Trans Mountain Storm Clouds Darken Outlook for Canadian Oil Market Access

- **The outlook for Western Canadian oil market access was dealt a significant blow on August 30 when the Federal Court of Appeal voted unanimously to overturn Ottawa's approvals for the Trans Mountain Pipeline Expansion Project.**
- **This decision pushes back a potential TMEP in-service date by at least one year to 2022–23, in our view, raising the stakes for the KXL pipeline and extending the period of sub-optimal pricing for Canadian crude exports given the interim need for higher cost oil-by-rail services.**

The outlook for Western Canadian oil market access was dealt a significant blow on August 30 when the Federal Court of Appeal (FCA) voted unanimously to overturn Ottawa's approvals for the Trans Mountain Pipeline Expansion Project (TMEP), which had officially commenced construction only days earlier. Prior to the FCA's decision, the TMEP was expected to enter service in 2021 and would transport crude from Edmonton to tidewater in Vancouver. This decision pushes back a potential TMEP in-service date by at least one year to 2022–23, in our view, and complicates the politics of pushing the project forward for its new owner, the Federal Government. Western Canadian oil pipeline capacity is already maxed out and weaker prospects for TMEP increase the importance of other potential pipeline projects like Keystone XL (KXL) given the need for at least two of the three major proposed pipeline projects to satisfy expected takeaway demand by the early 2020s. A slower startup for the twinned Trans Mountain pipe extends the period of time that the Canadian oil patch will need to bear the weight of steeper discounts for Canadian heavy crude, which reflect the higher cost of transporting marginal barrels to end markets by rail.

WHAT HAPPENED AND WHAT'S NEXT FOR TRANS MOUNTAIN?

The FCA took two main issues with the TMEP approval process, finding that: 1) Phase III consultations with First Nations groups fell short of the government's obligation as determined by the Supreme Court of Canada (SCC), and 2) the National Energy Board's (NEB) report and recommendation wrongly excluded consideration for additional Pacific tanker traffic that the pipeline would create in the scope of its cost-benefit assessment. The two potential next steps for the government include 1) appealing the FCA's ruling to the SCC—the time-debt of which is likely to be measured in years—and 2) conducting a redetermination, which will require the NEB to consider tanker traffic impacts and a do-over of Phase III consultations with First Nations communities.

In our view, the length of time associated with either of these options is likely to delay a TMEP in-service date by at least one year and increases the likelihood that the project is abandoned altogether, joining the similarly ill-fated energy infrastructure projects like Northern Gateway and Energy East. Even if remedying the issues identified by the FCA takes less than a year, as some more optimistic legal observers contend, it will at the very least take a matter of months which would miss the 2018 summer construction window that Ottawa was targeting, keeping the effective delay around one year. The ruling also prompted Alberta's

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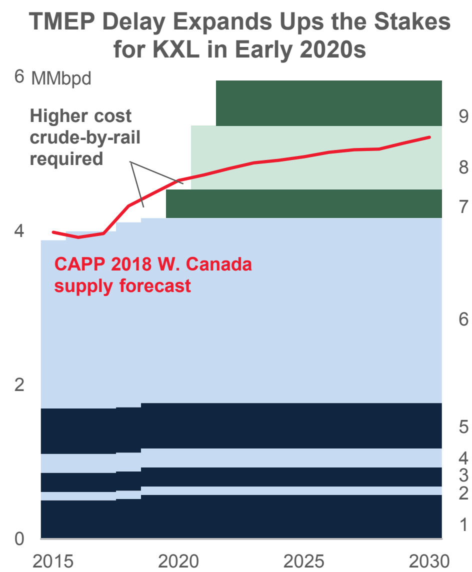
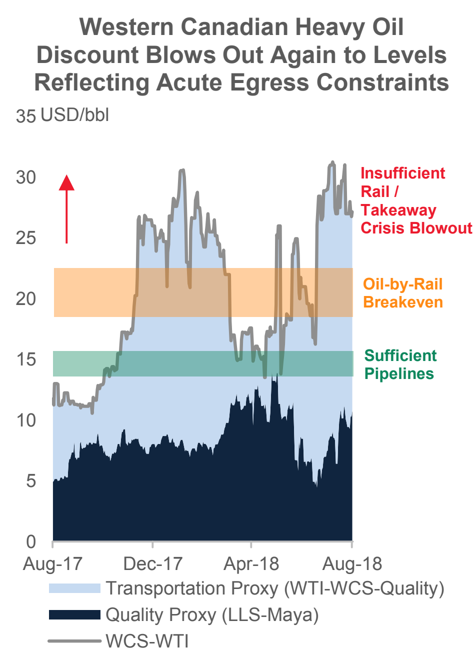
Chart 1



Source: Scotiabank Economics, CAPP.

