Analysis of Procedures for Residential Real Estate (Cottage Site) Leases on Idaho's Endowment Lands

by

Philip S. Cook

and

Jay O'Laughlin
The College of Natural Resources Policy Analysis Group (PAG) was established by the Idaho Legislature in 1989 to provide objective analysis of the impacts of natural resource proposals (see Idaho Code § 38-714). The PAG is administered by William J. McLaughlin, Dean, College of Natural Resources.

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**Policy Analysis Group Reports**


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No. 23. Comparison of two forest certification systems and Idaho legal requirements. P.S. Cook and J. O’Laughlin (December 2003).


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by

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and
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Report No. 28
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College of Natural Resources
University of Idaho

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About the Policy Analysis Group (PAG)

Role and Mission. The Idaho Legislature created the Policy Analysis Group (or “PAG”) in 1989 as a way for the University of Idaho to provide timely, scientific and objective data and analysis, and analytical and information services, on resource and land use questions of general interest to the people of Idaho. The PAG is a unit of the College of Natural Resources Experiment Station, administered by William J. McLaughlin, Director, and Dean, College of Natural Resources.

PAG Reports. This is the twenty-eighth report of the Policy Analysis Group (see inside cover). The PAG is required by law to report the findings of all its work, whether tentative or conclusive, and make them freely available. PAG reports are primarily policy education documents, as one would expect from a state university program funded by legislative appropriation. The PAG identifies and analyzes scientific and institutional problems associated with natural resource policy issues. In keeping with the PAG’s mandate, several alternative policy options are developed and their potential benefits and detrimental effects are analyzed. As an operational policy the PAG does not recommend an alternative.

Advisory Committee. A standing Advisory Committee (see inside cover) has specific functions assigned by the PAG’s enabling legislation. The committee’s main charge is to review current issues and suggest topics for analysis. Based on those suggestions, the dean of the College of Natural Resources works closely with the PAG director to design analysis projects. The Advisory Committee has a responsibility to suggest the appropriate focus of the analysis. This is done iteratively, until an outline for the project is mutually agreed upon by the committee and the PAG. The outline is usually organized as a series of focus questions, and the PAG’s analytical tasks are to develop replies to the questions. The PAG uses the resources of the university and other public and private organizations as needed. When the PAG becomes active on a project, the Advisory Committee receives periodic oral progress reports. This process defines the scope of PAG report content and provides freedom for the PAG to conduct unbiased analysis.

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Executive Summary

Idaho’s endowment trust assets include 354 cottage site lots on Priest Lake and 168 cottage site lots on Payette Lake. The state leases the lots, and lessees are authorized to construct and own single-family residences on the sites. The cottage sites are to be managed, like all endowment trust assets, to provide “maximum long term financial return” to the trust beneficiaries, primarily public schools. The State Board of Land Commissioners (Land Board) is the trustee for endowment trust assets and is mandated to “insure that each leased lot generates market rent throughout the duration of the lease.” Maximizing financial return to endowment land assets by obtaining market rent for cottage site leases raises several issues, addressed through replies to the following focus questions.

How were cottage site lease payments set historically? Most cottage site lots were leased for the first time during the mid 1940s and early 1950s. Rents were low and remained relatively flat from 1945 to 1988.

After selling 22 lots at Payette Lake in 1987 to determine fee simple market values, the Land Board began using a rental rate of 2.5% of fee simple market value in 1988. As of 2008, the rental rate remains 2.5% of current fee simple value of the vacant or unimproved land. At Priest Lake, the leased property is revalued every five years, and rent is adjusted annually by indexing based on market data. At Payette Lake, rent is adjusted annually based on assessed values determined by Valley County.

In 2008, the Idaho Legislature amended Idaho Code to allow the Idaho Department of Lands (IDL) to increase the lease term for all cottage sites on state endowment lands from 10 years to 35 years. The rationale for lengthening the lease term was that it would more generally coincide with a traditional 30-year mortgage term, and therefore the desirability of state cottage site leases could potentially increase due to the availability of residential financing.

What guidance on long-term residential real estate leasing is in published literature? The Land Board’s fiduciary responsibility to the trust beneficiaries and the goal of generating market rent from each cottage site leads to several pertinent areas of inquiry in the research literature, including: property rights and leasing real property, appraisal, appraisal of leases, market rent and contract rent, land leases, appraisal of land leases, rates of return, and rent adjustments and reevaluations. However, because of the unique nature of the state’s cottage site leasing program, guidance from the research literature is limited. Land leases for single-family residential use properties are rare in the United States, thus research has not been a priority.

The research literature leads one to question whether “market rent,” as the term is conventionally used, can be established for cottage site leases because so many characteristics of the “market” are unusual. For example, markets typically are defined by many buyers and sellers, or, in the case of a market for leases, many lessors and lessees. The state is the only lessor of cottage site land leases on Payette Lake. On Priest Lake only the state and federal governments lease land for residential use. In 1998, no private land leases were found at either location. Also, markets typically are defined by transactions that take place throughout a time period. In the case of state cottage site leases, all leases currently expire at the same time. In addition, current cottage site lessees have preferential renewal rights at the end of a term (i.e., no conflict bidding is allowed).

The lack of a competitive, open market for single-family residential land leases on either Payette Lake or Priest Lake forces appraisers to make unusual adjustments to standard appraisal methods for determining opinions of value. Unusual situations and markets make appraisals more subjective, more variable, and therefore less reliable for estimating market values, market capitalization rates, and market rents.

The research literature does not provide much guidance on either an appropriate rate of return or lease rate for cottage sites but does suggest that establishing an appropriate land-
lease rate involves a higher than normal degree of subjectivity.

**How do other states set lease payments for residential real estate such as cottage sites?** Few other states lease their trust lands for residential use or single-family cottage sites. Most of the states that do so set target lease rates at least double Idaho's 2.5% of assessed or appraised market value. For example, California leases recreational cabin sites at an annual rental rate based on 9% of the appraised value of the leased lands. Montana’s lease rate is 5% of appraised market value. Utah uses the appraised value of the land times the prime interest rate, which is currently 5%, as a base for determining the lease rate. Wyoming leases state trust lands for recreational purposes, including cabin sites, at a minimum rental rate of not less than 5.5% of the appraised land value.

The National Forest System is federal land, not state land, but nevertheless instructive. The U.S. Forest Service permits recreational residence sites on national forest lands under its special uses permit system. The base fee for a recreation residence special use permit is 5% of the market value of the recreation residence lot as determined by appraisal.

**What alternative methods are available to set lease payments for endowment land cottage sites for a 35-year period that are consistent with the "market rent" mandate?** Among the methods for setting lease payments are: using individual or multi-parcel appraisals to determine market rent, basing rent on what other state leasing programs are doing, setting rent comparable to rates of return on alternative investments, using benchmark rates of return from other institutional investors, using leasehold values, and auctioning the leases.

Appraisals can be used to estimate market rent in two ways. If a rental market exists, then a market rent can be determined by examining rental contracts from comparable properties. Adjustments have to be made for improvements, lease contract terms and conditions, and other property characteristics to arrive at a comparable rent for state land leases. If other similar leased properties do not exist in the market area, then determining market rent is more complex and involves appraising the current fair market value of the land that is being leased and then applying an appropriate annual rate of return to determine contract rent.

The current contract rental rate for cottage sites of 2.5% is below rental rates used by residential land leasing programs in other states. Determining the appropriate rate of return to use for setting contract rent based on rates of return reported for other investments is difficult because they include asset appreciation in addition to a cash return or dividend yield. The 2.5% contract rental rate is below the rates of return reported for other real estate investments. However, between 2003 and 2007, revenues to the cottage site program increased from $2.7 million to $4.4 million (63%, or 13% compounded annually), due to appreciation in the appraised value of cottage sites.

Adjusting contract rent to keep current with changes in land value is also challenging. The application of an index of overall price changes in the economy, such as the Consumer Price Index, does not accurately reflect price changes in the real estate markets at Priest and Payette Lakes. A local real estate price index would more closely reflect land value changes in these two areas, but such an index does not exist and would need to be developed.

**Conclusion.** Creating a cottage site leasing program that meets the Land Board's fiduciary responsibility to the beneficiaries as well as the market rent mandate is challenging. Identifying market rent is complicated because of the unusual characteristics of the cottage site lease "market." Appraisals to determine market rent for cottage sites are complex and stretch to the limit many of the assumptions on which standard real property appraisal methods are based. The choice of an appropriate rate of return or market rent, without having one indicated by the market, is subjective, and various elements and characteristics of the cottage site leasing program create arguments
for lower, or higher, rental rates. Accounting for and balancing all the factors involved in choosing an appropriate rate of return for the State of Idaho is a difficult political decision, and the market provides little direction. In addition, changing the program involves issues of fairness to current leaseholders.

