CHRISTIAN TEO PURWONO & Partners
LAW OFFICES
(in association with Stephenson Harwood LLP)

CLARIFICATION OF DIVESTITURE RULES – CONFIRMATION OF A RAKE'S PROGRESS[12345]

INTRODUCTION

The obligation of foreign owners of IUP/IUPK holders and, possibly, of CoW/CCoW holders to divest part of their shares to local parties ("**Divestiture Obligation**") has been a continuing source of controversy and uncertainty since being introduced as part of the 2009 Mining Law.

The Government has now taken a significant step in clarifying the policy and rules relating to the Divestiture Obligation with the issuance, in October, of Government Regulation No. 77 of 2014 re Third Amendment of Government Regulation No. 23 of 2010 re Implementation of Mining & Coal Mining Enterprise Activities ("**GR 77/2014**").

Though in many respects just a confirmation of previous policy statements of the Government, GR 77/2014 is very helpful in making somewhat clearer the current status of the Divestiture Obligation and the significance or otherwise of Indonesian Stock Exchange Listings ("**IDX Listings**") in satisfying the Divestiture Obligation. GR 77/2014 also highlights the extent to which the Government is increasingly using the Divestiture Obligation to promote policy objectives, far removed from encouraging greater Indonesian ownership of mining companies, including domestic processing and refining, coal upgrading and underground mining.

Whether GR 77/2014 is a positive development or not depends on one's general perception of the Divestiture Obligation and the extent to which it is a major impediment to new foreign investment in the local mining industry. Promoters of domestic processing and refining, coal upgrading and underground mining will, no doubt, see GR 77/2014 as very helpful to the advancement of their future business opportunities. Foreign investors as a whole, however, may be more inclined to see GR 77/2014 as confirmation of progress of a sort but less positive progress than progress in the nature of that depicted by 18th century English artist William Hogarth in his series of 8 paintings entitled "*A Rake's Progress***"** showing the inexorable decline and fall of the son and heir of a rich merchant, who comes to London, wastes all his money on luxurious living, women and gambling, is imprisoned for his debts and eventually ends up in a mental hospital. "*A Rake's Progress"* could well be a sad but all too appropriate allegory for the recent course of and future outlook for foreign investment in the local mining industry unless there is a significant improvement in the **overall** Indonesian regulatory

[1] Bill Sullivan, Licensed Foreign Advocate with Christian Teo Purwono & Partners (in association with Stephenson Harwood LLP).
[2] Bill Sullivan is the author of "*Mining Law & Regulatory Practice in Indonesia – A Primary Reference Source*" (Wiley, New York & Singapore 2013), the first internationally published, comprehensive book on Indonesia's 2009 Mining Law and its implementing regulations.

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environment for mining and foreign investment.

In this article, the writer will review GR 77/2014 and what it tells us about the current status of the Divestiture Obligation.

BACKGROUND

The background to the Divestiture Obligation and how it has morphed, over time, from a seemingly innocuous requirement, in Article 112 of the 2009 Mining Law, to divest some unspecified amount of shares to local parties, at no specified price and after 5 years, into what is now, possibly, that feature of Indonesia's current mining regulatory regime most objected to by foreign investors is described, at length, in the writer's earlier articles (i) "*New Restrictions on Foreign Investment – Nero Fiddles While Rome Burns"*, Coal Asia Magazine, July - August 2013 and (ii) "*Foreign Investors Experience a King Canute Moment*", Coal Asia Magazine, November - December 2013.

COMMENTARY

1. Overview

GR 77/2014 makes a variety of significant amendments to Government Regulation No. 23 of 2010 re Implementation of Mining & Coal Mining Enterprise Activities ("**GR 23/2010**").

The Divestiture Obligation has proved to be a huge challenge for the Government and for foreign investors in the local mining industry. As a consequence, GR 23/2010 has undergone numerous amendments since its issuance in 2010 and GR 77/2014 is just the latest attempt to try to, finally, get the Divestiture Obligation right. Striking a reasonable balance between the legitimate aspirations of Indonesia, as a resource rich nation, and the minimum requirements of foreign investors, with the freedom to choose from multiple countries as the destination for their investment funds, has wholly eluded the Government up to date.

It is probable that GR 77/2014 is far from being the final and long term position with regard to the Divestiture Obligation.

