CHRISTIAN TEO & PARTNERS
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COAL DOWNSTREAMING – INCONSISTENCIES AND QUESTIONABLE POLICY CHOICES [1][2][3][4][5]

INTRODUCTION

Coal downstreaming has become an important topic in the ongoing public dialogue about the future of the Indonesian coal mining industry and as low coal prices squeeze the profit margins of Indonesian coal producers.

The Government is offering very significant benefits and incentives for coal producers that engage in downstreaming.

The term "coal downstreaming", however, is somewhat ambiguous and misleading as it is open to different interpretations. There are material inconsistencies in the New Mining Law and the Omnibus Law which create uncertainty as to just what qualifies as "coal downstreaming". It is also highly questionable whether or not all the permitted types of coal downstreaming should really attract the benefits and incentives currently being offered by the Government.

In this article, the writer will review what is meant by "coal downstreaming" in the New Mining Law and the Omnibus Law before turning to the issue of whether or not it makes sense for all permitted types of coal downstreaming to receive the various benefits and incentives being offered by the Government.

BACKGROUND

The business prospects for **traditional** coal mining in Indonesia do **not** look very encouraging at this point in time.

Indonesia's coal producers are being confronted by a combination of weak international demand for coal and low coal prices. As Indonesia is one of the world's largest producers of coal for export, this is a worrying combination.

According to the Indonesian Coal Mining Association ("**APBI**"), Indonesia will export 395 million tons of coal in 2020, down from 455 million tons of coal in 2019 or a drop of 13.2% year on year. Although the Ministry of Energy & Mineral Resources ("**ESDM**") is projecting a modest 3.6% growth in 2021 coal exports to 430 million tons, this will still be 8.9% below the 2019 export figure. Further, ESDM is expecting coal exports to stagnate at 441 million

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[5] An earlier version of this article appeared in the November - December 2020 edition of Coal Asia Magazine.

tons per year during the period from 2021 until at least 2024.

The problem that the decline in Indonesia's coal exports creates for local coal producers is being exacerbated by low international coal prices. Although the Newcastle benchmark thermal coal price has shown some recent improvement, it has had considerable difficulty holding above US$60 per ton for an extended period. This is to be compared with an average 2019 coal price of US$77.89 per ton. Coal prices are **not** expected to improve significantly in 2021, with Bank Mandiri projecting an average coal price of US$59.2 for 2021. The coal price outlook for the period from 2021 to 2024 also remains subdued, with various forecasters surveyed by Bloomberg projecting coal prices of as low as US$53 per ton in 2024.

The fall-off in demand for Indonesian coal exports is the result of (i) reduced industrial activity and weak economic conditions generally as a result of the Covid-19 pandemic and (ii) the so-called "energy transition" from overwhelming reliance upon fossil fuels including, most particularly, coal to environmentally friendly renewable energy for electricity generation. While the Covid-19 induced reduction in industrial activity is presumably only a temporary phenomenon, the energy transition is expected to be a permanent phenomenon which is only likely to grow in importance with the passage of time. As such, it is probably **not** realistic to expect that export demand for Indonesian coal will ever return to its "glory days" of 2006 to 2016 when, according to an April 2019 study by the Institute for Essential Services Reform ("**IESR**"), Indonesian coal exports increased by more than 250% over 10 years.

Weak international demand for Indonesian coal would be much less of a problem for local producers if domestic demand for Indonesian coal was growing strongly. This, however, is **not** the case. As APBI has recently pointed out, **not** more than 25% of Indonesian coal production is absorbed domestically and this absorption level has been more or less unchanged for some years. With 75% of Indonesian coal production exported, it is impossible for local coal producers to avoid the fallout from weak international coal demand as exacerbated by low world prices for coal.

The poor business outlook for traditional coal mining in Indonesia is not only a problem for local coal producers. It is a major problem for the Government as well. Coal is Indonesia's most important mineral export and the Government relies heavily on revenue from the coal industry. The percentage contribution that the coal industry makes to Government revenue varies from year to year and is a matter of some debate. However, according to IESR, in recent years coal production royalties may, on average, have been as much as 80% of the Government's total non-tax and non-oil & gas state revenue.

