

Current Perspectives

The Crude Politics of Canadian Energy

At a glance

- **Curtailed measures and oil by rail prove positive for Canadian Energy:** The Alberta government's mandated policy curtailments have achieved the desired outcome of reducing the discount applied to Western Canadian Select (WCS) oil. The industry has also responded over the past few years by using rail to export oil; however, this is seen as an interim solution until major pipeline projects are completed.
- **Pipeline construction is the ultimate solution for what plagues Canada's stagnant energy industry:** Federal and Provincial governments need to find solutions to overcome existing barriers and bring completion of large-scale pipeline development to the finish line.
- **Investment implications:** The TD Wealth Asset Allocation Committee is modestly overweight Canadian equities. A combination of supportive valuations and robust free cash flow generation from established names in the Energy sector are key reasons for this stance. Resolving pipeline development constraints could be a catalyst that drives long-term sector and Canadian economic growth.

Pipelines: fuel for a brighter economic future

In October, Canadians went to the ballot box and gave Justin Trudeau a second opportunity to lead the country – but this time as Liberal minority leader.

The post-election atmosphere is often filled with an air of renewed optimism - a collective fresh start with visions for a brighter future. One question on the minds of many Canadian investors is whether this edition of a Trudeau government will successfully find solutions to reignite a Canadian Energy sector that has been mired in a prolonged period of stagnation.

In early 2019, we issued [Decoding the Canadian Crude Conundrum](#), a report outlining the challenges facing Canada's Energy sector. We're revisiting this topic to see what's changed in light of shifts in the political climate and to provide an update on our outlook for the beleaguered Energy sector - the second largest (~16.5%) of the S&P/ TSX Composite Index.

Facing the industry's challenges head-on

It's no secret: Canada's Energy industry has struggled for some time. A primary reason for this is the inability to complete major pipeline infrastructure projects. Pipeline development would enable corporations to more cost-efficiently transport WCS out of landlocked regions of the country to the U.S. or west coast for shipment overseas. Court battles, permitting delays, and political wrangling are all behind the delays.

As a result, WCS has experienced price instability over the years, and in extreme cases reached discounts of close to \$50 versus its West Texas Intermediate (WTI) rival. This created a challenging environment for Canadian producers to operate in, while constraining sector growth and depressing shareholder value.

Quick hit: WCS vs. WTI Price Differential

Extreme differentials between the price of WCS and WTI occur when Canadian oil storage is full and there is insufficient export capacity.

The Alberta government's mandated production curtailment in 2019 has contributed to a narrowing of the WCS discount to WTI to a more 'normalized' range of roughly \$10-\$20 over the past few quarters of the year.



Government curtailments prevent derailment

In response to spread differentials reaching a high point in late 2018 (**Chart 1**), the Alberta government mandated temporary production cuts designed to reduce excess inventories and narrow the price discrepancy. This initiative has had a significant impact on the differential with the discount narrowing and stabilizing to a more 'normalized' \$10 to \$20 range over the last few quarters of 2019. Better pricing has improved the ability of heavy oil producers to generate higher cash flow levels, however, the October 2019 leak and temporary closure of the Keystone XL pipeline shows how fragile the market balance remains as it caused the WCS-WTI differential to widen again to the \$20 range.

Longer-term we expect the price differential between WCS and WTI to be in the \$15 - \$20 per barrel range, with some fluctuation depending on seasonal or shipping factors. At this level oil companies can maintain stable operations, generate higher revenues, and potentially deliver better returns to shareholders. However, Canadian oil producers cannot invest or expand production meaningfully without additional pipeline export capacity. The lack of a permanent export solution has contributed to investors shying away from the Canadian oil sector despite improved WCS differentials and corporate fundamentals. An expanded pipeline capacity network would help lower transport costs, narrow differentials further, and provide an environment where Canadian producers operate unencumbered by export constraints for years to come.

Chart 1: WTI-WCS Differential



Source: Bloomberg, L.P.

