Competition and construction services

(MKK competition law team (research by Anderu Bionty, S.H.)

A KPPU study of 2011 set out that in the construction service industry, major players have the potential to breach Law Number 5 of 1999 by:

- Engaging in tender collusion;
- Establishing cartels;
- Carrying out Boycotts;
- Creating an entry barrier through certification process; and
- Using association membership as a barrier to entry.

General issues of business competition in the area of construction services:

a) Associations may be tempted to abuse their authority to issue certificates in order to stifle business competition. Associations might carry out this action by:
   a. only issuing legal certification to a certain group;
   b. using the terms and conditions of issuing a certificate as a barrier to entry.

b) Institutions also have the tendency to establish new associations that possess a more and more specific scope. The particular action could have the following impact:
   a. The presence of associations could influence the tender process;
   b. New associations are more likely to be used for vested interests by a close-knit group of businessmen

KPPU's position paper on the construction services industry

In its Position Paper, KPPU stated the need to evaluate the government's policy in the construction services sector. The evaluation is considered as a necessity, especially due to its correlation with the current development of the construction service sector and also the role of LPJK. In undertaking the evaluation, KPPU expects to establish better regulations for the sector, which are in line with Law Number 5 or 1999, concerning Ban on Monopolistic Practices and Unfair Business Competition.

Public participation

Over the years, KPPU has tried to raise public awareness regarding unfair business competition in the construction services sector. By raising public awareness, KPPU hopes the public will participate in identifying monopolistic practices and unfair business competition. The new construction service law also regulates society's participation, prior to any violations of the law and/or unfair business competition. Both the KPPU and the new construction service law have provided a platform for the public to participate, both online and offline.

*Source: KPPU Press Release: "KPPU: Terdapat Persekongkolan Tender di Proyek RSU Sulawesi Tenggara"

Gross Split production sharing contract

The MKK Oil and Gas Team (research by Indra Dwinugruho)

On January 16th 2017, the Ministry of Energy and Mineral Resources of Indonesia ("**MEMR**") issued a new regulation regarding Gross Split Production Sharing Contract under MEMR Regulation No. 8 of 2017 (the "**Regulation**"). The Regulation is the embodiment of the government's effort to increase state profit in the midst of economic uncertainty. A new gross split scheme was introduced, whereby the government and contractors may directly split the revenue of a project based on a percentage agreed upon between contractors and the government. The government will receive tax and a share of the project, without having the obligation to indemnify the operation and investment made by the contractors in producing oil or gas, as was the case in the cost recovery based production sharing contract.

Ignatius Jonan, Minister of Energy and Mineral Resources of Indonesia ("**Minister**"), recalled that during times when production sharing contracts were made according to a cost recovery system, upstream oil and gas companies had difficulties in operating efficiently.[1] Cost recovery in production sharing contracts is set out in Government Regulation No. 79 of 2010, regarding Operating Costs that can be Recovered and Treatment for Income Tax in the Upstream Oil and Gas Business Sector. Nevertheless, with the new Regulation being issued, the government will no longer be required to reimburse the operation costs of upstream oil and gas companies. The Minister also stated that the gross split scheme would foster competition among contractors in producing oil at a considerably lower cost, and at the same time, generate more profit by making production more efficient.

[1] Duwi Setiya Ariyanti, Annisa Lestari Ciptaningtyas. *Angin Segar bagi Kontraktor*. Bisnis Indonesia: Friday, 6 Januari 2017.

A. Regulation background

The reasoning of the Regulation is that it was made in order to increase the effectiveness and efficiency of production sharing in oil and gas, It has been studied and planned by the government for the last couple years. According to Article 1 paragraph (7) of the Regulation, Gross Split Production Sharing Contract is a production sharing contract in Upstream Oil and Gas Business which is based on a gross division principle without the operation cost recovery mechanism. These principal rules, which are applied as a standard to every Gross Split Production Sharing Contract, can be found in Article 3 of the Regulation.

B. Contract requisites

The Gross Split Production Sharing Contract has three important features: first, the ownership of the natural resources shall be in the hands of the government until the handover point. Second, operation management control shall be under the Special Work Unit on Oil and Gas ("**SKK Migas**"). And lastly, the Contractor shall bear all cost and risk. This means that the operational cost may not be reimbursed by the government, as it is in cost recovery contracts. Contract requisites are stipulated in Article 2 paragraph (2) of the Regulation.

