DRAFT REPORT

Analysis of Cabinsite Lease Payment Alternatives

State of Montana
Department of Natural Resources and Conservation

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TABLE OF CONTENTS

EXECUTIVE SUMMARY i

1.0 INTRODUCTION 1

1.1 Present Cabinsite Leasing Program 1
1.2 History of Cabinsite Leasing On State Lands 2

2.0 ANALYSIS OF CURRENT POLICY 4

2.1 Review of 2009 DOR Appraisal Values 7
2.2 Vacancy Rates 11
2.3 Property Taxes versus Lease Fees 12
2.4 Recreational Use 12
2.5 Percent of Lessees who are Montana Residents 12
2.6 Evaluation of Market Lease Rate 13
2.7 Survey of Residential Ground Leases in Western Montana 13
2.8 Evaluation of Leasehold and Assignments 14
2.9 Evaluation of Leasehold and Listings 14
2.10 Management of Improvements 15

3.0 PROPOSALS FOR ASSISTING LESSEES 15

3.1 Possible Provisions for Assisting Low Income Lessees 15
3.2 Possible Changes to the Management of Improvements 17

4.0 ALTERNATIVES FOR THE CALCULATION OF LEASE PAYMENTS 17

4.1 Alternative 1: Current Leasing Policy 18
4.2 Alternative 2: 2009 Phase-in Set Growth 19
4.3 Alternative 3: 2003 Set Growth 21
4.4 Alternative 4: Joint Venture 23
4.5 Alternative 5: Negotiated Rulemaking 25
4.6 Financial Analysis of the Alternatives 26

5.0 REFERENCES 29

6.0 APPENDICES 29

EXECUTIVE SUMMARY

This report provides an overview of the residential leasing program on Montana school trust lands, and analyzes four alternatives for calculating the lease fees for cabin and homesite leases. A fifth alternative, Negotiated Rulemaking, is also discussed.

The Montana Department of Natural Resources (DNRC) administers 802 cabinsites and homesites across the state. Currently 764 sites are considered "active" leases. The following table shows the FY09 cabin and homesite revenue generated by each Trust.

Trust	Leases	FY09 Revenue
Common Schools	319	$438,335
MSU 2nd Grant	195	$501,472
MSU Morrill	2	$4,839
Public Buildings	55	$40,132
Deaf and Blind School	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
U of M	1	$2,230
TOTAL	**764**	**$1,572,028**

Prior to 1983, the state charged nominal annual lease fees. Recognizing that the state was not obtaining full market return for cabinsites, the 1983 State Legislature set the lease fee at 5% of the "lease value" of a cabinsite. In 1989 the Legislature directed the DNRC to use the appraised value of cabinsites as determined by the Department of Revenue (DOR) through their periodic revaluation of property and set the lease rate at 3.5%.

With passage of SB424 by the 1993 Legislature, which directed the Land Board to establish all rates and fees for surface uses, the Land Board established an advisory council to review current lease rates. Upon the recommendation of the advisory council the Land Board maintained the lease rate at 3.5%.

In 1999, in *Montanans for Responsible Use of the School Trust v. State of Montana* (the Montrust case), the Supreme Court ruled in favor of Montrust, and concluded that the lease rate of 3.5% in rule at the time "violates the trust's requirement that full market value be obtained…". As a result of the Montrust case, the Land Board directed the DNRC to establish a negotiated rulemaking committee to establish fair market rate for cabinsite leases. The committee's recommendations were approved by the Land Board and adopted in January 2001. The amendments increased the cabinsite lease rate to 5% of the DOR appraisal value, to be phased in over five years, and addressed how lessees would be compensated for their improvements by a new lessee at the time of assignment.

As required by 77-1-208, Montana Code Annotated (MCA), DNRC uses the DOR regular appraisal values as the basis for calculating lease fees for cabinsite leases. Leases are about half-way through the process of completing a phase-in which, when complete between 2009 and 2013, will bring all cabinsite leases from a lease fee amount of 3.5% of the 1997 DOR value to 5% of the 2003 DOR value.

With release of the 2009 DOR preliminary appraised values in early 2009, it became clear to many lessees that their lease payments would go up significantly over the next several years as 2009 DOR values were used to calculate new lease fees. In general, current discussion of revising the policy for calculate rents is driven by concerns raised by lessees that new rents, based on the preliminary 2009 appraised values, are too high for some portion of cabinsite lessees to pay. Other common arguments include: 1) lease fees are too unpredictable for lessees to predict the future cost of owning a lease; 2) lease durations are insufficient for lessees to obtain long-term financing; 3) DOR appraised values are unrealistic and do not recognize the "bursting" of the real estate bubble or the present economic

downturn; and 4) if no change to current lease structure is made, many cabin and homesites will end up vacant and residential lease revenues will decline significantly.

FINDINGS

- Lease fees have gone up considerably over the last two appraisal cycles. This has led to unpredictable lease fees for cabin and homesite lessees, particularly in the high amenity, high value areas of the state.

- Most lending institutions that provide long-term financing for home construction on leased land require a minimum lease term greater than the expected mortgage term; a few require significantly longer lease terms. Cabin and homesite leases are issued for a 15-year term. A 15-year lease may not be long enough for some lessees to obtain long-term financing. Administrative Rules of Montana currently allow for a 25-year lease term for lending purposes.

- The DOR conducts a statewide appraisal of property every six years, the last being in 2009. In an effort to assess the DOR appraisal values in question, the DNRC evaluated and compared the historic rate of appreciation for state cabin and homesite leases to other sources of land appreciation data. DOR data were compared to data from three different sources; the long-term (20 to 30 years approximately) annual rates of appreciation suggested by these other sources ranges from 6.14% to 6.6%. This would reflect an average rate of appreciation over six years (corresponding to the six year DOR appraisal cycle) somewhere in the range of 42.9% to 46.7%.

  The average change in DOR appraised value from 2003 to 2009 for the state's cabinsite lease sites is 142%. The majority of the cabinsites, 619 sites, which is 81% of all cabinsites, saw an increase of 0% to 200%. A few cabinsites saw appraised values go down between 2003 and 2009. The two sites with the highest rate of increase, at 1142.5% and 1350%, are both in Eastern Montana.

- It is quite possible that new vacancies will occur as some lessees reach the upper limit of their ability to afford the lease fees for their cabinsite and homesite lease. There is no model which currently shows a solid relationship between rents and vacancies, nor demonstrates any causality therein.

  This report concludes that, should rents continue at 5% of the 2009 DOR values, then 20% of leases would have to go vacant to reduce revenue below an anticipated baseline of the income from all leases paying fees that are 5% of the 2003 DOR value with no additional vacancies. This estimate assumes that only the highest-valued cabinsites (cabinsites with the highest lease fees) are vacated.

- An examination of the private market place was conducted to analyze lease rates for similar type properties. Interviews of appraisers, other states, other agencies and research of historic Treasury notes were conducted. Lease rates range from 5% to 13% among the various respondents.

- Staff completed a survey of mobile home lots, recreational vehicle sites and cabins from Kalispell and Seeley Lake. Minimal amenities, if any, are provided and these rents could be considered as comparable to some of the state lease sites in the area used for primary residences having nominal recreational attributes. Cabin rentals from Kalispell to Seeley Lake, both on and by water, were also noted. Rents run from $270 to $1,950 per week, varying by whether they are located on water or not, the amenities included and time of year.

- Staff completed a study of non-family transfers to ascertain if leasehold values were being realized by the lessees. Leasehold value is the interest in property that is realized by a lessee when the lessee receives more than the value of their improvements when the lease is assigned to a new lessee. If the lessee pays market rent, then the leasehold has no market value. However, if the lessee pays less than market rent, the difference between the present value of what is paid and the present value of market rents would create leasehold value for the lessee.

  Thirty (30) assignments in the Seeley Lake area between August 2003 and May 2009 were reviewed, as well as eleven current listings if state leases with improvements. Information on these assignments and listings is provided in Appendix E. Taking into account other explanatory variables, it is evident that generally the rents charged are below market, either because the rate was too low and/or the land value used was too low thus creating substantial leasehold values.

- This report suggests a policy allowing for a rent freeze for low-income cabin and homesite lessees for up to three years. Repayment of any deferred rent would be required.

- This report also suggests modifications to the improvements management policy. This report recommends three specific policy changes:

  a) The time provided to lessees for the sale of improvements should be extended from two years to 3-4 years to provide time necessary for successful marketing and release of the property.
  b) The value of improvements may need to be calculated by a more formulaic process. For example, the value of improvements may be determined using the DOR's assessed value for improvements, or by requiring the lessee to hire an independent, qualified appraiser to value the improvements (using a DNRC-approved scope of work for the appraisal).
  c) The DNRC could offer a Maintenance and Marketing LUL, which would permit the lessee to maintain the improvements and provide for successful marketing and release of the property.

LEASE POLICY ALTERNATIVES

This report presents four developed alternatives for lease fee calculation. An additional alternative includes negotiated rule-making.

<u>Alternative 1: Current Policy</u> – This refers to the rent calculation methods currently in place.

<u>Alternative 2: 2009 Phase-in Set Growth</u> – The lease rate is set at 3.6% of the 2009 DOR value, phased in over five years, and then escalated at a set annual increase of 6.5%.

<u>Alternative 3: 2003 Set Growth</u> – Uses the 2003 DOR values as a base value and assumes annual increase in value to be 6.5% from 2003 forward. Escalates rent at 6.5% annually.

<u>Alternative 4: Joint Venture</u> –Uses the 2003 DOR appraised value multiplied by the consumer price index as the lease rate. This rate may change annually, and range from 3.6% to 5%. When leases sell/assign, lessees would be encouraged to sell for improvements value, plus "leasehold value" which is estimated at 50% of the land value. Seventy percent of the leasehold value obtained would be paid to the State.

<u>Alternative 5: Negotiated Rulemaking</u> – A negotiated rule making committee would be formed with equal representation from DNRC, lessees, the Beneficiaries and other interested parties. Negotiated

rulemaking would proceed as required by statute (2-5-101, MCA). With an arbitrator, the committee would make a new alternative and recommend the concept be formed into administrative rules. There is no financial calculation for this alternative because none of the contributing factors are known.

Key components	**Alternative 1: Current Policy**	**Alternative 2: 2009 Phase-in Set Growth**	**Alternative 3: 2003 Set Growth**	**Alternative 4: Joint Venture**
Sum of Forecasted Rents over 30 years	$249,112,260	$191,794,348	$231,737,511	$141,408,820
Appraisal Source	DOR (2009 value)	DOR (2009 value)	DOR (2003 value increased by 6.5% annually to 2009)	DOR (2003 value)
% of Appraisal Value Used	100%	100%	100%	100%
Rate	5%	3.6%	5%	Variable 3.6% - 5%
Phase-In	Yes	Yes	No	No
Annual Escalator	No	6.5%	6.5%	No
Cap	No	15% above/below 2025 fee, max cap 50% increase; 65% above/below max cap, escalate yearly	Same as Alternative 2	Yes; rate limited to between 3.6% and 5%
Term	15 years	Up to 50 years	Up to 50 years	Up to 50 years
12 Evaluation Criteria				
1) Results in revenue equal to or greater than 2009 revenue?	Yes	Yes	Yes	Yes
2) Lowers the future or predicted lease fee from status quo?	No	Yes	Yes	Yes
3) Provides a lease rate lower than 5%?	No	Yes	Yes; lower than 5% of 2009 DOR value	Yes
4) Provides a predictable lease fee?	No	Yes; escalate annually; value review every 15 years with caps	Same as Alternative 2	Yes; base lease fee is predictable
5) Increases the lease term to provide for lending?	No	Yes	Yes	Yes
6) Lowers 2009 DOR appraised value?	No, assumes 2009 DOR value	No, assumes 2009 DOR value	Yes, uses 2003 DOR value, adjust yearly	Yes, uses 2003 DOR value
7) Provides full market value for the beneficiaries?	Yes	Yes; Lease rate above 3.5% threshold	Yes; Lease rate 5% of adjusted 2009 value	Yes; see financial analysis
8) Eliminates the “A-E” cycles?	No	Yes	Yes	Yes
9) Provides a cap to help mitigate increases and decreases?	No	Yes	Yes	Yes; rate restricted to 3.6% to 5%
10) Clarifies lease administration for both DNRC and lessees?	No	Yes	Yes	Yes
11) Provides consideration for “low-income” residents?	No	Yes; rent freeze for qualifying lessees for limited time.	Same as Alternative 2	Yes; proposes EPTAP-style rent reduction.
12) Modifies the improvements management policy as recommended in the report?	No	Yes; extends time for marketing; provides for lessee maintenance of improvements	Same as Alternative 2	Same as Alternative 2
Alternative 5: Negotiated Rulemaking – The components of this alternative are unknown at this time.				

