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# Production Sharing Contract: Is It Within Private or Public Domain?[1]

**Achmad Zen Umar Purba**[2]

*Investment is always requires government attention including on the oil sector. Production Sharing Contract (PSC) is an agreement constitutes the regime of utilizing the interest of state is constitutionally used to the greatest possible extent for the prosperity of the people. PSC is part of Foreign Direct Investment (FDI) since it involves the private equity of foreign investors. Thus, PSC in one hand is a private contract and it belongs to the private domain, in the other hand, state as the owner of natural resources is act as a party in this business transaction. This paper discusses Production Sharing Contract, whether it is in private or public domain.*

***Keywords:*** *Production Sharing Contract, Cost Recovery, Contract Law*

## I. Introduction

It is interesting to note the statement made by the new appointed Minister of Energy and Mineral Resources, Dr. Darwin Zahedy Saleh, claiming that there should be no capping of operational cost recovery (hereinafter abbreviated "CR"). In his words, "such capping is causing concern, as it would hamper investment"[3]. The Minister's statement needs to be observed carefully, as the direction of the discourse on CR in the natural oil and gas mining sector which continues to attract a lot of attention is apparently due to take a reversed course. As stated by the Minister, now the focus of attention is on the security of investment flow.[4] Certain circles within the House of Representatives ("DPR") have been voicing the opinion for a long time that CR should be capped. In the meantime, the Indonesia Petroleum Association ("IPA") has been warning against including the CR in the State Revenues and Expenditures Budget.

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[1] Expanded from the author's seminar notes delivered at the seminar: The Energy Law Forum organized by Bimasena & Forum Hukum Energi, Jakarta, 26 May 2009.

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[3] Antara, 2 December 2009.

As CR is governed in the production sharing contracts ("PSC"), [5] signed between the State of the Republic of Indonesia as the "owner"[6] of oil resources on the one hand, and contractors on the other it is therefore very appropriate to first of all consider the legal relationship, especially due to the special nature of the object of PSC and the parties involved. Accordingly, as requested by the forum organizer, this paper will deal with the subject of PSC, namely from the perspective as to whether it is part of the private or the public domain. Whether, for example, with the government's role as the owner (*penguasa)* of natural, or oil resources in this case with an extremely strong authority, it can intervene in the substance of PSC assuming that PSC is within the public domain. Is PSC truly a contract entered into by parties of equal standing, who have the interest to complement each other for achieving a business purpose, and based on the mutually agreed provisions including the methods for dispute settlement and in accordance with applicable contract law. The specificity of this particular sector which is related to natural resources derives from the mandate given to the state to develop these national assets with an optimal outcome for the prosperity of the entire nation.

[4] Investment is still vital for Indonesia. For instance, in this first week of November 2009, President Soesilo Bambang Yudhoyono stated that there is a need for an average of Rp.2 thousand trillion of funds per year in order to achieve 7 % growth by the year 2014. This message of the President addressed to the new Chairperson of Investment Coordinating Board ("BKPM") was earlier conveyed by the Vice President – adding that out of the said amount, only 20 % could be made available from the State Revenues and Expenditures Budget (ABPN). In the context of Foreign Direct Investment ("FDI"), there is a long queue of countries in need of this private equity. Therefore, the facilitation of business activities is one of the primary indicators. At the same time, it has not been easy to do business in Indonesia. Based on the survey conducted by the World Bank (WB) in view of various regulations in 183 countries, Indonesia ranks number 122 – an improvement from previously 129. However, this position is extremely disappointing in comparison to several other neighboring countries such as Malaysia ranking 23, Thailand 12, Vietnam 93 and China 89. See A. Zen Umar Purba, "Dua Ribu Triliun dan Kepastian Hukum" (Two Thousand Trillion and Legal Certainty), Media Indonesia, 30 November 2009, Kolom Pakar (Expert's Column)

[5] Production Sharing Contracts, hereinafter referred to as "PSC" has been translated into Indonesian in official publications as "kontrak bagi hasil" (KBH), although in my personal view it is more appropriate to translate it as "kontrak bagi produksi" (KBP); see Achmad Zen Umar Purba, Kepentingan Negara dalam Industri Perminyakan di Indonesia: Hukum Internasional, Konstitusi dan Globalisasi (The State's Interest In the Oil Industty In Indonesia: International Law, the Constitution and Globalization), in JURNAL HUKUM INTERNASIONAL (INDONESIAN JOURNAL OF INTERNATIONAL LAW), Vol. 4/2, January 2007 ("Purba I"), p. 268 et.seq.





In addition to the above, the development of oil resources is heavily related to strong international nuances, which has been the case ever since this black gold was discovered. The history of developing countries' owning natural resources cannot be disregarded, and neither can be disregarded the impact that it has had on the development of international law, particularly in the context of foreign investment[7], a topic that requires special discussion.

The Energy Law Forum in mid-2009 discussed this issue, and one of the sub-topics was whether PSC belongs to the private or the public domain.

## II. The Scheme of Oil Development

1.The Era Prior to PSC and Law 44/1960

Before entering discussion on the main issue, the map of oil exploration in Indonesia with the CR aspect will first be reviewed.

