

Indonesia's Oil and Gas Legislation: Critical Issues

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The Natural Resource Governance Institute (NRGI) has prepared a briefing note on critical issues facing Indonesia as the government and legislature work to finalize revisions to the oil and gas legislation. In this document we share perspective on legislative options to pursue critical goals for the oil and gas sector, including reinvigorating investment, strengthening Pertamina, generating a fair tax take, reducing the risk of corruption and promoting accountability and good governance.

INSTITUTIONAL STRUCTURE AND THE ROLE OF STATE-OWNED ENTERPRISES

One of the most critical questions facing parliament and the government is how to structure the institutions responsible for managing the exploration, production and sale of Indonesia's oil. The country is seeking a system that promotes vigorous investment, strengthens the state-owned enterprise Pertamina as a flagship oil and gas company, advances strong oversight and reduces the risk of corruption. There are four key elements of this choice.

1. What kind of commercial privilege should Pertamina receive in relation to exploration and production activities?

In order to expand Pertamina's participation and returns, the legislation may address whether Pertamina should be granted additional privileges in gaining access to contracts for exploration and production. A purely competitive system that places Pertamina on completely "equal footing" in licensing processes with private companies—as is practiced in Norway or Colombia—is unlikely to be a good fit for Indonesia given the consensus that there is a need to boost Pertamina. Nor does there seem to be appetite for giving Pertamina a Saudi-style monopoly over exploration and production in light of the need for private investment.

The country's decision, therefore, might turn on what kinds of advantages (short of monopoly power) to build into the system. There are two basic options, as illustrated on the next page:

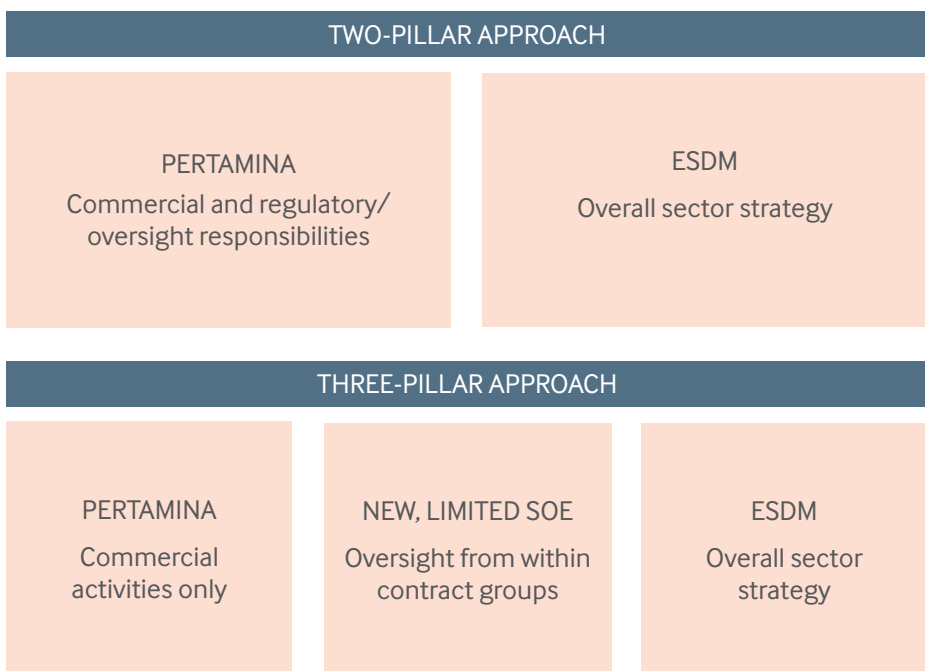
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System	Description	Examples	Advantages	Disadvantages
Guaranteed role/option	The SOE has either a predefined/uniform role in every commercial project (i.e., operatorship, a minimum equity stake, or a right to select its own partners), or an unfettered option to select such a role where it chooses.	Malaysia (partner selection); Brazil (operator in all “pre-salt” projects)	<ul style="list-style-type: none"> • Guarantees commercial opportunities • Gives SOE strong control over its path • Predictability in planning 	<ul style="list-style-type: none"> • Weakens incentives for SOE to improve performance • Reduces “market” pressure to be competitive
Application with favor	The SOE is given systematic advantages over private applicants in a licensing process. This can be via a right of first application, whereby the SOE is awarded the project if its bid meets a minimum acceptability threshold. It can also be via a bidding process, whereby the SOE receives some form of bonus points in its competition against private applicants.	Mexico (post-2013), Kazakhstan	<ul style="list-style-type: none"> • Seeks to strike a balance between access to projects and incentives for efficiency by creating advantages to increase the likelihood of SOE participation in projects without guaranteeing it 	<ul style="list-style-type: none"> • Less predictable than guaranteed role/option • Still has some risk of weakening incentives or discouraging private investment (if other companies do not feel system is clear or fair)

NRGI recommends that Indonesia pursue some version of an application with favor approach. This would provide Pertamina with greater opportunities to develop projects than it has had in recent years, but would boost incentives for it to become a more competitive and dynamic commercial company. It would also reduce the risk of crowding out private investment or of harming efficiency by mandating that Pertamina play a dominant role in every project.