The traditional coal mining industry is also a major contributor to the local economies of East Kalimantan, South Kalimantan and South Sumatera. During the 4 November 2020 launch of the Study Series Report on the Indonesian Energy Transition Road Map, it was suggested that as much as 70 percent of the economic activity in some regencies of East Kalimantan in particular is based on traditional coal mining, with more than 100,000 jobs at risk if the traditional coal mining industry cannot find ways to profitably evolve.

The myriad problems, which a declining traditional coal mining industry create for the Government as well as for various Provincial and Regional Governments, undoubtedly explain (at least in part) the growing concern, at the highest levels of the Government, about

the slow growth in domestic absorption of Indonesia's coal production. During a limited cabinet meeting, on 23 October 2020, the President was reported as having said in exasperated terms:

> "*I want solutions to solve the slowness in the development of this coal derivative industry. Because we have been exporting raw coal for a long time, I think it must be ended."*

Although it seems quite fanciful to imagine that domestic absorption of Indonesia's coal production can ever fully replace coal exports, the President's evident exasperation at the slow pace of domestic coal absorption is supported by Presidential Regulation No. 22 of 2017 re National Energy General Plan ("**PR 22/2017**"). PR 22/2017 contemplates that coal exports should be gradually fazed out before stopping altogether by not later than 2046. PR 22/2017 is, however, predicated on the assumption that domestic absorption of coal will reach more than 400 million tons in 2046. This level of domestic coal absorption is only achievable if there is a massive expansion of what is increasingly referred to as "coal downstreaming". Very diplomatically, the Executive Director of APBI was quoted in the 30 October 2020 on-line edition of Kontan as having said in response to the President's comments:

> "*We leave it to the government regarding the policy whether coal will be used entirely domestically or can still be exported*."

ANALYSIS AND DISCUSSION

1. Preliminary Remarks

"Coal downstreaming" is **not** a term that appears anywhere in either Law No. 3 of 2020 re Amendments to the 2009 Minerals and Coal Mining Law ("**2009 Mining Law**") ("**New Mining Law**") or Law No. 11 of 2020 re Job Creation ("**Omnibus Law**").

The common usage of the term "coal downstreaming" is both ambiguous and potentially misleading because "downstreaming" is a concept that actually applies to metal minerals rather than to coal in the sense of downstream "processing and refining" of metal ore in order to produce metal mineral products with a much higher metal content than the original unprocessed and unrefined ore. Downstream "processing and refining" of metal ore is synonymous with so-called local "value added activity" intended to produce metal products that can be sold for much higher prices than the original unprocessed and unrefined metal ore.

Casual observers might very logically expect that "coal downstreaming" must also necessarily mean processing coal to produce higher value derivative products. However, **neither** the New Mining Law **nor** the Omnibus Law requires holders of mining business licenses ("**IUPs**")/special mining business licenses ("**IUPKs**") for coal ("**Coal IUPs/IUPKs**") or holders of IUPKs resulting from the conversion of Coal Contracts of Work ("**CCoWs**") ("**Continuation Coal IUPKs**") to carry out local "value added activity". At the same time, both the New Mining Law and the Omnibus Law offer very significant benefits and incentives to holders of Coal IUPs/IUPKs and Continuation Coal IUPKs which carry out "Development and/**or** Utilization of Coal" ("**Coal Development/Utilization")**.

Coal Development/Utilization, in fact, includes activities that are very different from local "value added activity" or downstream "processing and refining" as these expressions are used in the case of metal ore.

2. Coal Development/Utilization

2.1 **Whose Responsibility is Coal Development/Utilization?**: The New Mining Law represents a very interesting departure from the 2009 Mining Law in terms of responsibility for Coal Development/Utilization.

Article 102 of the 2009 Mining Law **required all** Coal IUP/IUPK holders to:

> "***enhance the added value*** *of minerals* ***and/or coal*** *in the implementation of mining, processing and smelting* ***as well as utilization of*** *minerals and* ***coal***."

In other words, prior to the New Mining Law it was **compulsory/mandatory** for Coal IUP/IUPK holders to carry out **both** "added value activity" in respect of their coal production **and** utilization of their coal production. That said, the Ministry of Energy & Mineral Resources ("**ESDM**") effectively gave Coal IUP/IUPK holders a "free pass" on compliance with their coal added value activity and utilization obligations while insisting that holders of IUPs/IUPKs for metal minerals complied with their corresponding added value and utilization obligations in respect of their metal ore production (**i.e.**, "downstream processing and refining").

