

DOWNSTREAM PROCESSING & REFINING – KEEPING EVERYONE HAPPY IS NEVER EASY¹²³⁴⁵

INTRODUCTION

The Government has had considerable success in advancing its objective of full domestic processing and refining of all metal minerals produced in Indonesia. This is particularly so in the case of Nickel Ore and notwithstanding the many changes to the Government's policy on the banning of exports of Nickel Ore.

The Government is, apparently, now committed to not relaxing or changing again the present export ban on Nickel Ore that was controversially brought forward, in late 2019, to the beginning of 2020.

Continuing progress in domestic processing and refining is, however, dependent (at least in part) on the Government's ability to keep all stakeholders on side and at least minimally satisfied with the economic outcome for them of domestic processing and refining. Two of the most important stakeholders are Indonesia's producers of metal minerals and investors in/operators of smelters/refineries.

The Government has clearly found it particularly challenging to reconcile the competing interests of producers of Nickel Ore and investors in/operators of Nickel smelters as well as its own fiscal interests in avoiding any negative impact on Government revenue as a result of transfer pricing. In this regard, the Government is learning to its chagrin that keeping everyone happy is never easy!!

A newly issued regulation seeks to both placate producers of Nickel Ore by offering them a degree of price certainty, in respect of domestic sales of Nickel Ore to Nickel smelter operators, and minimize the risk of transfer pricing in domestic Nickel Ore sales. It remains to be seen, though, whether or not this latest initiative will be sufficient to either end the lobbying of certain Nickel Ore producers for a relaxation of the Nickel Ore export ban or effectively protect the Government's fiscal position.

In this article, the writer will review the newly issued regulation on benchmark pricing of Nickel Ore before considering whether or not this new regulation is likely to be effective in achieving its various presumed objectives.

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⁵ An earlier version of this article appeared in the August – September 2020 edition of Coal Asia Magazine.

BACKGROUND

In January 2017, the Government announced that it would allow (i) the continuation of exports of certain metal mineral concentrates (concentrates being intermediate and only partially refined metal mineral products) beyond the then 11 January 2017 deadline for full domestic processing and refining of all metal minerals (“**2017 Concentrate Export Continuation**”) and (ii) the resumption of exports of substantially unprocessed/unrefined Nickel Ore and Bauxite Ore which had been banned since 11 January 2014 (“**2014 Export Ban**”) (“**2017 Nickel Ore & Bauxite Ore Export Resumption**”) (together, “**2017 Export Ban Relaxation**”).

The 2017 Export Ban Relaxation allowed parties, producing concentrate forms of Copper and certain other metals, to continue to export their concentrate products, in quantities approved by the Ministry of Energy & Mineral Resources (“**ESDM**”), for a maximum of five years until 11 January 2022 and so long as they fulfilled certain conditions (“**2017 Concentrate Export Conditions**”).

The 2017 Export Ban Relaxation also allowed parties, producing Nickel Ore, to resume export of unprocessed Nickel Ore, with a Nickel content of less than 1.7% and in ESDM approved quantities, for a maximum of five years until 11 January 2022 and so long as they fulfilled certain conditions (“**2017 Nickel Ore Export Conditions**”).

Finally, the 2017 Export Ban Relaxation allowed parties, producing Bauxite Ore, to resume export of washed Bauxite Ore, with an aluminum oxide content of at least 42% and in ESDM approved quantities, for a maximum of five years until 11 January 2022, so long as they fulfilled certain conditions (“**2017 Bauxite Ore Export Conditions**”).

The 2017 Concentrate Export Conditions, the 2017 Nickel Ore Export Conditions and the 2017 Bauxite Ore Export Conditions are substantially the same, namely:

- (a) in the case of foreign-owned producers, commitment to divesting 51% of their issued shares to local parties within ten years of commencing production;
- (b) **commitment to constructing domestic smelters within five years;**
- (c) have smelter construction plans independently verified and approved by ESDM;
- (d) **make 90% ongoing progress in fulfilling their existing commitments to domestic smelter construction;**
- (e) renew their export permits every twelve months; and
- (f) pay the applicable export tax of up to 10%.

While the 2017 Concentrate Continuation was widely expected, the 2017 Nickel Ore & Bauxite Ore Export Resumption took many people by surprise.

