STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
UNITED WATER NEW ROCHELLE, INC.	:	DETERMINATION DTA NOS. 820237
for Revision of Determinations or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period September 1, 1994 through August 31, 2000.	:	AND 820238

Petitioner, United Water New Rochelle, Inc., 200 Old Hook Road, Harrington Park, New Jersey 07640, filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period September 1, 1994 through August 31, 2000.

A hearing was held before Timothy J. Alston, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on July 25, 2005 at 10:30 A.M., with all briefs to be submitted by April 7, 2006, which date commenced the six-month period for the issuance of this determination. Petitioner appeared by Ellis L. Reemer, Esq., and Diana L. Erbsen, Esq. The Division of Taxation appeared by Mark F. Volk, Esq. (Michael P. McKinley, Esq., and Marvis A. Warren, Esq., of counsel).

ISSUE

Whether electricity used to power pumps located at each of petitioner's pumping stations was used and consumed directly and exclusively in the production of petitioner's product, a

public water supply, which it sells to its customers and was thus exempt from sales and use taxes pursuant to Tax Law former § 1115(c)(1).

FINDINGS OF FACT

1. Petitioner, United Water New Rochelle, Inc., is a privately owned water utility that has operated since 1885. It serves approximately 145,000 people through 31,000 metered accounts in 11 towns, cities and villages in County A,[1] New York. It is divided into two divisions, Division A and Division B, with approximately 400 miles of pipe.

2. Petitioner is owned by United Waterworks, Inc., a subsidiary of United Water Resources, Inc., which is itself a subsidiary of Suez, an international provider of water services. United Water Resources, Inc. also owns United Water Management and Services, Inc., which provides management services to all of the operating units and subsidiaries of United Water Resources, Inc., including petitioner.

3. Petitioner's operations are governed both by franchise agreements with the towns, cities and villages for which it provides a water supply, and by the New York State Public Service Commission (the "Public Service Commission"), the New York State Department of Health (the "Department of Health") and the Environmental Protection Agency (the "EPA"), all of which regulate petitioner's operations.

4. Petitioner's product is a public water supply that must meet mandated levels of quality and pressure. As the exclusive provider of a public water supply to the customers it serves, it must produce water meeting the mandated levels of quality and pressure in amounts necessary for customer usage (including, at all times, fire protection) by complying with New York Health

[1] In response to petitioner's homeland security concerns, this determination shall refer to the relevant counties and townships, divisions, aqueducts, tanks and reservoirs, and pump stations pursuant to a legend submitted by petitioner which is part of the record herein.

Law regulations sections 5-1.1 through 5-1.100 (10 NYCRR 5-1.1 - 5-1.100) regarding water quality and New York Public Service Law regulations sections 503.1 - 503.11 (16 NYCRR 503.1-503.11) regarding service standards.

5. Bottled water differs from the public water supply provided by petitioner in that bottled water is simply a beverage, is available in only relatively small quantities in bottles, and is not pressurized.

6. Petitioner, as a water utility, is subject to regulation with respect to water quality by the EPA (EPA requirements have been incorporated into the New York Health Law) and the Department of Health. New York Health Law regulations (10 NYCRR 5-1.1 - 5-1.100) set forth requirements with respect to disinfection and removal of contaminants, including bacteria and inorganic compounds.

7. To satisfy New York Health Law requirements for water quality, petitioner must treat its water with chlorine in the form of a gas (which disinfects the water by killing germs and contaminants), caustic soda (which neutralizes the acidity of the water and helps control corrosion in the plumbing and piping), and zinc polyphosphate (a corrosion inhibitor that eliminates the leaching of copper and lead out of the pipe and into the water).

8. Many water quality parameters (including inorganic and organic chemicals, coliform bacteria, chlorine concentration and turbidity) are regularly tested by petitioner and results are reported monthly to the Department of Health. Sampling for these tests is conducted at various points throughout petitioner's system, including the customer's point of use. Depending on the test, it may be conducted daily, weekly, monthly, or quarterly.

9. In order to meet New York Health Law requirements, specified minimum levels of chlorine residual must be present. Accordingly, since the level of chlorine reduces naturally over

time, some areas of petitioner's system are required to have a "real time," continuous measure of chlorine residual to ensure that water quality requirements with respect to chlorine levels are satisfied.

10. Water quality requirements with respect to levels of lead and copper are also monitored and validated by sampling at the customer's point of use.

11. The average daily production of water in petitioner's system is 21 million gallons per day. The maximum daily production during peak periods throughout the summer can be as high as 50 million gallons per day.

12. Only about two percent of the water petitioner produces is used for consumption as drinking water, consistent with the industry average.

