MINING LAW AND POLICY IN INDONESIA: REFORMS OF THE CONTRACT OF WORK MODEL TO PROMOTE FOREIGN DIRECT INVESTMENT AND SUSTAINABILITY

Balbir Bhasin[*] and Jennifer McKay[**]

This article evaluates the innovative Contract of Work (CoW) system of law and policy in Indonesia. In particular the CoW system aims to ensure the continuous flow of foreign direct investment (FDI) to the sector but within the context of promoting sustainable mining in Indonesia.

The findings suggest that the Contract of Work system is a valuable and workable one. Its fundamental principles of security of tenure and lex specialis treatment in terms of taxation and royalties need to be stringently enforced. Other preconditions to sustainable development through FDI are political stability, retaining competitive advantage through system transparency and good governance, a meaningful implementation of regional autonomy legislation allowing benefits to trickle down to mining areas, and restructuring investment portfolios to allow for a better management of risk by foreign investors.

The current situation in Indonesia is untenable. No foreign exploration company has signed the current 8th Generation Contract of Work. The government is presently considering passing a new law. Immediate and urgent action needs to be taken so that the climate, once again, becomes conducive to continuing investment in the natural resource extraction sector, so vital for resuscitating the Indonesian economy.

1. INTRODUCTION AND BACKGROUND

Indonesia created a novel system to administer Foreign Direct Investment (FDI) in mining. The Contract of Work (CoW) system was created in 1967 when the end of the Sukarno era necessitated the opening of the country to foreign investment. The CoW system has played a key role in the success of Indonesia's contemporary mining industry.[1] The system was gradually revised and modernized over the past 30 years to keep pace with changing trends in the country and the international investment, the economic climate and issues of environmental sustainability.

The CoW System is a well-developed and meaningful system of granting concessions and mining rights to foreign companies. The basic needs of investors are well covered and protected. Security of Tenure is covered as *Conjunctive Title,* which empowers the investor to proceed from General Survey through Exploration all the way through Mine Development, Production, Processing and Marketing. Security of Investment is covered as *Lex Specialis* treatment, which assures that the investment is not subject to changes in government laws or policies after signing for the period in force and that these are expressly stipulated.

The CoW system initially worked very well for Indonesia. The country was able to jump start a very weak and highly inactive mineral sector source into a major industry that brought in a large number of well established and highly competent mining companies and huge amounts of capital investment, technology and expertise and revenue.

Today, the Indonesian mining sector stands at a near collapse. The current state of affairs in Indonesia has resulted in a halt to any new investment in exploration and mining activity. "*We have letters from some mining companies, both local and foreign, including Newmont, saying that they are suspending their activities for between one to two years, awaiting developments over the legal issues,"* declared the last Mines and Energy Minister Purnomo Yusgiantoro in Jakarta.[2] No foreign company has signed the proposed 8th Generation

[*] Ph.D., M.I.M, Assistant Professor of International Business, Eckerd College, St. Petersburg, Florida.
[**] BA(Hons) Ph.D., L.L.B., Professor of Business Law and Director, Water Law and Policy Group, University of South Australia.

[1] PriceWaterhouseCoopers (2000) *Indonesian Mining Industry Survey 1999*, Global Energy and Mining Group, PriceWaterhouseCoopers, Jakarta, Indonesia

[2] Straits Times (2001) *Mining Companies Stop Exploration*, Reuters report from Jakarta, February 21, 2002, Singapore.

Contract of Work (CoW) and the government is presently studying amendments and changes to its mining laws and policies.[3]

The main aim of this paper is to evaluate the current state of the mining industry in Indonesia and to propose action that will serve as a basis for improvement in the climate for sustaining FDI in the minerals sector of Indonesia. It also presents proposals on reforms aimed at creating a more effective system of managing and maintaining foreign investment contribution to the development of the mining sector.

2. EVALUATING THE PERFORMANCE AND CURRENT STATE OF THE MINING INDUSTRY IN INDONESIA

The mining industry in Indonesia, up till 1999, has not undergone an independent evaluation and assessment as to its nature and state of affairs, its potential, and its contribution to the economy and society. All this while, production figures, status reports and all general data were generated by the Indonesian Government through the Department of Mines. For the first time ever, an international public accounting firm produced a complete and thorough evaluation of the industry in October 1999. [4]

The report was based "on the results of a confidential, comprehensive survey questionnaire circulated by PriceWaterhouseCoopers to 27 producing companies and over 300 exploration companies that were involved with exploration projects during the period 1994 to 1998 (a significant number of which are no longer exploring in Indonesia)." [5]

Over the five-year period, investments in development and fixed assets totalled US$4.94 billion. Mineral exploration in 1998 was US$79 million, and this represented only 36% of the average expenditure in 1996 and 1997. This shows a decline in the industry by more than half.

> More than 150 exploration projects in Indonesia have been suspended, withdrawn or are inactive. Meanwhile, exploration investment has fallen from a peak of $345 million in 1997 to $165 million in 1999.[6]

The report makes it clear that "This decline in exploration spending is a cause of concern as the long-term success of the Indonesian mining industry is dependent on continued exploration and the discovery and development of new deposits." It emphasises that the success rate of exploration to the discovery of economic deposits, as well as the lengthy process from discovery to production, is of vital importance. Current exploration activities must increase.

