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PEAK GOLD!
A Primer on *True Hedging*, Part One
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Maximize life, not profits!

In a previous article *Gold Vanishing Into Private Hoards* I have examined the future of gold from the demand side. Now in *Peak Gold!* I examine it from the supply side.

For the title I am grateful to Tom Szabo of www.silveraxis.com. He said in his comments dated August 3, 2007: "the unanswered question is: are we approaching 'Peak Gold'? We often hear the term 'Peak Oil', but there are probably some pretty good arguments against being able to predict when the 'peak' date will arrive. Certainly no oil company has put out a prediction of peak production, much less one predicting that oil output will drop by 10 to 15% within a decade."

In this new series of articles I wish to provide a definitive answer to Tom Szabo's question: *yes, we are approaching 'Peak Gold' if we have not already passed it*. The last twenty-five years in the history of gold mining has been a gross aberration during which gold was mined as if it were a base metal, namely, at the top grade of ore reserves (that is, *most recklessly*). This is in the sharpest contrast with how gold has been mined traditionally as dictated by the economics of gold mining, namely, at the marginal grade of ore reserves (that is, *most conservatively*). The world is witnessing a sea change: gold, having been mined *qua* a base metal, is once more being mined *qua* a monetary metal.

By marginal grade of ore is meant that grade which can still yield a profit (*i.e.*, is payable), however, any lower grade is already submarginal (*i.e.*, is non-payable). Clearly, marginal grade varies *inversely* with price: it goes *higher* as the price goes *down*, and vice versa. Gold mining used to be the very opposite of base metal mining which must, of necessity, maximize profits, just like any other enterprise. Not many people realize that gold mining is the *only* exception to this rule. The goal of the gold miner is not to maximize profits. Far from it. His goal is to *maximize the life of the gold property*. There are several reasons for this, the outstanding one being that gold is the monetary metal *par excellence*. Whenever private enterprise rather than the government or its central bank controls its creation, new money is not railroaded (should we say air-dropped by helicopter?) into circulation. Money creation is then guided by economic rather than political considerations.

Worst grade first, top grade last

Historically, the propensity of governments is to debase the currency rather than maintaining its value. The longer gold stays underground locked up in the gold-bearing ore, the longer it stays outside of the government's reach. We must remember that gold in the ground can still be an efficient store of value. The aberration of the last twenty-five years of mining gold at break-neck speed, and selling it forward, in some case as much as fifteen years of mine production, is ending. All mines will realize that premature exhaustion of their gold property is suicidal. They will have to learn again the wisdom of gold miners of old: *worst grade first, best grade last*. Ben Franklin's dictum that "experience runs an expensive school, but fools will learn in no other" applies here as well and, therefore, the learning process may take some time. Be that as it may, the smartest gold miner has probably shifted back to mining at the marginal grade already. He reasons as follows: "If I can only keep my mine operational long enough, dollar debasement will catch up with my submarginal grades and will make them go through a metamorphosis. My submarginal grades of ore will become payable. My expiring gold mine will be rejuvenated and given a new lease on life, thanks to the misguided monetary policies of spendthrift governments. *Ergo* I had better work my mine as conservatively as possible and lengthen its working life by all available means". This line of thinking is well summarized by the adage: "*in and out of ground gold teaches man husbandry*".

Barrick bringing good tidings for gold bugs

The present *negative* roller coaster ride for monetary metals is leading to an increase in absolute terms of the price, which appears unstoppable. (Negative, because an ordinary roller coaster ride ends at the lowest, not the highest, level.) The latest confirmation has come from a most unexpected source. Barrick, the gold miner held in contempt by most gold bugs (for its presumed activities in trying to cap the gold price, nay, to club it down) is now saying that the price of gold will rise during the next five to seven years because supplies from the mines will drop more than anyone in the market can anticipate. This is an extraordinary statement coming, as it is, from a gold producer with a millstone-size and weight of a hedge book around its neck.

