

AMERICAN INSTITUTE OF MINERALS APPRAISERS

NEWSLETTER

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IN THIS ISSUE

2010 Annual Meeting

AIMA Officers for Year 2010 - 2011

Annual Dues

Recent Decision Involving Surface Condemnation Exclusive of Mineral Estate

2010 SME Annual Meeting & Exhibit Conference

International Valuation Standards Board Proposed Project

New Member & Associate Members

Continuing Education

Admin Law, Civil Procedure, Environmental Law, Government Law & Real Estate

Annual Meeting

March 2, 2010

Sheraton Phoenix Downtown Hotel

Our Annual Meeting is to be held on March 2, 2010 at the Sheraton Phoenix Hotel. Our Chairman, Stuart Limb, has put together a blowout program for us. He has been successful in getting twelve Authors who will present a total of twelve papers at the SME Conference. The presentations will precede our meeting on March 2, which is a Tuesday. AIMA Members are to assemble at the Sheridan's Arcadia Boardroom at 5:00 PM for cocktails/soft drinks and good conversation. Dinner and the AIMA business session then will begin at 7:00 PM. Our President, John Gustavson, has numerous issues for our Members to address. So, please make every effort to attend. Don't forget, all Members who attend our Meeting or the SME Conference are entitled to Continuing Education Credits. Furthermore, all Members presenting papers are entitled to additional CE Credits.

The Sheraton is located at 340 North Third Street. Telephone and Fax numbers for the Hotel are, respectively, 602-817-5366 and 602-817-5335.

Should you plan to attend, please contact Stuart Limb. His telephone number is 480-443-3978 and his e-mail address is cmc@cmccincusa.com. We (AIMA) are committed to 34

dinners. Please let him know so he can get an accurate dinner count.

AIMA Officers For Year 2010 – 2011

Many Members are probably scratching their heads now wondering if they had missed voting for Year 2010 – 2011 AIMA Officers. This is to inform you that you haven't. At last year's Meeting, the Membership voted to elect Officers for a two year term. Thus, last years Officers are the same for Year 2010 – 2011. They are:

President	John Gustavson
Vice President	John Chance
Secretary	Donald Warnken
Treasurer	William (Bill) Bagby

Annual Dues

As a reminder, AIMA annual dues are now due. The dues are \$60 for Full Member and \$30 for Associate and Emeritus (Retired) Members. Please forward your remittance to:

William Bagby, Treasurer
Western Mineral Appraisers, LLC
2270 Vista La Nisa
Carlsbad, CA 92009

2010 SME Annual Meeting & Exhibit Conference

The 2010 SME Annual Meeting & Exhibit Conference is to be held at the Phoenix Convention Center February 28 thru March 3, 2010. The Center is located at Washington & 4th Street, Phoenix, AZ.

The SME Valuation Session Chairman is Stuart Limb, AIMA Member. He has put together a total of twelve papers for the Valuation Session. The Authors and Titles of each paper are presented below. Available Abstracts are also presented.

Author: J. Stuart Limb

Title: Comparison Between IRS and Financial Accounting Rules For Post Acquisition Asset Value Appraisals and Other Government and SME Appraisal Rules

Author: John J. Manes

Title: Deriving Alternate Discount Rate Periods as a Method of Improving Mineral/Mining Appraisal Accuracy

Author: Michael Cartwright

Title: (1) Valuation Case Decisions for Mineral Appraisers

and

Title: (2) The Role of Checklists in Valuation Engagements

Author: Trevor Ellis

Title: A Review of the International Accounting Standards Board's Extractive Activities Draft Discussion Paper

Author: Michael Minnaugh

Title: Limiting Appraiser Liability Through Contractual Provisions

Authors: Mitch Albert/ J. Holmbacher

Title: Mineral Related Appraisals Under Uniform Appraisal for Federal Land Acquisitions

Author: Gerald Clark

Title: Appraising Mineral Rights of Large Acreage with Multiple Resources, a Case Study

Abstract: This case study looks at the valuation of the mineral rights for approximately 128,000 acres of land with multiple resources in Southern Ohio and Northern Kentucky. The land was previously used for timber production, but a new investment group wishes to explore the potential for mineral production for this acreage.

The area has a long rich history of production that includes coal, oil, gas, clays, aggregates, and other minerals. Proximity to electric generating power plants on the Ohio River also provides a potential for CO2 Sequestration.

This paper explores the methods that have been applied in valuing large expansive resources using tools such as Geographic Information System (GIS), Regression Analysis, and Discounted Cash Flow Analysis.

