Is Canada’s Heavy Oil Crisis Worsening?

Description

After rebounding sharply in recent weeks the price differential between Canadian heavy crude, known as Western Canadian Select (WCS), and the North American benchmark West Texas Intermediate (WTI) has once again widened significantly. WCS is now trading at just under US$42 a barrel, which represents a staggering discount to WTI of over US$23 per barrel. That represents a stunning 32% increase in the price differential in less than a week and more than double where it was a year ago. Such a large decline in an operating environment where oil could weaken further is a foreboding signal for Canada’s energy patch.

You see, almost half of all oil produced is benchmarked to WCS, meaning that such a steep discount will have a significant impact on Canadian energy companies.

Now what?

The lack of transportation capacity in Canada’s pipeline network is the primary culprit for the significant discount applied to the country’s heavy crude. That network is responsible for connecting landlocked Alberta at the heart of the energy patch to crucial U.S. and Pacific coast markets, but it has been unable to keep up with demand for some time.

Surprisingly, WCS trades at a discount to many other heavy oil blends with similar characteristics, particularly those from Mexico, Venezuela, and Colombia. This can be attributed to those capacity constraints and the distance it must travel to reach key heavy oil refineries located on the U.S. Gulf Coast. These transportation limitations are being magnified by growing Canadian oil production, particularly in the oil sands, where a number of major projects have started commercial production.

Another key reason for the significant discount applied to WCS is that refining heavy oil consumes more energy than light blends, making it more-costly to produce petroleum products.

Nonetheless, there is growing demand for WCS among U.S. refining markets because of the sharp decline in Venezuelan oil production. Planned pipeline extensions and the development of new pipelines — including **Enbridge Inc.’s** Line 3 Replacement Program, the Trans Mountain expansion project, which was recently acquired by the Canadian government, and the completion of the controversial Keystone XL pipeline — will alleviate these constraints. Volumes of crude by rail are also rising, which will go some way to easing current capacity constraints.

These factors bode well for growing demand for WCS and greater transportation capacity, which will give its price a boost and cause the discount to ease.

It will, however, take some time for those pipeline projects to be completed. The recent gyrations of WCS's price, sparked by fears regarding the allocation of space on Enbridge's Mainline system, underscores just how easily changes in pipeline capacity can affect its price.

So what?

In an environment where the price of WTI is declining and the differential to WCS is expanding, it can have a sharp impact on Canadian oil sands companies, especially those like **MEG Energy Corp.** (TSX:MEG), which is developing the Christina Lake SGAD project. **Athabasca Oil Corp.** (TSX:ATH) is also quite reliant upon heavy crude, which makes up the majority of its production, leaving it vulnerable to a growing discount for WCS. The impact of weaker WCS is heightened by the high breakeven costs associated with oil sands operations.

Those oil sands producers, unlike an integrated energy major such as **Suncor Energy Inc.** (TSX:SU)(NYSE:SU), are unable to offset that weakness through refining operations. Suncor also has a highly diversified production mix, which includes bitumen, conventional oil, and upgraded bitumen, which is sold as synthetic crude. That helps to minimize the impact of the deep discount applied to WCS.

Clearly, the sharp discount applied to WCS is worrying for Canada's oil sands companies, but it shouldn't deter investors from considering those energy companies operating oil sands assets. The discount should start to ease, while the decline of Venezuela's oil industry means that U.S. refineries fitted out to refine heavy oil will demand more WCS to fill the gap.

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Author
mattdsmith