西村あさひ法律事務所

NISHIMURA & ASAHI

Natural Resources & Energy Newsletter

Gross Split PSC: Changes to the Indonesian Production Sharing Contract

Mark Tudor, Hiroyasu Konno, Yoshiaki Otsuki, Jun Katsube

On 16 January 2017, a new regulation of the Indonesian Ministry of Energy and Mineral Resources ("**MEMR**") came into effect in Indonesia ("**Regulation 8/2017**").

Regulation 8/2017 implements the "gross split" production sharing mechanism and applies to all oil and gas production sharing contracts ("**PSC**") entered into after 16 January 2017.

How did the old production sharing system work?

The Indonesian PSC has been the mechanism for investing in the Indonesian petroleum sector for many years. Although aspects of the PSC structure have changed over time, in general the PSC allowed the production sharing contractor (i.e., an oil company) to deduct its historic capital and operating costs from the proceeds of sale of oil from the field ("cost recovery"), even before the oil revenue was shared with the Indonesian State. This advantage will not be granted to the contractor any more under the new "gross-split" mechanism (explained below). In early PSCs, there was a cap on the gross revenue that could be used for cost recovery purposes; however, this was later removed.

The portion of the revenue allocated to cost recovery (i.e., the historic capital and operating costs portion) will be shared between the State and the contractor as profit oil once the approved cost recovery has been fully paid. However, given the magnitude of the accrued capex and operating costs, this could be many years after sales of petroleum commence.

This newsletter is the product of its authors and does not reflect the views or opinion of Nishimura & Asahi. In addition, this newsletter is not intended to create an attorney-client relationship or to be legal advice and should not be considered to be a substitute for legal advice. Individual legal and factual circumstances should be taken into consideration in consultation with professional counsel prior to taking any action related to the subject matter of this newsletter.

© Nishimura & Asahi 2017

The 1988 incentive package introduced the concept of "First Tranche Petroleum", which gave the State and the contractor an entitlement to profit oil in advance of cost recovery. The First Tranche Petroleum mechanism allocates the first 20% of gross revenue from the sale of petroleum to the State and the contractor (to be shared in agreed percentages), with the remaining 80% being used for approved cost recovery. This allows the State and the contractor to receive a portion of the petroleum income as "profit oil" immediately, rather than having to wait for the cost recovery obligation to reduce to zero before receiving any "profit oil".[1]

How is the "gross-split" production-sharing mechanism different?

The "gross-split" system simply divides the proceeds of production between the contractor and the Indonesian State into agreed percentages. As this new system will provide an immediate split of revenues, the concepts of cost recovery and "First Tranche Petroleum" will no longer be necessary.

Rather than specifically allocating revenue for approved cost recovery (as in the current system), the contractor is required to recover its sunk capital and operating costs out of its production share after the split with the State—meaning that the contractor is taking more risk on field production over time, as recovery of sunk costs will take longer. As under the new system the contractor is expected to repay all of its capital and operating costs out of its production share (rather than having a priority right to recover sunk capital and operating costs), it is argued that there is an inbuilt incentive for the contractor to keep these costs to a minimum.

From the State's perspective, the State will receive a larger portion of the proceeds from the sale of petroleum immediately from the start-up of production.

How is the percentage split calculated?

The calculation of the gross-split amount received by the contractor is determined by:

- The base split percentage; and
- Any "variable adjustments" and "progress adjustments" to be applied to the base-split percentage.

The base split percentage is as follows:

	Contractor	**State**
Oil	43%	57%
Gas	48%	52%

The base split percentage may be adjusted in the initial contract, and it may also change over time (depending on a number of factors) by "variable adjustments" and "progress adjustments". These adjustments take into account issues such as:

- Field location (e.g., frontier or deep-water areas)
- Type of field (conventional or unconventional)

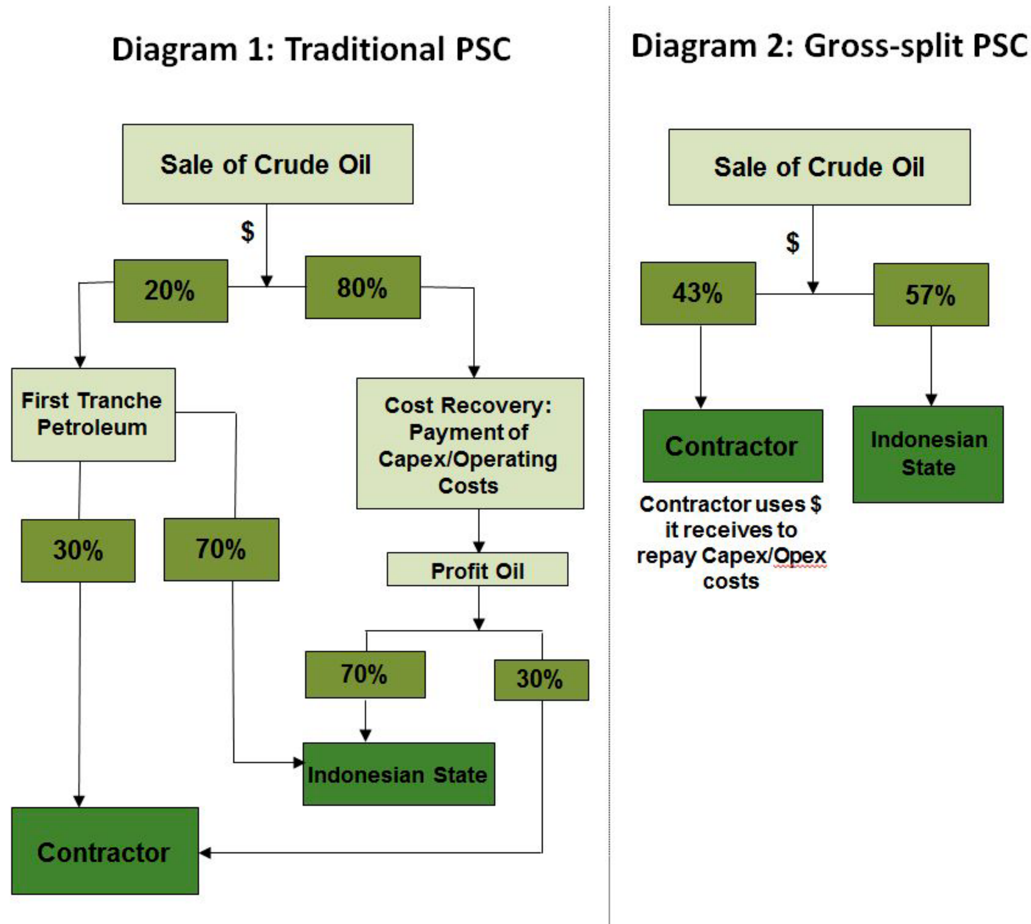
[1] The MEMR has reported that cost recovery in 2010 was about US$11.7 billion and increased to US$16.2 billion in 2014. Unaudited 2015 and 2016 data suggests that the amount of cost recovery has declined to US$13.7 billion (in 2015) and US$11.5 billion (in 2016) due to the lower oil price. Notably in 2016, the oil and gas revenues of the Government are only US$9.9 billion, and are therefore lower than the cost recovery amount.

