Mongolia's experience with investment treaties and arbitration cases

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Mongolia's web of international investment agreements and the promise of development

Signing international investment treaties (IIAs), in the hope of attracting foreign investment, has been a central strategy for governments looking to improve economic development.

IIAs have been around since 1959, when the first Bilateral Investment Treaty (BIT) between Germany and Pakistan was signed. By the end of 2015 there were 3,286 investment agreements (2,928 BITs and 358 "other IIAs"). "Other IIAs" refer to economic agreements other than BITs that include investment-related provisions, such as investment chapters in free trade agreements (FTAs).[1]

The bulk of these treaties was signed during the 1990s and early 2000s when most governments believed that economic liberalism would bring development. During that period, most developing countries were sold a myth. The idea was that signing investment agreements would help countries attract foreign investment. At the time, there was no awareness of risks involved and what governments were giving up in terms of sovereignty.

Mongolia is no exception. The government signed 43 bilateral investment treaties (BITs), of which 37 are in force. The vast majority of these were concluded between 1991 and 2001[2]. And, almost half of Mongolia's BITs (17[3] out of 43) are with countries of the European Union[4] (for further details on Mongolia's BITs with EU Member States and possibilities for termination see Annex 1).

Mongolia has also been a party to the multilateral agreement Energy Charter Treaty[5] since 1994. The Charter is a multilateral agreement that offers investors in the energy sector similar protections to those encountered in other investment agreements, including the possibility to recur to international investment arbitration. In 2015, European Member State Italy announced its withdrawal from the ECT,[6] out of concern that future energy policy changes might spark a spate of investment disputes.[7]

Today, more than 20 years later, the evidence that International Investment Agreements do in fact deliver on their stated purpose is at best inconclusive. Most research studies carried out by the academic community failed to find a direct correlation between IIAs and attraction of FDI[8]. The experience of many other countries like South Africa[9], Ecuador[10], Hungary[11] and Brazil[12] show that the promise of increased foreign investment when signing IIAs has not been fulfilled. Even the European Trade Commissioner Malmström recently admitted that most studies showed no "direct and exclusive causal relationship" between international investment agreements and foreign direct investment[13].

A recent study about the implications of the signing of Investment Treaties for Mongolia's development reached similar conclusions. It found that despite Mongolia boasting a very liberal investment law protecting the rights and property of foreign investors in the country, as well as very generous tax incentives, including tax exemptions and tax stabilization agreements, it largely failed to attract significant FDI into the country. In addition, what FDI did come into the country only served to create limited and unregulated employment, while not contributing to substantially increase (domestic) manufacturing - 72.5% of all FDI is in geological prospecting and mining -, and has contributed little to eradicate poverty.[14]

The underestimated risks of investment agreements

While the benefits of signing investment agreements were highly overstated, the risks were underestimated. When signing these treaties governments gave away their sovereign right to regulate in the interest of people and the environment and have exposed themselves to expensive lawsuits.

The incentives offered to foreign investors come at a high price, depriving countries like Mongolia of the necessary policy space to harness investment to serve sustainable development. Under the provisions of the investment protection agreements, foreign investors can challenge almost any government intervention if they consider that it has affected it current or future profits.

The investor-to-state dispute settlement clauses that form a standard part of investment agreements enable foreign investors to circumvent national courts and take a complaint straight to an ad hoc international tribunal consisting of three commercial investment lawyers, who will decide on whether government measures are legitimate or proportionate to their objective. These lawyers – whose independence is not guaranteed as they are paid commercial fees on a case by case basis, in a one-sided system where only foreign investors can bring cases and where there is thus an incentive to rule in their favour[15] – can and do award compensation that can run into many hundreds of millions, in some cases even billions of dollars. These awards are enforceable and must be paid out of public budgets, reducing the funds that are available for public policies.

Foreign investors have already used the investment dispute settlement system to challenge environmental protections, energy policies, financial regulation, public health, land use, taxation measures, etc. Even the threat of claims can cause governments to reconsider or shelve public interest regulation.

In recent years, the number of investment claims has burgeoned. From a total of six known treaty cases by 1997 to total of a 696 publicly known cases by June 2016.[16] Until 1999, there is registry of only 43 cases, which means that 653 cases were filed during the last 15 years. In 2015, 70 new investment cases were initiated – a record high.[17]

BOX 1

The crippling costs of investment arbitration

Awards in investment cases can easily amount to the entire annual public budget a country has available to provide for public health services, as in the case of Occidental Petroleum versus the state of Ecuador, where the initial award amounted to 1,7 billion USD, plus interest – roughly the equivalent of the country's annual health budget for 7 million people.[18]

