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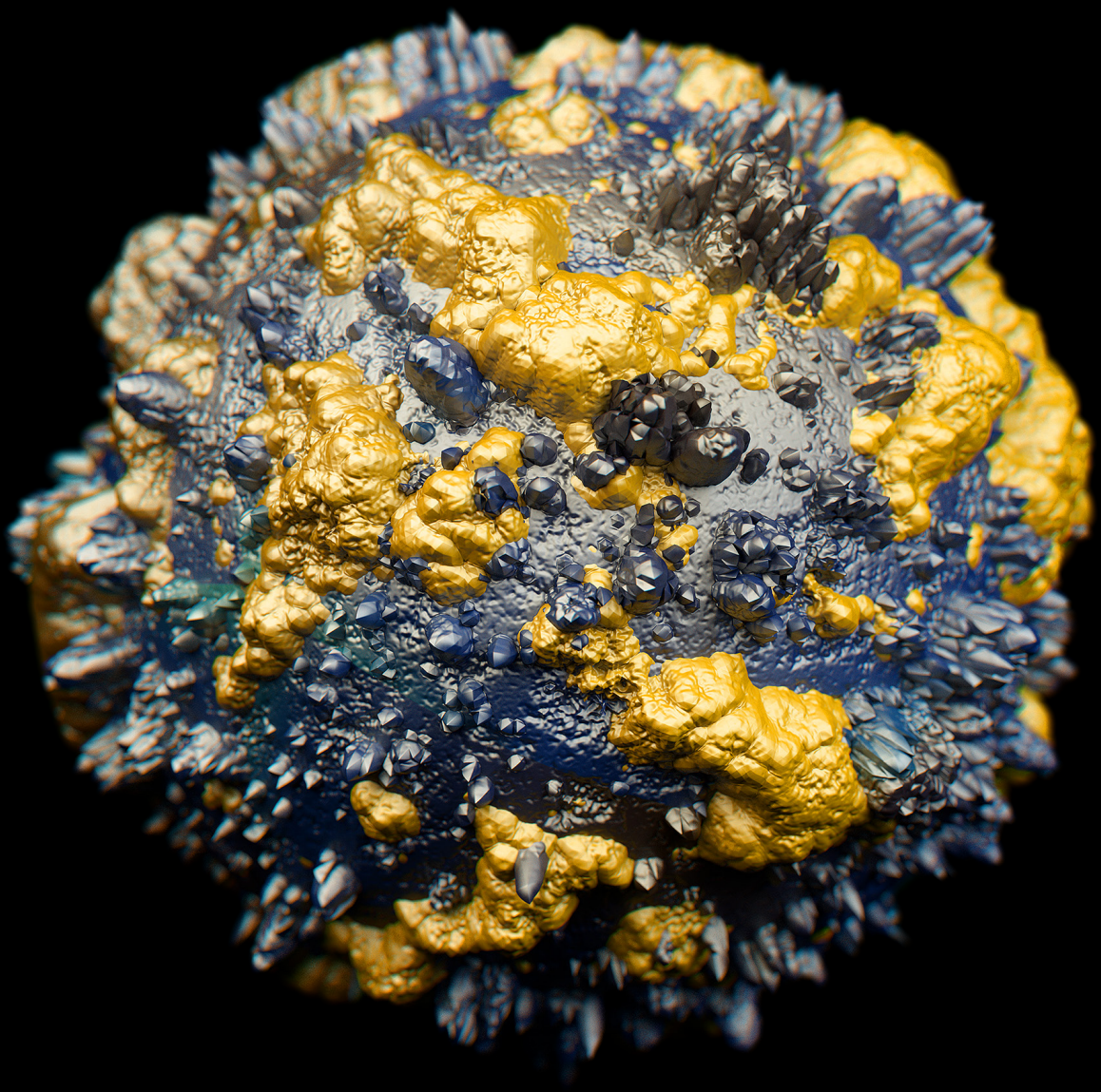

Deloitte Indonesia Business and Industry Updates

Impact of Law No. 3 of 2020 on Indonesia's Mining Sector

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Impact of Law No.3 of 2020 on Indonesia's Mining Sector

On 10 June 2020, President Joko Widodo signed a bill amending Law No. 4 of 2009 on Minerals and Coal Mining, which has now been ratified into Law No. 3 of 2020. This new law introduces a number of key changes to coal and mineral mining operations, which have so far been governed by Law No. 4 of 2009.

Key amendments include changes to the determination of mining areas, centralisation of authority, licensing of mining businesses, and divestment obligations. In addition, the law also regulates the continuation of operations under Contracts of Work or *Kontrak Karya* (KK), Coal-Mining Concession Work Agreements or *Perjanjian Karya Pengusahaan Pertambangan Batubara* (PKP2B), and other matters related to good mining practices, such as post-mining obligations for restoration and reclamation.

While mining companies and their stakeholders in Indonesia have generally welcomed this new law, they are also eagerly awaiting the upcoming release of the implementation regulations for more specific details on how this new law will impact their businesses. Currently, many aspects of this new law – enacted during a time of generally low commodity prices and in the midst of the COVID-19 pandemic – still remain unclear.

