


The Esquel Gold Project[94] is a proposed open-pit mine project near the town of Esquel, Argentina. With 30,000 residents, Esquel is the largest town in the western Chubut province. Located in the scenic eastern foothills of the Patagonian Andes, the community and its surrounding region have a diverse economic base that includes forestry and ranching. However, its primary economic activity is tourism. The area is well known for its excellent skiing, trekking, and fishing. It is also the gateway to Los Alerces National Park, a mountain preserve of the rare *alerce* tree, a massive species unique to the region that can live to be 3,000 years old. Esquel's residents are well educated and socially cohesive; many moved to the town from more urbanized areas to enjoy the community's natural amenities and alpine charm.

The Esquel project is owned by Meridian Gold, a mid-tier gold producer based in Reno, Nevada. Meridian hoped to develop an open-pit gold mine (with possible subsequent underground operations) 700 meters above and 7 kilometers east of the town.[95] The project was expected to cover an area of approximately 189 hectares, including facilities for extraction, processing, and waste disposal. It would extract ore from one or more 180- to 200-meter deep pits, and process it using cyanide vat-leach technology.[96] The mine was predicted to have an operating life of 8–10 years, and to yield approximately 3 million ounces of gold.[97]

Meridian obtained the development rights to the mine in July 2002 by acquiring its previous owner, Brancote Holdings. This transaction was self-financed by Meridian—the company purchased all of Brancote's shares in exchange for US $310 million in Meridian stock.[98]

## COMMUNITY OPPOSITION

Since the town of Esquel did not have any previous experience with industrial-scale mining operations, most residents were unfamiliar with the potential benefits and risks of a mining project for their community, and did not have strong preconceived notions about the project. They were primarily interested in obtaining more information about the potential impacts and risks, and in discussing the project with the sponsors to learn more about the potential effects before making up their minds.

At the time Meridian purchased the mine in July 2002, there was no clear community consensus about the project. On one hand, there were good reasons to anticipate stiff opposition to a large-scale mine. Many of the town's citizens had chosen to live in Esquel to take advantage of its abundant natural amenities, and were skeptical of any development initiatives that might radically alter its economy, mountain-community character, or the quality of its environment. These concerns were so deeply entrenched that community support for a large-scale mining project would most likely have been difficult (though not necessarily impossible) to obtain in even the best of circumstances. But those who shared these concerns had not yet organized in opposition to the project.

On the other hand, there was also reason to believe that the community could be persuaded to embrace the project. The community had recently completed an inclusive and widely supported long-term planning exercise called the *Plan Participativo de Desarrollo Local Social, Económica y Ambientalmente Sustentable* (SEAS), which articulated the residents' vision of how they wanted


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Esquel to develop. While emphasizing the importance of sustainably protecting the natural environment and mountain community attributes, the SEAS concluded that mining could be an important part of the community's development strategy.

Meridian did not fully understand how these considerations would affect community acceptance of the mine proposal during its pre-purchase due diligence investigations. Nor did it adequately reach out to the community or attempt to build a basis for constructive dialogue.[99] Rather than seeking to integrate its project objectives into the SEAS's agreed-upon vision of community development, project management publicly dismissed the SEAS as irrelevant to its concerns. Similarly, the company ignored two studies of the potential impacts of the mine project conducted by independent, locally respected institutions—one by a team at the local Universidad Nacional de la Patagonia San Juan Bosco, and the other by the Family Council, an organization that advises the local government on family and children's issues.[100]

Meridian's lack of responsiveness to community preferences and concerns carried over into the early stages of project development. The company consistently failed to share critical information about the potential benefits and risks of the project, or to engage with the community and address its concerns before they became points of contention.[101] An illustrative example was the company's response to concerns about the risks associated with the transport, use, and destruction of cyanide. In July 2002, the company set up a laboratory to sample the quality of the ore and test the use of cyanide. However, it made no effort to explain the purposes of the laboratory to the community, creating the impression that it wished to obscure the real dangers of cyanide in its operations. This led to the local public authorities' mistrust of the company. Meridian sought to quell these concerns by having a representative of the cyanide manufacturer explain the use of cyanide in the mining process. Some residents were not satisfied with the representative's answers. They began to do their own research about the dangers of cyanide use in mining, and to publicly present their findings.

