

## ENERGY

### Power

Some time ago the government announced a crash programme to build 10,000MW of new power, based mostly on using the country's huge coal reserves. Most of this new energy is required for the industrial heartland, Java. The only outside country that could support the required speed of development on a big scale was China; heads of agreement were signed at government level. While there is Chinese engagement in the power sector, the rate of engagement has been slow, with bureaucratic delays, lack of accord on certain guarantees and a concern over the quality of product. The deadline of end 2009 for the accord on certain guarantees and a concern over the quality of product. The deadline of end 2009 for the 10,000MW of PLN-owned generation is now not achievable. As regards the IPP Program, progress has been a little better with PLN and Cirebon having executed their PPA, and the project is now moving ahead. The 800MW Paiton Expansion Project is also going ahead.

Nevertheless, there are major constraints to the rapid development of new generation capacity, some of which are outside the limits imposed by PLN and the GOI, some of which are inside their control. The former group of issues are worldwide because power plant equipment manufacturers have full order books and this has resulted in significant increases in both prices to power developers and delivery times. Furthermore, there are fewer true EPC contractors and those that are left, are now in a much stronger position vis-à-vis risk allocation, which has resulted in a major increase in project costs.

Those constraints which are inside the control of GOI and / or PLN include:

- a) Lack of clear and balanced strategy for power generation development which reflects the availability of various energy sources, and other factors such as construction lead times for different power plant types, environmental impact, through-life cost which would recognize efficiency, reliability, maintenance cost etc. The current power development programme seems to be focused exclusively on capital price.
- b) The current skewing of the PPA PLN programme towards China. The government, in line with its policy of scheduled privatization of its public sector electricity companies, PJB and Indonesia Power, is planning to move ahead on the first stage of the restructuring of these companies, but is facing opposition from the electricity labour union.

### Recommendation

European and Japanese investors will not bid against Chinese competition in an environment where price will always win over quality, technology and reliability. The GOI needs to recognize that initial cheap solutions will not bode well for the future. A clearer, more balanced, power generation strategy needs to be formulated, and implemented by a power development programme that recognizes full life cycle costs.

## **Oil and Gas**

### **Upstream: Exploration and Production**

A key objective of the government at present is to restore and sustain growth in oil and gas production, since oil production has been declining since the mid 90/s. The fact that oil consumption now exceeds production is a key concern for the government at this time of a high oil price environment when the industry should be making a major contribution to the economy. Industry and government have been working together to increase exploration activity and accelerate development of new field and progress is being made. However exploration and development costs have increased dramatically as a result of high energy prices and increased demand for services. Under the oil and gas Production Sharing Contract System, most of these costs can be recovered by producers, but the government concerned by this cost inflation, is preparing a new regulation which may limit the recovery of costs. If implemented this is likely to reduce Indonesia's global competitiveness for oil and gas investment at a time when it is greatly needed.

Tax issues also continue to be a concern for the industry, and the existence of conflicting laws impede prompt and clear resolution. During the past year the government's decision to not extend exemption from payment of import duties and taxes on temporary imports, such as drilling rigs, almost brought exploration to a standstill on some projects. Fortunately, at the start of this year, the government re-instated this exemption for a further 12 month period, but longer term uncertainty remains.

### **Downstream: Oil Refining, Transportation and Marketing**

The government continues to open up the downstream oil sector to competition, following the passing of the 2001 Oil and Gas Law. However the state-owned oil company still maintains a dominant position throughout the supply chain. The introduction of market pricing for oil products sold to industrial users has attracted new entrant into this sector. However the much larger volume of oil products that are supplied to the general public are still subsidized by the government and PERTAMINA continues to be awarded the annual rights to supply these consumers through the Public Service Obligation (PSO). A few companies have started to invest in the retailing sector but large scale investment is hard to justify whilst they cannot sell subsidized oil products.

### **Recommendation**

Upstream: GOI have continually stressed the importance of increasing oil production, and the need to do so is compelling in this current high oil price environment. To make this happen GOI must recognize the needs and concerns of industry and provide, in particular, the fiscal certainty that they need to support these increased levels of investment.

Downstream: It is apparent that many new investors would like to enter the downstream oil sector, bringing much needed investment and competition, but they can sell oil products at market prices GOI must provide greater certainty about the near and longer term pricing of oil products, which should include a clearer roadmap for the introduction of full market pricing in all sectors, and deadlines for this.

## **Mining Sector**

There is a widely-held view, supported by data on international exploration and mining expenditure, that Indonesia in recent years has lost its international competitiveness and is failing to attract new mining investment even though Indonesia is considered to be a very mineral rich country. Some of the key reasons for this are, difficulties in obtaining forestry permits, and extensive delays in enacting a new mining law, which itself new disincentives for investment. Whilst high commodity prices have generated extensive activity in the coal mining sector, there has been little development in other mining sectors.

A major concern about the new mining law, which has still to be enacted, is the loss of legal certainty as it will largely and replace this with a less legally robust two phase permitting system. Some other concerns about this new law are, that it will increase the effective tax rate for large projects, it will oblige mining companies to process minerals in Indonesia, and the and of most concern this new law may be applied to companies operating under existing. Contracts of Work after a transition period (possibly 5 years). This latter provision will almost certainly be challenged by those affected by it, and could undermine government efforts to attract foreign direct investment into other sectors as well as mining.

Other concerns which are hindering investment are new forestry regulations, and the rapid increase in the issuing of new local mining permits by regional governments which often overlap with central government issued Contracts. There is also a rapid growth in illegal mining which is of great concern for both government and industry as many small mines are able to operate in remote locations with little of no monitoring.

## **Recommendation**

There has been extensive dialogue between industry and government on most of these investor concerns. However getting these resolved is a challenge due to the existence of conflicting laws (such as the Forestry Law and the existing Mining Law). These issues and conflicts extend across several government ministries and between different levels of government (Central, Provincial and Regencies)

There is a lack of effective inter-departmental and inter-government coordination. The imminent enactment of the new mining law, and the dilution of legal certainty it is likely to introduce, is also adding to investor concerns. The GOI needs to recognize the extensive economic and other benefits which new mining investment could bring to national and regional development, especially during this era of high commodity prices, and take steps to ensure key concerns are addressed and inter-departmental coordination improved so that new mining investment can be restored to its former levels at the very least.