



28 November 2007

Indonesia-Australia FTA Feasibility Study
Department of Foreign Affairs and Trade
RG Casey Building
John McEwen Crescent
Barton ACT 0221

Dear Sir/Madam

Please find attached the Minerals Council of Australia's submission in response to the FTA feasibility study with Indonesia.

The Council welcomes the commitment of both Governments to assess the merits of a bilateral trade and investment agreement between Australian and Indonesia.

Indonesia is more a source of investment opportunity rather than an export destination for minerals and metal commodity.

Whilst current commitments are low, MCA member companies are increasingly exploring and mining in Indonesia. It should be noted that mining contractors and mining companies alike are equally active in Indonesia, and the circumstances of both should be equally considered in the context of public policy reform.

Indonesia remains rich in mineral endowment and offers a number of significant cost advantages in an intensely competitive global commodity market. Future expansion, and new investment is however tempered by a number of 'beyond-the-border' barriers, including:

- Lack of pre-competitive geoscientific information
- Proposed changes to Indonesian Mining Law
- The 1999 and 2004 Laws on Regional Administration
- New Forestry Laws
- Inadequate infrastructure provision
- Taxation

The MCA encourages the Australian government to use the FTA as a platform to address these barriers. There is evidence to suggest that addressing these barriers may lead to greater investment and activity in Indonesia - leading to greater investment and socio-economic opportunities via higher income and royalty payment receipts, infrastructure development, employment, skills development, and technology and intellectual transfers (notably OH&S and environmental management).

In 2006/07, Australia's metals and minerals exports to Indonesia were minor - accounting for approximately 0.2% of Australia's total metals and minerals trade. However, Indonesia is Australia's largest market for mining and technology services. All these exports are subject to a number of tariff and non-tariff barriers. The MCA supports the removal of these barriers to increase the access and opportunities of Australian exploration, mining and service providers.

Trade with Indonesia is two way – with goods and services imported from Indonesia, including nickel ore for processing in QLD.



The attached submission provides further details on the trade and investment barriers currently impeding the industry as well as the MCA's policy position on international trade and foreign investment.

Please feel free to contact myself on (02) 6233 0649 to discuss this matter further.

Yours sincerely

A handwritten signature in black ink, appearing to read "David Rynne", with a long horizontal flourish extending to the right.

David Rynne
Director – Taxation and Industry Economics

Enc.



MINERALS COUNCIL OF AUSTRALIA

INDONESIA - AUSTRALIA FTA FEASIBILITY STUDY

NOVEMBER 2007

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1. MINERALS COUNCIL OF AUSTRALIA

The MCA represents Australia's exploration, mining and minerals processing industry, nationally and internationally, in its contribution to sustainable development and society. MCA member companies produce more than 85 per cent of Australia's annual mineral output. The MCA's strategic objective is to advocate public policy and operational practice for a world-class industry that is safe, profitable, innovative, environmentally responsible and attuned to community needs and expectations.

2. AUSTRALIAN MINERALS INDUSTRY

The Australian minerals industry has long been the foundation of Australia's economic and social prosperity. Assisted by effective trade and investment reforms that have increased access to international markets and encouraged in and outbound investment, this prosperity is likely to continue into the future. The industry is of considerable size, economic, regional and social significance, benefiting all Australians both directly and indirectly.

The minerals industry:

- accounted directly for around 8.5 per cent of Gross Domestic Product (GDP) in 2005-06;
- underpins vitally important supply and demand relationships with the Australian manufacturing, construction, banking and financial, process engineering, property and transport sectors;
- has contributed through export sales some \$550 billion directly to Australia's wealth over the past 20 years;
- is the world's leading producer of bauxite and alumina, diamonds (by volume), ilmenite, rutile and zircon and tantalum. Australia is the second largest producer of zinc ore, the third largest producer of aluminium, iron ore, nickel and gold, and the fourth largest coal producer. Australia is the largest exporter of gold, iron ore and black coal in the world;
- in 2006-07 generated exports of around \$90 billion, representing approximately 40 per cent of total exports of goods and services;
- directly and indirectly employs some 321,000 Australians, many of which are in sparsely populated, remote and regional Australia;
- is often the sole provider of social infrastructure – health, education and welfare – in remote areas of Australia. This infrastructure often endures long past the completion of mining activities;
- brings spending and jobs not only to traditional mining towns but also to smaller neighbouring communities;
- is at the forefront of new investment, the adoption of new technology and Research, Development and Demonstration (RD&D) activity in Australia; and
- contributed \$9.1 billion in total Government revenue payments of 2005-06 - comprising \$2.1 billion in mineral royalties, \$1.1 billion in Government port and rail charges, \$4.3 billion in income tax expense, and \$1.6 billion in other indirect taxes.

3. PROSPECTS FOR GROWTH

The industry's contribution to Australia's socio-economic future looks likely to emulate the past. The Australian minerals industry is well positioned to continue to underpin Australia's wealth creation. Just as Australia's minerals exports to Japan and the Republic of Korea and other industrialising economies since the 1960s underpinned Australia's wealth creation, the industrial and economic growth of developing countries, particularly China and India, presents Australia vast opportunities for wealth generation to the benefit of all Australians, both directly and indirectly.

Asian developing countries' economic development is fuelling demand for natural resources, for which the Australian minerals industry is well placed to supply. This growth in demand, coupled with expectations of a synchronised recovery in key western economies, underpins improved prospects for prices and global growth, which, in turn, has generated a resurgence of investment interest in the Australian minerals industry. The Australian industry is building capacity and international competitiveness to ensure its strategic position in converging global supply as companies increasingly rationalise and consolidate their operations, globally.

For growth to continue and for the Australian minerals industry to remain internationally competitive, it needs unfettered access to global markets to sell its products and buy its inputs, institutional reform in prospective countries to increase certainty and transparency, capital inflows to support development of Australia's natural geological wealth, and access to global professional expertise and leading edge technology.

4. MCA PRINCIPLES ON INTERNATIONAL TRADE AND FOREIGN INVESTMENT

4.1 International Trade

The MCA is a strong advocate of trade and investment liberalisation through the World Trade Organisation (WTO) multilateral system and regional and bilateral Free Trade Agreements (FTA).

