

An Economic Analysis of the Effects of Increasing Colorado's Conservation Easement Transaction Credit Cap

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Erik L. Glenn (871618404)
Executive MBA – Economics

Executive Summary

This report evaluates the overall effectiveness of Colorado's conservation easement state income tax credit from an economic standpoint to determine if increasing the established cap on a per transaction basis is appropriate.

The concept behind the Colorado state income tax credit is to incentivize landowners to restrict the use of their land to meet certain public policy objectives the state has determined to be important to the welfare of Colorado's citizens. These objectives include, the protection and preservation of open space, wildlife habitat, scenic views, recreational opportunities, and areas of historical significance (Section 39-22-522(2), Colorado Revised Statutes). Established in 1999, partly to address the explosion in population Colorado was experiencing, the tax credit has largely been effective at meeting the policy objectives established by the legislature.

Unfortunately, the tax credit has also been the source of abuse over the past decade. Problems with the tax credit led to legislation in 2008 and 2012 to create additional oversight and institute an overall cap on the amount of tax credits the state would issue in a given year (Office of the State Auditor, 2012). This has led to increased costs to landowners conveying conservation easements and a reduction in the number of easement contributions year over year.

Methodology

A review of available historical data from the Colorado Division of Real Estate and a significant literature review was conducted to complete this analysis. Assumptions were developed about the different land types and values of those land types using existing data. The existing data was largely provided by The Trust for Public Land (TPL) who compiled the information from various academic and scientific sources in conjunction with an economic analysis they completed in

2010. Following the examination of data, generally accepted methodologies were applied to determine the likely economic effects of an adjustment to the Colorado state income tax credit would have on easement conveyances, landowners and the state of Colorado.

Findings

Since establishment of the state income tax credit in 1999, Colorado has foregone \$748 million in revenue. This opportunity cost has resulted in more than 1.6 million acres of land being conserved across the state and an economic benefit of \$6.1 billion in natural capital¹.

Furthermore, using the concept of natural capital, my analysis concludes that Colorado's investments in permanent conservation easements is currently generating an economic benefit of approximately \$613 million each year. My analysis also concludes that additional conservation can be achieved by increasing the per transaction tax credit cap. This change will also increase economic efficiencies and provide additional economic benefit to the state of Colorado.

Additional Research

Additional analysis should be undertaken to further explore the concepts of natural capital and ecosystem services and how Colorado's conserved lands are providing significant annual economic benefits to the state. Of particular interest would be further investigation into the proper valuation of natural capital and ecosystem services. While I was able to find a substantial amount of information related to this field of study it still appears to be a relatively new economic concept that has not been fully explored. Most of the study's that have been conducted around this field seem to believe that valuations are conservative at best and at times significantly undervalue these resources. The undervaluing of these resources can lead to flawed

¹ Natural Capital is a concept that various naturally-occurring assets provide economic value over an extended period of time (New Jersey Department of Environmental Protection, 2007).

public policy decisions about the proper allocation of scarce resources. Further study should also be aimed at determining the “true” opportunity costs of the tax credit program to the state of Colorado. Currently, the state does not appear to factor in tax revenue the state receives from the transfer of tax credits from the credit-generator to the credit-user in determining the program’s opportunity costs.

Background

Established by state statute in 1976, a conservation easement is a transferable real property interest established to promote the preservation of open space, wildlife habitat and scenic views (Section 38-30.5-102, Colorado Revised Statutes). More simply put, a conservation easement is a recorded document that restricts certain uses of real property. Landowners are incentivized to convey conservation easements in many different ways. Most typically they are incentivized through tax benefits that have been established to promote public policy goals related to environmental protection and conservation.

Conservation easements are created generally under state law. Qualifying conservation contributions² however, are created under both federal and state law with state law in most cases mirroring federal law. A qualified conservation contribution is a conveyance of a conservation easement that qualifies for tax incentives. As this analysis is about the economics of the Colorado state income tax credit, the focus of the report will be on qualified conservation contributions.

