RAILROAD RIGHT OF WAY

Appraising Public Utility Easements

A RESPONSE BY ARTHUR G. RAHN, SR/WA, ASA

In the January/February 2006 and March/April 2006 issues of Right of Way magazine, there appeared a two-part article titled "Appraising Public Utility Easements in a Railroad Right of Way, authored by John T. Schmick and Robert J. Strachota, MAI, CRE, CBA, FIBA.

This article appears to be a continuation and amplification of a prior article entitled "Public Utility Easements in Railroad Right of Ways," written by George Karvel and printed in the January 1989 Appraisal Journal and reprinted in April 1989 Right of Way magazine. The current article is well written and should trigger a good discussion about the larger parcel concept.

Unfortunately, the article also contains some inaccuracies and misinformation, some of which I will try to dispel.

Right of Way or Corridor

First, as a matter of correct terminology, no one can place an easement on an active railroad right of way since that is the portion of the corridor where the trains operate. A corridor, or transportation corridor as it is more correctly called, is basically a long, narrow strip of property rights whose existence can be justified best by use for transportation and/or communication purposes. A transportation corridor has value because of its ability to connect two points with resulting cultural benefits or economic advantage.

We recently attended a national conference on corridor valuation and one of the topics was the definition of a corridor. Several participants noted corridor definitions usually include the words "narrow" and "long." Now a layman would probably have no problem understanding what was meant, but the terms are considered too vague and imprecise by some participants to constitute a legal definition. Another problem is that the definition usually mentions "desirable endpoints" which raises the question "why would someone build a corridor to an undesirable endpoint?" The matter was never really resolved, so when I came home, I developed my tentative definition as follows:

> *"A created property, usually very narrow compared to its overall length, consisting of acquired individual land parcels and/or real property rights, which were assembled into a single parcel for the purpose of delivering people, goods and services from one point to another."*

Right of way has been defined as "1) The right to pass across the lands of another; and 2) land, property or interest therein, usually in a strip, acquired for or devoted to transportation purposes." Originally, all corridors were called right of ways. When the land agents went out to acquire land, they asked for the right to cross the owner's land for the "railroad way." Even today, maintenance of the rail bed and improvements is done by a department called "Maintenance of Way."

The term right of way is a legal concept denoting the right or ability to cross another's land. A corridor, on the other hand, is a physical entity - a collection of parcels or property rights which makes the transportation of people, goods and services possible.

It is common, but not correct, for the terms to be used interchangeably. Technically, the railroad or other corridor user has a right of way on the corridor. The proof of this concept is that even if the railroad removed its right of way, the 100-foot wide corridor would still exist. There is no doubt that most corridors were originally created to serve the railroads. However, with the changes in time and technology, many other users have found corridors ideal for their industries and the railroads have become just one of many occupants of a typical corridor.

Comparing Past Rents with Current Market Levels

Under the heading "A Historical Perspective" there is a discussion about how the rents being charged by the corridor owners are higher

than they were in the past, and this is causing difficulty in the rental negotiations between owners and users. There is a real problem — which has been partially caused by the railroads themselves. I have seen this phenomenon (and problem!) arise many times. In the early days, the railroads did not employ real estate professionals to handle leasing transactions. Instead, they turned this function over to local railroad officials. These individuals usually leased the land under the premise that if the railroad got a dollar more for the land than it received yesterday, it was a good deal. Years later, when professional real estate managers tried to get rents based on the current land value, the rents would have had to increase many times over the previous rents and, as a result, there was a great deal of tenant resistance to these very large rent increases. So, the railroad has tried several methods such as shorter leases, CPI adjustments and stair-step rents to gradually increase the rents and eventually bring the rents up to market value. This process is still ongoing.

