CLIENT UPDATE
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OIL & GAS

New Era in Oil & Gas Sector as Government Moves from Cost Recovery to Gross Split Mechanism

1. Introduction

The Government has instituted a new mechanism for sharing out production from oil and gas fields as between the State and its contractors ("**Contractor**") under Production Sharing Contracts ("**PSC**"). The new "Gross Split" mechanism is set out in Minister of Energy & Mineral Resources Regulation No. 8 of 2017 ("**MEMR 8/2017**"),[i] which came into force on 16 January 2017, while the first PSC to employ the new arrangement was signed on 18 January 2017, covering the Offshore North West Java working area operated by state energy firm Pertamina, which had recently expired.

2. Production Sharing: Gross Split vs Cost Recovery

As discussed in greater detail in Section 4 below, the Gross Split mechanism appears likely to be applied to new PSCs going ahead, replacing the long-standing Indonesian production sharing concept, under which the share or take of the Contractor is set as a fixed percentage of gross production (before tax), calculated after recovery of the Contractor's costs under the cost recovery regime.

Despite having been conceived in Indonesia and adopted by many oil and gas producers around the world over the last 50 years, the cost recovery regime has come under increasing scrutiny at home in recent years due to its high cost. Not only does it demand that the Government set aside large sums every year in the State Budget to cover cost recovery expenses, but also requires layers of scrutiny, controls, and bureaucracy to ensure that it works effectively. In addition, despite cost recovery being a business arrangement, inadvertent miss-allocation could leave those involved liable to criminal charges for inflicting losses on the State.

By contrast, the Gross Split mechanism directly carves up gross production as between the Contractor (before tax) and the State, without any deductions being made, including deductions by the Contractor for cost recovery. However, the take allocated to the Contractor is grossed up and may be further adjusted to compensate for the Contractor's expenses.

As regards the implementation of the Gross Split mechanism, under Article 23(2) of MEMR 8/2017, the control authority of SKK Migas[ii] is now limited to approving Contractors' Work Programs & Budgets ("**WP&B**"), whereas previously it had the final say on virtually every aspect of Contractor operations. It is reasonable to assume that SKK Migas' authority with regard to the cost recovery regime remains unaffected.

3. Gross Split Calculation

The Gross Split is calculated based on two principal components: (a) the base split component; and (b) the adjustment component.

The base split component is governed by Article 5 of MEMR 8/2017, which allocates the following respective shares to the State and Contractor:

	State's Share	Contractor's Share
Crude	57%	43%
Natural Gas	52%	48%

In order to ensure flexibility and take account of the economic realities of a field, the Base Split may be adjusted having regard to two sets of additional factors: (1) Variable Components; and (2) Progressive Components. Such adjustment may be made after the Ministry of Energy & Mineral Resources ("**MEMR**"), or SKK Migas, as the case may be, has approved the Plan of Development ("**POD**") proposed by the Contractor prior to the development of the field.

The components that may be considered when deciding whether or not to adjust the Base Split are as described in the table below:

Adjustment Factors		**Base Split Adjustment**
Variable Components	Field Development Stage	Contractor gets an additional 5% share for the first POD of the Working Area. No additional share is available for subsequent PODs. In the case of a PSC extension that is not accompanied by a new POD, the Base Split is reduced by 5% in favour of the State.
	Field Location	Contractor's share may be increased based on a sliding scale depending on the location of the field. For example, a deep-water offshore field (1000 meters or more below sea level) is accorded an additional 16% share. No additional share is available for onshore fields.
	Depth of Reservoir	Contractor gets additional 1% for a reservoir lying at a depth of more than 2500 meters.
	Availability of Supporting Infrastructure	Contractor gets additional 2% if the working area is located in a remote or frontier area that lacks supporting infrastructure.
	Reservoir Type	Contractor gets additional 16% for non-conventional hydrocarbon reservoir (i.e., CBM, shale, etc.).
	CO_2 Content	Contractor gets additional share based on a sliding scale depending on the CO_2 content of the reservoir. For example, additional 4% for CO_2 content above 60%. No additional share is available of CO_2 content below 5%.
	H_2S Content	Contractor gets additional share based on a sliding scale depending on the H_2S content of the reservoir. For example, 1% for H_2S above 500 ppm. No additional share is available for H_2S below 100 ppm.
	Oil Specific Gravity	Contractor gets additional 1% if crude produced has a specific gravity of more than 25 API.
	Domestic Content during Field Development	Contractor gets additional share based on a sliding scale depending on the level of domestic content during development. For example, 4% for domestic content of above 70%. No additional share is available for domestic content of below 30%.
	Production Method	Contractor gets additional split of 3% and 5% for production using water injection and enhanced oil recovery, respectively.
Progressive Components (adjusted monthly by SKK Migas)	Indonesian Crude Price ("**ICP**")	Additional share for either Contractor or State using a sliding scale based on ICP. Contractor gets additional share if ICP drops

		below USD 70/barrel while State gets additional share if ICP exceeds USD 85/barrel.
	Cumulative Production (in MMBOE)	Contractor gets additional share based on a reversed sliding scale based on Contractor's cumulative production over a defined period. The higher the cumulative production, the lower the additional share for Contractor. For example, Contractor gets additional share of 5% if cumulative production is below 1 MMBOE. No additional share is available if cumulative production exceeds 150 MMBOE. No explanation is provided in MEMR 8/2017 as regards the period or method to be used in calculating cumulative production. However, MEMR has informed us that cumulative production will be calculated on a monthly basis.

The application of the above adjustment factors means that the Contractor's overall take (before tax) will fluctuate based on the following formula:

Base Split (+/ -) Variable Component(s) (+/ -) Progressive Component(s).

