Disputes in the oil and gas sector: Indonesia[†]

Karen Mills[*] and Mirza A. Karim[*]

Ever since Ptolemy disclosed the existence of oil in Indonesia in his *Geography of Eastern Asia,* in 954 AD, this archipelago has been known for her natural resources. And in 1295, Marco Polo returned to Venice carrying samples of Indonesian crude oil found in Aceh, Indonesia's northernmost province, along with accounts of the fabulous wealth to be found there. Since then Indonesia has continued to be sought after by those looking to benefit from her plenitude of oil, gas and hard minerals, with local and foreign interests competing to exploit her natural resources, each for its own maximum benefit. Long before Indonesia's independence, dealing with foreign interests over natural resources has been a significant part of Indonesia's history. After independence, the Government of Indonesia was mandated by the 1945 Constitution to control land, water and natural resources found therein, and any branches of production which are important for the State and which affect the lives of most of the Indonesian people.

In performing this mandate of the Constitution as stated above, sometimes the Government has faced conflicts between the interests of business players and the interests of the State and its people. It is also not rare that conflicts arise between or among business players. Most conflicts are settled amicably but some must be brought to court or arbitration to be resolved.

Disputes in the oil and gas sector in Indonesia can be categorized generally into six categories:

1. Disputes between the Indonesian Government authority and contractors that have been granted the right to explore and exploit oil and gas, such as Production Sharing Contractors.
2. Disputes between foreign contractors and their home state taxing authority.
3. Disputes among contractors.
4. Disputes between contractors and sub-contractors or suppliers.
5. Disputes between contractors and the local community or other business players.
6. Miscellaneous other disputes.

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[*] KarimSyah Law Firm, Jakarta, kmills@cbn.net.id.

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Before discussing these various conflict areas, we would like to provide a bit of background on the history and development of the legal framework covering oil and gas contracts in Indonesia.

1. Background

For over 350 years, until the declaration of Indonesia's independence, on 17 August 1945, Indonesia was under Dutch colonial rule. During this period the Dutch colonial government reserved to itself all mining rights, oil and gas included. This policy was relaxed gradually, so that by the 1850s mining rights could be afforded to private enterprises under an executive order.

The first well was drilled in Indonesia in 1872 at Madjan, West Java,[1] and in 1883 the first oil concession, in North Sumatra, was granted to Royal Dutch Shell. By the turn of the nineteenth century there were 18 companies exploring for oil in various parts of the archipelago. In 1899 a law was passed, the *Indische Mijnwet* to govern oil and gas production, allowing the government to grant concession rights to the private sector for a period of up to 75 years. Holders of concession rights were required to pay land rent to the colonial government and the minerals, oil and/or gas produced from concession areas became the property of the concessionaires. The *Indische Mijnwet* was amended in 1904 to provide that only Dutch citizens, residents of the Netherlands East Indies or companies established under the laws of the Netherlands or of the Netherlands East Indies were entitled to be granted concession rights. It was amended again in 1918 to allow non-Dutch foreign interests to obtain concession rights, but only for a period of up to 40 years. Such concessionaires would then pay an excise duty to the colonial government of 4 per cent of crude oil production, a 20 per cent tax on oil profits and a 20 per cent tax on corporate profits. These terms were comparable to those then prevailing in Middle-East contracts.[2]

By 1924 approximately 120 concessions had been granted, and thus in 1928 the government amended the legislation to provide somewhat more favorable terms for the government, including reduced tenure – up to 40 years only, mandatory drilling obligations and area relinquishments, with payment of royalties and progressive profit shares up to 20 per cent of net profits to be paid to the government.

By the start of World War II, Indonesia was the largest oil producer in Asia and was thus clearly an imperative strategic target for the Japanese invasion of South East Asia, to provide fuel for their armies of occupation and further invasion plans. Control of all mining activities in Indonesia was taken over by the Japanese Occupation Forces for a period of almost three and a half years. Many oil installations and mines throughout Indonesia were destroyed by the fleeing Dutch operators ahead of the Japanese invasion.[3]

At the end of the war, the three major oil companies that had had projects in Indonesia previously (Shell, Stanvac and Caltex, known collectively as the *Big Three*) were keen to

[1] RW van Bemmelen, *The Geology of Indonesia* (vol 2, 1970) 7.

[2] See also Mirza A. Karim and Karen Mills, *Indonesian Legal Framework in the Oil, Gas and Mining Sectors; including Dispute Resolution,* paper/course materials prepared for Indonesia Energy and Mining Law Course, M.U.C. Executive Development Centre, Jakarta, 24–26 June 2003.

[3] Ibid.

return to Indonesia and entered into agreements first with the Dutch and later with the newly formed government of the Republic of Indonesia.

In 1945 Indonesia declared its independence and promulgated its Constitution (*Undang Undang Dasar*) of 1945 (the 'Constitution'). Article 33 of the Constitution states:

1. The economy shall be organized as cooperative based on the concept of family.
2. Branches of production which are of importance to the State and which affect the majority of the people shall be controlled by the State.
3. Earth, water and natural resources contained within the earth shall be under the control of the State and shall be used for the maximum welfare of the people.[4]

The Constitution held that all existing legislation which was consistent with Indonesia as an independent state would remain in effect, not as binding legislation but as guidance, until such time as new legislation was promulgated by the Indonesian Government to replace it. Some legislation, such as the Civil Code and the Penal Code, have not yet been replaced to date of writing, and thus are still in effect in their original Dutch form.

It was some years before a new Oil and Gas Law (Law No. 44 of 1960, or 'Law 44/60') was promulgated by the Indonesian Government, on 26 October 1960. In that interim period, spurred by increased nationalism and anti-foreign sentiment, Dutch citizens were expelled from Indonesia and Royal Dutch Shell was nationalized, filling the international investment community with a considerable degree of caution in their sovereign risk analyses for Indonesia. During this interim period exploration and production in the petroleum industry in Indonesia were administered under the transitional regulations of the Constitution only, and such activities sank to their lowest recorded levels.

Law 44/60 reaffirmed the basic principle of the Indonesian state, as mentioned in Article 33 of the Constitution, that all minerals, including petroleum, belong to the people of Indonesia and shall be controlled by the State and used for the optimum welfare of the people. Law 44/60 provides, *inter alia*, that:

- All oil and gas found within the territory of Indonesia is national property and controlled by the State.
- Oil and gas mining shall only be carried out by the State and implemented only by state enterprises.
- The Minister of Mines may appoint other parties as contractors of the state enterprise if necessary.
- Contracts of Work between the state enterprise and any contractor must be legalized by law.
- The authority to mine shall not include any surface land rights.

[4] Article 33 of the Constitution of the Republic of Indonesia (*Undang Undang Dasar)* of 1945.

Law 44/60 reconfirmed the State's sovereignty over Indonesia's oil and gas resources and abolished the concession system, under which the early contractors had been granted ownership over the oil and gas extracted. Now the *Big Three* faced the prospect of becoming merely contractors to the Indonesian Government, no longer concession owners, with the right to retain only 40 per cent of the oil profits, a prospect which they did not particularly relish. Long negotiations between the Government and the *Big Three* seemed deadlocked until, in 1962, the Government negotiated a contract with a new US-based company, Pan American Indonesia Oil, a subsidiary of Standard Oil of Indiana, which contained all the elements of the new legislation and was much more favorable to the Government than had been any prior arrangement. With this new contract under its belt, the Government gave the *Big Three* an ultimatum: *accept our terms or lose your concessions*.

So it was that the first major dispute the Indonesian Government had to face with foreign oil and gas contractors was resolved. On 1 June 1963 the Government and the *Big Three* met in Tokyo and entered into what became known as the 'Tokyo Agreement' providing, *inter alia,* for relinquishment of all rights granted under the former colonial government and acceptance by each of the *Big Three* to act as a contractor to one of the then three national oil companies, with operating profits to be split 60/40 between the State and the company, respectively. And on 25 September 1963, subsidiaries of each of the *Big Three* entered into Contracts of Work (*Kontrak Karya*, or 'KK') with one of the then three state oil companies, as follows

PT. Caltex Pacific Indonesia and Calasiatic with PN. Pertamin;
PT. Shell Indonesia with PN. Permina; and
PT. Stanvac Indonesia with PN. Permigan.

