Intelligence MEMOS

From: Grant Bishop

To: The Honourable Rachel Notley, Premier of Alberta, and the Honourable Margaret McCuaig-Boyd, Alberta Minister of Energy

Date: November 30, 2018

Re: **Alberta faces tough choices on discounted oil prices: could auctioning pipeline capacity be an option?**

The plunge in Western Canadian oil prices relative to equivalent benchmarks is a well-publicized crisis for both producers and Alberta's public finances. Energy analysts from Peters & Co. estimate that a persistent WCS discount of US$40 a barrel would cost Alberta's government $5 bill in lost royalties next year - or roughly 10 percent of the provincial budget. In his report last week, University of Calgary's Trevor Tombe underscored that Alberta's finances are unsustainable in the long-term – partly owing to reliance on natural resource revenues. However, in the immediate term, the province faces diminished royalty revenues from depressed prices on Western Canadian crude oil.

In a fully functioning market, investments in new pipeline capacity would restore equilibrium by linking upstream production to demand in export markets. However, as well known, pipelines are not getting built. Therefore, governments must decide whether the persistent discount of Western Canadian production reflects a market failure (in an economic sense) and, if so, intervene to address the market failure. Intervening in markets risks unintended consequences and policy-makers must carefully study any option. However, auctioning uncommitted export capacity (i.e., common carrier capacity not already contracted by a shipper) might be a way to address a distortion from the current nomination/apportionment regime.

Some producers propose a cut in Alberta production to boost local prices, arguing for the Alberta government to impose quotas under section 85 of *Alberta's Mines and Minerals Act* (enacted and used by the Lougheed government in response to the federal National Energy Program – but which notably does not include oil sands production). Such a measure would create a regulated cartel to raise local prices and involve an arbitrary point-in-time to set each producer's quota of production. Imposing a pro rata production cut on all producers would be highly inefficient, reducing production irrespective of producers' production costs. It would penalize those who prudently hedged against a depressed price environment. It could also interfere with operations and face technical problems (e.g., losses if in situ production is not continuously operated).

As well, there is a strong argument that market forces should be allowed to bring the market back into equilibrium – and a note from TD Economics provides a thorough outline of some of the transient demand-side factors. Nonetheless, it is not clear that the market will rebound to a stable and socially-optimal equilibrium: a persistent and widening discount and ongoing nominations to export pipelines far in excess of capacity, are signs of a market failure that is destabilizing local price-setting.

For uncommitted pipeline capacity, volumes are apportioned: that is, if nominations exceed capacity, a shipper gets a pro rata apportionment of the capacity equal to its share of overall nominations. From the most recent data, the Enbridge Mainline is at around 50 percent apportionment.

The apportionment of capacity may distort production and access to the uncommitted export capacity – and drive down local prices. Notably, the apportionment regime fails to allocate uncommitted export capacity to the shippers with the greatest economic surplus (i.e., low-cost producers). By nominating to congested pipelines, shippers with high-cost production get a share of the available capacity to ship to export markets. Low-cost producers will have residual production capacity to supply local markets. Trapping low-cost supply in the local market could result in depressed local prices.

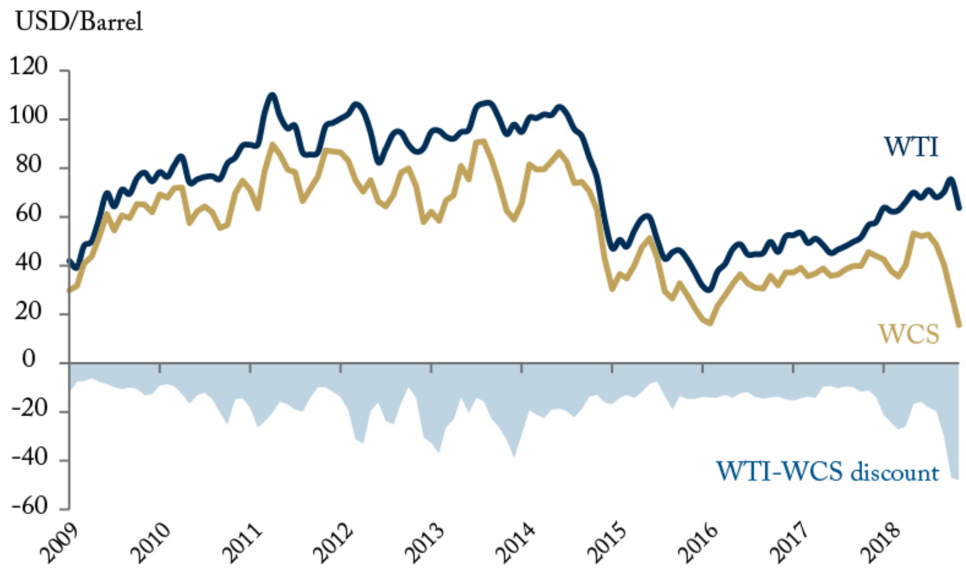
An option to address the present discount may be to auction export permits for uncommitted export capacity. This could address the congestion on uncommitted pipelines by allocating export capacity to the lowest cost producers.

