NATIONAL BANK OF CANADA FINANCIAL MARKETS

Public Sector Strategy

Fixed Income Trading Desk Strategy

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Quick Hit — T+3 reflections on Alberta's mandated oil production cut

If you somehow missed it, the Premier of Alberta, Rachel Notley, took significant action on the weekend, announcing a temporary curtailment of provincial oil production in order to "protect the value of Alberta's resources". This marked the latest step from Alberta's NDP government in an effort to redress the heavy discounting of Canadian crude oil vs global benchmarks. We've let the dust settle on this announcement and aim to highlight here what it might mean for Alberta's growth and budgetary outlook some 72 hours later.

Reaction — Reaction from key industry players was somewhat mixed. Some companies accepted the decision to shut-in production in the face of poor(er) economics, having already moved to do just that. Others lamented direct government intervention in the market, which could impact international investment attitudes towards the sector and Canada.

In terms of oil price mechanics/reaction, note that benchmark crude oil prices were generally better bid to start the week, capturing Russia-Saudi Arabia production coordination news and a post-G20 boost to risk-sentiment, the latter burning off *very* quickly. (North American equities were roundly crushed on Tuesday, with the US closed Wednesday.)

As it stands, the prompt contract on WTI currently sits at ~US$53.5/bbl, a better than two dollar improvement vs Friday's close. Fair to say that the initial market reaction and bounce back in Canadian heavy crude was even more meaningful. Western Canada Select (WCS) had been languishing at US$22/bbl as of Friday. In the immediate post-announcement trade, WCS touched US$33/bbl before settling back to US$30/bbl.

The corresponding light-heavy differential (WTI less WCS) narrowed at one point to US$20/bbl on Monday, although now trades closer to US$23-24/bbl. That's still the tightest relative price gap between WTI and WCS since mid-summer and far removed from the ~US$40/bbl gap observed as recently as two weeks ago. (The differential famously touched US$50/bbl back in mid-October.) Want greater insight on current pricing dynamics, look no further than the daily analysis produced by our *NBC Energy* colleagues in Calgary.

Economic impact — Assessing the marginal economic and fiscal impact of curtailment is somewhat complex. All else equal, a lower production level in a key industry means a lower level of real output in Alberta and Canada as a whole. From the Bank of Canada's perspective, transportation constraints, a buildup of oil inventories and associated production cutbacks mean "activity in Canada's energy sector will likely be materially weaker than expected." Note that a few macroeconomic forecasters have made downward adjustments to Canada's 2019 real GDP growth assumption in recent days. We have edged our own call for 2019 Canadian growth lower, from 2.0% to 1.8%. To be clear, there's more than marginal oil production cuts at play here. Indeed, we were struck by the weaker domestic demand profile and substantially lower savings rate that came out of Canada's Q3 economic accounts (which arrived last Friday). If you're looking for a bit more colour on our national growth call, we'd direct you to our *Economics* website.

Overall, the announced production curtailment looks to trigger a further negative adjustment to Alberta's 2019 *real* GDP growth (building on previous downward revisions a number of forecasters had already made). Importantly, however, the latest marginal subtraction from real growth needn't be enormous. After all, a non-trivial amount of production (somewhere around 150-160K barrels a day) had already been shut in before Sunday's announcement was made. While forced production cuts are significant in Q1, they're expected to moderate thereafter. All that suggests that the average level of curtailment for the entire year might not be so far above the amount of production already shut in.

Revenue impact — Notwithstanding lower production volumes, it's less clear that there's marginal damage to Alberta's *nominal* GDP profile. Consider that any improvement in the province's terms of trade via stronger prices for exported oil would lend support to nominal output and by extension government revenue, *ceteris paribus*.

The Premier pronounced that, in light of the forced production cuts, Alberta expected the average differential to narrow roughly US$4/bbl, which in turn would lift provincial revenue (from all sources) by more than $1 billion in fiscal 2019-20. That extra revenue would primarily take the form of bitumen royalties but could also be expected to include some marginal personal income tax revenue too. The presumed support for nominal GDP and the extra revenue the Premier flagged really isolates the impact of the narrower differential, since production was headed lower even before the province mandated it. Moreover, as Alberta's recent Q2 update clarified, the revenue/royalty base looks to be starting from a stronger-than-expected level. Finally, the barrels being shut by industry are likely to be the least profitable, which opens up the possibility of a higher effective royalty rate (i.e., proportionately more royalties for a given barrel of production).

