

# FDI LAW AND POLICY IN INDONESIA: REPLACING THE ‘CONTRACT OF WORK’ SYSTEM

Balbir Bhasin and Sivakumar Venkataramany

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## Abstract

Indonesia created a novel system to administer Foreign Direct Investment (FDI) in mining. This Contract of Work (CoW) system served the country well from 1967 up to 1997 when the national political (democracy revolution) and economic (Asian Currency) crisis, coupled with the Busang fiasco (where large scale fraud in gold discovery claims caused billions in losses) led to total collapse and cessation of FDI in the country’s extraction industry.

Since the stabilization of the political and economic framework in Indonesia after free elections in 1999, the government has attempted to create a new law to replace the CoW system which has yet to be passed. This paper evaluates the new proposals and compares them to the previously successful system and suggests concerns and reforms that need be addressed. Specific focus is placed on issues of security of tenure, taxation and royalties, local government involvement, and environmental damage.

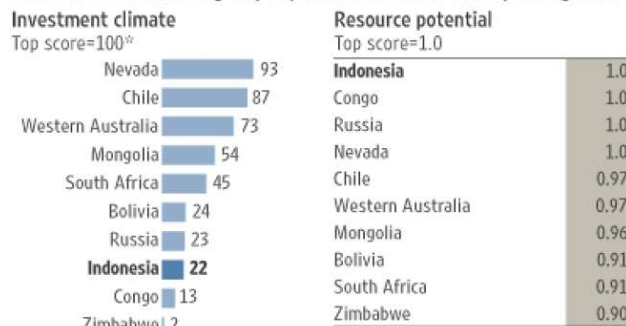
## Introduction and Background

Indonesia has some of the world’s largest reserves of gold and other minerals and commodity prices have soared in recent years. The price of gold has continuously risen from US\$384.40 in 1996 to US\$444.74 in 2005. Indonesia’s resource potential is ranked above Zimbabwe, South Africa, Bolivia, Mongolia, Western Australia, Chile, Nevada, Russian and Congo (Table 1). Yet the Wall Street Journal in February this year reported that mining companies “haven’t broken ground on a single mine here since Asia’s 1997-98 financial crisis” (Wright and Barta, 2007).

**Table 1 – Indonesia’s Mineral Potential**

### Untapped potential

Mining companies rank Indonesia’s investment climate as among the worst in the world. But its mineral wealth gets a top score from miners asked to assess countries assuming they implemented investor-friendly mining laws.



<sup>a</sup>Score based on a number of factors including regulatory consistency, security of investment, and taxation policies

Source: Fraser Institute 2005/6 Survey of Mining Companies

Source: Wall Street Journal, February 7, 2007

Mining has been one of Indonesia's top industries for foreign investment. It contributed 50,197 billion Rupiahs or around US\$5.5 billion to the economy in 2005, which accounts for 2% of the GDP. Total government revenues from taxes and royalties increased 62% to US\$2.7 billion, a record for the last 10 years. (mineIndonesia, 2006) Yet, the same survey by PricewaterhouseCoopers notes that the country continues to lag behind global trend of new investments. Canada's Metals Economic Group (MEG) budgeted worldwide exploration in 2005 at US\$5.1 billion. Current exploration spent in Indonesia is only 2% of the global total (Table 2). This is noteworthy in that expenditure on greenfields explorations is critically low in Indonesia, and dropped from an average of US\$40 million (1995-1997) to US\$7 million (2001-2005).

**Table 2 – Indonesia's Exploration Spending**



Source: Metals Economics Group

Source: mineIndonesia 2006, PricewaterhouseCoopers

The Fraser Institute in its 2004/2005 survey of mining companies ranked Indonesia very low for its investment conditions, scoring 22 out of 100 on the Policy Potential Index, and ranked it sixth last, marginally ahead of Zimbabwe, Papua New Guinea, the Democratic Republic of Congo, Venezuela, and the Philippines (McMahon, 2006). The main concern of foreign investors remains the lack of a clear legal framework. Among the factors that were deterring investment in Indonesia, a very large percentage of respondents (53%) cited the uncertainty in regulations (Table 3).

