The Oil and Gas Law Review

Eighth Edition

Editor
Christopher B Strong

The Law Reviews

THE OIL AND GAS LAW REVIEW

EIGHTH EDITION

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Christopher B Strong

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Published in the United Kingdom
by Law Business Research Ltd, London
Meridian House, 34–35 Farringdon Street, London, EC4A 4HL, UK

www.TheLawReviews.co.uk

ISBN 978-1-83862-482-8

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

AB & DAVID

ALLIANI & BRUZZON

AMERELLER LEGAL CONSULTANTS

ASHURST

BAROUDI & ASSOCIATES

BIRD & BIRD LLP

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CONTENTS

PREFACE

International oil and gas law is a fascinating field, sitting at an intersection of law, politics and business. Practitioners in this field must be familiar not only with international norms and practices, but also local legal and regulatory requirements that can vary substantially from jurisdiction to jurisdiction. The task can be daunting, especially in the context of fast-paced transactions or urgent legal or operational issues.

The Oil and Gas Law Review is intended to serve as a starting point for practitioners in gaining an understanding of the key legal requirements in the jurisdictions in which they may be advising clients on transactional and operational matters. The thinking behind the subtopics it covers has been to try to answer those questions that come up most frequently when dealing with a new or unfamiliar jurisdiction. Although not a substitute for detailed local law advice, the hope is that it will nevertheless serve as a reference guide and point users in the right direction when considering local legal issues.

I would like to thank the many experts who contributed to this volume. Without their substantial efforts, a work such as this would not be possible. Thanks also to the editors and publishers of *The Oil and Gas Law Review* for having the vision to publish a volume such as this and for their efforts in making it such a success.

Christopher B Strong
Vinson & Elkins LLP
London
October 2020

Appendix 1

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Chris Strong is a partner at Vinson & Elkins' London office, and has previously been resident in its Middle East, Texas and Asia offices. Chris counsels clients in a wide variety of transactions in the energy, infrastructure and natural resources industries, with a particular focus on project development and finance and mergers and acquisitions. His experience includes transactions relating to upstream oil and gas, power plants, petrochemical facilities, refineries, pipelines, liquefied natural gas, and mining and metals.

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Chapter 15

INDONESIA

Darrell R Johnson and Fransiscus Rodyanto[1]

I INTRODUCTION

Indonesia is home to one of the oldest oil and gas industries in the world. Its oil and gas industry has been active for more than 130 years, since the first oil discovery in North Sumatra in 1885.[2] The first-ever production sharing contract (PSC) in the world was executed in Indonesia.[3]

Indonesia's proven oil reserves at the end of 2019 amounted to 2.5 billion barrels, with production at 781,000 per day or 38.2 million tonnes per annum. With respect to gas, Indonesia's proven gas reserves at the end of 2019 were 1.4 trillion cubic metres and production amounted to 67.5 billion cubic metres. Globally, Indonesia ranks 21st and 12th for gas reserves and gas production, respectively. In the Asia-Pacific region, Indonesia ranks third for gas reserves, following China and Australia, and fourth for gas production following China, Australia and Malaysia.[4]

Oil and gas business activities in Indonesia are divided into the upstream sector (exploration and exploitation) and the downstream sector (processing, transportation, storage and trading).

In general, upstream oil and gas business activities by oil companies in Indonesia are based on PSCs, between the government, acting through the Special Task Force for Upstream Oil and Gas Business Activities (SKK Migas), and the oil companies as PSC contractors. Up until 2017, there was only one form of PSC, with a cost recovery mechanism, called a cost recovery PSC. In January 2017, the Minister of Energy and Mineral Resources (MEMR) introduced a new PSC scheme based on a gross production split without a cost recovery mechanism, called the gross split PSC.

The Indonesian oil and gas industry, like the global industry, has experienced significant difficulties as a result of the collapse of global oil prices. While oil prices are beginning to return to more normal levels, the government still faces the problem of a lack of new reserve discoveries. One reason for this is the overall struggle of the global industry generally, but it is difficult to ignore the role of domestic regulatory and bureaucratic issues, specifically for foreign investors. To attract new business players to the upstream oil and gas industry, Indonesian President Joko Widodo (Jokowi), through the MEMR, has attempted to clarify

1 Darrell R Johnson is senior of counsel and Fransiscus Rodyanto is a partner at SSEK Legal Consultants.
2 PWC Oil and Gas in Indonesia, Investment and Taxation Guide May 2019, 9th Edition.
3 Brad Roach and Alistair Dunstan, 2018, The Indonesian PSC: The End of an Era, *The Journal of World Energy Law & Business* 11 (2): 116-135.
4 PWC Oil and Gas in Indonesia, Investment and Taxation Guide May 2019, 9th Edition; *BP Statistical Review of World Energy 2020*, 69th Edition.

and simplify the regulatory regime for the oil and gas industry. These efforts include the issuance of tax incentives and facilities, the revocation of exploration permit requirements, and the relaxation of restricted positions for expatriate employment, as discussed in greater detail below.

