THE NEW ZEALAND VALUERS' JOURNAL

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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.

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Editorial Comment

Defining and Assessing "The Value"

Definitions of value for real estate in New Zealand have been in place since 1896 when the Government Valuation of Land Act was passed into law. This Act established a new system by which all valuations required by Government Departments for loan, taxation or other purposes and by Local Authorities for rating purposes, should be made by valuers employed by the State.

The Valuation of Land Act 1951 expanded on the 1896 legislation and provided definitions of Capital Value, Unimproved Value and Value of Improvements. An amendment to the Valuation of Land Act in 1970 introduced the concept of and defined Land Value which incorporated all non-structural improvements such as filling, draining, excavation and retaining work into the value of the land.

The definition of Capital Value under the Valuation of Land Act 1951 is "the sum which the owners's estate or interest therein, if unencumbered by any mortgage or other charge thereon, might be expected to realise at the time of valuation if offered for sale on such reasonable terms and conditions as a bone fide seller might be expected to impose". Such definition demands that "selling value" orin contemporary terms "market value" is the only consideration for determining value.

The International Asset Valuation Standards Committee (TIAVSC) in 1992 expanded on its definition of Market Value with recognition of the willing buyer. The TIAVSC definition, which has gained international support for asset valuation practice now states "market value is the estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arms length transaction after proper marketing, wherein the parties had each acted knowledgeably, prudently and without compulsion".

The New Zealand definitions under the Valuation of Land Act 1951 have, it is considered, withstood the tests of time well and because of the similarity in basis it could be expected that the TIAVSC definition will be just as robust. However, recent requirements in New Zealand for the valuation of insfrastructural assets such as roads, bridges, water and sewage systems and community and state assets such as parks and reserves, hospitals, prisons and power generation installations raise the question as to whether the TIAVSC definition and indeed the Valuation of Land Act 1951 definitions are adequate on their own.

Infrastructural assets are by nature assets which are not usually traded or exchanged in an open market. It is suggested that defining their value exclus ively in terms of "the market" may be limiting or even misleading. The term "market value" surely implies a value based on conditions relating to or extracted from an existing market and the valuation of infrastructural and community assets may need to be defined in other than market value terms.

Another issue related to definitions of value is the manner in which the assessed value is to be expressed. There have recently been quite widespread suggestions that valuers should express their valuations as a range of probable values for a property rather than assessing a specific figure. The proponents of the "range of probable values" or even "probable selling price" suggest that in such a diverse market as the property market where properties are not usually entirely comparable and where subjective judgements will inevitably have to be made, it is unrealistic for valuers to have to determine all these factors into one assessment.

However, it is considered that this is the role of the qualified valuer and the recipient of a valuers report should be seeking to find what that valuers conclusive opinion is on the value of a particular property in the knowledge of all those recent known transactions, the present demand for and the availability of comparable properties, which is "the market". A wider spectrum of property professions which may include real estate sales people, property managers and even accountants, bankers, lawyers, architects and building consultants may have some knowledge of particular types of property and they may express opinions on the range of probable market values for those properties. But it is the expertise of a qualified valuer which will enable that practitioner to determine a market value from the diverse range of market indicators that need to be considered.

It is understandable that suggestions of valuers' assessments being expressed as a "range of values" or "most probable selling price" should come from people having to confront valuers and contest property valuations. The frustration felt by a barrister cross-examining a valuer expert witness who has determined a specific valuation figure after researching and applying relevant market data would be much greater than if that valuer had concluded only a "range of values" or a "most probable selling price". A valuation figure determined by a qualified and suitably experienced valuer resulting from detailed research and analysis of relevant market data is likely to be more difficult to contest. But a valuers opinion expressed only in terms of a "range of values" or a "most probable selling price" would provide much greater opportunities for shadows to be cast on that valuation.

While definitions of value may have to be amended or expanded in the future to adequately encompass the much more diverse types of property that are now being valued, it is suggested that those definitions should continue to focus on the assessment of a relevant figure which represents "the value".

Trevor J Croot

From the President's Pen

' have welcomed the opportunity to visit almost all branches and sub-branches in the country over recent months, and talk directly with members on matters of concern or interest to them. Discussions have of course centred on the future direction of the Institute and the merger proposals in particular.

However, direct dialogue with members on arange of issues is certainly of assistance in planning the professional support and backup you require in today's demanding business environment.

The merger debate is, I believe, very healthy for branches and the Institute as a whole. It has stimulated at times heated discussion on who we are - valuers, land economists, property professionals in the wider sense or narrow focussed professionals concerned with the valuation of land and buildings and nothing else?

Our future direction as a professional body merger or not will be determined by your views as members communicated directly or through your councillors.

It is therefore absolutely essential that each and every member consider the issues facing the profession and formulate a view of their own.

My personal viewpoint has been conveyed to meetings from Whangarei to Invercargill.

This is that we are, in fact a broad based land profession, with a wide expertise and skill base.

In my view, the merger as proposed will enhance our ability to represent valuation, property and management professionals in banking, commerce and agri-business, as well as those in more traditional valuation businesses, both in the private and the public sector.

The contrary view has been forcibly put at some of the branch meetings attended - that the profession will be watered down and lose its pre-eminent position in representing the interests of independent valuation professionals.

Your Council obviously considered that the merger proposals had sufficient merit to enter into rather protracted discussions with the urban and rural management professions, the end result being the white paper that all members received earlier this year.

This makes it clear that the decision - to merge or not to merge will be made by the membership, not the Council. I therefore urge you to exercise your democratic right from a fully informed position and every effort is being made to assist in this regard.

Remember, only those who vote can decide the future direction of the profession.

A high response level is required to what is almost certainly the most important membership decision of recent years.

John Larmer

OBITUAR
Sylvanus Morris Jones (1909-1993)

A past President and life member of the Institute, Morris Jones passed away on 2 August 1993 at Tauranga.

Born in Wales, he came to New Zealand at the age of 13 and attended Flock House before working on sheep stations on the East Coast. In 1933 he went to Lincoln College and obtained a Diploma in Agriculture, coming top in seven of the eight subjects, He joined the Valuation Department and in 1934 was Assistant Valuer at Te K.uiti, becoming Assistant District Valuer some two years later in Taranaki and subsequently District Valuer in Wairarapa.

Following three-and-half years of war service with the army, mostly in the Pacific, he was appointed District Valuer, Rotorua, where he remained for three years before taking on the post of Inspecting Valuer in Napier.

In 1949 he was appointed rural Supervising Valuer at the Head Office of the Valuation Department and in 1958 became Deputy Valuer General which position he held until November 1967 when he *retired* to enter private practice on his own account.

Morris established permanent data and the original sales and property classification systems within the rural sec.-tion of his Department which are still in use today. The firm he founded at Tauranga is known as Jones, Tierney and Green.

Morris was a tireless worker for the Institute and the profession and was a foundation member of the NZ Institute of Valuers in 1930, having previously been a member of the Government Valuers Institute which he joined in 1934. He held many executive positions in the NZIV.

On the passing of the Valuers Act 1948, he was registered both Rural and Urban. In 1.955-56 he was a member of the Education Committee and Board of Examiners which he chaired in 1957-58. In 1959 he chaired the Executive Committee of the Institute.

In 1955, he was elected a Fellow of the Institute, in 1962-63 President and in 1967 a l it e member, He was an examiner on various occasions and published papers on valuation matters. He was responsible for the preparation of submissions to Government on behalf of the Institute and had also appeared before Committees of the House on Institute matters.

He had a particular interest with re gard to the recognition of Registered Valuers by the community and Government and also in connection with the difficult reciprocal agreements with the R.I.C.S. and other overseas valuations institutions.

He was a keen trout fisher and for many years had a cottage at Taupo from where he was able to enjoy this sport.

Morris married Cushla Fitzgerald who died in *1974*. He is survived by Gwynne, Heather and three grandchildren, Tim Jackie and Caroline.

Hui on Maori Land issues

Liz Brook interviews NZIV President John Larmer on the forthcoming Hui at Albany

Waitangi Treaty issues, Maori Reserved Land Act, Rating and Maori land - these are all issues deserving debate, and hence the need for a Hui on Maori land issues and valuation in particular.

In November this year, a Hui is to be held at the Massey University Albany campus (on Auckland's North shore) to educate NZIV members on Treaty issues, land issues and the technicalities involved. It will also provide a forum for expressing the various viewpoints on these issues.

Issues under consideration at the Hui include: Orakei-case study; Rating and Maori land, and Maori Reserved Land Act Review. NZIV President, John Larmer, says the Institute ran a conference at Massey University in 1991 on issues pertaining to the value of Maori land.

"The Institute believed that there were issues that had to be addressed if valuers and New Zealanders in general were to work towards solving the complex matters relating to Maori land," he says.

The 1991 conference, the first one to address the issues of Maori land, was a success in that it provided the opportunity to exchange information and views and had an education function. It was an interchange between Maori interest groups and property professionals.

Now the NZIV education board has called for the hui at Albany and Larmer believes there will be a strong Maori interest view expressed there. "It is a very useful forum for articulating the problems as they see them. Their perspective often goes right back to the Treaty and many of the things now in place appear to be at odds with the original Treaty.

"As property professionals we can't do a lot about that at the moment, but we do have the invidious job of being at the "coal face" in dealing with the actual arrangements that are in place, the various leases and from the Government valuers' point of view, the rating assessments."

Larmer feels that both sides need to become acquainted with issues such as the problems relating to concepts of unimproved land and market returns.

"I see the Albany Hui as being extremely helpful to Maori owners, occupiers and lessees of Maori land and also to the legal and valuation professions.

"Debating these difficult matters will increase our knowledge and awareness. We have to work through these contentious issues. The hui will help in that direction."

John Larmer, who became president of the NZIV in April this year, is a partner in New Plymouth-based Larmers valuation firm and is a rural land specialist holding both valuation and farm management consultancy registration. He is also a qualified arbitrator and, being based in Taranaki, is involved in a lot of "energy" type work with exploration companies and land owners, including land disturbance for access provisions.

Taranaki has extensive areas of Maori land, particularly Reserved Land under long term lease, and Larmer's location and background has given him considerable experience with respect to these. His firm has acted for Maori owners, the Maori Trustee and for PKW (Parininihi Ki Waitotara) Incorporation which inherited West Coast lease land.

"Although I act for Maori land owners from time to time, at present I have been retained by the East Coast Lessees Association to provide expert testimony on unimproved values and other issues that pertain to the rental basis of that land. The rating issues are causing increasing concern to Maori," says Larmer.

He points out that among problem areas are the provisions of the Valuation of Land Act which overlooks some Maori perceptions of land. The Act is based on the premise that land is a commodity to be bought and sold according to the dictates of a market-based economy, with the assumption of a monetary value of the land plus a willing buyer and willing seller.

That, he says, underpins the whole valuation of land framework and influences valuation even if the land is not going to be bought or sold. The rating burden flows on from the statutory valuations which are then used for rating purposes by the local authorities.

"The flow-on effect on rates can be very detrimental to tribal or multiple owners whose ideas of land use are quite different to the highest and best use concept. Land administrators and valuation professionals, and perhaps eventually the legislators need to consider these matters and in particular look at the assumption that all land is for sale," he says.

Larmer considers this an interesting issue as, under the right legal framework, valuers carrying out statutory valuations could take account of the restrictions that Maori themselves see on that land. He says that the problem for the Crown is that if it makes that sort of exception, how does it treat other land that may be similarly placed? There is a striking difference in attitudes toward the land by the people setting the legislation and the people it affects. Rating of land is a hot issue, particularly in Northland.

Northland has a some incredibly beautiful coastline, says Larmer. But adjoining it is some rugged and rather low use utility farming country. There are many examples of multiple-owned Maori land on a remote coast that is valued for rating purposes at market levels probably set by purchasers for long term investment. "It is totally out of context with the reality of what is happening on that land if it is multiple-owned because nothing is happening and that is a quite acceptable `use" to Maori owners.

"Then there is the other aspect of Maori land, particularly in Taranaki where we have more than 19,000 hectares of West Coast Settlement Reserve leasehold - mainly quality farmland. The issue here is the perpetual leasehold."

Doug Kidd, Minister of Maori Affairs, set up a team to review the Maori Reserved Land Act and, when the report was released recently, signalled an intention to change some of the provisions of the Act in regard to the perpetual right of renewal and also the 21-year term between rental reviews.

At the moment these leases are reviewed every 21 years and the occupier has the right of renewal as long as the rent is paid. Larmer says the Minister has taken on board the concerns of Maori, expressed over a long period of time, that they are completely separated from their land and under that system, never have the right to occupy the land. They do have the right to receive an income stream based on periodic revaluation of the unimproved value of the land.

"As I pointed out at the 1991 Massey University conference, there is also another side of the argument. There is a lessee who has developed the land, usually into a highly productive farming unit. Farmers also have an attachment to the land that transcends mere monetary value, and some of these lessees have been on the land for generations.

"Therefore the changes in the relationship between lessor and lessee needs to be discussed with sensitivity." 0

Book Reviews

Ground Rentals: A national and international perspective

by Leonie Freeman

Reviewed by Bob Hargreaves

Copies of the publication can be obtained from the NZIV, PO Box 27146 Wellington at a cost of $35 (inc GST and postage).

The topic of ground rentals for leasehold land is very controversial. Ground rentals are a contentious issue because most purchasers of leasehold land do not understand what they are buying and many appear to end up paying too much. Leonie Freeman points out that lessees only realise that they have paid too much when they are faced with substantial rental increases at the time of the rent reviews.

It is understandable that the complexity of leasehold assessments may be beyond the capability of the typical lessee. However, property professionals should be able to provide lessees with good advice. Unfortunately the "experts" agree to disagree on the methodology of leasehold assessment. Ms Freeman quotes numerous examples of court decisions and arbitrations to illustrate this point.

The assessment of ground rentals is thus a fertile field for property research. With a background in private valuation practice and university lecturing, Ms Freeman brings a unique blend of skills to the topic.

The stated objective of this publication is: *"To provide an objective look at ground rents in New Zealand* in an *endeavour to progress the issue closer to some resolution with the provision of useful, practical and applicable research."*

The publication is organised into three chapters. Chapter One provides a broad overview of the issues relating to ground leases. These are identified as the length between rent reviews (often 21 years), the very large rental increases over 21 years, and the difficulties in freeholding leases.

Chapter Two deals with the assessment of ground rentals. The first part covers the economic principles of rent. The analogy is drawn between Ricardian rent and the property accommodation market. The author then deals with legal principles and traverses a large number of legal precedents and arbitration decisions. Section three deals with ground rental assessments under the headings of existing methodology; economic rent theory; prudent lessee; improvements; land value assessments; rent rate; risk; lessors and lessees interest; and capital assets pricing model. Ms Freeman makes the observation that the standard 21-year Glasgow lease is an anachronism in today's environment and that it is her belief that a realistic and long-term solution will not come from arbitration or the Court arena.

The possibility of altering existing leasehold contracts by agreement between the parties is identified as a potential solution to current problems.

Chapter Three provides the reader with an international perspective on leases, based on a survey conducted by the author. Responses were received from 32 countries. Although ground leases are relatively common worldwide, Ms Freeman concludes that most overseas arrangements are not directly comparable with New Zealand leases.

This research publication is essential reading for property professionals. The author has a very readable style and minimises the use of technical jargon and mathematical formulae. Readers who expect a definitive exposition that will provide all the answers on leaseholds will be disappointed.

The publication claims only to be an introductory work and raises more questions than it answers. This is not a criticism of the publication but merely an observation that the current "state of the art" is in need of considerable further research. It is to be hoped that an academic researcher working in the University environment takes on this research challenge.

Maori Land Issues Hui

continued from page 7

There also needs to be knowledge of the valuation principles and the difficulties inherent in the unimproved value concept that underlies most of the Maori Reserved Land leases. Trying to modernise the leases is not easy and Larmer says a lot of discussion is needed to make peop,,le aware of the difficulties.

The Ministerial document mentions setting a market rental for these lands. We will have great difficulty in setting a market rental for land that is assumed to be unimproved. I am sure there will bea strong Maori interest view at the Hui and this is very useful in articulating the problems as they see it.'

The Hui is to be held on the weekend starting Friday 26 November.

Report by Liz Brook, Massey University Business Studies Faculty.

Property investments and their Financing

by P J Rowland

Published 1993 by The Law Book Coy Ltd, Australia
Order from PO Box 3139 Auckland. Price A$55

Reviewed by Keith McKeown

This is an excellent publication from P J Rowland, a senior lecturer, Dept of Property Studies, Curtin University ofTechnology, Perth. I note in the preface, that Rowland acknowledges the assistance of his colleague Tom Whipple better known to New Zealanders after his recent lecture tour of this country. However, it is not a text directed at property valuers, rather at property investors. Although the book does explain various methods of valuing property, it focuses primarily on the underlying reasons for investing in real estate and methods of financing. It is therefore a complement to many existing texts that emphasis valuation methods. Much of the material in the book is adopted from the school of financial analysis and a reasonable understanding of the subject will aid comprehension.

The author argues that the market value of a property and its value to a particular investor may not necessarily be the same thing. It is because of inefficiencies within both the real estate and financial markets that create opportunities for obtaining abnormal returns for investors. These opportunities will be best identified by utilising detailed cash flow analysis measuring a return from equity cash flow after taxation at an appropriate level of gearing.

The book starts with an outline discussion about the various measures of return, risk factors associated with property and the effect of borrowing. This theme is followed throughout the book with each issue being considered in considerable detail. From the investor's perspective it is aptly illustrated that investment analysis must include an examination of potential benefits of leverage that accrue principally as a result of irregularities in the tax system. The book draws heavily on the Australian tax experience much of which will be irrelevant in the New Zealand context. However, it does highlight the effect of the absence of the capital gains tax and the benefits of an investment that pays at least part of its return in this fashion.

The book sets out a clear and concise example of how to derive after tax cash flows that should be of considerable interest to practitioners. This is followed by discussions about the methods and hazards of forecasting, discount rates, concepts and measures of risk. This discussion is extended to include a particularly interesting section on the dissection of the discount rate. The proposition being that the income from a property can be attributed to either the existing income stream, expected growth or tax shelters, all of which could be treated differently or discounted at different rates to reflect their relative levels of risk.

Central to the use of any form of discounted cash flow model in analysis of real estate is the adoption of an appropriate discount rate. The author considers a number of ways that investors may arrive at such a discount rate including alternative investment analysis, weighted cost of capital and opportunity cost. Despite the fact that the current financial theory in this respect is difficult to apply to real estate, a further exploration of this topic may have been helpful for some readers.

Overall, a very interesting read that offers a different perspective on property analysis. It is a book that I would recommend to all valuers, particularly those who currently use discounted cash flow techniques.

Women in the Valuing Profession A Women's Suffrage Year Article

by S G Bond

Sandra Bond is a let turer in valuation at Massey University She *is an Associate of the NZJV and she gradawed fram Massey University in 1984 with a Bachelor of Business Studies in Valuation and Property Moatrm,yF meat. Sandra Bond was employedfZ a vtiluer with Valuation New Zealand tit lVellingran and with Hartouw t Vtilatation Division. She travelled overseas for* two *years* gaining valuing *experience in London before returning to her present position in* 1990,

At a recent Conference held in Sydney for Australasian Real Estate Educators, Steven and Kate Mooney (USA) presented their research on Valuer Income Determinants: Australia vs US. It was alarming to discover from the results of their study how male dominated the valuation industry is in both countries. The US sample was made up of 89% males and 11% females, while the Australian sample was 97% males and 3% females.

This led to investigations of the New Zealand position. As approximately one-third of the valuation students at Massey University are female, the author assumed thatthis would reflect in the sex structure of the profession as a whole, hence her surprise at the figures quoted for Australia and US. Surely New Zealand fared better? Figures collected from the Valuers Registration Board and the New Zealand Institute of Valuers proved this assumption wrong. As atMarch 1993 females accounted for only 6.7% of total membership. Of registered valuers only 5.7% were female, and of practising valuers only 4.9%. Of the total number of female members only 35% were practising.

In 1990 females accounted for 7% of total membership, 4.7% of registered valuers and 4.1% of practising valuers. Of the total number of female members only 29% were practising in that year. Ten years ago only 0.7% of practising valuers were female (4 out of 561), and 40 years ago no fem ales pracdsed.

The question that one is compelled to ask then is, considering some 30% of valuation students are females, why do so few become Institute members, and even fewer practising valuers? A nationwide survey is currently being developed by a Massey University researcher to investigate these issues in greater depth. However, in a more informal way it is hoped that this article will stimulate a response. Interested female valuers, or those holding valuation qualifications, are invited to write to the author providing their views in answer to these questions, and a personal brief of their experience in the profession. The responses will be collated and an analysis submitted for publication in the *New Zealand Valuers' Journal* next year.

To startthe ball rolling and to give some insight into one female's perspective of the profession, the author briefly outlines her experience to date.

While still at high school and going through the career decision-making process, two possibilities emerged having attended a career guidance course: Valuation and Quantity Surveying. Discussions were arranged with women working in both of these fields. Gwendolyn Jansen, then working for Valuation New Zealand (ex-Valuation Department) was so highly motivated and enthusiastic about her chosen profession that no more convincing was required. Valuation was the career to pursue. Having been granted a cadetship with the Department, I began study at Massey University, graduating with a Bachelor of Business Studies, Valuation and Property Management in 1984, along with six other females, a 33% representation.

As abonded cadetI spent ayear with the ValuationDepartmentin Wellingtonin 1985 being one of two female valuers, from a .total of 11 valuers. To get an insight into private practice I contacted the Principal of Harcourts, Robert Fisher, and spoke with him and Bill Smith, Head of the Valuation Division. Subsequently, I was offered a job there, and became the only woman on a team of eight Valuers in 1986. The "team", on the whole, were very accepting and made little issue of the fact that I was the only female. We simply worked side-by-side, socialised together, and even trained and raced together for running and corporate triathalon events. I was treated as an equal at all levels, work, social and sport. Occasional small gestures, such as having the door opened, or a drink bought for me were the only distinctions made. However, I was more than willing to reciprocate these when appropriate.

The majority of difficulties experienced came not from colleagues but from clients, both men and women, who were often surprised to be met by a woman, and a young one, rather than a man. The stereotype of a Valuer being a middle-aged man seems to predominate. Comments such as "You look too young to be a Valuer", or "We were expecting a man" were not uncommon. Once the job was completed and the client satisfied withthe service received, they seemed more than willing to accept that a female could be just as capable as a male in the valuation of property.

After a two-year overseas trip, I joined the Department of Property Studies at Massey University as a Lecturer. Of the then seven full-time lecturing staff, I was again the only female, Iona McCarthy, the only other female lecturer, being part-time. Again the problems encountered were not from colleagues but from students, many of whom commented that I appeared not only too young to be a Lecturer, but also too young to have had such extensive valuation experience. The issue of being female, interestingly, has not arisen and my feeling is that this is due to not only the younger generation, but students generally, being more aware and supportive of equal opportunitiesforall,comparedtothepopulation, as a whole. In conclusion, my experience to date, working in a profession dominated by men has been not only unhindered by conflict,butextremelysatisf iing.Exposure tothe "other" sex has led me to conclude that not only are we equal, but in fact by working as a team together, we complement each other and enhance the team's performance by the different perspectives we offer. A,

Valuation of a Tourist Venture Based on a Wildlife Sancturary

by I Dunckley

The assessment of the value of natural assets is a very complex and difficult assignment. Natural values have always been appreciated but not generally recorded. Accounting standards now require that these assets be recorded at a value within the balance sheets of the appropriate owning authority.

Realism in the assessment of value is of prime importance, if valuers are to retain credibility in the new fields of valuation.

The use solely of the historical depreciated replacement cost method of valuation for assets which have no market value because they are not transacted is no longer a defendable option available to the valuer and has resulted in the recent development of new valuation techniques. The valuation basis must conform with the stated purpose of the valuation.

This paper briefly outlines the background and development of the Taiaroa Head Tourist complex. A brief history of the headland, its development and the valuation of the cashflow business is presented.

John Dun, kley is a Director of Simes Valuation Limited and is the Managing Director ofSimes Dunckley Valuation at Dunedin. He is a Fellow of the New Zealand Institute of Valuers and holds a Bachelor of Commerce degree from Lincoln College and a Diploma for Valuation Professional (Urban). John Dunckley has been at the forefront of the development of valuation methodologies for major property and asset portfolios.

1.0 History of the Headland

People of Otakou

Taiaroa Head is an exposed headland situated some 30 kms east of Dunedin overlooking the harbour entrance. The Treaty of Waitangi was signed here in 1840 by Chiefs Karetai and Korako. The headland was of strategic value to the people of Otakau and later the European settlers. It remains a site of significance to these people.

Port Otago

Since the beginning of shipping into Dunedin this headland has been of strategic value to shippers. There is an unmanned lighthouse and an operational signal station (still manned 24 hours per day) on the site.

In the 1850s, when 16 Armstrong guns were dispatched to defend New Zealand from invasion, nine were commissioned in Dunedin. The lastremaining operational gun of this type in the world now forms part of the Taiaroa Head Centre.

Albatrosses

In 1920 seven Northern albatrosses from the Chatham Islands settled at Taiaroa Head. The new colony had a difficult establishment period, only achieving the current population of 100 birds, after sustained human protection and intervention.

