

Developing a Strong Mining Divestment Rule in Indonesia

David Manley and Emanuel Bria

Indonesia's "divestment rule" is an effort to assert greater control over the country's mineral resources. It mandates foreign mining companies divest increasing portions of equity in locally domiciled entities to Indonesians.

The government expects the rule will benefit Indonesians in two ways. First, it might allow Indonesians holding equity in mining companies to directly benefit from their business, as opposed to indirectly through an exclusive reliance on tax revenue. Second, it may allow Indonesian companies to acquire new mining technology and develop new business practices, encouraging greater domestic employment and business opportunities in the country.¹ The divestment rule is also part of the government's plan to establish a stronger state-owned enterprise (SOE) presence in the mining sector.

With the government undertaking mining sector legal framework reforms, now is an opportune time to consider the divestment rule and weigh whether it truly benefits Indonesia. Whether it could be improved, or whether it should be removed entirely, are up for debate. To assist government officials, parliamentarians and other stakeholders, staff at the Natural Resource Governance Institute (NRGI) analyzed the costs and benefits of the rule.

In this report, 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.

In addition to establishing greater sovereignty over mineral resources, the government's goal is to advance the country's infrastructure and increase productivity in the rest of the economy—building the ports, power stations, schools and hospitals the economy needs to thrive.² However, domestic capital to invest in infrastructure and other projects Indonesia needs to improve economic productivity might be scarce. In essence, it is not clear that these two objectives can be achieved at once.

1 Trias Kurnianingru. Bagian I kajian hukum atas divestasi saham bidang pertambangan di Indonesia: Studi kasus PT Newmont Nusa Tenggara dan PT Freeport Indonesia. Available at: http://berkas.dpr.go.id/puslit/files/buku_lintas_tim/buku-lintas-tim-8.pdf

2 Dave McRae. *Dr Yose Rizal Damuri – Jokowi's economic policies*. Indonesia at Melbourne podcast, 20 October 2016. Accessed 6 February 2017. <http://indonesiaatmelbourne.unimelb.edu.au/jokowis-economic-policies/>

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.

1. INTERPRETING THE DIVESTMENT RULE

The divestment rule was first established in the mining law in 2009. Subsequent regulations have given further details and amended the rule:

- Article 97 of the 2010 Government Regulation
- Article 97 of Government Regulation 77 of Year 2014 (GR 77/2014)
- Government Regulation 1 of Year 2017 (GR 1/2017)
- Ministerial Decree 1 of Year 2017 from the Minister of Energy and Minerals (MEMR 9/2017).³

According to our research, the rule potentially affects more than 100 existing projects in Indonesia, which collectively have more than USD 1 trillion (IDR 13,300 trillion)⁴ of mineral resources. As an indication of the coverage of the divestment rule, figure 1 shows the top 10 companies that currently or were recently under majority foreign ownership, ranked by the value of the mineral resource.

The rule potentially affects more than 100 existing projects in Indonesia, which collectively have more than USD 1 trillion of mineral resources.

3 We understand that the Ministerial Decree (MEMR 1/2017) does not change the law, but still affects the application of the law.

4 All Indonesian Rupiah values calculated using an exchange rate of USD 1: IDR 13,300. As of 14 February 2017.

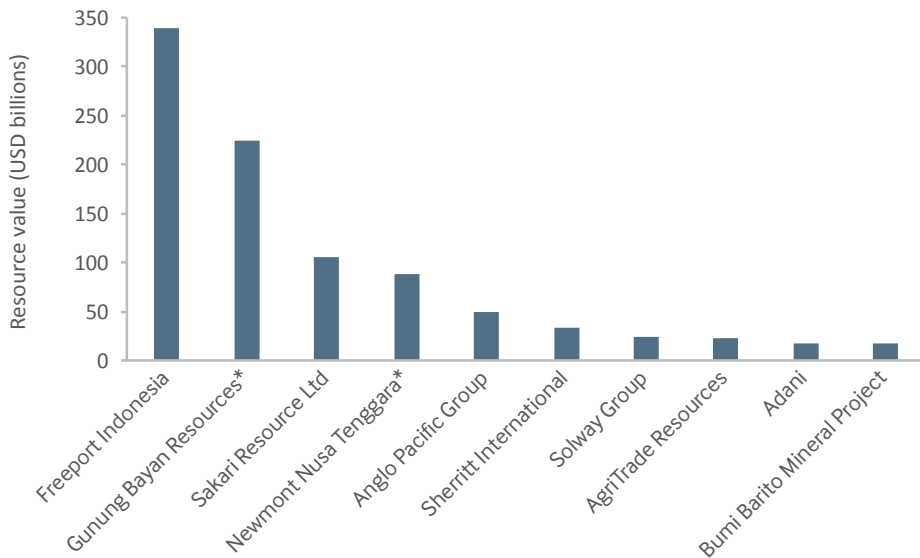


Figure 1. Foreign-owned or recently foreign-owned mines resource values (USD billion)

Source: S&P Global. SNL Platform. Accessed 6 February 2017. And authors' calculations

*Denotes formerly majority foreign-owned companies, now divested to Indonesian-owned companies. PT. Newmont Nusa Tenggara has subsequently changed into PT. Amman Mineral Nusa Tenggara.

Here we discuss three elements of the rule.

Element 1. How much to divest?

The first element determines what proportion of shares foreign mining companies should divest and in what year they should divest.⁵ The divestment rule requires that each foreign-owned mining company divest an increasing equity stake to the government, SOEs or a local company. The amount depends on the number of years the company has been producing.