In 2017, President Jokowi issued a regulation[5] classifying a number of upstream oil and gas projects as national strategic projects in an effort to increase Indonesian oil and gas production. Classifying these as national strategic projects allows the government, through the Coordinating Ministry for Economic Affairs, to ensure these projects can be put on stream immediately by expediting the infrastructure required for the projects and the issuance of regulations for their implementation. The national strategic upstream oil and gas projects are:

Project name	Operator	Onstream schedule	Expected production
Abadi Field Project	Inpex Masela, Ltd	2027	10.5 million tonnes of gas per annum
Indonesia Deepwater Development	PT Chevron Pacific Indonesia	2024	1.120 million standard cubic feet of gas per day and 40,000 barrels of oil per day
Jambaran-Tiung Biru Field	PT Pertamina EP Cepu	2021	190 million standard cubic feet of gas per day
Tangguh Train-3	BP Berau BV	2020	3.8 million tonnes of LNG per annum

The devastating impact of the covid-19 pandemic has extended to various industries, including the Indonesian oil and gas industry. Understandably, the pandemic creates uncertainty for the onstream schedules of the above projects.

So far in 2020, the key developments include:

a the issuance of a draft Omnibus Law, which would amend 79 laws including Law No. 22 of 2001 regarding Oil and Natural Gas (the Oil and Gas Law);

b the issuance of MEMR regulations reducing gas prices for sales to specific industries and power plants;

c the issuance of SKK Migas policies relating to upstream oil and gas operations in response to the covid-19 pandemic; and

d the issuance of a MEMR regulation granting certain PSC contractors the flexibility to adopt the cost recovery or gross split mechanism.

Further elaboration of the foregoing is provided below.

II LEGAL AND REGULATORY FRAMEWORK

i Domestic oil and gas legislation

The upstream oil and gas sector in Indonesia is mainly regulated by the Oil and Gas Law. Further provisions are regulated under Government Regulation No. 35 of 2004 regarding Upstream Oil and Natural Gas Business Activities, as amended most recently by Government Regulation No. 55 of 2009 (GR 35/2004).

5 Presidential Regulation No. 58 of 2017 regarding Amendment to Presidential Regulation No. 3 of 2016 regarding Acceleration of the Implementation of National Strategic Projects (16 June 2017).

In general, the Oil and Gas Law grants the government the exclusive right to oil and gas exploration and exploitation and requires all private companies that wish to explore and exploit oil and gas resources to enter into cooperation contracts with the government through SKK Migas. Such cooperation contracts most often take the form of a PSC.

There are currently two types of PSCs used for Indonesian upstream oil and gas business activities. Before 2017, all PSCs were based on a cost recovery scheme, where PSC contractors could obtain reimbursement of their operating costs through the production of oil and gas. In mid-January 2017, the government introduced gross split PSCs with no cost recovery arrangements. Under a gross split PSC, the government allowed PSC contractors a higher production split than that allowed under the cost recovery scheme, but all costs had to be borne by the PSC contractors.

The key provisions of the Oil and Gas Law include the following:

a the government's entitlement to oil and gas resources up to the delivery point;
b SKK Migas' control over the management of oil and gas operations;[6]
c all capital and risks of oil and gas operations are to be borne by PSC contractors;
d one company can only hold one oil and gas working area;
e the term of a PSC is 30 years, which can be extended a maximum of 20 years; and
f PSC contractors are obligated to provide 25 per cent of their production share to fulfil domestic demands.

ii Regulation

The MEMR, through the Directorate General of Oil and Gas (DGOG), oversees affairs in the energy and mineral resources sector, including supervision of the implementation of oil and gas business activities, preparation of policies for the upstream oil and gas business sector, determination of cost-recoverable and non-cost-recoverable activities in the upstream oil and gas business, and issuance of approvals related to upstream oil and gas activities, such as the first plan of development (POD), the transfer of participating interests, and direct and indirect change of control of the entities holding a PSC.

With the issuance of the Presidential Regulation No. 9 of 2013 regarding Management of Upstream Oil and Gas Activities, as amended by Presidential Regulation No. 36 of 2018, the upstream sector is managed and supervised by SKK Migas. In general, SKK Migas has the right to organise the management of upstream oil and gas activities, to the extent the management is in accordance with the relevant PSC. The Head of SKK Migas reports directly to the President. In performing its duties, SKK Migas is supervised by a supervisory committee, consisting of the MEMR, a Deputy MEMR, a Deputy Minister of Finance (MOF) and the Head of the Capital Investment Coordinating Board.

Currently, a draft oil and gas law is being finalised by the House of Representatives. One of the anticipated changes in the new law includes the establishment of a Specific Oil and Gas Business Entity (BUK Migas), which would take over the current authorities of SKK Migas and also manage downstream oil and gas activities.

6 Initially, the government through the Oil and Gas Law granted the authority over the management of upstream oil and gas operations to the Implementing Body of Upstream Oil and Gas Activities (BP Migas). However, a Constitutional Court Decision in 2012 disbanded BP Migas by declaring that its authority was unconstitutional. Afterward, the authority was transferred to a newly established entity, SKK Migas, through the issuance of Presidential Regulation No. 9 of 2013 regarding Management of Upstream Oil and Gas Activities, as amended by Presidential Regulation No. 36 of 2018.

In February 2020, the government submitted a draft Omnibus Law to the House of Representatives, which would amend the Oil and Gas Law. The draft Omnibus Law does not govern BUK Migas but instead is expected to establish a Specific Oil and Gas State-Owned Enterprise (BUMN Migas Khusus). BUK Migas and BUMN Migas Khusus are similar in concept, both being state-owned business entities that would serve as the new upstream oil and gas implementing body and assume SKK Migas' current rights and obligations. With BUK Migas/BUMN Migas Khusus assuming SKK Migas' authority in executing PSCs with investors, PSCs will become business-to-business instead of business-to-government cooperation schemes such as exists with SKK Migas. BUK Migas and BUMN Migas Khusus differ in that BUMN Migas Khusus, unlike BUK Migas, would not manage the downstream oil and gas sector.

