LEGAL AND REGULATORY CONSTRUCTS OF RESOURCE MANAGEMENT IN AFGHANISTAN AND MONGOLIA

Policy Update

By

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AFGHANISTAN: A DANGEROUS COUNTRY OF UNTAPPED POTENTIAL

Rugged and remote Afghanistan, with its warring tribes, destitute populations, corrupt governments and brutal warlords, is rich in untapped natural resources. A 1970's Soviet geological survey in Afghanistan recently expanded upon by a joint British-Afghan team detailed an untapped "trillion-dollar mineral play" including copper and iron ore worth hundreds of billions of dollars, in addition to gold, silver and exotic materials such as cobalt and lithium. On a surface level, such enormous reserves could be seen not just as a key future piece of the "global jigsaw puzzle of critical resources" (Mortished, 2010), but as a miracle-cure for Afghanistan's economic development woes. Now, after decades of conflict and limited progress in rebuilding efforts, Afghanistan's mineral resources are starting to attract a growing interest from international investors such as China. But in order to manage and protect its natural resources, Afghanistan must ensure legal and regulatory constructs around governance and self-protection are set firmly in place.

Afghanistan's Aynak Mine: China's involvement

In 2006, nine companies from Australia, Canada, USA, India, Kazakhstan, Russia and China submitted tender offers to mine Afghanistan's Aynak deposit – a trove of copper estimated at a minimum 240 million tonnes of high-grade ore. The state-owned China Metallurgical Group (CMG) was awarded the contract in November 2007, winning the government an $808 million signing bonus (Maylie, 2009). In all, over $3 billion was pledged to Afghanistan, making the mine the country's largest foreign investment project to date (Shroder, 2010, p. 94). This project is largely seen as kick-starting an industry that has the potential to create thousands of jobs and potentially pave the way for sustained development that could wean the country off its dependence on an illicit narco-economy; a step that could undermine the continuing Taliban insurgency.

Governance Concerns

Is poor governance tilting the scales in favor of countries like China in securing these hugely profitable contracts? Is China really a good example of the type of foreign investment that could lead to economic development and stability in Afghanistan? Although the Afghan government stands to reap $1.2 billion a year in revenues from the mine, (Vogt, 2010), socio-economic concerns and questions abound concerning corruption, depth of experience, and monopolization with regards to foreign mining practices, some of which may prove problematic from a governance and future-looking perspective. Historically, one of the largest concerns has been that

> Afghan officials have interpreted their mining regulations in such a way that if a company is awarded a concession to explore and then discovers valuable minerals, the government can tender the concession back and rebid it, undermining any incentive for a foreign firm to actually find large deposits. (Risen, 2010)

This style of regulation is hardly conducive to attracting growth opportunities. Further, James Yeager, former adviser to Afghanistan's Ministry of Mines, outlines the nearly "impossible" competition private (and largely Western based) companies face when bidding against state-owned enterprises (Risen, 2010). "The Chinese include money for infrastructure development in their bid, and since they do not have to deliver results to investors their projects can operate at a loss" (Risen, 2010).

There's also the trepidation that many Western investors have with sending their employees into a conflict zone. Murray W. Hitzman, a professor of economic geology at the Colorado School of Mines, states that with the length of time it takes to make money from a mine, "no mining company in its right mind would go into Afghanistan now" (McNeil, 2010). There are also substantial start-up costs, and the investment required to "build a stable government, fund development projects to placate the populace, [and] build and secure transportation infrastructure may make such an endeavor economically impossible" (McNeil, 2010). Yet, China is somehow able to breeze right through these constraints.

With China muscling themselves into a dominant bidding position in what appears to be a sliding scale of transparency with regards to Afghanistan resource management, what are the implications for the industry?

The Price of Success

Afghanistan desperately needs the influx of cash from deals like the CMG mine, but does the potential long-term reward match the risks? The rewards are clearly enormous: the price-tag of the Aynak mine is equal to 35% of all the international development money spent on Afghanistan since 2002, and the annual royalties of $400m to a frail government that is desperately trying to reduce its dependence on international aid money, could fund infrastructure projects that the country would "otherwise have to wait decades for, including Afghanistan's first railway line, which would link the country to Tajikistan and Pakistan" (Boone, 2008). CMG has even vowed to build a massive power plant that could supply its excess power to Kabul, resolving the capital's issues around intermittent electricity (Boone, 2008).

