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Newsletter

Indonesia

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Feature Article :

New Forestry Regulation - Replenish or Repay!

New Forestry Regulation - Replenish or Repay!

In May 2006, the Ministry of Forestry issued Regulation P.14/Menhut-II/2006 regarding Guidelines on the Lease-Use of Forestry Areas ("**Regulation P14**").

"Regulation P14 has raised strong criticism from those within the mining industry..."

The issue of Regulation P14 has raised strong criticism from those within the mining industry, principally on the basis that it is asking the impossible of mining companies who are mining within forestry areas, and if the mining companies cannot achieve the impossible, they are left to pay an additional production royalty to the Ministry of Forestry.

The Regulation revokes a number of previous Forestry Ministry Decrees, and purports to be an all-encompassing regulation on the carrying out of certain business activities (including mining) in forestry areas. Transitional provisions are explained further below.

Key Elements of Regulation P14

The key features of Regulation P14 as relevant to mining are:

- the provisions apply to mining activities conducted within areas classified as Production Forest as well as Protected Forest;
- any person carrying out mining activities within a forestry area is required to obtain an approval in principle (which lasts up to 2 years), which may be converted into a permit (of a term of 5 years);
- for mining activities, the applicant for the approval/permit must provide compensation in the form of either:

  (a) non-forest land in an area twice the size of the forestry area being used for mining activities; or

  (b) one percent royalty of the revenue from the mineral proceeds.

Ability to provide compensation land

"Regulation P14 requires the mining company to provide non-forest area of 2 times the area of forest area being used..."

As mentioned above, Regulation P14 requires the mining company to provide a non-forest area twice the size of the area of forest area being used for mining activities as compensation for carrying out mining in the relevant forest. However, there are additional requirements in relation to the nature of this compensation land:

- the replacement land must be non-forest area;
- the land must adjoin the mining area;
- the land must be clear and free of all competing land titles; and
- located within the same watershed area.

In Kalimantan, for example, due to the vast tracts of land which are either forestry or otherwise subject to mining concessions, it may be very difficult for a mining company to satisfy these requirements.

"...mining companies will be required to contribute an additional 1% production royalty."

As a result of the impracticality in complying with this requirement, it is likely that if this Regulation is maintained and enforced, mining companies will be required to contribute an additional 1% production royalty. Clearly, the financial impact will be very different depending on the type of mineral being mined. An increase in the existing production royalties from 13.5% to 14.5% (i.e. a 7.5% increase) has a substantially softer effect than say for a Freeport, whose royalty obligations would increase from 1.5% to 2.5% (a 67% increase).

Transitional Provisions

Regulation P14 does recognize the legality of pre-existing borrow and use permits and approvals. Existing permits will continue until their expiry (previous permits were issued for a 5 year period). After their expiry, the mining companies must comply with the requirements under Regulation P14, which means sourcing replacement non-forest area or paying a 1% royalty.

Further, if after obtaining a permit, the classification of the relevant forest area the mining company is working in is changed from production forest to protected forest (in which open cut mining is banned), the mining company can only continue open cut mining for the remaining validity period of its relevant 5 year permit. Again, this presents significant risk to mining companies, and fundamentally attacks the integrity of the Contract of Work system and the guaranteed regulatory protections provided for thereunder.

Conclusion

The issuing of Regulation P14 has caused significant concern amongst Indonesia's mining fraternity, and is generally viewed as a strong deterrent to further investment in Indonesia's mining sector. The Indonesian Mining Association and Indonesian Coal Mining Association are seeking to hold open discussions with the Ministry of Energy and Mineral Resources and the Ministry of Forestry to seek to reach some middle ground on the issue of protecting Indonesia's valuable forests.

The Arrival of Coalbed Methane in Indonesia

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"For mining companies, exploiting CBM could reduce captive power generation costs and also increase project returns through revenue raised from selling carbon credits."

