

## **Mongolia's Above-Ground Risk**

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A proposed amendment to Mongolian mining legislation which would give the government the right to own 30% of foreign mining projects and substantially increase operating costs has highlighted the uncertain "above-ground" risk environment in the country. While the amendment appears unlikely to pass in its current form -- although the scenario cannot be completely ruled out -- it highlights the broader political, environmental and social challenges facing mining companies in Mongolia.

These challenges are particularly important because Mongolia has attracted a lot of attention in the mining industry. The country is rich in copper, gold, phosphate, molybdenum, and other minerals. It is close to the enormous Chinese market for these resources. The country has become one of the fastest growing exploration regions with over 3,000 prospecting licences granted to date and almost one-third of the vast country being prospected.

BHP Billiton, Rio Tinto, AngloGold Ashanti, Cameco, Ivanhoe, and others have made investments in Mongolia. Although conventional wisdom holds that Mongolia is a relatively stable environment for mining, as the proposed changes in mining law indicate, much remains unknown about the long-term operating conditions in the country given the dearth of foreign investment to date.

Although we are optimistic about Mongolia's prospects and the opportunity for the mining industry, senior executives considering investing or expanding projects in the country need to fully understand the above-ground risk environment in Mongolia. A hybrid legal system with poor contract enforceability, a complicated and corrupt bureaucracy, increasing Chinese influence, prevalent illegal mining, and emerging environmental issues are just some of the challenges mining companies will have to manage to make their Mongolian projects a success.

More insights and intelligence around the above-ground environment in this country will emerge with time and experience. For now, as senior executives and boards of directors continue evaluating Mongolia as a place to do business, there are five important questions they must ask:

How does Mongolia's above-ground risk environment compare to other post-soviet/post-communist states?

Although Mongolia is geographically and culturally close to the Central Asian "Stans" -- Kazakstan, Uzbekistan, Kyrgyzstan, Tajikistan and Turkmenistan -- its political and social environment resembles far more closely the situation in Eastern Europe, particularly in Romania and Bulgaria.

On the positive side, the country is a well-functioning democracy, with a commitment to free market economics. While it does not have the security of EU membership to guarantee its stability (unlike Romania and Bulgaria who are scheduled to enter the EU in 2007 or 2008), there is little chance that the democratic progress made in the past decade will give way to the authoritarianism prevalent in Central Asia.

The downside, however, is that mining companies operating in Mongolia will face some of the same challenges that have made many reluctant to invest in Romania and Bulgaria. Mongolia's bureaucracy, like that of the two Eastern European states, is sprawling, inefficient, and corrupt. Its legal system is far from transparent and enforcing contracts is particularly difficult (stipulating that disputes will be settled through international arbitration, the typical solution to such problems, is effective up to a point). Moreover, unlike many Central Asian nations, the country is quite decentralized politically; reaching an agreement with a senior official in Ulaanbaatar will not be sufficient to overcome local political and community opposition.

The permitting environment is also similar to that found in Romania and Bulgaria. While exploration licences are fairly easy to get, production permits can be more difficult to obtain and will require overcoming substantial red tape.

The one major distinction between Mongolia and Eastern Europe is that mining is a major industry in Mongolia and represents one of the country's primary sources of foreign reserves and a key part of the GDP. As a result, the industry will have a far greater influence over policy-makers and may be seen as a strategic partner in economic development.

Can the legal system protect property rights and enforce key contracts?

Mongolia's legal system is a blend of Soviet, German, and American systems and combines the "continental" civil code system with the Anglo-Saxon system of case precedent. When combined with prevalent corruption in the judicial system, the result is limited predictability and enforceability of contracts and property rights. Moreover, the constitution is highly ambiguous on the judicial review of legislative acts, creating the possibility that legislators could arbitrarily override judicial opinions and the constitution.

To date, this weakness in the legal system has not been a significant barrier to entry in Mongolia because of the country's commitment to encouraging investment in the mining sector and its willingness to make the environment hospitable for companies. However, as the number of investors increases and they begin competing for properties, decisions around property rights, concessions, and permitting could become mired in political

games, particularly as companies from the U.S., China, and Russia begin to operate in the country.

How will Mongolia's political system react to the influx of capital generated by mining?

Over the past 15 years, Mongolia has been able to develop a stable democracy. Because its natural resources have been largely untapped during this time, it has managed to avoid some of the ugly internal conflicts which have plagued, and in some cases destroyed, many emerging democracies.

The country's mineral wealth has not generated significant tax revenue in the post-communist period, meaning that there has been little impetus for the corruption evident in Nigeria, Angola, and Central Asia. The relative underdevelopment of Mongolia's natural resources has also meant that its powerful neighbours have not been tempted to involve themselves in Mongolian politics.

