

Client Alert



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New Rules on Divestment and Share Transfers in Mining Concession Companies

On 13 September 2013, Minister of Energy and Mineral Resources Regulation No. 27 of 2013 on Procedures and Determination of Share Divestment Prices and Changes of Investment Particulars in the Mineral and Coal Mining Business ("**Reg 27/2013**") was issued. This regulation lays out the remaining details applicable to the mandatory divestment requirements imposed on foreign owned mining companies under the 2009 Law on Mining. However, Reg 27/2013 goes further and introduces a new layer of foreign ownership restrictions, over and above the 51% domestic ownership regime introduced under Government Regulation No. 23/2010 (as amended).

In addition, Reg 27/2013 introduces new restrictions on the ability to transfer shares in companies holding mining business licences ("**IUPs**") - an area that, up until very recently, was left completely unregulated by the Ministry.

We have highlighted below some of the key principles set out in Reg 27/2013, its impact on IUP holders, and potential strategies to mitigate some of the risks and obstacles introduced by this new regulation.

Eradication of trading in IUPs

The regulatory framework in effect prior to Reg 27/2013 was not entirely clear on the issue of whether any government approvals were required for the transfer of shares in companies holding IUPs. Recent procedures and requirements of the Capital Investment Coordinating Board ("**BKPM**") prior to the issuance of Reg 27/2013 suggest that it was only changes in foreign investment (PMA) companies (i.e., IUP companies with some foreign shareholding) that required governmental approvals - in that case, from both BKPM itself and the Ministry of Energy and Mineral Resources (and as a practical matter, the approval of the relevant regional government where the mining project was located). However, the transfer of shares in wholly Indonesian owned IUP companies has not traditionally required any approvals.

Reg 27/2013 now requires approval of the Minister, Governor or *Bupati* (based on their division of authority) for any change in shareholding in the IUP holder. More importantly, however, in order for any approval to be granted, the IUP holder must meet certain minimum requirements - one of which is to provide a feasibility study report demonstrating the discovery of at least 2 prospects within the IUP area. This requirement is clearly aimed at stamping out the practice of investors securing IUPs solely for the purposes of trading them to other investors. However, this new restriction does have a material impact on the very legitimate junior explorer market, where the business model is for a mining junior to carry out some exploration work (but, in the case of minerals at least, generally not take the projects through to the

feasibility stage) with a view to farming out to a larger mining house. Depending on how strict the government's view of "feasibility study" is, this restriction alone does have the potential to stamp out the role of junior explorers in the Indonesian minerals sector. For coal projects (where getting to the feasibility study is a much less costly exercise), the impact will not be as harshly felt.

Tighter foreign ownership restrictions for exploration and producing mines

The industry expectation was that Reg 27/2013 would lay out the remaining details of how the 51% divestment arrangement would be implemented. However, Reg 27/2013 introduces an additional foreign investment regime which further restricts the ability of foreigners to maintain their shareholdings in IUP companies.

The new restrictions introduced are triggered when either:

- a non-foreign investment (non-PMA) IUP company is first converted to PMA (i.e., when a foreign investor acquires any shares in that IUP company for the first time); or
- there is a change in the shareholding in an existing PMA IUP company.

The new foreign ownership limitations that are triggered in such circumstances are:

- foreign ownership in companies holding Exploration IUPs is limited to 75%; and
- foreign ownership in companies holding Production Operation IUPs is limited to 49%.

The effect of these new requirements is to introduce a faster divestment requirement than previously existed. For example, if an existing IUP company has an Exploration IUP and 80% foreign ownership and the foreign shareholder wishes to sell out to another foreign owner, the maximum foreign ownership would become 75% and the extra 5% would need to be sold to Indonesians. Similarly, the maximum foreign ownership that an incoming foreign investor would be able to obtain in an IUP company holding a Production Operation IUP would immediately be limited to 49%.

Aside from the obvious commercial impact, this also has ramifications for dilution under shareholders agreements and enforcement of pledges over shares.

The increased divestment requirements exceed (and apparently conflict with) the requirements currently contained in Government Regulation 23 of 2010 which allows:

- 100% foreign ownership for companies holding Exploration IUPs; and
- gradual divestment beginning after 5 years of production from 100% to 49% foreign ownership for companies holding Production Operation IUPs.

We understand that the Ministry's rationale for introducing these more accelerated foreign ownership restrictions is that the existing divestment requirements in Government Regulation 23 of 2010 only apply to IUPs which will be newly issued over mining areas under the 2009 Mining Law framework (none of which have yet been issued). The logical end-point of such an

argument is that nearly all other provisions in Government Regulation 23 of 2010 that seek to regulate IUPs and their holders could similarly be read as only applying to new IUPs issued under the 2009 framework, and not IUPs which exist as a result of having been converted from *kuasa pertambangan* under the 1967 mining law regime. We do not find the Ministry's rationale convincing - as even though all existing IUPs are resulting from conversions from *kuasa pertambangan*, this conversion process is nevertheless expressly provided in Government Regulation 23 of 2010, and therefore all currently issued IUPs are in fact IUPs issued under the 2009 Mining Law framework.

