
Skagit Bald Eagle Natural Area Preserve *Source: WA STATE DNR*

Chapter 12
Observations and Recommendations

Observations and Recommendations

INTODUCTION

Deloitte Transactions and Business Analytics, LLC was retained by the Washington State Department of Natural Resources to conduct the Trust Land Performance Assessment. The team assembled to execute the study also includes individuals that participated in the prior study in 1996 (also prepared by Deloitte). As such, the perspective that the team brings to the current engagement is influenced by the experience and observations during the prior study compared to the current study. The following are general observations from then (1996) and now (2018).

- Total trust land revenue in 1996 was approximately $204 million, and total revenue in 2018 has increased to approximately $218 million.
- Actual Trust Manager operating expenses for the Forest Development and Resource Management Cost Accounts have increased from $50 million in 1996 to $62 million in 2018.
- The population of the State of Washington has grown from 5.51 million in 1996 to 7.53 million in 2018, an increase of 36%.
- The 1996 median household income in Washington was under $37,000 and has increased to $79,726 in 2018.
- The 1996 median home price Washington was under $150,000 and grew to $362,100 in 2018.
- Common School trust revenue helps fund the School Construction Assistance Program (SCAP) administered by Washington State Office of Superintendent of Public Instruction. Over the past 24 years, the SCAP program has grown considerably, while Common School revenue has not. For example, in 1995-1997, the Common School Construction Account[1] (CSCA) contributed approximately 73% (~$265 million) of the total $364.97 million in SCAP funds for that biennium. In 2017-2019, CSCA contributed approximately 27% (~$259 million) to SCAP, which had grown to $947.17 million.
- The cost to construct a primary school in 2003 was $125 per square foot and has increased to $226 per square foot in 2018.
- The 1996 study and the 2018 study focus on trust land value and rates of return, but the importance of this focus may be misplaced. This focus has not led to change and improvements needed to generate more net cash flow to the beneficiaries.

[1] Common School trust revenue contributes approximately $122 million per biennium to the CSCA. The common school construction account is utilized by the School Construction Assistance Program (SCAP), which helps pay for K-12 school construction projects and is administered by the Office of Superintendent of Public Instruction (email correspondence with OSPI 9/2020).

- Recognition of environmental constraints on the trust land portfolio has increased between 1996 and 2018, leading to reductions in land areas available for timber harvest.

- Economic pressure to continue to increase the distributions to trust beneficiaries has also grown in response to population growth statewide, as well as ever-present fiscal pressures on local government and public education.

- Timber, a commodity, was the main source of revenue in 1996 and remains the main source of revenue from the trust land portfolio in 2018. Accordingly, the volatility of cash flows to beneficiaries was high in 1996 and continues to be in 2018.

The past twenty-two years has seen remarkable change in the State of Washington, including its population, economic base and promise of the future. Meanwhile, the overall productivity of the trust land operations and financial results have been largely static. The trends present today are expected to continue into the future, and they will likely intensify the pressure and challenges in managing the trust land portfolio in order to meet the needs of the trust beneficiaries and the operation of the trust lands owned by the State of Washington.

This final chapter the Trust Lands Performance Assessment includes a set of recommendations and observations the engagement team gathered throughout the course of the project. The recommendations and observations on the following pages are structured in a way that describes the topic, highlights the impact on the Trust Manager, and provides a recommended action item. There are many that impact the overall organization which are provided first and are followed by asset class specific recommendations and observations.

OVERALL OBSERVATION

Topic: Net Cash Flow Priority vs Rates of Return

Description: In the prior 1996 study and the current TLPA study, the focus has been on rates of return. For example, the RFP associated with this study requested the following metrics based on the budget proviso, which are reported in this assessment:

Net Operating Income (NOI)/Trust Value - This metric reports a commonly used relationship of income to value. For example, the timber asset class has a net operating income of $123,624,000 and an estimated trust value of $2,136,000,000, which results in a ratio of income to value of 5.79% (See Figure 1). This metric is commonly used to assess the cash-on-cash return of an investment before any consideration any debt payments (i.e., financial leverage, which there are none in this case). The same ratio is reported for all asset classes in the valuation, which are consistent with the rate of return analysis and discussion presented in an earlier (rate of return) chapter. In addition, Deloitte used an income approach to develop the trust value estimates for each asset class by dividing revenue by a direct capitalization rate. The NOI ratio is also consistent with these trust value estimates because the NOI ratios use the same inputs.

Gross Income/Trust Value – Using the timber asset class again, this metric uses the gross income of $171,700,000 and the trust value of $2,136,000,000, which results in a ratio of gross income to trust value of 8.04% (See Figure 1). This metric is not tracked and reported in investor surveys. While the inverse of this relationship is an income multiplier, a gross income multiplier is not readily used by market participants for the asset classes included in this report.

