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IN THIS ISSUE

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The New Zealand Valuers' Journal is the official publication of the New Zealand Institute of Valuers. The focus of the Journal is to publish researched articles on valuation, property investment and related matters, and to encourage the investigation and expansion of the frontiers of knowledge that cover such fields. It seeks to publish reports of decisions of hearings of tribunals, courts, and arbitrations of special relevance to the profession.

The New Zealand Institute of Valuers has a special interest in scholarly research that can be useful in property valuation and development, finance, investment, property management and market analysis, real estate and the valuation of plant. The Editorial Board is willing to work with any potential author who is developing new and exciting ideas.

Articles and correspondence for the New Zealand Valuers' Journal should be submitted to the Editor at the following address:

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All contributions should be typewritten and accompanied by a biographical note of the author. The Editor reserves the right to accept, decline or modify material. Views expressed by the editors and contributors are not necessarily endorsed by the New Zealand Institute of Valuers. Copies of manuscript should be retained by the author as they cannot be returned. Deadline: two months prior. Each manuscript submitted will be reviewed by the Editor to evaluate its appropriateness for the Journal and assigned anonymously for review by two or more referees. Complete editorial policy review process and style instructions are available from the editor. Business letters, subscriptions and advice of changed address should be sent to the General Secretary. The mode of citation of this volume of *The New Zealand Valuers' Journal* is (1993) N.Z.V.J. March page.

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Redefining what has been lost

he Government has announced, T through the Earthquake and War Damage Commission (EQC), the final details of changes to disaster insurance in New Zealand. From 1 January this year EQC will be progressively reducing its exposure to commercial property insurance cover. This will be achieved by only accepting applications for earthquake insurance to a limit of 75% of indemnity of commercial property during 1993, reducing to only 50% of indemnity value in 1994 and then to 25% of indemnity value in 1995. No applications for commercial property insurance will be accepted by EQC after 31 December 1995.

These changes will have significant effects for some commercial property owners and occupiers as they are forced to turn to the private insurance market for cover. Earthquake cover is apparently quite difficult to arrange currently on world markets and commercial properties situated in earthquake prone locations such as Wellington and particularly buildings which do not meet current seismic standards may prove to be virtually uninsurable.

Private sector insurance companies have always carried a significant proportion of disaster insurance risk as the EQC liability has previously been limited to the indemnity value only of the insured property., Any difference to make up to full reinstatement value has been at the direct risk of insurance companies.

However most insurance companies have in recent years sought to limit their exposure to risk by introducing artificial ratios whereby they would not accept full reinstatementinsurance applications for commercial property where the indemnity value was less than 25% of the assessed cost of reinstatement. But under this new insurance regime it is expected that insurance companies will be forced to focus much more closely on the actual risk that each particular property represents and buildings likely to be heavily damaged in earthquake prone locations must incur higher premium costs or even become uninsurable.

Consequently these changes represent a radical departure from the disaster insurance scheme that has been available in New Zealand for about 50 years since the introduction of the Earthquake and War Damage Act.

That Act had the intention of providing availability of disaster insurance for most properties in New Zealand at a uniform rate of annual premium. But like most other schemes with a perceived social welfare basis the "user pays" attitude to economic thinking has now prevailed and some of the users are going to be left to suffer the consequences in the future. There can be no doubt that the existing scheme needed considerable review and change, but there can be no claim of undue cynicism when the suggestion is made that the most pressing reason for change has been brought about by the extent to which the existing scheme has been mismanaged and stripped over a long period of years.

Contrary to some earlier expression of opinion, the changes in the Earthquake and War Damage Act will require, it seems a significantly clarified definition of "indemnity" value as this value component is going to become increasingly important in the phase-out period of the next three years.

It is suggested that the definition of "indemnity" value provide on the present New Zealand Institute of Valuers reinstatement insurance form is far from adequate and much too open-ended to fit the expected future circumstances during the EQC phase-out period.

To keep EQC insurance exposure within predictable bounds it would seem necessary that "indemnity" value will need to be redefined. The redefinition will need to be more in line with market value concepts so that "indemnity" value will have a basis capable of subsequent examination. Difficulties will arise, of course, with all classes of property for which there is not an established market, but clear guidelines could be determined for a depreciated replacement cost basis of value using specified building cost indices and specified rates of depreciation according to age, condition and mode of construction for these types of properties.

If a market related basis for "indemnity" value is adopted the next question to arise will undoubtedly be Who is qualified to provide such certification? It seems obvious that many of those professionals currently providing certification will neither have sufficient knowledge of property markets nor assessment skills to complete competent market-based valuations. Accordingly itis suggested thatonlyregisteredvaluers will have the necessary qualifications, skills and experience to satisfactorily complete the task.

As has already been suggested, the clarification and redefinition of "indemnity" value will become of increasing importance for the period of three years that it will take for the EQC commercial property disaster insurance policy to be completed. It is to be hoped that if such redefinition is adopted, it will be suitable to remain effective in valuation terms for some considerable time in the future. To continue to be effective, the redefinition will need to cross-reference and dove-tail accurately with all future property insurance policies and existing policies where appropriate.

It seems likely that as the prop presently provided for disaster insurance for commercial properties in New Zealand is progressively removed, there will arise a significantly greater demand for "indemnity" insurance cover. An accurate and reliable definition of that value will help immeasurably in satisfying the requirements of both the insured and their chosen insurer.

Trevor J Croot.

EQC to Phase Out Commercial Property Cover

In 1993 EQC will begin phasing out its provision of insurance cover for commercial property. EQC Chairman Ian McLean said that from 1 January 1993, commercial property, including buildings, contents, plant and stock will no longer be automatically covered by EQC when owners take out fire insurance.

Owners with fire insurance current at 31 December 1992 will keep their current EQC cover until the fire insurance expires, or ceases to apply to the property, or 31 December 1993, whichever comes first.

Mr McLean emphasised that these changes affect commercial property owners only; they do not affect dwellings or property used, for example, for sporting, community, recreational, charitable or religious purposes.

EQC will still make available on application earthquake insurance cover up to 75% of indemnity value when fire insurance policies are taken out or renewed during 1993 for commercial property.

The level of EQC cover will reduce to 50% for fine insurance taken out or renewed in 1994, and to 25% in 1995.

At present most commercial property owners get top-up earthquake cover from their insurance company. From 1993 the top-up will need to increase for commercial property.

Mr McLean said commercial property owners must apply forEQC cover through the insurance company that provides their fire insurance. "New Zealand-based insurance companies will be aware of these changes and how they apply to their clients. People insuring with overseas insurance companies should contact EQC or their broker for advice."

EQC earthquake insurance cover on dwellings (unchanged now) will continue until a bill is passed by Parliament and then on a slightly different basis. A

NZIV Young Professional Valuer of the Year Award

The "New Zealand Institute of Valuers Young Professional Valuer of the Year Award: is to be implemented with effect from 1 January 1993 with nominations called for by December 1993 for conferring of the Award in 1994.

ELIGIBILITY CRITERIA

1. Members or Affiliates of the Institute aged 30 years or less shall be eligible.
2. The criteria for the Award is:
   - a) Significant professional participation within the NZIV, or
   - b) Original research of outstanding significance; or
   - c) Original authorship of outstanding significance;
     and
   - d) i) outstanding technical and/or professional excellence; or
     ii) significant contribution to the community that brings credit to the Profession.

   The research or authorship shall be available to the Editor of the NZVJ for publication at the Board's discretion.
3. There will be only one national award each year, and this shall only be conferred if the candidate is worthy of the award and shall not be automatic.
4. The award shall comprise the presentation of an appropriate "certificate" and the full expenses for the awardee to attend the NZIV AGM and National Seminar, at which the award will be presented.
5. Initial selection shall be at local Branch level with final selection being by a national award panel comprising chairmen of the Institute' Promotions Committee, Education Board, Editorial Board and President.
6. Nominations may come from any sector within the profession or outside (eg Branch committees, Councillors, employers, community service groups etc) but may not be by application from prospective awardees.

Nominations to be forwarded to NZIV's Chief Executive Officer by 30 November each year at P 0 Box 27-146 Wellington New Zealand endorsed "Application for Young Professional Valuer of the Year Award".

Advice of the availability of the Award will be published in the NZVJ and Valuers NewsLine, by way of advice to all members, in the first issue of the Journal and NewsLine each year. Members are encouraged to advise their employers of the award, and to assist employers with nominations the NZIV has prepared an information kit to aid them in making nominations for the award.

John Gibson
Chief Executive Officer

Effect of Environmental Factors and Pollution

TIAVSC Information Paper No 11

The Standards Committee ofNZIVhas been holding discussions with major lending institutions regarding lenders potential requirements of valuers in reporting standards and investigative analysis for valuations of properties where environmental issues are a factor. There is an international realisation amongst lenders that some adverse environmental factors can affect lending security and the valuer's'role in reporting on relevant factors has become an issue in some countries. The International Assets *Valuation* Standards *Committee (TIAVSC) has produced the following discussion paper and Guidance Note on the subject.*

The Standards Committee of NZIV is anxious to open debate on these matters amongst valuers and readers. Communication should be directed to the Standards *Committee, NZIV Cl o The General Secretary, PO Box 27-146 Wellington.*

1. Many environmental factors and forms of pollution are already taken into account in the preparation of asset valuations. Where environmental factors or pollution particularly affect a property, they may impact directly on the Valuer's consideration of the appropriate figure to be reported. (See Appendix, para 1.5.)
2. Where a problem is identified by normal diligence, it is the Valuer's responsibility to provide a valuation in which the nature, extent and result of inquiry mustbe disclosed, whetherbased on the Valuer's research or an external environmental audit. There is also a positive responsibility on the Valuer to recommend that a detailed environmental audit be carried out where initial research identifies a problem or a potential problem. (See Appendix, para 2 and Information Paper No 9, para 2.1.)
3. In many cases, it will not be within the Valuer's competence to calculate the costs and means of dealing with specialist areas of environmental pollution. In those cases where such potential problems can be identified, the Valuer shouldrecommendanenvironmentalaudit as a precursor to the valuation report.

4.Valuation Principles

4.1 The reported asset valuation should be assessed having regard to careful analysis of market data, particularly in those cases where it is not possible to eradicate or modify the effects of pollution. A particular property may have such inherent advantages that adverse environmental factors, which would severely impact on similar properties in other areas, have no effect upon it.

4.2 In those cases where environmental factors affect all properties in a particular area equally, it may be inappropriate to make any further allowance.

4.3 The reduction in value attributable to pollution is generally measurable using the same methods and techniques that are used to measure loss in value or depreciation from other causes.For example, the cost of toxic waste clean-up may be likened to "cost to cure" in properties suffering from curable obsolescence. Valuers should, however, bear in mind that the market value of a property after remedial works, less the cost of such works, may for various reasons be either greater or less than the mathematical sum.

4.4 Costs (subject to any available grants or other financial incentives) to be taken into account by the Valuer include:

a) clean-up of on-site accommodation;
b) effective pollution control and management measures;
c) re-design of production facilities;
d) penalties and civil liabilities for non-compliance; and
e) indemnity insurance for the future.

4.5 The Valuer should consider whether:

a) the source of the pollution or hazard can be successfully and economically eliminated;
b) the pollution or hazard cannot be entirely eliminated but can be covered or contained so as to make the property fit for a particular use for a specified, perhaps limited, period;
c) it is possible to mitigate the pollution or hazard in any way; or
d) the pollution or hazard has no effect on the market value of the property. Where necessary the V aluer may need to take expert advice.

4.6 In those cases, however, where it may be possible to eliminate the source, or rectify the effects, of the pollution or hazard, the reported asset valuation may be assessed taking into account the market's view of the relevant estimated costs of such elimination orrectification togetherwith other influences affecting market value, such as:

a) inability to effect a total "cure";
b) stigma;
c) the risk of recurrence;
d compensation for disturbance to the enjoyment of the property; and
e) risk of legislation/remedial standards changing.

5. Furthercommenton factors which may be considered in assessing value are set out in the Appendix below.

Appendix to IP No I I

Consideration of Environmental Factors and Pollution in the Valuation Process

1. Introduction

1.1 There is an increasing awareness that human activities affect the environment with resultant effects on human life, ecosystems and the use and productivity of land. Such factors may directly affect the value of fixed assets and raise important considerations for Valuers regarding environmental factors and pollution, whetheractual orpotential.

1.2 The term "pollution" has been adopted in this Appendix to cover all forms of pollution and adverse environmental fac tors.

1.3 The following factors can affect perceptions of the importance of pollution:

a) the state of knowledge at any time of the influence upon human health and well-being of a particular form of pollution;
b) the effect of and changes in

legislation relating to particular pollution; and

c) the knowledge that futuretechnological change may fundamentally alter the potential uses of land and buildings currently affected by pollution.

1.4 As a matter of common practice many factors are taken into account in property valuations. These include both environmental and non-environmental factors, such as:

a) ecological, pedological and climatic factors such as acidrain,deforestation and overgrazing, and

b) economic, social and aesthetic factors such as population changes, noise and unsympathetic new development.

1.5 There are additional environmental factors which Valuers may need to take into special consideration. Examples, which are not exhaustive, are as follows:

1.5.1 Chemical Pollution

a) Atmospheric pollution resulting from smoke, toxic gases, dust, radioactive materials and other causes.

b) Agricultural pollution which affects the suitability of land for cultivation and growing and may also render land unsuitable for development. Examples include liquid and solid wastes from farming (eg run-off from pesticides, fungicides, fertilisers (nitrates) and feedlots), erosion and dust from ploughing, animal manure and carcasses, crop residues and debris.

c) Water pollution from industrial wastes and nitrates which, without expensive purification processes, can render water unsuitable for human or animal consumption. The irrigation of farmland by rivers subjected to pollution from industrial pollutants can result in desertification of otherwise fertile land.

d) Metallic elements (like mercury, chromium, cadmium, zinc, arsenic and lead) with high molecular weights can damage living things at low concentrations and tend to accumulate in the food chain.

e) PCB's (Polychlorinated Biphenyls) - a group of potentially highly toxic, persistent chemicals used in electrical transformers andcapacitors.

f) Petroleum products leaking from defective storage tanks.

1.5.2 Asbestos

A naturally occurring mineral fibre which is mechanically strong and highly resistant to heat, acid, alkali and chemical attack. Because of its special nature it has been widely used in the building industry for many years. Although scientifically established connections are not yet proven beyond doubt, it is now generally accepted that serious disease can arise from theinhalationofsomeasbestosfibres.

1.5.3 Radiation

The emission of high-energy particles or rays by the nucleus of an atom, which can cause cellular changes in the living things. Accidents affecting nuclear reactors, in which uncontrolled radiation emissions escape into the atmosphere, can have far reaching consequences, possibly with long-term effects on land and property values.

2.Recommended approach

The following recommendations are proposed in the case of any suspicion, indication or sign of pollution.

2.1 The Valuer should check whether either client or advisers have any knowledge of or reason to suspect that any forms of pollution affect the property or have done so in the past.

2.2 The Valuer may need to ensure that the nature of the appointment and responsibilities to the client would not compromise any legal, statutory or ethical duty which may be owed to third parties. For example, in some States it may be necessary, prior to accepting an instruction where a pollution hazard may be discovered, to ensure the client is aware of both the client's and the Valuer's obligation to report the discovery of a hazard to the appropriate government or local agency.

2.3 Where any such pollution is not within the experience and competence of the Valuer, the client should be advised to obtain technical advice. The completion of the valuation would then require association with or the retention of others who possess the required knowledge and experience. Such reliance on professional reports prepared by others who are reasonably believed to have the necessary knowledge and experience, is addressed in Information Paper No 9.

2.4 The technical expert's report should

a) record the use history of the site;

b) identify the hazard, its degree and extent;

c) identify its effect or likely effect upon the property;

d) advise on improvement measures to be taken or works to be done to return the property to an acceptable condition;

e) advise on the likely costof such measures; and

f) advise on the most probable results and effects of any work undertaken.

2.5 Where, after reasonable investigation, there is no reason to suspect that the property is affectedby pollution the Valuer should, in appropriate cases, include in the report a statement that the Valuer neither observed nor was otherwise made aware of any pollution affecting the property, at the same time clarifying the normal limits of the valuation process.

2.6 Consideration mustalso be given to the need to report alternative use values, particularly for those properties which, in their existing use, may not be so adversely affected by the pollution.

2.7 The basis of valuation should be market value (as set out in AVS No 2) or depreciated replacement cost (AVS No 3). In exceptional circumstances it may be necessary, in order to advise fully upon the potential value of a property, to report an additional valuation on a special assumption. This maybedefined as an assumption which, in the actual circumstances prevailing in the market at the time of the valuation, could not reasonably be expected by the Valuer to be made by a prospective purchaser.

3. Special Considerations

3.1 The proliferation of legislation relating to pollution can have a significant effect upon valuation. The increasing awareness ofgovernmentstotheproblemsofpollution in its various forms is leading to a stricter control of environmental pollution from industrial, domestic and agricultural operations. Some pollution, although of a long-term nature, and apparently of no immediate impact on property values, can become the target of future legislation. This legislation may limitthe working life of commercial and industrial operations. Even in those cases where there is no apparent immediate effect upon valuation,itmaybeappropnatetoincludeanote within the Valuation Certificate drawing attention to the potential consequences. The Valuer, when required to carry out valuations of the assets of an industrial undertaking, should verify carefully the anticipated future useful life of a plant susceptible to anti-pollution measures.

3.2 The introduction of environmental safeguards may result in an enhance value of operational facilities which are situated outside areas of special land use controls. This enhance value, deriving from a reduction in the supply of such available plant and buildings, may result in a supervalue of a temporary nature to which the Valuer should draw the attention of the Directors. A

The Future of Our Profession

A review of the Dribble Report to NZIV Council

by I W Dribble

When a report is completed for an organisation, it is usually given a name so it can be filed in the library and possibly forgotten about. It usually has the name of the topic, however John Gibson in his wisdom chose to call the report that was prepared by a sub committee under my Chairmanship the "Gribble" report. So if you are wanting a copy of what our committee had to say, visit the Institute's office library and look under "G".

This paper was presented to the NZIV Wellington Branch seminar held d"i Wellington on 1 October 1992, Ian Gribble is a Fellow of the New Zealand Institute of Valuers and is Councillorfor the Auckland Branch. He is a director of Robertson Young Telfer (Northern) Ltd, practising in Auckland

In November 1991, the Executive of the Institute through the General Secretary appointed a small subcommittee of five under my chairmanship as Branch Councillor for Auckland. Other members of the subcommittee were Rodney Jefferies, immediate past president, Len Green practising valuer from Tauranga, John Hudson practising valuer from Whangerei and John Dunckley a practising valuer from Otago. Secretary support was provided by John Gibson.

As noted, in November 1992 we were asked to "Review the NZIV Rules and Valuers Act (only as it impacts upon the rules) to accommodate:

- Compulsory Continuing Professional Development (CCPD);
- widening membership base of NZIV;
- review membership status;
- name of NZIV;
- functions of NZIV;
- such other matters as the Committee considers pertinent for a vibrant dynamic profession for the next decade in 21st century.

Ask the impossible!

The main problem, other than what had to be done, was the requirement to report to Executive in January 1992. John Gibson kindly added the right of an extension into February if required.

It was surprising to hear at our first meeting in December the degree of agreement in relation to most of the matters discussed, the geographical spread not introducing too many variations in the thought patterns.

The Institute had of course prepared a leaflet entitled "Toward the 21st Century" which set out, distinctly, the role of the New Zealand Institute of Valuers as well as where it stood in relation to deregulation and where it saw the future. We had, I guess in part, been indoctrinated.

When considering the future of the profession, deregulation, whether it be of the profession or the industry, is the key to which way the Institute and its members will move. The Committee ended up preparing two reports, one of the basis of Professional Deregulation, but Industry Regulation, and the second Continued Total Regulation of both the Profession and Industry. The third alternative of total deregulation, ie of both the industry and the profession, was not considered to any great extent as it was considered that this was an unlikely scenario, and not in the best interests of the public, members of the industry, and possibly the legislators.

It was accepted that the preference of members was for continued compulsory membership, however the subcommittee considered that the most likely happening was the deregulation of the profession with continued industry regulation, this meaning the Valuers Act would remain providing for registration of valuers, but the New Zealand Institute of Valuers would not retain the protection of being a statutory body incorporated under the Valuers Act 1948 and as such registered valuers would have the right to associate with whoever they wished (voluntary membership of the New Zealand Institute of Valuers).

Under this criteria, which we believe is the most likely, what c hanges are needed in order for the profession to progress.

Of all the issues discussed, there were six main recommendations within the report, four of which will be expanded later.

The unanimous recommendations of our subcommittee were that:

- A wider membership base be pursued.
- The name change to "The Property Valuation Institute" be pursued;
- Entry into the new group should be by specific conditions otherthan narrowly constrained.
- Council seek amendments to the Valuers Act 1948 to implement:
  - CPD;
  - the name change;
  - the wider membership base.

This was under two specific scenarios being professional deregulation/industry regulation or remaining as a statutory body but with widened membership of "Real and Personal Property Valuers".

- Members of the (new) Institute who offer a service to the public must be required to hold a minimum level of professional indemnity insurance.
- The Presidential triumvirate embark on a programme of branch visitations to speak on the issues of widening membership base, CPD/APC linkage, professional consultancy, etc to encourage debate and assist membership understanding of the issues.

Our final recommendation was that Council pursues scenario 1 which was described as "Professional Deregulation", and "Industry Regulation". If for any reason that this was considered unsuitable by Council, our recommendation was to Scenario 2, which provided for widening of the basic membership of the New

Zealand Institute of Valuers, but remaining as a statutory body incorporated under the Valuer's Act 1948 (ie compulsory membership of registered valuers). Our committee did not support, and we were aware the NZIV Council and general membership do not support, total deregulation of the valuation industry and profession.

Under each scenario, the subcommittee considered all changes which were required to the Valuers Act 1948 as well as consequential changes to the rules of the New Zealand Institute of Valuers (Property Valuation Institute).

At the Council meeting in Gisborne in April 1992, the report was fully discussed in a forum session where all matters were considered by Councillors.

Later in the Council meeting, the rep ort was received. After discussion, Council expressed a preference for Scenario 1 and if that were not possible, it adopted Scenario 2 subject to specifying changes where impracticable to be implemented.

Council then agreed to revisit the report once the outcome of the merger discussions had been clarified. The report was then adopted as a consultative document by Council to be kept under review as a guide to Council on important policy issues. The Education board were to progress the CPD issues whilst the subcommittee was to further consider changes to the rules of the NZIV.

Future Goals

The subcommittee saw the NZIV as being a "self-governing, non-statutory group of professionally qualified persons who value, appraise, advise, consult, manage, arbitrate and negotiate in all respects of land, buildings and other real and personal assets." Also that the NZIV should exist with a set of rules, independent of any state Certifications/Registration Board or system.

What we were saying here was that we should be able to survive without compulsory membership as is now stipulated in the Valuers Act.

We believe that with the mood of the Government, we must prepare ourselves for this probability. We also saw no difficulties in being a voluntary organisation which, as part of our membership base, incorporated registered valuers, registered through a Registration Board/State Certification Board etc.

This took us on to the membership base. We did discuss the possible professional merger between the New Zealand Society of Farm Management, Property Management Institute and the New Zealand Institute of Valuers, but finally 'believed that this was outside our brief and wasby no means clear cut. Howeveras we have taken on board, as affiliate members, plant and machinery valuers, we considered that this could well be extended to other valuers of personal property. In this way, part of the institute membership would be "registered land and building valuers" and some unregistered either as land and building valuers or personal property valuers.

This carried through to the name of the institute which we believe should retain "valuation in its title, but be widened to incorporate all types of property, not restricting it solely to land and building valuers. This would make other members feel more at home with the name, would be moving with the times, and at the same time we would be pushing the name property, as our members are involved in more than just valuations.

The subcommittee felt that the public of New Zealand must still be protected against bad professional practises. To this end it was considered necessary to retain a State certification Board (with Government set criteria). Those certified or registered valuers, practising, must be accountable to the public as has been evidenced in the past by Court and Registration Board decisions.

It was further considered that there should be protection against bad professional and valuation practices by all members via the avenues of the Institute's Standards Board - not just registered valuers.

In keeping with this, the subcommittee believed that there would need to be strong rewards for NZIV membership, and positive benefits mustbe seen to flow from such membership. Rewards to the membership would be in terms of the promotion of the Institute and its members and their professionalism, and enhanced environment for learning in advancement of professional skills created by a widened membership base, an enhanced information base and enhanced public recognition and status following from the publ is perceiving a better educated and more attuned profession.

Rewards to the public, for using members of the New Zealand Institute of Valuers could be that allpractis ing registered valuers required to carry out a minimum level of professional indemnity insurance and also that members of the New Zealand Institute of Valuers undertook continuing professional development (CPD).

This comes on to the final area that the subcommittee considered, which was in the area of CCPD, ie compulsory continuing professional development.

Notwithstanding that the subcommittee considered that this was a big selling point for the profession and in particular the New Zealand Institute of Valuers, to make it compulsory could be self defeating. It was agreed strongly that there should not be disincentives to CPD by way of threats of deregistration if CPD wasn't complied with, but rather there should be incentives for members to obtain CPD with the positive aspect emphasised, and recognition given to those who achieved their CPD.

After discussing this further, it was obvious that CPD should be tied to the annual practising certificate (APC) for valuers, being linked through the provisions in the Valuers Act 1948. As noted earlier, this would require a change to the Valuers Act 1948 as currently, the APC is issued on application. There are no checks or balances for valuers past their initial registration. Toretain this public protection which the subcommittee considered is absolutely necessary, CPD is considered a function of the Valuers Registration Board or Certification Authority. This was seen as registered valuers being kept up to date on current issues, methods etc adopted in the profession, and only those who were maintaining their level of competence should be entitled to hold an Annual Practising Certificate. On the other hand retired members, members who do not use their registration for valuation purposes and others would not be disadvantaged by not maintaining theirknowledgeof thevaluation professionattherequired"practising"level. If, subsequently, they chose to take out an Annual Practising Certificate, they would have to prove that they had kept up to date with professional related matters.

When applying for an annual practising certificate, the valuer would have to disclose CPD courses attended during the previous 12 months. Unless CPD had been complied with, the Valuers Registration Board, we contend, should not issue an Annual Practising Certificate. The Registration Board would have responsibility for setting the CPD criteria. The New Zealand Institute of Valuers, being a body made up of, in part, registered valuers, would provide specific educational courses of study which should meet the requirements of the Board. The Institute should strive, through the quality of their courses which they ran, to have them automatically recognised by the Valuers Registration Board as meeting the APC requirements. This would encourage registered valuers to maintain membership of the NZIV.

Any other body of registered valuers would have to compete with the same standards already met by the New Zealand Institute of Valuers.

This has been a cyclical discussion, as we come around again to the Standard's Committee and Registration Board of the NZIV. The subcommittee felt there was a positive link between Standards and CPD and as such the Standards Committee and Education Board should undertake checks of the CPD standards being offered by branches, and when dealing with complaints, compliance with CPD should be taken into account by the Standards Board. In summary, CPD would be seen as compulsory for those valuers holding an APC, but voluntary for all other valuers. It would however be encouraged to be met by all members by the NZIV.

Valuers Act 1948

The subcommitteethenconsideredtheRules and Act under each of the scenarios.

In brief, in looking at professional deregulation but industry regulation, the changes to the Valuers Act 1948 include:

- removing the linkages between the NZIV and the VRB;
- linking CPD with the annual practising certificate to retain annual recertification;
- seeking incorporation of the Institute under the Incorporation Societies Act for the consequent change of name to, for example, "The Property Valuation Institute";
- reviewing membership criteria includingwhethernon-registeredvaluerscould be associates, fellows and life members.

In a similar way, changes were considered under Scenario 2, where the NZIV would remain as a Statutory Body incorporated under the Valuers Act 1948, but with the ability to widen the basis of membership. Changes that were considered to be required included:

- A name change within the Act.
- Revision of clauses 2 and 10 to enable a wider membership base.
- Amend Act to allow rules, establishing and maintaining professional practice standards including the implementation of a Standards Board.
- The Institute should be able to discipline, fine or relegate in status its own members, except for the power to expel a registered valuer, as such it was considered that a new clause allowing for the NZW to impose a fine not exceeding ifve times the member's annual subscription, or to relegate the member's status within the Institute should be provided.

