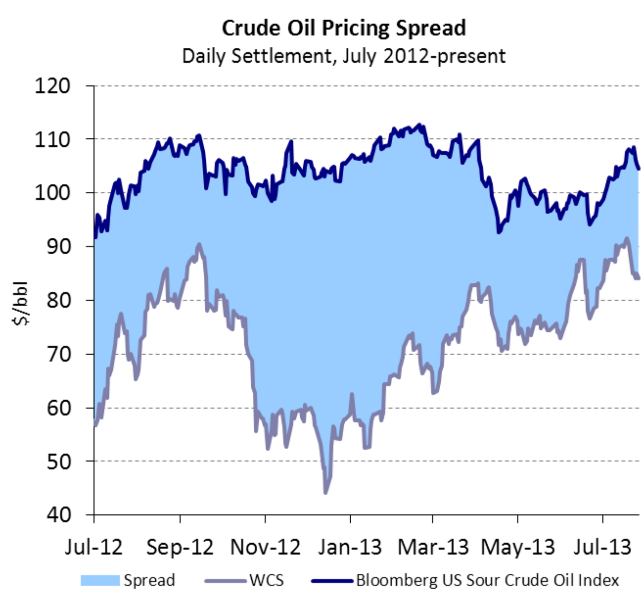
Canadian Crude Oil Prices Back from the Brink

From 4Q2012 to 1Q2013, the Western Canadian Select (WCS) crude oil benchmark experienced historically low prices during a period when Canadian crude oil production underwent rapid growth that shows no signs of slowing (see 8 February 2013 *Opinion*). WCS's struggles were caused by this influx in crude oil production and the resulting transportation bottleneck. While the building of TransCanada Corp.'s highly contested Keystone XL pipeline could provide relief to this supply glut, the project awaits U.S. regulatory approval, making it unlikely that construction will even start by 2015, according to TransCanada CEO Russ Girling.

Rail cars have provided relief to the WCS oil supply overflow

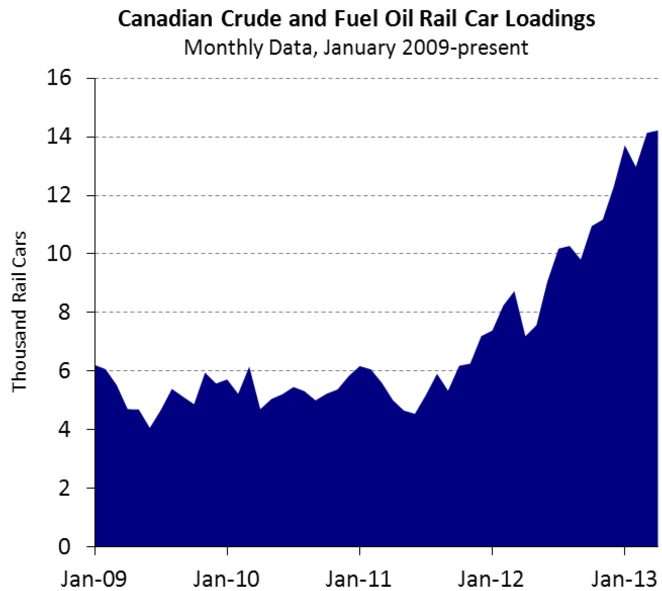
Yet recently WCS has seen a sudden reversal of fortune as its prices are rapidly converging with Bloomberg's U.S. Sour Crude Oil Index prices, revived by drastic increases in crude oil transportation by rail. As a result, the spread between the two crudes has decreased from $59.87 per barrel in December of 2012 to $20.42 per barrel at the time of printing. A recent Bloomberg article highlighted the success of producers of Canadian heavy oil, as their stocks "have returned an average of 15 percent in the past three months… [while] an index of global oil stocks rose 7.6 percent in the same period." Although more pipelines could still be built even if plans for Keystone XL falter, rail cars appear to be providing at least a temporary solution to the bottleneck issue surrounding Canadian crude oil.



