CITE: **2000-05-03-016 / PRECEDENTIAL**
ID: **CR970002**
DATE: **05-03-00**
DISPOSITION: **DENIED**
TAX TYPE: **SALES / USE**
APPEAL: **NO APPEAL TAKEN**

FINDINGS OF FACT AND CONCLUSIONS OF LAW

This matter comes on for final disposition of the above claim for refund of sales and use taxes paid on the pipe, piping, valves, compressors, separators, dehydrators and parts which make up taxpayer's gas gathering system, and a portion of the taxes paid on the separators and a heater-treater located at various well sites. An evidentiary hearing was held herein before one of the Commission's Administrative Law Judges, who entered findings of fact and conclusions of law, and a recommendation that the refund claim be allowed.

Now, having examined the record herein and the evidence adduced, and having considered the pleadings and arguments of counsel and the Administrative Law Judge's findings and conclusions, we enter the following order, denying said claim.

FINDINGS OF FACT

1. Claimant owned and operated two cryogenic gas processing plants in the State of Oklahoma during the period in question. At these processing plants, natural gas moves through pipes and piping and various scrubbers, compressors, dehydrators, heat exchangers, chillers, separators, demethanizers and a turbo expander/compressor, which results in the extraction or removal of natural gas liquids, impurities and a certain amount of the Btu content from the natural gas stream. The natural gas liquids are then sold or subjected to further processes such as fractionation, whereby single components such as butane, propane and natural gasoline are extracted and then sold. The remaining natural gas, having been removed of all or most of its impurities and inert substances such as water, carbon dioxide, etc., is recompressed and sold at the tail end of the processing plant, where it is delivered to claimant's customers' pipelines. The customers' contracts with claimant specified the acceptable amount of water, oxygen, carbon dioxide, Btu content, etc. that could be contained in the gas, and the pressure level at which it would be accepted into the customer's pipeline.

2. It is not disputed that the processing and activities that occurred at the processing plants constitute manufacturing or processing for purposes of Oklahoma's sales and use tax codes.

3. Claimant also owned and operated a gas gathering system, which brought the natural gas stream from various oil and gas wells to the processing plants. Approximately 5-10% of the gas transported through claimant's gathering system was from wells owned or partly owned by Claimant. The remaining 90-95% was gas purchased by Claimant from others.

4. Oil extracted from the ground by Claimant and others consisted of a raw mixture of oil, gas and water. At the well sites, this mixture was put through initial separators, which used centrifugal force and gravity to separate the natural gas from the oil, water and other impurities. The oil was then put through a second separator and a heater-treater, whereby water and other foreign substances were separated from the crude oil. The oil was then stored in production tanks at the well site or on the lease, and sold to third parties.

5. The natural gas stream coming from the initial separators was metered and sampled, at which point claimant purchased the gas from the other mineral owners in the leases. The gas was still saturated with water at this point and was at a pressure of between 5 to 10 pounds per square inch (psi). The gas stream entered a low pressure gathering system, whereby it was transported to either a field compressor station which was typically located within 5-10 miles of the wellhead, or directly to the gas plant if the wellhead was in close enough proximity to the plant.

6. Although it is physically possible to move gas for distances more than approximately 10 miles at low pressure, because of the large size of pipe required, it is neither practical nor economically feasible to do so. Consequently, gas from wells more than 5-10 miles from the processing plant is transported to field compressor stations, where it is put through a second separator to remove free liquids or solids before it enters a three-stage compression/cooling/separation system and dehydrator. The compressor system boosts the pressure up to approximately 800 psi. From here, the gas is transported to the gas processing plant through a high pressure gathering system. The free liquids and solids must be removed from the gas with the separators and dehydrators in order to prevent damage to the compressors and to facilitate the flow of gas through the high pressure gathering system.

7. In order for the equipment at the gas processing plant to work, the gas passing through the plant must be at a pressure of approximately 800 psi and be free of moisture. Therefore, gas coming into the plant at lower pressure from wells in close proximity was put through inlet scrubbers to remove impurities, and then through compressor units within the plant to boost the gas up to "operating" pressure. It was then joined with the gas coming in at the higher pressure, and all of the gas was subjected to a final dehydration system within the plant before entering the cryogenic process.

8. In 1981, Claimant determined that the compressor capacity of one of its plants needed to be enlarged. For reasons of his own, Claimant decided to construct a separate compressor facility downstream of the plant, rather than at the plant itself. This compressor station was built about one mile from the plant. Based upon Claimant's representation that the compressor station "performs exactly the same function for the plant operation that it would if located at the plant," the then Sales/Use Tax Division of the Tax Commission agreed that the compressors would be exempt from sales/use tax as machinery and equipment used in the manufacturing process.

9. In this case, Claimant seeks a refund of sales and use taxes paid in 1991 and 1992 on purchases of the initial separators which separate the natural gas from the oil, the separators and heater-treater which remove water and other substances from the oil, and the compressors, parts, pipes, valves, separators and dehydrators which make up Claimant's gas gathering system.

