

Government Land Rental Policy—is it fair?

By F.M. CUNNINGHAM, A.A.C.I.

This article concerns itself with land only rather than improved properties. In addition it relates to government lands administered by government or quasi government agencies. It is incumbent upon these administrators to maximize the use of such lands and obtain the best possible rent.

The processes of land alienation is apparent in the Provincial level through such agencies as the Ministry of Lands, Parks and Housing Provincial Railways, etc. It is also apparent in the provinces at the federal level through such agencies as the National Harbours Board, Department of Indian Affairs, etc.

The availability of lands so administered by these agencies is critical to the well being of the nation as a whole and to the local level of governments. The lands are made available on a lease basis with variable terms, conditions and rental rates. More often than not the lessee has no viable alternative to land use. During the past several years the determination of lease term and rental by the lessor has created an unfavourable situation to the lessee. This article will explore these situations and examine the present method of rental determination, the philosophy of leasing government lands, the problems now arising and a possible alternative to the present method of rental determination. It must be recognized that the objectives of the various Provincial Agencies and Federal Agencies responsible for administering Crown lands are varied. The remarks and observations made in this article are of a general nature. They may apply to some agencies but not others. In all probability the reader can apply his own knowledge of government agencies to the observations advanced in this discussion and form his own conclusions.

At the outset it is necessary to examine the very basic issue which is *to determine the reason for leasing government lands*. If the primary reason is to encourage and

accommodate land use then the policy concerning rental structure will be considerably different than if the primary reason is to maximize rental income from land. Originally it would seem that the former thinking applied, but more recently the latter has become a dominant consideration. In reality the probable objective now is to achieve both. If this is so then friction is inevitable. Both objectives should be tempered so that a leasing and rental policy can be developed which will establish a framework for the future which will not change and which will be beneficial to both parties.

Perhaps some thoughts and observations concerning leasing would be appropriate.

Most criticism relating to Crown or quasi Crown tenancies are related to purported abuses that sometimes creep in to the tenancy system. The landlord's bargaining power *is often close to being monopolistic*. This is a most critical factor. This makes it possible for the lessor to conclude a one sided arrangement to the disadvantage of the lessee or to claim a disproportionate share of the economic returns from the property. Problems also arise due to the vagaries of human nature involved when drawing up the lease document. It would seem that the lessee is, at times, not fully cognizant of the implications contained in a lease. If he is, he chooses to ignore them on the assumption that possible problems will not arise. For example, a lessee assumes that the rental structure will never be so punitive that a crisis will occur in 5, 10 or 15 years. He would also assume that a 20 year lease will be renewed. Otherwise it would be difficult to justify spending large sums of money on capital improvements which should logically be amortized over a period of 40 to 50 years. Virtually no one would enter into a lease with a 30 day cancellation clause unless he was reasonably assured that it would not be invoked

and yet such leases exist and for specific reasons.

In effect, when a lease is issued for say 20 years, only one thing is reasonably certain—that is that the lease will continue for 20 years (with a 30 day cancellation clause, even this is not certain). The rental for this term, however, is anything but certain. The base for establishing the term is year one. The base for establishing the rental *shifts forward each five years* to a new base. This negates any possibility of the lessee ever acquiring anything but a nominal leasehold interest. It is counter productive in that it discourages the investment of capital to improvements in the latter part of a lease term. It discourages the sale of a leasehold interest. It provides the security of a 20 year lease, but only the economic advantage of a five year lease. With a cancellation clause in effect, even the security of tenure is lost.

In preparing a lease document it is critical to anticipate all future problems and make provisions to solve them before the document is finalized. This is seldom done.

The most critical aspect of any lease is that both parties should enter into the contract with the belief that both are being dealt with in a fair manner at the outset, during the term of the lease, and at the conclusion of the lease. Changes in the economic climate, changes in land use, changes in social behaviour, changes in environmental attitudes should be anticipated and provisions made to cope with them. Quite often this is not done.

