

Hedging burns oil sector profit

But cash flow soaring

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Published: Friday April 29, 2005

Believe it or not, some of Canada's biggest oil and gas producers can't make money in today's energyobsessed market.

This week, EnCana Corp. reported a first-quarter loss of US\$45-million -- even though the price of oil averaged US\$50 a barrel for the first three months of the year. Similarly, Nexen Inc.'s first-quarter net earnings plummeted 80% compared to the same period last year. Petro-Canada's first-quarter earnings fell 77%.

The reason for the sudden reversal boils down to relatively new accounting rules over how companies recognize hedging, used by producers to lock-in prices and protect themselves from price fluctuations. Thanks to the new rules, hedging can translate into horrendous losses -- but these are "virtual" losses that don't actually show up on a balance sheet.

"It's interesting because you don't actually throw any cash out the door," said Brian Prokop, an analyst at Peters & Co.

For example, suppose a company produces oil at a cost of US\$25 a barrel and uses a hedging contract to sell it at, say, US\$40. The company locks in a profit of US\$15 a barrel. If oil is selling for US\$50, the company still earns a US\$15-a-barrel profit, but there is a theoretical cost here of US\$10 a barrel -- the difference between the price of oil and the price at which the company sold its oil.

Accounting rules make companies recognize their value based on current commodity prices. In the case of EnCana, this accounting quirk triggered a US\$628-million cut to earnings in the first quarter. Last week, Canadian Natural Resources Ltd. announced it would record a \$679-million hit in its first quarter because of its hedging program.

"You didn't really lose the money. You just didn't get it. It's an opportunity cost," Mr. Prokop said. For this reason, analysts recommend looking beyond corporate earnings and instead concentrate on how much cash a company is generating. "I would think that cash flow is probably the best place to look now," said **Sam La Bell**, an oil and gas analyst at **Veritas Investment Research**, who notes that the hedging losses are reversed for cash-flow purposes.

Here, Canadian oil and gas producers continue to astound. For example, EnCana's cash flow rose to US\$1.4-billion in the first quarter, an increase of about 40% over last year. Nexen's cash flow rose about 25% in the first quarter to \$520-million.

"Clearly, there is a disconnect for the market to have record cash flow and no earnings, but no one said fair market accounting for futures made sense," said John Herrlin, an analyst at Merrill Lynch.

Recently, gold producers that hedged production were punished by investors when the price of gold shot up. However, analysts don't expect a similar cold-shoulder treatment by oil investors.

"Oil companies make a lot of money at US\$25 or US\$30 oil. If they are hedging at US\$45, they could have realized more. But it's not like they're not making a lot of money," Mr. Prokop said.

So far, investors seem to agree. Shares of EnCana, Nexen and Petro-Canada are down only moderately this week. However, the decline may have more to do with relatively lower oil prices than disappointing quarterly reports.

"There's no reason for investors to punish a firm for these types of charges. If they can look past them, they're probably better off," **Mr. La Bell** said.