In this update, we will discuss some of the legal, tax and financial reporting consequences that mining companies should be aware of, and highlight some of the issues that they will need to consider as they prepare their businesses to comply with this new law.

Key Highlights of Law No. 3 of 2020

Currently, the government is preparing a series of government regulations (GR) known as *Peraturan Pemerintah* for the implementation of Law No. 3 of 2020, which are widely expected to be issued before the end of December 2020. However, it is worth noting that certain parties have lodged a judicial review with the Constitutional Court of Indonesia, and the outcome of this may significantly affect the overall mining regulatory framework.

Nevertheless, Law No. 3 of 2020 contains several important amendments to Law No. 4 of 2009, including but not limited to the following aspects:

Determination of mining areas

Under Law No. 3 of 2020, a mining area is considered to be part of a mining jurisdiction or *Wilayah Hukum Pertambangan* and shall be the basis for the determination of business activities. Mining areas will be determined by the central government with inputs from the relevant provincial governments, and in consultation with the House of Representatives of the Republic of Indonesia.

Furthermore, mining areas are defined as areas with mineral and/or coal potential and are not limited by government administrative boundaries under national spatial plans. Accordingly, mining areas can be located across regions or provinces depending on their mineralisation or coal basin outlines.

Although mining zones are not expected to be changed in the near future, there remains a lack of clarity with respect to some traditional issues of overlapping, for example, with forestry, palm oil plantations, and oil and gas concessions. Therefore, mining companies should continue to expect that the usual area usage licences and settlement arrangements, such as obtaining forestry rights to borrow or *Pinjam Pakai*, will continue to apply, especially in pre-existing mining concessions with such overlapping issues.

Assignment of state-owned, regional-owned, and private enterprises

The Ministry of Energy and Mineral Resources (MEMR) may assign state research institutes, state-owned entities (SOEs), regional-owned entities (ROEs), or private entities to conduct preliminary exploration activities in preparation of the Mining Business Licence Areas or *Wilayah Izin Usaha Pertambangan* (WIUP) for ferrous mineral and coal. In return, the SOEs, ROEs, and private entities who perform these assignments will be given the right to match when the WIUPs are later tendered out by the government.

Currently, the specifics of this remain unclear: although such a concept has already been adopted in other sectors such as geothermal energy, and oil and gas, previous mining regulations have not included an assignment process.

Furthermore, SOEs, ROEs and private enterprises may be concerned that this approach would require them to incur high exploration costs upfront – unless they can secure favourable financial terms for the pre-tender exploration costs – when the only incentive is the right to match the WIUP tender.

In addition, SOEs, ROEs and private enterprises are wary that other parties may significantly increase their bids during the tender process in order to win a concession that had been previously subjected to the preliminary exploration activities, as the tender process will likely require the government to disclose all relevant data about a WIUP area on an equal basis to all interested parties.

It is also not entirely clear what happens when other parties win the tender of a WIUP area. For example, SOEs, ROEs and private enterprises would be interested to know if the government would reimburse them for the pre-tender costs that they incurred, and if so, the timing and mechanism for such a disbursement.

Range and variety of licences

Although Law No. 3 of 2020 centralises the authority to issue mining-related licences with the central government, the central government has the right to delegate this authority to provincial governments. Overall, the following mining licences will be regulated under Law No. 3 of 2020:

- Mining Business Licence or *Izin Usaha Pertambangan* (IUP)
- Special Mining Business Licence or *Izin Usaha Pertambangan Khusus* (IUPK)
- IUPK for the Continuation of Operations of KK/PKP2B
- Community Mining Licence or *Izin Pertambangan Rakyat* (IPR)
- Authorisation Letter for Rock Mining or *Surat Izin Penambangan Batuan* (SIPB)
- Assignment Licence or *Izin Penugasan*, for mining activities relating to radioactive minerals
- Transportation and Sales Licence or *Izin Pengangkutan dan Penjualan*
- Mining Services Business Licence or *Izin Usaha Jasa Pertambangan* (IUJP)
- IUP for Sales or *Izin Usaha Pertambangan untuk Penjualan*

It is worth noting that the new regulatory framework does not appear to differentiate between licences for exploration and licences for production. If this is indeed the case, the new law would simplify the licensing process and provide assurance to holders of Mining Business Licences or *Izin Usaha Pertambangan* (IUP) that they can proceed with their mining activities between these two stages as long as they meet their statutory obligations, and comply with reporting requirements and other relevant mining regulations.

Foreign-owned or controlled companies dealing with C-class minerals, including rock, clay and limestone – and their subsidiaries, such as cement producers – will also need to take a closer look at Law No. 3 of 2020 to understand if their local subsidiaries in Indonesia can continue to hold SIPB/C-class mineral mining licences, or if additional restructuring may be required, as these areas have been traditionally reserved for locally-owned companies.

