

## Client Alert

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## The New Gross Split PSC; Problem Solved?

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The Special Taskforce for Upstream Oil and Gas Business Activities (**SKK MIGAS**) has issued the latest draft of the gross split production sharing contract (PSC) for the Indonesian 2018 oil and gas bid round.

We have prepared a summary of the differences between the gross split PSC and the conventional cost recovery PSC. Not surprisingly, the two documents are very similar - SKK MIGAS has essentially taken the conventional cost recovery PSC and replaced the cost recovery provisions with the various base split adjustments/sliding scale adjustments to be incorporated into the gross split regime.

However, there are a few key points to note in respect of the gross split PSC:

- The new PSC reflects the increased incentives granted to gross split PSCs by Minister of Energy and Mineral Resources Regulation No. 08 of 2017 on Gross Split Production Sharing Contract (as amended by Regulation No. 52 of 2017 of the Ministry of Energy and Mineral Resources) (**Regulation 8 of 2017**).
- There is a continuing domestic market obligation (DMO) for oil, as well as for gas. As a welcome relief, however, in line with Regulation 8 of 2017, the price set for DMO oil is the Indonesia Crude Oil (ICP) price.
- The new form of PSC contains additional requirements in relation to sourcing/import of goods and equipment. It says nothing about the PTK 007<sup>1</sup> guidelines not applying. Accordingly, it is not yet clear whether the new form of PSC will, in fact, significantly reduce bureaucratic oversight by SKK MIGAS. But some provisions of Regulation 8 of 2017, ie, articles 18(2) (which refers to "independent" procurement by contractor) and 23(1) (under which SKK MIGAS' key function is to supervise contractors' work programme and budgeting process) may - perhaps - offer a little comfort in this regard.
- Counter-intuitively, given the absence of a cost recovery regime, title in goods and equipment that are not otherwise leased to the PSC contractor continue to belong to the Government. The rationale for this is unclear (although it would seem to be premised on the argument that the Government is still paying for these through tax deductions).

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<sup>1</sup> SKK MIGAS Guideline No. PTK-007/SKKMA0000/2017/S0



- The tax provisions are complex to read. However, income tax is still set at the rate prevailing when the PSC is signed. In addition, among other deductible costs (in respect of which no value added tax (VAT) will be levied either), shared facility costs and indirect overhead charges are deductible.
- The PSC makes very clear that the contractor bears the risk of local Government taxes/levies. This is probably a fairly accurate reflection of what the position is under the current cost recovery PSC.
- In line with Minister of Energy and Mineral Resources Regulation No. 48 of 2017 on Supervision of the Implementation of Business Activities in the Field of Energy and Mineral Resources, changes in control happening at the level of the PSC party require Government approval. However, perhaps as an unanticipated consequence, control is defined widely, to also capture indirect changes in control. There is no longer what used to be interpreted as a package exemption, where a change in control is part of a larger set of transactions.
- The PSC seems to anticipate that there may be adjustments to the Firm Commitment, after the contract is awarded. As we can see no real reason why the Firm Commitment would ever be adjusted upwards, query whether this change is designed to accommodate a downward revision to the Firm Commitment (as part of an upward adjustment by an affiliated company under another PSC?).
- The amount of the performance bond to be submitted when applying for the PSC is still set at USD1,500,000. This is in line with Minister of Energy and Mineral Resources Regulation No. 35 of 2008 on the Procedures for Offering Oil and Gas Work Areas, under which the amount of the bond should be the higher of USD1,500,000 or 10% of the Firm Commitment.

Notwithstanding that the forms of agreement are substantially similar, the gross split PSCs offer a radical, conceptual break from the cost recovery PSC previously championed by Indonesia. It remains to be seen whether the Government has done enough to make the production splits in the gross split PSC sufficiently attractive - and definite - to oil and gas companies. Given the discretionary/variable elements that apply to these splits, any optimism that the new PSC format will be well received may be misplaced.