The Gross Split that is approved by MEMR for the first POD may subsequently be varied in the event that:

1. Commercial operation of the field *fails* to achieve the intended economic return: MEMR may grant an additional share of up to a maximum of 5% in favour of the Contractor;
2. Commercial operation of the field *exceeds* the intended economic return: MEMR may grant an additional share of up to a maximum of 5% in favour of the State;
3. The Variable Component/Progressive Component assumptions set out in the MEMR's approval of the POD turn out to be different from actual conditions in the field following commercial operation.

MEMR 8/2017 does not explain what precisely is meant by "intended economic return" in points 1 and 2 above. However, we have been informed by ministry officials that it refers to the anticipated economic return stated in the POD.

4. Application of Gross Split Mechanism

MEMR 8/2017 does not apply retroactively and all PSCs signed prior to its issuance remain in effect. An existing Contractor may, however, propose to MEMR that its PSC be amended so as to incorporate the Gross Split mechanism. In such circumstances, any unrecovered costs may be taken into account as an additional share in favour of the Contractor.

For expiring PSCs that are to be extended, however, MEMR has the option of applying either (i) the terms of the existing PSC; or (ii) the Gross Split mechanism.

Although MEMR 8/2017 does not specifically state that the Gross Split mechanism will be applied henceforth to all new PSCs, senior MEMR officials have been widely reported in the media as saying that this will be the case.

Indeed, the Deputy Minister of Energy & Mineral Resources. Mr. Arcandra Tahar, is quoted in *The Jakarta Post* daily on Jan 19 as saying that "no new field can use [cost recovery]. All must use the gross-split scheme."

We have also received independent confirmation to this effect from MEMR officials. Nevertheless, we must stress once again that MEMR 8/2017 does not expressly state that the gross split mechanism will be applied to all new PSCs.

5. AHP Commentary

Although not cast in stone, the Government has applied a set of standard (and rigid) terms under the Cost Recovery Regime, irrespective of the level of difficulty involved in exploiting a field. The Gross Split arrangement under MEMR 8/2017 provides greater flexibility, which is to be welcomed.

Incentives are provided in the form of possible increases in the Base Split in favour of the Contractor depending on the level of difficulty involved in getting the oil or gas out of the ground. There seems to be no cap in place as regards the maximum extent to which a Contractor's take could increase following the application of the Variable and Progressive Components. If the Contractor is eligible to avail of all of these at their maximum levels, then the State's take could even be reduced to zero. This should help encourage Contractors to develop frontier and difficult fields.

However, the corollary of this is that the Contractor will be disincentivised if the crude price or the Contractor's production increases beyond a certain level. The latter eventuality begs the question as to why a Contractor should be penalized for working more efficiently and producing more hydrocarbons?
Against the backdrop of the prevailing low oil-price environment, the incentives provided by MEMR 8/2017 may be appealing in the case of smaller fields, where Contractors would benefit from the Progressive Components and reduced bureaucracy. However, the disincentives that may kick in under the Gross Split mechanism may not be so appealing to Contractors in the case larger fields.

With the issuance of MEMR 8/2017, the status of SKK Migas' existing industry guidelines (*Pedoman Tata Kerja*/"**PTK**") has been left somewhat up in the air. As the role of SKK Migas is now limited to approving Contractors' WP&B, this should significantly reduce the level of bureaucracy involved in the procurement of goods & services, hiring and firing of manpower, and other micro-managerial issues on the part of Contractors. The bureaucracy under the Cost Recovery Regime was considered burdensome by many Contractors and hampered efficiency in oil and gas operations. The new mechanism will also eliminate cost recovery disputes and reduce the risk of criminal prosecution.

However, a caveat is in order here. In common with other many other nations, Indonesia has seen a surge in resource nationalism in recent years, including demands that the State be directly involved in resource exploration and exploitation. In light of this, the fact that the authority of SKK Migas has been diminished by MEMR 8/2017 makes it reasonable to assume that the regulation may be subject to challenges in the Supreme Court going ahead.

Thus far, the oil and gas industry's response to the Gross Split mechanism has been sceptical. Characterized by forward-looking and long-term planning that requires stability and continuity, the industry appears to regard the introduction of the new mechanism as being too big and sudden a change to digest easily. It will be a challenging task going ahead for the Government to rebuild the industry's confidence, particularly amid the current low-price environment.

i. *Peraturan Menteri Energi dan Sumber Daya Mineral Nomor 08 Tahun 2017 tentang Kontrak Bagi Hasil Gross Split.*
ii. *Satuan Kerja Khusus Pelaksana Kegiatan Usaha Hulu Minyak dan Gas Bumi, the State body responsible for managing commercial upstream oil and gas operations based on cooperation contracts.*

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ASEAN Economic Community Portal

With the launch of the ASEAN Economic Community ("**AEC**") in December 2015, businesses looking to tap the opportunities presented by the integrated markets of the AEC can now get help a click away. Rajah & Tann Asia, United Overseas Bank and RSM Chio Lim Stone Forest, have teamed up to launch "Business in ASEAN", a portal that provides companies with a single platform that helps businesses navigate the complexities of setting up operations in ASEAN.

By tapping into the professional knowledge and resources of the three organisations through this portal, small- and medium-sized enterprises across the 10-member economic grouping can equip themselves with the tools and know-how to navigate ASEAN's business landscape. Of particular interest to businesses is the "Ask a Question" feature of the portal which enables companies to pose questions to the three organisations which have an extensive network in the region. The portal can be accessed at http://www.businessinasean.com/.

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