The New Mining Law, however, treats holders of Coal IUPs/IUPKs and holders of Continuation Coal IUPKs very differently. Article 102(2) of the New Mining Law provides that holders of Coal IUPs/IUPKs "**may**" (**i.e.**, it is discretionary/optional) carry out Coal Development/Utilization once they reach production operation. Article 169A(4) of the New Mining Law, though, provides that holders of Continuation Coal IUPKs **"must**" (**i.e.**, it is compulsory/obligatory) carry out Coal Development/ Utilization.

It should be pointed out in passing that holders of Coal IUPs/IUPKs are also treated much better than are holders of metal mineral/mon-metal mineral/rock IUPs/IUPKs under the New Mining Law. Article 102(1) of the New Mining Law makes all too clear that holders of metal mineral/non-metal mineral/rock IUPs/IUPKs "**must**" carry out processing and refining in the case of metal minerals and processing in the case of non-metal minerals and rocks once they reach production operation.

The simple reader **might** reasonably assume that compulsory/obligatory Coal Development/Utilization represents an onerous additional obligation that is imposed on holders of Continuation Coal IUPKs only and as part of the "price" for former CCoW holders being allowed to receive Continuation Coal IUPKs upon the expiry of their CCoWs. As will become clear in 2.2 below, however, it is **not** the case at all that Coal Development/Utilization is necessarily going to be an onerous additional obligation for holders of Continuation Coal IUPKs. **It all depends upon what is actually meant by the term "Coal Development/Utilization" as this term is used in the New Mining Law and the Omnibus Law**.

2.2 **What is Coal Development/Utilization?**: Coal Development/Utilization is defined in Article 1.20b of the New Mining Law as being:

> "*efforts to* ***improve the quality of coal*** *with our without changing its initial physical properties*"

The emphasis in the above definition on "improving the quality of coal" **might** suggest that Coal Development/Utilization must involve local "value added activity" to produce a coal product that will command a higher price than coal that has simply be mined and delivered to stockpile.

Elsewhere in the New Mining Law, however, it is made clear that Coal Development/Utilization is **not** necessarily confined to just activities or efforts that improve the quality of coal. More particularly, the Elucidation to Article 102(2) of the New Mining Law provides that Coal Development/Utilization **may** include:

(a) in respect of "**Coal Development**":

(i) coal upgrading;

(ii) coal briquetting;

(iii) coke making;

(iv) coal liquefaction;

(v) coal gasification including underground coal gasification;

(vi) coal slurry or coal water mixture; and

(b) in respect of "**Coal Utilization**", **construction of mine mouth power plants**.

Although not beyond doubt, the better view would seem to be that Article 102(2) of the New Mining Law probably allows holders of Continuation Coal IUPKs to choose whether to carry out (i) Coal Development only, (ii) Coal Utilization only or (iii) both Coal Development and Coal Utilization.

Coal Development (as explained above) seems to be generally consistent with the definition of Coal Development/Utilization in the New Mining Law and its apparent focus on improving the quality of coal or at least producing a higher value coal product than coal that is simply mined and delivered to stockpile. However, it is very hard to see how Coal Utilization (as explained above) is in any way consistent with definition of Coal Development/Utilization in the New Mining Law and its apparent focus on improving the quality of coal or at least producing a higher value coal product than coal that is simply mined and delivered to stockpile. More particularly, Coal Utilization apparently involves **nothing more than** constructing a mine mouth power plant intended to utilize as its energy source coal that has simply be mined and delivered to stockpile by or on behalf of the sponsor of the relevant mine mouth power plant. In other words, Coal Utilization does **not** involve either (i) any improvement in the "quality of coal" used as the energy source for the relevant mine

mouth power plant or (ii) producing a higher value coal product than coal that is simply mined and delivered to stockpile. As it is explained in the Elucidation to Article 102(2) of the New Mining Law, Coal Utilization is a very surprising and, indeed, worrying departure from what seems to be actually contemplated by the definition of Coal Development/Utilization in the New Mining Law.