C. Calculation of Gross Split mechanism

A Gross Split Production Sharing Contract uses a simple mechanism where a base split between the State and the Contractor will be adjusted according to various variables and components. The Regulation sets out the amount of the base split as follows:

	Oil	**Gas**
State	57%	52%
Contractor	43%	48%

** Based on Article 5 of the MEMR Regulation No. 8 of 2017*

During the plan for development approval, the percentage within the base split will be adjusted according to variable components, such as Contract Area status, field location, reservoir depth, carbon dioxide and hydrogen sulfide content level, production stage, etc. The percentage will also be adjusted according to progressive components, namely the oil price, and the quantity of oil and gas production.

D. Minister's role and state income

The Minister may increase the Contractor's amount of profit sharing by 5% if a project does not achieve its planned production target. However, if production exceeds the production target, then the Minister may also increase the profit sharing percentage to the state. The minister will also, upon receiving an instruction from SKK Migas, determine the amount of production sharing during the first development approval plan. In the process, a greater share will go to the government in order for it to be in compliance with Article 33 of the 1945 Constitution.[2][3] Furthermore, under Article 11 of the Regulation, the state will receive earnings from its own share percentage, bonuses, and from income tax paid by the Contractor. The state will also receive indirect taxes in accordance with the applicable and valid regulations.

E. Contractor's take and obligations

The Regulation specifies the take and obligation of the Contractors as well. For the Contractor's take, under Article 12 paragraph (1) of the Regulation, it will be calculated from the gross production percentage after income tax has been settled. Contractors are obliged to fulfill the state's needs for oil and/or gas. In Article 17 paragraph (2) of the Regulation, Contractors have to hand over 25% of their production to the state. They are also required to prioritize employment of the local workforce and domestic logistics, services, technology, engineering, and designs. However, the percentage or allocation of such matters in the project are not specified in detail. All procurement of goods and services must be done independently by the contractors. The Contractors are obliged to pay income tax. Compiling and submitting a development plan to SKK Migas is also among the obligations of the Contractors.

---

[2] Djoko Siswanto, *New Scheme of O&G Contract is Prepared*, Petrominer No. 07/ August 1, 2015, page 73.

[3] Indonesian 1945 Constitution Article 33 reads as follows:

"(1) The economy shall be conceived as a common endeavor based upon the principles of the family order.

(2) Sectors of production which are important to the nation and which affect the life of the people shall be under the controlof the State.

(3) The land, the water and the natural resources shall be under the control of the State and shall be used for the greatest benefit of the people.

(4) The national economy shall be organized on the basis of economic democracy upholding the principles of togetherness, efficiency with justice, continuity, environmental perspective, self-sufficiency, and by keeping a balance between progress and unity of the national economy.

(5) Further provisions relating to the implementation of this article shall be regulated by law."

F. Income tax deduction

The Operation Cost incurred by the Contractors may be considered as a deduction for income tax purposes, as set out in Article 14 of the Regulation. A more detailed calculation of such deduction has yet to be issued.

G. Role of SKK Migas

In terms of capital goods, SKK Migas will manage all capital goods and equipment directly used in the upstream oil and gas business purchased by Contractors. The capital goods and equipment will later be taken by the State and become state assets. SKK Migas will also manage the land used by the Contractor, except for leased land. Consequently, SKK Migas will carry out management and supervisory duties in the implementation of the Gross Split Production Sharing Contract.

H. Transitional provisions

Uncertainty arises in terms of whether Contractors still be able to use a Production Sharing Contract with a Cost Recovery model after the issuance of the Regulation or not. If we look closely at the Regulation, it does not contain a provision which restricts the use of Cost Recovery Production Sharing Contracts. The Regulation does, however, mention the opportunity for those who had entered into "old" Cost Recovery Production Sharing Contracts to propose amendments to convert them into a Gross Split Production Sharing Contract. In the event that a Contract for a Working Area has ended and will be extended, the government may choose to assign the older version of the contract or use the new Gross Split Production Sharing Contract, as stated in Article 24 of the Regulation. Furthermore, the Regulation does not rule out the existence of a Cost Recovery Production Sharing Contract; thus, it can be concluded that the Cost Recovery Production Sharing Contract can still be used after the issuance of the Regulation.

I. Final provisions

The Sliding Scale Gross Split Production Sharing Contract provisions in MEMR Regulation No. 38 of 2015 were revoked when this Regulation took effect. Lastly, the provisions contained in the Regulation took effect subsequent to promulgation of the Regulation, January 16, 2017.

J. Implementation

On Wednesday January 18, 2017, only two days after the enactment of the Regulation, Offshore North West Java Block run by PT Pertamina Hulu Energy signed a Gross Split Production Sharing Contract with SKK Migas to renew an expired contract.

