TRANSITIONAL USE TCE

A more proper classification

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A property owner told us that his 500-acre rice farm had just leased for $400 per acre/per year—the highest rent ever paid for rice ground in the region. We acknowledged his delight and thanked him for the information. As we drove away, levees were being repaired and ground-squirrel holes filled before rice checks could be flooded in the following weeks to grow rice.

His farm was within an impressive 5,000-acre specific plan destined someday for commercial and residential development. However, grading for this new development was still a few years away because the approval process for such a grand plan would take at least another four years. In the meantime, the owner's land could be farmed for rice as it had been for decades.

Background

We met the owner because we were hired to appraise his property for a proposed high-pressure natural gas transmission line project that would install a large gas line along the Subject's frontage on an adjacent road. Five acres would be acquired as a permanent easement for the pipeline, and 10 acres would be needed for a term of two years as a temporary construction easement (TCE). The term of the TCE was scheduled to start at the end of harvest in about six months from the day we met the owner.

Comparable sales were readily available. All were fairly recent and all were being cultivated for rice; many had recently been leased. The sale prices being paid for the comparables included the envisioned future change in use identified by a colorful specific plan zoning map. We were comfortable with our fee simple interest estimate of $50,000 per acre.

Valuing the permanent easement for the gas transmission line was textbook routine: a reasonable percentage of fee value for property rights being acquired, crop loss consideration and finally, confirmation that levees, irrigation and hard pans would be restored as part of construction contract work. Next came the valuation of the 10-acre, two-year temporary construction easement.

A Difference in Opinion

Let us digress by saying that our appraisal was the second appraisal of the Subject property. Though the first appraisal was done by a very reputable firm, the owner was unhappy with the total compensation offered to him.

We were called to provide a second opinion. Without asking, the owner told us he had been offered $100,000 for the TCE. We realized immediately that if the owner was correct, the deposit appraisal likely used 10 percent of the land's fair market value (FMV) to estimate the value of the TCE. It's the same formula routinely used by condemnation appraisers, except perhaps for the specific percentage. The percentage used by appraisers is, in theory, supposed to reflect a reasonable return on the property's value—a convenient substitute for relying on actual market rental data.

But compensation for the TCE estimated by the prior firm was equivalent to $5,000 per acre/per year—not the actual market land rent of $400 per acre/per year that was just negotiated between the owner and tenant farmer close to the effective date of value.

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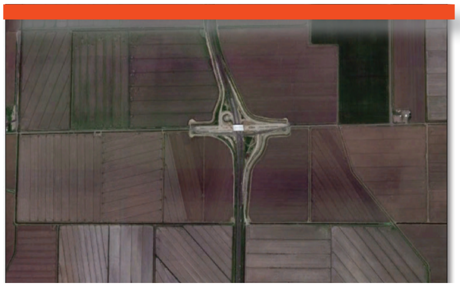


500-Acre Rice Farm.

Something was fundamentally wrong; Shouldn't the utility company pay fair market rent to prevent any loss to the owner? Why should the utility company pay $5,000 per acre/per year for the same type of ground for which the tenant farmer was only paying $400 per acre/per year? The simple answer is they should not.

Where Did They Go Wrong?

The apparent flaw in the prior appraisal's methodology was caused by assuming that the highest and best use of the property was consistent with the highest and best use of the property *at the time of occupancy* for the TCE by the condemnor. This method is not at all unusual because eminent domain (ED) appraisers routinely use the same FMV as a basis to estimate values for full takes, permanent easements and temporary construction easements. To be fair, that method is usually perfectly reasonable because the highest and best use of a property during occupancy is typically the same as in the future.

However, when a property is in transition from one use to another, the appraiser must now consider the possibility of two highest and best uses: one that includes anticipation of future benefits (FMV), and one that doesn't (FMV at the time of occupancy).

A New Term

Let's face it—a new appraisal term is needed to better identify this unique type of TCE. We recently started using the term *Transitional Use TCE* to better communicate to our clients that the manner in which compensation is calculated for a TCE may not necessarily be what they have grown to expect. The term Transitional Use TCE is a reminder to us that the property's highest and best use *at the time of occupancy* is inconsistent with the property's actual highest and best use. As such, the value of a Transitional Use TCE should be based on the highest and best use of the property at the time the property will be occupied, not on a value based on a future use unrelated to the present use.

Incorporating this new term into your practice will increase awareness of this particular type of TCE and ensure that consistent methodology is used to calculate total compensation for eminent domain assignments that include TCEs.

The definition of a TCE is self-explanatory: an encumbrance on a parcel for a particular use during a specific time period. In most cases, a rate of return for the use of the land is based on a percentage of fair market value (FMV) of the land instead of using actual comparable market rental data. On the other hand, a Transitional Use TCE is an encumbrance on land transitioning from one use to another. Though the value of a partial fee acquisition is based on FMV, the value of a Transitional Use TCE must be based on FMV or fair market rent at the time of occupancy by the condemnor.

Support

According to *Real Estate Valuation in Litigation:*

> *Some courts have ruled as a matter of law, that the property's loss in market value is not the proper measure of value in the case of temporary easement acquisitions. It has been held that the proper measure of compensation is the value of the property for the period it is to be held by the condemnor or the diminution in the value of the property by reason of the owner's loss of its use and occupancy during possession by the condemnor. The most common measure of damages accepted by the courts is the rental value of the easement area for the period of occupancy by the condemnor.*

Therefore, the value of a Transitional Use TCE should be calculated either by using market rent data reflective of highest and best use at the time of occupancy or the rate of return based on the land's FMV at the time of occupancy. Either way, the time in which occupancy occurs is the foundation for compensation for a TCE.

