Copper Conflict—Mongolia Making a High-Stakes Bet That Rio Tinto's Resolve Will Crash Before Mongolian GDP Does

Mongolia's antagonistic stance toward foreign investors risks driving investment dollars into other regions, such as Chile for copper and making Mongolia even more dependent on investment from China to fund mineral development.

Earlier this month, Rio Tinto and the Mongolian government began a face off over the tax and royalty structure on the massive Oyu Tolgoi copper/gold mine, which was scheduled to begin selling production in 1Q2013, but will now likely delay commercial sales by at least a few months as things are (hopefully) sorted out.

The Mongolian government has now dialed up the pressure even more by preventing the legal counsel for SouthGobi Resources, which is partially owned by Rio Tinto and is one of Mongolia's largest coal producers, from leaving the country, ostensibly due to her company's involvement in "corruption."

While it is possible that real corruption may have taken place, the more likely scenario is that "corruption" is actually code for key officials' attempts to abrogate the terms of previous mining tax agreements. In this case, by calling the agreements "corrupt," the resource nationalists in Mongolia are playing for local, and possibly international, support as they work to legitimize attempts to retroactively re-work agreements that induced Rio Tinto to invest billions of dollars in Oyu Tolgoi.

The foundation for the current conflict was laid in 2009, when, during a period of low commodity prices, the Mongolian government agreed to freeze tax rates over the Oyu Tolgoi mine's operating life. Now, however, it appears the Mongolian Mining Minister and other resource nationalists are grandstanding and making a high-stakes bet—that Rio Tinto's need for income from Oyu Tolgoi exceeds Mongolia's dependence on the mine to help it keep delivering the high GDP growth rates people are getting used to in Mongolia.

In practice, this means that if Rio can stand tall for six months--even if it means a project delay--once Mongolian GDP numbers began to take a hit, the government will very likely rethink its position and more or less honor the prior agreement. Oyu Tolgoi is expected to deliver as much as 30% of the Mongolian government's annual revenue once production is fully underway.

Investments in getting Oyu Tolgoi ready for production have helped fuel a major chunk of Mongolia's impressive GDP growth over the past several years, but now this money stream is tapering off because the mine's infrastructure is largely completed. Atop this, revenues from Mongolia's other major export commodity—coal—have declined this year along with weak Chinese demand and ensuing lower prices.

The end result is that in 2013, if Oyu Tolgoi's commercial production start-up is delayed, the country's GDP numbers will suffer a hit relatively quickly which will put pressure on the government to resolve the dispute and get the mine producing and earning.

The ongoing Oyu Tolgoi dispute also suggests that future mining projects in Mongolia, especially big ones, are likely to use a tax and royalty regime based on global commodity price benchmarks. Such benchmarks would provide additional flexibility to accommodate price swings. Perhaps most importantly, they would establish a transparent and objective set of metrics that would pre-empt local politicians who might otherwise be tempted to take extreme positions based on the idea that foreign investors have somehow "cheated" them.

Strategic Implications

Mongolia's resource nationalism will be strongly correlated to Chinese commodity demand (since coal and copper are Mongolia's core commodity plays for at least the next 4-5 years). Basically, if Chinese demand recovers well and prices jump back up, Ulaan Bataar will be more assertive. Conversely, if China moves onto a weaker "S-curve" growth path, lower commodity prices will make the Mongolians realize that it is better to make money at the current prices instead of waiting for higher prices that may not be back for quite a while, especially in the coal and copper sectors.

If Ulaanbaatar does not move past politically-motivated bribery cases and legislative resource nationalism, it will likely chase away the multinational miners its desires as part of the Third Neighbor policy, and instead only deepen its reliance on the Chinese firms it fears.

China's presence in Mongolia is already deep—with more than 5,600 known enterprises accounting for nearly 49% of FDI in the country at the end of 2011, according to the Chinese Ministry of Land and Natural Resources. Yet Mongolian officials should remember that while China is among their top preoccupations, Mongolia and its minerals are just one of many issues on the minds of policymakers in Beijing.

For Mongolia's Third Neighbor policy to work out and give it geopolitical cushioning against China and Russia, it must find a way to treat foreign investors more hospitably.

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China Oil Trader™ strives to provide a holistic, globally-oriented analysis of Chinese oil and gas issues. In doing so, we often view multiple classes of commodities simultaneously and assess how they interact with each other. Our ultimate goal is to provide a focused source of fresh, creative, and anticipatory research for policymakers, investors, and others interested in China's development as an energy and commodity superpower.

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