



REPORT OF

THE

STATE AUDITOR

**STATE BOARD OF LAND
COMMISSIONERS**

**PERFORMANCE AUDIT
November 2000**

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November 15, 2000

Members of the Legislative Audit Committee:

This report contains the results of the performance audit of the State Board of Land Commissioners. This audit was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government.

This report presents our findings, conclusions, and recommendations and the responses of the State Board of Land Commissioners and the State Treasurer's Office.

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**J. DAVID BARBA, CPA
State Auditor**

**State Board of Land Commissioners
Performance Audit
November 2000**

Authority, Purpose, and Scope

This performance audit of the State Board of Land Commissioners was conducted under the authority of Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. This audit was conducted according to generally accepted government auditing standards. We gathered information in this report through interviews, document review, surveys, and analysis of data. Audit work was performed from June 2000 through August 2000.

The purpose of this audit was to review and evaluate certain practices of the Land Board in terms of their effects on trust beneficiaries, and the Land Board's implementation of Amendment 16 to the state constitution. We also reviewed the status of prior audit recommendations made by the Office of the State Auditor in the August 1994 Public Land Management report. The audit contained six findings significant to the State Board of Land Commissioners.

This report contains findings and 16 recommendations for improving the Land Board's management of state trust lands. We would like to acknowledge the efforts and assistance extended by management and staff of the State Board of Land Commissioners and the State Treasurer's Office. The following summary provides highlights of audit comments, recommendations, and responses contained in the report.

Background

The State Board of Land Commissioners is the trustee of state trust lands and manages 2.8 million acres of land for the benefit of eight separate trusts. School Trust lands, which benefit kindergarten through twelfth grade public school children, comprise 93 percent of the trust lands (or 2.6 million acres) managed by the Land Board.

For further information on this report, contact the Office of the State Auditor at (303) 866-2051.

In November of 1996 Colorado voters passed Amendment 16 to the state Constitution. In recognition that school lands must support schools today and in the future, the Amendment stipulates that some lands must be preserved for future generations. Amendment 16 changed the Board from three full-time salaried commissioners to five part-time volunteer commissioners; removed the charge to “maximize returns” for trust beneficiaries to produce “reasonable and consistent (revenue) over time”; and broadened the Land Board’s mission to include preservation of open space, agriculture, and wildlife habitat. It also allowed the Land Board to begin disposing of and acquiring land through nonsimultaneous land exchanges.

Our audit focused on the School Trust; however, most of our recommendations could apply to the seven smaller trusts as well. We reviewed the implementation of constitutional directives and current Land Board policies and practices in light of their effect on its primary beneficiaries: Colorado’s public schools and districts.

Fiduciary Responsibility

The income generated from school trust lands is deposited into one of two trust funds. One is the Public School Permanent Fund (PSPF), which is nonexpendable, and the other is the School Income Fund, which is expended each year. Constitutional language sets forth that the PSPF is inviolate and any investment losses within a fiscal year must be made up by the General Assembly. Approximately \$9.7 million in revenue generated from land sales, royalties, and bonuses were added to the PSPF and invested by the State Treasurer in Fiscal Year 2000. Interest generated from PSPF principal (\$299 million Fiscal Year 2000) is appropriated to the direct benefit of Colorado’s public schools annually.

Investment policies for the PSPF are set forth in C.R.S. 22-41-104. The statute requires that the fund “break even” in the same fiscal year. We found that the PSPF corpus is shrinking, relative to inflation, and that PSPF investment income distributed annually to public schools is not keeping up with inflation or state spending for kindergarten through twelfth grade education. However, by simply extending the profitability “break-even” time restriction for PSPF investment to three fiscal years, the PSPF could hypothetically generate \$870,000 to \$1.2 million more in annual income without changing the lower-risk securities it currently invests in.

The State Board of Land Commissioners should work with the State Treasurer to recommend amendments to C.R.S. 22-41-104 that would extend the break-even time period from one year to three fiscal years, and apply this to the profitability of the fund, in aggregate.

State Board of Land Commissioners Response:

Agree. The Board agrees specifically with the strategy recommended by the Treasurer in his response. Further, while this method would allow for the possibility of the PSPF to increase, it is unlikely that the Fund would keep pace with the rate of

inflation. To make the PSPF truly inflation-proof, state statutes need to be amended to allow for the reinvestment of a portion of the interest income at a rate equal to the consumer price index for Colorado. Until such time as the PSPF is insulated from the effects of inflation, the Board will continue to favor reinvesting the proceeds of land exchanges in replacement property rather than the Fund.

State Treasurer's Response:

Agree. The Legislative Audit Committee has already reviewed and agreed to sponsor a bill that will make a number of alterations to the statutes covering the Public School Permanent Fund in the upcoming session of the legislature. One element of that bill is an extension of the time period for calculating losses from the one to two years. If this particular bill is not approved by the General Assembly, the Treasury will put forward a bill that focuses solely upon changing the time frame in the subsequent session of the legislature.

The Board has the constitutional authority to dispose of state lands as long as the transaction is for at least market value and is advantageous for the trust involved. Lands can be disposed of by sale at public auction, simultaneous exchange, nonsimultaneous exchange, or inter-trust transfer of assets, including land, money or both. A nonsimultaneous exchange is a sale of land for money and the purchase of a replacement property within two years of the original disposition date.

We found that since Fiscal Year 1999 the two-year nonsimultaneous deadline has been exceeded and the remaining funds were not transferred to the PSPF, as required by law. Consequently, the School Income Fund did not receive \$33,000 in interest that could have been earned. Additionally, over \$14,000 in earned interest was held in closed nonsimultaneous escrow accounts and not reverted to the PSPF when the escrow accounts were closed. We found the inter-trust transfer of about 233,000 mineral acres statewide was made without arms-length independent appraisals and in the absence of written policies for those transactions. We also found that local governments have not received payment in lieu of taxes as required when exchanges for commercial properties are made.

We recommend that the State Board of Land Commissioners use transaction closing dates to begin the two-year escrow period for land exchange funds; ensure that closing funds are available and credited to a nonsimultaneous land exchange escrow account at closing; ensure escrow funds and interest remaining after two years are transferred to the PSPF; establish and follow appropriate policies for inter-trust transfers of state lands, and ensure that independent appraisals are conducted prior to transfers; and include payment in lieu of taxes in all leases for commercial state trust properties and lands subject to development.

State Board of Land Commissioners Response:

Agree. The Board will work with the Treasurer to refine the escrow processes indicated. The Board has implemented a mandatory policy requiring all funds to be wired on the date of closing. The Board believes, through verification by the State Treasurer's Office, that there has been no lost interest on any of the applicable accounts regardless of the varying interpretations of the two-year timeframe. Interest was credited to the accounts the entire time any of the funds were on deposit. Specifically, the \$33,000 in interest was not lost to the beneficiaries, but was either used to purchase a replacement property for that beneficiary or was later reverted to the PSPF. The Board has informed the Treasurer's Office of the proper escrow account time lines, and will use the original transaction closing date as the trigger date for the two-year timeline. The Board will formalize the Attorney General's opinion regarding inter-trust transfers by Board order in December. Finally, the Board will enforce the lease provisions and statute requiring lessees to pay taxes to local governments.

Asset Management

The Land Board's fiduciary responsibility to produce reasonable and consistent income over time has resulted in a strategic outlook for managing trust assets, including its position that resource "appreciation is equally important as income." Consequently, the Board's challenge has been to ensure the appreciation of its land trust portfolios on a statewide basis as well to manage the appreciation of individual parcels. We found the Board has no method to independently determine and verify the appreciation of its land trust portfolios, nor does it have an information system able to provide timely and accurate information regarding the status of individual parcels.

We recommend that the State Board of Land Commissioners use the legislative council's annual statewide property assessment RFP process as a guideline for procuring qualified vendors to provide cost-effective and independent baseline and ongoing statewide valuations. The Board should coordinate with the timing of legislative council's RFP process in order to maximize economies of scale. The Land Board should also develop an information system for individual leased parcels containing current use(s) and lease terms; lease history; character and land improvements, including those made over time; appreciation potential, actual appreciation, and assessment information; and information on the trust beneficiary of each land asset.

State Board of Land Commissioners Response:

Agree. The Land Board has been engaged in the process of developing an asset management plan for the last two years. The Board is currently at the stage where

it will require a periodic baseline evaluation of state trust lands. The Legislative Council's process will be a helpful blueprint for the Board's first RFP which will be issued by December 31, 2001. Additionally, the Land Board is in the process of revamping and rebuilding an antiquated computer system which will, once completed, provide accurate and timely information on trust lands. The computer redesign project and timeline have been approved by the Governor and the Legislature through the budget process, have been approved by the Information Management Commission and is now being implemented by Board staff, Department of Natural Resources information technology professional staff and private contractors.

Field Operations

The Land Board's trust assets are divided into six regions, each containing approximately 400 parcels on 450,000 acres of land. Each is staffed by a District Manager and a half-time administrative assistant. A District Manager's duties include site inspections to determine the appropriate site-specific carrying capacity for each grazing lease in their region. The grazing rate is then reduced for every grazing lease statewide based on a 1991 study conducted by Colorado State University of federal land management practices in Colorado. The study found that the management burden for lessees of federal public grazing lands was about 35 percent greater than for private lands. The components that made up the greater public land management burden included:

- The expenses associated with moving to and from the leased land.
- The cost of traveling to and from the leased land.
- Water costs.
- Horse costs.
- Depreciation of development (fencing and water).
- The value of lost animals.
- Maintenance.

The 35 percent reduction equates to about \$2.5 million per year for state trust lands, based on a grazing lease income average of \$5.1 million annually. An across-the-board 35 percent reduction could be depriving the PSPF of revenue. In addition, it can create inequities among neighboring lessees who may have varying amounts of management burden, but get the same reduction.

We found that the Land Board has no system in place to measure the management burden of its individual lessees. Nearly 68 percent (21 of 31) of the files we reviewed showed that required site inspections were not performed or were incomplete, and that all lessees do not have the same management burden. Further, we found that leased trust lands were not inspected by managers as required, and that inspection criteria and guidelines have not been adopted.

The State Board of Land Commissioners should ensure that all rate reductions from market value are made on an individual lease basis, all leased trust lands are inspected by District Mangers as required, and that criteria and guidelines from which inspections can be made are established.

State Board of Land Commissioners Response:

Agree. Ideally, agricultural lease rate offsets should reflect the particular characteristics of that parcel. Practically, the Board does not have the staff resources to eliminate the 35% rate reduction and customize rate structures for each of the 3000 parcels it manages. As an attempt to achieve equity among lessees, the Board will continue working with the Colorado Agricultural Statistics Service and the Colorado Cattlemen's Association to develop a new methodology for setting grazing lease rates. To comply with the recommendations regarding inspections, the Board will make district and property management plans a central feature of the annual performance plan in the future.

Disposition of 1994 Audit Recommendations

As part of our audit we also reviewed the Land Board's progress in implementing recommendations made in the Office of the State Auditor's 1994 performance audit of Public Land Management. The report made six recommendations specific to the State Board of Land Commissioners including those to improve policies related to overall land management, adopt processes for setting grazing fees, determine land valuations, and establish procedures for land banking and sales. We found that some recommendations have not been fully implemented by the Board.

The State Board of Land Commissioners should identify what actions are needed to fully implement these recommendations and then develop an action plan to ensure they are dealt with timely. This action plan should include a method of holding district managers and Land Board staff accountable for completing the tasks needed to address individual recommendations.

State Board of Land Commissioners Response:

Agree. The Board's annual work plan for 2001 will reflect the progress it intends to make on both the 1994 audit and the 2000 audit.

