OBSERVATION

TD Economics

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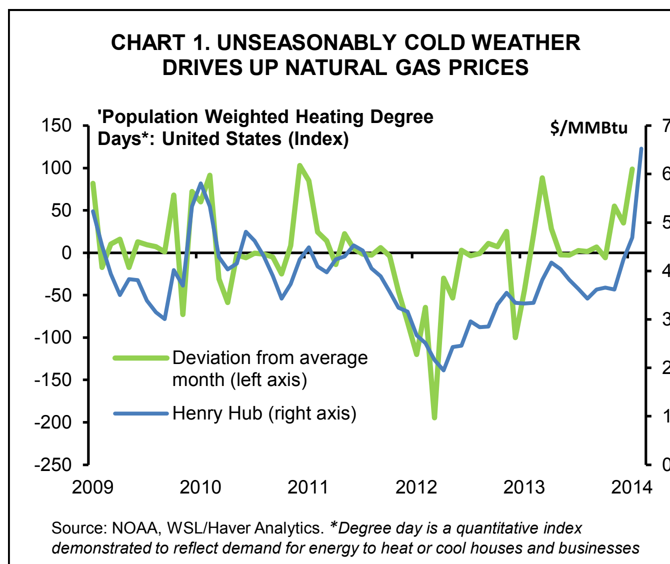
FINALLY SOME GOOD NEWS FOR CANADIAN NATURAL GAS PRODUCERS?

Highlights

- Canadian natural gas producers have endured a tough few years recently. The sizeable increase in U.S. natural gas production brought about by the shale gas revolution has lowered prices, and led to declining natural gas production in Canada.
- Now, a good old fashioned winter across much of North America has seen demand for natural gas surge, leaving inventories in the U.S. more than 30% below their five-year average at this time of the year. This has driven a spike in prices and increased imports of natural gas from Canada into the U.S. to their highest levels in three years.
- While the price spike is likely to prove short lived, forward-looking shipping commitments for Canadian natural gas suggest 2014 demand will be the strongest in five years. Overlaid with higher futures prices over the next year, and 2014 looks to be a much for better year for Canadian producers.

Natural gas prices have been making headlines recently; the near-term futures contract for the Henry Hub price has shot up nearly 70% in the past three months, outpacing any other commodity. Do these higher prices presage a new dawn for natural gas producers, who have endured very low prices in recent years brought on by the shale gas revolution? While the post-shale fundamentals of the natural gas market in North America remain in place, the demand spike from a very cold winter has dramatically improved the near-term situation for Canadian gas producers.

It wasn't so long ago that natural gas was a heavy hitter among Canadian commodities. At its peak in 2005, it accounted for 28% of the Bank of Canada's commodity price index basket, second only to oil. By 2013, its weight had fallen to 8% of the basket. The shale gas revolution lead to a 30% increase in U.S. production between 2006 and 2012, lowering prices, and reducing the need for imported natural gas from Canada. As a result of this and lower natural gas prices driving lower activity, Canada's natural gas production has fallen 18% over the same time period.



Source: NOAA, WSL/Haver Analytics. *Degree day is a quantitative index demonstrated to reflect demand for energy to heat or cool houses and businesses*

Now, a good old fashioned winter throughout much of North America has seen natural gas demand for space heating spike. This has drawn down U.S. inventories of natural gas to levels more than 30% below the five-year average, according data from the U.S. Energy Information Administration (EIA). With winter seemingly endless this year, the EIA also projects that inventories will end the heating season at their lowest levels since 2008. This has pushed the price of natural gas, as measured by the benchmark Henry Hub, to the highest level in four years (see Chart 1). The data also show that imports from Canada have been increasing

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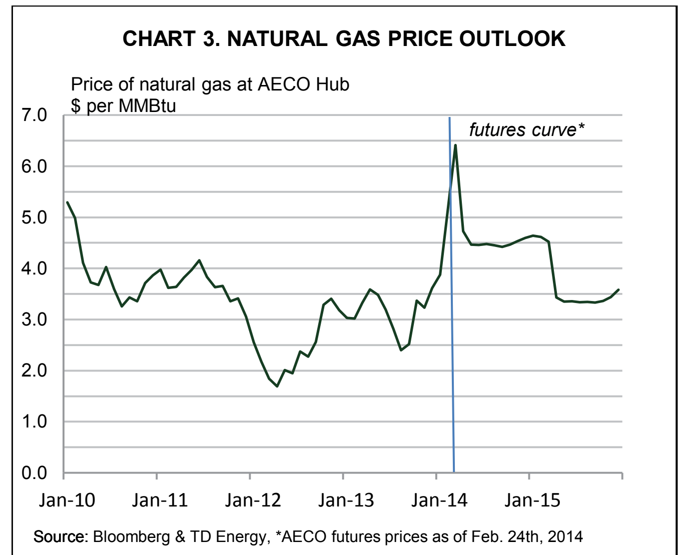
on a year-on-year basis for the first time in quite a while to meet this heightened demand.

Overall in 2013, U.S. natural gas production grew by approximately 2%, a slower pace than in recent years. The modest production growth in 2013 was clearly not enough to meet the larger demand caused by a more severe winter this year. Canadian producers have taken on the role of swing supplier to the U.S. market, meeting the seasonal surge in demand.

