

**NO LOW CV COAL EXPORTS AFTER 2014 – A NATIONALISTIC
ASPIRATION SOMEWHAT AT ODDS WITH REALITY¹²**

INTRODUCTION

In mid July, the Coordinating Minister for the Economy announced that the Indonesian government intends to proceed with its plan to ban the export of unprocessed and unrefined mining products as of 2014.

In support of the Coordinating Minister's announcement, the Minister of Energy & Mineral Resources has circulated an advanced draft of a Regulation re Value Added Upgrading of Minerals and Coal through Processing and Refining Activities ("**Draft Value Added Regulation**").

In its current form, the Draft Value Added Regulation envisages that, starting in January 2014, it will no longer be possible to export from Indonesia coal with a calorific value of 5100 kcal/kg GAD or below. Whether this makes sense or not depends on a variety of considerations including the availability and the cost of the technology required to upgrade low grade coal.

Commentators have suggested that, in the absence of widespread coal upgrading, this could prevent the export from Indonesia of up to 130 million metric tons of low grade coal. If this is correct, what are the real policy objectives underlying the Draft Value Added Regulation and do these policy objectives stand up to critical analysis? More particularly, is the Draft Value Added Regulation a case of putting nationalistic aspirations above commercial reality, with the inevitable result that the Indonesian economy as a whole will be disadvantaged?

BACKGROUND

The Draft Value Added Regulation is based on Article 96 of Regulation No. 23 of 2010 re Minerals & Coal Mining Activities which provides that IUP holders are (i) obliged to carry out processing and refining of mining products in Indonesia and (ii) prohibited from exporting mining products before local processing and refining has taken place.

The principal domestic user of low grade coal in Indonesia is PLN which, according to the 2011 Domestic Coal Supply Decree, had a projected 2011 requirement of 55.83 million tons of coal with a GCV of 4000 to 5200, representing some 70.69% of the total projected 2011 domestic coal supply requirement.

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COMMENTARY

It is appropriate to briefly review the most important provisions of the Draft Value Added Regulation before turning to an assessment of the likely impact of these provisions assuming the Draft Value Added Regulation ultimately becomes law in its current form.

1. Overview of Draft Value Added Regulation

- 1.1 **Upgrading as Processing and Refining:** The required domestic processing and refining of coal is now to be carried out in the form of “value added upgrading”, where “value added upgrading” is defined as being an increase in the value of coal in order to generate “economic, social and cultural benefits”.
- 1.2 **Extent of Upgrading Required:** A “minimum” level of value added upgrading required before export is to be determined, for each mining product, based on a variety of considerations including (i) the size of the relevant mineral resource, (ii) the desirability of boosting domestic production capacity, (iii) domestic demand for the end product of processing and refining, (iv) the by-products that will result from processing and refinement, (v) the importance of “raw” mineral products for domestic strategic industries; (vi) domestic energy needs, (vii) capacity for domestic absorption of “raw” and “intermediate” mining products and (viii) the availability of efficient processing and refining technology.
- 1.3 In the case of coal, the minimum level of upgrading required for export is that needed to deliver coal with a calorific value of 5100 kcal/kg GAD or more.
- 1.4 **Review of Upgrading Required:** The minimum level of value added upgrading required before export is to be reviewed and adjusted, as necessary, once every two years. The purpose of the review is expressed to be to ensure consistency between technological development and changes in national policy.
- 1.5 **Commodity/Source of Energy Distinction:** A far from clear distinction, for processing requirement purposes, is drawn between “coal as a commodity” and “coal as an energy raw material or domestic source of energy”.

In the case of “coal as a commodity”, the required processing may be in the form of (i) crushing, (ii) washing, (iii) blending, (iv) upgrading and/or (v) processing of low rank coal into “activated carbon”.

In the case of “coal as an energy raw material or domestic source of energy”, the required processing may be in the form of (i) the required processing for coal as a commodity, (ii) briquetting, (iii) liquefaction, (iv) water mixing, (v) processing of low rank coal into coking coal and/or (vi) processing or extraction of coal by underground coal gasification.

