CFTM
Committee on Forest Land Taxation Methodology
September 2, 2004
8:00 AM
STC 5CR1 Boise, Idaho

Chairman Watson called the meeting to order at 8:45 AM. As the members and guests were all familiar with one another the meeting moved on to business. The meeting notes from the last meeting were assigned for reference for the committee members and guests. Following is a list of those in attendance.

Name	Representing	E-Mail
Larry Watson	ISTC Commissioner	lwatson@tax.state.id.us
Mark Munkittrick	IFOA – CDA	baronflyer@icehouse.net
Phil Davis	Valley Cty Commissioner	pdavis@co.valley.id.us
Dave Ryals	Boundary Cty Assessor	dryals@boundarycounty.org
Stan Leach	Clearwater Cty Commissioner	commissioners@clearwatercounty.org
Steve Fiscus	Latah County Assessor	sfiscus@latah.id.us
Jane Gorsuch	IFA – Boise	jane@intforest.org
Dr. William Schlosser	NW Management Inc.	schlosser@consulting-foresters.com
Rod Brevig	ISTC	rbrevig@tax.state.id.us
Duane Little	Guest	duanelittle@hotmail.com
Don Pischner	Guest/Stimson Lumber Co.	pischcda@aol.com
John Currin	Potlatch Corporation	John.Currin@potlatchcorp.com
Michael G. McDowell	Kootenai Cty Assessor	mmcdowell@kcgov.us
Roy Eiguren	Boise Cascade	RoyEiguren@givenspursley.com
George B. Perala	Boise Cascade	georgeperala@bc.com
Dennis Parent	Inland Empire Paper	Dennis_Parent@iepco.com
Scott Gray	Stimson Lumber	sgray@stimsonlumber.com
Mark Benson	Potlatch Corporation	Mark.benson@potlatchcorp.com
Kevin Boling	Forest Capital	kboling@forestcap.com
Daniel G. Chadwick	IAC	dchadwick@idcounties.org
John EiKum	Idaho Rural Schools	jjikum@aol.com

Commissioner Watson turned the meeting over to Dr. Schlosser.

Dr. Schlosser began by taking the committee back to the ten-year T-Bill rates and inflation rates that were developed from the PPI. He pointed out that in some years the inflation rate was actually a deflation rate and the rate can go negative.

Commissioner Watson asked Dr. Schlosser to elaborate on what occurs if the rate does go negative.

Dr. Schlosser said that the predicted values can become very high and the model basically doesn't work anymore. He suggested establishing sideboards for the base rate so that values would remain within an acceptable range.

Phil Davis asked to have clarification as to why the inflation is backed out of the rate.

Dr. Schlosser said that it is normally a real rate that's used in this model with inflation taken out of the rate.

Dennis Parent added that the problem with including inflation in the rate is that you have to guess at what inflation will be in the income stream also if you do. As stumpage values and costs are two of the most influential components of the income stream, inflation would have to be a portion of these components also. In order to avoid these problems the real rate is used in the discount rate.

Dr. Schlosser led the discussion further with a reference back to the 10-year T-Bill rate.

Mark Benson asked if we could look at the real and nominal rate that would be developed from the 10-year T-Bill data set.

Dr. Schlosser calculated these values with inflation taken out and pointed out that the result will always be lower except in those instances when inflation is negative, in which case the real rate would be pushed higher. He suggested that there might be a good reason to consider using the 10-year rolling average for the 10-year T-Bill rather than the 5-year rolling average that had been discussed during the last meeting because that average doesn't go negative in the 1970's. He also suggested that sideboards might be in order to decrease the influence of exceptional economic conditions that the 50-year data set that he has for the 10-year T-Bill rates demonstrates has taken place.

Steve Fiscus stated that neither side wants to see the values spike in either direction because it leads to dissatisfaction with the process. He suggested that we needed to agree however on where these sideboards should be.

Dr. Schlosser suggested that we don't have to agree today on where these sideboards should be, but it would be good to examine the influence that sideboards would have on the data set. He suggested that the committee consider sideboards of 3 to 5% for the base rate and then add an equity risk rate and a tax rate to that.

Mark Benson said that we might never get to the sideboards as the model is used, but the sideboards provide some security that the model will remain relevant and stable over a longer period of time.

Dave Ryals asked if the committee had agreed to a five-year rolling average for the 10-year T-Bill or if we had moved on to a ten-year rolling average?

Dr. Schlosser said that we have examined both, but the 10-year rolling average seems to offer the best fit for the data set.

George Perala asked if the numbers being shown by Dr. Schlosser on the screen were real or nominal rates.