As key questions about the use of cyanide remained unanswered and perceived slights accumulated, latent community concerns hardened into organized opposition. In November 2002, a grassroots community group of "self-convened neighbors" formally came out against the mine after it was unable to engage the company in a meaningful dialogue. This community group began to organize demonstrations, which drew large crowds, and anti-mining graffiti started appearing in town. Also at this time, residents opposed to the mine presented a plan to municipal authorities for a popular referendum on the mining project.

Meridian reacted to the gathering opposition mainly by initiating a public relations campaign. The company organized a counterdemonstration in favor of the mine that was sparsely attended. It also retained a Buenos Aires public relations firm to implement a political strategy for winning a public referendum. This proved to be counterproductive, as the firm's materials and outreach efforts were seen to be out of touch with community's sensibilities. Meanwhile, the company failed to respond to an offer by the Catholic Church to facilitate a dialogue between the company and the community.

By the end of February 2003, the mayor of Esquel recognized that political momentum against the mine was growing, and agreed to authorize a public referendum to be held on March 23, 2003. Three-quarters of eligible voters participated, 81 percent of whom voted against the mine proposal. This popular rejection had two immediate effects. First, Meridian suspended all operations at the project site and sought to figure out where its community interactions had gone wrong. Toward this end, it commissioned Business for Social Responsibility (BSR) to conduct a review of its interactions with the community.[102] Second, on April 9, the Chubut provincial government "legalized" the outcome of the referendum by banning open-pit mining and the use of cyanide throughout the province, except in specifically designated areas.[103]

In August 2003, after receiving BSR's highly critical review of the issues faced and handled by BSR, Meridian issued a public apology for its failures to listen to the community's concerns and engage in open dialogue about the project. At the same time, it pledged not to move forward with the project until it could garner the support of the Esquel community.[104]

While the project has been stalled since the March 2003 referendum, Meridian continues to believe that it can persuade the community to embrace the project's development. The company is currently exploring the feasibility of a new underground mining plan and a re-engineered processing facility that it hopes will address the community's social, environmental, and technical concerns about the project.[105]

## CORPORATE EXPECTATIONS FOR ESQUEL

Meridian purchased the development rights to Esquel and 1,400 square kilometers of surrounding area in July 2002 for US $310 million in company stock. At the time of the purchase, it expected to secure permits for the mine and begin construction in the second quarter of 2003, and to begin producing gold 12 to 15 months later.[106]

Meridian's management viewed the Esquel project as a central pillar of the company's future growth and profitability. In its 2002 *Annual Report*, the company's chairman and chief executive argued that the acquisition was "[u]ndoubtedly, the highlight of the year...."[107] They explained that Esquel's estimated 3 million ounces of extremely low-cost reserves (about $100 per gold ounce) provided a "unique growth opportunity," and had the potential to nearly double the company's reserves, production ounces, and cash flow.[108] As a result, they argued that Esquel would represent the "next chapter" of corporate growth. It would help make Meridian a 600,000-ounce annual gold producer within the next two years, and would be a critical foundation of Meridian's medium-term objective of producing and replacing 1 million ounces per year by 2008.[109]

Meridian's confidence that Esquel was an extraordinary corporate opportunity is further evidenced by the fact that the company abandoned two longstanding corporate strategies to acquire it. First, Meridian had traditionally eschewed growth by acquisition in favor of expanding its operations through grassroots exploration.[110] As the company explained in its *2001 Annual Report*, since "finding gold is cheaper than acquiring it," it would only pay an acquisition premium for particularly valuable properties—a high-quality discovery, a project that was ready to go, or a project that had significant geologic


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potential.[111] For Meridian's management, Esquel seemed to meet all of these criteria. Second, prior to acquiring Esquel, the company was strongly disinclined to dilute equity to finance growth. Indeed, in the same *2002 Annual Report* that describes the stock purchase of Esquel, the chairman and chief executive said that equity finance was "the most expensive form of cash," because "[d]ilution is forever."[112] Nevertheless, the company issued 22 million shares to acquire Esquel—increasing its outstanding shares by almost 30 percent.[113]