FIGURE 1

Asset Class	NOI/Trust Value	Gross Income/Trust Value
Commercial RE	7.53%	10.76%
Communication Sites	8.16%	11.65%
Mining	7.99%	11.42%
Agricultural	7.00%	9.86%
Grazing	7.00%	10.00%
Timber	5.79%	8.04%
Other Resources	11.03%	15.76%
Total	6.07%	8.46%

Comparison of rates of return among various investments is used by investors as a diagnostic to evaluate investments. This information is most often used for the following:

- Investment Performance: to make buy-sell decisions related to existing or new alternative investments.
- Fund/Asset Manager Performance: to make decisions to keep or replace to fund or asset manager.

Impact of Issue: Rate of return has only very limited utility for the TLPA asset classes. This is because (i) of the restrictions on sale of the assets, (ii) the revenue distribution requirements and (iii) the fact that the Trust Manager cannot be replaced. As a result of these limitations, the Trust Manager's ability to act is limited. As detailed in the earlier chapter regarding restrictions and limitations, restrictions on the ability to sell or liquidate an entire investment in an asset class and reinvest in alternative investments limits the usefulness of rate of return information as a management tool at the entire portfolio level. Further, the inability to replace the Trust Manager diminishes the relevance of rate of return.

Recommendation: The Trust Manager and trust beneficiaries should focus on net cash flow to the beneficiaries as the preferred metric of performance and management competence. This includes increasing net cash flow and reducing net cash flow volatility.

Asset Classes Most Impacted: *All*

GENERAL ITEMS

1. Topic: Accounting and Reporting System

Description: DNR currently manages a $200 million revenue operation. Nonetheless, as a government entity, the Trust Manager does not have nor use an accounting system or chart of accounts that a for-profit enterprise would use to understand the financial performance of each of their assets. Key areas the accounting system (package) would have is financial accounting, management (cost) accounting, operations (sales, production planning, etc.), and real estate management. If a private enterprise-like accounting system were to be implemented, the Trust Manager would improve its ability to manage all of its assets more efficiently and profitably, if it used a chart of accounts that included elements typically tracked by private companies.

Impact of Issue: The trust lands are operating business enterprises that are managed to create net profit (cash flow) for the trust beneficiaries. The benefit of accounting system enhancements would be (i) the ability to measure profitability consistently and in a similar manner as private market peers and (ii) periodic conventional profit and loss statements that would enable the Trust Manager to make prompt decisions in order to improve cash flow to the beneficiaries.

As an example, the ability to track asset class specific operations would allow greater decision-making ability to determine if additional investment is appropriate to a particular asset class. Further, the use of chart of accounts and an enterprise accounting system would provide greater period-to-period comparability with private market peers.

Recommendation: The Trust Manager should acquire and use an accounting and financial reporting system that is consistent with that of a for-profit business enterprise, in addition to fulfilling its obligations as an organization agency of the State of Washington. The accounting system should enable the Trust Manager to provide financial statements by asset class. Further, the accounting system should enable detailed job costing, budgeting and tracking of actual performance. The chart of accounts should be consistent with the reporting for a for-profit enterprise.

In this manner, the Trust Manager would have the tools to implement cost benefit analyses for activities and to avoid activities that do not provide a net positive cash flow or enhance existing positive cash flows. If implemented, this recommendation will require the use of a consultant with accounting expertise to identify the additional accounting and reporting needs for the Trust Manager and then to implement the new system.

Asset Classes Most Impacted: All asset classes

2. Topic: Asset Class Financial Statements Are Inadequate

Description: Currently, the Trust Manager publishes an annual report that is consistent with governmental reporting standards used by Washington State. The annual report, however, is not a set of financial statements (income statement, balance sheet, statement of cash flows, etc.) and do not provide the level of detail and disclosure that is suitable for a for-profit enterprise, nor is the existing annual report audited.

Impact of Issue: Financial statements provide the results of operations, financial position, and cash flows of an organization in a consistent manner over reporting periods. Appropriate financial statements will enable the various stakeholders to monitor the current operations, accumulative results of operations, make comparisons to other similar entities or departments, understand the relationship of fixed assets employed for a particular asset class against industry norms, and other business drivers.

Recommendation: The Trust Manager should implement an updated and focused enterprise accounting system to produce comprehensive financial statements for land trust operations. The financial statements should at least include a balance sheet, an income statement, a statement of changes in equity, and a cash flow statement. At a minimum, separate financial statements should be produced for each of the major asset classes, but a combined set may be reasonable for the smaller asset classes.

Given the trust lands are managed for-profit, the standards for financial statements that are consistent with private industry may be appropriate, as opposed to governmental accounting standards. Changing the accounting function or providing dual reporting may mean that additional professionals need to be added to the payroll, but this would make the operational structure similar to private, for profit peers.

Asset Classes Most Impacted: All asset classes

3. Topic: Property (Lease) Management System

Description: The Trust Manager has a lease management system that is insufficient for managing leases. A similarly situated for-profit enterprise would use a lease management system.

Impact of Issue: Management of the trust lands involves oversight and management of thousands of leases of multiple lease or permit types. The current lease data management system does not adequately track and report lease details commensurate with for-profit professional real property lease management systems do, including data points such as options, annual increases, lease expiration reports, property physical details (property size, property type, land use, equipment included/excluded, tenant improvements, etc.) and, outstanding tenant improvement liabilities. Such systems can typically create cash flow forecasts, account receivable reports plus detailed property operation budgets. Further, the current system cannot track prospective lease opportunities, beginning with the lease negotiation process, nor can it synchronize with an accounting system to create property level profit and loss statements or asset class profit and loss statements.

