CHAPTER I

INTRODUCTION

1.1 Background of the Problem

As a rapidly developing country, Indonesia acknowledges that foreign direct investments (hereinafter, "**FDI**") serve as a necessary means for the capital-scarce country, to boost its economic growth.[1] This recognition is shown by the shift in the country's economic policies to be more focused on attracting future inflows of FDI;[2] measures such as opening up the country's markets to foreign businesses or deregulating foreign investments' procedures, have all been implemented to repair the dire economic conditions following the 1997-98 Asian Financial Crisis.[3]

Along with its attempt to be more open towards foreign investors, *however*, the Government of Indonesia has been posed with a challenge; for it must now attempt to strike a balance between the country's sovereign right to exercise regulatory powers in advancing legitimate public welfare objectives, and foreign

[1] "Bank Indonesia Says FDI Still Needed to Boost Growth," 28 September 2017, Tempo <https://en.tempo.co/read/news/2017/09/28/056911866/Bank-Indonesia-Says-FDI-Still-Needed-to-Boost-Growth>; "GDP Distribution Based on Current Price 2000-2014," Indonesian Statistic Bureau Website <http://www.bps.go.id/tab_sub/view.php?kat=2&tabel=1&daftar=1&id_subyek=11&notab=5>.

[2] "The unstimulating stimulus", 15 October 2015, The Economist <https://www.economist.com/news/finance-and-economics/21674794-jokowiadministration-tinkers-margins-unstimulating-stimulus>.

[3] Michael Ewing-Chow and Junianto James Losari, "Difficulties with Decentralization and Due Process: Indonesia's Recent Experiences with International Investment Agreements and Investor-State Disputes," in *The Journal of World Investment and Trade* 16 (Leiden-Boston: Brill Nijhoff, 2015), p. 974.

investors' right to have their investments and property rights protected from unnecessary governmental interferences.

This has not been proven to be an easy task, as evident from, for instance, the Government's earlier enactment of a mining regulation that banned exports of raw minerals in 2014. The impact of the enforcement of such mining regulation had unfortunately led to the departure of two foreign companies, Newmont Mining Corp. and BHP Billiton Ltd., from the country's mining scene. Most notably, these companies had cited "changes in regulations or laws, restrictions to foreign investment"[4] as one of the strongest factor contributing to their leave.

Whilst it is widely recognised under international law that states possess the legitimate right to regulate all properties situated within their territory,[5] such right is not absolute. As a matter of fact, there flows from it a corollary duty for states to refrain from *unlawful* interferences against property rights of foreigners,[6] which include unlawful takings of property such as expropriations.[7] However, expropriations are not *a priori* prohibited under international law; and may be a

[4] "Foreign Miners Pull Up Stakes in Indonesia", 30 August 2016, Wall Street Journal <https://www.wsj.com/articles/foreign-miners-pull-up-stakes-in-indonesia-1472558809>.
[5] Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law*, 2nd Ed., (Oxford: Oxford University Press, 2012), p. 98 [Dolzer and Schreuer]; Rosalyn Higgins, "The Taking of Property by the State: Recent Developments in International Law," 176 Recueil des Cours (1982) [Higgins].
[6] M. Sornarajah, *The International Law on Foreign Investment*, 3rd Ed., (New York: Cambridge University Press, 2010), p. 57 [Sornarajah].
[7] UNCTAD, *UNCTAD Series on Issues in International Investment Agreements II: Sequel* (Geneva: UNCTAD, 2012), p. 1 [UNCTAD II].

lawful measure of a state insofar as it fulfils certain requirements,[8] namely that such measure (**i**) is not discriminatory against foreign investors; (**ii**) is conducted for public purposes; (**iii**) complies with due process of law; and lastly, (**iv**) is accompanied by a prompt, adequate, and effective compensation.[9]

As regards its form, expropriation can be both direct and indirect. Whereas direct expropriations are easily identified given its conspicuous nature, *inter alia*, involving forcible transfer of property's title;[10] indirect expropriations are harder to discern. In fact, states' legislative or administrative measures that sufficiently restrict foreign investments, even if they do not involve formal transfers of properties' title, may be considered as expropriations.[11]

Accordingly, it has been rightly pointed out that in the modern legal regime of expropriation; the debate is not so much on whether the requirements of a legal expropriation have been met, but whether such act of taking even has initially taken place.[12] In this vein, it is pertinent to critically observe Indonesia's regulatory behaviour in order to ascertain whether its recent regulatory measures could fall under the ambit of 'indirect expropriation'.

