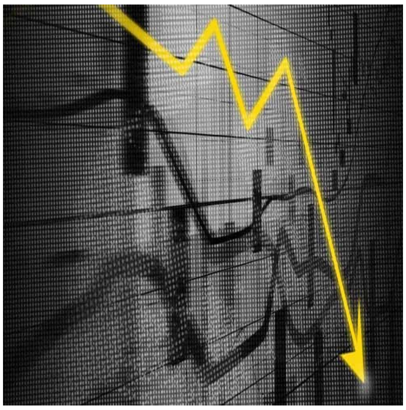

Why Canadian Drillers Are Down Even After Natural Gas Prices Surged

Description

In a somewhat surprising development, natural gas prices have surged strongly over the last three months to see the **United State Natural Gas ETF** up by a whopping 52% for the year to date. According to analysts, unseasonably cold weather in North America and growing demand from China for fossil fuels indicates that prices could rise even further and that natural gas' prolonged slump is over.

Nonetheless, Canadian gas producers such as **Encana Corp.** (TSX:ECA)(NSYE:ECA) and **Peyto Exploration and Development Corp.** (TSX:PEY) have failed to rally, losing 47% and 35% respectively.

Now what?

A significant increase in demand coupled with falling North American inventories saw the price of gas soaring in recent months. What is considered to be a low emission fossil fuel gained almost 45% over the last year to see the North American benchmark Henry Hub price trading at US$4.52 per million British thermal units (MMBtu).

This should give the earnings of some North American drillers a healthy lift for the foreseeable future, but it may not be result in a sustained rally nor fully benefit Canadian producers, as the latest rally is being driven by greater-than-expected demand for natural gas during the peak winter heating season because of colder than anticipated weather. Some analysts are expecting prices to retreat once winter comes to an end.

Even localized shortages in Asia triggered by soaring demand from China for natural gas will fail to support higher prices over the long-term a range of issues preventing Canadian drillers from fully enjoying the benefit of growing demand. Key among these is the lack of transportation capacity to facilitate the shipment of Canadian natural gas to Asia, although China's thirst for the low emission fossil fuel has created an opportunity for West Coast shale operators.

The only thing lacking is sufficient infrastructure to transport the gas from booming natural gas plays like the Montney and Duvernay to key east coast markets and the west coast so that it can be shipped to Asia. Those bottlenecks are sharply impacting Canadian natural gas prices.

As is the case for Canadian crude blends such as Western Canadian Select (WCS), the differential for the local natural gas price known as AECO and the Henry Hub benchmark have widened significantly in recent months. The current AECO price of US$1.41 per MMBtu is around a third of the Henry Hub price, which can be blamed on pipeline bottlenecks that are preventing drillers from transporting the gas they produce to key North American markets.

You see, a lack of transportation capacity coupled with soaring production has created a localized supply glut, which is suppressing prices, thereby impacting the performance of local producers. For the third quarter 2018, Peyto realized an average price of US$1.13 per MMBtu before hedging compared to US$2.93 for the average Henry Hub spot price during the quarter. As result, Peyto's operating netback – a key measure of profitability – fell by 6% year over year and net earnings tumbled by 34% to $29.5 million.

Encana also suffered a similar fate, reporting an average realized third quarter price of US$2 per MMBtu for its Canadian natural gas production compared to the average Henry Hub price for the period, which was almost US$1 per MMBtu higher. This had a sharp impact on earnings because Encana's Canadian natural gas output makes up around 45% of its total production. This, along with the losses incurred by hedges for its oil production, saw Encana report that third quarter net earnings had fallen to US$39 million, a thirteenth of what they had been for the equivalent period in 2017.

So what?

There is no sign that AECO prices will recover anytime soon. A lack of infrastructure in Western Canada, notably pipelines, will according to industry insiders weigh on domestic natural gas prices for at least another two to three years until transportation capacity expands significantly. Many Canadian gas producers therefore remain unattractive investments despite the latest huge spike in natural gas prices.

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