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Profit Sharing Contract on Oil and Gas Pursuant to Act Number 22 Year 2001

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Abstract

Oil and gas are nonrenewable energy resources that are strategically under the powers of the state, the Republic of Indonesia. The oil and gas management should optimally be implemented for the purpose of providing people's prosperity and welfare. The legal issues studied are the regulating profit sharing contract on oil and gas management in Indonesia. The type of the research is a legal research that is used to solve the appearing legal problems, and to prescribe what should be. The research uses primary and secondary legal materials. The result shows that according to Act No. 22 of 2001, the oil and gas management has changed from the centralized and monopolistic management into the decentralized one, so that it becomes better. Article 6 regulates upstream activities in the oil and gas business activities which are applied and controlled through profit sharing contract. The profit sharing contract shall contain at least the following terms and conditions, such as: (a) the ownership of natural resources shall remains on the hands of the government up to delivering them; management controlling operations shall be under the authority of the implementing agency; (b) entire capitals and risks shall be borne by enterprises and permanent enterprises; (c) the change of the statute shall separate upstream and downstream industry of oil and gas; (d) the mining authority shall return to the government not to *Pertamina* or enterprise; and (e) the enterprise that wants to invest in oil and gas sector shall sign profit sharing contract with the Implementing Agency for Oil and Gas (*SKK Migas*). Production sharing for oil and gas management in Indonesia is obtained from the production after being deducted with operating costs; the production is shared to the state and the contractor i.e. generally 85% of net oil production to the state and 15% to the contractor, and 65% of net gas production to the state and 35% to the contractor.

***Keywords*:** cost recovery; profit sharing contracts; oil and gas; comparative analysis; contractors.

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1. Introduction

Indonesia is blessed with abundant natural capitals. Fertile soil surfaces and contents consist of a variety of minerals such as grains, various chemical materials and various stones including diamonds that can be processed for people's welfare [1].

The natural wealth is considered as a gift of God which the Indonesian people should manage it well. In fact, the natural wealth is the property rights of the Indonesian people that the implementation and exploitation are delegated to the country. In the context of exploration and exploitation of oil and gas resources, the *Pancasila* (five principles) as the state foundation contains the meaning that implementing the business activities and exploiting the oil and gas resources should be designed to achieve people's welfare. The business activities of oil and gas resources should thankfully and responsibly be applied in the presence of God.

Pancasila as the way of how to manage the oil and gas resources contains values as follow [2]: (a) the principle of *Ketuhanan Yang Maha Esa* (Belief in God Almighty) gives moral ethics guidelines for the development of business activities of oil and gas resources that should be implemented to maintain the integrity and balance of the natural environment; (b) the principle of *Kemanusiaan yang Adil dan Beradab* (Just and Civilized Humanity) leads that business activities of oil and gas resources are done with respect to human rights in which the state shall guarantee sufficiency of the energy needs for all people; (c) the principle of *Persatuan Indonesia* (Unity of Indonesia) requires that the business activities of oil and gas resources should give priority to environmental sustainability, balances between local regions and central regions, between development interests and environmental protection, and balances between corporate interests and people's interests; (d) the principle of *Kerakyatan* (people's sovereignty or democracy) directs that the business activities of oil and gas resources should be controlled by the state and dedicated to Indonesian people; and (e) the principle of *Keadilan Sosial bagi Seluruh Rakyat Indonesia* (Social Justice for All Indonesian People) is a guideline for the business activities of oil and gas resources. Indonesia does not embrace capitalism that only promotes profit for the business. However, the implementation of business activities of oil and gas resources should be able to save and protect Indonesian people.

Aforementioned five principles are philosophically embodied in the Preamble to the 1945 Constitution of the Republic of Indonesia which contains the values as legal sources and basic law for the implementation of business activities and the utilization of natural resources. Appreciating the nature and dignity of the nation as cited in the first paragraph of the Preamble of the 1945 Constitution means that we should be a sovereign nation over all natural resources in Indonesia.

This is reasserted in Article 33 of the 1945 Constitution, Paragraph (2): "Sectors of production which are important for the country and affect the life of the people shall be under the powers of the State" and Paragraph (3): " The land, the waters and the natural resources within shall be under the powers of the State and shall be used to the greatest benefit of the people." The aforesaid provisions contain the main idea that the natural resources shall be controlled and exploited by the state for people's welfare.

Indonesian people's natural wealth mandated to the state should be managed well to achieve the goals of Indonesia. The government as a state representative is given the right to manage the natural resources in order that Indonesian people can equitably and evenly relished them. Furthermore, the people prosperity is the spirit and goals of the welfare state that must be realized by the state and government of Indonesia.

According to Bagir Manan, under the power of the state means as follows [3]: (a) the ownership of the state; it means that the state through the government holds the sole authority to determine the rights, including the authority over soil, water and all properties therein; (b) regulating and controlling its use and utilization; and (c) capitals inclusion by the state enterprises for certain business; the state authority to manage the natural resources is the concession right.