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
1	24	The State Board of Land Commissioners should work with the State Treasurer to recommend amendments to Section 22-41-104 C.R.S., that would extend the break even time period from one year to three fiscal years, and apply this to the profitability of the fund in aggregate.	State Board of Land Commissioners Office of the State Treasurer	Agree Agree	June 1, 2001
2	27	The State Board of Land Commissioners should take steps to ensure that exchange funds are available at closing and are credited to an escrow account upon receipt.	State Board of Land Commissioners	Agree	Implemented
3	29	The State Board of Land Commissioners should institute a procedure for: <ul style="list-style-type: none"> a. Identifying and informing the State Treasurer of escrow account time lines. b. Transferring nonsimultaneous escrow funds to PSPF upon the two-year anniversary of the original disposition or sale. 	State Board of Land Commissioners	Agree	Implemented
4	30	The State Board of Land Commissioners should establish a method to ensure that all “closed” nonsimultaneous escrow accounts have a zero balance once a formal request has been made. The Board should further review all escrow accounts to ensure lagging interest accruals are reverted to the PSPF.	State Board of Land Commissioners	Agree	December 1, 2000

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
5	32	<p>The State Board of Land Commissioners should establish a formal policy concerning inter-trust transfers. The Board should further go on record for each inter-trust transfer with a Findings of Fact that such exchange would be equally beneficial to both trusts. The Findings of Fact should include the results from:</p> <ul style="list-style-type: none"> a. An appraisal from an independent appraiser of the property or if an independent appraisal is not used , an explanation of how value was assessed. b. Disclosure in the Board meeting agenda when an independent appraisal is not used in valuating trust assets. c. An income assessment, including the rate of return on asset value and potential long-term appreciation. d. An assessment of nonquantitative values. e. A transcript of Board considerations pertaining to the inter-trust transfer to be placed in the transaction file. 	State Board of Land Commissioners	Agree	January 1, 2001
6	35	The State Board of Land Commissioners should comply with requirements of C.R.S. 36-1-120.5 and require lessees, when applicable, to pay all affected government entities an amount equal to that which would be owed if the land were privately owned.	State Board of Land Commissioners	Agree	December 31, 2001
7	36	The State Board of Land Commissioners should work with the Executive Director of the Department of Natural Resources to comply with statutory reporting requirements or recommend statutory changes to the General Assembly.	State Board of Land Commissioners	Agree	June 30, 2001

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
8	39	<p>The State Board of Land Commissioners should independently establish and verify the value and appreciation of its trust assets by:</p> <ul style="list-style-type: none"> a. Using the legislative council's annual statewide property assessment RFP/process as a guideline for procuring qualified venders to provide cost-effective and independent baseline and ongoing statewide valuations. b. Cooperating with legislative council to coordinate with the timing of their RFP process in order to maximize economies of scale. 	State Board of Land Commissioners	Agree	December 31, 2001
9	41	<p>The State Board of Land Commissioners should ensure that accurate and timely information is available for all leases by:</p> <ul style="list-style-type: none"> a. Determining a time line for the implementation and integration of the lease management software. b. Including pertinent information on all trust lands, specifically: current use(s) and lease terms, lease history, character and land improvements (including those made over time), appreciation forecasting, actual appreciation, and assessment information and designated trust beneficiary of land asset. 	State Board of Land Commissioners	Agree	December 31, 2001
10	43	<p>The State Board of Land Commissioners should review its files to identify all unleased land assets and prioritize them for:</p> <ul style="list-style-type: none"> a. Land use change b. Auction c. Disposition 	State Board of Land Commissioners	Agree	December 31, 2001

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
11	45	The State Board of Land Commissioners should assess the costs and benefits of the Stewardship Incentives Program to ensure it accomplishes short-and long-term goals at acceptable costs.	State Board of Land Commissioners	Agree	December 31, 2001
12	50	<p>The State Board of Land Commissioners should take steps to ensure that:</p> <ul style="list-style-type: none"> a. Criteria are established for determining a lessee's cost of managing state trust land. b. A procedure for making cost assessments and evaluations is established and enforced. c. All rate reductions from fair market value are made on a lease-by-lease basis. 	State Board of Land Commissioners	Partially Agree	December 31, 2001
13	52	<p>The State Board of Land Commissioners should:</p> <ul style="list-style-type: none"> a. Develop and uniformly apply a depreciation schedule for prorating the normal expected life of leasehold improvements on state trust lands. b. Use the Stewardship Incentives Program as a pilot to develop the necessary systems, policies and procedures. c. Determine a time frame for applying this method to leasehold improvements made on state trust lands. 	State Board of Land Commissioners	Agree	December 31, 2001

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
14	54	The State Board of Land Commissioners should ensure that the March 1999 lease inspection schedule is being followed and it sufficiently addresses the Board's land management goals, including specific guidelines and indicators.	State Board of Land Commissioners	Agree	June 30, 2001
15	56	The State Board of Land Commissioners should fulfill its oversight responsibility, and: <ul style="list-style-type: none"> a. Establish a format for a district management plan. b. Establish criteria for asset assessment based on land management benchmarks. c. Determine the frequency for submitting a plan to Land Board management. 	State Board of Land Commissioners	Agree	June 30, 2001
16	57	The State Board of Land Commissioners should review all recommendations that have not been completely implemented from the 1994 State Auditor's performance audit report and develop an action plan to ensure their timely implementation.	State Board of Land Commissioners	Agree	January 31, 2001

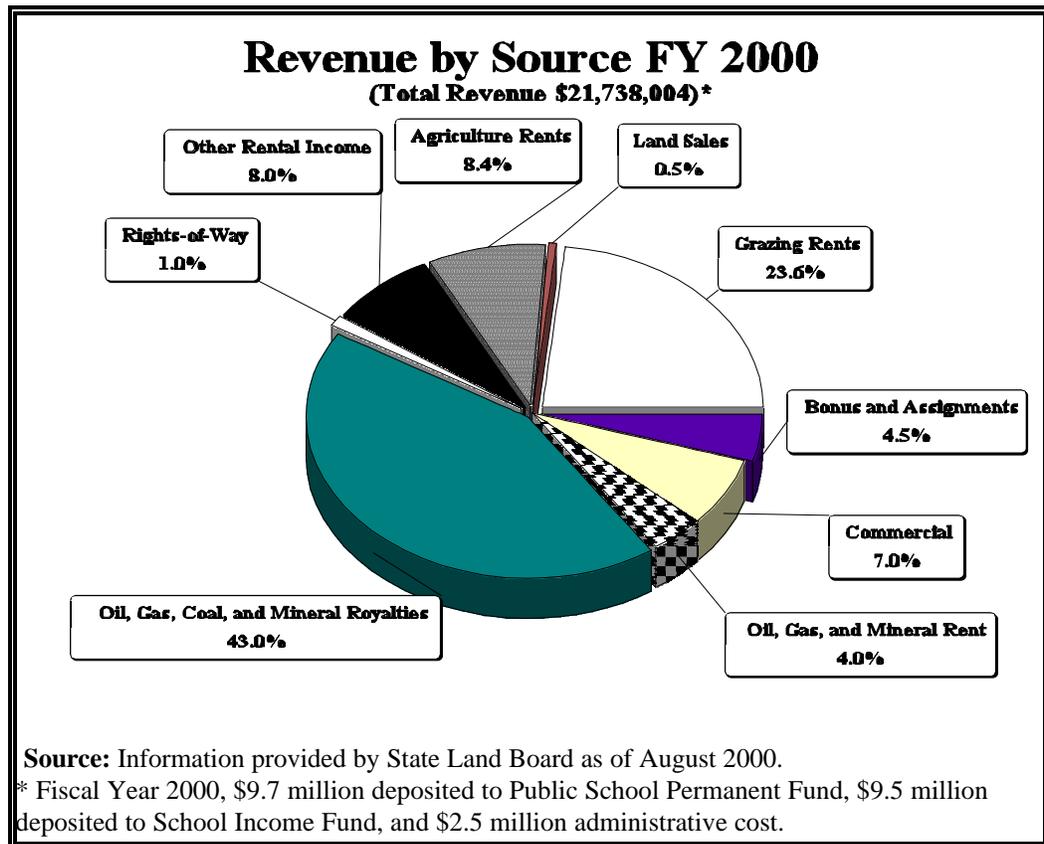
Overview

Upon Colorado's statehood in 1876, the federal government granted the State approximately 4.75 million acres of land: Two 640-acre sections in every township inside state boundaries. The grant included both the surface land and its underlying mineral assets. The Colorado constitution established the State Board of Land Commissioners as the trustee of the endowment.

Colorado townships were divided into 36 sections, each a mile square, each section numbered 1 through 36. The federal government gave sections 16 and 36 of every township, if available, to the State to support public schools. In the 125 years since statehood, about 40 percent of surface trust lands have been sold. Today Colorado has approximately 2.8 million surface acres, and 4.1 million underlying mineral-only acres that generate revenue for beneficiaries.

To manage its trust assets, the Land Board has divided the State into six districts, each containing approximately 400 parcels on 425,000 acres of land. District offices are located in Craig, Greeley, Sterling, Pueblo, Alamosa, and Denver. Each is staffed by a District Manager and a half-time administrative assistant who work under the Board's Field Operations Program. The Front Range district office, located in Denver, was added in Fiscal Year 2000 to increase customer satisfaction, consistency, management presence, and the number of overall land inspections.

The Board manages leases for grazing and crop production, as well as for development of residential, commercial, and industrial properties; timber harvesting; and mining. The Board also sells and collects royalties on minerals, oil, and gas extracted from trust lands. In Fiscal Year 2000 the Board earned about 24 percent of its revenues from grazing leases and 43 percent from oil, gas, coal, and mineral royalties, as illustrated on the following chart:



Ninety three percent of the land managed by the Land Board—approximately 2.6 million acres—is held in trust by the State for Colorado’s kindergarten through twelfth grade public schoolchildren. The remaining 200,000 acres benefit seven smaller trusts including:

- ▶ University of Colorado Trust
- ▶ Colorado State University Trust
- ▶ Penitentiary Trust
- ▶ Public Buildings Trust
- ▶ Hesperus Trust (Fort Lewis College)
- ▶ Saline Trust (state parks)
- ▶ Internal Improvements Trust (state parks)

Appointed by the Governor, the Land Board’s commissioners function as constitutional officers and trustees of state lands. The Board was appropriated 32 FTE and a budget of nearly \$2.5 million for Fiscal Year 2000. The annual operating budget is appropriated from a portion of the income generated from trust lands. The Land Board’s director administers the day-to-day activities of the agency, including maintaining the minutes of the Board, maintaining records of land activities, receiving

all monies collected on account of the Land Board, and depositing land revenue with the State Treasurer.

Amendment 16

In November of 1996 Colorado voters passed Amendment 16 to the state constitution. In recognition that school lands must support schools today and in the future, the Amendment stipulates that some lands must be preserved for future generations. To accomplish this, Amendment 16:

- ✓ Changed the Land Board's constitutional duty of *maximizing* revenue from state trust lands to managing the lands to *produce reasonable and consistent revenue over time*.
- ✓ Restructured the Land Board by increasing the number of members on the Board from three to five, and required that specific areas of expertise be represented on the Board.
- ✓ Eliminated the salary for Board members and limited members' service to two consecutive part-time terms.
- ✓ Requires the Board to designate nearly 300,000 acres of state lands (10 percent of all state surface lands) into a perpetual trust. Those lands designated to the trust cannot be sold, exchanged, or developed without first being removed by a vote of four out of five of the Board members.
- ✓ Instructs the Land Board to include in agricultural lease terms incentives that promote long-term agricultural productivity and community stability.
- ✓ Authorizes the Land Board to sell or lease conservation easements to protect open space and maintain environmental quality and wildlife habitat.
- ✓ Permits the Board to dispose of and acquire land through nonsimultaneous land exchanges as long as the exchange is completed within two years of the original land sale or disposition.
- ✓ Calls for fiscal impact studies to determine if the revenue from developing trust lands will be greater than the cost of educating new students associated with the development.
- ✓ Requires the Land Board to comply with local land use regulations and plans.

- ✓ Permits the Legislature to enact laws that allow the Permanent School Fund to be used to invest in and guarantee school district bonds and to make loans to school districts.
- ✓ Allows the Board to sell or lease trust lands to school districts for school buildings.
- ✓ Requires that revenue from school trust lands be in addition to and not a substitute for other funding provided by the state Legislature for public schools.
- ✓ Permits public schools to have access to trust lands free of charge for outdoor educational purposes as long as such access does not conflict with existing uses on the land.

As part of this audit we reviewed the Land Board's progress in implementing recommendations made in the Office of the State Auditor's 1994 performance audit of Public Land Management. The report made six recommendations specific to the State Board of Land Commissioners including those to improve policies related to overall land management, adopt processes for setting grazing fees, determine land valuations, and establish procedures to land banking and sales. We found that some recommendations have not been fully implemented by the Board.

Our audit method focused on reviewing the Land Board's policies and practices in light of their effect on Colorado's public schools, the beneficiaries of 93 percent of all state trust lands. However, many of the recommendations contained in this report affect all state trust land beneficiaries. The implementation of recommendations contained in Chapters 1, 2, and 3 of this report could increase income to Colorado's public school districts, both immediately and over time. Increased interest earnings for the Public School Permanent Fund (PSPF) are determined by the current year-to-date annualized interest rate for PSPF investments. It should be noted that anticipated increases in revenue streams to beneficiaries are based on a full, rather than phased-in, implementation of the recommendations contained in this report.