As a side note, Mining Law No. 3 of 2020 also requires certain adjustments of mining-related licences within one to two years from Mining Law No. 3 of 2020's enactment. These adjustments need to be processed and complied with by mining-related companies and local governments. It is likely that stakeholders of mining companies (e.g. lenders, off-takers) would want to have this obligation to be complied with and this may affect the terms of commercial arrangements between such stakeholders and the relevant mining companies.

New IUP/IUPK provisions

Law No. 3 of 2020 introduces several new IUP/IUPK provisions that mining companies would need to consider when carrying out their business activities. These include:

- **The concept of one IUP per company**
  Except for SOEs or IUPs for non-metal minerals and/or rock commodities, each company can only hold a single IUP. This means that, unless they are grandfathered, mining companies with multiple IUPs will need to undertake spin-offs or other activities to "assign" their IUPs to affiliates, which may in turn lead to additional administrative burdens, for example, with the separation of administrative reporting, contracts, and teams.

- **Priority for commercialisation**
  An IUP holder that discovers minerals within its WIUP area will be granted priority for the commercialisation of these minerals. If, however, it elects not to do so, an IUP can then be granted to other parties.

- **IUP validity for integrated mines**
  An IUP for integrated metal or coal mining operation shall be valid for 30 years, with a guaranteed extension period of 10 years upon fulfilment of the necessary requirements in accordance with the applicable laws and regulations. This represents a change from the previous policy, which provides for ministerial discretion, and is likely to give investors more assurance about the extension of their IUPs. However, the drafting of Mining Law 3/2020 is not clear for integrated IUP metal/coal mining companies on whether the 10-year extension period is applicable until the life of the mine expires or it is for the usual 2 x 10-year extension period.

- **Transfer of IUPs/IUPKs**
  In contrast to the previous law, Law No. 3 of 2020 allows for the transfer of IUPs/IUPKs subject to MEMR's approval. The minimum requirements to obtain such an approval include the following:
  - The IUP/IUPK holder must have completed its exploration activities, as evidenced by data on the availability of resources and reserves
  - The IUP/IUPK holder must fulfil the necessary administrative, technical, and financial requirements

Furthermore, unlike the previous law, Law No. 3 of 2020 does not make an explicit reference to the requirement for the IUP/IUPK transferrer to possess a minimum of 51% ownership in the IUP/IUPK transferee. It remains to be seen, however, if this measure will be re-introduced in the upcoming GR.

But assuming that the ownership requirement is no longer required, the new law may ease the process of restructuring in secondary markets for mining concession sales, as well as merger and acquisition activities. For example, it may enable players to avoid situations where they have to take on unnecessary risks to purchase shares in a target company in order to obtain control of their concession IUPs.

Licencing regimes for standalone or non-integrated smelters

Law No. 3 of 2020 stipulates that licences for standalone or non-integrated smelters will be issued solely by the Ministry of Industry, and gives greater clarity to the dualism of the licencing regime. By having standalone or non-integrated smelters, companies can benefit from structuring flexibilities between their mining and smelting assets as these two different assets can be held by stakeholders or project sponsors with different sets of capital and financing structures and, indirectly, avoid "divesting" the smelting asset when a mining company requires to meet its mandatory divestment obligations. However, careful tax planning would be needed, particularly with offtake arrangements for both feedstocks and final processed products, given the potential tax leakages that could result under such a structure.

Divestment obligations

Under Law No. 3 of 2020, a foreign-owned IUP holder is required to gradually divest 51% of its ownership to the central government, regional government, SOE, ROE, or national private entity. In the event that a direct divestment process cannot be implemented, the divestment will need to be carried out through an initial public offering on the Indonesia Stock Exchange.

However, the law does not provide for a specific timing for this divestment process. Previous regulations have stipulated that the divestment process should start after the fifth year of production at the latest, and should total 51% by the tenth year of production. While it remains to be seen if this timeline would be re-introduced in the upcoming GR, an absence of such a framework may lead to controversy if the divestment only occurs at the later stages of production when resources have been depleted and the mine is no longer economically viable.

KK/PKP2B extension

Applications for extension, and all accompanying documentation, must be submitted to MEMR no earlier than five years, and no later than one year, prior to the expiration of the KK/PKP2B. Furthermore, Law No. 3 of 2020 allows for the guaranteed extension of the KK/PKP2B concession period for two times for a maximum period of 10 years each, provided that certain statutory requirements are met. If the KK/PKP2B concession period has been previously extended, then a second extension period will be provided for a maximum period of 10 years. All extensions will be made in the form of an IUPK for the Continuation of Operations of KK/PKP2B.
It is not entirely clear if the existing mining concession area covered under the existing KK/PKP2B will be preserved following the extension, or if the government may require some parts of the area to be relinquished. However, given the fact that extension provisions for KK/PKP2B contracts mainly deal with the concession periods, and not the concession area, relinquishment is unlikely to be required (except in cases where there is voluntary relinquishment by the KK/PKP2B holder) as long as the KK/PKP2B holder is able to abide by matters relating to state revenues and other statutory administration obligations.

