

# THE COST APPROACH IN CORRIDOR VALUATION

BY ARTHUR G. RAHN, SR/WA

The cost approach relates to properties improved with structures and is a process in which the appraiser derives a value indication by:

- Estimating the current cost of reproducing or replacing the existing improvements,
- Deducting accrued depreciation which is defined as the difference between the replacement or reproduction cost new of an item and its value in its current used condition, and
- Adding the value of the land developed from the sales comparison approach wherein the site is considered vacant and available for its highest and best use which presumably is consistent with existing usage.

In the classic sense, in the appraisal of special use properties, it is the improvements which normally define the special purpose or use of the site such as a school, courthouse, hospital or a church.

In transportation corridors, it is the land not the improvements which are unique and constitute the special use. Long, narrow strips of land which provide continuity between desired end points are not ordinarily available in the usual subdivision of land uses. Therefore, the normal process of creating a transportation corridor is through assemblage and the cost approach includes both the acquisitions of the necessary properties to create the corridor together with the normal project costs to make it useable.

Those costs which can reasonably be anticipated in creating a corridor includes and, existing improvements, severance damages, relocation assistance, right of way clearance, legal and litigation fees, project and overhead costs including that giant project killer, environmental impact and mitigation. An analysis of these costs will assist the prospective right of way buyer in determining whether to locate on an existing corridor or to create a new one.

Similarly, there is in the law a "substitute facilities" doctrine which, like the cost approach, is based on the concept of replacement cost less accrued depreciation. This doctrine is used by the courts in condemnation of unique special purpose properties where, because of the special social utility of the property being condemned, just compensation calls for the replacement of the property rather than the mere payment of the value of the property as damages. In such a case, the market value of the property is irrelevant since the constitutional mandate requires nothing less than the replacement of the property.

For example, in 1974, the federal government condemned lands used by a church as nonprofit recreational camps and the 2<sup>nd</sup> US District Court held that the church should be paid either market value or, if that method was not available, the depreciated replacement cost of the properties. The church said there was no market for the property and the cost of substitute facilities was far in excess of the compensation offered by the government. The 9<sup>th</sup> US Circuit Appellate Court agreed with the church saying the only way they could be restored to their previous ownership position would be by obtaining a substitute property with a similar utility.

Our purpose here is to show that the distinction between the cost approach and the substitute facilities technique is shadowy and ill-defined. Since both concepts are applications of the basic principle of substitution, the concepts tend to overlap. One logical way to value a special purpose property like a transportation corridor is to determine its present cost of replacement and apply that to the part taken less any applicable depreciation or obsolescence. In many instances this method has been rationalized by

courts as a cost approach to value while other courts have simply asserted that just compensation may be had by requiring either the condemnor to provide a substitute or pay its cost.

There are two California condemnation cases where the cost approach/substitute facilities' technique has been used to value a transportation corridor. The first is, of course, the oft-quoted and much-referenced Sacramento case between the California Department of Transportation (Caltrans) and Southern Pacific Transportation Company (SPTC).<sup>1</sup>

The state of California condemned a long, narrow strip of land which was part of a railroad-owned transportation corridor in

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order to build a new highway. The condemned strip was about 6,340 feet in length and varied in width from 12.75 feet to 27.75 feet, having a total area of some 127,000 square feet or 2.915 acres. Caltrans also condemned easements to relocate certain underground sewer and water lines into several longitudinal strips bordering and just north of the fee simple take. There were four such parcels that total some 55,545 square feet. Lastly, Caltrans took two transverse easements area to widen street crossings that total 2,788 square feet.

The Caltrans appraisal argued that the portions of the take zoned C-4 were too small and too irregular to be used independently so their sole market value would be derived from their sale to adjacent landowners at a unit price of 75 cents per square foot, 50 percent of the

Caltrans estimated land value for unimproved C-4 land in the neighborhood. Those portions of the take zoned R-1 were deemed to have no market value whatsoever and, therefore, just compensation was nominal – \$1 per parcel for the property involved.

SPTC argued that the highest and best use of the property being taken is as part of its transportation corridor system. They pointed out that such corridors are not typically bought and sold on the open market and, therefore, the commonly employed sales comparison method of valuation was not available. Next, because the corridor is only a portion of a larger transportation system involving people, tracks, yards, operating equipment and other facilities, the income approach could not very easily be used. This left only the cost approach as a means to estimate value of the take.

After hearing all the arguments, the trial judge found that the cost approach was an appropriate method to establish the value of the take and the 3<sup>rd</sup> Appellate Court of Appeals upheld the lower court's decision.

