Court Provides Guidelines on Valuing Natural Resources in Eminent Domain Proceedings

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Courts have long recognized that valuing mineral rights in eminent domain proceedings is inherently speculative, which can lead to wide swings in property valuations. So how can appraisers, property owners and public agencies best deal with the uncertainty involved in valuing property that has the potential for mineral exploitation? In a recently published decision, *San Diego Gas & Electric Company v. Schmidt* (2014) 2014 Cal. App. LEXIS 740, the California Court of Appeal provided guidance on valuing mineral rights on land taken by eminent domain.

Background

The *Schmidt* case involved San Diego Gas and Electric Company's (SDG&E) condemnation of a 22-acre easement for electric transmission lines down the middle of a 115-acre vacant parcel for its Sunrise Powerlink Project. SDG&E's appraiser believed that the property's highest and best use was for residential development or habitat mitigation, and it valued the easement at $712,200. The property owners believed the property's highest and best use, before SDG&E's taking, was a for granite mining operation, and their appraiser valued the easement at $1.9 million. The owners' appraiser also concluded that the easement prevented the property from being used for granite mining, thereby causing severance damages of $6.6 million, for total damages of $8.5 million.

In support of the owners' valuation testimony, they retained a mining expert who opined that the property was zoned for mining, that a "very competitive aggregate environment" existed in the area, and that the property was located between properties owned by a mining operator, with whom the owners had discussed the possibility of leasing the property for mining. SDG&E, on the other hand, claimed a Major Use Permit would be required to conduct a mining operation, and that the owners would have to address the removal coastal sage scrub before such a use could be made of the property.
The jury ultimately agreed with the owners' experts that a mining operation was the "highest and best use" for the land, and concluded that the property owners were entitled to just compensation of over $8 million.

The Appeal
SDG&E appealed, arguing that the evidence was insufficient to show that a mining operation was the highest and best use of the property and even if a mining operation were the highest and best use of the land, the valuation method used by the owners' appraiser was improper.
The Court of Appeal began by noting that the measure of just compensation for property taken by eminent domain is the property's fair market value, and that this fair market value includes the right to exploit the natural resources located on or under the land in the future. So, "[i]n determining just compensation in eminent domain proceedings, the existence of valuable mineral deposits in the land taken . . . influences the market value of the land." The Court noted that while valuation of a mineral estate is inherently difficult, and to some degree speculative, that does not preclude the mineral estate from having an ascertainable market value.

To properly determine this value, the Court explained the first step is to present evidence that the exploitation of minerals is compatible with the highest and best use of the property. Following that, the next step is determining the proper valuation methodology. Usually, the comparable sales approach is the easiest and most reliable method, but if there are no comparables, other valuation approaches may be used. In such cases evidence of income that may be generated from the land may be considered.

For example, an appraiser can utilize the income approach by capitalizing potential royalties to be generated from the minerals, by multiplying the reasonably probable royalty rate by the estimated amount of minerals, discounted to present value. The Court explained that such "evidence is proper where there is proof of an active market for the minerals in question, that such transactions commonly take the form of royalty payments and that the estimate for recoverable deposits is not too speculative." Therefore, if a property owner wishes to pursue a land valuation based on the existence of natural resources, the owner will need expert testimony regarding "(1) the existence of the deposit, (2) the quantity and quality of the deposit, (3) whether a market exists for the deposit, and (4) the net income projected over the life of the deposit."

In this case, the property owners' experts satisfied the four requirements. They performed testing of core samples taken from the property to ascertain the existence, quality and quantity of aggregate that likely existed, and they demonstrated an active market for the minerals based on a market study. Based on the expected return for the minerals, the owners' appraiser then determined the average income that the owners could realize by leasing the property for mining purposes (approximately $3.3 million per year), applied a 50% risk factor associated with securing the Major Use Permit, and then discounted the future income stream in order to reduce it to its present day value.

The Court rejected SDG&E's argument that this discounted cash flow method used by the owners' expert constituted an impermissible use of the developers approach, or otherwise violated Evidence Code section 819, which permits the use of the income capitalization approach only for the land and the existing improvements thereon. The Court explained that the statute allows "the capitalized value of the reasonable net rental value attributable to the land," which included the capitalized value of the income stream from the potential lease of the property to a mining operator.

Ultimately, the Court upheld the jury's award of just compensation. It also determined the property owners were entitled to their reasonable litigation expenses, attorneys' and expert fees.

Conclusion

The *Schmidt* decision provides considerable guidance for parties involved in the valuation of land that contains natural resources. While the valuation of mineral rights will necessarily involve some speculation, there are certain steps that can be followed to minimize the guess-work to the extent possible. The decision allows appraisers to become a bit more creative and step outside the box of relying heavily on comparable sales, instead focusing on an income approach to value.