Given the complexities of meeting the market rent mandate, one must ask the question, would the Land Board and IDL better meet their fiduciary responsibilities to the beneficiaries by divesting the cottage site properties (i.e., selling or exchanging the land) and investing the proceeds in other lands or financial instruments? In 2001, an ad hoc committee formed by the Governor to recommend efficiency/effectiveness changes to the Land Board did not reach a conclusion or recommendation about whether all cottage sites should be sold or whether all proceeds from the sales of cottage sites should be reinvested in commercial real estate. However, the committee felt that investments in additional timbered properties and in other financial instruments should be considered. The committee felt that the majority, if not all, of the proceeds from the sale of cottage sites should be used to obtain office and industrial properties in communities around the state. The asset management plan adopted by the Land Board in 2007, however, clearly states an intention to retain the cottage site leasing program.

State trust land management is different than private trust management because state trust land managers may be answerable to beneficiaries, user groups, and voters in a manner that would be inappropriate, or at least unusual, in the context of a private trust. Many state trust land decisions involve social and political considerations that are unrelated to the land manager's fiduciary duties as a trustee. The decisions of the Land Board and IDL regarding cottage site leasing require balancing fiduciary responsibility to the beneficiaries with political considerations and stakeholder concerns. There is unlikely to be a simple “correct” answer to efficiency and fairness issues. Policy decisions that guide state trust land managers have been, and likely will continue to be, a balancing of financial, environmental, and social concerns.
1.0. Introduction

The State Board of Land Commissioners (Land Board) is the trustee for almost 2.5 million acres of "endowment lands" granted to Idaho at statehood for the purpose of supporting public schools and other public institutions (see PAG #1, O'Laughlin 1990). These lands are managed as trusts, with a constitutional mandate to provide "maximum long term financial return" to nine beneficiary institutions. Public schools receive approximately 95% of the returns. Endowment land assets include 1.1 million acres of timberlands and 1.8 million acres leased for grazing (IDL 2007). The Land Board functions as the trustee and the trust assets are managed by the Idaho Department of Lands (IDL).

Endowment land assets also include 522 cottage site lots that are leased for single-family residential use. The state leases the land (site), and lessees are authorized to construct and own the improvements on the sites. These lots are located on the shores of Priest Lake (354 sites) and Payette Lake (168 sites) (IDL 2007). State statute requires that the Land Board “insure that each leased lot generates market rent throughout the duration of the lease” (Idaho Code 58-310A). In FY 2007, IDL's cottage site leasing program brought in revenues of $4.4 million, with net income to the beneficiaries of $4.3 million (IDL 2007).

In 2001 we published a report titled Endowment Fund Reform and Idaho’s State Lands: Evaluating Financial Performance of Forest and Rangeland Assets (PAG #21, O'Laughlin and Cook 2001). In January 2008 Secretary of State Ben Ysursa, a member of the Land Board, requested that the PAG produce a similar report on cottage site leases, focusing on the challenges identified in the Land Board’s asset management plan (AMP) that was adopted in December 2007 (see Figure 1-1; Land Board 2007a). The AMP categorizes these assets as residential real estate cabin leases; the more commonly used term for these lots is cottage sites. All current leases expire on December 31, 2010, and the Land Board is carefully considering new approaches to cottage site leases.

Four focus questions addressing cottage site lease issues provide the outline for this report:

- How were cottage site lease payments set historically?
- What guidance on long-term residential real estate leasing is in published literature?
- How do other states set lease payments for residential real estate such as cottage sites?
- What alternative methods are available to set lease payments for endowment land cottage sites for a 35-year period that are consistent with the "market rent" mandate?

These questions were suggested by the PAG’s Advisory Committee to define the appropriate scope of inquiry reported herein. Due to limited resources, the PAG’s research methods are primarily review and synthesis of existing information, especially in published peer-reviewed literature and relevant reports by public agencies and non-governmental organizations. Replies to the four focus question follow.

2.0. How were cottage site lease payments set historically?

Idaho began leasing cottage sites as early as 1924, but most lots were not leased for the first time until the mid 1940s and early 1950s (Land Board 1997). Rents were low, for example $10 per year for Priest Lake lots in 1945 (Russell 2007a). Rents remained relatively flat from 1945 to 1988, with only sporadic adjustments. For example, no rent increase occurred from 1947 to 1961 (Land Board 1997, Knipe & Knipe 1998). In 1986, the IDL estimated that the state was receiving a return on asset value of 0.67% for all cottage site leases (Land Board 1986).

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Land Board began using a rental rate of 2.5% of market value, with the market values established by the 1987 fee simple auction sales (Land Board 1997, Knipe & Knipe 1998). In 1990, the Idaho Legislature enacted Idaho Code 58-310A, which states that the Land Board “shall ensure that each lot generates market rent throughout the duration of the lease,” and eliminated auctioning of a lease at the expiration of a term (i.e., conflict bidding) (Land Board 1997, Knipe & Knipe 1998). In April 1990, the Land Board began implementation of the new statute by having 13 benchmark lots appraised. This appraisal initially concluded that market rents should be based on an 8% annual return, but in light of additional market data, the range was moderated to 4.5% to 5.5% of market value (Knipe & Knipe 1998). In October 1991, after numerous hearings with representatives of the cottage site associations, the Land Board decided to continue with the 2.5% rental rate established in 1988. In June 1992, the base year for the leases was shifted to 1992, a 10-year phase-in plan was adopted to soften the impact on lessees, and a 5.3% cap on annual rent increases was established (Land Board 1997, Knipe & Knipe 1998).

By 1997, the Land Board had renewed concerns about the 2.5% rental rate being below market return levels. The IDL’s estimates of leasehold value changes from 1992 to 1997 (see Section 3.1) were continuing to escalate significantly: at Payette Lake the average annual rate of increase was 14.3% for lakefront lots and 9.6% for lots without lakefront footage. Market data in 1997 suggested that virtually all other types of investments were generating more than 2.5% annual return. Actual rents paid for cottage sites were well below the 2.5%
target rate because payments were based on 1992 assessed values and property values had appreciated significantly by 1997 (Knipe & Knipe 1998).

In 1998, the Land Board directed that multi-parcel appraisals be conducted at both Priest Lake and Payette Lake (Land Board 1998a, 1998b). The Priest Lake appraisal of 15 lots concluded that market rent was 3.5% of fee simple land value, and the Payette Lake appraisal of 14 lots concluded that market rent was 6% of fee simple land value (Land Board 1998c, 1998d; Knipe & Knipe 1998).

Lessees at Payette and Priest Lakes were unhappy with the appraisals for a variety of reasons including: adjustments made for the value of improvements and limitations of the leases, generally inadequate market rent analysis and a perception that appraisals were too high, and lessees were not given an opportunity for comment during the appraisal process (Land Board 1998c, 1998d). Lessees were also concerned about discrepancies between appraised and county-assessed values. For 11 of the 15 appraised lots at Priest Lake, the appraised value of the lot was higher than county-assessed value; for four lots it was lower (Land Board 1998c). At Payette Lake, appraised values were generally within 20% of county-assessed values, and in aggregate, the assessed value was about 88% of appraised market value (Knipe & Knipe 1998). One of the reasons such discrepancies can occur is because data used in county assessments tends to be older than that used by private appraisers (Knipe & Knipe 1998).

After discussions with lessees and their representatives, the Land Board voted to maintain the rental rate at 2.5% of current county-assessed land value (Land Board 1998e). As a result, rental rates reflected what was effectively a two-year delay because of the time between value assessment and rent payments based on that assessment (Knipe & Knipe 1998).

2.1. Current lease. In 2000, the Land Board directed IDL to develop a new lease for all cottage sites (Land Board 2000). The new lease was adopted by the Land Board in February 2001 (Land Board 2001a, 2001b). The rental rate remained at 2.5% of current fee simple value of the vacant or unimproved land (Land Board 2001a, 2001b; IDL 2001). Today it remains at 2.5% of fee simple value.

The revaluations and readjustments are computed differently at Payette and Priest Lakes. At Priest Lake the lots are revalued every five years, and rents are adjusted annually using an index based on market data. At Payette Lake, rent is adjusted annually based on lot values established by the Valley County assessor (IDL 2001).

At Priest Lake, the land value base was the 1999 Bonner County value of lease lots minus 20%. The land value was to be adjusted annually based on an index determined by market data collected by the IDL until the readjustment period between 2003 and 2006. The annual adjustment could not exceed 5% during the first period. At the time of the land value readjustment, the annual index was to be revised based on the previous five year history of market data increases in lot value. The state or the lessee could request a readjustment of land value and the index any time during the years 2003-2006, but no later than 2006. Readjustment of lot values was based on valuation of current market value of the lots. Lot value readjustments are to be done every five years from the date of the first readjustment and updated annually by indexing based on market data, after the first readjustment (IDL 2001).