How this system will react to the substantial inflows of capital and tax revenue expected in the next decade, however, is far from clear. For example, the Oyu Tolgoi project, owned by Ivanhoe Mines, could alone double Mongolia's GDP if its production reaches expected levels. As the country receives more investment, the temptation for corruption by local and national officials could increase substantially.

The growing attractiveness of Mongolia and increasing competition between mining companies may encourage the government to gain a larger share of the industry profits by changing its attractive fiscal terms. With the country on the radar of many mining firms, officials in Ulaanbaatar may come to think that the highly advantageous fiscal terms used to attract the initial set of firms are no longer necessary to attract more foreign investment. This is one of the likely explanations behind the proposed amendment currently being discussed.

Furthermore, Mongolia's political system is a unique compromise between federalism and regionalism which has created stable national institutions while respecting the Mongolians' traditional, decentralized way of life.

Although the system already faces its share of challenges due to the inevitable conflicts between different political authorities, hybrid systems cope particularly poorly with wealth generated by the natural resources industries.

With increased revenues from mining, the balance between regional and national authorities could be upset, resulting in battles over the division of tax proceeds, as has happened in countries where both national and local authorities are powerful, as in Nigeria.

Finally, Mongolia's mineral wealth could create increased geopolitical tension in a country that has largely avoided these during the post-communist period. Its powerful neighbours -- Russia and China -- could become embroiled in a battle for influence.

While Russia considers Mongolia part of its traditional sphere of influence, China has been both the largest market for Mongolian products and the largest source of foreign direct investment. Increased competition by great powers for influence in Mongolia could upset the functional but fragile Mongolian democracy.

What are the key social and environmental challenges in Mongolia?

Illegal mining, particularly in the gold sector, and environmental issues could present important challenges to companies operating in Mongolia.

The country has an extensive illegal mining sector, with individuals and entire communities looking for residue in the tailings of local enterprises or by operating small illegal mines. While the World Bank estimates that 24,000 people work in "informal" mining, the true figure could be as high as 100,000 (in a country of roughly 2.3 million), according to Mongolian politicians and industry observers.

As always, illegal mining presents several challenges for mining companies. Aside from the obvious property rights issues, any environmental damage caused by illegal miners or accidents that occur on the property of foreign companies will be blamed on the legal owners of the property.

While illegal mining is the primary social issue facing mining companies in Mongolia, there are a number of others. Mongolian mining communities tend to be poor and require the provision of basic social services such as hospitals and schools. Likewise, with revenue transparency essentially non-existent, the inevitable claims of local authorities that they are not seeing benefits from the presence of a mine in their area will be a challenge. Finally, the country is becoming more prominent on the radar screen of international environmental groups and NGOs. The Asia Foundation, a San Francisco-based NGO with extensive projects in Mongolia, has criticized the country for becoming "too mining-friendly." Earthworks and Oxfam, two other influential NGOs involved in the "No Dirty Gold" campaign, are increasingly interested in mining activity in Mongolia. While no major campaign has as yet developed, the entrance of a major international mining company into Mongolia as the primary operator of a large mine could tip the balance and create new pressures for all companies doing business in the country.

How will the increasing influence of Chinese companies affect business?

Chinese companies, spurred both by a national policy of actively securing sources of raw materials and the proximity of the Mongolian market, are actively seeking to make investments in Mongolia, and not just in border areas. Recently, for example, a subsidiary of China Nonferrous Metals International said it was investing in a zinc mine at Suhbataar, a city on the Russo-Mongolian border.

China accounts for 38% of total foreign direct investment (FDI) in Mongolia, and about 30% of FDI in the mining sector. It has also provided Mongolia with soft loans to fund

the building of infrastructure necessary to deliver the mineral wealth of Mongolia to China's fast-growing economy.

As Chinese companies continue investing in Mongolia's mineral sector, there will be inevitable competition for attractive properties. The influence of the Chinese government, its view of Mongolia as an important hinterland with substantial resources for China's growth, and the economic dependence of Mongolia on China in all spheres of the economy suggest that disputes with Chinese companies could result in judgments unfavourable to Western firms.

Opportunity or risk?

Mongolia presents a unique opportunity for the mining sector. While talk of Mongolia becoming the "next Peru" may be premature, the country has substantial mineral wealth, a historically mining-friendly and stable government, and easy access to the all-important Chinese market.

Nevertheless, as senior executives evaluate investments in the country, they need to consider the risks. And as those who made investments in Peru and Indonesia under those countries' previous regimes would attest, making assumptions about political and social continuity can prove exceedingly risky. As the proposed changes in mining law clearly show, companies should not assume that the status quo will prevail in Mongolia. Significant development of the mining industry will create new wealth and affect the political and social fabric of the country -- and with it the operating environment for firms.

There is no question that Mongolia will be transformed if a significant boom in mining development takes place. The only question is the nature and direction of the transformation.

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