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OYU TOLGOI: WAS IT A MISTAKE?

Last Sunday (2 June 2019) the Mongolian National Broadcaster (MNB), which is the most viewed TV channel in the country, ran a program that suggested the Oyu Tolgoi project (OT) was a mistake, it isn't mutually profitable, and there are learnings to be had. This program was based on the report that was presented to the Economic Standing Committee by the 12 MPs strong parliamentary working group who spent two months reviewing the massive project.

Whether it was a mistake or not, OT is a mega project that is carrying Mongolia's economy on its back. However, we continue to see increased negative sentiment towards OT. Based on a metric called the Q Score, the

gap between positive and negative sentiments appears to have consistently grown smaller from 2015 to 2019. There is now a need for the public to clearly understand what issues the Mongolian government and the investors are actually having differences on.

If Mongolian people don't achieve clarity over OT and come to a shared stance, there are growing concerns that the election fever might cause OT to stop and push investors out of Mongolia. Rio Tinto faced similar circumstances a year ago in Indonesia and ended up walking away from the 40 per cent interest they held in the world's second largest copper deposit Grasberg.

OYU TOLGOI: THE REALITY

It has been exactly 10 years since Mongolia signed an agreement with foreign investors to commence mineral exploitation at the world's third largest copper deposit Oyu Tolgoi (32 million tonnes of copper to mine). The project is jointly by the Mongolian government (34 per cent) and Turquoise Hill Resources (66 per cent), which is listed on the Toronto Stock Exchange. The fact that Rio Tinto owns 51 per cent of Turquoise Hill Resources has essentially allowed the deposit to be developed. Approximately 80 per cent of Oyu Tolgoi's total value lies at 700-1,300 meters underground, while the remaining 20 per cent has been mined from their open pit mine.

OT started their copper concentrate exports in 2013, having commenced mining operations from the open pit mine. The preparations for developing the underground mine resumed in 2016, and it is expected that the underground production will start in 2021-2022. The parliamentary working group said that approximately 12 billion USD was invested in OT, of which 3 billion came from equity capital, 6 billion from a loan from 15 international banks, and 4 billion from project financing.

Since commencing production, OT's sales reached 1.8 billion USD in 2014, 1.6 billion in 2015, 0.94 billion in 2017, and 1.2 billion in 2018, totaling at around 5.6 billion USD so far. This means the company is approximately worth 18 billion USD now (the combined value of total investment and sales revenue).

This sum is larger than Mongolia's GDP, and one half – 9.1 billion USD – was spent in the country. As reported by OT, 6 per cent of this in-country spend went to their full-time employees and contractors in salaries, 19 per cent went to government organizations in taxes, fees, and other payments, and 75 per cent went to over 800 Mongolian businesses in payments for goods and services supplied to OT. The other half of the total spend was expended on purchasing fixed assets, working capital, management and administrative expenses, and other costs.

