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Feeding the Hungry Dragon: Canada, Mongolia and China's Resource Strategy

by Hugh Stephens and Charles Krusekopf

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POLICY UPDATE

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While Canada ponders whether, and on what conditions, to approve CNOOC's bid for Nexen Inc., it might consider the consequences of getting the decision wrong. A failure to encourage state-owned enterprises (SOEs) like CNOOC to invest in the risk (and returns) of resource development – while simultaneously setting clear and transparent guidelines for such investment – can have a significant negative economic impact and send mixed signals not only to Chinese investors, but also to other players in the market. The case of China's northern neighbour, Mongolia, is a case in point and a cautionary tale.

Apart from the dubious distinction of sharing the world's two coldest capital cities (Ulaan Bataar and Ottawa, no. 1 and no. 2 respectively), Canada and Mongolia share several other attributes, such as an abundance of natural resources, and a common border with much larger neighbours (Russia and China for Mongolia, and the US for Canada) that are the main markets for the country's natural resources. China, with its growing appetite for natural resources, is seen as the market of the future, but both Canada and Mongolia have a deep suspicion of China's intentions with respect to resource development. Both countries recognize the importance of Chinese investment and involvement in its resource development, and are grappling with ways to deal with China in ways that will ensure its involvement brings maximum benefit to the host country. How Chinese investment is managed will have wide strategic implications, especially for Mongolia, but also for Canada, the wider Asian region, and even globally. To date, Mongolia's handling of the China file has been less than stellar, reflecting a deep seated ambivalence about China's intentions combined with a rise of resource nationalism, a phenomenon not unknown in Canada.

While concern over the goals and behaviour of Chinese SOEs is a common theme shared by Canada and Mongolia, there are obviously major differences between Mongolia's relationship with China, and that of Canada, starting with geographic proximity, history, relative size and dependency. Yet there could be lessons in the Mongolian experience that are relevant to the impending decision in Canada.

Mongolia relies on foreign investment to support development of its extensive deposits of coal, copper and other resources. Canadian companies, including Turquoise Hill Resources (formerly known as Ivanhoe) and Centerra Gold, have been leading investors in Mongolia. However, while Mongolia is highly reliant on China as an export market (over 90% of Mongolia's mineral exports, Mongolia's primary export, go to China), it has been reluctant to allow Chinese ownership of mineral resources. Its efforts to block Chinese ownership of resources, however, have impacted all foreign investors, raised uncertainty and potentially led to an overall decline in foreign investment.

In practice, it is difficult, if not impossible, to set restrictions on certain investors without impacting all investment to some degree. Restrictions that target specific countries are generally not allowable under international trade rules and therefore rules must be applied equally to all. Forcing a foreign investment proposal to go through a review process creates delays and uncertainty for potential investors, reducing returns and limiting the number of investors willing to take risks in sectors requiring a review. In addition, excluding potential buyers, such as Chinese SOEs, reduces the market value of companies and resource deposits. No other firms have emerged that are willing to pay more for Nexen than CNOOC, and therefore a rejection of the deal would lead to a fall in the market value of Nexen and other Canadian resource companies and deposits. Investors are discouraged from investing in assets that cannot be freely sold, further reducing the interest of foreign capital.

Mongolia has experienced these effects first hand. In May 2012, Mongolia hurriedly passed a law called the "Strategic Entities Foreign Investment Law", which requires Mongolian government review of any foreign investment economic sectors deemed to have "strategic importance", including mining, banking and media. As with Canada's Investment Review Act, the exact criteria and conditions of the review are not made clear in the law beyond general provisions such as that the proposed investment would not "conflict with the National Security Concept of Mongolia" and would not "have a negative impact on the operations of the concerned sector". Concerns have been expressed that it is unclear who is covered by the law, and the extent and conditions of the reviews required.

The first major foreign investment project affected by the new law was an effort by the Chinese state owned aluminum company, Chalco to buy a majority stake in a major Mongolian coal mine, Ovoot Tolgoi, from the Canadian company, SouthGobi Resources. In September 2012, Chalco withdrew its offer, the largest proposed Chinese investment in Mongolia to date, due to concerns about getting approval for the deal from the Mongolian government. The stock price of SouthGobi Resources fell sharply because of the collapse of the deal, and the company has been unable to resume production at the Ovoot Tolgoi mine due to further scrutiny from the Mongolian government.

The Strategic Entities Foreign Investment Law and other efforts aimed at foreign investors, including an effort to renegotiate the terms of an agreement with Rio Tinto and Turquiose Hill Resources for the flagship Oyu Tolgoi copper mine, have significantly raised the risks for foreign investors in Mongolia. A number of foreign investors have reportedly withdrawn from proposed projects, and the overall climate for investment in Mongolia has become pessimistic in the face of increasing risk and falling global commodity prices. The slowdown in foreign investment has reduced Mongolian government revenue, lowered the credit rating and stock prices of companies working in Mongolia, and slowed ambitious development plans for both mines and critical infrastructure projects.