Source: Bloomberg

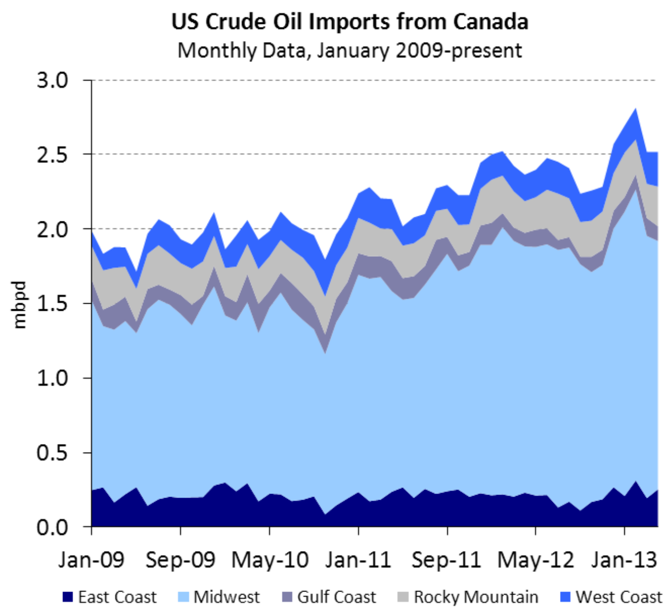
The aforementioned surge in rail transportation of Canadian crude oil has been stark. The number of rail cars used to transport oil has more than tripled over the last two years, rising from a low of 4,549 in June of 2011 to 14,217 in April of 2013. Given that each rail car holds around 700 barrels of oil, this growth amounts to an increase of more than 218 kbpd of crude oil.

Over the last two years, the number of rail car loadings has more than tripled



Source: Statistics Canada

While major pipeline expansions from Canada to the U.S. are in the planning stages, the increase in rail car transportation has enabled more Canadian crude oil imports into the United States, particularly to PADD 2, which is the Midwest. Indeed, PADD 2 imports of Canadian crude increased approximately 13% from 2012 to 2013.

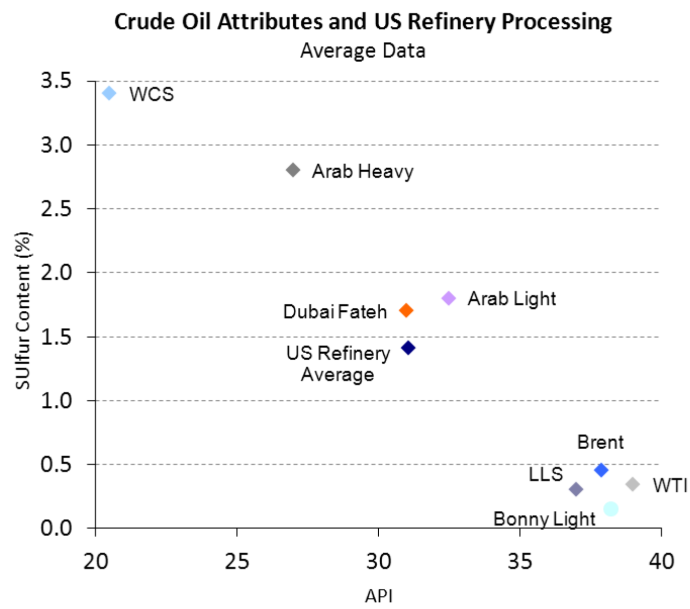


Source: Statistics Canada

A large reason for increasing imports into the Midwest is the fact that capital projects have been undertaken by BP and Marathon to be able to process heavier Canadian grades of crude oil at their Whiting and Detroit refineries, respectively.

U.S. refineries are unable to process Canada's heavy crude at a high rate

Although some heavier crudes are used at U.S. refineries, similar upgrades would be required in order for substantially larger volumes of these heavy grades to be processed. Therefore, the recent surge of heavy Canadian crude oil into the U.S. posed a threat to demand only for tankers loading heavier grades of crude.



Source: Bloomberg

Early pipeline plans could shift Canadian crude oil from the limited market in North America to Pacific Basin refiners

The recent surge in rail car movement, which appears to have counteracted the bottleneck effect of Canadian pipelines, has increased the amount of crude oil moving from Canada to the U.S. This fact is quite obviously a good sign for upstream companies located in Canada. However, the heavier, higher sulfur grade of crude oil, which makes up much of the increase in Canadian production, has a somewhat limited market in North America. Alternatively, Enbridge's Northern Gateway Pipeline and Kinder Morgan's Trans Mountain Pipeline hold the potential to open up the Canadian crude oil market to Asian refiners. The prospect of these pipelines, coupled with additional rail car movement towards the west coast of Canada could be beneficial for ton-mile demand in the tanker market as Canadian crude begins to compete in the Pacific Basin.

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