

Setting Capitalisation Rate Right: Discussions and Decisions of Norwegian Expropriation Courts

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SUMMARY

The cap rate is a (the) central variable of “value in use” compensation valuation. What level to choose, and what elements to consider, have for 30 years been discussed within Norwegian expropriation cases. The object of this paper is to document the levels and discuss the elements which are considered within the Norwegian courts in that period, and to briefly comment court decisions. The Supreme Court of Norway (SCN) has decided that the cap rate should reflect the economy in the probable reinvestment of the compensation. This means a rejection of a theory of “value in use” as a reconstruction of the actual business struck by the expropriation when comes to internal rentability, time perspective of investment, security or administration costs. Still the reinvestment should be seen in the owner’s perspective. Reinvestment and cap rate should then reflect an economy not too different from the business the owner actually was performing. SCN has rejected full compensation for possible loss by inflation. Effects of taxation have so far not been handled. After decades of cap rate component discussions the SCN in later decisions prescribes a fixed 5 % standard level of cap rate with few possibilities for exceptions.

1. CAP RATE AND THE COURTS

Norwegian Expropriation Law guarantee compensations reflecting the loss in marked value of the property purchased. If the capitalised loss of future economical income of the property is larger than marked value loss this “value in use” is correct compensation. If the owner can restore the capacity of the property through purchase of additional land or other investments, the costs involved still represents maximum compensation. Any how marked value is always the minimum.

$$K = i / p$$

Teaching bachelor-level students about “value in use” expropriation compensation, Norwegian professors usually tells: “Instead of the lost yearly income” (i) we need to deposit a bag of money (k) that with the capitalisation rate (p) should reconstruct the former situation by returning (i) every year.

This is probably the simplest version of capitalization for an everlasting row of yearly (lost) income. The cap rate may be set by agreement or professional tradition without much efforts of analysis and discussion of its components. Due to lack of professional evaluation

institutions in the front line expropriation compensations is in Norway much of a court business. Choosing cap rate is rather an economist's challenge than a question of law principles. Even so Norwegian courts have been rather busy in discussing these matters for the last decades. This paper reports and reflects on elements of capitalization rate discussed (or not discussed) in the Supreme Court of Norway (SCN) from 1981 until 2008, presented in the way the court has analyzed the subject through these years.

2. COMPONENTS OF THE PROBLEM

2.1 Cap rate reflecting outcome of the source or reinvestment

Evidently a loss deriving from an expropriated chunk of agriculture land will be best equalized by investing in another field, a forestry loss in a patch of forest etc. But such nearby patches of property will seldom be available. The owner will get an amount of money without any restrictions of where to reinvest. Felland (1980) found that only a minority of owners used compensations for reinvestments in their (agrarian) properties. Most used the money for consumption.

The question then raised is: Should the rate reflect the probable profits of the business actually struck by the expropriation (the source), which would lead to a low cap rate (and high value) in low-profit businesses, or should the cap rate reflect the profits in the "probable" or "best" reinvestment of the compensation? In the *Noem* case (NLR, 1992, p 217) the question was if the cap rate should differ between valuation of forestry land (low internal rate) and cultivated land (higher rate). The actual landowner lost both forest and fields. The SCN clearly answered that it was probable reinvestment possibilities of the compensation sum, independent of the effected business. The cap rent for forest and cultivation should be the same.

Quite clear messages from a court here. But up until today this principle still has been challenged especially by forest evaluators but also by economists like Eide (1995) and Hylland (1995), by politicians of the Parliament (proposal from the Committee of Justice no 25, 2003-2004) and by court decisions at local or appeal level. The arguments have been based on theoretical, empiric or political grounds. The discussions were also triggered by the low interest rate levels in Norway since the late 90ties.

2.2 Where to reinvest

In the *Noem* case the SCN prescribes that the cap rent should be found from reinvestment possibilities within the economical scope of the owner. So SCN claim that a normal owner of farm or forestry land probably will reinvest as far as possible in the farming and forestry business. Quite important is although that SCN remarks that most such owners have loans – which could be reduced.