Recommendation: According to the Trust Manager, efforts to improve existing lease systems have been implemented and we believe that they need to continue. A renewed effort to appropriately track and actively manage the leases in place through all portfolios with improved systems should continue.

Asset Classes Most Impacted: *Timber, Commercial, Agriculture, Mining*

4. Topic: Cost Accounting – Asset Management

Description: While financial statements ensure adequate financial information is disclosed externally, job costing and related cost accounting systems are different than GAAP financial reporting. They focus on providing executives with relevant data surrounding property and department operations to allow internal managers to make the best-informed decisions about business operations based on profitability and net cash flow. The Trust Manager’s job costing system and accounting system make it difficult to ascertain which properties and activities employed to a particular property are most profitable and which are not profitable at all.

Impact of Issue: The inability to assess which properties and/or harvesting jobs are achieving the greatest returns to the Trust Manager provides challenges to managing the returns. For example, it makes it difficult to judge if there are other non-economic reasons to keep lands available to harvest on the East side (recreation purposes, other interest groups, etc.) in the timber asset class.

Recommendation: The Trust Manager should work to put in place a job costing accounting system to track where time is spent and allocate expenses to specific properties and/or harvesting opportunities. Furthermore, to follow on the example noted previously, due to the slower growing and remote characteristics of the East side timber lands, if a job cost accounting system were in place, they may not be profitable and management could make an informed judgment whether to harvest the East side..

Asset Classes Most Impacted: *All asset classes*

5. Topic: Actual Expenses vs Operating Cost Percentage Deduction

Description: Currently, a percentage of revenue is held back and remitted to the Trust Manager to pay for the costs related to operations and management of the trust lands. This "Operating Cost Percentage Deduction", or management rate, is not well-correlated to reflect actual costs and/or liabilities. For some assets, the management fee or cost is much lower than the actual costs and liabilities. In this case, revenues from other assets and funding sources may be used to pay for the costs related to that asset class. For other assets, the management fee or cost is much higher than the actual costs and liabilities, resulting in lesser revenue distributed to the beneficiaries.

Impact of Issue: In some cases, profitable asset classes or activities are subsidizing unprofitable asset classes or activities. For example, the Commercial Real Estate asset class has typically incurred an Operating Cost Percentage Deduction of 31% for ground lease assets and improved property leased assets. Nationally, commercial real estate is widely managed by independent commercial real estate firms. For example, a simple telephone interview of real estate brokers in the state of Washington indicated the following rates for property management:

- Ground Lease Assets: 2% to 3% of gross revenue
- Improved Property Leases: 4% to 6% of gross revenue

Property management services provided include regular site visits to confirm allowable uses by the tenants, monitoring of age and condition, coordinating leasing activities, inventory of the existing improvements (square footage, mechanical systems, tenant allowances, etc.), preparation of monthly profit and loss reports, budgeting and variance reports, accounts receivable status reports, leasing status reports, etc.

These private property management services appear to be more comprehensive than currently provided by the Trust Manager, yet the independent property management cost is substantially lower than the current Operating Cost Percentage Deduction. It appears that the excess amount (actual Operating Cost Percentage Deduction less private-market property management fees) received by the Trust Manager is likely subsidizing other asset classes and activities.

There are examples where this is apparently the case. For example, the following assets (listed in the tables below) are managed by third-party real estate managers. It should be noted that in some cases the property management fee is paid by the tenant (Creekview Building and Boulevard Center noted in the table below), yet the Operating Cost Percentage Deduction amount is withheld and paid to the Trust Manager.

Trust Assets Managed by Third-Party Brokers

FIGURE 2

Asset	Broker Management Fee Structure	Mgmt Fee Paid 2017	Mgmt Fee Paid 2018	Mgmt Fee Paid 2019	Current Vacancy %	Notes
Creekview Building	3,5% of base monthly rent collected, with $1,000/mo. minimum fee.	$12,647.00	$13,474.00	$12,152.00	50%	PM fee is a pass-through per tenant leases
Boulevard Center	Fixed - $2,500/mo.	$30,000.00	$30,000.00	$30,000.00	19%	PM fee is a pass-through per tenant leases
I-90 Lake Place, Bldg B	Fixed $2,500/mo. with annual CPI adjustments commencing Year 3.	$30,000.00	$30,000.00	$32,126.00	100%	

The three assets in Figure 2 can provide an example where actual costs would increase the net cash flow to the trust beneficiaries. Using Creekside Building as a proxy, Figure 3 compares third-party management fee to the Operating Cost Percentage Deduction.

FIGURE 3

Creekview Building	Mgmt Fee Paid 2017	Mgmt Fee Paid 2018	Mgmt Fee Paid 2019	Comments
Management Fee - Actual	$12,647	$13,474	$12,152	Paid by tenant - No cost to beneficiaries
Management Fee %	3.50%	3.50%	3.50%	PM fee is a pass-through per tenant leases
Total Revenue (Gross up = Mgmt Fee/Mgmt %)	$361,343	$384,971	$347,200	
Operating Cost Percentage Deduction	31%	31%	31%	
Amount Remitted to Trust Manager	$112,016	$119,341	$107,632	Cost to Beneficiaries

In this particular case, using actual management fee would result a $90,000 increase in net cash flow available to the trust beneficiaries; this is 8.8 times higher.