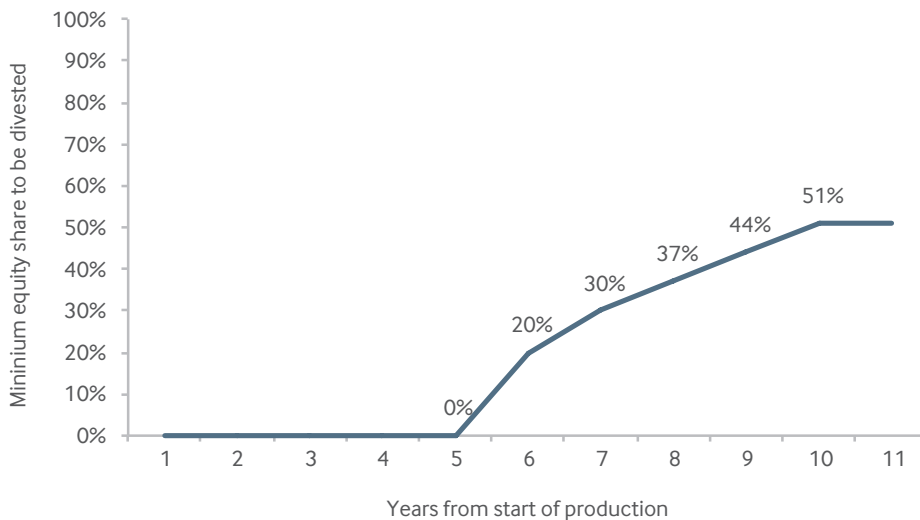


Figure 2. Minimum divestment requirements, as a percentage of the total shares in the locally established company

Source: GR 1/2017 and MEMR 9/2017

Element 2. Who can buy?

The second element of the divestment rule determines who can buy the shares. Before the recent MEMR 9/2017, the divestment rule included three tiers of potential buyers. MEMR 9/2017 adds a further option—the potential to list on the Indonesian Stock Exchange.⁶

5 In GR 1/2017 and MEMR 9/2017

6 Article 10 (1) of MEMR 9/2017

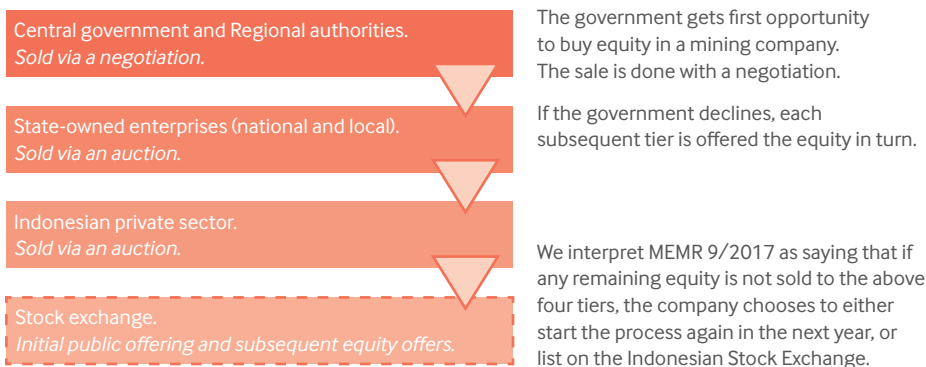


Figure 3. Three (plus one) tiers of potential buyers of mining equity

Source: Authors' interpretation of Article 97 (2) GR 77/2014, GR 1/2017 and Articles 2 (5) and 10 (1) MEMR 9/2017.

Element 3. At what price?

The third element of the divestment rule determines the price the shares should be sold at and the process by which they are sold. The price of equity offered to the government is determined by negotiation. An estimated valuation sets the upper limit for this price. Equity offered to SOEs and the private sector is priced by auction. In these cases, the valuation becomes the auction reserve price, i.e., the minimum price at which equity can be sold.

Before MEMR 9/2017, the divestment rule dictated that the valuation be based on “replacement cost.” This appears to differ from the definition used in mining valuation codes like those of the Canadian Institute of Mining, Metallurgy and Petroleum (the CIMVAL standards).⁷ The law defines the replacement cost as the cumulative sum of “investment cost expended since the exploration stage up to the year of obligation of share divestment.” This equals “accumulated depreciation and amortization based on the economic life or benefit of the different property group adjusted to the effect of inflation; and financial obligation until the end of the year at the time the obligation of share divestment is due.”

However, Article 14 (1) of MEMR 9/2017 replaces this valuation method with a method that estimates the “fair market value,” but crucially, without consideration of the value of the reserves at the time when the divestment is due.⁸ We interpret this to be almost economically equivalent to the replacement cost defined above. We discuss this further in section 2.2.

2. RISKS FROM THE DIVESTMENT RULE

We have evaluated the divestment rule to understand the potential costs and benefits to Indonesia.

2.1. THE BENEFITS FROM DIVESTMENT MAY BE DIFFICULT TO ATTAIN

Requiring foreign companies to divest offers three potential benefits to Indonesians. Our research suggests that these benefits might be difficult to attain.

⁷ Canadian Institute of Mining, Metallurgy and Petroleum. “Standards and Guidelines for Valuation of Mineral Properties.” Accessed 6 February 2017. <http://web.cim.org/standards/MenuPage.cfm?sections=177&menu=178>

⁸ Translation of Article 14 (1), MEMR 9/2017

Domestic purchases of equity would require an increase in foreign borrowing or direction of a significant amount of domestic investment from other sectors

Overwhelmingly, investment in Indonesia comes from foreign, not domestic, investors. Only a quarter of the almost USD 180 billion (IDR 2,394 trillion) invested each year in the Indonesian economy comes from domestic investors. The divestment rule aims to turn this around and provide Indonesians with a much greater ownership of the mining sector.

Over the last five years, the extractive sector attracted USD 21 billion (IDR 279 trillion) in foreign investment. This represents almost half the entire investment from Indonesians in all other sectors of the economy. Further, the divestment rule requires foreign companies to divest at least 51 percent of their equity capital—a stock amount that is likely to be many times larger than the average annual flow of investment shown in figure 4. If, under current conditions, Indonesians were to purchase over 51 percent of each companies’ equity, the amount required is likely to be a significant portion of Indonesian’s current investment in other industries.

