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New Mining regulations

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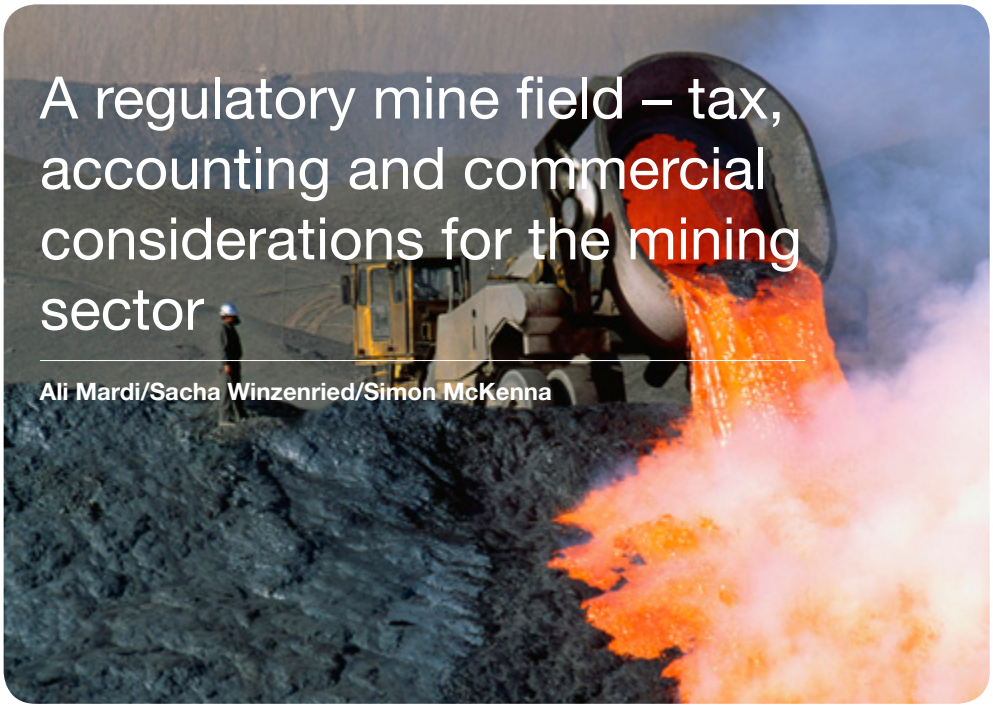

A regulatory mine field – tax, accounting and commercial considerations for the mining sector

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The introduction of Law No.4/2009 (**the Mining Law**) on 12 January 2009 provided as many questions as it did answers on the future direction of mining in Indonesia. Whilst the Mining Law radically changed many of the longstanding pillars of the Indonesian mining regulatory framework, it left much of the detail to be provided via four Government Regulations (**GRs**).

On 1 February 2010, the Indonesian President signed off on the first two of these four GRs:

- GR 22/2010 on Mining Areas (**GR22**); and
- GR 23/2010 on Mining Business Activities (**GR23**).

Two additional GRs remain in draft on the following matters:

- Mine Reclamation and Closure; and
- Mineral and Coal Mining Direction and Supervision.

In a previous EUM NewsFlash* (No.33), we provided an overview of the then four draft GRs (this included the draft versions of the now ratified GR22 and GR23 above).

In addition to GR22 and GR23, the Minister of Energy and Mineral Resources (MoEMR) has also released two Ministerial Regulations:

- PerMen 28/2008 on Mining Services (**PerMen28**); and
- PerMen 34/2009 on Domestic Market Obligations (**DMO**)(**PerMen34**).

Diagrammatically, the current state of play of the Indonesian mining regulatory framework can now be summarised as follows:

Mining Law
Law No. 4/2009
Ratified 12 January 2009

4 Government Regulations

Mining Areas GR 22/2010	Mining Business Activities GR 23/2010	Mine Reclamation and Closure	Mineral and Coal Mining Direction and Supervision
Signed 1 Feb 2010	Signed 1 Feb 2010	DRAFT	DRAFT

MoEMR Regulations

Mining Services PerMen 28/2009	DMO PerMen 34/2009	Future Implementing Regulations
30 September 2009	31 December 2009	Tender Procedures, Share Divestment, pricing and production quotas

In this special edition of our EUM NewsFlash*, we comment on the current regulatory state of play and the key commercial, tax and accounting issues arising from the recent passing of GR22 and GR23 and PerMen28 and PerMen34.