² A qualified conservation contribution is defined under federal law as a contribution of (a) qualified real property interest; (b) to a qualified organization; (c) exclusively for conservation purposes (Section 170(h)). Colorado’s law mirrors Federal law in determining a qualified conservation contribution.

The definition of a qualified conservation contribution is found under Section 170(h) of the Internal Revenue Code (“IRC”). To qualify as a conservation easement that can claim tax incentives, the contribution must be exclusively for conservation purposes. Conservation purposes are also defined under Section 170(h) to be (1) preservation of land for outdoor recreation; (2) the protection of relatively natural habitat; (3) the preservation of open space; or (4) the preservation of a historically important land (IRC Section 170(h)). A conservation easement only has to meet one of the conservation purposes to be considered a qualified conservation contribution. Colorado uses the standards established in Section 170(h) to determine which conservation easement conveyances will qualify to receive a tax credit.

Colorado created its conservation easement state income tax credit in 1999 partly in response to the 31% increase in population that occurred during the 1990s (Office of the State Auditor, 2012). Since that time, Colorado has used tax policy as a means of protecting sensitive natural resources and incentivizing land conservation. The Colorado state income tax credit is a dollar-for-dollar reduction of an individual’s tax liability that is generated through the conveyance of a qualified conservation contribution. In 2001, Colorado made the tax credit transferrable, meaning that a landowner who generates a tax credit through a contribution of a conservation easement can transfer the earned tax credit to another taxpayer for cash compensation (*Id.*). The effect that the tax credit has had on land conservation in Colorado is astounding. As of the date of this report, more than 3,600 conservation easements protecting more than 1.6 million acres of land have been conveyed (Welch, 2014).

The tax credit is typically used in conjunction with the Federal tax deduction for conservation easement contributions. Unlike the tax credit, the federal deduction is neither a dollar-for-dollar incentive nor transferable. Instead landowners are able to deduct a portion of the full fair market value of their conservation contribution from their adjusted gross income. Landowners receive both the state credit and the federal deduction in return for conveying a qualified conservation contribution. Both the amount of the allowable tax credit and the federal deduction are determined by the appraised value of a conservation easement as determined by a qualified real estate appraiser.

Mechanics of the Colorado State Income Tax Credit for Conservation Contributions

Currently, the state of Colorado makes \$45 million in tax credits available to conservation easement contributors each year (Welch, 2014). Further caps are placed on individual transactions.

Transactional Caps

Beginning in 2007, the total maximum dollar amount that can be claimed as a tax credit is equal to 50% of the fair market value of the conservation easement, up to a maximum value of \$750,000 (Office of the State Auditor, 2012). That means that a landowner can receive up to \$375,000 in tax credits for a contribution of a conservation easement valued at or above \$750,000.

Two major adjustments have been made to the transactional cap since the state first began to issue tax credits in 1999. Initially the state capped the number of tax credits an individual landowner could receive in any one year at 100% of the fair market value of their contribution up

to \$100,000 (*Id.*). In 2003, the transactional cap was adjusted to allow landowners to continue to claim 100% of the first \$100,000 worth of value and then claim 40% of any value beyond \$100,000. The maximum credit any landowner could receive under this cap was \$260,000 (*Id.*). In 2007, the transactional cap was adjusted to its current standard.

Utilization of the Tax Credit

Between 2000 and 2009, taxpayers claimed approximately \$639 million in conservation easement tax credits (*Id.*). Since 2009, an additional \$109 million in credits have been claimed (Welch, 2014). Tax credits represent an “opportunity cost” to the state of Colorado. For every dollar of tax credit issued the state foregoes that dollar in revenue that it could spend on other programs and needs. In sum, the State of Colorado has incurred an opportunity cost of approximately \$748 million since 2000 in making the conservation easement tax credit available to taxpayers. I believe that the number may be inflated, however, in pure economic terms because every time a tax credit is transferred from the taxpayer that generates the tax credit to another taxpayer the state receives tax revenue from that transaction. Furthermore, the dollars generated from the sale of the tax credit or the dollars saved in taxes through utilization of the tax credit against state tax liabilities will likely be put back into the economy and will likely generate tax revenue for the state in different ways. With all that being said, analysis of what the “true” opportunity cost when all economic profit and economic costs are considered is beyond the scope of this report. Future studies into the economics of the tax credit should consider addressing this question. For this report I will analyze the aggregate numbers that are readily available from the Colorado Department of Revenue and the Division of Real Estate.

