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INDONESIA'S MINING REGULATORY REGIME – DOMESTIC PROCESSING & REFINING – THE EMPEROR HAS NO CLOTHES [1234]

INTRODUCTION

In mid-February, the Government issued a Presidential Instruction re Acceleration of Domestic Processing & Refining ("**PI 3/2013**").

PI 3/2013 is addressed to 8 Ministers and all the Governors, Regents and Mayors of Indonesia directing them to take the necessary steps to accelerate making domestic processing and refining of certain metal minerals and non-metal minerals (but not coal) ("**Domestic Processing & Refining**"), by January 2014, a reality.

PI 3/2013 contemplates (i) policy coordination and synchronization, (ii) service improvement and licensing acceleration and (iii) policy improvements with regard to the implementation of Domestic Processing & Refining by January 2014. Accordingly, at first sight, PI 3/2013 seems like a positive and proactive initiative by the Government which should be welcomed by domestic producers of the relevant metal minerals and non-metal minerals as well as by prospective providers of Domestic Processing & Refining services.

Unfortunately, however, PI 3/2013 is almost certainly far too little, far too late. Further, if a recent major study on the economics of Domestic Processing & Refining in Indonesia is to be believed, PI 3/2013 is actually predicated on the erroneous assumption that Domestic Processing & Refining is an economically viable proposition, at least, for Indonesia's major metal mineral products.

Increasingly, it looks as though it is a case of "the Emperor having no clothes" when it comes to the viability of Domestic Processing & Refining in Indonesia in January 2014 or any time soon thereafter.

BACKGROUND

Domestic Processing & Refining was made an express obligation of every IUP holder at the time of the introduction of the 2009 Mineral & Coal Mining Law (Article 102) ("**Mining Law**") when it was contemplated that all IUP holders (for metal minerals, non-metal minerals, rocks and coal) would have 5 years to start Domestic Processing & Refining.

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[4] This article appeared in the March – April 2013 issue of Coal Asia Magazine.

The Domestic Processing & Refining obligation was subsequently set out at rather greater length in the 2010 Mining Mineral Activities Regulation (Articles 93 to 96) ("**GR 23/2010**").

Finally, having decided to exclude, for the time being, coal from the Domestic Processing & Refining obligation, the detail of just what the Domestic Processing & Refining obligation would entail was provided in the 2012 Mineral Value Added Regulation ("**MoEMRR 7/2012**").

The Government has also sought to extend the Domestic Processing & Refining obligation to CoW holders by way of the ongoing renegotiation of CoWs and MoEMRR 7/2012.

Notwithstanding that Domestic Processing & Refining, commencing in January 2014, has been contemplated for nearly 5 years, the number of Domestic Processing & Refining facilities actually constructed or under construction and anticipated to be operational, come January 2014, has been very small to say the least. Metal mineral producers, in particular, have repeatedly protested to the Government that it is not economically feasible for them to carry out Domestic Processing & Refining.

With the January 2014 mandated "start date" for Domestic Processing & Refining now less than 10 months away, the Government has clearly become seriously concerned as to whether or not Domestic Processing & Refining will really eventuate, on any significant scale, commencing in January 2014 or any time soon thereafter.

Having regard to the foregoing "thumbnail sketch" of the history of the Domestic Processing & Refining obligation, PI 3/2013 is really to be seen as a "last ditch" and somewhat desperate effort by the Government to make Domestic Processing & Refining happen in 2014 or soon thereafter as required by the 2009 Mining Law, GR 23/2010 and MOEMRR 7/2012.

COMMENTARY

1. **PI 3/2013**

1.1 **Overview**

1.1.1 **Relevant Ministries:** PI 3/2013 is directed to (i) the Coordinating Minister of the Economy as well as to (ii) the Ministers of Energy & Mineral Resources ("**MoEMR**"), Industry ("**MoI**"), Trade ("**MoT**"), Finance ("**MoF**"), Internal Affairs ("**MoIA**"), State-owned Enterprises ("**MoSOE**") and the Environment ("**MoE**"), (iii) Governors and (iv) Regents/Mayors.

1.1.2 **General Direction:** PI 3/2013 requires the relevant Ministers, Governors and Regents/Mayors to take all necessary steps to promote Domestic Processing & Refining through (i) policy coordination, (ii) service improvement and licensing acceleration and (iii) improved policy implementation.