In late 2019, the Government unexpectedly brought forward the ban on the export of Nickel Ore, with a Nickel content of less than 1.7%, from 11 January 2022 to 31 December 2019 and thereby effectively banned the export of all Nickel Ore as of 31 December 2019 (“**2019 Nickel**”).

Ore Export Ban”). The Government, however, left in place the 2017 Concentrate Continuation and the 2017 Nickel Ore & Bauxite Ore Export Resumption **in respect of Bauxite Ore only**.

Readers interested in knowing more about the confused and confusing history of the 2019 Nickel Ore Export Ban are referred to the writer’s earlier articles being (i) *“Is the Export Ban Really Going to be Enforced in January 2014 After All?”*, Petromindo, Coal Asia Magazine December 2013 – January 2014; (ii) *“The Export Ban as Finally Introduced – A Grand Compromise with Much Residual Uncertainty”*, Petromindo, Coal Asia Magazine, January – February 2014, (iii) *“The Unfinished Business of the Export Ban – Old and New Issues Frustrate the Grand Compromise”*, Petromindo, Coal Asia Magazine February - March 2014; (iv) *“Export Ban Upheld by Constitutional Court”*, Petromindo, Coal Asia Magazine, January – February 2015, (v) *“Metal Mineral Export Ban – Showdown at the O.K. Corral?”*, Petromindo, Coal Asia Magazine, October – November 2016, (vi) *“New Metal Mineral Export Conditions – Smoke & Mirrors”*, Petromindo, Coal Asia Magazine, February – March 2017 and (vii) *“Bringing Forward Nickel Ore Export Ban – Compounding Investor Uncertainty Problem”*, Petromindo, Coal Asia Magazine, September – October 2019.

The 2019 Nickel Ore Export Ban no doubt makes good sense, at least from the perspective of the Government and investors in/operators of Nickel smelters, given the undeniable progress that has been made in encouraging downstream processing and refining of Nickel Ore compared to other metal minerals. In this regard, it was recently reported by on-line news portal Kontan.co.id that ESDM projects 48 Nickel smelters will be fully operational by 2024. Of these projected 48 Nickel smelters, 11 are already operating and 19 are under construction.

It is, nevertheless, also entirely understandable that some producers of Nickel Ore feel very much unfairly treated, as a result of the 2019 Nickel Ore Ban, compared to producers of other metal minerals generally (which can still export in concentrate form subject to compliance with the 2017 Concentrate Export Conditions) and, more particularly, compared to producers of Bauxite Ore which can still export (if only until 2022 at this stage) Bauxite Ore subject to compliance with the 2017 Bauxite Ore Export Conditions.

It is those Nickel Ore producers, which have neither already constructed nor are proposing to construct their own Nickel smelters, that are most adversely affected by the 2019 Nickel Ore Export Ban. With export markets closed to them, these Nickel Ore producers are left with no alternative but to sell their production domestically to Nickel smelter operators. Self-evidently, Nickel smelter operators have the much stronger bargaining position when it comes to negotiating the purchase price for Nickel Ore supplied by producers, without their own Nickel smelters and no other alternative buyers available overseas for their production.

Nickel Ore producers, without their own already operating, under construction or proposed Nickel smelters, have continued to lobby vociferously for a relaxation of the 2019 Nickel Ore Export Ban, highlighting that (i) Nickel Ore producers are being treated less favourably than other metal mineral producers and (ii) the Government has not strictly enforced either the 2017 Concentrate Export Conditions or the 2017 Bauxite Ore Export Conditions, particularly with regard to required smelter construction progress. These Nickel Ore producers also represent a potential threat to the realization of the Government’s downstream processing and refining objectives as there must be a heightened risk of these Nickel Ore producers engaging in illegal export activities if they cannot obtain a domestic price for their Nickel Ore production that provides them with a reasonable return on their invested capital. Illegal mineral exports have

been a huge problem for the Government in the past and could easily become so again as effectively controlling illegal mineral exports is very difficult to achieve in practice and in an environment of weak Government control and widespread corruption. If the Government wants Nickel smelter construction to continue, it cannot afford to allow prospective investors in and financiers of Nickel smelters to have serious worries that illegal exports of Nickel Ore may become widespread and thereby undermine the international price competitiveness of fully processed and refined Nickel products from Indonesia.

