Valuation Issues Relating to the High Country Tenure Review Process

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The opinions expressed in this paper are those of the author and do not necessarily represent the views of the Parliamentary Commissioner for the Environment.

Executive Summary

1. Pastoral lease tenure was created by the Land Act 1948. Over time technology and innovation in farm practices combined to dilute the government's overriding concern for protecting its pastoral land asset. The 1980s saw the beginnings of a move to provide lease holders with the opportunity to acquire fee simple title. Unlocking these lands from controls administered by the Department of Lands and Survey by issuing fee simple title was seen as a necessary step to increasing the contribution that pastoral land could make to the economy.
2. However the 1980s also marked a time when community interest in Crown owned pastoral land extended beyond pastoral production to include conservation and access to recreation opportunities. The term 'multiple use' was coined to describe the various interests in high country lands. One obvious problem was the fact that multiple uses co-existed within a given pastoral lease. The lease holder had the exclusive right to occupy the land and farm that land within the conditions of the lease.
3. The Crown Pastoral Land Act 1998 (CPLA) provides a structure for voluntary participation in the Tenure Review process. Understanding the property rights associated with Tenure Review and the value that attaches to these rights is central to achieving transparency in the settlement process.
4. Unravelling the rights embedded in pastoral leasehold land and contrasting them alongside fee simple highlights two important differences. Duration, quality of title and transferability are similar to fee simple. However, rights defining exclusivity and use differ. The extent to which diluted exclusivity reduces market value will depend on specific features of the high country and the rules governing access. The right to use is probably the most distinguishing attribute. Pastoral land is constrained in this regard and it seems plausible that the market would recognise this difference by attaching a lower value.
5. Valuation for Tenure Review relies on the use of a transparent unbiased approach to establishing before and after values. Some commentators see the Crown owning the 'land exclusive of improvements' (LEI) and conclude that the lease holder should pay this value in settlement. This is not correct. Crown ownership of the LEI must be set

alongside the fact that the right to occupy the land – with perpetual right of renewal - was passed to the lease holder by virtue of the Land Act 1948. Under the Land Act the Crown does not have the right of occupancy, the lease holder does. Given the exclusivity of occupancy, the lease holder has the right to enjoy all the benefits from the land, including amenity values. The right of exclusive occupation, held by the lease holder, is a valuable right. But the Crown has the right to base rent on LEI. If the Crown is not charging a market price on LEI then it is subsidising occupancy. This appears to be the case and could be a contributing factor to the observation that pastoral land in lease hold tenure sells for a price similar to that for title in fee simple.

6. Relatively low rentals on Crown pastoral land has been acknowledged by successive Ministers since 1948. Almost 60 years later, this matter remains to be addressed. Although the right to occupy was passed to the lease holder in 1948 the Crown retained the right to levy a rent for occupancy. The benefits of occupancy include both access to pasture and amenity values. This latter class of values, recognised in the market, are part of LEI. The right of the Crown to levy rent on LEI is a source of lessor interest in pastoral land tenure.
7. Transforming pastoral lease tenure into fee simple removes land use from the shackles of government control. For land with latent – but unrealisable - potential for higher valued use (e.g. subdivision) removal of this constraint should be expected to add value.
8. The process of Tenure Review is sound in that it enables both parties to achieve their respective goals. The Crown can achieve its conservation goals by incorporating land held under pastoral lease into its conservation estate; pastoral lease holders can obtain fee simple title and pursue their interests like other land owners with fee simple title.
9. While the concept of Tenure Review appears sound, the CPLA is remarkably silent on the principles of valuation. Variation in the approach used to establish value is evident. Confusion over the property rights underpinning the valuation method remains; within the general public and even within the valuation profession.
10. Given the idiosyncratic nature of pastoral lease land it is misleading to judge settlement sums on the basis of what the respective parties to the transaction pay/receive. High level comparisons of settlement sums, without due attention being

given to property rights in pastoral lease land and the idiosyncratic features of the land, will neglect to account for the complexity associated with Tenure Review.

1. Introduction

The aim of this report is to provide background on the valuation system used in the tenure review process. The report addresses the following questions:

1. How appropriate is the valuation methodology currently used for tenure review?
2. What are the problems/issues with the methodology?
3. Are there improvements that could be made within current legislation which define the relevant property rights? What improvements to the methodology would you suggest?
4. Based on selected tenure reviews, is the methodology being applied well?

Approach

In the public domain it would be an understatement to say that the process of Tenure Review is a controversial topic. This review, undertaken at the request of the Parliamentary Commissioner for the Environment, has attempted to remain independent. The following reports were provided for reference: Brower (2006); Evans and Quigley (2006); Armstrong *et al.* (2005); along with a selection of valuation reports. These were read. Given the questions that this report was asked to address, greater reliance has been placed on primary sources of information *viz.* legislation, parliamentary records, a formal committee of inquiry, and a selection of Tenure Review valuation reports. The approach used to interpret and analyse the information draws from a large literature on the economics of property rights. This literature is not referenced in the background report.

Property rights in pastoral lease tenure, their shape and characteristics have changed over time, and the next section provides a summary of their evolution through to the current period. Section three analyses the set of property rights that comprise pastoral lease tenure. Characteristics of the property rights play a pivotal role in understanding the benefit flows that derive from pastoral tenure and the value that the market recognizes in these rights. The report finishes with a set of conclusions.