1.1.3 **Specific Directions:** Against the general direction set out in 1.1.2 above and in the context of promoting Domestic Processing & Refining, PI 3/2013 directs, among other things:

(a) MoEMR to facilitate energy supply and establish policies on the fulfillment of the Domestic Processing & Refining obligation in respect of particular mining products;

(b) MoI to prepare a "roadmap" of the "mineral basis industry";

(c) MoT to establish policies on export, import and domestic trading;

(d) MoF to establish policies on fiscal incentives;

(e) MoIA to develop, supervise and evaluate local government licensing policies;

(f) MoSoE to develop SoEs, establish priorities for state capital investment in SoEs and facilitate energy supply by SoEs;

(g) MoE to evaluate environmental laws and regulations impeding Domestic Processing & Refining;

(h) Governors to accelerate license recommendations and grants as well as to facilitate infrastructure development; and

(i) Regents/Mayors to accelerate license recommendations and grants as well as to facilitate infrastructure and associated facilities development.

1.1.4 **Coordinating Minister:** The Coordinating Minister is charged with responsibility for overall implementation of PI 3/2013 as well as with providing semi-annual reports to the President on the progress being made in facilitating the start of Domestic Processing & Refining in January 2014 or soon thereafter.

1.1.5 **Policies & Roadmap:** Completion of the policies and roadmap for Domestic Processing & Refining, called for by the general and specific directions outlined in 1.1.1 to 1.1.4 above, is required not later than 6 months from the issuance of PI 3/2013.

1.2 <u>Assessment</u>

The good intentions of the Government, in issuing PI 3/2013, may be wholeheartedly acknowledged and no one could seriously doubt the need for much greater policy co-ordination in the area of Domestic Processing & Refining. Notwithstanding these good intentions and the undeniable policy coordination imperative, however, PI 3/2013 is simply far too little, far too late in terms of making Domestic Processing & Refining a reality in January 2014 or soon thereafter. In this regard, any number of legitimate concerns re PI 3/2013 may be raised. Some only of these concerns are set out below.

First, as Domestic Processing & Refining, starting in January 2014, has been contemplated since 2009 one must ask why it is that the Government has only started to think about the need for better policy coordination 10 months before the deadline for Domestic Processing & Refining to begin.

Second, assuming the policies and roadmap, called for by PI 3/2013, will actually be available in July 2013, as also called for by PI 3/2013, the Government has left itself with a mere 5 months to implement those policies before the January 2014 deadline for Domestic Processing & Refining. At the risk of stating the obvious, there is clearly almost no possibility that policies, rolled out in July 2013 for the first time, on issues such as energy supply, fiscal incentives, infrastructure development and licensing, are going to have any material impact on making Domestic Processing & Refining a reality come January 2014.

Third, the chances of 8 Ministers and a far greater number of Governors, Regents and Mayors being able to (i) resolve all the issues that relate to intractable problems like energy supply and infrastructure development and (ii) then agree on detailed policies and roadmaps for implementing such resolution, all within 6 months, seem remote to say the least. This is all the more so given the very poor track record of cooperation and coordination among Indonesia's central, provincial and regional governments on much less difficult issues than Domestic Processing & Refining.

Fourth, PI 3/2013 is particularly notable for its complete lack of any detail or any meaningful substance, in terms of guidance, parameters or legal basis for the development of the policies needed to make Domestic Processing & Refining a reality by January 2014. While Presidential Instructions would not, by their very nature, normally be expected to contain a lot of detail, PI 3/2013 seems particularly devoid of substance and more of a grand statement of a noble objective rather than the articulation of a coherent action plan for achieving something as elusive and difficult as meaningful Domestic Processing & Refining by January 2014.

Fifth, PI 3/2013 may actually delay the implementation of Domestic Processing & Refining. This is because PI 3/2013 holds out the tantalizing prospect of fiscal and other incentives being offered by the Government in order to encourage the construction of the facilities necessary to make Domestic Processing & Refining a reality. Further, there is a definite suggestion, implicit in PI 3/2013, that the requirements for Domestic Processing & Refining, in respect of particular mineral products, may be reduced or varied from those requirements set out in MoEMRR 7/2012. Logically, anyone planning to start construction of processing and refining facilities in the near future will now stop all work and wait to see what may eventuate in terms of fiscal incentives or reduced/varied requirements for Domestic Processing & Refining in respect of particular mining products so as to make sure that they (i) qualify for such fiscal incentives and (ii) construct processing and refining facilities with technical capabilities that match and do not exceed any reduced/varied requirements for Domestic Processing & Refining in respect of particular mining products.

