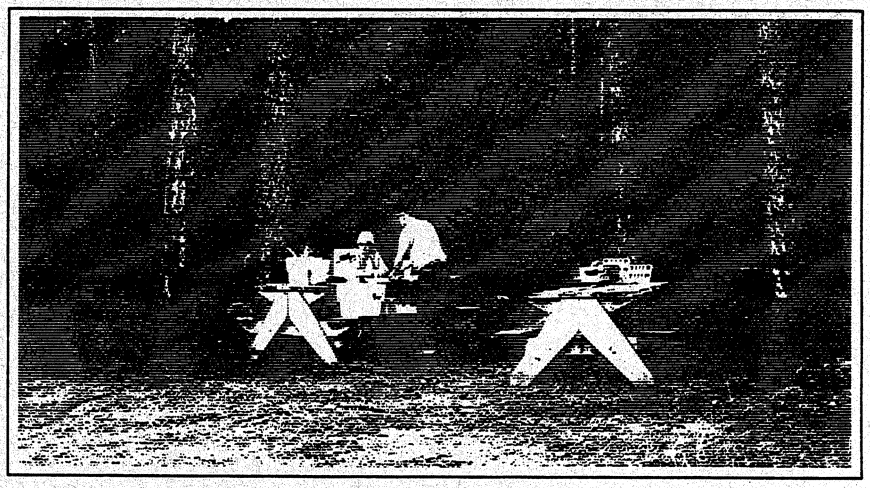
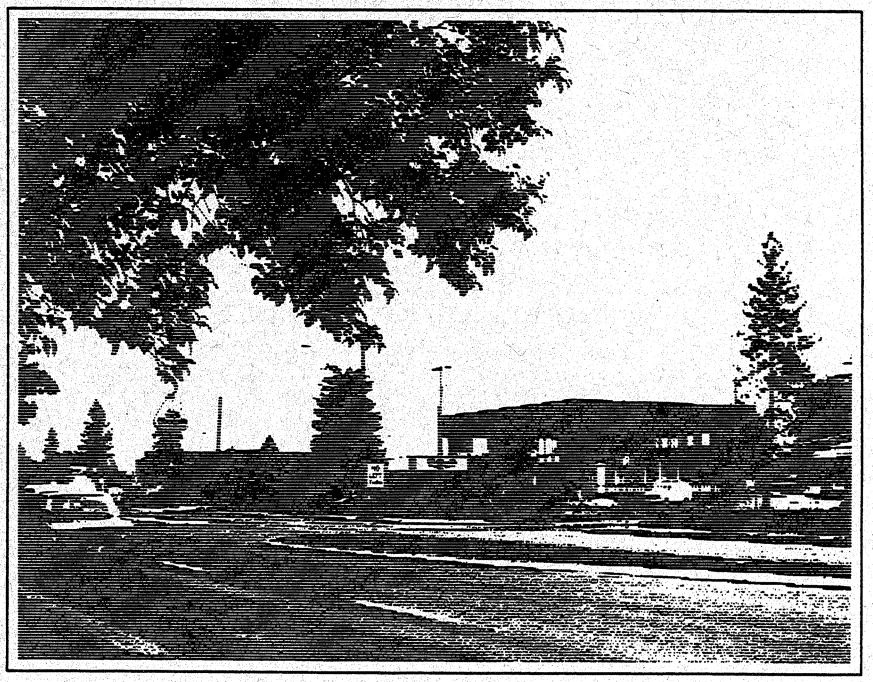
Final

Transition Lands

Policy Plan





WASHINGTON STATE DEPARTMENT OF
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STATE OF WASHINGTON
DEPARTMENT OF NATURAL RESOURCES
BOARD OF NATURAL RESOURCES

RESOLUTION NO. 590

A Resolution by the Board of Natural Resources, Department of Natural Resources, State of Washington, approving and authorizing The Transition Lands Policy Plan.

BE IT RESOLVED by the Board of Natural Resources, Department of Natural Resources, State of Washington:

1. The Forest Land Management Program prepared by the Department of Natural Resources committed the department to develop a comprehensive transition lands program.

2. The Department of Natural Resources has presented to the Board of Natural Resources a proposed Transition Lands Policy Plan for approval and adoption.

3. The Transition Lands Policy Plan supersedes previous Board of Natural Resources Resolution 286 (1980).

4. The Board of Natural Resources approves and adopts the Transition Lands Policy Plan.

APPROVED AND ADOPTED by the Board of Natural Resources, Department of Natural Resources, State of Washington this 14th day of June, 19 88.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed the official seal of the Commissioner of Public Lands.

BRIAN J. BOYLE
Commissioner of Public Lands

Approved as to form this 9th day of June, 1988.

John W. Hoyle
Assistant Attorney General

TRANSITION LANDS POLICY PLAN

WASHINGTON STATE DEPARTMENT OF
Natural Resources

Brian Boyle - Commissioner of Public Lands
Art Stearns - Supervisor

June 1, 1988

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Preface

The Department of Natural Resources manages over three million acres of trust land for the support of various public institutions. Historically, these lands have been managed for a sustained yield of natural resources. However, individual site characteristics and the changing context of surrounding land uses mean that many of these properties have become either too valuable or inefficient to administer and manage for natural resource production. These transition land properties are presently underutilized assets in the portfolio of the trusts. The purpose of this Transition Lands Policy Plan is to provide a systematic framework for addressing changing values and opportunities on these lands. This program will be the basis for the department's future management activities, including commercial leasing, on selected trust lands.

The conceptual heart of this document is a strategic plan for the management of the transition lands portfolio. Viewing the income-producing potential of the land assets of the trusts as an issue in portfolio management is a new direction for the department. This program provides the means for the department to purposefully deploy these real property assets and thus diversify and increase future trust incomes. Since each type of property asset contains a different combination of risk and income potential, the policies emphasize the need for periodic evaluation and assessment of the portfolio to protect the trusts' interests.

To develop this policy plan, the department brought together 16 working groups to address specific issue areas identified by Department of Natural Resources staff, state and local government officials, and the public. Working group members included state agency managers from the State Career Executive Program, faculty members from the University of Washington and department staff. Team members and their professional affiliations are listed on the inside front cover. These 16 teams developed alternative policy proposals for addressing each issue area. Policies presented here are the preferred choices among numerous alternatives considered. The preferred policies were selected by an executive review team including the Commissioner of Public Lands and top department managers.

A draft Transition Lands Policy Plan was issued in late August of 1987. Copies were distributed to local and state government agencies, organizations and individuals. Seven public hearings were held around the state in late September and early October. The written comment period was extended to early November to allow interested parties ample time to respond to the draft plan. The following document incorporates comments received from that review process.

This document is organized into four major sections: Basic Principles, Analysis of Transition Lands, External Relations, and Management Activities. Each major section contains chapters describing various aspects of the department's proposed policy plan. The goals of the program are presented at the beginning of Part I.

Each chapter opens with applicable goal statements, followed by a set of objectives, and a short narrative. As specific issues are addressed, proposed policies derived from the discussion appear in *italic*. These policies constitute the Summary following this Preface. The reader should note that the first appearance of unfamiliar terms appears in **bold face**. A glossary of these terms begins on page 95. Also note two chapters of this report, *A strategic plan for managing transition land assets*, and *Economic models and evaluation* contain many technical terms and concepts. We have made every attempt to make these sections as readable and accessible as possible.

Summary

Policy Recommendations

Effectively manage transition lands to enhance the financial performance of trust assets .

- o Manage transition land to optimize land value.
- o Manage land assets to achieve an optimum relationship between income and risk.
- o Increase the level of financial support to trust beneficiaries.
- o Further diversify the sources of income to trust beneficiaries.
- o Balance short- and long-term needs of the trust beneficiaries.

In pursuing the overall transition land management goals, the department will also be guided by the following sub-goals :

- o Provide for environmental protection through site specific analysis and through cooperative planning with local governments and comply with all local, state and federal environmental requirements.
- o Provide for the management of natural resources on transition lands in a manner consistent with the intended future use of the lands.
- o Provide for interim uses on transition lands when compatible with the proposed use of the parcel.
- o Develop and maintain a working relationship with governments.
- o Develop effective methods for interaction with the public.

The department adopts the following strategies :

- o Seek interim uses that will fully utilize the current potential of the property yet preserve and enhance the qualities that will attract higher and better uses.
- o Seek and use legal authority to provide efficient and effective transition land management.
- o Cooperate with state and local economic development efforts to realize transition land management goals.

o Promote, explore and develop new market opportunities.

o Develop and conduct effective external relations programs.

Identification of Transition Lands

As policy, the department proposes the following definitions for transition lands and urban lands.

Transition Lands: Land currently being managed for natural resource production that has characteristics indicating an opportunity for more efficient management or to obtain a higher economic return by the conversion of the land to another use. (p. 22)

Urban Lands: Land expected to be urban due to designation as "urban" by local land use plans; or authorization for commercial, industrial or residential uses by local government; or where capital improvements and services exist or are scheduled to be available. (p. 22)

A Strategic Plan for Managing Transition Land Assets

In managing and relocating trust lands, the department will neither deplete the publicly-owned land base nor reduce the publicly-owned forest land base (RCW 79.66.010). (p. 28)

The department will develop an overall asset management program for the trusts incorporating overall financial objectives in accordance with the economic analysis statute (RCW 79.01.095). (p. 29)

The department will optimize the income of the trusts in relation to financial risk. (p. 29)

The department will establish a policy defining acceptable levels of financial risk and develop an asset management strategy consistent with that policy.(p. 29)

In accordance with RCW 79.01.095(1), the department will establish asset values for each individual asset or for grouping of assets in the transition lands portfolio as soon as possible (p. 30)

For transition lands, structuring investments to balance current income and asset appreciation will be the preferred policy. (p. 32)

When considering the acquisition of new trust assets, the department will acquire assets that minimize life cycle management costs for given levels of income/risk. (p. 32)

In the Transition Lands Program, the department will recognize risk explicitly in any investment analysis by assigning probabilities to projected income streams. Both variability and the expected value of the return on capital investments will be considered. (p. 33)

The department will actively pursue a program of diversified property investments to reduce the risk of variability of income. (p. 34)

The transition land assets will be allocated to their ***highest and best uses.*** *(p. 35)*

Financial analysis will be central in directing the efforts of the program—establishing project priority, determining the allocation of capital, and in measuring the degree of success in carrying out specific projects. (p. 35)

The department will create additional value on transition lands by facilitating conversion of these lands to more economic uses. (p. 36)

Usually, the department will cease value enhancement efforts at a stage before the development of end-user improvements. (p. 36)

The department will consider acquiring various types of real estate ownership interests that meet the investment policies of this program. (p. 38)

In general, the department will not acquire single-family residential ground leasing investments for the real estate portfolio. (p. 38)

The department will invest in real estate with end-user activities which are shown to have potential for either growth or long-term stability. (p. 38)

All property acquisitions will be of investment quality suitable for ownership by a trust. (p. 39)

Each existing commercial holding in the portfolio of the trusts will be evaluated for retention. All proposed acquisitions will be evaluated by the same procedure. (p. 42)

The department will avail itself of the best expertise and procedures available in selecting trust quality investment assets for addition to the portfolio. (p. 42)

Environmental Review

The department will comply with applicable local, state and federal environmental review and analysis requirements. (p. 45)

Before assigning property to the transition land inventory, the department will assess the natural elements of the environment and sensitive areas on potential transition land parcels. (p. 46)

The department will use an interdisciplinary approach to (A) identify the elements of the natural environment which are located on a parcel, and (B) to determine whether the parcel alone or in concert with the surrounding area is environmentally sensitive. (p. 47)

Before allocating lands to the Transition Lands Program, the department will conduct a preliminary review of the renewable and nonrenewable elements of the natural environment, to determine which may be significant. (p. 47)

The department will encourage those uses which mitigate potential environmental problems and protect sensitive areas. (p. 48)

Leases on transition land may have conditions for environmental protection developed in cooperation with appropriate agencies indicated by the resource inventory and analysis and local government land use controls. (p. 48)

Economic Models and Evaluation

*The department will use **net present worth** as the primary model for evaluating investments. (p. 54)*

The current market yield on the Permanent Funds portfolio will be used by the department as a minimum acceptable discount rate. (p. 54)

The department will review investment decisions by annualizing the values, placing values in terms of an infinite time horizon or by taking them to a common point in time. (p. 55)

*Sensitivity analysis, rather than **discount rate** adjustment or ad hoc handling of risk, will be the technique chosen by the department for assessing the impacts of risk. (p. 55)*

The department will maintain records that track: (1) the return on past capital investment, (2) the status of current investment, and (3) plans for future capital investment. The department will prepare a periodic financial report for the transition lands portfolio. (p. 55)

Interim Uses

The department will analyze proposed interim uses on transition lands for impacts on existing and proposed future uses. (p. 57)

The department will use an analysis tree to evaluate proposed interim uses. (p. 57)

The department will actively manage transition lands to ensure that economic, creative and professional management of these lands occurs as these lands move from one use to another. (p. 58)

The department will develop site specific prescriptions for each transition land parcel and periodically re-evaluate the prescriptions as site characteristics or conditions change. (p. 58)

Public Involvement

The department will develop an active information program on the overall program and on individual projects. (p. 66)

In addition to legal requirements, the department will design a systematic public involvement program. (p. 66)

The department will comply with all legal requirements for public notice and testimony. In addition, the department will use other effective methods to gather information from the public on pertinent issues. (p. 67)

Intergovernmental Relations

The department's planning process will occur at both the programmatic and site specific levels. (p. 68)

The department will coordinate its programmatic planning process with the development of local comprehensive plans and other land use planning documents. (p. 68)

The department will work with local governmental entities to develop a cooperative planning process before lease, development, or disposal of transition lands. (p. 69)

The department will cooperate with local and state economic development efforts in making trust land available for commercial activities. (p. 69)

Working in cooperation with local government, the department will carry the site specific planning process to a level of detail appropriate to that property (sale, lease, exchange). (see also Environmental Review - pp. 45-48.) (p. 70)

Relationship with the private market

For purposes of consistency and acceptance in the private market, the department will consider and employ private sector mechanisms and methodologies. (p. 72)

The department will consider using the services of licensed real estate brokers in acquiring property. Brokers will also be considered for disposing of property. (p. 72)

The department will maintain a list of pre-qualified consultants to assist in project appraisal, development, acquisition and marketing. (p. 72)

The department will adopt a standard unsubordinated ground lease document for use with state trust lands. (p. 72)

Capital Investment Strategy

The department will continue to invest capital in transition land properties as long as properly evaluated projects demonstrate a risk-adjusted return higher than the cost of capital. (p. 76)

The department will, in most cases, limit direct capital investments on transition lands to preliminary value enhancement activities, soft investments such as rezoning, acquisition of access, etc., and participation in local improvement districts to bring services such as water and sewer to transition land properties. (p. 76)

The department will attempt to achieve market rates of return from its transition land assets consistent with stated risk limitations. In making future capital investments, the department will direct capital to investments where the returns are highest, commensurate with stated risk limitations. (p. 77)

The department will encourage investment on state land by lessees whenever it enhances the income potential of the property. The department will carefully structure these arrangements to avoid inappropriate risk to the trust. (p. 77)

The department will consider using nontrust sources of funds for capital investment in the real estate portfolio. (p. 78)

All improvements placed upon the land by the lessee shall become the property of the state at the end of the lease term unless it can be demonstrated that ownership of improvements is not in the best interest of the trust. (p. 78)

Leasing

The department will negotiate leases to create the highest level of income possible, consistent with evaluation of risk, income needs of the beneficiary and other aspects of this policy plan. (p. 79)

The department will develop a mix of levels of approvals required for leases depending upon value, term, complexity and sensitivity of the lease. (p. 80)

The department will use various forms of feasibility leases as a method to attract quality lessees to trust land. (p. 81)

Before beginning negotiations, all potential lessees will be required to submit evidence of their ability to perform satisfactorily to the terms of the proposed lease. (p. 81)

In reviewing the assignment of lease interests, the department will evaluate the proposed assignee with the same criteria used to evaluate the initial lessee. In considering whether to consent to the creation of other legal interests in the leasehold estate, the department will evaluate such proposals in terms of their commercial reasonableness, risk potential, and their potential impact on the trust asset involved. (p. 82)

Information /data base

A land use data bank will be developed for transition lands using information systems currently available within the department. Whenever possible, the department will develop and coordinate this information with other governmental and private entities. (p. 83)

Introduction

During the past decade, a new pattern of population growth and distribution became apparent in the United States. For the first time in nearly a century, rural areas grew at a faster rate than urban metropolitan areas.

From 1970 to 1980, Washington was the twenty-first fastest growing state in the country. Significantly higher growth rates occurred outside major metropolitan centers. Population grew as quickly in unincorporated areas. In King County, the most rapidly urbanizing county in the state, the population may increase by 30 percent between 1980 and 2000. Of this growth 70 percent is expected to occur in unincorporated areas. Population growth in rural and suburban areas accelerates demand for scattered, nonfarm housing and for subdivision of larger private forest holdings. Growth creates new demands and opportunities for major land owners and public land use management agencies.

Some view varied uses and demands competing for the same piece of land as the frontier now closing. Land managers are moving from a model of allocating land for a single or dominant use to allocating land to more productive uses, such as commercial forest, recreation, residential or commercial purposes. Conflicts are now seen less as a threat to historic natural resource use than as a sign of changing land market values.

Approximately 120,000 of the 3,000,000 acres of state trust land are located in or near urban areas. Changing land values resulting from recent population changes and land use suggest that long-term resource management may no longer be appropriate for certain properties. Public and private land managers with substantial holdings are beginning to make more detailed appraisals of potential opportunities and long-term prospects for continued resource management. In addition, state trust land management agencies in 22 western land-grant states have initiated similar programs to provide better returns to their trust land beneficiaries. Many of these state resource agencies have also sought and obtained new legislation providing greater flexibility for their management activities.

Throughout Washington, vacant parcels of trust land are often perceived by the public as providing desirable amenities and open space for nearby residents. In the past, conflicts have resulted when the department attempted to capture the increased value of transition land parcels through conversion of these properties to higher valued uses.

Needs of the trusts

The department manages three million acres of forest, agricultural and grazing lands for various public institution trusts (see p. 10). Over two-thirds (1.8 million acres) are managed to benefit common schools (Grades K-12). The state's policy from 1889 to the 1920s was to sell the public land base and place the proceeds in permanent funds. In 1966, a state constitutional amendment was enacted, allowing current incomes

from renewable resources to be disbursed through the Common School Construction Account. Interest income from the permanent fund is combined with money in the Construction Account and distributed to local school districts. This money is used to match construction and renovation levies. Because of revenues derived from trust lands, the state share of school construction has not, until recently, depended on appropriations from the General Fund.

Previously, trust land incomes provided about 50 percent of the necessary capital needs of the schools. Ninety percent of these revenues have been from timber harvesting. However, projected revenues are significantly lower than the projected needs of school districts around the state. During the next five years, this shortfall in funding may be as high as $200 million dollars ($40 million/year). Of even greater concern is the prospect that this shortfall will continue into the 1990s.

There are three major reasons for this decline in revenues: timber prices, timber inventory and increasing demands for school construction.

As of 1984, timber prices (stumpage) were about half as high as in 1980. Timber that once sold for $200/thousand board feet sold for $100. Schools that had received $100 million from trust land now received $50 million, although the same number of trees were being cut.

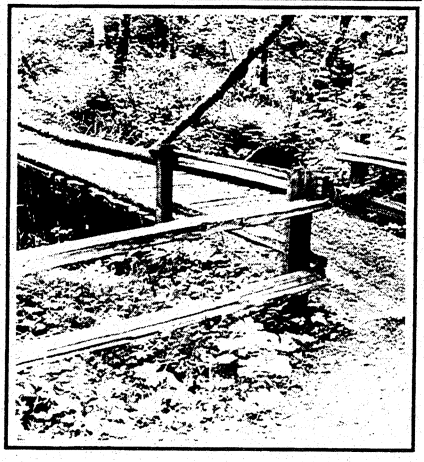
Timber inventory on Common School Trust Lands was heavily cut in the 1960-70s, leaving fewer harvest age trees for future decades. While no decline will occur in timber harvest from state land, harvest volumes from Common School Trust Lands will decrease.

The spreading suburbanization of the rural areas surrounding metropolitan centers and the school needs of children of the baby boom generation will require constructing many new schools during the next decade.

One consequence of these projected revenue shortfalls has been a review of the current status of state trust lands and the need to develop additional strategies for generating new revenues for the trusts.

The Transition Lands Program evolved from several previous department initiatives. The following section briefly reviews the history and evolution of the program.

Program history



Since statehood in 1889, Washington has had two basic options for managing trust lands to generate revenues for the trust beneficiaries: sale or management. Until the 1920s, the state sold trust lands to private interests and placed the proceeds in permanent funds. The interest income from these funds was (and is) used to support the designated beneficiaries. Sale of trust lands was the common practice of most land grant states. Because of their location and other characteristics, the logical alternative for retained lands was to manage them for income from natural resource production. Transactions conducted under either alternative had to be on a fair market value basis. Over the years, federal and state supreme court decisions have affirmed this obligation.

Since the 1930s, the people of the state have recognized the multiple advantages of retaining the trust land base. The location of these

properties was generally a function of history rather than design. Until recently, managing these properties for timber, agriculture and mineral production was generally the most economic and appropriate use. Active department management was limited to these traditional enterprises.

Certain other properties, because of their size, location, character, or surrounding land uses, were consequently underutilized. In recent years, the legislature, trust beneficiaries and trust managers have recognized the opportunity to generate increased and diversified revenues from alternative management strategies for these properties.

To accomplish this end, the legislature has recognized the need to reposition the trust land base. The department's obligation has been to expand management options for these properties to fully capture the underlying value of these assets. Although the department has a current portfolio of commercial, industrial, and residential leases, these leases have generally been granted in response to proposals from prospective private sector lessees rather than resulting from an active department management strategy. The Transition Lands Program developed from the recognition that there were opportunities to significantly improve the income potential of the trust assets through active management of these properties.

Before 1968 the department also managed transition lands as natural resource-producing properties. Individual parcels were occasionally managed differently. However, there was no overall strategy for addressing the special issues and needs of lands suitable for uses other than natural resource management.

During the late 1960s, public concern arose about commercial management proposals on trust land. Over the next 15 years, DNR developed a series of land allocation systems for trust land. (A history can be found in the 1981 *Report to the Legislature on Transition Lands* and in materials available at the department's Real Estate Division in Seattle.)

Resource allocation plans

In 1968 the department made its first statewide attempt to project future uses of trust land. This Resource Allocation Plan categorized land into four broad headings: urban, upper resource, principal forest and agriculture. The allocation, developed by department managers, was not always consistent with local government planning strategies and efforts to coordinate growth, services, land uses, densities and community services.

The 1974 Resource Allocation Plan further distinguished between types of urban lands. **Current Urban, Urban 1980,** and **Urban 2000** designations were used to inventory and classify trust land to indicate the range of potential opportunities on these holdings and when those opportunities were expected to occur.

Urban lands program

By 1976, the department realized these transition lands needed to be managed differently. Thus, an Urban Lands Program was created to actively manage and lease transition and urban properties. This new

program emphasized coordinating the department's strategies with those of local government planning agencies. Approximately 10,000 acres were identified as **urban** and allocated to either **urban conversion** or **transition.** Under this system, transition lands were seen as having the potential for more intensive uses 10 to 40 years into the future and, therefore, did not justify investment for forest production purposes. A 1978 revision of the allocation plan recognized a **special use** category for communications sites, parks, quarries and other uses. The 1978 plan also articulated specific guidelines for urban conversion and transition lands.

Together with the department's 1981 budget request for an expanded Urban Lands Program, the legislature directed DNR to prepare a report on the program, including an inventory of urban lands, a management plan for each parcel, and other necessary information. All lands inventoried having urban potential were categorized as transition land and further classified into **Urban 10**--expected to be converted to commercial, residential or industrial uses within ten years; **Rural**—resource lands likely to shift to nonnatural resource production uses in the future; and **Special Use lands.** DNR estimated that approximately 120,000 acres of its 3,000,000-acre landbase fell under the transition lands classification scheme. This inventory resulted in 128 parcels of land (16,300 acres) in 29 counties classed as Urban 10. Seventy-five percent had residential potential, 12 percent—industrial development, 11 percent—commercial development and 2 percent—other uses. This department-generated inventory and evaluation was included with the 1981 *Report to the Legislature* : *Transition Lands Program* by Haworth and Anderson, Inc.

1981 Report to the Legislature : Transition Lands Program

The *Report to the Legislature: Transition Lands Program* centered on identifying key management issues confronting the state regarding transition lands, the analysis of alternative approaches to resolving these issues, a management system recommendation, and a discussion of the legislative clarification needed for full program implementation.

The report made a number of recommendations, including:

o Single family residential property should be exchanged for other land.

o The department should make marginal capital investment in urban lands (commercial and residential) for planning, zoning, platting and off-site **infrastructure** development.

o The department should work with local governments in planning and zoning decisions affecting transition lands.

o Management of transition lands will require combining talents from department staff and the private sector.

The urban land inventory and the *Report to the Legislature,* in conjunction with the 1984 Forest Land Management Program, provided the basis for the department gaining increased flexibility to manage transition lands.

