New blow to Indonesia's upstream hopes

The arrest of upstream regulator Rudi Rubiandini on corruption charges has highlighted the problems the country's energy sector is facing. Damon Evans reports

THE arrest of the head of Indonesia's upstream regulator on suspicion of corruption has dealt a new blow to the nation's attempts to bolster its flagging oil and gas sector. SKKMigas was thrown into disarray after its now suspended chairman, Rudi Rubiandini, was arrested by an anti-graft agency on suspicion of receiving a $700,000 bribe from Simon Tanjaya, an executive of Singapore-based trader Kernel Oil.

Analysts say the scandal will do little to ease investor concerns at a time when Indonesia is struggling to restore confidence in its energy sector and reverse falling oil production. Rising nationalism and controversial criminal prosecutions against foreign oil company employees has already started to sour investor interest.

Nevertheless, energy and mineral resources minister Jero Wacik, claimed the alleged corruption case against Rudi would not affect investment in the oil and gas business. But Lin Che Wei of Independent Research and Advisory Indonesia said the case would paralyse the sector. "This will be the corruption case with the largest economic impact and ramification in Indonesia's history," he told Singapore newspaper *The Straits Times.*

The Corruption Eradication Commission (KPK), which has a near 100% conviction rate, has a record of using arrested officials to testify against their superiors and subordinates, which could lead to a temporary paralysis in decision-making at SKKMigas, Arvind Ramakrishnan, an Asian specialist at risk-analysis firm Maplecroft told *Petroleum Economist.*

Rudi was the first head of SKKMigas, which was created in January after industry watchdog BPMigas was abolished in an unexpected court ruling last November.

In Southeast Asia's largest producer – Indonesia pumps 2.1 million barrels of oil equivalent per day (boe/d) – there is a growing belief that foreign contractors have been operating under generous terms and that domestic hydrocarbons should be produced by Indonesian companies. Some analysts say the Constitutional Court's decision played to the rise in this nationalism and highlighted Jakarta's intent to influence future production sharing contracts (PSCs) in favour of state-owned companies, particularly Pertamina.

Rising protectionism has been reflected in changes to laws and regulations in the mining and energy sector over the past few years, notes Ramakrishnan. This year, Indonesian president Susilo Bambang Yudhoyono is likely to further that trend with an oil and gas bill that would strengthen control over hydrocarbon exploration and production. But it could also be a watershed for the industry as it offers an opportunity to make changes. The draft law would increase the domestic market obligation for oil and gas projects to a minimum of 25%, from a maximum of 25%, according to a report from Maplecroft.

Jakarta understands it has a huge domestic market to feed. Oil consumption rose 32% over the past 10 years to 1.56 million barrels a day (b/d) in 2012, while gas consumption edged up 9% to 35.8 billion cubic metres over the same period. But there is also a real desire to bring value to Indonesia, rather than exporting raw resources to competing economies in Singapore, China and South Korea. It's also likely that the new law will require investors partner with Indonesians, source more equipment locally, as well as deal with forced divestment clauses, added Ramakrishnan.

The House of Representatives is working on the draft and a vote is expected before presidential elections next April. All the political parties agree the bill should be pushed through, therefore the attractiveness of Indonesia as an investment destination will decline, regardless who wins the elections, added Ramakrishnan.

"To date there has been no overt policy of resource nationalism. It's been multifaceted in a diffused sort of way," Ashley Wright, an Indonesia-focused partner at law firm Norton Rose Fulbright, told *Petroleum Economist.* But Wright says there has been a backlash against the cost-recovery terms under which the major oil companies have increasingly benefited, as the oil and liquefied natural gas prices spiked over the past five to six years.

There is also more confidence in Pertamina as a credible alternative to the majors, whose slow progress developing resources has increasingly irked Jakarta as the government struggles to close the widening gap between energy supply and demand. The majors have been investing less as the investment terms are increasingly unattractive.

Wright describes Indonesia's dilemma as a "chicken and egg" situation. The government can either work to attract the majors, contrary to the populist nationalist rhetoric, or build an Indonesian alternative. It remains to be seen if Pertamina can carry out the technically challenging exploration in deep waters and unconventional basins. But they certainly have the ambition and have proven they can turn around ageing conventional fields.

Other options

In a way they are starting to look like a national champion and potentially offer Jakarta a homegrown alternative to arrest the country's output decline, which means they can push the majors harder, adds Wright. But as Yudhoyono has openly admitted, Indonesia still needs the technological expertise and capital brought by foreign investors to take full advantage of its extensive hydrocarbon resources.

However, signals from within Indonesia's government remain decidedly mixed. Chevron, ExxonMobil, PetroChina and Total, have all found themselves bogged down in seemingly intractable disputes. Indonesia's largest oil producer, Chevron, has publicly admitted that a harsher regulatory climate for foreign companies has given it cause to rethink its overall level of investment in Indonesia. Total has said the same.

Aside from the prospect of more nationalistic policies, part of the problem is that the regulatory environment is in a state of flux. But for the time being there is little political capital to be gained from supporting greater openness to foreign investment. It seems nationalistic policies will continue to dominate the agenda at least until Yudhoyono's successor is elected next year. And as Southeast Asia-focused oilman Peter Cockcroft points out: "Is it really a bad thing to try to preserve their resource base in an altruistic way?"

Probably not, but regulatory certainty and greater fiscal incentives would help reverse declining oil production, expected to hit 830,000 b/d this year, its lowest level since 1961. Still, Indonesia's upstream sector, despite being mature, does hold huge potential with 45% of its discovered resources yet to be produced. It has the region's highest remaining reserves, estimated at 28 billion barrels of oil equivalent, according to Wood Mackenzie. They just need to figure out how to tap it. Perhaps they should take a leaf from their neighbour's book. Malaysia's progressive fiscal terms and its efforts to encourage development of marginal and late-life fields has started to whet the industry's appetite. ●