**Private Letter Ruling**

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| **Ruling Number:** | **P-2005-025** |

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| **Tax Type:** | **Kansas Compensating Tax; Kansas Retailers' Sales Tax** |
| **Brief Description:** | **Natural gas producer; manufacturing machinery and equipment.** |
| **Keywords:** |  |
| **Approval Date:** | **10/12/2005** |

**Body:**

Office of Policy & Research  
  
  
October 12, 2005

XXXX  
XXXX  
XXXX

RE: Your letter to the KDOR about natural gas gathering systems

Dear XXXX:  
  
You work for a licensed natural gas producer that also operates natural gas gathering systems in Kansas. You ask how the Kansas sales and use tax exemption for manufacturing machinery and equipment applies to your employer's business operations. The integrated plant exemption is found at K.S.A. 2005 Supp. 79-3606(kk). How this exemption applies to different oil and gas operations has been discussed in Notice 00-08, Revenue Ruling 19-2002-2, and a Q & A --- Sales Taxation of Drilling Contractors, Well Service Providers, and Oil and Gas Producers that was published on October 21, 2002.  
  
You ask if processing equipment in a natural gas compressor station that is located in a gathering system or other pipeline is exempt under K.S.A. 2005 Supp. 79-3606(kk). The answer is no. Subsection (kk) does not exempt the sale or servicing of such processing equipment whether the equipment is located in a small or large compressor or booster station.  
  
The scope of the (kk) exemption is limited to production equipment located at a "manufacturing or processing plant or facility" which, the statute directs, does not include "any facility primarily operated for the purpose of conveying or assisting in conveyance of natural gas, electricity, oil or water." *K.S.A. 2005 Supp. 79-3606(kk)(2)(C).* Compressor stations are "primarily operated" to pump natural gas through gathering systems and pipelines. Accordingly, a compressor station is not a "processing plant or facility" for purposes of the exemption. *K.S.A. 2005 Supp. 79-3606(kk)(2)(C).* Because a compressor station cannot be a "processing plant or facility," none of the processing or transportation equipment located there can qualify for the sales tax exemption.  
  
K.S.A. 2005 Supp. 79-3606(kk) further directs that exemption does not extend to "transportation, transmission and distribution equipment . . . including the means of conveyance of natural gas, electricity, or water." *K.S.A. 2005 Supp. 79-3606(kk)(5)(C).* This includes power lines, pipelines, gathering systems, distribution systems, waterlines, gas lines, and all of the associated equipment, such as transformers, compressors, pumps, scrubbers, separators, strainers, condensers, contractors, absorption towers, and so forth. These statutory provisions will be reviewed in depth after natural gas production and distribution operations are discussed.  
  
Several natural gas associations and businesses operate web sites that describe how natural gas is produced, gathered, processed, and distributed to customers. These include, among others: (1) Natural Gas Supply Association, www.ngsa.org; (2) Independent Petroleum Association of America, www.ipaa.org; (3) Interstate Natural Gas Association of America, www.ingaa.org; (4) American Gas Association, www.aga.org; (5) Williams Company, www.williams.com; (6) Duke Energy, www.duke-energy.com; and (7) NaturalGas.org; www.naturalgas.org. Some of these web site description will be quoted to help explain the different operations involved in transporting natural gas from a well site to the final consumer.  
  
**I. NATURAL GAS OPERATIONS --- Gathering systems, compressor stations, processing plants, pipelines, and other natural gas facilities.**  
  
The Williams Company web site *(www.williams.com)* discusses natural gas pipelines and pipeline facilities:

**Types of Pipelines and Gas Facilities**  
  
There are essentially three major types of natural gas pipelines: gathering systems, transmission pipelines, and distribution systems. Williams owns and operates both gathering systems and transmission pipelines.  
  
Gathering systems collect raw (unprocessed) gas at the wells and transport to processing plants or other separation and purification facilities. The purpose of these facilities is to remove natural gas liquids or to remove other impurities. Gathering lines are typically smaller in diameter compared to the large transmission lines. Transmission pipelines consist of both higher pressure and larger diameter pipelines to quickly move natural gas long distances. Distribution systems then deliver the natural gas to homes, business and power plants. There are over 2 million miles of pipelines in the United States.  
  
Compression plays a major role in the transportation of natural gas through pipelines. Natural gas entering a pipeline is compressed to move the natural gas effectively and to increase the volume a pipeline can transport. Compressor stations are spaced along interstate pipelines at regular intervals to maintain this pressure and to control the movement of the natural gas. Natural gas is transported at pressures that vary from 200 to 1500 pounds per square inch.

The Duke Energy web site *(www.duke-energy.com)* provides definitions for terms that are commonly used in different natural gas operations:

**Processing Plant.**A facility in which raw natural gas from the wellhead is made to meet pipeline quality specifications and prepared for sale to consumers by reducing or removing undesirable impurities and extracting commercially desirable non-methane hydrocarbons from the gas stream.  
  
**Compression.**The action on a material which decreases its volume as the pressure to which it is subjected increases. Natural gas is usually compressed for transport.  
  
**Compressor Station.**Facility that provides energy to move natural gas within a pipeline by increasing the pressure of the gas at the discharge side of the facility compared to the intake side.