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## Annex 1

	COST RECOVERY PSC	GROSS SPLIT PSC
1. Introduction	<p><b>Parties:</b> (1) SKK MIGAS and (2) Contractor; “approved” by Minister of Energy and Mineral Resources (<i>MEMR</i>) for Government of Indonesia (<i>Gol</i>).</p> <p><b>Effective date:</b> On the date of <i>Gol</i> approval (ie, execution).</p> <p><b>Term:</b> 30 years from the Effective Date (Art. 2.1.1).</p>	<p>Same.</p> <hr/> <p><b>To note - under both the cost recovery and the gross split PSCs:</b></p> <ul style="list-style-type: none"> <li>• <b>Contractor parties are jointly and severally liable.</b></li> <li>• <b>Change of Operator, as well as direct or indirect transfers of interest, need SKK MIGAS approval.</b></li> </ul>
2. Contract extension	<p>The original six-year exploration period may be extended for four years (Art. 2.1.2).</p> <p>The PSC does not contain any provisions allowing the PSC to be extended beyond its 30-year term.</p>	<p><u>Extension of Exploration Period (Art. 2.1.2(b))</u></p> <p>SKK Migas may use the following bases for approving an extension:</p> <ul style="list-style-type: none"> <li>• Contractor's exploration activity;</li> <li>• fulfilment of Contractor's financial obligations.</li> </ul> <p><u>Investment to the end of Exploitation Period (Art. 2.5.1 - 2)</u></p> <p>Contractor shall maintain production [levels] through to the expiry of the PSC, subject to SKK MIGAS approval.</p> <p>If investment costs exceed what can be recovered in the remaining PSC period, the investment will be one of the factors borne in mind by the <i>Gol</i> in granting / rejecting the PSC extension.</p>
3. Contract area (km <sup>2</sup> )	<p>Initially the area is approximately [*] square kilometres. Relinquishment as follows:</p> <p>(a) 25% of Contract Area to be relinquished after three years (art 3.1); plus an additional 15% if initial work program is not completed (Art. 3.2).</p> <p>(b) Contract Area not to exceed 20% of original total Contract Area after six years (Art. 3.3) unless a discovery exceeds that area (Art. 3.4).</p> <p>(c) Any exploration area remaining after year 6 is subject to reasonable exploration activities (Art. 3.5).</p> <p>(d) Upon notice from SKK MIGAS in respect of an area in which no exploration activities were conducted for two years, Contractor must elect to either (i) conduct exploration within six months of such notice and immediately submit a POD or (ii) relinquish the Area (Art. 3.5).</p>	<p>Same</p>



	COST RECOVERY PSC	GROSS SPLIT PSC
	<p>Note:</p> <ul style="list-style-type: none"> <li>▪ Art. 2.2.4: if Contractor has received approval to develop a first field, but does not produce petroleum within five years of the exploration period, Contractor must relinquish the Contract Area to Gol.</li> <li>▪ Art. 2.2.5: With regard to a commercial discovery of natural gas, if it is expected that during such five-year time period Contractor will not have entered into a GSA, SKK MIGAS may grant Contractor's request to extend that five-year limit.</li> </ul>	
<p><b>4. Current status</b></p>	<p>(a)</p> <ul style="list-style-type: none"> <li>(i) The first three contract years and associated work obligations are compulsory for Contractor (the '<b>Firm Commitment</b>') (Art. 4.2).</li> <li>(ii) Contractor may not terminate PSC during this time (Art. 13.1).</li> <li>(iii) If at the end of the third contract year, Contractor has not completed the Firm Commitment, Contractor may terminate but will not be relieved of its obligations until the unspent portion of the estimated expenditure for the unperformed work is transferred to the Gol.</li> <li>(iv) Contractor must submit a performance bond for the benefit of Gol for the fulfilment of the "Firm Commitment".</li> </ul> <p>(b) The second three years are 'optional' – Contractor may terminate the agreement and relinquish the Contract Area (Art. 13.2) without the 'penalties' that apply during contract years 1-3.</p> <p>(c) Note that no guarantee is required for years 4-6.</p> <p>(d) After year 6, Contractor may (in accordance with the terms of the PSC) elect to extend the exploration period. In such case, the commitments in years 7 and 8 (which may include year 1 - 6 commitments) must be fulfilled by year 8, failing which PSC will terminate automatically.</p>	<p>Similar, but:</p> <ul style="list-style-type: none"> <li>• Contractor may submit revision of the Firm Commitment (to reduce investment / change nature)? (Art. 4.2)</li> <li>• The amount of the performance bond is set at USD1,500,000. The value of the performance bond can be reduced if the value of the Firm Commitment not carried out is less than the bond.</li> <li>• The performance bond is to be extended through to completion of the Firm Commitment.</li> <li>• If Contractor elects to extend the Exploration Period, the commitments in years 7 and 8 will include the year 1 - 6 commitments and must be fulfilled by year 8, failing which SKK MIGAS <b>may</b> terminate PSC.</li> </ul>