Broadeni

Pumping up the rail volume

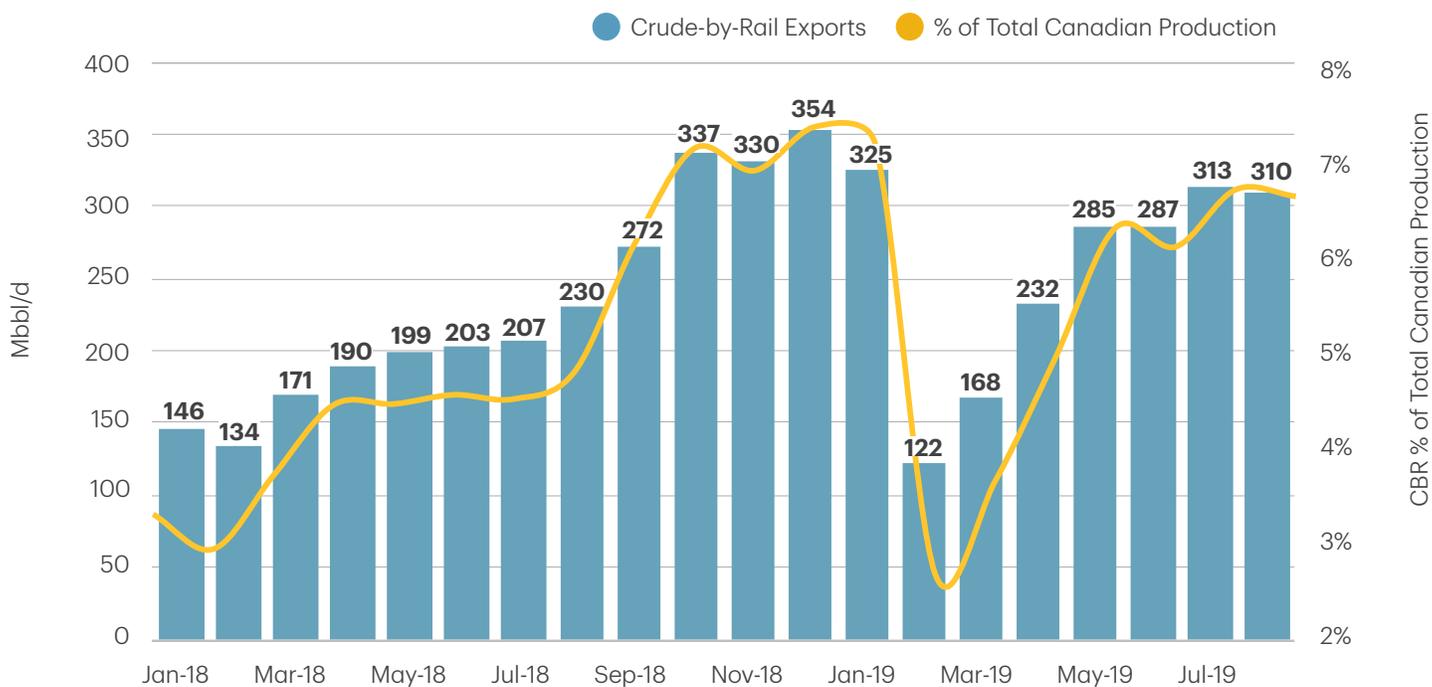
Curtailments have had a positive impact on exploration and production company fundamentals and government revenues. Current curtailment limits are set to remain in place until the end of 2020, as the Alberta government did not intend for these cutbacks to be permanent and are taking steps to phase out the program in an orderly fashion. The Alberta government announced that in December 2019 producers may apply to increase production provided that the oil is moved via rail. Theoretically, this will provide big industry players that have been subject to curtailment, with the flexibility to ramp-up volumes without disrupting differentials.

Over the years, pipeline constraints and wide differentials has incentivized many producers to increase shipments via rail. While exporting oil by rail has helped relieve

oversupply issues in the province, it is more expensive than pipelines. Rail use has fluctuated, but even prior to curtailment, the industry had been generally increasing utilization of rail to transport oil to export markets **(Chart 2)**.

Despite the oil-by-rail success, Alberta's current Conservative majority government has expressed philosophical objections to the Provincial government's own involvement in underwriting rail contracts entered into by the previous NDP government. They are now working to transition the leasing of locomotives and rail cars, to transport 120,000 barrels per day (b/d) of oil, to the private sector.

Chart 2: Crude by rail shipments



Source: Canada Energy Regulator (formerly National Energy Board)

Productive

Pipelines for progress

With Canada being a significant net exporter of crude oil, pipeline construction remains the ultimate solution for what ails the Canadian energy industry. Below is an update on some key projects, when once completed, could potentially energize a Canadian energy sector and Canadian economy much in need of a boost. These projects remain supported by the industry; however they continue to face various legal and regulatory challenges that make it uncertain when or if they will be built.

While Enbridge's Line 3 and TC Energy's Keystone XL projects remain mired in U.S. issues, the Trans Mountain Expansion (TMX) requires primarily a Canadian solution. The Federal Liberal government purchased TMX in 2018 and have indicated they want to use the profits to fund clean energy projects while keeping TMX out of any minority government negotiations.

Pipeline Project	Status
Enbridge's Line 3 Replacement Program	<ul style="list-style-type: none"> • Enbridge is working to replace its aging Line 3 pipeline • Canadian portion is built, and parts of the line have recently been brought into service • Regulatory hurdles are still pending in the U.S. i.e. environmental studies and permitting delays in Minnesota • This project was expected to be fully operational by the end of 2020, but delays may extend this into 2021
TC Energy's Keystone XL	<ul style="list-style-type: none"> • Keystone XL is an additional leg of TransCanada's existing oil pipeline system that is expected to transport 830,000 b/d of oil from Alberta into Steele City, Nebraska • In 2015 Keystone XL's application was rejected by then-U.S. President Obama, before being resurrected by President Trump • The pipeline is still facing court challenges and awaiting federal and state permits; will likely require 2-3 years to construct • Significant capital investment unlikely to go ahead before the 2020 Presidential election concludes
Trans Mountain Expansion	<ul style="list-style-type: none"> • A proposed twinning of the existing pipeline that carries crude and refined oil from Alberta to the coast of British Columbia • Liberal government purchased the pipeline for \$4.5 billion in 2018 and will want to complete the project, because in their view, it's in the national interest • Project re-approved by federal government in 2019 and construction authorized • Federal Court of Appeals still hearing legal challenges on the adequacy of First Nations consultations

Solutions

TD Wealth Asset Allocation Committee (WAAC) Perspective

Relative to where Canada's energy industry was a year ago, we feel that progress is being made. Political intervention and regulation have helped minimize differential volatility risk. With more predictable pricing there is greater reason to be optimistic about the industry's prospects. The Alberta government's plan to transfer rail contracts to the private sector, combined with the continued easing of curtailment restrictions, should benefit the industry.

The WAAC currently has a modest overweight stance on Canadian equities. A combination of supportive valuations and robust free cash flow generation from established names in the Energy sector is a key reason behind this view.

It goes without saying that completing major pipeline projects is critical to the overall health of the Canadian

market and Energy sector. Until energy really starts to work for the Canadian economy, it's difficult to see the market taking on an elevated stature in the minds of many investors.

We believe investment opportunities exist as Canadian energy companies trade at about a **10% discount** to U.S. peers, as measured by the trailing 12-month price/cash flow ratio.¹



¹ FactSet

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