INDONESIA FOREIGN INVESTMENT: THROUGH THE LENS OF ENERGY (COAL, OIL AND GAS)

The following article is a summary of the panel presented by the authors at the Singapore Legal Summit

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Indonesia is a splendid, almost magical place and has been since time immemorial. In the 8th Century, during the time of the Tang Dynasty in China, the lesser know Sailendra Dynasty in Central Java sponsored Buddhist monks and teachers in the area surrounding Borobudur. New scholarship postulates that the top level of Borobudur may have been gilded in gold, with each of the 72 Buddhas gleaming in the reflection of the others. A virtual mandala of Buddhas, where each visitor became a member of the Buddha mandala himself, blurring the line between pilgrim and participant.

So too Indonesia's foreign investment in coal, mining and oil and gas has been both extrinsically and intrinsically altered, indeed shaped, by the actions of the participants: government regulators, miners and foreign investors. The play at times resembles a tantric dance: a tension of passion, fervor and periodically violence. Built on the back on tremendous volumes of foreign direct investment (estimated to be, in aggregate, US$207.2 billion as of December 31, 2013 according to the CIA World Factbook), that bedrock is now threatened by a maze of conflicting regulations that appear to threaten, rather than invite, foreign investment. As a result, based on World Bank data, foreign direct investment levels in Indonesia have plateaued in the last three years in contrast to other Asian countries (Myanmar, Philippines, Thailand for example) where investment levels have increased each year. This is particularly ominous in an environment of precipitous commodity price declines.

Rich in natural resources including coal, oil and gas, Indonesia is the world's largest exporter of thermal coal (overtaking Australia in 2005), with over 75% of total coal production exported around Asia including, amongst others, to China, Japan and India, which coal exports constitute approximately 4% of Indonesia's GDP. Indonesia was also ranked as the 24th-largest crude oil producer in the world in 2013, accounting for about 1% of world production, and the 13th largest holder of proven natural gas reserves in the world in 2014, according to the U.S. Energy Information Administration (EIA).

Historically, foreign investors have been especially focused on Indonesia's coal miners and oil and gas producers whose low cost base and extensive mineral resource rights granted by the Indonesian government, combined with favourable market price conditions for oil, gas and coal, have resulted in profitable businesses and substantial investment returns. However Indonesia's foreign investor-friendly mask may be slipping. During their recent election campaigns, both Indonesia's newly elected president Joko Widodo, and his unsuccessful opponent, Prabowo Subianto, were unequivocal in their stance on the return of Indonesia's natural resources to its people. "For too long, we have allowed control over many things in this country to be in the hands of others. It is time we reclaimed our position of control so that our resources can be mobilized fully for our national interest" wrote President Widodo in the preface to his most recent book.

Indonesia's natural resources sector is therefore facing a period of uncertainty as the Indonesian Government and regulators seek to balance resource nationalism with the need for foreign capital and cooperation. Initial skirmishes seem to suggest an ambivalence, indeed tantric tension, between an increasingly nationalistic Indonesia and its needs for economic development, foreign capital and future energy production.

LEGAL DEVELOPMENTS AFFECTING THE NATURAL RESOURCES SECTOR INCLUDE:

• *New Mining Law; CCOW Renegotiations.*
The new Indonesian mining •law, Indonesian Law No. 4 of 2009 on Mineral and Coal Mining, adopted in 2009 and steadily being implemented through Ministerial Regulations, reflects Indonesia's increasing economic nationalism by banning the export of unprocessed minerals and ore, thereby requiring companies to process and refine their products in Indonesia, and accelerating historical divestment requirements to achieve certain levels of Indonesian ownership of natural resource companies within specified timeframes. There is general uncertainty in the mining industry as to how the new contradictory and conflicting legislation will be implemented, but with Indonesian regulators also seeking to amend the, formerly sacrosanct, favourable coal contracts of work (CCOWs) and oil and gas production sharing contracts (PSCs) considered attractive by foreign investors, there may be dwindling incentives for foreign investors to enter the Indonesian coal, oil and gas industries.

