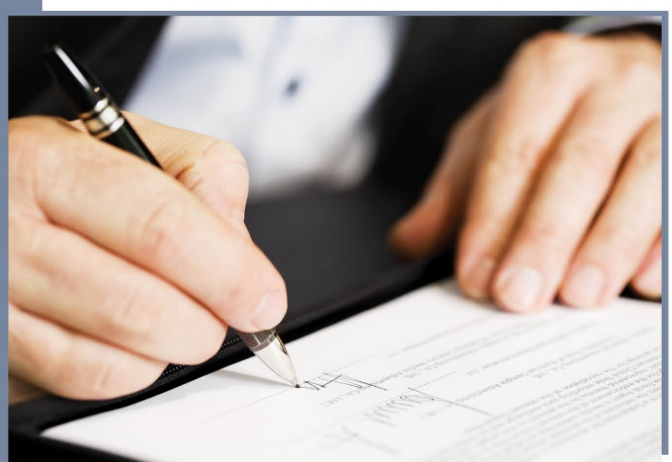
DTFH61-11-00037/0003

Option Contracts Research Study



Final Report

U.S. Department of Transportation

Federal Highway Administration

Notice

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16. Abstract

The purpose of this report is to explore how and when Federal agencies and State DOT's can best take advantage of real estate option techniques for real property acquisitions afforded under the of Moving Ahead for Progress in the 21st Century (MAP-21) amendments to the Uniform Act.

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Option Contracts Research Study

Final Report

Introduction/Background

The enactment of Moving Ahead for Progress in the 21st Century (MAP-21) provided new and revised methods for real property acquisition. Among the MAP-21 amendments was the revision of 23 U.S.C. 108 to include the term "real property interests," in place of the terms "real property," "right-of-way," and "rights-of-way." One of the changes afforded by this amendment is to allow the use of real estate option techniques for real property acquisitions.

Public agencies have not historically used option techniques in real property acquisition situations; therefore, this concept requires further analysis. Option techniques still must fit within the parameters of the Uniform Act so their use requires the development of overall program guidance for successful implementation. This guidance will provide a basis for acquiring agencies to develop procedures for consistent application of option techniques that provide an overall program benefit while ensuring property owners are treated fairly and that Federal and/or State funding is not susceptible to fraud, waste, and abuse.

The Federal Highway Administration (FHWA) is currently involved in two separate, but intertwined, regulatory efforts to update existing regulations. One of the efforts involves revising Part 710 of Title 23 of the Code of Federal Regulations (CFR). A Notice of Proposed Rulemaking (NPRM) was issued on November 24, 2014, and the Final Rule was issued on September 22, 2016. The second effort involves the development of an NPRM for 49 CFR, Part 24, which may be published at a future date.

In the recently amended Part 710, there is a new definition for the term "option" at 23 CFR 710.105. The definition states: "Option means the purchase of a right to acquire real property within an agreed-to period of time for an agreed-to amount of compensation or through an agreed-to method by which compensation will be calculated." Additionally, the definition of "real property" is amended to include new items such as "options." Under 23 CFR 710.203, Federal reimbursement is allowed for "[t]he costs of acquiring options and other contractual rights to acquire an interest in land, rights to control use or development, leases, rights-of-entry, and any other similar action to acquire or preserve rights-of-way for a transportation facility are eligible costs when FHWA determines such costs are actual, reasonable, and necessary."

The primary objective of this research study was to identify when and how the use of option contracts can be properly employed in federally-funded early acquisition projects. The research study was also performed to identify:

- Means, methods, processes and/or factors an agency should use in determining the price of an option; and

- When it is appropriate for an agency to use an option agreement on a Federal-aid highway project.

Specifically, the product of the research would be a decision matrix, formula, or guidance document that agencies can reference to assist in the determination of when an option contract should be used. Based upon the research gathered during the study, the research team developed an *Option Contracts Decision Matrix* to meet this goal, which is attached as Exhibit "B."

The team conducted this research in several steps, which are described in this report. The research culminated in an analysis of (1) when and how option agreements can be properly used in federally-funded advance acquisition projects, and (2) the extent to which they can add value to the overall process.

Review of Research

Literature and Web Research

The research team began the study with a search for websites and publications for relevant articles, case studies, and other legal doctrine addressing the use of real property acquisition options, specifically in governmental applications. A total of thirteen (13) publications were reviewed, including those from vendors, the Appraisal Institute, legal cases, and the CFR.