A high-level comparison of the Operating Cost Percentage Deduction (OCPD) amounts received by the Trust Manager to actual expenditures (amount allocated to each asset class) creates additional questions regarding the methods and consistency between reporting periods. As can be seen in Figure 4, it would appear that some asset classes are not increasing net cash flow in the reported period of time.

FIGURE 4

Asset Class	FY18 Gross Revenue	FY18 OCPD $	FY18 Actual Expenses	OCPD Minus Actual Expenses
Commercial RE	$10,911,373	$3,385,271	$808,960	$2,576,311
Communication Sites	$4,809,193	$1,434,592	$1,442,007	($7,414)
Mining	$1,561,113	$520,076	$641,435	($121,359)
Agricultural	$24,645,595	$7,660,420	$1,732,328	$5,928,092
Grazing	$1,060,399	$334,479	$961,965	($627,486)
Timber	$174,383,083	$49,633,129	$53,934,126	($4,300,997)
Other Resources	$3,079,134	$974,306	$3,599,890	($2,625,584)
Total	**$220,449,890**	**$63,942,273**	**$63,120,711**	**$821,562**

In other cases, asset classes are incurring liabilities, for example deferred maintenance or investment, due to the insufficiency of funds provided by the Operating Cost Percentage Deduction. Another example increases in labor and other costs, have diminished the ability of the Trust Manager to make necessary silvicultural investments or tenant improvements which would be customary in operating the properties to maximize returns. This has resulted in the delay or elimination of essential treatments, such as those to improve stand growth rates and timber quality that would increase the overall value of those stands at the end of their rotation.

Similarly, in the case of Communication Sites, the Operating Cost Percentage Deduction has been insufficient to pay for maintenance of towers and associated facilities. Industry standard for covering costs for communication sites is in the range of 60-80%, as compared with the Operating Cost Percentage Deduction, which is 25-31%. Because of this, the Trust Manager has been unable to fund maintenance of the communication sites and facilities adequately, leaving them in a suboptimal condition. Due to this dilemma, the Trust Manager is moved more towards cost-reduction strategies, such as focusing on ground leases, versus revenue-growth opportunities.

Recommendation: Use actual costs instead of the Operating Cost Percentage Deduction. Actual costs would work with the other recommendations regarding using a for-profit accounting system and analyzing and identifying unprofitable activities and asset classes. For example, an actual cost budget could be established on a rolling five-year basis to account for general cost trends and budgeting for large expenditures that may be required.

Asset Classes Most Impacted: *All*

6. Topic: Peer Assessment – Public Entities and Private Operating Companies

Description: The Trust Manager does not have any peer assessments scheduled to evaluate performance. Peers, as defined for this purpose, would be other states with trust land obligations. In addition, the Trust Manager does not have any peer assessments scheduled to evaluate performance. If the decision is made to implement a for-profit accounting system and financial statements, peers, as defined for this purpose, could also include other public/private entities with similar operations.

<u>Benchmarking</u>

Like the Washington Trust Manager, states like Oregon, Idaho, and Montana do not publish detailed financial information regarding operating expense nor the method of accounting for these costs. Some show net revenue only, while others show gross revenue. Further the financial reports present costs as a single line item without detail. As a result, benchmarking against other states with similar trust land operations is not really meaningful, if the comparability of the data cannot be confirmed. Further, at present, comparing the Washington trust land to private market participants is not as reliable as it could be, given the difference in financial reporting detail and methodology.

Impact of Issue: Without a peer assessment, it is difficult for beneficiaries and other governmental agencies to evaluate performance of the Trust Manager versus similarly situated public entities with similar responsibilities.

Recommendation: Consider preparation of reciprocal biannual peer assessments with other state trust land managers. This would require an agreement between the parties as to the level of detail and how financial data is reported, as well as expenditure of the costs associated with preparation.

7. Topic: Data Management

Description: The Trust Manager's lease management systems currently tracks land and revenues at varying scales and level of specificity, depending upon which asset class, data type, and data system is under consideration. For example, leases may be labeled as belonging to a certain asset class based upon their predominant usage (e.g., "a dryland agriculture lease"), and yet contain a variety of revenue streams one would typically associate with other asset classes, such as wildlife habitat or grazing. Since Trust Manager's data addresses these types of examples differently, inconsistent results can be produced from the system in place.

Impact of Issue: The complexity of the current lease management system makes it very difficult to answer basic questions about the Trust Manager's lease management and portfolio performance in a consistent and efficient manner.

As an example, it is difficult to quickly and simply answer questions on leases regarding how many acres are included within a particular lease and/or what are the revenues associated with a particular lease.