Whilst fostering business expansion and export growth, trade liberalisation has contributed to reduced levels of poverty and an increase in living standards across the globe.

As a medium-sized economy whose prosperity significantly depends on exports, the Australian economy has been a major beneficiary of trade liberalisation. Accordingly, Australia has a key stake in maintaining an open, non-discriminatory system of enforceable international trade rules.

The Council recognises the challenges in reinvigorating the WTO Doha Round of multilateral trade liberalisation negotiations and in particular, the sensitivities that remain in relation to manufactured goods access and agricultural subsidies and tariffs tradeoffs. In this context, bilateral FTA's are a second-best option.

We also recognise the necessity of bringing developing countries into the world trade system to ensure they can capitalise on their comparative advantages such as low labour costs, just as the developed countries capitalise on their natural comparative advantages.

The Council supports a comprehensive approach to trade and investment liberalisation, which involves reducing tariffs and non-tariff barriers, and addressing 'beyond-the-border' barriers in opening markets and reducing subsidised competition through:

- the WTO "Doha Development Round" round of multilateral trade negotiations;
- encouragement of nations to conform to the existing compliance provisions of WTO Agreements;
- regional and bilateral trade agreements which complement and emphasise the integrity of the WTO rules based trading system;
- reinforcement of the foundation or underlying principles of the WTO rules based trading system viz:
 - non-discrimination in like products and the concept of materiality, ie. any trade restrictions should be material, based on the physical characteristics of products, irrespective of the processes and production methods (PPMs);
 - respect for the principle of national sovereignty, rejecting trade coercion in the form of trade sanctions or restrictive measures beyond a country's general obligations to extra-territorially impose non-trade objectives on exporting countries without legal redress, or due and proper regard for the sovereignty of the nation state;

- sound science as the foundation to proper risk analysis and risk management in determining trade restrictions legitimately provided for in WTO agreements where there is a risk of the imported product affecting the environment, product safety and public, animal and plant health; it is legitimate to protect an importing country from such risks, but it is not legitimate to seek to impose social or economic standards on the exporting country by way of trade sanctions; and
 - the legitimate exploitation of comparative advantage in forming competitive strength in international trade of goods and services.
- closer economic integration of countries within Australia's region, to complement both multilateral, regional and bilateral trade agreements/initiatives;
 - preventing trade sanctions and other trade restrictive measures as a means of achieving non-trade outcomes (for example, environmental and social); and
 - ensuring that the application of Australia's laws governing anti-dumping and countervailing measures are not used for disguised protection and trade distortion but rather for the principal focus of protecting industries from predatory dumping.

4.2 Foreign Investment Policy

Access to global capital markets is vital to the Australian minerals industry, particularly as the scale of most minerals projects is beyond the ability of a capital market the size of Australia's to support (the Australian share market, for example, represents only around 2.5 per cent of the global equity market).

Australia's key strengths in attracting foreign direct investment (FDI) are its stable and transparent political, economic and legal systems, in addition to sound macroeconomic fundamentals and broader business regulatory arrangements. While recent reforms have enhanced the capacity of Australian business to attract capital, there is no room for complacency. International capital is highly mobile, competition for investment is vigorous and a number of nations provide investment incentives to Australia's detriment.

The MCA supports a foreign investment policy designed to maximise the benefits to Australians of increasing globalisation and the international flow of capital.

In principle, the MCA supports the development of multilateral rules governing FDI that:

- provides a legal right for investments from each party to receive treatment no less favourable (national treatment) to that given to national investors;
- provides parties and individual companies legal right to redress and access to dispute settlement;
- attaches no conditions to investment such as local content provisions, trade balancing requirements or environmental, or other non-trade considerations; and
- establishes a comprehensive and transparent legal investment framework providing predictability and legal certainty to investment decisions.

5. AUSTRALIA-INDONESIA METALS AND MINERALS RELATIONSHIP

5.1 Australian Mineral and Metals Exports to Indonesia

With a combined export value of approximately A\$265 million, Australia's mineral and metals exports to Indonesia in 2006-07 (mainly refined copper, aluminium, refined lead, and refined zinc) accounted for approximately 0.2% of Australia's total minerals exports (A\$106.5b).

A summary of these exports is at **Table One**.

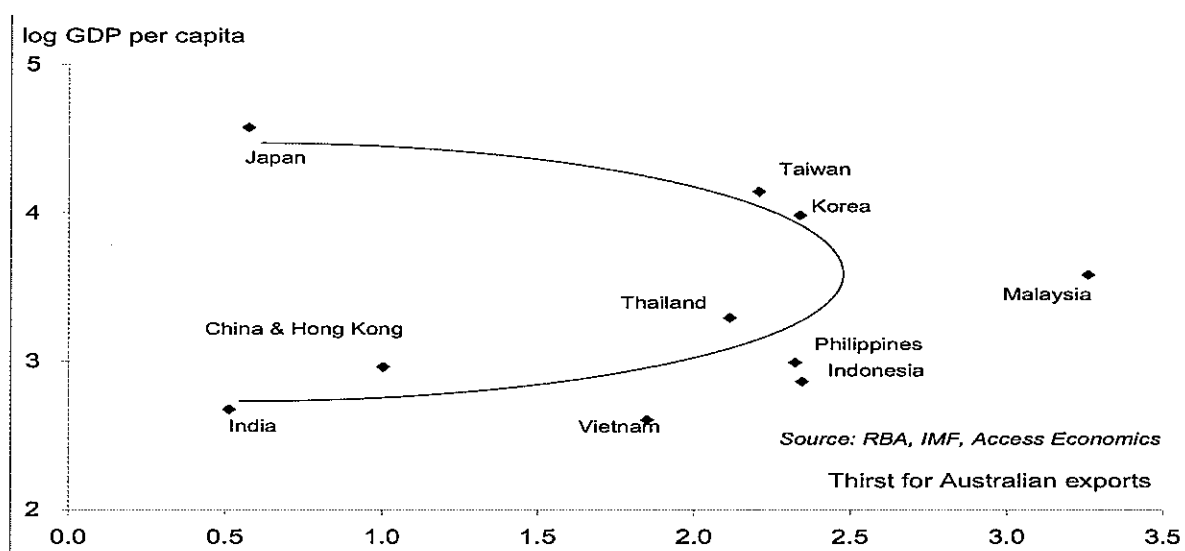
Table One: Main Australian Mineral and Metals Exports to Indonesia 2006-07¹

