# China, Japan, and Indonesia's LNG Ploys

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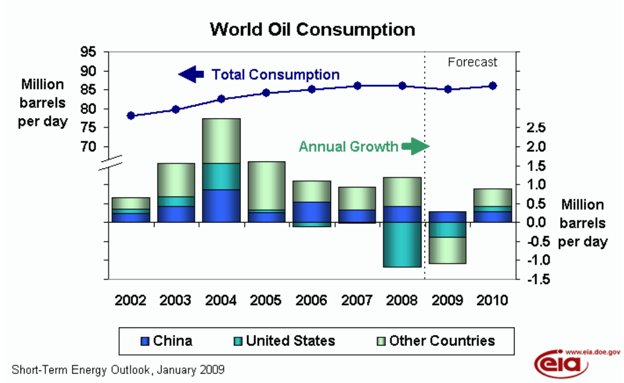
## Introduction

2008 was a rollercoaster year for those in the oil and gas industries. In July crude oil prices hit US$147 a barrel in the wake of attacks on Nigerian oil installations, before receding to under US$40 in December after months of economic decline in most major consuming countries. Weaker economies and record high prices have seemingly reduced worldwide demand and burst the speculative bubble in commodity prices. For those in government and business tasked with strategic planning such pricing movements make their jobs extremely challenging. Indeed, despite extensive research by the World Bank, analysts remain unsure if future oil prices will ever again climb above US$100 per barrel. [1]




World, US and China oil consumption and projections

For its part, Indonesia spent much of the year demanding and getting record prices for new liquefied natural gas (LNG) contracts to supply Japan and South Korea, in what was an increasingly seller's market. At the same time, Jakarta has been attempting to renegotiate a long-term LNG contract with China to more closely reflect the terms it agreed to with Japan and South Korea. This renegotiation process has travelled all the way up to presidential level and might yet hurt the increasingly close links between Beijing and Jakarta. However, the recent fall in oil and gas prices casts a large shadow over these delicate talks and ensures their outcome will be even more uncertain. At present it appears that Indonesia's resolve to renegotiate prices with China might have come too late, given that deliveries are scheduled to start in the spring of 2009.

This article will outline recent developments in Indonesia's LNG export relationship with both Japan and China. It will then assess what is driving Indonesian policy in the areas of energy and investment, with particular reference to China. Lastly, the implications for Indonesia of the recent drop in commodities prices will be assessed.

**Japan and Indonesia's LNG**

The Japan-Indonesia Economic Partnership Agreement (JIEPA), signed in August 2007 and ratified by the Diet on June 1, 2008, called for Japan to step up energy investments in Indonesia. In this sense, the JIEPA seems like a reaction to steadily increasing investment by China in Indonesia's energy sector. New Japanese investment has duly begun despite the impending reduction in LNG supply from Indonesia's Bontang plant. Sensing it is in a strong position, Indonesia has also been pushing for further concessions from Japan regarding future LNG supplies. For instance, on December 30, 2008 Iin Arifin Takhyan, vice president of Indonesian state oil company PT Pertamina, revealed that Japan had waived compensation for 90 outstanding cargoes of LNG due for delivery between 2002 and 2011. Since 2002 Indonesia has been struggling to meet contracted supply commitments to Japan, South Korea and Taiwan due to gas output shortfalls and rising domestic demand.

Japan is the world's largest importer of LNG, a policy prompted by the first oil shock of 1973. As Japan reduced dependence on oil, and moved towards a more diversified energy portfolio, natural gas has risen to account for about 15% of the nation's energy requirements, up from 2.7% in 1975. This shift turned the country into a major pioneer in the global LNG trade and Japan was the driving force behind the development of the Indonesian LNG industry. Indeed, both of Indonesia's processing facilities, Arun at Lhokseumawe in Aceh province and Badak at Bontang in East Kalimantan province, were constructed in the mid-1970s under supply contracts to Japan. Excess production has been made available to other buyers however, mostly in South Korea and Taiwan.

Despite this, in March 2008 it was confirmed that annual LNG export contracts to Japan would be slashed from around 12 million tonnes (MT) at present to 3 MT following their expiry in 2010 and 2011. Even though such contracts typically run for 15- to 25-year periods, they will be renewed for only 10 years, with 3 MT annually in the first five years and 2 MT per annum thereafter. The affected companies are Japan's Kansai Electric Power, Chubu Electric, Kyushu Electric, Osaka Gas, Toho Gas and Nippon Steel Corp. Their contracts cover gas from East Kalimantan, presently the source of around 90% of Japan's LNG imports from Indonesia, as the

Aceh fields are largely depleted and set to run completely dry in the next half decade. As resource supplies form the bedrock of the bilateral relationship, shorter contracts will invariably provide greater flexibility to Indonesia but represent a worrying trend for Japan. At the same time, Japanese buyers have been forced to pay record high prices to renew these contracts.

For example, in March 2008 it was revealed that Japan has agreed to pay around U$16-18 per MBTU (million British thermal units) to renew the Bontang LNG contracts. [2] This figure, which surprised analysts, set a new record price for Asian LNG beating the previous high of US$11 per MBTU agreed between state-run Korea Gas and Qatar under a 20-year LNG deal signed in November 2006. Analysts have been concerned that such high prices might be unsustainable, in part due to a raft of new LNG schemes projected to come onstream around 2015. Alarmed by safety fears in its nuclear power network, Japan did not appear to have many viable alternatives and Indonesia was able to take advantage of such vulnerability to drive the price up.

