An oil rig worker in Alberta. The discount on Canadian oil in the US, as much as $40 per barrel, seriously impacts the royalties of producing provinces, and the tax revenues of Ottawa. iStock photo

Canada's Cut-Rate Oil: Temporary or Permanent?

Douglas Porter and Earl Sweet

The oil discount of Western Canadian Select to West Texas Intermediate has been as high as $40 per barrel. And with WTI crude discounted to the world price, the actual discount to WCS can be even higher. Relatively low prices in Canada pose a serious challenge to oil producers and their servicers, and the differential has been a major trigger of softer economic activity in Western Canada. Federally, while Canada does not directly collect resource royalties, the wider discount has a negative impact on revenues through lower corporate and personal tax receipts and nominal GDP growth. But developments now under way, including pending pipeline projects, will expand the demand for heavy oil and facilitate its flow south to major refining hubs in the Midwest and the Gulf Coast. Meanwhile, the discount has narrowed sharply since the beginning of the year and should narrow further over the next year, boosting revenues of Canadian producers.

The discount on Canadian oil in US markets is a major issue for governments both in oil producing provinces and in Ottawa, which have seen declining royalty and tax receipts as result of lower oil prices and industry profit margins.

The good news is that the discount has narrowed substantially so far in 2013, partly due to seasonal demand for bitumen (i.e., asphalt, etc) but also thanks to completed refinery maintenance in the Midwest and more pipeline capacity linking the Cushing crude oil hub and the Gulf Coast refineries.

The oil price discount of Western Canadian Select to West Texas Intermediate has recently been as high as $40 per barrel. With WTI crude itself tracking below world prices, the actual discount to WCS product was even higher.

It is no mystery what this means to federal policy makers – lower revenues, a lot lower. The March 2013 federal budget forecast a shortfall of $4 billion in federal tax revenues due to the oil discount, a number which exceeds the contingency reserve of $3 billion.

For Finance Minister Jim Flaherty, this makes his task of managing the fiscal framework, and his target of balancing the budget by fiscal 2015, all the more daunting.

Discounted oil prices in Canada have caught national attention. The WCS discount from the WTI benchmark price has historically been very volatile, reaching a monthly average peak of 38 percent in December 2012 (*Chart 1*). At times during December, the discount rose to the vicinity of 50 percent. The impact on Canadian producers has been exacerbated by the fact that WTI itself has been trading at a significant discount from international prices (*Chart 2*) due to the growing mid-continent glut of oil stemming from insufficient pipeline capacity to transport oil south to the major Gulf Coast refining hub.

There's no doubt that relatively low prices in Canada, were they to persist, pose a serious challenge to oil producers and their servicers, particularly smaller operations that don't have the financial strength to comfortably weather the rough ride. This is amply evident in equity prices. For instance, the S&P/TSX index for oil & gas energy exploration and petroleumproduction companies fell 3.3 percent year to year by the end of the first week of May, while the overall index rose 5 percent.

The wider differential received by Canadian producers of heavy oil relative to WTI prices has been a major trigger of softer economic activity in Western Canada (particularly in Alberta). The good news is that the discount has narrowed substantially so far in 2013, partly due to seasonal demand for bitumen (i.e., asphalt, etc) but also thanks to completed refinery maintenance in the Midwest and more pipeline capacity linking the Cushing crude oil hub and the Gulf Coast refineries. Despite the challenge, oil production in Alberta was still up a solid 16 percent year over year in the fourth quarter of 2012, and Canadian exports to the United States rose 8.4 percent. However, capital spending intentions in the sector, surveyed in late 2012 and early 2013, are flat for this year.

The rise in the WTI benchmark and narrowing of the WCS discount from WTI since the time of the survey may mean that investment this year outperforms initial expectations, just like investment last year underperformed by a huge margin.

If reality matches intentions, that would mark the second consecutive year of virtually no growth in investment, following huge increases in 2010 and 2011. Weak capital expenditures in the oil and gas and related industries are a primary factor in our assessment that Alberta's real GDP growth will cool from 3.9 percent in 2012 to an estimated 2.5 percent this year.

More broadly across Canada, a wider discount has a negative impact on the terms of trade and investment activity. The Bank of Canada estimated in its quarterly Monetary Policy Report in January that deterioration in the oil-related terms of trade (i.e., WCS discount from imported Brent) cut national real gross domestic income (GDI) growth by an annualized 0.2 points in the second half of 2012.

