**ALASKA DEPARTMENT OF REVENUE**
**TAX DIVISION**
**ADVISORY BULLETIN 2011-01**

Re: Research and development costs and AS 43.55.170 reimbursements

**Request:** A producer has requested that the Department issue an advisory bulletin as to (1) whether certain testing costs for testing an experimental technology for recovering gas hydrates are lease expenditures; and (2) if not, whether the producer must adjust its lease expenditures under AS 43.55.170 to reflect reimbursements from a research grant for a portion of the gas hydrates test costs.

**Short Answer:** According to AS 43.55.165(a)(1)(A) only those costs that are, "to explore for, develop, or produce oil or gas deposits" are considered to be lease expenditures. Under the facts presented, the costs do not qualify as lease expenditures under AS 43.55.165 since they are not for exploring for, developing, or producing oil or gas deposits. Therefore, those costs may not be deducted in calculating monthly or annual production tax values. Since the costs are not lease expenditures, the fact that a portion of the costs will be reimbursed will not trigger the requirement under AS 43.55.170 to treat the reimbursements as an adjustment to the producer's lease expenditures. However, without knowing the exact nature of the costs in question, the Department is unable to rule out the possibility that a portion of the reimbursements might offset the producer's actual lease expenditures incurred for purposes other than the research project at issue here, in which case an adjustment could be required under AS 43.55.170.

**Background:** A producer has partnered with a federal government agency to test an experimental methane hydrate production technology and to gather scientific data for improved characterization of naturally occurring methane hydrates. The evaluation includes field testing of a technology developed at the laboratory level to determine if the method is viable for commercial production of methane. The testing will be done as a tract operation in a unit north of 68 degrees North latitude. Only one unit owner will be conducting the testing and paying 100 percent of testing costs. That unit owner will be reimbursed for 80 percent of its project related costs. No other working interest owners within the unit will incur costs, or receive reimbursement for costs of the hydrate testing. According to the producer, no taxable gas will be produced, and the planned well will be abandoned after testing.

**Analysis:** First, the producer requests the Department's opinion whether the gas hydrate test costs will be lease expenditures. The producer acknowledges that those costs will be incurred upstream of the point of production and are the type of costs –drilling, testing, plugging, and abandoning a well – that would reasonably be incurred in exploration, development and production of oil and gas. Typically those types of upstream costs would be considered ordinary and necessary costs of exploration, development and production. AS 43.55.165(a)(1)(B)(ii) and (*l*). The producer suggests that although these costs are ordinary and necessary for purposes of the gas hydrates testing project, they are not direct costs, but research and development costs disallowed under 15 AAC 55.250(g).

The Department agrees with the conclusion that the project costs are not lease expenditures, but for a more fundamental reason than suggested in the request for the advisory bulletin.[1] The costs of gas hydrate testing are not lease expenditures because the costs will not be incurred "to explore for, develop, or produce oil or gas deposits" on the producer's lease or property, within the meaning of AS 43.55.165(a).[2] Rather, the costs will be incurred to conduct a research project on an experimental technology that may or may not be used in the

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[1] The producer is correct, however, in noting that 15 AAC 55.250(g) reflects the Department's recognition that research and development costs are not direct costs of exploring for, developing, or producing oil or gas deposits.

[2] AS 43.55.165(a)(1)(A) and (*l*) (explore includes conducting geological or geophysical exploration, including a stratigraphic test well).

future to produce gas. The testing, including drilling a well, is to evaluate the effects of injecting $CO_2$ into the reservoir and exchanging for methane. The technology has only been tested in the laboratory and has not yet been tested, or proven, in the field.

Second, although the producer will pay 100 percent of the gas hydrate testing costs, it will be reimbursed for 80 percent of those costs by the federal Department of Energy. The producer requests assurance that it will not be required to adjust its lease expenditures to reflect the "reimbursement or similar payment that offsets the producer's lease expenditures." AS 43.55.170(a)(2). The producer suggests that if the hydrate test expenditures were claimed as lease expenditures, it would be required to make an adjustment to reflect any reimbursements received. However, if the gas hydrate expenditures are not claimed as lease expenditures, the producer contends that it should not be required to make any adjustments under AS 43.55.170

The Department agrees that a payment received as reimbursement of a cost of the research project does not become a payment that offsets the producer's lease expenditures simply because it reimburses that cost, since that cost is not a lease expenditure for the reasons discussed above. However, in the absence of more detailed information, the Department cannot exclude the possibility that a payment received as a reimbursement of a research project cost might *also* constitute a payment that offsets the producer's lease expenditures. Consider the following example. Suppose that the producer has previously spent $1,000,000 to acquire certain equipment to use in its oil and gas production operations and has deducted that cost as a lease expenditure. Now the producer decides it can temporarily spare that equipment for use in the research project and allocates as a cost to the research project $50,000 for use (i.e, capital recovery) of the equipment.[3]

[3] Note that the producer would not be allowed to treat as a lease expenditure such an allocation for use of the equipment in its actual production operations, since

Whatever portion of the $50,000 is reimbursed by the Department of Energy would offset the producer's $1,000,000 in lease expenditures and would have to be treated as an adjustment under AS 43.55.170.

**Scope and Non-binding nature of this bulletin:** This advisory bulletin is issued for the information and guidance of producers, explorers, and other interested persons. Opinions expressed here are strictly limited to the proposed conditions as presented above interpreted in accordance with existing Alaska oil and gas production tax law. These interpretations do not address other possible effects under other scenarios or types of tax laws, and as provided in AS 43.55.110(g), interpretations stated in this advisory bulletin are not binding on the Department or others.

Bruce Tang

Bruce Tangeman
Deputy Commissioner
Alaska Department of Revenue

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that would be double-counting (the acquisition cost of the equipment already having been treated as a lease expenditure).