



Ottawa, Monday, December 4, 1989

Appeal No. 2984

IN THE MATTER OF an application heard
May 17, 1989, pursuant to section 51.19 of the
Excise Tax Act, R.S.C. 1970, c. E-13, as amended;

AND IN THE MATTER OF a Notice of Decision
of the Minister of National Revenue dated
January 8, 1988, with respect to a Notice of
Objection filed pursuant to section 51.17 of the
Excise Tax Act.

BETWEEN

ESSO RESOURCES CANADA LIMITED

Appellant

AND

THE MINISTER OF NATIONAL REVENUE

Respondent

DECISION OF THE TRIBUNAL

The appeal is dismissed. The Tribunal declares that the appellant is not entitled to a refund under subparagraph 1(a)(i), Part XIII, Schedule III of the *Excise Tax Act* for federal sales tax paid for pipes, valves, fittings and other associated equipment used in the assembly of natural gas fuel pipelines located on the appellant's leased property.

Kathleen Macmillan

Kathleen Macmillan
Presiding Member

Sidney A. Fraleigh

Sidney A. Fraleigh
Member

W. Roy Hines

W. Roy Hines
Member

Robert J. Martin

Robert J. Martin
Secretary

UNOFFICIAL SUMMARY

Appeal No. 2984

ESSO RESOURCES CANADA LIMITED

Appellant

and

THE MINISTER OF NATIONAL REVENUE

Respondent

Excise Tax Act - Whether pipelines, valves, fittings and other associated equipment are used directly in the production of heavy oil - Whether sales tax exempt pursuant to subparagraph 1(a)(i), Part XIII, Schedule III of the Excise Tax Act.

DECISION: *The appeal is dismissed. Dictionary definitions of the word "directly," when interpreted within the context of the exemption clause, indicate that, in order for machinery or apparatus to fall within subparagraph 1(a)(i), Part XIII, Schedule III of the Excise Tax Act, there must be a close connection or link between the machinery or apparatus used in the production of goods and the process from which the goods are produced. Although the pipelines are used in the production of bitumen, the Tribunal considers that their nexus with or connection to the production process is more accurately and precisely defined as providing the infrastructural support that will enable specific types of machinery or apparatus to be directly used in the production of saleable bitumen.*

Place of Hearing: Calgary, Alberta
Date of Hearing: May 17, 1989
Date of Decision: December 4, 1989

Panel Members: Kathleen Macmillan, Presiding Member
Sidney A. Fraleigh, Member
W. Roy Hines, Member

Counsel for the Tribunal: Clifford Sosnow
Clerk of the Tribunal: Lillian Pharand

Appearances: Peter L. Miller, for the appellant
Peter C. Engelmann, for the respondent

Cases Cited: *Amerada Minerals Corporation of Canada Ltd. v. The Deputy Minister of National Revenue (Customs and Excise), 9 T.B.R. 106; Amoco Canada Petroleum Company Ltd. v. The Deputy Minister of National Revenue (Customs and Excise), 6 T.B.R. 386; 8 T.B.R. 696, affirmed 13 C.E.R. 102 (F.C.A.); Foundation-Comstock v. The Deputy Minister of National Revenue (Customs and Excise), 5*

T.B.R. 32, affirmed 5 T.B.R. 39 (Exch. Ct.); Horton CBI Limited v. The Deputy Minister of National Revenue (Customs and Excise) 6 T.B.R. 415; I-XL Industries Ltd. v. The Deputy Minister of National Revenue (Customs and Excise), 6 T.B.R. 106; Petro-Canada Inc. v. The Deputy Minister of National Revenue (Customs and Excise), 9 C.E.R. 121; Steetley of Canada (Holdings) Limited v. The Deputy Minister of National Revenue (Customs and Excise), 6 T.B.R. 30.

Statutes Cited:

Canadian International Trade Tribunal Act, S.C. 1988, c. 56, subs. 54(2) and s. 60; Excise Tax Act, R.S.C. 1970, c. E-13, subss. 27(1) and 29(1), and subparagraph 1(a)(i), Part XIII, Schedule III.

