

Considerations for Indonesia's New Government: Structuring Petroleum-Sector Institutions

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As Indonesia's new government seeks to maximize the country's benefits from the petroleum sector, one of its most important tasks will be to resolve the longstanding uncertainty surrounding the roles and responsibilities of the public institutions responsible for managing the sector. This briefing offers a perspective based on global experience in oil and gas as well as Indonesia's own history.

WHY PETROLEUM-SECTOR INSTITUTIONAL STRUCTURE MATTERS

Effectively allocating roles and responsibilities among ministries, Pertamina, and other government agencies is crucial if Indonesia is to tackle the challenge of reinvigorating its petroleum sector. Indonesia faces declining petroleum reserves and production, rising consumption, costly fuel subsidies and a desire to boost the performance of Pertamina. The country therefore requires an institutional structure that will enable it to execute a coherent strategy and that empowers the assigned entities to manage exploration, production, relationships with contractors, tax collection and the enforcement of Indonesia's laws and contracts. Most importantly, the government must decide whether to house regulatory (i.e., monitoring and oversight) responsibilities within Pertamina or in another body.

The new government has an opportunity to reconcile the Constitutional Court's decision on BP Migas and build a coherent, effective, forward-looking structure. In the aftermath of the 2012 Constitutional Court decision—which invalidated the role of independent regulator BP Migas as established in 2001 on the grounds that it did not meet the state's responsibilities under Article 33 of the constitution—there has been confusion about the present and the future of government responsibility for the petroleum sector. This dampens investor confidence and impedes citizens' ability to hold their government to account. By revising the legal framework with clear decisions on the division of responsibilities, the government can end this confusion.

Indonesia can act on lessons from international experience by implementing rules and incentives that reduce the risk of corruption and promote efficient performance among regulatory bodies and state-owned enterprises. Global research has highlighted several mechanisms that have made national oil companies and regulatory bodies more open, more performance-driven, and less susceptible to mismanagement. The new government has an opportunity to decisively install Indonesia-specific versions of these mechanisms, which include independent and public audits, extensive reporting to parliament and public and rigorous rules guarding against conflict of interest among public officials.

ABOUT THE SERIES

This series of briefings offers key considerations for the new government of Indonesia as it forms its agenda for the management of natural resources.

CONSIDERATIONS FOR THE GOVERNMENT OF INDONESIA

1. Roles and responsibilities should be clearly delineated, according to one of several models under consideration.

Perhaps the most important lesson for the government to consider in deciding where to house regulatory responsibilities—including the allocation of licenses, signature of contracts and enforcement of laws and regulations—is that legislation and regulation should explicitly define and clearly communicate the scope and limitations of each body’s authority, both within government and to oil companies. Countries such as Mexico and Venezuela, where the boundaries between responsibilities of the SOE and other government bodies have been shifting and permeable, have seen the performance of their SOEs and the development of their petroleum sectors suffer as a result.

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Indonesia has the option of returning to one of the two models that it has employed to date (models 1 and 2, below), or developing an innovative new systems that build upon the experiences of other oil producers (models 3 and 4, below).

Model 1: Split of regulatory responsibilities between ESDM and Pertamina

Under this system, which resembles the system employed in Indonesia before 2001, the roles that had been subsequently played by BP/SKK Migas would be split, with some being vested in Ministry of Energy and Mineral Resources (ESDM) and some in Pertamina. The specific parameters of the split would be subject to discussion, but one option could involve ESDM issuing rules and selecting contractors, and Pertamina serving as the contract signatory and doing day-to-day supervision of operations and compliance.

Potential advantages	<ul style="list-style-type: none"> • Empowers the state-owned enterprise (SOE) to play a stronger role while limiting risk of conflict of interest to a greater degree than the Pertamina-only model (discussed below) • Relatively simple, would not require creating new institution
Risks	<ul style="list-style-type: none"> • In many countries, incentives for personnel within a ministry are not sufficiently strong to attract or retain the country’s best and brightest, which is why many countries have housed these important functions in SOEs or specialized agencies. • Risk of confusion of roles is high unless there are extremely clear limits and internal reporting requirements

Model 2: Vesting of regulatory responsibilities in a largely bureaucratic regulator outside the ministry structure

This option represents a slight variation on the system that prevailed under Law 22-2001, from 2001 to 2012. Under this option a body that closely resembles BP/SKK Migas would retain responsibility for executing most regulatory/oversight responsibilities.

Potential advantages	<ul style="list-style-type: none"> • Can limit the risk of conflict of interest, if each institution has a specific role and the regulator is specifically charged with ensuring that Pertamina and other players follow the rules • Can enable Pertamina to focus on its commercial performance rather than devoting resources to regulation • Maintains the ability to hire personnel for the regulator outside of the ministry incentive structure
Risks	<ul style="list-style-type: none"> • Risk of confusion of roles is high unless there are extremely clear limits and internal reporting requirements • May not comply with the Constitutional Court’s mandate if the regulatory body cannot in some way be endowed with business activities—the complete separation was judged to result in the “degradation of the powers of the state,” though the government might be able to alter the legal form of the regulator to be a SOE in order to comply with the Constitutional Court’s mandate

Model 3: New, non-operator SOE with regulatory responsibilities and limited business activities.