**Table 3 – Factors Deterring Investment in Indonesia**

Factor	% of respondents who consider factor to be a strong deterrent to investment in Indonesia	Comments
Uncertainty concerning the administration, interpretation and enforcement of existing regulations	53%	10 <sup>th</sup> lowest rank
Infrastructure	34%	8 <sup>th</sup> lowest rank

Source: Fraser Institute\*

Source: mineIndonesia 2006, PricewaterhouseCoopers

Indonesia has had in place a very novel and unique law for inviting foreign investment in mining. Yet, the PricewaterhouseCoopers survey of 2005 reports that the new draft mining law, now before parliament "indicates that the CoW system will cease to exist for new projects, which is not favored by foreign investors." (mineIndonesia, 2006).

## Contract of Work (CoW) System

Indonesia's unique system to administer Foreign Direct Investment (FDI) in mining was created in 1967 and lasted till 1997 – a full thirty years. 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 (3<sup>rd</sup> to 7<sup>th</sup>) standardized working procedures and served to fulfill the needs of investors to the point of acquainting and familiarizing 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. During this time, seven generations of contracts were evolved based on the needs of the country as well as foreign investors, taking into account the prevailing market conditions.

## Collapse of the CoW System

Two major developments led to the collapse of the mining industry in the period 1997-1998. First was the Busang Scam also known as the Brea-X scandal, described as the biggest mining hoax in history. A small Canadian company claimed a find of over 200 tons of gold in Kalimantan, Indonesia which was valued at over US\$70 billion. The company's stock price rose from fifty cents in 1994 to \$286 in 1996 and ultimately dropped to nine cents in May 1997 when the false claims were discovered (Francis, 1998). This remains a serious blot on Indonesia's legal system. The second was the Asian Monetary Crisis of 1997 and the heavy depreciation of the Indonesian Rupiah which led to protests and the end of the Suharto era, and after 3 years of uncertainty, a new democratic government was elected in 1999.

The resulting political instability caused a severe decline in mining investment. By 2000, more than 170 exploration projects had been either suspended or withdrawn and rendered inactive, and only 12 of the 268 CoWs were in operation. The 8<sup>th</sup> generation of CoW proposed by the government remained unsigned by any investor (Bhasin, 2002). Indonesia got only 1% of exploration dollars worldwide. No new CoW has been issued for eight years (Table 4). The new democratization process demanded decentralization and this required a restructuring of the investment laws for mining in line with the local autonomy laws, which to this date has not been achieved.

Table 4 – Status of CoWs

### Contracts of Work by generation and status

	1st	2nd	3rd	4th	5th	6th	7th	Total
Producing	-	4	1	5	1	1	-	12
Other stages	-	-	1	9	5	25	14	54
Suspended/Terminated	1	13	10	80	2	39	24	169
<b>Total</b>	<b>1</b>	<b>17</b>	<b>12</b>	<b>94</b>	<b>8</b>	<b>65</b>	<b>38</b>	<b>235</b>

Source: Directorate of Minerals and Coal Enterprise

Source: mineIndonesia 2006, PricewaterhouseCoopers

## New Draft Mining Law

The new mining law (The Bill of Mining Law) does away with the CoW system established under Law No. 11 of 1967 altogether. It is intended to comply with the fiscal decentralization and regional autonomy brought about by Laws 22/1999 and 25/1999. The new mining law would also provide greater level of environmental protection and recognize needs of the local community's rights. The key elements as outlined by the US Embassy in Jakarta are:

1. **Reclassification of Resources** – Mineral resources have been reclassified from (a) strategic, (b) vital and (c) non-strategic and non-vital to (a) radioactive, (b) metal, (c) non-metal and (d) coal, peat and oil-shale. To these have been added two new areas of regulation – geothermal and groundwater – not formerly included as mineral resources.
2. **Reclassification of Parties** – Parties that may conduct mining operations are now limited to two: a business entity or a private person. Previously parties included government institution, state owned company, local owned company, cooperative, foreign major company, foreign minor company, a joint venture company, or a person or legal entity.
3. **Foreign Investment** – There is now no restriction on foreign capital. Previously foreign investment was regulated by the contents of the CoW (Article 10 of Law 11/1967) and foreign interests could not hold a KP (Kuasa Pertambangan - mining rights) which was restricted to local entities.
4. **Mining Licenses** – The new law simplifies mining administration by eliminating distinctions between foreign and domestic investors. Under the new law, both domestic and foreign investors will operate mines under the authority of a "mining operation permit" (Izin Usaha Pertambangan, IUP) or a "mining operation agreement" (Perjanjian Usaha Pertambangan, PUP). For small-scale traditional miners, a "people's mining license" (IPR) will be issued. Under the CoW system, domestic investors could operate mines under a mining right (Kuasa Pertambangan or KP), a local mining permit (Surat Izin Pertambangan Daerah, SIPD) and foreign investors operated under the special terms of the CoW (Kontrak Karya, KK).
5. **Mining Operations** – The stages of mining have also been simplified to two: the Explorations stage includes the general survey and feasibility study and the Operations stage which includes construction, mining operation, refining, processing, transportation and marketing. Previously, there were six stages: general survey, exploration, exploitation, refining and processing, transportation and marketing.
6. **Taxes and Levies** – Taxes now include a central tax, import duty, customs charges and local taxes. Additionally, there is a non-tax component which includes a fixed contribution, a production contribution, and an unspecified bonus. Previously there was a fixed contribution, an exploration contribution and a state levy.
7. **Refining and Processing** – The new law requires all refining and processing to be done in Indonesia. This was not regulated under the previous regulations.
8. **Decentralization** – control of mineral resources has been divided between the local governments and the central government. The CoW system recognized only the central government's role. The new law reduces the central government's role to policy and management oversight and direct management of undersea resources beyond 12 nautical miles. The local government's role has been expanded and defined.
9. **Community Development Obligation** - The new law requires that community development is a responsibility of the mining permit holder. Community development will be supervised and be developed based on local and community input. Reclamation security fund must also be provided. This was not required under the previous law, but the operator was required to recondition the mining area upon completion of operations.
10. **Additional Changes** - The draft law will also address areas on which Law No. 11/1967 was either silent or vague. These include environmental protection, reporting of data and operations, financial requirements, land compensation requirements, and criminal investigations and penalties.

## Drawbacks of the New Law

Several shortcomings of the new law have been observed both by the mining industry and legal specialists:

1. **Toxic Waste** (Article 39) - The new law does not provide a basis for exempting mining waste from being classified as "toxic waste" or provide a clear basis for conducting mining operations in areas designated as protected forests. While Article 16 allows mining operations to be conducted except in areas where otherwise not permitted with the consent of local authorities and the approval of the authorizing agency. The law is conspicuously silent on the identity of authorizing agencies and the appropriate procedure. On a positive note, the article says that mining operators shall not be obliged to pay regional taxes for mining wastes.
2. **Taxation** (Article 37) - does not clearly establish a tax regime for the life of a mine. It says changes in law and regulation can reduce the tax burden on a mine, but does not protect a mine from tax increases.
3. **Continuity** (Article 62) on transitional provisions does not grandfather existing Contracts of Work by clearly stating that they will continue to be administered under the old law.
4. **Duration** -- The draft law does not state the duration of mining permits.
5. **Central and Local Government role** – The exact roles of the central and local governments is not well stipulated and made specific.

## Major Concerns of Foreign Investors

The PricewaterhouseCoopers (PwC) annual survey of the Indonesian mining industry for 2006, issued in February 2007 strongly called on the Indonesian government not to scrap the CoW system for Mining Licenses. PwC mining partner Sacha Winzenried warned that some sectors of the mining industry are not fully supportive of the draft mining law (JakNews, 2007). The Indonesian Mining Association (IMA) also urged the government to keep the CoW system as it provides greater legal certainty than the proposed licensing system. The IMA serves as link between the mining industry and the government and has as its members all foreign mining companies operating in Indonesia, The main concerns of foreign companies are:

1. The change from dealing with one entity, the central government to dealing with local governments, many of who have no experience in dealing with long term based large investors. They fear that the local government with their new found powers may revoke the permit at any time. They feel that under the CoW arrangement, they had an equal status with the government and in the case of a dispute, they could seek independent arbitration.
2. No differentiation is made with regards to majors and minors. Investors propose that a "mining agreement" similar to the CoW should recognize mining projects involving total investment of more than US\$250 million. The agreement should also be effective for 30 years, which is the usual life of a CoW, and should be further extendable for 10 more years.
3. The additional requirement of community development and social responsibility. The law sets out the obligations of mining companies but lacks clarity. What concerns investors is the way the new mining legislation weighs them down with additional social responsibilities, the result of intensive lobbying by community-based groups. This would mean that mining companies would need to forge agreements with communities in the region who may be affected by their operations in advance of any mining activity.
4. The new law does not allow for "ring-fencing" which the mining community considers a more reasonable approach to involvement in more than one project at a time. The new law dedicates each license to one mineral and a company will be limited to one IUP or PUP only. The mining industry would prefer to an IUP or PUP to apply to multiple projects in order that excess cash from one project can be applied to another project. Assets from one project could also be secured for use by another project. Similarly, losses or profits from one project could be offset by gains or losses from another project.
5. The requirement for all mineral mining products to be processed within the country and export of partially processed minerals will be automatically banned. This is deemed difficult to achieve as presently, about one third of mineral products are processed in the country. There are only two large-scale smelters operating in the country, for copper and tin.