The accepted criterion at this time followed by virtually all government or quasi government agencies is to charge a lessee a market rent which equates to an economic rent. This rent would apply for the first five year period and be subject to a review at following five year intervals. At each five year interval, the rent would be adjusted upward to reflect the then current market value of the land.

Market rent or economic rent is therefore the result of two components—one being the market value of the land and the other being the economic rate of return to land. Market value is assumed to be the value of the fee simple interest. The economic rate of return is considered to reflect the prime bank rate or perhaps bond rate plus say 1%, the latter to reflect the risk associated with land alienation. The rate is applied for five years which does not reflect the vagaries in the money market. In the long run, however, the rate would tend to average out. At the present time the rate of return, as measured in the market place, is considerably less than bank rates. The above observations would apply to a less volatile money market.

Very critical to the establishment of market rent is the value of the land as *though held in fee simple*. This, of course, does not reflect the true facts as the land is only held under leasehold tenure.

In effect, a lease divides the "bundle of rights" and transfers only some rights to the tenant. The lessor keeps:

- The right to capital appreciation to the land (most significant).
- The right to the reversionary interests of improvements upon expiration of tenure (unless otherwise provided).
- The right to increase rents at periodic intervals and, in effect, shift the base year forward for economic considerations.

The right to obligate the lessee to develop the lands and possibly to a certain value level.

- The right to obligate the lessee to use Crown owned facilities to some degree.
- The right to refuse to allow an assignment or subletting.
- The right to limit the use of the leased land to a specific use.
- Plus others.

The lessee's interest is therefore something considerably less than fee interest. This factor is generally not recognized when computing lease rentals but it should be. The single most critical right which a lessee does not have is the right to capital appreciation. It is this factor which has and will continue to cause the very real problems encountered when renegotiating lease rentals. The problems intensify during a period of rapidly rising land values.

Perhaps a comparison can be made to the private sector. At first glance the observation can be made that many businesses rent office accommodation and suffer rent increases with time. However, the situations are different. A lessee under this situation has the freedom of movement. If rents rise beyond his ability to pay then he moves to more affordable premises. He is not tied to a site by virtue of large capital investments or by virtue of the fact that there is no real alternative site (emphasizes the monopolistic situation re-

lating to Government lands i.e. waterfront lands owned by the National Harbours Board or Provincial Governments).

A comparison case can also be made to renting vacant land from the private sector. Again the situation is not similar. In the private sector there is room for competition. There is certainly a different motivation behind the objectives in renting land. The private sector would probably have one objective only in mind and that is to maximize income. Large landowners are scarce and lands which are leased tend to be for temporary periods of time pending some future development of the lands by the owner. When the private sector does develop land expressly for the purpose of leasing, the rates and terms tend to encourage land use and development.

Considerable further observations could be made concerning leasing and effects in other areas of importance (mortgages, terms, reversionary rights, etc.) but they are beyond the scope of this essay.

Some observations should be made however, relative to the benefits which accrue to a lessee.

The lessee has the distinct advantage of not having to tie up a large amount of capital in land acquisition. This money can then be used for capital improvements or for other uses. In any event, the economic return to this money at prevailing interest rates is a benefit to the lessee. The lessee also has the opportunity to "write off"

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lease rentals as an operating cost. Leasing affords a tenant the opportunity to occupy and develop lands which may otherwise be beyond his present financial means. In the event of a long term lease at a fixed rent, the lessee can develop a leasehold interest (seldom possible now). In discussions with tenants of Crown lands, several issues appeared as problems in common to all. These are noted as:

- In the original instance, the Crown invited occupation of their lands by offering favourable terms, particularly rents. The emphasis at the start was to invite useage. This was the primary consideration. Land rental income was secondary, if not, at the time, inconsequential.
- Proposed rents at this time (1980) are now becoming so high that the large acreage land lessees feel that they must seek sites elsewhere.
- All would prefer to buy their land rather than lease. In this way they would know what their ongoing costs will be. Under a leasing arrangement they are never cer-

tain what their cost base will be in five years, 10 years, etc.

