COMMENT ON INDONESIA: MINERALS AND PETROLEUM

By N. Fabri*

I must commend Dr. Makarim for his excellent overview of the Indonesian developments in the history of the life and politics of Indonesia in the field of minerals and petroleum, the law applicable to minerals and petroleum and foreign investment and the contractual arrangements that may be entered into pursuant to these laws. I think the paper is very useful as a reference text to Indonesian law on minerals and petroleum which Dr. Makarim analyses in a most enlightened and captivating manner.

My commentary will be restricted to the last three sections of Dr. Makarim's paper which deal with oil and gas mining activities. The basic philosophy applicable to such activities is simple and straightforward. Mineral oil and gas[1] in the statutory mining territory[2] of Indonesia are owned by the State and the mining undertakings of mineral oil and gas, that is, exploration, exploitation, refining and processing, transportation and marketing are controlled by the State and are exclusively carried out by the State Oil Enterprise, Pertamina, as the sole holder of the 'authority to mine'. Pertamina may, however, co-operate with other parties, including foreign oil companies. appointed by the responsible Minister of Mines and Energy as contractors for the State Oil Enterprise for the performance of any of these mining oil and gas undertakings on the basis of contractual arrangements predominantly in the form of a production sharing contract (PSC).

This commentary is concerned principally with the juridical nature and effects of the Indonesian oil and gas mining arrangements in general and the production sharing contract in particular. It is divided into two main sections. The first section, 'Background', explores in a historical context the Indonesian legal framework in which these arrangements operate and gives an account of the evolution of the PSC from its inception up to the present day. Next, an analysis is undertaken of the legal nature of these arrangements with particular attention given to their legal basis, legal form and content as well as their effectiveness. The second section, 'Analysis of the Production Sharing Contract' attempts to pro-

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1 The term 'mineral oil and gas' is adopted by the Law No. 37 Prp. of 1960 and is defined as 'the minerals of mineral oil, asphalt, ozokerite, all kinds of bitumen, both in solid and in liquid form, and all mineral gas as well as all products refined or processed from these minerals, but not including the minerals of anthracite and all kinds of coal, whether young or old' (Art. 1, sub. a). The same term is used throughout this commentary.

2 The term 'statutory mining territory of Indonesia' includes 'the whole Indonesian Archipelago, the land under the Indonesian waters according to Government Regulation-in-lieu-of-a-Law No. 4 Year 1960 and the continental areas of the Indonesian Archipelago' (Law No. 37 Prp. of 1960, Art. 1, sub. j).

vide an analysis of the basic terms of the production sharing contract, being the main legal agreement which regulates the relationship between Pertamina and the foreign oil companies in the light of the fundamental stipulations contained in the contract, the Indonesian oil and gas policy and the interests of the parties.

BACKGROUND

The Applicable Law

Prior to 1960, mining in Indonesia was governed by the Netherlands East Indies Mining Law of 1899[3] and the Mining Ordinance of 1930,[4] the latter law being a modified re-enactment of the former law. Pursuant to this legislation, all mineral rights vested in the then Dutch Colonial Government, which was statutorily authorised to grant long term concessions for mining exploration and exploitation to private parties, including foreign oil companies.

The Mining Ordinance of 1930 was still valid on 17 August 1945, the day of the proclamation of the independence of the Republic of Indonesia, and remained so valid until 1960. It is true that, with the declaration of independence in 1945, the country's first constitution was ratified, and that Article 33 of the Constitution prescribed State control of important 'branches of production' affecting 'the life of most people', including the 'land, water and the natural riches', which in turn were to be 'exploited for the greatest welfare of the people'. The 1945 Constitution was widely interpreted to have had the effect of precluding foreign oil companies from enjoying concessionary rights to Indonesian mineral resources. The existing mining laws, however, remained still valid by virtue of the applicable transitional provision of the Constitution which rendered valid all existing legislation until otherwise modified or replaced.[5] Besides, the legitimacy of the Constitution itself was open to question until the official transfer of sovereignty from the Dutch to the Indonesians occurred in late 1949.[6] The security of existing colonial concessions was, however, undermined when the Indonesian Parliament passed a motion in 1951 prohibiting the Government from granting any more concession agreements until the formulation of a national oil and gas policy and a state commission was formed to draft, *inter alia*, a new mining law 'in harmony with present conditions' as laid down in Article 33 of the 1945 Constitution.

After eight years of deliberation, the commission issued its report on the formulation of the new national oil and gas policy emphasising, in the main, the increase of the production of the Indonesian mineral oil and

3 State *Gazette* 1899. Adopted through the promulgation of the implementing regulation Mijnordonnatie of 1906.

4 State *Gazette* 1930, No. 38. Adopted on 25 February 1930 through the promulgation of Mijnordonnatie of 1930 effective as of 1 October 1930.

5 Constitution of 1945 of the Republic of Indonesia Transitional Provision, Art. II, states: 'all existing public offices and regulations are still valid as long as they are not yet replaced pursuant to this Constitution'.

6 Law No. 7 of 15 August 1950 applied a more liberal Provisional Constitution until the completion of a permanent one by the Constitutional Assembly. The Constitution of 1945 was, however, re-instated by Presidential Decree on 5 July 1959.

gas industry.[7] This led to the repeal of the colonial mining laws, a division of the petroleum and mining sector into two categories and the adoption of two laws: Law No. 37 Prp. of 1960 regarding mining in general, and Law No. 44 Prp. of 1960 (the 'Oil Law of 1960'), covering the mining of mineral oil and gas.[8] By operation of the Oil Law of 1960, the traditional concessionary regime was replaced by a system which recognised the permanent sovereignty of the independent State of Indonesia to effectively control its natural riches for the welfare of the people as laid down in the 1945 Constitution.[9] The law recognises State ownership of mineral oil and gas resources, and the State's sole authority to undertake the mining of such resources. The government, in its turn, is empowered to grant 'exclusive authorities to mine' such mineral oil and gas resources to State enterprises.[10] In cases where the State enterprises cannot, or cannot yet carry out any of the extractive activities by themselves because of lack of capital and technology and technical know-how, the government is further empowered to appoint third parties, including foreign oil companies, as contractors to the State enterprises to co-operate with them in the execution of the operations on the basis of suitable contractual arrangements.[11]

The basic policy applying to foreign oil companies desiring to work in Indonesia within the field of mineral oil and gas extraction as formulated in the Oil Law of 1960 (and later supplemented by Law No. 1 of 1967 concerning foreign capital investment) was thus changed and became based on the following concepts:

— A contract may be concluded between the State Oil Enterprise and a foreign oil company.
— The legal relation between the State Oil Enterprise and the foreign oil company may only be one of a contractorship relation, such that the foreign oil company is rendered unable to exercise any of the mining undertakings of mineral oil and gas functions as an independent operator.
— The field of operations can only be those operations which cannot or cannot yet be executed by the State Oil Enterprise, as holder of the 'authority to mine'.

7 General Elucidation (10) of the Oil Law of 1960. For a discussion of this policy see, R. Rochmat, *Contractual Arrangements in Oil and Gas Mining Enterprises in Indonesia*, (1981) 22–26.

8 The Oil Law of 1960 was based on Art. 9 of Law No. 37 Prp. of 1960 regarding mining. The latter law was revoked and replaced by Law No. 11 of 1967 regarding basic provisions on mining.

9 Art. 3(1) and (2) of the Oil Law of 1960 states:

(1) . . . the mining of mineral oil and gas shall only be undertaken by the State.
(2) Mining undertakings of mineral oil and gas are exclusively carried out by the State Enterprise.

10 Government Regulations No. 3 and No. 198 of 1961 established respectively two State Enterprises, Perusahaan Negara Pertambangan Minyak Indonesia (P.N. Pertamin) and Perusahaan Negara Pertambangan Minyak Nasional (P.N. Permina), each charged with a specific function in the petroleum industry.

11 Art. 6(1) of the Oil Law of 1960 states: '(1) The Minister may appoint other parties as contractors for the State Enterprise, if required for the execution of operations which cannot or cannot yet be executed by the State Enterprise involved as holder of the authority to mine itself.'

— Judgment of the advantages of the potential capital, technology and skill that were available from the foreign oil company could only be based on the principle 'as long as they really serve the interests of the people without creating dependence on foreign oil companies.'[12]

The transformation to a form of co-operation contract to fit within the conceptual mould of the Oil Law of 1960 was not, however, immediate. The early 1960s was a difficult period for the oil industry in Indonesia due to the resistance by the earlier concessionaires of the implementation of the new oil and gas law and to the prevailing political instability, the intra-governmental conflict and to personality clashes within the Ministry of Mines. Much of the prevailing difficulties were, however, removed by, first, the successful negotiation of 'contracts of work' to replace the concessions held by the earlier concessionaires; secondly, the consolidation of the State Oil Enterprises into one single entity. Perusahaan Negara Pertambangan Minyak Dan Gas Bumi Nasional (P.N. Pertamina) [13] which, shortly thereafter, began to utilise the production sharing contract as the vehicle for its control over the exploration and exploitation activities of foreign oil companies; and thirdly, the enactment of a number of related statutes and regulations determining the same.

Against this background, the law regarding mineral oil and gas extraction in Indonesia can be said to have developed in a number of phases under different statutes and regulations, the principal of which fall into four phases.

1. MINING ORDINANCES OF 1906 AND 1930 UNTIL THE ENACTMENT OF LAW NO. 14 OF 1963

Within this phase, the existing oil concessionaires, Shell, Stanvac and Caltex were working under concession contracts in the form of a joint enterprise (gemengd bedriff) and/or 5a Contracts (5a Contracten) entered into pursuant to the Mining Ordinance of 1930 which adopted a concessionary system. Under these concessions, the foreign oil companies had virtually exclusive management and control over the petroleum operations and were obligated to pay a surface tax for each hectare of the concession area, an annual royalty amounting to 4 percent of the gross production and, in some cases, an annual share of the net proceeds obtained during the previous year from the concession area. The export oil belonged to the concessionaires and could be sold without the consent of the government. These concessions were replaced with contracts of

12 See R. Rochmat *op. cit.* 25; see also Law No. 1 of 1967 concerning foreign capital investment and General Elucidation (4), (5) and (6) of the Law.

