**Funding Approaches for long-Term Property Management**

**Notes from Tim Dicintio, National Fish and Wildlife Foundation**

**Primary Objective**

A discussion of the issues around *funding* for long-term (or perpetual) property management

■ Management plan → specific tasks

■ Specific tasks → itemized costs

■ Itemized costs → up-front funding need

Key Issues

■ Why up-front planning and modeling are important

■ Options for legal structure of funding mechanism

■ How to size the initial amount of the fund:

Cap Rate, investing, and spending

■ Ongoing operational rules of the fund

**Importance of Up-Front Planning and Modeling**

1. Whatever long-term funding approach is selected, it will be expected to “perform” for an indefinite period of time, perhaps in perpetuity.
2. Legal or regulatory options for returning to the payor for additional funds – if a long-term mechanism turns out to be insufficient – are likely limited.
3. The average lifespan of U.S. companies is estimated in the range of 10-25 years, suggesting that the up-front mechanism is likely to be the only resource as a  
   practical matter.
4. The bottom line: invest time at the outset to ensure  
   the selected approach is appropriately funded,  
   secure, and likely to endure over the long term.

**Legal Structures of Funding Mechanisms**

1. Most entail the deposit of funds into an account dedicated  
   to paying the costs of long-term management.
   * Trust Accounts
   * Escrow Accounts
   * “Endowments”
2. Key goals:
   * Ensurethefunds are legally restricted to the purposes and property for which they were extracted, consistent with applicable law, regulation, and permitting documents
   * Ensure the mechanism used to manage the funds is based on legal, financial, and operational principles that provide   
     the mechanism a strong statistical chance of  
     persisting indefinitely

**Implications of Different Legal Structures**

1. Whatever structure is selected and approved for the long-term stewardship fund should be memorialized in appropriate documentation.
2. Permitting agencies should consider the level of ongoing  
   oversight rights they need to retain to ensure the funds  
   are being managed and spent appropriately.
3. Whether the funds are “being managed and spent appropriately” will likely be measured by reference to:
   * The underlying laws pursuant to which the funds were extracted (e.g., ESA, CWA)
   * Accompanying regulations, policies, and guidance
   * The terms of the permit(s) that required the funds
   * “Background” law, e.g., contract law, trust law, fiduciary law, etc.
4. Remember: the *legal and accounting* treatment  
   of the funds matters!

**Sizing the Initial Amount of the Fund**

1. Long-term management plans should include a description  
   of the annual work items and cost estimates for those items.
2. This is often accomplished through different types of “property analyses.”
3. The accuracy of both the work items and the estimated costs presented in a property analysis is critical to the accuracy of  
   the up-front funding calculation.
4. The relationship of the annual cash need for management tasks to the initial amount of the fund is often expressed in terms of a “capitalization rate,” or Cap Rate.
5. Specifically, the Cap Rate is the percentage of the  
   fund necessary to be drawn each year to meet  
   the annual cash need.

**Understanding the Cap Rate:  
How the Cap Rate Drives the Initial Amount of the Fund**

1. As a formula:  
    Cap Rate x Initial Amount = Annual Cash Need
2. To solve for the Endowment Amount, the formula is:  
    Annual Cash Need ÷ Cap Rate = Initial Amount
3. So by selecting a particular Cap Rate, the initial amount can be calculated from the annual land management costs necessary for the property at issue.
4. Example: for a property requiring $20,000/ year for land management tasks, if a Cap Rate of 3.25% were applied, the calculation would be:   
    $20,000 ÷ 0.0325 = $615,385

**Understanding the Cap Rate:  
Consequences of Different Rates**

1. Inherent in the calculation is that the lower the Cap Rate,  
   the higher the necessary initial amount.
2. Why does this matter?
3. Example:

|  |  |  |
| --- | --- | --- |
| Annual Cash Need | Cap Rate | Initial Amount of Fund |
| $20,000 | 7% | $285,714 |
| $20,000 | 5% | $400,000 |
| $20,000 | 3% | $666,667 |
| $20,000 | 1% | $2,000,000 |
| $20,000 | 0.5% | $4,000,000 |

**Selecting the Cap Rate:  
Relationship to Investment Strategy**

1. The Cap Rate reflects the net amount of gain that the  
   portfolio must realize each year (on average) to meet  
   the cash requirement for management costs.
2. “Net” in this sense is not only net of fees (investment manager and other administrative), but also net of inflation.
3. Assuming administrative fees at 1% and inflation at 3.0%, the fund must be projected to return on average 4% annually *before* introduction of *any* Cap Rate.
4. For example, a Cap Rate of 3.25% would require average  
   “nominal” annual returns of 7.25% over time, and therefore  
   an investment strategy that is tailored appropriately  
   to this target.