These KKs, each for the period of 20–30 years, were legalized under Law No. 14 of 1963, which provided, *inter alia*, that:

- The contractor was responsible for the operational management of exploration and production of all oil and gas in the KK area, and bore all financial risks as the result of operations.
- Revenues from sale of the produced oil and gas were to be shared: 60 per cent for the state enterprise (including income tax) and 40 per cent for the contractor. Ownership of contractor's share of the petroleum products produced was transferred to contractor upon point of sale.[5]
- The contractor had the right of ownership of all equipment used in production or other operations relating to the petroleum products only until full permitted depreciation. Once depreciated, all such equipment became the property of the state enterprise.

[5] Generally the point where the oil is split between the State authority and the contractor after it has passed the measurement equipment at the end of the storage tank. Until it reaches that point, all of the oil remains the property of the state.

- The contractor was obliged to relinquish acreage to the state enterprise, in accordance with an agreed-upon schedule.
- The contractor must allocate 25 per cent of all production for the domestic market, if requested, at a price of US$0.20 per barrel.

Pertamina and the Production Sharing Contract[6]

In 1966 General Suharto (by then acting President) appointed Major General Ibnu Sutowo as Minister of Mines and Director General of Oil and Gas. Sutowo was not satisfied with the Contract of Work arrangement, as it bore little difference in substance from the concession agreements. He favored a production-sharing system, similar to that applied in Norway, whereby the State would be in control of the management and would share with the contractors not the revenue but the oil produced itself. This was similar to the system used in Indonesia's agricultural sector, would be in harmony with growing nationalism and would also create better transparency, eliminating any disputes as to the oil price at which the profit split would be calculated.

The major oil companies, who were at that time seeking contracts of work, found both the production-sharing and relinquishing management control ideas most unpalatable and would not agree to such terms. This left the field open to smaller oil companies eager to participate in Indonesia's oil boom. In early 1966 one such company, Independent Indonesian American Oil Company (IIAPCO), signed, with Sutowo's PN. Permina, Indonesia's first Production Sharing Contract (PSC), a contract which has been emulated throughout the oil producing world ever since. Later that same year Sutowo concluded similar PSCs with four other small oil companies.

In July of 1966 Sutowo stepped down as Minister of Mines to devote his energies to his role as President Director of state oil company PN. Permina and also that of Director General of the Bureau of Oil and Gas (MIGAS). His successor as Minister, Ir.[7] Bratanata saw things differently and preferred to revert back to a system more akin to the concessions and contracts of work. A power struggle ensued. After consideration, the government favored Sutowo's production-sharing scheme and made MIGAS independent of the Ministry of Mines, giving Sutowo virtually a free hand over administration of the country's petroleum resources.

Thereafter, seeing no alternative, the major oil companies began to accept the Production Sharing Contract scheme, in which they would contract no longer with the Indonesian Government but with the state oil company, Permina, of which Sutowo remained the President Director. First Conoco, and then a dozen other major foreign oil companies, signed PSCs with Permina in 1967 and 1968. The terms were essentially the same as that of the IIAPCO PSC, and included, *inter alia*:

[6] See also Ooi Jim Bee, The Petroleum Resources of Indonesia (Ch II Oxford University Press, Kuala Lumpur 1982).
[7] *Engineer.*

- The Production Sharing Contractor is responsible for all financing and funding; but its risk was substantially reduced because it could recover its costs out of 40 per cent of production annually, before the profit split.
- The state oil company retained control over the management of operations (although in practice the contractor had full responsibility for management with only approvals of the program and budget necessary from the state oil company).
- The parties shared the oil produced rather than the revenue from profits. After the cost recovery amount, the oil was to be split 60 per cent for the state oil company and 40 per cent for the contractor.[8]
- All equipment and supplies were provided by the PSC contractor and became the property of the state oil company once they entered Indonesian territory, but the contractor could recover these costs together with their cost recovery.
- In addition there was a certain signature bonus to be paid upon execution of the PSC, and additional production bonuses as annual production reached certain enumerated levels.

In 1968, the three state oil companies were merged into one: PN. Pertamina, with Ibnu Sutowo as its President Director. In the next few years a number of additional PSCs were signed between foreign oil contractors and PN. Pertamina, while those executed with the prior state oil companies were taken under control of PN. Pertamina.

The reorganization of the state oil industry was then codified, on 15 September 1971, by the enactment of Law No. 8 of 1971, which law has come to be known as the 'Pertamina Law'. Under this law Pertamina became a corporation established by law, known as *Perusahaan Pertambangan Minyak dan Gas Bumi Negara*, abbreviated *Pertamina*. The elimination of the designation: 'PN.' (*Perusahaan Negara*, or state business/company) meant that Pertamina was now a separate corporate entity established under its own law, with its own management, rights and obligations, and no longer a direct agency of the government.[9]

The Pertamina Law authorized the entering into of PSCs and laid the basis for regulation thereof as well as for the setting up a regulatory board to supervise its activities. The law further imposed upon Pertamina, *inter alia*, the obligation to deposit with the State Treasury: (i) 60 per cent of its net operating income on its own operations and from operations of PSCs, including bonus receipts and (ii) all of its income derived from the three KKs entered into in 1963, as mentioned above.[10]

Article 15 of the Pertamina Law further states:

> The deposit to the State Treasury as referred to in paragraph (1) sub a and b of Article 14 of this Law, shall discharge the Enterprise (Pertamina) and the Contractors and shall constitute the payment of:

[8] Most later contracts increased the state oil company's share to between 65% and 66%, until renegotiation of the PSC's in the mid-1970s when the after-tax split became effectively 85/15 in favor of Pertamina, as discussed further on.

[9] See Article 2, Law No. 8 of 1971, Regarding State Oil and Natural Gas Mining Enterprise, enacted 15 September 1971, together with Elucidation thereof (the 'Pertamina Law').

[10] Article 14 of the Pertamina Law.

1. Corporate Tax referred to in the Corporation Tax Ordinance (State Gazette of 1925 Number 319)[11] as amended and supplemented.
2. Fixed contribution, exploration contribution . . . and other payments . . . referred to in Law No. 44 of 1960.
3. Levies on exports of oil and natural gas as well as from refinery and processing products.
4. Customs duties . . ., sales tax on imports, . . . on all goods used in the operations . . ..
5. Regional Development Contribution.

Thus it can be seen that the concept that the contribution paid to the State by Pertamina was intended to satisfy the corporate income tax obligation of both Pertamina and its PSCs was first set out as regulation in the Pertamina Law, although as a contractual term between Pertamina and the Contractors it had already been incorporated into the text of the PSCs, as well as in the few Technical Assistance Contracts (TACs)[12] entered into by that time.

Changes in the mid-1970s

Article 6 of the Pertamina Law restricts Pertamina's activities to the oil and gas sector only and permits expansion into activities in other fields only upon approval of the President, and only provided such activities are related to oil and gas exploitation and are based upon the approved annual working program and budget. Because of the immense power and influence of Sutowo in the late 1960s and early 1970s, however, this restriction was not faithfully followed and Pertamina undertook a number of other activities for which it borrowed heavily.

> It was, in fact, PERTAMINA's over-commitment on its multiple ventures that was to make it the biggest corporate bank borrower in the developing world by 1974, and was to eventually precipitate it towards a major crisis affecting not only (Pertamina) but also the Indonesian Government.[13]

So it was that in 1975 the government was forced to restructure Pertamina, in measures codified in Presidential Decree No. 44/1975, to avoid financial collapse of the government itself. Sutowo was removed as President Director and strict financial controls were to be employed over Pertamina through a government supervisory body. A few years later a new regulatory body[14] was also set up to supervise and approve the exploration and/or development programs and budgets of the foreign oil contractors.

On top of the 'fall' of Pertamina, two other events occurred at around the same time, all of which collectively led to renegotiation of the existing PSCs and revision of all future ones. The first commenced with the Libyan revolution of 1969, resulting in a reduced oil

[11] The tax law in effect prior to 1984.
[12] See discussion of the TAC further on in this paper.
[13] Ooi Jin Bee, see note 6, p 31.
[14] *Badan Pembinaan Pengusahaan Kontraktor Asing (BPPKA)*, Foreign Contractors' Coordinating Body.

export to Europe and resultant increase in oil prices, which continued to increase due to various problems in the Middle East and actions by OPEC, all resulting in what was termed the 'World Energy Crisis' of the early 1970s.[15] At this time the Indonesian Government sought to amend the PSCs to bring Pertamina's share incrementally up to 85 per cent or more. The foreign oil industry reacted by scaling down exploration activities, to the further detriment of Indonesia's economic health.

