Have Production Cuts Made Imperial Oil Ltd. (TSX:IMO) a Risky Investment?

Description

Controversy continues to surround the mandatory production cuts introduced by Alberta's provincial government that began in January 2019 and are aimed at bolstering the price of Canadian oil prices, notably for heavy oil known as Western Canadian Select (WCS). A key critic of the cuts has been integrated energy major **Imperial Oil Ltd.** (TSX:IMO)(NYSEMKT:IMO).

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Canadian crude prices have risen significantly

Those mandatory cuts substantially bolstered Canadian oil benchmarks, causing the price differential between WCS and the North American benchmark West Texas Intermediate (WTI) to narrow significantly. As a result, WCS is trading at over US$49 per barrel, or almost four-times greater than the record lows hit in November 2018, despite WTI only trading marginally higher than it was at that time.

This has had a range of unanticipated consequences for the energy patch, making it uneconomical to continue shipping crude by rail.

You see, pipelines rate as the most cost-effective method of shipping crude with far greater capacity than rail.

The sharply lower price differential between WCS and WTI saw Imperial Oil, which is majority owned by **Exxon Mobil Corp.**, sharply reduce crude by rail shipments. For January 2019, the company stated that it had roughly halved the volume of carloads, and for February brought them to a near halt.

Imperial Oil's rationale was simple, by meddling with the market mechanism Edmonton had essentially eliminated the motivation to ship crude by rail and provided protection to those bitumen producers that were unprofitable in the prevailing operating environment. The provincial government had also sharply reduced the incentive for investment for oil sands operators to invest in expanding existing transportation infrastructure and build new pipelines to bolster pipeline exit capacity.

The lack of cost-effective high-volume transportation to key U.S. refining markets was the primary driver of the sharp slump in WCS prices during late 2018.

There were even concerns that the policy could attract an adverse reaction from the Trump Administration because of its impact on the profitability of U.S. refiners that are dependent on Canadian heavy crude.

Until the transportation bottlenecks are addressed, essentially by building new pipelines, Edmonton has by curtailing production effectively kicked the can further down the road because once the cuts come to an end there is every likelihood that another localized supply glut will emerge. That will cause Canadian benchmark oil prices to crash once again. It will also basically leave the energy majors, which have significant but profitable oil sands operations such as Imperial Oil and Suncor Energy Inc. to pick up the tab and pay for new pipeline infrastructure while not penalizing the weaker operators.

In response to this unintended fallout from a poorly thought-out policy, Edmonton has been progressively dialing down the cuts, but without moving to materially address the core issue, a lack of pipeline exit capacity.

Another reason for Imperial Oil's ire is that by significantly bolstering the price of WCS the provincial government's policy has sharply reduced the profitability of its downstream business. A wide differential between WCS and WTI means that Imperial Oil can obtain the feedstock for its refining operations at a deep-discount to the price it can charge for processed fuels and other products.

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Furthermore, unlike smaller upstream oil sands producers or those like Cenovus Inc., which lack significant refining capacity, Imperial Oil can refine the roughly 400,000 barrels daily produced by its upstream operations. This means that it can effectively offset the impact of wide price differentials for WCS on its upstream business because the margins and hence profitability of its downstream business will expand significantly. Because of the wide differential that existed between WCS and WTI during 2018 net income from Imperial Oil's downstream operations almost doubled compared to 2017 to $2.4 billion.

The considerable uncertainty triggered by Alberta's production cuts have forced Imperial Oil to slow the pace of development for its Aspen oil sands project, which it expects to be delayed by at least one year.

Is it time to buy Imperial Oil?

Aside from the uncertainty, Imperial Oil remains a top investment for those investors seeking exposure to Canada's oil sands. It has proven and probable reserves of 6.5 billion barrels, and can produce over 400,000 barrels daily across a diversified range of energy assets with relatively low breakeven costs.

The strengths of Imperial Oil's downstream operations, including considerable refining capacity, solid balance sheet and ability to leverage off Exxon's financial capacity, expertise and technology enhances that attractiveness. While investors wait for this along with firmer crude to boost Imperial Oil's market value, they will be rewarded by its regular and sustainable dividend yielding around 2%.

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