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Indonesia: Growing Strains in the Oil Sector

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An Intelligence Assessment

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EA 83-10055
March 1983

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Indonesia: Growing Strains in the Oil Sector [redacted] 25X1

An Intelligence Assessment

This assessment was prepared by [redacted] 25X1
Office of East Asian Analysis. Comments and queries are welcome and may be directed to the Chief, Southeast Asia Division, OEA, on 351-5208. [redacted] 25X1

This paper was coordinated with the National Intelligence Council. [redacted] 25X1

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Indonesia: Growing Strains in the Oil Sector [redacted] 25X1

Key Judgments

Information available as of 15 March 1983 was used in this report.

The current buyers' market for oil is creating the most serious problems for Indonesia's oil industry since the near-bankruptcy of Pertamina, the state oil company, in 1975. Output slipped to 1 million barrels per day (b/d) in February—600,000 b/d below capacity—and Indonesia's leaders must now adjust to lower oil prices. Jakarta is compounding the industry's difficulties by pushing for increased nationalization and adopting a hardline attitude in contract disputes with several US companies. [redacted] 25X1

If the March 1983 OPEC agreement on prices and production quotas holds, we project Indonesia's current account deficit will reach $10-11 billion, compared to $7.4 billion in 1982, unless there is a surge in nonoil exports or Jakarta acts quickly to cut imports. The Indonesians have already drawn down official foreign exchange reserves to less than $4 billion and have moved swiftly to increase foreign borrowing in early 1983. Fearing a tightening of commercial lending later this year, the Indonesians are arranging a $1 billion commercial credit, but they will have to pay considerably higher interest rates than they would accept as recently as a few months ago. [redacted] 25X1

Although US-Indonesian relations have improved over the past few years, falling oil revenues could lead to new friction with Washington. The Indonesians will need increased foreign aid and loans to deal with financial strains and are likely to focus some resentment against Washington if US support, either bilaterally or in the international financial institutions, falls short of their expectations. [redacted] 25X1

The soft oil market already is slowing exploration in Indonesia, and we believe Jakarta risks discouraging drilling—and its long-term oil production prospects—even more if it pushes foreign oil companies too hard for better terms. [redacted] 25X1

