

*Client Alert – 27 July 2017*

## Indonesia tightens control over changes in shareholding and boards of oil & gas, power, geothermal and mining companies



### Speed read

The Ministry of Energy and Mineral Resources (**MEMR**) issued Regulation No. 42 of 2017 on the Monitoring of Businesses in the Energy and Mineral Resources Sector on 14 July 2017 (**Reg. 42/2017**) in a move that has been viewed as a further tightening of controls on private and foreign investment by participants in the energy and mining sectors in Indonesia.

Reg. 42/2017 provides that most transfers of shares or participating interests in energy and mining companies and changes to the boards of directors and commissioners of such companies require prior approval from MEMR. Whilst similar forms of governmental control already existed in the upstream oil & gas and the mining sectors,

Reg. 42/2017 now extends these to the downstream oil & gas and power sectors (including geothermal).

The new regime will directly impact investment and divestment strategies in the sector and raises questions about the enforceability of share pledges in energy and mining companies which are typically required by lenders extending financing to projects on a limited or non-recourse basis.

Recognising that these changes create significant additional hurdles for investors, the Indonesian President has called for a review of a number of regulations which have recently been issued by MEMR. We understand that this review will include Reg. 42/2017.

# Overview and scope

Reg. 42/2017 covers the oil & gas (upstream and downstream), power, mining and geothermal sectors and requires MEMR prior approval for certain changes to participating interests, shareholdings, and/or the composition of boards of directors and board of commissioners for the following types of business undertakings in Indonesia and Indonesian incorporated companies (as applicable):

- upstream oil and gas contractors and downstream oil and gas companies;
- companies holding an electricity generation business licence (**IUPTL**);
- companies holding a geothermal licence (**IPB**); and
- companies holding a mining business licence (**IUP**), a special IUP operation production for processing and refinery (**IUP-OP for processing and refinery**) issued by MEMR, a special mining business licence (**IUPK**), a contract of work (**COW**) or a coal contract of work (**CCOW**).

Reg. 42/2017 has been fully effective from the date of promulgation (ie 17 July 2017) and does not provide transitional or grandfathering provisions for existing business undertakings in Indonesia, or Indonesian incorporated companies. This means that all existing business undertakings in Indonesia or Indonesian incorporated companies falling within the scope of Reg. 42/2017, will now have to seek the required approvals to transfer participating interests or shares or to effect changes to their boards.

MEMR's declared rationale behind Reg. 42/2017 is to ensure that only experienced credit worthy sponsors be given the right to develop energy and mining projects in Indonesia and to exclude speculative investors who seek to obtain licences and concessions they do not have the experience or financial capacity to develop, which in practice it is felt has led to a string of stalled projects. In addition, Reg. 42/2017 is intended to reaffirm and extend the control of the State over the energy and mineral resources sectors following a Constitutional Court decision in 2016 that addressed the constitutionality of the 2009 Electricity Law and concluded that private investment in the electricity sector is constitutional provided it is controlled by the State.

Interestingly, MEMR has declared on its website, that Reg. 42/2017 will only apply to private undertakings in the energy and mining sectors, but is not intended to apply to state-owned and regional-owned enterprises (although no such carve out is actually provided for in Reg. 42/2017 itself).

Schedule 1 to this alert provides a quick reference guide to the new application process and requirements under Reg. 42/2017 by comparison against the regimes that applied prior to the enactment of Reg. 42/2017.

## Key implications

### *Structuring of investment and exit strategies*

Existing and new investors seeking to invest, restructure or sell their participation in the energy and mining sectors will need to pay increased care and attention to the structuring of such investments given the new restrictions and requirements brought by Reg. 42/2017:

#### a) Transfer restrictions

Schedule 1 provides a summary of the new transfer restrictions applicable to each sector covered by Reg. 42/2017 but some of the more restrictive examples include the fact that:

- a transfer of shares in an upstream oil and gas contractor that causes a direct change of control can only be made to an affiliate of the transferor; and
- a transfer of shares in an IUPTL company (such as independent power producers – **IPPs**) before the relevant power plant has reached its commercial operation date (**COD**) is only allowed to an affiliate that is more than 90% directly held by the sponsor wishing to transfer its shares.

