State of Arizona Office of the Auditor General

PERFORMANCE AUDIT

ARIZONA STATE LAND DEPARTMENT

Report to the Arizona Legislature
By Douglas R. Norton
Auditor General
April 1997
Report No. 97-6

DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

DEBRA K. DAVENPORT, CPA
DEPUTY AUDITOR GENERAL

April 16, 1997

Members of the Arizona Legislature

The Honorable Fife Symington, Governor

Mr. J. Dennis Wells, Land Commissioner
Arizona State Land Department

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Arizona State Land Department. This report is in response to a May 29, 1995, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the Sunset review set forth in A.R.S. §§41-2951 through 41-2957.

The report addresses ways to better maximize revenues generated from state trust lands administered by the Arizona State Land Department and Permanent Fund assets managed by the Arizona State Treasurer. Specifically, the Department can increase the return received from valuable urban trust lands by adopting a more proactive approach to managing and disposing of these assets that includes greater emphasis on in-house planning, expanded marketing efforts, and installation of core infrastructure on selected properties. In addition, the Department can better ensure that it maximizes revenues obtained from grazing and agricultural lands by restricting grazing lease rent reductions, requiring a surcharge when grazing lands are subleased, and reviewing the methods used to determine grazing and agricultural lease rates. Finally, long-term returns generated from the Permanent Fund can be improved by reinvesting some Permanent Fund earnings to protect the Fund from inflation and investing a portion of Permanent Fund assets in stocks. However, changes to the Arizona Constitution and Enabling Act will be needed to authorize stock investment.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on April 17, 1997.

Sincerely,

Douglas R. Norton
Auditor General

Enclosure

2910 NORTH 44th STREET • SUITE 410 • PHOENIX, ARIZONA 85018 • (602) 553-0333 • FAX (602) 553-0051

SUMMARY

The Office of the Auditor General has conducted a performance audit and Sunset review of the Arizona State Land Department (ASLD) pursuant to a May 29, 1995, resolution of the Joint Legislative Audit Committee. The audit is part of the Sunset review set forth in Arizona Revised Statutes §§41-2951 through 41-2957.

The Arizona Legislature established the State Land Department in 1915 to ensure proper management and control of all state trust lands and the land's natural products. Arizona has approximately 9.4 million acres of trust land granted by the federal government to support schools and other public institutions. The Department sells or leases trust lands in order to generate revenues for the trust beneficiaries. Revenues derived from the sale of trust lands, as well as the sale of minerals and natural products on trust lands, are deposited in the Permanent Fund. As of June 30, 1996, the Permanent Fund balance was $767.6 million. The Permanent Fund principal is not expendable, but is invested in interest bearing securities by the State Treasurer. The interest earned on the Fund is available for the beneficiaries' use. In fiscal year 1996, beneficiaries received over $52.6 million in Permanent Fund interest earnings.

The Department generates additional expendable revenues for the beneficiaries. Revenues derived from trust land leases, permits, and interest on sales contracts administered by the Department are expendable. In fiscal year 1996, these activities produced over $18.3 million for the beneficiaries.

The Arizona State Land Department Can Do More To Maximize Urban Land Revenues

(See pages 10 through 23)

ASLD can improve the return it receives from selling or leasing urban trust land. The Department estimates that over 500,000 acres of trust land have urban development potential. These lands are potentially the trust's most valuable resource.

The Department has not maximized urban trust land revenues for several reasons. First, a limited number of sales and leases involve competition between bidders. Although competition between bidders is desirable because it generally results in higher prices, over the past four years most sales and leases had only one bidder. In addition, much of the urban property sold by the Department in fiscal years 1993 through 1995 has been in large parcels of land that has no infrastructure. In contrast, developers who purchase the land may receive substantially higher prices when they install infrastructure and resell the

improved land in smaller parcels to homebuilders and others. Also, the Department has sold land with commercial development potential, with little evidence of analysis concerning whether retaining and leasing the land would generate greater return. Leasing commercial property is desirable because leases can generate significant revenue while still leaving the land in the trust's possession.

The Department's passive approach to disposing of its urban lands has hampered its efforts to generate higher returns. Although the 1981 Urban Lands Act authorizes the Department to have a development plan prepared for urban lands to increase their value, due to resource constraints, the Department has had to over-rely on private developers to do planning. Further, although A.R.S. §37-335.06 authorizes the Department to enter into agreements to install infrastructure on undeveloped lands to increase their value, the Department has not installed infrastructure on any urban lands prior to selling or leasing them. Also, the Department has had few resources available to market its properties to potential buyers and lessees, and it has not used its authority to pay realtor fees, which could provide an incentive for real estate brokers to market state trust lands.

The Department has a number of opportunities to increase urban land revenues. First, the Department could increase its use of in-house and contract planners to prepare development plans and disposition strategies for urban properties. In addition, the Department could establish profit-sharing agreements with private developers who purchase land then resell it at higher prices after installing infrastructure. The Department could also install infrastructure on carefully selected properties and sell smaller parcels at a higher price, similar to the developer's current role. Finally, the Department could increase its marketing efforts to encourage more competition for available lands.

Expanding planning efforts and installing infrastructure would be costly and would require additional resources. The Legislature could either appropriate additional monies or pursue statutory, constitutional, or Enabling Act changes needed to grant the Department authority to use a portion of sales revenues for activities that enhance the land's value. Other states, such as Washington and Idaho, use a portion of their sales revenues for infrastructure improvements to increase land values.

Grazing and Agriculture Lease Programs Need Modifications To Maximize Revenues

(See pages 24 through 30)

The Department should modify its grazing and agriculture lease programs to maximize revenues. The Department could generate more revenues by limiting rent reductions to grazing leaseholders. Although statutes authorize the Department to grant rent reductions at the leaseholder's request, the Department has no criteria for determining when such reductions are warranted, and it has authorized rent reductions totaling over $285,000 for fiscal year 1997. In addition, the Department could generate an additional $120,000 or more annually by requiring a surcharge from leaseholders when they sublease trust land. Leaseholders may sublease land for a variety of reasons, including profit. By collecting a surcharge similar to the federal Bureau of Land Management, the Department could capture a portion of sublease revenues for the trust beneficiaries.

The Department could better ensure that leaseholders pay fair compensation for the use of trust lands by regularly evaluating lease rates. Although the Department implemented a new grazing lease rate in 1996, the rate is unreliable due to the methods used when developing it. Arizona's lease rate is one of the lowest in the western states. Also, credits given to leaseholders based on the Department's agriculture lease rate formula were developed 16 years ago, and should be updated to reflect current practices and market conditions.

The Department could also potentially increase revenue by encouraging more competitive bidding for available leases. On average, about 350 grazing and agriculture leases become available each year; however, the Department seldom receives more than 1 application for an available lease. The Department could increase competition by notifying the public of all available leases. In addition, the Department should study the costs and benefits that would result from requesting constitutional and statutory amendments to eliminate leaseholder preference rights. Several other states eliminated preference rights in an effort to generate additional competition.

Changes Needed to Permanent Fund Investment Strategy To Maximize Benefits

(See pages 32 through 39)

The State is presently unable to maximize Permanent Fund (Fund) benefits to both current and future generations of beneficiaries. Inflation has eroded the value of monies placed in the Fund. While the Fund has grown to over $767 million, after adjusting for inflation since 1984, its real value is only $515 million, a difference of over $252 million. Although beneficiaries currently receive most Fund earnings, by reinvesting a portion of the annual earnings sufficient to offset inflation, the Permanent Fund could maintain its real value, and furnish higher payments to beneficiaries in the long run.

The Permanent Fund could eventually earn more, and provide greater payments to beneficiaries, if voters authorized the State to invest a portion of it in stocks, and revised the State's current payout policy to allow beneficiaries to receive stock earnings. The Arizona Constitution limits Permanent Fund investments to interest bearing securities, such as government and corporate bonds. Historically, money invested in these assets has earned much less than money invested in stocks. For example, according to a financial research firm, from 1925 to 1995, after adjusting for inflation, a dollar invested in large company stocks would have grown to $130, while a dollar invested in bonds would have grown to no more than $6.

In addition, current laws allow beneficiaries to receive only interest generated by bond investments. If voters authorize stock investment, the State would need to revise its payout policy to allow beneficiaries to also receive stock earnings. Similar to other invested monies, the State could adopt a payout strategy based on the Fund's total market value, rather than interest earnings only.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit and Sunset review of the Arizona State Land Department, pursuant to a May 29, 1995, resolution of the Joint Legislative Audit Committee. This review is part of the Sunset review set forth in Arizona Revised Statutes §§41-2951 and 41-2957.

State Land Department's History and Mission

In 1915, the Legislature created the State Land Department to . . . administer all laws relating to lands owned by, belonging to, and under the control of the state. Arizona received land from the federal government during the statehood process that was to be held in trust for specified beneficiaries.[1] The Arizona Constitution and the Arizona Enabling Act contain detailed requirements concerning how these trust lands are to be administered. Additionally, in 1967 the U.S. Supreme Court ruled that Congress intended the lands granted to the State should provide the most substantial support possible to the beneficiaries. The Department's mission statement reflects this mandate: The Land Department's primary function is to administer Arizona's 9.4 million acres of valuable trust land in order to produce the highest revenue yield for its beneficiaries. To accomplish this mission, the Department performs several main activities, including selling trust lands and minerals and natural products on trust lands to generate revenue for beneficiaries; leasing and assessing fees for public use of trust land to ensure that beneficiaries are reimbursed for its use; and regulating public use of trust lands to ensure the land is protected.

Trust Land Overview

The Department classifies its 9.4 million acres of trust lands into several general categories. Major land uses include urban, commercial, mineral, agriculture, and livestock grazing. Lands used for urban, commercial, or mineral purposes have high revenue-generating potential. Lands that cannot be used for urban, commercial, mineral, agricultural, or other purposes are classified as grazing land. Most of Arizona's trust lands, about 8.5 million acres, are classified as grazing land. Figure 1 (see page 3), illustrates the location and current classification of trust land acres in Arizona.

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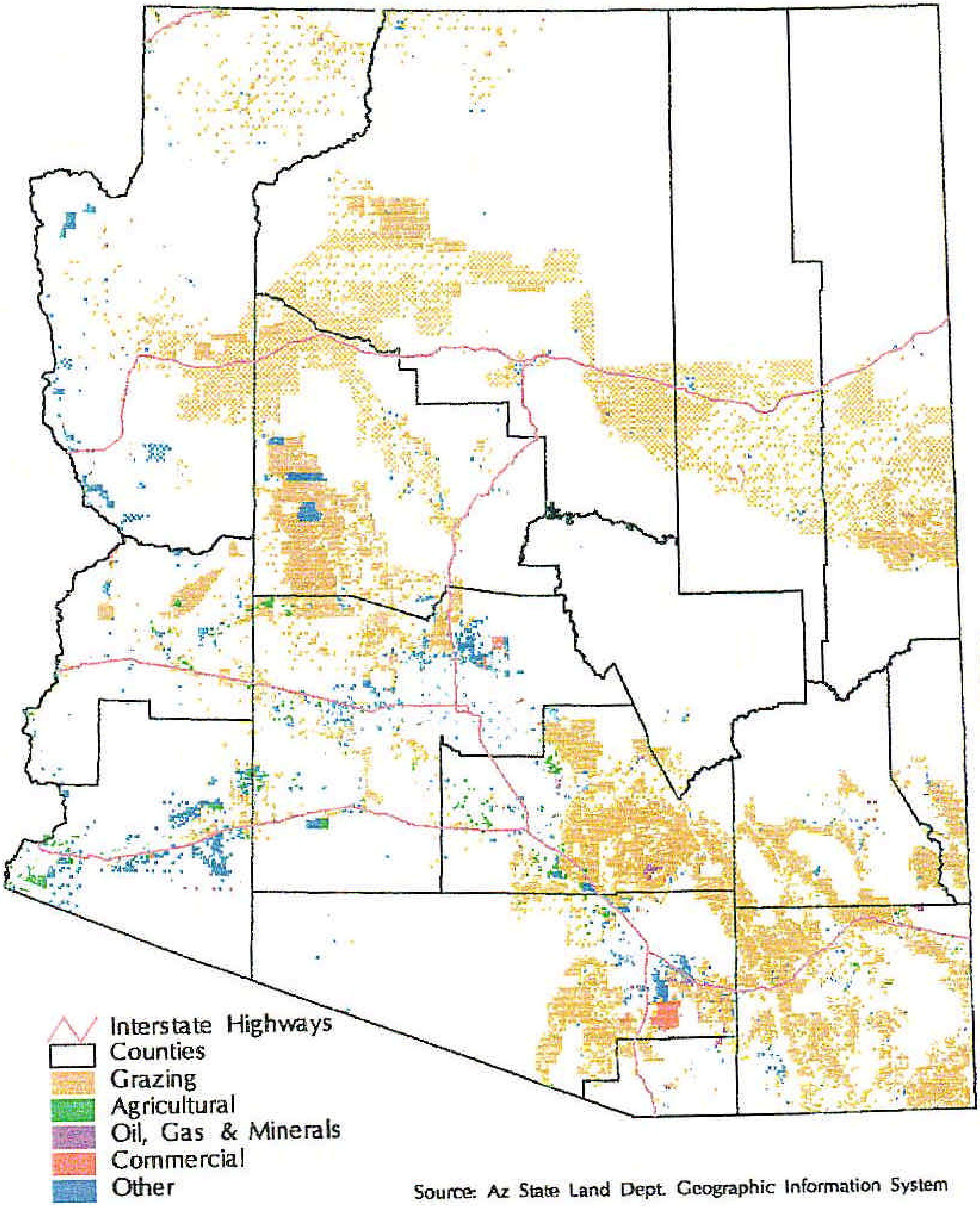
1 Public schools are the primary trust beneficiary. Other public institutions, such as the School for the Deaf and Blind, the Pioneer's Home, the Department of Corrections, and the Department of Juvenile Corrections, also receive monies from trust lands.

