



WILD GROWTH

AN ASSESSMENT OF ERDENES MONGOL

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JUNE 2019

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Key messages

- Erdenes Mongol is Mongolia's most influential state-owned mining enterprise. It was established in 2006 to represent the government of Mongolia's interests in strategic mines, manage mineral licenses and promote the mining sector.
- In recent years Erdenes Mongol has evolved into a complex conglomerate with interests in many sectors, including unconventional oil and gas, roads, hospitality, power generation, steel, and asset management. The company's expansion represents an implicit government choice to invest in specific sectors rather than others, such as education, healthcare or renewable energy.
- Erdenes Mongol does not publish financial information on most of its subsidiaries and joint ventures. However, many are unprofitable. Those that are profitable, such as the Tavan Tolgoi coal project, have yet to pay any dividends to the state treasury.
- The Government of Mongolia may wish to consider several reforms, such as: (1) Enacting a new state-owned enterprise or Erdenes Mongol-specific law; (2) Clarifying the company's financial and governance relationship with subsidiaries; (3) Performing project-by-project market assessments in order to determine which assets to purchase and sell; (4) Developing clear criteria and an open process for appointment and dismissal of board members and managers; and, (5) Requiring greater public disclosures and audits, especially of subsidiaries and joint ventures.

Abbreviations

ADB	Asian Development Bank	LLC	Limited liability company
CEO	Chief executive officer	MNT	Mongolian tugrik
EITI	Extractive Industries Transparency Initiative	NRGI	Natural Resource Governance Institute
EM	Erdenes Mongol	OECD	Organization for Economic Co-operation and Development
EOT	Erdenes Oyu Tolgoi	OT	Oyu Tolgoi
ETT	Erdenes Tavan Tolgoi	SIMD	Strategically important mineral deposit
FHF	Future Heritage Fund	SOE	State-owned enterprise
HDF	Human Development Fund	TT	Tavan Tolgoi
IFC	International Finance Corporation	USD	United States dollar
JSC	Joint stock company	WB	World Bank
LIBOR	London interbank offered rate		

Executive summary

Erdenes Mongol is a multi-faceted state-owned enterprise. The Mongolian government nominally established Erdenes Mongol in 2006 as a holding company to represent its interest in strategic mines, manage mineral licenses, and promote the mining sector. It has since evolved into a complex company with interests not only in mining but also mineral processing, unconventional oil and gas, roads, border crossing facilities, hotels, restaurants, power generation, engine repair, steel, trade promotion and asset management.

Still, its core activities are in holding shares and operating several of Mongolia's largest mines. These include the Oyu Tolgoi gold-copper mine

(in which Erdenes Mongol holds 34 percent ownership), the Tavan Tolgoi coal mine (65 percent), the Shivee-Ovoo coal mine (90 percent) and the Baganuur coal mine (75 percent). The company also operates or has stakes in gold, silver and uranium exploration companies.

Erdenes Mongol valued its assets at approximately MNT 9.36 trillion (USD 3.9 billion) as of end-2017, 82.5 percent of which is attributable to the company's Tavan Tolgoi coal mine shares. There are other large government owned mines, such as the Erdenet copper and molybdenum mine and the Bor-Undur fluorspar mine, which are managed by separate state-owned enterprises.

State equity in strategic mineral deposits seemed a more lucrative proposition before the financial crisis and commodity price crash of 2008 and 2009. Mineral price volatility and lower medium-term prices in recent years have dampened excitement among mining sector investors. As a result, the company's payments to government have proven weaker than expected. Weighted by ownership share, Erdenes Mongol's segment of Tavan Tolgoi, Oyu Tolgoi, Shivee-Ovoo and Baganuur as well as the parent company paid only MNT 317 billion (USD 130 million) to the government in taxes, royalties and fees in 2017. Erdenes Mongol has also struggled to attract private investment in its mining assets, which is one of its mandates.

While Erdenes Mongol and its subsidiaries do not publish disaggregated cost information that would be useful for financial analysis, and most of its subsidiaries do not publish any financial information, available data indicate that the company's revenues have been inadequate to cover its costs. As a result, Erdenes Mongol has often required government support from public entities such as the Development Bank of Mongolia. As of the end of 2017, Erdenes Mongol was responsible for MNT 877 billion (USD 361 million) in liabilities for the parent company, Tavan Tolgoi, Shivee-Ovoo and Baganuur.

The company is also relatively illiquid. The four entities for which we have financial information—the parent company and three subsidiaries, Erdenes Tavan Tolgoi, Shivee-Ovoo and Baganuur—held a total of MNT 72 billion (USD 30 million) in cash belonging to Erdenes Mongol as of the end of 2017.

From its founding in 2006 until 2015, Erdenes Mongol had not reported any profits. Today, the company is producing a profit for the first time: it declared profits of MNT 41 billion (USD 16.3 million) over three years, 2016 to 2018. The recent

increase in coal prices and increased shipment of coal to China from Tavan Tolgoi explain much of the improvement in profitability.

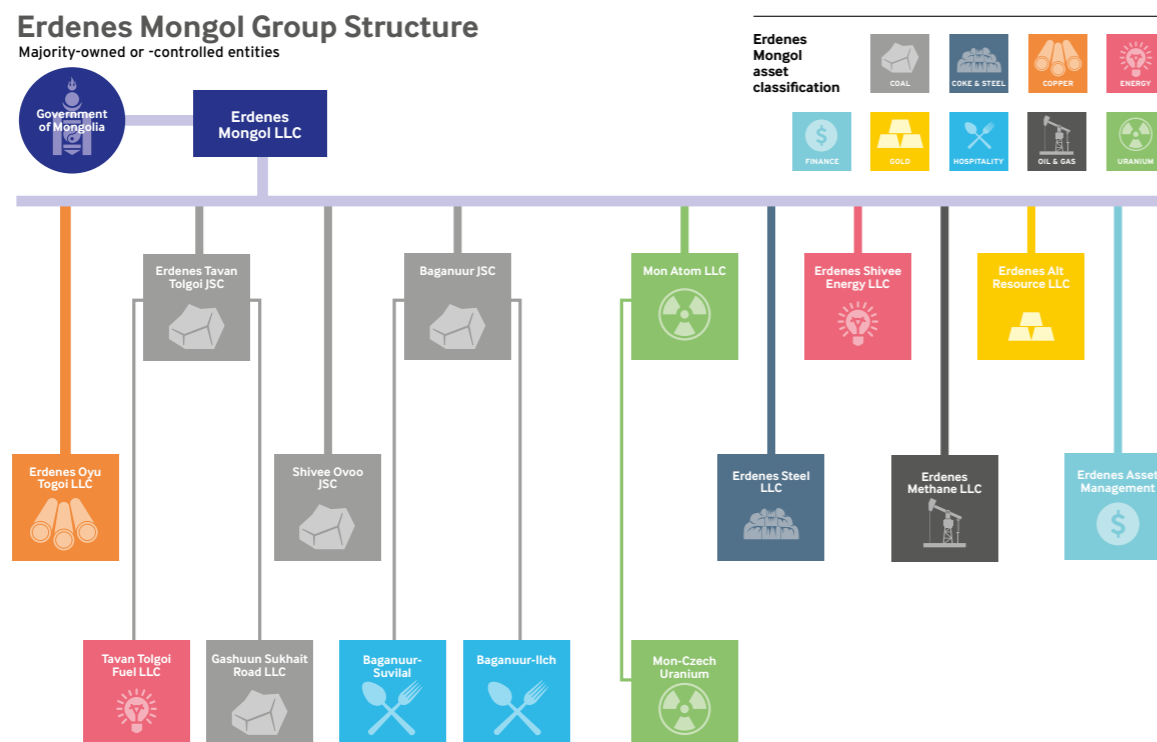
Despite an increase in overall profitability, Erdenes Mongol and its subsidiaries still do not pay regular dividends to the Mongolian treasury. In comparison, most other regional state-owned mining companies such as China's Shenhua Energy, Coal India and Indonesia's Antam regularly pay 30 to 100 percent of their profits to the state treasury as a dividend, which can amount to hundreds of millions or even billions of dollars each year.

Until Erdenes Mongol begins collecting dividends from Oyu Tolgoi around 2035, these improvements in profitability are conditional on coal prices remaining at current levels or above. Reforms are needed to transform Erdenes Mongol into a successful company that generates value for the Mongolian government under modest price scenarios. We propose reforms in four categories: mandate; corporate restructuring; governance and human resources; and transparency and oversight.

MANDATE

Erdenes Mongol's mandate—and more broadly the government's role in the mining sector—have never been clearly defined. Though there is political consensus that benefits from mining have been inadequate to date, there seems to be little analysis or discussion among policymakers on the role of the state versus the private sector in managing strategic mines.

As a result, Erdenes Mongol's expansion and evolution has been a product of organic growth, unencumbered by a strict legislative framework. The company has established new subsidiaries operating in sectors of the economy that require varying skills and expertise.



At the same time, there is no explicit vision on how and under what timeline the company will fulfill its mandate. Policymaking inconsistency has been exacerbated by high levels of turnover at the board and among senior managers, which has coincided with political changes such as elections.

To promote more streamlined government intervention in the mining sector, and to ensure that Erdenes Mongol's commercial decisions provide value-for-money for the Mongolian government, we suggest either a specific law covering Erdenes Mongol or one that covers all state-owned enterprises (SOEs). While legislation is being developed, Government of Mongolia could release a clear policy or resolution that improves Erdenes Mongol governance.

To begin, a mining SOE policy should identify clear goals and performance targets for Erdenes Mongol. An Erdenes Mongol-specific law or an SOE law could include the following elements: mandate and definition; strategic plans; non-commercial activities; shareholding; dividend policy; state liability; sale of assets and equity; role of parliament; role and tenure of management; board of directors; code of conduct; accounting; reporting; and auditing.

CORPORATE RESTRUCTURING

At this time, we do not recommend full or partial privatization of Erdenes Mongol. Erdenes Mongol is largely a holding company rather than a mine operator itself, though many of its subsidiaries are operational entities. As such, more than a company in the traditional sense, it is a body meant to serve the Mongolian government's industrial policy, namely to promote the mining sector and manage the state's mining interests on behalf of the government. This mandate could not be served

were Erdenes Mongol a private company.

However, we do recommend subsidiary-by-subsidiary and project-by-project assessments based on commercial viability, need for financing and/or technological expertise and strategic importance, among other factors, to determine whether asset sales or joint ventures may be appropriate. This would also allow Erdenes Mongol to restructure in a manner that ensures that its corporate structure reflects its mandate. It would also encourage subsidiaries to become more profitable.

Erdenes Mongol's relationship with its subsidiaries could also be clarified. At the moment, Erdenes Mongol can expand the sectors and activities in which it operates with ease, generally by establishing new subsidiaries or joint ventures. Recent examples include the establishment of Erdenes Ashid, Erdenes Asset Management, Erdenes Methane and Erdenes Gold Resources. These entities can become government budget liabilities should they take on debts or other financial obligations or if they are used to transfer commercial risk from private sector partners to the public sector. They also risk becoming sources of patronage and divert scarce resources away from key budget priorities such as healthcare, education and productive infrastructure. Thus, as part of its clarified mandate, Erdenes Mongol could define a clear policy for establishing new subsidiaries, for example by limiting subsidiaries or joint ventures to specific activities or sectors and providing due diligence for any prospective commercial undertaking.

GOVERNANCE AND HUMAN RESOURCES

Erdenes Mongol has many of the key institutions necessary for good governance, including a board, subsidiary boards, a clear management structure, audit committee and shareholding structure.

At the same time, boards and management of Erdenes Mongol seem politicized given frequent turnover after each election. Criteria for senior appointments remain unclear.

In order to promote integrity and professionalism at the board and senior management levels, we recommend developing clear criteria for appointment of board members and managers. We also recommend an open appointment process, including posting positions and using pre-qualification of applicants and objective hiring criteria. Independent external hiring firms could support this process.

Financial and non-financial performance incentives for senior managers could also be considered. For example, promotions and bonuses could be dependent on meeting performance indicators or passing strict management assessments. Our suggestion is that, should this option be considered, it should be implemented only after SOE transparency and oversight reforms have been enacted.

TRANSPARENCY AND OVERSIGHT

Erdenes Mongol and its subsidiary Baganuur JSC took significant steps towards transparency in 2018 with the production of semi-annual and annual reports, as well as publishing of the audit report by the National Audit Office. While the

National Audit Office audits Erdenes Mongol annually, oversight could be strengthened by enhancing parliament's role in publicly overseeing the company and its subsidiaries and by subjecting financial statements to independent external audit.

Notwithstanding the progress, the information made available does not yet meet international reporting standards for SOEs and does not provide sufficient information for assessing company or subsidiary performance. Most importantly, financial information on revenues, expenditures, profits, assets, liabilities and activities is only available for some subsidiaries, and is not sufficiently disaggregated for financial analysis. Thus, it is nearly impossible for parliament, the media or the public to measure performance of Erdenes Mongol projects in order to suggest ways to improve governance and overall profitability. Many of Erdenes Mongol's operations remain shrouded in secrecy.

We recommend that Erdenes Mongol build on its recent successes by following the path set by SOEs such as Chile's Codelco, China's Shenhua Energy and Zijin Mining, Colombia's Ecopetrol, India's ONGC, the Philippines' PNOC and Zambia's ZCCM-IH in disclosing greater information on their finances and activities. Financial statements should also comply with international financial accounting standards.

Methodology

In preparing this report, the authors carried out desktop research to look at Erdenes Mongol and its subsidiaries, including relevant laws and policies, government and parliamentary resolutions and government reports. Researchers also reviewed an extensive range of papers and reports on the mining sector of Mongolia and related subject matter. This included studies and assessments from major international and local organizations active in shaping mining policy globally and in Mongolia such as the World Bank, Chatham House, Organization for Economic Cooperation and Development (OECD), Extractive Industries Transparency Initiative (EITI), Natural Resource Governance Institute (NRGI), and the Open Society Forum.¹

The research used methodologies and tools developed for assessing the governance of SOEs including the Natural Resource Charter Benchmarking Framework, the OECD guidelines relevant to the governance of SOEs, and International Monetary Fund (IMF)'s Fiscal Transparency Code to inform our analysis.²

Researchers developed a research questionnaire, based on the above-referenced documents, to collect

primary and secondary data. The questionnaire aimed to obtain information on various aspects of Erdenes Mongol, including its remit, corporate governance, reporting arrangements, decision making procedures, meetings, personnel policies, procurement, commercial contracts and finance and budgeting rules. Following meetings with Erdenes Mongol senior management, the questionnaire was sent to Erdenes Mongol and its subsidiaries. When most of the companies failed to answer and return the questionnaires, a researcher conducted personal interviews with key officers at Erdenes Mongol and one of its subsidiaries, Erdenes Tavan Tolgoi.