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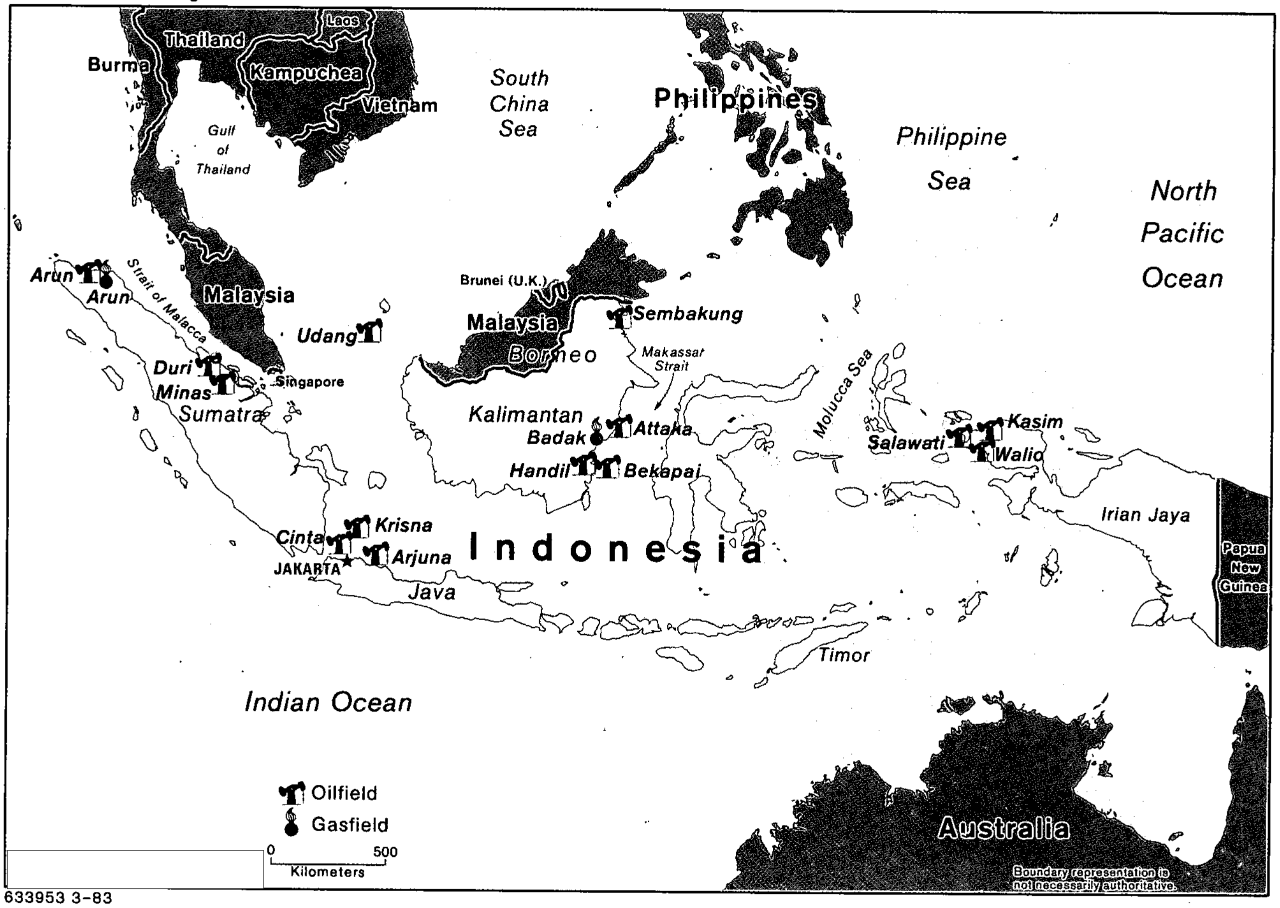
Indonesia: Major Oil and Gas Fields



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[redacted]

Indonesia: Growing Strains in the Oil Sector [redacted]

External Strains

Price and Production Pressures. Indonesia took a tough stand on oil prices last year despite customer demands for discounts stimulated by the weak global oil market. President Soeharto refused to break ranks with OPEC and rejected demands from Japanese firms to match discounts offered by other OPEC members (particularly Iran) and non-OPEC producers. Although oil company representatives told US Embassy officials in mid-1982 that price cuts of $2.50 to $4 per barrel would be necessary to make Indonesian crudes competitive, Jakarta kept its prices firm until November. It then offered only modest reductions ranging from 47 cents to $1.90 per barrel, which still kept Indonesian prices within OPEC guidelines on differentials. [redacted]

Since late 1981 Indonesia has been unable to sell all the crude oil it could produce, given its tough stand on prices. Buyers in Japan and the United States, which together absorb over 80 percent of Indonesia's oil exports, cut their combined purchases of Indonesian crude by 10 percent in 1981 and another 20 percent in 1982. After averaging 1.6 million b/d in 1981, oil output began slipping late in the year and continued to fall in early 1982. Jakarta then agreed to limit output to 1.3 million b/d in April 1982 in line with OPEC production quotas. Even so, Indonesia's output fluctuated 20,000 to 40,000 b/d below the quota in some months because the country could not sell all of its reduced allotment. Following OPEC's failure to agree on prices and output quotas at the Vienna meeting in December 1982, Indonesia's crude oil output slipped to 1.1 million b/d in January 1983 and to 1 million b/d in February 1983. [redacted]