13. Like water quality, pressure is also an integral component of petitioner's product. Different minimum levels of pressure are required depending on the government agency. The New York Health Law and regulations mandate certain minimum levels of pressure for health and safety needs. However, the pressure necessary to ensure health and safety is insufficient for use by consumers for purposes of industrial, commercial and personal consumption in operating and utilizing appliances and fixtures such as toilets, showers, sprinkler systems, dish and clothes washers and fire protection. Minimum levels of pressure for these purposes are established by the Public Service Commission and by the "Ten State Standards" (industry guidelines for public water systems, such as petitioner, that have been adopted by multiple states, including New York).

14. Pressure in the water utility industry is the force exerted by the water upon the surfaces (pipes, mains, appliances, etc.) it is in contact with. Pressure causes water to move or flow. It is customarily measured in pounds per square inch, or "PSI." Stated another way,

pressure can be measured as the amount of force necessary to cause water to rise vertically from a certain point. One pound per square inch of pressure equals approximately 2.3 feet of vertical elevation. Accordingly, a column of water 2.3 feet high would have at its base one PSI of pressure. As pressure is the force of the water against a surface with which it is in contact, and not the speed of water, it is possible to have pressurized water without movement. For example, since petitioner must provide certain minimum levels of force or pressure at the customer's point of use, that pressure is available even if faucets and appliances are turned off and there is no flow of water. Correspondingly, it is possible to have movement of water without much pressure. A flow of water is possible with even one PSI of pressure.

15. There are different levels of water pressure required for different regulatory concerns. Specifically, for health and safety reasons, a minimum of 20 PSI of pressure throughout petitioner's system is mandated by the New York Health Law and regulations, while a minimum of 35 PSI of pressure is required by the Public Service Commission and a minimum of 60 to 80 PSI of pressure is recommended by the Ten State Standards throughout petitioner's system.

16. As noted, New York Health Law and regulations mandate a minimum of 20 PSI at all points in petitioner's system. This minimum amount of pressure (essentially the force of water against the outer walls of pipes and mains) is necessary to assure that groundwater contaminants do not infiltrate into petitioner's pipes and mains. Health Law regulations further require that a water utility such as petitioner issue an alert that all water must be boiled if the pressure anywhere within petitioner's system drops below 20 PSI (***see***, 10 NYCRR 5-1.78).

17. While 20 PSI of pressure is satisfactory for health and safety purposes (to prevent contaminants from entering pipes), 20 PSI of pressure is insufficient for customer usage or fire protection. Accordingly, the Public Service Commission and the Ten State Standards require

substantially higher levels of pressure for customer usage. Although the Public Service Commission requires a minimum pressure of 35 PSI at each point of use throughout petitioner's system, the Ten State Standards recommends a normal working pressure of between 60 and 80 PSI of pressure at all points in the system, particularly at each customer's point of use. "Normal working pressure" is a water industry term for the pressure that is normally available (on average) when people are working with and using water.

18. Pressure of 60 to 80 PSI is the optimal pressure to be available at each customer's point of use because it is the amount of pressure that is required for a normal usable supply of water for public use, whether used for watering grass, showering, flushing toilets, using dishwashers or clothes washers. Many appliances, such as washing machines and dishwashers, have automatic valves. When the appliance is turned on, the valve is opened, allowing pressurized water to flow in. However, the valve will not open and the appliance will not work if there is inadequate force or pressure brought to bear on the valve. Other fixtures, such as showers and toilets, also require significant pressure to be used normally. In the case of showers, if there is not adequate pressure, there is insufficient flow rate to take a shower (flow rate is a function of pressure). In the case of toilet flushing or other uses where flow rate is relevant, like a bathtub, the lower the pressure, the longer it takes for the toilet tank or the bathtub to fill. A toilet would fill up eventually with a minimum amount of pressure; however, it would take an extremely long time.

19. Petitioner attempts to provide normal working pressure of 60 to 80 PSI throughout its system. If petitioner did not maintain this minimum level of pressure at each customer's point of use, it would anticipate thousands of complaints from people that have low pressure because they could not actually or effectively use the water. Petitioner monitors the water pressure

within its system; however, the Public Service Commission monitors and acts on complaints with respect to pressure. All complaints received by petitioner (including those regarding water pressure) must be reported to the Public Service Commission. The Public Service Commission has the means to take action against petitioner.

20. With regard to fire protection, petitioner is required to periodically test each of the approximately 3,100 hydrants in its system for water flow. To be effective, fire hydrants require a specified level of flow within a given period of time. As noted previously, flow rate is a function of pressure. Without adequate pressure, fire protection is unavailable. In order to produce the required level of flow for fire protection, petitioner must maintain a minimum of 40 PSI at each hydrant throughout its system.

21. Petitioner's system consists of two divisions, Division A, serving the towns and cities of Township A, Township B, Township C, Township D, Township E, Township F and Township G to the south and east, and Division B, serving the towns and cities of Township H, Township I, Township J and Township K to the north and west. Together, the two divisions have some 400 miles of pipes, which are totally interconnected.