1.0 INTRODUCTION

With release of the 2009 DOR appraised values in early 2009, it became clear to many lessees that their lease payments would go up significantly. In general, current discussion of revising the policy for calculate rents is driven by concerns raised by lessees that new rents, based on the preliminary 2009 appraised values, are too high for some portion of cabinsite lessees to pay. Other common arguments include 1) lease fees are too unpredictable for lessees to predict the future cost of owning a lease; 2) lease durations are insufficient for lessees to obtain long-term financing; 3) DOR appraised values are unrealistic and do not recognize the “bursting” of the real estate bubble or the present economic downturn; and 4) if no change to current lease structure is made, many cabin and homesites will end up vacant and residential lease revenues will decline significantly.

The Montana Department of Natural Resources and Conservation (DNRC) began investigating in May 2009 what changes to the lease fee process would entail, how lessee concerns might be addressed, and what any changes might mean to projected lease revenues. This report aims to 1) provide a summary of the cabinsite leasing program and its history, 2) review the Department of Revenue (DOR) 2009 appraised values for state cabinsites, 3) investigate real estate markets; 4) evaluate market lease rates; 5) evaluate leasehold interest; 6) evaluate recreational use on state lease sites and 7) assess the current methodology and three alternatives under consideration for calculating cabinsite lease fees.

1.1 Present Cabinsite Leasing Program

Under Montana’s Constitution, the Board of Land Commissioners is identified as having decision-making authority for school trust lands. The Land Board, in turn, delegates to the DNRC the responsibility for practical, day-to-day administration of these lands.

The DNRC administers 802 cabinsites and homesites across the state. Currently 764 sites are considered “active” leases, and 38 lease sites are “inactive” or vacant. Most of the active lease sites (624) are located in western Montana in forested or lakeside areas, with concentrations on Flathead, Echo, Rogers, Placid, Elbow and Seeley Lakes. DNRC also administers a smaller number of leases (140) in eastern Montana. Table 1 provides a breakdown of cabinsite leases by Area and Unit.

Table 1: Cabinsites by Area/Unit

AREA OFFICE											
CLO		**ELO**		**NELO**		**NWLO**		**SLO**		**SWLO**	
UNIT	**#**	**UNIT**	**#**	**UNIT**	**#**	**UNIT**	**#**	**UNIT**	**#**	**UNIT**	**#**
HEL	7	*NA*	22	HAV	6	KU	149	*NA*	16	ANA	1
BOZ	17			GLA	26	LIB	4			CLR	318
CON	7			LWT	35	PLA	66			MIS	16
DIL	3					SSF	71			HAM	0
						SWN	0				
Subtotal	**34**		**22**		**67**		**290**		**16**		**335**
Total											**764**

As required by 77-1-208, Montana Code Annotated (MCA), DNRC uses the DOR regular appraisal values as the basis for calculating lease fees for cabinsite leases on state trust lands. All DNRC cabinsite leases are assigned to a “cycle,” labeled A, B, C, D or E. Roughly one-fifth of all leases are assigned to each cycle

and renewed over a five-year period, resulting in a staggered lease fee review. Nearly all the leases are in the process of completing a phase-in which, when complete between 2009 and 2013, will bring all cabinsite leases from a lease fee amount of 3.5% of the 1997 appraised value to 5% of the 2003 appraised value.

With the staggered lease fee review and the DOR reappraisal schedule (operating on a six-year cycle), some leases experience a substantial lease fee increase at the time of review. To mitigate the impact of these increases, the five-year phase-in process, first initiated for the 5% rate implementation in 2003, is being used again for the 2009 reappraisal. Beginning January 1, 2010, the A and B cycle leases (which will have by that time completed their phase-in to the 2003 values) will begin a new five-year phase-in to 5% of the 2009 appraisal value. Thus over the five-year period, the new lease fee will phase in by an additional 20% of the increase each year until the lease fee for A and B cycle equals 5% of the 2009 value. The lease fee during the sixth year will be identical to the fee in year five. The process described here will be implemented for C, D and E leases as well once they complete their phase-in to the 2003 values. It is presumed that a phase-in will be implemented for the 2015 DOR appraisal values as well.

Table 2: Cabinsite Leases and Revenue by Trust

Trust	Leases	FY09 Revenue
Common Schools	319	$438,335
MSU 2nd Grant	195	$501,472
MSU Morrill	2	$4,839
Public Buildings	55	$40,132
Deaf and Blind School	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
U of M	1	$2,230
TOTAL	**764**	**$1,572,028**

1.2 History of Cabinsite Leasing On State Lands

1889: Under the Enabling Act of 1889, Congress granted the State of Montana over 5.8 million acres of land. The Act required that any proceeds from these state lands be held in trust for the benefit of public education. The Enabling Act and the Constitution provide that the lands be administered to return “full market value” to the beneficiaries.

1940-50’s: The majority of the cabinsite leases were developed in the late 1940s and early 1950s, and lease fees were reportedly nominal. Initially an annual lease fee of $5.00 was assessed. Later on the lease fee was raised to $50 and $75 annually, with more desirable lots in such places as Placid Lake and Flathead Lake going for $150 annually.

1983: Recognizing that the state was not obtaining a market return for cabinsites, the 1983 State Legislature set the lease fee at 5% of the “lease value” of a cabinsite. The DNRC appraised all residential sites and identified the lease value to be 70% of the appraised market value. The 5% lease rate was applied to the 70% of the appraised market value (Appraised value X 70% X 5% = annual lease fee). This method of assessment became effective in 1988.

1988: Beginning in 1988, leases were renewed for a 15-year term (using the new method of lease fee assessment described above) with annual lease fee review conducted every five years. Approximately one-fifth of the leases renewed each year from 1988 to 1992. Leases renewed in 1988 were termed “A” leases; those renewed in 1989 were termed “B” leases, and so on. Thus was established the current staggered renewal cycle.

1989: SB 226 passed by the 1989 Legislature directed the DNRC to use the appraised market value of the cabinsite lease lots as determined by the DOR through the statewide periodic revaluation of property pursuant to Title 15, MCA. This bill also set the lease rate to 3.5% (which is 70% of 5%) of market value.

1993: SB 424 passed by the 1993 Legislature directed all rates and fees for surface uses of state trust land be determined by the State Board of Land Commissioners.

1994: John Duffield, a Missoula economist, conducted an analysis of fair market lease rates for all uses of state trust lands. In his analysis of cabinsites on Montana school trust lands, "Task 2: Analysis of Cabin Lease Rates," he states that "from the standpoint of the [state] school trust, the rental rate should be at a fair market level" [Executive Summary]. Duffield presents three different models for deriving a market lease rate. The first model resulted in a "market rate" of 6.6%, the second model 10.5%, and the third model 12%.

The Land Board established an advisory council to review current lease rates and make a recommendation to the Board as to what would be an appropriate lease rate. Upon the recommendation of the advisory council the Land Board maintained the lease rate at 3.5% of the appraised market value as determined by the DOR, and increased the minimum fee from $150 to $250 annually. Additionally, the Land Board accepted the council's recommendation to increase grazing rates.

1999: In response to the Land Board's decision to hold lease rates at 3.5% despite the findings of the Duffield Study, the state found itself in court in *Montanans for Responsible Use of the School Trust v. State of Montana*. The plaintiff, also known as "Montrust," charged that the statutes and rules regulating payments for right-of-way and leases of state-owned cabinsites failed to ensure full market return to the trusts (in its case Montrust made reference to the Duffield study mentioned above). On this basis, claimed Montrust, the statutes and rules were unconstitutional. The Supreme Court ruled in favor of Montrust, and concluded that the lease rate of 3.5% in rule at the time "violates the trust's requirement that full market value be obtained for the school trust lands and interests therein."

In its opinion dated November 2, 1999 (Appendix D), the Court held that any statute affecting state trust lands must be "consistent with the constitutional mandates of the trust and the state's fiduciary duties as a trustee." The court also confirmed that the state's management of trust lands would be judged by principles applicable to private trusts and described that duty as follows: "When a party undertakes the obligation of a trustee to receive money or property for transfer to another, he takes with it the duty of undivided loyalty to the beneficiary of the trust. The undivided loyalty of a trustee is jealously insisted on by the courts, which require a standard with a "punctilio of an honor the most sensitive." A trustee must act with the utmost good faith towards the beneficiary, and may not act in his own interest, or in the interest of a third person."

2000: As a result of the Montrust case and Supreme Court decision, the Land Board directed the DNRC to establish a negotiated rulemaking committee, charged to negotiate and develop rules that would provide for full market return from cabinsite leases. *Negotiated rulemaking provides a process whereby state agencies may resolve controversial issues by allowing*

interested parties to participate on a limited basis in agency rulemaking prior to formal rulemaking and adoption.

The eleven member committee (comprised of three cabinsite leaseholders, two representatives of the trust beneficiaries, one representative of Montrust, three representatives of the Land Board, and two members of the DNRC Trust Land Management Division) represented the various interests in the cabinsite lease rate discussion. The committee's proposed recommendations were approved by the Land Board, and the amendments to ARM 36.25.102 and 36.25.110 were adopted January 12, 2001. The amendments increased the cabinsite lease rate to 5% of the DOR appraisal value, to be phased in over five years and addressed how lessees would be compensated for their improvements by a new lessee at the time of assignment (See Appendix F for the Final Committee Report and Meeting Minutes).

2.0 ANALYSIS OF CURRENT POLICY

As mentioned above, the DNRC uses the DOR regular appraisal values as the basis for calculating lease fees for cabinsite leases on State Trust Lands. The DOR conducts a statewide appraisal of property every six years, the last being in 2009. The 2009 DOR values are preliminary until final verification by the DOR, currently expected in August 2009.

Montana statute 77-1-208 MCA indicates that the DNRC will use DOR appraisal values, while the next statute 77-1-209 MCA describes the Land Board's authority to make rules related to the leasing of state lands, setting all fees and rental rates for the use of state lands for any purpose. Administrative Rules of Montana 36.25.110 describes the current lease fee calculation methodology, which was the result of negotiated rule making. (Appendix G)

The change in DOR appraised value between 2009 and 2003 for the state's cabinsite lease sites ranges from 1142.5% and 1350% increase (both sites are in Eastern Montana) to the average increase of 142%. Approximately 81% of all cabinsites, 619 sites, saw an increase of 0% to 200%. A few cabinsite appraised values went down from the 2003 value to the 2009 preliminary value.

A summary of appraised value changes by Area Office follows in Table 3. The alternately shaded rows in the lower portion of the table show the distribution of cabinsites across the range of value change.

An analysis of the actual 2009 cabinsite revenue provides the following:

- The 2009 statewide revenue from the 764 active cabinsite leases is $1,572,028. The average annual lease fee for 2009 is $2,058. In 2009, 398 lessees owed more than average of $2,058, 366 lessees owed less.
- Among the 624 active cabinsite leases in western Montana, the 2009 revenue is $1,506,474 and the average 2009 lease fee is $2,414.
- Revenue from the remaining 140 cabinsite leases is $97,819 for 2009, averaging $699 for a 2009 lease fee in eastern Montana.

Among the higher-value sites of western Montana, the change in rents closely follows the change in values. In eastern Montana, however, rents show a smaller rate of change due to the fact that many lessees were paying the minimum rent amount of $250 as required by statute, which equaled more than

5% of the appraised value of their cabinsite. The distribution of asset appreciation rates among cabinsite leases can be seen in Figure 1. Figures 2, 3 and 4 show the distribution of appraised value by the rate of change experienced between the 2003 and 2009 DOR appraisals for all cabinsites statewide, for the west side cabinsites, and the east side cabinsites, respectively.