Having regard to the above, the Government needs to try to address the domestic pricing concerns of those Nickel Ore producers without their own already operating, under construction or proposed Nickel smelters. Although probably relatively small in number, these Nickel Ore producers could have an outsize negative impact on the realization of Nickel smelter construction targets and, thereby, undermine the Government's biggest success story, to date, in terms of downstream processing and refining if they were to become seriously alienated by lack of action on their domestic pricing concerns.

In addition to the problems faced by Nickel Ore producers, without their own already operating, under construction or proposed Nickel smelters, the Government also has reason to be concerned about the potential for transfer pricing problems to arise in the case of Nickel Ore producers selling Nickel Ore to Nickel smelter operators which are affiliates of the Nickel Ore producers. The potential for transfer pricing problems to arise is increased by virtue of the preferred mining industry operating model which is to have different but affiliated companies carrying on the Nickel Ore production activities and the Nickel smelting activities. To the extent Nickel Ore production is more profitable than Nickel smelting, there is clearly an incentive for groups, with both Nickel Ore producers and Nickel smelters operated by different companies in the group, to shift revenue away from the more profitable Nickel Ore producers to the less profitable, affiliated Nickel smelters by setting the price for Nickel Ore sold to affiliates at less than an arms-length price. This has negative tax revenue implications for the Government in two distinct ways. First, the Government's non-tax State revenue or production royalty revenue is reduced as the production royalty is calculated on the basis of the price of Nickel Ore as first sold by the producer. Second, the Government's income tax revenue is reduced as income tax is calculated on the net profits of the Nickel Ore producer and the Nickel smelter operator respectively.

Having regard to the above, it is not surprising that the Government has recently moved to address both the domestic pricing concerns of Nickel Ore producers and its own transfer pricing concerns pursuant to Minister of Energy & Mineral Resources ("MoEMR") Regulation No. 11 of 2020 re Third Amendment to MoEMR Regulation No. 7 of 2017, dated 13 April 2020, re Procedures for Determining Metal Mineral Benchmark Prices and Coal Benchmark Prices ("MoEMRR 7/2017") ("MoEMRR 11/2020").

ANALYSIS AND DISCUSSION

1. Overview

MoEMRR 11/2020 came into force on 13 May 2020 and introduces so-called "benchmark pricing" for domestic sales of metal minerals including Nickel Ore.

The extension to metal minerals, of the preexisting benchmark pricing system for coal, was provided for in the amendments to the 2009 Minerals & Coal Mining Law approved by the Indonesian Parliament in the second quarter of 2020.

The objectives of MoEMRR 11/2020 are, most probably, at least three in number. First, MoEMRR 11/2020 seeks to ensure that Nickel Ore producers, without their own already operating, under construction or proposed Nickel smelters, receive a “fair” price for the Nickel Ore sold by them to operators of domestic Nickel smelters and given these Nickel Ore producers are precluded from accessing the export market for their Nickel Ore (“**Fairness Objective**”). Second, MoEMRR 11/2020 seeks to reduce pressure on the Government to relax the 2019 Nickel Ore Export Ban (“**No EB Relaxation Objective**”). Third, MoEMRR 11/2020 seeks to protect the Government’s revenue base by limiting the price setting discretion of Nickel Ore producers and Nickel smelter operators (“**Revenue Protection Objective**”).

Although the focus of this article is domestic sales of Nickel Ore, MoEMRR 11/2020 and the earlier regulation that it amends (i.e., MoEMRR 7/2017) have been drafted sufficiently generally so as to ensure that their provisions are applicable to coal and other metal minerals apart from Nickel Ore. It is also important to note that the provisions of MoEMRR 7/2017, only recently applied to Nickel Ore by virtue of the issuance of MoEMRR 7/2020, have been applicable (in many respects) to coal since 2017.

2. **Main Provisions**

2.1 **Benchmark Pricing for Nickel Ore:** Holders of Production Operation Mining Business Licenses for Nickel Ore and Special Production Operation Mining Business Licenses for Nickel Ore (“**Nickel Ore Production Operation IUPs/IUPKs**”) must follow the Benchmark Price (*Harga Patokan Mineral* or “**HPM**”) (“**HPM Requirement**”) for all sales of Nickel Ore (Article 2(1) of MoEMRR 11/2020).

