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INDONESIA'S NEW ENERGY SECURITY POLICY – IMPORTANT IMPLICATIONS FOR THE LOCAL MINING INDUSTRY AND FOREIGN INVESTMENT¹²³⁴

INTRODUCTION

The President delivered an important speech on 19 October in which, among other things, he outlined Indonesia's Energy Security Policy and its objectives for the next 3 years.

Although much of the newly articulated Energy Security Policy deals with electricity generation and oil and gas production, it also deals, directly and indirectly, with mining.

The Energy Security Policy should be compulsory reading for both domestic and foreign participants in the Indonesian mining sector as it provides some important insights into how the Government currently views the local mining sector and what the Government wants to achieve vis-a-vis the local mining sector over the next 3 years.

COMMENTARY

1. The Government's View of the Mining Sector

It is apparent from the President's 19 October speech that the Government views the local mining sector as being something of "a problem child". This is in the sense that, although the Government clearly accepts the local mining sector has the potential to play an important role in the economic development of Indonesia, it is seen by the Government to be presently causing a variety of problems for Indonesia and otherwise not delivering a commensurate level of benefits, economic and otherwise, to Indonesia. In this regard, it is particularly noteworthy that the President highlights the large number of overlapping mining concessions and the circumstances in which mining KPs/IUPs have been issued in the past. In a similar vein, the President alludes to the environmental damage caused by mining activities, particularly coal mining.

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The Government also clearly regards foreign investors as having excessive influence, interests and rights in the local mining sector. This can be seen in the prominence which the President gives to “unfair and unreasonable” contracts between Indonesia and foreign companies, something which the President says is becoming a matter of “public concern”.

It further seems to be the case that the Government considers the local mining sector to lack sufficient commitment to generating greater economic benefits for Indonesia. In this regard, the President talks about the need to change the “culture” of mining in Indonesia with its emphasis on the export of raw mining products and a corresponding lack of emphasis on local value added activities.

As should be readily apparent from the foregoing, the Government’s current view of the local mining sector is substantially negative. To this extent, the newly articulated Energy Security Policy may be seen as an endeavor, on the part of the Government, to bring the local mining sector into line with what the Government regards as being the proper role for the mining sector to play in Indonesia’s future economic development. The Energy Security Policy may also be seen as a clear signal from the Government that it intends to reduce the influence, interest and rights of foreign investors in the local mining sector as part of an effort to ensure that Indonesia and Indonesians, rather than foreign companies, derive the greatest benefit possible from the local mining sector.

The very prominence which the Energy Security Policy gives to the local mining sector suggests that the Government is looking much more closely, than it has done in the past, at the local mining sector and is not prepared to let things continue, as they have done previously, in the local mining sector.

This greater focus of the Government on the local mining sector is likely to be something of a mixed blessing for domestic and foreign participants in the local mining sector. The final outcome will be dependent upon the Government’s success or otherwise in realizing the various stated objectives of the Energy Security Policy to the extent the same apply to the local mining sector.

2. Energy Security Policy Objectives for the Next 3 Years

The President’s speech sets out a number of objectives of the Energy Security Policy over the next 3 years. It is not always easy to tell from the text of the President’s speech whether these objectives just relate to the mining sector or are, rather, intended to apply more generally to all energy related sectors. However, the writer has identified at least 9 stated objectives of the Energy Security Policy which, to a greater or lesser degree, are definitely relevant to the local mining sector. These 9 objectives of the Energy Security Policy, and the likely implications of the same for domestic and foreign participants in the local mining sector, are discussed in detail below.

2.1 Renegotiate Foreign Contracts: While stating that “all nations must respect contracts”, the President makes clear the Government’s intention to renegotiate contracts with foreign parties that are now regarded as being “very unfair and unreasonable” to Indonesia. This objective raises squarely the issue of CoWs/CCoWs and the proposed amendments to bring CoWs/CCoWs into line with the 2009 Minerals & Coal Mining Law.

Although the proposal to bring CoWs/CCoWs into line with the 2009 Minerals & Coal Mining Law is not a new issue, the President’s oblique, but very high level, statement of support for the amendments, as one of the objectives of the Energy Security Policy, strongly indicates that the issue is not going to be dropped in light of opposition from CoW/CCoW holders. Rather, it seems probable the Government is going to push, ever more vigorously, for the proposed amendments to be accepted by CoW/CCoW holders in the near future.

Of greater interest is whether the proposed amendments to CoWs/CCoWs are going to be expanded to include matters not previously on the table. In this regard, the writer is aware of a number of CoW holders who have recently been informed by the Ministry of Energy & Mineral Resources that they must now accept, in addition to the previously proposed amendments, a new amendment providing for a 51% foreign ownership divestiture requirement even though the CoWs in question are of a generation that does not presently make any provision for foreign ownership divestiture. This would seem to be consistent with the recently mooted proposal to increase the foreign ownership divestiture requirement for IUP holders to 51%.