22. Division A and Division B are each divided into "pressure zones" or "pressure districts," distinguished by topography with each pressure district or pressure zone being distinguished by elevation from sea level. Pressure zones or pressure districts are served by one or more pump stations which singly and in concert produce sufficient pressure to meet health and safety requirements as well as customer needs in each area.

23. Petitioner's system, including both Division A and Division B, as well as the pressure zones or pressure districts in each, are fully integrated, interconnected, interdependent, unified, and centrally monitored and controlled. Pressure in one portion of the system affects pressure in

other areas of the system. Similarly, a loss of pressure (as with water main breaks or extreme usage in, for example, fighting fires) in one area affects pressure in other areas. The pumps located throughout the system effectively pressurize the entire system with the result that system pressures are created by the action of multiple pumps acting in concert.

24. The source pumps in the system also mix and disperse the chemicals necessary to produce the water for sale to and for use by consumers. The source pumps are located at Pump Station A, Pump Station B, Pump Station C, Pump Station D, and Pump Station E. These pump stations receive raw surface water from one of the three New York City aqueducts which supply the system. Since petitioner's system is totally integrated and connected, changes in chemical treatment at one point in the system affect the status of chemical treatment at other points in the system.

25. Petitioner's system is not only integrated, unified and connected, working together as one system, but it is dynamic in the sense that water quality and pressure are subject to change and therefore must be monitored on a continuous basis to ensure compliance with all statutory and regulatory requirements.

26. As a closed, integrated and interconnected system, absent an emergency event, such as a water main break, there is no uncontrolled flow of water in or out of petitioner's system. Raw surface water is obtained, chemically treated and pressurized, and requisite levels of chemical treatment and pressure are maintained, controlled and monitored throughout the system so that each customer has access at its point of use to water meeting all requisite levels of quality and pressure.

27. Petitioner's production process begins when it obtains raw surface water from one of three New York City aqueducts, Aqueduct A, Aqueduct B, and Aqueduct C. When acquired,

although it has been treated with chlorine, the raw surface water is not suitable for use by petitioner's customers. Raw surface water meets neither the water quality requirements of the New York Health Law and regulations nor the pressure requirements of the Public Service Commission or the Ten State Standards. To produce a water supply meeting mandated levels of water quality and pressure, petitioner must chemically treat the raw surface water and pressurize the water.

28. Petitioner obtains approximately 90 percent of its raw surface water from Aqueduct A. Of this 90 percent, approximately 70 percent is obtained through Pump Station A and about 30 percent through Pump Station B. The remaining approximately 10 percent of raw surface water is obtained from Aqueduct B and Aqueduct C through Pump Station C, Pump Station D, and Pump Station E.

29. As secondary sources during high peak periods (e.g., summer) petitioner acquires raw surface water from Aqueduct B and Aqueduct C.

30. Raw surface water is acquired from Aqueduct B at Pump Station C and from Aqueduct C at Pump Station D and Pump Station E. Pump Station D is the primary site of acquisition of raw surface water from Aqueduct C.

31. Other than at Pump Station A, Pump Station B, Pump Station C, Pump Station D and Pump Station E, petitioner does not have any other source of raw surface water (except for emergency connections to neighboring water systems).

32. Pump Station A has three large pumps with electric motors. One pump has 350 horsepower and the other two have 100 horsepower each. The pumps at Pump Station A operate by having an electric motor spin a shaft to which an impeller is attached. Water from a pipe

attached to Aqueduct A flows into the pumps and the spinning action of the impellers moving through the water adds force to the water and causes the pressure to rise.

33. In addition to raising the pressure of the water, the pumps at Pump Station A also play another important role in the production process. Since raw surface water requires chemical treatment to satisfy the New York Health Law and regulations, chemical treatment is performed at Pump Station A. In this regard, chemicals are added to the water immediately as it exits from the pumps. By adding chemical treatment at this point, the action of the impellers creates turbulence in the water, mixing and dispersing the chemicals through the water.

34. Chemicals added at Pump Station A include chlorine in the form of a gas (to disinfect the water), caustic soda (which neutralizes the acidity of the water and controls corrosion) and zinc phosphate (also a corrosion inhibitor that prevents the leaching of copper and lead into the water supply).

35. The pumps at Pump Station A operate 24 hours a day, 7 days a week and are monitored and controlled as part of petitioner's central monitoring and control system. Pump Station A has the capacity to produce 28 million gallons of water per day.

36. While the pumps at Pump Station A can all operate simultaneously, all of the pumps do not in fact always operate at the same time. These pumps provide redundancy during normal operations and full capacity during peak demand periods (e.g., summer). During these peak demand periods, all three pumps may be operating together, 24 hours a day.

37. Pump Station A produces water that meets all of the requirements of the Health Law and regulations at pressures mandated by the Public Service Commission adequate for domestic, commercial and industrial use and fire protection for the Low pressure district or pressure zone of Division A.