Major tax issue: IRS ruling 76-215

By 1976 Indonesia's cash reserves had dwindled severely due to the increasing prices of imports. New oil activity was virtually at a standstill.[16] And to make matters worse, in May of that year the United States Internal Revenue Service (IRS), reportedly in response to an enquiry by Mobil[17], issued its Revenue Ruling No. 76-215 which concluded that, with respect to all contracts entered into subsequent to April 1976: "*No portion of oil production retained by the Indonesian Government under a production sharing contract with a US taxpayer is an 'income tax' creditable* (against that US taxpayer's US income tax) *or deductible* (as an expense against taxable income)".[18] The effect of this ruling was to further reduce the Contractors' retained share of production, already reduced by Pertamina from 35 per cent to 15 per cent under PSCs, to something in the area of 7 or 8 per cent, a figure which many US oil companies found economically unfeasible for continued exploration.

As a result of IRS Ruling No. 76-215, coupled with the now-reduced oil split instituted in 1976, and increased costs of imports, the US-based oil companies in particular were hesitant to increase operations in Indonesia. The Indonesian Government was in a difficult position, as it badly needed the revenue from the oil industry, but the then current contract terms were not encouraging either to itself or to the contractors.[19]

In order to alleviate the hardship on the contractors, in 1978 Pertamina instituted other incentives and revisions to the PSCs, both to make the arrangement more attractive to the contractors and also to clarify the tax position. Existing PSCs were amended, and new PSCs included the new terms, which included:

- Clarification that the contractor is directly liable to pay its own tax to the State Treasury, the tax element no longer being collected by Pertamina as a portion of its oil split.
- After cost recovery and tax, 'profit oil' is shared effectively 85 per cent/15 per cent. At that time, prior to the new tax regime of 1984, the effective tax rate for corporate

[15] See also D Zahar, 'The Production Sharing Contract – Current Status' *Paper presented at the eighth Annual Convention of the Indonesian Petroleum Association (IPA)*, Jakarta, 5–6 June 1979.
[16] See Exhibit 1 to Zahar, ibid, p 46 of compilation of proceedings.
[17] Sarwono Prawirosuryo, Tukirman and Soebagio, *Masalah Perpajakan Dalam Dunia Minyak Dan Gas Bumi Indonesia* [Tax problems in Indonesia's Oil and Gas World], (Directorate General of Tax, internal tax office publication, Jakarta) 29 July 1983.
[18] US Internal Revenue Service (IRS) Revenue Ruling No. 76-215.
[19] Prof Ir Mohammad Sadli (*then Minister of Mines*), *Address at the Opening Ceremony of the Sixth Annual convention of the Indonesian Petroleum Association,* Proceedings of same, Jakarta, 23–24 May 1977.

tax and dividend tax was 56 per cent of taxable income (corporate tax was 45 per cent of taxable income and dividend tax was 20 per cent of the balance [55 per cent], or 11 per cent). Applying this rate to the then 34–35 per cent share to which the contractors had theretofore been entitled yields a resulting share of approximately 15 per cent.[20]

- The contractor was able to recover 100 per cent of its costs. The 40 per cent annual ceiling was eliminated. Unrecovered costs could be carried over to succeeding years.
- Signature and production bonuses, formerly neither recoverable nor deductible, could now be expensed.
- Initially the contractors were required to allocate a portion of their oil for domestic consumption at US$0.20 per barrel. Now such allocation would be valued at market prices for the first five years.
- Twenty per cent investment credit was also afforded.
- Losses incurred after 1 January 1978 in one field could be offset against income from other work areas for Indonesian income tax purposes. Previously all areas were *ring-fenced* and losses from one area could not be set off against profits from others.

In order further to clarify the tax question, in August of 1978 the Minister of Finance issued its Decree No. 267/KMK.012/1978[21] making it explicit that PSCs are obliged to pay corporate tax as well as tax on interest, dividends and royalties and to file monthly and annual tax returns for the purpose, which would be subject to audit, and are entitled to receive receipts for payments of such taxes.

On 9 May 1978 the IRS, having reconsidered the question, apparently on application of another US-based contractor, issued its Ruling No. 78-222, this time concluding that the amounts paid to the Indonesian State Treasury by or on behalf of PSC contractors do constitute payment of taxes and are therefore entitled to tax credit.[22]

Although not one new PSC was entered into between early 1975 and late 1979, after the incorporation of these incentives, and clarification of the tax position, into the new form of PSC, many new PSCs were entered into from October, 1979 (two in that month alone), with the number steadily increasing. (As many as 26 PSCs were concluded in 1997 for example, and 20 in 1998, even after the onset of the Asian economic crisis).[23]

[20] "*In practice the 15% share is rarely perfectly achieved in value terms. Differences occur due to pricing variances, especially the requirement that the contractors must supply 25% of their profit oil, effectively 7.21% (25% of 28.8462%) of total production as the domestic market obligation (DMO) . . .*" Robert Darmadi, *Incentives for Investment in Energy Projects in Indonesia,* Summary of a presentation prepared for a seminar in Singapore, 18 January 1992, abridged and edited by Karen Mills and published in the Indonesia Branch International Fiscal Association Newsletter, June 1993.

[21] Decree of the Minister of Finance of the Republic of Indonesia No 267/KMK.012/1978, dated 19 July 1978, on Procedures for Calculating and Paying Corporation tax and tax against interest, dividend and royalty which are due by Contractor who Operates Production Sharing Contract in the Sector of Oil and Natural Gas with State Oil and Natural Gas Mining Corporation Pertamina.

[22] Note, IRS Revenue Ruling No. 84-172 declares obsolete, among others, Revenue Ruling 78-222, with the explanation that "*the purpose of this declaration . . . is to make it clear . . . . that the . . . rulings are not determinative with respect to future transactions.*"

[23] OIL CONTRACTS in Indonesia, app 17 to US Embassy Petroleum Report, 2001 (<http://www.usembassyjakarta.org).

Technical Assistance Contracts (TACs)

Aside from the areas allotted by Pertamina, and its predecessors, to foreign oil companies for new exploration and exploitation, whether under the three initial Contracts of Work (primarily onshore) or finally under PSCs (primarily offshore), there are certain fields, primarily onshore, which had been nationalized from Dutch concessionaires in 1945 and 1957 or were otherwise reserved for exploration and exploitation by Pertamina itself. Fields under early KKs and PSCs also reverted to Pertamina after the expiration of the term of the respective contracts or upon earlier relinquishment. These are all considered as Pertamina's own fields, but Pertamina is nonetheless authorized to contract for private sector participation in them.

In the case of a number of such fields which have already been exploited, and those in which it is determined that it will be more difficult to extract the hydrocarbons, more costly and economically less efficient methods must be employed in what is known as secondary or enhanced oil recovery (EOR).

To the extent that Pertamina has contracted with third parties for exploration and exploitation of areas that require EOR methods, and/or those earmarked for its own full management and control, Pertamina has awarded not PSCs but an almost identical form of contract, under a different name: the 'TAC'. The initial few TACs were awarded to foreign oil companies, with certain incentives to make up for the added costs and/or difficulty in extraction, primarily a 65/35 split rather than the then currently applicable 85/15. It was also easier for a TAC contractor to take over different oil fields where they had relinquished others that did not prove commercial.

Few TACs remain extant with foreign-based contractors. In 1993 Pertamina initiated a policy of granting TACs for exploration and exploitation of the petroleum resources in its own retained fields only to wholly Indonesian-owned companies, while granting to foreign contractors only PSCs.

A fourth type of contract has also been entered into by Pertamina for secondary oil recovery in a few of its fields, whereby Pertamina acts jointly with another contractor as a Joint Operating Body (JOB). One of the very few disputes which have actually been brought to arbitration occurred under such a JOB relationship and is discussed later in this paper.