---

[8] L. Fortier and S. Drymer, "Indirect Expropriation in the law of International Investment: I Know It when I see It or Caveat Investor?" (2004) ICSID Review, Vol. 19(2), p. 79 [Fortier and Drymer].

[9] UNCTAD II, *op cit*., p. 1.

[10] Anne K. Hoffmann, "Indirect Expropriation," in *Standards of Investment Protection*, (Oxford: Oxford University Press, 2008), p. 151.

[11] Jeswald W. Salacuse, *The Law of Investment Treaties*, 2nd Ed., (Oxford: Oxford University Press, 2015), p. 315 [Salacuse]; Steven R. Ratner, "Regulatory Takings in the Institutional Context: Beyond the Fear of Fragmented International Law" (2008) 102 American Journal of International Law 475 [Ratner].

[12] C. Schreuer, "The Concept of Expropriation under the ECT and other Investment Protection Treaties," in C. Ribeiro (Ed.), *Investment Arbitration and the Energy Charter Treaty* (New York: JurisNet LLC, 2006), pp. 108, 111 [Schreuer Expropriation Concept].

On 11 January 2017, the Government introduced several regulations, which serve to implement the existing Law No. 4 of 2009 concerning Mineral and Coal Mining (hereinafter, "**Indonesian Mining Law**"). The regulations are as namely (collectively referred to as, "**New Regulations**"):[13]

(**i**) Government Regulation No. 1 of 2017 on the Fourth Amendment to Government Regulation No. 23 of 2010 on the Activities of Mineral and Coal Mining (hereinafter, "**GR1/2017**");

(**ii**) Regulation of the Minister of Energy and Mineral Resources No. 5 of 2017 on Increasing Added Value Through Domestic Processing and Refining of Minerals, as amended in March 31, 2017 (hereinafter, "**MEMR 5/2017**"); and lastly

(**iii**) Regulation of the Minister of Energy and Mineral Resources No. 6 of 2017 on Procedures and Requirements to Obtain Recommendations for Export Sale of Minerals Resulting from Processing and Refining, as amended in May 15, 2017 (hereinafter, "**MEMR 6/2017**").

These regulations are intended to ease the blanket prohibition against export of minerals and coals contained in the Governmental Regulation No. 1 of 2014 regarding the Export Ban of Unprocessed Minerals (hereinafter, "**GR1/2014**").[14]

Initially, GR1/2014 was passed for the purpose of encouraging mining companies to construct domestic smelters and other infrastructures necessary to refine minerals prior to their exportation, as affirmed by Hatta Rajasa, Indonesia's former Economic Minister.[15] He added that the enactment of GR1/2014 is in line

[13] Hereinafter shall collectively be referred to as, "New Regulations".

[14] "Ekspor Mineral Mentah Kembali Dibuka, Ini Penjelasan ESDM", 21 January 2017, Detik Finance <https://finance.detik.com/energi/3402098/ekspor-mineral-mentah-kembali-dibuka-ini-penjelasan-esdm>.

[15] "Indonesia's law on ore exports takes effect", 12 January 2014, Jakarta Post, <http://www.thejakartapost.com/news/2014/01/12/indonesias-law-ore-exports-takes-effect.html>; "After Pushback, Indonesia Is Likely to Ease Ban on Mineral Exports", 11 January 2014, New York Times,

with the spirits of Articles 102 and 103 of the Indonesian Mining Law, both of which provisions impel mining companies to "add value" to their minerals prior to such minerals' exportations.[16]

In spite of the efforts exerted by the Government, *however*, GR1/2014 failed to properly incentivise or propel most mining companies toward the direction desired by the Government.[17] Article 170 of Indonesian Mining Law requires all mining companies to finish their construction of domestic processing facilities at no later time than 12 January 2014, providing *verbatim*:

> *"Article 170: Holders of contracts of works as intended by Article 169 that have made production must conduct refining/smelting as intended by Article 103 section (1) at the latest 5 (five) years of the promulgation of this Law."*

As the deadline was fast approaching, and that was yet any significant progress with regard to the building of processing facilities after three years; the Government felt the pressing need to pass another regulation which would loosen the strict requirements of the GR1/2014.[18]

<https://www.nytimes.com/2014/01/12/business/international/after-pushback-indonesia-is-likely-to-ease-ban-on-mineral-exports.html>.

