COMMENT ON INDONESIA: MINERALS AND PETROLEUM

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My commentary addresses aspects of Dr. Nono Makarim's paper concerning minerals, principally coal, gold and nickel. These mineral sectors are the ones in which Australian investors have a significant presence.

UNDERSTANDING THE FRAMEWORK

Makarim has mentioned a number of features specific to mining in Indonesia: contractual rather than proprietary mining rights; different generations of contracts of work; joint ventures with local partners; divestment of foreign equity; limitations on foreign management rights and the role of 'side letters'. Understanding many of these features of Indonesian mining requires an appreciation of the constitutional framework in which the relevant government agencies, the Ministry of Mines and Energy and the Directorate-General of General Mining must operate.

Article 33 of Indonesia's Constitution has two essential elements. First, Indonesia's mineral resources are to be controlled by the State (and are the property of the people). Secondly, those resources are to be used for the utmost benefit of the people. These two constitutional principles are embodied by the Mining Law in Article 5, by which a group of eight different organisations of government or wholly Indonesian private ownership are conferred the statutory right to engage in mining activities pursuant to a mining authorisation. Foreign investors, either in their own right or through an Indonesian subsidiary, are excluded from the group who may hold a mining authorisation. The foreign investor's rights are limited to the role of a contractor, to carry out activities which have not yet been or cannot be carried out by a government agency or state enterprise concerned as the holder of a mining authorisation. Furthermore, the form of contractual agreement by which the foreign investor may participate must be in a form both consistent with the guidance, instructions and conditions set by the Minister of Mines and Energy, but also approved by the President representing the government following his consultation with the People's House of Representatives.[1]

Between 1981 and 1988 there have been two 'generations' of coal agreements and four 'generations' of contracts of work for gold and other minerals, with a fifth 'generation' in the offing. These 'generations' have evolved mainly in the environment of a government committed to diversifying its mining activities beyond oil and gas, seeking to offer a framework attractive to foreign investors, yet consistent with the more restrictive principles of its own Constitution.

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1 Art. 10 of the Mining Law, Law No. 11 of 1967.

ROLE OF THE NATIONAL PARTNER

Foreign investors in the gold, coal and nickel sectors must include Indonesian individuals or companies as shareholders in their joint venture (PMA) companies (also known as contract of work companies). Some historical exceptions have permitted incorporation in the 1970s and early 1980s of 100 percent foreign-owned companies that have conducted mining activities without the involvement of an Indonesian partner. In most of these cases, wholly foreign ownership was permitted because of the large scale of the project and the absence at the time of national investors willing to commit to large scale risk investment. Makarim mentions in his paper that the Ministry of Mines and Energy will still consider a 100 percent initial foreign equity application favourably on a case by case basis. In practice, however, I believe it is unlikely that any foreign investor will succeed in any application for initial 100 percent ownership because of more recent stringent policy requirements on national participation (which reinforce express statements in the elucidation to the Mining Law) and the emergence of large Indonesian investment groups capable of and willing to take up national equity requirements in even the largest of projects. In the case of the existing 100 percent foreign owned companies, they are all under an obligation to introduce a national partner within a specified period.

Responses amongst foreign investors to criteria for selection of national partners has varied. A recent innovative response has come from PT International Nickel Indonesia (PT Inco). PT Inco has mined a major nickel deposit since 1977 which now produces in the order of 5 percent of world nickel capacity. PT Inco has announced its intention to satisfy its obligation to the government to divest 20 percent of its equity by a public offering on the Jakarta Stock Exchange, a strategy facilitated by the recent policies aimed at deregulating and stimulating investment in Indonesia's capital market. Particularly during the 'gold rush' of 1986 to 1987, when 94 gold contracts of work were entered into, many national partners were sourced from entrepreneurs holding KPs or engineers or other Indonesians with some technical experience in the construction or mining fields. A recent feature has been the entry into the sector of Indonesian investors of significant financial substance and diversified business interests. These new investors have also extended their investments to the Australian mining sector in respect of a few of the smaller Australian mining companies.

FINANCING OF THE NATIONAL PARTNER'S EQUITY

Response to the financing of the national partner's equity has varied. For the contracts of work granted between 1985 and 1987, many foreign investors agreed to the national shareholder receiving a carried interest for its 10 percent or 15 percent equity, carried to the time of commencement of commercial production. Some carried interests have been characterised as entirely 'free'. Others have been subject to an obligation to repay the foreign investor all advances contributed for the national party's equity, together with interest. The repayment obligation,

however, has been limited in recourse to a specified percentage of dividends payable in respect of the national partner's shares. The repayment obligation most often has been secured by a pledge of shares in favour of the foreign shareholder.

