Energy, Utilities & Mining NewsFlash*

Global Energy, Utilities & Mining Group Indonesia

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NewsBytes

New Cost Recovery Regulation - Who bears the risks?

It is widely recognized in the oil and gas industry that Indonesia was the originator of the Production Sharing Contract (PSC) fiscal regime in the late 1960's. The PSC fiscal regime has served the industry well over the past 40+ years and provided a stable framework that investors understood and were comfortable with while at the same time providing much benefit to the country. Over the past several years however investor's perception of the stability of the PSC cost recovery framework in Indonesia has been slowly eroding. In the May 2008 PricewaterhouseCoopers Indonesia (PwC Indonesia) publication "Exploring the Black Gold: Investor Survey of the Indonesian oil and gas industry" survey participants rated "uncertainty over cost recovery and BP Migas/ BPKP audit findings" as the biggest challenge. The second biggest challenge was seen as "contract sanctity" of which the cost recovery uncertainty is a subset.

Much of the recent "noise" related to these industry issues can be attributed to political posturing. With record industry profits the oil and gas companies are easy targets. With Indonesia's continuing production declines and increasing cost recovery it is easy to sway nationalistic and populists views especially given the general lack of understanding of upstream oil and gas activities and how the PSC fiscal regime operates.

In addition there have been political debates over the Tangguh LNG project pricing, the development of the Natuna D-Alpha block and most recently renewed allegations over the pricing of a co-generation facility being used by Chevron. While it is often difficult to understand the true merits of these debates these distractions are not helpful in the short-term to attracting much needed investment to the industry.

On 30 June 2008 the Minister of Energy and Mineral Resources issued Ministerial Regulation No. 22/2008 (Regulation No. 22/2008) in an attempt to clarify the Government's position on certain activities eligibility for cost recovery. The genesis for this regulation were 33 repetitive audit findings raised by the Government of Indonesia (GOI) auditors "Agency for Financial and Development Control" (BPKP) and the "Supreme Audit Agency" (BPK) in their audits of PSC Contractors. Regulation No. 22/2008 is believed to have been a political compromise to appease public sentiment towards perceived abuses in the sector. The regulation however lacks clarity on several issues or contradicts public statements on several matters. As an example several of the exclusions appear to have been written in absolute terms while PwC Indonesia understands that BP Migas intended to use a qualitative "reasonableness" approach.

The below table summarizes the business activity costs not eligible for cost recovery as outlined in the regulation along with PwC Indonesia's observations and comments:

Types of Oil and Natural Gas Upstream Business Activity Costs Non-recoverable to the Contractor of Production Sharing Contract[1]	PwC Indonesia Observations
1. Costs related to the private/ personal interest of the PSC contractors' workers including: personal income tax, losses due to the sale of private cars and houses.	All such personnel expenses have long been recognized as cost recoverable. Contractors need to be able to provide "benefits in-kind" to attract and retain personnel. This is particularly relevant in today's environment where there is a shortage of skilled workers available to the industry. • By specifically mentioning personal income taxes does this imply that employee compensation packages can no longer be structured on a net after-tax basis?
2. Incentives granted for the employees of PSC contractors constituting a Long-Term Incentive Plan (LTIP) or other similar incentives.	In practice LTIP's take many forms but generally are offered to attract and retain key employees. LTIP costs should be viewed as personnel costs. PwC Indonesia understands that the regulators have taken a softened stance on this item in that if the incentives are based strictly on the performance and metrics of the Indonesian operations they will be allowed for cost recovery. Contractors may need to reassess their incentive compensation programs to ensure that the performance metrics are only related to the Indonesian operations performance.
3. Employment of foreign employees/ expatriates not in compliance with the Expatriate Manpower Utilization Plan Procedures (RPTKA) and without being furnished with Expatriates Work Permit (IKTA) in oil and gas sector issued by BP Migas and/or the Directorate General of Oil and Natural Gas.	In principle most investors should not take exception to this item. However, in practice there have been issues with getting the necessary work permits processed in a timely manner. • Should a contractor that "acts in good faith" to obtain the needed work permits be disallowed these costs if caused by delays in the Indonesian bureaucracy? PwC Indonesia understands that BP Migas has agreed that so long as their approval has been obtained for the employment of the expatriate that the cost will be recoverable even if there are delays in getting the various permits.
4. Legal consultant fees that are not related to PSC contractor's operation.	In principle most investors should not take exception to this item. However, to fully understand the item further clarification is needed as to the examples of charges not considered to be related to the PSC operation.
5. Tax consultancy fees.	To unilaterally exclude all tax consultancy fees seems arbitrary. It is PwC Indonesia's understanding that this exclusion arose from tax consultancy fees paid to assist expatriate employees to comply with their personal Indonesian tax obligations. This sort of cost should be viewed as an employee benefit-in-kind and included in personnel costs as recoverable. PwC Indonesia understands that BP Migas has tentatively agreed that such tax consultancy fees will be recoverable as will tax consultancy fees paid to defend inappropriate indirect taxes levied against a Contractor. Tax consultancy fees paid for corporate restructuring or other unrelated items would not be cost recoverable.