2. Differential Divestiture Obligations for Different Mining Business Categories

2.1 **Differential Divestiture Obligations**: GR 77/2014 formally recognizes, for the first time, 5 different categories of mining business and assigns a different Divestiture Obligation percentage and/or share installment schedule to each category.

The 5 different categories of mining business, and their individual Divestiture Obligation percentages for the foreign owners of PMA companies holding IUPs/IUPKs, are as follows:

(a) **Exploration**: 25% or maximum 75% foreign ownership ("**Category 1**");

(b) **Production Operation <u>without</u> own domestic processing and refining**: 51% or maximum 49% foreign ownership ("**Category 2**");

(c) **Production Operation <u>with</u> own domestic processing and refining**: 40% or maximum 60% foreign ownership ("**Category 3**");

(d) **Production Operation involving underground mining**: 30% or maximum 70% foreign ownership ("**Category 4**"); and

(e) **Production Operation involving both underground mining and open pit mining**: 30% or maximum 70% foreign ownership ("**Category 5**") (New Article 7C).

It is tolerably clear that, notwithstanding Category 2 and its recognition of IUP/IUPK holders carrying on production operation mining activities **<u>without</u>** **<u>own</u>** domestic processing and refining, this does **<u>not</u>** mean that there has been any change in the requirement, for all holders of Production Operation IUPs/IUPKs for metal minerals, to carry out domestic processing and refining if they want to be able to export their mineral products. In this regard, GR 77/2014 is simply drawing a distinction, for Divestiture Obligation purposes only, between (i) holders of Production Operation IUPs/IUPKs for metal minerals which carry out their **<u>own</u>** domestic processing and refining and (ii) holders of Production Operation IUPs/IUPKs for metal minerals which use third parties to carry out domestic processing and refining on their behalf (Amended Article 36).

GR77/2014 confirms the commonly understood position that there is **<u>no</u>** Divestiture Obligation applicable to PMA company holders of Special Production Operation IUPs for Processing & Refining which provide processing and refining services to holders of Production Operation IUPs/IUPKs (New Article 97(1e)).

2.2 **Differential Divestiture Annual Installments**: With differential Divestiture Obligation percentages for different categories of mining business, it becomes necessary to specify different annual installment requirements for fulfilling the same. Accordingly, following the issuance of GR 77/2014, the following **<u>cumulative</u>** annual share installment requirements apply for each category of mining business:

Production Operation IUP/IUPK holder	Acquisition/PMA conversion year	6th Year	7th Year	8th Year	9th Year	10th Year	15th Year
Category 1	25%						
Category 2		20%	30%	37%	44%	51%	
Category 3		20%				30%	40%
Category 4		20%				25%	30%
Category 5		20%		25%		30%	

(Amended Article 97).

GR 77/2014 does not specify the divesture date for Category 1 (Exploration). Accordingly, it may be assumed this simply remains unchanged from the position prior to the issuance of GR 77/2014; that is, the date of acquisition of the Exploration IUP/IUPK holder/conversion of the Exploration IUP/IUPK holder into a PMA company.

3. Promotion of Domestic Processing & Refining

3.1 **Domestic Processing & Refining – General**: Allowing a maximum of 60% foreign ownership for PMA company Production Operation IUP/IUPK holders that carry out their own domestic processing and refining, effectively extends to PMA company Production Operation IUP/IUPK holders treatment similar to that which the Government had previously indicated it was willing to grant PMA company holders of CoWs for metal minerals as part of the ongoing CoW/CCoW renegotiations. This could represent a significant inducement to some PMA company IUP/IUPK holders to carry out their own domestic processing and refining as it offers the prospect of continuing majority foreign ownership of the PMA company IUP/IUPK holders throughout the production operation period whereas, prior to GR 77/2014, foreign investors in PMA company Production Operation IUP/IUPK holders faced the daunting prospect of losing majority control not later than 10 years after the commencement of commercial production.