Table 3: Comparison of Average 2003 and 2009 Appraised Value, by Area Office

	AREA OFFICE						
	CLO	**ELO**	**NELO**	**NWLO**	**SLO**	**SWLO**	**Grand Total**
Average 2003 Value	$34,383	$2,746	$8,459	$62,727	$12,310	$45,607	**$46,538**
Average 2009 Value	$81,106	$7,422	$13,407	$181,072	$28,461	$77,257	**$108,567**
Average Appreciation	137%	251%	99%	198%	143%	95%	**142%**
Average 2003 Rent*	$1,719	$270	$477	$3,141	$621	$2,280	**$2,337**
Average 2009 Rent*	$4,055	$423	$699	$9,054	$1,423	$3,863	**$5,432**
Average Rent Increase*	137%	52%	41%	193%	135%	95%	**129%**
Range of Value Changes, %							
500+		3	2	19			**24**
400-500		2		9			**11**
300-400	3	1	4	2	2		**12**
200-300	5	4	1	63	3	7	**83**
100-200	9	5	5	175	5	127	**326**
0-100	17	3	46	28	4	195	**293**
0 change		3	6				**9**
0-50% Decrease		1	3		2	11	**17**
	34	**22**	**67**	**296**	**16**	**340**	**775***

**Table 1 includes 12 cabinsites with inactive or terminated lease status. It should also be noted this table depicts average rents for cabinsites, calculating rents as 5% of the appraised value, which is what lessees are obligated to pay. However, due to management practices which include phasing in rent increases over five years, actual revenues in any given year are less than 5% of appraised value for all sites.*

Figure 1: Distribution of Change in Cabinsite Value among the 764 Active Leases

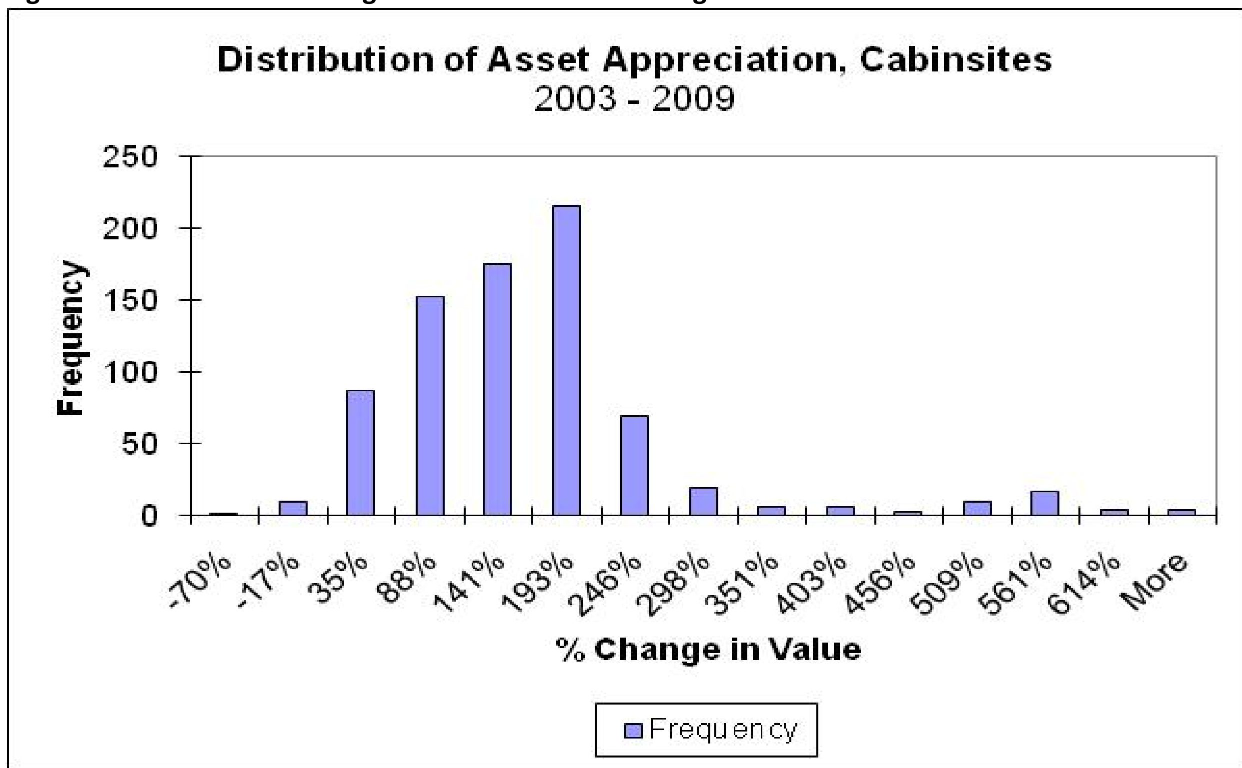


Figure 2: Distribution of Appraised Values by Percent of Change, Statewide

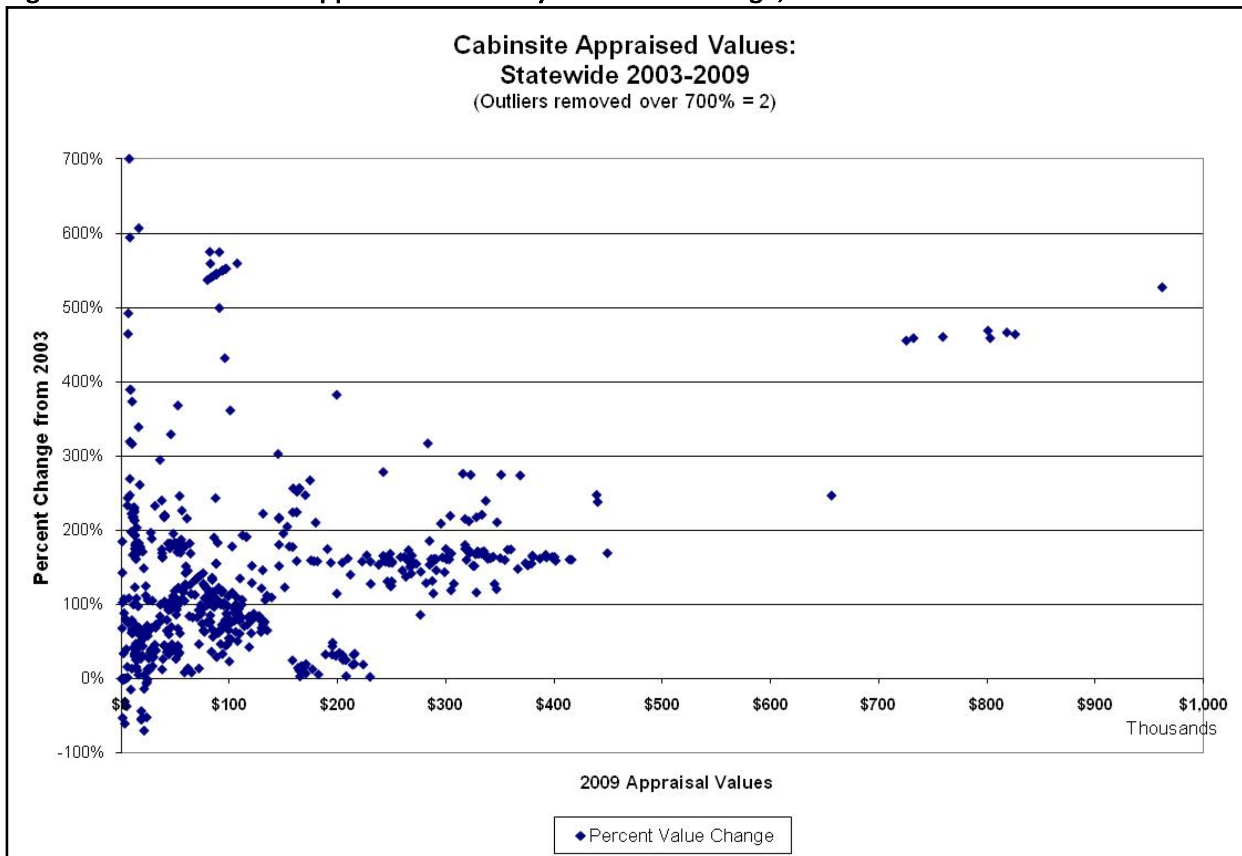


Figure 3: Distribution of Appraised Values by Percent of Change, Western Montana

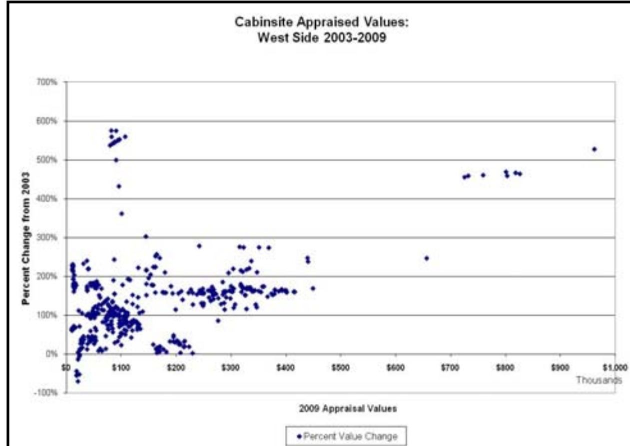
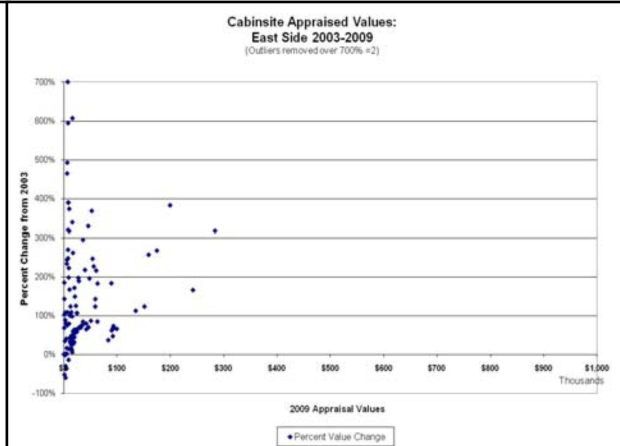


Figure 4: Distribution of Appraised Values by Percent of Change, Eastern Montana



A comparison of the rents for calendar year 2009 with the preliminary 2009 values from DOR suggests that the lease rate paid was 2.01% of appraised value. Those same calendar year 2009 rents compared with the 2003 appraised values shows the lease rate paid is 4.74% of appraised value. A large part of the reason for this is the fact that the highest rates paid in 2009 were 5% of the 2003 appraised value, and downward from there. Some groups of lessees are still phasing in from 3.5% of the 1997 value to 5% of the 2003 value – roughly 400 of 764 active leases have not reached this benchmark. Assuming positive appreciation of cabinsite values statewide, the real rate of return obtained by the state, as calculated by dividing the previous year's appraised values by the current year's real revenue, never reaches 5%.

