Regulation for exploitation of gold mine in Mongolia

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I. Introduction

An investment agreement on exploitation of Oyu Torgoi was concluded between Mongolian government, Canadian major mining company Ivanhoe Mines and English and Australian mining company Rio Tinto, one of the largest major resources companies, on October 6, 2009. Since then, Mongolia enjoyed a lot of investment from foreign companies, which is called gold rush.

That's not a mystery; Oyu Torgoi reserves the amount which can produce 330,000 ounce of gold in average every year for 35 years and it is said that GDP in Mongolia will increase by 34% every year due to loyalty revenue when they start to exploit gold in Oyu Torgoi. Needless to say the profit Ivanhoe Mines and Rio Tinto will receive will be higher than GDP of Mongolia and share price of both companies climbed up drastically after conclusion of the investment agreement.

Exportation of coppers from Oyu Torgoi started on June 2013 accompanied with open-pit mining as the first stage of the development. However, the development cost exceeded the budget for the project and Mongolian government insisted that the profit from the project is not distributed enough. Therefore, Rio Tinto stopped development plan of underground mines as the second stage on the end of July. After that, Mongolian government and developer companies came into conflict over profit distribution of the project and Mongolian government delayed its approval of the project. As a result, the start of development plan of underground mines was delayed. In the aftermath, foreign direct investment to Mongolia declined from 4,450,000,000 USD (2012) to 580,000,000 USD (2013).

Now, the development of the underground mine at Oyu Tolgoi in Mongolia has taken a significant step forward with the signing of the Oyu Tolgoi Underground Mine Development and Financing Plan (the Plan) by the Government of Mongolia, Turquoise Hill Resources and Rio Tinto in May 18, 2015. The Plan addresses the key outstanding shareholder issues and sets out an agreed basis for the funding of the project.
With a new pathway to development of the underground mine agreed, the focus now shifts to finalizing the project finance, the feasibility study and securing all necessary permits so that the underground mine development can proceed.

The construction of the first phase of the pioneering Oyu Tolgoi project – the open-pit mine – was completed on schedule in less than 24 months. The operation celebrated one million tonnes of copper concentrate shipped in March 2015, less than two years after the first production left the mine. Oyu Tolgoi has a workforce that is 95 per cent Mongolian and Oyu Tolgoi LLC has paid $1.3 billion in taxes, fees and other payments to date.

Then, is exploitation of gold mine in Mongolia really attractive for foreign companies? In this report, based on our experience, we explain the outline of regulation of gold exploitation and legal risk of gold exploitation for foreign companies in Mongolia.

II. Regulation for exploitation of gold mine in Mongolia

1. Change of regulations regarding exploitation of gold mine in Mongolia

It is Mineral Resources Law that regulates minerals in Mongolia in general.

Mineral Resources Law was enacted in 1988 of ancient regime by Mongolian People's Congress and work for revise started after 1992 when democratic Mongolia was born. In 1994 the revised law was promulgated and came into force in 1995. At the same time, Foreign Investment Law came into force in 1993 including protection of foreign investors and preferential treatment in taxation, but foreign investment could not be introduced as expected. Then on May 1, 1997, revision of Tax Law to abolish tariff, reduce tax for expense and introduce depreciation was implemented and in 2006 new edition of Mineral Resources Law adopted.

The major revisions of present Mineral Resources Law are as follows:

A. Loyalty rate the government obtains was reduced from 12.5 % in maximum to 2.5 % of the profit acquired through exploitation.

B. Financing with collateral of exploration and exploitation right

C. The Mongolian Central Bank shall buy exploited and refined gold by international market price (opaque price designated by the government before that)

2. Mongolian companies or foreign invested Mongolian companies may hold mining licenses

Before democratization, most of the production of gold in Mongolia was yielded from sand mine, and exploitation technique was limited to manual one. Also, exploitation of major mines was operated by joint ventures with Soviet Union or Eastern Europe, and Mongolia depended all on their fund, materials and techniques.

However, after the former Soviet Union and Eastern Europe were democratized, Mongolia was forced to introduce foreign capital aggressively after running out of funds, materials and techniques to exploit gold mines and actually introduces foreign investment through revision of Mineral Resources Law, Tax Law and Investment Law.