Sixth and most seriously, PI 3/2013 is predicated on the assumption that Domestic Processing & Refining makes sense and is otherwise a worthwhile objective for Indonesia to be pursuing in 2014 or soon thereafter. As we will see in Part 2 below, however, this assumption may be wholly unwarranted such that the introduction of Domestic Processing & Refining, whether in January 2014 of any time thereafter, could prove to be a costly mistake for Indonesia.

2. **Economics of Domestic Processing & Refining**

2.1 **Overview**

What appears to be the first comprehensive and serious study of the economic rationale for Domestic Processing & Refining in Indonesia has just been completed by a USAID funded team lead by Dr. Tyler Biggs ("**USAID Study**"). The USAID Study examined the value chains for the Domestic Processing & Refining of Indonesia's 3 main metal mineral products, apart from tin, being copper, bauxite and nickel.

A draft report on the results of the USAID Study was recently presented by Dr. Biggs, to the Ministry of Trade and other interested parties, at a forum on 4 March in Jakarta ("**USAID Report**")[5].

Although the USAID Report has yet to be finalized, its most important conclusions are that:

(a) In the case of each of copper, bauxite and nickel, there is already substantial excess smelting and refining capacity in the world, especially in China, and this excess capacity continues to grow.

(b) The presence of so much excess smelting and refining capacity will make it very difficult for "greenfields" domestic smelting and refining facilities in Indonesia to ever be competitive given the low capital and operating costs of the existing Chinese facilities.

(c) The required capital investments for Indonesia's contemplated smelting and refining facilities are huge and continue to grow. The opportunity cost of such capital investment is very hard to justify given the pressing need for capital investment in other areas of the Indonesian economy.

(d) The operating costs of "greenfields" domestic smelting and refining facilities in Indonesia will also be quite high, particularly in terms of electricity costs.

(e) As a result of the world wide excess capacity, market rates for the provision of smelting and refining services are exceptionally low and are not expected to rise much in the foreseeable future.

(f) The required complimentary investments in electricity generation and other infrastructure needed for Indonesia's contemplated smelting and refining facilities are huge and a long way off.

(g) There is little domestic demand for smelter by-products, something which greatly constrains the expected profitability of Indonesia's contemplated smelting and refining

[5] USAID and Nathan Associates Inc, "Export Restrictions: The Economic Effects of Indonesia's Impending Export Restrictions on Unprocessed Mineral Resources", draft February 2013.

facilities.

(h) Banks and other providers of finance, on arms-length commercial terms, will be very reluctant to finance Indonesia's contemplated smelting and refining facilities because of the low projected returns.[6]

The USAID Report goes on to record the finding that, if the Government persists with the Domestic Processing & Refining obligation, Indonesia will actually incur a very substantial net welfare loss and create deadweight efficiency distortions for the Indonesian economy as a whole.[7] In other words, not only will Domestic Processing & Refining fail to deliver the benefits for Indonesia and the Indonesian people which the Government has long claimed, Indonesia and the Indonesian people will actually be materially worse off than they would have been had the Government never sought to introduce Domestic Processing & Refining. The net welfare loss to Indonesia, from Domestic Processing & Refining, identified in the USAID Study is due to (i) the much lower smelting and refining costs in China which mean that smelting and refining facilities built in Indonesia are never likely to be able to carry out Domestic Processing & Refining as effectively and efficiently as in China and (ii) the lack of any material compensating and offsetting benefits to be derived from compulsory Domestic Processing & Refining in Indonesia, such as a significant increase in employment opportunities, which other benefits USAID Study found to be very modest indeed.[8]

Finally, the USAID Report makes the important point that the Government's support for Domestic Processing & Refining seems to based on the untested and, probably, false premise that promoting downstream processing of natural resources, previously exported as unprocessed raw materials, must be the best economic policy for a country, such as Indonesia, which is rich in natural resources to pursue. In fact, according to the USAID Report, insistence upon downstream processing and refining may make very little sense for Indonesia given it is operating in a world where (i) the costs of transport, information and communications technology are continuously falling and (ii) trade and globalization are continuously increasing.[9]

At the 4 March forum with MoT and other interested parties, the Government was not willing or able to present any evidence that showed the Government had carried out its own detailed analysis of the economics of Domestic Processing & Refining in Indonesia or that, if it has carried out such analysis, the results of the same were any different from the results of the USAID Study.

