

INSTITUTIONAL FRAMEWORK

“All natural resources in the soil and the waters of the country are under the jurisdiction of the State and shall be used for the greatest benefit and welfare of the People.”

-Article 33, Indonesian Constitution

The Indonesian Parliament (Dewan Perwakilan Rakyat – DPR) passed the oil and gas bill into law on October 23, 2001. The new law replaced Oil and Gas Law No. 44/1960 and Law for Pertamina No. 8/1971. It reduces the government's power over the petroleum sector and allows for open competition in the downstream oil and gas distributing and marketing area. The 2001 law authorizes the establishment of an implementation agency ("badan pelaksana") and regulatory agency ("badan peraturan") to assume state oil and gas company Pertamina's roles. The implementation agency has replaced Pertamina in managing Production Sharing Contracts (PSC) with private oil and gas companies, thus eliminating the conflict-of-interest inherent when upstream producer Pertamina regulated the activity of its competitors. The law also removed Pertamina's monopoly in the downstream sector with the regulatory agency assuming the responsibility for managing natural gas and domestic fuel distribution and supply.

The GOI generally met the law's stipulation that the two new agencies be established within one year of the law's enactment, and that Pertamina establish itself as a limited liability company ("persero") within two years (see below).

Originally, Pertamina was to have maintained its responsibility for domestic fuel supply and distribution only until December 31, 2006. However due to lack of interest by other companies in assuming the public service obligation, Pertamina will likely continue in this role at least through 2008.

Existing PSC's are grandfathered and in effect until expiration of the contract. By the end of 2003, the GOI had issued three of five required implementing regulations under the law covering Pertamina's transition to a limited liability company, and the establishment of the implementing and regulatory agencies. By October 2004, the government issued the remaining two implementing regulations, on the upstream and downstream sectors. All energy activities dealing with petroleum and gas fall under the Ministry of Energy and Mineral Resources, which is charged with creating and implementing Indonesia's energy policy. The Ministry of Energy and Mineral Resources is divided into several directorates, with the Directorate General of Oil and Gas (MIGAS) responsible for all aspects of petroleum industry development, including employee training and promulgating regulations.

BP Migas

On July 16, 2002, President Megawati signed Government Regulation No 42/2002, establishing an implementing body for oil and gas upstream operations, Badan Pelaksana Minyak dan Gas Bumi (BP Migas), as required by Oil and Gas Law No 22/2001. This upstream implementing body has taken over Pertamina's regulatory functions and

responsibilities in managing oil and gas contractors. BP Migas has managed upstream regulatory activities since mid-2002. However it lacked implementing regulations until 2004 when the GOI issued Regulation 35 under the Oil and Gas Law 22/2001.

BP Migas' main responsibilities are to: 1) provide recommendations to the Minister in preparing and offering work areas and cooperation contracts; 2) sign cooperation contracts; 3) control upstream business operations and 4) appoint sellers of the government's share of oil and gas. BP Migas is a non-profit state legal entity and acts on behalf of the government as party to the cooperation contract with business entities. At the same time it also controls all oil and gas business operations.

BP Migas is led by a chairman and vice chairman, assisted by five expert staff and four main operational divisions—planning, operations, finance and marketing, and general affairs. The chairman is appointed by the President, based on the recommendation of the Minister of Energy and Mineral Resources after approval by the House of Representatives (DPR). The Chairman must periodically report to the President (every six months or as requested), via the Minister of Energy and Mineral Resources. The agency must also report and give copies of signed Production Sharing Contracts to the DPR.

BPHMigas

On December 30, 2002 President Megawati Sukarnoputri signed Government Regulation (PP) 67/2002 establishing a new downstream regulatory body, the Badan Pengatur Hilir Minyak dan Gas Bumi (BPH Migas), which

assumed the role of Pertamina in controlling downstream activities. BPH Migas was given the responsibility to regulate, develop and supervise the downstream industry. However BPH Migas lacked implementing regulations until 2004 when the GOI issued Regulation 36 for the downstream activities laid out in Oil and Gas Law 22/2001.

BPH Migas' broad responsibilities are to: 1) regulate and determine the supply and distribution of oil-based fuel; 2) regulate the transmission and distribution of natural gas; 3) allocate fuel to meet national fuel oil reserve goals; 4) plan the use of oil and gas transportation and storage facilities; 5) set gas pipeline tariffs; 6) set natural gas prices for household and small consumers; 7) recommend pipeline levies; and 8) set the price of pipeline rights.

BPH Migas has the regulatory and development responsibilities to: 1) issue business licenses; 2) determine fuel types and standards for retail sale; 3) formulate strategic reserves policies; 4) determine price formulas for subsidized fuel; 5) protect occupational health and safety; 6) ensure environmental protection; and 7) promote community development. The agency is also charged with developing the master plan for national gas transmission and distribution. It also ensures the availability and distribution of fuel oil, and monitors reserves, market share and trading volumes.

