

CROWN PASTORAL LEASES — EARNING CAPACITY RENTS

Proposal

1. I propose Cabinet agrees to a new system for setting rents on Crown pastoral leases based on the earning capacity of the lease. The proposal in this paper is to be read with the proposal in the companion paper: *Crown Pastoral Leases – Policy for Time Payment of Back-Rent*.

Executive Summary

2. I propose a new system for setting rents for the 231 Crown pastoral leases that cover 1.6 million ha of Crown land mostly in the South Island high country. Crown pastoral leases are perpetually renewable every 33 years, are subject to rent review every 11 years, and require the land to be used for pastoral farming. Land Information New Zealand administers Crown pastoral leases on behalf of the Commissioner of Crown Lands (the statutory landlord).
3. The new system has been developed to implement one of the future directions for Crown pastoral land agreed by Cabinet on 27 July 2009: “lessees of Crown pastoral land will be charged rent on the basis of the earning capacity of the property” (CAB Min (09) 27/6C).
4. This paper has been developed in conjunction with the Ministers of Agriculture and Conservation (acting, with me, as South Island High Country Ministers). Officials consulted with a subcommittee of the High Country Accord when developing the proposals in this paper.
5. I propose an entirely new rent-setting system because the existing system – based on land values – cannot (even if modified) effectively produce earning-capacity-based rents.
6. The new system sets earning capacity rents by:
 - 6.1. capturing the productive capacity of what has been leased in standard stock units
 - 6.2. assessing the current net value of those stock units by using objective data about the current economics of high country farming
 - 6.3. calculating rent by reference to the net value of the stock units.
7. I propose two additional components to support the new system:
 - 7.1. a modern alternative dispute resolution process

- 7.2. a role for the Valuer-General (as an independent statutory officer) who will fix details of the system and provide guidance and data to help with the system's implementation.
8. The new system will directly measure the earning capacity of Crown pastoral leases for their statutory purpose — pastoral farming. Rents will rise if the net value of a stock unit increases. The new system also contains a 'floor' so that a minimum rent will always be payable.
9. At present 113 lessees are disputing rents set under the existing system, and more disputes are expected. To facilitate early resolution of these disputes, I propose an opt-in provision allowing lessees to reach a settlement by having rents fixed under the new system.
10. Analysis by officials and an expert peer review panel shows the existing system or any system based on land value:
 - 10.1. will not reliably capture or track the earning capacity of a Crown pastoral lease
 - 10.2. will not produce consistent, transparent, or auditable results across all Crown pastoral leases.
11. I consider that the new earning capacity rent system will be more stable and produce rents that are disputed less often.
12. Modelling by officials shows the new earning capacity rent system should produce a rental return to the Crown within the same range as the existing system. The new system should carry lower administration costs for the Crown and lower compliance costs for lessees if they wish to dispute rent assessments.

Background

13. Land Information New Zealand administers 231 South Island high country Crown pastoral leases on behalf of the Commissioner of Crown Lands (the statutory landlord). A Crown pastoral lease:
 - 13.1. is perpetually renewable every 33 years
 - 13.2. is subject to rent reviews every 11 years
 - 13.3. requires the land to be used for pastoral farming.
14. Rent for pastoral leases is 2.25% (or 2% if paid promptly) of the *value of the land exclusive of improvements* (VLEI). This VLEI rental formula is set out in the Land Act 1948 and Crown Pastoral Land Act 1998.
15. VLEI figures and the methods used to arrive at VLEI are the source of increasing dispute between the Crown and lessees. Land values have increased rapidly in recent years, however VLEI has proven unable to fully take account of a rapidly growing difference between a pastoral lease's market value and its pastoral rental value.

16. In response to these disputes, Cabinet agreed on 27 July 2009 that “lessees of Crown pastoral land will be charged rent on the basis of the earning capacity of the property” (CAB Min (09) 27/6C).
17. In August 2009, South Island High Country Ministers (the Minister of Agriculture, the Minister of Conservation and me as Minister for Land Information) directed officials to write a report on implementing the earning capacity rent policy. We set terms of reference for the report that included the following objectives:
 - 17.1. Propose an efficient and effective method for setting rents under Crown pastoral leases based on the earning capacity of properties, including a discussion of the impact of retrospective application.
 - 17.2. Determine whether the proposed method can be implemented within the current legal framework.
 - 17.3. If the proposed method cannot be implemented within the current legal framework, then recommend any changes required to implement the method.
18. The resulting report – *Earning Capacity Rents for Crown Pastoral Leases* (the ECR report) – proposed a new system for setting pastoral lease rents. The ECR report is attached to the Regulatory Impact Statement accompanying this paper.
19. Officials worked with a subcommittee of the High Country Accord when developing the rent-setting proposals in the ECR report. The Accord is a trust which represents the interests of a majority of pastoral lessees.
20. The ECR report was independently peer reviewed by Howard Fancy (Chair), Sir Thomas Gault and John Larmer (an experienced valuer). This peer review panel provided quality assurance on the policy, legal, and valuation elements of the report. The panel agreed that the overall package of recommendations in the ECR report will be a significant improvement over the current system. The panel’s report is attached to this paper.
21. The proposals in this paper are consistent with the ECR report recommendations. They are supported by South Island High Country Ministers. The proposals are supported in principle by the Accord, except for one area detailed in paragraph 66.
22. Both the current rent-setting system and the new system set rents only for pastoral activities. Charges for non-pastoral activities such as recreation permits will continue to be regulated by section 66A of the Land Act 1948.

Comment

Shift away from rent based on land value

23. Three options for implementing the earning-capacity rent policy were identified and analysed. Option 1 was to retain the status quo (current land-value-based

system). Option 2 retains the land value approach, but with minor changes to clarify the valuation methods and better dispute resolution.