1984 Forest Land Management Program

The 1984 Forest Land Management Program adopted by the Board of Natural Resources clarified department policies regarding transition lands. These decisions included:

- o The department proposed to remove 1,600 acres of forested Urban 10 parcels from the sustainable harvest base.

- o Approving the Forest Land Management Plan would not officially designate the parcels listed as Urban 10 in the 1981 inventory. This decision would be made by the Board of Natural Resources.

The document states that these lands hold numerous options and capabilities within the department's operational framework. Management decisions outside the stated guidelines and policies of the Forest Land Management Program are necessary and will be determined either on an individual or programmatic basis.

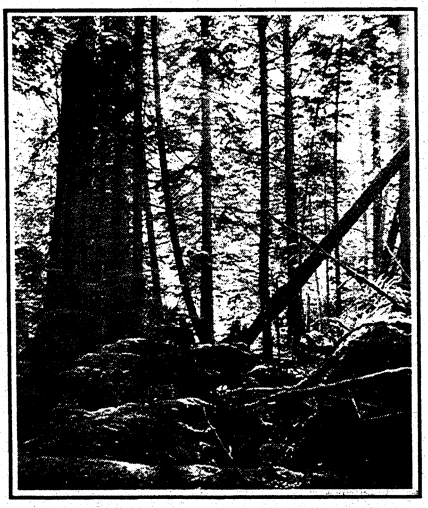
The Transition Lands Act (SSHB 181) 1984

The 1981 report generated increased public interest in how transition lands were managed. The trust beneficiaries, particularly the Superintendent of Public Instruction, also expressed an increased interest about the untapped revenue potential of these land assets. One consequence of this increased awareness was the 1984 passage of the transition land legislation contained in Second Substitute House Bill 181 (SSHB 181).

This act gave the department limited additional flexibility to manage its land portfolio for the best interests of the trusts. The act amended the land bank legislation allowing the department to dispose of certain lands and acquire income-producing, as well as natural resource-producing, property. The act also required that the department neither deplete the publicly-owned land base nor reduce the publicly-owned commercial forest base. DNR was also directed to comply with local land use plans and applicable growth management principles. The act granted the department additional flexibility and a broader range of acquisition options while retaining the forest base for commercial timber production.

Concern has been expressed that the Transition Lands Program would lead to an overall reduction in the department-managed commercial forest land base. During the past decade, the department consolidated the trust land base through numerous exchanges with small and large forest land owners and other public agencies (such as the USDA Forest Service). Some transactions involved acreage with high value old growth timber being exchanged for productive forest land with younger stands of timber. These exchanges resulted in a net increase of approximately 16,000 acres of commercially productive forest land. Recent out-of-court settlements for defaults on timber sale contracts also resulted in the state receiving approximately 10,000 acres of productive forest land adjacent to current trust land ownerships. Land bank purchases added 5,000 acres of commercial forest land. Since 1978, exchanges, default settlements and land bank purchase have resulted in a net increase of approximately 30,000 acres of commercial forest land.

Classification of property



Classification of property as transition land does not mean that a given parcel of land will be physically changed or altered. Rather, such classification is a signal by the department that it is no longer economically feasible to manage a particular parcel for natural resource production in the long run. While such classification means the department views the property differently and alternative uses should be sought, in the short-term, management of the property may not change.

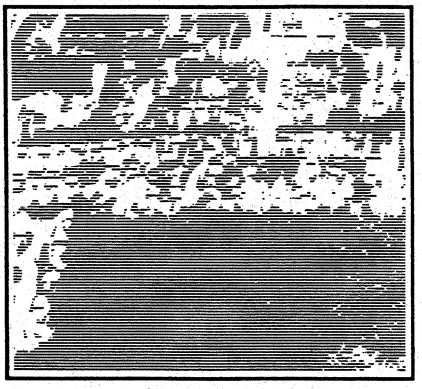
Competing demands, reflected in increasing land values and leading to classification as transition land, can also indicate or result in changing community awareness of a particular parcel. Judgements about its "best use" from a community perspective may be quite different from the "highest and best use" determined by the real estate market.

While the department is obligated to obtain full fair market value from trust land, several means exist to achieve this. The most common way to generate income from natural resource lands is from natural resource products. The Transition Lands Program utilizes the real estate market to increase land value and generate revenue from the land. Part of this effort involves pursuing reasonable opportunities for value enhancement.

If a community expresses, through a public agency, a desire to acquire property for public purposes, mechanisms exist to achieve this. Examples of such transfers include trust land becoming county parks through purchase and exchange, and additions to the state parks system from trust lands. The mechanisms include the statutory provision that when the department decides to dispose of designated "urban" land, various state and local agencies have a preferential right to acquire the land. In addition, the legislature acts directly to transfer trust lands to the state park system. The most recent examples include additions through actions by the 1987 and 1988 Legislatures. This involves using the Trust Land Account, an ongoing process for the state park system to acquire trust land. If property has special and unique plants, animals or ecosystems, requiring extraordinary protection measures, the department can protect it through the Natural Area Preserve program.

These options ensure trust land is allocated to a use most appropriate for its inherent characteristics. At the same time, it allows the state to meet its duties of loyalty to the trust beneficiaries. The plan which follows is the way the department will meet both objectives.

Program direction



Changes in land use patterns, the needs of the trusts (particularly Common Schools) for more predictable and higher levels of support, and the increased flexibility provided by the 1984 Legislature were major factors in the department's decision to develop a Transition Lands Program. Evolution of the program and development of this policy document allow the department to accomplish several objectives:

- o Define and clarify the future role transition lands play in the trust portfolio.

- Explain and clarify the planning and management process for those trust assets in transition from lower to higher valued uses.

- Maintain environmental quality while generating prudent incomes for the trusts from management activities other than resource production.

When scattered trust land holdings of the trust portfolios are viewed as potential income-producing opportunities, two direct benefits result:

- The value of underutilized or vacant property can be redeployed into more productive situations.

- Purposefully diversifying the location and type of acquisition allows the department to generate greater income less subject to concurrent income fluctuations typical of forest and agricultural lands.

The major purpose of the Transition Lands Program is more productive use of assets to generate present and future benefits for the beneficiaries. This plan proposes a more sophisticated and rational means to achieve the appropriate income and capital appreciation of the transition land assets than the department previously had available. The plan also emphasizes the department's duty to manage these assets actively and to pursue strategies which will better the long-term financial position of the trusts.

Because of the following policies, substantial and reliable income can be generated. By making trust land available for private development, the department can directly benefit the trusts while also enhancing local community economic development efforts.

Part I
BASIC PRINCIPLES

Part I
BASIC PRINCIPLES

Goals and subgoals

Transition land management goals

Effectively manage transition lands to enhance the financial performance of trust assets.

- o Manage transition lands to optimize land value.
- o Manage land assets to achieve an optimum relationship between income and risk.
- o Increase the level of financial support to trust beneficiaries.
- o Further diversify the sources of income to trust beneficiaries.
- o Balance the short- and long-term needs of the trust beneficiaries.

In pursuing the overall transition land management goals, the department will also be guided by the following subgoals:

- o Provide for environmental protection through site specific analysis and through cooperative planning with local governments and comply with all local, state and federal environmental requirements.
- o Provide for the management of natural resources on transition lands in a manner consistent with the intended future use of the lands.
- o Provide for interim uses on transition lands when compatible with the proposed use of the parcel.
- o Develop and maintain a working relationship with governments.
- o Develop effective methods for interaction with the public.

To achieve the transition land management goals, the department adopts the following strategies:

- o Seek interim uses that will fully utilize the current potential of the property yet preserve and enhance the qualities that will attract higher and better uses.
- o Seek and use legal authority to provide efficient and effective transi tion land management.
- o Cooperate with state and local economic development efforts.
- o Promote, explore and develop new market opportunities.
- o Develop and conduct effective external relations programs.

Legal context

Lands managed by the Department of Natural Resources were acquired (1) from the federal government through the Congressional Enabling Act of 1889, (2) from the Washington counties, and (3) by gift, purchase and escheat. These lands comprise 2,893,040 acres of uplands and approximately 2,000,000 acres of aquatic lands.

Uplands are managed to generate income for support of the various trusts while preserving trust assets for future beneficiaries. Aquatic lands are managed to provide a balance of public benefits for all citizens of the state.

Territorial grants

Federal land grant trusts are endowments of land by the United States to the state of Washington to be sold, leased or managed to support designated beneficiaries in perpetuity. The federal grant lands were donated to Washington in 1889 in the Congressional Enabling Act providing for admission of the territory of Washington as the forty-second state. These donated lands were expressly reserved in the act for various trusts (Table 1).

Table 1. Federal Land Grant Trusts
(present approximate acreage)

Trust	Acreage
Common school	1,785,165
Capitol grant	109,109
University transfer	84,085
Scientific school	81,024
Charitable, educational, penal and reformatory institutions	79,183
Agricultural school	70,298
Normal school	65,942
Original university	2,167

Case law pertaining to federal land grant trusts

The Enabling Act placed limits on the sale, lease and management of these lands. A summary of federal and state cases illustrates how courts have interpreted the provisions of the grants as they relate to land management activities on federally-granted lands.

In Ervien v. United States 251 U.S. 41 (1919), the United States (U.S.) Attorney General sued for an injunction to prevent the New Mexico Land Commissioner, the trustee of New Mexico grant lands, from spending trust earnings for publicizing the resources and advantages of New Mexico. The New Mexico Land Commissioner argued that

this advertising was a proper administrative expense since it could increase the value of trust lands.

The U.S. Supreme Court, however, granted an injunction prohibiting these expenditures. It ruled that the trusts were individually created to support public institutions specified in the Enabling Act. Therefore, the trustee could not use proceeds from a specific trust to benefit the state generally, even if the trust also might be indirectly benefited; rather, Congress intended that the trustee apply the trust earnings to the fund created to support the public institution designated in the Enabling Act.

In Lassen v. Arizona, 385 U.S. 458 (1966), the Arizona Highway Department sued the trustee of grant lands to condemn a highway right of way. The department argued that it need not compensate the trust since a highway across trust lands would enhance the value of remaining trust lands in an amount at least equal to the value of the trust lands taken. The U.S. Supreme Court rejected the argument and agreed with the trustee that the highway department must pay the trust for the property taken. The Supreme Court stated:

The Enabling Act unequivocally demands both that the trust receive the full value of any lands transferred from it and that any funds received be employed only for the purposes for which the land was given. First, it requires that before trust lands or their products are offered for sale they must be "appraised at their true value" and that "no sale or other disposal shall be made for a consideration less than the value so ascertained." Second, it imposes a series of careful restrictions upon the use of trust funds. As this court has noted, the Act contains a "specific enumeration of the purposes for which the lands were granted and the enumeration is necessarily exclusive of any other purpose." [Ervien v. United States, supra.] The Act thus specifically forbids the use of "money or thing of value directly or indirectly derived" from trust lands for any purposes other than those for which that parcel of land was granted. It requires the creation of separate trust accounts for each of the designated beneficiaries, prohibits the transfer of funds among the accounts, and directs with great precision their administration. All these restrictions in combination indicate Congress' concern both that the grants provide the most substantial support possible to the beneficiaries and that only those beneficiaries profit from the trust.

U.S. v. 111.2 Acres of Land in Ferry County, Washington, 293 F. Supp. 1042, (1970), is a Washington case adopting the principles set forth in Ervien and Lassen. The U.S. Government sought to acquire state school trust lands for a federal irrigation project. The United States argued that, as trust grantor, it was permitted to take the land without paying for it. The court disagreed, stating:

The school lands provisions of the Enabling Act further a liberal policy of school support... In this context the principle of indemnity requires that no land or proceeds be diverted from the school trust unless the trust receives full compensation. This principle is explicitly a part of the Washington Enabling Act.

The court concluded that donating school trust lands to the United States would constitute a breach of trust by the trustee (state of Washington) and ordered the United States to pay the trust the full market value of the land.

In State v. University of Alaska, 624 P.2d 807 (1981), the state of Alaska sought to include university grant land within Chugach State Park. The university opposed this action and sought a declaratory judgment whether the land could be used other than to support the university. The Supreme Court ruled with the university, stating:

Because the land was to be held in trust for the university, we must determine whether inclusion of the land in Chugach State Park caused a breach of the trust. The trial court concluded that the inclusion of university land in the park violated the trust provision of the federal grant. We agree. The use that can be made of park lands as compared to state lands in general is severely restricted. The general principle is that park lands are to be managed in a way that will increase the "value of a recreational experience." It is apparent that this objective is incompatible with the objective of using university land for the "exclusive use and benefit" of the university. The implied intent of the grant was to maximize the economic return from the land for the benefit of the university. This intent cannot be accomplished if the use of the land is restricted to any significant degree.

In Oklahoma Education Association Inc. v. Nigh, 642 P.2d 230 (1982), and in Anderson v. Board of Educational Lands and Funds, 256 N.W.2d 318 (1977), the court recognized the trustee must take necessary precautions to protect the trust assets.

More recently, The County of Skamania et al. vs. The State of Washington (102 Wn.2d 127 P.2d. (1984), reaffirmed the responsibility of the trustee as mandated in the Enabling Act. The Forest Products Industry Recovery Act of 1982, which permitted purchasers of timber from state trust lands to default on their contracts, or to modify or extend their contracts without penalty, was found to violate Article 16, Section 1 of the Washington State Constitution. The court held that the legislation breached the state's fiduciary duty as a trustee to act with undivided loyalty to the trust beneficiaries and to manage trust assets prudently.

Conclusions from the legal background

The Enabling Act and the Washington Constitution create an express trust. The United States is the grantor; Washington State is the trustee; certain schools and other designated entities are the beneficiaries of the trust. The Congressional intent and purpose in creating these trusts has been construed by the U.S. Supreme Court to be: The trustee is to sell or manage the granted lands to generate income for the support of those public institutions designated in the Enabling Act. Additional management direction comes from the Washington State Legislature, which has the authority to pass laws governing trust management. Such laws are presumed to be valid.

In addition to the constitutional and statutory mandates, the department, as trust manager, has certain responsibilities under traditional trust doctrines. The extent to which the whole of common law trust duties apply to a trustee of a federal land grant trust is a judicial question which has not been clearly decided by the courts.

Five common law duties are set forth in this discussion.

Two that have been judicially recognized are:

(1) *The duty to administer the trust in the interest of the beneficiaries and not for the benefit of others.*

(2) *The duty to use reasonable care and skill to preserve the trust property.*

Although not directly stated, implicit in the various case holdings is:

(3) *A duty to use reasonable care and skill to make trust property productive of income without unduly favoring present beneficiaries over future beneficiaries.*

The department, as trust manager and as an agency created by the legislature, recognizes that it:

(4) *has a duty as a trustee to follow the state constitution, Enabling Act and laws which affect the state land management programs.*

(5) *The duty to diversify the management of federal land grant trust assets in a manner to reduce risk of loss* has not been specifically addressed by courts. Diversifying management practices to moderate economic risks is seen by the department as its responsibility and is consistent with recent revisions of trust law (RCW Chapter 11).

The sum of these principles leads to the following conclusion: in managing federal land grant trusts the department is to be primarily concerned with generating income for trust beneficiaries. The department must follow prudent practices and take precautions to preserve the trust assets for future beneficiaries. The specific steps taken must conform with the Enabling Act, the Washington State Constitution and legislation which affects management of the trust assets.

Forest Board lands

Forest Board lands are forest lands acquired by the state as gifts and purchases, or as transfers from counties to perpetuate the forest resource in Washington. The two types of Forest Board lands—Forest Board Transfer and Forest Board Purchase—comprise over one-half million acres. The legislature has directed that these lands be administered and protected as other state forest lands (RCW 76.12). Questions arise about how these lands should be treated when they experience demands for uses other than natural resource production. The department has decided to review the issues surrounding Forest Board properties, independent of the Transition Lands Program.

Department of Natural Resources

The Washington State Legislature's first session in 1889 established the State Land Commission to supervise and control public uplands and aquatic lands. Another act during that session created the state School Land Commission to supervise selling and leasing school lands. In 1893, the two commissions were combined into the State Board of Land Commissioners. This board was replaced in 1897 by the Board of State Land Commissioners.

The State Board of Forest Commissioners was formed in 1905 to supervise protection of forest lands in the state. In 1909, the Board of State Land Commissioners membership was reorganized and administrative control over the Capitol Building Grant lands was placed under the State Capitol Commission. Powers of the State Board of Forest Commissioners were expanded in 1911 to include forest policy and management, as well as protection.

A complete revision of land administration came in 1921. Duties of the Board of Commissioners and the State Forester were vested in the new Department of Conservation and Development and its Division of Forestry. In addition, the Commissioner of Public Lands assumed most of the duties of the Board of State Land Commissioners. The State Capitol Commission was replaced by the State Capitol Committee.

The State Timber Resources Board, established in 1945, was the first major attempt to consolidate state grant and trust land management into one agency. The matter became controversial and was rejected by a referendum of the people in 1946. Except for aquatic lands the only state land not under control of the new proposed board was University Grant land, which was managed by the University of Washington Board of Regents.

In 1951 a committee on state government organization was formed. In its first report it recommended a sweeping reorganization of public land management. A bill introduced in 1953 failed to gain support, but the committee's second report restated its conviction that a single forest and land management agency be created. This attempt was successful. In 1957 the legislature established the Department of Natural Resources to administer state grant, trust and aquatic lands (RCW 43.30.030).

The diagram and map on the following pages outline the operating structure of the department. Generally, the divisions carry out research and develop programs, while the department's regional offices operate the programs in the field. However, the Divisions of Aquatic Lands and Real Estate develop programs and carry them out without major delegations to the regional offices.

Board of Natural Resources

The law establishing the department also created the **Board of Natural Resources.** The board establishes policies governing the department and makes necessary regulations to carry out its duties. The board is

Figure 1. Department of Natural Resources Table of Organization

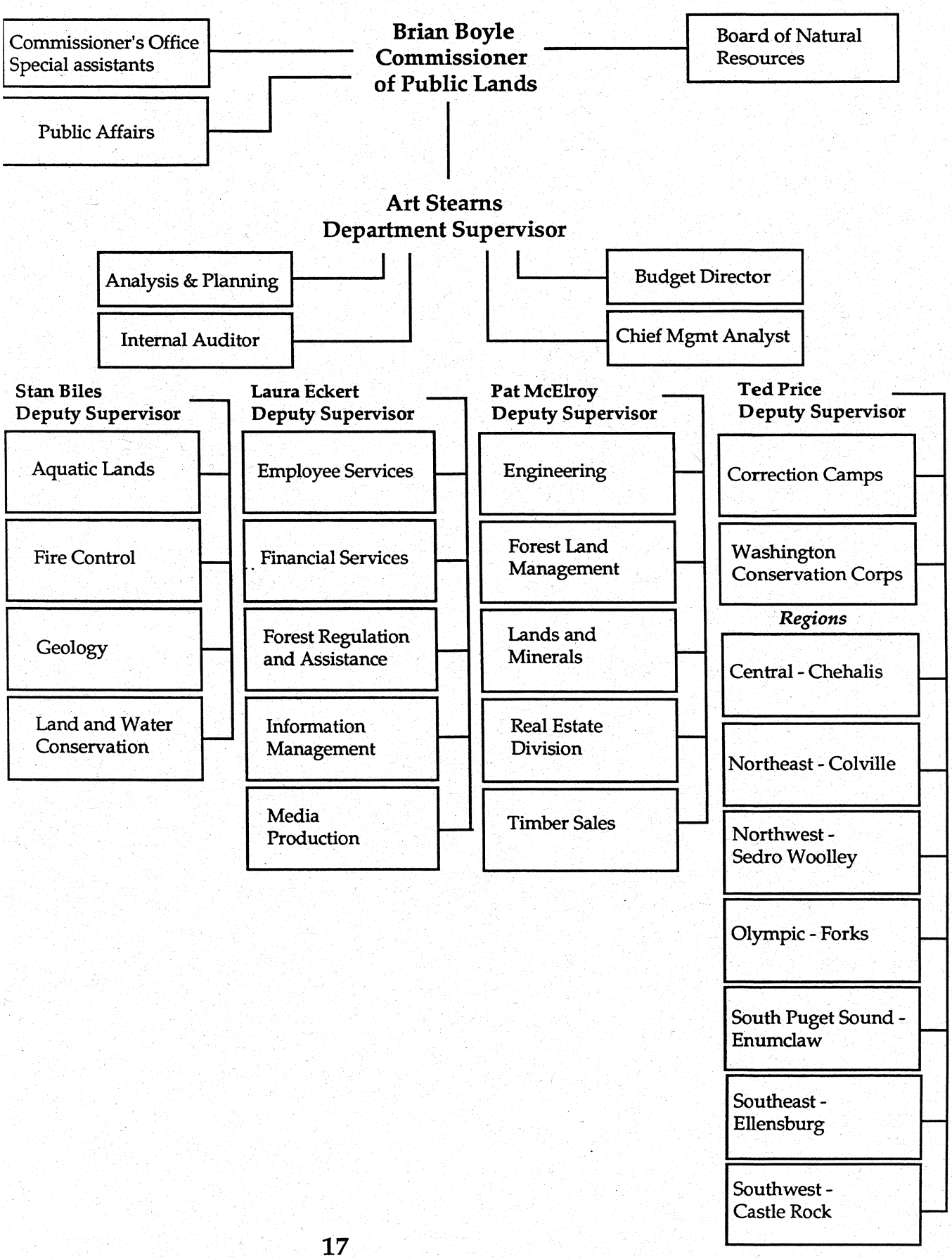
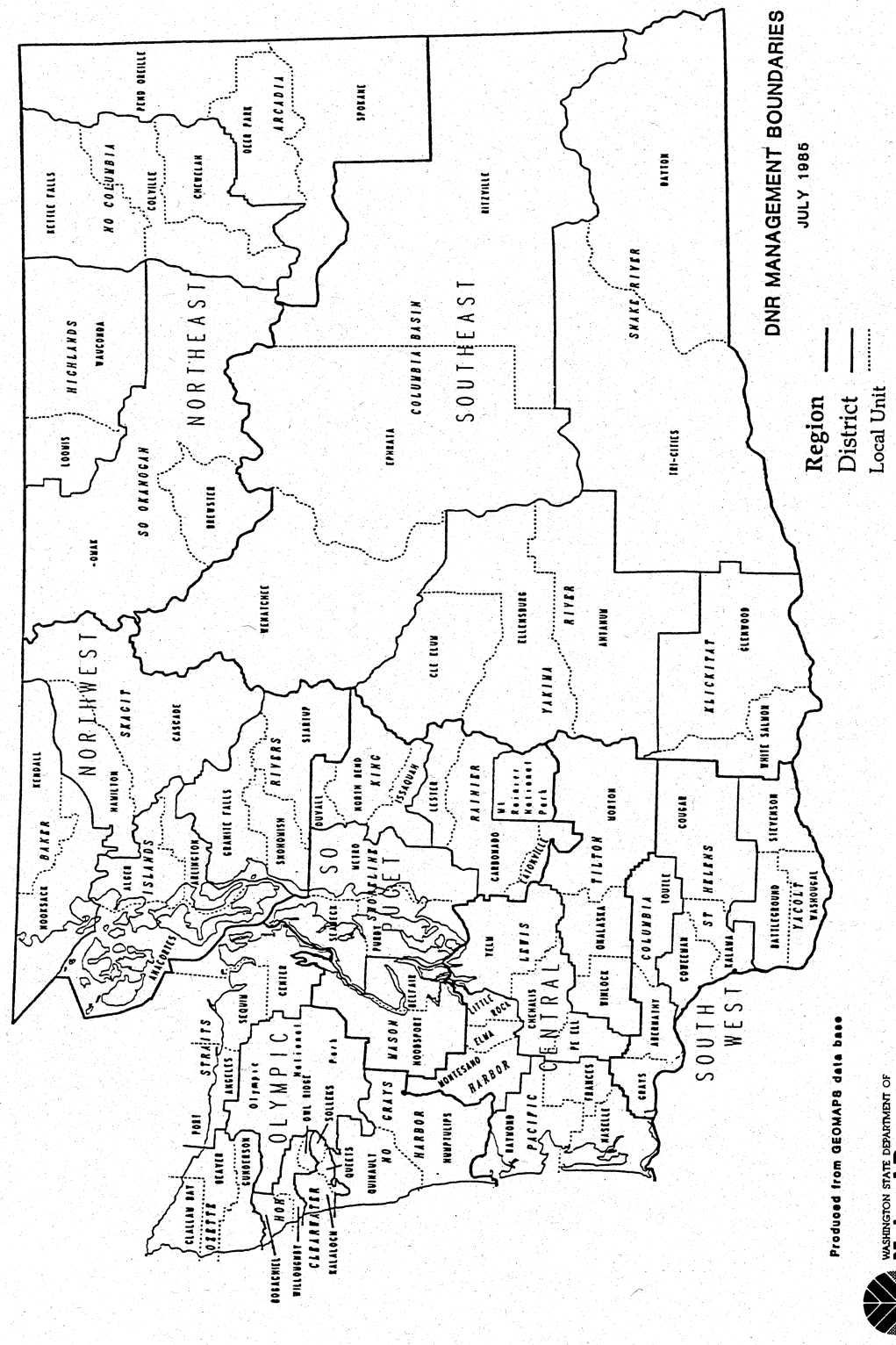


Figure 2. Department administrative unit boundaries



comprised of the Governor; the Commissioner of Public Lands; the Superintendent of Public Instruction; the Dean of the College of Agriculture, Washington State University; and the Dean of the College of Forest Resources, University of Washington. Beginning July 1, 1986, a sixth member was added to the board. This newest member represents Washington counties with Forest Board lands.