Having said all this, let me add my welcome to the real world! I bought my first house 50 years ago for $12,300, and it is now available for $400,000. I'll bet that the companies who are complaining about the rental rates are not charging the same prices they did 50 years ago. When I started to drive, gasoline was $0.19 cents per gallon - now it is approaching $3.00 per gallon. As I understand the Income Approach, Income is determined by Value times a Rate of Return (I =V x R). If the Value continues to increase and the Income does not, then the Rate of Return has to be shrinking. If this goes on long enough, the landlord will not receive enough income to perform maintenance and pay taxes. The Income Approach has been defined as the present worth of future rights to income and the principle of anticipation, which underlies the Income Approach, is defined in Appraisal Institute's Dictionary of Real Appraisal as "The perception that value is created by the expectation of benefits to be derived in the future." Welcome to the real world of economics. It is not our job as appraisers to be advocates for the rents our clients wish to pay, it is our job to collect the available economic data, analyze it, make a value conclusion and let the chips fall where they may.

History of the Across-the-Fence Methodology

On the second page of the article, the following statement is made: "First presented to the appraisal community in 1978, this railroad valuation model became commonly known as the Across-the-Fence value (ATF) for corridors." This statement shows a complete lack of knowledge about the ATF methodology. In my newly published book, Corridor Valuation, considerable time is spent explaining the history of the ATF approach, but it is suffice to say, for this article, that the methodology was developed around 1912 by the Interstate Commerce Commission (ICC) and was imposed upon the railroads to determine the value of the lands they have under their control.

"The Appraisal Institute seeks ... to demonstrate that the ATF is the preferred measure for valuing transportation and communication corridors..."

This procedure, the first organized and standardized appraisal methodology in the United States, is called the Across the Fence method (ATF) and is still the predominant method used in valuing transportation corridors today. It predated the Sales Comparison Approach and the Income Approach as we know them today by 20 to 30 years.

On the same page: we find "The premise of the ATF concept is that, once a group of parcels is assembled into a corridor, it creates a synergism." Not so. This is the premise of the enhancement factor or railroad factor or corridor factor, whichever term it is called. It is not the premise of the ATF concept - the premise of the ATF concept is that the land comprising the corridor should be worth as least as much as the land through which it passes. The article states that this method of pricing/valuation bears little relationship to the keystones of modern appraisal methodology: market value and functional use. I always thought that the concept of market value required a willing buyer/willing seller who were typically motivated, acting prudently and knowledgeably and acting in what they consider to be their best interest. There have been literally thousands of transactions using this method of pricing/valuation, and if this isn't proof that market value and functional use are being addressed, I don't know else would be required to meet the test.

After a number of years of sitting on the fence, the Appraisal Institute has finally taken a position on the merits of the ATF methodology. During the trial between Southern Pacific and the Santa Fe Pacific Pipelines, the Institute filed a brief as a "Friend of the Court" in which they said, in part, the following: "The Appraisal Institute seeks leave to file a brief in order to demonstrate that the ATF is the preferred measure for valuing transportation and communication corridors such as the pipeline right of way at issue here. The ATF method of comparing corridor sales is superior to the method of direct comparison that the trial court required the parties to employ. The trial court therefore abused its discretion by rejecting the ATF Method."

Finally, in Corridor Valuation, there is an appendix with the complete appraisal manual for the ATF approach as developed by the ICC, which should be required reading for anyone who plans on appraising corridors.

Multiple Users and Occupancy Factors

Another issue raised on this same page is described as: "One of the problems with right of way (ROW) land (especially in urban settings) is that the ROW may have multiple current users/uses, or if undeveloped, more than one potential user/use." I have seen many corridors with many concurrent users, sometimes as many as 10 different occupants. Why this is a problem I'm not sure. As long as each user has a document which describes the legal and physical limits he is entitled to have and as long as the individual easements do not overlap or interfere with the adjacent user, I fail to see a problem.