The subcommittee also considered that clauses 31-32 of the Act needed amending as we considered that the Institute needed the authority to investigate ethics'rules breaches, and ability to refer decisions of these to the Council for the Institute to determine the penalty, and thirdly we recognised the need for appeal procedures.

There should also be amendments to the Rules including deletion of the term "intermediate" with a new Rule 7(e) allowing for membership of"all persons who are practising valuation of real and personal property admitted under 15B".

Summary

The subcommittee saw a need for continuing protection of the public by maintaining a Registration Board or its equivalent. It also believed that the New Zealand Institute of Valuers shouldbea strong body, capable of attracting members, whether registered valuers or not which would give full support to its members. It also believed in continuing professional development of members and that the Institute would be strengthened by the introduction of a Standards Board.

Currently, are we supplying what our members need? Do we educate them to the level of expertise that the public expects from a professional person in the current economic climate.

We have had members deregistered, fined, suspended and reprimanded over recent years by the Valuers registration Board and whathave we, as members of the Institute,done.Usuallysatback,said"Thank goodness it wasn't me" and carried on with our work. I believe that the Institute has a responsibility to educate its members, not just in valuation procedures, but in ethics, what is expected of them by the public, new technologies etc. We do try, but how many Wellington members are never seen at an Institute seminar. This is fairly typical from what I can work out in the larger centres, whereas in the small centres a greater percentage of members turn up to Institute activities. You can take a horse to water but you can't make it drink. similarly, you can supply educational seminars and other activities which meet CPD requirements, but if it is not compulsory, how do you make it succeed. The subcommittee in one way consider that by linking CPD to the APC, it would ensure that those who currently don't attend these courses would have to, otherwise they would not be able to continue to practice as a registered valuer.

Do our members accept or realise the degree of accountability that their chosen employment involves. Theycan in factlose their livelihood for negligently carrying out a valuation. When it is realised thatresidential valuations have been completed throughout New Zealand by some members at fees of around $180 inclusive of GST and disbursements, how can a valuer put the time and effortinto that job to ensure that it is done to a professional standard while receiving that fee.

By having to move quickly, mistakes can happen. With mistakes, negligence can be proven, and their livelihood lost all for $150 net Maybeour members do notrealise the risk they are placing themselves in when quoting fees at these levels. The Institute is very cautious about talking fee levels, however warnings should be going to members to ensure that they are not putting at risk their livelihood under such circumstances.

If the profession is deregulated, how many members of the New Zealand Institute of Valuers will remain. Unless the Institute can provide strength to its members by promotion of its members, providing excellent information systems, business systems, CPD programs and enhanced public recognition, membership would fall. With reduced membership, subscriptions would rise with consequential resignation of further members who, due to their low charge out rate, are unable to meet the increased levies. This is particularly so if theRegistration Board continues to increase their charges to recover the costs of their disciplinary hearings, these being necessary, as discussed earlier in order to protect the public.

I believe that we only scratched the surface with this report to the Council of the Institute, but we were quite focused on where the Institute should be heading in relation to specific matters. I think at the present time, the question that should be asked is what can the Institute do for its Members to improve their standing? Forget the JFK line. It is only by having a strong membership base, being well educated and supported by each other that the profession can grow and be accepted by the public at large.

The introduction of a white list by the banking profession has shown what part of the business community thinks of some membersof ourprofession. Itwould appear to me that the quick, and sometimes easy dollar has had too great an influence on some of our members over recent years. Service to our clients has in some instances led to charges of advocacy which should always be guarded against. It is this chasing of the dollar, and limited compliance with ethics that is, I believe, one of the biggest threats to the future of our profession.

Analysing Rural Real Estate Markets

by R V Hargreaves

The farther backward you can look the farther forward you are likely to see
-Winston Churchill

nderstanding the behaviour of rural Ureal estate markets is an ongoing challenge for rural valuers and for their clients. Real estate markets tend to behave in a cyclical fashion that is closely linked to the general business cycle. Case (1965) notes the erratic nature of the time between real estate cycles but concludes that real estate activity within a particular cycle is predictable. By studying past market behaviour, valuers are better able to project future income streams and predict values. For example, with the benefit of hindsight it is now clear that the 1981 rural property boom was unsustainable because many purchasers had taken on so much debt that their businesses rapidly became insolvent when there was a predictable downturn in farm incomes. This type of scenario will almost certainly occur again in the future. The difficulty for valuers is that when the market is facing an obvious downturn then recent sales evidence from the boom times has to be appropriately adjusted to reflect current market conditions.

Valuers in New Zealand are fortunate that there is very good historical information contained in the rural real estate market series available from Valuation New Zealand (VNZ). This paper analyses data from "The Rural Real Estate Market in New Zealand" VNZ series with a view towards obtaining a better understanding of rural real estate market behaviour.

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Characteristics of Rural Markets

a: Comprises a Series of Submarkets

The market for Rural real estate comprises a series of submarkets according to the particular land use and locality. The VNZ statistics classify properties according to the main farming types, such as dairy, grazing, fattening, horticulture, specialist livestock, and other (includes forests, quarries etc). Valuation New Zealand publishes a series of indices for the overall market and according to the main farming types. The national farm price index has been graphed in Figure I to show movements in farm prices and the consumer price index over a 30-year period since 1960. The farm price index is a sales based index which relates sale prices to the government valuations of the properties that have been sold.

It is apparent that increases in farm prices over time can be largely explained as simply keeping pace with inflation, although from the early seventies through to 1981/82 farmland did rather better than just keep pace with inflation. Seed *et at* (1986) also concluded that inflation played a major part in determining the values for fattening farms and grazing farms over theperiod 1962-1983. LeathersandGough (1984) and Anderson *et al* (1991) found that the level of government subsidies to agriculture during the seventies had a positive effect on increases in land values. It is also noticeable on the graph shown in Figure 2 while the farm price indices for dairy, grazing, fattening and horticultural units have shown marked short term variations over the period 1980-1990.

After the change of government in 1984 there were major structural alterations to the New Zealand economy that resulted in a more open market approach. The level of subsidies to agriculture was progressively reduced and the barriers to imports removed. This had a dramatic effect on the value of farmland, particu-

Fig 1

FARM PRICE INDEX AND CONSUMER PRICE INDEX (1960-1989)

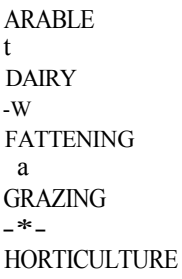
1960 1962 1964 1966 1968 1970 1972 1974 1976 1978 1980 1982 1984 1986 1988
1961 1963 1965 1967 1969 1971 1973 1975 1977 1979 1981 1983 1985 1987 1989

TIME

-'- CONSUMER PRICES -$- FARM PRICES

Fig 2

COMPARING FARM TYPES
(JUN.1980-DEC.1990)



TIME

larly for classes such as arable, where New Zealand does not have comparative advantage on the world market. Dairy farm prices held up relatively better than other farming types as dairy farmers were receiving the lowest level of subsidies. Overseas product prices were also part of the equation.

Low kiwifruit prices affected the horticultural index, as did the reduction in tax write-offs for business investors. A lesson from all of this is that subsidies quickly get capitalised into land values. When subsidies are removed land values fall to off-set this loss of income.

b: Some of the Submarkets are Very Small

The population size of the main categories of farmland is shown in Figure 3. These are further broken down into economic units and other (uneconomic) units. Uneconomic units are classified as "other" on the graph.

Economic units are classified by VNZ as "a farm which local practice accepts as being capable of supporting at least a single family". It is noticeable that for most categories that the majority of assessments are for uneconomic units. This means the numbers of economic units traded in the market may be very small. In a normal year 50-100 economic grazing farms change hands. The distinction between economic and uneconomic units is becoming less relevant. Le Heron *et al* (1991) reports that around half of rural households in the dairy, apple and sheep and beef industries are engaged in what is termed "pluriactivity". This means that one or more of the family are working off the farm.

During the mid 1980s only 20-30 economic arable farms were sold annually. The turnover rate of economic and uneconomic farms is substantially the same. Given such "thin" markets, it is unlikely the market can operate as efficiently as larger markets such as the share market or even housing markets.

In very small markets the sellers may also be able to influence market prices (at the least in the short run) by withholding properties from the market. The majority of farmers have a low debt structure and are unlikely to have to sell for financial reasons. It is unsound business practice to be a weak seller. When selling on a market that is dominated by forced sales all sellers are in a weak position.

The so-called uneconomic units consist of a variety of arrangements. Examples are stepping stone farms owned by young farmers who may work off the farm part-time. Others areowned by agricultural contractors and farm workers who may have no intention of purchasing a larger unit. A large number of women work off the farm to supplement family incomes. typically they have jobs in the nearest town and commute daily. There are also "lifestyle" farms where both partners work in town and perhaps run the farm on the weekend.

At one time it was thought that an uneconomic block would sell at a discount, but there is a lack of evidence to show that this is the case. If anything it is more likely to sell at a premium over an economic unit because of competition from existing farmers wanting to enlarge, and from "lifestyle" farmers.

C: Economic Units are Getting Larger and the Number of Farmers Getting Smaller

There is a very definite trend throughout the western world towards increased farm size for economic units. New Zealand is part of this trend.

This trend is occurring because, as the Porter report (1990) shows, the real prices for agricultural commodities has been decreasing over time, and the only way farmers can survive as full-time farm- 0

"There is a very definite trend throughout the western world towards increased farm size for economic units"

ers is to increase output. The easiest way to increase output is usually by acquiring more land. Technological improvements, particularly in mechanisation and, to a lesser extent, genetic improvements, have continued to allow farmers to produce more per labour unit. Over time the trend towards a smaller number of larger farm units will reduce the volume of sales information even further and make the task of the rural valuer more difficult.

It is sometimes suggested that the number of farms will reduce even more if there is a trend towards large scale corporate ownership. In New Zealand corporate farming structures have generally failed to stand the test of time. It is hard to find an example of a public farming company that has survived for more than 10 years. The basic difficulty with the public company ownership structure is that returns from farming are low compared with many other business opportunities.

An analysis of data from the Meat and Wool Boards Economic Service Annual Reports over the period 1970-1990 shows that the average cash return (excluding capital gains) on capital for sheep and beef farmers was just under four percent. Farm returns are also subject to seasonal fluctuations. These returns ranged from a low of 1.32 percent in the 1974/75 season to a high of 8.99 percent in the 1972/73 season.

The net result is that public fanning companies find it very difficult to achieve good returns over a reasonable period. Corporate farming structures are most likely to succeed in those farming areas that offer reasonably high rates of return such as horticulture and dairying.

History shows that family farming arrangements have the flexibility to-cope with economic downturns considerably better than corporate farms. Heady (1952) pointed out that in recessionary times family farmers do not consider labour costs an out-of-pocket cash expense and can remain in production at lower product price levels than the equivalent corporate farm that has to pay wages to the staff. The economies of scale evident in industrial production processes are more difficult to achieve in agriculture because larger herd or flock numbers may result in increased animal stress. Also the commitment to hard work is usually greater when the farmer has a stake in the ownership of the asset.

d: Subdivisional Activities

It is quite difficult to establish a statistical baseline for any rural land market because subdivisions are continually occurring. Valuation New Zealand statistics show that about 20 percent of sellers are subdividing. Subdivisions are most likely to occur within the commuting zone of all cities and major towns. The distance for the commuting zone tends to be afunction of the size of the town. For example, it is not uncommon for people to commute for 1-1/2 to 2 hours to Auckland. Commuting more than 30 minutes to a city such as Palmerston North is unusual.

The other major reason for rural subdivision is where the highest and best use of the land is intensifying. During the 1970s there were major subdivisional activities in the Bay of Plenty as a result of the move from dairying to horticulture (mainly kiwifruit). The intensification currently occurring as sheep farms are changed to dairy farms will also result in more subdivisional activities.

It also needs to be noted that the era of large scale land development is over and the potential to create more farmland by converting brush and scrub to pasture is now very limited. This means that the total area of farmland is unlikely to increase and will probably decrease as farmland is sold for forestry. The Resource Management Act 1991 has been framed to put restrictions on land development operations that might not result in sustainable farming systems. This is likely to effect the farm development potential of erodible hill country currently in bush and scrub. The strong interest in conservation also means that areas of native bush on the easy country are also likely to become increasingly "off limits" for farm development.

e:Turnover Rates a Leading Indicator

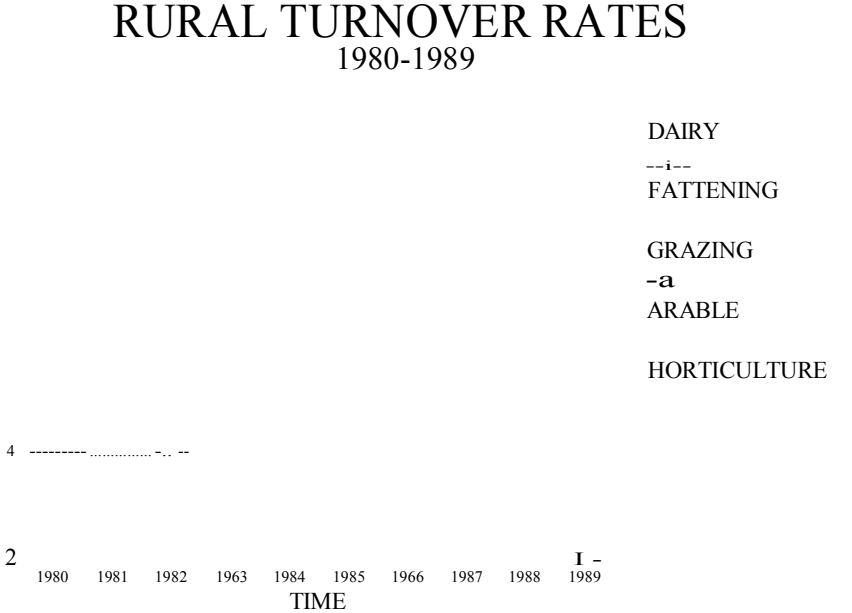
The turnover rates for the main classes of farmland are shown in Figure 4. It is apparent that during the 1980s the turnover rates for horticultural and arable units were appreciably higher than fattening and grazing units with dairy units, falling in the middle. The average turnover rate for farms during this period was approximately 3.5 percent. This implies a 28-year holding period.

There is very marked variation in the turnover rate for farms over time. For example, turnover rates in the mid 1980s were about half that experienced in 1981. Farm sales are typically high in the boom times and low in the recessionary periods. The turnover rates almost always change before farm prices change.

This is because during a recessionary period there is a surplus of unsold farms on the market.

The first positive sign of an upturn will usually be related to an improvement in overseas product prices, and the backlog of farms on the market will begin to sell. The first farms to sell will be those that are under pressure to sell. An improved economic outlook will bring more buyers into the market, the sellers will then capitalise on this by raising their asking prices and

Fig 4



purchasers will meet the market by paying more. Turnover rates and prices will continue to escalate until purchasers start to become reluctant to pay the prices being demanded. Thus turnover rates will start to fall off before the market reaches an absolute peak in terms of price. A market downturn is usually signalled by falling overseas product prices, and a growing reluctance by lenders to lend on such favourable terms as previously. Fora while the sellers may be able to hold prices up by strategies such as low deposits and favourable vendor mortgages.

Up until 1984 the modem history rural land market was characterised by the so-called "ratchet effect". This meant that in dollar terms farm prices always seemed to go up and never down. Across the board decreases in farmland prices were thought to be something that occurred only during the great depression of the 1930s. They did occur again both in nominal and real dollar terms after the major structural alterations to the economy were initiated in 1984.

Farm turnover rates fall off dramatically in bad times. This is because there is less interest from potential buyers and their lending institutions. Many potential sellers areprepared to take their properties off the market if they consider current prices are too low and there is a possible improvement on the horizon.

A lesson to be learnt from the 1984 restructuring is that rural lending institutions are very reluctant to precipitate widespread forced sales during recessionary times.The adverse publicity from farmer protests is bad for corporate images and may result in individual lenders losing market share. Perhaps more importantly widespread mortgagee sales and a collapse in rural land values dramatically increased the risk that a farm will be sold for less than the amount owing on it. This has serious implications for corporate balance sheets and it is usually much better to restructure loans than to call them in.

The turnover rates for farmland are also analysed by Valuation New Zealand according to the district. It is noticeable that there are sometimes quite big differences between regions. When wool prices are down and prime lamb prices are up turnover rates are likely to fall off more in Otago than in Southland: The turnover rates within a district are likely to vary according to locality and land use. Generally lifestyle blocks within the commuter zone are likely to change hands more frequently than economic farms further away from town. This may be because so many town dwellers aspire to live in the country. The reality of country living is that it is physically more demanding than life in town, and families with school-aged children often spend longer periods driving the children to and from various activities. The net result is that after a short period many "lifestyle" people find that it is more convenient to move back to town.

Fig 5

f: The Main Market Players

An analysis of the data as shown in Figure 5 reveals that existing farmers are the main purchasers of farmland. This is in line with the economic trends for larger farm units. Figure 5 shows a 20-year trend using the VNZ classification. New farmers typically account for around one-third of transactions with the balance split between businessmen and other.

Business people, particularly the overseas variety, are often blamed by farmers for boosting farm prices beyond realistic levels. It is hard to prove or disprove this argument.

Certainly the market is dominated by existing farmers and new farmers (80 percent plus) so it may well be that they are competing amongst themselves to push prices along. On the other hand de Cleene (1974) pointed to the ripple effect caused when a businessman buys an economic farm often close to town. The farmer who has sold out to the businessman takes the money from the sale and buys another farm further away from town thereby exerting pressure on this segment of the market.

The actual number of farms being purchased by businessmen appears to be declining because of low product prices and a removal of some tax incentives. Businessmen have maintained about the same percentage of the transactions in what is a diminishing market.

g: The Auckland Influence

There are significant regional differences in the Valuation New Zealand farm price indices. Figure 6 (over page) shows several of the main regions over the period 1960-1988. Up until 1970 there was low inflation and not a great deal of difference between the main regions.

Since 1970 and particularly in the 1980s increases in the Auckland area have been significantly greater than any of the other regions. This is almost certainly a function of the population pressures exerted on rural land by Aucklanders.

The demand for lifestyle blocks, market gardens, business people buying farms, and urban expansion are all greatest in the Auckland area. Most of the pressure on rural land near urban centres has very little to do with agricultural productivity and a lot to do with proximity to towns and beaches.

3. Income to Value Relationships

The relationship between the income earning capacity of rural land and the value of the land is of considerable interest to rural valuers. In the rural markets this relationship is often expressed in terms of some measure of gross income or an approximation of gross income. For 0

Fig 6

dairy farms the unit of comparison is the price paid per kilogram of milkfat, for sheep farms the price paid per stock unit, for kiwifruit orchards the price per tray. Although net income multipliers are a more accurate indicator than gross income in practice the people operating in the rural market often use gross income.

Gribble (1986) observed that the normal rule of thumb was that farm properties should sell for between two and three times gross income (depending on economic circumstances).

During the 1970s and early 1980s farm properties sold for as much as four times gross income. In the short run buyers could justify paying high prices, since the rapid escalation in land values during this period made farming for capital gain more profitable than farming for annual cash lfow.

The difficulty with buying rural land as an investment, and in anticipation of capital gains, is that capital gains can only be realised upon sale. Unless there is sufficient cash flow to keep the farm business running, the viability may depend on outside cashflows. Capital gains can be illusory in that when the investor comes to sell the market price may be less than the original purchase price, if not in nominal terms then possibly in real terms. New Zealand does not have a comprehensive capital gains tax. This means there are tax advantages to be gained from investing in land compared with other sorts of investments such as fixed interest securities.

The old adage that "cash flow is king" is certainly true for all types of investment property including farmland. Johnson (1971) found that farmers were highly influenced by current cash flows when formulating the prices they could afford to pay for land. Thus near cash flow is worth more than cash flow some way out in the future.

Figure 7 shows the relationship over time of the price that dairy farmers have paid per kilogram of milkfat divided by payment per kilogram. To achieve uniformity the price per kg used in this graph is based on the Dairy Board payout. Payout to individual dairy farmers varies between dairy companies.

The best buying from a productive point of view is when the ratio is at a low point. For the period 1969-1990 the average ratio has been just over five. Thus payment multiplied by five is about the price per kg. A $5 payout should result in farmers paying $25 per kg of milkfat. When the ratio moves well away from five it should be possible to predict thatchanges to the value of dairy farmland are likely to occur.

For example the ratios in 1971-73 were below five and there was room for some upward movement in the price paid. Conversely the peaks in 1975 and 1982 were likely to result in the ratio moving down again. Fluctuations in the ratio are likely to continue since payout is driectly influenced by overseas prices and there are no government or industry price smoothing arrangements.

Of course people do not buy dairy farms just on the basis of one year's income, and since the payout per kg of milkfat fluctuates with conditions in export markets, potential buyers need to formulate a view on long-term price trends. Very recent history shows the ratchet effects that resulted from the $5.80 payout in 1990. The reduction in the 1991 milkfat payout was not offset by a compensating fall in the VNZ dairy farm index.

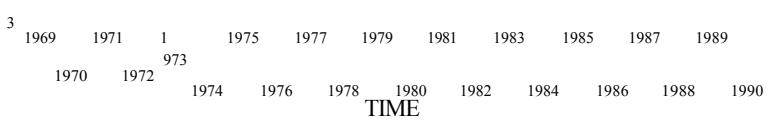
Davison (1992) demonstrated that for sheep and beef farms a strong correlation exists between thepre-tax profit per hectare and land values per hectare (excluding the farm homestead).

Thus, it is apparent that there is a fundamental linkage between income and value. When value gets out of line with income the market does adjust but not instantly.

Summary and Conclusions

New Zealand is heavily dependent on exporting food and fibre products to generate wealth. The world prices of these products are subject to unpredictable cy-

RATIO OF PRICE PAID PER KG.
DIVIDED BY MILKFAT PRICE



cical fluctuations. Overseas productprices are the key variable in determining the price of rural real estate. Although it is not possible to predict events such as wars and droughts it is possible to predict the impact of changes in product prices on sectors of the rural real estate market. The recent increases in prices paid for dairy farms is a direct consequence of higher milkfat payouts.

Real estate market turnover rates act as an early warning signal that future price changes are likely to occur. An increase in the sales volume is normally a signal that the market is hotting up. Conversely a drop off in sales volume may signal that the market is in trouble and there is likely to be downward pressure on real estate prices.

In real terms farm product prices have been trending down over time. This trend is unlikely to be reversed since developments in genetic engineering will almost certainly result in more productive plant and animal species.

Trade negotiations may result in the removal of some subsidised products from the world market but any price increases will be short term and rapidly offset by technological developments and increased production from the former Eastern bloc countries.

Existing farmers and new farmers are the main purchasers of farmland. In the past this group has been prepared to accept low annual profits but usually ended up making quite a good return on investment because of tax free capital gains. The current group of buyers are still accepting low annual cash returns.

The real question that needs to be answered relates to future capital gains. Previous experience shows that capital gains are generally closely linked to inflation. This is because land is viewed as a store of wealth.

Real capital gains over and above inflation are likely to be linked to real increases in productivity and profitability. It seems likely that New Zealand along with much of the world is entering a low inflation era. Low inflation is likely to equal low growth in farmland values.

Spatial considerations also play an important part in determining farmland values. Farms situated within the commuter zone to the nearest city may have subdivisional potential for city expansion or lifestyle units.

This effect is a function of population pressure and shows up most in the Auckland region. Land capable of being converted to a higher and better use is also likely to increase at a faster rate than land that does not have this same potential. Generally the most flexible land is fertile, flat, free draining and frost free.

There is an old adage in rural valuation that hill country is the last to go up in good times and the first to go down in bad times. The reason for this is that hill country has less flexibility in terms of land use options than flat or rolling country. Forestry has a history of underpinning the market for marginal farmland and this trend seems likely to continue. Environmentalists around the world are putting pressure on governments and first owners to conserve native forests.

Exotic forests specifically planted as "fibre farms" are seen by conservationists as a viable alternative to native forests. Fast timber growth rates mean that New Zealand has a competitive advantage for the production of wood products.

Valuation is an applied branch of economics. Traditionally valuers have just provided the client with a single point estimate of value. Very often the client is interested in future price trends as well as the current market value. Valuers who have studied the previous patterns of rural real estate cycles are well placed to comment on likely future trends in the market.

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Forestry Valuation Methods

A New Zealand Perspective

by A P Laing

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1: MARKET VALUE OR INVESTMENT VALUE?

A wide range of professionals from different disciplines are involved in the "valuation" of forests. Forestry consultants provide values for owners; accountants audit valuations in balance sheets and find them "true and fair"; and valuers assess values fora wide range of purposes which maybe statutory or otherwise.

Before proceeding to value a forest it will be necessary to define the client's requirements to determine the valuation approach and the suitability of the assessment for its intended purpose. In general terms two approaches to a valuation will be considered and these are defined as either market value or investment value. Market value is an assessment of value at a specific time which reflects the valuer's opinion of the market's view of value. Investment value is an assessment of the value to the owner. A comparison of the likely inputs for a market value assessment and an investment value assessment are included in Appendix II.

2: VALUATION METHODS

2:1 A New Zealand taxation case, *Rusk v C of IR* (1), makes a valuable contribution to forest valuation methods:

This was a sale of land with growing timber not then mature for milling. The valuation of that asset must, I think, be assessed in accord with accepted valuation principles. The starting point is to have reference to comparable sales. There is here, however, a real difficulty in adopting that approach, as the evidence showed there was an absence of what could properly be classed as comparable sales, ie sales of comparable land with comparable tree crops.

"All three experts called to give evidence referred to a very *limited number of sales in the area of land with growing timber. Those which were analysed were not really comparable, either as regards the land orasthetimber, and all required substantial adjustments for a number of factors to make them relevant. Indeed, none of the experts attempted to value the total asset on this basis and in each case the sales of afforested land were used for the purpose of ascribing the value (or the added value) of the timber, not the value of the land and timber. Because of this lack of evidence a lack which is quite understandable, as one would not expect there to be regular sales of similar land with crops of timber similar in age and quality-* in my view, it is necessary to ascertain first the value of the land, and second the value of the timber." *(emphasis added)*

The Value of the Standing Timber

The evidence disclosed that the recognised techniques for the valuation of an immature forest are first by ascertaining stumpage value, second by an analysis of sales of growing timber, and third by theoretical methodology, being either the crop expectation value or the cost compounded value.

The age and condition of theforest as at the relevant date was such that the stumpage value was minimal, if not nil. That does not of course mean that the timber then had no value at all but merely that it had no stumpage value. *(emphasis added)*

This case defines the steps to follow in forest valuation:

The preferred method for the valuation of land and timber is to use the evidence of comparable sales.

As there is usually inadequate evidence available from comparable sales the next best approach is to value the land by reference to sales of comparable land and value the standing timber by ascertaining stumpage value, or an analysis of sales of growing timber, or a theoretical method.

2.2 Valuation by the Use of Sales of Comparable Forests

The advantage of sales comparisons is that the activity in the market is represented and is therefore considered the best evidence of market value.

However, there is usually considerable difficulty involved in use of sales comparisons. Because of the diversity of forest type, age and quality being valued, comparison without interpretation may be meaningless and possibly misleading. A simplistic approach by a valuer comparing sales of stands of timber on an age basis only can be of limited assistance. In order to analyse sales it is necessary to adopt *a Forest Description Model* so each forest stand can be compared on a detailed and consistent basis. An example of a Forest Description Model is included in Appendix I.

Value of the Land

The value of the land component of a forest estate will be based on evidence of land sales in the locality and will be discussed later in this article.

2.4 Valuation of the Standing Timber

The stumpage valuation, being the value of the trees at the point of harvest, is the essential element in this approach. Where adequate sales evidence for timber at the point of harvest exists, stumpage value is a matter of direct comparison. However,

where sales evidence is limited or non-existent, or the forest operation is a component of an integrated wood processing operation, it will be necessary to derive a stumpage value from current market information for timber sales beyond the point of harvest.

A model to assess stumpage values from market information beyond the point of harvest is set out below.