**Gathering Line.**Network-like pipeline that transports natural gas from individual wellheads to a compressor station, treating or processing plant or main trunk transmission line. Gathering lines are generally relatively short in length, operate at a relatively low pressure, and are small in diameter.  
  
**Gathering Station.**A compressor station at which natural gas is gathered from wells by suction because wellhead pressure is not sufficient to produce the desired rate of flow into a transmission or distribution system.  
  
**Treating Plant.**Facility that treats raw natural gas to remove undesirable impurities such as carbon dioxide, hydrogen sulfide and water vapor. Treating plants may be owned by producers, independent treaters or transmission pipeline companies.

Definitions of commonly-used terms are also published on the America Gas Association web site *(www.aga.org)*:

**Extraction Plant.**A plant in which products, such as propane, butane, oil, ethane, or natural gasoline, which are initially components of the gas stream, are extracted or removed for sale. See GASOLINE PLANT.  
  
**Processing Plant.**A plant in which liquefiable hydrocarbons, such as propane, butane, ethane, or natural gasoline, which are initially components of the gas stream, are extracted or removed.  
  
**Compressor Station.**Any permanent combination of facilities which supplies the energy to move gas at increased pressure from fields, in transmission lines, or into storage.

The Williams Company web site *(www.williams.com)* explains how natural gas is gathered and processed:

**Gathering & Processing**  
  
Natural gas is a commodity produced by major oil and gas companies and independent gas producers and traded in a competitive market.  
  
During the production phase, gas producers use advanced technology to locate and drill for gas reserves. Gas is pumped from wells into gathering lines. Gathering operations bring natural gas to processing plants that remove moisture and impurities from the gas stream, and to separate liquid byproducts. Today, we consume about 22 trillion cubic feet of gas per year, which is about 25 percent of the energy consumed in the United States.

The American Gas Association's web site *(www.aga.org)* also reviews natural gas gathering and delivery systems:

**How Does The Natural Gas Delivery System Work?**  
  
Gas flowing from higher to lower pressure is the fundamental principle of the natural gas delivery system. The amount of pressure in a pipeline is measured in pounds per square inch.  
  
From the well, the natural gas goes into "gathering" lines, which are like branches on a tree, getting larger as they get closer to the central collection point.  
  
**Gathering Systems**  
  
A gathering system may need one or more field compressors to move the gas to the pipeline or the processing plant. A compressor is a machine driven by an internal combustion engine or turbine that creates pressure to "push" the gas through the lines. Most compressors in the natural gas delivery system use a small amount of natural gas from their own lines as fuel.  
  
Some natural gas gathering systems include a processing facility, which performs such functions as removing impurities like water, carbon dioxide or sulfur that might corrode a pipeline, or inert gases, such as helium, that would reduce the energy value of the gas. Processing plants also can remove small quantities of propane and butane. These gases are used for chemical feedstocks and other applications.

The Natural Gas Supply Association's web site *(www.ngsa.org)* details gas processing operations. The web site also explains what compressor stations do, how gas is stored, and how distribution systems operate:

**Gas processing plants**  
  
Natural gas, as it is used by consumers, is much different from the natural gas that is brought from underground up to the wellhead. Although the processing of natural gas is in many respects less complicated than the processing and refining of crude oil, it is equally as necessary before its use by end users.  
  
The natural gas used by consumers is composed almost entirely of methane. However, natural gas found at the wellhead, although still composed primarily of methane, is by no means as pure. Raw natural gas comes from three types of wells: oil wells, gas wells, and condensate wells. Natural gas that comes from oil wells is typically termed 'associated gas'. This gas can exist separate from oil in the formation (free gas), or dissolved in the crude oil (dissolved gas). Natural gas from gas and condensate wells, in which there is little or no crude oil, is termed 'nonassociated gas'. Gas wells typically produce raw natural gas by itself, while condensate wells produce free natural gas along with a semi-liquid hydrocarbon condensate. Whatever the source of the natural gas, once separated from crude oil (if present) it commonly exists in mixtures with other hydrocarbons; principally ethane, propane, butane, and pentanes. In addition, raw natural gas contains water vapor, hydrogen sulfide (H2S), carbon dioxide, helium, nitrogen, and other compounds. To learn about the basics of natural gas, including its composition, click here.  
  
Natural gas processing consists of separating all of the various hydrocarbons and fluids from the pure natural gas, to produce what is known as 'pipeline quality' dry natural gas. Major transportation pipelines usually impose restrictions on the make-up of the natural gas that is allowed into the pipeline. That means that before the natural gas can be transported it must be purified. While the ethane, propane, butane, and pentanes must be removed from natural gas, this does not mean that they are all 'waste products'.  
  
In fact, associated hydrocarbons, known as 'natural gas liquids' (NGLs) can be very valuable by-products of natural gas processing. NGLs include ethane, propane, butane, iso-butane, and natural gasoline. These NGLs are sold separately and have a variety of different uses; including enhancing oil recovery in oil wells, providing raw materials for oil refineries or petrochemical plants, and as sources of energy.  
  