“Coal upgrading” is defined as being the processing of low rank coal into high CV coal through the process of water content removal.

- 1.6 **Implementation of Upgrading:** Processing and refining of coal, in order to meet the minimum upgrade requirement, may be carried out by the mine owner (i) itself, (ii) in co-operation with other mine owners or (iii) in co-operation with the holders of Special Production Operation IUPs for Refining & Processing; that is, non-mine owners which act as refiners and processors on behalf of mine owners.

Co-operation, for the purposes of refining and processing, may take the form of (i) sale and purchase of unrefined/unprocessed coal, (ii) provision of processing and refining services or (iii) joint construction of processing and refining facilities provided that the prior approval of the Director General is obtained.

It is also possible for mine owners to “partner” with the holders of Special Production Operation IUPs for Refining & Processing; that is, non-mine owners which act as refiners and processors on behalf of mine owners. The “partnership” is to be in the form of share ownership and with prior approval from the Director General.

Although far from clear, it would seem that, in the case of “coal as a commodity” but not “coal as an energy raw material or source of domestic energy”, “co-operation” and “partnership” arrangements, for the purposes of processing and refining, are not possible.

In certain instances where processing and refining is otherwise uneconomic for mine owners to carry out, MoEMR may appoint a third party to carry out the processing and refining on the mine owner’s behalf. Most probably, however, this only applies to metal minerals and not to coal.

It is also envisaged that, in certain instances but again most probably only in the case of metal minerals, MoEMR may, together with mine owners and third party processors and refiners, construct “customized” processing and refining plants.

- 1.7 **Suspension of Processing & Refining Requirement:** In the case of metal minerals only, a suspension of the domestic processing and refining requirement is possible for a maximum of 3 years, where domestic processing and refining is not feasible, this is supported by a feasibility study and a request for suspension is approved by the IUP issuing authority.
- 1.8 **Management and Supervision of Processing and Refining:** Management and supervision of the processing and refining activities of mine owners and third party processors and refiners is to be carried out by the Director General and the IUP issuing authority through the medium of mining inspectors.
- 1.9 **Royalties and Taxes:** Mine Owners and the holders of Special Production Operation IUPs for Refining & Processing, which process mining products on behalf of other mine owners, are not liable to pay the applicable royalties

(non-tax state revenue) on behalf of the mine owners for which they carry out refining and processing. Such third party processors and refiners are, however, liable for value added tax in respect of the processing and refining services provided by them.

- 1.10 **Development of Processing and Refining Technology:** Mine Owners and the holders of Special Production Operation IUPs for Refining & Processing, which process mining products on behalf of other mine owners, may co-operate with various domestic research and development institutes, universities, professional associations and consultants for the purpose of problem solving, efficiency enhancement, technology innovation, mastery and transfer in connection with carrying out their processing and refining obligations.
- 1.11 **Sanctions:** Failure to comply with the processing and refining obligations of the Draft Value Added Regulation may result in administrative sanctions being imposed in the form of (i) written warnings, (ii) suspension of IUPs and (iii) ultimately, revocation of IUPs.
- 1.12 **Transition:** Already producing CoW (but not it seems CCoW) holders are obliged to start processing and refining activities in accordance with the Draft Value Added Regulation by not later than 12 January 2014.

Holders of CoW and CCoW that have not already commenced production must adjust their proposed processing and refining activities to meet the requirements of the Draft Value Added Regulation.

Holders of Production Operation IUPs issued prior to 1 February 2010 are obliged to start processing and refining activities in accordance with the Draft Value Added Regulation by not later than 12 January 2014.

Holders of Production Operation IUPs issued after 1 February 2010 are obliged to start processing and refining activities in accordance with the Draft Value Added Regulation by not later than 6 months from the effective date of the Draft Value Added Regulation.

Holders of Exploration IUPs issued prior to the effective date of the Draft Value Added Regulation are obliged to adjust their proposed processing and refining activities to meet the requirements of the Draft Value Added Regulation.

2. Analysis of Draft Value Added Regulation

The brief overview, in Part 1 above, of the main provisions of the Draft Value Added Regulation is intended to raise a number of issues for consideration. These issues are canvassed below.

