Subject: Finance/Capital Budgeting/Valuation/Real Options/Optimal Timing

Number: EBGN575

Course Title: Advanced Mining and Energy Asset Valuation

Section: A

Semester/year: Fall 2014

Instructor: Graham A. Davis

Contact information (Office/Phone/Email): EH323/303 273-3550/gdavis@mines.edu

Office hours: These may change week to week. Check the course Blackboard site or my office door posting for my current office hours.

Class meeting days/times: Tuesdays and Thursdays 9:30 AM – 10:45 AM

Class meeting location: EH211

Instructional activity: 3 hours lecture 0 hours lab 3 semester hours

Course designation: ___ Common Core ___ Distributed Science or Engineering
___ Major requirement  X Elective ___ Other (please describe ___________)

Course description from Bulletin: The use of stochastic and option pricing techniques in mineral and energy asset valuation. The Hotelling Valuation Principle. The measurement of political risk and its impact on project value. Extensive use of real cases. Prerequisites: Principles of Microeconomics, MATH111, EBGN504, EBGN505, EBGN509, EBGN510, EBGN511; or permission of instructor.

Textbook and/or other requirement materials:


Other required supplemental information: will be provided on Blackboard

Student learning outcomes: At the conclusion of the class students will...

1. Be able to produce the financial valuation component of mineral and energy venture scoping, pre-feasibility and feasibility studies
2. Understand and incorporate uncertainty into mineral and energy asset valuation
3. Be familiar with the classical literature on real asset valuation
4. Be able to incorporate option-pricing theory into mineral and energy asset valuation and management
5. Be able to read, understand, and use advances in real options techniques as they are discovered and reported in the literature
6. Be employable and make big $$$

Faculty learning outcomes: At the conclusion of the class the instructor will...

1. Have learned more about methods of valuation for oil and has projects
2. Become more familiar with new and innovative technological tools as used by today’s youth
3. Have learned current and real-world valuation issues from his students
4. Improve his Excel modeling skills by learning from his students
5. Have ideas for how to change and improve the course for the next offering

Brief list of topics covered:

1. Cost Approach to Valuation
2. Comparable Sales Approach to Valuation
3. The Income Approach to Valuation
4. The Need for Simulation
5. Evaluating Flexibility in Project Management and Design
6. Modern Valuation Techniques/Option Valuation
7. Valuing Political Risk

Policy on academic integrity/misconduct: The Colorado School of Mines affirms the principle that all individuals associated with the Mines academic community have a responsibility for establishing, maintaining an fostering an understanding and appreciation for academic integrity. In broad terms, this implies protecting the environment of mutual trust within which scholarly exchange occurs, supporting the ability of the faculty to fairly and effectively evaluate every student’s academic achievements, and giving credence to the university’s educational mission, its scholarly objectives and the substance of the degrees it awards. The protection of academic integrity requires there to be clear and consistent standards, as well as confrontation and sanctions when individuals violate those standards. The Colorado School of Mines desires an environment free of any and all forms of academic misconduct and expects students to act with integrity at all times.

Academic misconduct is the intentional act of fraud, in which an individual seeks to claim credit for the work and efforts of another without authorization, or uses unauthorized materials or fabricated information in any academic exercise. Student Academic Misconduct arises when a student violates the principle of academic integrity. Such behavior erodes mutual trust, distorts the fair evaluation of academic achievements, violates the ethical code of behavior upon which education and scholarship rest, and undermines the credibility of the university. Because of the serious institutional and individual ramifications, student misconduct arising from violations of academic integrity is not tolerated at Mines. If a student is found to have engaged in such misconduct sanctions such as change of a grade, loss of institutional privileges, or academic suspension or dismissal may be imposed.

The complete policy is online.

