May 14, 2018

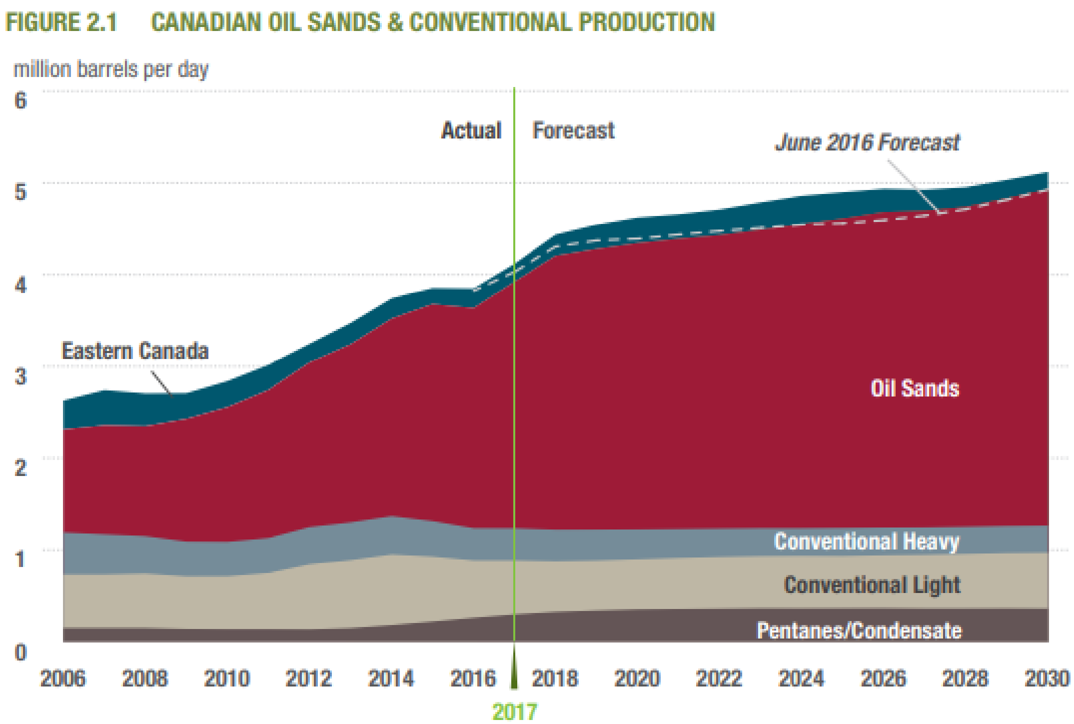
Canada's never-ending pipeline saga

While the global media focuses on the mounting trade tensions between China and the United States, Canada is mired in its very own domestic trade war.

This made-in-Canada trade dispute revolves around failed attempts to build the pipeline capacity Alberta needs to be able to continue delivering its oil to the United States and, later, to overseas markets. More than 80% of Canada's oil production and over 95% of its oil reserves are located in Alberta.

Growing oil production is straining pipeline capacity

According to the Canadian Association of Petroleum Producers, Canada's oil production will grow from 3.85 million barrels per day (bpd) in 2016 to 5.12 million bpd by 2030. The Alberta oil sands are the driving force behind these projections. [1]

