Are Canadian Natural Gas Stocks a Poor Investment?

Description

The long-awaited recovery in natural gas has failed to occur. After spiking in late 2018 to see the North American benchmark Henry Hub price almost doubling in the space of around three months to US$4.70 per million British thermal units (MMBTU), it has pulled back sharply to trade at US$2.68 per MMBTU. That — along with other significant headwinds, particularly the wide differential between the Canadian natural gas price known as AECO and the Henry Hub benchmark — is weighing on the outlook for Canadian drillers.

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This has impacted domestic upstream natural gas producers like **Arc Resources** (TSX:ARX), which has lost 21% over the last year. There is more bad news ahead for Canadian natural gas producers which makes many of them unappealing investments, despite claims by some pundits that natural gas is poised to surge in value.

Rising natural gas consumption

Central to this theme is the belief that demand and hence prices will soar, because of the ongoing transition from coal-fired to natural gas-fired electricity. That has seen many U.S. coal-fired powerplants either shut down or converted to natural gas, which saw generation of electricity in 2017 responsible for burning over a third of all gas consumed south of the border.

Natural gas is also the fuel of choice for households and an important feedstock as well as a source of energy for many industries. There has been a massive leap in consumption in China, where demand for the fuel is fast outstripping local supplies because of Beijing's push to eliminate coal as it fights to reduce severe air pollution in many major cities. While these factors undeniably point to a significant increase in demand for gas, they have failed to spark a sustained rally.

Natural gas production is growing

The reason for this is quite simple: natural gas production is expanding at a phenomenal clip, particularly in the U.S. because of the shale oil boom. Over a decade ago, the Marcellus shale didn't produce any natural gas and was believed to have minimal productive potential. By November 2018, it was the largest source of natural gas in the U.S., producing 21 billion cubic feet (BCF) daily, which amounted to a fifth of all U.S. production for the month and was a stunning 342 times greater than a decade earlier.

The shale boom has also triggered stunning growth of the volume of natural gas being pumped in the Permian shale. For November 2018, the play produced 8.5 BCF of gas daily which was 10 times greater than a decade earlier, making it the second-largest U.S. gas-producing basin behind the Marcellus.

A similar phenomenon is occurring in Canada, where the Montney and Duvernay shale formations have become the focus of a growing natural gas boom. Daily production in the Montney grew from zero in 2006 to around seven BCF in 2018, which sees that play alone responsible for almost a third of Canadian natural gas production.

North American natural gas supply will keep expanding at a rapid clip because U.S. and Canadian drillers are growing production, despite weak prices. The U.S. Energy Information Administration (EIA) predicts that U.S. domestic dry gas production alone will reach 92 bcf daily, which is 10% greater than forecast consumption over the same period.

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Gas production in Western Canada will also keep expanding, although analysts anticipate that overall national output will remain flat over the next five years because production in Atlantic Canada is forecast to fall to virtually zero. Arc, which is one of Western Canada's largest dry gas producers plans to grow production by 10% annually between 2019 and 2021. The marked increase in natural gas production in North America will further exacerbate the existing supply overhang, weighing further on prices.

This isn't the only headwind impacting Canadian drillers. A distinct lack of pipeline exit capacity in Western Canada is preventing producers from accessing crucial energy markets, causing a localized supply glut to emerge, which is weighing heavily on prices. AECO is trading at US$1.62 per MMBTU, or 39% lower than the Henry Hub price of US$2.64 per MMBTU.

Poor outlook for Canadian natural gas drillers

That wide price differential is magnifying the marked impact that natural gas's latest price collapse is having on Canadian drillers. This headache won't go away anytime soon, because of the significant regulatory hurdles that need to be overcome to initiate a new pipeline project.

The negative effect of weaker gas, which makes up over 70% of Arc's hydrocarbon output, can be seen from its 2018 results where net income plunged by 45% year over year to just under $214 million. Arc has taken measures to minimize the impact of the poor outlook for natural gas, including improving capital efficiencies to maintain netbacks, diversifying sales points to avoid the AECO price, and bolster liquids, notably high-margin condensate production. While Arc's moves to reduce the impact of weaker gas prices and solid financial position increases its appeal, the difficult operating environment and poor outlook for gas means investors will receive superior returns by looking elsewhere.

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