[16] "Indonesia's law on ore exports takes effect", January 12, 2014, Jakarta Post <http://www.thejakartapost.com/news/2014/01/12/indonesias-law-ore-exports-takes-effect.html>; "After Pushback, Indonesia Is Likely to Ease Ban on Mineral Exports", January 11, 2014, New York Times, <https://www.nytimes.com/2014/01/12/business/international/after-pushback-indonesia-is-likely-to-ease-ban-on-mineral-exports.html>.

[17] "Indonesia pledges leeway for obedient miners", 16 January 2017, Jakarta Post <http://www.thejakartapost.com/news/2017/01/16/indonesia-pledges-leeway-for-obedient-miners.html>.

[18] "Indonesia pledges leeway for obedient miners", 16 January 2017, Jakarta Post <http://www.thejakartapost.com/news/2017/01/16/indonesia-pledges-leeway-for-obedient-miners.html>.

Essentially, two main changes can be identified from the New Regulations, namely (**i**) the conversion of Contracts of Work/*Kontrak Karya* (hereinafter, "**CoW**") and Coal Contracts of Work to a Special Production Operation Mining Business Permits/*Izin Usaha Pertambangan Khusus* (hereinafter, "**IUPK**"); and secondly, (**ii**) the gradual divestment of shares currently held by foreign investors.

First, in relation to contract conversion, there are two possible scenarios. As for the current holders of IUPK, they are given an extra five years from January 11, 2017, during which they may export approved quantities of processed material; but such privilege is conditional upon whether the companies have sufficiently demonstrate their progress on constructing domestic processing and refining facilities. On the other hand, with respect to the current holders of CoW, MEMR5/2017 demands that such companies convert their CoW into an IUPK. They may apply for IUPK, which validity period mirrors their earlier CoW, should they wish to continue exporting mineral concentrates and resume exports of unprocessed nickel and bauxite for the extended period of five years.

Second, as regards the issue on the divestment of shares, there are no longer exemptions to this duty. According to the GR1/2014 divestment scheme, foreign investor holders of IUP or IUPK could previously apply for an exemption to the duty requiring divestment down to a 49% shares by the end of the tenth year of production. Such exemption was contingent upon two things: (**i**) *whether* the relevant mining companies conducted their own processing and/or refinery activities (in which case they could retain up to 60% shares); and (**ii**) *whether* the companies are engaged in underground or open pit mining activity (in which case

they could retain up to 70% shares). The most recent divestment scheme in GR1/2017, however, stripped away such exemption; and stipulates that foreign investors can now only own 49% of the total shares in mining companies, irrespective of the two-abovementioned factors. This automatically means that foreign investors must *per se* divest their majority stake by year 10 of production.

The implications of Indonesia's government actions are arguably far-reaching, as evident from the reactions of many foreign investors following the introduction of such regulations. The most notable reaction arose from Freeport-McMoRan Inc. (hereinafter, "**Freeport**"), as the parent company to PT Freeport Indonesia, based in Arizona, United States. Freeport is a company operating the Grasberg mine located in the remote eastern province of Papua, and constitutes the biggest copper mine and second-biggest gold mine in the world.[19]

As a response against the newly issued regulations, Freeport promptly sent a notification letter to the Indonesian Energy and Mineral Resources Ministry (hereinafter, "**EMRM**") on February 17, 2017. In its notification, Freeport argued that the Government's implementation of those regulations would undermine its rights protected under the original CoW, which was signed in 1967,[20] extended in 1991 and is not due to expire until 2021.[21]

---

[19] "Indonesia Warns US Mining Giant in Fresh Dispute," 5 March 2017, Asia Sentinnel, <http://www.asiasentinel.com/econ-business/indonesia-warns-us-mining-giant-in-fresh-dispute/>.

[20] Signed on the basis of the Law No. 11 of 1967 on the Basic Provisions of Mining during the Soeharto regime.