Commodity	Value	Status
Refined zinc	A\$68 million	Equal third largest consumer
Refined lead	A\$9 million	Fourth largest consumer
Refined copper	A\$131 million	Third largest consumer
Aluminium	A\$57 million	Seventh largest consumer

Predictions are that Indonesia's future steel, aluminium and minerals consumption may continue to increase in gross and per capita terms² on account of its concerted micro (infrastructure development notably) and macroeconomic reform agenda, and strong expected future growth (4.4% annual percentage growth in GDP in 2007 and 2008 is forecast³).

Indonesia is at a stage of economic development where its metals intensity consumption is likely to increase. **Figure Two** demonstrates that when countries reach a per income level of approximately US\$3,500 to \$4,000 per income level⁴, their demand for commodity imports per capita begins to ease. This is on account of less rapid industrialisation and urbanisation, and the emergence of new comparative and competitive advantages. Indonesia's per capita GDP is currently less than US\$3,000 and is likely to be a part of the 'Asia factory' phenomenon for a period yet. The 'Asia Factory' is where parts and components are supplied by countries like Japan, the Republic of Korea and Chinese Taipei, assembled in countries like China, Thailand, Vietnam and Indonesia, and exported to the developed economies of Europe, North America and Australia.

The export intensity is measured by the ratio of each country's share of Australia's merchandise exports compared to that country's share of the world economy.

Figure Two: Intensity of Australia's Merchandise Exports with Degree of Economic Development

Source: IMF, ABS and Access Economics

¹ ABARE, Australian Mineral Statistics, June Quarter 2007

² IMF and Access Economics presentation 2007 Minerals Week

³ IMF database

⁴ Access Economics and IMF analysis

5.2 Mining Investment in Indonesia

MCA member companies with the capacity to become more globally integrated have publicly stated that given the nature and anticipated strength of the global supply/demand commodities business cycle (i.e huge socio-economic development in the major economies of China and India et al⁵ with limited supply capacities), acquisition-led growth that enhances the quality, scale and growth of a company's portfolio is the preferred strategy into the future.

Indonesia accounts for a significant share of world mineral reserves. Indonesia's mineral reserves include 7.5 per cent of the world's known reserves of copper, more than 13 per cent of known reserves of tin, more than 5 per cent of known reserves of nickel, and more than 4 per cent of the world's known gold reserves⁶.

Indonesia's high prospectivity, low operating costs⁷, strong commitment to maintaining stable financial systems, strong economic development with relatively low (anticipated) inflation⁸, and proximity to markets, makes it an attractive destination for inwards (mining) investment and growth opportunities.

MCA member companies are increasingly active in Indonesia, for example:

- Rio Tinto has a 40 per cent interest in the Grasberg joint venture – one of the world's largest copper and gold mines in terms of reserves and production. Rio Tinto also undertakes grassroots and near mine exploration activities in Indonesia, with negotiations ongoing for a Contract of Work⁹ (CoW) for the La Sampala project (nickel) with the Government of Indonesia. Indonesia accounts for approximately 5 per cent of Rio Tinto's global employment.
- BHP Billiton have conducted exploration activities and feasibility studies into the development of a coking coal operation in the Maruwai Basin under various Coal Contract of Work (CCOW) agreements with the Indonesian Government. If approved, the first stage of the development will see the development and operation of a 1 mtpa facility by the end of calendar year 2008 with subsequent development of a 3 to 5 mtpa facility in the Maruwai CCOW.
- Further, PT Aneka Tambang (Antam) and BHP Billiton recently secured a principal license from East Halmahera regency of North Maluku province to convert mining concession (KP) into contract of work (KK) for the development of nickel mining. Early estimates are that US\$1 billion would be needed to develop the ferronickel project, while another \$2-3 billion would be needed to develop hydrometallurgical processing. The project might be able to produce 30,000 tons per annum of nickel contained in ferronickel and 60,000 TPA of nickel metal. Both companies signed a heads of agreement (HoA) to jointly develop the project last February.
- Oxiana under the Kalimantan Gold Agreement is actively exploring a suite of high potential copper-gold targets in Kalimantan, Indonesia.
- Newmont operates the Batu Hijau gold and copper mine in Indonesia.
- Thiess operates on three main mining projects in Indonesia – the Kaltim Prima Coal Mine in East Kalimantan, the Senakin Coal Mines in South Kalimantan, and the Satui Coal Mine South, Kalimantan, Indonesia. At a combined value of approximately \$2,040 million, these three mines employ nearly 7,000 employees and sub-contractors.

⁵ Fuelled by the continued expansion of the metals intensive construction and manufacturing sectors, the development of energy and transport infrastructure, rising household incomes and an associated rise in demand for consumer durables.

⁶ USGS (U.S Geological Survey) 2005, Mineral Commodity Summaries <http://minerals.usgs.gov>

⁷ According to PricewaterhouseCooper's 2006 Survey of producing and exploration companies, there is evidence that the average profitability of companies in Indonesia's minerals industry is relatively high compared with other economies.

⁸ The International Monetary Fund forecast that Indonesia's inflation will be considerably lower at 6.3 and 5.3 per cent in 2007 and 2008 respectively.

⁹ Tenure available to Australian investment is limited to that falling under a Contract of Work.

6. THE NEED FOR REFORM

Since the 1997 financial crisis, expenditure on exploration for minerals in Indonesia has followed a downwards trend. This fall in confidence, combined with proposed and recently enacted laws, has led to considerable uncertainty – causing projects to be delayed and/or suspended.