**Natural Gas Liquid Fractionation**  
  
Once NGLs have been removed from the natural gas stream, they must be broken down into their base components to be useful. That is, the mixed stream of different NGLs must be separated out. The process used to accomplish this task is called fractionation. Fractionation works based on the different boiling points of the different hydrocarbons in the NGL stream. Essentially, fractionation occurs in stages consisting of the boiling off of hydrocarbons one by one. The name of a particular fractionator gives an idea as to its purpose, as it is conventionally named for the hydrocarbon that is boiled off. The entire fractionation process is broken down into steps, starting with the removal of the lighter NGLs from the stream. The particular fractionators are used in the following order:

· **Deethanizer** - this step separates the ethane from the NGL stream.  
· **Depropanizer** - the next step separates the propane.  
· **Debutanizer** - this step boils off the butanes, leaving the pentanes and heavier hydrocarbons in the NGL stream.  
· **Butane Splitter or Deisobutanizer**- this step separates the iso and normal butanes.

By proceeding from the lightest hydrocarbons to the heaviest, it is possible to separate the different NGLs reasonably easily.

The Williams Company web site *(www.williams.com)* also discusses natural gas transportation and storage operations:

**Transportation & Storage**  
  
Interstate natural gas pipelines are transportation companies, like railroads or trucking companies. They do not own the commodity they carry in their pipelines or store in their underground facilities. Their job is to move natural gas from producing areas to market areas under contract to gas buyers. Buyers such as local gas distribution companies and marketers resell the natural gas to their customers. Others transport directly to industrial and electric generation facilities. The Federal Energy Regulatory Commission (FERC) sets transportation and storage rates charged by pipeline companies; however, FERC requires pipelines to operate "open access" systems that allow any shipper to request gas transportation on any pipeline.  
  
Williams transports approximately 12 percent of the natural gas consumed in the United States.  
  
**What is a compressor station?**  
  
Compressor stations, sometimes called pumping stations, are the "engine" that powers an interstate natural gas pipeline. As the name implies, the compressor station compresses the natural gas, (increasing its pressure) to push the gas through the pipeline.  
  
Pipeline companies install compressor stations along their pipelines, typically one every 40 to 100 miles. The size and the number of compressors varies, based on the diameter of the pipe and the volume of gas to be moved. Nevertheless, the basic components of a station are similar.  
  
When the natural gas enters the compressor station, it flows through separators used to remove solids and liquids from the natural gas in the pipeline. These separators are provided mainly to protect the compressor from any small debris that has gotten into the pipeline during construction and water from integrity testing. It should be noted that except for the small amount of debris and liquids captured to protect the compressors, and the natural gas needed to run the compressor station, all the natural gas that enters a compressor station leaves it again through the pipeline.  
  
After going through the separators the natural gas is then compressed by a centrifugal or reciprocating compressor.  
  
Simplistically a centrifugal compressor works like a fan, each fan is called an impeller and there may be one or several impellers in series depending on how much pressure is needed. A reciprocating compressor on the other hand is made up of one or several pistons configured much like an engine block. Deciding between which type of compressor to use is based on the flowrate through the compressor as well as the amount of pressure that is needed.  
  
The compressor is driven by either a gas turbine, electric motor, or reciprocating engine.  
  
A gas turbine is very similar to a jet engine found on an airplane except that instead of using the thrust to push the airplane, the jet turns a large fan to spin or rotate the compressor. An electric motor is a larger version of the electric motors you see every day just as the reciprocating engine is similar to your car engine just larger. The gas turbine and reciprocating engines typically use natural gas from the pipeline, where the electric motor uses power from an electric transmission line.  
  
Selection of this piece of equipment is based on air quality, available power, and the type of compressor selected. Typically electric motors are used when air quality is an issue. Gas turbines are used when electric power is not readily available. Reciprocating engines are used when smaller compressors are needed.  
  
Most compressor stations are automated so that the compressors can be started, controlled and stopped from a central control location regardless of the weather conditions, time of day, or day of the week. The automation system also acts to protect the equipment, facility, and surrounding area in the event that the equipment is not operating as it was intended. The operators of the system continuously monitor and adjust the mix of compressors that are running to maximize efficiency as well as keeping detailed operating data on each compressor station. The control center also can remotely operate shut-off valves along the pipeline system.

NaturalGas.org (www.naturalgas.org) explains compressor station operations:

In addition to compressing natural gas, compressor stations also usually contain some type of liquid separator, much like the ones used to dehydrate natural gas during its processing. Usually, these separators consist of scrubbers and filters that capture any liquids or other undesirable particles from the natural gas in the pipeline. Although natural gas in pipelines is considered 'dry' gas, it is not uncommon for a certain amount of water and hydrocarbons to condense out of the gas stream while in transit. The liquid separators at compressor stations ensure that the natural gas in the pipeline is as pure as possible, and usually filters the gas prior to compression.

NaturalGas.org also discusses the government's regulation of interstate pipelines:

Interstate pipeline companies, on the other hand, are regulated in the rates they charge, the access they offer to their pipelines, and the siting and construction of new pipelines. Similarly, local distribution companies are regulated by state utility commissions, which oversee their rates, construction issues, and ensure proper procedure exists for maintaining adequate supply to their customers.

The current regulation of transportation pipelines by the Federal Energy Regulatory Commission (FERC) has designated that interstate pipelines can serve only as transporters of natural gas. In the past, interstate pipelines acted as both a transporter of natural gas, as well as a seller of the commodity, both of which were rolled up into a bundled product and sold for one price. However, since FERC Order 636, interstate pipelines are no longer permitted to act as merchants and sell bundled products. Instead, they can only sell the transportation component, and never take ownership of the natural gas themselves. Pipelines must also now offer access to their transportation infrastructure to all other market players equally, referred to as 'open access' to the pipelines. This allows marketers, producers, LDCs, and even end users themselves to contract for transportation of their natural gas via interstate pipeline, on an equal and unbiased basis.