Dr. Schlosser said that the figures he was displaying were nominal rates. He used an average inflation rate of 3% that he calculated from the 50-year PPI data set. He calculated the real rate for today at 3.34% for a five-year rolling average, 4.33% for the 10-year rolling average and 5.38% for the 20-year rolling average. He said that his data set would indicate that sideboards of 3 to 6% might be most appropriate. If applied these sideboards would have kicked in during the extraordinary economic times when they really needed to in order to keep the model relevant.

Steve Fiscus suggested that had we had sideboards on our rates before perhaps we wouldn't have found it necessary to have this series of meetings that we're having now.

Dr. Schlosser did some additional work with the data set and found that the average rate would have been 6.83% in the 1980's and .03% in the 1970's.

Mark Benson suggested that there are three separate things that we currently have under discussion: (1) real rates, (2) a 10-year rolling average T-Bill rate and (3) using sideboards of 3 to 6% for the base rate.

Dr. Schlosser said that these rates can be harvested from the Internet, are easy to obtain, and can be replicated by anyone to verify the accuracy of the calculations that are being performed by the administrators of the model.

Steve Fiscus asked if we could confirm the variables that are under discussion: (1) real rates, (2) the 10-year rolling average 10-year T-Bill rate and (3) using sideboards of 3 to 6% for the base rate.

Phil Davis asked if there are times when there is no interest on the part of investors in investing in forestland.

Dr. Schlosser said that the question is appropriate because that is exactly what happens. In fact the FED relies on that fact when they raise or lower the interest rates. If they lower rates enough everyone becomes interested in investing aggressively because they can see great returns if they own the land. The reverse is true when interest rates go up because returns become marginal or negative. He continued by relating the discussions that he had the previous day with STC staff. He mentioned that the forest industry beta that had been developed by staff hovered in the area of .89 to 1.2% in a data set that had information for 1996 and 2004. He said that he doesn't feel good about this source for an estimated equity risk premium, because there isn't relevance to the process that is being undertaken by this committee. The beta comes from companies with diverse portfolio's, components of which have little or no relevance to forestland at all.

Dennis Parent asked if there is enough data on the TIMO's (Timberland Investment Management Organizations) to develop a beta for them.

Dr. Schlosser went to the data set for the companies that were included in the calculation done by STC staff. As he perused the list of companies and indicated the problems with some of them he reiterated that he would not want to use this methodology to develop a beta because some of the companies are heavily invested in other things and there is no relationship between the indicated beta for these companies and the income stream that would be developed for the forestlands in Idaho.

Commissioner Watson added that the discussion with STC staff indicated that these are not good numbers to compare with the problem facing the committee. It would be like comparing apples with horse apples. After three hours of discussion yesterday the general agreement was that the rates that would be developed from this process would not be good numbers to use for the purposes of the CFTM.

Dave Ryals asked if it would not also be appropriate to keep the equity risk premium low with the same application of sideboards so that this portion of the discount rate would not also get out of hand somewhere in the future.

Dr. Schlosser responded that this argument would also perhaps be true. He said that his feeling is that a rate of around 1% would be appropriate but he has not been able to devise an acceptable source or way to establish the equity risk premium rate.

Mike McDowell asked if it would perhaps make sense to make the equity risk rate some percentage of the base rate. The group seems to be feeling comfortable with the determination of the base rate, so if the equity risk premium were determined as a percentage of the base rate, it would enjoy some of the same advantages that the CFTM seems to be feeling are going to be inherent in the base rate.

John Currin agreed that he too was considering this same process and it seems to have the advantages that Mike is pointing out.

Dr. Schlosser performed the calculation using the original data set from the 10-year rolling average 10-year T-Bill rate. A calculation of 20% of the base rate indicated a 1% value for a five-year period, 1.3% for a 10-year period, 1.61% for a 20-year period, 1.99% for the 1980's and .01% for the 1970's. There was a general discussion of the sideboard's and Dr. Schlosser calculated a rate of .009 if the base rate is at 3% and .018% if the base rate is at 6% and the equity risk premium amount is based on 30% of the base rate figure.

Commissioner Watson asked if these figures seem to be reasonable to Dr. Schlosser.

Dr. Schlosser said that he does have a degree of comfort in them and the best part is that all of these figures come from public sources and there is no requirement for negotiation from the stakeholders in this process. He then calculated loaded rates of 3.9% to 7.8% if the equity risk premium rate is added to the base rate. He said that the 3.9% rate doesn't bother him as much as the 7.8% rate, because when taxes are added the figure would perhaps be too high.

John Currin asked if Dr. Schlosser could look at the 20% figures again for calculating the equity risk premium rate from the base rate.

Dr. Schlosser calculated those figures for the CFTM to examine.

Dave Ryals asked to look at what would be generated by a 25% rate.

Dr. Schlosser did so and then developed a graph with sideboards of 3 and 6% to examine how the values would respond to economic changes over time. He asked the CFTM to examine if these values seem to stay within an acceptable range given the amount of variability that has been in the market place over the last 50 years.