Department of Conservation

In 1964 Taiaroa Head was classified as a Flora and Fauna Reserve, the responsibility of the then Wildlife Service. In 1972 limited public access was first allowed although the Department retained (and still retains) the right to terminate public access to the reserve area. A concession payment has been negotiated with the Otago Peninsula Trust for the current tourist operation.

Otago Peninsula Trust

The Otago Peninsula Trust was formed in 1968. Trust members are elected and act on a voluntary basis. The Trust has a general commitment to:

> *the preservation of natural attractions ... and the protection of the flora and fauna of the Otago Peninsula ...*

The Trust recognised the Albatross Colony as a unique asset. Initially it raised community funds, although more recently attracted a major community commercial sponsor in Trust Bank Otago who invested in the development which we see today.

Clearly, the Albatross Colony presents a delicate balance of conservation, tourism, indigenous, commercial, and community interests.

2.0 Commercialisation of natural assets

Commercial status

In considering the potential commercial investment, examples such as the developments at the Moeraki Boulders in North Otago, Punakaiki Pancake Rocks on the West Coast of the South Island, the Kaikoura Whale watching venture on the South Island East Coast and the Waitomo Caves in the North Island have demonstrated that viable businesses can be built around natural assets.

The Moeraki Boulders

The Moeraki Boulders, which are large round rocks sitting on a beach just north of Dunedin, have an almost indefinite life as long as the sand build-up on the beach does not cover them and people refrain from removing them as was once very common. The intangible attraction (rock viewing) supported a development which in turn has created a commercial value for the site, and enabled an operator to set up a viable business. There is no ownership of the rocks although appropriate building consents for the tearooms and observatory erected on private land had to be obtained.

Punakaiki Pancake Rocks

A similar example is the Punakaiki Pancake Rocks located on the West Coast, between Greymouth and Westport. This comprises a magnificent bush walk past spectacular cliffs to a blowhole which puffs like a whale given the right conditions. There is a significant commer- t

This paper was presented at the NZIV Seminar held at Dunedin on 19 April 1993

cial centre living off this sometimes-puffing blowhole. Tourists appreciate the break in their trips, a bushwalk on tarsealed tracks and the breathtaking beauty of the coastal views. However, it is the intangible attraction of the blowhole, which actually lures them.

As a result of natural erosion, this blowhole cannot last forever and perhaps eventually an engineer will be called in to create an artificial one, which will puff in all seas, making the asset reliable and sustainable. Would this reduce the assets intangible value which depends on wildness and naturalness, the "real thing"? It is worth noting that internationally some vulnerable ancient treasures are being protected from tourists who are damaging them beyond repair just by coming to see them. In some cases tourists are encouraged to visit a replica instead.

Recently it was reported that a business consortium was investigating the redevelopment of the Pi nk And White Terraces. Will this once "wonder of the world" begin a Theme-Park New Zealand trend? Engineers and developers do have a role in the development and sustainability of an intangible "natural" asset. How successful their contribution may be is largely dependent upon the perceptions and expectations of the often unpredictable tourist.

Waitomo Caves

As in Punakaiki and Moeraki, the Waitomo Caves are a naturally occurring formation. However, the caves vary from the previous two examples in that the primary attraction is not the geological structure, but rather the life-forms within the caves. These agreeable worms glow, to the tourist's delight and ensure the commercial viability of the tourist infrastructure in the area.

I wonder if anyone has investigated the reproductive cycle of the glow-worm, or likely diseases or dangers to the habitat. How sustainable is the attraction given the current population of glow-worms and the current number of tourists?

What if tourist numbers should continue to increase?

At what point will the sustainability of the asset and the sustainability of growth in tourist numbers collide?

If I were a tourist operator at Waitomo, I would want to know everything I could about these little critters who love to grin at the tourist in the dark. Waitomo does have an advantage, in that, like Punakaiki, if the glow-worm population of the key cave were to do the unspeakable, lights out, nobody home - then the engineers could be called in to develop access to another cave within the vicinity. This would be at a considerable cost, but the level of return would be known and hence risks minimised and the infrastructural asset base preserved.

The Kaikoura Whales

Up the East Coast, at a small township, hurting like most isolated communities from the run down of railways and of traditional employment outlets, an innovative wildlife tourist venture established and largely financed by Ngai Tabu, that involves boating tourists up close to small groups of adolescent whales at sea, has proved successful.

Since the venture began, a 711% increase in visitor numbers, has led to a boom in tourist accommodation, food outlets, retailing and other businesses serving this influx of international and domestic whale enthusiasts. Commercial land values have doubled, residential values have increased by 50% and building is up 40%. New jobs have opened up often employing people formerly considered to be difficult to place.

The Department of Conservation recently intervened under the Marine Mammals Protection Act 1978 halting development until they are absolutely certain that none of the present attractions available are in any way adversely affecting the whales and dolphins.

If that means that not all of the tourists who want to pay good money to the business people of Kaikoura to see whales will be able to, then so be it. Disappointed entrepreneurs can perhaps console themselves by remembering that this is not Marineland. If these majestic, not to mention lucrative, sea creatures suddenly get sick of all the fuss at Kaikoura, the ocean's a pretty big place and they're as free as the birds at Taiaroa Head.

The Albatross Colony

The tourist venture at the albatross Colony must be considered to be at greater risk than any of the first three examples quoted and every bit as vulnerable as the whale watching at Kaikoura, despite the much more established and experienced nature of its administrators.

Every year, the albatrosses disappear to sea will they always come back or, one day, will it be bye-bye birdie forever? RememberTaiaroaHead is the only colony in the world on a mainland. Clearly the Royals have made a major exception for the Otago Peninsula. The question is how long will they continue to do so? And what role do visitors play in influencing their decision to call Taiaroa Head home?

Research has shown that courtship and nesting within sight of the observatory has reduced in relation to increased hours of viewing and numbers of visitors with 60% of chicks reared in sight of the observatory choosing sites away from people to court and nest. Almost all of the albatrosses born in the Chathams who later nest at Taiaroa Head do so away from the observatory.

Unfortunately this places not only the visitors' experience of the birds at risk but the very birds themselves as only a third of the reserve is suitable habitat. The areas that are increasingly preferred (away from people) are the warmer northern faces where the albatrosses are threatened by heat, dryness, flies and lack of winds to get airborne.

At Taiaroa Head, there are only 70 birds, including adolescents, in any one year, with the total population of the colony now 100. To be self-sustaining the colony needs to double to 40/50 breeding pairs. Unlike any of the other examples quoted, the asset, these birds, have been nurtured, cared for and treated with the utmost respect and skill. Of the 205 chicks fledged since the first chick flew off in 1938, roughly a quarter owe their lives to human intervention.

Although they are not endangered as are the yellow-eyed penguin (Hoi Ho), neither are they immune from mysterious and sudden death. During the epidemic of deaths in the Hoi Ho population in the late 1980s fears were held that whatever it was decimating the penguins; predators, food shortages, viruses, toxins might also affect the albatross colony. These fears underscore the reality that to a large extent the survival of this colony, if not the species itself, depends on largely unmanageable factors such as weather patterns, a non-polluted environment and stable food chains.

In the short term, practical steps can be taken to reduce the impact of visitors upon the behaviour of the albatrosses such as covering the walkways and reducing the size of the windows in the observatory, but always with the realisation that vital changes in the behaviour of a slow breeding, long-lived bird which spends much of its time at sea may be difficult, even impossible, to identify.

The gun emplacement and wild coast views are not dramatic enough to provide the basis for a commercial tourism enterprise. They have historical and scenery values and attract tourists as do the seals, penguins and other breeding colonies on the Peninsula but they could not support the sort of infrastructure of assets that 0

have been developed on this site.

The activities at the albatross Colony are always news in Dunedin and the newspapers report when the albatrosses arrive; they report sicknesses and report births; Dunedin lives with the albatrosses. When "Grandma" believed to be the world's oldest albatross at more than 60 years old, failed to rendezvous with her mate at Taiaroa Head in 1990 it made the front page.

The local, national and international tourism market rate this colony as a significant attraction. The Otago Peninsula Trust has developed the asset in response to this current and growing tourist interest in natural assets. In short, as Samuel Taylor Coleridge in the Rime of the Ancient Mariner expressed it, the albatross is "a pious bird of good omen". But for all concerned at Taiaroa Head, the Royal Albatross must remain a mysterious and inscrutable bird.

3.0 Analysis of the Taiaroa Head Business

3.1 Tour revenues

The revenues for the past three years have been analysed and this is shown below.

	1990	1991	1992	1993
Tourist numbers:				
*Dunedin City			230,000	250,000
*Taiaroa Head				
-Albatrosses (only)	19,442	25,431	27,973	30,007
-Gun/Fort (only)	1,133	911	980	879
-Combined tour	9,393	15,301	13,485	15,014
School (incl)	(31.83)	(1.381)	(91.97)	(82.22)
Total Numbers	29,968	41,643	42,438	45,900
Gross Revenue		$366,517	$427,463	497,392
Analysis Revenue/ Visitor		$8.80	$10.07	$10.84
Tariffs (GST Incl)				
*Albatrosses				$15.00
*Gun				$8.00
*Combined				$18.00

Notes

- School children at discount rates included (shown in brackets).
- Note Taiaroa Head operated through winter on a loss basis for the "good" of Dunedin.
- Static displays ($600,000) just installed should significantly improve winter revenues.
- Shop increased in size in 1992/93 year.
- Kitchen & cafe extended in 1992/93 year.
- Assembly/tutoring area added in 1992/93 year.

3.2 Tourist numbers

These are measured by two counts

Total Persons Through Centre Door

Year	Number
1990	95,488
1991	99,866
1992	109,000
1993	104,500*

*This decrease is probably due to the extensive building programme.

Total Persons On Tours

Year	Number
1985/86	10,954
1986/87	14,376
1987/88	19,088
1988/89	25,194
1989/90	30,111
1990/91	38,669
1991/92	42,438
1992/93	45,900

1992 research by James Higham, of Otago University, identified the growth as following an exponential curve.
See Fig 1.

He cautioned that an exponential growth curve cannot be maintained indefinitely and is difficult to predict when it will plateau or how it will evolve thereafter.

His research identified work by Butler (1980) who applied the exponential growth curve to the evolution of a tourism development. There were four identifiable stages:

1) Slow sales
2) Accelerating steadily
3) Exploding
4) Levelling, decline or experience rejuvenation

He observed that in the later stages management initiative should determine which form the exponential growth curve took. In fact management at Taiaroa Head is proactive in, and very conscious of, its role in the future viability of this tourist development.

Higham observed that the rapid increase in tourist numbers was seasonal and that the "peak season" was the four months December to March. This concentration of numbers is very relevant to managerial decisions concerned with how many tourists the attraction can sustain.

3.3 Carrying Capacity

The Department of Conservation, draft copy for Managing Tourism, October 1991 (still current), state:

> *Carrying capacity is the level of activity beyond which the environment is degraded...*

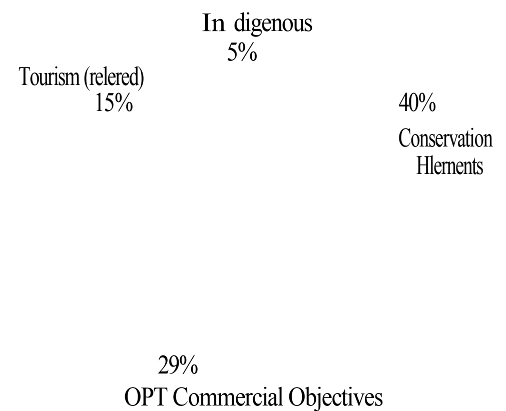
Two other considerations are the effect of the carrying capacity on visitor enjoyment and the physical constraints of the facilities.

Carrying capacity is determined by:

- Environmental and wildlife issues
- Visitor enjoyment
- Capacity of facilities

Overseas visitor limits have been placed on similar operations (Phillips Island Penguin Parade Victoria, Australia and Galapagos National Park) as evidence

Fig 1. Possible Balance of Values



that a finite carrying capacity has been set in order to balance the conservation and tourism objectives.

The Otago Peninsula Trust has invested heavily in order to attract visitors in the "off' season, in order to relieve the pressure on the facilities and the wildlife in the summer. A $600,000 investment in static displays last year created the information centre. Tour numbers are budgeted at a modest 5% increase for the 1993/94 year, a relatively conservative projection.

The potential carrying capacity will be affected by the tour limitations (facility capacity) in the summer months, whilst the visitor enjoyment (social capacity) will be the limiting off season capacity (weather and quality of experience). It is noted that daylight hours also limit the number of off season tours.

The current carrying capacity can therefore be defined not withstanding that the Department of Conservation has the right to close the reserve access at any time. (This is to guarantee that the welfare of the birds overrides all else.)

3.4 Projected Tourist Numbers

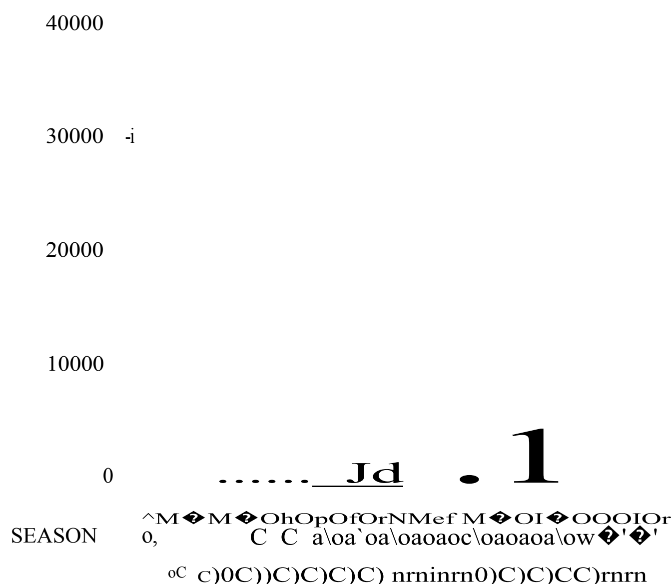
1993/94 Financial Year
(Assuming 5% Growth)

Total Through the Door	115,000
Total Tours	48,195
Non Tour	66,805

Average Tariff

Maintain at the 1992/93 levels of $10.84 per head.

Fig 2 Annual Visitor Numbers: 1972-1991



3.5 Expenses

The expenses for the 1991 and 1992 years have been analysed and all capital expenditure, interest and management wages deducted. The realistic operating costs have been established on a status quo basis.

Notes

The Department of Conservation concession is now set at 5% of albatross tour revenue excluding school parties.

Some further development capital is required to ensure sustainability of revenues and this is estimated at $250,000.

- The cafe was leased through 1991 and 1992 for a nominal rental. In 1992/1993, the Trust operated the cafe at abreak-even level, and turnover is reported at $84,639.
- The gross profit and expense items have been estimated for the 1992/93 year.

The three-year accounts indicate a significant increase in the maintainable net cash flow.

The business is in a growth phase and the likely net cash flow in five years is expected to improve further.

Taiaroa Head Operation (GST exclusive)

	1991	1992	1993
Income			
Shop sales	$99,580	$124,624	$154,524
Gross Profit	$50,067	$50,031	$62,034
Admission Fees	$366,516	$427,463	$497,392
Cafe	$2,600	$2,570	$0
	$419,183	$480,064	$559,426
Expenses			
Audit fees	$3,300	$855	$855
Depreciation plant & fittings, etc	$21,908	$20,269	$0
Ex gratia payment Dept. of Conservation	$12,570	$16,998	$20,414
Management fee (notional for OPEX)	$80,000	$83,000	$85,000
Operating expenses	$83,434	$88,494	$103,123
Rent (notional for OPEX)	$75,600	$75,600	$0
Wages	$206,404	$225,480	$262,755
	$483,216	$510,696	$472,147
Trading Loss	$(604.33)	$30.632	N/A
Adjustments:			
Add back depreciation	$21,908	$20,269	$0
Rent	$75,600	$75,600	$0
Adjusted Net Profit	$33.475	$65.237	$87.297

4.0 Cash Flow Valuation

4.1 Projected maintainable cash flow

Revenue			
Tours	$522,433	Say	$522,000
Shop	($154,524 + 10%) GP 40%		$68,000
Cafe	minimal contribution GP		$3.000
			$593,000
Expenses			
Audit fees		$1,000	
Concession (DoC)		$22,000	
Management fee		$85,000	
Operating expenses (18.4%)		$109,000	
Wages (47%)		$278.000	
			$495.000
Estimated Net Profit			$98,000

This net profit represents the "return" on assets or the financial objectives of the trust management.

The objectives of the Trust are focused on the community and the environment. Their commercial object is to remain viable.

It is not logical to capitalise the estimated net profit of $98,000 as in the normally accepted valuation process for commercial properties.

4.2 Value of community service policies

The Trust has deliberately adopted the following community service policies which limit profitability.

- To remain open throughout the year when a purely commercial operation might choose to close.
- Not to charge an entry fee to the visitor centre.
- To encourage school children visits on a cost recovery basis only.

The decision to remain open throughout the year is difficult to analyse. However the effect of the second two policies can be easily quantified, as minimal charges would be required in the operation and virtually nil expense.

For every non tour visitor a charge of $5 could be made for access to the displays. Of 66,805 non tour visitors some would be children and others may decide not to visit if they had to pay even this small charge.

To allow for this $4 a head on 55,000 visitors is allowed, or $220,000.

For the 2,282 school children, an extra $3 per head could be charged, netting a further $6,700.

Hence the effect of the community service policy is to reduce the profit by $226,700 pa.

The total revenue then becomes:

Commercial Revenue	$593,000
Trust Policy Foregone Revenue	$226,700
Commercial Equivalent Revenue	$819,700

4.3 Going Concern Value

Projected Notional Maintainable Cash Flow:

Revenue	$819,700
Expenses	$495,000
Net cash flow	$324,700
Capitalisation rate	15.5%
Business value	$2,100,000

The business value represents the market value of the assets when a predetermined market rate of return is applied to the enterprise net cash flow. This rate is derived from the analysis of businesses in the market.

4.4 Depreciated Replacement Cost

Improvements

Main building	744.33	©$1400 =	$1,042,000
Observatory	77	©$500 =	$30,000
Gun, Tunnels etc.		say	$250,000
Paving, fencing, layout		say	$30.000
			$1,352,000
less Physical & functional depreciation			10%
			$1,210,000

Land

Leasehold occupancy on crown land for 99 years with concession rights to the adjacent reserve land.

Rental paid for crown land:	$0
Market rental:	$5.000
Rent benefit	$5,000 pa
Value ofright to occupy (99 years at 14%)	$35,000
Services:	
Sewage	$20,000
Water	$20,000
Power	$15,000
Serviced land value	$90,000
Land and buildings value	$1,300,000

Market rental	$1,300,000 ©13%	$169,000
Apportionment of value:		
Land		$90,000
Improvements		$1,210,000
Goodwill and plant/equipment		$800,000
Going concern		$2,100,000

4.5 Apportionment of net cash flow

Projected notional maintainable net cash flow	$324,700
Less:	
Management (allowed for)	
Return on chattels and plant $700,000 © 13% over 10 yrs	($129,000)
Return on land & buildings	(9$16000)
	(8$29000)
Profit	$26,700
Rate of return	25%
Value of goodwill say	$100,000

4.6 Identification of the intangibles

Why do people visit the Albatross Colony at Taiaroa Head?

- Wildlife sanctuary value.
- Proximity to Dunedin *(InAustralia the Phillip Island colony of little blue penguins historically a big tourist dollar earner described as near Melbourne* is *actually more than 100 kilometres away.)*
- Accessibility - Visitors of all ages and standards of fitness can visit this colony easily, unlike any other in the world. You can have a wildlife experience even if you're in a wheelchair.
- Uniqueness - Visitors may be attracted to this concept, as only here in Dunedin, of all the places that Royal albatrosses breed, are they to be found on a mainland and close to a city. There is no competition from any city in the world claiming to have an albatross colony at its back door.
- Business goodwill This term could be said to encompass everything which makes up the quality of the experience which attracts the tourist the training, knowledge, skills and personality of the guides; the relevance and interest of the information; the venture is nonexploitive of the birds and of the visitors; the perception of the tourist that the whole situation is kosher, ie authentic, has conservation integrity and represents value for money, time and effort expended. When combined with prudent business management these factors generate a sustainable value.

4.7 Market considerations

In selection of the appropriate discount rate there is a balancing between normal commercial objectives and conservation values. The property is maintained as a wildlife sanctuary and foremost is the welfare and survival of the colony with the secondary and symbiotic tourism value. If there are no birds there is limited value. Conversely, the survival and increase in numbers of birds at the colony in partis attributed to the intensive public interest. The care which often begins before the chick hatches is part funded by the tourist dollar.

There is a further issue in the valuation due to the fact that the community partially funded on a non-commercial basis the tourist centre and its associated improvements. If the facility was closed, the tourism value to Dunedin would be considerably reduced although not completely eliminated.

Selection of rate of return

I have chosen to select a rate which reflects a commercial rate of return at 15.5% for the going concern value. This value is supported by the depreciated replacement cost when apportioned to the elements of the business. Can we adopt a finite life for the return of the albatrosses?

5.0 Value of the Sanctuary

The concession paid to the Department of Conservation by the Otago Peninsula Trust represents one element of value. The headland with its wildlife and history has an added value to:

- Conservation - on a local, national and international level
- Tourism local and national
- People of New Zealand and pre and post European settlement

The Taiaroa Head site is of significant "spot" location value which is in addition to but pre-dates the current commercial operation. Can the values be assessed? If they can is the sum of the fair identifiable values added to determine the overall value?

A cash flow approach cannot represent the meaning of the headland to the Maori people. Money simply could not buy, nor represent the value. The scale of value is measured differently. It is a humble subtle value which can never be destroyed or replaced. This is identified as an important part of Taiaroa Head.

Conservation values can be eroded through mismanagement and natural disasters. What is a conservation value?

- Quality of looking, seeing, feeling, living our experience
- Uniqueness of the conservatory
- Accessibility

The conservatory may be purely of scientific value. This may be where unique obscure and uninspiring flora is for example. The Taiaroa Head conservation value has not been assessed.

The value of Taiaroa Head to Dunedin and to New Zealand as a tourist destination is significant. Over one-third of the 250,000 annual visitors to Dunedin pass through the doors of this centre. Similarly other tourist attractions have an affect on the Taiaroa Head Centre. The quality of the New Zealand tourist experience and the placement of Taiaroa Head (which may be negative or positive) has not been considered.

The following judgement has been made as to the possible balance of these interests:

Conservation	40%
Otago Peninsula Trust (OPT)	40%
Tourism (referred)	15%
Historical	5%

The OPT interest can be split into commercial (29%) and community (11%) by apportioning the revenues previously established.

The concession paid to DoC by the OPT is approximately $22,000 pa. If this represents a 40% interest then a 100% interest equates $55,000 pa. This cash flow is a basis to commence the process of value.

From every action there is a reaction and values like nature are balanced when sustainable. A

Background to the Otago Peninsula Trust

by B Barnett

Statement of purpose of Otago Peninsula Trust

To provide and promote an integrated range of recreational and informational services and activities to the local and overseas visitors on the Peninsula, while maintaining a strong concern for the unique environmental qualities of the area.

Bernice Aaanert is the Chairperson of the Otago Peninsula Trusty as po,�irion she has held since 1988. She has *a harAground in retailing having held senior management positions over man), years and is currently a Director of Arthur Aarneu Limited Bernice /s,i rn.ett* has *been e a rcn s i ve!y involved in* a *i or~iety of fundraising appeals for public fa-il/ties in Dunedin,*

This charitable trust, one of the first conservation and preservation organisations in NZ was formed in 1967, in response to a survey which indicated that the Otago Peninsula was the area most likely to be developed in the future for tourism. This development would of necessity need to be controlled in environmentally sensitive areas of the Peninsula.

In 1968 the Glenfalloch property of 30 acres with historic homestead on the shores of the Otago Harbour was purchased, in order to maintain public access to the property after the Dunedin City Council of the day declined to purchase. The property is still owned and operated by the Trust.

In 1972 the Trust was instrumental in having visitor viewing established at the unique Royal Albatross Colony at Taiaroa Head and has managed the visitor viewing since that time, under an indefinite authorisation from the Department of Conservation.

The fact that we have an albatross colony to enjoy, is due to the total dedication of Dr Lance Richdale, who in the 1930s stayed with the albatross day and night to ensure the survival of the first live chick within the colony. Previously it was known that eggs were taken, and sometimes they were broken, with the albatross breeding only in alternate years this was a tragedy, and the colony would not have survived this wanton destruction without the efforts of Dr Richdale.

It has to be remembered that there were up to 100 people, mostly families living on the headland many years ago. It boggles the mind to think how conservationists would view such a situation today, but it was a military barracks in those days.

There is a delightful story of the albatross who insisted on nesting in the middle of the parade ground, completely untroubled by soldiers drilling around the nest site and resisting all attempts at relocation.

Modifications to the headland when establishing military installations has made the area more attractive to the albatross who make good use of the tracks created as nest sites as well as landing, takeoff and display areas for chicks and adults.

This colony is unique being the only albatross colony in the world close to a town or city. The visitoroperation is known worldwide as conservation working where visitors can view the albatross from an observatory with the birds being totally protected.

