



Is Alberta Inviting Criticism From Trump?

Description

In a surprise move toward the end of 2018, the Province of Alberta elected to impose mandatory production cuts on oil producers in response to [sharply weaker](#) Canadian oil price benchmarks. That decision came after significant industry lobbying primarily from **Cenovus Energy Inc.** ([TSX:CVE](#))([NYSE:CVE](#)) and **Canadian Natural Resources Ltd.** Both oil sands giants were suffering financially because the Canadian benchmark bitumen price Western Canadian Select (WCS) plunged to record lows in November 2018 despite the North American benchmark West Texas Intermediate trading at over US\$70 a barrel.

Oil production curtailments spark unintended fallout

A key reason for Edmonton deciding to introduce the cuts was the threat of losing up to \$4 billion in oil royalties if the deep-discount applied to Canadian crude continued. The cuts initially aimed to reduce provincial oil output by around 9%, or 325,000 barrels daily, but Alberta's government recently dialed them down by 75,000 barrels daily in response to unintended fallout. The announcement had an almost immediate effect, causing WCS and Edmonton Par prices to more than double.

While this has been a positive development for Alberta and those bitumen producers that lack significant refining capacity like Cenovus, it has triggered substantial fallout for an industry already labouring under a range of issues. This included lifting WCS prices to the point where it is essentially uneconomic to ship bitumen by rail. That has seen **Imperial Oil Ltd.**, one of the harsher critics of Edmonton's decision, to wind down rail shipments to almost zero during February 2019.

Aside from upsetting the economics of crude by rail, it could trigger significant political fallout because it has crimped the massive profits being made by U.S. refiners by narrowing the wide price differential between WCS feedstock and WTI.

The deep discount applied to WCS, which reached a record US\$47 per barrel in late October 2018, gave refiners' margins a substantial lift, thereby boosting fourth- quarter 2018 earnings, as they were able to access premium prices benchmarked to WTI while paying less than a quarter of that for bitumen feedstock.

The largest U.S. refiner by capacity **Valero Energy Corp.** ([NYSE:VLO](#)), where heavy crude makes up less than a fifth of its feedstock, reported that fourth-quarter operating profit surged by 50% year over year to almost US\$1.5 billion. This was supported by the refiner's throughput margin expanding by a healthy 26% to US\$11 per barrel and its operating income soaring by 50% to US\$5.36 per barrel.

Phillips 66 ([NYSE:PSX](#)), which is considerably more reliant upon WCS feedstock, saw its refining margin for the fourth quarter almost double to US\$16.53 per barrel seeing it report refining income before tax of US\$2 billion, almost four times greater than a year earlier.

Lower WTI coupled with substantially higher WCS with the price differential at less than US\$11 per barrel will squeeze margins for U.S. refiners, particularly with the North American benchmark trading at US\$55 a barrel. The additional costs of higher feedstock could be passed onto consumers at the pump. It is here that Edmonton's policy could trigger its most undesirable and least anticipated side effect: the wrath of President Trump. He has already established a history of being a vocal advocate of lower oil prices, criticizing Saudi Arabia and OPEC if prices move too high on reduced supply.

The dependence of U.S. refiners upon Canadian heavy crude, especially now that other sources such as Venezuela and Mexico are declining, means that higher WCS prices will compress margins and likely lead to costlier gasoline. It is difficult to predict whether Trump would intervene because it is a double-edged sword. The near collapse of Venezuela's oil industry and recent U.S. sanctions makes those refineries configured to process heavy crude even more reliant upon Canadian oil imports. Amid an operating environment in which many U.S. refineries are only capable of cost-effectively processing heavy oil, any moves that could potentially choke off supplies are risky.

What does it mean for the oil sands?

By meddling with the market mechanism, Edmonton has not only drawn harsh criticism from within the oil sands industry, but potentially damaged the province's reputation as a destination for investment, which could have a noticeable political impact and delay the markets ability to find equilibrium.

Once the [cuts wind down](#) toward the end of this year, there is every likelihood that the wide price differentials between Canadian crude and WTI witnessed last year will return until the noticeable lack of pipeline capacity is resolved. That makes investing in those oil sands operators like Cenovus, which lack the capacity to refine a significant portion of the bitumen they produce unattractive investments.

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