13 Government Regulation No. 27 of 1968: State *Gazette* No. 44, 1968. Revoked by the Pertamina Law of 1971 which dissolved P.N. Pertamina and transferred all rights and obligations including the consequences arising from any agreement/contract between P.N. Pertamina and other parties to the new Pertamina established under the Pertamina Law.

work ratified in statutory form by the enactment of Law No.14 Prp. of 1963 regarding Ratification of Contract of Work.[14]

2. OIL LAW OF 1960 WITHIN THE TRANSITION OF THE INDIES MINING LAW OF 1899, THAT IS, AFTER 1963 UNTIL 1967

During this phase, co-operation agreements in the form of a contract of work (Kontrak Karya) based on the Oil Law of 1960 were concluded with each of the three foreign oil companies in May 1963.[15] Under this contract, the foreign oil company's role changed from a concession holder to a contractor of the State-owned enterprises and was responsible for the provision of the risk capital, technical know-how and skill required for all operations, including exploration, exploitation and marketing activities. Petroleum ceased to be owned by the foreign contractor and instead remained vested in the nation and controlled by the State. Foreign contractors were no longer required to pay royalty on the basis of production but were to share the profits after recovery of costs with the government,[16] subject only to a special payment of 'pro rata' oil for domestic consumption limited to 25 per cent of annual production. The contract of work still contained, however, many aspects of the concession practice and provided for actions by the host country, the government and the State Oil Enterprise only if circumstances required. Thus, the foreign contractors retained most of their concessionary prerogative powers of management and control of their operations and continued to own the properties and assets until these were entirely depreciated. Although private mining rights were abrogated, the change from concession to a contract of work was, therefore, one of emphasis rather than substance since the then existing State Oil Enterprises showed little interest in assuming a meaningful supervisory and managerial role and the foreign contractor carried out the entire operation under the contract in its name and on its behalf.[17]

As a consequence of the lack of effective control exercised over the operations, a new form of co-operation contract, the so-called production sharing contract began to be adopted. Under this new contract, ownership and control of the mining undertakings remained in the hands of the State

14 Law No. 14 of 1963, regarding ratification of contract of work respectively between the State Oil Enterprises and P.T. Caltex Indonesia and Calasiatic/Topco, P.T. Stanvac Indonesia and P.T. Shell Indonesia.

15 Only two contracts of work remain in force (with Caltex and Stanvac). These will expire in 1993.

16 Initially, the profit oil split was 60/40 in favour of the State Oil Enterprise after deduction of operating costs (based on a 'base price' of US$5 per barrel). With the increase in the oil price in 1974, the difference between the base and the actual price became subject to an 85/15 split in favour of the State Oil Enterprise. In 1975, the profit oil split was further changed providing for the application of the 85/15 split on the remainder after cost recovery for production up to 150,000 BOPD, a 90/10 split for production between 150,000–250,000 BOPD and a 95/5 split for production over 250,000 BOPD in favour of the State Oil Enterprise.

17 R. Fabrikant, 'Production Sharing Contracts in the Indonesian Petroleum Industry' (1975) 16 *Harvard International Law Journal* 303, 309.

Oil Enterprise which, in turn, became active in all mineral, oil and gas mining activities.[18] This type of contractual arrangement came into being out of practice, because it is not in accordance with Article 6 of the Oil Law of 1960 which requires Parliamentary ratification for the effectiveness of the contract.[19] It was already applied by P.T. Permina in 1961 in North Sumatra, Indonesia.

The concept of production sharing referred to in the Presidential Statement of 3 August 1962[20] was adopted as the legal basis of the PSC in Phase 2. The first PSC was signed in 1964,[21] followed by three others in 1966.[22]

3. OIL LAW OF 1960 RELATED TO LAW NO. 1 OF 1967, THAT IS 1967 UNTIL 1971

Law No. 1 of 1967 regarding foreign capital investment became the legal basis of the PSCs concluded during this period. This is reflected in the preamble of the contract which provides that:

> Whereas, in accordance with Law No. 44/1960 and Article 8 of Law No. 1/1967 regarding foreign capital investment co-operative agreements may be entered into in the sector of mining between a State Enterprise and foreign capital investors.

The terms and conditions in the PSC used in Phase 2 were adjusted to the provisions of the Law No. 1 of 1967 which provides rules and regulations regarding, *inter alia* the term of the contract, namely thirty years, the obligation of the foreign company to train and educate Indonesian nationals in the field of management or business administration, especially in domestic and foreign marketing (Article 12) and the assignment of foreign managers, employees and experts for functions which cannot yet be performed by Indonesian nationals (Article 11). The term of the contract was, however, changed. If after 10 years from the effective date of the contract no petroleum is discovered, the contract shall automatically terminate in its entirety.[23]

4. OIL LAW OF 1960; LAW NO. 1 OF 1967; GOVERNMENT REGULATION NO. 29 OF 1969 AND LAW NO. 8 OF 1971 AS REVISED BY LAW NO. 10 OF 1974, PRESIDENTIAL DECREE NO. 44 OF 1975 AND PRESIDENTIAL DECREE NO. 31 OF 1983 (THE 'PERTAMINA LAW'), THAT IS, FROM 1971 ONWARDS

18 Below, 319–321.

19 These contracts probably existed in a legal vacuum until Parliament retroactively approved them through the promulgation of the Pertamina Law of 1971, and specifically Art. 31(2) which states that 'All rights and obligations and consequences emerging from any agreement/contract between P.N. Pertamina and another party shall become rights and obligations of the Corporation.' See also R. Fabrikant *op. cit.* 311–312.

20 Presidential Decree No. 201 of 1963 and Presidential Ordinance No. 20 of 1963.

21 Production sharing contract between P.N. Permina and Refining Associates (Canada) Ltd. 10 March 1964.

22 Production sharing contracts between P.N. Permina and Independent Indonesian American Petroleum Company August 1966 and between P.N. Permina and Japan Petroleum Exploration Company 6 October 1966.

23 Production sharing contract between P.N. Permina and the Continental Overseas Oil Company 12 May 1967.

The contractual arrangement in the form of a PSC finds its place in the laws and regulations in Indonesia. Article 12 of Pertamina Law of 1971 states:

1) The Enterprise may co-operate with another party in the form of a 'Production Sharing Contract'.
2) The terms and conditions of cooperation as referred to in paragraph (1) of this Article shall be regulated by a Government Regulation.

Until now this government regulation has not yet been issued. In this respect the legislator only stipulates in the Elucidation of Article 12: 'In this cooperation the most favourable terms for the State have to be sought'. It means, therefore, that the legislator still thinks about a negotiation with a foreign party. Such negotiation has, of course, to take into account the contents of the Indonesian oil and gas policy as determined in the related laws, regulations, decrees and statements.

The Production Sharing Contract Model And Its Evolution

The production sharing contract (PSC) model had evolved from the earlier 'contracts of work', having its legal basis in the 1945 Constitution, Article 6 of the Oil Law of 1960, Article 12 of the Pertamina Law of 1971 and other related laws and regulations. Aside from a few innovations and some further evolution in some terms, PSCs have not varied significantly through the years. The PSC model abandons the contract of work notions of profit-sharing and the investiture of management and ownership rights in the foreign oil company and adopts instead a system of production sharing, with management responsibilities residing in Pertamina and title to crude oil passing to the contractor only at the point of export. Other differences from concession models include the obligation of the contractor to supply a portion of its 'profit oil' to the domestic market in Indonesia and the requirements that Indonesian interests be offered participation rights and that contractors refine a portion of their oil locally or invest in other petroleum or petrochemical projects. Furthermore, Pertamina has a right to market part of the oil, to receive title to the contractor's equipment at the point of import, and to perform accounting and auditing functions. Based on the financial and fiscal terms concerning the mechanism applied in order to guarantee a certain portion of crude oil produced from the relevant contract area for the government, there can be said to have been three distinct generations of PSCs.[24]

FIRST GENERATION PSCs (1965–1975)

Under the first model PSC, a cost recovery cap of not more than 40 percent of total revenues obtained annually was applied for reimbursement of costs. The profit oil split after deduction of recoverable operating costs was initially 65/35 for Pertamina and contractor respectively; it was subsequently changed in 1974 to 85/15. Further, the contractor was obliged to contribute from each producing field 25 percent of production

24 G.A.S. Nayoan, 'Variations to the Indonesian Production Sharing Contract: Impact on Upstream Activities' (1989) *Institute for International Research*, Paper B. See also below the second section 'Analysis of the Production Sharing Contract'.

times the contractor's share percentage of the crude oil produced towards the Indonesian domestic market (DMO) for which it received US$0.20 per barrel contributed after the 60th month of production from the relevant field.

SECOND GENERATION PSCs (1976–1988)

The cost recovery cap was lifted under the second generation PSC model with the condition that a field development could only take place if the contractor could guarantee that total government take overall would not be less than 25 percent (formerly 49 percent) of the gross revenue obtained from that field over the life of that field. The DMO and the profit oil split remained unchanged. Due to the substantial decrease of exploration activities, a number of incentives to foreign oil companies were also introduced in 1976, especially for the production of newly discovered fields with the objective to encourage exploration.

THIRD GENERATION PSCs (1988 ONWARDS)

Following the announcement by the Government of Indonesia of the 31 August 1988 Incentives Package applicable to new and extensions PSCs, subsequently revised and modified by the 22 February 1989 Incentives Package for PSCs, the condition of the 25 percent minimum government return for the development of a field was abandoned and instead, a first tranche petroleum (FTP) was introduced. The FTP consists of a cap of 20 percent of oil or gas produced in each year which has to be shared between Pertamina and the contractor on the basis of the profit oil split percentages before deduction of recoverable operating costs. Thus, a cost recovery cap of up to 80 percent was introduced. The DMO is retained with the contractor receiving 10 percent of the export price (previously US$0.20 per barrel) of the crude oil produced from each field (applicable to all new fields in all contracts) after the 60th month of production from such field. The same profit oil split of 85/15 for Pertamina and contractor respectively is retained with variations in five cases.

1. The case of 'frontier areas'. Pertamina may define, based on geographical, bathymetric and geological criteria which are consistent, certain parts of Indonesia as frontier areas. The split in frontier areas is calculated on an incremental basis in relation to the equity split at specified production levels: up to 50,000 BOPD the split is 80/20, from 50,000 to 150,000 BOPD the split is 85/15, and from 150,000 BOPD upwards the split is 90/10 for Pertamina and contractor respectively.
2. The case of the first 'marginal field'. If a field has an average daily production of up to 10,000 BOPD within the first two years, then the split is 80/20. In 'frontier areas', the split is 75/25 for the new field.
3. The case of oil produced from 'pre-tertiary reservoir rocks'. In existing and new contracts the incremental split referred to paragraph (1) above applies. For oil produced from 'pre-tertiary reservoir rocks' in frontier areas, however, the split is more favourable

to the contractor: 75/25, 80/20 and 85/15 for the standard BOPD production as in the incremental split.

4. The case of oil produced from 'deep sea contract areas' (water depth over 600 feet). The same incremental split for frontier areas referred to in paragraph (1) above applies.
5. The case of oil produced from 'Tertiary Recovery EOR Projects'. In existing and new contracts the split is 80/20 and in frontier areas the split is 75/25.

