

PRELIMINARY GOVERNMENT RESPONSE TO REPORT OF THE HIGH COUNTRY PASTORAL LEASES REVIEW 2006

Introduction

- 1 The High Country Pastoral Leases Review (“Review”) has been carried out by a panel of three senior valuers, Donn Armstrong, Bob Engelbrecht and Rodney Jefferies (“Valuers”). The Review addressed South Island pastoral lease rental and tenure review valuation methodology. The Government has considered the Report and this paper sets out a preliminary government response (“Response”) to the Report.
- 2 The Government recognises the contribution of the high country to the economy of New Zealand, encourages sustainable high country farming, and is mindful of the potential impact of increased costs on the viability of the merino industry.
- 3 The Report and Response have significant implications for both the Crown and pastoral lessees. The Crown (as lessor) will consult with high country farmers to review options to address these implications and reach an outcome that is fair and reasonable for both parties and durable.

Background

- 4 The Crown owns 2 million hectares of high country land, located from Marlborough to Southland, which is leased or licensed. Pastoral leases were established under the Land Act 1948 (“Land Act”) although land in the South Island high country has been licensed or leased since the 1850s. Much of the high country land is environmentally sensitive (i.e. prone to soil erosion, pest incursion and natural fire spread). The Land Act was drafted with the intent of giving leaseholders an incentive to manage these environmental values in an appropriate manner (i.e. to act as a steward of the land). The Land Act granted lessees secure rights to the land (perpetual right of renewal), exclusive occupation of the land, and the right to use the land for a limited purpose, namely pastoral farming. The rent is set at 2.25% (2% if paid on time) of the land value exclusive of improvements (“LEI”).
- 5 In the late 1990s, the Government commenced a process of tenure review as a means of meeting both production and conservation objectives for the South Island high country. Tenure review is a voluntary process which, since 1998, has been carried out under Part 2 of the Crown Pastoral Land Act 1998 (“CPLA”). Part 2:
 - a. enables land with significant inherent values to be protected through a range of measures from restoration of the land to full Crown ownership under Department of Conservation (“DOC”) administration to protective covenants;
 - b. enables leaseholders to gain freehold title of high country land (except in those cases where all the land is proposed for conservation); and

- c. improves public access to the high country.
- 6 In recent years, the market value of certain parts of land in the high country perceived to possess desirable characteristics (i.e. amenity values¹, such as access to attractive land or views) has appreciated substantially. This has led to increased value being derived from the sale of pastoral leases.
- 7 Concerns have been raised publicly by some stakeholders (notably environmental NGOs) that the Crown is receiving rental from lessees at a level that does not fairly reflect the value of the land or a lessee's rights under a pastoral lease. This view asserts that the right of exclusive access a lessee has to any amenity values is undervalued or ignored. Consequently, these stakeholders believe that the Crown when participating in tenure review is forced to pay a premium for land returned to full Crown ownership because the Crown's interest is undervalued and the lessee's interest overvalued. In other words, there are concerns that lessees are unfairly benefiting from both concessionary rents and capitalising the benefits of lower than proper rents when parts of the leases are transferred back to the Crown pursuant to tenure review.
- 8 In 2000, LINZ commissioned and received a report on valuation methodology for pastoral lease valuation from Telfer Young. In 2003, LINZ commissioned and received a tenure review valuation review from DTZ New Zealand Ltd. However, concerns have persisted about the valuation methodology for pastoral lease land.
- 9 The Government responded to these concerns by initiating the Review and the Valuers have provided their Report to LINZ. The Government has considered the Report and this paper sets out below a preliminary government response to the Report.

