STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

THE BROOKLYN UNION GAS COMPANY :

for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 2000 through 2006. :

DETERMINATION
DTA NOS. 822692
AND 822693

In the Matter of the Petition :

of :

KEYSPAN GAS EAST CORPORATION :

for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 2000 through 2006. :

Petitioners, The Brooklyn Union Gas Company and Keyspan Gas East Corporation, filed petitions for redetermination of deficiencies or for refunds of corporation franchise tax under Article 9-A of the Tax Law for the years 2000 through 2006.

A consolidated hearing was held before Timothy Alston, Administrative Law Judge, in New York, New York, on October 20 and 21, 2009, with all briefs submitted by December 23, 2009, which date began the six-month period for the issuance of this determination. By letter dated June 21, 2010, this six-month period was extended for an additional three months (Tax Law § 2010[3]). Petitioners appeared by Kenneth T. Zemsky, CPA. The Division of Taxation appeared by Daniel Smirlock, Esq. (Jennifer L. Baldwin, Esq., of counsel).

ISSUES

I. Whether petitioners, public utilities engaged in the distribution and sale of natural gas, have established that all of their machinery, equipment, pipes and mains through which natural gas may flow from the point at which petitioners take custody of the gas to the point at which the gas is delivered to the end user is principally used in the production of natural gas by manufacturing or processing and thereby established entitlement to the investment tax credit in respect of such assets under Tax Law § 210(12).

II. Whether petitioners have established the amount of the investment tax credit claimed.

III. Whether assets acquired and placed in service by petitioners before the 2000 tax year, at which time petitioners were subject to tax under Tax Law Article 9 and thus not eligible to claim the investment tax credit under Article 9-A, were eligible for the investment tax credit in the 2000 tax year, the first year during which petitioners were subject to franchise tax under Article 9-A.

FINDINGS OF FACT

1. Petitioners, The Brooklyn Union Gas Company (BUG or Brooklyn Union) and Keyspan Gas East Corporation (Keyspan or Gas East), are public utilities engaged in the distribution and sale of natural gas to customers in the State of New York. The extent to which petitioners are engaged in the production of natural gas by manufacturing or processing for purposes of the investment tax credit under Tax Law § 210(12) is the crux of the dispute in this matter.

2. During the years at issue, petitioners were commonly owned by Keyspan Corporation. In mid-2007 they were acquired by National Grid, plc.

3. Petitioners service about 1.9 million customers located in New York City and on Long Island. Petitioners own and maintain an interconnected system consisting of 11,000 miles of

pipes, mains and equipment. Petitioners' system provides peak capacity of gas in the amount of 2.2 billion cubic feet per day. Petitioners sell about 370 billion cubic feet of gas annually.

4. Petitioners are known as local distribution companies and are regulated as such by the New York State Public Service Commission.

5. Petitioners take custody of natural gas through the interstate pipeline at eight delivery points known as city gates. Prior to its arrival at the city gates, natural gas is first extracted from a well by a natural gas producer and moved to a processing area where liquids and other impurities are removed using a scrubber or a dehydrator. The gas is then regulated and metered. At that point the gas is pressurized to be transported through the interstate pipeline. Odorant[1] is added by the producer or by the interstate pipeline operator.

6. Having been subjected to a scrubber and dehydrator by the producer, gas entering the interstate pipeline is relatively clean. As it moves through the interstate pipeline, however, the gas picks up impurities, such as water and scale, and may also lose odorant. Additionally, gas moving through the interstate pipeline is highly pressurized. Petitioners receive gas at the city gates at pressures of up to 1,400 pounds per square inch (psi). While such pressure enables the pipeline operator to move gas over long distances, gas pressurized at such levels is not usable by consumers. In fact, delivery of gas at such high pressure is highly dangerous. Accordingly, when petitioners receive gas from the interstate pipeline, they must take steps to reduce pressure, remove impurities, and add odorant in order to provide a safe product to end users that meets federal and New York regulatory requirements.

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[1] Odorant is added to natural gas for reasons of public safety. In its natural state, natural gas is odorless. Federal and state regulations require that odorant, a substance called mercaptan, be added to natural gas to make the gas readily detectable.

7. To remove impurities, petitioners use a series of continuously operating filters and scrubbers. Gas is filtered and scrubbed as it enters petitioners' system at a city gate transfer point. There are other filters and scrubbers at various points throughout the system because gas may pick up impurities as it travels in petitioners' system. Removal of impurities is necessary to maintain a safe system and to deliver a usable product to the end user and is required under public service regulations as well.

8. Petitioners regularly and continuously add odorant to the natural gas by using equipment called odorizers. Odorant is added by either a drip method or a wicking system. Both methods require sophisticated equipment to add the proper amount. New York public utility regulations require that petitioners maintain a certain level of odorant in the gas at all times. New York's odorant requirements are twice the federal requirement. Odorant levels must be monitored to be sure that appropriate amounts are present in the gas at all times. Petitioners add odorant at the city gates. Petitioners also add odorant in connection with the conversion of liquid natural gas to natural gas (***see*** Finding of Fact 15).

9. The problem of pressure is addressed by a series of regulator stations, which successively step down the pressure of the gas. Petitioners operate their system at 12 different pressure levels ranging from 650 pounds per square inch to approximately one-quarter of a pound of pressure. A small number of petitioners' customers (about 30) receive gas at pressures ranging from 650 psi to 350 psi. These are large industrial users. The rest of petitioners' 1.9 million customers receive gas at pressures ranging from 124 psi to one-quarter pound psi. For residential customers, safe pressure means about one-quarter of a pound per square inch (also measured as six inches of water column). The New York regulatory minimum pressure to residential customers is four inches of water column.

10. The stepping-down in pressure caused by the regulators affects the movement of gas through the system as gas flows from higher to lower pressure.

