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COAL BED METHANE PROJECTS – PROMISING SIGNS OF FLEXIBILITY¹²³⁴⁵

INTRODUCTION

The Government is seeking to encourage greater investment in exploration for and development of so-called “non-conventional oil & gas resources” (“**NC O&G Resources**”) (“**NC O&G Utilization**”) by offering more flexible fiscal terms for non-conventional oil & gas projects (“**NC O&G Projects**”).

This initiative to promote NC O&G Projects should be of interest to mining companies, as well as to energy and oil & gas companies, for at least three reasons. First, NC O&G Projects are really “cross over” projects that blur the traditional, division lines among energy, mining and O&G projects. Second, Indonesia’s principal NC O&G Resource is coal bed methane (“**CBM**”), something which raises the prospect of increased competition between coal mining companies and CBM companies for control of and the right to first exploit coal rich areas. Third and most importantly, the new found willingness of the Government to look at creative and previously untried ways of encouraging NC O&G Utilization may indicate the beginning emergence of similar flexibility, on the part of the Government, in terms of encouraging investment in energy, mineral and oil & gas projects generally.

At a time when the local energy, mining industry and oil & gas sectors area all struggling with multiple financial and other problems which, collectively, are discouraging new investment in exploration and development, greater Government receptiveness to creative ideas and more “tailored” solutions, from a contracting/licensing/fiscal regime perspective, for overcoming at least some of these problems could be a “game changer”.

There are already some encouraging signs that more “tailored solutions”, in terms of the applicable contracting/licensing/fiscal regime, are becoming a reality for conventional O&G projects (in addition NC O&G Projects) as well as in the case of metal minerals processing and refining.

In this article the writer will, first, review the main provisions of Minister of Energy & Mineral Resources Regulation No. 38 of 2015 re Acceleration of Non-Conventional Oil & Gas Utilization, which was issued on 2 November 2015 (“**MoEMRR 38/2015**”), before focusing on the possible “bigger picture” implications of MoEMRR 38/2015 for the local energy, mining and oil & gas sectors as a whole.

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BACKGROUND

Indonesia's National Energy Policy is set out in Government Regulation Number 79 of 2014 re National Energy Policy (“**GR 79/2014**”).

GR 79/2014 highlights the importance of developing and utilizing so-called “new energy sources” in realizing the overall objectives of the National Energy Policy, being “energy independence and national energy security” based on the principles of equity, sustainability and environmental soundness. New energy sources are meant to contribute at least 23% of Indonesia's primary energy needs by 2025 and at least 31% of Indonesia's primary energy needs by 2050.

“New energy sources” are defined, in GR 79/2014, as energy sources that can be produced using new technology applied to either renewable or non-renewable energy sources including CBM, liquefied coal and gasified coal. Shale gas is also regarded by the Government as being a non-renewable “new energy resource” for the purposes of GR 79/2014 and the National Energy Policy.

GR 79/2014 goes on to specify that the Government will provide fiscal and non-fiscal incentives to encourage diversification of energy resources and the development of technology required to exploit new energy sources.

At a minimum, MoEMRR 38/2015 and its focus on accelerating NC O&G Utilization may be seen as an early initiative by the Ministry of Energy & Mineral Resources (“**ESDM**”) to give effect to GR 79/2014's emphasis on developing new energy sources, for Indonesia, including CBM.

Contemporaneously with the issuance of MoEMRR 38/2015 last November, ESDM launched open bids for the exploration rights to three unconventional shale blocks in (i) Central and East Java, (ii) East Kalimantan and (iii) Central and East Kalimantan. ESDM has highlighted that these three shale block tenders will allow the successful bidder to take advantage of the flexible fiscal arrangements contemplated by MoEMRR 38/2015.

COMMENTARY

1. Overview of MoEMRR 38/2015

MoEMRR 38/2015 sets out a new contracting approach to NC O&G Utilization in respect of non-renewable strategic energy resources controlled by the State.

2. Main Provisions of MoEMRR 38/2015

2.1 **NC O&G Utilization:** NC O&G Utilization is to be carried out by way of co-operation between SKK Migas and a NC O&G Contractor in the form of a production sharing contract (“**KKS**”) (Article 3 of MoEMRR 38/2015).

