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Indonesia Legal Alert

The Indonesian PSC: The End of an Era

On 13 January 2017, the Ministry of Energy and Mineral Resources (*Kementerian Energi dan Sumber Daya Mineral*, the "**ESDM**") of the Republic of Indonesia issued Regulation No. 8 of 2017 (the "**Gross-Split PSC Regulation**"). It is perhaps the most significant regulatory development in the history of Indonesia's oil and gas sector since Law No. 22 of 2001 concerning Oil and Gas ("**Law 22 of 2001**"). New production sharing contracts ("**PSC**") must comply with a new model PSC prescribed by the Gross-Split PSC Regulation. This model PSC dispenses with the cost recovery system which has been a feature of all Indonesian PSCs since their inception.[1]

Its sudden emergence surprised many industry participants and is largely the result of political considerations, which have been dominated by the declining share of Government of Indonesia ("**GoI**") revenues from the oil and gas sector at a time of depressed global oil prices and declining production levels.

1. The Indonesian PSC

Indonesia was the first country to enter into a PSC in 1966. Since then this model has been used throughout the world.[2] The PSC permits countries to maintain sovereignty over their petroleum resources. International oil companies ("**IOCs**") act as contractors ("**Contractors**") to the host Government and assume exploration and development risk. Contractors recover their costs of exploration and development from a share of production if they make a commercial discovery and commence production.

The PSC developed in response to the concessions granted to IOCs in the Middle East and elsewhere in the first part of the 20th Century. These concessions conferred rights to explore vast tracts of land for long periods with almost complete discretion as to how and when the IOCs would conduct their activities. One of the few rights retained by the host Government was the right to receive a royalty payment based on oil production. The lack of control enjoyed by host Governments over the development of their oil and gas resources resulted in political dissatisfaction and, in some cases, nationalisation. The PSC developed by Indonesia was seen as an increasingly popular alternative in balancing the needs of the host Government and IOCs. When it was first introduced, the supermajors were opposed to its terms as they recognized the potential for it to set a dangerous precedent that could be used elsewhere in the world. However, there were a number of companies, primarily little-known U.S. independents, that did not have the global reach of the supermajors who were willing to accept these terms.

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The first Indonesian PSC was signed on 18 August 1966 in respect of the Offshore Northwest Java Block between Pertamina and the U.S. independent company, Independent Indonesian American Petroleum Company (the "**ONWJ PSC**"). The ONWJ PSC recently expired on 18 January 2017 (having been extended from its original 1997 scheduled expiry date). In one of the strange quirks of history, the ONWJ PSC became the first PSC to adopt the new gross-split contractual framework (a "**Gross-Split PSC**").[3]

2. What was wrong with the Cost Recovery System?

SKK Migas and oversight

The recovery by the Contractor of its capital and operating costs from production (the "**Cost Recovery System**") is a unique feature of the PSC, which differentiates it from other fiscal regimes. In return for permitting the recovery of such costs from production revenues, the Contractor is required to obtain the approval of the regulator for such costs. Unless such costs are incurred and approved in accordance with work programs and budgets, authorisations for expenditure ("**AFE**") requests and prescribed procurement guidelines and other laws and regulations governing the sector, they are ineligible for cost recovery once production commences.

Initially, when the PSC was introduced, the oversight exercised over such costs by Pertamina (which was then the regulator empowered to administer cost recovery on the part of the GoI) was relatively light as it was a national oil and gas company with fairly limited experience and it developed a very collaborative relationship with Contractors. The Pertamina unit responsible for this oversight, the Foreign Contractor Coordinator Body or *BKKA*, became increasingly intrusive over time with respect to its oversight of operations and tensions developed between it and the Contractors it regulated. Consequently, when Law 22 of 2001 was implemented, which, among other things, saw Pertamina stripped of its role of regulatory oversight, some industry participants welcomed the change as they hoped that there would be less oversight exerted by the fledgling BPMIGAS (the predecessor entity to the current regulator SKK Migas), to which Pertamina's role was transferred. Unfortunately, the consensus view of Contractors working in the Indonesian

upstream sector is that SKK Migas became more difficult to deal with than Pertamina under the previous regime. In hindsight, this is not surprising. Operational oversight was moved to a GoI department that did not understand the industry and so it was logical that the time for decision-making and obtaining approvals lengthened.

Moreover, a series of regulations were implemented, that, in many cases, altered long-standing administrative practices, which led to a drastic curtailment of the types of costs that were eligible for recovery.[4] The risk of non-compliance with an ever-widening array of regulations and practices grew and for many industry participants their enthusiasm for exploration and development waned in an environment in which the focus swung from encouraging exploration and development to managing costs and developing the capabilities of local contractors through the procurement guidelines and procedures administered by SKK Migas. Most worryingly in recent times, there have been criminal cases brought against Contractors who are alleged to have violated cost recovery procedures and caused "State losses", one of which resulted in the imprisonment of Contractor employees.

The GoI's reduced take

In 2016, the cost recovery amount was approximately US$11.4 billion, while the GoI's revenue from the oil and gas sector was only US$9.29 billion.[5] In the latter part of 2016, the ESDM and Commission VII of the Indonesian House of Representatives (which oversees the energy and mining sector) demanded a further reduction of cost recovery budgets for 2017. SKK Migas had reportedly sought US$11.7 billion, but only US$10.4 billion was approved. ESDM officials asserted that high cost recovery expenditures resulted from

the inefficiencies of oil and gas companies. These budgetary pressures have put the Cost Recovery System and the industry under increasing strain, and the evolution of the Gross-Split PSC Regulation is a direct response to those pressures. The hope is that by allowing Contractors discretion as to how they will implement activities, they will find ways to reduce their operating costs in order to preserve their returns since they will no longer be reimbursed for such costs. While this principle is laudable, the reality is that the oil and gas field services sector in Indonesia is a relatively 'high cost' environment compared to other jurisdictions, so a transition to a lower cost operating environment is unlikely to occur overnight unless local service providers reduce their costs to compete with international service providers.

Outside the industry, there is a misconception that the GoI is "paying" for cost recovery rather than reimbursing Contractors for expenditures they have made. Unlike other industries, the PSC system does not allow a taxpayer to deduct expenditures from one PSC against income earned from another PSC, so unless and until there is production, the Contractor must bear those costs without any ability to deduct them from its taxable income – the PSC 'ring-fencing' principle.

As the chart shows, Indonesia's oil production has been in steady decline, and this decline will continue as most of Indonesia's producing oil fields are in decline and, aside from a few exceptions, there have not been any recent major discoveries. The Minister of Finance, Sri Mulyani Indrawati, has stated that the GoI expects production levels to steeply decline to 480,000 barrels per day by 2020.