Recommendation: The Trust Manager should work to identify the questions that are foremost priority for operating staff to answer, and structure any replacement data systems or enhancements around answering these questions. The replacement or enhanced systems should also prioritize integration among each discrete component: real estate, financials, lease management, and GIS. Finally, it will be essential for the Trust Manager to conduct training on the new system to ensure that all users follow a consistent approach for answering business-essential questions.

Asset Classes Most Impacted: Timber, Commercial, Agriculture, and Grazing

8. Topic: Lack of Access to Capital for Investments

Description: The Trust Manager is unable to accumulate a capital base to make significant investments such as to develop property and or invest into new properties or other alternative investments. This is due, in part, to the fixed percentage (Operating Cost Percentage Deduction) that often does not pay adequately for all of the costs associated with many asset classes, including timber, and therefore does not provide the Trust Manager with an adequate reserve for continued investment in the asset class.

It may also result from the path of revenue related to the permanent funds on federal trusts and the lack of permanent funds for statutory trusts. For federally granted trusts, when individual parcels or non-renewable resources are sold, the royalties go into the permanent fund. Once cash is invested into the permanent fund, the Trust Manager does not have access to funds for asset management purposes or continuing investment in the asset classes. For statutory trusts, there is no permanent fund.

Impact of Issue: The retention of cash or access to capital via debt by the Trust Manager is integral to the manager's ability to provide a suitable and competitive investment return and to maximize cash flows. Management is unable to make strategic investment decisions because it cannot retain cash and provide new development opportunities. It is difficult to increase the returns available without continuing investment in the asset class.

Recommendation: The Trust Manager should be able to retain capital from earnings to continue to reinvest in the asset classes, and therefore better manage assets by reinvesting in properties already owned or new opportunities. This will allow the Trust Manager to operate the asset classes more like a typical asset manager and make appropriate investments to ensure cash returns are maximized throughout the asset life cycle.

Asset Classes Most Impacted: *All*

9. Topic: Divided Governance of Assets

Description: Currently the land assets are governed by the Board of Natural Resources, while the Permanent Funds (equities) are managed under Washington State Investment Board.

Impact of Issue: The majority of the land assets managed by the Trust Manager are of a low risk/low return nature, for example the timber land asset. Some of Trust Manager asset classes, such as commercial, are in the medium risk/return category but are current small in terms of the overall portfolio. Based on a review of Washington State Investment Board (WSIB) management practices, the cash manager does not invest the cash in any high-risk/high-return asset classes once they have the cash in hand than is achieved by the Trust Manager. The cash is typically placed into short-term cash low risk/return equivalent investments. This results in a non-diversified portfolio that does not fulfill its potential value.

Recommendation: We recommend that the Trustee manage all of the trust assets <u>collectively</u>, including the land assets and the equities within the permanent funds, under one governing body. This would allow the appropriate diversification of these assets to optimize risk and return. For example, timber and commercial are low risk categories, commercial is medium risk. A portfolio should diversify these risks. Once managed collectively, it is likely that the more cash-oriented assets could be invested in higher-risk funds to balance the overall portfolio.

10. Topic: Inconsistent Revenue Distribution

Description: Trust beneficiaries are receiving unreliable revenue.

Impact of Issue: Beneficiaries, particularly local governments like counties or taxing districts, are unable to predict when they will receive trust land funding, sometimes putting essential services, such as emergency response, at risk.

Recommendation: The Trustee should consider formation of a voluntary permanent fund to allow beneficiaries to retain cash in a similar manner as other state agencies (Idaho, Montana, etc.) to invest in properties, retain cash and manage cash-flow.

11. Topic: Commercial Real Estate (Transitional Land)

Description: The Trust Manager has a transitional land program that identifies land that is transitioning from a prior use (timber, agriculture, etc.) to a more profitable use (commercial, agriculture, etc.) However, it is difficult to ascertain how this process is tracked, monitored, and where these designated lands are located.

A new asset class for these "Transitional Lands" should be established to allow for more proactive activities surrounding these lands. Furthermore, enhancements to an updated land inventory system could assist both the Trust Manager and private and/or public developers to identify these transitional lands and their more valuable and productive alternative uses.

Impact of Issue: These transitional lands are being managed by the Trust Manager because cities historically have taken some of this land and downzoned it or utilized it for recreation or similarly less productive purposes and uses versus residential or commercial development. While this produces a public benefit, it is not consistent with the Trust Manager's duties to the trust beneficiaries to maximize returns as the reduction in zoning impacts the value. These actions and activities may adversely affect the potential cash flow distributions beneficiaries.

Recommendation: An evaluation should be completed of the benefits and costs of establishing Transitional Lands as a separate asset class. Also consider conducting an assessment of all existing statutes and/or regulations that inhibit the Trust Manager's ability to transact commercial real estate and seek revision so that they are more aligned with modern commercial market practices.

Further, the Trust Manager should consider updating policy guidelines to actively move these Transitional Lands into land uses that produce higher net income for the trust beneficiaries. This may warrant creation of an advisory council or expert team to assess and monitor an expanded commercial land program in the belief a majority of these transitional lands will be utilized for commercial purposes (housing, retail, or other uses). This new advisory council should be allowed to authorize modifications to an "auction only" bidding process and allow for negotiated sales. Finally, the Trust Manager should continue to improve existing or new databases allowing both private and public developers to evaluate and monitor these lands in the transitional category. This is likely a satisfactory method for publicizing the availability of transitional land for private development and creating a more agile and quick process for managing commercial properties.