- 2.2 **Role of DGoO&G:** The Directorate General of Oil & Gas (“**DGoO&G**”) has the authority to determine the (i) working area of each NC O&G Project (“**Working Area**”) and (ii) the form and the main terms and conditions of each KKS having regard to the technical and economic aspects of the relevant working area (Article 5 of MoEMRR 38/2015).
- 2.3 **KKS Alternatives:** A KKS may be in the form of (i) a standard production sharing contract (“**PSC**”), (ii) a sliding scale production sharing contract (“**Sliding Scale PSC**”) or (iii) a gross split sliding scale production sharing contract (“**Gross Split Sliding Scale PSC**”) (Article 5 of MoEMRR 38/2015).

The three KKS alternatives are differentiated by (i) provision for cost recovery/no provision for cost recovery and (ii) approach to sharing of resulting production if any (Article 11 of MoEMRR 38/2015).

The precise differences between the three KKS alternatives are not spelled out, in any detail, in MoEMRR 38/2015 except to the extent it is made clear that cost recovery is **not** part of the Gross Split Sliding Scale PSC alternative. These details are to be set out in the relevant KKS and, presumably, following negotiations between SKK Migas and the relevant NC O&G Contractor. Notwithstanding this lack of detail, the writer understands the principal differences between the three KKS alternatives to be as follows:

- (a) The PSC alternative reflects the long standing Indonesian O&G model whereby (i) the NC O&G Contractor is entitled to recovery of 100% of its development and production costs from production on a first priority basis, following the deduction of so-called “first tranche petroleum” (20% of annual production), and (ii) remaining production is shared between SKK Migas and the NC O&G Contractor on a fixed basis and pursuant to which the great majority of remaining production goes to SKK Migas in the case of both oil (85%/15%) and gas (65%/35%).
- (b) The Sliding Scale PSC alternative reflects a modest variation of the long standing Indonesian O&G model whereby (i) the NC O&G Contractor is entitled to recovery of its development and production costs from production on a first priority basis, following the deduction of so-called “first tranche petroleum” (20% of annual production), and (ii) remaining production is shared between SKK Migas and the NC O&G Contractor on a sliding scale basis and pursuant to which the respective production entitlements of SKK Migas and the NC O&G Contractor will vary as between (i) the period from the beginning of production to the recovery of the NC O&G Contractor’s total investment costs (“**First Production Period**”) and (ii) the period after the recovery of the NC O&G Contractor’s total investment costs (“**Second Production Period**”), with the NC O&G Contractor’s production share entitlement being greater in the First Production Period than in the Second Production Period.
- (c) The Gross Split Sliding Scale PSC alternative reflects a major variation of the long standing Indonesian O&G Model whereby (i) the NC O&G Contractor is **not** entitled to recovery of its development and production costs from production (**i.e.**, no cost recovery) but (ii) is entitled to the **majority** of all production during the First

Production Period, which entitlement will reduce to a **minority** of all production during the Second Production Period.

2.4 **KKS Common Terms:** Regardless of which KKS alternative is adopted in the case of a particular NC O&G Project, every KKS must make provision for:

- (a) state revenues;
- (b) Working Area and its relinquishment;
- (c) expenditure obligations;
- (d) transfer of NC O&G production ownership;
- (e) contract duration and conditions for extension of the contract;
- (f) dispute resolution;
- (g) obligation to supply NC O&G for domestic needs;
- (h) contract termination;
- (i) post-mining operations;
- (j) work health and safety;
- (k) environmental management;
- (l) transfer of rights and obligations;
- (m) reporting obligations;
- (n) plan of development;
- (o) preferential utilization of domestic goods and services;
- (p) social development and guarantee of rights of customary land owners;
- (q) preferential utilization of domestic workers; and
- (r) disposal of NC O&G produced during exploration (Article 5 of MoEMRR 38/2015).

2.5 **KKS Duration:** KKS duration is a maximum of 30 years with the possibility of at least 1 extension of 20 years depending upon technical considerations and the economic plan of development (Article 6 of MoEMRR 38/2015).

2.6 **Specific NC O&G Contractor Obligations:** Although nowhere actually stated in MoEMRR 38/2015, the NC O&G Contractor is to be responsible for 100% of the costs of NC O&G Utilization.