KK/PKP2B holders anticipating an extension would therefore need to revisit their funding arrangements, and possibly undertake fund-raising or refinancing activities, to support the continuation of their mining operations. Similar considerations would also apply to mining services contractors serving KK/PKP2B holders, who may also anticipate that further extensions of their contracts with KK/PKP2B holders.

Further considerations

Several other considerations that mining companies will need to take into account also include:

- **Export of unprocessed minerals/ores**
  KK/IUP/IUPK holders may continue to export raw and unprocessed minerals/ores for three years from the enactment of Law No. 3 of 2020, if they are able to meet the prescribed requirements, such as conducting refining activities, developing refinery facilities, and/or forming refinery co-operations with local smelters, and payment of export levies. This provision is expected to give mineral ore exporters some relief, as the resumption of ore production for export may enable them to create some interim cash flow.

- **Dedicated mining roads**
  IUP/IUPK holders will be required to utilise dedicated mining roads for their mining activities. These dedicated mining roads include those constructed by themselves, by other IUP/IUPK holders who have already constructed such roads, or by other parties already in possession of such roads. Although this provision is in line with the current practice, mining companies may be concerned about whether they would be required or expected to allocate capital and operating expenditure to the building and maintenance of such dedicated mining roads.

- **Reclamation and post-mining activities**
  Law No. 3 of 2020 requires IUP/IUPK holders to make allowances and fund reclamation and other post-mining activities. In addition, IUP/IUPK holders will be required to implement these reclamation and other post-mining activities with a 100% success rate prior to reducing the size or returning their WIUP/WIUPK. Failure to comply with these provisions may result in sanctions on the IUP/IUPK holder, in the form of a maximum of five years of imprisonment and a maximum fine of IDR 100 billion. Further details about this provision are expected to be provided in the upcoming GR.

- **Postponement of new licensing issuance**
  Letter No. 742/30.01/DJB/2020 issued by the Directorate General of Mineral and Coal on 18 June 2020 gives a provincial governor the authority to supervise mineral and coal mining activities within his/her provincial area for up to six months from 10 June 2020, or the issuance of the regulations for Law No. 3 of 2020, whichever is earlier. However, the Governor cannot issue new licences (IUP, IPR, Temporary Transportation and Sales License, IUP of Production Operation for processing and/or refining, IUJP, and IUP of Production Operation for sales) during this period. Licence applications that have been submitted to the Governor before 10 June 2020 (but have not been issued) cannot be processed.

- **Applicability to special autonomous provinces**
  Law No. 3 of 2020 will also apply to special autonomous provinces, including Aceh, Jakarta, Papua, West Papua, and Yogyakarta, and implies equal treatment and applicability throughout Indonesia, unless a strong legal basis can be established otherwise.

Fiscal Implications

Apart from geological potential, mining fiscal regimes are one of the top drivers for investments in exploration and development activities, and have important roles to play in ensuring the fair distribution of mining profits in resource-rich economies like Indonesia. Key investor considerations include the relative competitiveness of the fiscal regime in relation to other economies, fiscal stability and certainty, as well as the complexity of associated government audits.

Through the provision of a *lex specialis* status, which enables KKs to override prevailing tax laws, the KK/PKP2B system has provided Indonesia with a long track record of fiscal stability, and enabled it to attract the investments of many global mining companies, including in the areas of copper, coal, gold, and nickel.

Under Law No. 4 of 2009, however, the KK/PKP2B system was replaced with the IUP mining business licence system. In the IUP system, taxation of IUPs will adopt the prevailing tax regime (see "Prevailing tax regime"), and therefore tax stability is not guaranteed.

Although all existing KKs and PKP2Bs will remain honoured until their expiration dates, amendments were made to ensure compliance with Law No. 4 of 2009. This has resulted in some changes to the fiscal provisions, but certain *lex specialis* provisions continue to be maintained. Furthermore, under Law No. 4 of 2009, expiring KKs may be extended under a special IUP (Ex-KK IUPK), which may entail a specific fiscal regime. To date, two such special IUPs have been issued to replace KKs nearing their expiration dates.

With the passing of Law No. 3 of 2020 as an amendment of Law No. 4 of 2009, existing IUPs, IUPKs, Ex-KK IUPKs, KKs, and PKP2B will continue to be honoured until their expiration dates. This new law also provides greater certainty on the extension of KK/PKP2B in the form of an IUPK for the Continuation of Operations (IUPK-CO).

