

# INDONESIAN LEGAL FRAMEWORK IN THE OIL, GAS, ENERGY AND MINING SECTORS; INCLUDING DISPUTE RESOLUTION

by

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Throughout history Indonesia has been famous for its natural resources. Archeological evidence points to an early Indonesian understanding of the metallurgy of copper and tin even prior to the first millennium BC<sup>1</sup> and almost certainly an understanding of the value of gold and its fabrication into jewelry. Early Chinese references mentions Java as a source of salt, dammar, camphor and sandalwood in AD 13<sup>2</sup>. Cloves from Maluku had reached Rome by 72 AD<sup>3</sup>. Oil from Aceh had probably been known from time immemorial, but the first reference to it in Europe dates from 954 AD<sup>4</sup>. The ancient Greeks, in particular Ptolemy, may also have known about Indonesia's oil. In the late 1500s some early Dutch explorers brought Indonesian crude oil back to Holland "where it was held in high esteem for treating rheumatism and sciatica"<sup>5</sup>. Thus it can be seen that the ownership and management of Indonesia's natural resources is not an historically recent phenomenon created by either colonialism or the industrial revolution and its ensuing demand for raw materials.

Dealing with foreign interests over natural resources has been a significant part of Indonesia's commercial history for a period of over three millennia, almost certainly longer than it has in the west. Interest in Indonesia's oil would have risen rapidly with the invention of the internal combustion engine and the motor car, but even prior to that time

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<sup>1</sup> Belwood, Peter "Prehistory of the Indo-Malayan Archipelago", University of Hawaii Press, Revised Edition, 1977, p. 255.

<sup>2</sup> Ooi Jin Bee "The Petroleum Resources of Indonesia,". Oxford University Press, 1982; p 1

<sup>3</sup> *ibid.*, p. 275.

<sup>4</sup> Van Bemmelen, R.W. "The Geology of Indonesia Vol II – Economic Geology", Second Edition, Nijhoff, The Hague, 1970.

<sup>5</sup> *Ibid.* p 7

Indonesian crude oil had provided kerosene for fueling household lamps in South East Asia over the last two centuries.

Against that rough background, let us now address our topic firstly by examining the general philosophical approaches to the ownership, exploration and exploitation of mineral resources, first generally and then, specifically, the Indonesian approach.

### **International Legal Regimes in Mining**

Different systems of law are applied by different countries to regulate their oil and gas production industries depending upon their natural resource philosophy and their basic Constitution. As a general rule, the systems of law governing minerals, including oil and gas, can be divided into three basic categories plus a combination of these three:

Firstly, a system known as "*Regalia*", which historically meant rights belonging to the monarch, or today: the state. In this legal system, all minerals below the surface of the earth are owned by the state. In some countries, the state may, and does, give to private parties the right to explore and exploit such minerals. Such a system is applied in Australia, among other countries. With a few minor exceptions, in general Australia recognises the separation of the rights over the land from rights in the minerals below the surface.

Secondly, a system in which the ownership of the minerals below the surface is an integral part the ownership of the land above it. In such case, the owner of land also possesses the full right of ownership of the minerals lying beneath the surface of such land. This system is applied in the United States of America and in some parts of Australia. In such jurisdictions, any individual who owns land automatically becomes the owner of any minerals found thereunder.

Thirdly, a system in which the whole of the mineral resources below the surface of the land belongs to the people of the country and is not transferable nor assignable. Indonesia applies this system, whereby the state, as custodian for the Indonesian people, holds these rights in trust and administers the exploration and exploitation of these mineral rights. In this case exploration and exploitation may be directly carried out by the state or state enterprises, or by private parties based upon some nature of joint operating contract.

Fourthly, some countries apply a combination of these systems, or may allow their political subdivisions to determine which system is to be applied. In Australia, for example, although generally the system of *Regalia* is applied, in some states, such as Tasmania and Western Australia, the land owner is recognized as the owner of the minerals thereunder<sup>6</sup>, while in others, such as Victoria, exploitation of the minerals is permitted to be undertaken directly by the private sector.

In the Middle East, some countries apply the same system as we do here in Indonesia and others a combination, as applied in Australia. In Saudi Arabia, the government grants concession rights to the private sector under an agreement with the government, which covers all mining activities - from exploration to export of the extracted minerals, including petroleum products, but excluding domestic sales. The private sector, including foreign parties, are granted very comprehensive rights, as can be seen from the 1933 Concession Agreement between the Saudi Arabian government and Standard Oil Company of California, which provides to Standard Oil, *inter alia*: “...the exclusive right... to explore, prospect, drill for,

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<sup>6</sup> These land titles are termed “Imperial Grants” or, in some states of Australia, “Victorian Title” which grant both land rights and mineral rights extending to the centre of the earth. These titles were issued during the reign of Queen Victoria and many of such titles had their mineral rights ceded back to the state at by federal legislation in 1901 or were extinguished upon subsequent transfer to other parties.

