3 Reasons Why Crude Prices Will Normalize

Description

The ongoing crisis in Iraq continues to drive crude prices higher because of increasing concerns over the political stability of OPEC's second-largest producer. Since the crisis began, oil prices have surged 5%, a boon for the oil industry as whole and more specifically for those companies operating in lower-risk jurisdictions like Australia, the U.S., and Canada.

It is also fueling significant speculation among a number of analysts that crude prices will continue to rise as the crisis worsens and other sources of oil supply are disrupted. This sees some analysts predicting that crude prices will rise to over $120 per barrel, which would be a massive boon for the patch. However, there are growing signs that prices may soon normalize.

There are a number of factors which will act to drive oil prices lower from their current levels.

1. North American crude production continues to grow

The most significant reason is growing supply: U.S. crude production is expected to grow a massive 25% between now and 2015, while Canadian crude production is forecast to shoot up a healthy 14% for the same period. This forecast growth alone will add 13 million barrels of crude daily to global supplies. Interestingly, some analysts have stated that the contribution of these supply increases is not as significant as they first appear.

This is because U.S. production is skewed towards condensates, which are difficult to refine and can't be exported. However, U.S. officials have indicated that condensates or ultra-light crude can be exported if minimally refined. Since this development, there is growing investment across the U.S. in ultra-light crude refining infrastructure, allowing the refining of ultra-light crude for export, particularly to energy-hungry Asian markets.

In addition, the effect of growing Canadian crude production on supply will be curtailed by the pipeline crunch, which is preventing producers from transporting oil to crucial refining markets in a cost-effective manner, while growing development and production costs are making oil sands uneconomical.

However, a range of measures are already being undertaken to address these transport bottlenecks, including the recent approval of **Enbridge's** (TSX: ENB)(NYSE: ENB) Northern Gateway pipeline and increased crude-by-rail transport. The volume of crude transported by rail increased has almost 300-fold since 2009 and proved to be a boon for Canada's two largest rail companies, **Canadian National Railway** (TSX: CNI)(NYSE: CNR) and **Canadian Pacific Railway** (TSX: CP)(NYSE: CP).

This has seen their cash flow and bottom lines grow strongly over that period; these will continue to grow with signs that crude by rail will also continue to grow exponentially. Ratings agency Moody's predicts that oil transport will be the fastest-growing freight segment for North American railways, as it upgraded its industry outlook to positive.

According to a **Bank of Nova Scotia** report earlier this year, production costs for Canadian oil plays, including the oil sands, are lower on average than U.S. light crude production costs. This makes it likely that Canadian oil plays will continue to be developed and production will continue to grow for all types of Canadian crude.

Another factor supporting this is U.S. crude re-export licenses that allow companies to export Canadian crude from the U.S. Enbridge has already obtained one, and **Crescent Point Energy** (TSX: CPG)(NYSE: CPG) is investigating the option.

2. Greater exploration and development activity in Latin America will increase supply

Oil production across Latin America, which holds 20% of the world's total oil reserves, is expected to grow significantly. Argentina is now exploiting the vast reserves of the Vaca Muerta, while Colombia continues to boost production and Mexico deregulated its oil industry to attract foreign investment to boost production.

Brazil, the world's 11th-largest oil producer, also continues to grow production, with crude production a key driver of its economy and financer of social development programs.

All of these things can only see global crude supplies grow particularly, with some of the biggest oil discoveries of recent times being made in offshore Brazil.

3. The crisis in Iraq may have a lesser impact on Middle Eastern oil production than initially thought

While Saudi Arabia and other major OPEC producers do not have the necessary spare capacity to meet any shortfall in production from Iraq, it is unlikely that Iraq's level of crude production will fall as precipitously as feared. This is despite Sunni insurgents capturing Iraq's second-largest refinery near the city of Mosul.

This is because the majority of Iraq's oil resources and infrastructure are located in the Shia-controlled south or the Kurdish-controlled northeast of the country, and it is unlikely those areas will fall into the hands of the Sunni insurgents.

The current crisis will also more than likely see Western powers working more closely with Iran to stabilize the crisis and the broader region, which has the potential to release additional Iranian oil onto global markets. This is because it could lead to a swifter resolution of that country's nuclear ambitions, thereby seeing European Union and U.S. oil embargoes relaxed or even lifted in exchange for Iranian assistance.

What does this mean for investors?

The best way for investors to cash in on this short-term surge in energy prices before they normalize is by investing in those companies able to rapidly boost production to take advantage of higher prices while retaining tight control of costs.

Three players in the patch that stand out are **Parex Resources** (TSX: PXT), Crescent Point Energy, and **Surge Energy** (TSX: SGY). All three have recently completed substantial accretive transactions, which have boosted production, revenue, and cash flows. Parex is also able to take advantage of higher Brent prices, with it currently trading at an 8% premium to WTI, further boosting cash flow and the company's bottom line.

However, investors should approach investing in the patch with some caution. The current crisis is fueling a speculative frenzy over higher oil prices, which for the reasons discussed is not sustainable over the longer term.

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