2.2. Recent developments. In February 2006, the Land Board authorized IDL to proceed with an auction of two new lot leases at Priest Lake, with subsequent analysis of the results of these auctions providing IDL and the Land Board with a plan for leasing additional cottage sites at Priest Lake (Land Board 2006a). In September 2006, the Land Board directed...
IDL to review and recommend rental rate structures for new cottage sites, and to defer the auctions of new cottage sites, including the two on Priest Lake, until a rent structure for them was approved by the Land Board (Land Board 2006b).

Again in May 2007, the Land Board authorized IDL to initiate lease auctions during late summer of 2007 for the previously identified two lots on Priest Lake. The Land Board also authorized IDL to initiate informational meetings with cottage site lessees and their respective lessee associations regarding potential terms and rates for renewing cottage site leases and for any new cottage sites which the Board may choose to lease in the future. Lease rate structures and lease terms and conditions for the new sites were to be based on these recommendations with final Land Board approval prior to auction (Land Board 2007b).

In July 2007, the Land Board approved the auction of two cottage site leases at Priest Lake using a rental rate of 5% of appraised fee simple land value (Land Board 2007c). Lease bids started at 5% of appraised value, or $22,000 (Russell 2007c). The auction occurred in October 2007 and failed to attract a single bid (Russell 2007b). In November 2007, the Land Board directed IDL to postpone further cottage site auctions (Land Board 2007d).

In December 2007, the Land Board froze 2008 rates for cottage site leases at Payette Lake at 2007 values (Land Board 2007e).

**2.3. Premium rent.** In 1981, the Land Board recognized that low lease rent was resulting in significant leasehold value. With the consent of the lessees, the Land Board adopted an equity sharing “premium rental” policy (Land Board 1997). The policy was formally adopted into department administrative rules in 1987, with a sunset clause of December 1992. In May 1992, the Board adopted the policy again but without a sunset clause (Land Board 1997).

The premium rental policy applies if a lessee assigns the lease to another party (i.e., “sells” the lease). The current lessee then must pay the state 10% of the leasehold value established through the transaction as one-time premium rent. Leasehold value is determined by subtracting the value of approved lessee-owned improvements from the total sale price (IDL 2001). The lessee has the option to determine the value of improvements either by using the county assessed valuation of the improvements or by paying for the state to make an appraisal of improvement value (IDL 2001). Table 2-1 shows the number of lease assignments with and without premium rent at Priest and Payette Lakes between 2003 and 2007.

**2.4. Lease term.** Historically, the statutory maximum length for a cottage site lease was 10 years. In 2008, the Idaho Legislature amended Idaho Code to allow IDL to increase the lease term for all cottage sites on state endowment lands from 10 years to 35 years (Idaho Code 58-307(3)). The rationale for lengthening the lease term was that it would more generally coincide with a traditional 30-year mortgage term for residential real estate. The Land Board and the Legislature anticipated that this would heighten interest in state cottage site leases by prospective lessees and increase the availability of financing for residences on the cottage sites (Idaho Legislature 2008). For example, Freddie Mac (Federal Home Loan Mortgage Corporation) requires that leases terminate no earlier than five years after the mortgage term (Freddie Mac 2006).

**3.0. What guidance on long-term residential real estate leasing is in published literature?**

Compared to the body of real estate literature as a whole, guidance is sparse on long-term leases for residential real estate. The guidance related to cottage site leasing on state endowment lands is even more sparse because cottage site leases are land leases, or ground leases. The state leases the land, whereas improvements are owned by the lessee. Land or ground leases for single-family residential use are rare in the United States. Most single-family residences are either owned in fee simple by the resident, or are rented for short-term periods.

The goals of the Land Board and IDL are for the cottage site leasing program to a) meet the
Analysis of Procedures for Residential Real Estate (Cottage Site) Leases on Idaho's Endowment Lands

“maximum long-term financial return” constitutional obligation to the trust beneficiaries, and b) ensure that each cottage site lot “generates market rent throughout the duration of the lease” as required by statute. Several pertinent areas of inquiry in the research literature result from these goals, including: property rights and leasing, appraisal, appraisal of leases, market rent and contract rent, land leases, appraisal of land leases, rates of return, and rent adjustments and revaluations. Although these topics may appear disjointed, each addresses a part of the challenge of creating a cottage site leasing program that meets the two goals. Each of these topics is addressed in a subsection below, with a concluding “guidance” section.

### 3.1. Property rights and leasing.

The property rights, and therefore property values, of the state and cottage site land lessees are different than those of residents at Payette and Priest Lakes who own their properties in fee simple. A cottage site lease creates a partial private interest in the land asset property. The state has the *leased fee* interest, whereas the lessee has a private *leasehold* interest. Explanation of this key point follows.

One popular theory envisions property rights as a bundle of sticks (Figure 3-1; Barlowe 1986). Each stick represents a separate right or interest inherent in ownership. The bundle of private rights includes: the right to use and occupy the property, the right to sell an interest, the right to lease an interest, the right to mortgage an interest, the right to give an interest away, and the right to do none or all of these things. These individual rights can be separated from the bundle by sale, lease, mortgage, donation, or another means of transfer (Appraisal Institute 2001, 2007).

Ownership of the bundle of sticks (private rights) is known as the fee simple interest, or fee simple estate. Owning the fee simple estate means exclusive ownership unencumbered by any other interest or estate, subject only to the limitations imposed by governmental powers of taxation, eminent domain, police power, and escheat (Barlowe 1986, Appraisal Institute 2002).

When the fee simple estate is separated into bundles of one or more sticks (or a portion of individual sticks), a partial estate, or partial interest, in a specific property is created. When an owner enters into a lease with a tenant, two less-than-complete estates are created: a *leased fee* estate and a *leasehold* estate (Appraisal Institute 2001).

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**Table 2-1. Cottage site lease assignments per year, 2003-2007.**

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Priest Lake</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>without premium rent</td>
<td>11</td>
<td>7</td>
<td>9</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>with premium rent</td>
<td>14</td>
<td>9</td>
<td>9</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>25</td>
<td>16</td>
<td>18</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td><strong>Payette Lake</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>without premium rent</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>with premium rent</td>
<td>7</td>
<td>4</td>
<td>9</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>11</td>
<td>8</td>
<td>14</td>
<td>6</td>
<td>4</td>
</tr>
</tbody>
</table>

Data source: IDL 2008c.
A leased fee estate is an ownership interest held by a landlord, with the right of use and occupancy conveyed by lease to others. The rights of the lessor (the leased fee owner) and the leased fee itself are specified by contract terms contained within the lease. The lessor is compensated for the rights transfer by some form of rent. Typically, the lessor has the right of repossession at the termination of the lease, default provisions, and the rights to sell, mortgage, or bequeath the property during the lease period (Appraisal Institute 2001, 2007).

A leasehold estate is the right to use and occupy real estate for a stated term under certain conditions as conveyed by the lease. Under a lease, the tenant usually acquires the rights to possess the property for the lease period, to sublease the property, and to improve the property under restrictions specified in the lease. In return the tenant must pay rent, surrender possession of the property at the termination of the lease, and abide by the lease provisions established with the lessor (Appraisal Institute 2007).

In the case of Idaho’s cottage sites, numerous lease conditions affect the property rights distribution between the lessee and lessor. For example, the state restricts the use of the site to residential uses only, and lessees may not rent the property to others for more than 14 days per calendar year. No subleasing, assignment, or mortgaging is allowed without the consent of the state. Lessees must obtain consent from the state for improvement construction, landscaping, and fencing. The state also retains the right to use the land, or grant the public or others the right to use the land, to the extent that such use is not incompatible with the lessee’s use (IDL 2001).

3.2. Appraisal. Appraisal is the act or process of developing an opinion of value, or the opinion of value itself (Appraisal Institute 2002). Most of the time appraisals are used to estimate the market value of fee simple ownership in a property. Market value is the value of specific ownership rights to an identified parcel of real estate as of the
effective date of the appraisal (Appraisal Institute 2002).

Appraisers determine market value by studying what people have done in the past to predict what they will do again in the future under similar circumstances. This is usually sound logic, except when unique situations make predicting a buyer’s future behavior difficult (Rattermann 2007). Appraisers use one or more of three basic methods or approaches to develop an opinion of value: sales comparison, income capitalization, or cost replacement (Appraisal Institute 2001).

The sales comparison approach is a set of procedures in which a value indication is derived by comparing the property being appraised to similar properties that have been sold recently, then applying appropriate units of comparison and making adjustments to the sale prices of the comparable properties based on elements of comparison (Appraisal Institute 2002). In some markets there are so few market transactions, or the comparable properties are so dissimilar, that making comparisons is difficult, and the sales comparison approach is less reliable (NCREIF 1991). Elements of comparison include: property rights conveyed, financing terms, conditions of sale, market conditions, location, physical characteristics (access, visibility, topography, shape, and size), zoning, and available utilities (NCREIF 1991). The property rights of state endowment trust land leaseholders are different than those of equivalent owners, making comparison especially problematic (see Section 3.1). For waterfront properties, such as some cottage sites on Payette and Priest Lakes, more specialized elements of comparison may come into play. Several studies have shown that while lake frontage (linear feet of shoreline) is a primary determinant of value for lakeside residential property, other site variables also are important in determining the value (Boykin 2001, Colwell and Dehring 2005). In addition, the quality and types of views have effects on residential property values (Benson et al. 1998).