In addition, interviews were conducted with other stakeholders including independent researchers, former executives at SOEs, international experts, government employees and private sector representatives. These interviews allowed the researchers to better understand the context in which Erdenes Mongol operates and different perspectives on the company's governance and practices as well as expectations for the company by various stakeholders.

1. Introduction

Erdenes Mongol is a Mongolian government-owned holding company established in 2006 to manage the Mongolian government's interests in the country's strategic mineral deposits.

Since 1990, Mongolia has transformed from a centrally-planned economy and a single-party authoritarian regime to a free market economy and a multi-party parliamentary democracy. The government launched the first of several privatization programs in mid-1991 and by 1994 over 4,500 state-owned entities in various sectors had been transferred into private ownership.³ By 2006, around 70 percent of Mongolia's GDP was generated by the private sector.⁴

The privatization programs affected the mining sector, but in a more limited way than many other sectors. The government retained major SOEs in the energy, mining and transportation sectors including power plants, a national airline, a railway, power stations and large coal, fluorspar, copper and gold mines. However, the government had few resources to invest in mineral exploration, so private involvement in the sector expanded.

Despite this strong privatization trend, Erdenes Mongol was established and has grown into a large and complex organization with many subsidiaries

covering diverse sectors. Erdenes Mongol itself employed only 77 permanent staff members as of 2017, but the organization including subsidiaries employs over 2,500 people.⁵

In 2017, NRGi produced an assessment of 74 SOEs in 68 countries as part of its Resource Governance Index. Erdenes Mongol scored just 40 of 100 in this assessment, placing it in the "poor" performing category. Erdenes Mongol's governance was the weakest component of overall natural resource governance in Mongolia.⁶

This report assesses the evolution, structure and activities of Erdenes Mongol based on publicly available data and interviews. Chapter 2 provides an overview of the growth of Erdenes Mongol from its foundation and summarizes available information on a number of important issues for SOE governance: the mandate of the company; its relationship with its subsidiaries; its relationship with the government; corporate governance structures; financial information; and overall transparency. Chapter 3 considers some of the challenges facing the Erdenes Mongol group. The final chapter makes a set of recommendations on how the company can improve its governance and thereby its value to the government and people of Mongolia.

1 Open Knowledge Repository, Corporate Governance of State-Owned Enterprises – A Toolkit, openknowledge.worldbank.org/handle/10986/20390; Chatham House, Good Governance of the National Petroleum Sector, www.chathamhouse.org/publications/papers/view/108469; Organization for Economic Cooperation and Development, Guidelines on Corporate Governance of State Owned Enterprises: <http://www.oecd.org/corporate/guidelines-corporate-governance-soes.htm>; Extractive Industries Transparency Initiative, Guidance note 18 on SOE participation in EITI reporting, <https://eiti.org/GN18>; Natural Resource Governance Institute, Guide to Extractive Sector State Owned Enterprise Disclosures, <https://resourcegovernance.org/analysis-tools/publications/guide-to-extractive-sector-state-owned-enterprise-disclosures>; Open Society Forum, Governance assessment of state-owned and state-owned mining companies, http://forum.mn/index.php?sel=resource&f=resone&obj_id=993&menu_id=3&resmenu_id=5

2 Natural Resource Charter Benchmarking Framework: www.resourcegovernance.org/analysis-tools/tools/natural-resource-charter-benchmarking-framework; OECD, Guidelines on Corporate Governance; International Monetary Fund, Fiscal Transparency Code, <https://www.imf.org/external/np/fad/trans/Code2019.pdf>

3 Władysław Jermakowicz and Piotr Kozarzewski. Privatization in Mongolia (Center for Social and Economic Research, 1997), www.case-research.eu/sites/default/files/publications/9042285_103_0.pdf.

4 World Bank, Creation of Jobs Conducive to Investments, Assessment of Investment Environment and Study of Trade Integrity (2006), VI, siteresources.worldbank.org/MONGOLIAINMONGOLIANEXTN/Resources/Mongolia_ICA_DTIS_SCS_ES_TM_mon.pdf.

5 Erdenes Mongol, 2017 Annual Report (2018), www.erdenesmongol.mn/index.php?view=download&type=item&val=25.

6 Natural Resource Governance Institute, 2017 Resource Governance Index, resourcegovernanceindex.org/.

2. Overview of Erdenes Mongol Group

THE ORIGINS OF ERDENES MONGOL

Private sector investment in the Mongolian mining sector boomed following attractive new investment policies adopted by the government in the late 1990s and the discovery of valuable deposits, including gold and copper. Many multinational mining companies entered Mongolia at this time.

The sharp increase in commodity prices during the early 2000s raised public expectations and scrutiny of mining operations. Mongolians became increasingly concerned about the negative environmental impacts of extraction and the perceived lack of real benefits from the sector. One mine in particular raised public concern: the Oyu Tolgoi copper and gold mine, which was discovered in 2001 by a Canadian mining company, Ivanhoe Mines.⁷

Located in Southern Gobi Region of Mongolia, 80km north of the Chinese border, Oyu Tolgoi is one of the world's largest copper-gold deposits, estimated to hold over 35 million tons of copper and 1,275 tons of gold.⁸ In early 2005, the Chairman of the Ivanhoe Mines, Robert Friedland, made a speech at an investor conference in the US in which he said that Ivanhoe would make huge profits from the mine.⁹ The speech was circulated in Mongolia and Friedland's comments were taken to imply that the benefits would flow largely to his company and not to Mongolia.

In response to rising public protests and demonstrations against foreign miners, fueled by statements like those of Robert Friedland, the Mongolian government made a number of legal changes aimed at securing greater benefits from mining. These included increased taxes on mining companies and new laws and regulations aimed at increasing state ownership in major natural resource projects. For instance, in 2006, the government introduced a Windfall Profits Tax on gold and copper producers set at 68 percent and applied to a base that allowed only partial deduction of costs. This tax was viewed by industry analysts as a major impediment to new investments until it was repealed in 2009.¹⁰

Another key reform was the revised Minerals Law of 2006, which allowed the government to acquire equity stakes in "strategically important mineral deposits" (SIMDs). SIMDs are defined as deposits that can have significant impact on the national security, economy and social development of the country, or deposits that do, or could, contribute more than 5 percent of GDP.¹¹ A list of SIMDs is provided in Annex 1.

With this development, the government could own up to 34 percent of the shares in a given SIMD project if the mineral deposit was discovered using private funds, and up to 50 percent of the shares if the mineral deposit was discovered through state funded exploration and the project would be operated jointly by the state and a private entity.

The exact percentage of shares and the parameters for how the equity holders would finance the investment needs of any given project would be set through a mining contract.

It was against this backdrop that, in 2006, the government established Erdenes MGL (later renamed Erdenes Mongol) as a state-owned holding company to represent the government interests in SIMDs, manage mineral licenses, and develop mining deposits explored with state funds.

LEGAL FRAMEWORK

The legal framework under which Erdenes Mongol was set up and has subsequently operated has changed over time, which partially explains how the structure and function of the company has evolved.

Erdenes Mongol was originally brought into existence as a result of two government resolutions

(Government Resolution no. 266, dated 15 November 2006, and the State Property Committee Resolution no.52, dated 22 February 2007) that were based on Mongolia's Law on State and Local Property. (See Box 1.) These resolutions instructed relevant government bodies "to establish a state-owned company with the purpose of owning and managing exploration and mining licenses of SIMDs and of the mineral deposits for which reserves were determined through state funded exploration."¹²

As a company established within the parameters of the Law on State and Local Property, Erdenes Mongol was initially viewed more as a public sector agency than a commercial entity.¹³

The legal framework governing Erdenes Mongol evolved in 2009 with the introduction of the Human Development Fund Law. This law stipulated that an unnamed state-owned entity

Box 1. Legal framework for companies in Mongolia

Different legislation in Mongolia allows the state to own different types of businesses. Technically, the term 'state-owned enterprise' refers to enterprises that are either fully funded by the state budget, or operate on a 'self-financing principle,' and legally they are not considered 'companies.' The state can also own "companies," which are governed by company law, are established as either joint stock companies (JSC) or limited liability companies (LLCs), and can be either (fully or partially) state-owned or private. The company law regulates issues concerning the operations of companies,

issues related to shareholders and boards of directors, including appointment of executives and board members, activities of the board committees and the board secretariat, as well as shareholder and board meetings.

The Law on State and Local Property regulates the actual establishment of SOEs and the state representation in these entities. This law covers the issue of ownership rights of state and local property, including state-owned enterprises.

7 Charles Krusekopf. State Ownership and the Development of Natural Resources in Mongolia (American Center for Mongolian Studies, 2014), 5-6, sites.socialsciences.manoa.hawaii.edu/css/demr2015/_papers/krusekopf-charles.pdf.

8 Asel Isakova, Alexander Plekhanov and Jeromin Zettelmeyer. Managing Mongolia's Resource Boom (European Bank for Reconstruction and Development, 2012).

9 Patrick Barta. Mongolia Is Roiled by Miner's Huge Plans (Yale Global Online, 2007), yaleglobal.yale.edu/content/mongolia-roiled-miners-huge-plans.

10 Financial Times, Mongolian Mining Industry Protests Tax, 16 May 2016, www.ft.com/content/0e497490-e4f1-11da-80de-0000779e2340.

11 Parliament of Mongolia, Law of Mongolia on Minerals, Article 4.1.12, www.legalinfo.mn/law/details/63?lawid=63.

12 Government of Mongolia, Resolution 266 (2006), www.legalinfo.mn/law/details/4130?lawid=4130.

13 Asian Development Bank, Mongolia: Erdenes Mongol LLC Strengthening Institutional Framework and Management Capacity (2016), www.adb.org/sites/default/files/project-document/182379/49409-001-pam.pdf.



Mongolian State Great Hural

(which in practice was Erdenes Mongol) would be the main source of revenue to the (now-defunct) Human Development Fund (HDF), an extra-budgetary fund designed to help Mongolian citizens benefit from the mineral wealth of the country.¹⁴ The HDF law also regulated Erdenes Mongol's management structure and composition, allowed the government to appoint the leadership and senior employees and approve operational decisions at Erdenes Mongol.

The Mongolian parliament amended the HDF law in January 2016, removing several articles concerning Erdenes Mongol, and subsequently replaced the HDF law with the Future Heritage Fund law.¹⁵ These changes, amongst other things, led to an amendment of the Charter of Erdenes Mongol, which had originally been based on the State and Local Property Law.¹⁶

A new Charter for Erdenes Mongol, based on Company Law, came into force on 15 February 2016 (through Government Decree No. 104).¹⁷ This change had far-reaching consequences for the mandate of the company, as discussed in the next section.

SHIFTING OBJECTIVES

Erdenes Mongol's mandate has evolved over time, and not always in a coherent manner. As mentioned above, the key mandate of the company is to represent the state ownership in SIMDs. The resolution that established Erdenes Mongol mandated it to provide advisory services on the valuation of mineral reserves and the selling of state shares in SOEs.¹⁸

Erdenes Mongol was established to be a holding company. As such, it created subsidiaries and joint

ventures as the mechanisms by which it represents the state's interests in SIMDs, for instance by participating in board meetings and collecting dividends from mining projects.

The changes to the legal framework underpinning Erdenes Mongol, described in the previous section, played a key role in the evolution of the company's mandate. The 2009 HDF law linked Erdenes Mongol's operations directly to a sovereign wealth fund (the Human Development Fund) that was intended to fund cash payments and health and social insurance for citizens. One of the implications of this function was that Erdenes Mongol transferred payments it received to the HDF rather than paying them to the state budget or using them for reinvestment.

In addition, the HDF law gave the government a broadly defined role in the management of Erdenes Mongol. The level of government involvement in the company led to concerns about bureaucratic and inefficient decision-making. The government, recognizing this as a problem, attempted to increase Erdenes Mongol's independence by expanding the scope of the company's authority. For example, Resolution no.133 of 2014 gave Erdenes Mongol's board of directors the right to invest or divest in a range of companies.¹⁹ Under the State and Local Property Law, establishing subsidiaries requires a cabinet decision, but in 2014 the government delegated this right to Erdenes Mongol's directors, simplifying the establishment of subsidiaries.

These government actions paved the way for Erdenes Mongol to hold shares not just in SIMDs or mining companies but also in companies involved in other sectors, and thereby expand its mandate through new entities. (This issue is discussed

further in Chapter 3.) Furthermore, when the HDF law was replaced in 2016, and Erdenes Mongol adopted a new charter, its options for expansion, both for its business and its mandate, increased. The charter gave the company new capabilities, including allowing the company to retain dividends and certain revenues, such as advance payments from partners or buyers, which had previously been transferred to the HDF. It also allowed the company to reduce the number of government-appointed board members, gave the board greater power over senior management appointments and reduced direct parliamentary oversight.

Erdenes Mongol's bylaws, which came into force under the same 2016 government resolution that established the Charter, include the following roles for the company:

- Holding state shares and managing SOEs, especially holding SIMDs
- Exploration and exploitation of deposits
- Possession and administration of licenses and other property
- Mobilization of finances, and managing of investments and other assets
- Commodity sales and trading
- Advisory services related to feasibility studies and mineral reserves valuation, listing of companies on stock exchanges (initial public offering, or IPOs), and public relations work related to the industry
- Mining infrastructure development and management

14 Alicia Campi. Mongolia's Quest to Balance Human Development in its Booming Mineral-Based Economy, (Brookings Institution, 2012), www.brookings.edu/opinions/mongolias-quest-to-balance-human-development-in-its-booming-mineral-based-economy/.

15 Extractive Industries Transparency Institute, Mongolia Extractive Industries Transparency Initiative Reconciliation Report 2016, eiti.org/sites/default/files/documents/2016_m_eiti_report_final_english.pdf.

16 Asian Development Bank, Mongolia: Erdenes Mongol LLC Strengthening Institutional Framework and Management Capacity (2016), www.adb.org/sites/default/files/project-document/182379/49409-001-pam.pdf.

17 Government of Mongolia, Resolution 104 (2016), legalinfo.mn/law/details/11796?lawid=11796.

18 Government of Mongolia, Resolution 266 (2006), <https://www.legalinfo.mn/law/details/4130?lawid=4130>.

19 Government of Mongolia, Resolution No. 133 (2014), <https://www.legalinfo.mn/law/details/10312?lawid=10312>.



Oyu Tolgoi copper-gold mine

The scope of activity listed in these bylaws encompasses a range of commercial and state functions. For example, Erdenes Mongol's advisory services role includes regulatory and public relations functions, while the bylaws also envisage the company being an operator of mines through its subsidiaries, and not only a passive investor. In fact, the company explicitly states in its bylaws that it can engage in any other types of activities that are not explicitly prohibited by law.

