For Petrocan investors, too much cash can be a bad thing

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As problems go, **Petro-Canada's** is an enviable one: too much money.

That sounds like the kind of trouble an investor would like. It isn't necessarily so, however, because the company has few options for deploying its abundance of cash flow. When excess money marries limited opportunity, the offspring are usually ugly.

How will Petro-Canada's Fort Hills project turn out? Investors might want to take a closer look, according to **Veritas Investment Research** analyst **Sam La Bell**. The math is downright curious.

Fort Hills is a big oils sands project north of Fort McMurray and it is the linchpin of Petro-Canada's big, bold and long-term bet on oil sands. The partners are Teck Cominco and UTS.

Like all oil-mining endeavours, Fort Hills carries an astronomical price tag of almost $30-billion if taken to completion in 2014. A little more than half of that investment is the responsibility of Petro-Canada, on behalf of its investors.

You get the sense that Petro-Canada's management, and maybe its board, want to damn the torpedoes and take on the project because the company went to some lengths to massage the numbers it used to justify the green light on it.

One glaring point is that Petro-Canada's assessment of the project excludes the upfront costs of engineering and designing the project - about $1.9-billion for both phases of Fort Hills or almost 7 per cent of total costs. That's like budgeting for a house built on a cliff and ignoring the cost of pouring the foundation.

It's okay to ignore costs you've already incurred - sunk costs - when assessing a project's merits, because the idea is to look ahead (although to assess a manager's track record, you wouldn't ignore anything).

But Petro-Canada seems to be treating money it will spend as though it is already sunk - a sign that management is hell-bent on seeing Fort Hills through.

Including the front-end development costs would severely lower the economics of the project.

The company's assumptions are another sign of rigid determination.

Petro-Canada's base case analysis uses a $45 (U.S.) a barrel oil price that slides upwards, while the company assumes a constant 80-cent Canadian dollar in all oil price environments.

Today, we have $70 per barrel of oil and a 95-cent dollar. Coincidence? The last time oil was $45/barrel, the dollar was around 76 cents.

Sure, some of the rise in the loonie is because America is slowly falling into a recession, but a big part of it is because of commodities. Apparently Petro-Canada has never heard of the petro-dollar.

Using real exchange rates makes massive changes to the economics of the project and, depending on your assumptions on oil prices, could prompt a cautious investor to shelve Fort Hills, especially given cost creep in Alberta. Petro-Canada says it built a 15-per-cent contingency into its budget to cover overruns, but these projects have a history of blowing past their budgets.

We'll never know - until the synthetic crude starts to flow - whether the contingency was big enough.

A third and more technical point is the way Petro-Canada crunches its numbers. The company uses an internal rate of return figure to justify pursuing Fort Hills.

Mr. La Bell argues, convincingly, that a net present value approach is better because it captures risk better, is more suited to analyzing an expansion project on a per share basis and is more flexible. For instance, NPV can use more than one discount rate to account for the different risks of parts of the project.

Investors will be startled with **Mr. La Bell's** NPV conclusion, which includes the upfront costs, uses a more realistic exchange rate and ties it all up in a tidy NPV that suggests Fort Hills doesn't generate value for shareholders unless costs come in near budget and oil prices stay above $60.

That doesn't mean the project isn't profitable, but rather that it doesn't compensate shareholders fairly for the use of their money.

So why is Petro-Canada doing it?

Because the company oozes cash, has few interesting investment opportunities, is depleting its reserves and "you can convince yourself that it's a great project with the right assumptions," **Mr. La Bell** says.

If oil prices stay high, even **Mr. La Bell** admits that he will have been wrong to be negative on the stock at current prices.

But if oil prices fall in five years, then this is a stock that will cause a lot of regret.

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