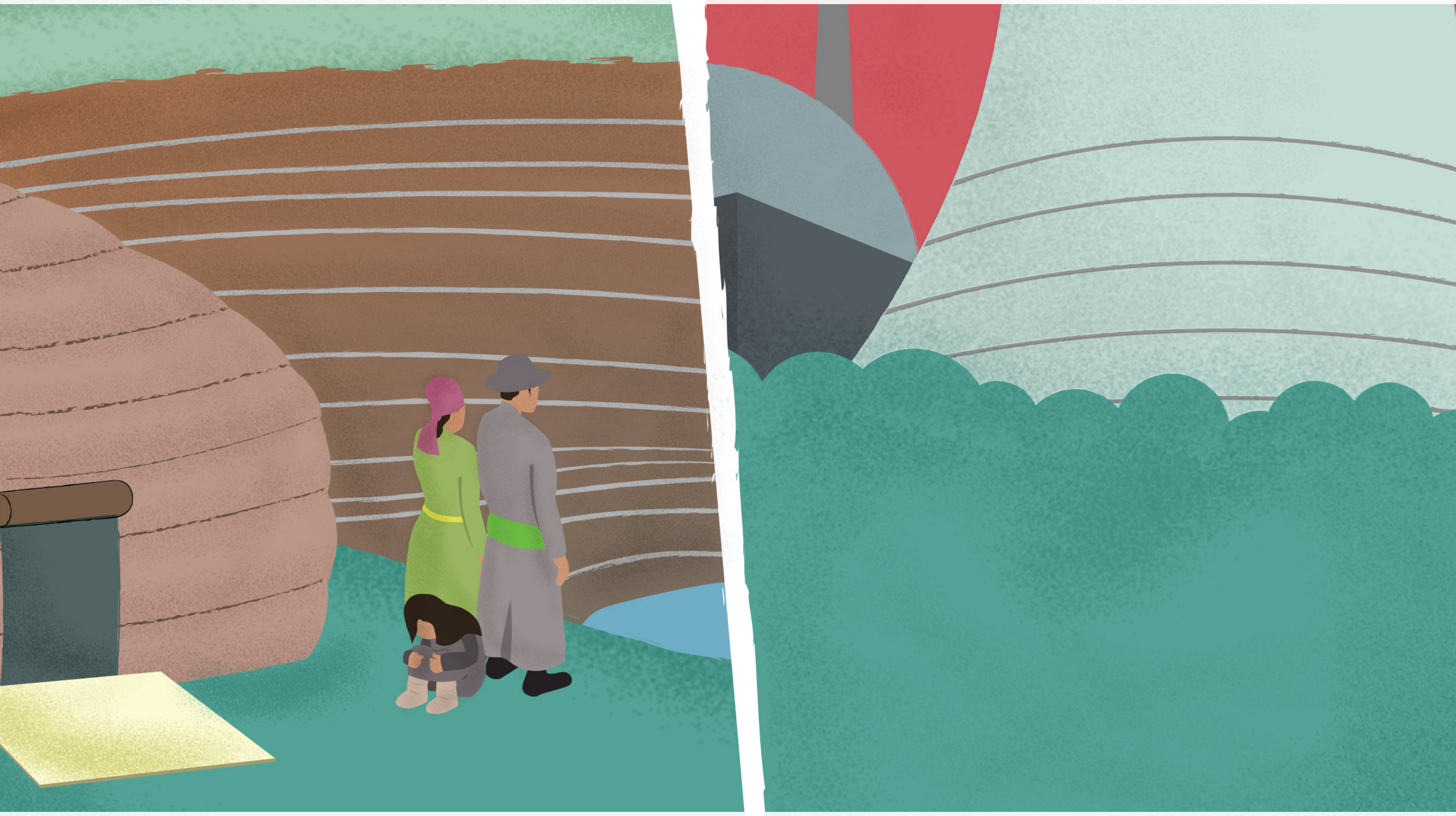
Mongolia's natural resources, burdening or benefiting democracy?