Legal Nature Of Oil And Gas Mining Contractual Arrangements

The legal basis of the contractual arrangements between the State Oil Enterprise, Pertamina, and the foreign oil company is stipulated in Article 6 of the Oil Law of 1960 which provides that:

> (1) The Minister may appoint other parties as contractors for the State Enterprises, if required for the execution of operations which cannot or cannot yet be executed by the State Enterprises involved as holders of the 'authority to mine' themselves.
> (2) When entering into contracts of work with contractors as meant in paragraph (1) above, the State Enterprises are obliged to follow the indications, directives and conditions as given by the Minister.
> (3) Contracts of Work as mentioned in paragraph (2) above become effective after having been ratified by Law.

The above Article incorporates some fundamental aspects of the contractual arrangements that may be entered into, such as government authority, the legal competence and relation of the parties, legal form and contents of the contract, the procedure and effectiveness of the contract and the legal status of the contract. The law does not, however, elaborate further on what the specific details of the terms and conditions of the contract should be. It opts instead for maximum flexibility and the dictates of the particular circumstances attending the contract area and the contractor's bids.[25]

THE GOVERNMENT AUTHORITY: POWERS AND COMPETENCES

The current structure of government involvement in the field of oil and gas mining in Indonesia is regulated by the Oil Law of 1960, Government Regulation No. 29 of 1969, Pertamina Law of 1971 as revised by Law No. 10 of 1974, Presidential Decree No. 44 of 1975 and Presidential Decree No. 31 of 1983. Pursuant to these laws, the powers and competences relating to the extraction of oil and gas are distributed between the government, *in casu* the Ministry of Mines and Energy responsible for the administration, supervision and regulation of mineral oil and gas mining undertakings and the State Oil Enterprise, Pertamina, responsible for the execution of such mining undertakings. Functionally, the powers and responsibilities of the ministry are centralised in the Department of Mines and Energy headed by a Minister with full rank.

The main functions of the department consist of the following:

— It is responsible for the establishment of oil and gas policy in Indonesia.

25 Elucidation of Art. 6 of the Oil Law of 1960.

— It is, through the representation of the Minister, the licensing authority in Indonesia.
— It supervises, through the Directorate General of Oil and Gas (Direktorat Jenderal Minyak dan gas Bumi — Migas), all oil and gas mining activities that are vital to the public interest.

Migas' main functions are:
— to supervise Pertamina;
— to supervise the remaining two contracts of work;
— to indirectly oversee, through Pertamina, the operations under the existing PSCs;
— to license service companies in the oil and gas sector;
— to enforce work safety and environmental regulations;
— to supervise training programmes for Indonesian workers;
— to monitor crude and product specifications, through the Indonesian Oil and Gas Research and Technology Development Centre (Lemigas);
— to operate the Oil and Gas Academy, through the Oil and Gas Manpower Development Centre (Pusat Pengembangan Tenaga Minyak dan Gas Bumi — PPTMGB);
— to ensure that Indonesian law is being administered in a satisfactory manner.

The State Oil Enterprise, Pertamina, is governed by the Oil Law of 1960 and Law No. 8 of 1971 as amended by Law No. 10 of 1974, Presidential Decree No. 44 of 1975 and Presidential Decree No. 31 of 1983. The Pertamina Law of 1971 as amended constitutes the memorandum of association and articles of association of Pertamina. It defines the objective of the corporation, its field of operation and the extent of its powers. It is an enterprise wholly-owned by the State, the capital of which consists of the assets of the State, separated from the State's budget.[26] Pertamina's role under the law may be said to be twofold: it acts in the capacity of the holder of a statutory mandate and, at the same time, it acts in the capacity of a public corporation[27] with the status of a legal person in its own right.[28]

As holder of the statutory mandate, Pertamina is given the power and the competence by law to execute the mining functions of mineral oil and gas undertakings based on an 'exclusive authority to mine'.[29] In performing these functions, Pertamina has to provide sufficient petroleum products for the domestic consumption and to accumulate capital funds,

26 Art. 2(1) and 7(1) of the Pertamina Law of 1971.

27 Law No. 19 of 1969, jo, Instruction of the President of the Republic of Indonesia No. 17 of 1967, of 28 December 1967.

28 R. Fabrikant, 'Pertamina: A Legal and Financial Analysis of a National Oil Company in a Developing Country' (1975) 10 *Texas International Law Journal* 495.

29 Art. 5 of the Pertamina Law of 1971 states: 'The objective of the Enterprise is to develop and carry out the undertaking of mineral oil and gas in the widest sense of the word for the maximum prosperity of the people and the State as well as for creating national strength'. This Article is the implementation of Art. 3(2) of the Oil Law of 1960, which states: 'Mining undertakings of mineral oil and gas are exclusively carried out by the "State Enterprise"'.

including foreign exchange for the national development programme.[30] The 'authority to mine' is defined in the law as 'the authority as given to a State Enterprise to undertake mining operations for mineral oil and gas.'[31] Characteristically, this definition may be said to contain three main aspects, namely the authority, the mining undertaking and the authority holder. First, no mining undertaking may be carried out without an authority to mine[32] which, in the field of oil and gas, is given by virtue of a government regulation.[33] Secondly, the authority to mine provides only the competency to carry out a mining undertaking consisting of the five functions mentioned in the law, namely 'exploration, exploitation, refining and processing, transportation and marketing.[34] Such authority does not, therefore, transfer the mining ownership or the mining areas[35] nor does it abrogate existing land rights over such areas.[36] Pertamina is consequently neither a mining owner nor the owner of the mining areas so that land rights over areas subject to the authority to mine are not thereby affected. Furthermore, the authority to mine does not automatically cover the statutory mining territory of Indonesia: this is further determined by the government.[37] Thirdly, the authority to mine given to Pertamina is exclusive in the sense that only Pertamina may execute any of the functions of the mining undertaking.[38]

Beyond what is stated above, the law does not provide any rules as to how the functions of mineral oil and gas undertakings should be carried out by the State Oil Enterprise. Instead, the law leaves the matter to be regulated by the Ministry which has the task of administering, supervising the work and implementing the mineral oil and gas undertakings. In practice, Pertamina's principal regulatory and control functions are threefold. First, it is responsible for the management responsibilities for all operations of contractors under the PSCs, from exploration to pumpside. Exploration, development and production, whether offshore or onshore, are within one management structure with the same rules applying, with few exceptions, both to onshore and offshore participation by foreign oil companies. Secondly, it is the Indonesian signatory to oil and gas contracts with foreign oil and gas exploration and production companies.

30 Art. 13 of the Pertamina Law of 1971:

The tasks of the Enterprise shall be:
a) To carry out oil and natural gas exploitation for the acquisition of maximum prosperity for the people and the State.
b) To supply and serve the domestic demand for oil and natural gas, the implementation of which shall be regulated by Government Regulation.

31 Art. 1, sub. h of the Oil Law of 1960.
32 Under Art. 18 of the Oil Law of 1960 and Art. 15(1) of Law No. 11 of 1967, regarding basic provisions in mining, anyone carrying out mining undertakings not covered by an authority to mine is liable to a penalty of imprisonment.
33 Art. 5 of the Oil Law of 1960.
34 Art. 4 of the Oil Law of 1960 and General Elucidation (9).
35 General Elucidation (9) of the Oil Law of 1960 and Elucidation of Art. 15 of Law No. 11 of 1967.
36 Chapter V of the Oil Law of 1960 and Chapter VII of the Mining Law of 1967.
37 Art. 3(2), Art. 1 sub. h and Art. 1 sub. k of the Oil Law of 1960, as amended by Art. 2(3) of the Pertamina Law of 1971.
38 Art. 1, sub. h and Art. 3(2) of the Oil Law of 1960.

This is Pertamina's most important role, at least insofar as the interface with foreign oil companies with whom it contracts to explore for and develop oil and gas resources in Indonesia is concerned. Pertamina not only obtains the bulk of its revenue and crude oil through such contracts, but obtains much of its power as a result of them. Thirdly, it acts as an independent oil company in its own right by exploring and exploiting onshore oil and gas fields, managing the downstream end (*i.e.* refining) of the business, developing petrochemical complexes, and controlling the export and shipping of oil and gas products.

The organ through which Pertamina's management control over foreign contractors is exercised is called the Foreign Contractors Coordinating Body (Badan Koordinator Kontraktor Asing — BKKA). BKKA oversees all activities of foreign oil companies operating in Indonesia and at the same time acts as an implementer of government procurement procedures. Its main functions include, *inter alia*,

— the administration of all purchasing contracts;
— the vetting and approval of all foreign staff working in Indonesia;
— supervision of the implementation of government policies and guidelines of manpower;
— the control of activities of sub-contractors by the enforcement of a system of registration for various categories of equipment, materials and services — without a Pertamina (BKKA) licence, approved by Migas, no sub-contractor will be permitted to bid for contracts;
— the monitoring of the Indonesianisation of the sub-contractors to optimal technology transfer and training — firms seeking registration have to submit plans for training personnel to eventually take over all aspects of management. Regular reports indicating degrees of achievement of such plans have also to be submitted when re-registration is applied for;
— the review of all bids for acreage;
— the approval of budgets and work programmes submitted by contractors under the PSCs, determination of the commerciality or otherwise of discoveries, and evaluation of the contractor's recommendations for granting service contracts to sub-contractors.

Pertamina, as the holder of the authority to mine, is fully accountable for its acts to the government for the operations which it is authorised to perform by statutory mandate. Since the government is vested with the administration, supervision and implementation of oil and gas mining operations, any problems that may arise from Pertamina's operation and performance within the field of the undertaking of mineral oil and gas mining may be said to fall within the scope of the responsibility of the government.[39] As to contractual arrangements with third parties, the relationship between the government and the State Oil Enterprise presents two essential features.[40] On the one hand, the government, *in casu* the Minister responsible for Mines and Energy, is vested with the authority to

39 Art. 16 of the Oil Law of 1960 and Art. 1 of the Pertamina Law of 1971.
40 Art. 6(1) of the Oil Law of 1960.

undertake oil and gas mining activities. This authority includes the power to appoint other parties as contractors for the State Enterprise and, more importantly, to issue from time to time indications, directions and conditions upon which foreign oil companies are allowed to be appointed as contractors to Pertamina. Such authority may also include the authority to determine solutions to overcome or settle problems arising from the contractual arrangements concluded between Pertamina and other parties. The State Enterprise may only recommend or bring forward an interested party to the Minister for approval and may propose solutions to problems associated with the arrangements concluded with other parties. On the other hand, Pertamina, as the sole holder of the 'authority to mine' entrusted with the execution of such undertaking, is competent to conclude a contract with other parties as contractor, but then only with the parties appointed or approved by the Minister and upon those terms and conditions which the Minister may indicate from time to time.