Slow Response to Falling Revenues. Jakarta was slow to respond to the deterioration in its export performance in 1982 because of a belief that the world oil glut would be temporary, according to US Embassy reports. Although the soft oil market reduced Indonesia's foreign exchange earnings from oil by $4.2 billion and helped push the current account deficit to $7.4 billion, President Soeharto continued to stress economic development in his speeches and in cabinet meetings. Through most of the year, he showed little recognition of the need for budget austerity as the oil glut persisted, and, according to Embassy reporting, the technocrats were reluctant to press for a slowdown in development spending [1]. A former Finance Minister and mentor of the technocrats, Professor Sumitro Djojohadikusumo, was the first to call publicly for a slowdown. Soeharto rejected this advice in his Independence Eve speech on 16 August and repeated the development theme in a major address to the nation on 1 October. By then, however, the technocrats had begun in press interviews to prepare the government and the public for the stiffer austerity measures that would be necessary in 1983 as a result of the prolonged slump in oil and nonoil exports. [redacted]

The Tougher Domestic Operating Environment

At about the same time as the onset of the world oil glut, foreign oil companies in Indonesia found the local operating environment toughening under the leadership of Pertamina's new President, Judo Sumbono. Since he was appointed in May 1981, Sumbono has taken a much more confrontational approach than his predecessor toward the foreign oil companies, which account for over 90 percent of Indonesia's crude oil output. In the past two years, disputes have arisen over the commercial prospects of new fields and other contract terms, as well as over the pace of training Indonesians to run the industry. [redacted]

[redacted]

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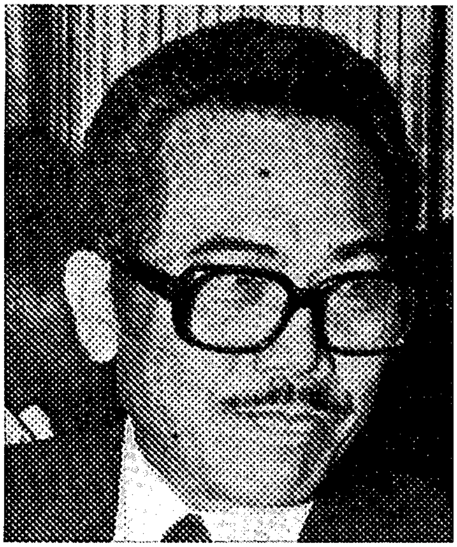

Judo Sumbono

As president-director of Pertamina, Brig. Gen. Judo Sumbono plays a major role in the formulation of overall Indonesian energy policy and in the selection of suppliers and contractors for important petroleum projects. According to US Embassy officials in Jakarta, Sumbono's complete loyalty and closeness to both President and Mrs. Soeharto were key elements in his selection for his current position. Nonetheless, he had developed a reputation as a good organizer and administrator in Pertamina's domestic supply operation during his 20-year career in the oil industry. Sumbono, 53, has never held a military command, and, according to US Embassy officials, many Indonesian military officers believe that his rank is unearned. [redacted]

Contracts and Commerciality. Under Sumbono, Pertamina has hardened its requirements for permitting oil companies to start commercial production of new fields. Pertamina is requiring that new fields contain sufficient recoverable reserves to assure that the government will obtain at least 51 percent of the recoverable oil. These estimates will be based on Pertamina's own calculations, rather than the reserve estimates made by oil company geologists as previously accepted. On several occasions since mid-1981, Pertamina has refused to declare new fields commercial, thus preventing the companies from beginning production and recovering their exploration costs. The issue first gained prominence in August 1981, when Pertamina refused to renew one of Atlantic Richfield's contracts and ordered the company to halt production at the Sembakung field in East Kalimantan. The field, which was producing almost 10,000 b/d at the time, had not yet produced enough crude oil to enable Arco to recover its costs. [redacted] 25X1

In this case, Pertamina geologists estimated that reserves in the field amounted to only 26 million barrels, compared with Arco's figure of 40 million barrels. Jakarta argued that reserves were insufficient to supply the government with at least 51 percent of the recoverable oil. After a year of negotiations, an oil industry trade journal reported in August 1982 that the two parties had reached an agreement permitting Arco to continue producing oil from the field until its costs have been recovered. Arco will then relinquish the acreage to Pertamina, which will have to decide whether further production would be profitable. If so, Pertamina will undertake production itself. [redacted] 25X1

