Canada’s Heavy Oil Crisis Worsens

Description

The spreads between Canadian oil blends and the North American benchmark West Texas Intermediate (WTI) have widened considerably since the end of May 2018. Canadian heavy oil, known as Western Canadian Select (WCS), at the end of October 2018 was trading at a 61% discount to WTI with it trading at a spot price of just under US$18 a barrel compared to US$64 for WTI.

This is having a noticeable impact on the energy patch, because heavy oil makes up roughly half of all Canadian crude produced.

That deep discount is weighing on the price of many heavy oil producers such as **Athabasca Oil**(TSX:ATH), which has lost 3% over the last year, despite WTI gaining over 17%. While the discount has whipsawed wildly since the start of 2018, having recovered briefly to be less than US$20 a barrel, there are indications that WCS will trade at a marked discount to WTI for some time to come.

Now what?

Heavy oil is more costly to refine than lighter sweeter types of crude, and this in part is responsible for the discount applied to WCS, but it isn’t the key driver. The primary problem is growing oil inventories in Western Canada, notably Alberta, which are expanding at a rapid clip because of a lack of transportation capacity.

A notable trigger of the recent widening of the spread was the restart of the Syncrude operation, which had been offline for roughly three months because of an unexpected power outage. This added pressure to already surging inventories and growing supply, which saw oil stocks in Western Canada recently reach record levels. That — along with upstream oil producers ramping up activity to expand production so as to take advantage of firmer crude — has created a localized oil glut in Western Canada.

Even crude-by-rail shipments are failing to clear the backlog, which is being exacerbated by a significant lack of pipeline capacity. Data from the National Energy Board (NEB) shows that crude-by-rail carloads reached 229,544 barrels daily for August 2018, which was an all-time high, but remained insufficient to clear inventories.

While many U.S. refineries are configured for and prefer to process heavy oil the maintenance, and turnaround season is underway because of lower demand for gasoline as well as asphalt. As a result, many refineries that are major consumers of WCS in the U.S. Midwest have gone offline because of planned maintenance.

This has sparked a noticeable drop in demand for WCS in Canada's core oil export market that even the sharp deterioration in the volume of Venezuelan heavy crude imports is failing to remedy. For as long the oil glut in Western Canada continues, the discount applied to WCS will be substantial.

So what?

That means the second-half 2018 outlook for Athabasca is not as positive as higher oil prices initially indicate because around 68% of its production is weighted to bitumen. For the second quarter 2018, Athabasca realized an average price for WCS of $62.89 per barrel, which is almost triple the current spot price of just over $23 a barrel.

Over the course of the second half of the year so far, WCS hasn't traded at above $60 per barrel since mid-July, although the impact of weaker WCS will be offset to an extent by Athabasca's commodity hedging contracts. Up until the end of September, it has 19,000 barrels daily hedged; after that it has 3,000 barrels hedged. The sustained weakness of WCS will impact many upstream heavy oil producers and could very well see a dip in financial results for the industry over the second half.

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