Energy Stocks Are Risky: Here's How to Reduce That Risk

Description

It's no secret that investing in energy, just like investing in any other commodity, has its own unique risks. It requires making projections, or at least educated guesses, about a future commodity price. It also requires riding out some extreme volatility as you wait for those projections to come true.

It's no wonder that so many great investors avoid energy altogether, opting instead for companies with strong pricing power. But there are ways to minimize this risk. For example, it helps to buy companies with long life projects and little debt. But perhaps most importantly, it helps to go with the low-cost producer.

With that in mind, below are three of the energy patch's lowest cost producers – two oil companies and one gas company.

1. Cenovus Energy

According to BMO Capital Markets, there are only four oil sands operations that would earn a sufficient rate of return even if the price of oil dropped below $40. **Cenovus Energy** (TSX: CVE)(NYSE: CVE) owns two of them.

One of them is Foster Creek, the lowest cost oil sands operation in the industry. And Cenovus has plenty of opportunity to grow production from Foster Creek – the operation could produce as much as 310,000 barrels per day by 2019, nearly six times its production in 2013.

The other is Christina Lake, which BMO pegs as the third lowest cost oil sands operation in all of Canada. Like Foster Creek, Cenovus thinks that production capacity at Christina Lake can eventually reach 310,000 barrels per day. And also like Foster Creek, that's a big step up from last year's production, in this case by more than a factor of six.

2. MEG Energy

It's no coincidence that one of Canada's other lowest cost producers also makes its living on Christina Lake: **MEG Energy** (TSX: MEG). MEG's operations are not quite as low cost as Foster Creek, but still only require about $45 oil to be economic. Future expansions will require about $55 oil to generate sufficient return, but that is of course well below where oil will be trading for the foreseeable future.

Like Cenovus, MEG Energy is expanding rapidly. After producing about 35,000 barrels per day in 2013, the company is on track to meet its goal of 80,000 barrels per day by 2015. And with such low cost operations, MEG's capital spending should earn excellent returns on investment in any realistic oil price scenario.

3. Peyto Exploration & Development Corp

Unlike MEG and Cenovus, **Peyto Exploration & Development Corp** (TSX: PEY) is a gas-weighted producer. But like the two companies above, Peyto is a low cost producer.

In 2013, Finding, Development & Administrative (FD&A) costs for total reserves was $1.86 per thousand cubic feet equivalent (mcfe). And operating costs were only $1.06 per mcfe. So in plain English, it cost $1.86 to find the gas, then $1.06 to get it out of the ground.

Furthermore, Peyto's gas comes with a high number of natural gas liquids, allowing the company to get a premium price. So even with such low gas prices, Peyto remains profitable.

Peyto also hedges much of its production, allowing the company to stay profitable no matter what stage of the cycle it's in. The year 2012 is a perfect example. Even though gas prices dropped below $2/mcfe for much of the year, the company remained profitable.

To sum up, the low cost of production from the companies above helps reduce the risk of investing in energy companies. Furthermore, it means these companies should be able to generate excellent returns on investment for a long time.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:CVE (Cenovus Energy Inc.)
2. TSX:CVE (Cenovus Energy Inc.)
3. TSX:PEY (Peyto Exploration & Development Corp)

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