As a *corporate body*[42] established under the Pertamina Law of 1971, Pertamina may act as a legal person for business purposes, that is, for commercial activities such as are referred to in Article 27 of the Pertamina Law. It may thus enter into agreements, contracts and other legal relations which are included under the law of contract generally, and under Article 27 of the Pertamina Law of 1971 specifically. In this regard, Pertamina acts independently in its capacity as a public corporation enjoying the status of a legal person. Consequently, such legal acts will legally bind the State Oil Enterprise and not the State, *i.e.* the government.[42] The government may interfere not on the basis of the law, but of policy in the interest of the State.

LEGAL COMPETENCE AND RELATION BETWEEN THE PARTIES

The legal competency of Pertamina and other parties, and the legal relation between them, is regulated both by the Oil Law of 1960 and the Pertamina Law of 1971 as amended.

The State Oil Enterprise

As has been observed above, the State Oil Enterprise, Pertamina, has legally a dual role. As the holder of the 'exclusive authority to mine', it has the power and competence to carry out mineral oil and gas mining undertakings; otherwise, in pursuance of Article 3(2) of the Oil Law of 1960, Pertamina is the performer of the State in carrying out mineral oil and gas mining undertakings based on the 'authority to mine', a competency derived from the law itself. As a corporation, Pertamina is

41 Art. 2(2) of the Pertamina Law of 1971 states 'The Enterprise . . . shall be a corporate body vested with the right to carry out its operations on the basis of this Law'.

42 All legal acts as are referred to in Art. 27 of the Pertamina Law of 1971 require the prior approval of the Board of Government's Commissioners which consists of ministers (Art. 16(3) of the Pertamina Law of 1971). These ministers, in regard to the granting of their approval, do not act in their capacity as members of the cabinet of the government, but in their capacity as members of the Board, an institution of the corporate body of Pertamina and not a government institution.

entitled to enter into any transaction pursuant to Article 27 of the Pertamina Law of 1971. Based on such roles, the legal acts contemplated by Pertamina when entering into a legal relation with other parties may be distinguished into, first, the legal acts related to the co-operation relationship in the execution of the undertaking of mineral oil and gas mining, and secondly, the legal transactions in its status as a corporate person as defined in Article 27 of the Pertamina Law of 1971.

Other Parties

As to 'other parties' eligible to be the contractor, the law does not lay down any conditions as to legal form and status. Accordingly, it may be interpreted that by 'other parties' could be meant private Indonesian national oil companies and foreign oil companies. In theory, there are two possibilities for private Indonesian nationals to establish oil companies. In the first place, a limited liability company (Perseroan Terbatas) may be set up as a legal person according to Indonesian law, having its seat in Indonesia with the whole of its capital owned by private Indonesian nationals. Secondly, a joint venture between Indonesian and foreign capital may be established in the form of a company with limited liability, having the status of an Indonesian legal person according to Indonesian law. A foreign oil company, on the other hand, may set up a limited liability company (Perseroan Terbatas P.T.) under Indonesian law, having its seat in Indonesia and enjoying the status of an Indonesian legal person,[43] or it may establish a company with the status of a foreign legal person.[44]

In all cases, the limited liability company, joint venture or foreign legal person will have no legal competence to exercise any of the functions of mining mineral oil and gas as an independent operator. These functions may only be carried out by the particular entity in the capacity of a contractor to the State Oil Enterprise based on contract.[45] Thus, the legal relation of the parties can only be one of contractorship. In practice, foreign oil companies mainly perform the functions of exploration and production. The functions of refining and processing are carried out by Pertamina itself. At present, all the refineries existing within the Republic of Indonesia are owned by Pertamina.

The conditions and terms regarding the status of the contractor and the relationship of the parties are not regulated by law; in practice these conditions are laid down in the contracts themselves. In essence, whilst Pertamina has the overall management of the mining undertaking, the contractor, as the exclusive company appointed to carry out and bear all expenses and risks associated with the operations required for such undertaking, must conform to the work programme and budget approved by Pertamina and implement them in a workmanlike manner and by appropriate scientific methods. If operations result in a commercial discovery, the contractor may recover all recoverable operating costs from produc-

43 Examples are the former P.T. Shell Indonesia, P.T. Caltex Pacific Indonesia and P.T. Stanvac Indonesia.

44 Contractors under PSCs fall into this latter category. An exception is the PSC concluded between Pertamina and P.T. Caltex Pacific Indonesia 9 August 1971.

45 Above 303.

tion and is entitled to receive a share of the remaining production as payment in kind for the services performed and risks assumed. The contractor does not, however, have ownership of any commercial oil and gas; this remains vested in the government at any stage of production. The contractor only receives title to its share at the point of export. The contractor, therefore, has merely a contractual right to and no ownership of its share of the oil and gas produced. The legal status of the contractor under the PSC may thus be considered to be unique. The contractor, either directly as a foreign legal person or indirectly through a locally established limited liability company, acts as a general contractor for the State Oil Enterprise, Pertamina, and as such, carries out in the name and on behalf of Pertamina, all operations required for the extraction of petroleum. Thus, the contractor is not a concessionaire licence holder, permit holder, or partner, but a provider of capital, skill and technical services. It is something less than a manager/operator since management of the operation is in the hands of Pertamina; at the same time, it is something more than an independent contractor because all the activities carried out by it are done in the name of the State Oil Enterprise which has legal title to all data resulting from the operations and petroleum produced.[46]

LEGAL FORM AND CONTENT OF THE CONTRACT

In terms of Article 6(2) of the Oil Law of 1960, the co-operation between a foreign oil company and the State Oil Enterprise in the field of mineral oil and gas mining should be in the form of a contract of work. By the enactment of Law No. 1 of 1967 concerning foreign capital investment, and the Pertamina Law of 1971 as amended, this co-operation may also be in the form of a production sharing contract or may take any other form which the government may consider necessary to facilitate economic development.[47] The types of contractual forms currently in use in Indonesia to which Pertamina is a party include production sharing, technical assistance contracts and petroleum loan agreements.

Within the framework of production sharing, three main types of contract exist:

1. The standard production sharing contract (PSC).[48] The terms and conditions of the PSC fall into three categories: PSC for conventional areas, PSC for frontier areas, and PSC for deep water areas.
2. The enhanced oil recovery contract (EOR) under which Pertamina has a 50 percent carried interest.[49] This was introduced to encourage enhanced recovery in fields operated by Pertamina.

46 N. Fabri, 'The Legal Nature of Petroleum Agreements' [1986] *AMPLA Yearbook* 10–11.

47 Art. 8(1) of Law No. 1 of 1967 stipulates: 'Foreign capital investment in the field of mining shall be based on a joint co-operation with the Government on the basis of a working contract, or in another form, in line with the existing regulations'. Since co-operation in the field of mineral oil and gas is not specifically excluded, it may be interpreted that such forms may also be used by Pertamina.

48 For a discussion of the terms, see below 319–336.

49 EORS are established in accordance with the Oil Law of 1960, Pertamina Law of 1971 and its related Ministerial Letter. For a descriptive analysis of the terms see page 288 of Dr. Makarim's paper.

3. Joint operations agreement (JOA) and a variant of the JOA, the joint operations agreement with a joint operating body (JOB) supervised by a joint operating committee (JOC) under which Pertamina has a 50 percent participating interest.[50] This is used for prime exploration acreage held by Pertamina.

Technical assistance contracts cover producing fields or old fields to be rehabilitated. Provisions for remuneration are likely to be the same as for standard production sharing contracts.

Petroleum loan agreements are arrangements providing for a non-recourse loan made to Pertamina for the exploration and development of oilfields. If oil is found in commercial quantities the lender is paid for both the principal amount lent and the interest thereon in kind and has the right to purchase a stipulated amount of production at prevailing market prices at the time of shipment for a certain period of time.[51]

As has been observed, the Oil Law of 1960 does not contain provisions with regard to the content of the contract between the State Oil Enterprise and the contracting foreign oil company, since the conditions required will in principle depend on the facts existing at the time of making the agreement, as for instance the potential of the mining territory to be explored or exploited, the capacity of the foreign oil company to supply the necessary skill and capital, as well as the marketing of the mineral oil and gas produced. Moreover, it is clearly stipulated in the General Elucidation (6) of the Oil Law of 1960 that the content of each of the contracts of work is left entirely to the discretion of the government.

PROCEDURE AND EFFECTIVENESS OF THE CONTRACT

Before entering into a contract with a foreign company, the State Oil Enterprise is obliged to follow the indications, directives and conditions given by the government, that is, the Minister for Mines and Energy.[52] Parliamentary ratification is a legal requirement for the effectiveness of the contract of work.[53] The contract derives its binding force from the law and by ratification thereof, the State *in casu* the Government of the Republic of Indonesia, becomes a contracting party and declares itself to be bound by the provisions of the contract.[54] On the other hand, PSCs do not have to be ratified by Parliament to become effective. Furthermore, the government does not become a party to the contract since the State Oil Enterprise, Pertamina, is authorised exclusively by law to carry out mining undertakings of mineral oil and gas.[55] In practice, PSCs are signed by the Minister of Mines and Energy 'on behalf of the Government of the Republic of Indonesia' and become effective upon the issuance of a letter by the President indicating presidential approval of the

50 For a discussion of the terms, see Makarim 287–288.
51 *Ibid.* 288–289.
52 Art. 6(2) of the Oil Law of 1960.
53 Art. 6(3) of the Oil Law of 1960 and General Elucidation (5) subsection 5.
54 The approval reads as follows: 'The [Ministry] acting for and on behalf of the Republic of Indonesia, hereby approves the within and foregoing Contract and agrees to be bound by its provisions.'
55 Art. 3(2) of the Oil Law of 1960.

terms and conditions of the PSC.[56] The government thus acts exclusively as a public authority and only grants approval of the contracts concerned.

LEGAL STATUS OF THE CONTRACT

In pursuance of the law, the Indonesian oil and gas contracts thus form a legal relationship between the State Oil Enterprise as holder of the statutory mandate to carry out mineral oil and gas mining undertakings and an oil company as a private contractor for the State Oil Enterprise appointed by a minister on behalf of the government to perform for and on behalf of the State Oil Enterprise specific operations. This legal relationship constitutes, therefore, a combination of private and public law elements, arising from two facts. First, the contractor is usually a private company willing to invest substantial resources of capital, of technology and of managerial and technical capabilities in the given project over a long period of time on the basis of a contract with the main objective of maximisation of revenue. Secondly, the State Oil Enterprise is a State-owned institution constituted by law and having the power and competence to implement government policy concerning state sovereignty over a strategic natural resource and over activities connected with it. Its primary objective is to assist the State in maximising the prosperity of the Indonesian people and the State as well as creating national strength. It is thus apparent that the oil agreement is in the nature of a commercial undertaking which contains elements of both consensus and bargain as to the rights and obligations of the parties and the negotiated financial and economic terms. To this extent, the agreement regulates the relationship of the parties in much the same way as any other ordinary contract. On the other hand, the agreement possesses elements of public law in the control, direction and supervision exercised by the State Oil Enterprise and the government aimed at protecting the public interest in the proper exploitation of the State's natural resource.