Sale Price of Logs (SP)	
On Stump, or	
On Truck, or	
On Mill skid, or	
F.O.B., or	
C.I.F., or	
Etc	$A
Less Profit and Risk	
x % of Outlay ((x/(100 + x)) *SP)	$B
Outlay	$C
Less Realisation Costs (where applicable)	
Management and Marketing	
Access	
Harvesting	
Cartage	
Wharf Costs (F.O.B. & C.I.F.)	
Freight (C.I.F. only)	
Finance	
Insurance	$D
Stumpage Value	$E

An allowance for profit and risk is included to ensure that, regardless of the point of sale adopted for stumpage valuation, the result is comparable.

For example the assessment of "stumpage" is often undertaken in plantations where the forest owner also mills and processes the resource within a corporate structure.

In such situations, various costcentres would be established for management purposes, and it would be normal to operate a forest operation up to harvest stage as a cost centre.

It would be unusual for executives in charge of the milling/processing cost centres to concede profit to the forestry operation, particularly when their opportunity cost is to buy other timber at stumpage on the open market. A profit and risk allowance ensures realistic profit allocation between cost centres.

The profit and risk allowance used to assess stumpage should not be confused with the risk component used in the derivation of a discount rate applied to the Forest Valuation Model.

2.5 Income Valuation Methods

Since the value of an immature stand of timber must be less than that of a more mature stand, a discount factor will be taken into consideration. This leads to a method recognising discounted future values. In the case of very young plantations, the establishment costs for the early years may be compounded, particularly where a reliance on discounting future cash flows could lead to a situation resulting in negative values.

Discounting cash flows using the Net Present Value (NPV) method usually is suited to stands aged from 11-12 years to maturity. The compounded costs approach is more suited for young stands of 1-5 years. The valuation of stands of between 5-11 years is the most difficult and a common sense approach is required. In defining the cash flow, the cost of operating and maintaining the forest will be taken into consideration, as well as recognition of future income streams at the point of harvest (stumpage).

"In the absence of comparable sales, accepted valuation practice is to assess the value of land and trees separately"

2.6 Summary

2.6.1 Comparable Sales Method

If adequate sales evidence is available the task is relatively straight-forward. In-depth analyses of the treatment given to the stand, the age at which this treatment was carried out, estimates of the logging costs and the distance from the sale point must be made to gauge a useful comparison.

2.6.2 Income Valuation Methods

In the absence of comparable sales accepted valuation procedure is to assess the value of land and trees separately. The value of the land will be assessed by reference to sales of comparable land. The value of the timber will be assessed by discounting stumpage income and operating costs. For young plantations, a compounded cost approach may be appropriate.

3. FOREST MANAGEMENT STRATEGIES ADOPTED FOR VALUATIONS USING THE INCOME APPROACH

3.1.1 .Sustained Yield Strategy

To assess the market value, an assessment on the basis of a "sustained yield" management strategy is required. This recognises that the forest is an ongoing entity and a policy of re-planting harvested areas will be followed. Under this strategy the forest is an Equivalent Normal Forest (ENF).

Consistent with a sustained yield valuation method is the adoption of "overcut" and "undercut" provisions in annual accounts.

TheNZ Forestry Corporation included in notes to the annual accounts an adjustment for "overcut" (2), as follows:

Earnings Statement	NZ$M
Abnormal Item - Forest Overcut	31.83
Forest Value	NZ$M`
Forest Acquisition Price	1,257.94
Less Net Overcut Adjustment	31.83
Plus Revaluation	1.59
	$1,227.70

Statement of Accounting Policies

Forest Assets

The corporation determines a sustainable yield for the major species of trees growing in its forests.

If the actual cut of species exceeds the sustainable yield cut of the species (overcut) the forest asset is reduced. If the actual cut of the species is less than the sustainable yield cut (undercut) the forest asset is increased. The accretion resulting from any undercut of a species is netted off against any overcut depletion of other species, to give a net overcut or net undercut.

The net overcut (debit) is expensed through the Earnings Statement. A net undercut (credit) is not recognised in the Earnings Statement, but the resulting increase in forest value is recognised in the overall revaluation of the forest at the balance date.

3.1.3. To assess the market value of a forest a sustained yield model is considered an acceptable criterion which complies with accountancy and audit standards. Implicit in this approach is the recognition of a rotation period equal to the time taken to reach maturity after planting, and a recognition of all revenues and costs relating to the forest and incurred during that period.

3.2 Optimal Realisation Strategy

An optimal realisation management strategy for a forest could involve a wide range of approaches. Basically it will be designed to optimise the cash returns from a forest which usually means realising income as soon as possible and could exclude re-planting the harvested areas. It can 0

also involve treating replanting as a separate investment decision.

4. SPECIFIC VALUATION PARAMETERS FOR THE INCOME APPROACH

4.1 Value of the Land

The value of the land is usually based on current market values assessed on the evidence of sales of comparable properties. It can be included in the cash flow model as either a cost input at the start of the rotation and a sale input at the completion of the rotation; or as an annual rent throughout the rotation. If based on pastoral sales, the value of grassing should be deducted to get back to a cleared land value. Where a second rotation is about to commence, the value of land in stumps may be less than the cleared land value.

4.2 Resource Management Considerations

In October 1991, the Resource Management Act (3) was introduced in New Zealand. This legislation consolidated more than 70 separate Acts relating to land, coastal resources, emissions and environmental issues. The Act concentrates on outcomes in terms of the impact on the environment with the fundamental principle being the sustainable use of resources. In forestry areas, parts of the land could be required to sustain permanent vegetation, particularly in erosion-prone regions. Resource consents may be required to mill the timber and in order to comply with a regional plan. Compliance with this Act may have a considerable impact on the planting programme and the staging of harvest. Cash flows may be affected with a consequent impact on value.

5. A MARKET VALUATION MODEL

5.1 Rotation

The aim is to value an Equivalent Normal Forest (ENF) being managed under a sustained yield management strategy. The basis of the model will be the rotation length for the particular site and regardless of the age of the trees the model follows that basis.

5.2 Application of the Model

A simplified valuation model is set out below and is an example of a forest planted during a one-year period. Note the following:

- The model covers the period of the normal rotation for a forest in the area (29 years).
- The stands, which all exceed 7 years in age, are valued on a discounted cash flow basis. The model includes their stumpage values as well as direct costs associated with those particular stands.
- Annual costs associated with the total forest estate are included for the complete rotation.
- The land cost is included as a notional rent based on the discountrate adopted for the model.
- To reflect the continuity of the forest estate, the values of the particular stands established as at the date of valuation have been included as an inventory on hand at the end of the valuation Period. This is a quick and reasonably accurate method to short-cutavaluationprocedureinwhich it is probably more academically correct to extend the cash flow to infinity.

This procedure assumes that in an equivalent normal forest, the stands replacing the existing stands have an equivalent value at the same age.

Sensitivity Analysis

The model can be used to test the sensitivity of the valuation to the various inputs. For example, variations in discount rates impact on the valuation to the extent shown in the tables below.

A high responsiveness to discount rate changes is shown in this model.

Discount Rate	8%	10%	12%
Forest Value	$1,347,936	$909,441"	$606,643
Land Value	$240,000	$240,000	$240,000
Value Land & Forst	$1,587,936	$1,149,441	$846,643
	Say$1,588,000	Say$1,150,000	Say$847,000

In general terms, forestry valuations

5.3 Forest Estate Valuation Model Adopting a 10% Discount Rate

FOREST VALUATION MODEL

Input		
Land Area (ha)		300
Land Value / ha		$800
Land Value		$240,000
Rent @ 10%		$24,000
Annual Costs/ha		$50
Planting (ha)		$400
Tending (ha)	year 6	$500
	year 7	$400
	year 9	$500
Stumpage(ha)		$21,000
Discount Rate		10%
Unproductive Area Adustms		85%
Rotation (years)		29

VALUATION	
- Discounted Cashflow	$855,510
- Discounted terminal value	$53,931
Forest Value	$909,441
Land value	$240,000
Value land & forest	$1,149,441

CASH FLOW MODEL

YEAR	ANNUAL COSTS	RENT	PLANTING COSTS	TENDING COSTS	STUMPAGE INCOME	CASH FLOW
15	$15,000	$24,000				($39,000)
16	$15,000	$24,000				($39,000)
17	$15,000	$24,000				($39,000)
18	$15,000	$24,000				($39,000)
19	$15,000	$24,000				($39,000)
20	$15,000	$24,000				($39,000)
21	$15,000	$24,000				($39,000)
22	$15,000	$24,000				($39000),
23	$15,000	$24,000				($39,000)
24	$15,000	$24,000				($39,000)
25	$15,000	$24,000				($39,000)
26	$15,000	$24,000				($39,000)
27	$15,000	$24,000				($39,000)
28	$15,000	$24,000				($39,000)
29	$15,000	$24,000			$5,355,000	$5,316,000
30	$15,000	$24,000	$102,000			($141,000)
31	$15,000	$24,000				($39,000)
32	$15,000	$24,000				($39,000)
33	$15,000	$24,000				($39,000)
34	$15,000	$24,000				($39,000)
35	$15,000	$24,000				($39,000)
36	$15,000	$24,000		$127,500		($166,500)
37	$15,000	$24,000		$102,000		($141,000)
38	$15,000	$24,000				($39,000)
39	$15,000	$24,000		$127,500		($166,500)
40	$15,000	$24,000				($39,000)
41	$15,000	$24,000				($39,000)
42	$15,000	$24,000				($39,000)
43	$15,000	$24,000				($39,000)
	$435,000	$696.000	$102,000	$357,000	$5,355,000	$3,765,000

"The choice of an appropriate discount rate will probably be the most contentious and difficult valuation input."

based on discounted cash flows are highly sensitive to changes in discount rates. A movement from 8% to 10% is not a 2% increase but a 25% increase, with the valuation responding accordingly.

6. DISCOUNT RATES

6.1 The choice of an appropriate discount rate will probably be the most contentious and difficult valuation input. The example shows the sensitivity of the valuation to changes in discount rate.

6.2 Alldwance for Inflation

If the cash flow does not include inflationary adjustments a real rate of interest should be the basis of the discount rate (currently in New Zealand this is about 6%). However, if the model does include inflated costs and income, a nominal rate of interest should be the basis of the discount rate (current 7%-7.5% in New Zealand). (Nominal rate = market rate = real rate + inflation).

6.3 Pre or Post-tax Rate?

For current market valuations, the pre-tax discount rate is considered most appropriate. The tax status of vendors and purchasers making the market and the industry as a whole can vary considerably. However, if instructions are an investment valuation, the post-tax rate may be more suited for your client's requirements.

A simple method to convert for comparison purposes is:

Pre-tax Rate 12%
Post-tax Rate @33c tax rate

$$=12 * \frac{100-33}{100}$$

$= 8,04\%$

In reality the pre-tax and post-tax figures could be considerably closer because of the deferred nature of taxation available for forest operations.

In accordance with valuation standards and protocol the valuation should be assessed exclusive ofGST, orany other Wes.

6.4 Adjusting the Discount Rate for Risk Factors

Basically the discussion will centre around where forestry as an investment "ranks" compared to the safe Government Stock real rate of interest.

If this industry is perceived to be more risky, a margin for risk will be added. In simple terms a discount rate could be derived as follows:

Real Govt Stock Rate (5%-6%)	Say 5%
Risk Margin @ 100%	5%
Discount Rate	10%

6.5 More sophisticated models have been developed to assess discount rates taking risk into consideration. Included in a risk assessment is an appreciation of the ongoing future demand for forest products, as well as the usual climatic and physical risks associated with the industry.

Total risk can be broken into two components:

- market risk (systematic)
- unique risk (unsystematic).

The Capital Assets Pricing Model (CAPM) (4) adopts a Beta factor (B) to measure the undiversifiable risk relative to the undiversifiable risk of the market as a whole, and is applicable for the valuation of forestry company shares or the forestry operation as a business.

The logic of the model also has applications for the valuation of forestry stands.

CAPM
>'Ri $= Rf + B (Rm\ Rf)$
Risk free rate + Beta
(return on the market-risk free rate)
=Risk free rate +Beta
(risk premium)
Example =5%+(.5(10%-5%))
= 7.5%

Data from analysisofUSA forestry corporation market performance usually provide a helpful indication of "ungeared" Beta, which of course must be interpreted for local conditions.

Weighted Average Cost of Capital (WACC) (4)

WACC can be used in a market assessment provided an assumption as to equity ratios for the industry is made.

Companies will have differing WACC due to variations in gearing and cost of debt, so it is considered a more appropriate model for deriving a capitalisation rate for investment values.

(i.) Calculation of Post-tax Weighted Average Cost of Capital (WACC)

$$WACC = Ke * \frac{E}{(E+D)} + Kd(I\ t) \frac{D}{(E+D)}$$

$= 7.2\%$

Where:
Ke = cost of equity capital (5%)
Kd = cost of debt (average) (9%)
t = long term company tax rate (33%)
D = Debt Capital (interest bearing debt) at market value ($4m)
E = Equity Capital at market value ($6m)
E+D = Capital employed at market value ($10m)

(ii) Calculation of the Pre-tax WACC

$$WACC = \frac{Ke * E}{(I-t)\ (E+D)} + Kd * \frac{D}{(E+D)}$$

$= 8.1\%$

6.7 Market Derived Rates

A careful analysis of sales may be helpful in determining the market discount rate. In reality, as will be apparent when the NZ Forest Corp sales are considered, accurately determining the discount rate applying to the market is quite difficult.

While there is a helpful selection of discount rate models available to the valuer the real issue is to choose a rate that represents the market at the time of valuation. The elegance of sophisticated models is no substitute for hard market information which may be derived from commercial transactions.

7. COMMERCIAL SOFTWARE USED BY THE FOREST INDUSTRY IN NZ

For the purposes of forest definition and cash flow income determination, a wider range of computer-based modelling packages is available.

7.1 Resource Models

These are part empirically or processed-based models producing both quantifiable and qualitative forest descriptions. The main models are outlined.

Stand Master/Forest Manager (Forest Research Institute F.R.I.)

Forest database that maintains detailed information about individual stands, keeps track of operations and produces reports and statistics for planning and control and valuation.

Standpak (Stand Evaluation Package) (F.R.I.)

This generates medium to long term yield

predictions for stands of radiata pine by simulating growth, harvesting and processing on astandbasis. Yields maybe expressed as log volumes/grades and/or yields of graded sawn timber and mill chips. Component programmes include agroforestry production and economic analysis. An invaluable tool for *assisting* (agro) forestry managers to evaluate alternative management options and for providing data for estate modelling with IFS and FOLPI, project evaluation and forest valuation.

Interactive Forest Simulator (IFS) (F.R.I.)

This simulates the consequences of adopting alternative strategies (including planting, tending, harvesting) when managing a forest estate on a medium to long term time horizon. It helps identify the trade-offs between strategies in terms of wood flow, cash flow and profitability.

FOLPI (Forest Oriented Linear Programming Interpreter) (F.R.I.)

This complements the Interactive Forest Simulator (IFS) but finds the forest management strategy best meeting a set of objectives and constraints.

7.2 Valuation Models

Valuation models, typically computer-based, are generally one of two types: modular systems written commercially to link directly with a central forest database (eg, Standmaster/Crop Value) or custom written models, usually spreadsheet based, which offer greater flexibility and more specific application.

Commercially Written Forest Valuation Model

Crop Value (F.R.I.)

These calculate an estimated value for plantation stands, crops or forests. Input data are organised into five bases: crop types; crop age structures; crop operational costs; crop yields by log product classes; and log prices by log product classes. Costs and returns are accumulated for each selected crop type and one of three rules is selected for discounting and compounding the predicted cash flows to estimate a net present value per hectare. Extracts bases information directly from Standmaster.

Custom Written Valuation Model

Typically written around spreadsheet software, these applications are more usually valuer-specific. Using features such as data tables these models allow interactive and flexible "what if" analyses.

RMS (Resource Management System)

Placed between IFS and FOLPI in functionality, this package was developed by NZ Forest Products as an in-house management tool. It incorporates more sophisticated modelling techniques providing significant enhancements on IFS including full forest valuation, taxation and ENF (equivalent normal forest) measures.

8. Acknowledgment

The assistance of Phil Taylor B.For.Sc (lions) NZCF, a technical forester with City Forests is acknowledged. In all major forestry valuation assignments I rely on the technical expertise of Phil Taylor and Mike Hetherington (CEO City Forests). Phil Taylor's contribution has been to critically review this paper and provide the section relating to commercial forestry software.

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Appendix 1:

FOREST DESCRIPTION MODEL

THE SALE			
Vendor	Smith		
Purchaser	Jones		
Sale Price	$400,000		
Title Area	86.3 hectares		
Legal Description	Section 10, Blk VI, North Harbour S.D.		
Certificate of Title	100/101		
Tenure	Freehold		
RMS Activity	No limitations indicated		
Advice	Hetherington/Taylor		
Locality	Situated on Hunter Road, 10 km north of Dunedin		
	Facilities:	Mill 15 km Palmerston	
		Port/FOB Port Chalmers 20 km	
Analysis	Sale Price	$400,000	
	Less Value of Land	50,000	
	Financial Adjustment	-	
	Timber Value	$350,000	
THE PROPERTY	Soils- Suited to forestry production		
	Land Classification VI/IV		
	Site Index-26-28		
	Contour - Steeper gully faces		
	Aspect - Cooler faces		
	Access - Internal) Requires upgading		
	External) prior to harvest		
THE WOODLOT			
Physical	Gross Area	- 60 hectares	
	Net Stocked Area	- 48 hectares	
	Species	- Pinus Radiata	
	Age	- 20 years	
	Silvicultural History		
		Planting	- 1 yr

Appendix 1 continued

-Blanking
Low pruning - 6 years
- to 2 metres
1st thinning - 6 years
- to 450 trees ha 1
Med pruning - 7 years
- to 4 metres
High Pruning - 9 years
- to 6 metres
2nd Thinning - 9 years
- to 300 trees ha 1

Woodlot Comments
Re: stand quality, with reference to timing and quality of silvicultural husbandries.
Estimate Yield at Clear Felling (Year 30)

	%	Yield (m3 ha-1)	Total Yields
Sawlogs	86%	475m3	2,800m3
Pulp Wood etc	14%	75m3	3,600m3
	100 u	55m3	26,400m3

FINANCIAL

Estimated Income prior to Clear Felling

1	Thinnings	$-	
2	Grazing	$-	
3.	sale of other forestry assets	$-	$Nil

Estimated Further Silvicultural costs relating to the Stand

1	Thinning	$-	
2.	Pruning	$-	$Nil

Estimated Land Developmept Required Prior to Clear Felling

1.	Harvesting Access (Reading)	$26,400	
2.	Fencing		
3.	Sundry, Firebreaks, Dams etc	$-	$26,400

Stumpage Budget
- FOB Basis
- Gross Sales

- Sawlogs- 22,800m3	0$100		$2,280,000
-Pulp Wood	- 3,600m3 @ $2	97,200	$2,377,200
- Profit and Risk @ 25% of outlay			475,440
- Outlay			1,901,760
- Realisation Costs			
Management & Marketing	@$2.00 m3	52,800	
Access	@ $1.00 m3	26,400	
Harvesting	@ $12.50 m3	330,000	
Cartage	@6.00 m3	158,400	
Wharf Costs	@$11.00 m3	290,400	
Finance	@		858,000
Stumpage Value 26,4000	@ $39.54		
48ha	@$21,745		$1,043,760

Appendix 2: A comparison of the Inputs Required for a Market Valuation Assessment and an Investment Valuation Assessment

FORESTRY VALUATION
IncomeApproach

	Input		Markeat Vlue I	Investment Value
1.	Management Strategy		Sustained Yield	1. Sustained Yield, or ii. Optimum Realisation, or iii. Client Nominated Basis
2.	Definition		Forest Inventory	Forest Inventory
3.	Cash Flow Income		Stumpage	Stumpage
	Costs	i. ii. iii.	Land Costs Maintenance Planting/Replanting	i. Maintenance till harvested ii. Other Client Nominated Costs
4.	Inflation		Not included	Can be included
5.	Discount Rates	i. ii. iii. iv.	Market Indicated Rate Real Rate of Interest + Risk Margin CAPM WACC	i. Market Inidcated Rate ii. Nominal or Real Rate of Interest + Risk Margin iii. CAPM iv. WACC v. Clients Nominated Rate
6.	Taxation		Prel-tax	Pre or Post-tax
7.	Valuation		Market Value of the Forest	Value of the Forest to the Owner or the Investor.

Lease Incentives and Effective Rents

Practical Valuation Aspects

by R L Jefferies

Rodney Je,`eries'Dip U rb Val, BCA (We111 rs a' Fellow of the NZIV and a Fellow of the Properly` Management Institute. He is Senior Lecturer in' Property at the University of Auckland and isalso a consultant to Barratt-B oyes Jefferi es Ltd. regzs . tered valuers and property consultants in Auck.;; land. Rod Jefferies is the Immediate Past Presi dent. *of NZTV and is the author of Urban Valuation zn. New Zealand Vol I, editor and contributing au thor to Vol 2 of tie .same teat published by NZJV and has contributed numerous articles on a wide::._ ._ ..... range of valuation subjectsto the New Zealand Valuers' Journal.T`hispaper* is *an abridgementof afull research paper recently completed for prey entation at the 3rd Australasian Real Estate Educators Conference held in Sydney in January: 1993.*

On both sides of the Tasman as well as in other international commercial property markets the theoretical and practical problems associated with lease incentives are currently a contentious topic. Lease incentives have impacted on property owners, managers, valuers, leasing agents, developers, financiers, lawyers and the taxation office. Lease incentives and their effects are the subject of considerable debate in seminars and in the Courts. They have arisen out of unprecedented market pressures resulting from a grossly oversupplied office space market facing a limited demand and a declining number of prospective tenants. They are not a temporary phenomenon, as some of the earlier commentators in Australia assumed (McNamara, 1989, Parker, 1991), nor are they merely a rogue symptom in a cyclical market but a result of a market undergoing restructuring (Horsley, 1992).

The problems caused by leasing incentives are dramatically highlighted in a well publicised recen t (1992) New Zealand High Courtcase involving New Zealand's largest office building The *Coopers & Lybrand Tower* in Auckland and New Zealand's as well as possibly Australia's most controversial property personality - Sir Robert Jones. This case centred (amongst other things) largely around the ability of the developer to perform in leasing up the building in accordance with a development agreement, the effect of leasing incentives on that requirement and the resulting value of the building.

Mr Justice Henry ruled that contractor face rental rates achieved by the use of abnormal incentives are artificial rentals and that all aspects of the deals between landlords and tenants in leasing agreements including any collateral agreements must be taken into account. He held that it is erroneous to take the passing rental as reflecting the totality of the exercise of the respective rights and obligations of the parties to the lease document. He also made important rulings on the inter-relationship with yields and capital values vividly reflected in the valuation figures he determined.

The pre-negotiated settlement price in terms of the agreement was approximately $243.3 million (being based on a 6.5% pa capitalisation rate). However, the Judge held that as at the date of actual completion in May 1991, if the developer had performed and achieved a 100% leasing at the scheduled rates also representing realistic rents in the eyes of the market, the market value of the building would have been $202.5 million being based on the total scheduled rent roll of $16.2 million to which he appliedamarketcapitalisation rate of 8% pa. However, he found that in the market the scheduled rates could have only been achieved with substantial incentives and would have resulted in contract lease rentals substantially in excess of a market level. On that basis he estimated the value of the building at $170 million (using a 9.5% pa capitalisation rate).

Contributing to the problem is the confidentiality surrounding leasing incentives. This was the subject of another recent (1991) New Zealand Court of Appeal judgement, *in Dickinson's case.* This decision broke secrecy agreements surrounding incentives in the over-riding public interest so that valuers could obtain leasing information in determining true market rentals. The Court upheld subpoenas issued by third parties to divulge leasing and collateral agreements to an arbitrator and the valuers involved in a major Wellington office building rental review.

The subsequent *Trust Bank* award, as it has become known, contains some very pertinent comments by the arbitrator on the effect of incentives, their decapitalisation to calculate "effective" rentals and the resulting relationship to open marketrentals. This arbitration award has received considerable publicity and valedictories (Wederell, 1992) and was recently the focus of a seminar paper in Wellington (Hanna, 1992). It has been variously described as a "beacon", "benchmark", or "milestone".

The need to rely, in assessing review rentals, on comparisons with freely negotiated rentals in new lettings as a true test of current market forces received judicial emphasis in an earlier (1991) New Zealand Appeal Court judgement in *Modick* (formerly *Dimock)* case.

Lifting the confidentiality veil

In New Zealand the effect of the *Dickinson's* case has resulted, to date, in only partly lifting the veil of secrecy afforded by confidentiality agreements. There remains a tight commercial sensitivity for lease incentive data and it is certainly not yet in the arena of general market knowledge. This is illustrated by the New Zealand High Court in the *Coopers & Lybrand Tower* case imposing confidentiality orders and undertakings on all the key witnesses involved in the trial and hearing all such commercially sensitive information in closed Court. Similarly in the *Trust Bank* arbitration the incentive data was released only to the

valuers involved, the parties' counsel and the arbitrator. The respective judgement and award carefully kept such data to a general commentary only. In the *Coopers & Lybrand Tower* judgement the pages covering even that data and conclusions thereon have only been released to those who had previously signed confidentiality undertakings to the Court and are not available for publication.

The effect of utilising subpoenas has been to release this data into the hands of only a few key witnesses, counsel for the parties, theCourtorarbitral tribunal. Those valuers involved are in the position of having had access to this data for one assessment but not being able to retain copies of the data or use it in any other assignment. Thus at present, in New Zealand, to use and rely on such data in another case or arbitration the whole process and cost of issuing subpoenas needs to be repeated.

In practice, however, the effect of incentives in holding up artificial levels of contract, passing or face rentals is being undermined by the rent review arbitration process where this data is obtained and benchmark rentals set. Prospective lessees are also resisting the imposition of ratchet clauses in new leases and thus incentives not tied to such devices are resisted by lessors. Some existing tenants are negotiating out of existing ratchet clauses and legal challenges are being discussed and planned to try and break the effect of ratchet clauses in other cases. Inevitably expediency and commercial forces will slowly return non-incentive driven new market leasings and rentals as normal in the leasing market. In New Zealand this process is being accelerated by these recent Court cases in exposing the limited benefits and ineffectiveness of incentives in artificially holding up face rental levels to above realistic market levels.

It will be interesting to observe to what extent the Australian Courts will take a similar interpretation in helping this process across the Tasman.

Types of incentives

The types of incentives found in the office market are quite varied and are listed as follows:

- Abnormal rent-free periods
- Cash payments
- Rent subsidies
- Free hard fitouts
- Free soft fitouts
- Take-out of existing space
- Payment of relocation costs
- Put options on additional space
- Caps on (or limits to) rental increases on review
- Free naming rights
- Free holidays, vehicles or other incentives

A detailed discussion of the effects of these various incentives and the way they are customarily handled by valuers is contained in the author's full research paper (Jefferies, 1992).

The latest Australian summary by Allen (1992) shows that similar types of incentives are found on both sides of the Tasman. However, valuers in both countries have struggled to deal effectively with both the legal and financial implications of properly allowing for incentives. In the financial analysis of incentives valuers tend to take a very pragmatic approach and apply simplistic and arbitrary decapitalisation methods.

The aims of this paper

This paper has arisen out of these recent New Zealand legal rulings and award as well as recent Australian cases, such as *Holmans, Rosenblaum, Bowdens, and AOTC* cases the legal implications of which are excellently summarised by Horrigan (1992). This paper, however, only looks at the important practical valuation aspects of determining truly current market rentals. The problems centre on the methodology of dealing with leasing incentives or inducements made by landlords to lessees in leasing office space which have the effect of artificially propping up otherwise comparable freely negotiated contract (or face) rental levels.

The paper aims to look at the practical valuation problems of how avaluer should convert such incentive driven contract rentals into effective rentals for comparative open market rental valuation purposes.

The valuation complexities arise out of how to properly interpret the effects of incentives on the true cost of occupancy.

Firstly the incentives impact primarily on the lessee's rental cash flows by benefiting from the incentives on one hand, and taking up obligations to pay an excessive contract rental on the other hand.

Secondly, the effect on the value of the building to the owner is quite another matter and will depend on whether the property is in course of being leased up or is already substantially leased. While in the hands of a developer-owner and until leased the need to allow for incentives to achieve required rental levels will impact negatively on the value of the Building as is well illustrated in the *Coopers & Lybrand* judgement.

