August 15, 2014

Government Accounting Standards Board
Director of Research and Technical Activities
401 Merrit 7, P.O. Box 5116
Norwalk, CT 06856-5116

Re: Fair Value Measurement and Application Exposure Draft

Director:

The North Dakota Department of Trust Lands (DTL) appreciates the opportunity to comment on the GASB Fair Value Measurement and Application exposure draft. We appreciate the time staff from GASB has taken to help us understand the purpose of the proposed Statement and how it might impact state land managers, such as the DTL, that oversee lands and minerals throughout the western United States.

Although our review of the exposure draft and related GASB Statements 31, 34, 51 and 52 indicates that the provisions of the proposed Statement do not apply to the lands and minerals managed by the DTL, we appreciate the opportunity to explain our position and why we feel that this should continue to be the case going forward. In our opinion, continued reporting of these assets under the provisions of GASB 34 (Capital Asset Accounting) and GASB 51 (Intangible Assets) is the most logical and cost effective way to report these assets, and also provides the most accurate and timely recognition of revenue and assets.

BACKGROUND

The DTL manages 700,000 surface acres and approximately 2.6 million mineral acres that are currently treated as capital assets on the DTL's financial statements. An explanation of these real estate assets and how they were acquired is detailed below.

Grant Lands

The DTL, and the trusts it manages, were created at statehood when the Federal Government granted the State of North Dakota 3.2 million acres of land for the support of common schools and other purposes. These lands were granted to the state without cost, with the specific provision that the lands, and the proceeds generated from the sale or use therefrom, must be applied exclusively to the benefit of the common schools (or other trust beneficiaries). Over time, much of this land was sold. Today the DTL manages just over 700,000 acres of original grant lands (with mineral rights thereunder) and an additional 1.1 million acres of grant mineral rights that were severed from the grant surface acreage when the lands were sold.

An additional provision of the grants was that grant lands could not be sold for less than $10 per acre; hence the DTL has carried these lands, and the minerals thereunder, on its books as capital assets at $10 per acre for many years.
Sovereign Lands
These lands consist of the area below the high water mark of navigable rivers and other bodies of water. These lands were granted to each state under the federal equal footings doctrine. In North Dakota, these areas include the Missouri River, the Yellowstone River and Devils Lake. Sovereign lands are managed primarily for navigation, recreation, fish and wildlife and other public purposes. In North Dakota, the mineral rights under sovereign lands are managed by the DTL; until recently there was little ability to access these minerals. The DTL has identified 92,815 acres of sovereign lands, primarily mineral rights lying under the Missouri and Yellowstone Rivers, though more acres could be delineated under other waters.

Acquired Minerals Rights
These minerals rights were acquired by the state of North Dakota when either the Bank of North Dakota or the State Treasurer foreclosed on real estate loans made to farmers and ranchers during the 1900s. Sometime after the original foreclosure, the surface acreage was sold, but in accordance with state law, the minerals rights were retained by the state. These mineral rights were not acquired for the purpose of making money, they were acquired as a result of the state losing money on bad real estate loans. In 1977, the management of these mineral rights was turned over to the DTL. The DTL currently manages about 667,000 acres of mineral rights that were acquired as a result of these foreclosures.

COMMENTS ON EXPOSURE DRAFT
The DTL’s position is that this exposure draft does not apply to the land and mineral rights managed by the DTL. However, there are a number of concepts and ideas in the draft that warrant comments as to how difficult, costly and misinforming it would be to apply the concepts and ideas in this exposure draft to DTL managed land and mineral rights.

Valuation Techniques
The proposed Statement would require government entities to use valuation techniques that are appropriate and for which sufficient data are available.

The DTL participates in a yearly study of land values in North Dakota, and thus has a good approximation of the value of the 706,000 surface acres it manages. Valuing surface land can be accomplished rationally as there are comparable sales, income streams and rental transactions, etc. that provide information as to the value of that land. Valuing minerals in and under the ground is an educated guess at best, and the valuation methods outlined in the exposure draft don’t really apply.