Moreover, such a relationship may also be 'transnational' in character if the contractor is a foreign oil company authorised to invest capital and provide technical and other services for the economic development of the country. This transnational characteristic is further indicated by the PSCs invariably providing for the settlement of disputes by international arbitration in accordance with the ICC rules. When all these elements are present, these contracts may thus be classified as 'transnational' contracts governed by the applicable Indonesian private and administrative laws and the applicable principles and rules of international law. If this is so, the theory for the application of private, public or international law to Indonesian oil contracts would seem to be as follows:

— Since the legal relation between Pertamina and contractor is founded on a private law contract which contains elements of public law, the function of private law may be considered as a general

56 Art. 12(3) of the Pertamina Law states: 'The [PSC] . . . shall become effective as of the moment of approval by the President.'

law and that of public law as a special law infringing on the private law. In other words, private law would be excluded if public interest so demanded.

— When the legal relation becomes 'transnationalised' the application of national law (private and public law included) becomes subject to the principles and rules of international law applicable to foreign investment (and operations connected therewith e.g. solution).

The application of this hierarchy of laws may be best illustrated by the consequences ensuing when the government or State party alters or revises unilaterally the terms and conditions of the contract and thereby extinguishes, modifies or alters any of the rights or obligations of the foreign party. As a matter of private contract law, the oil agreement is in principle subject to modification or amendment which should be executed by mutual consent by the parties thereto.[57] Otherwise a party may not cancel the contract except for a lawful cause.[58] This private law principle is, however, subject to the overriding rule of public law that the State, by an exercise of its legislative competence, may extinguish or modify contractual rights and obligations if this is so required by the public interest. The State's actions in this regard may, if the contract is 'transnationalised', become subject to the general principles of international law. The responsibility of the State at international law may arise for three reasons. First, by its actions the State may break some duty extraneous to the contract, including, in particular:

— breach of a bilateral investment treaty between it and the State of the foreign oil company protecting the investment of the latter;
— breach of duty set up by general international law *e.g.* unreasonable exercise of a power causing damage or loss (abuse of rights); or injuries suffered by the foreign investor;
— breach of human rights standards, *e.g.* unlawful discrimination;
— usurpation of jurisdiction;
— denial of justice;
— unlawful confiscation or expropriation of private property.

Secondly, by its actions the State may break a contractual duty imposed by contract terms which imply a waiver of sovereignty thereby infringing the international law principle of *pacta sunt servanda*. Thirdly, the State may have infringed, by its actions, the contractual interest of the foreign national represented by the investment made and the services provided which constitutes an 'acquired' or 'vested' right to which international law attaches special protection.[59]

57 PSCs invariably provide in the section entitled 'Effectiveness' that: 'This contract shall not be annulled, amended or modified in any respect except by mutual consent in writing by the parties thereto'.

58 Under the PSC, a party may terminate the contract in the event of the other party committing a major breach upon conclusive evidence being proved by arbitration or a final court decision.

59 The exact nature of the law in effect concerning these two latter grounds is, however, the subject of controversy: N. Fabri *op. cit.* 25–38.

ANALYSIS OF THE PRODUCTION SHARING CONTRACT MODEL

Since the introduction of the PSC in Indonesia in 1966, the terms of the PSC have undergone an evolutionary process guided by a desire to more faithfully meet two interests: on the one hand the interests of the Indonesian State, the owner of the mineral oil and gas resources with sovereign powers to administer, supervise and direct the mining undertakings; and the State Oil Enterprise, the promoter of mineral oil and gas mining activities with the competence by law to execute mining undertakings, and on the other hand the interests of the foreign oil company as foreign investor and operator with the capital, technical competence and skill necessary for furnishing the funds and services and carrying out the operations, and therefore having a vested economic interest in order to recoup all costs incurred and to receive an adequate return on the investments made and risks assumed. An attempt is, therefore, made to analyse against these two interests the fundamental stipulations and content of the PSC cogently described in Makarim's paper.

Mineral Oil and Gas Resources

As mentioned earlier, the basic Indonesian philosophy concerning natural resources is enshrined in Article 33 of the Constitution of the Republic of Indonesia. In essence, it prescribes State ownership of mineral oil and gas resources and control by the State over such resources, including the extraction thereof. This is reflected in the PSC provisions relating to title to mineral oil and gas, title to data obtained from petroleum operations, management of the petroleum operations and the applicable law and resolution of disputes.

TITLE TO MINERAL OIL AND GAS

Under the contract of work, title to mineral oil and gas passes to the contractor at the point of sale. Moreover, the contractor is also given the right to sell, deliver and otherwise dispose of its share produced by it from the contract area and products derived therefrom. The only exception to this is that portion of crude oil which Pertamina elects to receive in kind. It is not specifically stated in the contract by whom such transfer is carried out, but it might be interpreted that the transfer is actually carried out by the foreign oil company for and on behalf of the Government of Indonesia. In other words, the government has to ask for the oil it needs from the oil company. The government is, therefore, a formal owner or at least owner of the oil and gas in its geological state, while the foreign oil company is the owner at the 'wellhead'. Such interpretation is in agreement with the philosophy underlying concession contracts 'that the oil is owned in its geological state by the government, but as soon as man has done something to it, he becomes the owner of the oil'.

In contrast, under the PSC, title to mineral oil and gas in its natural state and at any stage of production is vested in the State. The contractor receives its share of the mineral oil and gas to which it is entitled under the

PSC as well as the portion exported and sold to cover operating costs only at the point of export. Legally, therefore, the Indonesian party hands over the contractor's share at that point.

TITLE TO DATA

As a consequence of control over the extraction of resources being vested in the government, *in casu* Pertamina, Pertamina has title to all original data resulting from the petroleum operations. Accordingly, the contractor is obliged to submit to Pertamina all original data and reports compiled during the term of the contract. In recognition of the sensitive nature of such data, Pertamina is, however, obliged not to disclose the data to third parties without 'informing' the contractor and giving the contractor the opportunity to discuss the disclosure of the data. The control which the contractor may exert over Pertamina in connection with the disclosure of such data is precarious, to say the least, since the right of contractor to merely 'discuss' does not permit it to override any decision taken by Pertamina.

MANAGEMENT OF OPERATIONS

In pursuance of the basic philosophy underlying Article 33(3) of the Constitution of 1945 of the Republic of Indonesia, all PSCs provide that 'Pertamina shall have, and be responsible for the management of the operations contemplated' under the contract. The contractor is 'responsible to Pertamina for the execution of such operations' and is appointed the exclusive company to conduct the operations. Each year the contractor is required to submit a work programme and budget of operating costs for the ensuing year, setting forth the particular operations the contractor proposes to carry out. Pertamina may propose revisions to the work programme and budget, upon which the parties will 'endeavour to agree'. The contractor thereafter is obligated to implement the work programme 'in a workmanlike manner and by appropriate scientific methods . . .' Pertamina, in turn, is obliged to 'assist and consult' with the contractor in the execution of the approved work programme and provide any necessary facilities, supplies and personnel required for the operations. Pertamina thus exerts an exclusive control over the management of petroleum operations. The contractor is fully accountable to Pertamina who has to approve all the contractor's budgets, work programmes, scheme of expenditures, manpower plans and procurement of equipment and services.[60]

When the 'management' clause was first introduced in the mid 1960s, it met with substantial resistance, especially from the oil 'majors'. The clause was seen as an inequitable splitting of managerial and capital risk bearing functions, and it was feared that it could be used as a convenient legal means to eject the contractor should Pertamina so desire. In actual practice, however, Pertamina has shown little inclination to involve itself directly in contractor's day-to-day operations and decision-making processes generally, particularly during the exploration period. This may, in part, be attributed to the limitations with respect to man-

60 Below 333–336.

power and managerial and technological skills, but it is also in large part due to Pertamina's desire not to impede contractors in their performance of their duties. Thus far the value of the management clause lies largely in the fact that it fills the short-term role of defusing political controversy as to whether Indonesians or foreigners control natural resources since, in itself, it creates an appearance of domestic control; it also provides the means of legally preventing contractors from pursuing policies detrimental to Indonesia. More significantly, the clause has been used primarily as a means for requiring the contractor to keep Pertamina informed of all aspects of operations through routine consultation with and the submission of written and oral reports to Pertamina. Such information enables Pertamina to exert some measure of control over operations and, in particular, over the allocation of capital, managerial skills and technology employed, and other technical and operational decisions such as determination of commerciality of a field and rates of production.

APPLICABLE LAW AND RESOLUTION OF DISPUTES

All PSCs provide that 'the laws of the Republic of Indonesia shall apply to the contract'. The methods of settlement applied in the PSC in cases of controversy or disputes are, first, negotiation between the parties, secondly, international arbitration if negotiated agreement cannot be obtained, and finally, judicial settlement by the Indonesian courts of law in the event the arbitrators are unable to reach a decision. It is also further stated that 'no term or provision of the PSC, including the agreement of the parties to submit to arbitration, shall prevent or limit the Government of the Republic of Indonesia from exercising its inalienable rights'. Such 'inalienable rights' are not defined in the contract but may be interpreted to refer to the right of the Republic of Indonesia, as an independent State, to exercise permanent sovereignty over natural resources and other foreign economic activities conducted on its territory in the interests of its national development. The attempt is, therefore, to 'municipalise' as far as possible the legal arrangement by asserting the application of national law for the interpretation of the agreement and the non-exclusive jurisdiction of local courts for the resolution of disputes between the parties as well as the inalienable right of the State to own and control oil and gas resources.

Undertaking Mineral Oil and Gas Mining

In the preamble to the PSC, it is usually stipulated that:

> Pertamina wishes to promote the development of the contract area and [contractor] desires to join and assist Pertamina in accelerating the exploration and development of the potential resources within the contract area.

The primary objective of the PSC consists, therefore, in the co-operation which the contractor is able to give Pertamina to promote the development of the mineral oil and gas resources that may be found in the contract area. As is stipulated in the General Elucidation (10) of the Oil Law of 1960, the basic idea of the Indonesian oil policy is to increase the production of mineral oil and gas as soon as possible.[61] This obviously cannot be done without the encouragement of rapid exploration. Under the PSC, the solution adopted in attaining this objective is to:

— stipulate a maximum contract term and limit the duration of the exploration period;
— define the contract area and make provisions for compulsory relinquishment;
— impose on the contractor financial and other commitments, that is, bonuses and minimum work obligations and levels of expenditure on exploration.

