ALBERTA'S OIL CUTS WILL REDUCE CANADIAN GDP MODESTLY IN 2019

December 3, 2018

In the wake of persistently low prices for Western Canadian heavy oil, Alberta on the weekend ordered major oil producers in the province to cut production starting January 1, 2019. These cutbacks are intended to allow bloated oil inventories to clear out and to shrink still-wide spreads between Western Canadian Select and global benchmarks.

Cuts not expected to last the full year

The direct impact of the production cuts is significant. The 325k bbl/d cut represents almost 9% of Alberta's oil production. Oil extraction directly accounts for a little under 3% of Canadian GDP. That said, our assumption is that the production cuts will not last the full year. Once bloated Alberta oil inventories have been returned to more normal levels, production cuts will reportedly be eased to 95k bbl/d, which we estimate will occur sometime this spring.

Given these assumptions, we expect that the direct impact will be to lower real GDP for Canada as a whole in the 0.1-0.2% range next year – but with that direct impact entirely concentrated in Alberta and mostly in the first half of the year. Our preliminary calculations suggest GDP growth in Alberta could be cut by as much as a percentage point relative to prior assumptions.

Limited spillover to broader economic activity

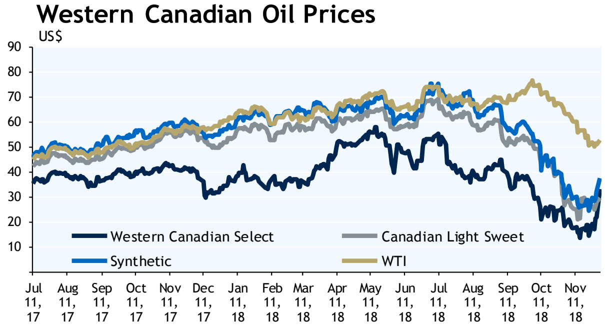
At this point, we are not assuming significant secondary spillovers to other sectors. There will likely be some lost hours worked but, given the cuts are expected to be short-lived, we expect companies will be hesitant to let too many workers go. The production caps are also expected to disproportionately impact larger producers who are more able than smaller ones to ride out near-term production disruptions. The first 10k bbl/d of production by any single company will reportedly be excluded from any production cuts to limit the burden on smaller producers.

The impact on economy-wide revenues is unclear because of the potential price response. Production will be lower but Western Canadian prices per barrel will likely be higher. Any offset from higher prices would limit the hit to royalties accruing to the Alberta government.

Measures won't address lower global benchmark prices

Companies – particularly larger companies -- have ways of dealing with wide Western Canadian price spreads. Some have dedicated transportation capacity to get production to markets that command higher prices, so lower oil prices mean lower input costs for those that own downstream refineries. Those spreads were already shrinking before this weekend's announcement from the Alberta government. The heavy oil spread had already shrunk to ~$US30/bbl from as much as $US50/bbl in October. Light and synthetic oil spreads have similarly eased to ~$US20/bbl from ~$US30-35/bbl. The mandated production cuts will help close the gap further. All that will do, though, is allow companies to realize prices closer to global benchmarks – and U.S. WTI prices, for example, are still sitting more than $US20/bbl below early October levels.

Western Canadian Oil Prices



Source: Bloomberg, RBC Economics Research

Looking ahead, we still expect that oil prices, both domestic and global, will move higher from recent levels as global supply is curtailed. That said, there was also not a lot of oil & gas investment that we were expecting with WTI oil prices at $US70/bbl that we weren't already expecting at $US50/bbl. O&G investment spending itself is still only half what it was in 2014, and much of what is left is probably maintenance spending that is more difficult to cut. Nonetheless, we estimate that global benchmark prices could subtract in the range of another 0.1-0.2% from Canadian growth over the next year or two if global benchmark prices to stay where they are.

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