3 Reasons Why Canada's Crude-By-Rail Business Is Suffering

Description

From 2008 to 2013, crude oil shipments by rail grew by an astounding 4,100%. And for a while, the industry was expected to keep growing rapidly. Just last year, the Canadian Association of Petroleum Producers (CAPP) predicted that Canadian crude-by-rail shipments would more than triple from 2013 to 2016.

Now the outlook is far more bleak. The Canadian National Energy Board reported that Canadian crude-by-rail shipments fell by 28% in the first quarter compared to the year-ago period. Both **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) and **Canadian Pacific Railway Limited** (TSX:CP)(NYSE:CP) have expressed doubts that their crude-by-rail forecasts will be reached.

So why is the crude-by-rail outlook so bleak? Below we look at three reasons.

1. Improved access

In late 2013, Canadian oil sold at a deep discount to American crude. In fact the differential between Western Canadian Select (a benchmark of heavy Canadian crude) and WTI widened to more than US$40.

Thus Canadian producers had more than enough incentive to ship their product to the United States, however possible. So they were perfectly willing to pay the additional cost to ship crude by rail.

Fast forward to today, and this differential has narrowed to less than US$10. The main reason for this has been improved pipeline access, including from **Enbridge's** Flanagan South pipeline.

This is far less than the cost of shipping oil by rail, which can easily exceed $20 per barrel. It's no wonder the business shrunk so much in the first quarter.

2. Lower prices

When oil prices were much higher, there was much optimism for Canada's energy sector. For its part, CAPP predicted that Canadian oil production would rise from 3.7 million barrels per day in 2014 to 6.4

million in 2030. With that kind of growth, rail had to play an integral role; there simply wouldn't be enough pipeline capacity.

But now that oil prices have dropped so much, numerous projects have been deferred. CAPP has certainly noticed this, and reduced its 2030 production forecast by 1.1 million barrels earlier this week.

Now it won't be so hard for pipeline capacity to keep up. And that doesn't bode well for Canada's crude-by-rail industry.

3. Growth in all the wrong places

I know what you're thinking: aren't these low oil prices being driven by increased production in the United States? And if so, doesn't that increase the demand for crude-by-rail? Won't CN and CP benefit?

Well there are a couple of problems with this idea. One, CN and CP are much better situated to transport oil from Alberta. By contrast, the Burlington Northern Santa Fe railroad (owned by **Berkshire Hathaway**) is better-positioned to transport American crude.

Secondly, American light oil can be highly flammable, and is much more dangerous to transport by rail. Remember, the Lac Mégantic disaster involved oil from North Dakota. Regulators have reacted forcefully, requiring older tank cars to be phased out over time, which will add costs. And pipelines from American oil fields should run into much less political opposition than Keystone XL.

Meanwhile, the Canadian rail stocks continue to trade at sky-high levels, and likely don't entirely account for these trends. Investors should stay away.

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Date

2025/07/21

Date Created

2015/06/15

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