Is Canada's Heavy Oil Crisis Far From Over?

Description

Regardless of the considerable optimism surrounding crude after West Texas Intermediate (WTI) broke through the psychologically important US$70 a barrel mark and Brent hit a new multi-year high, there is still considerable pessimism in Canada's oil patch.

This is because Canadian heavy crude Western Canadian Select (WCS), which accounts for roughly half of all oil production, is still trading at a deep-discount to WTI despite claims by some analysts earlier this year that it would ease.

The spread between the two benchmark prices has widened sharply in recent weeks placing renewed pressure on bitumen and other heavy oil producers. It has also triggered fears that the deep-discount applied to WCS won't ease over the remainder of 2018 as predicted.

This is having a marked impact on companies, which are focused on producing bitumen and other forms of heavy oil such as **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE).

As a result, while some Canadian energy stocks have soared in recent months, Cenovus has lagged well behind remaining flat since the start of the year despite WTI gaining a healthy 26%.

Now what?

WCS is ranked by industry magazine *Oil Sands Magazine* as Canada's largest commercial oil stream. Because such a large proportion of Canadian crude is produced from the oil sands, this benchmark blend is the actual realized price for many oil producers operating in Canada.

Even drillers such as **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE), which produce substantial amounts of light oil, also have considerable exposure to heavy oil.

For the second quarter 2018, heavy crude, which is bench marked to WCS, made up just over third of Baytex's total oil production. Due to the widening spread between WCS and WTI, this had a noticeable impact on its financial performance.

This becomes evident when it is considered that Baytex's Canadian operations, which produce mainly heavy oil, reported an operating netback of $18.12 per barrel compared to $35.42 for the light oil produced at its Eagle Ford wells.

There are many reasons for the discount applied to WCS, the key one being that heavier oil blends require significantly more energy to refine than light blends such as WTI. This makes it costlier to process WCS into usable petroleum products.

However, this isn't the end of the story when it comes to Canadian heavy crude. A major headwind for WCS is mounting transportation constraints. These are preventing heavy oil producers from getting their crude to key refining markets primarily located on the U.S. Gulf Coast.

Essentially, Canada's pipeline network lacks the capacity to meet demand, and this has created a massive transportation bottleneck, primarily at the heart of the oil sands in Alberta, which is responsible for creating the significant discount applied to WCS.

This is being exacerbated by a marked uptick in production as oil producers, notably those in the oil sands, open the spigots further to take full advantage of higher oil prices.

That has led to a massive build-up in oil inventories in Western Canada which, according to industry consultancy Genscape, reached a record high at the end of August 2018. This is applying further pressure to the price of WCS and is responsible for the discount to WTI deepening significantly in recent weeks.

There are no signs of these bottlenecks easing anytime soon. The additions of significant amounts of new pipeline takeaway capacity appear years away, and crude by rail has yet to step in and fill the gap.

That means as heavy oil producers bolster production and Canadian oil inventories grow WCS will remain under considerable pressure.

So what?

This is having a sharp impact on the performance of Cenovus, which after the 2017 acquisition of **ConocoPhillips'** oil sands assets became Canada's third largest oil producer. For the second quarter, oil sands made up 75% of the company's total production, yet only realized an average sales price of US$48.61 per barrel for its heavy oil compared to US$67.88 for WTI.

This weighed on Cenovus' profitability and saw it report a netback before commodity hedges were accounted for of $29.06 per barrel produced, which was significantly lower than any of Canada's light oil producers. **Whitecap Resources Inc.** reported a second quarter netback of $37.72 per barrel before risk management contracts were accounted for, while **Bonterra Energy Corp's** field netback for the period was $34.69 a barrel.

For these reasons, oil sands producers like Cenovus are less appealing investments than light oil producers.

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Date
2025/08/20
Date Created
2018/09/27
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