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## From Giant Maples to Bonsai The Decline of Producer Hedging

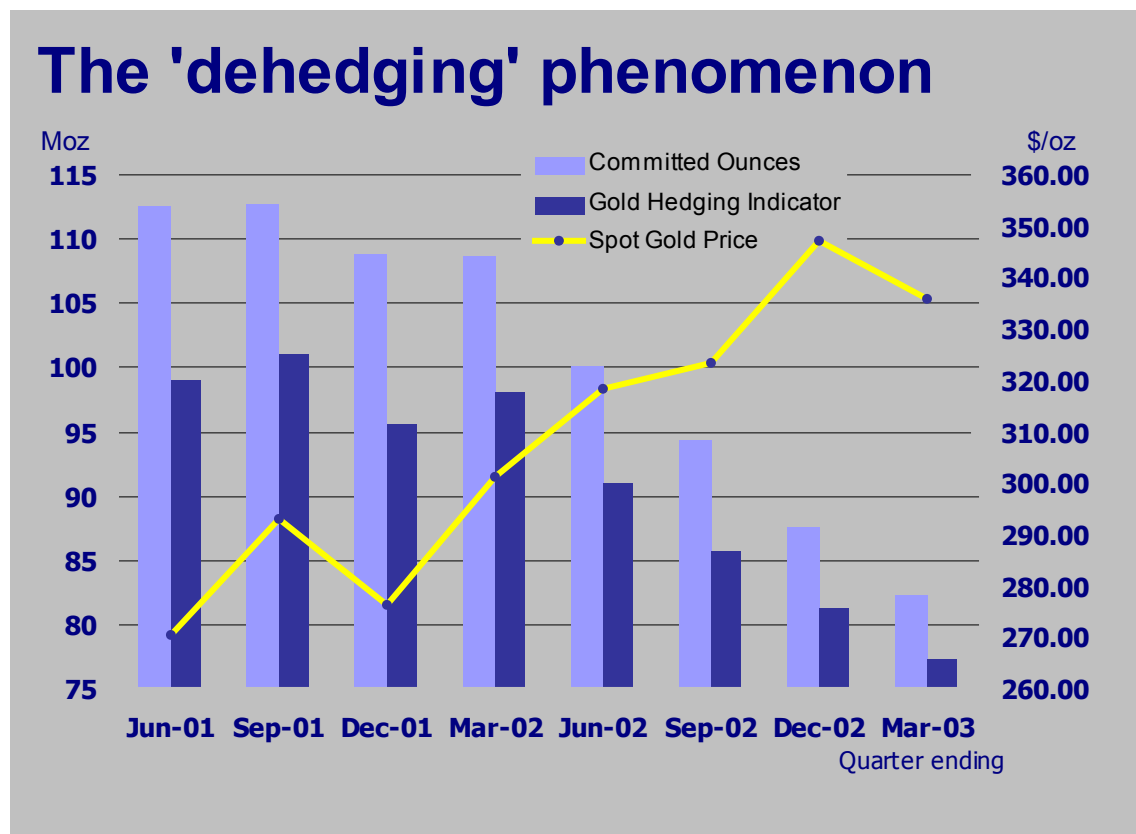
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Paper for the LBMA Conference, Lisbon June 2003

A very good morning to you all and thank you to the LBMA for inviting me to speak on hedging and derivatives. The change of venue from Shanghai to Lisbon fortunately does not change the content of my speech although I am rather puzzled as to why SARS has caused such a stir. In the South African context, SARS stands for "South African Revenue Services", and I have grown up being plagued by the SARS virus in the form of the dreaded taxman and accountants.

And it is indeed the taxman in the form of a financial authority who is the villain of this particular piece, as I will later demonstrate, for it is he who has probably had some of the most direct bearing on the way hedging has evolved in the past 3 years.

But before going into the reasons behind what has become known as the dehedging phenomenon, let me quickly update you on the very latest numbers, a data series literally hot off the press.