The second case is not nearly as well known since it has received virtually no publicity and, since there was no appeal of the valuation, it was not published.<sup>2</sup>

In the 1950s, Southern California Edison (SCE) acquired real property for an electrical transmission line corridor approximately 250 feet wide running from a substation in Irwindale, Calif. to a substation in Montebello, Calif., a distance of approximately 10 miles. In the mid-1960s, SCE was planning on upgrading the corridor to accommodate 500kV transmission lines. The lines have to be separated physically to a specified distance; they have to be parallel and they have to travel in a straight line.

In the late 1960s, Caltrans began construction of the 605 Freeway between the Interstate 10 and the Interstate 210 freeways on an existing street, Rivergrade Road, which ran along the side of the SCE transmission line corridor and on a portion of the SCE corridor.

In June 1969, Caltrans began construction of the freeway on SCE's property pursuant to a Permission to Enter Agreement. The agreement provided, among other things, that

Caltrans would pay SCE 1969 value for the property taken plus 7 percent interest until settlement. If the parties could not agree on value, Caltrans would also file a direct condemnation suit "without unreasonable delay." Since some of SCE's towers required relocation, Caltrans promised title to property on which the towers were relocated and also promised to acquire whatever rights were necessary to restore SCE's transmission line corridor.

The freeway was completed in 1971 but neither the compensation nor the title matters had been settled and negotiations between SCE and Caltrans continued on through the early 1990s. In 1994, SCE retained outside counsel and offered to settle the case for what proved to be a fraction of the eventual jury award. Caltrans countered with another offer which was rejected by SCE. On October 13, 1994, SCE filed an inverse condemnation suit against the state. In September 1995, Caltrans filed a condemnation action against SCE and deposited \$243,485 as probable just compensation for the takings of SCE property.

SCE hired an independent appraisal firm who used a "cost of reproduction" of a substitute corridor approach to best illustrate how the freeway takings had damaged the corridor. SCE could no longer use the corridor for the purpose for which it was assembled. The sales comparison approach was not applicable as there were no comparable sales of operating electrical transmission corridors. The income approach was not applicable as the property (land) did not generate any revenue.

Since the corridor was not useable for its intended purpose, a substitute corridor had to be considered. The appraisal reported that most reliable, least expensive and unobtrusive course for the replacement corridor was selected by engineers experienced in such analysis. The direct and indirect costs of acquiring the necessary property for the reproduced corridor were used to establish the value. The appraiser utilized both the Seymour/Dolman and the Clifford Zoll articles to justify this valuation methodology. His final value conclusion was \$54.9 million including payment for part taken, damages to the remaining corridor and \$6 million to reconfigure SCE's facilities back onto the remaining SCE property. The after value of the part taken was \$13.5 million.

The state's appraiser used the across the fence (ATF) approach and had a value conclusion of \$4.5 million. The state's technical experts advised the appraiser that the property could still be used for electrical transmission lines so no damages were assigned.

On March 11, 1997 after six weeks of trial, a jury in Los Angeles Superior Court awarded SCE a total of \$49.5 million in just compensation for the Caltrans takings. The award consisted of two elements, payment for the property taken (\$13.5 million) and severance damages (\$36 million).

It is probably safe to say the majority of corridor transactions are resolved through the use of ATF methodology since it is the quickest and easiest to resolve and the values produced usually in middle of the value range. However, it is also safe to say that the cost approach/substitute facilities is alive and well.

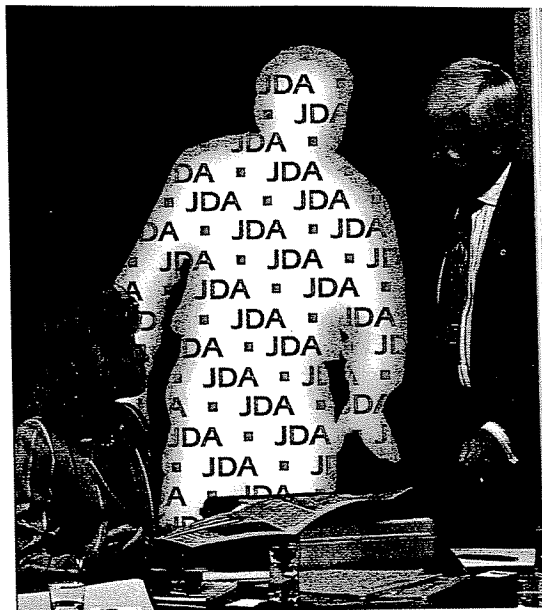
If you are planning a project that envisions taking a portion of a corridor, be aware of the damages your project may inflict on potential uses of the corridor and the cost you have to pay to correct those damages. ♦

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#### REFERENCES

<sup>1</sup> People ex rel. Dept. of Transportation V. Southern Pac. Transportation Co. (1978) 84 Cal. App.3d 315,327.

<sup>2</sup> People ex rel. Dept. of Transportation V. Southern Cal. Edison Co. (2000) 22Cal.4th 791



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