



THE UNDERGROUND WORLD OF PIPELINE APPRAISAL

BY DAVID HOWELL, SR/WA

The appraisal of pipelines has evolved into a highly-specialized profession. The primary reason is that, while standard appraisal methodologies are used to determine the land value, there are a host of unique factors to consider where pipelines are involved.

In working with pipeline appraisal projects for many years, I have found that pipelines are frequently valued incorrectly. Pipelines involved in mergers, acquisitions, and estate settlements are frequently valued incorrectly due to inexperience and lack of knowledge. Local taxing authorities will almost always over-value a pipeline property.

My company, Pipeline Equities, utilizes numerous methods of appraisal that are specifically suited to the pipeline industry. Our methods are based on the way a pipeline owner views a pipeline as well as the right of way in which it rests. The methods for determining value can be quite different from other types of appraisals and extend well beyond the land value to include demand for the property, utility of the property, scarcity or supply of the property and ready transferability of ownership rights.

A typical appraisal might use any number of standardized methodologies, such as highest and best use, across-the-fence or comparable sales to assign value to a particular right of way. However, in appraising pipelines, determining what the surrounding land is worth is only part of the equation. The value of what lays under the right of way will inevitably add another element.

Unique Factors to Consider

While pipelines are best suited for the original intent, there are occasions when pipelines are being valued for a usage change. Pipelines can be converted from crude to fiber optic conduits or conduits for electric power line cables from wind farm electric grid centers. In these cases, valuation considerations will need to include the cost to convert the pipeline into another use. Other factors depend on whether the product transported in the pipeline is purchased at the wellhead and resold. If the pipeline requires specific procedures, such as the cost to compress, enhance, treat, clean or process, this will add another factor into the mix.



Airports that have fuel trucked in can have significant cost savings by building a pipeline to the fuel source.

Situations frequently arise where a valuation report is needed for an active or inactive oil, gas, or product pipeline. The report might be required for a sale or divestiture, readjusting tax assessments, estate settlement, partnership termination, determining salvage value or preparing for a pipeline use conversion. Regardless of the purpose for the appraisal, there is always one objective – establishing an accurate value.

To underscore the need for specialized pipeline appraisal methodology, let's take a look at some recent appraisals.

Pipeline Rehabilitation

My company recently appraised a vintage crude pipeline in a mature field on the west coast. The line had been active in the past and later became idled. The operator was planning to rehabilitate and reactivate the line, and needed a new appraisal to help determine the level of common carrier transport fees and tariffs once the line was put back into service.

At the time, there was a great deal of new activity and production in the area as a result of higher prices. New wells were being drilled, and the area seemed to have a booming economy. Most of the right of way went through major thoroughfares, and 90% of the easements

existed in heavily congested urban areas. Since the right of way was underneath city streets, any potential access needed for rehabilitation or for laying new pipe would require cutting through the asphalt and concrete. We determined that, in order to renovate the old pipeline and get it up to current specifications, there would be many permits required, as well as oversight from municipal and state authorities. Realizing this would be costly, we created an estimate based on new construction costs, as well as depreciation, in order to account for rehabilitation costs. We soon recognized that the appreciation of the right of way in terms of costs in the heavily congested areas more than made up for any deficiency in depreciated new construction costs. In essence, the right of way would have been prohibitively expensive to purchase outright in today's market. This is not to mention the bureaucratic nightmare in securing new permits.

As it turned out, the new estimated throughput—in terms of barrels to be moved—was so much greater as a result of the new production that the appraised value far overshadowed the right of way estimates, new construction cost estimates and salvage combined. Rehabilitation was the only viable alternative, as new construction and obtaining fresh permits for right of way and construction would have been totally cost prohibitive. As a result, the company was able to activate and renovate two other pipelines in the area as well.

Appraisal for Construction Financing

When a lone entrepreneur with a good idea has the good fortune to find a banker who shares their vision, together they can accomplish great things. This case personifies the American success story.

A bank officer contacted me about a customer who had obtained a contract to supply jet fuel via pipeline to a municipal airport. The airport had been receiving their jet fuel from 30 to 40 trucks a day, and the entrepreneur projected that a pipeline would be a more efficient and reliable source of transport. The client had already secured contracts from two refineries and had planned

to purchase the jet fuel in equal quantities from both suppliers. This plan projected a considerable amount of savings for the city's airport.

The job would be ready to start within four to six months, and the bank needed an appraisal to satisfy their loan requirements. They turned over plans for the pipeline, along with other documents regarding financial information and estimated costs for the project. Blueprints for building the pipeline were also provided, along with the right of way contract documents, their contract to buy jet fuel from the two refineries and a contract to sell the fuel to the municipal airport. Since the loan amount would range between one to two million dollars, our appraisal was a critical component to getting loan approval.