11. There are about 600 regulator stations of various sizes located throughout petitioners' system. Regulator stations can be as large as several tons and 200 feet in length. There are also regulators at the end user's site, such as regulators on home appliances, which serve to ensure that gas flowing into the appliance does not exceed appropriate pressure levels.

12. The regulators control and regulate pressure in petitioners' system on a continuous cycle. A regulator functions by opening and closing an orifice through either a valve or a spring to raise or lower pressure and thereby maintain a constant level of pressure in the system. Failure of the regulators could lead to overpressurization and could pose a danger to the system and to public safety. To minimize this risk some of petitioner's regulator stations actually consist of two regulators that work in concert and which can still function even if one regulator fails.

13. When natural gas is depressurized, it cools, a phenomenon known as the Joule-Thompson effect. This creates an additional problem for petitioners because the cooling resulting from the depressurization performed by the regulators creates a risk to the structural integrity of the pipes and mains. Accordingly, petitioners use heaters to heat the gas following the step-down in pressure at the city gates delivery point to remove this safety risk.

14. The 11,000 miles of pipes and mains through which the gas flows to end users are also subject to regulatory requirements. Specifically, the size, the type of material used and the type of coating on the pipes and mains differ depending on the level of pressure at which the gas is flowing at that particular point in the system. Depending on their size, pipes and mains are referred to as transmission pipe, distribution pipe or consumer pipe.

15. When there is excess capacity, petitioners convert a relatively small amount of excess gas to liquid form (liquid natural gas or LNG) and store it for eventual use. Petitioners maintain liquefying equipment for this purpose. Petitioners maintain two liquified natural gas facilities. Odorant is lost in the liquefaction process and thus must be added when the liquified gas is converted back into a gas. Petitioners use equipment called vaporizers to transform the LNG back into a gaseous state. Petitioners do not sell liquified natural gas.

16. Petitioners also use compressors to increase the pressure on a relatively small amount of gas. Petitioners have two compressors located at isolated sites on their system. Such compressors increase pressure to about 60 pounds psi and discharge it into 60-pound systems.

17. Petitioners also sell a relatively small amount of compressed natural gas. Gas goes through a compressor station where it is compressed in stages to 3,000 to 5,000 pounds per square inch. Compressed natural gas is typically sold to fleet-type operations.

18. Petitioner's entire system is continuously metered and is monitored at a central location. Failures in the system trigger alarms at the central monitoring location. If necessary, valves in the vicinity of the failure may be closed remotely from the central location.

19. Petitioners' system necessarily contains built-in redundancy given the inherently unstable nature of natural gas. However, if any part of the system were to fail and the various failsafes were to malfunction, the entire system could destroy itself, causing significant harm to the public.

20. The various activities discussed herein, i.e., purification, odorization, reduction and regulation of pressure by regulators, heating, compression, and monitoring, all occur within petitioners' interconnected system of pipes, mains and equipment. All parts of the system must function properly in order to safely deliver a usable product to end consumers.

21. At hearing, petitioners presented the testimony of Thomas Amerige, an engineer who has been employed by petitioners for nearly thirty years. Petitioners also presented the testimony of Paul Beckendorf, an engineer with almost thirty years of experience in the natural gas industry. Mr. Beckendorf was accepted as an expert witness on natural gas systems. Both Mr. Amerige and Mr. Beckendorf described the various activities and equipment discussed in Findings of Fact 5 through 20. These witnesses characterized all of the actions undertaken by petitioners from the city gates transfer points to the delivery of gas to the end user as the production and processing of natural gas.

22. Petitioners do not own all of the gas that flows through their distribution system to consumers. At any one time approximately 20 percent of the gas in the distribution systems is owned by third parties.

23. Under New York law as it existed prior to January 1, 2000, petitioners were not subject to franchise tax under Article 9-A of the Tax Law, but were subject to tax under Article 9. Petitioners became subject to Article 9-A commencing with the 2000 tax year (***see*** L 2000, ch 63). Article 9-A has an investment tax credit (ITC) provision; Article 9 does not.

24. Petitioners were unaware of the availability of the ITC at the time they filed their original returns for the years 2000 through 2004.

25. Petitioners subsequently became aware of the ITC provision and authorized their tax advisors and internal staff to investigate the applicability of the credit.

26. The starting point in calculating their ITC claims was petitioners' fixed asset additions schedules for each of the years at issue. Petitioners and their tax advisors reviewed such schedules with a focus on the various asset categories which might qualify for the credit. It was (and is) petitioners' position that all pipes, mains, and machinery and equipment "downstream"

of the city gates through which gas flowed to the end user qualified for the credit. Toward that end, petitioners and their tax advisors included in their claims for credit all asset categories and line items in the fixed asset additions schedules that they determined met this criteria.

27. Schedules listing such line items and their respective tax bases were attached to petitioners' amended returns for the years 2000 through 2004. Each line item listed the "date placed in service," a coded "asset category," "asset number - description," "principal use" (always listed as "gas production"), "life" (always listed as "greater than 4 years") and "cost." Petitioners totaled the cost amounts listed on the schedules to determine their investment tax credit base and then multiplied that total by the investment tax credit rate to arrive at the claimed credit.

28. After completing the schedules of line items that comprise their claims, petitioners sought to assemble source documentation sufficient to verify the amounts claimed. This was a complicated process. The line items in petitioners' fixed asset ledgers flowed from "projects." Such projects contained multiple purchase invoices or, in the case of self-constructed assets, material invoices or work orders for capitalized employment costs. Upon completion of a project, or at various stages of completion, the expenditures were allocated into an asset category and entered in the fixed asset ledger. Petitioners estimate that the ITC claims that are the subject of the present matter consist of about 10,000 asset line items. Petitioners further estimate that the projects from which the asset line items were developed consist of approximately 416,000 primary source documents.