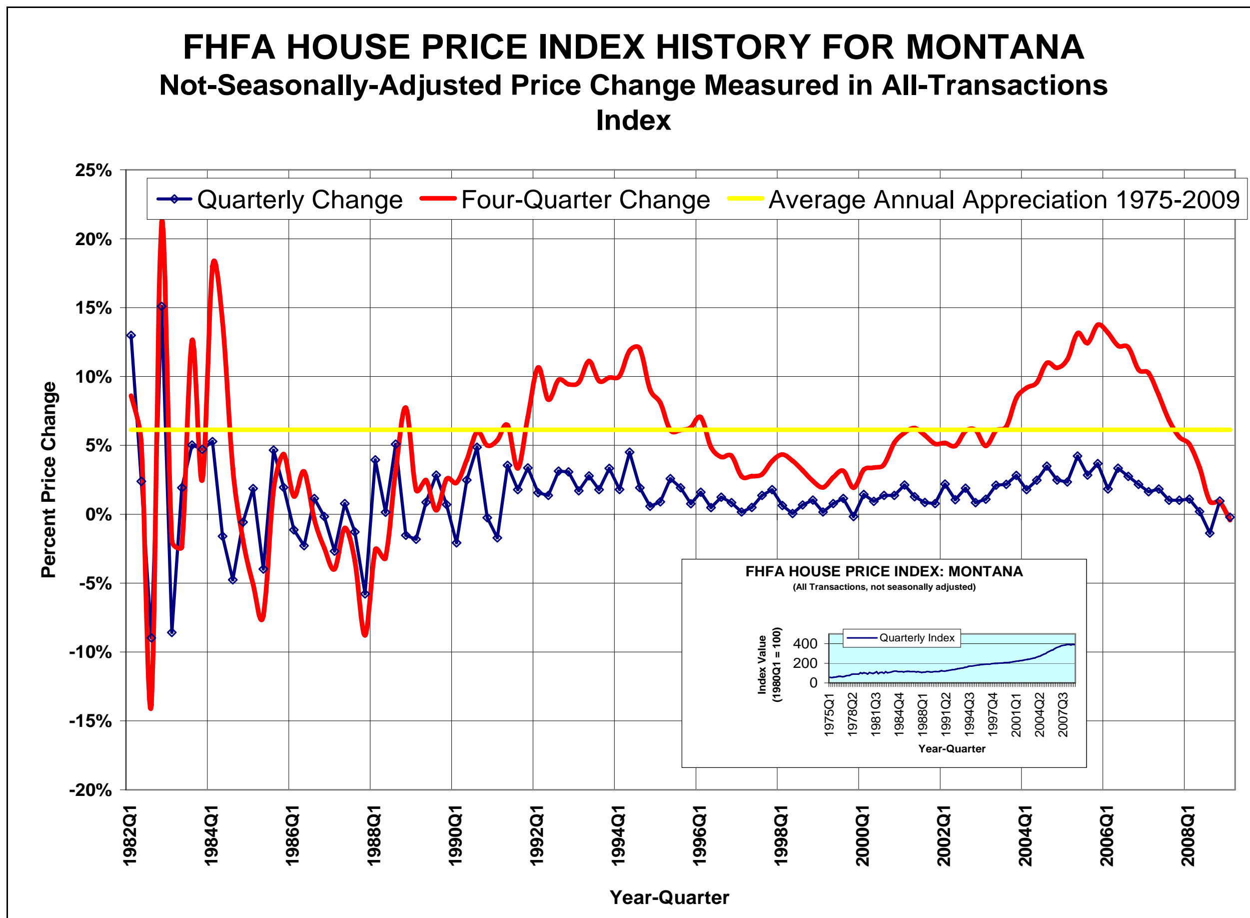
2.1 Review of 2009 DOR Appraisal Values

In an effort to assess the DOR appraisal values in question, the DNRC evaluated and compared the historic rate of appreciation for state cabin and homesite leases to other sources of land appreciation data.

FHFA House Price Index

One available comparison is provided by the Federal Housing Finance Agency's (FHFA) House Price Index. The FHFA has access to all conforming Fannie Mae and Freddie Mac mortgages and the attached sale or refinance amounts, and uses only properties for which there are pairs of repeat transactions. The all-transactions, not-seasonally adjusted index is available for Montana as a quarterly index from 1975-Q1 through 2009-Q1. Figure 5 displays this information graphically.

Figure 5: FHFA Housing Price Index History for Montana



The small chart inset shows the index itself, representing the trend in Montana house prices from 1975-present (base point 1980Q1 = 100.) The index is converted to percent changes for the larger chart: the blue series illustrates percent change in value over the previous quarter. The red series illustrates, for any given quarter, the percent change over the same quarter of the previous year, or the annual appreciation. The average annual appreciation of Montana values in this index from 1975Q1 – 2009Q1 is 6.14%. The index drops 0.43% in 2009Q1, which is a 0.21% annual drop from 2008Q1 values. This does provide support for the concept that 2008 values are a high mark for current 2009 market conditions. However, current values in Montana according to the all transactions index for 2009Q1 are 66.41% higher than 2002Q1 –certainly values have not dropped in relation to values from 2002, which corresponds to the last Montana DOR appraisal cycle.

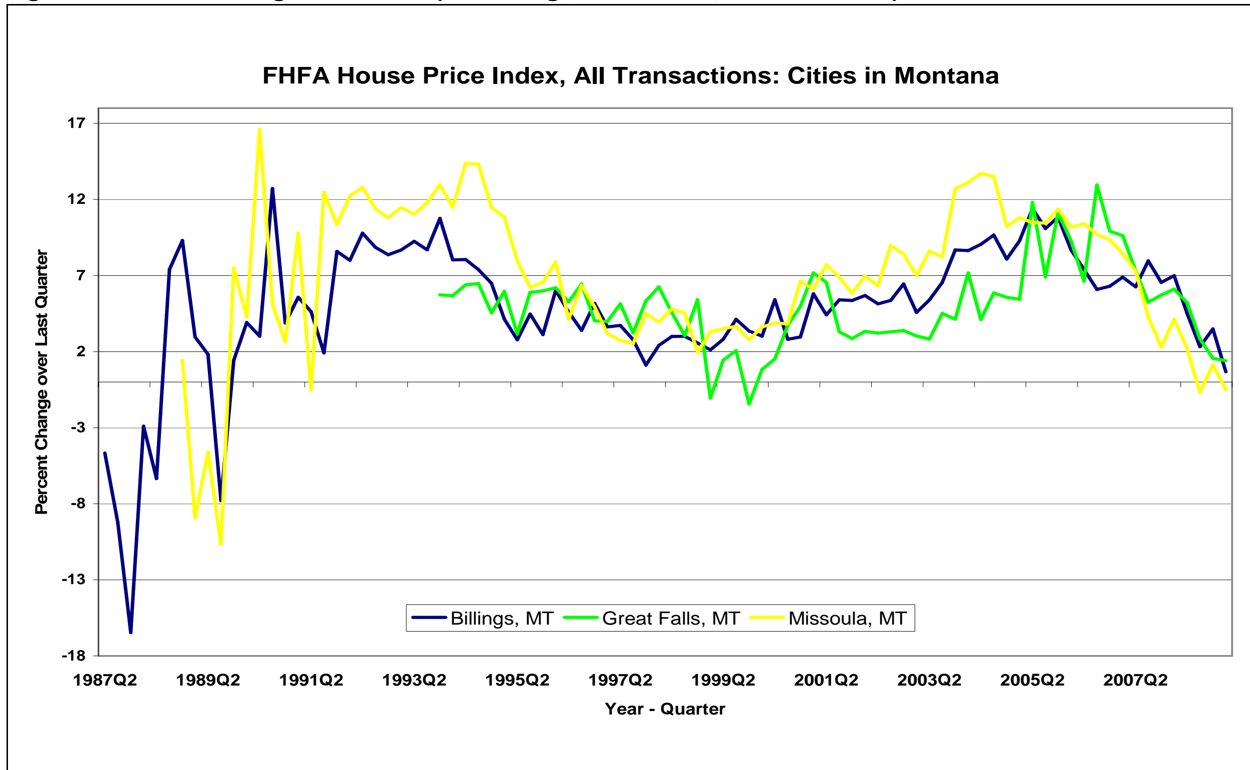
The House Price Index is also available in multi-state regions, or for specific metropolitan areas. The statewide index is most appropriate for this review, as the cabinsite rents are calculated identically for the entire state. However, the only three cities in Montana for which the index data is available are presented here for brief comparison.

Montana Department of Revenue Historic Values

A second source of data is the historic values from the DOR appraisal cycles beginning in 1982 (shown in Table 4). The DNRC has these values for cabinsites in five counties: Missoula, Lake, Flathead, Sanders and Lewis & Clark. While reviewing these data does not help with assessing the validity (or lack thereof)

in the DOR 2008 appraisals, it does provide useful comparison to the rates of appreciation shown by the DOR. The resulting understanding of long-term cabinsite value appreciation may be useful in devising an annual escalation rate for cabinsite lease fees that would provide predictability to a lease fee over a 15-year period.

Figure 6: FHFA Housing Price Index (for Billings, Great Falls, and Missoula)



The DOR values in Table 4 show an average annual value appreciation of 6.53% over the 20 years from 1982-2003, similar to the long-term average appreciation shown in the FHFA index. When the preliminary 2009 values are used, the average annual appreciation jumps to 8.81% from 1982-2008, which reflects the rapid climb in market values over the recent six years. Using the 2003 and 2009 DOR values for all active 764 cabinsites, the average annual appreciation is 16%.

Neil Appraisals

A third source of data is the historic appraised values for the DNRC-administered cabinsites. Prior to 1998, the DNRC used independent appraisers to determine the values of state cabinsites. Data were pulled from a DNRC report dated January 2, 1979 which summarized the results of appraisals performed by an independent contractor, the Neil Appraisal Company. In 1976 Neil Appraisal Company appraised 409 cabinsites, and in 1978 they appraised an additional 213 cabinsites. The average value of cabinsites in 1976 was $7,468; the average for cabinsites valued in 1978 was $5,250. Note that the difference in the average value between the two years is due to the relative mixture of waterfront and non-waterfront sites and does not reflect a decrease in value in the two-year timeframe.

Table 4: DOR Cabinsite Values, 1982 to 2009

Cabinsite Values, 1982 to 2009							Avg Annual Appreciation	
	Total 1982	**Avg 1982**	**Total 2003**	**Avg 2003**	**Total 2009**	**Avg 2009**	**1982-2003**	**1982-2009**
Missoula	$2,568,400	$10,570	$13,982,893	$50,663	$23,095,704	$83,680	8.15%	8.28%
Lake	$839,200	$28,938	$2,222,284	$65,361	$9,228,415	$271,424	4.16%	8.99%
Flathead	$3,537,107	$19,017	$15,785,445	$84,414	$44,814,470	$239,650	7.74%	10.24%
Lewis & Clark	$329,730	$4,996	$1,628,422	$23,947	$3,974,110	$54,440	8.15%	9.62%
Sanders	$142,300	$2,259	$346,800	$5,419	$847,837	$12,846	4.47%	6.91%
						Average	6.53%	8.81%

To reach a conclusion about the nominal appreciation of the specific cabinsites appraised in 1976 or 1978, we averaged the values for each neighborhood and compared the average to the average value from the DOR's 2003 appraisal cycle. The average annual appreciation was 6.6% across all neighborhoods for the 24- and 26-year time span. The range of average annual appreciation reaches from a low of 1.01% for the Mudd Creek cabinsites in the Northwest Land Office to a high of 15.26% for Beaver Lake, also in the Northwest Land Office. There were eight neighborhoods with higher than 10% annual appreciation, all of which were lake front/view cabinsites.

Lease Value versus Appraised Value

The legislature and Land Board use the terms "lease value" and "appraised value" in setting the lease fee for cabin and homesites. These two terms differ as follows: In 1983 the term "lease value" was used when the lease fee was set; DNRC appraised value of the land x 70%, resulting in "lease value" x 5% lease rate = lease fee amount. Then in 1989 the Legislature directed the DOR to provide the appraisal of cabin and homesites and changed the calculation of the lease fee to 3.5% (which is 70% of 5%) of the DOR appraised value.

Thus the lease fee calculations adopted in 1983 and 1989 was generally the same, and in theory did not change the resulting lease fee charged for a given cabinsite. Further, it was believed at the time that the resulting lease fee accounted for the terms and conditions posed by the current lease contract that did not support charging a higher lease amount; for example the lessee's responsibility for road maintenance and weed control as provided in their cabinsite lease.

Note that in both 1983 and 1989, while one factor was lowered, the corresponding factor was raised. When the appraisal percentage went up from 70% to 100%, the lease rate went down from 5% to 3.5%. Reducing the appraised value *and* the lease rate to provide for an acknowledgement of "lease value" would result in over-accounting for the factor.

The factors inherent to the land should be reflected in the land valuation (location, desirability etc.), and the factors inherent in the lease (use restrictions, risk uncertainty, etc.) ought to be reflected in the cap rate conclusion. Under no circumstance, however, should one discount a property's fee value for poor access, to use an example, then make a similar discount to the cap rate for that poor access. Even more blatant an error is penalizing the fee simple value conclusion of the lot for issues stemming from the lease-the fee value and the restrictions of the lease are entirely separate matters, and as much as possible must remain so to maintain the integrity of the analysis. (Knipe and Knipe 1998)

Conclusion

The above three separate analyses of historic property values for Montana points to range of annual land appreciation of 6.14% to 6.6% per year (FHFA House Price Index: 6.14% from 1975Q1-2009Q1, Montana DOR data from 1982 and 2003 cycles: 6.53%, and Neil Appraisal Company data 1976-78 vs DOR 2003 values: 6.6%.). This would reflect a six year appreciation rate (corresponding to the six year DOR appraisal cycle) from 42.9% to 46.7%.