CORPORATE STRUCTURE

The evolving mandate of Erdenes Mongol has allowed it to establish numerous subsidiaries and purchase of ownership stakes in many mining and non-mining projects. Figure 1 describes the majority-owned or controlled subsidiaries of Erdenes Mongol. Initially, the company focused on its core mandate of managing SIMDs on behalf of the government. The first project in which Erdenes Mongol became involved was the Oyu Tolgoi copper and gold project. Erdenes Mongol established a subsidiary, Erdenes Oyu Tolgoi, to manage its equity and board participation in this

project. Erdenes Oyu Tolgoi holds 34 percent in Oyu Tolgoi LLC, the company that holds licenses for the Oyu Tolgoi deposit. Turquoise Hill Resources (formerly Ivanhoe Mines), which is in turn majority-held by Rio Tinto, owns the remaining 66 percent. In 2017, Oyu Tolgoi produced 722.5 thousand tons of concentrate that contained about 160 thousand tons of copper, 3.6 tons of gold and 30.3 tons of silver. This accounts for approximately 60 percent of copper concentrate production in Mongolia.²⁰

The government's 34 percent share is financed through a carried interest arrangement with Turquoise Hill Resources, with recourse to future dividends payable to the government. According to an independent assessment of the financial agreement between the Government of Mongolia and Turquoise Hill Resources, the principal and interest paid by Erdenes Oyu Tolgoi to its private sector partner on its carried interest portion will postpone collection of returns on equity until at least 2035. Using current prices and assumptions, the net present value of these dividends is approximately USD 200 million over the lifespan

²⁰ According to the Mineral Resources and Petroleum Agency of Mongolia, Mongolia produced 1.3 million tons of copper concentrate in 2017. Mineral Resources and Petroleum Agency of Mongolia, Statistical Bulletin 2017, www.mrpam.gov.mn/public/pages/83/monthlyreport2017final.pdf; Oyu Tolgoi production data is available at finance.yahoo.com/news/turquoise-hill-announces-fourth-quarter-211500474.html.



Tavan Tolgoi coal mine

of the mine. However, dividends could reasonably range from nothing to USD 900 million.²¹ While Erdenes Oyu Tolgoi is not generating dividends for Erdenes Mongol now, it may in the future.

The next mining project with which Erdenes Mongol became involved was the Tavan Tolgoi coal deposit. Again, Erdenes Mongol set up a subsidiary, Erdenes Tavan Tolgoi, to manage its investment.²² Erdenes Tavan Tolgoi received four out of five licenses for the massive Tavan Tolgoi deposit of coking coal.²³

Two other companies operating key coal deposits that supply power plants in Ulaanbaatar, and were thus considered SIMDs, were transferred to Erdenes Mongol in 2013. These are Baganuur and Shivee Ovoo, which are both joint stock companies whose minority shares, 25 percent and 10 percent respectively, were privatized on the Mongolian Stock Exchange in the mid-1990s. Another 21.6 percent of Baganuur belongs to the Mongolian National Coal Corporation. In 2017, Baganuur and Shivee Ovoo, produced about six

million tons of coal, providing about 90 percent of the demand by power plants in Mongolia.

Baganuur produces about four million tons of coal annually and employs more than 1100 people. The company produced one ton of coal which cost MNT 28,500 in 2017, and sold the coal for MNT 31,381, with margins of less than one percent. The company accumulated a significant number of receivables mainly from power plants it supplies with coal, and subsequently was not able to fulfill its financial obligations to its suppliers, employees, and tax and social insurance authorities, accumulating MNT 85.9 billion in short-term liabilities by the end of 2017.

Shivee Ovoo provides approximately 30 percent of the coal needed for domestic energy production. The coal is sold to state owned power plants at below market prices as per regulations. As a result, the company does not make a profit and has in fact accumulated debts in excess of MNT 100 billion. Both mines are major employers in their respective regions.

²¹ OpenOil, Oyu Tolgoi Financial Model (2016), openoil.net/wp/wp-content/uploads/2016/10/Oyu-Tolgoi-Project-Fiscal-Model-Narrative-Report.pdf.

²² Erdenes Tavan Tolgoi later distributed parts of its shares (14.8 percent) to each and every citizen of Mongolia, to a group of national companies (0.05 percent), and the government's shares account to 65.2 percent. The other 20 percent of the company shares are not registered under any entity as the government intends to offer this part of shares in a planned IPO.

²³ Source Watch, Tavan Tolgoi Coal Project, www.sourcewatch.org/index.php/Tavan_Tolgoi_coal_deposit.

Erdenes Mongol Group Structure

Majority-owned or -controlled entities

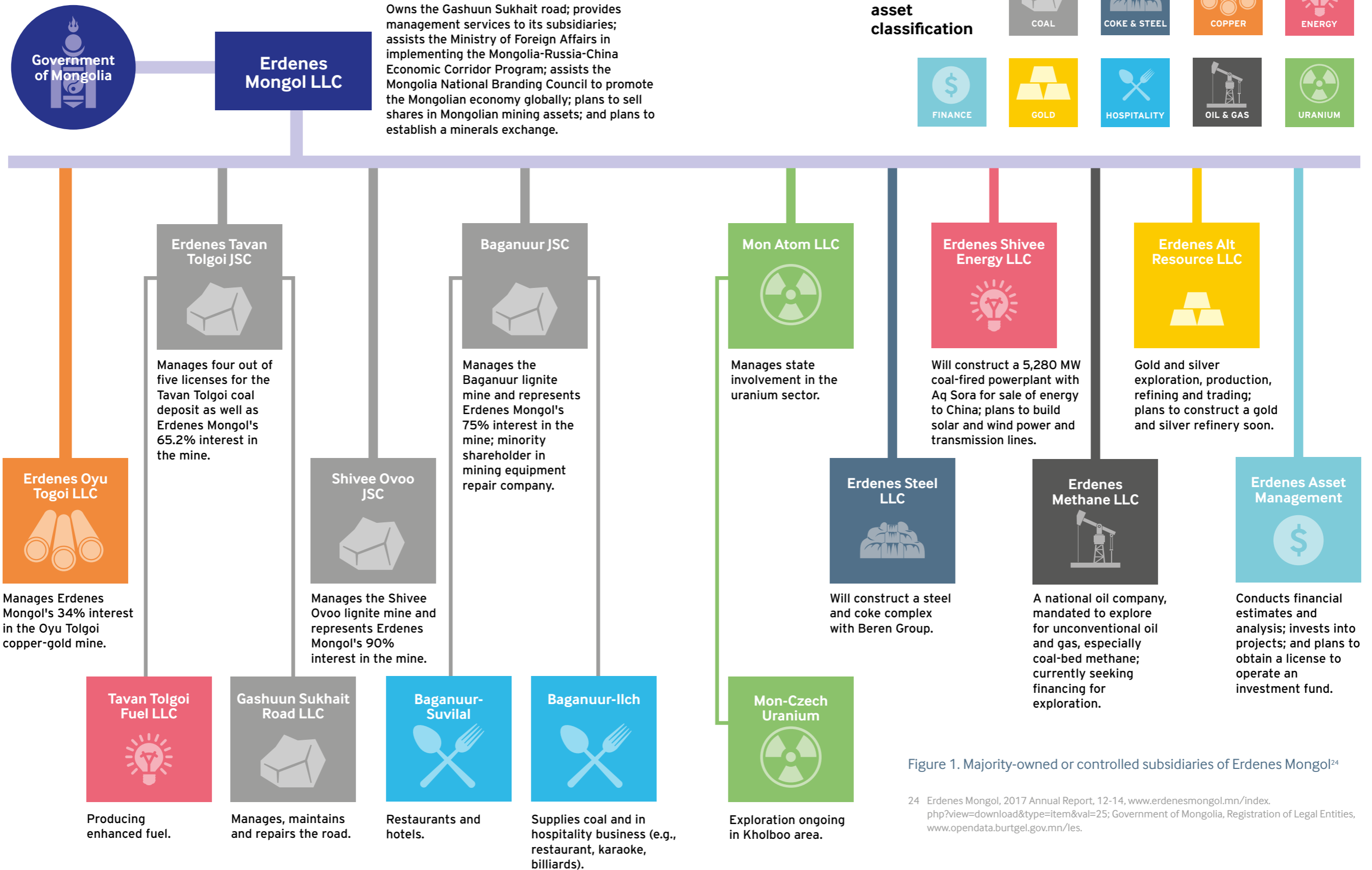


Figure 1. Majority-owned or controlled subsidiaries of Erdenes Mongol²⁴

²⁴ Erdenes Mongol, 2017 Annual Report, 12-14, www.erdnesmongol.mn/index.php?view=download&type=item&val=25; Government of Mongolia, Registration of Legal Entities, www.opendata.burtgel.gov.mn/les.



Shivee Ovoo coal mine

Subsequently, over the past three years, Erdenes Mongol has expanded its portfolio, covering a wide variety of sectors, including mining, oil and gas, fuel production, metal refining, hospitality, road maintenance, steel production, power generation and finance. The company has established at least 15 subsidiaries and taken minority ownership stakes in at least five other entities excluding Oyu Tolgoi. (See Figure 2.) Among Erdenes Mongol’s notable investments are:

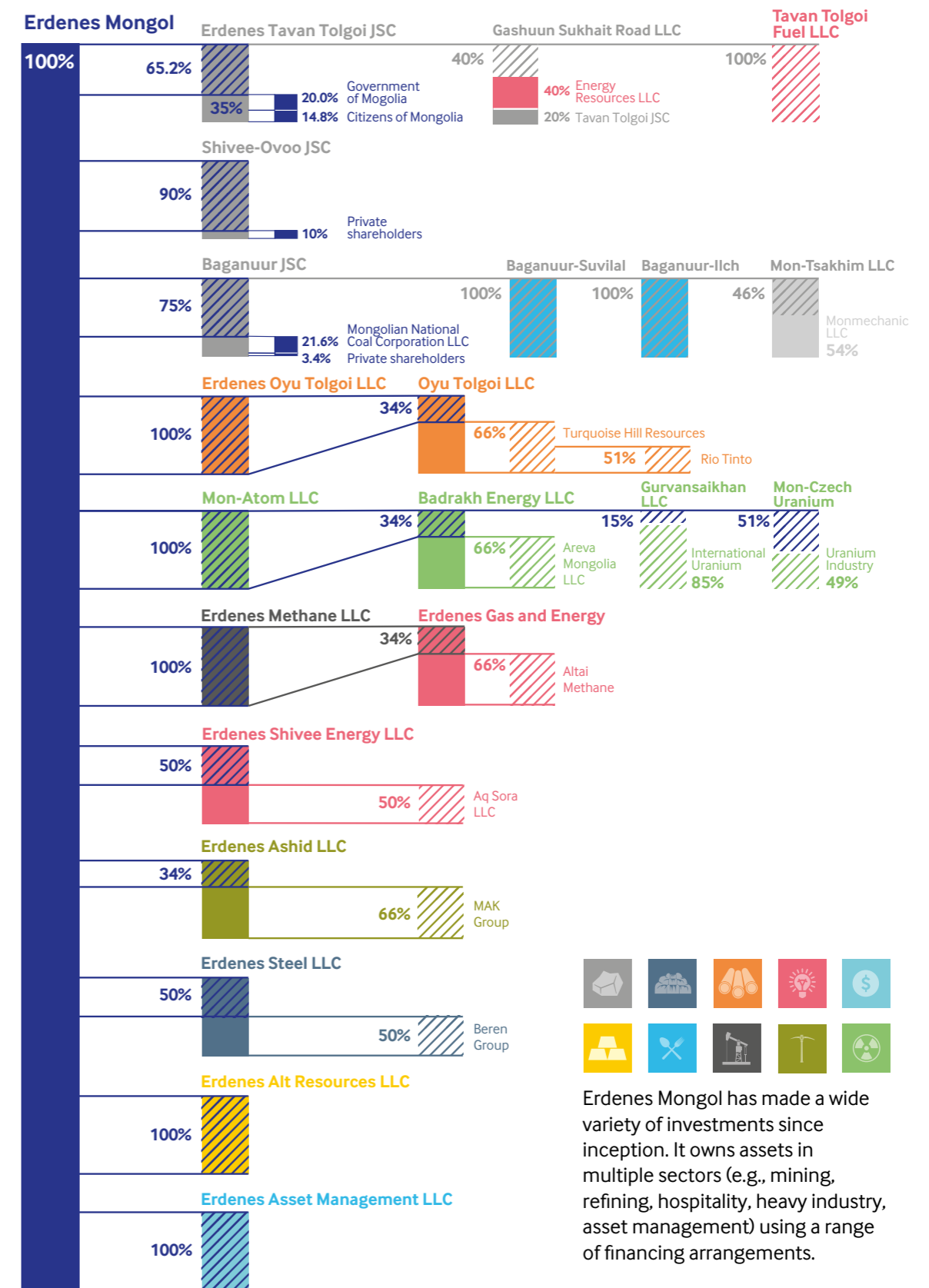
- **MonAtom.** 100 percent owned by Erdenes Mongol, manages state involvement in the uranium sector and was transferred to Erdenes Mongol’s portfolio in 2016.²⁵
- **Erdenes Alt Resources.** 100 percent owned by Erdenes Mongol, is a gold and silver exploration, production, refining and trading company. It plans to construct a gold and silver refinery soon.
- **Erdenes Steel.** 50 percent owned by Erdenes Mongol and 50 percent by Mongolia-based Beren Group, is building a steel and coke complex.
- **Erdenes Methane.** 100 percent owned by Erdenes Mongol, was established as a

national oil company, mandated to explore for unconventional oil and gas.²⁶ According to Erdenes Mongol, Erdenes Methane aims to become “a major ecology-oriented energy producer in the region” by developing coal-bed methane.²⁷

- **Erdenes Shivee Energy.** 50 percent owned by Erdenes Mongol and 50 percent by Hong Kong-based Aq Sora, will construct a 5280 MW power plant with State Grid Corporation, People’s Republic of China.²⁸
- **Erdenes Ashid.** 34 percent ownership by Erdenes Mongol and 66 percent by Mongolia-based MAK Group, was set up to carry out mineral prospecting and exploration.
- **Erdenes Asset Management.** 100 percent owned by Erdenes Mongol, is intended to “make and conduct financial estimates and analysis; invest into projects which meet an appropriate rate of return.” The subsidiary also “plans to obtain a license to operate an investment fund from the Financial Regulatory Commission, Mongolia.”²⁹

25 Gankhuu Purevjav, Erdenes Mongol Group (2019), www.deik.org.tr/contents-fileaction-18310.
 26 Erdenes Methane LLC, Company Website, erdenesmethane.mn/?sel=7070.
 27 Purevjav, Erdenes Mongol Group (2019), www.deik.org.tr/contents-fileaction-18310.
 28 Ibid.
 29 Ibid.

Figure 2. Erdenes Mongol ownership interests



Erdenes Mongol has made a wide variety of investments since inception. It owns assets in multiple sectors (e.g., mining, refining, hospitality, heavy industry, asset management) using a range of financing arrangements.