Economic Analysis of the Credit Program – Overall

Polls show that Coloradans strongly support (86%) – even with state budget problems - investments in the conservation and protection of Colorado’s land, water and wildlife (Colorado College, State of the Rockies Project, 2012). The Colorado legislature also affirmed its support for using tax policy to incentivize conservation as recently as 2011 (Office of the State Auditor, 2012). While support from the public and policymakers is high, it is important from time-to-time to evaluate the overall effectiveness of the program and its economic impacts. The last review of the program’s effectiveness came in 2012, when the Office of the State Auditor issued its Performance Audit (the “2012 Audit”). While the 2012 Audit was not an economic analysis, it does provide important information necessary to conduct an economic analysis.

Overall, the 2012 Audit determined that the overall effectiveness of the program to spur conservation activity was high (Office of the State Auditor, 2012). However, the 2012 Audit was unable to fully evaluate the economic benefits of the tax credit program. Specifically the 2012 Audit was unable to quantify the value of the ecosystem services easements provide. The 2012 Audit recognized that valuing these benefits could be done using acceptable valuation models but ultimately determined that at the time there was not enough available data to properly generate a value provided by the conservation purposes. Through my research, I believe that the data is available to determine the economic benefits associated with these ecosystem services.

Methodology and Approach

To analyze the value of the ecosystem services provided by Colorado’s conserved lands, I will rely primarily on two studies³ that build on significant literature review of scientific and

³ The two studies that are the basis of this analysis are (1) “*Valuing New Jersey’s Natural Capital: An Assessment of the Economic Value of the State’s Natural Resources*” as prepared in 2007 by the New Jersey Department of

economic studies on the valuation of the benefits of protecting lands that produce ecosystem goods and services. Additional studies and literature was reviewed in the development of this report, but these two studies were conducted by reliable and credible sources and do a good job of condensing and aggregating relevant information from several other studies. I then applied the methodology developed in these studies to further analyze the economics of Colorado's tax credit program.

Natural Capital and Ecosystem Goods and Services

To appropriately value the ecosystem goods and services provided by conserved lands in Colorado, it is important to understand the concept of "Natural Capital". Capital in traditional economic terms is the "human-made resources (buildings, machinery, and equipment) used to produce goods and services" (Campbell R. McConnell, Sean M. Flynn & Stanley L. Brue). Assets are things entities possess that have monetary value (i.e. they are exchangeable). Capital assets then are assets that are used to produce goods and services over an extended period (New Jersey Department of Environmental Protection, 2007). In economics, the value of a capital asset is determined by the value of the future benefits which the asset is expected to provide (*Id.*). Natural Capital is a term economists have begun to use to describe naturally-occurring entities (i.e. forests) that produce economic value over a period of time (*Id.*). The benefits of natural capital can be both goods and services – Ecosystem goods and Ecosystem services (*Id.*). "Ecosystem services are processes and functions by which natural ecosystems sustain and fulfill life [i.e. carbon sequestration], while [ecosystem] goods are physical commodities that can be weighed, packaged, and transported [i.e. timber]" (*Id.*).

Environmental Protection; and (2) "*A Return on Investment: The Economic Value of Colorado's Conservation Easements*" as prepared in 2010 by The Trust for Public Land.

Valuing the Natural Capital Provided by Colorado's Conservation Easements

To value the natural capital that Colorado's conservation easement program has provided to the

state, I determined how much natural capital is currently protected by conservation easements.

