



Is Every Oil Sands Project Doomed?

Description

To many, oil sands projects appeared to be doomed before any production even started. The biggest project of all, Syncrude Canada, which has big investors such as **Canadian Oil Sands Ltd.** (TSX:COS), **Suncor Energy Inc.** (TSX:SU)(NYSE:SU), and **Imperial Oil Limited** (TSX:IMO)(NYSE:IMO), has been mired by delays, cost overruns, and political backlash. The biggest long-term issue of all, however, may be simple economics.

You can't outrun high costs

A popular metric to determine how attractive an oil project will be is the energy return on investment, or EROI. For every unit of energy you expend, the metric estimates how many units you can expect to produce in return. Most conventional oil plays have an EROI of around 20:1. Not bad.

Oil sands projects are a whole different ballgame. Research done when oil prices were around \$100 a barrel showed that the EROI for various projects was between 3:1 and 5:1. With high selling prices, the industry could afford the large amount of energy needed to extract the oil and turn it into a usable fuel. With oil down to \$30 a barrel, however, many oil sands projects are nearing breakeven.

While conventional oil companies have been able to shift production towards higher-quality, lower-cost wells, this may not be an option for oil sands operators. "Those EROI numbers are going to go down as we move away from the highest quality to the lesser quality parts of the resource," said David Hughes, a fellow at the Post Carbon Institute.

The problem isn't just high costs either. Due to its low quality, most oil sands bitumen sells at a discount to market prices. The most followed metric for oil sands selling prices is Western Canada Select, a blend of heavy oil sands crude and conventional oil. As of this week, it's trading at a whopping \$20 discount from West Texas Intermediate crude.

Oil sands crude can be converted to synthetic crude, a light oil that trades in parity with conventional oil, but only after undergoing an expensive upgrading process. So not only do oil sands need to deal with onerous costs, but the market price for its output is significantly discounted from its conventional competitors.

A race to the bottom

Even if oil prices recover quickly, oil sands projects may be doomed to fail anyhow. In the past 20 years the price of both wind and solar power has dropped by over 95%. Meanwhile, production of wind turbines and solar systems has exploded.

"I don't think that if you put billions of dollars into a new tar sands project that you will see a decent return on it," said Jeremy Grantham, co-founder of \$120 billion asset manager GMO LLC. "It will be underpriced by solar, wind and other alternatives which are moving at considerable speed."

While there may be some opportunities to play short-term mispricings of oil sands stocks, the long-term outlook is extremely gloomy.

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2. Investing

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