Mongolia:

Making the Right Choices to Encourage Minerals Development

Mongolia has an extensive array of mineral and other deposits. However, it missed out on much of the recent boom in commodity prices. Often described as one of the 'last frontiers' for minerals exploration, Mongolia must now embrace change and encourage the development of its resource base with concrete action to attract and protect foreign capital.

By Guy Isherwood

MONGOLIA IS A country which has come a long way since its Soviet-dominated days. Although the following decade saw Mongolia endure both deep recession because of political inaction and natural disasters, it has emerged, managing to generate an average of 6-8 % GDP growth over the past five years. Recent World Bank reports have pronounced Mongolia as one of the potentially fastest growing and most stable economies in these current turbulent times. It also comes a respectable 58th in The Economist Intelligence Unit's Index of Democracy 2008.

Moreover, there are increasing signs that the government is now ready to reach out to international companies and push forward with the development of its huge minerals resource. As home to some of the largest underdeveloped resources on earth, and sitting next door to the 'world's workshop', Mongolia must now enact legislation to protect and encourage the mineral and other rights of foreign capital and address the lack of transparency and stability in Mongolia's mining laws. This is all the more important as Mongolia has a high, and increasing, fiscal dependence on mineral revenues.

Windfall mineral tax and other receipts have become an important fraction of the government budget, contributing 7.8 % of total public revenues in 2007; the main source of revenue of the government development fund. Much of it is imposed on sales of copper ore and concentrate extracted and levied at a rate of 68 % on the difference between actual copper prices on the London Metal Exchange and the sum of a base price (set at US$2,600 per tonne) and smelting costs. A significant proportion of the country's exports currently come from the Erdenet copper deposit, which is one of the largest copper reserves in the world run by Erdenet Mining Corporation and established in accordance with an agreement between the governments of Mongolia and the Former Soviet Union. Other key natural resource receipts include those from oil, coal, molybdenum, tungsten, phosphates, tin, nickel, zinc, fluorspar, gold, silver and iron ore.

Mongolia has a high, and increasing, fiscal dependence on mineral revenues

According to Michael Howard, Deputy Chairman and Director of Entrée Gold Inc. (and former leader of the UK Conservative Party) the time is now ripe for the new Mongolian government coalition to stimulate investment and exploration. But first the government must decide that it is willing to protect investors interests in a win-win scenario. Howard recently told *Commodities Now* that such a change was imminent. There is a pressing need for Mongolia to develop its resource endowment, "... to reach an agreement with miners that will benefit the people of Mongolia and get these resources moving" he says. No proposal has been put forward for that to start and the government must ensure that an agreement is reached. "It would be a great disappointment if an agreement was not reached in the first half of this year," says Howard.

Although Parliament had set a deadline of February 1st 2009 for the completion of a draft investment agreement, no concrete decisions have yet come to light. News reports and leaking of information have continued create confusion.

The effects of the Mongolian government's recent intentions to advance major mining projects was evidenced by President Nambaryn Enkhbayar's address before the country's parliament last October. Mongolia intends, "...to work on the policy to implement major mining projects abiding by the principle of win-win for two parties which incorporates interest of the investors and interest of the country," he said.

Mineral Resources

Mongolia has a number of very large mineral deposits. Chief among these are the so-called 'Two Toilgois' – the world class Oyu Tolgoi (OT – copper-gold) and Tavan Tolgoi (TT – coal) regions. The recent discovery of the world class Oyu Tolgoi copper and gold deposit confirmed the country's minerals potential. However, in 2009, the first output at the Rio Tinto/Invanhoe Oyu Tolgoi joint venture project has already been delayed until 2011 from 2010 following reports of a hold-up in approval for the project by Mongolia's parliament. Independent studies indicate that the OT region will be capable of an average annual production in excess of one billion pounds of copper and 330,000 ounces of gold for at least 35 years.

