Legal Analysis in the Mechanism of Shares Divestment in Indonesian Mining Law

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Keywords: Investment, Mining, Law, Shares, Divestment.

Abstract: This paper is based on shares divestment issues which are still problematic and caused some negative impacts. First, Indonesian government is always late in making purchases or executing divestment. Second, although the divestment is conducted by Indonesian government, it is often difficult to obtain funding for the purchase of divestment shares. Third, even if the divestment fund is successfully obtained, the divestment is conducted through a syndicated process which uses loan money from foreign party. This study shows that the dispute on divestment share pricing and potential losses between countries and foreign investors is not unusual to be happened. In some cases, governments and foreign investors often disagree on how to calculate the share price or the value of the company upon expropriation, or when the business license is revoked. The Indonesian government can learn the approaches from previous awards of the ICSID. In this research, there are 2 alternatives for divestment mechanism in the mining sector, namely: determining a clearer mechanism of the price of shares divestment and the divestment without the purchase of shares. This article is a legal research and the approaches used are conceptual approach, statute approach, case approach, comparative approach, and economic analysis of law.

1 INTRODUCTION

The mining industry for the economies of countries in the world including in Indonesia has a very important role. In fact, Indonesia has limited funding in the exploration and exploitation activities of the mineral and coal mining sector. In the management of natural resources, it is required a very large share, advanced equipment, experts and high risk, so it is necessary to cooperate with foreign parties in the management of natural resources by doing investment activities using the Contract of Work/ *Kontrak Karya* (*KK*).

Government policy related to investment in mining sector is the issuance of Government Regulation Number 1 of 2017.In that regulation, all foreign mining companies in Indonesia, both *KK* holders and Mining Business Licenses/ *Izin Usaha Pertambangan* (*IUP*) and Special Mining Business Licenses/ *Izin Usaha Pertambangan Khusus* (*IUPK*) shall be subject to Law Number 4 of 2009 concerning Mineral and Coal Mining are required to divest the 51% of shares. The obligation of Shares Divestment is also reinforced by the issuance of Regulation of the Minister of Energy and Mineral Resources Number 9 of 2017 on Procedures of Shares Divestment and the Mechanism of Determining Shares of Divestment on Mineral and Coal Mining Business Activities.

This divestment offer is conducted in stages to: Government, Provincial Government, or Regency/City Government, State-Owned Enterprises (*BUMN*), Regional Government Enterprises (*BUMD*), or National Private Enterprise. If the divestment is not preferred by the Central Government to BUMN, the implementation of the divestment must be carried out under a public offering scheme in the Indonesian stock exchange through Initial Public Offering (IPO).

The divestment policy in the process has never conducted smoothly. This can be seen from several cases at the International Center for the Settlement of Investment Disputes (ICSID) or the International Arbitration Body related to Shares Divestment cases (Prihandono, 2014), including as well as the very recent case, the Freeport divestment case (2016).In the Freeport case, the Government of Indonesia currently has 9.36% shares of PT Freeport Indonesia (Indonesia). Based on the previous policy (as stipulated in Government Regulation Number 77 of

Pawestri, W. and Prihandono, I.
Legal Analysis in the Mechanism of Shares Divestment in Indonesian Mining Law.
DOI: 10.5220/0010050903550361
In *Proceedings of the International Law Conference (iN-LAC 2018) - Law, Technology and the Imperative of Change in the 21st Century*, pages 355-361
ISBN: 978-989-758-482-4
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2014), Freeport which has underground mining activities is obliged to divest 30%.

In early January 2016, Freeport offered divestment of 10.64% of shares or USD 1.7 billion of 100% total valuation of USD 16.2 billion. This figure also includes the assumption that the company's investment is poured if the government extends Freeport operations until 2041. Freeport's obligation to release 51% of its shares-is up to this year. If it refers to a contract of work, the Freeport contract expires in 2021. However, the government has never approved the extension of the Freeport contract. This means that the company's copper and gold reserves since the contract expires in 2021 to 2041 are owned by the Government of Indonesia. In the *Permen ESDM* No.9 of 2017, the determination of the price of the divestment shares, it must be a fair market value. In addition, share pricing mechanism also do not take into account the mineral reserves contained therein, so that the offer of share price by entering the next investment value as done by Freeport cannot be done anymore because fair market value does not include the existing reserves beneath.

From the above cases, there is one major issue in the process of divesting shares in Indonesia the problem is the share pricing mechanism that will be divested. This resulted in the objective of divestment arrangement not being achieved due to unequal price fixing issues between the government and Freeport. This article will discuss how the divestment mechanism in Indonesia and the obstacles that hinder the divestment process.