Fiduciary Responsibility

Chapter 1

Background

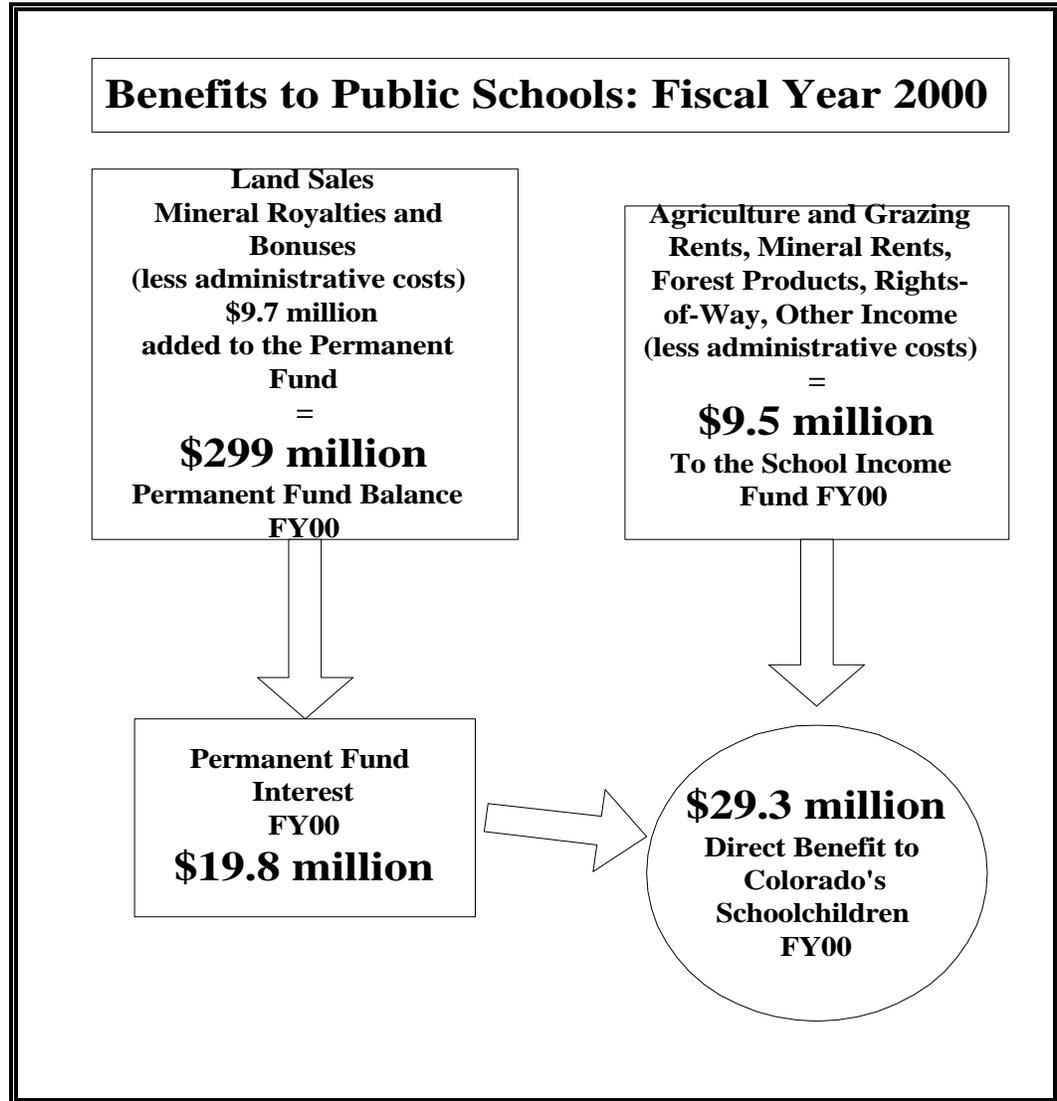
The Land Board is the only entity responsible for managing lands to make money for schools. Income from the trust lands is combined with other state and local revenue to fund public education under the state school finance law. As fiduciaries, the Land Board is obligated to generate reasonable and consistent income over time for its beneficiaries, primarily Colorado's public schools.

Originally, the land granted in 1876 provided all the income for schools. In Fiscal Year 2000 the income generated from school trust lands was nearly \$19 million. Public School Permanent Fund interest and School Income Fund deposits contributed \$29.3 million to public schools in Fiscal Year 2000, less than 1 percent of the State's \$3.5 billion public education budget.

The income generated from School Trust lands is deposited to one of two trust funds. One is the Permanent Fund, which is nonexpendable, and the other is the School Income Fund, which is expended each year. Money deposited to the Public School Permanent Fund (PSPF) is invested by the State Treasurer. Since this fund is required to "remain inviolate and intact" by Article IX of the Constitution, it provides a perpetual interest annuity to the expendable School Income Fund. Permanent Fund revenues are received from:

- Sales of state trust land.
- Consideration received for perpetual rights-of-way.
- Royalties received as the result of the depletion or the anticipated depletion of oil, gas, geothermal, coal, gravel, or other mineral resources.
- One-time bonus payments for any mineral tract sold at public auction.

The following chart depicts the flow of income generated from the Land Board's activities to Colorado's public schoolchildren:



The PSPF has grown from \$200 million in Fiscal Year 1991 to \$299 million in Fiscal Year 2000. The average interest contribution from the PSPF to the expendable School Income Fund was \$18.3 million over the past 10 years, as illustrated in the following table:

Public School Permanent Fund (Interest Income expended annually)			
Fiscal Year	SLB Revenue Transfer to PSPF	PSPF Balance*	PSPF Interest paid to School Income Fund**
1991	\$10,263,528	\$200,026,005	\$17,604,272
1992	8,416,370	208,550,187	17,970,067
1993	9,673,048	218,444,806	17,637,065
1994	11,149,770	229,627,331	16,155,932
1995	12,012,096	249,087,746	16,593,842
1996	12,767,043	261,854,789	17,988,262
1997	10,030,113	272,869,315	20,167,703
1998	7,377,987	281,234,427	19,752,508
1999	6,652,866	288,492,509	19,583,198
2000	9,718,017	299,010,729	19,798,365

Source: Department of Treasury CFO, August 2000.
 *The Department of Treasury reports that the PSPF balance is impacted by the transfer of revenues from the Escheat Fund and other small interest earnings posted annually.
 **Average PSPF interest payment made to the School Income Fund FY 1991 to FY 2000 is \$18,325,121.

Unlike the PSPF, the School Income Fund is disbursed annually for direct benefit to public schools. As set forth in the chart on page 18 of this report, the School Income Fund relies on money received from:

- Rentals from surface land, oil, gas, geothermal, coal, gravel, and other mineral rights given under lease contracts.
- Money received from timber contracts and permits.
- Consideration received for nonperpetual rights-of-way granted across state lands.
- Interest payments, including annual interest from the PSPF.

While the Land Board generated \$9.5 million in revenues for direct deposit to the School Income Fund in Fiscal Year 2000, over the past decade the Land Board’s direct contribution to the fund has ranged from \$6.5 million to \$10.1 million a year.

Public School Permanent Fund Investment Policies Are Inflexible

Public School Permanent Fund interest produced about two-thirds of the \$29.3 million generated from school trust lands for direct benefit to kindergarten through grade school children throughout the State in Fiscal Year 2000. Investment policies for revenue deposited to the PSPF are established by law and are carried out by the State Treasurer's Office. Statutory requirements are as follows:

The public school fund shall forever remain inviolate and intact; the interest thereon, only, shall be expended in the maintenance of the schools of the state and shall be distributed to the several school districts of the state in such manner as may be prescribed by law. No part of said fund, principal or interest, shall ever be transferred to any other fund or used or appropriated, except as provided in this article. The state treasurer shall be custodian of the fund, and the same shall be securely and profitably invested as may be directed by law. The state, by appropriation, shall supply all losses of principal that may occur as determined pursuant to section 2-3-103 (5), C.R.S., or section 22-41-104 (2).

(2) For the purpose of this article, "interest" means interest and the net of all realized gains over realized losses, except those losses restored by appropriation, associated with investment transactions during the fiscal year.

The state constitution requires that the PSPF remain forever inviolate and intact. Loss of fund principal must be made up by the General Assembly. As a result, the PSPF principal is invested in low-risk securities and pooled cash and not invested in equities, which represent a higher risk for loss of principal and profit but also represent an opportunity for higher yield. The Board and State Treasury staff have noted concerns about PSPF, including :

- ✓ The PSPF is not growing at a pace equal to or greater than the rate of inflation or the State's share of school funding, pursuant to the School Fund Act. For example, the fund increased about 14.2 percent from Fiscal Year 1997 through Fiscal Year 2000 while inflation increased 15.5 percent and interest paid to the School Income Fund increased about 10 percent and state school funding grew 17.2 percent. Consequently, the interest yield to public school beneficiaries has not kept up with inflation or state school spending.

- ✓ All interest earnings generated by the PSPF are spent each year. Consequently, the value of the fund's corpus or principal is diminished by inflation.

C.R.S. 22-41-104 restricts the State Treasurer's investment flexibility and options. Investment policies require that the fund must break even at the end of every fiscal year. Further, the Office of the State Auditor evaluates the investments of the Public School Permanent Fund annually, as required by C.R.S. 2-3-103, and reports any loss of principal of the fund.

Audit analysis revealed that in a rising interest-rate market, it could be advantageous to sell or exchange lower-interest investments for those with higher interest. When such an exchange is made, the lower-interest investment must be sold at a loss. Even if higher-interest investments are able to generate more income to the fund over time, such an exchange must be reported as a loss if it cannot break even in the same fiscal year. The break-even deadline can be very short because a full 12 months is available only on July 1, and is reduced each month thereafter. Also, as defined in the statute below, the legal time requirement can be interpreted to apply to individual exchanges or to the fund in aggregate.

The state treasurer in the state treasurer's discretion may invest and reinvest moneys accrued or accruing to the public school fund in the types of deposits and investments authorized in sections 24-36-109, 24-36-112, and 24-36-113, C.R.S., and bonds issued by school districts.

(2) The state treasurer has authority, to be exercised at the state treasurer's discretion, to effect exchanges or sales whenever such exchanges or sales will not result in any ultimate loss of principal and to effect exchanges or sales that will result in a loss of principal whenever such loss can be offset by a corresponding gain within the same fiscal year of such exchange or sale. No exchange or sale of securities shall be consummated by the state treasurer which will result in a net loss of principal unless the general assembly has previously appropriated a sum to the public school fund equivalent to the anticipated net loss of principal from such exchange or sale.

In Fiscal Year 1997 the PSPF "break-even" requirement was changed from 30 days to one fiscal year with no reported negative effects on the fund principal or profitability of investments. Extending the break-even time period could add flexibility and increase income with relatively little risk compared with equity investments. For example, the State's Controlled Maintenance Fund (CMF) offers a more flexible investment policy. The CMF is similar in size to the PSPF. Like the PSPF, the

Controlled Maintenance Fund investment policy allows those revenues to be invested in low-risk instruments and does not include equity investments. However, the policy allows a three-to five-year break-even period for investment exchanges.

To test investment yield potential, we asked the State Treasurer's investment staff to hypothetically invest PSPF monies using the same break-even policy that is allowed for the Controlled Maintenance Fund. The following scenarios illustrate the various possibilities for asset allocation for the PSPF, assuming losses could be taken in three fiscal years and that the three-year extension could be applied to the entire fund simultaneously:

Current Portfolio (June 30):		
	%	Yield
Treasury	9	7.23
Agency	30	6.70
MBS	24	7.53
ABS	27	6.66
Corporates	6	6.14
TPOOL	4	<u>6.00</u>
		6.80

Treasury = U.S. Treasuries
Agency = Quasi-federal agencies (i.e., FNMA)
MBS = Mortgage-Backed Securities
ABS = Asset-Backed Securities
Corporates = Corporate debt
TPOOL = Treasury Cash Pool
Bps = Basis Points

Scenario 1: Increase risk profile slightly; become fully invested.			
	%	Yield	Chng from Curr. Port.
Treasury	9	7.23	0%
Agency	20	6.70	-10% *sell low yield
MBS	34	7.58	+10% *buy good quality, volatility, yield
ABS	27	6.66	0%
Corporates	10	7.39	+4% *extend average life; less quality/higher yield
TPOOL	0	<u>0</u>	-4%
		7.10	

This scenario increases portfolio book yield by about 30 bps, or approximately \$870,000 per year.

Scenario 2: Increase credit risk, increase prepayment risk, extend average maturity significantly.

	%	Yield	Chng from Curr. Port.
Treasury	9	7.23	0%
Agency	10	6.70	-20% *sell lower yields; buy MBS
MBS	45	7.55	+21% *buy quality, increase volatility, increase yield
ABS	15	6.66	-12% *sell short AAA; increase maturity
Corporates	21	6.97	+15% *increase credit risk, 'A' quality; ext. maturity
TPOOL	0	0	-4%
		7.18	

This scenario increases portfolio book yield by about 38 bps, or approximately \$1,100,000 per year.

Scenario 3: Reduce overall credit quality modestly, extended average maturity mostly thru agencies and ABS, increase volatility thru MBS.

	%	Yield	Chng from Curr. Port.
Treasury	9	7.23	0%
Agency	30	6.88	0% *reflects selling 50% of short bonds & extend
MBS	45	7.55	+21% *increase volatility, increase yield; good qual.
ABS	5	6.66	-22% *sell ABS, therefore, extend average maturity
Corporates	11	6.97	+4% *extend to 15-yr 'A' quality
TPOOL	0	0	-4%
		7.21	

This scenario increases portfolio book yield by about 41 bps, or approximately \$1,200,000 per year.

Source: State Department of Treasury, August 2000.

Hypothetically, by changing the break-even time restriction from one year to three years and thus allowing a change to the investment mix, the PSPF could yield between \$870,000 and \$1.2 million per year in additional income. This additional income could be divided among the State’s public school districts and the PSPF, thereby increasing direct revenues to schools as well as the PSPF corpus without relying on general fund revenues to compensate for inflation.

The General Assembly is currently considering legislation that would allow for investment in equities and other changes designed to increase the PSPF corpus and the subsequent annual interest distribution to public school districts. However, if the

legislation does not pass, the Land Board and State Treasurer could develop a plan to broaden investment strategies and extend the time in which PSPF investments have to show a profit or break-even.

Recommendation No. 1:

The State Board of Land Commissioners should work with the State Treasurer to recommend amendments to Section 22-41-104 C.R.S., that would extend the break-even time period from one year to three fiscal years, and apply this to the profitability of the fund in aggregate.

State Board of Land Commissioners Response:

Agree. The Board agrees specifically with the strategy proposed by the Treasurer below. Further, while this method would allow for the possibility of the Permanent School Fund to increase, it is unlikely that the Fund would keep pace with the rate of inflation. To truly make the Permanent School Fund inflation-proof, state statutes need to be amended to allow for the reinvestment of a portion of the interest income at the rate of an annual consumer price index for Colorado. Until such time as the Public School Permanent Fund is insulated from the effects of inflation, the Board will continue to favor reinvesting the proceeds of land exchanges in replacement property rather than investing in the fund. June 1, 2001.

