OIL CHANGE

DEMAND FOR CRUDE HAS COLLAPSED SINCE THE START OF THE PANDEMIC. BUT COULD THAT BE A BLESSING FOR CANADA'S OIL SANDS PRODUCERS?

BY MAX FAWCETT

ILLUSTRATIONS BY MATT CHASE

FOR years now, energy companies have served as the unintentional ballast in most investors' portfolios. While virtually every other asset class has risen—and in some cases, like technology stocks, soared—energy stocks have taken beating after beating. That's been particularly true here in Canada, where the combination of collapsing commodity prices and ongoing frustrations around pipelines and market access have made them more appropriate for masochists than mainstream investors. But despite the Biden administration's decision to revoke the presidential permit for the Keystone XL pipeline, Canada's oil sands producers may be about to stage a dramatic turnaround. If they do, they'll have COVID-19 to thank for the opportunity.

It might seem strange to think a global pandemic that triggered an unprecedented collapse in demand for crude oil would be good for the companies producing it, but that's exactly what happened for those in Canada's oil sands sector. That's because COVID may have permanently wounded the U.S. shale sector. The wells these companies have been drilling for the past decade have helped push U.S. production to record levels, but that came at a cost. The production coming from an average shale well declines by as much as 50% in its first year and continues falling off from there, which means the company that owns it has to be constantly drilling and completing other new wells. And while that strategy worked when capital markets were willing to subsidize the upfront costs in the hope of recouping them later on, with both global capital flows and operational cash flows virtually disappearing in early 2020, the shale companies were forced to pull their rigs out of the field and shut in some of their production.

That effectively pulled them off the so-called "shale treadmill." And it's increasingly clear they may never be able to get back to where they were before COVID hit. "We think U.S. oil production is going to exit 2021 somewhere between nine and 10 million barrels per day," says Adam Waterous, the founder and CEO of the Waterous Energy Fund. "What that will mean is that over a 24-month period, U.S. oil production will decline by three and a half million barrels per day—which is the largest collapse in history."

Waterous, who began as an investment banker before running Scotiabank's energy investment banking unit and later serving as its global head of investment banking, is one of the Canadian energy sector's more outspoken bulls. He also has plenty of skin in the game, given that his fund has already bought out heavy oil companies like Cona Resources and Pengrowth Energy, and currently has a $126-million bid on the table to add Osum Oil Sands to the fold (the Waterous Energy Fund already controls 45% of the company's shares). And while Waterous actually called a top on Permian Basin production before the pandemic hit, the supply picture looks even better to him now.

That's in part because of the huge collapse in U.S. production, and in part because Europe's supermajors appear to have gotten religion (or, perhaps, have been forced to by the growing number of environmental, social and governance–oriented investors) on climate change and their role in it. BP has pledged to cut its oil and gas production by 40% by 2030, while others, including Shell, Eni and Total, have said they'll reach net-zero emissions by 2050 or sooner. All told, Waterous sees the unintentional U.S. production declines and deliberate European production cuts adding up to seven million barrels per day, with the majority of them coming off the market by 2025. According to his math, that will mean the proportion of global supply provided by "investor-controlled production" will fall from 27% to 18%. "In other words," he says, "while the sheer number of dollars looking to invest may be declining, so too are the opportunities to deploy them."

And while investors have shied away from deploying those dollars in Canada over the past five years, that could be about to change. After all, while the decline rates on shale wells will make it nearly impossible for the U.S. to grow production meaningfully for the foreseeable future, they're barely even an issue for oil sands companies. As a result, large integrated companies like Canadian Natural Resources and Suncor don't have to spend nearly as much money to hold their production steady, and can break even on their operations at between US$25 and US$30 per barrel—far lower than their American peers.

The cost of getting those barrels to market might be about to drop, too, given that the Trans Mountain pipeline expansion and Enbridge's Line 3 pipeline are both moving closer to completion. When the capacity of these two are added to the nearly 600,000 barrels per day of so-called "debottlenecking" work that could be done on existing infrastructure, that's upwards of 1.5 million barrels per day of additional egress capacity in the next few years. As a result, the "differential" between Canadian barrels and West Texas Intermediate looks set to hit levels that seemed unimaginably low just a few years ago, when that differential widened to more than US$50 per barrel and the Government of Alberta had to implement mandatory production cuts.

Now, after averaging more than US$20 per barrel between 2010 and 2020, the differential is set to narrow to between US$5 and US$7 in 2021. That's due to new pipeline capacity and because competing supplies of heavy crude from Mexico and Venezuela will continue to fall off. According to Kevin Birn, the vice-president of North American crude oil markets for IHS Markit, "Declining availability for other global sources of heavy, sour crude—such as Venezuela—could give Canadian producers an added boost."