29. In order to substantiate their ITC claims and to facilitate an audit of the claims by the Division of Taxation (Division), petitioners developed a sample of 1,324 primary source documents consisting of invoices and payroll data. This sample was developed by individuals

experienced in statistical sampling employed by petitioners' tax advisor. The sampling method divided the approximately 416,000 items into 6 strata based on cost. 250 items were then randomly selected from strata 1 through 5. All items from strata 6, which consisted of expenditures over $400,000, the most significant in terms of cost, were also included in the sample.[2]

30. In order to expedite the audit review process petitioners and their representatives requested and attended a meeting with representatives of the Division on April 25, 2006. At that meeting, which was attended by senior personnel from the Division's Audit Division and Office of Counsel, petitioners' representatives explained the basis of the claims, the magnitude of the claims and petitioners' proposed method of auditing the claims, i.e., the statistical sampling of source documents. Petitioners also requested an expedited review of the claims.

31. Petitioners filed amended franchise tax returns claiming the investment tax credit on September 12, 2006. Petitioner Keystone Gas East Corporation filed amended returns claiming the ITC for its open taxable years of 2000 through 2004. Petitioner Brooklyn Union Gas Company filed amended returns claiming the ITC for its open taxable years of 2002 through 2004.

32. Petitioners' amended franchise tax returns also included the flow-through of additional Internal Revenue Code (IRC) § 174 deductions because petitioners also filed amended federal returns reflecting these additional deductions. Since the section 174 deductions serve to reduce the eligible ITC base, petitioners made the corresponding adjustments in computing their ITC on their amended New York returns. The IRS did not act on the section 174 amounts, however, and

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[2] Petitioners contended that this sample had an error rate of 9.5 percent and that as such it met the minimum standard of a 25 percent error rate as referenced in the Division's publication Computer-Assisted Audits: Guidelines and Procedures for Sales Tax Audits (Pub. 132). Petitioners did not establish this contention as fact.

the Division informed petitioners that as to the section 174 amounts, the amended New York returns were prematurely filed and could not be accepted for processing until after IRS action, if any. At hearing petitioners' representative advised that petitioners were no longer claiming the section 174 deductions as indicated on the amended returns. Accordingly, petitioners' ITC claims no longer reflect the reductions attributable to the section 174 deductions.

33. Petitioner Keyspan's 2000 ITC claim also includes assets that it had placed in service in 1998 and 1999. Petitioner Keyspan calculated ITC in respect of these assets using their basis (i.e., cost less depreciation) as of the 2000 tax year.

34. The investment tax credits claimed by petitioners for the 2000 through 2004 tax years, together with the refunds and carryforwards claimed in respect of the credits are summarized below.[3]

Keyspan Gas East

Year	Total ITC	Refund	Carryforward
2000[4]	$8,027,427	$1,671,273	$6,356,154
2001	$5,753,997	$554,538	$5,199,459
2002	$4,368,763	$250,335	$4,118,428
2003	$3,221,813	$0	$3,221,813
2004	$2,917,148	$0	$2,917,148

[3] Total ITC amounts in the table do not include reductions attributable to section 174 deductions and are thus greater than ITC amounts as claimed on petitioners' amended returns. It is noted that the difference between the ITC totals without the section 174 deduction flow-through and the ITC totals with the section 174 deduction flow-through is $1,150,030.40 for Gas East and $477,716.95 for Brooklyn Union.

[4] As noted, Keyspan's 2000 ITC claim includes amounts placed in service in 1998 and 1999. Specifically, Keyspan claimed $2,398,426.58 in investment tax credit for assets placed in service in the 1998 tax year and $2,554,630.19 in investment tax credit for assets placed in service in the 1999 tax year.

Brooklyn Union Gas Company

Year	Total ITC	Refund	Carryforward
2002	$2,214,281	$2,214,281	$0
2003	$2,915,194	$2,915,194	$0
2004	$4,929,650	$4,929,650	$0

35. Following the filing of the amended returns in September 2006, petitioners' representatives and the Division had telephone conferences in respect of the ITC claims. By letter dated December 15, 2006, petitioners' representative responded to specific questions the Division had with respect to the claims. The letter includes the following list of asset categories deemed by petitioners as ITC-eligible:

Account No.	Description
3770	Compressor station equipment
3780	Measuring and regulating equipment
3950	Lab equipment
3050	Structures and improvements
3622	LNG equipment
3630	Purification equipment
3631	Liquefaction equipment
3632	Vaporization equipment
3634	Measuring and regulating
3635	Other storage equipment
3670	Compressor and regulator mains
3840	Gas regulation
3690	Measuring and regulating equipment
3760	Mains

36. Also during a telephone conference in 2006, petitioners' representative agreed to participate in a request for advice of counsel with respect to the issue of whether petitioners' equipment as described herein was eligible for the investment tax credit. In connection with that request, petitioners submitted a detailed memorandum outlining the relevant facts and law and the application of the law to petitioners' facts. By letter dated May 2, 2008, a senior attorney in

the Division's Office of Counsel, Legislation & Guidance - Income & Corporate Section, responded to that request, concluding in summary fashion that the assets in question were not principally used in the production of goods by manufacturing or processing, but were principally used in the distribution of natural gas and for inventory control of natural gas.

37. By letters dated May 16, 2008, the Division gave each petitioner, respectively, notice of disallowance of their respective claims for investment tax credit for the tax years 2000 through 2004. The notices of disallowance were based on the May 2, 2008 letter of the Office of Counsel.

38. The Division did not reject the claims based on the numerical computations. The desk auditor assigned to this matter did not request any documents from petitioners and did not review any primary source documents. The auditor had no engineering background and no training or experience in the utilities industry. His review of petitioners' ITC claims was the first audit of a utility he had done.