Stating the freedom of reinvestment SCN still doesn't accept a reinvestment perspective for farmers into blue-collar or down-town investment. When expropriating land in urban areas higher rates should be considered.

2.3 Individualized or objective perspective

In the *Svenkerud* case (NLR, 1986, p.1354) SCN without much discussion states that "value of use" compensation "should be objective". In that case: a hectare of cultivation land should be given same value independent of the present owner's age, capacity or even occupation. Land under lease and even fallow was valued as being well managed by its owner. Lands that had been added much value by the owners by extraordinary investments should any how not be compensated at this standard level. In other words: All owners of farm land should be considered as well performing cultivators. The exceptional good ones should be more individually investigated.

Still there are some exceptions and questions: Compensation for damage on the remaining property (badly shape of and access to remaining plots) must be judged individually for each holding. Differentiation of value from different soil conditions and other production factors is still possible. Different owners will have different capacity for adaption to the new situation by adjusting production, equipment and labour. This adjustment possibility should always be considered, but it is still unclear if individually or objective. Rented cultivation land which of structural reasons (small holdings etc.) probably will remain so, could be compensated by capitalized land rent.

Capitalization rate should normally also be "objective" within a relevant landowner group. If this is fair or even correct may be discussed: Many Norwegian farmers and forest owners accept low returns. On the other hand the Norwegian peasant always have been more than a Jack-of-all trades: He has been a master of that sport! Today you will find active stock-traders, investors and top industrial managers among small-holding farmers. Farms and especially large forest holdings have again become status assets for the economical jet-setters of the country.

2.4 Inflation component – the long term rate

Presuppose that the yearly income of the capitalization formula are set in today's money value, this will be a discussion about cap rate as a real or nominal figure. Nominal supporters have advocated the possibility to reinvest compensations in property or other assets that normally are solid towards inflation. One problem is of course that the capitalisation formula hardly lead to a marked value of such an equivalent asset. Eid and Svendsrud (1992) argue for a real rent perspective demanding homogeneity below and above the division bar of the formula.

In the *Sevaldsen* case (NLR, 1981, p.138) the SCN stated no compensation for loss by inflation. Still Eide (1995) observe the SCN approving 6% cap rate in this injury case – which

hardly could reflect a nominal rent at that time. In the 1986 *Noem* case SCN avoids the discussion by introducing “long term rate” as the correct perspective investigating reinvestment possibilities. SCN claims that in a long period of time inflation could be balanced by periods of deflation. Probably this statement confuses persons of post-war economical experiences only. Still this has been seen as an acceptance for some coverage of proposed inflation losses. Even if SCN never directly expresses so, the real rent perspective has been strengthened by the **Iberg* case (NLR, 1993, p.1524) and later cases.

2.5. Risk component, capital binding component, administration component,

As mentioned the SCN prescribes a reinvestment perspective in calculating “value of use”. The reinvestment is not limited to businesses exactly of same risk level, time perspective and administration costs as the business influenced by the purchase. The constitutional guarantee of full/fair compensation is not a total reconstruction of all components of the owner’s former activity. Except from investments in temples and pyramids, hardly any business matches the 100 year perspective of investments in northern forestry!

But the “reconstruction principle” is not fully rejected: The prescribed limitation of the scope to normal investments in the owner’s sphere of business/land excludes extremely different businesses. For fields and forests it will not be appropriate to use cap rates from stock-marked investments accepting large risk and demanding quick returns.

2.6. Tax component

The Expropriation Compensation Act of 1984, §3 states that: “extra tax on compensation should not be taken into regard”. This principle rejects to add (or lower) compensations from the fact that tax levels on periodical income could differ strongly from tax on the compulsory purchase compensation sum. This principle has been reconfirmed by the SCN in an pre-emptive realisation case (NLR, 1998, p.1389) even if the principle is not mentioned in the Allodial Possession (Odal) Act.