Moreover, low Canadian oil prices are complicating the task of government budgeters, particularly in those provinces that depend heavily on royalties from the industry, not to mention from taxes on related income. Resource revenues are expected to make up 19 percent of Alberta's operating revenue in fiscal 20013-14, with almost half, 46 percent, of that coming directly from bitumen royalties. The province estimates that a $1 drop in WTI prices or a 1 percent increase

Chart 1: WIDE DISCOUNT NARROWING
(% deviation below WTI) Western Canada Select (WCS)

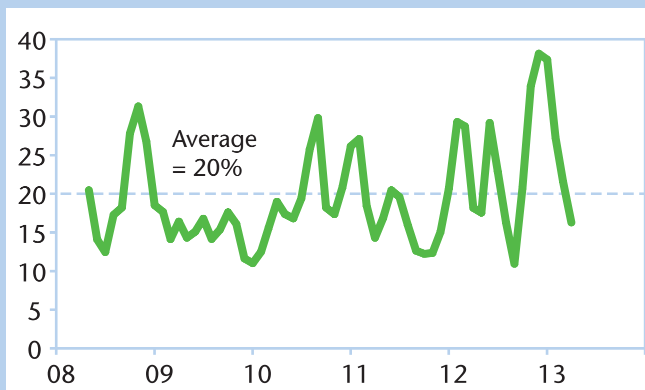


Chart 2: THE DOUBLE DISCOUNT
(US$/barrel) Crude Oil Benchmarks

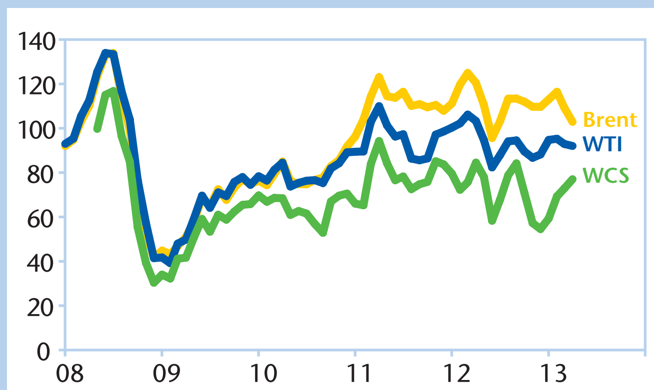


Chart 3: ENERGY DRIVES INVESTMENT
(average % change during period) Business Investment

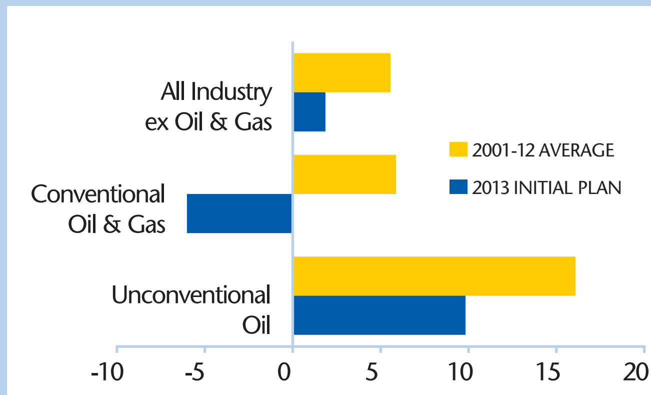
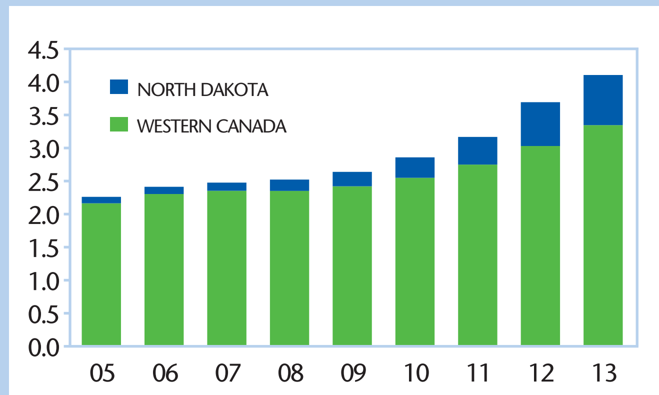


Chart 4: FAST GROWTH NORTH OF CUSHING
(millions of barrels per day) Crude Oil Production



in the WCS discount would cut revenues by an estimated $140 million. So, all else being equal, a 10 percent widening of the WCS discount would cut overall provincial operating revenues by nearly 4 percent. Additionally, lower prices received by oil sands producers could temper demand for land lease sales, applying additional downward pressure to revenue not captured by the above sensitivity (land lease sales are expected to make up 16 percent of resource revenue in fiscal 2013-14).

