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TSX Sector Strategy #4

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Adding to Energy Overweight

Jeff Rubin and Peter Buchanan

Market Weight	17.5%	Recommended Weight	23.0%

Summary

We are lifting our overweight in oil and gas stocks to 23% given prospects for continuing high prices on tight capacity, Mideast tensions and above-trend demand growth.

Oil's present rally appears to have staying power unlike the last trip above $40 in 1990. The fast growth of economies like China and India, which are 2-3 times as energy intensive as the mature industrial countries, means the world is fast eating through its limited supplies of low cost conventional crude. Dwindling US conventional supplies and peaking Canadian production are likewise constructive for natural gas, which has doubled in price in the last 2 years.

Although energy stocks have been the TSX's second best performer in 2004, valuations still do not factor in sustained high energy prices. The energy index's underlying value is around 1900 at the standard 5½ times the cash flow generated by $40/bbl WTI and $6.50-7.00/Mbtu natural gas.

Key Indicators

	Latest	Next 12 Months
WTI ($/bbl)	40.06	40
Natural Gas (Nymex, $/Mn. Btu)	6.39	6.50-7.00

	Latest	Yr Ahead Target
TSX Energy Index	1581	1900
	(Consensus)	(CIBC WM Estimate)
Fwd. Cash Flow	265	340

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High Energy Costs are No Flash in the Pan

Jeff Rubin and Peter Buchanan

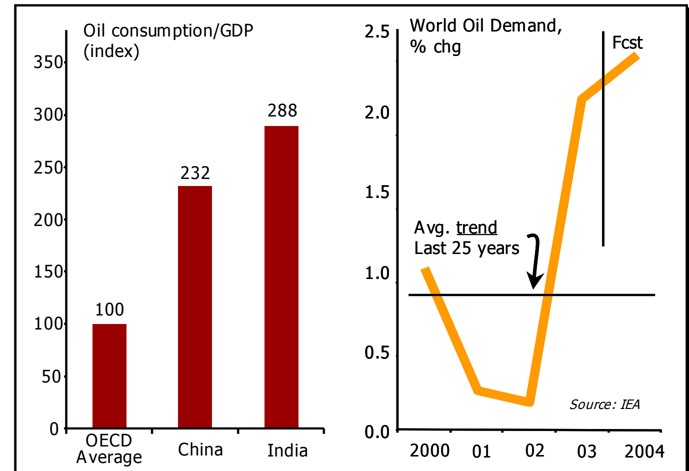
Depletionists, rather than pinning their hopes on future cost-saving technological breakthroughs, see underlying resource scarcity driving the global energy supply picture. If they're on the mark—as appears increasingly likely—global conventional oil production should be peaking at around the 65 million barrel daily level (Chart 1), raising the spectre of sustained $40 oil.

Rising production of non-conventional deep water oil, and the even greater potential of other non-conventional sources like the Athabaska and Orinoco tar sands, mean that the world is at little risk of running out of all types of crude oil. But there are growing concerns about the ability of conventional low-cost oil production to keep pace with fast-climbing demand. Oil consumption worldwide is now rising at a 2½% pace—the strongest pace in 16 years. That's a tribute to the explosive momentum of economies like China and India, which are 2-3 times as energy intensive as the established industrial nations (Chart 2). Reserve cuts by majors like Shell, and doubts about how much oil Middle East producers like the Saudis actually have, moreover, are challenging market complacency about supply.

Can oil prices hang onto their recent gains? The prospect, looking at history, is not so far fetched. Benchmark West Texas prices have averaged $35 in today's dollars over the last three decades, not very much below the current level (Chart 3).

Chart 2

Oil-Intensive Asian Economies (L) Powering World Oil Demand (R)



A rush to tap non-conventional oil supplies could ultimately necessitate even higher crude prices, perhaps rivalling the $50 plus levels of past supply shocks, adjusted for inflation. At $60 million-plus per well, deepwater drilling costs are up to ten times those of conventional on-land wells. Syncrude's $2.1 billion expansion cost overrun and rising operating costs call into question hopes that other non-conventional oil, like the tar sands, will come