What is the proposed process for divestment?

The shares that will be divested must be offered, in sequential order, to:

- the Indonesian government, the provincial/regional governments - and then if such parties do not wish to purchase the divested shares which are being offered
- Indonesian state-owned companies (BUMN) and provincial/regional-owned companies (BUMD), through a tender process - and then if such parties do not wish to purchase the divested that are being offered
- Indonesian legal entities, through a tender process.

There are also prescribed timelines under Reg 27/2013 in order for these proposed purchasers to express their interest to purchase the divested shares and certain other requirements (e.g. required approvals from relevant legislatures when the purchasers are the Indonesian government and/or provincial/regional governments) and the timeline for closing and paying the consideration/purchase price of the divested shares – but in general, the entire process would need to be completed within 1 year. If within the 1 year period there is no interested party that wishes to purchase the divested shares, the relevant shares are to be aggregated with the shares which are required to be offered during the next year.

What is the proposed price?

Under Reg 27/2013, the consideration/price for shares which are being offered will need to be independently appraised based on the replacement cost of the accumulated investment cost that has been incurred from the exploration stage up until when divestment occurs, minus:

- the aggregated depreciation and amortization costs which are based on the economic/benefit age of the relevant assets as adjusted by inflation rates; and
- the financial obligations of the IUP company at the end of the financial year in which the divestment is being undertaken.

Accordingly, the price at which the divestment offer must be made is likely to be significantly lower than the market value of the relevant shares.

Reg 27/2013 further provides for the price/consideration that is calculated by the independent appraisal to be treated as:

- the “highest” price/consideration when the divested shares are being offered to the Indonesian government or the provincial/regional governments; and
- the “floor” price/consideration when the divested shares are being offered to Indonesian state-owned companies (BUMN) and provincial/regional-

owned companies (BUMD) and Indonesian legal entities through the auction process.

Other matters affecting divestment

Reg 27/2013 does, however, give some indications of the Ministry of Energy and Mineral Resource's thinking on a number of other questions which have been open questions since the publication of Government Regulation 23 of 2010. Under Reg 27/2013:

- only companies who hold IUPs for mining are required to carry out divestment, and not companies which hold IUPs specifically for mineral or coal trading or IUPs specifically for stand-alone smelters/processing facilities;
- it is explicitly stated that listing on the Indonesian stock exchange does not guarantee that the listed entity will be regarded as "Indonesian" for the purpose of the divestment requirement (this is consistent with the BKPM's recently issued Regulation 5 of 2013 which now requires a listed Indonesian company which becomes foreign controlled to convert to PMA status);
- the divestment requirement will not apply to IUP companies which already have at least 51% Indonesian ownership;
- after the the required percentage of shares has been divested to Indonesian owners, that Indonesian shareholding must not be diluted; and
- there is a prohibition for the IUP company or its affiliates to lend money to an Indonesian shareholder to purchase the divested shares – similarly, query whether this prohibition would apply to shares held by Indonesian shareholders before the divestment clock starts or whether this would only be applicable for the divested shares purchased as part of the formal divestment procedure.

Impact on coal and mineral Contracts of Works

Reg 27/2013 provides that all coal and mineral Contract of Work ("CoW") holders must follow the divestment procedure and pricing mechanism provided in Reg 27/2013 from its issuance date. It is not clear whether this is just a requirement for the divestment process or whether the intention is to change the actual percentage of ownership which must be divested (more likely the former rather than the latter).

The most material impact for CoWs will be the change in the pricing methodology. All existing CoWs which contain divestment regimes provide that the mandatory divestment price of the shares in the CoW company is based on the market value of the shares. A change to a replacement cost value will wipe significant value off the foreign shareholdings in these CoW companies. Foreign shareholders in CoWs are at a further disadvantage as, unlike foreign investors owning shares in IUP companies who have an ability to find, on a business to business basis (i.e. based on market value), an Indonesian partner to take up the 51% stake, a foreign shareholder in a CoW company which has already been in production for a number of years will be automatically caught by the new pricing methodology, and forced to divest at replacement cost.

Although the wording of Reg 27/2013 seeks to unilaterally apply these new divestment procedures and pricing methodologies to CoW companies, CoW companies will likely take the view that, in accordance with the provisions of the Mining Law which confirm the continued validity of the CoWs, the

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obligation to comply with this new regime arises only if and when the CoW is amended to reflect these new principles, and that until that amendment is made, these new divestment provisions will not apply.

Conclusion

All in all, Reg 27/2013 represents another significant step backwards for foreign investment in the mining sector in Indonesia. The combination of bringing forward the onset of foreign ownership limitations, and requiring foreigners (who find themselves subject to the formal divestment program obligations) to divest at replacement cost, is inevitably going to dampen further the appetite for foreign investors to enter the Indonesian mining sector.