The same is true of occupancy factors - the percentage of the bundle of rights affected by a particular easement - which the article says worked well for both sides at a time when the easement/lease rents remained nominal and there was but a single easement in the ROW. Again, I fail to see the problem - if two parties can agree on the impact an easement has on the overall corridor and other parties use this agreement as a model for their individual agreements, where is any party being treated unfairly?

Different types of easement place different types of burdens on the corridor. An overhead power line may only affect 20% of the bundle of rights while an underground pipeline may affect 75% or more. As long as the occupancy factors are used appropriately for a given industry and as long as they are agreed to by both parties, there is no inequity and typical market forces are in play.

Mandatory Right of Way Width

This article, as well as the Karvel article, mentions that the maximum right of way width is often established by state law and indicates Minnesota law requires a side clearance of not less than 8 feet, 6 inches from the center line of the track. It then states that for valuation purposes, right of way beyond that boundary is available for other use and is referred to as excess right of way. This is erroneous! The 8 feet, 6 inches referred to is a safety restriction to ensure that passing trains do not contact the sides of adjacent trains or structures and has nothing to do with property rights. A railroad cannot be operated within an area of 8 feet, 6 inches from the rail center line. Grading, ballast, signals, sidings, spurs and switches are all found well beyond that distance.

California Court Structure

The authors are evidently not familiar with the California Judicial system - on page 3 of the article it is said that "the Superior Court of the state of California criticized the ATF methodology ...." There is no "the" Superior Court—all of the 58 counties have their own Superior Court—and each of those courts may have 20 or 30 individual departments.

Appraisal Journal Article

The July 2000 Appraisal Journal cited as support for some of their conclusions an article by Lusvardi, Wright and Amspoker which challenged current appraisal practices and the impact of subordinate or relocatable easement on corridor land values. The referenced article presented the Alternate Route Theory as the appropriate way to value corridors. The way the alternative route theory works is that a prospective corridor user first finds the cost of constructing an easement for his particular business purpose, using an established corridor. Then, he should investigate the possibility of an alternative route, possibly using city streets or other similar properties. The costs of the two possibilities are then compared and the difference between the choices is what the corridor owner would be entitled to receive for the use of his corridor. An extensive discussion of this theory can be found in the July 2000 Appraisal Journal that features a fictional case study wherein a city proposes to install a waterline along one mile of a power company's right of way. In this study, the city's construction cost of the waterline on the existing corridor is estimated to be $1,500,000, excluding land, and the total cost of installing a line between the same points in a city street or highway would also be $1,500,000 plus an extra $136,000 for pavement removal and reinstallation, extra traffic lanes, etc.

The article then surmises that, because the city would save $136,000 by using the existing corridor, it would be typically willing to pay that amount to place the waterline in the corridor, thereby avoiding the extra hassle on installing the line in the street. The reasoning behind this study is a complete mystery to me. Either way the city goes, they will spend $1,636,000 in construction costs to install the line, so there is no advantage for one route over the other. The biggest problem that I have with this theory lies in two other areas. First, to base the amount of compensation on anything other than the value of the land affected by the taking seems to fly in the face of the whole concept of just compensation, which requires the owner to be put in as good a position pecuniarily as he or she would have been prior to the take. Secondly, this theory bases the value to be paid for an easement solely on the benefits received by the buyer, not what the seller has lost, which is contrary to my understanding of eminent domain law.

Surprisingly, on the same page, they refute the logic of the referenced article in the paragraph titled "Public versus Private Users" where they insist correctly that just compensation requires that the seller be compensated for what he is losing, not what benefits the buyer is gaining.

As an aside, the referenced article was viewed critically by a number of appraisers who specialize in corridor appraisals. For example, in the January 2001 edition, a letter from Charles F. Seymour, MAI, CREA, and Russell E. Snyder, MAI, said in part, "To substitute a cost-avoidance calculation of estimated savings to the buyer alone for a market-based methodology in which buyers and sellers have a voice seems to be contrary to concept of market value." They went on to say "The article also take the position that if the business of the current owner of the corridor is not negatively impacted by losing some sticks from his bundle of rights - the trains still run or the electricity still flows over a subsurface easement - then the taking of a subsurface easement places no discernible burden on the underlying fee ownership and presumably does not have any value for compensation."

