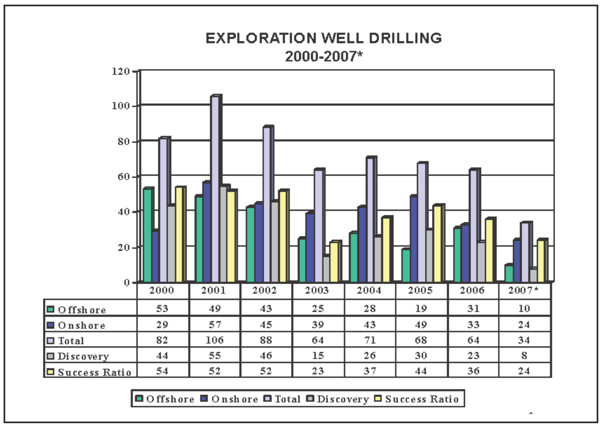
Public-Private Dialog Promotes Change in Oil, Gas and Mining Investment Climate

Summary

Indonesia is missing out on a global oil, gas and mining resource boom because its investment climate remains comparatively unattractive to international resource companies. Reduced investment in the oil, gas and mining sector harms the nation, as it means less economic growth, less government revenue, and a decline in energy security. A discussion[1] between resource firms and government sponsored by the World Bank and IFC identified twelve specific areas where rules and regulations were to varying degrees deterring new investment. In the half year since this event, there appears to have been forward movement on two-thirds of the issues raised during the discussion. This progress reflects the development of a healthy ongoing dialog between the private sector and the government.

Challenges

Despite a sustained worldwide commodities boom and excellent geological prospects, Indonesia is facing under-investment in oil, gas and mining. With respect to oil and gas, in the midst of a global scramble for energy, 22 of Indonesia's 60 oil and gas basins remain unexplored. Indonesia is now a net importer of oil and oil products, which creates a host of economic challenges for the nation. Indonesia has also missed opportunities for new minerals exploration. In the mineral sector, no new major investments have occurred over the past decade. World Bank mining expert John Strongman observes that, "Indonesia has missed out on as much as one billion dollars of mineral sector taxes over the past two to three years due to investment obstacles, and can probably expect to lose the same amount or more in the next two to three years so long as commodity prices remain strong, and much more in the next five to ten years."



	2000	2001	2002	2003	2004	2005	2006	2007*
Offshore	53	49	43	25	28	19	31	10
Onshore	29	57	45	39	43	49	33	24
Total	82	106	88	64	71	68	64	34
Discovery	44	55	46	15	26	30	23	8
Success Ratio	54	52	52	23	37	44	36	24

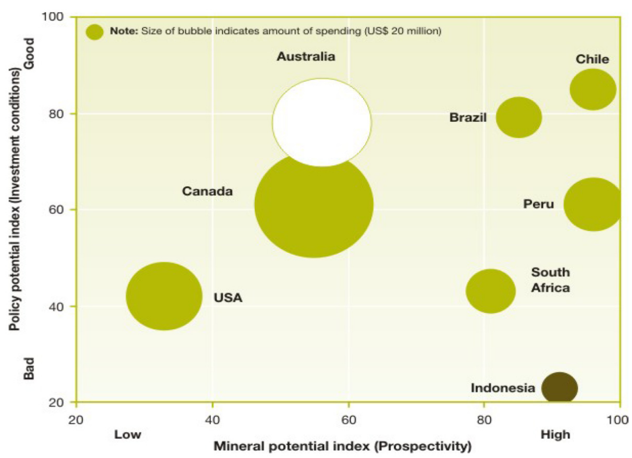
This Ministry of Energy and Mineral Resources bar graph shows how the drilling of oil and gas exploration wells is diminishing each year.

Solutions

Against the background of low oil, gas and mining investment, a half day discussion was organized by the World Bank and the International Finance Corporation on September 25, 2007. The discussion was attended by about 60 invited attendees consisting of company officials, government representatives and industry experts. Presentations and discussions pointed to key challenges that remain if the investment environment is to be improved so that new world class oil, gas and mining developments can begin to take place.

The government is faced with a choice. If it maintains the status quo, little increase in investment by international oil, gas and mining companies in large projects can be expected. However, if the government introduces reforms to establish more consistent, investment oriented polices then a substantial increase in large oil, gas and mining investments can be anticipated.

Surprisingly, there appears to have been some progress on two thirds of the recommendations offered by presenters and participants in the half year since the discussion took place. The table on the following page shows the problems identified by participants, the policy recommendations they offered, and what steps the government has taken with respect to these recommendations. The areas of the table colored green show where a substantial amount of progress has been made by government. Those colored yellow show where some progress has been made, although in some cases this progress is still of an uncertain nature, or has been accompanied by political backlash. Those colored red represent areas where no significant progress has been made.



This PriceWaterhouseCoopers chart shows that Indonesia is almost off the chart, both for its excellent minerals endowments but also for the anemic level of new mineral investment.

[1]The discussion was supported and financed by the Government of the Netherlands through the Trust Fund to Improve the Investment Climate and by IFC Advisory Services through IFC PENSA, a multi-donor initiative supported by the IFC and the governments of Australia, Canada, Japan, Netherlands, Switzerland and the Asian Development Bank. Funding from the UK DFID is also gratefully acknowledged.

Recommendations by discussion participants on how to overcome challenges in the oil, gas and mining sector

Key:

- Areas where a substantial amount of progress has been made by government.
- Areas where some progress has been made, although of an uncertain nature or accompanied by backlash.
- Areas where no significant progress has been made.