Figure 1

Arizona State Land Department
State Trust Land Uses



Source: Az State Land Dept. Geographic Information System

Trust Land Revenues

Revenues earned from trust lands are classified as either permanent or expendable. Revenues derived from the sale of trust lands, as well as sales of minerals and natural products on trust lands, are permanent revenues. The State Treasurer deposits permanent revenues into the Permanent Fund and invests them in interest bearing securities. In fiscal year 1996, the Department added $71.1 million from trust land and mineral sales to the Permanent Fund, and at the end of fiscal year 1996, this Fund totaled over $767.6 million.

Expendable revenues include Permanent Fund interest earnings, trust land lease and permit revenues, and interest on sales contracts the Department administers. The expendable revenues are distributed to trust beneficiaries, and in fiscal year 1996, the beneficiaries received almost $71 million in expendable revenues. The Permanent Fund earned over $52.6 million in interest in fiscal year 1996. Additionally, trust land leases, permits, and interest earnings from sales contracts generated over $18.3 million in fiscal year 1996. Table 1 shows distributions of expendable revenues to the public schools and other trust beneficiaries in fiscal year 1996.

Table 1

**Arizona State Land Department
Distributions of Trust Land
Expendable Revenues
Year Ended June 30, 1996
(Unaudited)**

Beneficiary	Permanent Fund Interest Earnings	Leases, Permits, and Interest Earnings from Sales Contracts	Total Distributions
Public schools	$48,599,884	$14,937,438	$63,537,322
Other beneficiaries	4,014,805	3,424,407	7,439,212
Total	$52,614,689	$18,361,845	$70,976,534

Source: Arizona State Land Department Annual Report for the year ended June 30, 1996.

State Land Department Organization and Budget

The Department operates under the direction of the State Land Commissioner, whom the Governor appoints for an indefinite term and exercises all powers vested in the

Department. Currently, the Department has 187 authorized full-time equivalent positions (FTEs) and is organized into six major divisions overseen by the Commissioner's Office.

- **Commissioner's Office (9 FTEs)** Includes the Commissioner, Commissioner support staff, the Department's legislative liaison, Arizona Preserve Initiative staff, and one Board of Appeals support position.

- **Planning and Disposition Division (32 FTEs)** Manages land use planning and zoning of trust lands in and around urban areas prior to leasing or selling; and administers all trust land sales, commercial leases, and rights-of-way for roads and utilities.

- **Operations Division (29 FTEs)** Maintains all titles and records on state trust lands; coordinates leases, permits, and contracts associated with surface use of trust land and its resources; responds to appeals and litigation involving the Department; performs or contracts appraisals of trust lands; and administers public records, information services, and land survey services.

- **Natural Resource Division (37 FTEs)** Administers grazing, agriculture, mineral, mineral material, exploration, and beekeeping leases; administers the Natural Resource Conservation District Program; manages water sales and mineral material sales; provides drainage and infrastructure studies and water rights management; and administers trespass, environmental contamination, and cultural resource programs.

- **Forestry Management Division (10 FTEs)** Oversees management and sale of natural products; provides technical urban forestry assistance and grants to cities and towns; and dispenses technical forest health, forest management, and tree planting assistance to private landowners.

- **Fire Management Division (26 FTEs)** Trains, equips, and enters into cooperative agreements with state and local firefighting agencies in order to prevent and suppress wildfires on 22.4 million acres of state and private land in unincorporated areas.[1] Also, this division develops operating agreements with federal agencies that fight wildland fires.

- **Administration and Resource Analysis Division (44 FTEs)** Administers budget development and implementation, personnel, fiscal monitoring and reporting, accounting, purchasing, and risk and space management; manages the Department's computerized business and administrative systems; and administers the Arizona Land Resource Information System (ALRIS), which provides coordinated data development, training, and technology assistance to public agencies in Arizona.

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1 A.R.S. §37-623 assigns the State Land Commissioner responsibility for preventing and suppressing wildfires on state and private lands located outside incorporated municipalities.

In addition, a Governor-appointed, five-member Board of Appeals must approve all sales and commercial leases of state trust lands. The Board also serves as an administrative review board to hear any appeals of decisions the State Land Commissioner makes regarding appraisals and land classifications.

The Department receives both appropriated and nonappropriated monies. General Fund appropriations account for over 85 percent of the Department's monies in fiscal year 1997. Additionally, the Department receives nonappropriated monies from a variety of sources, including federal grants, advertising and zoning cost reimbursements, and revenues generated from Geographic Information Systems products and services. Table 2 (see page 7), summarizes the Department's actual and budgeted expenditures for fiscal years 1995 through 1997.

Audit Scope and Methodology

Audit work focused on evaluating the State Land Department's performance in managing state trust lands and explored methods to maximize revenue yields for the trust beneficiaries. This report presents findings and recommendations in three areas:

- The need to modify the Department's urban lands program to better maximize the return received from these lands.
- The need to modify the Department's grazing and agriculture lease programs to maximize revenues for trust beneficiaries.
- The need to change the Permanent Fund's investment strategy to increase benefits to the trust beneficiaries.

Table 2

Arizona State Land Department
Statement of Expenditures
Years Ended or Ending June 30, 1995 through 1997
(Unaudited)

	1995 (Actual)	1996 (Actual)	1997 (Budgeted)
Personal services	$ 5,162,076	$ 5,563,939	$ 5,616,800
Employee related	1,131,464	1,247,228	1,263,100
Professional and outside services	1,030,209	772,761	492,900
Travel, in-state	200,311	202,034	256,000
Travel, out-of-state	28,610	26,082	18,400
Equipment	216,686	146,151	276,700
Other operating	12,186,543	11,584,331	7,363,100
Total expenditures	$19,955,899	$19,542,526	$15,287,000 [a]

[a] Actual expenditures may be higher because the Department may receive supplemental emergency fire monies in fiscal year 1997. Supplemental monies received in fiscal years 1995 and 1996 are included in expenditures for those years.

Source: Uniform Statewide Accounting System *Revenues and Expenditures by Fund, Program, Organization, and Object* reports for the years ended June 30, 1995 and 1996; the *State of Arizona Appropriations Report* for the year ending June 30, 1997; and *State of Arizona Proposed Budget FY 1996 and FY 1997 Non-Appropriated Funds.*

A variety of methods were used to develop the findings and recommendations in this report.

- Analysis of the Department's planning and disposition efforts for urban and other trust lands included a review of recent land sales and commercial lease case files; a telephone survey and focus group of Arizona land developers, homebuilders, and attorneys; a review of the Commissioner's orders for ten planned urban projects; and interviews of Department staff, ten other states' land department officials, and a national expert on trust land management, Dr. Jon Souder, assistant professor of forest policy and economics at Northern Arizona University and coauthor of *State Trust Lands: History, Management, and Sustainable Use*.

- Evaluation of the Department's grazing and agriculture lease programs included a review of relevant statutes and rules; analysis of current data from the Department's business system; interviews of Department staff, ten other states' land department officials, the Bureau of Land Management, and a national trust land management expert; and review of statistical models and methods used to develop the 1996 grazing lease rental rate.

- Evaluation of the Permanent Fund's investment strategy included analysis of financial data provided by the State Treasurer's Office; a review of the Uniform Management of Institutional Funds Act and information from the National Association of College and University Business Officers (NACUBO); interviews with officials at the State Treasurer's Office and State Land Department; and interviews with officials at the Joint Legislative Budget Committee, the Governor's Office, the Arizona State Retirement System, two trust beneficiaries, and other states with Permanent Funds.

This audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the State Land Commissioner, State Land Department staff, and the State Treasurer's Office for their cooperation and assistance during the audit.

FINDING I

THE ARIZONA STATE LAND DEPARTMENT CAN DO MORE TO MAXIMIZE URBAN LAND REVENUES

The Arizona State Land Department can improve the return it receives from selling or leasing urban trust lands. Urban lands are potentially the trust's most valuable resource. However, the Department does not always appear to maximize the value of these assets. The Department has generated limited competition for trust properties that have been sold or leased, sold large parcels with no infrastructure in place for vacant land prices, and sold lands that could be leased for commercial purposes. The Department's reliance on private developers to plan urban properties, insufficient marketing, and other problems contribute to low sales and lease returns. Adopting a more proactive approach to planning and disposing of urban trust lands could help the Department generate higher revenue for schools and other trust beneficiaries.

Urban Lands Provide Greatest Potential To Maximize Trust Revenues

Trust lands near urban areas are potentially the trust's greatest asset. The Department estimates that over 500,000 of its 9.4 million acres have urban development potential for residential or commercial use. As shown in Figures 2 and 3 (see pages 12 and 13), much of this land is near the Phoenix and Tucson metropolitan areas. For example, the City of Phoenix estimates that 70 percent of the lands within the City's boundaries north of the Central Arizona Project canal are part of the trust. Urban trust lands are a valuable asset because they offer the greatest revenue-generating potential. To illustrate, a January 1996 sale of 287 acres of land in north Phoenix to the Mayo Foundation brought $14.5 million in revenue. By comparison, fiscal year 1996 earnings from the trust's 8.5 million acres of grazing land totaled $2.6 million.

Review of Sales and Leases Indicates Maximum Returns Are Not Generated

The Department does not always generate maximum returns when trust lands are sold or commercial leases issued. Three factors contribute to less-than-maximum returns: 1) most sales receive only one bid at public auction, 2) most of the land sold is in large parcels, and 3) the Department has sold rather than leased commercial land.

Competition between bidders limited but generated increased revenue—The lack of competition at sale and commercial lease auctions negatively impacts the return generated from trust assets. Over the past four years, most sales and long-term commercial leases of trust lands had only one bidder. To encourage competition, the Arizona Enabling Act and Arizona's Constitution require the Department to hold public auctions whenever trust lands are sold or long-term leases issued. However, as shown in Table 3, the Department generally does not receive multiple bids when properties are sold. In fiscal years 1993 through 1996, the Department received only one bid for 75 percent of all properties sold, and these properties were sold for the minimum bid amount. By comparison, sales with competing bids earned nearly $11 million more than the combined appraised value of $47 million an increase of 30 percent. Similarly, the Department received little competition for properties auctioned for long-term commercial lease. In fiscal years 1993 through 1996, only 1 of 10 long-term commercial lease auctions had more than one bid. While it is unrealistic to expect competition at every auction because of the location and usefulness of some property, as well as requirements that the successful bidder reimburse the Department for administrative and other costs, even a small increase in competition could generate significant additional revenue.

Table 3

Arizona State Land Department
Trust Land Sales
Years Ended June 30, 1993 through 1996

		Sale without Competing Bids		Sales with Competing Bids			
Year	Number of Sales	Percent-age	Price [1]	Percent-age	Price	Appraisal	Differ-ence [2]
1993	53	77%	$33,495,501	23%	$16,400,800	$13,007,000	$ 3,393,800
1994	30	77	18,918,396	23	9,292,000	7,661,900	1,630,100
1995	40	85	16,836,845	15	6,241,750	4,811,350	1,430,400
1996	44	64	18,834,600	36	14,974,040	10,474,040	4,500,000
Total	167		$88,085,342		$46,908,590	$35,954,290	$10,954,300