**Japanese LNG tanker**

Indonesian LNG remains attractive to Japan due to its relative geographic proximity and thus lower transport costs. Recognising this, Jakarta has factored these lower costs into the higher price it demanded and received for the renewal of the Bontang LNG contracts. Djoko Harsono of Indonesia's Upstream Oil and Gas Regulatory Agency (BPMigas) reasoned that although Qatar agreed to sell LNG for less, "The cost of transporting LNG from Qatar is higher than from Indonesia to Japan. Now they have agreed to add the difference in these transportation costs to the price of LNG from Bontang. The talks with them now only concern technical transportation problems." [3] These problems concern Jakarta's request that around 75 percent of Bontang LNG exports be transported by Indonesian shipping firms. BPMigas head R. Priyono revealed that Japan was asking for 50 percent of the exports to be carried in Japanese ships but that Indonesia disagreed, adding that transportation to Japan of LNG costs US$30,000 per day. [4]

Following the deal with Japan, Indonesia subsequently agreed on a price of US$20 per MBTU with Korea Gas in July 2008 for a short-term contract to supply less than 1 MT annually from 2010 to 2012. This gas will come from the new Tangguh LNG plant in Papua province and was originally earmarked for Sempra Energy of San Diego, California. Korea Gas, like its counterparts in Japan, also wants to extend its

LNG contracts with Indonesia that expire in 2014 and 2017 and cover around 2 MT per annum, and is hoping that it can be serviced from recently approved new deep-water fields off East Kalimantan, which are expected to start producing by 2014 at the earliest. Energy Minister Purnomo Yusgiantoro has stressed that domestic needs will take priority however, and that such deep-lying resources were more difficult to tap and consequently more expensive to develop. [5]

Tangguh will be Indonesia's third LNG processing plant and the first opened since the mid-1970s. After receiving final approval from Jakarta in March 2005, deliveries from the plant have been repeatedly delayed but are now scheduled to begin in March 2009. The US$5 billion project will initially run just two trains and should yield 7.6 MT per annum at first. Further enhancements are expected to yield 10 MT by 2011, which would be timely for overseas buyers if the gas is earmarked for export. In recent years, Indonesia has begun to prioritise domestic gas consumption over exports, hence the forthcoming cuts in the Bontang LNG exports to Japan and also South Korea and Taiwan.

Despite these cuts, rising global demand has coaxed Japanese investors back into Indonesia. Whilst in 1996 Japan imported 62% of available world supplies, that proportion had fallen to 41% in 2005 and is under continuing assault as other countries respond to the attractiveness of LNG. [6] In particular, China's imports of LNG, which began in 2006, are expected to rise rapidly. Although it has two LNG receiving terminals at present, China intends to build as many as seven new LNG terminals in six provinces and municipalities. Indeed, plans were recently announced to build a LNG receiving terminal in Qingdao in China's Northeast. Responding to this threat, Japan is stepping up its LNG investment in Indonesia.

Then Japanese Prime Minister Abe Shinzo's visit to Indonesia in August 2007 coincided with an agreement to accelerate LNG development in Banggai district, Central Sulawesi province, where 51% shareholder Mitsubishi Heavy Industries is constructing an LNG refinery. Land clearance was slated to finish at the US$1.4 billion development by the end of June 2008, the natural gas to be sourced from the Senoro and Matindok fields owned by Indonesia's PT Medco Energi International and PT Pertamina. [7] The plant had been scheduled to open in 2011 but progress has been delayed due to difficult pricing negotiations. [8] However, in August 2008 it was finally agreed that Japan would buy 1.7 trillion cubic feet of gas (TCF) over 15 years from the two fields, with the price based on Japan's crude oil import costs. This formula, known as the Japan Crude Cocktail, estimates the value of the gas at US$16 billion, based on oil prices of US$100 a barrel. Survey results indicate an annual yield of 2 MT, all of which will be exported to Japanese utilities Chubu Electric Power Co and Kansai Electric. [9] Mindful of its increasing difficulties in securing a continued supply of Indonesian natural gas, Tokyo had demanded Senoro LNG supply guarantees as part of the JIEPA, whilst the Indonesian side cited a lack of infrastructure to supply it to the domestic market as a reason why the LNG would be exported to Japan. [10]


**Inpex's gas investments in Indonesia**

It is also possible that gas production currently under exploration in eastern Indonesia's Timor Sea, in which Japan's largest energy explorer Inpex holds a 100% share, could also be used to meet future export demand. In January 2008, Jakarta was exerting pressure on Inpex to submit a firm proposal by May 2008 or risk losing its rights to develop the field, despite Inpex's original exploration contract of November 1998 expiring in November 2008. [11] Thus, in the final week of May, Inpex duly submitted a project proposal based on estimates of more than 10 TCF of natural gas reserves in the Masela Block's Abadi field. [12] If confirmed, this will be Indonesia's second-biggest new gas field after Tangguh which has combined reserves of 14.4 TCF. Inpex has also complied with pressure from Jakarta to build Indonesia's first floating LNG plant instead of the cheaper option of using the Ichthys plant in Darwin, Australia. [13] The refinery will have just one LNG train but with a capacity of 4.5 MT a year. [14] Shipments are scheduled for a 2016 start, and should provide a huge boost to both countries. [15] Given the ratification of the JIEPA by the Diet on June 1, 2008 the timing of Inpex's proposal could not have been better. The Japanese government holds a 29.35% stake in the firm.

In addition, Inpex has also secured exploration rights for the Semai II block off Papua. It will carry out exploration with two partners, Consortia Murphy Overseas Ventures Inc from the United States and Thailand's PTT EP, who together will invest $127.5 million in the first three years of the scheme. The Indonesian government's share from the projected output from this block is set between 65 and 85 percent for oil and between 60 and 70 percent for natural gas.