38. There are five pumps at Pump Station D, two with a 150 horsepower capacity, one with a 75 horsepower capacity, and two with a 40 horsepower capacity.

39. Pump Station D is a dual purpose station. It is primarily a booster station. That is, in order to provide water meeting mandated levels of water quality and pressure and minimum levels of usability to customers in the Intermediate and High pressure districts or pressure zones of Division A, three of the pumps at Pump Station D (the two 40 horsepower and the 75 horsepower pumps) increase or "boost" the pressure of water that has been initially pressurized at Pump Station A.

40. The two 150 horsepower pumps at Pump Station D perform in the same manner and for the same purposes as the pumps at Pump Station A. That is, during peak periods, raw surface water from Aqueduct C flows into the two 150 horsepower pumps which raise the pressure to minimum levels set by the Public Service Commission (and recommended by the Ten State Standards). As is the case with raw surface water acquired from Aqueduct A at Pump Station A, chemicals are added as the water exits the pumps. As with the case of Pump Station A, the turbulence created by the impellers mixes and disperses the chlorine gas, caustic soda and zinc phosphate in the water. Water produced by these two pumps at Pump Station D directly serves customers in the Intermediate pressure district or pressure zone of Division A.

41. There are three pumps at Pump Station E, one with a 75 horsepower capacity and two with a 40 horsepower capacity. These pumps play a central role in the production of a public water supply for petitioner's customers located in the High pressure district or pressure zone of Division A, meeting requirements of health and safety and requirements of customer usability (adequate pressure as required by the Public Service Commission and recommended by the Ten State Standards).

42. In order to provide water meeting mandated levels of water quality and pressure to customers in the High pressure district of Division A, the pumps at Pump Station E increase or "boost" the pressure of water that has been initially pressurized at Pump Station A.

43. Pump Station E also has the capability to serve as a source station during peak summer periods to acquire water from Aqueduct C.

44. Pumps located at Pump Station D and Pump Station E work together with the pumps at Pump Station A in a unified, integrated fashion to produce water that is chemically treated to New York Health Law and regulatory requirements and meets the pressure requirements of not only the New York Health Law and the Public Service Commission, but also of the Ten State Standards.

45. All of the pipes, mains, etc., that run throughout Division A and to the homes and businesses of its customers are interconnected and pressure, as well as chemical "residuals" throughout Division A, are produced, increased and centrally maintained and monitored by petitioner's personnel.

46. Division A has one tank called Tank A, which is located in the north of the High Area. Tank A works in conjunction with the pumps to ensure adequate pressure at all times of the day, regardless of the season.

47. In a public water supply, tanks work in conjunction with pumps in order to have available a supply of water in sufficient quantity and at a sufficient pressure to meet customers' needs.

48. Reservoir A is physically located between Division A and Division B. Reservoir A works in conjunction with all of the pumps in petitioner's system and serves a function similar to

that of Tank A, but on a larger scale and, because of its physical location, helps balance water demand between Division A and Division B. Chlorine is also added at Reservoir A.

49. The primary source of raw surface water for Division B is Aqueduct A. Water from a pipe attached to Aqueduct A flows into the two pumps at Pump Station B. The two pumps have 200 and 150 horsepower capacities, respectively. The operation of Pump station B is identical to that of Pump Station A in that both raise pressure and mix and disperse chemical treatments.

50. Pump Station C is located in, and primarily services, Division B and has five pumps, three of which (with 466, 345 and 200 horsepower) obtain raw surface water from Aqueduct B. As with Pump Station A and Pump Station B, these pumps create pressure through the action of the impellers, and chemical treatments that are added to the water as it exits the pumps are appropriately mixed and dispersed by the turbulence created by the flow of water out of the pumps after pressurization. The other two pumps (with 100 and 65 horsepower) boost the pressure in the same manner as Pump Station E and Pump Station D.

51. The capacity of Pump Station C is approximately 17.5 million gallons per day.

52. Although similar in many ways, Division B is different from Division A in that Division B is more complex; the terrain is more hilly and, thus, multiple smaller pumps (Pump Station F, Pump Station G, Pump Station H, Pump Station I, Pump Station J, and Pump Station K), strategically located, are necessary to provide water meeting mandated levels of water quality and pressure to all customers regardless of location. In addition, given the terrain, the pumps work in conjunction with a number of strategically located "tanks" to ensure adequate pressure at all times of the day, regardless of the season.

53. Petitioner's system is monitored at a central location that is physically located at Pump Station C. It is monitored continuously, 24 hours a day, by a licensed operator who

operates all of the equipment within the system through a computerized instrumentation system. "SCADA," which stands for "supervisory control and data acquisition," is the term used for the control system. It functions as "the eyes, ears and brain" of petitioner's entire system and indicates, at any given time, which pumps are on, which pumps are off, what the water quality is and what the pressure is at strategic locations where there are instruments that measure such information.