The logical question that arises based on the basic thought that natural resources are controlled by their owner, in this case the State of the Republic of Indonesia, is related to the type of working relationship involved in the development of such resources. Considering that the state controls oil resources, the question is whether it going to be based on issuing licenses or based on contract[8]. The history of oil industry in Indonesia has indicated that following the concession era, contract or agreement (contract of work and PSC) has been the legal framework applied.

[6] In accordance with the wording of the 1945 Constitution, natural resources which are national assets are "controlled by the State". However, in this paper the word "penguasa" (controller) is used interchangeably with the term "owner" (pemilik) implying to have the equivalent meaning.[7] See Achmad Zen Umar Purba, "PERANAN SUMBER DAYA DAN INVESTASI ASING DALAM PERKEMBANGAN HUKUM INTERNASIONAL KONTEMPORER" (THE ROLE OF RESOURCES AND FOREIGN INVESTMENT IN THE DEVELOPMENT OF CONTEMPORARY INTERNATIONAL LAW). Inaugural Speech as Full Professor (Gurubesar) at the Faculty of Law, Universitas Indonesia, Depok, 7 September 2005 ("Purba II") p. 23.et.seq. See also Peter Muchlinski, Policy Issues, in Peter Muchlinski et.al. (Eds.), THE OXFORD HANDBOOK OF INTERNATIONAL INVESTMENT LAW. (Oxford: Oxford University Press, 2008), p. 6 However, the popular polarization between developed and developing countries will seemingly need a kind of restructuring as today China has been amazingly making significant leap in economic term.

[8] Licensing system has been determined for coal and other minerals as governed in Law No.4/2009 concerning Mineral and Coal Mining (State Gazette of the Republic of Indonesia 2009/4; Supplement to the State Gazette 4959).

[9] See Purba, II, p. 47.

There has not been much literature written about the concession issue .However what needs to be emphasized is that under the concession system, the mining party is granted the right to conduct mining activities in a certain area. Under the concession system, such right is general in nature, thus one of the greatest criticism of the concession system is that the right to conduct mining can potentially expand to extremely broad authorities which can practically cause the mining party to also exercise authorities as the owner of the concession area concerned.

Viewed from another dimension, granting mining rights under the concession system can cause the state, as the owner of such resources, to become losing control with the industry of the resources. Consequently, it would totally remain dependent on foreign investors.[9] In Indonesia, the issuance of Law No.44/1960 concerning Natural Oil and Gas Mining[10]("Law 44/1960") led to a change in the pattern of oil industry. The following was stated in the General Elucidation on Law 44/1960:

"Foreign companies have so far obtained concession rights on mining areas based on the aforementioned *"Indische Mijnwet"* and thus have authority over the natural oil and gas products obtained as a result of such mining activity conducted by them, which is contradictory to the Constitution."

Following that, no mining right was granted to private companies, including foreign companies. The General Elucidation on Law 44/1960 went on further in stating the following:

"It is no longer possible for foreign companies to obtain mining rights on certain areas in Indonesia. It is only possible for State companies to possess a certain natural oil and gas mining area, and even such right is different from the old concession right."

The concept of natural resources being "controlled" by the state is reflected in the instrument of mining authority (*kuasa pertembangan* hereinafter briefly referred to as "KP")[11], the holder of which has the mandate to implement the development of natural resources in compliance with the 1945 Constitution. KP covers the entire territory of Indonesia, which all mining area[12].

[10] State Gazette of the Republic of Indonesia 1960/133; Supplement to the State Gazette No 2070. Before passed as a law, it was known as Government Regulation In Lieu of Law No. 44/1960

[11] "KP" is a juridical term used in almost all mining laws that have ever existed, including the law currently in effect.





2. The Objective of *Oil* Development

Law No. 22/2001 concerning Natural Oil and Gas[13] ("Law 22/2001"), which has replaced Law 44/1960, applies the PSC system. However, before go on to elaborate further on the PSC itself; let us take a look at the background of oil development.

Pursuant to Law 22/2001, there are 6 objectives of oil development, five of which include the following:[14]

First, from the aspect of the interest of the oil industry itself, this law is aimed at maintaining and safeguarding the development of the said industry, namely by ensuring effectiveness in the implementation and control of exploration and exploitation activities, in order to make them effective, efficient, highly competitive and sustainable through an open and transparent mechanism. The issue of safeguarding the viability of the oil industry is of a high strategic significance anywhere in the world. Under Law No.11/1967 concerning General Mining[15], we know of three types of mining products, namely: strategic, vital and class C products. Oil was classified under the category of strategic products.

Second, the strategy is formulated in the form of guaranteeing the fulfillment of domestic needs, namely ensuring efficiency and effectiveness in natural oil and gas supplies, either as source of energy or as raw material for domestic needs. Domestic consumption has been on the increase, which has compared negatively to the continuously decreasing national production potential.

Third, the competition aspect under the current economic conditions has become important, in order to create a more viable industry, thus causing national potentials to become more competitive at the national as well as at the international level. Law 22/2001 states as follow[16]:

[12] Or wilayah kuasa pertambangan ("WKP").

[13] State Gazette of the Republic of Indonesia 2001/136. Supplement to State Gazette No.4152.

[14] Article 3 of Law 22/2001.