Asset Classes Most Impacted: *All*

12. Topic: Recreational Trails on Trust Manager Lands

Description: In spite of RCW 79.10.120, which provides that if multiple uses (i.e., recreation) are not compatible with the financial obligations in the management of trust land they may be permitted only if there is compensation from such uses satisfying the financial obligations, it is our understanding that recreational trails can interfere with the ability of the Trust Manager to move transitional land or potential commercial lands towards reuse and new development.

Impact of Issue: The ability to develop land by a future user could be impacted by recreational trails. Delays and/or difficulties in managing land uses, especially of adjacent or nearby properties, impact potential cash flow distributions. This may reduce the net cash flow potential of these lands to the beneficiaries.

Recommendation: The board should consider developing additional policy guidance to the Trust Manager for the establishment, alteration and use of recreational trails and facilities on trust lands. In general, the Trust Manager should actively monitor recreation trails on transition lands due to the potential impacts on land value for these lands. In addition, proposals concerning trail establishment, modification, relocation, or termination should be reviewed and revised, so as not to impair net income generating potential in reuse or redevelopment. Finally, the Trust Manager should be able to ask the Trustee for adequate funds to manage recreation to ensure compatibility with trust management obligations.

Asset Classes Most Impacted: *All*

13. Topic: Provide Reliable Cash Flow to Beneficiaries

Description: At present, the Trust Manager manages trust lands based in part upon their "trust domicile" – i.e., which of thirteen different trusts is entitled to the net income generated by lands associated with that trust. The work completed for this Trust Lands Performance Assessments suggests that consideration should be given to a process that would collapse all of the separate trusts into a single trust for management and administration purposes.

Impact of Issue: It is clear that a significant management and administrative effort is made annually to both manage the trust land assets (land management) and to administer them (asset management) in their separate trust structures. Maintaining the separate trusts may result in duplicative administrative activities and costs and that these costs reduce the net income available for distribution to the beneficiaries. It may also be possible that maintenance of the separate trusts results in land and asset management decisions that are suboptimal and impair operations and net income.

Recommendation: We recommend that the Trustee undertake a specific study of the costs and benefits of collapsing the several different trusts into a single land trust management and administrative structure, evaluating, among other elements, the impact upon land and resource management, revenues and operating expenses and administrative and overhead staffing. Following completion of the study, the Trust Manager should prepare a plan or program for the implementation of the findings of the trust consolidation study, including recommendations for legislation, regulatory action, policy changes, and associated stakeholder involvement and public communications.

14. Topic: Use of Debt to Smooth Distribution of Trust Net Income

Description: Because of the natural resource commodity (primarily timber) that drives net income for distribution to trust beneficiaries varies based on market conditions, trust beneficiaries must deal with the variation in distribution from year to year incidental to the use of those proceeds. For example, variation in distributions to higher income has to be accounted for in the funding streams for educational facilities (higher reserve amounts or additional credit support) and counties have to accommodate this variation in their annual operating budgets, or if applied to capital expenditures, in higher reserves, slower funding, or both.

The US capital markets have become quite adept at creating stable funding structures based upon variable dollar inputs. The techniques are used very widely, particularly in consumer finance products such as mortgages, consumer loans and other forms of consumer finance. Similarly, these techniques have been used for commercial mortgages and commercial lending. All of these programs share common elements of irregular income streams (such as rents, incomes or loan payments) entering into a trust that then issues a note or security that pays regular amounts to a third party or a related party. As applied to the trust beneficiaries, the variable net annual income from trust land operation would be pledged to a trust or intermediary in return for a stable annual income for a period of years.

Impact of Issue: From our work on the TLPA, we are left with the strong impression that variability in the net income from trust land operation is at the heart of the frustrations of beneficiaries with the Trust Manager. We believe that any formation of multiyear stabilization of net income may reduce beneficiary frustration and improve relations between the Trust Manager and the trust beneficiaries.

It is important to remind the reader that this use of debt to smooth distributions carries a material cost associated with the program, and the cost of this program is not clear at this time. Much as a borrower pays interest to a bank that provides a loan, this program would have a true net cost to the beneficiaries, in the form of interest expense, setting aside of financial reserves and deferral of income. What is much less clear at this writing, however, is the value or worth of the stability of income distribution to the beneficiaries.

Recommendation: We recommend that the Trustee explore the establishment of a program to borrow money to distribute beneficiaries evenly over a period of time, in order to level out the cash flow to the beneficiaries. Such a program may involve working with the state treasurer’s office and the Washington State Investment Board. We believe that the detailed work evaluating the feasibility and net cost of such a program will be largely done by investment banking firms with established relationships with the State. We envision that as many as three investment banking firms may be engaged to evaluate the feasibility and cost of such a program. Once the results of those studies are received by DNR, the agency can expose the results of feasibility and cost to beneficiaries to gauge the interest in and impact of such a program. If the program appears to be of interest to beneficiaries, the agency can then identify the legislative and regulatory changes necessary to allow implementation. It is possible, we think, that the benefits of income stability may well be worth the program cost to trust beneficiaries.