An important observation is that the level of planned investment for 1999 represents a significant decrease from actual expenditure over the period from 1994 to 1998, particularly in respect of fixed assets and exploration. Over the five-year period, foreign shareholders have contributed "a significant portion of the financing requirements for Indonesian mining projects, and represent a large proportion of new investment and development."[7]

Foreign mining companies have become valuable strategic partners for Indonesia's mining industry. After 1967, the mining sector in Indonesia had been functioning and growing with foreign participation and investment being the mainstay of almost all activity. In addition to equity, financing and investment, foreign miners brought a combination of new technology, global marketing advantages and experience and provided training to local employees. Of significance therefore is the fact that of the 38 7th Generation contracts negotiated by the Government with foreign investors, 34 were cancelled or postponed by the end of 1998. No contracts in the 8th Generation model have been signed. It is clear that the changes in the provisions are unacceptable to foreign investors.

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3 Straits Times (2001) *Jakarta to Amend Autonomy Laws Hurting Investors*, Jakarta Post/AsiaNews Network/AFP report from Jakarta, August 12, 2001, Singapore.

4 Ibid note 1 at p 55.

5 Ibid note 1 at p 4.

6 Dhume, Sadanand (2001) "Poor Prospects for Digging", *Far East Economic Review*, February 8, 2001, Hong Kong.

7 PriceWaterhouseCoopers (2000) *Indonesian Mining Industry Survey 1999*, Global Energy and Mining Group, PriceWaterhouseCoopers, Jakarta, Indonesia, p 23

3. BASIS FOR EVALUATING A COUNTRY'S COMPETITIVE ADVANTAGE AS A RECIPIENT OF FOREIGN INVESTMENT

Le Huray[8] lists seven special features of mining that need to be taken into consideration when evaluating the attractiveness of Indonesia to foreign investors:

> *1. High Risk.* Investment in exploration, development and production is relatively risky. With a few exceptions, metal prices can be volatile or unpredictable. The investment in a mine is locked into the host country. In the event of adversity, the mine cannot be shut down and moved to another location, and this applies everywhere,
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> *2. Capital Intensive.* All phases of mining are capital intensive, especially the exploration and production phases. Normally, the exploration phase can be financed by equity only. Debt is usually available only for financing mine development and production facilities,
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> *3. Price-taker.* Generally speaking, the mineral producer is considered a "price-taker" in that he has little or no influence over the price at which the metal is sold. The price is established by the marketplace and is based on supply and demand. One of the consequences of being a price-taker is that the producer cannot pass increased costs onto the customer,
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> *4. Remote Locations.* A mine is built where nature has deposited a commercial mineral reserve. As a result, mines tend to be found in somewhat remote locations. The consequences include the need to implement rather innovative and flexible remuneration packages to attract workers to remote locations, and sometimes the need to finance heavy infrastructure costs,
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> *5. Finite Life.* Unlike a manufacturing enterprise, a mining operation has a finite life. No ore body will last forever,
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> *6. Restoration.* Most mineral producing countries are at some stage of implementing or modernising legislation to impose far-reaching responsibilities on the mining enterprise to restore the mine site to its natural state after mine closure and to minimize environmental damage during mining and with regard to waste. Some legislation keeps the enterprise's environmental liability alive forever in the event of post-closure contamination or other adverse environmental consequences of the mining operation, and
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> *7. State Ownership.* In most countries, the original ownership of the resource belongs to the State. Ownership continues to be vested in the State, with the producer operating the mine under a production licence, lease or contract. The operator is obligated to pay royalties to the State.

4. RISING RISKS FOR FOREIGN INVESTORS IN INDONESIA

The high risk, long term nature of investment in mining and exploration requires that all attempts be made to make the foreign investor feel committed to the host country and in particular to the projects. The Indonesian Mining Association reported in 1994[9] that the attitude of the authorities towards making foreign investment inviting, had changed considerably.

In its report, the mining industry found many factors contributed immensely to the reduction of mining in Indonesia in the last five years. Suffice it to say the situation now has worsened due to increased political uncertainty:

1. *Rising Country Risk.* Indonesia's rising country risk, due to the numerous changes that have taken place recently (economic and political upheaval, major shift in legal structures such as local autonomy) have led to this serious decline in investments,

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8 Le Huray, Peter (1996) "Taxation of Mineral Investment – A Comparative Analysis of Indonesia's Position", paper presented at the Asia Pacific Mining Conference, November 1996, IMA, Jakarta.

9 Reid, Graham (1994) *Improving the Investment Climate in* Indonesia, Indonesian Mining Association, Jakarta, Indonesia. (proposal on behalf of the Indonesian Mining Association to the Government of Indonesia).

2. *Rising Security Risk.* The decline in general civil law and order and the failure of authorities to protect the interests and investment of foreign firms is seriously undermining investment,

3. *Rising Legislative Risk.* The proposed 8^{th} Generation of CoW has been rejected in toto by foreign investors. Not one company has signed it; and more than half the companies that had accepted the 7^{th} Generation have either cancelled or withdrawn from their projects. The plan to come up with a totally new law to replace the existing system (Contract of Work) and the Government's decision not to discuss it with foreign investors is exacerbating the situation rather seriously,

4. *Rising Inconsistency in Policy*. Policies have been changing over the recent years at a much faster pace than before, and the lack of consistency is frightening away would be investors, and

5. *Rising Cost of Doing Business*. Instead of the costs going down to the severe decline in the value of the local currency, actual costs of doing business in Indonesia have risen. This is due to the higher costs in labour, transportation, imports, and other operations.