Office of the State Treasurer's Response:

Agree. The Legislative Audit Committee has already reviewed and agreed to sponsor a bill that will make a number of alterations to the statutes covering the Public School Permanent Fund in the upcoming session of the legislature. One element of that bill is an extension of the time period for calculating losses from the one to two years. If this particular bill is not approved by the General Assembly, the Treasury will put forward a bill that focuses solely upon changing the time frame in the subsequent session of the legislature.

Land Exchanges Expand Opportunities for Trust Estate Portfolios

The Board has the authority to sell or exchange any state trust land pursuant to Article IX, Section 9 of the Colorado Constitution, and Title 36 of the Colorado

Revised Statutes. As a fiduciary, the Land Board must treat its land assets as a private trustee would. Each year the Board selects lands for disposal based on what is most advantageous for trust beneficiaries. These transactions are prioritized in the Land Board's annual work plan. Because of its fiduciary responsibility to each trust, when the Board does make a decision to dispose of a piece of land, it must be at or above market value.

According to Land Board staff, historically, the majority of lands listed on the annual work plan and disposed of are those that have had an inquiry or "letter of interest" submitted from a private buyer rather than those that require extensive management or are of low value. The Land Board's options for disposing of trust land include:

- ✓ **Land Sale at Public Auction.** The auction method is used to dispose of state land in exchange for money. Sale proceeds are deposited directly to the Public School Permanent Fund. Statute requires that the land being offered for sale must be properly advertised. Upon confirmation by the Land Board, a patent, deed, or a certificate of purchase is issued to the successful bidder and title is conveyed when the certificate of purchase is paid in full.
- ✓ **Simultaneous Land Exchange.** A land-for-land exchange occurs when state land is exchange for property of equal value.
- ✓ **Nonsimultaneous Land Exchange.** This method involves an exchange of state land for money, which is then deposited with the State Treasurer and credited to an individual nonsimultaneous land exchange cash fund account. Completion of a nonsimultaneous land exchange occurs when a replacement property is purchased with the funds withdrawn from a particular nonsimultaneous land exchange account. If the funds are not used to acquire replacement property within two years of the original disposition date, funds remaining in the nonsimultaneous land exchange account must be transferred to the PSPF.
- ✓ **Inter-trust Transfer.** This land transfer is similar to a nonsimultaneous or simultaneous land exchange but involves removing assets from one trust estate and transferring them to another of the eight trusts managed by the Land Board. The exchange can involve land assets, escrow funds, or both.

The Board reports that the preferred method to dispose of trust land is by nonsimultaneous exchange. Our analysis of real estate transaction files ranging from 1996 to date established that the Land Board engages in transactions that are initiated as a land-for-land exchange. It is important to note that these exchanges usually involve the exchange of land and cash. In cases where cash and land are received by the Board during a simultaneous (land-for-land) exchange, the monies are deposited

into an escrow account pending acquisition of another property, as would occur in a nonsimultaneous land exchange. If a land-for-land exchange involves the payment of both land and cash for the acquisition of a replacement property, the purchase monies are withdrawn from one of the nonsimultaneous escrow accounts administered by the State Treasurer.

The Land Board's development and use of land exchange options supports the organizational mission to manage state trust lands in ways that generate reasonable and consistent revenue over time for trust beneficiaries while maintaining precious land resources. The implementation of land exchange procedures are meant to secure the intergenerational nature of the School Trust by enabling the Land Board to shift assets and create an investment portfolio that includes both valuable and appreciating lands.

Nonsimultaneous Land Exchange Procedures Could Be Refined

The Colorado constitution, Article IX, Section 9 (7) establishes the process for undertaking nonsimultaneous exchanges of land, specifically:

*... purchase of lands to complete such an exchange shall be made **within two years** of the initial sale or disposition. Any proceeds, and the interest thereon, from a sale or other disposition which are not expended in **completing** the exchange shall be transferred by the state treasurer to the public school fund or such other trust fund maintained by the treasurer for the proceeds of the trust lands disposed of or sold....*

Section 36-1-124.5 C.R.S., sets forth a process for nonsimultaneous exchanges as authorized by the constitution. Statutory requirements include that:

- Money from the appropriate account in the nonsimultaneous exchange cash fund shall be used to purchase land at the completion or partial completion of a nonsimultaneous exchange.
- The nonsimultaneous exchange must be completed within two years of the initial disposition.
- The Board determines when the nonsimultaneous exchange is completed, and any money remaining in the designated account in the nonsimultaneous exchange cash fund must be credited to the trust fund for the trust whose lands were disposed of in the exchange.

Further, the Land Board's Real Estate Procedures Manual describes the completion of a purchase or sale of state trust land as the "closing."

We reviewed 37 nonsimultaneous land exchange escrow deposits to the State Treasurer totaling approximately \$21.4 million, made between July 1997 and June 2000. We found that nearly half of those deposits (17), in the amount of \$8.5 million, were not made on the date those sales were closed, nor were they on the next business day. Our audit method revealed that the time lapse from the date of closing to the date the money was deposited, for those 17 accounts, averaged 13 days. During those time gaps, benefits to Colorado's public schools are affected. For example, these funds are not available for the purchase of replacement properties that would generate income for beneficiaries. Therefore interest, which would have been realized on those monies during the deposit time lapses, was not generated in escrow or in the PSPF.

The two-year escrow timeline begins once the Board deposits the sale proceeds with the State Treasurer's Office. Land Board staff report that when disposition funds become available to acquire replacement property, the escrow time line begins. We believe it is the Board's fiduciary responsibility to ensure that sale proceeds are available on the day of closing. The State Land Board should follow the directives of Amendment 16 and implementing legislation and deposit the escrow funds for all nonsimultaneous land exchanges on the date of closing.

Recommendation No. 2:

The State Board of Land Commissioners should take steps to ensure that exchange funds are available at closing and are credited to an escrow account upon receipt.

State Board of Land Commissioners Response:

Agree. Implemented. The Board has implemented a mandatory policy requiring all funds to be wired on the date of closing. October 1, 2000.

Land Exchange Procedures Inhibit Direct Benefits to Schools

The Land Board can extend the two-year escrow deadline for PSPF reversion by putting down earnest money on acquisition properties that have no set closing date. Our file review of nonsimultaneous land exchange transactions showed that 14 of 19

escrow accounts used in the land acquisition process exceeded the two-year deadline for reversion to the Permanent School Fund, as illustrated in the following chart:

Nonsimultaneous Land Acquisitions Using Escrow Funds					
Account	Original Sale Date	Escrow Ends	Replacement property Acquisition	Amount of Escrow Used	Forgone PSPF Interest
*WMPK	11/13/97	11/12/99	11/15/99	*\$480,865	\$144
*DLIN	11/10/97	11/09/99	11/15/99	*\$41,403	\$25
WMPK	11/13/97	11/12/99	12/28/99	\$1,093	\$5
DLIN	11/10/97	11/09/99	12/28/99	\$94	0
CHOT	12/08/97	12/07/99	12/28/99	\$4,044	\$8
KENS	12/19/97	12/18/99	12/28/99	\$1,844,346	\$1,844
REDC	01/15/98	01/14/00	**none	\$19,543	\$374
RTDX	01/20/98	01/19/00	**same	\$500,950	\$9367
DSRX	05/19/98	05/18/00	**same	\$4,508	\$29
DSRX	05/19/98	05/18/00	***same	\$661,986	\$4,302
MERV	06/29/98	06/28/00	***same	\$570,694	\$1,712
WFBB	06/30/98	06/29/00	***same	\$4,249,02	\$12,747
BRIG	07/07/98	07/06/00	***same	\$1,136,851	\$2,046
ARCH	07/09/98	07/08/00	***same	\$166,811	\$267
<p>Source: State Land Board Chief Financial Officer, July 2000. * Indicates acquisition failed and funds were reverted to PSPF. **Indicates deposit date of 1/11/00 for potential purchase. Purchase has not been completed. ***Indicates deposit date of 5/19/00 for potential purchase. Purchase has not been completed. Forgone PSPF interest was calculated by state auditors using a 6.8 percent annualized daily interest rate, as reported by the State Treasurer. While funds on escrow accrue interest, those funds are not available to generate interest in the PSPF for the annual distribution to public schools, as was intended by law.</p>					

With regard to land exchanges, we found that the Land Board does not consistently follow procedures to ensure compliance with statutory and constitutional directives. Because of the Board's practice, funds deposited after the sale is completed remain available for land acquisition beyond the two-year time period established by law.

Beginning in November 1999, trust beneficiaries did not directly benefit from potential interest that could have been realized on \$9.7 million in land disposals. The State

Land Board should have deposited these funds to PSPF at the end of the two year period, as required by law. Had the Board done so, nearly \$33,000 in additional PSPF interest would have been deposited to the School Income Fund for annual distribution to Colorado's public schools.

Recommendation No. 3:

The State Board of Land Commissioners should institute a procedure for:

- a. Identifying and informing the State Treasurer of escrow account time lines.
- b. Transferring nonsimultaneous escrow funds to PSPF upon the two-year anniversary of the original disposition or sale.

State Board of Land Commissioners Response:

Implemented. While the Board disagrees with the premise of the recommendation, it has implemented the recommendation. Specifically, upon verification by the State Treasurer's Office, the records indicate that there has been no lost interest on any of the applicable accounts regardless of the varying interpretations of the two-year timeframe. Interest has been credited the entire time any of these funds have been on deposit. There was no loss of \$33,000 to the beneficiaries; interest continued to accrue on earnest money deposits past the two-year deadline. The Board has informed the Treasurer's Office of the escrow account timelines as recommended in this audit, and will use the original transaction closing date as the trigger date for the two-year timeline. October 1, 2000.

During our review of the nonsimultaneous land exchange escrow accounts managed by the State Treasurer, we identified that 9 of 10 of those accounts that should have been reverted have carried an average daily balance beyond the two-year deadline. Treasury interest accruals are posted monthly based on the average daily balance computed by COFRS. When closing a nonsimultaneous land exchange escrow account, the Land Board is required to send a formal letter to the Treasurer's office, requesting specifically the amount of money to be reverted from the escrow account to the PSPF. We found that daily interest accruals are not posted to the escrow accounts when Land Board staff submit their letter.

Since Fiscal Year 1999, at least \$14,160 held in various nonsimultaneous land exchange escrow accounts was not reverted to the PSPF at the time the escrow account was closed to accrue interest for K-12 education. This is because Treasury

requires the Land Board to include in its letter the exact amount to be reverted to the PSPF, despite the fact that interest earned on that money may not be reflected in the account balance on the day the account is closed. The Land Board could work with the State Treasurer and refine this process so that all proceeds are reverted to the PSPF when a nonsimultaneous escrow account is closed.

Recommendation No. 4:

The State Board of Land Commissioners should work with the Department of Treasury to establish a method to ensure that all “closed” nonsimultaneous escrow accounts have a zero balance once a formal request has been made. The Board should further review all escrow accounts to ensure lagging interest accruals are reverted to the PSPF.

State Board of Land Commissioners Response:

Agree. The Board will work with the Treasurer to refine this process. However, as custodian of these accounts, the Treasurer clearly has the final authority on their management. Further, the Board has no administrative or electronic control over interest postings to these accounts. December 1, 2000.

Inter-trust Transfer Procedures Present an Inherent Conflict of Interest

The Land Board is in a fairly rare position for a trustee in that, by virtue of law, it is the exclusive trustee for eight separate trusts, each with a designated group of beneficiaries. Under Article IX, Section 10 of the Colorado constitution, the Board has duties of loyalty and impartiality with respect to each group of beneficiaries. The constitution dictates that the “*board shall be governed by...laws generally applicable to trustees.*”

While the Board has a policy that directs land exchanges, the policy does not include the transfer of assets between trusts. The Board reports that it does not consider the transfer of land and mineral assets among trusts as actual land exchanges because the Board maintains ownership of the transferred assets. However, the Land Board solicited an Attorney General’s opinion asking if they could engage in inter-trust transfers of assets. The December 1997 Attorney General’s response said that inter-trust transfers create a conflict of interest given the Board cannot favor one side of

the transfer over the other, and referred to inter-trust transfers as a form of land exchange. The opinion cited steps the Board should take to ensure that both trusts get the best deals possible, and that a transaction does not benefit one trust to the detriment of the other. The opinion said specifically that the Board should:

- Obtain an appraisal from an independent appraiser of the property.
- Give notice to the public of the exchange.
- Give an opportunity for public comment and alternative bids.
- Obtain an assessment of non-quantitative values.
- Obtain an income assessment, including the rate of return on asset value and potential long-term appreciation.

The Attorney General's opinion stated that if these procedures are followed, the Board should not be subject to attack on the grounds that it entered into a private transaction with another trust.

We found that the Board has recently engaged in the transfer of trust assets between the School Trust and two trusts that benefit State Parks. Specifically, over the past three years, the Internal Improvements and Saline Trusts used over \$6 million in nonsimultaneous escrow deposits that were generated from the sale of school lands to purchase properties adjacent to state parks. To repay School Trust beneficiaries and complete the \$6 million inter-trust transfer, surface and mineral assets have been moved from the Parks trusts to the School Trust.