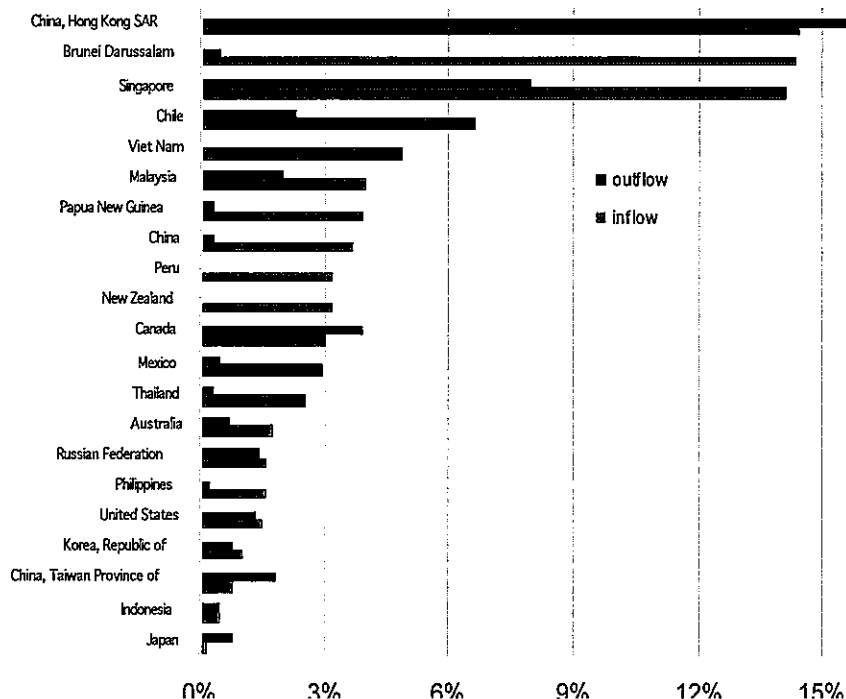
The latest available data suggests however that from 2002 exploration levels have trended upwards – albeit very slightly. Most of this exploration has been in relation to ‘brownfield’ sites, which is a concern as discovery and development of new deposits is required to ensure the long term sustainability of the Indonesian minerals industry.

Indonesia’s response to international calls for improved fiscal stability and concerted economic reform to improve its investment attractiveness has been slow. This point was made by Mr Mahendra Siregar, Deputy Minister of International Economic and Financial Cooperation, Republic of Indonesia, at a recent investment dialogue in Melbourne¹⁰, who stated:

Obviously we had to face many challenges in undertaking these reforms. We appreciate that public opinion, including international public opinion, is impatient with our reform. Expectations were high that significant reforms would be forthcoming faster than has proven to be the case, but we have to accept that we are operating in a new reality.

This idleness is reflected in recent FDI inflow and outflow statistics. Figure One demonstrates that for APEC countries at least, Indonesia has the second lowest FDI inflows (as a percentage of GDP – average 1996 to 2005).

Figure One: FDI inflows and outflows as a percentage of GDP for APEC economies (average 1996 to 2005)



Source: UNCTAD 2006a

Further, two recently completed reports demonstrate that Indonesia’s institutional settings are sub-par when compared globally.

¹⁰ Address to the APEC High-Level Public Policy Dialogue on the OECD’s Policy Framework for Investment in Melbourne, 26-27 April 2007.

The World Bank's 'Governance Matters 2007' collates the Worldwide Governance Indicators. These indicators capture six dimensions of governance; and make it possible to evaluate the quality of an economy's governance. The 2007 report found that against the indicator of:

- 'Political stability and absence of violence', 15% of surveyed countries scored worse than Indonesia;
- 'Government effectiveness', 40% of surveyed countries scored worse than Indonesia;
- 'Regulatory quality', 40% of surveyed countries scored worse than Indonesia; and
- 'Rule of law', 25% of surveyed countries scored worse than Indonesia;

The Fraser Institute is an independent research and educational organisation based in Canada. Each year since 1997, the Fraser Institute has conducted an annual survey of metal mining and exploration countries¹¹. The survey aims to assess 'how mineral endowments and public policy factors such as taxation and regulation affect exploration investment' (Fraser Institute 2007).

In 2007, the survey covered a total of 65 jurisdictions (countries, states or territories) from every continent except Antarctica. The 2006-07 results summarise the 333 responses to a survey of approximately 3000 exploration, development and mining consulting companies around the world. Survey results illustrate the opinions of executives and exploration managers from these companies.

The Policy Potential Index (PPI) is a composite index that measures the effects on exploration of government policies including uncertainty concerning the administration, interpretation, and enforcement of existing regulations; environmental regulations; regulatory duplication and inconsistencies; taxation; uncertainty concerning native land claims and protected areas; infrastructure; socioeconomic agreements; political stability; labour issues; geological database; and security.

Against the PPI, Indonesia scored 56th out of 65 countries/mining regions surveyed in 2006/07 (56/65). Against this measure, Indonesia has languished in the bottom quarter for four years straight.

Further results for Indonesia from the 2007 Fraser Institute report include:

- 44/65 against the criteria 'mineral potential assuming current regulations/land use restrictions';
- 15/65 against the criteria 'policy/mineral potential assuming no land use restrictions in place and assuming industry 'best practices';
- 20% of respondents said that 'uncertainty concerning the administration, interpretation and enforcement of existing regulations' served as a 'strong deterrent to investment, whilst 35% said that 'they would not pursue exploration due to this factor'. On a relative basis, Indonesia ranked in the bottom quarter compared to other countries/mining regions against this measure. Concerns stem predominately from proposed changes to Indonesia's mining laws (and possible elimination of CoW's), poor taxation outcomes, and Indonesia's democratisation process (more discussion below).
- 9% of respondents said that because of 'environmental regulations' they would not pursue exploration due to this factor'. On a relative basis, Indonesia ranked in the second top quarter compared to other countries/mining regions against this measure. Indonesia's new forest laws are a particular issue and are discussed below.
- 35% of respondents said that 'regulatory duplication and inconsistencies' served as a 'strong deterrent to investment, whilst 18% said that 'they would not pursue exploration due to this factor'. On a relative basis, Indonesia ranked well in the bottom quarter compared to other countries/mining regions against this measure. Again, regulatory decentralisation is an issue and is discussed below.
- 20% of respondents said that the 'taxation regime' served as a 'strong deterrent to investment, whilst 20% said that 'they would not pursue exploration due to this factor'. On a relative basis, Indonesia ranked in the bottom quarter compared to other countries/mining regions against this measure.

