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Coal DMO – a 1969 concept given new life in 2008?

Much has been said within Government and coal industry circles over recent months on the possibility of a domestic market obligation (DMO) for coal being introduced by the Government to ensure that domestic coal demands (particularly for the Government's 10,000MW coal-fired "crash program") are met. Allegations of "moving the goal posts" and adding to Indonesia's regulatory uncertainty have been leveled at Government and regulatory agencies. However the reality is that the DMO concept has been sleeping away in Indonesia's regulatory framework for the last 40 years.

Article 66 of Government Regulation 32/1969 on Basic Provisions on Mining (as amended) gives the Government very strong rights to restrict the export of coal and minerals where the national interest requires it. This ability of the Government to divert supply to the domestic market is exercised in three ways, all predicated on national interest grounds:

- the Minister of Energy and Mineral Resources can designate a certain area as being one which can only be exploited by the State;
- the Minister may impose export restrictions on certain minerals; and
- the Minister may impose an obligation on holders of mining concessions or Contracts of Work to deliver a portion of production to Government as a form of mandatory levy (i.e. akin to a DMO obligation).

“...the DMO concept has been sleeping away in Indonesia’s regulatory framework for the last 40 years”

The last category has found its way into the provisions of the various generations of coal Contracts of Work:

- *“Contractor shall have the right to export coal... provided that in exercising such right, Contractor shall give due consideration to the domestic demand within Indonesia...”* (First Generation)
- *“If a requirement for large quantities of coal develops within Indonesia which cannot be met by [Government’s 13.5%] share of coal ... at Government’s request, the Contractor shall sell all or part of its coal to [Government] based on terms as mutually agreed...”* (First Generation)
- *“Contractor may only export its portion of coal if the requirements of Indonesia have already been fulfilled by [Government] or other coal companies.”* (Second Generation)
- *“Contractor shall always give priority to fulfilling the needs of Indonesia. Whenever the coal requirements for coal in the country cannot be fulfilled by the Government share of the coal production and other sources, the Contractor must sell all or part of its coal directly to the consumers in Indonesia or with coal agents...”* (Second Generation)
- *“The Government will grant the Contractor the right to export [coal] after giving due consideration to the domestic requirements.”* (Third Generation)

“The very onerous DMO under the Second Generation is indicative of the history of these Second Generation contracts being awarded to Indonesian domestic investors”

The very onerous DMO under the Second Generation is indicative of the history of these Second Generation contracts being awarded to Indonesian domestic investors, as opposed to the First and Third Generations which were granted to a large number of foreign investors.

We understand that the Ministry of Energy and Mineral Resources is in the process of finalizing the decree on the DMO. The key tenets of the decree are:

Principle

The decree will apply to both CCoW companies and KP companies

Export of coal will only be permitted once the Government is satisfied that the domestic demand will be serviced

Implications

Whilst CCoW companies have the “lex specialis” status which generally protects in changes in law, the wording of each CCoW will need to be carefully reviewed to determine whether the issuing of the decree by the Ministry is within the rights already provided for in the CCoW.

We would expect this concept to follow the principle set out in the second generation CCoWs – i.e. that an export plan would need to be agreed and approved by the Government before any exports are permitted.

Principle

Domestic sale obligation can be satisfied directly by sales to end users, or Domestic Coal Traders

Each coal company will be set a DMO (as a % of production) by June each year

Implications

There is some concern that the involvement of intermediaries may give rise to probity and transparency concerns.

The fact that the DMO will be set annually, and may change annually, will make it difficult for coal companies to enter into long term contracts. Long term coal supply contracts are fundamental to the success of project financed power generation projects, and accordingly there is a concern that in trying to sure up supply for Indonesian power projects, the fluid nature of the DMO obligations may be making it more difficult for these same power projects to become reality.

This principle gives perhaps the greatest sigh of relief to Indonesian coal miners. There was some apprehension that the Government would go the same way as it did in the early days of oil DMO – i.e. that oil be sold domestically for \$0.10 per barrel.

