

THE CHURCHILL MINING DEBACLE – A WAKE UP CALL FOR MINE OWNERS AND POTENTIAL INVESTORS¹²

Introduction

The revocation of the four mining licenses, which provide the legal basis for Churchill Mining's East Kutai Coal Project, raises troubling questions about the real security offered by the 2009 Minerals & Coal Mining Law as well as about the effectiveness or otherwise of the administration of that law.

Many investors in the Indonesian coal mining industry will surely see the experience of Churchill Mining as not just an isolated and unfortunate incident affecting one hapless company and its shareholders but, rather, as a wake-up call for all mine owners and potential investors in the coal mining industry. Foreign investors are likely to be particularly disturbed by the Churchill Mining debacle and what it means for the long term security of their investments in the coal mining industry.

Background

Churchill Mining and its partners have completed a feasibility study in respect of the East Kutai Coal Project which established the existence of proven and probable coal reserves of more than 900 million tones.

In 2010, the Regent of East Kutai revoked the four mining licenses which provided the legal basis for Churchill Mining's East Kutai Coal Project. The official reason for the Regent's decision was that Churchill Mining had carried out illegal mining activities in forest areas.

Churchill Mining's subsequent application to the Administrative Court in Samarinda, East Kalimantan, seeking the reinstatement of its mining licenses, was rejected on 3 March 2011. Churchill Mining has expressed its intention to appeal the Administrative Court's decision, with the appeal to be heard by the Administrative High Court in Jakarta. The appeal will, realistically, take many months to be heard.

Market rumor has subsequently suggested that factors, quite unrelated to forestry issues, were the real reason for the revocation of the mining licenses.

The writer is not in a position to express any view on what actually motivated the decision of the Regent of East Kutai to revoke the mining licenses for the East Kutai Coal Project or the likely outcome of Churchill Mining's appeal.

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Commentary

Regardless of the legal merits or otherwise of the action taken by the Regent of East Kutai, the cancellation of the four mining licenses raises at least 5 issues which are of potential significance for all mining companies in Indonesia and, most particularly, for foreign owned mining companies in Indonesia.

1. Security of Mining Concessions: The holders of properly issued and registered mining licenses are meant to enjoy a high level of security and the protection of the law so long as they comply with the terms of their mining licenses and the applicable laws and regulations of Indonesia. Indeed, Article 2(f) of the 2009 Minerals & Coal Mining Law expressly states that one of the objectives and purposes of the mining license system is to “guarantee legal certainty in mineral and coal mining business activity”. It is on the basis of this assumed security and protection that investors are prepared to invest huge sums in exploring and developing their mining concessions.

If, however, mining licenses can easily be revoked by the Regent or other authority which issued the same, the assumed security and protection offered by mining licenses is highly questionable.

One of the major objections raised to the phasing out of contracts of work and the exclusive reliance on mining licenses, as part of the 2009 Minerals & Coal Mining Law, was that mining licenses were, relatively speaking, much easier to revoke than contracts of work. This was said to be because mining licenses did not enjoy the special legal status attributable to contracts of work as contracts between the central government, on behalf of the Republic of Indonesia, and the holders of the contracts of work. As such, holders of contracts of work were not as much at the mercy of the issuing authority as the holders of mining licenses who could find their mining licenses unilaterally revoked by mercurial Regents and which Regent changes every few years as part of the local election process. While it was acknowledged that mining licenses holders were not without legal redress in the case of the improper or unfair revocation of their mining licenses, the prospect of challenging, in the Courts, the revocation of mining licenses was not an attractive one given the dysfunctional and non-transparent record of many Courts in Indonesia.

It would seem that, if nothing else, the Churchill Mining debacle has shown this expressed concern with the phasing out of contracts of work and the exclusive reliance on mining licenses, as part of the 2009 Minerals & Coal Mining Law, to be well justified.

The reality surely is that mining licenses will never offer anything like as much security and legal protection, as do contracts of work, for mine owners. At the same time, the reduced level of security and legal protection inherent in mining licenses will only meet the minimum needs of mine owners when the process of administering mining licenses, particularly at the Regional Government level, becomes vastly more independent, professional and transparent than is currently the case. Realistically, this seems to be a long way off.

Holders of contracts of work and the supporters of the contracts of work system, looking at what has happened to Churchill Mining, will no doubt be saying, in unison,

“we told you so” and “all you supporters of the mining license system now know that what we said was true”.

The experience of Churchill Mining can only be seen as a material setback for Indonesia in its attempts to convince investors that mining licenses substantially offer mine owners equivalent protection and security to that traditionally enjoyed by contracts of work holders.

2. The Role of the Central Government: It would seem to be the case that the Central Government has, so far at least, chosen not to involve itself in or otherwise do anything to try to resolve the problems created by the revocation of the mining licenses for the East Kutai Coal Project. This is despite the fact that Article 142(2) of the 2009 Minerals & Coal Mining Law clearly contemplates a continuing role for the Central Government where Regional Governments are not exercising their authority in accordance with the provisions of the 2009 Minerals & Coal Mining Law.

Investors concerned about the transition from contracts of work to mining licenses no doubt expected and hoped that the Central Government would be zealous in exercising its residual powers in mining license administration as a means of reducing the risk to holders of mining licenses posed by Regents arguably acting beyond their authority in revoking mining licenses. To date, Churchill Mining and its unfortunate shareholders can only be disappointed by the apparent lack of any response from the Central Government to their invidious predicament.