2. Which institution should be responsible for regulation and oversight?

Indonesia needs to decide which institution will be principally responsible for regulation and oversight of upstream activity. It appears that the two principal options on the table are to assign regulatory responsibilities to Pertamina (the so-called “two-pillar approach,” wherein Pertamina plays the day-to-day implementation and oversight role under the broader supervision of the Ministry of Energy and Mineral Resources) or to assign them to a new state-owned enterprise which would assume many of the functions previously exercised by BP Migas (the “three-pillar approach”).



Versions of these systems have been instituted in other oil-producing countries with mixed results.

System	Examples	Advantages	Disadvantages
Two-pillar (exploration and production SOE as principal regulator)	Malaysia (successful, with some accountability challenges); Angola (good technical performance, low accountability); Venezuela (unsuccessful)	<ul style="list-style-type: none"> • Can facilitate the development and implementation of a strong, unified national vision for the sector • Concentrates resources and skills into one body, making it stronger • Can facilitate administrative efficiency • Strengthens SOE by giving it automatic decisionmaking power 	<ul style="list-style-type: none"> • Conflict of interest: if SOE is self-regulating, enforcement of national rules can be weak • Can weaken SOE's incentives for strong commercial performance • Combination of roles can overburden the SOE and distract from its principal commercial agenda
Three-pillar (third body as regulator)	Norway (successful); Colombia (successful); Brazil (mixed: long period of technical success, but recent large corruption scandal)	<ul style="list-style-type: none"> • Can reduce risk of conflict of interest • Can increase likelihood of consistent enforcement of rules • Can make it easier for SOE to focus exclusively on commercial goals • Often favored by private investors who are leery of unequal treatment under the two-pillar model 	<ul style="list-style-type: none"> • Can risk spreading human and financial resources thin • Can create confusion and inefficiencies if the roles of the different bodies are not clearly delineated • Not a lot of examples to study of "limited, regulatory SOEs": Norway's Petoro and Brazil's PPSA

NRGI's global research suggests that two-pillar approaches have tended to be most successful in countries that (1) have strong systems of unified political decisionmaking (such as Malaysia); and/or (2) have low capacity to manage the oil sector, thus necessitating a consolidation of government resources into one body. In countries with strong oil-sector capacity and more competitive systems for decisionmaking (such as Norway and Colombia), three-pillar systems have tended to be more successful. For this reason, we recommend that Indonesia pursue the three-pillar approach, which would reduce the risk of conflict of interest and promote strong and objective oversight of all commercial actors.

3. How should Pertamina (and any new SOE, if one is created) be financed?

Once it decides on the roles and responsibilities of Pertamina and any new SOE, the government will have to set up a system that gives the enterprise(s) access to the financial resources required to carry out their mandates. Financing state-owned enterprises requires a delicate balance. Giving an SOE control over too large a share of public revenues can damage the SOE's incentives toward efficient performance and starve the national budget of much-needed revenue. On the other hand, if the SOE does not have predictable access to a sufficient flow of revenues to execute its activities, then the company is unlikely to carry out its commercial strategy effectively. NRGi recommends that as a function of the decisions about Pertamina's roles and privileges, Indonesia's leaders should conduct a detailed assessment of the company's likely needs and set a commensurate financing rule.

If the country opts for a three-pillar approach and creates a new, limited SOE, it will also need to establish a financing mechanism commensurate with the level of responsibility and commercial activity of that SOE. As is the case with Petoro in Norway, given the limited mandate of such a "regulatory" SOE, the most logical starting point for this discussion would be that it would operate primarily as a budgetary entity.

4. What kinds of accountability mechanisms should be created or reinforced?

The legislative process provides an important opportunity for the country to consider strengthening the accountability mechanisms that apply to Pertamina, the Ministry of Energy and Mineral Resources and any new SOE that assumes some of the functions currently occupied by SKK Migas.

NRGI recommends that Indonesia's leaders include rules providing for the following mechanisms, which have promoted accountable performance of SOEs and state regulatory bodies in other countries:

- Clear rules and rigorous criteria for the qualifications of board members
- Strong internal codes of conduct
- Whistleblower protections to encourage employees to report concerns about corruption
- Regular schedules of reporting to parliamentary bodies responsible for oversight
- Regular audits by private, world-class audit companies

NRGI recommends that Indonesia's leaders include rules to bolster the accountable performance of SOEs and state regulatory bodies.

FISCAL REGIME FOR OIL AND GAS

As Indonesia seeks to boost supply and public revenues from oil and gas, it faces several challenges, including heavy risk in exploration, global investment cuts associated with low oil prices, regional competition, investor perceptions of a risky business climate and a high average effective tax rate in the sector.