If the methodology for the calculation of cabinsite rents is to be changed to some form of annual escalation, these data suggest the increase in rents should be set to 6-7% annually in order to simply keep the ratio of annual revenue to market value of all cabinsites static. Setting an annual escalator lower than this range suggests the rate of return on these cabinsites held in trust will decline over time.

2.2 Vacancy Rates

Current Vacancy

It is quite possible that new vacancies will occur as some lessees reach the upper limit of their ability to afford the rent fees for their cabinsite and homesite lease. There is no model which currently shows a solid relationship between rents and vacancies, nor demonstrates any causality therein.

Table 5: Family and Non-Family Transfers, 2005 to 2008

Year	Family Transfers	Non-Family Transfers	Total (for year)
2005	21	45	66
2006	32	48	80
2007	34	28	62
2008	28	19	47
Total	**115**	**140**	**255**
Avg. Non-Family Transfers per year			35
Avg. Percentage of Turnover per year			4.58%

Looking at the non-family transfers, which could happen for many reasons besides cost, the turnover rate averages less than 5% per year from 2005 to 2008, which is really quite low. The family transfers during the same period total 115, and appear to support the desirability of retaining a lease or it wouldn't have remained in the family. A summary of the lease assignments from 2005 through 2008 is presented in Table 5.

Potential Vacancy

The question has been raised: "If an increase in rent to 5% of the 2009 DOR values causes some leaseholders to cancel their leases, exactly how many of the 764 cabinsites currently under lease must go vacant to reduce total revenue if rents were otherwise frozen at 5% of the 2003 DOR values and assuming no lessees abandon their lease?"

In an analysis of the full rent amounts based on the two appraisals, with no regard for which year the phase-ins are completed, the total revenue based on 5% of 2003 values is $1,731,814 and the total revenue based on 5% of 2009 values is $4,202,499. By arranging the cabinsite leases in descending order by their 2009 value rent amounts, and subtracting the annual rent payment from each successively until total expected annual revenue drops below the 2003 revenue total, then 20.3% of the currently active leases would have to be abandoned.

These numbers suggest that should the DNRC implement new rents as 5% of the 2009 DOR values, roughly 155 lessees (20.3% of leases) would have to abandon their leases for the cabinsites revenue to drop below the level of rents based on 2003 values. This estimate assumes that only the highest-valued cabinsites (cabinsites with the highest rent payments) are vacated.

2.3 Property Taxes versus Lease Fees

It has been suggested that the lease fee should be no more than the property tax rate for the land (assuming the lands were not tax-exempt). Residential lessees pay taxes on improvements the same as do the owners of fee simple land; lessees, however, pay no taxes on the leased land itself. Lessees of commercial leases pay property taxes on the land in addition to an annual lease fee.

Taxes are a taxpayer's portion of a specific budget amount that is used to provide a variety of public services such as snow plowing, libraries, road maintenance, and the like. Government tax rates are not calculated with a view toward market rental rate or "return on investment;" rather, the intention of a tax rate is to generate an amount of revenue necessary to support a certain level of public services.

Lease fees, however, represent a return on the state's investment for the land leased for cabinsites. Investors typically want an investment to grow, not just to satisfy existing costs; therefore, lease fees would necessarily be higher than the cost of managing the cabinsite leases.

The comparison of cabinsite lease rates to tax rates is not appropriate. See Appendix A for a direct comparison of what an owner of the property or similar property would pay in property tax.

2.4 Recreational Use

The DNRC is often asked to clarify how the statutes that provide for public use along water bodies affect cabinsite leases on lakes and rivers.

The statute, 77-2-311, MCA, states that the 100' strip along the waterfront that is reserved from sale under 77-2-303 is also reserved for the use and enjoyment of the public. The DNRC has clarified that while 77-2-311 reserves the 100' strip along the navigable water bodies for public use and enjoyment, it does not mean that a recreationist has the right to recreate on a cabinsite/homesite lease that borders a water body. State statute, 77-1-804, MCA, empowers the Land Board to categorically close cabin and homesite leases from recreational use. The Board has exercised that right through the provisions contained in Administrative Rule 36.25.150. Although there is conflict between the authority for the public right of use under 77-2-311, MCA vs. prohibiting such activities under 77-1-804(3), MCA, it has been determined that because 77-1-804 is the more specific statute, it supersedes 77-2-311 MCA, and these lands remain categorically closed.

Therefore, cabin and homesites are closed to general recreational use, and the public does not have the ability to use the 100' strip described in 77-2-311. The public has the right to access the land between the low and high water mark on all lands, whether state or private land, as provided under the Stream Access Law (22-2-301 *et seq*, MCA).

2.5 Percent of Lessees who are Montana Residents

Eighty-eight percent of residential lessees have Montana mailing addresses (675 of 764 lessees = 88%).

2.6 Evaluation of Market Lease Rate

An examination of the private market place was conducted to analyze lease rates for similar type properties. Interviews of appraisers, other states, other agencies and research of historic Treasury notes were conducted. Table 6 summarizes the findings.

Table 6: Lease Rate Comparison for Other Public Agencies

State/Agency	Lease Rate (% of Appraised Value)
USFS	5% (reappraised every 10 years)
California	10%
Idaho Trust Lands	2.5% (in the process of changing rate to 5%)
Minnesota Trust Lands	9% five year leases reappraised every five years
Idaho State Parks	5%
Residential leases, Utah and Wyoming	5% – 5.5% (University of Idaho Report)
Typical investor return	7% -9%
30-year mortgages	6.04%
AAA Corporate Bonds	5.63%
20-year Treasury Bills	5.77%
30-year Treasury Bills	8%
Duffield Study	8% - 12%
10-year REIT	10.7% (University of Idaho Report)
35-year REIT	13.3% (University of Idaho Report)
Knipe & Knipe, 1998	6.5% - 13%

2.7 Survey of Residential Ground Leases in Western Montana

A survey was conducted by phone and internet of mobile home lots and recreational vehicle sites from Kalispell and Seeley Lake. Table 7 summarizes the rents charged at mobile home parks in Kalispell and Seeley Lake. Minimal amenities, if any, are provided and these rents could be considered as comparable to some of the state lease sites in the area used for primary residences having nominal recreational attributes.

All the RV campgrounds provide some level of on-site amenities; however, these amenities are shared and the rental site is little more than the area covered by the RV. Table 8 summarizes the findings.

Cabin rentals from Kalispell to Seeley Lake, both on and by water, were also noted. Rents run from $270 to $2,500 **per week**, varying by whether they are located on water or not, the amenities included and time of year.

Table 7: Mobile Home Parks, Kalispell And Seeley Lake

Location	Rate	Annual Cost
Kalispell, off water	$255-$350 per month + utilities	$3,060 - $4,200*
Kalispell, on river	$175-$193 per week for 8 month season	$5,888*
Seeley Lake, off water	$200 per month + utilities	$2,400*
**Typical size of lot is less than ¼ acre*		

Table 8: RV Sites, Kalispell And Seeley Lake

Location	Rate	Annual Cost
Kalispell, on river	$184 weekly, April – November	$6,256
Flathead Lake, across road from lakeshore	$525 per month (sites are 27'x45' and 27'x70', or .028 and .043 acres, respectively)	$4,200*
Kalispell, off-water RV sites	$310 - $640 per month	$2,480 - $5,120*
Seeley Lake	$175 per week	$5,950*
**Eight month season*		

2.8 Evaluation of Leasehold and Assignments

A study was done of non-family transfers to ascertain if leasehold values were being realized by the lessees. Leasehold value is the interest in property that is realized by a lessee when the lessee receives more than the value of their improvements when the lease is assigned to a new lessee. If the lessee pays market rent, then the leasehold has no market value. However, if the lessee pays less than market, the difference between the present value of what is paid and the present value of market rents would create leasehold value for the lessee.

Thirty (30) assignments in the Seeley Lake area between August 2003 and May 2009 were reviewed. Sales prices and closing dates were compiled along with the new 2009 appraised values of the improvements as supplied by the Montana Department of Revenue along with information the cadastral system. This information is included in Appendix E. Certain interpolation of improvements values relative to sale dates and dates of valuation were required. Based on the parameters indicated above, in 25 of the 30 sales lessees realized leasehold value at the time of assignment. Table 9 provides a summary of the 25 lease assignments providing leasehold value to the lessee.

Some factors may lower these leasehold value amounts somewhat; for example, if significant personal property is included in the sale, or the accuracy of the improvements valuation is questionable. However, it is still evident that generally the rents charged are below market, thus creating substantial leasehold values.

Kalispell Info and Appendix reference…

Table 9: Leases Receiving Leasehold Value, 2003 to 2009

Number of Leases Assigned	Leasehold Value to Lessee
4	$16,000 - $18,000
7	$21,000 - $40,000
9	$45,000 - $85,000
5	over $100,000

2.9 Evaluation of Leasehold and Listings

Through a search of information on the internet, eleven listings of State leases with lessee improvements were obtained. This information is included in Appendix E. Asking prices were compiled along with the 2009 appraised values of the improvements as supplied by the Montana Department of Revenue. Limited review of these listings indicates that 9 of these 11 sellers appear to be seeking a sizable leasehold value. Again, while some factors, like personal property included in the sale and accuracy of the improvements valuation may lower these leasehold value amounts somewhat, it is still evident that generally it is expected there is leasehold value being created.

2.10 Management of Improvements

The cabin and homesite lease provides for the placement of improvements on the land for the purposes of residential use. The improvements are owned by the lessee. Under current statute and rule, the lessee may be compensated for their improvements by a new lessee when a lease is either cancelled or expired or remove their improvements from the land. Upon termination or cancellation, the DNRC will market the state land for a period of two years. If the property is not leased with the two-year period the lessee will be notified of their right to remove the improvements within a reasonable time period. If the improvements are not removed, they will become property of the state at that time.

The compensation for the value of lessee-owned improvements is described in MCA 77-6-302 through 306, MCA, and further clarified in Administrative Rule ARM 36.25.110(6)(b)(i–vi) and ARM 36.25.125(2-5).

When a lease is canceled or expired, lessee-owned improvements are handled in one of two ways:

Option One:

(a) Former lessee establishes the value of their improvements.
(b) Former lessee and new lessee agree to value. New lessee pays former lessee the improvement value. Improvement settlement complete.

Option Two:

(a) Former lessee and new lessee do not agree to improvement value.
(b) Arbitration process is initiated (the cost of arbitration is born by the former and new lessees)
(c) Each party appoints an arbitrator.
(d) The two arbitrators appoint a third arbitrator.
(e) Arbitrators assign a value to the improvements.
(f) Former lessee and new lessee agree to the arbitrator's assigned value. Improvement settlement complete.
(g) Either party does not agree to the arbitrator's assigned value and appeal that value to the DNRC.
(h) DNRC will set a final value.
(i) Either party may petition the district court for a judicial review of the DNRC decision. Arbitration is complete.

The ownership of the improvements at the expiration of a cabin and homesite lease is similar to the standard commercial lease agreement. By comparison, commercial leasing statute 77-1-906(2), MCA, says, "Upon expiration of the lease, the title to all permanent improvements and fixtures located on the leased property and used in the operation and maintenance of the enterprise vests in the state."

3.0 PROPOSALS FOR ASSISTING LESSEES

3.1 Possible Provisions for Assisting Low Income Lessees

The DNRC reviewed various housing assistance programs of the Montana Department of Commerce and the US Dept of Agriculture (USDA) Rural Development agency. The DNRC found that most of these programs have four key eligibility standards in common:

(1) The recipient must use the assisted housing as his/her permanent residence;
(2) The recipient of assistance will have an annual household income not to exceed a specified limit;
(3) The house must be of modest size and cost; and
(4) The house must meet specified minimum housing quality standards for construction, energy efficiency, and safety.

The Section 8 program is administered by the Montana Department of Commerce and various housing assistance agencies around the state. The Section 8 program will provide monthly rental assistance for a ground lease. Demand for this program currently exceeds the available supply of funds, and there is an extensive waiting list in all areas of the state. Since this program involves several processing procedures both before and after being placed on a waiting list, interested families are encouraged to inquire at their local Section 8 Field Agency. Visit http://housing.mt.gov/Hous_S8.asp for more information about this program and to find the Section 8 field agency that serves your area.