This is also the only mainland colony of the rare Stewart Island Shag, also visible from the observatory.

Initially a Harbour Board house built around 1914 was adapted and used as visitor reception centre, however from the early 80s it was realised that better facilities were necessary to protect visitors to the exposed headland.

In March 1989 the international standard visitor reception centre was opened by HRH The Princess Royal becoming fully operational from that day. It was opened debt free at a cost of over $1 million after an extensive fund raising appeal to build both the visitors centre and a most necessary sewage plant to service the building.

The centre is open seven days a week all year round at no cost to visitors. The counter on the door reveals that in 1991/92 year 109,000 people visited the centre. It is providing a service to this community.

We provide clean toilets in an area where there were none before and the building provides a focus for visitors, thereby in effect exercising a measure of control on the movement of people visiting the headland.

Also at Taiaroa Head is Historic Fort Taiaroa with underground tunnel access to an Historical Military Museum with the Armstrong disappearing gun built in 1886 and completely restored to full working order, as the interesting focal point of this complex. This is the only such gun in working order in the world.

It was always the intention that the visitor reception centre would be a destination in its own right, not just a starting point for tours.

Recent additions to the building have increased the floor area by 30% to allow more space in the shop, refreshment cafe and for necessary storage.

The assembly room with attached resource room were added for the use of educational parties. A rapidly expanding area of tourism development involving overseas schools and universities and schools throughout NZ.

A comprehensive educational programme funded by the Trust has been developed by two wildlife scientists over the last two years assisted by educationalists which covers a number of different learning levels for which resource material will be provided. It is designed to complement and for integration into the school curriculum in addition there are programmes for overseas schools and adult education parties.

The access ramp for tour parties constructed as part of the recent development used NZ Eucalyptus Globoides for environmental integrity in preference to 0

Motels: Valuation of an Accommodation Industry Development

by G M Cheyne

Gary Cheyne is a Director of Darr, ch & Company and he is based in Au, Aland. He is an *Associate of the New Zeakmd Institute of Valuers, and holds a lachelm f C_ ornni.erce degree and a Diploma* in *Urban Valuation with tlanours.*
. pe,1ahsativn in particular valuation fields has involved Gary Cheyne in complex and multi-tier valuations, hotels and motels and he is an *eApez fenced negotiator, arbitrator and expert n itness.*

W ithin the broad band of the accommodation industry the types of properties most valuers will probably encounter are motels, motor hotels, hotels, and that increasingly important residential healthcare facility, the rest home.

I propose to restrict my paper to this middle ground, and specifically motels.

The portions of the valuation process I wi sh to highlight are those which I believe to be the most fundamental to the correct valuation of this middle group of accommodation industry based property. The valuer must address two issues.

The first issue is the determination of the category within which the property falls after taking full and conscious cognisance of the various factors which cause a property to be placed within a specific category.

The second issue, after having determined the first, is to select and apply those valuation techniques which are correct for the category within which the property has been determined as falling.

Property category

A particular property, such as a motel, will fall into one of four categories each requiring a different valuation approach or set of considerations. These categories are:

1. New or proposed.
2. Good quality offering a modem standard of accommodation without the need for immediate upgrading for either legislative or economic reasons.
3. Fair-marginal. In this category would fall property which requires upgrading to continue in operation or which may be at the point where an alternative use ought to be considered.
4. Properties with an expired economic life. These properties are now suitable only for conversion to some alternative use. 0

This paper was presented at the NZIV Seminar held at Dunedin on 19 April 1993

continued from previous page

imported hardwood and to avoid the toxic residue resulting from tanalised Pinus Radiata.

Plantings are yet to be completed but all plantings by the Trust on the headland are of endemic species.

During all ground disturbance on the headland the Trust employs an archaeologist to be in attendance throughout the duration of the disturbance.

The comprehensive high technology audio visual display installed in the albatross gallery through which all tour parties are guided, includes anatomical models of wildlife.

The first constructed in New Zealand, they are the combined work of sculptor Derek Ball and Russell Barnett, an anatomical scientist from the Otago Medical School.

The audio-visual material was tailored to specific requirements in the presentation of wildlife in its natural surroundings. Commissioned from the TVNZ Natural History Unit they also form part of the educational programme.

This display development allows tour parties an extended and enhanced experience at Taiaroa Head throughout the year assisting NZ Tourism, as seasonality is a major obstacle to improving visitors' experience and increasing visitor demand.

Unfortunately the display is not yet quite complete, with artistic elements often requiring more time to execute than was at first envisaged.

We are patient, as the end result is excellent well worth waiting for.

The Minister of Tourism commented after visiting the centre, "It is not just pretty good, it is awesome," stating that he had never seen the type of educational tourism the centre offered.

The display development is ongoing with plans now complete for the remaining large space, the Peninsula Gallery.

Some display units are already under construction for this area, although the high cost involved in displays particularly especially commissioned videos of which there are 14 more required covering the history of both Maori and European settlement, geology, marine values, military activity, the Otago Harbour, coastal environment and many other relevant subjects, may mean that the gallery will not be completed this year. This gallery is open to all visitors to the centre.

All amenities for visitors to Taiaroa Head have been provided by the Otago Peninsula Trust.

In December 1991 the Trust published the development proposals for Taiaroa Head to promote consideration of forward planning for the headland to ensure that the number of visitors accessing the headland were encouraged to enjoy the many interesting facets of Taiaroa Head without destruction of the rich values inherent in the area.

The Trust has researched establishing a World Heritage Convention status on the headland and adjacent wildlife area, and is currently preparing a submission to local authorities requesting that they actively investigate and promote this world classification status for the area. A

1. New or proposed

In New Zealand's major cities, property development has had a checkered reputation over the past decade as prices have risen and fallen dramatically and in more recent times as developments have been proven not to be tailored to the market and to be functionally obsolete on completion. Examples include the construction of substantial and in some cases palatial developments in areas without satisfactory demographic features resulting in an investment performance which cannot underpin initial construction costs.

This lack of profitability has in turn led to failed businesses and in a number of cases mortgagee sales which have failed even to fully repay mortgages.

This negative view of new accommodation development is no longer accurate; I believe that select development is now a viable and profitable option for certain sectors of the accommodation industry. By way of anecdotal example I was in Rotorua on business earlier this year and booked into a motel which had opened only that day. The motel was full on both the nights spent in Rotorua and will clearly be a successful business venture. But by way of contrast, older inferior motels in the same street were displaying vacancy signs.

There are continuing opportunities for further expansion of the tourist accommodation base in New Zealand and the next few years will see a continuation of a trend in new construction which has already commenced.

Important issues to be considered when valuing a new or proposed development include location, trends in tourist numbers to the area, the supply of beds of this quality in the area and whether the standard of development matches anticipated demand.

Where new or proposed accommodation developments have failed in the past there has been an incorrect assessment or in extreme cases complete disregard of one of these features. This has an immediate impact upon property value; functional obsolescence will arise and needs to be recognised in a correctly undertaken valuation.

2. Good quality

In many respects the valuation of a good quality development is the least complicated of all the property categories.

This type of property will have aproven economic performance, its near future will be more or less certain and barring factors such as the eminent construction of new beds in the area leading to potential oversupply, the valuation becomes the straightforward application of appropriate methods.

There is no need to take into account the immediate need for upgrading, either for legislative or economic reasons, and functional obsolescence, if any, will be accounted for through the application of standard valuation techniques.

> There are continuing opportunities for further expansion of the tourist accommodation base in New Zealand and the next few years will see a continuation of the trend in new construction...

3. Fair-marginal

In this property category are accommodation developments which require upgrading to continue in operation or which may rapidly be approaching the point where an alternative use ought to be considered.

This is the category into which older motels, particularly fairly utilitarian structures constructed in the 1950s might fall. The issue here is typically more than just need for the replacement or upgrading of chattels and interior decoration. There is a need for upgrading of certain structural elements as well.

Very often this category of motel will have limited wardrobe and storage facilities, outdated kitchen facilities generally taking up a disproportionately large area of the unit, and obsolete bathroom facilities such as porcelain hand basins on brackets.

For these properties to continue in their current use, capital expenditure is essential. Trading performance for this category of property will typically be marginal. A discussion of the financial aspects of the operation with the operator however will quickly reveal plans to repaint some of the units and replace the odd bed cover or drape.

Combined with this is the typical recovery plan which involves targeting certain tour company or joining some accommodation chain so as to enhance turnover.

Very often a budget will be produced predicting a strong upward growth in turnover, tightened expenditure control and a complete turnaround in profitability.

But in my years of valuing this category of property, I have only really come across one or two operators who acknowledge that the economic difficulties faced by the motel are a product of the need for extensive capital improvement. Most simply believe, or rather explain to the valuer, that the property is run down as a result of poor previous management. Every operator I have met claims unequivocally to be able to do better than his or her predecessor!

When this approach is taken by motel operators it misses the point. Once an older, fair-marginal unit has been struggling financially for a few years, in its current form it is not capable of generating sufficient income to finance upgrading from revenue. All the well intentioned budgets in the world cannot change a need for improvement by way of capital injection.

It may be of course that capital expenditure is simply throwing good money after bad. If that is thought to be the case the property will fall into the next property category to be considered in this paper.

> It is dangerous practice to base unswervingly a valuation upon budgets provided.

It is a dangerous practice to base unswervingly a valuation upon budgets provided. In my experience, budgeted rises in profitability for this class of property have rarely been achieved over the past few years unless there has been extensive capital expenditure. I am not advocating disregarding the future potential of a motel unit all together.

But I do suggest that proven past performance is the major factor purchasers take into account when considering the purchase of a motel property, with only limited weight given to the unproven future. Valuers should do likewise.

Where there is certainty that an extensive capital works programme is scheduled for a property the only valid course available is to base the valuation upon carefully researched budgets. In this instance the past would relate to a fair-marginal trading operation whereas after capital expenditure, the property will have a financial performance which reflects its offering a good standard of accommodation. 0

4. Properties with an expired economic life

These properties are suitable only for conversion to some alternative use. The current "solution" for larger accommodation developments is conversion into backpackers accommodation. In most instances this has been spectacularly successful but the economic validity of continuing to create beds of this standard must now be carefully examined. There is a danger of "backpackers accommodation"becoming the glib answer for future use of defunct buildings such as large nurses homes.

An important factor to be aware of when considering alternative uses for properties is the provisions of the Building Act 1991. The act came into force on 1 July 1992 and requires that amongst other things, buildings which are subject to a change of use must conform with modern standards. Section 46(2) states that if a building has been built for a specific use and that use changes, then the building will be required to comply with the code in relation to:

- Fire egress
- Protection of other property •
Sanitary facilities
- Structural and fire rating behaviour
- Access of facilities for use by people with disabilities

Compliance must be as is reasonably practical to the same extent as if it were a new building.

For this category of property, valuers are concerned with alternative uses and the costs of creating those alternative uses including aconsideration of such measures as the provision of on-site carparking. Existing income, if any, is of interest only in so much as it provides an interim or holding income.

Valuation techniques

Having considered the category into which a property falls, the valuer must select the correct valuation method or methods. There are four principal valuation methods in the armoury. These are:

1. Replacement cost approach
2. Rental approach
3. Business income approach
4. Comparable sales approach

1. Replacement cost approach

It is difficult to commend the replacement cost approach as adding any substantive element of accuracy to the overall valuation process. It is certainly of interest to know whether the valuation is supported by an adequate "bricks and mortar" value but beyond that the approach will, in the current market, almost always overvalue property.

Most, if not all accommodation developments in the classes typically encountered are income producing and need to be valued using income techniques. The replacement approach is of extremely limited assistance.

2. Rental approach

This approach is also known as the investment approach whereby rental is capitalised at an appropriate rate of return.

A large number of accommodation properties are owner-occupied and there is no contract rental. There are two ways of determining the level of market rent:

a) Comparable rentals
b) Turnover analysis

The comparable rentals approach is useful only if income is generated from a single activity. It is satisfactory for instance in the case of a motel where all income is generated from accommodation in which case rentals can be compared between motels on a dollar per unit basis. This can be furtherrefined into units of comparison for differing sizes of unit.

Expression of comparable rentals in terms of a single unit of comparison is not satisfactory where income is derived from a number of different departments such as a bar or restaurant as well as core accommodation.

Determining rental through turnover analysis enables rental to take account of affordability and a range of economic factors particular to the location, style and nature of the motel.

In recent years one of the major items to be carefully considered is expenditure on repairs and maintenance.

It is necessary however to undertaken analysis of turnover adjusting for unusual or extraordinary items and in all cases assuming an average, efficient standard of management.

Under this approach rental is determined by applying industry percentages to each component of the turnover once the turnover has been broken down into departments.

The following typical percentages could be expected for a motor inn operation with a small bar and restaurant:

Accommodation	30% to 35%
Restaurant	4% to 7%
Bar	9% to 10%

At the present time the market is relfecting percentages towards the lower end of the range although of course variations outside the range can and do occur. The turnover approach essentially relates property value to departmental business income.

The rental approach determines land and buildings realty value only. It does not value chattels, plant and equipment (other than that associated with the building) or goodwill. If the valuation is to be conducted on a going concern basis these items would need to be added into the equation.

3. Business income approach

This is an approach by which net business income is capitalised to produce going concern value. It is based upon an examination of past accounts generally for a period of three years.

An exhaustive treatment of this valuation technique is not intended and I propose only to highlight a number of issues.

The accounts presented to valuers are almost always unaudited and very often come from the enterprises own accounting system rather than through a chartered accountant.

However, even having accounts provided by a CA firm is no guarantee of improved accuracy; accountancy firms typically only coordinate information provided.

It is therefore essential that the valuation is made conditional upon the accuracy of the accounting information provided as representing a true and fair view of the enterprises performance. This condition does not relieve the valuer of responsibility for having a broad appreciation of how the accounts presented might relate to what he or she actually sees.

There are number of expected cost ratios which can be used to determine whether gross profit appears correct in relation to gross income.

Calculation of these ratios does not take a great deal of time and will lead to a better appreciation of the veracity of the accounts and business operation of the motel.

The accounts need to be adjusted for unusual or extraordinary items and to a basis which reflects an average efficient standard of management. Adjustments also need to be made for any debt servicing or other interest costs and for the manager's salary.

In recent years one of the major items to be carefully considered is expenditure on repairs and maintenance.

Figure 1.

Motel type	Replacement cost approach	Rental approach	Business income approach	Sales comparison approach
New	1. essential approach 2. differences between this approach and the investment approaches will represent development profit 3. usually does not reflect property value	1. essential approach 2. needs to be based upon accurately assessed economics 3. accurately reflects property value	1. difficult to apply since trading history not available 2. needs to be based upon accurately prepared budgets 3. accurately reflects going concern value	1. essential approach if comparable sales are available which is rare 2. loses applicability if income is derived from a variety of departments
Good	1. limited application 2. tends to overvalue property 3. not a valid approach in isolation	1. essential approach 2. needs to be based upon actual business turnovers and trading profile 3. accurately reflects property value	1. essential approach 2. needs to be based upon actual business turnovers and trading profile 3. accurately reflects going concern value	1. essential approach if comparable sales are available 2. loses applicability if income is derived from a variety of departments
Fair	1. limited application 2. tends to excessively overvalue property 3. not a valid approach in isolation	1. essential approach 2. needs to be based upon actual business turnovers and trading profile unless capital expenditure is programmed 3. accurately reflects property value 4. may indicate the imminent need for a change in use	1. essential approach 2. needs to be based upon actual business turnovers and trading profile unless capital expenditure is programmed 3. accurately reflects going concern value 4. may indicate the imminent need for a change in use	1. essential approach if comparable sales are available 2. loses applicability if income is derived from a variety of departments 3. care is needed to ensure that sales have a similar trading performance or overvaluation will occur
Poor	1. virtually no application unless based upon alternative use and adjusted for the costs of conversion 2. will excessively overvalue property if based upon existing use since the approach implicitly assumes that the existing use is the "highest and best"	1. an essential approach 2. virtually no application unless based upon alternative use and adjusted for the costs of conversion 3. will excessively undervalue property if based upon existing use approach	1. an essential approach 2. virtually no application unless based upon alternative use and adjusted for the costs of conversion 3. will excessively undervalue property if based upon existing use approach	1. essential approach if comparable sales are available which is rare 2. virtually no application unless based upon alternative use and adjusted for the costs of conversion 3. extreme care needed to ensure that sales are truly comparable

When times are tough, expenditure on this item which for a certain period of time at least is discretionary, tends to fall. An adequate allowance should be made in the pro forma accounts to be used in the valuation.

The net income derived through consideration and analysis of the business accounts is capitalised to arrive at a going concern value. If a land and buildings value only is required then an allowance for chattels and goodwill needs to be deducted.

4. Comparable sales

Except in the simplest of the cases where a motel is based upon accommodation only, comparable sales are difficult to meaningfully apply since generally they are not capable of being broken down into a direct unit of comparison.
Fundamentally, sales are capable of being expressed in terms of dollars per unit but this is clouded when a significant portion of the property comprises restaurant, bar and conference facilities.

I am not suggesting that sales should be disregarded; sales form the undisputed basis for any valuation but I am saying that direct comparison is not always possible and efforts in sales analysis are often better directed towards expressing sales as capitalisation rates in terms of the various income approaches available.

Having considered the four categories for motel properties and having considered four valuation techniques available, it is possible to make up a matrix which records those techniques best applicable to varying classes of property as shown in Figure 1.

Conclusion

The valuation of accommodation developments is often considered a difficult and sometimes mystifying area. When care is taken with the fundamentals and when adequate market research is undertaken this need not be the case. A

Traditional Implicit Approaches to the Valuation of Freehold Interests with Variable Income Streams

by R H Emary

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Richard Enun y has experience in public valuation practice in *New Zealand and overseas and he* has *lectured in valuation and investment appraisal at Massey University,*

D efinitions

All risks yields/implicit yields

1. Initial Yield

   The initial yield is the percentage return on price or value derived from the current net passing income. This is merely a statement of the ratio between the initial income and price or capital value, expressed as a percentage. No allowance is made for any future rental growth.

2. Equivalent Yield

   The equivlent yield is the percentage return on price or value derived from the current net passing income and the increases to current market rents, the latter being deferred until the date of the next market rent review. As with the initial yield, no allowance is made for any future rental growth in the calculation of the equivalent yield.

3. Reversionary Yield

   The reversionary yield is the percentage return on today's price or value that will be derived when the current market rents become payable. This yield relates the future growth in net income to the historic cost or value of the property and it is normally quoted together with the date from which it will apply.

Explicit yields

Explicit yields rely on periodic cashflow techniques and are based on one of two approaches. The Internal Rate of Return (IRR) methods determine the discount rate from the price or value of the income stream. Alternatively, the Net Present Value (NPV) methods use the investor's required discount rate to determine the current value of the cashflow.

Source: JLW Research, Sydney (1989) "Glossary of Property Terminology In the Asia Pacific Region May 1989"

Abstract

The traditional ("implicit") as opposed to discounted cashflow techniques ("explicit") approaches to the valuation of freeholds with variable income streams are well documented in New Zealand valuation texts. Yet, by convention, the shortfall approach using equivalent yields is in the main used for these situations. Some conclusions are drawn from recent events in New Zealand which suggest that practitioners should become more familiar with the alternative approaches and use them where they feel it is appropriate. Adjusted or split capitalisation rates are not illegal or bad practice as some might believe.

Introduction

The aim of this paper is twofold-first, to remind readers of the merits and demerits of the alternatives to the shortfall technique and second, a plea for a standard terminology as the New Zealand literature to date is confusing. Students and younger valuers who may avail themselves of their reciprocal rights with other Commonwealth Institutes will find the explanation which follows useful.

The use of the Equivalent Yield approach is questioned especially regarding inconsistencies relating to the application of market derived growth rates to capitalise rents that have no growth, namely, those fixed until a review to market rent. Enever (1981), Millington (1982) and Baum and Crosby (1988) support this critique yet the Trott Report (1980) and Sykes (1983) reporting on UK Institutional preference, if nd favour in the approach. A similar controversy wouldappeartoexistinNewZealand.

Thepapercomprises two sections. First a summary of the three approaches in diagrammatic and equation form with a simple worked example. Equivalent Yields are adhered to in each, demonstrating that there is no difference between each approach. This should be especially useful for spreadsheet valuations.

The next section looks at the application of traditional valuation techniques where Equivalent Yields are not used. These techniques are known as and tend to employ "split" or "adjusted" capitalisation rates. If the technique was to be applied to the New Zealand Shortfall method it may entail using a property market derived rate (yield) to capitalise the Shortfall and a different rate, for example marketrate plus 1%, to capitalise the Market Rent. This would serve to reduce the value from that obtained via the Equivalent Yield approach. An appendix references these techniques to papers by leading members of the New Zealand valuation profession in approved NZIV texts. Conclusions are drawn from recent events in New Zealand to suggest that practitioners should become more familiar with the alternative approaches - and use them where they feel it is appropriate. Adjusted or split capitalisation rates are not illegal or bad practice as some might believe.

Adjusted or split capitalisation rates are not illegal or bad practice as some might believe.

Implicit and explicit valuation techniques

Variable income streams occur by virtue of a future event, be it a rent review or lease termination, when an increase or decrease in rent (whether an increase or a decrease will depend on the relationship of the current "Market Rent" (MR) to the "Contract Rent" (CR). Overseas (as in the UK) the market rent is also known as the estimated rental value (ERV) and the contract rent as the passing rent. Subtraction of the Contract Rent from the Market Rent produces the rent shortfall identified as Difference Rent (DR) rather than Mar-

ginal Rent (UK) as this would be confused with Market Rent. In equation form:

MR-CR=DR

The shortfall approach using equivalent yields involves analysing comparable transaction to obtain past property transaction derived capitalisation rate i (or initial yield) for the "in perpetuity" capitalisation of the market rent and the same i for the "annuity" capitalisation of the "shortfall" or "Difference Rent".

A traditional "implicit" valuation is one that uses comparable transaction evidence from the property market at the date of valuation. The rental "growth" is subsumed or is "implicit" in the i or capitalisation rate. The Contract Rent (having been adjusted to a net income after freeholders outgoings if not a wholly net BOMA type lease) and the period to the reversionary event (rent review (RR) or lease expiry (LE)) is abstracted from the lease. The use of a Market (or Growth) "i" capitalisation rate in perpetuity and the use of market rents as at the date of valuation are the hallmarks of these traditional valuation techniques.

"Explicit" valuation techniques (discounted cashflow) conversely do not freeze the market rent as at the date of valuation, rather the valuer has to estimate the market rent for each year of the cashflow. He/she has to explicitly state what in a traditional valuation is hidden in the capitalisation rate. He/she uses an "i"discount rate from the money markets adjusted for the riskiness of the property to express the stated future income streams in present values.

The "sum of the present values" or discounted future income streams is the opinion of value and the discount rate is then the Equated Yield also known as the Internal Rate of Return (IRR). This is not a Net Present Value (NPV) which is a measure in dollar terms of the excess or deficit the project returns over the required return used as the discount rate. With the latter the initial purchase cost of the asset is subtracted from the sum of the discounted income streams, with a DCF valuation it is not. Discounted cashflow valuations will not be discussed further in this paper as they will be the subject of a further paper.

The three approaches equivalent yields

The shortfall approach using equivalent yields can possibly be traced back to the influence of US practice rather than to that of the Commonwealth. In the preface to the 1959 text "Principles and Practices of Urban Valuation in New Zealand" is stated the following: "It is on American methods and textbooks that the theory of urban valuation in New Zealand has been based."

Chapter XIV of the 1959 text refers to shortfalls in rental income due to vacancies and bad debts but does not explicitly recommend a solution for over or under rented properties in relation to the market rent which was defined as the "best rent" that can be obtained without taking a fine or a premium." (p 187).

Three annotated diagrams, Figure 1, serve to distinguish visually the salient difference in procedure that each employ.

Each method is demonstrated using an example of a non-market rented freehold property in Example 7. It can be clearly seen that the three techniques produce the same result when using equivalent yields. (See Example 1 over page)

The alternative approaches - adjusted capitalisation rates

The particular circumstance of a valuation is invariably specific to that particular property. For instance the freehold example in Table 1 is particularly valid in the following scenario.

Scenario 1

The Lease has 3 years to run to rent review and is the first review of a long lease of 12 years. The market currently has a low vacancy rate with inflation (rental growth) likely to stay at current levels above the cost of capital (ie negative real interest rates). It is valid to assume that the current marketrent of $50psm will be achieved and probably exceeded at review. The economy is in a growth phase with Gross Domestic Product growing in real terms. (This growth is implicit in the market derived capitalisation rate.)

