Avoid Canada's Natural Gas Crisis: This Is the Only Natural Gas Stock Investors Should Buy in 2019

Description

The outlook for natural gas remains poor, despite the claims of some market pundits that it was due to rally because of a substantial increase in demand. The fuel has lost almost 12% since the start of 2019, and there are signs it will continue to weaken as we head into summer, when consumption drops significantly because of reduced home-heating requirements.

Emerging crisis

This poses a major threat to Canada's once-booming natural gas drillers, particularly after considering that the Canadian AECO benchmark is trading at a deep discount to the North American Henry Hub price. While gas at Henry Hub is receiving US$2.55 per million British thermal units (MMBTU) the AECO price of US$0.69 per MMTBU is less than a third.

That is having a sharp impact on Canadian natural gas producers, which reported mediocre results for the first quarter 2019. **Painted Pony Energy** (TSX:PONY) announced a 10% year-over-year decline in production along with a $2.6 million net loss, which sees losses reported for four of the last five quarters. It reported a loss, despite realizing an average price for the quarter that was 24% greater than the average AECO benchmark. Its profitability was not assisted by a 16% year-over-year increase in transportation expenses, which negated an 11% decrease in operating costs.

That increase in transportation fees was caused by Painted Pony diversifying the prices received for its gas sold to minimize the impact of sharply weaker AECO pricing. The driller estimates that its transportation expense per million cubic feet sold will grow by another 15% over the remainder of 2019, thereby further impacting its profitability. Higher costs were the reason for Painted Pony's low quarterly netback of around $2.50 per MMBTU pumped.

Meanwhile, **Peyto Exploration & Development** and **Tourmaline Oil** reported an unhealthy decrease in net income, which plunged by 48% and 32%, respectively. That can be attributed to a combination of higher production and transportation expenses as well as weaker oil, condensate, and petroleum liquids pricing. This saw them report less-than-stellar netbacks of $2.57 and $2.87 per MMBTU. Those netbacks, while at the upper end of the range for the Canadian gas industry, are still low compared to drillers operating outside Canada, highlighting the profitability issues faced domestically.

The key issue driving the divergence between AECO and Henry Hub pricing is a lack of pipeline exit capacity, which is constraining the transport Western Canada's natural gas to the East Coast and U.S. markets. This is the same problem that was responsible for causing record Western Canadian heavy oil inventories, which sparked a price collapse; the heavy oil benchmark Western Canadian Select (WCS) plunged to record lows until Alberta's government intervened, imposing mandatory production cuts.

The quantity of natural gas produced in North America is growing at a furious pace. Booming production in the Montney and Duvernay plays as well as the surge in U.S. shale oil production have caused gas volumes to soar. The National Energy Board (NEB) expects Canadian gas production to expand by 29% between 2018 and 2040, while U.S. output is forecast to more than double. This means there will be an abundance of gas in North America and that the U.S. will cement its position as the world's leading gas producer.

This will weigh on gas prices for some time, more than offsetting growing demand for the fossil fuel, making Painted Pony, Peyto, and Tourmaline unattractive investments.

Pulling it together for investors

There is one Canadian gas driller in a position to avoid the growing impact of higher North American production and surge because of shortages in the market where it operates. That company is **Canacol Energy** (TSX:CNE), which is focused on Colombia. Over the last three years, it has pivoted its operations from oil to gas after identifying growing local supply constrictions, which allow it to lock-in favourable well-head pricing of around US$5 per MMBTU, which is roughly double the Henry Hub spot price.

Colombia's emerging supply constraints, rising decline rates at aging gas fields, and a lack of major discoveries have forced the once self-sufficient nation to import gas. That implies those higher-than-market prices will continue for the foreseeable future. This gives Canacol a handy financial advantage over its North American peers and, along with growing gas production as well as reserves, will boost its earnings and ultimately the company's market value.

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