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# COMPARATIVE ANALYSIS OF COST RECOVERY AND GROSS SPLIT MECHANISMS IN OIL AND GAS PROJECTS IN INDONESIA

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**Abstract**

This journal presents a comparative analysis of the cost recovery and gross split mechanisms in oil and gas projects in Indonesia. The cost recovery and gross split procedures utilized in Indonesian oil and gas projects are compared in this research. The objective is to evaluate the benefits and drawbacks of each mechanism and pinpoint the variables that affect the mechanism that businesses select. While gross sharing mandates that corporations share earnings with the government from the outset of production, cost recovery permits companies to recover their production and exploration costs prior to sharing revenues with the government. The journal presents that while gross sharing increases government revenue and lowers the likelihood of cost overruns, cost recovery provides businesses with greater certainty but also exposes them to higher risks. The project's size, the level of government involvement, and the political and regulatory landscape all influence the method chosen. In order to help stakeholders in the business and policy makers choose the best procedures for their projects, the studies also offer insightful information.

## 1. INTRODUCTION

Indonesia, a country rich in natural resources, holds immense potential in the oil and gas (O&G) sector. In the oil and gas business, profit-sharing agreements are categorized into two types: cost recovery and gross split. With the amendment of Regulation of the Minister of ESDM Number 8 of 2017 concerning Gross Split Production Sharing Contracts, the government provides oil and gas contractors with the option to choose between the Cost Recovery and Gross Split schemes, as outlined in Regulation of the Minister of Energy and Mineral Resources (ESDM) Number 12 of

2020. However, the guiding principles of the Republic of Indonesia's 1945 Constitution continue to emphasize the state's ownership of natural resources and their optimal utilization for the benefit of the Indonesian populace.

To enhance state revenue from natural resources and attract investments from investors, Indonesia's oil and gas industry utilizes the Production Sharing Contract (PSC) system for business agreements. The concept of profit-sharing agreements, acknowledged in customary law, gave rise to the PSC model. In 1966, an agreement between Pertamina and the Independent Indonesia America Petroleum Company (IIAPCO) marked the first implementation of PSC in Indonesia. At that time, Indonesia, as a global pioneer of PSC, introduced reforms to the concession system that were perceived to be detrimental to the country, considering Indonesia's oil and gas potential.

The application of the PSC concept emerged as a solution to overcome the limitations of capital, technology, and human resources faced by Pertamina, especially in the exploration and exploitation of oil. The long-term goal of PSC contracts is to enable the independent management of natural resources by the Indonesian nation. Through PSC, Indonesia can quickly learn to manage oil companies and acquire technological knowledge in the oil and gas sector.

In PSC Cost Recovery, the government shares the net production results with the contractor based on a certain percentage. The operational costs incurred during the implementation of the PSC Cost Recovery contract are essentially covered by the government. However, over time, the Cost Recovery scheme often sparks debates, particularly in the audit conducted by the Supreme Audit Agency (BPK), and is considered potentially detrimental to the country. To address this issue, the government has designed a new contract scheme called Gross Split. This scheme no longer involves Cost Recovery, and as a result, the Contractor Cooperation Contract (KKKS) is responsible for all upstream oil and gas operational costs.

The Indonesian government has explored various contract types to align with the potential of oil and gas resources in the country, ranging from concessions and working contracts to the adoption of Production Sharing Contracts (PSC) or profit-sharing contracts. With the enactment of Law Number 22 of 2001 concerning Oil and Gas, the government chose to engage in cooperation through a profit-sharing contract, namely the Production Sharing Contract (PSC). Initially, the PSC was accompanied by a system known as Cost Recovery.

However, due to substantial losses incurred by the government resulting from the reimbursement of operational costs and the potential for misuse by contractors, the government issued Minister of Energy and Mineral Resources Regulation Number 52 of 2017, which pertains to Minister of Energy and Mineral Resources Regulation Number 8 of 2017 regarding Gross Split.[1] This shift aims to encourage competition among contractors to explore challenging areas with significant oil and gas potential, ultimately boosting Indonesia's reserves in these resources.

The introduction of the new system brings about distinctions between cost recovery and gross split. In the implementation of the gross split system, the government employs a predetermined mechanism for the initial profit-sharing. Specifically, for crude oil, the distribution is 57% for the state and 43% for the contractor, and for natural gas, the state's share is 52%, while the contractor's share is 48%, as outlined in Article 5, paragraph 1 of Minister of Energy and Mineral Resources Regulation Number 8 of 2017.[2] The initial sharing in the Gross Split model is viewed as more favorable for the state since the gross revenue from the production process is directly divided based on the contractual agreement. This eliminates the need for the state to reimburse costs to the contractor, a requirement present in the cost recovery model.[3]

## 2. RESEARCH METHODOLOGY

The type of research used is quantitative. This research involves economic analysis, sensitivity calculations, and comparative statistics to compare variations in profitability

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[1] Floriantina, Elisha, and Yudho Taruno Muryanto. "Perbandingan Antara Production Sharing Contract Cost Recovery Dan Gross Split Dalam Usaha Hulu Minyak Dan Gas Bumi Di Indonesia." *Privat Law* 9, no. 1 (2021): 10–18. https://jurnal.uns.ac.id/privatlaw/article/view/29216.