How energy democracy should come on a Mongolian horse or camel[1]



Both ENDS

Connecting people for change

Policy paper

Both ENDS strives for a socially just and sustainable world. To this end we support organizations in developing countries that are active in the areas of poverty alleviation and environmental management. These local organizations have in-depth knowledge of what the problems are and often come up with inspiring, sustainable solutions. We support them by providing information and mediation in funding, lobbying and networking.

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Summary

The European Union, the government of the Netherlands as well as other western governments and institutions have the ambition to help democratize the countries that belonged to the former Soviet Union. However, their policies over the last twenty-five years have failed to do so, and in many cases have even had the opposite effect. Economic self-interest and geostrategic considerations in practice take precedence over the mission of democratization.

Investments by the EU and the European Bank for Reconstruction and Development (EBRD) in the former Soviet countries are mostly focused on mining and large-scale infrastructure for the export of natural resources. International public banks and EU aid and trade treaties have imposed the liberalization of prices, opening of markets and privatization of state-owned enterprises in countries such as Russia, Ukraine and Mongolia, a country under former Soviet influence.

The European Commission and EU member states moreover concluded partnership agreements and other economic treaties related to trade, investment and taxation with these countries. In practice, these treaties serve to secure the cheap supply of raw materials and energy resources to the European markets, and to integrate the neighbouring region into a single energy market.[2]

The idea behind the opening of markets and privatization is to enable the private sector to generate growth that will benefit society as a whole. However, the market integration process in the former Soviet countries lacked an effective legal and decision-making framework. Ill-advised and ill-prepared efforts to change the system from 'socialism' to capitalism with political plurality have created the circumstances where large-scale investments in energy and extractives have come to erode the foundations of democracy. Today's energy and mining companies have close relationships with the political sphere and an oligarchy of a few rich 'businessmen – bureaucrats' has been established in Russia and other former Soviet countries as well as Mongolia.

The case of uranium mining in Mongolia illustrates the unintended repercussions of Western treaty policies for the democratic aspirations of this country. Mongolia used to be dominated politically and economically by the Soviet Union. In response to the aggressive open market politics of the development banks and the EU, Mongolia's uranium mining industries now tend to slide back into old dependencies on an autocratic Russian state and its oligarchy of rich businessmen. This paper gives special attention to the role that the Netherlands play in the quite aggressive treaty policies towards Mongolia.

Apart from the impact of ill-advised or sudden policy changes, the chosen concept of development itself can have major implications for a young democracy such as Mongolia. The economic and development policies that public banks like the EBRD and the EU imposed on the former Soviet countries fail to address the problems related to the scarcity of natural resources. While this was one of the underlying causes behind the collapse of the Soviet Union in 1991, the way in which scarcity of resources and the limits to economic growth are dealt with today again poses a risk to the democratization process in former Soviet countries.
The common responses to the problem of resource scarcity include the use of more efficient technologies, innovation in the industry, or the establishment of permit systems to limit extracting activities. New technologies and innovation, however, are expensive and demand the concentration of capital and economics of scale to lower costs. In practice, this leads to ever fewer companies dominating the energy market. If the EBRD and the EU are truly serious about their mission to finance a democratic transition in Eastern Europe and Central Asia, their priorities for energy lending should therefore be redefined. The current domination by a few multinational enterprises and rich oligarchs in the energy sector, with the accessory concentration of political interests, does not benefit democracy; instead, investments in decentralized, small-scale production systems and energy distribution networks could offer a more democratic option.