To do this, I relied on data provided by the Colorado Division of Real Estate and data presented

in TPL's 2010 economic analysis titled, "*A Return on Investment: The Economic Value of*

Colorado's Conservation Easements". According to the Colorado Division of Real Estate, more

than 1.6 million acres of land has been permanently conserved that has generated a state income

tax credit. That is approximately 200,000 additional acres since the TPL study was produced.

Since I was unable to categorize this additional acreage in specific ecosystem types in the limited

time I had to conduct this analysis, I used the TPL report data to generate an average per acre

value for all ecotypes and then applied that number to the additional acres conserved since 2009.

Combining the TPL data and my data I was able to generate an overall natural capital value for

conservation easements in Colorado that generated a tax credit - **~\$6.1 billion**. See Appendix B

for the data table.

My analysis further shows that the natural capital protected by conservation easements produces

an annual return of at least \$613 million in ecosystem services. I believe that both the total value

of natural capital produced by lands protected by permanent conservation easements and the

annual return are conservative for two reasons, (1) 2010 data on acres conserved and credits

issued is not readily available; and (2) most economists studying the field of natural capital and

ecosystem goods and services believe that current valuations do not fully value the benefits

produced.

Putting this in the context of opportunity costs to the state, over the past 15 years, Colorado has foregone approximately \$748 million in revenue (~\$49 million per year). Based on my analysis and analysis completed by TPL, Colorado has received in return a net benefit of approximately \$6.1 billion in natural capital and is receiving, and will continue to receive into the future, an annual economic benefit of at least \$613 million generated solely from the ecosystem services provided by these protected lands. I believe that it is reasonable to conclude that if ecosystem goods (i.e. timber, cattle, etc.) were included the annual economic return would be much higher. Reflected another way, Colorado receives \$8 of economic benefit for every \$1 of foregone revenue from conservation easement tax credits. I believe that it should also be noted that this analysis is not entirely complete because it does not account for the other economic outcomes that occur from tax credit-generating conservation transactions. These outcomes include, but are not limited to, job opportunities for people who help facilitate these transactions, economic spending that occurs from tax savings and the monetization of tax credits.

Unfortunately, the tax credit program has begun to underperform in relation to what Colorado is willing to provide in terms of tax credits. The state has determined that it is reasonable to forego up to \$45 million in revenue each year to conserve land and add to its natural capital asset base. Over the past three years (2011 – 2013) only 277 conservation easements have been conveyed generating \$70 million worth of credits (an average of \$23 million/year). In comparison, for the previous three year period (excluding 2010), 861 easements generating \$233 million (an average of \$77 million/year) were conveyed – see chart on Appendix A (Welch, 2014). I believe that policy adjustments to the transaction cap could stimulate contributions to a level closer in line

with the overall cap of \$45 million and create economic efficiencies that will benefit landowners and help the state further its public policy objectives in land conservation.

Economic Analysis of Increasing the Transactional Cap

It is important to begin this analysis with the understanding that Colorado budgets annually to forego \$45 million worth of revenue to incentivize land conservation. Therefore, any adjustment to the transactional cap will have no impact on the state's revenue forecasts. Data from other state's (in particular North Carolina) indicate that upward adjustments to the transaction cap will stimulate additional conservation in terms of both conveyances and acreage⁴ (Conservation Resource Center, 2007). When Colorado increased its transactional cap in 2003, annual conveyances increased by 350% but when the cap was adjusted upward again in 2007, conveyances actually decreased by 20% (Welch, 2014). Why the difference? Anecdotal evidence suggests that there was significant pent up demand for conservation in 2003. The program was new, costs of conveying easements were low and there was very little oversight on the program. In 2007, the story was much different. Costs were increasing, demand had subsided and the IRS and the Colorado Department of Revenue were conducting a massive investigation into abuses of the program. Unfortunately, there have been no academic studies into why the two adjustments to the transactional cap in Colorado produced such vastly different results.