6. *Other Developments*.

   Land Tenure *and Compensation.* The lack of a well-defined tenure system and the ineffectiveness of the legal system in addressing compensation claims stands in the way of the development and successful operation of mines,

   Shifts in World Exploration Spending. Canada, Australia and the United States still continue to attract over 50% of the world's estimated expenditure in mineral exploration. These three countries all share low levels of country risk, well developed infrastructure, and very attractive tax and royalty regimes. New opportunities are opening up for investor companies in other countries such as Chile.

   Lacklustre Infrastructure Development. Indonesia has lagged behind in its development of basic infrastructure needs, especially since the country is so vast and separated by large bodies of water. Transportation and telecommunication has to be made efficient and cost effective, and

   Burdensome Bureaucratic Practices. The massive bureaucracy remains a tangled web of run around for the foreign investor, consuming time and money, and increasing the level of frustration for foreigners. The rampant corruption is also not very encouraging.

The then newly appointed Minister of Mines of Mines and Energy, Lt. Gen. Susilo Bambang Yudhoyono, in his first address to the mining community in November 1999 admitted the shortcomings the industry faced:

> Over the past three years, the Indonesian minerals industry has witnessed some remarkable events. The Bre-X drama, which came to surface in late 1996, reached its climax in early 1997, with the discovery of fraudulent claims regarding the size of the Busang deposit.
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> This incident had international as well as local repercussions. It shook the North American capital markets and caused deep concern within certain circles in Indonesian society, particularly with regard to the intervention by some Government authorities over the allocation of equity shares in the Busang Contract of Work (CoW).
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> This was the beginning of a series of issues that created a sense of uncertainty within the mining community, about the consistency of the Indonesian Government in implementing policy, with regard the CoW system.
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> There was an attempt by the Government to revise the agreed provisions of the CoW in order to give greater benefits to the Indonesian Government and national interests, which caused considerable concern within the mining community.
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> Although the Government was subsequently forced to give up the idea, it resulted in the downgrading of our credibility and seriously affected the flow of exploration capital, as the consistency of Indonesia's long term mining policy was called into question. We are now working hard to repair the damage. [10]

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[10] Indonesian Mining Association, (1998-2000) *Monthly Newsletter*, Oct.-Nov 1999:18.

5. THE DEVELOPMENT OF THE CONTRACT OF WORK SYSTEM AND ITS CURRENT STATUS

The 1st Generation of CoW was successful in every way. Since 1967, Freeport Indonesia has been carrying out a continuous program of exploration and development, and today the mine is the largest mine in the world. It produced, by 1994 approximately 28 million tonnes of copper and 2,700 tonnes of gold, from a most remote and underdeveloped part of the world, Irian Jaya. For the year ending 1997, Freeport's production was 57,663,55 kilograms and in 1998 total production exceeded 91,044,97 kilograms [11]. The Company has recently negotiated an additional CoW in the adjacent area. From this CoW alone, Indonesia has all these years benefited from taxation and royalties, import taxes, income taxes, exports, foreign earnings, ancillary transactions such as supply of equipment, transportation, food, as well as transfer of technology, employment, skills training and experience for its nationals. All this just from one operating mine.

From subsequent CoWs, four companies from the 2nd Generation are today producing, as are two from the 3rd Generation and five from the 4th Generation CoWs. In 1997, these other Contracts produced 28,664.99 kilograms of gold, and in 1998 the production increased to 31,095.29 kilograms.[12] The direct and spin-off benefits would also be immense.

Of the other CoWs signed, one from the 3rd Generation, 20 from the 4th Generation, five from the 5th, 62 from the 6th, and 38 from the 7th are at various stages of development. At the minimum, all explorers have invested millions of dollars in exploration work. Over and above this, even the 96 terminated, and the 34 postponed CoWs, the involved companies would have invested a not insignificant amount of money in exploratory and survey work, and many sectors of Indonesian industry and government would have derived at least some form of benefit from this investment.

Today, the Indonesian mining sector stands at a near collapse. What happened? Where was the turning point? It is now agreed that in the first Generation CoW, the Government had given away the farm. But the subsequent 2nd and 3rd Generation corrected the "wrongs", so why was there a need to go overboard? The lesson was clear when in the 3rd, all the excessive requirements such as the mining companies being subject to the general tax regulations and the addition of windfall tax obligations, and the very serious requirement of having to transfer 51% equity to Indonesian partners were included. This occurred at a time when metal prices were depressed and resulted in a not so enthusiastic response from the international mining community. Consequently the Government had no choice but to revise the 3rd to come up with the new 4th Generation CoW, and that is when investment started flowing again.

