Intelligence MEMOS

From: Brian Livingston

To: Sonya Savage, Alberta Minister of Energy

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Re: **Encouraging more crude-by-rail requires "rail above curtailment"**

As the Alberta government tries to escape its contracts to ship crude by rail, it faces a chicken-and-egg problem of its own making.

Rail is more expensive than pipeline, roughly $18 a barrel to the Gulf Coast versus $10. Therefore, the discount for Western Canadian Select relative to the comparable quality crude at the Gulf Coast (likely Maya crude rather than the more widely quoted West Texas Intermediate needs to be large enough to make these shipping decisions economic.

If the discount is wide, as it was a year ago, rail transport will be economic and rail exports will increase. The provincial curtailment of oil production late last year compressed the discount by February to the point that rail transport dropped. Although a widening discount since then has resulted in the gradual restoration of rail volumes, there is some irony to have rail capacity going unused exactly when Alberta is curtailing oil production because of constrained export capacity.

In order to avoid such a situation, any government policy hoping to increase rail transport has to ensure that such rail transport is economic.

The tools for increasing rail transport are (1) relaxing curtailment so that the discount increases, (2) providing some financial assistance for rail transport, and (3) adopting the so-called "rail over curtailment" concept; namely, that a company that increases rail capacity will have its curtailment reduced by that increase.

Rail transport requires four components to work: loading facilities, rail transportation, rail cars and locomotives, and unloading facilities.

Any shipper wishing to ship by rail must make commercial contracts with each of these four components, and must ensure that the total cost is no more than $18 per barrel at the time the shipping decision is made.

Alberta's previous government announced last February that it would lease 4,400 railcars with about 120,000 barrels per day capacity. The Alberta Petroleum Marketing Commission (APMC) would appear to have been central to the plan. APMC would lease the railcars and locomotives, make rail arrangements with CP and CN and sign contracts for loading and unloading. These contracts would likely be longer term (at least three years) in order to make it economic for the counterparties to make necessary investments in rail infrastructure.

APMC would "aggregate" production, buying heavy oil from Alberta producers (especially smaller ones that lack the necessarily large and consistent volumes to enter into crude-by-rail contracts) and then selling to US refiners.

Last week's Alberta budget stated that the railcar contracts are unprofitable, and the province is prepared to take a $1.5-billion charge to get out of contracts valued at $3.7 billion. In addition, the new government wants only the private sector to be involved with rail. Negotiations are under way to transfer these contracts.

As a first step, it would be helpful if the government at least disclosed the terms of these contracts so that the public would have some idea of what it is trying to divest. It would also be helpful to hear exactly why the proposal of the previous government is uneconomic; i.e., why the increase in revenues would be less that the cost of the contracts.

More substantively, by taking the $1.5 billion charge, the government is implicitly accepting that the original contract terms may be too high for the industry to accept and that it is likely to have to absorb a portion of these costs. By doing so, the government might be able to reduce the railcar costs to something less than $18 per barrel, which would induce industry to create new rail capacity and therefore reduce the need for curtailment. Such new investment would show the benefits of last week's corporate tax cut.

The government needs to face some clear economic realities. Investment in new production will not occur until new export capacity is created. Meaningful new pipeline capacity is at least three years away, even if TMX and Keystone XL are built. New rail capacity is the only immediate export capacity and should create new investment in production, along with the economic activity and jobs that go with it.

At some point, the government will make an announcement regarding these railcar contracts. It may have to use a combination of the three tools described above in order to make rail transport economic. This may well require adopting the rail over curtailment concept before disposing of the existing rail contracts.

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