This is perhaps the situation in which valuation is the least problematic and one in which the Equivalent Yield approach using any of the three methods is valid. The equivalent yield is optimistic in that the market rent will be achieved and the current estimates of rental growth at subsequent reviews will eventuate. The resultant valuation may even be conservative if the market rent achieved at review is in excess of that MR used in the valuation and if subsequent rental growth increases annually at a rate in excess of that implicit in the capitalisation rate. The use of the "growth implicit" market capitalisation rate in the Term and Reversion approach on the fixed rent to the next review is flawed as there is obviously no growth. I

FIG 1

TRADITIONAL VALUATION TECHNIQUES

KEY

PV in PERP

PERPETUITY CAPITALISATION

PV $1 PA

ANNUITY CAPITALISATION

PV $1

DISCOUNT TO VALN DATE

The available comparable evidence must indicate the same Market Rent and capitalisation rate. But there may be two very different scenarios regarding the supply and demand for leasehold accommodation, prospects for rental growth or decline and the macro economic prospects for the investment market. Two alternative scenarios serve to illustrate this possibility and are outlined below:

Scenario 2

The lease is identical to Scenario 1 with a binding upwards only rent review clause (ratchet). The market has a high vacancy rate, low inflation (ie the prospect of positive real interest rates) and almost no prospect of rental growth. The rental evidence supporting the estimate of MR (Market Rent) is contentious as open market lettings have diminished in volume in comparison to rent reviews. The 12 year lease, with its ratchet clause is to a "blue chip" national utility such as "Telecom". The contract rent is secure but the DR (Difference Rent) supposedly achieved on review is highly suspect.. The economy is at the peak of a growth phase with GDP growth diminishing, a few company failures are starting and there exists evidence of a potential oversupply of office accommodation in the near future.

The Equivalent Yield approach cannot accommodate this save by an intuitive (and unevidenced) adjustment to the capitalisation rate, the Market Rent, or a crude percentage to the resultant value. The Layer or hardcore method can be employed with adjusted capitalisation rates to reflect the upwards only rent review clause (ratchet clause) and the quality of the tenant. This is achieved by a 1 % or 2%, or greater, reduction in the capitalisation rate applied to the bottom layer (contract rent) and a +2% increment on the top layer to reflect the likelihood of not achieving the current Market Rent (MR) on review.

Scenario 3

This lease has only three years to run, thus instead of a rent review, the reversionary cashflow is dependent on a renewal to the existing tenant or securing a new tenant. The market and economic scenario is as in scenario 2 above, however the volume of unlet new stock coming onto the submarket, all perfectly substitutable for the subject property, suggests that high vacancy rates, perhaps 30% or more, will be in existence in the near future. Rental incentives such as substantial (1-3 year) rent free periods are beginning to occur and present the real danger of a vacancy at lease expiry.

It may be that a Term and Reversion approach with a+2% or greater increment in the reversion rate might be appropriate to reflect the risk of a void eventuating. The layer and the shortfall both ignore this danger.

To valuers in Wellington and Auckland scenario 3 surely is reminiscent of the first six months of 1988. However it is probable some valuers continued to use the equivalent yield shortfall technique using evidence from before Black Monday as convention decreed. Yet the economic signs were evident and as the months drew on in 1988 increasing frequency of company collapses indicated even greater vacancy levels. Senior members of the Institute such as McGough RM and Wall JNB indicate that the use of adjusted capitalisation rates in the Term and Reversion format are acceptable practice yet, for reasons unknown, their use appears not to have been widespread.

> The adjusted capitalisation rate models, ... may have generated more conservative values and thereby saved the profession from much criticism

If valuers had undertaken supply and demand data collation on the office markets and then undertaken economic analysis of the micro and macro economic climate they would have confidently adopted the alternatives. Discounted cashflow valuation models could have thus been substantiated or at the very least the adjusted capitalisation rate models, as outlined in this paper, may have generated more conservative values and thereby saved the profession from much criticism from other professions.

Many might claim that the property specific data is not available, yet as long ago as 1987 there were economists conducting these types of analyses. These could have been relied upon by valuers to substantiate different techniques. In May 1987 Dr C Moore of Westpac Merchant Finance, utilising data collected by Jones Lang Wootton Data, correctly identified a mismatch between a predicted rental growth and inflation predictions which when combined with the projected supply could result in a 20% fall in property values.

A schematic representation of Macro and Micro Property Market Risks devised by Moore is reproduced at Figure 2. The techniques are demonstrated in relation to the three scenarios in Example 2 (See over page)

The reduction in value as indicated with the Adjusted Rate, Term and Reversion approach reflects most adequately scenario 3 whereas scenario 2 is best accommodated by the adjusted Rate, Layer approach. Dogmatic application of the equivalent yield shortfall (without a raw adjustment) cannot adequately reflect scenarios 2 and 3 and so may overvalue in these circumstances. These adjusted rate approaches are no substitute for a detailed and thoroughly justified Discounted Cashflow approach as they are only quasi-explicit in that they take account of the reversionary event and pre and post reversionary income streams in a crude and implicit manner. Some practitioners say discounted cashflows are similarly intuitive due to the multiplicity of variables required to be estimated. This critique may be valid if no rigorous justification is undertaken.

Two other modifications of the shortfall which appear to be used in practice include the simple addition, in dollar terms, of each year's Shortfall without any annuity Capitalisation and the use of a money market based discount rate as an alternative to a property market derived capitalisation rate to Annuity capitalise the Shortfall. The effect of these two local modifications are quite different. If a money market derived rate of 15% is used rather than a property rate of 10% over a five year period, this reduces a shortfall by some 11.5% so increasing the value of the property. If the five years' rent is summated this increases the shortfall by 32% so reducing the value of the property under scrutiny. The former has some substance in that the Shortfall is fixed and should not be capitalised using a "growth" capitalisation rate. The simple addition method appears to have little justification and should be avoided unless perhaps the valuer is aware that the local market adheres to the methodology.

Conclusions

The methods used elsewhere in the Commonwealth have received attention in New Zealand and are discussed in various articles in the *New Zealand Valuers' Journal* and texts. A major problem has been a lack of standardisation of terminology resulting in confused readers and a general lack of awareness of the merits and demerits of each methodol-

EXAMPLE 1

A freehold office building with 1 floor of 30 m2. Let at below market rent at $30 p.s.m. with market at $50 p.s.m. fully net lease with a reversion ie rent review or lease renewal in three years. Market capitalisation rates are 12%.

EQUIVALENT YIELD APPROACHES

(a)Discounted Shortfall or Shortfall Approach

(i) Value as if let at Market Rent

Market Rent		
$50m2 x3 OM2	1500	
Capitalise in perpetuity		
PV Perp 0312%	8.33	
		12,500.00

(ii) Less Shortfall or Difference to Review

DR per annum = MR-CR = $20m2		
DR $20m2 x 30m2 =	600	
DR monthly	.50	
Annuity Capitalise		
PV $1 PA @ 12% 3 yrs	29.41	
		1,470.43

Market Value (MV)		11,029.57

(b) Term and Reversion Approach

(1) Term Value

Contract rent		
CR $30m2x 30m2	900	
CR monthly	75	
Annuity Capitalisation		
PV $1 PA 0312% 3 yrs	29.41	
		2,205.64

(ii) Add Reversion

MR $50m2 x 30m2	1500	
Capitalise in Perpetuity		
PV perp 12%	8.33	
Present value		
PV $1 PA 12% 3 yrs	.71	
		8,823.93

Market Value (MV)		11,029.58

(c) Layer or Hardcore Approach

(i) Bottom Slice or Layer Capitalisation

Contract Rent		
$30m2 x 30m2	900	
Capitalise in Perpetuity		
PV Perp @ 12%	8.333	
		7,500.00

(ii) Add Top Slice or Layer receivable in 3 years

DR = (MR-CR) = $20m2		
$20m2 x 30m2	600	
DR monthly	50	
Capitalise in Perpetuity		
PV Perp ®12%	8.33	
Present value		
PV $1 12 % 3 yrs	.71	
		3,529.57

Market Value (MV)		11,029.57

Using equivalent Yields the result is the same LM = 12

MR - CR = DR (Differential Rate) equals Shortfall per annum or uplift at review

CAP RATE or i = 12% Time to reversionary event = 3 yrs in all cases. All annuuity calculations are monthly in advance. N=35 im=i/12

(a) MV = (MR' 1/i)
- DR* (C1-(1+0.01A-(35))/0.01

(b) MV=
CR((1-(1+0.01) - (35))/0.01
+MR*(1/.12)(1I1+01)A35

(c) MV=
CR * (1/.12)
+DR*(1/.12)(1/1+.01)A35

It is clear that the equations are different combinations of the same total formula. If the Equivalent yield or constant i is employed, any of the three approaches can be used to produce the same result.

(a) This is the common approach used in New Zealand with some modifications

(b) Common in UK Australia.
Modified form in use in NZ for freeholds subject to 'Glasgow' type Ground leases and when Rent Reviews are to pre-determined rents. Multiple terms before reversion end of lease.

(c) This approach is used when valuing 'going concern' type properties that have some or all rent related to turnover such as retail complexes. Hotel and resort type properties where multiple top slices can be used until max turnover achieved.

ogy. Leading practitioners would appear to differ on the validity and a summary of the various views is included as an appendix. RM McGough's endorsement of the Term and Reversion with Adjusted capitalisation rates conflicts with RL Jefferies treatment of the approach with regards to shopping centres. Practitioners should constantly ask themselves whether the technique is appropriate to the economic fundamentals in the market, the lease and property in question.

Traditional implicit approaches are not as valid nor a substitute for a well researched and modelled explicit discounted cashflow valuation. This paper suggests that there are different approaches in achieving a traditional implicit valuation, incorporating a reversionary even whilst at the same time clearing up some terminology confusions. The Layer approach is particularly useful as a means of valuing multi-tenanted buildings on net leases using spreadsheets and is easier than the shortfall approach.

The valuer must be flexible and use any method which can be rationally and objectively substantiated. In most markets the supply and demand dynamics are the fundamental indicators - there is no substitute for actual data on the market well presented and analysed.

Some academics, practitioners and other finance professionals advocate the demise of traditional implicit valuations. However, as in stock markets, prices are set by market players who often use a simple formula such as Price to Earnings ratio. Similarly property players still often use a perpetuity capitalisation of current rental incomes. While this situation continues there is a place for the traditional "implicit" and "quasi-implicit" valuation techniques.

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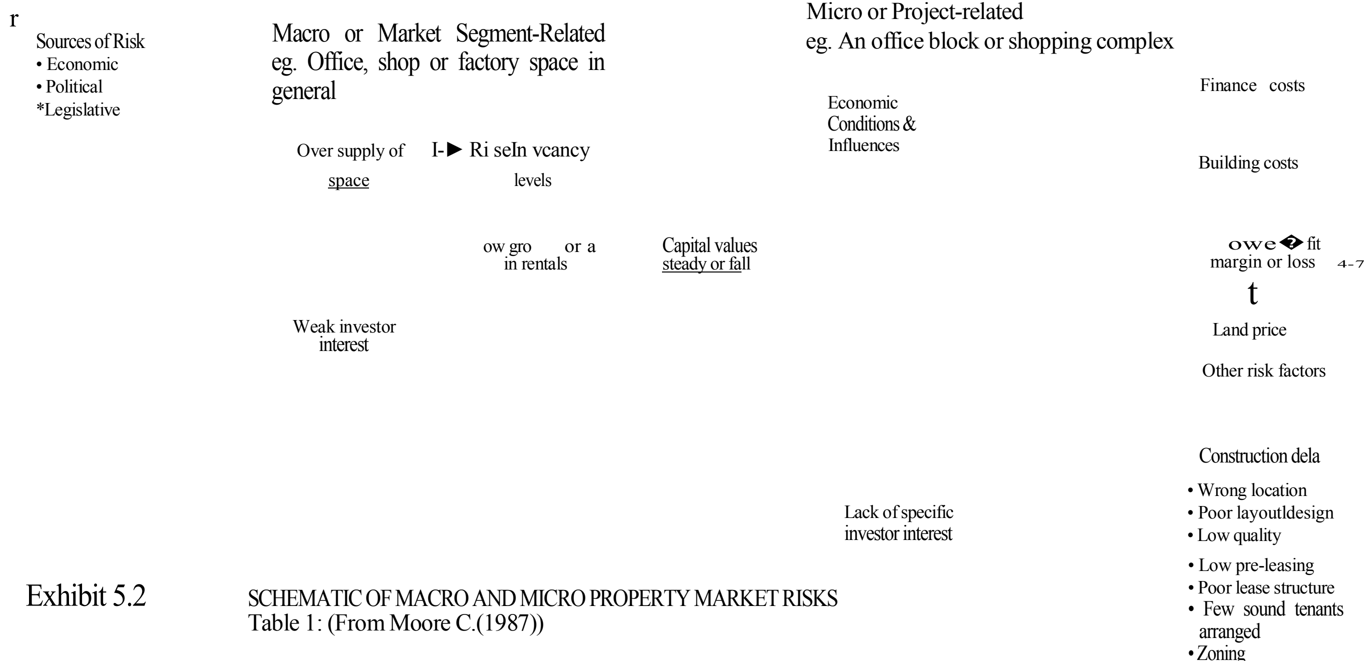

Exhibit 5.2 SCHEMATIC OF MACRO AND MICRO PROPERTY MARKET RISKS
Table 1: (From Moore C.(1987))

EXAMPLE 2 NON EQUIVALENT YIELD APPROACHES / ADJUSTED CAPITALISATION RATES

(a)Shortfall Approach (NZ practice)

SCENARIO 1

Standard Equivalent yield

(i) Market Rent

MR $30m2 x 30m2	1500	
PV inPERP®12%	$U	
		12,500.00

(ii) Less Shortfall

DR per annum = MR-CR = $20m2

DR $20m2 x 30m2 =	600	
DR monthly	50	
PV $1 PA©12%3yrs	2 „2.	
	1,441.09	
Market Value (MV)		11,029.57

SCENARIO 2

The only means of modifying the shortfall to accommodate this would be to ignore comparable market rent evidence and intuitively reduce the market rent to close to the contract thus effectively reducing the shortfall or DR per annum. Using intuitive rather than market rental evidence

SCENARIO 3

Some modifications to the method can be made;

a) A raw adjustment to the end value or +.

Market Value (.9x11,029.57)= 9,926.61

b)An increment to the market capitalisation rate

Market Value (@ 14%EYId.) = 9,292.17

Unless the arbitrary adjustments outlined above in 2 and 3 are adopted the Shortfall method is highly likely to overvalue the property. Certain valuers have found this to their detriment.

(b) Term and Reversion Approach with Adjusted Rates

SCENARIO 1

Practitioners overseas dislike annuity capitalising the Contract Rent (fixed) with a growth capitalisation rate. Therefore reduce Term Cap rate by 1 % to reflec this and security of R being below market rent MR

NB Capitalise Reversion at market capitalisation rate.

(1) Term Value

Contract rent

$30m2 x 30m2	900	
CR monthly	75	
PV $1 PAi@12%3yrs	29.41	
		2,243.18

(ii) Add Reversion

MR $50m2 x 30m2	1500	
PV in PERP @ 12%	8.3	
PV $1 PA @ 12% 3 yrs u		
		8.823.93
Market Value (MV)		11,067.11

SCENARIO 2

Reversion at the rent review suspect yet term secure. Could adjust market rent or add +2% to the reversion capitalisation rate but more appropriate to use Layer Method to reflect security of contract rent to lease expiry.

SCENARIO 3

Reversion is at lease exoirv not RR. Adjust the reversion cap rate +4%

(i)Term Value

CR $30m2 x 30m2	900	
CR monthly	75	
PV$1 PA ®11%3yrs	29.91	
		2,243.18

(ii) Plus Reversion

MR $50m2 x 30m2	1500	
PV in PERP @ 16%	6.25	
PV $1 @16%	.4	
		5.965.42
Market Value		8,208.60

It is contended that this method most adequately reflects this Scenario

(c) Layer Approach

SCENARIO 1

Practitioners who use this technique might reduce the bottom slice or Layer to reflect the security of the contract rent. Particularly appropriate with Ion leases > 12 yrs.

(i) Bottom Layer

CR $30m2 x 30m2	900	
PV inPERP®11%	9.09	
		8181.82

(ii) Top Layer

DR $20m2 x 30m2	600	
DR monthly	50	
PV in PERP 0312%	8.33	
PV$1®12%3yrs	.71	
		3.529.57
Market Rent		11,711.39

SCENARIO 2

Existence of the upwards only rent review clause (ratchet) protects this contract rent. The DR or uplift supposedly receivable at review is highly suspect so the top slice or layer capitalisation rate is increased.

Top layer + 2% on market rate

(i) Bottom Layer

if$30m2 x 30m2	900	
PV inPERP@11%	9.09	
		8181.82

(ii) Top Layer

DR $20m2 x 30m2	600	
DR monthly	50	
PV n PERP ®14%	7.14	
PV $1 @ 14%	16¢	
		2822.96
Market Value		11,004.78

It is contended that this method most adequately reflects this SCENARIO.

SCENARIO 3

Layer approach cannot reflect the possibility of a vacancy in an obvious manner

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APPENDIX

The approved texts of the New Zealand Institute of Valuers and various articles in the *NewZealand Valuers'Journalcoverthe* three approaches and introduce some local modifications which appear to be "home grown". The extent to which these non equivalent yield approaches are accepted by senior practitioners is unknown and perhaps a survey might reveal interesting results.

Jefferies RL in an earlier article called "The process of annual asset revaluation of commercial and industrial property" NZIVJ 1979 December outlined the conventional shortfall method and the Term and Reversion adjusted or split rates.

However it is particularly unclear in the approved Institute text *Urban Valuation in* NewZealandVolume II published in 1990 as the following commentary will indicate. Should readers still be unclear from this article, reference to the textbook whilst reading the following should further clarify the issue.

JNB Wall the author of Chapter 2 in Jefferies RL *Urban Valuation in NewZealandVol* 2 (1990) in a section entitled "Annual Asset Valuations" considers a freehold interest with a variable income stream. Wall demonstrates three different approaches:

(1) Example 2.15(G)(1) (page 2-37) is a classic Term and Reversion using split capitalisation rates. Wall calls this technique Dual Capitalisation Rates. This is unfortunate terminology as it can be confused with Dual Rate Annuity capitalisation techniques used in the valuation of leasehold interests. See Bell RA Ch 14 (page 108).

(2) Example 2.5(b)(ii) is a modified Term and Reversion using equivalent yield ie the rate of 10% is used for all the capitalisations in perpetuity, and the present value formula for discounting.
However Wall introduces a raw adjustment to discount the value of the reversion, to compensate for the danger of future rental growth being unrealised or the review going wrong, ie difference in marginal rent not being realised. However, he applies the discount to the combined total of this Term and Reversion surely erroneously as the "contract" rent is as secure as the tenant's covenant and therefore least risky. This is therefore a local modification of the technique and is not in widespread use overseas.

(3) Example 2.15(b) (iii) (page 2-38) again is a modified New Zealand Shortfall approach using equivalent yields, ie 10% for capitalisation in perpetuity and 10% forthe annuity capitalised of the shortfall. However, again Wall makes an intuitively derived adjustment "for risk" to the end value.

Wall proceeds to suggest all approaches are relevant for this type of valuation.

In summary on pages 32-38 Wall proceeds to calculate the relevant Initial Yield (ie Term) and the Reversionary Yield (ie on the Reversion after the rent review). He also suggests a modification of the Reversionary yield explicitly by estimating a rental growth, (ie inflating today's market rent) and recalculating the yield of a Reversion assuming this projection is realised by the review process.

(4) Example 2.6(1) Wall proceeds to consider a fixed rental formula leased freehold. The lease is rather strange having 15 years to run from today with a review in two years and no review thereafter.

(5) Example 2.16(ii) Wall also suggests a Shortfall approach to the same problem with an adjustment to the capitalisation rate for the capitalisation in perpetuity of the market rent. This second example would appearto be particularly intuitive as no guidelines are offered as to the appropriate discount and how it is derived.

(6) Example 2.16(iii) As a further modification of the Shortfall approach adopting Equivalent Yields but making raw adjustments to the income streams to be capitalised either the market rent in perpetuity or the shortfall annuity capitalisation.

RM McGough, the author of Chapter 4 "Periodic Asset Valuations" *(Urban Valuation in New Zealand* Vol II RL Jefferies) also considers the various approaches to the valuation of variable income stream freeholds.

(7) Example 4.3(ii) Represents a shortfall approach using equivalent yields ie as the same throughout.

(8) Example 4.3(i) Here a modified shortfall approach is demonstrated where the rental shortfall is not capitalised as an annuity ie (PV 1 PA formula) but just multiplied by the number of years and the total deducted forthe capitalised M R method. McGough states that when the shortfall occurs for over one year the shortfall should be discounted to present values rather than simply summed.

(9) Example 4.4This is a classic Term and Reversion valuation with adjusted or split rates to accommodate the different risk levels of the "Term" or contracted rent as opposed to the "Reversion" or future rent after rent review or reversion.

(10) Example 4.7 Here McGough considers the process of adjusting rents and yields for differing rent review periods. The principle is that a longer rent review period will command a higher rent because it is more attractive to atenantto "fix" his overheads, ie rent. Overseas tables and formula are used to adjust rents for say five years to say three years. Today in New Zealand three year rent reviews are the norm but how many valuers in New Zealand apply an intuitive adjustment rather than a standardised adjustment factor? McGough suggests in Example 4.7(ii) a valuation approach with an adjusted rent and an adjusted capitalisation rate to reflect the lower value to an investor of a longer review period.

(11) Example 4.8 Here McGough stresses the need to exercise caution in using the income approach where improvements upon land become functionally obsolescent and the real value lies not in the income stream but in the redevelopment potential. He advocates a Term and Reversion approach in which the Reversion is today's land value. This is similarto the concept of "abandonment" value used in discounted cashflow valuations.

(12) Example4.9(i) Is alerm and Reversion valuation ofafreehold subjecttoa long lease with afixed rent reviewformula? McGough applies a double term formula. McGough applies adjusted rates to the two terms and the reversion to reflect the income pattern and compares that to a conventional shortfall using equivalent yields applied in Example 4.9(ii). McGough believes that 4.9(i) is an improvement on equivalent yield approach and is therefore a valid technique. It must more accurately reflect value as it uses a known variable income rather than fabricating an unknown shortfall to occur at some time in the future.

Jefferies RL the author of Chapter 14 or *Urban Valuation in NewZealand* Vol II in considering the unknown valuation of shopping centres employs split capitalisation rates albeit with some reluctance.

(13) In Figure 14.4 Jefferies actually demonstrates (p. 14.10) a layer method with split or adjusted capitalisation rates where the bottom layers reflect the base rents and the top slice the variable percentage rates.

Jefferies does admit the approach may have merit for new or recently constructed shopping centres. However, he falls firmly in favour of a traditional capitalisation in perpetuity (initial yield) of an estimate of an annual net income or cashflow for the centre with the words...

> *"If a thorough rent analysis has been carried out and a realistic rental income project made, an overall capitalisation* and a *single rate applied to the anticipated maintainable cash/low should provide a soundly based investment valuation for a shopping centre. " (p. 1415)*

He does not state for whom such a valuation might be prepared. It is doubtful whether its implicit approach would satisfy today's bank or an accountant. In the 1990s major shopping centre valuations undertaken in Australia and New Zealand by international firms of valuers generally utilise "explicit" discounted cashflow projections while deriving risk adjusted discount rates from the money markets rather than property derived capitalisation rates. The latter might be used as a check should there be any comparables similar enough to warrant such an approach.

(14) Jefferies on page 14.16(b) describes in detail the Layer approach but fails to call it as such. In a shopping centre example the current rents (base and percentage) are capitalised. Then the difference (marginal) rents ie increase to base rents achievable at reviews, are capitalised in perpetuity and discounted and added to this bottom layer. Each tenancy will have a different review pattern requiring different calculations for each.

Jefferies in discussing the layer or hardcore approach does note the similarity to McGough's use of the technique and believes there is some usefulness in the approach.

Another NZIV approved text *Investment Property Income Analysis and Appraisal* (1988) by RA Bell does cover the alternative Term and reversion and Layer method in their equivalent yield forms but again fails to name them as such. Students have been found to read the sections but since there is no discussion of split rates remain confused.

(15) Example 13.5 (pp 101) Method 1 is a Term and Reversion and method 2 a Layer approach. On page 102 Bell demonstrates the Initial Yield on the Contract Rent, (he calls it for some unknown reason Present Rent) and the Reversionary Yield obtained on the reversion to the Market Rent and contrasts these with the Equivalent Yield used to obtain the value. He proceeds to demonstrate how if the Equivalent Yield approach is adopted each valuer, if he determines the same Market Rent and Contract Rent, can obtain the same yield or capitalisation rate. This is the main attraction of the technique over adjusted rates. A

The New Zealand Valuers' Journal
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2. The article shall not have been submitted to any other journal or published prior to being submitted for entry into the competition.
3. The article shall not exceed 10,000 words including any equivalent space where illustrations, diagrams, schedules or appendices are included.
4. The manuscript shall be typewritten.
5. The author shall supply a short synopsis of the article, setting out the main thesis, findings or comments contained in the article.
6. The author shall provide a brief biographical note which may be published.
7. The closing date for submission of manuscripts shall be 1st April in each year and any winning article shall be published in the Journal.
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Nonmarket Non.investment Property Valuations

by S G Bond

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As the valuation of a property involves the estimation, in monetary terms, of its worth it is important to secure a definition of market value. This helps to achieve uniformity and to provide a standard upon which assessments of value can be made. As Wendt (1974) says "...the precise meaning attached to the term "value" is the most important single influence affecting both the method of valuation to be employed and the final value estimate." (p 1) The recently revised definition of market value adopted by the International Assets Valuation Standards Committee that has won international support, is as follows:

> *the estimated amount for which an asset should exchange on the date of valuation between a willing buyeranda willing seller in an arm's length transaction, afterproper marketing, wherein the parties had each acted knowledgeably, prudently and without compulsion.*
>
> New Zealand Institute of Valuers, *Valuer's Newsllne,1992, p4)*

The definition is an economic concept and assumes a hypothetical sale between willing parties. Only those sales that conform to the definition represent open market transactions reflecting market value.

