Resource nationalism threatens Indonesia

Indonesia's government has announced a series of export bans and limits for its mineral resources over the past few months. ***Willem Klaassens*** looks at the impact of this bout of resource nationalism.

Indonesia is desperately trying to protect its natural wealth for its future domestic use and is willing to implement new regulation to do so. On May 6 this year, the country adopted an export ban for unprocessed raw metal ores and stones, taking everyone by surprise. The new regulations are expected to only take effect in 2014.

According to the ministry of trade, the ban is being applied to satisfy the fulfilment of its domestic needs, the conservation of its natural resources and to ensure the stability of mining product prices.

Over the next two years, mining companies can export unprocessed ore only if they have satisfied three conditions. They need to have a clear and clean mining business licence, known as an IUP [*Izin Usaha Pertambangan*], they have to stop the export of unprocessed ores by the latest in 2014, and have to submit plans for building smelting capacity, sharing smelters or selling their ore to refiners. Some of the larger mines that operate on a different licence than the IUP are exempted from the ban, until their long-term special licences expire.

In 2014, the full ban for exports of unprocessed metals, copper, gold, silver, lead and several other minerals will take effect. Only minerals with increased value through 'mineral purification or processing' will after that be allowed for export.

So where does this leave coal?

In line with the desire to preserve Indonesia's natural resources, the ministry of energy and mineral resources (MEMR) has circulated a preliminary version of an additional regulation. This one prohibits the export of coal with less than 5,700 Kcal ADB (air dry basis) heating value after 2014. Coal miners will have to upgrade the heating value of their coal if they want to continue to export.

Coal upgrading is simply the removal of water content from low-calorific-value coal. The processing may also require some form of washing, crushing or blending, briquetting or liquefaction. Whether the costs of this 'upgrading' makes mining of low-grade coal for export a viable economic activity, remains to be seen.

Even though the preservation of minerals in general seems to be a good cause, banning exports of low-grade coal may not achieve the desired economic, social and cultural benefits for Indonesia that the MEMR is hoping for. If one considers that according to the Indonesian Coal Mining Association (APBI), low-grade coal accounts for roughly 65% of the country's mineable reserves, that coal exports are more than 13% of Indonesia's total exports in 2011 and that local consumption is a fraction of the exported volumes, it certainly looks like the draft regulation is more politically or nationalistically motivated than based on sound economic reasoning.

One could even think that the underlying political motive for the ban is to secure a supply of low-grade coal below the global price for the domestic market. Whatever the real motive, the ban as it is envisaged today does appear to be a form of resource nationalism that ultimately could result in a disadvantage for the Indonesian economy as a whole.

Having understood at least some of the present economic reality, the MEMR, together with the ministry of economy and ministry of trade, responsible for the potential coal export ban, have hinted that a ban, or even an export tax, may not be the most beneficial measures for Indonesia's economic future.

However, the MEMR insists there will be some regulation of the country's vast coal mining reserves and coal exports to increase the government's revenues from the sector. This means a full-scale ban of low-grade coal exports may still be forthcoming once it is certain that the present coal upgrading technology is widely available and becomes cost-efficient.

What if there is another surprise?

What will happen if an export ban on low-grade coal is implemented after all?

Research by Standard Chartered shows that coal production in Indonesia increased by 13% in 2011 to 334 million metric tonnes and coal exports rose by 9.6% to 268 million tonnes. The bank expects that, on the back of strong demand for sub-bituminous and low-grade coal from Asia's developing countries and aggressive expansion plans of the largest coal mines, the country's coal exports will reach 387 million tonnes in 2017.

That may all change in 2014 if a ban on exports of low-grade coal is imposed after all. It is without doubt that, even if efficient technology is at that time accessible, the costs associated with the upgrading of low-calorific-value coal are simply too high for small and medium-sized producers. They will not be able to continue to produce economically. As a result, significant consolidation in the sector is to be expected, as many of these producers will be forced to sell their business to larger coal players, especially to the ones that already have access to upgrading facilities.

Also, a ban may have some effect on global pricing. Coal prices today are lacklustre. "This year it is really a combination of global and local issues that has an overall effect on the market," says Joshy Varghese, country head, Indonesia, for PT Coal & Oil Indonesia, a large trader of Indonesian coal.

"The increase in US shale gas production, a slowdown in the eurozone, but also additional hydropower generation, excessive production in Indonesia and a slowing growth in China are all causing the coal markets to be uninspiring."

China's recent growth slowdown has resulted in a stagnating demand for electricity. In combination with other forms of electricity generation and larger than usual stocks in China, there's been a slowdown of imports of low-grade coal from Indonesia.

However, Indonesia is still one of the largest exporters of coal and when exporting becomes uneconomical for Indonesian producers, the price for coal from other sources may rise. This is not good news for coal buyers in China and India, presently two of Indonesia's largest export markets.