Does it really matter that Coal Development/Utilization is **not** necessarily confined to local value added activity intended to "increase the quality of coal" or at least result in a higher value coal product than coal that is simply mined and delivered to stockpile? As will become apparent in 3 below, **"yes" it matters very much** because there are important benefits and incentives being offered to companies carrying out Coal Development/Utilization and even, so it would seem, if it is only Coal Utilization that will **neither** increase the quality of coal **nor** result in a higher value coal product than coal that is simply mined and delivered to stockpile.

3. Significance of Coal Development/ Utilization

3.1 **Extension of CCoWs**: As highlighted in 2.1 above, CCoW holders are entitled to Continuation Coal IUPKs if they are willing to assume the obligation of Coal Development/Utilization in addition to other obligations including "increasing state revenue" (Article 169A(1) and (2) of the New Mining Law).

Obtaining a Continuation Coal IUPK is hugely advantageous to CCoW holders as it ensures continued operating rights of up to 20 years and without any obligation to undergo a tender in circumstances where they otherwise had no clear right to an extension of their CCoWs. With many CCoW holders facing the imminent expiry of their CCoWs and the resulting shutdown of their coal mining operations, obtaining a Continuation Coal IUPK is not merely something that is desirable for CCoW holders but, rather, it is something that is essential to their very survival. In this regard, CCoW holders have, in recent years and with their CCoWs coming to an end, found it increasingly difficult to attract new equity investment and obtain bank financing. The legal certainty of continuing operating rights, which comes with obtaining Continuation Coal IUPKs, means that these investment and financing difficulties should be much alleviated.

Assuming that Coal Development and Coal Utilization are indeed individual alternatives, that do **not** both have to be carried out unless the relevant Continuation Coal IUPK holder so wants, undertaking Coal Utilization alone would seem to be a very easy way indeed for holders of Continuation Coal IUPKs to satisfy the Coal Development/Utilization obligation attaching to their Continuation Coal IUPKs.

3.2 **Life of Mine Right**: Holders of Coal IUPs/IUPKs/Continuation Coal IUPKs, at the production operation stage and which carry out "**integrated"** coal getting **and** Coal Development/Utilization are entitled to (i) **initial** license terms of 30 years rather than 20 years and (ii) **further** 10 year extensions of their license terms "as per the relevant laws and regulations" (Article 47(g) and Article 83(h) of the New Mining Law).

Although not expressly stated in the New Mining Law, it is the writer's present understanding that holders of Coal IUPs/IUPKs as well as holders of Continuation

Coal IUPKs, at the production operation stage and which carry out "**integrated**" operations, will be able to keep extending their Coal IUPs/IUPKs/Continuation Coal IUPKs until the end of the commercial life of the relevant coal concession area/mine. The same "life of mine" operating right is being offered to holders of metal mineral IUPs/IUPKs which carry out integrated operations of metal ore mining and downstream processing and refining of metal ore into value added metal products.

The term "integrated" is undefined in the New Mining Law. However, the writer's present understanding is that "integrated" means that a legal entity, which is the holder of a Coal IUP/IUPK/Continuation Coal IUPK must carry out **both** the coal getting **and** the Coal Development/Utilization of Coal.

Again assuming that Coal Development and Coal Utilization are indeed individual alternatives, that do **not** both have to be carried out unless the relevant Coal IUP/IUPK holder or Continuation Coal IUPK holder so wants, undertaking Coal Utilization alone and putting the resulting mine mouth power plant in the same company that carries out the coal getting **(i.e.**, integration) would seem to be a very easy way indeed for both holders of Coal IUP/IUPKs and holders of Continuation Coal IUPKs to qualify for "life of mine" operating rights.

3.3 **Reduced Production Royalty**: Article 39.1 of the Omnibus Law amends the New Mining Law to include a new Article 128A as follows:

> "*Business actors carrying out **value added activities** in respect of Coal (as mentioned in Article 102(2) of the New Mining Law**) may be granted special treatment** in connection with their state revenue payment obligations [**i.e.**, Production Royalties].*"

The reference in new Article 128A to "*value added activities in respect of Coal (as mentioned in Article 102(2) of the New Mining Law)*" is ambiguous. Is it only Coal Development (as mentioned in Article 102(2) of the New Mining Law and which does clearly amount to "value added activity") that may be granted "special treatment" in respect of Production Royalties? Alternatively, is it Coal Utilization (as also mentioned in Article 102(2) of the New Mining Law but which does **not** really involve any "value added activity") **as well as** Coal Development that may be granted "special treatment" in respect of Production Royalties?

