

# Forward Perspectives



## Decoding the Canadian Crude Conundrum

### At a Glance

- **Western Canadian Select (WCS):** The reference price for heavy crude from the oil sands, WCS, has faced numerous hurdles over the years, resulting in significant volatility of its price discount versus U.S. West Texas Intermediate crude oil (WTI). Lengthy delays in obtaining approvals and completing export pipeline projects have constrained growth and depressed prices of Canadian oil.
- **Bridges and Short-Term Fixes:** The Alberta government's mandated policy curtailments have helped to narrow the price differential between WCS and WTI, however they are not considered permanent solutions - more will need to be done.
- **Investment Implications:** The TD Wealth Asset Allocation Committee is neutral on Canadian equities and Canadian Dollar, in part because of the energy overhang discussed in this article. If the government successfully addresses prevailing challenges within the Energy sector, it could act as a catalyst for increased investment in Canada.

## Will Oil Power a Brighter Canadian Energy Sector?

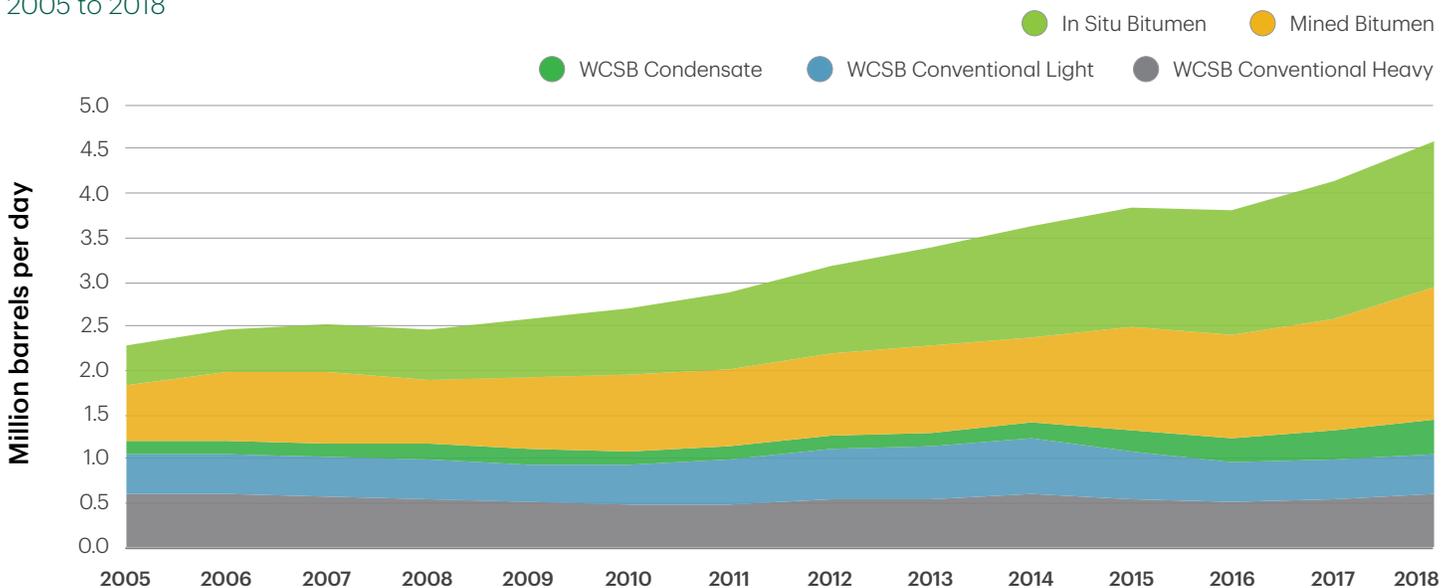
**Oil, black gold, Texas tea or rock oil** – choose your preferred term - is a crucial natural resource consumed throughout the world, and an important driver of the global economy. Here at home, WCS - the oil extracted from Alberta's Oil Sands – has major implications on the prosperity of the Canadian energy sector and broader economy.