"One of the rights of any property owner, regardless of how he or she is currently using some of their rights, is to sell or lease unused rights or the entire bundle to someone who can make more use of them. The taking of their subsurface rights eliminates or at least inhibits their ability to sell for this use. The owner is damaged by the loss of the subsurface even if he or she continues to use their other rights. In other words, the business of the property owner is not damaged but his property is."

In the same edition, I wrote the following letter, quoted in part. "On page 251, the authors state: Railroads and other monopolistic entities set unilateral and arbitrary prices for the use of their land." I have dealt with corridor valuation on an almost daily basis for 15 years, and I can state most of the values in the hundreds of cases I've seen were based on an appraisal. Further, railroads and other entities, like all property owners, have the right to ask any price that they feel is appropriate. Whether that price is reasonable or acceptable depends on the market forces at the time. Public agencies have the power of condemnation and can bring the valuation matter before a court to determine what is just compensation.

Are Public Utilities entitled to make only nominal payments for easements?

As a practical matter, this whole idea that public utilities can secure easements on transportation corridors for only a nominal payment has already been adjudicated and settled by the California Supreme Court in the case of City of Los Angeles v. Zeller, 176 Cal. 194 (1917). This case involved the longitudinal taking of a portion of a corridor, 1,600 feet long and about 35 feet wide, belonging to the Pacific Electric Railway Company. The trial court awarded only nominal damages ($10.00) because the taking would result in a concurrent use of the property which would not interfere with the existing operation of the railroad. The Supreme Court found the award was clearly inadequate. The court stated that the amount of damages awarded could not compensate the railroad for the detriment caused by the taking and held at page 200 that: "The trouble with the argument of the respondent upon this and the other branch of the case is that it ignores the possibility of the use of the real property for any other purpose than the operation of a railway."

Justice Henshaw wrote as follows: "I cannot bring myself to believe that an award such as is here made, of $10.00, for a strip of land 1,600 feet long by 35 wide, for which land unquestionably the appellant paid a large amount of money, is anything other than a cloak for confiscation."

He continued: "And finally, should the railroad corporation owning this land ever feel impelled to abandon its railroad service and devote this right of way to private use and sale, it will be deprived of a strip containing considerably more than an acre for the sum of $10.00, while there is no hazard in saying that its value to-day (September 1917) in the open market is easily many thousand dollars."

Clearly, the six to one ruling by the California Supreme Court is that, in cases involving longitudinal takings of a portion of a corridor, the corridor owner is entitled to receive as compensation an award based on the interference with all available uses of the property, including prospective ones.

How is "Just Compensation" measured?

It is true, as the authors state on the third page, that "By law, a public user is required to pay only for the damage or diminution in value caused to the seller." Then, like Karvel before them, they argue that the loss or diminution should be measured only by the amount of income that was lost. However, as the court case mentioned above, as well as many others, the owner is entitled to be compensated on everything that was lost, even prospective or potential uses.

I agree that the proper method of determining "just compensation" is the "before and after" but the income approach is inadequate in the case of transportation corridors. We turn to a 1980 survey conducted by David Lane, MAI, which concerned the various methods of corridor valuation. Among his many findings, we quote from the section labeled "F - Income Approach:"

> "Investigation revealed that a traditional 'income approach to value' was not feasible for this type of property, for the reasons that:
>
> a) It would be extremely difficult to segregate the income from an overall railroad use and apply it to a particular segment or branch line;
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> b) It would be even more difficult to apportion and deduct expenses of what is essentially a business operation in order to arrive at a net income for land only with which to capitalize;
>
> c) There is no evidence of a corridor reaching full usage at any given time;
>
> d) Where there have been railroad abandonments, the multiplicity of other uses is usually the result of permanent easements, not annual rents; and
>
> e) This approach is generally not acceptable or recognized in the valuation of corridor land.