#### b) Prior approval required

All transfers of a participating interest in an upstream oil and gas contractor, transfers of shares in an IUPTL and/or IPB company, and transfers of shares in most mining companies now require MEMR's prior approval. For transfers of shares in an upstream oil and gas contractor, only transfers of shares that cause a direct change of control require MEMR prior approval, whilst for the downstream oil and gas sector, only transfers of a majority of shares in a downstream oil and gas contractor require MEMR prior approval. Further, in the case of a transfer of shares in an IUPTL company,

Reg. 42/2017 also provides that the approval of the electricity buyer needs to be obtained (ie this would mean PLN, in the case of IPPs, or all electricity purchasers in the case of an integrated IUPTL company that owns a business area).

c) Specific conditions applicable to new investors

Reg. 42/2017 also seems to impose (perhaps not intentionally) certain conditions on new investors looking to invest in the energy and mining sectors that would be difficult to satisfy. For example, the application for approval of a transfer of shares in an IUPTL company needs to include the taxpayer registration number (**NPWP**) as well as income tax returns and audited financial statements of the transferee for the last two years. The apparent practical consequence of this requirement (if strictly applied by MEMR) would be that (i) foreign investors, (ii) individuals, and (iii) newly established Indonesian companies would be precluded from directly investing in an existing IPP as such parties would not be able to fulfill the documentation requirements necessary to obtain MEMR's approval. Although officials at MEMR we have spoken with seemed to indicate that the ministry may take a flexible approach on this and accept that such documents are not required for newly established companies or foreign shareholders, this will remain to be seen in practice given the lack of flexibility in the drafting of Reg. 42/2017 which does not provide for any exceptions to such requirement.

In light of these restrictions, investments may now have to be structured or restructured further up the corporate chain (one level up for example), as all the restrictions and requirements provided in Reg. 42/2017 seem to focus on the company holding the relevant energy or mining business licence. Another possibility which might be available to investors is to structure new investments and/or divestments through the issuance of new shares in the relevant energy or mining company and the redemption of existing shares by existing sponsors or the dilution of their shareholding. While such structuring may be possible, it is often cumbersome and time consuming to put in place and is unlikely to be attractive to new foreign investors looking at the Indonesian market for the first time. In addition, while such structuring solutions may be technically possible, they may not be viewed as being in line with the spirit of Reg. 42/2017 and, accordingly, may be difficult to enforce in practice.

### *Impact on financing and security package*

Existing and prospective lenders to energy and mining companies will also need to carefully assess the impact of these new restrictions. In the case of projects that are financed on a limited or non-recourse basis, such as many IPP projects, lenders require a pledge on the shares in the company that relies upon a transfer of the shares from the existing shareholders to a purchaser on enforcement. The Reg. 42/2017 requirements would appear to bring into question the enforceability of such share pledges, which are a key part of the typical security package in project financings and Reg. 42/2017 does not provide any exemption or carve-out for transfers upon enforcement of security.

For example, Reg. 42/2017 now strictly provides that any transfer of shares in an upstream oil and gas contractor that causes a direct change of control can only be made to an affiliate. It should be noted that the definition of control under Reg. 42/2017 is fairly wide and the drafting is far from clear.

Similarly, in the case of IUPTL companies (including IPB companies that also hold an IUPTL), lenders will be hindered from enforcing their share pledges before the relevant plant will have reached COD given that such pre-COD transfer is only allowed to a direct subsidiary of the transferring sponsor. Further, even post-COD, a transfer of shares from sponsors to a purchaser on enforcement would require MEMR prior approval. Such transfer might also be hampered by the documentary requirements for the approval application set out in Reg. 42/2017, which may limit the market of purchasers on enforcement.

Here also, a solution to these restrictions might be for lenders to require sponsors to set up a two-tier structure where the shareholding in the relevant energy and mining company would be held by another vehicle which is not caught by the restrictions of Reg. 42/2017 and which shares would be pledged to lenders. Despite such a structuring fix being technically available, it remains to be seen how enthusiastic sponsors and lenders are likely to be to yet another additional layer of complexity in structuring and financing projects in Indonesia. Of course all such additional requirements also come at a cost for investors, increasing risk and lowering rates of return and making the Indonesian market less attractive by comparison to alternative markets in the region.

