CONTRACTING IN MINING SECTOR

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Introduction

- FDI in general governed by generic investment contracts
- Mining as a special case
- Importance of mining for Mongolia
- Contract as a method to maximize benefits for a host country
- Unique features of Mongolian mining contracts for FDI investor with the government for large (strategic) investment
- Parliament resolution as a general framework for negotiations

Mongolia

- 35 contracts
- Including Local Level Agreement (LLA)
- Article 42.1 LLA are mandatory
- 15 strategic deposits, from which
- Copper OT agreement (successfully signed with a state ownership share)
- Copper MAC agreement (successfully signed without state ownership share)
- Coal TT agreement (rejected on preliminary stage)

Aim of the study

- The aim of this research is to study the legal and policy framework of Mongolia in entering into agreements with mining companies
- To compare this with international practices of mining investment agreements
- International mining contracts needs to be reviewed for comparative study

General framework for benefit sharing

- Ensuring a positive outcome on the host country: crucial issues and international practices
- Complexities of contracting: information asymmetry
- Calculating the macroeconomic benefits
- Lack of the contract evaluation capacity on the government side creates distrust and complicates negotiations
- Which contract is more beneficial for the developing country?
- Which contract is most beneficial for the investor?

2. Ensuring a positive outcome on the host country

2.1. Fiscal benefits to government

- Rates of taxes and royalty types are defined in the laws and regulations of the country, but companies want to have a stable tax environment when putting forth large and long-term investments.
- Globally, there are countless mining projects competing with one another to attract investment, so it is important to negotiate competitive but reasonable tax rates.
- Commodity prices fluctuate constantly, so the share of benefit to the both side can slightly increase or decrease from time to time. The side that holds a more advantageous position in the agreement depends on the phase which the commodity price cycle is in during negotiations.
- It is important to consider the role of the mining sector in the economy – how the public and the government understand as well as their attitudes towards the mining sector.

2.1 Fiscal benefits to government

- **ROYALTY**: Companies should pay additional payments to the national and/or local governments in exchange for mining **non-renewable** resources.
- The most common type of royalty is based on the **sales value**. The most straightforward way is to use an **international reference price** for the value.
- There are many alternative ways of calculating royalties:
  - In Nevada and Arizona of the United States, there are **no royalties** for most minerals.
  - In Saskatchewan, Canada, the royalties are 5% of net profit.
  - In Chile, the royalty rate is 5 – 14% depending on the amount of profit, while it is 1 - 6.28% in Peru.
  - In Laos, the royalty is based on gross revenue and 1 - 7% depending on the type of commodity.
  - In Australia, to support the refinery industry, the royalty rates are 7.5% for crude ore sales, 5% for concentrate sales and 2.5% for metals.
  - In Mongolia, the royalty rate increases from 5% as commodity prices increase and decreases from 5% as the level of processing increases.

2.1. Fiscal benefits to government

- **Corporate Income Taxes**: Like other businesses, mining companies must also pay CIT. The tax rate on mining projects have been declining worldwide in recent years, currently 25 – 35%. CIT related issues in the agreement:
  - rate of depreciation for assets
  - loss carryforward – 5 to 7 years in most countries. In Mongolia, 4-8 years
  - ring fencing - mining companies cannot combine the income and deduction of costs from one project with those of another projects.
- **Withholding tax:** Tax on the interest payments to creditors, dividends to owners, service payments to service providers and costs to subcontractors.
  - Withholding tax rate is usually 5 - 10%.
- **Other taxes**: VAT, import duties, commodity export taxes, local taxes, land or license payments, and other fees, production sharing agreement
- The negotiation determines whether those taxes are stabilized at the current rate or different rates, or special tax exemptions are provided either fully or partially.

2.2. Equity arrangements

- Government’s ownership of a share in a project - participation in the project’s management, representative on the board, and earn additional revenue via dividends.
- The public expects more benefits and less negative social and environmental impacts in case of shared state ownership
- However, equity ownership leads to disadvantageous situation for the government:
  - it cannot get capital gains by selling its shares
  - it has no real influence on board decisions
  - investors can use the government’s share and future dividends as leverage against government actions

2.3. Local procurement of goods and services

- A mining company spend ~ 50% of its total spending on purchase of goods and services.
- The quality and capacity of goods and services of the local companies will be boosted, which promotes technical, marketing skills and competitiveness of businesses. ⟹ Reduce dependence of mining.
- In international agreements: if the domestic producers' price, quality and terms of delivery are line with foreign producers', the mining company and its contractors should provide an advantage to the domestic producers.