As a proper example of how the before and after rule should be applied, let us consider a 5-mile corridor, 100 feet wide with an ATF value of $2.50 per square foot. The before value in this case would be 5 (miles) x 5,280 (linear feet/mile) x 100(width) x $2.50 or $6,600,000. A public utility wants a 25 foot wide easement for the entire 5 miles. Assuming a full fee take, the owner has a remaining corridor width of 75 feet. The after value would be 5(miles) x 5,280 (linear feet/mile) x 75 (width) x $2.50 or $4,950,000, a difference of $1,650,000, the amount of value diminution for which the owner is entitled to be compensated. To base the amount of compensation on anything other than the value of the land affected by the taking seems to fly in the face of the whole concept of just compensation, which requires the owner to be put in as good a position pecuniarily as he or she would have been prior to the take.

Self-Inflicted Severance

The current article then delves into a concept first introduced by the prior Karvel article, wherein it is maintained that the continued use of a railroad track for the movement of freight and passengers creates self-inflicted severance on the railroad's right of way. The major flaw in the application process results from confusing the railroad or other corridor user with the corridor itself. "Under all is the land" has been the motto of the Appraisal Institute and its predecessor's for as long as I can remember. The most important point to remember is that, in doing a corridor appraisal, we are valuing the land under the corridor improvements. The rails, ballast, signals, drainage ditches, power poles and all the other various and sundry items we find in a modern day corridor are all improvements. Critics often say that the improvements have changed the very nature of the corridor land, and it now has no relationship to the value of the adjacent or across the fence vacant land. But isn't the same thing is true in all improved parcels? Does the presence of an office building preclude the appraiser from valuing the underlying land by using sales of vacant parcels? Are we prevented from assigning a land value to a parcel because it is improved with an apartment complex or a shopping center? No! In every improved appraisal report, there is usually a section titled "Highest and Best Use of the Land as though Vacant."

This is the rationale behind the ATF approach. The land under the corridor improvements should be worth as least as much as the land through which the corridor passes regardless of the improvements placed in, on or over the corridor. Even if we accept the argument that the rail line severs the corridor, which I do not, the corridor is not damaged - what really happens is that there are now three corridors as is correctly pointed out in the current article - one containing the railroad right of way and one on each side of the railroad, going from the edge of the railroad right of way to each respective side of the original corridor. The same appraisal principles and methodology still apply.

I find the rules for corridor valuation outlined in the 1918 ICC appraisal manual are still the best way to deal with this perceived problem of self-inflicted severance. The original ICC instructions deal with the issue this way: "At times, values on the two sides are different, and the appraiser may conclude that the right of way is equally similar to both sides. If the difference in value is not great, the unit value may be intermediate between the values on the two sides, taking into consideration the area of the zone similar to each side."

"Where the values on the two sides are different, but the right of way is similar to one side only, the basis of value should be the similar side. However, it is usually the case that the value is influenced to some degree by both sides, and where this is so the unit value should be place accordingly."

In a 1923 letter to the Southern Pacific Company, the subject was again raised and was to be treated as follows: "Where the value of the adjoining property is not the same on both sides of the right of way, an average of the values of the two sides is taken, providing the right of way was of equal width on each side of the center line of the track. But if a larger area of carrier land lay on one side than on the other, the values assigned from either side would be weighted to allow for this fact. This would be done unless the carrier property more closely resembles the property from one side in which case its value would be reflected from that side."

