Get Ready for Canada's Heavy-Oil Crisis to Worsen

Description

While oil continues its relentless climb higher, the price of Canadian heavy oil and West Texas Intermediate (WTI) continues to diverge. Western Canadian Select (WCS) is trading a discount of US$29 a barrel to WTI, which is approaching levels not seen since the start of 2018, when WCS was selling for 46% less than WTI.

Surprisingly, this is occurring at a time when Canadian oil production has declined because of an outage at the Syncrude facility. The sharp discount applied to Canadian heavy oil is impacting the financial performance of those oil producers focused on the oil sands and negating much of the benefit being generated by higher oil.

Now what?

The divergence between the prices of WCS and WTI can be attributed to transportation constraints, especially on Canada's crude pipeline network, which is preventing the heavy oil being produced from reaching U.S. refining markets. This is being exacerbated by steep uptick in production among Canadian upstream oil companies, which are frantically ramping up activity to cash in on higher oil.

Growing oil output coupled with insufficient transportation capacity is causing domestic oil inventories to rise at frenetic pace, applying even greater pressure to WCS. There is no sign that the impact of any of these factors will wane any time soon.

You see, according to **Suncor Energy Inc.**, the Syncrude facility is set to become fully operational again by mid-September 2018 after going offline in June because of a transformer outage. That will add anywhere up to an additional 200,000 barrels daily to domestic oil production, further exacerbating existing pipeline capacity issues, which will cause the price differential to widen further.

Another issue is that Canadian oil inventories are expanding at a solid clip and will continue to do so for as long as WTI remains at over US$55 a barrel. This is the magic price for many Canadian oil producers, because it is the point at which they become cash flow positive. In an industry that has been starved of capital as well as cash flow for the last three years, companies are going to rapidly ramp up activity to maximize production in an operating environment where WTI is hovering at close to

US$70 a barrel. This is especially the case for those oil companies with massive piles of debt and looming repayments.

You only need to look at **Cenovus Energy's** (TSX:CVE)(NYSE:CVE) second-quarter 2018 results to see this. Canada's third-largest oil sands producer reported a 61% year-over-year increase in production after it loaded up on debt to complete the 2017 $17.7 billion acquisition of **ConocoPhillips's** Canadian upstream assets.

Companies such as **MEG Energy** and **Pengrowth Energy** are boosting investment in projects they have under development aimed at expanding production because of firmer oil.

Suncor's partner in the Syncrude facility, **Imperial Oil** (TSX:IMO)(NYSE:IMO), has also bolstered spending on development and exploration in order to expand production. For the second quarter, Imperial Oil reported that it had almost doubled capital and exploration spending compared to a year earlier to $284 million. It is likely that the integrated energy major will increase spending further on those activities if oil rallies further.

Because of higher oil, Imperial Oil reported a second-quarter profit of $196 million compared to a $77 million loss a year earlier. Such a significant increase in net income will provide Imperial Oil with the additional funding required to fund increased spending on drilling and other development activities to bolster its oil output. When this is coupled with Imperial Oil completing its maintenance cycle during the first half of 2018, the company is well positioned to significantly grow production at a solid clip during the second half of the year.

So what?

Until the pipeline capacity constraints are addressed by essentially expanding Canada's pipeline network, WCS will keep trading at a sharp discount to WTI. This could deepen significantly once operations at Syncrude fully come back online. If that occurs, it will have a marked impact on the financial performance of those oil sands companies like Cenovus that are highly reliant on heavy oil to generate a large portion of their earnings.

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