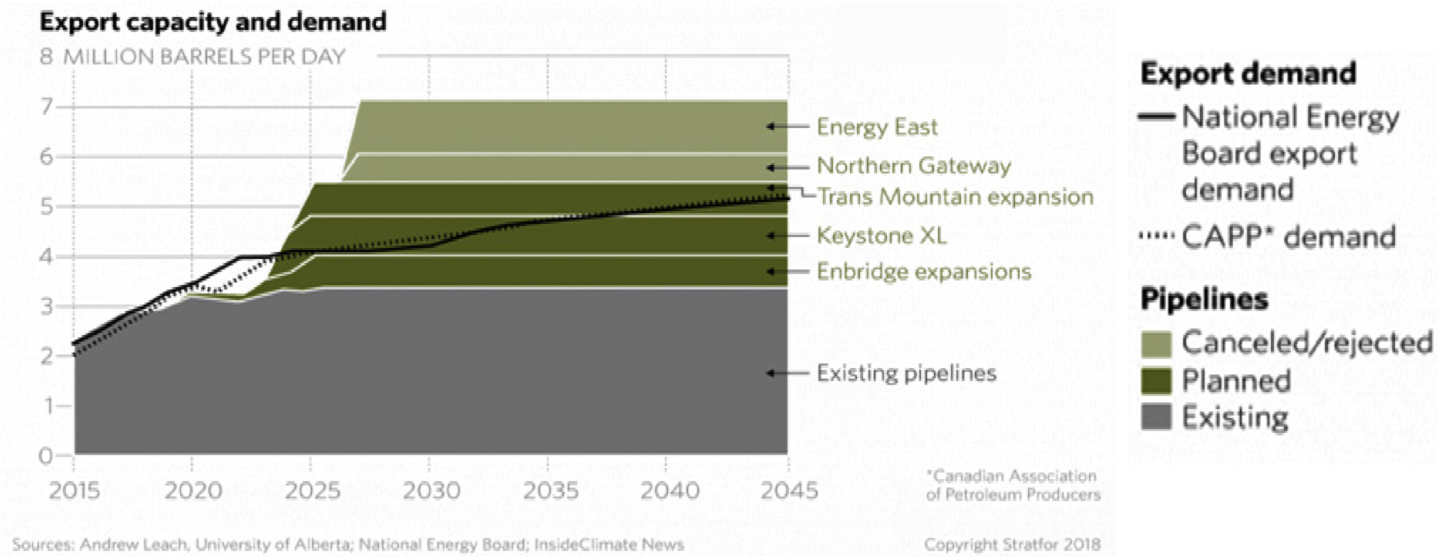


Source: "CRUDE OIL FORECAST, MARKETS AND TRANSPORTATION," Canadian Association of Petroleum Producers, 2017

However, Canada's oil production is increasingly running up against limited pipeline capacity.

[1] "Crude Oil Forecast, Markets and Transportation," Canadian Association of Petroleum Producers, 2017

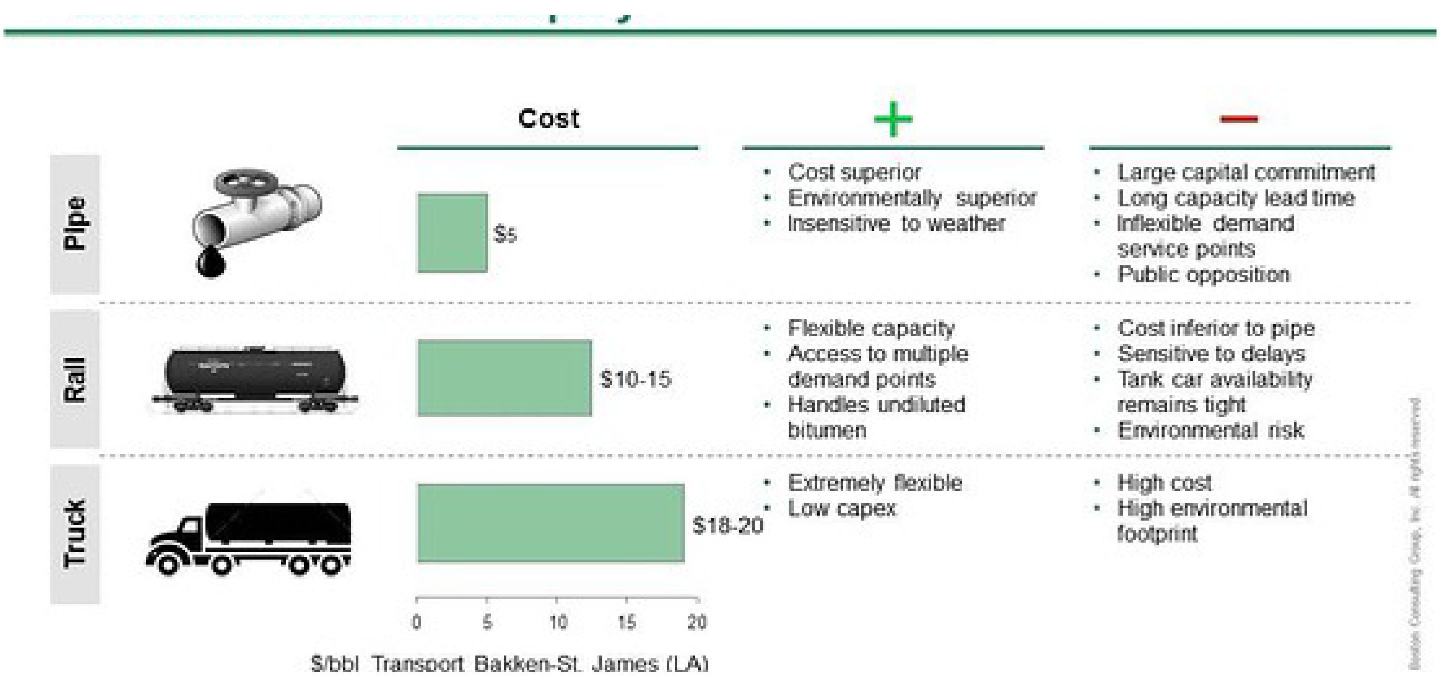
Canada's pipeline capacity is falling short of pipeline demand