No one, except perhaps the appraiser, truly benefits from a $5,000 appraisal for a TCE only worth $25. On a practical basis, it may make more sense to value the amount of compensation for a minor Transitional Use TCE by using a percentage of the land's FMV. But in those cases, I would simply include a hypothetical condition that informs the reader with the proper information.

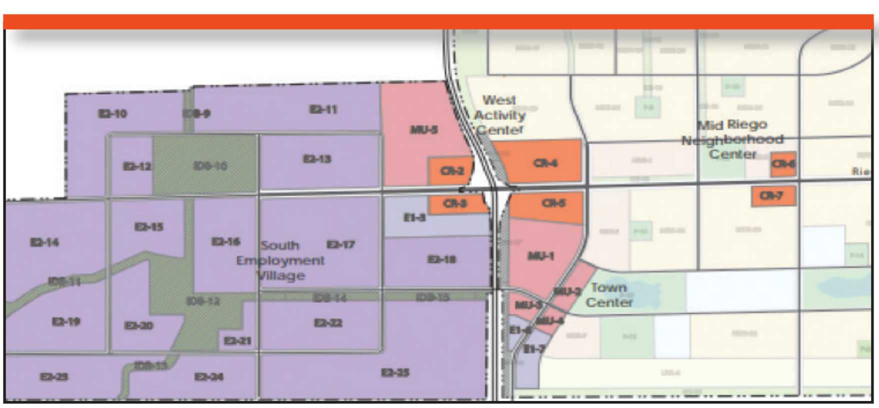
Significant Effects

In the case of the rice property, the need to value the *TCE as a Transitional Use TCE* was obvious. Market rent ($400 per acre/per year) for the Transitional Use TCE for two years totals $8,000, as opposed to a 10 percent rate of return based on the land's current FMV, which equals $100,000. That is a significant difference of $92,000.

In fact, the rice farm property was only one of 15 similar properties along the proposed alignment for the natural gas transmission line project. Compensation that was estimated in the deposit appraisals for all of the TCEs for the entire project could have exceeded $1,500,000 based on FMV rather than $120,000 based on fair market rent at the time of occupancy. This flaw in methodology cost the utility company/condemnor $1,380,000 more than required.

When appraising property for ED purposes, we appropriately appraise that property in the before condition in a fictitious state that ignores what factually exists: the project. Likewise, we might choose to ignore what factually exists when appraising a Transitional Use TCE: the project that created a change in future use. If fee simple interest includes an increase in value caused by anticipation of a future use yet to be realized, then that value represents a future use that has nothing to do with current use. All TCEs should be based on the property's value at the time of occupancy.

For a while, we assumed that the only time a Transitional Use TCE would be relevant, at least financially, is when commercial/residential speculation inflates agricultural land value. But our assumption was short-lived when we appraised a commercial property in an urban location.



5,000-acre plan destined for commercial and residential development.

An older, urban lot.

Finding Opposite Results

A five-acre property on a primary commercial corridor in an urban area was on its last legs. One older building with a large parking lot had seen better days, similar to many nearby properties. The city realized demand for high density apartments far outweighed older commercial stores and wisely rezoned the immediate neighborhood to high density residential.

The 20-year lease for the Subject included an older retail building plus five acres of parking. The end of the 20-year lease coincided with the city's adoption of the new zoning ordinance. The property owner offered his tenant a shorter three-year lease extension at a reduced rent to entice the lessee to remain while he was considering redevelopment of the property. He had yet to submit any application for redevelopment, but he knew that the approval process in this particular urban city would take at least two years.

Six months after the three-year lease for the property was signed, a road widening project was approved that affected the subject property. It was confirmed that the road project did not affect negotiations for the lease. The owner of the property simply wanted to both redevelop the site and also receive income during the lengthy approval process.

High-density land along the same corridor as the subject was selling for $250 per square foot or about $11,000,000 per acre. It was agreed that the value of the fee take should be $250 per square foot. But not everyone was on the same page when it came to the value of the TCE, a Transitional Use TCE.

One side based the value of the one-acre TCE on the FMV of the land, a value that included anticipated benefits related to a high-density redevelopment. But the lease for a temporary use before approvals could be gained did not include value for any anticipation of that future use. And if a future use is the force driving values up, it is illogical to include that anticipated value as a basis for market rent during occupation for the TCE.

One appraiser used a 9 percent return on the FMV of the land to arrive at $22.50 per square foot/ per year compensation for the TCE. If actual market rent for the subject property was used, compensation would only be about $2.00 per square foot/per year. The difference between actual market rent and rent based on a percentage of FMV was around $20.50 per square foot/per year, which equaled over $1,790,000.

In this example, basing compensation for the TCE of anticipated future redevelopment and not on actual market rent during the time of occupancy caused the agency to pay $1,790,000 more than required.

In Summary

Similar to the rice ground example, the obvious question was asked: why should the agency pay far more than actual fair market rent being paid for the same property if rent being paid is fair market rent? If an agency is required to rent land at the going market rate and the going market rate has been proven with recent rent comps, why should there be a difference between the two methodologies?

Common sense says there should not be a difference. Market rent is the appropriate return on the value of the property during the period of occupancy, especially for transitional properties. If rents are not available, a percentage of fee value can certainly be used, but the fee value must represent the use at the time of occupancy by the condemnor, not the value that includes future benefits. Just compensation should not only be just to the property owner, but also just to the public.

When valuing TCEs that will encumber a property that has a different highest and best use than the existing use (or use during occupancy by the condemnor), the term Transitional Use TCE can help classify these acquisitions so that they are valued using a consistent and common-sense methodology. The examples in this article demonstrate the importance of spending the additional time and effort in order to produce a credible result when a Transitional Use TCE is being acquired. ✪

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