OFFICIAL #B3

WELLINGTON TENTHS TRUST

Treaty of Waitangi Claim
(No.145)

Assessment of effects arising from the imposition of perpetual leasehold tenure and a statutory ground rental rate on certain Wellington properties.

Credentials

My name is John Kenneth Warcup Isles. I am a Principal in the Wellington Office of Ernst & Young. I head the economics group within that area of the practice covering real estate and corporate advisory services. I have appeared in arbitrations to determine appropriate ground rentals within the Wellington Central Business District, and have assisted in the preparation of evidence from a valuation perspective for ground rental disputes in Auckland and with rural land.

I am a director of several public companies in the finance and insurance sectors and am also director of several private companies involved in manufacturing and distribution. I have the degree of MA [Hons] in Economics from Canterbury University.

Purpose of Evidence

I was asked to independently consider the impact of the Maori Reserved Land Act 1955 on rentals from the 4 Pipitea Street sites and from the Wellington South Intermediate School.

My evidence seeks to identify and as far as possible, to quantify the losses incurred by the Wellington Tenths Trust in respect of that part of the Trust's portfolio which is held under lease-in-perpetuity tenure and is the subject of this claim - the Pipitea Street sites and the Wellington South Intermediate School site.

In particular I have attempted to isolate the effects flowing from the Maori Reserved Land Act 1955 in respect of :

a) The prescribed ground rental rate of 4% of land value
b) The imposition of lease-in-perpetuity tenure

General Comment

I have attempted to assess the Trust's position against two benchmarks. First, it is relevant to compare the returns received by the Trust with those which were received by other lessors of perpetually leased lands. This form of tenure is particularly common in Wellington and includes land owned by the Wellington City Council, the former Wellington Area Hospital Board, and New Zealand Railways.

Other well known examples outside of Wellington City and apart from land covered by the Maori Reserved Land Act 1955, are the extensive residential lands held in Auckland by various Trusts associated with the Anglican Church, and lands held in Napier City by the then Hawkes Bay Harbour Board [and now the Regional Council], the Napier City Council and the Diocese of Waipu.

In essence, in this submission I am testing first the differences between Maori perpetual leases from perpetual leases offered by other organisations in respect of the rate of return and the period between rent reviews.

The setting of ground rentals in Wellington has been contentious with the history of these leases being characterised by litigation both through the Court system and through arbitrations under the Arbitration Act 1908. I have not in this evidence traced the development of legal thinking or economic approaches to setting the rental.

Rather, I have adopted as the benchmark the rental which the Tenths Trust may reasonably have expected to receive had its leases been subject to the same arbitration process as other perpetual leases in Wellington. That is, I have not attempted to postulate what an appropriate rental rate ought to have been (and thus re-litigate the arbitrations) but have chosen what actually transpired.

Differences Between Maori Reserved Land Act Leases and other perpetual leases

Methodology

The first difference arises in respect of methodology. The Act requires the Valuer General to determine the market value of the land as if it were freehold and to that value, the prescribed rental rate of 4% is applied. Over the years in the litigation on Glasgow Leases, this has come to be known as the *traditional method.*

An alternative approach is to find open market rentals of comparable land where the rental is typically expressed according to the unit of land area. Thus the rate might be expressed at $ X per square metre. It is the basis on which office rentals for instance are largely set and it is also used in setting rentals for rural land. The method is known as the *classic method* and most valuers would prefer it to any other method. It has not been widely used in the Wellington area, at least in respect of core commercial land, because of the lack of open market ground lease transactions.

The third method is known as the *residual value method* and ought to be used where there is an absence of comparable sales. Under the residual method the value of the land is looked at from the perspective of a developer or investor who assesses the potential of a site in the following way :

* what is the best development for the site
* what are the likely rentals to be achieved from leasing offices etc
* what is the costs of building that best use and those costs to include a profit margin

* the value of the land is derived by deducting the development costs from the forecast building value.

Thus land is the residual element.

All three methods are potentially open to be used with Glasgow leases whereas only the traditional method may be used under the Maori Reserved Land Act 1955.