BPH Migas is a smaller body than its upstream counterpart, BP Migas. BPH Migas consists of a committee of nine (one Chairman and eight members). Committee members are appointed by the President, based on the recommendation

of the Minister of Energy and Mineral Resources after approval by the House of Representatives (DPR). The Chairman must periodically report to the President (every six months or as requested), via the Minister of Energy and Mineral Resources.

Pertamina

On June 18, 2003, President Megawati Sukarnoputri signed government regulation (PP) No. 31/2003 to transform the state oil and gas company Pertamina into a limited liability company (persero), although it remains 100% government-owned. The objective of the new regulation was to establish a competitive and efficient entity, thereby increasing economic activity and the welfare of the people.

Under the new regulation, all state assets belonging to Pertamina are to serve as the capital of the new entity. The Minister of Finance based on a joint evaluation by the Minister of Energy and Mineral Resources and the Minister of Finance determined the amount of capital allocated to the new entity. The restructured Pertamina has authority from the government to supply fuel oils for domestic consumption, with compensation for subsidy pricing to be provided by the government. The regulation also gave Pertamina all the state's geothermal power assets with the proviso that they be handed over within two years to a new subsidiary.

In February 2008, Pertamina shareholders approved a plan to take over PT Geodipa and combine it with PT Pertamina Geothermal Energy to form the new subsidiary called for under the 2001 law.

Pertamina contributes significantly to Indonesia's petroleum output. It ranked as the second highest in crude oil and natural gas production in 2006, according to government data. Pertamina executives have expressed their determination to enhance Pertamina's position in the newly deregulated upstream sector.

In the downstream sector, Pertamina will likely maintain its monopoly on the distribution of subsidized fuel products throughout the archipelago until December 31, 2008. President Susilo Bambang Yudhoyono delayed full downstream fuel market deregulation by issuing Regulation 71/2005 on November 16, 2005, which extended Pertamina's public service obligation (PSO) due to the lack of interest by other qualified companies.

In 2004, Pertamina suspended its operation in Block 3, Western Desert, Iraq due to political uncertainty. The company, however, says that it wishes to resume exploration activity there as soon as the contract is ratified and the environment is permissive. Pertamina also ventured into Libya, where it won two exploration contracts in October 2005 for Block 17-3 on the Mediterranean Sea and Block 123-3 on the Sahara desert. Pertamina said it targeted Libya for investment to increase its resource base and to develop professionalism and credibility in the global oil business.

Pertamina reported a provisional 21% jump in earnings in 2007, boosted by continued record high global oil prices. Pertamina executives told investors in January 2008 that the firm is expecting to post a net profit of 23 trillion rupiah (\$2.51 billion) for 2007 compared to 19 trillion (\$2.07 billion) in 2006. The

company said its upstream subsidiary Pertamina E&P is targeting production levels of 300,000 bpd of crude oil and 2.4 BSCF per day of natural gas by 2012.

Government Agreements and Contracts

Indonesia has two categories of agreements and contracts for the petroleum industry. The first category refers to the bundle of rights and obligations granted to an investor to invest in cooperation with the GOI in oil and gas exploration and exploitation. These types of contracts are the Production Sharing Contract (PSC), the Technical Assistance Contract (TAC), and the Enhanced Oil Recovery (EOR) contract, defined as follows:

Production Sharing Contracts

- A cooperation contract for oil and gas exploration between BP Migas and a private investor (which includes foreign and domestic companies, as well as PT Pertamina);
- BP Migas is the supervisor or manager of the PSC;
- Investors are participating interest holders and contractors;
- The government take is under a production sharing arrangement whereby the GOI and the contractors take a split of the production measured in revenue based on PSC-agreed percentages;
- Operating costs are recovered from production through contractor cost formulas as defined by the PSC;
- The contractor has the right to take and separately dispose of its share of oil and gas;

- Title of the hydrocarbons passes to the contractor at the export or delivery point.

Technical Assistance Contracts

- Variation of a cooperation contract, or PSC;
- Typically used for established producing areas and therefore usually covers exploitation only;
- BP Migas is the supervisor or manager of the TAC;
- Operating costs are recovered from production;
- The Contractor does not typically share in production;
- The TAC can cover both exploitation and exploration if it involves an area where the GOI has encouraged exploration;
- In accord with Oil and Gas Law 22/2001, existing TACs will not be extended.

Enhanced Oil Recovery

- Variation of a cooperation contract, or PSC;
- Used for established producing fields with the intent of applying advanced technology to increase the recovery of hydrocarbons in the reservoirs;
- Pertamina is usually a participant, along with investors; collectively they are the Contractor;
- BP Migas is the supervisor and manager of the EOR;
- Operating costs are recovered from production and typically capped at a percentage. In some cases, the incremental oil lifted from an EOR operation may be shared on a production sharing basis;
- In many cases, the EOR may also include provisions concerning how the

parties will conduct petroleum operations.