Source: IPA.or.id / SKK Migas

While this is due to a number of factors, it is recognised that there has been a lack of investment in the sector and exploration has steadily declined in response to the worsening regulatory regime and unfavourable fiscal terms compared to other countries in the world. In particular, the opportunities available in North America for unconventional and conventional exploration and development have been a 'game-changer' and are now consuming billions of dollars of capital and operating expenditure.

As can be seen in the chart below, exploration expenditures in the Indonesian upstream sector have been in decline since 2011:

Source: IPA.or.id / SKK Migas

The decline in production, coupled with reduced prices for such production, explains why the amount of costs available for recovery as against the GoI's revenues from the sector is rising – the amount of operating costs incurred by the industry will be more or less stable; however, given there is declining production from which to recover those operating costs, the GoI's take has been reduced accordingly.[6]

Prior to considering the specific changes brought about by the Gross-Split PSC Regulation, we outline below some of the fundamental revisions which have been made to the Indonesian PSC since it was first introduced in 1966:

	First generation PSC (1966 onwards)	Second generation PSC (1976 onwards)	Third/Fourth generation PSC (1988 onwards): 1988, 1989 and 1992 incentive packages	Fifth generation PSC (2008 onwards)	Gross-split PSC (2017)
Cost recovery cap	40%	None	None (although FTP effectively works as a cap on cost recovery).	None (although FTP effectively works as a cap on cost recovery).	N/A
First Tranche Petroleum (FTP)	N/A	N/A	20% (shared between Contractor and Pertamina).	10 to 20% (if 10%, this is usually allocated to the GoI; otherwise FTP shared between Contractor and GoI).	N/A
Contractor entitlement (oil)	35%	28.85 to 34.09%	28.85 to 40% depending on a number of factors.[7] From the mid to late 1990s, up to 62.5% was granted to Contractors, predominantly for Eastern regions.[8]	Ranges / negotiable – e.g. 55% to 67.5%.	43% base split, subject to application of progressive and variable components.
GoI/Pertamina entitlement (oil)	65%	65.91 to 71.15%	37.5-80% (depends on Contractor share – see above).	Ranges / negotiable (depends on Contractor share – see above).	57% base split, subject to application of progressive and variable components.
Tax	Pertamina liable for Contractor tax.	Paid directly by Contractor.	Paid directly by Contractor.	Paid directly by Contractor.	Paid directly by Contractor.

3. Gross-Split PSC Regulation

The idea of transforming the Indonesian PSC to a gross-split model was conceived as early as 2011.[9] However, we understand from our discussions with industry participants that they were only given limited time to comment on the draft Gross-Split PSC Regulation. While there were a series of meetings between the Indonesian Petroleum Association (the "**IPA**"), the Director General of Oil and Gas / ESDM, MIGAS, SKK Migas and Pertamina in late 2016, there was ongoing debate with respect to the economics of the new fiscal regime compared to the traditional PSC regime and the focus was on the abolition of the Cost Recovery Scheme to respond to political pressures. While the variable and progressive elements of the split do take into account various factors, an economic comparison between each type of contract can only occur if a particular project is modelled and the results are compared. The Gross-Split PSC Regulation was hastily implemented in order to ensure that it could be used for the ONWJ PSC, which was scheduled to expire on 18 January 2017. It is regrettable that more time was not taken by the GoI and ESDM to refine the Gross-Split PSC Regulation and solicit comments from the IPA and other stakeholders, but, as we have seen with other regulations in the sector, it follows a familiar pattern of an overarching regulation which will then be supplemented by further regulations that take into account industry feedback.

Model form

Article 2(1) of the Gross-Split PSC Regulation states that the "*Minister shall determine the format and basic provisions of a Gross-Split Production Sharing Contract*". Accordingly, until there is a form that has been approved and issued by the Minister, its precise terms are unknown. The areas that are required to be addressed in the Gross-Split PSC resemble those used in the traditional PSC (and the basic provisions set out in Article 11(3) of Law 22 of 2001) and are set out in the table below:

Gross-Split PSC provisions	
• GoI income	• Prioritisation of the employment of Indonesian manpower, and the use of Indonesian goods and services
• Conditions and timing for PSC extension	• Environmental management
• Abandonment obligations	• Oil and gas production custody transfer
• Reporting requirements	• Assignments / transfers of rights and obligations
• Working Area and relinquishment	• Community development and the guaranteeing of rights of indigenous communities
• Dispute resolution	
• Health and safety	
• Plans of development	
• Domestic market obligation	
• Disbursement of capital	

A number of provisions which exist in current generation PSCs will need to be removed or modified in order to reflect the principles prescribed in the Gross-Split PSC Regulation. While some of these are implicit (such as the removal of sections pertaining to the recovery of operating costs or First Tranche Petroleum), some are more nuanced. For example, the requirements that a change of operatorship or Change of Control of a Contractor party do not result in material additional costs and expenses may no longer be relevant. In addition, and as will be discussed further below, provisions relating to the training of Indonesian nationals and local content requirements may need to be revised.

Aside from the ONWJ PSC, it was recently announced that eight other PSCs scheduled to expire will be replaced with Gross-Split PSCs and operatorship awarded to Pertamina. These PSCs are in respect of the following blocks: Tuban, Sanga-Sanga, Southeast Sumatra, Ogan Komering, North Sumatra Offshore, Tengah, East Kalimantan and Attaka.[10] The terms of these Gross-Split PSCs will need to be produced quickly since it has been reported that the Gross-Split PSCs for Sanga-Sanga and South East Sumatra, together with Gross-Split PSCs in respect of some of the other blocks, will be signed during the IPA May 2017 Convention and Exhibition.[11] The Gross-Split PSCs for Sanga-Sanga and South East Sumatra are being prioritised given their imminent expiry (7 August 2018 and 5 September 2018, respectively) and significant production levels.

Split calculation

The Gross-Split PSC Regulation provides that gross production of oil and gas is to be divided between the Contractor and the GoI based on percentages, one specific to oil production and the other to gas production. The starting point for deriving these percentages are the base split percentages specified in the following table, which are then adjusted according to a number of variables as described below.