But experts say that Afghanistan's weak industry governance and fragile rule of law make them vulnerable to mega-projects like the CMG deal: projects that have caused "social, political and economic catastrophes in other developing nations" such as Nigeria and the Congo (Boone, 2008). Lorenzo Delesgues, executive director of Integrity Watch Afghanistan, an independent organization that published a report on Aynak in 2008, states Afghanistan is "not evenly matched with the [Chinese] company…this is a multi-national company that is far bigger financially than Afghanistan. It's like David and Goliath, only David doesn't have any laws or regulatory framework to help him" (Boone, 2008). Regardless of whether China's investment is required to succeed, Afghanistan first needs to overcome several existing industry governance concerns that are hindering growth.

Suspicion of Illegal Action

During the completion of the Aynak deal, Yeager raised suspicions about the tendering process, warning that "that legal requirements for an inter-ministerial council to consider the rival bidders was simply being ignored" and that "other sources close to the deal have warned that the process lacked transparency" (Boone, 2008). However, the World Bank – the bankrollers attempting to build the ministry's capacity to handle deals as large as Aynak – declared itself satisfied with the tendering process (Boone, 2008). Yeager's concern was that without proper due diligence by lawyers, experts and accounts, it would be impossible for a "Soviet-era structure that simply does not have the capacity to do the job" (Boone, 2008) to curb problems down the road, as opposed to before they occur. This was ironically echoed in a statement by Ibrahim Adel in 2008, Afghanistan's mining minister at the time, who claimed that since "extraction will not start for five years so there will be sufficient time to get our experts and environmental inspectors trained" (Boone, 2008). It seems apparent that this "act now, think later" statement from the leader of an embryonic portfolio completely misses the point of ensuring a deal is done right in the first place.

Transparency Required

In 2010, Afghanistan took a positive step in the right direction by joining the Extractive Industries Transparency Initiative (EIT); an international voluntary standard for disclosure and responsible management in the oil, gas and mining sectors (Anonymous, 2010). This important strategic decision equipped political leaders and citizens with a new tool in the struggle for regional stability: a clear and strong commitment to sound natural resource management and increased public accountability (Anonymous 2010).

The Revenue Watch Institute, a non-profit policy institute and grant-making organization that promotes the responsible management of oil, gas and mineral resources for the public good, stated that Afghanistan's "government adherence to the principles of transparency of payments increases the likelihood that the people will benefit from their country's valuable resources, and helps to build public trust" (Anonymous, 2010).

In a positive recent development, in November 2011, Karzai's cabinet selected a seven-member consortium of Indian companies led by Steel Authority of India as the preferred bidder for three of the four blocks in Hajigak that are estimated to hold more than 1.8 billion tonnes of iron ore – the world's second-largest reserves – and enough to feed a 6-million tonne steel plant for four decades (Anonymous, 2011). This is the first time an Indian consortium has successfully bid for a large mine, "reversing a depressing trend for the past several years where Indian consortiums had failed to acquire overseas resources, losing out mainly to Chinese groups" (Anonymous, 2011).

Hajigak, like the Aynak copper deal, is expected to generate billions of dollars in mining revenues (Hajigak is valued at $420 billion) and create thousands of new jobs. The infrastructure around the Hajigak deposit can also be connected to the rail being built by the Chinese for the Aynak mines (Anonymous, 2011). From a geopolitical perspective, even if India's play is simply a hedge against Chinese acquisition of iron ore assets, Afghanistan's mining industry stands to benefit from the increasing diversification of, and cooperation between, foreign investors.

Mine-golia: A Young Democracy Seeks Investors

Similar to Afghanistan, Mongolia has vast and largely untapped mineral deposits of copper, gold and coal, but until recently, has remained largely impoverished. With several big mining projects on the horizon, however, there is promise of an economic boom that will present the government with a very real challenge: how do you manage to successfully exploit these resources without further destabilizing the economy? And how will their proximity to China factor into the equation?

The International Monetary Fund foresees a double-digit annual-growth rate in Mongolia for the next several years, and a quadrupling of GDP per head – from a mere $2,000 – by 2018 (Anonymous, 2010). Two mines in Mongolia's southern Gobi region – Oyu Tolgoi, a copper and gold deposit, and Tavan Tolgoi, a coal mine – are expected to provide much of the new wealth, both of which will include road and rail links to Mongolia's hungriest customer: China (Anonymous, 2010).

Legal Constructs

Currently, the Mongolian government stands to profit handsomely from Oyu Tolgoi, of which they own one third (Anonymous, 201). But in a country where politics is based on patronage, such a windfall could spell disaster. With swollen government coffers, vote-buying and corruption could thrive, and even "virtuous public spending" could push up inflation (Anonymous, 2010). Further, if their economy becomes too dependent on mining, Mongolia becomes highly vulnerable to price shocks and market fluctuations. One recent construct is the adoption of fiscal stability law that sets indices for commodity prices for budgeting purposes. When prices go above the index, excess revenue will be stored in a "stability fund". If prices fall, the government can tap the fund to cover its costs (Anonymous, 2010).