This provision appears to be intended for the higher ranking coals being produced in East and Central Kalimantan, where a requirement to supply such high quality coals to the domestic market instead of to the higher-paying North Asian and European buyers and power utilities would be like burning dollar bills. So a door has been opened to allow these higher quality coal mines to continue to export.

“The price at which DMO coal must be sold will not be differentiated from the export coal price”

The price at which DMO coal must be sold will not be differentiated from the export coal price.

Where a coal mining company exceeds its DMO obligation, it can “sell” the excess to another coal mining company, and that other mining company can use that excess to satisfy its own DMO.

As with the ongoing debate of the new Mining Law, the question asked by the industry is “When?”. There is no clear indication as to when the new DMO decrees will be issued, but as they are Ministerial Decrees, they are not wedded to the same timetable as the ongoing debate on the new Mining Law. We expect the decrees to be issued prior to the end of this year.

Tightening the Screws on Contractors – New PSC Terms

New Production Sharing Contracts (“PSC”) both for the most recent 2008 tender round, and for CBM contracts, have been rolled out. The changes to the conventional PSC (and bid terms) seem to be driven by a combination of concerns covering, amongst others, escalating industry costs, the fuel subsidy, environmental protection, Pertamina’s demands for greater participation rights, and the creativity with which oil and gas companies were side-stepping the need for transfer approvals. The key changes to the conventional oil and gas PSC are highlighted below:

- **Ring Fencing.** Exploration costs may only be recovered from a subsequent POD. All other costs in respect of a field may only be recovered from that field. As the PSC still contains an obligation to carry out exploration following the exploration period, the new PSC is likely to further hamper exploration efforts. In this connection, previous proposals designed to prohibit cost recovery on relinquished acreage have been shelved for the time being, although query whether these may be reintroduced in subsequent rounds.
- **Tax in Kind.** The PSC now anticipates that tax may be payable in kind. There seems to be no mechanisms, however, to allow recognition of tax paid in kind and the industry has expressed concerns about how this clause would work in practice.
- **Joint and Several Liability.** Some drafts we have seen expressly recognize the joint and several liability of the Participating Interest holders under the PSC, with BPMIGAS having the right to communicate directly with any holder of a Participating Interest, and to enforce obligations against it. In our view, this is merely a restating of what was implicit in previous generations of PSCs.
- **Pertamina Participation.** The tender conditions for the 2008 round state that Pertamina will have a right to acquire a fifteen percent interest in any working area offered through a tender or direct proposal. This right is exercised by way of a notice submitted to the winning bidders following contact award, and the participation will be carried out on “business to business” terms. The tender offer does not stipulate whether Pertamina will have a restricted right to farm-out all or part of its fifteen percent interest to third parties.
- **Assignment.** All assignments, whether to affiliates or otherwise, now require BPMIGAS and DirGen approval. This seems intended to prevent inter-affiliate transfers followed by share sales, as a means of circumventing the approvals process. In addition, changes in control (i.e. changes in the ownership of at least fifty percent of the voting stock of a company) require BPMIGAS and DirGen approval. There is no limit on how far up the corporate chain such a change of control takes place, before it no longer triggers an approval requirement. However, in some drafts we have seen, changes in control relate only to transactions in which the Participating Interest is the sole substantive asset.

- **Third Party Access.** Third parties may now gain access to existing infrastructure. This merely seems to be a restating of powers that BPMIGAS already exercises. The compensation payable for such access is credited to the PSC Contractor's operating costs, or is treated as profit oil or gas.
- **Field Carve-Outs.** As regards subsequent discoveries, in respect of which the PSC contractor fails to submit a POD, such areas will be carved out from the PSC area and relinquished, presumably with a view to them being offered to third parties.
- **Associated Products.** The PSC seeks to encourage Contractors to develop associated products (which are not hydrocarbons), from petroleum operations. Presumably this relates primarily to sulphur. Proceeds from the sales of such products are credited to operating costs, or treated as profit oil or gas.

The net result of the changes is to make the PSC terms more onerous. At a time when oil prices are seesawing between US\$90 - US\$150 a barrel, the overall effect is likely to make oil and gas companies more cautious in upcoming tender rounds.