Once the building is fully or substantially leased with incentives having already been taken up by lessees, then the building value will be adversely impacted to the degree that the incentive induced rentals are in excess of the effective market levels which will affect the forecasted growth in rental cash flow together with the effect of any remaining rent-free periods and caps on rental reviews.

This paper deals only with the *first* aspect of the above complexities. the second aspect is an area of further urgent in-depth research.

The rental valuation aspect involves three main financial analysis problems of-

- how to decapitalise readily quantifiable lump sum type incentives, such as cash payments or free fitouts, into effective (or equivalent market) annual rentals;
- how to estimate the positive present value (PV) of other incentives which are dependent on future market forces affecting forecasted rental levels to estimate the benefit that lessees will receive in the future (such as from a rent-free period or cap on rentals at future reviews), and then similarly decapitalise them; and
- how to offset the negative PV's of the onerous obligations that lessees take on in accepting incentives and paying an above market (or premium) ratcheted contract rental (after any rent-free period has elapsed) until the forecasted effective market review rental breaks even with the contract rental.

Overriding these problems are wider issues dealing with the appropriate financial techniques of determining PV's and decapitalisation methods in general. These wider issues are not dealt with in depth in this paper but are mentioned as related matters worthy of further research, particularly when testing the effectiveness and sensitivity of the model proposed in this paper to changes in discount rates, rental forecasts, allowance for risk and other aspects of the time-value of money (Brown, 1991).

The present value and decapitalisation problem defined

The customary methods of incentive decapitalisation are generally accepted as involving calculating thePV of incentives and converting these to an annuity over an appropriate period, which is deducted from the contract rental in the lease agreement to derive the effective or equivalent rental

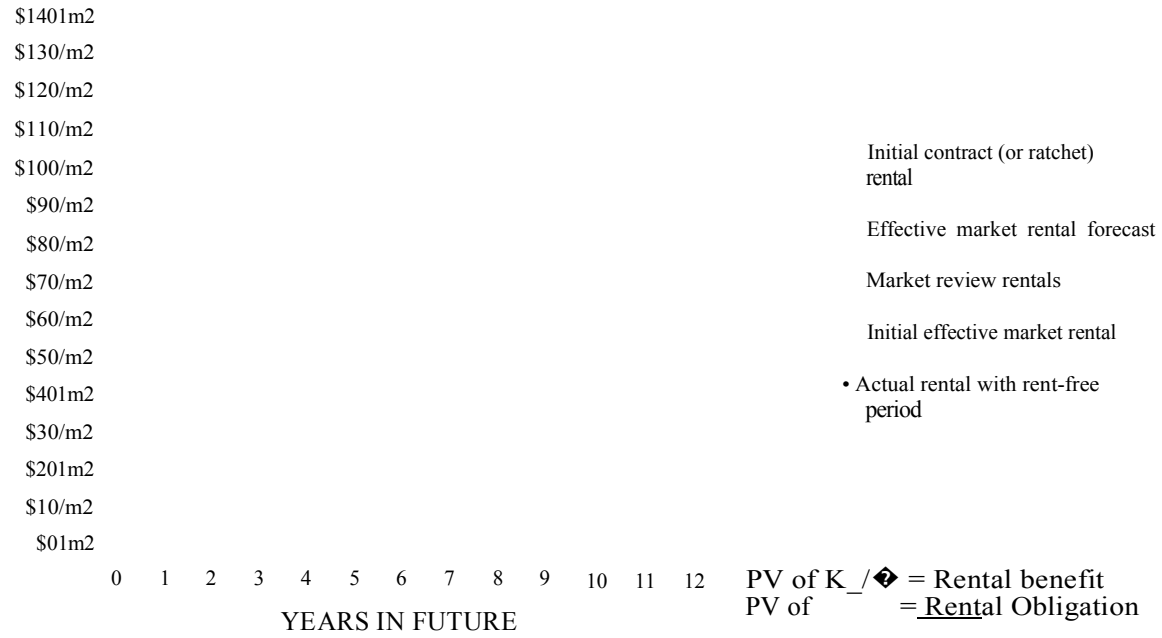
on a non-induced basis (Baum, 1986; Cocks, 1991; Locke, 1991; McCrudden, 1992; Muir, 1991; Whipple, 1990).

Customary incentive valuation methods, however, do not take into account the effect of future market rental levels on the benefits thatlessees enjoy nor on the rental obligations taken on in accepting incentives.

For example in calculating the PV of a rent-free period incentive, it is common for the PV of the contract or face rental to be discounted over the full period of the rent-free and then this is converted to an annuity over the lease term certain which is then deducted from the contract rental rate to derive an effective rental rate.

This customary decapitalisation valuation approach is illustrated in the example in CHART 1 (below)

CHART I
CUSTOMARY DECAPITALISATION OF PV of INCENTIVE
Based on lease term certain, with 5% p.a. forecasted rental increase and discounting @ 10% p.a.
Lease : 12 years with 3 yr. reviews, contract rental of $1001m2 with 24 month rent-free.



The example in Chart 1 assumes that the only incentive given to the tenant is a 24-month rent-free period, and it further assumes a forecasted constant rental growth rate of 5% p.a.

To explain the calculations involved, the components of the decapitalisation process are defined as follows;

Lease A = a lease with an incentive (in this example a rent-free period, but could be of any kind).

Lease B =an equivalent non-induced lease (ie without any incentives).

PVA = the PV of the rent-free incentive under Lease A

PVB = the PV of the incentive obligation measured as the *excess* actual rental paid underLease Aby comparison to the equivalent effective market rental in Lease B.

Base rate = 12 1.10 = 1.00797414 = (1+0.797414%)
(ie used to convert end ofperiod payments to beginning of period payments)

Effective monthly discount rate =
12 V 1.10 1 = 0.00797414= 0.797414%

Calculations: (All calculations allow for monthly rental payments in advance @ effective rate)

The calculation of PVA and PVB involves determining the PV's of the rental cash lfows (benefits or obligations) which are shown hatched in Chart 1.

The effective rental derived under the customary decapitalisation approach for the example in Chart 1 follows:

PVA = $100/m2 p.a. for 2 years (24 months) discounted @ 10% p.a. _ $182.82m2.

The equivalent annualised annuity discounted @ 10% p.a. over the 12 year (144 months) term = $25.47/m2 p.a.

Thus the effective rental under an equivalent non-incentive induced Lease B should be:

$100/m2 $25.47/m2 = $74.53/m2p.a.

The tenant should be indifferent as between Lease A (with the rent-free) and Lease B (without the rent-free)) being relfected in the difference in the rentals paid *provided* PVA = PVB. An alternative way of expressing this is that in an efficient market with competition between lease options, equivalent leases should produce zero net present value transactions when all incentive benefits and obligations are accounted for. Let us therefore see if the customary decapitalisation valuation approach meets this equivalent effective rental test.

PVB = PV of the excess rent from year 3 until year 9 when the effective review rental breaks even with or exceeds the contract rental = $47.34m2.

For sake of clarity the compilation of this PVB is set out in Table A.

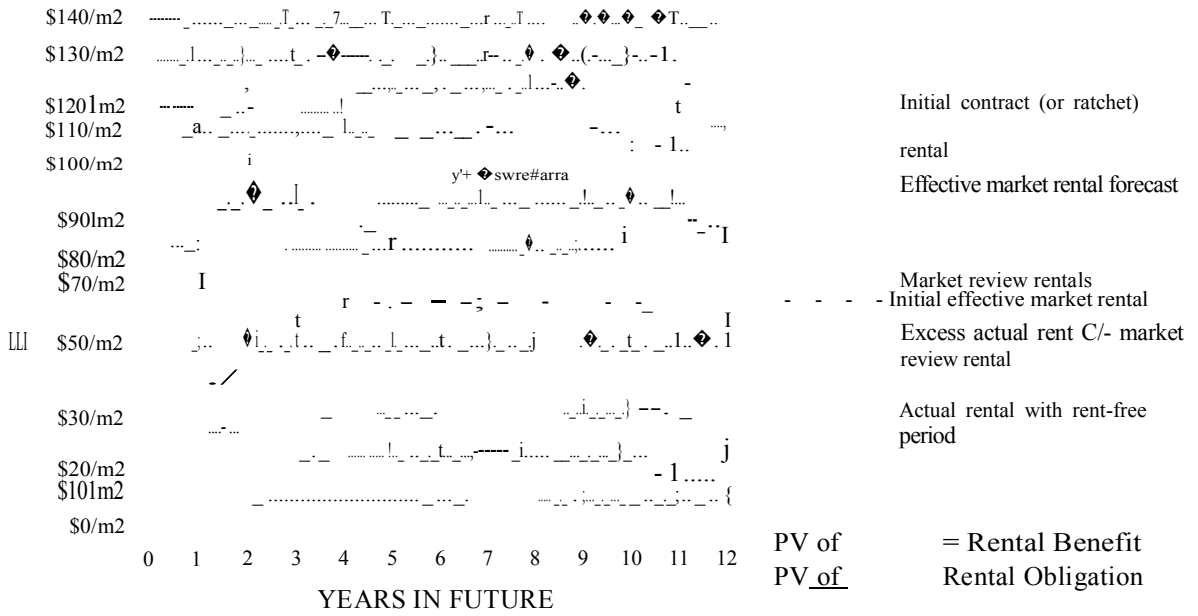
The earlier PVA and the above PVB series of excess actual compared to marketrental benefits or obligations are shown hatched in CHART 2.

In the example in Chart 2 the excess actual rent, compared to the market review rental, commences after 24 months due to the rent-free, reduces with the effect of the three year reviews and disappears after 9 years. Over years 6 to 9 the excess rental is almost immaterial and barely distinguishable in Chart 2.

Table A

Period (years)	Contract Rental $/m2p.a.	Effective Review Rental (escalated 0 5% p.a.) $/m2p.a.	Excess Rental /m2 a	PV ®10% p.a. (Calcmthly In advQeffective rate) $/m2
1 to 2	0	74.53	0.00	0.00
3	100	74.53	25.47	20.16
4 to 6	100	86.28	13.72	27.00
7 to 9	100	99.88	0.12	0.18
Total PV -				47.34

CHART 2
CUSTOMARY DECAPITALISATION OF PV of INCENTIVE
Based on lease term certain, with 5% p.a. forecasted rental increase and discounting @ 10% p.a.
Lease : 12 years with 3 yr. reviews, contract rental of $100/m2 with 24 month rent-free.



Under the customary decapitalisation methodology these PV's clearly do not meet the effective equivalent rental test as PVA # PVB. The difference (ie PVA less PVB) = ($182.82/m2 -$47.34/m2) _ $135.48/m2.

A prospective tenant taking up Lease A with an initial contract (or ratchet) rental of $100/m2 pa with a 24 month rent-free period would not therefore be indifferent to alternatively taking up Lease B without any rent-free at $74.53/m2 pa. Clearly the rental in Lease B is too high. Therefore, the implication that the PV of the tenant's rental payments under each lease are equivalent is erroneous under the customary decapitalisation technique and is always likely to be so, unless adjustments are made in the way the PV's are calculated to correct the errors in the method. (The only case where the customary decapitalisation would meet the test would be under a nil effective market rental growth forecast over the term of the lease.)

There are two reasons for these errors:

Firstly, the tenant, if the non-incentive induced Lease B had alternatively been taken up, would have only paid the *market rental* not the *contract rental* over the rent-free period. The PVA as calculated under customary methods being based on the higher contract rental is clearly overstated. This should be computed on the basis of the effective market rental, in this example at $74.53/m2 pa (putting aside the problem for the moment that the valuer doesn't know this figure until after doing the analysis) as follows:

PVA = $74.53/m2 pa for 2 years (24 months) discounted@ 10%pa=$136.25/m2.

This considerably reduces the PVA but still does not reconcile withPVB at$47.34/m2.

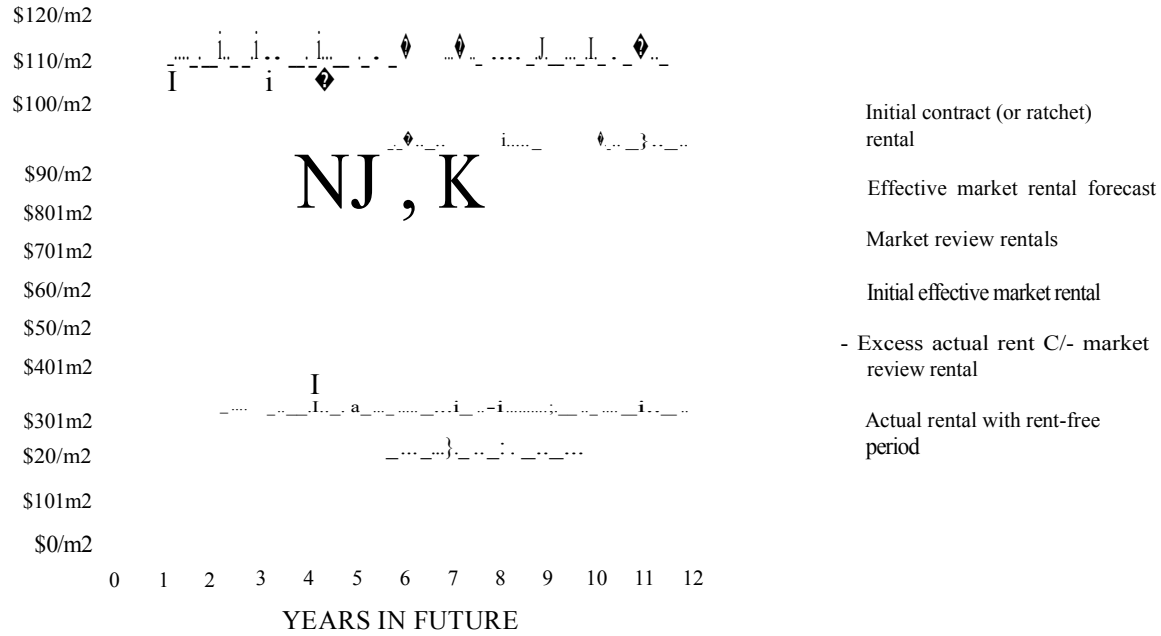
Secondly, the effective market rental paid under Lease B does not remain constant at the $74.53/m2 pa initial effective rental but will increase at each rental review until it eventually exceeds the contract rental.

Therefore *only* the PV of the *excess* actual rental compared to an effective market review rental (or *the premium* due to the obligation to pay the higher contract rental) should be computed in PVB (as above).

The combined effect of correcting for these *two* errors means that the effective rental can only be determined iteratively or by trial and error processes.

The correct solution is shown graphically in CHART 3 where the effective rental is $62.18/m2 pa.

CHART 3
BREAK-EVEN DECAPITALISATION OF PV of INCENTIVE
Based on break-even term, with 5% p.a. forecasted rental increase and discounting @ 10% p.a.
Lease : 12 years with 3 yr. reviews, contract rental of $100/m2 with 24 month rent-free.



For sake of clarity the compilation of this PVB is set out in Table B. This gives respective PV's of PVA = PVB = $113.67/m2, satisfying the equivalent effective rental test.

The constantly increasing marketrental assumption in the foregoing Charts 1 to 3 is unrealistic and it is more likely to be variable or cyclical. A more realistic forecast might be that shown in CHART 4 (next page).

The rental forecast in Chart 4 has been adjusted to end up at the same effective rental (of $111/m2 pa) at the end of the lease term as previously calculated and shown in CHART 3. The same principles of a break-even analysis and series of calculations are applied. The effective rental is similar at $59.90/mz pa (because of the overall effect of the long-term rental increase) with PVA = PVB = $109.51/mz. The lease decapitalisation model presented later in this paper allows for both types of constant or variable rental growth forecasts and solves for the effective rental that satisfies the PVA = PVB test.

Additional decapitalisation issues

Sophistications in the proper techniques to use involve the derivation of an appropriate discount rate, whether effective annual or nominal discount rates should be used, and whether these should be on the after-tax basis (Brett R, 1992; Horsley, 1992). The after-tax or tax-effective issue of incentives was also discussed by the arbitrator in the *TrustBank* arbitration but he rejected that approach in the award.

The decapitalisation models used to calculate the illustrative examples in the foregoing CHARTS and fully presented in APPENDIX 1 use an effective per period discount rate so that the effective annual rate equates the nominal annual rate. The model also assumes a flat yield curve, though it is recognised that when forecasting rental growth on a variable annual basis, as in the example in CHART 4 and in APPENDIX 1, the term structure of interest rates could dictate that a different (separate annual) discount rate be applied to each year in the future over the decapitalisation period (Brown, 1991). This paper does not explore this additional aspect, especially as customary valuation methods used in practice discount at both nominal and assumed flat yield curve interest rates. It is possible to adjust for both variable forecasts of single period rental growth rates, and the appropriateseparate single period discount rates. The model is currently being further developed so that variable growth rate forecasts are converted into an equivalent constant growth rate to overcome the problem of any incompatibility between the assumptions inherent in using a flat yield curve when discounting variable rental growth forecasts.

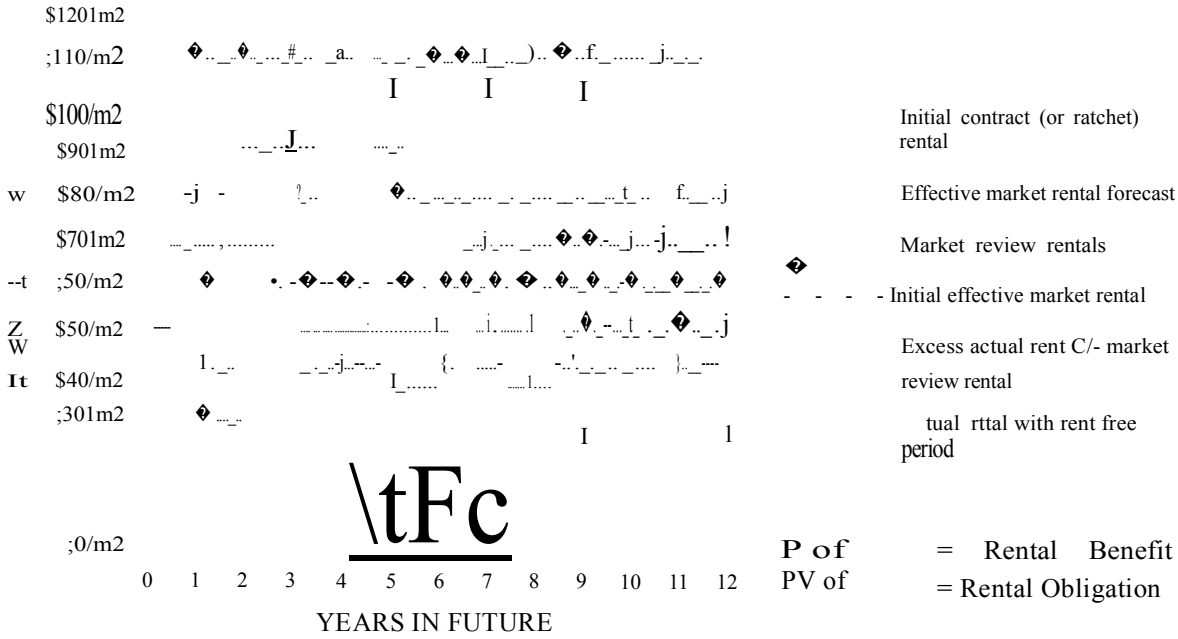
The model is developed on a pre-tax basis as market rentals are determined and paid on a pre-tax basis. It is accepted that the taxable status of incentives in the hands of the lessee is important, but an uncertainty currently exists in New Zealand tax law. The tax law applying to incentives appears more settled in Australia since the *Cooling* case (allen, 1992; Somerville, 1991).

Initial testing of the model contained later in this paper on typical examples of Auckland office leases indicates that the break-even method will produce effective rentals lower than if based on decapitalising the PV of the incentive as an annuity over the lease term certain. The results are similar to the general relationships between the two methods shown in the earlier examples in CHARTS 3 & 4 and in the example used in APPENDIX 1. Initial sensitivity testing of the model indicates that generally, as increased levels of future rental forecasts are made, the shorter the break-even review periods over which the decapitalisation is calculated and the lower the effective rental, ie the future market rental catches up faster to

Table B

Period (years)	Contract Rental $/m2pa	Effective Review Rental (escalated @ 5% p.a.) $/m2pa	Excess Rental $/m2pa	PV 0 10% p.a. (Calcmthly In adv0effective rate) $/m2
1 to 2	0	62.18	0.00	0.00
3	100	62.18	37.82	29.93
4 to 6	100	71.98	28.02	55.15
7 to 9	100	83.33	16.67	24.65
10 to 12		96.46	3.54	3.94
Total PVB =				113.67

CHART 4
BREAK-EVEN DECAPITALISATION OF PV of INCENTIVE
Based on break-even term, with cyclical forecasted rental increase and discounting @ 10% p.a.
Lease : 12 years with 3 yr. reviews, initial contract rental of $100/m2 with 24 month rent-free.



break-even with the contract rental.

As the office market is currently in a low (or possibly nil or still falling) short term prognosis of changes in rental levels, any upward recovery will be slow. Thus a market recovery in effective rentals will be unlikely until contract rentals fall to meet a non-incentive driven (or normal) rental market level, coupled with a more balanced supply and demand for office space.

All the legal authorities and recent writers accept the principle that *abnormal* leasing incentives should be taken into account in analysing a new letting to derive the equivalent rental on a non-incentive driven basis. However there is less than unanimity over the methodology to be applied. Some of the first writers (Whipple, 1989) treat even the "normal" rent free period as requiring decapitalisation to convert the contract rental into an effective rental. However, the correct methodology to employ is not simple to discover nor are the derived effective rentals truly equivalent to a non-induced first letting market rental. The problem arises out of taking the contract rental from one lease on its specific collateral terms and trying to equate that to a different non-induced lease of an equivalent lease period. No matter how many adjustments or conversions are made to the terms of an induced lease rental, the answer may be unconvincing as representing a non-induced rental equivalent. One cannot readily convert "oranges" into "apples". The process at best is artificial, but necessary. Empirical comparison with non-induced market evidence is therefore preferred.

There are a number of additional controversial aspects of the alternative methodologies that are in use and the decapitalisation processes used that come under the following headings.

- Allowing for and establishing the PV of a "normal" rent-free period.
- Estimating the cost of existing lease take-outs.
- Whether it is valid to allow for a put option to take up additional space.
- Allowing for caps on rental increases.
- Determining the correct decapitalisation period as to whether it should beover the: 1. first review period;
  2. lease term certain;
  3. total lease term including rights of renewal;
  4. in perpetuity;
  5. over the economic life of the building; or
  6. the break-even benefit period.

The appropriate decapitalisation term when applying the break-even period method put forward in this paper and the model may need adjustment for different situations where the lease terms differ as follows:

(1) with a ratchet clause - *until the forecasted effective current market rental breaks even with or exceeds the ratchet rental;*

(2) without a ratchet clause *over f rst review term only; or*

(3) with a cap on rental increases-over *the period of the review terms affected to the extent that the capped rental is lower than the forecasted market review rental.*

These additional decapitalisation issues briefly referred to above are dealt with in some depth in APPENDIX 4 to the author's full research paper (Jefferies, 1992).

Some of the problems raised above are only able to be solved iteratively. The PV of some incentives will be dependent on the resulting effective rental and also the break-even period over which the incentive is effective. Customary valuation techniques are ill equipped to solve such problems except by laboursome, trial and error calculations (Brett M, 1992). Hence the pragmatic customary practices used by the valuation profession of converting the PV of the incentives to an annuity over an arbitrary discount period and basing calculations on the contract or face rental.

However, with the use of powerful iterative methods using numeric analysis provided by modern computer spreadsheets a valuation practitioner (who like the writer has neither the time nor skills to do such numeric calculations) can use these tools to quickly provide an accurate solution to these problems.

The model developed by the author and used in an example in APPENDIX 1 makes available to practitioners a simple to follow and user-friendly *lease incentive decapitalisation model* that solves this type of trial and error calculation speedily and accurately.

The model described

The model, in the introductory text panels, briefly describes the software required, its purpose and how to use it. The instructions, calculation and printing processes are set out and when used "on screen" a GO TO panel with buttons appears at the beginning of the model to enable the user to go directly to various panels in the model. At the end of the model a PRINT panel contains buttons which automate a variety of print options. The user simply follows through a step by step inputting of assumptions, lease details and incentive data, and then activates the solver utility button to derive the answer.

Under the PV of INCENTIVES panel the basis of calculating each incentive is briefly described. All key inputs and parts of the spreadsheet have defined names and the formulae are shown when selecting the appropriate cell. The automated printable part of the model is limited to three pages, but the projection tables can be viewed and printed if selected manually.

1. Assumptions

The model is designed to solve for the forecasted break-even rental period as a basis for the decapitalisation based on the assumptions entered for the nominal annual discount rate, frequency of rental payments and basis of payment, ie in advance or arrears. A forecast of annual market growth or decline in rental levels over the term of the lease and any renewals is required, being simultaneously graphically represented (unless the manual calculation option is set in *Excel).* Each year's estimate is separately required which allows for a constant or variable estimate, including positive and negative changes allowing for cyclical estimates. Thus it is possible to allow for the possibility of a continuing fall in current market levels in response to the current oversupply of office space and an eventual recovery.

2. PV discounting

The mechanics of deriving some of the PV of the incentives, where these are not the same as the initial cash payments, requires recalculation by iterative numeric analysis. This applies to deriving the PV of the rent-free periods and cap on rental increases, if applicable.

3. Determining the future break-even rental period

The model solves for the break-even effective rental using iterative numeric analysis provided by *Excel's* "add in" *Solver* utility. This is activated when all the data has been input by selecting (clicking with a mouse) the SOLVER button which shows on screen in the CONCLUSION panel. This activates a macro selecting a default setting for the iteration process and solver constraints.

The model solves for the break-even rental period and effective rental by successively changing the initial effective rental so that the PV of the incentives matches the PV of the excess of contract rental *over* the effective market review rental. The latter is stepped up or down at the predetermined rent review periods in accordance with the forecasted annual market rental growth or decline assumptions. Where a capped rental increase applies this overrides the calculation and any benefit forecasted to derive from that incentive is allowed for also.

The speed of the solution is determined by the computer processor in setting up the problem using the solver utility, and on-screen dialogue box instructions enable the user to extend the time to enable a solution to be reached within the set default constraints set out in the CALCULATION panel.

4. Market application limitations

The limitation on the market accuracy of the model in determining the effective *market* rentresults from the model assuming that the derived effective rental from each comparable rental is a proxy for the wider market. In practice, after the model has been run for each comparable and a range of indicated effective market rentals derived, a market rental can be assessed in the normal manner correlating the results.

Each comparable rental analysis can then be re-analysed by inserting in the model the assessed market rental in lieu of the derived effective rental and the spreadsheet simply re-calculated (not resolved).

The resulting difference between the PV of the incentives and the PV of the excess rental payable by the tenant, shown also in the CONCLUSION panel will indicate the effectiveness of the individual incentives to match the market. If the PV of the incentives exceeds the PV of the excess rental then the tenant will have made a good deal in beating the market. Conversely, if the PV of the incentives is less than the PV of the excess rental then the developer will have made a good deal in obtaining a premium to the market.

5. Industry rules of thumb

A common method of describing and measuring incentives in the leasing industry is to convert the PV of the incentives into an equivalent number of years rent-free. The roughest form of this is to calculate the non-discounted value of the incentives and divide it by the annual contract or face rental. However a more useful method is to convert the PV of the incentives into a rent-free period equivalent by dividing the PV of the incentives by the monthly rental and expressing it as an equivalent number of months rent-free. A more correct and comparative measure is to calculate the period over which the

PV of an annuity at the contract rental equates with the PV of the incentives. The latter method will always be higher than the former. The results of both methods are shown in the CONCLUSION panel of the model.

Model example

APPENDIX 1 contains a sample model for a hypothetical Auckland building that combines most of the types of incentives that are currently found in the market. It is unusual, but not unknown, to find all types present in any one office leasing deal, but they are all similar to deals having been made in practice in the last two years. The total extent of the incentives can be measured both on a PV $/m2 basis oras apercentage reduction on the contract rental rate. The extent of the incentives in the example in APPENDIX 1 is in fact less generous than some of the deals negotiated in Auckland and Wellington (Horsley, 1992).It demonstrates the way in which both growth and declining or cyclical rental forecasts are allowed for and clearly shows the difference between the results adopting customary methods of decapitalisation and this break-even method. It also shows the relative effective rental rates calculated by the different methods.