¹¹ http://www.fraserinstitute.ca/commerce.web/product_files/Mining06rv2.pdf

Whilst Indonesia's taxation regime prima facie is comparable with other leading regimes with a 'headline' corporate tax rate of 30%; ad valorem royalties¹²; loss carry forward provisions¹³; profit/production sharing provisions, no export taxes (but export restrictions – see below); deductibility of exploration expenditure provisions; and relief under double taxation arrangements, a number of anomalies exist. These in themselves serve as a barrier to investment and are elaborated upon below.

- 20% of respondents said that 'uncertainty concerning native title claims' served as a 'strong deterrent to investment, whilst 5% said that 'they would not pursue exploration due to this factor'. On a relative basis, Indonesia ranked in the second bottom quarter compared to other countries/mining regions against this measure.
- 32% of respondents said that 'uncertainty concerning which parks will be protected as wilderness or parks' served as a 'strong deterrent to investment, whilst 10% said that 'they would not pursue exploration due to this factor'. On a relative basis, Indonesia ranked in the bottom quarter compared to other countries/mining regions against this measure. Again, Indonesia's forest laws are a particular issue and are discussed below.
- 25% of respondents said that 'infrastructure' served as a 'strong deterrent to investment, whilst 25% said that 'they would not pursue exploration due to this factor'. On a relative basis, Indonesia ranked in the bottom quarter compared to other countries/mining regions against this measure. Indonesia has chronically under-invested in essential infrastructure since the 1997 financial crisis. A lack of incentive currently exists to invest – especially in remote localities.
- 38% of respondents said that 'political stability' (or lack thereof) served as a 'strong deterrent to investment, whilst 20% said that 'they would not pursue exploration due to this factor'. On a relative basis, Indonesia ranked in the bottom quarter compared to other countries/mining regions against this measure. Indonesia's transition to a democratic nation has been difficult with very high turnover at the middle and senior levels of government and bureaucracy.
- 7% of respondents said that 'labour regulations/employment agreements' served as a 'strong deterrent to investment, whilst 8% said that 'they would not pursue exploration due to this factor'. On a relative basis, Indonesia ranked in the second bottom quarter compared to other countries/mining regions against this measure.
- 38% of respondents said that the 'geological database' served as a 'strong deterrent to investment, whilst 10% said that 'they would not pursue exploration due to this factor'. On a relative basis, Indonesia ranked in the bottom quarter compared to other countries/mining regions against this measure. Indonesia's geological information is provided at 1:100 000 scale (not ideal) and is not available online. Indonesia does not however place any restrictions on who can access the data and has a policy whereby companies are obliged to provide data after a period of time.
- 43% of respondents said that 'security' served as a 'strong deterrent to investment, whilst 20% said that 'they would not pursue exploration due to this factor'. On a relative basis, Indonesia ranked in the bottom quarter compared to other countries/mining regions against this measure. Indonesia allows foreign ownership and generally mining licenses are assured – assuming that the exploration is successful and reasonable conditions of mining (environmental, infrastructure etc) are met. Tenure and licensing problems exist and are elaborated upon below.

An interesting observation is that Indonesia rates about mid range against the 'composite policy and mineral potential' indicator, despite ranking in the bottom quarter or second last quarter on most of the measures above. This may indicate that mining companies believe Indonesia has strong potential as a future destination for mining and exploration activities, notwithstanding the institutional problems that exist.

¹² Under the Indonesian constitution, all natural resources are under the jurisdiction of the State and are to be used for the benefit and welfare of the people.

¹³ Loss carry forward is particularly important for 'junior' explorers [and those like the majors who depend upon their services] who are at times cash poor due to high risk nature of exploration.

In response to criticisms about the quality and effectiveness of Indonesia's institutional settings, the Indonesian Government in 2006 launched three broad policy reform packages to help achieve (its highly promoted) goal of improved fiscal stabilisation and seven per cent annual economic growth to achieve middle income status. Those reforms of specific interest to the mining industry are outlined at **Attachment One**. The Council believes these are positive reforms and encourages the reform process to continue.

7. REFORMS SOUGHT BY THE AUSTRALIAN MINERALS INDUSTRY

The MCA believes there are a number of tariff, non-tariff and beyond the border barriers that can be addressed in an Australian-Indonesia FTA.

The MCA is confident that reforms that address these concerns will lead to greater interest in Indonesia as a destination of exploration and mining activity. In any case, a number of MCA member companies are already highly committed to Indonesia – meaning further concerted improvements to the operating environment will maximise returns, encourage further investment and expansion - leading to greater investment and socio-economic opportunities.

7.1 Indonesia Mineral and Metal Tariffs

Consistent with the relatively liberalised nature of global trade in mineral products, Indonesia has low tariffs on almost all commodity lines with an applied tariff of 5 per cent on aluminium ores and concentrates, lead ores and concentrates, zinc ores and concentrates, refined copper (cathodes and sections of cathodes and wire-bars), and some unwrought zinc lines.

Whilst these appear to be largely non-discriminatory in nature, the MCA supports the removal of these tariffs.

7.2 Indonesia Export Taxes

Indonesia retains the right to levy a duty or other export related tax/tariff on mining commodity. For instance a duty was recently introduced for coal exports without industry consultation. Indonesia is currently the largest thermal coal (seaborne) exporter in the world.

A number of mineral-exporting nations have imposed export restrictions in order to maintain supply for their domestic industries. Export restraints are designed to increase availability of a product in a domestic market. By curbing more-profitable exports, more of the good is sold domestically, resulting in lower prices and a 'crowding out' of Australian export opportunities.

Export controls are also imposed on raw materials as part of a strategy to encourage exports of value-added derivatives from those raw materials. Export restraints can come in the form of outright bans, export quotas, export tariffs (also referred to as 'export duties; or 'export levies'), and restrictive export licensing requirements. Exports can also be reduced by introducing tax arrangement which discourage exports, or by removing export-inducing tax arrangements. Non-tariff export restrictions are generally prohibited under Article XI of the General Agreement on Tariffs and Trade (GATT).