MEMR Decree No, 1 of 2008 - Money in Old Assets

A little-remembered decree from 1996 has been recast for the post-2001 oil and gas regime. The regulation, designed to encourage the re-development of old wells, raises significant health, safety and environmental issues.

The decree requires Contractors to identify and commercialise old wells (i.e. wells drilled pre-1970), failing which, village cooperatives and local government companies ("KUD / BUMD") may seek to commercialise them, with DirGen's approval. The decree envisages that the Contractors will have the right to vet the applications made by the KUD / BUMD on the grounds of health, safety, technical and financial capability.

Significantly, the PSC Contractor has the right to reject the application made by the KUD / BUMD, but must report its decision to BPMIGAS. What happens then is not entirely clear; presumably BPMIGAS may seek further clarification of the grounds on which the proposal was rejected, and ask the PSC Contractor to reconsider its decision in light of such further clarification.

In the (perhaps unlikely) event that a proposal is accepted by the PSC Contractor, then it requires the further approval of DirGen. Thereafter, the KUD / BUMD enter into an agreement to produce oil with the PSC Contractor. The maximum term of the agreement is five years, extendable (presumably more than once) for five years. Each extension require DirGen's approval.

Oil produced under the oil production agreement is supplied to the PSC Contractor. In return, the PSC Contractor pays a service fee to the KUD / BUMD. There is little indication as to the level at which the fee should be set. Any third party financing the KUD / BUMD will seek to tie this into market price. However, it remains open to Contractors to push back on this.

The fee will be treated as an operating cost of the PSC Contractor and will, presumably, be cost recoverable under the terms of current PSCs. Where a PSC extension is agreed, however, (which in all likelihood, would introduce current-round PSC terms), query whether such fees could be cost recovered, given the POD ring-fencing principles outlined above.

The key issue arising out of the decree relates to health, safety and the environment. Under the decree, this is the responsibility of the KUD / BUMD. However, the decree goes on to state that the “Contractor shall carry out technical supervision”. Arguably, this may be sufficient, particularly if the KUD / BUMD has shallow pockets, to pin tortious, or environmental, liabilities on the PSC Contractor. Given this, the likelihood of getting Contractors to approve development proposals for old oil wells seems remote.

Biofuels – the on-again off-again story

Amid the soaring fossil oil prices and the global movement for the use of environment-friendly energy, the Minister of Energy and Mineral Resources is about to promulgate a regulation on the commercial exploration of Biofuel as a form of alternative fuel (“**Biofuel**”). The draft regulation (“**Draft**”) is being laid before public scrutiny. The draft is designed to replace MEMR Decree No. 51 of 2006 on the Requirements and Guidelines of Biofuel Business License (“**Decree 51/2006**”) and the promulgation thereof is intended to support the national movement of Biofuel utilization and accelerate the use of Biofuel as alternative energy as contemplated in Presidential Decree No. 5 of 2007 on National Energy Policy and Presidential Instruction No. 1 of 2006 on the Supply and Utilization of Biofuel as Alternative Fuel.

Though the Government has issued various policies to support the development of the Biofuel industry in Indonesia since 2006, in fact it stands stagnant. The lack of business-friendly policies is considered one impediment among others in its development. Although still a distance away from ideal, the promulgation of the Draft is expected to be a preliminary solution, as it provides possible incentives as a sweetener, and the mandatory use of Biofuel which may lead to an increase in the demand for Biofuel.

The following are some highlights cited from the Draft:

Mandatory use and incentives. The Draft provides the mandatory use of Biofuel, something which is not provided in Decree 51/2006. Any business entities which supply and/or use oil as fuel are obliged to use oil which has a minimum Biofuel content of 2.5 percent, and this percentage must be increased in stages up to 10 percent. To that end, the Draft provides an opportunity for

any business entities which consistently apply the mandatory use of Biofuel to receive incentives. However, details of the incentives are not specified in the Draft and will be further regulated.