The HPM Requirement specifically applies to domestic sales of Nickel Ore, by holders of Nickel Ore Production Operation IUPs/IUPKs, to Nickel smelter operators (Article 2(1) of MoEMRR 11/2020).

MoEMRR 11/2020 seeks to make clear that the HPM Requirement is equally binding on Nickel smelter operators purchasing Nickel Ore for use in their smelting operations and regardless of whether or not the seller of the Nickel Ore is an affiliate of the relevant Nickel smelter operator (Article 2(2) of MoEMRR 11/2020).

Notwithstanding the foregoing, there is some flexibility in the application of the HPM Requirement as is highlighted in 2.4 below.

2.2 **Methodology of Nickel Ore HPM Determination:** Nickel Ore HPM is to be determined in reliance upon one or both of the following methodologies:

- (a) the “market pricing mechanism”; and/or
- (b) having regard to a number of specified factors being:
 - (i) generally accepted international market prices;

- (ii) any increase in mineral added value; and
- (iii) the need to implement good mining rules (Article 2(3) of MoEMRR 11/2020).

Although far from clear, enquiries made by the writer's staff with ESDM indicate that the reference to the "market pricing mechanism" in (a) above is intended to refer to London Metal Exchange prices, being the traditional reference point for pricing metal minerals. No guidance, though, is provided as to in what circumstances one methodology is to be preferred over the other methodology.

- 2.3 **Nickel Ore HPM to be used for Calculating Production Royalty:** Nickel Ore HPM sets the lower boundary for calculating the Production Royalty payable to the Government in respect of the first sale of Nickel Ore (Article 2(3) of MoEMRR 11/2020).

Having regard to the above and even if the actual selling price of Nickel Ore, in a particular sale and purchase transaction, is lower than Nickel Ore HPM (see 2.4 below), Nickel Ore HPM must still be used for the purpose of calculating the Production Royalty payable in respect of that particular sale and purchase transaction. If, however, the actual selling price of Nickel Ore, in a particular sale and purchase transaction, is higher than Nickel Ore HPM, the actual selling price must be used for the purpose of calculating the Production Royalty payable in respect of that particular sale and purchase transaction.

- 2.4 **Provision for Selling Price Flexibility:** Notwithstanding 2.1 above, the drafters of MoEMRR 11/2020 recognized the possibility that transaction prices for Nickel Ore may legitimately differ as between the quotation period and the transaction period. Accordingly, the actual selling price of Nickel Ore may be not more than 3% lower than Nickel Ore HPM for the relevant transaction period. It seems, however, that there is no limitation on the extent to which the actual selling price of Nickel Ore may be greater than Nickel Ore HPM for the relevant period (Article 3(3) of MoEMRR 11/2020).

- 2.5 **Responsibility for Nickel Ore HPM Determination:** MoEMR is responsible for determining Nickel Ore HPM on a monthly basis and with the determined Nickel Ore HPM being stipulated in a MoEMR decree (Article 6(6) of MoEMRR 11/2020).

- 2.6 **Nickel Ore HPM Determination Formula:** MoEMR is to calculate or "determine" the monthly Nickel Ore HPM using a formula to be developed by MoEMR and which formula may be adjusted every six months if desirable or necessary (Article 6(3) of MoEMRR 11/2020).

The Nickel Ore HPM formula is to reflect a number of variables being:

- (a) relevant Nickel Ore grade;
- (b) constants;

- (c) **minimum** Nickel Ore HPM (“HMA”);
- (d) corrective factor;
- (e) treatment costs and refining charges; and/or
- (f) payable metal (Article 6(4) of MoEMRR 11/2020).

HMA is to be determined monthly having regard to Nickel Ore prices quoted by:

- (a) London Metal Exchange;
- (b) London Bullion Market Association;
- (c) Asian Metal;
- (d) Indonesia Commodity & Derivatives Exchange;
- (e) Jakarta Futures Exchange; and
- (f) other reference sources used in selling Nickel Ore domestically and abroad in accordance with statutory provisions (Article 6(7) of MoEMRR 11/2020).

