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Curtailing Alberta Oil: The Right Solution to the Problem?

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Part 1: Is Curtailment the Right Solution to the Problem?

Earlier this month, the Alberta Government began an oil curtailment policy that could continue for the rest of 2019. The curtailment is a response to low oil prices and excessive supplies of oil in storage. The policy does not restrict export volumes or mandate any price floors; rather, it limits the amount of raw crude oil and bitumen that can be produced in Alberta, including from the oil sands by 8.7 percent (325,000 barrels/day).[1] That means that Alberta has a production ceiling of about 3.411 million barrels of petroleum per day ("bpd"). No more and not likely any less. Alberta has promised to lift the curtailment by 2020, and will ease the production cap as oil storage levels make their way back to normal levels.

The stated reasons for the policy are low prices and excessive amounts of processed Alberta oil in storage – an estimated inventory of 35 million barrels.[2] It is normal to have extra inventory on hand, even for the leanest of businesses, but the current amount of oil in storage is about double historical levels. Most Alberta oil is expensive to extract and refine compared to other oils around the world. Thus, with narrow margins, Alberta oil producers are particularly sensitive to substantial levels of storage and low prices.

The weakness of the Canadian market is obvious when Canada's oil price benchmark, Western Canadian Select ("WCS"), is compared to the U.S. benchmark, West Texas Intermediate ("WTI"). The price difference between WCS and WTI, informally known as the Canadian discount, has averaged US$18[3] since about 2010, but it has more than

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1 Government of Alberta, "Premier acts to protect value of Alberta's resources," *Government of Alberta,* (December 2018).

2 Ibid.

3 Tim Pickering, "Deeply Discounted Oil - Trading The Canadian WCS Spread," *Seeking Alpha.* (November 2018).

All values expressed in US dollars unless otherwise indicated.

doubled in 2018. On November 30, 2018, the Friday before the Government's Sunday curtailment announcement, the discount sat at $36.[4] And the main culprit for these low prices? Lack of oil transportation. In the absence of pipeline infrastructure, energy companies must turn to pipelines' costlier cousin, rail transportation. Between September 2017 and September 2018, shipments of oil on rail increased by 101%.[5] (And even rail is hampered by a lack of cars to move the oil.)

Oil Pricing in Alberta

There is no standard approach to producing oil. It varies around the world because of input costs, construction times, political approval environments, geographical complications, etc. Consequently, oil project costs vary from place to place. Oil prices will also vary slightly because of the type of oil (sweet, heavy, etc.) and oil quality, but predominantly prices worldwide are based on general market cues (i.e. the price that buyers are willing to pay for oil). Unlike other commodities, oil prices do not tend to hover around daily production costs.

While there is a lot of petroleum in Canada's oil sands, it is also expensive to produce and requires very large investments. It requires heating and distilling syrupy and sandy petroleum to create a marketable, transportable commodity. These days, with a lack of oil transportation, combined with new global competitors emerging and changes in vehicle technology, demand in North America is flat and supply is reaching unprecedented heights.

Government mandated limits on oil production are not unique to Alberta. Oil producers in Saudi Arabia and Russia pushed OPEC in November of 2018 to mandate an overall oil supply curtailment of 1.4 million bpd.[6] Curtailment is recognized as a way to reduce excessive supply storage, as well as a mechanism to stabilize market volatility as investors react to falling prices.

Back in Canada, Albertans are feeling the hits from a localized inventory problem together with an overall decline in global oil prices. Competition for buyers and transportation infrastructure is sparking price wars among Canadian oil producers, which is, in turn, dragging selling prices closer to operating costs. This is one reason why the Canadian discount average doubled

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4 Oilprice.com, "Oil Price Charts," *Oilprice.com,* (2019).
5 National Energy Board, "Canadian Crude Oil Exports by Rail – Monthly Data," *Government of Canada* (October 2018).
6 Reuters, "Oil prices hit a 2018 low as OPEC considers an output cut," *CNBC*, (November 2018).

last year, and reached its highest point of $52 in October.[7]

Problems in Alberta's energy economy have a direct effect on the economic wellbeing of Canada as a whole. In 2018, the Canadian economy lost nearly $80 million a day in 2018 when the discount rates ranged between $30 and $50.[8]

