Canadian Oil Exports to US by Rail will be Next Target

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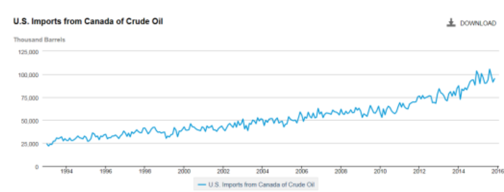
Alberta has long been smug in the knowledge that they produced an essential product that the US needed very badly. Indeed, a principal American objective of the Canada-US free trade agreement of 1987 centered around the US gaining secure access to Canadian oil.

But times change, and the new technologies of long horizontal well drilling and multi-stage hydraulic fracturing that developed in the period 1995-2005 enabled vast new shale oil and shale gas resources to be exploited in the US. The consequences are that America is on a par with Russia and Saudi Arabia in oil production (33% of the world's production), America is reasonably close to being self-sufficient in oil (though it may never quite get there), and Canada is now providing over 45% of America's much smaller oil imports (compared to 20% only five years ago). However, the actual imports of oil from Canada may have peaked in 2015 and could begin to trend downwards for the first time in history. The National Energy Board reported Canadian exports to the USA to be just over 3,200,000 barrels a day in the third quarter of 2015, and the USA was importing about a total of about 7,000,000 barrels a day in the same period.



See: Canadian Oil Imports

To date, slackening of Canadian exports is due to factors that in the short term, still favor status quo:

Canadian heavy oil is well suited to refineries in the US Gulf Coast, and competition from US shale oil has been met by steep discounts on Canadian oil that made up for the expense of higher freight charges (i.e. rail) from Canada. But volumes shipped by rail peaked in 2014Q3, and have been trending downwards since.

Most Canadian oil producers took the Keystone XL rejection by the Obama Administration with a certain smugness, believing that eventually markets for oil will rebound and Canadian oil will always get through, if only by slightly costlier rail vs. pipelines.

Now, the Obama Administration is giving signs that they intend to change the rules of the game. President Obama, in the annual budget request to the US Congress, asked for a fee of US$10/bbl to be levied on petroleum. Ostensibly, the fee is to fund highways and clean energy development.

One cannot predict how Congress will act on this request, but it is a foregone conclusion that if such a fee were to be enacted, it will be applied on imported oil as well. Given the budgetary limitations Congress faces and 2016 being an election year, and the US economy showing signs of weakness and needing stimulus, approval of a new "fee" on oil may happen.

What's more, the Obama Administration will almost certainly not object to having additional fees assessed on imported oil that emit higher carbon emissions upstream.   Whether this is enacted by Congress or the Administration is yet to be seen, but surely it will come, sooner rather than later. It is a fundamental principal in US politics that you should tax persons other than your voters, whenever possible.

I have been predicting that Greenhouse Gas Emissions embodied in traded products will bleed into trade regimes eventually. For example, Chinese exports of low value added steel products to the US is basically importing of Chinese coal and GHG emissions.

It is very likely that if Canada had proposed four or five years ago a binding commitment to making Keystone XL exports incrementally carbon neutral, the Keystone XL project would now be under construction.

Canadian oil producers must now ask the question of what they will do if exports of oil by more expensive rail will also be hit with US $10/b fees, and perhaps even additional fees as various US and Canadian jurisdictions move toward implementing carbon taxation.

They should also consider what might happen if Venezuela, potentially a much lower-cost producer of heavy oil for the Gulf Coast refineries, solves its ongoing political dilemma and encourages US investments again. With the new technologies and investor guarantees, the Venezuelans could increase production by several million barrels a day in perhaps five years, effectively undercutting more dangerous rail exports from Canada. A low cost competitor of that magnitude to Canadian heavy crude is a sobering and not impossible scenario.

Prime Minister Justin Trudeau may discover that his lavish State Dinner with President Obama this March will feature this bitter pill on the menu.

(Thanks to MB Dusseault of the University of Waterloo for helping organize these thoughts.)