2.4. Infrastructure

- The cost of infrastructure is 40 - 80% of the cost of mining development.
- Mining infrastructure bolsters economic activity and promotes development of the country.
- The extent of infrastructure impact on domestic economy depend on who uses infrastructure. → The shared usage of infrastructure creates profitable conditions in an economy.
- If the government can make investment agreement precisely based on research, all types of shared usage is profitable in domestic economy.
- In international agreements: Liberia-Putu (2010)
  - The shared usage of every infrastructure is clearly outline

2.5. Maximization of employment opportunities

- The high number of people employed by mining company. → Improvement in professional skills and experience of domestic labor. → Increase in income and livelihood of domestic citizens.
- 16% of the costs of a mining company is related to employment.
- In the investment agreement, the government should clearly define the level of employment of citizens in the company, the employment conditions and trainings.
- In international agreement: the company have to hire domestic citizens for all unskilled position and for certain percent of skilled position. The company should organize training for domestic workers and provide education funding to students.

2.6. Community engagement

- Local community should be active in the negotiation process
- Standards sets by international organizations:
  - Principles for Responsible Contracts guidance by UN Special Representative on Business and Human Rights
    - Consultation with communities who are directly or indirectly affected by project
    - An in-depth analysis to identify those individuals and determine how and to what extend they will be affected
- Cases:
  - Kolwezi Tailings Project in DRC – used local radio stations and mobile messages to spread information in both French and Swahili
  - Glamis Gold’s Marlin project in Guatemala – commission formed

2.7. Social and environmental issues

I. Land
- Mining-induced displacement and resettlement poses a risk to societal sustainability
- Commonly referenced or used standards: IFC's Sustainability Framework (Standard 5), EBRD's Environmental and Social policy (10 requirements)

II. Vulnerable groups
- Certain groups, such as indigenous peoples, women, are more vulnerable
- IFC's Standard 7 seeks to ensure that business activities minimize negative impacts, foster respect for human rights, dignity and culture of indigenous populations, and promote development benefits in culturally appropriate ways

III. Water
- A recurring issue in mining is the use of water and the risk of contamination/pollution
- Mining companies should take actions to minimize water losses during processing while maximizing water recycling, reducing evaporative losses in hot and dry areas and reducing water usage across mining operations in areas of water stress, invest in treatment of water

3.1 General points of interest in Mongolia’s case as a developing country

General points of interest

- Mongolia’s experience with FDI before market economy and its lasting heritage
- Intensively develop the industrial sector (1960)
- Establish the city of Darkhan (1961)
- Improve productivity, industrialize the agricultural sector, provide energy to rural areas, establish a new city of Choibalsan (1966)
- Develop carpet and leather industry, lay the foundations for biotechnology, establish meat and food industry (1971)
- Improve the quality of products of all sectors, develop the mining and heavy industry (1976)
- Develop milk industry, establish and develop modern agricultural farms, establish new export sector, develop cashmere industry (1986)

Understanding market changes

- 1993 FDI law: a legislative basis for the foreign investment and specified which government agencies should manage and promote FDI
- This law led to the creation of the Foreign Investment Agency or FIFTA, which under a different name (Investment Mongolia Agency in 2016) exists today
- However, relatively unimportant until 2000 due to lack of FDI (mostly in textile)
- Unsuccessful production sharing agreement in oil

Important steps for FDI in mining

- 1993 FDI law introduces courts for dispute resolution
- 1997 Mining law introduces stability agreement (5 years, 2 million USD threshold)
- 2002 investment agreement introduction
- 2002 stability agreement for all sectors FDI
- Stability agreement is to be signed with MOF
- 33 clauses of Mining law a precedent for LLAs
- 2012 Strategic Industries Foreign Investment Law
- 2013 Investment Law

Defining national interests for mining

- 2006-2008 Comprehensive National Development Strategy
- 2015 Sustainable Development Long-Term Vision 2030
- The general approach to large mining projects as engine of national and local economic development
- Related infrastructure
- Workforce issue
- Taxation and royalties as a priority
- Later added: local procurement,
- Recent focus: local urban development and LLA, social services, history, ecology, water issues
- Related policy papers for mining (2014): a general framework for added value

Preparation for large mining projects

- 2002 FDI law already contained all major parts necessary to bring large investment projects in the country such as:
- The investment agency in charge,
- The definition of the investment agreement,
- The concept of stability agreement and the agency in charge,
- Possibilities for equity participation and the possibility to protect investment in foreign courts
- 2006 Minerals Law defines strategic deposits
- Article 5.4 adds Government equity for deposits

