



STATE BOARD OF LAND COMMISSIONERS

C. L. "Butch" Otter, Governor and President of the Board
Lawrence E. Denney, Secretary of State
Lawrence G. Wasden, Attorney General
Brandon D. Woolf, State Controller
Sherri Ybarra, Superintendent of Public Instruction

Tom Schultz, Secretary to the Board

Final Minutes
State Board of Land Commissioners Regular Meeting
June 16, 2015

The regular meeting of the Idaho State Board of Land Commissioners was held on Tuesday, June 16, 2015, in the State Capitol, Lincoln Auditorium WW02, at 700 West Jefferson Street, Boise, Idaho. The meeting began at 9:01 a.m. The Honorable Governor C. L. "Butch" Otter presided. The following members were present:

Honorable Secretary of State Lawrence Denney
Honorable Attorney General Lawrence Wasden (*via teleconference*)
Honorable State Controller Brandon Woolf
Honorable Superintendent of Public Instruction Sherri Ybarra

For the record, Governor Otter recognized the presence of all Board members, with Attorney General Wasden joining the meeting via conference phone.

1. Director's Report

A. Interest Rate on Department Transactions – June 2015

B. Timber Sale Activity and Information Report – May 2015

DISCUSSION: Director Schultz stated that there are access issues with the Selway Fire salvage timber sale, which was originally projected to bring in revenue of about \$1.7 million. Current valuation has dropped to about \$1.4 million. The landowner has sued the Forest Service to preclude access claiming that the road is not a public road. The Attorney General's office is filing litigation today (June 16, 2015) to join the Forest Service in defense of the action. Governor Otter asked if the Department has met with the landowner. Director Schultz replied the Department has spoken with and met with the landowner. The landowner has objection to the use of the road and the timber sale. Governor Otter noted that the clock is running on the burn and inquired how long it would take to get the issue resolved. Deputy Attorney General Clive Strong replied the effort to get a temporary restraining order and preliminary injunction should go fairly rapidly; the Attorney General's office is moving to expedite that hearing due to the pressing need to auction the timber sale and begin harvest operations as quickly as possible.

C. Division of Lands and Waterways Activity and Information Report – May 2015

DISCUSSION: Director Schultz noted that Bill Barrett Corporation has let go a number of leases in southeast Idaho. Thanks to Deputy Attorney General Edith Pacillo, the Department was able to recover about \$70,000 in back rents and penalties.

2. Endowment Fund Investment Board Manager’s Report – Presented by Larry Johnson, EFIB Manager of Investments

A. Manager’s Report

DISCUSSION: Mr. Johnson began with a follow up to last month's meeting: as part of the discussion on the school board credit enhancement process, Governor Otter had asked about the lottery contribution toward school bond interest payments. Mr. Johnson explained the credit enhancement process is simply a way to guarantee school bonds by the Endowment Fund that reduces the interest rates the school districts pay. That is a small reduction but it is meaningful and saves in the range of \$250,000-\$300,000 a year in school bonds that are currently outstanding. To put that in context, the lottery contribution toward paying school bond interest rates is about \$12,000,000 a year on average. Governor Otter asked if that amount pays all the interest. Mr. Johnson replied that it does not. Governor Otter inquired what is the total interest paid by school bonds in Idaho. Mr. Johnson was not certain, but thought it is approximately \$30 million/year.

Mr. Johnson stated the Endowment Fund reserves are strong. Timber and land income have been very good this year.

B. Investment Report

DISCUSSION: Mr. Johnson reported earnings of half a percent in May, bringing year-to-date returns to 4.8%. Through yesterday, the Fund had lost one percent; fiscal year-to-date returns now stand at 3.7%. All investment managers are performing as expected.