Because Indonesia has numerous small fields, Pertamina officials have told news reporters they expect similar disputes to occur. Indeed, Mining Minister Subroto publicly cited the Salawati field in Irian Jaya operated by Phillips Petroleum as one that would not meet the current test for commerciality. Output in this field reached 47,000 b/d in 1977, its first year of production, but by 1982 had fallen below 4,000 b/d because of water encroachment into the reservoir—a level Subroto said is too low to produce income beyond the company's cost recovery. Phillips has complained in industry forums that Pertamina is demanding that it relinquish acreage faster than required by the terms of its production-sharing contract. [redacted] 25X1

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Indonesianization. Despite the soft world oil market, Jakarta is continuing to push nationalist policies that would increase Indonesian participation in the oil industry. During recent boom years, the oil companies criticized Jakarta's policies but took measures to avoid slowing their operations. In 1980, for example, when Pertamina ordered foreign oil companies to hire only local Indonesian subcontractors for services and supplies, oil company officials grumbled, but then took into account the expected delays and inefficiency by advancing their planning schedules and raising cost estimates, [redacted]

In its latest Indonesianization move, Jakarta ordered foreign oil companies in November 1982 to replace expatriates with native Indonesians in certain skilled drilling rig jobs by 1 January 1983—an action that could have affected 3,000 foreign workers, according to press reports. Oil company spokesmen have complained publicly that their operations would be hurt because there are not enough trained Indonesians. Although Jakarta has refused to back down from its ultimate goal and is giving preference in approving drilling permits to firms that comply with its regulations, enforcement of the order has been less rigid than originally expected, and Jakarta is continuing to approve work permits for essential expatriates. Furthermore, [redacted] companies have retained expatriates as "consultants" to oversee operations until their Indonesian employees are fully capable of assuming new responsibilities. [redacted]

The Caltex Negotiations. Jakarta is aiming to boost its return from Caltex, which normally accounts for about half of national output, without damaging the exploration climate for other oil companies. Pertamina and Caltex have been negotiating for more than a year on the terms of a new production-sharing agreement to replace an older concession-type Contract of Work that expires in November 1983.[2] The Indonesians hope Caltex's new agreement will not discourage other companies, all of which have been operating under production-sharing contracts since the late 1960s, from maintaining active exploration and production programs. Since no other company produces 150,000 b/d, according to Pertamina statistics, the Indonesians have proposed a three-tiered formula that would give the government the same 85-percent share currently in effect for all production-sharing contracts out of the first 150,000 b/d of Caltex's output. The government's share would rise to 90 percent for the next 100,000 b/d, and to 95 percent for output in excess of 250,000 b/d. If Caltex agrees, this formula would give Pertamina over 90 percent of its production versus the 85-percent share in effect with all other production-sharing companies. [redacted] 25X1

Although Caltex officials are balking at the 95: 5-percent part of the formula, we believe the two parties will reach a compromise escalation formula prior to the November expiration date to avoid jeopardizing production. There is a real risk, however, that they will fail to reach agreement before it is too late to avoid a temporary shutdown of Caltex's production. [redacted] 25X1

Oil Companies' Sensitivity to Contract Changes

Once before, changes in contract terms played a major role in discouraging exploration activity. Following the near bankruptcy of Pertamina, oil companies sharply cut back exploration drilling during 1975-77, when Jakarta sought to boost its income from oil production by unilaterally increasing its share of output under all production-sharing contracts from 65 percent to 85 percent. The result was a three-year drop in output from the 1977 peak. Exploration drilling began to recover in 1978, when rising world oil prices and improvements in Indonesia's cost-recovery provisions and depreciation allowances restored the country's attractiveness to foreign oil companies, but output did not increase until 1981. [redacted] 25X1

