
MEMORANDUM

DATE: MAY 19, 2009

TO: HON. BEN YSURSA
HON. DONNA JONES
HON. TOM LUNA

FROM: HON. LAWRENCE G. WASDEN, ATTORNEY GENERAL
CHAIR, GRAZING LEASE SUBCOMMITTEE
HON. C.L. "BUTCH" OTTER, GOVERNOR

RE: STATE BOARD OF LAND COMMISSIONERS GRAZING LEASE
SUBCOMMITTEE—RECOMMENDATIONS

EXECUTIVE SUMMARY

Over the past 20 years there has been much dissatisfaction with the grazing lease process both from the customers and from the State Board of Land Commissioners. Out of this dissatisfaction and a general feeling that the system needed revamping, the Grazing Lease Subcommittee was created by the Board to review the grazing lease process. The Subcommittee conducted a series of meetings among its members, stakeholders, and interested parties to analyze and recommend changes to the grazing lease process. Recognizing the responsibility of the Board to provide for the maximum financial return for Idaho's schools and to preserve the lands themselves, the Subcommittee recommends a leasing process with the following core revisions to existing procedures:

1. Applications should be accepted for competing uses.
2. Each applicant must reach agreement with the Department on the terms of the lease that will be executed if the applicant is selected by the Board.
3. The Department must develop and disclose to all lease applicants a list of criteria that will be used in structuring the lease terms.
4. The application fee for a lease will increase to \$250 to recapture a greater share of the administrative cost associated with the Department's processing the application.
5. The current improvement-credit process should be modified as to improvements approved after July 1, 2009.

6. Monetary penalties would be imposed on applicants qualifying for participation in a conflict auction but withdraw prior to or fail to participate in the auction or after submitting the high bid.

While some of the existing constitutional and statutory constraints are antiquated and need to be changed to conform with modern business practices, the Subcommittee's recommended modifications were developed within the context of existing law. The Subcommittee recommends that the Board and the Department pursue a statutory amendment to increase the maximum lease length for grazing, farming, communication site, conservation and non-commercial recreational leases from ten years up to 20 years. The Subcommittee determined that other constitutional or statutory changes are more appropriately addressed through the development of the Board's Asset Management Plan.

ANALYSIS

The State Board of Land Commissioners established the Grazing Lease Subcommittee at its June 2007 meeting to review current grazing leasing procedures and to report back to the full Board with any recommended modifications. The Board expressed concern that the current process is not transparent and does not provide applicants with all relevant financial and management information necessary to make an informed bid. This memorandum summarizes (1) the main concerns that led to the Subcommittee's formation and its general objectives; (2) the public process undertaken in connection with the Subcommittee's deliberations; (3) relevant Idaho constitutional and statutory requirements; and (4) recommended modifications to current leasing procedures which will assist in ensuring that those requirements are satisfied in the conflict auction context.

Grazing Lease Subcommittee Formation and Objectives. The Subcommittee was created by Board to review the grazing lease process.¹ Over the past 20 years there has been much dissatisfaction with the grazing lease process both from the customers and from the Board. Issues regarding alternative uses of grazing leases combined with the lack of transparency in the administration of the program have resulted in substantial controversy generally and related litigation. As Secretary of State Ben Ysursa accurately observed during the December 2007 Land Board meeting with respect to leases as to which conflict applications have been submitted and an auction is necessary, the process "needs to be revisited and redone" and that "all [administrative] expenses ought to be known up front"—*i.e.*, "there ought to be some sort of finality at th[e] auction knowing

¹ Implicit in that charge was the need to examine an entire subset of endowment-land leases treated identically under Idaho Code §§ 58-307(1) and -310. Section 58-307(1) limits leases to ten years, while § 58-310 governs conflict auctions. The Legislature over time has created various exceptions to the ten-year duration restriction and the public auction requirement. The result of these legislative actions has been to limit the restriction and auction requirement to five generic types of leasing purposes: grazing, farming, communication site, conservation and non-commercial recreation.

all the expenses up front." The Secretary of State summed up the sentiment of the Board with the succinct statement that "the whole process is broken."

In formulating its final recommendation, the Subcommittee gave substantial weight to the Secretary of State's observations in light of his direct involvement over more than 30 years with the Land Board's operation. There is a pressing need for the leasing process to give conflict-auction participants the ability to identify prior to auction all relevant leasing burdens, including potential administrative costs. The periodic controversies over the use of lands for both grazing and conservation purposes, moreover, served to underscore the need to consider modifications that would recognize the right of applicants to seek a lease for competing, or incompatible, uses.