2. Evolution of Rights

The aim of this section is to track the evolution of pastoral lease tenure beginning with the lead up to the Land Act 1948. Institutional change tends to be path dependent and insights into the current system of property rights in pastoral land can be gained by tracking the progression of pastoral lease tenure from the stage when the Land Bill was introduced to Parliament in 1948. The intent of legislators, relevant sections of the various acts, and where possible the outcomes associated with implementation, are summarised as they relate to pastoral tenure.

Prior to 1948 there were forty different tenures under which Crown land was held making it difficult to understand the rights and privileges of tenants. However, it seems clear from the debate leading up to the passing of the Land Act 1948 that Parliament wanted to retain a degree of control over land use. It was also clear, at least from the debate, that legislators understood the position of the Crown vis-à-vis the assessment of rentals. Speaking to the introduction of the Land Bill the Hon. C.F. Skinner noted:

"… these pastoral leases were given on land which was mostly high country and highly deteriorated land, and that it would be necessary to retain some control over the land so that, if necessary, conditions could be laid down as to the number of stock that the land could carry, and the way in which the land would be farmed." [Hansard, 1948, p.4080].

Concerning rentals and the nature of the relationship that binds the Crown and lease holder, Mr Skinner noted:

"The Crown has never had any authority to break its contract with its tenants by adjusting the rentals up or down to bring them into line with current land values or new principles of valuation. On the other hand Crown lessees have certain rights under the land laws to apply for revaluation of their rentals. If the Crown had similar rights, the bulk of the rentals on leases granted many years ago would be considerably increased." [Hansard, 1948, p. 4364.]

The point made about rentals vis-à-vis current land values in 1948 concerns the Crown's interest in pastoral lease tenure. Fifty years later, this issue has yet to be addressed.

The Land Act 1948 consolidated a wide array of legislation and provided a new basis for the classification of Crown land[1]. The Land Settlement Board (LSB) was empowered to classify and reclassify Crown land held on lease or licence into *inter alia* "farm land"

[1] s.51 Classification of Crown Land, Land Act 1948

and “pastoral land”. The latter category was to include Crown land that was considered, at the time, to be only suitable or adaptable for pastoral purposes. For pastoral land, the property rights created under the Land Act 1948 included:

1. The term of the lease was 33 years.
2. The lease was perpetually renewable.
3. There was no right to acquire fee simple.
4. The lessee was entitled to an exclusive right to pasturage.
5. The LSB had the power to limit stock numbers.
6. The lessee had no right to the soil.
7. The lessee was not entitled to burn or cultivate land without the consent of the Commissioner of Crown Lands (CCL).

The above structure of rights indicates that the government of the day saw that these lands were in need of control and that they doubted their suitability for alienation. During the period 1948 through 1979, the LSB fixed rentals on the basis of stock unit limitation and did not recognise the contribution of the lease holder to the productivity of the Crown’s asset. An amendment to the Act in 1970 provided for rentals on Crown leases, as determined by the LSB, to renewable at eleven yearly intervals. The Land Amendment Act 1975 provided for the LSB to grant a recreation permit. The Land Amendment Act 1977 relaxed the constraint on land use, subject to consent by the LSB, by permitting cropping and growing timber.

Speaking to the Land Amendment Bill 1979 the Hon. V.S. Young noted:

“There is, of course, no right of freeholding a pastoral lease and it is not proposed to give such a right.” [Hansard, 1979, p. 4050.]

Furthermore,

“…the rental value of the land ascertained for rent-fixing purposes shall not include any potential value that the land may have for subdivision for building purposes, or for commercial or industrial use. This recognises the fact that a pastoral lease gives rights of pasturage only, and lessees cannot gain benefit from any other potential use while holding a pastoral lease.” [Hansard, 1979, p. 4051]

The intention, signalled by the Minister of Lands, was that lease holders were not going to get the right to acquire fee simple. Excluding any potential value from subdivision is reasonable given the fact that use of the land was constrained to farming. However,

recognising that the lease holder has only a right to pasturage is a narrow view of the rights in pastoral tenure. Importantly, the lease holder has the right to occupy and enjoy the benefits of both pasturage and occupation. The issue of fairness was debated at length and centred *inter alia* on the use of a common percentage being applied to heterogeneous classes of pastoral land. The opposition proposed that rent fixing be determined by a consultative process. However the Land Amendment Act 1979 saw rentals based on land exclusive of the lessee's improvements (LEI) at a pre-determined percentage rate[2]. Provision was also made for the calculation of lessee's interest for the unexpired term of the lease when exercising the right to freehold. At the time this option was not available to pastoral lease holders.

The 1950s through the 1970s saw advances in technology and land management practices not anticipated by the Land Act. These advances contributed to improving the vegetative cover of pastoral land. Aerial topdressing and over-sowing with improved pasture species, fencing, soil erosion control, improved vehicular access and feral animal control contributed to the improvement of pastoral land. Access to finance and farm advisory services also played a role in transforming the quality of pastoral land.

