3 Reasons Why Oil Production Hasn't Collapsed

Description

As oil prices continue to decline, production continues to defy expectations. We take a look at three reasons why, using specific companies as examples.

A willingness to operate at a loss: Canadian Oil Sands

According to a recent investor presentation, it costs **Canadian Oil Sands Ltd.** (TSX:COS) as much as US$50 to produce a barrel of oil. So, with the WTI oil price in the low US$40s, why doesn't the company simply shut down until prices recover?

Well, unfortunately, it's not that simple. As put by Scott Arnold, director of investor relations at COS, "We believe the costs to shut in and later restart production are very significant. This is the case for most if not all oil sands projects."

Mr. Arnold has a point. There are numerous reasons why shutting in production is very expensive. To start, laying off thousands of workers would come with big severance costs, and rehiring them when oil prices recover would also be expensive. There also may be contracts with pipeline operators or refineries that require a minimum level of production.

It's hard to say how many of these factors affect COS specifically. But sales volumes in the most recent quarter were level with sales volumes one year earlier. And this isn't because COS is making any profits.

Boundless optimism: Suncor

The Fort Hills oil sands mega-project has never been particularly popular with investors, and it's easy to see why: with a capital cost estimated at $13.5 billion, the project requires oil prices of at least $90 per barrel to break even.

But project owner **Suncor Energy Inc.** (TSX:SU)(NYSE:SU) is pressing ahead anyways. Thecompany expects oil prices to rebound by the time Fort Hills is producing, and development costs havefallen sharply in the meantime.

Suncor has made this kind of bet before with its Millennium project, which turned out very well. Yet Fort Hills looks like a stretch, and symbolizes just how optimistic the energy industry is about future oil prices.

Sunk costs: CNRL

Throughout the plunge in oil prices, investors have been asking one very important question: how much does it cost to produce a barrel of oil? But this is impossible to answer precisely, because it depends what kind of measurements you use.

Take **Canadian Natural Resources Ltd.** (TSX:CNQ)(NYSE:CNQ) as an example. The company just reported cash costs of $29 per barrel at its massive Horizon Oil Sands Mining and Upgrading operations. Costs were even lower at other operations.

Of course, this doesn't mean CNRL is swimming in money. These numbers don't account for the cost of developing these assets in the first place. When factoring in these development costs, assets like Horizon become money-losers.

Yet CNRL has already poured $7 billion into the latest Horizon expansion, and can't get that money back. So, it is spending another $6 billion on Horizon over the next three years instead.

If you're expecting oil prices to recover significantly by the end of the decade, just remember there are lots of projects like Horizon, and they will hold down prices for a long time.

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