- 2.1 **Is the Minimum Level of Required Upgrading Realistic?:** Assuming Appendix IV to the Draft Value Added Regulation remains unchanged (which it may well not), is it realistic to expect that all those mine owners which

currently produce low grade coal for export will be able to, on a cost effective basis, start upgrading 100% of their coal production in 2014 so as to achieve a minimum calorific value of 5100 kcal/kg GAD?

Whether or not a minimum calorific value of 5100 kcal/kg GAD (or any other minimum calorific value that may be subsequently decided upon) for export coal is realistic, requires answers being found to 3 subsidiary questions. First, does there presently exist proven technology capable of upgrading low grade coal to a minimum calorific value of 5100 kcal/kg GAD? Second, even if such proven technology does exist, will that technology be widely available in Indonesia by 2014? Third, will it be cost effective for mine owners to upgrade their coal to 5100 kcal/kg GAD in 2014 having regard to the differential between the production cost of the upgraded coal and the market price obtainable for the upgraded coal? If and only if the answer to all three of these subsidiary questions is a definite “yes”, is a minimum upgrading requirement of 5100 kcal/kg GAD in 2014 realistic.

It is beyond the writer’s area of expertise to express an informed opinion on any of these subsidiary questions. The writer is, however, aware of reports that Arutmin Indonesia (part of the Bumi Resources Group) is in the process of building two coal upgrading plants in South Kalimantan and South Sumatra which may be capable of increasing the calorific value of coal from 4500 kcal/kg GAD to as much as 6100 kcal/kg GAD.

Although technical capability, availability and cost efficiency should be the only factors in determining the minimum level of required upgrading for coal, it is readily apparent from the Draft Value Added Regulation that various other factors have also been taken into account in determining the minimum level of required upgrading for coal. These other factors include resource size, domestic capacity and demand and national strategic considerations. Indeed, it should be highlighted that, at present, the Draft Value Added Regulation makes the availability of efficient processing and refining technology the last of eight factors that are to be taken into account in determining the minimum required level of upgrading.

At the same time, the objective of “value added upgrading” is expressed to be to generate “economic, **social and cultural** benefits.” It is not readily apparent to the writer what social and cultural benefits are likely to be derived from Indonesia banning the export of low grade coal. Notwithstanding this quibble, however, the more important concern seems to be that the push for domestic processing and refining of coal apparently has at least as much to do with non-economic and, possibly, nationalistic or political considerations as it does with sound economics. In this regard, it seems reasonable to ask whether the 5100 kcal/kg GAD minimum level of required upgrading for coal is, in fact, really about ensuring that low grade coal stays in Indonesia and is available for purchase by PLN at below the international market price because of the closing off of the export alternative that would otherwise normally be available to producers of low grade coal. If this is at least part of the Indonesian government’s real agenda behind setting such a high minimum level of required upgrading for coal, then cynical observers are likely to interpret the domestic processing and refining requirement as effectively being

used to help subsidize PLN's operations and an artificially low electricity price.

Assuming it is actually not the Indonesian government's intention to use the Draft Value Added Regulation as a means of ensuring a large supply of artificially cheap low grade coal in the domestic market, then it seems likely that MoEMR may be forced to reduce the minimum upgrading requirement to something considerably less than 5100 kcal/kg GAD as the 2014 deadline for implementing the domestic processing and refining obligation approaches. This is so unless, before 2014, the reliability, widespread availability and cost effectiveness of the existing coal upgrading technology can be amply demonstrated.

Making the availability of cost efficient processing and refining technology the primary, if not the only, proper determinant of the minimum upgrading requirement would suggest an incremental approach is more appropriate. Under this incremental approach, the minimum upgrading requirement would be set at a very modest level in 2014, to be followed by gradual increases in the minimum upgrading requirement as and when improvements in the reliability, widespread availability and cost effectiveness of coal upgrading technology take place.