The increased productivity of pastoral land is evidenced in the comprehensive report of Kerr *et al.* (1979). For the period 1950-76, their data show: mean stock limitations (in stock units) increasing; mean capital and unimproved values increasing in real terms; and the mean value of improvements increasing in real terms. Mean rent as a percentage of unimproved value declined continuously over this period. The mean percentage return on capital[3] fell from around 7% in 1960 to approximately 4% in 1976. A trend line of economic rent[4] earned by unimproved high country farms shows a decline from 12% in 1959 to around 2% in 1977; the mean over the period was estimated to be 6.9%. These results show that while productivity increased over the period, economic indicators fell. The results suggest that forces, in addition to the productive value of high country land, were contributing to the increase in capital value.

[2] 1.5% for the first 11 years and 2.5% thereafter.
[3] The calculation is based on the ratio of economic farm surplus (net farm income plus managerial salaries, interest and rent, less assessed managerial reward) to total farm capital.
[4] Kerr *et al.* (1979) use economic farm surplus as a measure of economic rent of the unimproved land plus the costs of capital employed to farm the land.

In 1981 Cabinet authorized a Committee of Inquiry to examine and report on Crown land held on pastoral leasehold tenure and pastoral land. The Committee was asked to recommend whether the terms of Crown leases are equitable in relation to other classes of Crown land and satisfactory in the public interest in respect of tenure, assessment and review of rentals, rights of renewal and rights to acquire fee simple title. The Committee was also asked to suggest equitable means for encouraging lessees in perpetuity to acquire ownership in fee simple.

Both the Department of Lands and Survey and Federated Farmers supported continuance of pastoral lease tenure[5]. Of interest to the current Tenure Review process was an acknowledgement that the legislation was silent on matters relating to the "unique" nature of the high country and "national and cultural heritage". These matters have assumed greater relevance in more recent times and are nowadays labelled as "significant inherent values" and "amenity values". The Committee concluded that pastoral lease tenure as a "protective device" had outlived its usefulness and there were ample instruments available (e.g. good farming practice, instruments under the Soil Conservation and Rivers Control Act and the Town and Country Planning Act) to safeguard the interests of the Crown as lessor.

Submissions by recreational and conservation groups advocated the need to retain areas of recreational and ecological value in public ownership. The Committee recommended that the LSB identify and designate these areas. The Committee referred to these lands as "multiple use" land. Should a lessee wish to obtain freehold title – with the consent of the LSB – then the exercise of securing fee simple title would involve the surrender of land designated "multiple use". The lessee would be compensated for improvements but not the lessee's good will. The Committee offered three reasons why it did not recommend compensation of the lessee's interest: (1) the lessee had first option to take up grazing rights if possible; (2) the value of this land for grazing was low relative to other values; (3) the lessee could elect to continue with the pastoral lease for its remaining term. Access to multiple use land should be guaranteed as a condition of lessee's acquiring fee simple title. The Committee concluded:

[5] Committee of Inquiry, 1982, p. 15

" … subject to designation of multiple use land and some additional special reserves, there is no longer any point distinguishing between pastoral land and farm land, it follows that we envisage no permanent future for pastoral leasehold tenure and likewise no obstacle (apart form the designation of multiple use land) to ultimate freeholding of pastoral land under pastoral lease tenure." [p. 27]

On the topic of rent, the Committee expressed a view that the rents are "absurdly low" compared to the value and potential productivity of the land. It goes on to say that leases have been traded at prices considerably exceeding in many cases the total government capital value of the land. Their view on freeholding pastoral lease land follows:

"Public interest requires, we think, that lessees pay normal market value for the Crown's interest on purchase." *p.33*

In summary, the Committee recommended *inter alia* that:

1. Subject to exclusion of multiple use land, pastoral leasehold tenure should be phased out and assimilated to renewable leasehold tenure. Phasing out should involve progressively increasing rentals, making available the right to fee simple; and the removal of restrictive covenants.
2. Land exclusive of improvements is the most suitable basis for assessing rentals on pastoral leases.
3. The purchase price of multiple use land should include the lessee's interest. Lessees should have the opportunity to freehold on terms requiring them to buy the residue of the Crown's interest, following the designation of multiple use land. The purchase price should be ascertained as in s. 122 of the Land Act with allowance for lessees' interest.
4. The present right to pasturage and not the soil is outmoded and should be replaced by an implied covenant against non-pastoral use without consent to the LSB.

Community interest in, and values associated with, recreation and conservation relative to agricultural production shifted considerably over the period 1980 through the 1990s. This coincided with a period when massive reforms to the economy were

implemented; subsidies to primary producers were removed, the exchange rate was floated, some government ministries and departments were transformed into state owned enterprises, and so on (Silverstone, *et al.* 1996). Re-structuring saw creation of the Ministry for the Environment and the Department of Conservation. Both agencies were viewed by recreation and conservation groups alike as champions of environmental management and policy. Once again, the legislation underpinning pastoral land was to be re-drafted. This time it focussed on "solving the problem" of implementing earlier recommendations of the Committee of Inquiry and addressing the mechanisms by which government could achieve its conservation goals. The Hon. J. Luxton, when introducing the Crown Land Pastoral Bill in 1998 noted that the Bill was first introduced into the House in April 1995. The Bill was aimed at providing guidance for the Tenure Review process. While drawing on the 1982 Committee of Inquiry Report, this interpretation of the report emphasised the importance of freehold tenure in unleashing incentives for further pastoral development:

"The 1982 Clayton report found that pastoral lands were in the main underdeveloped as a result of the inability to freehold the land. The report also found that the Crown's protective interest in holding the land had not been fulfilled." [Hansard, 1998, p.8330].