- Security is very important and essential where large amounts of capital are invested in buildings, equipment and machinery. They do not consider that the present leasing policies provides security.
- Many of the lessees who have occupied lands for many years were prepared to face many inconveniences at the outset. Some put in their own services. In a sense they feel that they helped to create the land value and are now being penalized by having to pay for this value through increased rents.
- All argue that if the rental structure was fair to all concerned at the start of occupation then it should be fair now. They are all quite prepared to pay an inflation rate increase to the original rent base but not the rent now being proposed.
- Some think that the land was underdeveloped and underpriced at the start.
- Again referring to security of tenure, mention is often made of the uncertainties associated with renewing tenure and es-

tablishing rents in the latter part of the lease term—say year 15 of a 20 year lease. At this point in time, it is difficult to justify large capital expenditures for improvements with only five years remaining in the lease.

- The consensus of most is that there were other benefits accruing to the Crown lands other than just rental income and therefore the administrators of such lands should not seek to maximize their economic return to land. These benefits would not necessarily apply to other land owners in the market place. It is also recognized that such benefits might not necessarily accrue to all Crown lands to the same degree. For example a Railway Company *anticipates a dollar return to their land but in addition expects to generate revenue through rail traffic*. Two separate economic benefits accrue to these lands. A similar analogy can be made with the National Harbours Board. Shipping fees are collected in addition to land rents (waterlot rents). In this sense it can be said that the Crown is a unique land owner. Very often Crown lands are being affected by outside forces which are beyond the control of the tenants. Adjoining properties are often developed to accommodate competitive uses. In turn this has resulted in competitive demand for sites. For example in the Port of Vancouver there is a continuing encroachment of commercial use upon the Vancouver waterfrontage. This has contributed to land value increases. It would be simplistic to suggest that if the highest and best economic use for the waterfrontage was for hotels, restaurants, marinas, etc. then the competitive economic forces in the market place would force a change in use from industrial to commercial. This, however, can not happen. For the good of the nation it remains necessary to have port oriented facilities on the waterfront in Vancouver. The wheat farmer in Saskatchewan relies upon such facilities for his economic well being.

In effect the large land users feel that outside forces are creating values (and increased rents) over which they have no control, nor does the lessor. These values are being created by uses which have no relation to the uses of the Crown land.

- The Crown *is in a monopolistic situation* to the extent that they have the only real suitable land for a particular purpose. Again using the Port of Vancouver as an example it is not possible for such users



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as the grain elevators to locate on inland sites. Such sites are available and much less expensive. However, they do not exist as an alternative to this type of use.

• The thought was expressed that the present system of tenure discourages the outlay of capital for improvements towards the end of the lease tenure. Most industries require continual upgrading of equipment and machinery and the addition or upgrading of buildings. In today's society such changes are required to remain in a competitive position in the market place. It is difficult if not impossible to justify any appreciable expenditure of capital when only a few years of lease tenure remains.

Comments

While there is merit to many of the above observations it is also recognized that some lessees tend to disregard reality. The issues that emerge, and deserve serious consideration are:

- 1) The Crown does enjoy a monopolistic position viz a viz land ownership. They do often control the most suitable lands for certain users. Alternatives are available but generally inferior as to location, servicing, topography, etc. In some circumstances *there is no alternative* (i.e. National Harbours Board lands).
- 2) The Crown will not sell their lands. Leases therefore have no control over the future as it relates to values, use, etc.
- 3) Any leasing policy *should be beneficial to both parties*. It should be so structured that the lessee has an incentive to maximize his use of land. In many circumstances this is not now the case.
- 4) The Crown often enjoys two sources of monetary returns from leasing their lands. One is land rent and the other is allied to the general use of the lands (i.e. Rail traffic). *It would be a mistake to maximize both unless the lessee somehow benefits*.
- 5) The present leasing policy in most instances tends to emphasize protection and benefits to the lessor and minimize protection and benefits to the lessee.