As mentioned above, data trends from other states with tax credit programs universally conclude that increasing the amount of credits a landowner can claim will result in additional conveyances and additional acreage being protected (Conservation Resource Center, 2007). Several

⁴ North Carolina increased its maximum allowable credit per transaction from \$100,000 to \$250,000 in 1999. The result, average annual conveyances more than doubled.

organizations that I spoke to believe that there is currently pent up demand for conservation but that many landowners are sitting out because transactional economics no longer work (i.e. landowners have concluded that the marginal costs outweigh the marginal benefits). Increasing the transaction cap would change this equation and would likely stimulate additional conveyances but it is hard to analyze what the specific equilibrium price point is for Colorado's landowners to determine that conveying a conservation easement makes economic sense. Regardless of whether or not an upward adjustment causes an increase in the number of conveyances, there are other economic reasons for adjusting the transactional cap.

Specifically, the 2012 Audit Report, concluded that phasing⁵ of conservation easement transactions created increased risk for program abuses (Office of the State Auditor, 2012). The risk is primarily due to the complexity involved with appraising phased conservation easements. More importantly though, phasing also creates economic inefficiencies that could be corrected by increasing the transactional cap. As discussed earlier in this report, the current transactional cap limits what a landowner can claim in tax credits to 50% of the full fair market value of their conservation contribution up to a maximum value of \$750,000. These limitations incentivize landowners with large or valuable tracts of land to phase their contributions over time to maximize value (Office of the State Auditor, 2012). This strategy also generates additional costs to the landowner and from time to time results in the state not receiving the full benefit of protecting the entire property when a landowner decides to forego conveying additional phases⁶.

⁵ “Phasing is a legal way for landowners to increase their tax benefits by donating conservation easements on different portions of a larger parcel of property or giving up additional development rights for the same parcel of land over time” (Office of the State Auditor, 2012). Both scenarios count as the conveyance of a new easement that may be eligible to receive a separate tax credit (*Id.*)

⁶ Landowners cannot be forced to contribute additional phases due to issues with “donative intent” and charitable giving law.

For this report, I analyzed the inefficiencies associated with the current transactional cap using a comparison model of outcomes that would likely occur if the transaction cap was adjusted upward. This analysis is based on the following assumptions, (1) the transaction cap is increased to \$2 million; (2) landowners are able to claim 50% of the full fair market value of their contribution as a tax credit; (3) the full fair market value of the conservation easement being conveyed is \$2 million; and (4) costs for conveying a conservation easement under both scenarios is \$58,000 per transaction⁷.

Scenario 1 analyzes the most likely conveyance strategy a landowner would employ under the current transaction cap (50% up to \$750,000) while Scenario 2 analyzes the conveyance strategy using an adjusted transaction cap (50% up to \$2 million). The analysis is provided in table form below:

Scenario 1: Current Transaction Cap				Scenario 2: Adjusted Transaction Cap
Year 1 (Phase I)	Year 2 (Phase II)	Year 3 (Phase III)	Total	Year 1
Costs: \$58K	Costs: \$58K	Costs: \$58K	Total Costs: \$174,000	Costs: \$58K
Credit Earned: \$375K	Credit Earned: \$375K	Credit Earned: \$250K	Total Credit Earned: \$1,000,000	Credit Earned: \$1,000,000
Net Return: \$826,000				Net Return: \$942,000

Using simple math, an upward adjustment to the tax credit transaction cap would save the landowner in this scenario \$116,000 over three years and achieve the same amount of conservation in less time. From an economic standpoint, increasing the transaction cap would

⁷ Based on anecdotal information collected from conversations with members of the conservation community, \$58,000 was determined to be the most accurate cost of conveying a conservation easement in 2014.

result in efficiencies by reducing costs, eliminating the need for phasing and allowing landowners to realize a greater return.

Taking this analysis one step further, if the landowner in this scenario were to transfer all of the credits generated to another taxpayer his realized gain would be (assuming that all credits were sold at a rate of \$0.83/dollar⁸): Year 1: Scenario 1 - \$311,250; Year 1: Scenario 2 - \$830,000. Under Scenario 2, the landowner would have an additional \$518,750 in Year 1 to invest or alternatively to spend on goods and/or services.