54. SCADA allows petitioner to control the different aspects of water quantity, quality and pressure from a central location. There are written guidelines titled "United Water New Rochelle Production Department Operations Guidelines" for its operators. The guidelines were prepared by Chris Graziano, the manager of production for petitioner, and were in effect during the audit period. The guidelines contain information regarding location of pumping stations, how they operate, where water is sourced, how and why chemicals are added, and how to meet required service levels, including pressure.

55. The individuals who operate SCADA are considered by petitioner to be part of the production team and are licensed by New York State to operate a public water supply system. The operators control the pumping, storage, and chemical feed facilities throughout the system. They determine when to turn pumps on and off, monitor pressure and levels in tanks and react to customer demands in order to meet those demands.

56. Petitioner has another department known as the "Transmission and Distribution" department ("T&D") whose personnel engage in field work. T&D is physically located in Township A, along with all of the trucks, tools, pipes and valves necessary to do the repairs, maintenance and construction required in the system. T&D, for example, is responsible for

digging up streets and fixing pipes, and replacing valves and meters. "Distribution," as used in this context, does not refer to a period post-production.

57. At hearing Gary Albertson and Jerome Gilbert testified on behalf of petitioner.

58. Mr. Albertson is a licensed professional engineer employed by United Water Management and Services, Inc. as vice president of engineering and asset management. In that capacity he is responsible for managing the operating assets of United Water Resources, Inc., including those of petitioner. He is intimately familiar with the business, product, and production processes of petitioner.

59. Mr. Gilbert, a civil engineer with a long career in public water utility operations and management, is an expert in the area of water systems, water production and water products. At the hearing, Mr. Gilbert was accepted as such an expert by the administrative law judge.

60. Mr. Gilbert is the co-author of two recent books on water utility management and operations and is a former president of the American Waterworks Association, a professional organization that represents the interests of approximately 50,000 water professionals and issues standards for service and provides policy guidance for utility operations. For the last 14 years, Mr. Gilbert has been a consultant in the areas of public water supply and water quality and water utility management. Previously, Mr. Gilbert had been general manager and chief engineer of the East Bay Municipal Utility District, a utility with 2,000 employees that provides water and wastewater services to the eastern side of San Francisco Bay and had managed a utility serving 50,000 people in northern Marin County, California.

61. The instant matter involves two audits by the Division of Taxation ("Division"). The first audit covers the period September 1, 1994 through May 31, 1997 and the second covers the period June 1, 1997 through August 31, 2000.

62. For the first audit, petitioner's books were determined complete and adequate by the Division. Petitioner, by its execution of a Test Period Audit Election Form, agreed to the use of a test period audit. The Division conducted a number of tests on petitioner's expense accounts and fixed asset accounts. Petitioner agreed with the audit findings and paid the additional tax proposed by the Division with respect to all matters except for tax proposed to be asserted on Power Purchased for Pumping Stations (petitioner's account number 623-01), which reflects electricity used and consumed solely in the operation of petitioner's pumps.

63. Each of petitioner's pumping stations has a separate electric meter which measures electricity purchased to power the pumps at those stations. For account 623-01, the Division selected the month of May 1996 as the test month and reviewed all invoices petitioner received from its supplier of electricity, Consolidated Edison, for the month of May 1996. The charges to this account for the test month totaled $125,111.00. Of this amount $74,880.00 were accrual charges entered for regulatory accounting purposes. On audit, the Division determined that such accrual charges were not subject to sales tax. The remaining $50,231.00 in charges to this account were for purchases of electricity to power petitioner's pumps. No sales tax was paid on these charges and the Division proposed sales tax of $4,144.05 on this $50,231.00 expense.

64. Next, the Division calculated an error rate for account 623-01 of 3.3123 percent ($4,144.05 divided by $125,111.00) and applied that error rate to total charges (including accruals) to account 623-01 for the entire audit period. Such total charges (including accruals) amounted to $4,432,663.00. Accordingly, the Division proposed additional tax due of $146,823.09 on petitioner's purchases of electricity used for its pumping stations.

65. On October 10, 2000, the Division issued to petitioner a Notice of Determination which asserted $146,823.09 in additional sales tax due, plus interest, for the period September 1, 1994 through May 31, 1997.

66. Subsequent to the issuance of the statutory notice, the Division adjusted the asserted liability by eliminating the accrual charges from its calculations. The Division also recalculated the proposed tax due on the $50,231.00 in claimed test period taxable electricity purchases to $3,583.68. These adjustments resulted in the application of an adjusted error rate of 7.1344 percent ($3,583.68 divided by $50,231.00) to total electricity purchases of $1,766,371.00. The net effect of this adjustment was to reduce the sales tax deficiency asserted in the October 10, 2000 notice to $126,020.00, plus interest. This reduction is reflected in a Conciliation Order dated August 6, 2004 issued to petitioner following a conciliation conference.