3. Movement for nationalization of strategic minerals

What foreign companies should be careful is the recent movement for nationalization of strategic minerals. For example, under the new Energy Law, not only foreign companies but foreign companies which hold joint venture with Mongolian ones faced difficulty in exploitation of

Uranium. It is said it represents that Mongolian government wanted to monopolize exploitation of Uranium in Mongolia as much as possible.

As an agreement was concluded regarding exploitation in Oyu Torgoi, it is said that Mongolia is not trying to nationalize gold mines. However, seeing drastic change of Mongolian government so far, we cannot say that there is no possibility that present regulation on gold exploitation for foreign companies becomes strict suddenly.

III. Present regulation for exploitation of gold mine

1. Outline of risk for nationalization regarding exploitation of gold mine

There will be little risk for the nationalization or mandatory ownership of the government of gold mines because it relates to following mining deposits:

a) "mineral deposit of strategic importance" means a deposit [with size][1] that may have a potential impact on national security, economic and social development of the country at the national and regional levels or that is producing or has a potential of producing more than five (5) percent of total Gross Domestic Product in a given year.
b) “deposit where State funded exploration was used to determine reserves”

As for above indicated deposits the state shall have mandatory ownership rights as stipulated by the Minerals law of Mongolia:

The percentage of the State share in a minerals deposit shall be established by an agreement on exploitation of the deposit where State funded exploration was used to determine reserves.

The State may participate up to 50% jointly with a private legal person in the exploitation of a minerals deposit of strategic importance where State funded exploration was used to determine proven reserves. The percentage of the State share shall be determined by an agreement on exploitation of the deposit considering the amount of investment made by the State.

The State may own up to 34% of the shares of the investment made by a license holder in a mineral deposit of strategic importance where proven reserves were determined through funding sources other than the State budget. The percentage of the State share shall be determined by an agreement on exploitation of the deposit considering the amount of investment made by the State.

So, if the gold mine deposit held by the Company is not classified as aforementioned deposits (“a” and “b”) you shouldn’t worry about mandatory ownership and nationalization but there’s always risk to lose (although risks are very rare) the deposit to the state if the deposit is considered by the state as following:

- "Special purpose territory" means land taken at the national and local levels by an

authorized government entities pursuant to Articles 17. 18 and 20 of the Land Law for special public needs where exploration and mining are either restricted or prohibited;
- "reserve area" means an area previously granted under exploration or mining license which is now taken under State control by decision of competent authority suspending any reconnaissance, exploration or mining activities;

2. Outline of regulation for gold exploitation

A. Ownership of Minerals

Under Minerals Law in Mongolia (the "Law"), the mineral resources are the property of the State.

The State, as owner of all minerals in Mongolia, has the right to grant exploration and mining licenses to a third person in accordance with the terms and conditions set under the Law.

B. Prospecting

Under the Law, prospecting means the investigation to identify mineral concentration without disturbing the subsoil.

Any individual or legal entity shall have the right to conduct prospecting for minerals within the territory of Mongolia without a license.

Any person proposing to conduct prospecting must notify the Office of Geological and Mining Cadastre (the "OGMC") and the local administrative body, and register its name and address and a description and location of the area in which it proposes to conduct prospecting.

C. Exploration

Under the Law, exploration means activities carried out on and under the earth's surface for the purpose of identifying the existence, location and quantity of mineral concentration and, determining the technical and commercial feasibility of mining such as mineral concentration.

Exploration license means the right to conduct exploration granted by the OGMC in accordance with the Law.

Any Mongolian citizen, foreign citizen, or legal person shall be entitled to hold an exploration license.

D. Mining

Under the Law, mining means the entire range of activities that include separating and extracting minerals from the earth, increasing the concentration of their usable contents, transforming these usable contents into marketable products, and marketing and selling those products.

Mining license means the right to conduct mining granted by the OGMC in accordance with the Law.

A mining license may only be held by a legal person formed and operating under the laws of Mongolia.

E. Registration of Gold

Mining license holder shall register all its extracted gold to the State Assaying Agency.