Author: Robert Hart

Title: The West Virginia Tax Department's Approach to Oil and Gas Valuation

Abstract: The author will discuss West Virginia's use of production decline curves, development of capitalization rates, and operating expenses in determining a mass appraisal approach to oil and gas well fair market values.

Author: John Gustavson

Title: Effect of Economic Upheaval on Oil and Gas Valuation

Author: Richard Wyman

Title: Evaluation and Appraisal of Patented Claims

International Valuation Standards Board Proposed Project

The International Valuation Standards Board of the IVSC recently met in Madrid, Spain. Item 5 of their agenda concerned the *extractive industries*. At their meeting, the Board agreed the views and financial support of the extractive industry be sought before beginning work on a project to review and update existing guidance in the International Valuation Standards.

Briefly, the IVSC is the global standard setter for the valuation profession. The IVSC has stated their mission is to set and maintain effective high-quality global standards for the performance of valuations by the valuation profession and to contribute to the worldwide valuation profession.

The IVS had published in their 8th edition (2007) Guidance Note 14 that concerned the *valuation of properties in the extractive industries*. Their stated purpose of the GN was to "provide clarification and guidance on the valuation of assets of property interest (rights) held by entities involved in the Extractive Industries."

Subsequently, other codes for the reporting on mineral asset valuation have been developed that are generally country specific, such as the Canadian CIMVAL Code, the Australian VALMIN Code and the South African SAMVAL Code. *Continued on page 3*

International Valuation Standards Board Proposed Project, *Continued from page 2*

proliferations in codes have resulted in a set of codes that are virtually irreconcilable, and which differ widely in terms of scope, definitions, approaches, jurisdictions etc.

The lack of a single well recognized International Code has caused the Hong Kong Exchanges and Clearing Ltd to contact the IVSC for guidance. They (HKEx) seek to develop new listing rules for mineral and exploration companies.

The IVSB is now consulting on whether to add a **project** to review and update its current guidance on the valuation of extractive industries to a standard supported by best practice professional guidance. The **project** development process would include the creation of an expert group and the appointment of a technical consultant.

The proposed expert group would consist of six members. The membership would be geographically and sector balanced and would represent producers, advisors, and regulators. The group would be chaired by a member of the IVSB. Membership is not a remunerated position, but IVSC will reimburse reasonable travel and other costs associated with attending meetings of the Group, or in representing IVSC on any third party working groups.

The expert group would conduct its business primarily by electronic means, but would retain the option of meeting to ensure some discussion occurs on a face to face basis.

The technical consultant would be appointed to be responsible for preparation of drafts of key documents that would be subject to review by the expert group.

Editors Note: Any AIMA Members interested. If so the IVSC may be contacted by internet at <http://www.ivsc.org>.

New Associate Members

Two new Associate Members have been added to our membership roster. They are:

Ms. Brianna Lamphier is Associate Member 2009 - 1 with AIMA. She is employed by Gustavson Associates LLC, Boulder Colorado.

Mr. Frank Bertrand is Associate Member No. 2010 – 1 with AIMA. He is owner of Bertrand Data Services, Towanda, PA.

Continuing Education

A Form for Members and Associate Members to record their Continuing Education Courses for CE credit has been furnished your *Web Master*. He will post the Form on the AIMA web site in March. Use of this Form will be beneficial

to the Members in tracking their CE Credits. Also, it will make our CE Chairman's job easier.

Trevor Ellis took a week long 33 hour course titled "Valuation of Conservation Easements". He has shared the following for the benefit of our Members.

In April 2009 I traveled from Denver to Milwaukee to take a week long, 33 hour course, "Valuation of Conservation Easements". Appraisal for taxation purposes of the donation value of conservation easements on minerals has become an area of high demand and hot dispute for appraisers in recent years throughout the USA. Properties in Colorado with donation value attributed to sand and gravel and/or water are now a focal point for the appraisals disputed by the US Treasury Department and the Colorado Department of Revenue. The reviews have resulted in a few Colorado Certified General Appraisers having their licenses revoked or suspended since June 2007. The incentive for my taking the course at this time was that I had begun work on a contract with a gravel property owner to re-appraise a conservation easement donation that was previously appraised by one of the appraisers who had their license revoked.

The course, which was organized by the Wisconsin chapter of the Appraisal Institute, was held at a society management center, well provisioned for such teaching. Development of the conservation easement course content was sponsored by the Land Trust Alliance and the three major USA –based appraisal societies – Appraisal Institute, American Society of Appraisers, and American Society of Farm Managers and Rural Appraisers. Their sponsorship of the development of the course came from recognition of the poor, incorrect, and abusive appraisal practices prevalent in conservation easement appraisals.