Observers have pointed out that most countries, including Canada and the US, have foreign investment review laws in place to scrutinize deals to insure they are compliant with national security and other national interests. Given its history of domination by its two large neighbours, Mongolia clearly has an interest in limiting the influence of its two neighbors over its natural resources, fearing that they will develop the resources for their own benefit. Mongolia is concerned that Chinese companies would sell Mongolian products to Chinese buyers at artificially low prices, and would impede efforts for value added processing in Mongolia. Similar concerns have been expressed by opponents of the CNOOC-Nexen deal and indeed by opponents of the Northern Gateway pipeline (in which Chinese SOE Sinopec has a minority share).

However, in its haste to close the door, or at least limit Chinese state investment, Mongolia has risked throwing out the baby with the bathwater, sideswiping non-Chinese foreign investments (including those by Canadian companies) and sending out mixed messages regarding whether foreign investment of any stripe is welcome in the resource sector. This is self-defeating, and while Canada's and Mongolia's situation and state of development are not comparable, there are some similarities with regard to mistrust of China, and need for new investment.

Investment is the life-blood of the Canadian resource sector and with few exceptions has been openly welcomed. Even sovereign wealth funds and state owned corporations have participated in Canada's energy development, e.g. Norway's StatOil. Chinese SOEs in the petroleum sector, CNOOC, Sinopec and PetroChina, already have significant, albeit minority, investments in a number of oil sands plays. While the Investment Canada Act contains several criteria for judging whether investments by SOEs will result in "net benefit" for Canada, these are really just general statements of principle and relate primarily to corporate governance and local benefits.

The CNOOC-Nexen acquisition review has been extended twice (with CNOOC's agreement) and we are informed that a decision will be rendered by December 10. Meanwhile, the rejection by the Canadian Government of the bid by Malaysian SOE Petronas to acquire Canadian natural gas producer Progress Energy has scrambled the cards, but if common sense and self-interest prevail it should not mean the end of the CNOOC-Nexen deal. In fact, the Petronas bid may yet be approved if the company submits more information with regard to its proposed operations, and makes a greater effort to satisfy Industry Canada's net benefit requirements.

What the substance of those requirements will be should be more clearly spelled out when the government completes its long-promised review of the Investment Canada Act and clarifies what is expected of SOEs investing in Canada. A clearer definition of what "net benefit" means with regard to SOEs will be welcome. Hopefully it will bring some stability and predictability to the issue of SOE investment in the Canadian resource sector which will benefit investors, Canadian shareholders and the Canadian economy alike. Mongolia likewise would be well served to clarify the many opaque provisions of its Strategic Entities Foreign Investment Law, which would benefit both foreign investors and the development of its domestic economy.

The Canadian process to date has been far from perfect. The government's promised review and clarification of the net benefit test has taken too long. The vacuum this delay has created has allowed a loud, and at times uninformed, debate to take place, with much of it fuelled by irrational fears of Chinese takeovers. In the process, it has cast uncertainty over both the Petronas deal and CNOOC's proposed acquisition of Nexen. This uncertainty drives away potential foreign investors and reduces the value of Canadian companies and assets.

The relatively small role that Nexen plays in the oil patch, the limited size of its assets in Canada, the insignificant amount of Chinese investment in Canada in proportion to total Foreign Direct Investment, and the fact that any investor, Chinese SOE or otherwise, has to operate within the framework of established laws and regulations that exist in Canada should help put this debate into context. However, as we have seen in the case of Mongolia, resource nationalism can trigger knee-jerk reactions bordering at times on the irrational. As a result, political decisions may be made that are not soundly rooted in economic realities. A clear road map for decision making, spelling out expectations and responsibilities, delineated by law and fairly applied, is the way to deal with such situations. Mongolia's current resource policy is an example of getting it wrong; let's hope that Canada gets it right.

About the Author

Hugh Stephens is a Fellow of the Canadian Defence & Foreign Affairs Institute, and has more than 35 years of government and business experience in the Asia region. He is currently senior advisor for Asia Pacific to Time Warner, based in Victoria, BC, Canada. Before returning to Canada in December 2009, he was based at the company's regional headquarters in Hong Kong for almost a decade where he managed the company's public policy program in the Asia Pacific region as Senior Vice President. Mr. Stephens has extensive experience in dealing with media and IT industry issues in China, India, SE Asia, Korea/Japan and elsewhere in Asia.

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