C. Distribution Report

DISCUSSION: Mr. Johnson indicated that the Land Board Asset Management Plan requires the Investment Board to review the distribution policy yearly. There are several aspects to the distribution policy, but generally the distributions are driven off of the three-year average size of the Permanent Fund. The Permanent Fund has been growing and the distributions will be rising. The Investment Board reviewed the policy and recommends that no changes be made. Using the current policy, what follows is an advanced look at likely 2017 distributions, based on balances through March. If the fiscal year closed in March, the Investment Board would likely recommend a 9.6% or \$5.4 million increase in total distributions. Distributions for FY2015 are around \$52 million. Those distributions will rise to \$56.5 million in FY2016, and this analysis implies that the Fiscal Year 2017 distributions will be in the range of \$62 million. No action is needed by the Land Board today. A decision will be requested at the Land Board's August meeting which fits in with the state’s budgeting cycle. The Land Board will establish distribution amounts in August so that agencies can build those distributions into their budgets for consideration by the Legislature in January 2016. The 9.6% total increase equates to 9% for public schools, almost 20% for three endowments, a small increase for three endowments and no increase for the university endowments. Under this scenario about \$28 million of excess

reserves are converted to permanent principal for five endowments that are listed. Reinvestment of some income is essential for the distributions in the permanent funds to keep up with population growth.

Mr. Johnson continued by considering what might change between now and the August meeting to affect distributions. The Fund market earnings through March were about 3.5% and through yesterday are at 3.7%; absent any major changes in the market in the next two weeks returns should be in line with March Fund returns. Land earnings are a facet; land earnings are somewhat higher than what was assumed in March. The Investment Board will also have a new 10-year land revenue forecast being developed by the Department that will be factored into the outlook.

Another aspect to be considered is the auctioning of cabin sites in the past year, with most proceeds being deposited in the permanent funds. That has some impact on how the distribution is calculated because it is a percentage of the Permanent Fund; as earnings assets from the land base are transferred to the Permanent Fund, the ratio of land income to fund income is changed. Investment Board members and staff will look more into the impact of that and discuss it at the August Land Board meeting. That discussion could lead to adjustments in the distributions, particularly for State Hospital South and Normal School. Historical earnings from endowment cabin sites are 23% of total land income for State Hospital and 13% for Normal School.

Governor Otter commented on Mr. Johnson's statement that when assets shift from income liquidity, cabin sites, and become capital, that capital is deposited into the Permanent Fund. Governor Otter asked how endowment beneficiaries could be held whole when capital is taken out of land and placed into the Permanent Fund. Governor Otter remarked that 8% might be significant for public schools. Mr. Johnson explained that the distribution policy in theory looks at all of the assets in total. Shifting assets from one pool to the other does not have a sizeable impact; it has some impact on the technical calculations of what percentage is used to multiply by the Permanent Fund to generate a distribution. There are adjustments made to hold the beneficiary whole. It does not have a major impact on their distribution.

Mr. Johnson provided an extreme example: State Hospital South has very profitable endowment lands, including cabin sites, but also good timber land. Their distribution target is 7% of their Permanent Fund. If all of their land was sold and all proceeds put into the Permanent Fund it would result in a huge distribution because 7% times a much bigger asset number would be a much bigger distribution number. Instead, in that extreme circumstance, the recommendation would not be a 150% increase in State Hospital South's distribution because the overall assets have not essentially changed. A more modest increase in the distribution would be recommended and it would not have a major impact. Mr. Johnson anticipates that endowments will continue to have rising distributions in this period when the Fund has had positive fund returns and the Department has had great land returns.

Governor Otter remarked, in summary, beneficiaries should not anticipate a loss in income when an asset is sold and turned into capital. Mr. Johnson concurred.

D. Commercial Real Estate Fund Update

DISCUSSION: Mr. Johnson recounted that at its December 2014 meeting the Land Board, in conjunction with Callan's report, asked the Investment Board to consider the following items related to the Endowment Fund: adding a diversified portfolio of U.S. real estate, overseen by outside experts; additional international stocks to further diversify the 100% U.S. land base; and a higher or lower equity mix depending on distribution goals. The Investment Board decided to focus first on the commercial property recommendation.

