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COMMISSIONERS OF THE LAND OFFICE

State of Oklahoma

July 31, 2012

To Superintendents and Finance Officers:

Upon being named Secretary of the Oklahoma Commissioners of the Land Office in 2011, I committed to the beneficiaries of the trust to attempt to improve lines of communication with schools to advise you of trends, investment issues, etc. that will impact funding from the CLO.

It is our prediction that distributions for both FY-2013 and FY-2014 will return to near FY-2011 levels-contrasted with FY-2012 levels. That may be a reduction of 6-7% for the next couple of years. We will continue to assess, and hope that the economic recovery proves us wrong.

In an attempt to minimize the year-to-year impact on beneficiaries, a recent decision by the Oklahoma Commissioners of the Land Office was made to provide as much stability and predictability as possible in distributions to the state's school districts. At the June 21st meeting the Commission voted to begin a 5-year rolling average distribution of lease bonus income to the schools to protect against a significant drop in lease bonus revenues, which is anticipated in FY-2013 and FY-2014,

Please allow me to explain in greater detail.

Background

In 2010 the Oklahoma Legislature authorized the CLO to begin distributing lease bonus monies to common school and higher education beneficiaries. The result has been the most extraordinary increase in distributions to public education in the agency's history. Distributions have risen dramatically each year. In the three years since 64 O.S. Section 1069 became law, distributions to all our beneficiaries have increased by over 40%.

FY-2012 ended with the most dramatic distributions in history. A total of $141.6 million was distributed to beneficiaries ($102 million to common schools; that will be a 10% increase from last year, which was the prior record year).

The Warning Signs

Earlier this year the CLO became concerned that the price of natural gas would result in reduced mineral leasing and reduced bonuses paid for CLO leases. The warning signs were:

- The price of natural gas fell to a decade low. As a result demand for new leases has diminished in many areas of the state.
- Volatility and uncertainty involving the largest oil/gas bidder and lessee of CLO mineral acreage became the daily headlines and has begun to impact lease prospects.
- CLO has less land to lease because a higher percentage of the mineral holdings is "held by production" than at any other time.

The good news is that we have had three consecutive extraordinary years of lease bonus distribution.

The bad news is that the level of lease bonus income is not sustainable for the foreseeable future.

Two Options

It became apparent that the CLO, at least the next couple of fiscal years, was facing two distribution strategies.

- Distribute the lease bonus revenues as they are received/ or
- Distribute on a 5-year rolling average until the natural gas market (price) improves, or until interest rates and dividend income rises in national and international markets.

5 Year Rolling Average Authority

The statutory language provides that the money be distributed as surface lease revenue…that is distributed in the year received…or, in the alternative, if the Commission decides it is in the "best interests of the trust" it may distribute lease bonuses on a 5-year rolling average. That makes sense because the predictability of our other income sources…agricultural leases, commercial leases, stock dividends and fixed income securities (bonds) is much more predictable and much less volatile.

Impact

Our concern is that uncertainty and volatility of lease bonus income in the market place will create ups and downs in the distribution pattern to our common school beneficiaries…and that those spikes will have a two-fold impact on the common schools.

CLO distributions are chargeable against a district's need in the state funding formula. Therefore, the schools are impacted "a year in arrears" by our distributions. If a great year is followed by a downturn in lease bonuses, not only are distributions reduced for use in the current fiscal year, but also the schools will be charged as though they received money from CLO consistent with the former year's greater distribution, creating a two-edged impact.

Effort to Prepare and Communicate

Since March we began to talk to school administrators groups and associations and superintendents throughout the state.
We have interacted with nearly 100 school superintendents throughout the state to ask their opinions. Uniformly, they urged that we create as much predictability in our funding model as possible… to avoid substantial swings.

As a result of our concern over the impact of what will be a downturn in distributions to state public schools until the price of natural gas rebounds, we believed it's prudent to implement a 5-year average distribution of lease bonus revenues to the public schools (as is authorized in the state statute 64 O.S. Section 1069) in order to create greater predictability and protect against potential wild swings.

What to Expect

Working with the OCCSA we have agreed to a 5-year plan that will attempt to hold your distribution for FY-2013 and FY-2014 at the level at least equal to FY-2011 levels.

Until 12 months ago that would have been the best ever. Market conditions, potential lawsuit settlements, and increased commercial lease revenues can improve our results. We will be working to achieve those gains every day.

Proposal

The actual motion approved by the Commissioners of the Land Office was as follows:

"the Commission have determined that it is in the best interests of the trust to begin a 5-year rolling average distribution of lease bonus income to common school beneficiaries effective July 2012…and to instruct the Secretary to advise the Commission of any market circumstances or CLO earnings that subsequently arise that might cause the Commission to reconsider the 5-year rolling average."

If you have questions, please contact Terri Watkins, Director of Communications at 405-521-4013.

Sincerely,

Harry Birdwell
Secretary