Appeal No. 2984

ESSO RESOURCES CANADA LIMITED

Appellant

and

THE MINISTER OF NATIONAL REVENUE

Respondent

TRIBUNAL: KATHLEEN MACMILLAN, Presiding Member
SIDNEY A. FRALEIGH, Member
W. ROY HINES, Member

REASONS FOR DECISION

SUMMARY

The appellant is engaged in the exploration, development and production of heavy oil (bitumen). The appellant recovers heavy oil by the application of high temperature steam to the oil in the reservoir, thereby softening it sufficiently to enable it to flow and be recovered. Natural gas is used as a fuel to heat water in steam generators. The resulting steam is then injected into the heavy oil bearing reservoir. The appellant purchased pipes, valves, fittings and other associated equipment for use in the assembly of pipelines which deliver the natural gas to the steam generators.

The issue in this appeal is whether the pipelines, valves, fittings and other associated equipment are used directly in the production of heavy oil. If so, then they are sales tax exempt pursuant to subparagraph 1(a)(i), Part XIII, Schedule III of the *Excise Tax Act*¹ (the Act).

The appeal is not allowed. Dictionary definitions of the word "directly," when interpreted within the context of the exemption clause, indicate that in order for machinery or apparatus to fall within subparagraph 1(a)(i), Part XIII, Schedule III of the Act, there must be a close connection or link between the machinery or apparatus used in the production of goods and the process from which the goods are produced. Although the pipelines are used in the production of bitumen, the Tribunal considers that their nexus with or connection to the production process is more accurately and precisely defined as providing the infrastructural support that will enable other machinery or apparatus to be directly used in the production of saleable bitumen.

1. R.S.C. 1970, c. E-13; now R.S.C. 1985, c. E-15.

THE LEGISLATION

The relevant legislative provisions, as they read during the assessment period, are as follows:

27(1)² There shall be imposed, levied and collected a consumption or sales tax ... on the sale price of all goods

(a) produced or manufactured in Canada

...

29(1)³ The tax imposed by section 27 does not apply to the sale or importation of the goods mentioned in Schedule III ...

SCHEDULE III

PART XIII

PRODUCTION EQUIPMENT, PROCESSING MATERIALS AND PLANS

1. All the following:

(a) machinery and apparatus sold to or imported by manufacturers or producers for use by them primarily and directly in

(i) the manufacture or production of goods ...

Although the appeal was originally commenced before the Tariff Board, the appeal is taken up and continued by the Canadian International Trade Tribunal (the Tribunal) in accordance with subsection 54(2) and section 60 of the *Canadian International Trade Tribunal Act*.⁴

THE FACTS

The appellant, Esso Resources Canada Limited (Esso), is a wholly owned subsidiary of Imperial Oil Limited. It is a licensed manufacturer engaged in exploration, development and production of petroleum, natural gas, other hydrocarbons and mineral properties.

The appellant purchased pipes, valves, fittings and other associated equipment for use in the assembly of natural gas fuel pipelines. The pipelines are used in its heavy oil (bitumen) extraction operations located in a leased area on the Alberta/Saskatchewan border, near Cold Lake, Alberta.

2. Ibid., subs. 50(1).

3. Ibid., subs. 51(1).

4. S.C. 1988, c. 56.

On March 3, 1987, by Notice of Assessment No. CAL 0786, Esso was assessed sales tax in respect of these purchases. The assessment covered the period between July 1, 1984, and September 30, 1986. Esso filed a Notice of Objection to the assessment on May 14, 1987, claiming that it used such equipment directly in the production of oil. Thus, it said, the purchases should be sales tax exempt pursuant to subparagraph 1(a)(i), Part XIII, Schedule III of the Act (hereinafter the exemption clause). However, the Minister of National Revenue (the Minister) issued a Notice of Decision (70094AE) on January 8, 1988, which confirmed the original assessment. The appellant then filed an appeal to the Tariff Board on March 31, 1988.

Mr. Brian Fowler, a civil technologist and civil engineer employed by Esso as a senior staff facilities engineer, appeared as a witness for the appellant. Mr. Fowler explained, in detail, the processes involved in the extraction of heavy oil and described the plant site and facilities.