In North Dakota, very few mineral rights currently exchange hands in arms-length transactions. Since oil was first discovered in North Dakota in the 1950s, sellers have generally reserved or retained mineral rights when selling their farm and ranch lands, so there are few comparable sales or other market based methods from which to estimate a value. The cost and income approaches also do not work well for mineral rights, as the present service capacity of mineral rights is unknown and in most cases, there is no income stream from the asset, or the current income stream does not reflect the ultimate income stream from the mineral rights (i.e. only the first of many wells has been drilled).

An individual or land trust may own mineral rights under a given tract of land, but until an entity with the financial resources and technical knowledge needed to drill a well and produce that oil is willing to take the risk to do so, the owner of those mineral rights has no way to exploit those minerals for financial gain. It is only through the sale or leasing of mineral rights that a mineral owner can truly recognize what a willing buyer will pay to get access to those minerals. In the case of the DTL, it is
only through leasing that a true value can be determined, as the DTL is banned by the state's constitution from selling minerals.

The DTL offers oil and gas mineral leases to successful bidders at quarterly public auctions. The lease gives the lessor the right to drill for oil for a five year period and produce oil from the lease for as long thereafter as commercial quantities are produced. As part of the auction, the DTL receives a bonus payment at the time a lease is issued that reflects what the lessor is willing to pay for the right to drill for those minerals; the mineral acres are not sold. This lease bonus is reflected in the DTL's financial statements as income when received and is the point that a value to those mineral rights should be recognized.

Once a lessor starts producing minerals from the lease, the DTL receives a royalty that is based on the value of minerals coming out of the ground. In the case of oil in North Dakota, that royalty rate is generally 1/8, 1/6 or 3/16 of the value of the production. The value of that oil can vary substantially based on when and where it is produced and sold. Recognizing the value of the oil after it comes out of the ground is the most accurate and timely method of recognizing the value of the mineral rights as they are being depleted.

Listed below are three examples of why valuing mineral rights at some sort of "fair value", while those minerals are still in the ground, does not make sense and can result in misleading financial statements.

• The United States Energy Information Administration (EIA) previously estimated that the Monterey shale formation in California could hold more oil than the Bakken formation in North Dakota. If a governmental entity had recognized the “fair value” of its mineral rights in the Monterey shale at that time, the value would have been quite high. However, the EIA recently reduced its estimate as to the amount of recoverable oil in the Monterey shale by 96%. If an entity had valued its mineral rights using the original estimate, the value of those assets (and income recognized) would have been grossly overstated by a factor 24. Considering the fact the DTL manages 2.5 million acres, the potential distortion of income and assets is huge. Recording huge swings in income and the estimated value of assets does not provide financial statement users with useful information; in fact, it would be misleading and confusing.

• On August 5, 2014, the DTL auctioned the right to drill for oil and gas on 21,332 acres of minerals in North Dakota. During that lease auction bidders were willing to pay anywhere from $1 per acre to $9,500 per acre for the right to drill for oil on any given tract. In fact, in one case there were two tracts located less than two miles apart. One leased for a bonus of $110 per acre, the other leased for a bonus of $725 per acre. Valuing mineral rights is very location specific, and even then, the values that a willing buyer might pay can vary substantially and cannot be known until an auction confirms that value.

• Prior to leasing, the DTL has the right to 100% of the mineral rights associated with a given tract. If the DTL had the financial means, the willingness to assume the risk and the technical knowledge to drill a well and produce those mineral rights, the DTL would receive 100% of the value of oil that comes out of the ground. However, the DTL does not have the wherewithal or desire to produce those mineral rights and instead gives up the majority (7/8, 5/6 or 13/16) of the value of the oil in the ground to the entity that is willing to take on the risk and cost of drilling a well. This raises the question; what is the proper value of these mineral rights for financial purposes?

Highest and Best Use
The proposed Statement states that “fair value” measurement should take into account the highest and best use of a nonfinancial asset. This may make sense in the context of many assets, but in the case of grant lands, it does not. The North Dakota Constitution restricts the use of original grant
lands to grazing and meadow uses; other states have similar restrictions as to how grant lands can or cannot be used. Thus even if the land has potential for farming, commercial development or some other higher use, the DTL cannot use the land for that purpose. It does not make sense to value something based on its highest and best use when it cannot be used for that purpose nor generate the hypothetical revenue steam that higher use would provide.