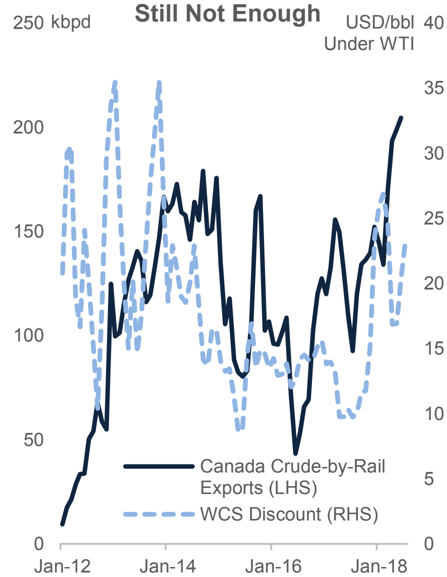
Chart 2



Source: Scotiabank Economics, Bloomberg.

provincial government to announce its intention to withdraw from the federal climate change strategy, citing the fact that the national plan was sold as a compromise that included pipeline approvals and market access for the Canadian oil patch.

Chart 3



Source: Scotiabank Economics, Bloomberg, NEB.

WHY IS THE TRANS MOUNTAIN EXPANSION PROJECT IMPORTANT?

There are three oil pipeline projects at various stages of the planning process in Western Canada—Enbridge's Line 3 (370 kbpd), Kinder Morgan's TMEP (590 kbpd), and TransCanada's KXL (830 kbpd)—and we are going to need two of those three pipes to satisfy demand for egress out of the Western Canadian Sedimentary Basin (WCSB) by the early 2020s (chart 1). Line 3 is the most likely of the projects to be completed and is expected to come online in early 2020, but the pipeline is also the smallest of the three contenders. A second pipeline, either TMEP or KXL, is needed and the two projects have spent years trading places as the favoured horse of analysts attempting to pin down potential in-service dates. Ottawa's late-May decision to purchase TMEP and the existing Trans Mountain system from Kinder Morgan in an effort to accelerate the project's completion made TMEP a clear favorite to beat KXL to the finish line. However, the court's decision to nullify previous approvals is a material blow to project's prospects and potential timeline, raising the stakes for the schedule underpinning the KXL pipeline—high-profile opposition to which essentially started the modern anti-pipeline movement.

WHAT DOES THIS MEAN FOR WESTERN CANADIANIAN OIL DISCOUNTS?

The TMEP news comes at a time when the discount borne by Western Canadian Select (WCS), Canada's primary heavy crude benchmark, is once again blowing out to levels reflecting an acute crisis in takeaway capacity. The differential between WCS and WTI rose back above $30/bbl in early-August on a combination of Midwest refinery weakness, Syncrude's operational return, and weaker-than-needed rail performance. We are operating on the knife's edge of takeaway capacity limits out of Western Canada and even small movements in production, refinery demand, or rail activity can easily push discounts $10/bbl higher over a week.

The WCS discount can be thought of as shifting between three different ranges (chart 2) based on the state of midstream assets between Western Canadian producers and their customers in markets typically south of the border. The discount is composed of two main elements: 1) a quality differential based on the fact that Canadian heavy oil is more expensive to refine than benchmarks like WTI, and 2) a transportation differential based on the cost of transporting a barrel of crude to end users. While the quality differential moves around based on the relative demand for heavy sour crudes, it is relatively stable compared to transportation factors. When pipeline capacity is sufficient, the WCS discount averages around $15/bbl under US light sweet benchmark WTI, reflecting quality differences and the price of pipeline tolls (see our piece from February for a fuller exploration of Western Canadian oil discounts). Discounts rise to around $20/bbl when oil-by-rail is needed to transport stranded barrels to market and should be a theoretical ceiling to the WCS discount due to rail's greater flexibility. However, in times of acute takeaway tightness, rail hasn't been able to keep up with demand and discounts have spiked toward $30/bbl. These periods will be painful but likely short-lived as rail providers move to close lucrative arbitrage opportunities. Furthermore, the longer we linger on the knife's edge of sufficient takeaway capacity, as we have been for almost a year now, the more value will be lost due to these periodic differential blowouts on small shortfalls in marginal takeaway.

TO WHAT DEGREE CAN OIL-BY-RAIL SERVE AS A STOP-GAP SUBSTITUTE?

One sector that has been booming in this era of pipeline scarcity are firms hauling barrels by rail. Canadian oil-by-rail shipments reached all-time highs of 205 kbpd in June (chart 3), up from 134 kbpd as recently as February and from virtually nothing before 2012. Prospects for future oil-by-rail growth are even more promising; in a world where Line 3 is built but TMX and KXL have stalled indefinitely, the additional demand for oil-by-rail will approach more than 400 kbpd by the mid-2020s, a 200% increase over current, already record-setting levels. Oil-by-rail capacity is difficult to measure because while terminal capacity—the facilities that form the jump-off point for shipments—is more than sufficient to meet this increased demand load, the real sticking point is the availability of proper railcars and trained crews. While realized oil-by-rail shipments are currently insufficient to meet current demand, as indicated by prevailing WCS discounts, we continue to expect to see volumes gradually increase over the coming 2–3 years as rail companies are able to mobilize sufficient assets.