Following proposals by some producers and consultations with the broader sector, and other stakeholders, the Alberta government proposed curtailment as a short-term solution to alleviate the pressure on Canadian oil companies caught in the downward spiral of oil prices. Curtailment is expected to up the price Alberta oil producers receive by at least $4 a barrel while other means of transportation, such as the Enbridge Line 3 and TransCanada Keystone XL pipelines, and more rail transport, languish in the approvals lane.[9]

Longer-term problems

The concern about curtailment is that it will have unintended, long-term consequences on Canadian energy investment, with spin-off effects on the nation's economy. According to data from Statistics Canada, overall foreign investment into Canada has deteriorated over the past few years, reaching its lowest level in 2017 since 2010.[10] The Global Competitive Index for 2018 highlighted "inefficient government bureaucracy" as Canada's biggest competitive burden.[11] Resource projects in Canada face long and inconsistent wait periods. Sometimes the wait can be less than half a year, but one oil project has been waiting since 2013 to receive approval.[12]

Foreign (and domestic) investors take a dim view of the Canadian investment climate when regulations are inefficient, inconsistent or seem changeable by political influence. For instance, in January of 2018, Parliament introduced Bill C-69, which aims to reform the federal environmental assessment

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7 Government of Alberta, "Premier acts to protect value of Alberta's resources," *Government of Alberta* (December 2018).

8 Ibid.

9 Government of Alberta, "Premier acts to protect value of Alberta's resources," *Government of Alberta* (December 2018).

10 *Statistics Canada*, "Balance of international payments, flows of Canadian direct investment abroad and foreign direct investment in Canada, quarterly (x 1,000,000)," *Government of Canada* (October 2018).

11 Canadian Chamber of Commerce, "Death by 130,000 cuts: Improving Canada's Regulatory Competitiveness," *Canadian Chamber of Commerce* (May 2018), 6.

12 Kyle Bakx and Tony Seskus, "Oilpatch CEOs blame high costs, red tape for erosion of Canada's competitive edge," *CBC News* (May 2018).

process by increasing Indigenous engagement in the consultation process.[13] In doing so, it also lengthens the assessment process for projects utilizing Canadian resources. While the bill intends to provide more consideration to the environment and the people affected by an energy project, there is no similar requirement to consider any of the potential economic benefits of a project.[14] Bill C-69 also gives full discretion to the Minister of Environment over whether or not a project will be assessed.[15] This represents the kind of politicization of the assessment process that could send investors to other markets.

For investors looking at Canada, regulatory ambiguity brings with it a higher risk of litigation, more uncertain outcomes, longer timelines, and higher costs. This adds up to an overall decrease in investor confidence. High standards are not themselves a disincentive to investment, but inefficient or uneven application of those standards is.

Despite the good efforts of the Alberta government to consult widely and provide a clear framework for the curtailment process, the interventionist aspects of this policy, together with the prospective effects of Bill C-69, are likely to contribute to investor unease. Most importantly though, the lack of sufficient transportation infrastructure diminishes the viability of Canadian energy investments for every day that pipelines do not get built.

Curtailment could be successful in the short-term. Its in-industry advocates, such as Cenovus Energy Inc. and Canadian Natural Resources Ltd.,[16] have argued that it will curb the downward spiraling of oil prices and will ease oil congestion in the province. Following the curtailment announcement, Canada's crude price jumped 70% and the Canadian discount now hovers around $11.[17] Does this mean the policy is working or is it, as some experts have said, the short-term results of agitated December speculation for high January oil prices?[18]

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13 Megan Helmer, "What does Bill C-69 – Impact Assessment Act mean for Canadian resource companies," *PR Associates,* (March 2018).

14 Ibid.

15 Ibid.

16 Kevin Orland, "Canada's Unprecedented Oil Cut Plan Boosts Crude, Stocks," *Bloomberg News,* (December 2018).

17 Kevin Orland, "Canada's crude is up 70% on Alberta's oil crisis plan before it cuts a single barrel," *Financial Post* (December 2018).

Oilprice.com, "Oil Price Charts," *Oilprice.com* (2019).

18 Kevin Orland, "Canada's crude is up 70% on Alberta's oil crisis plan before it cuts a single barrel," *Financial Post* (December 2018).

