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EQC
JANUARY 7, 2010
EXHIBIT 23

December 17, 2009

To: EQC Members
From: Hope Stockwell
Re: LFD Analysis of Cabinsite Leasing Proposal

Attached is a report written by Barb Smith, fiscal analyst, for the Legislative Finance Committee taking a look at the cabinsite leasing proposal put forth by the DNRC for consideration by the Land Board.

Ms. Smith's analysis finds that the proposal (known as alternative 3B) raises concerns about whether it meets the state's school trust obligations under the Montana Constitution and whether it assures that full market value would be obtained, as required by state law.

Representatives of the DNRC will attend the January EQC meeting to further discuss the issue and any action the Land Board may have taken at its December 21 meeting. Ms. Smith will also be available for questions.

CABIN SITE LEASING ON SCHOOL TRUST LANDS: A LOOK AT THE PROPOSED FORMULA

A Report Prepared for the
Legislative Finance Committee

By
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November 9, 2009

Legislative Fiscal Division



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PURPOSE

The lease rate for cabin sites established on state trust lands is reevaluated in conjunction with the Department of Revenue (DOR) reappraisal process. Over the past few months, the lease holders, Department of Natural Resources and Conservation (DNRC) staff and Land Board staffers have discussed options to calculate lease rates. A recent decision by the Board of Land Commissioners (Land Board) to implement rules on one alternative has raised questions regarding the fiduciary responsibility of the Land Board to obtain fair market value. The purpose of this report is to provide background material on the calculation rate and inform the legislature of potential issues with this formula.

BACKGROUND

DNRC administers 802 cabin sites and home sites on state trust land for the purpose of raising resources for the trust beneficiaries. Figure 1 shows the fiscal year 2009 cabin and home site revenue generated for each trust.

Lease rates have changed over time. Prior to 1983 nominal rates were charged. The 1983 legislature directed the department to set the lease rent at 5 percent of lease value. That was changed in 1989 when the legislature implemented a 3.5 percent rate of the appraised land value as determined by DOR during the periodic reevaluation of property.

However, in 1999 the Montanans for Responsible Use of the School Trust (MonTrust) challenged the lease rate under the belief that a 3.5 percent rate did not achieve fair market value for the beneficiaries. The Supreme Court ruled in favor of MonTrust and concluded that the 3.5 percent lease rate "violates the trust's requirements that full market value be obtained..." After this ruling the department, under the direction of the Land Board, initiated negotiated rule making and established a lease rental rate of 5 percent of the DOR appraised value and allowed for the rate to be phased in over time.

Recently, DOR released appraised values for 2009. Given the large increases in many areas, and the 5 percent rate, the department was contacted by lessees regarding the rise in lease rates and the ability of some cabin site owners to pay. During the summer of 2009, the department initiated public meetings, and established a working group to address the issue. In September 2009, DNRC released "*Analysis of Lease Rent Calculation Alternatives for Cabin Sites on Montana's State Trust Lands*". This document provided extensive background and information regarding five proposed alternatives. The executive summary of the DNRC report is included with this document.

After the public comment period on the document and alternatives ended, DNRC established a sixth alternative (3B) to capture the issues raised by public comments that "blends the alternatives and attempts to capture the increase and decrease in the market on an annual basis to more accurately reflect the potential vacancies and current market conditions"¹. At the October 2009 Land Board meeting the Commissioners directed the department to begin the rule making process to implement the 3B alternative, and preliminary approval of those rules is slated for the December 2009 meeting. Preliminary approval allows DNRC to put the rules out for public comment.