The split percentages were determined in the amount of 47.5% for the state, and 52.5% for Pertamina in terms of oil. As for gas, the percentages were 37.5% for the state, and 62.5% for Pertamina.[4] PT Pertamina Hulu Energy is a subsidiary of state-owned PT Pertamina (Persero). The contract will be valid for 20 years or up until January 17, 2037. More oil and gas contracts will expire in 2018, such as Tuban Block, Southeast Sumatera Block, East Kalimantan Block, among others.[5]

K. Conclusion

In previous production sharing contracts made in Indonesia, the government applied a cost recovery mechanism. Such mechanism in fact provided an incentive for oil and gas companies to operate in Indonesia, considering that a substantial portion of the production cost could be reimbursed by the government. However, the government viewed this mechanism as being inefficient and ineffective, considering that it was obliged to indemnify the costs of the project, even unsuccessful ones.

Hence, the government issued MEMR Regulation No. 8 of 2017 to “enhance” the efficiency and effectiveness of the Production Sharing Contract. The Regulation revoked previous provisions on cost recovery. Profit sharing is now done by a mechanism where a basic split percentage will be adjusted through a series of changes in the contract’s plan of development to make it as “flexible” as possible. The regulation also emphasizes the use of domestic goods and services. From the government’s perspective as the regulator, the Regulation serves as an instrument to achieve higher profit. From a Contractor’s or upstream oil and gas company’s perspective, however, the Regulation may seem to be a setback, due to the fact that companies will have to bear the cost and risk of production by themselves.

Contrary to previous efforts to attract investment, the government seems to have cut back support in upstream oil and gas exploration in the interests of earning more profit in a sector which relies substantially on foreign investment. Nevertheless, it is still too early to determine if the new Regulation will slow down or speed up the progress of the Indonesian upstream oil and gas market.

[4] *Bagi Hasil Kotor Resmi Berlaku,* Jakarta: Kompas, Thursday 19 January 2017.
[5] Duwi Setiya Ariyanti, *Skema Gross Split Perdana*, Bisnis Indonesia, Wednesday, 18 January 2017.

Company check-list for entering into contracts

MKK Corporate Compliance Team

Contract basics

In Indonesia, we refer to the Civil Code (**KUHPER**) for legal questions relating to contracts. According to the *Indonesian Civil Code*, there are certain basics that must be adhered to; for example, there is the concept of 'consensual agreement' (Article 1320) meaning that both or all parties must enter into the contract willingly. The parties to the contract must have the capacity to enter into the contract, and the object of the contract must be defined and be for a legal activity (Article 1135 jo 1337) (meaning that it cannot pertain to an illegal activity, such as smuggling, etc.). Article 1338 of the Civil Code stipulates that such a contract is binding until terminated by the parties. A contract should contain an arbitration clause and procedures to follow in the event of a breach or force majeure.

Recently, there have been new regulations setting out that a contract must be in Bahasa Indonesia (as per Law no. 24 or 2009 on the National Seal, Flag, Anthem and all monetary amounts and values must be in Indonesian Rupiah, pursuant to BI Reg. no. 14 of 2015 on the Mandatory Use of the Rupiah in the Territory of Indonesia. If one party commits a breach of a binding contract, an aggrieved party is able to pursue the counter-party in court.

Contract policy and checklist

Every company should have an internal policy and procedures in respect of contracts to manage risk. The prevailing language and place of arbitration should be checked carefully to ensure they are in conformity with the prevailing law. A current inventory of all live contracts should be maintained; schedules should be established to review and monitor performance, renewal, termination, etc. All employees in managerial positions should know the policies and procedures for entering into contracts, which would respond to the following questions:

- Does the company have archives for old contracts?
- Does it have a policy to determine how long those contracts will be kept?
- Is the company's policy in conformity with the prevailing law on Storage of Records[1]?

[1] As regulated in Law No. 8 of 1997, regarding Corporate Documents.

- Is there a designated storage area/ data room for contracts? Who has access to it?
- Is there a procedure/sign-off to obtain copies of contracts?
- Who is the signing authority at your company[2]?
- Are there different benchmarks, in monetary terms or in terms of content, to decide what level of authority is necessary to sign or approve contracts?

Conclusion

If you could not answer some or all of these questions, perhaps it is time to take a closer look at your internal procedures with respect to contracts. Contracts represent a company's legal obligations and the basis of its business operations: make sure the company is working from a solid platform. Litigation is expensive and fraught with risk. Ensure that you fully understand the contracts you enter into and that you have established a clear pathway to end the contract via performance, expiry or mediation.

DISCLAIMER
The articles in this newsletter are purely informational in nature and should in no way be construed as constituting legal advice.

[2] As stated in the Deed of Establishment for the company (if not stated, then the provision in Law No. 40 of 2007 will apply and the Executive Director is the authorized party)