Review of the Percentage of Revenue Framework
Phase 2 Engagement Paper
Assessment of options

Purpose of this paper

DOC is now in the second stage of the engagement process for the review of the Percentage of Revenue Framework (PRF).

The purpose of this paper is to provide information on the assessment of the options and seek partner and stakeholder feedback. The suggestions set out in this paper build on the feedback received so far and propose a preliminary option which DOC would like to explore and test further.

Some questions have been posed to assist with developing the detail in specific areas. Feel free to answers any of those where you can best contribute. Answering these questions is purely optional.

This paper covers

- an outline of the engagement to date and an overview of the feedback received
- how the issues raised in the feedback can be addressed
- an overview of the assessment of options
- an option for further development, including a request for further feedback
- options not favoured at this stage
- potential enhancements for the wider fee setting processes
- the next steps.

If you wish to discuss any of these matters further or have questions you can contact:

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If you would like to contribute to any of the topics and the questions asked in the paper, please email your feedback to PRFreview@doc.govt.nz by 23 July 2021.

DOC emphasises that no final decisions have been made yet on the future make up the PRF.

Department of Conservation
Te Papa Atawhai

Introduction

The Department of Conservation (DOC) supports the Minister of Conservation in looking after Public Conservation Land (PCL). In accordance with this governing legislation DOC seeks to protect native wildlife, manage natural and historical resources, and provide for recreation and tourism on PCL.

Businesses and commercial activities can be undertaken on conservation land through the granting of a concession and the payment of an "Annual Activity Fee". The concession approval process considers the application against the requirements of the Conservation Act 1987 to ensure appropriate activities will take place on PCL. This process also includes fee setting. Fees include one-off processing fees, management fees and the ongoing Annual Activity Fee.

This review focuses on the Percentage Revenue Framework (PRF) as one of methods used to determine the Annual Activity Fee for some (but not all) concessions.

The PRF is generally applied to activities such as ski operations, accommodation, hydro and guiding[1]. The revenue from all Annual Activity Fees is Crown revenue. This revenue is then allocated back to DOC to use in accordance with its overall management and operational priorities.

This review does not address wider issues such as the use or allocation of the revenue from these fees or the concession approval process. Neither can it address all issues relating to s4 of the Conservation Act, which would require a separate process.

Partner and Stakeholder engagement

Information DOC provided

Between January and February 2021, DOC provided its partners and stakeholders with several papers to assist them with providing input into the review of the PRF. These papers were:

- Issues and options Paper
- Treaty Partner Issues Paper
- Summary of the issues and options
- Concession Revenue Information Sheet

DOC is also working with an industry Reference Group made of representatives from its partners and industry stakeholders. The Reference Group is providing advice and assisting it with the review.

The feedback DOC received

The feedback period for the issues and options closed in March 2021. DOC received 74 submissions totalling around 300 pages. A summary of the key themes (High Level Feedback – Phase 1) raised in these submissions was provided to partners and stakeholders via the review webpage in early June 2021.

DOC was encouraged by the number and quality of the submissions. The partner and stakeholder perspectives were very helpful with identifying the issues and assessing the options. There was also a general theme that partners and stakeholders valued being involved in the process.

The key themes DOC takes away from the feedback are:

- there is value in using a percentage of revenue based approach for many activities

[1] Other methods, such as flat fees, are applied to other operations like aircraft landing and telecommunications.

- the current PRF should be modified to address issues such as too much subjectivity and difficulty in calculating consistent results
- one size does not fit all - more guidance is required on the use of the different methods open to DOC to determine the activity fee
- provide methods to differentiate revenue components earned on and off PCL
- provide guidance to manage a range of related fee consideration issues, such as:
  - factors within the concessions that can have a bearing on their value such as the term or duration, restrictions, or the provision of public goods (e.g. safety)
  - give better effect to s4 matters, such as tikanga and kaitiakitanga (amongst others)
- better recognise concessionaires' contributions to conservation.

How partner and stakeholder issues raised are being addressed

DOC is addressing the issues raised in submissions through two main means:

1. initially through assessing the options for improving/replacing the current PRF
2. in the next stages of the review in developing the operational detail on the preferred option.

DOC could not address all the feedback received. Some submissions raised issues that were beyond the scope of this review (e.g. the use of the revenue from the activity fees). Also, given the range of views, some matters raised were contradictory (directly opposite to other submissions) and require careful consideration.

