Alberta Government Cuts Provincial Oil Output

- **The Alberta government is planning to curtail provincial oil production by 325 kbpd (8.7%) beginning January 1st, 2019 in an effort to reduce the extraordinarily large discounts borne by Western Canadian crude stemming from insufficient pipeline capacity.**
- **The provincial government estimates that the current surplus of production over takeaway capacity is 190 kbpd, with the additional 135 kbpd cut intended to facilitate a draw-down of excess inventories that have built up over the egress crisis period.**
- **The policy intervention is expected to accelerate the rebalancing of the Western Canadian oil patch that is already taking place, and Western Canadian Select (WCS) discounts are now expected to average nearer $20/bbl under WTI in 1Q19 relative to a pre-announcement forecast of $29/bbl; discounts are then expected to remain relatively steady and annual average discounts are now expected to average $20/bbl in 2019 relative to a pre-announcement forecast of $24/bbl.**

This note is the latest in our ongoing coverage of the Western Canadian takeaway crisis and is meant to be **an initial reaction to the curtailment policy announcement rather than an in-depth discussion until additional details are released**. Our earlier research on this topic can be found here, here, and here.

THE PLAN: HOW BIG ARE THE CUTS & HOW LONG DO THEY LAST?

In a Sunday evening address, Premier Rachel Notley announced that **the Alberta government is moving to curtail provincial oil production by 325 kbpd (8.7%) beginning January 1st 2019 in an effort to narrow the extraordinarily large discounts borne by barrels of Western Canadian crude (chart 1)**. These acute discounts are the direct result of insufficient pipeline capacity, which increases the cost of transporting oil from where it's produced to where it's consumed**.** Premier Notley was clear that the only long-term solution remains the construction of additional pipelines; production cuts are meant to soften near-term discount pressure while the previously-announced oil-by-rail purchase is meant to provide medium-term insurance. **The curtailment policy will accelerate the natural rebalancing that was already taking place (chart 2) and WCS discounts are now expected to average nearer $20/bbl under WTI in the first quarter of 2019 relative to a pre-announcement forecast of $29/bbl**.

The curtailment will be implemented on an operator rather than a project-level basis and the first 10 kbpd of production is exempt from cuts, which will insulate smaller producers from the policy; only 25 of the more than 300 producing companies in Alberta produce more than 10 kbpd. The baseline against which cuts will be compared is the highest six-month production period over the past twelve months. **This baseline benefits producers that have already moved to pull back production in the face of low pricing and poor economics, while likely punishing producers that have recently ramped up production** given that new output will not have yet worked its way into a full six-month average period. This 325 kbpd curtailment should be compared to our baseline

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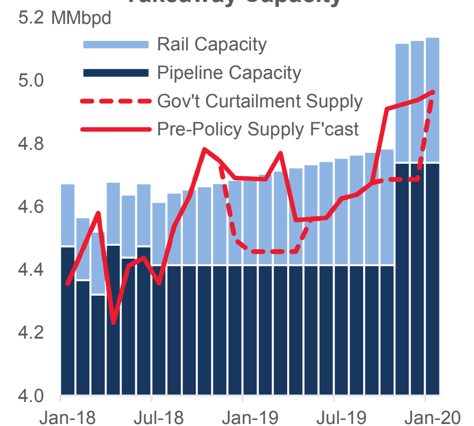
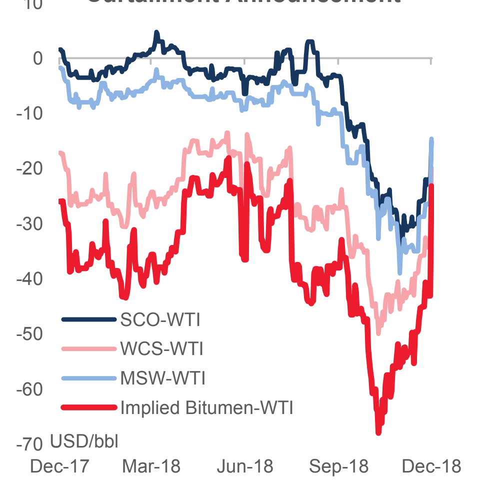
Chart 1



Notes: Curtailment supply assumes excess inventory worked off after 4 months and is only for illustrative purposes until more details are released.
Sources: Scotiabank Economics, Scotiabank GBM, CAPP, AER.