Our review of the inter-trust transfer files and documents pertaining to these exchanges found that files did not contain documentation establishing that the Board had followed the process recommended by the State Attorney General's Office. In one case, during Fiscal Year 2000 nearly 233,000 mineral acres worth approximately \$1.2 million were transferred to the School Trust without an independent appraisal of the mineral assets. Specifically, the Board did not:

- Obtain an appraisal from an independent appraiser of the property (specifically on the transferred mineral estates).
- Obtain an income assessment, including the rate of return on asset value and potential long-term appreciation.
- Obtain an assessment of nonquantitative values.

The Board reported that it relies on appraisals by its own staff to determine the value of mineral estates when qualified independent appraisers are not available. However, we found that public disclosure is not required before the exchange when internal appraisals are used. Consequently, in such cases trust beneficiaries may not be aware that asset values were not established by an independent source. This presents a conflict of interest for the State Land Board.

We found that the Board has not established formal policies concerning the transfer of assets from one trust to another reflecting the Attorney General's recommendation. The Board's lack of specific inter-trust transfer policies and procedures fails to mitigate its inherent conflict of interest because the Board is unable to show that decisions were made independently for each trust and that specific transactions do not benefit one trust to the detriment of the other.

Recommendation No. 5:

The State Board of Land Commissioners should establish a formal policy specific to inter-trust transfers, including:

- a. An appraisal from an independent appraiser of the property or, if an independent appraisal was not used, an explanation of how value was assessed.
- b. Disclosure in the Board meeting agenda when an independent appraisal is not used in valuating trust assets.
- c. An income assessment, including the rate of return on asset value and potential long-term appreciation.
- d. An assessment of nonquantitative values.
- e. A transcript of Board considerations pertaining to the inter-trust transfer to be placed in the transaction file.

State Board of Land Commissioners Response:

Agree. Historically, the Board has attempted to follow the Attorney General's opinion regarding this process; and, therefore, has not established a formal policy of its own. There are really three issues at play in this recommendation. First is the adoption of the formal policy, which the Board will do at its December meeting. Second is the location of the records of these transactions. Given the various generations of records on file in the

Board's offices, the records for a single parcel of land may not always be in one file or location. That was the circumstance for the case raised in the audit. Most of the elements of the finding exist, but not in one central physical location; therefore, the auditor's office was not able to locate the complete record. The Board will continue to consolidate these records as time, space, technology and funds allow. Finally, the third issue was the appraisal process used in the particular case raised by the auditor. In the administrative hearing for the transaction, the Board made a finding regarding the mutual beneficiality of the inter-trust transfer after review of significant evidence at the hearing. The Board always uses an independent appraiser to help set the value of property in the inter-trust transfer process, with only one exception, which was the transfer of mineral acres from one trust to another. No expertise in mineral appraisals of this type was available external to the agency. So, the Board relied on expertise from various state agencies, and outside experts checked the work of the agency experts. Independent appraisals typically include an income assessment as well as a market valuation. Long-term appreciation of a property is always factored in to appraisals. January 1, 2001.

Local Governments Do Not Receive Payment in Lieu of Taxes

The Land Board engages in nonsimultaneous land exchanges to dispose of some trust assets and acquire others. In some cases this results in disposing of assets in one county and acquiring replacement property in another. In these cases the exchange process can change the status quo for both counties by creating tax revenue and property valuation winners and losers. For example, the Land Board's Fiscal Year 2000 work plan shows the Board has planned to purchase up to four commercial office buildings by June of 2000. At the time of this report, earnest monies have been paid and these sales are pending completion. Currently, if owned by the Land Board, these properties will not generate property tax revenues for cities, counties, or school districts.

A statute addressing this issue is found in language contained in C.R.S. 36-1-120.5. It states:

In addition to any other payments made by the lessee to the state, the lessee shall pay to all affected governmental entities an amount equal to the amount which would be owed for property taxes if the real property involved were privately owned. This amount shall be based on what the valuation for assessment of the underlying land would be

if it were privately owned. These payments in lieu of taxes shall be made at the same time and in the same manner as real property taxes. If a lease commences or ends at other than the beginning of the calendar year, the payment in lieu of taxes shall be prorated for the year involved.

According to the same statute, payment in lieu of taxes is required for “lands subject to development.” These lands, like the commercial properties currently owned or being purchased by the Land Board, are those determined to be “suitable for commercial, industrial or residential uses.”

Our review found that, to date, the Land Board has not implemented the requirements of C.R.S. 36-1-120.5 and has not required lessees to make payment in lieu of taxes. As a result, when a commercial property is purchased by the Land Board instead of a private entity, local governments in that county lose revenue because the Board does not pay taxes. To illustrate the resulting tax revenue loss, we examined an Office of State Planning and Budgeting (OSPB) analysis of mill levy and revenue streams relating to the Land Board’s purchase of a building. In this case forgone revenues would have totaled \$157,961, including 36.636 mills, or \$106,244 for the local school district. While schools maintain their revenues because revenues are made up by the State’s equalization of school funding, the reduction in mill levy reduces the school district’s bond issue debt capacity.

The OSPB’s analysis indicated that the aforementioned purchase would have cost other local governments 17.824 mills, or \$51,006 in tax revenue. The local governments that would have been affected by this particular Land Board purchase included:

Affected Entity	Forgone Mills	Forgone Revenue
El Paso County	5.989	\$17,363
El Paso County Road & Bridge	1.175	\$3,405
City of Colorado Springs	5.323	\$15,433
City of CS Road & Bridge	1.175	\$3,404
Pikes Peak Library	3.336	\$9,672
Southeast Water Conservation District	.0826	\$2,395
Source: OSPB Report February 11, 2000.		

In addition, since the Land Board is not required to pay taxes, they could lease their commercial properties for less than market price, thus, putting competing private property owners at a competitive disadvantage. This could also reduce local government tax revenue and increase the tax burden on other commercial property owners.

The Land Board could mitigate the effects of its land exchange policies on local governments and private sector property owners by requiring lessees to make payments in lieu of taxes to local governments, when applicable.

Recommendation No. 6:

The State Board of Land Commissioners should comply with requirements of C.R.S. 36-1-120.5 and, when applicable, include in leases and enforce provisions that require lessees to pay all affected government entities an amount equal to that which would be owed if the land were privately owned.

State Board of Land Commissioners Response:

Agree. The Board's commercial leases include such a provision, but it has not been enforced. Unfortunately, the county assessors are not sending a notice to the Board, because they assume that the property is tax exempt. Therefore, the Board will notify the counties of the properties in question, so that annual statements can be sent to the Board. The Board will then forward the statements to the lessees for payment. December 31, 2001.

The Land Board Does Not Report on Trust Holdings as Required

Beginning in Fiscal Year 1997, the Land Board scaled down its annual report to a format that contains information about how the Board has progressed in implementing changes from Amendment 16. However, since 1996, the Board has not included the statistical information about trust asset holdings, as required by law. The Land Board does not publish a report identifying aggregate land assets belonging to the eight trusts, to whom land is sold, or the amount of land leased, nor have they reported a summary of transactions. Colorado Revised Statutes, 36-1-102(4) specifically states that:

The Board shall publish each year, subject to the approval and control of the executive director of the department of natural resources, a summary of the transactions of the state board of land commissioners, and the land affairs of the state, showing, by tables, the land belonging to the several funds of the state, to whom sold, the amount leased, and the receipts from all sources, and such summary shall contain any such other items or information concerning state lands as the state board of land commissioners or the executive director of the department of natural resources may deem worthy of publication.

We analyzed trust estate holdings for each of the trusts from 1989 to date. While there was no report prepared in Fiscal Year 1995 and the reports for 1997, 1998, and 1999 do not contain required information, the Board's staff were able to establish current surface and mineral holdings for each trust.

Amendment 16 imposed significant changes in the way the Land Board manages trust assets, including engaging in inter-trust transfer of land assets, land dispositions, and acquisitions. Therefore, this information could be a material component of Land Board public information. The Land Board should comply with statutory reporting requirements or recommend statutory changes to the General Assembly.

Recommendation No. 7:

The State Board of Land Commissioners should work with the Executive Director of the Department of Natural Resources to comply with statutory reporting requirements or recommend statutory changes to the General Assembly.

State Board of Land Commissioners Response:

Agree. The Land Board already annually prepares several reports with all of this information detailed. These reports are presented to the Board by staff at a monthly public meeting. Additionally, the Board publishes a summary annual report for the General Assembly and the public. In the future, the Board will publish two consolidated annual reports: an "overview" for the general public and a more specific and detailed report for the Executive Director and the legislature, which contains the information suggested. First report in the new format will be completed by June 30, 2001.

Asset Management

Chapter 2

Background

Constitutional changes ensured that the productivity of some trust assets would forever be protected. Amendment 16 directed the Land Board to create the Stewardship Trust consisting of 300,000 acres, or 10 percent, of all surface lands. Trust land placed into the Stewardship Trust must be valuable “primarily to preserve long-term benefits and returns to the state.” Once enlisted, land can be removed only by a vote of four out of five Board members.

Those lands designated to the Stewardship Trust continue to generate revenue from grazing, crop production, oil and gas production, and mining, as long as uses are compatible with conservation of natural resource values. The Board has the duty to ensure that sound stewardship of the natural values of lands placed into the Trust will provide long-term economic benefits to trust beneficiaries. In addition to ensuring exemplary management of Stewardship Trust lands, the constitution directs the Land Board to offer sound stewardship incentives in agricultural leases. In light of that goal, the Land Board has taken a position that resource appreciation is equally as important as income for all of the trust lands it administers.

The Land Board’s fiduciary responsibility to produce reasonable and consistent income over time recognizes that it is prudent for the Board to develop a strategic outlook for managing trust assets. Constitutional and statutory language establish the framework for the Board to provide some level of certainty to trust beneficiaries that they will receive a reliable level of income into the future. Land Board staff report that, at times, these intergenerational goals require the agency to forgo immediate short-term income opportunities if they potentially compromise future income streams and enhanced future value. We reviewed Land Board practices in terms of how they manage land inventories for trust estates as well as how current and future values of land and mineral assets are determined.

State Land Board Has No Method for Independently Determining Statewide Asset Appreciation

The Land Board has concluded that the most important goal for a perpetual intergenerational trust is to produce reasonable and consistent income over time, and that appreciation of assets is as important as income. Consequently, a process to verify the baseline value of Land Board assets and their appreciation over time, on a statewide and individual basis, is a key component of land disposal and acquisition policies.

The Asset Management System (AMS) is considered to be the “financial companion” to the Lease Management System. State Land Board staff report that it provides key information for land management decisions and allows the Board to manage its assets more efficiently. From the information provided by AMS, the Board is able to determine what type of asset mix or portfolio balance might be appropriate for a given trust and establish portfolio goals.

The Land Board’s strategic plan identifies the Asset Management System (AMS) as the primary tool for disposal, acquisition, and retention of trust lands. Once fully functional, the system is expected to include and provide the following information on all state trust lands:

- Current market value
- Appreciation rate
- Annual income
- Rate of return
- Mineral activity
- Recreational potential

The AMS contains baseline information on land assets gathered by Land Board staff over a one-year “Rapid Assessment” period. The Land Board has no method to independently establish baseline land valuations of its holdings on a statewide basis nor to independently measure the appreciation of its holdings over time. As a result, the information currently contained in AMS is unreliable.

Our audit noted a model used by Colorado’s legislative council to independently determine the accuracy of land assessments statewide. Specifically directed by C.R.S. 39-1-104 (16)(a), legislative council is to:

...contract with a private person for a valuation for assessment study to be conducted as set forth in this subsection (16). The study shall be conducted in all counties of the state to determine whether or not the assessor of each county has, in fact, used all manuals, formulas, and other directives required by law to arrive at the valuation for assessment of each and every class of real and personal property in the county. The person conducting the study shall sample each class of property in a statistically valid manner, and the aggregate of such sampling shall equal at least one percent of all properties in each county of the state. The sampling shall show that the various areas, ages of buildings, economic conditions, and uses of properties have been sampled. Such study shall be completed, and a final report of the findings and conclusions thereof shall be submitted to the general assembly and the state board of equalization by September 15 of the year in which the study is conducted.

The legislative council issues a Request for Proposal (RFP) for this study every two years. The study is performed annually, with a workload that is heavier the first year and lighter the next year. Meetings between the current vendor, legislative council staff, and the Land Board staff indicated that:

- The Land Board could use this RFP process as a model for procuring qualified vendors to independently establish and verify the appreciation of its assets.
- Coordinating the timing of both RFPs could yield economies of scale.

The Land Board could coordinate with the timing of legislative council's RFP to cost-effectively procure qualified vendors for its specific needs.

Recommendation No. 8:

The State Board of Land Commissioners should independently establish and verify the value and appreciation of its trust assets by:

- a. Using the legislative council's annual statewide property assessment RFP/process as a guideline for procuring qualified vendors to provide cost-effective and independent baseline and ongoing statewide valuations.
- b. Cooperating with legislative council to coordinate with the timing of their RFP process in order to maximize economies of scale.

State Board of Land Commissioners Response:

Agree. The Land Board has been engaged in the process of developing an asset management plan for the last two years. The Board is currently at the stage where it will require a periodic baseline evaluation of state trust lands. The process identified by the auditor will be useful to that end. Since the process is new, it may take some time to fully implement the recommendation. The goal, however, is to issue the first RFP by December 31, 2001.

Accurate and Timely Information Is Necessary to Make Leasing Decisions

Since resource appreciation is regarded by the Land Board as being equally as important as income, the Board's challenge has been to establish ways to determine appreciation rates for individual parcels as well as for trust asset portfolios. The Land Board employs a computerized database and a physical filing system to provide information on trust land assets.