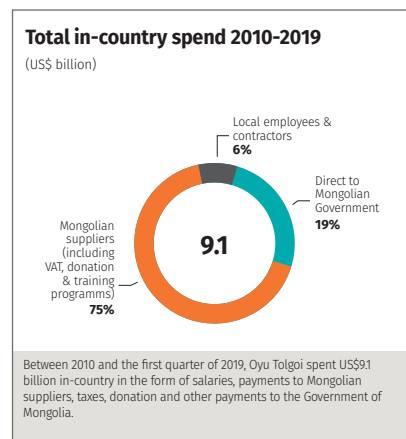
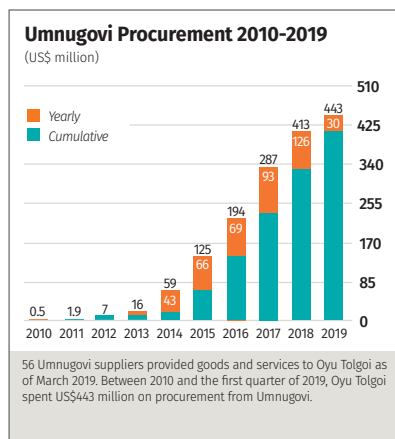
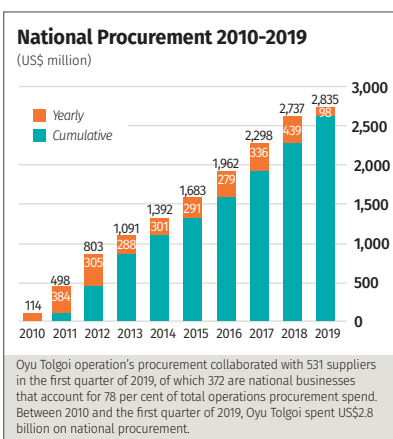
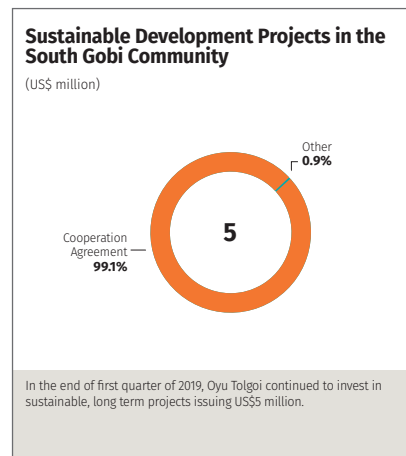
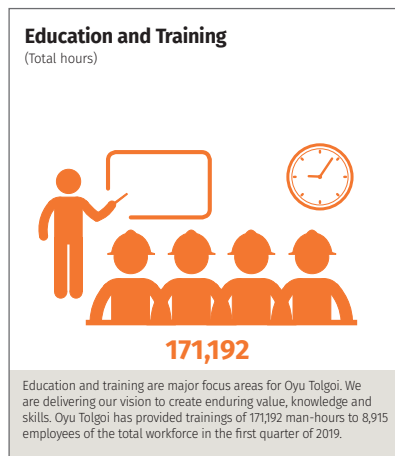
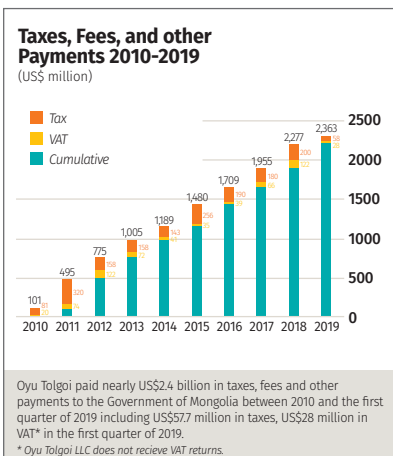
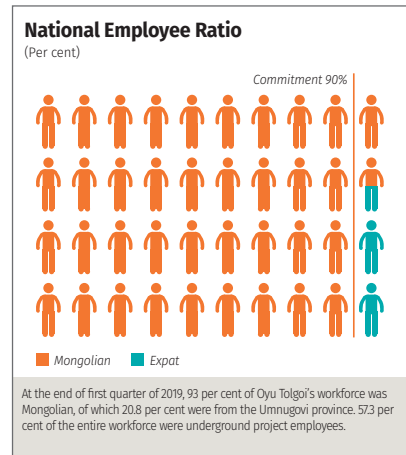
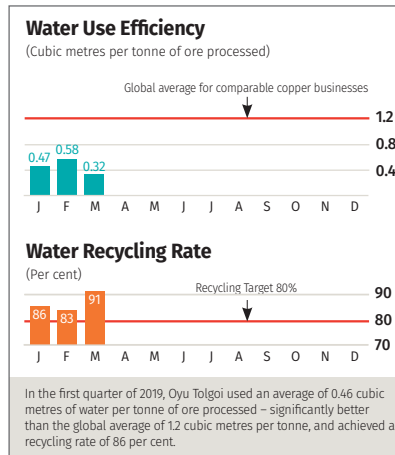
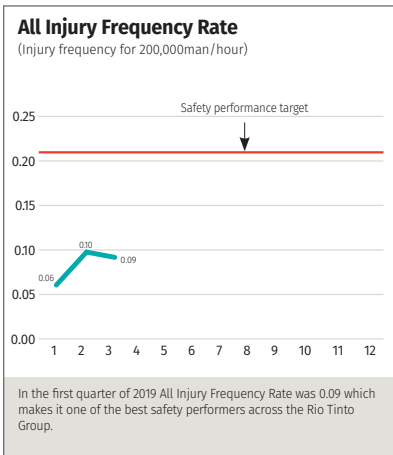
According to Erdenes OT, OT will not achieve their break-even point until 2029, after which the Mongolian government will spend 10 years repaying their equity loan of 1.07 billion USD along with its interest payments (541 million USD as of 2019), meaning Mongolia will start getting dividends from 2040. ▶▶