© Nishimura & Asahi 2017

- Depth of the reservoir
- Oil price
- Total cumulative production of oil and gas from the field

In addition, the State can increase the contractor's share of the gross split by up to 5% where the field does not perform as well as initially expected, or decrease it by up to 5% where the field exceeds certain expectations.

The diagram below illustrates the difference in cash-flows between the two systems.



NOTE: the percentage splits in diagram 1 are illustrative, and different PSCs will have different percentages depending on various factors (e.g., whether exploration and production is in conventional, deep-water or frontier areas).

Are there any other consequences of Regulation 8/2017?

As a consequence of the removal of the cost recovery mechanism, neither First Tranche Petroleum nor the "cash waterfall" will be necessary (see diagram 1). Instead of cost recovery, operating costs that have been incurred can be included as a deduction against the income tax liability of the contractor.

We do not expect other standard features of the Indonesian PSC regime (such as the domestic market obligation for supply, local

© Nishimura & Asahi 2017

content requirements, and abandonment fund) to be affected by Regulation 8/2017.

Does Regulation 8/2017 apply to Production Sharing Contracts entered into before 16 January 2017?

No. PSCs that are entered into before Regulation 8/2017 will continue in effect in accordance with their current terms until the end of their term.

Regulation 8/2017 provides that existing PSC contractors can elect to amend their existing PSC arrangements to the gross split mechanism, but are not required to do so.

Mark Tudor Partner (Foreign Law Partner*)
E-mail: m_tudor@jurists.co.jp
Mark Tudor joined Nishimura & Asahi in May 2016 and has over 18 years experience advising in the energy and natural resources (with 10 of those years being in Japan with an international law firm). Most recently he worked for an FPSO and engineering contractor and has experience advising on onshore and offshore FEED, EPC and other engineering and construction contracts and on development of oil, gas and LNG projects.

*Please note that we are not engaged in a Gaikokuho Kyodo Jigyo (the operation of a foreign law joint enterprise).

Hiroyasu Konno Attorney-at-Law
E-mail: h_konno@jurists.co.jp
Hiroyasu Konno advises clients on various matters of energy and natural resources transactions, such as LNG SPAs, oil upstream projects and metal mining projects. Besides such transactions, he was a committee member of Agency for Natural Resources and Energy's Study Group on Procurement Method of Raw Materials (2014-2015), and has been a committee member of the Institute of Energy Economics, Japan's Study Group on Energy and Law (2015-). While he was a deputy director of the Strategic Planning Division of Japan, Oil Gas and Metals National Corporation, he led LNG research project (2014) and rare earth research project (2015).

Yoshiaki Otsuki Attorney-at-Law
E-mail: y_otsuki@jurists.co.jp
Yoshiaki Otsuki joined Nishimura & Asahi in 2004 after graduating University of Tokyo and admitted in Japan in 2004. He mastered L.L.M of University of Southern California Gould School of Law in 2011 and was admitted in New York in 2012. He worked for Nippon Steel & Sumitomo Metal Corporation from 2012 to 2014. He is now seconded to Japan Oil, Gas and Metals National Corporation (JOGMEC). Recently he has been involved in LNG development and its procurement projects for Japanese clients.

Jun Katsube Attorney-at-Law
E-mail: j_katsube@jurists.co.jp
Jun Katsube joined Nishimura & Asahi in 2006. He mastered L.L.M of University of Southern California Gould School of Law in 2013 and was admitted in New York in 2014. He worked for the legal department of Mitsui & Co. from 2014 to 2016 where he dealt with various energy and natural resources projects in South East Asia region. Recently he has been working for LNG development, mining and FPSO projects.

Public Relations Section, Nishimura & Asahi
Otemon Tower, 1-1-2 Otemachi, Chiyoda-ku, Tokyo 100-8124, Japan
Tel: +81-3-6250-6202 Fax: +81-3-6250-7200 E-mail: newsletter@jurists.co.jp URL: https://www.jurists.co.jp/en
© Nishimura & Asahi 2017