Other measures are also being implemented to curb the risks, including the passing of new anti-corruption legislation, as well as promises to help boost investments in non-mining sectors, including tourism, finance and outsourcing so that the country does not become dependent on a single industry.

Proximity to China

Mongolia's neighbour China is one of the largest global consumers of coal and rare earth minerals (Anonymous, 2010). With healthy diplomatic ties established between the two countries, Mongolia is uniquely positioned to start undercutting China's existing coal suppliers such as Australia and Indonesia, pending the development of appropriate infrastructure.

Analysts estimate that when the Tavan Tolgoi mine opens, Mongolia could deliver coal to China for under $100/tonne, less than half of the $220/tonne for Australian coal (Anonymous, 2010). The main concern, however, is whether or not Mongolia can avoid becoming too economically dependent on China and their insatiable appetite for resources, and grow their mining industry in a sustainable way. To date, they have not been able to establish a solid foundation to achieve this.

Foreign Direct Investment: Shifting Frameworks

Similar to Afghanistan, Mongolian mining frameworks have historically been poorly defined, shifting dramatically between a keen focus on FDI and a state-protectionist model. After the fall of the Soviet Union – its primary trading partner until the early 1990's – Mongolia recognized the need to attract new investors (Anonymous, 2011).

Mongolia's 1997 Minerals Law aimed to attract FDI by reducing investment taxes, strengthening land tenure rights, and increasing transparency, and in 2002, the government further lowered royalty payments on all minerals to 2.5% (Anonymous, 2011). As a result, FDI in Mongolia grew 2,200% to an annual total of $344m in 2006. This economic boom was highlighted by the discovery of the world's largest copper and gold deposit at Oyu Tolgoi in the south Gobi Desert (Anonymous, 2011), but the government was starting to get nervous about the increasing foreign dominance in the mining sector.

A 2006 revision of the Minerals Law shifted the country to a significantly more protectionist model (Anonymous, 2011). The new regulation doubled royalty rates, imposed a Windfall Profits Tax of up to 68% on copper and gold, and reserved the right for the government to claim ownership of "strategically important" deposits (Anonymous, 2011). It also allowed the state to take up to a 50% equity stake in deposits discovered with government assistance or 34% for privately explored deposits (Anonymous, 2011). But investor backlash, coupled with the spread of the 2008 global financial crisis drove down demand and prices for Mongolian commodities, and in 2009 legislators repealed the Windfall Profits Tax and replaced it with a sliding scale of royalties, effective early 2011 (Anonymous, 2011).

The Role of China: What Should it Be?

The extent of China's role in the context of growing Afghanistan and Mongolia's national mining industries is far too complex to be intimately addressed in the scope of this paper, but by using China at a high level to illustrate the influence foreign direct investors will have in the future of these two emerging economies was worthy of a brief analysis. As Afghanistan and Mongolia will continue to rely heavily (if not almost entirely) on FDI to exploit their mineral wealth, regulatory reforms and governance will largely revolve around the relationships with these foreign actors, whether they be private consortiums or state-run companies. Systemically, it is the question of *to what extent* will FDI govern the future of these industries, and can Afghanistan and Mongolia grow and open their mining opportunities to an internationally diverse group of investors?

Mongolia's Mining Future

Mongolia's current mining regulatory framework is still a work in progress. While the Mineral Law allows 100% foreign ownership of businesses, only individual Mongolian citizens can own the real estate under mineral deposits to be exploited (Anonymous, 2011). The current tax code is an improvement over its predecessor and provides more opportunities for capital investment deductions, but in a country that is expanding at such a frenetic pace, not only must foreign companies ensure they are well informed of planned regulatory changes before they become law to ensure the viability and long-term stability of their projects (Anonymous, 2011). Perhaps most importantly though, Mongolians themselves must ensure that they keep their mining industry and reliance on China in check by establishing equally viable markets in other industries such as tourism, finance, and outsourcing.

Aynak: Afghanistan's Litmus Test

Afghanistan's Ministry of Mines is also taking steps in the right direction. Concerns around transparency and illegality with the Chinese Aynak deal have been curbed by the recent award of the Hajigaks blocks to an Indian consortium, as well as the news of a $50 million investment by J. P. Morgan Capital Markets into a gold prospect east of Mazar-e Sharif. Both the Asian Development Bank and the World Bank have also developed systemic plans for development in Afghanistan that provide oversight and guidance for mining opportunities (Shroder, 2010, p. 95). Like Mongolia, Afghanistan should continue to increase transparency in, and encourage the diversification of, FDI so as to develop their commodities market in a sustainable and transparent manner.

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