Challenges	Seminar recommendations	Recent actions
Oil & Gas: Lack of certainty over cost recovery.	Codify existing rules and regulations governing cost recovery, which have evolved over the past several decades, and continue to make additional refinements in them as audit findings are resolved.	**May 2008:** New Head of BP Migas Head pledges to define more clearly which "Petroleum Operations" costs will be recoverable in the future. New Head also announces that each department within the agency can now perform "self monitoring" where cost recovery is concerned.
Oil & Gas: Shrinking fiscal space from rising cost and volumes of oil imports.	Adoption of an automatic price adjustment mechanism, so that domestic prices track international prices somewhat more closely and fluidly.	**May 2008:** Although not willing to adopt an automatic price adjustment mechanism, the government did raise the prices of subsidized fuels by approximately 30 percent, and has thus saved Indonesian taxpayers Rp 65 trillion.
Oil & Gas: Slow issuance of permits by BP Migas.	Fewer and less complicated permits. Faster approval for those that remain.	**May 2008:** The new Head of BP Migas has promised to expedite the process for approval of Plans of Development (POD) and Put on Operation (POP) permits.
Oil & Gas: Uncertainties regarding whether VAT must be paid by PSCs issued between 1995 and 2001.	Harmonize contradictory approaches within Ministry of Finance, and between the Ministry of Finance, Ministry of Energy and BP Migas. Possible venue for such harmonization could be an Extractive Industries Transparency Initiative National Steering Group.	**May 2008:** A possible new venue for improved harmonization of oil and gas VAT issues may soon be available, with the recent signing of a Presidential Instruction requiring an MOU between the Minister of Energy and Mineral Resources and the Minister of Finance on the management of oil, gas and mining activities.
Mining: Uncertainty regarding the ability to establish new Contracts of Work, or even maintain old ones.	Under new Mining Bill, do not phase out existing Contracts of Work (CoW), and ensure that new "Special Licenses" emulate certain time-tested CoW mechanisms, like neutral binding arbitration.	**April 2008:** The Energy Commission of the National Legislature (DPR) continues to remain committed to the passage of a Mining Bill. One section of the bill on which work is still underway pertains to licensure for large mining projects.
Mining: Prohibition on surface mining in protection forests.	Proceed with efforts to issue a new regulation to relax this prohibition in some cases.	**February 2008:** Forestry issued, and the President signed, a new regulation allowing firms to operate inside protection forests. However, the public reaction has been negative.
Oil, Gas and Mining: Uncertainty regarding which taxes and royalties are owed, and to whom.	Better intra- and inter-agency coordination, possibly under the auspices of the Extractive Industries Transparency Initiative.	**May 2008:** A possible new venue for inter-agency coordination may soon be formed, in view of the recent signing of a Presidential Instruction requiring an MOU between the Minister of Energy and Mineral Resources and the Minister of Finance.
Oil, Gas and Mining: Difficulty in reforesting areas outside forest zone twice as large as concessions inside.	Proceed with efforts to issue a new regulation so that mines in the forest zone can pay a one percent royalty, instead of being required to reforest vast areas.	**February 2008:** The Ministry of Forestry issued, and the President signed, a regulation allowing firms to pay a royalty to operate inside of the forest zone. Forestry did not consult the regulation with the environmental community, or explain to them why such a regulation was needed. The office of the President also missed an opportunity to accurately explain the regulation to the public.
Oil & Gas: Lack of clarity regarding gas domestic market obligation requirements.	Clarify percentage of production that gas producers will be required to sell domestically, and the price at which they will be required to sell it.	No further clarification has been forthcoming about the Gas DMO. Meanwhile, in April 2008 a new spate of agreements which require gas producers to divert part of their production to state-selected firms at below market prices were entered into.
Oil & Gas: Land use conflicts by companies with villagers.	Use participative mapping as a conflict resolution tool.	Cepu, Indonesia's largest new oil discovery in a decade, faces challenges in getting its oil to the shoreline where it can be loaded onto ships.
Mining: District licensed mining permits that overlap with or are located inside national permits and/or which do not pay taxes to national government.	Erect better information systems regarding district permits (where they are located, who owns them, and whether they pay taxes to the national government), possibly under the auspices of the Extractive Industries Transparency Initiative.	The erection of a national information system to accurately describe the locations of, and the types of production taking place in, many thousands of quasi-legal district mines is still years away. As a result, large, legal nationally-licensed mines must strike individual deals with such local mines to avoid problems arising from co-location.
Oil, Gas and Mining: Uncertainty in having to renew five year temporary permits to operate in forest zone.	Provide temporary one-time-only permission to operate in the forest zone, for the length of the license.	Firms are still required to renew their temporary permits with the Ministry of Forestry each five years. Many firms elect not to apply for such permits, and operate illegally in this regard.

Conclusion

The government of Indonesia appears to be making efforts to improve the oil, gas and mining investment climate. Out of twelve recommendations made by participants in the September 25, 2007 Oil, Gas and Mining Investment Climate Discussion, three showed substantial progress in the half year following the Discussion, and another five some progress, albeit with unanticipated political backlash in some cases. The fact that there has been forward movement on two-thirds of the recommendations is due not only to the fact that a discussion took place, but more importantly to the development of an ongoing industry-government dialog. Although it may not always be apparent to investors, the government is listening to the concerns of extractive industry firms and is making efforts to improve the oil, gas and mining investment climate in many areas. Nevertheless, despite progress there are still several changes needed, such as greater clarity on how much gas producers will be required to sell domestically and at what price. Implementation of these changes would have a substantial positive impact on investment.

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