67. For the second audit, petitioner agreed to the use of the previously determined adjusted error rate and audit method (i.e., without accrual charges). As with the first audit, petitioner agreed with the audit findings and paid the tax as determined on audit except with respect to tax asserted on purchases of electricity for pumping stations. Application of the adjusted error rate of 7.1344 percent to total charges to account 623-01 (i.e., total electricity purchases) of $2,128,981.42 resulted in proposed tax due of $151,890.05.

68. On November 19, 2001, the Division issued to petitioner a Notice of Determination which asserted $151,890.04 in additional sales tax due, plus interest, for the period June 1, 1997 through August 31, 2000. A Conciliation Order dated August 6, 2004 sustained the November 19, 2001 notice.

69. Petitioner submitted proposed findings of fact numbered “1” through “82.” The following proposed findings of fact have been generally accepted and are incorporated herein:

"1" through "6," "8," "10" through "24," "28" through "30," "32" through "55," "59" through "62," "66," "69," and "71" through "82." The following proposed findings of fact have been modified to better reflect the record: "7," "9," "31," and "67." Proposed finding of fact "68" has been modified because it contained a legal conclusion. The following proposed findings of fact have been rejected because they consist of legal conclusions: "25" through "27," "56" through "58," "63" through "65," and "70."

SUMMARY OF THE PARTIES' POSITIONS

70. Petitioner contends that its purchases of electricity qualified for exemption pursuant to Tax Law former § 1115(c) because such electricity was used and consumed directly and exclusively in the production of petitioner's product, described by petitioner as a public water supply that must meet mandated levels of water quality and pressure, for sale. Petitioner observes that the electricity at issue operated its pumps and contends that the pumps were exempt production equipment under Tax Law § 1115(a)(12). The electricity to power the pumps was exempt, therefore, in accordance with section 528.22(c)(1)(i) of the Division's regulations (20 NYCRR 528.22[c][1][i]). On the question of whether the pumps are production equipment under Tax Law § 1115(a)(12), petitioner notes that the pumps are necessary in order for petitioner to meet governmental regulatory requirements and industry standards for pressurization of a public water supply. Petitioner further notes that levels of pressure created by the pumps are necessary for fire protection, the operation of certain appliances, and many regular and practical uses of water by customers (e.g., toilets and showers).

71. Alternatively, petitioner contends that the electricity at issue is used directly in the production of petitioner's product because it creates conditions necessary for production or performs an actual part of the production process (***see***, 20 NYCRR 528.22[c][1][ii],[iii]).

Petitioner argues that absent the electricity to power the pumps, petitioner could not create a water supply meeting mandated levels of water quality and pressure, and further, absent the electricity to power the pumps, there would be no finished product to sell because the water would not meet the mandated pressure requirements of a public water supply.

72. The Division asserts that an analysis of the issue presented herein must begin with a precise determination of petitioner's product and a correlative determination of when the production process for such product begins and, more to the point, ends. The Division defines petitioner's product as "chemically treated water" and thus contends that petitioner's production process ends with such treatment. According to the Division, then, the pumps serve the post-production purpose of product distribution and are therefore not directly and predominantly used in production (***see***, 20 NYCRR 528.13[b][1][iii]). The Division thus contends that the pumps are not production equipment under Tax Law § 1115(a)(12) and, accordingly, that the electricity to power the pumps is not exempt under Tax Law former § 1115(c).

73. In response to petitioner's alternative argument, the Division asserts that petitioner has not met its burden to show that electricity, as opposed to another form of power, created conditions necessary for production. The Division similarly argued that petitioner has not met its burden to show that the electricity itself performed an actual part of the production process.

CONCLUSIONS OF LAW

A. As the instant matter presents the issue of whether petitioner is entitled to an exemption from sales tax, it must be noted, preliminarily, that statutes and regulations authorizing exemptions from taxation are to be strictly and narrowly construed (***see***, ***Matter of International Bar Assn. v. Tax Appeals Tribunal***, 210 AD2d 819, 620 NYS2d 582, ***lv denied*** 85 NY2d 806, 627 NYS2d 323; ***Matter of Lever v. New York State Tax Commn.***, 144 AD2d 751,

535 NYS2d 158). In order to qualify for the exemption, petitioner bears the burden of clearly proving its entitlement to the exemption sought (***see***, ***Matter of Grace v. New York State Tax Commn.***, 37 NY2d 193, 371 NYS2d 715, ***lv denied*** 37 NY2d 708, 375 NYS2d 1027).

B. During the period at issue, Tax Law former § 1115(c)[2] provided for an exemption from sales and use taxes on sales of electricity "for use or consumption directly and exclusively in the production of tangible personal property . . . for sale" by, *inter alia*, manufacturing or processing.

