing lines of business and developing new revenue generating opportunities.

STATE LAND BOARD ORGANIZATIONAL REALIGNMENT

The chart below illustrates the results of the restructuring:

New Organizational Structure



The new organizational approach has separated program development and asset management from program administrative functions. The administrative staff will be given more responsibility and accountability than they have currently including responsibility for the lease documents, document files, and all accounting. Consequently, program staff would be able to focus on value-added activities. The FY 2013-14 budget requests concern areas where the State Land Board lacks resources and expertise for certain valued-added activities that will diversify revenues.

ORGANIZATIONAL STRATEGIES

The State Land Board's new organizational plan includes the following strategies:

Efficiency Strategies:

1) Implement new IT system(s) that collect, process, and report critical data to support efficient processing and effective decision making – New GIS system by December 2012 and new asset management system by June 2013
2) Consolidate administrative staff (leasing and accounting) to handle more of the workload, generate efficiencies and consistency – Consolidation of leasing staff by November 2012 and accounting staff by December 2012
3) LEAN review of leasing and accounting processes – Start December 2012

Business Strategies:

1) Identify line of business opportunities and determine existing capacity to meet the needs – Complete
2) Focus existing program staff/contractors on business development in asset management, grazing, farmland, oil and gas, commercial real estate, tower leasing, ROWs, and water – Complete by June 2013.

3) Hire new staff/contractors in areas where existing staff do not have the expertise and/or capacity – FY 2013-14 Budget Request (Recreation, Renewable Energy, Ecosystem Services, and Solid Mineral)

EFFICIENCY STRATEGIES

New Information Technology System

For FY 2012-13 and FY 2013-14, the State Land Board received a total appropriation of $1.5 million to upgrade and/or replace SAMS. The goals of the project are to expand the information that is collected from lessees, reduce or eliminate manual payment processing, vastly increase the reporting capability, and track and lease non-land assets (e.g. water and equipment).

This new system is expected to change the focus of the State Land Board's program administrative staff. Leases will be much easier to administrate and the system will be flexible enough to respond to new business opportunities. Accounting staff will move away from data entry and toward audit functions.

Administrative Consolidation

Increasing efficiencies in contract processing involves consolidating leasing staff and increasing their responsibilities. The State Land Board has formed a Transaction Services team that includes staff from each of the traditional organizational sections. This consolidation will occur in October 2012. The State Land Board will consolidate all accounting staff under a financial manager in November 2012.

LEAN

The State Land Board intends to conduct a LEAN project(s) on its contracting and accounting processes. The State Land Board submitted a request to DNR in June 2012 for a LEAN project. The LEAN project is nominally planned to start in November 2012 once the State Procurement LEAN project is complete.

BUSINESS STRATEGIES

Business Evaluation

The Board approved a new Strategic Plan in January 2011. As identified on page 4 of the plan, the Strategic Plan contains a "portfolio strategy" and "organizational strategy." The portfolio strategic objectives seek to create greater diversity of revenues and the development of new business. The organizational strategic objectives focus on enhancing internal skills and organizational capacities.

Staff spent the last two years evaluating business opportunities and lines of business and internal staff capacities. The lack of water expertise was acknowledged early on and submitted for funding in FY 2012-13. In early 2011, the State Land Board produced a functional organizational chart which is the basis for evaluating staffing capacity and determining the gaps. This led to the FY 2013-14 request.

Existing program staff and contract resources

The State Land Board has program staff and contract resources for a number of important lines of businesses:

- Asset Management
- Grazing
- Farmland
- Oil and Gas
- Commercial Real Estate

- Tower Leasing
- Rights of ways
- Water (newly funded in FY 2012-13)

As mentioned above these positions have traditionally focused on lease processing and not business development functions. Staff is developing new job responsibilities/job descriptions for these positions. Similar to the new line of businesses identified in the budget request, the existing staff/contractors will develop business plans and establish program performance measures. The goal is to have the business planning and job descriptions implemented by June 2013.

Hire new staff/contractors

As noted in the FY 2013-14 budget request, the Board does not have the capacity or expertise to expand and develop certain lines of business that will diversify State Land Board revenues. These are recreation, solid minerals, ecosystem services, and renewable energy.