Response

- 10 The methodology for valuing pastoral leases for rental calculation purposes is set out in the Land Act. The Report noted that pastoral leases are different to open market rural leases, and the Valuers were of the opinion that there was no requirement for lessees to pay rental on amenity values. The Report also concluded that the current methodology achieved "fair" outcomes for lessees by importing an "affordability" consideration into the calculation.
- 11 However, the Report also concluded that this approach may not strictly comply with the current legislation. Officials agree with that conclusion, and sought to clarify the framework within which such valuations are made.
- 12 The clarification process established that, for a valuation to comply with the Land Act, amenity values must be included. Consequently, given the current market demand for land with high amenity values, in some cases rentals may exceed what is affordable based on income generated from pastoral use alone

¹ "Amenity values" include inherent and locational, values and natural characteristics.

- 13 The essence of the issue currently at hand is how to accommodate the achievement of the Government's following high country objectives:
- a. to obtain a fair financial return to the Crown on its high country land assets (through a fair rent that reflects the level of Crown ownership interests); and
 - b. to foster sustainability of communities, infrastructure and economic growth and the contribution of the high country to the economy of New Zealand (recognising that high country farming and the merino industry contribute considerably to this objective).
- 14 A consideration of the legislative framework has resulted in the following preliminary responses to the issues raised in the Report.

The Crown should charge rent for amenity values of pastoral lease land in compliance with the Land Act.

- 15 Current law requires the Crown to use the valuation formula for calculating renewal rent set out in the Land Act, s 131. Rental is calculated as a percentage of the LEI Value, as ascertained under s 131.
- 16 The Report takes the view that lessees are prevented from deriving value from amenity values because they have only a right of pasturage over the land and should therefore not pay rent for amenity values.
- 17 The Government considers, however, that s 131 of the Land Act requires amenity values to be taken into account in rental calculations. This is likely to result in rent increases for Crown pastoral land that is perceived in the market to possess amenity values. The Crown owns the land that is subject to a Crown pastoral lease. The capital value of that land will include any amenity values, and those values are owned by the Crown. Amenity values are part of the entirety of the lease. In granting a pastoral lease, the Crown allows the lessee to exclusively occupy and farm the land subject to the terms of the lease and other legislative restrictions.
- 18 Through their exclusive right of occupation of pastoral lease land, lessees obtain the exclusive enjoyment of any amenity values that are part of the land they lease. This exclusive occupation and enjoyment of amenity values has been attributed increasing value by the market. Section 131 of the Land Act intends that values recognised by the market are to be reflected in the values assessed for the calculation of rents – the capital value is central to the ascertaining of values under s 131.
- 19 Proper application of s 131 will have the impact of increasing rents for Crown pastoral leases perceived to possess amenity values. In some cases, rentals may exceed what is affordable based on income generated from a pastoral use of the land. The consequences of this and options for responding to affordability will need to be examined.

- 20 Placing the above comments in context, the valuation formula for calculating renewal rent, set out in s 131(1) and provisos of the Land Act should be applied as follows:
- a. the LEI Value must take into account locational factors including proximity to transport, schooling, farm and domestic suppliers, freezing works, saleyards and services such as mail delivery and school buses;
 - b. the amenity values on which the market places value contribute to the total sum (“Capital Value”) that is realised for the land and improvements if sold by the lessee. They are not part of the lessee’s improvements. They are part of the land exclusive of improvements (“LEI”) and must be included in the valuation for rental calculation purposes;
 - c. to meet the requirement (proviso (i)) that equal emphasis be placed on ascertaining the LEI Value and the Improvements Value (“Values”), where either is arrived at as a residual value, it must be robustly ascertained and cross-checked; and
 - d. in meeting the requirement (proviso (ii)) that the Values must be ascertained on an equitable basis, having regard to the relationship between the lessor and the lessee, valuers must ensure that a fair value is ascertained for both the improvements and for the land. The Values must not be adjusted to reduce the effect of amenity values on the LEI Value, thereby arriving at a Capital Value that does not accord with the market.

The formula for setting rent is not inherently contradictory

- 21 The Valuers' finding that the statutory formula for setting rent is inherently contradictory was based on a misinterpretation of the Land Act's requirements. When the requirements of s 131 of the Land Act are examined carefully, it can be seen that the Act provides an appropriate framework for valuing pastoral lease land. The Valuers did not take into account that lessees can, and do, realise the real capital value of their leases when they are sold, due to the high value of the amenity values of the properties.