Chart 1

World Conventional Oil Production: Hubbert Curve

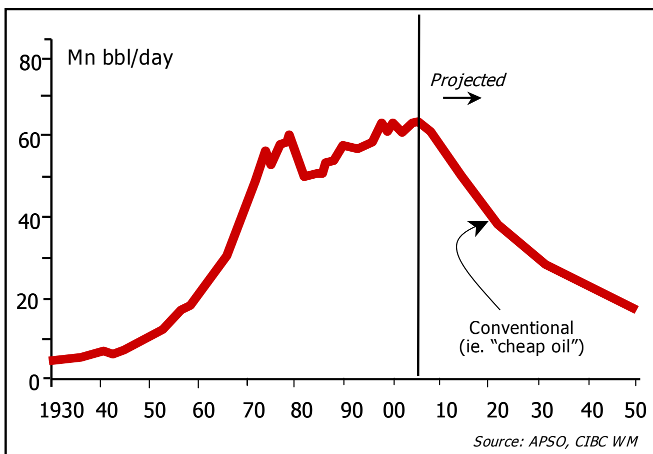


Chart 3

Price of West Texas Crude in Today's Dollars

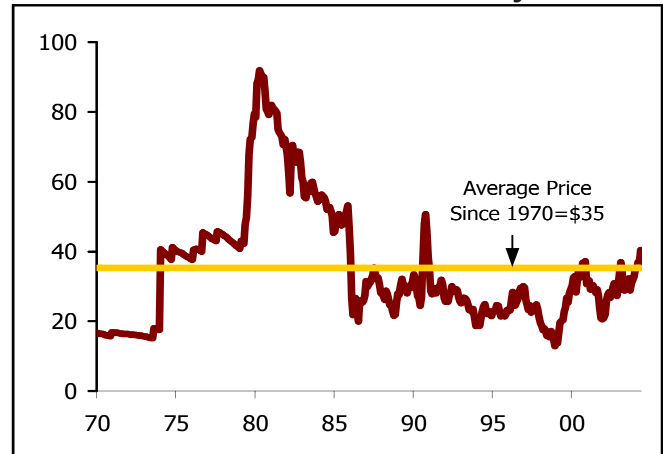


Chart 4
Non-Conventional Oil Costly

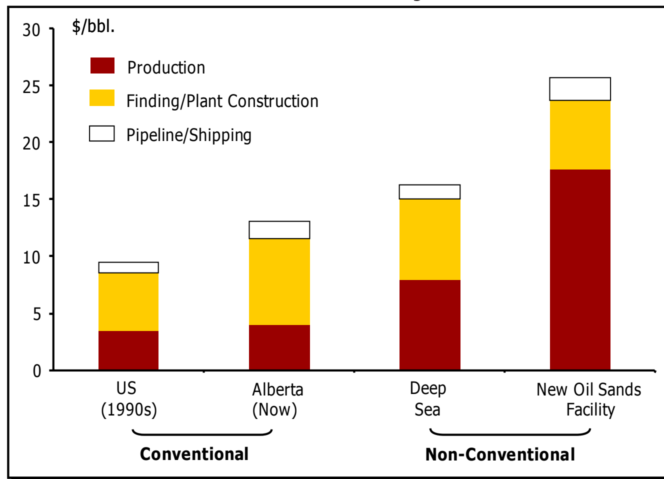
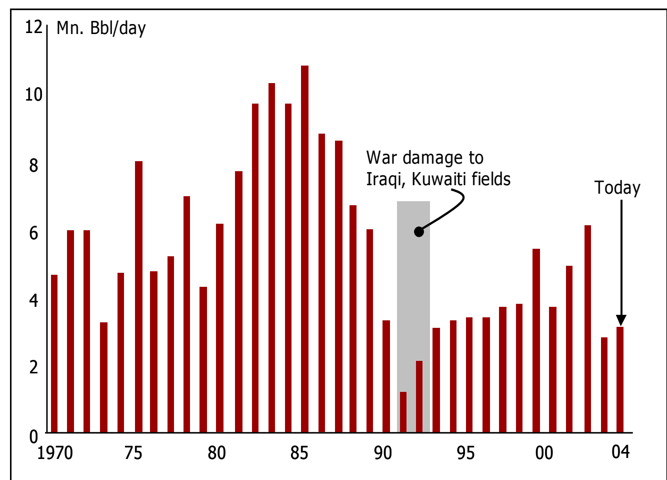


Chart 5
Tight Global Capacity Leaves Little Room for Error



cheaply (Chart 4). So too does the near doubling in natural gas prices in recent years. Not always recognized is the fact that producing tar sands oil is in itself hugely energy-intensive. Producing each barrel consumes over 500 cu ft of gas, principally to heat the asphalt-like raw material to make it flow freely.

Tar sands production currently uses nearly a quarter of all the gas consumed in Alberta. A rise in oil sands production to 2.2 million barrels per day over the next dozen years from the present 900,000—in line with most estimates—would significantly divert gas from exports to the oil sands, heightening pressure to find new sources. Given that gas finding costs have been rising faster than the 20-30% yearly pace for oil, the cost of developing new gas fields needed for even a modest rise in tar sands output will be huge.

The message is clear. As the world comes to rely more heavily on non-conventional oil, today's seemingly inflated wellhead price will come to be seen as the norm.

Has Conventional "Cheap Oil" Production Already Peaked?