To illustrate the fiscal importance of recent price action, consider the annualized boost to Alberta's royalty outlook moving from Friday levels to Tuesday's closes. If sustained, the additional US$2 per barrel on WTI and US$5 per barrel narrowing in the light-heavy differential might add up to more like C$1.7 billion in incremental royalties on a full-year basis (Chart 2), all else equal. Should it hold, it's the type of move that, along with the better base, could help allay concern over the near-term royalty outlook (i.e., 2019-20).

Caution & Opinion — Market participants will recognize that financial conditions—be in rates, credit markets, equities, currencies or commodities—are extremely fluid in this, a jittery and liquidity constrained environment. The immediate price action we cited above may not be indicative of where oil is destined to trade going forward.

All should appreciate that fiscal sensitivity analysis is more art than science. Sensitivities always need to be treated with caution and should never be blindly relied upon. Case in point, Alberta's official sensitivities didn't work all that well when stripping back adjustments (to oil prices and related royalties) in the Q2 update. Again, those adjustments were net positive, as a higher resource royalty yield brought about a smaller deficit than planned. As demonstrated almost daily, key prices/market levels/relationships bounce around a lot, which means the fiscal outlook is *highly dependent* on when exactly you put the pin in on WTI, the differential, the currency, interest rates, etc.

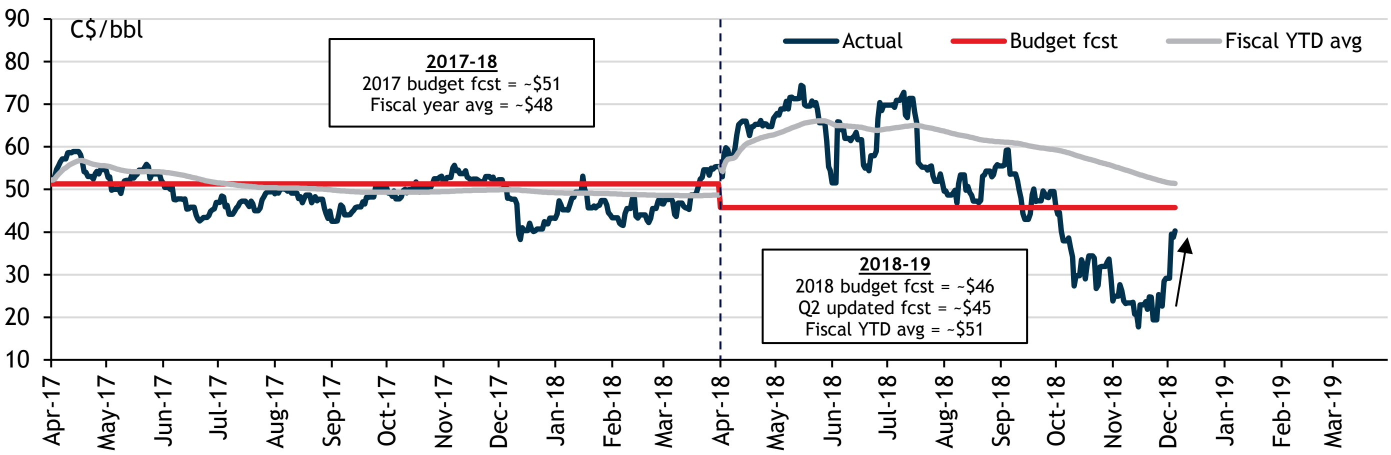
More to the point, if you can meaningfully cut production AND bring in additional royalties, some might ask why Alberta didn't cut production sooner and/or by an even larger margin!? We're being deliberately facetious here, but why not cut production to near-zero, drive WCS to the moon and watch an infinite amount of royalties poor in? Fact is, oil production volumes do matter… they're the "Q" in the "Price x Quantity" in a basic revenue calculation after all.