However, the Minister reminded Parliament that pastoral leases differ from fee simple tenure and that the Crown has an interest in its asset.

"… the perception held by some leaseholders that secure tenure provided by Crown pastoral leases bestows on them the same property rights as freehold owners, but this is not the case. … there have always been restrictions on land use aimed at protecting the Crown's interest in the land as its owner." [Hansard, 1998, p. 8330]

Coupled to the proposal to offer an opportunity to acquire fee simple title to productive land was the intention of securing Crown ownership of pastoral land with significant inherent value (SIV)[6].

"… the preferred mechanism for the protection of significant inherent values being restoration of full Crown ownership and control." [Hansard, 1998, p. 8331]

[6] Significant inherent value is defined in terms of land of "such importance, nature, quality, or rarity that the land deserves the protection of management under the reserves Act 1977 or the Conservation Act 1987".

The right to freehold land that does not have high conservation value was seen as a necessary condition for progress. This "offer to freehold" provided the Crown with an opportunity to acquire land of conservation value and incorporate those lands into the conservation estate. According to Land Information New Zealand (LINZ), 32 Crown leases completed tenure review before the CPLA came into effect in 1998[7]. Section 4 of the CPLA states that a pastoral lease gives the holder:

1. *Exclusive rights to pasturage over the land*
2. *A perpetual right of renewal for 33 years*
3. *No right to the soil*
4. *No right to acquire the fee simple of any of the land*
5. *Stock limitations continue apply, as determined by the Commissioner of Crown Lands (CCL)*[8]

Section 12 of the CPLA states that an occupation licence gives the holder:

1. *Exclusive right of pasturage*
2. *No right of renewal*[9]
3. *No right to the soil*
4. *No right to acquire fee simple*

The following blanket provisions apply to pastoral land:

1. *Burning of vegetation is by consent of the CCL.*
2. *Clearing, planting, soil disturbance is by consent of the CCL.*

When considering granting consent to the above activities the CCL is required to take into account the desirability of protecting inherent values alongside the desirability of making it easier to farm the land.

Part 2 of the CPLA is most significant because it provided for "Tenure Review". The general aim of Tenure Review is:

1. Conditional on promoting land management that is ecologically sustainable the process enables[10] reviewable land capable of economic use to be freed from the management constraints (direct and indirect) resulting from its tenure under a

[7] http://www.linz.govt.nz/core/crwonproperty/highcountry/tenurereview
[8] s.9 Crown Pastoral Land Act 1998.
[9] Regarding the issue of a further licence, the Commissioner of Crown Land is required to consult with the licence holder prior to the expiry of the licence.
[10] s.24 Crown Pastoral Land Act 1998.

reviewable instrument. For practical purposes this section opened up the opportunity to acquire fee simple title to pastoral land.

2. Protection of significant inherent values of reviewable land by creation of protective mechanisms or preferably by restoration of the land to full Crown ownership and control.
3. Securing public access to and enjoyment of reviewable land.
4. Freehold disposal of the reviewable land.

The CPLA lays out the Tenure Review process. The CCL puts a preliminary proposal to the lease holder, which specifies the amount of money paid to or by the lease holder; the land to be restored or retained in crown ownership and control; and the land to be transformed into fee simple title. After consultation with interested parties – e.g. Department of Conservation, local iwi, Fish and Game, public notification – a substantive proposal is prepared and put to the lease holder. If accepted, freehold title is issued and land with significant inherent values is retained under full Crown ownership. Other matters relating to public access are also dealt with in the substantive proposal.

Conclusions

Over time technology and innovation in farm practices have combined to dilute the government's overriding concern for protecting its pastoral land asset. Given these advances in high country land management the 1980s saw the beginnings of a move to provide lease holders with the opportunity to acquire fee simple title. This of course was antithetical to the earlier views expressed in Parliament by successive Ministers. Unlocking these lands from controls, through the issue of fee simple title, was seen as a necessary step to increasing the contribution that pastoral land could make to the economy.

However, the 1980s also marked a time when community interest in Crown owned pastoral land extended beyond pastoral production to include conservation and access to recreation opportunities. The term multiple use was coined to describe the various interests in high country lands. While the concept of multiple use seemed capable of capturing the range and diversity of interests, it was of limited use to policy makers faced with a difficult allocation problem. One obvious problem was the fact that these so-called

multiple uses co-existed within a given pastoral lease. The lease holder had the exclusive right to occupy the land and farm that land within the conditions of the lease. The CPLA provided a structure for voluntary participation in the Tenure Review process. The legal challenge was straightforward; the tenure of pastoral land suited to farming would be transformed into fee simple, pastoral land best suited to conservation would be transformed into Crown ownership. The CPLA also provided for some middle ground options that include the use of protective mechanisms on freehold land and concessions on Crown land. Thus the range of property arrangements available to the negotiation process spans fee simple through full Crown ownership. Understanding the property rights associated with Tenure Review and the value that attaches to these rights is central to achieving transparency in the settlement process.