Source: "In Canada, a Trade War Emerges," Stratfor, April 25, 2018

More expensive means of transportation

The shortage of pipeline capacity has forced companies to turn to other transportation options, such as rail or road. The International Energy Agency forecasts that the transportation of oil by rail in Canada will increase from 150,000 bpd in late 2017 to 250,000 bpd this year and 590,000 by late 2019.[2] However, this comes at a time when the railway sector is already struggling to meet demand. Farmers in particular are complaining about the long delay in getting their products shipped. As the following chart illustrates, pipelines are by far the most cost-effective and environmentally efficient way to deliver oil. Canada currently delivers about 95% of its oil by pipeline.



Source: "What Changes Are Needed for Transporting Crude in North America," Wall Street Journal, December 29, 2014

[2] "Crude-by-rail shipments in Canada to more than double by 2019, says international agency," Canadian Press, March 5, 2018

Recent planned pipelines that have been blocked

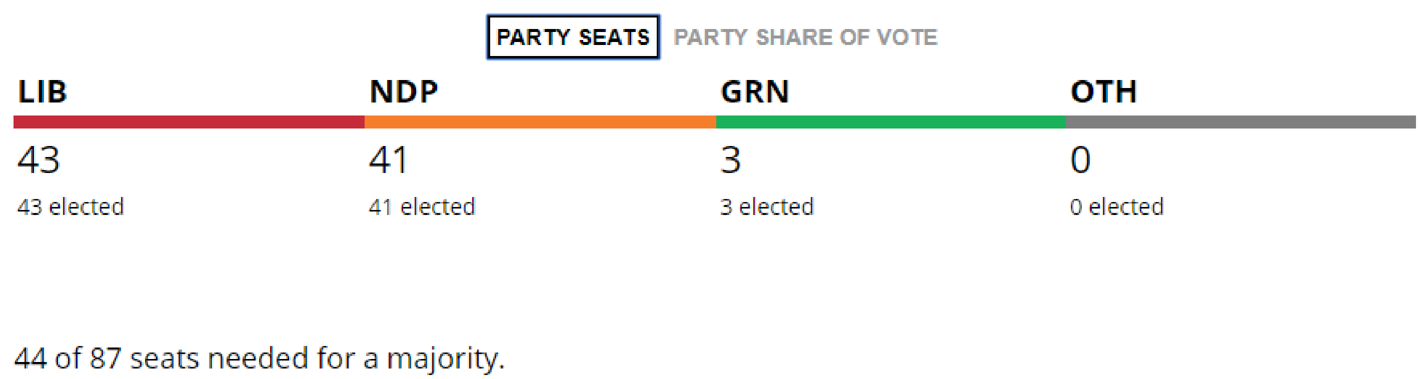
- Northern Gateway, which would have shipped oil from Alberta to Kitimat on British Columbia's northern coast, was blocked by the federal government in 2016. Environmentalists and local communities feared it would cause significant environmental damage to the Great Bear Rainforest.
- Energy East, which would have linked Alberta to the Atlantic Coast, was abandoned by TransCanada Corp. owing to rising costs and strong opposition from Quebec and Indigenous groups.