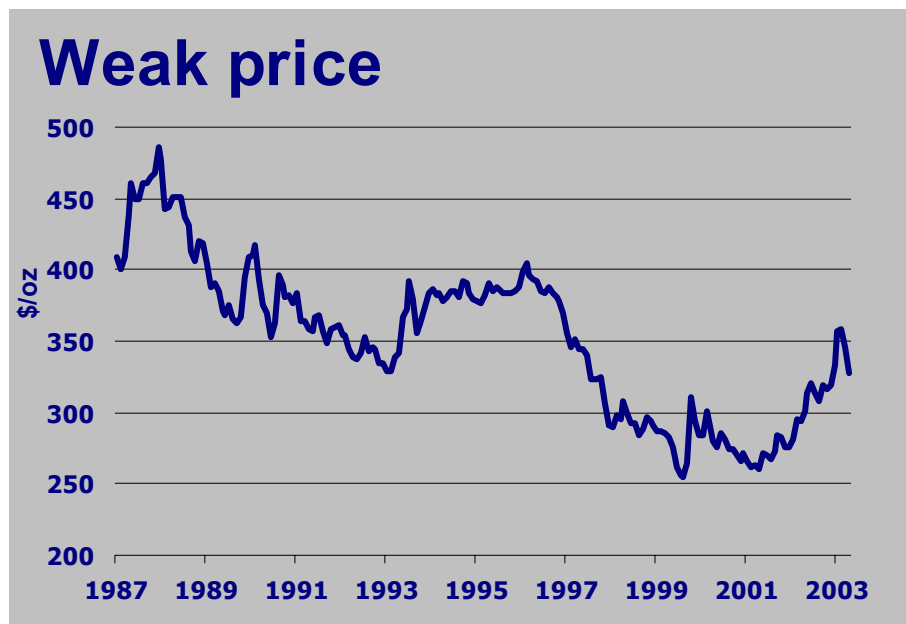
Data Source: VM, Haliburton Minerals and NM Rothschild

Our Gold Hedge Indicator, the industry benchmark collated by Ted Reeve of Haliburton Mineral Services and sponsored by NM Rothschild, indicates that for the first quarter of 2003 the hedge book shrank by a further 5%. Putting this into context this chart shows what has been happening over the past few years. We run with the net delta calculation, since this gives the market a more accurate picture of the real impact the hedge book has on the market, as opposed to the committed ounce figure, which can overstate the true situation. As one then would expect with the committed ounces, the decline is more pronounced because this does not take into account the effect of the net deltas associated with option positions.

Regardless of how you might elect to measure the level of overall hedging, the message is the same; the hedge book on a global basis has been declining and my intention today is to explore some of the reasons for this.

First and foremost there is the price. Hedging and price risk management in general from the gold producers' point of view has been conducted mainly in a climate of declining prices. Of all audiences, this is one I do not need to remind of the prolonged bear market that we have all endured. The cause and effect of this bear market and the role that hedging has played has been subject to endless debate and it is not my intention to revisit this here today.

But this next chart shows the monthly Dollar gold prices from 1987 onwards. It was against the background of these persistently declining gold prices that the majority of the global hedge book was established. This stands to reason. Why would a producer elect to lock in prices through forward sales or put in cap and floor prices in a bull market? In May of 2000, however, the direction of the gold price at last turned around and this forced the miners to rethink their derivative philosophies. Hedging into a rising market obviously made little sense but more than that, the miners began to review their existing positions and hence brought about the change in the direction of total hedging.