*produce, process, manufacture, deal with, transport and export...".* All contracts relating to the petroleum industry in Saudi Arabia must be executed directly with the kingdom's government since it is only the kingdom that truly owns the natural resources. The kingdom then receives royalties from the private sector contractor, in a similar manner to Indonesia's Contract of Work system. Iran, on the other hand, applies fully the same system as we do in Indonesia, with the minerals under the ground being the property of the state, and management delegated to a state enterprise, in that case the National Iranian Oil Company ("NIOC"), as set out in the Deed of Petroleum, dated 31 July 1957. The private sector may share in the resource through cooperation arrangements with NIOC.

### **Indonesia's Regulations during the Dutch Colonial Period**

During the Dutch colonial period, which lasted for over 350 years until the declaration of Indonesia's independence on 17<sup>th</sup> August 1945, the colonial government reserved to itself all mining rights, oil and gas included. This policy was relaxed gradually, so that by the 1850's mining rights could be afforded to private enterprises under an executive order.<sup>7</sup>

Exploration for oil and gas has been conducted in Indonesia since 1869, commencing approximately 14 years after the drilling of the first oil well in the world - in Pennsylvania, U.S.A. The first well was drilled in Indonesia in 1871. In 1883, the first oil concession was granted in North Sumatera to Royal Dutch Shell. By the turn of the nineteenth century, oil was being produced in north and south Sumatera, central and east Java, and Kalimantan, with 18 companies exploring for oil. One of these companies was the Shell Transport and Trading Company, owned by an Englishman, Marcus Samuel. Originally the company traded in sea shells and spices, then moved into oil shipping and then into oil exploration and ultimately production. It merged with Royal Dutch Company in 1907

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<sup>7</sup> Kusumaatmadja,, Muchtar; "Mining Law", Padjajaran University, Bandung 1974, p 2.

becoming Royal Dutch Shell, one of the major players in today's petroleum sector.

In Dutch colonial times, the mining of minerals, including oil and gas production, was governed by the "*Indische Mijnwet*" of 1899, as amended in 1904 and further amended in 1918. This *Indische Mijnwet* provided, *inter alia*, that:

- (i) The government granted concession rights to the private sector to explore and mine minerals and/or to produce oil;
- (ii) The period of any such concession right would not exceed 75 years.
- (iii) Holders of concession rights were required to pay land rent to the colonial government in accordance with prevailing regulations; and
- (iv) Minerals produced from concession areas became the property of the concessionnaires. Concessionnaires were thus free to sell or export their product, without the necessity of obtaining further permission from the Government.

The amendment of 1904 provided that concession rights could only be granted to Dutch citizens, residents of the Netherlands East Indies or companies established under the laws of the Netherlands or of the Netherlands East Indies. This was introduced in an attempt to limit the number of new companies applying for exploration concessions, particularly gold tenements.<sup>8</sup> At that time there had been several stock market scams perpetrated in Holland over what were claimed to be enormous gold deposits in Sumatera: a precursor to the Bre-X scandal in Kalimantan almost a century later.

In 1912, Standard Oil of New Jersey, a major US-based oil company – one of the "Seven Sisters" - through its Dutch subsidiary, *Nederlandsche Koloniale Petroleum Mattschappij* ("NKPM"), obtained concessions in Jambi, South Sumatera and Bunyu, East Kalimantan. NKPM eventually became

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<sup>8</sup> Ibid p.3.

known as PT. Stanvac Indonesia. In the period from 1924 to 1940, the Jambi field produced over 60 million barrels of crude oil.<sup>9</sup>

A further amendment in 1918 opened the possibility for non-Dutch foreign interests to obtain concession rights, but only for a period of up to 40 years, rather than the 75 granted to Dutch or colonial entities. Such concessionnaires would then pay an excise duty to the colonial government of 4% of crude oil production and a 20% tax on oil profits and 20% tax on corporate profits.<sup>10</sup> These were comparable to prevailing Middle East contracts.

Agreements made between the colonial government and foreign interests were based upon Article 5A of the *Indische Mijnwet*, and thus such agreements came to be known as “5A Contracts”.

