

PwC Indonesia
Energy, Utilities & Mining NewsFlash



Gross Split PSCs – a spur for investment?

By Alexander Lukito and Tim Watson

On 13 January 2017, the Minister of Energy and Mineral Resources (“MoEMR”) issued Regulation No.08/2017 (“Regulation-08”) introducing a new Production Sharing Contract (“PSC”) scheme based upon the sharing of a “Gross Production Split”. As part of the associated socialisation the Government of Indonesia (“GoI”) has promoted this new paradigm as the model for how upstream business activities should be conducted going forward. In short the GoI believes that the new scheme:

- a) should incentivise exploration and exploitation activities due to the spending and operational “freedom” it conveys to contractors. For instance, the scheme should better allow contractors to focus on cost efficiency, and reduce delays from the bureaucratic approval process for expenditures; and
- b) should nevertheless allow the State to retain appropriate control over the country’s energy resources as the GoI will continue to be involved in approving key phases of upstream business developments (i.e. from the PSC award up to production).

The real question therefore is whether industry players will share the same optimism as the GoI.

Whilst by no means a comprehensive framework, and requiring further implementing regulations, the salient features of Regulation-08 are:

Summary of Regulation-08

No.	Items	Description	Ref.
1.	Key Features	<ul style="list-style-type: none"> A Gross Split sharing concept based on a gross production split without regard to a cost recovery mechanism. A retention of the following key principles: <ol style="list-style-type: none"> that the ownership of the natural resources remains with the State until the point of delivery of the hydrocarbons (as per existing PSCs); that control over the management of operations is ultimately with SKK Migas (as per existing PSCs – although see below); and that all capital and risks should be borne by Contractors (as per existing PSCs). A Gross Split PSC should stipulate at least 17 items (including government take, financing obligation, settlement of disputes, etc.). 	Articles 1, 2 and 3
2.	Gross Split mechanism	<ul style="list-style-type: none"> This can be illustrated as follows: <div>Contractor Take = Base Split +/- Variable Components +/- Progressive Components</div> <div>Government Take = Government share + bonuses + Contractor's Income Tax</div> The base split shall constitute the baseline in determining the production split during the Plan of Development ("PoD") approval. These splits are: <ol style="list-style-type: none"> for oil: 57% (GoI); 43% (Contractor) for gas: 52% (GoI); 48% (Contractor) The variable components are adjustments which take into account the status of the work area, the field location, reservoir, supporting infrastructure, etc. The progressive components are adjustments which take into account oil price and cumulative production. The "actual" production split shall be agreed on a PoD rather than PSC basis. Depending upon field economics the MoEMR has the authority to adjust (to a maximum 5%) the production split in favour of either the Contractor or the GoI. Note that it has been reported that the one Gross Split PSC agreed to date (being for a mature field) was actually set at 42.5% : 57.5% GoI/Contractor. This outcome demonstrates just how flexible these splits might be in practice. 	Articles 4, 5, 6, 7, 8, 9, 10 and 11
3.	SKK Migas' role	<ul style="list-style-type: none"> This will be limited to control and monitoring of Gross Split PSCs. Control will mean to formulate policies on Work Programs and Budgets ("WP&B") (with the budget reportedly considered to be "supporting information" rather than requiring approval). The work program (i.e. not the budget) should be approved within 30 working days of complete documentation being received. Monitoring will mean to supervise the realisation of exploration and exploitation activities according to the approved work program. SKK Migas seems therefore to be no longer involved in approving procurement of goods and services (see point 6 below). The 1st PoD must be approved by the MoEMR. The Head of SKK Migas can approve any 2nd PoD. Any difference between the 2nd PoD and the 1st PoD should be discussed between the Head of SKK Migas and MoEMR with final approval by the MoEMR. 	Articles 15, 16 and 23
4.	Title	<ul style="list-style-type: none"> As indicated, ownership of natural resources remains with the State until the point of delivery of the hydrocarbons. Goods and equipment including land (except leased land) used directly in PSC operations become the property of the State (as per existing PSCs). Any technical data derived in relation to the PSC shall belong to the State (as per existing PSCs). 	Articles 2, 21 and 22
5.	Taxation	<ul style="list-style-type: none"> The income tax treatment of Contractors is to follow specific tax rules for upstream activities. This could mean that income tax arrangements will be incorporated within an amendment to Government Regulation No. 79/2010 ("GR-79") (which is separately ongoing). Another alternative may be to subject Gross Split PSCs to the general income tax rules (which we understand is also being considered). Either way certainty around the income tax regime, which would therefore replace the longstanding "uniformity principle" and the associated grandfathering features, will be crucial to analysing the attractiveness of Gross Split PSCs. As relief for costs incurred would be via tax deductions rather than cost recovery, it is likely that the key agency responsible for oversight of this area would also transfer to the Indonesian Tax Office. Any prevailing tax incentives applicable for an upstream business should continue for Gross Split PSCs. The question is therefore whether VAT reimbursement, import tax exemptions, the reduction on PBB (for exploration) etc can still be applicable. However this will not be clear until the relevant upstream tax rules are issued. 	Articles 12, 13 and 14

