Which Stocks Will Benefit the Most from Alberta's Oil Production Cuts?

Description

In a surprise move after lobbying from major oil sands producers **Cenovus Energy Inc.** and **Canadian Natural Resources Ltd.,** the government of Alberta has mandated production cuts for upstream oil producers. The provincial government has taken this extreme measure to drain the local supply glut of crude, free up capacity on Canada's pipeline system and ultimately boost the price of Canadian heavy crude known as Western Canadian Select (WCS). An important motive for this was the millions of dollars of lost royalty income for Alberta because of the deep-discount being applied to WCS and other Canadian crude blends.

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How do the production cuts work?

The cuts, which come into play at the start of January 2019, aim to reduce provincial oil production by 8.7%, or 325,000 barrels daily and will remain in place until the 35 million barrels of processed crude in storage is shipped to markets. Once that has been achieved, the mandated reduction in production will be reduced to 95,000 barrels daily until the end of 2019. Those companies pumping less than 10,000 barrels daily will not be affected by the cuts.

Not all industry participants agreed with the cuts. A key opponent was **Suncor Energy Inc.** (TSX:SU)(NYSE:SU), whose management believed it was best to allow market forces to dictate pricing and if bitumen producers should reduce production to bolster prices. The rational for Suncor's position is simple: the integrated energy major was benefiting considerably from the wide differential between WCS and the North American benchmark West Texas Intermediate (WTI).

This is because Suncor has enough refining capacity to process a large portion of its heavy oil production. The integrated energy major can refine around 470,000 barrels daily, which amounts to roughly 70% of its total oil sands output. This means if there is a wider differential between WCS and WTI, the earnings and profitability of its business will soar. That becomes apparent from Suncor's third quarter 2018 results, where its refining and marketing business reported record quarterly funds flow from operations of $1.1 billion, 35% greater than a year earlier. The key driver of this impressive performance was improved refining margins created by the wide differential between WCS and WTI.

Which companies will benefit?

However, the cuts will be of considerable benefit to Canada's first and third largest oil sands producers Canadian Natural Resources and Cenovus because their planned introduction has already significantly boosted the price of WCS. Since they were announced, the price of WCS has more than doubled from its record November 2018 low of less than US$12 per barrel to be almost US$27 a barrel. That significant increase in the price of WCS occurred despite WTI losing 21% over that period.

The biggest beneficiaries of the cuts will be smaller pure intermediate upstream oil producers with no refining capability such as **Athabasca Oil Corp.** (TSX:ATH), **MEG Energy Corp.** (TSX:MEG), and **Pengrowth Energy Corp.** (TSX:PGF). For the third quarter, they had average daily heavy oil production of 30,477, 98,751 and 16,408 barrels respectively, which amounts to 75%, 100% and 76% of their total petroleum output.

Not only will their first 10,000 barrels of oil production be exempted, but because a substantial proportion of their production is composed of heavy crude, they will benefit significantly from higher WCS prices. Alberta's production cuts could very well be the lifeline they need to weather the latest oil price collapse. Despite WTI having shed 33% since the start of November 2018 to be trading at around US$42 per barrel, WCS has gained 49% over that period to be trading at US$26.78. That will substantially bolster their profitability despite softer crude.

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It's likely that WTI will rally once the latest round of OPEC production cuts commence in January 2019. And this, along with a substantially narrower differential, will further bolster the price of WCS, giving oil sands producers' earnings a solid lift that will serve as a powerful tailwind for their market value.

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