1. The impact of liberalization on former Soviet countries

Mikhail Gorbachev, the last president of the former Soviet Union, hoped to transform the Communist state into a social democracy based on the Scandinavian model: a free market economy with a multi-party democratic welfare state. However, his Perestroika[3], or economic reform program, did not achieve its goals and he was unable to prevent the disintegration of the country. In November 2014 it was twenty-five years ago that the Berlin Wall was dismantled, which heralded the collapse of the Soviet Union two years later in 1991. In the fifteen newly independent countries that were formed, a free market economy soon replaced the socialist economic model. The free market economy was seen as the best model to accommodate the people's desire to have access to consumer goods, which the Soviet Union earlier had failed to deliver, and to make the exploitation of natural resources most effective and efficient.

However, the fast integration of the newly independent states into the global free market economy has certainly not been a sole blessing.

The governments of the fifteen new countries were heavily indebted. In return for economic support, the International Monetary Fund (IMF) imposed austerity demands on many of the countries, including the lifting of price controls and the privatization of state companies and other public property.[4] The banks pushed the development of private ownership.

1. Economics versus ecology

The deeper cause for the Soviet Union's economic failure had to do with a resource problem and environmental degradation. With its mining industry the Soviet Union first was exhausting the natural resources in the easiest accessible regions rapidly and forced to move to regions with less favourable geological and economic conditions. As soon as the costs of extracting and transporting were to exceed the cost figure for opening up a new mine, the Soviet mine operator was tempted to move. To maintain levels of extraction it became necessary to dig deeper, to discover new deposits and to transfer to less favourable fields. The capital investment was growing as well as the environmental degradation.[13]

The current situation in Russia shows that more than twenty years after the falling apart of the Union, the same structural problems to do with the environment still haunt both countries. Despite the introduction of new technology and the free market economy, environmental degradation is going on as before or even got worse due to a surge in the level of exploitation. The 1972 Club of Rome study Limits to Growth already assumed that the ecological crisis phenomena are an equal treat to states belonging to different socio-economic systems. The Soviet Union was an industrial country like the US and the EU, and the fundamental contradiction between the economy and ecology exists in any industrial society.

In 1991, the European Bank for Reconstruction and Development (EBRD) was established. This public bank had the task to support the privatization of state companies and to invest in private enterprises in Eastern Europe and the former Soviet Union. From the very start, the United States position prevailed in the board of the EBRD, insisting that a majority of the Bank's capital was earmarked for private as opposed to public sector investment.[5] European Union aid was similarly conditional upon the privatization of state utility companies.

What have been the effects of these policies? Firstly, the forced privatization in countries that were lacking money led to a sell-out of state properties and assets mostly to foreigners. The EU's Tacis and Phare[6] aid programmes also played a role in this. According to trade unionist Jo Brew, contract lists indicate that the main beneficiaries of Tacis and Phare were western corporations that concluded joint ventures with former Russian state companies.[7] An oligarchy of wealthy Russian businessmen, who maintained close ties with the Kremlin, was the result.

Secondly, the economic transformation had a severe impact on people's lives and wellbeing. Noreena Hertz, author of The Silent Takeover,[8] worked for the International Finance Corporation, the private sector branch of the World Bank, at the time that the IFC was advising the Russian government on its economic reforms. Hertz observed that the chosen privatization process was politically motivated ('to get rid of the communists') and carried out with little consideration for the citizens of Russia:

"If Russia did do as it was told, if state-owned enterprises were privatized en masse as we were recommending, the social costs would be huge. What would happen, I asked my Washington bosses, when, under unbearable financial pressure, the factories I was spending time in had to lay off thousands of their employees? What would happen to the health care, the schools, the sanatoriums that these factories were providing – not just to their workers, but to the entire locality?"[9]

UNICEF calculated that between 1989 and 1993 in Russia, Ukraine, Bulgaria, Hungary and Poland together 800.000 people died as a consequence of the economic transition.[10] In Russia, life expectancy fell by 5 years between 1990 and 1994. Most of the country's assets ended up in the hands of a select few.

