Beat the Looming West Texas Intermediate Price Crunch With These Players in the Energy Patch

Description

Energy investors are witnessing an intriguing phenomenon. Despite growing production disruptions in the Middle East because of escalating regional conflicts, which traditionally drive crude prices higher, oil prices are softening since peaking in late June of this year.

This phenomenon can be attributed to the U.S. shale oil boom, which has resulted in the U.S. overtaking Saudi Arabia earlier this year to become the world's largest producer of crude.

Surging U.S. oil production is set to flood the market with light sweet crude

More startling for energy markets is U.S. oil production is expected to continue growing at an exponential rate until 2030 and then start declining. Between now and 2016 alone, U.S. production of light sweet crude or West Texas Intermediate is expected to grow at an average of 7% per annum and flood refining markets.

This will more than offset supply side pressures coming from production disruptions in the Middle East and see North American refining markets flooded with light sweet crude, which will apply additional pressure to the benchmark WTI price.

All of this is predominantly causing the price differential between WTI and Brent crude prices, with Brent prices predominantly paid in European refining markets. While this differential has narrowed by 6% for the year-to-date, it is expected to widen as U.S. light sweet crude production continues growing.

What is the impact on the patch?

It will also have a significant impact on the patch with Canadian crude blend prices benchmarked to WTI, with the U.S. being the largest recipient of Canadian crude. By the end of 2013, the U.S. was accepting around 97% of all Canadian crude exported, which equates to around 70% of Canada's total crude production. This will cause the price differential between Canadian crude blends and WTI to widen.

Already the price differential for Edmonton Par (Canadian light crude) has widened 4% since January and is currently trading at a discount of 9% to WTI. West Canada Select (Canadian heavy crude) has widened by 11% since hitting a low of 13% for 2014 to currently trading at a discount of 24% to WTI.

The companies most affected will be those primarily dependent on accessing U.S. refining markets, which includes both light and medium crude producers as well as heavy crude and bitumen crude producers.

Which players in the patch are most vulnerable?

Among those most vulnerable to the looming WTI price crunch are **Crescent Point Energy Corp** (TSX: CPG)(NYSE: CPG), **Lightstream Resources Ltd** (TSX: LTS), **Penn West Petroleum Ltd** (TSX: PWT)(NYSE: PWE) and **Pengrowth Energy Corp.** (TSX: PGF)(NYSE: PGH). Even larger heavy crude and bitumen producers like **Cenovus Energy Inc.** (TSX: CVE)(NYSE: CVE) will be impacted.

But there are a number of players in the patch, who will be able to effectively mitigate the impact of the looming WTI price crunch because of their diversified oil production and ability to access alternate refining markets. The three that stand out most prominently are **Suncor Energy Inc.** (TSX: SU)(NYSE: SU), **Canadian Natural Resources Limited** (TSX: CNQ)(NYSE: CNQ), and **Husky Energy Inc.** (TSX: HSE).

All three have geographically diversified assets allowing them to access alternate energy markets including important premium Brent pricing in European refining markets. Suncor, Canadian Natural Resources and Husky's Canadian East Coast and international crude production outside of North America allows them to access premium Brent pricing.

Furthermore, Suncor and Husky produce a considerable portion of their crude from offshore East Coast Canada and internationally, with both focused on boosting this production. Finally, Husky has worked hard to build its presence in Asia, which is fast shaping up as the key energy export market Canada needs to tap.

Another edge is their integrated operations including crude refining and marketing, which allows all three to better manage the price differentials and the margins they are able to make.

However, what may surprise investors is a number of smaller independent oil and gas companies in the patch are also well positioned to mitigate these risks because of their ability to access premium Brent pricing. Two that stand out are **Parex Resources Inc.** (TSX: PXT) and **Gran Tierra Energy Inc.** (TSX: GTE)(NYSE: GTE).

Both companies operate predominantly in Colombia and are able to sell the majority of their oil production at average realized sale prices benchmarked to Brent. When coupled with Colombia's lower royalties and the ability to access lower costs structures associated with operating in Colombia, they are able to generate a healthy margin or netback per barrel. For the second quarter 2014, Parex reported a netback of $61.65 per barrel of crude sold, while Gran Tierra reported $70.55 per barrel.

These are significantly higher than the netbacks generated by those companies operating in North

America for the same period, including Crescent Point's $54.75, Lightstream's $57.49, Penn West's $36.67, Pengrowth's $23.86, and Cenovus' $50.41 per barrel.

Growing U.S. light sweet crude production and the WTI price crunch are looming as key threats to the profitability of the majority of operators in the patch.

Falling profitability will also have an impact on the ability of many players to sustain cash flow-based dividend payments, which require growing oil production, higher realized prices, and accretive acquisitions to remain sustainable.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:CNQ (Canadian Natural Resources Limited)
2. TSX:SU (Suncor Energy Inc.)
3. TSX:VRN (Veren Inc.)

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