Coal power plant

Erdenes Mongol subsidiaries have, in turn, either established subsidiaries of their own or entered into different joint venture arrangements with other companies or government entities. For instance, MonAtom has taken ownership stakes in at least three joint ventures to develop uranium projects: Mon-Czech Uranium (51 percent ownership), Badrakh Energy (34 percent) and Gurvansaikhan (15 percent). The Badrakh project is a partnership with French company, Orano, on a uranium exploration project that is expected to start pre-commercial production shortly, subject to certain licenses being issued.³⁰ Baganaur JSC has established at least three subsidiaries that repair engines, supply coal, and operate restaurants, a hotel, billiards and a karaoke bar. Similarly, Shivee Ovoo manages its non-core activities through a subsidiary, Shivee Service, though its mandate and ownership structure are unclear. Most recently, Erdenes Tavan Tolgoi fully financed the Tavan Tolgoi Fuel company, which is planning to produce “low emission coal” to help resolve air pollution in Ulaanbaatar.³¹

In addition to its subsidiaries, Erdenes Mongol has undertaken other commercial ventures, some

of which also involve subsidiaries. For example, Erdenes Mongol is the sole owner of the 239km Gashuun Sukhait road which connects the Tavan Tolgoi coal deposit area with China. Meanwhile its subsidiary, Erdenes Tavan Tolgoi, owns 40 percent of Gashuun Sukhait Road LLC, a company that maintains the road. Energy Resources LLC (a subsidiary of Hong Kong listed Mongolian Mining Corporation) holds 40 percent of the shares while Tavan Tolgoi LLC, which and is in turn majority owned by Umnugovi aimag local government, holds the remaining 20 percent. The Gashuun Sukhait Road Company collects toll fees from coal mining and export companies that use the road and transfer these fees to Erdenes Mongol. Erdenes Mongol pays all costs associated with the maintenance of the road.

Erdenes Mongol is also involved on an *ad hoc* basis in projects such as a research sub-center at the Ministry of Foreign Affairs, which aims to assist in implementing the Mongolia-Russia-China Economic Corridor Program and the Mongolia National Branding Council, which aims to promote the Mongolian economy globally.³² Erdenes



Steel plant

Mongol provided MNT 1.6 billion (USD 680 million) to finance the Council in 2017.³³

Very little is known about Erdenes Mongol’s subsidiary companies and ventures. Specific joint venture, shareholding or management arrangements for these companies are not disclosed to the public, making it difficult to assess specific roles and responsibilities, financial contributions and roles and responsibilities of different shareholders.

The lack of information is, in itself, a problem that will be discussed further in Chapter 3. The limited information that is available raises questions. From the publicly available documents related to these ventures, one might conclude that there are no specific criteria— at least none disclosed publicly— that justify this rapid expansion. There seems to be little or no consideration of whether the private sector could fulfill the role of newly established subsidiaries or joint ventures, what the economic benefits are or what financial risks to the state budget these ventures may bring about.

OWNERSHIP AND CONTROL

The parent company

The Government of Mongolia is the 100 percent owner of Erdenes Mongol. According to the Mongolia’s company law, the highest governing authority of any company are its shareholders. Erdenes Mongol has issued 100 million common shares, all of which are held by the government. Shareholders’ rights on behalf of the government can be exercised by different government entities. In the case of Erdenes Mongol, this right is exercised through the Cabinet Secretariat. Pursuant to the charter, the government exercises the full authority of the shareholders. Hence, the government has the overall responsibility for Erdenes Mongol.

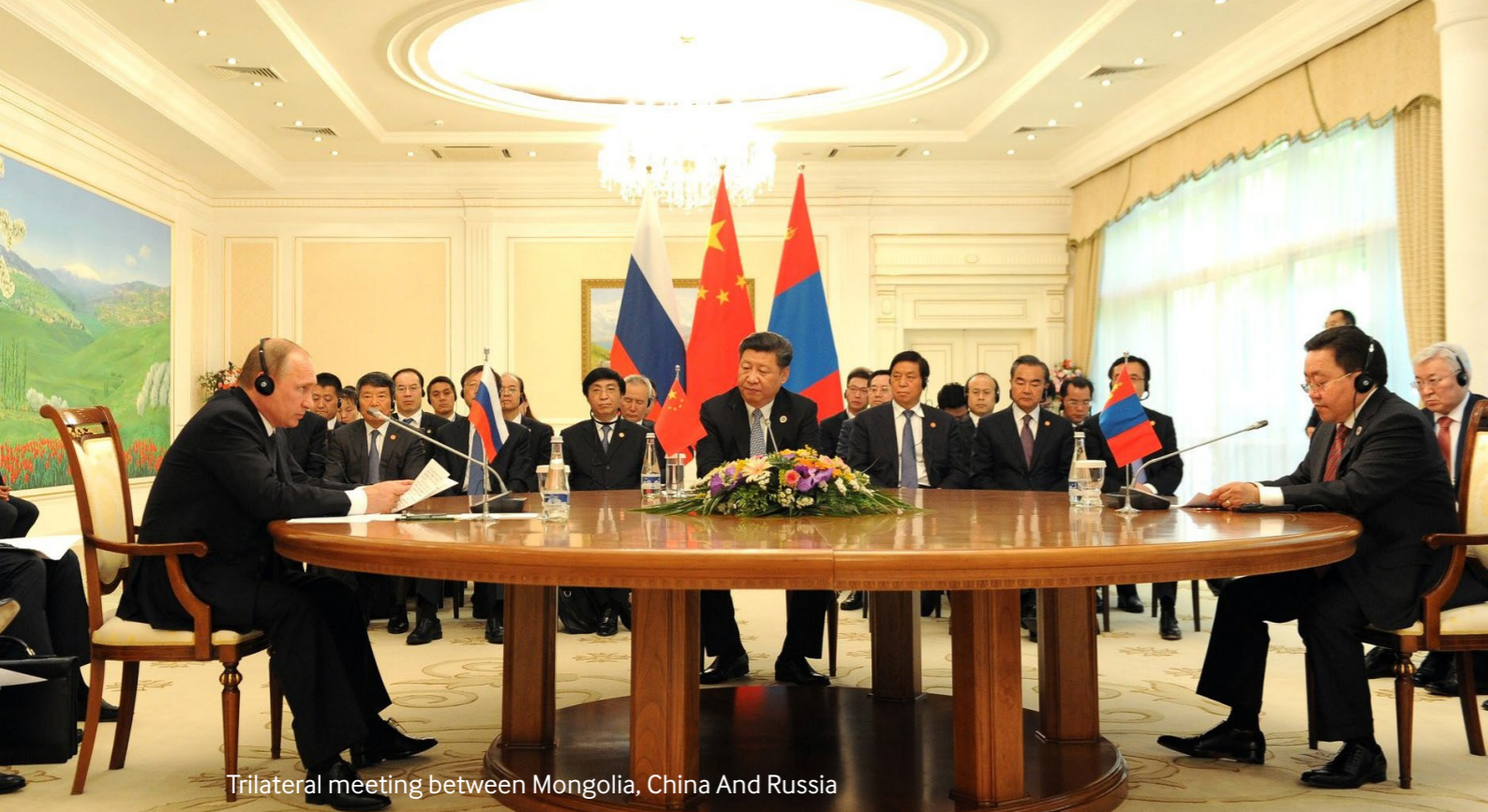
The company charter, which as noted earlier was adopted in 2016 in line with the company law, states that the top governing body of Erdenes Mongol during the recess of the shareholders meeting will be the board of directors. The minimum number of directors for an SOE is set at nine by Mongolia’s company law. Six out of the nine directors of Erdenes Mongol are senior government officials appointed to the board by the sole common shareholder, the Government of Mongolia. These board directors are formally

30 Badrakh Energy LLC, Company Website, www.badrakhenergy.com/EN/zuuvch-ovoo-project.html.

31 News MN, Interview with B. Bat-Erdene, Chair of Erdenes Mongol Board of Directors, 6 July 2018, <https://news.mn/r/782777/>.

32 Purevjav, Erdenes Mongol Group (2019), www.deik.org.tr/contents-fileaction-18310; Erdenet Medee, Interview with Erdenes Mongol CEO Ts. Tumentsogt (2017), erdenetmedee.mn/index.php?newsid=7540.

33 National Audit Office of Mongolia, Erdenes Mongol Audit Report (2018), www.audit.mn/wp-content/uploads/2018/04/TAILAN-ErenesMGL-zurchilgui.pdf.



Trilateral meeting between Mongolia, China And Russia

appointed by a government resolution.

Currently, the board includes senior officers from the Ministries of Finance, Mining and Heavy Industry, and Nature, Green Development and Tourism, and the cabinet secretariat. To limit political interference, the charter prohibits the appointment of any political position holders and senior members of a political party to the board of the company. However, in practice, board directors often receive briefings from the government, namely from the cabinet secretariat, on the issues on agenda before a board meeting takes place. It is also an obligation of the state representative “to exercise [duties] within the limits set forth in the guidance, instructions and authority [delegated] by the owner of the state shares.”³⁴

The company law requires that one third of the board directors of an SOE be independent and allows non-governmental organizations focused on good governance to suggest appropriately qualified individuals to the board nomination committee. However, in practice vacancies are not made public and there is no information on how the independent board directors are selected.

The board of directors approves the structure

and members of the company’s executive team, which is the body responsible for the day-to-day management and operations of the company. According to the company law, the executive team should elect a team leader, who will act as the chief executive officer (CEO) of the company. However, Erdenes Mongol’s CEO is appointed by the board based on the recommendation of the government. This has sometimes led to a disconnect between the CEO and the rest of senior management.

While the charter attempts to set a clear basis for the running and oversight of Erdenes Mongol, and to limit political interference in the operation of the company, there are a number of challenges.

One issue which may undermine the effective management of Erdenes Mongol is the high level of turnover of board members. Over the last decade, changes in board composition appear to be correlated with political changes such as elections. Though the directors are appointed for three-year terms, it is rare that they serve full terms.³⁵

Publicly available information also points to political involvement at the executive level of the company. The appointments of the CEOs of Erdenes Mongol are shown on the timeline in



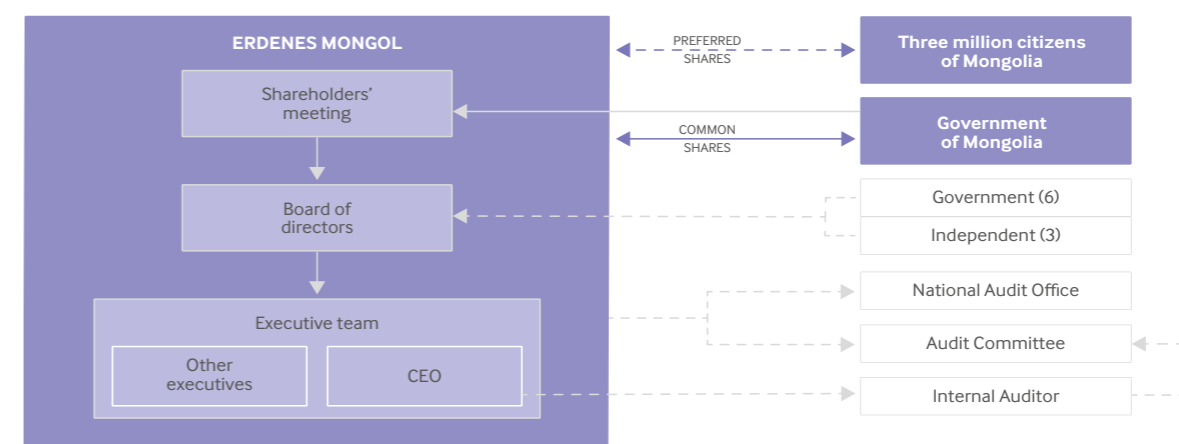
Figure 4, and it is clear that every new government has brought in a new CEO. The average length of service of a CEO at Erdenes Mongol is 1.7 years.

After the 2016 parliamentary election, the executive team including the CEO, deputy CEOs, and over 80 percent of mid-level managers, were reportedly replaced in the ten months after the new government took power.³⁶ The CEO who was replaced had been in his post for just over 18 months. There has been no public explanation for

these changes, nor is it clear how the vacant posts were filled. Vacancies for senior positions are not publicly advertised.

The 2016 shake-up at Erdenes Mongol was followed by further changes in 2017, when the governing party replaced the prime minister and his cabinet. Erdenes Mongol’s CEO was replaced within a year of the prime ministerial change. This practice extends to subsidiaries as well—most of the subsidiary CEOs have been replaced after elections.

Figure 3. Governance structure of Erdenes Mongol



34 Government of Mongolia, Government Resolution 80, Procedures for implementation of the state property representation in legal entities with state property participation (2016), www.legalinfo.mn/law/details/12142?lawid=12142.

35 In the latest appointment of the board of directors for Erdenes Mongol via Government Resolution No. 65 of 2016, the government’s representatives in the board are appointed not by individuals, but by senior public office holders in relevant ministries. Mongolia’s high turnover in its ministries and other agencies following the elections, even at mid-level positions, has been well documented.

36 Anonymous Erdenes Mongol staff member, interview with an author, May-June 2017. Researchers subsequently interviewed other staff in December 2018.

The impact of politically-driven changes to the management of the company may be compounded by other factors that affect employee morale and effectiveness. According to a member of Erdenes Mongol’s human resources team, the current pay structure does not sufficiently recognize the different degrees of technical capability and experience necessary for different jobs. Salaries at the company are lower than equivalent positions at larger private mining companies, and there is no performance-related pay.³⁷

Erdenes Mongol's management of subsidiaries

The charter regulates Erdenes Mongol’s relations with and oversight of its subsidiary companies. The decision to invest in subsidiaries or establish a branch is made by the board of directors, and Erdenes Mongol exercises shareholders’ rights in the subsidiary companies through its appointed

representatives in the boards and the executive management of these subsidiaries. Erdenes Mongol’s charter requires that representatives of government ministries in charge of energy and mining issues, as well as the cabinet secretariat, be included on the boards of directors of subsidiaries.

However, the charter’s provisions have not always been observed in practice and there is evidence of intrusive government involvement in the running of some subsidiaries. A 2014 assessment of governance of Erdenes Mongol found that government officials can make some crucial decisions within Erdenes Mongol and its subsidiaries without going through the Erdenes Mongol Board of Directors.³⁸ It also appears that the CEOs of some high profile subsidiaries such as Erdenes Tavan Tolgoi, the coal subsidiary of Erdenes Mongol, work much more closely with key government agencies and high-level government officials, often taking direct orders from the cabinet or relevant ministries.³⁹

Most recently, the government intervened in the operation of Erdenes Tavan Tolgoi by transferring the role of state representative from Erdenes Mongol to the Ministry of Mining and Heavy Industry and State Property Policy and Coordination Agency.⁴⁰ The shares of the company apparently remain held by Erdenes Mongol and Erdenes Tavan Tolgoi itself is still a part of the Erdenes Mongol Group, but the parent company is not represented on the board of the subsidiary where dividend distribution and other important decisions are made.

Conversely, Erdenes Oyu Tolgoi does not have a separate board. Its board was disbanded by Erdenes Mongol and operational authority over the subsidiary was delegated to the parent company.