Current legal regime

In 2001 the Government passed the current law covering oil and gas mining, Law No. 22 of 2001 on Oil and Gas Mining (Law 22/2001). This law has retained the PSC system but has revoked the role of 'authority' from Pertamina and assigned it to new government bodies: BPMigas for upstream activities and BPHMigas for downstream. Pursuant to Article 63 of Law 22/2001 the rights and obligations of Pertamina under existing PSCs are transferred to BPMigas, and new PSCs are now entered into between contractors and BPMigas rather than Pertamina. Pertamina now has virtually the same role as any other contractor to the Government. From the point of view of foreign contractors there is little change otherwise, except that they now must compete with Pertamina for new fields. The PSC itself has not otherwise changed significantly as yet, but a new model is under consideration.

Dispute resolution provisions

Contracts of Work and, later, PSCs contained basically standard terms, aside from commercial ones for each specific project. This means that each generation of upstream contracts had and has the same or virtually similar dispute resolution provisions. It may be of interest to look at what these were and to what extent they evolved over the years as sophistication as to dispute resolution increased within the government.

1. Dispute resolution clause in the original Contracts of Work:

Article 25 Disputes Settlement

a. Every dispute between (Pertamina) or the Government in one side and (the Contractor) in other side concerning matter related with this Agreement or work exploitations hereof, including opinions that one party is in default in performing its obligations, unless resolved by a mutual agreement or through a settlement, shall be submitted to an Arbitral Tribunal. The Arbitral Tribunal shall consist of two arbitrators, each of them shall be selected by each party, and a referee shall be jointly selected by both arbitrators; with the condition, that if both arbitrators do not reach any agreement on the referee within 30 (thirty) days after the appointment of the second arbitrator, then, upon request of one party, such referee shall be appointed by the President of Cantonal Tribunal in Geneva, Swiss. If the President of Cantonal Tribunal in Geneva, Swiss, fails to appoint a referee within sixty (60) days, having requested so, the disputes can be submitted by one of the parties before Indonesian courts as a legal dispute. If by any reason, one of the arbitrators or the referee fails or is unable to perform, its substitute shall be appointed using the same way as the replaced arbitrator or referee is selected. All members of the Arbitral Tribunal shall be persons having international position in the jurisprudence or, in regards to the arbitrators, shall be in the technical field related with the dispute. If one party fails to appoint an arbitrator in sixty (60) days having received the written request, the arbitrator appointed by the other party shall act as a sole arbitrator in the Arbitral Tribunal. Unless otherwise agreed by the parties, the arbitration shall be conducted in Indonesia.
b. Each party shall pay each arbitrator's fee and half of other arbitration fee. The Arbitral Tribunal shall determine its procedural rules. Award is by majority votes of the members, and shall be final and binding to both parties.
c. If the award of the Arbitral Tribunal finds that one party is in default, such party shall have a reasonable time as determined by the Arbitral Tribunal, to fix the error.

Fortunately no disputes had to be resolved under the above clause, as it clearly had a number of areas, which could have caused great difficulty to implement.

2. Dispute resolution clause in the first generation Production Sharing Contracts (1966–75):

"Section XI Consultation and Arbitration

1.1. Periodically, PERTAMINA and CONTRACTOR shall meet to discuss the conduct of the Petroleum Operations envisaged under this Contract and will make every effort to settle amicably any problem arising therefrom.
1.2. Disputes, if any, arising between PERTAMINA and CONTRACTOR relating to this Contract or the interpretation and performance of any of the clauses of this Contract, and which cannot be settled amicably, shall be submitted to the decision of arbitration. ***PERTAMINA*** on the one hand and ***CONTRACTOR*** on the other hand shall each appoint one arbitrator and so advise the other Party and these two arbitrators will appoint a third. If either Party fails to appoint an arbitrator within thirty (30) days after receipt of a written request to do so, such arbitrator shall, at the request of the other Party, if the Parties do not otherwise agree, be appointed by the President of the International Chamber of Commerce. If the first two arbitrators appointed as aforesaid fail to agree on a third within thirty (30) days following the appointment of the second arbitrator, the third arbitrator shall, if the Parties do not otherwise agree, be appointed, at the request of either Party, by the President of the International Chamber of Commerce. If an arbitrator fails or is unable to act, his successor will be appointed in the same manner as the arbitrator whom he succeeds.
1.3. The decision of a majority of the arbitrators shall be final and binding upon the Parties.
1.4. In the event the arbitrators are unable to reach a decision, the dispute shall be referred to Indonesian Court of Law for settlement.
1.5. Except as provided in this Section, arbitration shall be conducted in accordance with the rules of arbitration of the International Chamber of Commerce".

This showed some improvement, but the seat was not designated and paragraph 1.4 would also have been likely to cause serious difficulties in the hands of an uncooperative respondent should resort to arbitration have become necessary. Fortunately no dispute had to be brought to arbitration under this clause either.

3. Second generation PSCs (1976–88)

The Dispute Resolution Clause in the Second Generation PSCs was identical to that of the First Generation, except for a further, very useful, sentence, which was added at the end of the second paragraph, as follows:

> Pending decision of the Board of Arbitration, the Parties shall diligently proceed pursuant to the provision and terms of the Contract hereof.

4. Third generation PSCs (1988–2008)

The fatal fourth paragraph of the First and Second Generation PSC was deleted in the later, Third Generation, model and, although the seat was still not indicated, fortunately the new version at least called for any arbitration to be held in the English language. Fortunately because the 1999 Arbitration Law requires any arbitration held in Indonesia to be conducted in the Indonesian language if the parties have not designated a different language.

The Third Generation version reads

> Dispute which cannot be settled amicably, shall be submitted to the decision of arbitration. BPMIGAS on the one hand and CONTRACTOR on the other hand shall each appoint one arbitrator and so advise the other Party and these two arbitrators will appoint a third. If either Party fails to appoint an arbitrator within thirty (30) days after receipt of a written request to do so, such arbitrator shall, at the request of the other Party, if the Parties do not otherwise agree, be appointed by the President of the International Chamber of Commerce. If the first two arbitrators appointed as aforesaid fail to agree on a third within thirty (30) days following the appointment of the second arbitrator, the third arbitrator shall, if the Parties do not otherwise agree, be appointed, at the request of either Party, by the President of the International Chamber of Commerce. If an arbitrator fails or is unable to act, his successor will be appointed in the same manner as the arbitrator whom he succeeds. Pending decision of the Board of Arbitration, the Parties shall diligently proceed pursuant to the provision and terms of the Contract hereof.
>
> The decision of a majority of the arbitrators shall be final and binding upon the Parties.
>
> Arbitration shall be conducted in the English language at a place to be agreed upon by both Parties and in accordance with the Rules of Alternative Dispute Resolution (ADR) and Arbitration of the International Chamber of Commerce.

5. Current version

There is a more recent model PSC, drafted in 2008, presumably the Fourth Generation, reflecting the changes required by Law 22/2001. The dispute resolution clause in this new model shows a bit more improvement, as it now calls for *ad hoc* arbitration under UNCITRAL[24] rules and makes very clear the intention to divest the courts of any jurisdiction other than for enforcement of an eventual award. But it still fails to designate the seat and this time the appointing authority is ICSID,[25] which has little familiarity with qualified arbitrators in the Asian region and also has in the past declined to act in such capacity where they have not agreed in advance to do so, so if appointing authority were necessitated the parties might find themselves with no choice but the local courts, as provided in the Arbitration Law. The 2008 model PSC contains the following clause:

[24] United Nations Commission on International Trade and Law.

[25] International Centre for Settlement of Investment Disputes.

"Section XI Consultation and Arbitration

11.1. Periodically, **BPMIGAS** and **CONTRACTOR** shall meet to discuss the conduct of the Petroleum Operations envisaged under this **CONTRACT** and will make every effort to settle amicably any problem arising therefrom.

11.2. Disputes, if any, arising between **BPMIGAS** and **CONTRACTOR** relating to this **CONTRACT** or the interpretation and performance of any of the provisions contained in this **CONTRACT** shall be settled amicably and persuasively within ninety (90) days after the receipt by one Party of a notice from the other Party of the existence of the dispute.