Key Features of the Regulations

Mining Areas

The Mining Law provided that mining could only be conducted in areas designated by the Central Government (Government) as "open" for Mining. Whilst not articulating specific areas that will be “open” for mining, GR22 provides the procedural mechanism for determining "Mining Areas" (**WP**). GR22 categorises WPs into Mining Business Areas (**WUP**), State Reserve Areas (**WPN**) and Peoples Mining Areas (**WPR**). Having established a WUP, the Minister is then required to determine Mining Business Licence Areas (**WIUP**) split into coal, metallic minerals, non-metallic minerals and rocks. In all steps of this process extensive consultation with Provincial and Regional Governments must take place.

PwC comments

Swift action but lacking detail and clarity

Whilst the Government has been relatively swift in issuing GR22 and GR23, much of the anticipated detail required to effectively implement the new Mining Law has been left to the MoEMR to issue further Ministerial Regulations clarifying these outstanding matters. As such, many industry participants will be disappointed with the lack of detail and clarity from these two GRs.

Of particular importance is that the spatial planning process to allocate areas "open" to mining throughout the country is completed as quickly as possible. The move to clearly define areas as "open" to mining, and those that are not, is welcome as it should reduce the potential in the future for overlap of competing businesses (e.g. forestry, plantation, etc) with mining licence areas. However a delay in this mapping process will delay the issuance of new IUPs and the development of greenfields mining operations which are the lifeblood of a strong mining sector.

Mining Licences

One of the most notable transformations in the new Mining law from its predecessor (Law No.11/1967) was the overhaul to the licensing system. Gone is the longstanding Contract of Work (**CoW / CCoW**) system for foreign investors and the Kuasa Pertambangan (**KP**) permit system. The Mining Law now provides for three new categories of mining licence:

- Mining Business Licences (**IUP**) – applicable for WIUPs;
- Special Mining Business Licences (**IUPK**) – applicable for WPNs. These areas are prioritised for state owned enterprises; and
- Small-scale Mining Licences (**IPR**).

Furthermore, licences are sub-categorised according to two phases of the mining lifecycle. Initially an entity will apply for an Exploration IUP and upon commercial discovery and entering into production/operation a Production IUP must be attained.

PwC comments

Significant issues remain for existing KP and CoW / CCoW holders although some clarity has been provided in the transitional provisions of the GRs - see further below.

Key Features of the Regulations

Approval Framework

GR23 now provides the approval framework for the granting of each licence. This can be broadly summarised as follows:

Exploration IUP:

The issuance of a WIUP and subsequent Exploration IUP is performed as follows:

Grantor	Project location
Minister	where the area covers more than one province.
Governor	where the area covers more than one regency, but is within one province.
Mayor	where the area is within one regency.

Production IUP:

Upon successful commercial discovery, an Exploration IUP must be upgraded to a Production IUP. The mechanism for the grant of a Production IUP is less than certain and GR23 appears to provide two criteria; one based on the location of the mining area, processing and refining and port facilities; and the other based on the environmental impact of the project.

Grantor	Project location	Environmental impact
Minister	where the mining area, processing and refining and port facilities extend across more than one province.	where the environmental impact extends across more than one province (with the recommendation of the Mayor and Governor).
Governor	where the mining area, processing and refining and port facilities extend across more than one regency, but within one province.	where the environmental impact extends across more than one regency, but within one province (with the recommendation of the Mayor).
Mayor	where the mining area, processing and refining and port facilities are within one regency.	where the environmental impact is within one regency (with the recommendation of the Minister and Governor).

PwC comments

It is uncertain which test will prevail for the grant of a Production IUP in circumstances where there is inconsistency between location of the mining area and the environmental impact.

Key Features of the Regulations

Area Limitations on Exploration IUPs

The Mining Law provided for new area limitations for each Mining Licence at each phase of the mining lifecycle. GR23 provides for further limitations upon the expiration of three years of exploration. Accordingly, the limitations on IUP areas can now be summarised as follows:

	Exploration IUP	After 3 years of Exploration under GR 23	Production IUP
Coal	5,000ha – 50,000ha	Must be reduced to a maximum of 25,000ha	Max 15,000ha
Metallic minerals	5,0000ha – 100,000ha	Must be reduced to a maximum of 50,000ha	Max 25,000ha
Non-metallic minerals	100ha – 25,000ha	12,000ha (applies after 2 years)	Max 5,000ha
Rocks	5ha to 5,000ha	2,500ha (applies after 1 year)	Max 1,000ha

New Production IUP sub-licence

For entities wising to exclusively conduct activities in "transport and selling" and "processing and refining", GR23 also introduces specific sub-licences of Production IUPs for these activities.