Equity article implications

- Article 9.6 financing of equity
- Results in possible increase of sovereign debt,
- Sovereign debt management threshold issue and Fiscal Stability Law
- Budget Law for overall fiscal management
- Debt Management Law to manage sovereign debt
- Related infrastructure (if to be financed by investor), needs own legislation
- Creation of PPP Law (Concession Law)
- Financing large state investment (Development Bank Law)
- Paying special attention to local development (Creation of Local development fund structure), amending Minerals Law to create LLA

3.2. An assessment of Oyu Tolgoi agreement

3.2. An assessment of Oyu Tolgoi agreement

- The OT agreement is the largest and only publicly available investment agreement in Mongolia
- In international literature, the OT agreement is deemed as a “good” contract due to its transparency
- The agreement considers a number of issues, making it a good starting point in constructing a model contract.
- By analyzing the advantages and disadvantages of the contract, it will assist in identifying the clauses needed for subsequent agreements as well as the changes needed to be made in Mongolia’s mining sector and institutional environment

3.2.1. Fiscal regime: tax stabilization

- Corporate income tax
  - 25% of taxable income
  - a loss will be carried forward following 8 years
  - asset depreciation shall be calculated by straight line method
- Royalty: 5% of gross revenue and deducted from taxable income
- VAT: Imported, manufactured or sold goods, performed works and rendered services shall be taxed at the rate of 10%
- Withholding tax: 20% on loan interest and payment for issuing a guarantee, income from royalty, income from interest on financial leases, payments for administrative expenses or management services fee, rent payments
- Other taxes: 10% on income from dividends, royalties, interest, 2% on income from disposal of an immovable property, 30% on income from sale of rights

3.2.1. Fiscal regime: tax

Table 1. Taxes paid by Oyu Tolgoi, million USD

Year	CIT	Royalty	Other tax, payment	Total national	Local fees and taxes	Employer payroll taxes	Other payments	Total local	Total
2010	0	0	95	95	0	0	0	0	**95**
2011	0	0	366	366	0	6	10	16	**382**
2012	0	0	244	244	0	18	4	22	**266**
2013	0	4	175	179	0	20	21	41	**220**
2014	16	46	95	157	0	16	12	28	**185**
2015	66	111	74	251	9	13	5	27	**278**
2016	67	39	43	149	9	14	43	66	**215**
2017	0	54	76	130	8	16	74	98	**228**
Total	**149**	**254**	**1168**	**1571**	**26**	**103**	**169**	**298**	**1869**

Source: Rio Tinto Annual Reports

- Since the contract was signed, OT project paid $1,869 million for state and local taxes.
- Before 2013, VAT and customs duties used to contribute more due to intensive investment of the first phase of the mine development while after that CIT and royalty contribute more due to starting production of the open pit mine.

3.2.1. Fiscal regime: tax stabilization

- However, the issue of double tax treaties to which Mongolia is a party has been questionable.
- According to the General Taxation Law, if a tax rate in the double tax treaty in which Mongolia has entered is different from the rate in the investment agreement (2009), the rate in the double tax treaties will be applied.
- In the agreement, withholding tax rate is 20%, but due to its double tax treaty with Netherland, the government will receive 10% from from the transfer of loan interest payment to to its affiliate, Oyu Tolgoi Netherland B.V.
- As estimated in a SOMO report, the government lost $232 million withholding tax revenue in 2011-2015

3.2.2. Equity and financing arrangements

- The state owns 34% of Oyu Tolgoi LLC for the initial 30 years of the agreement, and the state may increase its share up to 50% after the extension of 20 years.
- However, the government was provided a loan to invest its 34 percent share of the mine by the investor. This equity and financing arrangements have major impacts on the benefit to government and are the most controversial issues of the agreement
- If the prices of gold and copper remain low for longer period, the government even may not receive any dividend before project closing.
- The annual interest rate of the government loan is high: 9.9% + US CPI for loan and after that, 6.5% plus LIBOR.

3.2.3. Local purchasing of goods and services

- The OT Investment Agreement does not contain detailed provisions on purchasing goods and services from local sources.
- However, the agreement includes two articles that are implicitly aimed at boosting the local purchase of goods and services:
  - The investor has the duty to pay the relevant taxes as defined by Mongolian law on both the domestic and imported goods it purchases.
  - The agreement includes measures to support numerous types of programs that are aimed at assisting local enterprises that supply goods and provide services to the Oyu Tolgoi project.
- The implementation of the agreement: The company reports that 83% of all purchased services and goods were supplied domestically in 2017.