The results of this literature research included information about the basic application of real property options, the structure of option contracts, and the necessary elements the contract must contain. The information also discussed the private sector use of option contracts and the financial considerations of structuring the option, i.e., how to value (or price) the option. The literature survey revealed past attempts by appraisers to try to establish an appropriate payment amount through use of valuation techniques for options that copy behaviors observed in the private sector. These valuation techniques and methodologies mimic the processes that a private developer would likely use when negotiating an option agreement with a property owner. These techniques are dependent on various current and anticipated interest rates, in conjunction with risk factors over specific periods of time. There were no articles found that related to a public agency's use of option contracts.

The results of the literature research also contain a comprehensive bibliography of all reference materials, with a short summary, abstract and list of key terms for each article, links to websites (as applicable), along with an outline identifying section headings, major topics and discussion points. A glossary of terms was also assembled.

Industry Working Group

In this stage of the research, the team worked directly with State Departments of Transportation (SDOT's), local public agencies (LPA's), and industry professionals to collect information about the use of option contracts that may be employed to expedite or streamline right-of-way (ROW) acquisition. There were two essential components involved in this effort:

1) Conducting interviews with SDOT's and other public agency personnel regarding their experience with these option contracts and endeavors; and
2) Convening a working group to identify the challenges that must be addressed when considering the use of option contracts on federally-funded projects.

Interviews with State DOT and other Agency Personnel

Prior to conducting interviews, the team collaborated with FHWA and developed an interview questionnaire to gather information from the selected agencies regarding their experience with the use of option contracts. A copy of the interview questionnaire is attached as Exhibit "A" to this report.

After a thorough search and survey process, the team discovered only a few isolated situations where public agencies were using option agreements to acquire real property. In November and December of 2014, two (2) members of the team interviewed representatives by telephone from three (3) SDOT's and one (1) municipal airport authority:

- California Department of Transportation (CALTRANS)
- Erie (PA) Municipal Airport Authority
- Texas Department of Transportation (TxDOT)
- Washington State Department of Transportation (WSDOT)

Summary/Analysis of State DOT and other Agency Interviews

The few agencies that did use option agreements used them for limited and specific reasons. For example, the Erie Municipal Airport Authority option agreements were so unique and specific that they held little value for purposes of this study, other than to demonstrate how the option payment was applied.

The interviews with the three SDOTs (CALTRANS, TxDOT, and WSDOT) indicated that option agreements for the purchase of real property were determined to be legally permissible under State laws; however, they were only used in specific circumstances. The WSDOT indicated that option agreements were used exclusively for obtaining rights to mitigation sites, and CALTRANS also stated that mitigation site reservation was a primary motivator for using option agreements. The TxDOT had used option purchase agreements in limited circumstances to protect future corridors, when deemed by the agency to be advantageous. The general opinion of the three SDOT representatives was that if it could be determined that a property would be needed in the future for main line purposes, the most applicable action would be a form of protective purchase.

The payment to secure the option agreement ranged from one to ten percent per year for the duration of the option. Each agency indicated that they had a preferred payment percentage range, but all noted that the percentage or size of the payment could be adjusted depending upon the importance of securing an option agreement for that particular property. There appeared to be no specific justification for the size of the payment, other than what seemed to be a reasonable amount (in the eyes of the responsible agency officials) for what was being acquired, and what the agency's experience had historically been with regard to payments to secure options.

The determination of the initial value estimate of the real property to be secured by the option was typically based on an informal estimate rather than an approved appraisal. In most instances, the option agreement stated that the final acquisition price, if the property was eventually acquired, would be determined by an approved appraisal. In some instances, however, a short-term option agreement (typically of one year or less) included a final acquisition price.

Each of the agencies interviewed stated that if a property was acquired through the use of an option agreement, the language in the agreement called for the deduction of the option payment from the final acquisition price of the real property. It should be noted, however, that this aspect of the option agreement is negotiable.