The latest pipeline to run into trouble: Trans Mountain Expansion Project

The Trans Mountain Expansion Project (from Alberta to a port near Vancouver) would triple capacity to 890,000 bpd. The project entails laying another pipeline alongside an existing one.

Until recently, it seemed that Trans Mountain was a done deal. Both Prime Minister Trudeau and the former B.C. Liberal government supported the project. However, the May 2017 B.C. election upended the political landscape. The NDP and the Green Party formed a governing coalition with a fragile one-seat majority. Both parties oppose the pipeline project.

British Columbia: May 2017 election results



Source: CBC

A month after the election, the B.C. coalition government proposed new environmental regulations prohibiting any increase in the transportation of bitumen until new spill containment studies were carried out.

The Alberta government responded by withdrawing from electricity trade talks between the two provinces, temporarily suspending imports of B.C. wines, and preparing a bill allowing for restrictions to be imposed on crude oil, natural gas and refined product exports to its western neighbour. If enacted, the bill would likely be challenged before the courts.

On April 8, Kinder Morgan halted investment in the project until the uncertainty hanging over the project was lifted.

The failure of Trans Mountain Expansion would have significant political ramifications

- It would likely significantly increase trade-related tensions between British Columbia and Alberta.
- The cancellation of yet another high-profile energy project could be taken as a sign by investors that Canada's energy sector is not open for business. Examples of past failed projects include Petronas's $36-billion LNG project in British Columbia and TransCanada's $15.7-billion Energy East project.
- It could mortally wound Prime Minister Trudeau's grand bargain of allowing one or two pipelines to be constructed in exchange for provincial acceptance of a carbon tax.

Indeed, Canada is already facing a potential carbon tax backlash. In Ontario, Doug Ford, leader of the Conservative Party, has promised to abolish the carbon tax if he wins the election on June 7. The polls currently show him in the lead by a wide margin. Jason Kenny, leader of the United Conservative Party in Alberta, is also an anti-carbon tax crusader. Though elections in Alberta are still about a year away, the Conservative Party's lead in the polls looks insurmountable. Having both Alberta and Ontario turn against the tax threatens its viability.