Thirdly, the opening up of the former Soviet Union to western markets has had severe impacts on the environment. While the deeper cause for the former Soviet Union's economic failure had to do with a resource problem and environmental degradation (see box 1), the newly independent countries came to serve as a resource base for the more advanced industrial countries of the West. Western mining companies, as said often in joint ventures with (former) state companies, accelerated the exploitation of mineral resources. Despite the fact that these modern mining companies invest in more effective and efficient extraction technologies, the environmental gains from technical efficiency and waste reduction are largely nullified by the surging level of exploitation. Resources are becoming ever less accessible and they will become dearer. In 2008, Russian Lukoil told the Wall Street Journal that $1 trillion would have to be spent on developing new oil reserves if current output levels were to be maintained.[11] In 2007, Der Spiegel reported that Russian Gazprom began production at the last major field and that tapping new reserves would involve huge and expensive technical difficulties.[12]

2. Mining uranium in Mongolia

The case of uranium mining in Mongolia illustrates the unmeant repercussions of the open market policies for Mongolia's democratic aspirations. The story about Mongolian uranium mining starts across the border in the town of Krasnokamensk in Russia.

The town Krasnokamensk in Russia, located close to both the Chinese and Mongolian borders, is not a place that many people will have heard of. Krasnokamensk was founded in the 1960s to house the miners and mining engineers who came to work in what developed into Priargunsky, one of the largest uranium mines in the world. At the time, the Soviet government was investing heavily in its nuclear industry. After the collapse of the Soviet Union in the 1990s, the investments in the mine and the uranium ore processing plant came to a halt. TEVL, the state company that owned the mine, no longer invested in its safety. The wages paid to the miners remained low, and the health risks for the workers high. In the surroundings of the mine, high levels of radon gas and uranium dust were measured as well as heavy metals such as mercury. Nuclear industry experts told the Moscow Times in 2005 that the profit-seeking behaviour of the state-owned company was no different from the practices of the Russian oligarchs.[14]

During the 1990s, uranium prices were low and few investors were keen to put money in the uranium mining industry. Part of the reason was that the release of materials from the Soviet Union's nuclear weapons program had caused a downward pressure on the prices. However, since 2006, the price of uranium is on the rise again due to a growing demand for nuclear fuel from, among others, China, India, South Korea and Finland. Currently, new investments by state company Atomredmetzoloto (ARMZ), formerly TEVL, are underway for the renovation and renewal of the Priargunsky mine and the town. There are plans to establish a new electricity grid, water facilities, a thermal power station, a motorway and an airport.[15]

With a view to increasing the processing levels of the uranium ore plant in Krasnokamensk, ARMZ in 2009 started showing interest in another uranium mine: the abandoned open-pit mine across the border, in Dornod province in Mongolia.[16] Between 1988 and 1995, Soviet and Russian companies had operated this mine and built a 'secret city', Mardai, to house 10,000 Russian engineers and workers. A 400 km long rail track connects the Mongolian mine with the uranium processing plant in Krasnokamensk.

At the time that ARMZ expressed its interest in the open-pit mine in Dornod, the rights to exploit the Mongolian mine were held by the Canadian company Khan Resources (58%), the ARMZ subsidiary Priargunsky Mining and Chemical Union (21%) and the Mongolian government (21%). However, in January 2009, Mongolia and Russia had announced their intention to form a new Mongolian-Russian joint venture to replace Khan Resources in mining the Dornod property. According to the website of Khan Resources, in July 2009, the Government of Mongolia promulgated its Nuclear Energy Law, which among other items, provided the State with 51% of the Dornod property without compensation to prior owners.[17]

According to the Mongolian government the new Nuclear Energy Law, which was endorsed by the Mongolian parliament, was meant to better regulate uranium mining in the country by granting the state more ownership of and control over uranium resources. The law stipulated that the government has the right to take ownership, without payment, of 51% of the shares of a mining project or joint venture if the uranium mineralization was discovered by a state-funded exploration.
Khan Resources claims that in response to the new ownership rules they first tried to renegotiate a diminished share in the joint venture it had with the Mongolian state company, but that this was frustrated by its Russian partner Priargunsky Mining. After suspending and then cancelling Khan's licences, the Mongolian government announced that it would develop Dornod in a joint venture with ARMZ, and would hold at least 51% of the new entity Dornod Uranium LLC. At that point, Khan Resources started an arbitration case against Mongolia and sued ARMZ at a Canadian court for US$ 326 million.