The Interstate Natural Gas Association of America web site *(www.ipaa.org)* explains compressor station operation:

**Compressor Stations**

The compressor station, also called a pumping station, is the "engine" that powers an interstate natural gas pipeline. As the name implies, the compressor station compresses the natural gas, (pumping up its pressure) providing energy to move the gas through the pipeline.

Pipeline companies install compressor stations along the pipeline route, typically every 40 to 100 miles. The size of the station and the number of compressors (pumps) varies, based on the diameter of the pipe and the volume of gas to be moved. Nevertheless, the basic components of a station are similar.

**Liquid Separators**

As the pipeline enters the compressor station the natural gas passes through scrubbers, strainers or filter separators. These are vessels designed to remove any free liquids or dirt particles from the gas before it enters the compressors. Though the pipeline is carrying "dry gas," some water and hydrocarbon liquids may condense out of the gas stream as the gas cools and moves through the pipeline. Any liquids that may be produced are collected and stored for sale or disposal. A piping system directs the gas from the separators to the gas compressors.

**Prime Movers**

There are three commonly used types of engines that drive the compressors and are known as "prime movers":

· Turbines driving/centrifugal compressor  
· Electric motors/driving centrifugal compressor  
· Reciprocating engines driving reciprocating compressors

**Local Distribution**  
  
If you have gas service in your home, your meter reader works for a local distribution company (LDC). LDCs contract for gas supplies and for interstate pipeline transportation to bring natural gas to their own "city gates," where they deliver gas to homes, businesses and industrial plants served by their own distribution pipelines. State public service authorities regulate these distribution companies and their sales.

**II. KANSAS SALES AND USE TAX: Sales tax treatment of natural gas operations under the Kansas law.**  
  
Sales of construction materials that are used to build, maintain, and repair pipelines in Kansas are subject to Kansas sales and use tax. So is machinery and equipment that is part of a pipeline or that is located at a pipeline compressor facility. Taxation of these sales was upheld by the Kansas Supreme Court nearly sixty years ago in *Natural Gas Pipeline Co. v. Commissioner of Revenue & Taxation*, 163 Kan. 458, 460, 183 P.2d 234 (1947)*("That plaintiff has exercised and will exercise, within the state of Kansas the privilege of using, storing or consuming articles of tangible personal property . . . of the following descriptions; transmission pipeline of various dimensions, casing, flanges, coupling, headers, tees, valves, compressor engines, generators, meters, regulators, tanks, separators, pumps, motors, oilers, structural and building materials, piping for water system, water well equipment, telephone wire, poles, cross-irons and appurtenances, radios, aerials and appurtenances, miscellaneous materials and supplies, and sundry equipment and machinery pertinent to the operation of an integrated interstate natural gas pipeline system; all of which articles were brought into the state of Kansas with the design and purpose of incorporating the same into the transportation system owned by plaintiff as an integral part thereof, by way of repair, maintenance, construction, reconstruction, replacement, addition or extension thereto as a necessary incident and requirement for the operation thereof.")*  
  
Kansas taxes labor services performed to install new pipelines and pipeline equipment. *K.S.A. 2005 Supp. 79-3603(p).* Also taxed are the services of maintaining, repairing, servicing, and altering pipelines and pipeline equipment. *K.S.A. 2005 Supp. 79-3603(q).* While Kansas statutes except the original construction of a building or a statutorily-defined "facility" from the labor services tax, the exception for a "facility" does not extend to work done on pipelines, pipeline equipment, gathering systems, pipelines, compressor stations, pumping stations, or similar facilities. *See K.S.A. 2005 Supp. 79-3603(p)(3) ('[F]acility' shall mean a mill, plant, refinery, oil or gas well, water well, feedlot or any conveyance, transmission or distribution line of any cooperative, nonprofit, membership corporation organized under or subject to the provisions of K.S.A. 17-4601 et seq.*[the electric cooperative act]*, and amendments thereto, or of any municipal or quasi-municipal corporation, including the land improvements immediately surrounding such facility . . . .); see also K.S.A. 2005 Supp. 79-3606(kk)(3); K.S.A. 2005 Supp. 79-3606(kk)(5)(C).*  
  
The Kansas exemptions for manufacturing machinery and equipment have never extended to sales of pipeline materials or equipment, or to services performed on pipeline or pipeline equipment. *1988 House Bill 2626 at 1988 Kan. Sess. Laws Ch. 386 (The exemption does not include "transportation equipment . . . not used at the plant or facility."; 2000 House Bill 2011 at 2000 Kansas Sess. Laws Ch. 123; see e.g. 1988 Kan. Sess. Laws Ch. 386, Section 3(mm)(1)(D) and 3(mm)(3)(C); K.S.A. 2005 Supp. 79-3606(kk)(3); K.S.A. 2005 Supp. 79-3606(kk)(5)(C).*The current manufacturing exemption is intended to benefit businesses that build and operate what are "commonly regarded by the general public as an industrial manufacturing or processing operation.” *K.S.A. 2005 Supp. 79-3606(kk).* Kansans understand that gathering systems and other pipelines are built and primarily operated for the purpose of transporting natural gas, natural gas liquids, and other petroleum products, and are not operated as manufacturing or processing businesses.  
  