Implementation of state concession right over natural resources is called a mining business, particularly oil and gas mining. The policy for mining exploitation of oil and gas is based on Article 33 of the 1945 Constitution. In implementing the policy the following terms can be considered:

- We will invite foreign companies if the Indonesian people do not dare to take the risk or do not master the technology for the mining sector. If the funds are issued by foreign businessmen, the funds, of course will be returned to the state from where the businessmen come. However, it will be more profitable if it is done by Indonesian businessman;
- If there is no much risk and the technology is mastered and the problem is only the capital, the funds can be collected in several ways, as follows: 1) as the government's revenues from the mining sector, it has generally provided benefits. The revenue can be used for exploration and investment in other mining sectors, including the oil and gas sector, so that most government revenues from oil and gas can be used for exploration and investment to other sectors of more clean energy, such as geothermal and hydropower; 2) the related State Enterprise can collect funds from the public shares which amount depends on public confidence on the result of the business; 3) national private enterprises that are interested in doing the business in these sector (either alone or consortium) are included in the business; and 4) if the funds are not enough collected from such sources, foreign capitals can be used;
- Both physical and social aspect of environment should be considered in any mining contracts; and mining businessmen should provide funds to address the environmental problems;
- If the profit sharing contract for general mining is more profitable than contract work, the more profitable one for society should be applied [4].

Article 3 of Act Number 44 *Prp*. Year 1960 states that enterprising the oil and gas mining is only implemented by the state. Then, the state delegates the implementation of mining exploitation of oil and gas to State Enterprises. Furthermore, based on Act Number 8 of 1971 as a derivative statute of Act Number 44 *Prp*. Year 1960 which the cooperation of enterprising the oil and gas mining shall be done in form of contract (profit sharing contract), the establishment of a state enterprise becomes a technical and strategic option both legally and economically.

Article 11 Paragraph (1) of Act Number 8 of 1971 states: the Indonesian mining jurisdiction is provided to the state company (*Pertamina*) in the case of oil and gas mining. The word "provided" means that only area for exploration is provided to *Pertamina*. In this context the concession rights remain to be the state right, not to be transferred to *Pertamina*. Here *Pertamina* only gets the power to undertake not to dominate. Therefore, *Pertamina* as the proxy of oil and gas mining in running the business of oil and gas can not act as the owner of a mining concession area [5].

Act Number 44 *Prp*. Year 1960 on Oil and Gas Mining and Act Number 8 of 1971 on State Company of Oil and Gas Mining that are declared not to be in force after the enactment of Act Number 22 of 2001 on Oil and Gas. Article 2 of Act Number 22 Year 2001cites: "the implementation of business activities of oil and gas resources regulated in this Act is based on principles of populist economics, integration, benefits, justice, equality, prosperity, people's welfare, security, legal certainty, and environment-oriented".

The business activities of oil and gas have characteristics that can not be updated (non-renewable) and have a higher speculative risk and have higher impact on both physical and social environment than other commodities in general [6]. They require a long enough time to get benefits; the investment in this business requires amount of costs; the decision in the oil and gas mining is often taken in high uncertainty and highly advanced technology.

As a primary energy, the oil and gas have a very important role in national development, as reflected in the trade balance and the budget of State Enterprise in the form of regular admission. The oil and gas become very significantly strategic and vital goods for industrialization in the developed countries. They are also an important source of income for oil producing countries. It can be analyzed from the revenue and the production aspects [7].

In 2015 the production target was achieved. Oil lifting between the government and the House of Representatives, Commission VII in the changed state budget is in the range of 825 thousand barrels per day (BPD), while gas lifting is 7079 million cubic feet per day (MMSCFD). Achievement of lifting production of petroleum per June 30, 2015 amounted to 763 600 BPH or 92.6% of the budget target-P to be part of an agent of oil and gas business in order to maximize production efficiently. Until the end of the first half of 2015, the achievement of lifting gas reached 6587 million cubic feet per day, or 6.4% of the target of 7709 MMSCFD. In whole, lifting oil and gas amounted to 1.94 million barrels of oil equivalent per day (MBOEPD) or 94.8% of the target 2.4045 (MBOEPD). Throughout the first half of 2015, oil and gas sector recorded a revenue of US $ 7 billion, or about Rp.92.5 trillion, almost half of the State Budget target in 2015 amounted to US $ 14.99 billion, or around Rp.198 trillion [8]. Based on the said description in the background section, the legal issue that is studied in this research is how the profit sharing contract management of oil and gas in Indonesia is regulated.

2. Materials and Methods

This research is a legal research in relation to academic activities. Black's Law Dictionary defines legal research as the finding and assembling of arthritics that bear on a question of law; and the field of study concerned with the effective marshaling of authorities that bear on the question of law [9].