Federally, while Canada does not directly collect resource royalties, the wider discount has a negative impact on revenues through lower nominal GDP growth and growth in corporate and personal tax receipts. This year's budget estimated that lower Canadian crude prices, relative to global benchmarks, cut GDP by about $28 billion per year, which again translates into more than $4 billion in foregone federal revenues—that would be 1.5 percent of total federal revenues for the current fiscal year.

Furthermore, investment has been one of the leading drivers of the Canadian economic recovery, along with residential construction. Now, with the housing market taking a strategic pause and consumers and governments gearing down, investment may be the only domestic driver. This will be a tall order, given the relatively small size of capital expenditures in the economy and the fact that, during the past three years, oil and gas sector capital expenditures (*Chart 3*) accounted for close to 20 percent of total private sector investment.

Since December, the oil discount has fallen sharply to 22 percent, not far above its long-run average of 19 percent. While there will be inevitable fluctuations along the way, we expect the discount to trend further downward. Its notable rise late in 2012 and early in 2013 reflected the sharp ramp up of both North Dakota and Alberta crude oil production last year – a combined increase of about 600,000 barrels per day – competing for limited space on pipelines south to Cushing Oklahoma, the pricing point for WTI on the NYMEX (*Chart 4*). Longer-than-expected Midwest refinery outages contributed to the discount by temporarily reducing the demand for Canadian crude. However, rising heavy oil conversion capacity in Midwest refineries will increase the demand for Canadian crude by the second half of 2013, by close to 300,000 barrels per day.

Additionally, a number of pipeline projects currently under way or proposals being developed will help reduce the bottlenecks from Cushing to major Gulf Coast refineries, where there remains substantial unused capacity (more than one million barrels per day) for upgrading heavy oil, and from Canada to the Midwest. These include: the recent expansion of the Enbridge/Enterprise Seaway pipeline from Cushing to the Gulf to a capacity of 400,000 barrels per day and the planned twin line following the same right-of-way that would further expand capacity to 850,000 by mid-2014; the southern leg of TransCanada's Keystone XL Project that commenced construction last August and should be ready during the second half of 2013, initially adding 700,000 barrels of daily capacity; Enbridge's Flanagan South Pipeline, that would expand the capacity of transporting northern oil south by close to 0.60 mmb/d600,000 barrels per day by mid-2014; and, the proposed reversal of Enbridge's Line 9 Pipeline, that would facilitate the flow of Alberta oil to Montreal and possibly further east, reducing reliance on imports. Of course, approval of the full Keystone XL Project would slice into the western Canadian discount by providing a direct artery from Alberta's oil sands to the Gulf Coast refining hub, with initial capacity of more than 800,000 barrels per day.

Even these major pipeline expansions will be hard-pressed to keep up with rising production in Alberta, Saskatchewan, and North Dakota. This highlights the importance of accessing new markets for Canadian crude through expanded pipeline capacity to the West Coast, the East Coast or both through a re-purposed TransCanada mainline, or both.

While Western Canada producers have been struggling with low domestic oil prices, developments under way will expand the demand for heavy oil and facilitate its flow south to major refining hubs in the Midwest and the Gulf Coast. Both the discount of WTI from Brent and the discount of WCS from WTI have narrowed sharply since the beginning of the year and should narrow further over the next year, boosting revenues of Canadian producers. Although earlier weak pricing may see industry investment remain flat in 2013, it will be at a relatively elevated level and medium-term growth prospects are good. **P**

Douglas Porter is chief economist of BMO Capital Markets. douglas.porter@bmo.com. Earl Sweet is a senior economist at BMO Capital Markets. earl.sweet@bmo.com