Income eligibility for most of these programs is set at 80% of the Area Median Income (AMI) for a given household size. Some of these programs have even more restrictive income eligibility limits, such as 50% or 30% of the AMI. At the time this report is written, the annual AMI for a family of four in Flathead County is $55,700. To qualify for most of these housing programs (at 80% of the AMI), a household of four in Flathead County may not earn more 80% of $55,700, or $44,550. Table 6 provides examples of the Section 8 AMI limits for selected counties.

Table 10: 80% AMI Limits for Selected Counties, effective 3/19/09 (Section 8 Program)

	HOUSEHOLD SIZE									
COUNTY	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Flathead	$31,200	$35,650	$40,100	$44,550	$48,100	$51,700	$55,250	$58,800	$62,350	$65,950
Lake	$29,950	$34,250	$38,500	$42,800	$46,200	$49,650	$53,050	$56,500	$59,900	$63,350
Lincoln	$29,950	$34,250	$38,500	$42,800	$46,200	$49,650	$53,050	$56,500	$59,900	$63,350
Missoula	$33,250	$38,000	$42,750	$47,500	$51,300	$55,100	$58,900	$62,700	$66,500	$70,300
Sanders	$29,950	$34,250	$38,500	$42,800	$46,200	$49,650	$53,050	$56,500	$59,900	$63,350

Using the criteria of existing housing assistance programs as a starting point, the DNRC has developed the following proposal for mitigating the impact of lease payments on cabinsite lessees experiencing severe financial hardship:

(1) The lessee may have his/her lease billing changed from annual to semi-annual.

(2) If the eligibility criteria are met, a cabinsite lessee may also have his/her lease payment frozen for up to three years at 75% of the next lease payment amount due by the lessee.

   (a) To be eligible for a rent freeze, the lessee must use the cabinsite for his/her primary residence and the lessee's annual household income must be at or below 80% of the most current AMI limit published by the MT Dept. of Commerce.

   (b) The three-year rent freeze period will begin on the date the DNRC approves the rent freeze and will expire on the anniversary date three years afterward.

   (c) The DNRC will verify the lessee's residence and household income at the time the lessee requests a rent freeze. The DNRC will also verify the lessee's residence and household income at 12 months and 24 months from the date DNRC approves the rent freeze. If the lessee no longer

meets the eligibility criteria at the time of re-verification, the rent freeze will be lifted and the lessee will be required to pay the full lease amount due at the next regularly scheduled due date. The rent the lessee would have paid without the freeze will still be due to the state. Collection of the deferred rent payment will occur in one of two ways: 1) upon expiration of the rent freeze the back rent may be due in a lump sum or be paid to the state in installments, or 2) the back rent may be deferred until the time of sale, and DNRC will capture the back rent from the sale proceeds. Either option will require the DNRC to work closely with the lessee to ensure a satisfactory outcome for both parties.

(d) The rent reduction concept could either be developed for the lessee to pay back the rental relief or the total amount of rental relief approved annually would be spread over all leases and included in all annual bills. This amount would be adjusted annually.

3.2 Possible Changes to the Management of Improvements

The current statutes governing the management and compensation for improvements are considered workable. These statutes require a lessee to remove their improvements at the end of a lease, or to be compensated by a new lessee at time of transfer. There has been no complaint from lessees that these requirements are difficult to meet or overly burdensome. Nor has there been a complaint regarding the optional arbitration process, which to date has been used only rarely.

However, future rules may need to consider three additional provisions:

(1) The time frame provided to lessees for the sale of improvements should be extended from two years to three or possibly four years to provide the time necessary for successful marketing and release of the property.

(2) The value of improvements may need to be calculated by a more formulaic process. For example, the value of improvements may be determined using the DOR's assessed value for improvements, or by requiring the lessee to hire an independent, qualified appraiser to value the improvements (using a DNRC-approved scope of work for the appraisal).

In some cases it may be possible that lessees will abandon their improvements. Though the DNRC maintenance of improvements is not mandated, the lessee has an obligation to mitigate damages to their own improvements if there is any intent to sell their improvements.

(3) The DNRC could offer a lessee a Maintenance and Marketing LUL, which would permit maintenance of the improvements by the lessee and successful marketing and release of the property.

In cases (2) and (3) above, it is important to have and abide by a pre-determined methodology for establishing value for improvements to avoid dissatisfaction and potentially a lawsuit from any party attempting to prove that the compensation for improvements was unfair, undervalued or overvalued.

4.0 ALTERNATIVES FOR THE CALCULATION OF LEASE PAYMENTS

The DNRC uses the DOR regular appraisal cycle values as the basis for calculating lease fees.

Awareness of the current DOR appraisal cycle, coupled with dissatisfaction with the methodology of the DOR appraisal, DNRC's use of 100% of that DOR value, and knowledge that lease fees would be increasing for all lessees over time, caused residential lessees to voice their concerns. The lessees indicated that lease fees were too high, that lease fee calculations were unfair, and that the DNRC should address these concerns before lessees abandon their leases and lease revenue from residential leases declines.

The DNRC began investigating what changes to the lease fee process would entail, how lessee concerns might be addressed, and what changes would mean to projected revenues.

Four developed alternatives are discussed below in Section 4.1 through 4.4. A fifth alternative, discussed in Section 4.5, involves negotiated rule-making. The four developed alternatives were created using the following twelve (12) evaluation criteria.

Evaluation Criteria:

(1) Results in revenue equal to or greater than 2009 revenue
(2) Lowers the future or predicted lease fee
(3) Provides a lease rate lower than 5%
(4) Provides a predictable lease fee
(5) Increases the lease term to provide for lending
(6) Lowers DOR appraised value
(7) Provides full market value for the beneficiaries
(8) Eliminates the "A-E" cycle
(9) Provides a cap to help mitigate increases and decreases
(10) Clarifies lease administration for both DNRC and lessees
(11) Provides consideration for "low-income" residents
(12) Modifies the improvements management policy as recommended in the report.

4.1 Alternative 1: Current Leasing Policy

This method came from negotiated rule making from 2000 and is described in ARM 36.25.110. A 5% lease rate is applied to appraised values from the DOR to calculate the full lease fee. That full lease fee is phased-in over a five-year period. The lease fee in the fifth and sixth years is the same. After that a new, full lease fee would be calculated from the current appraisal, estimated to occur in 2015, and the phase-in cycle would continue again. The phase-in would begin for different leases in different years, the A-E lease cycle, with each letter of the cycle representing about one-fifth of residential lessees.

Key Points of the Current Leasing Policy:

- 100% of 2009 value
- 5% lease rate
- Phase-in from old rate

All DNRC cabinsite leases are separated by a cycle, labeled A-E. Nearly all the leases are in the process of completing a phase-in which, when complete between 2009 and 2013, will have brought cabinsite leases from a lease fee amount of 3.5% of the 1997 appraised value to 5% of the 2003 appraised value.

Beginning on January 1, 2010, the A and B cycle lessees that had completed their phase-in, would begin a new phase-in. This new phase-in brings lessees from 5% of the 2003 appraised value to 5% of the 2009

appraised value over a five-year period. There would be a sixth-year fee which would be identical to the fifth-year fee, then a new phase in would be implemented, presumably to correspond with the 2015 appraised values.

This alternative keeps the "A-E" cycle and at the time of fiscal review for each lease the new lease fee is phased-in over five years until it reaches 5% of 100% of the most recent DOR appraisal.

How this alternative addresses the Evaluation Criteria:

(1)	Results in revenue equal to or greater than 2009 revenue	**YES**
(2)	Lowers the future or predicted lease fee	**NO**
(3)	Provides a lease rate lower than 5%	**NO**
(4)	Provides a predictable lease fee	**NO**
(5)	Increases the lease term to provide for lending	**NO**
(6)	Lowers DOR appraised value	**NO**
(7)	Provides full market value for the beneficiaries	**YES**
(8)	Eliminates the "A-E" cycle	**NO**
(9)	Provides a cap to help mitigate increases and decreases	**NO**
(10)	Clarifies lease administration for both DNRC and lessees	**NO**
(11)	Provides consideration for "low-income" residents	**NO**
(12)	Modifies the improvements management policy	**NO**

Component Justifications

- Appraisal: from DOR, as specified in 77-1-208, MCA.
- Rate: From negotiated rulemaking, ARM 36.25.110.
- Phase-in: From negotiated rulemaking, ARM 36.25.110.
- Annual adjustment: None.
- Cap: None.
- Term: From ARM 36.25.106.

4.2 Alternative 2: 2009 Phase-in Set Growth

This method would use the current 2009 DOR appraised value, but apply a lower, 3.6% lease rate. As with the current method a full base fee amount would be calculated, and leases would phase-in to that full base fee amount over five years. After that, to add a measure of predictability leases would increase at 6.5% annually after they had phased-in to the full base fee amount. In 2025 lease fees would be compared to the most current DOR appraisal to determine how close actual lease fees were to what a new lease fee would be if it were recalculated in 2025. Lease fees would be adjusted in 2025 if they exceeded certain cap requirements; but if not, they would continue at the 6.5% annual escalation amount.

Key Points of the 2009 Phase-in Set Growth Alternative:

- 100% of 2009 value
- 3.6% lease rate
- Phase-in from old rate
- 6.5% annual escalation after phase in
- Review in 2025 and cap applied

All DNRC cabinsite leases are separated by a cycle, labeled A-E. Nearly all the leases are in the process of completing a phase-in which, when complete between 2009 and 2013, will have brought cabinsite leases to 5% of the 2003 appraised value.

Over the next four years all leases would complete their current phase-in. After that phase-in, a new phase-in would be calculated to bring lease fees up from 5% of the 2003 DOR appraisal to 3.6% of the 2009 DOR appraisal. That new phase-in would take an additional five years. By 2018 all leases would be at 3.6% of the 2009 value, after which lease fees would escalate at 6.5% annually.

The alternative also assumes no lease fees would decline from 2008 fees. Analysis shows as many as 250 leases, 32%, would not have a fee drop.

Around January 1, 2025, the DNRC will take 3.6% of the most recent DOR appraised value for each lease lot to determine a new lease fee. This new lease fee will then be filtered through a cap evaluation process. In 2025 the new lease fee would be calculated at 3.6% of the most recent DOR appraised value of the state land. If the 2025 new lease fee calculation is up to 15% higher or down to 15% lower than actual annual lease fee as billed January 1, 2025, then no action will be taken to adjust the lease fee.

If the 2025 new lease fee calculation is higher or lower than 15% of the actual annual lease fee as billed January 1, 2025, then the lease fee will increase or decrease by the amount of the actual lease fee percentage increase, minus 15. A 22% actual lease fee increase would translate to an applied lease fee increase of 7%. In no case in the 2025 examination of lease fees, the maximum increase or decrease in an annual lease fee will be 50%.

Cap Example 1:
For example, in 2009 a new lot value might be $200,000. Escalating that value by 6.5% annually to 2025 makes a lot value of $ $547,802.13. The 2021 DOR appraised value might be $500,000.

Projected Fee Calculation: $547,802.13 X 3.6% = $19,720.88
DOR Fee Calculation: $500,000.00 X 3.6 = $18,000.00
($19,720-$18,000) / $19,720 = 0.0872 or 8.7% decrease.

Since 8.7% is less than 15%, the lease fee methodology will remain as it had for the past 15 years with the payments continuing to escalate at 6.5% annually.

Cap Example 2:
In another example, in 2009 a new lot value might be $200,000. Escalating that value by 6.5% annually to 2025 makes a lot value of $ $547,802.13. The 2021 DOR appraised value might be $750,000.

Projected Fee Calculation: $547,802.13 X 3.6% = $19,720.88
DOR Fee Calculation: $750,000.00 X 3.6 = $27,000.00
($27,000-$19,720) / $19,720 = 0.3691 or 37% increase.
37 – 15 = 22. Lease fee increases by 22%
$19,720 X .22 = $4,338. $19,720 + $4,338 = $24,058.