Aside from concerns over the basic fairness of the leasing process, the Subcommittee's formation coincided with the then-ongoing development of the Asset Management Plan and associated attention to an overall strategy for maximizing long-term returns from endowment lands. Parcels historically used for grazing purposes constitute a major component of those lands. The Asset Management Plan, for example, identified 1200 leases related to the grazing asset. Very few of these leases have necessitated the conduct of a conflict auction. During the 2007 and 2008, the number of conflict-lease auctions was, respectively, seven and ten. Nevertheless, as reflected in both ongoing and past litigation, conflicting applications for particular endowment land parcels can consume a significant amount of Department resources and Board attention. This phenomenon is unsurprising given the relative complexity of the process attendant to dealing with conflict applications, the infrequency of conflict auctions, and the time-intensive nature of ensuring that the conflict process is carried out properly. These administrative burdens and attendant costs nonetheless are particularly significant because the grazing land asset, unlike other trust land assets, has often produced little or no net income. The asset as a whole, in other words, has "underperformed."²

In furtherance of its considering fiscal issues related to the leasing process, the Subcommittee requested two accounting studies to address ongoing concerns expressed by some customers that the Department's financial information mischaracterized the performance of the grazing asset. The SCO conducted a review of departmental accounting practices, and its draft analysis concluded that the methodology for indirect cost allocation is reasonable and consistent with generally accepted accounting principles ("GAAP"). The SCO did note that prior to fiscal year 2008 the grazing program was allocated FTEs from other programs, which overstated the grazing program's indirect cost allocation of support service's expenses; however, changes were made in fiscal year 2008 so that only the FTEs determined to directly benefit the grazing program were used to allocate the support services indirect costs. The Subcommittee also requested an

² An analysis conducted by the State Controller's Office ("SCO"), for example, calculated the ratio of total net income to total revenue for all state endowment lands during fiscal years 2004 through 2008 as, respectively, 80, 73, 77, 76 and 73%. The same ratio for grazing lands alone was -11, -9, 10, 5 and 14%.

independent evaluation of whether the cost allocation methods used by the Department with respect to the grazing-lands program complied with GAAP. A draft of the evaluation's results was completed recently and concludes that the Department's "methodologies . . . in allocating expenses to the Grazing Program are in accordance with GAAP." The evaluation did identify several modifications to current allocation practices to provide "a more comprehensive determination without the detriment of spending additional time[.]" and the Subcommittee recommends that the Department consider those suggested changes when the evaluation is finalized. A second phase of the independent evaluation will examine the Department's procedure for determining the rate of return on assets to ensure that it is being done consistently with GAAP.

The Subcommittee, in sum, engaged in an examination focused on determining whether modifications could be made to present leasing procedures that would enable the Board to carry out its fundamental constitutional duty to manage state endowment lands with the twin objectives of maximizing long-term financial return to beneficiaries and preserving the trust lands for future productive use. An integral element of this focus was identifying modifications to existing procedures that will help ensure an open and fair process that allows an applicant to know what its responsibilities will be under the lease if awarded and thereby to assess knowledgeably the economic viability of the proposed use early in the application process; to use the leasing process itself to tailor terms and conditions for the proposed use that minimize fiscal risk to the trust and preserve the environmental integrity of the affected land; and to make the auction's result controlling in the virtually all cases and, as a consequence, to alert participants that they must maximize their premium bids if they expect to secure the lease.

Public Process Efforts. At its initial meeting in January 2008, the Subcommittee directed the Department to solicit public review and comment on proposed changes to the leasing procedures. As a first step, the Subcommittee through the Department requested comments on the existing grazing program through the mailing of over 900 letters to beneficiary representatives and lessees and the posting of the letter on the Department's website. Forty-nine written comments were received. The public comments and the Subcommittee's responses were captured in a comment summary.

Following the development of a proposed lease application/conflict auction procedure based on recommendations of the Department and the public comments, the Subcommittee scheduled public meetings at Nampa, Orofino and Soda Springs during August 2008 to present the proposal for public review and comment. The meeting notice was sent to the beneficiary representatives and lessees and was posted on the Department website. Presentations at the meetings included a PowerPoint overview of the grazing land asset, a review of the public comments received from the May 2008 solicitation, and distribution of a document containing a proposed expiring grazing lease process. Following these meetings, comment solicitation letters were sent to the beneficiary representatives and lessees, providing them with the summary of public comments reviewed at the public meetings, the proposed expiring grazing lease process document, and a comment form. During the 30-day comment period, 59 written comments were

received. The public comments and the Subcommittee's responses were captured in a comment summary.

