The Future of Canada’s Oil Sands Industry: Are High Production Costs a Myth?

Description

There has been much speculation about the future of Canada’s oil sands industry. It was only a short time ago that it was touted as the hottest new source of oil, with the capability to not only boost Canada’s economic growth but potentially end the argument over peak oil. But then reality hit, with softening crude prices causing oil sands to fall out of favor with investors.

This was triggered by spiraling development costs, low operating margins, higher levels of environmental degradation, and cheaper sources of conventional and unconventional oil flooding the market. But with the recent surge in crude oil prices — to their highest level in 18 months — there has been significant renewed interest in the sector. Crude oil future contracts deliverable in October are already over $106 and can only boost the profitability of industry participants.

Institutional investors have contrary views on the future of oil sands
The spike in crude prices has created a flurry of activity in the industry, with institutional investors taking significant stakes in Canadian companies operating in the sector. International oil majors such as **ExxonMobil** have also taken a renewed interest in oil sands with M&A activity heating up.

Two of the world’s greatest investors hold contrary views on the future of the industry. Legendary investor Warren Buffett, through his company **Berkshire Hathaway**, has taken a substantial holding in Canada’s largest integrated energy major, **Suncor** (TSX:SU) (NYSE:SU). Suncor derives more than 60% of its oil production from oil sands operations in Canada and investors see this as a vote of confidence in the industry.

Yet Jeremy Grantham, co-founder of $106 billion Boston-based investment manager GMO, has taken a contrary view. In February 2013, he explained that he had been advising clients to avoid oil sands investments:

> “I believe anyone investing in tar sands is very likely to end up with stranded assets in the next decade or two. Solar is getting cheaper by the minute, whereas petroleum is getting more expensive. It is only a matter of time before their expenses cross.”

Essentially, Grantham believes that oil sands production will become rapidly obsolescent. When it does, those assets associated with its production will not only become worthless, but will be transformed into costly liabilities for companies operating in the industry.

But the key questions for investors are: Which of these gurus is right and what opportunities — if any — exist for investors? To answer these, we’ll need to take a deeper look at the oil sands industry and the issues it currently faces.

While it’s high, the cost of production is competitive
One of the key problems with extracting oil from oil sands, tar sands, and bitumen is that it is a resource-intensive and costly process. But the **Bank of Montreal** recently published a report that pegged supply costs at between $50 and $90 per barrel; a May 2013 Canadian Energy Research Institute study found that supply costs ranged between $30 and $99 per barrel of oil.

These costs compare favorably with other unconventional oil plays. The U.S. Bakken shale oil formation has a supply cost per barrel of between $70 and $80. The Eagleford Shale formation located in South Texas has a lower cost, around $50 per barrel. Accordingly, the lower end of the supply cost range for Canadian oil sands production appears quite cheap.

Industry participants *should* be left with healthy profit margins. But unless the oil produced is passed through an upgrader — making the supply cost jump to $99 per barrel — then a substantial discount per barrel against the price of West Texas Intermediate is applied.

Synthetic crude oil — the end result of bitumen or extra heavy oil being passed through an upgrader — currently trades at a discount of 90 cents per barrel against West Texas Intermediate. Western Canadian Select heavy oil — a blend of bitumen with diluents and conventional light crude — trades at a discount of $26 per barrel.

Growing competition for materials and labor in the oil sands industry is also applying upward pressure to supply costs, causing thinner margins. Already, these costs have risen by around 13% year over year, according to the Canadian Energy Research Institute. With further investments across the industry as participants seek to boost production — to take advantage of higher crude prices — these costs should continue to rise.

Another emerging issue is a claim by Alberta’s Minister of Finance that Alberta’s bitumen bubble is set to re-emerge. This would create a glut of heavy oil and bitumen as production grows, potentially creating a higher discount of bitumen and heavy oil against West Texas Intermediate and lower realized prices for producers.

All of these factors indicate that the larger, diverse integrated energy majors like Suncor, **Husky Energy** (TSX:HSE), and **Imperial Oil** (TSX:IMO) are best positioned to manage the challenges. As integrated energy companies with downstream operations, they can hedge against wider price spreads. All three also have upgraders, allowing them to produce synthetic crude and negate the significant discount applied to heavy oil and bitumen.

Finally, their diversified operations across conventional and unconventional oil gives them alternate income streams, with their size and dominant market position giving increased purchasing power and the ability to access considerable economies of scale in order to control costs.

The Foolish bottom line
The claim that high costs make the oil sands industry uncompetitive appears to be something of a fallacy. It's just not as severe as some analysts, politicians, and environmentalists have led investors to believe.

Diversified integrated energy companies are well-positioned to profit from oil sands production, particularly with the price of crude spiking to over $100 per barrel. But this is not the only issue the industry faces — in subsequent articles, I'll review some of the other issues in more depth.

Canada = fueling a global shift in energy
Looking for a specific stock idea from the energy sector? The Motley Fool Canada's senior investment analyst has hand-picked two of his favorite in Canada. Download your copy of this Special FREE Report, "Fuel Your Portfolio With This Energetic Commodity," by clicking here!

*The Motley Fool's purpose is to help the world invest, better. **Click here now** for your free subscription to **Take Stock**, The Motley Fool Canada's free investing newsletter. Packed with stock ideas and investing advice, it is essential reading for anyone looking to build and grow their wealth in the years ahead.*

Disclosure: Matt Smith does not own shares of any companies mentioned.

The Motley Fool owns shares of Berkshire Hathaway.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:SU (Suncor Energy Inc.)
2. TSX:IMO (Imperial Oil Limited)
3. TSX:SU (Suncor Energy Inc.)

Category

1. Investing

Date
2025/08/26
Date Created
2013/09/16
Author
mattdsmith