Why Canada's Oil Sands Boom Could Bust

Description

Along with U.S. tight oil plays, Canada's oil sands are one of the most promising unconventional oil resources in North America. Alberta's oil sands industry supports tens of thousands of Canadian jobs and adds billions of dollars each year to this country's economic output.

So far, high levels of capital investment in the oil sands have been enough to sustain robust production growth. But soaring labour costs and other challenges are threatening to bring the oil sands boom to a standstill. Let's take a closer look at some of the biggest hurdles Canada's oil sands industry faces.

Initial optimism tempered by soaring operating costs
Optimism about Canada's oil sands has been shaped by rosy projections about production growth over the next several years. A study last year by the Canadian Association of Petroleum Producers forecast that oil sands output would grow from 1.8 million barrels a day to 5 million barrels a day by 2030. Yet that rate of production growth will require staggering amounts of new investment.

According to an estimate by Canada's Natural Resources Minister, Joe Oliver, Alberta's oil sands require roughly $650 billion in capital investments over the next decade, nearly five times the amount invested in them over the past half-century. But given the challenging economics of oil sands production, it's uncertain whether additional capital will be forthcoming.

According to a confidential government memorandum written by Mark Corey, a high-ranking official in Canada's Department of Natural Resources, and obtained by CBC News last year, investment in the oil sands could dry up if the industry fails to surmount the daunting challenges of spiraling labour and production costs.

Wood Mackenzie, a research and consulting firm, believes that break-even costs for new steam-driven projects in Alberta's oil sands range from $65 to $70 a barrel, while break-even costs for new mining projects are far higher, in the $90-$100 per-barrel range.

Depressed prices for oil sands crude
In addition to rising operating costs, oil sands projects have been besieged by extremely depressed prices for their product. Though prices recently surged due to the spring breakup, Western Canada

Select traded at a more than $30 discount to the U.S. crude oil benchmark, West Texas Intermediate, and at a more than $40 discount to the global benchmark, Brent, for much of the past year.

The combination of depressed prices for Canadian heavy crude and stubbornly high operating costs led to sharply lower profits for several operators last year. For instance, **Suncor Energy** (TSX:SU), the biggest Canadian oil sands producer by output, said fourth-quarter operating earnings were nearly a third less than in the year-ago quarter, due to lower average price realizations for oil sands crude.

As a result, operators are scaling back. For instance, **Canadian Natural Resources** (TSX:CNQ) said it will reduce spending on thermal-sands production, a process that uses steam to separate bitumen from sand underground.

Final thoughts
The oil sands industry faces some key challenges in the years ahead. If operating expenses climb higher, a decline in the price of oil could quickly render new projects uneconomical. If that were to happen, the massive amount of capital needed to sustain oil sands development could quickly dry up.

One way to cure oil sands producers' woes might be Keystone XL, the controversial pipeline proposed by **TransCanada** (TSX:TRP) that would bring hundreds of thousands of barrels of oil sands crude to U.S. refiners. If the pipeline is approved, it could help bring Canadian crude prices closer in line with other North American benchmarks, thereby improving the economics of new oil sands projects.

Though a recent U.S. State Department study concluded in favor of the pipeline, it continues to face heavy opposition from environmentalists and other groups who are doing their best to persuade lawmakers to reject the pipeline.

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1. Investing

TICKERS GLOBAL

1. TSX:CNQ (Canadian Natural Resources Limited)
2. TSX:SU (Suncor Energy Inc.)

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motley-fool-staff