Each agency realized that when multiple sites were placed under an option agreement for environmental mitigation purposes, some of the sites would eventually be disqualified for the agency's environmental purpose, and that the option payment would be forfeited to the owner. Each agency considered this to be a reasonable expenditure, and in the best interest of the public, because the agencies were able to secure the properties temporarily to forestall any price appreciation or speculative development without actually taking ownership. Not taking ownership saved the agencies the time and expenses of unnecessary acquisitions and avoided the potential of a cumbersome property disposal process. Each agency's project managers made it clear to their senior management that the use of an option agreement always includes the risk that the option may not be executed, and that the option payment would still be surrendered with no physical property to show for it.

The Working Group

In the next step of the research study, the team, in collaboration with FHWA, convened a stakeholder working group comprised of the agency representatives who participated in the interviews, as well as interested representatives from other agencies. The purpose of the working group was to identify the challenges that must be addressed when using advance purchase option agreements for Federally-funded projects.

The working group included representatives from the following public agencies:

- CALTRANS

- Erie (Pa) Municipal Airport Authority
- Minnesota Department of Transportation (MnDOT)
- Riverside (California) County Transportation Commission (RCTC)
- TxDOT
- U. S. Veterans Affairs (VA)
- WSDOT

In addition, a representative from the FHWA Office of Real Estate Services Headquarters (HEPR) and one FHWA Division Realty Officer participated in the working group.

The working group met a total of three (3) times over a period of approximately six (6) weeks (12/02/14, 12/16/14, and 01/15/15). These meetings progressed from a general discussion of how the participating SDOTs were using option contracts/agreements, to a more specific examination of the advantages and disadvantages associated with using such agreements. They also addressed techniques to aid in creating greater efficiencies in the ROW acquisition process. Finally, these discussions focused on technical issues such as the determination of the option price, exercise or strike price, structure of option agreements, extent of possible usage, and potential conflicts with the Uniform Act.

The working group did reach consensus on several specific issues:

- Option agreements would be a valuable tool for agencies to have available;
- The decision to use an option agreement should be documented in a manner similar to an administrative settlement;
- All costs associated with option agreements should be eligible for federal-aid highway (FHWA) participation; and
- The provisions of the waiver valuation process or similar abbreviated valuation approach should be incorporated into the option agreement process whenever applicable.

Using Option Contracts to Accelerate Right-of-Way Projects – Strengths and Weaknesses

If agencies already have the authority to acquire property as an early acquisition, the agency should evaluate under what circumstances the purchase of an option agreement would be a preferable alternative to an early (voluntary) acquisition of the real property. One advantage of acquiring the property is that the agency takes control of the property, and is thereby able to forestall sale or development of the property that might have caused future dramatic value escalation. If it should turn out that the property is not needed for project purposes, then the agency could theoretically sell the property for a price similar to the original purchase and, hopefully, recoup its investment. Unfortunately, experience has often shown that the administrative costs involved in both acquiring and disposing of previously acquired property can be quite substantial, as evidenced by the various States' assorted restrictions concerning the disposal of excess publicly-owned property. This could be a primary reason that in some instances, acquiring an option to purchase a property may be preferable to an actual purchase. It is possible that the potential forfeit of an option payment may be in the best public interest, as opposed to an acquisition that could prove unnecessary and result in an agency getting caught up in a bureaucratic spider-web of rules when it is time for disposal of the unnecessary publicly owned property.

There are certain situations when the purchase of an option would appear to be most useful and appropriate for an agency, such as:

- Various alternative environmental mitigation sites are being considered, and the agency needs time to perform studies and evaluations to determine if a specific site would meet project needs.
- Various construction staging or material resource areas are being considered, while project needs are in the process of being finalized.
- A particularly expensive property may be the key to several alternative alignment scenarios, but the project development process is still in its early stages and necessary funding and acquisition approvals have not yet been finalized. Obtaining an option agreement now to purchase this property sometime in the future would preserve the feasibility of all the alternative alignments without causing the acquiring agency to identify and commit the funds to early acquisition for a prohibitively expensive property that might not be on the final alignment.
- A property may be identified for one of the project alternatives, but the final alignment won't be selected for some time and it makes sense to secure key properties in a corridor because redevelopment and price escalation is imminent.

Possibly the greatest deterrent to an agency's use of an option is that the property owner is under no compulsion to enter into the agreement, since the agency may not be able to compel an option purchase under any eminent domain authority. Given this potential lack of condemnation authority regarding options, the agency would have to offer a large enough dollar amount as payment for the option agreement to attract the interest of the property owner. It is for this basic reason that use of option agreements could be limited to those relatively unique situations where early acquisition presents unacceptable risks to an agency, and where both the agency and the property owner believe that the option agreement would work to their respective advantages.