Modern transnational corporations can easily bring claims that amount to several percent of a country´s GDP. In the case of Gabriel Mining against Romania over refusal of a permit for a highly controversial and environmentally damaging gold-winning project for example, the damages claimed – 4 billion USD - amount to 2 percent of Romania's GDP.[19] Gabriel Mining's CEO openly threatened to sue to blackmail Romania into granting it an exploitation permit.[20] The largest damages award yet known in investment treaty arbitration was decided on 18 July 2014 by an UNCITRAL arbitral tribunal under the auspices of the Permanent Court of Arbitration (PCA). It ordered Russia to pay over 50 billion USD in compensation for the indirect expropriation of OAO Yukos Oil Company (Yukos).[21]

Because of the crippling amounts involved, even the threat of such claims can bring governments to water down or even shelve public interest policies. Indonesia has indicated that, under the threat of claims from some of the world's largest mining companies, it felt compelled to refrain from measures to protect its vulnerable rainforests from the effects of open-pit mining.[22]

In Europe, an investment claim from energy company Vattenfall resulted in the watering down of environmental regulations by the city of Hamburg.[23]

World-wide, countries like New Zealand and Malaysia have postponed anti-smoking laws to await the outcomes of a two billion-dollar investment claim by Philip Morris against the introduction of anti-smoking measures by Uruguay and Australia.[24]

Mongolia's experience with ISDS lawsuits brought by foreign investors

Mongolia relies heavily on the exploitation and export of natural resources as a driver of economic development. More than 89 per cent of Mongolia's exports are minerals, and this proportion is expected to rise to 95 per cent in 2015.[25]

Mongolia is rich in mineral deposits, including coal, copper, molybdenum, fluorspar, and gold, and 72.5% of all incoming foreign direct investment goes to the mining and extractives industry.[26]

Investors in the mining and extractives industry are among the most frequent users of the investor-to-state dispute settlement system. Any endeavours by Mongolia to reregulate its natural resources to ensure that their mineral commodities are not exported in raw form, but that value is added domestically; to set up regulatory frameworks to ensure that foreign operators contribute to domestic (industrial) development; and to harness its mineral wealth to promote economic diversification and environmentally and socially sustainable development could be challenged by foreign investors through ISDS. Investment protection can constrain the Mongolian government in amending laws or initiating the renegotiation of contracts with mining companies to, for example, tighten environmental protection or bind foreign investors to local content requirements, including technology transfers or the hiring of local staff[27].

To date, four known investment claims have been brought against Mongolia (see table below). Three of these cases originate in the mining and extractives sector.

TABLE 1 ISDS cases against Mongolia

Year of initiation	Case	Home State of investor	Applicable IIA	ArbiWtral rules	Summary	Outcome of original proceedings
2011	Khan Resources v. Mongolia	Canada, Netherlands, British Virgin Islands	The Energy Charter Treaty	UNCITRAL	**Investment:** uranium mining **Grounds for filing a claim:** Adoption of a new nuclear energy law alleged to amount to an unlawful expropriation of the investment	Decided in favour of investor
2010	China Heilongjiang v. Mongolia	China	China - Mongolia BIT	UNCITRAL	**Investment:** Iron ore mining. **Grounds for filing a claim:** revocation of licences	Pending
2007	Paushok v. Mongolia	Russian Federation	Russia -Mongolia BIT	UNCITRAL	**Investment:** gold mining and an oil and gas company. **Grounds for filing a claim:** Government increased taxes (windfall tax) to benefit from high mineral prices and government demands the hiring of locals to support job creation	Decided in favour of investor
2004	Alstom Power v. Mongolia	Italy	The Energy Charter Treaty Italy - Mongolia BIT	ICSID	**Investment:** thermal energy station project. **Grounds for filing a claim:** unknown	Settled

Source: UNCTAD - http://investmentpolicyhub.unctad.org/ISDS/CountryCases/139?partyRole=2

Each of these cases highlights key problematic aspects of the current investment protection regime.

Khan Resources Inc. v. Mongolia[28] - In 2010, following environmental concerns, Mongolian government passed a new nuclear energy law, requiring all uranium miners to re-register their licences. The new law also established that the state's share in any uranium joint venture should increase to 51%.

Canadian mining company Khan Resources held the concession to exploit the Dornod uranium mine. Following the passing of the new law, the government invalidated Khan Resources license arguing the investors had breached Mongolia's national radiation and safety law, had stored radioactive materials in protected areas and had failed to register uranium reserves with the state.

The company took the case to investment arbitration claiming Mongolia had breached its commitments under the Energy Charter Treaty and demanding 358 million USD in compensation. In 2015, the tribunal found Mongolia liable for unlawful expropriation and awarded the claimants more than 80 million USD in damages[29]. That amounts to roughly 16% of Mongolia's education budget for 2015.[30] Where public spending on education is currently already insufficient to finance new education programmes and teacher training,[31] this is not a sum that Mongolia can afford to lose.