Prevailing tax regime

There are three key components of the prevailing tax regime for mining companies in Indonesia:

1. Corporate income Tax

Under Article 31D of the prevailing income tax law[1], corporate income tax for mining business is separately governed under GR. Key aspects of GR No. 37 dated 1 August 2018, which applies to taxpayers in the minerals mining business that hold, amongst others, IUP, IUPK, Ex-KK IUPK, and KKs under prevailing tax laws, include the following:

- Provisions for an adjustment mechanism on the actual sales price of minerals if they are lower than 97% of the market price
- Provisions for the calculation of taxable income, tax-loss carry forward, and income tax rate in accordance with prevailing tax laws, except for holders of Ex-KK IUPK
- Provisions for the capitalisation and amortisation of stripping costs incurred prior to the commencement of production operations, with amortisation applied upon the commencement of production operations over the licence life and calculated on a pro-rated basis or unit of production method; where stripping activities and/or underground mining development activities are conducted during the production period, including for the purposes of new resource exploration, the expenditures shall be expensed when incurred
- Provisions for donations for research and development, educational facilities, sports development, and social infrastructure development to be channelled through an agency associated with the central and/or regional government, which will in turn be governed by a regulation under the Ministry of Finance
- Provisions for mining companies to use the prevailing debt-to-equity ratio (a maximum of 4:1) for financing costs in income tax calculations
- Provisions for Ex-KK IUPK holders, applicable until the expiration date of the Ex-KK IUPK, including:
  - Existing tangible and intangible assets to be depreciated or amortised under KK rules up to the fiscal year when the Ex-KK IUPK licence is issued; thereafter, depreciation or amortisation shall follow prevailing tax rules over the assets' remaining useful lives, with asset net book value as the depreciation or amortisation base
  - Royalty, dead rent, environmental fee/levy and forestry fee/levy shall be governed by the Non-Tax State Revenue or *Penerimaan Negara Bukan Pajak* (PNBP) law and prevailing regulations at the time of issuance of the Ex-KK IUPK
  - Additional levies on net profits by the central and regional government – currently 4% and 6% respectively – shall be governed by Law No. 4 of 2009 and prevailing regulations at the time of issuance of the Ex-KK IUPK, and are not deductible (net profit is defined as annual net profit after income tax based on the audited financial statements of the Ex-KK IUPK holder)
  - Corporate income tax of 25%
  - Tax on land and buildings to be governed by prevailing Land and Building Tax law and regulations at the time of issuance of the Ex-KK IUPK
  - For other taxes and/or PNBP not listed above, including obligations to withhold taxes, as well as import and export duties, the Ex-KK IUPK holder will be subjected to prevailing regulations until the expiration of the licence

The government is also expected to issue a similar GR for the coal mining sector, which will apply to IUP, IUPK, IUPK-CO, and PKP2B holders, that its fiscal regime to adopt prevailing tax rules.

Under the current regime, the corporate income tax rate on net taxable profit is 22%, and this will be reduced to 20% from fiscal year 2022 onwards. Net taxable profit is defined as the excess of revenue over deductible expenses, and tax losses incurred in a fiscal year may be carried forward to offset net taxable income in the next five years.

2. Royalty

Royalty is deductible for income tax purposes. It is calculated based on the actual sale price, or the benchmark price of the mineral or coal, whichever is higher. GR No. 9 of 2012 governs royalty tariffs for IUPs, and specific royalty provisions may also be applicable for KK/PKP2B and IUPK holders.

3. Value-Added Tax (VAT)

A VAT of 10% is applicable for the import and procurement of goods and services. Delivery of certain types of goods and services, including mineral ore and coal, are not subjected to VAT. As a result, any input VAT paid by a mining company delivering mineral ore or coal to its vendors is neither creditable nor refundable. This represents an additional cost for these companies, and should be taken into account when conducting economic assessments. Specific VAT provisions may also be applicable for KK/PKP2B holders.

[1] Law No. 7 of 1983 on Income Tax as amended by Law No. 36 of 2008

Key fiscal implications

With the implementation of Law No. 3 of 2020, mining companies will need to take into consideration the following fiscal implications:

- **Additional levy of 10% for IUPK holders**
  An upcoming GR will be issued to provide more details on the calculation, reporting, and payment of the additional levy of 10% on the IUPK holder's net profit since production. This levy will be split between the central and regional governments, who will receive 4% and 6% respectively. The 6% received by the regional government will then be further split into allocations of 1.5%, 2.5%, and 2.0% for the province, city or *kabupaten* of the producer, and other city or *kabupaten* within the province respectively. This is a change from the previous allocation of 1.0%, 2.5%, and 2.5% respectively.

- **Abolishment of exploration fees**
  Exploration fees previously paid to the central government have been abolished. This appears to be an incentive to stimulate greater exploration activities and expenditures.

- **Changes to tax facilities**
  Law No. 3 of 2020 stipulates that the central government may provide tax facilities and/or reliefs to stimulate mining investments in accordance with prevailing laws. This represents a shift from Law No. 4 of 2009, which requires tax facilities to follow prevailing laws unless otherwise determined in an IUP/IUPK.

  This provision also indicates the government's intention to not include any *lex specialis* tax provisions in future IUPKs. Therefore, IUP/IUPK holders should make a greater effort to understand prevailing tax laws, as these will now be applicable to them.

- **Extension of first-generation coal-mining PKP2Bs to IUPK-COs**
  The fiscal regime for minerals mining is government by GR No. 37. However, the relevant GR for coal mining has not yet been issued, and there is an urgent need for the government to do so in order to provide existing coal IUPs and PKP2B holders with greater certainty on the future direction of the industry. Currently, a significant proportion of coal production is carried out by seven first-generation PKP2B holders, whose contracts will expire within the next five years, and who will therefore need to extend these by converting to IUPK-COs.