Jurisprudence has a distinctive character of which the nature is normative [10]. In this case, the jurisprudence has distinctive properties (*sui generis*) that are characterized by empirical analysis that is exposing and analyzing the content and structure of the law; systematization symptoms of law; doing interpretation of the substance of the applicable law; and practical sense of law is closely related to the normative dimension.

The legal research is conducted by a method according to the characteristics of the jurisprudence which differ from the social sciences and natural science. This research method includes the approach of determining legal materials and the critical analysis on the materials that is therein contained explorative, inquiry and interpretative reasoning.

2.1. Research Design

The research method uses normative research. It means as a research which refers to the legal norms contained in the profit sharing contract of oil and gas in Indonesia. The approach on the issues therein used is the statute approach [11].

2.2. Types and Sources of Data

According to Black's Law Dictionary, the source of law is defined as: "something such as constitution, treaty, statute, or custom that provides authorities for legislation and judicial decisions; a point of origin of law or at analysis." Furthermore, sources of law include: "in the context of legal research, the term" sources of law "can refer three rent concepts should be distinguished. One, sources of law can refer to the origin of legal concepts and ideas ...; two, sources of law can refer to governmental institutions that formulate legal rules ...; three, sources of law can to the published manifestations of the law. The bolls, computer databases, forms, optical disks, other media that contain legal information are all of law [12]."

Sources of law in this research consist of primary source, secondary source and tertiary source. The primary source of law covers legislations on the management of oil and gas and implementing regulations and cooperation agreement made by the government and the oil and gas contractors. Secondary source of law is in the form of literature, scholarly writings such as textbooks, journals, papers, dictionaries, and articles contained in the print and electronic media.

2.3. Procedure of Data Collection

The collection steps of the source of law include reading, learning, quoting, comparing and connecting the source of law from statutory law and literature, so that they become a unity which makes the analysis easy. In collecting the sources of law the process is done through the following steps, such as: editing, the data are carefully checked to avoid errors of the collected data; making classification, the collected data are classified based on their respective subjects, in order to avoid errors in grouping the data; and organizing, the collected data are then sorted according to the grouping, in order to avoid mistakes in accordance with the systematization of sources of law [13].

2.4. Method of Data Analysis

The Sources of law are analyzed in several steps in accordance with the classified problems. The analysis is carried out and poured in the form of a description that contains explaining, studying, systemizing, interpreting and evaluating. The next step is a theoretical analysis on the sources of the law in order to find and understand and explain in depth the history of profit sharing contract in Indonesia, on regulations and provisions of the product sharing for the government in managing the oil and gas.

3. Results

3.1. Regulating the Profit sharing contract on Oil and Gas in Indonesia

Petroleum is derived from English term i.e. crude oil, while gas is derived from English term that means a natural gas. The meaning of petroleum is found in Article 3, the letter I of The Petroleum Tax Code, 1997 India as follows:

"Petroleum means crude oil existing in its natural condition, i.e. all kinds of hydrocarbons and bitumen, both in solid and in liquid from, in their natural state or Obtained from Natural Gas by condensation or extraction, Including distillate and condensate (when commingled with the heavier hydrocarbons and delivered as labeled at the delivery point) but excluding natural gas."

Aforesaid meaning of petroleum is regulated in Article 1, paragraph (1) of Act Number 22 Year 2001 on Oil and Gas. Petroleum or crude oil is:

"The result of a natural process i.e. hydrocarbon in pressured condition and temperature of atmosphere i.e. a liquid or solid phase, including bitumen, mineral wax or ozokerite, and bitumen that are derived from the mining process, but not including coal or other hydrocarbon-shaped sediment that is obtained from activities not related to the business activities of oil and gas."

Exploring the oil and gas in Indonesia has a very long history of mining which starts from pre-independence of Indonesia. In 1871 Jan Reeringk, a Dutch businessman, explored an area on *Ceremai* mountain slope, close to *Cibodas*, West Java. He drilled the well at four sites, but there is no sort wells providing commercially feasible results. The exploration was probably encouraged by the first discovery of oil in the world with methodological drilling in Titusville, Pennsylvania, USA in 1859.

Subsequently, in 1883 Aeilko Jans Zijlker, the leader of tobacco plantations in *Langkat* North Sumatra, found oil seepage informed by village people. After being investigated, it was turned out that the oil had a good and commercially feasible quality. To be able to exploit it, Zijlker established a commercial entity to facilitate the quest for financial aid from the Netherlands and to request concessions from the Sultan of *Langkat*. The concession is named as *Telaga Said* concession. Furthermore, Zijlker started to firstly drill in area of *Telaga Tiga*. This drilling got no results. On June 15, 1885 the second well was drilled in area of *Telaga Tunggal* and the results were very encouraging. The well was then known in the world as *Telaga Tunggal*, because it continued to produce oil until 50 years although only drilled in depth of 121 meter[2].

Encouraged by the Zilker invention, Andiran Stoop, an ex-Zijlker’s employee, explored the oil in Java. He managed to find commercially and technically feasible oil developed in Krukah, East Java in 1887 and in Ledok

Cepu, Central Java in 1901. To process the oil, the first oil refinery in Indonesia was established in Wonokromo, East Java in 1890 and then in Cepu, Central Java in 1894.