The income capitalization approach is a set of procedures through which an appraiser derives a value indication for an income-producing property by converting its anticipated benefits into property value (Appraisal Institute 2002). A key element of this approach is the selection of an appropriate capitalization or discount rate (Appraisal Institute 2001).

The cost approach is a set of procedures through which a value indication is derived for the fee simple interest in a property by estimating the current cost to construct a reproduction of, or replacement for, the existing structure. The estimate includes an entrepreneurial incentive, a depreciation deduction from the total cost, and an addition for the estimated land value. Adjustments may then be made to the estimated fee simple value of the subject property to reflect the value of the property interest being appraised (Appraisal Institute 2001).

Income capitalization and cost approaches to market value are not direct studies of behavior, but reconstructions of scenarios that buyers might logically be expected to follow. If the market follows the logic of these approaches, they are excellent valuation tools; if not, they are of little practical value (Rattermann 2007).

### 3.3. Appraisal of leases

When partial interests are to be valued, appraisal assignments tend to become complex (Harrison 1996). Adjustments to market value for *leased fee* and *leasehold* interests are difficult to derive, and the results are less reliable indications of value (NCREIF 1991, Ratterman 2007, see Section 3.1). Lease characteristics that affect value include duration (term), amount and frequency of rental payments, escalations or adjustments to the amount of rent, renewal options, reversion of improvements, and subordination to mortgage financing (NCREIF 1991, Rodgers 1989).

The *leased fee* interest usually will not have the same market value as the fee simple interest because the tenant holds only some of the rights to the property through the lease (Appraisal Institute 2000). Also, the value of the *leased fee* interest plus the value of the
leasehold interest might not equal the value of the fee simple estate (Harrison 1996, Appraisal Institute 2001). It is possible that both the lessee and the lessor are disadvantaged because of terms of the lease (Appraisal Institute 2001).

Leases present challenges for appraisers. The sales comparison approach can be used to value the leased fee interest, but the approach is only meaningful when the sales being used as comparables are similar leased fee interests. If not, adjustments for the real property rights conveyed must be considered (Appraisal Institute 2001). The best methodology to apply when appraising the leased fee interest is the income capitalization approach because it allows the appraiser to perform a careful analysis of the rent compensation associated with the owner’s interest, but if contract rent differs from market rent (see Section 3.4), adjustments for income potential are warranted (Keating 1998).

The sales comparison approach to valuing the leasehold interest is only meaningful in those relatively rare situations in which there are sales of similar leasehold interests that the appraiser can analyze. Leasehold interests are typically valued using the income capitalization approach. The income to the leasehold interest is the difference between market rent and contract rent (Harrison 1996). The cost approach is rarely, if ever, applicable to the valuation of a leasehold interest (Appraisal Institute 2001).

3.4. Market rent, contract rent, and leasehold value. Market rent is the most probable rent that a property should bring in a competitive and open market reflecting all conditions and restrictions of the specified lease agreement including term, rental adjustments and reevaluation, permitted uses, use restrictions, and expense obligations (Appraisal Institute 2002, Vernor 1988). Contract rent is the actual rental income specified in a lease (Appraisal Institute 2002). In simpler terms, market rent is the prevailing rental price for comparable properties in the marketplace, while contract rent is the compensation defined in the lease (Keating 1998). Contract rent may be equal to market rent, or it could be either more or less than market rent.

When contract rent equals market rent, the leased fee estate is nearly equivalent in value to the fee simple estate because if the property were to become vacant, the lessor could likely find another tenant who would pay approximately the same rent (Keating 1998). If contract rent exceeds market rent, the value of the leased fee estate exceeds the value of the fee simple estate. If the property were to become vacant, the lessor may not be able to find another tenant willing to pay the same rent. Instead a lower market rental rate would most likely be obtained (Keating 1998). If contract rent is less than market rent, the leasehold estate has a lower value than the fee simple estate. If the property were vacant, the lessor may be able to find a tenant willing to pay the prevailing market rent (Keating 1998).

When contract rent equals market rent, the leasehold estate basically has no value, except for the value of tenant-owned improvements. However, the potential for a positive leasehold value could arise, depending on the duration of the lease term (Keating 1998). If contract rent is lower than market rent, the leasehold interest could have positive value beyond the value of tenant-owned improvements. The value is positive if the lease agreement permits subletting or assignment and a significant lease period remains. Even if the lease does not allow subletting or assignment, it may be valuable to the tenant for its use value and opportunity cost savings over market rent levels. If the lease agreement can be cancelled or has a very short remaining term, however, it is unlikely that the leasehold position is marketable or has much value (Keating 1998).

If contract rent exceeds market rent, the leasehold estate has negative value, not considering any potential positive value resulting from tenant-owned improvements. The value is negative because the tenant is paying more than the typical market rent (Keating 1998). Negative or positive leasehold interests will cease if contract rent equals market rent any time during the lease or when the lease expires (Appraisal Institute 2001).
3.5. **Land leases.** With a land lease, also referred to as a ground lease, a landowner leases land to a tenant, but the improvements (i.e., buildings) on the land are owned by the tenant. Cottage site leases are land leases. In general, the motivation for a lessor to enter into a land lease is to retain ownership of the property while at the same time generating income (Carneghi 1994). The State of Idaho appears to follow this motivation with cottage site leases.

The motivations of a lessee are somewhat more complex because a ground lease is almost always more complicated than a fee simple ownership transaction. For example, leasehold financing is more difficult to obtain than fee financing due to a greater risk. The motivations of a lessee may include the ability to control and use property that would not otherwise be available (i.e., the property is not for sale) or to avoid the upfront capital cost of purchasing property (Carneghi 1994). The motivations of cottage site lessees likely could include either of these rationales, but for Payette and Priest Lakes the lessees’ motivations are not actually known.

In general, land lease transactions are infrequent compared to outright purchase and ownership. Land leases are relatively more frequent where property is limited, and for this reason landlords have relatively greater control in the negotiating process (Carneghi 1994). Market demand is an important factor in an initial land lease transaction. Only in markets with strong demand are lessees willing to enter into land leases (Carneghi 1994). The state’s recent experience when its two new Priest Lake cottage sites received no bids (see Section 2.2) may suggest weak demand for new land leases, at least under the terms and conditions offered by the state. Another aspect of market demand is the availability of substitute sites. Land leases are most commonly found where there is a shortage of alternative development sites (Carneghi 1994). Lakefront property is a relatively scarce resource.

Most land leases express the contract rent as a percentage of the fee simple market value of the land. This is the way cottage site rental rates are expressed on Payette and Priest Lakes. The problem in determining whether the contract rent equals market rent is that while sufficient data typically exist to establish market value of the fee interest in land, sufficient actual transaction data seldom exist to establish market rent. This is because land leases are generally infrequent compared to outright sales of property (Carneghi 1994). The market rent analysis in the 1998 appraisal of cottage sites at Payette Lake exemplifies this problem (see Knipe & Knipe 1998).

Most land leases in the United States are for commercial property. Land leases for single-family residential use, such as cottage sites, are much less common (Appraisal Institute 2007). A few other western states have programs where state land is leased for single-family residential use (see Section 4.0), but leases of private land for single-family residential use are more rare. Hawaii and some areas of Maryland have concentrations of land leasing for single-family residential housing (Neil 2006). Both of these situations are artifacts of historical land development: Hawaii because in times past a very few families owned most of the land in the state, and Maryland from the legacy of the English feudal land system adopted during the colonial period. Both states have undergone major land reforms, including encouraging conversion to fee simple ownership (Carneghi 1994, La Croix et al. 1995, Maryand’s Peoples Law Library 2008, Maryland Department of Housing and Community Development 2008).

Land leasing is more common in the United States for manufactured or mobile home developments. Residential land leasing is also more common overseas, for example in the United Kingdom and Hong Kong (Hong 1998, Dixon et al. 2000). The rarity of land leasing for single-family residential use in the United States appears to limit the amount of research literature available to provide guidance for cottage site leasing.

3.6. **Appraisal of land leases.** To reach an opinion of value for leased land, an appraiser uses the same methods applicable to other forms of property ownership. Sales comparison and income capitalization methods
are discussed below. The cost approach is generally inapplicable because the appraiser is interested in land value, not replacement costs of the improvements.