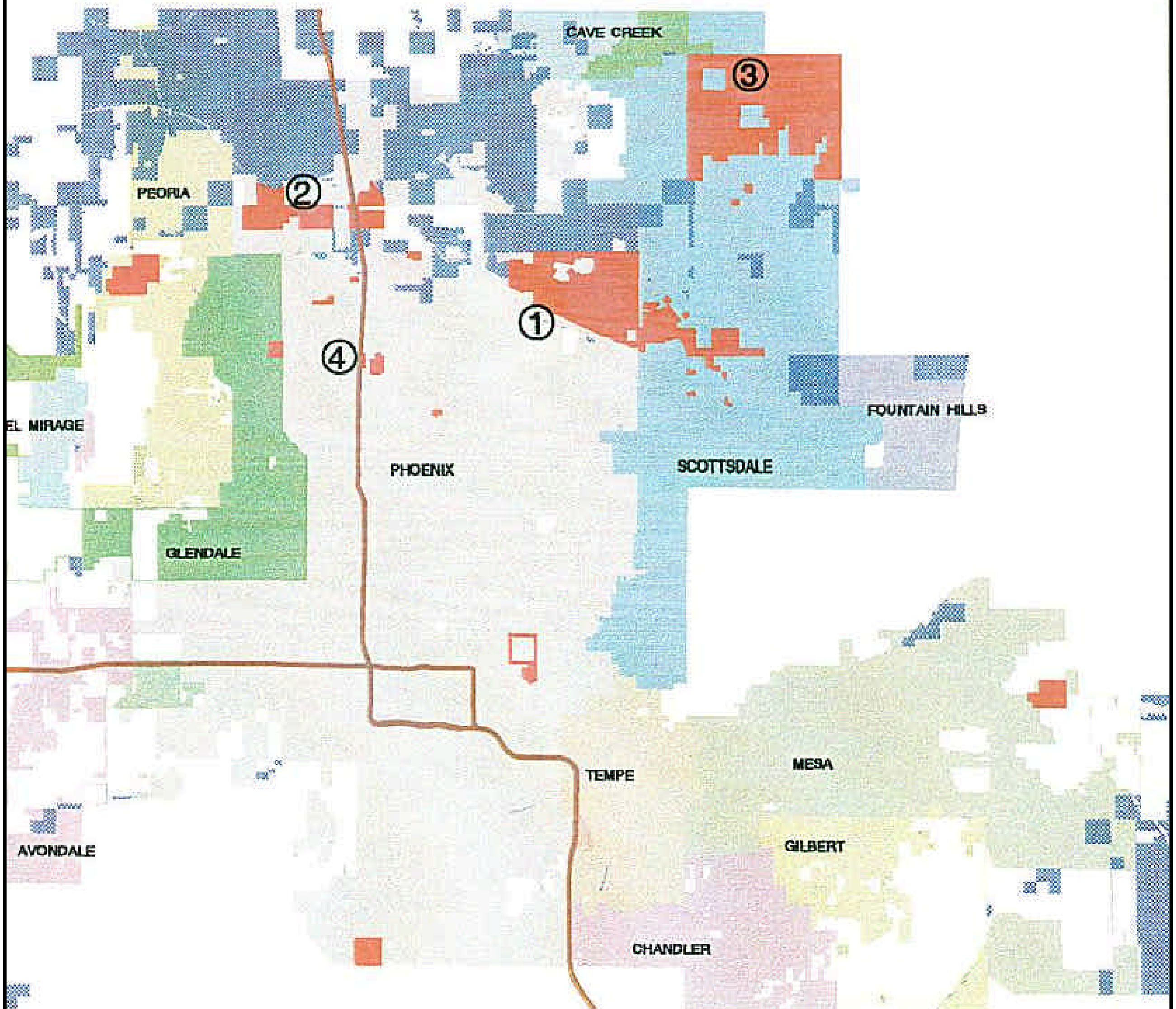
1 Same as appraised value.

2 Excess of sales price over the appraised value.

Source: Auditor General staff analysis of land auction reports, for years ended June 30, 1993 through 1996.

Figure 2

Arizona State Land Department
Phoenix Metro Area Trust Lands



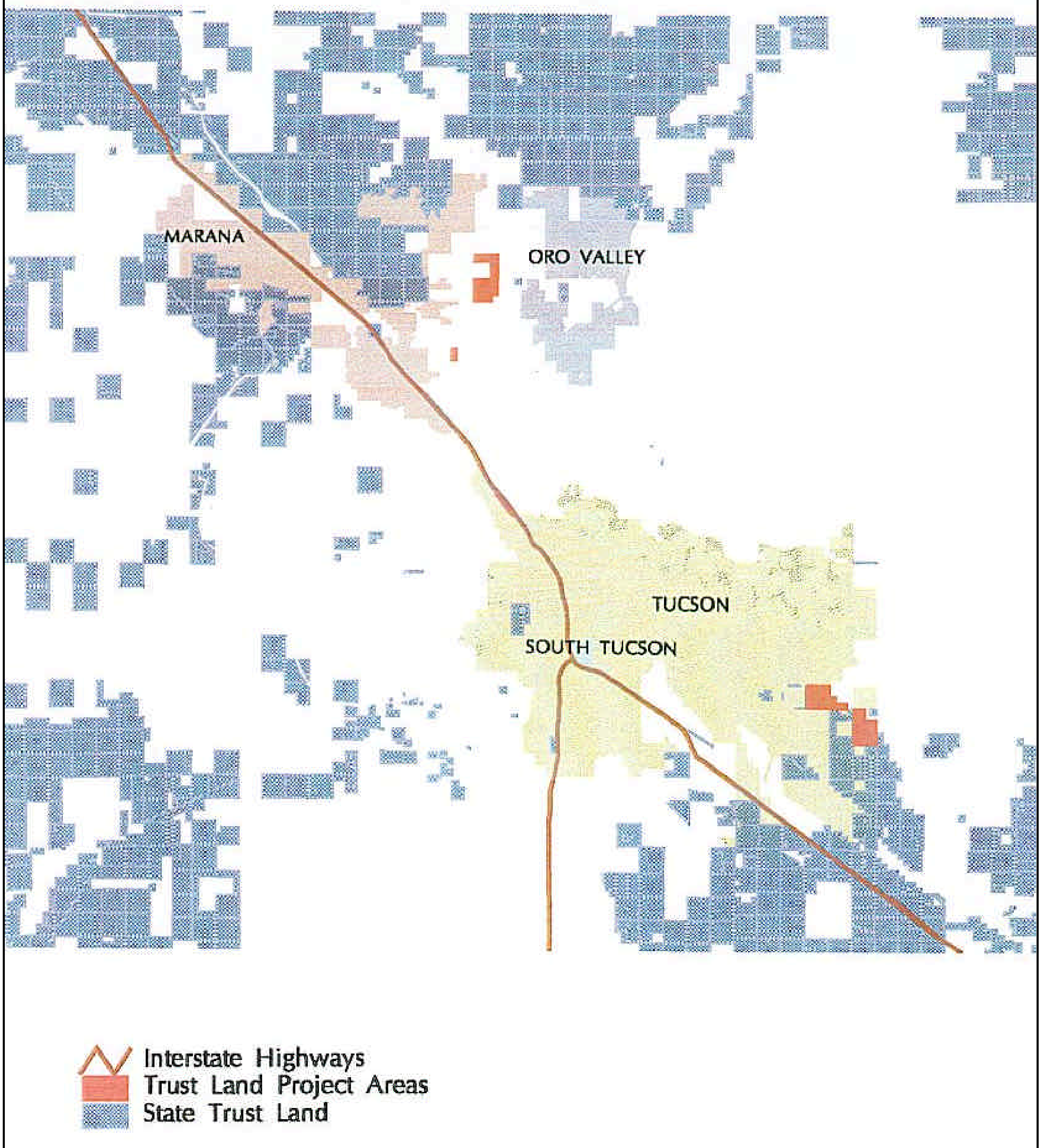
Interstate Highways
Trust Land Project Areas
State Trust Land

1. Desert Ridge
   Paradise Ridge
   Core North
2. Stetson Hills
3. Sonoron Village
4. Northgate

Source: AZ State Land Dept. Geographic Information System

Figure 3

Arizona State Land Department
Tucson Area Trust Lands



Source: Arizona State Land Department Geographic Information System

Parcel size impacts return—Sale of large undeveloped parcels of land restricts competition and reduces the amount the Department receives for trust lands. The Department currently sells vacant, unimproved land to developers.[1]

The large size of some properties the Department sells limits competition for the properties, which in turn may limit the return generated from trust lands. Urban land parcels the Department sells can be very large, often hundreds of acres. In fiscal years 1993 through 1995, 3 of 40 planned urban land sales accounted for 71 percent of the 3,698 acres sold. The Department's Manager of Planning and Asset Management indicates that a property's size can significantly limit its value. In addition, according to developers surveyed, the size of the property sold or leased limits the number of bids the Department receives.

The lack of existing infrastructure also affects the amount the Department receives when trust lands are sold or leased. Those seeking to acquire urban properties from the Department must have the resources to pay for infrastructure installation. The Department's economist recently estimated that the developer's costs to install core infrastructure for one large urban project will average $30,000 per acre. The high cost of installing infrastructure limits the number of parties that can afford to compete for trust land properties. In addition, since developers must bear these infrastructure costs, they are willing to pay less to acquire the land.

After buying large unimproved land parcels from the Department, developers may receive substantially higher prices when they resell the improved land in smaller parcels to homebuilders and others. Two of the largest urban land sales illustrate this point.

- In 1993, the Department sold 780 acres in northeast Phoenix for $12,000 per acre. The Department sold this large block of land for unimproved land prices because 1) the property was in the middle of the 5,700-acre Desert Ridge project and the developer had to extend utility lines to the site, and 2) the developer had to install core infrastructure on the property prior to development. After installing infrastructure and other improvements, the developer has sold land for estimated prices ranging from $97,000 to $120,000 per acre.

- In 1993, the Department sold more than 1,600 acres in north Scottsdale for about $14,000 per acre plus a small percentage of the return the developer receives when selected parcels are resold.[2] The Department reports that the property, which was in the

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1 Land is considered unimproved when it lacks basic infrastructure such as sewer and water lines and storm drainage.

2 The Department negotiated a participation contract with the developer who purchased the Core North property. Under this agreement, the Department receives $1,000 per acre or 2.5 percent of the developer's gross proceeds, whichever is greater, when selected land is sold for residential

2,250-acre Core North planning area, had significant drainage problems and lacked basic infrastructure improvements and, as a result, needed to be sold for unimproved land prices to encourage development. After installing infrastructure, the developer has sold the land for estimated prices ranging from approximately $115,000 to $266,000 per acre.[1]

Decisions to sell commercial land rather than to lease it—Sale of land with commercial development potential also may prevent the Department from maximizing the return received from trust assets. The Department's informal policy is to sell residential land but lease commercial land. Leasing commercial property rather than selling it is desirable because leases can generate significant revenue while still leaving the land in the trust's possession. However, the Department's decisions concerning whether commercial lands should be sold or leased appear to be based primarily on the developer's wishes. For example, staff recommended approving a developer's application to purchase the Northgate property at Interstate 17 and Bell Road in Phoenix even though the development plan called for commercial and industrial development of the property.[2] A review of the Department's disposition process showed little evidence of analysis as to whether nonresidential property should be leased rather than sold.

Department's Passive Approach Contributes To Its Inability to Maximize Revenues

The Department's passive approach to disposing of its urban trust lands contributes to it receiving lower prices for lands. In part, this is a result of a lack of resources to perform planning, install infrastructure, and market properties aggressively. As a result, the Department has relied heavily on developers to plan urban lands.

Reliance on developers for planning needed for sale or lease—The Department's over-reliance on private developers to prepare development plans for urban properties has negatively impacted its efforts to generate maximum returns for beneficiaries.

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development; and $2,500 per acre or 5 percent of the developer's gross proceeds, whichever is greater, when selected commercial property is sold.

1 These estimates are based on Auditor General staff analysis of developer sales and option agreement documents for parcels subject to the participation contract.

2 The application was later withdrawn at the Department's request because it conflicted with another application to purchase the property.

The 1981 Urban Lands Act (Act) establishes a process for planning urban lands. Planning is done to increase the value of the property and prepare it for disposition. The Act contains criteria for determining when trust lands are suitable for urban planning. Once lands are designated as suitable for planning, the Act authorizes the Department to have a development plan prepared for the property.[1] The Department can contract out for these planning services or issue a planning permit to a private developer.

Due to resource constraints, the Department has relied heavily on private developers to plan urban properties. The Department has had limited resources available to prepare development plans for its urban trust lands. The Department's Planning and Asset Management Section consists of a unit manager and three planners. In addition, the Department's annual budget for outside planning services was $89,400 in each of the four previous fiscal years. As a result, since passage of the Urban Lands Act, the Department has used in-house staff to develop land use plans for only two urban properties, covering just 1,400 acres. Contract planning services have been used for 15 projects, covering fewer than 8,000 acres. In contrast, the Department has issued permits to private developers to prepare development plans for more than 40,000 acres of urban trust lands, including most of the larger urban properties that have been planned.[2]

However, extensive reliance on developers for planning purposes has created several problems.

- **Planning done prematurely** In response to developer applications, the Department has designated lands as suitable for development planning and issued planning permits long before some properties were ready for development. For instance, although the Department expedited approval of the 2,230-acre Stetson Hills property in north Phoenix as suitable for a development plan because development of this particular property is imminent and delay may have a negative impact on the marketability, more than 10 years later, no disposition of the property has occurred. The Department has had to initiate efforts to update the plan, which is now seven years old.

- **Plans not fully reflecting the Department's needs** Although the Department must approve plans prepared by developers, some of these plans are tailored to the developer's specific interests and may not satisfy the Department's needs. For instance,

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1 A.R.S. §37-334(D) requires that development plans contain provisions for the allocation and location of specific uses of the land; acceptable densities and concentrations of designated land uses; the timing and rate of development; delivery of an adequate or assured water supply; public facilities and resources including water and wastewater systems, parks, roads and schools; resource conservation and the use of alternative sources of energy; and zoning.

2 Private developers prepared the land use plans for Desert Ridge, Paradise Ridge, Core North, and Stetson Hills. Each of these properties has a planning area greater than 2,000 acres. The Department also issued a planning permit for the 15,000-acre Sonoran Village property.

although developers spent nearly $2.6 million preparing the development plans for Desert Ridge and Paradise Ridge in north Phoenix, the Department found it necessary to conduct additional analysis of these properties' drainage and infrastructure characteristics in order to develop a strategy for selling or leasing these properties.

- **Perception that the developer with a planning permit (permittee) has the inside track to acquire property** Reliance on private developers to do much of the planning for urban properties has led to the perception that the permittee has an advantage in the subsequent auction, according to some developers and the Department. This perception exists because the permittee has a more intimate knowledge of the property than potential competitors and has developed a plan to meet the permittee's special needs.