Overwhelmingly, investment in Indonesia comes from foreign, not domestic, investors. Only a quarter of the almost USD 180 billion invested each year in Indonesia comes from domestic investors.

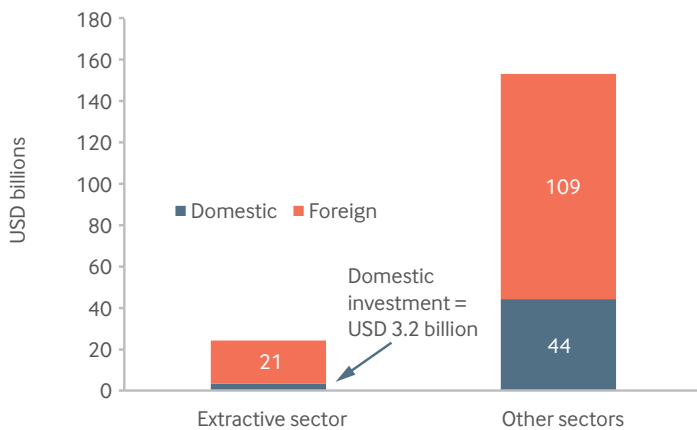


Figure 4. Domestic and foreign direct investment in Indonesia’s extractive sector and all other sectors in USD billions (annual average over 2011 to 2015)

Source: Badan Koordinasi Penanaman Modal. “Statistics.” Accessed 6 February 2017. [http://www3.bkpm.go.id/en/investing-in-indonesia/statistic and authors’ calculations](http://www3.bkpm.go.id/en/investing-in-indonesia/statistic-and-authors-calculations)

In other words, the divestment rule effectively requires domestic investors to inhabit the role foreign investors now do. However, these data suggest domestic investors are not investing enough to take the place of foreign investors. The difference is so large that to purchase the mining equity that foreign mining companies must divest, Indonesians will have four options:

- Reduce their investment or sell their existing assets in other sectors of the Indonesian economy to foreigners, and so swap Indonesian ownership of manufacturing, farming and services for mining equity.
- Borrow from foreign creditors or invite foreign investors to buy equity in the Indonesian companies, and so gain mining equity, but also gain foreign liabilities.
- Divest their foreign assets, and so hold portfolios highly exposed to commodity risks.
- Rely on the government to purchase the mining equity, and so force the government to borrow from foreigners itself; increase taxes; or reduce spending on infrastructure and other socially beneficially projects. See section 2.2 for a discussion of this issue.

The consequences of any of these options might not be palatable for Indonesia as a whole, which suggests that buying mining equity would be a hollow victory.

Dividend returns from investment may be less than expected

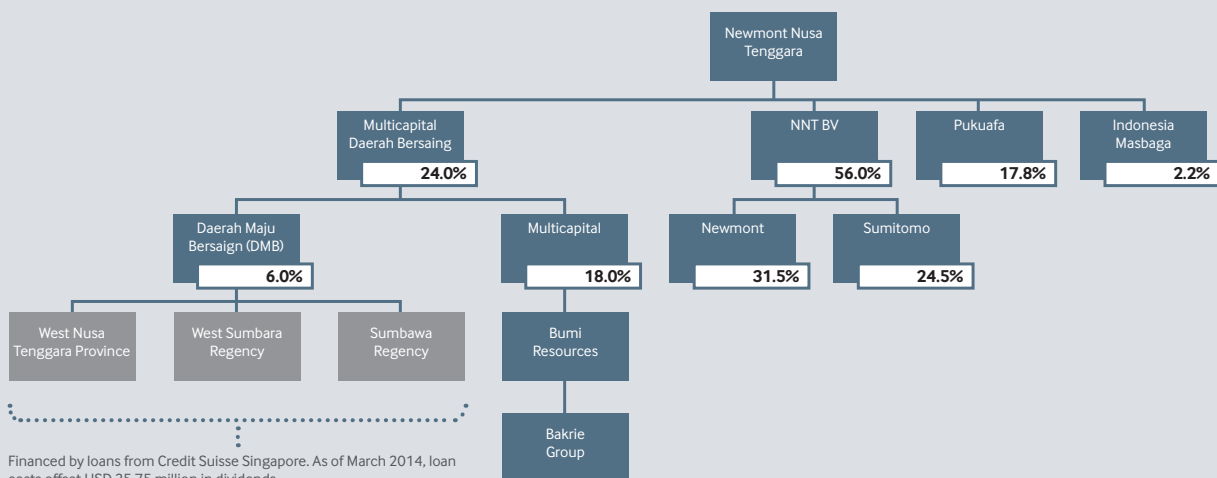
Owning equity in mining companies gives Indonesians or Indonesia state-owned enterprises opportunities to earn dividends. However, the actual dividends that Indonesian buyers receive may be disappointing, for two reasons. First, in many cases, the Indonesian entity may not have the funds to purchase equity stakes and must borrow instead. Clause 2 (7) of MEMR 9/2017 prevents the foreign company from loaning money for the equity purchase (as is common in other countries in which the state wishes to own equity in a mining company). This means the Indonesian buyer would borrow from a different source. Box 1 illustrates three subnational governments in the province of West Nusa Tenggara whose debt wiped out any proceeds from their share purchase. This is also an example of how private sector interests can become entangled in the complicated process of buying shares in mining companies—a situation that one day could enable corrupt practices. (See section 2.2.)

The actual dividends that Indonesian buyers receive may be disappointing.

Box 1. Lack of financial capacity leads to abusive practices⁹

One example of how the divestment rule may not yield benefits for Indonesians comes from the purchase of Newmont Nusa Tenggara (NNT) shares in the province of West Nusa Tenggara. As part of a contract signed between the government of Indonesia and NNT in 1986, almost a third of NNT shares had to be divested to Indonesian entities. In 2009, Daerah Maju Bersaing (DMB)—a joint stock company owned by the provincial government, two district governments in the province and a private company called Multicapital controlled by an Indonesian businessman and politician—acquired a 24 percent stake. Multicapital owned 75 percent of DMB (effectively owning 18 percent of NNT) while the subnational governments owned 25 percent of DMB (6 percent of NNT).