[21] "How Freeport's row over its Indonesian mining contract has escalated," 28 February 2017, Jakarta Post <https://www.pressreader.com/indonesia/the-jakarta-post/20170228/281956017563228>.

In essence, Freeport's argument can be boiled down to the premise that the Indonesian Government cannot unilaterally alter or terminate its original CoW, even by passage of subsequent law and regulations.[22] Freeport claimed that the Government could not demand for the forfeiture of its original CoW in exchange for an uncertain operating license, as Indonesian Mining Law itself had stated that CoW would remain in force until 2021.[23] Additionally, Freeport also contended that it is not subject to the new obligations such as to divest its current shares, to build a local smelter, or to pay additional export duties.[24]

In fact, Richard Adkerson, Freeport's Chief Executive Officer, went to the extent of asserting explicitly in a conference that "these forms of regulations are in effect a form of expropriation of our assets, and we are resisting it aggressively."[25] As a concluding remark, Freeport finally added that it would bring the case to an international arbitration as a means of last resort, if peaceful settlement failed to ensue within 120 days after the letter had been sent.[26]

In a follow-up event to this, the conflicting parties have sat together to discuss the likelihood of reaching an amicable settlement that could satisfy both

---

[22] "Freeport: Contract Alteration Bears Severe Consequences," 20 February 2017, Tempo <https://en.tempo.co/read/news/2017/02/20/056848433/Freeport-Contract-Alteration-Bears-Severe-Consequences>.

[23] *Ibid*.

[24] "How Freeport's row over its Indonesian mining contract has escalated," 28 February 2017, Jakarta Post <https://www.pressreader.com/indonesia/the-jakarta-post/20170228/281956017563228>.

[25] "Indonesia Wants Control of Freeport's Grasberg Within Two Years," 22 March 2017, Bloomberg <https://www.bloomberg.com/news/articles/2017-03-22/grasberg-dispute-deepens-as-indonesia-primes-miner-to-take-over>.

[26] "Freeport Warns of Arbitration as Indonesia Mining Dispute Escalates," 20 February 2017, Reuters <https://www.reuters.com/article/us-indonesia-freeport/freeport-warns-of-arbitration-as-indonesia-mining-dispute-escalates-idUSKBN15Z0EC?il=0>.

parties. The discussions proved to be successful, as the tension between both parties finally de-escalated on August 29, 2017; where the process of negotiation led to the conclusion that Freeport will comply with the new divestment scheme.[27] In spite of the simmering down of the tension between the parties, the principal objective of this undergraduate thesis is to analyse whether there existed a *possibility* for Freeport to invoke an indirect expropriation claim against the Government of the Republic of Indonesia on the basis of the issuance of the regulatory measure by the Government in 11 January 2017, *had their pursuit for amicable settlement reached a deadlock*.

As the most arduous task is "not to determine whether the conditions for a lawful expropriation have been met or not, but rather whether there has been an expropriation at all,"[28] the likelihood of Freeport's invocation of such claim will serve as the final conclusion of this undergraduate thesis. Such conclusion shall be derived by this Author by analysing the current landscape of investment laws in both the national and international levels; particularly, by observing the indirect expropriation standards, which will be extracted from customary international law and bilateral investment treaties (hereinafter, "**BITs**"); and finally, by applying such standards to the facts of the Freeport case.

In light of this, the scope of this undergraduate thesis is confined to the *existence of a sufficient legal ground* to invoke an indirect expropriation claim,

[27] "Freeport agrees to 51% divestment, other terms: CEO," 29 August 2017, Jakarta Post <http://www.thejakartapost.com/news/2017/08/29/freeport-agrees-to-51-divestment-other-terms-ceo.html>.

[28] K. Hobér, *Investment Arbitration in Eastern Europe: In Search of a Definition of Expropriation*, (New York: JurisNet LLC, 2007), pp. 14-5.

and will not be expanded to cover any follow-up issues such as the legality of such expropriation had it occurred. Likewise, the present thesis also excludes any discussion on the potential remedy, *inter alia*, compensation or restitution, the Government could provide in the event an unlawful taking occurred. On a different note, it must be noted by the readers that the analysis provided herein is made without prejudice to any administrative or jurisdictional issues, which might have arisen in such dispute.