Interstate transmission pipelines are regulated as common carriers. *(See www.naturalgas.org quoted above --- "The current regulation of transportation pipelines by the Federal Energy Regulatory Commission (FERC) has designated that interstate pipelines can serve only as transporters of natural gas."; www.williams.com quoted above --- "Interstate natural gas pipelines are transportation companies, like railroads or trucking companies. They do not own the commodity they carry in their pipelines or store in their underground facilities. Their job is to move natural gas from producing areas to market areas under contract to gas buyers. . . . The Federal Energy Regulatory Commission (FERC) sets transportation and storage rates charged by pipeline companies; however, FERC requires pipelines to operate "open access" systems that allow any shipper to request gas transportation on any pipeline.")* Like interstate pipelines, natural gas gathering systems and intrastate pipelines are built and operated to transport natural gas. While pipeline companies use separators, dehydrators, and other equipment to clean and separate liquids from the natural gas steam during its transit, the use of such equipment does not transform pipeline companies into something other than transportation companies that move natural gas from wells to consumers. *(See www.williams.com quoted above ---"When the natural gas enters the compressor station, it flows through separators used to remove solids and liquids from the natural gas in the pipeline. These separators are provided mainly to protect the compressor from any small debris that has gotten into the pipeline during construction and water from integrity testing."; www.ipaa.org "As the pipeline enters the compressor station the natural gas passes through scrubbers, strainers or filter separators. These are vessels designed to remove any free liquids or dirt particles from the gas before it enters the compressors. Though the pipeline is carrying "dry gas," some water and hydrocarbon liquids may condense out of the gas stream as the gas cools and moves through the pipeline.)*  
  
Natural gas pipelines do not become "industrial manufacturing or processing operation[s]" simply because they operate equipment that cleans and separates liquids from the natural gas stream. The provisions in (kk) that establish this include:  
  
· **K.S.A. 2005 Supp. 79-3606(kk)(2)(C): A facility used to convey or assist in conveying natural gas does not qualify as a "manufacturing or processing plant or facility."**K.S.A. 2005 Supp. 79-3606(kk)(2)(C) provides that exempt plants or facilities “*shall not include* any facility primarily operated for the purpose of conveying or assisting in the conveyance of natural gas, electricity, oil or water.” It states:

(C) "manufacturing or processing plant or facility" means a single, fixed location owned or controlled by a manufacturing or processing business that consists of one or more structures or buildings in a contiguous area where integrated production operations are conducted to manufacture or process tangible personal property to be ultimately sold at retail. Such term shall not include any facility primarily operated for the purpose of conveying or assisting in the conveyance of natural gas, electricity, oil or water. A business may operate one or more manufacturing or processing plants or facilities at different locations to manufacture or process a single product of tangible personal property to be ultimately sold at retail. . . . *K.S.A. 2005 Supp. 79-3606(kk)(2)(C).*

Facilities that are "primarily operated for the purpose of conveying or assisting in the conveyance of natural gas" include compressor stations, gathering systems, interstate and intrastate pipelines, distribution systems, and all of the equipment that is operated as part of those facilities. *(See above www.williams.com --- "Gathering systems collect raw (unprocessed) gas at the wells and transport to processing plants or other separation and purification facilities."; www.aga.org --- "A gathering system may need one or more field compressors to move the gas to the pipeline or the processing plant. A compressor is a machine driven by an internal combustion engine or turbine that creates pressure to "push" the gas through the lines. Most compressors in the natural gas delivery system use a small amount of natural gas from their own lines as fuel.").*Because the statute directs that a pipeline or compressor station cannot qualify as a "manufacturing or processing plant or facility," the equipment located in them cannot be part of an "integrated production operation" for purposes of the exemption.  
  
Nonexempt equipment includes scrubbers, compressors, dehydration equipment, and any other equipment that is operated as part of a pipeline or compressor station. This equipment is taxable even though it removes solids and liquids from the natural gas stream. *(See above www.ngsa.org --- "The natural gas used by consumers is composed almost entirely of methane. However, natural gas found at the wellhead, although still composed primarily of methane, is by no means as pure. . . . Whatever the source of the natural gas, once separated from crude oil (if present) it commonly exists in mixtures with other hydrocarbons; principally ethane, propane, butane, and pentanes. In addition, raw natural gas contains water vapor, hydrogen sulfide (H2S), carbon dioxide, helium, nitrogen, and other compounds. . . . Natural gas processing consists of separating all of the various hydrocarbons and fluids from the pure natural gas, to produce what is known as 'pipeline quality' dry natural gas.")*  
  
· **K.S.A. 2005 Supp. 79-3606(kk)(5)(C): Machinery and equipment that provides the means of conveyance of natural gas outside a plant or facility are not an integral part of a integrated production operation.**This provision specifies that exempt integrated plant equipment does not include transmission equipment “located outside the plant or facility.” It states:

*(5) "Machinery and equipment used as an integral or essential part of an integrated production operation" shall not include: . . .*  
*(C) transportation, transmission and distribution equipment not primarily used in a production, warehousing or material handling operation* *at the plant or facility, including the means of conveyance of natural gas,* *electricity, oil or water, and equipment related thereto, located outside* *the plant or facility;*