In February 2015, the Investment Board approved, in concept, a \$150 million allocation to commercial real estate in the form of U.S. core open-ended funds. Core basically means that this real estate is primarily leased property with only modest exposure to development risk and essentially no bare land. These are properties that have attractive cash flow and relatively low risk. Diversified means an asset mix of offices, retail shops, and malls, apartments, and warehouses. They would typically be focused in large metropolitan areas where there is a large amount of liquidity and plenty of activity in the real estate market. All management decisions would be made by the fund's manager not by the Investment Board or its staff.

Mr. Johnson continued, saying Callan's recent modeling work found that a diversified pool of U.S. commercial property enhances the Endowment portfolio from a risk return perspective. The total return of between 5% and 7% is expected to be competitive with the existing 70/30 portfolio. More importantly, this return pattern from real estate adds diversification. Many institutional investors have a real estate allocation. Callan also identified some benefits of real estate investments for the overall endowment portfolio. They confirm that an endowment such as the Endowment Fund benefits from a large allocation to real assets. The advantage of adding a diversified U.S. commercial real estate program within the Fund is that it gives the Land Board an effective tool to maintain or increase the real asset component of the overall endowment asset mix.

Mr. Johnson stated there are a few challenges to a real estate investment. It adds a layer of complexity to the management and explanation of the fund portfolio; EFIB cannot immediately rebalance the real estate portion of the portfolio due to leads and lags in buying and selling; benchmarks for real estate are not followed by the public so returns can be a surprise relative to stock and bond returns; finally, it is difficult to transfer the management of properties if one becomes disenchanted with the current manager. Also, investment vehicles appropriate for the Endowment Fund all use leverage, or some form of debt financing, which modestly decreases the income component of the return and increases a bit the downside risk compared to unlevered holdings. The Endowment Fund's current Idaho holdings are unlevered; the Fund holds no debt against those.

Mr. Johnson mentioned that Callan recommended a short list of managers to the Investment Board. EFIB staff is working with Callan performing due diligence on those managers. Around June 30th, the Investment Board plans to retain an outside legal advisor to examine issues that are unique to this asset class; this legal counsel will be appointed as special deputy attorney general. On August 11 the Investment Board is expected to approve an investment plan to prescribe how much of the funding will come from equity and how much from debt, taking into account the Funds' overall asset mix. In mid-August, the Executive Committee of the

Investment Board will select some managers. A final note on the timing of the investment – investments in real estate are made as attractive properties become available or existing owners decide to sell their ownership units in these funds. Full deployment of the \$150 million may take up to three years. Time diversification in a phased investment process is an advantage when investing in real assets.

Mr. Johnson summarized, stating the Investment Board believes that commercial real estate has good potential as a long-term investment for the Endowments; it is appropriate for buy and hold investors such as the Investment Board. Final implementation of this plan will begin in late summer.

Controller Woolf inquired if these attractive properties being considered for investment are outside of the state of Idaho. Mr. Johnson replied they would be outside the state if Idaho. Controller Woolf asked for clarification on the funds recommended by Callan, listed in the Appendix of the report on small page 11: are those six or seven potential funds actually listed on any of the major stock markets; can an individual track and follow these types of funds? Mr. Johnson responded these are private funds and not published to the public; however, EFIB would receive an estimated valuation each quarter.

Governor Otter referred to small page 5, the statement under approved strategy that the Department will opportunistically dispose of grazing lands. Governor Otter asked if the Department is disposing of grazing lands or trading grazing lands. Director Schultz responded that the Callan report did not specify either an auction or a trade. The Land Board has constitutional limitations in terms of how much can be sold on an annual basis and only 320 acres may be sold to an individual during their lifetime. Smaller tracts could be auctioned and proceeds would be reinvested in the Permanent Fund. Landowners with large ranches and multiple endowment parcels within would most likely use an exchange.

- **CONSENT**

3. Strategic Plan FY2016-FY2019 – Staffed by Bill Haagenson, Strategic Planning Manager

RECOMMENDATION: Direct the Department to submit the FY2016 – FY2019 Strategic Plan to the Division of Financial Management by the July 1, 2015 deadline.