[1] Negative list items taken from an "unofficial translation" of Minister of Energy and Mineral Resources Regulation No. 22/2008

Types of Oil and Natural Gas Upstream Business Activity Costs Non-recoverable to the Contractor of Production Sharing Contract[1]	PwC Indonesia Observations
6. Charges of oil and natural gas marketing costs borne by the PSC contractors and costs arising from intended mistakes, related to oil and natural gas marketing activities.	It is difficult to ascertain the Government policy on this item which is subject to a wide range of interpretations. Marketing costs should generally be viewed as operating costs under the PSC. PwC Indonesia understands that this exclusion is geared towards excessive and unreasonable marketing costs incurred in negotiating LNG and other gas sales. As for intentional mistakes this implies a degree of negligence or willful misconduct by the contractor. Most investors would not disagree with disallowing this sort of cost but defining “intentional mistake” would be a challenge. PwC Indonesia understands that this is intended to protect the GOI from potential liabilities which could arise on say missed LNG cargoes.
7. Charges of unlimited Public Relations costs for any type and amounts in the absence of the nominative list of beneficiaries as stipulated under the tax regulations, including costs related to: golf, bowling, credit cards, membership fees, family gatherings, farewell parties, contribution to the PSC contractor’s educational institutions, the PSC contractor’s anniversary, contributions to the association of employee’s wives, nutrition and fitness.	Many of the items contemplated by this exclusion can be characterized as employee benefits which should be cost recoverable. These employee benefits are part of most companies manpower development and retention programs in an effort to boost/maintain work motivation and at the same time to enhance a contractor’s competitiveness. As many of the mentioned items are internal in nature it is also uncertain if the tax requirement for nominative list of recipients is relevant.
8. Environmental and community development costs during the exploitation stage.	From speaking with industry participants it seems clear that Corporate Social Responsibility (CSR) and Community Development (CD) programs need to be differentiated. Generally CSR can be viewed as reputation management while CD is operational in nature. CD can include environmental impact assessments which are needed to ensure smooth operations and long term stakeholder acceptance. In addition, the benefits of CD will be received by the community around the production area who will provide security of production facilities, which actually belong to the GOI. Rather than unilaterally disallowing these sort of costs it would seem to make more sense for the GOI to improve the controlling mechanism/procedure by BP Migas such as pre-approval.
9. The management and depositing of reserve funds for abandonment and site restoration under the PSC contractor’s account.	For contracts that obligate the Contractor to undertake abandonment and restoration activities the funding of these obligations has been a long standing industry issue. Recent practice has been to obtain BP Migas approval as part of the annual Work Plan & Budget (WPB) process for estimated amounts to be funded in the current year. The funds were then deposited into an Indonesian bank account jointly controlled by the Contractor and BP Migas with the Contractor taking current year cost recovery for the deposited funds. This exclusion seems to indicate that these costs will no longer be cost recoverable until the expense is actually incurred. This could be problematic in the latter years of operation when there is insufficient production to cover these costs. It is PwC Indonesia’s understanding that this exclusion is primarily geared towards developing more robust and defined procedures for the funding of these obligations, however, this is not clearly articulated in the regulation.