The oil discoveries encourage the growth of the oil companies in Indonesia. Zijlker made the oil discovery a media to promote the idea of establishment oil industry in Indonesia. According to Zijlker, through earnestly striving and his friends' support in Den Haag, the *Koninklijke Nederlandsche* Petroleum Company established on June 16, 1890; it is known as the Royal Dutch Petroleum Company. The company focused on producing, processing and marketing the petroleum with administrative center at *Pangkalan Brandan*. For this purpose, *Telaga Said* concession was taken over by the Royal Dutch Petroleum Company.

Under the leadership of J.A. De Gelder, the Royal Dutch Petroleum Company began developing *Telaga Said c*oncession area by building refineries in *Pangkalan Brandan*, North Sumatra which the building finished on February, 1892. Then, supporting facilities such as storage tanks and harbor facilities were built and finished in 1898. It was the first facility of oil port in Indonesia. Because of good infrastructure, the Royal Dutch Petroleum Company was finally able to export. Other companies are Shell Transport and Trading Co., founded by Marcus Samuel, a British. He discovered oil in East Kalimantan and built oil refinery processing in Balik Papan in 1894.

Based on the findings of the oil resources, the Dutch East Indies government was supported to stipulate *Indesche Mijn Wet* Year 1899 by legalizing the authority of government to give concessions replaced the authority that was previously owned by the Sultan or King. This is the starting point of colonization and foreign colonization over oil and gas in Indonesia [14]. In the concession agreement, the contractor shall pay land taxes (*vast recht*) for each hectare and royalty equal to 4% of the gross product.

In the earlier of 20th century, two companies, Royal Dutch Petroleum Company which is powerful in the producing and processing and Shell Transport and Trading Co. which is powerful in transporting and marketing, were merged. With the agreement that Shell Transport and Trading Co. gets 40% of all combined assets, while Royal Dutch Petroleum Company receives 60% of them, on February 24, 1907 a new company was officially founded i.e. The Royal Dutch Shell Group which is then well known in the world as Shell. The Royal Dutch Shell Group was positioned as a holding company; and then three subsidiaries i.e. Asiatic Petroleum in marketing position, De bataafseche Petroleum Maatschappij (BPM) in producing and processing positions, and The Aglo-Saxon Petroleum Co. in transporting position were established.

In 1911 the Shell Petroleum Company acquired Dortsche Petroleum Company that operated in East Java in order to strengthen its position as the oil industry dominator in Indonesia. Because of the acquisition, the entire oil industries in Indonesia were practically under the supervision of Shell. In the process, the Shell competed with the Standard Oil. In 1921 the Standard Oil began to come in Indonesia by establishing a Dutch East Indies law-based subsidiary i.e. Koloniale Petreleum Nederlandsche Maatschappij (NKPM). The subsidiary bought an exploring license that was still valid for Talang Akar, Pendopo North Sumatra drilling 60 wells.

Indische Mijn wet Year 1904 was changed to reflect the tighter competition between Shell and Standard Oil in controlling the oil industry in Indonesia by giving up new oil concessions. The termination is intended to strengthen the Shell which the main shareholder is incidentally the Dutch. In 1918 the law was secondly changed to make allowances for new oil concessions.

By the World War II, Indonesia's oil industry was controlled by Shell and Standard Vacuum Petroleum Maatschappij (SVPM). Indonesia as the largest oil producer in the Far East at that time was predicted to soon receive the invasion from Japan. Having realized the inability to resist the Japan Invasion, the Dutch East Indies government intended to run a tactic of scorched earth to all oil installations and facilities. Japanese invasion took place so quickly, so that they could occupy the oil installations and facilities; they put the existing petroleum operations under the power of military. After Indonesia's independence in 1945, the oil industry came into a new phase until 1971.

The invasion started from the movement of *Laskar Minyak* (oil military troops) in all areas of Japanese oil and gas, while allies aggressively came into Indonesia to reclaim the power from Japan. The struggle to obtain and maintain independence in the oil and gas sector was led by oil military troops that were associated in the Association of Oil Workers. They were independence patriots who were experienced to work for Dutch and Japanese oil industry. The oil military troops were fully aware that their support was very strategic to achieve and maintain independence. The oil is required to mobilize the vehicles in struggling for independence.

The oil military troops struggle in North Sumatra was successful to take over the oil in *Pangkalan Brandan* on September, 1945. This was followed by establishing the first national oil company, i.e. *Perusahaan Tambang Minyak Negara Republik Indonesia* (*PTMNRI*) and then in 1954 the name was changed as *PT.Tambang Minyak Sumatra Utara (PT.TMSU)*. Taking over the petroleum was also struggled for in South Sumatra with soft strategy taken by Dr. M. Isa, representatives of the central government for South Sumatra and Jambi. The struggle was successful without any attacking from Japan. Then, *Perusahaan Minyak Republik Indonesia (PERMIRI)*, the Oil Company of the Republic of Indonesia was established. In Central Java, the government established the *Perusahaan Tambang Nasional (PT.MN)* (National Mining Company) to carry out the petroleum operations in the former Shell's oil field in Kawenang, Nglobo, Semanggi, Ledok including refinery in Cepu and oil field in Bongas, West Java.