[2] Farhani, Athari, Faiqah Nur Azizah, Panggalih Usadhani and Faridh Kurniawan. "Pembagian Hasil MIGAS Melalui Cost Recovery dan Gross Split Bagi Sebesar-Besarnya Kemakmuran Rakyat Menurut UUD NRI Tahun 1945." *Jurnal Hukum & Pembangunan: Vol. 52: No. 2, Article 10.* https://scholarhub.ui.ac.id/jhp/vol52/iss2/10.

[3] Brad, and Alistair Dunstan. "The Indonesian PSC: The End of an Era." The Journal of World Energy Law & Business 11, no. 2 (April 1, 2018): 116–35. https://doi.org/10.1093/jwelb/jwy001.

between the Cost Recovery and Gross Split schemes in oil and gas cooperation contracts. Quantitative method is a scientific approach that uses numerical data and mathematical methods to analyze phenomena, relationships, or patterns in a study. This approach allows researchers to measure certain variables, identify significant patterns, and make generalizations based on the data collected.

## 3. DISCUSSION

### 3.1 Introduction

In the oil and gas industry in Indonesia, operating within the framework of Production Sharing Contracts (PCS), which aim to balance the interests of the government and private parties involved in hydrocarbon extraction, there are two main types of systems that are often used in the production sharing mechanism between the government and contractors, namely cost recovery and gross split. These two systems have different characteristics. Cost recovery is a mechanism that allows oil and gas companies to reimburse operational costs, capital investment, and other costs to the government before sharing. Gross split, on the other hand, is a mechanism where production is shared in a fixed proportion between the oil and gas company and the government, with no cost reimbursement required. The Indonesian government introduced the gross split system through Minister of Energy and Mineral Resources (ESDM) Regulation Number 8 of 2017, which gives contractors the option to use the cost recovery and gross split systems.[4]

### 3,2 Cost Recovery System

The cost recovery system is a mechanism applied in production sharing contracts (PSC) in Indonesia's oil and gas sector. Under this scheme, the government offsets operational costs from the project development stage to the start of production to the contractor.

These costs include exploration, drilling, infrastructure and other operational activities required to start oil and gas production. As production begins to increase, the government begins to reimburse the operational costs incurred from the contractor's share of production. This is done by reducing the percentage of production sharing that the contractor receives.

[4]Darren Murpy. ''Indonesia's New Gross Split Production Contracts''. https://www.jonesday.com/en/insights/2017/02/indonesias-new-gross-split-production-sharing-contracts-for-the-oil--gas-industry. [Publised: February 2018]

That way, the contractor will gradually pay off the operational costs incurred by the state in the early stages of the project. While the cost recovery system provides contractors with certainty over project financing and reduces financial risk during the costly exploration phase, it has some drawbacks. These include the potential for disputes over recoverable costs and the potential lack of incentives for contractors to optimize operational efficiency, as operational costs are borne by the state.[5]

### 3.3 Gross Split System

The gross split system is an alternative to the cost recovery system in PSC contracts in the oil and gas sector in Indonesia. Unlike the cost recovery system, the gross split system does not involve the reimbursement of operational costs incurred by the state to the contractor.

Instead, the state receives a percentage of the total production, regardless of the actual costs incurred by the contractor. Current regulations assume that the government purchases 57% of the crude oil and 52% of the natural gas produced. This makes it easier to implement a total revenue sharing system and simplifies budgeting and budget allocation for both parties. However, this system has some implications that need to be considered. One of the disadvantages of the gross split system is that it potentially poses a risk to the contractor due to the greater financial burden that must be borne by the contractor. The contractor must bear all operational costs, including exploration, drilling, and infrastructure costs, and must bear greater risks related to operational efficiency and technology used.[6]

In addition, a total gross split system can make investment in innovative technologies and processes unattractive, as the contractor bears all the risks and costs. However, if implemented correctly and regulated appropriately, a total gross split system can benefit both the government and contractors and promote effective and efficient natural resource management.

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[5] Patricia Audrey R, Ikaningtyas, Rika Kurniaty. Faculty of Law, Brawijaya University, Malang, Indonesia. ''The Effect of Cost Recovery Mechanism in Production Sharing Contract (PSC) in Oil and Gas Industry in Indonesia''. https://www.atlantis-press.com/article/25902937.pdf. [Published: 2018].

[6] HFW. ''Indonesia – what's new? Moving cost recovery to gross split system in the upstream oil and gas sector''. https://www.hfw.com/Indonesia%E2%80%93whats-new-Moving-cost-recovery-March-2017.[Published: March 2017]

### 3.4 Advantages and disadvantages

Cost recovery has several advantages: such as Flexibility allows the government to adapt to changing economic conditions. In addition, cost recovery allows the government to bear some of the financial risk during the costly exploration stage. On the other hand, cost recovery can lead to disputes over the costs borne and reduce the contractor's motivation to optimize its operations.

