Is Canada Experiencing a Heavy Oil Crisis?

Description

After firming in recent weeks, triggering claims from some pundits that US$100-a-barrel crude is on the way, oil has whipsawed wildly because of a mix of positive and negative news. The crucial piece of bad news has been musings from Saudi Arabia and Russia that they are considering expanding oil production, along with reports that the U.S. has asked Riyadh to boost their oil output.

Since then, the price of crude has plummeted, as global energy markets digested the prospect of OPEC opening the spigots and expanding production. The discount applied to Canadian heavy crude Western Canadian Select (WCS) has grown once again, as the North American benchmark West Texas Intermediate (WTI) has fallen in value to be at just over US$17 a barrel. This underscores one of the fundamental risks facing Canadian oil producers.

You see, roughly half of all oil produced in Canada is heavy crude, meaning that WCS is the benchmark price received by many Canadian oil producers. If the discount for WCS rises again, it would have a sharp impact on Canadian heavy oil producers, particularly in an environment where the outlook for crude remains uncertain.

Now what?

An important driver of the price differential between WCS and WTI is the lack of pipeline capacity, which is limiting the volumes that can be transported to crucial U.S. refining markets. This — along with rising heavy oil production, growing inventories, and pipeline outages — has been responsible for the significant increases in the price differential for WCS compared to WTI since the start of 2018.

Enbridge Inc.'s May 2018 plan to establish rules aimed at preventing oil producers from claiming more capacity than required on a key pipeline from Alberta's oil sands to U.S. refineries caused the discount to rise sharply by the start of June to over US$26 per barrel. The decision to rescind those rules was directly responsible for WCS rising by almost US$9 a barrel in the space of a week, causing the discount to WTI to narrow to US$17 per barrel. That incident alone indicates just how sensitive the pricing of WCS is to pipeline capacity issues.

The requirement to transport heavy crude to U.S. refineries is crucial because Canadian refineries are already operating at capacity, while the majority of refineries configured to process heavy oil are predominantly located along the U.S. Gulf Coast.

If WCS is trading at a significant discount to WTI, it will have a material impact on the cash flow and profitability of smaller heavy oil producers like **Athabasca Oil Corp.** (TSX:ATH) and **MEG Energy Corp.** (TSX:MEG). While not life threatening at this time, it crimps their ability to invest in developing new and existing assets while reducing profitability. That would be a poor outcome for Athabasca and MEG, because they are both in the midst of requiring significant capital to invest in developing major thermal oil sands projects to boost their production.

Substantial domestic oil inventories and a lack of crude-by-rail capacity will weigh on the price of WCS for the immediate future, but over the long term the discount to WTI is expected to diminish. Growing Canadian refining and pipeline capacity, as a range of new projects come online between now and 2020, will ease transportation constraints. giving producers greater access to crucial energy markets. Increasing utilization of crude by rail will also contribute to easing transportation bottlenecks, supporting a higher price for heavy oil.

So what?

As the differential between WCS and WTI eases, it will be a boon for smaller oil sands producers like Athabasca and MEG, which, unlike integrated majors such as **Suncor Energy Inc.**, lack their own refining capability. That makes them highly dependent on being able to get the heavy crude they produce to major refining markets. As the WCS differential eases, it should give their earnings and hence their stocks a healthy lift.

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