3.2.4. Infrastructure

- While the subject of infrastructure was reflected in a relatively flexible manner in the OT Agreement, many of the issues surrounding infrastructure were incorporated in an unclear and broad manner.
- The implementation of the agreement:
  - While the water supply network and construction of the airport have been realized, issues surrounding roads, electrical power and railways have yet to reach a resolution.
  - In particular, “Souhern Region Power Sector Cooperation Agreement” was not implemented.

3.2.5. Labor relation

- The OT Agreement contains relatively detailed articles on maximizing employment opportunities.
- In particular, the agreement highlights the responsibilities of the government to train and build the capacity of the Mongolian employees who are to work on the project.
- While some articles of the agreement are well written and detailed, other articles may be seen as somewhat lacking when it comes to measuring outcomes.
- The implementation of the agreement:
  - As of Q2 of 2018, the project employed ~15,000 employees of which 93% are Mongolian citizens.
  - OT has provided both domestic and international scholarships to 260 university students since 2010.

3.2.6. Community engagement

- Included within the OT agreement is a section which says that a community cooperation agreement will be established with local administrative organizations in accordance with Article 42 of the Minerals Law
- The Oyu Tolgoi-Umnugobi Community Cooperation Agreement (CCA) was finalized in early 2015
  - Provide $5 million per year to the Development Support Fund for community-proposed projects and programs
  - Committee which ratifies any recommendations from community and presents them to OT

3.2.7. Social and Environmental issues

- Social issues
  - There is no mention of a women-targeted program within the agreement; however, Rio Tinto is committed to increasing the representation of women in mining and strives to support initiatives to promote gender equality
  - As of 4th quarter of 2017, 24% of OT's workforce is female
- Environmental issues
  - Complaints were filed by nomadic herders who were displaced, which was later resolved through CAO's Dispute Resolution
    - Agreements were formalized and signed in May 2017 after the parties reached agreement on issues and developed detailed action plans, which will be monitored by CAO for proper implementation
  - Water usage is very clearly outlined in the agreement

4. CONNEX Initative

CONNEX history

- UNCTAD's Investment Division's Research Branch proposed to create an investment contract aid facility to help developing countries negotiate better contracts for large-scale projects involving foreign investors (1999)
- Monrovia Declaration (2013)
  - An information-sharing and coordination mechanism
  - A contract negotiation support center
  - A rapid response advisory unit
- G7 Summit in 2014, CONNEX Initiative was introduced
  - "To provide developing country partners with extended and concrete expertise for negotiating complex commercial contracts, focusing initially on the extractives sector"

CONNEX history

- G7 Summit in 2016 in Ise-Shima, Japan, the commitment to continue and intensify efforts under the CONNEX Initiative was reaffirmed
- Between 2015 and 2017, the Negotiation Support Forum (NSF) was established by the German government and OECD
- September 2016, during the G7 CONNEX Initiative International Conference on Capacity Building and Transparency, the establishment of the CONNEX Support Unit was announced
  - Launched in January 2017 to assist requesting developing countries and economies in transition anywhere in the world in negotiation large-scale complex investment contracts, guided only by the interests of the requesting governments

CONNEX Support Unit

- There is no regional focus; developing and transition economies from any geographic region can request support and assistance
- Support can be requested for ongoing (re)negotiations of large extractive contracts as well as during the pre-negotiation phase when a government is preparing for upcoming (re)negotiations
- Assistance is provided for complex large-scale investment contract negotiations, initially in the extractive sector
- Designed to complement assistance offered by other initiatives and cooperates with a range of organization such as ISLP and ALSF; past and current collaborations include organizations such as the OECS, the IGF, the NEPAD Agency and others
- Experts provided include lawyers, financial and industry experts, business strategy specialists, economists, environmental specialists, community development specialists, geologists, mining engineers, and any other discipline needed in the context of specific project negotiations
- The scope, shape, and content of support are tailored to the needs of the cases at hand; support can vary from issue-specific short-term assistance to long-term negotiation support
- All support offered by the CONNEX Support Unit is free of charge and non-fee based
- The Support Unit attempts to minimize the time between receiving requests for support and fielding negotiating support as much as possible

General recommendations

- Definition of large project as compared to the legally established strategic mine issue
- Having all stakeholders' consensus
- Integrated form of agreement, integrated project delivery platform
- The spillovers from the main mining project to infrastructure, social issues and regional development, all governed by different laws, require unified approach which is not clear now
- The importance of having an integrated agreement and unified management

Thank you