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[2] Under production-sharing contracts, Pertamina gains an equity share of the crude oil output produced by its contractors. Pertamina has decisionmaking authority over all oil company decisions and obtains title to all equipment installed by the oil companies when they bring new equipment into the country. Production-sharing contracts also include signature bonuses and mandatory relinquishments of specified shares of contract acreage according to preset timetables. Under the older Contracts of Work, the oil companies obtained concessions and essentially made all the field development and production decisions independently of Jakarta. In addition, the companies paid a portion of their profits to Jakarta—a much more complicated arrangement that gave rise to Indonesian suspicions of the integrity of the oil companies' calculations. [redacted]

Table 1
Indonesia: Production-Sharing Contracts, 1982

Million US $

	Company	Block	Area (*square kilometers*)	Exploration Commitment		Signature Bonus (*million US $*)
				Million US $	Years	
14 January	Tesoro	Onshore Tarakan E. Kalimantan	240			2.0
11 February	Elf Aquitaine	Onshore Ritan C. Kalimantan	18,260	49.0	10	1.0
11 February	Elf Aquitaine	Onshore Maruwai C. Kalimantan	19,535	55.5	10	1.0
11 February	Union Texas	Offshore Cilacap S. Java	13,640	31.5	6	1.8
11 February	Louisiana Land (Getty Oil/ Pelabuhan Ratu/LL & E)	Offshore Pelabuhan Ratu S. W. Java	9,275	34.0	6	1.0
11 February	Mobil	Onshore Semayang E. Kalimantan	18,460	149.0	6	15.0
9 June	Jackson Exploration	Onshore Adang E. Kalimantan	10,140	40.0	6	1.0
9 June	INPEX	Offshore N. Aceh	29,905	88.0	6	1.0
9 June	Amoco	Offshore Lombok	26,640	68.6	6	1.0
20 October	Hudbay Oil (Pennzoil Asiatic/ Husky Oil)	Onshore and offshore Madura Strait	13,970	47.85	6	1.5
20 October	Sceptre Resources, Ltd.	Offshore Java Block A	18,315	50.0	6	
20 October	Sceptre Resources, Ltd.	Offshore Java Block B		47.0	6	1.1
20 October	Promet	Offshore S. W. Arafura Block, Irian Jaya	18,315	55.0	6	2.75

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Press reports indicate that other oil companies are monitoring the negotiations carefully to determine whether Pertamina might use the Caltex negotiations as a precedent to change the terms of their contracts. The record number (13) of new production-sharing agreements signed during 1982 suggests that so far Jakarta has been successful in persuading other oil companies that negotiations with Caltex do not presage changes in their contracts. This situation occurred in 1976 when Pertamina unilaterally increased its share of all production-sharing agreements from 65 percent to 85 percent.

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The 1983 Financial Squeeze

Indonesia and the World Oil Market. Current conditions in the world oil market promise a further decline in Indonesia's oil export earnings this year. There are no signs yet that the decline in oil consumption has bottomed out, and there is little hope that it will until a sustained economic recovery gets under way in the developed countries. According to press reports, the latest OPEC agreement to reduce the benchmark price by $5 per barrel calls for Indonesia's production

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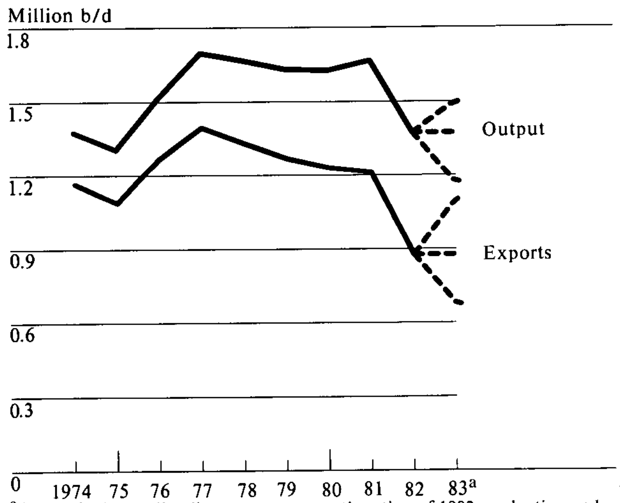
Figure 1
Indonesia: Crude Oil Output and Exports



[a] For 1983, the median line represents continuation of 1982 production and export levels. The upper limit represents a 100,000-b/d increase in output and exports. The lower limit shows a 100,000-b/d decline. The current world oil market suggests output and exports for the year are likely to fall in the lower half of the range.