All data updated to the end of Q1 2019.

MONITORING OUR PERFORMANCE

April 2019

At Oyu Tolgoi we have made a commitment to operate our business in a safe and sustainable manner that delivers benefits to all our stakeholders. This scorecard is designed to help track our progress on various key parameters, including safety, environmental performance, procurement, employment and social contributions to Mongolia.



- ▶ Currently, OT is doing preparatory works to start the underground production. Over 16,000 are working at OT today, and 93 per cent of them are Mongolian nationals. However, when the underground production reaches its normal state by 2023, OT will have a permanent workforce of 6,000 people. If we count the suppliers in, approximately 45,000 Mongolians are currently working on this project. OT has made an investment of 400 million USD in the local communities, giving Khanbogd soum the foundation to become a modern town and enabling Umnugovi aimag to change its outlook and appearance. In addition, thousands of young Mongolians are obtaining skills and international qualifications in their profession and receiving on-the-job experience.

If you look at copper alone, OT exports 160,000 tonnes of copper annually in copper concentrate. This volume will grow 3-4 times when the underground production

commences. By then, OT will presumably account for most of Mongolia's government revenue. However, OT's future has now become a contentious issue. As the 2020 election looms closer, the authorities are going through their political syndrome, with an increasing desire to appear as a 'hero' who stops the project, rather than making improvements.

OT is the largest project in Mongolia's history, the first ever deal we've established with the Western world, and the first agreement that was signed without advice from Russian experts. Therefore, there is bound to be room for error. The people who established the agreement are being imprisoned and investigated for conflict of interest. Mongolia is suffering from a common trouble shared by developing countries that are dependent on natural resources.

TAKING A HELICOPTER VIEW

OT is the largest project that is driving Mongolia's economy. In order to implement the project, we've been making many agreements and also many revisions – the initial investment agreement, the shareholder agreement, the underground development agreement, the Dubai agreement and so on. It should be noted that the parliamentary working group strongly argued that there have been many flaws in the existing agreements.

There still are many issues and challenges, including that the investment agreement was signed without clear agreement on the feasibility study, which allowed the project costs grow twofold than initial estimate, and the investing party receives 3 per cent of the cost in the form of management fees, and the ongoing tax disputes due to the absence of alignment between parties on language associated with costs. The parliamentary working group included in their report that there was a tax violation of 3.2 trillion MNT in 2009-2015.

However, mutual trust can be achieved only when the both parties sit on the same table to discuss the issues, understand each other, agree on solutions and timeframes, and review the outcomes together. Only when there is mutual trust, there will be an effective, mutually beneficial working relationship.

The Mongolian party is now saying that, instead of co-owning a mega project and holding an interest, it is better to agree on higher taxes and royalties without owning shares. We need to start comparing this option against the current arrangement, look into possibilities of selling our 34 per cent interest (how to value, and who to sell), and determine how the taxing and payment rates can be changed.

Also, our civil society needs to work hard on improving transparency and publicly revealing direct and indirect interests of the authorities and politicians in connection to OT. When the civil oversight is improved, the impact of OT's benefits will be felt more strongly to all Mongolian households. Only this way, natural resources can become a blessing, not a curse.