Such sales can therefore be used as evidence in the valuation process. However, as will be shown, the definition may not be appropriate when valuing non-market non-investment property.

Non-market non-investment property defined:

To classify properties as "non-market" "non-investment", a clear understanding of these terms is necessary.

"Non-market" property can be defined saproperty for which no or little demand exists for its current use. It is generally assumed that the property will continue in its existing use, being the use of the building for which it was originally designed. Alternative uses are generally not considered where the existing use is considered to be the highest and best use. Transactions such as sale and lease-backs, which only benefit the parties involved, are also not considered. These circumstances form a separate valuation issue and effectively leave the owners with a different interest from the one being valued.

The "willing buyer, willing seller" concept central in valuation practice has little practical application in valuing non-market non-investment property as there is no established market for this property type in the traditional sense due to the lack of demand.

There may be a willing seller but there are generally few, if any, willing buyers. Special interest purchasers are often the only buyers in the market for this type of property. Such property derives its value from its utility rather than its exchange potential. "Market value" then, which is based on the assumption that the property can be exchanged, cannot be assessed for these property types-

non-market non-investment property ... derives its value from its utility rather than its exchange potential.

"Non-investment" property can be defined as property for which the primary motive for ownership is either for occupation or for providing a service to the community. Such property is usually considered non-income producing.

However, occasionally owners will decide to sell the property and lease it back. In this instance the property becomes an investment to the new owner whose primary motive for ownership is the regular receipt of income and therefore can no longer be classified as "non-investment" property.

Classifying property as non-market non-investment:

The characteristics that suggest classification as non-market non-investment include:

1. *Ownership*
   Chritiansen (1991) suggests that the public ownership of land is more appropriate for the provision of highly valued community serving amenities, that have no cash value, rather than for personal and enterprise oriented land uses. Much non-market non-investment property is characterised by the former and so is commonly owned and administered by the Crown. However, as will be shown, this is rapidly changing.
2. *Location*
   Properties located in isolated areas where limited demand exists.
3. *Design and Use*
   Properties designed specifically to house a particular activity and having limited potential for conversion to alternative uses. These tend to have limited demand other than from those requiring the building for that special purpose. For example: special-purpose factories, oil refineries, ferry terminals, churches, prisons, and hospitals.
   However, purpose-built properties that achieve healthy rentals due to a ready demand for the use fall instead into the category of investment property. Examples include: hotels and motels, cinemas, caravan parks and marinas etc. 0

4. Size

Properties of an unusually large size tend to be in limited demand.

Methods of valuation

The classification of property as non-market non-investment helps determine the method of valuation to adopt. There are only three conventional valuation approaches to choose from: income, sales comparison and depreciated replacement cost. While the former two approaches are appropriate to assess investment and market value, they are not appropriate to assess utility (owner) value. This is more subjective and the depreciated replacement cost approach has inevitably been selected as the approach of last resort.

However, problems arise in using the replacement cost approach. The problems are those of deciding the initial cost of the building and then the deductions for the various factors affecting obsolescence. As Rees (1988) points out: "If the buildings are reasonably modern no great problems may emerge; if however the buildings are old structurally and functionally obsolescent but yet of great historic and architectural merit, then very careful thought has to be given to the initial estimation of costs and land values, and the allowances for all age and obsolescence factors." (p374). As will be discussed the approach has been refined and added to over the years to overcome some of the shortcomings.

Reasons for increased focus on valuing non-market non-investment property:

Under the State Owned Enterprises Act 1986, government departments have been required to define and value their assets and resources. Many of these include non-market non-investment property held primarily to provide services in the national interest rather than to generate revenue. This Act, the public sector financial reporting reform, and the Public Finance Act 1989 which requires the Crown to follow specific financial reporting guidelines, has highlighted some of the difficulties involved in valuing non-market non-investmentproperty, for which there is no established market.

However, with the major government restructuring that has occurred since 1984 when Labour gained control there has been far greater focus on profitability and accountability particularly in terms of the Public Finance act 1989. The change in focus has highlighted the difficulties in balancing social responsibilities with the need to be efficient and maximise profits in a commercial sense.

Property in public ownership, according to McKenzie (1991) now has a multi-purpose role in today's environment achieving three primary objectives:

1. The provision of property assets to ensure essential services. Assets such as: sewage treatment stations, water treatment stations, road maintenance depots etc, fall within this category.
2. Social and development role. This is the retaining of uneconomic property or the use of cashflow to invest in uneconomic property on the grounds of social or community benefit. Properties within these classifications would be community halls, libraries, swimming pools, parks, etc.
3. Business and profit role. These are properties held by the council on a purely profit motivated role earning market related rates of return and cashflow. This role has been further emphasised by the competition created from the shift in public service provision to the private sector. For example, Cabinet approval has recently been given for the partial privatisation of the prison system. By allowing private contractors to compete in offering prison services will help ensure that such services are supplied in the most cost effective manner. In turn this is expected to improve the returns on the land and buildings used to produce those services, which may attract further investment from the private sector.

Because of these changes many properties that previously had utility value only have become investment properties as they are now required to show a return. Purchasers of state owned enterprises are primarily interested in that return and so the investment approach to value is applicable. However, valuing community services that are in positions of monopoly concerning prices charged for these services, precludes the income approach from being a reliable measure of value.

Public sector properties that remain in the non-market non-investment category are shown separately in the Crown's financial statements as this is considered more informative and reflects the greater difficulty in valuing them. They have been valued by a qualified valuer and according to the NZIV's Asset Valuation Standards as required by SSAP-28. However, in each case the valuations have relied on the traditional methods or variations of these. For example, infrastructural assets which include roads, bridges, tunnels, water and sewerage reticulation etc, were valued on a replacement cost basis. National parks and conservation areas were valued using an adjusted sales comparison approach. National archives and library collections were valued using a combination of these two methods.

The problem is that the valuation approaches to adopt have not been well defined and to date no consensus exists. Once this develops, professional standards can be devised, providing guidance to all valuers concerned. To this end the NZIV Standards Committee is currently conducting a series of Standards Seminars to help clarify some of the issues involved and develop clear guidelines on the procedures to adopt, in valuing such assets.

New valuation approaches

As mentioned, the methods that have been advocated, to date, are generally variations of the three traditional methods. Little attention has been given to other possible alternatives that may better meet client needs. The most recent method advocated, a refinement of the cost approach, is the "Optimised Depreciated Replacement Cost Approach". This method is accepted overseas and recognised as a proper method of valuing some public assets.

According to Jackson (1992): "The approach is designed to assess the current value of a public asset that was built or developed in a past environment lacking in market based feedback and where this environment has subsequently changed, for better or for worse."

According to Horsley (1992) the approach accounts for the following factors:

- Exposure to private sector competition
- Obsolescence due to changes in public policy
- Under-utilisation due to over-development, or
- Other confounding factors, such as industry regulation

This is achieved by basing an initial assessment of replacement cost of the asset on the most efficient modern equivalents needed to provide the required lfow of services. It is based on the concept of optimisation.

The approach is an application of the substitution principle. According to Jackson, the cost should be assessed with reference to all highest and best use substitutes available in the present marketplace. Accrued depreciation may 0

then be fully and correctly accounted for as all subsequent loss in the existing property's ability to provide this hypothetical highest and best use. This includes all negative environmental changes, loss in functional ability and finally any material degradation. In contrast, the traditional replacement cost approach estimates the cost of building a modern substitute building using current building techniques but ignores the efficiency aspect. For example, this may mean not taking account of assets with a lower capacity where the current asset is over developed.

Methods employed by resource managers:

The traditional valuation approaches assess a value figure which reflects an economic viewpoint. This has been criticised as too narrow taking no account of aesthetic, political or utility values. To date the New Zealand valuation profession has ignored these alternative concepts of value.

> The traditional valuation approaches assess a value figure which reflects an economic viewpoint... This has been criticised as too narrow

With the introduction of the Public Finance act 1989, and more particularly the Resource Management Act 1991, has arisen the need to take non-marketable intangible qualities of property into account in the valuation process. Environmental concerns have been highlighted as have the need to consider the impact of various land use decisions on the environment.

Many resource economists and managers have, over the years, developed several techniques to value environmental attributes in monetary terms, in an attempt to achieve economic efficiency of resource allocation. These methods attempt to overcome the deficiencies of the "market value" definition by including intangible aspects such as aesthetics. This is particularly relevant in a country where many separate cultural groups live together. For example, land has both cultural and spiritual significance to Maori which the European definition of value ignores.

Kerr (1986) discusses four such techniques:

- Contingent valuation
- Travel costs method
- Indifference curve mapping, and
- Hedonic price method

These are used to value public goods that are not exchanged in markets such as natural resources, and could potentially be applied to non-market public property, however, to date, this has not been attempted.

Some features of public goods that have made quantifying them difficult, include:

1. *They are intangible.* There are no existing markets to price them adequately.
2. *They are non-rival property.* They can be enjoyed by one person without reducing the enjoyment they give to others.
3. *They are often non-exclusive.* People do not have to pay for enjoying them.

The methods considered to have greatest potential application to property are the contingent valuation and travel costs methods.

The contingent valuation technique involves surveying people to determine their willingness to pay for a possible change in supply or quality of a non-market good. The valuation is "contingent" on the specific hypothetical change identified.

All of the problems inherent in the technique result from its hypothetical nature. Obviously, asking someone what they will pay hypothetically is different to confronting them with a real market and observing what they actually pay. This differs from the hypothetical sale envisaged when considering the traditional sales comparison approach to "market value", which is based on evidence of what actually has been paid. As the approach is valuing non-market goods, no such evidence exists.

A major problem envisaged when applying this technique to valuing non-market goods is the difficulty in accurately defining intangible "aesthetic qualities" and providing a hypothetical situation that is concrete, and not merely symbolic, which the respondents can completely visualise. Also, the value of these qualities may vary between individuals.

Further, those that value the qualities highly and possibly have a personal interest in them may see the "game" merely as a vehicle for achieving their desired outcome by not responding truthfully. The results would then be strategically biased. Kerr (1986) found that "while the existence of these errors indicate that the contingent valuation method cannot be used for fine economic decision-making it does provide some information on the likely values of non-market goods and services which is useful in decision-making, certainly more useful than no information at all." (p20).

Thus, with careful foresight and planning such a technique could be developed and applied to valuing non-market non-investment property. Many lands in New Zealand with high scenic quality are publicly owned that people enjoy at no or little cost, such as national and state parks, forests and recreation areas. Acceptance and understanding of the technique, its limitations, and purpose will be a prerequisite for its success.

The travel costs method for estimating the aggregate demand curve of a site rests on the assumption that use of the site is dependent solely upon the travel costs to it. Should the price of travel to reach a site increase it is assumed that the use of the site will decrease.

Only where it can be shown that use is dependent upon travel cost, is this method of assistance. Another assumption that must be met for the approach to be reliable is that of single objective trips to visit the site. As Kerr notes, for sites such as recreational hunting areas where most users travel directly to and from the site for a specific purpose this assumption does not pose any problem. However, this is not so of visitors to many other sites, such as Mount cook National Park, most of whom are on a comprehensive touring holiday.

Travel cost may not be the only main determinant of use for much non-market non-investment property. Consequently the approach has limited application for valuing much of this property.

Indifference curve mapping relies upon interviews with subjects that are often long and difficult to conduct. This is primarily due to the explanation of probability that is required which many subjects ifnd difficult to understand. As a result, obtaining a representative sample is expensive and so this method has not been popular. It is therefore unlikely to be adopted by the valuing profession.

The hedonic price method assumes that the price of a property is determined by its characteristics, such as: number of bedrooms, age, construction etc. The method uses statistical means to estimate the marginal value of some environmental characteristic that are part of the package.

The method involves analysing prices of a well developed market for which price information is readily obtainable. Herein lies its limitation. As it requires an informed public and a well-behaved market it has limited application to valuing characteristics that form part of the non-market property package. Prices

for such property are not readily obtainable and so an analysis without data is impossible.

New Zealand examples:

According to Kerr (1988) the contingent valuation and travel cost methods have both been employed in New Zealand. Examples of contingent valuation studies include: valuing the scenery of the Kawarau Gorge in Central Otago to help determine the effects of hydro-electric development (Kerr 1985), and valuing the maintenance of water quality in the Waikato River (Harris 1984). The travel cost method has been used to value the Kaikoura rock lobster fishery (Cairns 1985), use values within the Kaimanawa and Kaweka Forest Parks (Sandrey and Simmans 1984), and to value nationally significant resources such as Mount Cook National Park (Kerr et al 1986).

The theoretical and practical problems associated with these methods limits their usefulness. As Kerr (1986) warns: "None of the methods claims to be 'exact', but all should be regarded as providing values indicative of true value."

He also points out that "...some of the major indicators of value used in resource allocation decisions, market prices are also affected by theoretical and practical concerns arising from imperfect markets." (p63).

These methods, though not perfect, provide a tool for aiding decision-making. As there is potential, through modification, for application of these methods to the valuation of certain non-market non-investment. property further research is warranted. It is likely that where the traditional valuation methods fail to provide a reliable solution, new methods such as these will be looked to in the future.

American solutions:

It is interesting that some of the problems that New Zealand valuers face in valuing public sector assets or specialised property in little demand are faced by valuers in the United States. However, due to the greater population and the demand for property that this brings in the United States the methods adopted there to deal with these have limited application in New Zealand.

For example, in an article by Aaron and Wright (1992), methods for estimating market value of churches and religious facilities are presented. These include a typical sales comparison approach and a modified income approach, alternatives to the cost approach that has typically been relied on both in New Zealand and the United States.

In the United States the traditional uses of churches is expanding to include such facilities as day care centres, counselling centres, and gymnasiums that warrant the use of alternative valuation approaches, as the facilities become less specialised.

A value in exchange has been found to exist for many church facilities that are operating economically as a "going concern", especially in the larger cities. Sales are analysed on either a per seat or a per square foot basis. However, in New Zealand such sales are rare. The few that have occurred have generally been to purchasers who modify the building for alternative uses.

As churches are non-profit organisations that generate income only to meet their expenses the traditional income approach to value is not applicable. However, Aaron and Wright suggest using a feasibility approach that is not a value estimate but a "test of reasonableness for the values developed" (p105), using the other approaches.

This method involves considering the potential financing of the church. Loan to value ratios required by lenders are determined, and a value estimated by determining the loan amount that the church can service from the income it generates. Such an approach could be applied in New Zealand, but as mentioned, it does not estimate "market value" and merely serves as a check for the other approaches.

Another example is the Stock and Debt approach, sanctioned by the Courts in the United States, used to value public utilities that though rarely sold on the open market are income earning. It is an objective measure reflecting the composite expectations of investors in public utilities. As these utilities in the United States are income earning they are not of a non-market non-investment nature as those in New Zealand generally are, and so this approach provides little guidance in respect to valuing the latter.

Even with the increasing privatisation of New Zealand public sector enterprise such an approach is unlikely to be of use. This is because, as at any given time, relatively few shares of stock for such companies are traded, so such data is not readily available for analysis.

Adams and Mundy (1991) provide a framework within which to quantify the non economically based value of high amenity natural land. Because of the lands attributes the public is often caused to constrain economic use of the land that they consider has a higher and better use.

In the United States a specialised market for undeveloped land purchased with the intent of preserving its natural, scenic and wilderness character, is developing. The purchasers, mostly public agencies, are motivated by the intangible, intrinsic qualities of the land and not the land's economic potential.

Often, these agencies are bidding against private developers. As such Adams and Mundy contend that such property meets the definition of market value where there are willing buyers and sellers acting prudently.

To preserve such land and take it out of economic production the purchaser will, according to Adams and Mundy, probably have to bid a price greater than the highest price at the land's economic highest and best use.

The value of a property is based on its potential uses and so highest and best use analysis is essential.

Where this analysis shows that land retained in its natural state forpreservation will maximise the present value then sales comparisons should be gathered thatreflect this highest and best use also. In this instance the sales comparison approach is utilised to assess value.

Again, this approach is not applicable in New Zealand where a market for such land does not exist, and is unlikely to until the Crown land owners are required to compete commercially with private investors.

In summary, these three examples illustrate that much of the property classified as non-market non-investment property in New Zealand is either investment or marketable property in the United States. therefore, the traditional sales comparison and income approaches, or modification of these, can be applied to valuing such property in the United States, but not in New Zealand.

Summary:

The valuation profession needs to enlarge its definition of "market value" taken from a merely economic viewpoint, to encompass the more intangible aspects of property.

Present definitions are based on assumptions that ignore social concerns. For example, the "highest and best use" is that use which earns the most money, yet it ignores the effects of use on the environment.

Also "market value" as determined by

> ... the highest and best use is that use which earns the most money, yet it ignores the effects of use on the environment.

one or more of the three conventional valuation methods, is based on the assumption that the property is marketable.

However, specialised property for which little demand exists, is not marketable. Such property is held for owner occupation or for servicing the community and not for pecuniary benefit. It has a high utility value but may have little or no exchange value.

As these properties do not have a ready market the valuation task becomes much more problematic. They do not derive a market rental nor does a ready demand exist for them and so the traditional income and sales comparison approaches to value are inappropriate.

The valuation of these properties must rely solely on a net replacement cost approach or a refinement of this until new method are developed and general acceptance of these gained.

With the government restructuring and passing of various legislation including the Public Finance act 1989, the State Owned Enterprises Act 1986, and the Resource Management act, the need to find new methods has become imperative.

Several techniques have been developed by Resource Managers for valuing non-market environmental attributes. Those employed in New Zealand include the contingent valuation and travel cost methods, which are considered to have the greatest potential application to valuing non-market non-investment property. Such methods encompass the intrinsic and non-economic aspects of value that the three traditional valuation methods have ignored.

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Horsley, G. "Asset Valuations and Site Assessment: Knowing Where You Stand".

McKenzie, D. "Local Authority Property Management: Social Responsibilities Versus Financial Profit".

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Auditor's Role in Asset Valuations

by I Goodwin

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Thispaperwasprepatrd Ztna.surveyandertaken aspaanofa reseaeh project on asset vuluationsand the e ierrutl auditor Jenny Goodwin was awarded NZ Society of Acc;ountantslCoopers & J.ybrand Peter Barr Fellowship in *I for this reseon Ir po jecct The author acknowledges the assistance of She Matthews in the collection of datafiir the dater.*

Considerable attention has been focused in recent years on the valuation of fixed assets for financial statement purposes. Valuers and auditors both here and in Australia have become increasingly aware of the need for cooperation between the two professions. In late 1991, for example, Australian property consultant, John Burdekin of Jones Lang Wootton, argued that "auditors, accountants and property valuers must form a much closer relationship to guard against increasing risks of litigation".' From the auditor's perspective, Robert Lynn, National Audit Partner of Coopers & Lybrand in Australia, earlierthis year claimed that "valuers and auditors have much to gain in reaching a greater understanding of how each operates". It is interesting to note that Burdekin's views were reported in a newspaper for accountants while Lynn's article was targeted primarily at valuers.

Similar concerns have been expressed in New Zealand, with a number of articles concerning the audit of property valuations appearing in the *Accountants' Journal3.* Wood and Chung (1992) stressed that property valuations can have a material effect on the truth and fairness of financial statements and that it is auditors who "have ultimate responsibility forreporting on truth and fairness" (p73). Arguing that auditors should not simply rely on the opinions of valuers, they focused on the ways that audit risk can be reduced by performing procedures to verify valuers' reports.

With the issue of SSAP-28 "Accounting for Fixed Assets" in 1991, the accounting profession in New Zealand established some much needed ground rules concerning asset revaluations. These rules have placed added responsibilities on both the valuer undertaking the valuation and the auditor who must verify the appropriateness of the valuation for financial reporting purposes. It can be argued that these responsibilities have further enhanced the need for a greater understanding and cooperation between the two professions.

In response to this need, a questionnaire survey was undertaken, first, to establish the level of communication that currently exists between valuers and auditors and, second, to obtain the opinions of valuers concerning the role of the auditor and the tasks the auditor should undertake when verifying a valuation. The remainder of this article reports the results of this survey.

Structure of questionnaire

The questionnaire consisted of three types of questions. The first related to personal data such as experience, position and area of specialisation. This was followed by a number of questions of a factual nature, designed to establish whether the respondent undertook valuations for financial reporting purposes and, if so, the level of communication between the auditor and valuer. The remaining questions were designed to determine the valuer's viewpoint on issues relating to financial statement valuations and on the tasks that should be undertaken by the auditor. In an attempt to maximise the level of response, the questionnaire was restricted to two pages in length and most of the questions involved circling a point on a scale. However, an opportunity was given to make any additional comments and almost 50% of respondents availed themselves of this opportunity.

Respondents

The questionnaire was sent to 175 valuers selected from a membership listing provided by the Institute of Valuers and from the professional directory appearing in the *New Zealand Valuers' Journal.*

The sample was restricted to members located in the four main centres of New Zealand, after excluding those with only a rural valuation qualification. This selection procedure was designed to ensure that those valuers who are likely to be involved in undertaking valuations for financial statement purposes were targeted. Useable responses were received from 131 valuers, giving a response rate of 75%. Some 36% of respondents had been registered valuers for at least 20 years while a further 43% had been registered for between 10 and 20 years.

More than 70% of those responding advised that they held senior positions in their firm, either at director, partner or manager level. These figures suggest a high level of expertise amongst those surveyed.

Results

(i) Frequency of Valuations for Financial Reporting Purposes

Table 1 (over page) indicates that almost one-third of respondents often undertake valuations for financial statement purposes while almost 40% indicated that they sometimes undertake such valuations. Less than 10% of respondents never undertake valuations of this nature. These valuers were asked to ignore those questions that related to communication with the auditor.

' See the *NewAccountant,* November 14th 1991, p4.

2 Lynn, RS. "Asset Valuation: The Auditor's Perspective",The *Valuer and Land Economist,* February 1993, pp 342-345.

3 For example, Locke S. "Audit Practice and Valuation *Standards,Accountants'Journal,* February 1990, pp 23-25 and Wood, D and Chung, R, "Property Valuation Reduce the Audit Risk", *Accountants' Journal,* March 1992, pp 72-73.

TABLE 1
Frequency of Undertaking Financial Statement Valuations

FREQUENCY	NO.	%
Never	13	9.9
Rarely	26	19.8
Sometimes	50	38.2
Often	42	32.1
Total	131	100.0

(ii) Communication Between Auditors and Valuers

Those valuers who indicated that they do undertake valuations for reporting purposes were asked a number of questions relating to the level of communication that they had experienced between themselves and auditors. As far as auditors are concerned, this issue is covered in Auditing Standard 5 (AS-5) issued by the New Zealand Society of Accountants, relating to using the work of an expert in the course of an audit. While the standard is primarily concerned with those situations where the auditor appoints an expert directly, it does not preclude situations where the expert has been appointed by the client. The standard requires that, when the auditor knows in advance that the use of an expert's work is required, the auditor should communicate with the expert over a number of matters. If the expert's work has already been completed, then the situation is less clear but it would appear that communication is not considered essential.'

The first question related to whether auditors communicate their intention to rely on valuations prepared by the respondent. Results are summarised in Table 2, giving a breakdown based on whether respondents rarely, sometimes or often undertake such valuations. This breakdown is important as one would expect the level of communication to be related to the frequency that this type of valuation is undertaken.

The table (below left) indicates that only a small number of valuers are regularly advised by auditors of their intention to rely on a valuation. Even for those who often undertake valuations of this nature, only just over a quarter indicated that they often or always receive this advice. NZIV Guidance Note No. 9, concerning the valuer's relationship with the auditor, points out that an auditor may request a valuer to produce explanations or working papers relating to the valuation. As Wood and Chung (1992) state, "often valuation reports are particularly abbreviated" (p73) and it may be necessary to request the valuer to supply additional information. Valuers were therefore asked how frequently auditors requested, first, explanations and, second, working papers to be provided. Results are shown in Tables 3 and 4, again giving a breakdown according to the frequency that valuations

TABLE 3
Request from auditor for explanations concerning a valuation

Contacted by auditor for explanations	Frequency of Undertaking Financial Statement Valuations						Total	
	Rarely		Sometimes		Often			
	No.	%	No.	%	No.	%	No.	%
Never	18	69.2	23	46.0	5	11.9	46	39.0
Rarely	6	23.1	23	46.0	27	64.3	56	47.5
Sometimes	2	7.7	2	4.0	7	16.7	11	9.3
Often	0	0.0	2	4.0	3	7.1	5	4.2
Always	Q	U	Q	Q.Q	Q	U	Q	Q n
TOTAL	26	100.0	50	100.0	42	100.0	118	100.0

TABLE 4
Request from auditor for working papers concerning a valuation

Contacted by auditor for working papers	Frequency of Undertaking Financial Statement Valuations						Total	
	Rarely		Sometimes		Often			
	No.	%	No.	%	No.	%	No.	%
Never	21	80.8	41	82.0	24	57.1	86	72.9
Rarely	4	15.4	7	14.0	14	33.3	25	21.2
Sometimes	1	3.8	1	2.0	4	9.5	6	5.1
Often	0	0.0	1	2.0	0	0.0	1	0.8
Always	Q	Q.Q	Q	Q.Q	Q	Q.Q	Q	U
TOTAL	26	100.0	50	100.0	42	100.0	118	100.0

of this nature are undertaken. Only five respondents indicated that they are often asked for additional explanations while only one is often asked for working papers. While results differ according to the frequency that valuations are undertaken, the majority of valuers have either never or rarely been asked by auditors to supply additional explanations and even fewer are ever asked to provide copies of working papers.