SEPARATE COMPANIES FOR EACH CONTRACT AREA

Since the first production sharing contracts were granted in respect of petroleum exploration in the early 1970s, it has been the consistent policy of the Indonesian government to require foreign investors to utilise a separate company for each exploration area. This policy has had the immediate effect of limiting the extent to which exploration expenditure from unproductive areas has been available for set-off against Indonesian taxable revenues generated from productive areas. Despite persistent efforts in the negotiation of the early generation contracts of work for gold mining, isolation of expenditure (and tax losses) to separate companies has continued with the practice of limiting contract areas for any one contract of work company for gold mining to areas currently not exceeding 250,000 hectares. As a consequence, some of the larger gold mining companies presently have up to 22 contract of work companies to administer.

The policy basis for requiring separate companies in coal, gold and nickel mining originates from the production sharing arrengements in respect of petroleum exploration. The Indonesian government took the view in the late 1960s and early 1970s that petroleum available from a productive area should be immediately available to the government after cost recoupment of expenditure by the foreign contractor for that area. The fact that a foreign contractor had incurred unrecouped exploration expenditure in unproductive areas should not operate to postpone the government's receipt of its production share until all other expenditure of the foreign contractor throughout Indonesia was recouped.

Apart from the tax disincentives, the existence of multiple contract of work companies has created some administrative difficulties for the contract of work companies. Since the 1970s, foreign investment policy and government administrative practices have been directed towards a limited number of company investment structures. For instance, where expatriates have worked for several Indonesian companies within the same group, the expatriates have been required to obtain work permits for each company in the group for which they have performed services. Allocation of office and other overhead administration services amongst a limited number of group companies has been accepted by the Indonesian tax office. Expansion of these practices to mining groups having interests in up to 22 contract of work companies, however, has created obvious difficulties in work permits and overhead allocation. In response, some of the larger mining groups have established PMA service companies to act as the employer of senior management and administrative staff who provide services to all of the group contract of work companies. Although the concept of the service company has resolved some of the administrative difficulties, the response of the Indonesian tax office to the concept of a non-profit service company is yet to be completely resolved. There

remain unresolved issues with the tax office in respect of withholding and value added taxes on the provision of services by the service company to each of the contract of work companies.

DIVESTMENT

Indonesia has entered a new phase in its history of foreign investment, whereby the foreign investors in the first PMA companies established after the enactment of the Foreign Investment Law (Law No.1 of 1967) are being required to offer shares for sale or issue to their national partners to increase the national ownership to 51 percent. The divestment phase awaits all foreign investors holding shares in contract of work companies in the mining sector. Commencing after the expiry of the fifth year after commencement of commercial mining operations, the contracts of work require shares to be offered for sale or issue firstly to the government and secondly (if the government does not accept the offer) to Indonesian nationals or companies controlled by Indonesian nationals normally according to the following schedule:

— by the end of the fifth year at least 15 percent;
— by the end of the sixth year at least 23 percent;
— by the end of the seventh year at least 30 percent;
— by the end of the eighth year at least 37 percent;
— by the end of the ninth year at least 44 percent;
— by the end of the tenth year at least 51 percent.

The price at which divestment is to occur is specified in the contracts of work to be the highest of three pricing formulas, being current replacement cost, the price at which shares would be accepted for listing on the Jakarta Stock Exchange and the value of the shares based on a fair valuation of the contract of work company as a going concern. Some of the alluvial gold miners particularly do not regard the divestment issue as being of great significance, as their mining operations are not expected to continue for the duration of the 10-year divestment period. For the larger scale projects with longer projected operating periods, divestment will become an issue. The Indonesian national mining sector is in the early stages of developing the required technical skills to manage mining operations. The rate at which these skills are developed will have some bearing on whether the government or Indonesian nationals or companies will wish to acquire majority interests. The availability of funding for the acquisitions will also be critical. If Indonesia's capital market develops significantly as a source of funds, there is a much greater prospect of the government or Indonesian nationals or companies raising public funds to take up all or some significant part of their entitlement under the divestment schedule. If local fund raising opportunities do not expand, it is less likely that the divestment schedules will be implemented, at least to the full extent and in accordance with the time schedule provided for in the contracts of work.