39. Petitioners also claimed investment tax credits on their initial returns for the tax years 2005 and 2006. Petitioners filed their 2005 returns on December 12, 2006 and their 2006 returns December 7, 2007. Petitioners provided the same type of documentation in respect of these ITC claims as had been attached to their amended returns for the earlier years. These claims are summarized below.

Keyspan Gas East

Year	ITC Claimed	ITC Utilized	ITC Carryover
2005	$1,727,869	$455,170	$1,272,699
2006	$2,934,900	$820,465	$2,114,435

Brooklyn Union Gas

Year	ITC Claimed	ITC Utilized	ITC Carryover
2005	$2,927,956	$2,927,956	$0
2006	$3,287,220	$3,287,220	$0

40. By letters dated October 17, 2008, the Division gave petitioners notice of disallowance, in full, of their respective ITC claims for the 2005 and 2006 tax years. The letters stated that the disallowance was based on the results of the prior audit and "the determination that [petitioners'] claimed property is principally used in the distribution and inventory control of natural gas."

41. On November 11, 2008, the Division issued to petitioners notices and demands for payment of tax due, which assessed additional tax due, plus interest, based on the denial of petitioners' ITC claims. The notices and demands assessed additional tax due (including MTA surcharge) as follows:

Year	2005	2006
Brooklyn Union	$3,425,708	$3,895,675
Keyspan Gas East	$522,861	$837,236

42. At hearing petitioners submitted 10 binders of documentation in support of their ITC claims. The binders contain summary documents, fixed asset reports, and petitioners' sample of 1,324 primary source documents consisting of invoices and payroll data. Petitioners also submitted a summary schedule listing each item in its sample, along with project numbers, invoice numbers and amounts. All items in the sample are accessible using the summary schedule.

43. The binders include summary asset addition schedules for petitioners for the tax years 2002 through 2004 (Binder 1). The schedules describe the assets by asset category number and description similar to the December 15, 2006 letter from petitioners' representatives (***see*** Finding of Fact 35). The schedules provide additional information regarding the asset categories under the heading "Asset Use." For example, category 3950 "Lab equipment" is described in Binder 1 as "installed cost of lab equipment used for general lab purposes." Also, category 3780 "Measuring and regulating equipment" is described in Binder 1 as: "Includes cost of installed meters, gauges, and other equipment used in measuring and regulating gas in connection with distribution operations other than the measuring of gas deliveries to customers." Line items under these categories are included in the claims at issue.

44. The asset schedules in Binder 1 also include asset categories not listed in the December 15, 2006 letter, but which are part of the ITC claims. For example, asset category 3750 "Structures and improvements" is described as "used in connection with distribution operations." Among the specific line items under asset category 3750 as listed in the asset addition schedules attached to the BUG's 2004 ITC claim are "new emergency generator," "new roof skylights," and "repave Staten Island yard." Line items under asset category 3750 are part of petitioners' ITC claims for other years as well.

45. Category 3050, which is identified in the December 15, 2006 letter, is also described as "structures and improvements." A line item under this category in Keyspan's 2001 ITC claim is described as "new cesspool, water svc, lockerm."

46. There are numerous line items included in ITC claims for various years under the category 3840 described in the December 15, 2006 letter as "gas regulation," which are further described in the asset addition schedules as "gas meter installations."

47. Asset category 3860, which is included in the claims, is not further identified in either the December 15, 2006 letter or Binder 1. BUG's 2004 ITC claim contains line items under this category described as "install CNG fueling station." BUG's 2005 claim contains line items under this category described as "CNG station upgrades."

48. Binder 1 further describes asset category 3760, "Mains," as the "installed cost of distribution system mains." Binder 1 also indicates that asset categories 3764 and 3766 are also mains. Additionally, as noted in the December 15, 2006 letter, category 3670 is "compressor and regulator mains." According to Binder 1, this category refers to "the installed cost of transmission system mains." All of the these "mains" refer to the underground gas piping used to distribute natural gas to petitioners' customers.

49. Upon review of the asset schedules attached to petitioners' ITC claims it is clear that the vast majority of line items are listed under asset categories 3760, 3764, and 3766 and are thus attributable to the installed cost of mains. Further, although the record does not contain totals for the ITC claims for all of the years at issue under these three categories, my review of the record indicates that the total cost (or investment credit base) attributable to these asset categories for all of the years at issue is about $750 million. Additionally, the ITC claims reflect about $52 million in investments attributable to compressor and regulator mains (asset category 3670). The total investment tax credit base for all assets is approximately $904 million.

50. The asset schedules attached to petitioners' ITC claims for all of the years at issue reveal one line item under asset category 3630 ("Purification equipment"). Specifically, BUG's 2003 ITC claim contains a line item under this category in the amount of $1,276,178.04.

51. There is no asset category specifically designated for odorizing equipment. A review of the asset schedules for all of the years at issue reveal two line items that reference odorant in

their description. Specifically, BUG's 2003 schedule contains a line item under asset category 3780 ("Measuring and regulating equipment") described as "new yz odorant skid" in the amount of $95,893.00. Additionally, Keyspan's 2001 ITC claim contains a line item under asset category 3632 ("Vaporization equipment") described as "odorant system replacement" in the amount of $305,794.85.

52. The asset schedules indicate investments totaling about $60 million in respect of asset categories 3690 and 3780 (measuring and regulating equipment).

53. Petitioners' Binder 2, which was submitted in evidence, contains asset schedules similar to those attached to the returns except that they are broken down by asset category and by company.[5] These asset schedules also include a "project number," while those attached to the returns do not. Binder 2 is incomplete, however, in that it contains no data with respect to the 2005 and 2006 tax years. It is also incomplete in that it lists no assets under category 3760 for Keyspan, notwithstanding that Keyspan had many pages of line items under this category in respect of its 1998-2004 tax years.

