

Client Alert

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Arrival of the New Domestic Market Obligation Regime in the Indonesian Mining Sector

On 31 December 2009, the Ministry of Energy and Mineral Resources issued a ministerial regulation on the Preferential Supply of Domestic Mineral and Coal Demands ("**PerMen No. 34/2009**"), otherwise known as the domestic market obligation/"**DMO**" regulation. The regulation is effective as of its issuance date.

Key Features of PerMen No. 34/2009

We set out below a summary of some of the key provisions of PerMen No. 34/2009 and our commentary on their likely practical impacts to mining companies and coal and mineral users:

1. Minerals covered under PerMen No. 34/2009

PerMen No. 34/2009 applies to all coal and minerals (i.e. metal-based minerals, non-metal based minerals and rocks). PerMen No. 34/2009 does not give further details of these classifications but in our view the details of the classifications will follow the coal and mineralization coverage which will be detailed in the soon-to-be issued government regulation on mining business.

2. Who is bound by the DMO Obligation

Only mining companies are bound by the DMO obligations. The obligation does not apply to domestic coal/mineral traders (who therefore are free to export 100% of the coal or minerals they buy from mining companies).

3. Formulation of DMO - Relationship of RKAB and DMO Plan

The formulation of the DMO obligation is primarily driven by the quantities of coal/minerals domestic consumers require to satisfy their annual operating requirements. To qualify as "domestic consumers or purchasers", consumers/purchasers must be parties who will actually use the mineral/coal as raw materials and/or fuels (as applicable), i.e. they must be the end-users of the coal/minerals and not some intermediary (e.g. coal aggregators/traders).

In general, the process of formulating DMO involves the following:

- (a) domestic consumers submit to MEMR their respective annual forecasted mineral and coal (including the mineral/coal specification) needs for the relevant year (Year X) by no later than March of the year prior to Year X (Year X-1);
- (b) the MEMR then reviews and calculates DMO requirements based on the submission of the domestic consumers and information that it has on the production plan of the mining companies - the MEMR needs to issue a

decree on DMO for Year X at the latest by June of Year X-1. The DMO plan (the "DMO Plan") shall cover:

- (i) the forecasted domestic mineral and coal needs for Year X, supplemented with a list of the domestic consumers and their respective coal/mineral volume and specification needs; and
- (ii) minimum coal and mineral DMO percentage;
- (c) the mining companies submit their respective work programs and budgets ("RKAB") for Year X to the issuers of their respective mining licenses (the MEMR, Governor or Mayors/Regents, as applicable), with a copy to the Director General of Mineral, Coal and Geothermal, at the latest in November of Year X-1.

The RKAB for each mining company will have to state commitments to the DMO obligations based on the minimum percentage of DMO referred to in the DMO Plan (see above).

Accordingly:

- (a) there is no prescribed DMO percentage under PerMen No. 34/2009 as the minimum DMO percentage will be determined by the MEMR on an annual basis based on the demands of domestic consumers – that said, theoretically, the larger the demand submitted by the domestic users/consumers to the MEMR, the more DMO volumes and the higher percentage will be imposed (and vice versa for low demand requirements); and
- (b) it appears that the DMO obligation will only be discharged if sales are made by the mining companies, pursuant to their respective RKABs, to the domestic users who are listed in the DMO Plan (unless certain permissible exceptions apply, as will be discussed below in Section 4). That said, mining companies will need to ensure that their domestic customers submit DMO quotations to the MEMR so that sales to such customers, from the perspective of the mining companies, can be considered as part of the DMO sales.

It is not clear whether:

- (a) a mining company which does not, at the time of RKAB submission, have an existing supply commitment with domestic customers is still required to fulfill its DMO obligation;
- (b) if the DMO obligation still applies (albeit without specifying who the domestic buyers are), a sale by a mining company to domestic users who are not listed in the DMO Plan can still be considered as sales within the framework of DMO sales;
- (c) the DMO Plan will set out the names of the mining companies and their DMO percentage given that DMO commitments from mining companies will only be known approximately 5 months after the DMO Plan is issued (see above); and
- (d) given that the DMO Plan will specify the coal/mineral specification, whether such mines which produce coal/mineral of different specification from what the consumers require under the DMO Plan will be discharged from their respective DMO obligations.