Mark Benson asked if these figures would indicate that the proposed model is better at working with the economic variables demonstrated in the market than the current model?

Dr. Schlosser suggested in response that we are better off to tweak the inputs to the model rather than the results.

Dr. Schlosser initiated a short discussion concerning the tax rates.

Rod Brevig described how the rates are developed for use in the current model. The levy rates for the code areas, which have a significant amount of timber, are averaged for the county. A weighted average is calculated for each of the forest value zones based on the number of timbered acres in the county and the total number of timbered acres in the forest value zone.

John Currin said that this method of calculation seems to make sense to him.

Phil Davis said that he too felt that the method that had been described seemed to be reasonable to him.

Dr. Schlosser asked if at this point the CFTM could agree on the variables, which have been under discussion. First, that we will use a 10-year rolling average 10-year T-Bill rate without inflation as the base rate. Second, that the equity risk premium would be developed as a percentage of the adjusted base rate. And third, that the tax rate would be developed in the method that is currently used. The formula used would be the Base Rate plus the Equity Risk Premium plus the Base Rate times the Equity Risk Premium.

Steve asked if Dr. Schlosser could spell out in detail again how this process would work.

Commissioner Watson asked if Steve could make that in the form a motion.

Steve said that he was feeling comfortable enough with the figures at this point in time that he thought that he could make it a motion.

Kevin Boling seconded the motion. Mark MunKittrick asked for discussion. Dr. Schlosser explained in greater detail how the equation that he was suggesting would work. The formula used would be the Base Rate plus the Equity Risk Premium plus the Base Rate times the Equity Risk Premium. This rate plus a tax component would comprise the total discount rate.

Phil Davis asked if conditions like those that occurred in the 1980’s occurred again if some would become dissatisfied with the values that were being generated by the model.

Mark Benson said that the situation, which occurred in the 1980’s, is the precise reason why sideboards are justified. It is less likely that the stakeholders will become dissatisfied with the results of the model if the values that are being generated don’t go to extremes.

Dr. Schlosser said that there are going to be issues that will arise in the future that are impossible for us to guess might happen at this point in time. If for instance another 1910 burn were to occur the model may no longer be found to work. Or some economic situation that is impossible to foresee today.

Roy Eiguren said that this was the reason why there were notes put in the HB 513 legislation. It is advantageous to the CFTM if in the future when the valuation process is questioned there is an opportunity to know what the thinking was that went into the basis for the calculations and the process that is being developed now.

Dr. Schlosser said that he intends to provide a detailed written report to the legislature so they can have something to include in the record. The CFTM will have the report and the administrators on the STC staff will have an owner’s manual which will detail the calculations and where they come from.

The committee took a 15-minute break.

Commissioner Watson asked if he had a motion before the committee.

Steve Fiscus responded that he has made a motion.

Kevin Boling said again that he would second the motion.

Steve asked Dr. Schlosser to again detail the motion that he is making.

Dr. Schlosser said that the discount rate would be developed by calculating a base rate from the 10-year rolling average 10-year T-Bill rate less inflation calculated from the PPI index for a like period. The equity risk premium would be determined by multiplying this base rate by 1.25% and this sum would be added back to the base rate. A tax rate would be added that is determined by the process that is used currently. The result would be the discount rate that will be used in the valuation model. There would be sideboards of 3 to 6%, which would be applied to the base rate. Additionally, there would be sideboards for the base rate plus the equity risk premium of 3.75 and 7.5%.

Mark Benson asked if we are solving for 'i' in the model?

Dr. Schlosser said that we are solving for the interest rate or the discount rate that is used in the model. He said that he uses these terms interchangeably but in some instances it might be better to be more precise in the application of these terms.

Commissioner Watson asked for a vote on this methodology to be used in developing the discount rate for the model. The motion was passed unanimously by the CFTM.

Dr. Schlosser asked if Rod Brevig could explain the information concerning the valuation process that was detailed on the sheets that he had passed out to the CFTM at the outset of the meeting.

Rod Brevig spent about an hour discussing the process that is used to determine the input variables in the current valuation process. George Perala argued that the valuation process did not include all of the components of the stand. Mark MunKittrick argued that the assumptions in the yield curves also do not include all of the components of the stand. If we try to include the detail required to include all of the components of the stand then we will also have to develop new yield curves that we use in the model. Rod explained that the process that he uses compares private stumpage values with Idaho Department of Lands stumpage values each year. With 20 years of data it's possible to demonstrate that the stumpage values from each of these sources track one another over time.

Dr. Schlosser suggested that because five-year rolling average values are used it would be appropriate to adjust these values for inflation so that they too can be expressed in real terms.

Commissioner Watson asked for a vote of the committee concerning the stumpage value determination that had been described by Rod Brevig with an adjustment for inflation. The CFTM passed this motion unanimously.