Hundreds of miles of natural gas pipelines crisscross Kansas. These pipelines with their compressor stations provide the means for conveyance of natural gas. Pipeline compressor stations contain machinery and equipment that is used to clean and transports natural gas. Even though some of the equipment may be considered "processing equipment," K.S.A. 2005 Supp. 79-3606(kk)(5)(C)directs that such equipment cannot be considered to be part of an "integrated production operation." Because the statute directs that this equipment cannot used as part of an "integrated production operation," these compressor stations cannot be considered to be a stand-alone "manufacturing or processing plant or facility." *See also above discussion of K.S.A. 2005 Supp. 79-3606(kk)(2)(C).* To be exempt, processing equipment must be: (1) used as part of an integrated production operation, which is; (2) located at a manufacturing plant of facility. *K.S.A.2005 Supp. 79-3606(kk)(1(A).* The statute was written so that processing and transportation equipment in a compressor station or pipeline cannot meet either requirement.  
  
· **K.S.A. 2005 Supp. 79-3606(kk)(3)(I): Transportation equipment is exempt only if it is located at a "manufacturing or processing plant or facility."**K.S.A. 2005 Supp. 79-3606(kk)(3)(I)limits exemption for transportation equipment to equipment that is used in “handling operation[s] at the plant or facility.” K.S.A. 2005 Supp. 79-3606(kk)(3)(B) and K.S.A. 2005 Supp. 79-3606(kk)(3)(I) provides:

(3) For purposes of this subsection, machinery and equipment shall be deemed to be used as an integral or essential part of an integrated production operation when used: . . .  
  
(B) to transport, convey, handle or store the property undergoing manufacturing or processing at any point from the beginning of the production line through any warehousing or distribution operation of the final product that occurs at the plant or facility. . . .

and:

(I) to transmit or transport electricity, coke, gas, water, steam or similar substances used in production operations from the point of generation, if produced by the manufacturer or processor at the plant site, to that manufacturer's production operation; or, if purchased or delivered from offsite, from the point where the substance enters the site of the plant or facility to that manufacturer's production operations;

Under these provisions, transportation equipment is exempt only when it is located at a manufacturing or processing plant and used as part of an integrated production operation. Transportation equipment used in pipelines include compressors. These compressors are located in compressor stations, which K.S.A. 2005 Supp. 79-3606(kk)(5)(C) instructs do not qualify as "manufacturing or processing plant[s] or facilit[ies]" because they are "primarily operated for the purpose of conveying . . . natural gas." *See also above discussion of K.S.A. 2005 Supp. 79-3606(kk)(5)(C).* Because the statute excludes compressor stations from qualifying as manufacturing or processing plants, a compressor at such a station is not transportation equipment that is being used at a qualifying "plant or facility" in an "integrated production operation." Because compression stations are not "manufacturing or processing plants" that contain "integrated production operations," none of the equipment located in them can qualify for exemption under (kk), including compressors, scrubbers, dehydrators and other equipment.  
  
When construing how statutes apply, the intent of the legislature governs when that intent can be ascertained from the statute. *State v. Walbridge, 248 Kan. 65, 68, 805 P.2d 15 (1991).* Words used in a statute are given their ordinary and common meaning and are presumed to have been consciously chosen and intentionally used, with the legislature having meant what they said. *State Dept. of SRS v. Public Employee Relations Board, 249 Kan. 163, 168, 815 P.2d 66 (1991)*. When the legislature directed that (kk) does not extend to "any facility primarily operated for the purpose of conveying or assisting in the conveyance of natural gas," the legislature was instructing that gathering systems, pipelines, distribution lines, compressor stations, and other related equipment cannot qualify for the exemption extended at (kk). Similarly, when the legislature directed that "machinery and equipment used . . . . as part of an integrated production operation" does not include "transportation, transmission and distribution equipment . . . including the means of conveyance of natural gas . . . located outside the plant," the legislature was instructing that machinery and equipment that are located in gathering systems, pipelines, distribution lines, and compressor stations cannot qualify as integrated production equipment for purposes of the exemption.  
  
The Kansas legislature's use of redundant language in K.S.A. 2005 Supp. 79-3606(kk)(2)(C), K.S.A. 2005 Supp. 79-3606(kk)(3)(B), and K.S.A. 2005 Supp. 79-3606(kk)(3)(I) emphasizes that it did not intend to exempt either the sales of materials or equipment that make up gathering systems, pipelines, distribution systems, compressor stations, or the charges for labor services performed to construct, service, repair, or maintain a such facilities. The Kansas legislature's approach in this area is not unique. Other states have recognized that natural gas pipelines operate to transport natural gas and do not operate as manufacturers. *See e.g. Oklahoma Tax Commission No. 2001-12-19-002 (Precedential) December 19, 2001; Oklahoma Tax Commission No. 2000-05-03-116 (Precedential) May 3, 2000; McWood Corp. v. Porterfied, Ohio Board of Tax Appeals, No. 64452 (August 2, 1967).*  
  
Although they arrive at the same conclusion by different reasoning, both FERK and Oklahoma recognize that the dehydration and condensate removal processes that take place in and along the taxpayer's gathering system are not "processing" under their laws.