Since there are no exams, and since I am to give you a grade that signals to the broader community your competence in this area, I must insist that the weekly projects or question sets that I am grading be done individually unless I have approved group work. Some discussion among yourselves is of course healthy and valuable, and I encourage this. I also encourage you to share data downloaded from public sources, and to learn from each other on the weeks that the assignments are not handed in. But complete the hand-in assignments individually. I do not want to see joint production. I cannot emphasize this enough. If I find that students are working together or copying from past years’ assignments, all parties involved will be awarded an F for the assignment and possibly the course.
Grading Procedures: Individual assignments and projects that have a quality acceptable for graduate credit will be awarded a grade of A (4.0), A- (3.7), B+ (3.3), or B (3.0), with the grade reflecting the proficiency of the work. Work that is below par but may be acceptable for graduate credit if sufficient acceptable work is done in this class and in other classes such that a 3.0 GPA can be maintained will be awarded grades of B- (2.7), C+ (2.3), C (2.0), or C- (1.7), with the grade reflecting the proficiency of the work. Work that is unacceptable for graduate credit is awarded a grade of D+ (1.3), D (1.0), D- (0.7), or F (0.0), with the grade reflecting the proficiency of the work. The final grade for the course will be a weighted average of the grades on the individual assignments and the final project, calculated just as a grade point average is calculated.

Coursework Return Policy: I will endeavor to return assignments, with comments and a grade, within 7 days of receiving them, and in all cases within 14 days of receiving them.

Absence Policy: I have no attendance policy – I assume graduate students are mature enough to optimally allocate their time given their budget and time constraints. There is no class participation grade. However, in some cases your presence will be required, as in cases where there is a presentation or group presentation. If you miss handing in or presenting an assignment because of an event that CSM classifies as an “excused absence” (see http://inside.mines.edu/Student-Absences), I will allow you to present or hand in a substitute assignment at a later date.

Homework: Due to the fact that we cover answers in class, homework and assignments must be turned in by the time they are due. For this reason I suggest you do not plan to hand assignments in at the very last minute.

Detailed Course Description and Schedule:

This course, which follows on from Professor Stermole’s Engineering Economics course (EBGN504), mainly explores advanced discounted cash flow techniques and the emerging use of option pricing theory in the valuation and management of mineral and energy firms and properties. It will also fill in a gap in our micro courses by providing theory and insights into irreversible capital investments. We first review two other approaches to valuation, the cost approach and the comparison sales approach, that are prevalent in industry regulation. We then review traditional DCF and Monte Carlo DCF valuation techniques. Monte Carlo techniques are an attempt to more rigorously deal with the uncertainty in capital budgeting. Following this, the third section of the course delves into the more difficult use of option pricing theory in valuation and property operation. This “real options” section takes up a good portion of the course. The course ends with a capstone valuation case. The presentation of this case will take place during the scheduled final exam period.

Textbooks

There is no one textbook that neatly covers all of the material in the course. This year I have adopted a new book, Graeme Guthrie’s Real Options in Theory and Practice (2009, Oxford University Press). Bear with me as we all experience it for the first time. I like John C. Hull's book, Options, Futures, and Other Derivative Securities, any edition, for the financial theory behind derivative asset valuation and will most likely provide you with some scans of chapters from there. I will supplement the Guthrie book by individual articles that I will either provide you with on Blackboard or in hardcopy. I also recommend Avinash Dixit and Robert Pindyck, Investment Under Uncertainty (1994, Princeton University Press) as a more advanced text on real options, though we will not be using it in this class. For those who would like an NPV refresher text, I recommend Professor Stermole’s book, which also deals nicely with the rules for taxing mineral rents in the United States.

To keep up with the latest in real options articles and ideas, visit the well-maintained real options web site http://www.realoptions.org/. The site also has electronic copies of papers delivered at the past annual real
options conferences. Two other sites, http://www.real-options.com/resources_links.htm, and http://marcoaqd.usuarios.rdc.puc-rio.br/, have some resources on them, but they are no longer maintained and updated.

Course Tools

Blackboard is the point of reference for all materials each week. I will also use Blackboard to post messages and certain additional items and papers. We will also be using Decisioneering’s Crystal Ball Monte Carlo software, which is installed on the EB server and available in our computer labs. Finally, we may use Hull’s Derivagem option pricing software, available on the EB server.