CONCLUSIONS OF LAW

1. The question in this case is whether the machinery and equipment for which a refund of sales and use tax is sought, were purchased and used in the operation of a manufacturing or processing plant as provided by the statutes. We conclude that they were not.

2. 68 O.S. 1991, §1359(C) provides the following exemption from sales tax:

> Sale of machinery and equipment purchased and used by persons establishing new manufacturing plants in Oklahoma, and machinery and equipment purchased or equipment built on site and used by persons in the operation of manufacturing plants already established in Oklahoma. This exemption shall not apply unless such machinery and equipment is incorporated into, and is directly used in, the process of manufacturing property for sale or resale. The term manufacturing plants shall mean those establishments primarily engaged in manufacturing or processing operations, and generally recognized as such.

A similar exemption from use tax is provided by 68 O.S. 1991, §1404(d).

3. A plain reading of these statutes reveals that, in order for the items to be exempt, three conditions must be met: (1) The machinery and equipment must be incorporated into a manufacturing or processing operation, and must be directly used in that operation; (2) the machinery and equipment must either be, or be part of, a manufacturing plant; and (3) the manufacturing plant must not only be *primarily* engaged in manufacturing or processing

operations, but *it must also be generally recognized as a manufacturing plant*.

4. It is basic law that statutes exempting property from taxation are to be strictly construed *against* the exemptions, *McDonald's Corp. v. Oklahoma Tax Com'n*, 563 P.2d 635, 641 (Okla. 1977), and particularly relevant to this case are the second and third conditions of the statute. In *McDonald's*, the Oklahoma Supreme Court repeatedly referred to the last phrase of the exemption statute that any manufacturing plant must be one which is "generally recognized as such" and declared that this phrase "modifies the whole" statute. *Id*., at 639. Thus, the Court said, "unless Appellant's operation is generally recognized as a manufacturing or processing operation, it does not fall within the exception" of the statute. *Id*. The Court went on to say "[I]t is doubtful that the average man would think of [this] operation. . .as 'manufacturing' and, thus, within the 'generally recognized' provision of the statute." *Id*. At 640.

5. The "average person" in Oklahoma is not likely to think of the well site extraction of raw natural gas from oil, the removal of water and sediment from the oil before placing it in lease production tanks, or the natural gas field gathering lines, as manufacturing. Within the industry itself, "Field processes, which normally take place on or near the lease, such as natural pressure reduction, mechanical separation, heating, cooling, dehydration, and compression are *not* considered processing." 8 Howard R. Williams & Charles J. Meyers, *Oil and Gas Law* 831 (1998) (emphasis added). And, under the industry classification system developed internationally and published by the United States Office of Management and Budget, activities such as operating separators, emulsion breakers, desilting equipment, field gathering lines and "all other activities in the preparation of oil and gas up to the point of shipment from the producing property," are considered as Oil and Gas Extraction, which is classified as "mining" not manufacturing. Office of Management and Budget, *North American Industry Classification System United States* 67 (1997).

6. We also note that neither oil nor gas is deemed "produced" for gross production tax purposes, until it is brought to the surface and confined in such a manner as to permit its measurement as to quantity and testing as to quality. *Atlantic Refining Co. v. Oklahoma Tax Com'n*, 360 P.2d 826, 829 (Okla. 1959) (oil); *Oklahoma Tax Com'n v. Sun Oil Co.*, 489 P.2d 1078, 1081 (Okla. 1971) (gas). In this case, that occurred *after* the well-site separators and heater-treater. The activities and equipment located at the lease sites for which claimant seeks a tax exemption as machinery and equipment used in manufacturing, are in actuality and generally recognized as employed in the production (mining) of oil and gas, not its manufacture. Likewise, the field processes of compression and dehydration of the gas, *which are essential to the operation of the gas gathering system itself*, are not generally recognized as manufacturing. H. Williams & C. Meyers, *Supra*. Any benefit to the ultimate operations at the plant is merely incidental, which is insufficient to qualify for the sought-after exemption. *McDonald's*, 563 P.2d at 639.

7. Claimant argues that the activities at the well site and along the gas gathering system serve to make the oil and gas "more marketable," and therefore should be considered as manufacturing or processing, relying on certain language in *Schulte Oil Co., Inc. v. Oklahoma Tax Com'n*, 882 P.2d 65, 72 (Okla. 1994). *Schulte Oil*, however, did not declare that any operation which made raw materials "more marketable" was by such definition "manufacturing." Obviously, mining and removing raw materials from the earth makes such materials more marketable. However, in *Tulsa Machinery Co. v. Oklahoma Tax Com'n*, 253 P.2d 1067 (Okla. 1953) and in *Curry Materials Co. v. Oklahoma Tax Com'n*, 319 P.2d 292 (Okla. 1957), the Court said that machinery and equipment used in extracting materials from the earth and screening, washing and transporting those materials to a plant where they were processed for sale, was *not* used in the manufacturing process.

