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Reflections on the Coal Market in 2010

(Part 1 of a 2 part series: SCoTA's INDO contract and doing business in Indonesia)

As the global economy recovers, demand for most raw materials has risen dramatically and so too have commodity prices. Coal provides one of the most graphic examples. Not only are prices continuing to rise sharply, but the financial press is full of reports of acquisitions in the sector as companies seek out coal assets around the world.

Indonesia's coal mining sector has certainly become the focus of renewed investment interest. The combination of comparatively low-priced coal reserves/low operating costs and Indonesia's geographic position (giving it a competitive edge so far as freight is concerned), means that Indonesian coal sector is very well placed to take advantage of strong demand in India and China.

No surprise therefore that Indonesia's vast coal reserves provide attractive opportunities to investors and coal buyers alike. In particular, the wide variety of quality within Indonesian coal allows for blending to meet specific buyer requirements, whilst the lack of a generally applicable minimum purchase quantity (such as that associated with Australian coal) appeals to a wider variety of buyer.

These factors have placed Indonesia among the world's biggest exporters of coal. In 2009, Indonesia produced 254 million tonnes of coal, of which approximately 200 million tonnes were exported.

This article focuses on some of the legal issues we are seeing associated with sourcing coal from Indonesia.

SCoTa 7B – The INDO Contract

The introduction in March this year of SCoTa 7b and the revised INDO RSS annexed to it should make it easier to trade Indonesian coal. The revisions to the INDO RSS are designed to balance the wide range of Indonesian coal qualities with the market's desire for standardisation through the implementation of an Indonesian index; thus providing a standard reference price for Indonesian coal in the Asia-Pacific market and increasing the number of hedging products available.

There is presently no single dominant index for Indonesian coal. The benchmark is a combined average of monthly prices from four indexes – the Indonesian Coal Index (the "ICI"), the globalCOAL Newcastle Index, Newcastle Export Index and Platts-1 index. Currently, there is a drive by the industry to develop a single index in order to provide price transparency in the Indonesian coal market and, therefore, stimulate competition with other coal producing nations.

The key changes to the INDO RSS are the introduction of a table setting out the standard

specifications for three grades of coal (INDO A, INDO B and INDO C) and the re-naming of the previous INDO A RSS and INDO B RSS to FOB INDO and FAS INDO, respectively.

The change to the FAS (Free Alongside Ship) delivery mode (seller's barge to buyer's vessel) is a novel one which leads to a number of minor amendments to the SCoTA and, significantly, include those terms concerning the transfer of title and risk. From a legal perspective these changes are the most significant and traders should be aware of their affect.

New Mining Law

On 12 February 2010, the Indonesian Government passed two key regulations concerning the implementation of the new Indonesian Law on Mineral and Coal Mining ("the Minerba"):

- Government Regulation No.22/2010 - Mining Areas ("GR 22"); and
- Government Regulation No.23/2010 - Conduct of Coal and Mineral Mining Business Activities ("GR 23") (together the "Regulations").

Although the Regulations have provided much needed clarification in relation to the issuance of mining licenses and the delineation of mining areas, the Regulations have also raised a number of potential concerns for foreign investors.

Local Divestment Obligations

The requirement for the divestment of shares to local shareholders has long been one of the main points of contention for those wishing to invest in Indonesian mining projects. Under the old Contracts of Work system, 51% of a mining company's shares had to be divested from any foreign shareholder to a local shareholder. The timing of the divestment was unclear. The high level of divestment and uncertainty as to timing has severely hampered the management of foreign-owned mining companies in Indonesia for the past decade.

GR 23 has brought much needed certainty to the local divestment obligations. GR 23 provides that 20% of a mining company's shares are to be divested from any foreign shareholder to a local shareholder after the fifth year of commercial production. This fixed level of divestment aims to provide foreign investors with an improved level of control and sets out a timeframe in which the divestment is to take place.

However, GR 23 provides that if the offer to divest is not taken up in the first instance then it must be repeated annually until take up has been completed. Significantly, GR 23 does not stipulate the mechanism for determining the sale price.

A lack of take up of shares can lead to uncertainty and inefficient project management resulting in foreign investors being penalised simply because a buyer cannot be found. The practical solution may be for foreign investors to seek to identify a suitable local shareholder from the outset of a project.

Domestic Market Obligations ("DMOs")

Whilst demand from Asian countries for Indonesian coal attracts investors and traders alike, the Indonesian Government has taken action to secure supply for its domestic requirements: GR 23 provides that the export of coal can only take place after domestic needs have been fulfilled.

Further details regarding DMOs are contained in Regulation No.34/2009 ("R 34") issued by the Ministry of Energy and Mineral Resources (the "Ministry") which provides that the annual allocation for the domestic market will be set by the Ministry. Further, R 34 sets out that DMO pricing of coal for the domestic market will be based on a prescribed benchmark price (*i.e.* the ICI) with heavy penalties to apply on failure to meet the DMO.

Coal Export Prices

Pursuant to GR 23 and R 24, the Indonesian Government had intended to use the ICI to set a minimum price level for exports of coal in order to combat companies exporting coal at low

prices to affiliates to reduce their tax liability. Recent indications show, however, that the Government is set to abandon this idea in the face of growing concern from key buyers in Japan, South Korea and Taiwan.

The Government has now switched its focus to using the ICI to determine a base price against which exports will be taxed and royalties calculated. Therefore, companies can sell coal below the base price, for example to attract new business, but taxes and royalties will be determined at the (higher) base price.

