Attracting New Mining Investment

By addressing the barriers to new mining investment in a coordinated manner, the Government can take an important step towards attracting new exploration and mining investment which can provide considerable benefits at the national, provincial and local levels along the lines outlined below.

The Potential is Great

A Mining Country

Indonesia is an important mining country. Indonesia ranks second in tin production, is the world’s 4th largest producer of copper, the 5th largest producer of nickel, the 7th largest producer of gold, and the 8th largest producer of coal. According to an annual survey conducted by Price Waterhouse Coopers (PWC), mining accounts for about 11% of exports and in 2002, mining provided about US$ 920 million in tax and non-tax state payments (i.e. levies and fees) to various levels of the Government and accounted for about 2.7% of gross domestic product. Mining also provides significant local employment – both directly at the mine site and indirectly through the supply of goods and services from Indonesian sources.

Investment has Stalled

Exploration and Investment on the Decline because

But in recent years mining investment has slowed to a trickle – partly due to external factors such as declines in world mineral and metals prices but also due a decline in Indonesia’s international competitiveness.

Still With Much Prospective Land

While the mining sector already makes an important contribution to the economy, the bulk of Indonesia remains unexplored and geologically Indonesia has some of the most prospective land areas anywhere in the world for further mineral development if the country wishes, and the sector has the potential to make a much larger contribution to the economy and to regional development. The Government is looking to new mining investment to be a source of economic growth and development, especially in Provinces with frontier regions such as Papua and Eastern Indonesia.

According to PWC’s estimates, exploration in Indonesia has declined from a peak of US$160 million in 1996 to about US$18.9 million in 2002 and overall mining investment has declined from over US$ 2 billion in 1997 and 1998 to under US$ 500 million in 2001 and 2002. In 2003 and 2004 the world mineral markets have improved considerably, but Indonesia remains poorly positioned to take advantage.

Competitiveness Has Been Lost

Indonesia has lost much of its competitiveness at a time when other countries are seeking new mining investment. According to a review of international mining companies conducted by the Fraser Institute of Canada (the Fraser Institute Annual Survey of Mining Companies 2000/2001) regarding how mining policy factors affect a company’s decision to invest in exploration, the mining policy environment in Indonesia ranks 40 out of 43 countries with only Russia, Kazakhstan and Zimbabwe being considered less attractive from a mining policy perspective.

And Long Investment Lead Times Mean Recovery Will Be Slow.

Given the long lead times to find and develop new mines (as long as 10 years or more from discovery to production for mega projects), production declines as mines deplete their reserves will be inevitable unless the policy environment is improved.
Environmental Risks Remain

Environmental Requirements For Large Projects Are Sound

If the people of Indonesia are to benefit from mining development, then mining needs to take place in an environmentally sustainable and socially acceptable manner. Indonesia has adopted a general approach to environmental management. The Ministry of Environment is the responsible leading authority for regulating and monitoring environmental aspects related to the mining sector. Mining projects with major environmental impacts must comply with the Indonesian Environmental Impact Analysis procedures (AMDAL) which are in line with good international practice.

But Effective Enforcement is Essential

The AMDAL procedures include preparing an Environmental Impact Statement (ANDAL), an Environmental Management Plan (RKL) and an Environmental Monitoring Plan (RPL). The ANDAL includes provisions related to regional social and economic development. The AMDAL provides that communities affected by mining activity may play a very strong role in the ANDAL’s preparation and approval process. But, it is important that the capabilities are in place to be sure that this is implemented and implementation arrangements need to be improved. Among other things, it is necessary to ensure that construction does not start before the ANDAL is approved.

Smaller Operations Often Perform Poorly

The largest operators in the mining industry have generally responded to the AMDAL requirements in a very substantive manner. But there are concerns that the present environmental legislation does not sufficiently address the environmental impacts of smaller operations with local mining licenses. There are many smaller mining operations under local mining licenses (“KPs”) issued by the district governments which seem to fall below the AMDAL radar and which are reported to cause considerable environmental harm and have little or no social development plans.

Illegal Mining Causes Great Harm

It is known there are considerable illegal activities related to mining, logging and forestry clearing. Reports include illegal coal and gold mining in Kalimantan and tin mining in Banka Island which are reportedly often ignored by both law enforcement and regulatory authorities. Such illegal mining causes some of the greatest harm with no oversight or supervision.

Four Key Factors to be Addressed

1. The Rules Are Missing

Lack of Clear Legal Framework

Over the past several years, the Government has been working to prepare a new mining law to reform the licensing regime in line with the provisions of Law 22/1999 (now superseded by Law 32/2004) regarding decentralization. But the draft law is still not finalized or presented to Parliament. Thus a vacuum has emerged which is unfortunately being filled in its absence by mining rules and regulations which are now being issued at Provincial and Local levels, as well as the National level.

Causes uncertainty and Risk.