54. The asset schedules attached to the returns for the 2006 tax year use a three-digit asset category code, which appears to correspond to the four-digit code used in previous years.

55. The source documentation submitted by petitioners does not tie any of the specific invoices which are part of the sample to any specific line item on the asset schedules that are attached to the ITC claims. This is because entries in the asset schedules consist of multiple expenditures and multiple primary source documents (***see*** Finding of Fact 28).

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[5] It is noted that the asset schedules refer to Keyspan under company code "37" and BUG under company code "38."

56. Petitioners submitted proposed findings of fact numbered 1 through 51.[6] Proposed findings of fact 2, 4, 7, 8, 10-13, 15-22, 29-32, 34, 37, 38, 42, 45, and 46 are, in substance, accepted. Proposed findings of fact 1, 6, 26, 33 contain conclusions of law and are therefore rejected. Proposed findings of fact 3, 5, 9, 14, 27, 49, and 50 are unsupported by the record and are therefore rejected. Proposed findings of fact 23-25, 28, 35, 36, 43, 44, 47, and 48 are rejected as irrelevant. Proposed findings of fact 39-41 and 51 recite the undisputed procedural history of this case. It is not necessary to repeat such facts herein.

57. The Division submitted proposed findings of fact numbered 1 through 35. Proposed findings of fact 1 through 4, 6 through 19, and 23 through 32 are, in substance, accepted. Proposed findings of fact 5 and 20-22 are rejected as irrelevant. Proposed findings of fact 34 and 35 are unsupported by the record and are therefore rejected.

SUMMARY OF THE PARTIES' POSITIONS

58. Petitioners contend that their system of machinery, equipment, pipes and mains from the city gates to the end user's location was an integrated, unified, interdependent system which substantially altered the gas as first received at the city gates into a product that was usable by the end user. Petitioners cite the pressure reduction and regulation, purification, odorization and pipe-heating activities as part of this integrated system. Petitioners further note that all of these activities are required by regulatory authorities and contend that all are necessary to the delivery of a safe and usable product to the consumer. Petitioners contend that the various items of equipment required to perform these activities are housed in one integrated system and that no one component of the system could function without the others working simultaneously.

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[6] It is noted that if any part of a proposed finding is unsupported by the record or is irrelevant or contains a conclusion of law, the proposed finding of fact has been rejected in its entirety.

Petitioners thus contend that the various items of equipment that are the subject of the credit, such as regulators, odorizers, scrubbers, heaters, pipes, mains, compressors, and liquefiers, are principally engaged in the production of natural gas by processing within the meaning of Tax Law § 210(12).

59. Petitioners also contend that they have met their burden of proof as to the amount of their claims through the excerpted portions of their fixed asset reports, which were attached to their returns; the verification that primary source documents exist to support the claims; the sample of primary source documents, which was received in evidence; and the Division's failure to examine any of the documentation supporting the claim, coupled with the Division's acknowledgment that its denial was not based on petitioners' computation of the claims. Petitioners also assert that an extrapolation of the sample provides corroboration of the amount of the claim.

60. Finally, petitioners contend that Keyspan properly included assets purchased in 1998 and 1999 in its ITC claim for the 2000 tax year. Petitioners assert that although such property met the criteria for eligibility under Tax Law § 210(12)(a) in 1998 and 1999, it was not "qualified property" for purposes of the credit until 2000 when petitioner became subject to Article 9-A and thus eligible to claim the credit.

61. The Division contends that the purification, pressure reduction and regulation, odorization and pipe-heating activities performed by the various items of petitioners' equipment did not constitute the production of natural gas by processing for purposes of the investment tax credit under Tax Law § 210(12) because such activities are not the sort of activities intended to fall within the ITC provision, and further, that gas delivered to end users is not significantly different from gas received at the city gates. The Division also notes that Article 9, under which

petitioners filed prior to 2000, did not have an ITC provision. The Division asserts that while the ITC may have become available to petitioners in 2000, this change in the law does not mean that the Legislature ever intended to provide "this statutory benefit to these types of corporations." The Division further contends that petitioners have failed the "principally used" requirement to qualify for the credit. The Division asserts that the principal purpose of the pipes and other equipment at issue is to transport and distribute gas. The Division notes that the 11,000 miles of mains and pipes in petitioners' system do not purify, odorize, regulate, or heat gas; they transport gas to customers.

62. The Division also asserts that petitioners have not met their burden of showing the amount of the claims. The Division asserts that while the sample of primary source documents demonstrates the existence of supporting documentation, it does not verify the amount of the claims. The Division contends that there is no link or connection between the primary source documents submitted and the asset schedules upon which the claims were based.

63. As to Issue III, the Division contends that, assuming the property met the criteria for qualification under the statute in 1998 and 1999, such property was qualified property notwithstanding that petitioner was not subject to tax under Article 9-A and thus not eligible to claim the credit. According to the Division, then, Keyspan did not claim the credit for the first year in which the property became qualified property as required (***see*** 20 NYCRR 5-2.1) and thus Keyspan's claim with respect to property purchased and placed in service in 1998 and 1999 must be rejected.

CONCLUSIONS OF LAW

A. Petitioners claim entitlement to tax credits. They must, therefore, demonstrate a clear-cut entitlement to these statutory benefits (***see Matter of Golub Service Station v. Tax Appeals***

Tribunal 181 AD2d 216, 585 NYS2d 864 [3d Dept 1992]). This standard requires that petitioners show that their interpretation of the relevant statute is the only reasonable interpretation (***see Matter of Brooklyn Navy Yard Cogeneration Partners, L.P.***, Tax Appeals Tribunal, May 9, 2006, ***confirmed*** 46 AD3d 1247, 848 NYS2d 747 [3d Dept 2007], ***lv denied*** 10 NY3d 706, 858 NYS2d 654 [2008]).