Just what is the "special treatment" contemplated by Article 128A of the New Mining Law is made clear in a recently circulated **draft** of Government Regulation re Implementation of Law on Job Creation in the Energy and Mineral Resources Sector ("**Draft GR EMRS**") which provides, in Article 1(1) and by way of elaboration of Article 128A of the New Mining Law, that:

> "1. *Holders of Coal IUPs/IUPKs/Coal Continuation IUPKs at the production operation stage which carry out Coal Development/Utilization **may be subject to a [reduced] Production Royalty of up to 0%**."*

Article 1 of Draft GR EMRS goes on to provide that:

> "2. *The [reduced] Production Royalty of up to 0%.... shall be imposed in respect*

of the amount/tonnage of Coal used in connection with Coal Development/ Utilization activities.

3. *Further provisions re the amount, requirements and procedures for the imposition of a [reduced] Production Royalty of up to 0%.... shall be set out in a ministerial regulation.*

4. *Minister of Finance approval is required for the amount, requirements and procedures for the imposition of a [reduced] Production Royalty of up to 0%....*"

Self-evidently, it is a huge benefit for holders of Coal Continuation IUPKs to have their Production Royalty rate reduced from the present level of 13.5% to 0% in respect of coal produced by them and used as the energy source for a mine mouth power plant that they construct if this constitutes Coal Development/Utilization for the purposes of the New Mining Law.

We will have to wait for (i) Draft GR EMRS to be finalized and (ii) the ministerial regulation, referred to in Article 1(3) of Draft GR EMRS, to be issued in order to know for sure whether or not the Government intends that Coal Utilization, as well as Coal Development, qualifies for a reduced Production Royalty of 0%.

4. Questionable Policy Choices

4.1 **Preliminary Remarks**: Indonesia has, supposedly, taken the decision to move away from simply producing and selling low value unprocessed metal ore and coal in favour of concentrating on the production and sale of value added mineral and coal products that command much higher prices and will help ensure Indonesia and its people receive materially more benefit from the local mining industry than they do at present. Coal Development may be consistent with the stated focus on producing value added coal products that command higher market prices. Coal Utilization (in the form of the construction of mine mouth power plants) does **not**, though, seem to be in any way consistent with a focus on producing value added coal products that command higher market prices.

It must also be questioned whether, given the likely permanent nature of the energy transition phenomenon, Indonesia should be encouraging the development of more mine mouth power plants utilizing coal at all. Yet, this is the seemingly logical consequence of allowing holders of Continuation Coal IUPKs to only carry out Coal Utilization in order to satisfy their Coal Development/Utilization obligations.

There is not necessarily anything wrong with Coal Utilization as such **other than, of course, from an environmental impact perspective**. However, it does **not** seem that Coal Utilization by itself should be sufficient to entitle coal producers to favorable treatment from the Government whether in the form of Continuation Coal IUPKs for former CCoW holders or "life of mine" operating rights and 0% Production Royalties for holders of both Coal IUPs/IUPKs and Continuation Coal IUPKs.

4.2 **CCoW Extensions**: Indonesia's continuing dependency on the coal industry is probably unavoidable in the near to medium term at least and even if this is definitely **not** desirable from an environmental impact perspective. Accordingly, ensuring legal certainty of future operating rights for CCoW holders may be an entirely reasonable policy objective. It is, in any case, certainly a much better outcome than allowing state-owned enterprises to take over most of the former contract areas of CCoW holders once they receive Continuation Coal IUPKs.

Given how valuable Continuation Coal IUPKs are to CCoW holders, though, it might reasonably have been thought that the associated Coal Development/Utilization obligation would not have been capable of being satisfied through Coal Utilization alone. Is constructing a mine mouth power plant, that uses as its energy source the coal produced from the Continuation Coal IUPK holder's mining operations, properly to be regarded as an appropriate "price", even in part, for a Continuation Coal IUPK?