Base Split Percentage		
	Contractor	GoI
Oil	43%	57%
Gas	48%	52%

- **Base Split**. The base split percentage is adjusted by reference to: (i) variable components, and (ii) progressive components. Although Article 5 of the Gross-Split PSC Regulation states that the base split percentage is to be used as a "*base reference*" in determining the actual split when a plan of development (a "**POD**") is approved, we understand the intention is that the base split percentage serves as a minimum threshold (although it should be noted that some components, such as the upward movement of oil prices, may reduce the Contractor percentage share). We have set out the variable and progressive components in the table at the end of this article. The actual splits are determined by the Minister, based on the proposal from SKK Migas, when the first POD is approved.[12] Interestingly, the splits to be used for subsequent developments are not determined by the Minister and are decided by the Chairman of SKK Migas. If a different split is determined by SKK Migas for subsequent developments, the Minister must approve the difference.[13] It is unclear what happens if the Minister does not approve the different split. Would the split

determined by the Minister for the first POD apply? Would separate developments be approved with different splits? These questions are likely to vex Contractors until they are clarified, especially for PSCs, which are converted to Gross-Split PSCs upon their expiry and which have remaining exploration potential.

- **Variable Components**. Variable components adjust the base split percentages. These include the achievement of the first POD, and other factors such as the location of the relevant field, the depth and type of the reservoir, CO_2 and H_2S content and compliance with local content requirements.

Variable components – hypothetical example (oil entitlement)	
Base Split	**Entitlement adjustment (%)**
Base Split	43%
Variable Components	**Entitlement adjustment (%)**
First POD	+5%
Offshore, depth of 500m	+14%
Reservoir depth at 2,400m	0%
New Frontier (lack of infrastructure)	+2%
Conventional	0%
CO_2 below 5%	0%
H_2S at 150ppm	+0.5%
Specific gravity greater than 25 API	0%
Use of domestic goods at 45%	+2%
Primary production	0%
Total entitlement	**66.5%**

- **Progressive Components**. There are two progressive components: (i) the level of the Indonesian Crude Price and (ii) cumulative oil production, which cause the percentage split to fluctuate.

Progressive Components	
Indonesian Crude Price	
US$ / barrel	**Entitlement adjustment (%)**
Price < 40	7.5
40 ≤ Price < 55	5.0
55 ≤ Price < 70	2.5
70 ≤ Price < 85	0.0
85 ≤ Price < 100	(-2.5)
100 ≤ Price < 115	(-5.0)
Price ≥ 115	(-7.5)
Cumulative oil and gas production	
MMBOE	**Entitlement adjustment (%)**
Production < 1	5.0
1 ≤ Production < 10	4.0
10 ≤ Production < 20	3.0
20 ≤ Production < 50	2.0
50 ≤ Production < 150	1.0
Production ≥ 150	0.0

Greater split for cost-intensive projects

Given the existence of variable components which increase the Contractor's entitlement based on how far offshore the field is located, reservoir depth, the availability of supporting infrastructure and its stage of production (e.g. whether it is enhanced oil recovery), the gross-split mechanism recognizes the more challenging economics that apply to projects which are remote or where there are likely to be greater development costs. With respect to non-conventional reservoirs, the additional split entitlement of 16% is considerable.

Tax deductibility of operating costs

Article 14 of the Gross-Split PSC Regulation provides that operating costs incurred by Contractors are deductible for income tax purposes. The 'Uniformity Principle' under the traditional Indonesian PSC meant that those costs that were recoverable under the Cost Recovery System were also tax deductible. Now that the Cost Recovery System has been abolished, the status of the "Uniformity Principle" is unclear. Presumably, any costs which were previously cost recoverable should continue to be treated as being tax deductible in addition to any other costs incurred by the Contractor, even if they would not have been cost recoverable, provided such costs are incurred in accordance with an approved work program and other prevailing laws and regulations that continue to apply to the oil and gas sector.

The transition from a cost recovery regime to a general corporate income tax regime is problematic. Contractors will require guidance as to what expenses are tax deductible and an assurance that new taxes will not be introduced that could jeopardise project economics. It is not known if 'freezing' or tax stabilisation provisions will be included in the model Gross-Split PSC or if Contractors will be exposed to changes in prevailing income taxes or the imposition of new direct or indirect taxes.

Domestic Market Obligation

The Gross-Split PSC Regulation abolishes the requirement for Contractors to supply crude oil to the Indonesian domestic market at a discounted price and permits Contractors to receive the Indonesian Crude Price.[14]

4. A dynamic split?

The Gross-Split PSC Regulation also contemplates adjustments to the splits based on actual performance / returns enjoyed by a Contractor during the life of a project, including:

- an adjustment to the gross-split allocation by the ESDM based on a "*commercial evaluation*";
- variances between those components factored into a POD and the reality of subsequent field developments; and
- monthly adjustments based on Indonesian oil prices.

Commercial evaluation. Article 7 of the Gross-Split PSC Regulation provides for an upward or downward adjustment of five percent if "*the commercial evaluation of a field or a number of fields*" either fails or exceeds a "certain economic level". What precisely is meant by a "certain economic level" or how or when it is determined is unclear (although the intention may be that these economics are agreed as part of the POD approval process). It is possible that these matters have been deliberately left vague to allow for negotiation on such points at the time a POD is submitted for approval, but this could be problematic since the absence of any guideline as to what is an acceptable rate of return for a development could lead to prolonged negotiations. Further, the uncertainty created by the possibility of a reduction is problematic given that investment decisions are made at a time a POD is approved. For example, if there is a cost overrun in the development phase which results in reduced returns to the Contractor, it is unclear why this should entitle a revision to the production split as this risk should be borne by the Contractor. While this flexibility may appear attractive at face value, it vests considerable discretion in SKK Migas and the ESDM.

Actual condition of variable and progressive components. Article 8(3) provides that where there are differences between the variable and progressive components factored into the relevant POD or further field developments and the "*actual condition*" of such components, then "*a production share adjustment shall be done with reference to the actual conditions after commercial production*". While such adjustments are understandable in relation to certain variable components (e.g. if CO_2 content is different from that envisaged), it is unclear how this will apply to the progressive components - cumulative oil production and changes in oil prices.

Indonesian Crude Price. Article 9 provides that the percentage split is to be adjusted every month based on movements in the Indonesian Crude Price. While this appears a more equitable arrangement between the Contractor and the GoI (i.e. when oil prices are high, the GoI's share increases and, when oil prices are low, the Contractor's share increases), it results in unpredictability given the volatility of oil prices. One notable omission from this progressive component is its limitation to oil prices – query, therefore, how the entitlement split works with regard to gas sales, especially for those gas sales agreements under which the gas price is not linked to the Indonesian Crude Price e.g. suppose it is indexed to fertilizer prices or other indices.

