

Establishment of Rental Values for Partial Development Rights Over and Under Streets and Lanes

By W. James West, AACI, FRI

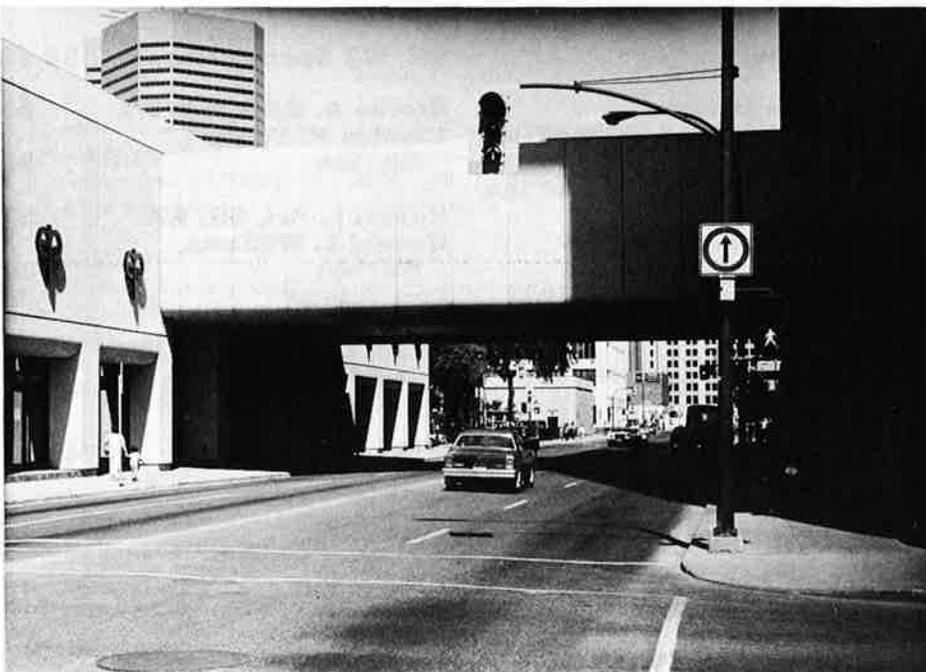
Prior to dealing with the matter of establishing or valuing the rental rates applicable to the leasing of rights above or below streets and lanes, it would be prudent to discuss the reasoning and the approval process leading up to the need and desire of a Public Body to make such a decision. Those who are employed by a Public Body in some area of Right of Way Use or Control, probably share my opinion that Public Rights of Way are owned by and for the people, and that turning over any portion of the rights of use to a private individual or developer or re-

stricting the Public's right to use the property for anything other than their common purpose, requires careful consideration. If you are involved in acquiring Rights of Way, you are thoroughly familiar with the high cost of acquisition and the difficulties inherent in the acquisition process.

Reality, however, requires that the ostrich approach of burying our heads in the sand and refusing to consider alternatives in all cases, be tempered by the needs of the citizens to reasonable and orderly development, a continuing and growing tax and assessment base, and development capable of economically paying its share of the cost of government. Consider, if you will, the following factors and difficulties which most cities are faced with in the older built up sections where the potential of replotting of lands is practically non-existent, or public demands for improved services and heritage preservation seriously restrict economic development.

A first Example would be located in an older downtown area where the original development occurred on 35 foot to 50 foot lots, and common floor areas of the buildings on the lots ranged from 3,500 square feet to 5,000 square feet. This floor area may be economic while used for the purposes of two-storey walk-up development, but it is totally incapable of multi-storey development to any degree of rental efficiency. Also, adjoining property owners may be either unwilling to sell their holding, or join in the redevelopment; or an active minority has been

*An Example of an Overhead Pedestrian
Corridor containing Commercial Sales Space*



W. James West, charter member of Keystone Chapter 66, has an extensive background assessing properties for the municipalities, and upon incorporation in 1972, the City of Winnipeg. At that time West was appointed Manager, Land Acquisition, Appraisal, and Property Management Branch of the new city. West continues in this position today.

*Air Rights Development
projecting over sidewalks.*



successful in having a property declared historic and placed on the preservation list. The alternative is to provide additional space for development on small sites by use of the air rights over the frontage street, flankage street, or rear lane.