Definition of an Investment
The DTL agrees that the intent of the governmental entity when acquiring an asset should continue to be a driving force in the definition of an investment. This principle is outlined in GASB Statement 31 and appears to be affirmed in paragraph 66 of the exposure draft.

WHY PROPOSED STATEMENT DOES NOT APPLY TO DTL LAND/MINERAL RIGHTS

There are numerous arguments that can be made as to why the proposed Statement does not apply to DTL managed grant lands, sovereign lands and acquired mineral rights. I have detailed some of those arguments below.

Grant Lands
At the present time, GASB 52, paragraph 2, specifically exempts grant lands from being treated as an investment. I see nothing in the proposed exposure draft that removes this exemption and so assume it will stay in place. Even if this exemption is removed from GASB 52, grant lands would still be exempt from the proposed Statement as they do not meet the definition of an investment, as these lands and minerals were not acquired for investment purposes.

GASB 34 specifically states that land is a capital asset and that intangible assets are also to be considered capital assets. Capital assets are required to be valued at historical cost. Grant lands, and the minerals thereunder, are valued in the DTL's financial statements as a capital asset at a value of $10 per acre, the minimum amount for which they can be sold by law. This seems to meet the criteria of GASB 34.

Finally when it comes to grant lands, the present service capacity is not based solely on the ability of the grant lands to generate income. Grant lands are open to hunting and other public recreation purposes; the Board has historically recognized the public's right to enjoy these lands for recreation purposes. If the Board's sole reason for owning these land assets was income generation, more of it would have been sold.

Sovereign Lands
The minerals managed by the DTL that are located under sovereign lands also were not acquired as an investment. Sovereign minerals were acquired as part of the process where the Federal government gave the major waterways in a state to the state in order to manage commerce and navigation. Thus, they are related to another government function, the service capacity of which is not based solely on the ability to generate income.

In addition, GASB 51 states that mineral rights are an intangible asset. In accordance with GASB 34, intangible assets are to be valued at historic cost. Because there was no cost in acquiring the minerals under sovereign bodies of water, that cost basis is $0.

Acquired Mineral Rights
The mineral rights managed by the DTL that were acquired by the state as a result of foreclosure on nonperforming loans were not acquired with the intent on earning revenue; they were acquired as a result of a governmental farm loan program. According to GASB, program related assets are not investments that need to be valued at fair value.
In addition, GASB 51 states that minerals are intangible assets that should be classified as a capital asset and valued at historic cost. The entire cost basis of the foreclosed properties was assigned to the surface estate of a property when it was sold back into private hands. Thus, the cost basis of the minerals rights that were transferred to the DTL to manage in 1977 is $0.

CONCLUSION

Thank you for the opportunity to comment on the Fair Value Measurement and Application exposure draft and how it could impact lands and minerals managed by the DTL and similar agencies in other states. We also appreciate the opportunity to explain why grant and other state owned surface lands and minerals managed by the DTL are not subject to the provisions of the proposed Statement.

The problem with trying to determine a “fair value” of mineral rights in the ground is that although estimates can be made, they are not reliable or accurate and they are subject to huge swings based on revised production estimates, federal regulation and the price of oil. Including an estimated value of minerals in the ground as an investment on the DTL’s financial statements would be a costly and time consuming process that would result in a valuation that grossly distorts the value and the earning capacity of the trust funds managed by the DTL.

The mineral industry, state trusts, and the federal government have an established method of recognizing the value of minerals (and the production thereof) that has worked for many years. The method provides for accurate measurement of the value of mineral rights, both while in the ground (lease bonus) and while being produced (royalty). There is no reason to complicate and distort this method of value recognition in order to provide financial statement readers what would very likely be inaccurate or even misleading financial information.

If you have any questions or would like to discuss this topic/issue in more detail, please feel free to contact me at 701-328-2800.

Sincerely,

Jeff Engleson, CPA
Deputy Commissioner and CIO