Indeed, Inpex was one of the first foreign energy firms to enter Indonesia in the early days of the Suharto regime in October 1966, and became the driving force behind the discoveries of crude oil and natural gas in Kalimantan. The latter is ironically processed at the Bontang plant whose supply to Japan will soon be restricted. Nevertheless, Inpex retains some rights to the oil and gas in Kalimantan's Offshore Mahakam Block, through a production sharing contract with the Indonesian government running to 2017 and the Mahakam Block remains a key component in the firm's profit outlook. As a result, Inpex is presently locked in talks with the Indonesian government to further extend the contract beyond 2017. Inpex also holds some rights to oil and gas in the Natuna islands in the South China Sea, whose gas is exported to Singapore and Malaysia via pipeline, and plans to commence new gas production from this area in 2009. Given that the firm saw its stake in Iran's Azadegan oil field fall from 75 percent to about 10 percent after missing a Tehran deadline to start work on the project, Inpex's gas investments in Indonesia have taken on even greater significance for the company.

**China and Indonesia's LNG**

The People's Republic of China (PRC) is a new player in the Indonesian LNG scene, and in recent years Chinese firms have invested around US$6 billion in Indonesia's resource sector. However, in the face of gas supplies delayed by diversions to meet domestic demand and record high prices, Japanese clients have been increasingly unhappy with new supply guarantees made to China. Ryoki Yasuo of Osaka Gas, for instance, has been quoted as saying, "Indonesia should offer LNG prices close to the price formula for Fujian". [16] This refers to the benchmark price agreed in 2002 of US$2.40 MBTU for the Tangguh gas to be supplied to China's Fujian LNG receiving terminal. Japan's average import prices rose 9% to US$5.18 MBTU in 2004 from US$4.77 in 2003.

Although the Tangguh to Fujian price was subsequently revised to US$3.35 MBTU at the end of 2006, this affair demonstrates that Indonesia had long seemed intent on charging Japan more for LNG than China. At present, the China National Offshore Oil Corporation (CNOOC) is due to receive 2.6 MT a year for 25 years at US$3.35 MBTU, whilst both K Power and POSCO from South Korea each agreed to an annual supply of 1.1 MT for 20 years at US$3.5 and US$3.36 MBTU respectively. The deals with the Koreans were originally sealed in the summer of 2004, whilst CNOOC's was inked in September 2002. The remainder of the initial production was originally earmarked for Sempra Energy at US$5.94 per MBTU for 20 years, whose deal allows 50 per cent to be diverted to other buyers who offer a higher price (subject to a cancellation fee, of course).

As a result, June 2007 the Energy and Mineral Resources Ministry and the Upstream Oil/Gas Management Board (BPMigas) began offering Tangguh LNG to Japan and South Korea at far higher prices than those agreed with CNOOC, K Power and POSCO, with the LNG being redirected from the Sempra share. Whilst Japanese utility Tohoku Electric also announced in May 2008 a 15-year commitment to acquire about 120,000 tonnes per annum of Tangguh LNG starting in 2010, negotiations to divert some of Sempra's allocation to Thailand's state-owned oil and gas company PTT fell through over price disagreements. [17] At the same time, Indonesia nearly reached a deal with Tokyo Gas for the diverted Sempra cargoes but again talks collapsed over pricing in October 2008. The two sides were discussing a price of US$20 per MBTU to buy 500,000 tonnes per annum for five years. We can thus assume that Tohoku Electric will be paying considerably more than US$5.94 per MBTU. Interestingly, in the wake of these two collapsed deals, a senior Indonesian official revealed in late November 2008 that the state-owned China Petroleum and Chemical Corporation (Sinopec) is keen to buy LNG from Sempra's original allocation. Pricing details were not released but it would appear that Sinopec is sensing favourable market conditions to satisfy its increasing hunger for natural gas.

On the surface, even the original sales price of US$2.40 MBTU seemed to compare favourably for Indonesia with a tender Qatar won the same year to supply Taiwan at a price of US$1.8 MBTU. However, the Fujian pricing formula was based on a price of US$25 per barrel, meaning that the gas pricing equivalency would have an upper ceiling of US$25 per barrel and the Tangguh LNG price would not rise if oil prices exceeded this. This effectively locked the LNG selling price, in contrast to a more progressive formula which ensures that gas prices mirror fluctuating global energy prices. Indonesian gas prices are usually linked to oil prices without any price ceiling, and such a progressive formula was applied to the contracts signed with Japan for both the Arun field in Aceh and the Badak field in Bontang, East Kalimantan.

As the price of oil exceeded US$50 per barrel, the Tangguh pricing formula became increasingly controversial, prompting Jakarta in January 2006 to request a revision. In late 2006 both parties eventually agreed that the price would be increased to US$3.35 MBTU, but once more the pricing formula featured an upper ceiling on the price of oil, now set at a maximum of US$38 per barrel. This new pricing formula was sealed when global oil prices were averaging about US$70 a barrel. It means that for 25 years the price of the Tangguh gas sold to Fujian will never increase much beyond US$3.35 MBTU, even if oil prices are always above US$100 per barrel or even higher. During June and July 2008 the price of gas on the international market was approaching US$20 MBTU to reflect high oil prices at the time. Prices agreed with Japan and South Korea in 2008 mirrored that new reality, and Indonesian energy analyst Kurtubi estimated that such pricing differentials would result in Indonesia losing US$3 billion annually. [18]

As the price of oil continued to climb in 2007 and 2008, domestic political pressures caused a further re-think in Jakarta and in March 2008 Vice President Jusuf Kalla announced that a further renegotiation of the Fujian contract would be desirable. In the summer of 2008, Jakarta established a Tangguh contract renegotiation team, reporting to Kalla himself and headed by Sri Mulyani Indrawati, Coordinating Minister for the Economy. In August 2008, Kalla has claimed that the Tangguh contract's present terms would cost Indonesia US$75 billion adding that, "This formula is the worst in the history of the oil industry. The contract is loss-making, especially when the price of oil is high." [19] Kalla has even pushed the House of Representatives (DPR) to review the deal and the Supreme Audit Agency (BPK) will supposedly investigate the Tangguh contract.

