What Investors Need to Know About Crude Oil Pricing

Description

The outlook for crude prices remains volatile and uncertain. There are a range of political and economic factors affecting the demand for crude and crude oil prices. As a result, energy analysts are divided over how crude prices will change over the short to medium term.

But there is growing consensus as to the direction of crude prices over the long term, with energy demand expected to continue growing as emerging economies continue expanding.

At this time, crude continues to trade at well over $100 per barrel, but over the short to medium term, realized prices for Canadian companies are expected to fall due to a number of global and domestic economic factors. However, in order to understand the outlook for crude prices it is necessary to understand what the key crude price benchmarks are, and what factors influence their direction.

What are the two key crude price benchmarks?

The two key benchmarks for crude prices are West Texas Intermediate and Brent.

West Texas Intermediate is a light sweet crude that is produced predominantly in the U.S. Midwest and Gulf Coast refineries, and is easily refined into high-quality crude products. It is priced in Cushing, Oklahoma, which has seen a flood of oil due to the U.S. shale oil boom and growing crude exports from Canada.

It is the key price benchmark for crude sold on the North American market and continues to be the primary benchmark price for Canadian crude blends, including West Canada Select heavy oil, Edmonton Par light oil, and Syncrude.

Brent is a light sweet crude with a higher sulfur content and a lower API gravity than West Texas Intermediate. It is produced predominantly in a range of oil fields scattered in the Atlantic Ocean and shipped to European refineries.

A number of other oil-producing regions also see their crude blends benchmarked to Brent. This includes Colombia, where Colombian light and medium crude shipped to the European market is benchmarked to Brent.

Brent has replaced WTI as the global crude price benchmark, with it representing crude prices for Northwest Europe, West Africa and the Mediterranean. WTI does not accurately reflect the global demand for crude because of an oversupply of crude in North America, which is seeing WTI now trade at a discount to Brent.

Over the last four years, this discount has continued to widen, as the chart below shows, and now results in Brent trading at a premium of just over 7% to WTI.

WTI Brent Price Chart 210514

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With the U.S. set to increase crude production on the back of the shale oil boom, its oil production will surpass Saudi Arabia’s by 2020, making it the largest producer of crude globally. Thus, WTI will continue to trade at a discount to Brent for some time to come.

What does this mean for investors?

This discount highlights the pricing advantage Canadian oil companies can obtain if they can access Brent crude pricing. Among Canadian oil producers, those best able to access Brent pricing are those with operations in Europe and Latin America.

This includes **Bankers Petroleum** (TSX: BNK), which operates in Albania, as well as **Parex Resources** (TSX: PXT) and **Gran Tierra Energy** (TSX: GTE)(NYSE: GTE), which both operate in Colombia. The ability to access Brent pricing has given these companies an edge over the majority of their Canadian-based peers.

This is most apparent when their operating netback per barrel of oil produced — an important measure of the profitability of their oil production — is compared to those peers. During the first quarter of 2014, Bankers reported an operating netback of $55.75, whereas Parex's was an impressive $62.70, and Gran Tierra's a massive $71.41 per barrel.

These operating netbacks are also significantly higher than those of companies operating exclusively in Canada, which have their oil sales benchmarked solely to WTI. They are well above the average operating netback of around $42 per barrel for oil companies operating in North America. As well as being superior to Canadian light oil, **Crescent Point Energy** (TSX: CPG)(NYSE: CPG), considered to be one of the most efficient operators in the oil patch, reported a netback of $52.65 for the same period.

Clearly, those Canadian companies that can access Brent prices for the oil they produce are able to generate a significant premium over those bound to WTI prices. This allows them to generate superior funds flow from operations and use those funds to invest in exploration and development, meaning that they are not as reliant upon debt as a means of funding the development of their assets.

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