This Oil and Gas Company’s Revenue Almost Tripled in its Latest Earnings

Description

Encana Corp. (TS:ECA)(NYSE:ECA) reported its Q2 earnings today which showed revenues reach over $1 billion for the quarter — almost tripling from revenues a year ago, which were only $364 million. Earnings also had a big swing; the company posted a profit of $331 million this quarter compared to a loss of $601 million a year ago.

With oil and gas companies struggling amid stagnant oil prices, and companies like **Cenovus Energy Inc.** seeing stock prices hit record lows, it’s both encouraging and intriguing to see that Encana has been able to do so well.

I’ll take a closer look to see how the company was able to pull of such an impressive result.

The company’s operating income improved year over year by $1.2 billion, $719 million of that (60%) is a result of the higher top-line figure. Another $484 million was the result of the company suffering impairment losses last year that were not incurred this year. If we take impairment expenses out of the equation, operating expenses only improved by $30 million. Besides impairment losses, the real change was the company’s growth in revenue.

A breakdown of the company’s revenues shows product revenues to be up over 25% for a total of $728 million — the largest contributor to revenue. The biggest dollar increase in revenue came from gains and losses on risk management, which, this quarter, added $129 million to total revenue, while last year it was a loss of $330 million. The last biggest change came from market optimization revenues, which were nearly double last year’s $91 million to $204 million for this quarter.

The gains and losses on risk management have come from the company’s use of financial derivatives to hedge against price fluctuations. For the remainder of this year, Encana claims that over 75% of its oil production is “protected” through its risk-management strategies. As a result of the company not using hedge accounting, these gains flow through to the company’s revenues. Use of hedge accounting would have provided more stability in the company’s earnings.

The marketing optimization revenues include the company's sale of its proprietary production to third parties. Encana does this to provide itself flexibility and a more diverse customer base.

Without the benefit of its hedging activities, and without the impairment expense from last year, Encana's operating income would have only improved by $290 million from last quarter. If you strip away the added market optimization segment, you are left with an improvement of just $177 million. Although it is still an improvement, it is important to keep in mind that a big reason for the company's significant results this quarter were related to factors outside its day-to-day oil and gas operations.

When a company relies on its investing and hedging capabilities for positive results more than its core operations, that could signal a problem. Because of the wild swings in its risk management — up $129 million one quarter and down $330 million the previous year — the company's earnings can fluctuate significantly. With fluctuation comes a lot of uncertainty and risk, and for those reasons, I would be a little hesitant in placing a bet on Encana. After all, Encana is known for being an oil and gas producer, not a hedging and financial risk-management company.

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