



**Canadian Centre for  
Policy Alternatives  
BC Office**

1400–207 W. Hastings St  
Vancouver, BC V6B 1H7

Tel: 604-801-5121

Fax: 604-801-5122

[info@bcpolicyalternatives.org](mailto:info@bcpolicyalternatives.org)

[www.policyalternatives.ca](http://www.policyalternatives.ca)

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**To arrange an interview  
with Fred Wilson, call  
Shannon Daub at  
604-801-5121.**

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# CCPA–BC Policy Brief

## **Who's making money on natural gas prices? What should government do?**

by Fred Wilson

*Fred Wilson is a National Representative with the Communications, Energy and Paperworkers Union of Canada, and a Research Associate with the BC Office of the Canadian Centre for Policy Alternatives.*

January 23, 2001

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# Who's making money on natural gas prices? What should government do?

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BABY ITS' COLD OUTSIDE, AND NATURAL GAS IS EXPENSIVE.

But don't blame me, says the gas company. We only pass along our costs.

Don't blame us, says the pipeline company. We just move the stuff from the producer to you.

Don't blame us, say the producers. It's those Californians who have increased the demand and sent the price up.

Don't blame government, say the politicians. It's the free market at work.

If you are a BC Gas customer, by now you are familiar with the price increases—a 33 percent increase in rates last summer, and another 27 percent increase in January 2001. In 2001, the new regulated consumer price for natural gas is over \$13.00 per thousand cubic feet (mcf).<sup>1</sup> According to BC Gas this amounts to almost \$1,500 per year for an average lower mainland home. Centra Gas home consumers on Vancouver Island have already being paying about that rate since July of 2000.

The bills are plain enough. The questions that many want answered are: Where is all that money going? And who, if anyone, can or should do something about high natural gas prices?

## Following the Money Trail

BC's three gas distribution companies – BC Gas (lower mainland/interior), Centra Gas (Vancouver Island and Sunshine Coast) and Pacific Northern (northwest) – are not racking up huge profits from the current price spike. The rates they charge consumers are regulated by the BC Utilities Commission on the basis of providing the companies with a predicted rate of return on common assets. In the case of BC Gas, the rates are designed to reward them with a 9.5% return on assets. BC Gas, the largest of the three, is nonetheless improving its profits, earning \$57 million in the first 3 quarters of 2000, of which \$24 million came from natural gas delivery.<sup>2</sup> BC Gas also

opened a new pipeline last year, connecting the Alberta border with Oliver in the Southern Okanagan. This kind of capital expansion, of course, builds assets that will be reflected in future rates to be approved by the Utility Commission.

The gas companies get delivery of natural gas from pipeline companies. In BC, there is only one pipeline company of significance—Westcoast Energy. Westcoast is a large, integrated company that owns gas distribution companies like Centra, processing facilities and pipelines. Like the gas companies, Westcoast's pipeline rates are regulated, although in their case by the federal National Energy Board. The rates (tolls) are a mixed bag of fixed and variable rates. Tolls for short-term contracts are higher when the price of gas goes up. The pipelines also benefit from supply and demand situations that maximize volumes of gas.

Westcoast also owns some of the major processing plants in BC. Natural gas must be processed before it can be shipped down a pipeline. Processing costs can also vary according to supply and demand factors. When the plants are running flat out, their costs can go up, and they will raise charges to the producers. However, regulated companies like Westcoast that can't raise all of its prices without regulatory approval also have an incentive to cut costs and increase profits.

One of the crueler ironies of the current natural gas market is that Westcoast is cutting about 35 jobs at its McMahon-Taylor, BC gas processing plant.

Westcoast's profits, predictably, are going up. In the first nine months of 2000 their *pipeline and gas processing profits* increased by 12% to \$140 million.<sup>3</sup>

Our search thus far, however, has yet to uncover the bags of money that consumers are shelling out. Until, that is, we reach the oil and gas producing companies that pump natural gas from wells and sell to the marketers.