Figure 5. Ownership structure of Newmont Nusa Tenggara, prior to Newmont’s sale to Amman Mineral Internasional in 2016 (percentage share in NNT)



Source: Yudhistira, Aria. "Ini Pemilik Saham Newmont Nusa Tenggara." *Kata Data*, 7 July, 2014. Accessed 6 February, 2017. <http://katadata.co.id/berita/2014/07/07/ini-pemilik-saham-newmont-nusa-tenggara>

To purchase 24 percent of NNT shares, the subnational governments and Multicapital had to borrow. This was done by arranging for Multicapital’s owner—a company called Bumi Resources Minerals (BMRS)—to borrow USD 300 million (IDR 3.9 trillion) from Credit Suisse in Singapore. In order to repay this loan, the arrangement stipulated BMRS repays the loan from the dividends from its stake in NNT. This has meant that as of 2014, the subnational governments in West Nusa Tenggara had not received money from the arrangement despite NNT paying out USD 35.75 million (IDR 475 billion) in dividends.

9 Aria Yudhistira. "Ini Pemilik Saham Newmont Nusa Tenggara." *Kata Data*, 7 July 2014. Accessed 6 February 2017. <http://katadata.co.id/berita/2014/07/07/ini-pemilik-saham-newmont-nusa-tenggara> and Abraham Lagaligo. "Saham Divestasi Newmont Terancam Disita Credit Suisse." *Dunia Energi*, 10 September 2012. Accessed 6 February 2017. <http://www.dunia-energi.com/saham-divestasi-newmont-terancam-disita-credit-suisse/>

Even when a share purchase doesn't necessitate a large debt accumulation, accounting practices by majority shareholders that serve to reduce the returns to minority owners could result in disappointing dividend payments to Indonesian shareholders. When there is a dominant shareholder and poor monitoring by other shareholders, there is a risk of abusive practices. Companies have various opportunities to limit the distribution of dividends from their Indonesian subsidiary company and instead indirectly remit cash to their own global shareholders. For example, loans are senior to common equity dividends (i.e., company income must first go to pay off these loans before distributing dividends). The controlling shareholder can ensure that the company borrows from an affiliated shareholder or similar entity and can divert income away from other shareholders, such as Indonesian shareholders.

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

When Indonesian owners become majority shareholders of a mining venture, it is possible that they will be able to successfully steer the company to generate more jobs and business opportunities for Indonesians than if mining companies stayed under the control of foreign companies. This could come from mining company job creation for Indonesians, or from Indonesian-owned mining companies contracting with Indonesian service companies rather than international companies. Local business networks are likely to be much stronger among Indonesian-owned mining companies. Theoretically, the transfer to Indonesian majority ownership after the tenth year of production (mandated under the rule) would help domestic connections proliferate.

However, the transition to Indonesian majority ownership may have less impact on these opportunities than the government expects.

First, 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.

Second, the project would have established a certain network of suppliers for those years. Indonesian owners may still wish to stick with these networks if it means more efficient operations. Meanwhile, the foreign company may not wish to remove access to this supply chain to safeguard a return on its remaining equity, and continued supply can also generate new business for the foreign company.

Third, it is reasonable to expect that local employment in the mining sector may not rise much as a result of a change in the company's ownership. For example, as of 2015, Freeport Indonesia employed 32,400 Indonesians and 152 "expatriates," only about 1.3 percent of the total workforce.¹⁰ Change of ownership, though, does not necessarily lead to more jobs for Indonesians. Indeed, if the divestment rule deters new investment—as we suggest in section 2.2 below—jobs could actually decline.

10 PT Freeport Indonesia. Ketenagakerjaan. Accessed 6 February 2017. http://ptfi.co.id/media/files/fact/57c932e96e1d1_3-ketenagakerjaan.pdf. This is similar to the three percent figure for expatriate employment given in: Berly Martawardaya. "Tegangnya Relaksasi Ekspor Mineral". Kompas, 24 January 2017. Accessed 6 February 2017. <http://bisniskeuangan.kompas.com/read/2017/01/24/192954726/tegangnya.relaksasi.ekspor.mineral>

2.2 REQUIRING DIVESTMENT MAY IMPOSE SIGNIFICANT COSTS ON INDONESIA

In our view, divestment rule benefits are potentially lower than the government expects. Our research also identifies three significant costs that the divestment rule will impose on Indonesia.

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

The divestment rule forces companies to sell equity at a potentially significant discount. It may seem counterintuitive to worry about how much investors expect to receive for their investment. But if investors cannot expect to receive enough returns to pay costs and creditors and satisfy shareholders, then they will not invest in the first place. 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.

While it may not be apparent when looking at large and successful mining projects such as Freeport’s Grasberg mine, mining exploration and development is risky and a significant number of projects fail. Much of the time, investors do not receive a return on their money and sometimes lose their investments altogether. In order for business to work, investors need to earn enough on successes to compensate for failures. The divestment rule obligates companies to sell shares on the successful cases, without any payment by Indonesian investors for the failures: those projects would never reach the divestment stage.

However, the equity is likely to be priced below the amount necessary to compensate some investors for the risks they face. This is for two reasons.

Figure 6 illustrates the first reason. It is likely the resulting price in divestment processes will be close to or under what we refer to as the “guide price” (set as the definition in Article 14 (1) MEMR 9/2017 of “fair market value”). While an auction may result in higher prices, if there are not enough competitive bids in each auction, the equity will only be sold at the reserve price—or not at all.