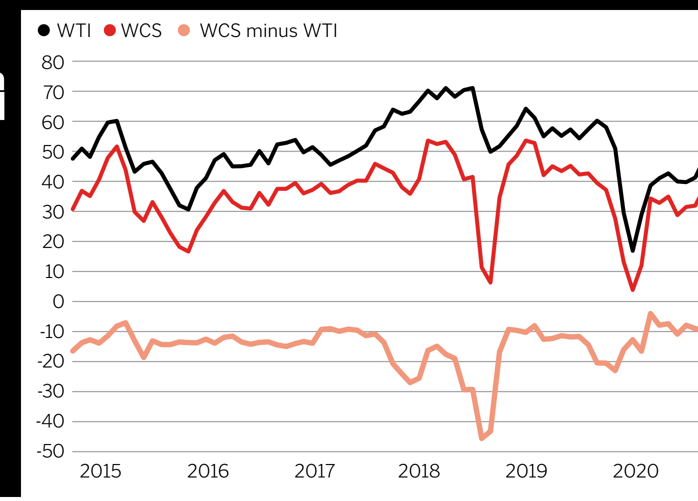
But the bull thesis for Canadian heavy oil doesn't just depend on declining supplies and rising prices. It also turns on the fact that Canada's oil sands companies are behaving far more like profit-seeking enterprises than they used to. "The industry went through a four-decade obsession with growth, starting in 1973 with the first Arab oil embargo," Waterous says. "That was a period when the industry was in an age of scarcity, and all things oil were driven for growth. Now that this age of scarcity has passed, we have to focus on the underlying profitability of the business." That's why the sector has seen a flurry of mergers recently, including Cenovus Energy's $23.6-billion takeover of Husky Energy in October and Whitecap Resources's all-stock purchase of TORC Oil & Gas in December. "There will be fewer companies out there," Waterous says, "but overall, the health of the industry will be better—and that's going to help attract investors to the sector."

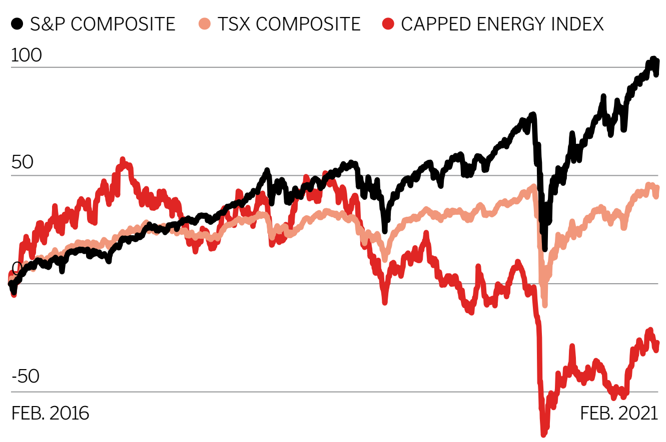
This isn't just Waterous talking his own book, either. As Morgan Stanley analysts Benny Wong and Adam Gray said in a recent note, "With improved cost structures and increased propensity to be capital disciplined, Canadian producers are emerging from the downturn stronger, with greater ability to generate free cash flow." But that strength will depend on their ability to resist the temptation to grow—something that has traditionally proven to be a challenge. "The industry has not been known for having significant capital discipline and providing reasonable long-term returns to investors," says Allan Fogwill, the president and CEO of the Canadian Energy Research Institute in Calgary. "And part of that is their fixation on growth."

Getting past that fixation won't be easy in an industry where production growth has traditionally been the defining operational metric. But oil sands producers' competitive advantage right now may be the fact that they don't have to grow in order to be profitable. Instead, they should be holding production flat, explicitly acknowledging the reality of peak demand and using it to reshape their businesses. Rather than trying to grow and expand, they should pay out every penny they can to shareholders in the form of dividends. And those could be considerable: According to a recent

CRUDE AWAKENING

PRICE OF WEST TEXAS INTERMEDIATE VS. WESTERN CANADIAN SELECT (US$), AND THE PRICE DIFFERENTIAL





WHAT A DRAG

ENERGY STOCKS HAVE PROVIDED UNINTENTIONAL BALLAST IN INVESTOR PORTFOLIOS

report from BMO Capital Markets, “Improved oil prices combined with operating cost reductions and restrained capital spending should allow oil sands companies to generate $12.5 billion of free cash flow (pre-dividend) in 2021.”

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That will be particularly attractive in a post-COVID world, where the combination of ultra-low interest rates and a rapidly aging population will make a healthy dividend nearly irresistible to the pension funds that collectively control trillions of dollars in global capital. As Guild Investment Management, a Los Angeles–based investment adviser, wrote in November 2019, “These pension funds require an annual return of 7.5% on their assets to meet their obligations—a figure that is relatively high due to rising obligations from accelerating retirements and low interest rates over the past two decades.” As companies still capable of generating significant free cash flow at current oil prices, oil sands players can help meet that demand for yield if they choose to shift away from growth. And ironically enough, the growing drumbeat around peak demand for oil and when it will arrive may free them up to do just that.