DISCUSSION: Director Schultz reviewed some of the larger items in the budget including the Land Information Management System (LIMS) for Forestry and Fire, and for Lands and Waterways; hiring a new strategic planning manager; the 2016 quadrennial water quality forest practices audit. As mentioned by Mr. Johnson, the Department continues with disposition of the cottage sites; between 80 and 100 cottage sites will be auctioned this year. Finally, in the fire program, the Department continues its work with RFPAs to provide them with training in fire suppression.

4. Conservation Easement: Bonner Lake Firehouse Road – Staffed by Karen Sjoquist, Forest Legacy Program Coordinator

RECOMMENDATION: Authorize the Idaho Department of Lands to acquire the Bonner Lake Firehouse Road conservation easement, comprising 45 acres, for \$99,750 plus escrow fees.

DISCUSSION: None.

5. Approval of Minutes – May 19, 2015 Regular Meeting (Boise)

CONSENT AGENDA BOARD ACTION: A motion was made by Controller Woolf that the Board adopt and approve the Consent Agenda. Secretary of State Denney seconded the motion. The motion carried on a vote of 5-0.

- **REGULAR**

6. Request for Proposal for Real Estate Investment Advisor – Presented by Tom Schultz, Director

RECOMMENDATION: Approve the draft Request for Proposal to be used by Callan Associates in the search for a Commercial Real Estate Advisor in substantially the form attached hereto; approve the Commercial Real Estate Advisor Contract in substantially the form attached hereto (subject to negotiation as set forth in the RFP), and approve the process to be used in the selection of the Commercial Real Estate Advisor.

DISCUSSION: Director Schultz noted that the AUM acronym on Attachment 4 did not stand for animal units per month but rather assets under management.

Controller Woolf asked about the length of the term of the contract for this commercial advisor. Director Schultz replied the contract would be in effect through the completion of the asset management plans, with ongoing advice provided regarding management of those contracts. The contract does not have an end date.

Governor Otter inquired if the Request for Proposal (RFP) has a conflict of interest provision and a required listing of those potential conflicts. If an advisor happens to come from Idaho and is engaged in other business in Idaho with a portfolio of similar properties, is there a conflict of interest provision and a required listing of those potential conflicts. Deputy Attorney General Edith Pacillo confirmed that there is a provision on page 10 of the RFP, item number 25, which asks the applicants to describe conflicts of interest in relation to the assignment.

Governor Otter expressed concern about the possibility of using one portfolio to support another, perhaps the sale or the lease of one that would end up conflicting with Endowment assets, and requested assurance that an advisor would not hedge the assets against each other using a pretty sizeable portfolio of Idaho's assets and a wide diversity of almost everything.

Attorney General Wasden asked if there is an immediate need for the Board to approve this item at today's meeting; could it be tabled. Director Schultz stated the pressing need is to keep with the timeline to have an Investment Policy and revised Asset Management Plan in effect by the end of December or early January. As was pointed out, the RFP has language on item 25 that potential advisors must disclose any conflicts of interest; the contract language needs to address it as well, in a consistent manner. Attorney General Wasden asked for clarification that the Director believes the issue is sufficiently addressed, but there is not an urgent need for action today. Director Schultz replied that is correct.

Governor Otter remarked that there is no need to delay. The recommendation now asks the Board to "approve the draft Request for Proposal to be used by Callan Associates in the search for a Commercial Real Estate Advisor in substantially the form attached hereto; approve the Commercial Real Estate Advisor Contract in substantially the form attached hereto (subject to negotiation as set forth in the RFP), and approve the process to be used in the selection of the Commercial Real Estate Advisor." Governor Otter requested that the recommendation include the phrase "including but not limited to inclusion of the conflict of interest disclosure provision."

BOARD ACTION: A motion was made by Attorney General Wasden that the Board approve the recommendation, with Governor Otter's requested modification: Approve the draft Request for Proposal to be used by Callan Associates in the search for a Commercial Real Estate Advisor in substantially the form attached hereto; approve the Commercial Real Estate Advisor Contract in substantially the form attached hereto (subject to negotiation as set forth in the RFP), and approve the process to be used in the selection of the Commercial Real Estate Advisor including but not limited to inclusion of a conflict of interest disclosure provision. Controller Woolf seconded the motion. The motion carried on a vote of 5-0.