On August, 1951, Parliament gave serious attention in the oil and gas sector. Mr. Muhammad Hasan as the Chairman of the Commission for Trade and Industry *(Ketua Komisi Perdagangan dan Industri)* in the Parliament researched and suggested two conclusions that the oil fields in North Sumatra could be nationalized with compensation payments; and Indonesia did not get a fair sharing of foreign oil companies operating under concession agreements and prevailing tax laws. Based on the conclusions, Mr. Mohammad Hasan submitted a motion unanimously supported by the cabinet at a session on August 2, 1951. The motion requested the government to quickly found a state committee for mining which have tasks of: (a) investigating the matters oil mining, tin mining, coal mines, mines gold / silver and others in Indonesia as soon as possible; (b) preparing a draft of law on Indonesian mining that is in accordance with the current situation; (c) giving consideration to the government about the government's stance on the status of oil fields in North Sumatra and Cepu and other mines; (d) giving consideration to the government on the status of a tin mine in Indonesia; (e) giving consideration to the government relating to the excise tax on oil ingredients and to stipulating the oil price; (f) submitting proposals on mining solar that give profit for country; and (g) completing the report within a maximum period of three months and submitting it to the government and parliament.

Otherwise, the motion urged the government to delay granting all mining exploitation concessions or extension of the license that has expired until the State Committee of Mining provides recommendations. Parliament insistence was so strong, and *Stanvac* concession would expire at the end 1951 and Caltex and Shell concessions would respectively expire in 1953 and 1955.

No longer after Mr. Mohammad Hasan's motion had spread to the public, Mr. Mohammad Hasan and Managers of foreign oil companies in Indonesia did some negotiations, such as the proposal to share the profits 50%: 50%, the acceptable proposal on results of production only without financing the operation. The results became the primary platform of renegotiating the Stanvac, Caltex and Shell Concessions. Finally, on March, 1954, Stanvac and Government achieved an agreement to renew Stanvac concession with the following provisions:

- Stanvac shall invest assets of US $ 70-80 million that are taken from foreign funds;
- Stanvac shall be granted exemption of import and export of all capital goods for facilitating the capital investment;
- Application of taxation shall eventually result in the division of 50%: 50%;
- Nationalization of employees shall be strived to be as much as possible; and
- The concession shall enact for a period of four years.

Caltex and Shell's concessions that ended in 1953 and 1955 were renewed with the agreement similar to the Stanvac's. Three contracts ended in 1960 by expecting the presence of new statute on petroleum, so that the extension of the contract would be based on such new statute. In 1960 Act No. 44 *Prp*. Year 1960 on Oil and Gas was enforced. Act No. 44 *Prp*. Year 1960 give only state company mandates to exploite the mining of oil and gas. Article 6 regulates that if it is neccessary, the minister can appoint another party as contractor of state companies to carry out the job that has not been or can not be executed by the state company.

Based on Article 33 of the 1945 Constitution of the Republic of Indonesia and Act No. 44 *Prp*. Year 1960, the government renegotiated the concessions that have been granted and valid with Caltex, Shell and Stanvac. A result of renegotiation is that Caltex concession contract was converted into a work contract between *PN Pertamina* and Caltex; Shell concession contract was converted into work contract between *PN Permigan* and Shell; and Stanvac concession contract was converted into work contract between *PN Pertamina* and Stanvac. The holders of a mining concession for oil and gas, such as Shell, Caltex, and Stanvac were converted into contractors of the state enterprises. The work contract is an agreement that governs the distribution of profit sharing agreement. The work contract is characterized as that the management is under the power of the Contractor; all equipment that are purchased by contractor remains to be the contractor's property until the end of depreciation period; profit division is based on the profits of oil and gas selling in the ratio of 60% for the state and 40% for the contractor after being deducted the costs; the ownership of the produced oil and gas is under the power of the state; and the work contract enacts after being legalised by law.

In 1966 Ibnu Sutowo firstly introduced the profit sharing contract to the foreign contractors. There are several traits of the profit sharing contract as follows: (a) the management is under the power of the state; (b) there is an operating cost recovery; (c) there is a division of profits; (d) the tax will be charged on top of the operating activities of the Contractor; and (e) the assets belong to the state (state enterprise).

The profit sharing contract is a model that is developed from the concept of profit sharing agreement known in customary law and then codified in Act No. 2 of 1960. The profit sharing agreement means an agreement that is held between the owners on the one hand and the person or the entity law on the other hands known as "tenants" under which agreement the owner is allowed to carry out agricultural activities on the owner land with the profit sharing between the two parties. The concept is then developed into profit sharing contract for the mining of oil and gas.