It could be argued that this low level of communication is due to the lack of a direct relationship between the auditor and the valuer. From discussions with auditors5 it is apparent that some believe that any communication with the valuer should be undertaken only through the client since it is the client who employs

TABLE 2
Frequency of communication by auditors that they intend to rely on valuations

Intention to rely communicated by auditor	Frequency of Undertaking Financial Statement Valuations						Total	
	Rarely		Sometimes		Often			
	No.	%	No.	%	No	%	No	%
Never	12	46.2	15	30.0	4	9.5	31	26.3
Rarely	9	34.6	22	44.0	12	28.6	43	36.5
Sometimes	2	7.7	11	22.0	15	35.7	28	23.7
Often	2	77	1	2.0	8	19.0	11	9.2
Always	1	is	1	2.0	a	7.1	Q	42
TOTAL	26	100.0	50	100.0	42	100.0	118	100.0

Paragraph 5.11 states that the auditor should ensure that all relevant matter are included in any communication with the expert but it does not state that the auditor should communicate with the expert.

TABLE 5

Request from client on behalf of auditor for explanations concerning a valuation

Contacted by client for explanations on behalf of auditor	Frequency of Undertaking Financial Statement Valuations						Total	
	Rarely		Sometimes		Often			
	No.	%	No.	%	No.	%	No.	%
Never	10	38.5	19	38.0	6	14.28	35	29.7
Rarely	15	57.7	20	40.0	20	47.6	55	46.6
Sometimes	1	3.8	9	18.0	13	31.0	23	19.5
Often	0	0.0	2	4.0	1	2.4	3	2.5
Always	a	Q.4	Q	Q.4	2	4.8	2	11
TOTAL	26	100.0	50	100.0	42	100.0	118	100.0

TABLE 6

Request from client on behalf of auditor for working papers concerning a valuation

Contacted by client for working papers on behalf of auditor	Frequency of Undertaking Financial Statement Valuations						Total	
	Rarely		sometimes		often			
	No.	%	No.	%	No.	%	No.	%
Never	17	65.3	36	72.0	22	52.4	75	63.6
Rarely	8	30.8	9	18.0	14	33.3	31	26.3
Sometimes	1	3.8	3	6.0	5	11.9	9	7.6
Often	0	0.0	2	4.0	0	0.0	2	1.7
Always	2	Q.Q	Q	Q.Q	1	2A	1	Q.$
TOTAL	26	100.0	50	100.0	42	100.0	118	100.0

the valuer. To cover this possibility, respondents were also asked to indicate how often they were contacted by the client on behalf of the auditor to provide explanations or working papers. Responses are summarised in Tables 5 and 6 (above). These tables indicate that, while slightly more auditors appear to make requests to valuers through the client rather than directly, the level of communication is still low.

These results suggest one of two possibilities. It could be concluded that the low level of communication between auditors and valuers simply indicates that communication is not usually necessary because valuers know what auditors are looking for and they ensure that this information is provided in their valuation reports. Alternatively, it may be that communication is inadequate and that auditors are too ready to accept a valuation without further inquiry. In an attempt to ascertain whether valuers believe that the level of communication is adequate, respondents were asked to indicate whether they agreed with a number of statements. First, they were asked whether, in their opinion, the information contained in valuation reports is generally sufficient for an auditor to assess the appropriateness of the values for financial statement purposes. Then they were asked to indicate whether the auditor should always communicate with the valuer when assessing valuations of this nature or whether communication should only take place when queries arise.' Responses to these questions are shown in Table 7 (over page).

It is apparent from this table that more than 70% of respondents either agree or strongly agree that the information contained in valuation reports is generally sufficient for the auditor to assess the appropriateness of values given. In spite of this, however, over 50% of respondents believe that the auditor should always communicate with the valuer, with 15% holding strong views on this matter. However, valuers' opinions concerning the need for communication appear to be extremely diverse, with more than 40% holding the view that communication need take place only when there are queries to resolve. Interestingly, communication between the two parties was the most frequently mentioned issue by those who chose to make additional comments. Only one valuer considered that communication should not be necessary, stating that, if clear instructions are given and NZIV standards followed, any further contact should be superfluous. Some examples of comments supporting greater communication are as follows:

"Direct verbal communication will provide both valuers and auditors with a better understanding of their respective attitudes and roles."

"I believe there is insufficient regular contact between auditors and valuers."

"In my experience the relationship is too remote."

"To enhance the credibility of financial reporting I consider it essential that there is dialogue."

"Much better communication is required to confirm correct instructions, basis and assumptions."

"Closer working relationships between valuers and auditors are essential and should be fostered via each of our respective institutes."

To conclude this section, it would appear that opinions vary and further research may be necessary in order to identify reasons for the different views. However, many valuers clearly believe that the current level of communication between auditors and valuers is inadequate and there is a need for an improved relationship between the two professions.

(iii) Procedures the auditor should undertake when assessing valuations

The last part of the questionnaire was designed to establish valuers' views about whether the auditor should undertake certain checking procedures when relying on the work of a valuer. Specifically, respondents were asked to indicate whether they agreed that the auditor should perform various checks before accepting a valuation for financial statement purposes. AS-5 requires the auditor to undertake a number of procedures when relying on the work of an expert and most of the questions

The author conducted a series of structured interviews with senior auditors in connection with asset valuations and the findings have been reported in the *Accountants'Journal* (March, April and May 1993).

The one valuer who indicated that working papers are always requested did quality the response by stating that these are always attached to the valuation report sent to the client.

All respondents were asked to answer the opinion questions regardless of whether they undertook valuations for financial reporting purposes.

Because there were no statistical differences between the responses of those who undertook valuations and those who did not, the results for all respondents are reported together.

TABLE 7
The opinions of valuers concerning communication issues

Statement		`3trongiy l)isagr ee2 1	Disagree {	tinr;eriahr		s1 rongly Agree	Total
Inforniatlon in valuers' reports generally sutlirient tot auditors	No		14	23	84		131
		1.5	10i	17.6	641		10110
Auditors should always communicate with valuer					46	2'()	131
					35.1	15.3	1100C)
Auditors should cornmunciate with valuer only when queries arise							

asked were prompted by these requirements.

The procedures can be divided into those that relate to the valuation itself and those that relate to the valuer undertaking the valuation.

Table 8 summarises the responses concerning procedures relating to the valuation. From this table it can be seen that a considerable majority of respondents believe that the auditor should both check the basis of the valuation and consider whether the assumptions made by the valuer are appropriate. AS-5 is somewhat vague in this area, asit requires the auditor to determine that the assumptions and methods used are "not unreasonable based on the auditor's knowledge of the client's business" (para 5.14) but at the same time acknowledges that their appropriateness and reasonableness are the responsibility of the expert concerned.

As far as checking the calculations in the valuation report and verifying any source data used by the valuer are concerned, results were more varied. Just over half of those responding believe that auditors should check the valuer's calculations while only one-third agree that the auditor should verify source data. There is no specific requirement in AS-S that the auditor should check any calculations but the auditor is required to consider whether the source data used is sufficient, relevant and reliable.

One of the procedures that the auditor might use to make this assessment is to conduct appropriate tests of data that have been provided by the client to the expert.

From the auditor's perspective, therefore, it would be quite reasonable to verify any source data used by the valuer and it is interesting that the majority of valuers do not believe that this should be necessary.

It can be argued, therefore, that some clarification as to the roles of the two professionals is needed to remove any feeling that one is "treading on the other's toes". As one valuer commented, "both valuers and auditors are professionals and therefore should not impinge unnecessarily on the professional ability of the other".

Table 9 summarises responses concerning the need for audit test relating to the valuer undertaking the valuation.

Over 90% of respondents believe that the auditor should check that the valuer is both independent and has the required level of experience while over 8% also believe that the auditor should check that the valuer is suitably qualified. All of these checks are required by AS-S and it would appear that valuers agree that they are necessary.

The results suggest that valuers are indeed concerned that members of their profession maintain an appropriate level of independence from their clients and do not act outside their area of expertise.

Conclusion

Both auditors and valuers have an important role to play in ensuring that financial statements contain relevant and reliable information.

The results of this survey suggest that there is a need for greater dialogue between the two professions.

This should lead to increased understanding and cooperation which, in turn, should benefit both clients who prepare financial statements and those who rely on those statements for their decision-making. ,&

TABLE 8
Audit procedures relating to the valuation

The auditor should		Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree	Total
Check the basis of the evaluation	No	1	18	12	72	28	131
		0,8	1.1 7	9.1	55.0	21.4	100.0
Verity any source data used by the valuer	No,	9	60	18	37	7	131
	%	6.9	45 8	13,7	28.2	5.4	100.0
Check the calculations in the valuation report	No.	8	39	18	57	9	131
	%	6.1	29.8	13.7	43,5	69	100.0
consider appropiateness of the asssunrptions made by the valuer	No,	2	10	8	83	28	131
	%	,15	7.6	61	63,4	21.4	100.0

TABLE 9
Audit procedures relating to the valuer

The auditor should,		Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree	Total
Ctheck the quailfica' lions of the valuer	No	4	11	4	717	41	131
	1%	31	8,4	3.1	54 2	31,3	100.0
assess whether the valuer has the appropriate level of experience	No	3	4	5	75	44	131
	%	23	31	3,8	57,3	336	100 0
Check whether the valuer is indepr ndertt	No.	1	5	5	69	51	131
		0,8	3.8	39	527	38.9	1001)

Service Station Rentals and Valuations

by P Smith

Philip Sm ith iconAssof,Part *of the New Zealand Institute of Valuers* and a *current member of the 'onterburyl Westland Branch Committee. He is a director of* Binns, *Barber* & Keenan *Ltd and has been involved* in *property* valuation *for the past 13 years. He* has *a slpccial interest in the valuations of servit e* stations. *This paper was pre, rented* t, x *a wor** shop *session at a Lincoln University seminar held in July* 1992.

For some time I have felt that the "conventional" approaches to assess a service station rent may not properly deal with all the issues or at least the final assessment might not reflect a rent that was in sympathy with an equitable return on the land, building and site improvements and the earning capabilities of the service station business. I approached our resource library in Wellington to see what was available on service stations and found that in 40 or 50 years only five articles have been produced - two with New Zealand origins, two Australian and one by an American author. The most recent article was published in September 1990 but one that caught my eye was an article on the selection and evaluation of service station sites by the real estate manager for Mobil Oil. This article was written 30 years ago and despite the many changes that have taken place, much of what was written then still has a great deal of relevance today. I would also refer everyone to Urban Valuation in New Zealand Volume 2 and the chapter on service stations.

Prior to 1988 oil companies or their nominee could not own service stations be it land, buildings or business directly or indirectly. The legislation at the time said that where a motor spirit retailers license was held, oil companies could not take up any form of ownership. They were simply wholesalers of petroleum products for which they received a wholesale margin and the retailer got his dealer's margin. Nothing more; nothing less. Many years previously the concept of one-brand sales had been formulated and the oil companies relied on this arrangement with the dealer to preserve their market share.

It is interesting that in the article written 30 years ago the author says, "if oil companies were allowed to own and operate service stations the wholesale margin together with the rental return from the real estate would permit the acquisition of sites of significantly higher land value. The value of land for service stations under present conditions (1961) is determined primarily by dealer profitability." Of course at that time dealer margins were controlled by price fixation and so the value of the real estate for service stations was similarly controlled.

This all changed however in the early days of post deregulation which followed the Petroleum Sector Reform Act 1987. This piece of legislation completely opened up the service station industry.

It allowed oil companies to own and operate service stations - land and buildings included - and for the first time there was out in the open competition amongst the oil companies for site acquisition and did they compete!

The relative performance of an oil company is driven by the almighty "market share" and a couple of percentage points increase by one at the expense of another oil company is reason for celebration. As well as buying existing service stations and land capable of later development, the oil companies negotiated supply contracts with their retailers to protect market share. In the case of high performance service stations, the supply contracts involved fairly substantial cash inducements and incentives. We have seen aggressive stances taken by the oil companies to acquire property as well as major redevelopment of existing service stations. This has attributed to real estate values increasing dramatically particularly in the early days ofderegulation. Often the prices paid seemed to bear little resemblance to earnings but rather it was a mad scramble to acquire the strategic properties to preserve and ultimately increase the all important "market share".

Valuing service station real estate during these times was extremely difficult and was almost a situation of assessing the best figure then watch it being doubled.

There was no relationship between purchase prices and historical sales or even business revenues of what we thought were comparable properties but instead it was a deliberate positioning by the companies for future profitability. I know that in some cases the oil companies looked at a 10-year investment period but some of the prices paid for some of the property in 1988/90 must extend the pay back period out longer than this. Thankfully those first few years of deregulation are behind us and four or five years later on, the pressure on land acquisition seems to have subsided. The oil companies have now positioned themselves and are concentrating on redeveloping and upgrading existing businesses and properties to bring them into line with the requirements of the modem service station. I also believe that there is now more emphasis on advertising and one brand marketing.

We have all seen the criteria for the modem service station ie larger and more easily accessible forecourts, an increased number of pumping aisles, well stocked shops, discontinuance of workshops and lube bays (but no lesser a concentration on customer demands particularly low overhead profit centres such as trailer hire, automatic car washes). 0

This paper was presented at a workshop session of The Continuing Education Seminar conducted at Lincoln University. Canterbury, in conjunction with the Canterbury/Westland and South Canterbury branches NZIV. on 8 July 1992

The next five years is unlikely to see much in the way of new construction in Christchurch other than perhaps in three or four locations on main arterial routes (or roads that will become main routes because of changes in roading patterns). Riccarton Road, Brougham Street, Marshlands Road and maybe the new ring road around the north part of the city.

Without doubt the oil companies are now the prime motivators in the determination of real estate values. They are either:

a) Owners of real estate with any type of management and/or supply contract in place to the dealer
b) Head lessees with a dealer supply contract, or
   Simply have the protection of a dealer/ supply contract.

There still exists, of course, a great many service stations that continue to be privately owned and operated or owned by an investor and leased to the operator but the driection in the market over the last few years has come (and will still come) from the oil companies in establishing levels of value, the structure of ownership and management and the supply agreements that finally preserve the oil company's all important market share.

Site selection

Where do the oil companies look to establish new service stations and which of the existing sites are considered to have the best potential for growth and so warrant major upgrading? The bottom line is volume and the site's ability to pour the most petrol. The most important site selection criteria is:

a) Traffic flows-this involves detailed traffic analysis, establishing peak hour traffic flows, directional flows and the anticipated long-term traffic flows.
b) Visibility and accessibility - easy access onto and off the site and a visible entrance that gives the motorist plenty of time to turn into the site are paramount. So too is the speed of traffic as it passes the site the slower the speed generally the better. The local authority has its own requirements for ingress and egress and sometimes these may not coincide with the views of the oil company.
c) Zoning this can have a major bearing on the selection of a site. Often, though, the land zone can be the least important criteria and maybe this explains why the oil companies spend a lot of time in town planning hearings,
d) Site area and dimensions - the wider the frontage the better and a corner location is regarded as a significant advantage provided the local authority does not impose any restrictions on vehicle crossing. The required area of land has increased with the modern service station because of the need for bigger forecourts and wider pumping aisles. The local authority may also want generous landscaping particularly if the service station is adjacent to a residential use.

Today's service station might typically be on a site of between 2000m2 to 3000m2 with a frontage of around 40 metres minimum.

Finally the best site is the one that serves the greatest number of potential customers, allows quick throughput and minimum delay.

Building and site improvements

Today's service station improvements under-capitalise the land. The improvements only represent a very simply constructed shop with some internal embellishment, a canopy, forecourt seal, concrete hard standing and landscaping. The simple fact is that the layout of the service station is designed to dispense as much petrol as quickly and as simply as possible and so there is not the requirement for large areas of building.

The design of the buildings, the colour scheme and signage is all coordinated and consistent to promote the particular brand of petrol. This is extended out to include marketing with coordinated promotional activity amongst that particular oil company's service stations.

The underground tanks, dispensing pumps and running gear, signage and LPG storage tank are usually owned by the oil company and the plant and equipment, and stock by the dealer.

Rental valuation approaches

The rental approach, notwithstanding any special or unorthodox method stipulated by the lease document, has been one or all of the following:

1) Rental as a return on land and building value

Questions

a) What is the basis for the comparison of land values ie is it compared to a similar block of commercial land supporting a different use or a service station doing similar trade?
b) How do you recognise any extraordinary payments that may have been made by the lessee oil company to the land owner as a form of lease incentive in reverse?
c) Is the approach to depreciation reasonable bearing in mind the volatility that has occurred in service station development particularly over recent times?
d) What level of return is equitable since there are very few sales particularly in the last year or so?
e) How does the final figure compare to business earnings?
f) Is the final figure a sound reflection of market rent?

2) Comparable rental evidence

Discussion points and questions

a) Comparable evidence can be difficult to get because of commercial sensitivity.
b) The comparative rental breakdown, unless assessed by valuers, might not be obvious and then it becomes a subjective breakdown which may or may not be relevant.
c) Should more or less emphasis be placed on the shop rent compared to the typical retail shop in the same location?
d) Similarly with the workshop?
e) How do you treat the analysis of a comparable development where a significant amount of ground rent is paid?
f) How do you treat large areas of excess land? (excluding the forecourt).
g) How do you rationalise the rental analysis between the modern service station with the older service station/workshop?
h) What is a proper approach to assess the rent for the forecourt?
i) Finally is this approach just too subjective in terms of its analysis to be a satisfactory basis of assessment?

3) Rental as a function of business earnings

Whenever valuers undertake a rental assessment (or market valuation) of a specialised going concern property (eg motels, rest homes, hotels etc) high reliance is placed on the trading results of the business.

This does not seem to be the case with service stations and yet I see no reason why there shouldn't be the same application of principles. The same fundamentals appear to exist, ie:

a) Specialised building improvements often with no obvious competing alternative use.
b) Often difficult to obtain comparable rentals and then having done so analyses may be too subjective or wrong! 0

c) The rent that is finally assessed must be affordable because of the specialisation of the property. This often is the final test for motel, rest home etc rental assessments.

The problem though, with all these types of properties, is availability of accounts which is equally difficult with service stations where there seems to be greater commercial sensitivity.

What are the advantages and disadvantages of this approach?

Advantages

a) The assessed rent should be affordable for the business.

b) The assessment of the rent is a sound approach for specialised land and buildings.

Disadvantages

a) Difficulty in getting copies of accounts - perhaps we should be recommending to our clients that it is to their advantage to provide accounts and maybe this should be a condition of the lease.

b) The assessed rent may not necessarily provide the lessor with a fair return on land and building investment.

c) One site might trade 50% better than the other but yet the land, buildings and location may not be dissimilar.

d) The final rent may be overstated against a return on land and buildings.

I am convinced that some form of accounting analysis is necessary to establish sustainable rental levels that are affordable to the tenant and at the same time provide a fair return to the investor. The subjective adjustments that are so often necessary in calculating rent as a return against invested capital and on comparable evidence makes these approaches uncertainparticularly with today's modern service station where there is a low level of improved value to land value.

Examples of rental assessment methods

Assume

1) Service station property owned by an investor, head leased to an oil company, sub-leased to an operator with a supply contract to the oil company
2) A modern 2-3 year old service station with sales expected to be 2.5 million litres per annum.

i) RENTAL AS A RETURN ON LAND AND BUILDING VALUE

a)	Land Value			
	2000m2 C© $250/m2			$500,000
b)	Building Value			
	Shop 185m2 © $680/m2 © 1.1		$140,000	
	Canopy 300m2 C© $680/ C© 0.3		$60.000	
			$200,000	
	Less depreciation 5%		$10.000	
				$190,000
c)	Other Improvements			
	Yard seal & concrete hard standing 1500m2			
	1500m2 © $20/m2	$30,000		
	Less depreciation 10%	$3.000		
			$27,000	
	Landscaping		$3.000	
				$30.000
CAPITAL VALUE				$720,000

Return say 11.5% = $82,800 Annual Rental

ii) COMPARABLE RENTAL EVIDENCE

a)	Building/Canopy Rent	
	Shop 185m2 ® $200/m2	$37,000
	Canopy 300m2 © $30/m2	$9,000
b)	Site Improvements Rent	
	Yard seal and concrete hard standing (excluding forecourt)	
750m2 @ $30/m2 ©15% return ©10% depreciation		$3,037
c)	Forecourt Rent (based on through put)	
	2.5 ml litres C© 0.070 per litre	
	= $175,000 + 15%	$26.250
ANNUAL RENTAL 1		$75,287

OR ALTERNATIVELY

a)	Building/Canopy same	$46,000
b)	Site Improvements	
	car parks 9 @ $10 per week	$4,680
c)	Forecourt Rent	
	Land area of forecourt say 1,000m2 © $250/m2	
	= $250,000 C© 8.5% return	$21.250
ANNUAL RENTAL 2		$71,930

III) PROPORTION OF NET CASH FLOW

TRADING RESULTS FOR XYZ SERVICE STATION
12 MONTHS TO 31 MARCH 1992

Sales		$2,316,000
Less stock at 31.3.91	$70,000	
Cost of sales	$1,800,690	
Direct wages	$220.000	
	$2,090,690	
Less stock at 31.3.92	$80.000	
		$2.010.690
Gross Profit		$305,310
LESS Expenses		
Accident compensation levy	$3,503	
Advertising	$17,500	
Bank charges and commissions	$7,600	
Cleaning, laundry and rubbish removal	$7,500	
General expenses	$500	
Insurance	$6,500	
Legal fees	$1,000	
Motor vehicle expenses	$8,500	
Power and lights	$7,500	
Printing, stamps and stationery	$7,500	
Protective clothing	$750	
Rates	$7,000	
Rental equipment	$300	
Repairs and maintenance	$5,000	
Secretarial and accountancy fees	$6,000	
Staff supplies	$1,200	
Staff training	$250	
Subscriptions	$1,000	
Telephone and tolls	$5,500	
Travel and entertainment	$4,000	
Wages/clerical	$23,400	
		$122.003
		$183,307
Less wages of management		$40.000
Estimated Annual Cashflow		$143,307

continued over page

CONTINUED ...

		$143,307
LESS depreciation of plant and equipment		$8.000
Pre Tax Profit		$135,307
LESS Recapture of capital invested in plant and equipment	$6,000	
Recapture of capital invested in good will	$11.000	
		$17.000
Net Cashflow Before Profit and Rental		$118,307

To arrive at the proportion of the funds available for rent, comparative evidence must be obtained from other accounts and rental agreements, say 60%

Funds available for rent = $70,984 Annual Rental

SUMMARY OF RENTAL AGREEMENTS

1)	Return on land and buildings		$82,800
2)	Comparable rents	1	$75,287
		2	$71,930
3)	Trading analysis		$70,984

Where should the final figure lie?

I believe that the rental assessment of service stations could become a very specialised field in future because:

a) Oil companies are the main players and as a rule they tend to use one or maybe two valuers exclusively.

b) More emphasis will be given to trading accounts in fixing rents with the necessary standardisation because comparable rents can be misleading.

It will be very interesting to see which direction the valuing profession takes with service station rental assessment over the next period of time.

Market Values

Much of what we have already discussed can equally be applied to market valuations. Once again the oil companies are the main participants.

Notwithstanding any requirements they may have for annual asset revaluations, the oil companies have largely acquired the properties that they wish to but for those remaining key sites where they do not hold or have a strong interest (ie either direct ownership or as a head tenant under a long-term lease) then their market share is preserved by the supply agreement. If the service station is such a performer and has greater potential, then they will often seek to acquire the land and buildings so that their position is completely protected.

As valuers we are all familiar and comfortable with the conventional approaches that have been adopted and these have equal application for service station market values. However one of the most difficult parts of the assessment is to calculate the value of the land.

Recently I was given an assignment to value an outlying service station that:

1) Traded at around 4,000,000 litres per year.
2) Had a diverse range of services including warrant of fitness, lube bay and workshop, well stocked shop, video hire, tyre bay, car wash and trailer hire.
3) The buildings were old but nevertheless functional.
4) The site had excellent attributes in terms of its forecourt, accessibility, visibility and area. It was not one of the modern super stations and so probably its only disadvantage was the number and width of the pumping aisles. However it still did 4,000,000 litres a year.
5) It was located out of Christchurch in a small town where it competed against two or three other smaller service stations.

The value of the land and buildings had significant value by virtue of their exceptional litreage. The problem though was what level of value did the land have?

The land was appropriately zoned but anything of a comparable type in this township might have been around $100/m2. However this didn't reflect the large volume of litreage and at the end of the day the site had attributes that any alternate site would probably fall short on.

I was conscious that the trading results were influenced to some extent by the long hours of trade, the strong owner-operated management and competitors whose sites were significantly poorer.