[15] State Gazette of the Republic of Indonesia 1967/22; Supplement to State Gazette No. 2831

[16] Art. 3[17] Article 11 (1) Law 22/2001;

"Support and develop national potentials in order to become increasingly competitive at the national, regional and international level."

In the era of global economy today, competition is one of the links of the chain. Regardless of the critique of the concept of global trade, one thing is for certain, namely that there is a need to develop national potentials in order for them to become competitive. By changing the structure of the oil industry under Law 22/2001, it is exactly this kind of effect that is expected to be achieved. As already mentioned previously, in the upstream sector, an opportunity is given not only to permanent establishments *(bentuk usaha tetap,* hereinafter briefly referred to as "BUT"), but also to other business entities or national companies, including PT Pertamina (Persero)[17], to operate.

This provision has the nuance of reform: national parties are given the equal standing as that of foreign companies. To PT Pertamina (Persero), this is a logical consequence of the revocation of KP from Pertamina's authority under the old regime.[18] Therefore, this ideal objective imposes a burden on the policy implementing parties to work hard in order to prove the various arguments supporting the enactment of this Law 22/2001.

Fourth, the aspect of state revenues consisting of tax and non-tax revenues. This is the most important aspect, even though the law itself does not put it in the first place. It is part of our national endeavors aimed at ensuring that the state does not suffer a loss. CR is an important part, as the issue related to its the payment can potentially cause a loss to state revenues.

Fifth, this is a sequence of the above described objective, related to the social aspect of prosperity, namely prosperity in general such as the creation of job opportunities, an equitable distribution of prosperity, including the protection of the environment.

In order to achieve the above mentioned objectives, two fundamental aspects need to be developed, namely: ownership and management (*penguasaan* and *pengusahaan),* two inter-related and complementary issues. Ownership is reflected in the legal relation of "controlling" the development of the oil resources as described here below. Such ownership is provided for in the context of upstream and downstream activities. Upstream activities consist of exploration and exploitation. Law 22/2001 expressly provides that upstream business activities are implemented and managed based on a cooperation agreement (*kontrak kerja sama* or briefly referred to as "KKS") which consists of:

[17] Article 11 (1) Law 22/2001;





"Production Sharing Contracts or other forms of cooperation in Exploration and Exploitation activities which are more beneficial to the State and the products thereof are used to the greatest possible extent for the prosperity of the people.[19]"

The development scheme becomes obvious: there are two elements here, namely "implementation" and "control". This control aspect is a special characteristic of contracts related to natural resources, because the state, through the government, remains in control. Unlike concession, under the KKS, KP remains in the hands of the government. It is in such context that the contractor, pursuant to its name, acts as the party working for the holder of KP. The controlling role is further spelled out in the articles providing for the legal relation between the two of them. In other words, the government, being a party to the contract, must be necessarily bound by the provisions of the contract concerned.

## III. Production Sharing Contract

1.The Creation of PSC

The development of oil resources, as of other minerals, has unique characteristics. Oil resources are non-renewable and strategic resources, with a transnational character, as the economics of this commodity are highly dependent on the international market. Furthermore, the development of oil resources is a substance mandated by the 1945 Constitution, especially under Article 33 (3). Another dimension is the substantial involvement of foreign parties, as a result of Indonesia's, as other developing countries', inadequate potentials for the extraction of minerals, and for generating revenues for the state and the people.[20]

[18] PT Pertamina (Persero) is totally different from Pertamina as further discussed below.It comes as no surprise that some people claim that, in practice, this new legal regime has seemingly diminished Pertamina's role..

[19] Article 1 item 19 jo. Article 6(1) Law 22/2001. This law refers to the legal relation between BP Migas and the contractor as "cooperation contract" (kontrak kerja sama), which can be in the form of PSC.

It has been in the context of the latter dimension that the concept of PSC was created: seeking a way to develop oil resources without the owner having to expend any money at all. As mentioned previously, the contractor is to obtain its CR if it is successful in discovering the source of oil. In other words, if the contrary is the case, the contractor does not obtain the CR. Moreover, in the event of a foreign contractor's involvement, all capital goods imported into the customs area of Indonesia, are declared as the government's property to be used for operational purposes in the oil industry concerned. The remaining portion of production is to be shared based on a certain percentage between the government as the owner of the resources, and the contractor concerned.

PSC in the field of oil industry first became known since Indonesia started its endeavors for revitalizing the oil industry by a total physical as well as non-physical restructuring.[21]

The latter involved the legal relation between the state of the Republic of Indonesia (as the owner of resources) and investors. As discussed earlier, ever since the Dutch times up to the first years of independence, the oil industry was based on the concession framework, namely the granting of full authority to third parties to conduct mining operation to the full extent during the designated period of time, granting full authority, including in administrative aspects, thus making no distinction between the concession holder and the authorities in the area controlled by it as concession holder.

From the historical point of view, we can see that PSC did not originally start out in its form as we know it today. Rather than that, it went through the transition process form contract of work (*kontrak karya*), which was applicable to minerals in general. It was during Pertamina's golden years that the PSC started to be developed. Undoubtedly, the PSC can be considered as a brilliant concept, although a similar scheme can also be found in agricultural management patterns in rural areas. Almost all oil mining contracts in developing countries are now applying the PSC pattern. As stated by Prof Sornarajah in his writing[22]:

[20] This is also in line with our extremely high level of dependency on FDI, as emphasized by the Minister, and as stated in Chapter I hereinabove.