Normally, the bitumen which is found in a heavy oil reservoir will not flow unless special recovery techniques are used to raise the temperature of the heavy oil in order to reduce its viscosity. The appellant employs a cyclic steam method at its Cold Lake operations. This involves the injection of high-temperature steam into the reservoir, which softens the bitumen sufficiently to make recovery possible.

To that end, water is heated in massive steam generators at each of four plant sites - they are called Mahihkan, Maskwa, Leming and May - located on the appellant's premises. The generators create high-pressure, high-temperature steam which is moved through pipelines to various wells on the appellant's leased property. The steam is injected into the wells and ultimately comes into direct contact with the bitumen in the oil-bearing reservoir.

When the oil is recovered, it is sent to one of the plant sites where water is removed from the bitumen (the water is due to the condensation of the steam). The water is treated to remove trace amounts of oil and then made available for further use in steam generation.

Although most of the water used is recovered and recycled, a certain amount of fresh water is required to be added to the steam generators. This is done by Esso pipelines which connect a pumping station at Cold Lake to the various plant sites.

The bitumen is further treated to remove any gas that it might contain, diluted to decrease its viscosity and put into a pipeline owned by the Alberta Energy Corporation.

Natural gas is used as a fuel to heat the water in the steam generators. The gas is ignited at the steam generators and the resulting heat is transferred to the water, thereby creating steam. When questioned, the witness said that the natural gas never comes into contact with the bitumen.

Mr. Fowler said that the extreme viscosity of the heavy oil means that steam production is essential and integral to the appellant's heavy oil operations.

Steam generation cannot occur without fuel to heat water and cause it to turn to steam. The appellant has chosen to use natural gas as the fuel although other types of fuel, such as butane, propane or naphtha, could be used. Regardless of the fuel used, pipelines are the only practical means of delivering the gas to the steam generators.

The natural gas is supplied by two companies, Nova and World Wide Energy, through their own pipelines to custody transfer points located on Esso's leased premises, at a distance from the steam-generating facilities.

The custody transfer points consist of a meter, which is owned by the supplier and which records the amount of natural gas that is being supplied to the appellant, and a pressure reduction facility, which reduces the pressure of the incoming natural gas as it crosses the custody transfer points.

The reduction in pressure at the custody transfer points is the only change that is made to the natural gas from the time that it enters the suppliers' pipelines to its combustion in the appellant's steam generators.

From these custody transfer points, the appellant has assembled its own natural gas pipelines to deliver the natural gas to the steam generators.

The pipes, valves, fittings and other associated equipment that are the subject of this appeal have been incorporated by the appellant into the assembly of the following natural gas pipelines:

- (a) a pipeline of approximately 250 m in length running from the Nova pipeline custody transfer point to the steam generators at the appellant's Maskwa plant site;
- (b) a pipeline of approximately 4.5 km in length running from the same custody transfer point to the steam generators at the appellant's Leming plant site; and
- (c) a pipeline of approximately 500 m in length, running from the World Wide Energy pipeline custody transfer point to the steam generators at the appellant's May plant site.

A fourth pipeline built by the appellant is approximately 20 m in length and runs from a second Nova pipeline custody transfer point to the steam generators at the appellant's Mahihkan plant. The equipment that was used to construct this line is not being considered in this appeal.

Nova and World Wide Energy could have built their supply pipelines closer to each plant site (thereby reducing the length of the appellant's pipelines), but the appellant chose the location of the custody transfer points after considering factors such as rights of way, new plant site construction and economic concerns.

THE ISSUE

The issue in this appeal is whether the pipelines, valves, fittings and other associated equipment are used directly in the production of heavy oil. If so, then they are sales tax exempt pursuant to the exemption clause.

The primary focus of the appellant's argument was that the equipment in issue is used directly in the production of heavy oil because it is an integral and essential part of the production process.