My analysis for this particular service station rested around the larger Christchurch service stations and the final value was at a level equivalent to or higher than some of the larger, more modern service stations in Christchurch.

Insurance values

It is important to be conscious of the two most recent pieces of legislation that could impact on replacement values ie the Resource Management Act and The Building Act.

If the service station building was destroyed its replacement would require consents under the new Resource Management act.

The major uncertainty arises with the underground tanks. If replacement is necessary and the existing tanks are untouched, then no additional resource consents are needed.

However if the tanks are replaced at the same time, then the installation must comply with the Code of Practice for the design, installation and operation of underground petroleum storage systems.

This will necessitate an Environmental Impact Audit which in turn could result in any contaminated soil having to be removed as well as the imposition of other obligations.

A building's reinstatement insurance certificate of course deals just with the buildings and the canopy disregarding the tanks and other equipment.

However we must advise our clients of the possible liabilities and it is a point that I raise in my letter to the client and/or insurance company without being able to stipulate however the costs involved. A

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Legal Decisions

Arbitration Rental review - Lease of forecourt of service station profitability of present use of site - highest and best use of site highest and best use of land Error of law.

The High Court of New Zealand, Wellington Registry decision in this matter was published in the March1993 New Zealand Valuers's Journal.

IN THECOURT OF APPEAL OF NEW ZEALAND

CA 171/92

IN THE MATTER of Section 12 of the Arbitration Act 1908

AND

IN THE MATTER of Memorandum of Lease registered number 709525.1 (Wellington Registry)

BETWEEN SEXTANT HOLDINGS LTD Appellant

AND NZ RAILWAYS CORPORATION Respondent

Coram: Richardson J
McKay J
Tipping J

Date of Hearing: 9 March 1993

Date of Judgment: 19 March 1993

Counsel: M R Camp QC and C M Stevens for the Appellant
J L Land for the Respondent

JUDGMENT OF RICHARDSON J

In proceedings it instituted in the High Court and again on this appeal Sextant Holdings Ltd challenged the award of an umpire in a rent review on the ground of error of law on the face of the award.

Background facts:

The land in question is a small triangle of only some 160m2 at the corner of Waterloo Quay, Balance and Whitmore Streets, Wellington. It is used as part of the forecourt of a service station. There are petrol pumps and underground tanks on the land. The buildings associated with the service station and the rest of the premises with an area of 232m2 are on a separate title. The balance of the land in that city block is a much larger area of 1277m2 and is on a third title or titles known as the Dalgety premises.

The lease:

Sextant, a subsidiary of Shell Oil is now the lessee and New Zealand Railways Corporation the lessor of the triangle. The lease which commenced on 1 January 1985 and is for 20 years renewable in perpetuity, provides for five yearly rent reviews. The lease provides for the land to be used for commercial purposes. That the document is itself a multi-purpose lease standard form, not site and use specific, is evident from the requirement that the lessee fence the property, keep it clear of noxious weeds and indemnify Railways against all damage to railway property and from the exclusion of any liability of Railways where animals on the land are destroyed or damaged by fire.

The rent for the initial five years was $5,200 per year and the umpire fixed the rent for the second five years commencing on January 1990 at $80,000. He did so relying on clauses 17 and 20, the material rent review provisions of the lease which provide as follows:

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 ifrst 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.

The lessee may either accept the rent as so fixed or require that it be determined by arbitration (c122).

If on arbitration the arbitrators fail to agree the umpire's duty is to make an independent and substantive valuation but not exceeding the higher and not less than the lower of the valuations made by the arbitrators (cl 27).

The award:

On his review of other land valuation cases, and referring particularly to *Wellington City Council v Wilson* (1936) NZLR s110 and *Wellington City v National Bank of New Zealand Properties Ltd* (1970) NZLR 660, the umpire concluded that the applicable test was what a prudent lessee would give as ground rent of the land for the second five year term. He went on to hold that:

1. The fair annual rental was required to be valued on the basis that there were no buildings or improvements on the land and that the use of the land under the lease document was commercial;
2. The use of the land was restricted in the main by town planning considerations and not by its present use as part of a service station site;
3. The actual profitability as related to the present use of the site was of little or no relevance in determining the fair annual rent of the land disregarding the buildings or improvements thereon;
4. The land was to be valued as vacant, "disregarding both the economics and the existence of the present buildings and other improvements".

The arbitrator appointed by the Railways favoured valuation of the triangle on the basis of its ability to be amalgamated with the rest of the land in the block for development purposes and the umpire referred to a conditional agreement of 22 May 1989 in respect of the whole block apart from the triangle. The arbitrator appointed by Sextant referred to another conditional agreement in respect of the whole of the service station premises including the triangle, but contended that the new rent for the triangle should be developed from the initial $5,200.

The umpire concluded that the concern was with the fair annual rental within the market as it existed on 1 January 1990 and that the highest and best use value of the triangle lay in amalgamation with the adjoining land and "as part of the adjoining land must have a value in the region of the overall psm value for that adjoining land". His conclusion was that there would be demand for redevelopment of the Dalgety site (and presumably the service station premise) in the latter years of the five year term of the lease of the triangle. It was on that footing that he fixed the

award of the ground rental under the prudent lessee concept at $80,000 which relfected a return of 6.5% on a land value of $1.248m.

The lease of the adjacent land:

Mr Camp submitted that to complete the factual picture we should have regard to the provisions of the lease affecting the rest of the service station premises which the umpire treated as part of the notionally amalgamated lands for which the highest and best use value was assessed. However the lease itself is not specifically mentioned in the award and there is no basis for treating it as having been incorporated into the award so as to justify the court in examining it in order to determine whether when read with the award the two taken together disclose a proposition of law which is erroneous and forms the basis of the award *(Max Cooper & Sons Pty Ltd v University of New South Wales* (1979) 2 NSWLR 257).

The award stands on its own and as the Privy Council also emphasised in *the Max Cooper* case any error of law must appear on the face of the award as a matter of actual exposition not one of inference only.

The judgement of the High Court:

Referring to clause 17, Neazor J concluded:

1. That the umpire is to assess a rent which is fair to the lessor but 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.
2. That 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.
3. That it was not an error of law for the umpire to conclude that the actual profitability as related to the present use of the site was of little or no relevance in determining the fair annual rent of the land disregarding the buildings or improvements thereon.
4. That it was not an error of law to disregard the existence of the present buildings and other improvements and the economics of the operation.
5. That 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 but that use was not confined by the lease other than to "commercial" and the use of the land as affected by town planning considerations was not limited to the present use.
6. That references to "highest and best use" of the land were to matters of valuation formulae or approach in the assessment of the value of the land, which were entirely within the umpire's competence and jurisdiction.

In the result he held that the umpire had adopted a proper approach to the fixing of the rent.

The submissions for Sextant:

An award is susceptible to challenge if it is demonstrated to be the product of faulty legal reasoning. For Sextant Mr Camp submitted that it is apparent from the award that the valuation test the umpire adopted was erroneous in law.

His submission was that the particular rent review clause called for an assessment of the fair annual rental which required consideration of all the factors that would have affected the minds of these particular parties if they had been negotiating the rent themselves. It followed, he said, that the umpire erred in excluding the economics of any particular activity pertaining to the triangle and considerations arising from the leases of adjoining but legally separate premises.

His alternative submission was that, even if the rent review clauses required an objective assessment of the fair annual rent of the land that would be agreed by a prudent lessee, the umpire was wrong to exclude the impact on any development of the notionally aggregated lands of existing buildings and other restrictions affecting other lands and to treat the whole block as if it were bare land.

The valuation approach under the lease:

The obvious object of rent review clauses in long term leases is to provide some protection to the parties, usually the landlord, where changes in property values or in the real value of money affect the return on the current value of the property. The exact nature and measure of the adjustment depends on the proper construction of the particular rent review clauses.

Various drafting approaches have been taken in statutes and leases. Speaking very broadly they tend to fall into two general categories. One focuses on the market rent and calls for the application of the familiar willing buyer/willing seller test. It requires valuers to enter the world of notional markets populated by hypothetical lessors and lessees and assumes a notional letting on the same terms as the subject lease except for the amount of the rent. The other looks to what the particular lessor and lessee would consider a reasonable rent in their circumstances. Although requiring an objective assessment, it may call for consideration of circumstances not relevant to a pure market test such as who paid for the improvements and the profitability of the business carried on by the lessee. In all cases it is a matter of identifying the intentions of the parties as expressed in their lease. The appropriate valuation approach turns on the wording of the particular rent review provisions considered in their contractual context and in the matrix of the material surrounding circumstances. There are numerous reported cases here and in England in which a range of rent review clauses have been analysed and particular considerations pointing one way or the other or in no particular direction - have been identified and weighed. In this country recent cases include *Mahoney v R C Dimock Ltd* (1990) 3 NZLR 114; affirmed *R CModickLtdvMahoney* (1992) 1 NZLR 150; *Jefferies v R C Dimock Ltd* (1987) 1 NZLR 419 and *Feltex International Ltd v J B L Consolidated Ltd* (1988) 1 NZLR 668 in which overseas authorities are also considered. Rather than review and repeat that analysis I shall go straight to the relevant provisions of the lease.

The valuation is of "the fair annual rental of the land hereby demised" (cl 17), taking no account of "the value of any buildings or improvements then on the said land" (cl 20). The first point about the contractual test is that it concerns the rental "of the land hereby demised". While those words do not directly answer the question on what basis the rental of the land is to be assessed, they point towards an assessment made on an objective basis by reference to the premises and to the terms of the notional lease affecting the premises and without reference to the personal circumstances of the particular lessor and lessee. Second, the rent as ascertained is the product of a valuation which if not accepted by the lessee is determined by arbitration. It is not one to be agreed between the parties (and only failing agreement to be settled by arbitration) which depending on the particular language of the rent review clause might allow consideration of the particular circumstances of the particular lessor and lessee.

The next requirement is that the valuation be of the "fair" annual rental. It is what is the fair rental of this land subject to the terms of the notional lease. I do not read the adjective "fair" as opening up

a wider inquiry as to the personal circumstances of either party. It is not what would be a fair rent for this particular lessee to pay because of its own business circumstances, but what is a fair rent for the premises. It is I think directed to what the hypothetical lessee and lessor could fairly expect to pay and receive for the rights and obligations undertaken in the notional lease. It is the rental which is just to lessor and lessee applying that standard. "Fair" is often used in conjunction with market, eg "fair market value", and tends to emphasise what would otherwise be implicit, namely that in considering the rents of comparable premises the valuer should disregard or discount rents which are unfair in the sense of being the product of freak or special circumstances. Certainly the presence of "fair" is insufficient to displace the hypothetical market basis which in my view is mandated by the clause as a whole in its contractual context.

Finally, viewed in terms of authority, the standard so set accords with the long standing rule laid down in *Draper & General Importing Company of New Zealand v The Mayor of Wellington* (1912) 31 NZLR 598, 605, namely that a valuer determining the valuation of the fair annual ground rent of the land:

> *"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, &c, mentioned in the lease. "*

In that regard I do not discern any significant difference between a prudent lessee and a hypothetical willing buyer/ willing seller. It follows that I am not persuaded that the umpire erred in law in his general valuation approach. and clause 20 is not of particular significance on the facts of the case. It is directed only to improvements on the demised land, here some pumps and underground tanks. Whether cl 20 requires the umpire to disregard their existence as well as their value is of no practical significance in this case.

The difficult question is whether, assuming for the moment that it is clear from the award that the umpire did so, he was entitled to value the triangle as part of a notional amalgamated block of which the other lots are deemed to be bare land unaffected by any restrictions affecting their present value.

The application of cl 20 is confined to the triangle and has nothing to say on that question. That is the subject of Mr Camp's alternative submission to which I now turn.

Assumptions as to the balance of the notionally amalgamated land:

Like the hypothetical willing purchaser, the notional prudent lessee is assumed to be a person of reasonable prudence who has informed himself or herself with regard to all the relevant facts affecting the property including its potentialities. Property is to be valued and rent to be set not merely by reference to the use to which it is being put at that time but also by reference to the uses to which it is reasonably capable of being put in the future. That is encapsulated in the highest and best use test adopted by the umpire.

In the assessment of that value the wiling lessor/willing lessee are to be regarded as possessing and taking account of all the information which prudent persons in their position would want to obtain, and which would be available to all such hypothetical parties. Any developmentpotential which involves the removal of existing buildings, compliance with or obtaining release from existing leases, or dealing with other restrictions affecting the nature, timing and cost of the development, should prudently reflect those factors unless they are excluded from consideration under the particular rent review clause. Clause 20 here is directed to buildings and other improvements on the triangle, not to considerations of those kinds affecting the development of the service station premises and the Dalgety premises.

In the absence of a contractual requirement it would be wrong in principle and bizarre in practice to assume the unimpeded development of bare land without taking account of the cost, including the time value of the money invested, in reaching that state. To do otherwise would be to ignore significant elements in any assessment of the development potential. Where the highest and best use of the land, the rent of which is being reviewed, is as part of a larger development, the higher value of the land is due to factors wholly extrinsic to the demised land.

There could be no justification for presenting a false picture of the development potential and related costs of the notionally aggregated land by refusing to take account of relevant information.

The remaining question is whether it is clear from the award that the umpire fell into that error. Mr Camp submitted that the umpire's conclusion in (4) above that "the existence of the present buildings and other improvements" was to be disregarded could only sensibly refer to buildings on the other lands since there were no buildings on the triangle. He also submitted that the umpire's further conclusion that the value of the triangle "as part of the adjoining land must have a value in the region of the overall psm value for that adjoining land" suggests that he was treating all the land in the block as notionally bare.

But the first of those findings followed immediately after the umpire had declared that the demised land was to be valued as vacant. The reference to buildings and other improvements followed the language of cl 20 and the adjective "present" may well have been a slip.

The second, in referring to the triangle "as part of the adjoining land" have a value "in the region of' the overall per square metre value for the adjoining land, is not inconsistent with allowing in the analysis of the development potential for the costs of demolition of building on the other lands and any other negative factors affecting that development. and it would be extraordinary if the two conditional agreements to which the umpire referred had not reflected that kind of assessment.

While there is some force in Mr Camp's submissions, in the end I have concluded that whether the umpire erred in law is no more than a matter of speculation. It is not possible to conclude from the reasoning in the award that, in assessing the development value of the notionally aggregated lands for the purpose of calculating the fair annual rent, the umpire proceeded on the basis that he was obliged by law to assume that the other lands were bare.

The Court being unanimous the appeal is dismissed with costs of $3,500 to the respondent together with all reasonable disbursements as fixed by the Registrar.

JUDGMENT OF MCKAY J

This is an appeal from a judgment of the High Court refusing an application to set aside the award of an umpire. The jurisdiction to set aside an award on the ground of error of law upon its face has been described by Lord Diplock, delivering the judgment of the Privy Council in *Max Cooper & Sons Pty Ltd v University of New South Wales* (1979) 2 NSWLR 257 at 261, as "an anomaly of legal history". That decision makes it clear that the error of law must appear on the face of the award as a matter of actual exposition, not as a matter of inference only, and if there

is any doubt the Court should regard this requirement as not satisfied (ibid 262). The award, of course, may refer to other documents so as to incorporate them as part of the award itself, but a mere reference is not sufficient. Unless the intention to incorporate other documents is clear, the presumption should be against incorporation (ibid 264).

The *Max Cooper* decision follows a long line of cases to similar effect, such as *Champsey Bhara and Company v Jivraj Balloo Spinning and Weaving Company Ltd* (1923) AC 480, *Giacomo Costa Fu Andrea v British Italian Trading Co Ltd* (1962) 2 All ER 53 (CA) and *Wellington City v National Bank of New Zealand Properties Ltd* (1970) NZLR 660.

In this case the award of the umpire is some seven pages in length and purports to set out the whole of his decision. He refers to the lease and quote certain clauses in full, so that those clauses have been incorporated into the award. There is no basis in the award for regarding any other documents as having been incorporated in it so as to enable other documents to be looked at in order to find an error of law.

The primary contention of Mr Camp for the appellant was that the Judge was wrong in law in holding that the rent review clause excluded a subjective approach, and therefore excluded the economics of any particular activity pertaining to the site and considerations arising from the lessee's business on adjoining but legally separate premises. He submitted that the clause in the lease required an assessment to be made which took into account all the considerations which would have affected the minds of the parties if they had been negotiating the rent themselves. It is clear from the award that the umpire rejected this approach, adopting instead the test of the notional prudent lessee. If he was wrong to do this, then there is an error on the face of the award.

The rent review clauses are set out in the award. The lessor is required to cause a valuation to be made which is to be "the valuation of the fair annual rent of the land hereby demised".

There is apparently provision for either agreement or arbitration, as clause 27 sets out the duty of the umpire "to consider the respective valuations of the two arbitrators in the matters in which the valuations do not agree".

The umpire is then to make "an independent and substantive valuation". This valuation is to be the decision of the umpire so that he is bound to make a valuation not exceeding the higher and not less than the lower of the valuations made by the arbitrators.

I think it is clear that the umpire's valuation is required to be a valuation "of the fair annual rent of the land hereby demised".

Those words and the references to "valuation" seem to me to require the application of the ordinary principles of valuation, the test being the rent which a willing but not anxious lessee would pay, and a willing but not anxious lessor would accept.

That test is not based on the expectations of the parties. In the words of Stout CJ, giving the judgment of this Court in *Drapery & General Importing Co of New Zealand Ltd v Wellington City Council* (1912) 31 NZLR 598 at 605, it is "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". I do not regard the "prudent lessee" test as differing from the "willing but not anxious lessor and lessee" test, but in either case it is a notional lessee who must be considered, not the particular lessee at the relevant date.

In a number of cases a distinction has been drawn between clauses which require a rent to be fixed for the premises by valuation, and clauses which focus on the parties as by referring to a rent to be agreed between the parties or in default determined by an arbitrator.

The distinction was emphasised by the Court of Appeal in *Thomas Bates & Son Ltd v Wyndham's (Lingerie) Ltd* (1981) 1 All ER 1077.

There the lease referred only to "such rents as shall have been agreed by the lessor and the lessee", and the Court granted rectification to provide for arbitration in the event of failure to agree. This raised a question as to the measure by which the arbitrator was to fix the rent if the parties did not agree.

It was conceded that the clause must be read as an agreement to arbitrate and not as an agreement to abide by a valuation, and on that footing the rent should be such as it would have been reasonable for the particular landlord and tenant to have agreed under the lease (see per Buckley LJ at 1087).

The same view was taken in *Lear v Blizzard* (1983) 3 All ER 662, where the lease provided for "a rent to be agreed between the parties hereto or in default of agreement at a rent to be determined by a single arbitrator", and by Barker J in *Jefferies v R CDimock Ltd* (1987) 419 and Eichelbaum CJ in *Mahoney v R CDimock Ltd* (1990) 3 NZLR 114, where the wording was similar.

I do not see how these cases can assist the appellant in the present case. The relevant clause as set out in the award makes no reference to agreement. What is to be assessed is "the valuation of the fair annual rent of the land hereby demised". If the arbitrators are unable to agree, then the umpire is to make "an independent and substantive valuation". He is not merely to arbitrate following a disagreement between the particular lessor and lessee. What is contemplated both at the initial stage and in the event of a reference to the umpire, is that the rent will be determined by a valuation as being the fair annual rent for the premises.

Mr Camp argued that the use of the expression "fair annual rental" was sufficient to bring the present case within the category of the *Thomas Bates* and *Lear* cases, in that the word "fair" required fairness as between the particular parties. The wording in *DIC v Wellington City Council,* however, was "fair annual ground rent of the said land". The "prudent lessee" test adopted in that case was again held to be the correct approach by this Court in *Wellington City v National Bank of New Zealand Properties Ltd* (1970) NZLR 660, where the lease required the rent to be fixed by two arbitrators or their umpire. In *Ponsford & Ors v HMS Aerosols Ltd* (1979) AC 63, the House of Lords held that on the true construction of a rent clause, "a reasonable rent for the demised premises" was that which was reasonable for the premises, and not what would be reasonable for the tenant to pay. The clause in that case went on to refer to the assessment being made by agreement between the parties, or if they failed to agree, then to be fixed by an independent surveyor.

The *Ponsford* case was distinguished in the *Thomas Bates'* case on the ground that it focussed attention on what was described as "a reasonable rent for the demised premises", before referring to agreement of the parties, and in default of agreement it provided for valuation by an independent surveyor. That was held to be different from a clause which referred first to fixing a rent by agreement, and in default of agreement requiring reference to an arbitrator (see per Buckley LJ at 1088).

Mr Camp referred also to the judg- 0

ment of Henry J in *Feltex v JBL Consolidated Ltd* (1988) 1 NZLR 668. There the lease required the annual rental to be fixed by agreement or arbitration, which would seem to put the case in the *Thomas Bates'* category. The Judge implied the word "fair" before the words "annual rental", and purported to adopt the "prudent lessee" test of the *DIC* and *Wellington City Council* cases. He then equated this with the tests applied in *Thomas Bates* and *Lear v Blizzard,* and accepted that market rent would not necessarily equate the fair rent between the particular parties. That is to depart from the "prudent lessee" test, but was justified by the wording of the review clause.

In many cases it will make no difference which approach is adopted. As Cooke P pointed out in *ModickRCLtd v Mahoney* (1992) 1 NZLR 150 at 155, an arbitrator could take the view that a reasonable landlord would require and a reasonable tenant would pay a rent commensurate with the optimum use of the premises, which would be a market rental. Similarly, where the rent is to be fixed by valuation as being a market rent, as in the present case, evidence of the trading results that can be achieved in the particular premises might be relevant.

Mr Camp relied upon the decision of the full Court of the Supreme Court of Western *Australia in Ricciardello v Caltex Oil (Australia) Pty Ltd* (1991) ANZ Conv R 445, and in particular a passage in the judgment of Malcolm CJ concerning the distinction between "a market rent" on the one hand and a "fair rent" on the other. He described the first as being objective, but the second as requiring the determination of "the rent which it would be fair for the particular landlord and the particular tenant to have agreed under the lease in question". The clause in that case, however, required the lessor initiate the process by giving a notice "specifying the rental increase claimed".

It went on to provide that "failing agreement as to a fair rental increase" that question was to be determined by an independent valuer.

The starting point was, therefore, the existing rental. The premises in question were, as here, a service station, and it does not appear to have been suggested that they would have had a greater value for any other use.

The valuer, whose decision was upheld by the Court, considered evidence of market value and preferred the evidence given for the lessee which was at the lower end of the range. He then considered the particular terms of the lease which differed from the normal, and he took account of the fact that the lessee could sublet his interest and achieve a rental of 2.5¢ to 4¢ per litre, due to the fact that he could negotiate in the open market, while at the same time paying a head lease rental at, say, 2¢ per litre.

This, he considered, would be most unfair, and although not likely in practical terms, was a circumstance which he considered had to be taken into account in determining a fair rental. He also took into account evidence that Oil Companies for a large number of sites were paying high rental rates, up to 4.5¢ per litre. His award was upheld.

One would have thought these considerations were all relevant to market rental, and the award could have been upheld on that basis. In so far as the decision draws a distinction between "market rental" and "fair rental", I would respectfully disagree with it.

Mr Camp's alternative argument was that even if the clause requires the umpire to adopt the market or prudent lessee test, then matters pertaining to the site and to the existence of the adjacent buildings should have been taken into account. The umpire held that the highest and best use of the small triangle of land was for it to be amalgamated with the remainder of the site. It would be absurd, said Mr Camp, to value it on such a basis if the remainder of the site had already been developed without it and was occupied by a large commercial building with an economic life of 30 years. This is obviously correct, but I do not think the umpire has assumed that the adjoining land was vacant as Mr Camp contended. The relevant passages in the award are as follows:

> *"It is accepted law the Valuers must proceed on the basis that there are no buildings or improvements on the land... "*
>
> *"That judgment* [Mahoney v Modick RC Ltd] *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. "*
>
> *"I have concluded here that the actualprofitability as related to the present use of the site is of little or no relevance here in determining the fair annual rental of the land disregarding the buildings or improvements thereon. "*
>
> *"Having decided as umpire that this land is to be valued as vacant, disregarding 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. "*

With the exception of the last of the above passages, the arbitrator is doing no more than to state what both parties accept was correct, namely, that he was required to disregard any buildings or improvements on the land comprised in the lease. The last passage refers to disregarding "the existence of the present buildings and other improvements", and Mr Camp pointed out that apart from some petrol pumps, there were no other buildings on the subject land. Therefore, he argued, the umpire must have elected to disregard the existence of the buildings on the adjoining land, and to treat the adjoining land as if it was vacant.

The sentence, however, refers to "this land", which seems to refer quite clearly to the land for which the rent is being assessed. The reference to disregarding the existence of present buildings says no more than is apparently contained in the lease, and does not necessarily imply that there were in fact buildings to be disregarded. The award must be read as a whole, and I do not think that when so read it shows that the arbitrator has ignored the existence of the buildings on the adjacent land.

There is in fact nothing in the award to show that the service station building is located entirely on adjoining land, with only the petrol pumps on the land in this lease. That fact can only be discovered by going outside the umpire's award, and that is something one is not permitted to do.

