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Executive Summary

The landmark regulation dealing with cost recovery and tax in the upstream sector has finally issued as GR 79. GR 79 is a potential watershed providing the first dedicated regulation dealing with cost recovery and tax arrangements for this important industry.

Further implementing regulations are to be issued.

Government Regulation No. 79/2010 ("GR 79") Cost Recovery and Income Tax for the Oil and Gas Sector

After a discussion period of over two years, including industry dialogue, the landmark regulation dealing with cost recovery and tax in the upstream sector has finally issued as GR 79 on 20 December 2010. GR 79 is a potential watershed providing the first dedicated regulation dealing with cost recovery and tax arrangements for this important industry.

This is therefore a significant regulation which will require detailed examination. However, some of the early points of relevance are set out below. As usual further implementing regulations are to be issued notably by the Minister of Energy and Mineral Resources ("MEMR"), the Minister of Finance ("MoF"), BP Migas and the Director General of Tax ("DGT"). We will provide more detailed comments as these implementing regulations are issued.

Effective Date and Applicability to Cooperation Contracts ("CC")

GR 79 stipulates that:

a. It became effective from the date of signing. This means GR 79 operates from 20 December 2010 (but see below).

b. It applies fully to CCs, consisting of PSCs and Service Contracts, signed after 20 December 2010.

c. CCs signed before 20 December 2010 continue to follow the rules relevant to these CCs until expiration. This is except for areas on which these pre-GR 79 CCs are silent in which case Contractors should adopt areas covered in GR 79 within three months.

Overall therefore GR 79 will be likely to operate generally from 20 March 2011 for both "new" CCs (on the assumption that no new CCs will be signed until 20 March 2011) and for the unregulated areas of pre-existing CCs, noting that for pre-existing PSC's there may be scope for GR 79 to apply from 20 December 2010.

Revenue

GR 79 provides that:

a. A Contractor's income is to be recognized at the "delivery point". The delivery point is where the transfer of title of oil/gas from the Government to the Contractor occurs. This appears to be similar to the historical position.

b. For Contractor's producing oil, the oil received should be valued using the "Indonesian crude oil price". This again appears to be similar to the historical position.

c. For Contractor's producing gas, gas should be valued based on the gas sales contract. This again appears to be similar to the historical position.

Some post lifting costs are specifically indicated as recoverable/deductible such as the financing costs of gas processing plant as well as plant operation, transportation and marketing costs. Whilst this is consistent with the historical treatment in practice to have these costs made specifically recoverable/deductible is considered a positive development.

Cost Recovery/Tax Deductions

GR 79 stipulates the following:

a. GR 79 requires that there be a "uniform treatment" between cost recovery and tax deductibility. This is pivotal as it appears to formally enshrine the long-standing "uniformity principle". To satisfy uniformity the amount should still:

   i) be spent on income production activities;

   ii) satisfy arms' length principles (for related party transactions);

   iii) be consistent with good business and engineering practices (which is technically a new requirement); and

   iv) be approved by BPMigas and included in the relevant Work Program and Budget.

b. GR 79 outlines 24 items of spending that are not allowed for cost recovery (as the "negative list"). These now include:

   i) administrative sanctions such as interest, fines, surcharges and criminal sanctions;

   ii) depreciation on assets not belonging to the Government;

   iii) bonuses paid to the Government;

   iv) costs incurred prior to the signing of the relevant CC;

   v) interest recovery incentives; and

   vi) commercial audit costs.

c. Via the uniformity principle, GR 79 also effectively allows tax losses to be carried forward until the CC expires.

d. The field based ring fencing appears to be included as does scope, via Article 19(2), for other general cost recovery limits.

Indirect Taxes

GR 79 stipulates the following:

a. Indirect taxes, regional taxes and regional levies are cost recoverable. Indirect taxes include VAT, customs duty, land & building tax, regional taxes and regional levies. This is a significant change as these taxes have generally been reimbursable in the past.

b. Customs duty and import taxes (such as VAT and Article 22 Income Tax) due on the importation of goods related to exploration and exploitation activities are to be exempted. This is a positive development as it should alleviate some of the recent tax concerns with rig and similar imports although detail on the exemption is still to issue.