In the mid 1980s, with the introduction of the 5th Generation CoW, activity picked up as did metal prices, and from this juncture Indonesia enjoyed a fantastic run of exploration and investment activity. By 1992 the mining industry was booming in Indonesia. However, more changes were made. With the introduction of the 6th Generation CoW, the mining community in Indonesia began a series of dialogues to work with the Government in avoiding the introduction of excessive regulation including the new tax and royalty schemes and additional bureaucratic requirements. In 1994, assessment of Indonesia's achievements over the preceding 25 years was attributed to:

1. Indonesia's mineral prospects,
2. The Government's open door policy for foreign investment in exploration and mining,
3. The CoW system,
4. The country's political stability and economic development since 1967, and
5. The international environment, and limited competition from other countries. [13]

From 1994 to 1998, production of gold increased three fold, from 1,252.3 hundred thousand ounces to 3,636.5 hundred thousand ounces.[14] This production was a result of earlier contracts. Exploration activity under the newly signed 6th and 7th Generation CoWs continued, but declined sharply due to:

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[11] Supra p 10.

[12] Supra p 11.

[13] Indonesian Mining Association, (1994) *Improving the Investment Climate in Indonesia for the Mining* Industry, I. M. A., Jakarta. p 14.

6. The Busang scam and fiasco in 1997
7. The introduction of the proposed 8th Generation CoW in 1997
8. The collapse of the Asian economies in 1998
9. The political and economic turmoil in Indonesia in 1998-1999, and
10. The Government's inability to stabilise the political and economic climate and reassure the international community.

It is difficult to say if one particular factor precipitated the decline, but the series of events permits some conclusions to be drawn that could be usefully exploited by other developing countries.

6. THE FUNDAMENTAL STRUCTURE OF THE CONTRACT OF WORK SYSTEM

The CoW system is a well-developed and transparent system of granting concessions and mining rights and obligations to foreign companies. The basic needs of investors: Security of Tenure (covered as Conjunctive Title which empowers the investor to proceed from General Survey through Exploration all the way through Mine Development, Production, Processing and Marketing)) and Security of Investment (covered as *Lex Specialis* treatment, which assures that the investment is not subject to changes in government laws or policies after signing for the period in force); are expressly stipulated.

The Indonesian Mining Law of 1967 does not cover in detail the terms and conditions under which the foreign investor must operate, so these are expressly outlined in minute detail in the CoW. The later generations of CoWs (3rd to 7th) standardised working procedures and served to fulfil the needs of investors to the point of acquainting and familiarising them with the system. Foreign investors came to feel "comfortable" with the system. The shortcomings with regard the inefficiencies in the bureaucracy, the poor infrastructure and bad business practices were overlooked as long as the return on investment was meaningful. Naturally, the political stability in the country allowed for long-term investment. Slow, creeping changes via the various generations of the CoW worked either to increase or decrease the enthusiasm of investors, but the confidence in and workability of the system remained intact.

It was only when the basic restructure of the CoW system took place in the 8th generation that the panic started. This change was the slow but serious dismantling of the Security of Tenure clause. Once mining companies began to realise that the very fabric of their reason for being in Indonesia was being taken away, i.e. they would not be guaranteed rights and access to the contract area, their attitude changed. This started to happen slowly from the 7th Generation but became apparent in the 8th Generation CoW. Of course, the slow dismantling of the *lex specialis* provisions was another factor affecting the total decline in foreign investment in mining in Indonesia.

The Indonesian Government failed to learn from the clear lessons and feedback it had received over the 30 years that the CoW system had been in effect. The changes made from the 1st to the 2nd were quite easily accepted, but the changes in the 3rd were not. Only three contracts were signed from 1977 to 1979. The Government was compelled to withdraw the new taxes such as the Windfall Tax, and reduce other direct taxation and royalties as well as lift the restriction on foreign remittances. This resulted in the revised 3rd and 4th Generation CoW which had very positive results. The first boom in 1985 to 1987 saw 94 contracts signed. After the collapse of the world stock markets caused a depression in almost every industry, and the Indonesian Government placed a moratorium on investment, it went back to the drawing board and came up with the 5th Generation. This 'Frontier Contract' gave incentives for companies to go to the hinterland areas and allowed companies to keep accounts in US dollars again, however, there were also serious problems introduced. There were added impositions on the mining companies such as increases in land and building taxes, increases in security deposits required, increases in the minimum expenditure requirement, removal of the guarantee by the government to purchase production in case of an export ban, establishment of import duties on parts, and the requirement that new royalty rates be on fixed dollar estimates. The net result by 1994 was again that only three 5th Generation contracts were signed. The Government had, once again, cause to reflect. The lesson that creeping changes and unpredictable policies are a disincentive to investors had still not been learnt.

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[14] Ibid fn 1.

In late 1994 and 1995 the government consulted and negotiated with the mining community. By 1997, the 6th Generation of CoW was formally enacted. There were some positive aspects of this generation such as the *lex specialis* and the maintenance of land rights for parts of the population and the right of the foreign investor to exercise full control over the management of the project. On the other hand, some additional costs were raised including some degrading of the *lex specialis* (no guarantee of access in forested areas (hutan lindung)), deposits increased and had to be paid in cash, pre-incorporation expenses could no longer be transferred to joint venture company, new taxation regime was implemented through VAT, withholding tax, and income tax, and a reduction in the final area after the general survey period was required. This was the time when there was a boom in gold prices (1994-1997) and a major influx of Canadian juniors had started raising finances. The Busang fiasco ended it all. By that time 260 junior-level investment applications were pending and 38 contracts had been approved, mostly from major companies. The 7th Generation CoW died a slow death, and no one has signed the 8th Generation.