1.2 Formulation of the Issues

In accordance with the abovementioned problem, there are two identifiable issues which are addressed and answered in this undergraduate thesis:

1. What is the current legal framework for 'indirect expropriation' under Indonesian Investment Law and International Investment Law?
2. Applying such legal framework, do the New Regulations concerning the Mining of Mineral and Coal amounts to an 'indirect expropriation' of Freeport's investments, which act is prohibited under Indonesian Investment Law and International Investment Law?

1.3 Objective of Research

Accordingly, in accordance with the foregoing formulation of issues, there are two objectives that this Author hopes to achieve:

1. The principal objective of this undergraduate thesis is to lay out the legal framework for the minimum protection of foreign investments

against host states' interference, specifically on the protection against indirect expropriation.

2. Having then identified the scope of rights and obligations of both host states and foreign investors under such framework, the underlying objective of this research is ultimately to apply the standards contained in the framework to the facts of the Freeport case. In other words, this Author bears the responsibility to give an analysis on whether there exists any possibility and/or legal ground for Freeport to bring an indirect expropriation claim against Government of Indonesia based on the issuance of the New Regulations by the latter.

1.4 Benefits of Research

The benefits that can be obtained from this undergraduate thesis can be divided into two aspects, namely the (**i**) academic benefits and the (**ii**) practical and immediate benefits.

1.4.1 Academic Benefits

From an academic perspective, this undergraduate thesis is expected to trigger future academic debates amongst legal scholars and practitioners alike regarding the vague standard of indirect expropriation both under Indonesian laws and international law; particularly given the lack of academic references/materials on such topic. Consequently, this undergraduate thesis is expected to enrich and make novel contribution to the existing literatures on the minimum standard of

protection towards foreign investments, including but not limited to issues of indirect expropriation. Such contribution would then be expected to continue to influence and develop any future study relating to the practices of indirect expropriation, which topic has yet to be fully explored.

1.4.2 Practical Benefits

Bearing in mind that this is a current issue, the practical purpose of this undergraduate thesis is to render whatever assistance this Author may be able to provide to the Ministry of Energy and Mineral Resources, the Ministry of Foreign Affairs and/or other governmental agencies involved in the Freeport case. In addition, the research contained herein also aims to provide a helpful reference to any legal scholar, legal practitioner or future investor in their work through the Author's proper summarisation of the current legal framework governing investment under both municipal laws and international law; the Author's examination of the existing judicial practice and investment treaties; and lastly, the Author's analysis on how the laws would apply in the hypothetical scenario concerning Freeport provided above.

1.5 Systematic of Writing

As a means to accommodate the readers in understanding this thesis and to simplify the key discussions of this undergraduate thesis, a brief illustration of this thesis is provided as follows:

CHAPTER I INTRODUCTION

As an introduction to this undergraduate thesis, the first chapter comprises: the background of the problem, the formulation of the identifiable issues, the benefits that can be obtained from this thesis, the research objectives, and the systematic of writing.

CHAPTER II THEORITICAL FRAMEWORK

In the second chapter, the Author of this thesis lays down the theoretical and conceptual framework that governs the main discussion of this thesis. Such framework acts as the primary foundation necessary in answering and resolving the issues already identified in Chapter I.

CHAPTER III RESEARCH METHODOLOGY

In the third chapter, the Author discusses about the research method and its approach, the type of research, the sources of research and the procedure of attaining such sources, and lastly, the research techniques used in writing this thesis.

CHAPTER IV ANALYSIS

The fourth chapter encapsulates the main body of discussion of this undergraduate thesis, which consists of: the

elaboration on the current legal framework on indirect expropriation under Indonesian domestic laws; the elaboration on the current legal framework on indirect expropriation under International Investment Law; the brief comparative analysis of the two regulatory framework, *i.e.* similarities and differences; the extraction of standards and rules from the two regulatory framework, and the application of such rules/standards to the fact pattern underlying the dispute between Freeport and the Indonesian Government.

CHAPTER V CONCLUSION AND RECOMMENDATION

Chapter V or the last chapter shall lay down the closing remarks from the Author for this undergraduate thesis, which content includes the conclusion of the overall analysis of this thesis, as well as the recommendations or underlying reasons as to why Indonesia should avoid any situations where the investments of Freeport are indirectly expropriated by the Government.