## *Additional administrative requirements for energy companies – changes to board members*

Whilst changes to the composition of boards of directors and boards of commissioners in the mining sector already required a recommendation process involving MEMR, Reg. 42/2017 now also increases the administrative burden on energy companies by requiring similar prior governmental approval of any changes to their board memberships.

Further, Reg. 42/2017 also seems to restrict (incidentally maybe) the identity of new board members in that it requires certain documents to be submitted to obtain MEMR's approval. These documents include Indonesian income tax returns for the last two years and the NPWP of the proposed new board members. If this requirement were to be applied strictly by MEMR, this would require all new board members to have been Indonesian tax residents for at least the past two years. This would be a difficult hurdle for many new investors considering whether to invest in the Indonesian market.

## Closing remarks

Whilst changes of participating interests and the shareholding of companies active in the upstream oil and gas sector and changes to the shareholding and boards of mining companies have long been regulated, this was generally not the case for power companies including IPPs and companies active in the downstream oil and gas sector. Reg. 42/2017 now also seeks to regulate changes to the shareholding and board composition of such companies as well as further reinforcing the control of the State over upstream oil and gas and mining companies.

Although Reg. 42/2017 is still fresh, it is almost certain that the new restrictions it brings will not incentivise more private (foreign and domestic) investment in the Indonesian energy and mining sector. President Joko Widodo (Jokowi) recently publically highlighted the fact that certain ministerial regulations were creating additional hurdles for investors rather than encouraging domestic and foreign investment. In this context, MEMR was singled out as having recently issued a string of regulations (including Reg. 42/2017) which hamper foreign investment and the vice MEMR minister, Mr. Arcandra Tahar, announced at a press conference on 24 July 2017 that the ministry would immediately conduct a review of recent regulations which may have a negative effect on private and foreign investment and make necessary adjustments. We understand from discussions with officials at MEMR that Reg. 42/2017 is indeed one of the regulations under review. Let us hope that MEMR moves swiftly to ensure that the President's declared goal of encouraging more investment in the energy sector is fulfilled.



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# Schedule 1 – Quick reference guide of Reg. 42/2017

No.	Corporate Action	Key Requirements		Remarks
		Previously	Reg. 42/2017	
I. Oil and Gas				
A. Upstream				
1.	Transfer of participating interest	As per the PSC terms (newer PSCs typically contain similar requirements with Reg. 42/2017).	<ul style="list-style-type: none"> <li>– Approval from MEMR based on consideration from the Head of SKK MIGAS;</li> <li>– No majority transfer of PI is permitted within the first three years of exploration stage.</li> </ul>	<p><i>Newly established entities may not be qualified transferees and the board members of the transferee may need to be Indonesian tax residents</i></p> <p>The documents that have to be submitted in the approval application include:</p> <ul style="list-style-type: none"> <li>– corporate tax returns (SPT Pajak Penghasilan Badan) of the transferee for the last two years and NPWP of the transferee and the board members of the transferee; and</li> <li>– audited financial statements of the transferee for the last three years.</li> </ul> <p>This raises the question whether a newly established Indonesian company or permanent establishment/foreign company can qualify as a transferee, as they would not have such documents. This may create an issue for the structuring of investments in the upstream oil and gas sector given the ring-fencing principle whereby separate entities must be set up for each oil and gas working area. The above documentary requirements (if interpreted strictly) would, make it impossible for a new entity to be proposed as a transferee.</p> <p>Further, the requirement of having to submit the NPWP of the board members of the transferee raises the question whether this implies that all board members of the transferee have to be Indonesian tax residents and what would happen if this is not the case (ie would the approval application be rejected for lack of compliance with the documentary requirements set out in Reg. 42/2017?).</p>