24. Option 3, a production-based system, measures the earning capacity of the lease by reference to its pastoral production. This option shifts the focus of the rent-setting formula from land value to the capacity of pastoral leases to produce outputs from pastoral farming.
25. It was clear from the options analysis that options 1 and 2 could not meet the objective of delivering an efficient and effective method for setting rents based on the earning capacity of properties. There are two fundamental problems with the land value approach to rent setting that cannot be overcome by system modifications.
26. First, the current system relies heavily on subjective assessments of land value. This makes it difficult to achieve a consistent, transparent or auditable approach to rental valuations across all Crown pastoral leases. The resulting uncertainty means that rent disputes automatically become complex disputes about valuation practice. Such disputes are much more difficult to resolve than typical commercial rent disputes.
27. Currently 113 rental disputes have been referred to the Land Valuation Tribunal for resolution since 2002 and more are expected if the current system is continued. All are currently on hold awaiting either the implementation of the earning capacity rent policy or the resolution of a test case currently under appeal.¹ Even with a final decision on this appeal, the remaining cases will be hard to resolve under the current system.
28. Second, the current land value system is not very effective at tracking the earning capacity of a property. Links between land value and the income that can be generated from a given lease have become increasingly tenuous. Land values in the South Island high country have risen markedly, while returns from pastoral farming have decreased.
29. More detail about why the current system does not work and the analysis of options appears in Appendix 1.

Proposal for production-based rent

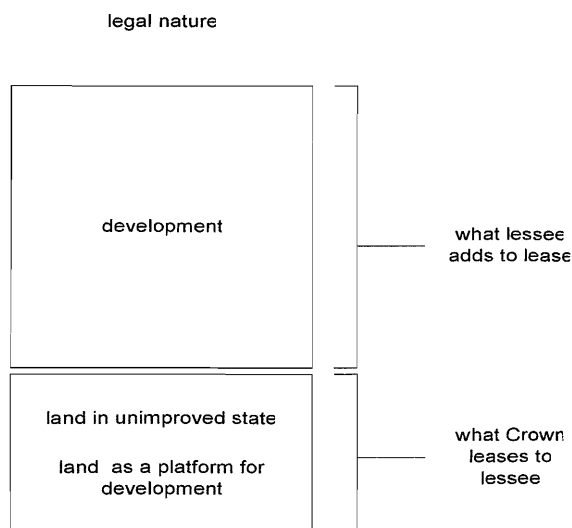
30. The ECR report recommended Option 3 – a new production-based system – as the preferred option for implementing the Government’s earning-capacity rent policy. The production-based system measures the earning capacity of a lease by assessing the productive capacity of the lease and the economic conditions at the time rent is set.

¹ Commissioner of Crown Lands v Minaret Station Ltd.

31. The new production-based system will set rents by:
 - 31.1. assessing the productive capacity of a lease as a pastoral farming operation
 - 31.2. using statistical data about farm revenues and how much farmers are paying to use land with the same productive capacity.
32. This system completely separates rent from land valuation issues. It will reduce subjectivity by relying on objective data as much as possible while reducing the areas for argument and dispute. It will also clearly capture and track the earning capacity of Crown pastoral leases.
33. The system produces earning capacity rents by using a formula that measures productive capacity and economic conditions through the application of objective data. The new system and formula (set out in paragraphs 43 to 77 below) is capable of producing consistent, transparent and auditable results.

Recognition of property rights under pastoral leases

34. One of the ECR report objectives was to determine whether the proposed method can be implemented within the current legal framework. The legal framework for rent-setting includes the legal nature of a pastoral lease as shown below:



35. The legal nature of a pastoral lease is that it is effectively a ground lease or “Glasgow” lease, where the lessor is entitled to a rental return on the value of the land only, excluding the benefit of any value which the lessee adds by development or improvements (as defined in the legislation). The intention of a Glasgow lease is that the lessee’s contribution to the capital value of the property is taken out of the rental equation.
36. The lessor is entitled to the benefit of any increase in the value of the land that does not come about through the lessee’s efforts in permanently improving the land (referred to as the “platform for development” in this paper).

37. The current system recognises that what is leased also includes a platform for development. The problem is that it does this in an indirect and non-transparent manner.
38. I consider that any rent system based on earning capacity must set rents on the aspects that are actually leased by lessees from the Crown, namely:
- 38.1. the land leased in an unimproved state
 - 38.2. the land as a platform for development.
39. The production-based system meets this requirement. It accounts specifically for the unimproved land by assessing the original productive capacity of the lease. It also recognises the platform for development clearly and transparently by measuring increased production from improvements and attributing a set portion of that increase to the platform for development. In recognising these separate aspects, the production-based system recognises the property rights and obligations inherent in a pastoral lease.
40. This is important as lessees have made investment decisions based on the respective obligations and interests of lessee and lessor. Lessees correctly expect they will get the benefits of increased value or production as a result of their own efforts without their rent being affected beyond the scope of what is attributed to the platform for development.
41. Since the creation of pastoral leases in 1948, lessees have invested heavily in improvements to increase productivity. As originally intended when the Land Act introduced perpetually renewable leases, most leases have been the subject of sustained development through fencing, topdressing, pasture management and improved access. Officials estimate the average lease has been improved 700% over its original productive capacity in an unimproved state.
42. Pastoral lease rents will continue to be set every 11 years. This is also in accordance with the current property rights of a pastoral lease. I have considered whether a more frequent review period may be appropriate under the new system. Officials have advised me that changing to a more frequent review period is inconsistent with the current legal nature of a pastoral lease and I agree with that assessment.