The 8th Generation is unacceptable to the foreign investors. It does not provide security of tenure, the royalty rates proposed are not internationally competitive, additional severe restraints affect a company's ability to raise funds, and the amount of tax payable can now vary as Provinces can change tax structures at their pleasure. [15]

7. THE NEED TO UNDERSTAND THE NATURE OF THE MINING INDUSTRY

The mining industry has its own unique characteristics which need to be understood in order to promote foreign investment in this sector. It appears that Indonesian authorities failed to understand the industry, and were unable to respond to its needs effectively and positively. Some of the complaints raised by foreign miners in their representation to the Government in 1994 focus particularly on the CoW:

> It is the experience of many mining operators in Indonesia that the principles of *lex specialis* is often ignored at various levels of government; officials are making their own interpretations of the CoW, or even choosing to ignore it. The Government's requirement that gold miners put their dore through the local gold refinery, even though that refinery is not internationally competitive, is one example of this. New regional government taxes and charges are another example.
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> Of greater concern is that the fact that – as stated above – the CoW cannot pretend to cover every issue that might arise in the course of such a long and complex venture. There will invariably be provisions in the CoW, which appear ambiguous or open to very different interpretations. In that situation, it is absolutely critical that the parties recognise the original purpose of the provision in question.
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> There has been a progressive move from the Third through to the Fifth Generation of CoW of the taxation regime for exploration and mining from the provisions of the CoW itself to general Indonesian tax law. This has resulted in varying – and in the view of the mining industry inappropriate – interpretations of that regime by the taxation authorities, who often display little understanding of the industry. This is perhaps one of the most retrograde features in the recent developments of the CoW.[16]

Had there been proper government policy making through a thorough understanding of the industry, reaction to changes in the marketplace could have been handled in a more meaningful manner. As Sanjay Lall[17] notes that *"the role of policy interventions has always been taken as crucially important in the growth process."* The process of understanding any complex internationally competitive industry may be lengthy and often slow, but a necessary precursor to effectively responding to the particular industry on a local level and implementing desired shifts in such a way so as not to kill the goose that lays the golden egg. Once the policy makers are informed, they can devise self regulation and co regulation policies utilizing commercial interests and finding surrogates for direct intervention and improve the effectiveness of conventional regulation. [18]

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15 McKay, J. and Bhasin, B. (2001) "Mining Law and Policy in Indonesia: Issues in Current Practice that Need Reform", *Journal of Energy and Natural Resources Law*, Vol.19 No.4, November 2001, London.

16 Indonesian Mining Association, (1994) Improving the Investment Climate in Indonesia for the Mining Industry, I. M. A., Jakarta: 23

17 Dunning and Narula (1996) Foreign Direct Investment and Governments – Catalysts for Economic Restructuring, Routledge, New York**.** (1996) in his concluding chapter 'The Investment Development Path – Some Conclusions'

18 Gunningham, N. (1998) *Introduction to Smart Regulation: Designing Environmental Policy*, Gunningham N. and Grabosky P., Clarendon Press, Oxford

Effective working relationships enhance the development of the industry and sustain foreign investment for the benefit of both parties.

8. POLITICAL STABILITY – MANDATORY FOR RESOURCE DEVELOPMENT

Political stability is a necessity not only to sustain foreign investment in the country but for the growth and development of domestic enterprise as well. Without political stability no business or investment activity is possible. An article entitled "Business in Difficult Places - Risky Returns" in *The Economist* [19] noted that:

> The gravest political risk for firms investing in difficult countries is that bad policies lead to an economic implosion. In Zimbabwe, for example, Robert Mugabe's misrule has meant shortages of fuel and foreign currency. Companies can neither keep vehicles running nor import spare parts. Potential investors are deterred by Mr. Mugabe's open disregard for property rights and gleeful incitement of mob murders. Those who already have money tied up in the country yearn for a change of government. But such transitions are sometimes more violent still. The economic turmoil that helped unseat Suharto in Indonesia was accompanied by riots aimed at foreign (mainly Chinese-owned) businesses.

The PhD research done by Kazi Golam Mohiuddin in 1981 at the University of California, Los Angeles[20] confirmed the hypothesis that "The more political instability a host country experiences, the higher the political risk to which direct foreign investment in mining in that country is exposed." Analysing the data for 50 countries, using multiple regression and correlation techniques in a time series, has confirmed (at the 95 percent confidence level) the existence of time dependent relationships during 1970-1979 between political instability and political risk. Mohiuddin has further confirmed in Hypothesis 2 that "The higher the political risk in a country, the lower the level of new direct foreign investment in mining in that country."

In his authoritative article, "Mining: The Mis-Understood Industry"[21] Wondemagegnehu G. Selassie asserts:

> The discovery of a huge and high-grade deposit alone is not enough for starting a mine. In addition to the discovery, there should a market, a stable tenure system, infrastructure, trained manpower, and above all peace and stability where the project should take place.

Minimising political risk is a factor all foreign investors take into consideration when embarking on a project. The worst-case risk scenario for any investor is political chaos and breakdown in law and order. It has been explained that this is of even greater concern for the mining industry, which operates in remote regions. The political situation in Indonesia has degenerated to such a point that the rule of law is not being enforced. Most foreign investment companies have put their projects on hold due to the risky political situation in the country.