The Netherlands East Indies Government, having opened the door to the entry of foreign interests for oil exploration and production concessions, found that by 1924 over 119 such concessions had been granted.<sup>11</sup> In view of this apparent attractiveness of the colonial administration’s terms, in 1928 the government, as governments predictably do in these circumstances, amended the legislation to provide somewhat more favorable terms for the government, including:

- Reduced tenure to 40 years;
- Drilling obligations were imposed;
- Area relinquishments were introduced for areas of low exploration prospectiveness;
- State royalties were introduced;
- Progressive profit share was introduced, amounting to as much as 20% of net profits.

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<sup>9</sup> Ooi Jin Bee, Op. Cit. p 4.

<sup>10</sup> Ibid, p.3

<sup>11</sup> Ibid, p. 4.

In 1930, another US major, Standard Oil Company of California (“SOCAL”), formed an Indonesian subsidiary, *NV Nederlandsche Pacific Petroleum Maatschappij* (“NPPM”), which was granted the Rokan block in Riau, Central Sumatera. Later, in 1936, NPPM and The Texas Corporation formed a joint venture company known as The California Texas Oil company (“Caltex”), which has become one of Indonesia’s major oil producers, discovering the Minas and Duri fields.

Apart from the oil industry, the colonial government controlled and operated a substantial part of the hard mineral mining industry. It controlled a large part of the tin mining industry, owned and operated coal mines and a gold/silver mine, and as well held a substantial share in *Netherlands Indische Aardolie Maatschappij* (“NIAM”), an oil exploration joint venture between Shell and the colonial government. This concept of government participation in the hard minerals mining industry carries through to the present day, with state corporations such as PN. Aneka Tambang (now privatized and listed on international stock exchanges), PN. Tambang Timah and PN. Tambang Batu Bara<sup>12</sup>. owning and operating mines, as well as acting as partners with foreign mining companies.

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 to their armies of occupation and further invasion plans. Control of all mining activities in Indonesia were 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.

At the end of the war, the “Big Three” oil companies (Shell, Stanvac and Caltex) were keen to return to Indonesia and entered into agreements first with the Dutch and later with the newly-formed government of the Republic of Indonesia.

## **Regulations after Indonesia’s Independence**

### **A. Transitional Period**

Article 33 of the 1945 Constitution (“UUD 45”), 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.”*

Although UUD 45 had been enacted a day before Independence was declared, the laws and regulations implementing UUD 45 with respect to oil and gas mining were not drafted and passed by legislation until 1960. Between the time of independence and the enactment of Law No. 44 of 1960 – The Oil and Gas Law (“UU 44/60”), exploration and production in the petroleum industry in Indonesia sank to their lowest levels, and were administered under the transitional regulations of UUD 45.

A similar, although longer, hiatus was experienced in the mineral exploration industry until the Provisional Mining Law, Law No 37 Prp<sup>13</sup> of

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<sup>12</sup> These three state corporations were established by Government Regulations Nos. 21, 22, and 23 of 1968.

<sup>13</sup> “Prp” stands for *peraturan pemerintah pengganti*, which translates as emergency presidential legislation.



1960 (“UU 37 Prp/60”) was completed into its final form, in 1967, and promulgated as the Basic Mining Law .

The concept of UU 44/60 and UU 37 Prp/60 was initiated in 1951 by a motion made by Teuku Mohammad Hassan, an Achenese member of the then DPR-S (*Temporary People’s House of Representatives*). He urged that the *Indische Mijnwet* be reviewed due to its incompatibility with the spirit of UUD 45. To some extent Hassan’s motion reflected increased and understandable nationalism in the new republic and anti-foreign sentiments generated by what was viewed at the time as the privileged position of “The Big Three” in relation to exchange controls and other benefits. Hassan’s motion was unanimously accepted by the DPR-S, but it effectively stalled further investment in the oil industry until UUD 44/60 was passed. It was in this period Dutch citizens were expelled from Indonesia and Shell was nationalized, which filled the international investment community with a considerable degree of caution in their sovereign risk analyses for Indonesia.

#### **B. Implementation Period of UU 44/60 and UU 37 Prp/60**

UU 44/60 was enacted on 26 October, 1960 under the title: “Oil and Gas Mining”. This law reaffirmed the basic principle of the Indonesian state, as mentioned in Article 33 of UUD 45, 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. UU 44/60 provides, *inter alia*, that:

1. All oil and gas found within the territory of Indonesia is national property and controlled by the state.
2. Oil and gas mining shall only be carried out by the state and be implemented only by state enterprises.
3. The Minister of Mines may appoint other parties as contractors of the state enterprise if necessary.

4. Contracts of Work between the state enterprise and any contractor must be legalized by law.
5. The authority to mine shall not include any surface land rights.
6. Should any land rights, which are not a state right, overlap with area of any mining authority, the land owner will be compensated.