5. Asset ownership – No cost recovery and yet no ownership for Contractors

Under a PSC equipment and other assets purchased for the purposes of operations become the property of the GoI even though they are depreciated by Contractors. Historically, this made sense given that the costs of sourcing goods and equipment would be reimbursed through the Cost Recovery System and, to the extent the GoI's share of production was reduced, it was in substance purchasing the assets on an instalment basis from the Contractor. Despite the abolishment of the Cost Recovery System, the Gross-Split PSC Regulation still provides that all goods and equipment become the property of the Indonesian State.[15] It is not clear why the position should be any different from other industry sectors in the absence of cost recovery and, logically, the Contractor should retain title to all assets and equipment it purchases. We understand from industry participants that asset ownership was raised during the limited period of engagement with the authorities. If this is not addressed, we expect that Contractors will continue their preference to lease equipment, where possible, which is unlikely to reduce operating costs.

6. What is the role of SKK Migas now it no longer administers cost recovery?

Reduced oversight of financial and procurement functions

One of SKK Migas' principal functions was the oversight and management of the Cost Recovery System through the approval of PODs, AFEs, work programs and budgets and its administration of procurement activities.

Contractors must still submit a work program and budget to SKK Migas, although SKK Migas is only required to approve the work program and the budget is simply provided as supporting data for the work program.[16] The implication of the language used is that SKK Migas does not have a right to approve the budget although how can a work program be approved without reference to an underlying budget? While Contractors had tended to inflate their budgets in order to avoid the need to seek further approvals from SKK Migas and to prevent arguments over cost recovery in the case of overruns, the new system raises many questions as to how SKK Migas can administer the sector without any control over a budget, which appears to be for informational purposes only.

Article 23 of the Gross-Split PSC Regulation states that SKK Migas is to have "*control and oversight over the execution*" of the PSC, but the "*control*" is "*limited to formulating policies on the work program and budget*", and the "*oversight*" is to be conducive "*to the realization of Contractor main operational activities including Exploration and Exploitation activities in accordance with the approved work program*".[17]

It is unclear how SKK Migas will exercise these functions given the nebulous description of its oversight role. If the intent of the Gross-Split PSC Regulation is to allow the Contractor to operate in the most cost-efficient manner and to free it from the regulatory processes previously imposed by SKK Migas, the reservation of a broad role of oversight is inconsistent with this objective. SKK Migas has been stripped of its ability to regulate AFEs and procurement decisions, yet it is still required to approve annual work programs and PODs. It is common for regulators to condition their approval of budgets on certain conditions and the Masela controversy with respect to the development of a land-based or floating LNG project provides an example of how such oversight can be used with dramatic consequences for a Contractor and a proposed development. It is clear that this is a further area where practice will need to be developed over time and the uncertainty this gives rise to, both for Contractors and SKK Migas, is unlikely to accelerate decision-making in the short term in the absence of more detailed and prescriptive guidelines/regulations as to how SKK Migas is to exercise its authority.

Procurement

One area of particular concern is the procurement of goods and services. Historically, procurement has been regulated through Presidential decrees, the latest of which is Decree No. 80 of 2003 and Guidance No. 007/SKKO0000/2015/S0 on the Management Framework for the Supply Chain for Cooperation Contracts ("**PTK 007**"). The PTK 007 regime required SKK Migas to approve procurement tenders over a certain amount and also only permitted certain qualified contractors to bid for the work. We understand that the procurement processes under PTK 007 will cease to apply to Gross-Split PSCs since Article 18(2) provides that "*the procurement of goods and services are conducted by Contractor independently*". However, the supervisory function reserved to SKK Migas raises questions as to whether or not Contractors will be free from interference in their procurement decisions. For example, Article 18(1) of the Gross-Split PSC Regulation states that Contractors must:

"*prioritize the use of a workforce of Indonesian citizens, the utilization of domestic goods, services, technology, as well as national engineering and construction abilities*".

There exist a number of regulations and decrees that impose local content obligations, such as ESDM Regulation No. 15 of 2013, which largely codified the PTK 007 guidelines that existed at the time and set out new local content targets and sanctions, ESDM Decree No. 31 of 2013 on Expatriate Utilisation and the Development of Indonesian Employees in the Oil and Gas Business, and also parts of PTK 007, which mandate that Indonesian employees must be employed for certain functions (e.g. human resources and supply chain oversight) (the "**Local Content Requirements**"). For example, ESDM Regulation No. 15 of 2013 set local content targets of 30% (onshore) and 45% (offshore) for drilling-related activities. Compliance with these Local Content Requirements is considered in the gross-split regime since one of the variable components used to determine the gross-split is the usage of domestic goods and services (*Tingkat Kompnen Dalam Negeri*). Depending upon the level of local content used, an adjustment of up to 4% can be made to the base split, but, aside from this provision, there are no other sanctions specified for non-compliance with Local Content Requirements.

There is tension between the objective of the GoI to allow Contractors discretion as to how they conduct operations and the obligations that are imposed with respect to Local Content Requirements. For example, suppose a Contractor wishes to have FEED work undertaken by a vendor outside Indonesia at a price which is lower than that available from local vendors. Can SKK Migas require the Contractor to demonstrate how it will meet these Local Content Requirements at the time it submits its annual work program for approval? Could SKK Migas insist upon the use of a local vendor even if it imposes a higher cost? Previously, the denial of cost-recovery was a powerful weapon that could be wielded by SKK Migas or auditors. PTK 007 will likely either need to be replaced or amended such that the Local Content Requirements remain and the procurement obligations removed.

Rumblings have already emerged from Commission VII of the House of Representatives, and several of its members have expressed concerns with the Gross-Split PSC Regulation.[18]

Compliance with the Constitution and Law 22 of 2001

One of the concerns raised with respect to the Gross-Split PSC Regulation is whether it violates the principle of GoI control of Indonesia's petroleum resources, which is enshrined in paragraphs (2) and (3) of Article 33 of The 1945 Constitution of the Republic of Indonesia, which requires that Indonesia's natural resources are to be controlled by the

State for the greatest benefit of the people. While, under the Gross-Split PSC Regulation, there should be far less control over the procurement of goods and services and the methods in which work program and budgets are implemented, there remains considerable oversight of the industry exercised by ESDM and SKK Migas and a vast array of operational regulations will continue to apply. Nevertheless, there are likely to be a number of influential stakeholders who may use this argument to lobby against the Gross-Split PSC Regulation. The influence of this group may be significant as there are many people employed in the oil and gas services sector in Indonesia and the 'outsourcing' of contracts to foreign companies is likely to be met with considerable public opposition, especially if it results in a loss of opportunities for local vendors or employees are made redundant. If so, this argument could be used to challenge the manner in which IOCs conduct their operations, even though they have been encouraged to do so in the most efficient manner possible and could be used to inflame public opinion against the remaining IOCs, which are still responsible for a major share of Indonesia's production.