For example, if the DMO Plan for coal is primarily driven by coal demands from domestic electricity companies which only need low to medium rank coal, would the producers of high rank coal:

- (i) be automatically discharged with their DMO commitments and do not have to state DMO percentage in their RKABs; or
- (ii) are still required to state minimum DMO commitments anyway given that Articles 10(2) and 10(3) of PerMen No. 34/2009 requires minimum DMO percentage be set out in the RKAB, and if this actually the case, how this commitment can be implemented given that, based on the DMO Plan, there will be no domestic off-takers of their high rank coal. It may be that the MEMR is expecting these high rank coal producers to meet their DMO obligations solely through the purchase of DMO credits (discussed below).

We expect that clarification in respect of these matters will be issued by the MEMR in due course.

An interesting point raised by PerMen No. 34/2009 is that the recipients of the RKAB (the MEMR, the Governor, the Mayor/Regent, as applicable) are obliged to maintain, and must guarantee the confidentiality of, the contents of an RKAB if the mining company which submits the RKAB is a listed company based on applicable regulations.

It is unclear whether:

- (a) the listing requirement is limited to listings in the Indonesian stock exchange;
- (b) assuming that the listing requirement is limited to Indonesian stock exchange listings, the same confidentiality treatment and assurance will be given to mining companies which are subsidiaries of an Indonesian listed company; and
- (c) assuming that the listing requirement covers offshore stock exchange listings, the same confidentiality treatment and assurance will be given to mining companies which are subsidiaries of an offshore listed company.

We appreciate that the information which may be contained in the RKAB is market-sensitive information as it relates to projected financial spending and, to a certain extent, sales. In our view, the same confidentiality guarantee needs to be given to all mining companies for fairness reasons.

4. What constitutes a DMO sale

In general, DMO sales covered by PerMen No. 34/2009 include:

- (a) domestic sales of coal or minerals by mining companies to domestic/actual users of such coal/minerals who use such coal/minerals as raw materials and/or a source of fuels (as applicable) pursuant to the applicable DMO Plan set out by the MEMR and the mining companies' respective RKABs;
- (b) subject to certain requirements set out under PerMen No. 34/2009, domestic sales of coal or minerals by mining companies to domestic

coal/mineral traders (further discussion on the sale of coal/mineral to traders in the context of DMO can be found in Section 7 below);

- (c) export of any non-purchased DMO portion which is not purchased by prescribed domestic purchasers, with prior approvals of the MEMR; and
- (d) any DMO credits purchased by other mining companies (further discussion on the DMO credits can be found in Section 8 below).

It is not clear if, during a relevant year, a mining company sells the mineral/coal to domestic buyers who are not listed in the DMO Plan, that mining company can still claim that it is selling its mineral/coal as part of the DMO sales.

5. Carry Forward of Unfulfilled DMO Commitments

PerMen No. 34/2009 requires mining companies to submit quarterly reports to the MEMR regarding implementation of their respective DMO commitments. If the mining companies cannot fulfill their committed DMO portion in the first quarter, such obligations will be carried forward to the subsequent quarters. However, if at the end of the 4th quarter in a year, the mining company is still unable to fulfill its DMO obligation for that year, PerMen No. 34/2009 is silent on whether the unfilled DMO portion in that year must be carried forward as the DMO obligation for the next year.

In our view:

- (a) as the sanction provisions of PerMen No. 34/2009 relate to non-fulfillment of the committed DMO obligation in a relevant year; and
- (b) there are measures for still fulfilling DMO obligation either by way of (i) exporting with prior approval of the MEMR; (ii) selling to domestic traders provided that the proposed sale has been addressed in the RKAB and sale agreements attached to it; and (iii) sourcing for DMO credits,

any unfilled DMO portion in a particular year should not be carried forward to the subsequent year and the mining company is therefore subject to the sanctions prescribed by PerMen No. 34/2009. Further discussion on sanctions under PerMen No. 34/2009 can be found in Section 10 below.

6. Sale Price under DMO Framework

The price for domestic sales (including sales of DMO portion) should refer to the referenced/minimum coal or mineral pricing, which we interpret to mean as a minimum floor price for the sales. Clearly, there is a possibility to have the coal/mineral DMO sale price above the applicable referenced/minimum coal or mineral price, if agreed by the transacting parties. The referenced/minimum coal or mineral price will be regulated in a separate MEMR regulation.