In addition to contracts that give bundles of rights to explore and exploit, the participants in the PSC, TAC or EOR may also enter into separate agreements to discuss how they are going to conduct petroleum operations. These are known as Joint Operating Agreements (JOA) and Joint Operating Bodies (JOB), defined as follows:

Joint Operating Agreements

- A separate agreement in addition to the cooperation contract;
- Governs the relations of the participating interest holders, defining their rights and obligations, and describing the procedures the Contractors will abide by;
- The JOA typically includes: 1) the scope of operations; 2) designation, rights and obligations of the operator; 3) establishment of an Operating Committee; 4) production disposition; 5) relinquishment, withdrawal and assignment; 6) confidentiality; 7) force majeure; and 8) dispute resolution and choice of law.

Joint Operating Bodies

- Typically part of the JOA;
- Governs the operations on behalf of the participating interest holders by establishing a non-legal entity, the JOB, to conduct petroleum operations;
- Representatives of the participating interest parties appoint representatives to the JOB;
- The JOB prepares an operating work program and budgets and carries out operations pursuant to the JOB agreement and the cooperation contract;

- Participating interest holders remain the Contractors;
- JOAs are supervised by BP Migas.

Fiscal Decentralization Law

With implementation of a new fiscal decentralization law in January 2001, revenue-sharing formulas came into effect that directed 15 percent of the Indonesian Government's net oil revenues and 30 percent of its net natural gas revenues to provincial and district governments. The GOI's net oil and gas revenues refer to profit *after* cost recovery and deduction of the PSC share. Of the 15 percent of the oil revenue flowing to the regions, 6 percentage points will go to the regency of origin (where the PSC is located), 6 percentage points will be shared among the other regencies in the province, and 3 percentage points will go to the provincial government. The same relative shares apply to gas revenues – 12 percent to the regency of origin, 12 percent among the remaining regencies and 6 percent to the provincial government.

OPEC

Indonesia joined OPEC in 1962 as an active member and hosted important OPEC conferences in 1964, 1976, 1980 and 1997. OPEC member countries meet at least twice a year to coordinate their production policies in light of market fundamentals. The Organization of Petroleum Exporting Countries (OPEC) produced about 42 percent of the world's oil and 50 percent of the oil traded internationally in 2006. During 2004, Indonesian Minister of Energy and Mineral Resources (MEMR) Purnomo Yusgiantoro held the rotating OPEC presidency.

The 13-member oil cartel last met in March 2008 and decided to leave official output targets unchanged at 29.673 million bpd for the 12 countries bound by output agreements. OPEC rebuffed requests from consuming countries for additional oil despite almost daily new record highs for petroleum during 2007 and 2008.

Although OPEC raised quotas in 2004 and 2005, it cut back production after that, most significantly in February 2007. These cutbacks raised prices significantly on the world markets. With its production in decline, Indonesia was never able to take advantage of its 1.451 million bpd quota. Its new dependence on imports for an increasing share of its energy needs have strained Indonesia's relationship with OPEC.

OPEC Quota (in 1,000 bpd)

Members	Jul 05	Nov 06	Feb 07
Algeria	894	59	25
Indonesia	1,451	39	16
Iran	4,110	176	73
Kuwait	2,247	100	42
Libya	1,500	72	30
Nigeria	2,306	100	42
Qatar	726	35	15
S. Arabia	9,099	380	158
UAE	2,444	101	42
Venezuela	3,223	138	57
Change		1,200	500
Production Target	28,000	26,300	25,800

Source: OPEC

Public speculation on withdrawal from OPEC began in 2004, but the Ministry of Energy and Mineral Resources stated for years that Indonesia intended to remain a cartel member despite its falling net oil export volumes. As Indonesia found it impossible to maintain a net exporter status, industry observers questioned whether the country should keep its OPEC

membership. In May 2008, President Yudhoyono called for a public review of Indonesia's membership. At the end of May 2008, MEMR Purnomo Yusgiantoro informally told the press that the decline of oil production since 1995 had triggered Indonesia to pull out of OPEC. Indonesia's OPEC governor indicated in August 2008 that Indonesia would withdraw from OPEC, but only temporarily. Indonesia had already paid its OPEC dues for the full year of 2008.

Other Professional Bodies

IPA

Indonesian and foreign oil companies operating in Indonesia established the Indonesian Petroleum Association (IPA) in 1971 in response to growing foreign interest in the Indonesian oil sector. Contractors and the government meet frequently to discuss matters such as production ventures and energy economics. The IPA's objective is to use public information to promote the exploration, production, refining and marketing aspects of Indonesia's petroleum industry.

IGA

Pertamina and key gas producers Mobil and Huffco sponsored the establishment of the Indonesian Gas Association (IGA) in 1980. The main objective of IGA is to provide a forum to discuss matters relating to natural gas and to advance knowledge, research and development in the areas of gas technology. IGA also aims to promote the development of infrastructure and cooperation among producing, transporting, consuming and regulatory segments of the gas industry.

The IGA and the IPA sponsored
Indonesia's membership in the Permanent
Council of the World Petroleum Congress
(WPC).