Intelligence MEMOS

From: Grant Bishop

To: Sonya Savage, Alberta Minister of Energy

cc: Louise George, Secretary to the Canada Energy Regulator

Date: September 19, 2019

Re: **Finding the exit door for Alberta's Crude Oil Curtailment**

Alberta's government has curtailed crude oil production in the province since January, imposing production limits on individual producers.

The move was announced as a temporary measure, and the province must now articulate its exit strategy. Without certainty about permitted production, major new investments will remain on hold and producers will remain unwilling to enter into contracts for new takeaway capacity. In particular, any plan must ensure incentives for new crude-by-rail and consider the impacts from inefficient allocation of uncommitted pipeline capacity – specifically, apportionment of nominations on the Enbridge Mainline rather than allocation to those shippers who most value the capacity.

After curtailment, crude-by-rail shipments plummeted and have recovered only sluggishly. Given rail costs, it may be uneconomic to fill take-or-pay volumes through purchases on the spot market when differentials are tight between Western Canadian oil prices and prices in export markets. And the ongoing uncertainty around curtailment discourages buyers just as the provincial government seeks to offload its contracts for 4,400 railcars.

A potential solution is to provide a "carve-out" from curtailment, which would grant an additional quota for production of crude oil equal to any crude-by-rail for which a producer contracts (so-called "rail over curtailment"). A producer could then be confident in profitably shipping rather than paying spot market prices to fill contracted volumes.

However, it is unclear why other forms of contracted takeaway should not also get such a carve-out. That is, why should producers get additional quota for contracting for new crude-by-rail, but not for previously contracted takeaway? A preferential carve-out for new crude-by-rail would comparatively penalize producers who had the foresight to anticipate the constraints and pre-emptively contracted for pipeline or rail capacity.

An alternative would be easing of curtailment, under which any producer is permitted to produce oil up to a limit equal to its contracted volumes for takeaway – whether by pipeline, rail or local refinery. That is, curtailment would only apply to volumes shipped on uncommitted "common carrier" capacity. This would encourage producers to contract for takeaway capacity and provide certainty for producers to produce only what they can ship.

The second consideration for an exit plan is the allocation of export pipeline capacity. While certain capacity is contracted to specific shippers, much is provided on a "common carrier" basis at fixed tolls. For example, the 2.8 million barrels per day that flows to US Midwest markets on the Enbridge Mainline, the network that moves roughly 70 percent of Western Canada's oil, is allocated on a pro rata basis (i.e., apportioned) when nominations exceed available capacity. Apportionment on the Enbridge Mainline has been roughly 40 percent of nominations for past years. Apportionment on TransMountain has been 30 to 40 percent during the past year and apportionment of uncommitted capacity on Keystone rose to nearly 90 percent during summer 2019.

As argued in an earlier Intelligence Memo, the pro rata apportionment of this uncommitted capacity may inefficiently distort local oil prices downward by trapping low cost supply. That is, while a low-cost producer will derive greater profit from producing and shipping oil, a shipper can nominate volumes sourced from a relatively high-cost producer to the common carrier pipeline. This could inefficiently displace a low-cost producer. As a result, low-cost producers could be stuck with residual supply that they must sell into the local market, depressing the local price. A March 2019 federal report also discussed such impacts of over-nominations on prices.

This possible distortion from the inefficient apportionment of uncommitted capacity is particularly relevant to the current debate around Enbridge's proposal to move to long-term contracts on its Mainline. While yet to formally apply to the Canada Energy Regulator (CER), Enbridge has commenced an "open season" to receive offers to contract for shipment volumes for terms up to 20 years.

Enbridge's express aim is transfer risks around export volumes to shippers. However, various producers oppose Enbridge's proposal, arguing it exploits market power in the present takeaway-constrained setting. Suncor has asked the CER to initiate a formal regulatory proceeding and compel a formal application from Enbridge, which opposes this request as premature.

Nonetheless, the present pro rata apportionment of uncommitted capacity – particularly on the Mainline – represents an inefficient allocation. While Enbridge's open season for Mainline contracts expressly seeks to shift risk to counterparties, it is not clear why this is economically inefficient. Indeed, allocating scarce pipeline capacity by long-term contracts should maximize overall profits with capacity allocated to shippers who derive the greatest value.

Looking ahead, Alberta's government must restore investor confidence for investments in new, low-cost production and incremental takeaway capacity. The CER must ensure that pipeline capacity is efficiently allocated and address possible distortions to Western Canadian oil prices. Promoting market competition and economic efficiency should guide this exit from curtailment and the allocation of scarce pipeline capacity.

Grant Bishop is Associate Director, Research at the C.D. Howe Institute.

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