***No self-development of infrastructure*—**In its current approach, the Department has not installed infrastructure on any of its properties prior to disposition. Legislation was passed in 1990 authorizing the Department to install infrastructure on undeveloped lands in the path of urban development prior to disposing of these assets. Specifically, A.R.S. §37-335.06 authorizes the Department to 1) enter into agreements with any public or private party to construct, operate, and maintain infrastructure on urban lands and 2) require reimbursement of infrastructure development costs from subsequent purchasers or lessees. The legislative intent in authorizing infrastructure development was to substantially increase the value of those lands and thereby increase the potential return to the state trust. However, to date the Department has not received funding for infrastructure installation and, as a result, has yet to complete any infrastructure development projects.

***Lack of marketing*—**The Department has had few resources available for marketing its properties to potential buyers and leaseholders. Its budget for marketing has been approximately $30,000 per year. This money has been used to prepare a brochure about the urban lands program, fliers concerning available urban properties, and some supplemental advertising. Its other marketing methods are limited primarily to newspaper advertising required by the Arizona Constitution. The Department currently does not begin advertising until ten weeks prior to scheduled auctions, even though a developer may have applied to acquire the property more than a year before advertising began.[1] This gives potential competitors little time to research the property and raise needed capital.

***Inability to motivate commercial real estate brokers*—**The Department lacks authority to pay real estate broker fees when properties are sold or leased. Legislation was passed in 1992 authorizing the Department to pay commissions to private realtors. The Department finalized rules concerning payment of broker commissions in March 1996 but A.R.S. §37-132(B)2, which granted this authority to the Department, expired on December 31, 1996.

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1 Article 10, Section 3 of the Arizona Constitution requires that trust lands be sold at public auction after advertising for not less than ten successive weeks.

More Proactive Approach Carries Potential for Improving Returns

The Department can improve the return it receives from urban lands by adopting a more proactive approach to managing and disposing of these assets. The Department should consider expanding its role in urban trust land planning, establish profit-sharing agreements with developers, install infrastructure, and increase marketing efforts.

Department attempting to become less reactive in its approach—The Department has recognized the problems associated with planning permits and has taken several steps to reduce its reliance on private developers.

- The Department has not issued any planning permits to private developers since 1993 and has recently initiated in-house planning for several of its urban properties.

- The Department recently completed infrastructure and drainage studies for two properties in north Phoenix and developed a strategy for disposing of these assets. The strategy establishes a sequence for disposing of parcels based in part on proximity to existing infrastructure. In addition, the plan specifies the size of parcels to be sold or leased. The disposition strategy proposes selling parcels with an average size of 254 acres, a size which is large enough to make it cost-effective to install infrastructure, while small enough to encourage competitive bidding.

- In an effort to generate greater competition and increase returns for trust lands, the Department also proposed changes to the Urban Lands Development statutes in 1996. These changes, which the Legislature adopted, eliminated commercial holding leases that gave the leaseholder a preferential right for future commercial leases and, as a result, discouraged competition. The changes also established a new planned disposition process designed to involve multiple developers early in the process. Under this process, the Department would send out a request for proposals to private developers soliciting concept plans for unplanned urban lands and then auctioning off the property with the plan.

- The Department established its first profit-sharing agreement in 1993 with the sale of the Core North property in north Scottsdale. The participation contract specifies that the Department is to receive a portion of the developer's return once properties are resold. Specifically, the agreement calls for the Department to receive $1,000 per acre or 2.5 percent of the developer's gross proceeds, whichever is greater, for selected residential property; and $2,500 per acre or 5 percent of the developer's gross proceeds, whichever is greater, for selected commercial property.

Expand Department role in urban trust land planning—The Department can improve the return generated from its urban trust lands by further expanding its role in planning. Specifically, the Department should increase its use of in-house and contract planners to prepare development plans for urban properties, develop disposition strategies for urban properties that are based on infrastructure availability and the land's drainage characteristics, and develop a statewide asset management plan to guide decision-making.

The Department can improve its urban lands program by making greater use of in-house staff and contract planning firms to prepare development plans for urban properties. Much of the Department's urban trust lands have yet to be planned. By using in-house staff and independent consultants to plan urban properties, the Department can address some of the problems that have resulted from issuing planning permits. First, increased use of in-house and contract planning can help eliminate the perception that a particular developer has an advantage in the disposition process. In addition, in-house and contract staff could prepare more generic plans that may be attractive to a larger number of developers.

Analysis of drainage and infrastructure issues could enable the Department to develop disposition strategies to better maximize the value of its urban properties. Infrastructure availability and drainage characteristics can significantly influence the value of property. The Department has traditionally lacked the resources to perform detailed research to address these issues. However, as previously mentioned, the Department recently developed its first detailed disposition plan for specific urban properties. The plan, which takes into account a property's drainage and infrastructure characteristics, appears to provide a well-thought-out approach to maximizing returns from these properties. A private developer who reviewed the plan indicated that it gives the Department a carefully considered blueprint for the development of its assets in the Northeast Valley. The Department should prepare disposition plans for other large urban properties as they become ready for development.

Beyond these actions, the Department could also improve its management and disposition of urban lands by preparing an overall asset management plan to establish development priorities and guide decision-making. Some other states contacted have developed such plans. For example, Washington has developed two plans related to asset management. The first, an asset stewardship plan for its trust resources, includes an economic assessment of trust assets by an independent consultant. Washington's second plan, a transition lands plan, guides management and disposition of urban lands. Similarly, Oregon has developed an overall asset management plan for its trust resources that includes 1) policies for managing broad classes of lands, 2) general methodologies and objectives for evaluating financial decisions, and 3) revenue enhancement strategies. Developers we contacted and trust lands expert Dr. Jon Souder also support asset management planning. The Department recognized the need for asset management planning in 1993, but has yet to develop such a plan. To date, efforts have focused primarily on 1) preparing an inventory of trust assets and 2) performing an assessment of current uses. The Department should make developing a statewide asset management plan a priority.

Establish profit-sharing agreements with developers—Another option that holds potential for increasing the return received from urban trust lands is profit sharing. Establishing profit-sharing agreements with developers would allow the Department to take advantage of the higher returns generated once core infrastructure has been installed.

Although to date the Department has entered into only one profit-sharing agreement for a land sale, recent legislation establishing the planned disposition process could result in greater reliance on profit sharing in future land sales. The planned disposition process is intended to encourage greater competition between developers by holding the land auction prior to preparation of a detailed development plan for a property. Since the Department may hold the auction before the land has reached its maximum value, to allow time for planning and zoning, the Department intends to enter into profit-sharing agreements with the successful bidder to ensure that the trust receives fair compensation.

The Department will need additional staff expertise to ensure that profit-sharing agreements are enforceable and generate maximum returns for beneficiaries. Developers participating in a focus group indicated that entering into profit-sharing agreements would pose risks for both the Department and the developer. The agreements would be based on projections of future land value and profits. In addition, the agreements would have to specify how profit is to be defined and contain mechanisms to allow the Department to determine the developer's profit. Two developers contacted indicated that the Department currently lacks staff with adequate expertise to develop and enforce agreements with developers. Specifically, the Department would need staff capable of projecting future costs and returns, as well as accounting staff to audit the developer. The Department requested an additional financial position in its fiscal year 1998 budget request, but it was denied. Dr. Souder suggested that the Department consider hiring a consultant to develop a model for participation agreements.

Install infrastructure prior to sale or lease of trust lands—Finally, the Department could improve the return it receives from its urban lands by installing core infrastructure on selected properties where analysis shows a potential for greater profits. Several states have undertaken projects to install core infrastructure to increase the return they receive when lands are sold. For instance, Montana has provided core infrastructure for a residential development project. Oregon has provided infrastructure for a variety of projects including golf courses, cabin sites, and industrial developments. Developers participating in a focus group to examine how the Department could improve the return received from urban trust lands suggested that the Department install core infrastructure and sell smaller parcels to end users. Dr. Souder also recommends infrastructure installation as a strategy for obtaining greater return for trust lands. Although infrastructure installation would require a significant investment and would expose the Department to greater risk, as shown in the case examples on page 14, this approach could lead to substantially greater returns for trust beneficiaries.[1]

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1 Taking a more active role in developing trust properties would expose the Department to some of the same

Increase marketing efforts—The Department could encourage more competition for available properties by advertising earlier in the disposition process, using the services of private real estate brokers, and studying the factors that influence the level of competition at auction. Utah's Trust Land Administration maintains a mailing list of private firms interested in buying or leasing trust lands. When the agency receives an application to buy or lease lands, those on the mailing list are notified. Utah's Trust Land Administration also advertises for three weeks after an application to purchase property is received to solicit competing applications. Marketing efforts could also be enhanced by using private real estate brokers. The Legislature should consider reestablishing provisions contained in A.R.S. §37-132(B) that authorized the Department to pay commissions to private real estate brokers from the administrative fee assessed to those who purchase, or obtain long-term commercial leases to, trust lands. Finally, analysis of factors impacting participation at sale and lease auctions could enable the Department to identify ways to obtain greater competition for trust lands.

Options Are Available to Provide the Additional Resources for a More Proactive Approach

The Department will need additional resources if it is to expand its planning efforts and install infrastructure for urban properties. The planning and infrastructure activities described above will be costly. Private developers have spent an average of $323,000 per parcel to prepare development plans for the Department's urban properties. A single drainage study for a large urban property can cost between $50,000 and $150,000. However, these studies are critical to developing disposition strategies for the Department's urban properties. Infrastructure development is also expensive. For example, the Department's economist estimates that installing core infrastructure for one large project in north Phoenix will cost an average of $30,000 per acre. On the basis of this estimate, installing infrastructure for a 100-acre parcel would cost $3 million.

In order for the Department to develop state property, the Legislature will need to grant the Department such authority and provide the funding, either through general appropriation or a portion of sales revenues. In 11 other western states, the trust land management agencies receive at least a portion of their funding from sale and lease revenues. Both Washington and Idaho use these monies for infrastructure improvements to increase the value they receive when lands are sold or leased. In addition, the New Mexico State Land Office obtains 100 percent of its funding from lease revenues. In Arizona, these revenues go directly to the Permanent Fund or are distributed to other

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risks that private developers must face. For instance, the Department (State) would incur infrastructure installation and project administration costs, and the accompanying risk that the project could be unsuccessful. However, in contrast to private developers, the Department would not incur the costs of acquiring land, borrowing money, and paying property taxes prior to final disposition.

beneficiaries as expendable revenue. In order to use a portion of sales or lease revenues to build the infrastructure and enhance the land value, the Enabling Act and the State Constitution will both have to be amended.

Proceeds from the sale of school trust lands could be used to cover the land sale expenses. The Arizona Enabling Act and the State Constitution make no mention of using the proceeds from the sale for the expenses associated with such sales. Such use is not prohibited, but would apply only to sales and would not apply to Permanent Fund administration or the Department's other management activities. The Legislature would have to authorize the Department to use a portion of sales proceeds to cover the costs of the sale. This statute could describe the types of costs that may be paid by the proceeds or the costs could be defined by the Department by rule. In either case, the costs could not include items not usually associated with a sale of property, such as infrastructure development, without further constitutional and Enabling Act amendments.

Recommendations

1. The Legislature should consider appropriating General Fund monies or adopting legislative changes, and proposing constitutional and Enabling Act changes that would allow the Department to retain a portion of trust land sale proceeds for value enhancement activities such as planning, developing disposition strategies, and installing core infrastructure.

2. The Legislature should consider reestablishing A.R.S. §37-132, which grants the Department authority to pay commissions to private real estate brokers who assist with the sale or long-term lease of state trust lands.

3. The Department should develop a statewide asset management plan to guide its trust land management and disposition decisions. Specifically, the plan should establish guidelines and priorities to direct future decision-making concerning the trust assets' use, improvement, sale, lease, planning, and potential value enhancements.

4. The Department should develop disposition strategies for large urban trust properties as they become ready for development.

5. The Department should examine the feasibility of installing core infrastructure on some urban trust properties to enhance the value of these assets.

6. The Department should expand its efforts to market available trust properties to potential bidders by:

    a. Establishing a mailing list of private firms interested in acquiring trust lands; and

    b. Advertising available properties earlier in the disposition process when applications to buy or lease trust lands are first received.

    c. Identifying the factors that influence the level of competition at auction.

FINDING II

GRAZING AND AGRICULTURE LEASE PROGRAMS NEED MODIFICATIONS TO MAXIMIZE REVENUES

While urban lands have the highest earning potential for trust beneficiaries, the Department could still increase revenues from trust lands classified for grazing and agriculture. The Department could increase revenues from grazing lands by prohibiting rent reductions to grazing land leaseholders except when needed to protect the trust land resource and assessing a surcharge when leaseholders sublease trust land. Additionally, by regularly evaluating lease rates, the Department could ensure that rates provide fair compensation to trust beneficiaries for the use of the trust lands. Finally, promoting competition for available leases could result in additional revenue for trust beneficiaries.

Limiting Grazing Lease Rent Reductions and Establishing Subleasing Surcharges Could Increase Revenue

Providing fewer rent reductions and collecting a portion of revenues generated by subleasing trust lands could result in additional revenue for public schools and other trust beneficiaries. The Department could realize additional revenue by prohibiting rent reductions except when needed to protect the trust land resources. Also, the Department could increase revenues by assessing a surcharge for subleases on trust lands.

Grazing leaseholder rent reductions limit revenues for trust beneficiaries—By reducing grazing lease rents, the Department limits revenues for public schools and other trust beneficiaries. Although A.R.S. §37-285 authorizes the Department to grant rent reductions at the leaseholder's request, the Department has no criteria for determining when such reductions are warranted. Instead, the Department grants all leaseholders' rent reduction requests. As a result, the Department receives less than the potential maximum rent for the trust lands. The Department has authorized rent reductions on 250 of 1,301 (19 percent) grazing leases for fiscal year 1997. These reductions total over $285,000.