The computerized Surface Lease Information Management System (SLIMS) provides information on active agricultural and surface leases. We found that the lease management system does not house or provide adequate, accurate, or timely information on current or past leases. Specifically, the system does not:

- Flag lease expirations individually, by region or statewide.
- Generate meaningful management reports.
- Provide updates and information on delinquent payments.
- Generate accurate billings.
- Provide or combine information on a regional or statewide basis.

The Land Board reports that they have current and complete records of all trust lands and access to those lands for public purposes. Our review of the Board's agricultural lease files found that:

- The physical filing system is set up by lease number rather than by legal description. Without a specific lease number, it can be difficult to find information on a particular parcel.
- Lease histories are not accessible. Once a lease is entered into or an expired lease is renewed, the computer assigns a new lease number. Prior lease history on that parcel is not contained under the new lease number.

In one sample case, an agricultural lease had been canceled by the lessee because there were significant fencing, water, and weed problems allegedly not disclosed by the Board at the time the lease was entered into. Consequently, the Board refunded to the lessee \$6,000, which included a 100 percent refund of rent paid to the Land Board along with the cost of physical improvements made by the lessee. We found that the District Manager responsible for leasing this property did not have critical information concerning the lease limitations put on the parcel.

During Fiscal Year 1999, the Land Board purchased a lease management software system from Utah's Land Board for approximately \$100,000. Once functional, the Utah system could replace the Board's antiquated lease management system. Without it, the Board does not have sufficient information to ensure that all leases are current. Accurate and timely information is necessary for the Board to fulfill its duties as land managers.

Recommendation No. 9:

The State Board of Land Commissioners should ensure that accurate and timely information is available for all leases by:

- a. Determining a time line for the implementation and integration of the lease management software.
- b. Including pertinent information on all trust lands, specifically: current use(s) and lease terms, lease history, character and land improvements, (including those made over time), appreciation forecasting, actual appreciation, and assessment information, and designated trust beneficiary of land asset.

State Board of Land Commissioners Response:

Agree. The Land Board is in the process of revamping and rebuilding an antiquated computer system which will, once completed, provide accurate and timely information on trust lands. The Board already has a timeline for the implementation of the lease management software. The project and timeline have been approved by the Governor and the Legislature through the budget process, have been approved by the Information Management Commission and is now being implemented by Board staff, Department of Natural Resources information technology professional staff and private contractors. December 31, 2001.

Unleased Lands Should Be Reviewed

Some lands with a history of agricultural use are currently unleased and are on the Land Board's "vacant land list." Land assets not currently under lease for agricultural purposes usually generate revenue from other uses, including rights-of-way, recreational, or mineral leases. The Board reports that each District Manager is responsible, on a yearly basis, for seeking land use changes and new leaseholders, or for facilitating the auction process for all lands which do not generate income from agricultural use.

We reviewed a sample of files from the list of 30 unleased lands provided to us by Board staff. These lands comprise over 9,000 acres of surface land. We were able to locate 8 of the 30 files in the Land Board's physical filing system. During our review we found that:

- Two of the lands had been leased for minimum rent (\$250).
- Four of the unleased lands were assessed at good or excellent range condition.
- One file indicated that the property was "one of the best irrigated farms the State owns."
- Three leases, expiring in 1998 and 1999, did not become part of the auctioning process. In these three cases the lessees claimed that they did not receive renewal or delinquency notices. In two cases the lessees continued to graze on the land for a year beyond their leases' expiration. The Board reports that it will try to recover delinquent income from those lessees.
- None of the files reviewed had indication that a site inspection was completed by Land Board staff prior to or after cancellation or expiration of the lease.

We discussed our file review findings with Land Board staff and found that the majority of unleased lands continue to have potential for agricultural use, which would generate revenue for trust beneficiaries.

We expanded our file review to include all canceled leases from 1996 to date. It showed an additional four "vacant" agricultural leases that were not included on the Board's unleased land list.

Our audit work revealed that the record keeping and oversight system established by the Land Board is not adequate to identify lands that are not producing revenue from agricultural use. As a result, School Trust beneficiaries bore at least \$30,000 in

forgone lease revenues through Fiscal Year 2000 from unleased lands. These lands have a history of generating revenue, but remain vacant. The total amount of forgone lease revenue from unleased lands is unknown because the actual number of unleased parcels is unknown. The Land Board could increase income to trust beneficiaries by reviewing its files and identifying the potential for all unleased land.

Recommendation No. 10:

The State Board of Land Commissioners should review its files to identify all unleased land assets and prioritize them for:

- a. Land use change
- b. Auction
- c. Disposition

State Board of Land Commissioners Response:

Agree. The computer redesign project will allow this review to occur. This project will be complete and operational by the end of calendar year 2001. Additionally, the fact that land is unleased for agricultural purposes does not mean that land is not generating money for the beneficiaries. On the contrary, lands generate income from a variety of other activities including: oil, gas and mineral leasing, rights-of-way, open space and recreation leases, etc. Finally, the district managers will be annually evaluated on their performance with respect to disposition of unleased lands. December 31, 2001.

Stewardship on State Trust Lands Should Be Measured

To further goals for trust asset appreciation, Land Board staff are in the midst of developing a voluntary stewardship incentive rider. This rider could be added to existing and future grazing and agricultural leases. The Stewardship Incentives Program is the Land Board's response to the guidelines established in Article IX, Section 10 of the Colorado constitution. Specifically, the law directs the Land Board to:

...include in agricultural lease terms, incentives and lease rates that will promote sound stewardship and land management practices, long-term agricultural productivity and community stability.

Recognizing the lessee's role as primary manager of state trust land, Land Board staff developed a program that gives lessees the option to participate at whatever level makes sense for their operation. The Board expects that all state trust land lessees take steps to ensure sound stewardship of the land, with or without a rider. Participation in a Stewardship Lease will be entirely voluntary. The Land Board has adopted the following overarching goal for the incentives program:

Encourage and maintain sound stewardship on all state trust land held within the agricultural portfolio, thereby creating an appreciating asset for present and future generation of trust beneficiaries.

The constitution does not provide a definition of "sound stewardship." For the Land Board to effectively enable and maintain sound stewardship on state trust land, it must first determine what sound stewardship is, identify where sound stewardship efforts are occurring, and identify where these practices could prove beneficial in the future. Board staff will make these identifications on a parcel-by-parcel basis in order to take into account rangeland variables such as soil type, rainfall, and weeds.

The backbone of the Stewardship Lease program is the incentives, such as, longer lease terms, increases in the number of animals allowed to graze on the property without additional rent fees, protection against competitive bidding, and first consideration for financial assistance for improvement and weed management projects.

While the Land Board's objective is to enable all lessees of state trust lands to incorporate sound stewardship practices into their leases, we found that the proposed Stewardship Incentives Program requires that certain conditions be met before a Stewardship Lease will be issued. These include requirements that:

- Lessee is in good standing and current on all rental payments and fees.
- Lessee has an acceptable prior relationship with the Board.
- Land is in average or better than average condition.
- Resource Management Plan including Stewardship Lease Strategy is developed by lessee.

A property that is in less than average condition may be considered for a Stewardship Lease if the lessee and Land Board field manager agree to a strategy that brings the property to at least average condition within five years.

The Stewardship Incentives Program increases the complexity of the existing standard lease in terms of its objectives, land monitoring and follow-up requirements. As we have discussed previously, the Land Board's lease management system is unable to provide necessary information about the Board's leases.

It is important for the Land Board to develop methods to integrate the requirements of the Stewardship Incentives Program into its lease management system in order to measure the effects of the program and accurately ensure that incentives and concessions made to lessees are consistent with the projected benefits. To the extent that these incentives result in less revenue to the State, offsetting benefits in the form of greater land asset appreciation need to be documented.

Recommendation No. 11:

The State Board of Land Commissioners should develop and implement methods to assess the costs and benefits of the Stewardship Incentives Program to ensure it accomplishes short-and long-term goals at acceptable costs.

State Board of Land Commissioners Response:

Agree. Like the auditor, the Board also questions whether it will have the resources and methodology to adequately manage and evaluate this program; however, it is a constitutional mandate. Ideally, the Board would like to be able to track the increase in stewardship which may result in an increase in the value of the land to the beneficiaries. The Board has requested resources through the budget process to support this program, but has not yet received them. In light of these circumstances and budget constraints, the Board will attempt to incorporate some of this analytical capability in the procedures being established for the program. A thorough cost-benefit analysis on each parcel may be cost-prohibitive. December 31, 2001.

Field Operations and Staff Accountability

Chapter 3

Background

The Land Board was appropriated \$1.4 million and 15 FTE for its Field Operations Program in Fiscal Year 2000. Field staff work with leaseholders on day-to-day land management issues as well as on longer-term initiatives to ensure that natural resources on trust lands are conserved. In addition to performing property inspections and recommending appropriate land disposal and acquisitions, District Managers are responsible for activities that include the development of agricultural policies and procedures; communications with lessees and local, state, and federal agencies concerning state land issues; and troubleshooting and resolving problems and conflicts involving trust land management. District Managers are required to conduct site inspections and determine the appropriate site-specific carrying capacity for each grazing and agricultural lease in their regions. Lease rates for agricultural lands are based on the productive capacity of the land, or crop yield.

Grazing lease rates are initially based on the carrying capacity of individual parcels as determined by a District Manager's inspection. Carrying capacity is based on Animal Unit Months (AUMs), which is converted into a per acre market charge. The market charge or rate is then discounted because the management burden on public land is generally believed to be higher than on private lands. Prior to 1993 the reduction was an across-the-board 50 percent discount for all lessees.

The Land Board commissioned a survey of private grazing lease rates in 1995. The survey, conducted by the Colorado Agricultural Statistics Service (CASS), demonstrated that State Land Board rates were significantly below private rates. The Land Board subsequently raised grazing rates. Every three years CASS continues to conduct a grazing lease rate survey from which the Board subsequently updates lease rates by region.

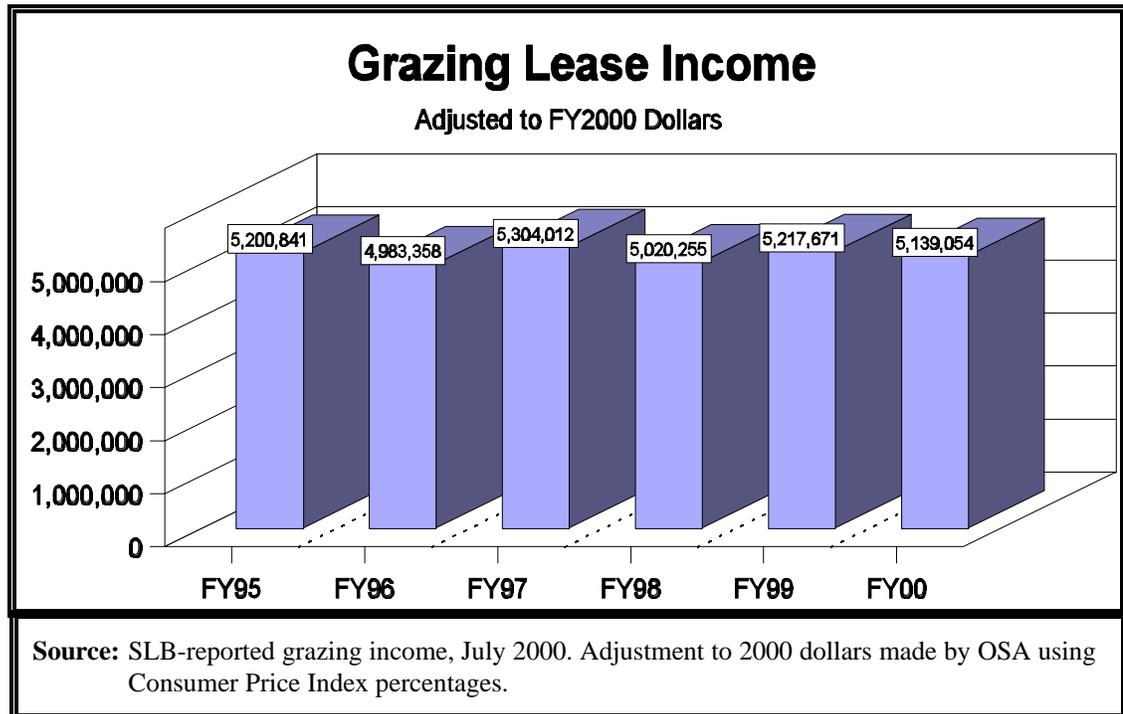
Lease Rate Reductions Can Lessen School Trust Income and Affect Equity Among Lessees

The grazing fees were increased and the 50 percent discount was reduced to 35 percent in Fiscal Year 1996. Grazing fees were reduced because the overall costs (management burden) for fence, water development, other improvements, and maintenance incurred by lessees of public grazing lands are greater than the management burden incurred by lessees of private grazing lands. Colorado State University conducted a study in 1991 of the Federal Bureau of Land Management (BLM) practices in Colorado. The study found the management burden for lessees of BLM grazing lands was about 35 percent greater than for private lands. The components that made up the greater public land management burden included:

- The expenses associated with moving to and from the leased land.
- The cost of traveling to and from the leased land.
- Water costs.
- Horse costs.
- Depreciation of development (fencing and water).
- The value of lost animals.
- Maintenance.

It should be noted that the CSU study reviewed Bureau of Land Management (BLM) lands, not on state trust lands.

