Does the Latest News Mean that Canada's Oil Crisis Is Over?

Description

There have been a raft of positive developments for Canada's energy patch in recent months, especially for oil sands operators, which for most of 2018 were labouring under the impact of the wide differential between Canadian heavy crude and the North American benchmark West Texas Intermediate (WTI).

Edmonton's actions boost prices

The Government of Alberta, after lobbying from major bitumen producers **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE) and Canadian Natural Resources Ltd. introduced mandatory industry wide production cuts. These were implemented at the start of January 2019 and will reduce output by 325,000 barrels daily to drain record oil storage levels in Western Canada. It is that localized supply glut that's been weighing heavily on the price of local oil blends. Alberta's announcement almost instantaneously lifted prices for Canadian light and heavy crude, causing them to more than double from the record lows reached in November 2018.

The provincial government also committed to finding longer term solutions to resolve the issues –primarily a lack of pipeline exit capacity –which were directly responsible for triggering the deep discounts applied to Western Canadian Select (WCS) and Edmonton Par. Alberta isn't the only one giving up the energy patch hope; one of the latest announcements from the Trump administration has further bolstered heavy oil prices.

Further punitive measures against Venezuela

In response to controversial and deeply embattled Venezuelan President Nicolas Maduro being sworn into office for a second term, Trump has tabled the prospect of imposing a complete oil embargo on the strife-torn Latin American nation. This has triggered a scramble among U.S. refiners to secure stocksof heavy oil, as many refineries are configured solely to process the high sulphur content low viscosity crude, much of which is sourced from Venezuelan imports. For October 2018, Venezuela supplied 570,000 barrels of crude to the U.S., most of which was extra heavy oil and accounted for 6% of all oil imports.

The higher crack spread traditionally associated with processing heavy oil motivated many refiners before the advent of the shale oil boom, which flooded U.S. energy markets with light sweet crude, to configure their operations to process heavier forms of oil. If Trump imposes a complete oil embargo on the strife-torn South American nation, it will cut off an important source of heavy crude for U.S. Gulf Coast refineries.

If those refineries are unable to obtain Venezuelan heavy crude, they will have to look elsewhere for feedstock with similar qualities. While Colombian and Mexican heavy oil will fill part of the supply gap, production issues experienced by both Latin American nations means that a shortfall will remain. This will in turn trigger a surge in demand for heavier forms of oil, notably bitumen sourced from Canada, thereby bolstering the price of WCS.

Canadian heavy oil to rally further

Since the Trump administration announced it was considering such measures, WCS has gained over 6% to be trading at US$42.60 per barrel, well above its November 2018 low of less than US$13 a barrel. If an embargo is successfully implemented, it will be a boon for Canadian oil sands operators because it will further narrow the price differential between WCS and WTI. This will give the earnings of Canadian oil sands operators like Cenovus, where oil sands operations are responsible for three-quarters of its total petroleum output, a healthy boost.

Given that Cenovus only realized an average of US$47.25 per barrel of WCS sold for the third quarter 2018, when WTI averaged US$69.50 a barrel, the latest news will boost its earnings despite WTI only trading at around US$54 per barrel. This is because the differential between WCS and WTI continues to narrow amid fears that heavy oil supplies will fall further. That means the price of WCS will move higher and could exceed US$47 per barrel even if WTI remains range bound at current levels, thereby giving Cenovus' earnings a healthy lift.

Higher heavy oil prices are here to stay

A confluence of events appears poised to buoy the price of Canadian heavy crude, at least for the foreseeable future, which will act as a tailwind for beaten-down oil sands stocks. These events have also reduced much of the immediate risk surrounding Canadian oil sands stocks, thereby increasing their investment appeal.

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Author
mattdsmith