



Oilpatch Now A **POWER** In The Canadian Economy

**Can the good times in the
oilpatch get any better?
Or are we at one of the famous
commodity cycle peaks with
the precipice looming?**

HOUSE

It's the billion dollar question that no one can really answer but the Canadian petroleum industry is betting many billions of dollars in investment capital — both in the oilsands of Alberta and in asset acquisitions over the past three years — on the premise that higher oil and natural gas prices are here to stay. And producers are showing their faith this year with a record 7,198 wells drilled in the first four months of 2004, up nearly 20% from a year ago.

The cycle of high prices will break — it always has in the past — but it's very hard to come up with a convincing scenario that will see a big drop in commodity prices anytime during the next few years.

On the oil side, world trade sets the price based on supply and demand patterns and OPEC has been a relatively better manager of its supply levels and stated price goals in the past several years than it was in the 1980s and 1990s. And demand is growing worldwide, led by the rapid expansion of the Chinese economy. Moreover, the Middle East — where most of the world's oil remains — is even more unstable and dangerous than in the past. And no new technology breakthrough is about to loosen oil's stranglehold on the world's transportation market anytime soon.

Oil in the \$30 (U.S.) a bbl range now seems likely and \$40 a bbl oil — reached in mid May — is not impossible for a variety of reasons best summed up in a recent study by Cambridge Energy Research Associates: "At present, physical fundamentals are keeping supplies tight while the psychological funda-

mentals are keeping geopolitical tensions and risks to the fore."

On the natural gas side, the North American continent sets the price for Canadian producers and here the problem appears to be more one of tight supplies. While producers are drilling up a storm, these small wells for the most part are just replacing the annual decline from existing producing fields. And no big new sources of gas supply will arrive for at least several years — due to the long lead times for Arctic pipeline construction and the time to set up infrastructure to import liquefied natural gas (LNG) in a big way.

Coalbed methane in Canada appears to be a huge potential resource, but producers are just beginning to unlock the puzzle with expectations that production will reach about 100 mmcf of gas per day this year (Canadian gas consumption is about 7.09 bcf per day while Canada exports about 8.5 bcf a day to the United States).

So high oil and gas prices may be here to stay for some time.

Since the year 2000 higher prices have largely turned around the fortunes of producers and, to a lesser extent, service and supply companies, while replenishing the Alberta government's coffers and contributing healthy sums to the British Columbia and Saskatchewan treasuries.

Canada's producers have become a powerhouse in the economy, generating an average of \$86 billion a year in revenues over the first four years of the new century compared to only \$29.6 billion a year over the

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first four years of the 1990s. Oil and gas producers accumulated profits of \$46.8 billion from 2000 through 2003 while they barely made money in the first four years of the prior decade with profits at a measly \$1.8 billion.

Gross export revenues from Canadian energy — gas, oil, electricity and coal — nearly reached \$62 billion in 2003, 27% more than the previous year. Clearly illustrating the importance of energy to the Canadian economy, energy export revenues accounted for an estimated 16% of the entire country's exports last year, up from 12% in 2002.

And although the energy sector only employs some 300,000 people across Canada (1.7% of the Canadian labour force), it accounted for about six per cent of the country's Gross Domestic Product (GDP).

Always big players on capital spending, the oilpatch ramped up investments over the past few years as cash flow grew and spent some \$118.6 billion over the 2000-2003 period – nearly five times higher than investments between 1990 and 1993. While more and more of that investment is going into oilsands and offshore ventures, conventional oil and gas spending is also on the rise with several records set for gas drilling in the past few years as industry tries to replace the annual erosion from older fields.

Nickle's Energy Group records show capital spending of



\$4.1 billion a year for the past three years in the oilsands regions of Alberta — about 20% of the producing industry's total Canadian budget, excluding acquisitions. After averaging more than \$7.7 billion in 2001 and 2002, acquisitions (of companies or assets) slowed down in 2003, presumably due to the high price of assets, falling to \$4.6 billion. Not surprisingly, Canada's producer income trusts accounted for the lion's share (71%) of all acquisition spending in 2003.