Conclusion

It is hoped that this paper and the model presented has brought into focus the current issues facing all involved in office market development, leasing, management and valuation. The issues have been developed primarily from a financial analysis and valuation viewpoint. It has been demonstrated that the customary methods of valuation of rentals taking incentives into account can lead to error. The underlying methodologies and customary theories have been challenged and a new method proposed which is considered practical and within the scope of the valuation profession to master.

A step-by-step computer spreadsheet model is offered for use and testing. It is hoped that user feedback and further development of the model will enable this controversial and vexatious area of current incentive induced office leasing and valuation practice to be better understood. The aim is that the problems of rental assessment, particularly on reviews will be more readily resolved.

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Appendix I

Lease incentive decapitalisation model

Version 1.0

This spreadsheet model has been developed by Rodney L Jefferies. It has been developed on Microsoft® Excel Ver 4.0, and requires the Microsoft Excel Solver utility to be installed. It is intended that the model will be upgraded as a result of further development and user feedback. Explanations are contained in the University of Auckland Real Estate Research Unit Working Paper No 4, *Lease incentives and effective rentals practical valuation* aspects. A copy of this paper is available on request. A copy of this spreadsheet model is available by subscribing a donation of NZ$200 to the Real Estate Research Unit C/- Department of Property, University of Auckland Private Bag 92019, Auckland, New Zealand, Tel 64 (09) 3737599; Fax 64 (09) 3737410, towards the development and further testing of this model. Any queries or suggestion for its improvement will be welcomed. All subscribers will be issued with updated versions. (Please specify DOS Windows TM or Apple® Macintosh® format and if DOS whether on a 51/4 or 31/2 disk.)

PURPOSE: This spreadsheet converts specified lease incentives to *Present Values* (PV), and decapitalises these on four methods as stated in the CONCLUSION section. The calculations are made in accordance with the ASSUMPTIONS as stated as default settings or as altered by the user. The results are expressed as an effective (decapitalised) rental rate ($/m2) in the conclusion section.

INSTRUCTIONS: Insert in the bordered (red) cells, the assumptions as to the basis of calculations or leave defaults as stated. These cells must contain inputs (except as noted). Insert forecast growth/decline in market rentals in the boxes belowthe graph, which will graph the results. Insert in the bold (red) bordered cells the data required to completethe LEASE DETAILS and INCENTIVES panelsforthe comparable rental being analysed. NB where an office rental includes a parking component this will need separating and if necessary the incentive proportioned between these components. (This model assumes all the stated incentives are decapitalised against the total office floor area stated). Leaving a bold (red) bordered cells blank or inserting a zero indicates that there are no incentives of the type stated.

CALCULATION:The model solves forthe effective (decapitalised incentive-free) rental by iterative methods using numeric analysis. When all Assumptions, Lease Details and Incentives applicable have been entered, GO TO the CONCLUSION panel and activate (by clicking with a mouse) the SOLVER button which appears on the screen. The model can be recalculated at any time by pressing the F9 key or activating the CALCULATE NOW button at the bottom of the incentives panel. This will calculated the spreadsheet based on the default effective rent ($100/m2) or the last solution (in cell E121). Recalculating the spreadsheet will not provide a solution, this is only found by using the SOLVER button or the Fojmula Solver Solve command which sets up the problem (be patient!). It then runs the solver function for a maximum of 600 seconds (10 mins) until a solution is found allowing up to 1000 iterations. If a solution is not found, the user is prompted to accept the trial solution or extend the process. It then inserts the results in the conclusion panel and graphs the solution using the breakeven rental period method. Simply follow the dialog box instructions to accept and save the solution. Rename the spreadsheet using the File save As command if saving the file to new name.

PRINTING: Go to the PRINT panel (use the GO TO panel at the beginning [Ctrl+Home keys] of the model). Activate the appropriate button to print the whole model, various specified panels only or graphs. Page breaks for A4 paper are preset. (The GO TO or PRINT panels or buttons will not be printed.)

ASSUMPTIONS

Nominal Annual Discount Rate 10.00%

Enter as number not a decimal or with % sign

Equncy of rental payments and discounting basis M

L M=. or thlyi Q=quarterly H=half-yearlyLY=yearly

Basis of payment and compounding interest calculation

L O=End of period; 1 = Beginning of period

Years in future

Forecasted annual % rental growth/decline:

Enter in each year's cell as number not a decimal or with % sign

Year:	1	2	3	4	5	6	7	8	9	10	11	12
Nominal annual rental % growth/decline:	3.0	5.5	8.0	9.0	10.0	10.0	9.0	8.0	4.0	1.0	-1.5	-3.0
(If term less than 24 yrs leave blank)												
Year:	13	14	15	16	17	18	19	20	21	22	23	24
Nominal annual rental % growth/decline:	-3.0	-1.0	1.5	4.0	5.5	7.0	8.0	9.0	10.0	10.0	9.0	8.0

Appendix 1 continued

LEASE DETAILS:

Enter data In unshaded bold (red) bordered cells

Location of comparable:	Building A		
Description of comparable:	10 levels with excellent views		
Lease commencement date:	01/08/92	(d d/m m/yy)	
Total annual office rental:	$3,340,470	(enter number only = excl naming rights & other rental)	
	$278,373	per month	
Total lettable area (sq.m.):	10,180m2	(enter number only)	
Contract rental rate ($/m2 pa)	$328/m2	(enter only if total rent and total lettable area not entered)	
Rental review frequency (years):	3.Oyrs	(enter number only)	H 36; Months
Lease term certain (years):	18.Oyrs	(enter number only)	216' Months
Total term (incl ROR's) (in yrs)	24.Oyrs	(enter number only)	Months

INCENTIVES:

Enter data in unshaded bold (red) bordered cells

1 'Normal' rent free period (mths)	6 mths	(enter number only will be adjusted in decapitalisation)	
Rent free period given (mths) 2	12 mths	(enter number only)	
Cash payment ($)	$1,500,000	(enter number only allocated to office space)	
3 Free hard fitout ($):	$1,800,000	(enter number only)	$177/m2
4 Free soft fitout ($):	$1,250,000	(enter number only)	$123/M2
5 Take out of existing space:			
Lettable area (if known):	7,300m2	(enter number only)	
Annual rental ($):	$1,825,000	(enter number only)	$250/m2
Annual OPEX ($):	$217,500	(enter number only)	$30/6
Term to run (mths):	27mths	(enter number only)	*Rental assumed to be paid monthly in adv.*
Est period to subletting (mths):	7 mths	(enter number only)	
Subletting rental as % of rental:	75.0%	(enter as decimal or number followed by % sign)	
Agents fees as % rental:	10.0%	(enter as decimal or number followed by % sign)	
Est PV of inducement ($):	$250,000	(enter number only)	34/m2
6 Partitioning compensation ($):	$150,000	(enter number only)	
7 Relocation costs/(4):	$125,000	(enter number only)	

8 Cap on rental increases:

Review	1	2	3	4	5	6	7	8	9	10	11	12	13
Future rental review (year)	3N'	6	9	12	15	18	21	24	na	na	Ina	na	na
Max % incr on previous rental(number only)	5	5		88									

(The above number may need to be calculated or estimated based in the deal involved)

9 Free naming rights ($pa):	$45,000	(enter number only)	
Period of free benefit (yrs)	12.Oyrs	(enter number only)	
10 Other ($PV estimate req'd):		(enter number only ie free-holiday	

PV OF INCENTIVES

		PV	(© effective discount rate per period, and basis of payment)
1	Excess rent-free period	$687,253	(PV of defered rent-free period ie after allowing for 'normal' period) (As
2	Cash payment	$1,500,000	in 2 above assumed paid at commencement of lease)
3	Hard fitout	$1,800,000	(As in 3 above assumed paid at commencement of lease)
4	Soft fitout	$1,250,000	(As in 4 above assumed paid at commencement of lease)
5	Takeout of existing space	$3,665,707	(PV of shortfall in rental+opex+costs until subletting or assignment)
6	Partitioning compensation	$125,000	(As in 6 above assumed paid at commencement of lease)
7	Relocation costs	$125,000	(As in 7 above assumed paid at commencement of lease)
8	Cap on rental increase	$0	(PV of diff betw est market rental & capped rental over period)
9	Free naming rights	$300,923	(PV of defered rent-free period ie after allowing for *normal' period) (as
10	Other (ie free holidays etc)	$0	in 10 above assumed paid at commencement of lease)
	Total PV of Incentives	$9,453,883	$929/m2

$525/m2
$500/m2
$4751m2
$450/m2
$425/m2
$400/m2
$375/m2
$350/m2
$3251m2
$3001m2
$275/m2
$250/m2
$225/m2
$200/m2
$175/m2
$150/m2
$125/m2
$100/m2
$75/m2
$50/m2
$25/m2
$0/m2

CONCLUSION

	$9,453,883	= PV excess actual rental solved to try &	= PV of incentives
Equivalent (gross) rent-free period =	34 mths	PV of incentives =	$9,453,883
Effiective equivalent rent-free period	39mths	Difference =	$0 = 0.00 00%

Contract (or face) rental: $328/m2

Equivalent initial rental decapitalising the PV of incentives based on:

1	Rental term certain of:	18.Oyrs		$220.65htt2	67.2%	of contract rate
2	Total term (incl ROR's) of:	24.Oyrs	=	$230.02/r 2	70.1%	of contract rate
3	First rental review term only of:	3.Oyrs		-$26.37/r 2	8.0%	of contract rate
4	Break-even period of:	21.00yrs		$144.44/r 2	44.0%	of contract rate
ie months until ratcheted contract rental equals forecasted market review rental		252mths		= Effective Rental		

The State Owned Enterprises Act 1986

Effects of Section *27B*

by B Gould

Brett Gould is a partner to the New Plymouth Lawlink firm Reeves, Middleton, Young. He graduated fro #. Auckland University in 1979 and has been a partner in the firm since 1983 practising in the commercial and prop erty areas with Aspectal'interest in real estate marws Brett is a member of the LawlinkBoard. "htspaperwaspresented at the NZIV Taranaki Branch seminar::: held in New Plymouth on 1 000b r" *1992 ...*

It is now common to find certificates of title for land now or formerly owned by the Crown or a State Enterprise with the memorial endorsed on it: "Subject to 27B of the State Owned Enterprises Act 1986".

In ascertaining what the memorial means it is necessary to trace the history of the section and the Act of which it forms part. The Act which became operative on 18 December 1986records in its intituling:

"An Act to promote and improve performance in respect of Government trading and to this end:

(a) Specify principles governing the operation of state enterprises, and
(b) Authorise the formation of companies to carry on certain Government activities and control the ownership thereof, and
(c) Establish requirements about the accountability of state enterprises and the responsibility of ministers."

It is also important at this stage to note section 9 which states:

"Treaty of Waitangi nothing in thisAct shall permit the Crown to actin a manner that is inconsistent with the principles of the Treaty of Waitangi."

The original Section 27 of the State Owned Enterprises Act purported to provide that:

Where land was transferred to a state owned enterprise prior to the enforcement of the Act and where a claim had been submitted in respect of that land under section 6 of the Treaty of Waitangi Act 1975 (relating to Jurisdiction of Tribunal to consider claims) then:

- *The land would continue to be subject to the claim*
- *Subject to subsection 2:*
  - *The state enterprise shall not transfer the land to any person other than the Crown*
  - *No District Land Registrar shall register the state enterprise as proprietor of the land or issue a certificate of title in respect of the land."*

Subsection 2 provided that where findings have been made pursuant to section 6 of the Treaty of Waitangi Act 1975 in respect of land which is held by a state enterprise pursuant to such a transfer the Governor General may:

- Declare all or any part of the land shall be resumed by the Crown, OR
- In respect of land which has been transferred to a state enterprise waive the restriction on transfer and the restriction on the District Land Registrar from registering the state enterprise as proprietor of the land or issuing a certificate of title in respect of that land.

Where any land was to be resumed the state enterprise was to transfer the land to the Crown on the date specified and the Crown would pay to the state enterprise an amountequal to thevalueof theinterest of the state enterprise in the land including improvements.

The amount of any such value was to be that agreed between the state enterprise and its shareholding ministers or failing agreement determined by a person approved by the state enterprise and its shareholding ministers.

The Act in bill form was introduced to the House of Representatives on 3 September 1986. The Waitangi Tribunal report thereo n expressed fear that by enabling the transfer of Crown land to State Enterprises, that land would cease to be Crown land and the Act would put it out of the power of the Crown to return the land to Maoris in accordance with a Tribunal recommendation.

The New Zealand Maori Council in *New Zealand Maori Council v Attorney General* Court of Appeal (1987) 1NZLR 641 applied for judicial review of the exercise of the statutory power to transfer the Crown land to a State Enterprise in terms of the Act. The Council argued that despite section 27 the Act still enabled the Crown to transfer to a State Enterprise lands, which were subject to claims which the Tribunal lodged after 18 December 1986 and to claims which were not yet lodged. The Council maintained that the exercise of the statutory powers without an opportunity for the Tribunal to investigate existing and potential claims and without the Crown establishing any system to consider whether any such transfer would be consistent with the principles of the Treaty, would be unlawful. The Crown unsuccessfully argued that section 27 was in fact a self-contained code regarding land claims based on the Treaty and that the general words in section 9 should be read as to place no fetter on the transfer of Crown land to state enterprises. The Court of Appeal held that:

1. Section 9 of the Act was a firm declaration that nothing in the Act permitted the Crown to act inconsistently with the principles of the Treaty and overrides the rest of the Act. Section 27 did provide adequate protection in accordance with the principles of the Treaty for land in respect of which claims were lodged with the Tribunal by 18 December 1986. Itdid notthough cover the risk in respect of land for which claims had not yet been received. In these circumstances the restraints placed by section 9 had particular importance. The Treaty required the Crown to give consideration to the possibility of such claims before completing transfers.
2. The crown had a fiduciary duty to act in the utmost good faith to ensure that

the powers contained in the Act were not used inconsistently with the principles of the Treaty. Accordingly the Crown must satisfy itself before transferring the land that known or foreseeable Maori claims do not requireretention ofcertain land. Because the Crown acknowledged it had no system to consider whether any claim existed a declaration was made that the transfer of assets to state enterprises in such circumstances would be unlawful. Directions were given regarding preparation of a scheme of safeguards to ensure that land or waters were not transferred in a way to prejudice Maori claims submitted to the Tribunal after 18 December 1976.

3. The Crown ought not in the meantime take any further action affecting the assets referred to.
4. To protect the position of Maori claimants and to ensure compliance with Section 9 safeguards were required:
   - Including a power for the Tribunal to make binding recommendations for return to Maori ownership of any land or interests in land transferred to State Enterprises, and
   - Requiring the Tribunal to hear any claims relating to such land or interests in land as if it had not been transferred, and
   - Precluding State Enterprises and their successors in title from being heard by Tribunal on claims relating to land or interest in land so transferred.

The outcome of the above case was the Treaty of Waitangi (S tate Enterprises Act) 1988 which came into force on the 9th day of December 1987. That Act has as its intituling:

"An Act:

a) To give effect to an agreement entered into between New Zealand Maori Council and the Crown in settlement of an *application for judicial review.*

b) To make the Treaty of Waitangi Act 1975 and the State Owned Enterprises Act 1986...the amendments proposed in that agreement.

c) To protect existing and likely future claims before the Waitangi Tribunal relating to land presently in Crown ownership.

d) To give better effect to the objects of the State Owned Enterprise Act 1986 and to ensure compliance with Section 9 of that Act."

That Act repealed the existing Section 27 of the State Owned Enterprises Act 1986 and replaced it with Section 27A to 27D inclusive. The new Section 27A provides that a submission in respect of any land or interest in land of a claim under Section 6 of the Treaty of Waitangi Act 1975 to the Tribunal does not prevent the transfer of that land or any interest in land by a Crown to a State Enterprise or a State Enterprise to any other person. Thereafter Section 27A provides that where any land is transferred to a State Owned Enterprise the District Land Registrar shall note on the Certificate of Title the words "subject to Section 27B of the State Owned Enterprises Act 1986 (which provides for the resumption of land on the recommendation of the Waitangi Tribunal and which does not provide for third parties such as the owner of the land to be heard in relation to the making of any such recommendations).

Accordingly in respect of land transferred toa StateOwnedEnterprisebetween 1 April 1987 (being the operative date of the State Owned Enterprises Act 1986) and 9 December 1987 (eight months) the old Section 27 applies to the affect that in respect of land where a claim had been submitted under Section 6 of the Treaty of Waitangi Act no transfer to a state enterprise could have been registered. If in that period the Tribunal declared that the land should be resumed the State Enterprise was required to transfer the land to the Crown. The new Section 27A applied to any transfers after 9 December 1987 and at the time of the transfer to a State Enterprise the memorial will be entered on the title. It is interesting to note that no memorial will be entered on the title of any land where at the date of the transfer to State Enterprise the land was subjectto:

- A Deferred Payment Licence
- A lease under which the lessee had the right of acquiring the fee simple.

This is because those persons obviously had a right to acquire the land and the memorial would affect those persons without notice.

What is the resumption mechanism

This requires a consideration of Section 8A and following of the amendment to the Treaty of Waitangi Act as inserted by the Treaty of Waitangi (State Enterprises Act 1988).

Section 8A relates to recommendations in respect of land transferred to or vested in a state enterprise. The Section records that subject to Section 8B where the claim relates to the subject land, the Tribunal may:

"a) If it finds the claim well founded and

b) That the actions required to compensate for the omission or otherwise that was inconsistent with the principle of the Treaty should include the return to Maori ownership of the whole or part of the land or that interest in land

include in its recommendation under Section 6 a recommendation that the land or part of the land be returned to Maori ownership on such terms and conditions as the Tribunal considers appropriate and the Tribunal shall identify the Maori or group of Maori to whom the land is to be returned.

On the other hand if the Tribunal finds that the claim is well founded but that a recommendation forreturn is notrequired the Tribunal can recommend to the Minister that part of the land be no longer subject to resumption under Section 27B of the State Owned Enterprises Act. The same applies if it finds the claim is not well founded. In deciding to recommend the return the Tribunal are to disregard the condition of the land and any improvements to it or any changes to its ownership or possession. If the recommendation is made to return the land or interest in land to Maori ownership Sections 40 and 41 of the Public Works Act 1981, requiring that any land be first offered back to the person from whom itwas acquiredorthe successor of that person does not apply."

Section 8B provides that any recommendations under Section 8A are in the first instance to be interim recommendations which are to be served on the parties to the enquiry. The Tribunal cannot confirm its interim recommendation without the written consent of both parties until 90 days after the making of the interim recommendation. A party served with the interim recommendation can, within the 90 days, offer to enter into negotiations with the other party for settlement of the claim and thereafter within 90 days inform the Tribunal:

a. Whether the party has accepted or implemented the interim recommendations and
b. The result of the offer if any is made.

At any time before the 90-day time limit is up the Minister of Maori Affairs and the claimant may settle the claim. If it is not settled the interim recommendation becomes a final recommendation.

Section 8C records that if a question arises in relation to the subject land the only persons entitled to be heard are:

- The claimant
- Minister of Maori Affairs
- Other ministers of the Crown
- Any other Maori with an interest

Section 8D is noteworthy in giving the Tribunal power on the application of any state owned enterprise or individual owner of land to which Section 8A applies, to make application to the Tribunal that it recommend to the Minister of Survey and Land that the whole or any part of the subject land be no longer subject to resumption under Section 27B. Such recommendation requires that public notice be given and that public notice must describe the consequences if no claim is made. It requires that there either be:

a. No claim submitted to the Tribunal in respect of the land or
b. Where it is subject to a claim all parties involved consent to the making of such a recommendation.

Section 8E is most important in providing that on receiving a recommendation under Section 8A, ie to resume or not to resume land or Section 8D, ie that the land no longer be subject to resumption, the Minister of Survey and Land Information is to issue a certificate to the effect that the land or interest in land is no longer subject to resumption under Section 27B and a copy of the same is to be lodged with the DLR who will without fee register the certificate against the certificate of title for the land. This applies where the recommendation is that the land or interest in land is no longer subject to resumption.

At this junction it is necessary to again refer to section 27B which provides that if the Waitangi Tribunal has recommended the return to Maori ownership of any land or interest in land transferred to a state enterprise, that land or interest in land shall if the recommendation has been confirmed under Section 8B (relating to interim recommendations) be resumed by the crown in accordance with Section 27C and returned to Maori ownership.

Section 27C provides that the resumption of the land by the Crown is to be effected under the Public Works Act 1981.

Under Part II of the Public Works Act that acquisition can be by agreement or it can be taken by way of compulsory acquisition. Appendix A sets out the procedures if the land is acquired by agreement as against where it is acquired compulsorily.

How should a valuer advise his clients and how will the memorial affect saleability and financing?

Section 62 of the Act provides that where land is taken the compensation payable shall be value of the land if sold on the open market by a willing seller to a willing buyer on the specified date. The specified date is the date on which the land became vested in the Crown and in terms of section 4 of the Acts Interpretation Act 1924 land includes houses and buildings. Some of you may be familiar with the provisions in respect of compensation.

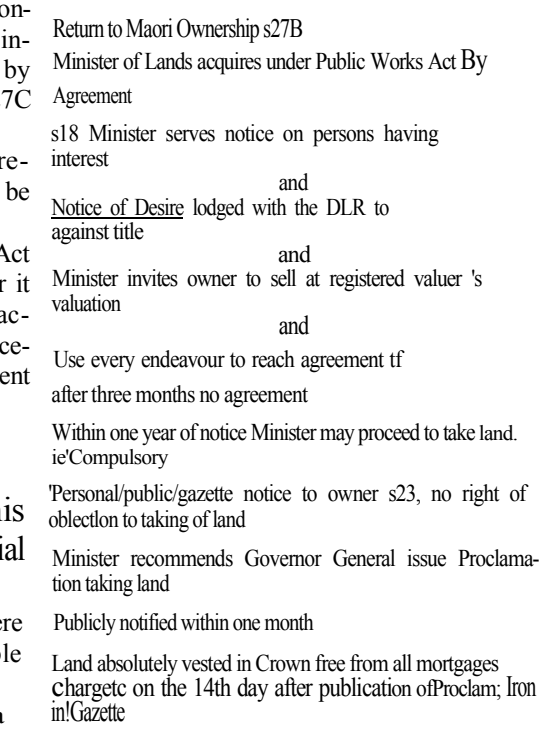
Referring to the words of Section 62, that is "if sold on the open market by a willing seller to a willing buyer..." one could assume that one will get market value.

The major difference though appears to be the timing factor, ie one loses the choice when one sells the property. The owner could be adversely affected if the land was taken at an inopportune time from a saleability point of view thus giving a lower compensation figure than the owner might have wanted. There could also be the effect on the owner's property portfolio for example if he is holding a mix of assets and does not want to see the property turned into cash. I would suggest to you that the downsides for any property in relation to which no claim has been made to the Tribunal are probably limited. They do exist and the potential purchaser must understand and accept them. They may include:

a. The degree of compensation does not cover the original acquisition price or does not give an adequate return on original acquisition cost plus inflation for the period between acquisition and resumption.
b. Resumption by the Crown may trigger early termination penalties for repayment of mortgages which may not be recognised in the compensation figure. But note Section 67 specifically provides for compensation for loss on repayment of mortgage.
c. In the event of the erosion of real prop er ty values there may be a loss because of the inopportune time of sale.
d. The reluctance of any purchaser to purchase where the land is the subject of a strong claim to the Tribunal which makes resumption and the consequent turmoil inevitable.

The attitude of financiers hasalso been interesting. The banks seem to have a diverse number of opinions as to the effect of the memorial.

I conclude by stating that other than the concern in respect of a known existing claim and the consequent timing factor mentioned previously, the memorial should not raise alarms. Inquiries reveal it is not. Accordingly valuers should, in respect of land in relation to which no known claim has been made, proceed as normal save for noting the memorial and the fact that it provides for resumption. For the same reason saleability should not be effected with any land subject to the memorial in relation to which no claim has been lodged with the Tribunal.



The Resource Management Act 1991

Putting Theory Into Practice

by B Bornholdt

Since the passing of the Resource Management Act 1991 (RM Act) and its coming into force on 1 October 1991, opportunity has been given to all those practising as "experts" in the area of the Act to now put "theory" into practice.

For some of us, it has been a memorable experience in trying to get to grips with the principles of the Act in a practical manner.

It has not been easy and I do not see it becoming any easier for a lengthy time to come. It has its own frustrations and is causing many challenges for our Courts, more particularly the Planning Tribunals at this time.

The problem lies in the interpretation area, where the Act in a number of its clauses is very poorly worded, the "English" leaving a lot to be desired.

The object of the legislators was to give the Act a clarity of purpose and to have an Act written in plain English for all to understand. Unfortunately, that is not the case.

Perhaps that was the reason for Section 360 (1)(g) of the Act which states:

"(1) The Governor-General may from time to time, by Order in Council, make regulations for all or any of the following purposes:

(g) Prescribing transitional and savings provisions relating to the coming into force of this Act, which may be in addition to or in place of any of the provisions of Part XV: and, without limiting the generality of the foregoing, any such regulations may provide that, subject to such conditions as are specified in the regulations, specified provisions ofthisAct shall not apply, or specified provisions ofActs repealed or amended by this Act, or of regulations, Orders in Council, notices, schemes, rights, licences, permits, approvals, authorisations, or consents made or given thereunder shall continue to apply, during a specified transitional period; "

Matters Dealt with to Date Under Section 360 of the Act

Because that Section has been used by the Minister for the Environment on a number of occasions now, to remedy defects in the Transitional Sections of the Act, some of theremedies have themselves created more confusion than that which it has attempted to remedy.

The first Regulation came into being on2 September 1991 torectify the"gobbly gook" of parts of Sections 389,390 & 413 of the Act.

"The Resource Management (Transitional Provisions) Regulations 1991 " to be followed by:

"The Resource Management (Transitional, Fees, Rents, and Royalties) Regulations 1991 "

where Part IV dealt with Transitional Regulations relating to the Harbours Act and Orders in Council relating to the reclamation of land and approval for harbour works (Regulations 17 & 18).

I would here note, that Regulation 78 was subsequently revoked by a new Regulation (Regulation 1992/107).

That regulation of 1991 was followed by:

"The Resource Management (Transitional Provisions) Regulations 1992: (1992/25)

That regulation dealt with clarification of matters under Sections 369, 389 & 405 of the Act.

Valuers will recognise Section 405 as being a Transitional provision relating to subdivisions in district plans. (Dare I mention esplanade reserves?)

That regulation was followed by:

"The Resource Management (Transitional Provisions) Regulation 1991 Amendment No 1 " (1992/106)

That regulation clarified the meaning of the term "right of appeal" for the purposes of regulation 3 of the Resource Management (Transitional Provisions) Regulations 1991.

That Regulation was followed by:

"The Resource management (Transitional Provisions) Regulations (No 2) 1992" (1992/107)

Thatregulation dealt with matterspertaining to Sections 393, 369, 385, 391, 369, 373, 378, 409,411 & 424.

I have included reference to all the amending Regulations to let you see that the "English" was not as plain and simple as the legislation would have led us to believe.

I do not accept that those regulations were brought about because of the fact that some fine tuning was required to those sections that the Regulations purported to clarify. They were brought about because what was there in the Act that they replaced, added to or clarified, could not be applied to the practical realities of everyday living, where people, District and Regional Councils, wanted to get about their lives and their work under the Act.

I can assure you that some of the amending Regulations have brought with them their own "gobbly gook" which I have had to deal with and am still dealing with on behalf of several clients I am acting for.

The Court's Reaction to Date

To date it is too early to clearly ascertain the Court's reaction to the many problems that I see arising under the Act.

Here I am using the term "Courts" loosely to apply to both the Planning Tribunals, the District Court and the High Court.

As you will be aware, there are gaps in

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the Act and some of them have surfaced publicly while others are yet to see the light of day.

Time precludes me from getting into any great detail in this area but let me refer to three for the purposes of this paper.

They are:

i) The fact that territorial authorities do not have authority under the Act to make designations in theirown district plans for their own public works. NOR are they authorised to make requirements of themselves for designations for their own works.