Apart from this crippling award, the Khan case highlights several other problematic aspects of investment arbitration.

Firstly, it shows the harmful effects of what is known as treaty-shopping. Khan Resources Inc., as a Canadian company, could not file a direct ISDS claim using one of Mongolia's Bilateral Investment agreements because the country does not have such a treaty with Canada. However, as a multi-national operator, Khan could easily avail itself of its offshore holding company in the Netherlands – a so-called letterbox operation set up to enable Khan to avoid taxes through of the generous Dutch double taxation treaties – to bring a claim against Mongolia under the Energy Charter Treaty to which Mongolia has been a party since 1994.

The Khan case also illustrates how, in a world that is characterized by globalised supply chains, transnationally operating companies no longer have a clear nationality. They are headquartered in one country, develop technology in another and produce in various third countries. This makes it very unclear what to define as foreign investment and who investment agreements really protect. Investment protection enforceable with treaty based dispute settlement simply serves to give transnational corporate industry a powerful weapon to fend off any government intervention.

Finally, this case also highlights the conflict of interests that plague the international investment arbitration system. Canadian lawyer Yves Fortier, one of the arbitrators selected in the case, served for almost 10 years as a member of the Board of Directors of Canadian mining giant Rio Tinto Alcan (2002-2011).

Paushok v. Mongolia - In 2006, the Mongolian government introduced a new tax in order to ensure a greater public share of the revenues from its resources. A 68% ‘windfall’ levy would be due on gold sold above the threshold price of 500 USD an ounce. In the same year, Mongolia also changed the rules for the employment of foreign workers in the mining sector – imposing high penalties if the number of foreign workers exceeded 10 percent.[32] Developing states often use performance requirements such as obligations to employ local workers as part of their policies to harness investment for sustainable domestic development. Imposing higher taxes on the sale and export of raw materials helps to boost public budgets available for economic diversification and sustainable development.

Three Russian investors - Sergei Paushok, CJSC Vosktekneftegaz, and CJSC Golden East – filed an investment case against Mongolia claiming that these measures constituted a breach of their rights under the Russia -Mongolia BIT. They opposed the new tax and the government’s demand that 90% of employees should be Mongolians as a breach of their legitimate expectations and violation of their right to a fair and equitable treatment.

In this case, the arbitration tribunal dismissed many of the investors’ accusations against Mongolia – stating that, in particularly in countries in their early stages of development, investors cannot expect that tax rates will not increase. The tribunal did not follow the investors’ line of reasoning that the levy imposed was excessive. It also dismissed claims that the penalties for employing foreign workers were excessive and arbitrary.[33] However, the tribunal did rule that Mongolia’s Central Bank seizing the gold reserves of Mr Paushok’s company without permission of the investors constituted a violation of the investors’ entitlement to fair and equitable treatment under the bilateral investment treaty between Mongolia and Russia.[34] The determination of damages is still pending.[35]

It is a positive development that the tribunal in this case dismissed some of the investors’ claims. But it remains worrying that the investment protection framework allows foreign investors, circumventing national judges, to challenge such measures in the first place. It should not be up to arbitrators at all to decide on the legitimacy and proportionality of public policy measures of a sovereign state.

Alstom Power v. Mongolia - Very little is known about the investment claim filed by the Italian subsidiary of French power company Alstom against the Mongolian state. The case was settled in 2006, but no information has been made public about the reasons that led to the lawsuit or the terms of the settlement. Usually settlement mean that the investor was compensated either monetarily or by a change in laws and regulations to accommodate their demands. There is no way of knowing which concessions were made by the state.[36] The complete lack of transparency surrounding investment claims is another highly problematic aspect of the investment protection system.

China Heilonjiang v. Mongolia - Another case against Mongolia where very few details have emerged is the case of three Chinese investors in the Tumurtei iron ore mine suing the government following the cancellation of a mining license. The case is pending and no information is available.[37]

Way forward

A growing number of countries around the world is revising and/or cancelling their investment agreements out of dissatisfaction with transnational investors challenging the legitimacy of their policy decisions and the threat to public budgets.[38]

BOX 2

False solutions: The European Union replaces ISDS with an Investment Court System

In response to public outrage over the corporate privileges enshrined in ISDS, the European Union in November 2016 published a proposal for an Investment Court System (ICS).

The European Commission claims that with this proposal they are preserving governments' right to regulate and solving all the conflicts of interest of arbitrators. However, the proposed reforms leave intact the fundamental flaws in the investment protection regime. The principle of a one-sided system, where only foreign investors can bring a claim and cases are weighed on the basis of investment protections only, without any reference to wider public interests under-pinning regulatory interventions by the state or to corporate social and environmental responsibilities, remains largely untouched[39].