8. In *McDonald's*, the Court said, "appellant seems to claim that the mere application of labor to an article by either hand or mechanical means constitutes 'manufacturing' for purposes of the sales tax exemption." *Id*., 563 P.2d at 640. Claimant makes a similar argument here. Noting its prior opinion in *Curry Materials*, however, the Court rejected this broad claim. *Id*. And, in *Tulsa Machinery Co*., the Court quoted with approval from an Ohio case, which rejected the argument that, since the means of conveying the raw material to the place of processing was essential to the end product, it should all be considered as one continuous process. The Court said: "Such a line of reasoning would except from taxation the sales of practically all instrumentalities for transportation used by manufacturers or processors of products." *Id*., 253 P.2d at 1070.

9. Claimant argues that the removal of water from and compression of the gas are activities which must be performed at its plant in order for the gas to be sold in conformity with its customers' requirements. Thus, according to Claimant, the dehydrators and compressors in its high pressure gathering system serve as "necessary [operations] adjunct to production," and that its gathering system is accordingly part of one continuous and integrated production process, citing *Schulte Oil Co.*, 882 P.2d at 74, and *United Design Corp. v. State ex rel. Oklahoma Tax Com'n,* 942 P.2d 725, 727 (Okla. 1997). We do not, however, accept Claimant's characterization of the facts.

10. The *Schulte* opinion declared that "[t]he §1359 sales tax exemption should receive a practical construction one that would not allow a manufacturing operation that is in fact but one continuous and integrated production process to be chopped up into discrete segments." 882 P.2d at 74. "The exemption applies to all items 'necessary to the production of a finished product'." *United Design*, 942 P.2d at 727. However, both *Schulte* and *United Design* dealt with activities and equipment which were integral to a manufacturing operation that had already begun. As in *Oklahoma Tax Com'n v. Oklahoma*

Coca-Cola Bottling Co., 494 P.2d 312 (Okla. 1972), the equipment in question was an "integral part" of and "necessary to" its manufacturing process because the processing system could not operate without the equipment. *Id*., at 315-316. "If any machine…fails to function the operation stops." *Id*., at 317. Such is not the case here.

11. First, we note that the dehydration and compression equipment utilized by claimant in its gathering system are used only in and for the primary purpose of facilitating or preventing damage to the high pressure portion of the system. The low pressure portion of the system needs no such equipment in order to operate, nor is any added to benefit plant operations. Secondly, all of the gas coming in to the plant, whether at high pressure or low, is combined in the plant itself, where such compression and dehydration as required by plant operations is performed. Finally, there is no evidence that the operations at the plant would stop or that the desired product would not be produced in the absence of the items for which exemption is here sought.

12. Basically, Claimant asks the Commission to extend the "front door" of its gas processing plant to the wellhead of every lease with which it does business, and deem everything just one big manufacturing or processing plant. This we decline to do, because we find that the well-site activities and the gas gathering system are neither generally recognized as manufacturing processes nor are they an integral part of one.

13. The Federal Energy Regulatory Commission ("FERC") recognizes the function of gathering systems as a step *between* production and processing. *See, Duke Energy Natural Gas Corp. v. C.I.R.,* 172 F.3d 1255, 1262 (10th Cir. 1999). Also persuasive is the case of *Western Gas Resources, Inc. v. Heitkamp*, 489 N.W. 2d 869 (N.D. 1992), *cert. denied*, 507 U. S. 920 (1993). In that case, the question was whether the condensate recovered from the dehydration and compression processes in and along the taxpayer's gathering system, which led to taxpayer's gas processing plant, was subject to an extraction tax on liquid hydrocarbons produced prior to processing at a gas plant, or could be deemed recovered at the plant and therefore not subject to the tax. There, as here, the taxpayer argued that its processing plant included and began at the head of the gathering system. Noting the definition of "processing" set forth in Williams & Meyers, *supra*, the court rejected that argument and held that "a reasoning mind could reasonably conclude that [taxpayer's] plant began at the inlet receiver" of the plant, and did not include the gathering system. *Id*. at 874.

CONCLUSION AND ORDER

The "generally-recognized" requirement of the statute followed in *McDonald's* is not incompatible with the "practical construction" mandated by *Schulte* and *United Design*. However, the Legislature clearly intended there to be a limit or boundary to the

manufacturing exemption. Under both rubrics, we conclude that the well site separation and treatment of oil, extraction of gas, and the gathering and transporting of gas to a processing plant or pipeline, including the field processes normally attendant thereon, do not constitute manufacturing, are not generally recognized as such, and go beyond the Legislature's intended boundary. The foregoing refund claim is denied.

OKLAHOMA TAX COMMISSION