The NC O&G Contractor is also obliged to:

- (a) deposit in a joint account, in the names of the relevant NC O&G Contractor and SKK Migas, funds equal to (i) the greater of 10% of the exploration expenditure commitment or US\$1.5 million and (ii) the greater of 10% of the approved exploitation work plan expenditure or US\$1 million;
- (b) provide guarantees in respect of the discharge of the NC O&G Contractor's work health and safety obligations and environmental management obligations; and
- (c) comply with all relevant O&G business activity laws and regulations (Articles 7 and 8 of MoEMRR 38/2015).

- 2.7 **Reserve Calculation and Development Plan:** The reserves calculation, for NC O&G Project development plan (“**Development Plan**”) approval, is to reflect (i) 100% of proven reserves and (ii) 70% of probable reserves.

The first Development Plan requires MoEMR approval following input from SKK Migas.

Second and subsequent Development Plans require Head of SKK Migas approval only (Article 9 of MoEMRR 38/2015).

- 2.8 **Commercialization and Utilization:** Domestic needs for NC O&G production must be prioritized over export opportunities.

Prior to approval of the first Development Plan, all sales of NC O&G production require MoEMR approval following input from SKK Migas.

Subsequent to approval of the first Development Plan, NC O&G production is to be divided between the NC O&G Contractor and SKK Migas according to the KKS alternative that applies to the relevant NC O&G Project (Articles 10 and 11 of MoEMRR 38/2015). The three KKS alternatives are outlined in 2.3 above.

- 2.9 **Existing CBM KKS and Variation Proposals:** CBM NC O&G Contractors, with existing KKS and which have fulfilled not less than 60% of their commitment implementation obligations, may submit proposals for either (i) amendment of their KKS or (ii) change of form of their KKS so as to take advantage of the greater flexibility of fiscal terms contemplated by MoEMRR 38/2015 (“**Variation Proposals**”).

CBM NC O&G Contractors, wanting to submit Variation Proposals, must deposit in a account, in the joint names of the relevant CBM NC O&G Contractor and SKK Migas, funds equal to 10% of their remaining commitments.

Variation Proposals require MoEMR approval following input from the Head of SKK Migas.

In the event that a Variation Proposal is approved, MoEMR will determine the relevant form and the main terms and conditions of the KKS that will apply to the existing NC O&G Project going forward (Article 13 of MoEMRR 38/2015).

3. **Assessment & Evaluation of MoEMRR 38/2015**

3.1 **Specific Issues**

- 3.1.1 **Actual Reasons for Lack of NC O&G Utilization:** There is an implicit assumption in MoEMRR 38/2015 that Indonesia’s current low level of NC O&G Utilization is due exclusively or, at least, primarily to the unfavorable fiscal terms offered by the Government in the past and, therefore, if only these fiscal terms are improved, increased NC O&G Utilization will automatically follow. The writer is not qualified to say how correct is this assumption. To

the extent, though, that Indonesia's current low level of NC O&G Utilization is actually due to a much greater number of concerns than just unfavorable fiscal terms, offering improved fiscal terms may not, by itself, be sufficient to result in a material increase in Indonesia's level of NC O&G Utilization. Improved fiscal terms will not, for instance, overcome problems of (i) unresolved priority rights as between mining companies and NC O&G Contractors, (ii) local community opposition to disruptive energy projects generally, (iii) residual, technical problems, if any, regarding NC O&G production having regard to the relevant geology in Indonesia, (iv) distribution and transportation difficulties or (v) low market prices for the relevant NC O&G product.

3.1.2 Alternative KKS Forms: Even assuming the substantial correctness of the implicit assumption, in MoEMRR 38/2015, that Indonesia's current low level of NC O&G Utilization is due exclusively or, at least, primarily to the unfavorable fiscal terms offered by the Government in the past, it is still difficult to express an informed opinion on how successful MoEMRR 38/2015 is likely to be in encouraging greater NC O&G Utilization. This is because, until such time as it becomes clear (i) how cost recovery will apply under the Sliding Scale PSC alternative and (ii) what production splits SKK Migas will agree to during the First Production Period and the Second Production Period in the case of both the Sliding Scale PSC alternative and the Gross Split Sliding Scale PSC alternative, it cannot be said with any certainty that the mere availability of the alternative KKS forms will be sufficient to make NC O&G Utilization, on a large scale, viable from an economic perspective.

The intention seems to be that these matters will be determined, in each case, on a negotiated basis and following consideration of the particular technical and financial characteristics of each potential NC O&G Project. If this is how it plays out in practice, then the availability of alternative KKS forms may well be helpful in improving the viability of many potential NC O&G Projects which are presently not proceeding due to poor economics.