- 2.2 **Is a Two Year Review Sufficiently Often?:** It is highly questionable whether a review of the minimum upgrading requirement every two years should be acceptable from a coal industry perspective. Given how susceptible are commodity prices to rapid movements and the uncertainty over whether market prices for higher grade coal at any point in time will justify the costs associated with coal upgrading, there is surely a danger that, if mine owners which want to export their coal production, are locked into a fixed minimum upgrading requirement for two years and regardless of what happens to the market price for coal during that time, any sustained downturn in coal prices could make the export of upgraded coal wholly uneconomic. Unless upgrading costs are more or less perfectly correlated with market prices for upgraded coal, something which is surely highly improbable, there can be no guarantee that producers of low grade coal will be able to recover their upgrading costs if the market price for coal drops significantly. In these circumstances, to lock producers of low grade coal into a minimum upgrading requirement for two years at a time must be regarded as very unwise.
- 2.3 **What is the Distinction between Coal as a Commodity and Coal as an Energy Source?:** The Draft Value Added Regulation seeks to draw a distinction between "coal as a commodity" and "coal as an energy raw material or domestic source of energy". The significance of this distinction is, however, very hard to fathom based on the current wording of the Draft Value Added Regulation. In the case of "coal as a commodity", domestic processing is to be in the form of crushing, washing, blending and/or upgrading while, in the case of "coal as an energy raw material or source of energy", domestic processing is to be in the same form as for coal as a commodity, as well as briquetting, liquefaction and so on. However, whether coal is categorized as a "commodity" or as "an energy raw material or source of energy", the 5100

kcal/kg GAD minimum upgrading requirement applies in all situations where the coal is to be exported.

There is also no indication in the Draft Value Added Regulation of how or who is responsible for determining whether or not, in a particular case, the subject coal is to be treated “as a commodity” or “as an energy raw material or source of energy”.

2.4 Is there a Risk of Monopolistic Behavior?: Many, if not most, producers of low grade coal will clearly not be in a position to establish their own coal upgrading facilities given the associated cost and technical constraints. It is, presumably with this in mind, that the Draft Value Added Regulation allows mine owners to carry out the required upgrading in co-operation with other mine owners or in co-operation with the holders of Special Production Operation IUPs for Refining & Processing. Although this is obviously desirable from a practical perspective, it does raise the risk that one or a small number of parties may come to dominate the coal upgrading process in Indonesia, with the result that small and medium size mine owners, wanting to export their coal production, will effectively have no choice but to use the services of these dominant coal upgrading service providers regardless of the costs involved. This could even, ultimately, result in substantial consolidation of the coal mining sector in Indonesia as small and medium sized coal producers are forced, by high upgrading costs which make their operations uneconomic, to sell out to those parties which control the coal upgrading facilities. In this regard, it would be interesting to know just how many coal upgrading facilities are currently under construction in Indonesia and the ownership of the same.

2.5 Are Coal Producers being Treated Less Fairly than Other Mineral Producers?: The Draft Value Added Regulation appears to be more sensitive to the concerns of metal minerals producers than it is to the concerns of coal producers. In this regard, it is particularly noticeable that producers of metal minerals only may seek a suspension of the domestic processing and refining requirement, for a maximum of 3 years, where domestic processing and refining is not feasible. It is notable that PT Newmont Nusa Tenggara, the operator of the Batu Hijau gold and copper mine, has already announced it will not be building a smelting facility for the foreseeable future because such a facility would not be economically feasible. Given the uncertainty over whether or not cost effective and widely available coal upgrading will be possible, in Indonesia, by 2014, one may reasonably ask why the possibility of a suspension of the domestic processing and refining requirement is not also being offered to coal producers as well. It also seems questionable why, as currently worded, the Draft Value Added Regulation envisages that MoEMR may help metal mineral producers, but not coal producers, with finding and even constructing suitable processing and refining facilities.