Moreover, don't lose sight of the fact that Alberta's longer-term deficit reduction plan hinges on significant growth in non-renewable resource revenue… revenue that, in turn, is dependent on securing market access (i.e., getting new pipelines built) and rising oil prices. On balance, however, those new pipes (TMX and KXL in particular) appear to be coming with a greater delay/lag than originally hoped. That's not great, since as my *NBC Energy* colleagues noted today: "We absolutely still need the takeaway solution, not just a production curtailment solution."

Look, a narrower differential is laudable goal and all Canadians should want Alberta to get a fair price for their oil. Nonetheless, if achieving the tighter spread requires lower industry production volumes (even temporarily), provincial purchases of more rolling stock, a federal purchase of a major oil pipeline and larger publically funded investments/subsidies to spur in-province processing, then it's less clear there's a significant positive federal-provincial fiscal adjustment once all aspects are accounted for. Love it or hate it, Sunday's announcement shows a provincial government unwilling to sit back and wait for pipeline politics to sort themselves out… dramatic action that comes ahead of a 2019 provincial election and appears to have paid immediate, near-term fiscal dividends.

Chart 1: For Alberta, differential makes WCS quite noisy… post-announcement bounce-back a relief

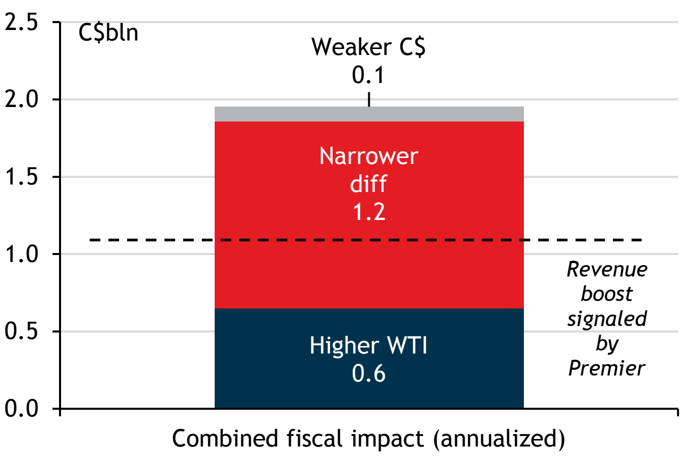
Western Canada Select crude oil price, expressed in Canadian dollars: Actual vs Alberta assumptions



Source: NBF, Alberta, Bloomberg

Chart 2: What a difference a few days can make!

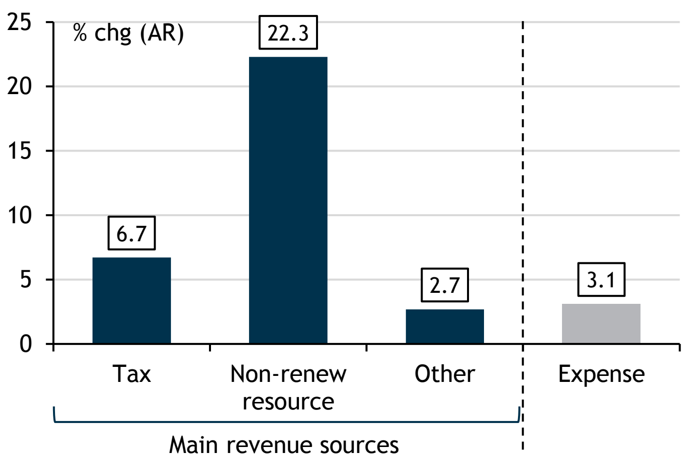
Illustrative impact (AR) of chgs in oil/C$: Pre- vs post-announcement



Source: NBF, Alberta, Bloomberg | Note: This is illustrative and not a forecast; applies official sensitivities to changes in WTI, light-heavy differential & Canadian dollar: 30-Nov (pre-announcement) to 5-Dec (post-announcement)

Chart 3: Path to balance based on market access

Average annual growth in key Alta fiscal metrics: 2018-19 to 2023-24



Source: NBF, Alberta 2018 Budget | Note: Core fiscal metrics from province's "Path to Balance", based on 2018-19 budget estimates and official projections through 2023-24

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