As Dorothy Kosich reports on Mineweb in her article *Barrick Opines on Gold Supply and Price* (Aug. 3, 2007), during a conference call Barrick delved into its future prospects including gold prices. President and CEO Greg Wilkins, and Executive Vice President and CFO Jamie Sokalsky revealed that Barrick has been "digging in very deeply on the supply side of the business" working with a research firm to uncover evidence and trends increasing Barrick's optimism for the future gold price. Mark the word *optimism*. Perhaps it should read *pessimism*. Barrick's hedgebook is so hopelessly under water that the company cannot afford to buy it back, as did Newmont making it the largest 'unhedged' gold mine, while the going is still good. The future gold price spells disaster for Barrick that cuts the pitiable figure of a moose standing on the train track fixated on the headlights of the fast approaching train.

"Timeo Danaos et dona ferentes"

Barrick is still studying the research reports, but Sokalsky already told analysts that "our initial analysis shows the buy side (*sic*) is likely to drop a lot quicker and more than most in the market are anticipating." While he insisted that "it is still too early to talk about any specific numbers", Barrick's research has uncovered much that "should be a lot more positive for the gold price". Sokalsky has divulged that a 10 to 15% drop should occur in overall mine supply of gold within the next five to seven years. That's a *volte-face* if there ever was one. Ten years ago gold was fetching \$300 an ounce and Sokalsky boasted that if *horribile dictu* the gold price went to \$600, Barrick would still be O.K. It could not get a margin call on its gold leases for fifteen years. It need not sell into its hedge book at a loss. It could always sell its output in the open market at a profit. 'Barrick would make every cent of that increase'.

Every cent? The gold price presently is well over \$600, and the same Sokalsky is talking about much higher gold prices for the next five to seven years. He must have Santa Claus for bullion banker who carries Barrick's short position most cheerfully, regardless of staggering losses. (Since then we have been told that there is no Santa Claus, not in the gold mining business anyway. The bullion banks have barred Barrick from speculating in the bond market with the proceeds from the sale of leased gold. Moreover, they took away Barrick's freedom to sell its output in the open market without putting a prescribed amount of gold into the hedge book. In effect, Barrick's gold production is in escrow. In all but name the company is foreclosed on its gold leases. The 15-year moratorium on margin calls is a myth that has been exploded by the market.)

Tom Szabo seems to be a bit skeptical about Barrick being the first to report the bad news (bad, that is, from the point of view of those who have endeavored to cap the price of gold during the last decade of the last century. Who knows, maybe the research shows an even bigger than 15% decline in output, but Barrick has opted to tamper with the data in order to show a smaller anticipated decline in gold production than justified by the research, as part of its undending quest to keep the lid on the gold price. Tom Szabo adds that, joking aside, these projections are incredibly bullish for the long-term gold price. What Barrick implies, in effect, is that despite billions of dollars thrown at exploration during the past 2 or 3 years, there are not enough new projects even in the early discovery stage (much less in the late development stage) to maintain the current level of output, as production at the existing sites will start to decline in the next few years.

I myself am also skeptical. "*Timeo Danaos et dona ferentes*" (Virgil, *Aeneid*, ii.49): I fear the Greeks especially when they bear gifts. President Wilkins is on record that, while reducing its hedge book some, Barrick will retain its hedge plan as an "essential risk-management tool" and a means of "stabilizing revenues". It gives Barrick "needed flexibility" and, Barrick's creditors, necessary collateral. I think Wilkins should have come clean during the conference call. The talk about 'risk-management' and 'stabilizing revenues' is for the birds. Wilkins should repudiate the hedge plan in no uncertain terms and put the whole unpleasant affair behind him for once and all. Barrick and its creditors

need the so-called hedge plan as they need pain in the neck. Unless... unless... there are yet more skeletons in Barrick's cupboard.

Logic would dictate that Barrick lift its short hedges first, and release the research report afterwards. Doing it in the wrong order could cost a pretty penny. Barrick brings the dictum of Cicero to mind: *Mendaci neque quum vera dicit, creditur* (a liar is not to be believed even when he speaks the truth).