C. Section 528.22(c) of the Division's regulations (20 NYCRR 528.22[c]) defines "directly" for purposes of the exemption under Tax Law former § 1115(c), in relevant part, as follows:

> (1) *Directly* means the . . . electricity . . . must during the production phase of a process, either:
>
> (i) operate exempt production machinery or equipment; or
> (ii) create conditions necessary for production; or
> (iii) perform an actual part of the production process.
>
> (2) Usage in activities collateral to the actual production process is not deemed to be use directly in production.

The regulations further provide that "exclusively" for purposes of the exemption means that the electricity must be used "in total (100 %) in the production process" (20 NYCRR 528.22[c][3][i]).

D. As noted previously, petitioner asserts that its pumps are exempt production equipment under Tax Law § 1115(a)(12). Petitioner thus asserts that since the electricity at issue operates the pumps, the electricity is used "directly" in the production of tangible personal property for

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[2] This subdivision was amended pursuant to Laws of 2000 (ch 63, effective September 1, 2000). As applied to the instant facts and circumstances, such amendment was not substantive.

sale under the regulations (20 NYCRR 528.22[c][1][i]) and is therefore exempt under Tax Law former § 1115(c). Accordingly, in order to ascertain whether petitioner is entitled to the claimed exemption, it is necessary to determine whether the pumps are production machinery or equipment under Tax Law § 1115(a)(12).

E. Tax Law § 1115(a)(12) provides for a sales tax exemption for "machinery or equipment for use or consumption directly and predominantly in the production of tangible personal property . . . for sale by manufacturing, [or] processing . . . ."

The Division's regulations define "production" as follows:

> Production includes the production line of the plant starting with the handling and storage of raw materials at the plant site and continuing through the last step of production where the product is finished and packaged for sale (20 NYCRR 528.13[b][1][ii]).

The regulations define "directly" in relevant part, as follows:

> (1) *Directly* means the machinery or equipment must, during the production phase of a process:
> (i) act upon or effect a change in material to form the product to be sold, or
> (ii) have an active causal relationship in the production of the product to be sold, or
> (iii) be used in the handling, storage, or conveyance of materials or the product to be sold, or
> (iv) be used to place the product to be sold in the package in which it will enter the stream of commerce. (20 NYCRR 528.13[c][1]).

With respect to the predominant use requirement for the exemption, the regulations provide that "[m]achinery or equipment is used predominantly in production, if over 50 percent of its use is directly in the production phase of a process" (20 NYCRR 528.13[c][4]).

F. As the Division correctly notes in its brief, in order to determine whether the pumps are used directly in production, it is necessary, first, to define petitioner's product and thereby determine which activities are part of the production process and which are not. The Division

posits that petitioner's product is chemically treated water. Hence, according to the Division, production ends with the completion of such chemical treatment. The Division thus asserts that the pressurization function performed by the pumps is a post-production activity whose sole purpose is to distribute the water to customers. In contrast, petitioner argues that its product is not merely potable water, but potable water under pressure consistent with regulatory requirements, industry standards and customer expectations.

G. The record in this matter clearly shows that petitioner's product is, as described by petitioner, a public water supply meeting standards of quality *and pressure*. Government regulatory agencies require that petitioner maintain certain minimum levels of pressure throughout its system. Specifically, for health and safety reasons, New York Health Law and regulations require petitioner to maintain a minimum pressure of 20 PSI throughout its system (***see***, Finding of Fact "16"). Additionally, the New York State Public Service Commission requires that petitioner maintain a minimum pressure of 35 PSI throughout its system (***see***, Finding of Fact "17"). Petitioner seeks to maintain pressure levels of 60 to 80 PSI throughout its system (***see***, Finding of Fact "19"). This normal working pressure is consistent with industry guidelines (i.e., the Ten State Standards) and enables petitioner's customers to effectively use the water and to operate certain appliances which require such pressure levels (***see***, Finding of Fact "18"). Petitioner's customers expect pressure levels of 60 to 80 PSI and the failure of petitioner to provide such normal working pressure would likely result in thousands of complaints from customers (***see***, Finding of Fact "19"). Finally, in order to produce the required level of flow for fire protection, petitioner must maintain a minimum pressure of 40 PSI at each of the 3,100 fire hydrants located throughout its system (***see***, Finding of Fact "20"). Accordingly, considering that regulatory agencies mandate certain levels of pressure, that petitioner's customers expect

and need certain levels of pressure, and that public safety requires certain levels of pressure for fire protection, it is concluded that pressure is an integral part of petitioner's product.