The resultant course has only been taught for a year now. Schedules published by the major appraisal societies indicate it will only be available a few times per year throughout the USA. The small attendance of about 15 students in Milwaukee suggests that on-going demand for the course will be low. However, the Colorado Department of Revenue has recently begun requiring that income tax deduction claims for conservation easement donations be accompanied by an appraiser certification form on which the responsible appraiser provides details of conservation appraisal education completed.

The course and instructor proved to be excellent. Without having completed the course I would likely have done the conservation easement appraisal incorrectly for my client. I had not been aware of the significant differences between taxation appraisals of conservation easement donations and, for example, Federal taking appraisals. Fully understanding the Treasury Department's "related party" rules is essential. I also found it an eye opening to learn of the crippling financial penalty that can be imposed on an appraiser by the Internal Revenue Service for submitting a taxation appraisal that is determined as resulting in an overvalued deduction claim.

Continued on page 4

Continuing Education, *Continued from page 3*

Editor's note: The civil and criminal penalties that Mr. Ellis refers to was addressed in our December 2008 Newsletter. The subject title was "Circular 230 – The New Tax Preparer Rules".

Admin Law, Civil Procedure, Environmental Law, Government Law, Property Law & Real Estate

The Following Has Been Furnished By Michael Cartwright,
CMA

Laro to BV experts: Value conclusion is last on my list

"This program has been the best panelist of any that I've seen in the country," the Honorable **Davis Laro** (U.S. Tax Court) told a rapt audience at the New York State Society of CPA's 2008 Business Valuation Conference, which met in Manhattan earlier this week. "These are *the* experts," he said – and attendees might as well have returned the compliment, as the esteemed Judge spoke on everything from his own experience (Candidly, I did not know much about discounts for lack of marketability before *Mandelbaum*, but I studied it and realized how important it is") to his expectations from the professionals who walk into his courtroom. For example – if he sees expert passing notes to the attorney on the case, he puts a stop to it. "That's advocacy," he said. "That's not neutrality – and I h've seen it," he added, meaning that some damage to credibility may have been done. "Once you are retained you must maintain your independence," he reminded valuation experts, "because if not, {your testimony} is of no value." [*Michael Cartwright interjects* – That is also my opinion and for the same reasons. If you want to be a consultant to the attorneys, go right ahead, but then do not try to also sell yourself as an unbiased appraiser.]

And what about the movement toward "thinner" reports, in an effort to omit extraneous matters and shave costs for clients? He sympathizes with the increasing complexity and cost of many valuation engagements, but expert reports should contain "all relevant information," he said, "everything you think the Judge needs to get into her [final] opinion," because in Federal Tax Court, the reports are tantamount to an expert's direct testimony. Moreover, "I read the bottom-line number last," Laro said, "The analysis is the most important – how do you took the data, analyzed it, and wed it to your conclusion. I want transparency: I want to see your thinking – because that's what appellate courts want to see from me" should they review his decision (which currently enjoys a 97% confirmation rate). One more tip: keep your supporting data on hand, so that when an opposing counsel asks where you got the information for your report you don't have to say that it's back in your files. "I always get bothered by that," he said. "No Judge stops a trial so that the expert can run back to the office."

Your job is to tell a story. Echoing Laro's comments, **Mel Abraham** (valuationeducation.com) told attendees that the "right" ratio for valuation reports is "two parts words and one part numbers." A valuation professional's job is not just the numbers – it's about telling the *story* of the numbers. "We are in the world of persuasion," he said. Persuasion is not advocacy; instead, it's taking the information, data, and concepts – and putting them together in a truthful, creditable opinion that persuades the users of the information and educates the tier-of-fact. "The focus is too much on the numbers," Abraham said, referring to clients as well as experts. "Be the story teller, from an objective, independent perspective."

Terrene Investments, Ltd. et al. v. Commissioner; T.C. Memo. 2007 – 218; No. 4797 – 04

Michael Cartwright writes; "In a memorandum opinion, the Tax Court has sifted through the arguments of taxpayer, Commissioner, and expert witnesses to determine the fair market value of a 31 - acre property that held valuable proven sand and gravel deposits at the time it was donated to charity. The taxpayer argued a value of \$1,801,618 while the Service tried to undermine (sorry, their metaphors, not ours) with a value of \$301,000. The Tax Court settled on a value of \$1,303,616."

Subject is an interesting Tax Court case. The Memorandum of Opinion covers about ten typed pages which are too great for presentation in this Newsletter. Your *editor* has therefore summarized the important issues involved and the Court's resolution below.