One might seek to justify the Draft Value Added Regulation’s disparate treatment of metal minerals and coal on the basis that the refining and smelting of metal minerals is inherently more expensive and technologically complex than is the case for coal upgrading. If this is the case, however, then it seems curious that PT Aneka Tambang has announced plans to build a number

of ferronickel smelters in East Halmahera, North Maluku and elsewhere as well as upgrade its existing ferronickel smelter in Pomala, Southwest Sulawesi while a chemical-grade alumina smelter is planned for Tayan, West Kalimantan, a smelter grade alumina plant is planned for Mempawah West Kalimantan and a nickel pig iron factory is planned for Mandiodo, Southwest Sulawesi. These examples would suggest that, if anything, more is currently happening in Indonesia in terms of building capacity for metal minerals refining than it is in terms of building coal upgrading facilities.

- 2.6 **Is Special Treatment being given to Already Producing CCoW Holders?:** As presently worded, the transitional provisions of the Draft Value Added Regulation appear to create an exception to the domestic processing and refining obligation in the case of already producing CCoW holders. In this regard, the Draft Value Added Regulation, as currently worded, only requires already producing CoW holders (but not CCoW holders) to start carrying out domestic processing and refining in January 2014 while Article 25(b) requires both non-producing CoW holders **and** CCoW holders to adjust their proposed processing and refining activities to comply with the requirements of the Draft Value Added regulation. Is this just a typographical oversight or is MoEMR intending to exempt already producing CCoW holders from the obligation to upgrade low grade coal commencing in 2014? If the latter is the case, searching questions need to be asked as to what is the rationale for this special treatment of already producing CCoW holders and who will be the main beneficiaries of such special treatment?
- 2.7 **Can MoEMR Legally Compel CoW and CCoW Holders to Carry Out Domestic Processing & Refining:** The Draft Value Added Regulation completely ignores the ongoing debate over whether or not it is legally possible for the Indonesian government to impose obligations on CoW and CCoW holders, as opposed to IUP holders, in addition to those obligations already expressly provided for in the CoWs and CCoWs. Certainly, the domestic processing and refining obligation contemplated by the Draft Value Added Regulation goes far beyond that contained in any CoW or CCoW. It also seems most unlikely that, given the cost of complying with the domestic processing and refining obligation, any CoW or CCoW holders are going to voluntarily agree to amend their CoW or CCoW to include a domestic processing and refining obligation equivalent to that envisaged by the Draft Value Added Regulation. As such, the Draft Value Added Regulation is surely destined to intensify the current acrimony between the Indonesian government and CoW and CCoW holders over amendments to CoWs/CCoWs.
- 2.8 **Is the Implementation Date Significant?:** Alert readers of the Draft Value Added Regulation will immediately notice that the January 2014 deadline for implementing the domestic processing and refining requirement falls just a couple of months before Indonesia's next presidential election and may well ask themselves whether or not this has any significance beyond the fact that it is the fifth anniversary of the introduction of the 2009 Minerals & Coal Mining Law, which also took place just prior to the last presidential election. Foreign mining companies, in particular, are likely to recall their deep concerns with many of the overtly nationalistic aspects of the 2009 Minerals & Coal Mining Law in the months before its introduction, only to find that most

of these concerns proved to be unwarranted when the much more benign Implementing Regulations for the 2009 Minerals & Coal Mining Law came out in the months after the presidential election. Is it possible, that we may see something similar this time around, with the relatively onerous coal upgrading obligations presently contemplated by the Draft Value Added Regulation being significantly watered down once the next presidential election has come and gone?

SUMMARY AND CONCLUSIONS

Although still very much a “work in progress”, the Draft Value Added Regulation raises many challenging issues including, most importantly, how appropriate and realistic is a tough domestic processing and refining obligation in a country like Indonesia. The 5100 kcal/kg GAD minimum upgrading requirement only makes sense if, by 2014, coal upgrading will be a proven technology, widely available to all Indonesian producers of low grade coal and cost effective.

In its current form, the Draft Value Added Regulation also appears to give rise to a real risk of depressed domestic prices for low grade coal which cannot be exported and much greater market power for those existing domestic buyers of low grade coal as well as for those few companies that will likely control Indonesia’s coal upgrading facilities. Substantial consolidation of low grade coal producers is also a distinct possibility.

A better approach would seem to be to initially set a very modest minimum requirement for coal upgrading. This modest minimum requirement could then be raised incrementally over time as the performance, availability and cost effectiveness of coal upgrading technology improves.

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