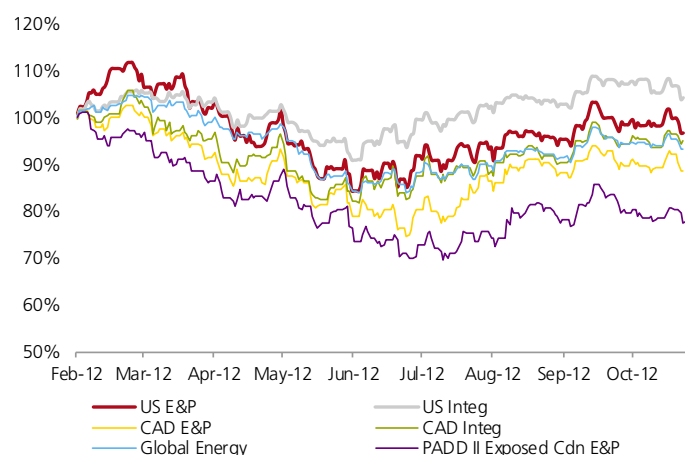


Oil: Uncertainty Reigns... Again

Andrew Potter, Equity Research Oil & Gas

Global investors have generally limited their Canadian oil & gas exposure for a number reasons. Widely speaking, this decision is driven by a combination of macro anxiety (Greece, Spain, and China slowing) and fears around short-term differential risk for Canadian oil producers. With the dismal YTD stock performance in the Canadian large caps, one could argue that much of our macro thesis is already discounted in stock prices – which is generally true. However, the negative backdrop with increasingly limited growth visibility and rising pipeline/differential risk means that global investors are unlikely to flock back to the Canadian oil and gas sector anytime soon (Chart 1).

Chart 1
Differentials Have Weighed on Canadian Producers



Source: CIBC, Bloomberg.

NORTH AMERICAN OIL GROWTH TO CONTINUE AT INCREDIBLE RATES...

In our “Boom Oil” report, we published a very detailed bottom-up analysis on 28 North American oil and natural gas resource plays. Based on our modeling, we believe North American oil production can grow approximately

800,000 bbl/d per year through 2016 – an incredible growth rate. The growth can be distilled down to approximately 500,000 bbl/d per year from US on-shore oil, ~45,000 bbl/d per year from US offshore, ~100,000 bbl/d per year from Canadian light oil and ~230,000 bbl/d per year from the oil sands, mitigated by expectations of a decline of ~100,000 bbl/d per year from Mexico.

...BUT BIG GROWTH WILL CONTINUE TO LEAD TO MAJOR PRICE DIFFERENTIALS

Pricing differentials have comprised a major theme in 2012. The most obvious differential is Brent vs WTI, which has averaged approximately US\$16.75/bbl in 2012 – a substantial opportunity cost for producers. Moreover, Canadian producers have, at times, seen meaningful pricing discounts vs WTI, reflecting constraints in the PADD 2 market. Relief valves will open with the Seaway expansion (250,000 bbl/d) in Q1/2013 and the south portion of Keystone XL (700,000 bbl/d in late 2013), and the consensus view presumes that these pipes will solve the pricing problems. In our view, they will help narrow the Brent-WTI discount but that discount will remain in the US\$10/bbl range. This is a similar conclusion to that reached by our commodities strategists (page 28). Our rationale is that these new pipes simply push the current PADD 2 glut into PADD 3, which will knock out PADD 3 light oil imports in early 2013 and prompt Light Louisiana Sweet (LLS) pricing on the Gulf Coast to begin discounting vs Brent. We believe LLS will move to an approximately US\$5/bbl discount vs Brent (vs its historical range of Brent + transportation costs) and WTI will move to a transportation discount vs LLS of approximately US\$5/bbl, leading to a long-term Brent-WTI differential of US\$10/bbl. As current consensus expectations generally reflect a narrowing of Brent-WTI down to US\$1/bbl–US\$2/bbl by 2014+, we believe consensus expectations overstate the value of domestic oil producers exposed to this theme and understate valuations of Brent-exposed and downstream-exposed producers.

PRICING DIFFERENTIALS ARE GOOD FOR DOWNSTREAM

If producers are losing out given price differentials, it means that refiners are benefiting and refinery economics are massively sensitive to every dollar change in crack spreads.

It is no secret that PADD 2&4 and Canadian refiners have been reaping super-normal cash flows in 2011 and 2012. Most investors believe this phenomenon to be very short term and have assigned very low valuations to refiners or integrators that are gaining from this theme. We believe there will be a recognition in 2013 that price differentials are here to stay, and that will keep downstream margins elevated in the long term (albeit decreasing from current record levels). As investors recognize the strategic value of downstream, we expect to see a gradual re-rating of downstream-oriented names [in Canada that is Suncor Energy Inc. (SU-SO), Cenovus Energy Inc. (CVE-SO), Husky Energy Inc. (HSE-SP) and Imperial Oil Limited (IMO-SP)].