Similar provisions were contained in UU 37 Prp/60 for hard rock mining, but were held in abeyance until the Mining Law of 1967 was promulgated. It was upon the eventual 1967 Mining Law that the First Generation Contract of Work for Hard Minerals with Freeport Indonesia Inc., dated 7<sup>th</sup> April 1967, for the Ertzberg gold/copper deposit in the Indonesian province of Papua was based.

In the oil industry, the “Big Three” balked at these new provisions. They saw the old concession system scrapped in front of them with a re-affirmation of state rights over natural resources and an increased government share to 60%. The Indonesian Government requested them to comply as contractors to the state. Negotiations with the “Big Three” seemed deadlocked until the government negotiated a proto-Production Sharing Contract (“PSC”) with a US-based company, Pan American Indonesia Oil, an international subsidiary, of Standard Oil of Indiana, in 1962. This proto-PSC contained all the elements of the new legislation, including cash bonuses, production bonuses and a 30 years’ tenure. Finally, with this political coup in hand, an ultimatum was issued to the “Big Three” (accept our terms or lose the concession). Seeing that the government had recently been nationalising a number of foreign agricultural projects, the contractors conceded and on 1<sup>st</sup> June 1963, in Tokyo each entered into in what became known as the Tokyo Agreement<sup>14</sup>. Salient points of that agreement included:

- Relinquishment of all rights granted under the former colonial government and acceptance to act as a contractor to one of the three state oil companies.

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<sup>14</sup> Ooi Jin Bee, *op.cit.* p 21.

- Twenty-year extensions were granted to existing production areas; with consent to apply for additional acreage with a 30 year tenure.
- Marketing and distribution to be surrendered to the state enterprises within five years, on an agreed price structure. As well, the contractors agreed to supply the state distribution organisation with products at cost-plus a fee of US 10 cents per barrel, for as long as required.
- Refineries would be surrendered to the state after a period of 10-15 years, according to an agreed price formula; subsequently the companies would be prepared to supply crude to state refineries at cost plus a fee of 20 US cents per barrel for as long as required.
- Operating profits would be split 60/40 between the state and the company respectively; and in any event the state would receive a minimum payment of 20 per cent of the gross value of produced crude in that year.

The other requirements of UU 44/60 obviously applied as well.

Following the enactment of UU 44/60, on 25<sup>th</sup> September, 1963, three Contracts of Work (“CoW”s) were concluded between the then three existing state oil companies and foreign oil companies. These were between:

- PN. PERTAMINA and PT. CALTEX PACIFIC INDONESIA, CALASIATIC and TOPCO;
- PN. PERMINA and PT. SHELL INDONESIA; and
- PN. PERMIGAN and PT.STANVAC INDONESIA.

These CoWs, were legalized under Law No. 14 of 1963, each for the period of 20 years, and provided, inter alia, that:

- The Contractor shall be responsible for the operational management of exploration and production of all oil and gas in the CoW area.
- The Contractor shall bear all financial risks as the result of operations.

- The period of tenure of the CoW shall be for 20 or 30 years.
- Ownership of Contractor's share of the petroleum products produced is transferred to Contractor only upon Point of Sale.
- The Contractor has the right of ownership of all equipment used in production or other operations relating to the petroleum products, through permitted depreciation. Once depreciated, all such equipment will belong to the state enterprise.
- The Contractor is obliged to relinquish acreage to the state enterprise, in accordance with an agreed-upon schedule.
- Revenues from sale of the produced oil and gas shall be shared: 60% for the state enterprise (including income tax) and 40% for the Contractor.
- The Contractor must allocate 25% of all production for the domestic market, if requested, at a price of US \$ 0.20 per barrel.

From this general format can be seen the seeds of the terms of the eventual Production Sharing Contract ("PSC")<sup>15</sup> which, in its final form, has since its inception satisfactorily governed the oil and gas industry in Indonesia up to today.

### **C. The Era of PERTAMINA**

In 1968, the three state corporations<sup>16</sup> previously responsible for the oil and gas industry were rationalized and merged into one: PN PERTAMINA, under a government regulation establishing the state oil and gas corporation. On 15 September, 1971, Law No. 8 of 1971 ("UU No. 8/71", also often referred to as the "PERTAMINA Law") was enacted, regarding the State Oil and Gas Mining Company (PN. PERTAMINA), serving as the legal basis for the incorporation of the current day Perusahaan Pertambangan Minyak dan Gas Bumi Negara ("PERTAMINA"). Here, for the first time the Production Sharing Contract ("PSC") is mentioned in Indonesian legislation.

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<sup>15</sup> It is understood that the conceptual origins of the Indonesian PSC derives largely from the one developed by the Norwegian Government to govern its oil and gas industry.