How rents will be set

43. The rent-setting system I propose applies objective data about the productive capacity of a lease and high country farming economic conditions. The formula the system uses for calculating rent is as follows:

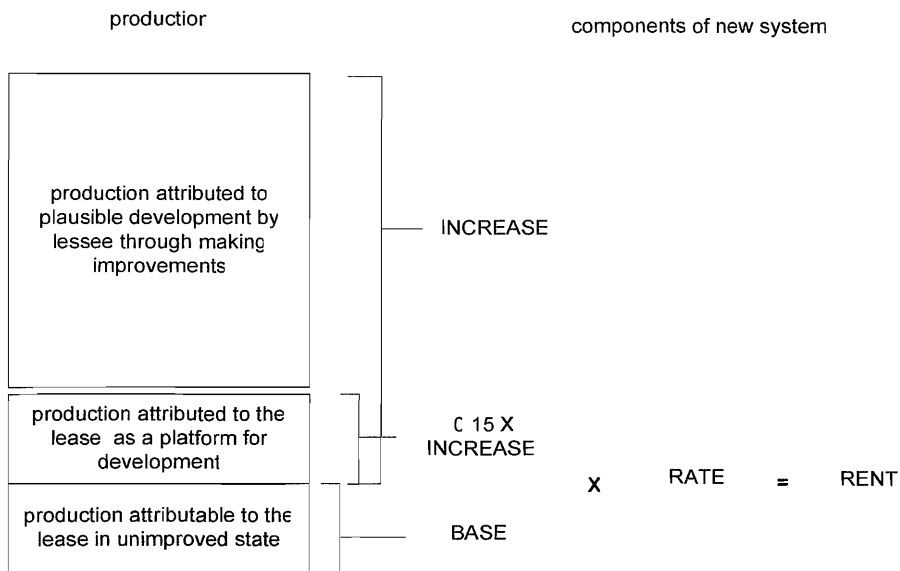
$$\text{Rent} = \text{RATE} \times (\text{BASE} + (\text{INCREASE} \times 0.15))$$

44. Three key pieces of data populate the formula:
- 44.1. a dollar-per-stock-unit rental rate calculated from economic data, referred to above as RATE
 - 44.2. the base carrying capacity (in stock units) of the original unimproved land – referred to as BASE

44.3. the increased production attributable to improvements made by the lessee – referred to as INCREASE.

45. Under this rent formula, a fixed proportion of 15% (or 0.15) of the increased carrying capacity made possible by improvements (INCREASE) is attributed to the development platform the Crown has provided to the lessee. This proportion attracts rent.

46. The new system is illustrated in the following diagram:



47. The diagram shows that the new system will attribute production to the components of the lease discussed in paragraph 38. A rate is then applied to arrive at a rent.

Productive capacity will be measured in two parts using standard stock units

48. The diagram above shows that rent will be set by attributing production to the two components of a pastoral lease:

- 48.1. BASE (in stock units) attributes some production to the unimproved state of the land. BASE is set once, with that figure being used for all subsequent rent reviews
- 48.2. INCREASE (in stock units) attributes some production to the platform for development the lease provides. INCREASE is set at every rent review in a two-step process:
 - 48.2.1. Step 1 – assessing plausible increased production above BASE
 - 48.2.2. Step 2 – attributing a proportion (0.15) of that increased production to the platform for development.

49. The new system will use standardised stock units. The stock unit is a readily understood measure that directly relates to the ability of a farming operation to produce income. An agreed definition of stock unit will be used for this work;

conforming to best practice determined by the Ministry of Agriculture and Forestry.

*Attributing a portion of production to the lease in an unimproved state — **BASE***

50. Base carrying capacity (BASE) attributes a portion of production to the lease in an unimproved state. Unlike the current system, which requires valuers to imagine land in an unimproved state, the system I propose would assess base carrying capacity as far as possible from objective scientific data about land types found on the lease.
51. Data about land types and the stock they can support can be derived from databases like the New Zealand Land Resource Inventory maintained by Landcare Research. Such databases record fundamental characteristics of land such as slope, altitude, underlying lithology and soil types. These characteristics change very slowly over time and current data can be used to determine historic details.
52. Where required, historic data can be used to refine the objective data on an individual lease.
53. Base carrying capacity does not change. I propose that it is set once and recorded on all pastoral leases, which are all registered in the land transfer system.
54. Officials envisage that the Valuer-General would provide indicative figures for base carrying capacity. The Valuer-General would also provide guidance on how to make any more refined assessments of base carrying capacity that might be needed for individual leases.
55. There will be one-off costs to set base carrying capacity for each pastoral lease. Over time these costs should be offset by simpler and cheaper rent reviews.

*Platform for development step 1: measuring the increased production — **INCREASE***

56. The total number of stock units a property can carry after improvements will be assessed at each rent review to determine a plausible current carrying capacity for a lease.
57. Subtracting base carrying capacity from plausible current carrying capacity will show the improved carrying capacity; this is the extra production the rent system attributes to lessee improvements (INCREASE).
58. The ECR report concluded that the best way to assess the plausible current carrying capacity of a lease was by using the concept “average efficient carrying capacity”. This concept, which captures the average of what efficient farmers could achieve with a similar property, is well understood by rural valuers, farmers and farm advisors.
59. Average efficient production generally lies above the average or median of actual production, but falls short of what the outstandingly successful farmers

are achieving on similar country. The average efficient production of a lease will increase over time as new techniques for managing pasture, crops and stock improve.

60. Any given farm may not actually be carrying the average efficient number of stock units. However, using this measure provides an incentive to under-performing lessees to increase their productivity without penalising over-performing farmers for their efforts.
61. Assessments of average efficient carrying capacity will take lease-specific characteristics into account. Officials envisage the Valuer-General will provide guidance on how to assess average efficient carrying capacity as well as exemplar assessments.