Historically, the profit sharing contract was firstly implemented in Indonesia between Pertamina and Hapco in 1966. It was followed by other countries such as Malaysia, Guantemala, Libya, Egypt, Syria, Jordan, Bangladesh, Gabon, China and Myanmar. Generally, the profit sharing contract is described by Howard AR.Williams and Charles J. Meyers as:

"A contract for the development of mineral resources under the which the contractor's costs are recoverable each year out of the production but there is a maximum amount of production roomates can be applied to this cost recovery in any year. In many such contracts, the maximum is 40%. This share of oil produced is referred to as "cost oil" The balance of the oil (initially 60%) is regarded as "profit oil" and is divided in the net profit ratio royalties for instance, 55% to the government. After the contractor has recovered its investment, the amount of "cost oil" will drop to cover operating expenses and profit oil only increases by a corresponding amount."

The concept of the profit sharing contract is adopted in Article 12 of Act No. 8 of 1971 on Oil and Gas Mining Company which provides that the company may enter into cooperation with other parties in the form of Profit sharing contract. The concept of profit sharing contract is well received by a foreign contractor. In 1966-1975 there were 55 foreign companies that operated in Indonesia based on the concept. The profit sharing contract has been strengthened by Act No. 22 of 2001 on Oil and Gas. Article 1 point 19 of Act No. 22 of 2001 states that the cooperation agreement is a profit sharing contract or other forms of cooperation contracts on the exploration and exploitation activities that are more profitable for the state and which the results are maximally used for people prosperity.

3.2. Pattern of Oil and Gas Profit Sharing in Indonesia

A number of oil and gas agreements is still effectively enforced up to now. The profit sharing contract is one of the forms in managing the oil and gas. The government chooses the form because it provides advantages for both parties. The profit sharing contract becomes a principle for two parties' interest, the government and contractors who have good intention and good faith [15].

Since the first introduction in 1960, the profit sharing contract has gained tremendous responses, especially from developing countries that have abundant resources, but do not have the skills or technical knowledge to explore and exploit the resources. In addition, in bad situations of the concession contract, the governments of developing countries tend to lean towards the profit sharing contract as a tool to protect the political and economic attacks. The main goal of every government is to ensure the best method that is able to recover some cooperation from their natural resources. Increasing the government's profit is the ultimate goal of the profit sharing contract. It is very important for the developing countries that strive to exploit the resources for economic interests, but they do not have the experience or technical expertise and financial burden for the activities .In profit sharing contract, the contractor will hold petroleum operations in certain areas with their own risk, own costs and more importantly under the control of the state as the owner of oil and gas resources.

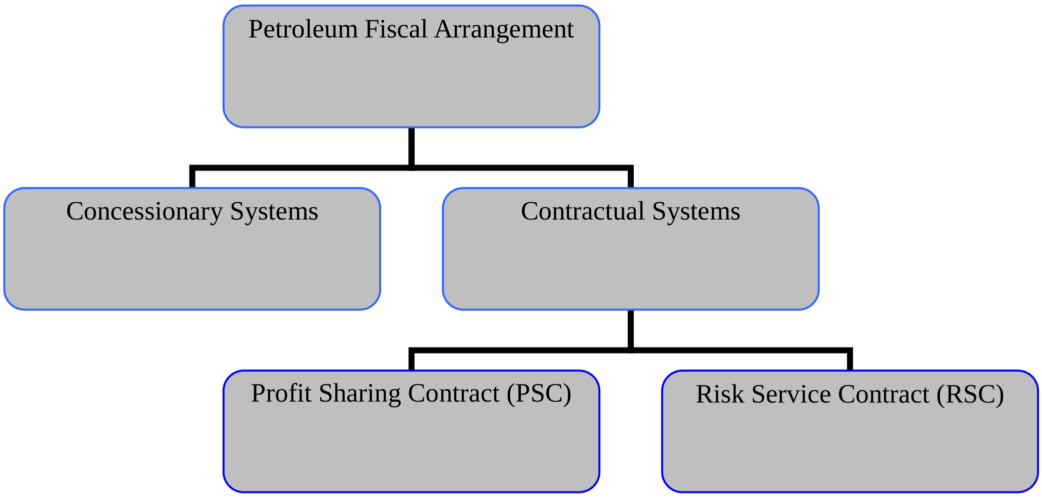

Figure 1: System of Oil and Gas Management

The profit sharing contract which is adopted by many countries around the world is derived from Indonesia [16]. The profit sharing contract was firstly implemented in Indonesia between *Pertamina* and Indonesian Independent American Petroleum Company (IIACO) in 1966. It is next adopted by several countries such as Malaysia, Guatemala, Libya, Egypt, Syria, Jordan, Bangladesh, Gabon, China and Myanmar. Historically, Ibnu Sutowo is an initiator to implement the profit sharing contract on oil and gas when he designed the system in earlier of 1966. He has implemented the profit sharing contract as an agreement system of the oil and gas in Indonesia. He has seen injustice prices and costs on the past profit sharing from contractors. Indonesia has undergone changes of profit sharing contract that comprise three generations, that is: (a) the first generation of profit sharing contract in 1966; (b) the second generation of profit sharing contract in 1976; and (3) the third generation of profit sharing contract in 1978. The last generation underwent changes in 1984.1988 and 1989 [17].

