



Don't Expect Canada's Heavy Oil Crisis to Ease Any Time Soon

Description

I have been bullish on energy stocks since late 2017 when the North American benchmark West Texas Intermediate (WTI) was trading at over the US\$50-a-barrel mark. Crude's sustained rally since the start of 2018, which many industry insiders and market pundits failed to anticipate, sees WTI trading at close to US\$70 a barrel after hitting a multi-year high of over US\$76 earlier this month.

While WTI has gained over 18% for the year to date, many Canadian oil producers have failed to keep pace with those operating in the oil sands among the poorest performers.

Two bitumen and heavy oil producers with significant exposure to the oil sands are **Cenovus Energy** ([TSX:CVE](#))([NYSE:CVE](#)) and **Canadian Natural Resources** ([TSX:CNQ](#))([NYSE:CNQ](#)), which have been marked down by 10% and 18%, respectively. That is because of the market's considerable concern over the impact of the [substantial discount](#) applied to Canadian heavy crude known as Western Canadian Select (WCS) to WTI.

Now what?

At the start of 2018, WCS was trading at US\$42.53 per barrel, which represented a US\$21.17 discount to WTI. Since then it has deepened, more than doubling to US\$44.25 per barrel, despite WTI rallying to be trading at over US\$68 a barrel. There are a range of reasons for this, notably that heavy oil is more [difficult and costlier](#) to refine than lighter blends.

Nonetheless, because most U.S. refineries are configured to process heavy oil and prefer them over the light crude produced by the U.S. shale oil industry, demand for heavy crude should remain high. This — in conjunction with a notable downturn in the volume of U.S. — heavy oil imports from Venezuela, which have plunged by around a third since 2016, should drive greater demand and hence higher prices for WCS, but this is not occurring.

You see, the key issue is that pipeline and other transportation constraints are creating a bottleneck, which is preventing Canadian heavy oil producers from getting their crude to crucial U.S. refining markets. This — in conjunction with rapidly expanding production in the oil sands — is causing heavy oil inventories in Alberta to grow at a rapid clip, putting additional pressure on WCS prices.

Industry sources put Western Canadian oil stocks at record levels and they will keep expanding because Canadian oil sands operators are swiftly ramping up activity at existing productive assets to boost production. This becomes clear when considering the second-quarter 2018 operating results for Canada's largest and third-biggest oil sands producers Canadian Natural Resources and Cenovus.

For that period, Canadian Natural Resources oil sands output shot up by a whopping 58% year over year to 407,704 barrels daily, while Cenovus's surged by 49% to 389,378 barrels daily.

There is every sign that for as long as WTI remains trading at over US\$60 a barrel, this trend will gain momentum. This is because since 2014, oil sands producers have slashed operating costs by roughly a third and many established oil sands operations have low breakeven costs that are estimated to be less than US\$50 a barrel. That means with WTI at US\$60 per barrel, they are cash flow positive and even profitable, thereby significantly boosting the incentive for operators to expand their oil output as quickly as possible.

It is highly unlikely that the transportation bottleneck that exists in Western Canada will ease any time soon. There is a dearth of large-scale pipeline projects under development, while the regulatory hurdles to developing new sizable pipelines are immense, plus there is a considerable amount of lead time required to develop them.

That sees many industry insiders concerned that existing oil pipeline bottlenecks will remain for up to a decade. This means that the considerable discount applied to WCS will remain in play for the foreseeable future, impacting the financial performance of those Canadian companies focused on producing bitumen and other forms of heavy crude.

So what?

That explains why Canadian Natural Resources's market value has been pummelled since the start of 2018, despite WTI's sustained rally. While WTI averaged US\$67.90 a barrel during the second quarter, Canadian Natural Resources only realized an average sale price of US\$46 for every barrel of crude sold because of the deep discount applied to WCS. This negatively affected Canadian Natural Resources's financial performance, causing net earnings to be 8% lower than a year earlier, despite higher oil. This makes Canadian heavy oil producers unappealing ways to play higher oil.

CATEGORY

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2. NYSE:CVE (Cenovus Energy Inc.)

3. TSX:CNQ (Canadian Natural Resources Limited)
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