Platform for development step 2 – attributing a portion of the increase to the platform for development — 0.15

62. The new system attributes a proportion of the increased capacity from improvements to the platform for development the lease provides. This proportion will attract rent, which is in accordance with the property rights noted in paragraphs 34 to 38.
63. I propose that the system use a fixed factor of 0.15 to attribute increased capacity to the platform for development. By implication, the remainder of the increased production (0.85) is attributed solely to lessees' improvements.
64. No empirical data exists from which the factor of 0.15 can be accurately derived. However, a factor of 0.15 is consistent with assessments of the nature of the pastoral lease. Modelling (described in more detail at paragraphs 94 to 97 and Appendix 1) shows that a factor of 0.15 would produce plausible rents.
65. It is essential to the new system that a factor is set in legislation. The factor cannot be left to individual assessments or the new system would have the uncertainty and subjectivity that attaches to the current system. The factor should be set in primary legislation so that any change requires due Parliamentary process.
66. Officials modelled a range of factors from 0.1 to 0.15. The High Country Accord accepted the principle behind the factor but reserved its opinion on the value of the factor. The Accord subsequently presented Ministers and officials with information to argue for a value of 0.1 based (largely) on the results of the *Minaret* test case in the Land Valuation Tribunal.
67. South Island High Country Ministers have considered the factor and models of its effects on rents provided by officials. We take the view that a factor of 0.15:
 - 67.1. fairly represents the platform for development the Crown has provided to lessees
 - 67.2. is able to produce an earning-capacity rent in accordance with Government policy.

68. South Island High Country Ministers agree that a factor of 0.1 is too low and does not fairly represent the platform for development the Crown has provided to lessees.

Measuring the economic value of a stock unit — RATE

69. The rental rate (RATE) applies a dollar per stock unit figure to the number of stock units calculated by the new system.
70. The rate will be set by:
- 70.1. identifying appropriate objective data series that measure comparable high country farm revenues and expenses
 - 70.2. using elements of these data series to establish the net value of a stock unit
 - 70.3. determining the portion of that net value to be attributed to rent.
71. A rental 'floor' will also need to be established. The rental floor will produce a minimum rent independent of net revenue figures. A floor recognises that a lease has value for pastoral purposes even if for a time the data series show a zero net return from pastoral farming.
72. The method for calculating the rental rate will need to be specified in regulations. Specifying the calculation in primary legislation will make it too difficult to change if required in future. The regulations will also need to provide for a default mechanism that allow data series (or elements of them) to be substituted if their basis changes.
73. The rental rates for the periods relevant to leases where rents are in dispute will also need to be calculated. These would be used to set rents for pastoral lessees who have disputed rents and who opt in to the new system as proposed in paragraphs 100 and 101.
74. Officials are working with a group of agricultural economists to settle the rental rate calculation. The expert group also includes a representative from the High Country Accord.
75. Work to date by the expert group has arrived at a rental rate of approximately \$5.50 per stock unit for 2010. The expert group have also arrived at a floor of \$2.50 per stock unit, which will be adjusted annually for inflation.
76. Officials will continue to finalise the rental rate formula, the rental floor, and the default mechanism for approval by Ministers.
77. I recommend that Cabinet delegates to the South Island High Country Ministers the power to agree on the calculation to set the rental rate.

The new system will be supported by better processes

78. I propose a number of components to support the new system for setting rents. These supporting components should reduce administration costs and produce fewer disputes. The components are:

- 78.1. a simpler and more co-operative approach to assessing rents
- 78.2. a modern alternative dispute resolution procedure
- 78.3. a role for the Valuer-General, assisted by expert panels.

A simpler and more co-operative approach to assessing rents

- 79. The current system requires the Commissioner of Crown Lands to issue a notice of proposed new rent. The only mechanism lessees have available to dispute rent is by appeal to the Land Valuation Tribunal. If a lessee wants to engage meaningfully in a rent dispute he or she also needs to pay for expert valuation advice.
- 80. The new system I propose introduces a more co-operative approach to assessing rent. Officials envisage that Valuer-General's Rules and guidance will require the Crown to co-operate with the lessee or lessee advisors when visiting the property to make the assessments for setting rents.
- 81. These on-farm assessments will be supported by relevant data published by the Valuer-General. Farm advisors and others should be able to make these assessments. Their services should be cheaper and more widely available than those of the expert valuers required under the current system.

A modern alternative dispute resolution procedure

- 82. I also propose a modern dispute resolution process for cases where the Crown and lessees don't agree on rental assessments. The intention is to resolve disputes at the earliest opportunity and lowest possible level to avoid costly and protracted legal disputes. The process will be based on current best practice for alternative dispute resolution, and will be included in the primary legislation.
- 83. While the detail of the dispute resolution process is still to be worked through, it will most likely include a three-tier process as follows:
 - 83.1. mediation
 - 83.2. if mediation fails, arbitration
 - 83.3. if arbitration fails an appeal to the High Court, preferably on points of law only.
- 84. I propose that Cabinet direct officials from Land Information New Zealand and the Ministry of Justice to report back to the South Island High Country Ministers and the Minister of Justice on the detail of the alternative dispute resolution process. Officials will be required to report back in September 2010 for the detail of the alternative dispute resolution process to be included in the draft legislation.

A role for the Valuer-General assisted by expert panels

- 85. The new system will have a new role for the Valuer-General as an independent statutory officer. The Valuer-General will set the details of the

new system so it can be applied consistently by the Commissioner of Crown Lands.