Unlike CoWs, PSCs entered into between PERTAMINA and its contractors (generally foreign oil companies) were no longer required to be approved by the Indonesian Parliament, as had the former Contracts of Work. After the enactment of UU No. 8/71, PERTAMINA entered into a large number of PSCs with foreign oil companies on a regular basis.<sup>17</sup> Since that time, no further CoWs were entered into by PERTAMINA.

Article 12 of UU No. 8/71 states that the requirements for and guidance on PSCs, will be stipulated in government regulations. However, although PERTAMINA, through its Foreign Contractor Coordinating Body (“BPPKA”<sup>18</sup>) issued comprehensive administrative procedures in 1980, in what was called the “Blue Book”, it was not until 1994 that the appropriate government implementing regulations for PSCs were issued, through Presidential Decree No. 35 of 1994 (“PP 35/94”).

PP 35/94 provides, among other things, that Production Sharing Contracts shall include at least the following matters:

- The management of the PSC shall be in the hands of PERTAMINA.
- The Contractor shall provide all funding, technology and expertise.
- All financial risks of operations shall be borne by the Contractor.
- The output of the production of petroleum products will be distributed between PERTAMINA and the Contractor based upon a percentage, as stipulated by the Minister of Mines, after deduction (and reimbursement to the Contractor) of operation expenditures. Thus Contractor is reimbursed for the cost of the operation, provided there is production sufficient to cover.

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<sup>16</sup> PN PERMINA, PN PERTAMIN and PN PERMIGAN

<sup>17</sup> It should be noted that a number of variants of the standard PSC have subsequently emerged. These include: Joint Ventures (JV) between PERTAMINA and a foreign oil company; Technical Evaluation Agreements (TEA) which grant to an oil company a limited period of data review on a specific area and, on tender, permits the oil company to match the highest bid; and Enhanced Oil Recovery (EOR) or Secondary Recovery Contracts to re-develop largely depleted oil fields.

<sup>18</sup> *Badan Pembinaan Pengusahaan Kontraktor Asing* (“BPPKA”).

- Contractor shall pay taxes in accordance with applicable tax regulations.
- The annual working plan and budget must be approved by PERTAMINA.
- All equipment and goods purchased for use in the operations shall be the property of PERTAMINA.
- The PSC shall be subject to the laws and regulations of the Republic of Indonesia.
- The necessity of Domestic Market Obligation (“DMO”).
- The PSC shall terminate automatically if oil and/or gas are not found in commercial quantities after 10 years.

**D. New Oil and Gas Legislation (Law No. 22 of 2001)**

For some time now, it has been widely recognised that Indonesia’s oil and gas industry was in need of a major overhaul with regard to general corporate efficiency, particularly in relation to regional autonomy – the devolution of power from Jakarta to the provinces and increased sharing of revenues derived from natural resources. Partially driving this desire for reform was an obvious comparison to be made between PERTAMINA’s performance and that of its Malaysian counterpart, Petronas. Petronas, originally created as a copy of PERTAMINA, has been in existence for only half the life of PERTAMINA but has proven a far more efficient corporation, producing 33 per cent of Malaysia’s oil and gas output compared with the 7.2 per cent of Indonesia’s produced by PERTAMINA.<sup>19</sup>

After predictable opposition from both PERTAMINA and the provinces, on 23 November, 2001, the new Oil and Gas Law, Law No. 20 of 2001 (“UU No 20/2001”) was finally passed, revoking previous

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19 . Newbery, Mark; ‘New Indonesian Oil and Gas Law’ in the International Bar Association Journal of Energy & Natural Resources, Vol 20, No 4, 2002, at p.356.

legislation (UU 44/60 and UU 8/71) and transferring total authority over oil and gas activities from PERTAMINA back to the government.

UU 20/2001 divides exploration and production of oil and gas into “upstream” and “downstream” activities. Upstream activities cover exploration and production, while downstream covers post-production activities such as refining, transport, storage, sales and trading.

Upstream activities are to be implemented and controlled through Cooperation Contracts with oil companies which shall be notified to the DPR (the Peoples’ House of Representatives) and supervised pro-tem by a new regulatory body, BP-MIGAS. Downstream activities are to be carried out based upon business licenses granted to Indonesian legal entities, and are to be supervised by a separate regulatory body as yet to be formed.

