



OBSERVATIONS

from the

Rail Line

Can railroad corridors be considered the highest and best use?

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A recent appraisal of a rail line right of way that ran through a very high priced New York suburb revealed several interesting observations. Until recently, general real estate values had been very high, and as the railroad industry has been declining for decades, the highest and best use analysis strongly indicates that rail lines through high-priced real estate market areas have a non-rail highest and best use. This has important implications for buyers, sellers and appraisers of rights of way.

Observations indicate that railroad businesses do not compete well with other more profitable businesses for the resources that the railroad businesses need, which include the land under the rail line. Non-rail land uses create a higher demand, and thus yield higher values, for the land. When this observation is accurate, buyers, sellers and appraisers must adjust their right of way valuation processes accordingly. In particular, a land residual for a railroad-use will not be an appropriate procedure to measure market value of the right of way. Land values for rail rights of way should assume non-rail land uses, and corridor factors should not be applied to land values when the values are based on non-rail uses in high priced markets. These observations may also apply to telecommunications and electricity transmission rights of way, which are also recently troubled or associated with low financial return industries.

Highest and Best Use

By definition, market value assumes the highest and best use of the appraisal subject. If the purpose of the appraisal is to ascertain market value, the subject property must be analyzed under its highest and best use. For example, in the sales comparison approach, the sales comparables used must be properties that are, or are intended to be, of similar uses to the subject's highest and best use. It is noted that current, actual uses do not always represent the highest and best use.

In order to be a highest and best use, a use must be physically and legally possible, financially feasible and maximally productive. This article focuses on the maximally productive criterion. To complete a maximally productive highest and best use analysis, an appraiser must measure the value of each of the competing uses. In an appraisal of an existing rail line, we want to test for the value of the rail line as a continued use. It is essential to test reasonably probable alternative uses, where such uses are defined as physically and legally possible, as well as financially feasible uses that have a reasonable probability of actually occurring in the market as of the valuation date. In a suburban location, these alternatives include the major property types: single family and multi-family residential, retail, offices and





warehouses. Given a long corridor, the alternative uses will vary as one moves down the rail line into neighborhoods and market areas of differing legal, physical and economic characteristics. Additionally, the appraisal adjustment process must account for the long narrow shape that the corridor may have.

Maximally Productive Analyses

Two types of maximally productive analyses were conducted for the corridor valuation. First, a rail corridor valuation was done to determine the value of the corridor, assuming it was not for rail use. This is tantamount to a land appraisal that assumes a non-rail line use and accounts for the unusual shape of the corridor and all other land characteristics accordingly. This is also known as an across the fence (ATF) valuation without a corridor assemblage factor/premium adjustment, but with adjustments for shape. An ATF valuation is an appraisal concept whereby the value of a subject right of way is assumed to be similar to the land adjacent to the subject, over a proverbial fence bordering a neighbor's land. It is a type of sales comparison approach that is widely used in the valuation of rail corridors. The technique is utilized because suitable sales comparables of rail corridors cannot be found. Instead, sales of land similar (except for use) to the land neighboring the subject are utilized.

Secondly, an overall rail business valuation was performed, even though the appraisal purpose was to find the value of only the land

portion of the overall business. This entails allocating the business value to the subject corridor portion of the overall business, based on the proportion of the miles of track in the subject corridor compared to the total miles owned by the rail business. Note that railroad companies often own many different rail corridors and sometimes own different businesses, such as road and shipping transportation companies. However, we made no attempt to exclude the value contributed by the other businesses. The value of the other businesses was assigned to the miles of rail track, and thus we over estimated the value of the rail business attributed to the right of way. Further, no apportionment was made for those tracks in the rail business's portfolio of tracks which are more profitable or less profitable than the average track. Admittedly, the lack of this adjustment could result in over or under estimations of the value of the subject corridor.

Now this is where things get interesting!

It was not necessary to do a residual on the railroad business valuation to find the right of way (real property land) value only. The business value included business intangibles plus real and personal property. To find the precise land value using a residual, the process involves subtracting the value of the business intangibles, personal property, and real property improvements. However, the business value was so low that it was below the ATF values before the corridor factor adjustment. The conclusion was that no rail use land residual could yield a value that was maximally productive.





Formulaic Expression

Using the Appraisal Institute notation convention, the findings can be expressed as follows:

Where;

- V = market value
- b = business
- bi = business intangibles
- rp = real property
- pp = personal property
- l = land
- i = real property improvements

And

$$V_{rp} = V_l + V_i$$

$$V_b = V_{bi} + V_{rp} + V_{pp} = V_{bi} + (V_l + V_i) + V_{pp}$$

Noting that;

1. To be a highest and best use, that value of a use must be maximally productive,
2. To be maximally productive, that use must have the highest value from among the probable alternatives

$$V \text{ (highest \& best use)} > V \text{ (any other probable use)}$$

3. If the sum of the several component values that comprise an aggregate value is lower than the value of a single asset, then neither the component assets nor the aggregate asset can be a highest and best use.

