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Riding The "Unconventional" Wave:

Despite recent volatility, the long-term outlook is positive for northern Alberta's lodging markets

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Northern Alberta's hotel industry and the balance sheets of countless lodging and financial organizations are fixed to the sustainability and performance of the province's oil and natural gas industries. Alberta's tar sands, with an estimated 315 billion barrels of recoverable oil,[1] provide the foundation for the province's recent industrial prosperity, but it is the investment into and the completion of various oil sands and conventional oil-related exploration, extraction, production, transportation, and refinement projects that will continue to guide lodging performance in the region.

The rapid growth of both oil and natural gas sectors over the past three years has caused hotel companies and developers to procure or construct hotels in Northern Alberta as soon as financially possible (at the same time that it has fuelled inflation and overloaded Alberta's infrastructure[2]). In 2005, 2006, and the first quarter of 2007, the fundamentals and cash flows of lodging assets in oil and gas-driven markets increased dramatically. Despite the continued surge of oil prices through 2007 and into 2008, however, some of Northern Alberta's lodging markets have experienced a significant reduction of crew and commercial demand. This is due to a contraction in exploration and drilling activity in both conventional oil and natural gas. The primary culprits are escalating labour costs, low natural gas prices and the strengthening of the Canadian dollar relative to the US dollar.

According to the Canadian Association of Oilwell Drilling Contractors, oil well completions in Alberta declined 4.4% while natural gas well completions declined a staggering 17.5% from 2006 to 2007, and rig utilization levels for both oil and natural gas industries declined from 63% in 2006 to 38% in 2007. Natural gas focused lodging markets like Edson and Grande Prairie echoed this trend, experiencing a 10 - 20% contraction of overall demand depending on the market. It is apparent that lodging fundamentals and cash flows will fluctuate in the short term. Moderation in the price, consumption, or supply of either resource will impact market occupancies and top-line revenues of many of Northern Alberta's hotels. And while "natural gas drilling budgets are unlikely to see much upside in the near term,"[3] the short-term outlook for the oil industry is slightly more upbeat but still mixed. In a recent industrial outlook, published on February 25, 2008, TD Economists forecast that oil extraction will continue to move forward and that total Canadian oil production will increase 6% per year over 2008-09, with new production being partly offset by declining productivity from maturing deposits.[4] It is in fact the declining productivity of maturing deposits and a slumping gas sector that has orchestrated the recent decline in lodging demand in some hotel markets over the past 12 months. The oil sector alone will provide stability for the province going forward. Given the potential of the global oil industry

[1] A. Lustgarten, "The Dark Magic of Oil Sands," Fortune (October 2005): 152(7), p. 136 - 148, retrieved March 30, 2008, from Business Source Premier Database, p. 2

[2] "Building on Sand: The Allure and Perils in Investing in Alberta's Oil Sands," *The Economist* (May 24, 2007), retrieved March 30, 2008, from http://www.economist.com/research/articlesBySubject/displaystory.cfm?subjectid=381586&story_id=9231894, p. 2

[3] P. Gauthier, "Canadian Industrial Outlook 2008-09," TD Economics (2008), retrieved March 30, 2008, from http://www.td.com/economics/qef/indfeb08.jsp, p. 4

[4] Ibid. p. 5

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much of Northern Alberta's lodging sector is well positioned for long-term growth and prosperity.

It has been widely documented that the world may soon run out of cheap oil, that which can be pumped out of the ground without great difficulty or cost.[5] "Canada's production of conventional oil peaked in 1973; our reserves of harder-to-develop unconventional oil are believed to be extensive and won't peak for some time."[6] Alberta currently has both conventional and unconventional oil, but most of Alberta's oil product is "unconventional oil," which is not cheap or easy to pump from the ground. "Technological advances now make it possible to refine tar sands into usable crude at a cost that is competitive with that of 'conventional' oil."[7] Massive investment into the midstream and downstream oil sectors has contributed not only to the prosperity of the oil sands and conventional oil but also to the stability and growth of several of Northern Alberta's lodging markets. These towns or cities have managed growth in room rates and occupied room nights even during periods of declining oil exploration and drilling.

Sherwood Park, a city located roughly 10 kilometres east of Edmonton, is a market that has benefitted significantly from investment in the infrastructure related to upgrading, transporting, and refining oil. Several mega projects are proposed or under construction in the immediate area. According to the City of Sherwood Park and Strathcona County, BA Energy will invest $1.8-billion to construct a bitumen upgrader; Shell Canada is immersed in "phase one" of a $5-million expansion to its Scotford Upgrader; Enbridge is constructing a pipeline terminal; and Statoil Hydro will invest $4-billion to build its own bitumen upgrader. These projects have insulated Sherwood Park's lodging industry from recent demand contractions experienced by exploration and drilling intensive hotel markets. Sherwood Park has maintained a consistent upward trend in RevPAR growth over the past three years.