The §3 don’t answer if tax should be brought into the capitalisation formula. Calculating the yearly losses or setting cap rate: With or without tax?

Tax level and regime of the predicted reinvestment activity could differ from those of the activity struck by the expropriation. There will even often be individual differences regarding taxation.

A demand of balance regarding tax above and beneath the division bar of the formula should be preferred: If yearly loss is tax corrected – so should the cap rate.

While Land Consolidation courts in some transactions consider taxation levels, this subject has never been touched by expropriation law.

3. OTHER ASPECTS

3.1. Clashing professional models

Traditionally Norwegian standard (public statistics) agriculture calculations don't contain full compensations for the farmer's labour costs. Even capital costs are underestimated. Probably this is a necessary (political) trick to make a positive bottom line. Using such statistics in search for a cap rate, then might bring us to a too high level.

Forest economists operate with models of optimal forest production/cultivation programmes. Most often the input rate has multiple functions in these models; both as capitalization rate and as important factor to set optimal cultivation programme. Forest valuation is complex and experts are called upon in such cases. Most of these forest experts manage a limited toolbox of calculation models. Forced to use cap rates above 4, these tools may produce strange outputs such as prescribed logging of Christmas tree size logs or negative value of cleared forest land. Many forest evaluators openly disagree with the SCN norms. They also even have problems to fit these norms into the capacity of their evaluation tool box.

3.2 Setting the level

Forest owners accept an average return of 2-3 % or even less on long term investments. Eide (1995) states this as a nice profit in a long term, low risk and low administration cost business, also when compared with investment in state bonds, average real rent etc.

The rate of reinvestment alternatives in the "objectivised owner's perspective" is not easy to quantify. Reduction of debts might be an exception. Through the years and many cases the SCN has approached the cap rate problem more or less based on economists' analytic dissolving of the phenomena. In the later years, and parallel to such discussions, SCN seem to aim for a standardized level of the rate: 5%.

The 1993 **lberg* case handled compensation principles of physical injury. A teenager was disabled by a car accident. His economical loss was calculated as loss of future income. The cap rate model of argument was complex, but the SCN ended up declaring that cap rent hardly could be set below 5%. In the *Fl*myra* case (NLR, 1994, p.557) (forest reserve) SCN declared that normally (but not in that case) there was no reason to choose lower cap rate in expropriation cases than in personal injury cases.

European jurisdictions struggle to keep principles and levels of American injury compensations out of the continent. Especially in countries of highly developed public security systems, keeping such compensations low is a part of the "public-private agreement" and institutional settings. There are reasons to keep injury compensation levels low. It could be discussed if similar "defence strategy" towards "malicious attacks from outside" is legitimate when comes to expropriation compensations.

In the *House-rent* case (HR-2008-359-A, not yet published) an obiter dictum solidly states that 5% cap rate is the present rule in expropriation cases. Still in the 1994 *Fl*myra* case and in the *Tors*terkampen* case (NLR, 1997, p.428) lower rates were accepted because of “special conditions” (special restrictions in parish common forests).

In Norway there is public prize control on purchase of agriculture and forestry land. The highest legal prize is calculated from yearly income capitalized with 4% rate (governmental by-law). In the 2008 *Gr*fjellet* case this max prize is rejected as argument for expropriation situations. The parallel to the 4% standard used by land consolidation of forest properties is also rejected.

In the *Gr*fjellet* case (HR-2008-225 -A, not yet published) (forest expropriated for military purposes) the SCN pronounce; “only exceptional conditions could legitimate a lower cap rate than the standard level of 5%” (authors translation). Such condition must be “individual” or “special”. A lower rate used in a whole business (like forestry) is “general” and does not fulfil this condition. This case is the most forceful 5% declaration in Norwegian law history. After all these years of interesting, expensive and maybe less fruitful court discussions; may be peace has been brought to the Kingdom; represented by the standard of 5% cap rate.

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