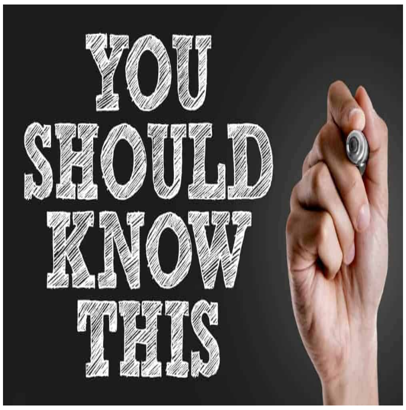

How Risky Is an Investment in Canada's Oil Sands?

Description

Despite claims from some pundits to the contrary, investing in Canada's oil sands is a hazardous activity. Not only is weaker oil weighing on many oil sands operators, but the ever wider spread between Canadian heavy oil known as Western Canadian Select (WCS) and the North American benchmark West Texas Intermediate (WTI) is magnifying the impact.

By the end of October 2018, that price differential had reached over US$43 per barrel, meaning that WCS is trading at a 61% discount to WTI.

It's also expensive to produce crude from the oil sands when compared to other forms of oil production, which is eating into the margins of oil sands producers. Growing environmental factors, including carbon pricing regimes and stricter regulatory requirements, will cause production costs to rise, making it even more costly to operate in the oil sands.

Those hazards indicate that the long-term outlook for Canada's oil sands is poor, and they could very well become stranded assets, which will be extremely costly to rehabilitate.

Now what?

The considerable pressure placed on WCS prices by pipeline bottlenecks and the ensuing massive localized oil glut that has emerged in Western Canada sees the third largest oil sands producer **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE) pushing for production cuts. The company believes that the only way to alleviate the heavy oil glut is for oil sands producers to curtail output.

This has become a crucial issue for Cenovus because it is highly reliant upon oil sands production, which is responsible for 83% of its petroleum output.

Essentially, the deep discount applied to WCS is causing Cenovus to lose money on every barrel of bitumen it produces. For the third quarter 2018, it reported a loss of $242 million continuing operations compared to a $275 million profit a year earlier. This was despite WTI for the quarter averaging US$66.75 a barrel, which was 35% greater than the same period in 2017.

What about **Suncor Energy Inc.** (TSX:SU)(NYSE:SU)?

The integrated energy major has invested significant amounts of capital in substantially ramping up its oil sands operations since the oil slump began in late 2014. Suncor reported solid earnings growth for the third quarter 2018 despite the deep discount applied to WCS.

During that period, net earnings expanded by a healthy 29% year over year to $1.8 billion, while funds from operations shot up by a notable 27% to $3.1 billion. This impressive improvement in Suncor's financial performance was driven by a combination of higher bitumen production because of Fort Hills coming online, firmer oil prices and record quarterly earnings from its refining business.

Suncor's refining and marketing division reported record third quarter earnings of $939 million, which was a 57% year over year increase. This formidable performance can be attributed to the considerably wide differential between WCS and WTI. Despite higher crude, with the average price for WTI over the quarter being 44% greater than a year earlier, Suncor's refining margin expanded by an impressive $10.20 to $34.45 per barrel of oil processed.

The heightened discount applied to WCS during the period significantly boosted Suncor's refining margin despite firmer oil, which typically causes margins to fall.

More important, Suncor's considerable refining capacity of over 450,000 barrels daily allowed it to generate a substantial profit from its oil sands production despite incurring loss on every barrel produced. That will continue to allow the energy giant to report solid earnings despite the continuing deep-discount applied to WCS, which is having a marked financial impact on other oil sands operators.

This gives Suncor a distinct financial advantage over other oil sands producers that lack substantial refining capacity. This is why Suncor objected to Cenovus' call for government mandated production cuts to alleviate the massive oil glut that has accumulated in Western Canada because of pipeline bottlenecks. Suncor argues that this issue should be left to market forces and that it shouldn't be penalized for having the foresight to make sizable investments in its refining capacity.

So what?

Canada's oil sands are shaping up to be a poor long-term investment. Only Suncor appears capable of appropriately managing the myriad issues impacting other producers and remaining profitable, particularly if the wide spread between WCS and WTI remains in play for a prolonged period.

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