OGIB INTERIM BULLETIN #193 - JANUARY 21, 2013
PORTFOLIO PURCHASE:
CALLON PETROLEUM(CPE - NYSE)
UPDATES: REFINERIES, NEW ZEALAND ENERGY, DEETHREE, GOLAR

GOLAR LNG (GLNG-NASD)

It was announced Sunday that Golar will be purchasing some western Canadian gas from the BC LNG Cooperative, presumably to transport to Asia. This fits in with Golar's stated aim of becoming a more vertically integrated LNG company.

This is breaking news and here is the story--
http://www.theglobeandmail.com/report-on-business/industry-news/energy-and-resources/bc-lng-inks-sales-contract/article7563307/

Now, this creates more questions than it answers at this early stage. We don't know exactly how much Golar is paying for the gas, though the Houston-based head of BC LNG, Mr. Tom Tatham, said producers won't get much more than they're getting now as Asia is buying based on North American prices ($3.50/mcf) vs. Asian pricing (over $15/mcf).

Also, Mr. Tatham himself is a part owner of one of the buyers besides Golar, putting him on both sides of the negotiations. I'm not sure what to make of this obvious conflict of interest other than that I probably don't know all the facts just yet.

Also, Mr. Tatham said Golar would probably be involved in helping finance the more than $400 million Kitimat/Douglas Channel project. Golar is already highly leveraged, so I'm not sure if the market will take that as a positive or not.

Conclusion: it’s too early to say how good this is for Golar. It doesn’t sound that great for western Canadian producers part of the BC LNG cooperative, but I think there just aren’t enough details out yet to make an informed decision. Stay tuned.

REFINERY TRADE—WHERE COULD I BE WRONG?

Whenever I make an investment, I have bullish ideas in mind. But once I’m long, I’m always trying to look for chinks in my argument; where could I be wrong.

As subscribers know, I’m very keen on the refinery sector in oil and gas right now. I see that the surge of shale production should overwhelm North American refineries in the next two quarters, dropping light oil prices by (I’m guessing blind here) $10-$15/bbl and setting up a LARGER Brent-WTI and Brent-LLS differential than there is now. Most of the Street is calling for a slightly smaller Brent-WTI spread this year.

One thought came to me today as to how/why I could be wrong. I don’t know how true this may be, but it’s a theory. US growth is improving, jobless claims are declining, and there COULD be a big increase in oil demand in the US this spring. If that happens, WTI prices could increase.

The Saudis, who control the market, don’t care about WTI; they care about Brent prices. They clearly want a $105-$110/bbl range on Brent. They have shown for the last few months that they’re willing (so far) to move their production up or down to guarantee that range.

Should US growth and oil demand improve such that the WTI-Brent spread NARROWS for the next four months before domestic light oil replaces Gulf Coast imports, then crack spreads could narrow dramatically, falling back into the five-year range and perhaps the five-year average. That would drop the share prices of regular corporations like Valero, HollyFrontier and Marathon by 30%, IMHO. But the MLPs like NTI, ALDW and now CVRR have shown themselves to be very skittish traders; they would probably drop more.

Worst case scenario is I'm wrong on when Gulf Coast imports end by two quarters (so Q4 2013) and US oil demand—and the WTI price—surges up. I'll be right, but wrong for the next 2-3 quarters.

Point #2--The famous activist investor Carl Icahn had a big stake in CVR Energy's MLP that went public this week, symbol CRVV. It was clearly mispriced at $25/share, and is below issue price already. Another theory of mine (and again, I'm looking for negatives here to disprove my bullish refinery thesis) is that it instantly becomes the bellwether of the sector.

If this stock doesn't perform, it has the potential to drag down the sector the sector for a month while the market separates the wheat from the chaff in this suddenly overheated, single-refinery MLP industry.

So that's what I see as my downside.

Regarding NTI specifically: I listened to the conference call Thursday, and a couple thoughts came to mind. Management said they could not speak freely about the departure of ex-CEO Mario Rodriguez; and it was said in such a way as to raise questions in my mind how amicable this split was.

Management was grilled hard by institutional investors asking why they should be buying ex-management's paper at what could be the top of the market for crack spreads (I don't think that's the case but that's the way questioning went). The stock dropped 50 cents during the last part of the call as management didn't have data the Street wanted to hear—updated numbers.

And then on top of that, all refiners took a hit Friday as crack spreads declined. The West Texas Sour (WTS) discount in particular dropped a lot in one week, going from $19 on Jan 11 to $8.50 on Jan 18. (This is not good news for ALDW.)

I guess it's possible that NTI could reprice this offering, giving the stock some short-term weakness, but this has nothing to do with the fundamentals of the mid-continent crack spread.

NEW ZEALAND ENERGY (NZEC-TSXv)

New Zealand's stock dropped from $1.33 close last Friday to $1 this Friday, hitting an intraday low of 86 cents—a new all time low—on big volume. The reason was (sadly) three-fold. One was a low flow rate of 151 bopd from its latest well, Waitapu-2. This compares with the first well of over 1000 bopd.

Second was the combined flow rates of the other three wells was only 272 bopd—a far cry from the 600 bopd that management was hoping for, and from which they expected a lower decline rate. Really what we're seeing here is a 85-90% decline rate on their Taranaki wells in the first year.

Third was analyst comments that they found it doubtful NZEC could secure enough gas to get their Waihapa processing station operational—whenever that deal closes. Management (and shareholders like me!) want that deal to close ASAP so they can drill some low hanging fruit there—re-entries on existing wells that will only cost $1 million or so. Even at 151 bopd those wells could recycle cash faster than they are now.

I've said for weeks now it's highly unlikely their 3000 bopd Q1 target could be met. Unless this new well targeting the deeper Moki formation comes in at 3000 bopd, that almost certainly won't happen. And even if it does, shareholders should hope the decline rates are much lower than Mt. Messenger/Urenui wells—or that flush production won't last.

Future positive news could include NZEC finding a partner for the East Coast—the industry is now relatively assured the reason Apache left TAG was NOT due to geological concerns. But it's always harder for a stock to move up the second time.

CALLON PETROLEUM (CPE-NYSE)

I bought 2000 shares of Callon at $5.10 to put my position back to 5000 shares. I like the chart. Their immediate liquidity issues are resolved. They're hitting good flow rates on their wells so far. There are only 40 million shares. My stop loss on this trade is $4.50.

DEETHREE EXPLORATION (DTX.TO, DTHRF)

This company remains the strongest domestic stock in the junior portfolio. Both Belly River and Alberta Bakken are only 15% drilled off; there is A LOT of running room left in both plays. This sets 2013 up as a cracker jack year for production growth. Obviously it will be hit same as everybody else, as light oil prices fall, but in terms of sheer production growth both in terms of absolute numbers and percentage, it is still one of – if not THE – best growth stories onshore in Canada.

DIVIDEND STOCKS

Many Canadian energy stocks that pay a dividend have a sustainability ratio over 100%. A sustainability ratio=(dividends + capex)/cash flow. Over 100% means they're paying out more than they're taking in. If I'm right about the North American oil price dropping in Q3, these companies could/should take a BIG hit as they are forced to reduce or eliminate their dividend.

A $15 drop in oil price=25-30% drop in netback, or profitability. Some are hedged in the 30-50% range, but not all. In particular, I'm avoiding any/all the new junior dividend stocks, but even the mid-tier ones; anybody with sustainability ratios over 100%. I will put together a list of these companies later this week. But right now, I'm avoiding all of them. (Some of them are likely very good shorts; those with REALLY high sustainability ratios, but I'm not the shorting kind.)

- Keith