H. Having concluded that pressure is part of petitioner's product it follows that the pumps were used directly in the production of that product since the operation of the pumps creates the pressure. The record shows that the use of the pumps is a necessary part of petitioner's closed, integrated, and dynamic process of producing a public water supply meeting mandated levels of water quality and pressure (***see***, ***Matter of Niagara Mohawk Power Corporation v. Wanamaker***, 286 App Div 446, 144 NYS2d 458, ***affd*** 2 NY2d 764, 157 NYS2d 972). Indeed, the "entire use" of the pumps is "intimately and directly connected" to the process of producing petitioner's product and therefore the pumps are directly used in production within the meaning of Tax Law § 1115(a)(12) (***see***, ***Matter of B.R. DeWitt***, Tax Appeals Tribunal, September 19, 1991). In the language of the regulations, the pumps are used "directly" in the production of petitioner's product for sale as they "act upon or effect a change in material [unpressurized water] to form the product [water meeting mandated levels of pressure] to be sold" (***see***, 20 NYCRR 528.13[c][1][i]). The pumps also "have an active causal relationship in the production of the product to be sold" as they create the pressure which is part of the product (***see***, 20 NYCRR 528.13[c][1][ii]).

I. As noted, the Division contends that pressurization relates to the distribution of petitioner's product and not to its production. The Division thus contends that the pumps are not used directly in production. While there is no question that the pressure created by the pumps serves to transport or distribute water to the customer's point of use, the record also establishes that the pumps were used directly and predominantly in production as discussed above.

The Tax Appeals Tribunal has held that machinery and equipment may qualify for the production exemption under Tax Law § 1115(a)(12) notwithstanding that such equipment simultaneously serves a transportation or distribution function. Specifically, in ***Matter of B.R. DeWitt*** (***supra***) and ***Matter of Miron Rapid Mix Concrete Corp.*** (Tax Appeals Tribunal, January 9, 1992), the Tribunal concluded that concrete mixer trucks and mixer truck chassis were exempt production equipment even though such equipment was essential to the transportation or distribution of the taxpayers' product, transit mix concrete. In ***Matter of National Fuel Gas Distribution Corporation*** (Tax Appeals Tribunal, March 14, 1991) the Tribunal found that compressors that were used in both the purification and transmission of natural gas were used directly in production and therefore exempt under Tax Law § 1115(a)(12).

In each of these cases, the Tribunal evaluated the equipment in question in the context in which it was used. In evaluating petitioner's pumps in the context of their use, it is clear that the pumps were "at the essence" of petitioner's production process, for, as the record shows, the pumps created pressure, and pressure is an essential component of petitioner's product (***see***, ***Matter of Envirogas, Inc. v. Chu***, 114 AD2d 38, 497 NYS2d 503, ***affd*** 69 NY2d 632, 511 NYS2d 228). The pumps were thus used directly in production and the role of the pumps in the distribution of petitioner's product does not disqualify such equipment from the production exemption. Indeed, in ***National Fuel Gas Distribution (supra)***, the Tribunal concluded that it was "immaterial" that gas purification "may not have been the primary purpose of the compressors." Similarly, in the instant matter, since the pumps were used directly in production,

their role in the transmission or distribution of petitioner's product is immaterial to their status as exempt production equipment under Tax Law § 1115(a)(12).[3]

J. As to the statutory requirement that equipment exempt under Tax Law § 1115(a)(12) must be used predominantly in production, the pumps are creating pressure, an integral part of petitioner's product, at all times when they are in use. The pumps thus meet the "predominantly" requirement of Tax Law § 1115(a)(12) (***see***, 20 NYCRR 528.13[c][4]). Accordingly, petitioner's pumps were exempt production machinery or equipment within the meaning of Tax Law § 1115(a)(12).

K. Having determined that the pumps are exempt production machinery or equipment under Tax Law § 1115(a)(12), the electricity at issue was, by regulation, used *directly* in production within the meaning of Tax Law former § 1115(c) (***see***, 20 NYCRR 528.22[c][1][i]). Moreover, as the electricity in question was used solely to operate the pumps, such electricity was also used *exclusively* in production within the meaning of Tax Law former § 1115(c) (***see***, 20 NYCRR 528.22[c][3][i]). Accordingly, the electricity at issue was exempt from sale and use tax pursuant to Tax Law former § 1115(c).

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[3] It should be noted that even under the Division's narrow definition of petitioner's product, i.e., chemically treated water, certain of petitioner's pumps were used directly in production and thus qualify as exempt production equipment on that basis. Specifically, the record shows that the source pumps are an integral part of the chemical treatment process as these pumps mix and disperse chemicals throughout petitioner's system (***see***, Findings of Fact "24," "33," "34," "40," "49," and "50").

L. The petitions of United Water New Rochelle, Inc. are hereby granted and the Notice of Determination dated October 10, 2000, as modified by the Conciliation Order dated August 6, 2004, and the Notice of Determination dated November 19, 2001 are canceled.

DATED: Troy, New York
October 5, 2006

/s/ Timothy J. Alston
ADMINISTRATIVE LAW JUDGE