86. The Commissioner of Crown Lands will remain the statutory landlord for Crown pastoral lessees, and will continue to be responsible for the administration, notification and enforcement of rents. The new role for the Valuer-General will reduce the scope for any conflict of interest between the Valuer-General's regulatory functions and the Commissioner's duties as a landlord.
87. The Valuer-General is an independent statutory officer with functions under the Valuers Act 1948 and the Rating Valuations Act 1998. The Valuer-General's functions under these Acts include powers to make rules, provide guidance and audit compliance.
88. The powers of the Valuer-General are analogous to the functions I propose for the Valuer-General in the new rent-setting system. The Valuer-General's functions and powers will be set out in the primary legislation.
89. The Valuer-General will also have access to a pool of valuers, farm advisors and accountants with a long history of dealing with South Island High Country properties. I propose the Valuer-General will have the power to set up an expert panel (or panels) whose role will be to provide advice on the information required for the exercise of the Valuer-General's functions. The Valuer-General should determine the procedures for the expert panels as required in each case.
90. The Valuer-General should have several different mechanisms available to set the details of the new system through binding rules and guidance. The Valuer-General will be able to:
 - 90.1. make binding rules about data and methods that must be used in assessing BASE and current carrying capacity
 - 90.2. set out guidance, examples and indicative figures for use in assessing BASE and current carrying capacity
 - 90.3. calculate and publish RATE
 - 90.4. appoint and settle the procedure for an expert panel or panels to assist with his or her functions
 - 90.5. monitor how the new system is being implemented.
91. I also propose that the members of the expert panel (or panels) should have appropriate expertise and include someone nominated by a group or groups which represent the interests of lessees.
92. A panel or panels such as I propose should give lessees confidence that appropriate expertise will be applied to the new system and that lessee views will inform how details of the new system are set and implemented. An expert panel could deliver the mediation or arbitration roles referred to in paragraphs 83.1 and 83.2.

93. Any binding rules made by the Valuer General would be regulations for the purposes of the Regulations (Disallowance) Act 1989.

Revenue is expected to be within the same range as the current system

94. Modelling by officials showed that the likely rent revenue to the Crown under the new system is expected to be in the same range as expected under the current system.

95. The table below shows the likely rents under three possible scenarios:

Scenario	113² of 231 leases	all 231 leases
Current system or improved current system carried into the future (option 1 or 2) low scenario	\$0.9M	Not able to be modelled
Current system or improved current system carried into the future (option 1 or 2) high scenario	\$1.6M	Not able to be modelled
Proposed new production based method (option 3) assuming \$5 per stock unit	\$1.1M	\$2.3M

The details of the scenarios officials used in the modelling are described in detail in Appendix 1.

96. Within the limits of the modelling, individual rents for most pastoral leases are expected to remain within the range expected under the current system.
97. Officials consider that the modelling is accurate enough to show the gross effects of the new system. However, the modelling is limited by:
- 97.1. the availability of information because of the 11 year rent cycle
 - 97.2. the need to eliminate the effects of factors unrelated to pastoral farming
 - 97.3. the need to use a close approximation for current carrying capacity from development.

The new system should carry lower administration costs for the Crown and lower compliance costs for lessees

98. The new system should result in savings to both the Crown and lessees because:
- 98.1. assessments of average efficient carrying capacity are expected to cost between 25% and 40% of the cost of a VLEI valuation
 - 98.2. the co-operative process will result in fewer disputes than the current system

² Detailed information is available for 113 leases currently before the Land Valuation Tribunal.

98.3. disputes will be cheaper to resolve than the current system.

99. Officials estimate that the Crown will save between \$0.744 million and \$1.482 million over a full 11-year rent cycle.

Transition

100. Lessees are disputing 113 rental valuations at the Land Valuation Tribunal. The earliest of these disputed rents dates back to July 2002. Officials also expect more disputes to arise under the current system. I consider that the new system will provide an effective way for the Crown and lessees to settle these disputes.

101. I propose that the legislation for the new system includes a provision that allows lessees to opt to have rent set using the new system if their rents:

101.1. fell to be renewed on or after July 2002 and

101.2. are the subject of appeals to the Land Valuation Tribunal.

102. Lessees with disputed rents who do not wish to adopt the new system would have their appeals treated under the existing land-value-based system. Officials anticipate that a significant number of lessees will use an opt-in provision because it should be simpler, quicker and cheaper than settling disputed rents under the existing system.

Consultation

103. The Ministry of Agriculture and Forestry, Department of Conservation and the Treasury were consulted on this paper. The Ministry of Justice, the State Services Commission and the Department of Prime Minister and Cabinet were informed of this paper.

Financial Implications

104. The proposals have no financial implications. The ongoing revenue from the new system is expected to be in the same range as under the current system. The implementation of the new system is expected to be funded from within baselines, with consequential operating cost savings from the new process.

105. The new system is likely to result in back-rent being owed by some lessees. This paper is accompanied by a companion paper containing recommendations on the treatment of back-rent.

New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993

106. The proposals I make in this paper are in no way inconsistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Legislation

107. Legislation will be required to implement the proposals in this paper. The Land Acquisition, Management and Disposal Bill (category 3 priority (to be passed if possible in 2010)) is already on the 2010 Legislation Programme.
108. The proposals in this paper, however, deal with one small facet of land management. I therefore propose that Cabinet agree to add a new bill, "the Crown Pastoral Lease Rent Bill", to the 2010 Legislation Programme to give effect to the new rent system, and that this bill be given a category 2 priority (must be passed in 2010) on the programme.
109. I expect a Bill to be ready for introduction to Parliament by October 2010.
110. This legislation should bind the Crown. This is in accordance with the considerations set out in Cabinet Office Circular CO (02) 4: *Acts Binding the Crown: Procedures for Cabinet Decision*.

Regulatory impact analysis

111. A Regulatory Impact Statement (RIS) has been prepared by Land Information New Zealand officials and is attached to this paper as Appendix 2. The RIS itself annexes and refers to the *Earning Capacity Rents for Crown Pastoral Leases* report.
112. Mark Jones of Land Information New Zealand has reviewed the RIS statement prepared by David Kelliher of Land Information New Zealand and associated supporting material. The reviewer considers that the information and analysis summarised in the RIS meets the regulatory impact analysis quality assurance criteria.
113. I have considered the analysis and advice of my officials, as summarised in the attached RIS, and I am satisfied that, aside from the risks, uncertainties and caveats already noted in this Cabinet paper, the regulatory proposals recommended in this paper:
 - 113.1. are required in the public interest
 - 113.2. will deliver the highest net benefits of the practical options available
 - 113.3. are consistent with our commitments in the Government statement "Better Regulation, Less Regulation."