	<b>COST RECOVERY PSC</b>	<b>GROSS SPLIT PSC</b>
<b>5. Government back-in right</b>	<p>SKK MIGAS has the right to require Contractor to transfer a 10% participating interest to a local government company, in the first instance, which failing to an Indonesian national company designated by Gol, the shareholders of which shall be Indonesian nationals (Art. 16.1). This right lapses unless exercised by SKK MIGAS within one month of Contractor notifying the Gol of its first commercial discovery (Art. 16.2). The Indonesian participant must reimburse Contractor 10% of the historical Operating Costs incurred in the Contract Area (Art. 16.8).</p>	<p>Local participation rights are granted to local Government Companies (<b>LGOC</b>) only (Art. 16). These are companies that are effectively wholly (99% - 100%) owned by the local Government; established by local Government regulation.</p> <p>Note: No consideration is payable by LGOC. Schedule D anticipates a "cooperation" scheme, similar to a carry.</p> <p>During the Contract period, LGOC shall not dispose of any part of its 10% Participating Interest, and LGOC's shareholders are restricted from transferring their shares.</p>
<b>6. Fiscal terms</b>	<p>Key fiscal terms are as follows:</p> <p>(a) Contractor pays a <b>signature bonus</b> (which is not cost recoverable) of US\$[*] (Art. 8.1) and US\$[*] worth of equipment and services in the first contract year at the request of the Gol (Art. 8.2).</p> <p>(b) Contractor pays <b>production bonuses</b> (which are not cost recoverable) of US\$[*], US\$[*] and US\$[*] on reaching cumulative production of each of [*] MMboe, [*] MMboe and [*] MMboe, respectively (Art. 8.3-8.5).</p> <p>(c) 20% of total petroleum production in each year ('first tranche petroleum' or <b>FTP</b>) is shared between SKK MIGAS and Contractor in accordance with their Profit Oil / Gas Shares (Art. 6.4.1).</p> <p>(d) Contractor has the <b>right to recover Operating Costs</b> against available production as follows:</p> <p>(i) Operating Costs are defined in the PSC (Exhibit C, Art. 2.1) to include depreciated capital costs and non-capital costs in relation to each year's operations, such as labour and materials, services, plus the costs of surveys and the intangible costs of drilling exploratory and development wells.</p> <p>(ii) Non-capital costs are expensed while capital costs are generally depreciated using the declining balance method. Different depreciation rates apply to different classes of assets.</p> <p>(iii) Separate calculations are done for</p>	<p>Material changes on the key fiscal terms are as follows:</p> <p>(a) Removal of the provisions regarding signature and production bonus payment.</p> <p>(b) Removal of Contractor's right to recover the Operating Costs. Instead:</p> <ul style="list-style-type: none"> <li>• Contractor has the right to calculate Operating Cost as a deduction for tax purposes. Capex costs are depreciated at the same rates as cost-recovery PSC.</li> <li>• In Exhibit C, Operating Costs are defined as expenditure and obligations incurred in carrying out Petroleum Operations, including expenditure on tangible assets (Capital and Non Capital Costs) and intangible assets (Capital and Non Capital Costs).</li> </ul> <p>(c) New provisions on the calculation of oil and gas profit share are as follows: <b>Profit oil and gas share.</b> <u>Contractor</u>: Base Split + Variable Component + Progressive Component</p> <ul style="list-style-type: none"> <li>• Crude Oil Base Split - 57% to SKK MIGAS and 43% to Contractor.</li> <li>• Natural Gas Base Split - 52% to SKK MIGAS and 48% to Contractor.</li> </ul> <p>The sum derived from the above formula is adjusted by the Variable Component and the Progressive Component applicable to each field <u>at the time commercial production begins</u> (Art. 6.2.3).</p> <p>(d) Note: continuing DMO obligations, made at 100% of ICP.</p>