Contract Execution Issues

Indonesia's seasonal rains and poor infrastructure and often of a combination of the two makes delays to the shipment of cargoes commonplace. Mines are often subjected to heavy rains and flooding. Mine operators and sellers hastily turn up the force majeure provisions in their sale contracts – sometimes with justification, sometimes not. Sometimes it seems price volatility alone is reason enough to try to declare force majeure.

Indonesia's poor infrastructure remains a major impediment to the country attracting foreign investment, especially where the mining sector requires the transportation of large quantities of coal from up country mines to ports. Although the Government has allocated significant funds to remedy this problem, the execution of such Government-funded projects has been poor. Until the infrastructure is substantially improved, delays in shipment are likely to remain a feature of doing business in Indonesia.

As we say, sometimes those delays are legitimately the subject of force majeure, but our experience over recent months has been that those who trade in that market are more susceptible to default than in other markets when there is price volatility.

In view of the likelihood of delays in execution and a risk of price based non-performance, we suggest that parties buying and selling Indonesian coal review carefully their force majeure and default provisions in order to ensure the clauses operate as required (or as expected) and provide a clear exit route from the contract either after force majeure or indeed after non-performance.

Corruption

In 2008, Transparency International's survey of perceived corruption in 180 countries ranked Indonesia 126th indicating a high level of corruption. Those companies with interests in the country will already be alive to the global drive to reduce corruption. For many years "US Persons" (be that corporations or individuals) have had to be well versed in the operation of the US Foreign Corrupt Practices Act. The UK's new Bribery Act which was passed last month and is expected to come into force later in the year, is arguably even stricter than the FCPA. For more information see our client alert entitled "The Bribery Act 2010 – What it means for you". What is clear is that any company operating in Indonesia ought to ensure that its compliance procedures and the training provided to its employees is adequate and right up to date.

Indonesian Language Requirement

In July 2009, Law No.24/2009 regarding Flag, Language and Symbol of State and National Anthem (the "Law") came into force. Although the title of the Law seems innocuous, Article 31 has sprung an unpleasant surprise on the market.

Article 31 provides that:

- Indonesian language must be used for an agreement which involves Indonesian parties including Government institutions, state-owned enterprises, private companies and individuals; and
- Where an agreement involves a foreign party, the parties may, in addition to the Indonesian language, also use the national language of the foreign party or English.

Article 31 is vague in nature and does not clearly set out the requirements for compliance. Until

the follow-up regulation is released which clarifies the effect of Article 31, foreign parties may wish to act as follows:

- When contracting with an Indonesian party and the agreement is subject to Indonesian law, the agreement should be drawn up in both Indonesian and English.
- When contracting with an Indonesian party and the agreement is subject to foreign law, the agreement should be drawn up in the language of the parties' choice. Article 31 should not affect enforceability where, in theory, the Indonesian Courts do not have jurisdiction over contracts governed by foreign law.

Language Governing Interpretation

Article 31 is silent as to which language should be used to interpret an agreement. Current local opinion is that as long as an agreement satisfies Article 31, the parties should be free to choose which language is to govern interpretation. However, the Indonesian Government is yet to confirm this approach and the market waits tentatively for guidance.

Non-Compliance

Article 31 does not contain any express sanctions or penalties regarding non-compliance. However, it is conceivable that an Indonesian Court may hold that an agreement is unenforceable as result of non-compliance with Article 31.

Until clarification is provided by the Indonesian Government, we suggest that foreign parties contracting with Indonesian counterparts ensure that:

- the governing law is expressly agreed and recorded in the written contract;
- where the governing law is Indonesian, agreements are accurately translated;
- the effect of any common law term is clearly explained/defined in the contract; and
- the language which has precedence when interpreting the contract is expressly provided for.

Enforcement in Indonesia

Despite the fact that Indonesia ratified the New York Convention (the "Convention") in 1981, concerns still remain regarding the recognition and enforcement of foreign judgments and foreign arbitral awards by the Indonesian Courts.

The implementation of the Convention by the Government was subject to various conditions including a public policy exception. This exception has now become the most common defence used to oppose the enforcement of foreign arbitral awards in Indonesia. The exception has a wide application and enables the Indonesian Courts to refuse to enforce a foreign arbitral award for reasons ranging from issues of morality to a lack of commerciality. A graphic example of the wide application of the exception is the case of *Karah Bodas Company LLC v Perusahaan Pertambangan Minuak dan Gas Bumi Negara (2004) (Arb.)* in which it was held that that "against public policy" meant any measure that detrimentally affected the "welfare" of Indonesia and its people. Could enforcement of an award relating to what would have been a loss making transaction for the Indonesian counterparty really be refused on grounds that the transaction lacked commerciality and so was contrary to public policy?

It remains to be seen whether the Indonesian Courts will enforce foreign awards and judgments more readily as the Government seeks to attract increased foreign investment. In the meantime, it is important that those doing business there be aware of the issues and wherever possible negotiate some form of performance security from their counterpart when any contract is put in place. That way, with luck enforceability issues will be irrelevant.

Conclusion

Indonesia's natural resources and advantageous location makes it especially attractive to foreign investors and traders alike at present. As is so often the case, with opportunity comes risk. Over this past year we have seen more and more examples of clients experiencing first hand the

operational and legal issues associated with the Indonesian market. We hope that this alert has highlighted a few of the recurring issues we are seeing.

Of course, we are not in Indonesia nor are we qualified to advise on Indonesian law. If you wish to probe any more deeply into any of these issues, you should seek advice locally. We would be happy to introduce you to our correspondents there.

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