FARMING-IN

Of the eleven coal contractors who entered into coal agreements between 1981 and 1986, only one contractor has relinquished its area (subsequently split in two and recontracted to two separate companies). The other contractors have pursued general survey, exploration, feasibility and in several cases, production, without any farming-in of new investors. By contrast, there has been a great deal of activity in the gold sector within the 103 contracts of work granted between 1985 and 1987. The world-wide stock market crash of 1987, the falling gold price and (it is argued) overcommital of contract areas by some foreign investors has led to much activity by way of sales of interest by foreign investors, farm-ins and relinquishment of areas. The gold sector is described as entering a 'time of consolidation' in which the larger mining companies will complete exploration and feasibility and proceed to construction and operation, and the smaller companies will relinquish areas to concentrate their exploration and exploitation activities.

In September 1988, the Director-General of General Mining of Indonesia expressed his dissatisfaction at what he referred to as almost 50 percent of the gold contract of work companies performing below standard. In particular, he referred to the practice of contractors concentrating their general survey and exploration work in target areas rather than complying with the obligation to survey and explore all of the contract areas. At the same time, the Director-General stated that it was against the spirit of the contract of work for contractors in the early stage of general survey and exploration to farm-in new foreign partners. There has since existed a policy within the Department of Mines and Energy that in the early general survey and exploration stages, contractors are not expected to farm-out. Approval from the minister required under the contract of work for a sale of shares in the contract of work company in these early stages should not be expected to be forthcoming.

An underlying concern of the Department of Mines and Energy has been the ability of foreign investors in the early stages of general survey and exploration to sell all or part of their interests to other foreign investors at a profit. These sales have been facilitated by the existence of offshore holding companies, being the shareholders in the contract of work companies. Sales of shares in the offshore companies has proceeded beyond the regulation (and sometimes notice) of the Department of Mines and Energy. Accepting the strong constitutional commitment to the minerals being controlled by the State and for the utmost benefit of the people, the Department of Mines and Energy has become increasingly concerned at these offshore 'sales'. Some of these sales have related to specific Indonesian mining interests, whilst other sales have formed part of sales of world-wide mining interests. The dilemma for the Indonesian government appears to be twofold. Firstly, the people do not receive any benefit from the offshore sale of the mining interests. More importantly, the government, which is charged with control of Indonesia's resources, has no legal basis under the contracts of work to regulate or control the offshore sales. Ultimately the Department of Mines and Energy has taken

a pragmatic approach. It has a responsibility to its government to ensure the development and exploration of the resources. Indonesia is on a major drive to promote its non oil and gas revenues and export of minerals is identified as a significant contributor to these revenues. Faced with declining gold prices and worldwide restructuring in ownership of mining companies, the Department of Mines and Energy has needed to be flexible. Sales of shares in offshore companies being themselves shareholders in contract of work companies has proceeded in consultation with senior department officials. New contract of work companies have recently been approved with offshore holding companies as shareholders, although in some instances, undertakings as to continuity of ownership and management have been required by the department.

FINANCING MINE DEVELOPMENT

Investors in several coal and gold companies are entering the mine development phase and are expected to seek substantial fund raisings in the next few years. By contrast, some smaller companies remain without sufficient funding and will struggle to raise funds to finance their continuing activities. Contract of work companies may borrow from both onshore and offshore banks. There are no exchange controls on the remittance of funds, although the prior approval of the Ministry of Finance and Bank Indonesia, Indonesia's central bank, are required for offshore borrowings.

The domicile of the lender will have some bearing on the amount of tax withholding required to be withheld by the borrower on interest payable on borrowed funds. If the lender is an onshore bank, tax withholding at the rate of 15 percent will apply. If the lender is an offshore bank, tax withholding at the rate of 20 percent will apply, subject to reduction generally to 10 percent or 15 percent in accordance with the various double taxation treaties to which Indonesia is a party. As withholding tax is usually grossed up as a cost of funds to the borrower, the domicile of the lender will have some bearing on the overall cost of funds. In respect of transaction fees payable for onshore or offshore loans, only nominal Indonesian stamp duty is payable on loan and security documentation. However, notarial fees incurred in respect of charges by Indonesian notary publics and registration fees can be substantial and usually amount altogether to 1 to 2 percent of the principal amount of secured loans.

The contracts of work specify for gold and coal contracts of work the ratio of debt to equity permitted for the purposes of tax deductibility of interest expenses. For coal contracts, the acceptable maximum debt to equity ratio is currently 5 : 2. For gold contracts, the ratio is currently 3 : 1. In respect of securities available to secure repayment of loans, Indonesia's Constitution precludes the minerals being used as collateral or security for repayment of loans until such time as title passes to the contractor, being after the time of extraction from the ground and payment of all royalties due to the government.