Definition of Land

The second point of difference relates to the description of the land being valued. The Maori Reserved Land Act requires the unimproved value of the land to be appraised and this definition is taken to mean the nature of the land in its pre-European state. Thus, in calculating the value of unimproved rural land it can be argued that the costs of bush clearance, drainage, pasture sowing etc should be deducted from its capital value to derive the unimproved value.

Most 'Glasgow' leases to my knowledge approach the land value with slightly different terminology. The valuer is required to disregard any improvements on the site such as buildings or asphalt etc. Conceptually there could be a difference between the two approaches but given the effluxion of time I have assumed that for this urban land there is no practical difference.

Prescribed Rate of Return

The Maori Reserved Land Act prescribes the rate of return to be applied to land value whereas Glasgow leases leave this decision to the valuers and arbitrators who can then take into account factors such as inflation, interest rates or any other benchmark.

I turn now to the key assumptions used in the appraisal of the impact of leases and perpetuity.

Land Values

For the purpose of assessing rental shortfalls I have adopted the relevant Government Valuations because they provide a consistent measure from a common database and this narrows the possible points of complexity. However, the school site is treated separately.

Wellington South Intermediate School

The rental assessment for this school was based on its designation as a school site. This may be appropriate for rating purposes but my understanding is that in considering the market value of land occupied under special uses, the valuer would normally also consider the underlying zoning, which in this case is Residential B.

Mr R L Jefferies in *Urban Valuation in New Zealand Vol.I 18-6, states* :

> 'Land which is designated for a particular use should be valued in accordance with the designation with regard being made to the underlying zoning of the land and taking into account the chance or potential of having the designation uplifted.'

Volume II of the series goes on to assert that the basic approach should be to value the land as designated [for a church or school etc] plus an allowance for *the chance, if any, of permission being obtained for some other uses at some future time.*

In the case of Wellington South School however, there is a de facto acquisition by the Crown which, if the site was freehold, would almost certainly warrant compensation under the relevant legislation.

Therefore for Wellington South Intermediate School I have adopted the Valuer General's (1979) market value for the site free of the designation, of $380,000. The value of the site used in the calculation of the rental assessment was only $110,000 (September 1979).

Interest Rates

Interest on any rental shortfalls represents an opportunity cost to the Trust. The amounts have been calculated by using average interest rates on 5 year Government Stock for each calendar year.

Ground Rental Rates

In calculating the rentals which were likely to have been achieved had those 5 sites been subject to market valuation under the traditional methods. I have adopted a representative rate for each calendar year since 1979.

For the next rental reviews I have assumed that these will have a rate of 5.5% taking into account recent awards.

The Maori Reserved Land Act prescribes a rate of 4% on land value. The issue is against which benchmark can it be tested.

Before its 1969 amendment, the Public Bodies Leases Act set a rate of 5% on perpetual leases and that rate was formerly used in the calculation of lessee's interest for the purposes of the Valuation of Land Act.

By contrast, in the Wellington CBD perpetual leases were struck at around 4% during the 1950's and by the mid-1960's were around 4.25%. The major shift upwards occurred in 1969 and 1970 with two significant sites being determined by arbitration [and Supreme Court decision] at 4.75%.

The first benchmark I have adopted is the rate which the Trust may reasonably have expected had it been in the same position as the Wellington City Council, the major lessor in the Wellington region.

It should also be noted that in 1969, the Public Bodies Leases Act was amended to allow these bodies to set market rentals. In Napier City for instance, where there was and remains a significant quantity of perpetually leased land, the various lessors continued a ground rental rate of 5% for 21 year leases for residential purposes but settled at higher rates on commercial and industrial lands.

In other areas, lessors gradually increased rental rates, including the Wellington Area Hospital Board. The various Anglican Trusts assessing large areas of Remuera and Meadowbank in Auckland, for instance, progressively increased their rental rates to levels higher than achieved in Wellington.

Last, it should be noted that in Wellington there has historically been higher rental rates in the suburbs, fringe CBD land such as Thorndon, and land for industrial purposes. If alternative costs of financing freehold tenure were the sole factor in deriving rental rates there should in principle be no difference in rates according to location. However, the rationale for the difference is that core CBD land is likely to show stronger capital appreciation than fringe and industrial land and therefore the rental rate should be lower.