## THE FINANCIAL IMPACTS OF THE PROJECT'S COLLAPSE

Meridian's experience with Esquel had a dramatic impact on the company's balance sheet. Most obviously, Meridian expended considerable resources to acquire, assess, and manage the Esquel site. As of September 30, 2005, Meridian estimated the net carrying value of the Esquel project at US $350 million: $310 million in acquisition costs and $40 million in pre-development costs.[114]
In February 2006, accounting regulations forced the company to write down the value of the Esquel property to its fair commercial value without mineral resources. As a result, Meridian reduced the value of its Esquel

holdings by US $542.8 million ($378.9 million after tax adjustments), producing a net loss for fiscal year 2005 of US $346.4 million.[115]

Meridian's assets and reserves were also severely affected by the conflict in Esquel. At the end of 2004, Esquel represented approximately 53 percent of the proven and probable reserves, and 48 percent of the total reserves in the company's portfolio.[116] While Meridian is working to earn community support for an underground project, there remains a very real possibility that these resources will never be developed. This represents a considerable loss of asset value. In 2002, Meridian assumed a price of US $325 per ounce for Esquel's estimated 3 million ounces of reserves.[117] At that price, Esquel's reserves were worth about US $1 billion. Since then, gold has sold at more than US $720 per ounce[118] and averaged $603 per ounce in 2006.[119] At this average price, Esquel's reserves would be worth US $1.81 billion.

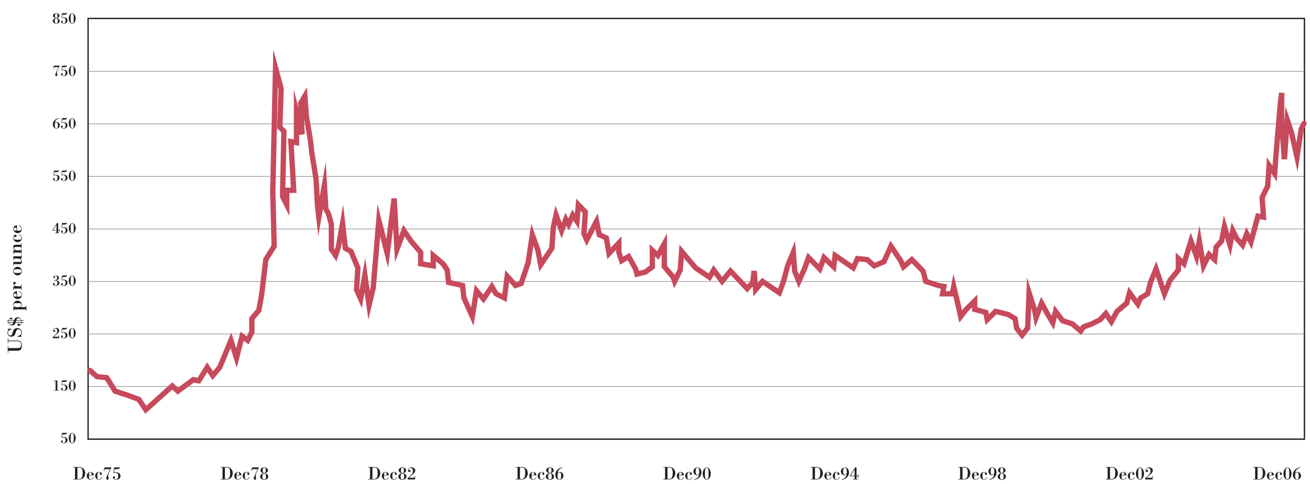
The cessation of development activities at Esquel has already cost Meridian the opportunity to sell some of Esquel's gold reserves at these extremely attractive market prices. When Meridian purchased the mine in early July 2002, it expected to begin producing gold some time around September 2004.[120] As Figure 3 illustrates, gold prices have risen dramatically since September 2004. Had Meridian reached its target of 300,000 ounces per year between September 2004 and February 2006, it could have brought in over US $200 million in additional revenue, based on the average gold price of US $453 per ounce during that period.[121] After netting out estimated production costs of US $100 per ounce, Meridian could have earned US $160 million from operations in Esquel during that period.