Land Continuity and Physical Barriers

A typical corridor is crossed by hundreds of streets, creeks, culverts, bridges, trails, power lines, sewer and water lines. These crossings do not necessarily break the continuity of the corridor. There are numerous instances where occupants of a corridor may cross over and under each other and yet the corridor remains intact. It is not enough to simply drive along the corridor, observe the street crossing and conclude the streets break the continuity of the corridor. In many, many cases the railroad was there first and the street came later. In these cases, the railroad still owns the subsurface and overhead rights while sharing the surface rights with the street users. In appraising those projects where the railroad had no ownership interest in the street, we would use the ATF approach up to the street boundary, assign a nominal amount, say $1.00, to the area of the street and then continue the ATF approach until we came to the next barrier. I'm aware of a situation where three different pipelines on a Southern Pacific (SP) corridor came to a river. Two of the pipelines decided to leave the corridor, bury their pipe in the river bottom and rejoin the SP corridor; on the other side of the river. The third pipeline was strapped to the bottom of the rail bridge, crossed the river and was reunited with the other two. The first two were not charged anything since they left the corridor; the third paid only a nominal fee since they paid for the expense of attaching the pipeline and agreed to assume responsible for the safety of the bridge in case of an accident.

> **"what may be an endpoint for one user on a corridor might not be appropriate for another user ..."**

A common misconception is that a corridor has to connect two major metropolitan areas to be considered a transportation corridor ,but that is simply not true. A corridor is used to move people, goods and services from one endpoint to another. In my opinion, the idea of an end point or terminal is a relative, not an absolute term. By that I mean, what may be an endpoint for one user on a corridor might not be appropriate for another user on the same corridor. For example, a pipeline owner sending fuel from Long Beach to San Jose would consider those two cities the corridor termini. However, the Santa Clara County Transportation Agency seeking a rapid transit system from Gilroy to San Jose, on the same corridor, would only be interested in those two points. The City of Morgan Hill, seeking to extend a sewer line along the corridor might only be interested in points five blocks apart. The importance of the endpoint or terminal depends on the needs of the individual corridor user, not necessarily the major population centers ultimately connected by the corridor. So the presence of a physical barrier is not a major issue - we simply use the ATF between the actual, not perceived barriers and make a nominal adjustment for the barrier.

Crossings versus Longitudinal Easements

As a final issue, the article mentions "in November 1989, the Public Service Commission of Wisconsin rejected the use of occupancy factors, stating that the damages caused by, and the compensation to be paid for, a natural gas pipeline crossing under a railroad right of way was one dollar for each of those crossings not in a public street and nothing for those crossing located within the public street right of way." I have no problem with this concept. In fact, the Southern Pacific Railroad did not charge for transverse crossings for many years although they maintained the right to insure that any crossing was engineered and constructed so as to not create a hazard for train traffic. I do object to trying to trying to apply this crossing concept to longitudinal easements. In the 1978 case of People v. Southern Pacific Transportation Co., the Appellate Court dealt with the issue of crossings versus longitudinal takings in these words:

> "Plaintiff (state of California) also asserts that the defendant (Southern Pacific) is only entitled to nominal damages as a result of that diminished value. The case authority relied upon by the plaintiff in support of that assertion is inapposite; in each instance they involve transverse crossings which did not interfere with the railroad's operation and are not applicable or similar to a longitudinal taking such as is presented in this instance. A similar claim was rejected in Los Angeles v. Allen (1917) 32 Cal. App. 553 at page 561, where the court stated, "There is an important difference between the extension of a street crossing over a railroad track and a taking for the purpose of constructing a street longitudinally covering a right of way. The right to take longitudinally is very different from the mere right to cross, for in the one case the rights of the railway company are materially impaired, while in the other the taking is such that both uses can stand together."

Conclusion

As a final note, I applaud the authors of this article for their efforts and their diligence in their research, and I would encourage others in the field to take a pen in hand and enlighten us all. Whether we agree or not, if your article makes us stop and think about how and why we do our jobs, it serves a useful purpose. There was once a TV program which ended with these words: "What kind of a day was it? A day like all days - filled with those events which alter and illuminate our times!" Hopefully your article will do the same for the rest of us! ◉