Again it is necessary to review *the basic reason* for leasing Crown or quasi Crown lands.

A rental formula can be devised to reflect the variables of interest rate, inflation rate, etc. All of these figures are available

from banks or Government agencies. The rates can therefore be amended quite simply each year or each month.

The sharing of capital appreciation with the lessee will soften the blow as to rent increases. The division of capital appreciation can be shared 50-50 or 40-60, etc.

While this proposal appears complicated, it can be simplified and made workable.

The problems associated with term, reversion, etc., have not been considered but should be given some thought. They are real problem areas.

While this article deals only with some problems relating to leasing Crown lands (or quasi Crown lands) and is by no means exhaustive, it does perhaps touch on the main problem areas. Suffice to say that an exhaustive commentary is beyond the scope of this article. It is recognized that a problem may exist in some parts of Canada but not in others due to differing economic considerations, availability of alternate supplies of land etc.

It should also be noted that viable alternatives to that considered in this article could be and are presently being considered by some government agencies in B.C.

The most beneficial alternative to the lessee is a long term prepaid lease. There would be no provision for rental escalation. This type of tenure has many of the

benefits associated with fee simple ownership. In particular the lessee has the advantage of capital appreciation and can develop a substantial leasehold interest. Alternatively the lessor has no rights to capital appreciation and this may conflict with the leasing philosophy of some agencies.

A more flexible leasing policy could also be considered. In order to ensure the continuity of capital appreciation benefits a provision in the lease could provide for renegotiating the lease at mid term (say at year 15 on a 30 year lease). This ensures that the lessee would always have a minimum of 15 years and a maximum of 30 years ahead of him. This would tend to maximize the development of the land. The lessee would always have a reasonable potential to sell his leasehold interest and a purchaser could foresee a reasonable potential for security of tenure.

Again it should be noted that these alternatives are by no means exhaustive.

Comments to this article are invited.

It is obvious that again the most significant factor creating the disparity in advantages is the five year review clause which measures inflationary increases in land. The lessee pays increasing rentals to his disadvantage whereas the fee owner accumulates value to his advantage.

In a leasing situation the land owner (Crown) derives all of the benefits of capi-

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tal appreciation. Perhaps consideration could be given to a formula which shares capital appreciation so that the lessee derives some of the benefits and the lessor some of the benefits. At the same time the lessor will be assured an effective 2-3% rate of return. This would not appear to be a desired return but in the past few years, with inflation at 9% and savings at 9% the effective rate of return was zero.

We shall assume:

- A 2% assured rate.
- Inflation continues at 8% per annum.
- Land values increase at 8% per annum.
- The effective rate will be built into the overall rate.
- The rental shall be no less than the first five years rent (unless deflation occurs).
- Land value year 1 = \$100,000.
- A 50-50 division of capital appreciation between lessor and lessee.

Then:

Upon issuance of a 20 year lease, the following is suggested:

1) Year 1—rental $10\% \times \$100,000 =$

\$10,000 (rental assures 2% effective return)

2) Year 5—rental $10\% \times \$148,000$ (new land value) = \$14,800 amended to reflect sharing of capital appreciation. (half or 4% to lessor and half or 4% to lessee). Revised rent would be:
 $4\% + 2\% = 6\% \times \$148,000 = \$8,800$

However, the policy has been adopted that the rent shall not be less than the first 5 year rental. The rental for year 5-10 would remain at \$10,000 per annum.

3) Year 10—rental $10\% \times \$219,000$ (land value through inflation) = \$21,900 amended to reflect sharing of capital appreciation. Revised rent would be:
 $4\% + 2\% = 6\% \times \$219,000 = \$13,140$

At this point the lessee will be realizing some of the benefits of capital appreciation. The lessor at the same time is receiving a 13.14% return on his invest-

ment in land and a 5.14% effective return over and above inflation.