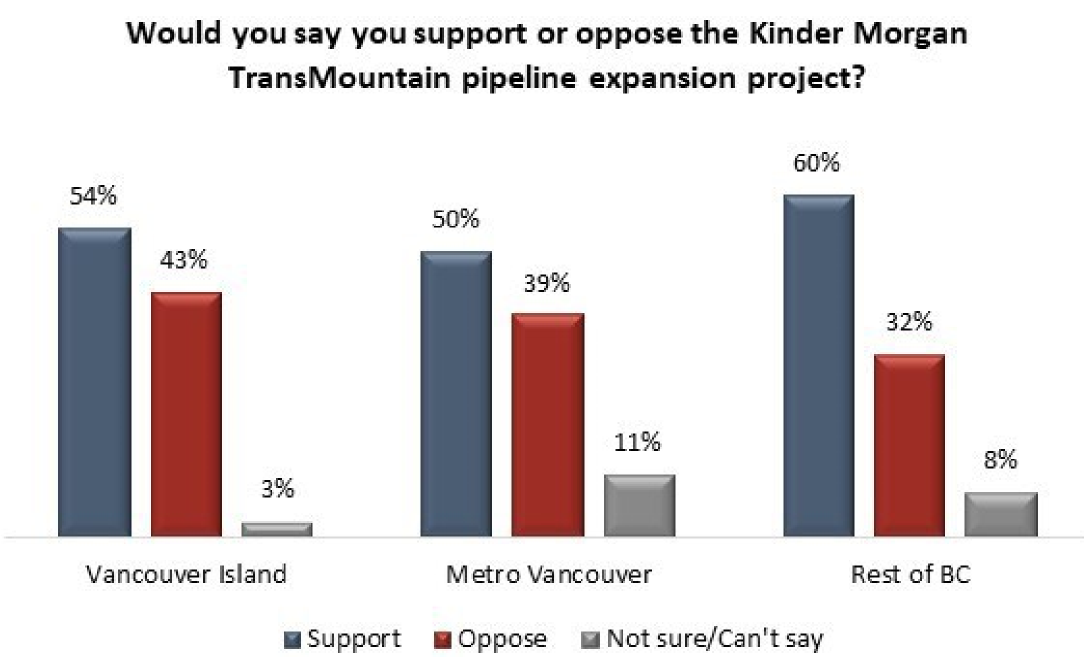
Trudeau has vowed to get project built

Sensing political danger, Trudeau has promised to pass legislation that would reinforce the federal government's existing constitutional authority over inter-provincial pipelines. He also instructed his finance minister to sit down with Kinder Morgan and work on a financial solution that would counteract the political uncertainty surrounding this project. Finally, the federal government has entered into discussions with certain First Nations tribes on the possibility of their taking an ownership stake in the pipeline.

Politically, the Liberal government is being squeezed on two fronts. If the project is abandoned, Albertans will rage against a country that takes their money to finance equalization payments to poorer provinces while simultaneously taking measures to hurt their economy. But if the federal government and the Alberta government find a way to push the pipeline through, there is a risk of alienating environmentally conscious voters in B.C. and elsewhere. Even a small left-wing voter shift away from the Liberals could cost the party seats and victory in the next election. Meanwhile, winning the votes of people who strongly support the pipeline is easier said than done as many of them tend not to be natural supporters of the federal Liberal party.

Support for pipeline rising in B.C. and elsewhere

An April poll by the Angus Reid Institute found that 54% of British Columbians backed the expansion project. Not surprisingly, opposition to the pipeline was strongest in areas around Vancouver and Victoria, the provincial capital. However, support is strong for it elsewhere in the province where the resource industries are big employers. Support for the Trans Mountain project had grown as well nationwide, going from 49% in February to 55% in April.



Source: Angus Reid Institute, April 2018

Other legal decisions pending regarding Trans Mountain Expansion

While Trans Mountain has received the support of 43 indigenous communities, there are seven First Nations among the dozen or so groups mounting a challenge before the Federal Court of Appeal against the government's decision to approve the project. A ruling against the project would leave Ottawa with three tough options: return to the bargaining table, appeal to the Supreme Court, or abandon the project. A Supreme Court case would take several years to litigate.

Meanwhile, the B.C. government has asked the province's highest court to determine what authority it has over shipments of crude oil delivered over its territory.

Two pipelines likely to be built first

Even if Trudeau got his way with this pipeline project, its completion would no doubt be significantly delayed by endless court battles and protests. Indeed, the current B.C. government would be unlikely to expend a great deal of effort to protect the pipeline or vigorously prosecute anyone blocking it.