Key Findings

For Federal-aid early acquisition projects that will include the purchase of option agreements to preserve the status of certain real estate parcels, an agency should develop and follow a specified process, that is in accord with all applicable Federal and state laws and regulations. An example of such process is described below, in general terms.

As with any early acquisition activity, environmental compliance must be addressed [23 USC 108 (c)(3)(C)]. At a minimum, this would include approved environmental clearance for a Federal-aid early acquisition project or an activity thereof proposed. This possibly could be accomplished with categorical exclusion for this activity in accordance with 23 CFR 771.117 or other authority that may be applicable.

1. *Ensure appropriate Federal-aid programming for federally-funded early acquisition projects and receive authorization to proceed with preliminary ROW activities.*

Before an agency undertakes any valuation or acquisition activities related to option contracts for federally-funded early acquisition projects, it must program Federal-aid funds properly [23 USC 108 (d)(4)(A) & 23 CFR 710.501(e)], and have an authorization to proceed with preliminary right-of-way activities.

2. *Establish the purchase price of the real property in the option agreement using a valuation procedure compliant with the Uniform Act.*

Once an agency decides that the use of option agreement(s) is justified, a process would be required for the determination of the final purchase price, or "strike price" of the real property needed for the project if the option were exercised.

The strike price must be based on an appraisal, or other acceptable estimate of value of the real property interest being acquired compliant with the Uniform Act [23 USC 108(c)(3)(A)]. An agency could accomplish this in one of two ways:

- Prepare a real estate appraisal and appraisal review, which could involve the use of an appraisal format that is already incorporated into the agency's approved ROW manual. Depending on the specific factors in each case, the scope of work (SOW) for the valuation could range from simple to highly complex. The SOW might also specify the estimation of a fair market rent of the property considering limitations imposed during the term of the option. This rent information may be helpful and could be used in the analysis of the option payment amount discussed below.

- Prepare a waiver valuation, if appropriate, to estimate the acquisition price or strike price of the option. This may have limited application, since it's anticipated that the final acquisition price would, in most cases, exceed the Uniform Act regulatory limits or the appraisal problem would likely be complicated and therefore, not qualify for the waiver valuation.

For longer term option agreements, it may be appropriate to include language to permit the updating of this value if required by market conditions.

3. Determine the price of the option payment using a standardized analysis or process. The Option Contracts Decision Matrix developed for this research study represents an example of one such approach.

Typically, two initial elements are required to estimate the option payment to be offered as the inducement, or compensation for the owner to enter into an option contract:

1. Estimated value or strike price of the property to be optioned, and
2. Factor or percentage of the estimated market value that represents compensation for granting the option, and giving up certain rights related to the property during the term of the option contract. The fair rental cost could be used as a good cross check for the option payment.

Relative to Item #1 immediately above, (i.e., estimated value or strike price of the property to be optioned), it would be helpful from the standpoint of cost and time schedule if some form of abbreviated valuation analysis would suffice for this calculation when appropriate. Whatever value documentation approach is used, it would have to be compliant with Uniform Act appraisal and appraisal review requirements or waiver valuation requirements as appropriate for the situation [23 USC 108(c)(3)(A)]. The research team understands that certain agencies have developed abbreviated appraisal formats that are Uniform Act compliant, and have incorporated compliant procedures in their approved ROW manual.

As to the factor calculation described in Item #2, it is anticipated that most option pricing factors will likely be determined using the *Options Contract Decision Matrix* (Exhibit "B"), or some other analytical process that measures the urgency and risk of performing an early acquisition in the context of a given project. This would typically be accomplished by agency staff that are aware of and understand the agency's project planning needs and constraints, along with the analysis of market factors that are specifically impacting the subject property(s). It is expected that this analysis would be prepared in writing for each parcel, or a group thereof that are experiencing similar economic land use dynamics on the project, and thus making a case for proceeding with the purchase of option contracts.

Once the option price and the option factor have been determined, the option price (#1) is multiplied by the option factor (#2), resulting in an estimated option payment.

4. Acquire the option agreement voluntarily from the property owner using an approach or process in the agency's approved ROW manual.