A second Example might be that a developer has acquired two sites separated by a public lane but where, due to the use presently made of the underground rights, or by the adjoining property owners of the surface rights, relocation of the lane is not feasible, and in order to adequately develop the two sites as one unit, it is possible to join the two base towers into one building by cantilevering over the lane at the second floor level, or allow the development and connection of the two sites by use of the underground rights.

A third Example (and this list is by no means exhaustive,) is occurring in the Great White North where weather conditions require enclosed pedestrian corridors to protect the newly developing group of softies from the inclement weather. Rather than destroy the beauty of the surface of the land and impede the ability of the public to drive their automobiles over the streets, pedestrians are being forced either underground or overhead, and owners of the so-called benefitting properties are being asked to financially assist in the cost to construct and maintain the structures, and in

turn are using these newly constructed rights of way for additional commercial purposes.

Process of Approval

As the rights to be granted intrude into publicly owned lands, it is necessary that the approval process be exhaustive in nature and scope, and give full recognition to the loss of the public right over the property for, at times, a very extended period of time. I will not attempt to outline the specific process used by The City of Winnipeg, as no two Government organizations are parallel in duties and responsibilities. For the purposes of this article, it is suggested that as a minimum the following staff members be involved in the review approval process. This would include environmental planners, property management staff, traffic and transit planners, all utility companies both private and public, fire and police services, legal advisory, and of the highest importance—that it receives full support and approval at the political level, possibly including liaison with the affected private citizens.

Should an application survive this process and receive all of the necessary approvals in a form that a Developer and/or Architect finds acceptable, then the Real Estate Appraiser/Negotiator gets his kick at the cat. The appraiser's role and purpose in the process is to recom-

mend the terms and conditions of the agreement or license required, negotiate the acceptance by the developer, and obtain any necessary approvals at the political level. This sounds simple enough, but in one case, a predecessor of mine spent six years struggling with the subject of valuing air rights used for commercial purposes, and never did come up with an answer. He retired early.

Approximately eight years ago, a colleague and I were given thirty-six hours to solve the problem and negotiate the solution to acceptance with the developer. As my colleague was a very busy person, and could not afford to spend more than that amount of time on the problem, we actually developed a process that has been found to be highly acceptable and reasonable over the long term. This process of valuation or development of rental rates has been used on encroachments dealing with office towers, multi-storied apartment and senior citizen's accommodation, overhead pedestrian corridors containing commercial sales space and underground parking structures. Subsequent renewals based on actual rents collected indicate a realistic return to the City for the rights and advantages offered.

Recommended Approach to Terms and Conditions

For the purpose of the discussion we will use a hypothetical building proposed for development for office accommodation on a corner site having a frontage of 44 feet, a depth or flankage of 130 feet, for a surface area of 5,720 square feet. The building proposed for the site would contain 18 stories with full basement and thus would provide for development of a building having a gross floor area of 108,680 square feet.

The proposal for encroachment over the adjoining streets, being approximately 6½ feet over the flankage street will provide an additional 13,406 square feet of floor area, and allow the construction of a building containing a gross floor area of 122,086 square feet, an increase of 11%.

As the common services to be provided, such as stairwells, elevator shafts, and washrooms, require little if any expansion due to the increase in floor area, the additional floor area available becomes, in essence, full rentable area and increases the rental efficiency of the development in direct proportion at minimum cost.

Once these mechanical calculations have been developed, it is then necessary to establish the terms and conditions to be made applicable to the license or agreement, and my comments and recommendations are as follows:

Term of Agreement

It is obvious that the terms required by a developer will vary somewhat according to the probable economic or physical life of the proposed building.

In the case of a modern steel frame, glass and masonry building, a full term of 99 years may not be unusual, however, should the proposal provide for attachment to a structure or expansion to a building having a foreseeable economic life of shorter duration, then a shorter term should be required. It is typical at present to grant a 99 year term, as to grant a shorter term might adversely effect the owner's ability to adequately finance the development and future sales. The length of the lease though is not a primary concern. The main objective is to promote an owner's ability to gain future sales.