4) Year 15—rental— $10\% \times \$324,000 = \$32,400$ amended to reflect share situation.

Revised rent would be:

$6\% \times \$324,000 = \$19,400$

Again the lessee benefits and the return to the lessor is now 19.4% on the original investment of \$100,000 or an effective return, over inflation of 11.4%.

Comments

The above assumes many things, some of which may not happen as portrayed. However, inflation is probable in the foreseeable future.

Referring to the hypothetical investment alternative above, it was assumed that land values increased at a rate of 8% per year. In actual fact, land values in some parts of the country over the past 7-8 years have increased at a much more dramatic rate than this. With a rental formula of $8\% \times \text{M.V.}$ the effective return would exceed the figures indicated.

A further comparison can be made between a fee simple ownership and leased ownership. Assume land value of \$100,000.00 and an 8% inflation rate—10% interest rate. Assume a 30 year occupation and lease.

Fee Simple Owner:

- Buys land in year 1 at \$100,000.00 (outlay)
- Annual cost thereafter (opportunity cost) would be $10\% \times \$100,000.00 = \$10,000.00$
- Has advantage of easier mortgage financing
- Has advantage of owning improvements in perpetuity
- Can lease his land, sell it or choose to do nothing with it
- At end of 30 years has land worth \$1,052,000.00.

Lessee

- 1) Does not have to invest \$100,000.00 in land. Would therefore invest in alternative position.
- 2) Receives \$10,000.00 per year income.
- 3) Pays originally a rent of \$8,000.00. At this point in time he "saves" \$2,000.00 per year. In year five he pays \$11,840.00 per annum. From year five onward, his return on investment (\$100,000.00) will not meet his rental



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obligation. In year 10 his rental will be \$17,520.00 per annum. In year 15 his rental will be \$25,940.00. In year 20 it will be \$38,400.00, and in year 25—\$56,848.00.

- 4) Receives one advantage of charging lease rental against annual operating costs. This is an important consideration as it reduces the rental cost by 25% \pm (small business) to 50% \pm (large business). In the latter situation, the effective rental would be about 50% of those noted above. In year 25, however, the effective rental would still be \$28,424.00. Offsetting this again is the \$10,000.00 annual return on the investment of \$100,000.00 thus reducing the effective rental to \$18,424.00.
- 5) At the end of 30 years still has original \$100,000.00.
- 6) Has no reversionary rights to improvements unless provided in lease.

The above serves as a simple comparison. It is reasonably realistic in that it portrays what has happened in the market place during the last 7–10 years. There is every indication that it will continue.

This analysis shows conclusively that a fee owner is, at the start, in about an equal position, but after five years, is in a much superior position. He also acquires a definite competitive edge over the lessee in that his base costs are fixed. His borrowing power increases very substantially.

Perhaps consideration can be given to a formula which will divide the advantages of capital appreciation to both the lessee and the lessor.

First it is necessary to make a comparison between an investment in land (Crown) and an investment in say a bond (at 10%). Assume that both are for a period of 20 years and that an inflation rate of 8% exists, and that land value increases at this rate. Assume return on land at 8% and value of \$10,000.00. Then:

BOND—The return would be 10% per annum or \$1,000.00 per year for 20 years plus return of \$10,000.00. The effective return would be 2% as inflation would absorb 8% of the return.

LAND—**Year 1**—Rate 8%—rent \$800.00 for first 5 years. Effective return nil as inflation absorbs all of the return.

Year 5–10—rate 8%—land value now \$14,800 (8% increase/annum)—rent \$1,184.00. Return is now 11.8% on original investment or an effective return of 3.8% after inflation.

Year 10–15—rate 8%—land value now \$21,900 rent—\$1,752.00. Return is now 17.52% on original investment and 9.52% after inflation.

Year 15–20—rate 8%—land value now \$32,430 rent—\$2,594.00 per annum. Return is now 25.9% on original investment and 17.9% after inflation.