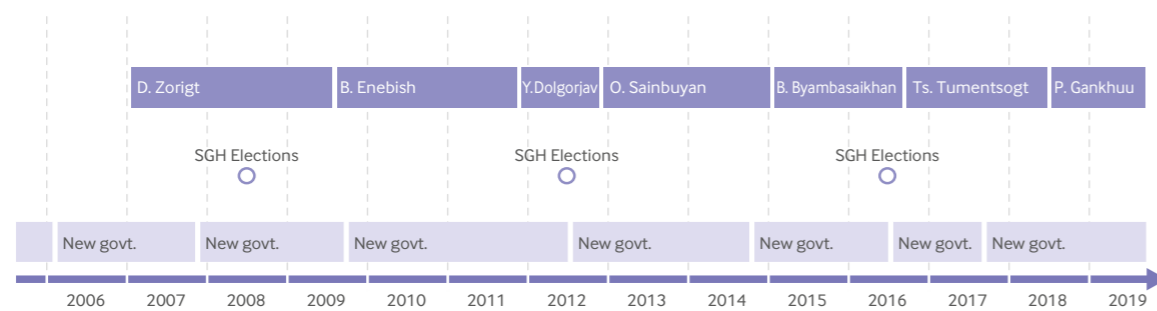
While such arrangements are allowed by the company law, the company has not provided the public with a rationale for its decision.

In order to improve the governance of subsidiaries and Erdenes Mongol Group performance, the “group council” was established in January 2019 by the board of the company to include all CEOs of the subsidiaries. The CEO of Erdenes Mongol leads the council and could potentially improve the performance of the subsidiaries.⁴¹

FINANCES

Until recently, little information on the finances of either Erdenes Mongol or its subsidiaries was available to the general public.

Figure 4. Major political events and CEO tenure



37 A staff member of the Human Resources Department of Erdenes Mongol, interview with an author, June 2017 and December 2018.
 38 Open Society Forum, Governance Assessment of State-Owned Mining Enterprises (2014), forum.mn/index.php?sel=project&menu_id=250&obj_id=4955.
 39 The formal shareholder, Erdenes Mongol, does not have a representation on the Erdenes Tavan Tolgoi Board of Directors. Currently, the Minister of Mining and Heavy Industry leads the company’s efforts to issue an IPO, in close coordination with the cabinet secretariat and without much participation from Erdenes Mongol.

Table 1. Boards of Directors of selected Erdenes Mongol subsidiaries⁴²

Company name	Erdenes Mongol share	Directors of board	From government	From Erdenes Mongol	From other shareholders	Independent directors
Erdenes Oyu Tolgoi	100%	No board				
Erdenes Tavan Tolgoi	65.2%	11	7			4
Shivee Ovoo	90%	9	4	1	1	3
Baganuur	75%	12	3	3	2	4
Gashuun Sukhait Avto Zam	40%	9	6		3	
Erdenes Shivee Energy	50%	9		4	5	

40 The UB Post, Erdenes TT appoints new Chairman, 10 October 2018.
 41 Erdenes Mongol, Erdenes Mongol Group Council Meeting Held (2019), www.erdnesmongol.mn/index.php?view=article&type=item&val=557.
 42 Erdenes Mongol and subsidiaries, Company Websites, Erdenes Mongol, www.erdnesmongol.mn, Baganuur Mine, www.baganuurmine.mn/; Erdenes Tavan Tolgoi, www.erdnesstt.mn/; Shivee Ovoo, shivee-ovoo.mn. Websites of the companies accessed on 30 November 2018; A staff member of Legal Affairs and Contracting Department of Erdenes Mongol, interview with author, December 2018..

With Erdenes Mongol’s publication of audited financial reports for 2015 to 2017 and its semi-annual and annual report for 2017, as well as information disclosed on some of its subsidiaries’ websites and through EITI and the Mongolian Stock Exchange, the Erdenes Mongol Group has started to provide more information on its financial performance.⁴³

This section examines Erdenes Mongol’s financial performance and related issues, based on the

information that it has disclosed. It looks at the revenues, expenditure, profitability, assets and liabilities of Erdenes Mongol as well as those of its subsidiaries that publish information on their finances. It also considers the payments made by the Erdenes Mongol Group to the Government of Mongolia. Table 2 summarizes the financial information gathered on Erdenes Mongol and the four most important mining entities in which it has a major ownership stake.

Table 2. Financial information for Erdenes Mongol and major subsidiaries, in billion MNT, 2016-2017⁴⁴

	Total		Expenditures		Income tax payments		Net income		Total payments to government	Erdenes Mongol ownership share	Permanent employees
	2016	2017	2016	2017	2016	2017	2016	2017			
Erdenes Mongol	34	64	33	39	0.2	6	0	20	12	100%	77
Erdenes Tavan Tolgoi JSC	486	1,194	515	608	-15	94	-199	461	230	65.2%	717
Baganuur JSC	115	127	113	126	0.2	0.1	2	1	12	75%	1,122
Shivee-Ovoo JSC	46	52	43	51	0.3	0	2	1	5	90%	543
Oyu Tolgoi LLC	2,546	2,279	2,176*	1,991*	144.4 ⁺	18.2 ⁺	226 [~]	269 [~]	415	34%	2,462
Total	3,227	3,716	2,880	2,815	130.4	118.2	31	752	674		
Weighted total by ownership share	1,345	1,760	1,232	1,253	40.1	73.2	-49	413	317		

* EITI 2016 data + CIT and withholding tax ° denotes by deduction ~ Erdenes Mongol’s share of the profits is earmarked to repaying a loan to Rio Tinto

43 Erdenes Mongol and subsidiaries, Company Websites.

44 Mongolian Stock Exchange, Filings of Joint Stock Companies, http://mse.mn/mn/companies_info/2/168; Turquoise Hill Resources, Financial Statements, <https://turquoisehill.com/site/assets/files/3779/combined-mda-and-financial-statements-final.pdf>; Mongolia EITI, E-reporting Website, <https://e-reporting.eitimongolia.mn/reportList>. This includes company payments to government, including corporate income tax, royalties, customs duties, VAT, land and water fees, property tax, and employee social and health contributions. Discrepancies between revenues, expenditures, CIT and net income are due to exchange rate adjustments or fixed asset value adjustments; USD 1 = MNT 2,116 (2016); USD 1 = MNT 2,425 (2017)

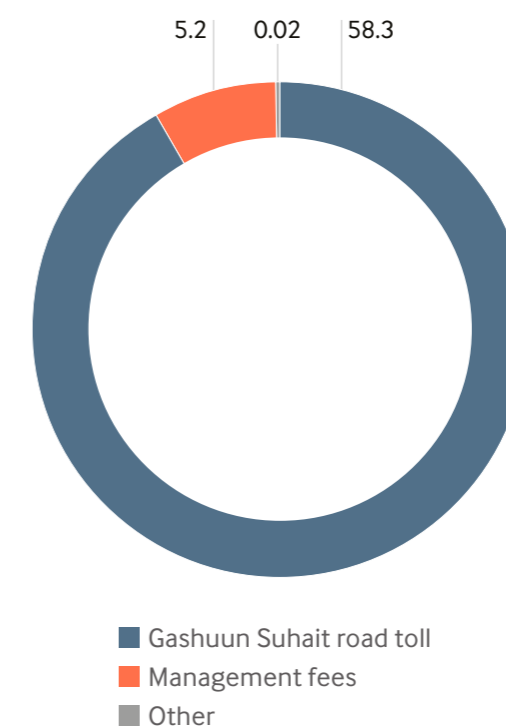
Revenues

The main source of revenue for holding companies such as Erdenes Mongol is usually the dividends they receive from subsidiaries. In addition, a parent company could typically expect significant revenues from management fees (for providing management services to subsidiaries) and fees from securing funding to subsidiaries. Other sources of revenue might include fees for renting assets the holding company owns, such as licenses or facilities.

In 2017, the parent company Erdenes Mongol reported revenues of MNT 64.2 billion (USD 26.5

million). The most significant revenue stream was the tolls paid by companies using the Gashuun Sukhait road that connects the Tavan Tolgoi coal deposit area with China. In 2016, it charged MNT 2,000 per ton of coal for using the road. The fee was increased in 2017 to MNT 3,200 per ton, but apparently this is still a subsidized rate that is insufficient to ensure the maintenance and long-term utilization of the road.⁴⁵ This revenue constitutes about 91 percent of the parent company’s total revenues.

Figure 5. Erdenes Mongol (parent company) revenue in 2017, in billion MNT⁴⁶



45 National Audit Office of Mongolia, Erdenes Mongol Audit Report (2018), www.audit.mn/wp-content/uploads/2018/04/TAI-LAN-ErenesMGL-zurchilgui.pdf; D. Davaadulam, Multi-hill issues surrounding ‘five hills’, (Article by Mongolian National Broadcaster, 2017), <http://www.mnb.mn/i/115665>.

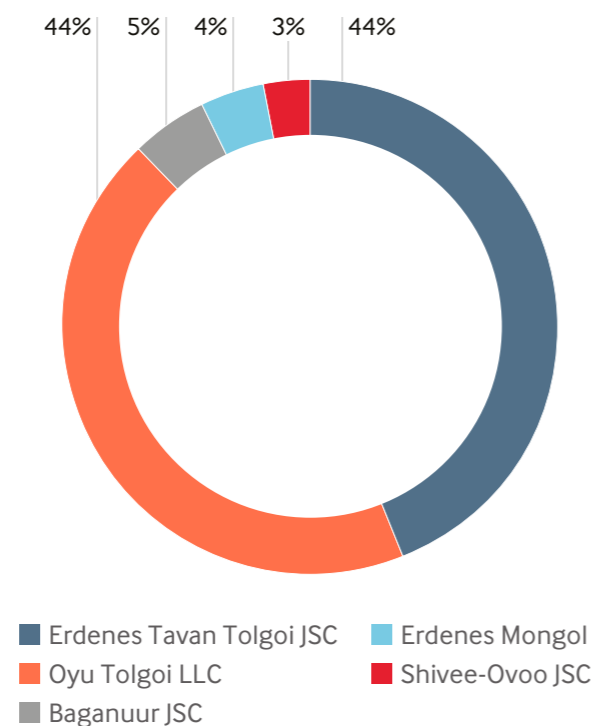
46 Erdenes Mongol, 2017 Annual Report, www.erdenesmongol.mn/index.php?view=download&type=item&val=25.

The other significant revenue streams reported by Erdenes Mongol are management fees paid by its subsidiary companies and rents from licensed coalfields in Gobi-Sumber province. Erdenes Mongol currently collects management fees from only three subsidiaries—Erdenes Tavan Tolgoi, Baganuur and Shivee Ovoo. Erdenes Mongol apparently made an agreement with these subsidiaries setting the management fee at a rate of 0.3 percent of each company’s revenue.⁴⁷ In

2017, Erdenes Tavan Tolgoi paid MNT 4.4 billion to Erdenes Mongol, which constituted about 0.37 percent of its sales revenue, and represented 85 percent of the total management fees paid to Erdenes Mongol.⁴⁸

The third and smallest source of revenue for Erdenes Mongol is rent paid by Shivee Ovoo for the licensed area for brown coal owned by Erdenes Mongol; Shivee Ovoo itself does not hold licenses for the deposit it operates.

Figure 6. 2017 Erdenes Mongol Group revenues by parent and subsidiary, weighted by Erdenes Mongol share⁴⁹



47 A staff member of Legal Department, interview with author, December 2018. The detailed information on the level of management fees was not available in the company annual reports.

48 National Audit Office of Mongolia, Erdenes Tavan Tolgoi Audit Report (2018), www.audit.mn/wp-content/uploads/2018/04/ERDENES-5-TOLGOI.pdf.

49 Erdenes Mongol and Subsidiaries, Company Websites, and authors’ calculations.

Erdenes Mongol has not received any dividends from its subsidiaries, despite some, namely Erdenes Tavan Tolgoi, generating profits in 2017, as shown in Table 2. The prospects of the Tavan Tolgoi project distributing dividends in the future are dependent on the project’s profitability, which in turn is dependent on coal prices and exports to China and on whether the officials managing the mine decide to use any profits to pay for infrastructure such as railway and border crossing facilities.

While the Oyu Tolgoi project has generated profits for Erdenes Mongol’s foreign partner, Turquoise Hill, in recent years, it is not expected to generate dividends for Erdenes Oyu Tolgoi, the subsidiary that represents Erdenes Mongol’s 34 percent share in the project, until about 2035. This is because Erdenes Oyu Tolgoi will not share in Oyu Tolgoi’s profits until it has repaid the government equity share and interest on the loan from Rio Tinto to purchase the equity. The interest on the loan was set at the London Interbank Offered Rate plus 6.5 percent.⁵⁰

The majority of the Erdenes Mongol Group’s revenues are generated at the subsidiary level. Data from company websites, EITI reports and securities disclosures allows for some analysis of four subsidiaries.

As Figure 6 shows, weighed by Erdenes Mongol ownership share, 88 percent of the group’s revenues are generated by two mines: the Oyu Tolgoi copper mine and the Tavan Tolgoi coal mine. Only the five entities for which we have information are counted: financial information is unavailable for Mon-Atom LLC, Erdenes Shivee Energy LLC, Erdenes Steel LLC, Erdenes Ashid

LLC, Erdenes Asset Management LLC and Erdenes Alt Resources LLC, nor for their subsidiaries.

Expenditures

Erdenes Mongol’s annual budgets are approved by its board every December, prior to the fiscal year. Currently, detailed Erdenes Mongol budget information is not available to the public. The company has disclosed some information on expenditures in its 2017 annual and semi-annual reports. As shown in Figure 7, the main expenditure item is the maintenance of the Gashuun Sukhait road, followed by the company’s operational costs.

Subsidiary expenditures are much larger than those of the parent company. Erdenes Tavan Tolgoi reported MNT 608.2 billion (USD 251 million) of expenditures for 2017. While we do not have access to fully disaggregated costs, public disclosures show that only 62 percent of Erdenes Tavan Tolgoi’s costs are directly attributable to the production of coal, including machinery and labor.⁵¹ Twenty-six percent of costs were associated with “sales expenditures”, which may refer to marketing, maintenance, benefits, or travel and entertainment. This is much higher than the sales and marketing expenditures reported for the Shivee Ovoo mine (three percent) or the Baganuur mine (zero).