• *Bilateral Treaties.*
Formerly a safeguard for foreign investors, Indonesia intends to terminate its bilateral treaties (BITs) (starting with its BIT with the Netherlands in July 2015) to recover jurisdictional control from the international tribunals in which investors have sought protection for their investments. Perhaps a result of various cases, including Indonesia's failed challenge of jurisdiction in the International Centre for Settlement of Investment Disputes (ICSID) arbitration with UK listed miner, Churchill Mining Plc, the impact of terminating these treaties may cause more risk averse foreign investors to reconsider future investments in Indonesia.

• *Foreign Exchange Regulatio*n.
Effective from January 2015, Regulation No. 14/25/PBI/2012 regarding Foreign Exchange Derived from Export Transactions and Offshore Loan Drawdowns will impose new minimum hedging and liquidity requirements on Indonesian private sector companies which will make it more difficult to borrow international money. This will affect the natural resources sector where many miners are already heavily leveraged, having borrowed significant sums from foreign lenders to develop their mining areas, infrastructure and expand production, and are struggling to generate sufficient revenue to service existing debt in an environment of tumbling commodity prices.

• *Constitutional Uncertainty; New Oil and Gas Law.*
Passed in 2001, Indonesia's Oil and Gas Law significantly restructured Indonesia's oil and gas industries, creating a new regulator, BPMigas, tasked with granting new and managing existing PSCs. However, in November 2012, the Indonesian Constitutional Court declared BPMigas's remit and powers to be unconstitutional and ordered that the regulator be dissolved. Interim measures were put in place with regulatory responsibilities assumed by the Ministry of Energy and Mineral Resources established SKK Migas. However, the story does not end there. The Jakarta Post reported in September this year that, according to a member of President Widodo's transition team, the President had been considering disbanding SKK Migas, which has itself been rocked by a high-profile corruption case involving the arrest of its chairman. Two years after the Constitutional Court decision, Indonesia still needs a new Oil and Gas Law.

• *Oil & Gas Regulations; Cost Recovery and Income Tax and Land & Building Tax for exploring PSCs.*
Despite the potential for exploration of significant untapped resources, complicated and unfavorable regulations have hindered progress. There remains considerable uncertainty about the cost recovery system under Government Regulation No.79/2010; a saga which casts a shadow over the sanctity of PSCs. Further, the lack of a PSC extension policy, a tightening in the work permit process making it more difficult for companies to bring in expatriates, uncertainty over the application of land and buildings taxes to the sector and the growing threat from the criminalization of PSC-related activity following recent judicial decisions all combine to cause great concern to would-be investors. The Indonesian Petroleum Association (IPA) forecasts that Indonesia will become a net energy importer in 2019. In light of Indonesia's recent under-investment in its reserves, a lack of development of untapped resources could result in the acceleration of this already seemingly inevitable energy crisis.

Notwithstanding the issues described above, Indonesia remains attractive to inter-national coal, oil and gas industry participants.

There is still potential for significant further oil and gas discoveries in Indonesia with Wood Mackenzie estimating in 2013 that the country still has 3.67 billion boe of YTF resources and is only utilizing 45% of its discovered resources. Additionally, Indonesia has the world's largest unconventional coal bed methane reserves after China, which reserves are expected play a large part in Indonesia's energy future. Whilst there have been high profile exits from the market, Indonesia continues to generate interest. In particular:

- a cohort of international oil and gas participants who understand the market, continue to invest;
- Asian national oil companies are looking to neighbors, such as Indonesia, as they work towards expanding their reserves bases offshore; and
- there is growing interest in the sector for private equity and financial buyers, with players such as First Reserve, Clio Capital Ventures, Black Platinum and Blackstone all active.

As for coal, the scale of Indonesia's reserves and its low comparative costs of production will also continue to attract interest from foreign investors. However, at this time, with slumping coal prices, coal miners will find it increasingly difficult to make ends meet on revenue alone. We expect that, in the coming years, such companies will have to undertake significant 'financial engineering' in the form of refinancings and restructurings to survive in their current forms.

Although there are many regulatory challenges in Indonesia and significant recent underperformance of the sector, it is clear that Indonesia continues to have substantial natural resource potential that will attract future foreign capital. In the meantime, both Indonesian natural resource companies and foreign investors must hope for an about-turn on commodity prices and an Indonesian Government whose policies strike the right balance between economic and resource nationalism on the one hand, and the need for foreign investment and cooperation on the other.

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