Pointing to a world of costlier oil, the American geologist M. King Hubbert correctly predicted in 1956 that conventional oil production in the lower 48 states would peak in the early 1970s. Others, drawing on his insight into reservoir dynamics, have predicted a 65 million barrel per day global conventional production peak.

International Energy Agency (IEA) data show global oil production already through that mark at over 80 million barrels. But the IEA numbers include 8 million barrels a day of non-conventional production like tar sands and deep water oil and another 8-9 million barrels of gas liquids, things like ethane, that cars can't burn. Strip out unconventional sources of supply, and crude production is hovering around 65 million barrels, where it has been for the last four years (Chart 1). The world may have already seen the peak in conventional crude production.

Saudi Reserves: Are they Inexhaustible?

Not only has conventional production not grown over the last four years, but there is virtually no spare capacity left among OPEC producers. Excluding the brief period when Kuwaiti and Iraqi oil wells were ablaze during the Gulf War, the industry has not operated with only 3 million barrels a day spare capacity in nearly thirty years (Chart 5). You can call it just in time inventories or you can call it for what it really is—Saudi Arabia is running out of reserves. In fact, some commentators like Matt Simmons of Simmons Associates believe the giant Ghawar field, supposedly home to one-eighth of the world's "proven" reserves, may in fact be 80-90% depleted. Moreover, Mr. Simmons notes that depletion from Ghawar, whose production has already slowed despite massive injections of salt water to maintain well pressure, is far exceeding the discovery of replacement oil elsewhere in the kingdom.

The tightness in today's crude market is unlikely to change unless there are major supply discoveries. Production in most of the world's major oil fields has already peaked and is now declining. For example, the US, which is still the third largest crude producer in the world, pumps out 25% less oil than it did thirty years ago. Royal Dutch Shell's recent 20% cut in its global proven reserves reinforces other signs OPEC's remaining producable oil deposits may be smaller than earlier believed.

Oil Prices Should Maintain $40/Bbl

The recent 20% rally in the oil and gas index still leaves lots of upside for energy stocks, viewed from that perspective. Stocks are fairly valued given analysts' expectations that oil and gas prices will retreat from their recent high ground.

But what happens if prices instead remain high or rise further? If conventional crude production cannot rise beyond 65 million barrels, where it has been stuck for the last four years, that's precisely what will have to happen, in the face of fast-growing demand. Not because there are not abundant sources of non-conventional oil, but because greater reliance on such sources invariably means switching from low cost to high cost supply. That's a bullish scenario for natural gas, prized increasingly for its cleanliness, as well. Our forecast for sustained $40 oil implies a near $7/Mn Btu Henry Hub price given natural gas' tendency to trade closer and closer to oil on an energy equivalent basis.

Higher Cash Flows Support Energy Valuations

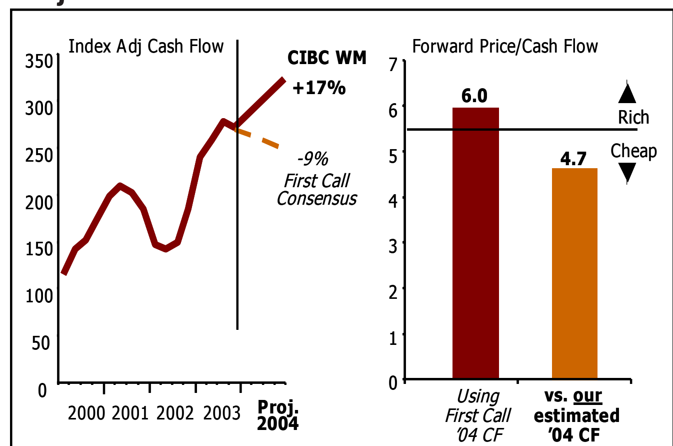
Industry cash flow given these estimates is unlikely to fall in the coming four quarters as analysts expect but instead rise nearly 20% on the year. And instead of oil and gas stocks trading at a generous six times forward cash flow they are actually trading at a heavily discounted 4-5 times future cash flow. When the market sees future cash flows, valuations for the oil and gas sector index should be near the 1900 mark, 300 points higher than today (Chart 6).

Investors' greatest fear should not be that oil and gas cash flows will fall, but rather, that they will be squandered on drilling a lot of dry holes. Alberta's conventional oil production peaked 30 years ago and even natural gas production has seen its peak. Costly tar sands and heavy oil aside, all the big deposits of cheap oil and gas in this mature basin have long been exploited.

What investors really want Canadian oil and gas companies to do is not ramp up exploration budgets, but plough their swelling cash flows from rising energy prices into dividends. It's the demand for higher payout ratios that have seen an ever increasing share of Canada's oil and gas patch become income trusts. When you are operating on the slippery slope of the Hubbert curve, restrictions on capital spending suddenly become a good thing, not a bad thing.

Chart 6

Projected Cash Flow and Index Valuation



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