[21] See inter alia: Tengku Nathan Machmud, THE INDONESIAN PRODUCTION SHARING CONTRACT: AN INVESTOR'S PERSPECTIVE, (The Hague: Kluwer, 2000,) pp. 51-52; the author of this article has quoted extensively from this book in Purba I,op.cit. The most recent one is Madjedi Hasan, KONTRAK MINYAK DAN GAS BUMI BERAZAS KEADILAN DAN KEPASTIAN HUKUM (OIL AND GAS CONTRACTS BASED ON JUSTICE AND LEGAL CERTAINTY). (Jakarta: Fikahati Aneska, 2009), pp. 185 et.seq.





The production sharing agreement, pioneered by the Indonesian state owned company, Pertamina, became the industry-wide agreement that came to replace the concession agreement, reflecting the changes that had been effected.

Sornarajah goes on to write as follows[23] *:* Indonesia was a pioneer in introducing the new arrangements into the petroleum industry. They were widely-copied.

*2. PSC Control*

In the context of control, Law 22/2001 prescribes for KKS to include provisions on the following[24]:

a. State revenues;
b. Working areas and the relinquishment ;
c. Obligation to expend funds;
d. Transfer of ownership of products obtained from natural oil and gas production;
e. Term of validity and conditions for extending contract;
f. Dispute settlement;
g. Obligation to supply natural oil and/or gas for domestic needs;
h. Termination of contract;
i. Post-operational mining obligations;
j. Work safety and health;
k. Environmental management;
l. Transfer of rights and obligations;
m. Reporting requirements;
n. Site development plan;
o. Prioritizing the domestic use of goods and services;
p. Development of surrounding communities and guaranteeing customary community rights;
q. Prioritizing the use of Indonesian manpower.

[22] M. Sornarajah, Op.Cit., pp. 82, 134-135; Cf. Rudioro Rochmat, CONTRACTUAL ARRANGEMENTS IN OIL AND GAS MINING ENTERPROSES IN INDONESIA. (Rockville: Stijhoff, 1981).

All of the above specified substantive items reflect the national interest as the owner of natural resources – which, in my view, is a manifestation of the term "control" exercised in the development of oil resources.

The requirement to include the mentioned substantive items originates from the three main conditions that must be included in PSC, namely that[25]:

1)the ownership of oil resources remains in the government's hands, up to the point of submission;
2)operations are managed by Badan Pelaksana Kegiatan Usaha Hulu Minyak dan Gas Bumi[26] ("BP Migas");
3)The capital and risks are fully borne by the contractor concerned.

These three matters are the main pillars of PSC. The ownership of natural resources is the reflection of dimension of controlling natural resources by virtue of the 1945 Constitution.

Management is the consequence of the first pillar. The nature of contract, which is based on mutual agreement, is combined with the confirmation of the government's role which remains in a dominant position, as management has an extensive meaning. This is part of the obligation to control the use of oil resources in line with the mandate of the 1945 Constitution. In other words, this is a form of manifestation of the state's responsibility to its people in the development of natural resources. That is one of the reasons, to be further elaborated below that Law No. 25/2007 on Investment Law[27] ("Law 25/2007") for instance relates CR to potential corruption. On the other hand, such circumstances do not change the status of PSC as a private contract. The government is not able and legally not allowed to intervene in the substance of the contract, including CR.

3. Cost Recovery: A Control Facility

CR is a part of control facilities on the government's side, and is in line with the third pillar that the capital and risks are the obligations of the contractor. In general, CR contains two basic provisions based on agreement. First, the

[23] M. Sornarajah, Op.Cit, p. 42n25.
[24] Article 11 (3) Law 22/2001.
[25] Article 6(2) Law 22/2001.
[26] On this agency, it will be further discussed below27 State Gazette of the Republic of Indonesia 2007/67; Supplement to State Gazette No. 4724.





contractor's right to "recover operating costs", however, with the limitation of "only commercially produced", and second CR consists of "Exploratory Expenditures" and "all Capital Costs and Non Capital Costs".[28]

There has been lately a number of discussion on CR, affected by various factors, both external related to the soaring of world oil prices[29], as well as internal, *inter alia* the decrease in the national domestic oil production, but a substantial increase in domestic consumption, causing Indonesia to become an oil importer. The culmination of these issues lies in the relation between CR and the potential of corruption. The latter originates from the scheme, according to which although there is no direct expenditure by the state for the payment of CR, it ultimately affects the revenues of the state of the Republic of Indonesia which has the authority over its oil resources. Moreover, as the issue of CR is related to foreign investment, the criminal sanctions provided for in Law 25/2007 must also be taken into account, namely in the event of unlawful payment of costs referred to as " recovery cost markup", which according to this law means [30]:

an expense incurred in advance by an investor, the amount of which is unreasonable and will subsequently be calculated as expenditure for investment activities at the time of determining the Government's share.