In an attempt to further diversify Indonesia's fuel mix, the Government has recently issued further regulations on the development of coalbed methane ("**CBM**") projects in Indonesia, through Minister of Energy and Mineral Resources Regulation No. 33 of 2006 on the CBM Business ("**Reg. 33/2006**"). CBM as a source of energy has been somewhat slow to catch on globally, with a number of countries around the world, including Australia, only recently introducing regulations specific to CBM development. For mining companies, exploiting CBM could reduce captive power generation costs and also increase project returns through revenue raised from selling carbon credits.

Regulatory outline and challenges

From an Indonesian perspective, one of the first regulatory challenges in dealing with CBM projects is the demarcation issues that arise due to essentially a gas resource being located within a mineral resource. CBM is hydrocarbon with methane as its primary component, which naturally forms during the coalification process, and such CBM is usually trapped between coal seams, or absorbed into the coal. Accordingly, in order to develop CBM projects there is a need to determine where the regulatory authority lies.

"...some structuring flexibility built into these regulations whereby tax-friendly foreign incorporated companies can be used to develop CBM projects."

As with the other natural resources, the CBM is owned by the State and managed by the Government. The development of the CBM projects (for both exploration and exploitation activities), falls within the gambit of the Indonesian Oil and Gas regulations, and is to be implemented using the Cooperation Contract to be entered into by a business entity or a Permanent Establishment with BP Migas. Accordingly, there is some structuring flexibility built into these regulations whereby tax-friendly foreign incorporated companies can be used to develop CBM projects.

Reg 33/2006 provides that the development of CBM projects is to be conducted within an "Open Area", being an area that is not already stipulated as a working area of CBM development. The procedures for determining and offering of the working areas for CBM projects are based on the same procedures for the offering of upstream oil and gas blocks.

"If CBM reserves are found within a mining company's CCoW or KP areas, the mining company will have the first right to develop the CBM resource".

However Reg 33/2006 recognizes that CBM reserves are likely to be located in areas already the subject of a Coal Contract of Work ("**CCoW**") or Mining Authorization (Kuasa Pertambangan - "**KP**"). If the CBM reserves are found within a mining company's CCoW or KP areas, the mining company will have the first right to develop the CBM resource. If the CBM reserve straddles the boundary of two concession areas, the right to develop the CBM reserve will be granted to both concessionaires, based on a mutual agreement between the two of them.

Any utilization of the CBM as secondary development for non-commercial use shall be subject to the report or approval from the MEMR.

Constitutional Court flexing its muscles - have the full ramifications been felt?

Constitutional Court flexing its muscles - have the full ramifications been felt?

Decisions from the Constitutional Court have, over recent years, struck fear in the heart of investors in the energy and natural resources sectors. The investment uncertainty created by the continued review of Government laws and regulations in these sectors has led to a continued decline in investment in the sectors affected.

The hardest hit sectors have been the electricity and oil and gas sectors.

No market price for electricity

In the electricity sector, the Constitutional Court declared that the entire Electricity Law 20/2002 was unconstitutional, and therefore invalid. Despite a long judgment, the fundamental basis of the Court's decision is based on Article 33 of the Indonesian Constitution, which provides that:

(a) sectors of production that are important for the country and affect the life of the people will be controlled by the State; and

(b) the land, the waters and the natural riches contained therein will be controlled by the State and exploited to the greatest benefit of the people.

The 2002 Electricity Law sought to introduce fundamental competitive reforms on both the demand and generation side of the electricity market. On the demand side, the Law gave high voltage and medium voltage consumers of electricity the ability to negotiate an arms-length price for electricity from the supplier. On the generation side, the Law foreshadowed the introduction of a competitive power pool for generators, where generators would compete with each other over regular intervals (e.g. 30 minute blocks) to sell electricity into the grid, with the generators being dispatched based on merit order (i.e. the lowest price being dispatched first, followed by the next lowest, then the next lowest and so on until the demand for that 30 minute block had been met).