President Yudhoyono subsequently met his Chinese counterpart Hu Jintao to renegotiate the Tangguh pricing scheme on October 23, 2008, and this followed a similar meeting after the Beijing Olympics closing ceremony when Kalla also met with Hu and Vice President Xi Jinping. While the two heads of state agreed upon further price negotiations, the concessionary loan programme China has initiated for Indonesia and recent oil price declines might effect Jakarta's bargaining position. Yudhoyono is pushing for enhanced energy cooperation with China, especially in the construction of power plants, under the concessionary loan scheme. Indeed, energy cooperation has become key to Sino-Indonesia relations, similar to Beijing's growing ties to other resource-rich developing countries in Africa.

After previously threatening delays, Jakarta has thereby more recently stated that it will not delay Tangguh LNG shipments despite the ongoing price renegotiations. Nevertheless, some analysts have argued that it would make greater financial sense for Indonesia to cancel the contract, and pay US$300 million in contractual penalties, rather than undersell the gas for 25 years. Such a move would undermine their bilateral memorandum of understanding, inked in October 2006, to expand cooperation in the energy and mineral resources sectors but the supply price of US$20 per MBTU agreed with Kogas makes this logic financially compelling. Kalla himself has declined to state what price Indonesia is looking for but US$7 per MBTU seems a fair assumption based on his assessment of a US$75 billion 'loss' if the contract is not revised again. [20] An anonymous Indonesian government official said in September that Indonesia is seeking a price of US$10 per MBTU for the renegotiated Fujian gas deal. [21] Although Kalla has stated that negotiations will open again in January 2009, the two sides still appear far apart. Beijing has agreed to pay US$3.80 per MBTU but Jakarta has insisted that is too low.

The situation appears delicately balanced with deliveries due to start shortly. Kalla claims that Beijing is willing to change the pricing agreement. However, government insiders paint a very different picture of numerous meetings and Chinese intransigence. [22] Rather than pay higher Tangguh prices Beijing will probably look for more pipeline supplies from countries like Turkmenistan or accelerate its own gas field development. Therefore analysts have speculated that the contract could be cancelled as this scenario is actually provided for within the agreement. As the maximum penalty for any such eventuality of US$300 million, cancellation makes financial sense. Whilst there is a risk that China could take its case to international arbitration this prospect appears unlikely given the damage that bilateral relations would suffer. [23]

Indeed, analysts are amazed that Indonesian negotiators accepted a pricing formula which placed such a low ceiling on the price of crude. Whilst oil and gas prices were falling in 2002, and China took full advantage with regard to the Tangguh contract, this was a temporary phenomenon as prices subsequently rose over the following years. To assume that oil prices would not rise for 25 years, when accepting such low pricing ceilings of first US$25 then US$38 per barrel, now appears very shortsighted. According to Purnomo, Energy and Mineral Resources Minister since 2001, the low price was the result of Indonesia's failed tender for China's larger Dapeng supply contract in Guangdong. As a consolation prize, Beijing invited Indonesia to become the sole bidder for the Fujian supply contract but with the US$25 per barrel pricing formula included within that invitation. At the time the price of LNG on the international market was reflecting a supply glut, and Purnomo claims Indonesia had also recently lost tenders in Taiwan and South Korea. Having difficulty wooing buyers in Japan too, the original Tangguh pricing formula reeked of desperation. For different reasons, this formula is now causing consternation among both Chinese and Japanese buyers, and in hindsight seems to have been handled poorly by the Indonesian government.


**China's LNG receiving terminals**

## Indonesia's China Policy

The spat over the Tangguh pricing scheme casts something of a shadow over increasingly close economic and political relations between the two countries. In 2006 Indonesia became, after Australia, the second largest destination for Chinese investment in energy and commodities.

Indeed, Sino-Indonesian relations have been transformed after years of wariness during the Suharto era (1966-98), when when the Indonesian government went so far as to ban the display of Chinese characters. Suharto's seizure of power was also accompanied by the closing of Chinese schools and the prohibition of public displays of Chinese culture, whilst the country's ethnic Chinese were strongly encouraged to adopt Indonesian names. Even diplomatic relations between the two countries were suspended from October 1967 and August 1990.

However, since Suharto's fall in May 1998, the Indonesian government has been trying to bolster sagging foreign investment and increase the archipelago's economic prosperity. Attracting foreign capital to spur fresh mineral exploration has become a priority in the face of declining output from the archipelago's existing oil and gas fields. This decline has forced Indonesia to become a net oil importer and to scale back LNG exports from existing plants. Nevertheless, the country remains a major repository of resources and home to significant reserves of oil, coal, and natural gas, as well as being the world's second largest producer of copper and tin and the fourth largest of nickel. The Grasberg mine in Papua remains the world's largest gold mine, and Indonesia is also a major exporter of palm oil, cocoa, and coffee. Until the recent global recession, strong demand from China and India was driving prices for many of these commodities up to record levels. With China becoming one of the biggest investors in them, Trade Minister Mari Pangestu wants to position Indonesia to ride the bandwagon of China and India's economic growth.

**The Grasberg mine**

Such a policy requires huge foreign investment however, which Indonesia has struggled to attract since the Asian Economic Crisis of 1997-98. Seen by many as a risky investment destination, endemic corruption, an uncertain legal climate, opaque bureaucracy and poor physical infrastructure all deter foreign capital. Sweeping political decentralisation since 1999 has compounded this situation, making the approvals process even murkier as local government power has increased. In addition, the lengthening of the investment licensing procedure has also made approvals more complex and time consuming. [24] Consequently, fresh overseas capital has largely gravitated towards existing operations rather than the exploration of new mineral sources. As a result, Indonesia has not experienced the recent economic growth rates that some similarly endowed countries, such as Russia and Brazil, have enjoyed of late.