International spending, following some major property acquisitions in prior years, slipped to \$4.7 billion in 2003 from \$8.16 billion in 2002.

All that capital investment is making life a lot easier for the companies which provide services and supplies to Canadian producers. Service and supply companies in Canada had a much stronger year in 2003 with revenues climbing nearly 30% from 2002 and net earnings surging 75% to \$485 million but still below profits booked for the previous busy drilling year in 2001.

Although most service and supply firms are either private companies or subsidiaries of American corporations, Daily Oil Bulletin tracking of public companies and U.S. subsidiaries which reveal Canadian numbers, shows revenues reached \$9.16 billion in 2003, up \$2.07 billion from 2002 as operators were much busier drilling and servicing wells last year.

And in the first quarter of 2004, preliminary data shows Canadian service and supply companies enjoyed a further 20% (\$357 million) jump in revenues from the first three months of 2003. This will diminish, as usual, during the spring break-up lull, but should pick-up rapidly through the summer and fall. Nickle's Energy Group is predicting 2004 will set yet another record for Canadian drilling, topping the all-time high of 21,853 in 2003.

Part of the robust health of the energy sector in Canada is due to recycling of capital created by the high investor demand for income trusts, although it is questionable whether this structure will create enough domestic exploration, in the absence of the majors who are looking to the oilsands and offshore plays to grow supplies of gas and stem the continuing erosion of conventional oil production in Canada.

Preliminary reserves data compiled by Nickle's Energy Group shows new gas reserves (over four tcf) added by record drilling levels in 2003 replaced about 94% of production in Canada, using proved reserves only. However, negative revisions to proved gas reserves — prompted partly by tighter definitions under new regulations — knocked off



1.46 tcf from existing reserves, leaving the country with less gas than it had at the end of 2002.

With the middle tier of producers now largely occupied by trusts, which as a rule do not explore, and the big players, for the most part, looking for easier to find big prey in less picked over parts of the world, exploration in Canada is largely being left to the juniors and a handful of seniors. The juniors seem willing to play the game and are enjoying the lower competition, but don't have the budgets for a lot of risky, longer term, grassroots wildcat hunting.

But they do have a clear exit path to wealth creation if they can expand production rapidly (which is much easier from a small base) and then sell their assets to the income trusts which have a huge appetite to buy in order to maintain cash flow and distributions to their unitholders who love the high income generation of the trusts.

Only a spurt in interest rates (which would allow other investments to compete with trusts for the retail investor) or a sharp plunge in oil and gas prices could derail this successful model now at work in Western Canada.



High oil and record natural gas prices along with growing oil production, mainly from the oilsands and offshore eastern Canada, made 2003 the most profitable year in the history of the Canadian oil and gas industry. The numbers don't look so good for producers in the first quarter of 2004 — partly due to the comparison with extremely high commodity prices for the first three months of 2003 and partly due to the sharp appreciation of the Canadian dollar in the past year — but the industry as a whole is still very profitable and near-record world oil prices combined with continued high gas prices in the second quarter of 2004 will keep the field industry hopping for the rest of the year.

Preliminary numbers compiled by Nickle's show producer

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profits fell by more than one third in the first quarter of this year to \$3.4 billion, still a handsome return. Cash flow dropped 16% to \$7.5 billion from \$8.9 billion in the first three months of last year. So far in the second quarter, Canadian light crude prices have ranged from \$49 to \$53 a bbl, well above year-ago numbers, which, along with continued high natural gas prices, should bring strong second quarter profits.

Canadian oil and gas producers had a record profit of \$15.8 billion in 2003 although the final three months of the year brought the weakest results, mainly due to the strong gains in the value of the Canadian dollar which depressed commodity prices in Canada.

Return on revenues for the producer segment of the industry was 16.6% in 2003, up from 11.1% in 2002. Revenues soared on higher prices and growing oil production to \$95.8 billion, a gain of 23% from 2002. And high export prices for both oil and gas coupled with a surge in oil exports pushed Canada's energy trade surplus (exports minus imports) to \$36 billion in 2003, a \$6 billion increase from the previous year, according to the National Energy Board.

Natural gas remained the key component of the country's energy export revenues with crude oil and equivalent and petroleum product exports adding the second largest component.