Therefore, it is quite obvious that CR does not stand along – even though this subject has been frequently discussed as if CR were not a part of a large system. This is very understandable, bearing in mind the extremely strategic nature of oil resources,[31] which is also related to the above mentioned mandate of the 1945 Constitution. Second, the issue of CR is clearly within the practical domain, as CR is merely a matter of application. For instance, there has been a suggestion to reduce the number of items treated as CR so far, from 33 to only 17.[32] That is why; however, the above mentioned views of Minister Zahedi and IPA are highly relevant.

[28] The text of Article VI of the PSC concerning CR is as indicated in Attachment I
[29] Even though at the time of starting to write this paper the price was below US$ 100 per barrel, it was relatively still high.
[30] Elucidation on Article 33(3) of Law 25/2007. On different view, see Madjedi Hasan. p.213.
[31] Under previous general mining legislation, Law 11/1967, mining products were classified as strategic, vital and not belonging of either of these two categories; oil was "strategic"

Another important matter is that CR is a link in the overall legal scheme which serves as a platform for the relationship of cooperation between the owner of natural resources and the contractor.. Accordingly, studying CR should always be done in conjunction with its framework, namely the PSC itself. In other words, CR is a derivative of the reform in the process of thinking about the previously applicable mining concept, according to which foreign parties had the full enjoyment of an area with oil resources, by managing the same in the form of a concession, thus granting full mining rights to mining companies[33].

*4. BP Migas as Party to PSC*

The inclination to underestimate the significance of CR comes from the incertitude related to the status of PSC. On the state's side, for the purpose of signing a contract, the government has established BP Migas.[34] This body has been stated as a "State owned legal entity" (*badan hukum milik negara).* [35] Regardless of how it is legally called, the party entering into contract is a representative of the state. By the establishment of BP Migas, the state through the government has granted exclusive authority to this agency to sign the PSC. KP, rather than being transferred to BP Migas, has remained in the hands of the government.[36] Despite of such transfer, this legal act would not change anything, unless it is made based on a law as was the case when Pertamina was stipulated as the holder of KP by virtue of Law No. 8/1971[37].

[32]Letter of BP Migas and the Minister of ESDM No: 1431 dated 29 February 2008. At the same time, the DPR's Fuel Price Increase Inquiry Commission would be looking into the indications of corruption in oil cost recovery. Member of the Inquiry Commission, Rama Pratama, said that in the report of the Audit Board ("BPK") there were indications of such corruption. kapanlagi.com, 17 July 2008 (05.27WIB).accessed on 19 July 2009, at 09.55 a.m.

[33] In Indonesia, the concession system had been applied ever since the colonialization era, Indische Mijnwet 1899 (S.1899 no.214 jo. S 1906 no.43; see also Detlev F.Vagts, TRANSNATIONAL BUSINESS PROBLEMS. (New York: Foundation Press, 1998). p.500

[34] Articles 4(3) and 44(3) sub-article b of UU 22/2001

[35] Article 45(1) and elucidation jo. Article 1 item 23 of Law 22/2001

[36] Article 4 (2) of Law 22/2001

[37] State Gazette of the Republic of Indonesia 1971/76; Supplement to State Gazette No. 2971.





The presence of the government as a party to the contract does not in any way change the status of PSC as a private contract. It becomes quite obvious here that the government undertakes activities within the scope of *jure gestionis*, rather than *jure imperii*.[38] The state is a party, which in the words of Lord Denning in English Court of Appeal, 1979[39]:

When the government of a country enters into an ordinary trading transaction, they cannot afterwards be permitted to repudiate it and get out of their liabilities by saying that they did it out of high governmental policy or foreign policy or any other policy. They cannot come down like a god on to the stage the *deux ex machina*, as if they had nothing to do with it beforehand. **They started as a trader and must end as a trader.** They can be sued on the courts of law for their breaches of contract and for their wrongs just as any other trader can. **They have no sovereign immunity.**

The state which becomes party to a contract has been intended to take the position of a private business actor, unrelated to public authority which requires certain conditions to be met in order to enter into a public contract based on statutory provisions. Under international law, absolute and limited liability have been long known concepts.

5. Approval by the Minister

Another matter that needs to be discussed is that PSC is signed by the Minister of ESDM with the following note:

Approved by the Minister of Energy and Mineral Resources this .... day of..... on behalf of the Government of the Republic of Indonesia.

With regard to this approval by the Minister, it is not at all to change the legal position of the government as a party to this private transaction, in this instance represented by BP Migas.

This is only a part of the control function, due to the special nature of contracts related to natural resources. In other words, the approval of a person

[38] Jure gestionis (law of management): the state engages in non-governmental activities; jure imperri (law of command): the state implements governmental functions. Ray August, INTERNATIONAL BUSINESS LAW. (Upper Saddle River: Pearson Prentice Hall, 2003), pp'.156-157.uj n.

[39] Quoted from ibid.

who has the highest authority in the oil sector is merely a part of the oversight function of the government as regulator. Furthermore, this contract witnessing is in favor to foreign contractors as they obtain a kind of guarantee that they are in correct track by concluding PSC. As will be discussed herein below one of the major investors' concerns is stability.[40]

After all, one has to bear in mind that BP Migas, as the party signing PSC, is only the government's proxy.

