HARSONO STRATEGIC CONSULTING

NEW BUSINESS MODEL FOR OIL AND GAS EXPLORATION AND PRODUCTION

Minister of Energy and Mineral Resources Regulation No. 8/2017

GROSS SPLIT CONCEPT: A NEW ERA FOR THE OIL & GAS INDUSTRY

Intending to improve cost efficiency and create a more attractive investment climate for oil and gas exploration and production, the Minister of Energy and Mineral Resources ("MEMR") has begun to replace cost recovery with a gross split system. Without having to reimburse for cost recovery, government spending can be allocated to other sectors.

Below is a brief discussion of the gross split system and its potential impact on the industry. We do not attempt to provide a detailed analysis as to which system, cost recovery or gross split, is superior.

The upstream oil and gas industry has been operating under a cost recovery system whereby PSC contractors are reimbursed by the government for eligible exploration and production costs. Remaining revenue is then split between the PSC contractor and government on a certain percentage basis. The cost recovery approach has been a burden (timing difference) on the state budget and is likely the impetus for the change to gross split.

Gross Split System

In essence, the gross split business model is similar to a typical mineral mining model insofar as the investor is fully responsible for the funding, without any responsibility from the government to reimburse such costs upon the discovery of the oil and gas (hydrocarbon). The costs related to exploration, development and eventual production will be treated as costs to be deducted from the split gross revenue (lifting) to arrive at the profit of the PSC contractor before tax. Therefore, under this gross split business model, oil & gas companies will basically follow common business practice.

Under the new gross split system, base revenue is based on the initial gross production calculation and is split between the government and PSC contractor as follows:

- Oil: 57:43
- Gas: 52:48

These percentages can be adjusted up or down (within certain limits), depending on certain variable and progressive components when the plan of development is approved.

VARIABLE AND PROGRESSIVE COMPONENTS

Variable components:

a) Status of working area
b) Field location
c) Depth of reservoir
d) Availability of supporting infrastructure
e) Type of reservoir
f) Carbon dioxide content
g) Hydrogen sulfide content
h) Specific gravity of oil
i) Local content during field development
j) Production stage

Progressive components:

a) Crude oil price (evaluated once a month)
b) Cumulative production of oil and gas

Other adjustments:

1) If a field fails to meet certain economies of scale, MEMR may give an additional portion of up to 5% to the PSC contractor.
2) If a field surpasses certain economies of scale, MEMR may give an additional portion of up to 5% to the government.

Other provisions remain essentially the same as existing PSCs, such as use of local goods and services is a priority, the work program and budget are approved by SKKMIGAS, and the government will continue to own the acquired land, equipment and data. Domestic Market Obligation (DMO) remains 25%, but is now extended to include gas. This has been required because the Indonesian economy needs the gas as energy to power industrialization and also feedstock for the industrial sector. However, the government will need to address the pricing of DMO gas to ensure it is affordable to industrial users while economically viable to PSC contractors.

Although there is no cost recovery for the PSC contractor, operating costs can be deducted for income tax calculation purposes. Guidance on how to calculate corporate and dividend tax based on the gross split system is yet to be issued. However, we anticipate the treatment will be similar to that of non-PSC companies. We understand the Ministry of Finance and MEMR are currently discussing amendments to be made to Government Regulation No. 79/2010, which should be revised in the near future.

Other issues, such as tax facilities and incentives, remain regulated under other regulations.

APPLICATION OF GROSS SPLIT

The gross split system applies to all new PSCs. The first PSC to apply the gross split concept is the Offshore North West Java (ONWJ) block; a Pertamina subsidiary is the PSC contractor. Existing PSCs will remain as they are, although they will have the option to apply the gross split system, rather than cost recovery, should they choose.

POSSIBLE IMPLICATIONS

Whereas the cost recovery system is administratively burdensome, the gross split system should increase overall efficiency. The new system could also prevent corruption as there is less government agency (SKKMIGAS) involvement.

The government sees this gross split system as a win-win situation as it could:

(a) Free up government spending on cost recovery for other sectors, and

(b) Pressure PSC contractors to be more cost conscious in order to increase their profit.

However, PSC contractors could have a different perspective of the financial impact of the new system on their business.

Issues that are important to be addressed in the future include:

- Treatment of deductible head office costs may be become more narrow and specific and could be limited to overhead costs at the head office which relate to the Indonesia operation.
- Government pressure to use national suppliers for goods and services during the exploration, development and production stages. We understand that such requirement is expected to add value to the Indonesian economy.

We will have to wait and see how this new system evolves in practice to determine whether this change is going to increase investment in the upstream oil and gas sector.

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