7.3 Indonesia Regulatory and Beyond-the-Border Barriers

The key area of interest for Australian mining companies is reforms of Indonesia's regulatory and 'beyond-the-border' barriers. This is needed to reduce costs and make Indonesia more accessible.

Given the pace of globalisation and the connectivity of markets (supply and demand), the global minerals market is as competitive as ever. Indonesia remains just one potential source of minerals for world markets, and there are many other competing producers worldwide. Further, governments with high mineral endowment also seeking to reform their institutions to capture a greater share of the investment dollar to create direct and indirect economic benefits such as royalty payments, infrastructure development, employment and skills development.

World Bank studies¹⁴ indicate that every dollar a company spends on a mine, \$US 2.80 in economic benefit is generated elsewhere in the economy.

The relative costs of production are an important determinant in a mining multi-national corporation's decision making. In this context, Indonesia's proximity to key export markets and relatively low labour costs are potential cost advantages.

Building on the results of the aforementioned World Bank and Fraser Institute reports, and direct feedback from MCA member companies, the specific 'beyond-the-border' barriers¹⁵ in Indonesia that are impeding greater inwards investment that should be examined in a FTA context are below. It should be noted that the need for fiscal stability and general certainty is paramount when companies are considering large, long-term capital investments where returns are realised over a number of decades.

7.3.1 Geoscientific Information

Indonesia should improve the quantum and quality of the pre-competitive geoscientific information that is made available and remove barriers for exploration. It should be noted that globally, the majority of exploration is now carried out by small and highly nimble 'junior' exploration companies (not internally by the major companies). This reflects the growing speciality of this service. These small companies need streamlined regulations and generous taxation provisions because they are often cash, time and resource poor. Increasingly, governments are offering special incentives (eg flow-through share schemes) to attract these companies to their shores.

7.3.2 Proposed changes to the Mining Law 1967

Proposed 'democratisation reforms' that will refer decision making and power to the 'district' level is creating uncertainty in terms of how consistency, transparency and certainty will be achieved - especially if a company is operating across multiple districts.

An example is that Indonesian provinces now have tax making powers. It must be ensured that companies incur the same uniform level of low effective tax burden – regardless of what level of Indonesian Government is imposing the burden.

There are provisions in the proposed new mining law for a project to be called a 'strategic national resource' to be governed by the central government. There are concerns about what the criteria to define such a project will be. It has been proposed that companies can sign an agreement with agencies to produce metals in these areas. To be eligible for such a contract, companies may need to:

- spend at least US\$250 million on each project;
- agree to sell shares to the public; and
- may also be required to pay 10 per cent of profit to the government in addition to other taxes.

Industry has concerns about the removal of the Contract of Work (CoW) system and the proposal that the new license system will not provide an automatic right to convert licenses from exploration to development (removing security of tenure).

The proposed new mining law will require companies to do more value added processing domestically than what might otherwise be justified/desirable in a commercial sense. As such, developers will be required to process mined ores into refined products. The MCA does not support this requirement and companies should be afforded the opportunity to compete for specific mining projects/activities based on their individual strengths.

¹⁴ MMSD (Mining, Minerals and Sustainable Development) 2002, *Breaking New Ground: mining, minerals and sustainable development*, Earthscan Publications, London.

¹⁵ The MCA defines 'beyond-the-border' barriers as policy or institutional shortcomings that impede investment and thereby an economy from achieving optimal growth and productivity.

7.3.3 *The 1999 and 2004 Laws on Regional Administration*

One outcome of the move to regional autonomy in Indonesia has been uncertainty regarding the roles of different levels of government involved in the management of the minerals sector and an increase in the overall regulation of the sector. In particular, regional governments have not necessarily clearly specified the requirements or preconditions for investment in the minerals sector. Further, negotiations with mining companies are conducted on an ad hoc basis. This has led to differences in the attractiveness of regions for investors by increasing transaction costs and can increase the costs of undertaking exploration and development activity.

In addition, the capacity to administer the minerals industry is less developed at this level of government. This reflects a lack of technical skills as well as to limited capacity in general administration.

7.3.4 *New Forestry Laws*

Whilst the MCA supports efforts by the Indonesian Government Greater to reduce deforestation, certainty of long term rights in forestry areas is required to enable large capital investment projects to proceed with the knowledge that return on investment can be achieved without any unexpected changes to forestry permitting conditions.

7.3.5 *Mining Tenure*

Adequate terms (30 years +) for holding mining tenure are needed where large capital investments are contemplated as such projects are generally marginal or uneconomic without subsequent expansions and development on the initial investment. The ability to extend tenure for the life of the resource being developed (subject to meeting reasonable performance criteria) is very important.

7.3.6 *Infrastructure*

Indonesia has had chronic under expenditure on essential infrastructure since the 1997 financial crisis. Typically, mining projects occur in regions where there is virtually no supporting 'hard' (ports, harbours, railways etc) or 'soft' infrastructure (community and social amenities such as schools, hospitals etc).

Whilst funding options that draw upon the expertise and financial support of the private and public sectors (eg PPP's) are difficult to pursue in Indonesia, they should be actively encouraged via appropriate legislative provision. In reality, given the remoteness of mining projects, companies will fund the infrastructure themselves. In time, this infrastructure is utilised by the local community. Given this, the Council supports additional incentives (eg tax rebates, accelerated depreciation, deduction uplifts such as 150 per cent etc) and additional commitments from government where significant local infrastructure is required as a result of project development. In this context, the long-term benefits to the Indonesian community need to be better understood and recognised.

7.3.7 *Taxation*

Notwithstanding that Governments usually avoid incorporating tax issues into FTA discussions, mining companies with interests in Indonesia state that it serves as one of the more profound barriers to invest.