Ruthless exploitation

During the past twenty-five years gold was mined following the worst traditions of ruthless exploitation of a resource. Barrick served both as brain-trust and ring-leader, by mining gold at the top grade of ore defying the tradition and economics of gold mining, and by promoting a thoroughly mendacious, false, and self-defeating forward sales program under the banner of 'hedging'. At one point during the past fifteen years Barrick had to close down operations at no fewer than ten of its gold producing sites as a result of exploitation, because ore reserves became submarginal in the wake of the falling gold price. For years, Barrick has been selling gold forward with wild abandon at ridiculously low prices, in effect blocking its own escape route to short covering should the need arise. It is hard to imagine a gold mine managed more incompetently from a global point of view. Of course, Barrick's highly touted 'hedges' are no hedges at all. In so far as they mature over one year, and their volume exceeds one year's mine output, they are naked forward sales misrepresented as hedges. The whole scheme has been a mindless and extravagant exploitation of a world resource.

In all likelihood it has also been a 'gold laundering' scheme. I have coined this expression to describe clandestine transfer of shareholder equity, either to management (a.k.a. embezzlement), or to an unnamed third party (a.k.a. defalcation). We do not know whether Barrick is guilty of embezzlement, defalcation, or both, and perhaps never will.

Forewarned but not forearmed

We need not keep guessing. I submit that Barrick has been put on notice that its so-called hedge plan would invite charges of unfaithful stewardship as soon as the bear market in gold is over. I warned Sokalsky in person ten years ago at Barrick's headquarters. The meeting took place at the suggestion of Chairman Peter Munk with whom I exchanged letters on the matter. Sokalsky and I discussed Barrick's hedge plan for an hour and a half. I can testify that he understood my point very well. At the end of our meeting I presented to him a 50-page document entitled *Gold Mining and Hedging: Will Hedging Kill the Goose To Lay the Golden Egg?* which treated this issue exhaustively. He promised to read it and to pass his comments on to me within a month. I have never heard from him again.

In my document the process whereby a rising gold price inevitably makes world gold output shrink (in terms of tonnes) is very clearly demonstrated. To explain this, first I have to discuss another remarkable difference between the ways gold and base metals are

traditionally mined. This is the deliberate variation of the rate at which mill capacity is being utilized. The base metal miner is under constraint to mine at the top grade of ore. But he is free to vary the rate of mill capacity utilization in response to changing market conditions. Accordingly, he will increase it if he has to increase output, and vice versa. *Not so the gold miner*, who is under constraint to run his mill full time, as close to capacity as practicable. But he is free to vary the grade of ore at the mill in response to changing market conditions. Whenever the price of gold rises he *decreases*, and it falls he *increases* the grade. He does this because the marginal grade of ore varies inversely with the gold price. If he is to run his mine economically, the gold miner is compelled to go after the marginal grade of ore and leave the better grades alone. He knows that premature exhaustion of his gold mine means dissipating shareholder equity and wasting capital resources. The prematurely exhausted gold mine would have a lot of valuable ore-reserves left behind that would become payable later when the dollar is sufficiently debased. But then it would be too late. Once the gold mine is closed down, it could be prohibitively expensive to re-open it.

Mechanism of Peak Gold

For example, whenever the gold price rises, the marginal grade of ore falls as heretofore submarginal grades become payable. Since gold mines run their mills close to capacity, output shrinks every time the gold price has reached a new high plateau, provided that they are managed economically. Uneconomically managed gold mines get exhausted prematurely and fall by the wayside, as they well deserve.

Peak Gold can be confidently predicted since the increasing gold price (an inevitable consequence of deliberate dollar debasement) causes a world-wide shift in the marginal grade of every gold mine. The marginal grade of ore drops. Since the combined milling capacity of the world's gold mines is a given quantity, and it can only be increased slowly, after a great capital outlay which management may well be reluctant to make (as it would eat into profits and shorten the life of the gold property to boot), the upshot is that the gold content of mill output is falling. World production of gold shrinks (in terms of tonnes) with the rise in the price of gold.