Finding that;

1. V_l (assuming non-rail uses) $>$ V_b (assuming rail use)
2. Therefore, V_l (assuming non-rail uses) $>$ $V_{bi} + V_l + V_i + V_{pp}$ (assuming rail use)
3. Therefore, V_l (assuming non-rail uses) $>$ V_l (assuming rail use), even if V_{bi} , V_i , V_{pp} (assuming rail use) = \$0
4. Therefore, V_l (assuming non-rail uses) $>$ V_l (assuming rail use), unless either/or V_{bi} , V_i , V_{pp} (assuming rail use) $<$ \$0, which is not likely, albeit possible in the sense that the business may have legal (contractual and regulatory) liabilities, and/or may suffer large economic obsolescences.

Conclusion;

The highest and best use conclusion is obvious; rail uses cannot be the highest and best uses, and should not serve in any way as the basis of market value.

“...no rail use land residual could yield a value that was maximally productive.”

Corridor Factors

Corridor factors are a special adjustment made only in ATF appraisals. They are made to adjust up the otherwise similar ATF sales—which are not used or intended to be used for rail uses—to the presumed higher and better rail use. Corridor factors add to value, and the adjustment is positive because presumably the rail uses are more productive, more profitable and more valuable than the ATF uses. Of course, if rail uses are not more productive, profitable and valuable, then the corridor factor adjustment makes no sense.

Corridor factors should most likely not be applied in high priced land markets. Corridor factors only make sense in viable competitive businesses, where the return on other assets of the business justify paying a premium over otherwise normal market value for the real estate. While there is a cost to create an assembled right of way, no value enhancement is created by the assemblage when the assembled business assets do not enjoy an assembled value enhancement. The old appraisal principle that “cost does not always equal value” applies. The rail line could spend the money to assemble the right of way, paying a premium for a corridor for the land, but the business does not justify the expense. If the rail line paid a premium, the cost would immediately suffer a 100 percent economic obsolescence (or be classified as an imprudent management decision).





These findings, which pertain to rights of way just outside of New York City (a high real estate value area), will also be true in many other places, especially urban and suburban areas, given the still high prices of real estate and the low status of the rail industry. In rural areas, these findings probably do not apply, because the alternative land uses will not be as profitable.

Corridor Factors and Value in Use

It is now speculated that there are few appropriate occasions to apply a corridor factor. While a rail road business may have a legitimate business reason to pay a corridor factor premium over an ATF value, the rail business reasons may not represent the probable or typical motivation when other land uses are more common. Similarly, it's questionable whether rail uses ever qualify as probable or typical, even when they are more profitable. While a right of way use may be most profitable in rural areas, this value is a value-in-use and may not be a value in exchange (market value), because the right of way use is not probable or typical.

Conclusion

As real estate values continue their long-term trend upward and the railroad industry continues to decline, rail lines are no longer the highest and best use. Non-rail land uses actually create higher land values. Under such conditions, a land residual for a railroad-use

will not be an appropriate procedure to measure market value, and corridor factors should not be applied to land values when the land values are based on non-rail uses. These observations may apply to telecommunications and electricity transmission rights of way, which are also considered low return industries. ☺

¹USPAP 2008-2009, line 548

²The Appraisal of Real Estate, 12th Edition, Interim Uses, page 323

³The Appraisal of Real Estate, 12th Edition, page 307

⁴The Appraisal of Real Estate, 12th Edition, page 314 and 318

⁵USPAP2008-2009, line 548

⁶The Dictionary of Real Estate Appraisal, 4th Edition, Electronic Edition. Corridor Valuation: The process of estimating market value for the corridor rights defined in the appraisal assignment. Relevant valuation approaches include land-based methods such as the across the fence method, going rate (sales comparison) approach, alternate route (cost avoidance) approach, and before and after method, and non-land-based methods such as liquidation value, replacement, income value, and competitive bid methods.

⁷The Dictionary of Real Estate Appraisal, 4th Edition, Electronic Edition. Across the Fence Method: A land valuation method typically used to estimate the value of a real estate corridor, including railroad or pipeline rights of way, highways, or other corridor real estate. The price or value of land adjacent to the corridor (i.e., "across the fence") is considered for the valuation. Other considerations include corridor factor and usage factor adjustments. Note that this term and related corridor valuation terms may be defined differently in different jurisdictions. Pending federal legislation and the interpretation of the courts may render current definitions invalid.

