Further Changes To Foreign Ownership Rules in Indonesian Mining Sector

On 14 October 2014, then-President Susilo Bambang Yudhoyono signed Government Regulation 77/2014 (GR 77/2014), which further amends Government Regulation 23/2010 (GR 23/2010), the principal Government Regulation that implements the 2009 Mining Law.

Nature of the changes

A number of the changes to GR 23/2010 which have been introduced under GR 77/2014 have been made to align GR 23/2010 with some recently issued Ministerial Regulations which lay out further detail on divestment and foreign ownership restrictions that apply to holders of Mining Business Licenses (known by the Indonesian acronym, IUPs). Largely similar treatment is afforded to Special Mining Business License holders (IUPKs), but in this Client Alert we will focus on the more common IUPs.

Other changes formalize some of the agreements recently reached by the Government and holders of Contracts of Work, and again, seek to align the rules that apply to IUP holders with the arrangements that will apply to these Contract of Work holders.

While the focus of the changes relate to divestment, there are some changes to the coal processing provisions of GR 23/2010, which may have implications for how coal blending operations are structured.

Foreign acquisitions of domestic IUP holders

Our previous Client Alert summarized the new share transfer restrictions imposed on IUP holders under Regulation of the Minister of Energy and Mineral Resources 27/2013 (MEMR Reg 27/2013). The restrictions introduced under that Ministerial Regulation were:

- a 75% maximum foreign shareholding restriction where there is:
  - a conversion of a domestic (PMDN) Exploration IUP company to a foreign investment (PMA) company; or
  - a change of shareholding in a PMA Exploration IUP company; and
- a 49% maximum foreign shareholding restriction where there is:
  - a conversion of a domestic (PMDN) Production Operation IUP company to a foreign investment (PMA) company; or
  - a change of shareholding in a PMA Production Operation IUP company.
One of the criticisms of MEMR Reg 27/2013 at the time was that it introduced shareholding restrictions which were contrary to what was provided for in GR 23/2010 (which, up until the recent amendments introduced by GR 77/2014, only provided that there was a 51% foreign sell down requirement in Production Operation IUP holders starting from the 5th year of production).

Accordingly, GR 77/2014 now seeks to align (albeit, after the fact) the provisions of GR 23/2010 with the provisions of MEMR Reg 27/2013.

However, the changes introduced under GR 77/2014 fall short of achieving full alignment. While GR 77/2014 aligns the provisions of MEMR Reg 27/2013 in respect of conversion of a PMDN company to a PMA company, it remains silent on the requirement for a foreign shareholder in an already-existing PMA company to reduce to 75% or 49% in the event of a change of shareholding in that PMA company. In this respect, MEMR Reg 27/2013 remains inconsistent with GR 23/2010 (as amended).

**Higher foreign ownership limits allowed in certain cases**

GR 77/2014 now provides for higher foreign ownership limits in certain mining projects:

- For mining projects where the Production Operation IUP holder carries out its own processing or refining activities (i.e. within the same entity that holds the mining license), foreign shareholders are permitted to maintain a 60% shareholding instead of the generally applicable 49% and are given 15 years to achieve the sell-down referred to below, rather than the generally applicable 10 years. The sell-down requirements are as follows:

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<th>Year of Production</th>
<th>Sell-down percentage (i.e. Indonesian shareholding required)</th>
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<tr>
<td>6th</td>
<td>20%</td>
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<td>10th</td>
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<td>15th</td>
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- For mining projects where the Production Operation IUP holder carries out underground mining, foreign ownership is permitted to remain at 70% instead of the generally applicable 49%, and are given 15 years to achieve the sell-down. The sell-down requirements are as follows:

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Importantly for the processing and refining concessional treatment, what is required is that the processing and refining activities are housed within the same entity that owns the mining license. Where a mining company decides to develop its own processing or refining facilities in a subsidiary or affiliated company, the 60% foreign ownership treatment will not be afforded to the mining project, and instead the mining project will be subject to the 49% foreign ownership restriction (whilst the refining/processing project may remain 100% foreign owned).
For the underground mining exception, it is not clear from the regulation at what point the Government needs to be satisfied that the mining project will involve underground mining operation. It is not uncommon for mining projects to commence their life as open cut mines, and move to an underground operation after a number of years. We would expect that at the time of the upgrade of an IUP from an Exploration IUP to a Production Operation IUP, the Government will ask for a life of mine plan, and if that involves underground operation, the Government will at that time permit the foreign shareholders to retain a 70% shareholding.

