

**ALASKA DEPARTMENT OF REVENUE, TAX DIVISION
ADVISORY BULLETIN 2011-03**

Re: AS 43.55.025(l): Production tax credits for use of a jack-up rig to drill offshore exploration wells in Cook Inlet.

Introduction: This advisory bulletin addresses production tax credits under AS 43.55.025(l) (the jack-up rig credit). Because of the unique aspects of the jack-up rig credit, discussed below, the Department of Revenue (Department) believes there may be some confusion among producers, explorers or other interested persons about the nature of this credit. For these reasons, the Department is issuing this bulletin stating its interpretation that the jack-up rig credit is exclusive, meaning a taxpayer that obtains a credit under AS 43.55.025(l) may not obtain credit under another provision of AS 43.55.025 or AS 43.55.023 and that the provisions of the jack-up rig credit require all statutory qualifications must be met before the Department may authorize a credit under AS 43.55.025(l).

AS 43.55.025(l): In 2010 the legislature added a jack-up rig credit to AS 43.55.025, the alternative tax credit for oil and gas exploration.¹ The jack-up rig credit applies to qualified expenditures incurred after March 31, 2010 and made by “[t]he first three unaffiliated persons that drill an offshore exploration well for the purpose of discovering oil or gas in Cook Inlet . . . using a jack-up rig.” The credit may be taken against the oil and gas production tax levied under AS 43.55.011(e) or may be redeemed for cash.² The amount of credit for each qualifying exploration well is capped as follows:

The person that drills the first exploration well is entitled to a credit in the amount of 100 percent of its exploration expenditures or \$25,000,000, *whichever is less*; the person that drills the second exploration well using the same jack-up rig is entitled to a credit in the amount of 90 percent of its exploration expenditures or \$22,500,000, *whichever is less*; and the person that drills the third exploration well using the same jack-up rig is entitled to a credit in the amount of 80 percent of its exploration expenditures, or \$20,000,000, *whichever is less*.³

¹ Ch. 15, SLA 2010 (enacted as AS 43.55.025(a)(5) and (l)).

² A person to whom a transferable tax credit certificate has been issued and whose total tax liability under AS 43.55.011(e), after application of all available tax credits, is zero may apply to the oil and gas tax credit fund and receive cash for the amount of the transferable tax credit certificate. AS 43.55.028(e)(5). Other qualifications apply under AS 43.55.028.

³ AS 43.55.025(l) [emphasis supplied].

No other credit provision in AS 43.55.025 places a cap on the total *amount* of credit that may be authorized for an exploration activity. Therefore interpreting the credit cap provisions in a manner consistent with legislative intent has been an issue of first impression for the Department, and will be discussed below.

In addition to the credit caps, the jack-up rig credit has a payback provision that provides:

If the exploration well for which a credit is received under this subsection results in sustained production of oil or gas from a reservoir discovered by the exploration well . . . 50 percent of the amount of the credit received shall be repaid . . . by the person that received the credit [.]”

Any credit authorized under AS 43.55.025(*l*) is subject to this payback provision. As with the credit caps, this payback provision is unique to the jack-up rig credit.

Furthermore, the legislature clearly mandated: “A taxpayer that obtains a credit under this subsection [AS 43.55.025(*l*)] may not claim a tax credit under AS 43.55.023 or another provision in this section for the same exploration expenditure.”⁴

Thus, the jack-up rig credit contains unique aspects – credit caps, a credit payback provision, and an explicit statement of exclusivity within the subsection authorizing credit.⁵ But as with other credits in AS 43.55 a producer or explorer claiming the jack-up rig credit must meet certain statutory requirements. Specifically, the first explorer (as well as the second and third explorers) must drill an exploration well that “penetrates and evaluates a prospect in the pre-Tertiary zone” as “determined by the commissioner of natural resources and reported to the commissioner [of revenue].⁶ Since the legislature has directed that credit be authorized only if the exploration wells reach a certain target zone, the Department may not issue credit absent a determination by the Commissioner

⁴ AS 43.55.025(*l*).