An analogy is fixed highway capacity, where the lack of a price for congestion results in traffic bottlenecks. A toll equal to the marginal willingness-to-pay for the marginal commuter will reduce congestion, and those commuters with the greatest value will use the highway.

In any auction scheme, a government should recycle the accrued proceeds: to retain these proceeds as general revenues would indirectly increase the effective royalty on producers and undermine investor confidence. One way to recycle proceeds might be to subsidize certain investments that increase export capacity: an auction price conceptually corresponds to an efficient subsidy for an investment that incrementally increases capacity. Auction proceeds might also be returned directly to producers through a royalty rebate.

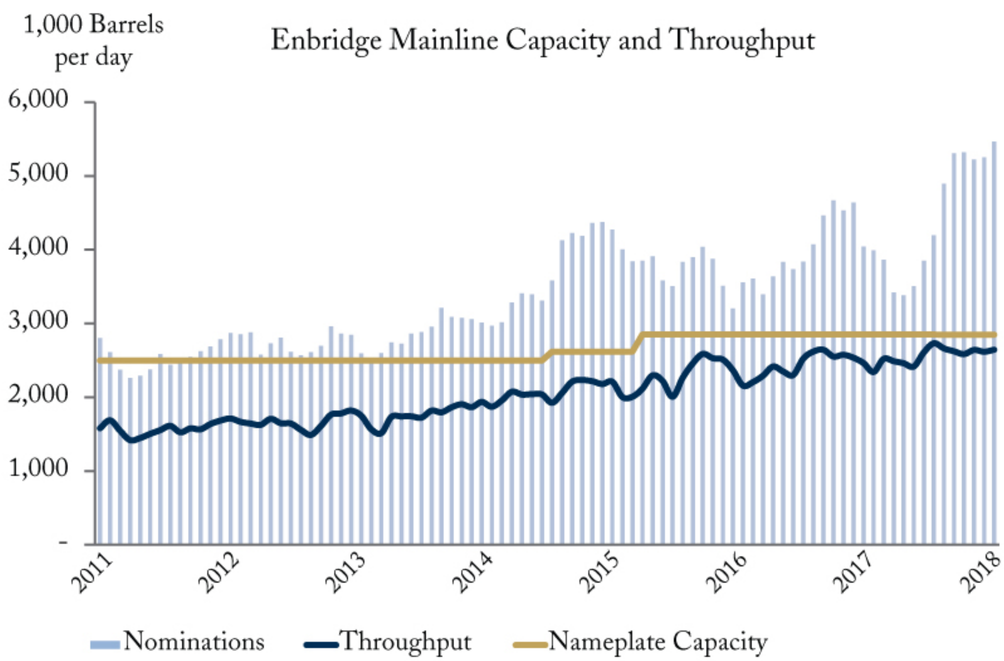
In the face of the failure to get pipelines built, Alberta's government faces a growing crisis and tough decisions. We face this situation because of federal government failure to get export capacity built. Policy-makers must act to get Western Canadian oil moving efficiently to market.

Price on Western Canada Select (Hardisty, Alberta) relative to West Texas Intermediate (Cushing, Oklahoma)



Source: Alberta Energy, U.S. Energy Information Administration.

Enbridge Mainline Capacity and Throughput



Sources: National Energy Board.

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