In order to fully implement these relaxed foreign ownership restrictions, the Ministry of Energy and Mineral Resources will need to further amend MEMR Reg 27/2013 (which currently provides for a 49% foreign shareholding limitation, irrespective of whether the mining operation involves processing and/or underground mining).

GR 77/2014 relaxes some of the restrictions around how to deal with Indonesian participants in the event there are future funding requirements of the IUP company which would result in the Indonesian participant being diluted below the required Indonesian ownership threshold. The previous requirement was that no dilution was permitted (thereby forcing the foreign shareholders to bear any additional funding requirements, or alternatively find a new Indonesian partner to come in and fund the diluted portion). The new requirements allow for dilution of the Indonesian participant to occur, but requires the foreign shareholders to re-start the divestment process to re-establish the required Indonesian shareholding percentage.

Foreign ownership and IDX listed companies

GR 77/2014 now provides that for holders of IUPs whose shares are listed on the Indonesian Stock Exchange (IDX), a maximum of 20% of those shares are recognized as being held by "Indonesian participants", irrespective of whether those shares are in fact held by Indonesians or foreigners. This provision has been introduced in recognition of the fact that once a company's shares become listed on the IDX, both foreigners and Indonesians are able to freely trade those shares without restriction.

This provision in practice will only have limited effect, as it relates only to situations where the IUP holder itself is a listed entity that is subject to the divestment requirement (i.e. a listed IUP holder that has PMA status). Importantly, it does not apply to an IDX-listed shareholder of an IUP company.

Strangely, the provision does not seem to take into account the nature of how IDX-listed shares are dealt with under the capital markets regulations. The new provision introduced under GR 77/2014 simply states that where an IUP holder has its shares listed on the IDX, then a maximum of 20% of its total issued shares will be recognized as being held by Indonesian participants. When a company lists its shares on the IDX, all of its shares become listed (whether those shares make up part of the public float portion, or are held by the founding or controlling shareholders). So applying the literal reading, an IDX-listed IUP holder would never be able to establish Indonesian participation higher than 20%, as the wording of the regulation imposes a hard 20% cap. We suspect that the intended drafting of the provision was to reflect that, where an IUP holder lists its shares on the IDX, then Indonesian participants will be recognized as holding that public float portion, subject to a cap of 20% of the total issued shares of the company. Using an example, if an IUP holder (who is under a 51% divestment requirement) floats 30% of its shareholding on the IDX (with the remaining 70% owned by a foreign shareholder), then from the float portion, the Government will recognize a
20% Indonesian participant, and therefore the foreign shareholder will need to satisfy the remaining 31% sell-down requirement from its 70% shareholding. Using a different example, if an IUP holder (who is under a 51% divestment requirement) floats 10% of its shareholding on the IDX (with the remaining 90% owned by a foreign shareholder), then from the float portion, the Government will recognize a 10% Indonesian participant, and therefore the foreign shareholder will need to satisfy the remaining 41% sell-down requirement from its 90% shareholding.

Divestment obligations applied to existing Contract of Work holders

GR 77/2014 introduces a transitional provision which seeks to apply the divestment provisions to Contracts of Work.

Where the Contract of Work holder has, as at 14 October 2014, been in production for less than 5 years, it is required to comply with the divestment regime which is applicable to IUP holders as laid out under GR 23/2010 (as amended). Accordingly, where a Contract of Work holder is in its 5th year of production, it will be required to commence the divestment process in the following year.

For Contract of Work holders that have been in production for five years, there is a requirement to implement the share divestment provisions in an amount of 20% within one year (i.e. by 14 October 2015), and thereafter there is a requirement to continue with divestment in the revised percentages under GR 77/2014 such that the full divestment obligation has been met by no later than 14 October 2019.

Restrictions on miners selling coal/minerals of other miners

Before GR 77/2014, the regulations provided that a where a mining company did not itself conduct the activities of transport and sale of coal/minerals, that activity could be carried out by (i) the holder of a domestic coal/mineral trading license, or (ii) another mining company. Despite this flexibility, it has never been entirely clear how a mining company could choose not to conduct its own transporting and sale - i.e. even where mining company A was transporting and selling mining company B’s product, it would typically involve a sale by mining company B of product to mining company A.

In any event, GR 77/2014 now removes (ii) above as an option.