Recent history tends to suggest that Chinese companies have a higher tolerance than others to such obstacles, however. In addition to Tangguh and various other exploration and production contracts, CNOOC is making its biggest overseas investment by channeling some US$5.5 billion into biofuel production derived from palm oil and sugarcane in Papua and Kalimantan. Rivals PetroChina and Sinopec are also seeking to acquire more exploration and development rights in Indonesia.

However, for its part the Indonesian government wants foreign investors to sign local production agreements that it hopes will create a feedback effect of wealth and employment inside the country. For instance, new legislation was passed in December 2008 which requires mining firms to process all mining products into metal locally either by establishing their own smelters or using another smelter for processing, rather than just exporting the raw materials abroad. Jakarta thus hopes that foreign mining concerns will develop new copper smelters and nickel furnaces that will enable Indonesia to produce high-quality finished goods. The government argues that such new rules will give Indonesia greater control over its natural resources and therefore boost revenue. However, investors argue that any such moves will deter investment by increasing their costs, thus decreasing government revenue. The new law also promises to shorten mining contracts to 20 years with an option to extend for a further 20 years. As contracts presently last for 30 years with an additional 20 year extension possible, investors have been critical of the proposed changes. The bill took more than three years to pass as lawmakers argued whether to apply the law to existing projects or only new ones, and ends the uncertainty which had hampered mining investment in recent years. It was finally decided that existing mining contracts will be honoured, but that all contractors would have five years to fall in line with the new legislation.

This new paradigm affects China because, in addition to energy, Chinese economic growth feeds on raw materials from Indonesia. For example, China has markedly expanded aluminium production capacity in recent years with further growth planned over the next decade. To feed its own production, China will continue to remain heavily dependent on supplies from Indonesia, which has large bauxite resources in Kalimantan. However, as emerging economies need alumina to develop, the Indonesian parliament has discussed banning future bauxite exports in favour of constructing its own refineries to convert bauxite to alumina domestically. As a result, Chinese alumina refineries have been scrambling to find other suppliers, particularly in Australia and Guinea.

With specific regard to Tangguh, an anonymous Indonesian official who travelled with Vice President Kalla to Beijing, has confirmed that the Tangguh contract could be used to attack domestic political opponents with elections due in April and July 2009. With the Indonesian Democratic Party of Struggle (PDI-P) of former President Megawati Sukarnoputri strongly advocating a parliamentary enquiry to investigate the government decision to increase fuel prices, the low price the Megawati administration agreed to with China could become politicised. Whilst the PDI-P has stressed that both President Yudhoyono (SBY) and Kalla were also serving in the Megawati government at that time, the Tangguh issue could easily end up as ammunition for SBY and Kalla to attack Megawati during the presidential race of 2009. Such a scenario could complicate relations with China.

**Tangguh LNG facility under construction**

Whilst it is possible that the Tangguh pricing negotiations could cause a rift in Sino-Indonesia relations, it is inescapable that Indonesia has what China needs – large deposits of mineral resources. Moreover, Jakarta has been able to get its own way with Japan on a number of energy-related issues in the last 12 months. Nevertheless, Indonesia must manage its relationship with China carefully to get the most of this new opportunity. Indonesia's perception of China might also affect the future course of the relationship, and this perception is shaped by many factors.

Whilst the bilateral trading relationship has blossomed of late, the two nations are actually direct competitors in several spheres, and many in Indonesia view China as an economic threat. For instance, since 1997 Jakarta has seen a drastic reduction in inbound foreign investment, most notably from Japan, much of which has been channelled to China instead. Exacerbating this has been China's remarkable success at mass producing high-quality but inexpensive finished goods. In stark contrast to when their trading relationship began, Indonesia now mostly exports raw materials and primary commodities to China (crude oil, logs, palm oil, paper pulp and veneer), whilst most of its Chinese imports are manufactured goods (electronics, machinery, motorcycles and textiles). Indonesia's huge footwear industry has suffered at the hands of Chinese competition, and its textile industry faces a similar threat. Whilst Indonesia still enjoys a healthy trade surplus with China thanks to its commodities exports, the proposed China-ASEAN Free Trade Area is perceived by Indonesian labour unions as a sword of Damocles hovering over the country's manufacturing sector. Once completed in 2010 these unions worry that locally-produced goods will be unable to compete with cheap imports from China.

In addition, many in the Indonesian elite still perceive the PRC as an unreformed neo-imperialist state. Whilst unspoken, this notion has been successively reinforced by the annexation of Tibet, the treatment of Taiwan as a renegade province, its seizure of the Paracel Islands, the 1979 border war with Vietnam and, most significantly, its view of the South China Sea as a 'Chinese lake'. Indeed, official Chinese maps have claimed the entire South China Sea from Hainan Island to Indonesia's gas-rich Natuna Islands as its territorial waters. Despite verbal assurances that this archipelago is not claimed by China, Beijing has failed to provide similar pledges regarding the giant Natuna gas field, located some 225 kilometers northeast of Natuna's main island. Chinese maps have shown the gas field falling well inside China's maritime jurisdiction, prompting Jakarta to remain uneasy about China's growing economic and military muscle. Concerns over both PRC and Vietnamese encroachment lead to the completion of Ranai Air Base in the Natunas in May 1981, and subsequently Jakarta has been prepared to base F-16 jet fighters in the archipelago to protect against actions similar to Beijing's 1995 occupation of Mischief Reef in the Spratly Islands. [25] The Indonesian government has also been active in international forums designed to ameliorate South China Sea sovereignty tensions. Whilst worries about PRC encroachment on the Natuna gas fields have receded since the mid-1990s, Jakarta will still be concerned about comments made by China's Ministry of National Defense in December 2008 that building aircraft carriers is being seriously considered "to safeguard the country's marine safety and sovereignty over coastal areas and territorial seas". [26]

Indeed, many in Indonesia's conservative elite consider China's ultimate aim to be a measure of neo-suzerainty over Southeast Asia, which clashes with Indonesia's self-image as the de facto leader in the region. Whilst such aspirations have been dashed by the archipelago's political and economic decline after 1997, this period has also coincided with an enhanced political, economic, and military profile for China in Southeast Asia. Indeed, some in Jakarta increasingly regard Beijing as a rival for regional influence and leadership as China fills the vacuum left by Indonesia's various crises since 1997.