Looking ahead, at the current gold price of US $650 per ounce,[122] Meridian is foregoing an additional US $13.75 million per month in net earnings, or about US $165 million per year (see Table 2). To put this in perspective, in 2005 Meridian reported a total of US $131.8 million in revenues, and US $39.9 million in net earnings (excluding the Esquel write-down).[123] While many industry analysts believe that gold prices will continue to rise, periods of such high gold prices have historically tended to be unsustainable.

TABLE 2 | ESQUEL BALANCE SHEET—THE COSTS OF COMMUNITY OPPOSITION

| | |
|---|---|
| Value written-off balance sheet | $378.9 million |
| Value of lost reserves | $1.81 billion (est.) |
| Value of lost revenue (9/04–2/06) | $200 million (est.) |
| Value of lost profits (9/04–2/06) | $160 million (est.) |
| Value of lost revenue going forward | $13.75 million per month (est.) |

FIGURE 3 | PRICE OF GOLD 1975–PRESENT




*Source:* www.kitco.com

FIGURE 4 | **SHARE PRICES OF MERIDIAN GOLD INC.**

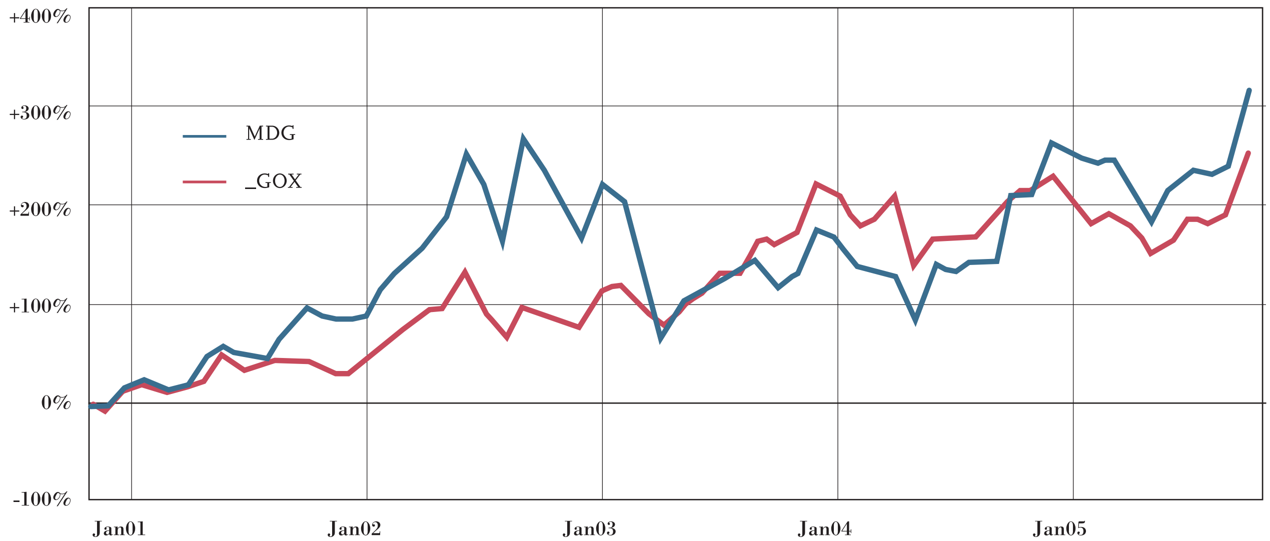



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Figure 4 shows how the company's share price fluctuated and then collapsed as the conflict unfolded in Esquel. Not all of the decline in Meridian's share price in the first quarter of 2003 can be attributed to the conflicts in Esquel. Share prices across the industry fell during this time, as the markets came to believe that gold had become overvalued in the run-up to the impending war in Iraq.[124] But even by industry standards, Meridian's stock performed poorly during this time. Figure 4 illustrates the decline in Meridian's performance in the wake of its involvement with Esquel by comparing Meridian's stock performance with that of the Chicago Board of Exchange Gold Index (GOX), an index of 12 leading global gold mining and production companies. As Figure 4 shows, Meridian began 2001 in rough parity with the industry index. But by late 2001, it had distinguished itself from its peers and posted gains that exceeded that of the index by 100–150 percent through 2002. By March 2003, however, Meridian's stock price had lost all of the gains it had made over the industry benchmark in the two previous years, and was actually underperforming its peers for the first time since January 2001. While Meridian's share price did rise over the remainder of the year, it was still off 17 percent for 2003—a year in which gold prices rose over 20 percent.[125] Meridian did not begin to consistently outperform the industry benchmark again until the end of 2004, after its market valuation doubled on the news of the discovery of two new high-grade ore veins at its highest-margin facility.[126] Despite these promising new finds, Meridian has not beaten the industry standards by the levels it did before the conflict in Esquel.