There are over 250 oil and gas companies operating in BC. The top 10 producers are Canadian Natural Resources, Petro Canada, Talisman Energy, Mobil, Canadian Hunter, Anderson Exploration, Burlington Resources, Domcan Boundary, Husky Oil, and Penn West.<sup>4</sup> Not one of them has a head office with a BC address. To speak to anyone in authority at any of these companies you will have to call an Alberta office.

The current prices mean huge profits for natural gas producers. According to a BC government study in 1999, the cost of exploring for gas, drilling a well, producing gas, gathering raw gas in local pipelines, processing it so that it can be moved through a pipeline and sending it down a pipeline was \$1.30 per mcf. In addition to these costs there are taxes and royalties, which were \$0.40.<sup>5</sup> These costs are now somewhat outdated. Producer costs have increased and royalties have increased. But with current spot market gas sales of \$7–\$8, producers are netting \$5 or better for each thousand cubic feet of gas sold in these short term markets.

***The current prices mean huge profits for natural gas producers. With current spot market (short-term) gas sales of \$7–\$8, producers are still netting \$5 or better on spot markets, and \$3–\$4 on average prices for every thousand cubic feet of gas sold.***

In fairness, not all gas sales are fetching those \$7-plus mcf prices. Many gas sales are locked into long term contracts at lower prices. Gas futures have become a major market that entices producers to hedge against market swings. Another variation in the market has been the introduction of broker/agents who have been re-selling as a speculative venture against the market. Many agent/brokers who sold gas directly to consumers months ago, by-passing the gas distribution companies, are now being massacred by the market they bet against.

We can get a better sense of the average return from Petro-Canada, one of the two leading natural gas producers in BC. Petro-Canada cites “price realization” (an average price) of \$4.67 in the third quarter of 2000, almost double the \$2.71 price in the same quarter of 1999.<sup>6</sup> Financial statements from Canadian Natural Resources, the other leading producer, report a similar average price for the third quarter 2000 (\$4.30), and further adds that its operating costs and royalties amounted to \$1.50, providing a “netback” (profit) of \$2.80.<sup>7</sup>

Prices increased further in the final quarter of 2000, and gas analysts now predict continuing high prices throughout 2001/02. As Table 1 shows, price estimates range from a high of \$7.50 at the BC wellhead for 2001, according to oil and gas consultants Sproule Associates,<sup>8</sup> to a lower \$5.55 at the BC plant gate, according to Gilbert Laustsen

**Table 1: Natural Gas Price Forecasts—January 1, 2001 (constant \$Cdn/million BTUs)**

Year	Sproule: Alberta gas reference price plant gate	Gilbert: Alberta average plant-gate	Sproule: BC Average Wellhead	Gilbert: BC Plant Gate	Gilbert: SaskEnergy Plant Gate
2000	3.76	4.50	4.00	4.00	4.85
2001	7.72	6.70	7.50	5.55	6.85
2002	5.31	4.85	5.22	4.10	5.00
2003	3.91	4.35	3.71	4.00	4.50

Source: Sproule Associates, Ltd., Gilbert Laustsen Jung Associates

Jung Associates.<sup>9</sup> Both analysts agree that prices are not expected to return to last year's levels until 2003.

Here is where the money trail leads. The top ten producers in BC pumped 8.2 million thousand cubic meters of gas in 2000 – about a third of BC's total production. (Total 1999 production of BC natural gas was 25.9 million thousand cubic meters.) These top 10 BC producer companies alone stand to generate over \$1 billion in profits from natural gas at the prices predicted for the next year, and possibly much more. This will represent an increase of more than 25% over the past year. (This profit margin is before tax, and not including head office administrative costs. It also does not reflect exploration costs.) As the table below shows, natural gas profits from BC operations are contributing significantly to huge profit gains by the oil and gas giants at the corporate level.

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There is another player in the money game. A chunk of the money that producers are earning ends up in royalties to the provincial government. These royalties, of course, are the dividends that are owing to all British Columbians, who remain the collective owners of the natural gas in this province. Provincial royalties are "price sensitive," meaning that the higher the price, the higher the percentage royalty. Currently royalties are about 25% of prices. The BC government reports that in the fiscal year 2000/01 it is expecting to realize about \$1 billion in royalties from BC natural gas production, three times the \$335 million that was expected in last year's provincial budget.