2 MATERIAL AND METHODS

This article is a legal research. It will be a reference in policy making process and as a foundation in the development and establishment of law. The approaches which are used are conceptual approach, statute approach, case approach, comparative approach, and economic analysis of law. The primary legal materials which are used in this research are all applicable legislation, international conventions and court decisions related to investment and mining in Indonesia. The international conventions include the GATT, the Agreement Establishing the WTO in particular on TRIMs, and the decision of ICSID decisions. Meanwhile, the secondary legal materials are in the form of literature and related materials regarding investment law and mining law, as well as previous research related to this issue.

3 PROVISIONS OF SHARES DIVESTMENT IN THE CONTRACT OF WORKS BETWEEN THE GOVERNMENT OF INDONESIA AND FREEPORT

The existence of Law No. 1 of 1967 initiated a Contract of Work between Freeport Indonesia Incorporations and the government of Indonesia or better known as Generation I of Contract of Work (KK Generation I) signed on April 7, 1967 (Putra, Mencermati Posisi Freeport dari UU Minerba, Kontrak Karya, serta MoU, 2017). The establishment of the Contract of Work is motivated by the circumstances at that time, in which there is no standard form of contract in the mining sector. The provisions on compulsory divestment of shares are stipulated in the Contract of Work between PT Freeport Indonesia and the Indonesian government effective on 30 December 1991, also known as the Generation II of Contract of Work (KK Generation II).After Government Regulation No. 77 of 2014 issued, PT Freeport Indonesia renegotiates with the Indonesian government regarding the extension of the contract of work (Putra, Mencermati Posisi Freeport dari UU Minerba, Kontrak Karya, serta MoU, 2017). In this case, PT Freeport Indonesia attaches a Memorandum of Understanding (MoU) which was agreed with the Indonesian government on July 25, 2014.

The provisions for PT Freeport Indonesia to extend contracts with the Indonesian government where one of the six required points before signing a contract is a divestment, but this divestment obligation is not regulated specifically about the stages and the amount of shares to be divested.The government subsequently renegotiated the KK Generation II with PT Freeport Indonesia resulting in an amendment to the divestment provisions from 51% to 30% (Putra, Mencermati Posisi Freeport dari UU Minerba, Kontrak Karya, serta MoU, 2017). Not only there, PT Freeport Indonesia's contract of work with the Indonesian government was extended to KK Generation V. Based on Article 24 of KK Generation V, PT Freeport Indonesia is required to divest the shares in two stages: The first phase, PT Freeport Indonesia sold shares to Indonesian participants of 9.36% in the first ten years since 1991; and The second stage, PT Freeport Indonesia is required to sell its shares at 2% per annum from

2001 until the ownership of Indonesian participants to 51%.

The liability for the first stage of Shares Divestment has been successfully performed, in which 9.36% of PT Freeport Indonesia's shares are owned by PT Indo Copper. However, the obligation of the second stage of Shares Divestment was delayed due to the issuance of Government Regulation No. 20/1994 concerning Share Ownership in Companies Established in Foreign Investment Framework. This means that the government currently has only 9.36% shares of PT Freeport Indonesia and there are still 41.64% more shares that need to be acquired.

4 OBSTACLES OF SHARES DIVESTMENT IN MINING SECTOR

The provisions concerning the obligation of Shares Divestment in the mining sector is an effort of the Indonesian government to realize the state control over the resources it has, as stated in Article 33 paragraph (3) of the 1945 Constitution. The share ownership of the divestment proceeds is expected that the Indonesian government can provide benefits for Indonesian participants in two ways (Manley & Bria, 2017). First, Indonesian participants can benefit directly through share ownership in mining companies rather than indirect benefits through tax revenues. Secondly, through this provision, mining companies can acquire new technology and develop new businesses, open jobs, as well as larger business opportunities at domestic level. In other words, the implementation of the Shares Divestment obligations for foreign investment companies in the mining sector is expected to bring benefits to Indonesian participants. However, in practice this is not easy to implement.

4.1 The Government Expectations on the Policy of Shares Divestment Will be Difficult to Achieve

Based on an analysis report from the Natural Resource Governance Institute (NRGI), the terms of the Shares Divestment have little chance of achieving the initial target intended by the Indonesian government. In addition, the government also has other obligations such as improving infrastructure and increasing overall economic productivity. It should be considered that domestic capital will be difficult to meet both of the above objectives, to purchase shares of foreign mining divestment and build infrastructure. If the Indonesian government still chooses to use the existing budget to purchase the shares of foreign mining divestment, the benefits gained by society will not be felt.