Besides higher oil and gas prices, the growth story of 2003 was on the oil side as most other Canadian energy sources, including natural gas, experienced modest production declines.

Oil and equivalent production rose seven per cent last year to about 395 000 cubic metres per day with natural gas liquids extracted from gas production adding a further 91 700 cubic metres per day. The growth came from higher synthetic and bitumen output in Western Canada combined with more light oil production offshore Newfoundland which rose 24% to nearly 57 000 cubic metres a day. In Western

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Canada, the long-term decline in conventional light oil continued, falling 6.2% to 90 900 cubic metres per day.

Exports of oil from Canada (63% blended heavy crude oil) rose by about 14 000 cubic metres a day in 2003 to 246 500 cubic metres per day. With prices high due to tensions in the Middle East and Venezuela, the value of Canadian oil exports reached \$20.7 billion last year, up from \$18.9 billion in 2002. The much higher value of the Canadian dollar eroded much of the rise in oil prices in U.S. dollars last year.

Despite a sharp 11.5% plunge in the volume of gas exported to the United States in 2003 — which the NEB attributed to lower Canadian production, higher Canadian demand and lower U.S. demand — revenue from those exports jumped 41% to \$25.6 billion from \$18.3 billion in 2002. That was entirely due to a steep rise in gas export prices to \$6.75 per gigajoule last year from \$4.47 in the prior year.

Marketable gas production dropped to 476 million cubic metres per day (16.8 bcf a day) from 490 million cubic metres a day (17.3 bcf a day) in 2002. Net exports of gas accounted for 52% of total Canadian production during the year. Between 1998 and 2002, new reserve additions have replaced about 89% of gas production.

Conventional oil has been declining from Western Canada for many years while gas production has flattened out in the past few years, leading producers to look to non-traditional supply potential from the North, the East Coast, coalbed methane and possibly imports of liquefied natural gas.

Canadian wellhead prices averaged a record \$5.88 per

mcf for natural gas last year, up 47% from the previous year while oil prices rose about five per cent to \$33.12 per bbl. For three of the past four years, Canadian producers have received more than \$30 a bbl for their oil and the only year that missed that level (2001) averaged \$29.73 a bbl.

The oilpatch remained vigilant with its expenditures and kept total capital investment remarkably close to cash flow from operations. Capital spending of \$32.31 billion in 2003 (up only four per cent from 2002) was slightly more than cash flow of \$32.21 billion for the year.

However, as always, some companies were more aggressive than others. Trust companies, in particular, with their ready access to capital markets, continued to spend big dollars buying companies and assets in 2003 with capital spending of \$5.36 billion (16.6% of industry total) outpacing cash flow of \$3.6 billion (based on 23 reporting trusts). And that was in addition to the large chunk of cash flow (\$2.56 billion) which was paid via distributions to unitholders of the trust companies. Apart from the trust sector, 2003 saw fewer big acquisitions than the previous year.

While most producers increased investment spending in 2003, there were two large anomalies: Petro-Canada's capital spending fell by \$1.78 billion due to high spending in 2002 when it made a large international acquisition and Shell Canada Limited which reduced capital spending by \$1.5 billion due to completion of its massive oilsands project.

EnCana Corporation had the largest year-over-year increase in capital investments with an outlay of \$7.4 billion in 2003, up \$2.32 billion from a year earlier. Suncor Energy Inc. had the second largest increase with an \$841 million climb from 2002 while Talisman Energy Inc. was third with an increase of \$836 million.

The largest year-over-year profit increases for 2003 were posted by EnCana (up \$2.05 billion), Canadian Natural Resources Limited (up \$837 million), Petro-Canada (up \$695 million) and Husky Energy Inc. (up \$517 million). Very few companies recorded lower profits compared to 2002.

On the production side, Imperial remained Canada's largest oil producer in 2003 with average output of 256,000 bbls per day followed by Suncor at 216,600 bbls a day and Husky at 188,200 bbls per day. On the gas side, EnCana rules with production of 2.2 bcf per day, followed by Canadian Natural at 1.2 bcf a day and Devon Canada at nearly 960 mmcf per day.