In the absence of some major concessions from the Government, there is likely to be strong push back from foreign investors to a 51% foreign ownership divestiture requirement for CoW/CCoW holders as well as IUP holders. The prospect of minority shareholder status in an Indonesian company, with few meaningful legal protections, is not going to be readily accepted by most foreign investors in the local mining sector. This anticipated unwillingness on the part of foreign investors to accept a 51% foreign ownership divestiture requirement for CoW/CCoW holders, as well as IUP holders, will only be exacerbated if the divestiture requirement effectively gives the incoming local shareholder a “free carried interest” for the remaining life of the project and does not mandate the payment of full value, by the incoming local shareholder, for the divested foreign shareholding including for the foreign investor’s foregone share of the estimated future dividend stream from the project company.

Intriguingly, the President makes reference to renegotiations with foreign parties in the context of “contract extensions”. Whether this is intended to include CoW/CCoW extensions (or just oil and gas PSC extensions) is unclear but, if it does include CoW/CCoW extensions, that would be a significant departure from the commonly held, current understanding that there are to be no extensions or renewals of CoWs/CCoWs once they expire but, rather, former holders of expired CoWs/CCoWs will simply be offered the opportunity to obtain IUPs. To the extent the Government may be signaling that it is now willing to consider extensions/renewals of

CoWs/CCoWs, as part of the renegotiation of CoWs/CCoWs on more terms more favorable to Indonesia, this could make the proposed amendments to CoWs/CCoW, including the newly raised 51% foreign ownership divestiture requirement, more palatable to foreign CoW/CCoW holders.

- 2.2 No Adverse Environmental Impact:** The President exhorts all levels of Government to ensure that mining (including, specifically, coal mining) “absolutely does not harm the environment”. While exploration mining activities can be carried out with little attendant harm to the environment, it is clearly an impossibility for large scale production operation (i.e., exploitation) mining activities to be carried out without considerable harm to the environment unless we are talking about entirely underground production operation mining activities.

If the Government is serious in making “no harm to the environment” an objective for the local mining sector, in giving effect to the Energy Security Policy, this can only have major adverse ramifications for the future of mining in Indonesia. One hopes that, in staking out “no harm to the environment” as an objective of the Energy Security Policy, what the President really means is that the post mining and reclamation obligations of mining companies must be strictly enforced such that already mined areas do not remain environmentally degraded indefinitely. Unfortunately, however, this is not what the President actually said.

- 2.3 A Fair Tax for the State:** A “fair” tax for the State from mining is also expressed by the President to be one of the objectives of the Energy Security Policy without, however, any guidance being provided as to how “fair” should be defined.

Mining companies may well take the view that, so long as they pay the currently mandated royalties on their mineral production and the currently mandated level of income tax on their net profit (if any), this represents the “fair” tax return to the State because they have fully complied with all the tax payment obligations currently imposed on them by the State. The writer, however, discerns from the President’s remarks that this is probably not how the Government interprets a “fair” tax for the State from mining. It seems likely that, from the Government’s perspective, a “fair” tax, in the context of the Energy Security Policy, really means more tax than mining companies are currently paying. One can already see evidence of this intention to make mining companies pay more tax in the ongoing public controversy over Freeport and its net return from the Grasberg Mine compared to the tax revenue received by the Government from Freeport.

The objective of a “fair” tax return to the State may well be realized by the Government increasing the royalty rates applicable to mining products or making it harder for mining companies to take tax deductions for all their exploration and other operating costs. There is an obvious parallel here with the much tougher approach the Government has taken, in recent times, to cost recovery in the oil and gas sector.

2.4 Benefit to the Local Community: Benefit to the local community from mining projects is stated to be another objective of the Energy Security Policy. On its face, this objective seems to be non-controversial given that the promotion of local community development is an express condition of every IUP, and IUP holders must prepare comprehensive local community development programs. However, “reading between the lines”, this objective surely implies the Government is of the view that local communities do not currently benefit sufficiently from mining projects and that mining companies need to do substantially **more** in this regard. Again, one can see overtones of the on-going public controversy surrounding Freeport and its Grasberg Mine in this objective. Many mining companies will surely take exception to the implication they are not doing enough to promote local community development, arguing that the current widespread local community dissatisfaction with mining projects is actually a function of the Government’s failure to ensure that a sufficient amount of the tax revenues collected from mining companies are properly distributed to the local communities and otherwise spent on local community projects in those areas where the mining activities take place. From this perspective, the stated objective of benefiting the local community is actually an attempt by the Government to make mining companies assume an enhanced financial burden when the problem of local community dissatisfaction with mining projects should really be addressed by internal Government reforms designed to ensure more efficient, equitable and transparent distribution of the tax revenues already collected from mining companies.

2.5 Changing the Culture of Mining: In making it a stated objective of the Energy Security Policy to “change the culture” of mining in Indonesia so as to ensure the local mining sector carries out more value added activities in Indonesia, the President is clearly signaling that the Government is not going to back down from the recent regulatory initiatives to make domestic processing and refining of metal minerals and domestic upgrading of low CV coal a reality. It now seems inevitable that the existing draft regulations on domestic processing and refining of metal minerals and domestic upgrading of low CV coal will come into force in the near future with the only residual issue being the initial minimum requirement specifications.