6 Provisions on Dispute Settlement

The PSC provides for dispute settlement in a chapter with the title "Consultation and Arbitration"[41], which basically contains two substantive matters: amicable settlement referred to as non adjudication settlement, and settlement through adjudication.

BP Migas and the contractor concerned would meet periodically to discuss the implementation of petroleum operations as provided for under the PSC, making their utmost efforts to amicably settle any disputes that may arise. Similarly, in the event of a dispute, endeavors would be made for amicable settlement within 90 days as from the time of receiving notification by one of the parties about a dispute. However, if such endeavors for amicable settlement fail, the dispute will be brought to arbitration based on the UNCITRAL Arbitration Rules.

In the PSC, the agreement of the parties to this effect is evident from the following wording:

Dispute pursuant to Sub-section . . . ,which cannot be settled amicably, shall be submitted to the decision of arbitration by a three (3) person arbitration panel conducted in accordance with the UNCITRAL arbitration rules . . . . .

BP Migas and the contractor concerned would each appoint an arbitrator and these two arbitrators appoint a third arbitrator. There is also a provision concerning the involvement of ICSID in the event that the parties fail to appoint

[40] Although this is not a comparative study, it is appropriate to see experience in other countries concerning the concerns of foreign oil contractors. See, e.g. Chijioke E. Emole. RECENT LEGISLATIVE DEVELOPMENTS IN PRODUCTION SHARING CONTRACTS IN NIGERIA, 2 International Energy Law & Taxation Review, 2000,

[41] Section XI PSC concerning CONSULTATION AND ARBITRATION as attached.





their respective arbitrators. The arbitral award is final and binding on the parties. However, that is not all. The parties are bound to refrain from submitting the dispute arising from a PSC to any court other than the arbitration institution thus agreed upon by them. The relevant PSC provision in this respect reads as follows:

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

This form of dispute resolution indicates that the contract is a private contract, and the agreement of the contracting parties implies that they submit to the jurisdiction of arbitration, as a non-public institution.

7. The Role of the House of Representatives ("DPR")

In relation to DPR, Law 22 /2001 provides as follows[42]:

The House of Representatives of the Republic of Indonesia must be notified in writing of every Cooperation Contract[43] signed . . .

With the above provision, the law places DPR in a passive position. On 13 August 2007, eight DPR's members filed for judicial review of this provision. They basically requested the Constitutional Court that this provision be declared as contradictory to the 1945 Constitution, namely Articles 11 (2), 20A(1) and 33(3)(4). In various points of their argument, they also stated that in reality the realization of this notification takes a long time. At the same time, several KKS have inflicted a loss on potential state revenues. They also pointed out that the implications of Article 11 (2) of the 1945 Constitution include KKS,

[42] Article 11(2) of Law 22/2001

[43] They used the term "kontrak kerjasama" which legally includes PSC..

due to its broad and fundamental impact on the life of the people, posing a burden on state finances. It is therefore appropriate for KKS to be first approved by DPR prior to being signed by the parties concerned. Interestingly, however, in their view KKS falls under the category of: "other international agreements" as intended in Law No. 24/2000 concerning International Agreements[44], thus requiring the approval of DPR rather than just a notification.

The Constitutional Court rejected the petitioners' request, considering them to have no legal standing or *locus standi* to file the petition, as they were the official members of an institution which had officially adopted the above mentioned law. In fact, their request could have been addressed by DPR itself, under the mechanism of legislative review.

The Constitutional Court's refusal was highly appropriate, as it was able to meet the people's sense of justice. The only reason, if any, to regret such refusal is that we have no way of knowing the Constitutional Court's actual standpoint on the issue at hand.

## IV. Contract under Indonesian Civil Law

### 1. The Main Elements

In Indonesia, commercial contracts are provided for in the *Burgerlijk Wetboek* ("BW")[45] — which basically sets forth the following minimum requirements for the validity of a contract:

1. Consent
2. Capacity
3. A certain matter
4. A lawful cause[46]

In order to consider the applicability of elements 1 and 2, it would be appropriate to quote several initial phrases from the recitals of PSC, which read as follows**:**

**WHEREAS,** all mineral oil and gas existing within the statutory mining territory of Indonesia are national riches controlled by the State; and

[44] State Gazette of the Republic of Indonesia 2000/185; Supplement to the State Gazette of the Republic of Indonesia 4012.

[45] See Prof. R Subekti and R. Tjitrosudibio, Kitab Undang-undang Hukum Perdata (Civil Code) (Jakarta: PT Pradnya Paramita, 1992, which is a translation of BW.

[46] Article 1320 of BW





**WHEREAS,** in accordance with Law No. 22/2001/. . ., the Government of the Republic of Indonesia has an "Authority to Mine" and wishes to promote the development of the Contract Area and appoint **CONTRACTOR** in accelerating the exploration, and development of the resources within the Contract Area; and

**WHEREAS,** in accordance with Law No. 22/2001. . . . , **BP MIGAS** is authorized to enter into this **CONTRACT** and to oversee Petroleum upstream business activities carried out by **CONTRACTOR** in the Contract Area; and

**WHEREAS, CONTRACTOR** represents that it has financial ability, technical competence, and professional skills necessary to carry out the Petroleum Operations hereinafter described, and is willing to enter into this **CONTRACT** with **BP MIGAS** under the terms and conditions described herein.