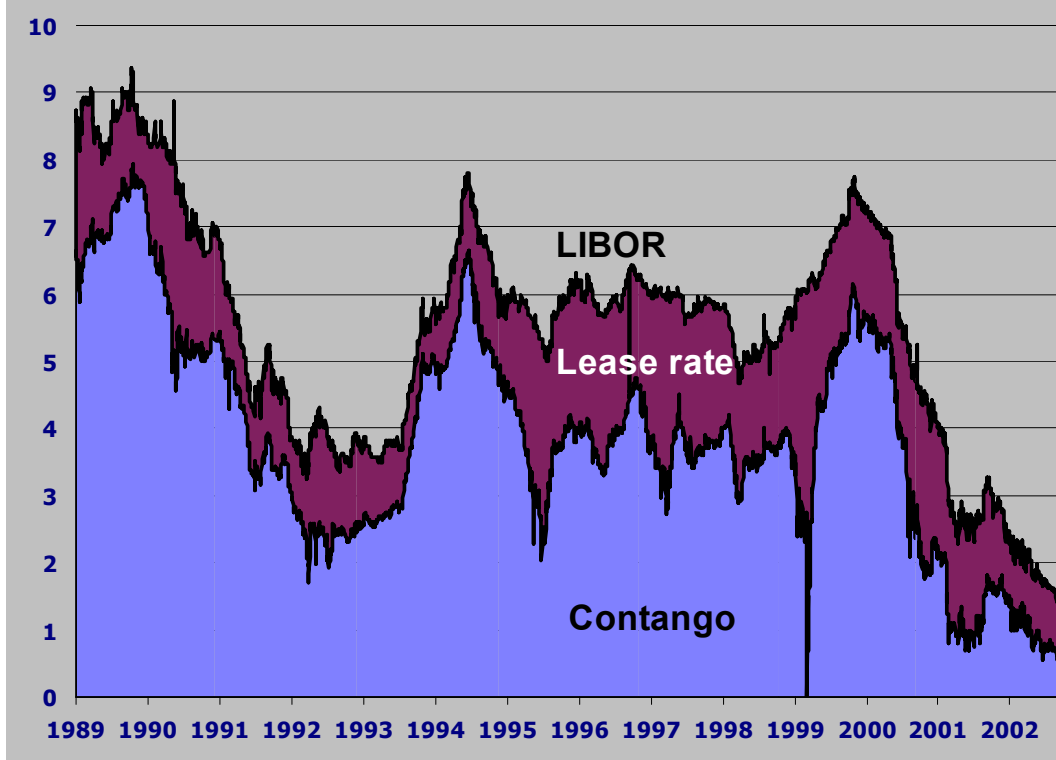


Data Source: Virtual Metals

The next important issue was undoubtedly the decline in interest rates which had the impact of reducing the contango to be earned by the miners.

Here again the next chart shows this clearly.

## Falling interest rates & contango



Data Source: Virtual Metals

Unlike base metals, which can and frequently do lapse into steep and prolonged backwardations, the ready availability of gold market liquidity means that, except on very rare occasions, gold remains in contango, and the earning of that contango was a prime reason for hedging in the first place. But when the contango falls to the low levels seen in the past 3 years, there is not much incentive for the miners to hedge and this development triggered a rethink.

Then of course there is the shareholder and his perception of hedging. Over the years there has been a gradual but persistent and noticeable shift in sentiment away from being largely pro-hedging to questioning closely the role hedging ought to play –if any - in a company's overall strategy. I believe that three landmark events led to this change of heart on the part of the shareholder. Chronologically these had an incremental effect on thinking:

First came the European Gold Agreement in September 1999, which for a very short period of time disrupted the lending market and caused lease rates to spike. The backwardation that resulted was indeed very short lived but it did expose the vulnerabilities of a small number of hedge books via their more exotic and volatile derivative products. The fallout seen in specifically two companies is well known to this audience and there is no need to pick over old wounds. But the resultant media attention and in some cases the direct impact this had on share prices and the shareholders' investment brought the whole issue to the fore and to the attention of the private and institutional investment communities alike. I like to think of it as three out of the seven veils being lifted – probably forever.

Second came FAS133 and the requirement that derivative reporting become substantially fuller and more transparent. I am going to return to this later in my paper. FAS133 effectively lifted another three of the seven veils and on the back of the fact that shareholders were already starting to feel a bit vulnerable with respect to hedging, their degree of discomfort was further

heightened when the intricacies and size of the many of the hedge books were revealed in the public accounts. Someone said to me: "it's like knowing that you have a reptile behind your sofa in your living room. It's in the back of your mind all the time but because you actually don't see it, you decide that you can live with it - until you actually see the thing and note that it might be venomous and larger than you thought. Suddenly you cannot ignore it any more."