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10. Costs related to all types of technical training activities for foreign employees/expatriates.	In principal the GOI's viewpoint on this matter is understandable as expatriate personnel are suppose to be experts in their chosen field. However, this is shortsighted in that all professionals need ongoing training to stay abreast of current developments in their area of expertise. PwC Indonesia understands that BP Migas has softened their stance on this exclusion and will now generally accept training costs for expatriates which are required for maintaining a license or professional qualification (such as for geologists, petroleum engineers, etc).
11. Costs related to merger and acquisition.	Based on a BP Migas bulletin it is believed that this exception is targeted at costs related to acquiring a working interest or corporate mergers which require Indonesian operations to undertake changes to conform to the new entity (such as changing computer systems, signage, letterheads, office design, etc). While the exclusion is understandable there may be instances where (say) a computer system change prompted by a merger does provide synergies and efficiencies and therefore should be considered for cost recovery.
12. Costs for loan interest of Petroleum Operation Activities.	Under most PSC's the Contractor may cost recover interest costs only as an incentive and if BP Migas approval is obtained. The draft of this regulation apparently allowed interest cost recovery as an incentive for a marginal project. This language was dropped from the final regulation. PwC Indonesia understands that an amendment will be issued to reestablish the incentive policy.
13. Costs for third party income tax.	Presumably this exclusion will require Contractors to ensure that all contracts are on a gross basis and not include any sort of reimbursement for the vendor's income tax withholding obligation.
14. Procurement of goods and services as well as other activities which exceed the Authorization Financial Expenditure/AFE approval by more than 10% and are not completed by sufficient justification.	It is a long standing requirement that Contractors need to obtain supplemental approvals from BP Migas when they exceed an AFE by 10% or more. It should be noted that in practice this supplemental approval is often not obtained on a timely basis or before incurring the additional expenditures which may be what this exclusion is targetting.
15. Excess material surplus due to improper/mistaken planning and purchase.	Historically certain non-capital inventory was cost recoverable upon purchase. The recent rounds of PSC's signed now only allow cost recovery upon inventory usage. This exclusion appears to be geared towards disallowing cost recovery for bad planning by a Contractor in purchasing excess inventory. Whilst it is difficult to find fault with this basic premise there may be instances where it makes commercial sense for a Contractor to purchase inventory beyond its immediate needs and then a change of events makes this inventory no longer needed. Should a contractor solely bear this risk?

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16. The establishment and operation of Placed in Service (PIS) Projects/ Facilities that are not able to operate in accordance with the economic life due to the PSC contractor's negligence.	On the surface not allowing an investor to recover costs for negligence seems to be a reasonable stance. However, it again requires defining what actually constitutes negligence. The fundamental question has to do with risk and who is responsible (see comments below).
17. Transactions with affiliated parties that cause losses to the Government, without tender, or contradictory to Law No. 5 of 1999 concerning Anti-Monopoly Practice and Unfair Business Competition as well as tax regulations.	This exclusion appears to be directed towards related party transactions that do not follow requirements as stipulated in PTK 007.

Regulation 22/2008 doesn't explicitly state if these new cost recovery guidelines will be applied retroactively or prospectively. PwC Indonesia understands that BP Migas has taken the view that the new rules will only be applied prospectively. In other words, the guidelines should not apply to outstanding government audit claims from periods prior to the issuance of this regulation (or for that matter costs that have already been approved). In addition, PwC Indonesia understands that more detailed implementing regulations will be forthcoming to clarify some of the ambiguities. How quickly these implementing regulations will be issued is currently uncertain. It is also understood that there is general agreement amongst the senior government officials responsible for auditing the Contractors on the approach to be taken on some of the ambiguous items although it remains to be seen how quickly these clarifications can be disseminated amongst the various auditing teams. A real fear is that government auditing teams apply the most literal approach to Regulation 22/2008 and this leads to protracted disputes.