Rather than allowing the leaseholder to determine rent reductions, other states reduce lease rents only in extreme situations, while some require leaseholders to pay the full rental value of the land at all times. Interviews with eight other states and the federal Bureau of

Land Management (BLM) revealed that all of the nine entities restrict rent reductions.[1] Five of the nine entities permit rent reductions only in extreme situations, such as drought conditions, and four entities never reduce rent.[2]

Like other western states with grazing lease programs and the BLM, the Department should limit rent reductions to increase revenues for trust beneficiaries. To do this, the Department needs to request statutory language to prohibit rent reduction except when the Land Commissioner determines it is necessary to protect the trust land resources.

Sublease and pasture agreement surcharges could generate additional revenue—The Department could generate $120,000 or more in additional annual revenue for public schools and other trust beneficiaries by establishing a surcharge for subleases and pasture agreements.[3] Leaseholders may sublease or enter into a pasture agreement for a variety of reasons, such as profit. Currently, 105 grazing leases have sublease or pasture agreement arrangements. A.R.S. §37-283 requires that all subleases and pasture agreements be approved by the Department. However, this statute does not require leaseholders to pay a surcharge or percentage of the revenues generated from sublease and pasture agreement arrangements.

Several other states capture a portion of revenues generated from subleases and pasture agreements for the trust beneficiaries. A recent Congressional fact-finding survey of 15 western states with grazing lease programs found that 12 states permit subleases. Six of those 12 assess a surcharge or collect a percentage of revenues generated from subleases and pasture agreements (California, Colorado, New Mexico, Oregon, Utah, and Wyoming). Three other states reserve the right to raise a leaseholder's rent if the sublease produces profits or prohibit the leaseholder from assessing fees higher than the state rental rate (Montana, Nebraska, and Oklahoma).

Additionally, in 1996 the BLM established a surcharge for pasture agreements on federal lands, which is 35 percent of the difference between the current year's BLM rental rate and the prior year's private lease rate for the appropriate state.

A surcharge for subleases and pasture agreements on state trust lands could generate additional revenue for public schools and other trust beneficiaries. Arizona cattle ranches can include a mixture of both state and BLM land. By establishing a state surcharge similar

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1 The eight other western states interviewed were Colorado, Idaho, Montana, New Mexico, Oregon, Texas, Utah, and Washington.

2 Four western states report they never reduce rent: Colorado, Montana, New Mexico, and Oregon.

3 A sublease is when a leaseholder gives control of their leased land to the sublessee, and the sublessee manages his/her own livestock on the leaseholder's land. A pasture agreement is when a trust land leaseholder brings another person's livestock onto the leased trust land, and the leaseholder has control over that person's livestock.

to the current BLM surcharge, the Department could generate an estimated $120,000 or more in additional revenue.

Regular Evaluation of Lease Rates Could Ensure Fair Market Value for Trust Beneficiaries

The Department should regularly evaluate methods and credits it uses to set lease rates to ensure fees generate fair market value for public schools and other trust beneficiaries. Although a new grazing lease rate was implemented in 1996, it is unreliable due to the methods used when developing it. Additionally, credits given in the Department's agriculture lease rate formula were developed 16 years ago and need updating to reflect current practices and market conditions.

Methodology resulted in an unreliable grazing lease rate—Methods used to establish the grazing lease rate produced a rate that is unreliable. Legislation passed in 1994 required the Governor to establish a grazing land valuation commission to develop and recommend a new grazing lease rate to the Department.[1] Using a regression model of private lease rates in Arizona, the Commission arrived at a lease rate estimate of $3 per animal unit month (AUM) for rangeland with fences and water facilities.[2] However, the Department does not provide its leaseholders with fences and water facilities; therefore, the Commission reduced the lease rate of $3 per AUM by 82 cents to arrive at its recommended Department lease rate of $2.18 per AUM.[3] In 1996, the Department accepted the Commission's recommendation and raised its grazing lease rate from $1.53 to $2.18 per AUM.

Methods the Commission used to develop the new grazing lease rate resulted in an unreliable rate. The regression model, used to determine the lease rate estimate of $3 per AUM, deviated from acceptable modeling practices by including only one of several critical factors that can influence lease rates. Because the model omitted several critical variables, the $3-per-AUM rate produced by the model is biased. Moreover, a review of

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1 A.R.S. §37-285 specified that the Commission be comprised of a professional appraiser certified in Arizona, a professor serving on the faculty at the University of Arizona College of Agriculture, a retired employee of a financial institution actively engaged in agricultural lending, an individual who primarily derives income from livestock grazing and holds no state trust land leases, and a Natural Resource Conservation District conservationist.

2 As defined in A.R.S. §37-101, an animal unit month (AUM) means one animal unit (AU) grazing for one month. An animal unit (AU) means one weaned beef animal over six months of age, or one horse, five goats, or five sheep.

3 The Commission studied fencing and water facility costs for a sample of Arizona ranches. It determined the average cost to be 82 cents per AUM.

methods used to establish the 82-cents per-AUM value for fencing and water facilities suggests that this amount may be too large of a reduction.

Additionally, a survey of western states' 1996 grazing land rental rates shows Arizona's rate ranks low, as displayed in Table 4 (see page 27). Western states with significant trust land acreage devoted to grazing or unique leasing practices, such as lease auctions, were included in the survey.

Table 4

Selected Western States Grazing Lease Rates per Animal Unit Month (AUM)[1]

State	Lease Rate per AUM [2]
Colorado	$6.50
Washington	6.20
Idaho	4.88
Montana	4.53
Texas	4.00
New Mexico	3.44
Oregon	3.18
Arizona	2.18
Utah	2.05

1 Arizona uses an average of seven trust land acres to graze one animal unit for one month (AUM). Other states that report using similar or more average acres (between 7 and 15 average acres) per AUM include Washington, Idaho, Texas, Oregon, and Utah. However, this ratio may not be an absolute indicator of comparable states because states may use different approaches in determining the number of acres required to support one animal unit.

2 Stated in 1996 dollars.

Source: Telephone survey conducted by the Office of the Auditor General staff.

Due to the concerns surrounding methods used to establish the 1996 grazing lease rate and Arizona's low rank among western states, the Department should reevaluate the grazing lease rate as soon as statutes permit. A.R.S. §37-285 states, Before September 1, 1994, and at such other times as the commissioner may propose, but not more frequently than every five years, the governor shall appoint a grazing land valuation commission. . . to determine the true value of the use of forage on state grazing land and recommend a grazing fee. . . . Therefore, the grazing lease rate should be reevaluated in 1999 to determine whether it is generating fair market value for trust beneficiaries.

Agricultural lease rates need to be updated—Rent credits included in the agriculture lease rate formula were developed 16 years ago and need to be updated. Currently, Arizona's average agriculture lease revenue per trust acre ranks low when compared to other states, as shown in Table 5.

Table 5

Selected Western States[1]
Total Agricultural Trust Acres and
Average Revenue per Trust Acre

State	Total Acres	Revenue per Acre [2]
Oregon	5,227	$20.14
Colorado	113,068	18.99
Idaho	13,735	15.17
Montana	600,000	13.51
Washington	232,292	12.60
Arizona	152,684	12.32
Utah	11,090	9.29
New Mexico	65,956	7.00

1 With the exception of Texas, which does not have significant agriculture trust land acreage, the western states in this survey are those shown in Table 4, page 27.

2 Stated in 1995 dollars.

Source: Telephone survey conducted by the Office of the Auditor General staff.

The Department's lease rate formula provides credits to leaseholders. The Department bases its agriculture lease rates on private lease rates. However, private lease rates often include various services and facilities that the Department does not provide such as land clearing, land leveling, and water facility installation. Therefore, the Department reduces its rates to fall between 50 and 70 percent below private rates. These reductions totaled over $2 million in fiscal year 1996.

The Department needs to reevaluate the credits it uses to reduce its lease rates. These credits are based on a consultant's 1980 recommendations. According to Department management, documentation of specific activities included in the credits cannot be found. As a result, the Department has been unable to modify or update the credits to reflect current practices and market conditions. In order to ensure that agriculture trust lands generate fair market value for trust beneficiaries, the Department should update its lease rate formula by identifying current practices that qualify for a credit and reassessing dollar values assigned to each qualifying activity.

Increasing Competition for Available Leases Could Result in Additional Revenue

Another way to potentially increase revenues for public schools and other trust beneficiaries is to implement procedures that encourage competition for available leases. Currently, the Department receives little competition for available leases. Several other states have implemented procedures that promote competition, and they report annual revenue gains of up to 15 percent above standard lease rents. Changes adopted by other states, if also adopted here, could encourage competition and potentially increase lease revenues for the trust beneficiaries.

Few competitive bids received**—**The Department seldom receives more than one application for grazing and agriculture leases. Over the past 3 years, an average of 285 grazing and 65 agriculture leases became available each year. However, on average, only 2 grazing and 2 agriculture leases received more than 1 applicant each year, or less than 1 percent and 3 percent, respectively.

Competition could generate additional revenue for trust beneficiaries**—**Increased competition for available leases could result in additional lease revenue for trust beneficiaries. Other states' land department officials and Dr. Souder advocate competition as a tool to produce maximum revenue from trust lands for the beneficiaries.[1] Additionally, other states with procedures that promote competition report generating up to 15 percent in additional annual lease revenue from competitive bids. For example, Idaho increased its fiscal year 1995 lease revenues by over 5 percent, or almost $81,000, due to competitive bids on its approximately 1.9 million acres of grazing and agriculture trust land. Also, Oklahoma significantly changed its lease program in 1982 to competitively bid leases and reports average yearly revenue gains from competitive bids of about 15 percent, which equaled about $200,000 in 1996, from its 800,000 acres of trust land.

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1 Seven of the eight other western states interviewed during this audit have competitive bidding procedures: Colorado, Idaho, Montana, New Mexico, Texas, Utah, and Washington. Also, trust land management expert, Dr. Souder, praised Nebraska's and Oklahoma's competitive bidding procedures; therefore, these states were contacted in addition to the originally surveyed states regarding the issue of competitive bidding.

Changes could increase competition—The Department could do more to encourage competition for available leases. The Department should begin notifying the public of all available leases in an effort to generate as much interest as possible. While statutes specify that leases over ten years must be advertised and auctioned, they allow the Department to issue leases of ten years or less, which include grazing and agriculture leases, without advertising. In contrast, seven of nine other states surveyed post available leases in local land offices and courthouses, or advertise leases in local newspapers.

In addition, the Department should study potential trust benefits that would result from constitutional and statutory amendments to increase competition for available leases. Currently, several laws assign specific groups of people a preferred right to receive or renew a trust land lease.[1] According to research conducted by Dr. Souder, . . . states with no preference right had the highest percentage of competitive bids. . . . [2] Four of nine states (Idaho, Nebraska, Oklahoma, and Texas) surveyed do not provide a preference right of renewal to existing leaseholders. The Department needs to analyze whether eliminating preference rights would provide additional revenue to the Trust.

Recommendations

1. The Legislature should consider amending A.R.S. §37-285 to prohibit rent reduction except when the Land Commission determines it is necessary to protect the trust land resources.

2. The Legislature should consider amending A.R.S. §37-283 to establish a surcharge for subleases and pasture agreements on grazing trust lands.

3. The Department should reevaluate the grazing lease rate in 1999 to determine whether the rate generates fair market value for trust beneficiaries.

4. The Department should update the 16-year-old credits it uses to reduce its agriculture lease rates to ensure rates generate fair market value for trust beneficiaries.

5. The Department should:

    a. Begin posting public notifications of all available leases; and

    b. Study whether trust revenues could be increased through eliminating leaseholders' preference rights.

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1 Arizona Constitution Article 10, A.R.S. §§37-284 and 37-291 provide preference rights. If two or more applicants apply to lease the same land, the Department must award the lease to the applicant who appears to have the best right to the lease. A preferred right is one factor the Department will consider when determining which applicant has the best right to the lease.

2 Between 11 percent and 20 percent of the available leases in these states received more than one application.

FINDING III

CHANGES NEEDED TO PERMANENT FUND INVESTMENT STRATEGY TO MAXIMIZE BENEFITS

The State presently is unable to maximize Permanent Fund benefits to both current and future generations of beneficiaries. Although added revenues have caused the Fund's balance to increase significantly, inflation has steadily eroded the Fund's real value. In addition, the State Constitution limits investments to interest bearing securities, thereby restricting the Fund's ability to earn higher returns. By investing a portion of the Permanent Fund in stocks, and adopting a payout strategy based on several national models, the State could potentially furnish higher levels of income to beneficiaries, and protect the Fund from inflation.

The Arizona Enabling Act, passed in 1910, requires the State to establish a Permanent Fund comprised of proceeds from the sale of trust lands and the land's mineral and other natural products. By fiscal year-end 1996, the Permanent Fund balance totaled over $767 million. Because revenues deposited into the Permanent Fund replace lands or resources that are sold or removed, they are not expendable for any purpose. Instead, the State Treasurer invests the Fund in interest bearing securities, and its ongoing interest earnings are available to help support the financial needs of both present and future generations of beneficiaries.