One major concern expressed by coal mining companies in particular around the DMO framework was that the regulation was going to require sale of DMO coal at heavily subsidized prices (with some suggestion of the DMO pricing being on a "cost plus" basis). However, PerMen No. 34/2009 makes it clear that the pricing for DMO coal will be subject to the same minimum pricing as applicable to export coal – i.e. the coal mining companies will be required to sell for a price at least equal to the minimum coal price to be introduced under foreshadowed minimum pricing regulations.

7. Sales to Domestic Traders

In general, a sale of minerals/coal to domestic traders will not be deemed as a sale in the framework of DMO sales. However, as mentioned above, PerMen No. 34/2009 provides exceptions. Sales to domestic traders may be considered as sales under DMO framework, provided that:

- (a) the sales to such domestic traders are conducted between June and November of the relevant year;
- (b) the domestic traders hold valid mineral/coal trading licenses (i.e. the IUP-OP for transportation and sales); and
- (c) the relevant sale and purchase agreements between the mining companies and the domestic traders are attached to the annual RKAB of the mining companies for the relevant sale year.

It is interesting to note that:

- (a) "domestic traders" are defined as business entities which undertake sale and purchase of mineral/coal within the jurisdiction of Indonesia. In relation to this matter, it is unclear whether an offshore entity which is designated to undertake trading in Indonesia can qualify as a domestic trader for the purpose of PerMen No. 34/2009. In our view, this depends on the requirements of the mandated mineral/coal trading licenses (the IUP-OP for transportation and sale). Based on the latest draft mining business regulation that we have, holders of IUP-OPs will have to be in the form of Indonesian legal/business entities. Accordingly, any offshore entities/permanent establishments which are designated to undertake sale and purchase of coal/mineral in Indonesia (not for the purpose of export), in our view, will not be qualified as "domestic traders"; and
- (b) in addition to definitive sale arrangements with domestic traders, in our view, there is a possibility for mining companies to enter into term purchase arrangements with such domestic traders, where the domestic traders become "stand-by" buyers of the mining companies for any untaken DMO portion which is supposed to be purchased/sold to the original domestic consumers, provided that the abovementioned PerMen No. 34/2009 requirements are fulfilled.

8. DMO Credits Trade

PerMen No. 34/2009 introduces the concept of DMO credits trade. In our view, the primary reason why this concept is introduced is so that mining companies can fulfill their annual DMO commitments which have been set out in their respective annual RKABs.

In general, the trading of DMO credits must comply with the following requirements:

- (a) there has to be a mining company (Mining Company A) which has exceeded its DMO commitment/domestic sales at a relevant year;
- (b) there is another mining company (Mining Company B) which is likely to be unable to fulfill its DMO commitment for the relevant year;

- (c) Mining Company A can sell and transfer its excess DMO commitment (the DMO credit) to Mining Company B; and
- (d) the purchase price of such DMO credit is basically subject to commercial agreement of Mining Company A and Mining Company B, provided that, the maximum price of the DMO credit is equal to the referenced/minimum sale price of the relevant product applicable in the current month (i.e. the month in which transaction of the DMO credit occurs).

It is interesting to note that PerMen No. 34/2009 does not address the tenure of the DMO credit and whether a DMO credit for the first year can be carried forward to subsequent years (either for the purpose of satisfying the subsequent year's DMO commitment or trading purposes). In our view, and consistent with the treatments of DMO obligations carry forward as discussed in Section 5 above, DMO credits will only be valid and applicable in the year in which those credits are produced and cannot be carried forward to any subsequent years.

9. Prohibition of Domestic DMO Purchasers from exporting Purchased DMO Products

PerMen No. 34/2009 prohibits domestic purchasers of the DMO products from "exporting" the purchased DMO minerals/coal. However, it is unclear whether such domestic purchasers are allowed to re-sell the purchased DMO products to local buyers. PerMen No. 34/2009 is silent on this matter. In our view, the domestic purchasers of the DMO products should not be allowed to re-sell the purchased DMO products as this would not be consistent with the spirit and reasoning behind PerMen No. 34/2009 and the preparation of the annual DMO Plan.