11.3. Dispute pursuant to Sub-section 11.2 which cannot be settled amicably, shall be submitted to the decision of arbitration by a three (3) person arbitration panel conducted in accordance with the UNCITRAL arbitration rules contained in resolution 31/98 adopted by the United Nations General Assembly on 15 December 1976 and entitled "Arbitration Rules of the United Nations Commission on International Trade Law" as in force at the time such arbitration is commenced. **BPMIGAS** on the one hand and **CONTRACTOR** on the other hand shall each appoint one arbitrator and so advise the other Party and these two arbitrators will appoint a third. If either Party fails to appoint an arbitrator within thirty (30) days after receipt of a written request to do so, such arbitrator shall, at the request of the other Party, if the Parties do not otherwise agree, be appointed by the Secretary General of the International Centre for Settlement of Investment Disputes. If the first two arbitrators appointed as aforesaid fail to agree on a third within thirty (30) days following the appointment of the second arbitrator, the third arbitrator shall, if the Parties do not otherwise agree, be appointed, at the request of either Party, by the Secretary General of the International Centre for Settlement of Investment Disputes. The third arbitrator appointed hereunder shall act as the chairman of the arbitral panel. If an arbitrator fails or is unable to act, his successor will be appointed in the same manner as the arbitrator whom he succeeds. Pending decision of the arbitral panel, the Parties shall diligently proceed pursuant to the provisions and terms of this **CONTRACT** hereof.

11.4. The award rendered in any arbitration commenced under this **CONTRACT** shall be final and binding upon the Parties, and judgment thereon may be entered in any court having jurisdiction for its enforcement. The Parties hereby renounce their right to appeal from the decision of the arbitral panel and agree that neither Party shall appeal to any court from the decision of the arbitral panel and accordingly the Parties hereby waive the applicability of any provision of laws and regulations or any competent authority that would otherwise give the right to appeal the decisions of the arbitral panel. In addition, the Parties agree that neither Party shall have any right to commence nor maintain any suit nor legal proceeding concerning the dispute hereunder, except the legal proceeding required for the enforcement of the execution of the award rendered by the arbitral panel.

11.5. Arbitration shall be conducted in the English language at a place to be agreed upon by both Parties."

Over the past year or so, BPMigas, together with the Indonesian Petroleum Association have consulted contractors and arbitration practitioners with a view toward revising the dispute resolution provisions further to bring them into line with best international practice. Although BPMigas was inclined to require arbitration before the local institution, *Badan Arbitrase Nasional Indonesia* (BANI), the consensus among the practitioners was to avoid institutional arbitration altogether, as experience has shown that *ad hoc* arbitrations are more cost- and time-efficient and better serve the needs of both the authority and the contractors. Furthermore BANI's current policy is to disregard the agreement of the parties as to language if other than Indonesian and often the parties' agreement as to criteria for qualifications of the arbitrators as well, appointing its own choices regardless.

Apparently the foreign contractors, or at least the most vociferous of them, tend to prefer that the seat be outside of Indonesia, which is actually contradictory to their own interests, seeing that the administrative burden for registration of foreign awards in Indonesia makes domestic arbitration far more efficient. The practitioners collectively recommended *ad hoc* arbitration in Jakarta under UNCITRAL rules, whereas at least some contractors preferred SIAC[26] arbitration in Singapore. The matter is still being considered and it is hoped that a decision will be rendered and applied to new PSCs soon.

A further potential problem is that once BPMigas has settled upon the Dispute Resolution terms to be used in PSCs, they may, as they have indicated, require the same mechanism to be used in services and supply contracts between the contractors and their sub-contractors or risk BPMigas withholding its approval of such contracts. This requirement would be contrary to Indonesia's freedom of contract regime as embodied in Article 1338 of the Civil Code. We can but wait and see how this matter evolves.

Disputes

With that history and background in mind, let us look at some of the disputes that have arisen over the years, as categorized at the beginning of this paper, and how they have been dealt with.

1. Disputes between the Government (or Pertamina) and contractors

To this date not a single dispute between Pertamina or BPMigas and an oil and gas contractor under a PSC has been submitted to arbitration or litigation. Several have come close, but all, so far, have been settled.

Early disputes are described in the discussion on history, earlier in this paper. They were more in the line of power struggles between Indonesian and foreign interests for control of Indonesia's petroleum resources. This nature of dispute has, to a lesser extent, continued, as indicated in the discussion of the two ExxonMobil disputes just below. Understandably, after being barred from participation in development of, and sharing in, her own resources by colonial powers for hundreds of years, Indonesia needed to, and eventually did, regain control of these national riches. In this effort a very workable

[26] Singapore International Arbitration Centre.

system evolved, and to some extent is still evolving, so far without the necessity of court or arbitral intervention.

The only dispute in the oil and gas sector involving Pertamina that has been arbitrated was under an EOR contract in which Pertamina and a local contractor acted jointly, under a Joint Operation Body (JOB) as contractor to BPMigas, after the latter institution took over Pertamina's former role as government authority. This recent case (Lirik) is described below.

Aside from Lirik, the only disputes involving the Government or its mining authorities that have resulted in arbitration or litigation related not to oil and gas but to geothermal energy and mineral mining projects, which are beyond the scope of this paper. Such cases were high profile and some very controversial, whereas the disputes in the oil and gas sector would seem rather tame by comparison. This phenomenon is often attributed to the general underlying professionalism of, as well as the huge investments required in, the oil and gas industry when compared with that of mineral (particularly gold) mining which, by its nature, has, throughout history, all too often attracted dilettantes, cowboys and get-rich-quick wheelers, dealers, dreamers and brokers.

Recent disputes

ExxonMobil conflicts

Over the past few years the most major disputes to be resolved in Indonesia's oil and gas sector related to two of her largest deposits of hydrocarbons as yet discovered, one oil and one gas, and both involving ExxonMobil. Both have involved protracted, if intermittent, negotiations, coupled with occasional threats of arbitration or litigation, but, as is normal for the oil and gas industry, it appears that both have been, or are in the process of being, resolved in a professional and more or less amicable manner.

The Cepu matter

The Cepu field sits on the border of Central and East Java and is the most significant oil discovery in Indonesia for the past decade, with estimated reserves of 600 million barrels of crude oil and 1.7 trillion cubic feet (TCF) of gas.[27] It was originally operated in a more or less informal manner by MIGAS as a training field for petroleum engineers. In 1990 the block was granted under a TAC to PT Humpuss Patragas, a company owned by President Suharto's youngest son, together with an Australian publicly listed company, Ampolex. Ltd.[28] Then, in early 1996 Mobil made a successful stock market takeover bid for Ampolex, subsequently, in 1998, purchasing the Humpuss share as well, thereby taking over the project. Mobil then, in 2001, commenced sophisticated seismic exploration and drilled a discovery well which flowed at 3,817 barrels of oil per day (PBD).[29]

There was considerable public outcry when the role of Mobil was announced, with nationalistic popular support from student activists, NGOs and intellectuals for

[27] Jakarta Post, 1 September 2009.
[28] New York Times (14 February 2006) referring to an offer of $935 million for all of Ampolex stock.
[29] Jakarta Post, 13 April 2001.

Pertamina to assume the operatorship to ensure a greater benefit to the State and her people. However, following protracted negotiations between Mobil, later ExxonMobil, and Pertamina, in 2006 ExxonMobil was declared Operator in a 30-year joint venture PSC with Pertamina, with each of Pertamina and ExxonMobil holding 45 per cent and the remaining 10 per cent held by the local provinces of East and Central Java and related districts.

Over the past few years Pertamina has on a number of occasions publicly registered its dissatisfaction with ExxonMobil's inability to bring the field into an increased production phase of 15,000 BPD and threatened arbitration if this target was not met by the end of August 2009.[30] There has been no recent announcement but it does appear that oil production at Cepu has now reached expected levels.

Natuna case

In January of 1980, Esso Natuna and Pertamina entered into a joint operating agreement for the exploration and exploitation of the Blok Natuna D-Alpha gas field, in the South China Sea, for a period of 30 years. Natuna is estimated to hold one of the largest gas reserves in the world, with 222 trillion cubic feet (TCF), of which about 46 TCF is thought to be commercially recoverable. At that time, each of Pertamina and Esso Natuna held a 50 per cent participating Interest. In 1996 Pertamina transferred 26 per cent of its participating interest to Mobil Natuna. And in November 1999 Exxon and Mobil merged. Therefore, Pertamina now holds a 24 per cent participating interest and ExxonMobil subsidiaries hold a 76 per cent participating interest.