CONTRACT TERM

The term of the PSC consists of a total contract duration of 30 years. The initial exploration term of the PSC is six years. Under the second generation PSCs, the initial term is extendable, at the contractor's option, by two additional periods of two years each, and in the event of a discovery, the remainder of the contract term. Pursuant to the 22 February 1989 Incentives Package, the initial term for existing contracts which are still in the exploration stage, may be extended by one optional four-year period. For third generation PSCs, the initial term is similarly extendable by one optional four-year period, and in the event of a discovery, the remainder of the contract term.

There are other provisions regarding termination of the PSC in case no petroleum is discovered in the contract area within the initial or extended term. First, the contractor is normally given an opportunity to voluntarily terminate the contract at any time after the minimum contract term, normally consisting of two or three years, if in its opinion 'circumstances do not warrant continuation of the Petroleum Operations'. The only requirements are for the contractor to provide a prior written notice to that effect and consult with Pertamina on the same. The contractor will thereupon be excused from all obligations undertaken in the contract. Secondly, if no discovery is made during the initial term, the contract will terminate unless the contractor elects to extend it. Thirdly, if petroleum has still not been discovered by the time the extension period runs out, the contract automatically terminates in its entirety.

61 General Elucidation (10) of the Oil Law of 1960 states:

> ... the only way to achieve the object of making the Indonesian mineral oil and gas industry of real significance to the living requirements of the masses as mentioned in paragraph (2) of Article 33 of the Constitution is to increase the production of the Indonesian mineral oil and gas industry as soon as possible, in order to accomplish the following:
> 1. to meet the increased demand for petroleum for domestic consumption as a result of the increase in population and the industrialization efforts in the framework of the overall development of Indonesia (change of Economic Structure of Indonesia);
> 2. to meet the foreign exchange requirements of Indonesia for the overall development;
> 3. to obtain a favourable balance between the domestic consumption and exports from Indonesia;
> 4. to maintain the position of Indonesia on the world market;
> 5. to increase the State's proceeds from oil enterprises;
> 6. to solve the unemployment problem;
> 7. to increase the national income and the per capita income of Indonesia i.e. the standard of living in Indonesia'.

If petroleum is discovered in any portion of the contract area which, in the judgment of Pertamina and the contractor, based on consideration of all pertinent operating and financial data obtained from previous exploratory and appraisal work, can be produced commercially, the contractor is obliged to commence exploitation in that particular portion of the contract area. Should the contractor, however, with the concurrence of Pertamina, determine that economic and safe deep water production equipment is temporarily unavailable, the development of a discovery may be delayed until the equipment becomes available.

It is not certain what the outcome will be if there is disagreement on the commercial prospects of a discovery; no provision is made in the contract for the undertaking of the development by either party at its sole risk. Presumably, the contractor may be able to retain that portion of the contract area where the discovery was made until the end of the exploration term.

In the event of the other party committing a major breach, either party may also terminate the contract upon giving a 90 days prior written notice. This is, however, contingent upon 'conclusive evidence' of such breach being proved by arbitration or a final court decision.

RELINQUISHMENT

PSCs uniformly provide that the contractor shall relinquish stipulated percentages or portions of the contract area at intervals during the initial exploration term. The percentage of the area to be relinquished and the frequency of the relinquishments are matters that the contractor may propose in his bid and that may be negotiated with Pertamina. By the end of the initial exploration term, it is normal for the contractor to have relinquished 40 to 60 percent of the original contract area.[62] It is important to note, however, that the relinquishment provisions 'do not apply to any part of the Contract Area corresponding to the surface area of any field in which Petroleum has been discovered'. Moreover, Pertamina and contractor are expected to maintain a 'reasonable exploration effort' with respect to non-relinquished areas; if during any two consecutive years the contractor does not submit an exploration programme for such areas, the parties must reach agreement as to whether any portion of the non-relinquished areas are to be surrendered or exploration is to be resumed at a later date. In some cases, automatic surrender is provided for non-relinquished areas in respect of which the contractor has not submitted an exploration programme.

Besides these mandatory surrender provisions, PSCs normally give the contractor the right to surrender at the end of the second contract year and prior to the end of any subsequent contract years any portion of the contract area upon giving 30 days written notice to Pertamina. Such

62 Examples of recent relinquishment schedules are as follows:

End Year	2	3	4	5	6
Relinquishment	—	—	20%	30%	30%
	25%	—	25%	—	30%

Source: Petroconsultants, *World Petroleum Laws* (March 1988).

relinquishments may be credited against those portions of the contract area which the contractor is obliged to surrender in each year. The parties are also to consult with each other with regard to the size and shape of relinquished areas. No specific configuration requirements are usually provided in the contract beyond the statement that, as far as is reasonably possible, each surrendered area 'shall be of sufficient size and convenient shape to enable Petroleum Operations to be conducted thereon'.

BONUSES

The contractor is obliged to pay Pertamina the bid amount as 'compensation' for information concerning the contract area held by Pertamina and made available to contractor. Since the amount of the bonus is a matter upon which the contractor is required to bid and is usually unrelated to the quality and quantity of information held by Pertamina, the payment may be more properly viewed as an inducement for the contract award or a 'signature bonus', rather than a payment for information. The amounts bid vary considerably from contract to contract. A payment of $1m appears to be the minimum acceptable and figures commonly range between $1 and $5m. Larger amounts are paid in some cases. Signature bonuses are deductible against tax.

Another matter for bid is the amounts the contractor is willing to pay Pertamina once production averages certain levels over a period of time. The number and amount of production bonuses are themselves a matter for bid. The first volume trigger is in the range of 0 to 50,000 BOPD, the highest is 100,000 to 300,000 BOPD. The number of bonuses may be from two to five. If the highest threshold is reached, total payments are commonly in the range of $15 to $50m, though they may go as high as $100m or more.[63] It is normal for payment of such bonuses to be made within 30 days 'following the last day of the period' during which production has been maintained at the stipulated level.

WORK EXPENDITURES

The contractor is obligated to commence petroleum operations 'not later than 6 months after the effective date' and to expend in each year of the initial six-year term of the contract no less than the amount undertaken by the contractor in his bid for the acreage. Minimum exploration expenditures for each year of any extension period will also have to be committed by the contractor in his bid and expended during each

63 Two examples of recent production bonus commitment schedules were as follows:

	Production (BOPD)	Bonus ($m)
(1)	30,000	10
	50,000	15
	100,000	20
(2)	25,000	3
	50,000	3
	100,000	6

Source: Petroconsultants, *World Petroleum Laws* (March 1988) contract year of the extended period.[64] Any over-expenditure in any year may be applied against the required expenditures in subsequent years, but under-expenditures may only be carried over to the succeeding year or years if Pertamina so agrees.

If the contractor exercises his option to terminate the contract at the expiration of the minimum contract term, only the expenditures required for those years must actually be expended.

Implementation of the Work Programme

Rapid exploration may only be achieved through the efficient implementation of the work programme by the contractor, which is appointed as the exclusive company entrusted with such operations. The contractor is, therefore, expected to inject foreign capital, technology and skill and bear all financial risks associated with the programme.

OPERATING COSTS

The contractor is obliged to advance all funds required in the conduct of petroleum operations. This includes the provision of all necessary funds for purchasing or leasing materials, equipment and supplies, the furnishing of all technical aid (including foreign personnel) and all other funds requiring payment in foreign currency. To the extent that Pertamina furnishes any facilities, supplies or personnel, the costs thereof are reimbursed by the contractor to Pertamina. To this end the contractor is obliged to advance to Pertamina a minimum sum in U.S. dollars prior to the beginning of each annual work programme. This sum varies from contract to contract, but usually approximates US$75,000. If additional funds are needed, the contractor is required to make the necessary advances. Any unexpended amounts are credited against the minimum amount to be advanced in the succeeding annual work programme period. All financial risks associated with such expenditure are borne by the contractor.

TITLE TO EQUIPMENT

All equipment (moveable physical assets purchased by the contractor for purposes of operations in the contract area) becomes the property of Pertamina when landed at an Indonesian port. Pertamina has to discharge all import duties on such imported equipment. Once commercial production commences, the contractor is able to recover the cost of such equipment through depreciation provisions which may be viewed as the way Pertamina actually 'purchases' the equipment *i.e.* on an instalment basis whereby the contractor periodically makes deductions rather than

64 Total exploration commitment may vary from $15m to $100m and over.
Two examples of recent expenditure commitment schedules are as follows:

Year	1	2	3	4	5	6
$M	3	7	12	12	15	15
	3.75	6.25	20	30	30	30

Source: Petroconsultants, *World Petroleum Laws* (March 1988)

Pertamina actually making cash payments. The contractor, however, is required to make rental payments to Pertamina for the use of such landed equipment 'at a rate commensurate with the useful life of the relevant asset, but not to exceed 10 per cent per annum, until the total of such payments equals the purchase price'. In effect, the contractor is required to pay for the equipment purchased. Pertamina has the right to use all equipment imported by the contractor to which it gains title, after consultation with the contractor, so long as the use of such equipment does not interfere with the contractor's performance of the petroleum operations. The passing of title and the requirement of rental payments do not apply to leased equipment belonging to third parties who perform services as sub-contractors to the contractor. Such leased equipment may be freely imported to and re-exported from Indonesia.

CONDUCT OF OPERATIONS

The basic principle is that operations are to be implemented in a workmanlike, good technical manner and by appropriate scientific methods. Beyond what is stated in the PSC, the contractor is obliged to take the necessary precautions for the protection of navigation and fishing and prevention of extensive pollution and to execute the work programme so as not to conflict with obligations imposed on the government by international law.

Financial and Fiscal Terms and Conditions

Based on the constitutional precept that mineral oil and gas are strategic assets, the financial and fiscal terms of the PSC are devised to complement the government policy relating to the utilisation of oil and gas generally, that is, utilising any petroleum found, first, as a source of energy and, secondly, as a source of capital funds in accelerating national development. This policy is, however, implemented with the realisation that the co-operation of foreign oil companies within the field of mineral oil and gas mining undertakings is essential because of, *inter alia*, a lack of capital and technical know-how. In pursuance of the spirit of the Oil Law of 1960, which is reflected in the Explanatory Memorandum (5), the Department of Mines and Energy has pursued a policy which seeks to maintain the investment momentum and step up exploration so that new reserves can be found. This has been achieved through the creation of an attractive foreign investment climate by the incorporation of terms and conditions which ensure, as much as practicable, that in case of success the contractor recovers all costs within an appropriate time-frame and makes an adequate return on the investments made and risks assumed.