The NRGI in its analytical report addresses several factors that would be an obstacle for the Indonesian government to achieve the objectives of a mandatory stock divestment policy in the mining sector for foreign companies. First, the purchase of divestment shares by Indonesian participants will require an increase in foreign debt or divert large amounts of domestic investment from other sectors. It is worth noting that during the last five years the extractive sector, which also includes mineral and coal mining activities, attracted US $ 21,000,000,000 from foreign investors. This amount is worth almost half of all investment from Indonesian participants in all other sectors of the economy. In accordance with the provisions of our laws that must be divested by foreign investment companies at least 51% of the total number of shares. If an Indonesian participant buys more than 51% of all foreign direct investment stocks, the required amount will likely require significant engagement from Indonesian investors from other industrial sectors.

Indonesian participants who purchase the shares of the divestment will then take on the role of replacing foreign investors. Then the question arises, whether the Indonesian participants in this case able to maintain its role just like with foreign investors before? Based on data collected by NRGI, the answer is no. We can conclude that each option has significant consequences and certainly less useful for the benefit of the people of Indonesia. The NRGI concludes that buying the shares of the foreign companies' divestment in the mining sector is a hollow victory.

One of the risks to be faced by the Indonesian government in achieving the main objective of a mandatory stock divestment policy for foreign direct investment in the mining sector is the acquisition of dividends from investments made by Indonesian participants may be below expectations. This can be explained by two reasons. First, the number of shares of Indonesian participants will not be enough to buy the divestment share price offered by the foreign investment companies, so that Indonesian participants must owe to other parties. *Permen ESDM* No.9 of 2017 has stipulated that holders of IUP of Production Operation IUP and IUPK of

Production Operation and its affiliates are prohibited from lending funds to Indonesian participants who will purchase their divestment shares. As a result we can see in the case of Newmont, where Multicapital as an Indonesian participant purchasing NNT BV divestment shares borrowed US $ 300,000,000 to a foreign party, Credit Suisse Singapore. This case reflects that the Indonesian participants will seek loans to other parties to be able to purchase the divestment shares offered by the foreign investment companies.

Article 2 Paragraph (7) of *Permen ESDM* No. 9 of 2017 provides a loophole for majority shareholders, in the case of Newmont above is NNT BV, to reduce the dividend income for Indonesian participants as minority shareholders which may result in payment of dividends that do not meet the expectations of Indonesian investors. As in the case of Newmont, the DMB did not gain any profit because the dividends received were used to pay its debts to Credit Suisse Singapore. NNT BV as the majority shareholder in this case can ensure that the company owes funds from related shareholders or similar entities and may transfer income from other shareholders, such as the Indonesian shareholders to affiliated companies (Manley & Bria, 2017).

The second factor that can be a barrier to the government in achieving the main objective of the mandatory Shares Divestment policy in the mining sector is the ownership of shares by Indonesian participants can actually reduce the number of Indonesian workers and business opportunities for the people of Indonesia (Manley & Bria, 2017). Acquisition of shares affecting control holders in mining companies may create opportunities for Indonesian participants to open new businesses and create jobs in the mining sector for Indonesians. Networks owned by foreign companies previously may develop domestic connections following the transfer of ownership and control of the company to Indonesian participants. However, this is likely to be difficult because foreign investment companies will not release the connections they previously had for free. Foreign companies have spent most of the cost of mining projects during the development process and the first 10 years of production. During the two processes, foreign companies have established a network of suppliers that foreign firms can keep in order to maintain maximum dividends from their remaining shares and continuous supply can generate new business for foreign companies. The possibility of achieving the goal of increasing the number of Indonesian workers in the mining sector will also be difficult to achieve, since a change of ownership does not always guarantee an increasing number of domestic workers. Logically, if this divestment provision causes investment activity in the mining sector to decline significantly, then employment for the people of Indonesia also decreased.

4.2 Requiring Divestment Will Charge Large Expenses for Indonesia

The provisions on divestment for foreign investment companies in the mining sector will not be far from the possibility that there will be a significant share price discount, given the ability of Indonesian participants in the mining sector will not be able to meet the divestment share price offered by the foreign companies. In other words, the divestment rules can hinder foreign investment and thus the overall development in the mining sector. Analogously, foreign investors will find it hard to expect anything to receive sufficient returns to pay their costs and creditors to satisfy their shareholders, if at the end of their shares should be divested by possibly lower than they expect.