There is pressure on government to return some of this money to consumers to offset higher prices, and the response of the BC government has been snail-paced. As one ministry insider said to me, "winter

**Table 2: Top 10 BC gas producers: production and estimated profits**

Company	Global corporate net earnings for first 9 months of 2000 (\$ millions) <sup>1</sup>	Raw gas produced in BC 2000 (1000M <sup>3</sup> ) <sup>2</sup>	Estimated 2001 profit from BC natural gas production at \$5.55 per mcf (\$ millions) <sup>3</sup>
Canadian Natural Resources	\$558	1,492,938	\$187.2
Petro Canada	\$507	1,460,463	\$183.1
Talisman Energy	\$621	992,055	\$124.4
Mobil	\$12,500 <sup>4</sup>	788,920	\$98.9
Canadian Hunter	\$94.5	679,572	\$85.2
Anderson Exploration	\$314 <sup>5</sup>	675,386	\$84.7
Burlington Resources	\$371 <sup>6</sup>	626,238	\$78.5
Domcan Boundary	n/a	574,010	\$72.0
Husky Oil	\$232	509,183	\$63.8
Penn West	\$134.9	445,950	\$55.9
<b>Top ten</b>		<b>8,244,715</b>	<b>\$1,033.7</b>

Notes:

1. Company third quarter reports, 2000.
2. BC Ministry of Energy and Mines, December 2000.
3. Estimate by author based on 2000 production, and Gilbert and Associates BC price forecast of \$5.55 for 2001, less \$2 producer costs and royalties = netback of \$3.55 mcf.
4. US Dollars. Exxon-Mobil consolidated 3Q 2000 net earnings; financial results for Mobil Canada not available.
5. 12 month earnings, Anderson Exploration 4 Quarter and fiscal year earnings to Sept. 30, 2000.
6. US Dollars. Burlington Resources consolidated 3 Quarter net earnings; financial results for Burlington Resources Canada not available.

will be over before BC does anything.” Government is also the industry’s favorite target. As the CEO of BC Gas said in December, “the provincial government is making a fortune out of these gas prices. Hundreds of millions of un-budgeted dollars...”<sup>10</sup> While this is undoubtedly so, it should be pointed out that the province is also a big consumer of gas and faces its own cost increases throughout the public sector. Already we are hearing reports is schools and universities deciding to cut services and programs in order to pay rising heating bills.

The province’s gain has certainly put it in a position to spend dollars that it would not have except for natural gas revenues. However, the province’s royalty gains are not the cause of high consumer prices. Unlike consumer taxes at gasoline pumps, lowering these natural gas royalties would not reduce consumer prices. The royalty charged by the province is a percentage of the producer price which, in the BC case, is set at the wellhead. The wellhead price is the market price net of processing and transportation costs. If the royalty was reduced, or eliminated, the producer price would be unchanged.

Since our federal and provincial governments jointly deregulated natural gas in 1986, the wholesale price for natural gas has been determined by supply and demand in the market (which today is effectively a continental market). Market prices are established at pipeline “hubs” where gas can be diverted in separate directions. There are three main hubs in Canada. One is in Dawn, Ontario; a second is the interconnect between the Nova and AECL pipelines in Alberta; the third is the Sumas exchange where Westcoast’s pipeline diverts gas either into the BC market or south towards California.

Proponents of deregulation have argued that for most of the years since 1986, Canadian consumers have benefited from low natural gas prices. While that is true, other factors need to be taken into account to understand the low gas prices of the past decade. Limited pipeline capacity from Canada to the US meant that there was usually a surplus of gas to serve the Canadian market. As a

National Energy Board report on natural gas explains, “Canadian pipelines were operating at near capacity and excess gas supply conditions existed in Western Canada, creating intense gas-on-gas competition. Consequently, prices were determined by local market conditions.”<sup>11</sup> Pipeline expansions, and new pipelines like the Alliance pipeline from northeast BC to the US midwest have altered this equation. It is another irony that the larger the pipelines we build to export gas to the US, the higher the price in our local market because of more direct competition with US purchasers.