Sales comparison is usually the most reliable way to estimate leased land value (Appraisal Institute 2001). However, if information on sales of comparable sites subject to land leases is unavailable, the appraiser can investigate sales of comparable plots of land that are not leased. Analysis of these transactions may yield an estimate of the rate of return an investor expects from comparable sites—i.e., a market-derived capitalization rate that can be applied to determine the land rent for the subject property (Appraisal Institute 2001). However, adjustments to the comparable properties’ values must be made to reflect differences in the property rights conveyed and the specific terms and conditions of the land leases (Carneghi 1994, Janssen 2003, Appraisal Institute 2007). Residential properties on leased land can sell for significant discounts as compared to similar fee simple properties (Capozza and Sick 1991).

Ground rent capitalization, a form of the income capitalization approach, also can be used to appraise either the leased fee interest or the leasehold interest of property subject to land leases, but it is not generally applicable to single-family residential properties (Appraisal Institute 2001, Appraisal Institute 2007). To apply ground rent capitalization, an appraiser must derive a capitalization rate from the market that reflects the relationship between land sales and land rents. However, if sales are available to support such a derivation, these sales can often be used to value the land directly using the sales comparison method (Appraisal Institute 2007). On lands with improvements, the appraiser must be able to separate the value of the improvements from the value of the leased land. A land residual or allocation method is used most often (Appraisal Institute 2001; NCREIF 1991; Bioeconomics, Inc. 1993). The allocation method is based on typical ratios of land value to improvement value for specific categories of real estate in specific locations. Allocation is useful when transactional data on comparable sites in the immediate area are not available. The typical land value can be inferred by the price range of improved properties in the immediate area if an appropriate allocation ratio can be established in the community for a specific property type (Appraisal Institute 2001).

3.7. Rental rate and rate of return. The rental price for land leases usually is set as a percentage of fee simple market value. The percentage or rental rate usually reflects the lessor’s expected rate of return on the real estate investment. Rates of return on investments generally reflect the risks associated with the investment (Appraisal Institute 2001).

Rates of return also are used to capitalize or discount benefits or costs in the income capitalization approach to appraisal. Comparable properties in the income capitalization approach should have the same degree of risk as the subject property because risk is a consideration in the selection of the capitalization rate (Appraisal Institute 2001).

No studies were found identifying common rates of return for residential land leases. One study suggests that a commercial land lease is often much like a bank certificate of deposit or a corporate bond, but real estate risks may be somewhat higher so that a land lease rate would be higher than a corporate bond with the same maturity schedule (Carneghi 1994). Another study suggests that equity real estate investment trusts (REITs) may provide an appropriate target for rate of return for leased properties (Hendershott 1996). Current rates of return for 10- to 35-year real estate investments are in the 10 to 13% range, which includes both capital appreciation and dividend yield (NAREIT 2008). Dividend yields over the last five years have averaged 5% (NAREIT 2008).

Total rates of return for other real estate investments are not directly comparable to the cottage site contract lease rate of 2.5% of land value. The 2.5% expresses only the proportion of cash rent as a function of the underlying cottage site asset value. In addition, the cottage site asset is appreciating, and that
change in asset value is part of a total rate of return. Cottage site program revenues are indicative of asset value appreciation. Revenues increased from $2.7 million in FY 2003 to $4.4 million in FY 2007, an increase of 63% overall or 13% compounded annually (Table 3-1).

3.8 Investment risk. Various types of risk apply to real estate investment (Appraisal Institute 2001). Market risk is the risk that revenue will be affected by changes in the market—i.e., shifts in demand and/or supply—and is influenced by factors such as the type and location of property. Financial risk is related to the use of debt to finance an investment—e.g., default, prepayment, contractual financing terms that cannot respond to interest rate changes—and is influenced by the amount and type of debt. Capital market risk is the risk that market value will be affected by changes in capital markets—e.g., mortgage yield rates, equity yield rates, or overall yield rates—and is influenced by changes in levels of interest rates, changes in availability of both mortgage and equity capital, and the rate of return for alternative investment opportunities (Appraisal Institute 2001).

Other types of risk include the following: Inflation, or purchasing power, risk is influenced by lease provisions that provide inflation protection. Liquidity or marketability risk is the difficulty of converting a real estate investment into cash at market value in a reasonable time. Environmental risk is the risk that the market value of a property will be affected by its physical environment, including perceived health hazards, costs associated with dealing with potential environmental problems, and acts of nature such as earthquakes and weather conditions. Legislative risk is the risk that legal factors will affect the market value of a property and is influenced by tax law changes, environmental regulations, change in land use regulations (zoning), and ability to navigate permitting processes. Management risk is the risk that management cannot ensure that the property meets defined goals and is influenced by the competency of management (Appraisal Institute 2001).

Each of these types of risk can influence a property separately or in various combinations. The terms of a land lease and the relative risks to the lessor and the lessee influence the

### Table 3-1. State of Idaho Cottage Site Program revenues, FY 2003 - FY 2007.

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Payette Lake—waterfront rent</td>
<td>$636,948</td>
<td>$765,069</td>
<td>$776,681</td>
<td>$1,133,897</td>
<td>$1,498,288</td>
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<tr>
<td>Payette Lake—non-waterfront rent</td>
<td>$162,576</td>
<td>$152,898</td>
<td>$149,546</td>
<td>$177,465</td>
<td>$226,662</td>
</tr>
<tr>
<td>Payette Lake—premium rent</td>
<td>$24,081</td>
<td>$214,835</td>
<td>$219,302</td>
<td>$565,275</td>
<td>$257,228</td>
</tr>
<tr>
<td>Priest Lake—waterfront rent</td>
<td>$1,796,113</td>
<td>$1,810,449</td>
<td>$1,805,310</td>
<td>$1,985,197</td>
<td>$2,192,857</td>
</tr>
<tr>
<td>Priest Lake—premium rent</td>
<td>$102,341</td>
<td>$185,658</td>
<td>$155,934</td>
<td>$155,026</td>
<td>$259,123</td>
</tr>
<tr>
<td>Other revenue</td>
<td>$5,576</td>
<td>$4,188</td>
<td>$2,877</td>
<td>$5,816</td>
<td>$10,091</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$2,727,635</td>
<td>$3,133,097</td>
<td>$3,109,650</td>
<td>$4,022,676</td>
<td>$4,444,249</td>
</tr>
</tbody>
</table>

Data source: IDL 2008b.
appropriate rate of return and thus the land-lease rental rate (Carneghi 1994). For example, generally, there is more risk in obligating money for a longer term than a shorter term, and longer term investments generally provide a higher rate of return to compensate for this commitment (Carneghi 1994, Jones and Roach 1989). Also, generally, there is less investment risk associated with below-market rental rates than with a rate at or above market level, so the rate of return is lower (Keating 1998).

Subordination also can significantly influence a land lease rate (Carneghi 1994). A subordination clause means the lessor subordinates his or her interest to that of a lender. The existence of a subordination clause makes it considerably easier for a lessee to finance improvements on the land-lease parcel. This is because in the event of a default the lender’s interest takes priority over that of the landowner, so the lender will view the property as substantially less risky than an unsubordinated land lease. Given that increased yield is based on increased risk, an unsubordinated land lease (with lower risk to the landlord) would carry a lower land-lease rate than a subordinated land lease, all other factors being equal (Carneghi 1994).

3.9. **Rental adjustments and revaluations.** There are two basic ways that lessors attempt to keep contract rents current with market rents (Carneghi 1994, Rodgers 1989, Jones and Roach 1989). The most common is to adjust rent according to some standard price index such as the Consumer Price Index (CPI). The adjustment is usually made annually, or it can be periodic, for example every five years. The adjustment can be applied to the base lease rate as simple interest or cumulatively compounded. The adjustment can have a cap or a floor or be unlimited. The adjustment may be some fraction of the index change (Carneghi 1994).

Adjustments using the CPI are controversial. For example, in the 1998 appraisal of lots at Payette Lake, the appraiser suggested that CPI is not an appropriate index because it reflects the national general inflation rate, rather than the increase in local real estate values (Knipe & Knipe 1998). On the other hand, cottage site lessees claim that it is normal and customary to have an adjustment tied to CPI and not exceeding 3% per year (Payette Lake Cabin Owners Association and Priest Lake State Lessee Association 2008).

The other common adjustment in leasing is to reappraise the property periodically to bring the contract rent back to the market rent level. The reappraisal can be done as often as the parties wish, but typically because of the expense it is done every 10 or 20 years. Variations on this adjustment include reappraising the land value, but leaving the land lease rate fixed; reappraising the land value and moving the land lease rate to market; reappraising one or the other but not allowing rent to be less than the most recent amount paid; and having the reappraisal clause only at the option of the lessor or the lessee (Carneghi 1994).

3.10. **Guidance from the literature.** Because of the unique nature of the state’s cottage site leasing program, guidance from the research literature is limited. Land leases for single-family residential use properties are uncommon in the United States, thus research has not been a priority for lessors, lessees, or real estate researchers. Also, in general, research on leases has lagged far behind research on loans or mortgages (Hendershott 1996).