  Of the seven first-generation PKP2B holders, only one is subjected to the prevailing fiscal regime, with the remaining six governed by *lex specialis* fiscal provisions. Under Law No. 3 of 2020, which stipulates that tax facilities for mining IUPKs should follow prevailing laws, PKP2B holders will need to consider several specific implications of a conversion to IUPK-COs (see "Specific considerations for the conversion of first-generation PKP2Bs to IUPK-COs").

First-generation PKP2B holders will need to commence a thorough review of the possible changes to their fiscal regimes, and assess the impacts that these will have on the economics and lifespan of their mines, in preparation for discussions with central and regional governments on the upcoming implementation of IUPK-COs.

Specific considerations for the conversion of first-generation coal-mining PKP2Bs to IUPK-COs

- **Corporate income tax**
  First-generation PKP2B holders are subjected to a corporate income tax of 45%, which was the rate prevailing at the time that these contracts were signed. Under the current regime, the corporate income tax rate on net taxable profit is 22%, and this will be reduced to 20% from fiscal year 2022 onwards.

  However, although the PKP2B entailed a higher corporate income tax rate, it offered several income tax facilities – such as an investment allowance of 30% of capital expenditures, accelerated depreciation, extended tax loss carry forward periods, and higher debt-to-equity ratios for tax purposes – that are not generally available under prevailing tax laws. Once converted to an IUPK-CO, mining companies will therefore need to comply with the prevailing tax laws and regulations.

- **Royalty**
  For coal mining PKP2Bs, the royalty rate is 13.5% of actual sales or the coal price benchmark, whichever is higher. In contrast, the prevailing GR No. 9 applicable for IUPs entails a royalty rate of 3%, 5%, or 7% for open-pit mines depending on coal quality. Whether the government will decide to retain or change the PKP2B royalty rate remains to be seen.

- **VAT**
  First-generation PKP2B holders are not subjected to the VAT system, but are subjected to a sales tax or *Pajak Penjualan* that is based on the prevailing regulation at the time that the contracts were signed. Under this arrangement, certain types of services are subjected to a 2.5% sales tax. Once converted to an IUPK-CO, mining companies will need to comply with the prevailing VAT rules, which will likely increase their operating costs as most goods and services are subjected to the 10% VAT rate, which is neither creditable nor refundable.

- **Levy on net taxable profit**
  IUPK holders are subject to a 10% levy on their audited net profit after tax. This levy is not deductible for corporate income tax purposes, and is hence akin to a dividend that will need to paid to the government, even if it is not a shareholder.

- **Lease of state goods**
  For first generation PKP2Bs, the title to all goods acquired for coal operations remains with the central government as state goods, with the mining company owning the exclusive right to use these goods for their coal operations until the expiration of the PKP2B. However, under Law No. 3 of 2020, an IUPK-CO holder will need to pay the government leasing fees for the use of these state goods, which will represent an additional cost for mining companies.

Potential areas of improvement

To ensure that Indonesia's mining sector continues to remain competitive, it will need to continue to optimise its allocation towards exploration and development activities with the appropriate fiscal regimes.

Given the limited potential for sizeable new mine developments under the existing KK/PKP2B system, one immediate area of focus for the government would be the enhancement of the fiscal regime for IUP holders. Regarding this aspect, it is noteworthy that the government has invested significant efforts into improving the minerals mining investment climate with the implementation of GR No. 37 and Ex-KK IUPKs. With the upcoming GR for the coal mining sector, there are hopes that this will continue to be the case.

Looking ahead, several potential areas of improvements could also include the following:

- Providing specific fiscal regimes for different mining stages that could include, for example, VAT exemption/deferment or deferment of costs incurred during exploration to encourage greater levels of green-field exploration
- Increasing fiscal stability in terms of the rates and calculation mechanisms for corporate income tax and royalties; here, stability does not necessarily mean a fixed rate, but could entail a system of progressive rates that vary with a mine's scale, location, life, reserve, resource quality, and commodity price
- Providing a more flexible fiscal regime for uneconomic or marginal mines that takes into account their size, location, life, resource quality, as well as production, logistics and other costs
- Continuously assessing the effective tax rate of mining operations, including all aspects of royalty, dead rent, income tax, and VAT, to ensure competitiveness against other key mining regions, while also taking into account non-fiscal considerations such as geological potential and socio-economic landscapes
- Enhancing the ease of doing business, including pre-empting potential disputes with the appropriate socialisation of new fiscal policies, and addressing existing grey areas in a timely manner.

Implications on Financial Reporting

Under Law No. 3 of 2020, mining companies will also need to take into consideration several implications of the new regulations on their financial reporting requirements and processes. As a preliminary overview, these potential impacts could include:

Accounting for leases

The enactment of Law No. 3 of 2020 coincides with the introduction of a number of new Indonesia Financial Accounting Standards or *Pernyataan Standar Akuntansi Keuangan* (PSAK) which came into effect on 1 January 2020, in particular PSAK 73– Leases.

