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Reflections on the Indonesian Coal Market in 2011 and its impact on Indian Power Projects

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Indonesia accounts for 50% of all thermal coal imports into India. Its vast coal reserves have provided attractive opportunities to investors and coal buyers alike. In particular, the wide variety of quality within Indonesian coal allows for blending to meet specific buyer requirements, whilst the lack of a generally applicable minimum purchase quantity (such as that associated with Australian coal) appeals to a wider variety of buyer. The facts that these reserves have been relatively low priced and its geographical position (giving it a competitive edge on freight) have meant that Indian power companies have looked to Indonesian coal supplies as an important part of the solution to mid-to-long-term thermal power generation.

Yet the Indonesian Government's decision to benchmark export coal prices against international prices has caused problems in the Indian power market that have prompted calls for political intervention. Existing concerns have been exacerbated by a recent Indonesian Government mandate that requires that Indonesian coal producers must allocate 24.2% of their annual production for domestic use.

Indian power projects have already been put on hold because the price of off-take agreements has been negotiated on an assumption that Indonesian coal would remain at pre-September 2010 levels. This latest domestic market directive has increased concerns that there will be a reduction in exported tonnage from Indonesia which will in turn push prices up further. It is no surprise then that the Indian government is currently seeking a formal "special status" agreement with the Indonesian Government through the India-Indonesia Joint Working Group on Coal.

Meetings are ongoing with the focus on the creation of a bilateral investment treaty based on the identification of possible new coal concessions for Indian companies. The initiative is obviously based on the belief that Indonesian coal will continue to be the most economical source of imported coal and the intention is to ensure that this economic incentive is enhanced and made more reliable as India's demand for imported coal continues to grow.

However, the Indian government has openly expressed that certain Indonesian policy issues would have to be resolved before formalising any bilateral agreements.

This article focuses on some of the legal and commercial issues we are seeing associated with sourcing coal from Indonesia.

The current coal export pricing regime

The Indonesian Government's Decree No.17/2010 established that, for the purposes of calculating royalties, companies are required to sell at a minimum benchmark price established as follows:

SPOT SALES:

Every month the Directorate General of Mineral, Coal, and Geothermal at the Ministry of Energy sets an export benchmark price calculated as the monthly average of four international coal sales indexes:

- Indonesia Coal Index (ICI 1),
- Platts-1,
- Newcastle Export Index, and
- Newcastle globalCOAL Index.

The price reference is based on coal with GCV (GAR) 6,322kcal/kg, total moisture (arb) 8%, total sulphur 0.8%, ash content 15%, and delivery Free on Board (FOB) Vessel.

LONG-TERM CONTRACTS (BEYOND ONE YEAR):

The same pricing index is used but this time the price is set annually using the average of the previous three months. This mechanism clearly creates further benefits for Indonesia when the market is in backwardation.

The monthly price can be obtained from the Government's website as follows: djmbp.esdm.go.id, but you will need to be fluent in Indonesian.

PROCESS:

All contracts must be submitted to the Department of Mines and Energy at least two weeks prior to shipment. The shipping documents will not be released if the contract is not considered to be compliant.

If a company fails to comply with the Decree, they will be issued a warning. If they are issued with three warnings their business licence may be revoked.

Initially the effects of the Decree were not always felt by buyers as suppliers were using high barging costs and other inflated expenses to make it look as though the FOB sales price was over the benchmark price, but the Government has now set benchmarks for these costs also. This is probably why it took many months before Indian power companies began properly to feel the economic impact of the Decree.

The SCoTa INDO Contract

The introduction in March 2010 of SCoTa 7b and the revised INDO RSS annexed to it aimed at making it easier to trade Indonesian coal. The revisions to the INDO RSS were designed to balance the wide range of Indonesian coal qualities with the market's desire for standardisation through the implementation of an Indonesian index; thus providing a standard reference price for Indonesian coal in the Asia-Pacific market and increasing the number of hedging products available. Of course, since then the price benchmarking regime has been introduced which should have enhanced these aims. The downside is that while the price may be easier to hedge, the overall price has increased.

The 2010 Mining Law Changes

On 12 February 2010, the Indonesian Government passed two key regulations concerning the implementation of the new Indonesian Law on Mineral and Coal Mining:

Although the Regulations have provided much needed clarification in relation to the issuance of mining licences and the delineation of mining areas, the Regulations have also raised a number of potential concerns for foreign investors.