Energy is the second largest sector (~19%) in the S&P/TSX Composite Index, Canada's stock market gauge,

behind only Financials (~36%)<sup>1</sup>. Canada's Energy sector accounts for almost 11% of nominal Gross Domestic Product (GDP)<sup>2</sup> and crude oil production in Canada has more than doubled since 2005 (**Chart 1**), with total production exceeding 4.5 million barrels per day (b/d) at the end of 2018. Despite Canada's production growth record, the Energy sector is mired in political and social upheaval, casting a shadow over its prospects, as well as over the broader Canadian stock market and currency. Is there a brighter path forward? Let's drill into the details and determine if Canada's vast oil reserves can be the engine that ignites Energy sector growth and the Canadian equity market, well into the future.

**Chart 1: Crude Oil Production from the Western Canadian Sedimentary Basin (WCSB)**

2005 to 2018



Source: NEB, Canada's Energy Future: 2018.

## A Hot Commodity

Before we can see a way forward, it's important to understand the main issues surrounding Canada's oil industry, their potential investment implications, and the outlook for the sector. A brief look back is needed to help explain the current climate, how we've arrived here and the urgency around pipeline development.

Prior to 2014, when U.S. shale oil (an unconventional oil produced from oil shale rock fragments) emerged onto the scene, oil was viewed as an invaluable finite resource that was depleting at a relatively rapid rate. Alternative

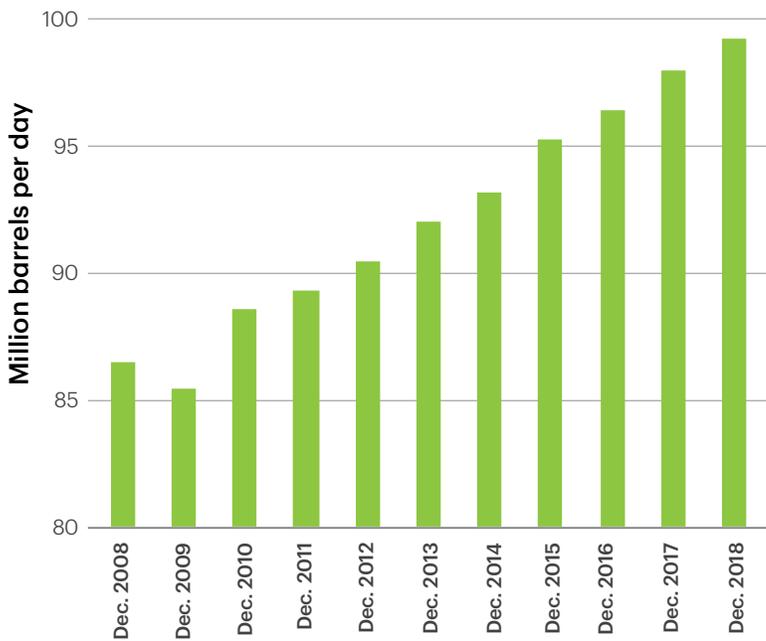
resources and technology, such as mainstream renewable energy and electric cars, were not yet major disrupters to the oil industry. As a result, there was significant demand to find, extract and refine all available resources. During this time, Canada's extensive oil sands became highly coveted, elevating the country's status as a legitimate competitor in the global oil space. Large investments were made, and the production and export of oil became a significant source of growth for the Canadian economy.

This supportive environment for WCS was disrupted when U.S. shale oil gained prominence, which

contributed to a global oversupply, and caused the price of oil to collapse in 2014. Furthermore, the growth of Canadian production caused existing export pipelines to operate near capacity, forcing producers to turn to rail - a more expensive transportation option. This pipeline constraint led to wider and more volatile price differentials for WCS versus WTI and hindered the industry's willingness and ability to invest in future growth projects.