[redacted]

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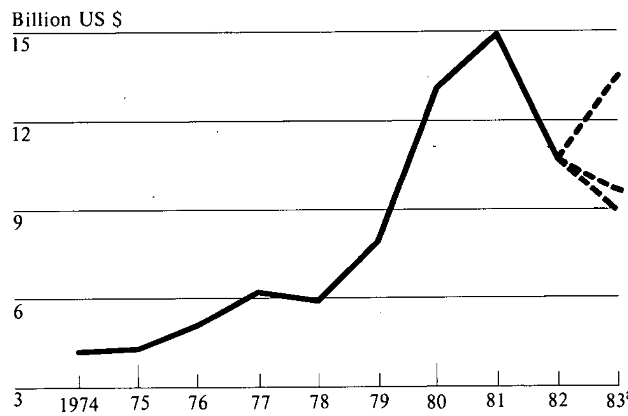
Figure 2
Indonesia: Oil Export Earnings



[a] For 1983, the upper limit represents a 100,000-b/d increase in exports to 975,000-b/d at OPEC's new benchmark price of $29 per barrel, producing revenues of $10.3 billion annually. The median line, based on Indonesia's 1.3-million-b/d production quota, reflects a continuation of 875,000-b/d exports at $29 per barrel. The lower line represents 875,000-b/d at $25 per barrel, producing oil export revenues of $8 billion. Current world oil market conditions suggest earnings will fall in the lower part of the range. 25X1

[redacted] 25X1

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quota to remain at 1.3 million b/d—some 300,000 b/d below capacity, but 200,000 b/d above early 1983 production levels. According to our projections:

- If the new agreement holds, Indonesia's oil and gas export revenues will fall by nearly $2 billion to $10.8 billion this year.
- If the agreement does not hold, each $1 per barrel drop in price will reduce oil export revenues by $320 million annually and LNG export earnings by about $70 million (see appendix). [redacted]

Current Account Deteriorating. Without a dramatic improvement in export performance or a drastic shift in import policy, we now estimate the current account deficit in 1983 will fall in the $10-11 billion range and could be even higher if oil prices spiral downward. As it is, exports of wood, rubber, tin, palm oil, coffee, and other traditional agricultural and mineral products have not yet recovered, and earnings from these sources appear likely to lag the economic recovery of major markets in Japan, the United States, and Western Europe. We believe a downward spiral in oil prices would produce unmanageable projected deficits that would force the government to adopt stern measures to cut imports. [redacted] 25X1

Jakarta is already increasing its foreign borrowing to help finance this year's deficit because, in our judgment, it would prefer to avoid a further sharp reduction in monetary reserves. The government financed the 1982 deficit through a combination of drawing down reserves and borrowing abroad. By the end of 1982, Jakarta had drawn down official foreign exchange reserves by nearly $3.5 billion to less than $4 billion. [redacted] 25X1

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Jakarta also has access to another $4 billion in net foreign assets accumulated by the state banks over the past few years. In addition, press reports disclose that

Table 2
Indonesia: Current Account Scenarios, 1983 [a]

Billion US $

Price Per Barrel	Crude Oil Exports (*1,000 b/d*)			
	1,100	1,000	875 [b]	775
33.60 [b]	−6.2	−7.4	−9.0	−10.2
30.00 [c]	−7.4	−8.5	−10.0	−11.1
27.00 [c]	−9.0	−10.0	−11.3	−12.3
25.00 [c]	−10.0	−11.0	−12.1	−13.1
20.00 [c]	−12.5	−13.3	−14.2	−15.0

[a] Projections assume: (1) 5-percent real growth in imports in 1983. Each 1-percent reduction in imports would cut the current account deficit by $200 million; (2) nonoil exports are assumed to grow at 5 percent with no adjustment made for faster world economic growth caused by lower oil prices.
[b] Indonesia's average price and volume for 1982.
[c] OPEC average prices.