10. Sanctions

In general, violation of PerMen No. 34/2009 is subject to administrative sanctions. The sanctions can be imposed by the MEMR, the Governor or the Mayor/Regent based on their level of authorities.

At the outset:

- (a) the MEMR has the authority to impose sanctions on:
 - (i) mining companies whose mining licenses are issued by the MEMR (including Contracts of Work and Coal Contracts of Work companies), which fail to:
 - fulfill their DMO commitments (in a relevant year);
 - submit quarterly DMO implementation reports; and/or
 - submit notification to the MEMR stating their failure to satisfy the DMO commitments.
 - (ii) domestic purchasers (as listed in the DMO Plan) which fail to purchase the designated DMO mineral/coal.
- (b) the Governor, the Mayor or the Regent (as applicable) has the authority to impose sanctions on mining companies whose mining licenses are issued by them and who fail to:

- (i) fulfill their DMO commitments (in a relevant year);
- (ii) submit quarterly DMO implementation reports; and/or
- (iii) submit notification to the MEMR stating their failure to satisfy the DMO commitments.

The sanctions which can be imposed for violation of PerMen No. 34/2009 are generally administrative sanctions. These range from warning letters (3 letters, with each letter valid for a period of 1 month) to, if the party does not comply after the warning letters, a reduction of up to:

- 50% of the total mineral/coal allocation for the relevant domestic purchaser; or
- 50% of the total mineral/coal production for the relevant mining companies.

While the reduction of mineral/coal allocation and production is meant to be a last resort sanction, it is certainly a risk which both mining companies and domestic purchasers need to monitor as this may substantially affect the operation of the relevant companies.

It is interesting to note that Article 13(2) of PerMen No. 34/2009 provides for an obligation of a mining company to notify the MEMR if it cannot fulfill its DMO commitments. Assuming that the MEMR is notified, it is not clear whether such notification can simply discharge the DMO commitments and therefore the mining companies can avoid the administrative sanctions mentioned above. A conservative view is that it does not relieve the mining company from its obligations under the PerMen No. 34/2009, and accordingly the administrative sanctions may be imposed regardless of the prior notification.

Similarly, Article 15(2) of PerMen No. 34/2009 provides a requirement for domestic purchasers to notify the mining companies (with a copy to the MEMR) if the domestic purchasers cannot realize the purchase of the relevant DMO portion which they have committed to. Clearly, while available contractual remedies may be exercised by the mining companies, it is not clear whether such domestic purchasers can avoid the administrative sanctions set out in the PerMen No. 34/2009 (relating to non-purchase of the committed DMO products) if they give this prior notice. These are other PerMen No. 34/2009 items which MEMR need to clarify.

Concluding Remarks

Whilst the concept of a DMO for coal companies has been bandied around for many years in Indonesia (and generally accepted by mining companies as inevitable), the concern was always as to the devil in the detail, and ensuring that the framework developed was workable.

The major concern expressed in early reactions of mining companies to this PerMen No. 34/2009 is that, due to the annual nature of the setting of DMO targets, the regime introduced under PerMen No. 34/2009 makes it very difficult for mining companies to enter into long term marketing or sale agreements with any certainty, as a higher domestic need for coal/minerals in one year, coupled with a higher allocation of DMO percentage for the particular mining company in the same year, may mean that the mining company will find itself in a position where it cannot both meet its DMO

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obligations and meet its commitments under long term pre-existing contractual arrangements.

The better news from PerMen No. 34/2009 is that DMO sales are not carried out at an overly subsidized price, albeit that with the lack of competition for DMO coal introduced under the regime (i.e. where the DMO supply obligation is matched with the DMO demand requirements) will ensure that coal mining companies can expect to negotiate a sale price equal to the Indonesian standard coal price floor. So whilst competition amongst export buyers of coal may result in export trades occurring at a price higher than the to-be-introduced Indonesian standard coal price, the lack of competitive pressure on domestic buyers may lead to all DMO trades will be at the Indonesian standard coal price.

How aggressive the MEMR and Provincial and Regional Governments are in enforcing this new regulatory framework is yet to be tested. It is hoped that regulators will give the mining industry some breathing room to adapt to this new annual framework for determining the DMO coal requirements, however that remains to be seen.

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