3. Analysis of Property Rights

Property rights are central to a clear understanding of the economics of Tenure Review and the valuation method. Numerous definitions of a property right exist. A relatively uncontroversial definition views a property right as a legally recognised right to selected uses of an economic good or service. The definition can be broadened to include both formal and informal rules that guide and govern the allocation and use of resources and distribution of welfare within society. To illustrate, the holder of a pastoral lease has a legally recognised right to pasturage and occupancy. When exercising this entitlement the lease holder has to conform to rules regarding stock limitations and conditions regarding residence. Distributional aspects become relevant when discussing matters such as public access to high country land and the interests of the Crown vis-à-vis the lease holder.

From the brief overview of parliamentary debates it should be obvious that government policy, as enacted in law, is a source of real property rights in the tenure of pastoral land. In so far as pastoral land tenure is concerned, the lease holder's rights are shaped by characteristics (attributes) of the rules provided by legislation and policies implemented by agents of the Crown, such as the CCL. The rights embedded in pastoral lease tenure are fragmented and distributed between the Crown as lessor and the farmer as lessee. This view has led to the popularised notion that property rights are "bundle of rights" akin to a piece of rope. Characteristics of the property rights are strands in the piece of rope that combine to give shape to the pastoral lease system of property rights. Pastoral leasehold tenure is unique (at least relative to other forms of leasehold tenure in the market) and the historical over view shows that the bundle of rights has been modified by Parliament over time.

The following characteristics of pastoral leasehold tenure can be readily identified.

1. <u>Duration</u>:

The term of a pastoral lease is 33 years with the right of renewal, provided of course, that the lease holder satisfies the standard of "good husbandry". The conditional nature of renewal is probably a relic from earlier concerns about protecting high country land from degradation. Renewal at 33-yearly intervals is the only point of difference with fee simple

title. In this respect, there should be little difference in the market value, between fee simple tenure and pastoral lease tenure that attaches to the characteristic "duration".

2. Use:

The use of pastoral land, beyond that of grazing, requires the CCL's consent. For example, consent is required for the following uses:

a. Burning.
b. Clearing, over sowing, cropping and planting.
c. Generally disturbing the soil, for example putting in tracks.
d. Subdivision of land for commercial purposes.

Although pastoral land held in fee simple title is regulated by councils under the Resource Management Act 1991, it is obvious from the above list that lease holders do not enjoy the same "right of use" opportunities. It is not clear just how significant this attenuation is in terms of influencing market value. The market would assess the cost with which the likelihood that, for example, consent can be obtained from the CCL to undertake practices similar to those undertaken under fee simple title. From a commercial point of view, attenuating the right to subdivide the land and sell off blocks of land for more intensive use is probably the most valuable opportunity cost associated with this form of tenure. The right to subdivide is probably the most relevant characteristic that would distinguish the market value of two identical properties, one held under fee simple (e.g. subdivision possible) and the other pastoral lease tenure (e.g. subdivision not possible).

3. Exclusivity:

Assuming the lease holder operates within the constraints imposed by legislation and rules established by the CCL, exclusivity enables the lease holder to align investment and managerial decision making with future profit streams. This characteristic is essential for efficient resource allocation. For example, the lease holder has the right to exclusively enjoy the benefits of investment in pasture improvement. The value of this investment forms part of the lease holder's interest. Similarly, the benefits of improved vehicular access are exclusive to the lease holder. A recreation permit may be issued by the CCL to

the lease holder for any commercial undertaking involving the use of the land for recreational purposes and tourism[11]. The value of this permit attaches to the lease holder's interest. The exclusive right to occupy land, coupled with the "duration" characteristic, suggests that there should be very little difference in the market value between fee simple tenure and pastoral lease tenure that attaches to the characteristic "exclusive right to occupy". Like investment in improvements on the land, this characteristic enables the lease holder to "capture" the benefits of living in the high country and explains, in part at least, the market premium paid, over and above productive value, for high country leases. Access easements over pastoral land could work to dilute the degree of exclusivity enjoyed by the lease holder.

4. Transferable:

The lease holder has the right to transfer the lease and sub-lease. There is little to distinguish this characteristic from that of fee simple.

5. Quality of title:

Pastoral leases have relatively high quality title in the sense that the Crown recognises its contract with the leaseholder. However, it seems plausible that pastoral lease land might be exposed to a greater risk of attenuation from competing interests.

Figure 1 illustrates a mapping of the above characteristics into market value. A qualitative score (ranging from 0 to 1) is given to each dimension of the polygon; "1" being the score given to fee simple title. Obviously, fee simple property rights are attenuated to varying degrees (e.g. by council planning provisions) but the purpose of the illustration is to show "how close" pastoral lease tenure is relative to fee simple. Obviously the scores are judgements. The score given to the quality of title, duration and transferability of a pastoral lease is the same as fee simple. On the basis of the earlier discussion the score given to use and exclusivity is less than one. Downgrading exclusivity is debatable but there might be cases where public access over pastoral lease dilutes the benefits of occupancy enjoyed by the lease holder. The greatest difference between the two systems of property rights is in use. Although both systems of rights

[11] s. 62A(1) Land Act 1948.

exist within the same "external" planning constraints the use rights of the pastoral lease holder are attenuated relative to fee simple. If anywhere, it is along this dimension that the additional value added by transforming a pastoral lease into fee simple title should be the greatest[12].