For those who would make such arguments, it is important to contrast the position of the oil and gas industry with the mining sector, in which concessions have been used throughout its history without the challenges being made against 'foreign' control on constitutional grounds. There has never been a cost recovery system or history of GoI oversight and control of expenditures made by mining companies, and GoI revenues have been limited to a royalty regime and the payment of dead rent (in respect of Contracts of Work) and corporate income taxes. If a challenge can be made to the Gross-Split PSC Regulation on such constitutional grounds, then the same argument can be levelled at the mining industry, which has far less GoI control than the oil and gas industry, even post-implementation of the Gross-Split PSC Regulation. The contribution of the mining sector to Indonesia's Gross Domestic Product has been material and this has occured without the degree of regulation and control exercised over the oil and gas sector.

Leaving aside the argument based on the Constitution, some may contend that SKK Migas' reduced "*control and oversight*" function is inconsistent with Law 22 of 2001. Article 6(b) of Law 22 of 2001 provides that "*the management control of operations [under a PSC] shall be by the Implementing Body*". Further, Article 56 of Government Regulation No. 35 of 2004 regarding Upstream Oil and Gas Business Activities ("**Regulation 35 of 2004**") provides that "*the investment and operating expenses incurred under the Production Sharing Contract shall be approved by the Implementing Body*" and, further:

"*The Contractor shall recover…the expenses it has incurred to carry out Exploration and Exploitation…according to the work plan and budget and the Authorization of Financial Expenditure approved by the Implementing Body after the commercial production*".

There are also inconsistencies between the Gross-Split PSC Regulation and other GoI regulations, such as Regulation 79 of 2010 and a number of tax regulations. We understand that the ESDM / GoI recognises that appropriate revisions to these regulations will need to be made (and, of course, the replacement of Law 22 of 2001 and a draft new oil and gas law was announced in 2015, although this has yet to be deliberated by the Indonesian legislature).

Notwithstanding this, the ESDM has left itself and the Gross-Split PSC Regulation exposed to possible judicial review actions with the Indonesian Supreme Court pending new laws and regulations being passed. It is also unusual as a legal matter for a regulation of such importance to be implemented by way of a ministerial regulation, which is subordinate as a matter of Indonesian law to Law 22 of 2001 and Regulation 35 of 2004, neither of which contemplate a gross-split PSC. Since Commission VII of the House of Representatives is tasked with the drafting of a new regulation to replace Law 22 of 2001 it is possible that opposition to the regulation could see it challenged and overruled if it meets with opposition from Commission VII and industry stakeholders, including Pertamina.

7. New and expiring PSCs and gross-split conversions

New and expiring PSCs

GoI officials have stated that new PSCs will need to adopt the gross-split structure.[19] Article 24 of the Gross-Split PSC Regulation states that the gross-split structure will apply for any PSC which is not extended.

For those expiring PSCs in respect of which, at the time the Gross-Split PSC Regulation came into force (13 January 2017), an extension had *already* been approved, Article 25(b) of the Gross-Split PSC Regulation provides that the original PSC structure may continue to be used. However, in these circumstances, the PSC parties have the option to propose changing to the gross-split structure. Article 24(2) of the Gross-Split PSC Regulation provides that for those expiring PSCs which are extended, "*the Government may determine the same original Cooperation Contract or the Gross-Split Production Sharing Contract*". As such, the GoI has discretion as to the imposition of a Gross-Split PSC, which is at odds with the statements made by GoI officials.[20]

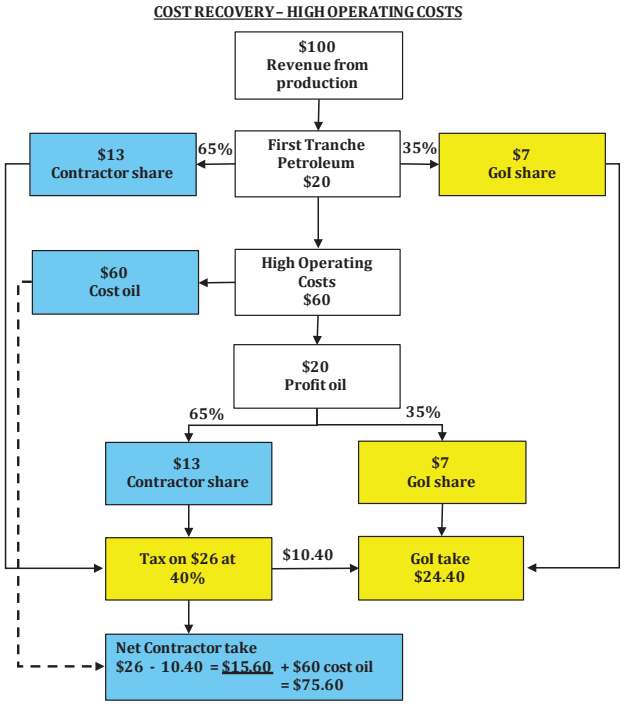
Gross-split conversions

Similarly, in respect of any PSC signed prior to the enactment of the Gross-Split PSC Regulation, parties have the option of proposing a change to the gross-split structure. Under the Gross-Split PSC Regulation, when an application to convert an existing PSC to a Gross-Split PSC is successful, operating costs which had not yet been recovered may result in an adjustment of up to 5% in favour of the Contractor.[21] However, quite how this additional split will be calculated is unclear as there is no objective basis to convert a sum of unrecovered costs to an equity split adjustment so this process is likely to be contentious and subject to negotiation between Contractors and SKK Migas, unless the terms are simply 'imposed' upon the remaining Contractors. The position regarding the carry-forward of operating costs, however, appears more ambiguous where expiring PSCs are not extended (and will, therefore, be replaced by a Gross-Split PSC, as mentioned above) or where they are extended (and the form of PSC going forward is left to the discretion of the GoI) – the Gross-Split PSC Regulation is, unfortunately, silent on this front. This is likely to cause consternation among industry participants, especially those with large unrecovered costs.