Therefore, using the benchmarks of various CBD arbitrations is likely to result in a conservative appraisal of any shortfall arising from the prescribed rate.

The second conservative factor is the choice of 1970 as the point from which to calculate shortfalls when, if the criterion or benchmark of the Public Bodies Leases Act was adopted, the shortfalls were arising from the inception of the Act.

Appraisal of Losses Arising from the Prescribed Rate

The shortfall arising from the prescription of a rental rate needs to be assessed in three parts:

i) <u>That arising since the last rent review and taken up to September 1994</u>.

The basis of the spreadsheet included as Appendix 2 is :

* for each rent review occurring from 1979 on, derive the shortfall by deducting the new rent from the rent which would have been received had a rental rate representative of other perpetual leases been adopted. Thus for a property being reviewed in 1979, a rate of 7.50% was likely, and the shortfall would be 7.50/4.00 times the new prescribed rent.

* the annual shortfall would be re-invested and would receive interest at a level reflecting the yields on medium-term Government Stock

Thus, this approach makes no allowance for the effect of 21 year review terms compared to shorter review terms.

ii) From September 1994 to the next review

These are the losses which have been crystallised or "locked-in" during the current review and continue until the next review.

This has been derived by :

* taking the current annual shortfall
* calculating the time until next review
* and bringing that lost income stream and its associated interest foregone back to 1994 dollars by using a discount rate of 6% per annum.

It is in essence a negative annuity.

iii) Losses past the next rent review

I include this component by way of being conditional upon the outcome of the current review of Maori leases-in-perpetuity. These are cash or income losses in perpetuity.

This part of the analysis seeks to answer the question :

What are the shortfalls if no change is made to prescribed rental rates?

The simplifying assumption is made that Maori perpetual leases after their next review would otherwise attract a rental rate of 5.5%, being the current rate for perpetual leases.

It is also assumed that freehold land values will increase by 2% per annum from the 1993 Government Valuation. A discount rate of 6% per annum is again applied to the shortfall.

Losses Arising from Imposition of Perpetual Lease Tenure

The issue is whether, after adjusting for the effects of having a prescribed rate lower than market, there is an additional loss carried by the perpetual lessor so long as the land is leased.

I consider it is relevant to consider whether the lessor voluntarily entered into perpetual tenure, and whether the lessor is able to receive a market determined return.

If the lessor voluntarily entered, or continued the perpetual leasing and the rates were set in accord with a freely-negotiated lease then, in my view, no loss of value would arise.

This is not to imply that the decision was necessarily wise or profitable but simply that it is a freely negotiated choice. Thus if a lessor's interest is sold for less than freehold value this is not a "loss" for which the willing lessor should be compensated.

For the Tenths Trust however :

* it was not a willing <u>perpetual</u> lessor,
* it has received less than market rentals, and therefore it is consistent that some additional recognition is given to its permanent capital loss.

The probable value of the lessor's interest may be lower than for other lessor's interests as a ratio of the current freehold value. This reflects the rental rate being lower than market rates.

Many other perpetual lessors of residential land permit freeholding by tenants. There are various formulae ranging from a simple discount of 20% off freehold value to more complex approaches which take into account the time till next review, or the adoption of valuer's specific appraisals.

Typically, however, other lessors will allow freeholding in a range of 20-35% off freehold value, even though on occasion the lessor's interest may be even less. Tenants are willing to pay a premium over the amount a non-tenant purchaser of the lessor's interest would pay.

The Tenths Trust leases are at a substantially greater discount. Indeed there is a "double whammy" effect on the Trust. Having received less than market rentals, those annual discounts then impact on the value of its interest in the land.

The value to the lessee of enjoying a rate significantly below market can be seen in the potential exchange of the GPS Pipitea Street leases which effectively crystallise the lessor's loss from alienation. That loss could occur periodically over time whereas in my estimate of the loss I have treated it as a one-off cost.

However, should the annual shortfalls be redressed then, in principle, the Trust's interest in the land will be hypothetically increased up to the level held by other perpetual lessors.

