What Happens to TransCanada Corporation Shares if Energy East Is Rejected?

Description

Without a doubt, **TransCanada Corporation's** (TSX:TRP)(NYSE:TRP) most well-known and controversial project is its Keystone XL pipeline. The Keystone XL application was rejected by President Obama in 2012, and was vetoed by the president earlier this year after the U.S. congress passed a bill to build the pipeline, likely delaying the pipeline until the next administration.

Despite the media attention on Keystone, it is actually a fairly small project for TransCanada. TransCanada currently has $46 billion in capital projects slated for development, and Keystone is expected to comprise about $8 billion of the total.

TransCanada's largest project—and by far most important—is the $12 billion Energy East pipeline. Like Keystone, Energy East is facing increasing challenges, including political, environmental, and economic opposition. This begs the questions: What are Energy East's key challenges, and what happens to TransCanada shares if it is eventually rejected?

Energy East is facing many challenges

The $12 billion Energy East pipeline is meant to connect energy producers in Alberta with refineries in Quebec and New Brunswick. The pipeline will also involve the construction of marine terminals in Quebec City and Saint John, which will allow crude to access global markets via the Atlantic Ocean.

TransCanada will create the Energy East pipeline by converting half of its Canadian mainline pipeline from natural gas to oil service, while leaving the remainder available for natural gas transport. Although the project greatly benefits oil producers as they will be able to realize better prices on their crude, numerous parties have been opposed, and the project has hit a series of hurdles.

Just recently, TransCanada announced it would scrap a planned marine terminal in Cacouna, Quebec due to the fact that the terminal would interfere with a beluga whale habitat. This decision is estimated to push the in service date for the pipeline from 2018 to 2020, which in turn pushes TransCanada's growth even further into the future, and risks its ability to fund the project. TransCanada now needs to work to either access a different location in Quebec, or look to Saint John's.

This hurdle came as Quebec announced they would only approve the pipeline if it has clear economic benefits to the province, and the premier of Quebec recently stated that he sees little economic value in Energy East, especially if Quebec simply serves as a transit location for the pipeline to move en route to the east coast.

Along with opposition from provincial governments and environmental groups, TransCanada is also facing vocal economic opposition from gas distribution companies. These companies, like Union Gas, worry that by converting part of the Canadian mainline to oil service, it will reduce available natural gas capacity, especially during peak seasons. These companies are warning that the lower capacity will result in higher prices, and possibly even gas shortages during the winter months.

TransCanada will need to resolve all these issues to achieve approval by the National Energy Board.

What if Energy East is not approved?

Currently, of TransCanada's $46 billion in capital projects, only $12 billion is totally approved and ready to be in service by 2017. TransCanada is expecting that these projects will lead to an 8% annual growth rate between now and then.

The remainder of TransCanada's growth depends on its major projects, of which, Energy East is the largest. TransCanada currently trades at a low 2016 forward price-to-earnings ratio of 18.77, which is well below its peer group average of about 27. This is largely due to the uncertainty of TransCanada's projects, and if its projects were approved, TransCanada could expect to trade in line with its peer group due to higher growth.

Since Energy East is TransCanada's largest project, analysts at **RBC** estimate it would add nearly $11 per share of value if it were approved. TransCanada's low valuation compared with its peers suggests that shareholders are not pricing in the approval of its major projects, which means there is little downside should the project be rejected, but if it is not approved, TransCanada would lose much of its upside potential, with its growth being restricted to Keystone XL and its LNG pipeline projects.

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