Due to various difficulties, ExxonMobil failed to develop the project. According to reliable data of the Ministry of Energy and Natural Resources, the last drilling was in 1994. After further negotiations, on 9 January 1995, Pertamina and ExxonMobil entered into an agreement granting ExxonMobil an additional ten years in which to develop the project, ie up to 9 January 2005.

But by 9 January 2005, ExxonMobil had still failed to fulfill its commitment to develop the project. Under the PSC, ExxonMobil is obliged to submit its work program for developing the project in order to meet commerciality. The Government therefore took the position that the PSC with ExxonMobil Natuna had terminated on 9 January 2005. ExxonMobil did not agree with such termination, having given assurances that they would continue to develop the project.

Protracted negotiations ensued between the Government and ExxonMobil. At the end of October 2006, the Government announced that it had terminated ExxonMobil's contract, but ExxonMobil continued to claim its rights. On 3 November 2006, about 2 weeks before former US President Bush came to Jakarta, the Minister of Energy and Natural Resources proposed three options to settle the Natuna case: (i) appointing Pertamina to develop the project; (ii) re-tendering the project; and (iii) renegotiation with ExxonMobil.

[30] Jakarta Post, 28 August 2009.

On 19 February 2008, the Government finally decided to grant the project to Pertamina, which was to develop the project together with a partner. Eight foreign companies, including ExxonMobil, have submitted their tenders to work with Pertamina in development of the Natuna field. It thus appears that the dispute over Blok Natuna D-Alpha is likely to be settled soon and without litigation or arbitration. However it still remains to be seen whether ExxonMobil will take action if a different contractor is eventually awarded the project.

Lirik case

In 1991, Pertamina joined with a local company, PT. Lirik Petroleum (LP), owned by a domestic Indonesian group with considerable experience in the oil and gas business, to form a joint operating body (JOB) to act as Operator of an enhanced oil recovery project (EOR) in several South Sumatran fields over which Pertamina itself had control, after the original contract for primary recovery in such areas had been completed. Pertamina and LP entered into an EOR Contract (the 'Contract') for the purpose, which, *inter alia*, provided that the fields which would be further exploited would be those that were declared commercial jointly by Pertamina and LP. After conducting further exploration and research, LP submitted its plan of development for four fields: North Palai, South Palai, Molek and Lirik. Of these four fields, Pertamina approved only the Lirik field as being commercial. Costs spent on exploration can only be recovered against revenue from fields declared commercial, so that costs expended on non-commercial fields must be borne by the explorer itself. LP claimed that Pertamina had breached the Contract by failing to approve the commerciality of the other three fields, whereas Pertamina argued that commerciality depended upon mutual such declaration and in any case, under the Pertamina Law, the determination as to whether or not a field is commercial is Pertamina's exclusive right. There were other issues, but it is not necessary to detail these for purposes of this paper.

After years of negotiations, in May of 2006, LP commenced arbitration against Pertamina in Jakarta, under the rules of the International Chamber of Commerce (ICC), in accordance with the dispute resolution provisions of the Contract, seeking to recover damages, including its cost recovery and the anticipated profits it would have earned had Pertamina agreed upon commerciality of the other fields. After two years of submissions on the various matters in dispute, hearings were held in Jakarta in July of 2008 and, on 27 February 2009, the arbitral Tribunal issued its award which, *inter alia*, obliged Pertamina to pay compensation to LP in the amount of US$34,495,428.

Article 59 of the Arbitration Law requires that arbitral awards rendered in Indonesia must be registered with the court within 30 days of issuance in order to be enforceable. Despite this clear requirement, the award was registered with the District Court of Central Jakarta only on 21 April 2009, almost 60 days after issuance.

Pertamina therefore applied to the court to contest enforcement on the grounds that the award was unenforceable under the law and also sought annulment on public policy grounds.

Article 70 of the Arbitration Law provides very limited grounds upon which a court may annul an award, far more limited than the UNCITRAL Model Law or that of most other jurisdictions. Article 70 states

> An application to annul an arbitration award may be made if any of the following conditions are alleged to exist:
>
> a. letters or documents submitted in the hearings are acknowledged to be false or forged or are declared to be forgeries after the award has been rendered;
> b. after the award has been rendered documents are found which are decisive in nature and which were deliberately concealed by the opposing party; or
> c. the award was rendered as a result of fraud committed by one of the parties to the dispute.[31]

On 2 September 2009, the District Court rejected Pertamina's application for annulment on the grounds that the reasons put forward by Pertamina to annul the award did not meet the criteria of the Arbitration Law. Although without jurisdiction to rule on the merits of case, the judges nonetheless also expressed their opinion that Pertamina is bound by the terms of the contract it made with LP in accordance with Article 1338 of the Indonesian Civil Code, which provides that all agreements validly entered into shall apply as law between the parties thereto. They opined that if Pertamina deems it has the exclusive right to determine commerciality of a field, it should have so stated in the Contract, despite it having been set out in the law.

The Court also rejected Pertamina's contest against enforcement, despite the clear language of the Arbitration Law rendering unenforceable any award not registered within 30 days. Article 59 of the Arbitration Law states:

> **Article 59**
>
> (1) Within thirty (30) days from the date the arbitral award is rendered, the original or an authentic copy of the award shall be submitted for registration to the Clerk of the District Court by the arbitrator(s) or a legal representative of the arbitrator(s).
>
> . . . .
>
> . . . .
>
> (4) Failure to comply with the requirements set out in paragraph (1) above shall render the arbitration award unenforceable.[32]

Pertamina has appealed this court ruling to the Supreme Court and the resolution is still pending at time of writing.

[31] Article 70, Law No. 30 of 1999. Unofficial translation by KarimSyah Law Firm. No 'official' English translation exists of most Indonesian Laws, including this one.

[32] Article 59 of Law No. 30 of 1999 (*Undang Undang 30/1999*) on Arbitration and Alternative Dispute Resolution. Unofficial translation by KarimSyah Law Firm.

2. Disputes between foreign contractors and their home state taxing authority

This nature of dispute was relatively common during the 1970s when home state taxing authorities did not recognize that the share of profit oil allotted to the foreign contractors was based on after-tax profits, the tax portion having already been calculated as having been paid to the Indonesian Government, thereby entitling the contractors to tax credit in their home state. This culminated with the US Internal Revenue Service IRS Ruling No. **76-215**, discussed in some detail above in this paper. Had this ruling prevailed, the profits of the PSCs would have been reduced below the level that would make further exploration and exploitation commercially feasible. Fortunately, recognizing this dilemma, the Indonesian Government revised its profit share calculation to require the PSCs to pay their own tax, so that their after-tax profit would approximate their agreed upon share of oil. As mentioned above, in 1978 the IRS finally recognized this and codified this recognition in its Ruling No. 78-222, thereby relieving US contractors of their threatened additional tax burden and revitalizing the Indonesian oil exploration industry.

It should be noted, however, that despite IRS Ruling No. 78-222, some other countries' taxing authorities took a great deal longer to recognize that their contractors were already paying Indonesian taxes, and a number of cases were brought by such taxing authorities against their domiciliaries seeking to impose double taxation on their profits even as late as the early 2000s. To our knowledge these cases were eventually dropped as the home state authorities were provided with documentation similar to that which had been provided to the IRS in 1978.

3. Disputes among contractors

It is very common that conflicts arise between or among two or more contractors whose fields are contiguous as to how to determine which has the right to the *straddling petroleum* reserves in their neighboring contract areas. Oil being liquid it migrates and can be extracted from a nearby well adjoining a different contract block. This oil, in oilfield boundary areas, is known as *straddling petroleum*.

In order to alleviate, or at least minimize, disputes as to the right to exploit straddling petroleum in adjoining contract areas, the Directorate General of Oil and Gas issued Decree No. 402/D.D/MIGAS/1967 dated 20 December 1967 (Decree of Dir.MIGAS 402/1967) which provides, *inter alia*, that

- Oil companies are obliged to conduct exploration and exploitation on petroleum straddle between two or more contract areas with a unitized, or cooperative, method.
- If those oil companies cannot reach an agreement as to how to share the operating costs or the method of operations to be applied, then the Director General of Oil and Gas shall determine such matter.