Up to the 1990s, Mongolia used to be dominated politically and economically by the Soviet Union. In the past five years Mongolia uranium mining industries appear to be sliding back into old dependencies on an autocratic Russian state and its oligarchy of rich businessmen. The following two sections show that this is partly due to aggressive open market politics of the international development banks and the EU. Mongolia of course has its own political choices to make, but the international policies have not helped Mongolia to create the enabling environment needed to prevent the current regression and to choose for its own independence.

3. The role of the Netherlands

The Netherlands indirectly plays a role in the conflict between Khan Resources and the Mongolian government. First of all, the Canadian Khan Resources is registered in the Netherlands as a Dutch company. It is one of many so-called 'letterbox companies' registered in the Netherlands. In order to attract foreign investment and to support Dutch companies in their business ventures abroad, the Dutch government has signed around 100 Bilateral Investment Treaties (BITs) with other nations, most of these developing countries. A similar network of bilateral agreements has been established in the field of taxation. In the eyes of developing countries like Mongolia, the main purpose of most of these tax treaties is to reduce the tax burden for foreign investors and transnational companies. The term 'letterbox companies' refers to companies that are registered in the Netherlands while they do not have any real economic activities in the country; the purpose of the company's legal presence in the Netherlands is to be able to make use of the Dutch bilateral tax agreements with third countries. In the last five years, the Netherlands faces growing international criticism about this practice and the multitude of letterbox companies that it is hosting.[18]

2. Investor-State Dispute Settlement (ISDS)

ISDS is an instrument of public international law that grants an investor the right to use dispute settlement proceedings against a foreign government. The alleged purpose of ISDS is to protect foreign investors from economic harm caused by host-government actions, including asset expropriation. Proponents argue that ISDS strengthens the rule of law. Sceptics argue that ISDS weakens the rule of law by bestowing special rights exclusively on foreign investors to circumvent domestic legal systems and win judgments against democratically elected governments. Provisions for ISDS are contained in a number of BITs and in international investment agreements such as the Energy Charter Treaty.

In the case of Khan Resources it means that the company, because it is registered in the Netherlands, can receive its dividends through its Dutch company, free of Mongolian tax. As a result, Mongolia stood to lose millions in tax revenue.

Secondly, there are several diplomatic ties and agreements between the Netherlands and Mongolia. In 1995, the Dutch and Mongolian governments signed an Agreement on Encouragement and Reciprocal Protection of Investments. This BIT was signed in the fashion of most BITs between a developed and developing country, that is, at the initiative of the former to secure protection of its investors.[19] The provisions in the BIT cover the common key features of such treaties: the protection of investment abroad, the promotion of market-friendly policies to support private investments, a notion of national treatment[20] and most-favored nation treatment[21], limitations to the expropriation of investments and provisions for payment of compensation in case of expropriation. Like most BITs, the treaty between Mongolia and the Netherlands contains the controversial Investor-State Dispute Settlement mechanism (ISDS)[22] that allows foreign investors to sue governments outside of the national legal system of the country where the investments are made (see box 2). Bilateral Investment Treaties are legally binding on their member countries and are enforceable under interaction law.[23]