While these two subsidiaries sell their products at regulated prices to power plants in Ulaanbaatar and may have lower sales costs, the private sector coal miner, Energy Resources, which exports its products to China and incurs additional costs due

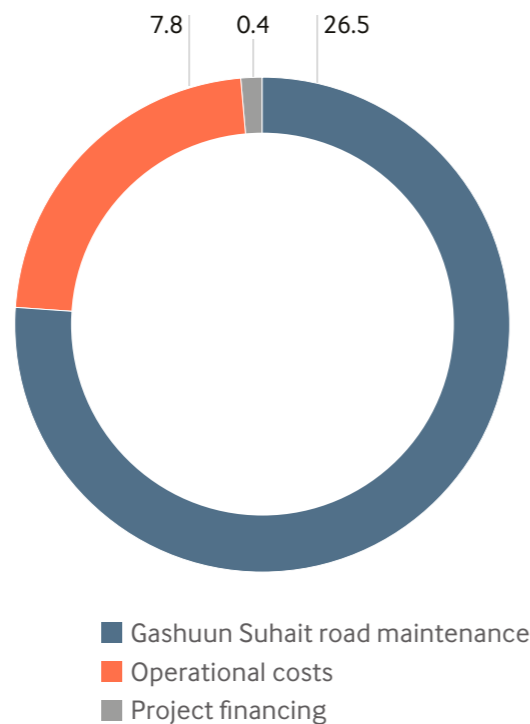
50 Rio Tinto, Oyu Tolgoi Past, present, and future (2018), www.riotinto.com/documents/RT_Oyu_Tolgoi_Past_Present_and_Future_EN.pdf.

51 Ibid; Erdenes Mongol and Subsidiaries, Company Websites

to Chinese regulations, reported sales and distribution costs which equaled 16 percent of total costs, which were 10 percentage points lower than those of Erdenes Tavan Tolgoi.⁵² The remaining costs are related to general and administrative expenses (e.g., executive salaries, utilities, rent, depreciation, insurance), financial expenditures (e.g., interest on borrowed funds) and other expenditures (e.g., land purchases). Erdenes Mongol and its controlled subsidiaries do not publish disaggregated cost information

that would be useful for financial analysis, such as wages and unit production costs. Oyu Tolgoi does provide a significant amount of cost information because Rio Tinto subsidiary Turquoise Hill Resources controls it and it is therefore subject to securities disclosures in Canada. Recently, Rio Tinto has come under pressure from the Mongolian government for the project's runaway development costs, which are expected to be USD 1-2 billion higher than projected in the feasibility study. These higher costs would lower overall payments to the government.⁵³

Figure 7. Erdenes Mongol expenditures, in billion MNT⁵⁴



52 Mongolian Mining Corporation, 2017 Annual Report, www.mmc.mn/uploads/MMC_AR2017_ENG_f.pdf.

53 David Stanway, "Mongolia to grill Rio over Oyu Tolgoi costs-govt source," Reuters (2013), www.reuters.com/article/riotinto-mongolia-oyutolgoi/mongolia-to-grill-rio-over-oyu-tolgoi-costs-govt-source-idUSL4N0B60XW20130206.

54 Erdenes Mongol, 2017 Annual Report, www.erdenesmongol.mn/index.php?view=download&type=item&val=25.

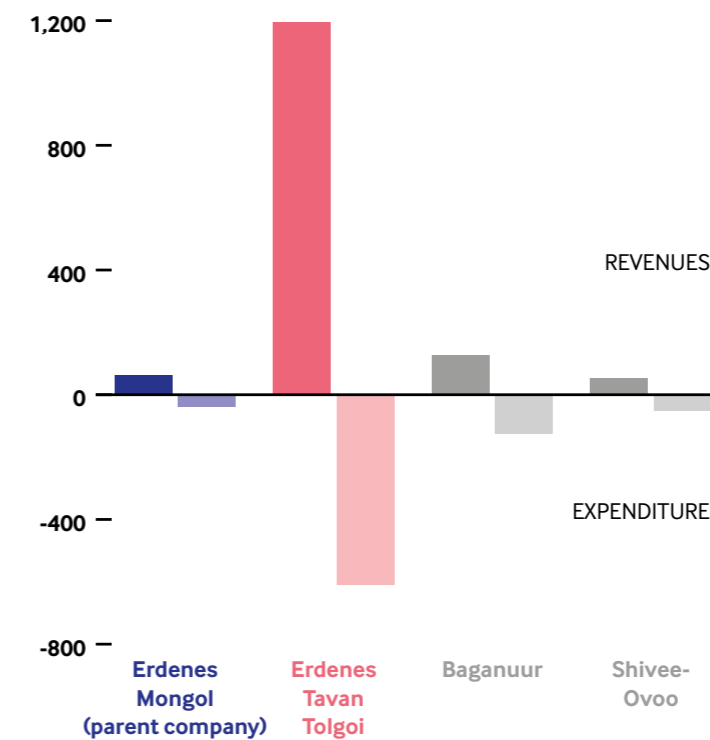
Profits

The Erdenes Mongol parent company did not report any profits from when it was established in 2006 to 2015. From 2016 to 2018, the company reported a net income of MNT 51.5 million (USD 24 thousand), MNT 20 billion (USD 8.3 million) and MNT 21 billion (USD 8 billion) respectively. Increases in coal prices and shipment of coal to China explain much of the improvement in profitability, as Erdenes Mongol's revenues are currently tied to toll fees from the Gashuun

Sukhait road and management fees from coal-producing subsidiaries.

The Erdenes Mongol share of the parent company and three subsidiaries for which we have audited financial statements generated MNT 322 billion (USD 133 million) in net income for the state in 2017.⁵⁵ Ninety-three percent of this income was generated by Erdenes Tavan Tolgoi, the main coal exporter. As previously mentioned, we do not have financial information for Erdenes Mongol's other subsidiaries.

Figure 8. Erdenes Mongol parent and subsidiaries revenues and expenditures (billion MNT)⁵⁶



55 Erdenes Mongol will not receive dividends from Oyu Tolgoi in the foreseeable future as the latter will have to recover the massive investments in the project before reporting any profits. For example, the OpenOil model on Oyu Tolgoi estimates that corporate income taxes (which kick off when the company is profitable after all income tax deductions and allowances) will only start being paid from 2032.

56 Erdenes Mongol and subsidiaries, Company Websites.

How much would have been transferred to the Mongolian treasury in 2017, had there been a clear dividend policy? Taking into account that Oyu Tolgoi profits are earmarked for debt repayment, a payout ratio of 40 percent, which is on the low-end in the state-owned resource sector, would have

resulted in an approximate MNT 129 billion (USD 53 million) dividend to Erdenes Mongol in 2017, based on available profit data from the parent company and some subsidiaries. A 60 percent payout ratio would have resulted in a MNT 193 billion (USD 80 million) dividend.⁵⁷

Figure 9. Erdenes Mongol profits



57 World Bank, SOE Dividends: How Much and to Whom? (2005), siteresources.worldbank.org/INTCHINA/Resources/318862-1121421293578/SOE_En_bill.pdf.

Assets

As of the end of 2017 Erdenes Mongol as a group had valued its assets at approximately MNT 9.36 trillion (USD 3.9 billion), not including its interest in Oyu Tolgoi. As Table 3 shows, Erdenes Tavan Tolgoi has valued its subsoil assets at MNT 11.2 trillion (USD 4.7 billion). Therefore, as Erdenes Mongol owns 65.2 percent of Erdenes Tavan Tolgoi, approximately MNT 7.7 trillion, or 82.5 percent, of Erdenes Mongol’s asset value is derived from the value of its unrealized coal potential at Erdenes Tavan Tolgoi.

Erdenes Mongol does not publish the value of its assets or liabilities in Oyu Tolgoi LLC, Mon-Atom LCC, Erdenes Shivee Energy LLC, Erdenes Asset Management LLC and Erdenes Gold Resources LLC. However, Turquoise Hill Resources values Erdenes Mongol’s equity (assets minus liabilities) in Oyu Tolgoi at MNT 2.2 trillion (USD 900 million).⁵⁸

The Erdenes Mongol group is relatively illiquid. The four entities for which we have financial information—the parent company and three subsidiaries, Erdenes Tavan Tolgoi, Shivee-Ovoo and Baganuur—held a total of MNT 72 billion (USD 30 million) in cash belonging to Erdenes Mongol as of the end of 2017. Oyu Tolgoi holds significant cash reserves, however these are controlled by the majority shareholder, Rio Tinto, and therefore not available to the Government of Mongolia. In general, subsidiaries have negative net working capital, meaning they are faced with short-term liquidity issues. As Table 3 shows, the majority of the assets of Erdenes and its affiliates are held underground or in machinery.

Erdenes Mongol also holds a high level of receivables. Days that are required to service receivables constituted more than a year in 2016 and were somewhat lower at 235 days in 2017,

Table 3. Assets of four Erdenes Mongol affiliates and parent company in 2017 (billion MNT, data is not weighted by Erdenes Mongol ownership share)⁵⁹

Companies	Cash	Inventory	Fixed assets	Intangible assets	Other	Total
Erdenes Tavan Tolgoi	88	178	20	11,194	367	11,847
Oyu Tolgoi	3,504	769	17,816	5,524	3,507	31,120
Shivee-Ovoo	1	13	63	-	41	118
Baganuur	2	28	150	5	34	219
Erdenes Mongol	12	.03	2	157	9,187*	9,358

* represents estimated value of assets owned by Erdenes Mongol including Tavan Tolgoi shares but not including Oyu Tolgoi

58 Turquoise Hill, Annual Report to Shareholders (2017), www.turquoisehill.com/site/assets/files/3779/combined-mda-and-financial-statements-final.pdf.

59 Erdenes Mongol and Subsidiaries, Company Websites; accounting practices differ from subsidiary-to-subsidiary; for Oyu Tolgoi exchange USD 1 = MNT 2,425.

which is a significant amount of time. In contrast, the subsidiaries averaged about a month to settle their receivables, which is much healthier than the parent company’s performance.

Liabilities

There is not a lot of publicly available information on Erdenes Mongol liabilities other than aggregate figures. As Table 4 shows, as of the end of 2017, short- and long-term liabilities for the five entities for which we have financial information totaled MNT 12.8 trillion (USD 5.28 billion). Erdenes Mongol owned and controlled MNT 877 billion

(USD 361 million) of these liabilities. This is slightly less than in 2016, largely due to Erdenes Tavan Tolgoi having repaid a USD 100 million loan to the Development Bank of Mongolia in 2017 as well as repayment of a loan to the Aluminum Corporation of China Limited (Chalco).

It should be noted that the companies’ leverage is relatively high, especially for Shivee Ovoo (its debt to equity ratio is 94 percent). Even the much-improved figures for Erdenes Mongol (parent) and Erdenes Tavan Tolgoi are due to a somewhat artificial valuation of state-owned shares in the company in 2017.

This explicit valuation of Erdenes Tavan Tolgoi shares and reflection in the balance sheets of both the subsidiary and the parent company has increased the size of assets in the company tremendously, 25-fold in case of Erdenes Tavan Tolgoi and 42 times for Erdenes Mongol in just one year. But the artificial price, set at MNT 933 per share by a government resolution, raises questions about the actual value of the company.⁶⁰ The National Audit Office issued only a limited opinion on Erdenes Tavan Tolgoi’s financial statements because they could not find justifications for valuing shares of the company at this price.⁶¹

to distributing dividends or retaining earnings. To date, Erdenes Mongol has not paid any dividends to the government, instead spending or reinvesting its profits. In other words, all net income the company has earned in the last three years has been retained by the company, mainly to pay down debt or invest in subsidiaries. Although the charter gives the board of directors decision-making power with regard to disbursement of dividends, there is currently no clear policy to guide these decisions.

Similarly, the dividend policy at the subsidiary level lacks clarity. To date no subsidiaries have paid dividends to Erdenes Mongol, although some have, as noted above, made profits. It is not clear how these decisions have been made and by whom. We assume that subsidiaries spent some of their profits on reducing debts accumulated in the previous years or on reinvestment.

Dividends to government and the parent

According to the Erdenes Mongol’s charter, the board of directors makes any decisions with regard

Figure 10. Erdenes Mongol total valued assets, end of 2017

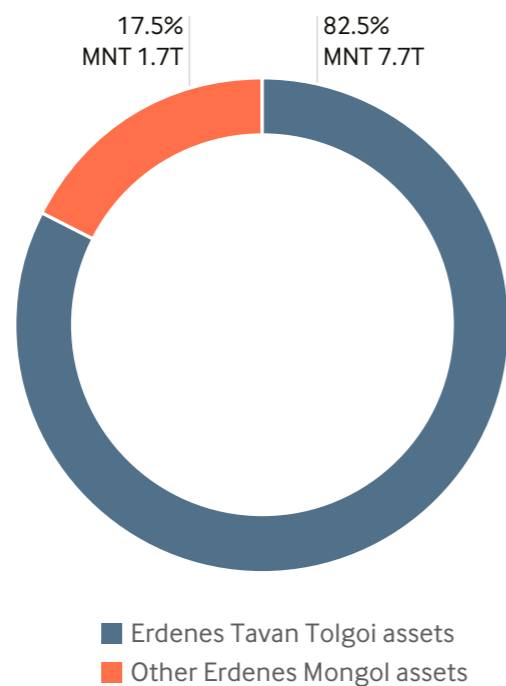


Table 4. Liabilities of Erdenes Mongol and three Erdenes Mongol subsidiaries, in billion MNT, 2017 (data is not weighted by Erdenes Mongol ownership share)⁶²

	Short-term liabilities	Long-term liabilities	Total
Erdenes Mongol	4	254	258
Oyu Tolgoi LLC	1,221	10,453	11,673
Erdenes Tavan Tolgoi JSC	461	153	614
Shivee-Ovoo JSC	65	46	111
Baganuur JSC	86	72	158
Total (five entities)	1,837	10,978	12,814

60 Government of Mongolia, Resolution No. 154 (2017), <https://www.schcd.mn/wp-content/uploads/2016/06/2017-05-30-154.pdf>.

61 National Audit Office of Mongolia, Erdenes Tavan Tolgoi Audit Report (2018), www.audit.mn/wp-content/uploads/2018/04/ERDENES-5-TOLGOI.pdf.

62 Turquoise Hill, Annual Report to Shareholders (2017), www.turquoisehill.com/site/assets/files/3779/combined-mda-and-financial-statements-final.pdf; exchange rate USD 1 = MNT 2425.

The question of dividends, and the approach taken to the payment of dividends—whether and how much to reinvest/spend, starting new subsidiaries and businesses versus paying dividends to Erdenes Mongol—is starting to gain importance as subsidiaries and affiliates, specifically Erdenes Tavan Tolgoi and eventually Oyu Tolgoi, report profits.