Each business entity, be it an Indonesian company or a foreign entity, may obtain rights over and operate in only a single contract area. This restriction is known as “ring-fencing” and remains unchanged from the prior legislative regime. The consequence is that costs and losses from one unproductive area cannot be offset against profits from a successful area for tax purposes. The period of a Cooperation Contract shall not exceed 30 years, with a possibility to extend for up to a further 20 years. The exploration period is 6 years and is included in the 30 years tenure period. The exploration period may be extended once but not for a period greater than 4 years. UU 20/2001 also states that if the appointed contract operator fails to commence exploration activities within five years, the entire contract area will be forfeit and returned to the Minister of Mines.

UU 20/2001 also sets out the obligation of the Contractor to allocate the optimum of 25% of all petroleum production, including gas, for the domestic market. All exploration data gained through general survey, exploration and production activities shall belong to the state and be controlled by the government.

Currently, eleven oil and gas blocks are on offer by the Ministry of Energy and Mineral Resources under the terms of the new Cooperation Contract, with attractive terms, including an after-tax production share for contractors of between 20 and 25 per cent for oil and between 35 to 45 per cent for gas<sup>20</sup>. To date some 36 oil companies have expressed interest. Bids close at the end of July and successful applicants will be announced in August, 2003.

### **Contracts of Work for Hard Minerals**

Because of its geological history, Indonesia has some of the most attractive mineral exploration potential in the world. Today it is a significant producer of gold, copper, coal and nickel and, in the past, also of tin. Compared with the oil industry in Indonesia, the hard minerals industry is currently considered the “ugly step-sister” by foreign investors. Successive generations of minerals Contracts of Work (“CoW”s) have been hampered by tax issues, forestry issues, divestment requirements and more recently by perceived local rights arising out of regional autonomy. Further, considerable delays have been caused by the requirement that each CoW be approved by both the DPR and the President.

Over the last twenty years Indonesia has seen two mineral exploration booms, largely stimulated by world commodity prices, primarily that of gold. In 1986, the Fourth Generation CoWs were signed and resulted in several short-lived commercial mines: Kelian and Mt Muro, and one long-term mine at Batu Hijau, Sumbawa. In 1997 literally hundreds of companies, from very small to very large ones, applied for the Sixth Generation CoWs. Some Seventh Generation CoWs were signed, but after the Bre-X scandal in 1998, there was a mass exodus of foreign mining interests from Indonesia.

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<sup>20</sup> Jakarta Post, 21<sup>st</sup> June 2003, p 13.



Today, there is still a proposed Eighth Generation CoW available, but there are very few explorers currently operating in Indonesia. A draft for a new mining law is slowly emerging, to address a wide range of issues and intended to bring the Indonesian Mining industry into line with accepted international practice and to reconcile it with the current draft Investment Law.

### **Settlement of Disputes in the Petroleum and Related Industries and Mining Industry.**

Petroleum industry contracts (early CoWs and PSCs) generally provided a mechanism for resolution of disputes between PERTAMINA and the Contractor arising out of or relating to each such contract. Production Sharing Contracts generally called for a two-tiered dispute resolution mechanism: attempt at amicable settlement and, failing that, arbitration. A standard dispute resolution clause for Production Sharing Contracts might read as follows:

*“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, which cannot be settled amicably, shall be submitted to the decision of an 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. The decision of a majority of the arbitrators shall be final and binding upon the parties. Arbitration shall be conducted in English, at a place to be agreed upon by both parties, in accordance with the Rules of Arbitration of the International Chamber of Commerce”.*

In the hard mineral sector, recent Contracts of Work also provided for settlement of disputes first through alternative/party-driven means, such as conciliation and, failing that, by arbitration, normally applying the UNCITRAL rules and held in Jakarta.

Arbitration awards are final and binding upon the disputing parties and cannot be contested on the merits. Courts do not have

jurisdiction to adjudicate disputes between parties who have agreed to submit their disputes to arbitration. Thus, except for matters reserved to the courts by law, or for enforcement of arbitral awards (or in limited circumstances their annulment), no recourse can be had to the courts under the Production Sharing Contracts or CoW's that call for resolution by arbitration.

Article 70 of Law No. 30 of 1999, regarding Arbitration and Alternative Dispute Resolution ("UU 30/99"), allows a party to contest an arbitral award, and thus allows the courts to annul one, only under the following circumstances:

- "(a) if 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) if, after the award has been rendered documents are founded which are decisive in nature and which were deliberately concealed by the opposing party; or*
- (c) if the award was rendered as a result of fraud committed by one of the parties to the dispute."*

A decision of the District Court annulling an arbitration award may be appealed to the Supreme Court.