Under PSAK 73, a lease is defined as a contract that conveys to the lessee the right to use an asset for a period of time in exchange for consideration. Fulfilment of the contract depends on the use of an identified asset and control of the use of the asset during the lease period. For lessees, there is no longer a separation of finance and operating leases. Instead, this has been replaced by a single accounting method for lessees to recognise lease transactions, and the application of PSAK 73 would require a company to assess whether the leased assets should be recorded on the balance sheet.

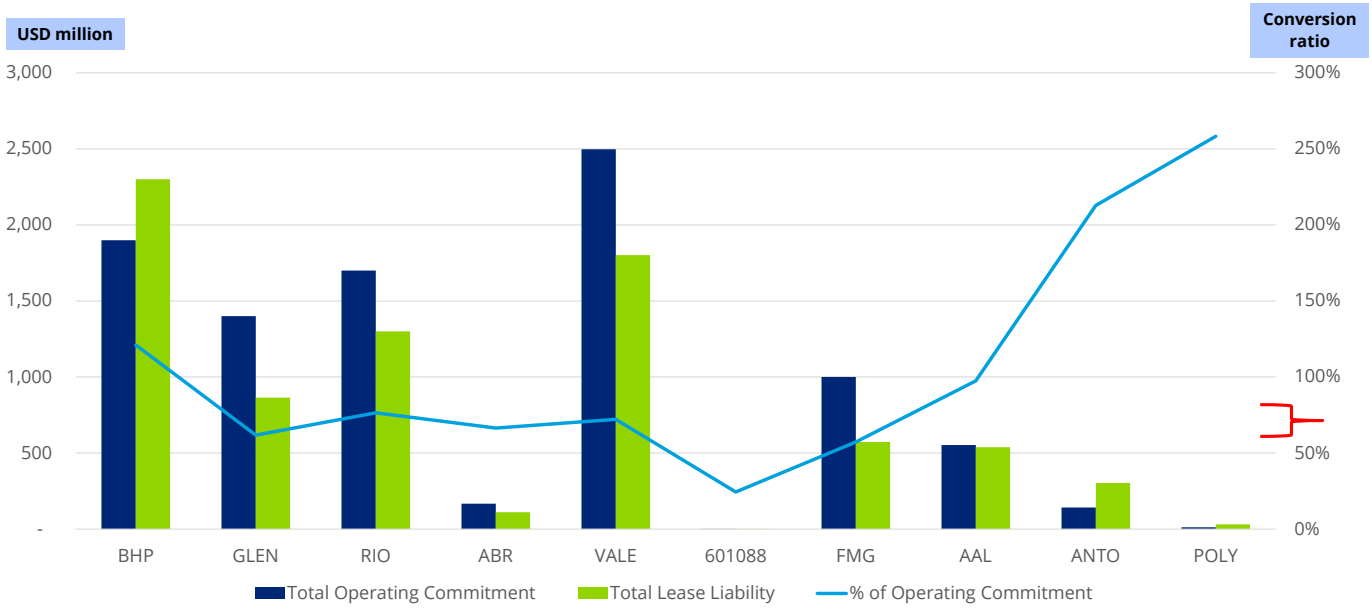
Mining companies with substantial off-balance sheet items prior to the adoption of PSAK 73 are therefore likely to witness the following financial reporting implications:

- Significant increase in assets and liabilities on their balance sheets, with potentially material impacts on the calculation of covenants
- Changes to the cost profile of their income statements, as costs skew towards the early years of leases and higher volatility due to the frequency of re-calculations that have become necessary due to changes in assessment of lease terms
- Changes to the nature of costs in their income statements, with a positive impact on EBITA, but with higher proportions of financing costs and depreciation costs, with potentially material impacts on the calculation of covenants

This is likely to have significant implications for first-generation PKP2B holders. Similar with the previous law, article 169A Paragraph 3 of Law No. 3 of 2020 stipulates that all equipment purchased by companies becomes the property of the government. However, a leasing fee will now be charged for the use of these assets. When first-generation PKP2B holders convert their licences to IUPK-COs upon extension, they will need to start leasing their equipment from the government, unless they have other alternatives.

But the impact of PSAK 73 is not only limited to first-generation PKP2B holders: overall, most major international mining companies have reported average conversion ratios of about 50-75% from their off-balance sheet operating lease commitments to lease liabilities upon adoption of IFRS 16 (see Figure 1). While most companies are currently in the final stages of their implementation of PSAK 73, many continue to face a number of different implementation challenges (see Figure 2).