That leaves the gap between the willing lessor's interest and freehold market value. The Trust is not a willing lessor and it follows that it should not have to absorb a value writedown. Therefore, I have included a capital loss factor of 25% as a general reflection of the permanent loss taken by willing permanent lessors.

Conclusions

The income losses can be summarised thus :

	Shortfalls to			
	1994	1994 - next review $000s	From next review	TOTAL
13 Pipitea	58	9	27	94
15 Pipitea	44	7	24	75
9 Pipitea	150	29	57	236
11 Pipitea	231	284	20	515
School	1047	119	269	1435
TOTAL	1530	448	397	2355

The above represents the cash or income losses to the Trust [with the attendant interest foregone] which have been incurred over the past 14 years since the previous rent reviews. Some $~~1.3~~ 2 million of those losses are "locked-in" and a further $~~599,000~~ 397,000 will arise if the Act remains unchanged and present rental rates continue.

To that are the losses arising from alienation by way of perpetual leasehold tenure, at a broad 25% of the 1993 Government Valuation and summarised thus [under the assumption that the rentals shortfall is redressed] :

The Pipitea Street sites	-	$162,500
The School site	-	$305,000
		$467,500

In addition there are losses which have not been quantified :

a) the comparative effect if ground rental rates for Maori Reserved Lands had been at the level of those permitted under the Public Bodies Leases Act [5%] for the period up to the last review date.

b) the comparative effect of shorter review terms had been permitted.

Further still, I am not aware of the protocols which may have been followed in earlier valuations of the Pipitea Street sites. These are contiguous sites with important street frontage. Larger sites within the CBD have usually had premiums attached to the standard "inside lot" value per square metre and additional premiums for street corner frontage. I have not taken these factors into account.

John Isles

17 August 1994

Compensation Assessment for Pipitea Street and Wellington South Intermediate School properties

Properties Details:

Address	Area m2	Catg.	Annual Rent $ (GST Excl.)	Lease Expiry	Previous Review	1993 Govt. (Land) Valuation	Tenant
13 Pipitea St	202	LHBLD	1,800	31/08/01	1/09/80	125,000	Govt Property Serv.
15 Pipitea St	169	LHBLD	1,360	31/08/01	1/09/80	115,000	Govt Property Serv.
9 Pipitea St	713	LHBLD	5,400	19/10/02	20/10/81	280,000	Govt Property Serv.
11 Pipitea St	212	LHBLD	26,000	30/06/09	1/07/88	130,000	Greig & Davidson
28-32 Russell Tce	18,211	LHSCH	4,400	31/08/00	2/09/79	1,220,000	Wgtn Educ. Board

Compensation to 1994:

Address	Year	Reviewed Rent	Market Rate	Annual Shortfall	Equivalent Interest Rate	Compounded Shortfall
13 Pipitea St	1980	1,800	7.50%	1,575	13.89%	58,706
15 Pipitea St	1980	1,360	7.50%	1,190	13.89%	44,356
9 Pipitea St	1981	5,400	7.50%	4,725	13.89%	150,489
11 Pipitea St	1988	26,000	8.50%	29,250	10.90%	230,868
28-32 Russell Tce	1979	4,400	7.50%	24,100	13.89%	1,047,165
						$1,531,583

Compensation for losses to next review and past next review:

Address	Last Rent Review	Next Rent Review	Shortfall	Years	PV 6%	1993 Land Government Valuation	Est. GV at next rent review	Capitalised Shortfall	Present Value
13 Pipitea St	1980	2001	1,575	7	8,792	125,000	146,457	39,943	26,564
15 Pipitea St	1980	2001	1,190	7	6,643	115,000	134,741	36,747	24,439
9 Pipitea St	1981	2002	4,725	8	29,341	280,000	334,626	91,262	57,259
11 Pipitea St	1988	2009	29,250	15	284,083	130,000	178,462	48,671	20,309
28-32 Russell Tce	1979	2000	24,100	6	118,508	1,220,000	1,401,397	382,199	269,435
			$60,840		**$447,367**				**$398,006**
					(next review)				**(future reviews)**