Indonesia is generally considered a high-taxing country with inefficient tax administration. The Council strongly recommends that Australia's (mining) tax regime be used as a template for reform. Specific concerns include:

- **Lex specialis.** CoWs have investment-specific tax rules that override general tax rules. These rules (typically) apply for the life of the mining investment. Some CoWs also provide protection against taxes that are promulgated post-CoW. This is generally considered attractive by investors because:
 - mining investment tends to be single purpose, long term and capital intensive. Stability in fiscal modelling is therefore attractive and is not perceived to be the default environment; and
 - the general Income Tax rules have significant deficiencies in regard to the treatment of these types of investments in any case (e.g weaknesses in the treatment of exploration/intangible costs, unhelpful limits on tax loss carry forward rules, uncertainty on interest deductibility entitlement). Considerable fiscal uncertainty would therefore exist if the general Income Tax rules were applied to many major mining investors.

Observance of the *lex specialis* principle by tax officials varies considerably in practice. In particular, the

VAT status of mining companies has been particularly problematic.

Relief/consistency may also not be achieved through the dispute resolution system.

Further, the legal/moral entitlement for one type of investor to be the “beneficiary” of special tax arrangements via CoW *lex specialis* arrangements is now openly questioned in the Parliament, the media, etc. Industry’s support for both CoW and the application of the *lex specialis* principle is very strong. Its preservation should be a high priority.

- **General administration.** Apart from *lex specialis*, general tax administration practices add to costs and provide unpredictable outcomes. Whilst nominally a self-assessment system, compliance is monitored through detailed document and time intensive audits (see VAT comment above). Assessments etc can be arbitrary in nature. An FTA might therefore consider how administration could be more investment neutral.
- **Grouping.** There are no provisions within the Income Tax, VAT or most other tax rules allowing for consolidated filings or any similar Group relief arrangements. Investors with multiple investments must therefore allocate resources amongst their investments with each allocation constituting a specific tax event. Resulting taxes include Income Tax (including withholding obligations) and VAT. Whilst WHT and VAT are nominally cash flow concerns, refunds are not processed without mandatory audits - which create follow-on inefficiencies (i.e mainly time value of money and foreign exchange fluctuation financial losses).

Indonesia’s dividend WHT serves as major investment disincentive as it makes large capital investment projects difficult to pursue due to initial projects being marginal or uneconomic. Profits earned by a non-resident mining company are taxed at 30 per cent. When the remaining profits are transferred out of the country to the resident country, an additional 15 per cent dividend WHT is also payable. In effect, the companies effective tax rate becomes approximately 40 per cent – which is high by international standards. This has a major bearing on project internal rate of return assessments. Whilst Australia has a double tax treaty with Indonesia, the rate of 15 per cent WHT is 5 per cent higher than that negotiated between Indonesia and other countries.

- **Tax on share transfers.** There is a 5% Income Tax on the sale of shares in Indonesian incorporated entities by foreign shareholders. The Australian tax treaty with Indonesia is one of the few that does not protect against this. Australia does not levy a similar tax.
- **Regional taxes.** Recent autonomy laws have transferred significant taxing powers to regional Governments. The existence and administration of these taxes is not transparent (e.g there is no centralized gazetting etc). Contractual protection via CoWs may be ineffective in providing financial relief.
- **Exports/imports.** Indonesia retains the power to levy a duty or other export related tax/tariff on mining produce. For instance, a duty was recently introduced for coal exports without industry consultation (although the duty has since been at least temporarily withdrawn). Contractual protection via CoWs may be ineffective in providing financial relief.

There are at least three taxes (customs, VAT, and income tax) that are levied on physical imports. For mining companies, the ‘master list’ arrangements usually provide exemption to these taxes – however, this is being weakened even with CoW protections. Regrettably, these taxes apply to mining contractors as they are not subject to standard CoW provisions. Given the uncertainty in relation to the on-going existence of CoW’s, this is a significant issue.

- **Tax on Indonesian Groups.** There is only limited outward/international investment by Indonesian Groups. The Indonesian Income Tax system places Indonesian Groups at a considerable disadvantage to those based in Australia and investing into Indonesia. For instance:
 - all foreign sourced dividends are fully taxable (@30%) to the Indonesian shareholder irrespective of the level of foreign taxes suffered, or the source of the profits (i.e. no concessions would be available for mining profits earned in Australia is also has a 30% tax rate); and

- no foreign tax credit relief for underlying profits.
- **Other general concerns identified include:**
 - the difficulty in enforcing contracts in Indonesia;
 - the need to simplify the requirements for starting (and closing) a business;
 - licensing arrangements;
 - customs processing time and general inefficiencies; and
 - industrial relations and the cost of retrenching workers.

8. FOREIGN DIRECT INVESTMENT

Australia should always be receptive to improving its investment settings. Whilst investment from Indonesia in mining projects is limited, opportunities for joint ventures etc are continually emerging as the industry continues to consolidate and rationalise. Reforms that Australia should consider include:

8.1 Less restrictive FIRB arrangements¹⁶

MCA encourages the Australian Government to consider treatment equivalent to that granted to the US in the recently negotiated US-Australia FTA. That is, all investments other than in specific industries, and where there is no takeover, be completely free of FIRB scrutiny (current threshold is \$10m). In the case where a takeover is proposed, the threshold should be increased to \$A800m (currently 19% and \$50m).

8.2 Flexible Commercial Arrangements

International concerns in relation to energy security and high commodity prices (resulting in improved project economics and greater access to capital), has led to a significant increase in the amount of FDI utilised in Australian brown and greenfields project expansions in recent years¹⁷. This investment takes a number of forms, including joint ventures and mergers & acquisitions (M&A).

Acquisitions (takeovers) in the Australian mining sector have increased substantially over the past three years - rising 70% in 2004 and a further 70% in 2005. These levels were expected to be sustained in 2006/07¹⁸. In the main it has been the mid-cap sized companies in the Australian resources sector that have consolidated, however, a significant number of new junior companies have listed. It is anticipated that more takeover activity will occur across all sized resources companies.

The major resources companies are generating substantial cash flows and are funding large acquisitions with cash. Conversely, mid and small-cap resources companies are issuing scrip to fund their acquisitions and preserving cash for project development. Regardless of size, Australian resource companies are seeking to align commercially with foreign investors to not only fund expansions but to secure market access.