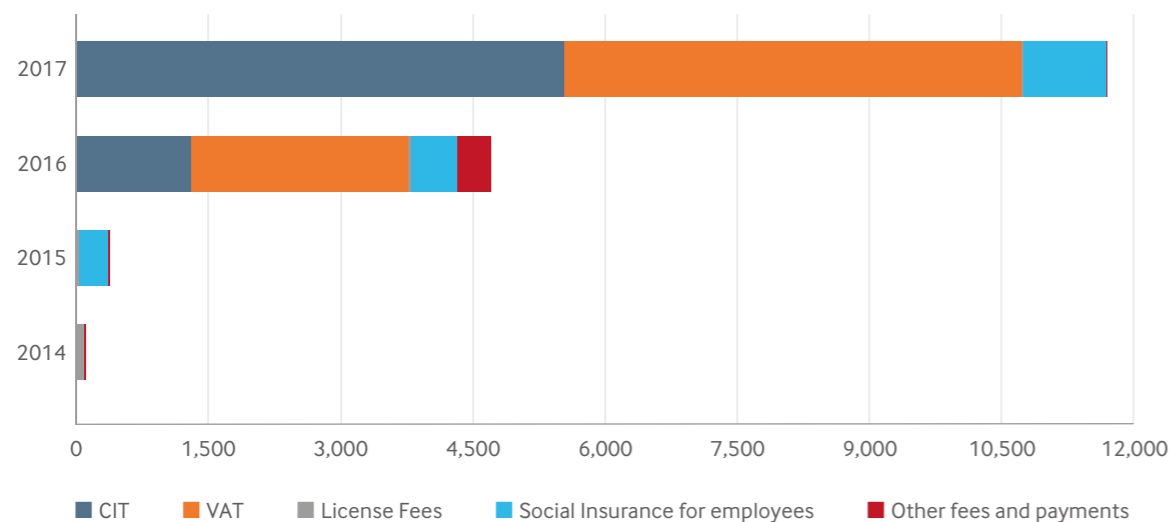
Other payments to government

Erdenes Mongol and its subsidiaries are responsible for paying taxes and fees directly to the treasury, and this relationship is regulated by Mongolia’s tax laws. There is no special treatment of SOEs in this

regard compared to private companies. The types and amounts of payments made by the Erdenes Mongol parent company to the government over the last four years are shown in Figure 11 below.

Data on payments to the government from Erdenes Mongol’s subsidiaries are shown in Table 2. Based on these data, in 2017, the Erdenes Mongol group (i.e., the parent company and the weighted share of the three subsidiaries and Oyu Tolgoi for which information is available) paid MNT 317 billion (USD 130 million) to the government in corporate income tax, royalties, value added tax, customs duties, license fees, land and water fees, property tax and employee social and health contributions.⁶³

Figure 11. Erdenes Mongol (parent company only) payments to the government for 2014-2017 million MNT⁶⁴



63 Mongolia EITI, E-reporting Website, <https://e-reporting.eitimongolia.mn/reportList>, and authors’ calculations.
 64 Ibid.

Box 2. Auditing

Pursuant to Mongolia's State Audit Law, Erdenes Mongol's operations are subject to state audit since it is an SOE. The company has been audited by the National Audit Office (NAO), which directly reports to the legislature. The NAO disclosed Erdenes Mongol’s and its subsidiaries’ financial audit reports for 2017 on its website.

The NAO identified financial irregularities of MNT 178 billion (USD 75 million) and made recommendations to correct these irregularities. Their recommendations include transferring border crossing facilities to the state, properly reflecting

the depreciation of Gashuun Sukhait road and other assets in financial reports, properly analyzing and building reserves for overdue receivables and correcting VAT liabilities and bank fees for road tolls. The report also concluded that two out of five recommendations made to the company in 2016 had not been fulfilled in the reporting period: reporting delayed tax payments due to challenges in repaying foreign denominated loans and reporting financial information related to the Mon-Atom subsidiary. Despite these issues the NAO classified its 2017 audit as free from violations.

REPORTING

Transparency is critical for Erdenes Mongol shareholders and ultimately the people of Mongolia to hold the company accountable. The preceding sections of this report have highlighted some significant gaps in the information that is publicly available on Erdenes Mongol’s finances and operations. These were reflected in the latest Resource Governance Index on which ranked Erdenes Mongol 14th out of 22 state-owned mining companies in terms of public disclosure. (See Figure 12.)

The company took important, positive steps in 2017 with the production of semi-annual and annual reports that included much of the information on which this report is based. Subsidiary Baganuur JSC has recently produced a comprehensive 2018 report which includes operational details, performance indicators, transfers to government, audited financial

information, and board bios, shareholding and expenses, among other information.

Erdenes Mongol also has to comply with a number of legal requirements to disclose information, including the Glass Accounts Law (2015). Under this law, the company must disclose annual procurement plans, tenders and their results, concession and investment information, which it must make available at the central Glass Accounts website as well as on its company website.⁶⁵ Information from Erdenes Mongol on the Glass Account website is incomplete; specific aspects of the required disclosures and many transactions are not recorded properly. For example, the details of procured goods, work and services with a value of more than five million tugrik are missing from the Erdenes Mongol Glass Account site.

In Erdenes Mongol’s annual report for 2017, the CEO states that the company “has developed draft information transparency procedures and will

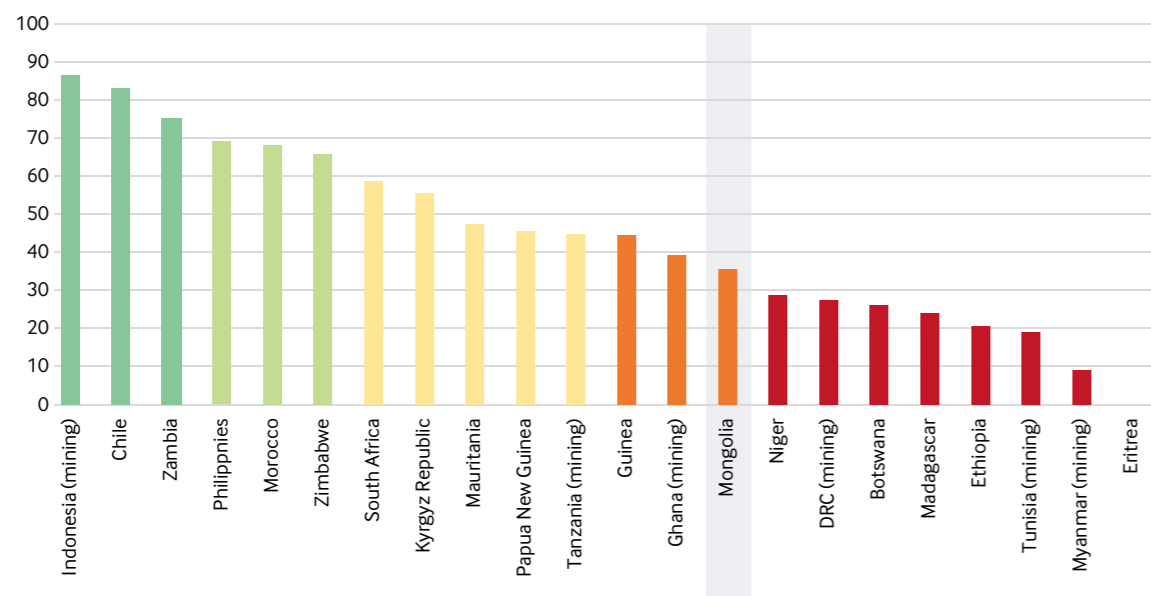
65 Government of Mongolia, Erdenes Mongol filings, Glass Account Website, <https://www.shilendans.gov.mn/org/5231>.

have it approved in the near future.”⁶⁶ As of March 2019, there has been no further development on this issue.

Most importantly, unlike similar SOEs such as Indonesia’s Antam, Chile’s Codelco or Zambia’s ZCCM-IH, financial information on revenues,

expenditures, profits, assets, liability and activities is not available on a consolidated basis, or on a subsidiary-by-subsidiary or project-by-project basis for every entity. In short, Erdenes Mongol still does not comply with international accounting standards or international state-owned enterprise disclosure standards.⁶⁷

Figure 12. Resource Governance Index 2017 mining SOE transparency scores



66 Erdenes Mongol, 2017 Annual Report, 5, www.erdenesmongol.mn/index.php?view=download&type=item&val=25.

67 The 14 disclosure standards that apply to state-owned mining companies are described in EITI, Upstream Oil, Gas and Mining Enterprises: Governance Challenges and the Role of International Reporting Standards in Improving Performance (2018), eiti.org/document/upstream-oil-gas-mining-soe-governance-challenges.

3. Challenges confronting the Erdenes Mongol Group

In resource-rich countries, SOEs can have a major influence on the economy and society as a whole. Their activities often have a significant impact on how the government manages resource extraction and how much revenue the government earns.

The EITI’s research on SOEs found that the mandates and operations of SOEs vary significantly, as does their performance and contribution to a country’s economy. Some natural resource SOEs, such as Abu Dhabi’s ADNOC, China’s Shenhua Energy and Sinopec, Norway’s Equinor, Saudi Arabia’s Saudi Aramco and Thailand’s PTT have arguably generated significant value for their primary shareholder, the state, and have made substantial economic contributions to their countries. However, financial and governance challenges are common.⁶⁸ The EITI study noted that, while each context is unique, problems such as slow project development, high costs, low revenues, excessive liabilities and inefficient allocation of revenues between SOEs and other public entities have led to billions of dollars in losses annually. Poorly managed SOEs can also enable and foster corruption and enrich the well-connected at the expense of the citizens of a country.

This chapter examines some of the challenges facing Erdenes Mongol, focusing on those aspects of the group’s governance, management and operations that are vital to enabling it to fulfill a critical element of its original purpose: to ensure the people of Mongolia benefit from their natural resources. The analysis is inherently limited by the lack of publicly available information on many important aspects of Erdenes Mongol operations. The lack of transparency is, in itself, a key challenge, one that Erdenes Mongol has been attempting to address.

68 Andrew Bauer, Upstream Oil, Gas and Mining SOE Governance Challenges (EITI, 2018), eiti.org/document/upstream-oil-gas-mining-soe-governance-challenges.

UNCLEAR MANDATE

Erdenes Mongol’s mandate—and more broadly the government’s role in the mining sector—has never been clearly defined. There is no evidence that the company’s evolution over the past decade has been guided by any overarching strategy. Legislative changes affecting the company’s scope of authority appear haphazard, and there has been little continuity of senior management in recent years.

The lack of a clear industrial policy for the mining sector has led to *ad hoc* decision-making at Erdenes Mongol regarding establishment of subsidiaries, associates and joint ventures as well as asset purchases. Objective criteria does not exist for determining whether a given action provides value-for-money for the Mongolian state or whether the public sector is best placed to participate in a given project.

Clearly defining the rationale for the SOE and its mandate are important steps that would help guide Erdenes Mongol’s decision-making so that it generates revenue for the state, grows the Mongolian economy and improves public welfare. This would entail enacting a policy on state involvement in the mining sector and circumscribing what types of assets Erdenes Mongol can and cannot purchase. It might also imply setting clear performance targets for the organization based on the clearer mandate.

POLITICAL INVOLVEMENT IN DECISION-MAKING

Although the changes made to the law in 2016 and Erdenes Mongol’s new charter appear to give the company greater independence from political involvement, in reality the government is still



heavily involved. Under the HDF legal framework, the cabinet appointed the CEO of Erdenes Mongol; under the new charter the Board appoints the CEO, but the cabinet directs the majority of the board, and acts as the shareholder of Erdenes Mongol.

While there has been no public explanation of the many changes in Erdenes Mongol's senior management, the available data suggests that the appointment of senior managers is based on political and not business imperatives. The company has had seven CEOs in 12 years, and two in the last two years. For some CEOs, their tenure has been so brief as to raise questions about the extent to which they could fully know the complex group of companies they were charged with overseeing. Such high turnover is not conducive to long-term business development.

INSUFFICIENT CONTROL AND GOVERNANCE OF SUBSIDIARIES AND JOINT VENTURES

Without the guidance of a clear mandate and robust legislative framework, Erdenes Mongol has evolved into a complex company with interests not only in mining, but also mineral processing, unconventional oil and gas, roads, border crossing facilities, hotels, restaurants, power generation, engine repair, steel, trade promotion and asset management. Each of these subsidiaries requires

different skills and expertise. Moreover, Erdenes Mongol can continue to expand the sectors and activities in which it operates with ease, generally by establishing new subsidiaries or joint ventures. It is unclear whether Erdenes Mongol is well equipped to engage effectively in all these sectors and projects that may require different skills, management and resources.

As a holding company, the successful management of its related companies should be a key function of Erdenes Mongol. However, the company's relationships with its subsidiaries and joint ventures takes many forms, and decision-making involves many stakeholders from different government agencies. While some subsidiary boards are directly linked to Erdenes Mongol, others, such as Erdenes Tavan Tolgoi, have been appointed without much input from the company. As a result, it is unclear how much control Erdenes Mongol asserts over its subsidiaries and whether subsidiaries are held accountable for decisions they make.

Even those few subsidiaries that have generated profits have not paid dividends. It is not clear why. There may be good reasons for these decisions, but in the absence of publicly disclosed guidance on the dividend decision-making process, it is impossible to know. The transfer of power of Erdenes Tavan Tolgoi from Erdenes Mongol to the Ministry of Mining and Heavy Industry and State Property

Policy and Coordination Agency in 2018 suggests that the government is not fully confident in the company's ability to manage all its assets well.

LOW PROFITABILITY

Generating a profit and providing value-for-money is a central objective of most state-owned enterprises. Assessing Erdenes Mongol's overall financial performance is, as already noted, difficult due to the complexity of its structures and the limited and unstandardized information available on its operations and finances and those of its subsidiaries and affiliates. However, the information presented in the preceding chapter raises questions about the contribution that the Erdenes Mongol Group has made and may make to Mongolia in the future.

Erdenes Mongol has only generated profits in the past two years, and these have been relatively modest. Moreover, in the short to medium term, they are linked to a precarious Chinese coal market and are dependent on Erdenes Tavan Tolgoi remaining within the Erdenes Mongol Group. In comparison, many other regional SOEs in the mining sector have generated significant taxes, profits and dividends for their governments. For example, Indonesian SOE Antam, which has a corporate profile similar to Erdenes Mongol, had a gross profit margin of 13.77 percent in 2018. Its net profit margin (net earnings/revenues) was 3.46 percent or USD 60 million in after-tax operating profits in 2018, of which a minimum of 30 percent must be distributed to the shareholders as a dividend. It also paid USD 110 million in taxes.⁶⁹

China's Shenhua Energy, which is also focused on coal and power, had a gross profit margin of 27.1 percent in the same year. It paid USD 1.45 billion in taxes and paid approximately 40 percent of its net profits to shareholders as dividends.⁷⁰

Majority state-owned Coal India, the world's largest coal producer, had a gross profit margin of 17.4 percent in 2017-2018. The company transferred more than USD 1 billion in taxes and paid 121 percent of its net profits to shareholders as dividends, of which 79 percent, or USD 1.15 billion, went to the Indian government.⁷¹

Other performance indicators, such as asset to liability ratios, return on assets, debt ratios and liquidity ratios, are also impossible to calculate for Erdenes Mongol. The company does not produce consolidated financial information covering all controlled entities and asset valuation may not be accurate. In comparison, the three other companies mentioned do produce audited consolidated financial statements that include performance indicators. For instance, liability to asset ratios are 41 percent for Antam, 31 percent for Shenhua Energy and 74 percent for Coal India.