It remains to be seen, however, whether or not imposing an obligation to carry out serious levels of domestic processing and refining of metal minerals and domestic upgrading of low CV coal will have a material adverse effect on new investment in the local mining sector. This is especially likely to be the case with regard to otherwise marginal projects which cannot bear the extra deadweight cost associated with uneconomic domestic processing, refining and upgrading obligations.

2.6 Developing Eastern Indonesia and Papua – Maluku: The President further highlights the enhanced development of Eastern Indonesia and Papua – Maluku as an objective of the Energy Security Policy. The principal implication of this policy objective for the mining sector would seem to be what it implies in terms of the Government’s likely infrastructure development priorities over the next few years. Given the limited funds

available for infrastructure development in Indonesia and the hugely pressing need for further infrastructure development in traditional mining areas of Indonesia such as East Kalimantan, Central Kalimantan and South Kalimantan as well as South Sumatera, any suggestion that infrastructure development in these areas is going to be regarded by the Government as being less of a priority than infrastructure development in Eastern Indonesia and Papua – Maluku must be a source of serious concern to mining companies. That said, the recent announcement by the Government-sponsored infrastructure guarantee agency, PT Penjaminan Infrastruktur Indonesia, of its decision to guarantee the promised returns to investors in respect of the proposed US\$2.3 billion railway to be built in Central Kalimantan should go some way to assuage those concerns.

- 2.7 Solving the Problem of Overlapping Mining Concessions:** Solving the problem of overlapping mining concessions (which the President, somewhat surprisingly, numbers as high as 6,000) is another stated objective of the Energy Security Policy as it applies to the local mining sector. The Government has already made some modest progress in realizing this objective with the publication by the Ministry of Energy & Mineral Resources of its “Clean & Clear List” which purports to list those IUPs which have been found not to have overlapping and related problems. The Clean & Clear List, however, does nothing to correct the identified overlaps and related problems with IUPs not on the Clean & Clear List or the underlying causes of such overlaps. As one only of the main causes of overlaps seems to be disputed Provincial and Regency boundaries, addressing the causes of overlaps, as opposed to merely identifying where the overlaps exist, is no easy task and will certainly take a long time to realize.
- 2.8 Preventing Warehousing of Mining Concessions:** The President targets overcoming the perceived problem of business people obtaining mining concessions without any intention of developing the same on a timely basis as an objective of the Energy Security Policy. This has long been an endemic problem in the local mining sector which was greatly exacerbated by the previous opaque practices surrounding the issuance of KPs on the basis of private application. Now, however, that IUPs for metal minerals and coal are only to be awarded to successful bidders in public auctions for the underlying mining concession, one may reasonably expect some progress in ensuring that IUPs are issued to parties which have the financial, human and technical resources needed to explore and, if warranted, develop mining concessions on a timely basis. Realistically, however, identified issues with the draft tender guidelines suggest that it will be very difficult to ensure that well-connected insiders, whose only interest is in controlling mining concessions as an investment opportunity, will be eliminated as a force in the local mining sector any time soon.
- 2.9 Improved Safety & Transport Management:** Finally, the President has highlighted improved safety and transport management as an objective of the Energy Security Policy. Given the inherent safety issues and transport logistical problems which are common to all mining projects in Indonesia, as well as the associated costs of the same, anything the Government is able and

willing to do to make material improvements in these areas should be welcomed by all responsible mining companies.

On the safety front, better and more rigorous training in safe work practices, as well as wider availability of and greater insistence on the use of appropriate safety equipment, is needed.

Improving transport management is really all about infrastructure enhancement and human resources training. Unfortunately, these are matters which it is difficult to improve in the short run and without a great deal of investment.

SUMMARY AND CONCLUSIONS

The recently articulated Energy Security Policy is really less concerned with encouraging and ensuring energy security for Indonesia per se than it is with setting out the Government's vision of what role the local mining sector should play in Indonesia's future economic development and, to a lesser extent, what role foreign investors should play in the local mining sector.

It is apparent the Government has very serious concerns about the current state of the local mining sector and whether or not it is sufficiently serving the legitimate interests and needs of Indonesia.

Responsible companies operating in the local mining sector will have little difficulty in accepting some of the stated objectives of the Energy Security Policy; namely, those objectives related to dealing with the problem of overlapping mining concessions, preventing the warehousing of mining concessions and improving safety and transport management. However, even responsible companies will surely be concerned about those objectives that imply mining companies should pay more tax, assume even greater responsibility for local community development and commit to domestic processing, refining and upgrading regardless of the associated costs.

Meanwhile, foreign investors in the local mining sector also cannot fail to be concerned by the stated objective of renegotiating CoWs and CCoWs and the attendant possibility of a 51% foreign ownership divestiture requirement for both IUP holders and CoW/CCoW holders.

The great weakness of the Energy Security Policy is its lack of detail about how the objectives are to be realized in a fair and equitable manner (that is, fair and equitable not only to Indonesia and Indonesians but also to foreign investors) and without making mining companies effectively responsible for the Government's own failings and shortcomings.

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