Notwithstanding the foregoing, the question should be asked whether or not the Divestiture Obligation advantage given to PMA company Production Operation IUP/IUPK holders which carry out their own domestic processing and refining, as compared to PMA company IUP/IUPK holders which use third parties to carry out domestic processing and refining on their behalf (**i.e.,** maximum 60% foreign ownership versus maximum 49% foreign ownership), makes any sense from an economic efficiency perspective. This Divestiture Obligation advantage seems to encourage every PMA company Production Operation IUP/IUPK holder to build its own processing and refining facility rather than relying on the services of holders of Special Production Operation IUPs for Processing & Refining operating processing and refining facilities available to multiple Production Operation IUP/IUPK holders. The end result could be the proliferation of a large number of small scale, less efficient processing and refining facilities, owned and operated by individual Production Operation IUP/IUPK holders for their exclusive use, rather than a much smaller number of large scale, more efficient processing and refining facilities, owned and operated by holders of Special Production Operation IUPs for Processing & Refining and available for use by multiple Production Operation IUP/IUPK holders. This does not seem like a desirable outcome in terms of economic efficiency or in terms of facilitating the effective control and management of the negative environmental consequences of domestic processing and refining.

GR 77/2014 does not make clear what happens where foreign investors acquire a **non**-PMA company Production Operation IUP/IUPK holder and want to convert that **non**-PMA company into a PMA company in which they can legally own shares. Prior to GR 77/2014, the foreign investors would have been immediately limited to a maximum of 49% foreign ownership. Logically, however, with the advent of GR 77/2014, the position should be that, as long as the **non**-PMA company Production Operation IUP/IUPK holder is or will be carrying on its own domestic processing and refining, foreign investors should be able to acquire the **non**-PMA

company, convert it into a PMA company and legally own 60% of the issued shares.

3.2 **Own Domestic Processing & Refining – Coal Upgrading**: A particularly interesting aspect of GR 77/2014 is the definition of "Processing" in the case of PMA company holders of IUPs/IUPKs for coal carrying out their **own** domestic processing and refining. In this case, "Processing" is defined as:

(a) **coal upgrading**;

(b) coal briquetting;

(c) coke making;

(d) coal liquefaction; and/or

(e) coal slurry/coal water mixture (Amended Article 94(1)).

The inclusion of "coal upgrading", as a type of domestic processing and refining which will allow PMA company holders of IUPs/IUPKs for coal to retain 60% foreign ownership, would seem to offer a significant inducement to PMA company holders of IUPs/IUPKs for coal to carry out coal upgrading themselves. This inducement may be sufficient to overcome traditional concerns about the cost and reliability of coal upgrading technology. Companies with already proven coal upgrading technology and operational upgrading plants, such as Australia's GTL Energy, would seem well placed to capitalize on what is likely to be renewed interest, among PMA company holders of IUPs/IUPKs for coal, to seriously consider the merits of coal upgrading.

3.3 **Third Party Domestic Processing & Refining – Coal Blending and Coal Upgrading**: Curiously, GR 77/2014 has a separate definition of "Processing" in the case of PMA company holders of IUPs/IUPKs for coal using **third parties** to carry out domestic processing and refining on their behalf. In this case, "Processing" is defined as:

(a) **coal blending**;

(b) **coal upgrading**;

(c) coal briquetting;

(d) coke making;

(e) coal liquefaction; and/or

(f) coal slurry/coal water mixture (Amended Article 94(1)).

Why **own** "processing" should include coal upgrading only while third party (**i.e.**, **without** own) "processing" should include both coal blending and coal upgrading is not immediately

clear to the writer. Perhaps, however, the rationale is that, because PMA company holders of IUPs/IUPKs for coal, using **third parties** to carry out domestic processing and refining on their behalf, are **not** entitled to the benefit of the reduced Divestiture Obligation (**i.e.**, 40% or 60% maximum foreign ownership), they should be given more leeway as to what they have to do in terms of domestic processing and refining. On the other hand, PMA company holders of IUPs/IUPKs for coal, carrying out their **own** domestic processing and refining, are entitled to the benefit of the reduced Divestiture Obligation (**i.e.**, 40% or 60% maximum foreign ownership) and, therefore, should not be allowed to get away with less demanding coal blending but, rather, should at least have to carry out coal upgrading in order to "earn" the benefit of the reduced Divestiture Obligation.

4. Promotion of Underground Mining

4.1 **Underground Mining – General**: For reasons that are not apparent to the writer, GR77/2014 gives the greatest inducement to underground mining by allowing a maximum of 70% foreign ownership for PMA company IUP/IUPK holders that carry out underground mining. This inducement seemingly applies not only to underground coal mining but also to underground metal mineral, non-metal mineral and rock mining.