Ring-fencing

With the exception of mining companies listed on the Indonesian Stock Exchange (**IDX**), GR23 provides for the ring-fencing of one IUP to one company. GR23 also confirms that existing companies that held multiple KPs can convert these to IUPs and continue to hold them under the one company.

PwC comments

One of the industry concerns that GR 23 now clarifies is that one company that currently holds multiple KPs can continue to hold these upon conversion to IUPs.

An important consideration of ring-fencing is that offsetting tax losses between projects is not possible; tax losses are therefore quarantined to an individual project.

Tender Requirements

The new Mining Law made it clear that direct application for coal and metallic mineral mining licences would cease to exist and that all licences for coal and metallic mineral mining would be granted through a tender process (licences for non-metallic minerals and rocks may still be granted by direct appointment). GR23 fleshes out some of the details of the tender process and selection criteria, although precise details are still to be confirmed by Ministerial Regulation.

Key Features of the Regulations

Procedures are as follows:

- The tender process must be announced at least three months prior its commencement.
- Provision is made for all three levels of government (Central, Provincial and Regency) to participate in the tender committee.
- Foreign Investors wishing to bid in the tender process must use an Indonesian legal entity (i.e. a PT PMA).
- There must be more than one bidder in a tender process. If there is not more than one bidder, there must be a re-tender. If upon re-tender, there remains only one bidder, the licence can only be awarded to the sole bidder where the "tender base price" has been met.

PwC comments

It is uncertain how the provision for all levels of government to participate in the tender committee will practically impact who has the authority to grant the licence (see Approval Framework above). The basis for the "tender base price" is also not yet clear.

Selection criteria:

- GR23 provides that the successful bidder will be determined on "Price bid and technical considerations". The precise details of how this broad principle will apply are to be determined by further Ministerial Regulation.
- In accordance with these "technical considerations", detailed technical, administrative and financial requirements are to be submitted during the tender process. These requirements include:
  - evidence of at least three years of previous mining experience by the company (for newly established entities of a group, this can be substantiated by recommendation letters by parent or affiliate companies) and evidence of at least one employee that has mining/geological expertise with at least three years of experience;
  - submission of an annual work plan for the first four years of exploration.

PwC comments

It is uncertain which test will prevail and the extent to which technical considerations will prevail over price.

Key Features of the Regulations

Divestment Requirements

The Mining Law provided that majority foreign shareholders must divest part of their interest in a mining concession company after the fifth year of production. Whilst the provisions in previous drafts to GR23 provided that the divestment obligations ceased upon 20% Indonesian ownership in the mining concession company, the ratified version of GR23 now refers to the obligation of "foreign capital holders" to divest 20% within five years. This may mean that an IUP holder which is 80% owned by foreign shareholders may still be required to divest below this level. Many ambiguities still exist over the foreign divestment provisions which it is hoped will be clarified in future Ministerial Regulations.

PwC comments

Outstanding issues with the divestment provisions:

- the procedures to value the divested shares;
- how this requirement should be treated for accounting purposes;
- the potential to trigger a capital gain for foreign shareholders giving rise to 5% tax (prior to tax treaty relief) on the divestment proceeds;
- whether an IDX listed company is required to perform any divestment if it has foreign shareholders.

Domestic Market Obligation (DMO)

Whilst not a new concept in the mining sector, the Mining Law provides that the DMO should be set by Government Regulation. Whilst the Minister had already released PerMen 34/2009 on 31 December 2009 on this matter, GR23 now provides the legal basis for the Ministerial Regulation.

PerMen34 provides that the DMO only applies to all types of coal and minerals (see categories above). Broadly, Mining Companies must comply with the DMO by selling to "domestic consumers or purchasers" who "use" the minerals/coal (i.e. a sale to a trader or intermediary is not included as a DMO sale).

Neither PerMen34 or GR23 provide for a specific DMO percentage, rather the decision is to be made by the Minister upon the following procedures:

- Domestic "users" submit their forecasted requirements by no later than March of the preceding year;
- The Minister reviews and calculates:
  - the domestic requirements submitted above; and
  - the production plans of the mining companies.
- The Minister must then issue a decree on the minimum DMO percentage by no later than June of the preceding year. The decree must also list the domestic users and their respective needs.
- The Mining Company must then submit its work programme and budget for the relevant year to the authority that issued its licence (Minister, Governor or Mayor) and the Director General of Minerals, Coal and Geothermal stating its commitment to the DMO percentage.