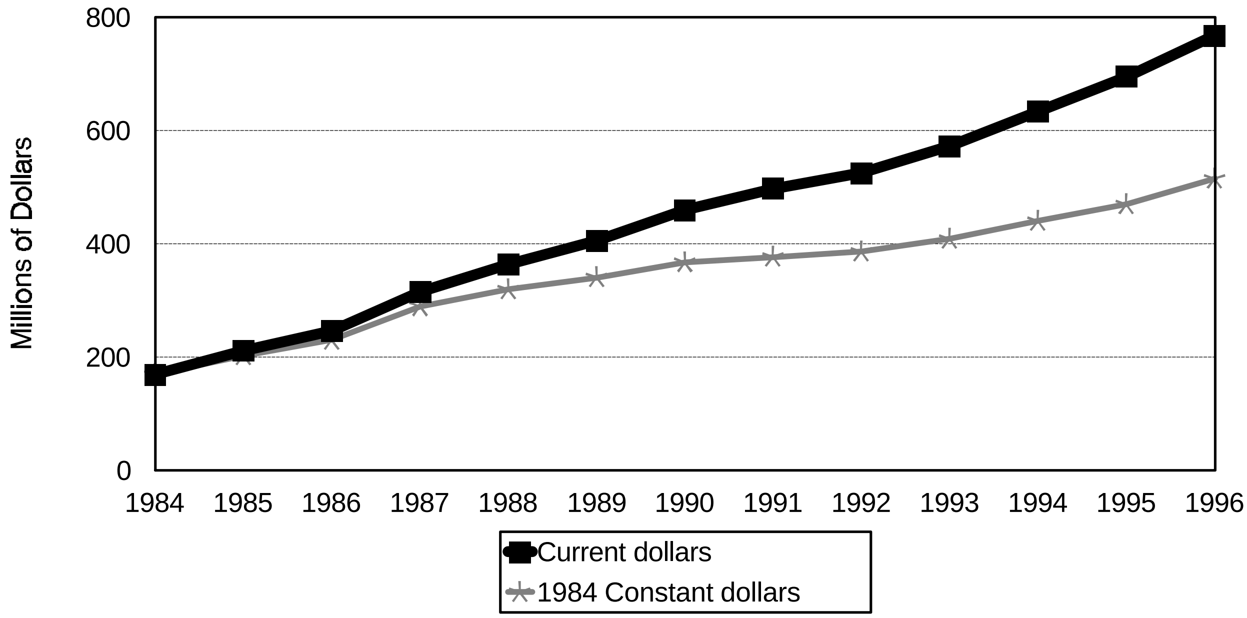
Inflation Eroding the Fund's Real Value

Although the Permanent Fund has grown substantially since fiscal year 1984, inflation has eroded the value of monies placed in the Fund. By reinvesting a portion of its earnings, the Permanent Fund could maintain its real value, and furnish higher income levels to beneficiaries over time. Other states have amended their constitutions to require reinvesting a portion of permanent fund earnings to offset inflation. While reinvesting some earnings appears possible under current Arizona law, the State should consider amending the Arizona Constitution to specifically authorize income reinvestment.

Inflation eroding value—Although the Permanent Fund has increased significantly since fiscal year 1984, inflation has eroded the Fund's real value. Since fiscal year 1984, the State Land Department has added over $551 million to the Permanent Fund, increasing the Fund balance from nearly $170 million to over $767 million. However, as shown in Figure 4 (see page 33), after adjusting for inflation, the Fund's real value is only $515 million, a difference of over $252 million.

Figure 4

Arizona State Land Department
Permanent Fund Balance
Years Ended June 30, 1984 through 1996
(Unaudited)



Source: Office of the Auditor General staff analysis of data provided by the Arizona State Treasurer's Office.

Reinvesting some earnings would produce long-term benefits—By reinvesting some investment earnings each year, the Fund could maintain its real value. Currently, the Treasurer distributes all interest the Permanent Fund earns to beneficiaries. However, by reinvesting an amount equal to the rate of inflation each year, the State could preserve the real value of the Permanent Fund, providing higher payments to beneficiaries over time. An analysis was done to assess the effects of investing $767,654,046 over a 50-year period using two methods for distributing earnings: 1) the current method of paying out all interest income, and 2) a recommended method of distributing the interest earnings after the inflation premium has been deducted and reinvested.[1]

[1] The analysis assumed the following: 1) The initial invested amount is $767,654,046, 2) the interest rate is 8 percent annually, 3) the inflation rate is 3 percent annually, and 4) there are no additional revenues added to the Fund from land, mineral, or natural resource sales.

The analysis found that maintaining the current method of distributing all investment earnings, if no additional proceeds from land, mineral, or natural resource sales were added to the Permanent Fund, would keep the Fund balance at $767,654,046 throughout the 50-year period. Because the balance would not grow, annual distributions of earnings to beneficiaries would also remain constant at $61,412,324. While the fund balance and distributions would remain constant in dollars unadjusted for inflation, their real value would decline in accordance with the rate of inflation. Over time, the distributions would provide less financial support to beneficiaries, including public schools, because the purchasing power of these monies would decrease.

In contrast, by reinvesting a portion of the earnings equal to the impact of inflation, the Fund balance would maintain its real value even if no additional proceeds from land, mineral, or natural resource sales were added to the Permanent Fund. As a result, the Fund would not be affected by inflation.

Beneficiaries will be affected in the short term—Although reinvesting an amount equal to the inflation rate would result in higher income distributions to beneficiaries over time, short-term distributions may be reduced. The reduction amount is difficult to determine because monies added to the Fund from the sale of land and natural resources vary from year to year. For example, since fiscal year 1984, deposited revenues ranged from approximately $18 million to approximately $71 million annually. New deposits directly affect distributions because they increase the invested balance, allowing the Fund to generate more interest.

Other states reinvest a portion of their interest earnings—Other states reinvest a portion of the income they earn from permanent fund investments, rather than distribute all of it to beneficiaries. For example, Utah mandates that the state treasurer determine the average annual inflation rate using the Consumer Price Index,[1] then reinvest the amount needed to offset inflation before paying out income to beneficiaries. In addition, Montana retains 5 percent of all interest for reinvestment each year, regardless of the year's inflation rate. Alaska also reinvests a portion of interest earnings sufficient to offset inflation each year.

Reinvestment may be possible under current law—Reinvesting some earnings does not appear to be prohibited under current law. Currently, Article 11, Section 8 of the Arizona Constitution states that investment income *shall be apportioned only for common and high school education in Arizona*. Reinvesting some interest would not violate this provision because it would still be apportioned only for common and high school education when it is retained in the Permanent Fund. However, to minimize the likelihood of a legal challenge, the State may want to consider a constitutional change to specifically authorize reinvesting some earnings. Both Utah and Montana amended their constitutions to allow

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1 The Consumer Price Index (CPI) is a measure of inflation.

them to reinvest a portion of their earnings. Also, a statutory provision would be needed to clarify the formula for determining how much should be reinvested.

State Could Potentially Earn Higher Returns and Provide More Support to Beneficiaries

The State could potentially generate more earnings by investing a portion of the Permanent Fund in stocks. However, the Arizona Constitution limits Permanent Fund investments to interest bearing securities, and additional laws would prevent beneficiaries from receiving any stock earnings. To allow the beneficiaries the opportunity to benefit from potentially higher returns, the State should consider legal changes to authorize stock investment and adopt a new payout method. If the Legislature decides to pursue these changes, a special study committee could be established to develop new constitutional provisions.

***State could potentially earn more by authorizing some stock investment*—**By investing a portion of the Permanent Fund in stocks, the State could take advantage of the opportunity to earn higher returns. Historically, money invested in stocks has earned more than money invested in bonds. For example, over the past 20 years, stocks in the Standard and Poor 500 Stock Index[1] earned on average 14.12 percent annually, while bonds in the Lehman Brothers Aggregate Bond Index[2] earned an average of 9.73 percent annually.

A comparison of dollar returns adjusted for inflation also illustrates the increased return stocks have generated over a 70-year period. According to Ibbotson Associates, a financial research firm, from 1925 to 1995, a dollar invested in large company stocks would have grown to $130 after adjusting for inflation. In contrast, a dollar invested in bonds would have grown to no more than $6 after adjusting for inflation.

Many other permanent funds, education endowments, and Arizona retirement systems invest a portion of their assets in stocks to take advantage of the opportunity to earn higher returns. For example:

> **Other states' permanent funds** Both New Mexico and Utah are authorized to invest up to 65 percent of their permanent funds in stocks. Texas, North Dakota, Nebraska, Oklahoma, and Alaska may also invest a portion of their permanent funds in stocks, in amounts ranging from 30 to 44 percent.

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1 The Standard and Poor 500 Index is a grouping of America's biggest corporations listed on the New York Stock Exchange.

2 The Lehman Brothers Aggregate Bond Index is made up of the Lehman Brothers Government/Corporate Bond Index, the Lehman Brothers Mortgage-Backed Securities Index, and the Lehman Brothers Asset-Backed Securities Index.

College and university endowments According to the National Association of College and University Business Officers (NACUBO), college and university endowment funds predominantly invest in both stocks and bonds. In fiscal year 1995, 463 endowment funds invested, on average, more than 50 percent of their assets in stocks.

Retirement funds The Arizona State Retirement System is authorized to invest up to 80 percent of its fund in stocks. In addition, the Public Safety Personnel Retirement System may invest up to 60 percent of its fund in stocks.

Legal provisions restrict investments and expendable earnings—Although stock investment would allow the Fund to earn potentially higher returns, the State Treasurer is restricted by Article 10, Section 7 of the Arizona Constitution to invest in *interest bearing securities*, such as government and corporate bonds. The constitutional provision reflects language contained in the Enabling Act that allowed Arizona and New Mexico to attain statehood. However, in 1957, at New Mexico's request, Congress repealed the investment restriction for both states, allowing them to invest in stocks. At that time, New Mexico voters amended the New Mexico Constitution to reflect the federal changes, and has been investing a portion of its permanent fund in stocks since 1958. Although the opportunity exists, Arizona has not taken, or attempted, similar action.

Additional legal provisions would prevent beneficiaries from receiving any stock earnings. Section 25 of the Arizona Enabling Act and Article 11, Section 8 of the Arizona Constitution allow Permanent Fund income to be distributed to beneficiaries. According to the Uniform Principal and Income Act, A.R.S. §14-7401, interest is recognized as income, but capital gains[1] and stock dividends[2] are recognized as principal that cannot be expended. These legal restrictions have not had a substantial impact on the revenue beneficiaries receive from the Permanent Fund because interest is the primary source of earnings produced by bond investments. However, if a portion of Permanent Fund monies were invested in stocks, the legal restrictions in A.R.S. §14-7401 would prevent beneficiaries from receiving investment earnings from capital gains and stock dividends.

Changes needed—Two constitutional changes are needed before the State can invest a portion of the Permanent Fund in stocks. First, the Arizona Constitution needs to be amended to authorize stock investment; and second, the Arizona Enabling Act and Constitution need to be revised to allow beneficiaries to receive stock earnings.

- **Authorize stock investment** Establishing a stock investment program would first require a constitutional change. Voters need to approve an amendment to remove the

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1 A capital gain is the profit investors receive when they sell an asset that has increased in price from the time they purchased it.

2 A dividend is a share of a company's profits paid to stock shareholders.

investment restriction in Article 10, Section 7 of the Arizona Constitution. Officials at the State Land Department, Treasurer's Office, Governor's Office of Management and Budget, and Joint Legislative Budget Committee staff agree that the restriction unnecessarily limits the Fund's ability to earn potentially higher returns.

- **Revise the payout strategy** If stock investment is authorized, the State would need to change the method used to distribute Permanent Fund earnings to beneficiaries. As mentioned above, beneficiaries currently receive all interest earnings generated from Permanent Fund investments, but do not receive any capital gains. To take advantage of capital gains and dividend earnings derived from stock investments, the State would need to adopt a payout strategy based on distributing a portion of the Permanent Fund's total market value. Typically, organizations using this payout strategy distribute between 4.5 and 5.5 percent of a fund's total market value annually. In addition, to moderate fluctuations in investment performance, these organizations may base distributions on a fund's average market value over a three- to five-year period.

The market value payout strategy is endorsed and adopted by several national organizations. Specifically:

The Ford Foundation In its 1967 report, *Managing Educational Endowments,* the Ford Foundation recommended that educational endowments adopt the market value payout method. The Foundation recommended distributing 5 percent of a fund's three-year average market value.

The National Conference of Commissioners on Uniform State Laws In 1972, the Commissioners approved the Uniform Management of Institutional Funds Act (UMIFA), and recommended that states adopt it. This model act establishes a legal basis for endowment funds to use the market value payout method. To date, 38 states have adopted UMIFA, but Arizona has not.

National Association of College and University Business Officers (NACUBO) In 1994, NACUBO offered the market value payout method as a model policy. According to a NACUBO director, the organization recommends distributing between 4.5 and 5.5 percent of either a fund's three- or five-year average market value. According to a NACUBO survey, 60 percent of college and university endowment funds use a market value payout strategy with the average payout rate being 4.7 percent.

In addition, New Mexico voters recently approved a constitutional amendment to allow the state to implement the market value payout method for its permanent fund. Voters authorized the state to annually distribute 4.7 percent of the fund's five-year average market value. Because New Mexico cannot implement the voter-approved strategy without

Congress' approval, the state is seeking to change language in the New Mexico Enabling Act to authorize the market value-based payouts.[1]

Similar to New Mexico, adopting the market value payout strategy in Arizona will require changes to the Enabling Act and Arizona Constitution. Specifically, Section 25 of the Enabling Act and Article 11, Section 8 of the Constitution need to be amended to authorize the State to implement a payout strategy based on the Fund's market value. Changes to these provisions would supersede the restrictions in the Uniform Principal and Income Act currently applicable to Permanent Fund distributions.