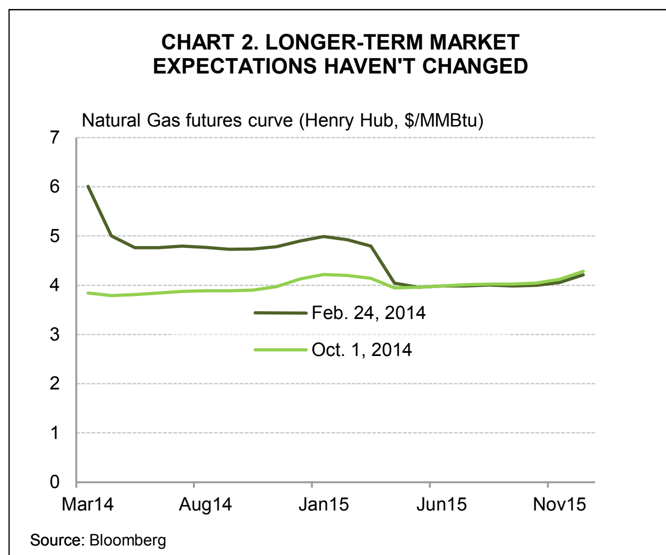
With some of the recent demand surge, and resulting price spike likely to be undone as the weather warms, it may be too early to pop open the champagne for Canadian gas producers. But a celebratory beer may be in order as prospects for natural gas do look better than they have in a few years. The demand surge has been strong enough to shift up expectations for prices over the next year or so (see Chart 2). However, the longer-term fundamentals of natural gas in a post-shale world have not changed, and farther along the futures curve price expectations have not changed since the demand surge.

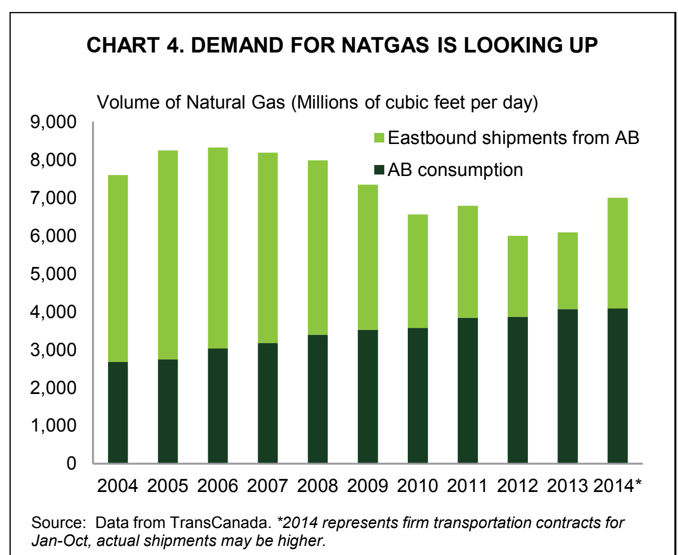
That should not diminish the near-term gains. Looking at the futures curve for prices at the AECO Hub in Alberta, markets are expecting prices to remain above levels that have prevailed in recent years through the end of this year (see Chart 3). The implied 2014 annual average price would be the highest since 2008. That translates into a price gain of over 40% over 2013's levels, which were already up around 28% over 2012's lows.

It should also be noted that these prices are in US dollar terms. The Canadian dollar has already depreciated by about 10% over the past year, which raises the prices Canadian producers receive in Canadian dollar terms. TD Economics expects the Loonie to continue to weaken in 2014. On average it is forecast to be more than seven per cent weaker than its 2013 level, lending a further hand to Canadian producers' top-line.



Not only are prices looking up, but the very low levels of gas in storage will need to be replenished in the coming months, and that is good news for natural gas production in Canada. The current outlook for Canada's natural gas production from the National energy Board (NEB) is for production to continue to fall until 2019. However, it looks like 2014 should be a better year. Data from TransCanada (an operator of major natural gas pipelines) shows that firm transportation contracts for gas shipped eastbound out of Alberta on its main pipeline, are up strongly in 2014, for the first time in years (see Chart 4), in part due to changes





in its contracting terms. This represents a minimum amount of natural gas that has been committed to ship, and could in fact be higher, depending on market conditions. The oil sands are also a major consumer of natural gas in Canada, and strong growth in the oil sands has kept natural gas demand within Alberta strong. All told, 2014 is shaping up to have the strongest demand since 2009.

The Bottom Line

Higher prices and stronger demand should produce a much better top-line for Canadian natural gas producers in 2014, and likely improved profitability. This is very good news for natural gas producers in Canada who have endured a particularly difficult few years recently, with rock-bottom prices, and loss of traditional markets in the United States. Longer-term challenges are likely to persist, as the U.S. continues on the road to becoming a net natural gas exporter, increasing the need for Canada to access other offshore markets to unlock the value of Canada's natural gas resources. The advent of shale gas production has increased the available supply of natural gas in North America. As prices rise, drilling becomes more profitable and production can be increased to meet demand, insuring natural gas prices are unlikely to return to their pre-shale revolution levels. Moreover, on the demand side, increased use of natural gas has occurred because natural gas prices have remained low and relatively stable since 2009. Natural gas has been branded the abundant low-cost fuel of the future, and consistently higher prices would put this in jeopardy and induce switching to other fuels, such as coal for electricity generation. However, prices are expected to remain well above the lows of the 2012-13 period, which is still good news for the sector.

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