Who bears the risks?

Many of the debates related to cost recovery can be narrowed down to the simple concept of which party to the PSC should bear the relevant risks. (Note that the author recognizes that some of the debate hinges on the reasonableness of certain costs) A basic premise of the PSC fiscal regime is that the Contractor bears all exploration risks but once a commercial discovery is made the investor is entitled to cost recovery out of resulting production. Investors understand and can accept the geological risks of exploration but unnecessary uncertainty has been created with the recent debates over cost recovery.

At a recent industry forum a participant summarized this concept with a question which is paraphrased as – "Which Party (ie. the Contractor/Investor or the GOI?) bears the risks if despite "best efforts" and proper planning a program doesn't deliver results as originally anticipated?". In other words who shoulders the risks if a project (approved by BP Migas) doesn't deliver the results as originally planned either because of geological risks, operational risks, commercial risks or any other risks? There doesn't appear to be a consistent understanding amongst the various government "entities" on this basic principle. Unfortunately until such time as a consistent viewpoint can be reached on this basic principle the industry is likely to experience ongoing uncertainty over contract sanctity and cost recovery matters.

Stay tuned as PwC Indonesia will provide further updates on the new regulation and its practical implementation in future newsletter articles.

William Deertz

[1] Negative list items taken from an "unofficial translation" of Minister of Energy and Mineral Resources Regulation No. 22/2008

Expansion of Industries qualifying for GR No.1 Investment Incentives

Readers will recall from our last Newsflash (No.27/2008) that Government Regulation No. 1/2007 outlined a series of tax related incentives such as:

a. a 30% "investment credit" on qualifying capital spending;
b. accelerated tax depreciation/amortization entitlements;
c. reduced cross-border dividend withholding rates;
d. an extended tax loss carry forward period.

On 23 September 2008 GR No.62/2008 was issued as an amendment to GR No.1/2007. GR No.62 operates to expand the industries entitled to GR No.1 incentives. These new industries include:

a. the mining and utilization of "low rank" coal to meet local gas demands (i.e. via gasification);
b. those involved in the "conversion" of geothermal energy into electric power;
c. a wide range of hydrocarbon refining activities, where the hydrocarbons are refined to meet local demands;
d. certain gas to LNG/LPG processing activities particularly where small scale (e.g. "mini" LNG projects).

Hopefully GR No.62/2008 will increase investment levels in the energy sectors included in the expanded list.

Dicky Rudiwibowo/Tim Watson

New regulation for oil & gas mining service providers

The Ministry of Energy and Mineral Resources has issued a new regulation No. 27 on 22 August 2008 regarding the provision of oil and gas mining support services. This regulation revokes the Decree of Ministry of Mines and Energy No. 147/kpts/M/Pertamb/1972 issued in year 1972 regarding the licensing of foreign companies engaged in oil and gas mining services.

Under the old Decree of 1972, a foreign company could directly provide oil and gas mining support service by obtaining a licence from the Director General of Oil and Gas (DGOG). In practice this should be performed in cooperation with a local company. Oil and gas mining support services includes a broad range of activities such as drilling, seismic and geophysical survey, underwaterwork and consulting.

This new regulation allows a company or an individual to provide oil and gas mining support services. A company is defined as a state owned enterprise, a regional government owned enterprise, cooperatives or a private company having Indonesian legal status. The definition does not include a foreign company so that, consequently, a foreign company can no longer directly provide oil and gas mining support services. A foreign company which intends to provide oil and gas mining support services must now perform it through a subsidiary in Indonesia.

The transitional provision still allows a foreign company to provide oil and gas mining support services until the current licence from the DGOG expires.