Subject property is located near Houston, Texas. All parties were in agreement that the property contained valuable sand and gravel deposits and could be readily marketed. The Commissioner's expert had used comparable sales and income (DCF) approaches to value. The two values were weighted two thirds comparable sales and one third DCF. The Petitioner's expert relied solely on the income (DCF) approach to value arguing that comparable sales did not exist. The Court agreed with the *Petitioner* on that issue.

Further, the Court basically discarded each party's value estimate then calculated its own estimate. The Court had issue with nearly all pertinent factors involved; total volume of minerals on the property, setbacks, slope of pit walls, waste disposal area, rate of extraction, royalty rate and discount rate. The Court did, however, adopt the *Petitioner's* expert residual value estimate.

The Court relied heavily on testimony presented by local operators in the area in their estimation of work area size, pit slope, rate of extraction and royalty rate.

In the matter of the volume estimates, the Court stated that the methods used by the *Petitioner's* expert and the *Respondent's* (Commissioner's) expert were reasonable but neither method were transparent or adjustable. Thus, the Court simply relied

Continued on page 5

**Admin Law, Civil Procedure,
Environmental Law, Property Law &
Real Estate, Continued from page 4**

on a third party's estimate, claiming it to be reasonable and adjustable. The Court divided the third party's estimate by the total number of acres involved to obtain a per acre volume estimate. Next the Court reduced the total acreage of the subject in recognition of setbacks. The estimated work area was then further reduced in recognition of work plant area. A gross recoverable volume was then calculated. It was reduced to account for pit slope and waste for the net recoverable volume estimate.

The Court noted that subject was a small tract compared to other tract operations in the area. Therefore the Court relied on actual extraction rates of other sand and gravel operators in the area for their rate of extraction estimate. Basically they adopted an in between rate of extraction for small operations and large operations which resulted in a 92 month recovery.

In the Houston area, royalty rates for sand and gravel ranged from \$0.25 to \$1.00/ton. The Court concluded that sand and gravel would be sold at one price because subject was small in size. Therefore they relied on the royalty rate paid for a similar sized tract which was \$071/ton.

The single largest source of the disparate valuations claimed by the *Petitioner and Respondent* experts was the discount each had applied. The *Petitioner's* expert used a 9% discount rate, which he arrived at by taking the prime rate as of November 1998 and adding 1%. On the other hand the *Respondent's* expert used a 28% discount rate which he said reflected the risk perceived by the market according to his sensitivity analysis.

The Court concluded that the *Respondent's* expert high discount rate was due to two fundamental choices. **First was to treat the relevant cash flow to be discounted as a cash stream from a mining operation rather than a royalty interest.** The owner of a royalty interest bears much less risk than does a operator. Therefore that approach to discount estimation was discarded by the Court. **Second, the Respondent's expert tried deriving a discount rate from the sales that the Court had previously discarded as not comparable to subject.** Therefore it to was discarded.

The Court acknowledged that risk is involved but was of the opinion that the *Petitioner's* 1% addition to the prime rate was insufficient. Therefore having discarded both expert's discount rate estimate, the Court built a discount rate beginning with the average rate on three-five year Treasury notes as of November 13, 1998. Then the Court added risk premiums to create an implied rate of return for buyers of comparable properties. As explained by the AICPA Audit and Accounting Guide, "Guide For The Use of Real Estate Appraisal Information" sec. 3.27 (May 1, 1997).

"The discount rate is the rate of return that investors require as a condition of purchasing the type and class of property being appraised. The rate may vary, depending on economic and other conditions, but generally should be based on market rates, reflecting the rate of return demanded by buyers of comparable properties. In addition, the following factors should be considered in determining the discount rate:"

1. Recovery of the investment over its estimated economic life
2. A safety factor to recognize additional risk, management burden, and lack of the buyer's liquidity
3. An investment factor to recognize the property's quality of income, its marketability, and tax advantages

The Court states "The property here, to be precise, represents an illiquid eight-year stream of royalty payments from a smallish parcel of land. Part of the risk is the risk of inflation, but inflationary risk is presumably reflected in the rate on Treasury notes. Further, the parties left us (the Court) little in the way of estimating noninflationary risk to value of the income stream (i.e., the probability that the income stream would be interrupted). At a minimum, we (the Court) think that we have to add another 3%, which was the spread between Treasury notes and corporate bonds rated Baa back in November 1998. But we also think that the risks associated with interruptions of operations on the Hamblen Road property – interruptions like flooding, malfunctioning equipment, small-operator, bankruptcy, etc. and the risk of interruptions in getting a mine started in the first place require an additional risk premium of 4%. The final discount rate that we will use, then is 11.5%, which (as a reality check) is reasonably close to discount rates in other cases involving royalty rates."



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