	COST RECOVERY PSC	GROSS SPLIT PSC
	<p>oil and gas.</p> <p>(iv) Excess gas costs can be recovered from oil revenues (and vice versa).</p> <p>(v) Unrecovered costs can be carried forward to future years for cost recovery purposes.</p> <p>(vi) Interest on intra-group and third party loans may be recoverable at rates 'not exceeding prevailing commercial rates'. In practice, interest is not deductible.</p> <p>(e) <b>Profit oil share</b> is split 58.333% to SKK MIGAS, 41.666% to Contractor in the case of crude (including condensate) tertiary reservoir production (Art. 6.2.3). Different Contractor shares can apply for other projects. <b>Profit gas share</b> is split 41.6667% to SKK MIGAS and 58.333% to Contractor (Art. 6.3.2).</p> <p>(f) A percentage of Contractors' share of Profit Oil is required to satisfy <b>domestic market obligations (DMO)</b>, such percentage not to exceed 25% of the oil produced from the Contract Area multiplied by Contractor Profit Oil Share, Contractor is to sell DMO Profit Oil at 25% of the generally applicable market price. However, DMO Profit Oil is to be paid for at full price during the first five years after commencement of production. The PSC also provides for DMO on natural gas but DMO gas is paid for at 100% of the contract price.</p> <p>(g) Contractor pays '<b>income tax</b> including the final tax on profits after tax deduction imposed on it under the Indonesian Income Tax Law (art 5.2.23). In practice, Contractor is required to pay Indonesian corporate taxes at an effective rate of 25% on profits after tax deduction, if applicable, of the revenue from the sale of its Profit Oil Share and Profit Gas Share (including its share of FTP).</p> <p>(h) An <b>administration fee</b> of US\$[*] is payable (Art. 5.3.3) by Contractor to SKK MIGAS at the start of each contract year to cover administrative requirements such as transport, visas and security requirements and further advances may be payable in</p>	<p>(e) New provision regarding Production Share Adjustment, as mentioned below: If the calculation of the returns on a field does not reach a certain economic level, the Minister can allocate an additional production sharing percentage to Contractor. However, where the commercialization of a fields exceeds a certain economic level, the Minister can stipulate an additional production sharing percentage with SKK MIGAS. Such stipulation of additional percentage shall only be made once for each POD.</p> <p>(f) New provisions regarding SKK Migas' obligation in relation to tax matters, as mentioned in paragraph (i) below.</p> <p>(g) To note, Contractor freezes the income tax rate as at the date of PSC (Art. 5.2.23 and definition section of Indonesia Income Tax Law). However, Contractor bears the local Government tax risk (Art.s 5.2.25 and 5.2.26).</p> <p>(h) Contrary to Art. 1.1.6(f), Contractor's tax liability is several.</p> <p>(i) SKK MIGAS agrees to bear import duties and Value-added Tax on materials, equipment and supplies imported in connection with Petroleum Operations and 100% of land and building tax (except for any local Government taxes imposed in connection with the Contract Area), imposed on exploration and exploitation activities until commencement of commercial production as required by laws (Art. 5.2.26).</p> <p>(j) Shared facility costs and overhead costs are tax deductible (Art. 5.2.26).</p> <p>(k) Note: provisions entitling Gol to take tax in kind, under both cost recovery and gross split PSC.</p>