"Currently, India and China are driving Indonesian export growth, but the appetite for Indonesian coal in India is gradually reducing, due to the arrival of low-grade coal from other countries," says Varghese. "An export ban in Indonesia will also gradually have less impact on India, as the US, Australia and South Africa are ready to load capesize vessels [ocean-going cargo vessels physically too large to fit through the Panama or Suez Canal] with higher quality coal at competitive prices."

With present low shipping costs expected to continue in the next five years, these new flows may substitute Indonesia's exports to India more permanently.

> *"India and China are driving Indonesian export growth, but the appetite for Indonesian coal in India is gradually reducing."*
> **Joshy Varghese**, PT Coal & Oil Indonesia

Financing the coal flows

With so much uncertainty in Indonesian markets, who will finance the trade flows and necessary investments in the coal sector? Traditionally, there were the European commodity banks that provided trade finance and alternative ways of working capital financing in the form of structured transactions to large and medium-sized commodity players.

Due to the global financial crisis, these banks have encountered their own fundamental issues at home and are retreating from markets like Indonesia, despite this country's upgrade earlier in the year to low investment grade with stable outlook by both Moody's and Fitch Ratings. The departure leaves mining companies with a considerable gap in funding needs.

A step up by local and regional banks is required to fill this gap. Today banks in Singapore, Hong Kong and Malaysia are investigating further overseas expansion in Asia, and Indonesia remains one of their main targets.

A notable example of this is DBS, Singapore's biggest bank by assets. With prudent risk management and government support, it may be far easier for these banks

"Coal traders, miners and stockists will now entertain solutions offered by seasoned alternative finance providers."

Andrew Church, Falcon Group Singapore

than their European competitors to establish a consistently profitable business in the ever-changing regulatory environment of Indonesia.

Local financial institutions in Indonesia however, have all the more to gain from the withdrawal of European banks. Their in-depth knowledge of the political and regulatory risk environment as well as the proximity to all the medium and small Indonesian coal and other commodity producers provides them with the best chance to understand the dynamics of the wider commodity business in Indonesia and deal a serious blow to the Europeans.

The window is wide open to drastically increase their market share and build support for the Indonesian commodity sector with financing products that have always provided foreign banks with good revenue and returns.

Unfortunately, local banks all over Asia are moving too slowly. Now, almost four years into the global banking crisis, the question arises whether they should have already taken much of the space left open by retreating Europeans.

But it appears to be somewhat difficult for Indonesian banks to get their heads around European-style commodity business, even though they have an overwhelming advantage over foreign competitors. Both cost reasons as well as internal political unwillingness to enter new businesses, or rather to enter old businesses in new ways, hold back decisions to hire outside expertise.

Furthermore, compared to European competitors, there may be less pressure on capital ratios and returns to start applying the techniques of commodity finance, which under the present Basel II rules allow for significant reduction of the capital that banks need to support their lending business.

"Indonesian banks have already awoken to this opportunity and are taking expert advice on how to build commodity and structured finance teams and exposure," says Andrew Church, head of business development at Falcon Group Singapore, a trade finance boutique which, through alternative solutions, partners Asian companies in their regional trade needs. "Similarly we also believe that customers in Indonesia are keen to look at support of this sort from local banks. The speed at which these banks can launch such offerings to clients and support the commodity sector is something we can only guess. But with a bit of clear thinking and under proper guidance, teams drawn from retreating banks could be quickly installed at all levels to fill the space."

"Indonesian banks will be in a better position culturally to manage their local risks," adds Church. "The challenge for local Indonesian banks however, is to graduate from the traditional balance sheet-based and pure asset-backed financing approach and adapt themselves to the demands of commodity finance with a pragmatic view on 'transactional' risk."

In the meantime, alternative financiers are quickly filling the financing gap. Trade finance funds, private equity funds, hedge funds and structured financiers are looking to enter into a coal market that continues to have huge potential in years to come, export ban or not. Less bound by stringent bank regulation, they are fast, flexible and still have adequate funds at their disposal.

"Alternative finance does of course have limitations in terms of appetite for risk and solutions that can be offered, not forgetting also, that the provider has returns to achieve which do often elevate overall costs. However, the fact that such alternatives do exist creates something of a beacon of light in an otherwise lacklustre market," adds Church. "Coal traders, miners and stockists will now seriously entertain solutions offered by seasoned alternative finance providers. We believe there is room in the market for all to co-operate and provide a blend of transactional funding support to Indonesian clients."

However, because of their more opportunistic nature and different risk approach, the forms of financing alternative financiers provide are considerably more expensive. This will again drive up production costs of producing Indonesian coal, eating into competitiveness.

Whether this is a sustainable long-term form of funding for medium-sized and smaller producers is doubtful, but until local banks have stepped up their game, regional banks have acted on their expansion plans, or the Europeans are back, there is little alternative. And if uncertainty surrounding coal continues, it may take the Europeans a long time to come back to the sector.

All the changes leave the ball firmly in the court of the three ministries in Indonesia. Will there be a ban on export of low-grade coal, an export tax or nothing at all? That is going to be the main topic of debate for the months to come, with progress of the wider Indonesian economy at stake. **GTR**

Willem Klaassens is the managing director of Latour Commodities Advisory.