Based on the Decree of the Director of MIGAS 402/1967, any dispute between oil companies on the right over straddling petroleum reserves within the boundary of their contract areas shall be solved by entering into a unitization agreement. If they fail to reach the unitization agreement, then the Director General of Oil and Gas shall determine on how such straddling petroleum reserves shall be explored/exploited. Up to now, oil companies operating in Indonesia have eventually managed to work out the unitization where these disputes have arisen and thus far no resort to litigation or arbitration has been necessary to determine respective rights over straddling petroleum reserves.

4. Disputes between contractors and their sub-contractors or suppliers

By far the most common disputes in the oil and gas industry are those that arise between or among a contractor and one or more of its various suppliers and sub-contractors. This relationship will, in each individual case, be embodied in the individual agreement between or among the relevant parties. There is no standard model for any of these contracts, the terms being based upon the parties' agreement and supported by the freedom of contract provisions of the Indonesian Civil Code (Article 1338). Thus each such contract will have its own particular dispute resolution provisions which will govern the sequence, forum, seat, governing law, language and other parameters of how a dispute will be settled.

Although impossible to generalize, one might comment that since most of these contracts relate to construction-related activities and similar, the dispute resolution mechanisms often follow sequences and contain terms more similar to construction contracts than to PSCs themselves. But, as with the PSCs, resolution of disputes is seldom left to the courts. Most of them have a party-agreed system built in, often involving mediation, executive or project manager review and often adjudication before arbitration may be commenced. The choice of institution or rules and seat vary enormously although the majority would have their seat, if not in Jakarta, often in Singapore.

Since each contract with each different subcontractor or supplier is negotiated separately, it is possible for a sub-contract to call for one mechanism while an integrally related sub-contract, or sub-sub contract for the same service, calls for an entirely different forum and/or seat. This can, and often does, cause considerable unnecessary cost and delay in resolving disputes over exactly the same default or difficulty under a chain of responsibility involving various parties. And it is very rare to find provisions allowing for consolidation of these different disputes, or the same dispute with different parties, incorporated into these contracts. Although theoretically such consolidation provisions would seem a natural solution, in practice few sub-contractors will be willing to provide for it, specifically to avoid being held responsible to the contractor when they are only a sub-sub contractor to the sub-contractor. It is in their interests to keep as much distance between themselves and the ultimate 'client' as possible.

It is likely that it is in an effort to minimize this kind of problem that BPMigas would like to see a uniform dispute resolution mechanism used throughout the industry. But to impose this would indeed be in violation of the freedom of contract provisions of Article

1338 of the Civil Code, as well as the freedom of choice of forum provisions embodied in the Arbitration Law.

It would be beyond the scope of this paper to try to give a catalog of all nature of dispute resolution mechanisms, and an impossibility to try to list all disputes which have arisen in this category because, Indonesia being a civil law jurisdiction, cases are not reported and do not constitute precedent for future cases, while arbitration awards, for the most part, remain confidential, except when registered. Since locally rendered awards are registered in the District Court having jurisdiction over the losing party, and since there are almost 300 judicial districts in Indonesia, no statistics are available.

It should be noted here, however, that as of 2003, pursuant to Supreme Court Regulation No. 2 of 2003, as amended by Supreme Court Regulation No. 1 of 2008, no case brought to litigation before the courts may be heard until the parties have been ordered by the court to attempt mediation. This regulation has tended to reduce the number of cases that must be resolved through the courts, although only minimally successful at first. But the trend is growing and it is hoped that it will help to expedite resolution of disputes where the parties have not opted for arbitration.

5. Disputes between contractors and local people/other business players

a. Disputes related to environmental damage or pollution

It is undisputed that oil and gas operations pose a serious risk of environmental damage or disaster, which can seriously adversely affect the health and livelihood of local communities in the project area vicinities.

Law No. 23 of 1997 regarding Environmental Management provides that environmental disputes can be settled through the courts or out of court, based upon the voluntary choice of the disputing parties. However, as arbitration is limited to commercial matters, or those which the parties have the power to resolve themselves, clearly out of court settlement cannot apply to criminal actions. Out of court settlement may, however, be utilized to reach agreement on the manner and quantum of compensation and/or agreement to take certain actions to ensure that negative impacts on the environment will not occur or be repeated.

Of course best practices must be faithfully applied to try to avoid environmental disasters in the first place. There have been several cases in recent years relating to environmental damage from mineral mining operations, in particular during demobilization, but by far the major environmental disaster (other than natural disasters of course, which are all too frequent these days) is the continuing mudflow in the Sidoardjo area in East Java, which has inundated several villages and left thousands of people homeless, and this concerned an oil and gas project.

Lapindo Brantas cases

On 28 May 2006, an Indonesian oil company, PT. Lapindo Brantas, targeted gas in the Brantas PSC area of East Java by drilling a well. At the first stage of drilling

(500–1,300 m deep) the mandatory steel conductor casing was installed. The second stage of drilling went deeper but this time no protective casing was used, after which massive amounts of hot mud, water, steam and a small amount of gas erupted. Despite various efforts to stem the flow, the mud has continued to spurt out at an alarming rate to this day. This mud volcano shows no signs of remission and is expected to continue for many years to come.

From this occurrence have arisen a number civil and criminal disputes against the Operator, PT. Lapindo Brantas. In the civil arena, disputes have involved the local people whose lives and/or livelihoods were destroyed by the mud, Lapindo's joint venture partner(s), the Legal Aid Foundation (YLBHI), the Indonesian environmental watchdog (WALHI), various contractors, the Minister of Energy and Natural Resources, the Minister of Environment Affairs and even the President of the Republic of Indonesia.

The standard model of PSC in Indonesia does contain a clause covering environmental protection; however, the clause is not particularly detailed nor comprehensive. The standard clause usually states:

> Contractor shall: (a) conduct an environmental baseline assessment at the beginning of contractor's activities; (b) take the necessary precautions for protection of ecological systems, navigation and fishing and shall prevent extensive pollution of the area, sea or rivers and other as the result of operations undertaken under the Work Program; (c) after the contract expiration or termination, abandonment of any field, remove all equipment and installations from the area. . .

The Indonesian Government has no experience in filing lawsuits against its oil and gas contractors based on breach of contractor's environmental obligations, such as that stated above. In the Lapindo Mud case, instead of bringing legal action against Lapindo Brantas on the ground that it had breached its environmental obligations, the Government announced that Lapindo Brantas and its owners (which included a high profile then government Minister) must compensate thousands of victims affected by the mudflow. The President established a special team to monitor and supervise the payment of compensation from Lapindo Brantas to the people. As of today some of the people affected by the Lapindo Mud have received some, although invariably inadequate, compensation for their lost land and/or houses, temporary accommodation and/or daily allowances. But not all. And more and more people are left homeless all the time as the mud rises and spreads.

Legal aid case

YLBHI, the legal aid foundation, filed a civil suit in tort against Lapindo Brantas, the President of the Republic of Indonesia, the Minister of Energy and Natural Resources, the Minister of Environmental Affair, and local officials, claiming the Government was negligent in failing to provide sufficient protection to the people affected. The District Court rejected YLBHI's claim on the ground that it had not proven negligence. The Government claimed that, to the contrary, it has taken an active role in assisting the

people to obtain compensation from Lapindo Brantas. The Government has ordered Lapindo Brantas to pay compensation to the people, established a team to monitor and supervise the payment of the compensation to the people and facilitated negotiations between the people and Lapindo Brantas. Some of the people affected by the Lapindo Mud have received the compensation for their land and/or houses but others have not. Lapindo Brantas argued that compensation payments have only been delayed because the claimants have not provided adequate proof of their home or land ownership. (As would be imagined, much of the residents' ownership documentation was lost and/or destroyed under the mud.)

On 3 April 2009, the Supreme Court issued its decision, stating, *inter alia*, that the Lapindo mudflow was a natural disaster and was not caused by the failure of Lapindo adequately to case the well. It deemed the underlying cause to have been an earthquake which occurred near Yogyakarta on 27 May 2006, and that the Government has performed its duty to protect people's interest as a result of Lapindo disaster.