This hybrid model would involve the creation of a new SOE that would represent the state in oil project operating committees with the responsibility of promoting the state’s interests. This new SOE would not aspire to be an “operator” of oil projects itself—it would not run or manage projects on its own but rather would exist exclusively as a champion for the government’s goals within partnerships with other oil companies, including Pertamina. Under this system, Pertamina participation in projects would be limited to the development of its commercial strategy and return to shareholders. Brazil has been developing this model in large new deep water fields; Petrobras serves as the operating company and a new, non-operator SOE called Petrosal has been created to perform regulatory functions and advocate for the state’s interests within operating groups.

Countries employing this model	<p>Brazil, in new offshore fields. Norway also has a non-operator SOE called Petoro charged with promoting the state’s financial interests, though it does not have other regulatory authority.</p>
Potential advantages	<ul style="list-style-type: none"> • Reduces risk of conflict of interest and builds in checks and balances while enabling personnel to execute the regulatory function, thereby benefitting from a business-oriented structure and incentives • Can free Pertamina to unequivocally pursue its commercial agenda • Compliant with the Constitutional Court’s ruling, since an SOE would carry out the regulatory function and would be the legal party representing the state’s interests in oil contracts
Risks	<ul style="list-style-type: none"> • Untested innovation—Brazil is just establishing Petrosal now, so there is not a strong historical evidence base • Risk of confusion of roles is high unless there are extremely clear limits and internal reporting requirements

Model 4: Concentration in the SOE (granting most/all regulatory power to Pertamina).

Under this model, Pertamina would become the body responsible for negotiating and signing contracts with private oil companies, representing the state’s interest in those relationships, and ensuring that laws, regulations and contracts are enforced. Pertamina would need to develop systems for taking on these roles while also driving forward its own commercial agenda.

Countries employing this model	Malaysia, Angola
Potential advantages	<ul style="list-style-type: none"> • Relatively simple and cost-effective: no need to build new institution, and would allow Indonesia to concentrate expertise and decision-making • Oil companies, the public and the Ministry of Finance would only have to interact with Pertamina and ESDM, not another body • Unquestionably in line with Constitutional Court decision, since SOE holds the economic right, not only the mining right
Risks/ Challenges	<ul style="list-style-type: none"> • Expansive Pertamina role could hurt its efficiency • Pertamina micro-managing its own activities would create heavy risk of conflict of interest and rent-seeking; damages Pertamina’s incentives to become world-class competitive company • Mexico’s example is instructive—in the context of dwindling reserves and a desire to increase investment, a strong concentration of power in the SOE did not work, and Mexico has just reformed its constitution to remove the company’s regulatory power

2. The decision about how Pertamina gains access to stakes in oil projects will have significant implications for the company’s future.

Empowering Pertamina to become a stronger, more efficient company with a dynamic role at the forefront of Indonesia’s oil sector is one of the stated goals of the new administration. The system that determines the process by which Pertamina gains the right to participate in (or manage) operating groups will have a major impact on Pertamina’s portfolio and incentives. Global oil producers employ a range of strategies for giving access to their SOEs; ranging from largest guaranteed role to most competitive, they include:

- SOE has a monopoly over all exploration and production, no private company participation allowed (Saudi Arabia, Mexico pre-2013).
- SOE is “concessionaire” for all projects, and can choose its own private-sector partners (Angola, Malaysia).
- SOE has a guaranteed role or minimum stake, but another state body selects private-sector partners (Brazil in new deepwater fields, where Petrobras has guaranteed operatorship but the National Petroleum Agency selects partners).
- SOE must compete, but has certain built-in advantages in bidding system (Kazakhstan, Mexico post-2013).
- SOE must compete on equal footing with private companies (Colombia, Norway).

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In general, the more competitive the system is, the greater is the incentive for the SOE to become a dynamic and efficient commercial player capable of standing on its own. The downside of a completely competitive system, however, is that it can reduce the opportunities available to the SOE if the company is not already in a competitive position when a tender is launched. In order to promote Pertamina's continued rise while preserving some incentive for competitiveness, we recommend that the government consider one of the middle-ground approaches such as models 2, 3 or 4 above.

3. The government should consider several steps to strengthen the public accountability and the performance incentives of Pertamina, and of any other body empowered with regulatory responsibility.

Institutional structures on their own provide no guarantee of effective performance. International experience has demonstrated repeatedly that other mechanisms for public and intra-governmental accountability are necessary if these entities are to maximize their effectiveness and reduce the risk of scandal or conflict of interest, including:

- Indonesia could create an advisory board for the SOE(s) and any regulator, composed of representation from different constituencies (e.g., civil society, academia, the private sector), which would track the activities of these bodies, publicly analyze their progress, and communicate to the government the key concerns of the stakeholders they represent.
- Ensuring that the executive appoints board members based on their technical skills and experience, and gives them independence to make sound technical decisions.
- The SOE(s) and any regulator should be subject to independent audits, the results of which should be published.
- These entities should be subject to standards for public reporting the same as, or higher than, private companies. They should be obligated to report regularly on the revenue streams under their control; fiscal relationships with the treasury and other public entities; spending and earnings projections; reserve and production data; sales of oil for which they are responsible; and any "quasi-fiscal expenditures," i.e., spending by the company on activities that would traditionally fall under the purview of ordinary government institutions, such as infrastructure, energy provision, debt servicing, or social services.

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