But that’s only part of the story. If they’re to prosper over the longer term, oil sands companies will have to find a way to substantially reduce their emissions—far more than they have in recent years. And while the federal government’s intention to increase the carbon tax to $170 per tonne by 2030 will give them a good reason to do that, they’ve yet to make the sorts of investments that will be required to get to net-zero emissions. “Yes, this focus on dividends and efficiency is a short-term benefit,” says Jamie Bonham, the director of corporate engagement at NEI Investments, an ethical investment firm. “But if we are talking about a long-term ESG play, you do need to see—in relatively short order—some commitments and larger gains on that greenhouse gas front.”

The good news, Bonham says, is that oil sands companies are accustomed to thinking about the long-term more than most oil and gas companies. “These projects have 20- to 30-year windows, and that’s almost unheard of outside the oil sands. So that thinking alone puts you in that mindset of what is going to happen five, 10 or 15 years from now.” But, he says, there’s still a disconnect between companies acknowledging where the destination is and deciding on how they’ll actually get there. “The commitment is there, the intention is there, and increasingly, these companies are starting to piece together the strategy. That is what gives me some hope they can get there. But it’s still a question mark.”

Bryan Helfenbaum is another interested observer with both questions and hope. He’s the executive director of advanced hydrocarbons in the clean energy division of Alberta Innovates, which is responsible for steering the government’s Bitumen Beyond Combustion program. That program, which seeks to find alternative applications for Alberta’s massive stores of bitumen, has taken on new urgency in recent years, as the growing popularity of electric vehicles and their impact on demand for oil becomes more obvious by the day. “We’ve talked about diversification before, but we really didn’t need to—if we waited and dawdled long enough, oil prices came back, and we were back in business,” Helfenbaum says. “The sheer size of supply offset the basic fact that bitumen, as a feedstock for fuels, isn’t very good. We’ll always be vulnerable as a feedstock because of that higher proportion of carbon atoms.”

But, he says, when it comes to other applications, that carbon intensity isn’t nearly as much of a problem. Take carbon fibre, a high-strength, low-weight material used in everything from wind turbines to textiles to concrete additives, with new applications being added all the time. “As these advanced materials, like carbon fibre, carbon nanotubes and even graphene, become used more and more,” Helfenbaum says, “bitumen’s higher proportion of carbon atoms actually becomes a strategic advantage.” And while there’s still plenty of work to do when it comes to scaling up the conversion of bitumen into value-added products, the science has largely been completed. “We still have a little ways to go to hit the kind of specifications to really have large commercial application,” Helfenbaum says, “but the proof of concept has really just been demonstrated in the past couple of years.”

Bitumen can even continue to play a major role in how we move people and goods, even if they’re increasingly being transported in electric vehicles. “No matter what is fuelling cars in the future, one thing we’re going to need is roads,” says Helfenbaum. “And roads are currently made with high-carbon-intensive feedstock. So heavy oil out of Canada may be the last oil produced, because having those heavy ends becomes an advantage.” Then there’s the vanadium and lithium that currently ends up in the tailings ponds of Alberta’s oil sands companies but are key inputs in the batteries that will power the world’s growing fleet of electric vehicles. Calgary’s E3 Metals says its proprietary direct lithium extraction technology can recover upwards of 90% of the lithium contained in the waste water from oil and gas operations, and turn it into battery-grade material. And the global vanadium market, which stood at approximately 80,000 tonnes per year in 2018, could nearly double by 2030. “Processing recovered vanadium into a usable electrolyte could also represent a significant business opportunity,” the Bitumen Beyond Combustion report concluded.

All told, these are multibillion-dollar opportunities that don’t have anything to do with global demand for products like gasoline and diesel—and, in some cases, provide a natural hedge against their inevitable decline. And now, thanks to the COVID-driven imperative to stimulate economic growth, the Government of Canada is looking hard at ways to support new opportunities for Alberta’s traditional resources. In time, and with some luck, those efforts could prove more beneficial to the oil sands sector than the federal government’s decision to buy and build the Trans Mountain pipeline expansion.

But if there’s anyone who can mess up the industry’s surprisingly bright future, it’s the industry itself. The federal carbon tax is only an asset if the companies advertise it accordingly, and for an industry whose leaders haven’t always been enthusiastic supporters of the idea, that might be more difficult than it should be. Indeed, some of those leaders continue to trade in dead-end arguments about the ethical nature of Canada’s oil production or the sins of the OPEC regimes—the very same arguments that failed to gain traction with investors five years ago.

And while they’re talking a better game when it comes to emissions and climate, oil sands companies have yet to put their money where their mouths are. The longer they wait to do that, the further behind they risk falling. “If you have already laid out this broader strategy, which has accepted as a core tenet that you have to be carbon competitive to survive in the future, then it’s a no-regrets policy to start making some of these steps that get you there—regardless of what the price will be,” Bonham says. “If that’s the end goal, then it’s better to start sooner than later.”