In contrast, the gross split system has clear advantages such as simplicity and transparency, making it easier to plan and allocate budgets. However, an all-separate system places all risks and costs on the contractor, which can discourage investment in innovative technologies and processes.[7]

### 3.5 Implementation and Application

Cost Recovery System:

The application of the cost recovery system to oil and gas projects in Indonesia includes:

3.5.1 Contract provisions: Contains provisions regarding the sharing of operating costs between the government and the contractor Making a PSC contract.

3.5.2 Cost Monitoring: The government monitors and approves the operating costs incurred by the contractor during the exploration and production stages.

3.5.3 Cost reimbursement: Reimbursement of operating costs to the contractor is done by reducing the percentage of production sharing in accordance with the contract agreement.

Gross Split System:

The application of the Gross Split System to Indonesian oil and gas projects includes:

3.5.4 Contract Conversion: The PSC in accordance with the provisions applicable to the Gross Split System requests a transfer to the holder.

3.5.5 Percentage Sharing: Determination of production sharing between the government and the contractor. 57% crude oil and 52% natural gas.

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[7] Niza Upperline. ‘’ Comparison Between Psc Gross Split And Cost Recovery". https://web.ipa.or.id/news/comparison-between-psc-gross-split-and-cost-recovery. [Published: 18 March 2020].

**3.5.6** Revenue Stability: No need to reimburse contractors for operational costs, ensuring government revenue stability.[8]

## 3.6 Laws and Regulations

Constitution of the Republic of Indonesia 1945 (UUD 1945):

The UUD 1945 is Indonesia's fundamental legal document that guides governance across various sectors, including oil and gas. It sets out principles for resource management, environmental protection, and economic development.

Law Number 22 of 2001 concerning Oil and Gas. This law provides general guidelines for upstream oil and gas business activities in Indonesia, including cost recovery and gross split aspects.

Government Regulation Number 35 of 2004 on the Implementation of Upstream Oil and Gas Business Activities. This regulation provides further procedures regarding cost recovery and gross split.

Regulation of the Minister of Energy and Mineral Resources Number 48 of 2017 on Supervision of Business in the Energy and Mineral Resources Sector. Aims to realize maximum benefits for the community through strict supervision in the energy and mineral resources sector.

Regulation of the Minister of Energy and Mineral Resources Number 15 of 2018 concerning Procedures for Calculating Operating Costs and Investment Costs in Upstream Oil and Gas Business Activities. Aims to improve the operating cost (BO) and investment cost (BI) assessment system in upstream oil and gas business activities.

Government Regulation Number 79 of 2010 on Refundable Operating Costs and Income Tax Treatment in the Upstream Oil and Gas Business Sector. Aims to regulate the procedures for refunding operating costs and income tax treatment in upstream oil and gas business activities, in accordance with the applicable provisions in Law No. 22 Year 2001 on Oil and Gas.

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[8] Irvan Yulian Pratama, Bayu Satiyawira, & Prayang Sunny Yulia. (2023). Implementation Of Psc Cost Recovery And Psc Gross Split Contracts In The Iyp Field. Petro: Jurnal Ilmiah Teknik Perminyakan, 12(2), 80–88. https://doi.org/10.25105/petro.v12i2.16096.

Minister of Energy and Mineral Resources Regulation Number. 8 of 2017. Aims to define gross split production sharing contract in the energy and mineral resources sector.

## 4. CONCLUSION

Indonesia, a country rich in natural resources, has immense potential in the oil and gas sector. The government offers oil and gas contractors the option to choose between cost recovery and gross split schemes. The Production Sharing Contract (PSC) system is used to enhance state revenue and attract investments. The PSC model was first implemented in 1966 by Pertamina and the Independent Indonesia America Petroleum Company (IIAPCO). The long-term goal is to enable independent management of natural resources by the Indonesian nation.

The PSC Cost Recovery scheme shares net production results with contractors based on a certain percentage, but it often sparks debates and is considered potentially detrimental to the country. To address this issue, the government has designed a new contract scheme called Gross Split, which no longer involves Cost Recovery and instead, the Contractor Cooperation Contract (KKKS) is responsible for all upstream oil and gas operational costs. The new system distinguishes between cost recovery and gross split, with a predetermined mechanism for initial profit-sharing.

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Niza Upperline. ‘’ Comparison Between Psc Gross Split And Cost Recovery".
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Irvan Yulian Pratama, Bayu Satiyawira, & Prayang Sunny Yulia. (2023). Implementation Of Psc Cost Recovery And Psc Gross Split Contracts In The Iyp Field. Petro: Jurnal Ilmiah
Teknik Perminyakan, 12(2), 80–88. https://doi.org/10.25105/petro.v12i2.16096.