Key Features of the Regulations

There are provisions for a minimum floor price for DMO sales which will be subject to Ministerial Regulation. However, PerMen34 does provide that the minimum price for coal will be subject to the same minimum price for exports (see Coal and Mineral Benchmarking below).

PerMen34 provides for a "cap and trade" system whereby Mining Companies that exceed their DMO obligations may sell/transfer DMO Credits to a Mining Company that is unlikely to meet its DMO commitment. The pricing mechanism for DMO Credits is to be determined on commercial terms, but cannot be below the minimum floor price.

PwC comments

Many issues remain unresolved with the DMO commitment, in particular:

- how to deal with non-homogenous products such as coal;
- uncertainty for long-term coal offtake agreements;
- can a group of companies offset under the "cap and trade" mechanisms and whether transfer pricing principles will apply;
- legitimate sales to Indonesian entities not listed on the pre-approved DMO Plan; and
- confidentiality of work plans submitted by the Mining Company.

Coal and Mineral Price Benchmarking

GR23 does not articulate beyond general requirements to adhere to the Benchmark to be established under further Ministerial Regulation. GR23 does however provide the framework upon which the MoEMR will issue the regulation on this matter.

Broadly, the MoEMR will be responsible for setting the Benchmark for coal and metallic minerals and the Regent or Mayor will be responsible for setting the Benchmark for non-metalic minerals and rocks. The Benchmark price will be updated monthly and determined in accordance with market prices (likely to include a basket of recognised coal indices in the case of coal).

PwC comments

Significant issues remain unresolved with the Benchmark, in particular:

- how the benchmark price will accommodate non-homogenous products such as coal;
- at what point will the benchmark be applied (FoB port, vessel);
- this will significantly impact the ability to enter into long-term contracts due to lack of certainty on what the benchmark may be in the future;
- any impact from gains or losses generated from coal hedging through the use of derivative contracts?
- the impact on royalty and income tax calculations. What if you sell at a price lower or higher than the benchmark?
- is a specific approach required for the sales to related parties or will the use of the benchmark price automatically satisfy transfer pricing requirements?

Key Features of the Regulations

In country processing and refining

The Mining Law provides that an IUP holder is obliged to perform in-country processing either through their own facility or though cooperation with another local party. CoWs / CCoWs already in production have five years from the implementation of the Mining Law to comply with this requirement (i.e. by 12 January 2014). GR23 further enshrines the policy of "enhancing added value" however much of the detail of what constitues "processing" (except in the case of coal whereby the elucidation provides certain examples including amongst others crushing, washing, blending) and "refining" is left to further Ministerial regulation. It appears that the position for KPs converted to IUPs is now the same as for CCoWs / CCoWs (i.e. they must perform in-country processing within 5 years of the implementation of the Mining Law).

PwC comments

In-country processing requirements may have a significant impact on the VAT treatment of arrangements involving minerals. Typically minerals taken directly from source are non-VATable goods and consequently any input VAT incurred in producing non-VATable goods is not creditable (i.e. it is a cost). The requirement to process minerals may alter the character of the ultimate transaction resulting in the end product being a VATable good. This may result in a change in the creditability of input-VAT and could have a substantial impact on the economics of the project. Detailed advice should be sought on this matter.

Transitional Provisions

Existing CoW / CCoW

The Mining Law provided that existing CoWs / CCoWs could remain valid until expiration of their term, but these needed to be “transitioned” to conform with the new Mining Law within 1 year of the implementation of the new Mining Law (i.e. by 12 January 2010) except for terms related to state revenue (not defined, but presumably includes income tax and royalties). Transitioned CoWs / CCoWs are also able to be extended beyond their term without the need for being re-tendered.

The Mining Law did introduce a caveat on the "transition", principally where there is an effort by the Government to “increase state revenue”. The pure lex specialis status of the CoW / CCoW is now clouded by what circumstances may constitute an “effort to increase state revenue”.

GR23 further provides that where an extension of the term of an IUP is granted it must comply with the prevailing regulations at that time “unless where it concerns more profitable state revenue”.

