Is it Time to Plunge Back Into the Oil Sands?

### Description

Canadian energy stocks remain under significant pressure. The latest news, including a surprise inventory build and an escalating trade war between China and U.S. caused crude to pullback sharply.

Even rising geopolitical tensions in the Middle East, which typically provide support to oil have had little positive effect.



Regardless of the bleak outlook for crude, the North American benchmark West Texas Intermediate (WTI) has gained 21% since the end of 2018 yet many big names in the energy patch are down significantly over the last year.

Oil sands heavy weight **Cenovus** (TSX:CVE)(NYSE:CVE) has lost 12%, integrated energy giant **Suncor** plunged by 31% and **Canadian Natural Resources** lost a whopping 34%.

There are growing concerns that outlook for the oil sands is far worse than for conventional or shale oil. Sentiment toward the industry remains poor because it is perceived to suffer from high costs, have a significant environmental impact and is vulnerable to softer heavy crude prices.

## Weaker prices could return

Fears that the deep discount that drove Canadian heavy oil prices to record lows during the second half of 2018 could return is weighing heavily on oil sands stocks.

Unless there is a massive expansion in pipeline exit capacity before Alberta elects to end the mandatory production cuts that have buoyed **Western Canadian Select** (WCS) since the end of 2018, this is indeed likely to occur.

This is slated to occur on December31, 2019 and could cause the price differential between WCS and WTI to widen substantially causing Canadian heavy oil prices to return to record lows.

When this occurred during the second half of 2018, where WCS fell to as low as US$5.97 per barrel, many oil sands companies like Cenovus were producing bitumen at a loss.

The core issue is the significant capacity constraints across Canada's pipeline network. Those combined with growing bitumen production caused local oil inventories to swell to record levels, placing considerable pressure on the price of WCS.

That was not helped by the additional costs associated with refining heavier crude blends and production outages at U.S. mid-west refineries, many of which are configured to process heavy oil. Even record crude by rail shipments failed to alleviate the glut.

There has been no substantial expansion in pipeline capacity since the production cuts announced at the end of 2018.

Permitting delays forced **Enbridge** to push out the in-service date for the Line 3 Replacement, which is seen as a short-term solution to Canada's pipeline capacity woes, to the second half of 2020.

This has heightened fears that WCS could collapse once again when the cuts at end of 2019 as planned. That would be a poor development for oil sands producers like Cenovus that lack the ability to refine a significant proportion of their bitumen production.

## Cenovus is vulnerable



For the second quarter 2019, bitumen made up 78% of Cenovus's total hydrocarbon output, yet it only refined 194,000 barrels of heavy oil daily, making it highly dependent upon U.S. energy markets to sell the remainder of its bitumen. That sees Cenovus being a key beneficiary of the production cuts.

Despite the second quarter WTI average price being 12% lower year over, Cenovus's adjusted funds flow of $1.1 billion was a whopping 40% greater.

Free funds flow rose by an impressive 73% to $834 million and net earnings of $1.45 per share was four times greater than a year earlier. That can be attributed to the average WCS price of US$45.87 being 5% higher year over year despite WTI being sharply weaker.

## Foolish takeaway

Oil sands stocks, notably those like Cenovus, which lack the ability to refine most of the bitumen they produce, are a risky investment. There are a range of threats on the horizon, and it's likely that if bitumen prices plummet once again, Cenovus's stock will plunge.

Given that it's been one of the strongest gainers among oil sands stocks since the start of the year, investors should consider taking profits.

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