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

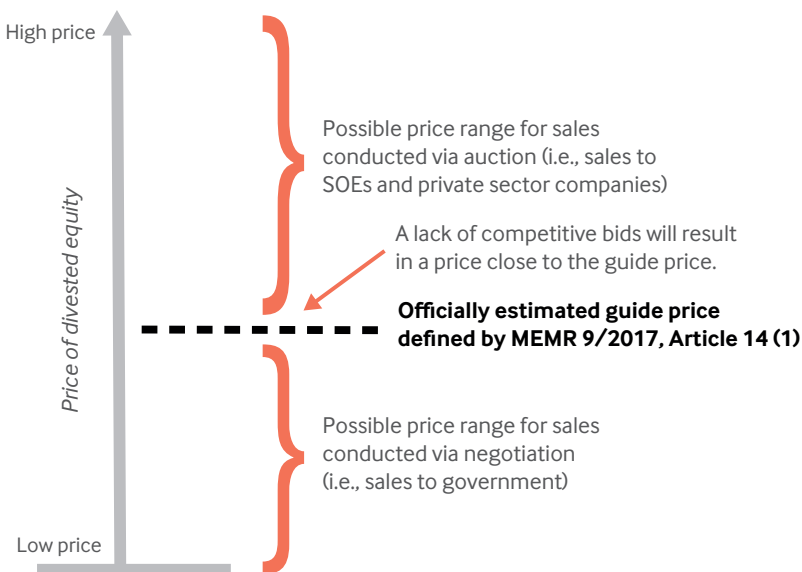


Figure 6. Potential range of prices that can result from negotiations and auctions within a divestment process

Source: Authors’ interpretation of MEMR 9/2017

Determining the guide price is particularly important. This is the second reason why the divestment rule is unlikely to sufficiently compensate investors. MEMR 9/2017 replaces the previously used “replacement cost” approach to valuing equity with a fair market value approach. However, a crucial caveat is that this fair market value cannot include the value of reserves of the project at the time of divestment.¹¹

Fair market value’s name suggests an improvement from the perspective of a company and its investors. In this case, however, our initial interpretation of MEMR 9/2017 is this caveat makes the fair market value almost equivalent to the replacement cost defined in previous regulatory language.

Theoretically, the value of equity traded on in the market would include the amount traders expect the company to make from selling future production less taxes (which is equivalent to the value of reserves less costs and taxes). However, Article 14 (1) in MEMR 9/2017 eliminates the possibility of future production being used to value equity. The remaining value that is allowed are the above ground assets a mine currently has—the infrastructure and capital it has accrued, less depreciation of these assets. This value is equivalent to the replacement cost defined in previous regulation.

While it’s not necessarily the case that investors should expect to receive the full net of tax income from future production in order to invest, they will usually need to expect a return comparable with other uses of their capital. There is no defined figure on this, but extractive sector analysts tend to use a benchmark of close to 12.5 percent return.¹² However, by not allowing future expected profits to be part of the guide price calculation, it is possible that for many projects, the expected return will fall below this benchmark. In our financial model of a hypothetical Indonesia copper mine that must divest equity using the divestment rule valuation for the price, we estimate that for a mining project that makes a 12.5 percent return without needing to divest would make only a 9 percent return under the divestment rule. This analysis suggests that some projects in Indonesia will not attract investment under the divestment rule. (See box 2 for a summary.)

Box 2. Modeling the impact of the divestment rule valuation

We used a discounted cash flow model of a typical copper mine in Indonesia that produces USD 207 million (IDR 2.8 trillion) of copper per year on average for 15 years. After five years of production, the accumulated net costs of the project (as defined by the “replacement cost”) amount to USD 157 million (IDR 2.1 trillion). According to the divestment rule, the company would have to divest 20 percent of its equity. Assuming that it received the replacement cost valuation for this equity, the company would receive USD 31 million (IDR 412 billion) from this first tranche of equity.

However, using an “income-based approach” to valuation, the company would receive USD 74 million (IDR 984 billion) from the sale. This approach approximates the amount required to ensure the company’s investors would receive a 12.5 percent return—the benchmark frequently set by investors when deciding whether to invest in the first place—on their capital. This amount is also a basic estimate of what the company might receive from selling on a stock market, since investors tend to look at future returns as the key determinant of the price of equity. Using the same method to value the amounts the company receives from subsequent divestment, we calculate that by the time the divestment reached 51 percent, the loss from divestment would mean a post-tax return of 9 percent compared, with the 12.5 percent if the company was not required to divest.

11 Article 14 (1) of MEMR 9/2017

12 A survey of petroleum company analysts suggests a 10 percent nominal rate as a benchmark, on to which a “country risk premium” is added. We assume this to be 2.5 percent in this case. Source: Wood Mackenzie. *Upstream Valuation Survey 2015*. (2016)

In addition, the divestment rule comes on top of a 2014 fiscal regime that already places a relatively higher burden on mining companies than the previous regime. This remains the case even if the export duty is also removed. This may be beneficial to Indonesia, with the government generating greater tax revenues. However, higher taxes *and* the divestment rule might be too much for some investors to bear. The risk is greatest for new mining projects that might be seen as risky, or where potential profit margins are believed to be relatively small. For some of these projects, the divestment rule would represent the tipping point that prevents them from getting off the ground.

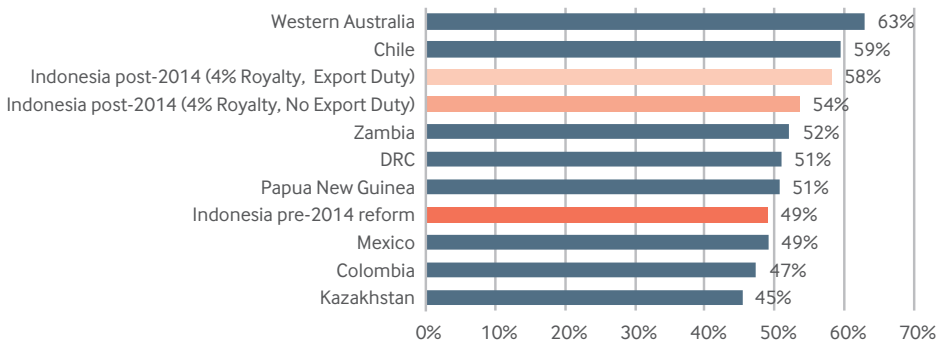


Figure 7. Average effective tax rate for a model copper mine

Source: Authors' calculations. Modeled with USD 2.27 per pound of copper (USD 5,000 per metric ton) C1 cash costs of USD 1.57 per lb.