PwC comments

The Government appears to have hedged any possible downside from a future change in royalty or tax rate upon the transition and extension of current CoWs / CCoWs. It remains to be seen how state revenue provisions will play out in transition negotiations.

Key Features of the Regulations

Existing KPs

GR23 provides that existing KPs must be converted to an IUP within three months of the issuance of GR23. As KPs follow the prevailing tax law, there should be no significant tax issues on conversion to an IUP per se (please note there may be significant tax considerations for existing KP structures arising from PerMen28 on Mining Services – see below).

Upon conversion, under the Mining Law foreign investors can now technically hold a direct interest in a company holding an IUP (ex KP) KP converted to an IUP.

PwC comments

Foreign investors wishing to unwind arrangements with KP companies should consider the potential of creating a taxable capital gain and the VAT and withholding tax impact of the restructuring.

It is currently still unclear how quickly foreign investors can acquire shares in a company holding an IUP (ex KP). There seems to be a bottle neck in the application process of changing the IUP company status and obtaining the necessary approval from the relevant government agencies.

Mining Services

On 9 October 2009, the MoEMR released PerMen28 on Mining Service Business (dated 30 September 2009). The provisions in the Mining Law and PerMen28 on this issue have generated significant industry concern and debate as to what constitutes "mining services" and exactly what an IUP/IUPK holder can or cannot do. What is clear is that an IUP/IUPK holder can no longer contract out all activities, it must actually remove the coal/ minerals ore from the ground itself.

PerMen28 further provides that an IUP/IUPK holder must carry out mining, processing and refining and can only engage a Mining Services Company for the purposes of consultation, planning and testing, overburden stripping and transportation. Mining Services are further defined in Attachment I to PerMen28.

PwC comments

Issues remain unresolved as to what extent (if any) the IUP/IUPK holder can engage a Mining Service Contractor for activities "in pit" given the broad definitions.

What constitutes non-core mining services is extremely broad and could arguably apply to any company providing any service to an IUP/IUPK holder.

Changes to current mining service or cooperation arrangements between KP companies and foreign investors may have different tax implications.

Classification of Mining Services and Mining Service Companies

Companies wishing to provide services to an IUP/IUPK holder must obtain the following licences:

Mining Service Subcategories and licensing requirements	
Mining Service Business	Non-Core Mining Service
Expansive list in PerMen 28/2009 Attachment I Licence: IUJP	Any Service business other than "Mining Service Business" that provides services in support of mining business activities Licence: SKT

Key Features of the Regulations

Mining Services must be provided by an Indonesian entity with a clear priority for the use of Local and/or National Companies. In this regard, PerMen28 provides the following classifications:

Local Company	A wholly Indonesian owned company which operates and is domiciled only in one regency/province.
National Company	An Indonesian legal entity where all of its shares come from Indonesia.
Other Company	An Indonesian legal entity where some/all of its shares are owned by a foreigner.

Further entrenching the local theme, is the requirement of the mining service company to use local goods, local subcontractors and local labour.

Restriction on the use of affiliates/subsidiaries

Further restrictions are placed on the ability to use subsidiaries and affiliates of the Mining Business, namely the requirement to obtain approval from the Directorate General.

Approval will only be granted in circumstances where there are no other mining companies of the same kind in the Regency/Province, the IUP/IUPK holder has put the services to tender and there is a guarantee that no transfer pricing will occur.

PwC comments

The definition of subsidiary/affiliates is not clear. In particular whether this is limited to direct ownership or expanded to indirect cross ownership or companies under common control.

Restriction to receive any fees from mining services company

The IUP/IUPK holder is prohibited to receive any fees from the mining services company.

PwC comments

This restriction on fees is a clear attempt to stop "royalty" arrangements between passive concession holders and the mining contractors.

Transitional Provisions

Mining Companies which have already engaged Mining Services Companies before the enactment of this PerMen28 must comply with the regulation not later than three years from the effective date.

All existing IUJPs will continue to be valid until their expiration but must comply with the provisions of this Regulation.

PwC comments

KP holders with existing royalty, cooperation or production sharing arrangements need to carefully consider the options available to them to unwind these arrangements.

Concluding remarks

The mining regulatory framework remains in a state of flux. Whilst industry participants expected clarification on the Mining Law to be provided via these two significant GRs, many questions remain unanswered that will be left to further Ministerial regulation and guidance. Investors should therefore keep abreast of industry developments and contact their PwC advisor on any particular concerns or issues they may have.

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