It is not entirely clear what behavior this change is seeking to encourage or discourage. It may be that the change is aimed at ensuring that a mining company does not source coal supply from another mining company (as that may make the Government’s ability to track sources of origin and payment of production royalties more difficult). So the aim may be for the Government to ensure that each mining company deals only with its own product, and where a mining company wants to deal with other products, it must be done through a domestic trading company as an intermediary. This may all relate to the Government’s current drive to reduce illegal mining, and a key theme of the initiatives that have been adopted to tackle illegal mining is a drive for transparency of coal production and export volumes.
Re-definition of coal processing activities

What does and does not constitute "coal processing" has two important implications under the regulations:

- As mentioned above, where a coal mining company also carries out its own coal processing, the foreign ownership ceiling is lifted to 60%; and

- Article 94 of GR 23/2010 provides that mining companies must carry out coal processing to increase the added value of coal produced, either directly or in cooperation with (i) IUP holders or (ii) "other companies" (i.e. non-mining companies that are licensed to carry out mining services or domestic trading).

The Government has revisited what types of activities constitute "coal processing".

Previously, coal processing included coal crushing, coal washing and coal blending. Accordingly, it would be very easy for a coal mining company to avail itself of the 60% foreign ownership ceiling, simply by (for example) owning and operating its own crusher, or by carrying out blending activities. To avoid such abuses, the Government has now defined coal processing (as it relates to mine owners) to include only the following:

- coal upgrading;
- coal briquetting;
- coke making;
- coal liquefaction;
- coal gasification;
- coal slurrying.

With the passing of GR 77/2014, it is only when one of the above activities is carried out (within the same legal entity that holds the mining license) that the 60% foreign ownership ceiling is applied.

In relation to the second aspect of the coal processing definition, namely the mandatory requirement for mining companies to process so as to add value, the deletion of crushing, washing and blending now means that a mining company cannot say it has met any requirement to "add value" merely because it has crushed or washed coal.

Interestingly, for the non-mining "other companies" referred to in Article 94 (i.e. companies who themselves do not own the resources), coal blending is still considered a form of "coal processing". It is not very clear why the different treatment has been applied. One interpretation is that "value adding" is satisfied by coal blending, albeit that the blending cannot be done by the mining company, but must be done by a separate non-mining company licensed to carry out coal blending services. The second aspect of this might reflect an intention of the Government to prohibit mining companies from blending coal themselves (as blending would typically involve a mining company taking some of its coal and blending it with coal from another supplier). As mentioned above, perhaps for the purposes of tackling illegal coal mining and ensuring full royalties are collected, the Government appears to be pushing mining companies towards a very simplified business model (i.e. extract coal, and sell that product and pay royalties based on the product mined), and requiring other activities (e.g. blending and aggregating supply) to be done outside the mining company (i.e. in non-mining companies licensed as mining services providers or traders).
The implications of these new regulations may require some restructuring of the sales of a blended product. In particular, it may be that all coal miners wishing to sell a blended product will need to establish a separate entity (licensed as a coal trader and coal processor), sell the mined coal to that affiliated processing/trading entity (and pay royalties on the internal sale price), and have that processing entity then re-sell the coal to the market.

It is likely that only when an implementing Ministerial Regulation on coal processing is issued will the real implications of this definition treatment of "coal blending" within the context of "coal processing" be fully appreciated.

Return of mining areas to State
Other provisions revised under GR 77/2014 relate to the return of mining areas to the State after expiry of the IUPs, or their earlier revocation.

Essentially, following the expiry of the IUP (and the two extensions provided for in the regulations), the Government may re-offer the concessions by way of auction (in the case of coal and metallic minerals). Key for investors are provisions which give the former holder of the relevant IUP the right to match in any re-auction process.

Extensions of Contracts of Work
As expected, GR 77/2014 has confirmed that where a Contract of Work is extended, it will be extended in the form of an IUPK, not an IUP as had been previously provided for. The major implication of this is that during this extension period, the IUPK holder will be subject to the additional 10% net profits royalty that is only applicable to IUPK holders.

GR 77/2014 does indicate that when the Contract of Work is rolled over into an IUPK, if the mining area under the Contract of Work exceeds the maximum mining area generally applicable for IUPKs, the mine owner will need to relinquish some of the area in order to bring it down to the maximum allowed for IUPKs.

Re-issuance of foreign-owned IUPs
The provisions of the earlier MEMR Reg 27/2013 provided a deadline of 14 September 2014 for the Regional Governments to submit the details of foreign owned IUPs (whether Exploration IUP, Production Operation IUP, special IUP for processing and refining or special IUP for transport and sale) to the Minister so that the Minister could renew (which we expect to mean re-issue) the IUP. That deadline has come and gone, and GR 77/2014 now extends that deadline to 14 October 2015. As with previous deadlines set under the mining regulations, it is expected that if the deadline is not met, the Minister will nevertheless continue to renew those IUPs after the deadline.