REVERSION—At year 20 receive land back—value \$48,000.

This is a hypothetical situation but it does tend to reflect the situation in the market place today.

The effect of five year review periods does give the owner of land a much greater effective return on investment than a similar investment in bonds, savings, etc. It can also be seen from the above what the long range effect to a tenant will be in relation to a competitor who has bought his land at year 1. In the latter case the cost base remains the same. In the tenants case the cost base continuously shifts upwards.

This is not to suggest that any government agency or quasi government agency should lease their lands at a rate of 8–9% without a review clause. By so doing, they

would simply keep pace with inflation and would never realize a return on their (taxpayer's) investment. Any formula for determining rentals should incorporate a provision for inflation plus an assured rate of *return on the original investment*. This must be emphasized. The original investment would remain a constant during the term of the lease. Upon expiry of the lease (or cancellation and re-issuance etc.) the investment base would change and would reflect the market value at that time.

Even in depression years with a zero inflation rate, a return of 3% could be realized on savings. In today's market (1980) with a 12% return on savings an effective 3% is returned (9% to inflation). In the past few years, however, with a 7½% to 9% inflation rate and an 8% to 9% return on savings, there was no real effective return to money.

If the primary objective is to induce users to occupy the lands for the purpose of providing a facility required for the general well being of the nation then the rental structure may have to be amended to facilitate this occupation. For example it is in the best interests of all Canadians to have

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port facilities and to have the development as provided by the private sector. In the interest of the Canadian economy it may prove necessary and even desirable to subsidize such use where values and rentals increase to the point where such development is uneconomical. As previously noted this may be (and is in many cases) due to external forces beyond the control of the lessee or the lessor.

If the primary objective is to maximize land use on the basis of the highest and best economic use then the occupiers of Crown lands should be encouraged to leave to encourage alternatives, more profitable use. This, however, is not always possible nor practical and, in many cases, certainly not in the public interest.

If the Crown follows a policy of maximizing land rents then the inevitable result will be that some land users will have to vacate. With respect to rail oriented lands they may choose sites further removed from the high value location. If they relocate on the same railway then perhaps little is lost. If they relocate on a competitive railway or facility then much could be

lost. Again it must be noted that Port oriented facilities often do not have an alternative. Provincial government harbour lands are in a similar position to National Harbours Board lands.

Probably both objectives are really wanted and policies should be introduced to facilitate achieving these objectives. The most critical issues which evolve and which disrupt the desired harmonious relationship between lessor and lessee are:

1. Term—should be long enough to allow the lessee to recapture the cost of improvements.
2. A five year review clause effectively shifts the advantage of capital appreciation to the lessor and minimizes (often negates) the development of a leasehold interest.
3. Rental determination is presently based on rate times market value. The value of a lease is less than market value and must be reflected in the formula for computing rent.
4. Reversionary rights. The lessee should have access to some of these rights, particularly when capital expenditures

are made late in the lease term.

5. Any lease agreement must be fair and equitable to both parties.

Of all the above issues, the single most important issue is *the determination of lease rental at periodic review periods*. This does create an economic hardship. It discourages effective land use. It creates an unknown cost to conducting business which can never be measured with any degree of success. Who can foresee values in five years or 15 years? In summary, it is counter productive. At the same time it is necessary to protect the lessor's interest and reviews are accepted as necessary.

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The hammerhead pier is currently used in areas along the southern corridor where clearance for the Florida East Coast Railway and several major intersections is needed in order to provide adequate space between the roadway and the base of the pier.

Structurally, the hammerhead pier is composed of a six-by-six foot column and a 27 foot long pier cap which is attached to the column and resembles a "T." However, the shape of the hammerhead pier could also resemble an unbalanced "T" due primarily to its flexible design, which allows the pier cap or column to be fixed in one of several positions to accommodate special aerial requirements or provide clearance so as not to interfere with traffic.