In this case the new fee is more than double the 15% cap, so the 37% would be reduced by 15 (to acknowledge the 15% cap "base") then the lease fee would be increased by 22%. Payments would continue to escalate at 6.5% annually.

Once all the adjustments are made from the 2025 examination, beginning in 2026, leases will again increase at 6.5% annually.

If 65% of leases exceed the maximum lease increase or decrease, the annual lease fee escalator will change to be effective with the January 1, 2026, lease fee billing.

The term would be adjusted to up to 50 years in five-year increments above 15 years for lending purposes.

Low-income considerations described in Section 3.1 and management changes from Section 3.2 would be added to this alternative as well.

How this alternative addresses the Evaluation Criteria:

(1)	Results in revenue equal to or greater than 2009 revenue	**YES**
(2)	Lowers the future or predicted lease fee	**YES**
(3)	Provides a lease rate lower than 5%	**YES**
(4)	Provides a predictable lease fee	**YES**
(5)	Increases the lease term to provide for lending	**YES**
(6)	Lowers DOR appraised value	**YES**
(7)	Provides full market value for the beneficiaries	**See component justifications**
(8)	Eliminates the "A-E" cycle	**YES**
(9)	Provides a cap to help mitigate increases and decreases	**YES**
(10)	Clarifies lease administration for both DNRC and lessees	**YES**
(11)	Provides consideration for "low-income" residents	**YES**
(12)	Modifies the improvements management policy	**YES**

Component Justifications

- Appraisal: From DOR as specified in 77-1-208, MCA.
- Rate: 3.6%. Lease rate is higher than 3.5%, which was deemed too low by the Supreme Court.
- Phase-in: Concept from negotiated rule making in ARM 36.25.110.
- Annual adjustment: 6.5%. 6.5% represents the annual rate of appreciation of our cabin and homesites from 1982 – 2003. This number is also supported by information and statistics from sales and resale of properties financed by the FHFA from 1975 to present.
- Cap: 15% above/below 2025 fee amount, max cap 50% increase; 65% above/below max cap then change annual adjustment.
- Term: Propose rule change of ARM 36.25.106.

4.3 Alternative 3: 2003 Set Growth

This method would use the established 2003 DOR appraised value, projected forward to 2009, appreciating at 6.5% annually. That new, projected 2003 value would be multiplied by the 5% lease rate. There would be no phase-in as not all leases are even at 5% of the 2003 appraised value now; they are expected to all be at that 2003 full base fee by 2013. After leases attain their 2003 full base fee, lease fees will increase at 6.5% annually. In 2025 lease fees would be compared to the most current DOR

appraisal to determine how close actual lease fees were to what a new lease fee would be if it were recalculated in 2025. Lease fees would be adjusted in 2025 if they exceeded certain cap requirements, but if not, they would continue at the 6.5% annual escalation amount.

Key Points of the 2003 Set Growth Alternative:

- 100% of 2003 value escalated at 6.5% annually to 2009
- 5% lease rate
- 6.5% annual escalation after phase in
- Review in 2025 and cap applied

All DNRC cabinsite leases are separated by a cycle, labeled A-E. Nearly all the leases are in the process of completing a phase-in which, when complete between 2009 and 2013, will have brought cabinsite leases from a lease fee amount of 3.5% of the 1997 appraised value to 5% of the 2003 appraised value.

Over the next four years all leases would complete their current phase-in. After each lessee had paid one year of that fully phased-in fee, lease fees would escalate at 6.5% annually.

The alternative also assumes no lease fees would decline from 2008 fees.

Around January 1, 2025, the DNRC will take 5% of the most recent DOR appraised value for each lease lot to determine a new lease fee. This new lease fee will then be filtered through a cap evaluation process. If the 2025 new lease fee calculation is up to 15% higher or down to 15% lower than actual annual lease fee as billed January 1, 2025, then no action will be taken to adjust the lease fee.

If the 2025 new lease fee calculation is higher or lower than 15% of the actual annual lease fee as billed January 1, 2025, then the lease fee will increase or decrease by the amount of the actual lease fee percentage increase, minus 15. A 22% actual lease fee increase would translate to an applied lease fee increase of 7%. In no case in the 2025 examination of lease fees, the maximum increase or decrease in an annual lease fee will be 50%.

Once all the adjustments are made from the 2025 examination, beginning in 2026, leases will again increase at 6.5% annually.

If 65% of leases exceed the maximum lease increase or decrease, the annual lease fee escalator will change to be effective with the January 1, 2026, lease fee billing.

The term would be adjusted to up to 50 years in five-year increments above 15 years for lending purposes.

Low-income considerations described in Section 3.1 and management changes from Section 3.2 would be added to this alternative as well.

How this alternative addresses the Evaluation Criteria:

(1)	Results in revenue equal to or greater than 2009 revenue	**YES**
(2)	Lowers the future or predicted lease fee	**YES**
(3)	Provides a lease rate lower than 5%	**YES (lower than 5% 2009 DOR)**
(4)	Provides a predictable lease fee	**YES**
(5)	Increases the lease term to provide for lending	**YES**

(6)	Lowers DOR appraised value	**YES**
(7)	Provides full market value for the beneficiaries	**See component justifications**
(8)	Eliminates the "A-E" cycle	**YES**
(9)	Provides a cap to help mitigate increases and decreases	**YES**
(10)	Clarifies lease administration for both DNRC and lessees	**YES**
(11)	Provides consideration for "low-income" residents	**YES**
(12)	Modifies the improvements management policy	**YES**

Component Justifications

- Appraisal: From DOR as specified in 77-1-208, MCA.
- Rate: From negotiated rule making in ARM 36.25.110.
- Phase-in: None.
- Annual adjustment: 6.5%. This represents the annual rate of appreciation of our cabin and homesites from 1982 – 2003. This number is also supported by information and statistics from sales and resale of properties financed by the FHFA from 1975 to present.
- Cap: 15% above/below 2025 fee amount, max cap 50% increase; 65% above/below max cap then change annual adjustment.
- Term: Propose rule change of ARM 36.25.106.

4.4 Alternative 4: Joint Venture

Alternative 4 was developed in a brief but productive collaboration between DNRC and a small group of informed leaseholders in the Northwestern and Southwestern Land offices. This group focused on addressing the following two factors by devising a solution that achieves maximum benefit for Trust beneficiaries while treating lessees fairly. The group also desired that this alternative would be acceptable to other stakeholders.

The existing Cabinsite Lease policy includes two factors identified by the lessees as both problematic and likely to significantly increase the lease vacancy rate: 1) The current Department of Revenue (DOR) appraisal practice of basing the value of leased land on fee simple property comparables and 2) the short-length-lease terms and valuation cycles have resulted in extreme unpredictability of annual lease fees.

Currently the vast majority of cabinsite lease holders are Montana residents. The Montana Legislature passed legislation to mitigate the rise in property value impacts on taxes by enacting a cap on tax increases. Although they did not specifically pass legislation concerning cabinsite rental rates, their intent was to protect Montana citizens from extreme fee increases and treat them fairly.

Enact a freeze of current lease rates for one year and sanction a comprehensive study and market analysis to develop the specifics of the Joint Venture solution. The study would include representatives from all stakeholder groups to further develop the strategies outlined below and other strategies that may come to light during the study. The one-year time frame would allow sufficient time to fully develop strategies, complete the analysis, and vet the solution with all stakeholders to ensure it is the optimal solution to this long-standing problem; and, time to complete what would likely be rulemaking to implement the results. It would also allow time to complete a detailed financial and economic analysis on the effects of the solution. At the conclusion of the study period (September 2010), the committee would propose a fully developed and vetted alternative for the Land Board to take to rule making.

Concept Pre-Requisites

- A-E payment cycles would be eliminated.
- Lease-term lengths would be extended to the longest available credit-term length plus 5 years.
- A fee assistance program for low/fixed -income residents, similar to the EPTAP program used by the Department of Revenue, would be established.
- Subleasing options would be expanded to increase options for lessees in meeting their annual fee obligations.
- A DNRC appeals process concerning valuation factors and rates would be established.
- A lease cancellation process would be established that would likely include at least the option of a 4-year Land Use License to sell improvements and a discounted auction process.
- A floor and cap would be established and applied to the rental rates.

The Joint Venture concept is grounded on designing and implementing two revenue strategies:

> Strategy 1**:** Based on a nationally recognized framework for developing fair value measurements (Statement of Financial Accounting Standards No. 157), **establish fair market value rental rates for leased property** by commissioning a valuation analysis that would establish adjustment factors to apply to the current DOR appraisal values and commissioning a market study to identify market rental rates. The resulting rental rate would be affordable and designed to minimize vacancy rates.
>
> DOR appraisal→ Adjustment (from Analysis)→New Appraisal Value→ Market Factors (from Analysis) →Annual Rental Rates
>
> Strategy 2**:** Leaseholders would be encouraged to maximize leasehold and improvement value appreciation using a "**valuation incentive system.**" Trust beneficiaries would receive a payment that captures a fair "leasehold value" interest upon lease assignment and/or sale. The reasonable annual rental rates and increased predictability achieved by implementing Strategy 1 (above) would have the effect of re-starting the real estate market for DNRC leases and would encourage an active market to ensure the on-going revenue stream. A fair way to complete **family transfers** would be a part of the valuation incentive system.

The result of affordable and stable annual lease rates combined with leasehold value appreciation payments should result in greater Trust revenue than a single-revenue-source system.

Joint Venture Alternative Points

- One year rent freeze at current lease rates.
- Collaborative effort between stakeholders, including DNRC, lessees, the beneficiaries, and Montrust, to flesh out the Joint Venture solution, or other solutions that may emerge as a result of the collaborative process.
- Market analysis to set affordable and predictable annual rental rates with a floor and cap set to minimize vacancy rates. Rate adjustments would coincide with 2-times or more the DOR appraisal cycle, but not more frequently than every 10 years. Rate adjustments would include a floor and cap to ensure that the rate adjustments remained within market. Lease-term length would be available for up to the longest available credit term + 5 years.
- Leasehold and improvement values would appreciate and be realized by both the beneficiaries land the lessees from a valuation incentive system
- Fair and sequential appeal and cancellation procedures

How this alternative addresses the Evaluation Criteria:

(1)	Results in revenue equal to or greater than 2009 revenue	**YES**
(2)	Lowers the future or predicted lease fee	**YES**
(3)	Provides a lease rate lower than 5%	**UNKOWN**
(4)	Provides a predictable lease fee	**YES**
(5)	Increases the lease term to provide for lending	**YES**
(6)	Lowers DOR appraised value	**YES**
(7)	Provides full market value for the beneficiaries	**See component justifications**
(8)	Eliminates the "A-E" cycle	**YES**
(9)	Provides a cap to help mitigate increases and decreases	**YES**
(10)	Clarifies lease administration for both DNRC and lessees	**YES**
(11)	Provides consideration for "low-income" residents	**YES**
(12)	Modifies the improvements management policy	**YES**

This method identifies an additional five criteria:

(13)	Method will function in either an inclining or declining market	**YES**
(14)	Includes a fair appeals process	**YES**
(15)	Fairly addresses family transfers	**YES**
(16)	Provides consideration for "fixed-income" residents.	**YES**
(17)	Results in an acceptable vacancy rate	**YES**

Component Justifications:

- Appraisal – from DOR as specified in MCA 77-1-208
- Term – propose rule change of ARM 36.25.106, supported by the current banking industry length-of-terms for credit, lost revenue from the vacancy rate, previously calculated DNRC leasehold value losses, and revenue opportunity from combining multiple revenue sources
- Rental Rates – propose rule change of ARM 36.25.110 concerning both the use of the DOR appraisal values, and the rental rate supported by the concepts for fair value measurement included in SFAS No. 157, market comparables, increased administrative costs of vacancies, and legislative support for low/fixed income housing needs in Montana
- Subleasing – propose rule change to ARM 36.25.117 and ARM 36.25.119 supported by lost revenue from DNRC's vacancy rate and the increased administrative costs of vacancies
- Cancellation – propose rule change of ARM 36.25.121 supported by the increased administrative costs of vacancies
- DNRC Appeals process – propose new rule supported by lost revenue from DNRC's vacancy rate

4.5 Alternative 5: Negotiated Rulemaking

A negotiated rule making committee would be formed with equal representation from DNRC, lessees, the Beneficiaries and other interested parties. Negotiated rulemaking would proceed as required by statute (2-5-101, MCA); and with an arbitrator, the committee would make a new alternative and recommend that the new alternative concept be formed into administrative rules. Negotiated rulemaking provides a process whereby state agencies may resolve controversial issues by allowing interested parties to participate on a limited basis in agency rulemaking prior to formal rulemaking and adoption. There is no financial calculation for this alternative because none of the contributing factors are known at this time.