3.2 The Bigger Picture

MoEMRR 38/2015 shows a much belated but very welcome realization on the part of ESDM that (i) "one size does not fit all" when it comes to the appropriate contracting/licensing/fiscal regime for NC O&G Projects and (ii) what is actually required is a "tailored" contracting/licensing/fiscal regime based on careful research and in-depth knowledge of the technical and commercial peculiarities of different types of NC O&G Projects.

Although MoEMRR 38/2015 is only concerned with NC O&G Projects, including CBM and shale gas projects, it may be the start of a much more nuanced approach to all sorts of issues currently troubling the local energy, mining and O&G sectors. If the Government is now, for the first time, willing to consider different contracting/licensing/fiscal regimes for NC O&G Projects, then the Government may also be willing to look more favorably at the possibility of different contracting/licensing/fiscal regimes for such things as (i) geothermal, solar and wind energy projects versus coal and O&G projects, (ii) offshore versus onshore O&G projects, (iii) mineral exploration versus mineral exploitation and (iv) domestic processing and refining of copper, manganese and bauxite versus domestic processing and refining of nickel and tin.

Indeed, we have already started to see evidence of the Government's willingness to consider different contracting/licensing/fiscal regimes in the case of NC O&G Projects spread to **conventional** oil & gas projects. A September 2015 tender of eight **conventional** O&G blocks offers the Gross Split Sliding Scale PSC alternative, for both onshore and offshore blocks, with no cost recovery but a much improved gross production revenue split, as between SKK Migas and the relevant contractor, of (i) between 70:30 and 65:35 for oil and (ii) 60:40 for gas.

Support for the idea that MoEMRR 38/2015 is actually evidence of a more broadly based rethink, by ESDM, of at least some of its long held positions regarding investment in the energy, mining and O&G sectors can also be found in recent statements by MoEMR with regard to the "possible" need to relax the rules on the export of metal concentrates in light of the fast approaching January 2017 deadline for full domestic processing and refining of all metal minerals. A 4 January report by the Bloomberg News Service quotes MoEMR as having said in early January that:

*"2017 is the deadline for processed metal exports, but can we meet the targets for smelter construction by 2017? It must be reviewed. **We must be realistic to ensure a conducive investment climate.**"*

Although it surely comes as no surprise, to most mining industry participants at least, that the January 2017 deadline for smelter construction is not achievable and, indeed, was never likely to be achievable, it is the first time (to the writer's knowledge) that the Government has publicly acknowledged that this is the case. Such a public acknowledgment would have been politically untenable only six months ago.

Further, the writer has direct knowledge of a surprising, apparent willingness on the part of ESDM to look again at and reconsider the domestic processing and refining requirement applicable to a particular manganese product once the impracticality of the existing processing and refining requirement was brought to its attention and explained in terms of the foregone investment and export opportunities for Indonesia that continued insistence on the existing domestic processing and refining requirement would represent.

Just what is driving this apparent increase in flexibility, on the part of the Government, is open to various interpretations. At one level, MoEMRR 38/2015 may simply reflect ESDM's good faith efforts to encourage more NC O&G Utilization as part of the implementation of the National Energy Policy. It seems likely, however, that the Government's ongoing fiscal difficulties and the consequent need to stimulate more business activity in the energy, mining and O&G sectors, as a precursor to increasing the tax revenue generated from these sectors, is also forcing ESDM to rethink many of its long held positions regarding investment in the energy, mining and O&G sectors. Positions that seemed to make sense, from a resource nationalism perspective, during the last commodities boom now surely look much less realistic, even to ESDM, during the current protracted slump in commodities prices. This, of course, can only be a good thing. Readers interested in knowing more about the probable relationship between the Government's ongoing fiscal difficulties and the likelihood of an improved policy, regulatory and legal environment for the local mining sector are referred to the writer's earlier article "*Paying the Price for More Mining Industry Revenue*". Petromindo, Coal Asia

Magazine, April – May 2015.

