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Mongolia: Eyes on the future

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Mongolia is vast, sparsely populated, exceptionally mineral-rich and has a land mass largely unworkable for agriculture – an ideal mix for the mining industry. The country has the opportunity to use mining to drive significant economic growth but it is locked in a fierce battle against its own inexperience.

Mongolia only swapped its one-party Soviet-style system for a parliamentary and more capitalist way of life in 1990. Thirteen short years later, there were almost 20 exploration rigs working on the Oyu Tolgoi (OT) copper-gold project and Mongolia was on centre stage for the biggest commodities boom since the industrial revolution.

An undermanned minerals department was inundated with exploration applications and parliament was under immense pressure to ensure the country's wide range of resources returned the maximum value to Mongolians, without scaring away investment. Even experienced mining nations can mismanage resource investment (see Australia's Mineral Resources Rent Tax) so it isn't surprising that Mongolia has largely got it wrong.

The first murmurings that things may go pear-shaped came with a 68% Windfall Profits Tax on copper and gold concentrates in 2006, which targeted the massive OT development. Though the tax was repealed in 2009, well before OT shipped its first copper last year, it was a sign of things to come.

The Mongolian government has continued to battle with its investment legislation, the bureaucracy surrounding its mining industry, and specifically the investment agreement with miner Turquoise Hill Resources Ltd that is managing the development of OT. The situation came to a head last year, when private-sector contribution to GDP collapsed from more than 80% to less than 50%, FDI came back at pre-OT levels, and the Mongolian Tughrik sunk at historical lows (lower than when the IMF last bailed out the government).

But changes are afoot and recently the government has been on a charm offensive in a bid to convince the private sector that Mongolia has learnt its lessons and, more importantly, to highlight the work being done to improve the regulatory environment around its burgeoning mining industry.

Minerals and geology

Mongolia is in the top three producers in the world of both acid and metallurgical-grade fluorspar but is most famous for its coal, copper and gold potential, according to the US Geological Survey. Mineralised systems hosting molybdenum, tin and tungsten occurrences are also common.

As of 2008, it was estimated that granitoids intruded into some 30% of near-surface rocks, most of which have greisens and vein mineralisation associated with calc-alkaline magmas. The central region of Mongolia is characterised by complex folded structures and basins that are regularly mineralised. The South Gobi desert, meanwhile, plays host to the country's large and extensive coal deposits. Petroleum is produced in the east.

Projects

Existing mines in Mongolia include a handful of privately held operations but the open-pit, underground OT development co-owned by majority-held Rio Tinto subsidiary Turquoise Hill Resources (66%) and the Mongolian government (34%) remains the most important symbol of the government's ability and willingness to partner with miners in the development of its resources sector.

Turquoise Hill expects to produce 150,000-175,000t of copper and 700,000-750,000oz of gold in concentrates in 2014, making OT one of the world's largest operations. However, a US$4 billion investment needed for the underground development has been put on hold until Rio can nut out its differences with the government.

The deadline for take-up of the underground finance package was extended last year and now expires at the end of this month, by which time Rio and the government are meant to agree on a number of issues, namely: the prefeasibility study for the underground development, water rights and usage, royalties, finance terms, licences adjoining OT, and an audit on the first-phase open-pit development.

Back office contracts such as catering for the project were signed off at the start of this year, indicating a level of assumption on the part of Rio, which is managing the development, that agreement would be reached. Mining Journal sources on the ground in Mongolia have also suggested that the finance deadline would be met and, even if it wasn't, the banking syndicate would be willing to extend the deadline within reason until the joint venture was ready.

The other major project that flirted with a public-private partnership is the massive Tavan Tolgoi (TT) coal mine in the south. The government has been toying with various structures to take advantage of TT's potential 7,000Mt coking and thermal coal reserves since 2007 by using a combination of nationalisation and public-private partnership. The most recent plan in 2011 was to float almost 30% of TT's state-owned holding company across several major exchanges to fund half the project, with the other half to be sold to a consortium of major mining groups. That has proved too ambitious and, together with a falling coal price, means that TT remains relatively undeveloped.

TSX-listed Centerra Gold Inc is one of the very few private mining companies to fully own a producing mine. The company's Boroo gold mine is Mongolia's largest hard-rock gold mine and produced 85,000oz last year. Mongolrostsvetmet LLC operates the Dzuntsagaan Del fluorspar mine, while state mining company Erdenet Mining Corp has a handful of joint ventures, mainly with the Russians and the Chinese, principally covering coal and copper mining operations.

The junior end of the market that threatened to overrun Mongolia mid-last decade is under-represented because of a moratorium on exploration licences that has so far lasted three-and-a-half years. What's more, the government has rescinded 106 exploration licences issued by a former government as part of a corruption investigation.