However, these obstacles did not necessarily foretell the end of Canada's energy industry. Globally demand for oil continues to increase (**Chart 2**), and oil is expected to remain a crucial transportation fuel for decades to come. The key will be how energy producers, pipeline companies, and the Canadian government work to overcome the existing barriers and meet this still-growing demand, while elevating Canada's status as a capable world-class energy producer.

**Chart 2: International Energy Agency Crude Oil Demand World Total**



Despite technological advancement and alternate renewal energy sources, **global demand for oil continues on an upward trajectory.**

Source: Bloomberg, L.P.

## Pipelines and Politics

During the era of \$100 price per barrel (p/b) oil (2011 – 2014), Canadian oil companies like Suncor Energy and Canadian Natural Resources invested billions of dollars in oil sands projects to grow production. It was believed that pipelines would be built to ship this additional supply into the U.S. or to reach tidewater and access overseas markets. These projects included major initiatives such as Enbridge's Line 3 Replacement Program, Keystone XL, Energy East and the Trans Mountain Expansion.

Unfortunately for oil producers, these pipelines did not proceed as anticipated. A complex mix of political and environmental factors, along with considerations for Indigenous Peoples, yielded delays or even cancellations. This resulted in a massive surplus of oil being trapped in Alberta with nowhere to go. By mid-2018 storage facilities in Western Canada were overflowing with excess supply, resulting in a precipitous decline in the price of WCS versus its U.S. counterpart. At its worst point, the price differential of WCS versus WTI spiked to \$50 in October 2018 (**Chart 3**).

Investor sentiment on Canadian oil arguably reached its low point in late 2018, due largely to the persistent challenges facing the industry. Today many investors feel disenchanted when looking at Canada's energy sector as a viable investment opportunity, at least while pipeline construction barriers remain. Canada has recognized the need to seek solutions to shift from this negative sentiment and create a more stable investment environment - which explains the Alberta government's decision to intervene.

## Alberta Government Mandates Temporary Fixes

In December 2018, with the spread differential reaching

a high point, Alberta Premier Rachel Notley mandated an 8.7% (325,000 b/d) oil production cut beginning January 1, 2019, to help drain some of the excess supply and pump up prices. This decision was designed to help provide time for reconstruction of Enbridge's Line 3 (an older line being upgraded) to increase takeaway capacity by ~370,000 b/d to its original 760,000 b/d. While the Alberta government has since eased mandatory production cuts as the price of oil increased, the industry remains concerned about the underlying problem that drove the curtailment in the first place: a lack of adequate pipeline capacity. However, the production cuts had an immediate impact on the differential, with the discount on WCS initially narrowing to ~\$9 per barrel, versus WTI, before widening modestly, as shown in the chart below.

**Chart 3: WTI-WCS Differential**



Source: Bloomberg, L.P.

## Why is there a price difference between WTI and WCS?

**Not all oil is created equal.** The price a producer receives for a barrel of oil depends on the type of oil, transportation costs, and supply and demand factors.

WTI is a light oil and considered to be the highest quality. WCS is a heavy oil mixed with some blends of bitumen and diluents. Since WCS is heavier than WTI and further away from main markets, WCS is priced at a discount to WTI to account for the quality difference and transportation expenses needed to bring it to market. The expected or 'normalized' longer-term price differential is about \$15 - \$20 per barrel, and will vary within this range depending on if the oil is shipped by pipeline or rail.

The pipeline constraints and wide differentials have been incentivizing many producers to increase shipments via rail. The Alberta government furthered this with its own plan to lease locomotives and rail cars to transport 120,000 b/d out of the province by mid-2020. While exporting oil via rails will help relieve the oversupply in the province, it is more expensive than pipelines, and in theory, can lead to a normalized WCS-WTI differential at the higher end of the \$15-\$20 range.