Given that the state has capped the overall number of credits that can be conveyed in a given year at \$45 million, adjusting the transactional cap will have no impact on the projected revenues of the state and will very likely stimulate additional conservation conveyances. Under an adjusted system, I believe that the conveyances will be larger (in terms of acreage), more cost efficient and result in permanently protected resources that will generate significant economic returns to Colorado on an annual basis. Adjusting the transaction cap will also serve to more efficiently meet the stated public policy goals of the state in terms of land conservation and further reduce the potential for abuses to the program by dis-incentivizing phasing.

⁸ Conservation Easement Tax Credits currently transfer on the open market for an average of \$0.83/dollar (Tax Credit Connection, 2014).

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Additional Personal Communication with:

Chris West, Executive Director, Colorado Cattlemen's Agricultural Land Trust

Amanda Barker, Program Director, Colorado Coalition of Land Trusts

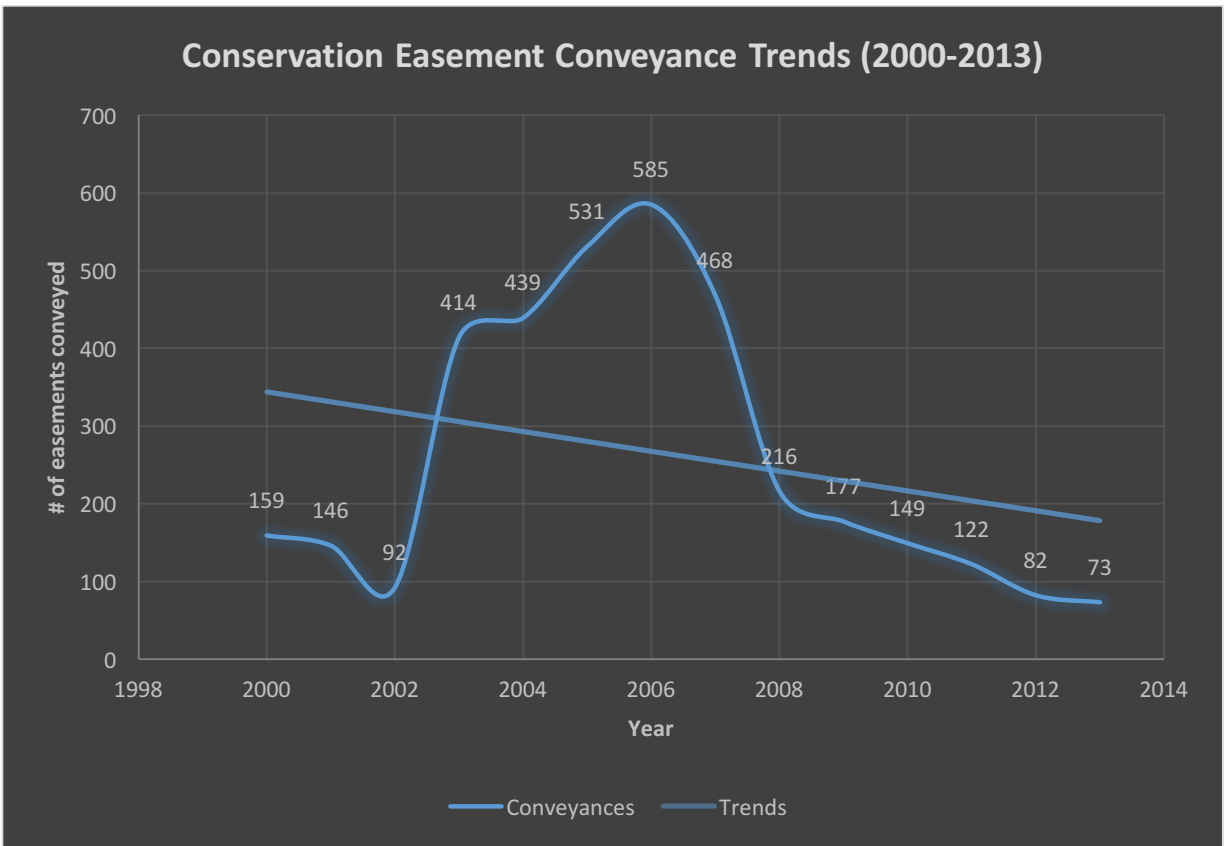
Ben Lenth, Executive Director, San Isabel Land Protection Trust