All of the above quoted four phrases clearly fulfill elements 1 and 2 of Article 1320 of BW – both from the government's, as well as from the contractor's points of view. Three out of the above quoted phrases refer to the government/BP Migas and one refers to the contractor concerned, which can be further elaborated as follows:

(1) the status of oil resources is that of national assets "controlled by the State"
(2) KP is held by the government; and
(3) the authority of BP Migas to sign the contract.

In the context of the requirements of a contract under BW, the key word is that in addition to the above recitals, the

CONTRACTOR . . . . is willing to enter into this CONTRACT with BPMIGAS under the terms and conditions described herein.

This provision indicates the existence of consent and the capacity to act in accordance with the terms and conditions mutually agreed upon based on elements 1 and 2 described above.

Requirements 3 and 4, which are also referred to as objective requirements, refer to a clear object, namely the development of oil resources, a transaction which complies with the law and is lawful.

BW contains the principle of the freedom of contract, rooted in the legal principle of civil law which originates from Europe, more specifically from the

Napoleónic Code. This concept is known as the doctrine of *pacta sunt servanda*, namely that a contract or agreement must be respected by the parties that have made it because it applies as law to them. Prof. Ole Spiermann analyses *pacta sun servanda* that "bindingness and equality between parties are constituent elements of any contract."[4747] Ole Spiermann,

Applicable Law, in Peter Muchlinski et.al, (Eds), THE OXFORD HANDBOOK OF INTERNATIONAL INVESTMENT LAW. (Oxford: Oxford University Press, 2008), p. 94. Prof. Sornarajah is of the view that pacta sunt servanda is a reflection of the doctrine of the sanctity of contracts.[48].

2.Stability vs. Sovereignty

The legal relation serving as a framework for oil development, just as FDI, is a long-term relation for an average of 30 years. However, it is not only a matter of being concluded for a long term, but the concern is more related to political stability, as described by Andreas Ziegler and Prof. Louis Philippe Gratton[49]*:*

Many investment opportunities exist in emerging economies but for multinational companies concerns about uncertain policy environments and perceptions of political risk often inhibit investment. The paradox is that countries that need investment the most are more or less identical with those that are prone to facing an unstable political environment.

Investment protection has been reflected in various avenues in the context of international investment law. One of them is stablization clause ("SC").. Several international arbitral awards can be traced in relating to SC. For instance, the Kuwait-Aminoil 1961-1973, even though it is not an SC in the actual meaning of the word.....*[50]. Prof Sornarajah refers to SC as an essential factor in the

[47] Ole Spiermann, *Applicable Law*, in Peter Muchlinski *et.al*, (Eds), THE OXFORD HANDBOOK OF INTERNATIONAL INVESTMENT LAW. (Oxford: Oxford University Press, 2008), p. 94.

[48] M. Sornarajah, Op.Cit., p.421.

[49] Andreas Ziegler and Louis Philippe Gratton, Investment Insurance, in Peter Muchlinski et.al, (Eds), Op.Cit., p. 525. Cf. I.A.Shearer, STARKE'S INTERNATIONAL LAW. (London: Butterworths, 1994)("Starke", pp. 342 et.seq.

[50] Read the discussion on SC related to the case of Kuwait v. Aminoil; Andreas F. Lowenfeld,, INTERNATIONAL EONOMIC L;AW. (Oxford: Oxford University Press, 2008), p. 506 et.seq





legal relation of FDI. Furthermore, in the case of Shappire, the Sheik of Kuwait stated that he would not make a regulation that would be contradictory to or that would change an earlier signed contract[51].

Up to the present time, there has been no agreement as to whether SC can be included as a standard concept in FDI. This depends on the sovereignty of a state which has the legislative authority to change any regulation within its own domestic jurisdiction.[52] Does that mean that in the long term a state, which has full sovereignty over its own territory, is not allowed to make any changes in the contract concerned?

Prof Sornarajah writes that one of the objections made by states in this respect based on the issue of the authority of the official making the SC. The French Court was of the view that a state is not bound by a contract only because its officials have signed it. In other words, there are other requirements as well. [53]

The concept referred to as *rebus sic stantibus* ("RSS") then emerged, which in principle implies a fundamental change of circumstances. According to its history, this RSS concept started to emerge following world war one, at a time when conditions in Europe experienced an economic setback as a consequence of the war. Following this concept, there will always be a reason for the government, as a party to PSC, to intervene in the contract due to changes considered by the state as extremely important.

This term of RSS is not used in international law. However, in the Vienna Convention on the Law of Treaties there is a provision on "Fundamental Change of Circumstances", consisting of two paragraphs. Paragraph 1, which is relevant for the purpose of this discussion, states as follows

A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of the treaty, and which was not foreseen by the parties.

[51] M. Sornarajah, Op. Cit., p. 409.; In Model Cosession Agreement for Oil Developemnt in Egypt, for instance there are provisions under the heading: "Stabilization, but this is also subject to the parties' approval. Similarly under Model Production Sharing Agreement 2004 in Tanzania but the issue is related to changes in legislation.