Some rents are currently being charged at a lower rate than is legally required

- 22 The Valuers are of the view that lessees should only be charged rent for pasturage rights only. Due to some valuers not applying the s 131 framework as discussed above, it is apparent that some rents are currently being charged at a lower rate than the legislation requires.

Rental valuation should not be based on the original stock unit carrying capacity

- 23 The Report recommends that rent be based on original stock unit carrying capacity on the basis that it would provide for rentals that reflect the land use restrictions placed on lessees. This approach is not favoured as it would not take into account the amenity values of which lessees have exclusive possession. Instead, valuers should be instructed to adopt the above approach to the current law for reasons of legality and fairness.

- 24 A valuation based on stock units raises issues of fairness between lessees of Crown land. In addition, it raises issues of fairness of rental return to the taxpayer for the Crown's interest in the asset. It would also conflict with the Government's objective of obtaining a fair financial return for the Crown on its high country land assets.

Affordability

- 25 Affordability of rents is not a factor central to the rent setting process. Rather, several provisions in the Land Act seek to achieve fairness for the lessee. Values must be ascertained in a way that is equitable between lessor and lessee (s 131(1) (ii)). Following the valuation process, a lessee has several choices, including accepting the rental valuation as notified or requiring that the values ascertained under s 131(1) are determined by the Land Valuation Tribunal ("LVT") (s 132).
- 26 The government intends to consult with lessees and stakeholders on the implications of applying the proposed methodology above to rental valuations, and on options for addressing these implications. The objective is to reach a solution which is fair and reasonable for both parties and durable.

Tenure review valuations will be affected

- 27 The rental stream from a pastoral lease is a major component of the value of the Crown's interest for the purpose of tenure review. Applying the Valuers' approach would result in the Crown's interest in pastoral land being undervalued, and the lessee's interest in pastoral land being overvalued during the tenure review process.

Transaction prices for tenure review should be made publicly available

- 28 There is merit in the argument for more transparency in transaction costs. Transaction prices are now supplied on request. Further consideration is needed, however, about how this data could best be made publicly available.

A group, similar to the former Land Settlement Board, should not be established to improve the relationship between the Crown, lessees and the public

- 29 It is not considered that such a group is necessary at this stage as there are existing means for the Crown and stakeholders to exchange views.

Implications of the preliminary government response for lessees and the achievement of the government's high country objectives need to be considered

- 30 The Crown's valuations must be consistent with the law. The Government wants to work with lessees to ensure the full implications of the likely rent increases are understood. It is not the Government's intention to make rents unaffordable for the lessees, although this may be a result of the rent increases for some lessees whose income is generated from pastoral use alone. Unaffordable rent would serve neither the Crown as landowner nor lessees as

this could place sustainable land management and the pastoral farming industry at risk.

- 31 Officials will also consider the implications of the above methodology for the achievement of the government's high country objectives, in particular, the tensions between the objectives to:
 - a. promote the management of the Crown's high country land in a way that is ecologically sustainable;
 - b. foster sustainability of communities, infrastructure and economic growth and the contribution of the high country to the economy of New Zealand; and
 - c. obtain a fair financial return to the Crown on its high country assets.

Next steps

- 32 The Crown, undertakes to consult with its lessees on the implications of the application of the above methodology and possible ameliorating options. The objective is to reach a solution which is fair and reasonable for both parties and durable.
- 33 Officials from LINZ, MAF and DOC will consult with lessees in October and November 2006 to understand better the implications for lessees and to discuss the possible options to address these implications.
- 34 The Valuers will consider the analysis of submissions and a final Report will be provided to LINZ thereafter.
- 35 Officials will report to the Minister for Land Information in March 2007 with advice on a way forward.
- 36 Submissions can be sent, in writing, by 15 December 2006, to:

High Country valuations review submissions
c/o Land Information New Zealand
Private Box 5501
Wellington 6145

Or by email to: valuation-review@linz.govt.nz