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Central Bank officials are arranging a $1 billion loan, which would be the second-largest commercial credit ever obtained by an Asian borrower, and they expect to borrow more later this year. Jakarta has moved quickly out of concern that commercial bank loans will become more restrictive later this year and is willing to pay a considerably higher interest rate than it would accept as recently as late 1982. As long as Indonesia is willing to pay higher rates, commercial bankers in early 1983 appeared inclined to continue providing credits, according to financial press reports. Nonetheless, in the absence of an export recovery or stiffer austerity measures, we believe bankers will become more reluctant to lend to Indonesia. [redacted] 25X1

Jakarta has also displayed increasing nervousness over its financial prospects. [redacted] 25X1 25X1 With declining oil earnings in view, we believe Jakarta will have to cut development spending and live more austerely without excessive borrowing to avoid a severe financial squeeze within the next few years. [redacted] 25X1

Political Fallout. We believe shortfalls in oil earnings will intensify political infighting within the Indonesian bureaucracy as ministers who have become accustomed to growing expenditures find their resources squeezed. With development spending budgeted to rise only 7.9 percent and routine spending only 3.9 percent in the fiscal year beginning April 1983, even the excessively optimistic budget projections published by the government indicate a spending decline in real terms. Some hint of the conflicting pressures was revealed in an Embassy report of a cabinet meeting attended by World Bank President Clausen during his visit to Jakarta last November. At the meeting, Finance Minister Wardhana reported on the magnitude of the drop in export earnings and concluded with an eloquent call for restraint by ministers in their budget proposals for FY 1983/84. Minister of Research and Technology Habibie, however, followed Wardhana's presentation with a similarly eloquent speech stressing the need for continued spending on development with little apparent regard for resource constraints. [redacted] 25X1

US-Indonesian Relations: Potential for a Downturn

Although US-Indonesian relations have improved considerably since 1980 when disputes over rice sales, notification of US naval vessels transiting Indonesian waters, and declining US military aid angered the Soeharto government, the continuing sharp decline in oil revenues is creating an atmosphere that could produce another downturn in bilateral relations. We believe that financial difficulties over the past year have led the Indonesians to complain more forcefully about US policies on tin sales, coffee export quotas, and limitations on textile imports. [redacted]

The March 1983 OPEC agreement on prices and production virtually assures a continuing decline in Indonesia's oil revenues this year. If the agreement collapses, Jakarta's financial situation will become even more precarious, forcing more stringent austerity measures than those already in place. Besides retrenching spending, Jakarta will need to turn increasingly to foreign lenders and aid donors, including the International Monetary Fund and other international institutions. In our judgment, Jakarta would almost certainly seek a more forthcoming US attitude toward economic and military aid, greater support for loans from the IMF, and a more generous approach in general to Third World interests—areas where the Indonesians could very well be disappointed. We also might expect the Indonesians to be extremely sensitive to any hint that multinational firms or developed countries, particularly the United States, are benefiting from Indonesia's financial hardships. Any resentment against foreign investors or lenders could create difficulties for American firms operating in Indonesia as Jakarta seeks to increase its revenues at their expense. [redacted]

Sumbono's Vulnerability. The continuing weakness in oil earnings almost certainly will cause Judo Sumbono some political problems. [redacted] We believe his opponents will try to retaliate if an opportunity arises. In our judgment, Pertamina's current revenue shortfalls will impair Sumbono's ability to satisfy all the demands for unofficial funds and could make him vulnerable to the same charges of noncooperation that apparently led to his predecessor's downfall. [redacted] We believe falling oil prices might weaken his standing with Soeharto. [redacted]