B. Tax Law § 210(12)(b) allows for an investment tax credit against the tax imposed by Article 9-A of the Tax Law for investments in tangible personal property or other tangible property which meets various criteria not at issue in this matter and which is *principally used* by the taxpayer in the *production* of goods by, among other things, *manufacturing* or *processing*.

C. For purposes of the investment tax credit, "principally used" means more than 50 percent (20 NYCRR 5-2.4[d]). "Manufacturing" means:

> The process of working raw materials into wares suitable for use or which gives new shapes, new quality or new combinations to matter which already has gone through some artificial process by the use of machinery, tools, appliances and other similar equipment.

"Processing" for purposes of the credit has been defined as "activity related to industrial production" and "an industrial activity related to manufacturing" (***Matter of General Mills Restaurant Group v. Chu***, 125 AD2d 762, 509 NYS2d 184, 186 [3d Dept 1986]).

D. Preliminarily, it is noted that the Division's argument, in reliance on language in ***Matter of General Mills Restaurant Group v. Chu***, that petitioners' claim must fail because, as local gas distribution companies, petitioners are "dependent on locale for their existence" and "of necessity are dependent on locality to service their clientele" is rejected. This language uses the legislative intent underlying the ITC, i.e., the revitalization of production facilities within the New York State (***see Matter of General Mills v. Chu***, 509 NYS2d at 186), to define

"processing" for purposes of the credit (***see*** Conclusion of Law C) and thereby distinguish between the industrial production of food (an industrial activity for ITC purposes) and the preparation of restaurant food (not an industrial activity for ITC purposes). There is no language in Tax Law § 210(12)(b) itself restricting the application of the credit to businesses that are not dependent on a particular locality. The Division's argument reads such nonexistent language into the statute. Additionally, as petitioners note, the lack of any such locality restriction is demonstrated by the former State Tax Commission's decision in ***Matter of Plattekill Mountain Ski Center*** (State Tax Commission, August 1, 1985), which granted an investment tax credit to a ski resort, a business as dependent on a particular locality as a business can be.[7]

E. The Division's related argument, that the lack of any investment tax credit in respect of the tax on gross receipts in Article 9 of the Tax Law, under which petitioners filed their franchise tax returns prior to 2000, indicates that the Legislature never intended to provide the ITC to petitioners, notwithstanding their transition to Article 9-A, is also rejected. As petitioners correctly note, where a taxpayer is made subject to tax under Article 9-A all provisions of that Article properly apply to that taxpayer unless expressly stated otherwise. The Division has pointed to no such language in Article 9-A restricting former Article 9 taxpayers from eligibility for the investment tax credit.

F. As noted, petitioners argue that their system of machinery, equipment, pipes and mains was an integrated and interdependent system principally engaged in the production of natural gas by processing. Petitioners thus argue that their entire system from the city gates to the end user is properly considered a single production system. This contention is rejected. While the record

[7] As decisions of a body of coordinate jurisdiction, decisions of the former State Tax Commission are not binding precedent but are entitled to respectful consideration (***Matter of Racal Corp.,*** Tax Appeals Tribunal, May 13, 1993).

shows a sophisticated, interconnected system, which required the proper functioning of all components to safely deliver usable gas to the end user, the record also shows that by its design and function the system was principally engaged in the distribution of natural gas to petitioners' 1.9 million customers. Furthermore, even considering separately the various types of equipment discussed herein, petitioners have failed to meet their burden of proof to show that any of this equipment was principally engaged in the production of natural gas within the meaning of Tax Law § 210(12)(b). Petitioners' investment tax credit claims are therefore properly denied in their entirety.

G. Despite petitioners' focus on the regulators, purifiers, odorizers, and heaters, the plain fact of the matter is that their system consists overwhelmingly of pipes and mains, the purpose of which is to deliver gas to end users. More specifically, the system contains 11,000 miles of pipes and mains by which petitioners, who are known as local distribution companies, deliver gas to their 1.9 million customers. There is no doubt that the pipes and mains are not production equipment, as they effect no change in the gas, but serve merely as conduits through which the gas flows to the end user. Indeed, petitioners do not argue that the pipes and mains themselves constitute production equipment, but argue that, as a necessary part of an integrated system consisting of certain production components, the pipes and mains are properly considered production equipment. As discussed below, such other equipment is not production equipment for ITC purposes, but even if it were, the fact that the system consists so overwhelmingly of pipes and mains that deliver gas to end users compels the conclusion that the system was principally engaged in the distribution of natural gas and precludes any finding that the system, considered as a whole, was principally engaged in production.

To demonstrate the predominance of pipes and mains as compared to other equipment in the system, the record shows petitioners had about 600 regulators of various sizes throughout the system, with the largest 200 feet in length (***see*** Finding of Fact 11). Even assuming that all regulators were 200 feet long, the total length of all regulators would be about 23 miles, or only about .2 percent of the 11,000 miles of pipes and mains in the system. Furthermore, petitioners' investment in the system, as indicated by the ITC claims, is predominantly an investment in pipes and mains. About $750 million of the approximate $900 million total investment credit base, or about 83 percent, is attributable to pipes and mains, with an additional $52 million attributable to compressor and regulator mains (***see*** Finding of Fact 49). In contrast, petitioners' investment in regulators, purifiers and odorizing equipment as measured by the ITC claims is relatively small. Specifically, the ITC claims indicate a total investment in measuring and regulating equipment (asset categories 3690 and 3780) of about $60 million, while investments in purification and odorizing equipment total less than $2 million (***see*** Findings of Fact 49 - 52). Accordingly, as measured in terms of both size and cost, the system is chiefly comprised of petitioners' distribution infrastructure of pipes and mains. As a result, even if certain components of the system were deemed production equipment, such a finding would not transform petitioners' $800 million investment in 11,000 miles of pipes and mains into production equipment.