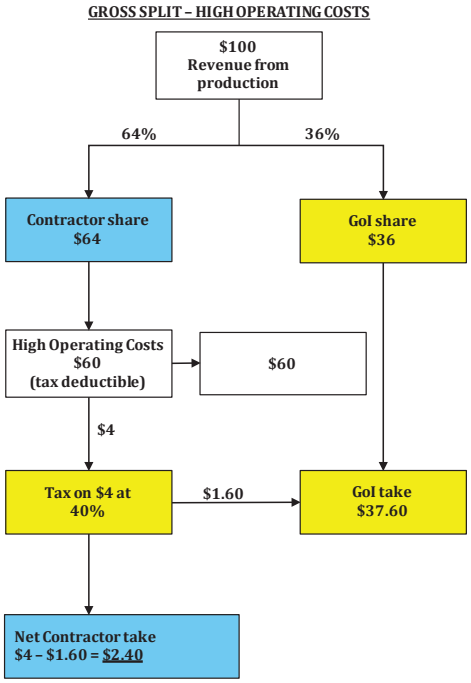
8. Gross-Split PSC economics

We set out below two sets of diagrams comparing the economics of the Gross-Split PSC to a current generation PSC. The first diagram shows the GoI and Contractor take when there are high operating costs, and the second diagram depicts a scenario when there are low operating costs.

High operating costs

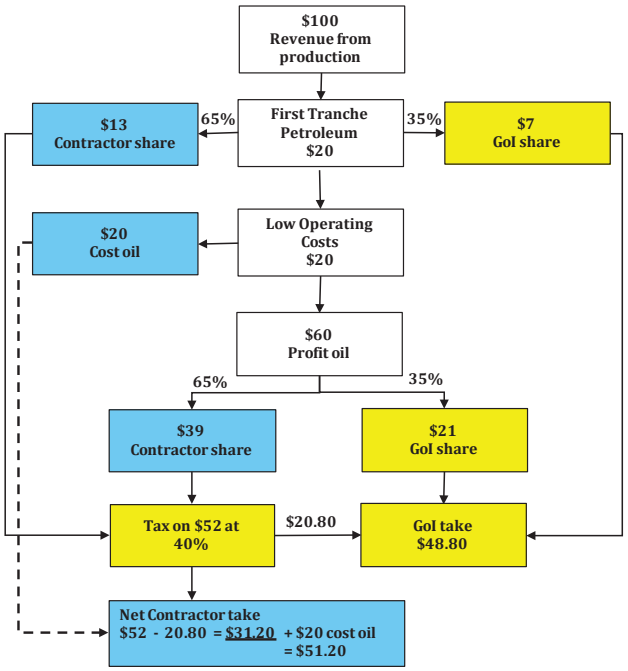


1. Assumes a contractor 65:35 GoI pre-tax split
2. Excludes DMO considerations
3. Excludes incentive and bonus considerations

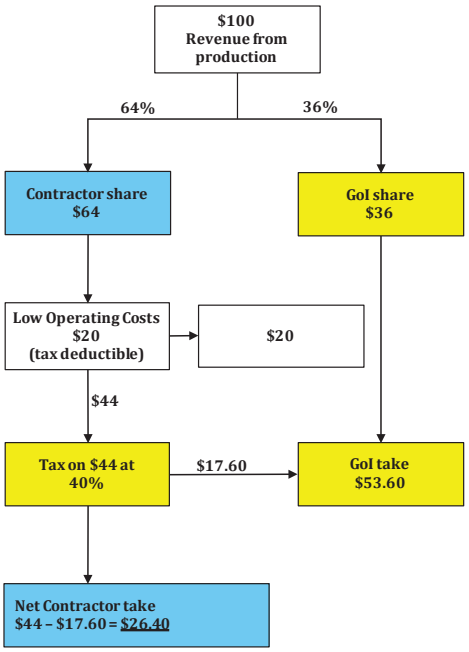


1. Assumes first POD achieved (+5%), an offshore depth of 500m (+14%) and a new frontier area (+2%)
2. Excludes consideration of all other variable and progressive components

Low operating costs



1. Assumes a contractor 65:35 GoI pre-tax split
2. Excludes DMO considerations
3. Excludes incentive and bonus considerations



1. Assumes first POD achieved (+5%), an offshore depth of 500m (+14%) and a new frontier area (+2%)
2. Excludes consideration of all other variable and progressive components

As can be seen, in both cases, the returns to the Contractor in the Gross-Split PSC are worse. The effect of ensuring a guaranteed share of production to the GoI, which would have normally only come after recovery of operating costs after First Tranche Petroleum, means that all (if operating costs are high) or a significant amount of the Contractor's production revenues are required to meet operating costs. As mentioned above, the GoI's hope is that, by allowing Contractors to manage their costs without being subject to SKK Migas' procurement procedures and oversight of AFEs, Contractors will be able to significantly reduce their costs. Wood Mackenzie has suggested that based on its analysis cost reductions of 10 – 20% are necessary in respect of some Gross-Split PSCs in order to bring the economics to the level they would have been under a current generation PSC.

Further, the "dynamic" nature of the gross-split outline above, whereby the Contractor's share of production will change during the term of the PSC based on fluctuating progressive components and a "*commercial evaluation*" of the project may have a significant impact on the financial assessment of future revenue streams. The "*commercial evaluation*" which the ESDM has in mind could be pegged to an IRR which is lower than returns available in other countries.

9. Conclusion – what does the future hold?

Royalties. Viewed from a fiscal perspective, the Gross-Split PSC has similar characteristics to a royalty regime and these have been successful elsewhere in the world. However, the economics of a royalty regime may not be well suited to Indonesia's oil and gas industry where there are a large number of low-margin, high-cost fields and very capital intensive projects located in deep water frontier areas. The Gross-Split PSC may provide improved economics for certain Contractors where they are producing from fields where there are low ongoing operating costs and where the relevant fields are located close to existing production and transmission infrastructure. As Benny Lubiantara observed at the time the idea of the Indonesian gross-split style PSC was initially mooted in 2011, "*a one-size-fits-all model does not exist*".[22] As far as royalty regimes go, the GoI has also reserved itself one of the largest in the world – if the hypothetical entitlement example of 66.5% used earlier in this article (which ignores progressive components) is taken as a reference, this would

effectively leave the GoI with a 33.5% royalty. While this guarantees the GoI more income in the short term, it will likely deter investment in the sector which is desperately needed to maintain production meaning that, in the long term, both the industry and the GoI's take from it will continue to suffer.

Expiring PSCs. For those PSCs which are approaching expiry (and, therefore, will be replaced by a Gross-Split PSC if their term is not extended),[23] it will obviously need to be assessed how they will be affected by the Gross-Split PSC economics. As the waterfall diagrams above show, even where there are relatively low operating costs, the Contractor's economics under a Gross-Split PSC could be worse. Further, mature fields require significant costs in order to sustain continued productivity. Consequently, late life fields governed by a Gross-Split PSC may fail to attract the investment they need to continue production given the absence of cost recovery.

