QUARRY VALUATION IN LITIGATION

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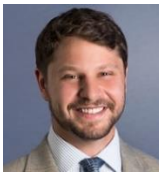

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It is necessary from time to time to value quarry property – for financing purposes, when contemplating a sale or purchase, or in a condemnation context. Nationally, appraisals often rely on royalty capitalization for such valuations, particularly given the scarcity of comparable sales. Moreover, the Virginia attorney general's office has opined that royalty capitalization is appropriate in valuing mineral lands for *property tax* purposes.[1] Royalty capitalization is akin to the discounted cash flow method to value developable property. It assumes a direct relationship between the value of the property and the income it will produce in the future; in the case of a quarry, it would be the royalties from mineral sales. Future royalty expectations are discounted by an assumed rate to achieve a present value.

Nevertheless, a recent decision by the Virginia Supreme Court stated that reliance on future income, capitalized over time, is risky and, arguably, outright inadmissible. In *VEPCO v. Hylton*,[2] the landowner, while computing fair market value, attempted to include the value of an unopened surface mine on its property, and relied at least in part on potential future rents and royalties. Reversing the decision of the trial court, and ruling the landowner's evidence of quarry value inadmissible, the Court emphasized that the mine was *unopened* and that there were *no existing plans* to mine the property. However, the Court also stated that "the future rents and royalties that would be received for [the mineral reserves] when and if they are removed from the land, are inadmissible for proving either the value of the property taken or damage to the residue."[3]

Hylton was an apparent departure from prior case law and arguably only applies to the weak facts in that case. In *East Tennessee Natural Gas Co. v. Riner*,[4] although not central to its holding, the Supreme Court of Virginia noted that a prospective purchaser of quarry property "would necessarily contemplate acquisition of the income stream presently produced by the mineral lease as well as the prospect of future royalties."[5]. This is consistent with use of the income approach to value involving any income producing property. But the *Riner* formulation leaves open the question of how to value the quarry lessee's interest – which ought to be part of the value of the "undivided fee," the

[1] Opinion Letter 10-006, Office of the Attorney General (April 26, 2010).

[2] *VEPCO v. Hylton,* 292 Va. 92, 108 (2016).

[3] *Id.*

[4] *East Tennessee Natural Gas Co. v. Riner,* 239 Va. 94, 98 (1990).

[5] *Id.*

value of *all* interests in the land. Notably, *Riner* was cited with approval in *Hylton*, which could be distinguished because the mine at issue was unopened, and thus, there was no existing income stream. Future royalties in *Hylton*, absent even a plan to mine, were far more speculative than when a property is actively being mined and actually producing an income stream.

The language in *Hylton*, prohibiting the use of future business income in valuing the land, nevertheless must be taken seriously – landowners cannot risk doing otherwise. Moreover, Virginia has similarly cut against the grain of popular valuation methodologies in other contexts. The *Hylton* Court's apparent rejection of royalty capitalization for quarries is similar to the Virginia Supreme Court's well-established rejection of development cost and discounted cash flow analysis in litigation, even though that methodology is accepted in many states and by many lending institutions.[6] It is safest to avoid any reliance on future income.

Simultaneously, the *Hylton* Court reiterated a more widely-accepted prohibition of the "Unit Rule" to value mineral resources on property taken by eminent domain.[7] Specifically, landowners cannot calculate value by multiplying mineable tons by the anticipated price. *Hylton*, 292 Va. at 108. Taken together, these rules create challenges when valuing an operating quarry owned by the operator (that is, an operating business earning income from mining rock as opposed to an absentee landowner just collecting royalties).

Litigants must focus on what the Court has unambiguously permitted. The Supreme Court of Virginia, when valuing an ongoing quarry operation, *has* authorized the *consideration* of the marketability, quantity and character of mineral resources. In *Board of County Sup'rs of Henrico County v. Wilkerson*,[8] the Supreme Court of Virginia approved the following jury instruction:

> [Y]ou may not consider the existence of sand and gravel deposits on the land being taken as an element contributing to the market value of the land as a whole, unless you determine:
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> (1) that the development of such sand and gravel deposits is consistent with the highest and best use of the property; and,
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> (2) that there is a market for such sand and gravel in the area, and
>
> (3) that the mineral deposits are of such quantity and character that they may economically be mined taking into consideration all relevant factors; and
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> (4) that the presence of such sand and gravel deposits on the property contributes to the market value of the property when compared with other land in the area.

Consequently, the Court permitted expert testimony from a geologist discussing the nature and quantity of the minerals as well as a line of questions, on cross-examination concerning the market price per ton of sand and gravel.[9] The *Hylton* Court cited to *Wilkerson* with approval, and this jury instruction – as well as its authorization to consider the marketability, quantity and character of mineral resources on a condemned property – is still good law.

When confronted with a quarry valuation issue in litigation, there is a way to navigate the ambiguous terrain of these Supreme Court of Virginia holdings. Appraisers will likely need to forgo the royalty

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[6] See *Fruit Growers Express Co. v. City of Alexandria*, 216 Va. 602, 604-06 (1976).

[7] *Hylton*, 292 Va. at 108; *see also East Tennessee Natural Gas Co. v. Riner*, 239 Va. 94 (1990); *Bd. of Cnty Supervisors of Henrico Cnty v. Wilkerson*, 226 Va. 84 (1983); *see also* 4 *Nichols on Eminent Domain* § 13.14(4).

[8] *Bd. of Cnty Supervisors of Henrico Cnty v. Wilkerson*, 226 Va. 84, 92 (1983).

[9] *Id.*

capitalization methodology they typically employ in other states (or for lending and property tax purposes in Virginia), and the case will require the retention of several additional experts, *to wit*:

Litigants should retain a *mining* expert. The quantity and character of the available rock needs to be analyzed by a competent geologist and/or mining engineer. Mining engineers can prepare a Mine Plan to analyze the usable material in a quarry.

Litigants should also retain a certified *blaster* and a *seismologist*. A critical component in quarry valuation is required setbacks under local, state, and federal laws and regulations. One of the most important setbacks involves blasting, a process required to actually retrieve the rock for sale in the market. The metric for determining setbacks is called the maximum allowable *peak particle velocity* in terms of inches per second. This measures ground vibrations caused by the blast, which naturally could impact nearby structures. Regulations will likely permit different levels of peak particle velocity depending on the type of structure, and require different levels of protection from nearby blasting. Structures to be built on the land taken in a condemnation may well change the required setback.

In order to determine any blasting setbacks at a quarry site, it will be necessary to work with both a blasting expert and a seismic engineer, who can render opinions on how far back mining operations have to be to remain within allowable limits. The change in that distance before and after a condemnation will be a critical issue in the case.

The marketability of the mineral resources can be addressed by the appraiser, a competitor, or perhaps by the operator of the quarry.

Finally, it will be necessary to hire an appraiser who *specializes in quarry valuation*. Quarries are valued so rarely that a general commercial appraiser may never see a quarry valuation in his career. It is critical for an out of state quarry appraiser to understand the limits in valuation set forth by the Virginia Supreme Court. Appraisers should not blindly rely on appraisal methodology which may be admissible in another state, and even in Virginia for property tax purposes, but not in the context of condemnations. Most importantly, the out of state appraiser should be instructed to avoid royalty capitalization–or any method which solely values the quarry on tonnage to be mined at some point in the future. Based on the mining, blasting and seismology experts' opinions, however, the marketability, quantity and character of the rock should be permissible as adjustments to quarry sales data to achieve an admissible value.