Why the Oil-by-Rail Boom May Be Close to Ending

Description

For the last five years, both **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) and **Canadian Pacific Railway Limited** (TSX:CP)(NYSE:CP) have been among the best performers on the TSX Composite. Canadian National has gone up more than 26% annually since 2010, while Canadian Pacific has done even better, surging more than 35% annually over the same period.

Needless to say, it's been a good time to hold these stocks.

There have been a few factors leading to these great results. Both companies shook up top management, and both benefited from activist investors. Not only did they benefit from becoming the low-cost shipping option for goods when oil went up, but the real prize was shipping crude to refineries. Canada's pipeline network just couldn't keep up to demand from oil producers.

But lately, the oil-by-rail business is looking a little shaky. Is it just a temporary blip or the beginning of a real trend?

Safety issues

Perhaps the biggest issue with shipping oil by rail is the risk of a nasty accident.

The incident at Lac-Mégantic in 2013 has faded from our memories, but the disaster is still a big deal to residents of the region and for those who lost loved ones in the explosion. There have been several accidents since, including a recent derailment and huge fire in northern Ontario. Luckily this wasn't near any residential area, but the fire caused by the accident burned for several days before being put out. In 2015 alone, Canadian National has had four incidents across the country, two of which caused fires.

This isn't to knock the transport of oil by trains. It's still, relatively speaking, a very safe way to transport crude. For the amount of kilometers these trains travel, derailments are extremely rare. And in response to Lac-Mégantic, new safety regulations were put in place, including mandating the use of higher quality rail cars and limiting train speeds to 80 km/hr.

But these things keep happening. And if they continue, political figures will make serious changes to the system. Those changes could include slower speed limits, shorter trains, or other things that could damage the profitability of railroads hauling oil.

Oil supply

The whole reason why oil producers turned to the railroads in the first place is because there just wasn't the pipeline capacity to handle all the production.

There are two things happening to alleviate this issue. First of all, producers in western Canada are cutting production aggressively. Cuts in capital projects all but assure cuts in production for 2015, and likely through 2016 as well. If crude continues to be weak through 2015, many producers will likely cut future production even further.

It's amazing how conservative oil companies get after experiencing a downturn. Even if crude recovers to $80 per barrel sometime this year or next, executives will likely tiptoe back into drilling again. Memories are short, but nobody wants to be the company that expanded too quickly, only to see hard times come back.

Additionally, pipeline capacity in Canada should increase in the next few years. Both **Enbridge** and **TransCanada** have many smaller pipelines in the works, as well as major projects like Keystone XL, Northern Gateway, and Energy East. If these mega-projects get approved, we're looking at increased pipeline capacity of 2-3 million barrels of oil per day. It'll take a few years to get these pipelines built, but transporting crude by pipeline is safer and cheaper for producers. There will be demand for them.

With P/E ratios of 22.3 for Canadian National and 27.9 for Canadian Pacific, these stocks are priced aggressively, especially Canadian Pacific. If a major pipeline project gets approved, or we see another accident that includes loss of life, these stocks could sell off, and in a big way. They could also go down if the overall market goes down.

I'd avoid the railroads at today's levels. There are more attractive ways to play the oil transport business.

CATEGORY

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