Presumably, the Government views underground mining as less environmentally intrusive than open pit mining and, therefore, wants to encourage underground mining as a way to address growing community opposition to the often severe environmental damage caused by open pit mining. Promoting underground mining in Indonesia, however, seems to ignore the much greater safety risks involved in underground mining compared to open pit mining. Many hundreds of underground coal miners in China lose their lives, every year, in tunnel collapses, explosions, gas leaks and other underground mining accidents. It may not be prudent to encourage underground mining in Indonesia unless and until such time as the Government can ensure the highest possible safety standards for underground mining.

The writer also questions why underground mining is considered more desirable than domestic processing and refining such that the Government considers it appropriate to only require 30% divestiture (thereby allowing a maximum of 70% foreign ownership) for PMA company IUP/IUPK holders that carry out underground mining while requiring 40% divestiture (thereby allowing a maximum of only 60% foreign ownership) for PMA company IUP/IUPK holders that carry out own domestic processing **and** refining. To the extent that domestic processing and refining is a worthwhile objective for the Government to be pursuing (something which many people, including the writer, have repeatedly questioned, especially in the case of metal minerals), it would only seem sensible to allow PMA company IUP/IUPK holders that carry out own domestic processing **and** refining at least the same preferential treatment (in terms of an equivalent reduced Divestiture Obligation percentage) as PMA company IUP/IUPK holders carrying out underground mining will now be entitled to. Has the Government got its policy priorities right?

4.2 **Underground Mining – Together with Open Pit Mining**: GR 77/2014, somewhat confusingly, appears to draw a distinction between the **cumulative** annual share installment requirements for (i) Category 4 where the relevant PMA company IUP/IUPK holder only carries out underground mining on the subject mining concession and (ii) Category 5 where the relevant PMA company IUP/IUPK holder carries out both underground mining **and** open pit mining on the subject mining concession. Although the required divestiture percentage (30%) and maximum permitted foreign ownership (70%) is the same in both cases, divestiture has to be carried out somewhat faster in the case of combined underground mining **and** open pit mining (not more than 15 years).

Recognizing that the preferential Divestiture Obligation of only 30% (maximum 70% foreign ownership) applies to both PMA company IUP/IUPK holders **exclusively** carrying out underground mining only and to PMA company IUP/IUPK holders carrying out a mixture of both underground mining **and** open pit mining, creates an obvious (although probably unintended) incentive for every PMA company IUP/IUPK holder to have some element of underground mining, no matter how minor, on its concession so as to have to only comply with the lesser Divestiture Obligation of 30% (maximum 70% foreign ownership) compared to the standard Divestiture Obligation of 51% (maximum 49% foreign ownership) which applies to PMA company IUP/IUPK holders exclusively carrying out open pit mining without own domestic processing and refining. The write can readily see non-economic, "for show only" underground mining operations suddenly popping up all over Indonesia while all substantive mining activities continue to be open pit. Does this make any sense?

5. IDX Listings

5.1 **IDX Listings – General**: The current state of the law is confused and confusing as to the implications, for the Divestiture Obligation, of a PMA Company, holding a Production Operation IUP/IUPK, being IDX Listed. Contrary to popular belief, however, there is presently no consensus, within DGoMC, that undertaking an IDX Listing means, by itself, that a PMA company Production Operation IUP/IUPK holder thereby becomes a "local party" and is not subject to the Divestiture Obligation or has otherwise automatically fulfilled the Divestiture Obligation.

5.2 **IDX Listings – 20% Rule**: GR 77/2014 now provides that, if IUP/IUPK holders are IDX Listed, then a "**maximum"** of 20% of the "**total amount of shares**" may be counted towards satisfaction of the Divestiture Requirement (New Article 97 (2a)).

Among the various matters that are unclear from the wording of New Article 97(2a) is whether GR 77/2014 allows a "**maximum**" of 20% of (i) all the issued shares of the IDX Listed company or (ii) 20% of all the issued shares of the IDX Listed company not held by founders and/or insiders (**i.e.**, 20% of the "public" shares only) to be counted towards satisfaction of the Divestiture Obligation. Enquires made with DGoMC indicate that the "20%" mentioned in New Article 97(2a) is actually intended to mean 20% of all the issued shares of the IDX Listed company regardless of whether those shares are held by the public or by founders/insiders. **For example**, if a PMA company Production Operation IUP/IUPK holder carries out an IDX

Listing and offers 40% of its shares to the public, then the PMA company IUP/IUPK holder will only be considered to have divested a "**maximum**" of 20% of all of its issued shares to Indonesian parties as a result of the IDX Listing. Accordingly, if the PMA company Production Operation PIUP/IUPK holder does not carry out either underground mining or own processing and refining activities, then the now IDX Listed Production Operation PIUP/IUPK holder is required to divest a further 31% of its shares to Indonesian parties in order to satisfy the Divestiture Obligation as opposed to a further 11% of its shares only if it was able to count the full 40% of its shares sold to the public as part of the IDX Listing.