The research literature leads one to question whether “market rent,” as the term is conventionally used, can be established for cottage site leases because so many characteristics of the “market” are unusual. For example, markets typically are defined by many buyers and sellers (Appraisal Institute 2002), or in the case of a market for leases, many lessors and lessees. In the case of cottage site land leases on Payette Lake there is only one lessor—the State of Idaho—and on Priest Lake only the state and federal governments lease land for residential use. During the 1998 appraisals of cottage sites on Payette and Priest Lakes, appraisers were unable to locate any private land leases for residential properties on either lake (Land Board 1998c). Also, markets
typically are defined by transactions that take place throughout a time period. In the case of cottage site leases, all leases currently expire at the same time. In addition, current cottage site lessees have preferential renewal rights at the end of a term (i.e., no conflict bidding).

The lack of a competitive, open market for single-family residential land leases on Payette and Priest Lakes forces appraisers to make unusual adjustments to standard methods of arriving at opinions of value. For example, the comparable properties used to establish market lease rates in the 1998 appraisal of cottage leases at Payette Lake included properties in South Carolina, Oregon, Arizona, Washington, California, Minnesota, and Alabama (Knipe & Knipe 1998). One could question whether properties in these states are valid bases of comparison for properties in Idaho. Unusual situations and markets make appraisals more subjective, more variable, and less reliable for estimating market values, market capitalization rates, and market rents.

Does the literature suggest an appropriate lease rate for cottage sites? No, the research literature does not provide much guidance but suggests that establishing an appropriate land-lease rate involves a higher than normal degree of subjectivity (Carneghi 1994). One study of land lessors of commercial properties found the most common opinion was that leased fee interests are inherently similar in investment appeal to long-term debt instruments such as mortgages or bonds (Rodgers 1989). The second most common general opinion in the study was that 10% was an appropriate rate of return for land leases, but the rationale was not identifiable (Rodgers 1989).

4.0. How do other states set lease payments for residential real estate such as cottage sites?

Few other states lease trust land or other real estate for residential use or single-family cottage sites. Most of the states that do set a target lease rate at least double that of Idaho’s 2.5% of assessed or appraised market value. Details follow.

4.1. Alaska. The state of Alaska leases remote recreational cabin sites, but the bases for comparison to Idaho are limited. The intent of the Alaska leasing program is to facilitate transfer of remote, unsurveyed lands into private hands. The initial lease period is three years with a lease payment of $100 per year. During that time the Alaska Department of Natural Resources surveys and appraises the property and enters into a purchase contract with the lessee. If the lessee does not wish to purchase the parcel during the three-year lease period, he/she can renew the lease for a single five-year term with lease payments of $1,000 per year (Alaska Department of Natural Resources 2008).

4.2. California. California does not allow long-term residential use of its school trust lands, but does lease other state lands for recreational cabin sites. The California State Lands Commission leases recreational cabin sites under its non-incoming producing (for the lessee) general permit system. In general, the annual rental rate is based on 9% of the appraised value of the leased lands with a minimum rental of $50, although the commission has some discretion in determining the rent. The lease period for a general permit for recreational use is 10 years (Title 2, California Code of Regulations § 2000 et seq.).

4.3. Montana. The Trust Land Management Division of the Montana Department of Natural Resources and Conservation manages Montana’s residential leasing program on state trust lands. For residential leases Montana has a target lease rate of 5% of appraised market value, with a reappraisal every five years. The term of the lease is variable from 10 to 25 years (Montana Department of Natural Resources and Conservation 2008).

4.4. Oregon. The Oregon Department of State Lands has only four cabin site leases, all on Lake Owyhee in the southeastern part of the state. Oregon’s asset management plan calls for the renegotiation of leases to market rates and periodic review to ensure market rates are attained. The plan also calls for the investigation of the potential for additional cabin site development. The revenues from
cabin site leases have been diminishing from $2,040 in 2000 to $406 in 2005 (Oregon Department of State Lands 2006).

**4.5. Utah.** Utah leases state trust land for residential purposes and recreational cabin sites. The Division of Forestry, Fire and State Lands must receive at least fair market value for the leases. According to Utah Administrative Code, lease rates are determined by multiplying the fair market value of the subject property by the current division-determined interest rate (Utah Administrative Code R652-30). In practice, Utah uses the appraised value of the land times the prime interest rate as a base for determining the lease rate. The division has some latitude for adjustment of the lease rate based on location of the land and other factors (Higgins, personal communication). In June 2008, the prime interest rate was 5.00% (Federal Reserve 2008).

Utah adjusts base rental rates based on changes in market value, changes in established indices, or other methods which may be appropriate and in the best interest of the beneficiaries. Indices may include information from any or all of the following sources: changes in assessed value for the most current year, the applicable component of the Consumer Price Index for All Urban Consumers (CPI-U), the applicable Implicit Price Deflators for the Gross National Product, data from market analyses of comparable leases, or public comment. The determination of which method to use may be based upon an analysis of the cost effectiveness of performing the review (Utah Administrative Code R652-30).

**4.6. Wyoming.** The Wyoming Board of Land Commissioners is authorized to lease state trust lands for recreational purposes, including cabin sites (Wyoming Statutes 36-5-115). Wyoming currently leases 24 cabin sites, and most of the leases are for 25 years, although leases may be up to 75 years in length (Van Hatten, personal communication). The annual rental rate is the amount bid by the applicant, if accepted by the Board, but is not to be less than fair market value for the same or similar use of the land and any improvements owned by the state after an economic analysis is made. In cases where annual rent cannot be established based on fair market value for the same or similar use of the land, the minimum rental rate is not to be less than $250.00 or 5.5% of the appraised land value and any improvements owned by the state (Wyoming Board of Land Commissioners 2007).

**4.7. National forests.** The National Forest System is federal land, not state land, but nevertheless instructive. The U.S. Forest Service permits recreational residence sites on national forest lands under its special uses permit system, and there are currently 121 such permits on national forest lands on Priest Lake (Butler, personal communication). The recreational residence special use permit program has undergone numerous changes in the last decade in response to the Cabin User Fee Fairness Act of 2000 (CUFFA, P.L.106-291). The purpose of the recreational residence program as described in CUFFA—“to preserve the opportunity for individual and family oriented recreation”—is different than the revenue-generating mission of state endowment trust lands. Unlike a state cottage site, a recreation residence on national forest land cannot serve as a permanent residence. The features of the federal leasing program are as follows.

The base fee for a recreation residence special use permit is equal to 5% of the market value of the recreation residence lot as determined by appraisal. The base fee is recalculated at least once every 10 years. The U.S. Forest Service allows a 3-year phase in of the new base fee if it increased more than 100% from the previous base fee. The term of a permit is normally 20 years (USDA Forest Service 2006).

Recreation residence fees are adjusted annually using a price index. During the transition period for implementing CUFFA the index is the Implicit Price Deflator, Gross Domestic Product (IPD-GDP). After the transition period, the index used will be changes in agricultural land prices in the appropriate state or county, as reported in the Index of Agricultural Land Prices published by the U.S. Department of Agriculture. However,
the U.S. Forest Service may select and use another index if it determines that a different index better reflects change in the value of a lot over time (P.L. 106-291). The annual adjustment to the base fee can be no more than 5% in any single year. When the annual adjustment would be more than 5%, the amount of the adjustment in excess of 5% is applied to the annual fee payment for the next year in which the change in the index factor is less than 5% (USDA Forest Service 2006).

5.0. What alternative methods are available to set lease payments for endowment land cottage sites for a 35-year period that are consistent with the "market rent" mandate?

The following reply summarizes relevant methods for setting lease payments identified previously by examining the literature (Section 3.0) and other leasing programs (Section 4.0). The challenges of meeting the “market rent” mandate are addressed further in the Conclusions (Section 6.0).

5.1. Appraisal. Theoretically, appraisal is an accurate and efficient way to estimate market rent, and therefore set contract rent, or the lease payment. If a lease market exists, appraisal of market rent is a matter of collecting information on similar properties and their leases to estimate contract rent that represents market rent. Many leases express contract rent as a percentage of appraised or assessed fee simple market value, and therefore the contract rental rate is known directly. Other leases may express rent as a periodic lump sum of cash, which then requires an appraisal of fee simple market value in order to determine the contract rental rate.

The lack of a residential land lease market at Payette and Priest Lakes complicates appraisal for determining cottage site lease payments or rates. Appraisal of fee simple bare land value is fairly uncomplicated, although it is becoming more complicated because of the lack of comparable sales of unimproved lots on Payette and Priest Lakes (Land Board 2008). Appraisal complications arise primarily because few residential properties at Payette and Priest Lakes are leased under similar conditions as state leases. For example, the limited number of private leases at Payette and Priest Lakes are for improved properties (i.e., residence and land) with shorter terms (e.g., weekly, monthly, or seasonal) (Land Board 2008). Differences in property characteristics and lease conditions require appraisers to make adjustments to value estimates, making them less accurate and more subjective and thus open to question. Additionally, appraisers must look for comparables in lease markets in other geographic areas that may not accurately represent the local lease market.