2013 WILL BE A DEFINING YEAR FOR CANADIAN PIPELINE POLITICS

Pipeline capacity out of Western Canada is adequate for the short term, but substantial progress must be made on this front in 2013. Progress (or lack thereof) will have a big impact on sentiment towards Canadian oil producers. We estimate that pipeline capacity out of the Western Canadian Sedimentary Basin (WCSB) could effectively be full in the 2014 time frame (our production forecasts are higher than consensus), suggesting little room for error/politicking in bringing on new pipeline capacity.

There are ~2.9 mmbbl/d of long-haul pipeline proposals on the table (out of Western Canada). That sounds like a lot until one considers that two of the largest (the proposed 525,000 bbl/d Gateway and 450,000 bbl/d TMX expansion through BC) face ever-increasing political risk; we assign no better than 50/50 odds that these pipes are built before the end of the decade. The proposed TransCanada Mainline conversion (estimated ~600,000 bbl/d) is compelling but very early stage and could also provoke some political backlash in Québec. We also note that the 2.9 mmbbl/d proposed capacity is quickly depleted given our forecast of 100,000 bbl/d per year growth in Canadian conventional oil and 230,000 bbl/d per year growth in oil sands (or ~300,000 bbl/d when blended). Canada needs pipe – and lots of it – to avoid the opportunity cost of stranding over a million barrels a day of potential crude oil growth.

GAS OUTLOOK IMPROVES

Natural gas prices remain a roller-coaster but we believe

the next leg looks sustainably stronger, thanks to a major shift away from gas to oil drilling. In this we also agree with our commodities strategists (page 29). While a supply correction is long overdue, our bottom-up modeling suggests that US gas production remains static in 2013 while Canadian production continues to decline. This is a sharp change to the +3 bcf/d per year US growth over the past three years. The gas cycle is more sustainable this time around as the US rig fleet is largely drilling higher-return oil and liquids plays, implying that a big ramp-up in gas drilling will only transpire if pricing is sufficient to move rigs from oil plays to gas – which, in our view, is difficult to justify until the US\$5/mcf range on most plays.

GOOD OPPORTUNITY STILL IN QUALITY GAS PRODUCERS

For the first time in many years, the outlook for natural gas prices looks quite attractive. With tightening storage balances in 2013/2014 and a rig count that will likely be slow to return to gas drilling, gas prices should move into the US\$4/mcf range in 2013. With some marquee gas players, such as Encana (ECA-SP), already reflecting relatively high gas prices (~US\$4.50/mcf), we favour mid- to small-cap producers or large-cap companies that have material gas assets but that the market has been slower to re-rate for that value. Our top picks for gas exposure are: Talisman Energy Inc. (TLM-SO) in the large caps, Tourmaline Oil Corp. [TOU-SO] in the mid caps, and Painted Pony Petroleum Ltd. (PPY-SO) in the small caps.

NORTH AMERICAN LNG IS ADVANCING

We published a major report on North American LNG in early 2012, with the key takeaway being that North American LNG is viable and that we would see a resource grab for strategic gas assets in 2012 – even during a low gas-price year. This thesis has proven largely correct. In the US, construction has started on the first LNG export terminal (Sabine Pass). Export approvals are still pending on a number of other US terminals, and we expect several approvals to occur in H1/2013 (later than originally expected, with decisions being deferred until after the US Presidential election). Canadian LNG has been on a more mixed path.

On the negative side, the Apache-led (APA-NYSE) Kitimat LNG project (1.4 bcf/d) is about one year behind schedule

for signing off-take agreements, and its significant lead is rapidly eroding. Despite the delays we remain optimistic on this project although we would not be surprised if ownership were to change hands. On the positive side Petronas and Royal Dutch (RDS.A-NYSE) formalized plans for their projects and, consequently, there has been major deal flow, with Petronas bidding \$5.5 billion for Progress Energy Resources Corp. (PRQ-SP), PetroChina (PTR-NYSE) buying a +US\$1 billion of gas assets from Royal Dutch, and Mitsubishi (8058-T) signing a \$2.9 billion joint venture with Encana to supply its share of the RDS project. More recently ExxonMobil Corporation (XOM-NYSE) has offered \$3.1 billion for Celtic Exploration Ltd. (CLT-SP), partly motivated by LNG opportunity. We believe there are still more deals to be done to consolidate the massive resource required to build these facilities, but further deal announcements will wait until the Canadian government firms its rules regarding acquisitions by State-Owned Enterprises (SOEs). We believe the next most likely sellers of gas resource for LNG are Talisman Energy and Painted Pony Petroleum.

M&A – CANADIAN SECTOR RIPE FOR MORE CONSOLIDATION...BUT PENDING GOVERNMENT CLARITY

A major theme from last year's edition of *Look to the Future* was the increasing potential for big-cap M&A in Canada given how absurdly low valuations had become. That theme has started to play out with CNOOC Ltd. (CEO-NYSE) bidding US\$15.1 billion for Nexen Inc. (NXY-SU) and Petronas bidding \$5.5 billion for Progress. We foresee the potential for other M&A transactions if the Canadian government establishes guidelines for acquisitions of Canadian companies by SOEs. Companies such as Talisman Energy, Encana and Canadian Oil Sands Limited (COS-SU) would, in our view, be the most likely big-cap M&A targets. ■