Another Oil Sands Project Runs Over Budget

Description

Producers in Canada's oil sands have encountered a range of issues over the years that have hampered the region's ability to grow. One of the biggest issues has been cost overruns, which have crimped returns and forced producers to defer investments on other projects until they can figure out ways to drive down costs. Even the industry's devastating downturn over the past few years hasn't seemed to fix the problem. That's clear after **Suncor Energy Inc.** (TSX:SU)(NYSE:SU) ratcheted up the cost estimate for its Fort Hills project.

Bumping up the budget

Suncor initially expected that Fort Hills, which it's building with French oil giant **Total** and Canadian miner **Teck Resources Ltd.** (TSX:TECK.B)(NYSE:TECK), would cost $15.1 billion. Suncor also anticipated that the project would deliver first oil later this year and produce 180,000 barrels per day once it reached full capacity. However, Suncor recently said that the project would now cost between $16.5 billion and $17 billion.

An issue driving the increase was last year's forest fires in the region, which delayed construction. However, the company also changed the complexity and scale of the project, which will add to the cost. One of the biggest changes is an increase in its production capacity to 194,000 barrels per day. Because of that expansion, the company's cost per flowing barrel will remain around its original estimate of $84,000. Further, the project remains on track to deliver first oil later this year.

That's good news and bad news for Suncor and its partners. In Teck Resources's case, it had to record an after-tax impairment charge of $164 million relating to the cost increase. Further, it will need to raise its capex budget this year to fund the additional capital to bring this project to completion. That said, Teck will benefit from the project's larger production capacity, especially if oil prices rebound sharply.

We've seen this all before

Suncor had initially hoped that the downturn in the oil market would keep a lid on construction costs, enabling it to avoid the cost overruns that have plagued its peers in recent years. The poster child for the industry's problems was the Kearl oil sands mine by **Imperial Oil Limited** (TSX:IMO)(NYSE:IMO).

When Imperial first proposed the project in 2009, it expected the facility would cost $7.9 billion. However, it ratcheted up that price tag to $10.9 billion two years later due to changes in the scope and design. It then tacked on another $2 billion to the budget in 2013 after facing issues transporting the Korean-made modules to its mine site as well as the extra costs associated with setting it up during harsh winter conditions.

Making matters worse, it took the company more than a year to work out the kinks in the project after completion; output initially ran well below nameplate capacity due to a variety of issues, such as installation-related defects on some of the valves.

Costs had gotten out of control industry-wide before oil prices collapsed. According to a study by E&Y, 58% of large energy projects in North America ran ahead of budget by an average of 51%. Because of this, several producers decided it was better to defer new projects until the industry could get cost under control rather than risk wasting capital on a high-cost project; the oil sands were a prime target of budget cuts.

For example, Fort Hills partners Total and Suncor stopped working on their $11 billion Joslyn project well before oil prices started to collapse in 2014. Total laid off 150 employees that had been working on the project, which it said had unappealing economics, even though oil was in the triple digits at that time.

Meanwhile, Norway's **Statoil** stopped working on its multi-billion-dollar Corner project, and it recently decided to unload its oil sands assets in a deal that resulted in it recording a half-billion-dollar write-down of its investment in the region because it did not see a way forward. **Royal Dutch Shell** halted work on its Pierre River project due to rising costs and poor economics.

Given where oil prices are these days and the fact that costs haven't come down, it doesn't appear that any of these projects will get a green light anytime soon.

Investor takeaway

The oil sands were once a hotbed of activity after producers swooped in to get a piece of the pie. The ensuing spending boom resulted in costs escalating out of control, forcing many to reevaluate and abandon growth plans.

Unfortunately, like Suncor's recent announcement shows, the oil market downturn hasn't drained costs out of the region, which is why it could still be quite some time before producers start working on any of their long-delayed mega-projects.

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mdilallo