Revisions were made to the proposed procedure and the Subcommittee scheduled a public video conference on March 26, 2009 to present the revised proposal and again solicit public comment. Advance notice of the meeting was sent to the beneficiary representatives and lessees and was posted on the Department website. The meeting presentation was broadcast to Nampa, Lewiston, Salmon, Idaho Falls and Jerome and focused on the February 19, 2009 Revised "Grazing" Lease Application/Conflict Auction Process Summary (handout) followed by a question-and-answer session. The Summary Overview of the Land Board Subcommittee Recommendations was also provided as a handout. One hundred sixty-two people attended the conference. During the two-week comment period, 37 written comments were received. Those comments and the Subcommittee's responses have been captured in a comment summary.

The Subcommittee's final recommendation largely incorporates the proposal discussed during the March 2009 meeting. It differs from current lease-application procedures and the August 2009 draft proposal in three principal respects.

First, the revised procedure replaced the current requirement for submission of "management plans" predicated on "performance standards" with a process under which the applicant's leasing responsibilities are detailed in a lease specifically directed to the proposed use. This approach, in the Subcommittee's view, better accommodates the range of possible uses to which lands used traditionally for grazing can be placed under existing statutes than continuation of the "management plan" method of processing lease applications and has the benefit of reducing the Department's administrative costs.

Second, the Subcommittee concluded that the objective of reducing administrative costs and bringing greater up-front certainty to potential applicants for leases would be furthered by modifications to the existing improvement-credit system. A substantial portion of the comments received in March 2009 addressed this aspect of the draft proposal, and the Subcommittee has revised the proposal in its final recommendation to address concerns regarding the residual value of improvements.

Third, the final recommendation seeks to recapture a greater share of the administrative costs attendant to the leasing process than was provided for under the original proposal which continued existing fees in that regard.

Constitutional and Statutory Requirements. Article IX, section 8 of the Idaho Constitution requires the Land Board "to provide for the location, protection, sale or rental of all the lands heretofore, or which may hereafter be granted to or acquired by the state by or from the general government, under such regulations as may be prescribed by law, and in such manner as will secure the *maximum long term financial return* to the institution to which granted or to the state if not specifically granted." [Emphasis supplied.] Another portion of this provision conditions "disposal" of congressionally-

granted state lands through "public auction." The Idaho Supreme Court construed the "maximum long term financial return" and the "public auction" requirements most recently in a two cases.

In *Idaho Watersheds Project v. State Board*, 133 Idaho 64, 982 P.2d 367 (1999), the Supreme Court invalidated Idaho Code § 58-310B insofar as it directed the Land Board to consider the long term return not only to the beneficiary schools but also to the State as a whole when making conflict lease determinations. The Court reasoned that "[r]ather than seeking to provide income to the schools and the state in general, Article IX, § 8 requires that the State consider *only* the 'maximum long term financial return' to the schools in the lease of school endowment public grazing lands." 133 Idaho at 67, 982 P.2d at 370 (emphasis supplied). Several years earlier in *Idaho Watersheds Project, Inc. v. State Board*, 128 Idaho 761, 766-67, 918 P.2d 1206, 1211-12 (1996), the Court broadly construed the term "disposal" in Article IX, section 8 to include the *leasing* of grazing lands.

Section 58-310, Idaho Code, incorporates both requirements where two applicants for the same lease exist. It mandates a public auction at which "premium bids"—*i.e.*, amounts in addition to the Board-established rental rates—are made. The statute also recognizes that the highest premium bid may not represent the best measure of such return by giving the Land Board authority to reject bids for "fraud or collusion, or for any other reason." The Board therefore has discretion in making leasing decisions, but its determinations must comply *procedurally* with the public auction requirement and *substantively* with maximizing long term financial returns to the beneficiary schools.

Recommended Leasing Process Modifications. Current departmental leasing procedures with respect to certain classes of endowment lands can be improved to ensure compliance with the Board's procedural and substantive duties under the Constitution and relevant statutes. The Department will analyze conflict applications to determine whether uses could in fact coexist. Such review is consistent with the Asset Management Plan and the desire to maximize income to the beneficiary through multiple layers of income associated with a parcel of land.