This can be attributed to several factors, such as the enormous cost and potential decline in foreign investment activities in the mining sector significantly in the future. This enormous cost will collide with the interests of the government also in terms of building infrastructure in the country. The reduction of the state budget for the purchase of shares of divestment has far less benefits for the Indonesian people in general. It is also written by Michael Agustinus, the Indonesian government has reached a divestment agreement with 51% (Agustinus, 2017) of PT Freeport Indonesia. The Indonesian participant who will purchase the divestment is a holding of state-owned mines consisting of PT Inalum, PT Aneka Tambang Tbk, PT Timah Tbk and PT Bukit Asam Tbk. The problem arising from this agreement is the insufficient amount of assets from the holding of the BUMN to meet the divestment price of shares offered by PT Freeport Indonesia.

Through the debt, the holding assets of BUMN will not be able to buy Freeport shares divestment (Agustinus, Berapa Harga 51% Saham Freeport? Ini Hitung-hitungannya, 2017). It was not feasible because it would violate the rules of debt to equity ratio. Based on an article written by Amy Gallo, the debt to equity ratio in general must be balanced (Gallo, 2015). Based on the calculation formula of debt to equity ratio, if the value of a company's debt is higher than the value of assets owned, it will be

higher the debt to equity ratio of the company. The higher debt to equity ratio of a company will indicate that the company is experiencing financial difficulties or distress, where there is a possibility that the company will not be able to pay its debts (Gallo, 2015). Therefore, if the holding of a state-owned mine proposes a debt whose value is higher than its asset value in order to fulfill the Freeport divestment share price, then the debt to equity ratio will be of high value and affect the financial state of the holding of the BUMN.

On the other hand, the difficulties in implementing Shares Divestment obligations occurred in Newmont's case. Based on the contract of work between the Government of Indonesia and Newmont Nusa Tenggara BV (NNT BV) in 1986, NNT BV is required to divest shares to Indonesian participants at least one third of the total shares (Manley & Bria, 2017). The implementation of this divestment obligation is conducted after the arbitration of the United Nations Commission on International Trade Law (UNCITRAL) decision on March 31st2009.

5 RECOMMENDATION OF SHARES DIVESTMENT IN INDONESIAN MINING LAW

5.1 Determining a Clearer Mechanism of the Price of Divestment Shares

There are various methods of pricing divestment shares, so the government of Indonesia and PT Freeport Indonesia should not be fixated on the method that has been debated. Here are the various methods of divestment share pricing that can be adopted. The NRGI in its analytical report argues that the approach used by the Indonesian government to determine the divestment share price is likely to hamper future foreign investment activities in the mining sector. Therefore, NRGI provides two main suggestions in its report with the following details (Manley & Bria, 2017): (a) Determination of divestment share price should include component of capital cost of equity of foreign investment company. Without this change, the effective divestment rule would be a considerable fiscal burden for investors which would impact the decline in future foreign investment; and (b) The need to consider several other methods of determining the price of a divestment share, such as a method based on income (discounted cash flow) or replacement cost. This is in accordance with the practice in the mining industry in general and reflects that the Indonesian government does not only refer to one particular method.

The Indonesian government may follow different international appraisal rules in each of the cases. Some mineral-producing countries have detailed and detailed rules regarding the valuation of mining assets such as VALMIN (the Australian Institute of Mining and Metallurgy), CIMVAL (Canadian Institute of Mining, Metallurgy and Petroleum), and SAMVAL (South African Mining Associations). Implementing one of these international rules will likely reduce the potential for conflict between various stakeholders and reduce uncertainty in determining the price of divestment shares in the mining sector.

5.2 The Divestment without the Purchase of Shares

The determination of the price of the Shares Divestment to be offered by foreign investment company in the mining sector to Indonesian participants is a crucial factor in the success of achieving a Shares Divestment agreement. It has been briefly discussed above that Minister of Energy and Mineral Resources Regulation No. 9 of 2017 regulates the shares divestment, where the divestment share price of the holders of IUP of Production Operation or IUPK of Production Operations offered to Indonesian participants is determined based on fair market value by not taking into account mineral or coal reserves at the time of implementation of the offer Shares Divestment. However, according to Yustinus Prastowo, the use of fair market value method in determining the share price of divestment is considered unsuitable to be applied especially to Freeport shares divestment case (Energi, 2017). This is because the fair market value method is applied only to assets with comparative value, while underground mining assets conducted by Freeport have no comparative value with other assets in general (Energi, 2017).