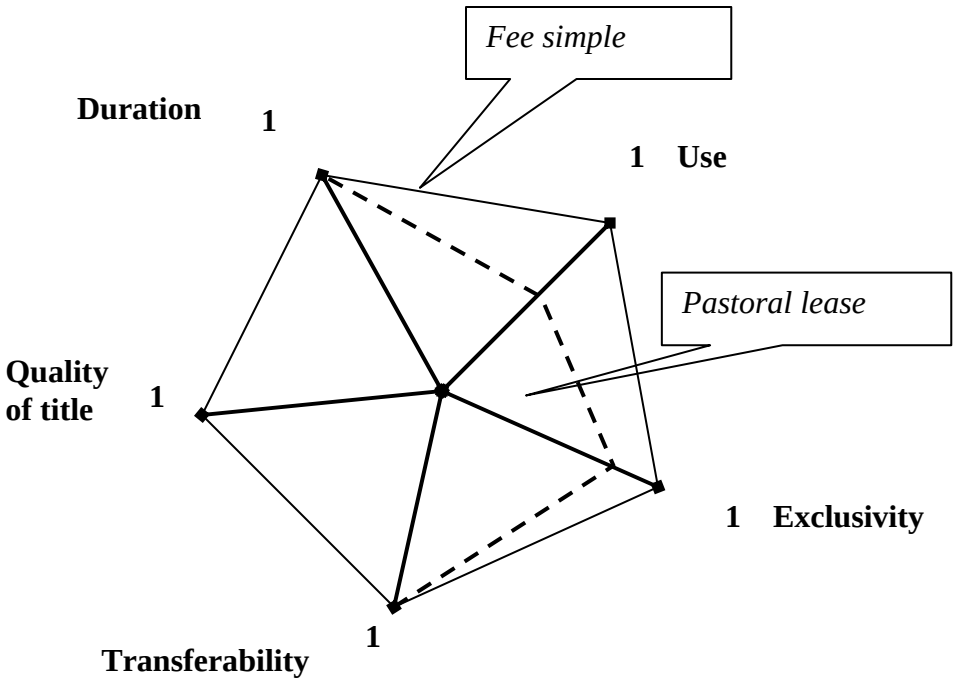

Figure 1: Mapping rights into value

Conclusions

Unravelling the rights embedded in pastoral leasehold land and contrasting them alongside fee simple highlights the importance of use and exclusivity. Duration, quality of title and transferability are similar to fee simple and in this regard there should be little difference in the market value of these rights. The extent to which diluted exclusivity reduces market value will depend on specific features of the high country and the rules governing access. The right to use is probably the most distinguishing attribute. Pastoral

[12] In 2002, a valuation report assessed the premia attached to location and the right to subdivide land with inherent values and scenic qualities at between $0.5m and $2.0m.

land is constrained in this regard and it seems plausible that the market would recognise this difference accordingly by attaching a lower value.

4. Valuation Method

Tenure Review proceeds in two stages. Pastoral land of value to the Conservation Estate and that suited to alienation is identified. Land required for access easements to conservation land is also identified. Based on these assessments a preliminary proposal is put to the lease holder, which includes *inter alia* the amount of money involved in the transaction if it goes ahead[13]. The CPLA provides for a substantive proposal that may be put to a lease holder that is the same or a modified version of the preliminary proposal[14].

Valuation of the Crown's interest and the lease holder's interest in the land is an integral part of Tenure Review. On the surface the valuation method is simple. The market value of the going concern is based on comparable sales. Valuation data used for this exercise should, in principle, contain sales of comparable properties (for example, location, aspect, size, altitude, balance of summer and winter grazing land, flat land, and so on)[15]. Comparability should also extend across property rights; not only with the system of property rights but also in terms of "external rules" governing land use. For example, some territorial authorities constrain subdivision and thus limit the opportunity for the land to move to higher valued uses. Greater accuracy of value can be obtained when more evidential sales can be used in the assessment. Tenure review valuation relies on the market's perception of the rights in pastoral lease tenure and fee simple. The valuation is an informed judgement by a registered valuer.

First a "*before valuation*" is undertaken that provides an assessment of the market value of the lease. That is, the expected market price for the lease considering the bundle of property rights embedded in a pastoral lease. An *"after valuation"* is then prepared that provides an assessment of the current market value of the property held under fee simple. To summarise:

Settlement sum = before valuation – after valuation

The difference between before and after values is the net exchange value: the effect is that the Crown buys back the lease holder's interest in the pastoral lease; then the Crown subdivides the land between that required to go into the Conservation Estate and into

[13] s. 34(3)(a) Crown Pastoral Land Act 1998.
[14] s. 46(2)(a) Crown Pastoral Land Act 1998.
[15] Establishing comparability in a market that is not liquid and highly idiosyncratic is difficult.

marginal trips with the residual land sold to the lessee subject to negotiated covenants, easements and so on. The money that changes hands is the net exchange value. It is very misleading to quote "S*ettlement sums*" without recording the areas involved, the location of the pastoral lease, conditions that attach to title, planning constraints, and so on. Each valuation report is specific to that particular pastoral lease.