No.	Corporate Action	Key Requirements		Remarks
		Previously	Reg. 42/2017	
2.	Transfer of shares	As per the PSC terms.	<p>Transfer of shares that causes a “direct change of control”:</p> <ul style="list-style-type: none"> <li>– requires approval from MEMR with consideration of recommendation from the Head of SKK MIGAS; and</li> <li>– can only be conducted to an affiliate.</li> </ul>	<p><i>a) The scope of direct change of control is unclear</i></p> <p>“Control” is defined in Reg. 42/2017 as both direct ownership (through direct ownership by a parent company one tier up) and indirect ownership (through majority ownership of shares with voting rights or majority ownership of rights/interests to control or otherwise through an agreement). It is therefore not clear whether the approval requirement is only intended to capture the change of direct ownership of upstream oil and gas contractors or extends beyond that to an indirect change of control. Reg. 42/2017 provides that a transfer of shares that causes an indirect change of control needs only to be reported to the MEMR, which suggests that the regulation intends to differentiate between direct and indirect change of control.</p> <p>However, it should also be noted that from a close reading of the definition of “control” in Reg. 42/2017, it seems that the changes in direct ownership (which require MEMR prior approval) are not limited to changes in majority ownership given that there is no threshold mentioned in the regulation for direct ownership by a parent company. Hence, there is a risk that any change of direct ownership in an upstream oil and gas contractor (even a minority one) would need to be pre-approved by MEMR</p> <p><i>b) Newly established entities and foreign entities may not be qualified transferees and the board members of the transferee may need to be Indonesian tax residents</i></p> <p>The documents that have to be submitted in the approval application include:</p> <ul style="list-style-type: none"> <li>– corporate tax returns (SPT Pajak Penghasilan Badan) of the transferee for the last two years and NPWP of the transferee and the board members of the transferee; and</li> <li>– audited financial statements of the transferee for the last three years.</li> </ul> <p>Again, this raises the question whether a newly established Indonesian company or a foreign company can qualify as a transferee, as they would not have such documents. In addition, in this case, it is not clear whether corporate tax returns (and additionally, the deed of establishment, company profile, organization chart, etc, that are also required to be submitted) of the transferee would strictly be required as individual transferee would not have such documents.</p>
			<p>Transfer of shares that causes indirect change of “control”:</p> <ul style="list-style-type: none"> <li>– report to MEMR through the Head of SKK MIGAS.</li> </ul>	<p>Please see our comments on the definition of “control” under I.A.2. above.</p>

No.	Corporate Action	Key Requirements		Remarks
		Previously	Reg. 42/2017	
3.	Change to boards	Not regulated.	Approval from MEMR based on consideration from the Head of SKK MIGAS	<p><i>Proposed new board members may need to be Indonesian tax residents</i></p> <p>The documents that have to be submitted in the approval application include income tax returns (SPT Pajak Penghasilan) for the last two years and NPWP of the new board members. This might create an issue if the proposed new board members are not Indonesian tax residents and do not have such Indonesian tax documentation.</p>
B. Downstream				
1.	Transfer of shares	Not regulated.	Approval from MEMR (only for transfer of majority of shares).	<p><i>Newly established entities and foreign entities may not be qualified transferees and the board members of the transferee may need to be Indonesian tax residents</i></p> <p>Please refer to I.A.2.b) above.</p>
2.	Change to boards	Not regulated.	Approval from MEMR.	<p><i>Proposed new boards members may need to be Indonesian tax residents</i></p> <p>Please refer to I.A.3. above.</p>
II. Power				
A. IUPTL company				
1.	Transfer of shares	<p>Not regulated by law but typically regulated in the relevant power purchase agreement (<b>PPA</b>).</p> <p>No prior approval from MEMR required but typically prohibition of sponsors to sell out before COD and limited lock-in of initial sponsors for a certain period of time (generally up to five years from COD), both subject to discretionary waiver/approval by PLN.</p> <p>MEMR regulation ten of 2017 on principles of PPAs which was issued in January 2017 sets out similar transfer restrictions as those now reflected in Reg. 42/2017 except that MEMR's approval is now also required in addition to that of PLN.</p>	<ul style="list-style-type: none"> <li>- Approval from MEMR and the electricity buyer(s) in all cases.</li> <li>- Pre-COD: transfer is only possible to an affiliate which is more than 90% directly held by the sponsor wishing to transfer its shares.</li> <li>- Post-COD: no transfer restriction.</li> </ul>	<p><i>a) Pre-COD transfer only allowed to a direct subsidiary of the sponsor</i></p> <p>Reg. 42/2017 provides that transfer of shares pre-COD is only allowed to an affiliate which is more than 90% directly held by the sponsor transferring its shares. This will effectively limit any restructuring or divestment of existing sponsors pre-COD to a direct subsidiary of such sponsors. It should be noted that Reg. 42/2017 does not provide for any lock in the shareholding in the direct subsidiary which means that the sponsor in the IUPTL company who has transferred its shares to its direct subsidiary could sell all or part of its shareholding in such subsidiary after the pre-COD transfer of shares in the IUPTL company has been approved by MEMR.</p> <p><i>b) Newly established entities and foreign entities may not be qualified as transferees</i></p> <p>The documents that have to be submitted in the approval application include:</p> <ul style="list-style-type: none"> <li>- Income tax returns (SPT Pajak Penghasilan) for the last two years and NPWP of the transferee; and</li> <li>- audited financial statements of the transferee for the last two years.</li> </ul> <p>This raises the question whether newly established entities and foreign entities can be qualified transferees, as they would not have such documents. The above documentary requirements (if interpreted strictly) would, make it impossible for a new entity or a foreign entity to be proposed as transferee.</p> <p><i>c) Electricity buyer(s)' approval is required</i></p> <p>The required documents for the approval application also include the approval from the buyers of the electricity (produced by the IUPTL company). For IPP projects, this means that the approval from PLN is a pre-requisite (throughout the term of the relevant PPA). For holders of an integrated IUPTL which have a business area with many customers, it seems from Reg. 42/2017 that the approval of each such customer would need to be procured which may be extremely cumbersome. In this regard, it should also be noted that Reg. 42/2017 does not provide details on the procedures and, most importantly, the timeline for such buyers of electricity to issue their approval.</p>