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## Progressive Policy Alternatives

After fifteen years of deregulation, what can be done now to soften the blow of price increases for natural gas? After all, we live in a cold climate and heating our homes is hardly a luxury.

In truth, governments have several policy alternatives left to them, even though they have already deregulated on a continental basis, and creating a new regulatory framework that would make sense would be a complicated matter indeed.

In the longer term, the federal government is likely the government best suited to take effective action on the gas market. For example, the federal government has the ability to put a lid on any new pipeline capacity to the United States, thereby creating a more favorable supply and demand market for Canadian consumers. All new capacity makes Canadian prices more dependent on American market prices.

The federal government should also impose an excess profits tax on oil and gas companies that are realizing windfall profits because of market conditions in the United States. A federal tax, applied across Canada, would address the problem of inter-provincial competitiveness.

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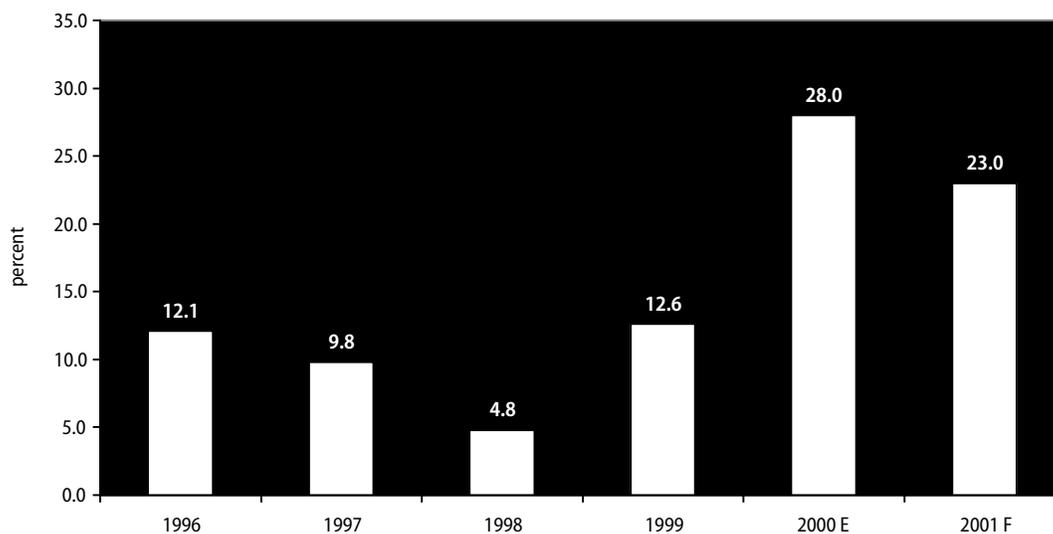
At the provincial level, hard decisions have to be made about how much of the royalties should be used to offset consumer prices. In the BC case, if \$200 million was allocated for consumer relief, and applied equally to the province's 845,000 regulated gas consumers, it would offer only about \$236 per household—or a little less than half of the average annual increase resulting from the latest 27% increase. The rebate would be larger, of course, if targeted to low income households.

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The fundamental question is whether the natural gas production and marketing system could or should be regulated again to stop market swings that batter consumers and energy-dependent industries.

There are credible arguments that gas and oil prices are not too high, given full cost accounting of environmental impacts. Many environmentalists have argued that prices were too low for the past decade, thereby encouraging

**Figure 1: Canadian Natural Resources Return on Net Equity<sup>1</sup>**



Note:

1. Canadian Natural Resources Ltd., Presentation to Investors, November 2000. Estimated returns for 2001 are based on a commodity price for natural gas of \$5.50 mcf. CNR ranks itself among the top earners in the industry with the 2nd highest return on equity in Canada, and in North America. Industry analysts argue that returns for regulated sectors like distribution companies and pipelines are based on "no risk" and returns for oil and gas companies should be higher.

excessive use of fossil fuels. This may well be so, but it is hardly an argument for market based energy prices, because the low prices of the past were also the result of deregulation. Moreover, the current high prices of natural gas are now resulting in large and industrial consumers switching to dirtier fuels. If we are looking for a way to reduce greenhouse gasses, the current oil and gas market formula seems to be a very unstable and ineffective mechanism.