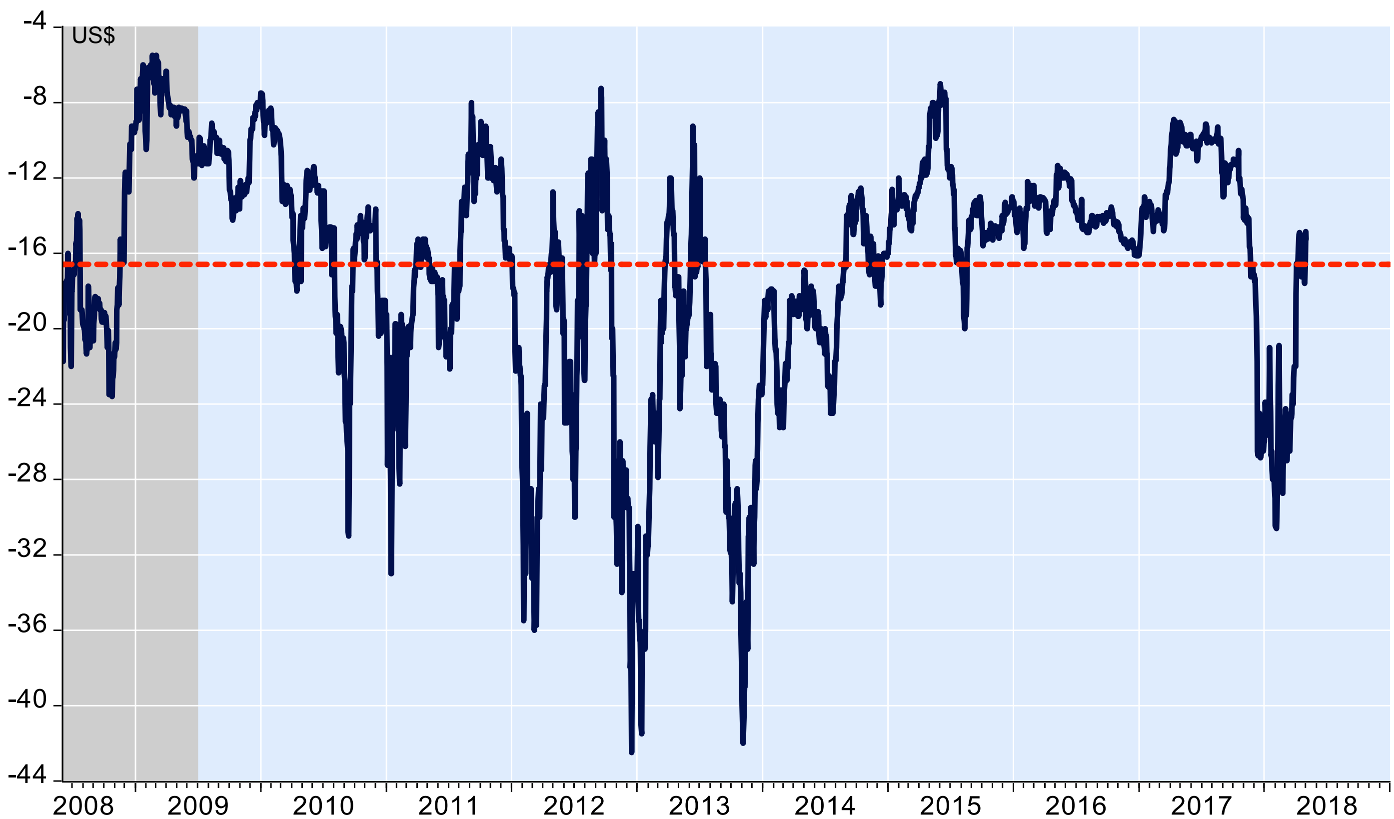
Consequently, the following two pipelines running through the United States have a greater chance of coming online before the Trans Mountain expansion: Enbridge's Line 3 replacement project and the Keystone XL pipeline. Though they both must still overcome significant regulatory and legal hurdles, these pale in comparison to the challenges facing the Trans Mountain expansion.

Price discounts as far as the eye can see

Because of the inability to export to overseas markets and the fact that heavier oil tends to sell at a lower price, Canadian oil trades at a significant discount. Alberta's Western Canada Select (WCS) was selling for $30 less than West Texas Intermediate (WTI) did in February. The WCS-WTI price differential has since narrowed to the high teens.