PSC contractors' activities are subject to audit by the government. The auditing authority rests with the Agency for Finance and Development Supervision (BPKP). Based on Government Regulation No. 60 of 2008 regarding the government's internal management system, the BPKP has the authority to audit the state treasury as part of an internal government audit. These audits include state revenue and expenses including the allocation of cost recovery costs under the state budget. With respect to the audit of income tax obligations, a joint audit will be conducted by BPKP, SKK Migas, and the Directorate General of Taxation, based on MOF Regulation No. 34/PMK.03/2018 regarding Implementing Guidelines for Joint Audits of the Implementation of Cooperation Contracts in the Form of Production Sharing with Recovery of Operating Costs in the Upstream Oil and Gas Business.

iii Treaties

While Indonesia does not recognise foreign court decisions, international arbitration awards can be enforced in Indonesia through mechanisms provided in Law No. 30 of 1999 regarding Arbitration and Alternative Dispute Resolution. In general, Indonesia has bound itself to enforce foreign arbitral awards if (1) the award is rendered by a tribunal in a country bound by the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the Convention) or a bilateral treaty with Indonesia; (2) the dispute is commercial in nature, as that term is understood under Indonesian law and the Convention; and (3) the award does not contravene Indonesian law or notions of public order or policy.

International treaties and other multinational agreements are binding upon Indonesia after ratification, which may be done by way of a law to be approved by the House of Representatives, or by way of a presidential regulation to be further implemented by a ministerial regulation, which will be notified to the House of Representatives. All regulations and decrees issued afterwards must not deviate from the provisions of the international treaty or the national regulation enacted in light thereof. Therefore, once an international treaty is binding upon the government, regulatory policy or activity shall develop in accordance with the international treaty. Indonesia is a party to, among others, the United Nations Convention on the Law of the Sea (UNCLOS), the 1987 Montreal Protocol, and the International Convention on Civil Liability for Oil Pollution Damage and the protocols and amendments thereof.

Indonesia has entered into many bilateral tax treaties with other countries to avoid the imposition of double taxation in both countries. As of 2020, Indonesia has entered into double tax treaties with 66 countries, with contracting states including Australia, France, Japan, Malaysia, Singapore, the United Arab Emirates and the United States.

III LICENSING

The right to explore oil and gas is provided by the execution of cooperation contracts, generally based on a production sharing scheme through a PSC between the government, through SKK Migas, and the company that wins the right to the working area covered by the PSC. Pursuant to MEMR Regulation No. 35 of 2008 regarding Procedures for the Stipulation and Tender of Oil and Gas Working Areas, a working area can be offered either through a direct offer or a tender. In a direct offer, a company that performs a technical assessment through a joint study with the DGOG will receive the right to match the highest bidder of the tender round. Most new working areas are awarded through a tender process.

A PSC is granted for 30 years, typically comprising six plus four years of exploration and 20 years of exploitation. A PSC that has entered into the exploitation phase shall be subject to cost recovery. The production output of the traditional cost recovery PSC is subject to a first tranche petroleum (FTP) requirement where 10 per cent of oil and gas production shall be given to the government first and the remaining portion will be distributed between the PSC contractor and the government based on the production split proportions set out in each PSC, cost recovery and certain taxes.

In 2017, MEMR Regulation No. 8 of 2017 regarding gross split PSCs, as most recently amended by MEMR Regulation of 12 of 2020 (MEMR Reg 8/2017), introduced a gross split production sharing scheme through a gross split PSC. The gross split is agreed through negotiations with SKK Migas, and the production output is split at gross without FTP or cost recovery, stipulated at the beginning of a field's development and subject to fluctuation depending on certain variables and progress components. Existing PSCs signed prior to MEMR Reg 8/2017 shall be valid until their expiry and may be converted to gross split PSCs. If this option is exercised, the incurred and non-recovered operational costs of these cost-recovery PSCs shall be calculated as an additional split to the PSC contractor's share. For expiring PSCs, the MEMR shall determine either to adopt a gross split PSC, a cost-recovery PSC or other form of cooperation contract, whether or not the expiring PSC is extended. The MEMR shall also determine the form of new PSCs based on the level of risk, investment climate and maximum benefit for the state.

In general, GR 35/2004 provides that a PSC should at least contain the following provisions: state revenues, the working area and its relinquishment, obligatory funding expenses, the transfer of ownership of oil and gas production, the contract period and contract extension requirements, settlement of disputes, the obligation to supply crude oil or natural gas (or both) for domestic needs, post-mining operation obligations, occupational health and safety, environmental management, the transfer of rights and obligations, reporting requirements, field development plans, preferential utilisation of domestic goods and services, the development of the surrounding community and a guarantee of the rights of nearby traditional communities and the prioritisation of the use of Indonesian workers.

Below is a table summarising brief key differences between cost recovery and gross split PSCs.