Albertan producers such as Husky Energy Inc., Imperial Oil, and Suncor Energy Inc. have argued that the unintended consequences are likely to be worse than a short-term differential in the long-term. Among the main criticisms of the policy is that the results of government intervention are unpredictable and may be contradictory. A Calgary Herald editorial cites the example of U.S. gulf coast refiners who were willing to take Canadian crude while the discount was $18 a barrel (i.e. larger than shipping costs) but can't make a profit at a smaller discount, thus pushing inventory stockpiles back up. This may in fact drive some of the current rail car capacity out of Alberta at the very time when it is most needed. The Calgary Herald editorial is skeptical about government's ability to successfully intervene in the energy industry:

> Intervention into a fast-moving and unpredictable industry like oil is always inappropriate and can prove to have volatile results. OPEC, a much larger and more sophisticated oil player, has learned this hard lesson many times in the past and most recently in the past few months as it sought to increase production, and is now scrambling to reduce production to prop up depressed prices.[19]

The question now is what happens at the end of 2019 if winding down the policy sends the differential back up. For example, policy makers with a 2019 perspective might see voluntary curtailments, which were already starting to happen in 2018 as the more sustainable solution, but might also see it come in slower, more hesitantly from industry.

Even if the interim policy is successful, a lasting solution will be one that focuses directly on the problem, not on government-mandated supply-side tweaks. More pipelines, more rail cars and more efficient approvals will eliminate bottlenecks and restore the benefits of the energy economy both to Alberta and to the rest of Canada. As the Alberta Premier, Rachel Notley, tweeted over the Christmas holidays:[20]

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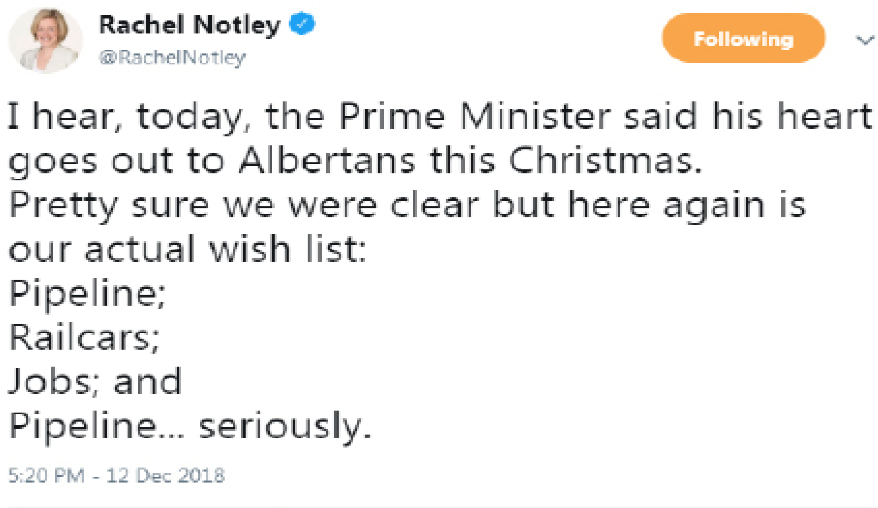
19 *Calgary Herald*, "Opinion: Messing with Alberta's oil production is already hurting," *Calgary Herald* (January 2019).

20 Rachel Notley, "I hear, today the Prime Minister said his heart goes out to Albertans this Christmas...," *Twitter*, (December 12, 2018).



Part 2: How Deep is the Problem?

Canada and U.S. Divergence

As David Goldwyn, a senior State Department official during the Obama administration, and others have pointed out, Alberta's curtailment policy is another step in a trend toward re-nationalization of Canada's oil sector.[21] As far back as 2012, following CNOOC Group's purchase of Nexen, Prime Minister Harper changed foreign investment review regulations to make it harder for state-owned enterprises to buy Canadian oil sands companies. Following steep oil price declines and continuing market access challenges, 2017 saw Canadian companies buying major assets from international players exiting the oil sands. In 2018, the Government of Canada purchased the floundering Trans Mountain Pipeline expansion project ("TMX", formerly owned by Kinder Morgan, Inc.) and the year concluded with Alberta's government-mandated production curtailment.

In contrast, the U.S. ended its crude oil export ban – itself a multi-decade intervention in international energy markets – and, since then, the U.S. has seen record oil production, record export volumes and substantial foreign investment by companies looking to capitalize on U.S. shale resources.

There can be little doubt that President Obama bears much of the responsibility for this divergence. In the space of a few weeks in 2015 he

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21 David Goldwyn, Interview with Meghan Gordon and Brian Scheid, "Has Alberta become OPEC North?" *Capitol Crude Podcast,* (January 07, 2019).

rejected the Keystone XL Pipeline Project ("KXL") and signed legislation ending the U.S. crude oil export ban.