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. These officials might be in a position to arrange an equity sale at a discount to a company, allowing affiliated officials to acquire assets at artificially low price. Similarly, officials could arrange an equity sale to an SOE financed by private sector interests affiliated with the officials. Such practices are common, particularly in extractive sectors across the world. (See box 3.)

A proliferation in mining sector corruption cases could further deter investment, and should therefore be prevented.

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.

Box 3. Abusive practices in Angola

An example from Angola highlights the risks when officials arrange deals between companies in which they have some beneficial interest. In 2012, the *Financial Times* reported that a U.S. oil company Cobalt International Energy was under investigation by U.S. authorities under the Foreign Corrupt Practices Act. The head of the state-owned enterprise, Sonangol, and two former army generals owned shares in an Angolan company called Nazaki Oil and Gas, a partner with Cobalt International Energy in winning and developing a license area off the coast of Angola.¹³ This was against Angola's own beneficial ownership law. It likely generated a substantial profit for the three Angolan officials, while potentially losing money for the Angolan state—the signatory bonus for the Cobalt-Nazaki project was a tenth of the amount paid for similar licenses.¹⁴ The scandal resulted in a class action suit against the company (still ongoing)¹⁵ and was covered by international press, damaging Cobalt International Energy's reputation.

13 Tom Burgis and Cynthia O'Murchu. "Angola official held hidden oil stakes". *Financial Times*, 15 April 2012. Accessed 6 February 2017. <https://www.ft.com/content/effd6a98-854c-11e1-a394-00144feab49a>

14 IHS Markit. "Sinopec Offers US\$1-bil. Signature Bonus in New Licensing Round in Angola". 5 December 2006. Accessed 6 February 2017. <https://www.ihsmarkit.com/country-industry-forecasting.html?ID=106599357>

15 Rosen Law Firm. "Cobalt International Energy, Inc". Accessed 6 February 2017. <http://www.rosenlegal.com/cases-327.html>

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.¹⁶ 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. One way to select the better investment area is to compare expected social rates of return. The total benefits over the life the project, after all, accrue not only to the government, but also society. The social return from investing in mines could include dividends, greater employment and expanded local business opportunities (subject to the challenges described in section 2.1). The social return on infrastructure would include charges or tolls (e.g., selling power, port fees) from users and the benefits Indonesians and their businesses get from using the infrastructure.

We do not have estimates for such returns. Further, it is difficult to make such estimates.¹⁷ But government officials ought to think about the costs and benefits of using its money for one purpose over another to ultimately benefit Indonesians.

Further, even if the government itself refrains from purchasing equity directly, there is a risk that SOE purchases would require government funding. The government has already signalled that mining SOEs or an SOE holding company might acquire the bulk of the equity and would be mostly financed by the private sector. In this manner, SOE purchases of divested equity effectively allow the government to share some of the investment risk with other financiers, rather than take on the full exposure of state ownership. However, it is not certain how such a financing structure would work, or whether financiers would be willing to fund the SOEs. If there is insufficient domestic capital, as our analysis suggests in section 2.1, it is possible that the government will either fail to find private sector financing or require foreign investment to help. (This would effectively allow foreign capital back into the mining sector.) It risks public funds being used to support SOEs rather than building infrastructure and other projects that could provide potentially deliver bigger benefits to Indonesia.

3. STRENGTHENING OR ELIMINATING THE DIVESTMENT RULE

Indonesia has a long history of foreign operators extracting the country's mineral resources. 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. Our analysis suggests that the divestment rule may not provide all the benefits that might be expected, while imposing significant costs.

Crucially, imposing the rule may work against the objectives of building infrastructure and developing the economy outside the mining sector. We take no position on what objectives are best for Indonesians. However, we can comment on the extent to which the divestment rule helps or hinders these objectives. If the government wishes to enhance productivity and competitiveness, it must ensure capital is invested into sectors such as infrastructure and manufacturing. The rule

Buying mining equity means less money available to build infrastructure.

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.

16 Dave McRae. *Dr. Yose Rizal Damuri – Jokowi's economic policies*. Indonesia at Melbourne podcast, 20 October 2016. Accessed 6 February 2017. <http://indonesiaatmelbourne.unimelb.edu.au/jokowis-economic-policies/>

17 Antonio Estache and Marianne Fay. *Current Debates on Infrastructure Policy*. The World Bank Policy Research Working Paper 4410 (2007).

has the potential to divert capital away from infrastructure and into the mining sector. Therefore, attempting to meet the second objective on sovereignty in the mineral sector might endanger the government's ability to meet its first objective on economic productivity.

Recommendation 1: Consider eliminating the divestment rule and explore other approaches to a state-led mining sector.

Given the conflict between achieving these two objectives, we recommend that the government and parliament remove the divestment rule entirely and concentrate on policies that are more in line with the government's overall objectives to improve lives in Indonesia. This does not preclude seeking a more state-led approach to the management of the mining sector—developing larger SOEs might be one approach, for example.

However, if government and parliament decide to continue with the rule, we have seven further recommendations intended to ensure the divestment rule cause the least damage and greatest benefit for Indonesia.

Recommendation 2: Limit government purchases of mining equity and limit how public funds are used to finance SOE investments.

Given that public investment in mining means less public investment in infrastructure and manufacturing, we recommend that the government limit how much mining equity it buys and ensures that the amount of public funds used to finance SOEs is limited.

Recommendation 3: Reduce the 51 percent requirement.