It would appear that little difference exists in the market's perception of the property right characteristics that distinguish pastoral lease from fee simple title. In their analysis of the two forms of tenure (pastoral lease under CPLA and freehold tenure) Armstrong *et al.* (2005) conclude that evidence in the market confirms that there is not a great apparent difference between the two forms of ownership. If this is correct then it suggests that the principles used to assess LEI and/or the rental rate levied on LEI, are not in line with the market. Viewed another way, the Crown, as lessor is not getting a market return on its asset, which under pastoral lease tenure is the LEI. Returning to valuation for rental purposes, Part 1 of the CPLA is linked directly to Part VIII s.131 of the Land Act 1948:

(a) the value of improvements which are then in existence and unexhausted on the land included in the lease:
(b) the value at the commencement of the lease of all improvements included in the rental value at the commencement of the lease:
(c) the value of the land included in the lease exclusive of the improvements referred to in paragraph (a) above: provided that, subject to the provisions of this Act:

> *(iii) the sum of the values under paragraphs (a) and (c) shall equal the capital value of the land.*

Furthermore,

(2) For the purposes of the last preceding subsection, the expression ***capital value*** *means the sum which the land and improvements thereon might be expected to realize at the time of valuation if offered for sale, …*

For the purpose of valuation it is clear that the sum of improved value plus LEI equals an assessment of capital value, which is the market value of the pastoral lease. Land exclusive of improvements means exactly that: the market value of the land, without improvements but including inherent attributes of the property that give it value in the market. Variables that would combine to determine an assessment of LEI would include:

aspect, altitude, exposure to adverse climatic events, proximity to centres, access to public highways, scenic views, and so on.

Another puzzle remains. If, like pastoral land – that is, one held under pastoral lease and the other under fee simple – facing the same external planning constraints, but with the important difference that the lease holder cannot subdivide for commercial benefit; should not the value of fee simple title be higher? In other words, in some settings – e.g. property with a lakefront or views of mountains – the full market value that attaches to amenity values cannot be realised under pastoral lease title. It can however be realised under fee simple, provided of course planning consents can be obtained. In these situations, the value of the right to use would augment the value of the *"after valuation"* relative to *"before valuation"*. Clearly, the valuation exercise gets more complex when dealing with easements and access to land targeted to go into the Conservation Estate. Given the heterogeneous nature of high country it is not possible to generalise whether the *"settlement value"* should be positive or negative; each Tenure Review will be different.

Whether the valuation method has adopted, or modified, the above principles for Tenure Review is not entirely clear. It would appear that concern over achieving consistency in the method used to establish value resulted in LINZ undertaking a review of valuation methodology. Specifications for the Tenure Review valuation methodology were obtained from the LINZ website[16]. In an attempt to improve transparency in the valuation process it was suggested that the following valuations be undertaken[17]:

1. Current market value (as leasehold) of pastoral lease.
2. Current market value of freehold, land included in the review.
3. Current market value (as freehold) of former pastoral lease land for freehold disposal.
4. Current market value (as freehold) of former conservation area (or reserve) for freehold disposal.
5. Current market value (as freehold) of former unused crown land for disposal.

A review of Tenure Review valuation methodologies was commissioned by LINZ. The report prepared by Armstrong *et al.* (2005) report draws attention to SIVs and takes

[16] http://www.linz.govt.nz/core/crownproperty/highcountry/tenurereview/index.html
[17] Letter to The Pastoral Contract Manager, from John Larmer, dated 16 May, 2003.

the view that SIV do not comprise a value that can be included in the calculation of the Crown's interest in the lease. This is in contrast to claims by others that SIVs belong to the Crown. If we return to Figure 1 and the discussion about "use" it seems clear that the lease holder has an exclusive right to occupy the land and derive benefit from that occupation. That this benefit is of no productive value is not material to valuation. The right to occupy passed to the lease holder by virtue of the Land Act 1948. The market premium that attaches to the right to occupy and enjoy the flow of benefits associated with SIVs is a direct consequence of Parliament passing the exclusive right of occupancy to the lease holder.

However, the issue of SIVs raises an anomaly in the assessment of rent. At present rent is assessed on the value of LEI[18]. Capital value is the sum which the land and improvements might be expected to realise at the time of valuation if offered for sale. Significant inherent values are not improvements because they derive from the natural character of the land and, as such, are a component of LEI[19]. Thus the Crown would have to buy back the exclusive right to SIVs as this right passed to the leaseholder by virtue of the right to occupy. While the right to occupy enables the lease holder to enjoy the benefits of SIVs (for example) payment for this right (rent) should, on the basis of Part VIII of the Land Act be based on LEI which, by definition, includes SIVs.