4.6 Financial Analysis of the Alternatives

Revenues for cabin and homesite lease program are projected over a 30-year time period for each alternative. A detailed discussion of the alternatives in these analyses is included in Chapter 4 of this document. The projection includes all 764 cabinsites, accounting for the various review years and expiration dates. For the purposes of building the 30-year forecast, assumptions must be made concerning long-run market conditions. Based on separate data presented in Section 2.1, parcel values were assumed to appreciate at an average annual rate of 6.5%. This assumption directly impacts the projections, as rents are derived from a continuous six-year reappraisal cycle. In a further effort to analyze how the scenarios' various timing elements affect the rates of return on cabinsite parcels, the aggregate rate of return is calculated each year for each alternative. This naturally is highly dependent on assumptions made about land values for any given year.

Table 11 shows forecast aggregate revenues to the trusts over 30 years for each alternative, and the far-right column compares those aggregate figures with the expected revenue under the current management practices. While the aggregate revenues are presented in nominal values for comparison, they are also presented in net present value to account for the time-value of money. The net present value calculation assumes a 4.4% discount rate. The entire projection was then replicated with the necessary modifications for the proposed alternative methods of rent calculation. The benefit of this in-depth approach is the ability to compare the impacts of the alternatives either in aggregate, to show how the trust beneficiaries are affected, or case by case, to show how lessees are affected.

Figure 7 provides a look at annual aggregate revenues under all three alternatives addressed in this document. Figure 8 present the forecasted annual return on asset by alternative.

Finally, in order to understand the potential impacts of each alternative at the lessee level, six random leases were selected from several western Montana neighborhoods. Projected lease payments for the selected leases are presented in Figure 9. The corresponding parcel values and projected rent amounts are presented in Appendix A.

It should be noted that all these projections use <u>preliminary</u> 2009 values from the DOR.

Table 11: Cabinsite Revenue Projections for each Alternative

	Net Present Value	Sum of Rents - Nominal $	Total 30yr Revenue Impact
Alternative 1: Current Policy	$100,982,966	$236,579,556	-
Alternative 2: 2009 Phase-in Set Growth	$79,460,901	$184,551,189	-$52,028,367
Alternative 3: 2003 Set Growth	$96,184,455	$222,954,540	-$13,625,016
Alternative 4: Joint Venture	$59,352,659	$124,390,099	-$117,074,388

Figure 7: Cabinsite Revenue Forecast

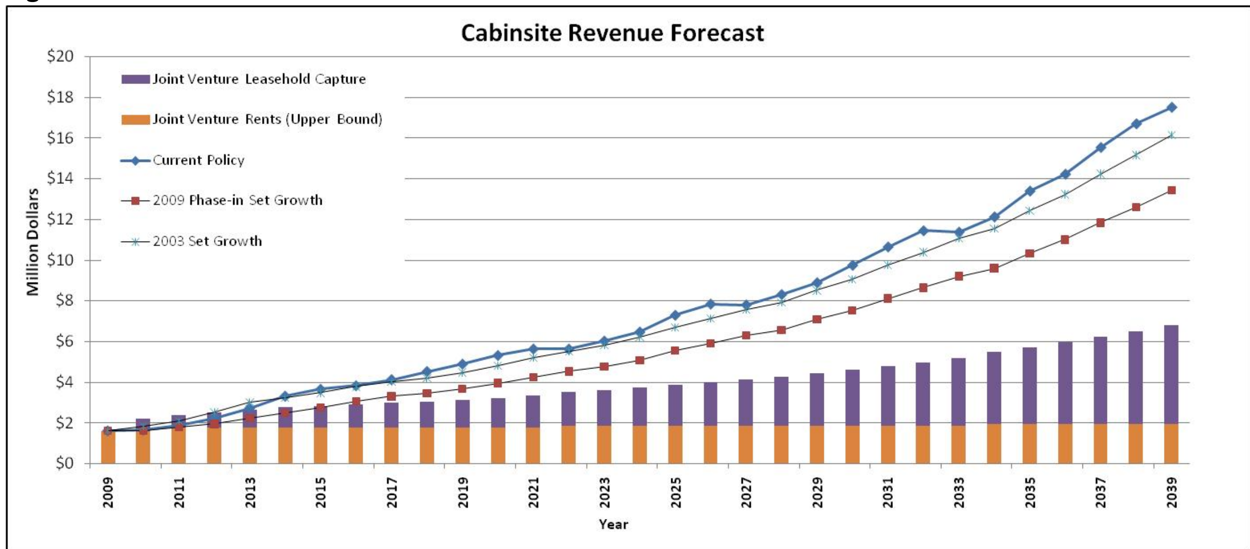


Figure 8: Annual Return on Asset: Cabinsite Parcels

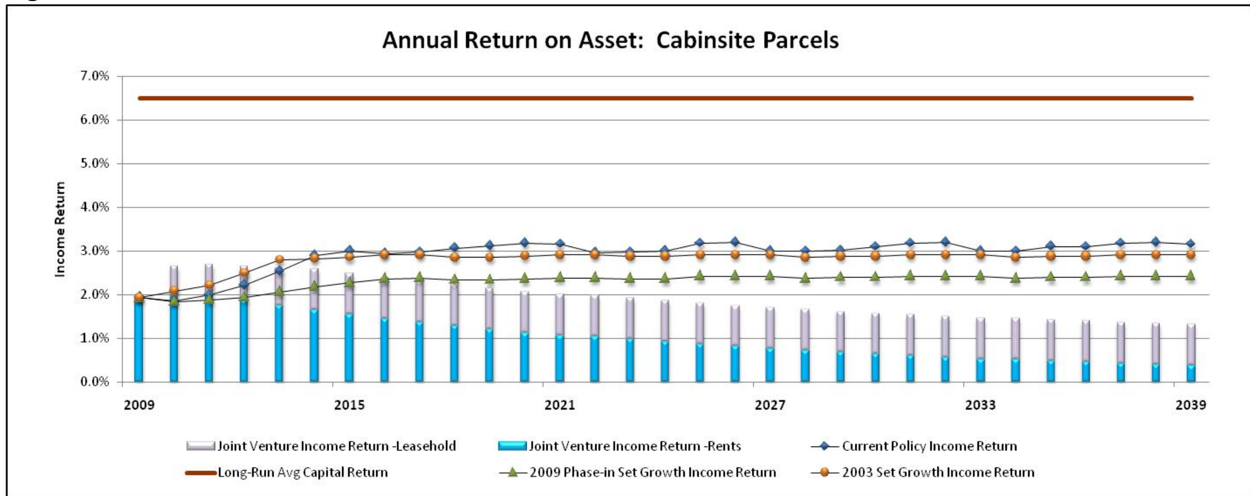
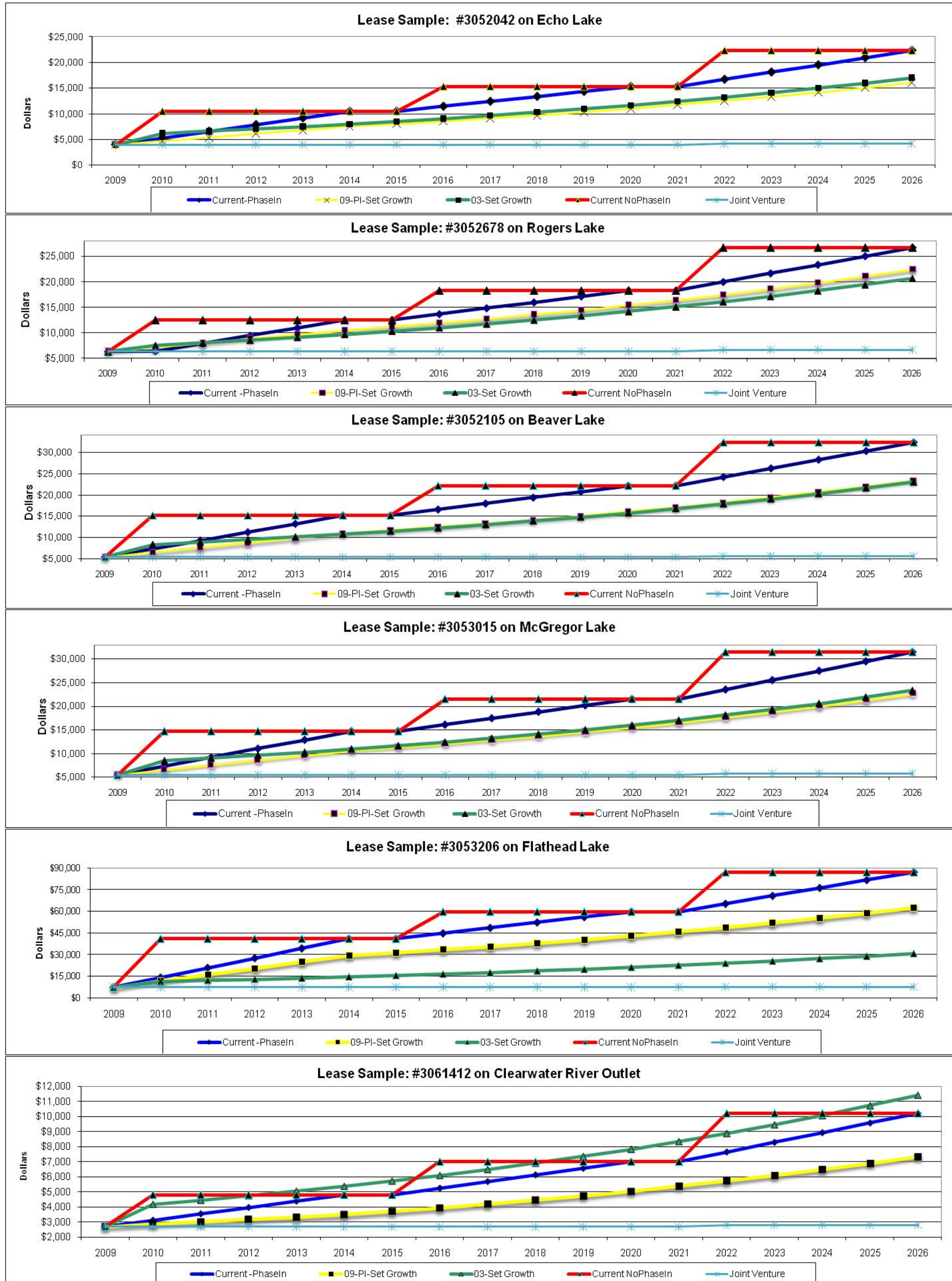


Figure 9: Lease Payment Projections across the Alternatives for Selected Leases



5.0 REFERENCES

Duffield, John. 1993. Task 2: Analysis of Cabin Lease Rates. Missoula, MT: Bioeconomics, Inc.

Montanans for Responsible Use of School Trust v. State ex rel. Bd. of Land Commissioners, 989 P.2d 800, 296 Mont. 402, (Mont. 1999)

6.0 APPENDICES

Appendix A: Projected Lease Payments for Each Alternative; Selected Leases.

Appendix B: Duffield, John. 1993. Task 2: Analysis of Cabin Lease Rates. Missoula, MT: Bioeconomics, Inc.

Appendix C: Knipe & Knipe, Inc. 1998. State of Idaho Department of lands Market Value and Market Rent Analysis. File ID 98.886.

Appendix D: Montanans for Responsible Use of School Trust v. State ex rel. Bd. of Land Commissioners, 989 P.2d 800, 296 Mont. 402, (Mont. 1999).

Appendix E: Evaluation of Market Lease Rate; Costs for Alternative Property Occupancy in Parts of Western Montana; Evaluation of Leasehold and Assignments; Evaluation of Leasehold and Listings; Kalispell Info.

Appendix F: Negotiated Rule Making Minutes and Final Report, 2000.

Appendix G: Montana statutes 77-1-208 MCA and 77-1-209 MCA.