Assessment of Options

DOC commissioned Deloitte to advise on issues and potential options to improve the PRF. Following feedback from partners and stakeholders two additional options were added to those identified by Deloitte in its Issues and Options paper. There were options 5 and 6 (see below).

Consequently DOC considered and assessed six options:

1. **Status quo** (current PRF)
2. **Royalty** (modified PRF)
3. **Excess returns model** (modified PRF)
4. **Auction concession rights** (new)
5. **Proportion of land value** (existing method)
6. **Abandon PRF altogether** (use remaining methods in pricing book and may require bespoke methods from time to time)

Each option was assessed against 5 criteria:

1. Gives effect to s17Y and s17X of the Act (fee setting considerations)
2. Gives effect to s4 of the Act (principles of the Treaty of Waitangi)
3. Transparency
4. Fairness
5. Administrative efficiency

The options assessment team included DOC staff from its Planning, Permissions and Land[2], Pricing and Economics[3] and Kahui Kaupapa Atawhai[4] teams. Deloitte and Tourism Industry Aotearoa (TIA) were also represented to provide independent input. This range of people provided a diversity of skills and perspectives in the assessment.

The current thinking – further develop the Royalty option

The Royalty option is essentially a modification of the current PRF.

Reasons for further developing the Royalty option

The assessment of the options indicated that the **Royalty** option should be progressed to seek feedback from partners and stakeholders and to develop the operational detail. This aligns with much of the feedback from partners and stakeholders that a modified PRF was favoured.

> A **Percentage of Revenue** formula is a commonly used commercial method and therefore a reasonable basis to use to generate the rental for many activities; the key is to arrive at the correct percentage to apply.

The **reasons** for looking further into the Royalty option are:

- it removes the more subjective elements (in particular, infrastructure investment and environmental compensation) from the current PRF. This also makes the method simpler and more transparent to the industry and generates a fairer fee
- it is linked to market data so it would stay relevant to industry and national economic conditions, be more transparent to the industry and generate a fairer fee for the industry and DOC
- the development and inclusion of guidelines to better address relevant fee related s4, s17Y and s17X issues will provide improved transparency for the industry.

A description of the Royalty option

The Royalty option is essentially a variation of the current PRF and reduces some of the current PRF's weaknesses.

The Royalty option has the potential to address the following matters raised in submissions:

- reduce subjectivity by removing the infrastructure and environmental components and providing more clarity on the Premium and Exclusivity components
- will allow a more easily calculated and consistent determination of the percentage to apply
- if the investment basis is kept, it would re-set the Base Rate (and reduce subjectivity) by using market based data
- provide guidance to:
    - differentiate revenue components earned on and off PCL
    - address factors within the concession approvals such at length of concession, restrictions, or the provision of public goods
    - better give effect to s4 matters such as tikanga and kaitiakitanga (amongst other matters)
    - better recognise contributions to conservation.

[2] Unit that processes concession applications for approval
[3] Commercial and pricing advisory unit
[4] Maori advisory unit

- can involve developing procedures to help reduce the use of the disputes process
- the development of supporting principles for the PRF.

DOC is considering two possible approaches to determine the percentage under the Royalty option (the names are coined):

1. *Concessionaire Investment Model (CIM)*
2. *Fixed Percentage Model (FPM)*

Both these approaches would require a separate consideration to address other matters in s17Y & X and s4 (and would require development of guidance material). For example, DOC is currently developing a discount policy to address the reduction/waiver component in s17X. This will provide greater clarity and transparency.

The Concessionaire Investment Model

This model would involve:

1. the removal of two components (which increases the size of the percentage that would be applied to a concessionaire's revenue) –
   - Environmental Compensation, which would no longer exist in any form
   - DOC infrastructure, which may, where appropriate, take the form of a separate user charge[5].
2. a link to market data for the Base Rate that is the foundation for determining the percentage that would be applied to a concessionaire's revenue
3. clarification of, and improved criteria, for the Premium and Exclusivity factors
4. clear guidance to account for revenue earned on and off PCL.

The current thinking is that the formula would be:

<u>Percentage (%) = Base Rate + Premium + Exclusivity</u>

The <u>Base Rate</u> is the key component of the formula and seeks to recognise the investment a concessionaire brings to the success of their operation alongside the value that the PCL provides. It would provide incremental steps between a lower and upper percentage value limit.