Description	Cost recovery PSCs	Gross split PSCs
Production sharing split	Depending on each PSC, typically 65:35 between the government and the PSC contractor for oil, and 60:40 between the government and the PSC contractor for gas.	57:43 between the government and the PSC contractor for oil, and 52:48 between the government and the PSC contractor for gas, both of which can be increased based on: • variable components (i.e., working area status, field location, reservoir depth, infrastructure availability, reservoir type, CO_2 content, H_2S content, specific gravity, local content achievement, production phase); and • progressive components (i.e., oil or gas price and cumulative oil or gas production). It has been reported that one gross split PSC (for a mature field) was set at 42.5:57.5 between the government and a PSC contractor[7].
Approvals required	Approvals are provided for work programmes and budgets (WP&B) and the POD, and the Authorisation for Expenditure (AFE).	Approvals are provided for the POD.
Recovery of costs	All allowable current costs as well as amortised exploration and capital costs.	None.
Procurement of goods and services	Regulated under the prevailing working guidelines issued by SKK Migas.	Managed independently by each PSC contractor, not based on SKK Migas working guidelines.

The continuation of operations following the expiry of the term of a relevant PSC is regulated under MEMR Regulation No. 23 of 2018 regarding the Management of Oil and Gas Working Areas with Expiring PSCs, as most recently amended by MEMR Regulation No. 3 of 2019. This regulation provides that upon the expiry of a PSC, a PSC may either be taken over by Pertamina, extended, jointly operated by Pertamina and the PSC contractor, or tendered to the public.

IV PRODUCTION RESTRICTIONS

Oil and gas production remains owned by the state until its possession is delivered at the point of export or other delivery point. Once it reaches the point of export or other delivery point, the PSC contractor is entitled to any production of oil and gas based on the production split as regulated under the PSC.

The PSC contractor can take its share of the oil and gas production in kind. For oil production, the PSC contractor may take its oil production share in kind and sell it with the option not to commingle the sale with the government's share of oil production. For gas production, in practice, the PSC contractor's and the government's share of production are sold jointly.

Exports of oil and gas are subject to the fulfilment of the Domestic Market Obligation (DMO) and the initial domestic offering under MEMR Regulation No. 42 of 2018 regarding Prioritised Use of Natural Oil for the Fulfilment of Domestic Needs. This regulation requires PSC contractors or their affiliates to offer their crude oil portion to Pertamina or holders of the crude oil processing licence, or both, through a negotiation process on a business-to-business arrangement no later than three months before commencing the export recommendation

7 PWC Oil and Gas in Indonesia, Investment and Taxation Guide May 2019, 9th Edition.

period for the PSC contractor's entire portion of crude oil. Through the negotiation process, Pertamina may directly appoint a PSC contractor for the purchase of the crude oil, which may be made in the form of a long-term contract with a term not to exceed 12 months.

In January 2019, the government issued Government Regulation No. 1 of 2019 on Export Proceeds from the Exploitation, Management and/or Processing Activities of Natural Resources. This regulation requires foreign exchange proceeds derived from the export of natural resources, including oil and gas, to be placed in the Indonesian financial system through a special account in an Indonesian foreign exchange bank, which must be licensed by the Financial Services Authority. The Indonesian branch offices of overseas banks do not satisfy this requirement. The placement of the export proceeds in a special account must be carried out no later than the end of the third month after the registration of export declaration. The funds in the special account can only be utilised by the PSC contractor for certain payments, such as customs, loans, imports, profits or dividends, and other purposes permitted by the Indonesian Investment Law (namely Law No. 25 of 2007 regarding Capital Investment).

A PSC contractor is required to fulfil the DMO by supplying oil or gas, or both, to meet domestic needs. The participation of the PSC contractor is determined on a prorated basis in accordance with its share of total oil and gas production. Typically, the amount of the PSC contractor's participation is 25 per cent of the oil and gas production, subject to stipulation by the MEMR. In the past, there was no DMO requirement related to gas production. A DMO requirement for gas was introduced in PSCs that were signed after the issuance of the Oil and Gas Law.

The value of oil to determine the sharing of production and for tax purposes must be not less than the Indonesian Crude Price (ICP). With respect to gas, the relevant gas sales contract is based on negotiations on a field-by-field basis between SKK Migas, buyers and individual producers. There is a requirement that the determination of gas prices by a PSC contractor must follow the considerations provided under MEMR Regulation No. 6 of 2016 regarding Provisions and Procedures for Determining the Allocation, Utilisation and Price of Gas, as amended by MEMR Regulation No. 32 of 2017, namely the economics of a particular gas field, domestic and international gas prices, and the added value of the domestic utilisation of gas. After determining the gas price, it must be submitted to the MEMR, through SKK Migas, for approval.

In April 2020, the MEMR issued MEMR Regulation No. 8 of 2020 and MEMR Decree No. 89K/10/MEM/2020, which amended gas prices for specific industries (e.g., the fertiliser, petrochemical, oleochemical, steel, ceramics, glass and rubber glove industries). Additionally, MEMR Regulation No. 10 of 2020 and MEMR Decree No. 91K/12/MEM/2020 amended gas prices for power plants. The adjustment of existing gas prices because of the foregoing regulations will not affect a PSC contractor's entitlement, but instead becomes a reduction of the government's entitlement in accordance with the PSC for the working area for the current year. This reduction cannot exceed the government's entitlement for the current year.

V ASSIGNMENTS OF INTERESTS

PSCs contain different approval requirements for the transfer of participating interests, depending on when they were entered into. For a transfer to an affiliated company, some PSCs do not require any approval. For a transfer to a non-affiliated company, PSCs require either the approval of the MEMR, the MEMR and SKK Migas, or the MEMR through SKK Migas. As noted, the different approval requirements depend on the generation of the signed PSC.