(Refer Auckland City Council & Others Dcn A.54/92 - a decision of Planning Judge D F G Sheppard sitting alone pursuant to Section 309 of the Act).

That decision has had major repercussions for many local authorities in a practical way. As a result of that decision I am further of the view that territorial authorities cannot give notice to themselves that they require a designation to be altered (Section 181 of the Act).

I shall expand upon those matters further in this paper.

ii) The fact that requirements by a Regional Council or other Territorial Authority to a territorial authority under Section 168 of the Act, if issued after notification of a Proposed District Plan (formerly a district scheme review) cannot be accommodated because there is no provision in Section 175 of the Act for inclusion of requirements in Proposed District Plans after notification of that Proposed Plan and before it becomes operative. A gap therefore exists between the notification of a Plan and the Plan becoming operative where a requirement for a designation cannot be made.

I shall deal with the practicalities of that gap in the Act later in this paper.

iii) The fact that there appears to be a lack of reference to Section 294A of the Local Government Act 1974 in the Act with particular reference to Section 409 of the Act. Section 294A refers to the payment of Development Levies. It is my view that the payment of Development Levies as such are not provided for in the Transitional part of the Act.

Again I shall deal with the matter in a practical manner later in the paper.

iv) Esplanade Reserves

All valuers have been made aware of the problems associated with the application of the Act to Esplanade Reserves in subdivisions near waterfronts, rivers and lakes. (Refer NZ Valuers' Journal June 1992 pages 19-38.)

I do not propose dealing any further with the issues arising and commented upon in the paper as reported in that Journal. The Minister has issued a policy paper on the matter and no doubt many of the practical problems that have arisen will be dealt with by way of proposed amending legislation.

That there have been many practical difficulties arising out of and flowing from the theoretical aspects of the Act there is no doubt and they will in my view, continue for a long period to come, despite attempts at amendments to the Act.

The approach to the practical problems is not easy, particularly when there is a gap in the legislation in this case the Act as was noted by his Honour Judge D F G Sheppard in the Auckland City decision (Supra p. 4) when he quoted a passage from the Court of Appeal's decision in *Northern Milk Vendors Association v Northern Milk* (1988) 1 NZLR 530 at p 537 as follows:

"This is one of a growing number of recent cases partly in a category of their own. They are cases where, in the preparation of new legislation making sweeping changes in a particular field, a very real problem has certainly not been expressly provided for and possibly not even foreseen. The responsibilityfalling on the Courts as a result is to work out a practical interpretation appearing to accord best with the general intention of Parliament as embodied in the Act- that is to say, the spirit of the Act. In doing so we have to bear in mind that freedoms such as that of the owner of a business to conduct the business as he seesfit are not to be restricted unless it clearly appears that this must have been the intention of the legislature. Obviously therefore a great deal turns on the needfor the Courts to appreciate and give weight to the underlying ideas and scheme of the Act.

It can be helpful, even crucial, to have statements of general principle or purpose in the Act itself..."

Some General Matters of Interest Arising From Several Decisions of the Planning Tribunals

So far as the Act is concerned I have commented that:

"What we needed... was a piece of legislation to provide a system that meets the community's social and environmental needs without the shifting of responsible development, which to my mind is every bit as important to the community's well being and more so, on a national basis." (Darroch Aspect -December 1991 p 11)

The question might well be asked has that shifting occurred to date?

My own experience has been, that in the main, local authorities are trying to balance responsible development with its community's well being and I have discerned some positive signs in that direction. On the other hand one or two of the more recent decisions of the Planning Tribunals may be pointing in another direction.

Let me cite the following examples:

i) R *A Batchelor & Others v The Tauranga District Council* Dcn A64/92 a decision of the Planning Tribunal presided over by Planning Judge D F G Sheppard.

That case has created a stir amongst "workers in the field" over the treatment by the Planning Tribunal of Section 105 of the Act.

The activity proposed, was an off licence liquor shop to be established in a building that was previously a truck service station since 1962.

The proposed activity was a non-complying activity not falling within those activities as provided for within the Industrial C Zone of the transitional district plan.

The Tribunal's conclusions on the legal issues were:

"First, because the Resource Management Act is a reform measure, we decline to compare its provisions for non-complying activities with corresponding provisionsof earlier law. Secondly, we accept that a consent authority can only consider an application for a non-complying activity if one of the alternative conditions in section 105 (2) (b) isfulfilled. We hold that those conditions are not tests, the passing of which would justify the granting of consent; but are conditions thefulfilling of which enables the consent authority to consider the proposal on its merits having *regard to the matters referred to in section 104.*

Thirdly, we accept that an application for a non-complying activity is not to be refused on the ground that the respondent has not yet adopted policies under the Resource Management Act.

Fourthly, we hold that where the intent of detailed provisionsof theActis clear, and express guidance is given for the exercise of a discretion, it is not

necessary to refer to the general purpose of the act.

Fifthly, we hold that the Resource Management Act does not preclude councils from making provision in districtplansfor people that are capable of serving the promotion of sustainable management of natural and physical resources.

Sixthly, we hold that when considering an application for consent to a non-complying activity, a consent authority is to have regard to the effects of undertaking the activity, and to the effects of allowing it, including anyeffectsonpublic confidence in consistent administration of the district plan, and on the coherence of interrelated objectives, policies and rules which make up the district plan.

Seventhly, we consider that in general a so-called precedent effect (that if consent is granted to a non-complying activity, applications may be made in other similar cases) is not worthy of serious consideration by a consent authority."

(Refer p 15 & 16 of the decision)

The Tribunal's decision was:

"Although the transitional districtplan was prepared and became operative under earlier legislation, the Resource Management Act provides for it to continue until it is replaced by a district plan prepared under that Act. Therefore in our judgment the adverse effects of allowing the proposed non-complying activity on confidence in the consistent administration of the district plan, and on its coherence, ought to prevail over the advantage of making use of the resource represented by the existing building on the site, which is currently unused. In our judgment, the application should be refused."

The question may well be asked:

"Are we backin playing the `Specified Departure game' despite the Act?"

and despite the Planning Tribunal's comments at page 9 of the *Batchelor* decision when it stated:

"We do not consider that there is value in comparing the provisions of the Resource Management Act with the provisions of theTown andCountryPlanning Act, or with speculating whether by amendments made in the course of the Resource Management Bill's passage through Parliament previous law was intended to be dispensed with.

The Resource Management Act is avowedly a reform measure (see the long title), and there is ample material within its own provisions from which Parliament's intentions for the new regime can be seen. In our opinion, the true issue is not whether the conditions for consenting to non-complying activities are more relaxed than the conditions for consenting to specified departures under the former Act. Rather, the issue is the true meaning of the provisions of the Resource Management Act which prescribe how applicationsfor consent to non-complying activities are to be decided."

It appears that that Tribunal's view of Section 105 is also the view of another of thePlanningTribunals,namely thatofJudge Skelton's (refer *Kennett & Thetford v Dunedin City Council* Dcn C78/92 dated 14 August 1992).

For valuers this leaves the question: What would your market valuation approach be now towards the former service station property, in the light of *theBatchelor* decision?

ii) *Shell Oil New Zealand Limited v Wellington City Council* Dcn N57/92 a decision of the Planning Tribunal presided overby PlanningJudgeTreadwell. The case relates to a desire by Shell to establish a service station out of zone (a non-complying use). The decision is interesting in that it sounds a note of strong caution to commercial enterprises as follows:

"We observe that the RM Act and in particular the provisionsofPartII of that Act give a strong caution to commercial enterprises wishing to establish utilitarian brightly coloured and eye-catching structures of standard design in areas where they are not permitted merely for the purpose of attracting attention and custom. If operators such as the present appellant wish to bring their enterprise into zones of residential character and of harmonious design, then they must tailor their structure to fit the amenities there at present.

The definition of "amenity values" places strong emphasis on present neighbourhood character. It would not be exaggerating to state that the design of most modern service stations is effectively a complete advertisement for the product."

Needless to say the Tribunal refused Shell's application.

A further question for Valuers: How would you view the vacant site for market valuation purposes in the lightof the Tribunal's decision?

iii) *Marlborough Hockey Association Inc and L J Hogg & Others and Marlborough District Council* Dcn W.45/92 a decision of the Planning Tribunal presided over by Planning Judge Treadwell.

Put briefly, this case revolved around the provision of a floodlit all weather artificial playing surface for Hockey on a playing field owned by the Ministry of Education but operated by the Marlborough Boys' College.

One of the problems associated with the playing field was the provision of floodlights which formed partof the submissions of the local resident subcommittees. That was the only concern of the Planning Tribunal together with other uses that might lfow as a consequence.

Again it was a case in which Sections 105 & 104 of the Actwere underconsideration by the Tribunal. In that case the Tribunal held that the granting of a consentwould not be contrary to the objectives and policies of the District Plan (Section 105

(2)(b)(ii)) and because of that it was not necessary for it to consider Section 105

(2)(b)(i) as to whether or not the "effect" was minor.

Having reached the conclusion that the Section 105 hurdle (non-complying activity) was overcome the Tribunal then had to turn its mind to Section 104 in order to ascertain whether the matters to which a consent authority shall have regard, led it to the conclusion that the resource consent should be granted.

In considering that matter, the Tribunal had cause to examine the effects of allowing the activity (both beneficial and detrimental). In so doing it did not consider that a majority of residents were affected to a degree where night time sporting activities should be prevented upon the Park.

It then turned to consider the amenities which a neighbourhood can expect, where it stated atpage 14 of its decision as follows:

"...we do not consider that sS nor the plan contemplate anyparticularsacrifice on the part of any resident in order to permit a brightly lit arena to be accommodated on a common boundary."

It then went on to say at pgs 14 & 15:

"We have considered the evidence carefully and have *reached the conclusion that despite the difficulties the Association may face, it must come to grips with the problem of the neighbours closest to the park to the north. We see no reason why those neighbours shout d be subjected to greater light annoyance than could be expected if they had a common residential boundary with another home or if their house was fronting on to a street lit to suburban standards. The evidence placed before us indicated that there could be a significant spill of light onto the rear part of the properties of the two*

neighbours most closely affected. It may be possible in some ways to screen that out but we do not think that this is a problem which the neighbours should face."

Finally, in its consideration of actual light measurements, the Tribunal considered that the RM Act required it to take a conservative approach.

A question: How would you as Valuers prepareevidenceinsupportof theresidents' claim that the provision of the all weather hockey pitch with its floodlights would detrimentally affect the capital value of their properties?

Is the "amenity of the neighbourhood" a matter in which the Valuer takes particular notice when compiling a valuation?

Other Matters of Interest

There are one or two other areas of the RM Act which have evoked considerable interest, they are:

i) Section 311 applications

The applications under section 311 are related to declarations, which apart from subsections (2) & (3) of Section 311 may be made by any person in respect of those matters set out in Section 310 of the Act, by way of example:

a) Whether an activity is a complying or non-complying activity
b) Matters requiring interpretation within a District Plan.

It would appear that Section 311 is going to be continued to be used on a fairly frequent basis.

ii) Abatement Proceedings under Section 324 of the Act

Again, this is a proceeding that gives the appearanceofbeingusedon a fairly frequent basis and that obviously was the reason for its inclusion in the Act.

From several of the decisions the Planning Tribunals in this area it is obvious that much care needs to be taken in the preparation of the formal documents required to be lodgedwith the Planning Tribunal. (Refer *J E Dennis v Tauranga District Council* Dcn A61/92) (Refer G R *Wilhelmsen v Dunedin City Council* Dcn C59/92)

iii) Applications for Interim Enforcement Orders and Enforcement Orders (Section 314 et seq of the Act)

Again, these are proceedings that give the appearance of being used on a fairly rfequent basis and again that was obviously the reason for the inclusion of the enforcement sections in the RM Act.

From the decisions received from the Planning Tribunals to date it is obvious that this part of the Act is going to be an interesting "battleground" to come.

In this regard I would particularly refer you to the case *ofRangioraNew World Ltd v Barry, Hanna & Smith* Den C 16/92 (a decision of Planning Judge Skelton sitting alone) where Judge Skelton stated at pgs 8 & 9 as follows:

"I think there is some force in Mr Milligan's contention that an *enforcement order is not the same as an injunction. If Parliament had intended otherwise it would probably have used the word injunction, as indeed it did in earlier legislation-see for example section 173A of the former Town and Country Planning Act 1977, that gave a District Court the power to grant an injunction to restrain the continuance of an offence.*

Consequently, I think that applying common law tests applicable to the making of permanent injunctions to enforcement order cases needs to be done with a good deal of care. It has to be borne in mind, as Mr Milligan submitted, correctly in my view, that an enforcement order is a remedy provided to enforce public duties. There are of course, examples of statutory injunctions that are provided for the same purpose and I have just referred to one in the former Town and Country Planning Act, but many of the common law tests that have been developed over the years to assist in determining whether to exercise the discretion to grant an injunction have developed out of private law litigation."

Again, in this general area Judge D F G Sheppard sitting alone had the following to say in the record of his oral judgment in *Walden, Gordon & Others v The Auckland City Council* Decision A.3/92 at page 3 as follows:

"7reeognise that in invoking thejurisdiction of the Planning Tribunal, perhaps rather than the general courts, the applicants might have sought a forum where there would be less emphasis on formality and greater attention to achieving what underlies the principles of the Resource Management act.! would like to think that that will always persist.

Nevertheless, an interim enforcement order which is similar in nature to an interim injunction is a very particular kind or proceeding, one which can lead to orders which have adverse affects on parties who are not present or represented. It is not a kind of proceeding where great flexibility can properly be given."

Perhaps we are gleaning from some of the cases that I have referred to that we are not finding the greater flexibility arising out of the Act as was anticipated would be the case be by our legislators.

It is my view that we are unnecessarily trammelled by legal form and niceties which we did not suffer from in the legislation which the Act has replaced.

iv) Other Applications

We are being led by the Act into areas such as:

- Applications for a "Stay of Proceedings" where in one case it was accepted on behalf of the Manukau City council that in general the Planning Tribunal hasjurisdiction to grant a stay pursuant to Rule 710 of the High Court Rules which apply by way of Section 299 of the Act. (Refer *The Manukau City council v The Minister of Social Welfare* Den A.57/92
- Applications for the Striking out of Appeals Section 279(4) of the Act. (Refer *Sadd v Marlborough District Council & Stope & McQuillan* Dcn C.65/92)

v) Other Acts

It is interesting to note that in the W ilhelmsen Case (Supra p 10) the Bill of Rights Act 1990 - Section 27 was raised, but the Tribunal found it not necessary to consider in any detail the argument that was based on Section 27, however, the Tribunal did say at p 10 of its decision: "We do not wish to be taken as closing the door on a Bill of Rights Act argument in this jurisdiction..."

Conclusion

In this paper I have endeavoured to give an overview of the transformation of "Theory into Practice" so far as the Act is concerned. I am aware that the Ministry for the Environment is attempting to rectify a number of practical problems through an amending Bill which hopefully will shortly see the light of day. That will be a surprise in store for all of us and I can only hope that the New Zealand Institute of Valuers both at Branch and National level, will take a greater interest and a more active role towards the amending legislation than it did while the present Act was still in Bill form.

To date I have no reason to resile from my comments as made during your National Institute'sEditorial Board Sponsored Lecture Tour as reported in NZ *Valuers' Journal* (supra at p 21) as follows:

"It is my view that the Act will:

i) Create delays in the decision making process across the board, despite the fact there are time limits imposed on hearings of applications and other matters.
ii) It will increase litigation.
iii) It will be costly for all involved
iv) It will greatly increase the work of our Planning Tribunals...and also that of the High Court and possibly the Court of Appeal.
v) It will create a great deal of uncertainty over a long period." A

Economic Variables Affecting Residential Property Value
Using past performance to predict future trends

by I E Mitchell

Six macro economic factors were identified as influencing residential house prices in New Zealand between March 1970 and June 1991. This is the main finding of the research project which had two objectives. First the research aimed to identify which economic variables are correlated highly with the value of residential houses. The second purpose was to build an econometric model which could explain both trends in value and predict future trends.

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Variable Identification and Selection

Over the last 12 months the debate concerning the economic factors that influencehouseprices has become more heated as both theorists and practitioners attempt to forecast future residential house prices. An extensive review of the literature was undertaken to identify which variables were likely to influence residential house values.

Westpac (1991) examined residential house prices and concluded that "ultimately the price of any good is determined by the interrelationship of supply and demand ataparticularpointoftime. Supply constraints look minimal at the moment but if any significant recovery was to occur there could be a supply side problem in years to come" (page 1).

The critical economic factors identified by Westpac (1991) were inflation, real disposable income, real interest rates, and consumer confidence. These factors all relate to the demand for residential property.

The New Zealand Real Estate Institute (Dominion 5/11/91 page 12) disputed Westpac's conclusions and suggested that the fall of high nominal interest rates of the 1980s allowed households to borrow more. This, they argued, had an inflationary effect on house prices.

Brown (1990) found that expected capital appreciation rates influenced values. Significant serial correlation existed in some cases indicating that past capital appreciation may influence future capital appreciation, and hence the prices investors are willing to pay. Brown (1990) found that by lagging the inflation rate by three quarters, he was able to improve the explanatory power of his model.

Wheaton (1985) concluded that inflation had influenced the economy wide demand for housing and hence house prices. Wheaton argued that inflation creates a growth in real equity asborrowed debt is leveraged against the inflating value of houses.

Birks (1984) concluded that there was a causal relationship between movements in residential property prices and government monetary policy. Birks (1984) studied the relationship between seasonally adjusted M3 money supply and the urban house price index between 1964 and 1983. He concluded that increases in money supply increased the growth rate of the house price index. This effect was maximised 12 months after the change in money supply. These findings were supported by Pedersen (1991).

This review of the literature led the researcher to select 20 economic variables. These on the basis of the literature and because they were important economic indicators. The variables included in the analysis are presented in Table 1(nex page)

Not all the statistical series were obtainable for the whole period because the Statistics Department had periodically changed their base years and methods of calculation. Consequently, it was necessary to merge series together to collate series covering the full time period.

The VNZALL variable was an aggregate index calculated by Valuation New Zealand for all residential property in New Zealand. This index was used in the absence of a superior index covering the same time period. The CAPAP4, capital appreciation, variable was calculated using the VNZALL index. The CAPAP4 index was calculated as the percentage increase in value over the past year.

The CPI variable was an aggregate index calculated for all sectors for the whole of New Zealand, and is the accepted variable for measuring inflation. TheGDP, gross domestic product, variable was used as a composite variable to measure economic activity.

PERMITS, the number of residential building permits issued gave an estimation of the increase in the size of the housing stock. The cost variable was calculated by dividing the total value of residential permits issued divided by the number of permits issued. This gave an indication of the inflation related to the costs of constructing a dwelling. RDIHLDS, real disposable income for households, gave an indication of the real income available to households for consumption. This index has only been calculated since March 1980. EFFNOMIN, effective nominal income, was used as an income variable that spanned the whole period. This is the nominal income index based on weekly wages adjusted for changes in the CPI index.

Beer, consumption of beer, was included as a variable to measure the state of depression within the economy on the basis that in depressed times people tend to drink more. RETAIL, retail turnover, was included as a measure of the economic activity within the economy.

The next three variables, TOTEMP, total people employed, UNEMPRAT, un-

Table 1: Data series used to construct the independent and dependent variables

Code	Series	Source
VNZALL	Valuation NZ Index for residential house prices for all New Zealand	VNZ
CAPAP4	Capital appreciation in residential values over previous 12 months	Calculated
CPI	Consumer Price Index (all items)	NZS CPIQ SE9A
GDP	Gross Domestic Product (expenditure based)	NZS SNBA. SB9
PERMITS	Number of residential building permits issued	NZS BLD.SCC11C0
COST	Average cost of a dwelling or permit issued	NZS BASQ.S2A and BLD.SCC1 1CO
RDIHLDS	Real disposable income for households	NZS RDIQ.SP7
EFFNOMIN	Effective nominal income for adult (all sectors combined)	NZS PWIQ.S1329
BEER	Beer consumption in Dollars	NZS SEPQ.SADDP
RETAIL	Retail Turnover	NZS RTLM.S1A19
TOTEMP	Total employed in the work force	NZS HLFQ.SAA3A2
UNEMPRATE	Unemployment rate	Calculated
TOTUNEMP	Total people unemployed	NZS HLFQ.SAA3A2
POP	Total population	NZS DPEA.SADC
M3	M3 Money Supply	NZS FINM.SAGB
SW	Total social welfare payments	NZS SOWA.SM21 to SM27
CONFID	Industry confidence index	NZIER
INTRATE	Mortgage interest rates	NZS RBKM.SIM*
RIR	Real interest rate	Calculated
INFRATE	Inflation rate	Calculated
BKRPT	Number of bankrupticies	NZS BALQ.SA

KEY
NZS = New Zealand Statistics DepartmetnStatistical Series
NZIER = New Zealand Institute of Economic Research Series
VNZ = Valuation New Zealand Series
8 Part provided from NZS Statistical Series and part from New Zealand Reserve Bank Bulletins
Note: All variables were converted to quarterly values

employment rate, TOTUNEMP, total people unemployed, were included to determine if there was any interaction between the labour market and residential house prices. TOTUNEMP was calculated by dividing the total number of unemployed by the total labour market. POP, total population estimates, was included to give a measure of increase or decrease in people requiring housing.

M3, M3 money supply gives an indication of changes in the money supply. SW, total social welfare payments, was included to provide a relative measure of governments social spending. CONFID, industry confidence index, was included to provide a measure of the level of consumer confidence. The index used is a composite index produced by the New Zealand Institute of Economic Research and covers all industry groups. This index was found to be highly correlated to the consumer confidence index produced by the Westpac economic division. This index was used in preference to the consumer confidence index and has only been calculated for the last seven years. INTRATE, mortgage interest rates, was included to give a relative cost of capital to the investors. RIR, real interest rates, was calculated by deducting the inflation rate from the mortgage interestrate to give a relative measure of the cost of capital and inflation rate.

INFRATE, inflation rate, was calculated from the rate of change of the CPI index. This gave an indication of relative rate of change of inflation. BKRPT, number of bankruptcies, was an alternative measure of the relative level of confidence in the economy.

Method of Analysis

The 20 variables were examined using four statistical techniques. First, stepwise regression was applied to the data series. Second, cross correlational analysis was used to identify leading indices which were then included in the stepwise regression analysis. Third auto correlational regression techniques were applied to the data to try and reduce the amount of auto correlational error present. Finally auto regressive integrated moving average analysis (ARIMA) was employed to try and explain the behaviour of the time series.

Regression analysis was used to build an econometric model to explain changes in house price values over the last 20 years. Regression analysis is based on the following assumptions:

- normality
- equality of variance
- independence between observations of independent variable; no serial or auto correlation between error terms
- linearity.

Time series analysis was used to identify indices leading the VNZALL index and to develop a predictive regression model based on this indices. Time series analysis involved measuring a variable or variables regularly over a period of time. The primary goal of any time series analysis is to build a model that will explain the variation in the dependent series (variable).

Box Jenkins analysis was used to develop a non seasonal model to predict house prices. Auto correlational regression models were used to calculate apredictive equation to account for the serial correlation of the residuals. The objective, given a particular time series such as VNZALL, is to derive a linear stochastic model that would generate the series.

Results

The data were analysed using the SPSSPC statistical package. The following proce-

Table 2 Results of stepwise regression including dummy variables and cases with missing values.

Variables	Regression Coefficient	T Test Values
POP	0.1582	5.7
COST	0.00395	4.4
DUM2	-39.979	-6.3
TOTUNEMP	3.5467 x104	2.3
PERMITS	0.01081	7.7
CONFID	-0.2893	-5.4
CPI	0.2337	7.6
BKRPT	0.01526	3.4
INTRATE	-2.7141	-2.2
CONSTANT	-526.908	-6.5
GDP		
Adjusted r2	0.998	
Standard Error	15.037	
F Statistic	4042	
Durbin-Watson	1.1995	

Table 3: Results of stepwise regression using only leading indices

Variables	Regression Coefficients	T Test Values
CPILD2	0.4799	8.851
M3LD5	0.01341	8.085
SWLD2	-6922 x 105	-4.702
Constant	-50.917	3.4
Adjusted r2	0.994	0.994
Standard Error	23.79	23.79
F Statistic	4416	4416(100)
Durbin-Watson	0.196	0.196

dures were used: stepwise multiple regression analysis, lagged regression, auto correlation regression, and Box Jenkins analysis (ARIMA).

Regression analysis

The data were analysed in a number of different ways to obtain an optimal result. A summary of the stepwise regression is contained in Table 2. This regression equation included dummy variables to accommodate changes in the slope of the VNZALL index with time and included cases with missing values in the analysis.

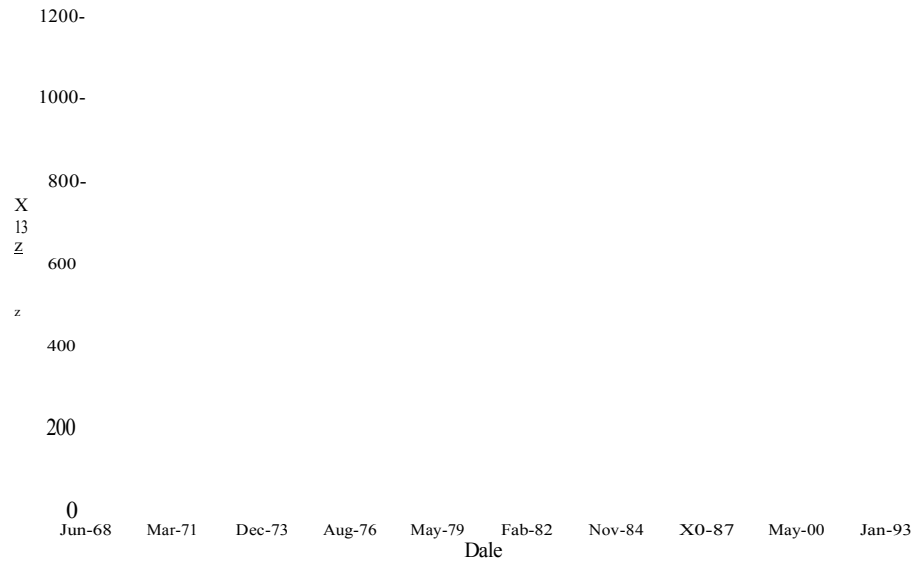

Fig 1: Stepwise regression Including dummy variables and cases with missing values vs VNZALL Index VNZALL Stepwise regression

The results indicate that there is a moderate amount of auto correlation present between the residuals and some heteroscedasticity. The r2 indicates that the equation accounted for 99.8% of all variance.

Figure 1 demonstrates graphically the actual VNZALL index plotted against the line predicted by the equation.

Lagged Regression

Leading variables, and the number of periods by which they led the dependent variable, were identified using cross correlational analysis. M3, money supply, CPI, consumer price index, COST, the average cost of constructing a dwelling, and SW, total social welfare payments were identified as the leading variables. Money supply led by five quarters and had the greatest lead time, indicating that it is a very important indicator when trends in future residential property prices are examined.

The Consumer Price Index led by two quarters, as did total social welfare payments, and the average cost of constructing a dwelling led by one quarter.

Table 3 summarises the results of stepwise regression analysis of all the leading indices with the VNZALL index.

The results indicate that both significantauto correlation and heteroscedasticity were present.

The adjusted r2 indicated that in excess of 99% of the variance was explained by the equation.

Figure 2 plots the predicted values from this equation vs the actual values. The equation provides a reasonable fit but fails to predict the decline in values over the last three quarters.

This procedure was then repeated including all the other variables. This produced a more satisfactory result, which is summarised in Table 4 (next page).

The results showed that the inclusion of the other variables the adjusted r2 increased to 99.9% and the standard error fell to 9.50.

Significant auto correlation existed and the data was heteroscedastic. Overall, this equation appeared to be superior to the equation which included the leading variables only. However, because some of the basic assumptions required by the regression model were violated, there is some doubt concerning the accuracy of this equation.

Figure 3 plots the predicted against the actual values for this regression equation.