The following is offered as one example of a recommended approach to acquire an option contract. There are numerous other possible approaches. In any case, the process would necessarily be included in the agency's approved ROW manual [23 CFR 710.201(c)].

The agency acquiring an option would determine a price for the option and an estimate of the final acquisition value via a URA compliant appraisal and appraisal review of the fee interest of the parcel. Once the option price and the estimate of final acquisition value have been determined and approved by the agency, negotiations for the option contract could proceed. This would occur in a manner consistent with the procedures used by the agency for the acquisition of other property interests, and as specified in the agency's ROW manual.

The agency would then offer the approved amount for the option, although it would be free to negotiate a settlement of the option strike price and/or final acquisition value amount using the administrative settlement process, if needed. The administrative settlement alternative could also be applicable to the final price of the option contract, again consistent with the agency's approved operating procedures, including written justification for such actions.

5. ***Establish a policy for determining how to account for the option payment if the option is exercised.***

Based on the research undertaken, it was apparent that there is not always a consistent approach regarding whether the price of the option paid to the property owner should be deducted from the eventual acquisition price of the real property, if the option is exercised. The terms of the payment should the agency exercise the option must be clearly specified when developing an option agreement. There are typically two payment options when an agency exercises an option. They are to either:

- Deduct or offset the option payment from the final purchase price; or
- Not deduct or offset the option payment from the final purchase price.

There are competing theories regarding the effectiveness of either approach. One argument in favor of treating the payment for the option agreement separately from the final purchase price (i.e., not deducting or offsetting the option payment) is that it would induce the property owner to more seriously consider the option contract offer and result in a higher success rate in securing option agreements. A competing theory suggests that the option payment is part of the entire compensation package and therefore must be deducted from the final purchase price. Both theories are speculative without empirical data to support the effectiveness or accuracy of either theory.

The charges for the option payment would be considered eligible for Federal-aid participation regardless of which theory prevailed in the local jurisdiction.

Recommendations

As with any new practice, the use of option agreements will have to be integrated into the right-of-way process, and their use must fit within Uniform Act projects and programs [23 CFR 710.501(d)(1)].

1. ***The final acquisition price of the real property in the option agreement must be established using a valuation procedure compliant with the Uniform Act*** [23 CFR 710.501(d)(1)]**.**

As mentioned throughout this report, the use of option agreements will likely occur in the early acquisition stages of a project. Regardless of the methodology employed in establishing the estimated value of the real property being acquired, if an agency exercises an option, compliance with the Uniform Act is required. The acquiring agency is required to document its compliance with all applicable Uniform Act valuation and acquisition requirements. In this regard, an approved appraisal, appraisal review and just compensation determination by the acquiring agency would be necessary to support value, unless a waiver valuation is deemed appropriate [23 CFR 710.501(d)(1)].

2. ***The amount of the option payment should be determined through a documented methodology or analysis to support the factors and percentage used.***

The option payment is frequently set out as a percentage of the property value. The research team developed an example of one methodology to determine the option payment, which is included in the *Option Contracts Decision Matrix* in Exhibit "B" of this report. An agency is not restricted to using the cited example. It may use this approach or develop another process or analysis that supports the urgency and risk factors that lead to an agency's decision to perform early acquisition in the context of a given project, along with the analysis of market factors that are specifically impacting the subject property(s).

3. ***Some form of FHWA concurrence with the proposed option acquisition process for the various agencies is necessary for the costs associated with the purchase of options to be eligible for Federal-aid participation [23 CFR 710.201(c)].***

Depending upon circumstances, this procedural concurrence could either occur as a right-of-way manual update, or as a separate Division Office interim concurrence. Since the use of option agreements would be a new effort on the part of many agencies, an interim concurrence would probably be preferable to a manual update. Once the agency had confidence that the option procedure met their specific needs and requirements, then a formal manual update could be instituted.

4. ***As a new technique and methodology, FHWA should monitor the use and effectiveness of option contracts.***

The newly published 23 CFR Part 710 requires that each SDOT update its right-of-way manual within two (2) years from the effective date of the rule. The research team recommends FHWA request those SDOT's that have set-up a procedure for the use of option agreements to submit a report detailing their implementation experiences within three (3) years from the effective date of the rule. This will provide sufficient time for the SDOTs to prepare the new procedure and start using it.