Until MEMR 9/2017, companies faced three divestment schedules. The ministerial decree eliminates all but the first schedule, requiring companies to divest at least 51 percent of their shares by the tenth year of production. This both improves and worsens the previous version of the divestment rule. Reducing the number of divestment schedules simplifies the rule, eliminates unfairness and removes the potential to game the system. However, it now requires majority ownership to be given up by the tenth year of production. This is problematic if other aspects of the divestment rule are not changed, specifically how equity is valued. The rule essentially places a high fiscal burden on companies that is likely to deter investment. The greater the amount of equity that companies are forced to divest, the higher this fiscal burden.

In addition, if the government plans for SOEs to hold most of the divested mining equity, the requirement can quite quickly result in SOEs owning a large portion of the country's mining sector. This may be the government's ultimate objective. But ensuring SOEs can manage newly acquired projects should be considered in the context. (See recommendation 8.)

Recommendation 4: Establish clearer rules for negotiation and auction processes, and designate a third party to administer the processes.

It is important that both foreign companies and prospective equity buyers have trust in the divestment process to both attract foreign investment and limit corruption. The government should consider establishing rules on how negotiations and auctions are managed. This might include rules to ensure that prospective bidders in auctions are technically qualified. This could be done in a similar manner to the vetting applicants to Indonesia's petroleum licencing rounds undergo.

We also recommend that an agency be designated as the authority that manages negotiations and auctions. This need not be an independent agency, nor a new agency, since the costs of establishing one might be large. However, the agency may wish to hire external experts to undertake certain aspects of the processes—for instance Article 5 (2) or MEMR 9/2017 allows MEMR to seek an independent valuation expert.

Recommendation 5: Require companies that buy mining equity to publicly disclose their beneficial owners.

Such disclosure should be aligned with existing commitments and efforts to publicly disclose beneficial owners of extractive companies by 2019 through the Extractive Industries Transparency Initiative.¹⁸

Recommendation 6: Allow companies the option to sell via an IPO.

We are in favor of MEMR 9/2017 adding sales on the Indonesian Stock Exchange to the four existing tiers of entities that can buy mining equity. First, divestment to a public stock exchange is likely to be a more transparent method of selling the equity than negotiations or auctions, reducing the risk of corruption. Second, public trading of equity also increases the ability of the initial buyers of equity to subsequently resell it. This reduces the risks they face and allows them to realize capital gains where available. Third, public trading establishes a “market price” that according to economic theory should be the best approximation of the value of the equity.¹⁹ This market price could then be used as a guide price to subsequent divestments by the same company (and perhaps as a guide to divestment by other companies).

The cost of an initial public offering can be high and is a concern going forward. Research suggests IPOs in the United States cost between 5 to 7 percent of the total proceeds raised in the IPO, most of which is paid to legal and financial advisors.²⁰ Such costs be problematic for any mining companies that cannot afford the costs of an IPO.²¹

Given these benefits and costs, we recommend that the government continue to explore how to use the IPO option to meet its objectives.

Recommendation 7: Reconsider and further define the approach to valuing equity.

In section 2.2, we argued that the current approach to valuation of divested mining equity is likely to deter foreign investment in Indonesia. Our interpretation of MEMR 9/2017 suggests that this is the case for both the “replacement cost” and “fair market value” approaches.

18 See Indonesia EITI. *Indonesia – beneficial ownership roadmap*. (2016). Accessed 6 February 2017. <https://eiti.org/document/indonesia-beneficial-ownership-roadmap>

19 The economic theory is called the “efficient market hypothesis.” For a textbook explanation see Hal Varian. *Intermediate Microeconomics: A Modern Approach*, Eighth edition. New York: W.W. Norton & Co. (2010).

20 PwC. *Consider an IPO? The cost of going and being public may surprise you* (2012), 5. And Ritter, Jay. “Why is Going Public So Costly?” *Forbes*, 19 June 2014. Accessed 6 February 2017. <http://www.forbes.com/sites/jayritter/2014/06/19/why-is-going-public-so-costly/#1bf31e7f56dd>

21 Based on data shown in figure 1. Source: Authors’ calculations and S&P Global. SNL Platform. Accessed 6 February 2017.

To address these problems, we suggest the following.

- Most critically, allow some measure of foreign companies' cost of equity capital as part of the valuation.²² Without this change, the divestment rule effectively imposes a substantial fiscal burden on investors, which would likely lead to a fall in investment over time.
- Consider using multiple valuation approaches—an income-based (discounted cash flow) method as well as the replacement cost, for example. This ensures that the authorities are not reliant on one approach that may not be appropriate for a particular context. This follows common practice in the mining industry.²³
- Follow international valuation codes in each case. Some mining countries already have well-developed codes detailing how to value mining assets.²⁴ Adopting one of these codes will reduce the potential for arguments between parties and reduce uncertainty around valuations.

Recommendation 8: Develop a policy to manage mining SOEs.

Whether the government continues with the divestment rule or not, it is essential that it develops a policy to guide the development of its mining SOEs, or the planned SOE holding company.²⁵ Without a well-managed SOE, the risks are that the SOE:

- Fails to attract private sector financing, and so creates the possibility of the government diverting funds from infrastructure and other public spending to finance the SOE (See recommendation 2.)
- Is not properly resourced to monitor majority shareholders for those companies it is a minority equity holder, and so loses out on dividends
- Mismanages mining companies in which it has operational control, limiting returns on its investments and failing to enhance employment and domestic business opportunities

Establishing an SOE may eventually lead to substantial benefits to Indonesia. But requiring foreign-owned mining companies to divest their equity before the government knows how the equity will be managed risks deterring foreign investment and wastes the opportunity to create a viable state-led mining sector. Ultimately, this will undermine the drive to increase productivity and limit the economic future of Indonesians.

22 Defining how this would work in practice is beyond the scope of this report. However, one approach could be to use similar methods to measuring cost of capital in regulated industries in the U.K. and U.S. See, for example: Tim Jenkinson "Regulation and the Cost of Capital" in *International Handbook on Economic Regulation*, ed. Michael Crew and David Parker (London: Elgar, 2006).