Board / Department relationship

RCW 43.30.150 defines the powers and duties of the Board of Natural Resources. The board's duties include:

establishment of policies to insure that the acquisition, management and disposition of all lands and resources within the department's jurisdiction are based on sound principles designed to achieve the maximum effective development and use of such lands and resources consistent with laws applicable thereto.

The board also constitutes the Board of Harbor Line Commissioners and Board of Appraisers for the sale of state land as provided for in Article XVI, section 2 of the state constitution. No land can be sold unless the sum bid is at least equal to the appraised value.

The role of the board in the Transition Lands Program is to:

- Review and adopt goals and policies for trust management programs, including the Transition Land Policy Plan.
- Review and comment on a regular basis on the department's performance and plans for trust land management, including the Transition Lands Policy Plan.
- Approve land sales and purchases.
- Approve land exchanges.
- Approve marketing lands (not sold at public auction) through licensed state real estate brokers or other means.
- Designate suitable trust land as urban land at intervals not greater than once every two years.
- Review advice and counsel from the Land Bank Technical Advisory Committee regarding land bank sales, purchases, and exchanges involving transition and urban property.

Technical Advisory Committee / Board of Natural Resources relationship

The Transition Lands Act created a Land Bank Technical Advisory Committee to provide professional advice and counsel to the Board of Natural Resources regarding land bank sales, purchases and exchanges involving transition and urban property. The Commissioner of Public Lands appoints one member qualified by experience and training in

matters pertaining to land use planning and real estate. The Superintendent of Public Instruction appoints a person qualified by experience and training in public trust matters. The third member, qualified by experience and training in financial matters, is appointed by the State Treasurer (members serve for five-year terms).

The Board of Natural Resources defined its policy on the role of the Committee in Resolution 456 (July 1984) :

- o Review and comment on Land Bank sales, purchases and exchanges involving urban and transition property.
- o Assist in identifying lands feasible for development.
- o Advise on department procedures to ensure maximum revenue to the trust regarding long-term lease conditions and marketing of urban and transition lands.
- o Review procedures and regulations for the planning and leasing process.

Legal authority for the program

The department relies on several authorities for managing properties to produce income from trust lands. Particularly important to the Transition Lands Program are leasing land (RCW 79.01.096) and selling land (RCW 79.66, RCW 79.01). Equally important is acquiring property by purchase and/or exchange for income producing property (RCW 79.66, RCW 79.08.180).

Legal Authority to Lease

The principal authority to lease is found in RCW 79.01.096 and provides up to 55-year lease terms for commercial, industrial, business or recreational uses and up to 99 years for residential uses.

Especially important to the Transition Lands Program is RCW 79.01.242(3):

Leases which authorize commercial, industrial, or residential uses on state lands may be entered into by negotiation. At the option of the department, these leases may be placed for bid at public auction.

Legal Authority to Sell

Before 1966 the proceeds from sales of state lands were placed in the Permanent Fund. In 1977 and 1984, statutory changes were made recognizing the need of the department to sell lands that could not be managed effectively. The legislature also recognized the importance of replacing those lands to maintain the publicly-owned land base (RCW 79.66). The land bank (RCW 79.66) facilitates selling trust land and purchasing by replacement property with natural resource or income-producing potential.

Other important sales procedures to the Transition Lands Program are:

- All sales of trust lands are to be at public auction (RCW 79.01.200). When lands have not sold at public auction, sales by brokers for cash or by real estate contract may be authorized (RCW 79.01.216).

- No public lands shall ever be disposed of unless the full market value be paid to the state. Article XVI, sec.1 and 2. Washington State Constitution.

For further explanation of other state land sales procedures and criteria see RCW 79.01.

Legal Authority to Purchase

The department is authorized to purchase land for resource production (timber, agriculture or grazing) and for income production. All purchases and sales must be approved by the Board of Natural Resources, acting as the State Board of Appraisers (RCW 43.30.150, RCW 79.66).

Legal Authority to Exchange

The department may also exchange state land under authority of RCW 79.08 and RCW 79.66. Provisions important to the Transition Lands Program include:

- The department may exchange property held in the land bank for property of equal or greater value...which has greater potential for natural resource or income production...(RCW 79.66.030)

- Exchange of urban land for land bank land. County, city, town, or certain state agencies (Departments of Fisheries, Wildlife, and General Administration, Parks and Recreation Commission) are given the opportunity to acquire state-owned designated urban land at fair market value (FMV) prior to such land being proposed for exchange to private parties. (RCW 79.66.090)

Source of department operating funds

RCW 79.64.030 (Resource Management Cost Account) provides funds to defray the costs and expenses incurred by the department in managing and administering public lands. A maximum of 25 percent of the revenues generated from the management of state lands is appropriated by the legislature for this purpose.

RCW 76.12.110 (Forest Development Account) funds activities of the department on state forest lands and for reimbursement of expenditures that have been made or may be made from the resource management cost account in managing state forest lands.

State laws significant to the Transition Lands Program

The State Environmental Policy Act (RCW 43.21C)

The department is required to follow the guidelines and procedures specified in Chapter 43.21C RCW in planning and decision-making. This program document constitutes the first phase of **State Environmental Policy Act** compliance for the Transition Lands Program. Designation by the Board of Natural Resources of properties as **urban** (RCW 79.66.080) requires separate State Environmental Policy Act review. The department will also comply with the substantive requirements of State Environmental Policy Act by site-specific environmental review and analysis.

The Multiple Use Act (RCW 79.68)

The department is directed to use a **multiple use** concept in managing and administering department-managed lands when in the best interests of the state and the general welfare of the citizens and consistent with applicable trust provisions.

Urban lands - Cooperative planning, development (RCW 79.01.784)

The department is directed to cooperate with applicable local governments when planning management activities for state-owned urban lands.

The department shall contact those local governments which have planning, zoning, and land-use regulation authority over areas where urban lands under department jurisdiction are located, thus facilitating annual or other meetings.

This statute defines urban lands as:

... those areas which within ten years are expected to be intensively used for locations of buildings, structures, and usually have urban governmental services.

Identification of transition lands

DNR will use these definitions in the transition lands identification and designation process:

Transition Lands: Land currently being managed for natural

resource production that has characteristics indicating an opportunity for more efficient management to obtain a higher economic return by the conversion of the land to another use.[1]

DNR is required to designate certain transition lands as urban under RCW 79.66.080. DNR will be guided by the following definition:

Urban Lands : Land expected to be urban due to designation as "urban " by local land use plans; or authorization for commercial, industrial or residential uses by local government; or where capital improvements and services exist or are scheduled to be available.

Transition lands identification and urban designation process

Based on these definitions the department will identify and inventory transition lands. Periodically reviewing and identifying the trust land base for changing circumstances allows DNR, the public and other governmental agencies to examine alternative opportunities.

The process contains three major activities:

- o Department trust land asset evaluation process
- o Transition Lands Program process
- o Urban designation process

These three major activities and steps are in Figures 3-4 on pages 24-26 to illustrate the timing of each action and how the transition lands identification and urban designation processes will be implemented.

By using this identification and designation process DNR intends to:

- o Show the department's perception of changing land uses or values.
- o Recognize changes in local zoning/comprehensive plan designation.
- o Provide opportunity for comment and input about appropriate interim management strategies.
- o Provide notice to local government and other state agencies to facilitate their acquisition, if desired.
- o Provide notification to the public regarding urban designated properties.

[1] Some indicators of opportunities for higher economic returns include: changing land values, market forces of supply and demand, urban land use trends, demographic projections and surrounding land uses.

Figure 3 Major Steps

Transition land identification and urban designation process

IDENTIFICATION PROCESS

Department trust land asset evaluation process

The department will develop an overall asset management program to guide trust land allocation and management strategies. The asset evaluation process will be an integral part of this program. While overall program formation will occur outside the scope of the Transition Lands Program, discussion of a conceptual asset evaluation process will demonstrate generally how properties will be assigned to the Transition Lands Program.

1 Statewide land use evaluation.
2 Perform preliminary physical/environmental inventory and assessment on trust parcels utilizing existing information from federal, state and local agencies and programs.
3 Intradepartment review.
4 Review information with state and local government agencies to assess potential uses and environmental elements of parcels.
5 Present information and gather comments through appropriate public forums.
6 Perform property evaluation and determine range of alternative uses.
7 Designation of appropriate management regime and functional responsibility. (Asset allocation)

Department of Natural Resources management functions:
Agriculture land management
Forest land management
Transition/urban land management
Mineral land management
Sale for conservation/preservation
Disposal to other public or private entities

Transition lands program process

1 Parcel assigned to Transition Lands Program through trust land asset evaluation and allocation process.
2 Department develops management plan for parcel to guide management in the short- and long-term.
3 Continued management of parcel for interim uses.
4 Increased monitoring of local land use activities to note changes indicating residential, commercial, or industrial land use trends in surrounding areas.
5 Based on noted changes above, update physical/environmental inventory.
6 Update land use inventory.
7 Evaluate updated information and (1) propose for urban designation; or (2) maintain parcel in transition land management status; or (3) assign to other functional program.

RBAN DESIGNATION PROCESS

Public and governmental input process

1 Notify state and other government entities of pending public hearings on the proposed designation of urban lands.
2 Notify affected government and local officials of proposed urban land additions to inventory and pending public hearings.
3 Notify local planning departments, elected officials, and the general public of pending hearings on the proposed designation of urban lands.
4 Hold public hearings on action to designate urban lands. Evaluate comments of public and local government.
5 Set aside socially or politically sensitive properties for further study to result in either: (1) mitigation actions or (2) removal from current consideration for urban land designation, or (3) determination of another method of disposal.

State Environmental Policy Act process

1 Complete environmental checklists for each proposed urban land parcel.
2 Make threshold determination of environmental significance.
3 Defer from current consideration specific sites that may need more analysis.
4 Issue Determinations of Environmental Nonsignificance for nonsensitive sites for 15-day comment period.
5 Receive and evaluate comments on Determinations of Nonsignificance.
6 Defer from current consideration specific sites that may need more analysis based on comments.

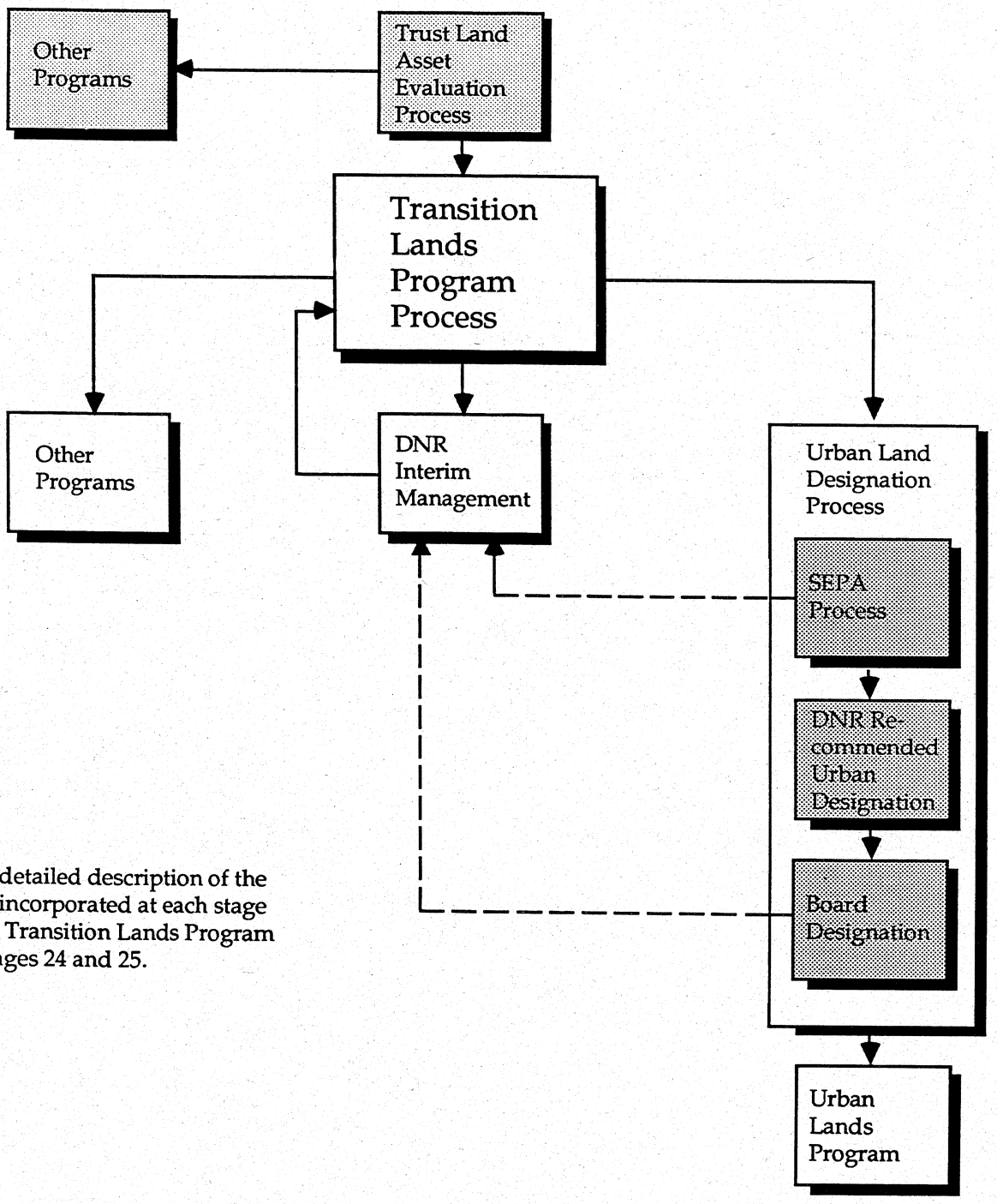
Department and Board of Natural Resources action

1 Recommend to Board of Natural Resources specific sites for urban designation.
2 Send maps of sites proposed for designation to affected governments and resource agencies identified in RCW 79.66.
3 Designate urban properties by resolution of Board of Natural Resources.
4 Notify county, city or town where designated lands are located.
5 Notify local governments at regular meetings of proposed management actions.

Urban Lands program

1 Management of property as urban land.

Figure 4 Transition Lands Program Process



For a detailed description of the steps incorporated at each stage of the Transition Lands Program see pages 24 and 25.

A strategic plan for managing transition land assets

Applicable goals :

Effectively manage transition lands to enhance the financial performance of trust assets.

- o *Manage transition land to optimize land value.*
- o *Manage land assets to achieve an optimum relationship between income and risk.*
- o *Increase the level of financial support to trust beneficiaries.*
- o *Diversify further the sources of income to trust beneficiaries.*
- o *Balance short- and long-term needs of the trust beneficiaries.*

Objectives :

- o *Develop a strategic plan for the transition land assets.*
- o *Identify appropriate investment objectives for these assets.*
- o *Prescribe a framework for managing these assets.*
- o *Provide direction for creating and composing a commercial real estate portfolio.*

The department initially focused its attention on the underlying assets of the various trusts (the trust portfolios). These assets provide the basis from which a strategic plan is developed. Historically, the trust assets managed by the department have been natural resource-producing real estate. The financial assets of the Permanent Fund are managed by the State Investment Board. The department now has the opportunity to purposefully reposition certain land assets and acquire other properties with income production potential to more effectively meet its **fiduciary** obligations.

In formulating a strategic plan, the department adopts the principles of modern portfolio management[2], particularly the need to consider individual investments as components of an overall portfolio. Accordingly, policies relating to transition lands need to be developed in light of overall asset management objectives. The land assets held by the department for proprietary management purposes are a composite of the

[2] The means by which the portfolio is operated is called a plan formulated to achieve objectives. Responsible asset management also requires a system of performance evaluation be established to monitor and evaluate the effectiveness of the plan in achieving its goals. The modern theory of portfolio management is a set of perspectives for analyzing investment opportunities and managing portfolios. The conceptual framework is designed around the notion of maximization of the present value of net cash flows (income which includes changes in asset values); that efficient investment analysis requires a consideration of all achievable opportunities; that estimates of future earnings are of a probabilistic nature; and that an efficient portfolio is one in which diversifiable risks associated with any given income expectation are minimized. (C. D'Ambrosio, *Principals of Modern Investment*; Haley and Schall, *The Theory of Financial Decisions*.)

decisions spanning more than 130 years. Initially, the state received an endowment of lands at statehood. This ownership has been modified, supplemented or decreased by numerous decisions to buy, sell or exchange lands. The development of this policy plan provides an appropriate opportunity for the department to re-evaluate these land assets.

Modern portfolio theory is consistent with both legislative directive to the department and common law duties of a trustee. RCW 79.01.095 directs that:

> **Periodically** at intervals to be determined by the Board of Natural Resources, **the Commissioner of Public Lands shall cause an economic analysis to be made of those state lands held in trust,** where the nature of trust makes maximization of the economic return to the beneficiaries of income from state lands the prime objective. The analysis shall be by specific tracts, or where such tracts are of similar economic characteristics, by groupings of such tracts.
>
> **The most recently made analysis shall be considered** by the Department of Natural Resources **in making decisions whether to sell or lease state lands,** standing timber or crops thereon, or minerals therein, including but not limited to oil and gas and other hydrocarbons, rocks, gravel and sand.
>
> **The economic analysis shall include, but shall not be limited to the following criteria: (1) Present and potential sale value; (2) present and probable future returns on the investment of permanent state funds;** (3) probable future inflationary or deflationary trends (4) present and probable future income from leases or the sale of land products; and (5) **present and probable tax income derivable therefrom specifically from potential private development of land currently used primarily for grazing and other similar low priority use;** such private development would include, but not be limited to, development as irrigated agricultural land. (emphasis added)

Various statutory directives also constrain the range of alternative investments to be considered. For example, RCW 79.66.010 recognizes that:

> ...it may be desirable for the department of natural resources to sell state lands which have low income potential for natural resource management or low income-generating potential or which, because of geographical location or other factors, are inefficient for the department to manage. However, it is also important to acquire lands for long-term management to replace those sold so that the publicly owned land base will not be depleted and the publicly owned forest land base will not be reduced.

Although individual parcels may be disposed of, a primary activity of the department will remain forest land management.

In managing and relocating trust lands, the department will neither deplete the publicly-owned land base nor reduce the publicly-owned forest land base.

General considerations in developing an asset plan for transition lands

The goals for the Transition Lands Program need to be consistent with the objectives of the portfolios of the various trusts. Actions taken on transition land assets of the trusts will affect the overall performance of the portfolio. The plan for transition lands must recognize and work with management plans for other portfolio assets, such as the timber production plans embodied in the Forest Land Management Program, and how those plans relate to the overall trust objectives.

Viewing the portfolio of the trust as a whole, rather than treating different classes of assets as relatively distinct, isolated or separately managed activities has the advantage of integrating actions taken regarding specific trust assets to advance overall trust objectives. This approach recognizes that the policies of the Transition Lands Program can affect overall portfolio performance.

The following considerations are part of the investment objectives upon which this strategic plan will be based.

- o Expected income from assets
- o Financial risk
- o Asset value
- o Timing of income
- o Management costs

The department will develop an overall asset management program for the trusts incorporating overall financial objectives in accordance with the economic analysis statute (RCW 79.01.095).

Expected income from assets

The department recognizes that financial risk and expected rate of return are interrelated and adopts a policy of optimizing the income of the trusts relative to that risk.

The department will optimize the income of the trusts relative to financial risk.

Financial risk

The department has been relatively risk-averse (e.g., being conservative in relation to risk) (*Forest Land Management Program*, p. xiii). Historically, the focus of asset management plans has been on the natural resource issues involved. Since there is a necessary relationship between the degree of acceptable financial risk and the expected rate of return, the department requires a policy that explicitly recognizes the relationship between expected income and financial risk.

The department will establish a policy defining acceptable levels of financial risk and develop an asset management strategy consistent with that policy.

Asset value

Most assets held by the trusts were received at statehood from the federal government without cost. Because these assets were managed for resource production, valuation of these trust assets was not seen as a significant concern. However, the authority granted the department to dispose of certain assets, or to use assets for purposes other than resource management (RCW 79.66) raises this issue. If certain trust assets have higher and better uses than natural resource production, in many instances this will be indicated by their underlying asset values. To determine the total rate of return on capital employed both the value of an asset and any additional capital to be invested should be accounted for.

Asset valuation involves a range of methods from basic staff estimates to a formal appraisal process. Currently, the department establishes value of land assets before requesting capital budget funds for lease, sale or exchange activities. In the future, the values of transition land assets need to be established when assets are assigned to the program. A primary advantage of valuation is the role these values play in identifying assets that can be put to better uses. Asset valuation will also help the department make more rational investment decisions by directing additional capital investments where the returns, balanced against appropriate risks, are expected to be highest. Regular or periodic valuations measure the effectiveness of management activities in meeting overall objectives of the trusts.

Large parcels currently devoted to forest use represent the highest and best use because of location or other factors. For these holdings, asset valuation is not worth the cost of establishing this information. Although the forest base must be maintained, the location or use of individual components of that base may change over time for a variety of reasons. The definition of transition lands (p. 22) suggests there may be many characteristics leading to considering a parcel **transitional**. Some characteristics that suggest the need for asset valuation include resource management conflicts, strategic location of a parcel near commercial activity or proximity to a major transportation corridor.

Valuation of assets allows the department to make more rational investment decisions, assists in allocating its resources and provides a basis for determining how effective management activities are in meeting overall objectives of the portfolio.

Such policy implementation requires developing procedures to determine when and how asset valuation should be accomplished. Assets in the transition land base must be valued at the start.

In accordance with RCW 79.01.095(1), the department will establish asset values for each individual asset or for grouping of assets in the transition lands portfolio as soon as possible.

Timing of income: the trade-off between capital gains and current income

In a typical private trust, there are income beneficiaries and holders of remainder interests. Income beneficiaries receive the income generated

from investment of trust assets; holders of remainder interests receive the assets of the trust at the time the trust terminates. What a benefit accruing to such a trust is called can have important financial consequences for the holders of these different interests. If a benefit is called income, it would be available for distribution to the beneficiaries. If it is called principal, it would ultimately be distributed to the holders of the remainder interests in the trust.

Because the state constitution does not consider distribution of the assets of trusts managed by the department to trust beneficiaries, whether receipts are considered **income** or **principal** only affects the timing of income between current income beneficiaries and future income beneficiaries. The value of trust assets has increased substantially since being placed in trust at the time of statehood. There are no specific legal restrictions on increasing the total dollar value of the assets held in trust.

Economists define income as not only cash receipts minus the expenses of earning the income, but also net changes in asset values. In contrast, normal business accounting practices treat positive changes in asset values as income, but only when the assets are sold. The department treats increases in asset values (capital gains) as additions to principal. When real estate assets of the trusts are sold for cash, the proceeds are added to the principal balance of the permanent fund. When real estate assets are exchanged, any increase in the value of disposed property is reflected in the value of the property acquired by the exchange. This practice is consistent with the requirements of the Washington Principal and Income Act.

Regarding replacement investments for the real estate portfolio, trust managers often can structure the transaction so the total expected return can be allocated (to varying degrees) between income during the life of the investment and increases in capital value which can be realized when the investment is disposed of. Ground leasing transactions, for example, adjust readily to this variable structuring. If income can be shifted from one period to another within the life of the investment, it can affect the timing of the beneficiaries' receipt of income. The amount of current income foregone in favor of increasing asset values reduces cash flow during the life of the investment. However, increases in the value of the assets of the trust presumably increase the potential income to be received by future beneficiaries when these assets are disposed of and the proceeds reinvested. Portfolio management policies guide trust managers in structuring the portfolio in relation to this trade-off between current income and capital gains. Within the portfolio of a specific trust, different assets can be structured in different ways regarding this trade-off. The net present value analysis used by the department in making investment decisions evaluates overall gain from the investment, but does not provide an answer about which investment is preferred for cash flow reasons. Pricing the existing assets in the real estate portfolio must also be considered since it is difficult to determine an appropriate current income/capital gains trade off without knowledge of how much appreciation is occurring with existing assets.

Varying needs of the beneficiaries of the various trust assets managed by the department suggest that different policies are appropriate for different periods of time for managing the various trusts. Likewise, within the portfolio of a specific trust, different assets can be structured in different ways. Different policy alternatives concerning the trade-off between current income and capital appreciation include:

- o Manage assets of the trusts for reasons independent of the effect that management has on the current income/capital appreciation trade-off.

- o Structure investments to maximize cash flow (current income).

- o Aggressively structure assets to increase total asset values recognizing that this implies corresponding reduction in income available for current distribution to trust beneficiaries.

- o Structure investments to balance current income and asset appreciation.

For transition lands, structuring investments to balance current income and asset appreciation will be the preferred policy.