This profusion of local laws is causing great uncertainty and increases risk regarding discretionary interpretation and implementation of laws. It can also open the door to weak enforcement of legal framework and corruption. While the most experienced provinces and kabupatens may be able to administer the sector fairly effectively, there are as many as ninety kabupatens (out of over 460 kabupatens at present) which presently have significant mining activities, or have the potential for such activities in future.

2. Access to Prospective Lands is Restricted.

Access to Hutang Lindung Restricted since 2000

According to Forestry Law 41/2000 (Article 38) all mining is banned in higher quality “conservation forest” which covers about 20.5 million hectares (ha) (about 10% of Indonesia’s land). This is in line with good international practice. However, Law 41/2000 goes well beyond legislation in most other countries by also banning surface mining from “protection forest” which involves hutang lindung which covers about 33.5 million ha (about 17% of Indonesia’s land area). Hutang lindung is typically forest and scrub land on steep slopes that is being preserved to protect watersheds from erosion, sedimentation, and disturbance to hydrologic regimes.

But Permits will be Issued for pre-2000 License Holders

The Government’s proposed approach is to issue forestry permits for a number of promising projects presently in the pipeline for which development licenses were issued under previously signed Contracts of Work (COWs). This will help move forward on as many as 13 projects, including four COWs with a potential investment of more than US$ 2.5 billion in investment which are in advanced stage of feasibility work.

Yet Larger Issue Remains Unresolved

Serious investors prefer clear rules, consistently enforced across the whole sector

Serious investors prefer clear and consistent environmental, health and safety policies, reflected in workable legislation. Absence of clear environmental and community-related requirements makes it more difficult for them in raising financing in international capital markets. It also exposes them to criticism that they are not performing responsibly. The poor performance of small operations and illegal miners can place all of the industry in disrepute. Thus, there is a key role for the Ministry of Environment to strengthen implementation of the AMDAL and to provide stronger rules for small projects not covered by the AMDAL.

And Decentralization may weaken environmental enforcement

One of the most important decentralization issues that needs to be addressed is the implementation arrangements regarding supervision of environmental, health and safety aspects of mining operations. Mining operations are typically much more complex and often very much larger than manufacturing and services activities. This means that mining operations generally require a considerable amount of technical supervision to ensure that operations are in compliance with license conditions and health, safety and environmental criteria and respect the rights of and bring benefits to the local community. It is not clear in practice who has supervising authority regarding mine health and safety, environment and other inspections and the
necessary skills and capabilities simply do not exist in many local and regional authorities.

4. Mining Fiscal Regime No Longer Attractive

Mining Fiscal Regime Is No Longer Competitive. Investors and lenders are concerned to have a fair and competitive tax take, that agreements be honored and that taxes be stable and predictable—especially during the period when debt is being repaid. For over three decades mining has taken place under a Contract of Work (COW) system and Indonesia’s tax system under the most recent COW (the 7th COW) was broadly competitive with other mineral producing countries. However, the prevailing mineral tax system (that has replaced the 7th generation COW) imposes a higher tax burden than is imposed in most other “mining” countries. This more burdensome tax regime also applies to future mining operations.

Three Key Mining Fiscal Reforms Are Needed. The higher tax burden today and for new mining projects relates to three key differences. First, the level of production contribution (also called a “royalty”) now averages about 4% which is about double the level of royalties in the 7th COW. Second, coal, gold and silver were changed to VAT “tax exempt” status in 2000 (Law 18/2000 regarding VAT) which has the effect of increasing production costs (because unlike other minerals which are zero rated, VAT payments are no longer refunded for VAT “tax exempt” minerals). Third, district and provincial taxes, levies and fees have increased (facilitated by Law 34/2000 regarding local taxes). This has significantly increased tax payments by the mining industry (from US$636 million in 1996 to US$920 million in 2002 making new investments much less attractive to investors.

And Lack of consistency and predictability worsens the situation. Mining companies also raise concerns that there is no consistent VAT treatment of COWs at present and there is no assurance that tax rules will remain stable and predictable—particularly important for projects with large up-front capital costs (as much as US$1-2 billion for a large project) and long production periods (30-40 years or more for major projects). Some mining companies also report long delays in receiving tax refunds.

What to Do

A Comprehensive Cabinet Approved Mining Sector Sustainable Development Policy

A Comprehensive Not Piecemeal Approach is Needed

Indonesia’s mining investment climate is in need of improvement. What is needed is to move from a piecemeal approach to a comprehensive policy approach. First, the Government needs to decide where they want to position Indonesia in global competitiveness and then develop a plan on how to best get there.

Which Positions Indonesia To Attract New Mining Investment

If Indonesia is to again be successful in attracting major mineral exploration and development investments, then the cabinet needs to set up a process involving representatives of all the key ministries and key stakeholder groups to prepare a Mining Sector Sustainable Development Policy Statement/White Paper. The White Paper should then be adopted by the Cabinet and become the agreed basis for developing a new mining law and making other changes such as in the mining fiscal regime and the mining/forestry interface in a coordinated, holistic manner.