Petitioners' argument that their network of pipes and mains is properly characterized as merely a delivery component of a production system is unpersuasive. The cases cited by petitioners on this point are factually distinguishable from the present matter. There is simply no comparison between petitioners' 11,000-mile system of distribution infrastructure by which gas is delivered to 1.9 million customers and a concrete mixer truck (***Matter of Miron Rapid Mix Concrete Corp***., Tax Appeals Tribunal, January 9, 1992); an oil refinery with an off-shore marine

terminal (***Hawaiian Independent Refinery, Inc. v. U.S.***, 82-1 US Tax Cas ¶ 9183 [Ct Cl Trial Div February 1, 1982], ***affd*** 697 F2d 1063 [Fed Cir 1983], ***cert denied*** 464 US [1983]); or snow-making equipment, including pipelines for air and water (***Vail Associates, Inc. v. Commr***., 88 TC 1391 [1987]; ***Matter of Plattekill Mountain Ski Center*** (State Tax Commission, August 1, 1985).

Petitioners seek to diminish the predominance of the pipes and mains in the system by asserting that the pipes and mains would be configured "markedly differently" if all petitioners did was deliver gas. Certainly, petitioners' system would be different if regulators, purifiers and odorizing equipment were not part of it. Considering, however, that even under petitioners' hypothetical, they would still be delivering gas to 1.9 million customers, it seems highly likely that the distribution network of pipes and mains would remain intact.

Petitioners argue that the product they are selling to their customers is safe usable gas and that such a product must be purified, must have the proper level of odorant, and must be delivered at the appropriate pressure levels. Petitioners further argue that their entire system from the city gates to the end user's location is necessary to produce this product. As discussed above, the predominance of the distribution infrastructure of pipes and mains in the system compels the conclusion that the system is principally engaged in distribution. Furthermore, as discussed below, petitioners' regulation of pressure levels is not a production function, but is a distribution function. Additionally, as discussed below, petitioners have not met their burden to show that their other equipment was principally engaged in production for ITC purposes. Accordingly, the necessity of the subject equipment to petitioners' operations notwithstanding, the ITC claims must be rejected.

In reaching the foregoing conclusions, I note that the testimony of petitioners' witnesses has been considered (***see*** Finding of Fact 21). On the ultimate question presented herein, i.e., whether the system or any component thereof is principally engaged in production for ITC purposes, such testimony was unpersuasive.

H. Turning to an examination of the specific categories of assets, petitioners note in their reply brief that the function of regulators in the system is possibly "the most important aspect of petitioners' business." Despite this importance, however, the regulators do not qualify as production equipment under Tax Law § 210(12)(b), as this equipment performs a distribution function. As noted in the record, gas is initially highly pressurized for transport through the interstate pipeline. Following transfer of custody at the city gates, petitioners' regulators step down and maintain certain pressure levels throughout the system to safely deliver usable gas to their customers. The regulators thus make natural gas safely accessible to end users, as gas which has been pressurized solely for transport is depressurized for safe delivery and use. This is the essence of distribution and delivery, not production.

Matter of Brooklyn Union Gas Company (Tax Appeals Tribunal October 10, 2002) supports a finding that the regulators were not engaged in production. In that case, which involved petitioner Brooklyn Union, the Tax Appeals Tribunal found that compressed natural gas was, by "composition" and "essential nature," a gas and therefore not subject to use tax. In other words, changes in pressure necessary to compress gas did not change its composition or essential nature. Similar to compressors, regulators change and maintain pressure levels. Consistent with the Tribunal's reasoning in the prior ***Brooklyn Union*** case, if changes in pressure make no essential changes to natural gas, it follows that gas that has passed through petitioners' regulators is not significantly different from gas that has not passed through the regulators (***see Matter of J.***

H. Wattles, Inc., State Tax Commission, October 30, 1981). Accordingly, gas regulation as described herein may not be considered production for ITC purposes.

Petitioners focus on the potentially catastrophic effects of regulator failure and over-pressurization to support their position that the regulators are engaged in production. The necessity of the regulators in the system and the vital safety role that they play is clearly demonstrated in the record. Such facts, however, do not compel a finding that the regulators are engaged in the production of natural gas.

It is noted that the last regulator through which natural gas passes before being consumed is often located on a home appliance (***see*** Finding of Fact 11). Petitioners did not differentiate between this last regulator and the regulators in their system. Consistent with petitioners' position in this matter, then, this last regulator would be engaged in the production of natural gas within the home. That such a definition of production and processing is overly broad seems self-evident.

Petitioners erroneously cite ***Matter of National Fuel Gas Distribution Corporation*** (Tax Appeals Tribunal, March 14, 1991) in support of the proposition that the regulation of gas pressure constitutes a production process. In that sales tax production exemption case under Tax Law § 1115(a)(12),[8] the Tribunal found that natural gas compressors were directly used in the production of gas. The basis for this conclusion, however, was not that pressurization, by itself, constituted production of the gas, but that, under the particular facts of that case, such pressurization resulted in the removal of water from the gas. Since the compressors removed water from the gas "in the context of the purification system" the Tribunal concluded that they

[8] Tax Law § 1115(a)(12) contains language similar to the subject ITC under Tax Law § 210(12)(b) as it provides an exemption from sales tax for purchases of "machinery or equipment for use or consumption directly and predominantly in the production of [inter alia] . . . gas for sale by manufacturing . . . ."

were used directly in production. Petitioners make no claim that the regulation of gas in this instance had any impact on purification. ***Matter of National Fuel Gas Distribution Corporation*** is thus inapposite to the present matter.