The principles by which rent is assessed arises again when Armstrong *et al.* claim that without transactional evidence of LEI the sales valuations for Tenure Review can only be based on a discounted cash flow (DCF) basis to value the Crown's interest. Applying this method the Crown's interest is calculated as the present value future of rental earnings until the next review, plus then the expected future rentals based on an assumed LEI for the next term, less management costs[20]. This might be reasonable if the Crown was receiving a market return on the LEI because the market price for the right to occupy would, in a well- functioning market, annualise (in some manner) the value derived from occupying the land[21]. To draw an analogy, holding all other characteristics equal, rentals on houses with a view of water are higher than those without a water view. This is an

[18] s. 131(1)(c) and 131(4) Land Act 1948.
[19] One valuation report notes: "This property represents both income and lifestyle but if marketed would be actively sought by corporate and overseas buyers mainly for the lifestyle aspect."
[20] The term used in the DCF analysis is probably immaterial beyond 20-25 years.
[21] Given that LEI is re-assessed on an 11-year cycle there will be an element of lessee's interest involved.

empirical fact and there is no reason to expect market rentals on freehold land in the high country would not reflect SIVs. The exclusive right to occupy and enjoy amenity values has been attributed to increasing value in the market and this value should be included in the values assessed for the calculation of rent. The lease holder's interest should include the market value of the right to occupy and enjoy the benefits of any SIVs[22]. However, rent based on pasturage alone will not, in many cases, adequately reflect the lessor's interest. Proper application of s.131 of the Land Act will have the impact of increasing rents for Crown pastoral leases perceived, by the market, to have amenity values. LEI must take into account location values and amenity values that contribute to market value. These values are not part of lessee's improvements and should be included in the valuation for rental calculations. The rental stream deriving from the right to occupy might turn out to be a major component of the lessor's interest, omitting the market value of this stream of rent will result in the Crown's interest being under valued and the lessee's interest being overvalued.

Conclusion

Tenure Review is a voluntary process and relies on the use of a transparent unbiased approach to establishing before and after values. A clear understanding of the property rights associated with the two forms of tenure is essential. Some commentators see the Crown owning the LEI and conclude that the lease holder should pay this value in settlement. This is not correct. Crown ownership must be set alongside the fact that the right to occupy the land was passed to the lease holder by virtue of the Land Act 1948. Under the Land Act the Crown does not have the right of occupancy, the lease holder does. Given the exclusivity of occupancy, the lease holder has the right to enjoy all the benefits from the land, including its inherent values. But the Crown has the right to base its rent – assuming all improvements belong to the lease holder – on LEI. If the Crown is not charging a market price on the LEI then it is subsidising occupancy. This appears to be the case and could be a contributing factor to the observation that pastoral land in lease hold tenure sells for a price similar to that for title in fee simple.

[22] Depending on when the review occurred within the 11-year cycle.

Transforming pastoral lease tenure into fee simple removes land use from the shackles of government control. For land with latent – but unrealisable - potential for higher valued use (e.g. subdivision) removal of this constraint should be expected to add value. More detailed empirical analysis would be needed to establish whether or not this is the case.

5. Conclusions

Over time technology and innovation in farm practices have combined to dilute the government's overriding concern for protecting its pastoral land asset. Given these advances in high country land management, the 1980s saw the beginnings of a move to provide lease holders with the opportunity to acquire fee simple title. This of course was antithetical to the earlier views expressed in Parliament by successive Ministers. Unlocking these lands from controls, through the issue of fee simple title, was seen as a necessary step to increasing the contribution that pastoral land could make to the economy.

However, the 1980s also marked a time when community interest in Crown owned pastoral land extended beyond pastoral production to include conservation and access to recreation opportunities. The term 'multiple use' was coined to describe the various interests in high country lands. While the concept of multiple use seemed capable of capturing the range and diversity of interests it was of limited use to policy makers faced with a difficult allocation problem. One obvious problem was the fact that these so-called multiple uses co-existed within a given pastoral lease. The lease holder had the exclusive right to occupy the land and farm that land within the conditions of the lease. The legal challenge was straightforward; the tenure of pastoral land suited to farming would be transformed into fee simple, pastoral land suited to conservation would be transformed into Crown ownership. The CPLA provided a structure for voluntary participation in the Tenure Review process. Understanding the property rights associated with Tenure Review and the value that attaches to these rights is central to achieving transparency in the settlement process.

Unravelling the rights embedded in pastoral leasehold land and contrasting them alongside fee simple highlights two important differences. Duration, quality of title and transferability are similar to fee simple and in this regard there should be little difference in the market value of these rights. The extent to which diluted exclusivity reduces market value will depend on specific features of the high country and the rules governing access. The right to use is probably the most distinguishing attribute. Pastoral land is

constrained in this regard and it seems plausible that the market would recognise this difference accordingly by attaching a lower value.

Valuation for Tenure Review is voluntary and relies on the use of a transparent unbiased approach to establishing before and after values. A clear understanding of the property rights associated with the two forms of tenure is essential. Some commentators see the Crown owning the LEI and conclude that the lease holder should pay this value in settlement. This is not correct. Crown ownership must be set alongside the fact that the right to occupy the land was passed to the lease holder by virtue of the Land Act 1948. Under the Land Act the Crown does not have the right of occupancy, the lease holder does. Given the exclusivity of occupancy, the lease holder has the right to enjoy all the benefits from the land, including its inherent values. But the Crown has the right to base its rent – assuming all improvements belong to the lease holder – on LEI. If the Crown is not charging a market price on the LEI then it is subsidising occupancy. This appears to be the case and could be a contributing factor to the observation that pastoral land in lease hold tenure sells for a price similar to that for title in fee simple.

Transforming pastoral lease tenure into fee simple removes land use from the shackles of government control. For land with latent – but unrealisable - potential for higher valued use (e.g. subdivision) removal of this constraint should be expected to add value.

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