The appellant cited several Tariff Board decisions as authority for this proposition: *I-XL Industries Ltd. v. The Deputy Minister of National Revenue (Customs and Excise)*;⁵ *Stetley of Canada (Holdings) Limited v. The Deputy Minister of National Revenue (Customs and Excise)*;⁶ *Horton CBI Limited v. The Deputy Minister of National Revenue (Customs and Excise)*.⁷

The appellant argued that production of heavy oil could not occur without the production of steam. The appellant's natural gas fuel pipelines are indispensable in feeding gas to fuel the steam-generating facilities which produce steam for subsequent injection. If the fuel supply pipelines are removed, the appellant's bitumen extraction facility will completely cease to operate. Therefore, the fuel lines and, consequently, the equipment needed for their assembly are used directly in the production of bitumen.

The appellant also argued that the equipment in issue was used directly in the production of heavy oil because it was used to assemble pipelines located on the appellant's production premises.

The respondent argued that the goods in issue were not used directly in the production of bitumen. The fact that the supply of fuel to the generators is essential and integral to the production process is not sufficient to exempt the pipelines and, thus, the equipment used in their assembly from federal sales tax. Rather, apparatus such as the equipment in issue is used directly in the production of heavy oil only if there is no intervening medium or agent interrupting the role of the pipelines in the production process.

Like the appellant, the respondent cited several cases as authority for this proposition: *Foundation-Comstock v. The Deputy Minister of National Revenue (Customs and Excise)*;⁸ *Amoco Canada Petroleum Company Ltd. v. The Deputy Minister of National Revenue (Customs and Excise)*;⁹ *Amerada Minerals Corporation of Canada Ltd. v. The Deputy Minister of National Revenue (Customs and Excise)*.¹⁰

The respondent argued that there was an intervening factor which interrupted the role of the fuel lines in the production process. Natural gas was carried in the pipelines to steam-generating stations, where it served as heating fuel in the steam-generating process. The steam generators were the intervening factor in the production process. They totally changed the properties of the natural gas by fully consuming it as fuel.

5. 6 T.B.R. 106.

6. 6 T.B.R. 30.

7. 6 T.B.R. 415.

8. 5 T.B.R. 32; *affirmed* 5 T.B.R. 39 (Exch. Ct.).

9. Amoco Canada Petroleum Company Ltd. and the Deputy Minister of National Revenue (Customs and Excise) have been involved in two different appeals before the Tariff Board. The first is reported in 6 T.B.R. 386, *hereinafter* Amoco No. 1. The second is reported in 8 T.B.R. 696, *affirmed* 13 C.E.R. 102 (F.C.A.), *hereinafter* Amoco No. 2.

10. 9 T.B.R. 106.

DECISION

In order for the pipes, valves, fittings, etc., to qualify for an exemption under the exemption clause, the goods must be apparatus or machinery for use primarily and directly in the production of heavy oil. The respondent accepts that the goods are apparatus for use primarily in the production of heavy oil. The Tribunal agrees. The Tribunal considers, and the focus of the testimony and argument indicate, that the central issue in this appeal is whether the pipelines, for which the appellant purchased its pipes, valves, fittings, etc., are used directly in the production of heavy oil.

After having examined the facts, the statutory language of the exemption clause and the relevant jurisprudence, the Tribunal considers that the appellant's pipelines, although used in the production of bitumen, are not directly used in the production process.

The Tribunal has examined Tariff Board jurisprudence which has been presented by both parties for guidance in construing the word "directly," as set out in the exemption clause. This case law indicates that the Tariff Board used two different tests in resolving the issue of whether the goods under consideration were directly used in the manufacturing or production process.

In older Tariff Board cases, such as those cited by the appellant, the word "directly" was defined according to the following test: machinery or apparatus are used directly in the manufacture or production of goods if they are an integral and essential part of a production or manufacturing process. They are so considered if production ceases when the machinery or apparatus are removed from the process.

More recent Tariff Board cases, such as those cited by the respondent, define the word "directly" according to a different test. According to this test, the word "directly" means "without an intervening medium or agency."

The case of Amoco No. 1 (supra) typifies the manner in which this second test has been used. In this case, the Tariff Board examined whether pipes, valves and fittings, incorporated into a pipeline system, were used directly in the production of crude oil. The pipelines were used in two types of systems: the Miscible Flood System and the Water Flood System.