In addition, Michael Agustinus also said that the use of fair market value method in determining the price of PT Freeport Indonesia divestment shares would not make it possible for Indonesian state-owned holding companies to be able to buy 51% of the divestment shares. When calculated using the fair market value method, the divestment price will also cover mineral reserves until the end of the Freeport Contract of Work, which is 2041. Until then, the value of 100% PT Freeport Indonesia

shares is US $ 15.9 billion or approximately Rp 211 trillion, then the value of 51% of its shares about Rp 107 trillion. Yustinus Prastowo said that assets owned by holding state-owned mining only reached Rp 58 trillion, in other words that the assets of Indonesian participants do not undertake the price of 51% shares of PT Freeport Indonesia divestment.

On the other hand, addressing the NRGI's analysis report, the use of the fair market value term poured by the Indonesian government in *Permen ESDM* No. 9 of 2017 has an interpretation that is not different from the method of replacement cost ever Indonesia pour in the previous regulation (Manley & Bria, 2017). In theory, the value of shares that brokers expect to trade on the market includes the value the firm derives from selling its future yields minus taxes (taxes equivalent to reserves less minus expenses and taxes) (Manley & Bria, 2017). However, Article 14 paragraph (1) of *Permen ESDM* No. 9 of 2017 excludes the possibility of future production, where the allowed assessment is to calculate the assets on the land owned by the current mining company (such as infrastructure and capital developed, less depreciation of the assets). The result of the calculation expected by the Indonesian government is equivalent to the implementation of the replacement cost method defined in the previous rule (Manley & Bria, 2017).

Yustinus Prastowo also stated that the use of replacement cost method in determining the price of Freeport divestment shares is not fair, because the divestment share price will only be based on the cost incurred by Freeport alone in doing mineral mining in Indonesia without covering the expectations of shareholders of PT Freeport Indonesia itself as an investor. The NRGI adds that even if investors do not have to fully receive net tax revenues from future production to invest, they will usually expect returns that are comparable to their capital use (Manley & Bria, 2017). In this case, the intended return does not have a certain amount, but according to the results of analysis conducted in the mining sector investors tend to use the benchmark close to the yield of 12.5% of the capital used (Manley & Bria, 2017).

PT Freeport Indonesia's refusal to use the replacement cost method in determining the share price of divestment by the Indonesian government seems to be true. On September 29th2017, a letter from Richard Adkerson as Director of PT Freeport Indonesia refused the Government of Indonesia's proposal regarding the divestment of 51% shares (Henricus & Aron, 2017). This is because the Indonesian government only gives divestment price valuation valued at 51% based on the benefits of mining activities acquired up to 2021, when PT Freeport Indonesia Contract of Work will come to an end. PT Freeport Indonesia believes that the divestment of shares should reflect the fair market value of the business run by them until 2041, which they say conforms to international standards in assessing the mining business and is consistent with their rights contained in the Contract of Work (Henricus & Aron, 2017).

In essence, the implementation of the stock divestment will be very difficult to implement considering that neither the Indonesian government nor the foreign investment companies in the mining sector have reached an agreement in determining the share price of the divestment in accordance with the interests of each party. Therefore, the divestment without the purchase of shares by the government should be regulated at the beginning of the granting of the Business License. This obligation is direct without any financial compensation. Mining business actors may conduct business feasibility assessments under the terms of this 'direct divestment'. Business actors may consider whether the investments made will be profitable at the beginning of the operating plan of the mining business activities, including by calculating the costs incurred by 'direct divestment' obligations without this purchase.

6 CONCLUSION

This paper is based on shares divestment issues which are still problematic and caused some negative impacts. First, Indonesian government is always late in making purchases or executing divestment. Second, although the divestment is conducted by Indonesian government, it is often difficult to obtain funding for the purchase of divestment shares. Third, even if the divestment fund is successfully obtained, the divestment is conducted through a syndicated process which uses loan money from foreign party. Therefore, there is an urgency to reform or make legal changes in the mechanism of Shares Divestment in this mining sector.

This study shows that the dispute on divestment share pricing and potential losses between countries and foreign investors is not something unusual to be happened. In some cases, governments and foreign investors often disagree on how to calculate the share price or the value of the company upon expropriation, or when the business license is

revoked. Unfortunately practices and decisions on investor-state dispute settlement (ICSID) disputes have not shown uniformity. At least, the Indonesian government can take lessons from previous cases. In this research, there are 2 alternatives for divestment mechanism in the mining sector, namely: determining a clearer mechanism of the price of shares divestment and the divestment without the purchase of shares.

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