Business license. The Minister is authorized to issue Biofuel business licenses. The license is valid for 20 years with the possibility of extension. Business license-holders are permitted to carry out Biofuel production, purchase, sale, export and import, transport, storage and marketing to end-users using specific trademarks, but the license does not include the right to trade oil fuel mixed with Biofuel. In light of regional autonomy, the Minister delegates to Governors to issue business licenses to Biofuel producers with an annual production capacity of up to 10,000 tons.

Domestic market. The first priority to procure Biofuel products and to market Biofuel must be given to the domestic market. Hence, import or export activities involving Biofuel can be carried out after securing a recommendation from the Minister. The Biofuel supplied and marketed to the domestic market must comply with the specifications and standards stipulated further by the Minister.

Biofuel categories and pricing mechanisms. Under the Draft, Biofuel is loosely categorized as follows:

- Specific Biofuel is in line with public interest in terms of its practical nature. The use of this Biofuel must be subsidized. The Minister will stipulate the benchmark price of this fuel.
- Industry Biofuel has different specifications from those of Specific Biofuel. This type of Biofuel is not subsidized. The Minister will stipulate the pricing formula of this fuel.
- Common Biofuel is a common commodity, and its price is determined through market mechanisms.

Sanctions. The Draft provides administrative sanctions as regards violation of the business license requirements, ranging from a suspension to the revocation of the business license.

AND IN SHORT....

Coal transfer pricing concerns heading towards minimum price regulation

The Government's perceived transfer pricing abuses of coal companies appears to be leading towards the Ministry of Energy and Mineral Resources issuing a decree mandating a minimum price of the sales of coal. The Government's complaints are essentially two-fold:

- the coal royalties payable to the Government are based on a percentage of FOB coal price, hence the lower the sales price ex-concession owner, the lower the Government royalty revenue;

“If the coal company breaches the minimum sale price restriction three times, the concession can be suspended”

- the shifting of coal mining profits out of Indonesia into related foreign “marketing” companies results in the Government losing corporate income tax revenue that it would have otherwise received had the profits from coal sales all been earned by the concession holder.

The draft decree requires that all coal sales be effected at a price not less than a “Standard Coal Price”, which is an index price derived as an aggregate of 50% of the Barlow Jonker Coal Index and 50% of the Indonesian Coal Index (ICI-2). If the coal mining company fails to sell at the index price, it must nonetheless pay the Government royalties and corporate income tax based on the sale having occurred at the index price. If the coal company breaches the minimum sale price restriction three times, the concession can be suspended.

Despite the strong deterrents on selling at a price lower than the index, the decree also requires all sales contracts (including spot sales) to be approved by the Directorate General. This additional administrative requirement is likely to cause delays in finalization of coal supply arrangements, and certainly in relation to spot contracts, appears completely unworkable.

Technical Verification or Investigation for Export of Certain Mining Products

The price of commodities is going up due to the increase of oil price and to monitor the export of those commodities and to handle illegal export issues, especially on mining products. In early May 2008, the Minister of Trade issued a regulation which requires technical verification for export of certain mining products. The verification has to be done before the mining products are loaded to the vessel for export. The technical verification can only be carried out by a surveyor company licensed by the Minister of Trade.

The technical verification consists of:

1. research and examination of the data or information, at least on the administration validity and the technicality of the source of the mining products;
2. determination of the product quantity;
3. determination of the category and specification of the product which includes the tariff posting number (HS) through qualitative analysis in a laboratory; and
4. shipping time and loading port.

This requirement for technical verification only applies to certain mining products, e.g.: coal, titanium, uranium, nickel, cobalt, copper, zinc, bauxite, silver, etc.

Due to this regulation, exporters of mining products would be required to engage a surveyor company to conduct a technical verification before they could load the products to be exported. This regulation came into force on 5 July 2008.

December... The Awaited Regulation Framework of REDD and CDM in Energy Sector

After a long expectation from investors and key industry players, it appears that the regulation setting out the framework of Avoided Deforestation projects in Indonesia will arrive before long. The President of the Republic of Indonesia, through a recently issued Presidential Instruction, has instructed the Minister of Forestry and Minister of Environment to issue a joint regulation on Reducing Emissions from Deforestation and Degradation (REDD). The regulation that will provide programs and mechanism of REDD is targeted to be issued in December 2008.

