Southern Discomfort: Latin America's Crisis Spells Opportunity for Canada

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Supporters of Venezuela's government take to the streets during the country's unrest that may destabilize the oil industry
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As Canadian oil producers continue to manage their way through low oil prices and a slow national economic recovery, some are investigating how the decline in heavy crude beyond the U.S.'s southern border is freeing up capacity in U.S. Gulf refineries.

Together, Mexico and Venezuela once provided more than 45 percent of the total crude imports to the Gulf coast. However, they have plunged by more than 1 million b/d since 2007. In a March 2016 report, the Canadian Energy Research Institute (CERI) describes how the drop is creating a gap for Canada to increase market share in the Gulf. With bitumen blends and conventional heavy oil, Canada could provide 1.5 million b/d. However, the existing transportation infrastructure from Alberta to the Gulf will continue to pose a challenge, especially without the Keystone XL pipeline.

For Venezuela, while the oil story is bleak, the country is experiencing a perfect storm of crises. Low oil prices, hyperinflation, food and medicine shortages, drought, soaring foreign debt, more than a decade of mismanagement, corruption, and socialism, have sent Venezuela to the brink of collapse, taking its oil industry with it. By September, oil output had plummeted to 2.4 million b/d—350,000 b/d less than a year ago and almost 1 million b/d less than when Hugo Chávez became president in 1998. Political forces trying to unseat President Nicolas Maduro are underway. Oil tankers and drills are idle, and the government is using its national oil company, Petróleos de Venezuela (PDVSA), to issue bonds and contribute to social welfare programs. The Venezuelan government is delaying payments to contractors and oil services companies. Consequently, Schlumberger has reduced its operations because it is owed US$1.2 billion by PDVSA. Major airlines have discontinued service there because they are owed money by the government.

Drought has exacerbated Venezuela's crisis. The country relies on the huge Guri dam for 50 percent of its electricity, but behind it is now a drought plain. There are rolling blackouts across the country, riots, and for public employees a two-day work week. The IMF expects electricity prices to rise 720 percent in 2016. The power shortage is crippling the oil industry. Barclays' worst-case scenario for Venezuela has output falling by 500,000 b/d in 2016.

Venezuela's national debt totals around $150 billion and a default would trigger a market rout, economic implosion, and Venezuela's assets being seized by its creditors—they may include its refineries and tankers which are sitting idle off shore. Two-thirds of PDVSA's exports pay off Chinese and other lenders, leaving it unable to pay its own staff or buy basic equipment such as drilling mud. Workers report going hungry and not being given boots, gloves or hard hats. Between 2007 and 2016 China loaned Venezuela about US$65 billion, which is being repaid in oil. This has diverted Venezuelan oil away from U.S. Gulf refineries.

Government control of imports has created a black market, and accentuated Venezuela's need to devalue the bolivar, print more money and delve into its gold reserves. "Venezuela has made a moral choice to stay in power by not defaulting on Wall Street, but instead, defaulting on its people," says Dany Bahar, a Venezuelan economist and fellow at the Brookings Institution. Bahar believes that Venezuela will need a lot of resources to recover from this crisis. Because it cannot borrow on the financial markets, it is heavily reliant on China to adjust payments and interest rates. But even those measures do not address the underlying problems.

"Venezuela cannot rely on increasing production to address its debt or on the Chinese for much more assistance," says Bahar. "It is going to need the IMF or other institutions to provide a big bailout, the question is, for how much?" And what will the IMF ask for? Usually an austerity plan, privatization and opening up closed markets to international competition.

On the other side of the Caribbean, Mexican production is expected to continue its decline by up to 700,000 b/d over the next three years. But after that, things look better—or worse from a Canadian oil sands perspective.

In Mexico, though oil production has been in a slow decline, the country has been taking steps to address internal issues with Petróleos Mexicanos (Pemex) and the industry. President Enrique Nieto announced a series of energy reforms in 2013, which ended state-owned Pemex's monopoly on the oil market. Unfortunately, that opening to the private sector coincided with the sharp fall in crude prices. In its first auction open to private investors, in 2015, only two of 14 blocks were awarded, partially due to low prices, and partially due to the way the auction was structured. Mexico had to revise its criteria to make the process more attractive to potential investors. The third auction saw Canada's International Frontier Resources, through its jointly owned Mexican company, Tonalli Energia won the Tecolutla Block—becoming the first Albertan company to operate a block in Mexico. It will drill its first horizontal well in Q1 2017. There will be a tender in December for deep-water blocks, but it will be a few years before this foreign investment turns production around.

Pemex's internal problems, market conditions, and now, private competition are pressuring the firm. Pemex lost US$32 billion in 2015, is about US$87 billion in debt, and hasn't recorded a profit since 2012. In January, Pemex, cut about US$3.9 billion from its budget and laid off 13,000 employees. Then in April, the Mexican government provided a US$4.2 billion capital injection to Pemex, in part to cover payment of severances and pensions.

Pemex averaged 2.267 million b/d in 2015. About 80 percent of that came from offshore shallow water deposits. "I do see in the short term a decrease in Mexican oil production because it will take time for projects to be awarded and to produce, says Benjamín Torres-Barrón, an oil and gas specialist at Baker & McKenzie in Mexico. "Over the next four years, I see a slow decline, but in 5-10 years, I see an increase in production. Right now, it is at 2.2 million b/d and I can see it going down to 1.5 million b/d in the next 2-3 years, then back up to 3 [million b/d] after the five-year mark."

Though Mexico is making the right decisions to create growth, there is concern that a possible Donald Trump presidency could negatively impact trade and investment in Mexico, as well as the entire economy. Trump's threat to "Build a Wall" is the least of Mexico's worries. Of much greater concern are his proposals to clamp down on immigration and deport illegal immigrants. Legal and illegal Mexican immigrants in the U.S. wired $24.8 billion to family members in Mexico in 2015. That is significantly more money than Mexico derived from its oil industry revenue. A Trump presidency would likely stall Mexico's economy and any progress with its oil production for several years.

Herein lies the opportunity for Canada—the U.S. Gulf refineries have relied on crude oil imports from Venezuela and Mexico. With their production falling, is there room for Canadian producers to fill the gap?

The CERI report says 'Yes'. "If oil sands could displace most of the Mexican and Venezuelan imports, the opportunity for bitumen blends and heavy oil would be about 1.5 million b/pd," it says. Without the Keystone XL pipeline, the question is one of transportation through the existing pipeline system and rail to Cushing, Oklahoma. "We can get crude by pipeline to the mid-west and then by rail to the Gulf, or we can get it by rail from Alberta to the Gulf," says Dinara Millington, co-author of the CERI report. "We are able to transport 3.7 million b/d, but if the volumes coming in from US sources to Cushing are greater than that, we will need to find another way."

Canadian crude has been reaching the Gulf in increasing volume by rail and by existing pipelines and lacking Keystone XL, the current transportation infrastructure cannot accommodate a more significant increase without continuing to increase transport by rail. Between 2014 and 2015, exports of Canadian crude by rail increased 172 percent. The Canadian Association of Petroleum Producers (CAPP) projects that exports by rail will continue to increase, by as much as 250,000 b/d crude oil in 2016 and 600,000 b/d in 2018.

Fortunately, while the price of oil is edging up slowly, the cost of rail is dropping as natural gas pushes the U.S. coal industry into decline. The Association of American Railroads reported a plunge in total rail traffic in early 2016. The decline of U.S. coal and Latin American heavy crude are a much-needed double boost to Canadian oil sands operators.