It is estimated that the Tavan Tolgoi coal deposit alone stands at 6.5 bn tons. "It is the reality that Mongolians cannot invest in this deposit independently, introduce advanced technology and provide qualified experts. Therefore, there is no other way than attracting major investors, their financial resources, technology and experts. Investors would want to calculate their investment returns and control investment expenditures. They would aspire to recover their investment and make profit. This is natural," President Enkhbayar told parliament.

According to Rebecca Darling, Director of natural resources and development programmes at The Asia Foundation in Mongolia, "The Working Group (WG) appointed by the Prime Minister in the autumn of last year decided not to significantly amend the 2006 Minerals Law, but instead would continue to meet and discuss potential changes. Also, the Working Group on the Minerals Law urged the government and parliament to focus on producing and signing investment agreements for OT and TT. Following that, the government announced it would go forward with both OT and TT investment agreements simultaneously This wasn't really practical as OT is much further along in pre-production phase. The exploration is complete and a great deal of planning and investment has already gone into the OT site. TT, on the other hand, is nowhere near ready for 'prime time'. It took some time, but the government eventually disaggregated the two projects."

The government (an appointed working group with Ministers and representatives from Ministry of Minerals and Energy Resources, Ministry of Nature, Environment and Tourism, and Ministry of Finance) with a hired firm and the Ivanhoe/Rio Tinto representatives have negotiated an investment agreement (IA). Some of this IA has been made public through media outlets in the region. Currently, the IA is winding its way through the legal process of Mongolia. It is presently with the Cabinet and on approval will move to the full parliament for discussion and ratification in the near future.

Concurrently, the government has put the TT project out for bids. JP Morgan and Deutsche Bank have been hired to help it in this process. Beyond the big boys – BHP, Vale, Peabody – other joint ventures are also in the mix; Russians, Chinese, Japanese and Koreans. The TT thermal and coking coal mine, which currently has small scale coal operations, will need capital expenditure of up to US$3 bn before its coal resources are depleted. On that basis, the mine could be worth more than US$5 bn. Although the initial plan is for the mine to sell thermal and coking coal, the government has stated its eventual intention to build power plants so that power can be exported to China.

> The TT thermal and coking coal mine ... will need capital expenditure of up to US$3 bn before its coal resources are depleted

In the current climate it is perhaps Chinese bidders – who have recently been active in buying Brazilian and Australian assets – who are likely to be the front runners for TT because of the domestic financing lines open to them. Moreover, China Shenhua Energy Company has, reportedly, already started construction on a rail line to the Mongolian border.

"Meanwhile, the WG on the Minerals Law continues to meet and some small, administrative changes have been made to the law recently (before the recess). Mostly, we're all waiting," says Darling.

Minerals Law

The 2006 version of the Minerals Law allowed the state a share of up to 34 % of deposits found with private funds and up to 50 % of those discovered with state funds. In the same year, the government also issued a 68 % tax on profits that accrue to miners from selling gold whenever the precious metal sells

Entrée Gold Inc.

In Mongolia, Entrée specialises in the development of gold, copper, molybdenum and coal assets. The company holds three exploration licenses that comprise the 179,590-hectare Lookout Hill property in Mongolia's South Gobi region, which completely surrounds the 8,500 hectare Oyu Tolgoi project. The property is right next to Rio Tinto and Ivanhoe Mines' giant – albeit delayed – OT project, touted as the world's largest undeveloped copper/gold project.

The Lookout Hill property has been split into two: The eastern half is owned in joint-venture with Ivanhoe, which gained a controlling interest through an earn-in agreement, while the western portion is wholly owned by Entrée. Ivanhoe and Entrée have completed NI 43-101-compliant resource estimates on two deposits on their jointly owned property – the Hugo North Extension copper-gold porphyry and Heruga copper-gold-molybdenum porphyry.

Entrée also has the right to ask Ivanhoe to fund its share of joint venture costs through to production, to be repaid from production cashflow, which means that its treasury is freed up for exploring other assets or for potential corporate activity.