Related to this perception is the fact that the PRC has played a significant, and occasionally controversial, part in Indonesia's modern history. By the 1960s the Indonesian Communist Party (PKI) was the third largest communist party in the world after those of China and the Soviet Union. It was also the richest of Indonesia's political parties, with much of its membership income coming from the ethnic Chinese business community, some of whose contributors were probably pressured by the Chinese embassy. [27] As founding President Sukarno's political balancing act between the PKI, the military, nationalists, and Islamic groups appeared increasingly precarious, he looked towards the PKI for support. However, everything changed on the night of September 30 and October 1, 1965 when the party was blamed by the military for a failed coup. The PKI and its members were subsequently exterminated in a wave of mass killings throughout Indonesia, orchestrated by the army and largely carried out by Islamic political organisations. Major General Suharto then seized upon the coup to manoeuvre Sukarno out of the presidency. Under Suharto's so-called New Order the PRC and communism were painted by Indonesia's civilian and military elite as the major danger to Indonesia's fragile national unity. The official line was that the PRC had promoted revolution in Indonesia by agreeing to arm the PKI and Suharto demanded an apology from Beijing. China refused however and instead provided asylum to surviving PKI leaders. [28] As the diplomatic relationship ended, the PRC embassy in Jakarta was symbolically burnt to the ground by a mob.

Given their financial support for the PKI, Indonesia's ethnic Chinese community was targeted along with PKI members in the aftermath of the October 1 coup. Indeed, Chinese-Indonesians constitute a delicate situation for both Jakarta and Beijing. Despite making up only around 5 percent of the population, they control the commanding heights of the domestic economy for which indigenous (pribumi) Indonesians particularly resent them. Such feelings have occasionally erupted into anti-Chinese bloodletting, as in the events of May 1998 which culminated in Suharto's resignation. Reports were rife about sexual assaults against ethnic Chinese girls and women, and Chinese homes and businesses set ablaze. The widespread capital flight that accompanied this particular pogrom also fuels pribumi doubts about ethnic Chinese loyalty to Indonesia, and China's growing economic presence in Indonesia risks inflaming pribumi jealously towards the ethnic Chinese community. Many Indonesians fear China acting on behalf of Chinese-Indonesians, and during the May 1998 riots, the PRC Foreign Ministry issued statements that Indonesia should protect its ethnic Chinese. [29] Jakarta accused the PRC of internal interference and Beijing quickly downplayed such statements. Nevertheless, fears were raised that China may act more forcefully in future if ethnic Chinese are endangered. Any future occurrences of anti-

Chinese riots would need to be handled carefully by both parties, especially by an increasingly nationalistic PRC.

**Anti-Chinese riots of 1998**

Despite all of the above, the most significant driver of Sino-Indonesian relations is mutual and pragmatic economic self-interest. During times of recession, such as in the mid-1980s and the late-1990s, Jakarta has tried to expand trade with the PRC to bolster its economy. Moreover, since the May 1998 riots Indonesia has also strived to improve its image in the eyes of ethnic Chinese in order to encourage Chinese-Indonesians to repatriate billions of dollars moved offshore after the riots. Chinese-Indonesians now have more freedom to speak openly, to establish political parties, to perform traditional customs, to study Mandarin and publish in Chinese. Television news can now be broadcast in Mandarin, and more ethnic Chinese have served in the cabinet. However, although the 2008 Citizen Law prohibits racial and ethnic discrimination, ethnic Chinese must still produce a citizenship document to secure a passport, credit card, or business license, or to send a child to school - a situation that often leads to extortion by rogue officials.

This pragmatic economic self-interest was nevertheless evident in the 1980s when the Indonesian military and the Department of Foreign Affairs were locked in a battle over China policy. [30] The military still viewed China as a threat and pressed Suharto not to normalise the diplomatic relationship, but the Department of Foreign Affairs argued that failure to do so would be to the detriment of Indonesia politically and economically. Declining oil prices in the mid-1980s encouraged Suharto to loosen trading restrictions with the PRC in the hope of expanding Indonesia's non-oil and gas exports. The president's subsequent decision to normalise relations in 1990 demonstrated both his increasing omnipotence and his cooling relationship with his own military as a younger generation rose up the hierarchy. Despite growing ties between the two countries, elements in Indonesia's military leadership remain suspicious of China's emergence and seek to counterbalance the PRC's influence by consolidating ties other regional powers such the US and Japan. [31] High ranking military officers privately concede that China is still considered the most likely external threat to Indonesia's territorial integrity, and the military's defence posture still reflects such concerns. Even so, the military has a much reduced political role since the Suharto era and its China complex is largely ignored in the formation of Indonesian foreign policy. This enabled Abdurrahman Wahid, President from 1999 to 2001, to make his first official trip as head of state to China, and his successor, President Megawati paid a state visit to China in March 2002. Current President Yudhoyono first visited China in July 2005, following up with further trips in October 2006 and October 2008 ostensibly to strengthen bilateral economic ties.