In the profit sharing contract, the government as the owner of working area of oil and gas mining turns over the management to the "peasants" or contractors i.e. the oil and gas companies, National Oil Company (NOC) and International Oil Company (OIC). Both oil and gas contractors, IOC and NOC, came and bought with their own capital all needs to work on the area. All expenditures the contractor distributes must be approved by the government as the land owner, because when the "harvest" comes, all costs spent by the tenants will be recovered. The costs will be recovered if the "harvest" is successful. On the contrary, if it fails, the loss is fully borne by the contractor. In the profit sharing contract, after being reduced the operating costs, the oil and gas profit is shared based on the agreement that is regulated in the profit sharing contract. The profit sharing contract refers to Act No. 22 of 2001. The sharing will be further regulated in the lower regulations on the profit sharing contract. One of the implementing regulations is the Government Regulation No. 35 of 1994 on Requirements and Guidelines for the Profit Sharing Contract on Oil and Gas.

Article 16 of the Government Regulation No. 35 of 1994 stipulates that the profit sharing is determined by Minister of Mines and Energy Affairs. If the sharing is based on the profit sharing contract, the third generation, the profit sharing is as follows: oil: 85% for *SKK Migas* or the Government and 15% for contractor; and Gas: 70% for *SKK Migas* or the Government and 30% for the contractor.

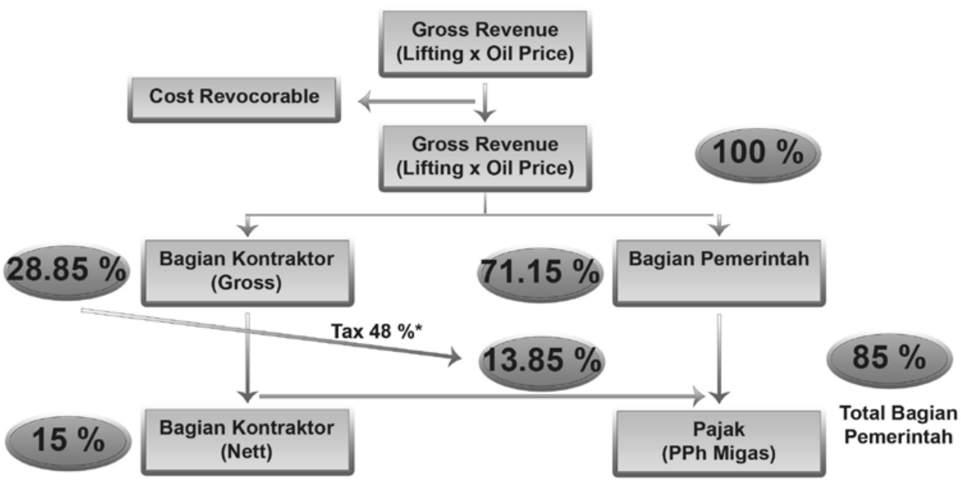

Figure 2: Oil Profit Sharing Contract in Indonesia

3.3. The Cost Recovery in the Profit Sharing Contract Pursuant to Act No. 22 of 2001 on Oil and Gas

Article 6 of Act No. 22 of 2001 on Oil and Gas regulates that upstream activities conducted and controlled through the profit sharing contract shall contain at least the following requirements: (a) the ownership of natural resources remains to be on the power of the government until the point of delivery, (b) controlling the operational management is under the Executive Agency or *SKK Migas*; and (c) costs and risks are entirely borne by the contractor [18]. The important point to be observed on the profit sharing contract is the operating cost or the cost recovery. The operating cost is defined as all the expenses and liabilities incurred to carry out the petroleum operation. The operation covers the exploration, development, extraction, production, transportation and marketing which are authorized in the contract, including the costs incurred to purchase the capital expenditures such as area/land, buildings, production facilities, after being bought, as state capital expenditure. Daniel Johnston defines the cost of oil as "a term commonly applied to profit sharing contract that refers to the oil (or revenues) used to reimburse the contractor for exploration, development and operating costs incurred by the contractor."

Normatively, the cost recovery has been stipulated in the Government Regulation No. 79 of 2010 on the Refundable Operating Cost and Income Tax Enforcement in the Upstream Sector of Oil and Gas with reference to the Tax Act No. 41 of 2008. The costs that can be included as the cost recovery is the expense incurred by the contractor directly related to oil and gas exploration and production operations in Indonesia as stipulated in Article 12 of the Government Regulation No. 78 of 2010.