Having obtained a loan from those large international banks and having been the project manager of this massive project, Rio Tinto has no choice but to ensure insurance on all fronts. It is true that there is a need to make amendments to the OT deal or to clarify the abovementioned issues within the framework of the current agreements. The investor party has made a statement that they're ready to enter negotiations to increase the benefits Mongolia receives.

Therefore, we can't allow OT to be an election show again. We need to let the election pass, and then have the dialogue. Otherwise, if we cancel the agreement as some officials are suggesting, we would be shooting ourselves in the foot. There are neighboring countries who will be willing to purchase this project. On the other hand, the third neighbors and the banks who granted the loans are carefully observing if Mongolia will honor its agreed commitments.

We need to finish building to have a house, and – if we don't finish and stop halfway – it will only become a pile. Let's ensure OT becomes a house first. If OT becomes a pile, there won't even be an accountable owner and we will be left with huge debts, including costs of going to international arbitration.

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IS MONGOLIA READY TO MAKE CHANGES TO THE CONSTITUTION

Talks of amendments to the Constitution have been present ever since the Mongolian People's Party ascended to power. A working group on the formulation of amendments presented their proposals to the Speaker of Parliament on Thursday with the backing of over three-fourths of Parliament. The ruling party asserts that these amendments would be proper and lead to stable governance given that it was formulated on the basis of a consultative opinion with input from thousands of individuals.

In fact, a three-day consultancy session was organized in the Parliament Palace for the formulation and articulation of those opinions. A total of 5.4 million comments were received by the working group and more importantly, its proposals are endorsed by 67 of the 76 Members of Parliament. In accordance with Provision 69 of Article 6 of the Mongolian Constitution, amendments to the constitution shall take place with the support of three-fourths of Parliament.

Given that the current amendments enjoy the support of over three-fourths of Parliament, it is likely that they shall be incorporated into the constitution. The question on everyone's mind is whether those amendments will facilitate Mongolia in becoming a better, prosperous country. In order to answer this question, we need to examine the roots of the instability of Mongolian government as we have seen almost 20 governments since 1990.

This instability is fueled by conflict of interests and the ambiguity surrounding party financing. Ultimately, this fosters and facilitates the development of corruption. Another issue worth looking at is that the Mongolian bureaucracy operates under more of a patronage system than a meritocracy. Through this, the Mongolian bureaucracy becomes increasingly weak and

stagnant. Finally, another concern is the lack of separation of powers within the three branches of Mongolian governance.

The current amendments address those issues by firstly requiring political parties to disclose their finances and calls for the establishment of conditions through which the government the government can part finance political parties. The amendments attempt to delve into the question of bureaucracy by inserting a provision that all civil servants shall outlast shifts in leadership. It also seeks to address separation of powers, judicial independence in particular through the establishment of a Judicial Accountability Council consisting of ten members. However, the fact that five members shall be nominated by the Parliament raises questions as to its impartiality. While the amendments also hold a provision whereby politicians can't serve on the Constitutional court, they remain vague on who it classifies as a politician.

As the amendments address the main concerns leading to the instability of governance in bit-parts, I believe that it is a step forward from the current constitution. Also, one of the main controversies regarding the 2000 Constitutional amendments was that it failed to address the issue of "Davkhar Deel" or the ability of legislators to serve as Ministers. While the current amendment limits the number of legislators that can serve concurrently as Ministers, it is another attempt to solve an issue that can be fixed by for example a two chamber parliament. Presidents shall also be limited to one six-year term and the minimum age shall be extended to 55 under the amendments.

When all cabinet posts are filled by legislators, it creates a situation where a fourth of legislators concurrently serve in the executive branch. Having an executive completely independent of

the legislator on the other hand creates a very powerful Prime Minister who does not listen to its Parliament. This was actually the main reason for holding that legislators can serve in the executive through the 2000 amendments.

The main question that should be on the public's mind is whether those amendments will lead to justice prevailing in Ulaanbaatar and Mongolia.

Currently those in positions of power are selling our lands in an illegal manner which can be seen from how Ulaanbaatar land, especially the valleys of Bogd Mountain are used with no one taking responsibility. The proceeds from those land sales would have constituted enough funds to establish adequate sanitary conditions for the inhabitants of the Ger District.