Establish special study committee—If the Legislature decides to pursue constitutional and State Enabling Act changes to authorize stock investment, a special study committee could be established to develop new constitutional provisions. The committee could determine the maximum percentage of Permanent Fund assets that can be invested in stocks. In addition, the committee could identify the type of stock investment that would be allowable. For instance, Utah's constitution limits stock investment to common and preferred stocks issued by corporations listed on a major securities exchange, restricts the percentage of assets that can be invested in a single company or industry, prohibits ownership of more than 5 percent of a corporation's voting securities, and requires that 75 percent of the corporations appear on the Standard and Poor's 500 Composite Stock Price Index. Finally, the committee could determine the percentage of the Fund's total market value that beneficiaries would receive each year, and whether that percentage should be based on an average of the Fund's value across several years.

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1 According to an official at the New Mexico State Investment Council, the New Mexico Attorney General advised that a constitutional change alone is not sufficient to allow the state to distribute a percentage of the permanent fund's market value. An Enabling Act change is also needed because Congress granted the trust lands and therefore must also dictate the terms of the trust. Because New Mexico's Enabling Act does not address how capital gains and dividends should be used, the state must refer to common trust law for guidance, which treats capital gains as principal. However, if language in the Enabling Act is changed to allow the new distribution method, it would prevail over common trust law.

Recommendations

1. The Legislature should consider the following legal changes to protect the Fund from inflation:

   a. Enacting legislation to specify the amount of annual investment earnings the Fund should retain and reinvest.

   b. Enacting legislation to refer a ballot measure to Arizona voters requesting their approval to amend Article 11 of the Arizona Constitution to authorize the State to retain and reinvest a portion of annual Fund investment earnings.

2. The Legislature should consider the following changes to authorize a portion of the Permanent Fund to be invested in stocks:

   a Establishing a study committee to propose new constitutional provisions for Articles 10 and 11 of the Arizona Constitution needed to authorize stock investment.

   b. Enacting legislation to refer a ballot initiative to the Arizona voters requesting their approval to amend Articles 10 and 11 of the Arizona Constitution to authorize stock investment and the total market value payout method.

   c. If voters approve this ballot initiative, the Legislature should request that Congress amend Section 25 of the Arizona Enabling Act to authorize the State to use the total market value payout method.

   d. Once the Arizona Enabling Act is amended, the Legislature should consider amending A.R.S. §§37-521 through 37-525 to authorize distributions based on the total market value payout method.

OTHER PERTINENT INFORMATION

During this audit other pertinent information was obtained regarding state trust land leased to Sumitomo Sitix of Phoenix (Sitix), a silicon wafer manufacturing plant in northeast Phoenix. Questions have arisen concerning the lease agreement. This review found the following information regarding the Sitix lease.

On May 1, 1995, the Northeast Phoenix Partners (NPP) applied to lease about 520 acres of trust land in the Desert Ridge Master Planned Development between Tatum Boulevard and 56th Street, south of the proposed Pima Freeway, in Phoenix. The partnership intended to develop the property as a high-tech business park, with the possibility of subleasing about 100 acres to Sitix.

At the time, Phoenix was competing with Portland, Oregon, to attract the Sitix manufacturing plant because it would bring economic benefits to the State. Various organizations, including the City of Phoenix (City) offered incentives to attract Sitix to Phoenix. According to a City official, the City had identified the state trust land as a potential site, and offered to construct the infrastructure Sitix would need to begin operating.

After receiving the lease application, the Department requested in a letter dated June 7, 1995, that two independent appraisers determine the property's market value, a determinant in lease rates. The letter stated that the proposed use for the property was a high-tech wafer manufacturing plant, and requested the appraisers to assume that the property's current zoning (commercial and residential) could be changed to industrial.[1] The Department added that the City of Phoenix is granting special consideration and will be installing significant infrastructure. According to Department staff, the specific infrastructure needs were not yet known, and the City only pledged to provide the infrastructure so that the Sitix site would be usable.

In late June 1995 the appraisers valued the land at $63,250 and $60,000 per acre, using the market or sales comparison approach.[2] Specifically:

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1 According to a NPP representative, only a portion of the property would be used for the wafer manufacturing plant.

2 The market or sales comparison approach involves estimating market value by comparing the land being appraised to similar land that has been sold recently, or for which offers to purchase have been made. The premise is that the market value of a property is directly related to the prices of comparable, competitive properties.

In his June 28, 1995, report, Certified General Real Estate Appraiser Mike Chierighino valued the land at $63,250 per acre. This appraiser considered the land's highest and best use was for land investment with the potential of development over the next 5 to 6 years for research institute, medical facilities, and ancillary uses. The appraiser analyzed 7 property sales, including 4 residential, 2 commercial, and 1 hospital. The sales ranged in size from 18 to 121 acres, and ranged in price from $84,970 to $109,668 per acre. Three sales were located within Desert Ridge, while the remaining sales were located near Desert Ridge.

- In its June 30, 1995, report, Appraisal Technology, Inc. valued the land at $60,000 per acre. The report stated that the highest and best use in its current state was for residential development, but if a freeway and bridge were completed, the highest and best use could become mixed use. In his analysis, the appraiser used 6 residential sales ranging in size from 27 to 108 acres, and ranging in price from $94,422 to $102,191 per acre. Five sales were located in the Desert Ridge development, and 1 sale was located nearby. The appraiser also included a 97-acre property with mixed zoning that sold for $51,546 per acre, and a 724-acre property purchased to construct an industrial building that sold for $27,978 per acre.

Both appraisers made adjustments to the prices of the comparable sales to reflect differences from the land being appraised.[1] For example, both appraisers made adjustments because the comparable properties had utilities available, while the property being appraised needed all utilities and additional off-site improvements.

Department records indicate that staff reviewed the appraisals on August 10 and 15, 1995, and recommended using the value of $63,250 per acre when establishing a long-term lease for the 520-acre site.

On August 30, 1995, the Phoenix City Council approved an ordinance authorizing the City to construct up to $7 million of infrastructure Sitix needed.

Between August 22 and 24, 1995, Sitix hired two independent appraisers, Burke Hansen, Inc., and CB Commercial Real Estate Group, Inc. to 1) appraise the property, and 2) evaluate the Department's appraisals. According to a Sitix attorney, their consultants found that the Department's appraisals were flawed because they derived their valuations for the proposed industrial property by comparing it to prices for residential properties. In addition, the Department's contracted appraisers assumed that infrastructure promised by the City of Phoenix was already in place. Sitix provided the Department with reports from their hired consultants dated August 30 and September 1, 1995.

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1 Generally, major items to consider when making adjustments include property rights, financing terms, motivation of buyer or seller, market conditions, location, size, shape, zoning, access, availability of utilities, topography, flood zone, and improvements on the property at the time of sale.

- In the report dated August 30, 1995, CB Commercial determined that the value of the 520-acre property was no more than $36,000 per acre if developed for residential use, or $32,000 per acre if developed for business park use. In addition, the report criticized the Department's appraisals for a number of reasons. For example, the report criticized Appraisal Technology, Inc., because the appraiser assumed the property could be rezoned to an industrial use, yet compared it to residential property to determine its value, without making adjustments for zoning differences. Similarly, the report criticized the Chierighino appraisal because Mr. Chierighino uses residential sales comparisons to value land proposed for industrial use, without discussing adjustments made for zoning differences. Also, the report criticized both appraisals because neither provided any detailed discussion regarding the cost of installing infrastructure at the site.

  In a report dated September 1, 1995, Burke Hansen, Inc., determined that the value of the 520-acre property was $30,000 per acre, whether used for residential or commerce park development. The report also criticized the Department's appraisals for many of the same reasons that CB Commercial listed.

Additionally, according to the Sitix attorney, Sitix representatives expressed the same concerns about the Department's appraisals to the Department of Commerce. According to a Commerce official, to allay Sitix's concerns, Commerce staff worked with the Governor's Office to prepare a letter from the Governor to Sitix's General Manager. The letter, dated September 5, 1995, states:

> *I have discussed the issue of the state land required for your factory with the State Land commissioner and emphasized to him the need to provide fair treatment to Sumitomo Sitix, in the quickest manner possible. I am aware that the original appraisal on this property might have been flawed in that certain proposed future improvements were considered to be already in place. We are confident that the new appraisals will correct this and provide a fairer market value as the basis for the lease.*

At about the same time, the Department ceased negotiations for the 520-acre parcel with the original applicant, NPP, and began working directly with Sitix to obtain a lease for approximately 100 acres. According to a Department administrator, the Department did not consider Sitix to be an applicant, so staff continued to process the NPP application even though they were working primarily with Sitix.

Further, according to Department staff, because Sitix was interested in a smaller parcel than the original applicant, the Department needed to determine the value of the smaller parcel separate from the original 520-acre valuations. In addition, cost estimates for needed infrastructure were available from the City of Phoenix, and could be considered in a new valuation.

On September 13, 1995, the Department verbally authorized Mr. Chierighino to amend his original valuation. The Department also authorized Appraisal Technology, Inc., to do the same, but the specific date of this verbal request is unknown. The Department also sent a written request dated September 15, 1995, although the amended appraisals had already been completed on September 13 and 14, 1995. According to Department staff, they often give the appraisers verbal instructions first, then follow up with written instructions for Department records.

The letter told the appraisers to appraise the property in two parcels, 131.82 acres (the proposed Sitix site) and 388 acres. The letter also instructed the appraisers to consider that both sites would need $7 million each in off-site infrastructure based on City estimates**.** Both appraisers returned a lower per-acre value for the 132-acre site than their original estimate for the 520-acre site**.**

In its September 13, 1995, amendment, Appraisal Technology, Inc. revised its valuation for the 132-acre site to $37,000 per acre, and $68,000 per acre for the 388-acre site. The appraiser now claimed the highest and best use for both parcels was for commerce/business park development because, according to the report, the City of Phoenix indicated it would rezone both parcels to allow for that use within the next several weeks. For both parcels, the appraiser used 3 residential, 1 commercial, 2 mixed-use, and 2 industrial land sales for comparison. None were within Desert Ridge due to lack of sales within the neighborhood. For the smaller parcel, the appraiser placed the most consideration on two sales in particular, a 265-acre residential property in Glendale that sold for $37,000 per acre, and a 97-acre mixed-use property in west Phoenix that sold for $51,546 per acre. Although the report indicates that adjustments were made to these 2 sales, it does not specify the adjustment amount. For the 388-acre parcel, the appraiser valued the land at $68,000 per acre. He placed the most weight on 3 comparable sales ranging in price from $37,000 to $68,182. Again, the appraiser made adjustments to their values, but did not specify the adjustment amount. The appraiser also noted that the parcel would benefit from City plans to build infrastructure for other sites, such as the nearby Mayo Clinic, and it would have two interchanges and frontage along the proposed Pima Freeway, making the land more valuable than the smaller parcel.

In his amended report dated September 14, 1995, Mr. Chierighino valued the 132-acre parcel at $36,000 per acre after adjusting his original estimate for such things as the change in size, the immediate development time factor, the lack of infrastructure, and the lack of freeway interchanges. The appraiser analyzed 3 comparable sales, 2 zoned for industrial use, and 1 zoned for mixed use. The properties ranged in size from 38 to 110 acres. After adjusting their prices for factors that differed from the land being appraised, their values were estimated at $37,000, $38,200, and $34,900 per acre, respectively. In addition, the appraiser reported that the remaining 388-acre parcel was valued at approximately $60,000 per acre. This value varies from the smaller parcel

> because development would occur over 5 to 6 years, rather than immediately, so the developer would not have to install infrastructure until lots were ready for development. He also noted that the larger parcel would have valuable freeway interchanges, unlike the smaller parcel.

Department records indicate that Department staff reviewed the amended appraisals on September 18, 1995, and recommended using $37,000 per acre for the 131.82-acre parcel (the proposed Sitix site), and $68,000 per acre for the remaining 388 acres of the 520-acre parcel.

On September 20, 1995, the legal description in the application NPP filed was amended from 520 to 106 acres, which was the parcel size Sitix wanted to lease.[1]

On September 29, 1995, Sitix initiated an effort to begin working on the site by providing the Department with a $110,000 bond from its parent company, Obayashi Corporation. On October 12, 1995, the Department issued Sitix a special land use permit to allow the company to grade the site, provided Sitix would restore the land to its original condition if the company was not the successful bidder at the public auction. Arizona Administrative Code, Title 12, Chapter 5, Article 11 authorizes the Department to issue special land use permits to allow prospective lessees to begin working on a site prior to the public auction of a lease or sale. The Land Commissioner may require the prospective lessee to post a bond to cover the anticipated costs to restore the property.

On December 12, 1995, the Department auctioned a 99-year lease of the 105.8 acres. Sitix was the only bidder, and obtained the lease commencing on December 12, 1995. According to the lease agreement, the base rent is calculated using the land value of $37,000 per acre for the first 10 years. To adjust for inflation, after 10 years, the land value figure used to calculate the annual base rent increases by 20 percent. The lease agreement also specifies that the land value figure used in the base rent calculation increases an additional 10 percent every 5 years thereafter. Alternatively, the lease agreement requires Sitix to pay additional rent if increases in the land value of similar industrial properties exceed the scheduled increases in Sitix's base rent. Based on the base rent schedule, the Department determined the overall annualized internal return rate will be 8.1 percent.