3.3 Reservations

Notwithstanding the encouraging signs of greater flexibility and a willingness to look at more “tailored solutions” in the case of some mining related situations, as highlighted in 3.2 above, one should be careful about extrapolating too much from the energy and O&G (whether non-conventional or conventional) sectors to the mining sector and, in particular, to the coal mining sector. First, the National Energy Policy is not concerned with mining as opposed to energy development, production and consumption. Second, the National Energy Policy makes clear that the Government actually wants to reduce the contribution of coal to Indonesia’s primary energy mix from its current majority position to not more than 30% by 2025 and to not more than 25% by 2050. Accordingly, it would seem somewhat inconsistent with these objectives for ESDM to actively pursue strategies designed to increase investment in the coal mining sector except, possibly, as either a short run solution to the rising unemployment in the coal mining sector or if the Government becomes concerned that, without more “tailored solutions” to the problems confronting the local coal mining sector, Indonesia may eventually start to produce less coal than required for domestic market use and as part of the expansion of Indonesia’s network of coal fired power plants. Therefore, the real benefit, to the coal mining industry, of the implementation of the National Energy Policy and more flexible contracting/licensing/fiscal regimes generally may be largely limited to providing coal mine owners with an alternative way, in the form of CBM extraction and co-operation with NC O&G Contractors, to monetize their coal reserves.

Having regard to the foregoing, it is likely to be areas of the mining sector other than coal that see the most benefit from the Government’s acceptance of a need for more flexible contracting/license/fiscal regimes and for more “tailored solutions” to particular mining industry problems. Further, this benefit will have little, if anything, to do with the implementation of the National Energy Policy per se as opposed to having everything to do with the Government’s urgent need to raise more revenue from the mining industry.

Two possible mining sector beneficiaries may be (i) metal minerals exploration and (ii) metal minerals process and refining. With regard to metal minerals exploration, mining industry bodies, such as The Exploration & Mineral Development Indonesia Association (“**EMDI**”), have long highlighted that, contrary to what is implicitly assumed by the 2009 Mining Law and its implementing regulations, metal minerals exploration is not really mining at all and that, as a consequence, a different contracting/licensing/fiscal regime is urgently required for metal minerals exploration, compared to that currently in place for all mining and mining related activities, so as to ensure that Indonesia has an adequate “pipeline” of newly discovered metal mineral resources to carry it into the future once the existing metal mineral projects have exhausted their mineable reserves. To the extent the Government really does now understand that “one size does not fit all” in the mining industry, metal minerals exploration would be a logical place for the Government to start in coming up with a contracting/licensing/fiscal regime that takes account of the very high failure rate of metal minerals exploration projects and the consequent need to provide particularly attractive incentives for the small and medium sized companies that have traditionally been the mainstay of metal minerals exploration in

Indonesia but have now substantially abandoned Indonesia altogether as being “too hard” from a contracting/licensing/fiscal regime perspective. In the last quarter of 2015, EMDI made a detailed submission to the Government on these issues.

SUMMARY AND CONCLUSIONS

At a minimum, MoEMRR 38/2015 represents a good faith attempt to show some creativity in encouraging greater NC O&G Utilization as part of the implementation of the National Energy Policy.

Whether or not MoEMRR 38/2015 succeeds in achieving its intended purpose remains to be seen.

MoEMRR 38/2015 may, however, also be an early sign of something much more important than simply encouraging greater NC O&G Utilization; namely, a belated recognition by the Government of the need to move away from the “one size fits all” approach to the appropriate contracting/licensing/fiscal regime for energy, mining and O&G projects. To the extent ESDM is now willing to look more closely at and take the time to properly understand the particular economic and technical characteristics of particular types of energy, mining and O&G projects, before settling upon the applicable contracting/licensing/fiscal regime, this could be a “game changer” which holds the possible promise of finally coming to terms with any number of seemingly intractable problems in the regulation of the energy, mining and O&G industries. If this is, indeed, the case, the ultimate success or otherwise of MoEMRR 38/2015, in encouraging greater NC O&G Utilization, is largely irrelevant.

MoEMRR 38/2015 is particularly interesting because NC O&G Projects are “cross over” projects that blur the traditional, division lines among energy, mining and O&G projects. As such, MoEMRR 38/2015 has potentially important implications for the local mining industry in addition to the more obvious implications for the local energy and O&G industries.

There are some encouraging signs that more “tailored solutions”, in terms of the applicable contracting/licensing/fiscal regime, are already becoming a reality in the case of conventional O&G projects (as well as NC O&G Projects) and metal minerals processing and refining. Coal mining, as such, may nevertheless still be a “bridge too far”.

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