Oil and Gas
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INDONESIA – WHAT'S NEW?

MOVING COST RECOVERY TO GROSS SPLIT SYSTEM IN THE UPSTREAM OIL AND GAS SECTOR

The Indonesian government (State) introduced the new gross split system in production sharing contracts (PSC). The new system stipulates the production sharing split between the State and the contractors up front on approximately a 50:50 basis. This percentage split will be subject to further uplift as generally set out in this briefing. For further clarification, please contact Brian Gordon or Eviaty Jenie.

The gross split system was introduced through the enactment of the Indonesian Minister of Energy and Mineral Resources (MEMR) Regulation No. 8 of 2017 on gross split production sharing contracts (Regulation 8).

Objective

The enactment of Regulation 8 is an attempt to stimulate the upstream oil and gas industry with a move away from the traditional cost recovery regime and towards the gross split regime. The first gross split PSCs were entered into in January 2017 between the Upstream Oil and Gas Regulatory Task Force (SKKMigas) and PT Pertamina Hulu Energi for the production of Offshore North West Jave block, evidencing the country's eagerness to implement the new system.

How does the gross split system work?

The most distinct change brought about by the gross split system is the upfront calculation of the production sharing portions between the State and the contractors (approximately 50:50). This calculation is based on the gross production of the oil and gas working area (Working Area) and before tax and is stipulated prior to the commencement of exploration activities. This is a divergence from the conventional cost recovery PSCs, where the production sharing portions are calculated after deducting the exploration and production costs. In addition, the contractors can no longer recover capital and operating expenditures from the State which also means that the contractor will be required to fully fund the capital and operating expenditure.

A further long-term objective of this new system is that it will allow for a more accurate revenue prediction/calculation for the State which will be generated through the State's part ownership of the Working Area, as well as any bonuses, contractors' income tax and other indirect taxes.

holman fenwick willan hfw

By applying the gross split system, it is expected that contractors are likely to be more conscious and cost effective in allocating their budget to fund their exploration and production activities.

What provisions need to be incorporated?

Regulation 8 expressly requires that all gross split PSCs, at a minimum, incorporate the following provisions:

- That ownership of the natural resources remain with the State up to the delivery point.
- That SKKMigas will have the control over the operational management of the Working Area.
- That capital and operational costs are borne entirely by the contractor.

Gross split percentages and components

In the gross split system, the production sharing portion between the State and the contractors is calculated using two main components:

1. Base split components (Base Split), utilised as a base reference in stipulating the production sharing amount upon the approval of a plan of development (POD).
2. Adjustment components which include the variable (Variable Components) and progressive components (Progressive Components).

Regulation 8 stipulates the following Base Split percentages:

- Crude oil - 57% and 43% for the State and contractors respectively.
- Natural gas - 52% and 48% for the State and contractors respectively.

Upon the approval of a POD, the contractor's production sharing portion may be increased using the Base Split and adjusted by the Variable Components and Progressive Components.

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BRIAN GORDON, PARTNER

The Variable Components and the general uplift percentages are set out in Fig 1 below.

The Progressive Components comprise the price of crude oil using the Indonesia Crude Price (ICP) and the cumulative production of the Working Area. In the event the oil price is less than US$40 to US$70 per barrel, the contractors will receive an additional

Fig 1. The Variable Components and the general uplift percentages

Variable Components	Uplift Percentage
Status of Working Area (for the first POD (or 'fresh' developed Working Area) or subsequent POD)	5% for the first POD
Location (whether onshore or offshore)	8% - 16% depending on the depth of the Working Area
Well vertical depth in which hydrocarbon is discovered	1% for wells ≥ 2500 metres in depth
Supporting infrastructure	2% for frontier Working Areas
Type of reservoir	16% for non-conventional reservoirs
Content of CO2 and H2S	0.5% - 4%
Crude oil gravity (relates to the quality of the crude oil using the American Petroleum Institute standard)	1% for quality >25
Local content (relates to equipment manufactured locally used for exploration and production activities)	2% - 4%
Production stage	3% - 5%

uplift between 2.5% to 7%. The lower price of crude oil will get a higher uplift percentage up to 7%. Upon initial production, contractors may receive an additional uplift of between 1% to 5% up to the point their cumulative production reaches 150 million barrels of oil equivalent (Mboe).

Another feature that is viewed by the State to be beneficial for the contractors is that, in the event a Working Area does not achieve the stipulated economic level, MEMR may give a maximum of 5% additional uplift percentage to the contractors. In the event of a Working Area surpassing the stipulated economic level, MEMR may add a maximum of 5% to the production sharing portion of the State as well as the contractors.

Remaining provisions

Regulation 8 also requires gross split PSCs to include the typical provisions under the cost recovery PSCs such as the contractor's obligation to comply with the domestic market obligations (which is set at 25%), local content requirements and the ownership of all data and assets by the State.

Grandfathering provisions

Regulation 8 stipulates that cost recovery PSCs entered into prior to 16 January 2017 (being its date of enforcement) shall remain enforceable and valid until their expiration date. Upon the expiration of these PSCs (which extension thereof has been approved) the contractor may propose to the MEMR that the gross split system be implemented or that the existing cost recovery system be maintained. The contractors of the valid PSCs also have the option to amend their cost recovery terms and apply the gross split terms.

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EVIATY JENIE, ASSOCIATE

How HFW can assist?

While the new gross split system attempts to provide greater commercial benefits for both the contractors and the State, the new system still requires further consideration, careful interpretation and proper testing. The State needs to closely supervise the implementation of the new system and the commercial benefits generated from it for both the contractors and the State.

Although Regulation 8 does not appear to strictly require existing PSCs to implement the gross split system, we expect that the Indonesian government will issue further regulations or policies to fully implement the system across all PSCs.

In light of the above, it is important that existing and future contractors are guided throughout the entire oil and gas exploration and production process in Indonesia. HFW can advise existing and future contractors generally on acquisition and disposal, farm-in/farm-out of participating interests in Indonesian PSCs, investment models, financing and borrowing structures and, in particular, how the provisions of Regulation 8 may impact upon these transactions. We have Indonesian and international lawyers who have advised on complex acquisitions and farm-in/farm-out transactions in the upstream oil and gas sector. We can also direct you further on the regulatory compliance under the Indonesian upstream oil and gas legislation in order to secure your investment in Indonesia.

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