Requirements under Indonesian law and government approvals requiring subscription and payment in full of all authorised capital of the contract of work company within a specified period generally dictates

application of shareholder funding to equity rather than shareholder debt in the earlier stages of general survey, exploration and feasibility. As the projects approach the construction phase, external financing to fund construction work and to discharge shareholder debt is sought.

In 1988 the first gold loan was made to an Indonesian gold mining company by an Australian bank. Bank Indonesia approved the transaction after some months of consideration.

TECHNICAL ASSISTANCE ARRANGEMENTS WITH KP HOLDERS

In his paper Makarim has referred to the arrangement that a foreign investor may enter into with the Indonesian holder(s) of a KP, which arrangement precedes the grant of a contract of work. Although this arrangement (often referred to as a technical assistance arrangement (TAA) is mostly of a short-term nature, which terminates on the grant of the contract of work, for some investors the TAA may be a permanent arrangement. In brief, the TAA involves the foreign investor contracting (from outside of Indonesia) to provide technical support and to procure for employment by the KP holder the foreign investor's personnel for work in Indonesia. The foreign investor charges the KP holder a technical assistance fee, which is intended to equate with (but cannot be expressed as) a profit share and seeks reimbursement of salaries and other direct expenses. Loan funds provided by the foreign investor to the KP holder to finance mining activities are usually secured by an assignment of dividends agreement and a pledge of shares agreement. As previously stated, the Constitution precludes any collateral or security interest in the minerals being granted to the lender, until such time as title passes to the KP holder on extraction of the minerals and payment of royalties to the government. The foreign investor receives return on its investment by means of technical assistance fees, reimbursement of expenses and repayment of loan funds together with interest.

The limitations of the TAA are principally concerned with the potential insecurities of the arrangement. If the KP holder seeks to terminate the TAA prematurely, the foreign investor will usually be limited in its rights to the position of an unpaid creditor. Once any outstanding loans are repaid, the foreign investor is likely to be precluded from claiming any beneficial interest in the mining activities. The tax and legal limitations of the foreign investor receiving returns on its investment in excess of repayment of its loans with interest, costs and commercially justifiable technical assistance fees are an added complexity. From the perspective of security of investment, the contract of work is undoubtedly the preferable course. The foreign investor's ownership and management rights in the contract of work company are directly secured by share ownership.

There are some attractions to a TAA, however, despite the absence of the protections provided by a contract of work. For instance, for those areas permanently or temporarily closed to grant of further contracts of work (i.e. Bengkulu and Central Kalimantan), a TAA is the only real option for a foreign investor to participate with a KP holder. Expediency

is another advantage. A further one is that the method for applying for and gaining KP rights is much simpler and quicker. If the project life or size is smaller, the TAA arrangement can be more flexible and can permit exploration work to commence within a few months of application rather than experiencing the many months of delays in entering into a contract of work.

ILLEGAL MINING

During the last two years, the Indonesian mining industry has been faced with a serious problem presented by the activities of illegal miners. The alluvial miners in the various provinces of Kalimantan have been particularly affected. The seriousness of the problem is illustrated by the Department of Mines and Energy estimate that of the approximate 20 tonnes of gold produced in Indonesia in 1988, only 4.7 tonnes representing less than 25 percent of production was from registered mines, with the balance derived from illegal mining activities. The problem presents the Indonesian government with serious social, economic, environmental as well as security problems, apart from the disincentive to the conduct of legitimate mining activities in Indonesia.

Illegal mining is defined as mining activities undertaken by persons resident outside the areas of mining activity who enter an area to mine using sophisticated equipment. The extensive scope of the activities has been made possible by financiers who are suspected of funding and organising large numbers of the illegal miners. Illegal mining is not to be confused with people's mining, which is defined in the Mining Law to mean mining activities conducted by local people on a small scale or in mutual co-operation for their own living and using simple equipment. A licence or permit may be granted in respect of people's mining activities and these activities are intended to be carried on as authorised activities independent to contract of work or KP mining. Alternatively, people's mining may consist of small non-structured mines or activities integrated with small industrial businesses, provided they are engaged in by local people.

In 1987, the Minister of Internal Affairs by Instruction No. 25/1987 declared 1 July 1988 as the deadline for the termination of illegal mining activities and removal of illegal miners. Partly because of the remoteness of the activities and the size of the areas to be supervised, however, the measures were not very successful and illegal miners have continued to return to their original prospecting areas. In January 1989 the minister instructed governors of the affected areas to take sterner measures to protect the mining areas granted to the contractors and peoples (traditional) miners. In an effort to contain the activities, the Directorate-General of Mining has requested contractors and KP holders to accelerate their exploration activities and relinquishment of non or less prospective areas. It is the government's hope that this acceleration will make possible the future relocation of the illegal miners to the relinquished areas. It will also facilitate the government in protecting what is intended to become smaller target areas of the contractors. Other operational plans of charting of authorised and illegal activities, security

surveillance and confiscation of equipment are being implemented. Problems still remain, however.