MoEMRR 11/2020 does not provide any elucidation or explanation as to what is meant by the various, specified Nickel Ore HPM formula elements of (i) “constants”, (ii) “corrective factor” and (iii) “payable metal”. Enquiries made by the writer’s staff with ESDM have done little to make entirely clear just what each of these elements refers to. The writer’s **present** understanding, though, is that (i) “constants” are intended to refer to certain mathematical variables, (ii) “corrective factor” is an adjustment or compensation amount proposed by MoEMR and (iii) “payable metal” refers to the quantity of Nickel Ore that the relevant Nickel smelter operator is obliged to pay for pursuant to the underlying sale and purchase contract. The intention may well be to ensure that ESDM has a considerable degree of flexibility in determining Nickel Ore HPM as it tries to balance the competing concerns of Nickel Ore producers and Nickel smelter operators.

2.7 Quality Verification by Surveyor and Appointment of Surveyor: Holders of Nickel Ore Production Operation IUPs/IUPKs are obliged to verify the quality and quantity of the Nickel Ore sold by them and using a surveyor registered with the Director General of Minerals & Coal (“**Director General**”) (“**Registered Surveyor**”) (Article 9A(2) of MoEMRR 11/2020).

Contracts for the sale and purchase of Nickel Ore must include a provision for the appointment of a referee or umpire to decide any disputes that arise between the sellers and the buyers, which referee or umpire must be a Registered Surveyor (Article 9B(2) and (3) of MoEMRR 11/2020).

In the event that the respective seller and buyer analyses of the Nickel Ore sold and purchased in a particular transaction differ, the discrepancy is to be resolved on the basis of tests carried out by the Registered Surveyor named as referee or umpire in the

underlying contract for sale and purchase of Nickel Ore (Article 9B(1) of MoEMRR 11/2020).

2.8 **Administrative Sanctions:** Nickel Ore producers, which violate various provisions of MoEMRR 11/2020 including (most importantly) the HPM Requirement, may receive administrative sanctions in the form of:

- (a) written warnings;
- (b) temporary or partial suspension of mining business activities; and/or
- (c) revocation of Nickel Ore Production Operation IUPs/IUPKs (Article 12(2) of MoEMRR 11/2020).

Likewise “other parties”, which violate various provisions of MoEMRR 11/2020 including (most importantly) the HPM Requirement, may receive administrative sanctions in the form of:

- (a) written warnings;
- (b) temporary or partial suspension of mining business activities; and/or
- (c) revocation of business licenses (Article 12(2) of MoEMRR 11/2020).

Although not made clear, the “other parties” referred to above, presumably, include Nickel smelter operators.

3. **Evaluation of MoEMRR 11/2020**

3.1 **Fairness Objective:** The Fairness Objective behind MoEMRR 11/2020 was well expressed by the Acting Director General of Minerals & Coal, Rida Mulyana, when he said, during a virtual press conference on 20 July 2020 and as subsequently quoted by on-line news portal Tambang.co.id, that:

“[The task of the Government] is how to find a balance or fair price between profits for smelters and guarantee nickel mining activities can provide sufficient margins for miners.”

“Fairness”, however, is inevitably always a relative concept rather than an absolute concept as Rida Mulyana subsequently made clear, in the same virtual press conference, when he indicated that the Government intended to set Nickel Ore HPM below international prices in order to improve the financial performance of domestic smelters. In this regard, the Director of Development and Mineral Exploitation, Yunus Saefulhak, said (again as quoted by Tambang.co.id):

“For example if the international price [of Nickel Ore] is USD60 [per WMT], in us [Indonesia] the most [highest HPM] is USD30 [per WMT].”

The above quotes should be interpreted as meaning that the Government attaches the highest priority to ensuring strong Nickel smelter economics as this will serve to encourage greater investment in Nickel smelter construction. However, at the same time the Government does not intend to ignore altogether the financial plight of Nickel Ore producers and, to this end, wants to ensure that the Nickel Ore HPM is at least sufficient to cover the production cost of Nickel Ore producers as well as guaranteeing them some profit margin.