The <u>Premium</u> and <u>Exclusivity</u> factors need greater clarification and refinement to reduce the subjectivity and useability. Such improvements would involve clear objective criteria to determine the applied percentages. This work will be undertaken as part of the development of the operational detail for the preferred option.

Further detail on how these elements will be developed and shared in the next stage of the engagement process.

Potential features for improving the Base Rate include:

- the percentage could be between the Risk-Free Interest Rate and Government Cost of Capital. These upper and lower levels are actual economic elements determined by independent organisations. DOC could benchmark them for a certain period and then update them if those market elements have changed.

[5] Some concessions are already charged a separate infrastructure fee.

- the value of investment could be based on minimum and maximum industry asset values. The increments could be 1% or 0.5% steps between the minimum and maximum asset value.
- the risk-free interest rate (usually the government bond rate) and Cost of Capital adjust with the movement of the economy. The relevant market rates would apply at the time of the review. They can also be fixed over designated time periods (e.g. 3 or 5 years) within the Pricing Book and/or concession agreements.

The key strengths and weakness of the CIM are set out below and should be read as being relative to the current PRF formula.

Concessionaire Investment Model (CIM)	
Strengths	Weaknesses
• Simpler formula with greatly reduced subjectivity	• While much reduced, some subjectivity remains in the formula
• Stronger market connection to reflect wider market conditions and value	• The market data is not perfect and may require further development
• Greater clarity and transparency in the formula	• Still an "estimate" (approximation) for fair fee
• Clearer criteria and guidance (to be prepared)	• Will still rely on concessionaires providing information for the fee determination
• It will not rely on a 2-year investment window but on the stated value of the subject organisation's assets and reduce information accuracy risks.	• Less long-term certainty for the percentage (i.e. it would increase or decrease the activity fee over time depending upon the prevailing economic conditions)
• Concept aligns with strong stakeholder feedback to enhance current PFR formula	• Does not directly address profitability margins for businesses (i.e. it is not specifically designed as a profit-sharing method).
• A separate process to address s4 and s17 matters during fee setting (transparent).	

The Fixed Percentage Model

This model would replace all the components of the current PRF with a constant (or fixed) percentage for specified industry groups for a set period. The percentage would be applied to Revenue.

The percentage could be based on either:

1. industry averages from DOC's database (refer to Deloitte's Issues and Options Paper), or
2. industry profit margins and applying the "rule of 25" to determine the percentage (e.g. 25% of an average industry profit, at say 10%, would be 2.5%).

The strengths and weaknesses of the FPM are largely the same as for the CIM, with the following relative (to the CIM) distinctions set out in the table below.

Fixed Percentage Model (FPM)	
Strengths	**Weaknesses**
• Further simplified formula	• Profit data for determining the market percentage is reliant on information that can be manipulated
• The percentage is more consistent across organisations	• If DOC "average" data is used it is more reflective of past decisions than current market conditions
• Avoids increments and thus 'edge' effects (i.e. those organisations close to the boundaries for the percentage increments disproportionally affected by potentially a small change in value)	• this method is not as strong at reflecting individual circumstances in determining the percentage. • Setting the percentage using the "rule of 25" is very subjective and could be seen as arbitrary
• Factors in industry 'profitability' in determining the percentage	• Profit levels tend to fluctuate more than asset value (i.e. out of date more quickly)
• Potentially a less variable percentage over the longer term through economic cycles.	• Still requires reviewing the percentage at set periods from a first principles basis.

Questions:

Do you agree that the Royalty option methodology is an improvement to the PRF? If so/if not - why?

Which of the Royalty method approaches would fit your business better (i.e. the CIM or FPM)? If so, why?

Do you think any parts of the Royalty options need improvement or clarification? If so, what?

Options not favoured at this stage

The following options were not favoured as a replacement/evolution of the PRF when assessed against the criteria:

- The **Status Quo option** (current PRF method) was not favoured due its short comings which were identified in Deloitte's Issues and Options paper and submissions.
- **Excess Returns option** was not favoured because it would be less efficient than the current PRF (i.e. involve more work for everyone and potentially more complex). It is also reliant on concessionaires providing correct data on 'profit' levels. Some organisations considered a weakness of the PRF was that it did not recognised business margin. Factoring profitability into other methods has challenges, such as increasing complexity and inconsistency, and requiring validated evidence about an organisation's profit levels.
- **Auction option** was not favoured due to some inherent problems in relation to activities on PCL. These include it not being suitable for more than a few activity types (on PCL), potential workability in terms of s4 and the Ngai Tai decision and potential fairness issues in some areas. Many stakeholders and partners considered auctions were not appropriate. However, the

assessment team considered that auctions have potential in some areas and that further investigation as a separate project should be considered.