Another common argument is that the industry's profits at this time are extra-ordinary and must be averaged over a longer period. High profits at the top end of market cycles are necessary to fund new investment, which is crucial to maintaining gas reserves. The argument has not been made, however, that oil and gas company profits were too low in the past. Taking Canadian Natural Resources as an example, (see figure 1, facing page) the company's return on equity over the period 1996 – 1999, before the current market swing, averaged 9.8%. By comparison, the BC Utility Commission grants BC Gas a return of 9.5%, and the National Energy Board provides a return of 9.6% to pipeline companies.

Regardless of producer returns, it remains a matter of public policy whether an essential service – energy, hot water

and home heating – should be subject to dramatic market swings when the result is hardship for consumers and economic catastrophe in energy dependent industries.

The most fundamental question of regulation is whether Canada should, or must, remain in a single continental market. If one considers it appropriate that the price of natural gas in BC should be significantly determined by the political and economic decisions of Californians, it makes sense to continue Canadian support and involvement in a single, continental oil and gas market. The alternative is to reintroduce a regulatory framework that would have the effect of regulating market prices in Canada, which under NAFTA rules would extend that market price to Americans as well. NAFTA rules out a two-price system for domestic use and exports, requires equal treatment of domestic and foreign companies, and also prohibits a deliberate reduction in exports of gas or oil to the US (unless proportionate reductions are made in Canadian supply). However, within this context Canadian governments retain the ability to intervene in the market. Needless to say, one province acting alone would likely result in capital flight affecting future supply. Ultimately, if Canada wants to return to a regulated, stable domestic price, the terms of NAFTA must be reconsidered.

## Notes:

1. The current rate per thousand cubic feet (mcf) can also be described in Gigajoules (GJ) or Millions of BTU (MMBTU) at \$12.42. Natural gas units can also be expressed in thousand cubic metres (M3), which is approximately 35 times larger than per unit of mcf. Unless otherwise specified, all units expressed in this paper are in thousand cubic feet (mcf).

2. BC Gas, Third Quarter Report, Sept. 30, 2000. The balance of BC Gas' earnings were from petroleum transportation fees and non recurring items related to income taxes.

3. Westcoast Energy, Q3 interim report, Sept. 30, 2000.

4. BC Ministry of Mines, Energy and Resources.

5. BC Ministry of Mines, Energy and Resources, Natural Gas Industry Competitiveness Study, September 1999. This study is based on average costs in the Ft. St. John region and may differ in other regions of Northeast BC. In addition, data is based partly on information dating to 1995. A revised cost estimate will be completed in 2001,

but Ministry officials indicate that some costs such as drilling may have increased as much as 25% in the past year as a result of competition for rigs.

6. Petro-Canada, Price Realizations (Natural Gas Prices Received by Petro Canada), Quarterly Report, Oct. 24, 2000.

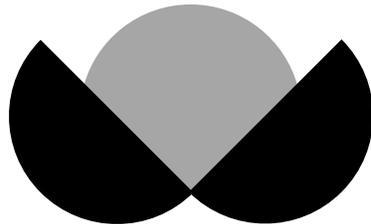
7. Canadian Natural Resources, Third Quarter Report, Sept. 30, 2000. Netback does not include administrative costs or exploration costs.

8. Sproule Associates Limited, Natural Gas Price Forecasts – Various Shippers as of Jan. 1, 2001.

9. Crowfoot, Carol, Senior Energy Economist, Product Price and Market Forecasts for the Canadian Oil and Gas Industry, Gilbert Laustsen Jung Associates Ltd., Quarterly Update, January 1, 2001.

10. John Reid, President BC Gas, Speech to news conference, December 6, 2000.

11. National Energy Board of Canada, Canadian Natural Gas Market: Dynamics and Pricing, November 2000.



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