The report should include information regarding the number of option agreements executed and exercised. Each agency should also report what it considers to be best practices and lessons learned related to its option program.

After the initial reporting, FHWA may wish to require annual or bi-annual status reports. An "Options Clearinghouse" could be created and housed on the FHWA website to accumulate this data, which would include the best practices and lessons learned.

Summary

The ability to use options will provide agencies with an alternative to advance purchases in those situations where there are concerns regarding imminent development or sale of property that is necessary for future projects. Option agreements can limit an agency's financial exposure while providing protection against undesired development activity. This technique gives agencies another tool that can streamline the right-of-way process and reduce costs.

FHWA - Next Steps

In order to use option contracts as a part of a Federal-aid highway program, the SDOT's might want to first create a procedure in their approved ROW manual that outlines the use of options in a way that complies with the uniform act.

1. Care should be taken to avoid charges of disparate treatment in the selection of qualifying properties.
2. The State's procedure may be applied on a project wide basis or on a program wide basis.
3. The approved procedure for pricing option contracts would likely follow one of two tracks:

Track 1 Acquire an option contract to secure the right to purchase the property but include language in the contract that both parties agree that a final estimate of compensation for the acquisition will be based upon an approved appraisal report or waiver valuation if the option is exercised. One point of acquiring options would be to prevent speculative property development or redevelopment and the customary price escalation that accompanies this activity. The option contract could stipulate to an effective date of value as a point of reference for any appraisals that may later be obtained if the option is exercised.

Since this tactic assumes the determination of compensation for the real property necessary for any project will occur after the signing of the option contract, a waiver valuation or other simplified valuation method could be used to produce an estimate of compensation for the option fee (option payment) in compliance with 49 CFR 24.102. If the acquiring agency decides to exercise its option to acquire the property, the agency would be required to obtain an appraisal report or develop a waiver valuation to establish the final estimate of compensation [23 USC 108(c)(3)(A)]. That report must comply with the Uniform Act requirements in 49 CFR 24.102, 24.103, and 24.104.

Track 2 Obtain an appraisal of the whole property compliant with 49 CFR 24.102, 24.103, and 24.104, and base the option fee (option payment) on a percentage of the final estimate of value of the whole property. This track anticipates that the acquisition will be for the whole property. In the event the option is exercised; the acquisition price may be the value estimated in the approved appraisal. It will be left up to each state whether the final compensation estimate will combine both the payment for the option fee and the payment for the property necessary for the project into one approved compensation estimate.

Exhibit A – Interview Questionnaire

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Interview Questionnaire

Background: This information is being solicited from a knowledgeable party of a governmental agency that is using option contracts. Prior to conducting the interview, the interviewer will contact the agency representative to explain/clarify the purpose of the interview, and what is meant by the term "option contract" or "advance purchase options."

Organization Information	
Name:	Organization:
E-mail:	Phone:
Interviewer:	Date:

Use of Advance Purchase Options

Questions:		
1. Are there any prohibitions or restrictions to using advance purchase options in your state?	Yes:	No:
If yes, please describe?		
2. Does your state or agency presently use advance purchase options?	Yes:	No:
3. What circumstances or factors does your agency consider when making a decision to use an option contract?		
4. Does your agency coordinate the use of option contracts with early location/design activity including environmental documentation for the project?	Yes:	No:

If yes, how does this coordination occur?		
5. In the last 5 years, how many parcels has your agency encumbered with an option contract?		
6. Can you describe the type of option your agency uses?		
7. Can you provide a copy of the document you use?	Yes:	No:
8. Is there a reason your agency selected this type of option?		
9. Has your agency ever used or considered using a "right of first refusal" option?	Yes:	No:
10. Is your agency required to provide any written support for its decision to use an option contract?	Yes:	No:
If so, what does that entail?		
11. How does your agency determine a reasonable term, conditions or length of time, for a proposed option contract?		
12. If your agency does not exercise the option to purchase, is the forfeit of the option payment a problem for your agency?	Yes:	No:

Valuation of Advance Purchase Options

Questions:		
1. What valuation methodologies does your agency follow to determine the amount of the option payment?		
a. Has your agency adopted a specific documented, written procedure or process that applies to the pricing of acquisition options?	Yes:	No:
If yes, can you provide a copy?	Yes:	No:
b. Does your agency link the amount of the option payment to the fair market value of the subject property?	Yes:	No:
c. Does your agency apply or use any type of formula for estimating this amount?	Yes:	No:
If yes, please describe.		
2. Does your procedure or process comply with URA appraisal procedures?	Yes:	No:
3. Does your agency perform an appraisal review for an option valuation?	Yes:	No:
If so, what criteria do you use?		