How to Make It Work

1. Filling the Legal Vacuum

A New Mining Law

The obstacle of inconsistent laws is not one that is specific to the mining sector alone and Government is addressing these issues in many sectors. In mining, this can be addressed by passage of a new Mining Law. Investors will only be willing to commit large investments if they are certain of security of tenure. This will require local licensing rules that are consistent, predictable, non-overlapping and that provide exclusive title. It will also require provisions for mine closure and rehabilitation to be spelled out and a level playing field where foreign investors are treated no differently from local investors.

Supported by Appropriate Regulations

The draft law will need to be supported by associated implementing regulations and ordinances that should ensure that regional and local perdas/regulations are issued in full consistency with the rules and regulations, guidance and supervision provided by the national government. In some cases, the details of the regulations will be equally as important as the provisions of the law itself. There should be national regulations and uniform national standards regarding criteria and procedures for granting licenses; land access agreements and compensation; relinquishment rules; reporting requirements; mine closure and reclamation fund requirements.

And National/Sub-National Agreements

It may be useful to consider reinforcing the use of regulations with a Memorandum of Understanding between the National government and the Kabupatens and Provinces where mining is presently, or in future could be, important that addresses how the different levels of government will implement their respective functions and responsibilities as specified in the law and the regulations. This has been done successfully in other countries, such as Argentina. Most importantly, since mining can involve large investments for projects that can operate for 2-3 decades or more, rules regarding dispute resolution at all levels should be prepared in advance and put in place as a matter of priority following enactment of the law.

2. Making the Right Land Use Choices

Resolving Inter- Ministerial Differences

The ban on surface mining in hutan lindung has created an unresolved policy conflict regarding land use and an impasse between the Ministry of Energy and Mines who believe the COWs should be honored and the Ministry of Forestry which believes that mining license holders
should be denied access to hutan lindung. This impasse reflects the underlying issue of ineffective policy coordination and lack of procedures to ensure that land usage decisions are be made transparently, in consultation with all stakeholders, and in consideration of all relevant information including potential environmental, social and economic impacts. For mining, the situation would be improved if the Dept of Forestry, Planology sits down with representatives from the Ministry of Mines and Energy, and the COW holders to review COW overlaps with hutan lindung and conservation areas, agree the forestry maps and then jointly post the maps in some readily accessible manner such as a public web-site.

By Bringing The Parties Together.

As a way forward to resolve the policy conflict, a Policy Workshop should be convened to address the mining and forestry interface with representatives of all involved stakeholders (the relevant government ministries, affected communities, mining companies, IMA and NGOs) including representatives of main concerned provincial governments and the Association of Bupatis. This workshop could provide information on procedures and practices in other countries facing a similar situation and how to plan for evaluating alternative land uses. The resolution of this type of policy conflict would be a positive signal to both the donor community and potential investors that the Government is prepared to make the needed improvements regarding inter-agency communication and co-operation to resolve conflicts and have sound development policy and procedures.

3. Supporting Communities and Protecting the Environment

New Rules and the Capacity to Implement Them

It is important that the Ministry of Energy and Mines and the Ministry of Environment work together to ensure that the draft Mining Act includes provisions designed to improve the benefits of mining to local communities and that measures are taken to improve the enforcement of environmental protection requirements – especially regarding controls, community development and conservation for KP license holders. Improving the present situation and building the necessary capacity in all of the kabupatens will take a coordinated effort lasting several years, and it is important that the needs of the lesser experienced kabupatens not be ignored, lest they get left behind. It is also important that each of the kabupatens with mining activity develop not only the capacity to administer and regulate the industry but also to have effective dispute resolution procedures.

Including Taking Aim at Illegal Activities.

There are no easy solutions either to the problems of illegal mining or to the problems of environmental harm by irresponsible smaller scale miners. The Government should start the process of addressing illegal mining (a) prepare a fact finding analysis of the scale of illegal mining and environmentally irresponsible small scale mining; and (b) based on the findings, work with the relevant local and provincial officials in the most effected provinces and kabupatens to identify possible measures to improve the situation that local officials would be willing and able to implement.

### Setting Priorities and Developing Action Plans

A Comprehensive, Coordinated Approach is Essential

The starting point should be the Cabinet putting in place an agreed mining policy. The mining policy should cover all the key mining development issues including filling the present legal vacuum regarding the role of national and regional/local governments, making sound land use choices, respecting the rights of and improving benefits to communities, strengthening environmental protection and making the mineral fiscal regime competitive. It is precisely because these issues involve different authorities that they should be addressed with an overarching Cabinet approved Mining Sector Sustainable Development Policy that will guide the way forward. Once this is in place, the priorities should reflect the degree of influence that the Ministry of Energy and Mines has over the process. Thus, the first priority would be finalizing the draft Mining Act and submitting it to DPR. The second priority would be for the Ministry of Energy and Mines to work with other central Government ministries on issues identified above – namely, Ministry of Forestry on land use issues, with the Ministry of Environment on community and environmental issues, and with Ministry of Finance on mineral fiscal regime issues. The third priority would be to address illegal mining issues which involve many different national, regional and local authorities.