Andrew Mackie, Executive Director, Land Trust for the Upper Arkansas

Mike Strugar, President, Conservation Resource Center

Ariel Steele, President, Tax Credit Connection

APPENDIX A TRENDS



Appendix B

Ecosystem Types for Acres Under Conservation Easement (The Trust for Public Land, 2010)

Ecosystem Type	Conservation Easement Acres (as of 2009)
Barren	10,600
Emergent Herbaceous Wetland	16,400
Woody Wetland	42,500
Deciduous Forest	78,900
Evergreen Forest	334,000
Mixed Forest	20,500
Scrub/Shrub	189,000
Sagebrush	125,000
Grassland/Herbaceous	129,000
Shortgrass Prairie	231,000
Open Water	5,090
Developed – Low Intensity Urban/Open Space	1,790
Developed – High Intensity	872
Urban Altered or Disturbed	31,200
Agriculture	191,000
Developed – Oil/Mine/Quarry	250
Total	1,410,000

Additional Conservation Easement Data (2010 – 2013)

Data Provided by the Colorado Division of Real Estate (2014)

Conservation Easement Acreage for 2010: Unknown

Conservation Easement Acreage for 2011: 61,684

Conservation Easement Acreage for 2012: 112,296

Conservation Easement Acreage for 2013: 52,374

Total additional conserved acres: 226,354

Total Conserved Acres (2000 – 2013): 1,633,456⁹

⁹ This is an approximate figure since data for 2010 is unknown.

Estimated Annual Per Acre Value of Ecosystem Services by Ecosystem Type (TPL, 2010)

Ecosystem Type	Ecosystem Service(s)	Value/Acre/Year	Source
Barren	None	N/A	
Emergent Herbaceous Wetland	Flood control, water supply; fish and wildlife habitat; recreation; aesthetics	\$784	Roberts & Leitch, 1997
Woody Wetland	Flood control, water supply; fish and wildlife habitat; recreation; aesthetics	\$784	Roberts & Leitch, 1997
Deciduous Forest	Grazing; carbon sequestration; habitat provision	\$879	Ingraham & Foster, 2008
Evergreen Forest	Grazing; carbon sequestration; habitat provision	\$879	Ingraham & Foster, 2008
Mixed Forest	Grazing; carbon sequestration; habitat provision	\$880	Ingraham & Foster, 2008
Scrub/Shrub	Carbon Sequestration	\$610	Ingraham & Foster, 2008
Sagebrush	Dilution of waste water; natural purification of water; erosion control; habitat for fish and wildlife; recreation	\$82	Loomis et al, 2000
Grassland/Herbaceous	Grazing; dilution of waste water; natural purification of water; erosion control; habitat for fish and wildlife; recreation	\$85	Loomis et al, 2000
Shortgrass Prairie	Grazing; dilution of waste water; natural purification of water; erosion control; habitat for fish and wildlife; recreation	\$87	Loomis et al, 2000
Open Water	Fresh water regulation and supply; habitat provision	\$267	Ingraham & Foster, 2008
Developed – Low Intensity Urban/Open Space	Gas and Climate Regulation; Water Regulation	\$194	McPherson, 1992
Developed – High Intensity	Gas and Climate Regulation; Water Regulation	\$194	McPherson, 1992
Urban Altered or Disturbed	None	N/A	
Agriculture	Aesthetics; crop production; grazing	\$283	Rosenberger & Walsh, 1997
Developed – Oil/Mine/Quarry	None	N/A	
Average		\$376	