Tax Calculation, Payment and Audit

GR 79 stipulates the following:

a. For CCs signed after GR 79, the income tax rate is that which prevailed at signing or that prevailing from time to time. This appears to breathe life into the Income Tax rate "election" which is in 2001 Oil and Gas Law.

b. For CCs signed before GR 79, the income tax rate is that which prevailed when the CC was signed. This grandfathering is consistent with the retention of the uniformity principle.

c. If the income tax payment is reduced including via a change in the domicile of the Head Office ("HO") (say due to a favorable tax treaty), the after tax "Government share" shall remain the same. This enshrines the recent trend in PSCs to counter tax treaty use.

d. Contractors pay income tax on monthly basis based on actual liftings with the tax due by 15th of the following month.

e. The Government may demand the income tax payment in the form of crude oil or natural gas. This is a new feature for which detailed guidance is needed.

f. Income tax payments are subject to tax audit carried out by the DGT. The DGT will issue any assessments after audit. Whilst this is not new in practice guidance will be needed on the technical aspects of these new procedures.

g. A temporary tax assessment can be issued (without any tax audit) if needed by the Contractor's HO for internal management purposes.

h. For Contractors in exploration, unrecovored costs are subject to tax audit on annual basis by the Government auditor (eg BPKP) on behalf of the DGT. This is effectively a new development.

Non Lifting's Income

GR 79 stipulates the following:

a. Uplift (or similar income) is subject to tax at 20% of gross proceeds. This is consistent with the recent practice.

b. Transfers of PSC/CC interests will be taxed as follows:

   i) during exploration stage:

   – the transfer will be taken to be for risk sharing purposes and exempted if the following criteria are met:

      ▪ less than the entire interest is transferred;

      ▪ the interest has been held for more than three years;

      ▪ exploration activities have been conducted; and

      ▪ the transfer is not intended to generate a gain; or

   – if the transfer is for "non-risk sharing" purposes, 5% final tax on gross proceeds;

   ii) during exploitation stage, 7% final tax on gross proceeds except for a transfer to "national company" as stipulated in the CC (i.e. national participating interest).

c. The Contractor should report all transfers (including share transfers).

d. After the transfer (of an interest), the acquirer assumes all the rights and obligations related to taxation of the disposing party. Whilst this is not an entirely new development this does provide some clarity around an issue that has been a historical concern.

There are still a number of uncertanties on this key area of tax policy. For instance, it is not yet known whether the tax is due on withholding or self remittance basis.

It is also unclear whether the transfer tax only applies for on-shore asset sales. The definition of a participating interest is however broad enough to potentially include off-shore share sales. Implementing regulations on this will be keenly awaited.

Bookkeeping and Tax Registration

GR 79 stipulates the following:

a. Contractors are permitted to use English and US$ bookkeeping after approval from the MoF.

b. All books, records, etc should be kept in Indonesia until the relevant costs are recovered.

c. A CC will be required to register for its own tax ID number. The registration will be carried out by the operator of the particular CC. This is a new development similar to the existing Joint Operating Body (JOB) arrangements.

d. Operators are responsible for transactional taxes (including WHT and VAT), presumably meaning that the transactional taxes should continue to be reported under the Operator's tax ID number.

Other Matters

GR 79 stipulates the following:

a. HO costs are recoverable subject to the following:

   i) the costs support activities in Indonesia;

   ii) the Contractor provides consolidated audited financial statements of the HO and an outline of the method of allocation (noting that this is a new requirement). It is not clear what conditions apply where the HO is an SPV; and

   iii) the HO allocation does not exceed a ceiling determined by the MoF.

b. Certain post lifting costs, including for transporting natural gas (including marketing costs approved by BP Migas) and other post upstream activities, are recoverable.

c. Expatriate costs are recoverable but should not exceed a ceiling determined by the MoF (in coordination with the MEMR).

As indicated this summary represents a preliminary outline only. More detailed comments will be provided early in the new year. Otherwise please feel free to discuss this important regulation with your usual PwC adviser.

Finally, Happy New Year to all our readers and we wish you success with your business endeavours in 2011 in Indonesia's dynamic upstream sector.

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Code of conduct
The way we do business

Putting our values in action

Excellence
Delivering what we promise and adding value beyond what is expected.

We achieve excellence through innovation, learning and agility.

Teamwork
The best solutions come from working together with colleagues and clients.

Effective teamwork requires relationships, respects and sharing.

Leadership
Leading with clients, leading with people and thought leadership.

Leadership demands courage, vision and integrity.

This summary is not intended as professional advice. It is suggested to always consult with your usual PwC Indonesia contact.