ENVIRONMENTAL ISSUES

There is a growing awareness of environmental issues in Indonesia. The international spotlight is now squarely focused on the world's remaining large rain forest areas including Indonesia and South America. Community groups both within and outside Indonesia seek more actively to participate in formulating the direction of environmental policy. In an unprecedented move, a community group has recently commenced litigation suing the Indonesian government as well as the owner of a pulp and rayon plant in North Sumatra in which damage to the environment is alleged.

As a requirement under the contract of work, the contract of work company must include in the feasibility study for each mining operation an environmental impact study (known as an Andal). Although the contract of work companies have to date not experienced significant environmental difficulties in dealings with governmental or community groups, the increased environmental damage caused by use of mercury by illegal miners is raising some environmental concerns.

FUTURE CONTRACTS OF WORK

As Makarim has mentioned, there are eight contracts of work awaiting execution. Delay in proceeding to execution has occurred as the government seeks to resolve its own internal conflicting interests of those government forces seeking to increase taxation receipts in Indonesia and those competing government forces seeking to enhance the deregulation and stimulation of the economy, including foreign investment. Whether the 'fifth' generation contracts of work will contain the same, more stringent or more lenient taxation provisions awaits a final outcome.

In respect of the general terms of the contracts of work, Makarim has referred to the practice of and the legal deficiencies of the execution of 'side letters' not submitted to the People's House of Representatives but merely executed between the relevant government contracting authority (i.e. PT Batubara in the case of coal) and approved by the Ministry of Mines and Energy. From a strict legal view, Makarim's call for caution on the enforceability of the side letters is correct. From a practical view, the execution of the side letter may be the only means of addressing the relevant issue in dispute.

The constitutional limitations weigh heavily on the Ministry of Mines and Energy as it must ultimately obtain the approval of the People's House of Representatives to any amendments to the contracts of work. The Ministry's resilience in agreeing to amendments to contracts of work, particularly amendments which restrict the government's management rights over the minerals, is understandable. Execution of a 'side letter' is often the only practical solution. This has certainly become the developed practice in respect of production sharing contracts for oil and gas since the mid 1970s. One suspects, however, that the minerals sector

does not yet have the economic strength that the oil and gas sector enjoys in Indonesia as a contributor to government revenues for the government to extend, for the benefit of the gold and coal contractors, the concessions presently offered to the oil and gas contractors by way of such 'side letters'.

WHAT NEXT FOR AUSTRALIAN MINING COMPANIES?

I am often asked what impact the fluctuating political relations between the Indonesian and Australian governments has on the prospect of continuing Australian investment in Indonesia. In 1986, at the height of political tensions between the Australian and Indonesian governments, the Indonesian government was in the process of approving gold mining contracts of work for new investors. Notwithstanding the political events of the time, over 70 percent of contracts awarded were to companies in which Australian investors held a majority interest. Whilst some 'trafficking' in contracts of work and liquidity problems of some of the smaller companies have recently diminished to some extent the highly favourable reception of Australian investors in the Indonesian mining industry, the Indonesian Department of Mines and Energy continues to take a pragmatic approach in recognising the expertise of the Australian mining sector as a source of investment, technology and skills for the development of Indonesia's resources.

The next few years will see large scale projects with significant Australian equity in gold, coal and nickel proceed to mine development and operation. These projects will be a strong source for both mining companies and support services in the participation by Australian companies in the development of Indonesia's mineral resources. The next few years will also see continuing efforts by the Indonesian government to expand the development of Indonesia's own capital market as a ready source for funding participation by Indonesian nationals in the mining sector. The recent deregulation measures aimed at stimulating the Jakarta Stock Exchange, the opening of an over-the-counter market (Bursa Parrallel) in Jakarta, the opening of the Surabaya Stock Exchange and the approval for the first time for foreign investors to acquire shares listed on the Indonesian exchanges are all signs of increasing the available funds for participation by Indonesian nationals in the mining sector, amongst other investment sectors. Perhaps it is a little premature to herald the emergence of a golden era for mining in Indonesia, but there are certainly many substantial opportunities for Indonesians and Australians alike to pursue.