In the Miscible Flood System, the pipelines were used to collect natural gas and natural gas liquids from a number of source points. These components were then transported to an injection station where they were mixed in predetermined portions and injected, alternatively with water and natural gas, into an oil-containing reservoir, to act as a solvent. In the Water Flood System, the pipelines were used to collect water from a river and transport it to an injection station, where the pressure of the incoming water was increased and subsequently injected into a reservoir.

The Tariff Board concluded that only the pipelines in the Water Flood System were used directly in the production of oil because, in the Miscible Flood System, the injection station acted as an intervening medium by controlling the type of material injected into the reservoir.

The intervening medium test has also been considered in a number of Federal Court of Appeal decisions. In the decision of *Petro-Canada Inc. v. The Deputy Minister of National Revenue (Customs and Excise)*,¹¹ the Court examined whether booster compressors, located at a custody transfer point at a crude oil operation, were used directly in the production of oil. The compressors raised the pressure of incoming natural gas destined for injection into a crude oil reservoir to act as solvent for the oil. In resolving the question, the Court made the following comments about the intervening medium test:

*I have been unable to find any higher authority than the [Tariff] Board itself for its apparent view that the presence of an "intervening medium" is conclusive of the question of direct use and express no opinion as to its validity.*¹² (emphasis added)

Subsequent to the Petro-Canada case (supra), the Federal Court of Appeal, in an appeal from the Tariff Board decision in Amoco No. 2, again examined the meaning of the word "directly" in the exemption clause. In that case, the Court considered whether pipelines, which were part of a system that gathered liquid hydrocarbon mixes from gas processing plants and transmitted the mixes to a fractionation plant, were used directly in the production of propane, butane, etc.

The Court defined the issue as follows:

... the question in this case is, what is the correct meaning of the word "directly" in the statutory provision before the court? ...

*The appellant [the Deputy Minister of National Revenue for Customs and Excise] argued that "directly" as used in the statute means "immediately or without delay". The respondent [Amoco Canada Petroleum Company Limited], on the other hand, viewed the word as meaning "without any intervening medium ..."*¹³

The Court resolved the question as follows:

*To give it [the word "directly"] the meaning espoused by the appellant would be to give it a narrow, restricted one. On the other hand, that which the respondent wishes to ascribe to it gives to it a broader meaning. I see nothing in the context of the statute in which the word "directly" is used which indicates that the narrow meaning should prevail.... [The broader] view of the meaning is objective and seems more consonant with the apparent intention of Parliament than the narrow meaning ...*¹⁴ (emphasis added)

11. 9 C.E.R. 121.

12. Ibid. at p. 124.

13. 13 C.E.R. 107-8.

14. Ibid. at p. 108.

Although the Tribunal has carefully considered the jurisprudence, it does not consider the tests helpful in resolving the present dispute. The intervening medium test has been used in several cases, but, in the Tribunal's view, those cases dealt with factual circumstances that were not similar to the present dispute. The test was not used to resolve the question of whether pipelines transporting fuel are used directly in the production process.

Although the Federal Court of Appeal has stated that in construing the meaning of the word "directly," the phrase "without any intervening medium" is more consonant with the apparent intention of Parliament than the phrase "immediate or without delay," the Tribunal does not consider that this pronouncement prevents it from construing the word "directly" in another manner which might be more helpful in resolving a set of circumstances different from those before the Court.

With respect to the test developed in older Tariff Board cases, the Tribunal does not consider that the word "directly" is synonymous with the phrase "an integral and essential part of a manufacturing process." In *Amoco No. 2*, Mr. Justice Urie of the Federal Court of Appeal provided the following guidelines in construing the meaning of the word "directly" as set out in the exemption clause.

*The Act does not define the word "directly" nor does the record disclose that any evidence was adduced as to a special meaning attributed to it in the industry. Therefore, it should be given its grammatical and ordinary meaning unless such a meaning would lead to an absurdity, repugnance or inconsistency. In determining ordinary meaning the use of dictionaries is permissible and helpful....*¹⁵ (emphasis added)

In that case, several dictionary definitions of the word "directly" were cited from well-known authorities:

Black's Law Dictionary, 5th edition:

Directly *In a direct way without anything intervening, not by secondary, but by direct, means.*

The Shorter Oxford Dictionary, 3rd edition:

Directly 1. *In a direct manner; in a straight line of motion; straight;*
3. *completely, exactly;*
4. *without the intervention of a medium; immediately; by a direct process or mode;*
5. *immediately (in time); straightway.*

Webster's Third New International Dictionary:

Directly 1. *a:without any intervening space or time: next in order: squarely, exactly; b: in a straight line: without deviation of course;*

15. *Ibid.* at p. 107.