**The Cap Rate and Investment Strategies**

1. In approving banking instruments and other permitting  
   documents, agencies make implicit or explicit determinations  
   as to whether a particular Cap Rate is acceptable.
2. Whatever Cap Rate is approved, agencies should ensure that it is supported by a suitable underlying investment strategy.
3. For example, Cap Rates in the range of 3-4% would require investment strategies expected to return, on average, 7-8% annually.
4. In turn, target returns in the range of 7-8% (which align with the current return targets of many defined-benefit and endowment funds nationally) would necessitate diversified asset allocations within the corresponding investment portfolios.
5. The characteristics of the portfolio, driven by the Cap  
   Rate, should be reflected in a written Investment   
   Policy Statement applicable to the portfolio.

**Competing Interests in the  
Selection of a Cap Rate**

1. Agencies generally attempt to balance two primary competing factors in evaluating any proposed Cap Rate:
   1. On one hand, applying a lower Cap Rate increases the  
      statistical likelihood of successful funding in perpetuity;
   2. On the other hand, allowing the use of a higher Cap Rate decreases the amount that must be paid up front,  
      and thus is often advocated by payors (permittees).
2. These competing factors reflect the risk-reward calculus inherent in determining the appropriate initial amount to be funded into a long-term stewardship account.

**Cap Rate, Investing, and Spending**

1. Most Cap Rates will require diversified portfolios.
2. Diversified portfolios are not “principal and interest” portfolios!
3. References to “principal and income” or “non-wasting” or “historic dollar value” funds are obsolete.
4. Not to worry - this is consistent with modern “prudent investor” and endowment law, such as the Uniform Prudent Management of Institutional Funds Act (“UPMIFA”).
   * UPMIFA has been enacted in 49 of the 50 states (not PA)
   * UPMIFA incorporates a general standard of prudent spending  
     measured against the purpose of the fund, and invites consideration of a wide array of other factors
5. Most long-term stewardship fund modeling assumes the annual  
   cash need *will* be disbursed, regardless of fund balance  
   or performance over any arbitrary period of time.

**Spending Plans and Ongoing Operational Rules**

1. Common approach to spending allowed by agencies:
   1. Presumption that the annual amount needed for work specified  
      by the property analysis will be disbursed in advance each year  
      to fund the necessary work.
   2. Requiring (or approving) an initial fund amount and an investment strategy that are designed to create a high statistical likelihood that  
      the necessary annual spending will be sustainable over a very long  
      period of time, potentially in perpetuity, without the availability of   
      any additional “outside” funding.
   3. In this sense the long-term management funds are more  
      analogous to defined-benefit plans (e.g., pensions) than true endowments.
2. Agencies may also require various “buffering  
   mechanisms” or fail-safes in conjunction with  
   the above approach.
3. Common buffering or fail-safe mechanisms:
   1. Require several years’ worth of initial annual funding (“I and C”)  
      in order to allow the long-term fund to mature.
   2. Require certain minimum contingency line items in the property analysis.
   3. Do not allow incremental disbursement of funds for non-annual   
      activities modeled in the property analysis (i.e., allow only the full  
      draw in the year needed).
   4. Retain ability to suspend or reduce disbursements in certain  
      extreme circumstances, e.g., prolonged contraction in   
      financial and investments markets.
   5. Develop early consultation process with affected land managers  
      to determine draws against the fund in “negative value”  
      years or unforeseen/extreme investment climates.

**Case Study:  
California Renewable Energy Action Team**

1. REAT is comprised of US FWS, BLM, CDFW, and CEC
2. Coordinated permitting approach to renewable energy development in the Mojave and Colorado deserts in CA
3. REAT developed an MOA with NFWF through which NFWF is one potential option for administration of mitigation funds
4. Among several types of mitigation funds contemplated by the MOA are long-term land stewardship or “endowment” funds
5. Key questions addressed in REAT-NFWF process to develop a system for mitigation endowment funds:
   1. Who is responsible for determining what long-term management activities are required on the property over time?
   2. How will line-item costs be developed for those activities?
   3. What is the agencies’ risk tolerance for investment of funds,   
      and therefore the “expected return” that drives a Cap Rate?
   4. What are the general rules around annual disbursement   
      of funds to long-term property managers?
   5. What are the agencies’ rights and responsibilities with   
      respect to ongoing monitoring of the stewardship   
      work, the “endowment,” the long-term property   
      manager, and NFWF?

**Recent Developments:  
California Senate Bills 436 and 1094**

1. SB 436, which addressed mitigation endowment management in California, took effect in 2012
2. SB 436 was subsequently amended by SB 1094,   
   which took effect in 2013
3. Both bills specified rules for:
   1. What entities are eligible to hold mitigation endowments
   2. What standards and obligations apply to holders
4. Key point for federal permitting agencies: be aware of the impact of state laws on funding for long-term mitigation land management!

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