In addition to the BIT, the governments of the Netherlands and Mongolia also signed a bilateral double taxation treaty in 2002. Under normal circumstances, Mongolia levies a 20% withholding tax on dividends paid by mine companies. The dual taxation agreement, however, allowed Dutch-registered firms to channel income from dividends, royalties and interest earned in Mongolia through their Dutch company without having to pay any withholding tax.[24] In 2011, Mongolia decided to cancel the double tax treaties, arguing that it would cost the country income from lucrative gold, copper and uranium mines.[25]

When Khan Resources lost its stake in the Mongolian uranium mine in 2010, the company decided to sue the state of Mongolia and filed an international arbitration against Mongolia under the Investor-State Dispute Settlement mechanism (ISDS) of the Energy Charter Treaty (ECT) (see box 3). This mechanism has been receiving growing public attention. Two of the best-known cases are the claims by the Swedish company Vattenfall against the state of Germany. In the first case, Vattenfall challenged environmental requirements for a coal-fired power plant in the city of Hamburg. While the details of the final settlement are not publicly known, it appears that the city of Hamburg was obliged to at least roll back some of the environmental requirements on the Swedish power plant.

The second case against Germany is still pending. Vattenvall has levied an investor-state claim at the ECT for at least US$ 1 billion against Germany for decisions aiming to phase out nuclear power following the 2011 Fukushima nuclear disaster.[26] Using its letterbox company in the Netherlands, Khan Resources followed the example of Vattenfall and sued Mongolia for US$ 326 million in compensation for losing its stake in the Dornod mine. The case is still pending.[27] In comparison, the Dutch government spent roughly € 13 million (US$ 17 million) on three aid programmes to Mongolia in 2009 and 2010.[28]

3. Energy Charter Treaty (ECT)

The energy Charter Treaty is one of the international trade agreements that contain provisions for ISDS (see box 2). In the early 1990s, the Netherlands initiated the negotiations for an energy agreement between the European Union and Central Europe and former Soviet Countries. The Energy Charter Treaty (ECT) and the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects were signed in 1994 and came into legal force in 1998. To date, the ECT has been signed or acceded by 52 states, the European Commission and Eurotom. Both the Netherlands and Mongolia are full members of the Charter. The ECT was meant to provide ‘a multilateral framework for energy trade, transit and investments’. In effect, it locks the treaty partners into a regulatory framework that serves to protect the direct foreign investments by Western European companies in mines and pipelines from counter-protectionist measures such as discrimination, expropriation, nationalization, breach of contract, or damages due to war.

4. International treaties sideline domestic policies

The complex conflict between Khan Resources and the Mongolian government illustrates the inherent tension between international trade and tax treaties and the democratic aspirations of developing countries like Mongolia. Khan Resources suspects, probably with reason, that Mongolia's Nuclear Energy Law was instrumental to the interests of ARMZ, on behalf of which the Russian government brought clout to the negotiation table. In 2009, then Prime Minister Putin and President Medvedev both visited Mongolia to discuss uranium mining. To sweeten the deal, Russia wrote off over 98% of Mongolia's debt.[29] On the other hand, Mongolia's expropriation of the uranium mine from Khan Resources can also be explained by the valid fact that the government tried to implement the wishes of the parliament.

Investment treaties that provide rights to extract natural resources may turn out in future arbitration to override domestic environmental laws that are meant to protect the lands and rivers that nomadic herders in Mongolia depend on for their livelihoods.

When it became clear that there was renewed interest in the Dornod mine that was abandoned in 1995, Mongolian herders expressed their concerns about the risk of environmental contamination that this would pose to their natural surroundings. In 2012, herders in Dornogovi sounded the alarm when cattle that had been grazing close to a uranium mine, then exploited by the French nuclear company Areva, suddenly died. Some sources suggest that leaked reports with test results by a veterinary agency revealed chronic poisoning by heavy metals and radioactive isotopes. Other sources say that the veterinary agency found no evidence of causality between the mining activities and the dead animals.