3. Increasing Sensitivity of Forestry Issues: It is interesting that the stated reason for the revocation of Churchill Mining’s mining licenses is the carrying on of illegal mining activities in forest areas. This just serves to highlight what an extremely challenging and sensitive issue mining activities in forest areas have become in recent times.

Many mining companies have surely failed to appreciate just how challenging and sensitive a subject is forestry and, consequently, how important it is to make sure that they have all required MoFor permits in place (in addition to their mining licenses) before carrying out any activities in or near forest areas. As the MoFor permits are becoming increasingly difficult to obtain, attending to forestry related matters can no longer just be an after thought. Given many of the coal mining concessions currently being offered for sale include significant forest areas, the implication of this issue for prospective buyers and investors is that they should not just rely on bland assurances, from the existing owners, that the MoFor permits will be forthcoming “in due course” or that the forestry issues can otherwise be “sorted out”.

Because the precise boundaries and status of many forest areas are often matters of genuine dispute in Indonesia, mining companies can easily find themselves exposed by making robust and, ultimately unwarranted assumptions about their legal ability to carry on mining activities in those parts of their mining concessions which are or may be designated as forest areas.

Mine owners also often fail to understand that not even the most preliminary exploration activities are permitted in forest areas without a MoFor permit and that an “approval-in-principal” for a MoFor permit actually does not allow any activities to take place in the forest area until the permit itself is issued.

Great caution in all matters related to forest areas is clearly warranted.

The experience of Churchill Mining may only serve to highlight that, in the case of those mining concessions with significant forest areas, having a valid mining license is largely meaningless unless the mine owner also has the necessary MoFor permits.

4. Importance of Strict Compliance with All Mining License Obligations: As Churchill Mining has found to its chagrin, the Regional Governments have a lot of discretion in the revocation of mining licenses. It is also possible that this discretion will not always be exercised for the right reasons or third party considerations will be allowed to intrude on a particular Regent's decision whether or not to revoke a mining license.

Regardless of whether or not there is any truth to the market rumors in Churchill Mining's case, the easiest way for a well-connected third party to obtain control of a promising mining concession in Indonesia is, often, to find a defect in the license position of the existing mining concession holder (e.g., lack of the necessary MoFor permits) and then "encourage" the Regional Government to use this defect as the grounds for cancelling or revoking the mining license of the existing mining license holder in the expectation that, when the mining concession is re-offered, the self-interested third party will be able to procure the award to itself of a new mining license in respect of that concession. While the tendering process contemplated by the 2009 Minerals & Coal Mining Law is meant to go some way to overcoming this sort of manipulation, it seems unlikely that such occurrences will be eliminated entirely.

The principal implication of the "third party manipulation problem" for existing mine owners is the fundamental importance of not exposing themselves to this sort of risk by ensuring that they scrupulously comply with all their mining license obligations. The secondary implication is the importance of maintaining a good and professional working relationship with the Regional Government so that the Regional Government will be willing to "show some understanding" if the mine owner finds itself in technical or temporary breach of its license obligations for any reason. Mine owners which are dismissive of the Regional Governments and which otherwise fail to show a reasonable modicum of goodwill and respect towards Regional Government officials do so at their peril. For better or for worse, with the advent of regional autonomy, it is really the Regional Governments, rather than the Central or Provincial Governments, which have the relevant authority in the case of most mining license issues.

5. The Frustration of Court Proceedings: The extra-ordinarily time consuming and protracted nature of legal proceedings in Indonesia pose real problems for Churchill Mining and all other mine owners.

Regardless of the merits or otherwise of Churchill Mining's legal position, now that its mining licenses have been revoked, getting the Indonesian courts to overturn the decision of the East Kutai Regent is going to be an uphill battle which will almost surely drag on for many months, if not years, before the dispute is finally resolved. As a foreign party, Churchill Mining is also likely to be at a strategic disadvantage in these legal proceedings.

Even if Churchill Mining ultimately prevails in its appeal and the four mining licenses are ordered to be reinstated, Churchill Mining will have been put to vast expense in vindicating its position and a large mining project, with the potential to create many jobs for Indonesians and generate considerable tax revenues for all levels of Indonesian government, will have been indefinitely delayed.

The implication for mine owners, particularly foreign mine owners, must be to never let any licensing disputes/problems get to the stage of legal proceedings in Indonesia because the chances of a mining company, particularly a foreign owned mining company, prevailing against a Regional Government, especially if a well-connected third party is also involved, are not high regardless of the legal merits of the mining company's position.

Summary and Conclusions

The Churchill Mining debacle highlights some significant weaknesses in the measure of protection and security offered by mining licenses as compared to contracts of work. If nothing else, one of the strongest objections voiced to the mining license system, as introduced by the 2009 Minerals & Coal Mining Law, seems to have been vindicated. Mining licenses definitely do not offer mine owners the same level of protection and security offered by contracts of work.

Based on the Churchill Mining experience to date, it would be a mistake for mine owners to assume that the Central Government is going to be very pro-active in investigating the activities of Regents who may have acted improperly in revoking mining licenses.

Mine owners would do well to recognize the critical importance of reducing their exposure to mining license cancellation risk by ensuring they are scrupulously careful in complying with the terms of their mining licenses and with all other applicable laws and regulations. In this regard, forestry issues should receive particular attention.

At the same time, the practical ability to effectively challenge, in the courts, improper revocations of mining licenses may well be largely illusory.

Regardless of the ultimate outcome of Churchill Mining's appeal, the cancellation of the mining licenses for the East Kutai Coal Project is a clear wake-up call for all mine owners and potential mining industry investors in Indonesia.

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