ASSET CLASS: TIMBER

T1. Topic: Land Management Assessment

Description: As currently structured, the Trust Manager is unable to break this asset into smaller units to evaluate those that generate income from those that do not for measurement and performance assessment.

Impact of Issue: The inability to assess which lands are producing more income than others hampers the ability to make well informed management decisions to maximize revenues for each of the trust beneficiaries.

Recommendation: The Trust Manager should work to put in place a system to track land revenues and expenses to assess effectiveness of management of income producing land resources versus non-income producing land resources.

T2. Topic: Data Extraction System – Timber Appraisals

Description: The Trust Manager currently collects an array of data related to past and future timber sales, including (but not limited to) anticipated volume, retail pricing to be assumed achieved, road and bridge construction costs, clear costs, logging costs, and others. However, the data is not located in one system and is only retained in the individual appraisal files. Therefore, for example, when evaluating the prior sales of timber, in order to understand volumes, retail pricing assumed and achieved, and logging costs, individual appraisals need to be individually reviewed and extracted to a database. The data is not currently gathered. The data is prepared in evaluating the auction initial bid amounts and provided in both internal appraisals and externally completed appraisals.

Impact of Issue: The inability to evaluate the retail values and average logging costs for each bid makes it more difficult to identify what factors may be causing bids to either exceed minimums significantly or, conversely, to not achieve minimum bids.

Recommendation: The Trust Manager should work to put in place a single system to track all elements relating to the financials of a particular property, including the retail values of timber, logging cost, extraction cost, development costs, and other pertinent information. This should be collected both from internal appraisals and externally prepared appraisals. Furthermore, any data that is provided actual costs incurred by winning bidders to harvest the timber should also be collected and tracked.

T3. Topic: Harvest Model Application

Description: Ideally, it is better to harvest more in favorable market conditions and harvest less under unfavorable market conditions. However, timing the market in this manner presents the problem of reliably distributing revenue to beneficiaries over time. For example, during the periods where the Trust Manager does not sell, it is not distributing revenue to the beneficiaries.

Impact of Issue: The inability to distribute income in other manners can result in suboptimal harvesting decisions.

Recommendation: The Trust Manager should use any tools available to optimize selling during favorable market conditions. However, the Trust Manager's ability to implement this recommendation and avoid any impacts to the distribution of trust beneficiary revenue would be greatly enhanced by other mechanisms to ensure reliable income is provided to beneficiaries, such as implementing general recommendation #14, "Use Debt to Smooth the Distribution of Trust Net Income."

T4. Topic: Rotational Cycle

Description: There are three categories of harvestable acres on the trust land base: riparian management zones, uplands, and general ecological management (GEM) lands. The first two categories encompass acres that are harvestable but restricted to either thinnings or longer rotations due to HCP commitments to manage for salmonid, NSO or murrelet habitat, or hydrologic maturity. GEM lands are not restricted, and yet the average age of harvest is typically older than private industry. In evaluating the typical harvest rotational age, it would appear private industry would use 40 to 50 years. The Trust Manager both has policy direction to optimize harvest rotations to ensure maximum revenue and is on a path toward implementing similar rotation lengths on GEM lands. However, significant acreages of GEM stands older than 40 to 50 years remain on the landscape.

Impact of Issue: The higher harvest rotational age likely impacts cash flows.

Recommendation: The Trust Manager should continue to strive to harvest stands on GEM lands so that it may enacting a shorter harvest rotational cycle to allow the Trust Manager to increase yields.

T5. Topic: Approach to Harvesting Decisions

Description: The Restriction chapter describes how 40% of the available land portfolio in the timber asset class is either not or only partially harvestable. This was due to a decision made by the Trust Manager to negotiate a Habitat Conservation Plan to obtain an incidental take permit, in order to ensure that a land base containing a larger percentage of older forests would comply with the Endangered Species Act and provide operational certainty to its beneficiaries.

Impact of Issue: Some industry competitors suspect that the acres needed to mitigate for the incidental take in the HCP may result in lower net incomes and returns compared to private industry's compliance with Forest Practices.

Recommendation: Work with the beneficiaries, stakeholders and, as necessary, the legislature to conduct a cost/benefit study to evaluate the protections in place for trust lands under the State Lands Habitat Conservation Plan with other approaches to Endangered Species compliance on a similar land base, in terms of age class range and proportions of the land base in those age classes.

T6. Topic: TIMO Management Model Project

Description: The Trust Manager manages all trust timberlands in a uniform manner. This management and oversight regime is routinely criticized by trust beneficiaries as being ineffective and costly, resulting in less net income for distribution than trust beneficiaries believe is possible.

Impact of Issue: The dissatisfaction of the beneficiaries and the continuing allegation that the Trust Manager is less efficient than private industry peers give rise to conflict between the Trust Manager and beneficiaries. The conflict may empower other stakeholders to the disadvantage of both the Trust Manager and beneficiaries.