The assignment an appraiser undertakes also determines the results. One of the criticisms that lessees at Payette and Priest Lakes have voiced about the state’s method for setting cottage site rents is that the appraisal assignment has always been to appraise fee simple fair market value and then assign a lease rate, not appraise market rent directly by looking at other rent contracts on the lakes (Land Board 2008). It is unclear whether there are enough rental contracts to create a sufficient data set of comparable properties. This uncertainty could be readily addressed.

Despite the challenges of estimating the fair market value of or rent for cottage site leases, appraisal is one of the tools available. Appraisal options include individual appraisal of each cottage site or a multi-property appraisal whereby several representative properties are appraised and then the values are extrapolated and aggregated to all properties. The 1998 multi-property appraisals at Priest and Payette Lakes, for example, indicated a fair market lease rate of 3.5% and 6% of fee simple market value, respectively (Land Board 1998c). The current lease rate is 2.5% of fee simple market value.

5.2. Other programs. Another option for setting lease rates is to adopt rates based on what other residential land leasing programs are doing. In Section 4.0, we examined residential and recreational leasing programs in other states and on National Forest System lands. Among programs with financial objectives similar to Idaho’s, contract lease
rates ranged from 5.0% to 9.0% of fee simple market value with most in the 5.0% to 5.5% range. The appropriateness of adopting a contract lease rate based on comparison with other states is open to question, but is consistent with the comparison approach of real property appraisal.

**5.3. Alternative investments.** Generally, investors seek similar rates of return on investments with similar risks. Target rates of return for land leases for commercial properties have been compared to mortgages, government and corporate bonds, and REITs, but unusual conditions may affect comparability. For example, target rates of return normally reflect the cost of capital to the landowner, such as mortgage costs (Keating 1998), but in the case of cottage sites, the state already owns the land outright, having received it as a federal land grant at statehood.

Historic average rates for 30-year fixed-rate mortgages, 30-year government bonds, and AAA corporate bonds have all followed the same pattern over the last 30 years, with high rates in the early 1980s and historically low rates since 2000 (Figure 5-1). The June 2008 rates for each were 6.32%, 4.69%, and 5.68%, respectively.

**Figure 5-1.** Historic rates for 30-year mortgages, 30-year U.S. Treasury bonds, and AAA corporate bonds.¹

Note: 30-year U.S. Treasury bonds were discontinued in February 2002 and reissued in February 2006.


Apparently, IDL has considered using the average 30-year fixed-rate mortgage rate because it is defined as a “transaction rate” in the draft 2008-2018 cottage site lease (IDL 2008a). However, the rate is not mentioned elsewhere in the lease, and the 2008 draft lease prepared by IDL has not been adopted.

The National Association of Real Estate Invest Trusts (NAREIT) compiles an Equity REIT Index. The index indicates 5-, 10-, and 35-year return rates of 18.34%, 10.69%, and 13.27%, respectively (NAREIT 2008).

The rates of return reported on alternative investments often include asset appreciation in addition to the cash return. For example, the 5-year return on the NAREIT Equity REIT Index of 18% includes capital appreciation and a dividend yield that averaged 5% (NAREIT 2008). As we pointed out earlier (Section 3.10), the contract lease rate of 2.5% of land value used for cottage sites is the cash return, which is similar to a dividend yield. Total cottage site program revenues have been increasing at a compound interest rate of 13% annually between FY 2003 and FY 2007 (Table 3-1), due to appreciation of the cottage site asset.

5.4. Benchmarks. Another option is to set a lease rate based on a benchmark rate of return derived from other institutional investors such as pension funds or other endowments. For example, the California Public Employees’ Retirement System (CalPERS) uses 8% as the minimum target rate of return on its single-family housing investment program (CalPERS 2005).

The National Council for Real Estate Investment Fiduciaries (NCREIF) also provides benchmarks for real property investments that may be useful (Agland Investment Services, Inc. 2000). The NCREIF was established to serve institutional real estate investors as a non-partisan collector, processor, validator, and disseminator of real estate performance information (NCREIF 2008). The NCREIF Property Index (NPI) includes both national and regional indices (Figure 5-2). The national NPI for 2007 was 15.85%, while the western regional NPI was 18.29% (NCREIF 2008).

The Governor’s Citizens Ad Hoc Committee on Lands/Endowment (2001) recommended that the Land Board use the NCREIF indices for appropriate land categories as a benchmark for endowment land investments. (See further recommendations of this committee in Section 6.1.) Unfortunately, the NCREIF does not have an index specific to single-family residential use land leasing, probably because such leases in the U.S. are uncommon.

5.5. Leasehold value at lease assignment. Another approach to estimating market rental rates is to use leasehold values, which are the sale prices in the assignment (transfer) of state leases from one party to another, as a basis for computing market rent (Bioeconomics, Inc. 1993; see Section 3.4).

This approach assumes the leasehold value plus the present value of the future annual contract rent equals the fee simple market value of the property and that a purchaser is ambivalent between taking over a given state lease or paying market value for a comparable privately owned site (Bioeconomics Inc. 1993).

Bioeconomics, Inc. (1993) used a lease assignment approach to compute market rents for cabin site leases in Montana, but other appraisers (e.g., Knipe & Knipe 1998) question some assumptions used in this approach. For example, one has to either assume a market capitalization rate or assume that the market capitalization and market rental rates are equal (Bioeconomics, Inc. 1993). A more important complication is that if the “market rent” mandate is met (i.e., contract rent equals market rent), leasehold value is zero.

Another potential complication is negative leasehold values. Some current leaseholders at Payette Lake argue that contract rents are already greatly above market rents because no one wants to purchase a leasehold. Therefore, leasehold value is zero because the State of Idaho bases its market rent on market values for fee simple properties (Payette Lake Cabin Owners Association 2008).

5.6. Auction. The most accurate way to set contract rent equal to market rent at the initiation of the lease term would be to auction each lease at the end of its current term. An
An accurate way of ensuring that contract rent continues to equal market rent would be to stagger lease auctions each year over the next lease term so that an annual metric of changes in lease values is created. Lease payments could then be increased or decreased according to this metric.

Although this alternative would be most likely to meet the market rent mandate, it involves the most financial risk to the State of Idaho. Under current statute and lease arrangements, if the Land Board cancels a lease, the state is responsible for paying the current lessee for the value of improvements. The state thus assumes the financial risk for all the improvements on cancelled leases.

Legislative change would have to occur for auctions to happen. Auctions are not consistent with the current statute that removed cottage site leases from the conflict bidding process and created the market rent mandate (Idaho Code 58-310A).

**5.7. Summary.** The setting of lease rental payments for cottage sites can be accomplished via several methods. Appraisals are one method and can be used to estimate market rent in two ways. If a rental market exists, then market rent can be determined by examining rental contracts from comparable properties. Adjustments have to be made for improvements, differences in lease contract terms and conditions, and other property characteristics to arrive at a comparable rent for state land leases. If other similar leased properties do not exist in the market area, then determining market rent is more complicated and is

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**Figure 5-2. NCREIF Property Index.**

Data source: NCREIF 2008.
determined by appraising the current fair market value of the land that is being leased and then applying an appropriate annual rate of return to ascertain the contract rent.

Determining the appropriate rate of return to use in setting contract rent is difficult because rates of return reported for other investments include asset appreciation as well as a cash return or dividend yield. While the current contract rental rate for cottage sites of 2.5% is below rental rates used by other residential land leasing programs and is below the rates of return reported for other real estate investments (Table 5-1), program revenues have increased at 13% compounded annually between 2003-2007, which reflects appreciation of the cottage site asset and is a part of a total rate of return for the asset.

Adjusting contract rent to keep current with changes in land value is also challenging. The application of an index of overall price changes in the economy, such as the Consumer Price Index (CPI), does not accurately reflect price changes in the real estate markets at Priest and Payette Lakes. A local real estate price index would more closely reflect land value changes in those areas, but whether such an index could be developed is open to question.

6.0. Conclusion

Creating a cottage site leasing program that meets not only the Land Board’s fiduciary responsibility to the beneficiaries of the state endowment trust but also the market rent mandate is challenging. Changes to the existing program also involve issues of fairness to current leaseholders. How can the State of

Table 5-1. Rates of return (RoR) on residential real estate implied by various market measures.