ICS is also a missed opportunity to counterbalance the extensive protections for foreign investors with corresponding actionable responsibilities in the fields of labour, environmental, consumer, or other standards.

In 2011, Mongolia decided to cancel its double taxation treaty with the Netherlands because it allowed companies registered in the Netherlands to channel income from dividends, royalties and interest out of Mongolia without paying the 20 percent withholding tax that Mongolia would normally levy.[40] Mongolia also cancelled double-taxation treaties with Luxemburg, Kuwait and the United Arab Emirates. Tax evasion through these treaties was costing Mongolia an estimated 1 – 2 billion USD in public revenues much needed for the country's social and economic development.[41]

Mongolia would be well-advised to look at the potential risks of international investment agreements for public budgets and policy space through the same development lens. There is a considerable foreign presence in Mongolia's economy, in particular in the extractives industries, but also increasingly diversifying into areas such as food and trade, ICT, construction, transportation, banking and finance and tourism.[42]

The top-ten home states of foreign investors in Mongolia include the Netherlands, China, Luxemburg, British Virgin Islands, Singapore, Canada, South Korea, USA, Russia, Australia.[43] Mongolia maintains bilateral investment treaties with seven countries in this top-10: The Netherlands, China, Luxemburg, Singapore, South Korea, the USA and the Russian Federation, and there is a real risk that changes in policy and government interventions will become subject to further investment claims.

Because of these risks, Mongolia should consider terminating and revising its International Investment Agreements. Transnational corporations should bear their own business risks, including from policy change. There is a market-based alternative open to foreign investors: as Mongolia has been a full member of the Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group since 1999, there is nothing preventing foreign investors from availing themselves of the political risk insurance schemes MIGA offers. Privatising their gains, but socialising their losses should not be an option. And if investment is to be genuinely harnessed for sustainable development, investors should be bound to strict and enforceable responsibilities in areas such as social and environmental policy. To ensure inclusive and sustainable growth, states should maintain full regulatory scope and flexibility to adopt and adapt regulatory frameworks to changing conditions and respond to public demands. In preserving the public interest, states have a duty to regulate, which cannot be undermined by investment protection provisions and investment dispute settlement.

ANNEX 1 Mongolia's BITs with EU Member States

Most Bilateral Investment Treaties include a termination clause, which gives States the legal right to terminate the treaty unilaterally. Usually, this clause establishes conditions for amendment or termination.

An analysis of the termination clauses in the 15 BITs in force between Mongolia and EU Member States shows that 8 treaties are ready to be terminated at any time. Another 7 treaties, can only be denounced at a future date ranging between 2018 and 2028.

Mongolia's BITs with European Member States all contain a so-called 'sunset clause', which continues to extend the protections of the agreements to established investors for a set period of time. In the EU Member States – Mongolia BITs the time frame ranges from 5 to 20 years.

TABLE 2 Mongolia-EU Member States Bilateral Investment treaties[44] in force[45]

Status	Partner	Date of signature	Date of entry into force	Beginning of period when treaty could be terminated unilaterally[46]	Sunset clause
BITs that may be terminated at any time	United Kingdom	04-10-1991	04-10-1991	2001	20 years
	France	08-11-1991	22-12-1993	2003	20 years
	Denmark	13-03-1995	02-04-1996	2006	10 years
	Germany	26-06-1991	23-06-1996	2006	20 years
	Poland	08-11-1995	26-03-1996	2006	10 years
	Czech Republic	13-02-1998	07-05-1999	2009	10 years
	Belgium-Luxembourg	03-03-1992	15-04-2000	2010	20 years
	Austria	19-05-2001	01-05-2002	2012	10 years
Initial term of application has expired, but BIT was tacitly renewed, creating a new deadline for expiration and termination	Lithuania	27-06-2003	03-05-2004	2018 (New deadline to notify termination is April 2017)	10 years
	Italy	15-01-1993	01-09-1995	2020 (August 2014 was the deadline to notify termination in 2015. New deadline to notify termination is August 2019)	5 years
	Netherlands	09-03-1995	01-06-1996	2021 (New deadline to notify termination is December 2020)	15 years
	Hungary	13-09-1994	06-03-1996	2026 (Feb 2015 was the deadline to notify termination in 2016. New deadline to notify termination is Feb 2025)	10 years
	Romania	06-11-1995	15-08-1996	2026 (Feb 2016 was the deadline to notify termination in 2016. New deadline to notify termination is February 2026)	10 years
Original term of application of the BIT is yet to expire	Sweden	20-10-2003	01-06-2004	2024 (the initial period for this treaty is 20 years, next deadline to notify termination is 2023)	20 years
	Finland	15-05-2007	19-06-2008	2028 (the initial period for this treaty is 20 years, so until 2027 the parties can not terminate)	20 years

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46 Based on an analysis of the termination clauses found in the text of each treaty.

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