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The Long-Term Threat. Although financing is the most serious immediate challenge, a longer term danger is reduced exploration for oil. We believe Indonesia will find it difficult this year to maintain the exploration boom of the past few years even though foreign oil companies signed 13 new production-sharing contracts in 1982, compared with nine in 1981. Exploration spending budgets in 1981 and 1982 topped $1 billion annually, but actual spending in 1982 almost certainly dropped by at least 20 percent as the number of exploration wells drilled—which had risen steadily from 154 in 1978 to 244 in 1981—dropped sharply. According to the US Embassy, production-sharing companies drilled only 149 exploration wells through October 1982 out of 266 projected for the year and slowed seismic survey activity. Companies also cut back on signature bonuses they were willing to pay to explore. None of the new contracts signed in 1982 included bonuses even remotely approaching the $40 million paid by one US firm in 1980 or the record $71 million paid by Caltex in 1981 for an offshore North Sumatra block. [redacted]

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We believe Jakarta's efforts to spur exploration will be weakened by the government's plans to transfer all onshore drilling operations to Indonesian firms within the next two years and to press ahead with Indonesianization in oil company employment practices. In [redacted]

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addition, lower oil company profit margins suggest that companies are likely to take a much more cautious approach to new spending commitments in Indonesia. For example, oil company representatives have told US Embassy officials that they are interested in several of the new blocks Jakarta is offering for exploration, but that cash flow problems of their parent companies are forcing slowdowns in their Indonesian operations and elimination of marginal projects. [redacted] 25X1

A slowdown in oil exploration would have serious consequences for Indonesia's oil production capacity later in the 1980s, in our judgment. Most of Indonesia's oil deposits occur in small reservoirs that are quickly depleted, and active exploration programs are necessary to maintain the country's production capacity. The exploration slowdown that occurred during 1975 to 1977, for example, resulted in declining output from 1977 until the 1978 exploration boom finally reversed the downward trend in 1981. [redacted] 25X1
[redacted] Pertamina does not yet have 25X1
enough sufficiently skilled oilfield workers to make up for the slack in exploration by the foreign oil companies. [redacted] 25X1

Appendix

Relations With OPEC

During OPEC deliberations on price and production quotas in 1982 and early this year, Indonesia continued to follow the lead of Saudi Arabia and Kuwait on prices while seeking to gain a compromise on pricing and production among OPEC's various factions. US Embassy [redacted] reporting indicate Indonesia had accepted the March 1982 production quotas as the only effective means of maintaining the cartel's pricing power. Even though US Embassy reporting disclosed increasing Indonesian dissatisfaction with its 1.3-million-b/d quota as the year progressed, Jakarta did not cut prices to boost production above its quota.

Indonesia went into the OPEC meeting in Vienna in December 1982 hoping to obtain a 200,000-b/d increase in its production quota. Although the meeting collapsed without agreement on new production quotas or price differentials, Mining Minister Subroto told one press reporter that Indonesia's output would be held at 1.3 million b/d. [redacted] In subsequent conversations with US Embassy officers in Jakarta, Indonesian officials uncharacteristically blamed Saudi Oil Minister Yamani for deliberately causing the collapse of the Geneva meeting in January.

In our judgment, Jakarta remains committed to a compromise on output quotas within OPEC, although the Indonesians believe they are entitled to a larger quota. We believe the Indonesians fear a downward price spiral, which would cause an even sharper reduction in their revenues and which they are nervously hoping the March 1983 OPEC agreement can avoid. In our view, they will press their OPEC partners to avoid excessive cheating that could lead to a price war. According to the government's budget, the Indonesians have based their revenue projections for the fiscal year beginning in April 1983 on a $34 benchmark price and output of 1.4 million b/d. They are counting on Saudi financial assistance to make up for any shortfall from either of these projections to avoid even tighter government spending than the austere budget already proposed.

[redacted]

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