RE-WRITING ELECTION LAW

The Mongolian People's Party proposed an amendment for one constituency elections that would give each Mongolian the right to choose 76 Members of Parliament. According to the Deputy Head of the Mongolian People's Party, Mongolia has implemented different election systems but that a single constituency system would be best. Larger political parties will likely field 76 candidates and smaller party's fewer candidates. After accounting for independents, it is expected that there will be 500 – 600 candidates that would run for an election.

It is called a Party List system and similar system exists in Israel where the entire country is one constituency but in those iterations, seats are allocated to political parties after which Members of Parliament are chosen from pre-determined party lists based on their ranking on the list. The one positive that this system would bring is that the voter will have more choices. It would therefore, in theory, reduce blank votes that are cast as a result of lack of appeal from any candidate standing in an election. Given that people will already know who they are going to vote for before going to the booth, they can simply vote for their candidate, mitigating the technical issues arising from such an overwhelming number of candidates.

Independent candidates and those without a significant public profile shall be at a disadvantage. This calls for a prolonging of the official campaign

period which currently stands at two weeks. One concern is that this system will lead to rural areas being underrepresented in Parliament given that the most notable individuals tend to live in Ulaanbaatar. On the other hand, legislators will no longer be compelled to devote significant resources to their own constituency to affect votes which will free up public money for more significant, comprehensive infrastructure projects.

Opening the elections to such an extent will see a decline in negative campaigning and force politicians to stand out on their policies, principles and values and lead to more substantive debates. An issue that the legislation will most likely not encompass is a minimum threshold to gain a seat in Parliament which is set at 3.2% in Israel, 7% in Kazakhstan and 5% in Kyrgyzstan. The absence of a clear and transparent threshold shall inevitably lead to animosity from smaller parties who may feel cheated out of seats.

Concerns have been raised as to whether these proposals are simply a smoke screen and will fail to lead to substantive changes. There is no doubt that the issues will be discussed in parliament but Members of Parliament with less of a public profile may be threatened by the proposed system. This is the only impediment to the adoption of the law in my opinion but a traditional system of whips should be able to keep those members in check.

MONGOLIAN DIPLOMATS CAUGHT SMUGGLING DRUGS

International news outlets have picked up on a story of two Mongolian diplomats detained near Dresden after refusing a luggage check based on their diplomatic immunity. Given that the diplomats were not posted to Germany, the German police refused to honor their diplomatic immunity and the subsequent luggage check yielded 70 kg of heroin. The news originated on June 6th from www.akipress.com, a Turkish news outlet despite the fact that the events took place a month prior.



This is unfortunately not the first instance of Mongolians diplomats being involved in tobacco, cigar and drug smuggling. Given that civil servants receive international assignments on the basis of patronage, those individuals are directly connected with high ranking officials in Mongolia. Mongolian diplomats were caught smuggling various contraband in Russia, Belgium, Germany, Hungary, and Bulgaria and so on. It is shameful that those individuals believe that their diplomatic immunity provides impunity for their smuggling and other illegal operations.

These cases are also a testament to the corrupt system of selling of high ranking posts domestically and internationally. Mongolian civil society should demand that the Minister of Foreign Affairs take urgent and direct measures regarding the situation and preventing those actions in the future by

ensuring that such individuals don't receive international assignments.

A functional, independent judiciary and a shift in Mongolian attitude towards public office are instrumental to ensuring those actions don't take place in the future. Mongolians view public office as a mechanism for accumulating wealth. In Western democracies, public officials are referred to as public servants as their main function is to serve the public. The resolution of those issues first and foremost requires a vibrant and energetic civil society committed to rectifying the situation.

This review has been edited here for space and clarity. You can watch the full 30-minute review on the Defacto website [\[HERE\]](#).

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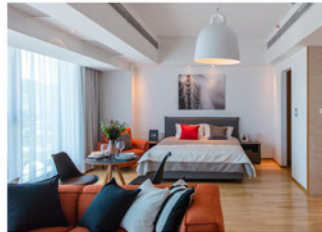
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