The reaction to MoEMRR 11/2020 has been mixed to say the least. As might have been expected, the Indonesian Nickel Miners Association (“**APNI**”) has expressed qualified support for the HPM Requirement and suggested that MoEMRR 11/2020 is the outcome of a collective process in which the interests of all relevant parties were carefully considered. By contrast, the Association of Processing & Refining Industry Companies (“**AP3I**”), which represents Nickel smelter investors/operators among others, has been noticeably “lukewarm” about MoEMRR 11/2020, maintaining that domestic Nickel Ore prices should be determined, on a “business to business” basis, by direct negotiation between Nickel Ore producers and Nickel smelter operators. AP3I has also suggested that the HPM Requirement relies on Nickel Ore prices that are three months old and, therefore, do not necessarily reflect the market price of Nickel Ore at the time any particular sale and purchase of Nickel Ore takes place. In this regard, the AP3I vice chairman was quoted, in the 27 July 2020 edition of The Jakarta Post, as having said:

“The know nickel is a global commodity and the world follows LME prices. keep changing and cannot be pegged at one figure and so on.”

AP3I has gone so far as to suggest that MoEMRR 11/2020 and the HPM Requirement are just another example of bureaucrats making regulations in respect of an industry and a technical subject that they do not understand.

- 3.2 **No EB Relaxation Objective:** A cynical observer might suggest that what the Government is actually seeking to do is to identify the minimum Nickel Ore HPM that Nickel Ore producers are willing to accept in return for (i) dropping their lobbying efforts to overturn the 2019 Nickel Ore Export Ban and (ii) no longer continuing to embarrass the Government by publicising the Government’s poor record in strictly enforcing the 2017 Concentrate Export Conditions and the 2017 Bauxite Ore Export Conditions, particularly with regard to required smelter construction progress.

While generally supportive of the HPM Requirement, APNI has pointed out that MoEMRR 11/2020 does not even begin to address an associated problem of what to do with Indonesia’s large reserves of low grade Nickel Ore. Claiming that only a small part of Indonesia’s reserves of Nickel Ore actually comprises so-called high grade Nickel Ore (i.e., Nickel Ore with a metal content of more than 1.7%), APNI has highlighted that, if domestic Nickel smelter operators continue to exclusively buy high grade Nickel Ore, Indonesia’s existing reserves of high grade Nickel Ore may not be sufficient to support much more than another 7 years of domestic Nickel smelter operation. By implication, APNI would seem to be advocating the possible amendment/expansion of MoEMRR 11/2020 to also control what grades of Nickel Ore are bought by domestic Nickel smelter operators and, so, ensure that Indonesia’s producers of low grade Nickel Ore are not left without any market for their production. In the alternative, it may be that APNI still wants to see the relaxation of the 2019

Nickel Ore Export Ban at least in respect of low grade Nickel Ore and assuming domestic Nickel smelter operators cannot be otherwise “persuaded” to buy more low grade Nickel Ore.

- 3.3 **Revenue Protection Objective:** MoEMRR 11/2020 seeks to protect the Government’s revenue base by providing that the Production Royalty payable by Nickel Ore producers is calculated on the higher of Nickel Ore HPM and the actual selling price in any Nickel Ore sale and purchase transaction. Setting Nickel Ore HPM as the effective “floor price” for Production Royalty calculation is substantially the same approach that the Government has previously adopted in the case of coal. This, presumably, indicates the Government has found, based on its experience with coal producers, that using a Government determined benchmark price as the “floor price” for Production Royalty calculation is, at least, a somewhat effective way to avoid transfer pricing between related sellers and buyers of mineral commodities and otherwise protect its revenue base.

SUMMARY AND CONCLUSIONS

MoEMRR 11/2020 seeks to balance the interests of multiple parties including Nickel Ore producers, Nickel smelter investors/operators and the Government. This is a very challenging task and it remains unclear how successful MoEMRR 11/2020 is going to be in achieving the desired balance.

Neither Nickel Ore producers nor Nickel smelter investors/operators are entirely satisfied with MoEMRR 11/2020 as was, perhaps, always inevitable.

As the Government continues to be under pressure to do more to help both Nickel Ore producers and Nickel smelter investors/operators, MoEMRR 11/2020 is arguably a good example of the perils of Government interference with the normal market mechanism for determining demand, price and supply – **no one is happy and everyone expects the Government to do still more.**

Trying to keep all the stakeholders, in the local Nickel industry, more or less happy and at least somewhat onside with the Government’s downstream processing and refining policy for metal minerals is indeed not an easy task and, perhaps, it was a mistake for the Government to even try to do so. “Fairness”, in particular, is the most elusive of objectives and one in respect of which consensus, among the competing stakeholders, is **never** likely to be realised.

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