Has the Latest OPEC Deal Reduced Risk for Canadian Oil Sands Companies?

Description

Oil prices remain soft, despite some pundits claiming that the international benchmark Brent could rebound to as high as US$80 a barrel before the end of 2018. Energy markets were waiting with bated breath to see what would emerge from OPEC's December 2018 meeting. Many analysts predicted that OPEC and Russia would agree to further production cuts to stave off another global oil glut.

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After a series of contentious negotiations, an 11th-hour deal was reached; it was agreed that commencing in January 2019 the cartel and its partners would shave 1.2 million barrels daily from their oil output. The deal was achieved despite opposition from President Trump, who sees low oil prices as being crucial to promoting growth and key to achieving his campaign promise to rejuvenate the U.S. economy.

What does the deal mean for oil prices?

According to analysts, it could boost Brent to as high as US$70 per barrel; based on the current differential of around US$9, it would see WTI rise to around US$60.

Nonetheless, this has done little to buoy oil prices, and Brent has since softened to trade at just over US$60 a barrel. This is because the details of the agreement are murky, and there are no country-specific quotas. Then you have Iran claiming that it received an official exemption contrary to statements from other OPEC officials.

There is the very real risk that the cuts may not occur as stated, along with rapidly growing U.S. shale oil production and weaker demand growth because a slower global economy is weighing on prices. If prices remain weak, this will act as a significant headwind for Canada's energy patch.

Weaker oil is bad news for the oil sands

Major oil sands producers, including **Cenovus Energy** (TSX:CVE)(NYSE:CVE), have been labouring under the impact of the deep discount applied to WCS. The company appealed to the government of

Alberta to introduce mandatory production cuts to alleviate the record local oil glut, which has emerged because of transportation constraints. After the government committed to those cuts, WCS rallied substantially, more than doubling from its record November 2018 low to over US$32 per barrel. The relief provided by those cuts will only be temporary because they fail to resolve the key problems: pipeline bottlenecks, which are preventing WCS from being shipped to crucial U.S. refining markets, and sharply weaker crude.

There is every indication that unless OPEC's latest deal is successfully implemented, WTI will keep trading at under US$60 a barrel and could even plunge below US$50 a barrel on any indications of failure. This could have a crippling effect on many oil sands producers because of the high breakeven costs associated with the industry.

While most conventional onshore oil and shale operations breakeven with WTI at somewhere between US$30 and US$50 a barrel, it is a different story for the oil sands. Analysts estimate that many operations break even with WTI at US$60 a barrel or more because of the high upfront expenses associated with developing oil sands assets. That means many oil sands producers, especially small- to mid-sized operators such as **MEG Energy** (TSX:MEG), which lack any refining capability, will suffer if WTI remains soft for a prolonged period, regardless of a narrower WCS differential.

That becomes apparent when reviewing the latest round of results from the oil sands.

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For the third quarter, Cenovus announced operating and transportation expenses for its oil sands segment of over $14 per barrel of bitumen produced, whereas for MEG, those same costs came to $13.45 a barrel. As a result, both reported operating netbacks of $27.43 and $23.96, respectively, for their oil sands operations, despite WTI averaging over US$66 per barrel during the quarter.

These are significantly lower than many light oil producers such **Baytex Energy Corp.** (TSX:BTE)(NYSE:BYE), which reported netback of $38 per barrel for light oil produced from its Eagle Ford acreage. This is because production costs for those operations are significantly lower than for the oil sands to see Baytex report total expenses of $6.72 per barrel of light oil produced. The oil produced in the Eagle Ford also sells at a significantly higher price than WCS, further emphasizing the greater profitability associated with U.S. tight light oil production compared to Canadian heavy crude.

This indicates that U.S. shale oil producers will keep the spigots open and growing production, even if WTI trades at US$60 or lower, while also highlighting the unattractiveness of investing in the oil sands.

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