For the sake of unification, the MEMR issued MEMR Regulation No. 48 of 2017 regarding Business Supervision in the Energy and Mineral Resources Sectors (MEMR Reg 48/2017), which requires prior approval from the MEMR, through SKK Migas, to transfer a participating interest to affiliated or non-affiliated companies. In practice, the government currently refers to the transfer of participating interest approval requirements in MEMR Reg 48/2017 rather than those set forth in individual PSCs.

GR 35/2004 and MEMR Reg 48/2017 prohibit a PSC contractor from transferring its majority participating interest to a non-affiliated party within the first three years of the PSC contractor's exploration period.

A change of control through the transfer of a majority of the shares of a PSC contractor, on the other hand, does not always require the approval of the MEMR (through SKK Migas). A change of control can take one of two forms, namely a direct change of control and an indirect change of control. MEMR Reg 48/2017 defines 'direct control' as the direct ownership by a parent company being one level above through the ownership of a majority of the shares having voting rights. It is commonly understood that 'indirect control' means transfer of shares by a parent company beyond one level above that owns a majority of the shares with voting rights in a PSC contractor.

Only PSCs signed in 2008 and later require approval for a direct and indirect change of control, either from the MEMR, through SKK Migas, or from both the MEMR and SKK Migas. MEMR Reg 48/2017 requires the prior approval of the MEMR, through SKK Migas, for a direct change of control and notification to the MEMR, through SKK Migas, for an indirect change of control, which is typically given after the transaction has been completed. In practice, the government currently refers to MEMR Reg 48/2017 and not PSCs for the approval and notification requirement for direct and indirect changes of control.

The government does not have a right of first refusal or preferential purchase rights upon a transfer of a participating interest or a change of control. Other than imposing a final tax to be paid out of the consideration for any transfer of a participating interest or change of control (i.e.,, 5 per cent for a transfer during the exploration stage and 7 per cent for a transfer during the exploitation stage), the government does not impose any other requirements with respect to the consideration for any transfer of a participating interest or a change of control. Therefore, the consideration can be agreed between the parties in the transfer documentation.

A PSC contractor is required, under MEMR Regulation No. 37 of 2016 regarding the Requirement to Offer a 10 per cent Participating Interest in an Oil and Gas Block (MEMR Reg 37/2016), to offer through SKK Migas a 10 per cent participating interest to a regionally owned business entity (BUMD) or state-owned business entity (BUMN) after the first commercial discovery. In essence, MEMR Reg 37/2016 regulates that following the first approval of a POD, SKK Migas will notify the governor of the relevant working area. Within a period of one year, the governor must prepare a BUMD and submit a letter to SKK Migas indicating the appointment of the BUMD. SKK Migas will deliver the letter to the relevant PSC contractor requesting it to start the offer process to the BUMD. If the BUMD rejects the PSC contractor's offer (or if the governor does not submit the letter to SKK Migas), the PSC contractor must offer the 10 per cent participating interest to a BUMN. There is no regulation that establishes the purchase price or the valuation method for the 10 per cent participating interest.

VI TAX

Taxes that are applicable to PSCs include income tax, value added tax, import duties, regional taxes and other levies. Each PSC may stipulate whether the tax laws and regulations applicable at the time the PSC was executed shall apply or whether the PSC shall follow changes to tax laws and regulations that are issued over time. Currently, the income tax rate is 25 per cent. VAT has a rate of 10 per cent, which is imposed on the provision of services and may be reimbursed with respect to cost recovery PSCs. Branch Profits Tax (BPT), which is assessed on the after-tax profits of a PSC contractor's permanent establishment (i.e., a foreign entity as discussed below), also applies and has a rate of 20 per cent, subject to reduction under an applicable tax treaty. If the PSC contractor is a business entity (i.e., an Indonesian entity as discussed below), the BPT is not applicable; however, its disbursements of dividends are subject to a withholding tax of 20 per cent, from which an exemption can be obtained if (1) the dividend is derived from retained earnings of the business entity, or (2) the recipient of the dividend is a legal entity holding at least 25 per cent of the shares in the business entity. In addition, PSC contractors are required to pay non-tax state revenues such as exploration and exploitation fees and bonuses, including signing bonuses and production bonuses, which vary depending on the PSC.

Currently, tax arrangements for cost recovery PSCs are regulated under Government Regulation No. 79 of 2010 regarding Refundable Operational Costs and Income Tax Treatment in the Field of Upstream Business of Oil and Gas, as amended by Government Regulation No. 27 of 2017 (GR 79/2010). Tax arrangements applicable for gross split PSCs are regulated under Government Regulation No. 53 of 2017 regarding Tax Treatment for Upstream Oil and Gas Business Activity through Gross Split PSCs (GR 53/2017). The procedures to be granted certain tax facilities under GR 53/2017 are elaborated in MOF Regulation No. 67/PMK.03/2020 regarding the Granting of VAT or VAT and Luxury Goods Sales Tax, as well as Land and Building Tax Facilities for Upstream Oil and Gas Business Activity through Gross Split Production Sharing Contracts (MOF Reg 67).