2.2 Analysis

It would hardly be an understatement to say that the USAID Report is a searing indictment of the economic rationale for Domestic Processing & Refining in Indonesia. Given Domestic Processing & Refining is meant to be a critical element of the Government's determination to

[6] Ibid at pages 19 to 20.
[7] Ibid at page 59.
[8] Ibid at pages 59 to 63.
[9] Ibid at pages 53 to 58.

ensure that Indonesia and the Indonesian people as a whole derive more benefit from the local mining industry than they have in the past, the key finding of the USAID Study, that Indonesia and Indonesians will actually be worse off rather than better off if the Government continues to insist upon Domestic Processing & Refining, seems to undermine the whole basis and rationale for Domestic Processing & Refining in Indonesia.

The writer is particularly struck, however, by the fact that it is only now, in March 2013 and with the start date for Domestic Processing & Refining a mere 10 months away, the hard questions are apparently being asked, for the very first time and in any carefully researched and documented manner, about whether or not Domestic Processing & Refining actually makes good economic sense for Indonesia to pursue. This seems to be a classic case of "shutting the stable door after the horse has bolted". Surely, the Government should have commissioned its own carefully researched and documented study, of the economics of Domestic Processing & Refining and the likely resulting implications of Domestic Processing & Refining for Indonesia and Indonesians as a whole, **<u>before</u>** it committed itself to a policy of Domestic Processing & Refining and setting a start date for Domestic Processing & Refining of January 2014. If the Government actually does have any serious economic analysis which justifies its commitment to Domestic Processing & Refining, now would seem like a good time to make it publicly available. In the event the Government has not previously commissioned any serious economic analysis which justifies its commitment to Domestic Processing & Refining, troubling issues inevitably arise as to how the Government goes about setting policy for the local mining industry.

Assuming the Government has, indeed, not previously commissioned any serious economic analysis, which justifies its commitment to Domestic Processing & Refining, the explanation for this extraordinary lapse may be found in the beguiling character of Domestic Processing & Refining as a policy initiative. At first glance, the inherent attractiveness of Domestic Processing & Refining, to a country such as Indonesia, seems so obvious that any serious economic analysis of the same may be regarded as unnecessary and, indeed, a waste of time and money. While this is an understandable initial impression, the USAID Study indicates that this initial impression is, most probably, misconceived in the case of Indonesia. At the risk of stating the obvious, however, Government policy on critically important matters such as Domestic Processing & Refining, should not be based on first impressions or "gut" reactions but, rather, be firmly grounded in serious and properly documented analysis.

SUMMARY AND CONCLUSIONS

Despite the Government's not to be questioned good intentions, PI 3/2013 is simply far too little, far too late in terms of making Domestic Processing & Refining a reality by January 2014 or any time soon thereafter.

More importantly, however, if the results of the recently concluded USAID Study are to be accepted at face value, PI 3/2013 is based on the wholly erroneous assumption that Domestic Processing & Refining makes good economic sense as a policy for Indonesia to be pursuing.

Assuming it really is the case that Domestic Processing & Refining will actually produce a significant net welfare loss for Indonesia, the misconceived nature of PI 3/2013 and the damning USAID Report seem to make very clear that, at least when it comes to Domestic Processing & Refining in Indonesia, this is an all too obviously a situation of the "Emperor having no clothes".

The Government's policy on Domestic Processing & Refining may well be in real danger of being cited as a main contributor to the recent finding of the highly regarded and widely read Fraser Institute Survey for 2012/2013[10] that Indonesia is now the least desirable country in the world, from a government policy perspective, in which to carry on a mining project. In the "race to the bottom", Indonesia has finally beaten out other traditional stalwarts such as the Congo, Zimbabwe and Venezuela. The Government's policy on Domestic Processing & Refining may well provide, at least in part, the answer to why Indonesia has finally achieved this unenviable position.

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[10] Alana Wilson, Fred McMahon and Miguel Cervantes, Fraser Institute Annual Survey of Mining Companies 2012/2013, February 2013.