



How Will the U.S. Shale Oil Boom Impact Canada's Oil Patch?

Description

There are growing fears that demand for Canadian crude will fall drastically now that the U.S. is set to become the world's largest oil producer in 2015 on the back of the shale oil boom. The U.S. is the biggest export market for Canadian crude, accepting around 97% of all Canadian crude exported. Even more troubling is some market sources and industry insiders expect the U.S. to become energy self-sufficient by 2020.

Such developments will certainly have a significant impact on the demand for Canadian crude and potentially affect the profitability of a number of the key operators in the patch. Shale oil or tight oil is a form of light sweet crude and the explosion in its production in the U.S. is already having a significant impact on light oil producers in Canada.

How is this impacting Canadian crude prices?

Since the start of 2014 the price differential between Edmonton Par, Canada's key light oil blend, and West Texas Intermediate has widened considerably, increasing by 9% to almost \$16 per barrel.

The key light oil plays in Canada are the Saskatchewan Bakken, Alberta's Cardium formation and the Viking formation that spans Alberta and Saskatchewan. And it is those companies, which have the majority of their production made up of Canadian light oil, that will experience the greatest impact on their bottom line.

Who will be the most affected?

Three companies I believe are particularly vulnerable are **Crescent Point Energy** (TSX:CPG)(NYSE:CPG), **Lightstream Resources** (TSX:LTS) and **Whitecap Resources** ([TSX:WCP](#)).

Crescent Point and Whitecap are dependent upon growing their cash flow in order to sustain their significant dividend yields of 7% and 5%, respectively. This is because both have dividend payout ratios in excess of 100% — 163% and 158%, respectively, in order to sustain these yields.

Any significant fall in operational cash flow will force them to either slash the dividend payment or

borrow funds – thereby increasing their degree of leverage – to continue funding them.

Since slashing its dividend by 50%, Lightstream now has a sustainable payout ratio. But with the company having taken a knife to capital expenditure as part of its restructure aimed at reducing debt, it is unable to boost production through additional well development, making it dependent on ongoing high crude prices in order to maintain cash flow and, ultimately, profitability.

Clearly as the U.S. demand for Canadian light crude wanes, each of these companies will see their revenue, cash flow and bottom line hit. I do not expect them to perform as strongly in 2014 as they have in 2013.

But the impact this will have on Canada's oil patch doesn't stop there. Growing U.S. shale oil production is expected by many industry analysts to generate a glut of light oil. This will impact the revenue of the majority of players in the patch by widening price differentials between Edmonton Par and West Canadian Select heavy oil as U.S. demand for Canadian crude wanes.

The only players that will be able to minimize that impact will be the large integrated majors that have geographically diverse upstream operations coupled with downstream processing and refining. The two Canadian oil majors that are best positioned to weather this coming storm are **Suncor Energy**([TSX:SU](#))([NYSE:SU](#)) and **Husky Energy** (TSX:HSE).

Both have diverse asset bases producing a range of different crudes in Canada and internationally. They also have downstream operations that will allow them to better manage widening price differentials and optimize their sales mix. Most importantly the crude they produce internationally is benchmarked to Brent, which trades at a 10% premium to West Texas Intermediate. This premium is expected to grow as U.S. production of tight light crude explodes.

Foolish bottom line

The U.S. shale oil boom is certainly a worry for Canada's oil patch, as it is expected to create a glut of light crude leading to wider price differentials between Canadian crude blends and their benchmark West Texas Intermediate. This will impact profitability in the patch, with the hardest hit being those players that solely produce Canadian light crude.

CATEGORY

1. Investing

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1. NYSE:SU (Suncor Energy Inc.)
2. TSX:SU (Suncor Energy Inc.)
3. TSX:VRN (Veren Inc.)
4. TSX:WCP (Whitecap Resources Inc.)

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