In general, both GR 79/2010 and GR 53/2017 regulate the taxation of the production sharing income and non-production sharing income of PSC contractors. Both Regulations allow certain tax incentives and tax facilities. The tax facilities under GR 79/2010 and GR 53/2017 are similar. During both the exploration and exploitation stages, there is an exemption from import duty for the import of goods used in the context of petroleum operations, an exemption from VAT or Luxury Goods Sales Tax for certain goods and services used in the context of petroleum operations, a reduction in the Land and Building Tax (PBB) amounting to 100 per cent, which is applicable during the exploration stage, and a reduction of subsurface PBB amounting to 100 per cent, which is applicable during the exploitation stage. Tax facilities in the exploitation stage will be granted by the MOF based on its consideration of project economics. GR 79/2010 provides tax incentives including a DMO holiday (with no time limit specified), a range of tax incentives as long as they are in accordance with the prevailing tax laws and a range of non-tax state revenue incentives including the use of state-owned assets for upstream activities. With regard to gross split PSCs, the procedures to obtain non-collection of VAT or VAT and Luxury Goods Sales Tax, and Land and Building Tax are provided under MOF Reg 67.

VII ENVIRONMENTAL IMPACT AND DECOMMISSIONING

PSC contractors are required to comply with the provisions of occupational health and safety, environmental management, and community development regulations. In the exploration stage, PSC contractors must complete an environmental monitoring and environmental management report (UKL/UPL). In the exploitation stage, PSC contractors must further conduct an environmental assessment (AMDAL), which must be approved by the relevant government authority. PSC contractors are also required to make periodic reports to the relevant government authority regarding their compliance with the UKL/UPL or AMDAL. In addition, Law No. 32 of 2009 regarding Protection and Management of Environment requires PSC contractors to obtain an environmental licence from the Minister of Environment and Forestry. While the DGOG is responsible for supervising the implementation of health, safety and environment (HSE) regulations in the oil and gas sector and imposing sanctions for non-compliance, it designates mining inspection enforcement teams to examine the work safety compliance of oil and gas businesses. If the facilities and techniques satisfy work health and safety standards, the DGOG will issue certifications for installations and equipment. In the event that a company does not comply with applicable HSE rules, it will be subject to various administrative sanctions ranging from warnings to the revocation of its licence.

The Oil and Gas Law highlights post-operation obligations as a means of ensuring environmental management and protection, and GR 35/2004 obligates contractors to allocate funds for post-operation activities. In 2018, the MEMR issued MEMR Regulation No. 15 of 2018 regarding Post-Operation Activities in Upstream Oil and Gas Business Activities. This Regulation requires PSC contractors to carry out post-operation activities before or on the expiry of the PSC. Post-operation activities include well-plugging, site restoration and managing the disposal of equipment, installations and facilities. These post-operation activities must be initially reported to SKK Migas through the submission of a WP&B (if the PSC is in the exploration stage) or through a POD (if the PSC is in the exploitation stage). PSC contractors are also required to deposit funds for post-operation activities in a joint account between SKK Migas and the PSC contractor in an Indonesian state-owned bank. The deposited funds must be in accordance with the estimated costs in the post-operation activities plan submitted to SKK Migas. Other specific decommissioning obligations include land reclamation and the dismantlement of facilities that are no longer used.

VIII FOREIGN INVESTMENT CONSIDERATIONS

i Establishment

Under the Oil and Gas Law and GR 35/2004, upstream oil and gas business activities may be carried out by a business entity or a permanent establishment (PE). A business entity is a legal entity established under the laws of Indonesia and operating and domiciled in Indonesia. It may be in the form of a state-owned enterprise, a regional administration-owned company, a cooperative, a small-scale business or a private business entity. A PE is a business entity established and existing outside the territory of Indonesia that engages in activities within the territory of Indonesia and is subject to prevailing Indonesian laws and regulations. An offshore subsidiary holding the participating interest in a PSC is considered a PE.

A business entity can be in the form of a wholly Indonesian-owned company (PMDN) or a partially or wholly foreign-owned company (PMA). Based on the 'ring-fencing' principle under the Oil and Gas Law, only one PSC may be granted to each company, meaning that one company cannot hold a participating interest in more than one PSC. However, several companies can own participating interests in a single PSC.

Before a PMDN or PMA can be established, it must meet the minimum capital requirements, which are significantly higher for a PMA. The establishment of a PMDN is less complicated; it can freely determine its line of business and may freely modify or change its line of business by simply amending its articles of association. A PMA must comply with foreign ownership requirements by referring to the prevailing negative investment list issued by the government. In the current negative investment list, upstream oil and gas activities are open to 100 per cent foreign ownership. The process for establishing a PMDN and PMA consists of the preparation of a deed of incorporation by a notary, approval of the deed by the Minister of Law and Human Rights, and the issuance of a taxpayer registration number (NPWP). With the establishment of the single-window licensing platform, called the online single submission (OSS) system, through the issuance of Government Regulation No. 24 of 2018 regarding Electronic Integrated Business Licensing Services (GR 24/2018), a PMDN and PMA in the oil and gas sector must be registered in the OSS system to obtain a business identification number (NIB). The establishment process can take a total of three to four weeks.

The establishment of a PE, on the other hand, is significantly simpler. Other than a requirement to obtain an NPWP, it only has to register with the OSS system to obtain an NIB, which is required by common practice and unwritten Capital Investment Coordinating Board (*Badan Koordinasi Penanaman Modal* or BKPM) policy despite GR 24/2018 not specifically requiring a PE to do so. In total, the establishment process can take three to four weeks.

ii Capital, labour and content restrictions

In the Indonesian oil and gas sector, capital refers to funds that are disbursed during the operation of the PSC. For cost recovery PSCs, the only restriction on the movement of funds is that a PSC contractor's funds during the implementation of the PSC can only be disbursed to the extent it is in accordance with the yearly WP&B or AFE, or both, approved by SKK Migas. Any excess of funds requires a separate approval from SKK Migas. Gross split PSCs do not contain any restriction on the utilisation of funds during the implementation of PSC operations as the budgets are not approved by SKK Migas.