Publicity

114. I propose that I, as Minister for Land Information, in conjunction with the other South Island High Country Ministers make a public announcement about the new rent system proposed in this paper. I also propose that the ECR report (and associated modelling), the peer review panel report, the RIS, and this paper is published on the Land Information New Zealand website.
115. Officials have developed a communications strategy for the policy described in this paper. Officials from Land Information New Zealand will meet with the

High Country Accord at a series of meetings to explain the new system. Officials from Land Information New Zealand will also meet representatives of environmental organisations interested in this proposal.

116. Officials from Land Information New Zealand (in conjunction with the Ministry of Agriculture and Forestry and Department of Conservation where required) will work with Ministers to manage the ongoing public communications.

Recommendations

117. I recommend that the Cabinet Domestic Policy Committee:
1. **Note** that Crown pastoral leases are perpetually renewable every 33 years, are subject to rent review every 11 years, and require the land to be used for pastoral farming;
 2. **Note** that on 27 July 2009 Cabinet agreed that lessees of Crown pastoral land will be charged rent on the basis of the earning capacity of the property” (CAB Min (09) 27/6C);
 3. **Note** that Crown pastoral leases were created by the Land Act 1948 to incentivise increased production and sustainable management of the land;
 4. **Note** that the existing system for setting rents for Crown pastoral leases:
 - 4.1. is specified in the Land Act 1948 and the Crown Pastoral Land Act 1998;
 - 4.2. is based on a valuation of the pastoral lease land in an unimproved state;
 - 4.3. does not adequately reflect the earning capacity of Crown pastoral leases;
 - 4.4. is complex, expensive, subjective, uncertain, difficult to audit, and frequently produces results that are disputed by lessees; and
 - 4.5. has resulted in 113 leases currently disputing rent before the Land Valuation Tribunal;
 5. **Note** that analysis by officials shows that an improved land-value based system is likely to suffer many of the same problems as the current system and will not meet Government policy;
 6. **Note** that I propose a new system to set Crown pastoral lease rents, based on productive capacity and economic conditions;
 7. **Note** that the new system will require legislation to amend the Crown Pastoral Land Act 1998 and that some subsidiary legislation will also be needed;
 8. **Note** that any system for setting pastoral lease rents must recognise both the unimproved land originally leased and the platform for development the leased land provides;

The new system will be based on productive capacity and high country farming economics

9. **Agree** to a new production-based rent setting system for Crown pastoral leases that:
- 9.1. captures the productive capacity of a lease in standard stock units;
 - 9.2. assesses the current net value of those stock units by reference to objective data about the current economics of high country farming; and
 - 9.3. calculates rent by reference to the net value of the stock units;

Formula

10. **Agree** that the new production-based system for setting rents incorporate in primary legislation the formula:

$$\text{Rent} = \text{RATE} \times (\text{BASE} + (\text{INCREASE} \times 0.15))$$

11. **Note** the formula in recommendation 10 is consistent with the Crown pastoral lease, in that the formula:
- 11.1. attributes a portion of the productive capacity BASE to the unimproved land originally leased;
 - 11.2. attributes the rest of the productive capacity INCREASE to the sum of:
 - 11.2.1. the platform for development provided by the lease plus;
 - 11.2.2. the lessee's improvements;
 - 11.3. attributes a proportion of 0.15 of INCREASE to the lease as a platform for development;

*Capturing the productive capacity of a lease — **BASE** and **INCREASE x 0.15***

12. **Agree** BASE in the formula in recommendation 10:
- 12.1. be set as far as possible from objective scientific data about land types found on the lease and, where required, historical evidence for individual leases;
 - 12.2. be set once and recorded on the pastoral lease;
13. **Agree** INCREASE in the formula in recommendation 10 will be calculated by subtracting BASE from the current plausible productive capacity of a lease;
14. **Agree** the current plausible productive capacity of a lease will:
- 14.1. be set using the concept of the average efficient carrying capacity of that lease, taking into account lease-specific characteristics;
 - 14.2. be set at each rent review;
15. **Agree** INCREASE and BASE in the formula in recommendation 10 be in standard stock units;

16. **Note** the proportion of 0.15 in the formula in recommendation 10 is consistent with the nature of a pastoral lease;
17. **Note** the High Country Accord:
 - 17.1. agrees with the use of a fixed factor to account for the platform for development; but
 - 17.2. disagrees with the specific value of 0.15, preferring a value of 0.1;

Measuring the *economic* value of a stock unit — **RATE**

18. **Agree** an economic rental rate (RATE in \$/stock unit) be applied to the number of stock units attributable to what is leased;
19. **Agree** that RATE in the formula in recommendation 10 will be calculated by a method that is set out in regulations and :
 - 19.1. identifies appropriate objective data series that measures comparable high country farm revenues and expenses;
 - 19.2. uses elements of these data series to determine the net value of a stock unit for a pastoral lease; and
 - 19.3. determines the proportion of that net value to be attributed to rent;
20. **Agree** that the method for calculating RATE include a floor value to recognise there is a value in a lease for pastoral purposes even if for a time the data series show a zero net return from pastoral farming;
21. **Note** that officials are working with agricultural economists, and consulting with the High Country Accord, to complete the RATE calculation;
22. **Agree** that the method for calculating RATE be specified in regulations to provide the correct level of certainty and flexibility for the future;
23. **Agree** to delegate decisions on the method for calculating RATE to South Island High Country Ministers (Minister of Agriculture, Minister of Conservation and Minister for Land Information) as part of the power to make final policy decisions in recommendation 41;