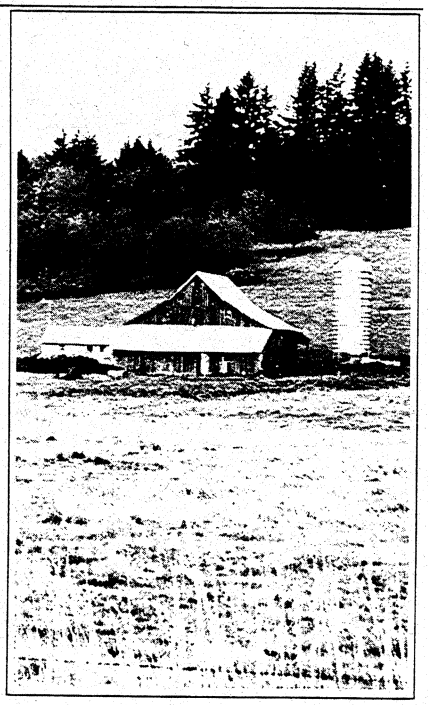
Management costs

Historically, the department was limited to acquiring assets for natural resource production. The ability to acquire commercial income-producing property gives the department various options for replacing underproductive assets with more productive assets. However, different assets with similar income/risk characteristics can vary markedly in the amount of management required. Certain assets have attractive rates of return, but when management costs are considered, the returns are significantly diminished.

Life cycle management costs can also significantly affect the net return of a given investment. The financial analysis of alternative investments should include these costs.

When considering acquiring new trust assets, the department will acquire assets that minimize life cycle management costs for given levels of income/risk.

Risk



The economic analysis statute, court decisions (such as Skamania vs. Washington), and other precedents, require that the prime objective of trust land management is the **maximization of the economic return to the beneficiaries of income from state lands.** However, all forms of trust management involve certain levels of risk. Since expected returns and risk rise together, it is important that asset managers have a well-defined set of objectives on risk and income as well as an understanding of the many forms that risk may assume in any given transaction.

There are two primary forms of financial risk to trust assets: the risk that an asset will not produce the expected income and the risk that the value of trust assets may decline. Focusing on the rate of return based solely on cash receipts for a particular period does not address the risks of negative (or possible positive) change in asset values. The risk of change also varies over time. For instance, renewable resource trust assets may require capital inputs, such as reforestation and competition control costs, to sustain their income production. Therefore, the analysis of investment alternatives should include risk in view of expected rates of return.

The department also recognizes that income/risk operate at the project level and the portfolio level. At the project level, risk is introduced into the analysis by assigning probabilities to possible income streams associated with each investment alternative. The variability of expected income is also important. Generally, if two alternative investment strategies have equal expected values, the alternative with the smallest variance will be preferred. Or, for two alternatives of equal variability, the proposal with the maximum expected value will be preferred.

At the portfolio level, income/risk are potentially reduced by engaging in a range of investments. Diversifying investments across a range differentiated by risk is one way to deal with risk. Another is to be conservative and concentrate capital investments in low-risk investments.

In the Transition Lands Program, the department will recognize risk explicitly in any investment analysis by assigning probabilities to projected income streams. Both variability and the expected value of the return on capital investments will be considered.

Strategies for dealing with risk

Risk can be dealt with in several ways, including specialization, diversification and investment in low risk financial instruments.

Specialization involves concentration of investment in areas of expertise -- what is known best. This doesn't avoid risk, but allows toleration of a higher level of risk because of more sophisticated knowledge concerning the nature of the risk elements.

Diversification involves making investments in a variety of different assets with differing risk characteristics. Investment in low risk assets, such as United States Government securities, is a common strategy for dealing with risk .

The Permanent Fund, (managed by the State Investment Board) with its state constitutional limitations on types of investments, is an example of this approach. Yields can be expected to be correspondingly lower under such a strategy .[3]

Trust law sets the ceiling (at some point) on an acceptable level of risk as well as a floor on an acceptable yield. Risk is generally discussed by comparing risk elements among various classes of assets.

Investment objectives of the trusts relating to risk

Trust assets are now in two forms—land (with associated improvements) and investments in the Permanent Fund. The Permanent Fund assets have an on hand carrying value (book value) as of December 31, 1986, of $287,800,000. Land assets do not have an established value, but currently

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[3] The perception of investment risks has changed from 30 years ago when most fiduciaries considered it prudent to invest most of the assets under their control in long-term, fixed rate government securities. Although this strategy reduces the uncertainty of income, it may increase the risk of reducing capital asset values.

produce about $110 million a year in cash income. The trust portfolio is mainly concentrated in timber producing land. The trusts consist of approximately two million acres of timber and one million acres of agriculture and grazing lands; however, the timber lands produce approximately 90 percent of the total income to the trusts.

The Permanent Fund reflects one element of trust diversification. The fund contributes about 10 percent of trust cash receipts annually and produced a 1986 revenue of $26,200,000 for a checkbook or annual cash revenue return of 9.0 percent. The Permanent Fund is invested in high quality securities.

Agricultural lands and the present commercial lands are additional diversification elements. However, current income contributions from these sources are considerably less than that provided by timber. Trust law dictates that assets be evaluated from a diversification point of view according to the **prudent person** standard. Diversification includes shifting to differing kinds of assets located in different industries, markets, and regions.

A conservative approach to risk management dictates that the department further diversify its assets. The department's statutory obligation to maintain the forest base limits the extent to which alternative investments can be made. Constraints on the permissible range of department investments (forestry and other natural resources) may create a volatile situation (variability of expected returns) because of market fluctuations. In the case of the department's timber lands, biological and physical risks are diversified by cultivating different species and different age classes. The value of these different forest lands and the current income they produce are highly correlated over time. However, financial diversification is achieved by investing in assets whose values and incomes are not correlated to provide income stability over time. Thus, **a program of biological diversification does not necessarily accomplish financial diversification.**

An efficient portfolio should be managed so that the lowest possible risk is incurred for any given rate of return. However, all financial risks in managing a portfolio cannot be eliminated by diversification. The reduction of risk to the portfolio from diversification occurs because high returns on some assets offset low returns on others, decreasing the variability of portfolio income as a whole.

In acquiring assets for a diversification program, each separate asset should be subject to an investment analysis which considers the asset's income contribution to the portfolio as well as its effect on the portfolio's total risk.

The department will actively pursue a program of diversified property investments to reduce the risk of variability of income.

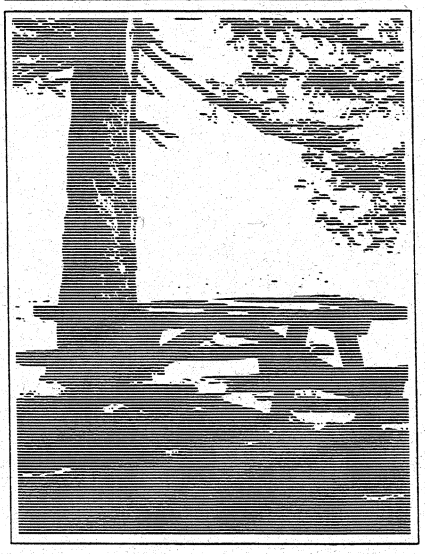
As part of a diversification program, the trusts invest in all types of prudent real estate assets. These assets should become a significant portion of the total assets of the portfolios as they are diversified. The Permanent Fund currently represents a set of financial assets that are an important part of this diversification proposal. Its primary drawback is the limitation on the type of investments currently permitted by the state constitution.

Diversification

Some department land assets are currently being put to their highest and best use as commercial real estate. They will be retained as part of the real estate portfolio (which is a main element of the diversification strategy discussed above), providing they approximate the investment objectives of trust managers. Other lands may be converted from natural resource uses to higher and better uses, which may involve commercial real estate, as well as other uses. Trust land should be valued at its highest and best use. This type of valuing, although not appropriate for financial statement accounting, would be appropriate for economic modeling and would form the basis for evaluating transition lands for conversion. (i.e., retention with capital investment or disposition and replacement.)

The decision to convert property to a higher and better use is independent of whether additional capital will be invested in the conversion or whether those assets will be retained by the trust once its value is enhanced.

Transition land assets will be allocated to their highest and best uses.



Managing the transition land base

Transition land assets frequently do not provide appropriate returns to the trusts based upon their underlying market value. Recognizing this opportunity, the department will use different management strategies to increase income and realize the goals of this program.

Value enhancement

Historically, the department has developed several approaches to deal with transition lands including offering property with conversion potential for **ground lease** to the end-user, assisting in the formation of local improvement districts to bring utilities to a property, working actively with the planning and zoning process to obtain more valuable or certain land uses, and funding capital improvements for infrastructure. All these efforts are part of the value enhancement process.

A goal of assigning transition lands to the program is to increase the current rate of return. Specific activities to achieve this goal will be determined by identifying parcels which promise the highest yield on investments over the time period considered. To evaluate alternative projects, site planning must be sufficiently detailed to identify the likely amount of resources that must be invested to achieve the desired result.

Performance tracking and review will provide the necessary feedback to assess the appropriateness of specific value enhancement projects in meeting portfolio objectives; financial analysis is also an essential component. The department intends to periodically assess the success of these various projects.

Financial analysis will be central in directing the efforts of the program—establishing project priority in determining the allocation of capital, and in measuring the degree of success in carrying out specific projects.

Value enhancement activities

A review of current statutes shows no significant legal constraints to value enhancement. Value enhancement, as used here, is limited to natural resource management activities, paper improvements (changes in the legal status of the property), site enhancement and those physical infrastructural investments characteristically financed through local improvement districts (such as those for providing water, sewers and roads to the property). From an economic perspective, the specific activities undertaken should be limited by analyzing the project return and the availability of capital and managerial skill to carry out the project. A critical element in determining the highest and best use for a parcel is analyzing the market for alternative uses (the demand for the end product of conversion). Depending upon the timing of conversion, many parcels undergoing value enhancement can still be managed for natural resource production. Those activities will be tailored to the end use anticipated for each property.

The value enhancement process relating to real estate includes various stages. These extend from such activities as a change in platting and zoning, acquiring access, site preparation and development of infrastructure, to the addition of improvements.

Acquiring adjacent parcels to create an economically sized property (land assemblage) may be an important part of the conversion plan for a particular parcel of real estate. The *Capital Investment* section p.77 identifies potential sources of capital for this effort.

While potential returns from value enhancement can be at least as great, or greater, than the returns from other proprietary activities, the department has the option of deciding that value enhancement of any particular parcel is not worth the effort; that gains can be realized from passively holding property until the opportune time for disposition.

The department will create and realize additional value on transition lands by facilitating the conversion of these lands to more economic uses.

The department will structure the value enhancement process to best reflect the planned disposition of the parcel. At this point, the full benefits of these efforts will be realized. Currently, parcels can be either sold or exchanged. Certain enhanced parcels may be desirable additions to the real estate portfolio of the trusts, if appropriate end-user arrangements can be made. However, the value enhancement process should be viewed independently of considerations guiding the decision to acquire real estate assets for the trust portfolios. The value of transition land parcels should be enhanced until they convert to their highest and best possible use. The result of this process will not necessarily produce investment quality assets appropriate for the trust portfolios.

On certain individual parcels it may be desirable to structure an agreement with end-users for developing the property. Properties considered for retention should be fully analyzed and comparable to that undertaken when potential new real estate investments for the portfolio are being evaluated.

Usually, the department will cease value enhancement efforts at a stage before developing end-user improvements.

Role of real estate in a trust portfolio

Diversification is one major benefit of holding income-producing commercial real estate. Currently, the predominant source of income for the trusts is from forest management. Fiduciaries consider commercial real estate a desirable portfolio element for many reasons, including capital appreciation, opportunities for direct management and cash flow. Real assets, such as land, might gain capital appreciation during inflationary times.

Real estate also provides an opportunity for more direct management of assets than is possible with financial instruments. The degree of involvement (and potential returns) can be selected by the way in which the ownership/financing of a particular piece of real estate is structured (e.g., holding a mortgage, a ground lease, or a limited partnership interest or fee ownership). Real estate investments can also generate cash flow that offers a potential rate of return competitive with other investment alternatives.

Types of real estate assets to be included

A fundamental question regarding the portfolio is what type of real estate investments the department should make. The department has a long history of ground leasing. In contemporary real estate transactions ground leasing occupies a relatively minor role; unsubordinated ground leasing is even less common. (Subordination of property interests is fully discussed on page 72 [Private Sector].) In an unsubordinated leasehold mortgage the owner of the land has not permitted its fee interest to be placed in a subordinate position to any lender's mortgage for the benefit of the lessee.

Most fiduciaries consider purchasing or holding raw land to attract ground lease development a speculative strategy. **Sale and lease backs** on improved realty are uncommon where only the ground is acquired. Sale and lease back refers to the sale of a property and the simultaneous leasing of it back to the seller or another party at a previously agreed upon rent. Each transaction needs to be custom-tailored to the particular requirements of the parties. These negotiations can be time-consuming with no guarantee that a particular transaction can be completed within a set time.

The department's timing of new investments is often dictated by the sale of existing assets, which is not always predictable. Additional skills are required of those who attempt to structure and evaluate sale/lease back transactions for the department. In addition, ground leasing does not generate the returns available from participation at more advanced stages of real estate management.

In recent years, fiduciaries began acquiring direct equity or ownership interests in real property, often structuring those interests to avoid assumption of active management responsibilities. Pension funds have become substantial outright buyers of real estate and also hold various other forms of real estate interests.

As a trust manager, the department will not limit its investments in real estate solely to acquiring land (subject to ground leases). There is nothing inappropriate in acquiring land only (subject to ground leases). However, restricting real estate investments to ground leasing makes realization of financial objectives more difficult. Advantages of direct forms of ownership include the ability to acquire equities in properties that would otherwise not be available under ground leasing and to realize higher rates of return from ownership interests in already developed properties.

The department will consider acquiring various types of real estate ownership interests that meet the investment policies of this program.

One type of investment which raises serious management questions for the department is ground leasing involving single-family residential development.

Experiences in Hawaii, the Irvine Ranch in California, and elsewhere suggest that attempts to adjust rents to reflect underlying value increases can create significant management problems.

In general, the department will not acquire single-family residential ground leasing investments for the real estate portfolio.

Directions of real estate investments

Diversification and attractive potential yields are the main reasons for acquiring a commercial real estate portfolio. Certain sectors of the state economy are expected to achieve better than average growth. This may change over time and should continue to be evaluated. Program activities will be directed toward end user groups likely to achieve above average growth. In considering various investments, the department intends to consider businesses in which the end users of real estate are involved. A current assessment of promising areas of the state's economy suggests that desirable end user groups include trade and service sectors, high technology and tourism/recreation. Industrial activities with high capital facilities investment may also be long-term, stable producers of lease revenues.

The department will invest in real estate with end-user activities which are shown to have potential for either growth or long-term stability.

Investment opportunities that capture benefits from existing adjacent department ownership warrant attention. In particular, the department has a significant inventory of over-the-water properties. The recently enacted aquatic lands legislation (RCW 79.90.450 *et seq.*) provides lower than market rental rates for water dependent uses. This enhances the value of privately-owned adjoining upland properties. Locations throughout the state may exist where multiple public objectives can be realized by purchasing this type of property, particularly where nonwater dependent uses exist on adjoining uplands.

Characteristics of desirable portfolio assets

The department will consider all interests in improved and unimproved real estate and give particular emphasis to certain key sectors of the state's economy in property selection and management for the portfolio.

Generally, the department will invest in improved property since current and reliable income is an important need of the beneficiaries. However, in certain cases, unimproved property may have a high potential for development on leaseholds and may also have significant appreciation potential.

Some characteristics of investment quality **improved** real estate include:

- o Superior location
- o Demonstrated successful management
- o Reliable income stream
- o Quality tenants
- o Well-constructed and maintained improvements
- o High marketability
- o Limited management requirements for the investor
- o Ease of conversion to other uses

Characteristics of **unimproved** real estate which might be considered for acquisition include:

- o Superior location with defined access and visibility
- o Established stable zoning
- o Fast-paced absorption in market place
- o High ground lease marketability (high demand for limited supply of land)
- o Utilities in place and sized to contemplated uses
- o Defined growth area
- o Adequate supply of both interested and experienced developers/ lessees

Table 2 illustrates some characteristics of various real estate investments.

All property acquisitions will be of investment quality suitable for ownership by trusts.

Evaluation of the existing portfolio

The basic question about existing assets is whether they have the potential for, or can currently meet, the investment objectives of the trust. A thorough analysis of each property is necessary. When properties do not meet stated investment objectives, they should be prudently disposed of and the disposed proceeds reinvested in trust quality assets. Currently, many parcels in the transition lands portfolio produce little or no income.

Table 2. Characteristics of Property Types

	Agricultural and undeveloped land	Predeveloped land	New apartments	Existing apartments
Function	Agricultural, forest, and mineral production; recreation	Held for investment and speculation on successful development	Shelter, housing, amenities, and living environment	Shelter, housing, amenities, and living environment
Investment characteristics:				
Cash flow	Low (or negative)	Negative	Low to medium	Reasonable
Tax shelter	Low	Low	High	Low to medium
Inflation hedge	Good	Good	Good	Good
Operating risk	High	High	High	Average
Liquidity	Relatively illiquid	Generally hard to sell	Generally good for smaller units	Generally good for smaller units
Mortgage financing	Financing primarily by sellers and specialized government programs	Financing almost exclusively available from seller; favorable financing terms reflected in higher selling price	70 to 80% conventional financing, with land lease possible for developer to "mortgage out"	70 to 80% financing available from conventional sources; seller often carries back secondary financing
Ownership characteristics:				
Owner's equity	Generally owned by user with increasing tendency to investment by institutional investors and partnerships	Owned primarily by individuals, partnerships, and large corporations	All types of owners, including many individuals and partnerships	All types of owners, including many individuals and partnerships
Size	Can be bought in all sizes, but meaningful operating economies require substantial holdings	Can be of any size	All sizes; tend to be somewhat larger than existing apartments	All sizes; tend to be many small units available
Management time required	Heavy; constant supervision required if in use	Low, although it is essential that important developments be monitored, but when disposition occurs, substantial management time could be required	Extensive for initial rent-up; average to heavy for ongoing operations	Average, except that "problems" can make excessive time demands
Management expertise required	Very high; timing of paramount importance	Moderate, although ability to interpret—and influence—political and economic trends is important	Average	Average
Economies of size	With the trend to use of more advanced technology and larger capital-intensive equipment, large land holdings advantageous	Large acreage can represent substantial economies of scale	Substantial economies realized with larger units	Substantial economies realized with larger units
Economic characteristics:				
Users	Farmers, ranchers, individuals, corporations	Large corporations, individual speculators	Families and individuals of moderate means or those who choose not to own a home (usually rents for more than an existing unit)	Families and individuals of moderate means or those who choose not to own a home
Term of use	Lifetime down to yearly leases	1 to 5 years	Year leases, condominiums, and cooperatives to lifetime	Month to month, some year leases, condominiums and cooperatives
Demand influences	Population levels, food and other consumption levels, technology, transportation systems	Population trends, general economic conditions, land-use controls, transportation systems, availability of money for development, government programs (new communities financing)	Population increases, family formation rates, social and economic changes, life-style modes, amenity packages offered	Population increases, family formation rates, social and economic changes
Supply influences	Water availability, transportation access, removals due to development activity, fertility and soil conditions, scenic or other recreational possibilities	Land-use regulations, conversion to developed status, establishment of parks and natural preserves, regional growth patterns, density and sprawl trends, volume of land promotion activity	Removals from housing stock by demolition or condemnation, availability of money for new financing, land-use approval process, political environment, special government programs (FHA subsidized housing, housing allowances)	Removals from housing stock by demolition or condemnation, political environment, conversions to other use (condominiums), conversions from other uses (e.g., hotels), supply of new units
Government controls	Crop subsidy programs, formal financing programs, land-use controls	Land-use controls, restrictions on marketing practices	Restrictions on condominiums, property tax assessment policies, financing availability (specialized government programs), land-use regulations	Restrictions on convertibility to condominiums, property tax assessment policies, financing availability (specialized government programs)

Hotel and motel	Individual, strip, commercial, and small office properties	Shopping centers	Office buildings	Industrial property
Protection for travelers, home away from home for travelers, a communications related property	Exchange goods; distribution centers; personal services; administration and management	Exchange goods, distribution centers; opportunity for concentrated shopping experience	Personal services, administration and management of economic and social systems	Conversion of raw materials, production of manufactured goods, labor, land and capital meet here
Possibly high	Average to good	Average to good	Average	Average to high
Medium to high	Low to medium	Low to medium	Low	Low
Good	Low	Average	Average	Poor
High	Average to high	Low	Average	High
Harder to sell because of operating risks	Low to average	Relatively good if leases are strong	Relatively good if leases are strong	Very hard to sell unless there is strong long-term lease
Financing dependent upon previous operating record and strength of management	70 to 80% conventional sources; seller may often provide secondary financing	Financing dependent upon major department store as anchor tenant as well as designated percentage of leases signed	Financed often on a floor-ceiling arrangement whereby additional increments of financing depend on threshold levels of leasing being achieved	Financing depends on credit rating, often owned by occupant; if not, financing will depend on credit rating of lessee
By operating companies or when owned by individuals or partnerships, generally leased to an operating company	Smaller investors, individuals, small groups	Tend more to be owned by larger investors including corporations, REITs, and insurance companies	Tend more to be owned by larger investors including corporations, REITs, and insurance companies	Often owned by users; otherwise, REITs and other institutional investors
Range from "Mom and Pop" operations to very large units	Moderate	Some smaller investment properties available, but tend to become larger	Come in all sizes, but a number are very large and require substantial capital	Tend to be medium-sized to larger units
Excessive; a 24-hour operation requiring constant attention	Average to high, particularly where leases are of shorter term	High; requires constant promotion and attention to maintenance and tenant satisfaction	Average to low	Relatively low, although negotiating leases can be very time-consuming
High; the constant client contact and continual turnover, combined with diverse array of services provided, require broad knowledge	Average	High, particularly in negotiating leases and conducting promotions	Average, though lease negotiation requires high level of sophistication and expertise	Average to high; lease negotiation can be particularly complex
Trend to larger units is more efficient for operations	Low, unless multiple properties owned	Substantial management economies with larger centers; can enjoy joint promotion activities	Size tends to be of less concern, although it can effect certain savings	Manufacturing trend to larger facilities, although many businesses require modest amount of space
Individuals, families, travelers, business	Households, small businesses, chain stores, white-collar workers	All households (particularly heavy usage in suburbs); small businesses and chain stores	White-collar workers, administrators and managers, large and small businesses	Blue-collar workers, managers, large and small corporations
Overnight, weekly	1-year to long-term leases	1 to 50-year leases	1- to 10-year or longer leases	Lifetime down to short-term
General economic conditions, recreation and leisure trends, transportation availability and pricing, special events (conventions, conferences, expositions)	Population levels, transportation access and technology, parking, competition	Population, density, general economic conditions, spending patterns, presence of demand "magnet" (special attraction to bring people to center)	Economy, politics, social modes, communications technology, size of work force, work technologies (space per worker, equipment per worker)	Economic conditions, business cycles in specific industry, foreign trade and tariffs, raw-material availability, technological developments, land-use laws
Removal of space of existing units from market; conversion of existing units to alternative uses; perceived demand; financing availability; land-use regulations; conference, convention, and exposition demand	Land or lot availability, existence of commercial "strip," local government attitude toward transportation and strip development	Capital availability, competitors' perceptions of demand potential, department-store location decisions, new housing development, economic conditions, government regulations	Corporate location decisions, financing availability, government decision (i.e., locating new facilities), corporate "image" decision, space utilization patterns, business climate, removal of space from market, movement in direction of "urban" downtown	Land-use controls, pollution regulations, technological obsolescence, changing manufacturing or service orientation of economy, conversion of space to alternative uses, removal of industrial space from market
Restrictions on convertibility to condominiums, property tax assessment policies, financing availability (specialized government programs), land-use regulations	Zoning, building codes, willingness to supply services, traffic control	Property tax assessment policies, financing availability (specialized government programs), land-use regulations	Restrictions on convertibility to condominiums, property tax assessment policies, financing availability (specialized government programs)	Property tax assessment policies, financing availability (specialized government programs), land-use regulations, pollution emission standards

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As land values are enhanced, an income stream from interim uses may be produced. An analysis (similar to that used for the existing portfolio) is appropriate to determine if such properties will be investment quality, and if they should ultimately be included in the portfolio. If so, they can be retained at a substantial saving of the transaction costs associated with acquiring assets. A formal decision process should be established as part of this analysis. Recommendations by the **Technical Advisory Committee** (p. 19) should be an important element of this process.

Each existing commercial holding in the portfolio will be evaluated for retention. All proposed acquisitions will be evaluated by the same procedure.

Asset acquisition

Historically, the department has chosen to rely on both internal agency resources and outside contractors when selecting real estate investments - - whether by purchase or exchange.