F. Selling gold to the Central Bank

Mining license holder shall sell the extracted gold to the Mongol bank or other banks authorized to purchase gold in Mongolia. Mongolia Central Bank and other banks shall purchase the gold at the international market price.

Additionally, when the mining license holder desired to export the gold, it is possible under complicated restrictions.

At the time, the necessary procedures are the following, but it is necessary to individually make inquiries to the person in charge at the bank.

① Mining license holder has sold 500kg of gold per year more than 2 years and the company has good reputation, steady operation, and vast amount of gold deposit.

② At the time exporting gold, appoints an agent from the Mongol bank or other banks.

③ Obtains authorization from Mongolian Financial Bureau at the time of export.

G. Royalties

A mining license holder shall pay royalties to the treasuries of the central and local administrative bodies on the sales value of all products extracted.[1]

Royalties shall be equal to 2.5% per cent of the sales value of golds extracted.

According to new amendment of the Minerals law, royalty amount shall rise depending on rise of market price of the mineral as stated in article 47.5 of the Minerals law of Mongolia.

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[1] Under the Law of Mongolia, minerals are properties of the State. There may be a question that gold exploited by a foreign invested Mongolian company with exploitation license belongs to the State and it sells properties of others when selling gold.

However, as a foreign invested Mongolian company is permitted to sell gold to the Central Bank in Mongolia, the company acquires the property right of minerals including gold after exploiting them.

As a value of acquiring property or sales right, a foreign invested Mongolian company shall pay royalty at the time of selling gold.

H. Increased value tax

Previously, if the international value of extracted gold abnormally increases after the registration of gold until it is sold, the license holder had to pay 68% of the increased value as increased value tax but now this regulation is abolished and been changed by the above regulation on change of royalty amount depending on market price of the mineral.

VI. Legal risk of developing gold mines in Mongolia

1. Risk concerning acquisition of license

A. Risk concerning selling and purchasing of license

There are many cases in which one who try to sell or purchase license actually does not have the license or only holds partial of the license.

In addition, there are many cases in which Russians who conducted geological survey before the democratization of the Soviet Union still lives in Mongolia with their survey results, without returning to the Soviet Union.

There are cases in which Mongolians who purchased such information at a cheap price only conducted casual geological survey and has acquired exploitation license.

There are many cases in which one tries to sell its exploitation license inaccurately claiming there is plenteous amount of reserved gold mine based on such exploitation survey. Our firm has represented victims of these fraudulent cases.

It is necessary to fully legally and geologically investigate the content of the purchasing license.

B. Obligation of exploration and mining

If one does not exploit or mine within a certain time, exploration license holder or mining license holder may lose its license.

However, the cost for exploration and mining is abundant, and is impossible to exploit or mine from autumn until spring due to the weather in Mongolia (it even reaches minus 40 degrees Celsius during the winter).

It is necessary to confirm the cost and term necessary for exploitation and mining before acquiring exploitation or mining license.

C. Regarding infrastructure

There are not many paved roads, once away from Ulan Bator and cannot be said that Mongolia has improved infrastructure necessary to mine gold mines or to refine gold.

Promoting infrastructure cannot be done by a private company beside Ivanhoe Mines or Rio Tinto. It is necessary to confirm the infrastructure of the vicinity of the mine.

D. Local partner

It is difficult to develop gold mines by only foreign companies and is necessary to look for a reliable local partner.

Administrative officials, politicians, relatives or related person of administrative officials and politicians are usually introduced as local partners.

However, same as China and other developing countries, morals of these administrative officials and politicians are not that high and is not safe to easily believe the words of the administrative officials, politicians, relatives or related person of administrative officials and politicians.

V. Summary

As described above, there are plenteous gold in Mongolia. Therefore, it is even regarded as Gold-Rush and many foreign companies are trying to develop gold mines in Mongolia.

However, in a developing country such as Mongolia, it is not safe to invest enormous amount of money to the Mongolian mines without proper legal due diligence and choosing of reliable Mongolian partner.

Additionally, in order to purchase exploitation and mining rights, it is necessary to fully investigate in prior if the holder actually and individually holds the license, when and how much amount of money shall be prepared in order not to lose one's license, and if the local partner can be fully relied on.

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