Research showed that the airport and surrounding area had a history of sustained growth. On the demand side, the airport traffic was growing, and the adjacent area was showing an expanding base of customers from tourism, as well as government and private industry. The need was there, and money could be saved through a reliable alternative.

Our primary method of appraisal included the cost for new construction and the projected revenue stream. Other factors that were taken into consideration included front office management, contracts, and the source of supply and demand. Additionally, the pipeline company's financial projects demonstrated that they could get their money back in a three-year payout. The loan was quickly approved and the pipeline is now being built. For the sake of economics, the operations plan was outsourced, and the pipeline company is now focused on building the pipeline as expediently and economically as possible in order to pay off the loan on time.

The entrepreneur had found a niche market in an underserved segment where larger pipeline companies had shown little interest. There are many more situations like this where fuel is being trucked in at a cost that is significantly higher than simply building a pipeline to a refinery or a fuel source. The bank is on the lookout for more deals like this one, and we see enormous opportunity for others who are willing to take on this type of project.



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Appraisal for Pipeline Divestiture

In 2009, a pipeline company contacted us about their plans to split from their private equity investor group. A few years earlier, the investor group had backed their company in the purchase of almost 2,000 miles of transmission, trunk and mostly gathering systems. In this case, the original seller had divested itself from what they deemed to be an obsolete pipeline and gathering system, caused by depleting oil and gas fields throughout the country.

When the deal lagged behind the projections established by the pipeline company, the investor group grew impatient and wanted out. They would need to divide the property, so value was needed to form the basis for settlement between the two parties.

None of the forty systems were currently operating, but they seemed to have potential because they were in active areas. In many cases, a good marketer can sometimes raise the pipeline value significantly simply by finding someone who is willing to explore different uses. An entrepreneurial company might envision converting these same junk pipelines to serve as fiber optic cable conduit, CO₂ lines for revitalizing an oil field, irrigation lines or other appropriate uses.

Unfortunately, all efforts to find other uses and buyers for the vast majority of systems had failed. We realized that our only option was appraising the pipelines using the salvage method. If the right specifications were present,



When gas or oil fields have neared depletion, the pipelines serving them must be appraised before taxing authorities will lower rates.

we knew that a pipeline salvage or recovery operator could complete the recycling process and return the pipe to the mill as scrap or to the structural market as steel for other uses.

As these were primarily gathering systems, there was no discernible right of way. We proceeded to determine a salvage value for each of the forty systems based on demand the current demand for the various diameters of pipe. We gave each a net value after take-up costs and landowner damages were taken into account. This enabled us to assign an appropriate value, and the parties involved were able to split up the assets accordingly.

Appraisal for Tax Authorities

Every oil and gas producing state has a field where initial production was flush and new gathering lines were laid to transport new production to market. As time goes by, and the field nears depletion, the pipeline throughput in the gathering and transmission and trunk lines can be operating at as little as 10 to 20 percent of the initial production. In these cases, the operators still must pay regular taxes accordingly to earlier throughput or initial values, which were generally not depreciated accordingly.

Appraisal districts can be tenacious and resistant when it comes to giving up potential tax revenues and lowering tax rates. They require hard evidence in the form of substantiated asset valuations or appraisals before considering any kind of change that might result in lowering tax rates.

Many local tax appraisers use a method based on the cost of new construction depreciated over the estimate life of the pipeline, with no regard for diminished throughput. This

can result in an unrealistic value, as it is based on new or replacement cost with no regard to the current value of the pipeline or the other ways it might be used. My company takes a slightly different approach by determining value based on current volumes of throughput, if any exists. If there are no significant or measurable volumes, then we might submit a salvage value.

Appraising for tax authorities is more basic and routine than any other type of pipeline appraisal, as there are just not that many ways to approach the problems. This is primarily because tax districts are accustomed to dealing with real estate, but not with the different types of inventory that may exist on the property.

Conclusion

Given some of the unique factors associated with pipelines, the appraisal of pipelines has evolved into a highly-specialized and niche industry. The methods for determining value are different from any other type of appraisal practice due to the uniqueness of the product being appraised.

The best way to appraise a pipeline is to gain a better understanding of its potential uses in today's marketplace in conjunction with the property on which it resides. With pipelines, value can be assigned through a combination of demand for the property, utility of the property, scarcity or supply of the property and ready transferability of ownership rights.

Ultimately, the appraiser can only offer an opinion based on data available and market conditions. When it is all said and done, a property's value is what the seller will take and what the buyer will give.



David Howell, SR/WA

David is a Managing Partner at Pipeline Equities, a pipeline merger and acquisition firm located in Houston. His fields of expertise range from pipeline appraisal to supply and distribution, production, pipeline, refining and working with well service contractors. He is also the author of the Pipeline Appraisal Handbook. David can be reached at davidhowell@pipelineequities.com or on the web at www.pipelineequities.com.