7. Grazing Rate Methodology Review – Presented by Mike Murphy, Bureau Chief-Endowment Leasing

RECOMMENDATION: The Department recommends the Land Board establish a process to direct the review of the existing grazing rate methodology and to develop recommended changes for Land Board consideration.

DISCUSSION: Controller Woolf asked for a review of the advantages or disadvantages, what has worked and what has not worked in the past with subcommittees, non-subcommittees, or by using a work group. Mr. Murphy spoke of other subcommittees such as the one used on this issue in 1990 and the more recent cottage site process in 2007. Governor Otter asked if there was an institutionalized process for establishing a subcommittee; Mr. Murphy responded not to his knowledge.

Controller Woolf inquired about any legal or financial timeframes that need to be considered in this process. Mr. Murphy noted there is a practical cost of having meetings and that there are statutory requirements for notifying lessees of the changes in rates. Rent is due in May with six months prior notice; whether the subcommittee is finished in December, or June of next year, changes would not take effect until 2017. Controller Woolf asked if the subcommittee were to not have a recommendation by December/January, does it mean a year lost. Would the subcommittee have to wait until the following year, or is it just the matter of six months notice to

lessees if there was a rate increase. Director Schultz responded that in terms of implementation, there is a requirement of six months notice of a rate change prior to when rent is due. Rent is due in May so whether the subcommittee finished in December or May or June of next year it would not affect any changes until 2017.

Attorney General Wasden commented that the Board's typical process of forming a subcommittee does not occur by motion, it occurs by the Chair exercising the authority. Governor Otter, as President of the Board, has formed several subcommittees in the past including a grazing subcommittee. It can be done by a motion, but it is not normally the process that the Board employs creating a subcommittee. Governor Otter remarked that he did not anticipate including the establishment of a subcommittee in the motion. The motion would approve going forward with a process, then the Chair could exercise, as in the past, the establishment of a subcommittee. Attorney General Wasden added that it is incumbent on the Board to always look at the grazing issue. The Board has a constitutional mandate to obtain the maximum long-term return on grazing lands. Attorney General Wasden expressed curiosity as to what the Board is deciding by deciding to have a process going forward when the Constitution already imposes that process and responsibility. Attorney General Wasden does not envision a process where other persons would be appointed on a subcommittee. It would have to be members of the Board and then other persons would be presenters to that subcommittee.

Governor Otter explained his understanding that today the Board would be giving the approval to proceed with a process, and then the Chair will ask two members of the Board, as done in the past, to form a subcommittee and engage in the formulation of a process. The subcommittee would then come back with recommendation to the Board for that process under the advice of two members of the Board. Director Schultz agreed with the Governor's assessment and noted that the Department looked at this issue 20 years ago and in 2012 a market rent study was completed that suggests it would be prudent to look at this issue again. The Department is looking for concurrence to move forward on this issue; how that process unfolds, whether there is a subcommittee or the Department leads the issue, is at the Board's discretion. Governor Otter informed the Board that with successful passage of the Department's recommendation, he would ask two members of the Board form a subcommittee.

BOARD ACTION: A motion was made by Attorney General Wasden that the Board approve the recommendation. Secretary of State Denney seconded the motion. The motion carried on a vote of 5-0.

Following passage of the motion, Governor Otter put on notice the Secretary of State to Chair and the State Controller to also serve on that subcommittee, pending additional discussion with each.

For the record, at 10:07 a.m. Attorney General Lawrence Wasden (via teleconference) excused himself to attend another meeting.

Background information was provided by the presenter indicated below. No Land Board action is required on the Information Agenda.