Mr Camp also relied on the following statement in the award:

> *"It is fact that this land area is relatively small at 60m2, 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 overall psm value for that adjoining land. "*

That passage appears after references to values for the adjoining land assessed by analysis of a sale agreement and references to other land values fixed by ar-

bitration awards. To say that the land in this lease must have a value "in the region" of that of the adjoining land does not suggest that the umpire has made any error of law.

The umpire approached his task by first arriving at the capital value of the land, which he approached on the basis of its "highest and best use" as being the use which would determine its value in the market.

He then applied a rate of return to this capital value in order to arrive at his rental assessment. His approach to the assessment of capital value appears to be correct and in accordance with principle. Whether the same approach should be taken to a rental assessment may be open to doubt.

The notional purchaser of the land would be likely to be someone seeking it for development in conjunction with the adjoining site.

It may follow that the notional lessee would also be a person seeking to amalgamate and develop the block, but such a lessee might not pay a rental for the next five years that would give a return on the capital value of the land for such a development.

The notional lessee would have to take account of the time required for acquisition of adjoining sites and for development, and the income to be derived during the term before the next review date. The potential value of the land for amalgamation and development might not be fully reflected in the rental which a notional lessee would pay.

However, as was said by North P in *Wellington City Council v National Bank of New Zealand Properties Ltd* (1970) NZLR 660 at 669,

> *"the Courts have consistently declined to be drawn into considering principles of valuation save in so far as they depend on purely legal considerations ... The method of valuation which finds favour with the arbitrators or the umpire is essentially a matterfor them ".*

Possibly for this reason the point was not raised in the argument before us.

For these reasons, I too would dismiss the appeal.

JUDGMENT OF TIPPING J

The first issue in this appeal concerns the construction of the vital words of the rent review clause in the lease. They are: "the fair annual rent of the land hereby demised". Such rent is to be assessed on the basis that no account is to be taken of "the value of any buildings or improvements then on the said land". The question was approached in argument on the basis of the distinction between the line of cases exemplified by *Ponsford v HMSAerosols Ltd* (1979) AC 63 and the line of cases exemplified by *Thomas Bates & Son Ltd v Wyndham's (Lingerie) Ltd* (1981) 1 All ER 1077 and *Lear v Blizzard* (1983) 3 All ER 662.

Rent review clauses of the *Ponsford* type are frequently described as objective, whereas those of the *Bates* type are often described as subjective.

As stated by this court in *Modick v Mahoney RLLtd (1*992) 1 NZLR 150these terms are potentially confusing because there is a significant element of objectivity in the so-called subjective type of clause. Nevertheless provided the concepts are truly understood the expressions "objective" and "subjective" can be a convenient form of shorthand.

The *Ponsford* type of clause is framed on the basis of what the hypothetical lessor and lessee would be willing to pay and receive for the land or premises in question.

The *Bates* type of clause looks to the rent which it would be reasonable for the particular lessor and the particular lessee to agree for the land or premises in question.

The *Ponsford* type of clause looks to the premises and what they would reasonably command by way of rent in the market, whereas the Bates type of clause looks to what would be a fair or reasonable rent as between the particular parties, albeit of course for the subject premises.

It was Mr Camp's submission for the Appellant lessee that the Umpire had wrongly construed the clause in this case as *a Ponsford* type of clause, whereas he should have construed it as being in the *Bates* category.

If the Umpire did make this error of construction then clearly it would have been an error of law apparent on the face of his award.

In *Modick* the rental for the term in question was "such rental as is agreed upon by the landlord and the tenant" and failing agreement as fixed by arbitration. Sir Thomas Eichelbaum, CJ at first instance held that this, on its true construction, was a subjective type of clause and the matter was remitted to the arbitrator accordingly.

That view was upheld by this court. It was emphasised that the true difference between the two types of clause lies in the considerations which are relevant to the determination which is to be made: see in particular per Hardie Boys, J at page 156. Usually the two approaches will or should lead to the same result.

In *a Bates* case it is only if there is some consideration particular either to the lessor or the lessee which the other ought reasonably to recognise that some difference may result from the *Ponsford* approach.

In the decision under appeal Neazor, J upheld the construction of the Umpire and I am of the view that he was entirely right to do so.

When the matter was before the Umpire, and indeed before Neazor J, the decision of this Courtin the *Dimock* case had not been given. The case had however been decided by the Chief Justice in the High Court and the Umpire had that decision in front of him.

Although I do not agree with the Umpire's reasons for distinguishing the *Dimock* case I am satisfied that he was nevertheless correct to do so. The clause in *the Dimock* case clearly focussed on such rental as was agreed between the landlord and the tenant. That is a classic *Bates* type of clause.

The high watermark of Mr Camp's contention that the clause in the present case was of a *Bates* type lay in the use of the word "fair" in the expression "fair annual rent of the land hereby demised". It is, however, to be noted that in *Ponsford* the rent was to be fixed on the basis of what was a "reasonable rent for the demised premise".

In my judgment there is no relevant distinction in the present context between the word "reasonable" and the word "fair". The point is, and this is reinforced by the provision to ignore buildings and improvements in the valuation exercise, that the review clause is looking to the land; what is a fair rent for the land. The clause speaks of the fair annual rent of the land. It is not looking to what should be regarded as a fair rent for these particular parties to pay. The exercise is hypothetical as to parties not particular.

Mr Camp prayed in aid the decision of Henry, J in *Feltex International Lt v JBL Consolidated Ltd* (1988) 1 NZLR 668. In that case the lease provided that on any renewal or extension "the annual rental" to be paid was to be such rental as was fixed by agreement between the par-0

ties or failing agreement fixed by arbitration. Henry, J held that it was proper to imply the word "fair" into the expression "annual rental" so that it read "fair annual rental".

He held that, in order to determine fair annual rental, what he described as the "prudent lessee" approach should be adopted. At page 671 His Honour said:

"Rather the enquiry is as to what a prudent lessee would pay for these premises, having regard to the term and conditions of the lease. This must represent the amount which he can reasonably expect to pay for the rights and obligations which are undertaken in the lease. That is where the element of the fairness lies, as the lessee cannot expect to receive the benefits without payment of a fair consideration for them. "

His Honour went on to refer to *Lear v Blizzard* and the *Bates* case. He also indicated that he did not see any distinction between the words "reasonable" and "fair" in this sort of clause.

The key point in *Feltex* was that the principal focus was on such rent as the parties might agree. This is what led to the clause being construed in accordance with the *Bates* approach. Henry, J's use of the expression "prudent lessee" must be read in that light and there is, with respect, perhaps a slight mixing of concepts. It should also be noted that in the passage immediately following those to which I have referred Henry, J said:

"MrDunning went onto submit, and I think rightly so, that `market rent' does not necessarily equate fair rent', because the former may exclude the subjective factors which could influence the determination of what is fair as between two particular parties. Although the distinction between market and fair rent does exist, in some circumstances the market rent may also represent the fair rent, and in others ascertainment of the fair rent may well warrant consideration of market rent. Here it was for the arbitrator to give such weight to evidence of market rent as he thought fit. "

That, with respect, is a good summary of the distinction between the two classes of case and is similar to the approach adopted by Hardie Boys, J in *Modick.*

I do not consider that the *Feltex* case helps the Appellant in the present appeal. When properly understood the clause in *Feltex* was clearly of the *Bates* type. Mr Camp also mentioned an Australian decision which was not referred to Neazor J.

The case is *Ricciardello v Caltex Oil Australia* (1991) ANZ Conv Reports 445. This was a decision of the Full Court of the Supreme Court of Western Australia. Mr Camp drew attention to the following passage from the judgment of Malcolm, CJ at page 449:

"In the context of rental valuation or assessment there is a well established distinction between `market rent' on the one hand and a fair rent' on the other. In the former case the rent is determined on the basis of the rent the premises would bring on the open market having regard to the rents paid for comparable premises in the same or a comparable area. The testis objective. In the latter case the rent is determined on the basis which it would be fair for the particular landlord and the particular tenant to have agreed under the lease in question having regard to all the circumstances relevant to any negotiations between them of a new rent from the review date. The test is largely subjective. "

His Honour then went on to say that *Ponsford* was an example of the former type of case and *Bates* and various other cases cited were examples of the latter.

Mr Camp submitted that *Ricciardello* "squarely holds that fair rent is subjective". Mr Camp seemed to be saying that if the word "fair" or for that matter the word "reasonable" appeared anywhere in the formula then the assessment must of necessity be of the so-called subjective kind. That is not correct.

Ponsford itself was a case where the word "reasonable" qualified the word "rent" but nevertheless it was held by the House of Lords, albeit by a majority, that the necessary approach was the market or objective approach.

In the passage cited, Malcolm, CJ was in my view using the expressions "market rent" and "fair rent' 'in a shorthand way to distinguish between the *Ponsford* and *Bates* lines of authority. *Ricciardello* is no authority for the proposition that whenever the word "fair" or the word "reasonable" qualifies the word "rent" in a rent review clause this means that the clause must be of the *Bates* type.

It is of the essence of the exercise that the rent ultimately fixed pursuant to either sort of clause should be reasonable or fair. Those latter words of themselves do not inevitably lead to the clause being regarded as subjective.

The matter is ultimately a question of construction. It is from the words which the parties have adopted, in their contractual setting, that their intention must objectively be derived.

This was aperpetually renewable lease with the rent to be assessed every five years. The words which the parties have used would of themselves have led me to the conclusion, in agreement with Neazor J, that they were intending *a Ponsford* approach.

That conclusion is reinforced when one considers the circumstances in which the lease was entered into and its terms. It is in my judgment inherently unlikely that the lessor of a perpetually renewable lease would have intended a rent review clause which left him vulnerable, for example, to the particular economics of the then lessee's business.

That can be one of the incidents of a *Bates* clause. It seems to me in the circumstances to be inescapable that the lessor intended to obtain at each rent review the best rent which the land would fairly command in the market, ie in a negotiation between a hypothetical lessor and a hypothetical lessee. For these reasons I do not consider that the Umpire committed any error of law in construing the rent review clause as he did.

The second issue, as ultimately summarised by Mr Camp, was this. It was argued that even if the Umpire was right in his construction of the clause he should have brought into account what Mr Camp described as adjoining site circumstances. Mr Camp submitted that it was apparent on the face of the award that the Umpire had ignored altogether the buildings on adjoining land, their tenure and the steps which would have been necessary to amalgamate and develop the whole block as one.

Mr Camp raised the further point that the Umpire had misconstrued clause 20 of the lease, being the clause which requires "the value of any buildings or improvements then on the said land" to be ignored for the valuation process.

He suggested that it was only value which should not be taken into account and that the presence of buildings or improvements on the subject land was something which ought to have been taken into account.

This argument has some initial attraction, particularly when one is talking, as in this case, about prospects of amalgamation and ultimate development of the whole site.

The argument is however academic on the facts of this case because for all

practical purposes there are no buildings or improvements on the triangle of land in question.

The point is, of course, that as demonstrated in the judgment of Richardson, J, which I have had the advantage of reading in draft, the Umpire has treated the highest and best use of the land as being realisable only as part of the ultimate development of the whole block the amalgamation point.

The essence of Mr Camp's submission on this aspect of the case was that the Umpire had treated both the adjoining land and the site in question as if they were bare land ready for development without taking into account the cost of getting the land to that state and the contractual and other impediments involved. There can be no doubt that a potential contender in the market for the lease of the site in question would be a developer of the whole block.

Such temporary impediments as there might have been in the way of amalgamation and the ultimate re-development certainly would not remove such a contender altogether.

Before proceeding further it is important to recognise that on this aspect of the case, as with the first, the attack on the Umpire's award is on the basis that there was an error of law on the face thereof. In this respect the decision of the Privy Council in *Max Cooper & Sons Pty Ltd v University of New South Wales* (1979) 2 NSWLR 257 is of importance. Lord Diplock, who gave the judgment, emphasised at page 262 that for an error of law to make an award vulnerable it "must appear upon its face as a matter of actual exposition not one of inference only". Mr Camp submitted that it was apparent on the face of this award that the Umpire had misdirected himself in law by saying that he could not take into account adjoining premises and allied considerations.

There are two passages in the Award upon which Mr Camp relied for this submission. The first appears at page 7 where the Umpire said:

> *"Having decided as Umpire that this land [meaning the triangle] is to be valued as vacant, disregarding both the economics and existence of the present buildings and other improvements, that eliminates the need to traverse quite an amount of Mr Finnis's submission [he was the lessee's arbitrator]. "*

The point is that the arbitrator's reference to "present buildings" cannot literally be correct when applied to "this land". That of course is because there are no present buildings on the land in question. It is therefore suggested that the Umpire was directing himself that he could not take into account the existence of buildings in the vicinity, these being the only buildings to which he could have been referring. I consider there is considerable force in Mr Land's reply to these submissions.

He suggested that what the Umpire was doing in this passage was simply translating the words of clause 20 of the lease into his award. Those words are: "In making the valuations referred to ... no account shall betaken of the value of any buildings or improvements then on the said land."

The Umpire has translated the word "value" in this clause into the word "economics". He has translated the word "then" into the expression "existence of the present" and he has used the word "buildings" in the plural because it is in the plural in clause 20.

I consider this to be a much more likely explanation for this slightly awkward passage in the Umpire's award than the proposition that he has directed himself to disregard adjoining buildings. That would be an extraordinary thing for a valuer to do. Taking the proposition to its extreme, it would mean that if one were to value a building or land in the centre of Wellington one would ignore the fact that Wellington City existed.

The second passage in the award to which Mr Camp referred is to be found at page 9. The Umpire said:

> *"It is a fact that this land area is relatively small at 160ml, its highestand 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 overall psm value for that adjoining land. "*

It is suggested that by his use of the expression "as part of the adjoining land" the arbitrator was already notionally treating the triangle as part of the adjoining land on a bare land basis.

While it cannot be gainsaid that at this part of his award the Umpire was notionally treating the triangle as part of an overall development, he was doing so only for the purpose of demonstrating that this was the triangle's ultimate highest and best use. I am far from satisfied from these passages, and indeed from the Award generally, that the Umpire directed himself to ignore all adjoining buildings. He brought into account the fact that there had been a conditional contract for the sale and purchase of the whole block.

He took the view, rightly in my judgment, that the proposed price in that contract, viz $15.3M, was relevant in the overall assessment.

In a passage immediately following the passage last cited from his award the Umpire posed the question:

> *"Would a prospective purchaser of the Dalgety site [meaning the whole block] pay this level [this being a reference back to the overall psm value just referred to jfor the 160m2 of land as a separate entity for future amalgamation which is desirable but not essential?"*

By implication the Umpire must be taken as having answered this question in the affirmative.

By dint of the fact that he valued the triangle at $1.248M he must have been satisfied that a prospective purchaser would have been prepared to pay this amount for the triangle in the light of the prospects of future amalgamation. As stated the conditional contract was one of the factors which the Umpire was entitled to take into account in valuing the triangle. The purchase price must have been reached on the basis of the actual state of the whole block and the tenure of the various titles.

I have already noted that, in terms of *Max Cooper,* an error of law must for present purposes appear on the face of the award by direct exposition and not by inference.

I am by no means convinced that the Umpire made any error of law of the kind I am discussing, but even if he did there is certainly no direct exposition of it in the award and at the very best it appears only by rather tenuous inference.

On the first issue I agree largely with the reasoning of Neazor, J. On the second issue my reasoning has been a little different but I arrive at the same destination. In short the Appellant has not satisfied me that there was any error of law on the face of the Umpire's award. Therefore I too would dismiss the appeal.

Solicitors:

Phillips Nicholson, Wellington, for Appellant

Kensington Swan, Wellington, for Respondent

Compensation = Injurious affection Appellant owned orchard taken for Clutha River development by agreement granting lease of land back to appellant - Provisionexluding claim for damage except for work for purposes associated with development - Roading work affects export crop whether right to claim for injurious affection precluded - Public Works Act 1981S.63.

IN THE COURT OF APPEAL OF NEW ZEALAND
CA 106/92

IN THE MATTER of the Public Works Act 1981

BETWEEN HENRY JOHN O'REILLY Appellant

AND THE MINISTER OF WORKS DEVELOPMENT Respondent

or m: Casey J
Hardie Boys J
McKay J

Hearing: 24 September 1992

Counsel: R J Somerville for Appellant
J A L Oliver for Respondent

Judgment 24 September1992

JUDGMENT OF THE COURT DELIVERED BY MCKAY J

The appellant was for many years the owner of an apricot orchard in the Cromwell Gorge. The land was required for the Clutha Valley development and will be submerged as the filling of Lake Dunstan proceeds. It was acquired by the Crown under the Public Works Act 1928 by an agreement dated 4 September 1979, and compensation of $74,287 was paid. That agreement included a provision by which the Crown offered the appellant a lease of the land for six years from the date of settlement on terms set out in an attachment to the agreement.

The appellant accepted the offer of a lease, and an agreement to lease was entered into dated 4 May 1981. The lease was for a term of 6 years from and including 10 October 1979, at a rental of $5,400 payable quarterly in advance. By clause 14 the lease was terminable by the lessee at any time on 3 months' prior written notice. By clause 15 the lessor was given the right to terminate the lease in the event of the land being required by it for any purpose, subject to the giving of 12 months' written notice to coincide as near as possible with the end of a fruit growing season. No compensation was to be payable to the lessee for early termination under this clause. The other significant provisions, for present purposes, were the following:

"4 TO permit the Lessor or her agents to enter upon the said land and to carry out work for purposes associated with hydro-development provided reasonable prior notice is given.

8 THAT the rental shall be reviewed as at 10th October 1982 to a rental agreed upon between the parties hereto or failing agreement to be settled by arbitration in accordance with the Arbitration Act 1908 PROVIDED that the Lessee may have the rental reviewed if and when the Lessor renders part or parts of the said land incapable of being utilised for horticultural purposes.

9 THAT the Lessee acknowledges that the land is liable to damage by the Lessor's operations in accordance with Clause 4 hereof and accepts that the Lessee shall have no claim whatsoever against the Lessor for damage to the land or any improvements thereon caused by the Lessors operations save and except the right of rental review as provided in Clause 8 above. "

A memorandum of variation of the lease agreement was entered into on 17 May 1983, by which the rent was reduced to $3,740 for the year commencing 10 October 1982 and payment of that rent was to be made on or before 31 March 1984. For the remaining two years of the lease the rent was to revert to $5,400 per annum, payable quarterly in advance. Clause 2 contained a proviso in the following form:

"PROVIDED THAT the Lessee may have the rental reviewed to a rental agreed upon between the parties hereto or failing agreement to be settled by arbitration in accordance with the provisions of the Arbitration Act 1908 if and when the activities of the Lessor pursuant to clause 4 of the said Agreement result in part or parts of the said land becoming incapable of being utilised for horticultural purposes. "

On 22 December 1988 the appellant lodged a claim to compensation under section 63 of the Public Works Act 1981, alleging that his interest as lessee had been injuriously affected by a public work, namely the roading and blasting work carried out during 1983-84 on the section of road opposite the orchard. The claim alleged dust damage to the appellant's export apricot crop as a result of which it did not reach the standard of cleanliness required for export, and damage from falling debris and rocks which are said to have fallen on the orchard and caused damage to land and buildings.

The matter came before the High Court on a preliminary question of law whether such a claim was precluded by certain provisions in the relevant documents, in particular clause 9 of the lease agreement of 4 May 1981. The Judge held that clause 9 applied, and that the only remedy that the appellant would have for damage arising from the operations of the Crown in the area was either to withdraw from the lease or to endeavour to negotiate a lower rental. The claim was accordingly dismissed. The present appeal is from that judgment.

Mr Somerville for the appellant accepted that the appellant would have no claim if clause 9 had not included the words "in accordance with clause 4 hereof'.

The lessee's acknowledgment in the first part of clause 9 was that the land was liable to damage by the lessor's operations in accordance with clause 4, under which the Crown was permitted to enter on the land and to carry out work. What was contemplated, he said, was damage caused by the Crown's entry on the land for the purpose of carrying out work.

The second part of the clause provided that the appellant should have no claim for damage caused by the lessor's operations, and this was subject to the same limitation. It referred back to the same words "lessor's operations" earlier in the sentence, and imported the same qualification referring to clause 4.

Mr Oliver for the respondent accepted that the reference to "Lessor's operations" in the second part of clause 9 was similarly qualified by reference to clause 4, but he submitted that clause 4 gave the Crown as lessor two quite separate and independent rights. The first was a right of entry on the land.

The second was the right to carry out work for purposes associated with the hydro development. such work was not limited to work on the land itself, but extended to work carried out elsewhere. It extended to the work on which the present

claim was based, which was carried out on the other side of the river, but affected the appellant's land.

We think this is a forced construction of clause 4. The obvious meaning of the clause is that the lessor is permitted to enter on the land and to carry out work for purposes associated with the hydro development.

The entry on the land and the carrying out of work are both to be for suchpurposes, and both are subject to the requirement of reasonable notice. The Crown did not need the permission of the lessor to carry out works not involving entry on the land, unless it could be suggested that what was contemplated was a permission to carry out works which might otherwise constitute a nuisance. That would be a sufficiently unusual provision that if such was the intention, one would expect it to be dealt with separately and explicitly. The obvious and natural meaning of the clause is that the lessor is permitted to enter on to the land and to carry out work on the land for purposes associated with hydro development.

The right to claim for injurious affection where no land is taken was conferred for the first time by section 63 of the Public Works Act 1981. That Act was enacted on 3 October 1981 but did not come into force until 1 February 1982. Mr Oliver accepted that the provisions of section 63 would not have been in the contemplation of the parties when they entered into the agreement of 4 May 1981.

Mr Oliver's second submission was that regard should be had to the earlier documentation in order to determine the intention of the parties.

It was this argument which was adopted by the Judge. He considered that the wording of clause 9 was ambiguous, and that he was entitled therefore to have regard to the prior documents. He referred to the original agreement of 4 September 1979 and to the terms on which the lease was offered.

Those terms included the following:

"4. The Lessee reserves the right to have the annual rental reviewed if and when the action of the Lessor renders part or parts of the said land incapable of being utilised for horticultural purposes.

5. The Lessee shall permit the Lessor, or its agents the right of ingress and egress and or carrying out work for purposes associated with hydro development, provided reasonable prior notice is given.

6. The Lessee acknowledges that the land is liable to damage by the Lessor's operations and accepts that the Lessee shall have no claim whatever or howsoever by or against the Lessor for damage to the land or any improvements thereon caused by the Lessor's operations. "

It will be noted that clause 6 refers to damage "by the lessor's operations", and acknowledges that the lessee is to have no claim for "damage to the land or any improvements" caused by those operations. Those words are of the widest scope, and are not subject to any such limitation as is contained in the later document. Mr Somerville conceded that if the later document had followed the wording of the original offer, the appellant would have no claim.

The Judge did not regard the earlier document as being mere evidence of negotiation or of subjective intentions, but as evidence of what the parties agreed. He accepted that where such an agreement is intended to be followed by a formal document, the parties cannot refer to the earlier agreement to defeat the clear wording of the later formal document, but he said:

"That is not the case here. There is an ambiguity arising from the words used in clause 9 of the document and I am satisfied that clause 9 does not apply only to damage caused by the operations of the Crown following an entry on the leased land, but applies as is stated in the latter part of clause 9 so as to prevent any claim against the Crown fordamage to the land orany improvements thereon caused by the lessor's operations. "'

We respectfully disagree with the Judge as to clause 9 of the later document. We agree that if clause 9 were ambiguous, then it would be permissible to refer to the prior agreement as an aid to its proper construction, although it is the later document which must govern the situation and which is to be construed. We do not, however, find any ambiguity in clause 9. It is an acknowledgment that the land is liable to damage from the lessor's operations under clause 4, and an acceptance that there is to be no claim in respect of those operations.

It deals only with operations in accordance with clause 4. That clause refers to work carried out pursuant to the lessor's right of entry on the land, and cannot apply to activities on other land.

The provision for review of rental in clause 8 does not appear to us to assist the Crown. It applies when the lessor renders part of the land incapable of being utilised for horticultural purposes, which is a different situation.

Mr Oliver referred to other provisions in the 1981 document as evidencing an intention that there should be no compensation.

These included clause 10, under which there was no obligation to repair or maintain building or improvements; clause 13 under which there was to be no compensation for improvements following termination or expiry; clause 14 entitling the lessee to terminate on three months' notice; and clause 15, under which no compensation was payable in the event of the lessor requiring the land and giving 12 months' notice.

None of these provisions, however, address the question of compensation for injurious affection as a result of activities carried out on other land. The right to such compensation was conferred by statute on 1 February 1982, and it is not surprising that the 1981 agreement did not deal with it.

One cannot, however, write into the agreement an exclusion of liability which was not in the contemplation of the parties at the time.

Mr Oliver also referred to the low rental for the property, which recognised the risk and uncertainty of crop yields in the orchard.

The rental of $5,400 on land valued for the purposes of compensation at $74,287 may be lower than an ordinary market return, but given the uncertainty of tenure, the location and the specialised nature of the land use, this would not be surprising. It does not call for any further explanation by way of construction of clause 9. In any event, however, the wording of clause 9 is clear, and such considerations are irrelevant.

We accordingly allow the appeal and set aside the orders made in the High Court.

We allow the appellant costs in this Court in the sum of $2,500 together with disbursements, including the cost of printing and the reasonable travel and accommodation expenses of counsel, as fixed by the Registrar. The question of costs in the High Court is to be dealt with by that court.

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