The 20% restriction has, presumably, been imposed in recognition of the difficulty of tracking who really owns the shares of an IDX Listed company once the IDX Listing has taken place and the shares are able to be freely traded on market.

To the extent the 20% restriction will act as a (i) negative inducement for PMA company Production Operation IUP/IUPK holders to undertake IDX Listings and (ii) consequentially, a positive inducement to, instead, sell shares privately to substantial Indonesian business groups so as to satisfy the Divestiture Obligation, the 20% restriction may be seen as inconsistent with encouraging greater, broad based (**i.e.**, retail) Indonesian ownership of mining companies.

It remains uncertain just what factors will be considered in determining the **actual** percentage of shares considered to have been divested by an IDX Listed, Production Operation IUP/IUPK holder given New Article 97(2a) refers to a "**maximum**" of 20% being counted towards satisfaction of the Divestiture Obligation. According to relevant DGoMC officials, MoEMR is currently in the process of revising MoEMR Regulation No. 27 of 2013 re Procedures and Price Determination of Divestiture Shares, and Change of Investment in Minerals and Coal Mining ("**MoEMRR 27/2013**") so as to include further details of the procedures for satisfying the Divestiture Obligation in the case of IDX Listed, PMA company Production Operation IUP/IUPK holders. It was suggested that the revision to MoEMRR 27/2013 will include the procedures for determining the actual percentage of shares that is considered to have been divested by an IDX Listed, PMA company Production Operation IUP/IUPK holder in various situations.

As many PMA company Production Operation IUP/IUPK holders have blithely assumed that an IDX Listing would be an easy way to satisfy the Divestiture Obligation, there is clearly going to be much disappointment, among PMA company Production Operation IUP/IUPK holders, following the issuance of GR 77/2014.

6. Divestiture Price

GR 77/2014 says nothing about the price that will apply if the Government exercises its first priority right in respect of divestiture shares ("**FPR Divestment Price**"). Accordingly, it must be assumed that the FPR Divestment Price continues to be determined in accordance with MoEMRR 27/2013 or, in other words, on the basis of adjusted investment cost recovery only and not on the basis of the underlying fair market value of the mining project carried on by the relevant PMA company Production Operation IUP/IUPK holder.

Given foreign investors have objected at least as much, if not more so, to the determination of the FPR Divestment Price as they have to the existence of the Divestiture Obligation itself, the failure of GR 77/2014 to introduce a more realistic FPR Divestment Price is discouraging to say the least.

7. CoWs/CCoWs

7.1 **Divestiture Obligation – General**: GR 77/2014 purports to apply to CoW/CCoW holders as well as to IUP/IUPK holders.

CoW/CCoW holders, which have carried out less than 5 years of commercial production as of 14 October 2014, are required to comply with the Divestiture Obligation in GR 77/2014 (New Article 112D(1)).

CoW/CCoW holders, which have carried out at least 5 years of commercial production as of 14 October 2014, are required to divest 20% of their issued shares not later than 12 months after the issuance of GR 77/2014 (**i.e.**, by not later than 14 October 2015) (New Article 112D(2)).

Although it is not apparent from the actual wording of New Article 112D(2), MoEMR presently interprets New Article 112D(2) as also implying a subsequent obligation, on the part of CoW/CCoW holders, which have carried out at least 5 years of commercial production, to meet the applicable cumulative divestiture installment percentage in the following years as if 2014 – 2015 was their 5th year of commercial production.

GR 77/2014 effectively seeks to require all CoWs/CCoWs, that either do not presently provide for any Divestiture Obligation or provide for a Divestiture Obligation different from that set out in GR 77/2014, to comply with the Divestiture Obligation as set out in GR 77/2014.