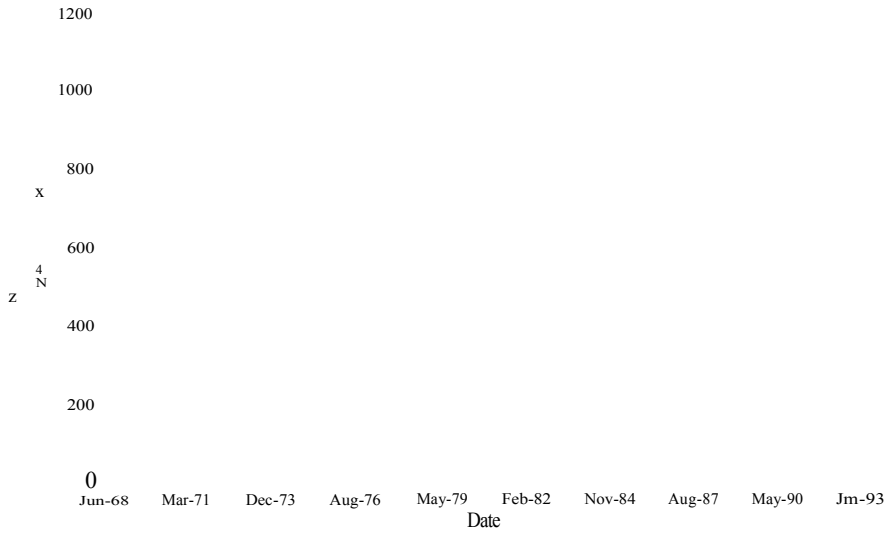

Fig 2: Results of stepwise regression using ony the leading indices.

Table 4: Results of stepwise regression using leading indices and other variables

Variables	Regression Coefficients	T Test Values
CPILD2	0.0766	1.86
POP	0.7929	6.4
PERMITS	0.00927	4.2
CONFID	-0.15269	-2.85
M3LD5	0.01177	7.70
CAPAP4	1.6099	5.39
EFFNOMIN	-0.1713	-3.88
RIR	1.9998	3.69
CONSTANT	-2247.8	-5.91
Adjusted r2	0.999	
Standard Error	9.50	
F Statistic	5009	
Durbin-Watson	0.118	

Table 5: Results of auto correlation regression analysis using Prais-Winsten method and including leading variables

Variables	Regression Coefficients	T Test Values
CAPAP4	1.08363	4.8
CPILD2	0.18568	6.6
PERMITS	0.00139	2.6
POP	0.39263	4.6
M3LD5	0.00831	5.7
CONFID	-0.04592	-2.6
CONSTANT	-1146.04	-4.5
Adjusted r2	0.9126	
Standard Error	6.209	
Durbin-Watson	1.018	

Auto Correlation Regression Analysis

Because the data exhibited high auto correlation, regression techniques were employed to create models that minimise the auto correlation present.

The Prais-Winsten and the maximum likelihood methods were used. The Prais-Winsten method produced the most precise result, however, significant auto correlation was still displayed.

Table 5 summarises the results of the auto correlational regression analysis using Prais-Winstenmethod which included the leading variables.

The equation has a low standard error and only has moderate auto correlation. the adjusted r2 fell to 91.3%. This is a truer estimate of the coefficient.

Figure 4 displays the plot of the predictedversus the actual values for the VNZALL index.

ARIMA Analysis

The analysis using auto regressive moving average analysis did not produce a superior model for explaining the variability of the VNZALL index. The results indicated that the series was not stationary.

These results were inconclusive and none of the dummy variables were significant. The plot of the auto correlational function for the residuals were consistent with the hypothesis that these residuals were white noise.

Summary and Conclusions

The analysis identified four equations which provide reasonable predictors of the VNZALL index and each has its own limitations and advantages. All displayed significant auto correlation of theresiduals which limits the explanatory power of these equations.

Of the equations, the stepwise regression equation using only leading indices had the advantage of using known data in the series to predict future values of VNZALL.

The most regularly occurring variables in the regression equations are set out in Table 6. These variables are expressed as a percentage.

POP, total population, CPI, the Consumer Price Index, PERMITS, number of residential building permits, and CONFID, business confidence, were the most frequently included variables. M3 was only included when it was lagged by five quarters, and was included in every equation as a lagged variable. CAPAP4, capital appreciation over the previous four

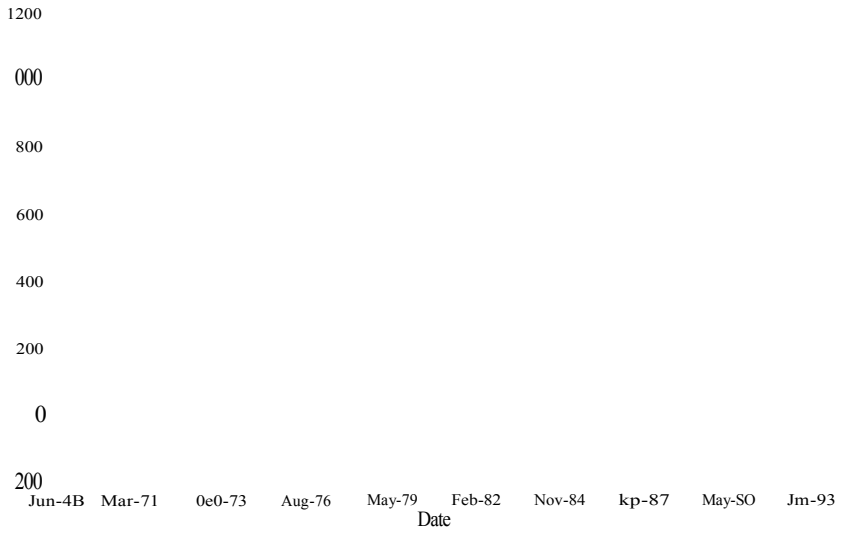

Fig 3: Results of stepwise regression using leading Indices and other variables

Table 6: Frequency of inclusion of variables in regression equations

Variable	Frequency (%)
POP	100
CPI	90
PERMITS	90
CONFID	80
CAPAP4	60
M3	40

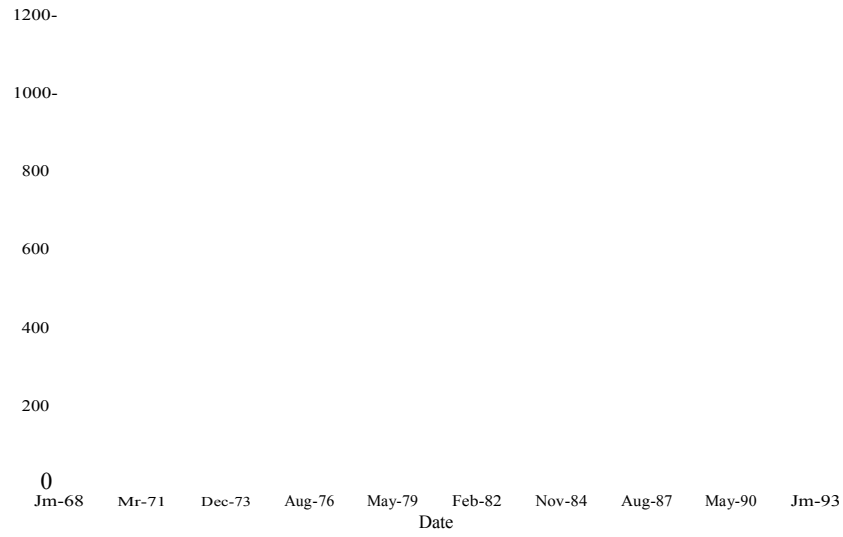

Fig 4: Results of the autocorelational regression analysis using the Prais-Winsten method including leading variables

quarters, was included in all equations in which the leading variables were incorporated.

The invariable appearance of these variables is consistent with the literature. Changes in these variables are the ones most likely to influence the value of residential properties. The only exception is the absence of any income related variables, which do appear as significant in the literature.

Limitations

There are several limitations associated with this study and these can be seen as follows. First, it was necessary to merge data series together to generate data that covered the period of study. This could have introduced errors into the results as the base of calculation may have been changed and the smoothing process itself may incorporate a degree of bias.

Second, this research assumed that the relationship between all the variables remained constant over the whole time period. These relationships could have changed easily.

Third, the dependent variable is aggregated data and this may have resulted in additional error as the aggregate index may not have been as volatile as the economic series.

Lastly, government intervention in the market place can cause sudden changes in direction or the relationship of the variables which are difficult to incorporate in the analysis. This could add to the error.

In conclusion, it would appear that there is a strong relationship between the prices of residential property and at least six economic variables.

These variables are population size, the Consumer Price Index, the number of building permits issued, the level of business confidence, the capital appreciation on property over the last 12 months, and the M3 money supply.

These relationships were difficult to analyse because of high serial correlation in the data. Four equations were developed to establish these relationships and these can now be used to predict the future prices of residential property. A

Mussel Farms: factors central to site value

by I E Mitchell

his research was a preliminary in-T vestigation which aimed to explore the current processes and practices employed in the appraisal of New Zealand's coastal resources. Particular emphasis was placed on marine farm licences in the Marlborough Sounds. Between January 1988 and June 1990, these marine farm licences traded at between $2000 NZD and $21,052 NZD per hectare. This large variation in value and the underlying characteristics were the foci of this research.

Aquaculture is the use of an aquatic environment to farm fish, shellfish, and marine plants. Aquacultural development in New Zealand is facilitated by the relatively clean and unpolluted water surrounding the country and an absence of organisms causing paralytic shellfish poisoning. Paralytic shellfish poisoning has occurred in the waters used for aquaculture of the west coast of United States of America and Canada.

New Zealand's aquacultural industry is still relatively young. Currently exports of aquaculturally produced commodities are worth approximately $40.2 million NZD per annum. The major markets for this produce are Australia, Japan and the United States of America.

Mussels are bi-valve filter feeders. They grow naturally in New Zealand's coastal waters. Attempts to farm this shellfish have been quite successful with the majority of produce being sold overseas as frozen meat. The government is responsible for the issuing of licences to mussel growers which grants these marine farmers the right to grow mussels on a specific site. Typically, they are grown on 3 hectare sites within 200 metres of shore. While recent times have witnessed large price fluctuations for produce, interest in this area of marine farming is growing.

The areas examined by this article are:

1. The site characteristics identified as integral to the value of a marine farm site.
2. The current appraisal practices and processes employed in marine farm appraisal and the relative merits of each of these.
3. The implications of the changes incorporated in new legislation.

Because of its relative youth, marine farming in New Zealand is characterised by a paucity of literature and the lack of an existing body of knowledge. An overriding objective of this research was to begin to tie together diverse strands of research and knowledge.

Existing legislation has limited the development of marine farming. Both government and industry recognise that the present planning and licensing procedures are slow, cumbersome and have negative consequences for aquacultural development. Government is attempting to overcome these problems in the Aquaculture Bill and Resource Management Act.

The need to be able to establish a market value for a licence is becoming more crucial as the numbers of individuals entering the industry grow. This research was concerned with identifying and investigating the factors integral to the appraisal process. These come under four broad headings and include the notion of land rent, the implications of legislation, the characteristics of the site that influence value and the appraisal practices themselves.

Method

The research on which this article is based used two data collection techniques. These were the personal interview and a mail survey. The interview was used to collect exploratory data relating to the characteristics central to mussel farm appraisal, industry participants involved in appraisal and the effects of the proposed legislation. Information collected in this first phase was then used to form the basis of the mail survey questionnaire.

A semi-structured interview format was employed to extract the information and explore the opinions of the individuals and representatives of interest groups. Aquaculturalists were selected to give a broad cross-section of the industry with two small, two medium, and three large marine farm licence holders forming the sample.

This group owned over 75 licences and had at least another 124 licences under contract out of a total of 368 licences in the Marlborough Sounds. The respondents were personally selected by discussing their selection with their peers. All were operating licences in the Marlborough Sounds. The interview list was finalised by telephone and a broad outline of the questions was forwarded to the participants prior to the interviews.

All purchasers of licences in the Marlborough sounds between January 1988 and June 1990 were sent a mail survey to complete. The response rate for this was 72%.

Results and Discussion

Seventeen possible site characteristics were identified by the interview process. Mail survey respondents then ranked these variables on a seven point liken scale to indicate the relative importance of the characteristic. Table 1 (overpage) presents htese resul ts. These results identified eight factors and site characteristics crucial to establishing a licence's value. These are as follows:

1. Natural water quality
2. Quality of produce
3. Ease of access by sea
4. Water quality (potential for pollution from both human and natural sources)
5. Water depth
6. Scarcity of licences.
7. Income ($ per tonne of mussels)
8. Shelter from wind and open sea.

All variables, excluding the scarcity of licences, relate to the site's income producing ability.

Scarcity relates to the supply of licences available for purchase. This is an intuitively reasonable result, as one would expect investors to be concerned with potential production and resulting returns.

In response to the second research question, the interviews indicated thatthere were no professional appraisers, other than those employed by the Government, who had been involved in the appraisal of marine farm licences. Furthermore, appraisals carried out by Government were for local governmentproperty tax purposes only. One other individual was located who had been involved in the appraisal of these licences. Appraisers cited the unpredictability and volatility of licence prices and their lack of expertise as reasons for not becoming involved.Those who had been involved had all employed the summation method to appraise licences' values. Further information about appraisal methods was collected by the mail questionnaire. 0

Table 1. Means and standard deviations of the rankings of the relative importance of the various site characteristics

	Characteristic	Mean	Standard Deviation
1	Water quality	1.27	.47
2	Quality of produce	1.73	.90
3	Sea access	2.00	1.34
4	Water quality potential for pollution	2.09	1.22
5	Water depth	2.18	0.87
6	Scarcity	2.27	.90
7	Price $/tonne of mussels	2.55	1.7
8	Shelter	2.64	.67
9	Surrounding land uses	3.09	1.51
10	Access navigation	3.36	1.61
11	Location	3.45	1.69
12	Aplication delay	4.00	1.67
13	Structures	4.00	1.49
14	Witholding period	4.09	1.22
15	Water temperature	4.18	1.17
16	Shipping lanes	4.18	1.83
17	Access land	5.09	1.64

The prices paid for licences varied between *$2000* NZD per hectare to $21,051 NZD per hectare over the period January 1988 to June 1990. Respondents were asked to estimate portion of the sales price that could be attributed to any chattels or improvements. A site's value was calculated by subtracting the cost of improvements and chattels from the purchase price.

Respondents were also asked to rate the quality of the purchased site on a scale from one to seven, with one being the most positive rating of site quality and seven being the most negative. Table 2 presents these results.

Table 2: Bare licence value in NZD on a per hectare and per tonne of potential yield

Site Quality	Net sale price per hectare of the site		Net sale price per tonne of potential yield	
	Mean (NZD/hectare)	std dev	Mean (NZD/tonne)	std dev
2	4770	4530	60	42
2	7190	2710	100	30
5	3440	1650	69	21

The quality of all sites were classified as either 2 (very good), 3 (good) or 5 (poor). Considerable variation exists in these results. As can be seen in Table 2, the sites with very good ratings had lower net sale prices than the sites with good ratings. The inconclusive nature of these results places limitations on the use of these results. This variation may be attributable to four factors. First, the sample size was relatively small. Second, respondents may have interpreted the scale differently. Third, *they* could have used different basis for estimating the value of improvements and chattels at sale. Fourth, some movement in the market could have exacerbated the sampling error.

Respondents were asked about the potential yield from a fully developed three hectare site. Full results are presented in Appendix 1. These results indicated that the site would have gross income of $76,800 NZD and anet incomeof $14,450 NZD for a 15-month crop cycle. Also presented in Appendix 1 is a sales analysis of a fully developed three hectare marine farm licence. This demonstrates a 13.2% return on all invested capital.

Mail survey respondents considered the income approach unsuitable due to the unpredictable nature of the net income of a licence. Unpredictability was seen to be the result of natural variations in yield per hectare, length of crop cycle and price paid for produce. Sites tended to be in different stages of development. This also complicated the use of the direct sales comparison technique.

Mussel farmers themselves were inconsistent when they considered which method was the most appropriate for the appraisal of a marine farm licence. The interviews identified the summation and sales approaches as the only methods of appraising a site's value.

Alternatively, the mail survey indicated that more respondents used the comparison of potential incomes of sites to determine value, rather than comparing the subject licence with the sale price of other units.

Mail survey respondents were asked how they determined the purchase price of their sites. Sixty-three percent of respondents suggested future income streams was the most appropriate method of determining a site's value. Thirty-seven percent of respondents indicated that they had determined the purchase price of their site by comparing the sale price of other sites withaconsideration for improvements.

The third research question identified the following effects of the proposed legislation. The Resource Management Act and proposed Aquacultural Bills, if passed, were identified as influencing the value of marine farm licences in five basic areas. These are:

1. Resource rentals The legislation is proposing to change the method of rental determination. Currently, rental is levied at a nominal fee of $10 per acre ($24.71 per hectare) per annum. The legislation proposed a change to this and while the alternative method to be used is still under discussion, it has the potential to increase the resource rental. The net effect of this could be a reduction in the value of licences because of the decrease in the land rent accumulated by the licence holder. A positive outcome of increased rentals is that licence holders will be motivated to develop sites to offset holding costs.
2. Classification system The legislation proposes to classify each site to allow a variety of species to be grown. Currently, only one specified species is allowed to be grown on each site. The opportunity for greater flexibility of species grown within a licence area will provide the aquaculturalist with the opportunity to diversity. This should have apositive effecton licence value because marine farmers will be able to expand from a mono-cultural base and protect themselves, to some degree, against the vagaries of farming a single product.
3. Length of tenure - The proposed legislation will increase tenure from 14 years to between 25 and 50 years. This is expected to have a positive effect on licence value as it will extend the time frame and provide motivation and

additional security for mussel growers, thus encouraging them to develop sites.

4. Allocation - The allocation of sites between competing aquaculturalists is currently achieved on a first come first serve basis. Various allocation procedures have been proposed and these include a continuation of the present system, and tendering by different interested parties. If Treasury's tendering option is adopted, it will have a negative effect on value.
   This is because the greater the land rent captured by the government the less there is to accumulate to the licence holder.
5. Scarcity The procedures incorporated in the proposed legislation will free up the licensing process. This could have the effect of decreasing value as supply of licences will be increased. However, this may be offsetby the fact that the environment has to be divided up amongst competing uses. Consequently, the supply of sites is limited. Furthermore, while the supply of mussel sites is limited, it is possible for other species requiring slightly different habitats and condition to be grown successfully nearby. This would have the net effect of making licences more readily obtainable for these new ventures.

To summarise, this research was exploratory in nature. It focused on the appraisal of mussel farms in the Marlborough Sounds and attempted to draw together the various and different strands of knowledge possessed by different individuals and interest groups operating within the industry to establish the beginnings of a body of knowledge.

Both quantitative and qualitative approaches to data collection were employed and these can perhaps account for some of the variation in results and the inconclusive nature of much of the data gathered.

Limitations

There are a number of limitations associated with this research. First, this research concentrated on marine faun licences in the Marlborough Sounds and this means that ifndings are not easily generalised across the aquacultureindustry. Differentspeciesrequire differentsitecharacteristicsandconsequently, would need to focus on different issues.

Second, the sample size was relatively small and this may have had undue influence on some of the results obtained. The findings of the interviews and mail surveys differ and these differences are perhaps attributable to the sampling frames. The response rate of the mail survey was adequate. However, those involved in more than one purchase did not respond and this could have influenced results as individuals with larger operations may emphasise different characteristics and features. Some participants were reluctant to give information because they believed that this information was commercially sensitive.

Conclusions

This research was an exploratory study concerned with identifying the factors and characteristics that influence the value of a marine farm licence.

It is also aimed to explore the implicaitons of the Resource Management Act and Aquaculture Bill on the value of mussel farms. A structured interview and a mail survey were used to collect information from mussel farmers, representatives of government and interest groups.

Eight characteristics were identified as having a material influence on the value of a marine farm. These were the natural water quality, quality of mussels produced, ease of access by sea, potential for natural and human pollution, site water depth, scarcity of licences, price paid per tonne of mussels, and shelter from the open sea. the majority of these related to actual physical features of the site and hence, the productive ability of the site.

The summation approach seemed to be the most appropriate method of establishing the value of a marine farm. This was because the fluctuations in both price per tonne and productivity of a site coupled with large variations in stages of site development rendered other appraisal approaches unsuitable.

Proposed legislation was seen to be a potential influence on the length of tenure, resource rentals, allocation procedures,and scarcity of licences. All these factors were identified as having a significant effect on the value of a licence.

The sample size meant that some of the results were inconclusive. Driections for future research include investigation of other species grown and quantifying the size of the effect of individual characteristics on the value of marine farm licences. A

Appendix 1: Income costs and returns from a three hectare marine farm licence.

Expenditure

Seeding droppers every crop cycle cost: approx $0.50 per metre for spat and for labour. Each longline has between 300 and 3500 metres of droppers.	$26,000
Average expected life of a long line is 5-8 years. This is contingent on factors such as shelter. Thus, one would expect to replace one long line per year. This is exclusive of anchors, chains, shackles and navigation lights.	$6,300
Sundry repairs and maintenance.	$750
Harvesting - cost: $45-$62/tonne depending on location. Average yields would be 20-25 tonnes per long line.	$17,100
Annual rental for the licence-cost:$1 0/hectare	$50
Management reward	$7,200
Service and Administration costs	$5000
Total expenditure per crop cycle	$62,350

Income

Gross Income 8 longlines producing 22.5 tonnes per longline yielding $225/tonne	$76,800
less costs	$62,350
Net income for 15-month cycle	$14,450

Sales analysis of a fully developed three hectare marine farm licence

Sale price of the licence		$126,000
Less mussels included in the sale		
Line 1(80mm museels: lightseed 25 tonnes)	$9,375	
Line 2 (85mm mussels: medium seed 30 tonnes)	$11,250	
Line 3 (85-90mm mussels; medium seed part 15 tonnes)	$5,650	
Line 4 Kaitaia spat)	$200	
Line 5 (65-70mm mussels: heavy seed 40 tonnes)	$14,100	
Line 6 (65mm mussels: medium seed 30 tonnes)	$10,575	
Kaitaia spat (260 ropes)	$1000	
Total Crop Value		$52,150
Less chattels present		
Floats (66 ribbed IML Floats)	$3,950	
Floats (160 Smooth IML Floats)	$12,800	
Six longlines (anchors, backbones, all 24mm prolypropylene	$6,800	
Droppers	$7,000	
Less total Chattel Value		$30,550
Undeveloped licence value		$43,450

Returns on capital on an annual basis

	Total Invested Capital
Gross income	45.8%
Net Income	13.2%

Legal Decisions

Arbitration Rental review Lease of forecourt of service station - Profitability of present use of site Highest and bestuse ofLand Error of law.

IN THE HIGH COURT OF NEW ZEALAND
WELLINGTON REGISTRY
CP NO. 770/90

IN THE MATTER of Section 12 of the Arbitration Act 1908
AND

IN THE MATTER OF of Memorandum of Lease Registered No. 709525.1 (Wellington Registry)
BETWEEN SEXTANT HOLDINGS LTD (In liquidation) Plaintiff
AND NEW ZEALAND RAILWAYS CORPORATION Defendant

Date of Hearing: 22 April 1991
Date of Judgment: 14 May 1992
Counsel:
MR Camp QC with Miss Bronwyn Barnard for Plaintiff
S S Williams with J L Land for Defendant

JUDGMENT OF NEAZOR J

In this proceeding the plaintiff lessee seeks an order setting aside an award made by the umpire in an arbitration relating to rent under a lease, or an order remitting the dispute back to the umpire for rehearing. The grounds of the application are that the umpire technically misconducted himself in making four errors of law in his award.

The defendant lessor denies that there have been errors and alternatively says that if the umpire did make an error of law, it was of no significance in the result of the award.

The leased premises are 160m2 of land in central Wellington which is used as the forecourt of a service station. The buildings associated with the service station are on a separate title. The bulk of the land in the same city block is on a third title. The purpose for which the land was leased is described in the document as "commercial" and the use of the land is limited to such a purpose. The term of the lease was for 20 years with provision for five-yearly rent reviews.

The provision as to rent reviews are these:

"17. WITHIN six *calendar months previous to the expiry of the first second and third periods of five (5) years of the within term or so soon thereafter as may be the Lessor shall cause a valuation to be made by a person whom the Lessor reasonably believes to be competent to make the valuation of the fair annual rent of the land hereby demised so that the rent so valued shall be uniform throughout the period of five (5) years next following the first second or third period of five (5) years PROVIDED THAT such rentals shall not be less than the rental payable for the first five (5) years of the within term.*

20. IN making the valuations referred to in Clauses 17 and 19 hereof no account shall be taken of the value of any buildings or improvements then on the said land."

Failing acceptance by the lessee of the rent so valued, provision is made for arbitration by two arbitrators and an umpire. The umpire's duty, if the matter goes so far, is:

"27. THE duty of the umpire on reference to him of any question shall be to consider the respective valuations of the two arbitrators in the matters in which their valuations do not agree and then to make an independent and substantive valuation and the last mentioned valuation shall be the decision of the umpire but in giving his decision on any question so referred to him the umpire shall in every case *be bound to make a valuation not exceeding the higher and no less than the lower of the valuations made by the arbitrators respectively."*

The rent originally reserved in the lease was $5,200.00 per annum. The umpire determined that for the second period of five years it should be $80,000.00 per annum.

In his award the umpire determined that the terms of the lease required the fair annual rent of the land for five years to be determined, and that as a matter of law valuers must proceed on the basis that there are no buildings or improvements on the land. In this case, there is express provision in clause 20 of the lease that in making the valuations referred to in clauses 17 and 19 "no account shall be taken of the value of any buildings or improvements then on the said land".

Reference was then made to *Wellington City Corporation v Wilson* (1936) NZLR s110, 113 and *Wellington City v National Bank ofNew Zealand Properties Ltd* (1970) NZLR 660 for the proposition that the valuer's approach should be to ascertain what a prudent lessee would offer to the landlord.

The award then said that it had been submitted that the circumstances were similar to those dealt with in the decision of Eichelbaum CJ in what is reported as *Mahoney v Giltrap Group Holdings* (1990) 3 NZLR 114. The award stated:

"Having read that decision I believe that case was quite different from the one in question here. That judgment related to a rental for land and buildings whereas here a fair annual rental is required to be valued on the basis that there are not buildings or improvements on the land and the purpose/use of the land under the lease document is commercial.

Use of the land is restricted in the main by Town Planning considerations, and not to the present use of the land which is as part of a service station site.

I have concluded here that the actual profitability as related to the present use of the site is of little or no relevance here in determining the fair annual rent of the land disregarding the buildings or improvements thereon."

The award then proceeded to set out the valuation evidence presented to the umpire. That indicated that the valuers' approach was to assess the freehold value of the land and to apply an interest rate to that value to produce the rental valuation. The lessor's valuer made his valuation on the basis of the ability of the land to be amalgamated with adjoining land in the same city block. Such amalgamation was regarded as the highest and best use for the land. [In fact the land in the block is in three titles, that on which the forecourt is, that on which the buildings of the service station are and, adjoining the latter, the bulk of the block.]

In discussing the lessee's valuer's valuation the umpire said:

"Having decided as umpire that this land is to be valued as vacant, disre-

garding both the economics and the existence of the present buildings and other improvements, that eliminates the need to traverse quite an amount of Mr Finnis's submissions."

Having discussed how the original rental was arrived at the umpire said:

'Be that as it may what we are concerned with here is thefair annual rental within the market as it existed on 1 January 1990.

It is a fact that this land area is relativelysmallat 160m2, its highest and best use value lies in amalgamation with the adjoining land and when considered with the adjoining land provides a desirable frontage and harbour views, which although not necessary in the development of the adjoining land is certainly desirable, and as part of the adjoining land must have a value in the region of the overallpsmvalueforthatadjoining land.

The question here then is would a prospective purchaser of the Dalgety site pay this level for the 160m2 of land as a separate entityfor future amalgamation which is desirable but not essential.

It has been shown to me at this hearing that not only is the prospecti ve owner of the Dalgety land interested in acquiring this site but also at one time had a conditional contract with the Lessor over it..."

Consideration was then given to demand for development of the site. The umpire reached the conclusion that there would possibly be demand during the second five years period, that the prudent lessee would have seen market land values increase and decline between 1987 and 1990 and differences in other ground rentals. He then made his award which was approximately 72% of the lessor's valuer's valuation.