The Constitutional Court determined that such market mechanisms were not in accordance with the constitutional requirement for State control. This "control" was essentially interpreted by the Constitutional Court to mean that the State must set or approve all electricity prices. As a result, the Court annulled the 2002 Law, resulting in the re-instatement of the previous 1985 Law on Electricity.

"For IPP developers, this news is not bad. It signals many years of long term, fixed price Power Purchase Agreements."

For IPP developers, this news is not bad. It signals many years of long term, fixed price Power Purchase Agreements. Developers will not have to face the power pool price uncertainties faced in more deregulated power jurisdictions such as the UK, Australia and Singapore.

Partnership with PLN for all power projects?

However other comments made by the Constitutional Court in its judgment should give IPP developers pause for thought. In rendering its judgment, the Constitutional Court also stated that all power supply projects should be implemented "in partnership with" PLN, through the "ownership of shares" in a company or "through a loan arrangement". The Court went further to give more detail as to this requirement, stating that the Government's share ownership in the power plant generation company could be either more or less than 50 per cent, as long as the Government maintained ultimate authority for policy/decision-making.

All regulations and statements made by the Government since the issuing of the Court's decision have effectively ignored these statements of the Court. The Government's stated position is that the Constitutional Court has no power to make new laws or regulations, it may merely adjudicate on the constitutionality of existing laws and regulations.

"...the comments from the Court could justify a future challenge even to the 1985 Law on Electricity and related regulations, which allows 100% privately owned power generation projects.

Nevertheless, taken to their full extreme, the comments from the Court could justify a future challenge even to the 1985 Law on Electricity and related regulations, which allows 100% privately owned power generation projects. No action has been foreshadowed as yet, and we are of the view that such an action, due to its ramifications throughout the investment community, is unlikely to be successful if initiated.

But this continued uncertainty in electricity sector regulation continues to have an adverse impact on much needed investment.

No market price for oil based fuels

For essentially the same reasons the Court had annulled the Electricity Law, the Court determined that provisions of the 2001 Oil and Gas Law providing for the price for oil-based fuels to be determined by fair and healthy business competition were unconstitutional.

"...as oil-based fuels were a natural resource or product of significant public importance, the price should be determined by the State and not left to the market to determine."

Similar to the case of the Electricity Law, the Court determined that as oil-based fuels were a natural resource or product of significant public importance, the price should be determined by the State and not left to the market to determine.

Should non-subsidized fuel nonetheless remain price regulated by the Government?

In response to the decision, the Government has since implemented a split oil-based fuel market, consisting of subsidized and non-subsidized fuel. The price for subsidized fuel (being oil-based fuels of lower quality than their non-subsidized counterparts) is set by the Government. However the non-subsidized fuel is set at a price determined by the fuel companies, and subject to market competition.

However the Constitutional Court in reaching its decision on the relevant provision of the Oil and Gas Law did not distinguish between certain types of oil-based fuel being "natural resources" and other higher quality oil-based fuels not being considered "natural resources". The statement from the Constitutional Court was clear - the price for oil-based fuels should not be determined by the market, but should be set by the Government.

"...there remains a risk of a further Court challenge seeking to declare invalid any laws or regulations which allow private oil companies to set their own prices for any forms of oil-based fuels."

Again, taken to its logical conclusion, there remains a risk of a further Court challenge seeking to declare invalid any laws or regulations which allow private oil companies to set their own prices for any forms of oil-based fuels.

Conclusion

So although the initial impact of the Constitutional Court decisions in the electricity and oil and gas sectors have been felt and largely accommodated by the Government in its revised regulatory framework, there remains the risk of further aftershocks which may further add to the uncertainty of investors in these sectors.

Strong Resistance to the Draft Labor Law

Strong resistance to the draft Labor Law

In its effort to attract foreign investment to Indonesia, the Government of the Republic of Indonesia plans to amend Law No. 13/2003 on Labor. Employees and the unions strongly oppose the Proposed Amendment, because it contains provisions that substantially reduce employee benefits. This opposition was expressed through demonstrations and rallies.