Figure 1
Department of Natural Resources and Conservation
Cabin and Homesite Revenue from Trust Lands

Trust	FY 2009	
	Leases	Revenue
Common Schools	319	\$438,335
MSU 2nd Grant	195	501,472
MSU Morrill	2	4,839
Public Buildings	55	40,132
School for the Deaf and Blind	37	27,360
School of Mines	107	461,873
Veterans Home	1	973
State Industrial School	35	72,517
State Normal School	12	22,297
University of Montana	1	2,230
Total	<u>764</u>	<u>\$1,572,028</u>

Source: DNRC

¹ Land Board Agenda Item #1009-2, October 19, 2009

THE 3B ALTERNATIVE

The base of the lease cost is the 2003 DOR value projected to 2009 at 6.53 percent annually. The 6.53 percent represents the average annual real estate appraisal rate from 1983 to 2003. Therefore, a property with a 2003 DOR value of \$100,000 is indexed to a 2009 value of \$146,141. This would be the base value to calculate the lease cost.

The base rent is calculated as 5 percent of the adjusted 2009 parcel value. This base rent would apply in 2010; rent in subsequent years would be calculated to increase annually by the latest Lease Fee Index (LFI). The LFI is the average of two numbers: (1) the average annual real estate appreciation rate (REI) for the last 25 years; and (2) the annual change in the consumer price index (CPI). The annual LFI adjustment would be no larger than 6.5 percent and no smaller than 3.25 percent. The example below illustrates the calculation

EXAMPLE

$\$146,141 \times 5\% = \$7,307$, base rent for 2010
 $REI + CPI = (8.74\% + 1\%) / 2 = 4.87\%$ LFI
 $\$7307 \times 4.87\% = \356
Rental rate for 2011 is $\$7,307 + \$356 = \$7,663$

The REI will be re-calculated after every new set of Department of Revenue values becomes available (currently a 6 year cycle.) However, the change in the CPI will be updated annually. Thus the LFI will change every year.

In 2025, the contract rent based on the LFI system will be compared to 5 percent of the most recent DOR value. If contract rent is either more than 15 percent above the appraisal-based amount or more than 15 percent below the appraisal-based amount, the contract rent will be adjusted to fall within that 15 percent margin.

POTENTIAL ISSUES

Full Market Value

77-1-208, MCA, provides direction regarding cabin site licenses and leases to the Land Board. Statute specifically states:

“The fee must obtain full market value based on appraisal of the cabin site value as determined by the department of revenue.”

This language was placed in statute at the passage and approval of SB 424 in the 1993 legislative session. The title of the bill described the bill as “ An act requiring the board of land commissioners to attain full market value for leases on state school trust land...”² The intention of the legislature is clear - full market value was to be obtained and the avenue to obtain such value was the appraisal of cabin sites completed by DOR. This bill did not contemplate using a value other than the most recent value.

Alternative 3B calculates base rental rates on the 2003 value indexed forward to the 2009 value using an average real estate growth factor. However, a portion of cabin lease sites are located in areas where real property has escalated at a faster than average pace. Conversely, there are some sites where the rate is lower than average. As part of the cabin site leasing analysis, the department took a sample of leases to review and apply proposed methodologies. Figure 2 below illustrates three examples of the implementation of 3B comparing the market value to the indexed value as well as the current rental rate to the 3B alternative rental rate.

² 1993 Montana Session Laws, Volume 3, Chapter 586

Figure 2
Comparison of Current Rate with Alternative 3B

Site Location	2003 DOR Appraisal	2009 DOR Appraisal	Adjusted 2009 Value	Difference	Five	3B	Rent Difference
					Percent Rent	Alternative Rent	
Placid Lake	\$144,961	\$148,086	\$211,482	\$63,396	\$7,404	\$10,574	\$3,170
Elbow Lake	46,414	81,100	67,839	(\$13,261)	4,055	3,392	(663)
Flathead Lake	\$144,560	\$818,432	\$211,290	(\$607,142)	\$40,922	\$10,565	(\$30,357)

In reviewing these examples, the lessee on Placid Lake will pay more than the lessees on Elbow and Flathead Lakes. Since the 2009 DOR value is less than the adjusted value, Placid Lake lessees rates will be based on the 2009 DOR value. The Elbow Lake lease leaves little value out of the lease calculation compared to the lease on Flathead Lake whereby \$607,142 in appraised value is not considered in the lease calculation. In leaving 75 percent of the value out of the calculation, full market value is not achieved.