Partner's case

In November 2006 MedcoEnergy, one of Lapindo Brantas' joint-venture partners, commenced arbitration against Lapindo Brantas in New York. MedcoEnergy accused Lapindo Brantas of breaching safety procedures during the drilling process, ie: not installing the well with adequate conductor casing. MedcoEnergy claimed that it had reminded Lapindo Brantas prior to drilling that adequate casing should be installed to prevent any possible blowout of mud, which was known, from the near-surface seismic survey, to exist under high pressure in that area. MedcoEnergy sought a declaration that it should be exempted from any obligation for compensation, since the Lapindo Mud disaster was caused by the negligence of Lapindo Brantas only.[33] Under the relevant Indonesian mining regulation (MPR-State Gazette 1930 No. 341), using conductor casing is mandatory in every oil well. MedcoEnergy won this case.

Criminal case

Besides the civil cases, criminal investigation was also conducted by the police. Thirteen Lapindo Brantas' executives and engineers face charges of violating Indonesian laws. However, up to the date hereof, none of these cases has as yet been heard before the court. By the issuance of the Supreme Court decision in the Legal Aid case, mentioned above, it seems that the police have decided simply to close their cases.

b. Disputes regarding overlapping areas

Article 33 of Law No. 22/2001 on Oil and Gas Mining provides that the right to mine does not confer any rights over the surface of the contract fields. Article 34 of Law 22/2001 also provides that if an oil company desires to use any part of the surface of land under which it will be operating, where another party has rights over the surface, such

[33] Information from Tempo magazine, 13 November 2006 (See <http://www.tempointeraktif.com> or <http://www.tempointeractive.com> for the English version.)

oil company must reach agreement with the holder of the surface land right and pay appropriate compensation, as agreed with the land right holder.

In most cases where there are overlapping rights between oil and gas contractors and individual holders of land rights these can be settled through land purchase or lease agreements.

Where there are overlapping rights between an oil company and either a plantation or a forestry concession, usually agreement can be reached through negotiation enabling both companies to conduct their business without adversely affecting the other. For example, an oil company may be permitted access to and use of a certain area around producing wells, in return for adequate compensation to be paid to the right holder over the surface land.

So far, to the best of our knowledge, none of this kind of arrangement has broken down to the extent that recourse to the courts – or arbitration if they have already concluded a contract – has been necessitated.

6. Other miscellaneous disputes

Two other disputes, both involving Pertamina, may be mentioned here, although these are rather unique and should not be taken to be characteristic.

a. Pipeline dispute

During the presidency of Suharto (1966–97), and particularly in the later years when his children were grown up and engaged in business endeavors, it was common for all nature of lucrative projects to be awarded to companies owned, in whole or in part, by one or another of the Suharto children or with which they had some other form of relationship. As might be expected the terms of many of these contracts were not exactly 'arms-length' and often the benefits to these companies were disproportional to the benefits to the State or state-owned companies themselves. Pertamina was only one of the state-owned companies whose own resources were affected by this situation. Of course, projects that were still in progress after the fall of Suharto had either to be continued under their terms, to the detriment of the State and/or state enterprises, or somehow untangled to reduce the unbalanced disbursement of state funds, particularly in the wake of the financial crisis of 1997/1998.

One project, which had been awarded to one such company, gave that company (contractor) the right to build pipelines linking certain offshore gas fields with onshore power plants and other downstream facilities. Besides having been paid for constructing these pipelines, the contractor was entitled to charge a flow-through tariff for all gas delivered from these fields to their markets. When additional wells were drilled nearby the contract areas, the contractor claimed the right to the flow-through tariff for all gas found in those new areas as well. Pertamina, now under new management, objected, on the ground that the new wells were not within the contractor's contractual rights and, further, that the contractor had already been more than adequately paid for their work and were continuing, and would continue, to collect enormous profits from the fields which were within their contractual rights. Long and arduous negotiations ensued while all revenue from the

pipelines accumulated in a joint account, which was blocked, so that neither party was able to obtain any of its revenue, even for purposes of repair of a section of the pipline that had been damaged and was no longer operative. Eventually it was agreed in principle that Pertamina would buy the contractor out of the balance of its contractual term, so that no recourse to the courts or arbitration should be necessary. But as of today, the parties have not yet finalized their agreement as to the price, which apparently must depend, at least in part, upon the gas price to be determined by the Government.

b. Financing dispute

Aside from the Lirik case, described above, the only oil and gas dispute involving Pertamina, which has been brought to arbitration, is, again, an unusual one and is ongoing so no specific details may be provided as yet. In 2002 Pertamina was invited to submit a tender for exploration and exploitation of oil and gas in the fields of a middle-eastern country (X). Pertamina had joined with other foreign oil companies for exploration ventures outside of Indonesia before, but this would be the first time it would act on its own as Operator outside of Indonesia's own borders. The Government was wary of such an undertaking, although it recognized the good public relations value, and probable future expansion prospects, of having its national oil company assist other countries in developing their oil and gas reserves. However, funds were limited and needed for development within Indonesia, so the Government gave its approval for this project only on the basis that third party funding could be arranged on a no-risk basis to Pertamina or Indonesia. No budget could be allocated for these operations outside of Indonesia.

A major European banking institution (Z) approached Pertamina with the proposition that Z would provide all funding and take all risks in return for a 45 per cent share in the eventual profits of the enterprise. This was to be effected by Pertamina and a subsidiary of Z setting up a joint venture company to tender for several fields and to act as the Operator of the project in any fields which might be awarded, the shares in such joint venture company to be held 55 per cent by Pertamina and 45 per cent by Z's designated subsidiary (Y). Y would provide all funding necessary for the bidding and for performance of the project, operations, bonuses, etc, and take all risks, whereas Pertamina would undertake all operations of the project if awarded. The parties entered into several agreements outlining these terms. On that basis tenders were made for four fields and two (one onshore and one offshore) were awarded. Y paid the signature bonuses to X and Pertamina went to work exploring the two fields in X.

But things quickly went wrong. Y simply ceased providing funds. It defaulted on its obligations to provide security deposits, guarantees, operating funds and facilitating actions for setting up of bank accounts, etc. After numerous demands and meetings to try to sort this out, at each of which Y or Z or other subsidiaries of Z brought up various new ideas and requirements rather than addressing its defaults head on, it was finally admitted that the company Y had never been established, so it was not a legal entity, and the segregated fund which Y was to have set up to administer the funds for the project had no funds in it whatsoever. Y, or Z, then advised Pertamina that it had passed off its rights and obligations to certain investors and that the investors were now responsible

to provide the funding, shortly thereafter to further advise that these investors had not in fact invested any funds after all. Meanwhile Pertamina has had to fund the project on its own, which was exactly what the whole transaction was designed to avoid. And because of the delay the costs have almost doubled and Pertamina risks losing not only the whole project but also its international reputation if it cannot complete the exploration and survey stage in time.

After years of negotiations, and digressions, Pertamina finally this year commenced arbitration pursuant to the dispute resolution provisions of their contract with Y. This case is ongoing so no outcome can be reported as yet. However, it would appear that Z never intended to provide the funding itself but that its real intention was to be the first bank to securitize an international oil and gas project, selling off pieces of it to investors, taking its profit at the outset and leaving the investors to take the risks and Pertamina to do the work. Only it never mentioned this to Pertamina. And it apparently misjudged its market because it could not sell this new 'product' as easily as it must have anticipated.

Although this is, we certainly hope, a most atypical case, it is perhaps an apt one on which to end this paper because it may be indicative of the disasters, which can occur, and have been occurring elsewhere, when lack of professional regulation allows solid industries to be turned into financial 'products'. Should bankers be engaging, and involving its customers, in the oil and gas business? Will they bring to gas exploration and all nature of other technically exacting enterprises the kind of chaos they made of the home mortgage business? We make no judgments here but it certainly must give us food for thought.

Conclusion

The bottom line, at least in Indonesia's oil and gas sector, is that it IS professionally run. With very few exceptions the monumental costs involved in exploration make it essentially self-regulating and its disputes self-resolving. Speedy and amicable resolution of those disputes that do arise are clearly in the interests of all involved, and the industry generally reacts appropriately. Dilettantes and cowboys are few and far between in the oil and gas industry, something that cannot be said about many others. If other industries would take a lesson from that of oil and gas, perhaps the world would see fewer disputes, fewer litigations and more professionalism.