The CFTM broke for lunch. The meeting started back at 12:30 pm.

Dr. Schlosser began the discussion with the question of costs that would be appropriate to use. He projected the values and components of the cost study that was done in 1998 by Northwest Management for the ISTC and IFA. Dr. Schlosser asked if anyone was aware of why the costs for road management and public use had been taken out of the data set that he was using.

John Currin suggested that the cost of road management and managing public use were taken out because we are trying to value the bare land and these components are for land with standing timber.

Dennis Parent made the argument that if you start with bare land and wait for 80 years you still have bare land. If you want to manage a stand you have to make sure that the stand is established. He suggested using IRS rules for determining which costs should be included in the model.

Duane Little asked Dr. Schlosser if the number of years to stand establishment should be added to the rotation ages that had been discussed previously.

Dr. Schlosser said that whether or not and how many years to add would depend on the Forest Value Zone we are working with. In some instances experts will argue for five years being used for stand establishment, sometimes ten years and sometimes 15 years. In all that he knows about stand establishment he finds it difficult to argue for one time period or another, because they all depend on a number of conditions to be true in any given location or condition.

Steve Fiscus suggested that the $49.28/acre average cost that is shown for FVZ 1 seems to be very high.

John Currin gave statistics in terms of the number of respondents for each of the classes of property that were queried by the survey. The groups were owners with 5 to 500 acres, owners with 500 to 5,000 acres and owners who had over 5,000 acres.

Mark Benson added that one way that the costs get masked for NIPF (non-industrial private forestland owners) is that they can become part of the logging costs for small owners. A small owner doesn't keep track of the fact that many of the costs that occurred during the logging process, happened because needs had been ignored for the 15 years leading up to the sale, and were being taken care of during the sale. The NIPF owner may not know what all of the costs are or have any way to segregate those costs from others after the sale is completed and report them.

Dennis Parent said that he remembers that the figures are weighted by acres. He encouraged the group not to get too disturbed with the figures that are shown because they may appear high but when they are weighted by the acres that are being treated the contribution to the overall cost could be very small.

Mike McDowell argued that if we are going to include all of the costs that are included in the survey we are not considering custodial management for a natural stand. If there is an insistence on doing that, we will need to go back to the start of our process and look again at yields and rotation lengths also.

Dr. Schlosser suggested that custodial management would not include all of the costs that were included in the survey. Some of the listed costs are not appropriate and others should be modified to accommodate the context of the model development that the CFTM is currently occupied in.

Kevin Boling said that his company certainly has costs that are associated with public use and abuse.

Mark Benson said that Potlatch incurs costs of $500,000 per year in repairing damage caused by the public on their ownership.

Mike McDowell said that he considers those costs legitimate and would not have a problem with including some allowance for those costs. Phil Davis added that he certainly incurs costs in repairing damage caused by the public in using his forestland.

Dr. Schlosser asked if the committee could go through the list of variables in the cost study and determine which of the costs seemed legitimate and which should be adjusted. There was a lengthy general discussion of each of the variables. The overall decision was as follows:

(1) Landowner Labor (only NIPF) (Corporate costs for labor included in items below)	Include
(2) Reforestation	Include
(3) Timber Stand Improvement	Leave Out
(4) Silvicultural Administration	Leave Out
(5) Road Management	Include
(6) Managing for Public Use	Include
(7) Surveying	Include @ 50%
(8) Forest Inventory	Include
(9) Forest Fire Suppression	Include @ $.50/acre
(10) Planning	Include
(11) Research and Development	Leave Out
(12) Facility Operating & Maintenance	Include
(13) Environmental Analysis & Documentation	Include
(14) Appeals & Litigation	Include
(15) Other Management	Include (some)

The overall cost for FVZ 1 was decreased by this process from an average cost of $18.85/acre to a figure a little under $15.00/acre.

Dr. Schlosser suggested that he would use a similar process for each of the FVZ's and use an inflation adjustment to bring the cost allowances to current levels. The adjustment would take place from the middle of the study period, which was 1995 to today. He will provide a report to the CFTM when he has completed these adjustments.

Commissioner Watson asked if we were done for today.

Dr. Schlosser said that he had accomplished all that he had hoped to through the course of the meeting today.

Dan Chadwick said that there needed to be an adjustment in the starting time for the next CFTM meeting scheduled in Coeur d'Alene. The start time needs to move from 10am to 11am. He said the meeting will be in the Beauty Bay Room and lunch will be provided.

Mark Benson asked Dr. Schlosser if he would determine if there has been a real appreciation in the value of wood in the last few years. He asked Dr. Schlosser if he would report to the CFTM on his findings at the next meeting in Coeur d'Alene.

Commissioner Watson concluded the meeting at 2:30pm.