- **INFORMATION**

8. Pre-Season Fire Forecast/Update – Presented by Fire Bureau

A. Predictive Services Forecast – *Jeremy Sullens, Wildland Fire Analyst, NIFC*

DISCUSSION: Mr. Sullens gave an overview of weather effects brought on by El Niño and La Niña. The first several months of this year a Modoki El Niño was in effect, which led to a circumstance where the country was split in half: warm versus cool temperatures. What that meant for precipitation was a dry situation west of the Rocky Mountains, a wet center of the country, and a drier condition to the east. In the last month and a half, a traditional El Niño has manifested. There has been a long trend of above-normal temperatures across the northwestern states.

Snowpack levels in Idaho were decent at the beginning of 2015 but due to warmer weather have dwindled significantly across most of the west. Last year drought conditions were significant only in southern portions of the state; this year all of Idaho is in some form of drought.

Precipitation is a key factor in forecasting fire; it is not only how much precipitation is received but when it occurs and what that means for the growth of the grass crop. Even though there is significant drought, an input of precipitation with the right timing can add a significant amount of grass crop leading to a heavy continuous fuel bed underneath the brush. This robust grass crop leads to a condition that allows for rapid fire growth which is evident in some areas of the west.

Above-normal fire activity in the northern half of the state is expected this year. A significant increase in above-normal activity is anticipated across most of the northwestern states including some portions of the northern Great Basin, northern Rockies and Pacific Northwest states that will likely continue through September.

B. Resource Readiness – *David Groeschl, State Forester and Deputy Director-Forestry and Fire*

DISCUSSION: State Forester Groeschl stated readiness reviews have been conducted at each of the Fire Protection Districts. Equipment and crews are staged around the state and are relocated where needed as the various storm fronts move through. The aviation resources, except for the fire boss, are provided by Idaho vendors under exclusive resource contracts. Once IDL brings on the resource it is available and committed to IDL. IDL has price agreements with other aviation resources that are on call to supplement existing resources as needed.

Mr. Groeschl noted that IDL has all of its seasonal resources on board now. All of the first year fire fighters have gone through guard school over the last couple of weeks. IDL hosted an interagency guard school in the northern part of the state with 300 firefighters in attendance. 150 were first-year firefighters who went through basic fire training for a week then attended advanced guard school. This year IDL added another component by hosting an engine academy in Kamiah.

Governor Otter asked how many initial attack crews have been trained at the prison. Mr. Groeschl replied there are three to four crews at the Department of Corrections.

C. Rangeland Fire Protection Associations – *Julia Sullens, South Idaho Fire Liaison, IDL*

DISCUSSION: Ms. Sullens remarked that an additional RFPA, the Shoshone Basin RFPA south of Twin Falls, is operational for this fire season, bringing the total RFPAs to six. Two RFPAs have expanded their boundaries: Saylor Creek expanded to encompass the area in the far southwest corner of the state adding 1.7 million acres in coverage, and Mountain Home RFPA added 66,000 acres south of I-84 in conjunction with US Fish and Wildlife who has supported IDL with additional grant funding to support that expansion. IDL trained 24 additional individuals this year; currently there are about 235 individuals between the six operational RFPAs.

Ms. Sullens mentioned that four other areas have proposed RFPAs. It is anticipated that one or two of those will be ready for the next fire season; Clark County RFPA is the furthest along. Governor Otter asked for clarification of some lines on the map. Ms. Sullens explained that the 'donut hole' shaped areas indicate there is already an existing rural fire district. RFPAs do not overlap existing fire district boundaries.

- **EXECUTIVE SESSION**

NONE

There being no further business before the Board, at 10:31 a.m. a motion to adjourn was made by Controller Woolf. Secretary of State Denney seconded the motion. The motion carried on a vote of 4-0. Meeting adjourned.

IDAHO STATE BOARD OF LAND COMMISSIONERS

/s/ C. L. "Butch" Otter

C. L. "Butch" Otter
President, State Board of Land Commissioners and
Governor of the State of Idaho

/s/ Lawrence E. Denney

Lawrence E. Denney
Secretary of State

/s/ Thomas M. Schultz, Jr.

Thomas M. Schultz, Jr.
Director

The above-listed final minutes were approved by the State Board of Land Commissioners at the July 21, 2015 regular Land Board meeting.