Federal Aid Participation in Advance Purchase Options

Questions:		
1. If the purpose served by acquiring an option and the value/cost of an option can be reasonably documented and justified, is there any reason that your agency could not use state funding for this purpose?	Yes:	No:
Please list any such reasons.		
2. Is there any reason that Federal-aid participation in such expenditures should not be considered if Federal regulations allowed for such reimbursement?	Yes:	No:
Please list any such reasons.		
Other:		
1. Are you willing to participate in a working group for this research study	Yes:	No:
2. If yes, are you available for a meeting on 11/20?	Yes:	No:

Other Comments:

Lessons Learned:

Best Practices:

Exhibit B - Option Contract Decision Matrix

The answers to the following questions will assist an agency in determining whether the use of an option contract is appropriate or useful in a given situation. An agency should evaluate the predominance of positive responses and consider all pertinent information when making its decision.

First the agency must determine if the use of the option is legally permissible under state law and whether agency procedures provide for the use of an option.

	Yes	No
1. Is there a reason to acquire the parcel in the early acquisition stages of the project?		
2. Has the agency evaluated the cost to purchase the parcel versus the cost of entering into an option agreement?		
3. Does the agency have proper authority to purchase an option?		
4. Is there adequate funding to purchase the parcel?		
5. Is there adequate funding to enter into an option agreement?		
6. Is there adequate funding anticipated to exercise the option if the agency decides it needs to acquire the property?		
7. Does the agency have a reliable target date for the initiation of project construction?		

Determination of the Price of the Option Contract / Agreement

NOTE: In the following example, the "Factors" and "Weights" shown here are intended for illustration purposes only.

An agency could use the following factors to determine the amount of the payment for the option contract. The current safe rate will be adjusted by the following factors, which are weighted as explained below:

Factor		Weight
Length of term of the option	Safe rate of return = 2% (Based upon current 10 year Treasury Bonds)	
Real estate market price appreciation	Annual	
Low appreciation	None to less than 1%	1.0
Moderate appreciation	1% - 3%	1.2
High appreciation	Greater than 3%	1.5
Parcel specific appreciation (less general market appreciation)	Consider pending zoning change, utility or property improvements, development or access approvals, potential for lot splits	
No risk		1.0
Moderate risk		1.2
High risk		1.5
Parcel value (either estimated or appraised)		
Less than $100,000		1.5
$100,000 - $500,000		1.2
More than $500,000		1.0

EXAMPLE: A parcel of real property has an estimated value of $200,000. An agency is considering the use of an option to secure the property temporarily while they assess the feasibility of acquiring the parcel for environmental mitigation. A final decision about whether the property will be needed for the project should be made, based on various studies of the parcel, in the next eighteen months to two years. Given this information the agency is considering whether to acquire a 2-year option to purchase the property. Property values in the general area are experiencing about 2% annual appreciation, and there is a high risk that the value of the specific parcel will raise quickly given recent development in the immediate area.

In order to price this option the acquiring agency will need to begin with the safe rate of 2% and adjust it for the factors described in the example to determine the amount of the option payment:

Safe Rate = 2% (0.02)			
Factor	**Weight**	**Calculation**	**Results**
Moderate appreciation	1.2	0.02 x 1.2	0.024
Parcel specific appreciation – high risk	1.5	0.024 x 1.5	0.036
Parcel value	1.2	0.036 x 1.2	0.0432
Adjusted price for option			4.32%
Amount of Option Payment			
Estimated value of parcel = $200,000	x 4.32%	=	$8,640 per year (estimated)
Length of option period = 2 years	x 2 years	=	$17,280

Discussion of example:

The mathematical approach presented in the example above is drawn from the materials discussed in the literature review of the full report and a detailed discussion with agencies that have experience with option contracts. This example is not intended to be an absolute determination of how to set the price of an option. Instead, it presents a logical and explainable approach to begin negotiations with an owner.

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