- The **Land Value option** is already in DOC's toolkit. This option was included in the assessment with the other options as many submitters indicated a preference for it. It was assessed being a very good method in the right circumstances but not favoured as a full replacement for the PRF. However, there is a need for better guidance about how and where the various methods in the toolkit should be applied (transparency and fairness).

- **Abandon PRF option** was the weakest of all the options considered. Removing a revenue based methodology will reduce the range of methods, result in more work for all parties (less efficiency) and a loss of fairness. There were not many partners and stakeholders advocating this option.

Wider fee setting processes that can be enhanced

The submissions and assessment of options raised several wider fee-setting processes that could be enhanced to improve the use of the PRF (and other fee setting methods). The suggested enhancements that can be further developed are set out below. DOC will be improving the guidance material as set out in enhancement 1. DOC is still considering enhancements 2.-4.

1. Improved guidance on:
    - where, when, and how to use the PRF methodology
    - addressing s4 Conservation Act issues in setting the Annual Activity Fee
    - addressing all factors in s17Y and 17X Conservation Act.
2. Creation of a '**reconsideration**' process. This could be a step before the formal dispute process to address fee issues (try to recreate a more willing-buyer-seller relationship) and to try and avoid the more expensive dispute process.
3. Improve the **notification process** for reviews as there would be information DOC would require from concessionaires if the royalty formula were used.
4. A fee setting **governance group**, with industry representation, for the fee setting processes.
    - the purpose would be to oversee DOC's fee setting process and to help improve those processes (including seeking feedback)
    - this governance group would not review the fees for individual cases.

Next steps

The next steps in the PRF review process are:

1. Receive and consider your feedback on this paper.
2. DOC will develop the operational detail for the Royalty option (including road testing this detail) with the assistance of your feedback. If you would like to help and test this with your business, please contact Steven Kerr (PRFreview@doc.govt.nz).
3. Seek a further round of feedback on the operational detail.
4. Finalise the review, seek necessary approvals and establish the associated guidance.
5. Communicate this decision to partners and stakeholders.

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Help develop the detail (specific questions)

There are a range of matters that need to be worked through to develop the detail for the Royalty option. The questions below are to help you provide feedback on these matters.

1. Section 4, Conservation Act
   - What do you see as the key matters for setting concession fees (not concession approval) to give effect to the Treaty? (e.g. claim agreements, kaitiaki roles, co-management with DOC)?
   - How should they be included?

2. Defining "Gross Revenue"
   - Should this be the standard accounting definition? Or
   - Should it be a Net Revenue (e.g. less revenue earned off PCL or specific costs)?

3. Proportion the revenue or proportion % that is applied to the revenue
   - How should Gross Revenue or the percentage (%) be proportioned to recognise operations split over PCL and private land (e.g. land area / costs / revenue source / time spent on PCL / others)?
   - What if the business is fundamentally tied to PCL yet only a small part of the operation is on PCL - is a proportion relevant at all?

4. Use of asset value in Base Rate in the Concessionaire Investment Model (CIM) Royalty formula
   - Do you agree with using asset value (i.e. shown on an organisation's Balance Sheet) as the foundation of the Base Rate (replace the 2-year investment criteria)?
   - What should DOC do if a business refuses to supply the value of its assets for calculating the fee?
   - If not asset value, why? Do you see any practical alternatives?

5. Reconsideration process
   - Is there value in a negotiation step before the formal dispute process?
   - Should this opportunity apply to all or just the larger or more complex businesses?

6. Two tier fee structure
   - Should the fee be split into 2 tiers (fixed and variable)?
   - What could the tiers be based on (e.g. Fixed and Variable components)?

7. Stability period for the percentages
   - What is the basis to best reflect market conditions and balance the need for stability (i.e. open or fixed periods)?
   - If fixed for a period, then over what period (e.g. annually, every 3 or 5 years)?

You do not have to confine yourself to the above questions. We are happy for you to provide input in other areas where you think further detail is required.