In its efforts to boost investment, the country faces several possible options, each with advantages and disadvantages:

- Reduce the average effective tax rate (government take), which might make marginal exploration projects more attractive to investors, but can also reduce revenues that any successful projects ultimately deliver to the state.
- Offer fiscal incentives such as accelerated depreciation, investment credits, tax breaks or exemptions, government subsidies and high cost-recovery limits. Several countries have used such incentives to encourage investment during economic downturns (recently in the U.K. and Argentina). However, the actual impact on investment levels generated by these incentives has been mixed. Therefore, any fiscal incentives should be limited in time and scope.
- Improve perceptions of the business climate by enhancing the overall competitiveness of the Indonesian oil sector: streamline procedures and invest in research, education and infrastructure.

Some stakeholders in Indonesia have called for a shift from production-sharing contracts to concession-based systems. International experience demonstrates that contract form alone is not determinative of government take and different types of contracts can be designed to yield similar economic results. Which type of contract is best for a country depends on the strength and structure of its institutions, the role of the state in the sector and its capacity to be exposed to exploration/commodity cycle risks.

Another key question surrounding the country's oil and gas contracts relates to the concept of "stabilization." Frozen fiscal terms are generally associated with petroleum contracts signed under a *lex specialis* regime, such as joint operation contracts or cooperation contracts in Indonesia. The reliance on stabilized contracts under *lex specialis* in Indonesia has created a stable legal environment for some investors, but it creates disparity between them. Recently, these *lex specialis* arrangements have prevented the government from applying new regulations and taxes equally on the industry. Indonesia could consider moving to a system with fewer contract-specific terms and a larger application of the general law and regulations on the industry's fiscal regime. Generally applicable fiscal terms could be developed to account for different geological areas (shallow versus deep water, for example), and be designed to be progressive so as to avoid regular calls for renegotiation.

SUBNATIONAL TRANSFERS OF OIL AND GAS REVENUES

The government and parliament might want to consider whether the new oil and gas legislation could be used as an opportunity to clarify confusion that currently exists around the relationship between the oil and gas industry and Indonesia's decentralization process. In particular, there may be an opportunity to enhance mechanisms to help subnational governments manage some of the trickiest elements of oil and gas revenue transfers. Non-renewable resources are finite and revenues generated from them are notoriously volatile, responding sharply to fluctuations in commodity prices. These characteristics imply that any large transfer linked to these revenues could exacerbate the boom-bust cycle in a producing region that is highly dependent on such a transfer.

Given the size of oil and gas revenue transfers to subnational levels in Indonesia and their impact on expenditure volatility, we recommend that the national legislation authorize and encourage revenue-smoothing mechanisms. For example, stabilization funds at the provincial and district levels or other macro-fiscal tools could be created to prevent boom-bust cycles at the subnational level.

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TRANSPARENCY MECHANISMS

One of the most important opportunities presented by the legislative process is to formally incorporate some of the evolving global norms on natural resource transparency into the legal framework.

1. Revenue transparency

Publishing detailed information on revenues received from oil and gas extraction can help governments inspire public confidence that they will manage resources for the public benefit and ensure that the country gets the best deals possible for the exploitation of its resources.

At a basic level, governments can opt to publish only primary revenue streams, including in-kind revenues from the host government's (including SOEs') production entitlement, profit taxes, royalties, dividends, bonuses, license fees, rental fees and any other significant payments and material benefits to government. The global standard for the level of detail for revenue disclosures is to publish revenues received on a project-by-project basis. The legislation provides an opportunity for Indonesia to enshrine this type of detailed reporting in law.

2. Contract transparency

Contract and license transparency promotes constructive relationships between citizens, companies and governments, which can reduce conflict and promote stability in the sector. It helps set realistic expectations about the terms of and timelines for extraction: this facilitates accurate government revenue collection and forecasting. The disclosure of contracts also provides enhanced opportunities for stakeholders to monitor adherence to obligations, which encourages all parties to act responsibly in project implementation. A growing number of countries are choosing to publish their oil, gas and mineral contracts, including many that have laws requiring publication—Colombia (legislation), Guinea (legislation), Liberia (legislation), Mexico (constitution), Niger (constitution), Sao Tome & Principe (legislation) and Sierra Leone (legislation), among others.

3. Company beneficial ownership transparency

Secret ownership structures can enable some companies to evade tax payments or hide improper relationships with public officials. To address this, the government of Indonesia has begun considering options for the disclosure of information on “beneficial owners” – that is, the individuals that ultimately control or profit from a company – through a number of different platforms, such as the G20, Extractive Industries Transparency Initiative (EITI) and Open Government Partnership. At the 2016 Anti-Corruption Summit, Indonesia committed to exploring the establishment of a public, central register of companies’ beneficial ownership information. Currently, the government is working on a national action plan on beneficial ownership disclosure, and inclusion of the extractive sector will be key. By January 2017, Indonesia will need to develop plans for meeting the EITI requirement for public beneficial owner disclosure. It will be important for reforms to the oil and gas law to be aligned with national beneficial ownership disclosure plans, which could ultimately mean including provisions on company beneficial ownership disclosure in the law itself.

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