Local Divestment Obligations

The requirement for the divestment of shares to local shareholders has long been one of the main points of contention for those wishing to invest in Indonesian mining projects. Under the old Contracts of Work system, 51% of a mining company's shares had to be divested from any foreign shareholder to a local shareholder. The timing of the divestment was unclear. The high level of divestment and uncertainty as to timing severely hampered the management of foreign-owned mining companies in Indonesia for the past decade.

GR 23 has brought much needed certainty to the local divestment obligations. GR 23 provides that 20% of a mining company's shares are to be divested from any foreign shareholder to a local shareholder after the fifth year of commercial production. This fixed level of divestment aims to provide foreign investors with an improved level of control and sets out a timeframe in which the divestment is to take place.

However, GR 23 provides that if the offer to divest is not taken up in the first instance then it must be repeated annually until take up has been completed.

A lack of take up of shares can lead to uncertainty and inefficient project management resulting in foreign investors being penalised simply because a buyer cannot be found. The practical solution may be for foreign investors to seek to secure a suitable local shareholder from the outset of a project.

Domestic Market Obligations ("DMOs")

While demand from India and other Asian countries for Indonesian coal attracts those looking for long-term supply contracts as well as investors and traders, the Indonesian Government has taken action to secure supply for its domestic requirements: GR 23 provides that the export of coal can only take place after domestic needs have been fulfilled. As noted above, these needs have recently been increased to 24.2%.

Contract Execution Issues

Indonesia's seasonal rains and poor infrastructure, and often a combination of the two, makes delays to the shipment of cargoes commonplace. The operation of mines and their supply routes are often hampered by heavy rains and flooding. Mine operators and sellers hastily turn up the force majeure provisions in their sale contracts - sometimes with justification, sometimes without. Often it seems that price volatility alone is reason enough to try to declare force majeure.

Indonesia's poor infrastructure remains a major impediment to the country attracting foreign investment, especially where the mining sector requires the transportation of large quantities of coal from up country mines to ports. Although the Government has allocated significant funds to remedy this problem, the execution of such Government-funded projects has been poor. Until the infrastructure is substantially improved, delays in shipment are likely to remain a feature of doing business in Indonesia.

In view of the likelihood of delays in execution and a risk of price based non-performance, it is suggested that parties buying and selling Indonesian coal review carefully their force majeure, default and shipment date versus ship arrival provisions in order to ensure the clauses operate as required (or as expected) and provide a clear exit route from the contract either after force majeure or indeed after non-performance.

Enforcement in Indonesia

Despite the fact that Indonesia ratified the New York Convention (the "Convention") in 1981, concerns still remain regarding the recognition and enforcement of foreign judgments and foreign arbitral awards by the Indonesian Courts.

The implementation of the Convention by the Government was subject to various conditions including a public policy exception. This exception has now become the most common defence used to oppose the enforcement of foreign arbitral awards in Indonesia. The exception has a wide application and enables the Indonesian Courts to refuse to enforce a foreign arbitral award for reasons ranging from issues of morality to a lack of commerciality. A graphic example of the wide application of the exception is the case of *Karah Bodas Company LLC v Perusahaan Pertambangan Minuak dan Gas Bumi Negara (2004) (Arb.)* in which it was held that that "against public policy" meant any measure that detrimentally affected the "welfare" of Indonesia and its people. It seems then that enforcement of an award relating to what would have been a loss making transaction for the Indonesian counterparty may be refused on grounds that the transaction lacked commerciality and so was contrary to public policy.

In our experience many Indonesian companies seem to be aware of how a default could impact on its reputation in the international market and many have both engaged in arbitrations and negotiated settlements. But it remains to be seen whether the Indonesian Courts will enforce foreign awards and judgments more readily as the Government seeks to attract increased foreign investment. In the meantime, it is important that those doing business there be aware of the issues and wherever possible negotiate some form of performance security from their counterpart when any contract is put in place. That way, with luck, enforceability issues will be irrelevant.

Conclusion

Indonesia's natural resources and advantageous location makes it especially attractive to Indian coal buyers, investors and traders despite recent relative price increases. As is so often the case, with opportunity comes risk. Over this past year we have seen more and more examples of clients experiencing first hand the operational and legal issues associated with the Indonesian market.

Of course, we are not in Indonesia nor are we qualified to advise on Indonesian law. If you wish to probe any more deeply into any of these issues, you should seek advice locally. We would be happy to introduce you to our correspondents there.