Chart 2



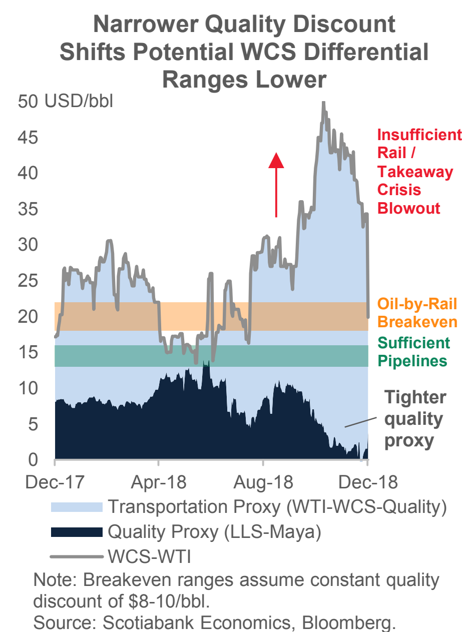
Sources: Scotiabank Economics, Bloomberg.

assumption 150 kbpd of economic shut-ins through 1Q19, with a net impact of nearer 175 kbpd.

The government estimates that the current surplus of provincial oil production over combined pipeline and oil-by-rail capacity is roughly 190 kbpd. The additional 135 kbpd (325 – 190 kbpd) is meant to drain the glut of excess crude in storage that has been built up amid takeaway constraints. Provincial oil inventory is estimated by the government to currently stand at 35 million barrels, which it says is "about twice normal levels". The volume of curtailed production is set to fall to 95 kbpd once the roughly 17.5 million barrels of "excess" inventories are drawn down, which would take roughly 4 months at 135 kbpd though the rebalancing could be quicker given the assumed increase in oil-by-rail capacity over that period. The curtailment policy also includes a termination date of December 31, 2019, which reflects the expectation that Enbridge's Line 3 will enter service and alleviate egress constraints.

There is also a possibility that WCS discounts narrow further than we're expecting as inventories draw down through the first quarter of next year due to declining quality-related discounts around the US Gulf Coast. We have long benchmarked WCS discount performance against theoretical ranges associated with sufficient pipelines ($10–15/bbl) and oil-by-rail economics ($18–22/bbl). However, while these levels are a useful heuristic for understanding the relative impact of pipeline bottlenecks, we assumed a steady "quality" discount of roughly $8–10/bbl, which reflects the typical premium enjoyed by light sweet crudes like WTI over heavy sour crudes like WCS. But this quality discount is also a moving target and is currently sitting nearer $1–2/bbl (chart 3) as surging ultra-light US shale production runs up against falling heavy supplies from Venezuela and Mexico. If relative heavy pricing remains stable at current levels and WCS barrels are able to tap into that rising demand for those heavy crudes, we could theoretically see discounts fall toward $9–13/bbl reflecting rail transport economics alone without any additional quality discount.

Chart 3



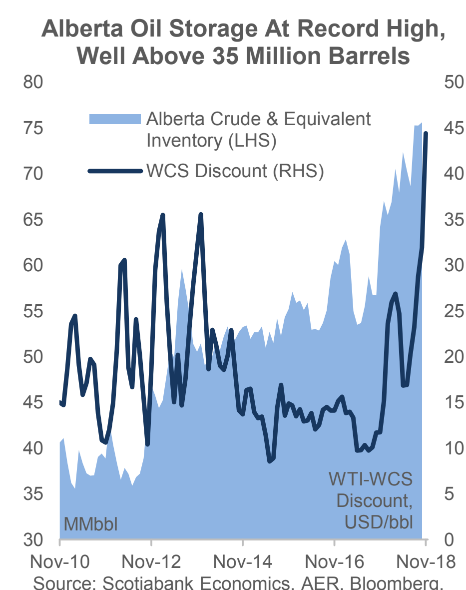
Note: Breakeven ranges assume constant quality discount of $8-10/bbl.
Source: Scotiabank Economics, Bloomberg.

BENCHMARKING PROGRESS REQUIRES CLARITY ON INVENTORY STATISTICS

The main question we have following the curtailment announcement relates to provincial oil inventory statistics, which will be a key indicator to follow over the coming months as the government adjusts allowable production levels and assesses the efficacy of its policy intervention. Storage levels stand at roughly 35 million barrels today according to the provincial government's press release, which it claims are twice as large as they should be. Meanwhile, the Alberta Energy Regulator—the regulatory body charged with the administration of the curtailment policy—publishes a monthly report that puts inventories north of 75 million barrels as of October (chart 4).

We believe the discrepancy is due to one of two factors: 1) a distinction between "working" storage and total storage, the latter of which would include structural inventories needed to guarantee the steady flow of oil essential to the smooth operation of refineries and pipelines, and would thus not need to be drawn down; 2) a distinction between total provincial oil inventories and inventories held at key storage hubs like Hardisty and Edmonton, though this could similarly mirror the first interpretation that major hubs are where most surplus or merchant storage capacity exists. This statistical question doesn't change the process of how the policy is implemented, but clarification on this point from government would assist the market in better benchmarking the initiative's progress. Given the relatively weak provincial inventory estimates readily available to the market today, this policy intervention could provide the government with an incentive to address this long-standing information gap to the benefit of future price formation and general oil patch understanding.

Chart 4



Source: Scotiabank Economics, AER, Bloomberg.

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