A review of the contemporaneous assessments of Meridian's situation by Wall Street analysts confirms that community opposition in Esquel helped to drive Meridan's stock price decline during this period. For example, a January 2003 report by Deutsche Bank Securities explained that despite rising gold prices, the bank was reducing its net present value of the stock by almost 14 percent to reflect the risk that Esquel would not meet its development schedule. To support this assessment, Deutsche Bank noted the local concerns with the cyanide extraction processes and the deferment of public hearings related to the Argentine government's permitting process. The report concluded that any delays in construction would have further negative impacts on net present value and calendar year 2004 earnings estimates.[127]

Credit Suisse First Boston's (CSFB's) February 24, 2003, report on Meridian reached similar conclusions. CSFB devoted most of its report to the risks to company share price posed by Esquel.[128] CSFB stated: "[T]he risks of a delay in the development of Esquel appear to be very high. These risks, in our view, are not fully discounted in Meridian's share price, despite their recent decline."[129] Noting that continued delays would cause the stock to fall even further, CSFB recommended a competitor of Meridian as a better value in the sector.[130] In two subsequent 2003 reports, CSFB's equity researchers remained "cautious" on the stock, due largely to the uncertainty related to the development of Esquel, declining earnings due to higher spending, and the significant event risk associated with a company so heavily invested in a single mine.[131]

Ultimately, despite optimistic self-reports on Esquel in its *2002 Annual Report* and in dialogue with stock analysts, Meridian conceded in its *2003 Annual Report* that its difficulties in Esquel caused its share price to underperform the industry and many of its peer producers.[132]

The conflict in Esquel also introduced volatility to its market valuation.[133] Because such a relatively high proportion of Meridian's reserves were held in its Esquel property, the company was particularly vulnerable to fluctuations in its stock price based on events in the community. In fact, volatility was most significant at the height of community protests and the public referendum against the Esquel project.[134]

In addition to these quantifiable balance sheet and stock valuation costs, Meridian endured significant unquantifiable management and reputation costs. Given what was at stake for the financial health of the company, it is reasonable to assume that Meridian dedicated substantial management resources into defusing the conflict in Esquel, repairing the relationship between the company and the community, and devising a new development proposal.[135] Meridian's reputation costs have also been significant. The Esquel controversy has become the focus of significant attention throughout Argentina and internationally. For example, Esquel is a featured case study of the "No Dirty Gold" campaign in the United States.[136]

## CONCLUSION

Meridian's Esquel experience underscores the importance of gaining the consent of the host community from the earliest stages of project assessment and planning. Meridian did not initiate the kind of dialogue processes that could have alerted the company to the community's concerns, or that could have ultimately resulted in consent being granted. Indeed, Meridian has publicly conceded that its failure to listen to the community's concerns, or engage them in open and honest dialogue, led to the broad community opposition to the project.[137] Ironically, after this opposition manifested itself in the results of the referendum, Meridian adopted an FPIC approach and promised the community that it would not develop the project without the community's consent. So far, this approval has not been forthcoming.

This is not to say, however, that a better dialogue would have allowed Meridian to bring the project to fruition. Given the quality-of-life concerns of many residents, it is entirely possible that such dialogue would have helped the community to more fully understand its own values and priorities, and to conclude that industrial-scale mining was not compatible with its development aspirations. This suggests that project sponsors should not consider community engagement as primarily a mechanism for achieving consent. In many cases, it may have greater utility as a tool for assessing the political and social risks of proceeding with a project at all. Indeed, a dispassionate assessment of the Esquel community's preferences during pre-purchase due diligence could have informed Meridian's senior management that there were significant social obstacles to project development, and would have better enabled them to make reasoned judgments about the value of the mine and the wisdom of acquiring it.