Article 66 of UU 30/99 provides that International Arbitration Awards (those rendered outside of the territory of the Republic of Indonesia) shall only be recognized and be enforced in Indonesia under the following circumstances:

- "(a) The International Arbitration Award must have been rendered by an arbitrator or arbitration tribunal in a country which, together with the Republic of Indonesia, is a party to a bilateral or multilateral treaty on the recognition and enforcement of International Arbitration Awards.*
- (b) International Arbitration Awards, as contemplated in item (a), above, are limited to awards which, under the provisions of Indonesian law, fall within the scope of commercial law.*

- (c) *International Arbitration Awards, as contemplated in item (a), above, may only be enforced in Indonesia if they do not violate public order.*
- (d) *An International Arbitration Award may be enforced in Indonesia only after obtaining an order of Exequatur from the Chief Judge of the District Court of Central Jakarta.*
- (e) *An International Arbitration Award, as contemplated in item (a), in which the Republic of Indonesia is one of the parties to the dispute, may only be enforced after obtaining an order of Exequatur from the Supreme Court of the Republic of Indonesia, which order is then delegated to the District Court of Central Jakarta for execution."*

Through Presidential Decree ("Kepres") No. 34 of 1981, Indonesia ratified the 1958 United Nations New York Convention on the Recognition and Enforcement of International Arbitration Awards (the "NY Convention"), thereby agreeing to enforce arbitration awards rendered in any of the other countries party to such Convention (currently approximately 120 countries).

Article V of the NY Convention provides that recognition and enforcement of an award may be refused by a court, at the request of the party against whom it is sought to be enforced, if the contesting party can show, among other things, that:

"....

*"(b) The party against whom the award in invoked was not given proper notice of the appointment of the arbitrator or of the arbitration proceedings or was otherwise unable to present his case; or*

.....

*(d) The composition of the arbitral authority or the arbitral procedure was not in accordance with the agreement of the parties or failing such agreement, was not in accordance with the law of the country where the arbitration took place;"*

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Paragraph 2 of Article V of the NY Convention further states that

*" The recognition or enforcement an arbitral award may also be refused if the competent authority in the country where such recognition and enforcement is sought finds that:*

- (a) *The subject matter of the difference is not capable of settlement by arbitration under the law of that country ; or*
- (b) *The recognition or enforcement of the award would be contrary to the public policy of that country."*

Despite clear and comprehensive dispute resolution clauses in these contracts, there have not, to the knowledge of the writers, been any disputes between contractors and either PERTAMINA or any of the regulatory bodies party to any of the hard mineral CoWs which have gone to arbitration. There have been a number of disputes between contractors and local authorities relating to land utilization, taxes, environmental cleanup, and there have been some manpower disputes as well, but none of these are contractual disputes falling within the dispute resolution provisions of the relevant contracts and thus they are not arbitrable.

The only arbitration in which PERTAMINA has been directly involved in a dispute with one of its contractors recently has been one relating to energy production. This has been a matter of major interest internationally and thus merits discussion.

### **The Karaha Bodas Case**

Recently the District Court of Central Jakarta annulled an international arbitration award rendered in Geneva by a tribunal of three foreign arbitrators, against PERTAMINA and PLN in the second set of arbitral references concerning private power production projects which failed in the wake of the Asian economic crisis of 1997-1998. While not relating specifically to oil and gas, but to geothermal exploration and production of electric power, this case is nonetheless of current and topical interest.

After the collapse of the Rupiah in late 1997 and early 1998, on the insistence of the International Monetary Fund (the "IMF"), the Indonesian government issued regulations (Keppres 37/1997 jo. Keppres 5/1998)

suspending a number of infrastructure projects, including certain of the 27 private power contracts that had been entered into in the five or so preceding years. Although the regulation which enabled foreign parties to build, own and operate power plants in Indonesia called for pricing to be denominated in Rupiah, many of the contracts nonetheless called for payment denominated in United States dollars. When the Rupiah depreciated sixfold against the dollar, the effective price of energy called for under the private power agreements increased sixfold, making it impossible for the state-owned electricity company (PLN) to meet the payment obligations where the power plants were built and ready to produce. Almost all of the private power producers (“IPPs”) have since renegotiated these contracts and many are on line and producing. Only two such groups, neither of which had been involved in Indonesia previously, and neither of which had as yet completed plants licensed to produce, opted to bring arbitration against their Indonesian contractual partners for anticipatory breach (no actual energy having as yet been provided) seeking damages in the amount of the full anticipated profits for the expected 30 year term of their contracts, plus the amounts already expended, being only a small percentage of their contractual project expenditure obligation.

