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
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 are looking far more like profit-seeking enterprises than they used to. “The industry went through a four-decade obsession with getting certain parts of the world to commit to declining supplies and rising prices. It also turns out we were living in a world where production growth was an issue for oil sands companies. 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 among the strongest, 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 been 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 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 go up, too, as the cost of pipeline capacity and Enbridge’s Line 3 pipeline are both moving closer to completion. When the capacity of these two are added to 200,000 barrels per day of so-called “dilbit” 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—medicate levels on the sleuths that seemingly never lower just a few years ago, when that differential widened to more than US$30 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$10. 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’ US$23.2-billion takeover of Husky Energy in October and Whitecap Resources’s all-share 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 among the strongest, 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 been 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
companies are accustomed to thinking about the
greenhouse gas front.” For that reason, they've yet to make the sorts of investments that will be required to get to net-zero emissions.

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 7.2% 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 have a little ways to go to hit the kind of specifications 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 $70 per tonne by 2030 will give them a good reason to do that, the further behind they risk falling. “If you have their money where their mouths are. The longer they wait to do that, the more difficult it will be to do just that. But if there’s anyone who can mess up the industry’s 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
talking 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 inter-
ested 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 Com-
bustion program. That program, which seeks to find alternative applications for Alberta’s massive stores of bitu-
men, 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 diver-
sification 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 feed-
stock because of that higher propor-
tion of carbon atoms.”

But, he says, when it comes to other applications, that carbon intensity isn’t nearly as much of a problem. Take car-on fibre, a high-strength, low-weight material used in everything from wind turbines to textiles to concrete addi-
tives, 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 propor-
tion of carbon atoms actually becomes a strategic advan-
tage.” 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 the

The good news, Bonham says, is that oil sands companies are accustomed to thinking about the

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