Figure 1: Conversion ratios from off-balance sheet operating lease commitments to lease liabilities upon adoption of IFRS 16



Sources: 2019 financial statements of BHP, Glencore, Rio Tinto, Barrick, Vale, China Shenhua, Fortescue, Anglo American, Antofagasta, Polymetal International

Figure 2: Challenges faced by companies implementing PSAK 73

PSAK 73 Knowledge Management

- Limited understanding of PSAK 73
- Current lease landscape and lease profile (Branches, Outsourcing of data sources, Software, etc)
- Incomplete understanding of contracting methods across companies

Selection of Transition Options

- Election of transition options and practical expedients
- Pros and cons of each option

Contract Population and Lease Segmentation

- Large volume of contracts
- Lack of visibility of contracts across organization
- Decentralised contracts and lack of standardization between contracts
- No contract management system or centralized repository
- Verbal agreements entered
- Types of contracts and modifications: Master Agreements, Work Orders, and Amendments

Lease Measurement

Understanding the:

- Lease terms, extensions, termination or cancellation options, etc.
- Fixed and variable payments
- Lease and non-lease portion
- Lease modifications
- Forex impacts
- Discount rate
- Type of asset
- Period of use
- Impact of joint arrangement

Lease Assessment

- Identification what contract contains leases
- Multiple components (lease and non-lease portions)
- Embedded leases (leases which are part of service contracts)
- Exemptions: Low value items and less than 1 year

Financial Impact and Organizational Changes

- Preparation of disclosure in the financial statements
- Determination of IT solution (temporary vs permanent)
- Internal control consideration
- Risk management strategy for contracts management

Impairment of non-financial assets

Exploration and evaluation assets are to be assessed for impairment only when there is an indication that impairment exists. These indications include, but are not limited to, the following conditions where:

- Exploration rights have expired, or are expected to expire in the near future without renewal
- No further exploration or evaluation is planned or budgeted for
- An absence of commercial reserves has led to a decision to discontinue exploration and evaluation
- Sufficient data exists to indicate that the book value will not be fully recovered from future development and production

Mining assets will also be subjected to a similar impairment assessment. These indications include, but are not limited to, the following conditions where:

- There is a significant decline in the market capitalisation of the entity
- Significant deterioration can be expected in future commodity prices
- There is a significant and adverse movement in foreign exchange rates
- There are adverse changes in government regulations
- There are material downward revisions to the reserves

Ultimately, impairment assessment is a matter of judgement, and both internal and external factors must be taken into consideration in impairment (or impairment reversal) decisions. Under Law No. 3 of 2020, there is a stronger legal certainty with regards to the extension of a KK/PKP2B. However, this may or may not be sufficient basis to extend the life of a mine beyond the existing legal rights. Companies will need to exercise care in accordance with engineering standards when evaluating their mineral reserves, as any changes in their recognition could have significant impacts on depreciation and impairment (or impairment reversal). Furthermore, companies will also need to exercise care to determine if their cash flow assumptions continue to be valid beyond their current contract expiration dates, and avoid double-counting the impacts of lease payments and reclamation payments in their assumptions.

Restricted cash

Currently, some mining companies have set aside cash to fulfil their obligations for mine reclamation and closure, as was required under the previous law. The previous law also allowed for an accounting reserve to be used as a form of mine reclamation guarantee if the company is a publicly listed company or has paid-up capital of at least USD 50 million as stated in their audited financial statements.

However, under Articles 100, 108 and 112A of Law No. 3 of 2020, several requirements have been outlined that could affect the cash positions of mining companies. Specifically, the new law has removed accounting reserves as an acceptable form of guarantee. This means that setting cash aside is now a requirement, and this restricted cash must be presented as a current asset unless the cash cannot be exchanged or used to settle liabilities for at least 12 months after the reporting period.

For IUP/IUPK holders, Law No. 3 of 2020 will also require them to set aside a reserves security fund during their production stage. These funds are meant to be used to guarantee continued exploration activities for the discovery of new reserves. More details on this measure are expected to be provided in the upcoming GR.

Next steps for mining companies

As mining companies look forward to the upcoming implementation regulations for Law No. 3 of 2020 for greater clarity, they should nevertheless begin anticipating and planning for a number of legal, tax, and financial reporting consequences in order to ensure their business' long-term viability.

Notwithstanding significant changes as a result of the current possible judicial review at the Constitutional Court of Indonesia, mining companies and their stakeholders will need to revisit their licencing, business structures, and operational practices to ensure that they are in full compliance with the new law and its accompanying regulations.

Coal mining companies, in particular, are expected to be the most significantly affected in terms of their fiscal regime. As first-generation PKP2B holders anticipate their conversion to IUPK-COs, and in light of the imminent issuance of a GR relating to taxation and PNBP that will have significant impacts on IUP, IUPK, IUPK-CO and KK holders, coal mining companies must ensure a thorough review of their mine economics, life of mine, and cash flows.

In terms of measurement, presentation, and disclosures, Law No. 3 of 2020 is expected to affect the financial reporting requirements and processes across the board for all mining companies in Indonesia. Key changes here include the need to lease assets from the government, judgements on impairment (or impairment reversal) of non-financial assets, and restricted cash.

Ultimately, the implications of this new law go beyond mere compliance: they require mining companies to take on the challenging endeavour of strategically balancing sometimes competing business priorities to optimise their allocations, taking into account the mining business cycle, current volatilities in global commodity prices, and various circumstantial factors surrounding their market positions.

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