Better processes to support the new system

24. **Note** that the new system will be supported by a number of components to reduce administration costs and decrease disputes;

A modern alternative dispute resolution procedure

25. **Agree** that the new system will have an alternative dispute resolution process including:
 - 25.1. the Crown and Lessee (or their agents) endeavour to agree on rent;
 - 25.2. if there is no agreement, mediation;
 - 25.3. if mediation fails, arbitration; and

25.4. if arbitration fails appeal to the High Court, preferably on points of law only;

26. **Note** that further work is required on the detail of the proposed alternative dispute resolution process;
27. **Direct** Land information New Zealand and Ministry of Justice officials to report back to South Island High Country Ministers and the Minister of Justice in September 2010 with a detailed proposal for an alternative dispute resolution scheme;

A role for the Valuer-General assisted by expert panels

28. **Note** that the Commissioner of Crown Lands will continue to be the statutory landlord under the new system and responsible for carrying out rent reviews;
29. **Agree** that the Valuer-General will have a role as an independent statutory officer to set the details of the framework for the new system which are not in primary legislation or prescribed in regulations;
30. **Agree** the Valuer-General's role under the new system will include:
- 30.1. making binding rules about data and methods that must be used in assessing BASE and current carrying capacity;
 - 30.2. setting out guidance, examples and indicative figures for use in assessing BASE and current carrying capacity;
 - 30.3. calculating and publishing RATE;
 - 30.4. appointing and setting the procedure for an expert panel or panels to assist him or her in his functions; and
 - 30.5. monitoring how the new system is being implemented;
31. **Agree** that any Rules made by the Valuer-General are to be regulations for the purposes of the Regulations (Disallowance) Act 1989;
32. **Agree** that any expert panel should include someone nominated by a group (or groups) that represent the interests of pastoral lessees;
33. **Note** an expert panel on productive capacities could deliver the mediation or arbitration roles set out in recommendation 25;

Revenue from the new system is expected to be within the same range as the current system

34. **Note** that modelling shows rents under the new system would occupy the same range as rents that could be expected if the current system continued into the future;
35. **Note** that the companion paper on back-rents contains recommendations on the treatment of back-rent;

36. **Note** that the administration and compliance costs under the new system are expected to be lower than the current system;

Transition

37. **Note** that legislation will be required to implement the new system;
38. **Note** that the Land Acquisition, Management and Disposal Bill (category 3 priority (to be passed if possible in 2010)) is already on the 2010 Legislation Programme, but these proposals only deal with one small facet of land management;
39. **Agree** to add a new bill, “the Crown Pastoral Lease Rent Bill”, to the 2010 Legislation programme to give effect to the new rent system, and that this bill be given a category 2 priority (must be passed in 2010) on the programme;
40. **Agree** that legislation for the new system includes a provision that allows lessees whose rents:
- 40.1. fell to be renewed on or after July 2002; and
 - 40.2. are the subject of appeals to the Land Valuation Tribunal;
- to opt to have their rents set using the new system;
41. **Agree** to delegate to South Island High Country Ministers the power to make final policy decisions on any outstanding matters for earning capacity rents;
42. **Invite** the Minister for Land Information to issue drafting instructions to the Parliamentary Counsel Office to give effect to the proposals in this paper;

Publicity

43. **Note** that officials have developed a communications strategy to publicise the new rent system;
44. **Agree** that:
- 44.1. the Minister for Land Information, in conjunction with the other South Island High Country Ministers, make a public announcement about the new rent system proposed in this paper;
 - 44.2. the officials’ report (and associated modelling), the peer review panel report, the regulatory impact analysis, and this paper is posted on the Land Information New Zealand website;
 - 44.3. officials will meet with pastoral lessees at a series of meetings arranged by the High Country Accord and Land Information New Zealand to explain the new rent system;
 - 44.4. officials will meet with representatives of environmental organisations to explain the new rent system;

44.5. officials from Land Information New Zealand (in conjunction with the Ministry of Agriculture and Forestry and Department of Conservation where required) will work with Ministers to manage the ongoing public communications.

A handwritten signature in black ink, consisting of several overlapping, sweeping strokes that form a stylized, somewhat abstract shape.

Hon Maurice Williamson

Minister for Land Information

17, 7, 2010

Appendix 1

FURTHER DETAILS OF OFFICIALS' ANALYSIS

1. This appendix elaborates on some issues too detailed for treatment in the body of this paper:
 - 1.1. why the existing land-value-based rent system does not work
 - 1.2. how officials analysed options for achieving rents based on earning capacity
 - 1.3. modelling the effects of the new production-based system
 - 1.4. the rents that a typical lessee has paid over the last few years and could pay in the future.

Why the existing land-value-based rent system does not work

2. The Land Act 1948 and the Crown Pastoral Land Act 1998 provide that rent for pastoral leases is to be 2.25% (or 2% if paid promptly) of the value of land exclusive of improvements (VLEI).
3. VLEI (as assessed by some valuers) may incorporate some form of capitalisation of future earning capacity but not in any reliable or predictable way.
4. Links between land value and earning capacity have become tenuous because land values in the South Island high country have increased markedly while returns from pastoral farming have been decreasing. Officials believe valuers may backsolve VLEI to arrive at a plausible rent given the economics of high country farming at the time.
5. VLEI is an exceptionally difficult form of land value to work with. VLEI is defined in section 131 of the Land Act 1948 as:

$\text{Capital Value (CV)} - \text{Value of (lessees) Improvements (VI)} = \text{VLEI}.$
6. The reductive formula ($\text{CV} - \text{VI} = \text{VLEI}$) is only a statement of principle. Valuation case law and valuation practice recognise that the formula does not, of itself, provide an implementable valuation method. This is so mostly because the formula is extremely sensitive to how improvements are defined and valued to arrive at VI.
7. VLEI is a valuation of LEI – land exclusive of improvements – essentially land as if it existed today but in a completely unimproved state. There is no thoroughly agreed method for constructing this notional LEI state.
8. There is no comparable sales evidence to use in valuing LEI because there is no land in an LEI state. Valuers use a number of indirect methods to determine VLEI. These indirect methods include looking at (and discounting)

sales of developed land, and discounted cash flows from notional developments.