Compounding the issues, the March 2019 announcement of a further one-year delay to Enbridge's Line 3 Replacement program, due to permit holdups, will

likely mean further headwinds for Alberta's struggling oil and gas sector. More trains will be needed to get product to market and the Alberta government will need to decide how long to extend the curtailments beyond the original plan to help keep the market balanced. The construction delays to Line 3 could result in the WTI-WCS differential remaining wide for an extended period. In the long-run, the inability to export oil from Canada will likely continue to constrain industry growth. Confidence in Canada's energy industry can only be restored when a clear direction forward is established – a direction that leads to permanent solutions – pipeline construction.

## Pumping Out Permanent Solutions

If Canada is committed to establishing a prosperous oil industry, then sufficient pipeline capacity will need to be built. For example, by building the Trans Mountain

Expansion, Canada will be able to sell oil outside North America, helping to bring in higher prices for its product. This can enable producers to generate higher revenues, help the government collect more tax dollars and improve investor confidence.

## Here is a closer look at three proposed pipeline projects that could reshape Canada's energy landscape if constructed:

# 1

### Enbridge's Line 3 Replacement Program

Enbridge is working to replace its aging Line 3 pipeline, which once completed is expected to return it to its original capacity of ~760,000 b/d (adding ~370,000 b/d versus current operations). This project is now expected to be fully operational by the end of 2020.

# 2

### TransCanada's Keystone XL

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-President Barack Obama, before subsequently being resurrected by President Trump. The pipeline is still awaiting permits and will likely require 2-3 years to construct.

# 3

### Trans Mountain Expansion

A pipeline that carries crude and refined oil from Alberta to the coast of British Columbia. The expansion is designed to create a pipeline system with the nominal capacity increasing from 300,000 to 890,000 b/d. Although the Canadian government purchased this project last year, it remains mired in legal challenges and in a state of limbo after a court quashed the project's permits. Whether these issues can be reconciled will be critical to the success of the Canada's energy sector.

## TD Wealth Asset Allocation Committee (WAAC) Perspective

The WAAC is overweight equities versus bonds, and geographically we prefer U.S. and Emerging Market stocks; while maintaining a neutral rating on Canada. One of the key drivers of this relatively cautious stance on Canada has been the 'energy overhang' reviewed in this article. However, Canadian equities trade at a forward price-to-earnings (P/E) multiple of  $\sim 15x^3$ , a significant discount to U.S. stocks that trade at a forward P/E of  $\sim 17x^3$ , suggesting that some of this overhang is already priced in.

The completion of major pipelines could solve Canada's oil distribution challenges for years to come, help stabilize the price of WCS, and potentially anchor the differential to a range in the low to mid-teens. It could also act as a catalyst to a broad-based reevaluation of Canadian equities.

If pipelines are eventually constructed, valuations of Canadian energy stocks will likely improve, and

drive investment to the entire sector. Having greater and more efficient export capacity would certainly give oil producers more confidence to invest in their business and grow production over the long-run. These outcomes combined, could improve investor sentiment towards Canadian stocks, broadly, and Energy stocks particularly. Additionally, adversity has compelled Canadian oil companies to become better at running their operations and identifying greater efficiencies over the years. Having navigated a maze of challenges, they are now well-positioned to power Canada's energy industry forward, as major infrastructure projects are completed.

For now, the political and social deadlock surrounding pipelines in Canada continues, and a path forward remains elusive. However, we are monitoring developments closely and any tangible signs of progress on pipeline construction is likely to lead us to a more positive view on the Canadian investment landscape.



<sup>1</sup> <https://web.tmxmoney.com/indices.php?section=tsx&index=^TSX#indexInfo>

<sup>2</sup> <https://www.nrcan.gc.ca/energy/facts/energy-economy/2006>

<sup>3</sup> Source: Bloomberg, L.P. Canadian market represented by S&P/TSX Composite Index; U.S. market represented by S&P 500 Index

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