Course Design and Requirements

Research has shown that lecturing is a poor method of instruction. Students typically “tune out” for about 50% of a lecture, and retain very little: three months after a course, students that have taken the course know only 8% more on the course topic than students that have not taken the course. I have therefore structured this course in a way that will improve learning and retention. Most weeks a project or question set will be assigned along with some suggested readings and several optional readings. I will always give you more work than is humanly possible to complete: always look carefully at any required readings, and then in the remaining readings continue with what interests you and fulfills your own particular needs. In the Thursday lecture, I will lead a discussion of the week’s readings, bringing out the important points and clarifying any problem areas. In the Tuesday lecture a designated student or group of students will present the results of the assignment and field any questions. An anonymous student will perform and publish a peer review of the presentation. My job will be to help the presenting students out if they get stuck, and to moderate if necessary. This will not only give you good practice at presenting financial analyses and leading discussions, but will also generate a true “seminar” environment. Since the class is small, you will each have at least one opportunity to present.

Each project or question set must be completed by the students not presenting. Assignments tend to build on the previous week’s assignment. Every third week or so I will ask you to hand in an assignment for grading. Since the assignments build on one another, you should have plenty of incentive to do the assignments each week even though you are not handing them in. The presenters for the week will be graded on their classroom presentation, and are not required to hand anything in. The graded assignments and presentations will be weighted equally, totaling 70% of the grade. The capstone case, in week 15, will be worth the remaining 30% of the grade.

I assign a healthy amount of work for each week based on the premise that 3 courses is a full time load at the graduate level. Note, however, that only a modest amount of work is required for a passing grade, and that students have done well without spending long hours on the assignments. What I am looking for in these assignments is clear presentation of the results, not necessarily fancy presentations and pages and pages of text. Handwritten work is fine (do not waste hours using MSWord’s Equation Editor or making your Powerpoint presentation fancy!). Another key to staying on top of things is to do some of the work each day and make use of my office hours. Do not attempt to do the entire assignment or read all of the required readings the night before it is due.
Weekly Outline

I. Cost Approach, Comparable Sales Approach

Week 1   Definition of Value, Cost Approach, Comparable Sales Approach


II. Traditional DCF Valuation Techniques (Income Approach)

Week 2   Review of Basic DCF Concepts


Week 3   Incorporating Monte Carlo and Strategy/Project Optimization into DCF Analysis

Monte Carlo:


Strategy/Optimization:


Week 4 Stochastic Processes and Monte Carlo Simulation


Week 5 Modeling Forward-looking Strategy Using Binomial Lattices: Flexible Investment Timing and Flexible Project Management

Guthrie, Chapters 1 and 2

Typos in book: 1) p. 195, line 16 from the top: insert “and” after V_1 in “binomial trees for V_1 for V_2”; (2) p. 288, line 9 from the end of Table 12.6: replace “becomes” with “become” in “while up moves becomes”


Daniel R. Siegel, James L. Smith, and James L. Paddock, “Valuing Offshore Oil Properties with Option Pricing Models,” Midland Corporate Finance Journal Vol. 5, No. 1 (1987): 22-30. (NB: there is no Appendix A and B with this paper, even though the text refers to these)

III. Modern Valuation Techniques (Income Approach)

Weeks 6 and 7  State Pricing (a.k.a. risk-adjusted discounting, risk-neutral discounting, contingent claims analysis, modern asset pricing)

Guthrie, Chapters 3 and 4

Hull, Ch. 1 (Introduction - Forward Contracts, Futures Contracts, Summary), Ch. 2 (Mechanics of Futures Markets - everything up to Delivery), Ch. 5 (Determination of Forward and Futures Prices - ignore Known Income, Futures prices of Stock Indices, Forward and Futures Contracts on Currencies, Delivery Options, Appendix).


Week 8  Combining Valuation and Strategic Decision Making

Guthrie, Chapter 5


Week 9  Model Calibration

Guthrie, Chapters 12 and 14

Week 10  Simple Operating Options

Guthrie, Chapter 6


Week 11  Simple Timing Options

Guthrie, Chapter 7

Week 12 Compound Timing Options

Guthrie, Chapter 8


Week 13 Developing a Gas Field

Guthrie, Chapter 16


Week 14 Mothballing an Ethanol Plant, Next Steps

Guthrie, Chapters 17 and 18


IV. Capstone Case

Week 15 TBA