The obvious conclusion this analysis forces is that political stability is mandatory for any country intending to invite and sustain direct foreign investment in the resource development sector. However, the common experience is that this is difficult to achieve especially in South East Asian economies. [22]

9. GOOD GOVERNANCE THROUGH TRANSPARENCY

A pre-requisite to managing political and regulatory risk is the requirement for best business practices of good governance and transparency. In the case of Indonesia it was apparent that a poor and inefficient business *modus operandi*, that of "collusion, corruption and nepotism" (termed KKN by the Indonesians) has had a devastating effect on the economy in general and on the minerals sector in particular.

Wilhelms [23]contends that "the reason for seemingly disadvantaged countries attracting relatively large FDI inflows is that they have found a niche in the global FDI market that makes them more attractive than other

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[19] 'Business in Difficult Places: Risky Returns', *The Economist*, 20 May, 2000 v355 (8171) pp. 85-88, London

[20] Mohiuddin, Kazi Golam (1981) A Cross Country Prediction Model for Political risk Assessment by American Mining Corporations Operating in Developing Regions, PhD Thesis, University of California, Los Angeles.

[21] Selassie, Wondemagegenehu G (1999) *Mining – The Misunderstood Industry (African Perspective)*, The Centre for Energy, Petroleum and Mineral Law and Policy, Dundee, U.K.

[22] Backman, Michael (1999) *Asian Eclipse: Exposing the Dark Side of Business in Asia*, John Wiley & Sons (Asia) Pte Ltd, Singapore

countries competing for FDI, even if the latter are more richly endowed with more natural resources. Brains, not brawn, make the difference. This is an immense opportunity for countries that appear disadvantaged in the global competition for FDI, and an even larger one for those with a natural resource base that already attracts FDI– as long as they do not become complacent.” What is this Institutional FDI Fitness model? It recognises the ability of the nation’s institutions to take advantage of open opportunities. The institutions are: Government (Legislature, Executive and Judiciary); the Markets (Goods, Services, Capital and Linkages); Educational; and Socio-cultural. It is imperative that such institutions be efficient and effective.

The study explored determinants of net FDI inflows in 67 emerging economies between 1978 and 1995 and was intended to assist policy makers in attracting private capital, and to make the investor decision making process more objective. The focus was on the FDI component as opposed to the portfolio component of FDI. The finding was that it is not sufficient to merely decree new policies. Rather, national institutions have to be efficient and effective in transmitting these policies in day to day FDI transactions. It is also important that the parties understand each other’s interests and constraints, enhancing communication and cooperation to shape institutional structures that relate to FDI policies and processes in a manner consistent with national development goals.

All the participants in FDI schemes need to exercise good governance and transparency principles. This applies not only to the host government and the relevant departments, but to the investing companies and their officials as well. There needs to be a fair and effective implementation of legislation through an impartial judiciary and responsible officers who are all well paid. In his exposè on the New Indonesian Company Law, Pulle[24] observes that it is necessary to establish and develop a body of decisional law “that would stabilise expectations of management, shareholders, employees and investors.” Later Pulle,[25] emphasises the need for removal of “excessive regulation and vestiges of anti-business attitudes” and at the same time the need for more transparency for stimulating foreign investment.

An interesting suggestion would be the possibility of establishing a Code of Conduct for FDI participants – the home country, the host country, the investor and the local partner, if any. McKay[26] noted that such codes could have the effect of acting as ‘standard bearers’ even if they have no legal standing. They serve to identify those acting unethically and not living up to their obligations if the media is able to report such issues. Even though such a code may have minimum impact on the actions of the participating entities, it is a small step in creating a set of rules governing the behaviour of all parties to FDI activity. Until now, all efforts such as OECD and other guidelines have only been aimed at local governments hosting FDI investors. The main criticism against such codes has been that they serve to limit only the powers of the host government in acting against foreign investors.

The clear conclusion here for Indonesia and indeed for all host and home governments and participating investing companies is that good governance and transparent behaviour should form the mainstay of all economic and legislative activity at all levels.

10. ENSURING REGIONAL DEVELOPMENT KEEPS PACE WITH RESOURCE DEVELOPMENT

In order for FDI to be successful in the most effective way, it is necessary that the benefits reach the hinterland and the community from whom the resources are being extracted. In the Indonesian scenario, it was shown that this had not happened. As a result both companies in the case studies were facing insurmountable challenges of illegal mining and the failure of local authorities to prevent such activity. It was argued that for FDI to be accepted by the rural population, where most of the mining projects are located, they have to have some share in the benefits that FDI brings to the host country.

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23 Wilhelms, Saskia Katenka Susanne (1998) *Institutional FDI Fitness: Determinants of Foreign Direct Investment to Emerging Economies,* PhD Thesis submitted to The Fletcher School of Law and Diplomacy, Tufts University, February 1998.

24 Pulle, Austin I (1996) ‘The New Company Law in Indonesia”, *The Company Lawyer*, Vol 17 No 4, April 1996

25 Pulle, Austin I (1998) ‘A Time of Transition, A Time of Turbulence?, in *Business Opportunities in Indonesia,* Prentice Hall, Singapore.