	COST RECOVERY PSC	GROSS SPLIT PSC
	<p>addition to this amount where requested by SKK MIGAS.</p> <p>(i) SKK MIGAS agrees to bear <b>import and export duties</b> on materials, equipment and supplies brought into Indonesia by Contractor in connection with Petroleum Operations (Art. 5.2.25).</p> <p>Note:</p> <ul style="list-style-type: none"> <li>▪ Art. 15.5.1 provides that the fiscal percentages under the PSC assume Contractor is subject to dividend tax on after tax profits under Art. 26(4) of the Indonesian Income Tax Law and is not sheltered by any double-tax treaty to which the Gol is a party. Those percentages are to be revised if any portion of Contractor's participating interest becomes subject to a tax treaty, so as to maintain the same net income after tax.</li> <li>▪ Art. 15.5.2 provides that if Contractor at any time during the PSC term pays less than the amount stipulated in that same Art. 26(4) due to double-tax treaty sheltering, Contractor must 'refund to SKK MIGAS an amount equal in value to the additional amount of production share enjoyed by Contractor due to such sheltering.</li> </ul>	
<p><b>7. Hydro-carbon pricing</b></p>	<ul style="list-style-type: none"> <li>▪ Crude Oil valued at (i) the weighted average per unit price received by Contractor / SKK MIGAS from sales to third parties during the preceding three months, adjusted as needed or, if no third party sales have been made, then used to value ICP of similar quality.</li> <li>▪ There are no separate valuation provisions for condensate.</li> <li>▪ Natural Gas is valued at contract sales price.</li> </ul>	<p>ICP paid by 3rd parties; where sales are to Affiliates, ICP during the three months preceding such sale is used.</p> <p>Note: SKK MIGAS has the right to require sales of crude oil to domestic refineries, where there is not sufficient production from SKK MIGAS's share. (Art. 7.1.7).</p>



	COST RECOVERY PSC	GROSS SPLIT PSC
<p><b>8. Assign-ment / change of control</b></p>	<p>Contractor may <b>assign</b> to its affiliate with Gol's consent through SKK Migas (Art. 5.2.7) and to a third party with the consent of Gol through SKK MIGAS (Art. 5.2.8), which consent is not to be unreasonably withheld. No assignee is to hold an interest in more than one PSC at a time.</p> <p>Contractor is to obtain the approval of Gol through SKK MIGAS prior to any proposed direct or indirect Change of Control, which approval is not to be unreasonably withheld (Art. 5.2.9).</p> <p><b>Control</b> is defined as ownership (direct or indirect) of at least 50% of the management rights of the company (Art 1.2.11).</p> <p><b>Change of control</b> is defined as 'any direct or indirect change of Control of a Participating Interest Holder (whether through merger, sale of shares or other equity interests, or otherwise) through a single transaction or series of related transactions in which the Participating Interest is the only substantive asset involved in that series of related transactions.' (Art. 1.2.7).</p>	<p>Transfer of Participating Interest - same.</p> <p>Contractor to obtain approval of Gol through SKK MIGAS for any direct Change of Control, which approval is not to be unreasonably withheld (Art. 5.2.9).</p> <p>Contractor to notify Gol, through SKK MIGAS, prior to any proposed indirect Change of Control.</p> <p><b>Control</b> means direct ownership (by a holding company one level up) or indirect ownership through (a) majority ownership of the voting stock, if the company is a corporation issuing stock, or (b) majority ownership of the controlling rights or interests, if the other entity is not a corporation issuing stock, or (c) an agreement designated by the shareholders of stock/interest to vote for a Controller (art 1.2.17).</p> <p><b>Change of control</b> means 'any direct or indirect change of Control of a Participating Interest Holder (whether through merger, sale of shares or other equity interests, or otherwise) through a single transaction or series of related transaction. (e.g., Art. 1.2.14).</p>
		<p><b>Note: No package sale exemption.</b></p>
<p><b>9. Abandon-ment</b></p>	<p>Contractor is, on termination of the PSC or development of any field, to remove all installations from the area in a manner acceptable to SKK MIGAS and perform all necessary site restoration activities in accordance with applicable regulations.</p> <p>Contractor to include in each plan of development an abandonment and site restoration program together with a funding procedure for such program (art 5.2.6).</p> <p>Sums estimated to be required for this program are to be determined each year in conjunction with the Budget of Operating Costs for the plan of development and treated as Operating Costs. Such sums to be deposited in an escrow account controlled by Contractor and SKK MIGAS (Art. 5.2.6(e)).</p>	<p>Same</p>