The cost recovery will ensure an access for the government to determine the future production and economic benefits, whereas for contractors to determine all the operating costs of production if there are a new profitable invention, opportunities of better market price of crude oil in the world, and reducing some conflicts of responsibility relating to local resources and investment.

Article 7 of the Government Regulation No. 78 of 2010 regulates that contractors obtain cost recovery in accordance with the work plan and budget approved by the Head of the Executive of Implementing Agency for Oil and Gas, after working area has resulted commercial production. The operating costs consist of (a) exploration costs that include costs of exploration drilling, geological and geophysical costs, general and administrative costs on exploitation activities and depreciation costs; (b) exploitation costs that cover the direct costs of oil and gas production, gas processing costs, utility costs, general and administrative costs and depreciation exploitation; and (c) other costs that include the costs of moving gas from the point of production to point of delivery and costs of post operative activity of upstream activities.

The cost recovery can be returned in the calculation of profit sharing and that the income tax must fulfill the following requirements such as that the recovery shall aim at obtaining, collecting and maintaining the income in accordance with the provisions of the law and it is directly related to petroleum operations in the contractor-concerned area in Indonesia; that it shall use a reasonable price uninfluenced by special relationship as referred to the Tax Act; that the petroleum operations shall be in accordance with the rules of business practices and good technical; and that oil operations shall be in accordance with the work plan and budget approved by the Head of the Executive of Implementing Agency for Oil and Gas. The cost recovery having been incurred by the contractor in the profit sharing contract means that the contractor firstly has a duty to bail out the costs for necessary operations which the costs are repaid from the selling profits or by taking part of the produced oil and gas.

Implementing Agency for Oil and Gas controls on stepping activities that in early impending the costs, pre-audit is done through approval of Plan of Development (POD) and the project as outlined in the Authorization for Expenditure (AFE); in executing the costs, the current audit is carried out by implementing guidelines for the reference work for contractors in the procurement of goods and services; and after the costs have been determined and the work has been off, the post-audit is carried out with general auditing procedure [19].

The profit sharing contract part VI entitled the Recovery of Operating Costs and Handling of Production Article 6.1.2 regulates that the contractor shall recover all operating costs out of the sales proceeds or other disposition of the required quantity of crude oil equal in value to such operating cost which is produced and saved hereunder and not used in Petroleum Operations. Except as provided in clauses 7.1.4 and 7.1.5, the contractor shall be entitled to take and receive and freely import such crude oil. For purposes of determining the quantity of crude oil delivered to the contractor required to recover said operating costs, the weighted average price of all crude oil produced and sold from the contrac area during the calendar year will be used, excluding however deliveries made pursuant to clause 5.2 .15. If, in any calendar year, the operating costs exceed the value of the crude oil produced and saved hereunder and not used in Petroleum Operations, then the unrecovered excess shall be recovered in succeeding years.

The cost recovery starts from 40% during the first generation of the profit sharing contract (1966-1976), then changes up to 100% in the second generation of the profit sharing contract (1976-1978), and the cost recovery period changes from seven years to 14 years. This change is made as the response of two events. Firstly, the government reacts to oil price increasing and hopes that the increasing will continue. Therefore, the government increases the oil profits. Secondly, based on the rules of the Internal Revenue Service, United State of America companies are not eligible for a foreign tax credit. The first generation of the profit sharing contract provided for tax payments will be done by the contractor to the government. The third generation of the profit sharing contract, introduced in 1988, shows that the flexibility increases. The costs approved when oil prices decrease, production cost increasing and international competition are tightened for the purpose of capital risk [20].

4. Conclusions

The management of the profit sharing contract on oil and gas in Indonesia is regulated in Act Number 22 Year 2001 on Oil and Gas and in the Government Regulation No. 35 Year 2004 and the Government Regulation No. 55 of 2009 on Upstream Business of Oil and Gas. Upstream activities conducted by business entities or permanent enterprises based on the profit sharing contract with the Executive of Implementing Agency for Oil and Gas. The signed profit sharing contract is in written version notified to *Dewan Perwakilan Rakyat (DPR)* or Houses of Representatives. Characteristics of the profit sharing contract cover the management under the power of the government, operating cost recovery, profit sharing, taxation and asset ownership under the power of the state.

The profit sharing on the management of oil and gas in Indonesia is obtained from result of oil and gas production after having been deduced by the operating costs that are shared between the state and the contractor. The net division is generally 85% for the state and 15% to the contractor for oil production and 65% for the state and 35% to contractor for natural gas production.

The government should immediately provide facilities and incentives for contractors of the National Oil Company and International Oil Company who will apply oil and gas businesses in Indonesia, because the oil and gas reserves from year to year decrease, so that it is necessary to immediately find new wells for the purpose of fulfilling the national oil and gas supplies. Therefore, the government should immediately revise Act No.22 Year 2001 on Oil and Gas for the purpose of fulfilling the current contractors' needs.

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