26 McKay, Jennifer M (1994) ‘Classification of Australian Corporate and Industry Based Codes of Conduct”, *International Business Lawyer,* December 1994

The main grievance that has led to demands for social reform in Indonesia has been that while the populace was watching natural resource extraction taking place, the national's policy makers were not involving them in the economic development process. The social unrest that led to the overthrow of the existing regime has demanded greater autonomy for the regions and municipalities. They have since demanded a share of the taxes and royalties paid by mining companies to the Central Government. Clive Aspinall[27] outlines the change taking place and forecasts the trend, as follows:

> Recent government regulations on regional autonomy, royalties and hazardous waste and banning open pit mining from certain forested areas (hutan lindung) have been legislated, and are pending implementation. Some laws were legislated so rapidly by Parliament that they will have to be repealed. As they stand, the latter are unworkable. Mining companies are also facing growing nationalism, village rights to ancestral properties, local customs and expectations, and challenges from environmental groups and concerned NGOs.
>
> In the past mining companies depended on their Contract of Work (CoW) document as their guide and law to operate in Indonesia. When local social matters at mine sites conflicted with Contracts of Work, companies reported matters to the Department of Mines in Jakarta. The authorities sometimes sent in troops to restore order. Mining companies have not liked this procedure, but were only following the law of the land. The way of doing resource-based business in Indonesia, especially mining is now facing a new beginning and multiple challenges. No longer can mining companies depend on the President of Indonesia to protect their development projects. From now on, I believe, all challenges will have to be confronted by the mining companies themselves. Consequently, laying the foundations for good cooperation between provincial and regional administrations, local small-scale miners, village people and traditional natives should be the order of the day.

The lesson here for all parties, is that local community development should become part and parcel of host government responsibility with the participation of the investing organisation. A suggestion here is the list of guidelines prepared by the World Bank for implementation.[28]

10.1 What the mining companies can do:

Exploration Stage	Identify and inform communities
	Overcome mismatch of interests
Project Design Stage	Build respect and trust
	Consult with affected communities
	Minimise negative impacts
Operational Stage	Forge effective community partnerships
	Set up joint monitoring arrangements
	Support training and capacity building
	Outsource jobs to the community
Closure Stage	Physical reclamation
	Help community prepare for mine closure

27 McKay, Jennifer M (1994) 'Classification of Australian Corporate and Industry Based Codes of Conduct", *International Business Lawyer*, December 1994

28 The list is entitled "Mining and the Community: From Enclave to Sustainable Development" and was presented by John Strongman, Mining Adviser to the World Bank on 26-30 July 1998 at the *Asia/Pacific Mining and the Community Conference* in Madang in Papua New Guinea, The World Bank, Washington, D.C.

10.2 What Governments can do:

Exploration/Overall	Set administrative rules and procedures for information sharing and consultation
Project Design Stage	Require good practice in terms of environmental and social assessments
	Ensure community has access to studies
Operational Stage	Ensure good monitoring and compliance
	Provide community services
	Ensure equitable sharing of benefits
Closure Stage	Help community prepare for mine closure
	Oversee mine closure/decommissioning

10.3 What Communities and NGOs can do:

Exploration Stage	Educate community members about mining
	Become prepared to respond to proposals
Design Stage	Organise members and build consensus
	Develop mechanisms to resolve internal differences and conflicts
Operational Stage	Develop leadership and community capacity to stand on own feet
	Avoid dependency/handout mentality
	Build community assets
Closure stage	Prepare for post closure situation

The conclusion made by the World Bank is that focus on common goals and interests, the community and the mine, and with the active support of the government, will lead to a better understanding of each other. This will lay the foundation for each to see each other as an asset and a partner and thereby create the possibilities for shared successes, increased benefits and sustainable development. [29]

11. FINANCING RESOURCES DEVELOPMENT: BANK-ABILITY OF MINING PROJECTS

One of the main considerations for minimising risks in mining ventures is the need to ensure the bank-ability of the project. "Most natural resource projects are of such large scale that they require special purpose investment and financing structures to undertake them which must satisfy the requirements of bank-ability".[30] This would mean that the contract between the two parties (the Government and the investing company) plus the governing regulations and the taxation regime should indicate that the project is workable and viable, to the satisfaction of the bankers. This is termed as bank-ability. When bankers assess a project for financing they consider the creditworthiness of the borrower (in this case the foreign investor); the credit risk where some recourse must be available to the lender; the completion risk which takes into account the feasibility of the project, including the

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[29] Ibid.

[30] Pritchard, Robert (1999) *Before You Venture Forth – A Checklist of Legal Safeguards for Foreign Investment in Energy and Natural Resources Projects*, The Centre for Energy, Petroleum and Mineral Law and Policy, Dundee, U.K.

ability to complete the project in a certain time and the ability to meet cash flow projections once in operation, for the repayment of the moneys advanced; and the Currency Risk. [31]

> Financing for exploration and mining development activities is very difficult to raise. The Financial Times reported that world wide foreign investment of US$195 billion in 1993; while the amount of funds available was only US$2.5 billion, which is less than 1.3% of the total. Considering the degree of risk involved and the extended period of time the investment is exposed to such risk; one even wonders that there are still funds available for mining.[32]

The CoW must be acceptable, not only to the mining company but the financing organisations as well. If the CoW is not bankable, there is little point in any serious investor signing it. In Indonesia, all previous generations of CoW were bankable "in that banks have been prepared to advance many hundreds of millions of dollars to develop new mines under those CoWs. There is a real danger that a number of the changes proposed in the Eighth Generation CoW make the CoW no longer bankable."[33]

What were the changes that made the CoW not-bankable? The miners complained that the lack of the following assurances, were the causes of uncertainty:[34]

1. Security of tenure. Banks need to be assured that the company will be able to produce and sell minerals from the contract area without interference from others, thereby maintaining the predicted after-tax cash flows.