Time savings. Responding to research produced by Wood Mackenzie suggesting that the Gross-Split PSC may not be appealing to investors, the ESDM Deputy Minister, Arcandra Tahar, argued that the time between discovery and first production will be considerably reduced through the independent procurement process and the removal of the bureaucracy associated with the cost recovery process. For Tahar, this time saving will result in improved economics.[24] The question is to what extent this will be possible in practice. It is possible he may well be right as the first major gas discoveries in Indonesia were commercialized in less than eight years in the absence of regulatory bureaucracy, and one should never underestimate the ability of Contractors to 'fast-track' a development if the regulatory regime is conducive. The NPV benefit of production being brought forward by 5-10 years is substantial so any modelling of the Gross-Split PSC should take this into account. A recent example of a 'fast-

track' development is the 30 trillion cubic feet Zohr gas field in Egypt, which was discovered by Eni in 2015. Its plan of development was approved in the same year and production is expected to occur later this year. This process was assisted by Eni being granted a dispensation from having to conduct a competitive bid process for some of its construction contracts and demonstrates how quickly a development can be commercialised if the conditions are right and direct appointments can be made by Contractors.

In the short term, there are two litmus tests that the Gross-Split PSC Regulation will need to pass:

- The first test is whether or not any Contractors opt to continue in expiring PSCs which, as at 13 January 2017 (the date the Gross-Split PSC Regulation came into force) had been granted extension approval, rather than converting these to a Gross-Split PSC. The response of those Contractors who operate under a Gross-Split PSC will also be closely scrutinised; and
- The second test is the response of the industry to the next bid round for Indonesian acreage, which will adopt the Gross-Split PSC model.

Industry feedback. It is surprising that a regulation of such importance should have come into existence in the space of less than three months and with such limited input from the industry and other stakeholders. The precision used to define the splits and the various adjustments thereto belies the fact that no one can explain how they were arrived at. What is known is that the IPA did not have time to endorse them or provide meaningful input on the various adjustments contained in the Gross-Split PSC Regulation and Pertamina itself did not approve the splits to be used for the conversion of the blocks it is mandated to operate following their conversion to a Gross-Split PSC. In the short term, Contractors will conduct their own sensitivity analysis on the economics of each model and decide whether or not they believe the Gross-Split PSC is an improvement. Cost savings will take time to harness. The local market servicing the industry is unlikely to willingly reduce its costs simply to preserve the economics of its customers, who in the short term will find it difficult to procure alternative suppliers.

One cannot help but be dismayed as, while the reforms are well intentioned, it is apparent that more time was needed to implement such a transformative change to the industry, so it is to be hoped that the ESDM will not insist upon further conversion of expiring PSCs to this model and that it will take into account the comments raised by industry stakeholders to clarify the operation of the Gross-Split PSC Regulation.

Time will tell if the Gross-Split PSC Regulation is the much needed panacea to arrest the decline of production in Indonesia and encourage IOCs and domestic E&P companies to express interest in new acreage in upcoming bid rounds. If Contractors are able to generate returns on their investment that exceed their IRR thresholds for project sanction and have confidence that those returns will be preserved through the life cycle of a project, they will invest. Without this comfort, they will not. Unless the concerns identified in this article with respect to the operation of the Gross-Split PSC Regulation are addressed quickly, it is likely that new investments will not be made and exploration expenditures will continue to decline, which will result in a further reliance on imported crude oil and, unless significant domestic natural gas reserves are brought on stream, Indonesia may be forced to import LNG to meet its energy needs, which would be an outcome that has serious long term economic and security implications for the country.

Gross-Split PSC Regulation – Variable and Progressive Components

1. Variable components

Variable component	Entitlement split percentage change	Remarks
Status of field	+5%	Awarded for the first POD upon the status of the field changing to production. No percentage changes for further PODs. In the event production in a terminated working area continues without POD, 5% is subtracted.
Location of field	0% (Onshore) 8 to 16 % (Offshore)	Offshore percentages depend on sea depth, as follows: • Below / equal to 20 metres: +8% • Above 20 metres, but below / equal to 50: +10% • Above 50 metres, but below / equal to 150: +12% • Above 150 metres, but below / equal to 1000: +14% • Above 1000 metres: +16%
Depth of reservoir	1%	If vertical depth of wells exceeds 2,500 metres.
Availability of supporting infrastructure	0% (Developed) 2% (Frontiers)	Increased percentage only awarded where supporting infrastructure (such as roads) is not available.
Reservoir type	0% (Conventional) 16% (Unconventional)	Increased percentage for coal-bed methane and shale reservoirs.
CO_2 content	0 to 4%	Increased percentage dependent on percentage of CO_2 content above 5%, as follows: • Below 5%: +0% • Above / equal to 5%, but below 10%: +0.5% • Above / equal to 10%, but below 20%: +1% • Above / equal to 20%, but below 40%: + 1.5% • Above / equal to 40%, but below 60%: + 2% • Above / equal to 60%: + 4%
H_2S content	0 to 1%	Increased percentage dependent on H_2S content above 100 ppm, as follows: • Below 100ppm: +0% • Above / equal to 100ppm, but below 300: +0.5% • Above / equal to 300ppm, but below 500: +0.75% • Above / equal to 500ppm: +1%
Gravity	1%	Increased percentage if specific gravity above 25 API.
Local content	0 to 4%	Increased percentage dependent on level of local content usage based on existing regulations (please see commentary in article in respect of local content requirements), as follows: • Below 30%: +0% • Above / equal to 30%, but below 50: +2% • Above / equal to 50%, but below 70: +3% • Above / equal to 70%, but below 100: +4%
Stage of production	0 to 5%	Increased percentage dependent on whether primary, secondary or tertiary production, the latter including enhanced oil recovery, as follows: • Primary: +0% • Secondary: +3% • Tertiary: +5%

2. Progressive components

Progressive component	Entitlement split percentage change	Remarks
Oil price	(-7.5) to 7.5%	Range depends on crude oil price (in US$/barrel), as follows: • Below 40: +7.5% • Above / equal to 40, but below 55: +5% • Above / equal to 55, but below 70: + 2.5% • Above / equal to 70, but below 85: +0% • Above / equal to 85, but below 100: -2.5% • Above / equal to 100, but below 115: -5% • Above / equal to 115: -7.5% Crude prices are based on the Indonesian Crude Price.
Cumulative production	0 to 5%	Range depends on cumulative production (in MMBOE), as follows: • Below 1: +5% • Above / equal to 1, but below 10: +4% • Above / equal to 10, but below 20: +3% • Above / equal to 20, but below 50: +2% • Above / equal to 50, but below 150: +1% • Above 150: +0% For already producing working areas, the quantity of cumulative production shall be the level of production reached when the PSC is signed.