The "unconventional" oil boom has intensified in the past five years. "Alberta's oil-sands deposits have courted an estimated $86-billion worth of projects that are now either under way or in the works in the region."[8] A significant percentage of the capital investment in the region has been directed at the Athabasca tar sands and the city of Fort McMurray, Alberta. The city is widely regarded as the epicentre of Alberta's energy industry. "Oil and gas behemoths including Suncor Energy, Imperial Oil, Shell Canada and Canadian Natural Resources Limited are investing billions of dollars in tar sands production."[9] Because of the anticipated duration of these investments, Fort McMurray's higher-quality hotel assets have traded for two to three hundred thousand dollars per room while posting RevPAR in the $120 to $160 range for 2007. Hoteliers are betting on the prosperity of this market, and why wouldn't they given that, according to Alberta Energy, oil sands production is expected to rise from 1.2 million barrels per day in 2008 to 4.0 million barrels per day by 2020?[10]

Perhaps the most certain piece of Alberta's oil equation is the growing demand for its conventional and unconventional oil supply. In North America, oil is a relatively inelastic consumer good as demand for it remains constant regardless of price. According to the CIA World Factbook, the United States currently consumes upwards of 21 million barrels of oil per day. Through the North American Free Trade Agreement and a royalty system that, despite the recent modest increase, remains lower than the world average for oil deposits of similar capacity,[11] Canada has strategically aligned itself with the world's largest consumer of oil. Canada currently supplies 2 million barrels of crude oil daily to US consumers.[12] The amount of Alberta and Canada's oil exports is expected to grow as the industry's upgrading, refining, and transportation infrastructure grows. Moreover, global demand for oil is expected to increase at an average annual rate of 2% for the next 30 years. In the future, Alberta's oil will continue to flow south to the

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5 L. McQuaig, It's the Crude Dude: War, Big Oil, and the Fight for the Planet (Canada: Doubleday, 2004). p. 3

6 Ibid. p. 30

7 P. Roberts, The End of Oil: On the Edge of a Perilous New World (New York, NY: Houghton Mifflin Company, 2004). p. 348

8 C. Waxer, "Alberta Oil-Sands Boom has Companies Piling on Perks to Draw Workers to Hinterlands," Workforce Management (April 2006): 85(7), 40 - 43, retrieved March 30, 2008, from Business Source Premier Database. p. 1

9 Ibid. p. 1

10 "Building on Sand: The Allure and Perils in Investing in Alberta's Oil Sands," *The Economist* (May 24, 2007), retrieved March 30, 2008, from http://www.economist.com/research/articlesBySubject/displaystory.cfm?subjectid=381586&story_id=9231894. p. 1

11 "Sweating the Sands: Alberta Raises Oil Royalties - But Less than Meets the Eye," *The Economist* (November 1, 2007), retrieved March 30, 2008, from http://www.economist.com/world/la/displaystory.cfm?story_id=10064119. p. 1

12 A. Lustgarten, "The Dark Magic of Oil Sands," Fortune (October 2005): 152(7), p. 136 - 148, retrieved March 30, 2008, from Business Source Premier Database. p. 2

US and increasingly west to the Pacific Rim and China, the world's fastest growing economy and second largest consumer of oil. China currently consumes approximately 6.5 million barrels of oil per day.

Alberta's role in world oil production continues to grow. Cheap oil is becoming harder to find, and soon the world's inhabitants will rely on "unconventional oil" for much of its energy. International oil companies like Exxon Mobil, Royal Dutch Shell, BP, and Total have invested massive amounts of capital into Alberta. This inevitable transition from light to heavy crude has transformed the economic and physical landscape of Northern Alberta forever. The lodging sector is one of Alberta's industries that has benefitted from robust oil activity. Over the past three years, the region's hotels have sheltered more white- and blue-collar workers than ever before. It is difficult to predict the strength of Canada's currency going forward or where the price of oil will be in one, two, or 20 years. What is relatively simple to assume is that as long as it is profitable to produce a barrel of oil in Alberta, the oil industry alone-and the hotel markets that shelter under it's existence-will prosper well into the future. ▲

DEFINITIONS

Occupancy:	Rooms sold divided by rooms available.
Room Revenue:	Total room revenue generated from the sale or rental of rooms.
Average Daily Rate (ADR):	Room revenue divided by rooms sold.
Room Revenue Per Available Room (RevPAR):	Room revenue divided by rooms available (occupancy times average room rate will closely approximate RevPAR).

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