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1 Although the Department appraised a 132-acre parcel, Sitix pursued a lease for only 106 acres. The remaining acres were purchased by the City of Phoenix for development of rights of way and a well, as required by the City.

SUNSET FACTORS

In accordance with A.R.S. §41-2954, the Legislature should consider the following 12 factors in determining whether the Arizona State Land Department should be continued or terminated.

1. The objective and purpose in establishing the agency.

The Legislature established the Arizona State Land Department (ASLD) in 1915 to ensure proper management and control of state trust lands. The federal government granted these lands to Arizona to support schools and other public institutions. The Department is responsible for managing the surface and subsurface products on state trust lands in a manner that produces maximum revenues for the trust beneficiaries, including public schools. To produce revenues, the Department sells and leases land to the general public for grazing, farming, mining, and commercial development. Revenues derived from those activities are then placed into either permanent or expendable trust funds for the beneficiaries' use.

In addition to managing state trust lands, the Department's responsibilities include suppressing wildfires on over 22 million acres of state and private land outside municipalities, overseeing the Natural Resource Conservation Districts, providing assistance to other state agencies through the Arizona Land Resources Information System and State Cartographer, organizing Cooperative Forestry Assistance Programs, and providing information to the Navigable Streambed Adjudication Commission.

2. The effectiveness with which the agency has met its objectives and purpose and the efficiency with which it has operated.

Although the Department has generally met its prescribed objectives and purpose, our review identified several areas where the Department could improve its effectiveness and efficiency in fulfilling its responsibilities.

Specifically, the Department can improve the return it receives from selling or leasing urban trust lands by adopting a more proactive approach to planning and disposing of these assets (see Finding I, pages 10 through 23). In addition, increased revenues can be generated by modifying the Department's grazing and agricultural lease programs (see Finding II, pages 24 through 30).

Moreover, the Department can strengthen its efforts to protect state trust lands. Recently, an Arizona State Land Department in-house committee identified the need for the Department to assess land conditions before selected commercial leases are approved. By doing initial assessments, then periodically reassessing land conditions, the Department could better determine who is responsible for any environmental damage it finds. Currently, leaseholders are responsible for any damage they cause, pursuant to language in the lease agreements. However, because the Department is often unaware of land conditions prior to approving commercial leases, it cannot easily assign responsibility when environmental damage is discovered.

3. The extent to which the agency has operated within the public interest.

Generally, the Department has operated within the public interest by managing state trust lands to produce revenue for the 14 beneficiaries, primarily public schools. Over the past 10 fiscal years, the Department has generated nearly $164 million in expendable revenues, and nearly $451 million for the Permanent Fund. In addition, Permanent Fund investments have generated over $416 million in interest income for the beneficiaries over the same period. The Department also serves the public interest by providing fire protection for state and private lands outside municipalities. In fiscal year 1996, the Department coordinated fire suppression efforts for 865 wildfires throughout Arizona.

However, the Department could do more to operate in the public interest. The Department can do more to maximize urban land revenues by increasing its use of in-house and contract planners to plan urban properties, rather than overly relying on private developers to do most planning. In addition, the Department could establish profit-sharing agreements with private developers who purchase urban land then resell it at higher costs after installing infrastructure. The Department could also install infrastructure and sell smaller parcels at higher prices, similar to private developers. Moreover, the Department could increase its marketing efforts to encourage more competition for available urban lands (see Finding I, pages 10 through 23).

Further, grazing and agriculture lease revenues could be increased by prohibiting rent reductions except when needed to protect the trust land resources and collecting a surcharge from lessees who sublease state trust land. The Department could also better ensure that lessees pay fair compensation for the use of trust lands by regularly evaluating lease rates. Finally, the Department can do more to encourage competitive bidding for grazing and agriculture leases (see Finding II, pages 24 through 30).

4. The extent to which rules adopted by the agency are consistent with the legislative mandate.

Rules and regulations appear consistent with the Department's legislative mandate. With the exception of the Arizona Preserve Initiative enacted last year, all rules currently mandated by statute have been promulgated. In addition, as part of its five-year rule review process, the Department is in the process of deleting or amending a number of obsolete rules. For example, the Department recently deleted the rule pertaining to its control over water distribution, because this responsibility was transferred to the Department of Water Resources in 1980.

5. The extent to which the agency has encouraged input from the public before adopting its rules, and the extent to which it has informed the public as to its actions and their expected impact on the public.

The Department appears to encourage public input when developing or amending regulations. In addition to publishing meeting notices pursuant to the Arizona Administrative Procedures Act, the Department has an extensive mailing list and sends letters explaining proposed rule changes and soliciting input. Further, the Department appears to be in compliance with A.R.S. §37-332 relating to public hearings for urban land development. In particular, the Department publishes meeting notices in newspapers, mails notices to appropriate municipalities, leaseholders, property owners, and interested parties, and posts meeting notices at the State Land Department. Finally, the State Land Department Board of Appeals has complied with the Open Meeting Law.

The Department also keeps the public informed of its actions by publishing a semiannual newsletter and hosting educational seminars. In addition, the Department works with federal agencies to issue press releases to the media to notify the public of fire conditions.

6. The extent to which the agency has been able to investigate and resolve complaints that are within its jurisdiction.

According to the Department, most complaints it receives involve trespass on state trust lands. Trespasses may include such things as unauthorized construction of ditches and roads, removal of valuable resources or historical artifacts, dumping waste materials, or persons illegally residing on state trust land. During fiscal year 1996, the Department opened 163 trespass cases. As discussed in Sunset Factor 8, statutory deficiencies limit the Department's ability to resolve trespass violations (see page 49).

7. The extent to which the attorney general or any other applicable agency of state government has the authority to prosecute actions under the enabling legislation.

A.R.S. §37-102 authorizes the State Land Department to request prosecution by the Attorney General or the County Attorney. While the Attorney General's Office has assisted the Department in negotiating settlement agreements between persons accused of violating trespass regulations and the Department, they seldom prosecute trespass cases due to the limited utility of the trespass statutes.

8. The extent to which the agency has addressed deficiencies in its enabling statutes which prevent it from fulfilling its statutory mandate.

The Department has sought numerous technical and administrative changes to agency statutes over the years. For example, Laws 1992, Chapter 357 authorized the Department to pay brokerage real estate commissions to private realtors. Laws 1993, Chapter 168 allowed the Department to require earnest deposits from people who apply a second time for the same piece of land. Laws 1994, Chapter 171 established a five-member Grazing Land Valuation Commission to prepare an appraisal of the true value rental rate for state grazing land. Laws 1995, Chapter 238 increased the liability the Department can incur for fire suppression activities from $1 million to $2 million in a fiscal year. Furthermore, Laws 1996, Chapter 133 modified the requirements for the planning and disposition of state trust land.

However, deficiencies in A.R.S. §§37-501 and 37-502 appear to limit the Department's ability to control trespass violations. In our 1987 Sunset review, we noted that the Attorney General's Office researched the problems with the Department's trespass statutes and concluded that they were inadequate for dealing with the trespass problem. In particular, the Attorney General's Office identified several problems, including 1) lack of clear authority to cite persons endangering public safety while on state trust land, 2) lack of clear definition of trespass and effective penalties to deter potential violators, and 3) no specific prohibition against dumping trash and debris on state lands. Since then, the Department has requested two legislative bills be introduced to clarify what constitutes a trespass, and actions that can be taken for damages caused; however, neither bill was enacted.

9. The extent to which changes are necessary in the laws of the agency to adequately comply with the factors listed in the sunset laws.

Based on our audit work, the Legislature should consider the following changes in the Department's laws:

The Legislature should consider amending A.R.S. §§37-501 and 37-502 to strengthen the Department's ability to control trespass on state trust land by creating an enforceable definition for unauthorized use of trust land, and establishing stronger penalties for those found guilty of trespassing.

The Legislature should consider adopting legislative changes and proposing constitutional and Enabling Act changes that would allow the Department to retain a portion of trust land sale proceeds. The retained amount could be used for activities that enhance the land's value, such as planning, developing disposition strategies, and installing core infrastructure.

The Legislature should consider re-establishing A.R.S. §37-132, which allowed the Department to pay fees to commercial real estate brokers and leasing agents who assist with the sale or long-term lease of state trust lands. This would allow the Department to better market available trust lands. A.R.S. §37-132 expired on December 31, 1996 (see Finding I, pages 10 through 23).

- The Legislature should consider amending A.R.S. §37-285 to prohibit rent reductions for grazing leases except when the Land Commission determines it is necessary to protect trust land resources. By limiting rent reductions, the Department could generate additional revenues (see Finding II, pages 24 through 30).

  The Legislature should consider amending A.R.S. §37-283 to establish a surcharge for subleases and pasture agreements on grazing trust lands. By establishing a surcharge for subleases and pasture agreements similar to the current federal Bureau of Land Management (BLM) surcharge, the Department could generate an estimated $120,000 or more in additional revenue (see Finding II, pages 24 through 30).

  The Legislature should consider enacting legislation to refer a ballot measure to Arizona voters requesting their approval to amend Article 11 of the Arizona Constitution to authorize the State to retain and reinvest a portion of annual Permanent Fund investment earnings to offset inflation. Subsequent to voter approval, the Legislature should consider enacting legislation to specify the amount of annual earnings the Permanent Fund should retain and reinvest (see Finding III, pages 32 through 39).

  The Legislature should consider enacting legislation to refer a ballot measure to Arizona voters requesting their approval to amend Articles 10 and 11 of the Arizona Constitution to 1) authorize the State to invest a portion of the Permanent Fund in stocks, and 2) authorize the State to adopt a payout strategy based on the Fund's total market value to allow beneficiaries to receive some stock earnings. If voters approve, the Legislature would need to request Congress to amend the federal Arizona Enabling Act to authorize the new payout method. The Legislature should also consider amending A.R.S. §§37-521 through 37-525 to authorize payouts based on the Fund's market value, and enact legislation specifying the percentage of market value beneficiaries should receive each year, and the number of years to include in the average (see Finding III, pages 32 through 39).

10. **The extent to which the termination of the agency would significantly harm the public health, safety or welfare.**

Administration of state trust lands for the benefit of the common schools and other institutions is required by the Arizona Constitution and the Enabling Act. If the State Land Department was terminated, another state agency would need to execute these duties in its absence. In addition, unregulated use of state trust land could result in damage to the land and loss of valuable resources. Such loss could reduce the revenues generated from the sale or lease of the land and its natural resources. The Department also provides fire protection for more than 22 million acres of state and private land outside municipalities.

11. **The extent to which the level of regulation exercised by the agency is appropriate and whether less or more stringent levels of regulation would be appropriate.**

The Department is not a regulatory agency. It functions in a fiduciary capacity as the trustee of the state trust lands and its natural resources. The Department's management activities are governed by extensive and detailed provisions in the Enabling Act, the Arizona Constitution, and Arizona Revised Statutes. According to an attorney from the Attorney General's Office who works closely with the Department, the Department has sufficient authority to develop rules to ensure that state trust lands are used in a manner that benefits trust beneficiaries.

12. **The extent to which the agency has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished.**

The Department relies on contractors to assist in performing several important duties, including planning, appraisals, archaeological surveys, forest thinning, and environmental studies. The Department also contracts with local fire departments to assist in fighting fires throughout the State. In fiscal year 1996, the Department signed 193 cooperative agreements with local fire departments such as Rural Metro and other volunteer departments to control wildland fires throughout Arizona.

Agency Response

FIFE SYMINGTON
GOVERNOR

Arizona
State Land Department
1616 WEST ADAMS
PHOENIX, ARIZONA 85007

J. DENNIS WELLS
STATE LAND COMMISSIONER

April 10, 1997

Mr. Douglas R. Norton
Auditor General
2910 North 44th Street, Suite 410
Phoenix, AZ 85018

Dear Mr. Norton:

The Performance Audit of the State Land Department identified several functions of the agency that need improvement to increase revenues for the Trust beneficiaries.

The Department generally agrees with the findings related to maximization of urban land revenues. Undoubtedly, lack of staff and funding to plan and advertize properties have an influence on competitive bidding and revenue production. The Department has reservations regarding the auditor's recommendation for the Department to fund and install infrastructure prior to auction. An extensive analysis of risk, cost, and staffing should be conducted before concluding such an endeavor would actually generate more revenue over the long run. The auditors give examples of two developers that have sold land at significantly higher prices than was originally sold by the State, however, they neglect to include the cost of infrastructure in the figures. The true margin of profit is, on average, fairly narrow, and in some cases the developer may lose money if property values drop over time.

The recommendations related to the grazing and agriculture lease programs identify three main areas of potential revenue enhancement. Without a more in depth analysis of the cost of implementation, of the impacts to the resource, of the market response by the industry, and of the likelihood of implementation, the Department is hesitant to agree that increased revenue will result.

The Department supports the proposed changes to the investment of the Permanent Fund and applauds the auditors for highlighting this issue. In a relatively short period of time the beneficiaries of the Trust will benefit significantly from implementation of these recommendations.

The State Land Department would like to acknowledge the professional and courteous manner in which your staff conducted the performance audit. Your staff should be commended on their success in evaluating a multi-faceted agency and correctly identifying the areas where deficiencies exist within the administration of the Trust resources. We appreciate the assistance you have given us in evaluating and improving our programs.

Sincerely,

Michael E. Anable

for J. Dennis Wells
State Land Commissioner

JDW/MEA/lfm