6. Under the existing (new) regional autonomy law, regional governments retain 80 percent of mining royalties. This has resulted in severe increases in royalty rates. Several companies have held back royalty payments amounting to Rp. 1.4 trillion because of unresolved issues. Another company PT Newmont Nusa Tenggara paid US\$3, 206749.22 in the first quarter of 2003. Mining companies want regional government transparency in the use of these royalty revenues.
7. Many local governments are adding on new taxes for such things as street lighting and mine vehicles. In North Sulawesi, local authorities taxed construction materials Newmont used to build a public road at its own expense.
8. The problems of excessive bureaucratic red tape, security concerns in the regions, illegal mining all continue to plague foreign investors.
9. There is a conflict between mining and forestry regulations. According to Forestry Law 41/200 (Article 38) all mining is banned in higher quality “conservation forest” which covers about 10% of Indonesia. Although this is in line with good international practice, the law goes well beyond legislation in other countries by banning surface mining in “protected forests” which covers 17% of Indonesia’s land area. Companies are having a problem in obtaining forestry permits in this regard. The situation is further exacerbated by the fact that boundaries for these areas are subject to mapping uncertainties.
10. The environment rules are inconclusive and insufficient. Many mining companies have been subject to serious prosecution by Indonesian authorities, even though they had complied strictly with environmental regulations. Newmont settled one civil case by agreeing to pay UD\$30 million over 10 years to fund environmental monitoring and community development (Nones, 2007).

### **Continuing Delay in Passing of New Law**

One main reason for the delay in passing of the new law has been the fight over control of Indonesia’s natural resources by the national and local authorities (Wright and Barta, 2007). The WSJ expects this battle, which is part of a wider struggle for local autonomy in Indonesia, to have an impact on global mining companies and world commodity prices in the coming years. The lack of legislation is preventing the launch of new investment ventures as miners see an investor-friendly mining law. The law is now on hold before Parliament and the mining industry through its association (IMA) issued a White Paper recently which calls fundamentally for a return to the CoW system (Krisnamantari, 2007). The proposal seeks to merge the old contract system with the new licensing system where both the government and the mining companies will have equal say, and disputes would be settled through independent arbitration instead of leaving all decisions up to local governments.

Another cause of delay is the need to synchronize the new law with the multitude of existing regulations in the mining sector. It is expected that the new law could be passed this year, but in Indonesia one never underestimates the power of lobby groups and interested parties such big business.

### **Conclusions**

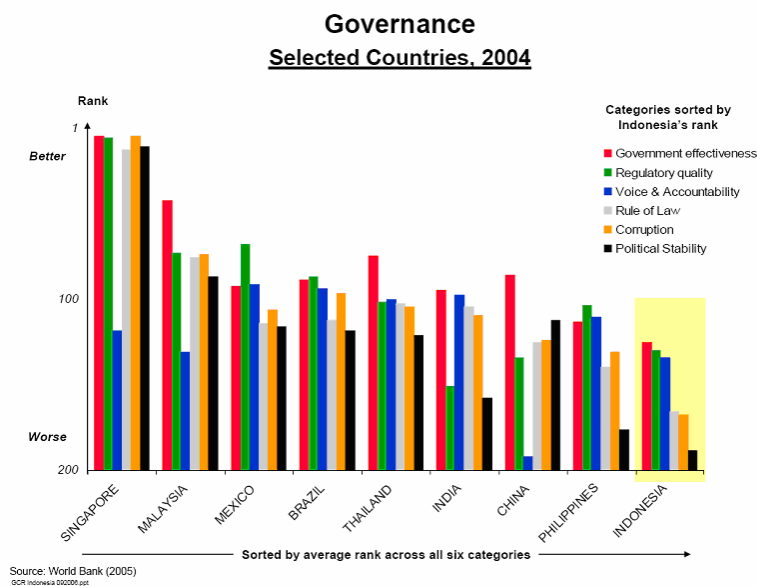
The World Bank, in its assessment of Indonesia’s need to attract new mining investments, lists seven steps to make the mining fiscal regime competitive (World Bank, 2005):