I. Petitioners have also failed to meet their burden to show that their purification equipment is principally engaged in the production of natural gas and therefore eligible for ITC. Purification is initially performed by the natural gas producer soon after extraction from the well. This activity is clearly part of the process of natural gas production. Indeed, in the context of the sales tax production exemption *the removal of impurities at the natural gas well site* has been deemed "an essential element" of natural gas production (***see Matter of Envirogas, Inc. v. Chu***, 114 AD2d 38, 497 NYS2d 503 [3d Dept 1986], ***affd*** 69 NY2d 632, 511 NYS2d 228 [1986]). Petitioners would thus expand this sales tax definition of natural gas production to include the removal of impurities by a local distribution company where, as here, the presence of such impurities results from the transport of gas through the interstate pipeline (***see*** Finding of Fact 6). Petitioners have not shown, however, the extent to which the quality of the gas has been compromised as a result of transport and thus have not shown that the quality of the gas downstream of their purification equipment was significantly different from the gas upstream of the purification equipment (***see Matter of J. H. Wattles, Inc***.).

Furthermore, the ITC is properly construed more narrowly than the sales tax production exemption (***see Matter of Pantelopoulos v. Commissioner of Taxation and Finance***, 213 AD2d 768, 623 NYS2d 17 [3d Dept 1995]). It would be inconsistent with that rule of construction to expand the definition of natural gas production in ***Matter of Envirogas, Inc. v. Chu*** to include the removal of impurities under the circumstances described herein. Additionally, it is noted that case law indicates that natural gas is of usable quality prior to purification by a local distribution

company (***see Matter of Envirogas, Inc. v. Chu*** [certain customers tapped into the well head to obtain gas]; ***Matter of Tenneco***, ***Inc***., State Tax Commission, January 17, 1986 [an interstate pipeline operator used gas in the pipeline to operate compressors]). This supports a finding that production does not extend from the producer to the local distribution company. Accordingly, the Division's position is not irrational (***see Matter of Brooklyn Navy Yard Cogeneration Partners, L.P.***) and the purification equipment was not qualified property for ITC purposes.

J. Additionally, petitioners have not met their burden to show that their odorizing equipment was principally engaged in the production of natural gas and therefore eligible for the investment tax credit. Although not at issue, it seems likely that the initial addition of odorant by the producer or pipeline operator is part of the production process of natural gas. Similar to the situation with respect to the purification equipment, however, petitioners have not shown that their addition to or supplement of odorant following transfer of custody at the city gates to compensate for odorant fade during transport or to meet regulatory requirements resulted in gas that was significantly different from the gas upstream of the odorizing equipment (***see Matter of J. H. Wattles, Inc***.). It cannot be concluded, therefore that the denial of ITC with respect to odorizing equipment was irrational.

K. The heaters in petitioners' system are clearly not engaged in production activity. Petitioners use heaters to offset the cooling of gas resulting from depressurization (***see*** Finding of Fact 13). Such heating is necessary to maintain the structural integrity of the pipes and mains. Heaters thus minimize a safety risk as well as allow petitioners to avoid the cost of repairing pipes and mains, which might be damaged otherwise. The change in the gas resulting from heating is significant only to the extent that it serves to maintain petitioners' distribution

infrastructure. Accordingly, the heating of petitioners' pipes and mains cannot reasonably be construed as the production of natural gas.

L. Petitioners argue that their liquefaction equipment, by which they liquify natural gas for storage purposes and vaporize the liquid back into a gas for distribution to customers, is properly considered production equipment not because this activity by itself constitutes production, but because this activity is intertwined with petitioners' system. As discussed, however, petitioners' system is not principally engaged in production. Accordingly, the liquefaction equipment may not be deemed production equipment under this theory.

M. Petitioners did not articulate a specific basis for the inclusion of the compressors as production equipment other than as part of petitioners' overall system. The system, however, is not engaged in production. Furthermore, as noted previously, for use tax purposes compressed gas is by composition and essential nature a gas (***see Matter of Brooklyn Union Gas Company***, Tax Appeals Tribunal, October 10, 2002). Accordingly, in the present context, and consistent with Conclusion of Law H, it is reasonable to conclude that the compression of gas is not production and that the compressors do not qualify for the ITC.

N. Even if petitioners had established that their system of machinery, equipment, pipes and mains from the city gates to the end user's location was an integrated system engaged in the production of natural gas, and thereby established entitlement to the ITC generally, a portion of the claims would fail for evidentiary reasons. Specifically, petitioners claimed lab equipment (asset category 3950), but there is insufficient evidence in the record to show how such equipment was used in petitioners' operations (***see*** Finding of Fact 43). Asset categories 3750 and 3050 both involve structures and improvements, but there is insufficient information in the record to show how these expenditures were related to petitioners' operations (***see*** Findings of

Fact 44 and 45). Items under asset category 3860 are also insufficiently identified in the record (***see*** Finding of Fact 47). Additionally, a significant number of the line items under asset categories 3780, 3690 and 3840, indicate the purchase and installation of meters (***see*** Findings of Fact 35, 43 and 46). The record, however, does not explain the manner in which such meters were used and thus does not explain the role of such meters in petitioners' system. All line items involving meters under these asset categories are thus properly denied in any event

O. In light of the foregoing conclusions of law, Issues II and III are moot.

P. The petitions of The Brooklyn Union Gas Company and Keyspan Gas East Corporation are denied and the notices of disallowance dated May 16, 2008 and October 17, 2008 are sustained.

DATED: Troy, New York
July 29, 2010

/s/ Timothy Alston
ADMINISTRATIVE LAW JUDGE