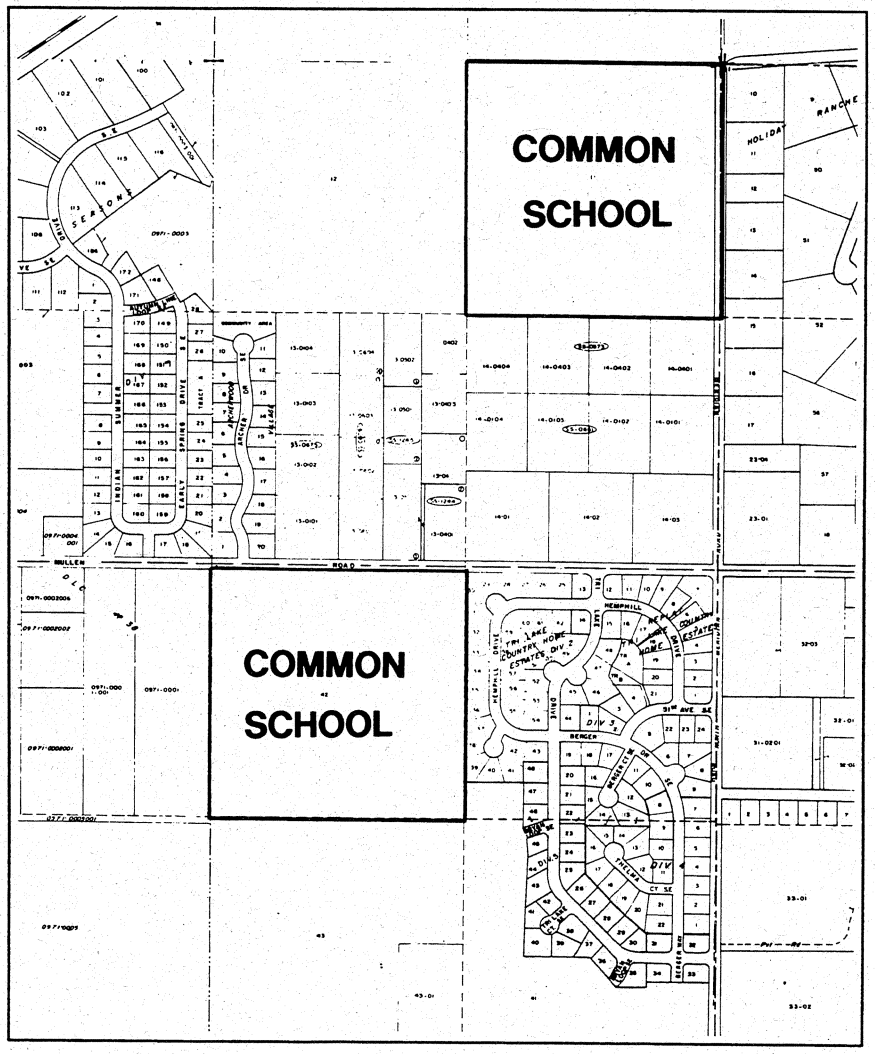
Acquiring suitable assets requires sophisticated skills and in-depth market knowledge about property availability and other factors. Many such properties may never be publicly listed. Because investments are periodic, the department is not sufficiently and continuously active in the market to be aware of all opportunities available.

Although the department must necessarily review and finally determine which properties to acquire, initial selection of alternative properties can be conducted by one or more available private institutional investor real estate advisory services.

The internal department analysis of investments will be based upon established investment objectives relating to rate of return, cash flow, and other established criteria. A rigorous, well-documented process of analysis will be established in selecting investments for the trusts.

The department will avail itself of the best expertise and procedures available in selecting trust quality investment assets for addition to the portfolio.

Part II
ANALYSIS of TRANSITION LANDS

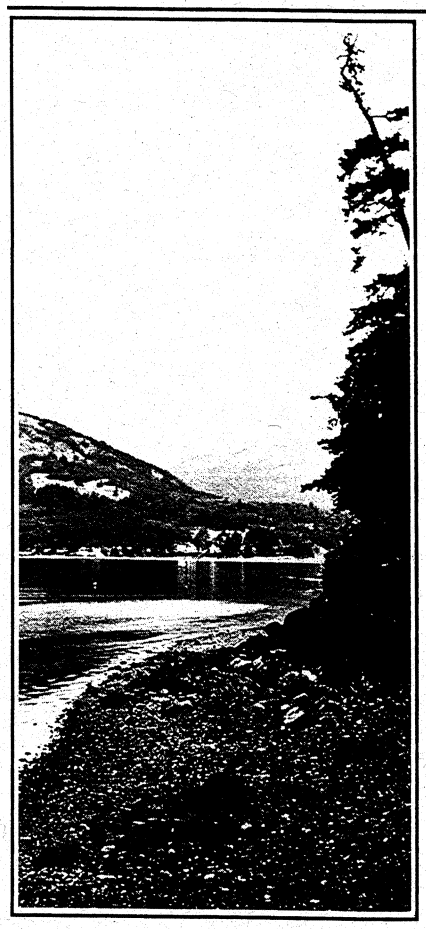


Part II
ANALYSIS of TRANSITION LANDS

Environmental review

Economic models and evaluation

Interim uses



Environmental review

Applicable goals :

Provide for environmental protection through site specific analysis and through planning with local governments and comply with applicable local, state and federal environmental requirements.

Objectives :

- *Identify and assess the natural elements on transition lands.*
- *Promote quality of environmental analysis and consistency of environmental review on transition lands.*
- *Promote protecting and enhancing environmental quality on transition lands, using policies and goals of the State Environmental Policy Act.*

A detailed review of the environmental components of property is a key step in successful land allocation and management decisions. The review process provides a series of evaluative sieves by which properties are separated. Those properties recognized as more environmentally sensitive would catch the attention of the land manager for appropriate action or further analysis.

Environmental analysis of properties before they are formally identified as transition lands leads to environmentally sensitive and cost effective allocation decisions, while implementing the program goals.

The department will make land allocation decisions which acknowledge the resources identified in the trust land asset evaluation process. Decisions will also weigh economic, political and social factors in determining land use that serves the interests of the trusts.

Environmental analysis on transition lands currently consists of phased review. An environmental checklist, required by the State Environmental Policy Act was completed in 1984 for lands which were designated by the Board of Natural Resources as **Urban.** When the department proposes site specific actions, environmental review and analysis is required. Generally, local government will be the lead agency for State Environmental Policy Act review.

The department will comply with applicable local, state and federal environmental review and analysis requirements.

Timing of environmental review

Identifying and evaluating the environmental elements and the natural resource capabilities on potential transition lands aids the department in determining a range of suitable uses for the land.

Preliminary environmental information assists in identifying potential natural resource constraints on a parcel of land and enables the department to assign the property to the Transition Lands Program or to another area of department responsibility. Other state or local agencies may be better suited to own or manage a particular site. For example, the department recently conducted a review of trust lands suitable for acquisition by the State Parks and Recreation Commission as required by the legislature). Allocation of a parcel to the transition land inventory will be based upon prior environmental assessment (Figure 3, pp. 24-25).

DNR seeks environmental information about its lands before it makes land management decisions or enters into transactions. The department also conducts an environmental review of prospective properties to acquire (by purchase or exchange) for the real estate portfolio.

A process of environmental review ensures that potential transition lands are initially reviewed from a natural resource basis. By taking this stance, the department assumes responsibility for examining the natural resources to identify potentially sensitive elements.

Instrumental in this examination process will be the Natural Heritage data system developed by the Washington Department of Game and the department's Natural Heritage Program. This system, accessible throughout the department's Total Resource Application Cross Reference System (TRAX), contains reference information on high quality natural communities and sensitive plant and animal species throughout Washington. The system indicates when site-specific information is available for the state's natural heritage resources. This data base is continually updated through the inventory of lands for special plants, animals and plant communities by the Departments of Wildlife and Natural Resources.

Environmental evaluation of potential transition lands aids the department in making appropriate land management decisions.

Before assigning property to the transition land inventory, the department will assess the natural elements of the environment and sensitive areas on potential transition land parcels.

Inventory and assessment

Step One in an environmental analysis is to inventory elements of the natural environment located on potential transition land parcels. Identifying these elements and the relationship of the elements to the parcel, as well as the relationship of the parcel to surrounding land, constitutes a catalog of the physical characteristics of the natural resources on that property. Natural environment means those aspects of the physical environment which include:

earth	geology, soils, topography, unique physical features, erosion, accretion
air	quality , odor, climate
water	surface water movement, quantity and quality; runoff; absorption; floods; ground water movement, quantity and quality; public water supplies

plants and animals	habitat for and numbers of; diversity of species of plants, fish or other wildlife; unique species; fish or wildlife
energy and natural resources	amount required, rate of use, efficiency, source, availability, nonrenewable resources, conservation and resources, renewable scenic resources, archaeological sites
historical and cultural preservation	places or objects listed on or proposed for national, state, or local preservation registers; landmarks; evidence of historic, archaeological, scientific, or cultural importance.

Identifying whether a parcel is environmentally sensitive is necessary when planning by State Environmental Policy Act rules. DNR's purpose in identifying such sensitive areas is to provide additional information about the character of the natural elements on the parcel and the relationship between the parcel and the surrounding area. This allows the department to make better management decisions and develop measures to mitigate potential problems.

The department believes that a flexible interdisciplinary approach is most appropriate for site analysis. However, it does not require that professionals from each biological and geological discipline review each parcel. The department will consult with other agencies of jurisdiction to determine the necessary level of professional review for a particular parcel.

The department will use an interdisciplinary approach to:

- *Identify the elements of the natural environment which are located on a parcel.*
- *Determine whether the parcel alone or in concert with the surrounding area is environmentally sensitive.*

Assessment and protection

The department proposes to make a preliminary evaluation of the significance of environmental elements through evaluation by technicians in the department when available and through review by other state and local government agencies. Flora and fauna information about the importance of particular species or habitat is available from the Natural Heritage Program, the Washington State Departments of Fisheries and Wildlife, and the USDI Fish and Wildlife Service. Local agencies and environmental authorities will be consulted to determine elements of local and regional significance.

Thus, the department can make a preliminary assessment of the local, regional, and statewide significance of natural elements on trust lands being evaluated for the Transition Lands Program. Management prescriptions can then be recommended for protecting the resource together with proposed land uses.

Before allocating lands to the Transition Lands Program, the department will conduct a preliminary review of the renewable and nonrenewable elements of the natural environment, to determine which may be significant.

Environmental information in transition land management

Adequately addressing the environmental aspects of a site before allocation to the Transition Lands Program assures that fewer problems in future management will arise from going against the grain of the property.

In the department's management of the transition lands portfolio, environmental analysis will be one of the foundations for land use and land allocation. This inventory and analysis (conducted in cooperation with other resource agencies and organizations and in conjunction with an objective analysis of the capacity of the land to support a variety of uses) provides a solid base from which allocation decisions can be made. The department is considering the resource base from the beginning in determining the allocation of trust assets.

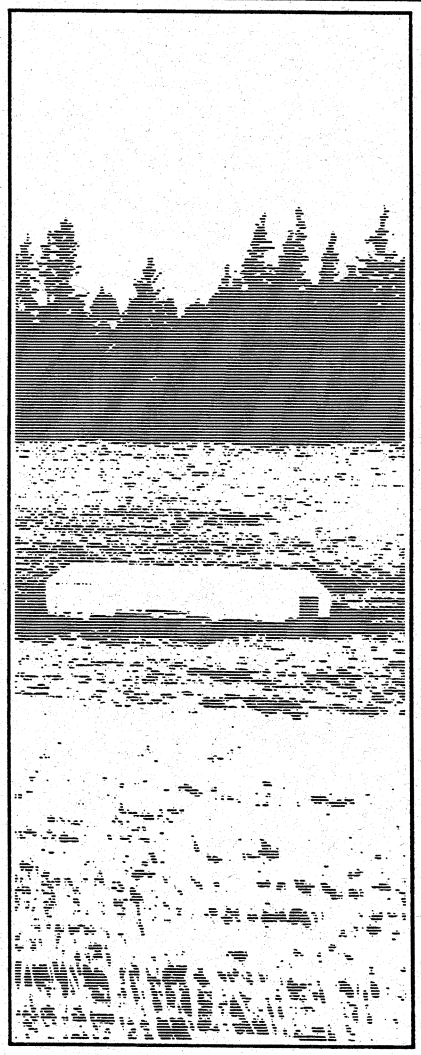
The department then will emphasize market place determinations for the particular uses and actual improvement of a property. Environmental inventory and assessment provide the information necessary to make decisions which protect the resources from significant damage and minimize environmental impacts. In consultation with local governments, the department's emphasis on proposed property uses having the least potential for nonmitigable environmental impacts, allows ample flexibility in land use decisions.

The department will encourage those uses which can mitigate potential environmental problems and protect sensitive areas.

Conditioning land transactions

For land identified as transition land and retained as a trust quality asset, the department retains greater control of potential impacts by setting appropriate guidelines or conditions for uses. These conditions will be developed before offering property for lease to the private sector. Monitoring and compliance will be a necessary part of lease administration to ensure that terms of the contract, including resource protection, are enforced. By using flexible guidelines, the department can protect important resources while allowing lessees to manage the property. The property lessees are free to use their judgement for management, but the department retains underlying control of the property while structuring a relationship of trust and stewardship with the potential lessee.

Leases on transition lands may have conditions for environmental protection developed in cooperation with appropriate agencies indicated by the resource inventory and analysis and local government land use controls.



Economic models and evaluation

Applicable goals :

- o *Manage transition land to optimize land value.*
- o *Manage land assets to achieve an optimum relationship between income and risk.*
- o *Seek interim uses that fully utilize the current potential of the property yet preserve and enhance the qualities that attract higher and better uses.*

Objectives :

- o *Develop a framework for economic evaluation that identifies the highest and best use for each tract of transition land.*
- o *Select an economic model(s) for evaluating investment alternatives.*
- o *Identify an appropriate discount rate, time period and means to incorporate risk and uncertainty when evaluating trust investments.*
- o *Determine a method of comparing actual and expected economic performance for evaluating trust investments.*
- o *Determine a method of comparing actual and expected economic performance of transition lands assets.*

Economic analysis

Commercial real estate management is a complex segment of the department's total land management operation. Economic modeling is needed in planning new or enlarged projects and in evaluating and comparing both current projects and new opportunities. Within each of these areas, the department makes decisions relating to:

- o Disposal: sale or exchange, with or without value enhancement
- o Leasing: marketing, promotion and negotiation
- o Acquisitions: feasibility analysis
- o Property management: future impacts

Economic analysis is needed to determine whether the above activities are cost effective for the benefits sought. Economic analysis also assists the department in determining **holding costs** for lands held in the transition lands inventory. Finally, economic analysis and performance review allows the department to estimate the time required to recover

capital investments made to enhance property value in preparation for disposal or leasing.

Economic models are systematic methods of measurement from which business decisions are drawn while considering other related information and professional expertise. The department recognizes it cannot develop exacting economic models for each type of transaction contemplated or for each investment decision.

Economic models used by the department must satisfy statutory requirements and aid in the selection of the highest and best uses for tracts of trust land. Models selected should allow sensitivity analysis of the values imparted by possible alternative uses of the tract. When a preferred use is selected, the department should be able to determine the appropriate intensity of use, as well as the appropriate level of improvement for the tract in question. Tests of varying degrees of investment by the department should show which level of investment and development generates the highest level of revenue for the trust consistent with other adopted policies.

During the entire process of managing trust properties, cost and price projections must be tested. Specific questions need to be asked. For example:

- How accurate are the plans and projections?
- Is the project profitable?
- How can the department improve the management of similar properties in the future?

The answers to these questions guide the department to improve future activities and policies.

Limitations exist in the development process. These may be physical, technical, economic, legal or institutional and may limit the activity, thus increasing costs and/or reducing revenue production. The models chosen to evaluate each activity should be able to measure in some way the impact of each constraint. For example, exposure to risks, timing of events, market activities and liabilities incurred under different contractual arrangements all are potentially constraining.

Economic methodology must reflect costs and benefits or revenues that result from investment choices and policy decisions. In making investment decisions, the department is obligated to identify the highest and best uses for each tract of trust land. Alternative management proposals are evaluated and produce the information necessary to accept, reject or condition a proposal.

By comparing the rates of return for each property management option, the most suitable economic development strategy can be determined—that which provides the department the highest positive net present value on feasible projects, consistent with acceptable levels of risk and other considerations.

Management options

Economic analysis must address whether the department should retain full responsibility for future use/management of any specific property or groups of properties. If so, at what level of involvement and at what costs or benefits to the trust.

One result of the transition lands program process (p.22) is an inventory of land parcels which could be converted from current natural resource uses to higher and better economic uses. The inventory process provides an orderly mechanism for periodically reviewing the most appropriate use(s). When a property is allocated to the program, the department will consider the socio-economic environment, the characteristics of the land parcel and the staff and financial resources available for management. The department will also review the priority of other projects underway or planned, the staff skill levels and market demands the parcel could serve. The department will then select the option which best serves the trusts from a range of management options.

The following management alternatives should be considered each time such an evaluation is conducted:

- o Active operational management by the department
- o Passive management through ground leases
- o Active joint proprietary management
- o Exchange or sale of property asset

Active operational management by the department

Active operational management can range from one or more direct management activities, such as planting and fertilizing trees to complete vertical integration. For any land use activity undertaken by the department a decision must be made as to the appropriate level of involvement (stages of production) or extent of vertical integration. Economic modeling can be useful in determining incremental impacts of proceeding to each added step toward more complete vertical integration of management.

Passive management via ground lease

The current policy of retaining ownership of land with the department administering commercial ground leases to provide for rental incomes represents a passive position regarding vertical integration and degree of participation in proprietary functions. Such leases represent a decision that alternative land uses other than natural resource production are the most economically viable for the specific land parcel or site, but that the department should play only a minimal role in the ongoing proprietary function.

The distinguishing feature of this management alternative is that the department be dissociated from the ongoing functional management

once the improvements, if any, are made. The proprietary management functions are contracted through a lease to other parties. Conditional restrictions can be placed on the lessee about use, management activities, etc., as deemed desirable to maximize the economic value to the trusts. Economic analysis must permit the department to distinguish between the relative advantages of such ground leases and passive management from other management alternatives. It must also permit evaluating the most appropriate level of capital receipts and the scope of conditional lease restrictions.

Active joint proprietary management

If the department has decided about the appropriateness of proprietary management for a specific use, it must also decide about department management of specific proprietary functions.

The economic analysis will be capable of discriminating between functional land uses most advantageous for specific sites, and stages of production (vertical integration) and level of participation most advantageous once a functional use is identified. Within constraints of legality and other policies in this plan, the option for department retention and full or partial participation should be explicitly evaluated. Economic analysis should be capable of indicating when such an involvement is in the best interest of the trust.

Disposal of property assets

Specific assets may have negative or reduced returns to the state under either continued management by the department or through retained owner/passive management ground leases. As indicated in the *Strategic Plan* section, the state may be best served through disposal of the land/assets. Replacement land is acquired and the future use of the disposed property is determined by the new owner (public or private).

The economic analysis should distinguish between the reasons for asset disposal. If the reasons for rejecting retained ownership are economic, the underlying reasons leading to this will be reflected in the net asset value obtainable by the state through disposal.

The distinguishing characteristic of this option is that the disposal decision is based on the economic evaluation of future management potential of the property independent of any reinvestment decision.

The land exchange alternative represents two separate decisions undertaken jointly for expediency, or to overcome other constraints, such as limited cash flows for investment.

First, a decision is implied that specific assets subject to disposal are either unproductive under alternative management options or less profitable than another available option.

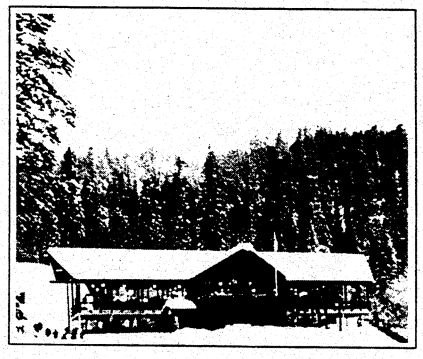
They are deemed *unsatisfactory performers* in the current portfolio due to either current (and projected) economic circumstances and/or constraints placed on department management programs. By law and policy, the asset cannot be disposed of for less than **fair market value.** Subject to this, once disposal is judged as the appropriate course of action the department must determine how the assets will be reinvested.

Second, a reinvestment decision is implied; the asset is acquired through exchange or trade representing a *preferred* way of reinvesting capital resources released through the disposal decision.

Investment decisions will represent a conscious choice of a more productive option available to the department. Such acquisitions must be thoroughly evaluated, trust-quality assets. With careful analysis, an exchange of land assets can simultaneously meet the requirements of both disposal and investment decisions.

Usually it is preferable that the economic analysis of the disposal decision and the investment decision be made on separate grounds. The analysis should identify any constraints requiring an exchange in preference to separable decisions. It should also identify the opportunity cost (if any) represented by the loss of value incurred because of limitations placed on considering other alternatives. This option provides a desirable way to diversify various trust portfolios.

Diverse expectations will be placed on the evaluation of any management alternative. The economic models used for the Transition Lands Program require that the range of management alternatives be evaluated and contrasted before a specific option is chosen. A program of complete economic analysis, using the appropriate economic methodology for the issues involved, combined with evaluating noneconomic factors, can enhance overall economic results of trust management. This will require not only *planning* analysis for decision-making, but also adequate monitoring and reporting to permit performance evaluation and review of actual results.



Selection of economic models

Economic modeling

Economic modeling provides a logical and consistent means for evaluating investment alternatives supporting the goals and objectives of transition land management. Net present value, internal rate of return and benefit-cost analysis are the most useful for this program. In addition, some quasi-economic formulations, such as the pay back period and the break even period, may be useful for certain analyses.

Time is critical in evaluating measures of economic value—because a dollar today has more value than a dollar at a later time, all future values (both costs and benefits) must be discounted to their present value. The discount rate (or interest rate) is a measure of this difference in value. Properly applied, net present value, internal rate of return and benefit-cost ratio all depend on discounted values. **Net present value** is calculated by subtracting the sum of discounted costs from the sum of discounted benefits or revenues. **Internal rate of return** is the interest rate at which the sum of discounted costs equals the sum of discounted revenues. That is the interest rate at which net present value equals zero. **The benefit-cost ratio** is determined by dividing discounted benefits by discounted costs.

Net present value or present net worth models analyze the values in a project with the proper measurement of the impact of time preference.

The net present value model maintains a measure of the magnitude of the values in the computations. When different time periods are involved in the projects being compared, there is a tendency (when discount rates are high) for projects with shorter time spans to be favored over projects with long time spans. When discount rates are low, long-term is favored over short-term. These biases can be overcome by using a modification to annualize the results. One input variable in the calculation is the alternate rate of return or discount rate selected by the agency for similar projects.

Net present value appears to measure the return to the trusts in the most comprehensive and direct way. It always shows the magnitude of the projects and the discounted value. It can reflect results without time-span bias, can be used to compare diverse activities and will always show the proper order of economic desirability. However, measures such as internal rate of return, financial internal rate of return, benefit-cost ratio and pay back period may be best suited for some specific questions.

The department will use net present worth as the primary model for evaluating investments.

Discount rate

Using the net present value model requires the selection of a **discount rate** to bring all costs and returns to the present. The discount rate or alternate rate of return chosen should reflect the next most desirable rate available in the market. Several alternatives considered were: the prime rate, State Treasurer's Money Management Fund rate, bank rates, Permanent Fund rates for new funds and trust permanent fund portfolio average rates.

Trust Permanent Fund rates on new funds show the rates that can be earned by money invested in current low risk securities markets. Securities purchased for the Permanent Fund accounts normally mature in 5 to 30 years. Yields reflect current investor expectations about the impact of inflation on rates of return. This provides an objectively determined opportunity cost of capital that can be revised periodically from the portfolio lists of the trust Permanent Fund. Current portfolio composition reflects the market opportunity cost of capital for long-term projects on trust lands.

The current market yield on the Permanent Funds portfolio will be used by the department as a minimum acceptable discount rate.

Time period

The time period of investments is an important consideration because the comparison between net present values for various management alternatives must be comparable. For instance, a comparison of the net present value of a 20-year investment with the net present value of a 50-year investment may distort the priority ranking of projects. In general, if investment periods extend at least 50 years, the net present values will not be affected by benefits and costs that occur beyond that time.

The department will review investment decisions by annualizing the values, placing values in terms of an infinite time period, or by taking them to a common point in time.

Risk and uncertainty

Risk and uncertainty are two measures of impacts that cause other than expected results from a project. **Risk** is defined to include occurrences happening in a repetitive sequence that can be described statistically, such as long-term appreciation trends, inflation, financial rates of return, market absorption and rental rates. **Uncertainty** contains all occurrences that cannot be statistically described.

Risk analysis is an important consideration in trust management. The department wants to make prudent investments which will receive yields commensurate with the level of risk.

Sensitivity analysis changes assumptions for variables, such as inflation and other factors. Exploring various alternatives provides information about how the final outcomes would be affected under different assumptions. Generally, the most *robust* option (that alternative least sensitive to changing assumptions) will be chosen.

Sensitivity analysis, rather than discount rate adjustment or ad hoc handling of risk, will be the technique chosen by the department for assessing the impacts of risk.