Further clarification is needed as to whether, under this new regulation, an agency arrangement with a local company is still an option for a foreign company and whether the definition of "individual" includes a foreign individual as well. This regulation also stipulates a registration and certification requirement for those who are engaged in oil and gas mining support services.

Anthony J Anderson

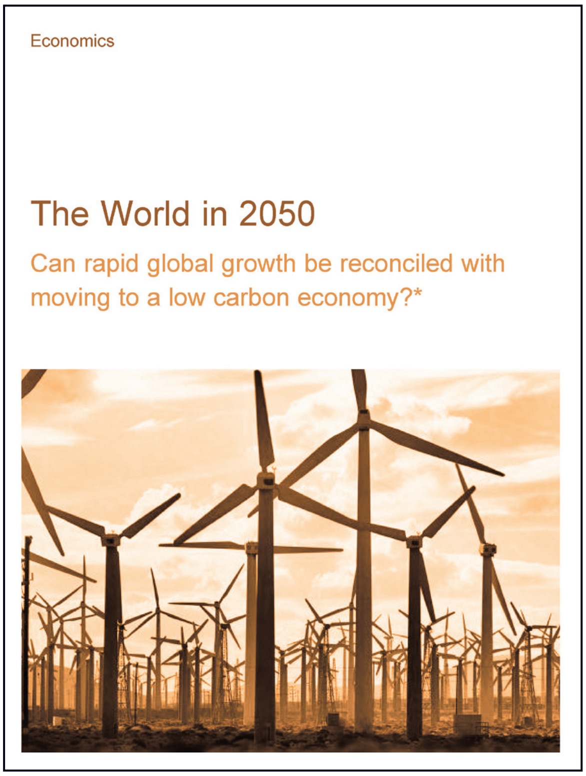
Mine* – As good as it gets?

PricewaterhouseCoopers released the fifth annual review on global trends in the mining industry. The report provide a comprehensive analysis of the financial performance and position of the global mining industry.

The recently released "Mine* – As good as it gets?" looks at the performance of the 40 leading global mining companies as measured by market capitalisation for the year ended 31 December 2007. It also looks at issues that will impact the future of the industry. It also summarises views of a number of CEO's of these majors, particularly with respect to their thoughts on the future.

The first blush through the findings look spectacular – market capitalisation rose significantly, profits were up and total shareholder returns more than doubled on average. On closer inspection, however, the major issue of cost inflation emerges.

The World in 2050



PricewaterhouseCoopers LLP (PwC) recently released our report The world in 2050: Can rapid global growth be reconciled with moving to a low-carbon economy? – authored by John Hawksworth, PwC's head of macroeconomics. This analysis updates PwC's report The world in 2050: Impact of global growth on carbon emissions and climate change policy, originally published in September 2006.

PwC's updated analysis re-emphasises the scale of the challenge posed by global warming, which actually now seems even greater than at the time of the original report two years ago, due in particular to higher projected economic growth in China and India. The other key development has been the sharp rise in oil and gas prices, which has raised questions regarding whether the current global energy model will be sustainable in the long term.

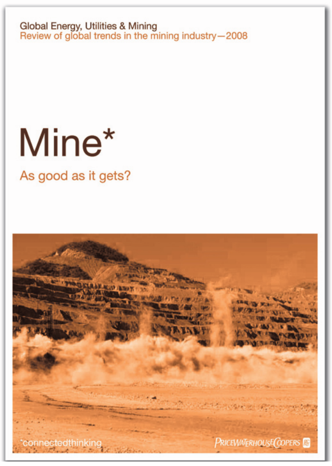
In the report PwC conclude that global carbon emissions from energy use in a "business as usual" scenario would more than double by 2050—whereas what is required to reduce the risks of adverse climate change to acceptable levels in fact is a reduction in global carbon emissions, to only around half of current levels by that date.