4. a: *without any intervening agency or instrumentality or determining influence; without any intermediate step;*
6. a: *without a moment's delay; at once; immediately.*

The Living Webster Encyclopedic Dictionary:

Directly In a direct manner; in a straight line or course; immediately; instantly; soon; without delay; expressly; without circumlocution or ambiguity; following immediately in order.¹⁶

The Tribunal was not presented with any evidence to suggest that the word "directly" means "integral" or "essential" in the heavy oil extraction industry. Further, the Tribunal considers that the above-quoted dictionary definitions indicate that the ordinary and grammatical meaning of the word "directly" is not "integral" or "essential."

The Tribunal considers that the functional relationship between machinery or apparatus and the production process provides a more helpful guide in considering whether goods are directly used in the production process.

In the Tribunal's view, the above-quoted dictionary definitions of the word "directly," when interpreted within the context of the exemption clause, are useful in defining the scope of this relationship.

Keeping in mind Mr. Justice Urie's statement in Amoco No. 2, that construing the word "directly" to mean "immediate or without delay" is not consonant with Parliament's intention in drafting the exemption clause, the Tribunal considers that the dictionary definitions, taken as a whole, indicate that the word "directly" implies a close nexus or connection.

The concept of close nexus or connection is consistent with the statutory language of the exemption clause. In order to fall within the exemption clause, machinery or apparatus must be primarily and directly used in the production of goods. In other words, the machinery or apparatus must be primarily and directly used in the process that will result in a finished product.

Thus, Parliament, in defining the scope of the exemption clause, drafted the provision in a restrictive manner. Not only must the machinery or apparatus be used in the production process, their involvement in the process must be primary and direct. Indeed, Parliament's use of the word "directly" in the exemption clause implies that it does not consider every element of the production process to be directly used in the production of goods.

Because the word "directly" implies a close nexus or connection, and because Parliament has drafted the exemption clause in a restrictive manner, the Tribunal considers that in order for machinery or apparatus to fall within the exemption clause, there must be a close connection or link between the machinery or apparatus used in the production of goods and the process from which the goods are produced.

16. Ibid. at pp. 107-8.

In the Tribunal's view, the function of the appellant's fuel pipelines indicates that they are not closely connected to the process from which heavy bitumen is produced. The pipelines in issue carry a material that is completely consumed by a machine (steam generator) to provide the energy needed to convert water into steam. The pipelines do not transport raw materials from which the finished product, saleable bitumen, is to be made. The pipelines do not carry a material which, when applied to the bitumen, will bring that material one step closer to its finished state. And neither the pipelines nor the material they transport comes into contact with the goods under production.

While none of the factors cited above, by themselves, would be conclusive, taken together, they convince the Tribunal that although the pipelines are used in the production of bitumen, their nexus or connection to the production process is more accurately and precisely defined as providing the infrastructural support that will enable other machinery or apparatus to be directly used in the production of saleable bitumen.

During the course of the argument, the appellant submitted that the pipes, valves, fittings, etc., in issue were used directly in the production of heavy oil because they were used to assemble pipelines located on the appellant's production premises. However, the Tribunal does not consider that the location of machinery or apparatus in relation to the production premises, by that fact alone, is conclusive of whether the machinery or apparatus are used in the production of goods.

CONCLUSION

In view of the foregoing, the Tribunal does not consider that the pipes, valves, fittings, etc., used by the appellant in the assembly of the natural gas fuel pipelines are used directly in the production of heavy oil within the meaning of subparagraph 1(a)(i), Part XIII, Schedule III of the Act.

Accordingly, the appeal is not allowed.

Kathleen Macmillan

Kathleen Macmillan
Presiding Member

Sidney A. Fraleigh

Sidney A. Fraleigh
Member

W. Roy Hines

W. Roy Hines
Member