⁵ Other tax credit statutes also provide that if credit is taken for an expenditure under one credit statute, credit cannot be taken under another tax credit provision. *See*, AS 43.55.023 (a)(1) (credit may be taken under this section unless a credit for that expenditure is taken under AS 38.05.180(i), AS 41.09.010, AS 43.20.043 or AS 43.55.025); AS 43.20.043(g) (a taxpayer may elect not to obtain a credit under this section in order to qualify for a credit provided under AS 38.05.180(i), AS 41.09.010, AS 43.55.023 or AS 43.55.025).

⁶ The Commissioner of Natural Resources is also directed to make the determination of whether the exploration well for which credit is authorized resulted in sustained production of oil or gas from a reservoir discovered by the exploration well. This Advisory Bulletin does not address the timing of the determination of sustained production.

of the Department of Natural Resources (DNR) that the exploration well has penetrated and evaluated an oil or gas prospect in the pre-Tertiary zone.

To account for the possibility that explorers could “stampede” to Cook Inlet with jack-up rigs, the Department is required to “make a determination of the order in which the wells are drilled based on the date and time that the drill bit first turns to the right against the seafloor for the purpose of drilling the well.” As will be discussed below, this provision accounts for the stampede nature of the credit, but this determination does not assure that an explorer *qualifies* for the credit, nor does it allow an explorer to *reserve* a credit.

Analysis: Exclusivity of the Jack-Up Rig Credit. The Department has considered how to implement the jack-up rig credit should the exploration well or wells cost more than the credit caps. One approach would be to authorize credit up to the credit caps of 100%, 90% or 80% or a certain amount - \$25, \$22.5 or \$20 million—*whichever is less*—but allow the explorer to apply for additional credit under AS 43.55.023 for expenditures in excess of the jack-up rig credit amount. But the plain statutory language and the legislative history are strongly weighted towards a different conclusion, namely, that an explorer who obtains a jack-up rig credit may not apply for production tax credits under any subsection of AS 43.55.023 or AS 43.55.025 for the same exploration well, even if the explorer’s costs incurred in drilling the qualifying exploration well are in excess of the jack-up rig credit cap.

First, the plain statutory language states that an explorer who obtains a jack-up rig credit “may not” claim a tax credit under AS 43.55.023 (tax credits for certain losses and expenditures) or another provision in AS 43.55.025 for the same exploration expenditure. This limitation shows the legislature’s intent to provide a generous credit, but one limited by the provisions specific to that credit.

Second, statements made by legislators during debate on the jack-up rig credit strongly support the Department’s interpretation. For example, the bill’s sponsor and other legislators characterized the State’s “gross exposure” under the jack-up rig credit at \$67.5 million.⁷ The possibility that a qualifying exploration well could cost more than the maximum credit amounts was not explicitly discussed during legislative debates, but testimony by an administration official indicated that the total credit would still be

⁷ *Minutes, H. Fin. Comm.*, Testimony of Bill Sponsor Sen. McGuire, 4/16/10, p. 66 at 10:21:13 AM (noting cap was \$67.5 million); *Minutes, H. Fin. Comm.*, Testimony of Co-Chair Hawker, 4/16/10, p. 66 at 10:21:13 AM (pointing out “gross exposure” to State was \$67.5 million but bill would ensure recovery of 50% of expense).

capped at \$67.5 million even if each well cost \$25 million.⁸ His statement was not questioned by committee members, suggesting that the committee understood that if the second and third wells cost more than \$22.5 and \$20 million, no credit would be available for those excess costs.

In addition to limiting the State's exposure under the jack-up rig credit, the legislature also imposed a credit payback provision: "If the exploration well for which a credit is received . . . results in sustained production of oil or gas . . . 50 percent of the amount of the credit received shall be repaid to the department by the person that received the credit [.]” Any credit allowed in addition to AS 43.55.025(l) would not be subject to the this provision, thereby undermining legislative intent to offer the generous jack-up rig credit but only in conjunction with the credit payback provision.