The lessee contends that in his award the umpire made four errors of law:

(a) on a true construction of the lease the review provisions required a subjective approach encompassing the circumstances of the actual lessee whereas the umpire applied only objective criteria;

(b) holding that case law determined the valuation approach rather than the intention of the parties to the lease expressed in the rent review clause in the context of the sale lease and the matrix of material surrounding circumstances;

(c) holding that the provision in clause 20 of the lease

"In making the valuations referred to in clauses 17 and 19 hereof no account shall be taken of the value of any buildings or improvements then on the said land"

meant that the buildings on the land and the use to which it was put should be disregarded from the valuation process;

(d) holding that the decision in *Giltrap GroupHoldingsLimited* (Eichelbaum CJ, 14 December 1989, Auckland, CL 68/89) was inapplicable.

These allegations are put into context by the lessee's proposition in argument that the general approach of the award is wrong in that, whilst not expressly saying so, it proceeds on a basis that ground rental valuation cases mean not only disregarding the value of buildings and improvements but require establishing the highest and best use of the site without regard to the party's circumstances when regard for those is in fact called for by the subjective rent review clause.

Central to all of the issues is what regard, if any must be had under the review clause in this lease to the circumstances of the actual lessee, the relevant circumstances in this case being the use to which the lessee puts the land.

Reliance was placed on the decisions in *Mahoney v R C Dimock Ltd* (1990) 3 NZLR *14, Jefferies v R C Dimock Ltd* (1987) 1 NZLR 419 and *Feltex InternationalLtdvJBLConsolidatedLtd* (1988) 1 NZLR 668.

The review clause in *Mahoney v RC Dimock Ltd* was in terms that:

"the rental fixed at each review shall be such rental as is agreed upon by the landlord and tenant and if they cannot agree to be determined by arbitration in the manner herein provided but not in any case to be a rental less than the rental chargeable immediately prior to such review."

Barker J in *Jefferies vR CDimockLtd* (which related to the same lease), after consideration of *Thomas Bates & Son v Wyndham's (Lingerie) Ltd* (1981) 1 All ER *1077, Lear vBlizzard* (1983) 3 All ER 662 and *Ponsford v HMS Aerosols Ltd* (1979) AC 63, had concluded thataclause so worded required an assessment by the arbitrator of considerations which would have affected the minds of the parties if they had been negotiating for the rent themselves. That that was the proper approach in respect of that lease was accepted in *Mahoney v R C Dimock Ltd* (1990) 3 NZLR 114 by Eichelbaum CJ and it was accordingly the approach rejected by the umpire in this case.

In the English cases referred to, a clause worded to produce that result had been contrasted with a clause differently worded which required the valuer to value the land without regard to considerations personal to the parties, including their activity on the land.

Ponsford v HMS Aerosols Ltd was in the latter category. There the words of the review clause were that the rent would be such sum as would be assessed as "reasonable rent for the demised premises". A clause so worded was held to indicate the intention that the rent was that which was reasonable for the demised premises, not that which would be reasonable for the tenant to pay. The context in which the decision was made was that during the term preceding that in which the review would be applicable the premises had been damaged and reinstated at the cost of the lessee. The question was whether the rent should be assessed on the value of the premises or whether the circumstances that the lessee had paid for restoration would require a diminution of rent for that lessee if the rent was to be reasonable.

The key to the distinction made in the English cases is whether the rent was expressed to be one "agreed between the parties", which would bring in all the issues material to either party, or a rent "for the premises", which directed attention to the premises and not to the views or activities of the parties- see, for examples, per Buckley LJ in *ThomasBates & Son v Wyndham's (Lingerie)Ltdat* 1087 and per Tudor Evans J in *Lear v Blizzard* at p 668. The clause in this case is, looked at in light of the English cases, significantly different from that under consideration in *Mahoney v R C Dimock Ltd.*

The conclusion that the clause in this case may be required to be looked at differently from that in *Mahoney vDimock* is, in my view, reinforced by the judgments of the Court of Appeal in that case (sub nom *Modick R C Limited v Mahoney and Giltrap Group Holdings Limited* CA 12/90, judgment 24 June 1991). Cooke P differentiated between the two:

"Although the expressions `objective' and `subjective' have occasionally been used in contrasting two kinds of rent review clause (see for example Ponsford v HMS Aerosols Ltd *(1979)* AC 63, *85 per Lord Keith;* Lear v Blizzard *(1983) 2 All ER 662 , 668 per Tudor Evans J) I think with respect that they are not truly helpful. The wider approach, whereby the arbitrator has the task of determining what reasonable parties would have agreed, itself poses an objective test of reasonableness. The real question in such cases as* Ponsford *has been whether the review clause is worded in such a* way *that, even if reasonable parties would have agreed on a deduction to reflect tenant's improvements, the arbitrator cannot take that into account. In* Ponsford *the majority of the House of Lords attributed that inhibiting effect to a clause re-*

quiring an assessment of `a reasonable rent for the demised premises'. They held that a reasonable rent was the market rent."

So did Hardie Boys J:

"A number of cases decided in England in recent years have demonstrated the various drafting techniques employed in statutes as well as leases to fulfil the original purpose ofrent reviews. These are of two general kinds. One calls for the assessment of a market rent, what the hypothetical willing lessee would pay to the hypothetical willing lessor for the particular premises. An example is WJ Barton Ltd v Long Acre Securities Ltd *(1982) 1 All ER 465. The other, of which the present case affords an example, directs attention to what the particular parties, acting reasonably, would agree as the proper sum in the current circumstances. Such a case is* Thomas Bates & Son Ltd v Wyndham's (Lingerie) Ltd *(1981) 1 All ER 1077. Describing the former* as *an objective approach and the latter as subjective confuses rather than clarifies, for the second is objective too. To the extent that there is any difference between them, it is in the considerations that may be relevant to the determination that is to be made. It may well be that there is, or ought to be, no difference in result between the two approaches. For it is clear that neither party is to be advantaged or disadvantaged by the fact that the review occurs during the term of the lease: it proceeds on the basis that a new lease is being negotiated at that time. And reasonable parties would expect to pay and receive the going rate."*

InPonsford vHMSAerosolsLtd (1979) AC 63, the House divided three to two on the construction of the clause. Of the majority, Viscount Dilhorne, having noted that the purpose of the review clause was to protect against inflation and to secure that in real terms over a period the rent payable does not fall below that initially agreed on, asked what has the surveyor to do? and answered:

"Surely it is to assess what rent the demised premises would command if let on the terms of the leases and for the period the assessed rent is to cover at the time the assessmentfalls to be made. The rent may depend to some extent on local factors such as deterioration of the neighbourhood. In assessing it, the surveyor will be assessing the reasonable rent that others, not just the sitting tenant, would be prepared to pay for the use and occupation of the premises. He will not consider the tenant's position separate."

Thus the approach required by such a clause is the open market rental, but qualified as "reasonable": not what would be a reasonable rent for the lessees to pay, but what is a reasonable rent for the premises.

Lord Fraser of Tullybelton put it in this way (p 83):

"...effect would be the same whoever the landlord or the tenant might be. It is true that the words for the demised premises" do not add anything new, because there is no doubt about the identity of the premises for which the rent is payable, but in my opinion the words are of importance because they emphasise that the assessment is to be made by reference to the premises and not by reference to wider considerations or to what would be reasonable between this particular landlord and tenant."

Lord Keith of Kinkel (p 86) considered that whether the surveyor was required to assess a "market rent" for the premises or a "reasonable rent" his approach would be the same:

"1 consider that in either case the surveyor would have regard to the condition of the premises, the terms and provisions of the lease, and the general level of rentfor comparable premises in the same locality or in similar localities, and I would not expect any difference in the resulting assessment.

In my opinion the words 'a reasonable rentfor the demised premi ses' simply mean `the rent at which the demised premises might reasonably be expected to let' .... The fact that the assessed rent leads to an unreasonable result as between the particular tenant and the particular landlord does not mean that it is not a reasonable rentfor the premises."

In *Feltex v. JBL Consolidated* (1988) 1 NZLR 668 Henry J was concerned with an award in respect of a lease which provided in these terms for a rent review:

"2. At the expiration of each five (5) year period during this Lease or any renewal or extension thereof the annual rental payable hereunder shall be reviewed and fixed for the five (5) year period following each such date of review by agreement between the parties or failing agreement shall be fixed by arbitration pursuant to the provisions of the Arbitration Act 1908 and its amendments but in any event shall not be less than the annual rental payable for the five year period immediately preceding each such date of review."

Henry J held that the word "fair" should be implied so that the lessee was to pay the fair annual rent and that in New Zealand, following *Drapery & General Importing Co of NZ Ltd v Mayor of Wellington* (1912) 31 NZLR 598, *Devonport Borough v Robbins* (1979) 1 NZLR 1 and *Barr v Bowden* (1981) a All ER 1070, those words required inquiry as to what a prudent lessee would pay for the premises having regard to the terms and conditions of the lease.

Henry J equated the test propounded in the New Zealand cases with those applied in *Lear v Blizzard* (1983) 3 All ER 662 and *Thomas Bates & Son Ltd v Wyndham's (Lingerie) Ltd* (1981) 1 all ER 1077. There is no difficulty with that equation in that case because the clause in the lease provided for the rent to be reviewed and fixed by agreement between the parties, which on the English cases would make relevant those considerations which would affect the mind of the lessee, as well as those affecting the lessor.

In the present case, however, there is no reference to agreement in the lease, nor is the use of the land confined by the lease to the business of a service station. The rent is to be the fair annual rent of the land fixed by valuation. In my view, Mr Camp's submission that the approach in *Mahoney v Dimock* and the two English cases last mentioned was the proper one to apply to this lease cannot be sustained. The clause in this case is different in the significant aspect from the clause in those cases.

If, so far as the English cases go, the approach in *Ponsford v HMSAerosolsLtd* is the proper one in such a case, there is still a question as to how that sits with the prudent lessee test indicated by the New Zealand cases to be the proper approach were the words used are "valuation of the fair annual rent of the land"? If there is a difference, in my view the construction must follow the New Zealand view, because the words have acquired a well settled meaning in New Zealand conveyancing.

The prudent lessee test was stated in very basic terms in *DIC v Mayor of Wellington,* which is its source. The lease required assessment of "the fair annual ground rent of the said land only, without any buildings or improvements. Stout CJ for the Court said:

"...the true basis on which the valuers must proceed is that there are no buildings or improvements on the land. They must ascertain what a prudent

lessee would give for the ground-rent of the land for the term, and on the conditions as to renewal and other terms etc, mentioned in the lease. They must put out of consideration the fact- if it be a fact - that there are buildings and improvements on the land."

The Courts in later cases have regarded it as inappropriate to expand on that statement beyond the view endorsed in the decision in *Wellington City Council v National Bank of New Zealand Properties Limited* at 671/2 by North P:

"In my opinion, what the umpire was saying was this; the principle laid down in the DIC *case required him to ascertain what a prudent lessee would give as a ground-rent of the land for the new term of 21 years. This being so he was obliged to consider what factors would be taken into account by a prudent lessee. In short he was onl y concerned wi th matters which would affect the mind and ultimately the judgment of the prudent lessee in making his offer to the landlord.*

I agree with the observation of Sir George Finlay: `It is the motives which inspire the tenant which are material, ...' In my opinion, this is the way the learned umpire looked at the matter for he agreed, by way of qualification, that f the landlord was seeking a rent basedi

on too high an interest rate, then the prudent lessee would ask himself why he should be called upon to pay the rent sought by the landlord and would immediately turn his mind to the return that a landlord was obtaining from the land."

In Re *Lund's lease* (1926) NZLR 541 which related to the fixing of a"fair ground rent ... exclusive of any buildings erections or improvements" Sim J remarked that the ground rent is a rent which, in the circumstances, is to be "fair" to both landlord and tenant and concluded that the proper approach was that of *DIC Ltd v Mayor of Wellington,* namely to ascertain what a prudent lessee would give as a ground rent for a lease for the specified term and subject to the specified conditions.

The clause in *In re Brechin and Drapery Importing Co Ltd* (1928) NZLR 241 (CA) required determination of "the fair and reasonable rent of the said premises calculated on the basis of the unimproved value of the said lands".

The Court held that the requirement of the arbitrator was:

"...to ascertain what a prudent lessee would give as *a ground-rent for a lease of the land for the term of fourteen years without any buildings or improvements thereon, and subject to the obligations imposed on the lessee, including the obligation of remaining the tenant thereof for two further periods of fourteen years, and the obligation of leaving on the land any buildings and improvements erected by the lessee."*

Smith J in *In re A lease, Wellington City Corporation to Wilson* (1936) NZLR s110 had to fix the rental under a clause which the parties agreed imported the test in *DIC Ltd v Mayor of Wellington,* to ascertain what a prudent lessee would give for the ground rent of the land for the term, and on the conditions as to renewal and other terms etc mentioned in the lease. The first consideration Smith J discussed was who is the prudent lessee? and concluded that the proper course was to "judge the character of the prudent lessee in relation to this particular lot by inferring from the evidence what the parties expected that a lessee would do with this particular site".

In his conclusion as to how the rent should be assessed Smith J said the lessor "must not expect to get what a prudent lessor would consider he ought to get. It must take the ground rental which a reasonable but prudent lessee thinks it proper to give".

The effect to be given in New Zealand to a clause of the type in issue here in my view is that result which will provide fairness to the lessor, but will give particular regard to the factors which would affect the mind of a prudent lessee.

The application of those considerations would appear to call for regard to be given to the value of the land, in the case of urban land to where the premises are, the size of them, any restrictions on their use and the provisions of the lease which give both a right and an obligation to occupy the premises for 15 years from the date at which the reviewed rent is to apply, with a right to obtain a renewal in perpetuity in 20 year terms.

The test for rent review within the term would in my view no doubt bring in as a factor that it is not then open to the tenant to accept or reject further occupancy of the premises, as would be the case at the end of the term when an offer for renewal for another term of 20 years would be in contemplation.

Mr Camp argued that the lease required the "subjective approach" exemplified *by Mahoney v Giltrap* taking account that the lessee had a short term lease of the land adjoining the dem iced premises with limitation of use to a service station, and of the lessee's personal economics; and that it was an error of law to take account of the "highest and best use" of the land related to possible development of the whole block which he said is "a straight and open market approach", and to leave out of consideration anything to do with the actual use of the site.

Mr Camp contended that the arbitrator's reference to a "fair annual rental within the market" contained an indication of error because the juxtaposition of "fair" and "market" was illogical. If the clause in the lease require the fixing of such a rent as the lessor and lessee agreed that might be so, but in my view it is not in relation to the clause in issue here. The element of fairness is not to be looked at only from the point of view of the lessee, but also of the lessor, and what will be fair to him will presumably be tested against what he could receive on a purely market approach of hypothetical willing parties.

Mr Williams contended for the lessor that the terms of the lease do not require a subjective approach encompassing the circumstances of the actual lessee, but that in any event the umpire did not adopt such an approach.

As indicated, I do not consider that either absolute proposition is correct in relation to such a lease as this, but rather that the arbitrator or umpire is to assess a rent which is fair to the lessorbut is to have particular regard to the factors which would affect the mind of a prudent lessee in relation to the premises in issue and the terms of the lease in issue.

The economics of a particular activity are not brought into account by that test, nor are considerations arising from the lessee's business on adjoining, but legally separate, premises.

Any element of fairness to the landlord would be at least diminished if his rent was determined or affected by his neighbour's decisions.

In my view the umpire correctly stated the applicable law in his references *to DIC Ltd v Mayor of Wellington* (1912) 31 NZLR 598 and *Wellington City and the National Bank of New Zealand Properties Ltd* (1970) NZLR 660 and in his reference to an award made by the Rt Hon Sir Clifford Richmond who said in relation to a local authority lease provision "I have to fix a figure which I think would appeal to the prudent lessee as conservative but not unreasonably so".

I consider also that the umpire was correct in concluding that *Mahoney v Giltrap* related to a different situation, 0

and that it was not an error of law for the umpire to conclude that "here the actual profitability as related to the present use of the site is of little or no relevance in determining the fair annual rent of the land disregarding the buildings or improvements thereon".

There is nothing in his references to decisions in the Courts which suggests that he applied the decisions rather than the terms of the lease. In fact, in my view, the umpire correctly assessed the effect of the Court's decisions as to such terms.

Mr Camp argued that it was an error of law to disregard the existence of the present buildings and other improvements. He related that to disregard of the economics of the operation.

In my view that is not shown to be an error of law. The lease required disregard of the value of improvements in the assessment (the improvements being petrol pumps and underground tanks).

The only reason apart from value for having any regard to the presence of the buildings could be in relation to the use of the land and the attitude of a prudent lessee in respect of the rent to be paid. As to that, the use is not confined by the lease other than to "commercial", and the umpire had regard to the use of the land as affected by town planning considerations which is not limited to the present use.

What weight should be given to use in assessing what is fair to the lessor and what a prudent lessee would pay is not a question of law but a matter of evaluation by the umpire.

In my view none of the errors of law which the lessee has contended exist is apparent in the award, either in particular statements made by the umpire or in his approach throughout the award. He was entitled to treat the matters of economics of the operation and use of the land as he did.

His references to "highest and best use" I conclude were to matters of valuation formulae or approach in the assessment of the value of the land, which was entirely within his competence and jurisdiction.

Having considered those matters, the umpire assessed the rental having regard to what a prudent lessee would consider he should take into account in respect of rent. That was a proper approach.

Accordingly the action to set aside the award fails. The defendant is entitled to the costs of the proceedings.

Easement - Restructure covenants for building height Injunction sought and granted - Appellant sought to modify convenant - Relevance of height restriction - whether covenant to be modified Property Law Act 1952

IN THE COURT OF APPEAL OF NEW ZEALAND
C.A. 331/91

BETWEEN ANITA BARBARA JANSEN
Appellant

AND DENNIS MICHAEL MANSOR and HOPE VERONICA MANSOR
Respondents

Coram: Cooke P, Hardie Boys J, McKay J
Hearing: 16 October 1992
Counsel: D J Jenkin for Appellant
R J Johnson for Respondent
Judgment: 16 October 1992

JUDGMENT OF THE COURT DELIVERED BY McKAY J

The parties to this appeal reside on opposite

sides of a street in Heme Bay, Auckland. The respondents are on the higher side of the street and enjoy a view of the Waitemata Harbour and of the Birkenhead district on the North Shore. This view is over the top of the buildings on the other side of the road. It is protected by a restrictive covenant in favour of the respondents over the land opposite. The covenant was created at the time of subdivision in 1958, prior to the construction of buildings on either piece of land, and prior to the acquisition of title by either of the present parties.

The covenant is created by a memorandum of transfer registered under the Land Transfer Act 1952, and is noted on the certificate of title of the servient tenant. It is expressed to bind the transferor and its successors and assigns as registered proprietors of the servient land, and to be in favour of the transferee and the registered proprietors for the time being of the dominant land. It accordingly runs with the land. The operative words of the covenant are:

"DOTH HEREBY COVENANT and agree with the Transferee and them the registered proprietor or proprietors for the time being of the land firstly above-described that Transferor will not at anytime hereafter erector permit the erection of any building (excluding chimneys and radio aerials) on the land secondly above-described exceeding one storey of a maximum overall height of twenty-five feet measured from the highest point of the permanent street level of the north western side of the street on the said Deposited Plan Number 45427 where it abuts said Lot 1 ..."

On the servient land there is now erected a single storey block of five apartments parallel to the road frontage. These are owned under separate titles, each in respect of an undivided one-fifth share in the fee simple and a leasehold interest for a term of 999 years in the particular apartment. The appellant became the registered proprietor of flat 2 in July 1987. It appears that she was not informed of the existence of the covenant, although it is noted on her title. In 1990 she decided to enlarge her small apartment by adding a second storey, and obtained a building permit for this work. After the work had commenced the respondents became aware of her intentions and complained. They issued the present proceedings seeking an inunction to restrain the proposed work.

In granting an interim injunction, Barker J on 28 November 1990 drew the attention of the appellant to her right to apply under section 126G(1) of the Property Law Act 1952 for a modification of the easement, although refraining from expressing any view as to the likely outcome. The appellant subsequently filed a counterclaim seeking relief under that section. The section so far as relevant to the present appeal, is as follows:

"126G.(1) Where land is subject to an easement or a positive covenant or a restrictive covenant, a Court may from time to time, on the application of the occupier of the land, by order, modify or wholly or partially extinguish the easement or covenant upon being satisfied

(a) That, by reason of any change since the creation of the easement or covenant-

(i) In the nature of extent of the user of the land to which the benefit of the easement or covenant is annexed or of the user of the land subject to the easement or covenant; or

(ii) In the character of the neighbourhood; or

(iii) In any other circumstances of the case that the Court considers relevant, the easement or covenant ought to be modified or wholly or partially extinguished; or

(b) That the continued existence of the easement or covenant in its present form would impede the reasonable user of the land subject to the easement or covenant in a different manner or to a different extent from that which could have been reasonably foreseen by the original parties at the time of the creation of the easement or covenant; or

(c) ...

(d) That the proposed modification or extinguishment will not substantially injure the persons entitled to the benefit of the easement or covenant."

The alterations originally proposed would have raised the roof line to a maximum of approximately 23 feet above the datum level referred to in the covenant, and thus would not have infringed the restriction to a maximum of 25 feet. They would, however, have infringed the restriction to a building not exceeding one storey. They would also have adversely affected the respondents' view. In an endeavour to meet the respondents' concerns, the appellant modified the plans so as to reduce the maximum roof height to some 19 feet 9 inches, while still giving her the benefit of the additional storey. She asked that the covenant be modified by striking out the restriction to one storey, but reducing the maximum permitted height from 25 feet to 20 feet.

Temm J was not persuaded that any of the grounds under the section had been made out, and he declined to modify the restrictive covenant. He found the respondents were entitled to the injunction sought, although this would not be necessary if a suitable undertaking were given by the appellant. The appeal is from his decision.

The appeal has been ably argued on both sides, and we are indebted to both counsel, not only for the assistance they have given us, but also for the sensitivity they have shown in dealing with this unfortunate dispute between neighbours. One must feel a great deal of sympathy for the appellant and the position in which she found herself after she had embarked on her alterations and had incurred expenditure. On the other hand, the respondents are naturally anxious to preserve their view, and they are not responsible for the appellant's ignorance of the nature of the restrictive covenant registered against her title.

Mr Jenkin for the appellant submitted that the purpose of the covenant was to protect the view. The only certain protection which it gave was the height limitation of 25 feet. The proposed alterations will not infringe that, and indeed will not exceed 20 feet. He submitted that what was protected was the view above 25 feet, and that view would not be affected. The restriction of building to one storey did notensure any lower height, or any greater protection than the 25 foot restriction, and should not be used to make the covenant more burdensome than was necessary to protect the view above 25 feet.

We do not accept this argument. The covenant clearly contains two elements, and both must be considered. If the covenant had been limited to requiring a single storey building, it would have given the respondents a substantial protection, even if the extent of that protection could not be defined in terms of height. The respondents would be at risk of a high single storey building, such as an A-frame, but in the ordinary course could expect single storey buildings to be of limited height.

The addition of a second requirement limiting the maximum height to 25 feet is not in substitution for the covenant not to build more than one storey. The respondents have a dual protection. The present case demonstrates the dual nature of that protection, and the additional ben- 0

efit to the respondent which the single storey requirement can provide.

Mr Jenkin approached the provisions ofparagraph (a) of section 126G(1) in two stages. First, he submitted, the Court had to consider whether the threshold had been established of a change in user of the land, or in the character of the neighbourhood, or in any other circumstances of the case. Once that was established, the court had then to consider whether by reason of that change the covenant ought to be modified. He submitted that the Judge had en:ed in holding that the threshold had not been established.

No doubt one could approach the application of the section by the two step process suggested, but the real question in paragraph (a) is whether, by reason of any change of the kind mentioned, the covenant should be modified. The focus is not on the fact of change, but rather on its impact from the point of view of making it appropriate to modify the covenant. It is unhelpful to consider the existence of a change separately from the context as part of the composite test which the section provides.

Both pieces of land were vacant at the time of the creation of the restriction, but the restriction was clearly entered into in contemplation of residential buildings being erected on both sites. No doubt in 1958 single unit dwellings were in contemplation, rather than the five unit block offlats subsequentlyerectedon the servient land. We agree with the Judge, however, that this is not a change in user which in any way suggests that the covenant should be modified.

As to changes in the neighbourhood, the Judge said:

> *"These two properties are in the heart of Herne Bay which has seen considerable development and increase in popularity in the last 30 years. It is perfectly true to say that on a number of sites in the neighbourhood, flat developments have taken place and that there has been a general tendency to use this valuable land more intensively than used to be the case in times gone by. But so far as the character of the neighbourhood is concerned, it seems quite obvious, after having taken a view as I did, that it remains a residential neighbourhood in which there are very many single unit dwellings. It is perfectly correct that there have been a number of building sites where single unit dwellings have been demolished and where flats have been constructed in their place but overall there has not been a change in character of* any *significant degree since 1958. The population has altered somewhat, and the number of multi-unit dwellings has increased, but the residential character has not changed."*

Mr Jenkin suggested that the Judge had taken too narrow a view of the neighbourhood, in that he had focussed primarily on the two streets at the intersection of which the two properties are located. The above passage suggests to the contrary. No doubt there have been changes in the neighbourhood, particularly in housing density, but the nature of these changes is not such as to justify modifying the covenant. The position would be quite different if, for example, a row of high rise buildings nearer the sea front already effectively blocked the respondents' view of the harbour.

Under subparagraph (iii) of paragraph (a), the court can take into account other circumstances which it considers relevant as satisfying the test that the covenant ought to be modified. Mr Jenkin's argument under this head relied on his contention that the protection to the respondents was of the view above the height limitation of 25 feet. For the reasons already given, we disagree. The respondents are also entitled to the *pro*tection afforded by the single storey restriction. The photographs confirm the Judge's finding that the proposed alterations, even in their amended form, have a significant impact on the view which the respondents enjoy and which the covenant protects.

Paragraph (b) of subsection (i) enables the court to make an order where the continued existence of the covenant would impede the reasonable user of the land in a different manner or to a different extent from that which could have been reasonably foreseen by the original parties at the time of its creation. We accept that the addition of the further storey would in itself be a reasonable user of the land if permitted by the building and town planning laws. It is inherent in a restrictive covenant that what is restricted is something thatwould otherwise be lawful. What is restricted in this case by the requirement to build only a single storey is in no way different from what was contemplated when those words were put into the covenant in 1958.

Finally, Mr Jenkin relied on paragraph (d), that the proposed modification will not substantially injure the persons entitled to the benefit of the covenant. The meaning of the word "substantially" in this context was considered by this Court in *Plato v Ashton* (1984) 2 NZPR 191. In delivering the judgment of the Court, McMullin J said:

> *"We think that in the sense in which it is used here it is to be read as meaning real, considerable, significant, as against insignificant, unreal or trifling."*

MrJenkin accepted this definition, but argued that in the present case the modification would not be such as to substantially injure the respondents.

This argument also depends at least in part on his earlier submission, which we have rejected, that what was protected was really the view over a height of 25 feet. The photographs convey the extent to which the view will be modified. In addition, the respondents are rightly concerned at the implications of any modification of the easement so far as the other parties in the block are concerned. If a modification were granted to the present appellant, it would obviously have some relevance as a precedent for possible future applications by the owners of the adjoining apartments.

It might be difficult to refuse them if the Court had granted modification in the present case, and the result could be a substantial increase in building height possibly over the entire length of the block. The present appellant is perhaps in a somewhat different position in that she has already expended money in ignorance of the restriction, and one has every sympathy for her predicament. That, however, is not a matter which can be laid at the door of the respondent. As has been pointed out in the lower court, she may well have a remedy elsewhere for the failure to warn her of the content and effect of the covenant registered against her land.

The Judge in the High Court had the advantage of a view of the area in question, and he was not satisfied that the case was one in which he should exercise his discretion to modify the covenant. We are satisfied that no grounds have been established which would justify this Court in interfering with the exercise of his discretion. He has applied the proper tests and has taken into account the appropriate matters. On the evidence we would agree with his decision, even if it were not a matter of an appeal from a discretion.

The appeal must therefore be dismissed. The respondent will be entitled to costs which we allow in the sum of $2000, together with the reasonable travel and accommodation expenses of counsel, as fixed by the Registrar. A

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