Annual Rental Rate

The most reasonable approach to the development of an annual rental rate appears to be that of participation in the annual rentals received by the property after development. It should be noted that this type of air rights encroachment, being cantilevered, does not interfere with surface or sub-surface rights of ownership, nor require extensive ground support structures.

Obviously, "participation" infers that both sides of the agreement will share equally in the success or

failure of the development, and the rental schedule developed should take this into account.

I would suggest, therefore, that the annual rental received or paid should be based on the "effective gross income" received from that portion of the building benefitting from the expansion.

From our own experiences I would suggest that tax escalation or tax participation by tenants forms an integral part of the rents paid and should be included, however, operating costs, such as heating, lighting, janitorial services and improvements made by tenants for their own occupancy, are generally based on actual costs for services provided and should be excluded.

In assessing the matter of contri-

bution of land or land value to the total development, it is important that the rents paid for the air rights reflect the land value after development, thus including any increasing land value caused by successful development, demand and economic conditions. The return required is that applicable to a non-depreciating asset (essentially land) and would not include a requirement for depreciation. At the present time, and for an initial period of 20 to 25 years, we are using the figure of 12½ percent, reflecting a land/building ratio of 1 to 7.

Thus the annual rental required for the initial rental period would be the result of the application of a formula based on 12½ percent (return to land) of 11 percent (being the per-

AIR RIGHTS AGREEMENT RE: PROPOSED OFFICE BUILDING

Corner of Main Street and Flank Avenue

<i>Gross Area of Building - 44 x 130 x 19</i>	<i>= 108,680 sq. ft.</i>
<i>+ Projection 2nd (Flank Avenue)</i>	<i>= 788.5 sq. ft.</i>
<i>+ Projection 3rd to 18th (Flank Avenue)</i>	<i>= 12,617.5 sq. ft.</i>
<i>Total Gross Area</i>	<i>122,086 sq. ft.</i>
<i>Total Area of Encroachment</i>	<i>13,406 sq. ft.</i>
<i>Ratio of Encroachment to Total Area of Building</i>	
<i>$\frac{13,406 \text{ sq. ft.}}{122,086 \text{ sq. ft.}}$</i>	<i>= 11%</i>

On the basis of the above ratio, it is felt that the City of Winnipeg should participate in 11% of the total gross income of the 2nd to 18th floors.

Total Estimated Effective Gross Income (2nd to 18th floors)

<i>Rentable Area (1) 80% x (2) 110,646</i>	<i>= 88,516 sq. ft.</i>
<i>Total Rental Value (88,516 sq. ft. @ (3) \$5.00)</i>	<i>\$442,580.00</i>
<i>City of Winnipeg Participation</i>	
<i>\$442,580.00 x 11%</i>	<i>= \$ 48,683.00</i>

Land value generally contributes between 10 and 15% to the rental value of buildings in the initial stages. It is, therefore, considered that 12½% of \$48,683.00 or \$6,000.00 be the rental value of air rights.

It is considered that \$6,000.00 would be the initial rental value, and that it be reviewed after 5 years, the basis for calculation being the above formula using actual effective gross rents collected.

It is also recommended that after periods of 25 years, the percentage of 12½% be renegotiated in light of change to land/building ratios. The land contributing more and the buildings less as it depreciates, therefore, requiring an adjustment in the percentage.

Recommended term of agreement - 99 years.

- (1) Building is 80% rental efficient
- (2) Excludes basement and ground floor
- (3) Reduced from actual to allow for probable vacancy factor

*Air Rights Development
bridging a dissecting lane*



*Air Rights Development
over City Owned Underground
Parking Structure*



centage of the example encroachment described above to the gross floor area of the building) of the estimated effective gross income of the second to eighteenth floors of the building.

Additional Requirement

Other criteria to consider are:

1. That the annual rent be reviewed each five year period and re-computed using the same formula and using the actual rentals received for the year immediately preceding the review.
2. That the lease be re-negotiated at each 20 or 25 year interval at which time the percentage of land value and its contribution to the total development would be reappraised. The agreement should provide for arbitration if mutual consent cannot be achieved.
3. The agreement must provide for assignment for both purposes of sale and financing.

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