

NEW POLICIES ON DOMESTIC MARKET OBLIGATION FOR COAL – (UPDATED)¹

In the first quarter of 2018, the Minister of Energy and Mineral Resources (“MEMR”) issued a couple of new regulations relating to Domestic Market Obligations (“DMO”) for coal, starting with the issuance of MEMR Decree No. 23 K/30/MEM/2018 on the Determination of Minimum Domestic Market Obligation of Coal Sales for 2018 (“MEMR 23”) on 5 January 2018 and followed by MEMR Decree No. 1395 K/30/MEM/2018 on Coal Price for Power Generation for Public Interest (“MEMR 1395”) on 9 March 2018 as amended by MEMR Decree No. 1410 K/30/MEM/2018 (“MEMR 1410”) on 12 March 2018.

Background

Under MEMR 23, coal mining companies are required to satisfy the DMO where each company is required to sell at least 25% of its total production within 2018 to domestic market, including to state utilities company (PLN) as well as independent power producers (IPPs). Unlike the decrees on DMO issued in previous years, there are no specific details on the recipients of coal allocation under the DMO framework in MEMR 23. In addition, MEMR 23 does not list down mining companies that are required to satisfy the DMO requirement. Accordingly, it can be interpreted that the current DMO obligation is applicable to all coal mining companies in the stage of operation and production and the coal allocated for DMO may be sold to any local user.

In the past, price of coal sold to PLN was regulated under MEMR Decree No. 0617 K/32/MEM/2011 (“MEMR 0617”) which provided that such price was based on Coal Benchmark Price (*Harga Patokan Batubara* – “HPB”)² determined by the

¹ Within only a few days after the issuance of MEMR 1395, MEMR issued MEMR 1410. This updated newsletter is aimed to highlight the change made under MEMR 1410.

² The mechanism to determine HPB and *Harga Batubara Acuan* (Coal Reference Price -“HBA”) is provided under MEMR Regulation No. 7 of 2017 on the Procedures to Determine Reference Price for the Sales of Mineral and Coal as lastly amended by MEMR Regulation No. 19 of 2018 (“MEMR 7”). Under MEMR 7, HBA is determined by the MEMR based on the average of Indonesia Coal Index (ICI), Newcastle Export Index (NEX), Globalcoal Newcastle Index (GCNC) and Platts-5900, while HPB is determined based on a formula set out by MEMR (this formula uses HBA as the price variable). Mining concession holders (*Izin Usaha Pertambangan Operasi Produksi* (IUP OP), *Izin Usaha Pertambangan Khusus Operasi Produksi* (IUPK OP)) must refer to HPB in selling their coals.



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Director General of Mineral and Coal (“**Director General**”) on behalf of the MEMR.

Following the promulgation of Government Regulation No. 8 of 2018 which amended for the fifth time Government Regulation No. 23 of 2010 on the Implementation of Mineral and Coal Mining Business (“**GR 8**”),³ the government authorized MEMR to determine the coal price under the DMO framework. To date, MEMR has only used its authority above, through MEMR 1395, to determine the coal sale price for public interest in the electricity sector. It is unknown at the moment whether MEMR will issue the DMO’s mandated coal sale price for other industries (such as fertilizer, textiles, cement, pulp and paper, etc).

Key Provisions of MEMR 1395

MEMR 1395 substantially states as follows:

1. Coal sale price for electricity sector for public interest is fixed at USD70 per metric ton (on FOB Vessel basis), with standard specification of 6,322 kcal/kg GAR, Total Moisture 8%, Total Sulphur 0.8% and Ash 15%.

MEMR 1395 does not further elaborate the coverage of “public interest”, and it is therefore unclear whether such term indicates that the pricing formula under MEMR 1395 covers the sales of coal to both PLN and IPPs which have entered into power purchase agreements with PLN. However, since Law No. 30 of 2009 on Electricity (“**Electricity Law**”) stipulates that power supply business for public interest can be done either by PLN or IPPs which hold electricity supply licenses, it could be argued that MEMR 1395’s pricing formula may be applied for both PLN and IPPs who sell the electricity generated by their power plants to PLN.