The President is also keen to encourage the implementation of Clean Development Mechanism (CDM) projects in the energy sector. A joint regulation of Minister of Energy and Mineral Resources and Minister of Environment on CDM in the energy sector is targeted to be issued, also in December 2008.

Whilst there have been experiences where some departments failed to meet the targets in previous Presidential Instructions, it is highly expected that the Ministers will meet the targets, as there has been significant investor interest both in the area of REDD and CDM in the energy sector.

New regulations on private sector power generation and distribution projects

A widely held belief in the Indonesian power sector is that PLN has always had, and continues to have, the monopoly on power distribution and retailing to consumers. However, ever since the introduction of the 1985 Electricity Law, and its implementing regulation passed in 1989, it has been clear that private developers could supply electricity direct to consumers.

Article 6 of Government Regulation 10/1989, as amended (PP 10/1989) provides that, as far as it does not harm the State interests, electricity business licences can be granted to private corporations by the Minister, Governor or Bupati (based on their respective authorities). The types of electricity business licences (IUKU) that can be granted are generation, transmission and/or distribution. Accordingly, there has always been a clear regulation on the right of private companies to develop generation and distribution projects. Examples are found in the Cikarang Industrial Estate, and industrial estates in Cilegon.

However Article 10 of PP10/1989 provides that the relevant operational business area for the private supplier must be determined by the Minister.

Regulation of the Minister of Energy and Mineral Resources No 26/2008 issued on 14 August 2008 sets out the procedure by which private developers can apply for such business area approval from the Minister, prior to applying for the relevant IUKU. Requirements for the approval of “business area” only apply to transmission and distribution projects, or “integrated” power projects (which involve generation and transmission/distribution), as it is only those types of projects (and not stand-alone generation projects) which are required to have a defined “business area”.

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Accordingly, even for new off-grid “integrated” power projects where the licensing authority rests clearly with the Regional Government, Ministry approval is still required due to the need to define this “business area”.

Mining in forest areas made easier

As further implementation of Government Regulation No 3/2008 earlier in 2008 which replaced the concept of “compensation forest” area with the payment of levies, the Ministry of Forestry has issued its Regulation No P.43/Menhut-II/2008 on Guidelines for Borrowing and Use of Forestry Areas (“**Reg 43**”). Reg 43 revokes the much-maligned Ministry of Forestry Regulations No. P.14/Menhut-II/2006 and P.12/Menhut-II/2004. Some of the key differences under Reg 43 from its predecessors are as follows:

- Where the mining concession has been issued by the Regional Government, in addition to obtaining the recommendation letter for the grant of an Exploration Activities Licence or “Pinjam Pakai” (i.e. the forestry approval for exploitation phase), the mining company now needs also to obtain a recommendation letter from the central Ministry of Energy and Mineral Resources. This could be viewed as a desire of the Central Government to grab back some control over regionally-administered mining projects.
- There is no longer any requirement to obtain the non-objection letter from the holder of any logging concession over the forest area. Instead, the mining company is required to pay a forest management or utilization fee (*biaya investasi pengelolaan hutan or pemanfaatan hutan*) to the concession holder (if any) or the regional government. It is not entirely clear whether this fee is a prescribed fee, or how this fee is calculated.
- A Pinjam Pakai can be issued for up to twenty years with rights to extend, instead of the previous five-year term.
- A Pinjam Pakai cannot be granted over a logging concession area where the total logging production lost as a result of the grant of the Pinjam Pakai (and all other Pinjam Pakai granted to other mining companies over that logging concession area) would exceed 10% of the total logging production from that concession. Previously, there was a sliding scale of such limit, from 3% to 10%, depending on the area of the logging concession (i.e. the larger the logging concession area, the lower the percentage cap on lost timber production).

The new regulation is a step forward for mining in forest areas, however we would expect to see some teething issues as this is implemented.

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