The recommended modifications summarized below relate to the leasing process where multiple applicants have applied to lease a parcel and the Department has made an incompatibility determination. The modifications' overall purposes are to make the auction process transparent and to foster increased competition at the auctions themselves while simultaneously maintaining the parcel's long-term economic and environmental utility and reducing administrative costs. They seek to accomplish these purposes in four principal ways:

- Applications will be accepted for competing uses. The proposed modifications permit applications for different uses, thereby creating the potential for greater financial returns. Currently, conflict applications are limited to a particular use. The Land Board's fiduciary responsibilities, however, require it to consider in

awarding a particular lease all uses that are consistent with its fiduciary duty "to secure the *maximum long term financial return* to the institution to which granted or to the state if not specifically granted." A core purpose of the recommended revisions is to achieve a "level playing field" with respect to competing uses *prior* to the conflict auction.

- Each applicant and the Department, prior to the auction being conducted, must reach agreement on the terms of a lease that will be executed if the applicant is selected by the Board following the auction. This requirement ensures that the applicant knows, prior to participating in the auction, what its costs will be if awarded the lease and enables the applicant to structure bids consistent with its needs and resources. The recommendations include, in this regard, modifications to existing improvement-authorization procedures that will result in a fixed value for the improvement being established as the potential credit if, at the lease's termination, the lessee making the improvement does not assume lessee status under the new lease. The subcommittee anticipates that, over time, this approach will lessen both the administrative expense to the Department attendant to making improvement valuation determinations and time-consuming disputes over the valuation itself. The lease formulation process additionally allows the Department to tailor the lease's terms to the particular use to ensure that the parcel's long-term economic and environmental utility is maintained and eliminates the current practice of completing new resource assessment reports when leases are advertised—a practice which has not proven cost-effective.
- The Department must develop and disclose to all lease applicants a list of criteria that will be used in structuring the lease terms. The criteria will address issues that pertain to maximizing long-term return to the parcel's beneficiaries, such as net income to the trust anticipated if a proposal is accepted and the short and long term consequences on future leasing of the particular parcel or adjacent state endowment lands under a proposed use. This modification will assist not only applicants in formulating lease terms or responding to terms proposed by the Department but also the Board in acting as a prudent investor manager in leasing determinations under Idaho Code § 58-307(4).
- The application fee for a lease will increase to \$250 to recapture a greater share of the administrative cost associated with the Department's processing the application. Auction-related procedures also will be modified to set a minimum bid requirement of \$250, where the Department has not been required to make an independent improvement valuation determination, or the cost of Department making the valuation. Penalties will be imposed on an applicant who has qualified for participation in an auction but who withdraws from the process prior to the auction and on a high bidder who withdraws after the auction.

Concluding Observations. The above procedure is consistent with constitutional and statutory constraints. Certain of these constraints are antiquated given modern business

practices and warrant study and possible revision. Any revisions should be developed in the context of the implementation of the Asset Management Plan. The Subcommittee, however, recommends a statutory amendment to increase the maximum lease length for grazing, farming, communication site, conservation and non-commercial recreational leases from ten years up to 20 years. This modification should encourage more competition for leases by providing to successful applicants greater certainty with respect to recapturing investments or making long-term business decisions. It would require an amendment to Idaho Code § 58-307(1).

Attached is a more detailed summary of the recommended changes.

LEASE APPLICATION/CONFLICT AUCTION PROCESS SUMMARY

5/19/09

The proposed process will address processing of applications for those types of leases subject to Idaho Code 58-307(1) and -310: grazing, farming, conservation, noncommercial recreation and communication site leases.

EXPIRING LEASES

Determination to Issue New Lease The Land Board will determine in advance (generally 9 – 24 months) of lease expiration if it is in the best interest of the endowment beneficiaries to continue the current use through issuance of a new lease.

If it is not, the lessee will be notified of the Land Board's decision to discontinue the use. If it is, the Department will send a lease application to the current lessee at least 30 days prior to the established application deadline.

Advertising Expiring leases will be advertised on the Department's website beginning one year in advance of the established application deadline (currently April 30 of the lease's final year; Idaho Code 58-307(8)).

Application Fee The lease application fee will be \$250 and is non-refundable.

Application Processing if No Conflict or No Management Concerns If the Department has no concerns with the current lease, the new lease will be issued with the existing lease provisions.

Application Processing if Management Concerns But No Conflict If the Department has concerns with the current lessee's management, the current lessee will be required to meet with Department staff to review the Department's proposed lease provisions that address the identified concerns. The new lease will be issued using the new lease provisions.

Processing Conflict Applications

Multiple applications for grazing, farming, conservation, noncommercial recreation and/or communication site uses on the same parcel of land will be considered conflict applications.

Conflict applications must be submitted by the established deadline. All applicants for conflicted leases will be required to meet with Department staff to provide additional information regarding their proposed use in order for the Department to develop appropriate lease provisions.