23 Montek Mayal. *How (and Why) to Value a Coal Mine*. FTI Consulting (2015). Accessed 6 February 2017. <http://www.ftijournal.com/article/how-and-why-to-value-a-coal-mine>

24 For instance, VALMIN (the Australian Institute of Mining and Metallurgy), CIMVAL (Canadian Institute of Mining, Metallurgy and Petroleum) and SAMVAL (South African Mining associations). An internationally-applicable code, based on these three codes, is currently being drafted by the International Valuation Standards Council, see International Valuation Standards Council. Access 6 February 2017. <https://www.ivsc.org/>

25 Indonesia Investments. "Holding Company for Indonesia's State-Owned Miners Ready in Q1-2017". 20 January 2017. Accessed 6 February 2017. <http://www.indonesia-investments.com/news/todays-headlines/holding-company-for-indonesia-s-state-owned-miners-ready-in-q1-2017/item7541?>

REFERENCES

Badan Koordinasi Penanaman Modal. "Statistics." Accessed 6 February 2017. <http://www3.bkpm.go.id/en/investing-in-indonesia/statistic>

Burgis, Tom and Cynthia O'Murchu. "Angola official held hidden oil stakes." *Financial Times*, 15 April 2012. Accessed 6 February 2017. <https://www.ft.com/content/effd6a98-854c-11e1-a394-00144feab49a>

Canadian Institute of Mining, Metallurgy and Petroleum. "Standards and Guidelines for Valuation of Mineral Properties." Accessed 6 February 2017. <http://web.cim.org/standards/MenuPage.cfm?sections=177&menu=178>

Estache, Antonio and Marianne Fay. *Current Debates on Infrastructure Policy*. World Bank Policy Research Working Paper 4410, 2007.

IHS Markit. "Sinopec Offers US\$1-bil. Signature Bonus in New Licensing Round in Angola." 5 December 2006. Accessed 6 February 2017. <https://www.ih.com/country-industry-forecasting.html?ID=106599357>.

Indonesia EITI. *Indonesia – beneficial ownership roadmap*. 2016.

Indonesia Investments. "Holding Company for Indonesia's State-Owned Miners Ready in Q1-2017." 20 January 2017. Accessed 6 February 2017. <http://www.indonesia-investments.com/news/todays-headlines/holding-company-for-indonesia-s-state-owned-miners-ready-in-q1-2017/item7541>

International Valuation Standards Council. Accessed 6 February 2017. <https://www.ivsc.org/>

Jenkinson, Tim. "Regulation and the Cost of Capital" in *International Handbook on Economic Regulation*, edited. Michael Crew and David Parker. London: Elgar, 2006.

Kurnianingru, Trias. *Bagian i kajian hukum atas divestasi saham bidang pertambangan di Indonesia (Studi kasus PT Newmont Nusa Tenggara dan PT Freeport Indonesia)*. Available at http://berkas.dpr.go.id/puslit/files/buku_lintas_tim/buku-lintas-tim-8.pdf

Lagaligo, Abraham. "Saham Divestasi Newmont Terancam Disita Credit Suisse". *Dunia Energi*, 10 September 2012. Accessed 6 February 2017. <http://www.dunia-energi.com/saham-divestasi-newmont-terancam-disita-credit-suisse/>

Martawardaya, Berly. "Tegangnya Relaksasi Ekspor Mineral". *Kompas*, 24 January 2017. Accessed 6 February 2017. <http://bisniskeuangan.kompas.com/read/2017/01/24/192954726/tegangnya.relaksasi.ekspor.mineral>

Mayal, Montek. *How (and Why) to Value a Coal Mine*. FTI Consulting, 2015. Accessed 6 February 2017. <http://www.ftijournal.com/article/how-and-why-to-value-a-coal-mine>

McRae, Dave. *Dr Yose Rizal Damuri – Jokowi's economic policies*. Indonesia at Melbourne Podcast, 20 October 2016. Accessed 6 February 2017. <http://indonesiaatmelbourne.unimelb.edu.au/jokowis-economic-policies/>

PricewaterhouseCoopers. *Consider an IPO? The cost of going and being public may surprise you*. 2012. Accessed February 6 2017. <https://www.pwc.com/us/en/deals/publications/assets/pwc-cost-of-ipo.pdf>

PT Freeport Indonesia. *Ketenagakerjaan*. Accessed 6 February 2017. http://ptfi.co.id/media/files/fact/57c932e96e1d1_3-ketenagakerjaan.pdf

Ritter, Jay. "Why is Going Public So Costly?" *Forbes*, 19 June 2014. Accessed 6 February 2017. <http://www.forbes.com/sites/jayritter/2014/06/19/why-is-going-public-so-costly/#1bf31e7f56dd>

Rosen Law Firm. "Cobalt International Energy, Inc." Accessed 6 February 2017. <http://www.rosenlegal.com/cases-327.html>

S&P Global. SNL Platform Proprietary data available from S&P Global Market Intelligence: <https://www.snl.com>

Varian, Hal. *Intermediate Microeconomics: A modern approach*, Eighth edition. New York: W.W. Norton & Co. 2010.

Wood Mackenzie. *Upstream Valuation Survey 2015*. 2016.

Yudhistira, Aria. "Ini Pemilik Saham Newmont Nusa Tenggara." *Kata Data*, 7 July, 2014. Accessed 6 February 2017. <http://katadata.co.id/berita/2014/07/07/ini-pemilik-saham-newmont-nusa-tenggara>

David Manley is a senior economic analyst at NRG. Emanuel Bria is NRG's Asia-Pacific senior officer.

The authors thank Nathaniel Adams, Philip Daniel, Patrick Heller, Thomas Lassourd, Amir Shafaie, Rani Febrianti and Eve Warburton for their helpful comments and suggestions.

The Natural Resource Governance Institute, an independent, non-profit organization, helps people to realize the benefits of their countries' oil, gas and mineral wealth through applied research, and innovative approaches to capacity development, technical advice and advocacy.
Learn more at www.resourcegovernance.org



Oil, gas and mining for development