Qualification for credit. In addition to implementing the credit caps, the Department will authorize credits under AS 43.55.025(l) only if the offshore exploration well has been drilled for the purpose of “discovering oil or gas in Cook Inlet,” and the Commissioner of DNR has made a determination that “the exploration well for which credit is requested . . . penetrated and evaluated a prospect in the pre-Tertiary zone[.]” Absent this determination, no credits will be authorized.⁹

Some may interpret AS 43.55.025(l) as allowing an explorer to “reserve” credit based on when drilling of an offshore exploration well began. This possible interpretation is due to the requirement that the Department “shall make a determination of the order in which the wells are drilled based on the date and time that the drill bit first turns to the right against the seafloor for the purpose of drilling the well.” But this provision accounts for the stampede nature of the credit, and the exploration well must first qualify by penetrating and evaluating a prospect in the pre-Tertiary zone.¹⁰ Although there has not yet been a stampede resulting in the positioning of two or more jack-up rigs at the same time, the Department must consider whether the first explorer to spud a well can “reserve” the jack-up rig credit. The Department does not interpret AS 43.55.025(l) to allow an explorer to “reserve” its place for credit based on when its “drill

⁸ *Minutes, H. Fin. Comm.*, Testimony of DOR Comm'r Galvin, 4/16/10, p. 67 at 10:31:48 AM.

⁹ Other requirements apply – the explorer must complete the exploration activity, file for credit within six months, and submit data as required by AS 43.55.025(f).

¹⁰ *See Minutes, S. Fin. Comm.*, Testimony of Bill Sponsor Sen. McGuire, 4/15/10, p. 4 at 9:17:03 AM (explaining credit was called “Stampeder Provision,” and intended to bring a jack-up rig to Cook Inlet); *Minutes, S. Fin. Comm.*, Testimony of Bill Sponsor Sen. Wagoner, 4/15/10, p. 7 at 9:28:18 AM (noting there were two or three small independent companies set to take advantage of jack-up rig credit).

bit first turns to the right against the seafloor,” and thereby foreclose another explorer that meets the statutory qualifications from receiving credit.

Instead, the Department interprets AS 43.55.025(l) as a whole and in light of the Legislature’s intent to encourage a stampede to mean that the first explorer *to meet all of the statutory requirements will be the first explorer eligible to receive credit*. To interpret this provision otherwise would allow an explorer who first spuds a well with a jack-up rig in Cook Inlet to block another explorer from qualifying for the credit even if the first explorer never resumes drilling or completes a qualifying exploration project. The Department concludes this latter interpretation (allowing an explorer to “reserve” credit) is inconsistent with the requirement that all statutory requirements must be met before the Department may authorize credit. Furthermore, to allow one explorer to “reserve” credit could discourage other explorers interested in exploring for oil and gas in Cook Inlet, which is clearly inconsistent with legislative intent. If, however, more than one explorer qualifies for credit at approximately the same time, then the Department will determine which should receive credit based on when each explorer’s “drill bit first turn[ed] to the right against the seafloor for the purpose of drilling the well.”

Conclusion: The jack-up rig credit provision in AS 43.55.025(l) authorizes credit to the first three explorers that drill offshore exploration wells for the purpose of discovering oil or gas in Cook Inlet. Each well must penetrate and evaluate a prospect in the pre-Tertiary zone; that latter determination will be made by the Commissioner of DNR and reported to the Commissioner of Revenue. The Department will not authorize credit until all statutory requirements are met.

The jack-up rig credit is an exclusive credit, that is, an explorer that *applies for and qualifies for the jack-up rig credit* may not also apply for production tax credits under AS 43.55.023 or other subsections of AS 43.55.025. Instead, an explorer who drills an exploration well that meets all qualifications of AS 43.55.025(l) must choose to apply for credit under either AS 43.55.025(l), another provision of AS 43.55, or AS 43.20.

Nature of this bulletin: This non-binding advisory bulletin is issued for the information and guidance of producers, explorers and other interested persons under AS 43.55.110(g). The interpretations stated herein apply to all producers and explorers subject to AS 43.55 and should not be considered specific to any one producer or explorer, nor do the interpretations in this bulletin constitute an appealable action under AS 43.05.240 or other provision of Title 43.


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