# Is Canada’s Heavy Oil Crisis Easing?

## Description

Fears of a heavy oil crisis in Canada continue to grow despite oil’s latest rally that saw West Texas Intermediate (WTI) surge above US$70 per barrel and the differential between Canadian heavy oil and WTI narrow sharply in recent days. The discount applied to Western Canadian Select (WCS) is now at US$21 per barrel, which is around 13% lower than it was at the start of 2018. It is also 20% less than when WCS dipped sharply at the start of June because of **Enbridge Inc**. (TSX:ENB)(NYSE:ENB) introducing rules limiting the volumes that heavy oil producers could claim on its pipeline network. Those rules were later abandoned, causing the price for WCS to surge.



Nonetheless, the deep discount applied to WCS is sparking considerable trepidation in the oil patch because almost half of all oil produced in Canada is heavy crude. There are concerns that after easing recently, the differential between WCS and WTI will widen, once again impacting heavy oil producers such as **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE).

**Now what?**

There is every likelihood that this will occur given that the recent decrease in the discount applied to heavy crude appears to be only temporary.

This event is related to additional capacity temporarily opening up on Canadian liquid pipelines because the Syncrude facility went offline after a transformer exploded. This has taken up to 335,000 barrels daily offline potentially until the end of July. When the Syncrude operation recommences operations, the additional capacity will be eliminated, more than likely causing the discount to rise once again.

The core issue, which is the lack of capacity to transport the volumes of heavy oil being produced to the primary market refining market on the U.S. Gulf Coast, remains unresolved. The pressures being applied to existing transportation bottlenecks can only get worse.

According to the Canadian Association of Petroleum Producers (CAPP), an additional 1.6 million barrels daily will be added to domestic oil production by 2035, making it imperative that these transportation bottlenecks are removed.

While there are moves afoot to resolve this issue, there is no guarantee that they will be successful and cause the discount to ease. Tighter regulations, a lack of investment and growing community discord regarding the oil industry as well as its impact on local regions are all weighing heavily on whether new projects will be approved.

The $7.4 billion expansion of the Trans Mountain pipeline, which was acquired by the Canadian government from **Kinder Morgan Inc.** remains mired in controversy, as does **TransCanada Corp.'s** Keystone XL pipeline. These factors will delay the construction of new pipelines and could also see restrictions placed upon them, thereby limiting the volume of crude they can transport. They also don't bode well for plans to expand existing pipelines such as Enbridge's Line 3 replacement, which faced considerable local opposition before it was approved.

Crude by rail will also struggle to fill the gap. Not only is it more costly than pipelines, but riskier as well, and demand for bulk freight from other industries including grain farmers as well as miners is increasing, placing greater pressures on existing rail networks and rolling stock.



It may therefore take a considerable amount of time before capacity constraints are successfully resolved. This means that for at least the foreseeable future, the differential between WCS and WTI won't narrowly as significantly as many pundits believe. That will weigh apply considerable pressure on Canadian heavy oil producers.

**So what?**

The impact of those constraints can be seen in Cenovus' first quarter 2018 results. Despite a massive year over year jump in oil production, it reported a net loss of $914 million from continuing operations. This was because of the deep discount applied to WCS, which weighed heavily on margins. What many pundits fail to appreciate is that higher oil magnifies the impact of the wide differential between WTI and WCS on Cenovus' earnings. This is because it causes the cost of all-important condensate – a critical diluent used to make heavy crude flow – to increase. In an environment where WCS remains heavily discounted and WTI is rising in value pure-play, oil sands companies appear less attractive compared to those with diversified light, medium, and heavily oil production.

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