<table>
<thead>
<tr>
<th>Market measure</th>
<th>RoR%</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Idaho appraiser’s opinion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Priest Lake</td>
<td>3.5%*</td>
<td>Land Board (1998c)</td>
</tr>
<tr>
<td>Payette Lake</td>
<td>6.0%*</td>
<td>Knipe &amp; Knipe (1998)</td>
</tr>
<tr>
<td>Residential leases, MT, UT &amp; WY</td>
<td>5.0-5.5%*</td>
<td>this report, Sections 4.3 to 4.6</td>
</tr>
<tr>
<td>Recreational residence leases, nat’l forests</td>
<td>5.0%*</td>
<td>this report, Section 4.7</td>
</tr>
<tr>
<td>Recreational cabin leases, California</td>
<td>9.0%*</td>
<td>this report, Section 4.2</td>
</tr>
<tr>
<td>Residential lease program, CALPERS</td>
<td>8.0%</td>
<td>this report, Section 5.4</td>
</tr>
<tr>
<td>30-year mortgages</td>
<td>6.3%</td>
<td>this report, Section 5.3</td>
</tr>
<tr>
<td>30-year government bonds</td>
<td>4.7%</td>
<td>this report, Section 5.3</td>
</tr>
<tr>
<td>AAA corporate bonds</td>
<td>5.7%</td>
<td>this report, Section 5.3</td>
</tr>
<tr>
<td>10-year REIT</td>
<td>10.7%</td>
<td>this report, Section 5.3</td>
</tr>
<tr>
<td>35-year REIT</td>
<td>13.3%</td>
<td>this report, Section 5.3</td>
</tr>
<tr>
<td>National Property Index (NPI)</td>
<td>15.8%</td>
<td>this report, section 5.4</td>
</tr>
<tr>
<td>Western region NPI</td>
<td>18.3%</td>
<td>this report, Section 5.4</td>
</tr>
</tbody>
</table>

*Estimated market rental rate
**Contract rental rate. Does not include asset appreciation.
Idaho balance these challenges? No rental system has yet been devised that has the advantage of appearing equitable to both the lessor and lessee throughout its term (Barlowe 1986). The lessor and the lessee have different interests each wishes to protect. In this case, the lessor must meet goals prescribed in law, which essentially are maximizing financial return to land assets by obtaining market rent for cottage site leases.

Previous sections have outlined the complications in identifying market rent because of the unusual characteristics of the cottage site lease “market.” The 1998 appraisal report for Payette Lake cottage sites summarizes the situation:

“In the case of recreational lots in McCall, Idaho, outside of the State Dept. of Land's program, we are aware of no ground leases, and individual lots vary greatly in view, location, amenities, size, frontage, and other attributes. Expanding the search for data regionally or nationally, parallel situations are extremely rare” (Knipe & Knipe 1998).

As appraiser Ed Morris told the Land Board Cottage Site Subcommittee in April 2008, “It's a really, really complex appraisal situation” (Land Board 2008). Conducting an appraisal to determine market rent for a cottage site is indeed complicated and appears to stretch to the limit many of the assumptions on which standard appraisal methods are based.

The choice of an appropriate market rental payment, without having one indicated by the market, is subjective and based on varying perspectives (Knipe & Knipe 1998). Various elements and characteristics of the cottage site leasing program create arguments for lower, or higher, rental rates (Figure 6-1). For example, the lessee improvement buyout provision creates less risk for the lessee, so to compensate, a higher rate of return for the lessor may be warranted. On the other hand, the current rent escalation formula creates increased risk for the lessee, similar to an adjustable rate mortgage (Hendershott 1996), and thus a lower rental rate may be warranted. How the State of Idaho should account for and balance all the factors involved in choosing an appropriate rental payment is a difficult political decision, and the market provides little direction.

The law that includes the market rent mandate is also inconsistent. Idaho Code 58-310A states that the Land Board “shall ensure that each lot generates market rent throughout the duration of the lease.” It also states “maximum long-term financial returns to the institutions to which granted are best obtained through stable leases at market rent” (Idaho Code 58-310A(1)(h), emphasis added). A given level of market rent exists only for a moment in time and will change with market conditions. Market rent is therefore inherently unstable.

6.1. Exploring divestment. Given the complications in meeting the market rent mandate, one must ask the question, would the Land Board and IDL better meet their fiduciary responsibilities to trust beneficiaries by divesting the cottage site properties (i.e., selling or exchanging the land) and investing the proceeds in other lands or financial instruments? We do not have a good answer, but we are not the first to ask this question. In 2001, Governor Kempthorne formed an ad hoc committee to recommend efficiency/effectiveness changes to the Land Board regarding endowment trust assets and management practices (Governor's Citizens Ad Hoc Committee on Lands/Endowment 2001). The committee asked the same question about cottage site leases. Their reply follows.

The Ad Hoc Committee fully recognized that cottage site leasing is an emotional issue. The committee recognized that it easily can be shown that while the market value of the cottage sites has appreciated and will probably continue to increase, the cash return to the endowments is significantly below the returns provided by other investments (Governor's Citizens Ad Hoc Committee on Lands/Endowment 2001). However, a 2.5% cash return on asset value is above the cash returns of 1.1% on rangeland assets (see PAG #21, O’Laughlin and Cook 2001, Table 1, p.5).

The Ad Hoc Committee commented that opponents to selling cottage sites argue that
Idahoans will be denied access to Payette Lake and Priest Lake in favor of wealthy people from out of state. However, the committee noted that under the current system Idahoans in general are denied access to the lakes from these cottage sites now, as they are improved properties used by individuals and families. They are held under long term agreements that are controlled by what the Ad Hoc Committee called “an elite group of generally wealthy people, many of which are from Idaho, and many of which are already from out of state” (Governor’s Citizens Ad Hoc Committee on Lands/Endowment 2001).

The Ad Hoc Committee also noted that selling the cottage sites and buying commercial real estate could provide higher, safe returns to the endowments while still keeping the investment in good quality Idaho real estate. The sale and reinvestment of proceeds also may offer additional benefits because, once sold to private entities, the land is taxable, thus increasing a county’s tax base (Sunderman et al. 2004). The committee also recognized the important role real estate plays in a diversified portfolio of assets in order to minimize risk and maximize long-term asset appreciation (Aglad Investment Services, Inc. 2000; Governor’s Citizens Ad Hoc Committee on Lands/Endowment 2001; Sunderman et al. 2004).

The Ad Hoc Committee did not reach a conclusion or recommendation about whether all cottage sites should be sold or whether all proceeds from the sales of cottage sites should be reinvested in commercial real estate. However, the committee felt that investments in additional timbered properties and in other financial instruments should be considered. The committee felt that the majority if not all of the proceeds from the sale of cottage sites—what the committee called “good Idaho real estate”—should be used to obtain office and industrial properties in communities around the state—which are also “good Idaho real estate” (Governor’s Citizens Ad Hoc Committee on Lands/Endowment 2001).

In December 2007, the Land Board adopted its Asset Management Plan that lays out management objectives for the cottage site leasing program (Figure 1-1). It appears that despite the difficulties of administering the residential real estate leasing program, the Land Board intends that cottage sites will remain a part of the endowment portfolio for the foreseeable future.

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![Rate of Return Continuum](image)

**Figure 6-1. Rate of return continuum.**

Source: Knipe & Knipe 1998.
6.2. Trust responsibility. Low cash returns on leased properties and pressures from lessees to keep contract rents low are not unique to Idaho (Agland Investment Services, Inc. 2000; Sunderman and Spahr 2006). This occurs in part because state land trust managers face pressures not seen by private trust managers (Culp et al. 2006).

State trust land management is different than private trust management because often many entities perceive themselves either as trust beneficiaries—school boards, school administrators, teachers’ unions, and other school advocates—or trust stakeholders—lessees, development interests, conservationists, or the public (Culp et al. 2006). Trust managers may be answerable to beneficiaries, user groups, and voters in a manner that would be inappropriate, or at least unusual, in the context of a private trust. As a result, there is not a clean separation among the roles of the state as a trustee and public agency, as well as a lawmaking and rule-making body. Many trust decisions thus involve political considerations that are unrelated to the land manager’s duties as a trustee (Culp et al. 2006).

Trust management decisions, including those related to cottage site leasing, are not made in a vacuum. On the contrary, decisions are politically responsive to diverse stakeholders and concerns including those of the state legislature, the constituencies that use and benefit from trust lands and their natural resources and influence legislative and executive officials, the beneficiaries who receive the financial returns from trust decisions, and the general public whose agenda may or may not align with the strictly fiduciary concerns of the trust (Culp et al. 2006). There is unavoidable tension between obtaining financial returns for trust beneficiaries and addressing the concerns of specific stakeholders and the broader public (Culp et al. 2006). The decisions of the Land Board and IDL regarding cottage site leasing require balancing fiduciary responsibility to the beneficiaries with political considerations and stakeholder concerns.

We conclude with the same statement we made with regard to the forests and rangelands in the endowment asset portfolio. Policy decisions that guide trust land managers have been, and likely will continue to be, a balancing of financial, environmental, and social concerns (PAG #21, O’Laughlin and Cook 2001).
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Analysis of Procedures for Residential Real Estate (Cottage Site) Leases on Idaho’s Endowment Lands

____. 2008. Transcript of April 22 Cottage Site Subcommittee meeting. In authors’ files.


**Personal communication**