No wonder one financial executive bemoaned the fact that at equity road shows he was obliged to spend 40 of his allocated 45 minutes defending the hedge book as opposed to getting to say what he really wanted to convey about the growth and prospects for the company. As I already mentioned, I will return to FAS133 in a minute since the impact that this has had on how shareholders view hedging is in fact somewhat more complicated over and above the question of transparency and reporting.

And finally, came the recent but long awaited price increase in which shareholders have rather understandably wanted and indeed expected to participate. Loss of potential upside participation has always been a major complaint levied by the shareholders against a large hedge book and here, right before their eyes, in their opinion, their worst nightmare was played out.

And now back to the SARS virus and the accounting nightmare.

In my research completed for the WGC in August 2000 on the subject of derivatives, FAS133 was still on the horizon and yet to be implemented. It was therefore too early to comment on the effects that it might have on the hedge book. Acutely aware of the looming situation, however, I wrote in the summary:

"The introduction of the new FAS133...accounting system is certainly going to influence future hedging decisions, primarily with respect to the choice of product and the degree of expected disclosure which will render the intricacies of the hedge book substantially more visible. Product choice will be influenced by the way in which a derivative is defined for accounting purposes."

Well three years after FAS' implementation it is interesting to see how things have unfolded and in many instances, unfolded they certainly have with a number of knock on effects.

First FAS 133 in a nutshell:

It represents the culmination of a decade's worth of work on the part primarily of the Financial Accounting Standards Board in an attempt to establish generally accepted accounting practises. The emphasis was on US based companies or affiliates but in practise the impact has been global. With simplicity not it's strongest point, FAS133 essentially is a halfway compromise falling short of full fair value accounting (which ultimately must be the goal) but having moved a long way from its predecessor dating back to before the 1980s. Earlier accounting norms focused on the commodity or the currency in question. FAS 133 focuses on derivatives no matter how they are used or to what they are applied. Derivatives being what they are, this of course has begged the complex question of definition.

The definition of whether or not a product is a pure hedge or a speculative instrument for accounting purposes has without question affected the mining industry's choice of product. Inevitably, the very process of definition has not been without considerable debate revealing a world not conveniently separated clearly into black and white but one displaying many, many shades of grey. The result has been a continued move towards more basic products, such as forwards, which can be categorically defined as a hedge in the pure sense and therefore their accounting treatment has remained largely unaffected. Where a product is defined as a speculative one or a non-hedge the experience has been different. Take the writing of calls for example. Defined as speculative these options have to be marked to market at birth and then brought into the quarterly reported income statement. Thus in any quarter or reporting period,

the derivative is either above or below the water, giving rise to volatility in the earnings throughout the option life. As the FAS133.com website says, ....” Even if the option hedge is perfectly effective at limiting the company’s downside risk with respect to future cash flows, the cost of the hedge...can become a source of undue volatility.” The result is simple: with this kind of potential impact on earnings, fewer miners have been writing calls. But even the simple definition of writing calls appears to be fraught with difficulties and these products can be treated for accounting purposes as a forward sale provided the hedger undertakes to deliver into the option if called.

Another problem highlighted by the hedgers is that marking products to market on a quarterly basis only serves to focus the world’s attention on the latest set of financial results, a problem already encountered in not just the gold industry. As another miner said: “The preoccupation with the latest quarterlies with marked to market values that are the result of static measures frozen in time does nothing to bring about a better appreciation of the long term wisdom of a well managed hedge book.” Certainly options that in one quarter can be out of the money and thus show a large negative mark to market, over the full life of the option cannot do a hedge book proud – no matter how well structured or managed that book might be. The reaction to this was predictable. Neither company management (CFOs and CEOs) nor equity markets like earnings surprises at quarterly results presentations. This in turn implies that risk management advisors are now charged with the brief of reducing the volatility generated by hedge products. But the impact this volatility has is a lot more complex and potentially more serious than merely causing some periodic discomfort some quarters. A knock in earnings in any reporting period can in fact result a breach in loan covenants through the erosion of the company’s equity value, the consequences of the company being financially very serious. Ironically this can happen just when the company is actually doing well on other fronts with the unhedged production and reserves rising in value with a rising gold price.

