Policy Paper Summary
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Natural Resource Governance Institute

Developing a Strong Mining Divestment Rule in Indonesia

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Indonesia's "divestment rule" mandates foreign mining companies to divest increasing portions of equity in locally domiciled entities to Indonesians. This is aimed to increase Indonesia's control over the mining sector. There are three components of the rule.

How much to divest

Companies must start to divest from 5th year of production. Must divest at least 51 percent by 10th year.

Who can buy

Three tiers of potential buyers:

1. Central and regional authorities
2. State-owned enterprises
3. Indonesian private sector

After being offered to these tiers, if equity remains unsold the company can opt to list on the Indonesian stock market.

At what price

Equity sold according to negotiation (for sales to government authorities) or auction (for SOEs and private sector).

A guide price calculated for each process based on "fair market value" BUT NOT including value of future production.

In our policy paper that accompanies this summary we argue that the intended benefits of the divestment rule might be difficult to attain. Costs, meanwhile, could be substantial. Crucially, our analysis suggests that the rule may deter foreign investment in the future, reducing the overall size of Indonesia's mining sector. Further, the government wishes to both establish greater sovereignty over mineral resources and advance the country's infrastructure and increase productivity in the rest of the economy. However, domestic capital to invest in infrastructure is scarce so it is not clear that these two objectives could be achieved at once.

THE BENEFITS FROM DIVESTMENT MAY BE DIFFICULT TO ATTAIN

Domestic purchases of equity would require an increase in foreign borrowing or direction of a significant amount of domestic investment from other sectors. Domestic investors are not investing enough to take the place of foreign investors. Indonesian purchases may instead result in either capital diverted from other sectors or increased foreign borrowing.

Dividend returns from investment may be less than expected because:

- The Indonesian entity may not have the funds to purchase equity stakes and must borrow instead, wiping out net investment income.
- When there is a dominant shareholder and poor monitoring by other shareholders, there is a risk that the foreign majority shareholder will use abusive practices to avoid paying out dividends.

Indonesian ownership may create less employment and fewer business opportunities for Indonesians than expected.

- Most mining project costs are expended during the project development phase and the first 10 years of production, when a foreign company would hold the controlling share.
- Local employment in the mining sector may not rise much as a result of change in the company's ownership as the vast majority of jobs already go to Indonesians.

REQUIRING DIVESTMENT MAY IMPOSE SIGNIFICANT COSTS ON INDONESIA

The divestment rule may deter foreign investment and thus the overall size of the mining sector

While the divestment rule might allow Indonesians to buy equity cheaply from existing companies, if future investment falls, there will be less equity for Indonesians to buy then. And if domestic investors do not match the decline in foreign investment, there will likely be less tax revenue and job creation.

The recent regulation (MEMR 9/2017) replaces the previously used "replacement cost" approach to valuing equity with a fair market value approach. However, this fair market value cannot include the value of reserves of the project at the time of divestment making it equivalent to the replacement cost defined in previous regulatory language. This approach severely limits the returns investors can expect from investing in Indonesia.

The divestment rule creates opportunities for corruption. The sale of mining equity could create opportunities for officials to benefit at the expense of the public and create risks of bribery, conflicts of interest, political capture and favoritism. For example, government officials might arrange for sales to private sector companies or SOEs in which they, family or close associates are beneficial owners.

Buying equity in the mining sector is a lost opportunity to invest in other areas of the Indonesian economy. President Joko Widodo has expressed a goal of building infrastructure in Indonesia. Obviously, this requires public money or borrowing. Similarly, government or government-financed SOE purchases of mining equity require public money or borrowing. However, buying mining equity means less money available for the country's infrastructure.

Even if the government itself refrains from purchasing equity directly, there is a risk that SOE purchases would require government funding. It is not certain how such a financing structure would work, or whether financiers would be willing to fund the SOEs.

OUR RECOMMENDATIONS

It is understandable that many Indonesians support a policy that attempts to secure greater sovereignty over these resources. However, what is arguably more important is people's welfare and prosperity.

Given these concerns, we make eight recommendations:

- **Recommendation 1:** Consider eliminating the divestment rule and explore other approaches to a state-led mining sector.
- **Recommendation 2:** Limit government purchases of mining equity and limit how public funds are used to finance state-owned enterprise investments.
- **Recommendation 3:** Reduce the 51 percent requirement.
- **Recommendation 4:** Establish clearer rules for negotiation and auction processes, and designate a third party to administer the processes.
- **Recommendation 5:** Require companies that buy mining equity to publicly disclose their beneficial owners.
- **Recommendation 6:** Allow companies the option to sell via an initial public offering.
- **Recommendation 7:** Reconsider and further define the approach to valuing equity.
- **Recommendation 8:** Develop a policy to manage mining state-owned enterprises.

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