Bank Indonesia Regulation No. 17/3/PBI/2015 regarding the Mandatory Use of Rupiah (PBI 17/2015) restricts most transactions within the Indonesian territory from being carried out using foreign currency. Bank Indonesia Circular Letter No. 17/11/DKSP was issued as an implementing regulation for PBI 17/2015 and it exempts oil and gas infrastructure projects from the required use of rupiah for transactions. To obtain the exemption, the project owner must seek confirmation from the relevant ministry and obtain a waiver letter from Bank Indonesia.

SKK Migas Working Guideline No. PTK-007/SKKMA0000/2017/S0 (Revision 04) Book Two regarding Guidelines for the Implementation of Goods/Services Procurement requires business players to prioritise local goods, services, technology, and design and engineering, so long as they are of comparable quality, price and availability. Indonesian-made equipment must be purchased if it meets the requirements, even if the cost of the equipment is higher than foreign-made equipment. Local goods must be given preference if their price is within 15 per cent of the lowest tender price and within 7.5 per cent for local services. Goods, services, technology, and design and engineering can be imported if they are not produced domestically. These Guidelines do not apply to gross split PSCs.

PSCs require that PSC contractors give preference to qualified Indonesian personnel and train such personnel for staff positions, including in administration and executive management. The Oil and Gas Law also requires PSC contractors to prioritise Indonesian personnel. PSC contractors may employ expatriates if the expertise is unavailable in Indonesia. In 2018, the government relaxed the restricted positions for expatriates in the oil and gas sector by revoking MEMR Regulation No. 31 of 2013 regarding the Procedures to Utilise Expatriates in Oil and Gas Activities. This is supervised by way of expatriate and local manpower utilisation plans submitted by the PSC operator to SKK Migas for its review and approval.

iii Anti-corruption

The relevant anti-corruption laws and regulations in Indonesia consist primarily of the Indonesian Criminal Code, Law No. 11 of 1980 regarding Bribery and Law No. 31 of 1999 regarding the Eradication of Criminal Acts of Corruption (the Corruption Law). The Corruption Law applies to government officials or any other person who commits an illegal act to enrich himself or herself or who favours himself or herself or abuses power, opportunity or facilities, which in either case may harm state finances and the national economy. Any person who accepts or makes any gift in kind or payment in view of a government official's position or authority is guilty of an act of criminal corruption, whether or not a loss is suffered by the state as a result.

Despite having laws and regulations for the prevention of corruption in Indonesia, anti-corruption efforts have proven difficult to implement. Historically, major corruption cases have resulted in the issuance of new regulations, in the hope they would eradicate corruption practices in the future. One example of this involves Pertamina, which in the past served as both regulator and operator, prompting the issuance of the Oil and Gas Law to end Pertamina's regulatory rights.

Research by the professional services firm Ernst & Young found that the highest risk of corruption was among vendors that provide goods and services to PSC contractors, during the procurement process and related to permitting and licensing.[8] In 2013, the head of SKK Migas was arrested for taking bribes from a Singaporean oil company as part of a tender. Also, the complicated procedures for obtaining the numerous exploration licences required have created an environment conducive to bribery, corruption and extortion. In February 2018, the MEMR issued regulations to revoke past regulations related to licensing and simplify the number of exploration licences required.

A recent major corruption case has caused some legal uncertainty, in particular as to the line between bad business decisions and graft. In June 2019, the former president director of Pertamina was sentenced to eight years in prison for her involvement in alleged graft related to Pertamina's investment in an Australian block, which ultimately resulted in losses to the company and caused state losses amounting to 568 billion rupiah. Some observers say there

8 Center for International Private Enterprise, https://www.cipe.org/legacy/publication-docs/CIPE%20AntiCorruption%20Guidebook%200815.pdf.

was a lack of legal evidence to prove graft and that the losses may simply have resulted from a bad investment. This begs the question as to the extent that bad business decisions in the oil and gas industry can be criminally charged.

IX CURRENT DEVELOPMENTS

i Updates on the Oil and Gas Law

A draft of a new oil and gas law, which will revoke and replace the current Oil and Gas Law, is being prepared by the House of Representatives. Throughout the preparation process, the government has publicly disclosed several working drafts, most recently in 2018. The 2018 draft is widely expected to change the oil and gas regulatory framework, with the proposed changes including the establishment of BUK Migas to replace SKK Migas, increased privileges for Pertamina in acquiring work areas, contracts and licensing mechanisms in the upstream sector, the prescribed maximum period for exploration activities, and an obligation to dedicate production to the domestic market through a safeguarding business entity established by the law.

The draft Omnibus Law only amends the current Oil and Gas Law as opposed to replacing it, which is the case with the 2018 draft oil and gas law. The draft Omnibus Law is expected to grant more power to the President over the oil and gas sector as it establishes the President as the sole mining rights holder and the only authority entitled to issue sanctions, as compared to the 'the President and his ministers' under the Oil and Gas Law. The draft Omnibus Law also removes the obligation to submit a newly executed PSC in writing to the House of Representatives, moves civil servant investigators in the oil and gas sector under the coordination of the Indonesian national police force and simplifies licensing procedures in the downstream oil and gas sector.