In 1994 Karaha Bodas Company, LLC. (“Claimant”), a special purpose vehicle established by several United States companies together with an Indonesian company owned by the son of a former Vice President of Indonesia, entered into a Joint Operating Contract (“JOC”) with Indonesia’s state oil company, PERTAMINA for exploration and exploitation of the geothermal resources (steam) in a certain project area known as Karaha Bodas, and also entered into an Energy Sales Contract (“ESC”) with both PERTAMINA and PLN for the construction of a power plant and production of electrical energy for ultimate use by the public. Claimant also claimed in the arbitration that it had also received a letter of comfort, backing up its financing, from the Minister of Finance. As it happens no such letter had ever been executed by the Minister and the

unsigned draft submitted by claimant was later rejected by the tribunal in a preliminary award.

Claimant brought one single arbitration reference under the three above-mentioned distinct instruments, each of which had its own arbitration clause calling for *ad hoc* (non-institutional) arbitration in Geneva applying United Nations UNCITRAL rules, against the parties to the three instruments (PERTAMINA alone in the case of the JOC; PLN and PERTAMINA in the case of the ESC and the Minister of Finance under the alleged comfort letter). None of the Indonesian parties had consented to consolidate these arbitrations together into one and before they (PLN, PERTAMINA and the Minister) had had an opportunity to contest jurisdiction, or even determine which party or parties were entitled to appoint an arbitrator or arbitrators, the Claimant caused the designated appointing authority, ICSID, to appoint a single Egyptian arbitrator, unfamiliar to any of the respondents, as party-appointed arbitrator for all three. Thus none of the Indonesian party respondents had the opportunity to participate in the appointment of the arbitrators.

In the arbitration, held in Geneva, this tribunal, consisting of a Frenchman, an Italian and the Egyptian appointed for all of the Indonesian parties, after releasing the Minister of Finance from the reference on the basis that no comfort letter had in fact ever been executed, issued its award in favor of the Claimants, on 18 December, 2000, awarding very substantial damages (almost 300 million U.S. dollars) to the Claimant against PERTAMINA and PLN, covering both the costs claimed to have been expended, together with interest thereon, and anticipated profitability for the 30+ years of the expected life of the contract.

The Claimant neither registered nor sought to enforce the award with the Central District Court, as required for enforcement under UU 30/99, but rather sought enforcement in various other jurisdictions, in the US, Hong Kong, Canada and elsewhere, against Indonesian assets held in

such jurisdictions in the name of PERTAMINA on behalf of the Indonesian treasury. The U.S. courts found that approximately 5% of these assets belonged to PERTAMINA and that these could be attached for satisfaction of the award.

PERTAMINA and PLN sought to contest the award in Switzerland but were unsuccessful. PERTAMINA therefore brought an action in the District Court of Central Jakarta to annul the award based upon various procedural and substantive defects and breach of natural justice, primarily that none of the Indonesian parties had had the ability to participate in the designation of the arbitrators, and on other public policy grounds. The US District Court for the Southern District of Texas then issued contempt orders against PERTAMINA for seeking annulment in the Indonesian court.

On 19 August 2002 the District Court of Central Jakarta issued its decision<sup>21</sup> in favor of the Plaintiff, PERTAMINA, and annulled the award, primarily based upon breach of natural justice in the appointment of the arbitral tribunal and consolidation of the proceedings without party consent. It also found presumed fraud in the calculation of damages, which the tribunal had not examined when the same was asserted by respondents in the arbitration. It must also be noted that the tribunal had declined to consider either the fact that the Claimants had not performed their own obligations or the question of validity of the underlying JOC and ESC contracts, which were not tendered as required by governing law (Keppres 16 of 1994) and were assumed to have been granted through KKN (*corruption collusion and nepotism*).

The Claimant has appealed to the Supreme Court, which has not yet rendered its decision, but it is hoped that that court will not bend to

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<sup>21</sup> *Perusahaan Pertambangan Minyak dan Gas Bumi Negara ("PERTAMINA") v. Karaha Bodas Company, LLC. and PT Perusahaan Listrik Negara [Persero] ("PLN")* (Decision of the District Court of Central Jakarta No. 86/PDT.G/2002/PN.JKT.PST)

foreign pressure but will confirm the decision of *Pegadilan Negeri Jakarta Pusat*.

On Friday, 20 June, 2003, the 5th U.S. Circuit Court of Appeals in New Orleans annulled an earlier decision by a U.S. District Court in Texas blocking PERTAMINA from seeking the annulment in the Indonesian court system, and ordering them in contempt for so doing. The US Court of Appeals held that there was no need or legal basis to interfere in the proceedings in Indonesia, thereby implying that the Indonesian court was well within its rights to annul the award.

The ultimate result of Karaha Bodas's appeal to the Indonesian Supreme Court, as well as the fate of the various attachment actions in the U.S., Canada, Hong Kong and elsewhere, remain uncertain as of time of writing.

*Jakarta, 24 June, 2003*