The following are the significant changes in the Proposed Amendment:

1. with respect to the employment of expatriates:

   (a) a differentiation between expatriates who have been permanently resident in Indonesia and those who hold limited stay visas.

   (b) allowing expatriates to work in Indonesia based on an employment relationship with an Indonesian company or "other legal relationship". Examples of expatriates who have "other legal relationships" are:

      (i) expatriates who work in Indonesia as directors or commissioners;

      (ii) expatriates who are seconded from a principal office to an Indonesian company based on a secondment agreement between the principal office and the Indonesian company;

      (iii) expatriates who are hired by a company that wins a contract or tender in Indonesia; and

      (iv) expatriates who work in Indonesia to install or maintain equipment/machines for the purpose of after sales services of the products that are purchased from offshore companies.

      Under the current Labor Law, an expatriate must have an employment relationship with an Indonesian company.

   (c) an exemption for expatriate directors and commissioners from the obligation to obtain work permits. Under the current practice, expatriate directors and expatriate commissioners are obligated to obtain work permits if they reside in Indonesia.

   (d) an exemption for expatriates who have "other legal relationships" from the obligation to have Indonesian counterparts. Currently all expatriates (except directors and commissioners) must have Indonesian counterparts and they are obligated to transfer their knowledge to the Indonesian counterparts.

   (e) allowing expatriates to hold a position managing personnel (for example: HR Director or HR manager). Currently, expatriates are not allowed to hold this position.

2. with respect to the employment of definite period employees:

   (a) allowing employment, in all fields of work, of definite period workers for certain periods (under the current Labor Law, the employment of definite period workers is allowed only for work which is temporary in nature, for example: seasonal work, work relating to new products, work related to a project, etc.).

   (b) a maximum five year period of employment with no provision on extension or renewal of contract. Currently, the maximum period of an initial contract is 2 years, and the contract can be extended once (for a maximum of 1 year) and renewed (for a maximum of two years). The renewal can only be conducted after a 30-day break.

   (c) the entitlement of definite period workers who are terminated due to the expiration of their employment contracts to receive "assistance" (known as "santunan"), the amount of which will be regulated by a Government Regulation.

   (d) the stipulation that the entitlement under the current Labor Law of definite period workers who are terminated prior to the expiration date of their employment contract to receive compensation that is equal to the amount of their remaining contracts does not apply to workers who violate the provisions of their employment agreement.

3. with respect to outsourcing (which is an industry strongly opposed by Indonesian employees/unions), the deletion of the provisions that relate to the outsourcing of work. Under the current Labor Law, there are two types of outsourcing:

   (a) the outsourcing of supporting work; and

   (b) the outsourcing of workers.

Under the outsourcing of work, the company may outsource part of its work (which is not considered one of its main activities) to a third party contractor. The service fee will be based on the products that are produced by that third party contractor. For outsourcing of workers, the company may request a labor provider to provide workers for the company, but the employment relationship remains the same i.e., between the labor provider and the workers. If the provision on the outsourcing of work is deleted, the company may only outsource workers.

4. with respect to the termination of employment:

   (a) the introduction of a provision that the termination of employment is applicable only to the termination of employment between workers and employers who conduct a regulated sole proprietorship business. Under the current Labor Law, all employers are subject to the provisions on the termination of employment.

(b) in the process of termination of employment, allowing employers to suspend an employee for a maximum period of 6 months and only obliging the employer to pay the employee's salary for a period of 6 months. After the elapse of 6 months, the employer is no longer required to pay the employee's salary, unless the labor court decides that the employer must re-instate the employee because there are not sufficient grounds to terminate the employee. Under the current Labor Law, employers who suspend their employee(s) are required to pay the employees' salaries until the issue of the labor court's decision even if that decision is issued after more than 6 months.

(c) the obligation to pay severance pay, long service pay and compensation of rights (the three of them will be referred to as "Termination Package") being made applicable only for workers who receive a salary less than or the same as the value of their non-taxable income (currently around Rp. 1,200,000). Under the current Labor Law, all employees (regardless of the amount of their income) are entitled to receive Termination Packages.