In 2009, the same year the Nuclear Energy Law was passed in Mongolia that triggered the dispute between Khan Resources and the Mongolian state at the ECT, the Mongolian parliament also adopted a 'Law to Prohibit Mineral Exploration and Mining Operations at the Headwaters of Rivers, Protected Zones of Water Reservoirs and Forested Areas'. The people in Mongolia call it 'the law with the long name'. It is the only significant Mongolian law protecting nomadic herders' traditional lands and watersheds against radioactive and chemical contamination and other environmental harm. Unfortunately the law has not been implemented or enforced and many protected lands have been mined regardless. This fact may signal that the Mongolian democracy is slipping into mere autocracy in which corporate interests prevail. Protests against an amendment to the law, which would result in major dilutions of the provisions, resulted in riots and the arrest of environmental activists, who heard long-term prison sentences issued against them.

The case of uranium mining in Mongolia illustrates the unmeant repercussions of Western treaty policies for Mongolia's democratic aspirations. Mongolia used to be dominated politically and economically by the Soviet Union. In response to the aggressive international investment agreements and tax treaties, however, Mongolia's uranium mining industry now appears to slide back into old dependencies on an autocratic Russian state and its oligarchy of rich businessmen. Moreover, Mongolia's uranium feeds the Russian nuclear industry, which from the perspective of democratization is a risk factor in itself. Apart from environmental risks and waste disposal problems, nuclear energy production requires a very expensive, highly secured and controlled centralization of energy production. This is bound to result in a concentration of power in oligarchies, in which nuclear industries and governments are intertwined, as is the case at ARMZ in Russia (and for example EDF in France, or TEPCO in Japan).

5. Recommendations: democratize energy

The immediate action of individual states and international institutions is required to prevent further negative implications of international agreements in the fields of trade, investment and tax policies for states like Mongolia and to implement energy policies that are more in tune with the objective of sustainable development. The history of free trade agreements, supported also by the Netherlands, reveals that the promotion of human rights and sustainable development goals remains occasional and limited to words on paper instead of orienting, as it should, the overall EBRD and EU action on trade and investment. This is unacceptable.
The EBRD writes in its political mandate that it assists 'only those countries committed to and applying the principles of multi-party democracy [and] pluralism'. Safeguarding the environment and a commitment to sustainable energy are also central to the Bank's mission. It is high time that this mission is translated to practice.

First, to truly support democratization, the EBRD and other public banks should divert their investments in developing countries from centralized, large energy infrastructure and export-oriented extractive industries towards the support for more democratic, sustainable and small-scale production systems as well as more democratic, effective and controllable distribution networks.1 Energy Democracy for Mongolia, Russia and the EU will come on a Mongolian horse or camel.

Secondly, The EBRD is one of the International Organizations with Observer Status at the Energy Charter Treaty. Together with the Netherlands and other EU governments, the Bank should strive to address the problem of letterbox companies filing Investor-State Dispute Settlement (ISDS) cases against countries such as Mongolia.

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20) The principle of giving others the same treatment as one's own nationals.

21) The principle of not discriminating between one's trading partners.

22) Ever since it was proposed to include the ISDS mechanism in EU trade agreements with the USA, Canada and Singapore, the issue has been high on the political agenda in Europe. See for instance http://www.bothends.org/en/News/newsitem/368/Juncker-against-controversial-dispute-settlement-mechanism-ISDS-as-part-of-EU-US-trade-agreement-TTIP and http://stopttip.net/investor-state-dispute-settlement-isds/ and http://www.foeeurope.org/isds

23) Law between different legal systems.

24) A withholding tax, also called a retention tax, is a government requirement for the payer of an item of income to withhold or deduct tax from the payment, and pay that tax to the government. In most jurisdictions, withholding tax applies to employment income. Many jurisdictions also require withholding tax on payments of interest or dividends.

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27) While little is know about arbitration procedure at the ECT some limited information can be found here on the ECT website http://www.encharter.org/index.php?id=533

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