No.	Items	Description	Ref.
6.	Procurement	<ul style="list-style-type: none"> Contractors shall carry out procurement of goods and services independently. It has been reported that this will mean that government procurement regulations (such as PTK-007) may no longer be required to be followed. 	Article 18
7.	Transitional Provisions	<ul style="list-style-type: none"> The operation of existing PSCs should continue until expiry. Contractors can however propose changing to the new Gross Split scheme. An option to change is also available for extended PSCs (if initially signed under the cost recovery arrangements). We understand that for extended PSCs the option to continue with the existing cost recovery arrangements will require approval from MoEMR. If the PSC format is changed any unrecovered costs may be taken as additional split for the Contractor. PSCs about to expire but not extended shall automatically be “re-awarded” under the new Gross Split scheme. 	Articles (arguably) 24 and 25
8.	Others	<ul style="list-style-type: none"> The DMO remains at 25% of the Contractor’s entitlement/split and paid by the GoI at ICP. Contractors should prioritise the use of local manpower, domestic goods, service, etc (note the potential impact on procurement processes). Other matters pertaining to Indonesian participation, unitisation, abandonment and reclamation costs, etc should follow prevailing rules. 	Articles 17, 18, 19 and 20

Conclusion

At this stage it is difficult to determine whether the Gross Split scheme will promote or discourage investment. In particular, there are likely to be different outcomes for mature operations compared to newly producing fields. It is also questionable whether the new scheme will encourage investment in exploration in a new block. The cost recovery scheme gave investors more return in the early years of production to recover exploration and development costs (incurred at the full risk of the investor without any guarantee of success), which significantly improved the overall economic return over the life of the PSC.

The devil, as always, will be in the detail. Existing Contractors and prospective investors will need to carefully model the economic outcomes of the new methodology, once full details are known. In particular, certainty around the tax rules will be key, including the degree to which the rules on tax deductibility compare to those under cost recovery. Apart from concerns around the stability of tax rates, these include:

- the robustness of the tax regime around the Gross Split (e.g. the application of unlimited tax loss carry forward, deductibility of VAT and regional taxes, accelerated asset depreciation, etc). This creates not only technical questions but also whether the tax audit process will be managed in a way that is supportive (from a technical perspective) and reasonable (from the commercial side) for the industry; and
- how comfortable the industry is in having a Gross Split scheme regulated under a MoEMR regulation rather than a higher regulatory instrument (such as a GR or an amendment to the oil and gas law). For tax, a new GR or amended GR-79 is required to support the tax regime for Gross Split PSCs.

In a high level sense, the traditional PSC scheme arguably provides more certainty (via the longstanding cost recovery mechanism) and tax stability (via grand-fathered income tax rates). The new scheme appears to carry inherent forecasting risks due to its “floating” production split (determined on an individual PoD, rather than entire PSC basis), variable and progressive components etc.

It is encouraging that the MoEMR sees the need to reduce some of the regulatory hurdles and bureaucratic processes for approval of expenditures which have often delayed investment in the past. However, it should be noted that investors often voice concerns with delays resulting from government institutions outside the control of MoEMR (e.g. those responsible for tax, forestry, environment) as well as local government authorities. We expect that it will be important that there are clear guidelines for coordination between these various government entities to ensure that the full benefit of less intrusive oversight from SKK Migas in day-to-day operations is realised.

So on the question of whether the new Gross Split scheme will spur investment? The jury may still be out....

PwC will continue to monitor developments and we look forward to discussing any specific concerns with you. Please feel free to contact your regular PwC adviser or any of the contacts listed below.

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