But there are day-to-day issues as well. The major affect of FAS133 from a hedger’s point of view is that it limits the flexibility with which an existing book can be restructured. The extent to which a miner might see the benefits of restructuring is often negated by the accountants who maintain the way the hedges are put through in the income statements remains virtually unchanged. Once a non-hedge product has been introduced into a hedge book, it can leave a sort of permanent accounting footprint irrespective of the way it might be altered in the future. Now when does this occur? If a hedge is restructured via the original counterparty, then in general this problem does not develop assuming of course that valuation changes are fully reflected up to the date of the restructure. But if a hedge originally undertaken with one counterparty is then restructured with another bank then there is no accounting offset permitted and the miner has to report the gross level of hedging which of course leaves the footprint.

This, according the mining industry, greatly limits what they do with whom and complicates rather than simplifies how the miners convey this to the shareholder and how the shareholder appreciates the overall price risk management programme. As one treasurer said: “ Hedging is an already complex concept to get across to shareholders in a cogent and unemotive way that places the rationale into perspective. Superimpose on these the apparently not particularly rational intricacies of the accounting mist and the situation becomes as clear as mud on a foggy day. This does nothing to enhance our ability get across to the shareholder the benefits of the hedge or indeed the wisdom of restructuring to accommodate changing market circumstance. Of course we then play hostage to fortune with respect to comments from our non-hedging colleagues.”

What all this does is highlight the difficulties faced by equity analysts when they have to complete company results comparisons. This is no longer a concern about how to fairly compare hedged against non-hedged producers. It is now a lot more complex than that. It is more an intricate question of appreciating in full the structure of the hedge book, what is defined as hedges and are thus off balance sheet and what are speculative products that introduce the

volatility into the income statements and how all this compares with other hedge books and results.

One final point to note that I have already alluded to is that the implementation of these accounting practices is an ongoing process, part of an evolutionary progression. The next step is certainly the intention to include all risk management products into the fair value accounting net, irrespective of their current hedge or non-hedge status. This will imply that all hedging will have to go through the incomes statements. The downside is: expect more of what the miners have been bemoaning with respect to income statement volatility. The upside however will be in the fact that any debate as to product definition will be ironed out the system, circumventing the time consuming debates that have characterised the past three years. It also will automatically allow equity analysts a shot at genuinely fair comparisons.

In my 2000 report I included some rather caustic comments from the mining industry on the subject of the accounting standards.

“The authorities are removing the incentive to mine.” was one and which with hindsight probably should have read “The authorities are removing the incentive to hedge.” Another comment was: “FAS 133 is poorly prepared and in general is unreasonable”. This complaint obviously came from the heart but it was said just as FAS was beginning to impact and we can expect more to come. Regardless of how the miners feel about FAS133 they are not alone since FAS133 is affecting almost every business that might make use of derivatives, from producers of commodities right through to hedge funds, from banks through to traders – in short both users and creators of derivatives are being affected. FAS133 is here to stay and we can only expect accounting standards to become more onerous and encompassing in the years to come.

Thus overall, the hedger has not had an easy life of late. Higher gold prices, lower contangos, onerous accounting standards and in some cases grumpy shareholders – not exactly the recipe for blissful existence. Is it any wonder that we have seen a persistent decline in hedging? And to add insult to injury those producers who have actively reduced their book, a process which certainly has been supportive of the price, have received no credit for this course of action. They have been criticised for years for their hedging policies and then when they unwind them, no one bothers to acknowledge their effect on the market.

But what of the future? In this current price and contango regime we would expect more of the same but there must come a stage when the rate of decline slows and we are left, all other parameters being equal, with a core level of price risk management. On a delta hedge basis the hedge book since June 2001 was contracted from a fraction under 99 million ounces to a little over 77 million ounces, a difference of 21.6 million ounces. This equates to a decline of 673 tonnes or almost twice South African gold production at 2002 levels. Looking at this slightly differently, this 637 tonnes is actually demand, it is gold coming off the market. This begs the question: what other source of demand is going fill the vacuum if and indeed when the dehedging phenomenon has run its course?