Performance review

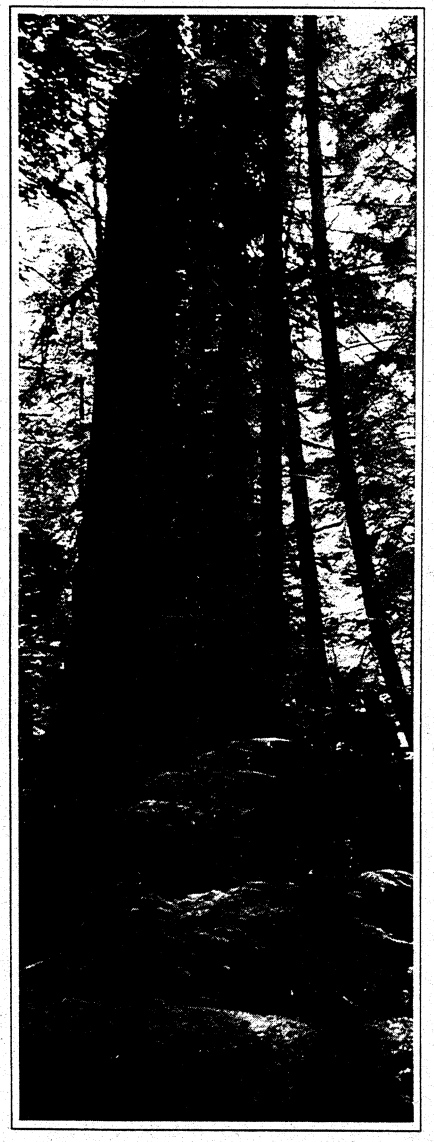
The department must be able to evaluate options before decision-making. However, it is also essential that the department be able to review decisions after they have been made to know how well the decision-making process works and to adjust the analysis where weaknesses appear. The analysis of the results of past decisions can be a powerful tool for making better decisions in the future.

Performance review entails periodic analysis of each project to compare its actual performance with the expected performance under the economic assumptions made to justify the project. Since some projects have an economic life of 50 years or more, this is a long-term process. Such comparisons will be made using appropriate economic models selected to measure the assumed costs, prices, constraints and actual results.

The department can analyze the progress of the transition lands portfolio by using a periodic financial report that includes an income statement. Conventional accounting methods will be employed that identify sources of realized income and known expenditures, as well as estimates of asset value. As a further evaluation tool, select projects will be isolated and accounted for individually. This will also apply to specific project evaluation. By evaluating projects separately (for an optimum relationship between economic return and risk), the portfolio income will be enhanced. Separate project accounting also provides a history which allows for more informed future decision-making.

The department will maintain records that trace (1) the return on past capital investments (2) the status of current investment and (3) plans for future capital investment. The department will prepare a periodic financial report for the transition lands portfolio.

Interim uses



Applicable goals :

- o *Manage transition lands to optimize land value.*
- o *Increase the level of financial support to trust beneficiaries.*
- o *Further diversify income sources to trust beneficiaries.*
- o *Seek interim uses that will fully utilize the current potential of the property yet preserve and enhance the qualities that will attract* ***higher and better uses.***
- o *Provide for management of natural resources on transition lands in a manner consistent with the intended future use of the lands.*
- o *Provide for interim uses on transition lands when compatible with the proposed use of the parcel.*

Objectives :

- o *Evaluate interim uses for their effects on present and future trust benefits.*
- o *Retain management options consistent with anticipated uses.*
- o *Provide for the trust beneficiaries by maximizing current benefits.*

Interim uses can be an important income source while property is being readied for its ultimate use. The department employs land use information, environmental analysis and economic analysis to identify transition land parcels that can support interim uses. A unique set of management strategies is then applied to each property as its use shifts from natural resource production.

Because commitment of property to a particular use may preclude, condition or diminish future productive uses, a systematic analysis of present or proposed uses is necessary. This analysis provides information to formulate rational and documentable decisions based on an assessment of the benefits and costs associated with a proposed use and the long-term consequences of allowing such uses.

The department recognizes the following characteristics of transition lands:

- o They are located throughout the state.
- o Each parcel has unique possibilities.
- o Every potential use is considered or proposed for a parcel that requires analysis.
- o Each use must be initially analyzed on its own merits. Interim uses must be compared after initial analysis for individual uses. In some cases, two or more different activities may be compatible. All uses must be examined together to determine the mix of uses with the greatest value and lowest risk to the trust.

- o Any use may add to, or detract from, the total benefits from the parcel.

The variability of uses and tracts indicates a need for a common analysis system that can be incorporated for any use on any parcel. Each use raises questions about its short-and long-term effects on trust revenues, the environment and the community. Every proposed use evaluation ends in one of the following options:

- o Exchange or sell for current fair market value.
- o Keep and manage the property to mitigate problems.
- o Have federal, state or local government, or private party pay for foregone value.
- o Obtain commissioner's withdrawal for nonmanagement of resources.
- o Manage as is.

The department will analyze proposed interim uses on transition lands for impacts on existing and proposed future uses.

To evaluate proposals for any tract of land, the department will use the **analysis tree** shown on pages 60-62. The process requires analysis and decisions for specific physical, social and economic factors and consideration of short- and long-term trust benefits. The factors considered include: encumbrances (physical and legal), significant adverse environmental consequences, access, reclamation, historical public use, conflict with adjacent land uses, public acceptance, relations with other governmental entities with jurisdiction, timing and consistency with department policy.

The department will use an analysis tree to evaluate proposed interim uses.

The system considers both current and proposed uses. Because these uses are systematically analyzed, cumulative effects of interim uses will also be considered. Documentation of the process provides the department with a step-by-step record of the factors used to reach land use decisions for transition lands.

The analysis tree process accomplishes preservation of trust assets by reviewing:

- o any use on any site
- o other applicable programs in the department
- o environmental concerns
- o public concerns
- o legal concerns
- o net trust revenues

Present and future managers will have the necessary information at the end of the process to make an informed decision.

Once the analysis is completed, management options are available to department managers as they develop prescriptions for specific parcels. Management choices are guided by the goals and policies of this program and other policy plans, such as the Forest Land Management Program. These management options vary regarding the proposed use and intensity of that use. Whatever the use, the department will develop the best management prescription that satisfies trust management responsibilities.

The department will actively manage transition lands to ensure that economic, creative and professional management of these lands occurs as they change from one use to another.

It has been suggested that various forest management strategies (such as shelterwood cutting and long rotation harvesting regimes) would be appropriate for transition land properties, especially those near urban areas. The department believes that such silvicultural methods are a means to an end rather than an end in itself. As the *Economic Models* section shows, the department can consider possible management strategies as long as the economic costs and consequences to the trusts can be fairly evaluated. To this end, all management actions on transition lands will be conducted in the context of a long-range site plan.

The department will develop site specific prescriptions for each transition land parcel and periodically re-evaluate the prescriptions as site characteristics or conditions change.

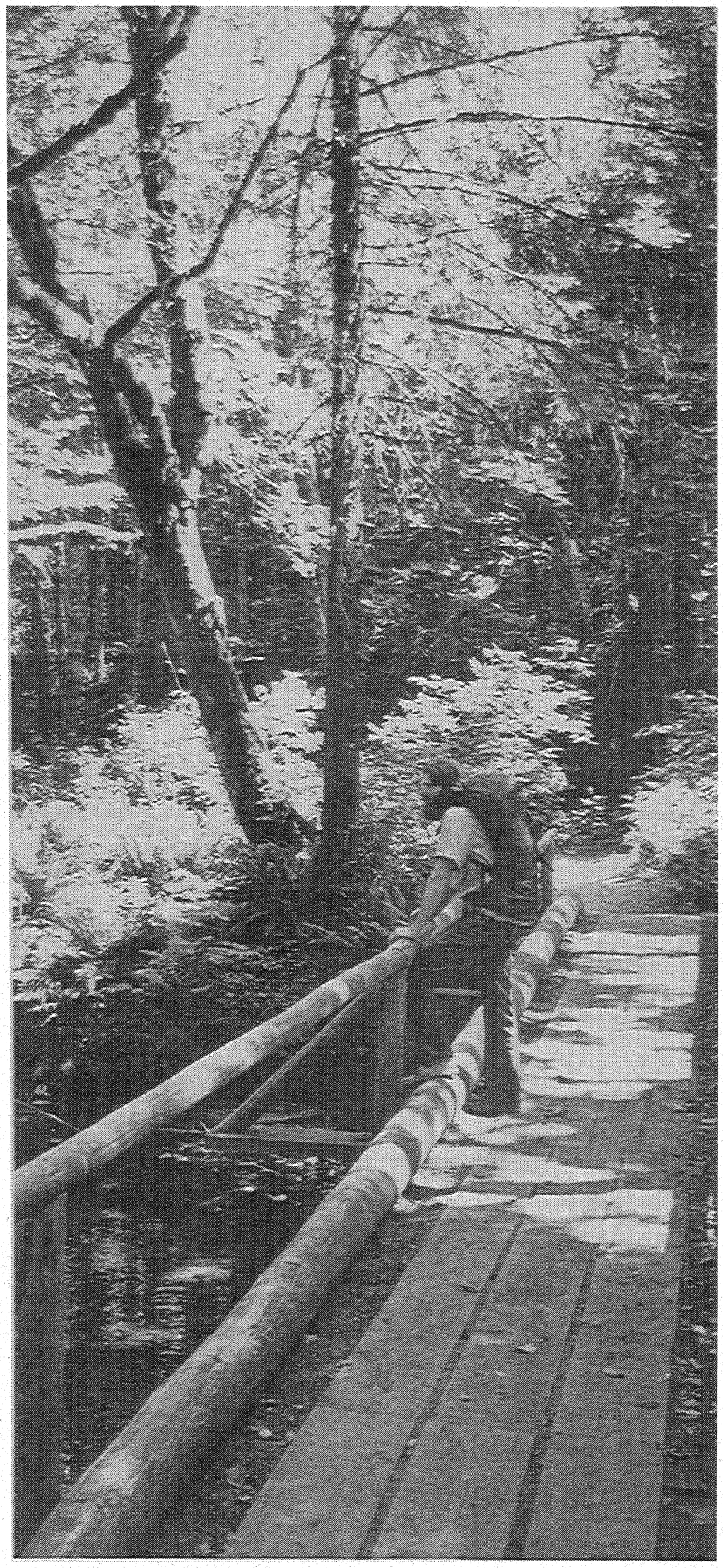
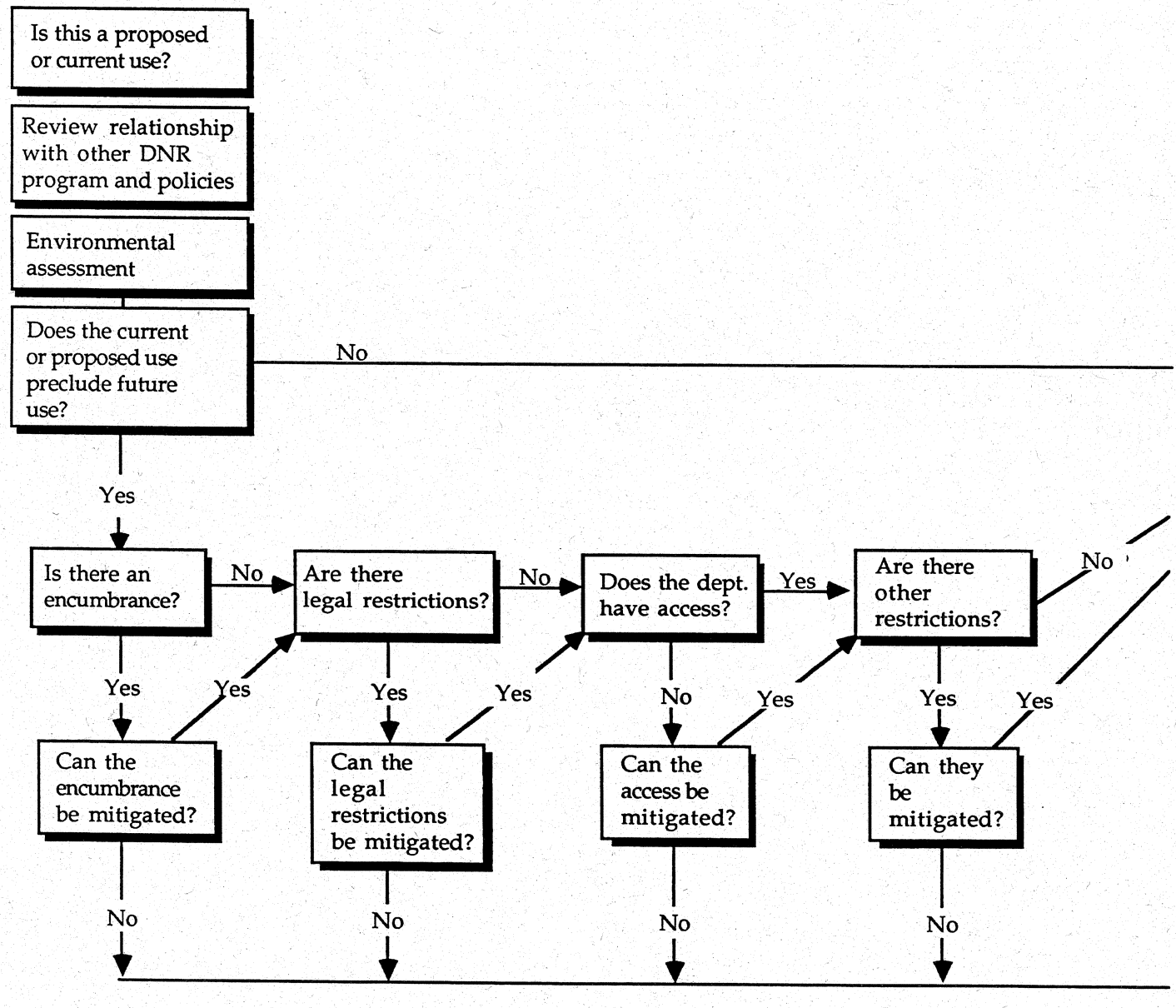
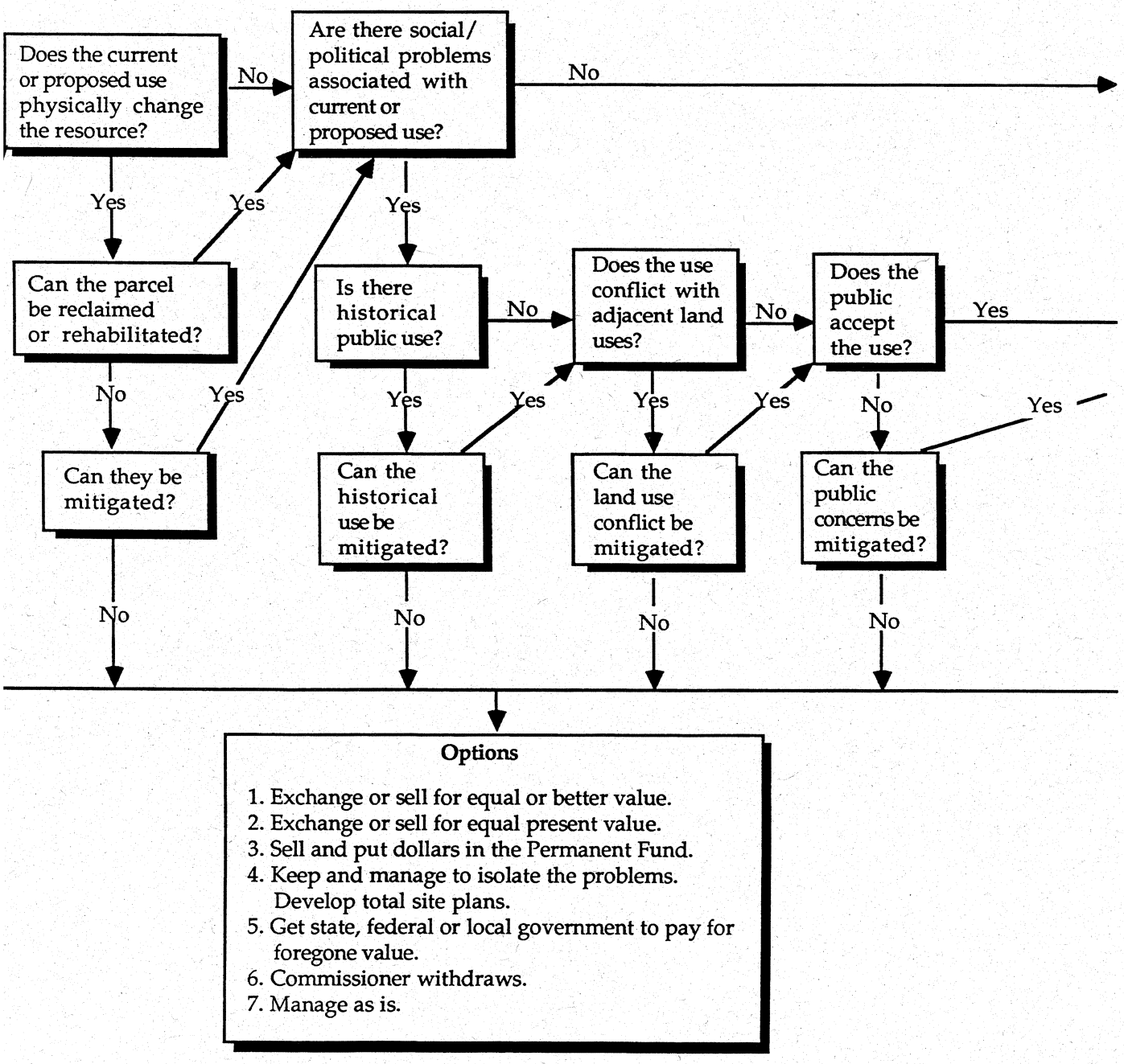
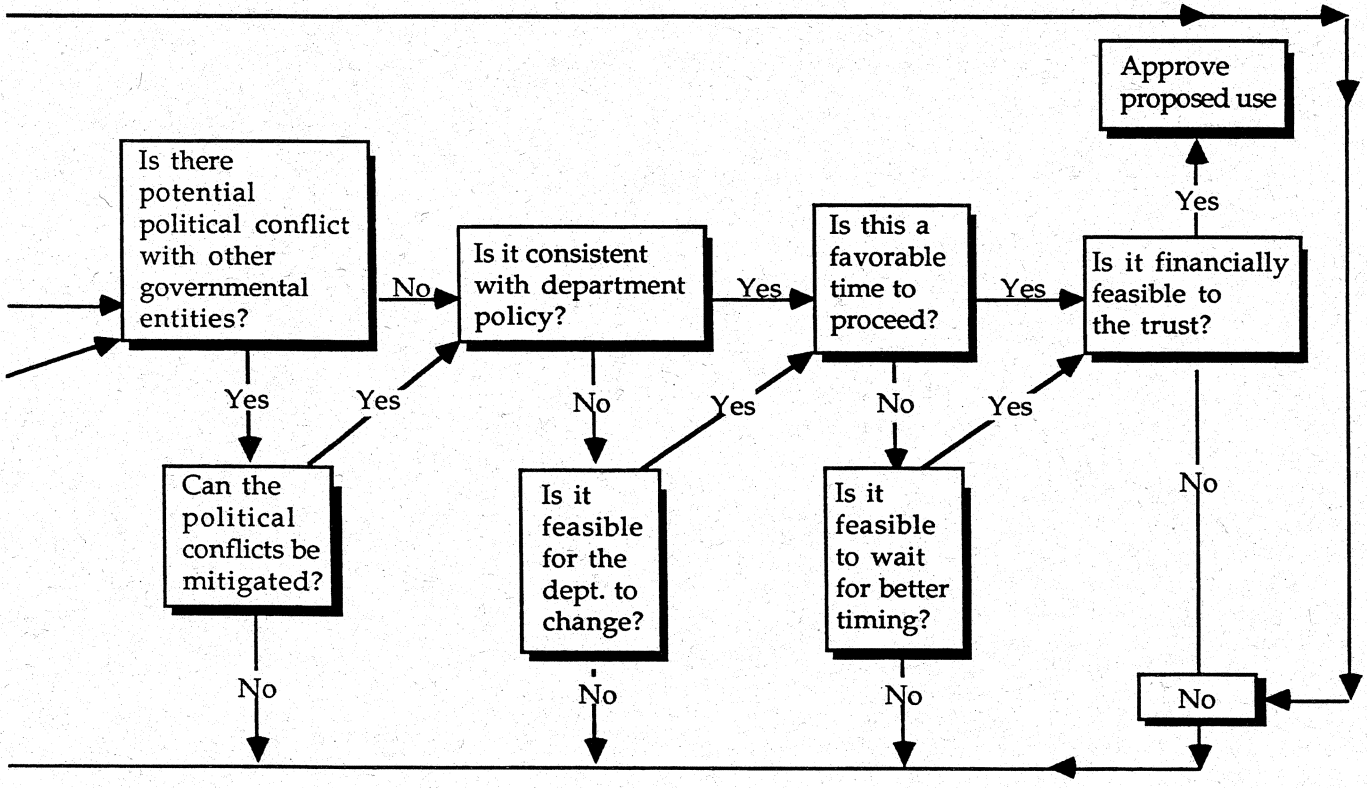


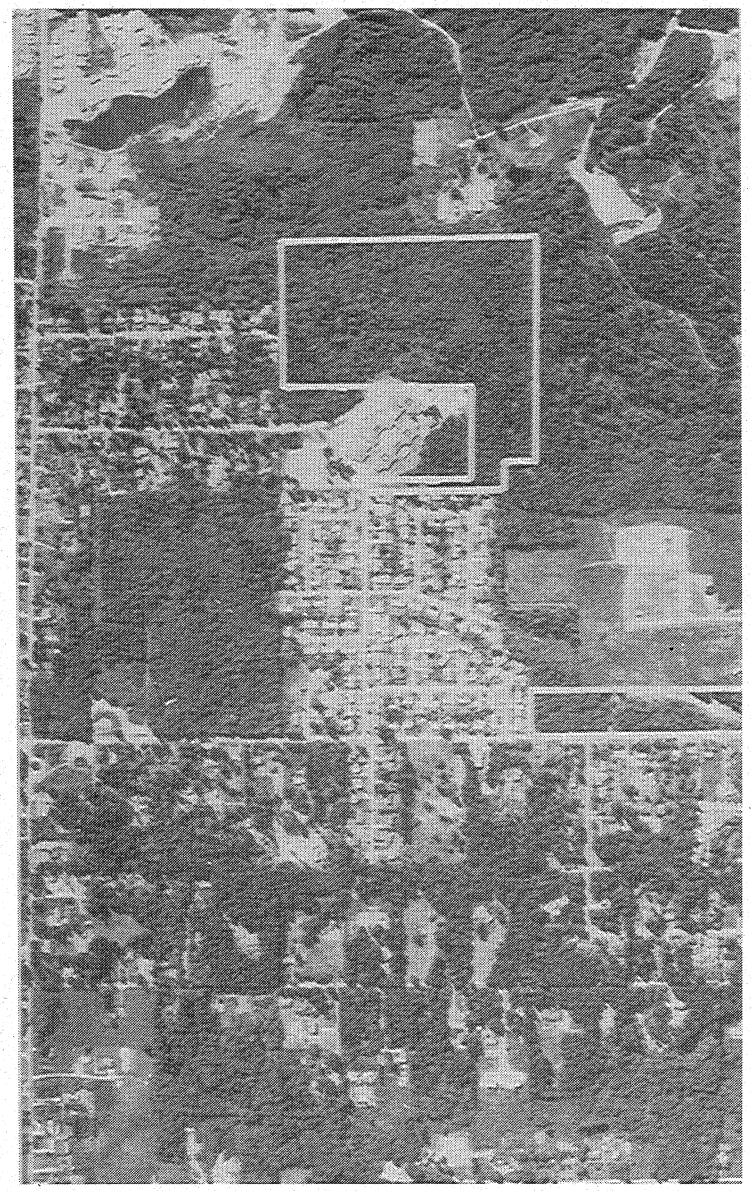
Figure 5 Interim Use Analysis Tree



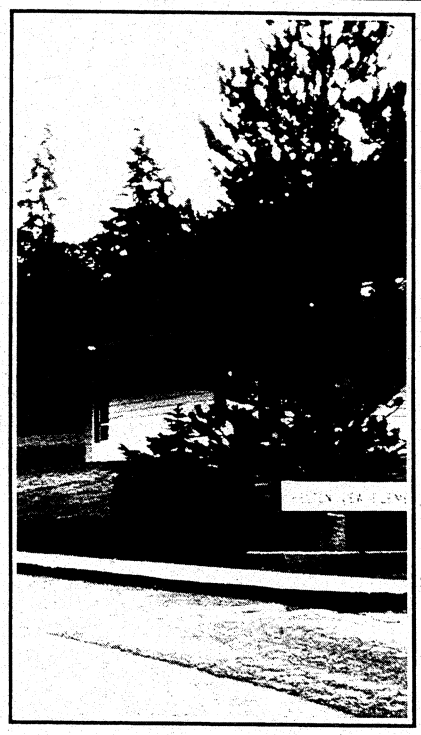

Does the current or proposed use physically change the resource?
No
Are there social/ political problems associated with current or proposed use?
No
Yes
Yes
Yes
Can the parcel be reclaimed or rehabilitated?
Is there historical public use?
No
Does the use conflict with adjacent land uses?
No
Does the public accept the use?
Yes
No
Yes
Yes
Yes
Yes
Yes
No
Yes
Can they be mitigated?
Can the historical use be mitigated?
Can the land use conflict be mitigated?
Can the public concerns be mitigated?
No
No
No
No
Options
1. Exchange or sell for equal or better value.
2. Exchange or sell for equal present value.
3. Sell and put dollars in the Permanent Fund.
4. Keep and manage to isolate the problems. Develop total site plans.
5. Get state, federal or local government to pay for foregone value.
6. Commissioner withdraws.
7. Manage as is.