While widespread scepticism of China remains in Indonesia, especially among the upper echelons of the military, foreign censure of Indonesia in the last decade has pushed Jakarta closer to Beijing. Western criticism of Indonesia's dubious human rights record, particularly East Timor and Papua, means that Indonesia and China increasingly find themselves sharing common ground at international fora. Likewise, the United States arms sales embargo led government ministers to consider weapons acquisitions from the PRC as part of its modernisation plans. China did agree to provide technical assistance to Indonesia's state-owned defense industries during President Hu's April 2005 visit, covering both aircraft and ship building and also small arms and ammunition. During President Yudhoyono's first visit to Beijing in July 2005, Indonesia's Defence Minister confirmed that Indonesia was seeking Chinese assistance to build short- and medium-range missiles to replace some of its American F-16 fighter jets grounded by the embargo. [32] However, whilst Jakarta did agree to buy six Russian Sukhoi fighters as an alternative, resistance from within the Indonesian military and the poor quality of Chinese equipment, suggest that such statements were largely political theatre designed to persuade the US Congress to lift the arms embargo. In November 2005 it was duly lifted as Indonesia's importance to the so-called 'war on terror' increased.

For its part, Beijing's Indonesia policy is part of its effort to weaken what it perceives as a policy of strategic containment by Washington. First was a 'strategic partnership' signed with Russia in October 2004, followed by similar agreements with India and then Indonesia. Similar to Japan in the mid-1970s, China's appetite for Indonesia's energy resources coincides with Beijing's desire to lessen its dependence on Middle East energy resources and the strategic vulnerability of the Malacca Strait. In this sense, Indonesia's importance to China is identical to Indonesia's importance to Japan, and why both powers are increasingly becoming rivals for influence in Indonesia. In addition to energy investment however, Jakarta is trying to encourage both countries to help overhaul Indonesia's physical infrastructure in order for the archipelago to be competitive in many different economic spheres rather than just commodities exports. Whilst Sino-Indonesian diplomatic relations are breaking new ground, it remains to be seen if the two sides' objectives and goals will be mutually compatible.

**Indonesian President Yudhoyono welcomes Chinese Premier Wen Jiabao to Jakarta**

**The effect of plunging prices**

It seems highly likely that the ongoing descent into global recession will have far-reaching implications for the oil and gas industry. Oil prices are being further depressed by increasing stock reserves and falling demand. Analysts foresee continuing low prices into 2009 as the economic malaise is predicted to deepen. As a result, the much-needed introduction of energy-saving technologies will likely be delayed by lower oil prices, and alternative fuels will likewise be less attractive.

The International Energy Agency (IEA), the energy watchdog of the 26 OECD industrial countries, has warned that lower prices may reduce new investment in oil and gas and could also presage a fall in production of unconventional reserves. [33] The IEA also cautioned that future production will require ever increasing levels of investment to maintain supply, and foresees an annual output decline of 6.7 percent from the world's existing oilfields. [34] However, the present tight credit environment means that energy firms could find it increasingly difficult to secure the large sums necessary for exploration and production. This is exacerbated by the fact that oil and gas production costs have increased steadily in recent years as new finds are located in less accessible areas which are expensive and difficult to develop. Consequently, whilst higher oil prices did encourage greater investment in new projects, cost inflation accounted for much of this extra capital. For instance, Edi Purwanto of BPMigas has said of Tangguh's construction costs that, "In 2002 they amounted to only between US$250 and US$300 per tonne", compared to Mitsubishi's Senoro LNG refinery in Central Sulawesi where costs have reached US$1,000 per tonne. [35] As a result, project cancellations and postponements have already been rising and this trend is likely to continue well into 2009.

The implications of the global downtown for Indonesia are already becoming apparent and extend well beyond oil and gas exports. Given that Indonesia still relies heavily on commodities exports, the Jakarta stock market and the wider economy closely reflects fluctuations in global commodity markets. For instance, the boom in the country's main commodity exports such as gas, coal, gold and copper since the middle of 2007 inflated the Jakarta stock market index to a peak of over 2,800 in April, 2008. Similarly high prices for other Indonesian exports such as palm oil, rubber, coffee and cocoa contributed to the stock market bubble but also improved the purchasing power of many smallholders throughout the archipelago. The result was one of the best performing stock markets in Asia and Indonesia's best economic growth for in a decade in 2007. However, the end of the boom in August 2008 dragged down the Indonesian stock index to below 1,100 at one point as the prices of many commodities fell to as little as one third of their market valuations only three months previously. In addition, recession in the U.S, Japan and Europe, the nation's top three export destinations, is also hurting Indonesia's economy.

Indonesia's untapped gas resources lie in remote areas, and thus are more costly and technically challenging to explore and develop. They will require intensive long-term capital investment to exploit. For instance, largely as a result of its LNG developments in Indonesia, Inpex's annual expenditure may rise above 600 billion yen over the next five years from around 330 billion yen in the 2007-2008 fiscal year. As a result, and with the number of gas exporting countries increasing, Jakarta has introduced greater commercial transparency and more attractive production sharing terms, under which the government and operating firms share the output of the block. However, the annual number of gas exploration wells drilled in the country has fallen by around 50% since 1998, and in the government's 2007-2008 regular tender only nine oil and gas blocks out of the 21 attracted investors. This is partly due to a series of contractual production-sharing and long-term-supply disputes that have pitted Jakarta against multinational energy companies and Japanese natural-gas importers in recent years. Many gas importers in Japan look wistfully back to the Suharto Era (1966-1998) when its LNG exports were reliable and abundant. Ryoki Yasuo of Osaka Gas, for instance, has previously gone public with his firm's dissatisfaction at Indonesia's management of its gas industry. [36]

To forestall the effects of the global credit crunch, Inpex revealed in December 2008 it was looking to sell stakes worth $30 billion in LNG exploration projects in Indonesia and Australia to raise capital. Chairman Kunihiko Matsuo was particularly optimistic that investors would be found for the Abadi project in Indonesia's Timor Sea, with Royal Dutch Shell apparently interested. [37] Pertamina has also been looking to gain a 30 percent participating share in the scheme, but Matsuo cited access to low interest loans from the state-run Japan Bank for International Cooperation and cash reserves of around US$5.5 billion to keep its new LNG projects afloat even without foreign capital. Nevertheless, such an announcement would have been somewhat disquieting for the Indonesian government.