While grazing rates were increased and lessees' reduction was decreased to 35 percent in Fiscal Year 1996, trust beneficiaries experienced little increase in revenue streams, as shown by the following table:



The 35 percent reduction equates to about \$2.5 million per year based on lease income of \$5.1 million annually. An across-the-board 35 percent reduction also can create inequities among neighboring lessees who may have varying amounts of management burden, but get the same reduction. Consequently, across-the-board reductions may not be justified. In some cases the lease reduction should be less than 35 percent, and in other cases it should be greater than 35 percent.

We selected a sample of 22 agricultural lease files and reviewed them for indicators of lessee management burden, as per the CSU reported components. We found that:

- The Land Board has no system in place to measure lessee management costs or to determine appropriate discounts to individual lessees.
- Required site inspections were either not performed or not completed in 68 percent of the agricultural lease files we reviewed (our audit method included the review of 31 files for site inspection documentation. This information was not completed or not documented in 21 of 31 cases). As a result, we and Board staff were not able to determine how much the management burden varied from parcel-to-parcel.

- The majority of lessees either owned or rented property adjacent to state trust land. This means that transportation to and from the state trust land would not be among the extra costs incurred by state trust land lessees.

We surveyed 18 states' leasehold improvement policies and found that offering "blanket" lease rate reductions from fair market value for land improvements is not a common practice among state land managers. In fact, Colorado is the only state we found that offers an across the board reduction on all grazing leases. For example, North Dakota's Board of University and School Lands manages grazing leases for trust beneficiaries. The state charges 100 percent of land value for all lessees as determined by the North Dakota Agricultural Statistics Service. Those land valuations include the value of fencing and water improvements, regardless of whether those improvements currently exist on the land. If there is excessive costs associated with putting necessary improvement on the land, those reductions from established lease rates are made on a case-by-case basis. The North Dakota Land Board will cost-share up to 25 percent of the total cost of agreed-upon improvements. The remaining 75 percent of the lessee's total cost for the improvement is depreciated over a 10 year time period, until the improvement is valueless.

Lease reductions from market prices given by the State should be correlated to the amount of actual lessee management burden required by the lessee. The Land Board could establish evaluation criteria, and identify a process by which lessee management burden is measured and evaluated in order to verify the appropriateness of the percent reduction.

Recommendation No. 12:

The State Board of Land Commissioners should take steps to ensure that:

- a. Criteria are established for determining a lessee's cost of managing state trust land.
- b. A procedure for making cost assessments and evaluations is established and enforced.
- c. All rate reductions from fair market value are made on a lease-by-lease basis.

State Board of Land Commissioners Response:

Partially agree. Ideally, agricultural lease rate offsets should reflect the particular characteristics of that parcel. Practically, the Board does not have

the staff resources to eliminate the 35% rate reduction and customize rate structures for each of the 3000 parcels it manages. Additionally, while the suggested method might increase equity, there is no evidence to suggest it may increase revenue, nor is the cost of implementing such a regime known. Additionally, North Dakota is not an appropriate comparison as they have only 700,000 acres, not the 2,800,000 acres managed by the Board. As an alternative, the Board has been working with the Colorado Agricultural Statistics Service and the Colorado Cattlemen's Association to develop a new methodology for setting grazing lease rates. December 31, 2001.

Prorated Reductions of the Cost of Improvements Should Be Uniformly Applied

Improvements made to state trust lands by lessees must be authorized by the Land Board. In most cases, land improvements are the property of the lessee and, upon termination of the lease, can be removed by the lessee as long as removal does not damage the trust land. More commonly, land improvements, such as fencing and livestock wells, are transferred by the lessee to the succeeding leaseholder at a price they agree on. The Land Board has the authority to establish the value of leasehold improvements, as set forth in Section 36-1-119 C.R.S. The Board intends to use its authority to prorate the cost of improvements made by lessees participating in the Stewardship Incentives Program, as follows:

Capital improvements will not be reimbursable to the lessee to the extent that they are funded through State Land Board participation. The value of reimbursable improvements constructed with a lessee cost share will be prorated over the normal expected life of the improvement. The expected life of an improvement will be agreed to by the lessee and the State Land Board prior to construction of new improvements, or at the time of approval of a Stewardship Lease application based in part on existing improvements. At the end of that prorated period the improvement shall be property of the State Land Board.

The states of North Dakota, New Mexico and Idaho depreciate and prorate the cost of all permanent land improvements made at the lessees expense. For example, North Dakota deems permanent improvements on trust lands to be the property of the state. Seventy-five percent of the cost paid by the lessee for the improvement is depreciated over ten years, based on a uniform schedule developed by the North Dakota Land Board. The lessee can then be paid for any remaining undepreciated costs by the subsequent lessee or purchaser upon termination of the lease.

We found that Colorado's Land Board has not developed uniform guidelines for establishing the current and future values of leasehold improvements.

Recommendation No. 13:

The State Board of Land Commissioners should:

- a. Develop and uniformly apply a depreciation schedule for prorating the normal expected life of leasehold improvements on state trust lands.
- b. Use the Stewardship Incentives Program as a pilot to develop the necessary systems, policies and procedures.
- c. Determine a time frame for applying this method to leasehold improvements made on state trust lands.

State Board of Land Commissioners Response:

Agree. The Stewardship Incentives Program is the Board's first step in this direction. The Board plans to develop a more comprehensive approach to improvement depreciation over the next several years. As mentioned, the Stewardship Incentive Program will be implemented during FY2002. December 31, 2001.

Leased Properties Are Not Regularly Inspected

The Land Board has historically required inspection of each leased property a minimum of one time during a 10-year lease term. A March 1999 memo directed District Managers to step up land inspections. Specifically, each parcel within a region is required to be inspected upon or prior to any of the following events: receipt of a renewal application, at mid-term or at least once every five years, prior to lease cancellation, and upon receipt of an assignment application. Complete and appropriate documentation of the site visit and observations is required to follow the District Manager's inspection within two weeks.

Our review of 31 lease files included lease data compiled since Fiscal Year 1996. We found that 68 percent of lease files (21 files) had either no site inspection or incomplete inspection documentation. Specifically, we found:

- One file had a signed-for-completion inspection form with a note attached from the District Manager acknowledging that no inspection had actually been completed on the property.
- Two lease files were cancellations. No inspection was made prior to or after the leases were canceled.
- Required mid-term inspection reports were not found in any file examined nor did we find any indication a mid-term site visit was made.
- There was no documented indication of trespass, access problems, or other “high management cost” issues.
- The majority of files reviewed had incomplete inspection reports with little or no range condition information provided on the inspection checklist.

We concluded that the Land Board’s monitoring practices do not sufficiently address the Board’s land management goals. Like Board staff, we were unable to analyze range conditions and management burden based on the information available in the sample of lease files we reviewed. We found some site-specific information detailed by the lessee on the leaseholder’s Report of Improvements, as well as on the lease application and Renewal Agenda.

Benchmarks for site inspections and monitoring plans are found in federal, state, and private practices. To coincide with the required Resource Management Plan for federal lands, the BLM reports that “monitoring to determine the success of management actions and towards meeting resource objectives is presently an integral part of BLM’s analysis, interpretation and evaluation process. Monitoring of standards is...considered an integral part of the process to determine compliance with standards or to measure progress towards achieving land health.”

The Land Trust Alliance suggests that a trustee must know the property it protects so it can plan for wise stewardship. A trustee “marks its boundaries and regularly monitors the property, at least annually, for potential management problems...and takes action to rectify such problems.” We found that other states generally require more frequent site inspections on trust lands than Colorado’s Land Board requires. For example, the Oklahoma Land Office reported that it requires Land Management Technicians to generally visit each property twice each year to check on the condition of the land and to review what types of management practices need to be implemented.

Because sound stewardship and lease management practices are not routinely inspected on state trust lands, range conditions and overall appreciation on some trust

lands is unknown. Our analysis of lease files found cases where problem leases go unnoticed and where the Land Board is experiencing no pay or slow pay from lessees. Sound stewardship and lease management practices should be ensured with more frequent and comprehensive site inspections. Further, the information ascertained during the inspection would be part of the data necessary to make lease-by-lease assessments for grazing rate reductions, as recommended on page 50 of this report.

Recommendation No. 14:

The State Board of Land Commissioners should ensure that the March 1999 lease inspection schedule is being followed and it sufficiently addresses the Board's land management goals, including specific guidelines and indicators.

State Board of Land Commissioners Response:

Agree. Each year the district managers develop a plan to manage the land use and disposition changes within their district. Their supervisor reviews and revises that plan, then monitors their progress towards the goals contained therein through the year. At the end of the year, the managers are evaluated and disciplinary actions are taken when warranted. Also, while some properties are inspected infrequently, many others are monitored on a yearly or even monthly basis. This is because each property is unique and requires individualized attention depending upon the circumstances. Finally, Oklahoma has 93 employees who cover less than 900,000 acres, compared to Colorado's 33 employees for 2.8 million acres. The current monitoring schedule became effective March, 1999; therefore, it is inappropriate to judge lease data compiled prior to that date. However, compliance with this policy will be included in the May 2001 evaluation and planning period for district managers. June 30, 2001.

Resource Management Requires Standards and Planning

During our review of the Board's Lease Management and Asset Management systems, and lease files, we determined that the Land Board needs to find alternative ways to assess whether land assets are appreciating and if lease rates are appropriate given the potential productivity of the land. Best practices in land trust management suggest that a land management plan is necessary to identify, meet, and achieve trust goals.

For example, in 1997 the Federal Bureau of Land Management (BLM) established standards for healthy public lands in Colorado. Formal “Standards and Guidelines” have been set forth to measure, control, and meet BLM objectives. “Standards” directly relate to the health and productivity of the land while “Guidelines” are specific to livestock grazing. Both provide a common understanding of the minimum resource conditions and management practices expected and help focus discussion on where land health problems exist. The BLM reports that implementing and following Standards and Guidelines allow range personnel to follow assessment steps, prioritize site visits, and prepare required Resource Management Plans that relate to federal leasing strategies. It is important to note that each BLM field manager in Colorado oversees approximately 60 percent fewer acres of trust land than State Land Board District Managers. Each Land Board District Manager oversees on average about 470 leases on about 425,000 acres of state trust land.

Considering the BLM benchmark, we reviewed the Land Board’s policies and practices to determine how land health and asset appreciation goals are met. We found that similar to BLM requirements, Land Board District Managers are required, as part of their job description, to develop a management plan that addresses the concerns of all users in each district: agriculture, recreation, silvaculture (those pertaining to forest trees), mineral extraction, and conservation. According to the Land Board’s requirements, District Managers are to “determine the asset value of the land, what factors limit or enhance value, and how to use opportunities to increase portfolio asset value through land improvements, appropriate usage and repositioning.” However, the Land Board has not:

- Established criteria and guidelines for assessing land condition.
- Consistently enforced its requirement that District Managers produce a district management plan with any regularity.

As a result, the Land Board is not able to measure progress toward achieving land management goals. For example, during our file review, we identified one lease where the property had been recently damaged by wildfires. The file did not include a management plan to bring this parcel to a healthy condition. Our file review further determined that there are no appreciation goals or criteria established by which District Managers can evaluate trust assets for the purpose of developing a district management plan.

A district management plan, based on documented criteria, would provide the Land Board with essential information necessary to make management decisions for the trust beneficiaries and establish asset appreciation goals for state trust lands.

Recommendation No. 15:

The State Board of Land Commissioners should fulfill its oversight responsibility, and:

- a. Establish a format for a district management plan.
- b. Establish criteria for asset assessment based on land management benchmarks.
- c. Determine the frequency for submitting a plan to Land Board management.

State Board of Land Commissioners Response:

Agree. The Board believes that a district management plan should be a part of the performance planning process for each district manager. To that end, each district manager's yearly plan currently includes district and property specific goals. To comply with these recommendations, the Board will make district and property management plans more of a central feature of the annual performance plan in the future. Also, as noted by the auditor in the narrative and by the Board in the response to Recommendation 14, the standard that the auditor is proposing for the Board is set by the BLM, which has a per acre management cost over 10 times higher than the Board's. It is important to note that the BLM in Colorado receives \$7.58 per acre to oversee, manage and inspect its acreage. The Board receives \$0.73 per acre to oversee, manage and inspect its acres. The Board believes that these goals are necessary and important objectives, and will attempt to accomplish them within the resources provided. This will be included in the next evaluation and planning period for district managers in May 2001. June 30, 2001

Disposition of 1994 Performance Audit Recommendations

Several Recommendations Made in the 1994 Performance Audit Have Not Been Fully Implemented

Our current audit included procedures to determine implementation status of recommendations made in our August 1994 performance audit of Public Land Management in Colorado. This report contained six recommendations that addressed the State Board of Land Commissioners' fiduciary practices, management and procedures relating to state lands, and other issues. The Land Board generally agreed or partially agreed to implement most of the recommendations.

The State Board of Land Commissioners, after the passage of Amendment 16 in 1996, was recreated to be a five-person voluntary board that meets on a monthly basis. In late 1997 the Land Board hired a new director and in mid-1998 created a strategic plan that mirrored many of the recommendations of the 1994 Audit report. However, we found that the majority of the 1994 audit recommendations still need to be fully addressed by the Land Board.

The State Board of Land Commissioners should identify what actions need to be taken to fully implement these recommendations and then develop an action plan to ensure they are dealt with as soon as possible. This action plan should include a method of holding district managers and Land Board staff accountable for completing the tasks needed to address individual recommendations.