The writer readily acknowledges that holders of Continuation Coal IUPKs are also subject to onerous tax and other burdens intended to "increase state revenue" that form a critically important part of the "price" CCoW holders have to pay for their Continuation Coal IUPKs. The writer's concern is more that while the **compulsory** Coal Development/ Utilization obligation **looks** potentially onerous and something that **seems** to materially distinguishes holders of Continuation Coal IUPKs from holders of Coal IUPs/IUPKs, it is in fact **not** onerous at all if it can be so easily satisfied by undertaking Coal Utilization alone rather than either Coal Development alone or both Coal Development and Coal Utilization. This may be viewed as being part of the carefully crafted "window dressing" that has been included in the New Mining Law so that it looks as though the Government has extracted a much higher "price" from CCoW holders in return for Continuation Coal IUPKs than is really the case.

4.3 **Life of Mine Operating Rights**: Giving "life of mine" operating rights to non-PMA Company Coal IUP/IUPK holders and holders of Continuation Coal IUPKs which carry out integrated coal getting and Coal Development/Utilization also does **not** seem to be justified in the case of those Coal IUP/IUPK holders and holders of Coal Continuation IUPKs which are **not** foreign investment companies ("**PMA Companies**") and only carry out Coal Utilization. What real additional value is Indonesia getting, in return for "life of mine" operating rights, from integrated coal getting and Coal Utilization only by **non**-PMA Companies?

It must be remembered that most (but not all) of the CCoW holders and future Continuation Coal IUPK holders are wholly Indonesian owned companies, **not** PMA Companies. Accordingly, it is **not** necessarily the case that the "quid pro quo" for life of mine operating rights, at least in the case of Continuation Coal IUPK holders carrying on integrated operations, will be extension of the 51% divestiture obligation to their Coal Development/Utilization Activities in addition to their coal getting activities. The extension of the 51% divestiture obligation is only relevant in the case of PMA Companies (or deemed PMA Companies) carrying on integrated coal getting and Coal Development/Utilization activities.

4.4 **Reduced Production Royalties**: The Government is understandably concerned about the poor outlook for traditional coal mining in Indonesia and the very serious

economic implications of this for both the Government and those Provinces most dependent upon coal mining.

With no real prospect of a material improvement in coal exports, it is also understandable that the Government wants to ensure much greater domestic absorption of Indonesia's coal production than is currently the case. To this end, it may well be sensible (**other than from an environmental protection perspective of course**) to provide incentives to holders of Coal IUPs/IUPKs and holders of Continuation Coal IUPKs which facilitate greater domestic coal absorption. Is, however, constructing a mine mouth power plant really sufficient to justify a 0% Production Royalty in respect of the coal used as the energy source for that mine mouth power plant? This seems particularly problematic in the case of holders of Continuation Coal IUPKs which would otherwise pay a 13.5% Production Royalty in respect of that coal.

SUMMARY AND CONCLUSIONS

Despite the widespread usage of the term "coal downstreaming", this is **not** what the New Mining Law and the Omnibus Law encourages and, in some cases, requires. Rather, the New Mining Law and the Omnibus Law, in fact, seek to encourage and in some cases require Coal Development/Utilization.

Value added activity is **not** necessarily part of Coal Development/Utilization as envisaged by the New Mining Law and the Omnibus Law.

Coal Utilization, involving the construction of mine mouth power plants, would seem to be a very doubtful "value added activity", especially in a time of growing environmental concern about the use of fossil fuel for electricity generation and given the reality of energy transition which is, apparently, here to stay.

While Indonesia's dependence upon the coal industry is not likely to change any time soon, the Government needs to make sure that the benefits and incentives it offers to the coal industry, in order to ensure its continuity and prosperity, are justified with respect to what Indonesia and its people receive in return for those benefits and incentives. The Government also needs to ensure that these benefits and incentives do not encourage Indonesian coal producers to ignore the energy transition phenomenon and continue to build mine mouth power plants when the rest of the world is moving towards electricity generated from renewable energy.

The New Mining Law and the Omnibus Law reflect some very questionable policy choices when it comes to the apparent acceptance of Coal Utilization alone as being sufficient to constitute Coal Development/Utilization and thereby qualify parties carrying out the same for very significant benefits and incentives.

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