Had KXL been approved in 2015, it would be moving 720,000 barrels/day of Canadian crude today,[22] eliminating the need for Alberta's 325,000 barrels/day production curtailment and likely weakening the case for Canada's purchase of the Trans Mountain Pipeline. Instead, the President's decision removed vital takeaway capacity just as oil prices declined. This led, in part, to foreign investors exiting Alberta and cemented many Canadians' belief that Canada needed to control its own economic destiny buy building a domestic pipeline like TMX.

President Obama's decision stemmed from a multiyear advocacy campaign waged by U.S. environmental groups founded on the belief that it would be easier to convince governments to stop pipelines than upstream oil production. The last few years have validated this strategy but also has driven Canadian governments to intervene in new ways to try and maintain a core economic sector. Environmental groups now find themselves combatting governments directly in an ongoing contest to determine the growth prospects of Canada's oil industry.

Where does this leave Canada?

As discussed in Part 1, there can be little doubt that investors face many complicating factors as they assess Canada's situation. Government intervention can lead to many unintended consequences, undermining the very market signals that drive private-sector investment in needed oil transportation capacity.

The Government of Canada's intervention to save the TMX project brought some near-term benefits by keeping a critical project viable, and Alberta's curtailment policy is really a symptom of the much larger challenge for Canada's energy sector, the lack of pipelines. However, the fact that the government needed to take over a private sector project will not instill confidence in Canada's regulatory system. So, while Alberta production curtailment has temporarily brought price relief for oil sands producers, its initial success and broad support among Canada's political class suggests that there may be pressure for intervention in the future, a prospect that will give investors pause.

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22 TransCanada Keystone Pipeline, L.P., "Final Supplemental EIS for the Keystone XL Project," *U.S. State Department* (2013), 61.

Exit Plan

The Government of Alberta is clear that it does not want to be in the business of managing oil markets. Likewise, the Government of Canada has been clear that it does not see itself staying in the pipeline game. Both governments express a desire for Canada to converge back with the U.S. market-driven model where the private sector drives energy development and transportation.

What is clear, however, is the political and market dynamics that led governments to intervene will likely remain until a new pipeline, either the Keystone XL Project or TMX, comes into service. Enbridge Inc.'s Line 3 Replacement Program and rail cars may alleviate some of the pressure, but oil sands production continues to grow and the sector wants the certainty that comes with sufficient pipeline capacity.

For Alberta, any pipeline delay will increase the difficulty of the curtailment balancing act. While prices have moved in Alberta's favor, the likely costs of the policy in terms of upstream investment and private investment in rail capacity have yet to emerge. Inevitably, the longer the government tries to manage the market the greater the risk that a policy mistake will have lasting consequences on the sector. These risks are in addition to the reputational cost that comes from shaking investor confidence in the stability of Alberta's policy environment.

Premier Notley's public statements before and after curtailment suggest that she was well aware of all of these risks before she took the decision. Her caution also suggests that managing the end of curtailment may be the biggest challenge of all.

To find out more about this issue, see:

Alberta curtailment policy

- Calgary Herald, Messing with Alberta's oil production is already hurting, (January 10, 2019).
- Devika Krishna Kumar and Julie Gordon, Some Canadian producers push back as Alberta orders oil cuts, (December 3, 2018).
- Government of Alberta, Protecting the value of our resources, (2018).

Oil pricing

- OilPrice.com, Oil Price Charts, (2019).

Canadian discount rate

- Matt Lundy, Why Alberta's latest oil-price plunge is unprecedented, (November 27, 2018).
- Mike Hughlett, Bargain Canadian crude isn't easing prices at the pump, (November 12, 2018).

Alberta investment climate

- Canadian Association of Petroleum Producers, Update: A competitive Policy and Regulatory Framework for Alberta's Upstream Oil and Natural Gas, (September, 2018).

OPEC curtailment

- CNBC, Oil Prices hit a 2018 low as OPEC considers an output cut, (November 22, 2018).

Bill C-69

- Megan Helmer, What does Bill C-69 – Impact Assessment Act mean for Canadian resource companies, (March 19, 2018).
- The Globe and Mail, Globe editorial: Bill C-69 kills the National Energy Board but keeps all the problems, (September 26, 2018).