Recommendation No. 16:

The State Board of Land Commissioners should review all recommendations that have not been completely implemented from the 1994 State Auditor's performance audit report and develop an action plan to ensure their timely implementation.

State Board of Land Commissioners Response:

Agree. The Board's annual work plan will reflect the progress it intends to make on both the 1994 audit and the 2000 audit. January 31, 2001.

Overview

Our 1994 audit of Public Lands Management included recommendations to the State Department of Administration, Division of Wildlife, the Department of Natural Resources, the State Board of Land Commissioners, the University of Colorado, Colorado State University, and the Department of Transportation. The recommendations made specifically to the State Board of Land Commissioners, the Land Board's 1994 responses, and our current assessment of the status of the Land Board's implementation efforts are shown below.

1994 Recommendation No. 2

The University of Colorado, Colorado State University, the State Board of Land Commissioners, and the Division of Wildlife should ensure they have processes to plan for, manage, and evaluate their land assets by:

- a. Establishing specific mission-related performance criteria for their land assets.
- b. Conducting periodic evaluations of these assets to determine if they are performing adequately, should be considered for sale, or should be held for an identified future need.
- c. Regularly updating their goals, objectives, and criteria for evaluating these assets.

1994 State Board of Land Commissioner's Response:

Agree. As a part of the Land Board's latest 5-year plan, strategies have been developed for generally increasing yields from the portfolio of land assets. The strategies include exchanging out of parcels surrounded by Bureau of Land Management and U.S. Forest Service lands, sale or exchange of uneconomic parcels (especially those which lack access or return less than \$250 annually), sale of market-ready parcels, and a shift to increased holdings of urban and commercial properties with proper regard to risk and reward.

Further, the Land Board is currently working to formalize its analysis process to evaluate the performance of specific properties. The evaluation will consist of analyzing factors such as rate of return on the asset value, long-term appreciation potential, and an assessment of potential unusual or extraordinary management time and cost associated with the specific asset as well as an assessment

of the potential risk and reward related to the particular property. Some properties also will merit an overall assessment of environmental, educational and community or social considerations and benefits.

The Board will phase in a process beginning with lease reviews in calendar year 1995 – the review of the 3,000 properties will occur over a 10-year period as leases come up for review.

2000 Office of the State Auditor Disposition:

Partially implemented. In Fiscal Year 1999 the Land Board instituted a practice of inspecting surface lands at midterm and prior to cancellation or renewal of a lease. Historically, site visits have been conducted by District Managers to assess the condition of a property one time every 10 years at the end of the lease term. District Managers do not use specific, performance-related criteria to evaluate land assets, nor are goals, objectives, and criteria for evaluating these assets regularly updated.

Land evaluation in terms of asset value, appreciation potential, and cost assessment began during Fiscal Year 2000 to compile baseline information for the proposed Asset Management System. In Fiscal Years 1999 and 2000, nearly 800,000 acres have been evaluated in terms of environmental, educational, and social benefits upon their nomination for the perpetual Stewardship Trust created under Amendment 16.

1994 Recommendation No. 12:

The State Board of Land Commissioners should improve its management of unproductive land by:

- a. Establishing a cost-effective process to determine current costs of managing individual land parcels.
- b. Adopting a policy with specific criteria for determining whether to retain or sell land whose management costs exceed revenue.
- c. Developing a system to identify individual unproductive parcels which cost more to manage than the revenue they generate.
- d. Implementing a program to evaluate individual land parcels regularly to assess if they are performing as a sound investment, or if they should be considered for sale, or held for an identified future state need.

1994 State Board of Land Commissioners Response:

Partially agree. The State Land Board partially agrees with the recommendation with specific exceptions.

- a. Establishing a cost-effective process to determine current costs of managing individual land parcels.

The Land Board disagrees with this portion of the recommendation because it believes that tracking exact costs of management for 3 million acres in nearly 3,000 different parcels would not be feasible or cost-effective. A simple average cost per acre, while easily available, is not a true reflection of the actual cost of management of an individual parcel and, therefore, is not helpful in decisions on retention or sale of lands. The Land Board believes the criteria listed in the response to Recommendation No. 2 might best resolve this issue with inclusion of a generalized assessment of recent or potential unusual or extraordinary management costs.

On average in 1993-94, it costs the State Land Board \$0.69 per acre for management with an average return of \$7.33 per acre including the additional nearly one million acres of minerals only ownership.

- b. Adopting a policy with specific criteria for determining whether to retain or sell land whose management costs exceed revenue.

The State Land Board disagrees with this recommendation. Although the Board considers management costs as one factor in evaluation of properties for sale or retention, it should not be the major consideration. Management costs fluctuate over time dependent upon what activities are occurring in the area at the time. Such costs are not a good indicator of future earning potential or appreciation potential of said property.

The Board does have a policy of reviewing all properties which earn less than \$250 per year in revenue. This policy requires consideration of sale or exchange of small, isolated parcels of State Trust Lands. The review occurs at the end of the current lease term.

- c. Developing a system to identify individual unproductive parcels which cost more to manage than the revenue they generate.

See item (b) above for response.

- d. Implementing a program to evaluate individual land parcels regularly to assess if they are performing as a sound investment, or if they should be considered for sale, or held for an identified future state need.

The State Land Board notes that over the past several years it has focused on the issue of getting its rental rates for properties “as close to market rates as feasible.” This action is critical in any effort to assess how well the asset is performing. The Board is close to finalizing its review of all the rate structures involving its lands. The Board has nearly 3,000 properties located around the state and inspects and reviews each property as leases expire. The Board will consider a process to analyze the rate of return on assets as part of future property reviews.

The Board agrees to phase in a process to address item (d) in calendar year 1995 as noted in the response under Recommendation No. 2.

2000 Office of the State Auditor Disposition:

Partially implemented.

- a. Rejected (1994 Audit Response). The Land Board currently has not established a process to determine costs of managing individual land parcels.
- b. Initially rejected (1994 Audit Response). The Land Board has adopted a policy of identifying and including in a district work plan a list of those lands that are difficult to manage or that produce little or no revenue for the trusts. These lands are prioritized on a central “disposition” list.
- c. Initially rejected (1994 Audit Response). Through its strategic plan and annual work plan, the Land Board has begun to develop an Asset Management System along with improving their Lease Management System. Rapid Assessment in Fiscal Year 2000 provided a baseline market value of all surface land assets from which annual income, rate of return, and appreciation rate can be derived. Currently management cost is not part of the Asset Management System.
- d. Although not operational at this time, a new software system has been purchased from the state of Utah that will work in conjunction with the above-referenced Asset Management System. The software is intended to be used as a Lease Management System, to help Board members evaluate individual land parcels in light of performance, appreciation, and disposition potential.

1994 Recommendation No. 13:

The State Board of Land Commissioners should improve its management of inaccessible land by:

- a. Completing its analysis of trust lands that lack public access on a priority basis.

- b. Seeking a limited statutory authority to use the right of eminent domain.
- c. Proposing a land bank demonstration project to test the effectiveness of this approach at improving access, value, and productivity of trust lands.

1994 State Board of Land Commissioners Response:

Partially agree. The State Land Board compiled general information regarding access to state trust lands in 1991. Currently, the Board's field employees note access status as a part of their field inspection process on each parcel of land. Approximately 25 percent of the State Trust land does not currently have access available. These properties are generally leased to ranchers and farmers whose deeded lands surround such lands. Other parcels of State Trust Land which do not have good access for Land Board lease purposes are those isolated within wilderness areas of the U.S. Forest Service and Bureau of Land Management lands.

The State Land Board has complied with the recommendation of proposing a land bank demonstration project. Senate Bill 94-102, sponsored by Senator Claire Traylor, is related to the Ridge Home property and passed the legislature last year. The Land Board has discussed the general concept of land banking authority with the General Assembly in the past. The Board currently has the authority to exchange lands, but additional legislation would streamline the exchange process.

The State Land Board does not believe it is necessary for it to secure limited authority to use the right of eminent domain. The Board believes its constitutional authority to sell or exchange State Trust Land is a more effective method of dealing with "landlocked" properties. Nevertheless, the Board is prepared to approach the Legislature for eminent domain authority on a case-by-case basis if it becomes necessary to do so. The Board does not believe it is currently necessary to do so and, therefore, has no request for the next legislative session.

2000 Office of the State Auditor Disposition:

Partially implemented.

- a. The Land Board has targeted a number of landlocked parcels that yield a low rate of return for exchange either to the federal agencies or private individuals that abut the property boundary. No analysis of trust lands lacking public access has been completed to date. Land Board staff are currently unaware of how many acres of land are landlocked by private lands and are therefore inaccessible. The Land Board maintains that management of landlocked parcels usually presents less of a management burden because access to the public is more difficult; therefore, the Land Board has fewer problems with trespass, illegal uses, etc.
- b. Rejected (1994 Audit Response). The Land Board continues to feel that a case-by-case approach to gaining access will achieve the same ends.

- c. Amendment 16 changed the land banking authority of the Land Board. Nonsimultaneous land exchanges, a form of land banking, began in 1997 and has been highly utilized. Since land tracking and Asset Management Systems are in their infancy stages, the Land Board cannot determine how these exchanges have improved access, value, and productivity of trust lands.

1994 Recommendation No. 14:

The State Board of Land Commissioners should continue efforts to improve its process to set grazing rentals and maximize grazing income. Specifically, the Board should:

- a. Revise its grazing rental formula to produce additional revenue by reducing the averaging period from five years to three to two years.
- b. Develop and implement a plan to expand its use of auctions as a way to increase revenues from grazing-contract renewals. This should include documenting the reasons for excluding parcels from the planned expansion.
- c. Implement a process to explicitly establish the value of land management services provided by lessees and adjust grazing rentals according to this factor.

1994 State Board of Land Commissioners Response:

- a. Agree. The State Land Board's recently adopted policy on grazing rental rates contains an adjustment of grazing rental rates based on regional market rates with adjustments every third year based on private sector rental rates.

The State Land Board has initiated the survey process of regional rental rates with implementation of new billing rates for grazing scheduled to begin October 1, 1995.

- b. Partially agree. The State Land Board currently auctions grazing leases as opportunities have arisen to do so. In most instances auctions have been used where vacant lands are available for lease due to defaults in rental payments, lease cancellations, and other circumstances. Auctioning of grazing leases where the current lessee desires to continue with the lease is cumbersome, time-consuming and costly. In most instances auctioning leases would require an appraisal of lessee improvements on state trust lands, additional fencing, and/or water development. In addition to the time involved, the Board believes that the additional costs associated with auctioning leases would in many cases exceed the increased revenues.

The Land Board believes its amended grazing rental formula will accomplish its goal of "getting as close to market rates as feasible" and will be fully implemented by October 1,

1995. Its current rate increase has resulted in over \$1 million in increased revenue in grazing rental rates on its 2.6 million acres of State Trust Lands.

- c. Partially agree. As a part of its recently adopted grazing rental formula, the Board stipulated that the Land Board staff is to recommend a process to determine the amount of credit to be received by lessees for fence and water development and maintenance on State Trust Lands. Currently, the Board allows a 35 percent credit of the private sector AUM rate for these activities. Over the next few months the staff will work with the livestock industry, agricultural universities, and the U.S. Department of Agriculture to determine a fair credit for water and fence maintenance and development. Other “management costs” are difficult, if not impossible, to calculate and will not be part of the new formula. The process will be implemented by October 1, 1995.

2000 Office of the State Auditor Disposition:

Partially implemented.

- a. The Land Board revises its grazing rate on a three-year schedule.
- b. The Land Board currently auctions grazing leases only when lease terms have expired and current lessees have not expressed an interest in renewing their leases. Otherwise, the lessee’s lease is renewed. Only vacant, unleased agricultural lands are auctioned. The auction process is used when the Land Board has more than one written or verbal expression of interest for a parcel.
- c. A flat 35 percent lease reduction is given to all agricultural lessees. This figure was derived from a study comparing federal and private lease costs. The value of land management services provided by lessees has not been explicitly established by the Land Board.

1994 Recommendation No. 15:

The State Board of Land Commissioners should develop and implement policies, procedures, or guidelines to clarify and strengthen its valuation process. Specifically, the Board should:

- a. Ensure that the valuation of real property is established through a standardized process which complies with all applicable statutes.
- b. Ensure that it applies its procedures in a consistent manner.

1994 State Board of Land Commissioners Response:

Agree. The State Land Board will take steps to ensure that its appraisal procedures are well documented and applied consistently. Further, the Land Board will ensure that outdated material will not be handed out to the public. Implementation will begin immediately.

2000 Office of the State Auditor Disposition:

Partially implemented. The Land Board has a Real Estate Procedures manual in place describing how the valuation of real property is established. However, audit work revealed that Real Estate Procedures are not consistently applied. For example, the Board has not documented a procedure for the independent valuation of mineral assets, as reported on page 31 of this audit report.

1994 Recommendation No. 16:

The State Board of Land Commissioners should consult with the Attorney General's Office and/or federal officials as appropriate to clarify the need for auctions. The Board should develop cost-effective procedures to resolve boundary errors and recommend appropriate changes to statutes as necessary.

1994 State Board of Land Commissioners Response:

Agree. Recommendation will be implemented in January 1995.

2000 Office of the State Auditor Disposition:

Not implemented.

The Land Board has not obtained an Attorney General's opinion regarding resolving boundary-error cases via other forms of "sale." No policy exists for resolving boundary errors.

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