9. The limited amount of law and much more extensive practice around VLEI has become very complex. Only a small and reducing cadre of highly experienced valuers have the knowledge and skills to assess the VLEI of a Crown pastoral lease.
10. Though these expert valuers can reach a VLEI, their techniques are not directly rooted in the legislation. This background means it is very difficult to get a consistent, transparent, or auditable approach across all Crown pastoral leases.
11. The background also means that disputes about rent automatically become complex disputes about valuation practice and are much more difficult to resolve than a typical commercial rent dispute.
12. There are 113 other pastoral lease rents currently in dispute at the Land Valuation Tribunal. These cases will be difficult to resolve under the current system.

How officials analysed options for achieving rents based on earning capacity

13. The table below shows how officials analysed three options to achieve the Government's policy that rents for pastoral leases based on the earning capacity of the property.
14. The criteria are taken from the terms of reference agreed by South Island High Country Ministers in August 2009, and first principles-based policy analysis.
15. Option 1 is the current system.
16. Option 2 is a land-value-based system which still attempts to value LEI (land exclusive of improvements) but is improved by:
 - 16.1. provisions that better define LEI
 - 16.2. a process that has less variation in the methods used to estimate the value of LEI
 - 16.3. a modern dispute resolution procedure.
17. Option 3 is a production-based system which sets rents on the value of the productive capacity of a Crown pastoral lease.

Criterion used in officials' analysis	Option 1 Current land-value-based system	Option 2 Improved land value system	Option 3 Production-based system
Captures earning capacity	✓ Poorly	✓ Poorly	✓✓ Directly and transparently
Clearly specified	x	✓	✓✓
Certainty for lessees	x	✓	✓✓
Avoids disputes over rent and litigation	x Ongoing dispute likely	x Some reduction if the system were more clearly specified but many disputes would still occur because the conceptual underpinnings would be the same	✓✓ Significantly fewer disputes expected
Legislative change needed	None	Minor	New code for rent-setting needed in primary legislation; details in subsidiary legislation
Conforms with the legal nature of the pastoral lease	✓	✓	✓
Income to Crown from rents	Same	Same	Similar within the limits of modelling
Administration costs	Same	Slightly less	Lower
Horizontal equity between lessees	Same	Same	Appears to be similar within the limits of modelling
Incentives on lessees	Rent does not provide incentives that change lessee behaviour	Rent would not provide incentives that change lessee behaviour	Weak but in right direction – above average production does not increase rent

Modelling the effects of the new production-based system

18. Officials have modelled the likely rent to the Crown under each of the options.
19. Options 1 and 2 differ only in process; both produce the same VLEI rent. Officials modelled rents under options 1 and 2 under a high and a low scenario.
20. The scenarios for options 1 and 2 extrapolate rents from the most recent Land Valuation Tribunal decision under the existing system, *The Commissioner of Crown Lands v Minaret Station Ltd.*

21. The high scenario assumes rents to be around 66% higher than those extrapolated from the *Minaret* case. The low scenario assumes rents to be around 33% higher than those extrapolated from the *Minaret* case.
22. The accuracy of the modelling is limited by current uncertainty with the figures for BASE and INCREASE. Officials consider, however, that the modelling is good enough to give a useful picture of what Option3 would produce as compared with options 1 or 2.
23. The modelling shows income to the Crown from rents as noted at paragraph 94 in the body of the paper:

Scenario	113³ of 231 leases	all 231 leases
Current system or improved current system carried into the future (option 1 or 2 low scenario)	\$0.9M	Not able to be modelled
Current system or improved current system carried into the future (option 1 or 2 high scenario)	\$1.6M	Not able to be modelled
Proposed new production based method (Option 3 assuming \$5 per stock unit)	\$1.1M	\$2.3M

Rent a typical lessee has paid in the last few years and could pay in the future

24. The table below shows what rent a hypothetical lessee has paid over the last few years and could pay in the future.
25. The hypothetical lease is assumed to be similar to the lease in the *Minaret* case, around 17,000 ha and able to carry 17,000 stock units at an average stocking rate. The lessee is assumed to have objected (as 113 lessees have) to their most recent rent assessment.

³ Detailed information is available for 113 leases currently before the Land Valuation Tribunal.

Period	Rent assessment	Rent paid	Notes
1994–2005	\$5,000 pa	\$5,000 pa	Assessed as 2% of VLEI as at 1994
2005	\$105,000 pa	\$5,000 pa Almost all lessees disputed rents assessed during this period and have continued to pay at the old rate	Rents of this order were assessed by LINZ under protocols that assessed VLEI as including amenity values (like those attaching to views and iconic locations and unrelated to pastoral farming). Many (though not all) leases have significant amenity values.
July 2009 to date	Potentially \$20,000+ pa No assessments have actually been issued using the approach set out in the <i>Minaret</i> case pending decisions on a new system for setting rents	\$5,000 pa	The <i>Minaret</i> case at the Land Valuation Tribunal established that amenity values are not to be included in VLEI and that VLEI should only include matters related to pastoral farming
Future if the existing system is not changed	\$20,000+ pa	\$20,000+ pa would be payable	The <i>Minaret</i> test case fixed \$20,000 pa as a rent for that lease As other rents play out through the system the rent for similar properties could be fixed at that level or higher
Future under the proposed new system	≈ \$24,000 pa	≈ \$24,000+ pa would be payable	Modelling by officials suggests a rent around this level for a lease like Minaret