	<b>COST RECOVERY PSC</b>	<b>GROSS SPLIT PSC</b>
<b>10. Environ- ment</b>	Contractor to: <ul style="list-style-type: none"> <li>▪ conduct an environmental baseline assessment at the beginning of Contractor's activities (Art. 5.2.6(a)); and</li> <li>▪ take precautions for protection of ecological systems, navigation and fishing and prevent pollution (Art. 5.2.6(b)).</li> </ul>	Same
<b>11. Local particip- ation / content</b>	Contractor must: <ul style="list-style-type: none"> <li>▪ give preference to Indonesian goods and services provided they are offered "at legally advantageous conditions" with regard to quality, price, availability at the time and in the quantities required (Art. 5.2.21);</li> <li>▪ employ qualified Indonesian personnel and undertake training of such personnel (Art. 12.1); and</li> <li>▪ provide funds and conduct development programs for the community near the Contract Area (at Contractor's expense) (Art. 5.2.22).</li> </ul>	In addition to the terms included in the costs recovery PSC, the Gross Split PSC has further terms regulating the import of foreign goods and technology; such goods can only be imported if they are not produced in Indonesia and do not meet Indonesian national quality standards.  In addition, Contractor shall prioritise Indonesian goods and services in accordance with applicable laws/regulations.
<b>12. Title</b>	All goods and equipment purchased by Contractor pursuant to the Work Program and Budget used directly in Petroleum Operations become the property of the Republic of Indonesia.  Title in leased equipment belonging to third parties who perform services as a Contractor (Art. 10) does not transfer.	Goods and equipment purchased by Contractor pursuant to a Work Program and Budget used directly in Petroleum Operations become the property of the Republic of Indonesia, other than leased equipment belonging to third party service providers.  Excess inventory may be transferred to other Contractors in accordance with applicable laws and regulations.  Land acquired by Contractor becomes the property of the GoI, and shall be certified in accordance with applicable laws and regulations.
<b>13. Insurance</b>	Contractor must maintain sufficient insurance during the term of the PSC, including on Petroleum kept in storage before delivery. Insurance must be with established insurers doing business in Indonesia and be on terms approved by SKK MIGAS. SKK MIGAS will be named as co-insured and Contractor must obtain waivers of subrogation in favour of the GoI and SKK MIGAS. (all under Art. 5.2.28).	Same



	<b>COST RECOVERY PSC</b>	<b>GROSS SPLIT PSC</b>
<b>14. Force majeure</b>	Applies to circumstances beyond the control and without the fault or negligence of the relevant party that may “affect economically or otherwise the continuation of operations” under the PSC (Art. 1.2.19). Where it applies, failure to perform is excused and the timetable is extended (Art. 15.4.3).	Same  <b>Note: Under both forms of PSC, Gol agreement needed to be able to declare FM; if no agreement, remedy is to arbitrate.</b>
<b>15. Liabilities</b>	No provisions expressly allocating liability between SKK MIGAS and Contractor for, e.g., injury or death to personnel, third party claims.	Same
<b>16. Termination</b>	SKK MIGAS may issue a notice to Contractor for failure to perform as a reasonable/prudent operator and failure to fulfil any of its obligations under the PSC (Art. 13.5). Contractor has a 120-day cure period after which, absent an agreement between the parties to extend that period, SKK MIGAS has ‘conclusive evidence’ of Contractor’s breach of the PSC and may terminate the agreement (Art. 13.5).	Same.  <b>Note: a number of termination rights are common to both forms of PSCs (2.1.3 - no discovery, 2.2.4 - delay in developing POD, 2.2.5 - delay in executing GSA, 4.5 - delay in carrying out work commitments accrued through to year 8).</b>
<b>17. Dispute resolution</b>	Governed by Indonesian law (Art. 15.3.1). UNCITRAL arbitration conducted in English. Seat of arbitration in Indonesia. Arbitrators appointed by ICSID if parties fail to do so (Art. 11.3).	Same.  <b>To note: in both forms of PSC, Bahasa Indonesia version governs contract.</b>
<b>18. Stabilisation</b>	There is a limited tax stabilisation provision. It provides that if the prevailing Indonesian tax laws change such that the percentage shares of Profit Oil under Art. 6 changes, then the terms of the PSC are to be revised to maintain the same net income after tax for Contractor (Art. 15.5.3).	N/A