For the advanced G7 economies, this means a reduction in carbon emissions of around 80% relative to current levels by 2050. For the E7 emerging economies, it involves mitigating the growth of emissions up to around 2020 and then aiming for reductions in emissions after that date, initially at a gradual rate but ultimately at a more rapid rate as lower-cost green technologies are introduced in these countries.

To obtain a copy of the report and find a more detailed summary, please visit our website at www.pwc.com.

For the first time in the 5 years that we have compiled "Mine*" the increase in operating costs of 38% exceeded the increase in revenue of 32%. Whilst profits in absolute terms still increased to a combined US$80 billion for the top 40 companies, the profit margins reduced from 28% to 26%. Whilst these margins are still at levels that most industries would kill for, the warning of cost increases impacting the outlook is clear for all to see.

Indeed the supply challenges of developing new projects on time and on budget, or even producing at consistent costs appears out of the reach of most. Therefore, whilst demand for many minerals suggests prices will stay "stronger for longer" (note that this report was completed prior to the recent significant commodity price declines), the real issue is whether the cost of production enables a good margin to be achieved. To be fair, as reflected in the figures presented in "Mine* – As good as it gets?" the industries largest companies have many/ most of the tier 1, low cost, long life mines, so they are not suffering as much from the challenges as some of the mid tier and junior miners around the world. Having said that, the cost increases are biting into margins, and are ignored at your peril.



Copies of the Mine* publication can be downloaded from www.pwc.com/mining.

New Tax Rules for Construction Services

On 23 July 2008 Government Regulation No.51/2008 was issued to alter the withholding tax (“WHT”) arrangements for “construction” and associated services. Essentially GR No.51:

a. renders the withholding made against these services to be a “final” (ie non- creditable to the vendor) tax under Article 4(2) of the Income Tax Law. This is similar to the mechanism that applied before 2001;

b. increases the general WHT rate on construction payments from 2% to 3%;

c. renders the various WHT obligations due on a payment rather than accruals basis;

d. introduces a new category of “non-qualifying” construction services with rates at 4% and 6%;

e. expands the definition of construction services to potentially include all EPC contracts;

f. has retrospective application (back to 1 January 2008) for contracts signed 1 January 2008 and after.

GR No.51 has the potential to impact the WHT activities of parties engaging for a wide range of construction and similar services both prospectively and historically. The retrospective nature of the GR is particularly problematic. One major uncertainty is how to “correct” for payments made before July 2008, but in respect of contacts signed after 1 January 2008. These payments will, quite understandably, have been made under the pre-GR No.51 rules but will now be incorrect. This will impact both the engaging party and the construction company.

Mining companies operating pursuant to CoWs or CCoWs will also need to factor in any lex specialis positions.

Tim Watson

NewsBytes

Tax Technical Updates for the Mining Sector and Oil & Gas Sector

PricewaterhouseCoopers Indonesia Energy Utilities and Mining Group is pleased to announce that it will hold two industry specific seminars in regard to developments in Indonesian taxation for the Mining and Oil & Gas Sectors.
Details as below:

Mining Tax Technical Update

Date : Monday, 10 November 2008
Time : 8.30 a.m – 11.00 a.m (registration and breakfast starts at 8.00 a.m)
Venue : Dua Mutiara 2, JW Marriott Jakarta
Jl. Lingkar Mega Kuningan Kav. E.1.1 No. 1&2
Mega Kuningan, Jakarta 12950, Indonesia

Oil & Gas Tax Technical Update

Date : Wednesday, 12 November 2008
Time : 8.30 a.m – 11.00 a.m (registration and breakfast starts at 8.00 a.m)
Venue : Ulos & Songket Room, Four Seasons Hotel, Jakarta
Jl. H.R Rasuna Said, Jakarta 12920, Indonesia

Please speak to your usual PwC Indonesia contact for further details. Invitations will be sent out – shortly to Vice Presidents of Finance/Country Controllers and their local Tax Managers/Tax Team Leaders.

For further information on how PricewaterhouseCoopers Indonesia can assist you, please contact one of the following specialists based in our Jakarta office:

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