Erdenes Mongol's subsidiaries have not, to date, generated dividends for the parent company. It appears that many are not profitable. Except for Baganuur JSC, there is little information available that would enable an effective assessment on the extent to which each new subsidiary and project is commercially viable now or will be in the future. Concerns are compounded by the lack of evidence Erdenes Mongol carries out robust due diligence prior to deciding to engage in new ventures.

⁶⁹ Antam, Laporan Tahunan Annual Report (2018), www.antam.com/images/stories/joget/file/annual/2018/ANTAM_AR2018_OJK_FINAL.pdf.

⁷⁰ China Shenhua Energy Company Limited, 2018 Annual Report (2018), www.csec.com/shenhuaChinaEn/Report2018/201903/62d5f3cb424944fd9480863bdc574f81/files/8910a91b77a44239bb1c4c1d5c3f30d5.pdf.

⁷¹ Coal India Limited, Annual Report and Accounts 2017-2018 (2018), www.coalindia.in/DesktopModules/DocumentList/documents/AnnualReport201718.pdf.

The limited data that is available raises questions about the viability of some subsidiaries and business activities. For example, the prices at which Baganuur and Shivee Ovoo sell their coal to power plants are heavily regulated; as a result these companies incur losses and have little possibility for independent growth.⁷² In the case of Gashuun Sukhait Road, the toll fees are reportedly subsidized, raising questions about the viability of the current fee structure for the road.⁷³

LACK OF DIVIDEND POLICY

Two central roles of Erdenes Mongol as a holding company are to collect dividends from the various investments it manages on behalf of the government and to deliver dividends to its shareholder, the state. Neither of those roles have been fulfilled to date. The lack of dividends is partly a function of low profitability. However, even if Erdenes Mongol and its subsidiaries were profitable, it is unclear what percentage of the profits would be transferred to the Mongolian treasury.

As a result, the company and its subsidiaries are able to reinvest their profits rather than transferring them to the treasury. This reinvestment is an implicit industrial policy; by not having a dividend policy, the government is essentially investing in Erdenes Mongol and its subsidiaries at the expense of other sectors, namely healthcare, education and productive infrastructure.

In other countries, there is a clear dividend policy for SOEs. Payments are made as a percentage

of each share owned or a percentage of profits. Dividends from SOEs range from 30 to 100 percent of profits, on average, with some outliers.

The question of dividends, and the approach taken to the payment of dividends (whether and how much to reinvest/spend, starting new subsidiaries and businesses versus paying dividends to Erdenes Mongol) may become particularly important once Erdenes Mongol's subsidiaries and affiliates start reporting significant profits.

FUTURE LIABILITIES

Erdenes Mongol and its subsidiaries can become government budget liabilities if they take on debts or other financial obligations, or if they are used to transfer commercial risk from private sector partners to the public sector, without adequate collateral. Should the company not meet its debt obligations, taxpayers would need to bail out the company, as has happened in other parts of the world (e.g., Mexico's Pemex, New Zealand's Solid Energy, China's Guangxi Nonferrous Metals Group).⁷⁴

There is some evidence that the Erdenes Mongol Group has already taken on debt and plans to incur more. Already, it owes more than USD 350 million to creditors from just the subsidiaries for which we have information. The company is also currently seeking USD 320 million project financing for its metallurgical industrial complex project and USD 7 billion for Shivee energy export project.⁷⁵ The lack of information on the

nature of Erdenes Mongol partnerships with its private sector partners, such as Beren Group for Erdenes Steel, Altai Methane for Erdenes Gas and Energy and MAK group for Erdenes Ashid further aggravates this concern.

A critical issue for the public of Mongolia is the lack of information and transparent decision-making processes with regard to the Erdenes Mongol's group finances. It is nearly impossible for the parliament, the media or the public to measure the performance of different projects in order to assess governance and overall profitability.

In order to understand the extent to which Erdenes Mongol's complex structure is providing Mongolia with value and serving the public interest, it is necessary to have information on each subsidiary and each project to ascertain which are well run,

which are—or will be—profitable and where costs are being incurred.

LIMITED TRANSPARENCY

Erdenes Mongol took significant steps on transparency in 2017 and 2018 with the production of semi-annual and annual reports, as well as publishing the audit report by the National Audit Office. Baganuur JSC has also taken an important step as the first subsidiary to publish a comprehensive annual report and audited financial statement. The publication of these reports marks an important achievement in terms of becoming a more open and transparent company. Notwithstanding the progress, the information made available does not yet meet international reporting standards for state-owned enterprises.

72 Kh.Balsandorj, interview with G. Iderkhangai, 8 October 2018, <http://www.baganuurmine.mn/?p=4912>.

73 National Audit Office of Mongolia, Erdenes Mongol Audit Report (2018), www.audit.mn/wp-content/uploads/2018/04/TAI-LAN-ErenesMGL-zurchilgui.pdf. Interview with a staff member, and Multi-headed issues surrounding 'five hills', Article by Mongolian National Broadcaster, <http://www.mnb.mn/i/115665>

74 Bauer, Upstream Oil, Gas and Mining SOE Governance Challenges (EITI, 2018), eiti.org/document/upstream-oil-gas-mining-soe-governance-challenges.

75 Purevjav, Erdenes Mongol Group (2019), www.deik.org.tr/contents-fileaction-18310.



Recommendations

This report has raised serious questions about whether and how the Erdenes Mongol group can contribute to a coherent government approach to mining or to the revenues of Mongolia. The findings of this report suggest a number of reforms that would help improve Erdenes Mongol's performance so that it better serves the Mongolian public interest. The following recommendations focus on clarifying the mandate and operations of Erdenes Mongol and on addressing open questions about the viability of the various operations of the group. They draw on international comparators of how other SOEs have addressed some of the challenges faced by Erdenes Mongol.

RECOMMENDATIONS TO THE GOVERNMENT OF MONGOLIA

Draft an industrial policy for the mining sector

One reason Erdenes Mongol's subsidiaries and joint ventures have proliferated is the lack of clarity around the role of the state in the mining sector. The government could clarify this role by, for instance, revising and streamlining state policies on minerals and industry, refining Erdenes Mongol's corporate objectives and setting well-defined criteria for the establishment of new subsidiaries or joint ventures and sale of mineral assets. For instance, the State Policy on Minerals outlines in general terms the government's intention to support the private mining sector but has not detailed SOE-related policies.

Draft an SOE policy and law

To promote more streamlined government intervention in the mining sector, and to ensure that Erdenes Mongol's commercial decisions provide value-for-money for the Mongolian government, we suggest either a specific law covering Erdenes

Mongol or one that covers all SOEs. While legislation is being developed, the Mongolian government could release a policy or resolution that improves Erdenes Mongol's governance.

To begin, a mining SOE policy should identify clear goals for Erdenes Mongol and performance targets. An Erdenes Mongol-specific law or an SOE law could include the following elements: mandate and definition; strategic plans; non-commercial activities; shareholding; dividend policy; state liability; sale of assets and equity; role of parliament; role and tenure of management; board of directors; code of conduct; accounting; reporting; and auditing.

Clarify dividend policy for Erdenes Mongol

While Erdenes Mongol ought to determine its subsidiaries' dividend policy, it is up to the government to determine the share of Erdenes Mongol's profits that will be transferred to the state treasury in any given year. In some countries, dividends are determined as an amount per share. In others, dividends are simply a percentage of profits to be transferred to the government. While the board can make dividend decisions on a year-to-year basis, it ought to be providing guidelines by the government.

Tighten the debt management framework

Currently, Erdenes Mongol and its subsidiaries can issue debt without government oversight. As a result, increasing liabilities could pose a risk to overall government finances in the future. The debt management framework for SOEs could be adjusted to ensure general government fiscal sustainability, for instance by requiring that all SOE debt be approved by the Ministry of Finance.



Ulaanbaatar

Establish human resources policy for board and managers

One way to increase professionalism and expertise within the board and senior management while simultaneously improving their experience level would be to establish objective criteria for board and manager appointments, promotions and dismissals. This would lengthen the tenure of senior officials. These criteria could be linked to an SOE oversight office within the government which would train managers, administer an open appointment process and carry out objective performance evaluations of the board and senior managers. This process could also establish clear and impartial financial and non-financial performance incentives based on meeting company objectives and penalties for poor performance.

Managers should receive appropriate training and be measured based on performance. Erdenes Mongol could also consider financial and non-financial performance incentives for senior managers, once transparency and oversight reforms have been enacted.

Loosen constraints on profitability

Profitability within several subsidiaries is limited by government legislation, regulation or policy. For example, Shivee Ovoo sells its coal at below market price. Loosening these types of constraints could improve company profitability and generate greater benefits for the ultimate shareholder, the Mongolian state.

RECOMMENDATIONS TO THE STATE GREAT HURAL

Enact an SOE law

The State Great Hural could revise the State Policy on Minerals and work on a new SOE or Erdenes Mongol law to reflect this policy and fill the legislative gaps which exist, particularly since the withdrawal of the Human Development Fund Law.

Enhance oversight of the Erdenes Mongol group

The State Great Hural could ask more and tougher questions of why Erdenes Mongol has made the investment choices it has and whether they serve the interests of Mongolian citizens. Ultimately, parliament could put pressure on the company to improve its performance. This report could provide background information to inform such investigations.

RECOMMENDATIONS TO ERDENES MONGOL

Carry out a subsidiary-by-subsidary and project-by-project assessments to determine commercial viability

In order to improve profitability, assessments could be carried out for all of Erdenes Mongol's activities, including at all subsidiaries and joint ventures. The assessments could cover market dynamics, commercial viability, value-for-money, need for financing and technical expertise, strategic importance of the project (e.g., links to other sectors; national security; employment), and social and development impacts, among other factors. Erdenes Mongol could establish the assessment criteria, though projects could be independently

assessed. Based on these assessments, Erdenes Mongol could determine whether a specific asset should be further invested in, sold or liquidated.

Carry out and disclose due diligence for all new commercial ventures

Regardless of national government policy, Erdenes Mongol should define a policy for establishing new subsidiaries and associates, for example by limiting subsidiaries to specific activities or sectors or basing decisions on assessments of commercial viability.

Cost audits

In order to reduce costs and thus increase profits, Erdenes Mongol could audit or hire independent auditors to audit its subsidiaries and joint ventures. This would provide the company with a better sense of whether improvements to profitability could be made immediately.

Clarify relationship with subsidiaries and associates, including dividend policy

Following an assessment of its current subsidiaries and other ventures, Erdenes Mongol could put in place mechanisms to improve oversight of its subsidiaries. This could include a clear dividend policy; a clear management fee policy; developing a joint venture policy and providing due diligence for any prospective joint ventures; clarifying debt management rules for subsidiaries; measuring performance of managers and acting on those measures; auditing subsidiary activities; and improving public reporting of subsidiary finances and activities.

Promote integrity and professionalism

Erdenes Mongol should develop clear criteria for the appointment of subsidiary board members and

managers. The process for appointing managers should be open and appointments should be based on transparent hiring criteria. Managers should receive appropriate training and be measured based on performance. Erdenes Mongol could also consider financial and non-financial performance incentives for senior and mid-level managers, once transparency and oversight reforms have been enacted, and extend this practice to subsidiaries.

Comply with international accounting standards

Erdenes Mongol could build on its recent positive action to disclose information by continuing to publish annual reports and also by disclosing more detailed audited financial statements for the parent company and subsidiaries, in line with international financial report standards and good practices in SOE disclosures.⁷⁶ This would also involve publishing consolidated financial statements and comprehensive and accurate asset valuations. We also recommend that the company disclose its agreements with subsidiaries, in particular, those that determine financial and other obligations of the parties.

Comply with the Glass Accounts Law

In line with the law, annual procurement plans, tenders and their results, concession and investment information, should be available at the central Glass Accounts website as well as on the Erdenes Mongol website. In addition, significant procurement contracts should be disclosed.

⁷⁶ Natural Resource Governance Institute, Guide to Extractive Sector State Owned Enterprise Disclosures (Mongolian language) (2018), resourcegovernance.org/analysis-tools/publications/guide-to-extractive-sector-state-owned-enterprise-disclosure-mongolian.

Annex 1. Strategically important mineral deposits⁷⁷

No.	Deposit name	Type of mineral	Location	Reserves
1	Tavan Tolgoi	Coal	Umnugobi, Tsogttsetsii	6,420 mln tons of coal, of which 1.4 Billion tons are of coking coal quality
2	Nariin Sukhait	Coal	Umnugobi, Gurvantes	125-380 mln tons of coal
3	Baganuur	Brown coal	Ulaanbaatar, Baganuur	600 mln tons of coal
4	Shivee Ovoo	Brown coal	Gobisumber, Shiveegobi	646.2 mln tons of coal
5	Mardai	Uranium	Dornod, Dashbalbar	1,104 tons at 0.119 percent U3O8
6	Dornod	Uranium	Dornod, Dashbalbar	28,868 tons at 0.175 percent U3O8
7	Gurvan Bulag	Uranium	Dornod, Dashbalbar	16,073 tons at 0.152 percent U3O8
8	Tumurtei	Iron	Selenge, Khuder	229.3 mln tons at 51.15 percent Fe
9	Oyu Tolgoi	Copper and gold	Umnugobi, Khanbogd	2.2 bln tons ore, 21.2 mln tons Cu, 772.9 tons Au
10	Tsagaan Suvarga	Copper and molybdenum	Dornogobi, Mandakh	16 mln tons oxides, 250 mln tons sulphide ore with 1.6 mln tons of Cu and 66,000 tons of Mo
11	Erdenet	Copper and molybdenum	Orkhon, Bayan-Undor	1.2 bln tons at 0.51 percent Cu and 0.012% Mo
12	Burenkhaan	Phosphor	Khubsgul, Alag-Erdene	192.24 mln tons at 21.1 percent P3O5
13	Boroo	Gold	Selenge, Bayangol	24.523 thousand tons at 1.6 g/T Au
14	Tomortein Ovoo	Zinc	Sukhbaatar, Sukhbaatar	7,689.4 thousand tons at 11.5 percent Zn
15	Asgat	Silver	Bayan-Ulgii, Nogoosnuur	6,402.6 thousand tons at 351.08 g/T Ag
16	Gatsuurt	Gold	Selenge, Mandal	40.0-50.0 tons of Au

⁷⁷ Mineral Resources and Petroleum Authority of Mongolia, Annual Bulletin of Mining and Geology of Mongolia for 2016, 32-33, https://www.bgr.bund.de/EN/Themen/Zusammenarbeit/TechnZusammenarb/Downloads/mongolei_MRAM_AnnualBulletin2016.pdf?__blob=publicationFile&v=2.

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ACKNOWLEDGMENTS

The report benefited greatly from the contributions of Amir Shafaie and Audrey Gaughran of NRGI who provided valuable input on the design and content of the assessment, and Bayan-Altai Luvsandorj who conducted interviews and background research.

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