Multiple Use Management

The Land Board has the duty to manage the land in the interest of the public and for the beneficiaries of the trust. Basic trust law and common trust practices require that an entity manage a trust solely on the behalf of the beneficiary and has a fiduciary responsibility to that beneficiary. State trust lands are slightly different as the lands must be managed in such a manner that income is perpetuated and the public interest in the land is protected.

The 3B alternative does not assure full market value is obtained. If full market value is the value of the land and the improvements, the full market value of the property should equal the taxable rate of the property as if the land was owned by the leaseholder. Since the 3B calculation for the Flathead lease leaves over \$600,000 in value out of the lease calculation, some other source of funding will have to make up the difference.

If cabin site leasing fails to bring in the same level of revenue, other entities could be forced to make up the difference. In the case of the common schools it would be the general fund, which is where property taxes are deposited. In the case of the University system, it could be the student. An increase in student housing costs or third party leases may be necessary to cover costs that would have been funded with these revenues..

Fiduciary Responsibility

In 1999 the Supreme Court ruled that the policy used by DNRC in renting cabin site leases on state trust lands resulted in lower than market rentals and violated the state's school trust obligations under the Montana Constitution. 3B raises similar issues.

During the October 2009 Land Board meeting, Mr. Roy Andes representing MonTrust appeared before the board. His statement, as per Land Board minutes, included the following:

“Mr Andes stated that it is not necessary to use formulas to determine fair market value: the market will establish them itself, if allowed. Mr. Andes concluded by stating that he respects the problems of lessees, and believes they need to pay no more than fair market value; but, it should be insisted that fair market value is in fact be paid.”³

Additionally, Greg Munro, Board of Regents attorney, stated that the regents oppose the approval of Alternative 3B for three reasons:

1. “3B advocates the formula that was set nearly a decade ago in negotiated rulemaking. At that time there was an agreement between the leaseholders and the state to set the formula

³ Draft minutes of the October 19,2009 Land Board Meeting, edited for clarity

based on the most recent appraisal. 3B uses the 2003 DOR appraisals, rather than the 2009 values (for which there is insufficient justification) as the upward adjustment is lower than the actual appreciated percent. The DNRC estimate states that this alternative will produce \$14 million less over the thirty years than the current formula.

2. 3B sets the lease fees at five percent of the appraised value, while the Duffield study shows that the lease rates need to be set between six and twelve percent to be at full market value.
3. The DNRC proposes changing the lease term from 15 years to 35 years. There is concern regarding placing property in the hands of a single party for 35 years. That takes a public asset and gives a private citizen so much of an interest in that asset that it compromises the public ownership.”⁴

At this writing it is unknown if either party will pursue legal action.

Legislative Options

The legislature has a number of questions to consider, including:

- o Does the 3B alternative meet the statutory requirement that full market value must be obtained?
- o Does alternative 3B represent the interests of the public?
- o Did the legislature intend to allow the Land Board to select which appraisal cycle to use in calculating lease rates?
- o Is it reasonable to expect the general fund or student tuition to make up any lost revenue?
- o How does this decision impact obtaining full market value of any other trust land activities?

Later this month, the Land Board will determine whether or not the draft rules implementing the 3B alternative should be released for public comment. The Legislative Finance Committee may wish to:

- o Draft a letter to the members of the Land Board outlining concerns with the 3B alternative
- o Appoint members to review the formula and prepare written comments outlining any concerns to the Land Board members prior to the December 21, 2009 meeting
- o Allow the rules to be proposed and work with the Environmental Quality Council to submit comments to the draft rule
- o Allow the process to proceed

⁴ Ibid