Policy

Mongolia would not consider withdrawing 100-plus licences in the fight against corruption a mistake. It has, however, acknowledged publicly that its Strategic Entities Foreign Investment Law (SEFIL) introduced in the lead-up to the 2012 elections was a faux pas on an epic scale.

Neil Ashdown, from the Mongolia desk at international risk consultancy IHS, told Mining Journal SEFIL was "as nationalistic a piece of legislation as you could imagine". He said it was poorly drafted to boot and supporting legislation was delayed, making an already offensive piece of legislation both confusing and messy, too. Shortly after SEFIL was introduced, a new and unhelpful Mining Policy was also published.

This questionable legislation was presented against a backdrop of uncertainty surrounding OT as talks with Rio reached breaking point, and a US$300 million lawsuit against the government was pursued relating to an expropriated exploration licence from 2009.

The good news is that the resulting economic capitulation of Mongolia, combined with leadership from the more pragmatic Democratic Party, has resulted in a tangible turnaround in attitudes.

The SEFIL was replaced last year by the Investment Law, a far better piece of legislation and covers both Mongolian and foreign investments. The Mining Policy, re-released late last year after industry consultation, will form the basis of a more suitable Mining Law in the near future, which is also likely to lead to an end to the moratorium on exploration. Gold royalty legislation has already been amended to bring down rates from 10% to 2.5% for gold sold to the central bank as Mongolia looks to boost national bullion reserves.

This effort to undo the damage done in the years leading up to the 2012 elections in Mongolia has been matched by a concerted push to have the new-look Mongolian government acknowledged in the mining world. Ministers have been touring Australia and the PDAC conference in Canada, and the government has improved its use of global news services to send a more positive, unified message.

"The main message is we are giving more advantages to the private sector," Mining Ministry head of strategic policy and planning, Ch Otgochuluu, told Bloomberg recently. "If there is too much state involvement, it's not good. Last year was the best lesson."

The past decade has been a learning curve for Mongolia. First-world mining nations such as Canada or Australia would struggle to manage the influx of explorers that descended on Mongolia last decade, without having to establish a framework from scratch for the development of world-class operations. In this context, though far from a flawless performance, Mongolia has done well.

“You would struggle to find someone who knows Mongolia that doesn’t think the government is improving its understanding and its capacity to facilitate investment and enterprise,” Ashdown said.

Risks

Still, there remain several clear risks to investment in the Mongolian mining sector. An obvious concern in such a large, undeveloped country is a lack of infrastructure, which generally means high capital expenditure bills, particularly for bulk-commodity developments such as coal mines. Most of the risks, however, are political.

Mongolian bureaucrats have a reputation for sluggish administration (read: slow permitting) but more worrying is the historic overlap between business and politics, which leads to a problematic level of corruption. One reason for the stop-start nature of the OT development is related to change in government bringing with it the need to have companies run by newly elected politicians incorporated into the project.

The primary concern for miners should be political longevity. Just as many of the major mistakes that have been made preceded the 2012 elections, there is the potential for a similar round of crowd-pleasing paperwork to be rolled out at the next round of elections in 2016.

“Since the Democratic Party came to power, we’ve seen a shake-up,” Ashdown said. “It’s been a move from the legacy of a State-Soviet leadership to a democratic party.

“[At the] next elections, the question will be politically whether the DP is in a position to consolidate its leadership or whether a return to the MPP [Mongolian People’s Party] looks likely, or even possible. If it does, then you’re going to see an increased occurrence of resource nationalistic politics.”

Investment

Current presiding wisdom suggests a decision on OT will immediately release the next wave of FDI into Mongolian mining, but this seems unlikely. While there are some companies that will move on the back of OT, a larger group is likely to wait for the Mining Law and other supporting legislation to be established before committing time and money. The presumption that OT is the ‘on-off’ switch for mining in Mongolia also discounts the effect a declining coal price and poorer commodity prices in general have had on FDI. A changed government outlook to mining cannot counter commodity risk.

But the fact remains that there are thousands of miners and professional investors watching Mongolia and they all want a piece of the undeniably rich Mongolian minerals pie. Miners feel that they can manage political risk but not geological risk, and in this light a near-virgin, resource-rich nation with a government that is trying is exceptionally attractive. Investment may come back slowly and in stages, but it will definitely return.

Fast facts: Mongolia

- Location: landlocked between Russia and China (46 00 N, 105 00 E)
- Population: 2.9 million
- Area: 1.56 million km2
- Land use: arable – 0.4%, permanent crops – 0%, other – 99.6%
- Natural resources: oil, coal, copper, molybdenum, tungsten, phosphates, tin, nickel, zinc, fluorspar, gold, silver, iron
- Government: parliamentary
- Population below poverty line: 30%
- GDP: US$11.4 billion
- GDP growth: 11.8%
- Export partners: China (89%), Canada (4%) *Source: CIA World Factbook*
- Fraser Institute policy perception ranking: 100th (of 112)