The efficiency and magnitude of the global supply response to meet the rapidly growing minerals and metals needs of developing countries such as Brazil, Russia, India, and China is currently hampered by a number of capacity constraints¹⁹. Hence the current buoyancy associated with global minerals prices, share prices, and general 'investment attractiveness' is somewhat tempered. Expectations are, however, that notwithstanding a

¹⁶ MCA does not recommend changes to Australia's Foreign Government FDI restrictions however.

¹⁷ In the 12 months ending April 2007, there were 42 mining and minerals processing projects 'completed' at a combined value of \$6 billion. Further, as at April 2007 there were 84 projects at the 'advanced' stage with an estimated combined capital expenditure of \$34.4 billion and 165 projects at the 'less advanced' stage with a collective value of approximately \$61.8 billion (ABARE).

¹⁸ Ernst & Young

¹⁹ The significant capacity constraints include inadequate export infrastructure; inefficient project approval processes; declining national minerals inventories and real value of exploration expenditure; restricted access to human capital and essential production inputs (specifically energy and water); barriers to international trade and foreign direct investment; climate change management; and sovereign risk.

positive market correction in response to these constraints, global minerals prices will continue to move in cycles but at a higher plateau than previously experienced.

Given expectations of continued buoyant market conditions; an increasing desire by mineral dependent countries and Australian suppliers to guarantee supplies and markets (respectively); a track history of successful foreign ownership (part and full) in Australian minerals projects; and sound governing institutions²⁰; the attractiveness of the Australian minerals industry as an investment destination remains very high.

9. GENERAL BENEFITS OF AN AUSTRALIA / INDONESIA FREE TRADE AGREEMENT

The MCA supports the negotiation of a free trade agreement with Indonesia. The Australian minerals industry enjoys a small but significant trading relationship with Indonesia. Australian metal and minerals companies are however increasingly interested in Indonesia as a preferred destination for exploration and mining activity despite perceived institutional and public policy shortcomings.

The general benefits of a comprehensive FTA would include:

- a broadening and strengthening of the bilateral relationship with Indonesia;
- the promotion of more intense trade and investment flows between the two nations. While there are few tariff barriers to the export of minerals products to Indonesia, a FTA could clear away remaining barriers in a number of other and related sectors (eg mining technology services²¹), and build a stronger and broader economic relationship;
- an FTA with Indonesia will further anchor Australia within the emerging East Asian community. The economic architecture of East Asia is in the process of evolution, and it is in the interests of leaders to play a leading role in shaping that community. An ambitious and comprehensive bilateral FTA between the two nations can provide a rules- based template for economic interaction in the region that is both complementary to the global trading system and can be emulated by other nations in East and South Asia;
- the removal of restrictions on goods, services and capital and an expansion of two way trade and investment;
- securing a hedge against further preferential access being granted to global competitors; and
- better access to knowledge, technology and intellectual capital.

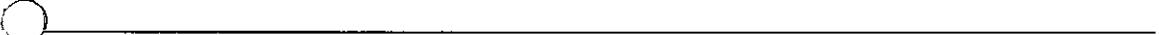
10. CONCLUSION

From the perspective of the Australian minerals industry, the completion of a comprehensive FTA would:

- via the elimination of tariff and non-tariff barriers on products, increase the access and competitiveness of Australian mineral and metals imports into Indonesia;
- provide a stimulus to further 'beyond-the-border' economic reform that may enhance and reinvigorate both Australia's and Indonesia's attractiveness as a preferred FDI destination, as well as maximise opportunities for those companies already operating. Internal reforms (especially in Indonesia) may

²⁰ See Fraser Institute Annual Survey of Mining Companies 2006/2007. This annual survey of metal mining and exploration companies assesses how mineral endowments and public policy factors affect exploration investment in 65 jurisdictions around the world. Australian jurisdictions rate very highly.

²¹ The report – Mining Technology Services, a Review of the Sector in Australia (ABRAE, April 2005) found that the Australian MTS sector in 2004-05 had sales of \$4430 million - \$1110m being export sales. Of this amount, \$382 million in MTS goods and services was sold to Indonesia (single largest export market).



also stimulate greater domestic investment which is critical if the industry is to develop scale and scope that encourages the provision of world class infrastructure. Against the background of expected continued strong international demand for metals and minerals, further expansion via greater domestic and foreign direct investment in brown and greenfield sites will intuitively boost economic growth and social outcomes; and

- improve the potential for Australian mining technology and service industries to enter the Indonesian mining market and/or build partnerships with Indonesian technology firms.

Attachment One

Investment climate reform

The investment climate reform package consists of policies designed to strengthen investment service institutions; synchronise central and regional regulation; improve customs, excise, and taxes services; create an environment conducive for employment generation; and provide support for small & medium enterprises. After twelve months, 90 per cent of planned measures have been implemented with a second stage of reform to be announced later in 2007.

One important law recently passed provides for:

- national treatment for foreign firms;
- land tenure close to 100 years; and
- the right of foreign firms to seek redress through binding foreign arbitration if there are disputes with government.

Infrastructure reform

Since the 1997 financial crisis, investment in infrastructure has fallen to 2 per cent of GDP, down from its long run average of 6 per cent previously. The infrastructure development reform package consists of :

- a change of policy about government partial risk guarantees,
- the establishment of a unit at the Ministry of Finance to assess projects and contingent risks; and
- a greater allocation of funds for land acquisition, guarantees and an infrastructure fund (with power generation a priority agenda).

Financial sector reform

The financial sector reform consists of:

- 40 policy actions aimed at maintaining and strengthening financial sector stability;
- diversifying funding sources (i.e banking industry, capital markets and non-bank institutions); and
- improving the market efficiency of the financial sector through promoting competition between banks, non-bank financial institutions and the capital market.

Other important proposed reforms include:

- an overhaul of Indonesia's taxation system;
- the establishment of a national single window that will allow importers and exporters to deal on line with customs and all related government agencies; and
- the expansion of the Community Driven Development (CDD) program nationwide where government grants will be expended on local level infrastructure, thereby generating employment and longer terms returns through improved access and services.