Canada: WCS discount back to historical norm

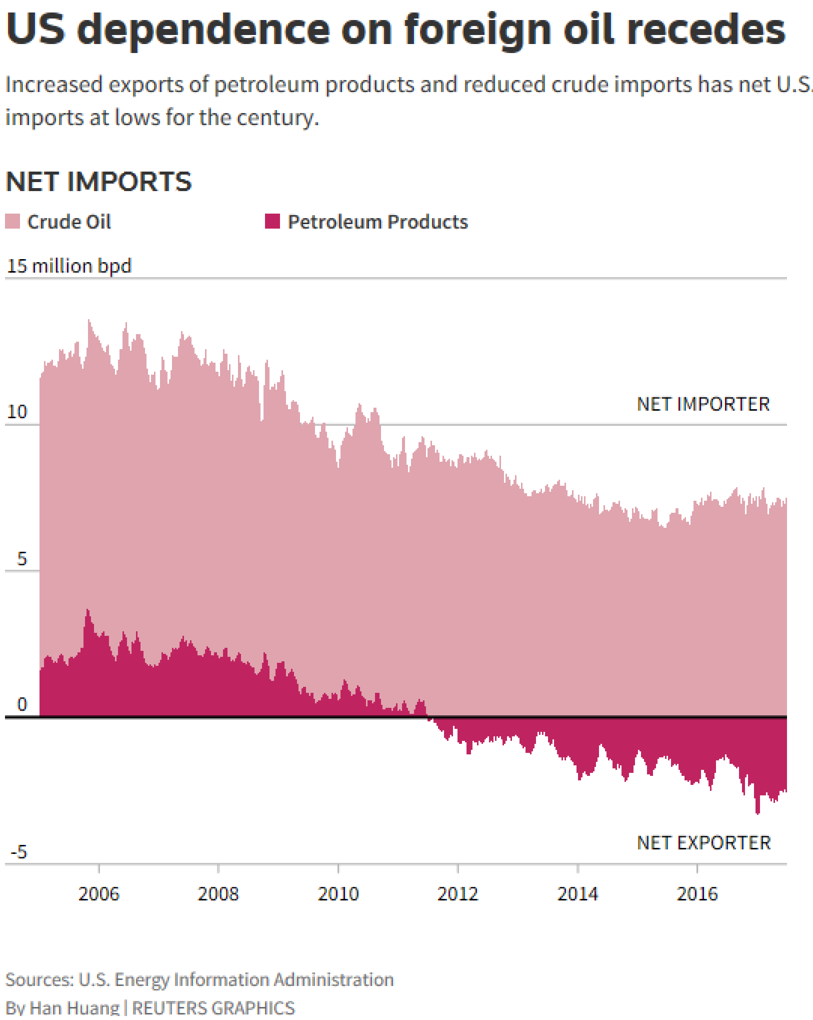
Western Canada Select spread with West Texas Intermediate barrel price



NBF Economics and Strategy (data via Bloomberg)

Conclusion: winners and losers

The biggest winners by far in this story are U.S. refineries. They buy oil – often at a significant discount from countries like Canada and Venezuela -- refine it into gasoline or diesel, and then resell it at a much higher price. The United States is the world's top exporter of refined oil products, shipping today more than 3 million bpd, up from 1.3 million bpd a decade ago.[3] Many countries do not have sufficient refining capacity to meet their domestic fuel needs.



Source: "Why record U.S. oil exports are poised for even more growth in the near term," Reuters, July 27, 2017

The biggest losers are Canadian oil producers. For starters, the shortage of pipeline capacity means they will be forced to sell their oil to U.S. markets at a discount to international prices for the foreseeable future. They also face a much more competitive U.S. energy sector following the passage of recent legislation south of the border that has lowered tax rates and allowed companies to amortize capital investments immediately. Energy regulations have also been significantly relaxed under the Trump administration.

Angelo Katsoras

[3] "Marathon creates top U.S. refiner with $23-billion Andeavor deal," Reuters, April 30, 2018

Geopolitical Briefing

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