13. The Federal Energy Regulatory Commission ("FERC") recognizes the function of gathering systems as a step *between* production and processing. *See, Duke Energy Natural Gas Corp. v. C.I.R.,* 172 F.3d 1255, 1262 (10th Cir. 1999). Also persuasive is the case of *Western Gas Resources, Inc. v. Heitkamp,* 489 N.W. 2d 869 (N.D. 1992), *cert. denied,* 507 U. S. 920 (1993). In that case, the question was whether the condensate recovered from the dehydration and compression processes in and along the taxpayer's gathering system, which led to taxpayer's gas was subject to an extraction tax on liquid hydrocarbons produced prior to processing at a gas plant, or could be deemed recovered at the plant and therefore not subject to the tax. There, as here, the taxpayer argued that its processing plant included and began at the head of the gathering system. Noting the definition of "processing" set forth in Williams & Meyers, *supra,* the court rejected that argument and held that "a reasoning mind could reasonably conclude that [taxpayer's] plant began at the inlet receiver" of the plant, and did not include the gathering system. *Id.* at 874. *Oklahoma Tax Commission No. 2000-05-03-116 (Precedential) May 3, 2000.*

**III. EXEMPTION: What natural gas operations does K.S.A. 2005 Supp. 79-3607(kk) exempt, if any?**  
  
K.S.A. 2005 Supp. 79-3606(kk) directs that the integrated plant exemption does not extend to machinery and equipment located in "any facility primarily operated for the purpose of conveying or assisting in the conveyance of natural gas." However, the exemption does exempt: (1) operations "at [a] . . . gas well . . . where the . . . gas . . . that has been extracted from the earth is cleaned, separated . . . or otherwise treated or prepared before its transmission to a refinery."; or (2) a "petroleum refining" plant. *K.S.A. 2005 Supp. 79-3606(2)(d)*. "Petroleum refining" means the cracking, distillation, separation, conversion, upgrading, and finishing of refined petroleum or petroleum products. *40 CFR Sec. 280.200.*  
  
To implement these provisions in a practical way, cleaning or separation equipment located "at [a] . . . gas well" begins with the first scrubber, strainer, filter separator, or otherequipment that is located at a well site and accepts natural gas from the well. The equipment that caps the well and leads up to the first scrubber of other equipment is taxable. The last piece of exempt equipment is equipment located at the same site that contains the output pipe that feeds the natural gas into a feeder or gathering line. "At the same site" means that the equipment is next to or near the other equipment. The reasons why the equipment in a gathering lines or compressor station that cleans and removes liquids from the natural gas steam is not exempt has been discussed in Subsection II, above. This position is supported by the Oklahoma Tax Commission discussion quoted above at the end of section II. *Oklahoma Tax Commission No. 2000-05-03-116 (Precedential) May 3, 2000.*As the Oklahoma discussion recognizes a gathering systems functions as a step *between* production and processing.  
  
For purposes of K.S.A. 79-3606(kk), the term "petroleum refining" plant includes natural gas liquid factionation plants. A "natural gas liquid factionation plant" lies between the gathering system and the interstate or intrastate pipelines. Such plants engage in the factionation of mixed natural gas liquids into natural gas products. These plants are generally classified as North 3American Industrial Classification System (NAICS) code 211112. The exemption extends to any equipment at the natural gas liquid factionation facility that separates natural gas liquids from the gas stream. The term does not include a compressor station along a natural gas gathering system or other pipeline, or dehydration units, heater treaters, sweetening units, or other equipment that is not physically located at the natural liquid gas fractionation plant or at the well site area.  
  
Products obtained at natural gas liquid factionation plants include ethane, liquefied petroleum gases (propane, butane and propane-butane mixtures), isopentane, natural gasoline, plant condensate and other minor quantities of finished products such as motor gasoline, special naphthas, jet fuel, kerosene and distillate fuel oil. Natural gas liquid factionation plant are often part of a lager complex that can includes other processes such as hydrocarbon extraction plant, ethane extraction plant, helium extraction plant, butane isomerization unit, and so forth. When equipment is part of such a complex, all of the equipment would qualify for exemption even though they may perform the same processing that is done at a compressor station.  
  
As has been discussed, the exemption at (kk) does not extend to compressor stations that are equipped with liquid separators that separates natural gas liquids from the gas stream. While separating natural gas liquids from the gas stream may be considered to be "processing," compressor stations are "primarily operated for the purpose of conveying or assisting in the conveyance of natural gas." *K.S.A. 2005 Supp. 79-3606(kk)(2)(C).* The Interstate Natural Gas Association of America web site shows that it is common for compressor stations to remove some liquid natural gas from the gas stream.

**Liquid Separators**

As the pipeline enters the compressor station the natural gas passes through scrubbers, strainers or filter separators. These are vessels designed to remove any free liquids or dirt particles from the gas before it enters the compressors. Though the pipeline is carrying "dry gas," some water and hydrocarbon liquids may condense out of the gas stream as the gas cools and moves through the pipeline. Any liquids that may be produced are collected and stored for sale or disposal. A piping system directs the gas from the separators to the gas compressors. *www.ipaa.org quoted above.*

So does the NaturalGas.org (www.naturalgas.org) web site:

In addition to compressing natural gas, compressor stations also usually contain some type of liquid separator, much like the ones used to dehydrate natural gas during its processing. Usually, these separators consist of scrubbers and filters that capture any liquids or other undesirable particles from the natural gas in the pipeline. Although natural gas in pipelines is considered 'dry' gas, it is not uncommon for a certain amount of water and hydrocarbons to condense out of the gas stream while in transit. The liquid separators at compressor stations ensure that the natural gas in the pipeline is as pure as possible, and usually filters the gas prior to compression.

