Petro-Canada Faces Challenge

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Long-suffering **Petro-Canada** investors may think their luck has turned this past year as the company starts to shake off a reputation for unreliability and its share price has risen. But its biggest challenge lies ahead: a massive 26.2 billion Canadian dollar (US$24.8 billion) oil-sands project that has some analysts wondering whether it might halt the stock's upward march.

Canada's fourth-largest oil and gas producer has set an aggressive schedule for bringing 280,000 barrels a day of synthetic crude onstream by 2014. Meanwhile, other oil-sands projects are struggling with scarce labor and materials, sending budgets spiraling upward.

So the question is, can Petro-Canada pull it off?

Even a year ago, the response probably would have been doubt, but now opinion is mixed. While all acknowledge the cost pressures that are straining Alberta's oil-sands patch, some believe the company is being unfairly penalized for past mistakes and is undervalued by the market.

Sam La Bell, vice president at Toronto-based ***Veritas Investment Research Corp***., has doubts about the oil-sands project. In an August research note, he calls the cost estimates "a careful bit of subterfuge" to disguise borderline economics. The company didn't return calls for comment.

Petro-Canada, together with **UTS Energy** Corp. and mining firm **Teck Cominco** Ltd., plans to develop an oil-sands mine north of Fort McMurray, Alberta, and build an upgrader to convert the sludgy bitumen into a light, sweet synthetic crude near Edmonton. In late June, the Fort Hills partners announced that the first 140,000-barrel-a-day phase would cost an estimated C$14.1 billion, and the second C$12.1 billion. But these numbers exclude the initial engineering costs needed ahead of project sanction: C$1.9 billion for both phases, or nearly 7% of total costs.

As the majority shareholder with a 55% working interest, Petro-Canada shoulders the bulk of this cost thanks to an agreement when the company bought its stake from UTS two years ago. And with UTS indicating it may sell down its 30% stake further, Petro-Canada could be tempted to add to its interest.

This is a "bet-the-company type of investment" that provides decent returns only if oil stays above $60 a barrel and the project sticks to its budget, ***Mr. La Bell*** says. But its track record with managing big projects leaves much to be desired.

Terra Nova, a 125,000-barrel-a-day oil field off Canada's east coast, is an example. The development was beset with problems since it started five years ago, and returned to near normal rates only at the end of 2006.

The company stresses that it is learning from its mistakes. In a July conference call, Chief Executive Ron Brenneman said, "We've made execution a priority, both the reliability of our operations and the management of our projects." And Petro-Canada seems to be reaping the rewards, with robust profit in recent quarters.

Martin Molyneaux, managing director of institutional research at Calgary-based FirstEnergy Capital, advises against using Terra Nova as a symbol for the company's management skills.

"You have every right to criticize Terra Nova ... but everyone is struggling offshore right now because it's so busy," Mr. Molyneaux said. "And I would caution against equating offshore with oil sands -- it's a different kind of project."

Previous oil-sands developments have run into difficulties on the mining side. A recent example is the expansion at the mine run by the Syncrude consortium, in which Petro-Canada holds a 12% stake, that was completed for nearly twice the initial C$4.1 billion estimate.

Teck Cominco will be in the driving seat for the Fort Hills mine, which analysts regard with approval.

Teck Cominco has "a lot of experience with large-scale mining projects," ***Mr. La Bell*** said. "They're a credible partner."

Meanwhile, Petro-Canada's main role will likely be on the upgrader, and the company is no slouch when it comes to the downstream.

Despite challenges, many analysts are still positive about Petro-Canada, whose shares have gained more than 30% in the past year, after trailing its peers in the past, trading recently at around C$53.

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