2. Freedom to sell product at international prices and hard currency.

3. The right to manage the project independently. An article had been removed which had provided "full and effective control and management of all matters" relating to the project.

4. Stability and transparency in the tax and royalty regime. The changes made to the 'Local Government Taxes and Charges' failed to provide for a clear-cut position on this, and this would affect the project's after-tax cash flows.

5. Dispute resolution by international arbitration or in the courts of an independent jurisdiction. The original procedure of arbitration under UNCITRAL conciliation and arbitration rules has been replaced by the requirement to settle all non-tax disputes by the national Arbitration Body of Indonesia (BANI) and tax disputes by the Consultative Board of Taxes. Foreign companies are not comfortable with these arrangements.

The net result has been that no company has signed the 8th Generation CoW in the last two years. What can developing countries learn? That the investors cannot be encumbered by legislation and requirements which jeopardise their ability to raise finance for the projects from bankers and other financial institutions worldwide.

12. CONCLUSIONS AND SUMMARY

It is a difficult problem for all third world countries[35] to use their mineral potential in order to boost economic growth and capital accumulation. His findings showed that most of the mineral rich Third World countries had witnessed an unprecedented expansion of their mineral sector, not only in terms of their need for foreign earnings, but also for internal capital accumulation. It appeared that the foreign mineral firms operating in these countries to a large extent also depend on such mineral projects. This creates a bargaining position whose outcome depends on the control over the following fundamental factors:

1. The control over relevant information regarding the mining business,

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[31] Supra.
[32] Ibid fn 20.
[33] Indonesian Mining Association, (1998-2000) *Monthly Newsletter* Jan Feb 1999.
[34] Supra.
[35] Described well Bah, Abdul Radiaye (1991) *Foreign Investment, Capital Accumulation, and Growth in the Developing Economy: The Case of the Mining Sector in the Republic of Guinea*, PhD Thesis submitted to the State University of New York at Buffalo, August 1991.

2. The control over technical and managerial resources,

3. The control over mineral resources, and finally,

4. The level of dependence on the minerals.

Given that most of these factors are overwhelmingly dominated by the foreign firms and their states, Third World mineral producing countries are left with few alternatives. They are: 1) either they succeed in forming real and effective cartels, or 2) they accept whatever could accrue to them from the exploitation of their resources (take it or leave it), or 3) they withdraw their resources from exploitation until better conditions are created. His finding was that the second alternative be maintained, not because it is the best, but because it is the most realistic.

In the case of Indonesia, there is an addition to those presented by Bah. That fourth alternative is the opportunity to effectively partner with the foreign investor as an equal. The elements of this important fourth alternative are those presented earlier in this article, the key is good governance. The good governance extends to legislation being transparent and enforced with the locals actually seeing some of the fruits of the exploitation.

This possibility is proven in this analysis, as Indonesia did manage to share in the generation of profits from the mining done by the foreign investors, while making it profitable for them too. This win-win situation worked as long as it was attractive to the investors (worth the high risks up to the 6th Generation) and started to decline only when it became too restrictive in legislation and loss of control. The main lesson for developing countries that are currently seeking foreign investment in their natural resources sector such as China, Vietnam, Myanmar, Cambodia, Laos, and others, is that the terms most important for sustaining investment are the two key elements of miner's needs. First, that of security of tenure, giving rights and access to contract or concession areas. Second, consistency and transparency of all forms of taxes and royalties (also called *lex specialis*). These guarantee the investor that the terms and conditions imposed on entry (and based on which the calculations of risk/rewards has been done) will remain intact and will allow the investor to at least recover the huge amount of investment that mining projects these days require.

In addition, this study has found that there are other critical factors that will sustain foreign investment both in the short and long term. These have been identified in the preceding section. They are: the need to know the peculiarities of the industry, safety and security for all, the benefits of investment activity to be passed down to the communities where the operations are taking place, and the capacity to raise finances from banks and other institutions.

For further research, it is recommended that the unfolding of events in Indonesia be studied over this transition period. The country is revising its basic legal framework[36] and restructuring the entire mining sector. Will the Contract of Work system survive? A modified form may emerge which focuses on operations at the regional and community level. There is already a drive towards decentralisation. How will this work? What sort of organisations and procedures will be set up to allow for regions to deal directly with foreign investment companies?

These and many more questions can form the basis of an exciting original research as Indonesia imposes decentralisation on its CoW model. Maybe, the inter-regional competition will create a competitive market oriented climate where regions will compete on such factors as transparent government with less corruption and giving the locals direct benefits. Clearly, the CoW was effective when it was stable and allowed security for the foreign investor. Those needs still exist, and the CoW model (pre 6th generation) at least provided an overall framework where all investors were treated fairly. To change this fundamental principle and make it subject to provincialism may or may not be regressive. It remains to be seen.

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[36] The basic Mining Law of 1967.