The draft Omnibus Law is listed as a prioritised bill in the House's 2020 National Legislation Programme. The 2018 draft oil and gas law is not a prioritised bill in the 2020 National Legislation Programme but is listed in the 2020–2024 National Legislation Programme. For this reason, it appears that the draft Omnibus Law will be enacted prior to the 2018 draft oil and gas law. In this case, the 2018 draft oil and gas law may be amended to adjust to the Omnibus Law.

ii Impact of covid-19 on the Indonesian upstream oil and gas industry

In general, PSC contractors are required to prepare internal procedures and policies for emergency situations, including outbreaks and pandemics, under SKK Migas Working Guideline No. PTK-005/SKKMA0000/2018/S0. In the wake of the covid-19 pandemic, SKK Migas issued several circular letters in February and March 2020 in anticipation of an outbreak or a pandemic in the oil and gas working areas. The letters instructed PSC contractors to, among other things, continue production but mitigate risk by imposing work-from-home arrangements for workers outside of oil fields and temporarily changing work schedules at oil and gas fields, and to require SKK Migas to coordinate communications with the head of the relevant regional government.

To achieve accelerated investment and production, SKK Migas has proposed to the government the following facilities for oil and gas investors:

a postponement of Abandonment Site Restoration reserves;
b a tax holiday for income tax in the form of BPT if repatriated to Indonesia;
c exemption of LNG from income tax;

d exemption of lease fees for state-owned assets;
e exemption of a certain amount of the Badak LNG plant utilisation fee;
f up to 100 per cent reduction of indirect taxes;
g the implementation of upstream gas price adjustment by maintaining a PSC contractor's entitlement;
h temporary incentives such as accelerated depreciation, temporary split adjustment (such as a sliding scale) and full price of ICP for DMO; and
i support from related ministries supervising oil and gas supporting industries to impose a tax exemption for oil and gas supporting business activities (e.g., drilling, etc.).[9]

iii Contract area tenders and projects

All tenders of contract areas in 2020 have been postponed as a result of the covid-19 pandemic, affecting tenders for 12 working areas, consisting of 10 conventional and two non-conventional working areas.[10]

Nevertheless, the first and second quarters of 2020 saw the realisation of five upstream projects from a total of 15 projects expected to come on stream this year. These realised projects are:

a the Buntal-5 field by Medco E&P Natuna Ltd;
b the Randugunting field by PT Pertamina Hulu Energi;
c Grati Pressure Low by Ophir Indonesia Ltd;
d Bukit Tua Phase 3 by Petronas Carigali Ketapang II Ltd; and
e the Sembakung Power Plant by PT Pertamina EP.

Proposed projects in the third quarter of 2020 include:

a the Malacca Strait Phase I by EMP Malacca Strait;
b the Cantik field in the Belida PSC by Sele Raya Belida;
c the Betung Compressor and SKG-19 Musi Timur by PT Pertamina EP;
d the Meliwis field in the Madura Offshore PSC by Ophir Indonesia Ltd; and
e the Peciko 8A field in the Mahakam PSC by Pertamina Hulu Mahakam.

9 SKK Migas Bulletin May 2020.

10 Directorate General of Oil and Gas, https://migas.esdm.go.id/post/read/jadi-anggota-mdr-peserta-lelang-wk-migas-bebas-akses-data; CNN Indonesia, www.cnnindonesia.com/ekonomi/20200409104447-85-491960/corona-esdm-jadwal-ulang-lelang-10-blok-migas.

Appendix 1

ABOUT THE AUTHORS

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Darrell R Johnson has resided and practices in Indonesia for more than 40 years. He has been the senior legal counsel of SSEK Legal Consultants since its founding in 1992 and is now its senior of counsel. Darrell works with international companies and large Indonesian firms and has a wealth of experience advising on large and complex transactions across numerous sectors. Darrell has represented major oil companies active in Indonesia, including ExxonMobil, Total, British Petroleum, ConocoPhillips, Chevron, Anadarko and Hess Corporation, among others. He has been active in the representation of a major US oil company in a joint venture project with Indonesia's largest coal-bed methane company. Representative engagements include advising Indonesia's state-owned oil and gas company on the acquisition of a stake in a petrochemical company, counseling Mobil Cepu on regulatory and land issues related to an oil and gas project in Java and advising Exxon Natuna on regulatory issues pertaining to a multibillion-dollar oil and gas development. Darrell is a graduate of the University of Southern California and Stanford Law School, where he served on the board of editors of the Stanford Law Review. He is admitted to practise in California and the United States Supreme Court.

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Fransiscus Rodyanto is a partner at SSEK. He is heavily involved in projects related to the oil and gas, mining, geothermal industry, clean-water supply, ports, real estate and general corporate matters, as well as various commercial transactions. His areas of expertise include project finance, structuring, and procurement. Frans' experience includes advising various major oil and gas companies including Pertamina, ExxonMobil, PetroChina and Repsol on its operations and projects in Indonesia, advising a multinational oil and gas company on various environmental issues relating to its operations in Indonesia, and assisting Energy Development Corporation, the largest producer of geothermal energy in the Philippines and the second-largest in the world, with its corporate and financing matters in Indonesia. He is also advising a Middle East-based petroleum and natural gas company in relation to its Joint Venture Development Agreement with PT Pertamina (Persero) for a US$5 billion upgrade of the Cilacap refinery in Indonesia's Central Java province. Frans received his Bachelor of

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ISBN 978-1-83862-482-8