"...an employer to immediately terminate the employment relationship of an employee who commits a major mistake..."

(d) the entitlement of an employer to immediately terminate the employment relationship of an employee who commits a major mistake (for example: theft, embezzlement, or other criminal actions), if the worker is caught in the act, there is a confession from the worker concerned, or if there is evidence in the form of an incident report. This provision is contained in the current Labor Law, but the Constitution Court invalidated this provision in 2004. Based on the above, the employer currently cannot terminate employees until the issue of the criminal court decision that confirms the employee's action.

As a result of the strong opposition, the Government opened a tripartite meeting (with the Association of Employers and the Association of Employees) to decide whether it is necessary to amend the current Labor Law, and if so, which provisions under the Labor Law need to be amended.

And In Short...

Better Terms for New Upstream Acreage

Tax on Gains from Transfers of PSCs

Compulsory Land Acquisition - One Step Forward, Two Steps Back?

Better terms for new Upstream Acreage

In April 2005, the Minister of Energy and Mineral Resources issued a regulation providing incentives for marginal oil fields in the form of additional cost- recovery equal to 20% of operating costs incurred on marginal oil fields.

To apply for this incentive, companies must get prior approval from BP Migas, and the related marginal oil fields should be developed within a year after the approval date. The eligible marginal oil fields should (i) be located in a Producing Working Area and (ii) be based on PSC terms and conditions where it is not economic to exploit the field, i.e. the projected rate of return without the incentives would be less than 15%.

The incentive will cease effectively from the subsequent calendar year if the actual cumulative rate of return in any calendar year is more than 30%.

Tax on gains from transfers of PSCs

The Amendment Bill to the Tax Law expanded the definition of taxable income to encompass gains resulting from transfers of PSC interests. As a result, gains from transfers of PSC interests will be taxable in the near future. As sales by foreign owners of foreign companies holding PSC interests will not be liable to corporate tax, this is one of the factors that will need to be considered in structuring the most efficient way of transferring PSC interests.

Compulsory land acquisition - one step forward, two steps back?

The life of Presidential Regulation 36/2005 ("**PR 36**") may have only been a short one to date, but in its short life it has come under much criticism from the public, NGOs and the Indonesian Parliament.

Passed in mid-2005, PERPRES 36/2005 was issued to appease the long-stated concerns of infrastructure investors that the previous uncertain and "toothless" compulsory land acquisition regulations were a significant deterrent to the significant investment required in social infrastructure projects, particularly those projects especially sensitive to land issues (such as toll roads).

PERPRES 36/2005 significantly extended the list of "public interest" projects (previously 6, now 21) pursuant to which the Government would be lawfully entitled to exercise its compulsory acquisition powers. Importantly, the list includes electric power generation, transmission and distribution. However the most important step taken under PERPRES 36/2005 was the introduction of references to the Government's ability to "revoke" land title, which was a significant step forward to enable infrastructure developments to move forward even if there existed a dispute over the amount of land compensation to be paid for an owner losing its land title.

However in June 2006, the Government amended PR 36 through the issuing of Presidential Regulation No. 65 of 2006 on the Amendment of the Presidential Regulation No. 36 of 2005 on Land Procurement for the Development Implementation for Public Interest ("**PR 65**"). PR 65 has been a substantial backward step in the move towards a more efficient land acquisition system:

(a) the references in PR 36 to the ability of the Government to "revoke" land title have been removed completely;

(b) the list of "public interest" projects to which PR 36 applies has been substantially reduced (e.g. the following have been excluded: public hospitals, worship facilities, post and telecommunication facilities); and

(c) although the wording is not entirely clear, there appears to have been introduced a pre-condition that PR 36 can only be used in relation to land which will subsequently become owned by the Government or Regional Governments, raising the issue of how, for example, PR 36 can be employed to acquire land for a privately owned IPP project.

So it appears that we are back to status quo in relation to the continuing problem of dealing with land acquisition issues for infrastructure in Indonesia.

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