Based on previous drafts, Greg Crowe, President and CEO, expects that the mining agreement will govern all Ivanhoe-controlled property that surrounds the OT mine, which would then include the eastern half of Entrée's Lookout Hill property.

Public statements by government officials indicate that the country realises that delays to the agreement resulted in potential revenue being lost during the resources boom of the last few years. Prime Minister Sanjaa Bayar has also indicated that the review of the country's minerals law does not need to be completed before investment agreements can be finalised.

One highlight of Entrée's 2008 exploration programme included the discovery of bituminous to anthracite coal on Entrée's 100% owned Togoot licence in Mongolia, "... which has reinvigorated our exploration efforts on Lookout Hill west. This year's programme is designed to expand the known zones of coal mineralisation and locate additional targets," says Crowe.

Entrée is listed on the TSX (ETG), AMEX (EGI) and Frankfurt (EKA) exchanges.

above US$500 an ounce, and on copper concentrate when the price of copper moves above US$2,600 per tonne.

Minister of Minerals and Energy, D. Zorigt, recently confirmed that both sides in the discussions had agreed on the government's proposal to take 34% of OT's profits (in the form of taxes, fees, royalty payments and loans). "The Government may still need to review the 68% windfall profits tax," Zorigt recently told reporters.

There has been speculation that the government will push for a much bigger stake in the project, but Greg Crowe, President and CEO of Entrée Gold, believes the latest indications are that it will return to the originally proposed 34% interest. [Ivanhoe owns 15% of Entrée and Rio Tinto holds 16%].

The Mongolian parliament is scheduled to start initial discussions on the OT project in March. Zorigt has also informed the media that a draft investment agreement on TT will be submitted for the spring session.

External Finance

Mongolia's external finances, like elsewhere, are under pressure. Earlier this year, Fitch Ratings downgraded Mongolia "... based on continued pressures on the country's external finances and ongoing problems with respect to economic policy continuity". Fitch confirmed that the county may need to rely on external financial support from bilateral and/or multilateral sources. Therefore, Mongolia could be looking to allow investors to own more than the 51% of deposits, at least in the initial stage to encourage investors.

"It will require enormous amounts of investment to put major deposits such as Tavan Tolgoi into economic cycle and the Erdenet mining corporation case illustrates to us that 25 years will be sufficient (on average) to recover the investment and make profit in today's tax environment," Enkhbayar told parliament last year.

Although falling commodity prices are a big concern for the government – and the financially strapped Mongolian government is facing a budget deficit this year, partly due to declining copper prices and cutbacks in mining exploration – an increasing number of mining and exploration companies (juniors and majors) are active in Mongolia. The aforementioned Entree Gold Inc. is one, and like others keen to motor on with its production. Key reasons for this increasing attention according to Greg Crowe include:

- The local geology is highly prospective for large size mineral deposits.
- The country is under explored.
- The government has firmly demonstrated its commitment to developing the mineral sector by attracting foreign capital.
- Appropriate laws have been adopted to encourage foreign investment and are being defined further.
- Proximity to major metal and coal markets in China and Japan.

The recent worsening of the financial crisis and contagion to the real economy. It's like elsewhere, adding pressure for Mongolia to address macroeconomic imbalances. In particular, the fall in copper prices and the shortage of liquidity worldwide confirm the slowdown in global economic growth. Nevertheless, Mongolia has been blessed with real, in demand assets which have significant value potential for decades to come. The current economic stagnation won't last forever and as recovery takes shape – particularly in the form of infrastructure development – revenues from this rich endowment present a significant legacy for its three million inhabitants as and when the government decides to clarify its position.

The current implications for Mongolia – a larger current account deficit, much lower government revenues and continued large investment needs – pose significant policy challenges for the government to maintain growth while lowering inflation, according to the World Bank. Nevertheless, "... the Prime Minister is making all of the right statements ... and the government has now set the stage for changes to the mining law and for the finalisation of investment agreements," says Crowe. •

Guy Isherwood is Editor of *Commodities Now* magazine.
www.commodities-now.com