If the coal specifications differ from the above baselines, MEMR 1395 provides a variety of formulas to adjust the mandatory coal price. In principle, the adjustment formula is the formula to determine HPB, where the prevailing HBA (which becomes the baseline of HPB) is fixed at USD70 if the prevailing HBA is higher than or equal to USD70. Consequently, if the

³ Until the date of this Newsletter, we have not received a copy of GR 8. However, from publicly available materials, we understand that one of the important points of GR 8 is the revised Article 85A of GR 8 which now allows the MEMR to set the coal price for fulfilment of coal domestic market obligations.

applicable HBA is lower than USD70, the adjustment formula shall use the prevailing HBA as the baseline.

2. Regarding payment of royalty to the government of Indonesia, MEMR 1395 requires coal suppliers to use, as the reference price for the calculation of such royalty, the actual coal sales price (*Harga Jual*) if the HBA is equal or greater than USD70 per metric ton; or to use HPB if the HBA is less than USD70 per metric ton.
3. Incentive in the form of up to 10% increase of production capacity (against the capacity previously approved by MEMR for such year) shall be given to coal mining concession holders that have satisfied its DMO requirement under MEMR 23 and coal price requirements under MEMR 1395. However, MEMR 1395 does not specify the formula for calculating the increase of capacity and whether the percentage of the increase will be based on the percentage of DMO portion that is allocated to the power sector by the relevant coal mining concession holder. Further confirmation from MEMR is required for this issue.
4. The coal price determination and formula for power generation sector provided under MEMR 1395 shall be retroactively applied since 1 January 2018 until end of December 2019. It was unclear whether this rule can be applied against coal sales that have already been closed prior to the issuance of MEMR 1395 and whether this means that payment made prior to such issuance must also be adjusted. Given its retroactivity nature and the fact that such rule affects the rights of Indonesian entities, the validity of such provision might be subject to further legal challenges

However, by the issuance of MEMR 1410, MEMR has removed the retroactive provisions and provides under MEMR 1410 that the coal sales price for power generation sector shall be applicable starting from the date of the promulgation of MEMR 1395 (i.e. 9 March 2018).

5. Under MEMR 1395, the maximum volume of coal sales required for the electricity sector is set at 100 million metric ton per year. It is unclear whether this limit is set for the entire Indonesian coal industry or for each individual coal producer. Both possibilities warrant further clarifications from MEMR, particularly with respect to (i) division of responsibility among coal producers to satisfy such volume, and (ii) the actual effect in case the limit has been satisfied. In case the limit has been satisfied, does that mean that coal producers are free to sell their coal at whatever price available regardless of the industry?

Conclusion

We understand that MEMR 1395 is aimed to mitigate risks relating to volatile coal price in the electricity sector, including shielding PLN from price fluctuations due to the recent increase of market coal price which will allow PLN to maintain the current electricity tariff.

However, since MEMR 1395 is specifically targeted at the power industry without regulating satisfaction of DMO obligation for other industries, there is a possibility that such attempt might backfire, namely, coal suppliers will choose to satisfy their DMO obligations by selling their coals to other industries where the price has not been regulated yet, creating a lack of supply for the industry that need it the most.

In addition, introducing retroactive components in the regulation might create unnecessary complexities in coal supply contracts within the power industry, and probably, other industries too. However, the Government has addressed this issue through the issuance of MEMR 1410. The government's swift action is much appreciated and shows its adaptability to changing circumstances in Indonesia.

Another issue that still need to be considered relates to classic problem of governmental force majeure (change in law) clauses and how such clauses under the coal sales agreements can be triggered due to the issuance of MEMR 1395 and MEMR 1410. We may expect that future provisions relating to such risk will be heavily negotiated, consuming more costs and time in closing the deal.

Finally, while MEMR's decision to provide incentive in the form of 10% production capacity increase should be appreciated, it is questionable whether such offer is attractive enough for coal mining companies to allocate its coal to domestic electricity sector. Time will tell.

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