The Crude Reality of Shipping Oil By Rail

Description

Sadly, as I'm sure you've heard, a town in Quebec endured a horrific train derailment over the weekend. The ensuing explosion tore through a small town and destroyed several buildings. Even more tragically, it cost the lives of at least five people and at last count there were still more than 40 missing. Unfortunately, this dark tragedy highlights a major risk of shipping crude oil by train.

The train, which was operated by a unit of privately held **Rail World**, had been stopped and secured about seven miles outside the town. Its crew was off the train when it started moving again and didn't stop until derailing seven miles later in the town of Lac Megantic. The incident is by far the most devastating derailment since Canadian and American oil producers began to turn to the rails to get crude oil from production basins to refineries.

Not an isolated incident

Most concerning is this derailment is one a series of issues that have cropped up over the past few years with crude oil being shipped by rail. Just this past March, a **Canadian Pacific** (TSX:CP) train derailed in Minnesota and spilled about 30,000 gallons of crude oil. Needless to say environmental concerns, while taking a backseat to the human tragedy, will grow much louder when considering that oil from the Lac Megantic derailment leaked into the town's lake and a nearby river.

While we don't yet know the exact cause of this tragedy, it does remind us of the challenges of transporting crude oil by rail. Canadian Prime Minister Stephen Harper has called railroad transit "far more environmentally challenging" than the controversial Keystone XL pipeline proposed by **TransCanada** (TSX: TRP). Because of the environmental risks, state agencies in Maine, for example, have begun developing protection plans for the areas of the state where crude oil is being transported via rail. Meanwhile, some environmental groups are calling for a moratorium on rail transportation of crude through that state.

The underlying truth

The root of the problem goes back to the lack of pipeline takeaway capacity as producers really don't have any other viable option to get crude oil to end users. That's been the real driving force behind the surge in crude oil shipments by rail, which in Canada should double to 300,000 barrels per day by the end of the year. Both Canadian Pacific and **Canadian National** (TSX: CNR) have been taking advantage of this boom in shipments, which could be short lived in light of the recent derailments, coupled with a potential approval of the Keystone XL.

Of the two, a potential curtailment of oil shipped by rail could hurt Canadian National the hardest as it's in the best position to capture crude oil volumes from the oil-sands. The company, which expects to double its volume this year to 60,000 carloads, has potential for larger volumes in the future because of its strategic position in the oil-sands region. It also has the ability to offer a single line to the Gulf Coast, which provides it a significant advantage, if crude oil shipments by rail continue.

Hog tied

The big problem for oil producers like **Suncor Energy** (TSX: SU) is that its access to oil markets could be in jeopardy if restrictions tighten, which could boost the cost to transport crude oil by rail. The company, and its peers, don't have a lot of takeaway options on the horizon as pipelines like **Enbridge's** (TSX: ENB) Northern Gateway and the Keystone XL remain big question marks. The Northern Gateway project, which would move 525,000 barrels of oil per day to the Pacific Coast, is opposed by both environmental and native groups. When you combine that capacity with the proposed 830,000 barrels per day Keystone XL, you can see that substantial proposed takeaway capacity still remains in limbo.

For an idea on how that impacts Suncor, consider that the company produced an average of 317,000 barrels of oil per day this year. However, takeaway capacity issues significantly impacted its production as a shutdown of Enbridge's regional oil sands pipeline system held back Suncor's production in June by two million barrels. That, along with planned maintenance, has reduced the company's average production from about 349,000 barrels of oil per day, down just 317,000 barrels per day for the year. Suncor's growth and profitability could be hampered if it can't get its oil to the market.

Finally, the overall lack of takeaway capacity has caused a well-documented discount for Canadian oil which at one point was more than $40 per barrel. More recently that discount has narrowed to about $15.50 per barrel, which is still substantial when you consider the average of $11 per barrel it costs to ship crude by rail. Producers run a real risk the discount will widen again if market access begins to tighten.

The Foolish Bottom Line

That's why tragedy in Quebec is a stark reminder to investors of the real risks faced by the industry when it comes to transporting oil. Sadly, no matter how many precautions are taken, accidents do happen. While some would say that the incidents suggest we should leave the oil in the ground, that's really not a viable option. Instead, the hope is that the accident will be something that can be learned from in order to mitigate future incidents.

The incident should also be a reminder to investors to have a well-diversified portfolio so you can better navigate these risks. That diversification needs to not only be among sectors, but among countries. So, while the Canadian market contains its share of great companies, you can't look past the number of quality businesses that are domiciled in the U.S. For a deeper look at three of the world's highest quality, U.S. based businesses, we've created a **FREE** specialty report "**3 U.S. Stocks Every Canadian Should Own**

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Fool contributor Matt DiLallo does not own any of the companies mentioned in this report. David Gardner owns shares of CN Rail. The Motley Fool has no position in any stocks mentioned at this time.

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