FIRST TRANCHE PETROLEUM

The first tranche petroleum (FTP) concept was introduced by the Incentives Package of 31 August 1988 to apply to existing and extended PSCs and PSCs for new contract areas. The FTP consists of a portion of gross production amounting to 20 percent which will be split between the contractor and Pertamina each year on the basis of the applicable 'profit oil' split percentage before any deduction for recovery of operating costs (and investment credit).[65] Pertamina's share of the FTP is, in effect, a royalty in kind which varies according to the amount of production and the percentage 'profit oil' split applicable.[66]

INVESTMENT CREDIT

As an incentive for sensitivity to cost overruns and time delays during the development and production stages, the contractor is accorded an investment credit amounting to a fixed percentage of the capital investment (tangible development) costs directly required for developing crude oil production facilities in each new field as well as for developing new secondary (and, at times, tertiary) recovery EOR projects. The credit is taken out of gross production (less FTP) before recovery of operating costs in the earliest year of production, with a right of carry forward in the event such production does not fully cover the credit amount. The investment credit is taxable.

Under the second generation PSCs, the percentage was fixed at 17 percent (20 percent according to the Old Tax Law) and was conditional upon the contractor being able to guarantee that the total government 'take' was not less than 49 percent of the gross revenue over the life of the field. Moreover, a considerably higher percentage was negotiated for deep water areas. Under the third generation PSCs, the percentage remains the same without the condition; however, an additional credit of 110 percent (for oil) and of 55 percent (for gas) of the capital investment cost previously available but individually negotiated, is now established for deep sea contract areas[67] for all contracts, existing and new. It is not clear why this additional incentive, justified because of the high costs in developing fields in deep water, does not also apply to frontier areas which present the same costing problems caused by infrastructural remoteness and geologic risk.

COST RECOVERY

As discussed above,[68] all PSCs obligate the contractor to provide all the financing for the operations and to sustain the risk of all expenses made. If petroleum is discovered in commercial quantities, the contractor has the right to be reimbursed for all operating costs from the sale proceeds of production.[69]

Under the first generation PSCs, operating costs were recoverable out of the first 40 percent of production each year. If recoverable operating costs exceeded 40 percent, the unrecovered excess could be re-

65 Below.
66 Below, 328–331.
67 Below, 330.
68 Above, 325.
69 For purposes of determining the quantity of oil needed for recovery of operating costs (and investment credit), the weighted average price of all crude oil sold from the contract area during the relevant calendar year is used. For a historical analysis of the determination of the cost oil price, see Makarim 284.

covered in succeeding years. This limit was dropped in 1976 under the second generation PSCs when Pertamina's share of 'profit oil' was increased from 65 percent to 85 percent. Cost recovery was then limited only by total revenue and depreciation provisions. Under the third generation PSCs, the cost recovery is limited in each year to the first 80 percent of production as a result of the introduction of the FTP. Any unrecovered excess may be recovered in succeeding years.

Operating costs include rental payments to Pertamina for use of property imported by contractor, rental of equipment from third parties, depreciation on property imported by contractor,[70] personnel expenses, general and administrative expenses, expenses for contract services, transportation costs, insurance costs, claims expenses, and other expenses incurred by the contractor 'for the necessary and proper performance of his obligations' under the contract. Excluded as recoverable operating costs are financing costs (interests for capital investments excepted) and bonuses paid by the contractor to Pertamina in connection with obtaining and maintaining the PSC.

In order to ensure the accuracy of costs, the contractor is required to maintain an 'operating costs account' which lists separately the expenditures incurred. Moreover, Pertamina has the responsibility for 'keeping complete books and accounts with the assistance of [the contractor] reflecting all Operating Costs . . .' Prior to the commencement of commercial production, Pertamina delegates this accounting responsibility to the contractor.

EQUITY OIL

Once investment credit and operating costs have been fully recovered, crude oil and gas production is shared by Pertamina and the contractor in accordance with contractually stated percentages. Under the first generation PSCs, the profit split was 65 percent for Pertamina and 35 percent for the contractor, and those figures had, in effect, remained substantially unchanged under the second generation PSCs. The contractor, however, became obligated to pay Indonesian corporate income tax out of his share. In effect, this meant that the contractor's post-tax profit share was reduced to 15 percent for crude oil (fixed in 1976) and 30 percent for gas (fixed in 1982). Since the 22 February 1989 Incentives Package, the contractor's post-tax share for oil and gas has been modified and revised both for existing and extended PSCs and new PSCs. The package has introduced variable splits linked to five categories of production, that is, production from marginal fields[71], pre-tertiary reservoir

70 For purposes of the 'operating costs account', intangibles (exploration and production drilling costs), current operating costs and interest on loans raised for capital expenditure are deductible immediately. Other capital costs are subject to depreciation based on a declining balance depreciation method.

71 'Marginal field': the proposed definition is 'a field which produces an average of up to 10,000 BOPD within the first two years'. No definition is, however provided for 'field'. Moreover, it is not certain whether the qualification '*first* marginal field' refers to the first field discovered in the contract area or to any field discovered at any time during the term of the contract.

rocks,[72] tertiary recovery enhanced oil recovery (EOR) projects, deep sea contract areas,[73] and other areas not falling under any of the previous four categories. Moreover, a distinction is made between conventional and frontier areas[74], for which different 'profit oil' splits are at times applicable.

Existing and Extended PSCs

The equity split has remained the same for production from the first marginal field and from other areas not being tertiary recovery EOR projects, pre-tertiary reservoir rocks and deep sea contract areas, that is, 85 percent/15 percent in favour of Pertamina. A more favourable equity split of 80 percent/20 percent is now available to the contractor for production of oil from new tertiary recovery EOR projects. Moreover, an incremental split has been introduced for oil produced from pre-tertiary reservoir rocks and from deep sea contract areas. The incremental split is as follows:

BOPD	Split
Up to 50,000	80 percent/20 percent
On 50,000 to 150,000	85 percent/15 percent
Over 150,000	90 percent/10 percent

New PSCs for Conventional and Frontier Areas

For oil produced from the first marginal field the equity split is:
— in respect of contracts in conventional areas: 80 percent/20 percent;
— in respect of contracts in frontier areas: 75 percent/25 percent.

For oil produced from pre-tertiary reservoir rocks the equity split is calculated on an incremental sliding scale basis as follows:
— in respect of contracts in conventional areas:

BOPD	Split
Up to 50,000	80 percent/20 percent
On 50,000 to 150,000	85 percent/15 percent
Over 150,000	90 percent/10 percent

72 No definition is provided for 'pre-tertiary reservoir rocks'. Presumably, this means petroleum reservoir rocks deposited or formed in pre-tertiary times.

73 'Deep sea contract areas': the proposed definition is 'water depth over 600 feet'. The bathymetric line will presumably be calculated from the point on the sea-bed where production platforms *or* subsea completions are constructed.

74 No definition is provided for 'frontier/conventional areas'. These will presumably be designated by Pertamina when areas are opened for bidding and will be differentiated on the basis of geographical, bathymetric and geological criteria which are consistent. Areas will probably be classified as 'frontier' because of the current geological risk and infrastructure remoteness aspect. Excluded, therefore, would be Sumatra, Java, Sulawesi, the Natuna Islands and the Birshead region in Irian Jaya (*i.e.* Western Indonesia and the latter region).

— in respect of contracts in frontier areas:

BOPD	Split
Up to 50,000	75 percent/25 percent
On 50,000 to 150,000	80 percent/20 percent
Over 150,000	85 percent/15 percent

For oil produced from deep sea contract areas the equity split for contracts in conventional and frontier areas is calculated on an incremental sliding scale basis as follows:

BOPD	Split
Up to 50,000	80 percent/20 percent
On 50,000 to 150,000	85 percent/15 percent
Over 150,000	90 percent/10 percent

For oil produced from tertiary recovery EOR projects, the equity split is:

— in respect of contracts in conventional areas: 80 percent/20 percent;

— in respect of contracts in frontier areas: 75 per cent/25 percent.

For oil produced from other contract areas other than those mentioned above (including, therefore, production from tertiary reservoir rocks and waters less than 600 feet) the equity split is:

— in respect of contracts in conventional areas: 85 percent/15 percent;

— in respect of contracts in frontier areas the equity split is calculated on an incremental sliding scale basis as follows:

BOPD	Split
Up to 50,000	80 percent/20 percent
On 50,000 to 150,000	85 percent/15 percent
Over 150,000	90 percent/10 percent

These revised equity splits will presumably be calculated after deducting FTP, investment credit and operating costs and would be applicable over the life of the particular field. It is not clear, however, whether the values of production will be applied on a field-by-field basis or to the entire production of the contract area, that is, on a contract-wide basis with production from the first marginal field, tertiary recovery EOR projects, pre-tertiary reservoir rocks, deep sea contract areas, and other areas not falling under any of the former categories being treated as separate segments from each other. If the latter case is adopted, a specific allocation method has to be provided for the calculation of FTP, investment credit and operating costs. Such method may be based on a pro rata basis in the sense that in each year the recoverable FTP, investment credit and operating costs will be apportioned for deduction from the production of each of the segments in the same ratios as the production from each such segment bears to the total production from the contract area for that year.

TAXATION

Until 1976 Pertamina paid, out of its percentage share of the value of crude oil after deducting operating costs, the contractor's Indonesian income tax, on the contractor's behalf. For a variety of reasons, however, this fiscal regime proved unacceptable to the United States Internal Revenue Service as a basis upon which contractors could claim U.S. tax credits for Indonesian income taxes. The second generation PSCs provided that the contractor is to pay the Indonesian corporate tax and the tax on interest, dividend and royalty pursuant to the Indonesian Income Tax Law. Pertamina was obliged to pay all other Indonesian taxes, imposts and duties, such as value added tax, import duties and other levies, incurred by the contractor or its sub-contractors in the course of the petroleum operations. The same situation obtains under third generation PSCs.

The composite tax rate applying to contracts signed before 1984 is 56 percent (45 percent basic income tax and 20 percent withholding tax on the balance). The post-1984 tax regime provides for 48 percent (35 percent basic income tax and 20 percent withholding tax on the balance). The contractor's post-tax share of 'profit oil' remains unchanged with the pre-tax share decreased to compensate for the lower tax rate. The contractor's gross revenue for tax purposes includes profit oil plus FTP share plus investment credit plus cost oil allocation plus cost deductions. Income reached in the form of interests, dividends or royalty is also taxable. The rules regarding depreciation and other allowances are the same as for calculating cost oil. Additional items allowable as deductions for tax purposes are bonus payments and home office overheads.

The oil price used by the tax authorities has hitherto been Pertamina's official selling price (OSP) which traditionally has been set by the government.[75] This has historically been an OPEC-type guide price. The breakdown of OPEC pricing in late 1985 and early 1986 led to an announcement that the link would be cut retrospectively from 1 February 1986. For tax reference purposes, each crude is now priced monthly based on a spot price for a basket of crudes. The composition of baskets is negotiable. Pursuant to the 31 August 1988 Incentives Package, a tax incentive was introduced whereby the contractor has become entitled to a tax incentive calculated monthly from the contractor's taxable income to compensate for any discrepancy between the government selling price (GSP) as set monthly and the price actually received.