End Notes

1 Indonesia has adopted other contractual models besides the PSC, including Technical Assistance Contracts and the KSO model for areas operated by Pertamina. These contractual models were not widespread and are not being renewed as they progressively expire.

2 The production sharing model has been used in several countries, including Angola, Cambodia, China, Egypt, Equatorial Guinea, Ethiopia, Gabon, India, Liberia, Libya, Malaysia, Mauritania, Mongolia, Mozambique, Myanmar, Nigeria, São Tomé and Principe, Sudan, Syria, Tanzania, Timor-Leste, Trinidad and Tobago, Tunisia, Vietnam and Yemen.

3 The Gross-Split PSC for the ONWJ Block was entered into on 18 January 2017 by Pertamina subsidiary, PT Pertamina Hulu Energy Offshore North West Java, and its partners and is scheduled to expire on 18 January 2037. The agreed production splits are 47.5% for the GoI and 52.5% for the Contractor for crude oil and, in respect of natural gas, 37.5% for the GoI and 62.5% for the Contractor.

4 For example, ESDM Regulation No. 22 of 2008, implemented on 30 June 2008, set out a negative list detailing those costs which could not be recovered under the Cost Recovery System, including personal employee expenses (such as personal income tax), employee long-term incentive plans, marketing costs, environmental and community development costs post-exploration, M&A costs, procurement costs 10% above permitted levels without justification, and losses arising from certain affiliate transactions. This was followed by Government Regulation No. 79 of 2010 ("**Regulation 79 of 2010**") further restricting those costs recoverable under the Cost Recovery System, including, *inter alia*, tax consultancy fees, expatriate technical training costs, interest for debt finance, and surplus materials.

5 SKK Migas, "Oil and lifting exceeds the target", 4 January 2017 <http://skkmigas.go.id/detail/1978/oil-and-gas-lifting-exceeds-the-target>; RambuEnergy, "SKK Migas says investment in upstream oil and gas sector in 2016 likely below target", 6 December 2016 <https://www.rambuenergy.com/2016/12/skk-migas-says-investment-in-upstream-oil-and-gas-sector-in-2016-likely-below-target/>; RambuEnergy, "*Indonesia issues ruling on gross-split scheme for new oil and gas contracts*", 19 January 2017 <https://www.rambuenergy.com/2017/01/indonesia-issues-ruling-on-gross-split-scheme-for-new-oil-and-gas-contracts/>.

6 Indonesian Financial Statistics, Bank Indonesia.

7 Factors include whether production is from conventional, marginal fields or enhanced oil recovery and entitlement also varies according to cumulative oil production. Contractors were also given additional incentives with respect to new fields, such as increases in DMO prices and investment credits (T. N. Machmud, "Production Sharing Contracts in Indonesia: 25 Years' History", (1993) 11 J. Energy & Nat. Resources L. 179, 182).

8 Additional incentives were provided in 1992, including capital cost depreciation at 50%, an increase to investment credits and increased Contractor equity splits, especially for frontier areas and offshore, deep-water fields (T. N. Machmud, "Production Sharing Contracts in Indonesia: 25 Years' History", (1993) 11 J. Energy & Nat. Resources L. 179, 182).

9 See Darmawan Prasodjo, Arcandra Tahar and Erwinsyah Putra, "Turning petro dollars back on: A game theory approach", *The Jakarta Post*, 4 October 2011, in which the authors (Darmawan Prasodjo and Arcandra Tahar, being the Deputy of the *Kantor Staf Presiden*, and the ESDM Deputy Minister, respectively) discuss the application of game theory to the Indonesian upstream oil and gas sector, the introduction of a royalty system and improving cost efficiencies.

10 "Pertamina uses gross-split to manage eight oil and gas blocks", *The Jakarta Post*, 31 January 2017

11 Galih Gumar, "ESDM Dahulukan Renegosiasi Kontrak Blok Sanga-Sanga dan SES", *CNN Indonesia*, 6 April 2017 <https://cnnindonesia.com/ekonomi/20170406115622-85-205400/esdm-dahulukan-renegosiasi-kontrak-blok-sanga-sanga-dan-ses/>.

12 Article 8, Gross-Split PSC Regulation.

13 Article 16(3), Gross-Split PSC Regulation.

14 Article 17(3), Gross-Split PSC Regulation.

15 Article 21, Gross-Split PSC Regulation.

16 Articles 15(2) and 15(3), Gross-Split PSC Regulation.

17 Article 23, Gross-Split PSC Regulation.

18 For example, Dito Ganinduto has stated that the Gross-Split PSC Regulation will result in Contractors opting to use foreign technology and overseas workers to maximize profits. The Confederation of National Trade Unions (KSDN) has also voiced concerns regarding the inability of the Government to safeguard the welfare and employment of Indonesian employees in the sector (Retno Ayuningtya and Euis Rita Hartati, "Government plans to replace oil & gas cost recovery scheme in January", *Jakarta Globe*, 10 December 2016).

19 ESDM Deputy Minister, Arcandra Tahar, has stated that no new field can use cost recovery and that all fields must use the gross-split scheme (Fedina S. Sundaryani, "All new oil and gas contracts must use gross-split", *The Jakarta Post*, 19 January 2017). Similar statements have been made by other officials.

20 In practice, the willingness of the GoI to grant such extensions in the PSC's original form is untested and so much will depend upon whether or not Pertamina is assuming operatorship of the extended PSC, in which case it is likely to be required to use the model Gross-Split PSC.

21 Article 25(d), Gross-Split PSC Regulation.

22 Benny Lubiantara, "Comment on Opinion by Prasodjo et. al: Turning petro dollars back on: a game theory approach", *Ekonomi-Migas.blogspot.co.id*, 6 October 2011 <http://ekonomi-migas.blogspot.co.id/2011/10/comment-on-opinion-by-prasodjo-et.html>. Interestingly, he also observed that there is no support for the hypothesis that Contractor's costs will be lower in a royalty regime than in a PSC regime.

23 See commentary above in this respect.

24 Galih Gumelar, "ESDM Tuntut Wood Mackenzie Revisi Riset PSC Gross Split," *CNN Indonesia*, 27 March 2017 <http://www.cnnindonesia.com/ekonomi/20170327085528-85-202926/esdm-tuntut-wood-mackenzie-revisi-riset-psc-gross-split/>.

We wish to thank Pramu Priyandono of Soebagjo, Jatim, Djarot for his advice and assistance on Indonesian law matters. Gibson Dunn represents clients on Indonesia-related matters primarily from its Singapore office. Although our lawyers have considerable exposure to Indonesian law matters, like all other international law firms, we are not qualified to advise on Indonesian law.