[52] Ibid , p. 407.

[53] See his intensive elaboration relating oil development contracts, Ibid. pp. 416 et.seq.

[54] Starke, Op.Cit., p. 431.

These circumstances are not applicable, unless their existence: "constituted an essential basis of the consent of the parties to be bound by the treaty", and the effect of such change "is radically to transform the extent of obligations still to be performed under the treaty"[54].

Based on the above elaboration, it can be concluded that fundamental change of circumstances must be in view of matters already existing but not of proper attention. To date, this concept of RSS has not been known under Indonesian law; therefore there has been no case that could serve as reference. In other words, every change made to a contract remains within the control of the parties concerned.

## V. Conclusion

1. Investment requires the government's serious and utmost attention, particularly nowadays amidst the prevailing trend of investors' market, including in the oil sector. Our attitude, which reflects the need for foreign investment, is within the pragmatic practical realm, meaning that the need for foreign investment is not a strategic orientation, as it is not the objective. Therefore, we should not allow this attitude contradictory to the mandate of the 1945 Constitution, in this case related to controlling and managing natural resources.
2. PSC, as one type of cooperation contract based on Law 22/2001, is a unique form of agreement as it constitutes the regime of utilizing the interests of the state which, in the case of Indonesia, are constitutionally used to the greatest possible extent for the prosperity of the people. Similarly to other developing countries, Indonesia does not possess adequate financial and technological capacity to be fully self-sufficient in conducting upstream mining activities.
3. The development of oil resources through PSC is a part of FDI as it involves the private equity of foreign investors. Therefore, PSC is a private contract and it belongs to the private domain.
4. The three main pillars of PSC, namely the status of oil resources controlled by the state/government, the management conducted by BP Migas and the funds provided by the contractor concerned do not in any way affect the private status of PSC.
5. Under contemporary international law, it is common for a state to act as





party in a business transaction. The concept of *jure gestionis* is a breakthrough in this respect – which is beneficial for both parties.
6. The oversight role of authorities in controlling PSC, including the position of authorities as signatory of PSC, does not in any way reduce the meaning of PSC as a medium for private transaction
7. The participation of DPR in the form of notification of acontract signed does not prejudice the private aspect of PSC. Even if PSC had to be approved by DPR prior to itbeing signed by the government, it would not reduce theprivate nature of PSC.
8. Dispute settlement through arbitration is clearly a choice ofthe contracting parties.
9. PSC is in line with the contract law applicable in Indonesia.
10. Accordingly, as indicated in the initial part of this article, the issue of CR is a derivative of the legal relation which has the characteristics of and belongs to the private domain. ZP.

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Attachment I

SECTION . . .

RECOVERY OF OPERATING COSTS AND HANDLING OF PRODUCTION

6.1 RECOVERY OF OPERATING COSTS

6.1.1 CONTRACTOR will recover Operating Costs out of the sales proceeds or other disposition of the required quantity of Petroleum equal in value to such Operating Costs, which is produced and saved hereunder and not used in Petroleum Operations in the manner specified in Sub-section 6.1.2 below.

6.1.2 The right of CONTRACTOR to recover Operating Costs referred to in Sub-section 6.1.1 above shall be subject to the following:

a) CONTRACTOR may recover Operating Costs only out of Petroleum commercially produced from a particular Field or Fields which is approved based on a particular POD.

b) The Operating Costs that may be recovered from the Petroleum produced from a particular Field or Fields approved by a particular POD shall consist of the following:

(1) The Exploratory Expenditures defined in Sub-section 2.2.4 of Exhibit C incurred by CONTRACTOR for the conduct of exploration activities within the Contract Area prior to the date of approval of the POD for such Field or Fields, provided that such Exploratory Expenditures have not been included under the Field(s) previously approved by a particular POD.

(2) All Capital Costs and Non Capital Costs other than the Exploratory Expenditures referred to in paragraph (1) of this Sub-section 6.1.2 (b) incurred by CONTRACTOR for the conctract of Petroleum Operations in the relevant Field.

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Attachment II

SECTION . .
CONSULTATION AND ARBITRATION

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

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

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

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

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



# Fundamental Changes of International Economic Law: Challenges toward Legal System based on Fairness and Human Values

**Adolf Warrouw**[1]

*Economic globalization supported by the latest technology information and communication has brought major influence in the structure and substance of international law development. Such globalization leads to market integration, transportation system, and communication, which makes possible to companies, states, and individual to reach the world. This article explains on the fundamental challenges of international economic law to legal system based on fairness and human values.*

***Keywords:*** *International economic law, legal system, Globalization.*

## I. Introduction

The development of International society, which is increasingly integrated in various human aspects, has created demand for establishing new legal norms and for reviewing existing concept of international law concepts and rules. For the last few decades, there were major changes in the development of international law as the necessity of international people. Structural changes which began after World War II were demonstrated by enlargement of international society composition through inclusion of most new states that emerges from decolonization process. These states carried different interests and aspirations from their preceding nations, and also followed by new establishment of international organizations such as United Nations, and new born concept of human rights in international level. Economic globalization in the few last decades following the Cold War occurring in line with the economic development supported by advance communication and information technology, which provides

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