The gas price has also been traditionally fixed by the government. In most cases, LNG prices were linked to the prices paid to a basket of

75 See Art. 10 of the Decree of the President of the Republic of Indonesia No. 476 of 1961.

Indonesian crudes.[76] Pursuant to the 22 February 1988 Incentives Package, the gas prices will henceforth be oriented towards field development economics (applicable only to new projects). This price basis also applies for tax reference purposes for gas production.

NATURAL GAS

Recognising that the development of a natural gas discovery may well involve economic considerations that differ significantly from those applicable to a commercial crude oil discovery, most PSCs contain special provisions pertaining to gas. Flaring of natural gas[77] is permitted if the processing and utilisation of the gas is not economical, but only to the extent that the gas is not required in order to effect the maximum economic recovery of petroleum by secondary recovery operations, including repressuring and recycling.

If Pertamina and the contractor decide to exploit a gas discovery, the same cost recovery and FTP principles will apply to such development as apply to a crude oil development. Under the first and second generation PSCs, no investment credit was provided for. Under the third generation PSCs, an investment credit of 55 percent has been provided for development of a gas field in deep sea contract areas. In all cases, the equity split is fixed in the ratio of 70/30 in favour of Pertamina and is applied uniformly regardless of production.

Additional Costs of Development

In the discussion that follows, it will be seen that many other items of PSCs impact on the return a contractor could expect to realise from its investment in petroleum operations in Indonesia. The impact, however, results indirectly from such factors as cash flow timing differences, terms affecting crude access and disposition, and obligations to encourage Indonesianisation by fostering local industry, employment, education and the economy and generally to aid in the realisation of the constitutional mandate that natural riches be controlled by the State and be exploited for the greatest welfare of the people. Additional obligations of a purely financial or fiscal nature, such as royalties, special taxes or area fees, are not a feature of PSCs.

DOMESTIC SUPPLY OBLIGATION

After the commencement of commercial production and when the contractor has come into a 'profit' position — that is, once the FTP is shared and investment credit and operating costs have been fully recovered and the contractor begins to receive 'equity oil' — the contractor becomes obligated to make available to Pertamina, each year, a portion of such equity oil in order to fulfill domestic supply needs. The amount to be

76 Early in 1989, LNG prices were linked to spot crude prices with monthly adjustments.

77 Natural gas is defined as 'all gaseous hydrocarbons produced from wells, including wet mineral gas, dry mineral gas, casing head gas and residue gas remaining after the extraction of liquid hydrocarbons from wet gas'.

supplied is the lesser of either 25 percent of the contractor's pre-tax share of profit oil (*i.e.* a quarter of 34.0909 percent for pre-1984 contracts or of 28.8462 percent for post-1984 contracts) or, alternatively, its pro rata share of the total domestic supply requirement determined by a formula whereby the market supply obligation of any contract area bears the same proportion to total domestic market needs as the total production from such area bears to the total production of all producing areas.

For the first five years of production from each new field (or attributable to new secondary recovery facilities) the contractor is paid for the domestic market supply oil the same price it receives for recovery of operating costs, that is, the weighted average price. Thereafter, the price paid by Pertamina becomes 10 percent of the said price (increased from US$0.20 per barrel in 1988). During the five-year moratorium, the contractor is, however, obliged to utilise the proceeds in excess of the 10 percent to finance continued exploration efforts in the contract area or in other areas of Indonesia if such opportunity arises (unless this can be shown to be contrary to good oilfield practice).

MARKETING

Most PSCs require the contractor to market all crude oil produced from the contract area. There are, however, a number of exceptions to this requirement. Thus, Pertamina has the right to market all or part of its share of equity oil provided it has given the requisite advance notice and provided that its election does not interfere with sales commitments already made by the contractor.[78] Also, if Pertamina is able to obtain a higher price for oil allocated to investment credit and operating costs than that obtainable by the contractor, it may take over the marketing of such oil unless the contractor is willing to meet the higher price. In such a case, Pertamina is required to remit to the contractor the full proceeds of the sale; this sum is then applied to the investment credit and operating costs account.

Another exception states that if in any year the quantity of crude oil which Pertamina is due to receive as equity oil is less than 50 percent of total production, Pertamina may market the difference between the lesser amount and the amount that equals 50 percent of total production at the weighted average price. Moreover, the contractor may in any year transfer to Pertamina the right to market any oil which is in excess of the contractor's normal contractual requirements, although Pertamina does not thereby assume the contractor's market obligation.

PARTICIPATION

Second and third generation PSCs require the contractor, on Pertamina's demand, to offer to an 'Indonesian participant', designated by Pertamina a 10 percent participating undivided interest in any com-

78 Several contracts contain provisions reducing the total quantity of crude oil which the contractor is obliged to market on behalf of Pertamina. This ceiling is ordinarily expressed through a formula which, in effect, requires the contractor to market a quantity of Pertamina's share equalling almost twice its domestic supply requirement.

mercial discovery on a carried interest basis.[79] This demand may be made upon the discovery of the first commercial field. A participant accepting such an offer becomes obligated to pay its proportionate share of all future development and production expenditures, to reimburse the contractor for a proportionate share of past operating costs and the compensation payment or 'signature bonus' previously paid to Pertamina, and a proportionate share of any production bonus.

The share to be paid by the Indonesian participant may, at times, be a bid item and may be greater than the percentage participation the participant receives. The participant remains always advantaged, however, because it is not exposed to pre-exploration and appraisal financial risks and because, it may, at its option, make all payments to the contractor out of 50 percent of its future production, albeit at a premium (usually being 150 percent on top of the actual amount). The rights and duties of the contractor and the participant will obviously have to be regulated by a joint venture operating agreement.[80] Essentially, the participant's role will be passive since the contractor will be able to preserve its operational autonomy by remaining the operator responsible for preparing and executing the work programme and budget.

INDONESIANISATION PROVISIONS

The contractor (or the foreign operator appointed by the contractor) is required to appoint an authorised representative in Indonesia and to maintain an office in Jakarta. It must employ qualified Indonesian personnel in its operations and 'prepare and carry out plans and programmes for the industrial training and education of Indonesians for all job classifications with respect to operations . . .'[81] After production commences, the contractor is required 'to undertake the schooling and training of Indonesian personnel for labour and staff positions, including administrative and executive management positions'. The contractor must also be willing to undertake assistance programmes for the training of Pertamina personnel. Moreover, the contractor must 'give preference to such goods and services [as] are produced in Indonesia or rendered by Indonesian nationals, provided that such goods and services are offered at equally advantageous conditions with regard to quality, price [and] availability at the time and in the quantities required'.

Starting from 1980, the Ministry tightened procurement policies requiring that in addition to the contractor and Pertamina, a special government team within the State Secretariat (Sekneg) review procurements for large contracts. Because of Rupiah devaluations, these reviews came to be triggered at US$300,000. This policy was further enforced in 1985

79 An 'Indonesian participant' is defined as being a limited liability company the shareholders of which are Indonesian nationals or an Indonesian entity.

80 PSCs usually attach the main principles to be inserted in the joint venture operating agreement as an exhibit to the PSC.

81 Art. 12 of Law No. 1 of 1967 states:

> Enterprises with foreign capital are obliged to arrange and/or to provide facilities for training and education at home or abroad for Indonesian nationals in an organized way and with a set purpose in order that the alien employee may gradually be substituted by Indonesian ones.

by BKPM, the organisation that co-ordinates foreign investment. Bid handicaps were established in favour of local companies and more use of domestic resources was encouraged with the aim of creating more local job opportunities, more technology transfer and more training. Following the collapse of the world oil prices and the decline of exploration, development and production investment, the government adopted a more 'realistic' attitude towards its previous stringent procurement policies requiring preference for local support companies. The bureaucracy surrounding the procurement policies affecting foreign companies, including oilfield support companies, was streamlined in May 1987 to permit contractors still at the exploration stage of operation to tender and purchase without further authority once Pertamina (BKKA) had approved the work programme. In April 1988, procurement policies were further overhauled as a part of a more general change in government procurement regulations announced in April.[82]

Under the new guidelines, however, preference is still retained for procurement of domestic goods and services, but they also stress that procurements should reflect a price most favourable to the State and one for which there can be accountability. According to these guidelines, Pertamina would thus rely on post audit checks to uncover abuses. Under these deregulation measures, foreign contractors are allowed to procure equipment up to the value of Rp. 1 billion (US$600,000) without prior approvals from Pertamina (BKKA). Procurements between Rp. 1 billion to Rp. 3 billion (US$1.8million) require approval by the minister or head of non-departmental institutions (*i.e.* Pertamina). Pertamina has reportedly set up a new group, to be known by the acronym TPP, to review tenders up to US$1.8 million. Procurements beyond the Rp. 3 billion will have to be approved by the Co-ordinating Minister for the Economy, Finance and Industry (Ekuin). Ekuin is, however, precluded from becoming involved in contract negotiations or having direct contact with the supplier of goods or services. These restrictions do not apply to purchases made by the contractor during the exploration stage. Moreover, investment terms have now been considerably relaxed by the lowering of the minimum investment level to US$500,000 and allowing greater foreign equity for a longer period of time than before.

Pertamina still remains, however, an important player in the award of all support contracts related to exploration, development and production of oil and gas in Indonesia. Although the new regulations are making Pertamina's intervention in such contracts less direct, it nonetheless must still be regarded as a factor in all such contracts. In essence, this means that all goods and services provided by foreign firms will probably have to be channelled through local Indonesian companies. This can be done either through an arms-length agency agreement, or in the case of services, through joint venture or technical management agreements. With equipment and materials supply, the real problem is to secure payment. Many of the local firms do not have the financial strength to issue letters of credit and payment will therefore have to be secured by the contractor concerned. If letters of credit are not forthcoming, then the

82 Presidential Decree No. 6 of 1988 and Presidential Instruction No. 1 of 1988.

best course is for the local company to give instructions for the money to be paid directly to the supplier in its home country. It is generally unwise to rely on the local agent to make payment after the delivery of the goods.

DOWNSTREAM ACTIVITIES

Second and third generation PSCs require the contractor to consider entering into agreements for the processing of products derived from petroleum operations under the relevant contract. A certain percentage of the contractor's equity oil, which the contractor may stipulate in his bid, should be refined in Indonesia.[83] If no refining capacity is available, the contractor should consider the establishment of such capacity or, if the contractor's share of production is of minimal size[84] or such a project would otherwise be uneconomical, the contractor is expected to make an equivalent investment in another project related to the petroleum or petrochemical industries.

83 This percentage usually amounts to 28.57 percent of the contractor's 'profit oil' share.

84 Set at 200,000 BOPD.