Approve proposed use
Is there potential political conflict with other governmental entities?
No
Is it consistent with department policy?
Yes
Is this a favorable time to proceed?
Yes
Is it financially feasible to the trust?
Yes
Yes
Yes
Can the political conflicts be mitigated?
No
Yes
Is it feasible for the dept. to change?
No
Yes
Is it feasible to wait for better timing?
No
Yes
No
No
No
No

Part III
EXTERNAL RELATIONS



Part III
EXTERNAL RELATIONS



Public involvement

Applicable goals :

Develop and conduct effective external relations programs.

Develop effective methods for interaction with the public to achieve transition lands management goals.

Objectives :

- *Keep the public informed about program and project decisions.*
- *Encourage the public to become involved at meaningful points in the decision process.*
- *Seek the full range of view points on each issue.*

In the Forest Land Management Program, (1984, p. 54) the department committed itself to "involve the public and interested agencies in planning and decision making."

The Forest Land Management Program plan relies on a Sensitive Area Planning Process to determine whether a management proposal is of interest or concern to the public. Proposals that elicit significant public response require using a conflict resolution process before proceeding with the standard evaluation required by the State Environmental Policy Act. The Forest Land Management Program describes a detailed decision process to address sensitive issues.

An important first task is for the Transition Lands Program to expand the department's current *open communications* policy with the public. This includes presentations to better educate the public about department activities and obligations as a trust manager. The success of this program depends on public understanding of the responsibilities that underlie department actions in bringing previously under-used state real property assets to the point of producing income. Equally important is involving and securing public participation during the information gathering and decision making phases of the transition land management process.

A program of public education about the various trusts, the department's role in managing those properties, and the objectives and purpose of the Transition Lands Program in pursuing real estate activities is also necessary. The department recognizes the need for public support in pursuing real estate activities in the private market place.

Statutes governing the lease, sale or exchange of trust land have been discussed in the *Legal Context* of this plan (p.12). Each action has different statutorily-required steps for public notification and participation.

Through public participation, the department becomes aware of problems earlier and is able to more thoroughly evaluate potential concerns. Involving the public in program decisions allows an objective evaluation of issues apart from site specific considerations. Early and continuing public involvement also contributes to solving problems positively,

rather than simply reacting to problems as they develop. For instance, the transition lands program process has a number of clearly defined opportunities for citizens, local governments, and state and federal agencies to contribute meaningful and useful information early.

Information about the Transition Lands Program may be provided by various means, including a program newsletter, presentations and guest appearances at regional or statewide interest group meetings, periodic meetings with local officials and video tapes or movies about the program available through public libraries or department offices.

Site specific project information may also be distributed by periodic meetings with local officials, video tapes about the projects, local workshops, tours of the site, presentations at community clubs, posting of signs on project sites, notices on reader boards, recorded messages, toll free number, publicly announced name of staff contact, opening special project offices and sharing information in the course of other department business.

The department will develop an active information program on the overall program and on individual projects.

For the purposes of public involvement, the Transition Lands Program is designed so the public can participate and inform the decision-making process at those points when substantive commitments are contemplated.

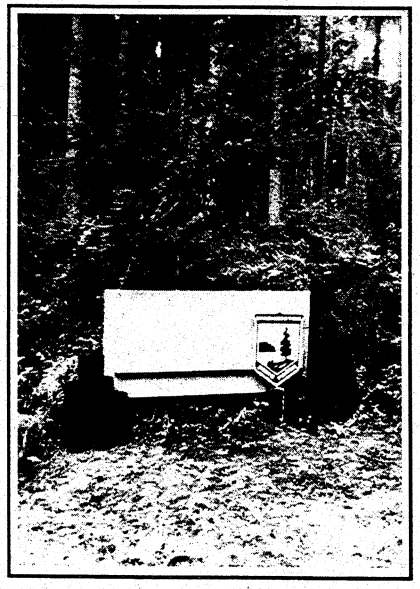
Opportunities for public involvement are also included in the" urban" designation and inventory process (p.22). Periodic meetings in each county to discuss the program and decisions being made on parcels in that jurisdiction are a central part of this process.

Public involvement before critical decision points provides a better public understanding of the program and contributes to timely problem solving. By organizing the involvement process along functional lines, closely related decisions will be seen as a whole rather than segmented pieces. Consequently, the public will better understand the program, thus reducing the need for redundant explanation and the possibility for confusion.

In addition to legal requirements, the department will design a systematic public involvement program based on related actions.

Because of their complexity or sensitivity some issues or decisions require a greater degree of public involvement. Many effective methods are available to the department. For example, local public information meetings and workshops may be used early and throughout the process. On a project-by-project basis, other possibilities include establishing a public contact list or using statewide or ad hoc project advisory committees, sensitive area analysis to identify potentially controversial situations, and public information gathering questionnaires. Exploring appropriate high impact methods of public involvement will assist the department in developing more productive public to agency relationships, as well as keeping the staff continually aware of current public issues. Timely use of public involvement strategies can potentially reduce conflict and engage a wider spectrum of the public in trust land management decisions. Such methods lead to more durable solutions, as well as developing public identity with those solutions.

The department will comply with all legal requirements for public notice and testimony. In addition, the department will use other effective methods to gather information from the public on pertinent issues.



Intergovernmental relations

Applicable goals :

- o *Cooperate with state and local economic development efforts.*
- o *Develop and conduct effective external relations programs.*
- o *Provide for environmental protection through site specific analysis and through cooperative planning with local governments and comply with all local, state and federal environmental requirements.*
- o *Develop and maintain a cooperative working relationship with government entities.*
- o *Develop effective methods for interaction with the public to achieve transition lands management goals.*

Objectives :

- o *Identify, clarify and improve relations with other governmental agencies.*
- o *Develop a consistent method of establishing and maintaining intergovernmental relationships.*
- o *Develop a system that maintains communications and provides procedures for intergovernmental liaison within the department.*

The primary and continuing contact for the Transition Lands Program is local government. The department must lay the groundwork for site specific developments and coordinate with local governments to enhance the value of transition land assets. The department intends to comply with all local, state and federal environmental and permit requirements, and provide for environmental protection through site specific analysis in compliance with local government planning and the policies of this plan.

A number of current laws and policies apply to intergovernmental relations:

- o The Multiple Use Statute directs the department to comply with local land use plans if the department is not being treated any differently from adjacent landowners (RCW 79.68.110) This statute governs the land use designation of all trust land including properties covered under the definition of transition lands.
- o More specifically, the department is required to comply with existing local comprehensive plans, zoning classifications and adopted local policies when identifying trust lands expected to come into urban use in ten years. (RCW 79.66.080)

- o The department must also notify local government jurisdictions containing trust land and state agencies when such land will be exchanged or sold through the Land Bank. The notified government agencies will have 60 days to apply for purchase.

- o The department reviews appropriate uses of urban lands with local governments in accordance with RCW 79.01.784, and may enter into formal agreements for cooperative planning. For instance, King County and the department have entered into a *Cooperative Planning and Coordination Agreement* in which both parties agree to hold annual information meetings, notify the other of pending management or land use decisions, allow opportunity for executive comment before action on a specific management approach and integration of planning activities.

- o Development plans on department trust lands are contingent, in part, upon acceptance of the development plans by applicable planning and sanitation authorities.

The department has long-standing intergovernmental relations with local governments, special purpose districts and other state agencies. The level of interaction with these agencies has varied with changing circumstances and policies. For the Transition Lands Program, there are two primary levels of intergovernmental involvement: **programmatic** and **site specific.**

Programmatic issues involve the relationship of trust land to local comprehensive plans and other land use planning documents. **Site specific** issues involve the proposed land uses for individual properties. Site specific review and involvement with local government integrates other governmental entities' planning programs and associated permits, as well as local government requirements. In this sense, the local government focus is inclusive rather than exclusive. Depending on the activity, other state and federal agencies are necessarily included because of regulatory or permit authority. Native American tribes will also be included to the extent they are an agency of jurisdiction.

The department's planning process will occur at both the programmatic and site specific levels.

Under a policy of maintaining and improving intergovernmental relations, the department will undertake the following specific actions:

- o Examine the relationships of trust land and local land use plans to determine areas of mutual interests.

- o Monitor local land use plans

- o Work with local governments when plans are being developed.

The department will coordinate its programmatic planning process with the development of local comprehensive plans and other land use planning documents.

The department intends to strengthen existing communications with local governments regarding management plans for transition lands, including department/local government annual work plan meetings.

The department will also develop systems with respective local governments to ensure timely notification of **short plat** and other land use activities that may impact department lands.

Cooperative relationships are required throughout the planning process, as well as at the time of local plan adoption or application. The conduct of the Transition Lands Program also affects perceptions of the department's other activities (just as the conduct of all department programs reflects upon the Transition Lands Program).

The department will work with local governmental entities to develop a cooperative planning process before lease, development, sale or exchange of transition lands.

Each governmental jurisdiction in the state is unique with different goals and policies. The department will develop a system to identify department trust land relationships on a county-by-county level (programmatic), as well as defining relationships with ports, cities and other governmental entities. This will be followed by a clarification of site specific relationships with assignments to the appropriate department administrative units.

Even though local governmental jurisdictions adopt different goals and policies, a uniform intergovernmental relationship is possible. This should be accomplished through a systematic approach at the programmatic, as well as the site specific level.

Determining the form and content of intergovernmental relations allows identification of explicit agency relationships, as well as a recognition of the complexity of that relationship. The department presently interacts with such agencies as the Departments of Ecology, Fisheries, Wildlife, and the Parks and Recreation Commission. In the future, agencies such as Trade and Economic Development and the Department of Community Development, as well as local Economic Development Councils, will become increasingly important to the program.

The department will cooperate with local and state economic development efforts in making trust land available for commercial activities.

Site enhancement

The department undertakes activities to enhance the value of selected transition lands. To determine which activities are appropriate, the department will pursue a site analysis and evaluation. However, not all identified transition lands will require a site specific development plan. Certain transition land parcels may be disposed of following environmental and financial analysis. On sites deemed suitable, the department will complete a conceptual site plan either through consultant contracts or by department staff consulting with local government before offering the property for lease or disposition.

In specific cases the department will use a **feasibility lease** (p. 98) in which a private party can approach the department and propose a specific use for a parcel of trust land. Under this practice, the department will initiate and facilitate discussions between local government, project proponents and the department before the public offering to identify aspects of the site needing further study. The department will

also evaluate whether the proposal and the attendant improvements will create a trust quality asset.

The major advantage in both approaches is that the department evaluates the potential for property value enhancement while consulting with local government before property disposition by lease, exchange or sale.

This approach is systematic and programmatic, as well as site specific. The key governmental entity is local government. This posture has many advantages:

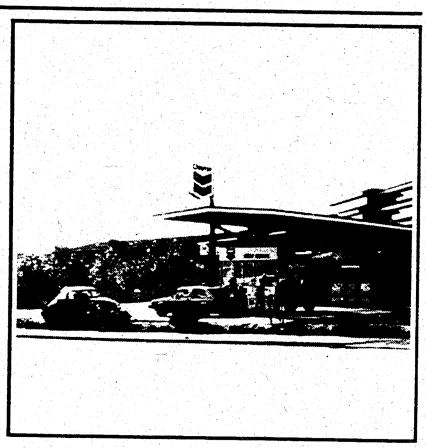
- o Maximizing outside participation
- o Creating certainty by having either development permits or conceptual site plans before leasing or exchanging land
- o Maintaining or increasing land value
- o Placing the department rather than the lessee in control of critical land use decisions
- o Addressing environmental concerns early in the planning process

This policy plan initiates a planning process in which the department, through the transition lands program process (p. 22), determines which trust parcels are in transition to a potentially more valuable use. It carries the planning process to the stage where a range of acceptable development options have been approved by local government. The process considers environmental issues and incorporates the concerns of local government entities in relationship to locally adopted comprehensive land use plans. This cooperative planning process also allows the department to define and analyze potential site constraints and opportunities before a potential lessee enters into a contractual relationship with the department.

The thrust of these policies is to promote intergovernmental relationships that move the department into the lead planning role for transition lands.

Working in cooperation with local government, the department will carry the site specific planning process to a level of detail appropriate to that property (lease or disposition). (See also Environmental Review - - pp. 45-47.)

Relationship with private market



Applicable goals :

- o *Cooperate with state and local economic development efforts to realize transition land management goals.*
- o *Promote, explore and develop new market opportunities.*
- o *Conduct and develop effective external relations strategies.*

Objectives :

- o *Communicate with real estate professionals and financial institutions about the opportunities available on state trust land.*
- o *Utilize the unique and specialized services of the private sector to accomplish the goals of the Transition Lands Program.*
- o *Attract quality lessees to participate in opportunities on state trust land.*
- o *Work cooperatively with local and state agencies to create economic development opportunities on selected trust land sites.*

To define the department's relationship with the private market there is a need to reach a basic understanding of what either *perceived* or *real* image the department now exhibits to the private business sector and how this perception materially affects the private-public relationship. Ultimately, this determines whether the department can successfully interact as a public real estate trust in the private marketplace.

The department's best and most consistent market opportunities have been and will be in authorizing and encouraging the private sector development of department managed trust lands. Because of the significant potential of added revenue that private sector development could provide the trusts, the department will pursue an active yet conservative and cautious program to continue its presently authorized real estate activities. The department will also actively cultivate new relationships and improve existing relationships in the private sector marketplace.

Like most other large property owners, the department maintains immediate control of trust property by providing internal services, such as property management, financing, appraisal, predevelopment planning, sales/leasing, promotion and other predevelopment activities on state lands in *project status.*

The general real estate community is relatively small, even in the larger and more populated Washington metropolitan areas. Within this context, brokerage contacts need to be carefully cultivated and respected for their particular market knowledge and expertise. The department also recognizes the significant importance of the lessee's contribution to the various trust assets. Without their tenancies, the income potential from this program could be less stable and substantially offset.

The department is required to offer all state properties for lease or sale through public offering auctions. Initial leases for commercial, residential or industrial uses may also be entered into by negotiation. (*Legal Context* section p.12) The remainder of the promotion of the sale or lease offering is left to the professional judgment of the department.

To promote and market transition lands, the department will employ as many successful private concepts as possible within budget and legal limits. Information about projects will continue to be distributed to brokers, likely users and interested parties. Advertisements in local newspapers and real estate publications accentuate the department's efforts in attracting sufficient proposals to make competitive selections and awards. The department has successfully used private sector marketing concepts and will employ methods that do not impose excessive costs to project budgets.

For purposes of consistency and acceptance in the private market, the department will consider and employ private sector mechanisms and methodology.

The department will consider using the services of licensed real estate brokers to acquire property. Brokers will also be considered for selling or disposing of property.

The department will maintain a list of qualified consultants to assist in specific aspects of project appraisal, development, acquisition and marketing.

The ground lease

The department recognizes that a **ground lease** may afford the private market place an opportunity to make a given project more profitable, or even facilitate and make possible projects that would be difficult to justify if **fee ownership** of the property were required. Despite these advantages, the ground lease is infrequently used by most private investors since few have been interested in holding land (in a passive sense) for another's benefit. Traditionally, the rent received under a ground lease is limited, perhaps indexed against the Consumer Price Index or similar guide, to provide scheduled rent increases over a long lease term.

Clearly, the major *upside* potential will primarily benefit the ground lessee who more immediately controls and benefits from future revenue generation of the project. A ground lease may facilitate developing a project by permitting the developer only to require debt financing on the improvement. Several tax advantages occur. The actual rental payments are *deducted* as costs of doing business. Also, since the county property tax is not charged, the state substitute leasehold tax at 12.84 percent of rental currently provides the lessee with a determinable expense based on a percentage of rental payment. [4]

The unsubordinated position of trust land

It is not always easy to secure leasehold financing necessary to pay the cost of constructing an expensive commercial or industrial building on a leased site. This is particularly true in a financial market unaccustomed to the use of mortgages only against leaseholds. It has become more common for lessees to enlist the cooperation of the lessor in financing construction. If the lessor is willing to let the mortgage cover the value of the land, as well as of the building, funds from an institutional lender become much more readily available. Leasehold loans are characterized as either *subordinated* or *unsubordinated*. In an unsubordinated leasehold mortgage, the landowner has not permitted its fee interest to be placed in a junior or subordinate position to any lender's mortgage for the benefit of the subject lessee. The rights of the fee owner continue to be superior to those of any leasehold lender. Financing is more difficult to obtain where construction loans and long-term financing are secured only by a lien on the leasehold estate.

The department will adopt a standard unsubordinated ground lease document for use with state trust lands.

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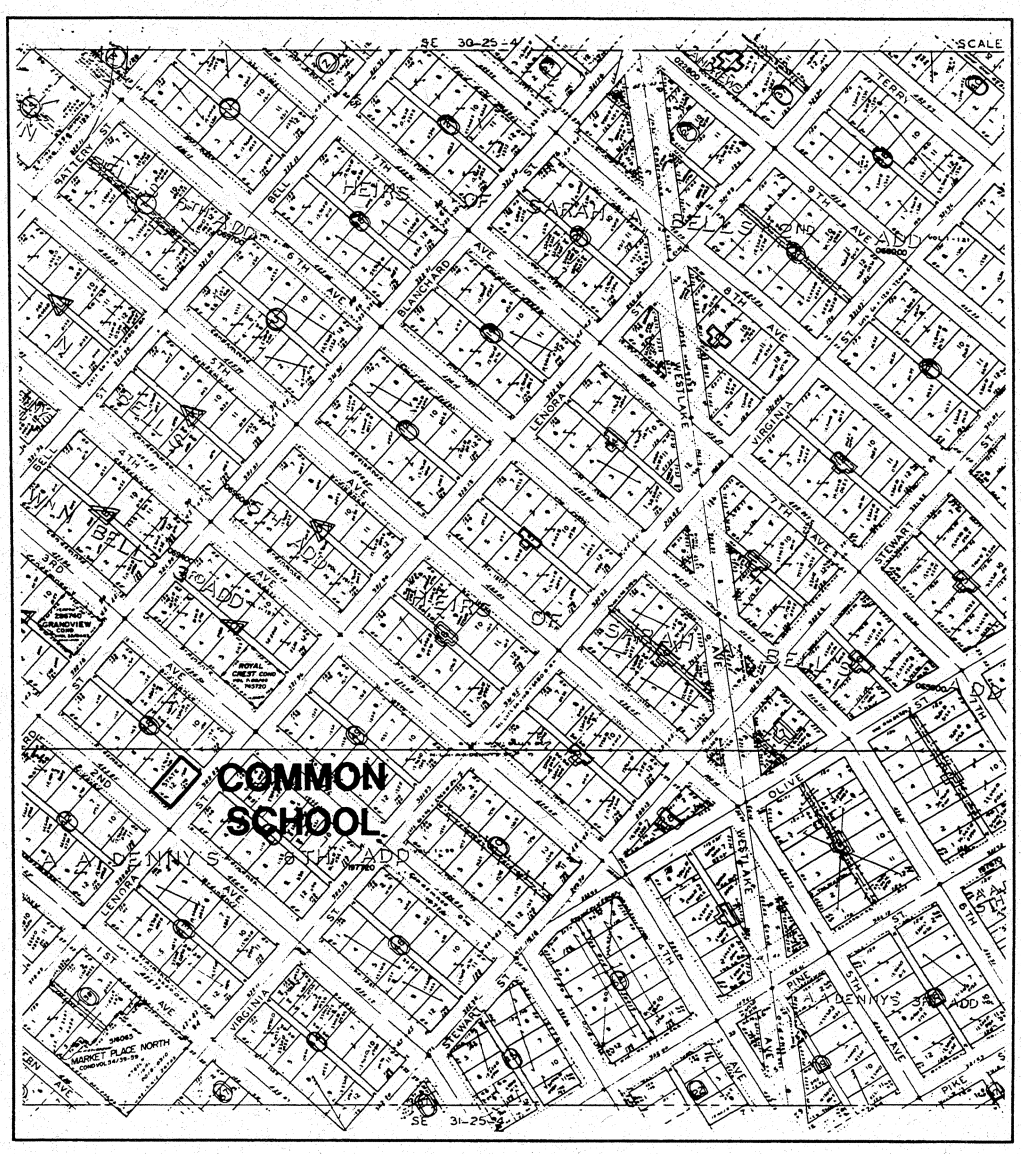
[4] State land is not subject to property taxation. Leasehold tax is compensation to local government for this loss of tax revenue. Leasehold tax is designed to approximate the amount of tax dollars the taxing district would receive if the state land were privately owned.

Part IV
MANAGEMENT ACTIVITIES



Part IV
MANAGEMENT ACTIVITIES

Capital investment strategy

Applicable goals :

- o *Manage transition land to optimize land value.*
- o *Manage the land assets to achieve an optimum relationship between income and risk.*
- o *Increase the level of financial support to trust beneficiaries. Further diversify the sources of income to trust beneficiaries.*
- o *Balance short- and long-term needs of the trust beneficiaries.*

Objectives :

- o *Identify the level of investment appropriate for transition land.*
- o *Identify potential sources of capital for transition land investment.*
- o *Develop a policy for ownership of improvements on transition land.*

Capital investment on transition land properties is one way to enhance the value of these lands and increase the overall return to the trust. On department-managed lands, as is the case with privately-owned lands, financial resources must be invested in lands to produce income (i.e., building a road in a forest to gain access to standing timber or digging a well for irrigation of agricultural land). Money must be invested either for realizing the income potential of the property or for ensuring that the income from a parcel will continue.

The level of investment on trust lands is determined by site specific financial analysis and the department's legal requirements. In making decisions on investing additional capital in trust assets, the department intends to achieve a balanced relationship between income and risk. Modern portfolio theory will be incorporated into the decision process. Portfolio theory requires an explicit recognition of expected income and risk in the decision calculus. A large body of knowledge on investment strategy and analysis is available and can be brought to bear on this important issue.

Expenditures

The department undertakes various outlays to realize income from existing assets. The department currently makes its investments on trust lands from a portion of trust revenue. State law allows the department to retain up to 25 percent of the revenue from trust assets for management and reinvestment on trust lands.

Some of these outlays are considered operating expenses and are funded from appropriations by the legislature from the **Resource Management Cost Account**. Other expenditures are considered investments and appropriated to the department by the legislature from the Resource Management Cost Account through the state capital budget.

Expenditures are made in anticipation of their favorable effects upon current and future revenues. Expenditures are evaluated to determine whether the favorable effects are limited to the current operating periods or whether they extend into future periods. In the Transition Lands Program all expenditures that benefit only the current period are treated as operating expenses. However, expenditures benefiting operations beyond the current period are treated as capital investments.

Level of investment

Economic theory suggests that investments should continue until the marginal rate of return on those investments is equal to the opportunity cost of capital. When there are no constraints on the level of investment, the opportunity cost of capital is either the cost of borrowing additional capital or the rate of return received from investments of excess capital. However, capital available for investments is limited.

The department will continue to invest capital in transition land properties as long as property evaluated projects demonstrate a risk-adjusted return higher than the cost of capital.

Timing of investments

Timing of capital investments in a parcel under transition to more intensive uses is a critical decision. If the investment occurs too early, the time value of money will render an otherwise viable project unprofitable. If the capital inputs occur too late, income opportunities may be lost. An essential element for making sound investment decisions is having good prediction and evaluation models that identify the highest and best use of transition lands. Without such models, investments in interim uses could preclude utilizing a site to its fullest potential over time; or alternatively, investments in such uses may not be recaptured at the time of conversion to higher uses. Unless linked to a long-term site improvement plan, investments may not be recovered and also may not contribute to maximizing the return from more intensive land uses.

Types of investments

Typically, investment of resources for the purpose of making changes in comprehensive plan designations, rezoning, annexation, and formation of **Local Improvement Districts** before lease or disposal can produce increased asset value with little cost. Participation by the department in Local Improvement Districts is restricted by state law. Any investment by the state must show it can bring additional value at least equal to the cost of participation. Recognizing that the first assessment is not due until the second year, the flexibility exists to assume this type of obligation and sell or lease a property before payments are due. Disposing of or leasing transition lands without considering whether to improve their value through such limited investments would be contrary to trust responsibilities.

The department will, in most cases, limit direct capital investments on transition lands to preliminary value enhancement activities, soft investments (such as rezoning, acquisition of access, etc.) and participation in local improvement districts to bring services (such as water and sewer) to transition land properties.

Expected rates of return

Besides providing an additional element of diversification, the moderate risk minimal management Current Market Permanent Funds Portfolio Rate recommended earlier in *Economic Models* will be the measure of the opportunity cost of other types of department investments. The Permanent Fund represents an alternative investment opportunity for trust funds. Financial resources should be invested in transition lands only when the expected return is greater than what can be achieved by placing the money in the Permanent Fund. The fund sets the lower limit of an acceptable internal rate of return in evaluating other investments with similar risk characteristics.

A variety of anticipated rates of return and their associated levels of risk are typically available when selecting investments, and/or determining the level of investment. Generally, expected returns and the level of risk rise together.

The department will attempt to achieve market rates of return from its transition land assets consistent with stated risk limitations. In making future capital investments, the department will direct capital to investments where the returns are highest, commensurate with stated risk limitations.

Other sources of investment capital

In addition to the capital resources which the department may invest on selected transition land properties, several other potential sources of future investment capital exist. These include private sector resources as well as other state capital resources. Whatever the source of capital, the department intends to use the same evaluation techniques when making its investments.