The Department will review conflict applications to determine if the proposed uses are compatible. If they are, no auction will be required and the Department will issue multiple leases. If they are not, an auction will be required.

APPLICATIONS FOR UNLEASED LAND

Application Processing

Applications to lease unleased lands may be submitted at any time or by a Department designated deadline. The applicant will be required to meet with Department staff and, upon request, to provide additional information regarding the proposed use in order for the Department to develop appropriate lease provisions and to prepare a proposed lease for the applicant's review and concurrence.

DEPARTMENT REVIEW OF LEASE APPLICATIONS

List of Lease Provision Criteria

The Department will provide all applicants for conflicted leases with the list of criteria that will be used to develop lease provisions.

Evaluation Criteria

Criteria may include:

- The applicant's proposed use and the compatibility of that use of the parcel with preserving the land's long-term leasing viability for purposes of generating maximum return to trust beneficiaries; i.e., the impact of the proposed use and any anticipated improvements on the parcel's future utility and leasing income potential

- The applicants’ access to and/or control of land or other resources that will facilitate the proposed use (e.g., grazing rights on neighboring property that will permit more efficient use of the parcel)
- The applicants’ previous management of land leases, land management plans, or other experience relevant to the proposed use or ability/willingness to retain individuals with relevant experience
- Potential environmental and land management constraints that may affect or be relevant to assessing the efficacy or viability of the proposed use
- Any other factors the Department deems relevant to the management of the parcel for the proposed use
- Mitigation measures designed to address trust management concerns such as:
 - Construction of improvements at lessee’s expense
 - Payment by lessee of additional or non-standard administrative costs
 - Bonding to ensure removal of any improvements installed for the lessee’s benefit only and which would impair the future utility and leasing income potential of the leased land
 - Bonding to ensure future rental payments due under the lease in cases where the lessee is determined by the Department to pose a significant financial risk because of lack of experience or uncertain financial resources

Application Rejection

If, after the meeting between the applicant and Department staff, the Department’s lease provisions are not acceptable to the applicant, the application will be rejected by the Department.

Appeal of Rejection

The Department’s decision to reject an application is appealable to the Land Board. The applicant will have 20 days to appeal following the receipt of the rejection notice from the Department. Scheduling of the auction will be postponed until the Board has issued its decision on the appeal.

Lease Inspections

Endowment lands included in any lease application will be inspected at the discretion of local Department staff. Inspections are not required, but when conducted, will be documented using the appropriate Department form.

Resource Assessments are no longer required for all expiring leases. Concerns regarding resource management will be addressed in the lease.

IMPROVEMENT CREDITING**File Review and Department Valuation**

When meeting with applicants to develop lease provisions, the Department will also provide the following information based on a file review:

- authorized improvements
- age of improvements
- value of improvements if previously established or estimated valuation range if not so established

Where an established value does not exist, the Department will use the valuation methodology now in place unless otherwise provided in the existing lessee's lease or improvement permit. Objections to the Department valuation can be filed in accordance with IDAPA 20.03.14.102.

Authorization for New Improvements

For improvements authorized after July 1, 2009, the Department will establish, at the time of authorization, an initial value of the improvement using NRCS cost tables or actual value, whichever is less. If the improvement is maintained consistently with lease terms, the lessee shall be entitled to recover the value established at the time of approval from any new lessee of the affected parcel or, at the Department's option, from the Department or, alternatively, to remove the improvement if so authorized by the Department in writing.

CONFLICT AUCTIONS

Minimum Bid If the Department has prepared an improvement credit valuation, the cost of doing the valuation will be used to establish a minimum (starting) bid at the auction. The minimum bid for conflict auctions without improvement credits will be \$250.

Withdrawal Prior to Auction Applicants who withdraw their application prior to the auction or fail to participate (submit a bid) at the auction will forfeit all or part of

- The first year's rental deposit for conflict applicants
- The improvement credit payment for current lessees

The amount forfeited will be the lesser of the Department's cost of making the improvement valuation or the rental deposit/improvement credit payment.

High Bid Payment The high bidder will be required to submit the amount of the high bid at the conclusion of the auction.

Withdrawal After the Auction If the high bidder withdraws or refuses the lease after the auction, the high bid payment will be retained by the state. If the auction involves two participants the second high bidder will be offered the lease. If there are more than two participants, the lease will be re-auctioned.

LAND BOARD REVIEW OF AUCTION RESULTS

Land Board Action The Land Board will review the proposed leases and auction results and make the determination required under Idaho Code § 58-310 consistent with its fiduciary obligations under Article IX, Section 8 of the Idaho Constitution and all relevant statutory provisions.