As discussed above, a compressor station that is equipped to separate natural gas liquids from the gas stream is not a "manufacturing or processing plant or facility" for purposes of K.S.A. 2005 Supp. 79-3606(kk). Even though these stations may remove natural gas liquids from the gas stream, they are "primarily operated for the purpose of conveying or assisting in the conveyance of natural gas." *K.S.A. 2005 Supp. 79-3606(kk)(2)(C).*  
  
Some of the industry definitions of "gas processing plant" may be inconsistent with the department's policy of limiting exemption under K.S.A. 79-3606(kk) to facilities that fractionate liquid natural gas. For example, industry definitions of "gas processing plant" may include compressor stations that separate natural gas liquids from the gas stream. These compressor stations do not qualify for exemption under the statute because compressor stations are "primarily operated for the purpose of conveying or assisting in conveying of natural gas." *K.S.A. 2005 Supp. 79-3606(kk)(2)(C).* It is not unusual for statutory definitions and industry definition not to be identical.  
  
**IV. YOUR SPECIFIC QUESTIONS.**  
  
Your letter identifies the equipment that the XXXX want the department to rule is exempt under K.S.A. 2005 Supp. 79-3606(kk):

The natural gas we produce from our wells enters a scrubber integrated with compression located at the well site. The scrubber removes impurities such as ferrous and silicone based compounds and particles as well as water and liquid hydrocarbons before entering a compressor. The gas then enters the suction side of the compressor (keeping in mind that the scrubber and compressor are an integral unit) where it is compressed and is moved though gathering lines to our smaller booster stations. . . . The next stage in the process is getting the gas to the central compressor station. The gathering system is used to gather gas produce from several well and/or areas and deliver it to various distribution points such as the processing plant or sales pipeline. The gas is sent though network of plastic and steel pipes that are connected to each well. Along these lines, we have about 60 booster stations (see enclosed pictures of small booster stations such as XXXX, XXXX, XXXX) in Kansas that "boost" or compress the gas from one station to the next to move it down the line. Also, the pressure must be raised to deliver the gas into third party transportation lines. Most gas processing plant inlets and most sales pipelines must be raised to deliver the gas into third party transporter lines. Most gas processing plant inlets and most sales pipelines flow at high pressures, so the gas must be compressed to a higher pressure in order to enter them. Some of these stations have only compressors (all with scrubbers) and some have the compressors (all with scrubbers) and dehydration units as well. The dehydrators remove water vapors from the gas. Gas dehydration is needed to prevent water condensation which could lead to corrosion and free-water accumulation in the low points of a pipeline . . . The delivery point is where our company, XXXX as gatherer, deliver the product to a third party transporter's pipeline, to the inlet of a gas processing plant, or to other customers along the gathering system. . . . The branches of the gathering system lead to our smaller booster stations as mentioned above, then to our larger booster stations such as XXXX, XXXX, XXXX, and XXXX Stations (see enclose pictures) and then to our XXXX plant (also see enclosed pictures). Our XXXX plant is the last step in the process before the gas goes into the third party transporter's pipelines. The gas will then be sent to the third party gas processing plant and either sold at the tailgate of those plants or sent back to our third party transporter's pipelines for further transport."

Other than any equipment that might be located at the well site, all of the facilities you describe are "primarily operated for the purpose of conveying or assisting in the conveyance of natural gas." *K.S.A. 2005 Supp. 79-3606(kk)(2)(C).* The equipment that you argue is exempt is either the equipment or "equipment related thereto" that provides the "means of conveyance of natural gas."  
  
In your letter you state: "Our XXXX plant is the last step in the process before the gas goes into the third party transporter pipelines. The gas will then be sent to the third party gas processing plants. . . ." Presumably you mean a natural gas liquid fractionation plant.  
  
XXXX operates a gathering system with "60 booster stations." For purposes of K.S.A. 2005 Supp. 79-3606(kk), XXXX does not operate 60 separate "integrated production plants" that are linked together by its pipeline. As your letter acknowledges, XXXX operates its gathering systems to deliver natural gas to "the third party gas processing plant[s]." Accordingly, the sale and servicing of all of the equipment that you describe in your letter is taxable under the Kansas sales and use tax statutes, except for the equipment that is located at the well sites and meets the various requirements for exemption discussed in Subsection III.  
  
This is a private letter ruling pursuant to K.A.R. 92-19-59. It is based solely on the facts provided in your request. If it is determined that undisclosed facts were material or necessary to an accurate determination by the department, this ruling is null and void. This ruling will be revoked in the future by the operation of law without further department action if there is a change in the statutes, administrative regulations, or case law, or published revenue ruling, that materially effects this private letter ruling.

Sincerely,  
  
  
  
Thomas E. Hatten  
Attorney/Policy & Research

**Date Composed: 10/17/2005 Date Modified: 10/17/2005**