Lessee and sublessee investments

The most common forms of capital investments on transition lands are the improvements and value enhancement brought to the property by the lessee or sublessee. These investments most typically take the form of improvements, such as buildings. If the investment is made by the lessee or sublessee, then the primary risk, as well as a substantial portion of the return, is theirs. The department must consider the liability of the **encumbrance** on the property associated with financing improvements and may be compelled to assume certain liabilities if the lessees fail to meet their obligations. The lease document can allocate the liabilities and risks associated with lessee investments on transition land parcels. Department leases will be written to ensure that unwarranted liabilities are not shifted to the trust. Economic models will aid in measuring the impacts of potential liabilities.

The department will encourage investment on state land by lessees whenever it enhances the income potential of the property. The department will carefully structure these arrangements to avoid inappropriate risk to the trust.

Potential sources of capital

The department will investigate all potential for capital which can be prudently invested on transition lands. In addition to investments funded by the Resource Management Cost Account, other public

sources of capital include, but are not limited to, other trust revenue generated by the department from renewable and nonrenewable resources; trust assets not managed by the department (the Permanent Fund); revenue from the sale of bonds backed by trust assets; or the use of nontrust assets including other state assets, state pension funds or state general obligation bonds.

Leveraging (financing capital investments with borrowed funds) can increase the expected return if the overall rate of return from a project is greater than the rate at which the funds are borrowed. However, risk is also increased as well.

Leveraging is a common practice in real estate investment, but less common in trust management because of the increased risk. Trust managers have typically avoided leveraging that would be contrary to prudent trust portfolio management. In the future, the department will explore the use of borrowed funds.

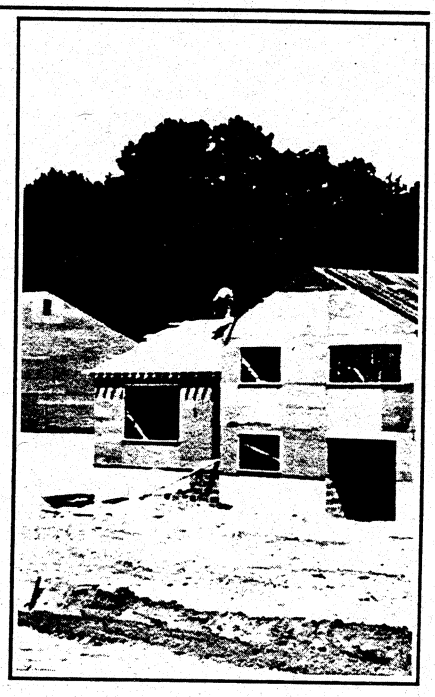
The department will consider using nontrust sources of funds for capital investment in the real estate portfolio.

Ownership of improvements

Typically, in ground lease transactions, improvements placed on the land by the tenant at the tenant's expense become the property of the lessor upon termination of the lease. Depending upon the lease terms, the nature of improvements and other factors, obtaining ownership of the improvements at the end of the lease term can be an additional source of income to the trust. WAC 332-22-110 currently requires that improvements become the property of the state *unless otherwise provided.*

All improvements placed upon the land by the lessee shall become the property of the state at the end of lease term unless it can be demonstrated that ownership of improvements is not in the best interest of the trust.

Leasing



Applicable goals :

- o *Manage transition land to optimize land values.*
- o *Increase the level of financial support to trust beneficiaries.*
- o *Further diversify sources of income to trust beneficiaries. Seek interim uses that will fully utilize the current potential of the property yet preserve and enhance the qualities that will attract higher and better uses.*
- o *Promote, explore and develop new market opportunities.*

Objectives :

- o *Determine the appropriate level of approval for leases on transition land.*
- o *Establish guidelines for the use of feasibility leases.*

- o *Determine the appropriate level of negotiating flexibility for transition land leases.*

When properly implemented, leasing transition lands allows the trusts to benefit from an income stream not possible under traditional resource management. While commercial and industrial leasing of transition lands offers greater revenue potential, it is also more complex and needs greater lease procedure flexibility.

Several steps are involved in leasing transition lands. Each step provides an opportunity to consider management alternatives.

The elements of leasing can be identified by considering the natural progression of events that lead to a completed lease. Several elements are basic to all leases. These include the basic lease document, the level of approval and the administration of lease contracts. Other items are flexible and will vary with each lease situation. These include analysis of proposals, ownership of improvements and other issues. Generally, the purpose of a lease is threefold:

- o Clarify the interests and relationships of the parties.
- o Properly allocate costs (taxes, repairs, maintenance, etc.).
- o Allocate risks.

The department will negotiate leases to create the highest level of income possible, consistent with evaluation of risk, income needs of the beneficiary and other policies in this plan.

Level of approval

Currently, department regional managers or division managers with regional responsibility (Real Estate and Aquatic Lands) have signature authority on commercial leases of less than ten years duration. Commercial leases over ten years are signed by the commissioner.

In determining the appropriate level of approval for transition leases, these factors need to be considered:

Monetary: Many policies about the level of approval for department activities are based on monetary value. For example, the Timber Sales division uses a monetary factor to determine the level of approval of each timber sale—sales over $20,000 require Board of Natural Resources approval. By comparison, a commercial lease could earn $30,000 annually and be approved by a regional manager if the term is ten years or less. If the lease term exceeds ten years, it must be approved by the commissioner.

Complexity of Decision or Action: The level of approval can be established based on the complexity of the decision or action. If the decision or action involves large sums of money but the decision or action is routine and easily standardized, the approval authority may be delegated but the responsibility will be maintained at a higher level.

Level of Expertise: After all other factors are considered, it is customary to assign the approval authority as closely as possible to the person(s) in an

organization having the best technical expertise on the subject. However, where properties will be encumbered over a long period, the decision should be assigned to a higher level in the organization.

Impact of Error: Impact of error is a major consideration in determining level of approval. The impact of some errors can be irreversible and permanent. For example, the impact of error in a land exchange or land sale where the property has been deeded has a permanent long-term impact, while a poorly constructed lease can be renegotiated at the end of the lease period. The authority to sell or exchange trust land rests with the Board of Natural Resources; the authority to lease presently rests with the department.

Reduce Possibility of Fraud: Under current procedures, the Real Estate Division can approve leases. This is appropriate due to the division's focus on real estate transactions, the increasing degree of sensitivity and risk, and the more sophisticated staff skills available within the division. Future leases will probably have greater monetary level than previously and be of a more sensitive nature. Criteria will be developed to determine which leases will be approved by the commissioner, the Real Estate Division or the regional office. The criteria for approval will be based on length of term, value, complexity and sensitivity. It is important the criteria are not so complex or time consuming that evaluation to determine the level of approval delays timely completion of lease negotiation.

The department will develop a mix of levels of approvals required for leases depending upon value, term, complexity and sensitivity of the lease.

Feasibility lease

Department staff establish priorities for potential projects based on perceived market forces and opportunities. However, budget constraints preclude analyzing all inventoried transition land parcels. High priority projects receive analytical attention, and, at times, value enhancement of a parcel is sought before marketing for either sale or lease.

Occasionally, through a shift in market demand, opportunities become available on a property before the previously described process is completed or even initiated. A correctly used **feasibility lease** allows the department to be responsive to such market changes.

All properties need to have a prerequisite level of department staff analysis before entering into a feasibility lease. The range of land uses acceptable to local government should be determined and environmental concerns addressed; compatibility with surrounding land uses understood, and acceptability to trust land management needs assessed before making any commitments through the lease instrument.

A range of alternatives available for using feasibility leases in managing transition properties includes:

- Awarding feasibility leases through the public auction process. Once necessary study work has been completed, negotiations take place with the feasibility lessee on the terms and conditions of a long-term lease.

- o Following a feasibility lease and the development of marketing options the long term lease is re-offered at public auction.

- o Negotiate a combined feasibility lease/long-term lease before awarding a parcel to a developer.

The department intends to use each alternative where appropriate. The uniqueness of a given site/project determines which of the three is practical.

Alternative one retains management flexibility while making certain commitments to the lessee. These commitments provide incentives to invest analysis funds and seek project financing. The interested parties know that if the proposal proves viable from the department's perspective, development will proceed. *Alternatives two* and *three* have potential market force limitations, but in certain instances either would facilitate attaining management goals. A range of alternatives will allow greater program responsiveness.

The department will use various forms of feasibility leases as a method to attract quality lessees to trust land.

Lessee's ability to perform

The policies in this plan will improve the department's existing lease processing and documentation process. Terms of the ground lease will verify adequate funding, construction of improvements according to lease terms, leasing of rental space, and payment of the rental due the state under the lease. A detailed and specific lease tailored to the project will give the department sufficient control to ensure proper and expedient development of the site through cooperation with the lessee, or in the event of a default by the lessee, exercising the department's discretion to *call* all bonding and complete the project as planned. The strength of the lessee's track record and financial credit history will be major factors in the department's decision to approve any proposed leasehold interests.

Before beginning negotiations, all potential lessees will be required to submit evidence of their ability to perform satisfactorily the terms of the proposed lease.

Transfer of leasehold rights

Because of the long-term nature of many department leases, it is likely that successive lessees may want to transfer leasehold interests at various times during the lease term. In many cases, the lessees may also want to create other legal interests in their leasehold, such as sub-tenancies involving other parties in direct ways; for instance, lenders to finance improvements or the creation of leasehold condominiums.

The department must be able to act promptly to facilitate these commercially appropriate transactions when they benefit the trust. The department must also exert sufficient control and/or approval of the involvement of third parties to protect fully the interest of the trusts. The primary consideration is the impact any proposed assignment or transfer of rights would have on the value of the trust asset and the income to the beneficiary.

In reviewing assignments of lease interests, the department will evaluate the proposed assignee with the same criteria used to evaluate the initial lessee. In considering whether to consent to creating other legal interests in the leasehold estate, the department will evaluate such proposals according to their commercial reasonableness, risk potential and potential impact on the trust asset involved.

Information/data base

Applicable goals :

- o *Develop and conduct effective external relations programs.*
- o *Develop effective methods for interaction with the public.*
- o *Develop and maintain a cooperative working relationship with governments.*

Objectives :

- o *Identify a model(s) to help identify and monitor transition land parcels.*

Adequate portfolio management requires high quality and timely information. Land management planning associated with the transition lands base is complex and substantially different from forest or agricultural land management. However, existing department information systems may be used to develop a transition lands data bank.

Land use information

In managing transition land assets, timely and up-to-date land use information is essential. Opportunities for value enhancement through zoning designation changes are an important soft investment in these land assets. Equally important is the ability to track changing land use patterns so the department does not forego opportunities to improve the trusts' future options. Knowledge of the local land use planning processes at the appropriate time is a critical part of the department's management activities.

The department's land use data base is currently available through the Geographical Multiple Use Analysis and Planning System (GEOMAPS). This system is a multiple data layer fully interactive information system capable of both inventory and analysis. Although this system is presently used for natural resource management information, it can handle land use information, such as zoning and comprehensive plan maps and other land use planning mapping systems. The system's capabilities for coordinating land use information was demonstrated when the department and Spokane County produced the *Spokane County Atlas* in 1982.

Development of a state land use data bank by the department and coordination of information with other state and federal agencies, state political subdivisions, colleges and universities, as well as the private sector, was authorized in 1971 in RCW 79.68.120.

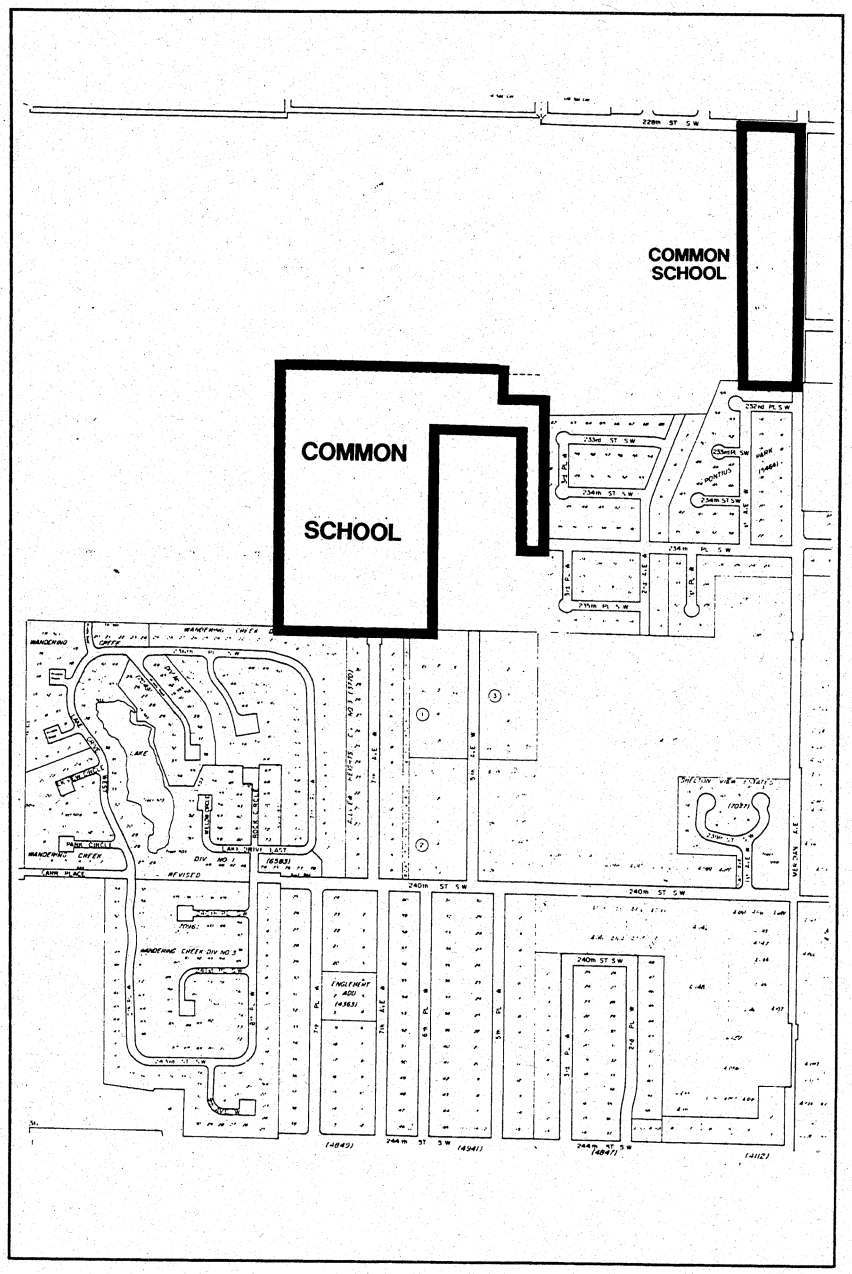
The data bank is to include information that:

> ... will assist in the formulation, evaluation, and updating of intermediate and long-range goals and policies for land use, population growth and distribution, urban expansion, open space, resource preservation and utilization, and other factors which shape statewide development patterns and significantly influence the quality of the state's environment. The system shall be designed to permit inclusion of other lands in the state and will do so as financing and time permit.

In the past, lack of funding has precluded the department from more actively developing this statewide land use data base. Through the sophisticated capabilities of GEOMAPS, the department can now develop this capability for trust land assets, as well as other lands in the state. Local or regional planning authorities may also be interested in joining this effort.

A land use data bank will be developed for transition lands using information systems currently available in the department. Whenever possible, the department will develop and coordinate this information with other governmental and private entities.

COMMITTEE MEMBERS



COMMITTEE MEMBERS

Goals and Subgoals Committee

Team Leader	**David Bortz**	Natural Resource Assistant Manager Aquatic Lands Division Department of Natural Resources
	Bob Coon	Assistant Division Manager Timber Sales Division Department of Natural Resources
	Jerry Otto	Assistant Division Manager Real Estate Division Department of Natural Resources

Legal Context Committee

Team Leader	**John Hough**	Assistant Attorney General Department of Natural Resources
	Ann Cockrill	former Assistant Attorney General Department of Natural Resources
	Jack Hulsey	Assistant Division Manager Forest Land Management Division Department of Natural Resources
	Jerry Otto	Assistant Division Manager Real Estate Division Department of Natural Resources
	Don Vogt	Manager of Project Development Real Estate Division Department of Natural Resources

Identification of Transition Lands committee

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	Gordon Bradley	Professor of Forest Resources Planning College of Forest Resources University of Washington
	Chuck Chambers	Lead Biometrician Analysis and Planning Department of Natural Resources
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Team Leader	**Steve Starland**	formerly Parks Planner Land Leasing and Recreation Division Department of Natural Resources

	Ann Cockrill	formerly Assistant Attorney General Department of Natural Resources
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Multiple and Special Uses committee

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	Bonnie Bunning	Geologist Geology and Earth Resources Division Department of Natural Resources
	John Edwards	Acting Division Manager Land and Water Conservation Division Department of Natural Resources
	Bob Lee	Professor of Forest Sociology College of Forest Resources University of Washington
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	Bob Salerno	Administrator, Real Estate Division Department of Licensing

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Team Leader	**Glenn Yeary**	Manager Analysis and Planning Department of Natural Resources
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	John Osborn	Assistant Regional Manager Northwest Region Department of Natural Resources
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Capital Investment Strategy committee

Team Leader	**Rick Cooper**	Commercial Property Manager Eastern Washington Department of Natural Resources
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	Bruce Bare	Professor of Forest Economics College of Forest Resources University of Washington
	John Olson	Chief of Audit Excise Tax Division Department of Revenue

	Neil Smith	Assistant Regional Manager Southwest Region Department of Natural Resources

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	Judi Brunner	Natural Resource Coordinator Lands and Minerals Division Department of Natural Resources
	Rick Cooper	Commercial Property Manager Eastern Washington Department of Natural Resources
	Vic Hawley	Director, Division of Real Estate Department of General Administration
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	Donald Miller	Professor of Urban Planning Department of Urban Planning University of Washington
	Jerry Probst	Natural Resource Program Coordinator Real Estate Division Department of Natural Resources

Sam Ramos	Project Leader, Data Base Management Data Administration Information Management Division Department of Natural Resources

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Project Manager..... BobRose AICP
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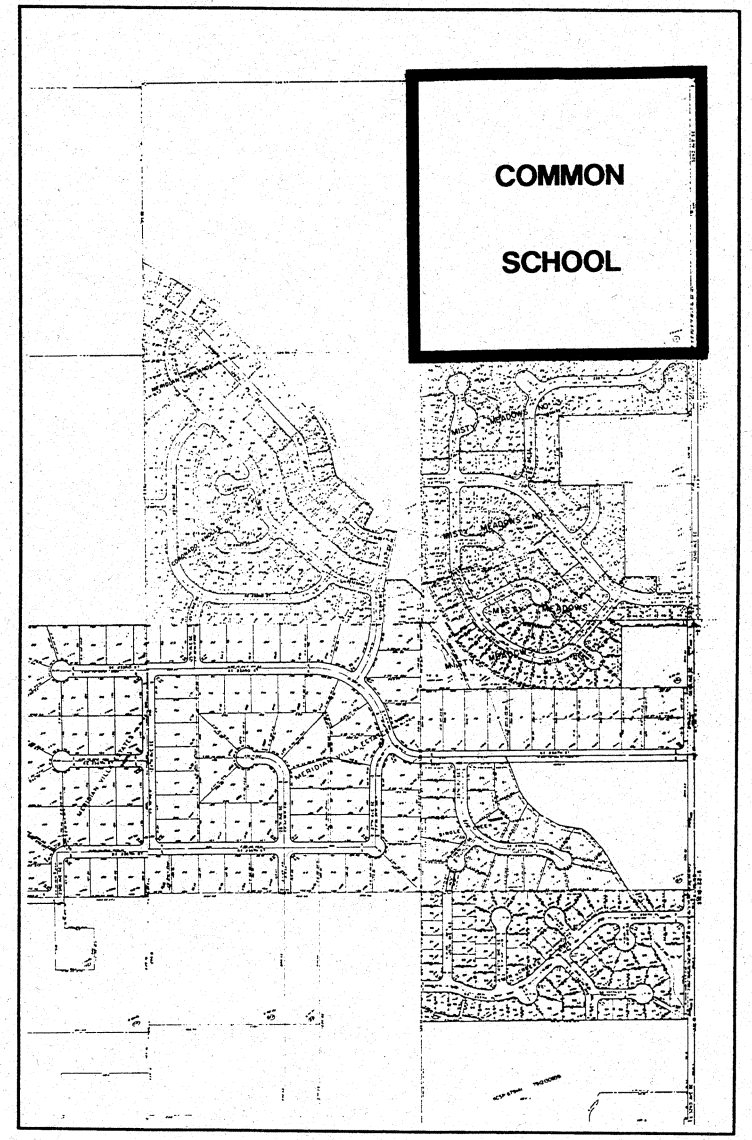
GLOSSARY



GLOSSARY

*The first appearance of the following less familiar terms are **boldfaced** in the main document.*

ASSET - A useful or valuable quality or possession.

BENEFIT/COST RATIO - A number derived by dividing the sum of discounted revenues by the sum of discounted costs. A value greater than one means the benefits (of a project or investment) exceed the costs; a value less than one means that costs exceed benefits; a value of exactly one means benefits equal costs.

BOARD OF NATURAL RESOURCES - A six-member board created by statute to establish policies governing the Department of Natural Resources and make necessary regulations to carry out department duties.

CAPITAL - Wealth or assets in the form of money or property.

CAPITAL INVESTMENT - Acquisition price of a capital asset; money spent to increase the value of an asset.

CASH FLOW - The net spendable income from an investment after deducting from gross income all operating and fixed expenses, including interest and and principal.

DISCOUNT/INTEREST RATE - The percentage of a sum of money charged for its use.

ENCUMBRANCE - A claim, lien, charge, or liability attached to and binding upon real property, such as leases, contracts, and rights of way easements.

FAIR MARKET VALUE - The highest monetary price which an asset will bring, if offered for sale for a reasonable period of time in a competitive market, to a seller who is willing but not compelled to sell; from a buyer, willing but not compelled to buy, both parties being fully informed of all the purposes to which the asset is best adopted and is capable of being used.

FEASIBILITY LEASE - Leasing of property for the purpose of analysis of a proposed project with emphasis on the attainable income, probable expenses, and most advantageous use and design.

FEE (Ownership) - The highest type of interest a person can have in land. Fee denotes absolute ownership of land (subject to laws) with the right to dispose of it or pass it on to the owner's heirs as he or she sees fit.

FIDUCIARY - A person (or entity) in a position of trust and confidence.

FINANCIAL RISK - The probability of future loss.

FLMP - Forest Land Management Program. Program intended to guide forest management by the State Department of Natural Resources on 2.1 million acres of state-owned lands during the period 1983-1993.

GEOMAPS - Geographical Multiple Use Analysis and Planning System. The department's geographical computer information system with the ability to produce information in map form.

GROUND LEASE - A lease of land alone, sometimes secured by improvements placed upon the land. The ground lease is a means used to separate the ownership of land from the ownership of the buildings and improvements constructed on the land.

HISTORIC PUBLIC USE - Pertaining to perceived public rights generated by long-term public use such as motorbikes and horse trails.

HIGHEST AND BEST USE - That use which, at the time of

appraising the property, is most likely to produce the greatest net returns to the land and/or building over a given period of time.

IMPROVEMENTS - Additions or changes to land or buildings that increase the overall value; more than a repair or replacement.

INFRASTRUCTURE - The basic underlying framework or features (utilities and services) of a property (i.e., sewer, water, etc).

INTERNAL RATE OF RETURN - A rate of discount at which the present worth of future cash flows is exactly equal to the initial capital investment.

LAND BANK - Legislatively created mechanism for accomplishing sales and purchases of state trust land.

LEASEHOLD TAX - Tax on state leases designed to compensate local government for loss of property tax as a result of the state owning property in the taxing district. The state does not pay property tax.

LEVERAGING - The use of borrowed funds to purchase investment property with the anticipation that the property acquired will increase in return so that the investor will realize a profit.

L.I.D. - Local Improvement District. A method of financing improvements (utilities) for an area by assessing those persons and entities whose property would benefit.

MULTIPLE USE - To provide for several uses simultaneously on a single tract of land and/or planned rotation of one or more uses on and between specific portions of the total ownership.

NET PRESENT VALUE - The current value of an amount or series of amounts of money to be received in the future.

OPERATING COST - An expense incurred in conducting the major activities of an enterprise usually excluding nonoperating expense or income deductions.

RATE OF RETURN - The relationship (expressed as a percentage)

between the annual net income generated by a business and the invested capital, or appraised value, or the gross income, etc., of the business.

RMCA - Resource Management Cost Account. Fund to defray the costs and expenses incurred by the department in managing and administering public lands.

SEPA - State Environmental Policy Act.

SHORT PLAT - A division of land into four or less lots.

TECHNICAL ADVISORY COMMITTEE - A committee created by Chapter 79.66 RCW to provide professional advice and counsel to the Board of Natural Resources regarding land bank sale, purchases, and exchanges involving transition and urban property.

TRUST LANDS - Endowments of land to the state of Washington to be sold, leased or managed to support designated beneficiaries in perpetuity.

URBAN 10 LANDS - Lands expected to convert to commercial, residential or industrial uses within ten years.