Recommendation: The Trustee should work with the beneficiaries, stakeholders and Trust Manager to design, fund and implement a study to compare the services provided by the Trust Manager to the services provided by a TIMO. Those services may include (but are not limited to) forest management and timber sales for purposes of establishing revenues, income, and returns on a similar land base in terms of age class range and proportions of the land base in those age classes.

ASSET CLASS: COMMERCIAL REAL ESTATE

C1. Topic: Asset Management Function

Description: From a review of the information available, it appears the current asset management practices are not actively managing the commercial properties adequately. Asset management should involve the active management of preservation and growth monitoring of capital needs at a property, tenants, lease rollovers, and other responsibilities. However, under Trust Manager's stewardship, there is at least one improved property that has been vacant since 2014. This asset must be managed more actively to reduce the likelihood of buildings going year after year without tenancy.

Impact of Issue: The inability to actively manage the assets impacts the rental rates achieved and ultimate cash flow achieved from the commercial properties.

Recommendation: The board should evaluate the best way to ensure active management of trust assets. We are aware that certain functions, like property management, are already in place. Perhaps addition of an asset manager to the list of outsourced activities should be considered.

ASSET CLASS: COMMUNICATION RESOURCES

CC1. Topic: Record Keeping

Description: The Trust Manager currently does not have record of what improvements are included at each communication site, who owns the improvements (Trust Manager vs. lessee), as well as (over a given period of time) what the allowed and used communication type is; as an example, a contract for a site being utilized for radio transmissions between 2015 and 2018 was modified to TV transmissions in 2018 with no way to update the records in the database.

Impact of Issue: The inability to properly record and manage uses of communication sites can result in uses that are impermissible per the lease agreement in place.

Recommendation: The Trust Manager should work to put in place a software system to properly manage the communication sites and associated leases.

ASSET CLASS: GRAZING

G1. Topic: Rental Rate Determination

Description: The Trust Manager currently establishes rent annually for grazing permits on an AUM basis – Animal Unit Months – consistent with the formula in WAC 332-20-220. This should be evaluated periodically to ensure it is keeping pace with grazing leases on state and private lands. Grazing leases also use AUM's to establish rent. Currently rent is determined using a five-year rolling average of the National Agricultural Statistics Service (NASS) report AUM values for Washington.

Impact of Issue: Revenues may be captured in an incorrect manner if permit fees are not modified regularly along with evolving industry standards.

Recommendation: We recommend that the Trustee undertake a study, on a periodic basis, to compare the Trust Manager's agreements (including but not limited to leases, both initial and renewal terms, permits, and fees) with private and federal equivalents in order to confirm that the grazing program is earning revenue that is market based and standard with how private industry operates

CONCLUSION

The recommendations in this section are based upon our study, and many are consistent with the recommendations that have been provided to the Trust Manager in other past studies completed by or provided to the Trust Manager; these prior studies are outlined in the summary in Appendix C. We also recognize that many of the recommendations in this TLPA analysis are consistent with observations and recommendations completed by Deloitte in the 1996 study.

At this point, it is important that management actions be taken by the Trust Manager to be as effective as possible in producing net income for the beneficiaries. The trust manager needs to be allowed to be more active in improving and diversifying trust land revenue streams through improved effectiveness.

The reader should remember that the ownership and operation of trust lands are unique. Ownership of the trust lands resides with the State of Washington, while the net income benefits of the trust land portfolio lie with a group of defined beneficiaries. Neither the State nor the beneficiaries of the trust lands have complete discretion and control of the management of the land portfolio and its operating net income. Both are also subject to the federal and state statutes and regulations that influence land management, as well as the oversight of the lands through the Board of Natural Resources.

Notwithstanding the ownership of the land portfolio, the duties of the state to its defined beneficiaries and the overlay of applicable federal and state laws, regulation and policy, among the highest duties of the trust manager is the production of net income for distribution to the beneficiaries and the maintenance of intergenerational equity among beneficiaries. We believe that in order to better manage the trust land portfolio and produce net income, efforts to make the business operations of the land portfolio more efficient must continue. With over $200 million in annual revenue and with a mandate to produce a profit for the beneficiaries, the trust lands are a business enterprise and they should be managed in a business-like manner. We believe this is possible, but it may require ongoing review and potential change to the existing framework of applicable laws, regulations and policies governing the Trust Manager and the trust lands within the land portfolio.

The approach to trust land operations and management needs to continue to move towards greater business and beneficiary-oriented practices, with a strong emphasis on the dollar productivity of the land portfolio. We acknowledge that because the land portfolio is a public asset and not a private asset, certain management options and practices must continue, and that these practices will or may result in reduced or less productive operations than if the trust lands were privately held. Trust beneficiaries must also recognize that they are not the owners of the trust lands but only a beneficiary of its operating net income. Ultimately, the management and operations of the trust land portfolio is a complex balance that seeks to provide the best possible long-term stewardship of the land portfolio asset, while providing an effective distribution of net income to its defined beneficiaries. We believe that a continued focus on entrepreneurship and business-like management of the land portfolio and using the best practices of private industry wherever possible is in the best interest of good asset stewardship as well as meeting the on-going and ever-changing needs of the defined beneficiaries of the trust land portfolio.