1. Reduce the rates for production contribution (royalty) from the present average of 4% to a uniform rate of 2% regardless of mineral type
2. Modify Law 18/2000 to include coal and gold dore and silver dore, (but not retail gold and silver bars), within the VAT system and zero rate them when exported
3. Modify Law 34/2000 to establish a closed (but expanded) list of district and provincial taxes and state non-tax fees and levies (which specifically excludes turnover-related) taxes
4. Introduce a tax stabilization provision to provide for stabilization of mining-related state non- tax revenues such as royalties for a period of ten years from the start of production
5. Provide VAT tax refunds without undue delay
6. Make mining sector social support and mitigation expenditures to be tax deductible

7. Modify the mining fiscal regime to permit social assets, which may have been imported duty free during the mine life, to be transferred to appropriate social service delivery agencies at the time of mine closure without incurring tax liabilities.

The World Bank also notes that the profusion of local laws is causing great uncertainty and increases risk regarding discretionary interpretation and implementation of laws. This can lead to weak enforcement of legal framework and corruption. The law must provide certainty and equality. As it is, Indonesia is direly lacking in transparency and governance, when compared with many other nations (Table 5).

**Table 5 – Indonesia’s Governance**



Source: World Bank 2005

The country ranking for bureaucracy involved in regulating businesses with regards to protecting investors and trading across borders, as well as in paying taxes and dealing with licenses is very uncompetitive indeed (Table 6). Indonesia has been constantly listed as a difficult place to do business and where nepotism, cronyism, corruption, inefficiency and bureaucracy rule. It is imperative that the authorities use this opportunity to enact and implement legislation that will enhance their credibility and succeed in securing foreign investment, which the country so direly needs.

**Table 6 – Indonesia’s Business Regulations**

**Business Regulations  
Indonesia’s Relative Position 2006**

Competitive Advantages Relative to GDP per Capita		Competitive Disadvantages Relative to GDP per Capita	
	Country Ranking		Country Ranking
Protecting Investors	60	Starting a Business	161
Trading Across Borders	60	Enforcing Contracts	145
Getting Credit	83	Employing Workers	140
		Closing a Business	136
		<b>OVERALL</b>	<b>135</b>
		Paying Taxes	133
		Dealing with Licenses	131
		Registering Property	120

Note: Out of 175 countries, Indonesia ranks 110<sup>th</sup> in 2005 PPP adjusted GNI per capita.  
Source: World Bank, Doing Business (2006)  
DOI: 10.1016/j.dbs.2006.01.001

Source: World Bank, Doing Business 2006

The CoW system is a well developed and meaningful system of granting mining rights to foreign companies. The basic needs of investors are well covered and protected. The country needs to retain fundamental principles of the CoW. They are Security of Tenure which is covered as *Conjunctive Title*, which empowers the investor to proceed through all stages of mining – from exploration to mine development and marketing without further licenses. Security of Investment, provided under *Le Specialis* treatment assures that the investment is not subject to changes in future laws or policies.

Investment in mining in Indonesia declined once the fundamentals were dismantled. This was certainly exacerbated by the ensuing political turmoil, and though this has long been checked, the issues of illegal mining, security risks and long term needs of investors still demand attention and fixing. Finally, the need to cater for the needs of local communities is paramount but this must be handled in a very congenial manner. The mining companies must be made to feel welcome and their rights and obligations must be clarified in the most transparent manner. Unlike conventional industries, mining is higher in risks and capital and projects are very long term. Hence, predictability with a thorough and upfront understanding of the risks involved is an absolute necessity.

The mining industry has not been able to self-regulate itself. A strong case can be made for a set of international standards of performance applicable to all mining company operations (Garner, 2003). With strong headway being currently made in enacting legislation covering all fields of business and based on global standards, it is only a question of time before calls for greater regulation of the industry on an international scale are heard.

Indonesia’s need for foreign investment is particularly acute. The country will need in excess of US\$150 billion in infrastructure development projects over the next five years (Guerin, 2005). In March this year, the Indonesian government at long last passed the new investment bill as part of an effort to improve the investment climate in the country (DPA, 2007). It replaces the 1967 Foreign Investment Law and the 1968 Domestic Investment Law and gives equal legal status and equal treatment to both domestic and foreign investors. It also does not require foreign investors to divest the majority of their shareholding after a specified period of time. It is time the Indonesian government also enacted a new mining law that will be a win-win for both the investors and the country.

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