But what about opening new gold mines? As Tom Szabo has hinted, the artificially induced bear market in monetary metals between 1981 and 2001 has resulted in a great reduction in prospecting, exploration of known sites, and development of mines at proven sites. We must realize, however, that the whole episode of explosive increase in world gold production from 1914 through the end of the century was a great anomaly. Even though it was engineered by governments on the warpath, the feat cannot be repeated. The inflationary escapades of governments, either acting in solo or in concert will of course continue. The governments can stay on the warpath and can expand their pet welfare projects as long as they want. In vain: the nexus between the welfare-warfare state's inflationary design and the value of gold, or the tectonics of marginal gold ore underground, has decisively been broken. Governments have expended their ephemeral power to work the miracle of multiplying cash gold through multiplying paper gold. Ditto, no longer can they pretend that gold locked up in ore deposits below surface is a

valid substitute for cash gold. From now on it is "*cash gold on the barrel*". Falsecarding in the gold business has been exposed and discredited.

The great increase in world gold output during the twentieth century was a non-repeatable event, largely due to the inflationary propensities of governments under the gold standard artificially suppressing, as they did, the value of gold. This has caused a world-wide shift in the marginal grade of ore in every gold mine. The marginal grade was boosted and, with it, the world's gold output. That is the background that has created Peak Gold in the first place: a reckless exploitation of a world resource whose production would have increased much more evenly in the absence of inflationary escapades.

But this is history. The present reality is that uneconomic increases in production and naked forward selling are over for good. On the supply side, limited and diminishing injections of newly mined gold shall replace unlimited and ever increasing dumping of paper gold. When you need gold, you demand *cash* gold, the supply of which from the mines is going to decrease from now on. It is satisfying to see Barrick acknowledge this first.

Hedging proper

In the next part of this series *Peak Gold!* I shall explain, as I have explained to Jamie Sokalsky ten years ago, the principles of *proper* hedging. I suggested to him that Barrick should announce a *bilateral* hedge plan to succeed its notorious *unilateral* plan. The latter involves short hedges (forward sales) to the exclusion of long hedges (forward purchases). The former involves *both*.

Just as its forward sales are balanced by Barrick's need to market future production, forward purchases, had they been entered, could have balanced Barrick's future need to acquire new gold properties in anticipation of the exhaustion of its ageing sites. Had Barrick listened to my advice, Peak Gold would not have been to its chagrin. Not only would profits on the long hedges have outstripped losses on the short ones; they would have covered the hefty increases in the price that Barrick has now to pay for new gold properties. Barrick could have scaled Peak Gold with the flying colors, and without a penny loss on its short hedges. What is more, it could have plenty of money left on its long hedges to pay for the acquisition of fresh gold properties in preparation for a bright future bringing higher gold prices in its wake. Barrick would have been ready for the new bull market and could contemplate its own future with *genuine* optimism.

Gold Standard University Live

Session Two of Gold Standard University is taking place between August 17 and 24, 2007, at Martineum Academy in Szombathely, Hungary. It is featuring a one-week course (13 lectures) entitled *Gold and Interest*, as well as a blue-ribbon panel discussion on the subject of *Last Contango - Basis As an Early Warning Sign of the Collapse of the International Monetary System*. Tom Szabo will chair the panel. He is the world's

foremost expert on the gold and silver basis who on his website www.silveraxis.com has been tracking the basis for half a year. He is a member of the research team of GSUL.

Session Three is planned to take place in Bessemer, Alabama, U.S.A., in February 2008. It will feature a one-week course entitled *Adam Smith's Real Bills Doctrine*. An *advocatus diaboli* from neighboring Mises Institute will be invited to challenge the wisdom of Adam Smith. The session in Alabama will also feature a blue ribbon panel discussion on the subject of *True Hedging for Gold Mines*. Representatives of hedged and unhedged gold mines will be invited to participate. The present series *Peak Gold!* is a primer on true hedging.

This is a preliminary announcement only. Stay tuned. For more information please contact: GSUL@t-online.hu

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