No.	Corporate Action	Key Requirements		Remarks
		Previously	Reg. 42/2017	
2.	Change to boards	Not regulated.	Approval from MEMR.	<p><i>a) Electricity buyer(s)' recommendation is required</i></p> <p>The required documents for the approval application include the recommendation from the buyer of the electricity (from the IUPTL company). The same issues as the ones flagged under II.A.1.c) above may arise in this case.</p> <p><i>b) Proposed new board members may need to be Indonesian tax residents</i></p> <p>Please refer to I.A.3. above.</p>
B. IPB company (new geothermal regime – not applicable to the joint operation contract scheme under the old regime)				
1.	Transfer of shares	Typically regulated in the relevant PPA. Approval from MEMR for transfer of shares listed at the Indonesia Stock Exchange after exploration phase.	Approval from MEMR. It seems that an IPB company which also holds an IUPTL (for example, a geothermal IPP company) would need to submit two applications and obtain two approvals for such transfer of shares, considering that the respective requirements for each of these are not exactly aligned and given that Reg. 42/2017 does not provide that a single application may be submitted in such case.	<p><i>a) Foreign entities may not be qualified transferees given the need to submit Indonesian documentation</i></p> <p>The documents that need to be submitted in the approval application include: latest articles of association as ratified by the ministry of law and human rights (MOLHR), the company registration certificate (TDP) and NPWP of the transferee.</p> <p>If the transferee is a foreign entity, it may not have such Indonesian documentation.</p> <p><i>b) Newly established entities and foreign entities may not be qualified transferees given the need to submit past Indonesian tax documentation</i></p> <p>Please refer to II.A.1.b) above.</p>
2.	Change of boards	Not regulated.	Approval from MEMR.	<p><i>Proposed new board members may need to be Indonesian tax residents</i></p> <p>Please refer to I.A.3. above.</p>
III. Mining company (IUP and IUP-OP for processing and refinery issued by the MEMR, IUPK, COW and CCOW)				
1.	Transfer of shares	Recommendation from MEMR	Approval from MEMR.	<p><i>a) Foreign entities may not be qualified transferees given the need to submit Indonesian documentation</i></p> <p>Please refer to II.B.1.a) above.</p> <p><i>b) Newly established entities and foreign entities may not be qualified as transferees due to the need to submit past Indonesian tax documentation</i></p> <p>Please refer to II.B.1.b) above.</p>
2.	Change of boards	Recommendation from MEMR	Approval from MEMR.	<p><i>Proposed new board members may need to be Indonesian tax residents</i></p> <p>Please refer to I.A.3. above.</p>