The major question is how long the current global recession will continue. While oil and gas prices are expected to drop in the short term, subsequent economic recovery will lead to increased demand and higher prices. Beyond the current recession, various factors are expected to drive prices higher again. These include: rising demand from developing economies; insufficient investment to maintain production capacity; decreasing new field discoveries; increasing oil-field depletion rates; not enough spare capacity to meet spikes in demand; and growing resource nationalism as national oil companies gain increasing influence over oil production at the expense of international oil companies. The increasing potential of producing countries to use energy as a geopolitical tool, as seen recently with regard to Russian gas exports to Europe, could easily lead to a future spike in oil and gas prices. With gas prices commonly tied to oil prices, any increase in the latter will likewise result in a similar rise in the former.

Such scenarios are exacerbated by the fact that the major oil and gas exporting economies are themselves rapidly developing, and consequently consuming more of their resources domestically. As a result, it is likely that less oil and gas will be available on the international market, and such a trend is already being witnessed in Indonesia with regard to LNG exports to Japan. In particular, greater domestic use of oil and gas in other exporting countries such as Mexico, Iran and Russia is expected to cause global price rises. As a result, Tanaka Nobuo, the head of the IEA, has repeatedly cautioned that after the present global downtown is over an oil supply crunch will occur which will be more acute than any experienced thus far. This is largely because of increasing energy usage in developing countries, with rising consumption as ever greater numbers enjoy car ownership and a middle class lifestyle. In addition to transportation, growth in construction and electrical appliance sales will all increase demand for energy. Infrastructure projects in developing countries will likewise require greater energy consumption, just as they did in the industrialised world between the 1860s and 1960s. Consequently, the IEA estimates that oil demand from Asia, the Middle East, and Latin America will surpass that of the developed world by as early as 2015, and will continue soaring thereafter.

Referring specifically to gas, on December 23 2008 the Gas Exporting Countries Forum (GECF) signed a joint charter in Moscow to establish a new group to monitor the gas market, conduct joint research and coordinate policy. The new body has not ruled out future price cooperation, and major gas consumers are concerned that the new body will set output quotas, like the Organisation of Petroleum Exporting Countries (OPEC). At the meeting Russian Prime Minister Vladimir Putin stated that, "The expenses necessary for developing fields are rising sharply, and the era of cheap energy resources, of cheap gas, is coming to an end". [38] The membership consists of most of the major gas exporting countries such as Brunei, Indonesia, Iran, Malaysia, Qatar, Russia and the United Arab Emirates. Whatever the effect of this new grouping, it is highly unlikely that such a cartel will act to keep down gas prices and that is another reason why gas prices will rise again in future.

**Conclusion**

These developments in Indonesia indicate the volatility of commodities prices and their ability to affect diplomatic relations. Until mid-2008 government officials were able to demand from Japan and South Korea record prices for future LNG shipments, whilst at the same time wrangling other concessions out of Japan, its biggest customer. Duly emboldened, Jakarta has attempted a similar strategy with China but with no success as yet. This is because the Tangguh contract has already been renegotiated once and deliveries are due to begin in March 2009. Unlike buyers in Japan and South Korea who signed agreements with Indonesia at the top of the market, China signed its own deal with Indonesia at the bottom of the market when Jakarta was desperate for a buyer. Exacerbating matters is the fact that CNOOC is a major shareholder in Tangguh and has an expanding portfolio of investments in Indonesia's energy sector.

The situation appears delicately balanced with deliveries due to start shortly. Whilst Kalla claims that Beijing is willing to change the pricing agreement, other evidence suggests the two sides remain far apart in their pricing assessments. If Beijing does not agree to pay closer to market rates, and with a closer tie to the prevailing crude oil price, Jakarta's best option appears to be cancellation. China could react by insisting upon international arbitration but with so much investment tied up in Indonesia it will be interesting to see which side blinks first. Moreover, with global energy prices in freefall, in November 2008 both Tokyo Gas and Thailand's PTT refused to pay the prices that Japanese and Korean utilities agreed to just a few months previously, further indicating the volatility of even a comparatively stable commodity like LNG. Complicating matters further is Sinopec's interest in purchasing some of the Sempra share of the Tangguh LNG after Tokyo Gas and PTT pulled out of negotiations.

The Tangguh contract with CNOOC is something of an anomaly among Indonesia's LNG supply agreements which usually feature a close tie to the price of crude. If deliveries begin at the current contracted price, China will be able to reap huge profits by selling the gas to other parties or could sell electricity domestically at very low cost. Indonesia meanwhile continues to suffer electricity shortages which have even caused Japanese firms operating in the archipelago to issue threats of pulling out over continuing power outages. Hence the current administration's determination to renegotiate.

It is possible that the Tangguh pricing negotiations could cause a rift in Sino-Indonesia relations. However, Indonesia has what China needs – large deposits of mineral resources – Jakarta will feel confident it is holding most of the cards, a fact that Japan has been recognising recently. Even so, with a raft of LNG projects set to come online by 2015, Jakarta must manage this new relationship carefully. Cancelling the Tangguh contract would probably ensure that Indonesia will earn more money from its natural gas, assuming that energy prices will soon rise again, but this should be the last resort.

Despite their recent difficulties in dealing with Indonesia, both Japan and China are pushing ahead with heavy investment in the archipelago's resource sector. Indonesia's importance to China as it is to Japan, so that both powers are becoming rivals for influence in Indonesia. In addition to energy investment however, Jakarta is trying to encourage both countries to help overhaul Indonesia's physical infrastructure so that Indonesia can be competitive in many different economic spheres not just commodities exports. Indonesia's aim is to move beyond being a simple repository of resources and into a manufacturing powerhouse like Japan and China. Ironically, Jakarta is reaching out to both countries to secure such a future but it appears unlikely at present that Indonesia will become a potential manufacturing rival to China and Japan.

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