7.2 **Divestiture Obligation – Ongoing CoW/CCoW Renegotiations**: GR77/2014 arguably further complicates the already extremely complicated and long running CoW/CCoW renegotiations. First, the fact that GR 77/2014 purports to require all CoWs/CCoWs to comply with the Divestiture Obligation can be reasonably considered to be little different from unilaterally amending the CoWs/CCoWs and seems quite inconsistent with the supposedly voluntary nature of the CoW/CCoW renegotiations which are meant to only result in changes to the individual CoWs/CCoWs based on mutual agreement and consensus. Second, the existence of GR 77/2014 implies that, even once the CoW/CCoW renegotiations are concluded and the individual CoW/CCoW Amendment Agreements are signed, the applicable divestiture requirements can be unilaterally varied over time by the Government through the simple expedient of issuing a new government regulation. Third, it is not presently clear to the writer that the Divestiture Obligation, as set out in GR 77/2014, is entirely consistent with the changes the Government is presently seeking to get all CoW/CCoW holders to agree to in terms of including a new or amended divestiture requirement in their respective CoWs/CCoWs.

SUMMARY AND CONCLUSIONS

GR 77/2014 is very much a "mixed bag".

Clarifying how the Divestiture Obligation is to be applied in various situations, when previously informal MoEMR policy only governed the position, is a good thing in terms of legal certainty. Likewise, offering reduced Divestiture Obligation percentages, as an inducement to PMA Company Production Operation IUP/IUPK holders to carry out their mining activities in a way that achieves certain supposedly worthwhile objectives makes sense if the specified objectives are, indeed, worthwhile.

It must be queried, however, whether the Government has either (i) identified the right objectives for the purpose of providing inducements to PMA Company Production Operation IUP/IUPK holders to carry out their mining activities in a way that achieves these objectives or (ii) even if the objectives have been correctly identified, properly determined the appropriate level of inducements to be offered for the achievement of each such objective on a relative basis. In this regard, (i) encouraging underground mining, even as a minor and wholly inconsequential "add on" to open pit mining, as well as (ii) implicitly according a higher level of desirability, as an objective, to underground mining as compared to own domestic processing and refining seems highly questionable. Further, implicitly encouraging every PMA company Production IUP/IUPK holder to build its own processing and refining facility is surely of very dubious merit from an economic efficiency perspective.

Allowing a maximum of 20% of the issued shares of an IDX Listed PMA company, holding a Production Operation IUP/IUPK, to be counted towards satisfaction of the Divestiture Obligation is quite inconsistent with the supposed objective of encouraging Indonesians as a whole to have a bigger equity interest, than is presently the case, in mining companies operating in Indonesia. At the same time, the Government seems determined to use the Divestment Obligation and the inducement of reduced Divestment Obligation percentages as a way of realizing policy objectives which, in fact, have nothing at all to do with encouraging Indonesians as a whole to have a bigger equity interest, than is presently the case, in mining companies operating in Indonesia. Arguably, the Government is seeking to achieve what **could** be worthwhile policy objectives (**eg**, own domestic processing and refining or underground mining) using the wrong policy tool (**i.e.**, reduced Divestment Obligation percentages).

Leaving the FPR Divestment Price unchanged, substantially eliminates much of the benefit which might otherwise have flowed from reducing the applicable Divestiture Obligation percentages in certain situations. The FPR Divestment Price is at the very heart of foreign investor opposition to the Divestiture Obligation.

Purporting to require all CoWs/CCoWs to comply with the Divestiture Obligation, as set out in GR 7/2014, at a time when the Government is in the middle of what are meant to be voluntary CoW/CCoW renegotiations, is not likely to create a positive impression in the minds of many CoW/CCoW holders as to the good faith of the Government in its approach to those CoW/CCoW renegotiations.

All in all, GR 77/2014 is undeniably progress of a sort but, to many foreign investors at least, GR 77/2014 will probably seem more like confirmation of "a Rake's Progress" than real progress in the

nature of genuine improvement of the much disliked Divestiture Obligation.

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[This article has been contributed by Bill Sullivan, Licensed Foreign Advocate with Christian Teo Purwono & Partners. Christian Teo Purwono & Partners is a Jakarta based, Indonesian law firm and a leader in Indonesian mining law and regulatory practice. Christian Teo Purwono & Partners operates in association with international law firm Stephenson Harwood LLP which has nine offices across Asia, Europe and the Middle East: Beijing, Dubai, Hong Kong, London, Paris, Piraeus, Seoul, Shanghai and Singapore. Readers may contact the author at email: *bsullivan@cteolaw.com*; office: 62 21 5150280; mobile: 62 815 85060978]