EXECUTIVE SUMMARY

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Investment in the Canadian and U.S. Oil and Gas Sectors: A Tale of Diverging Fortunes

by Steven Globerman and Joel Emes

The oil and gas industry is critically important to Canada's economy. It accounts for almost 8 percent of Canada's GDP, as well as for a significant share of the tax revenue collected by governments. The oil and gas sector is particularly important to the provincial economies of Alberta and Saskatchewan. It accounts for almost 30 percent of Alberta's GDP and slightly over 23 percent of Saskatchewan's GDP. As such, the economic health of the oil and gas sector is a direct contributor to employment and economic activity in Western Canada and an indirect contributor to the rest of the domestic economy through links to industries that supply inputs to the sector, as well as use the outputs of the sector.

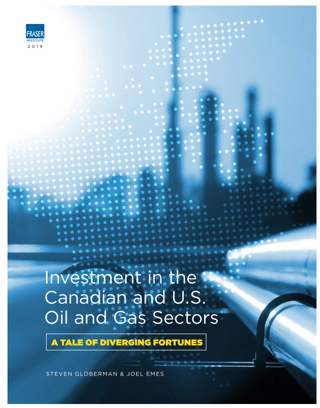
The upstream segment of the oil and gas sector encompasses exploration and production of crude oil and natural gas. It is the single largest segment of the oil and gas sector, which also includes midstream gathering and pipeline facilities and downstream refineries. The oil sands account for almost two-thirds of Canada's oil production. Since activity in the mid and downstream sectors will ultimately reflect the production of crude oil and natural gas in the upstream sector, the willingness of companies to explore for and produce oil and gas in Western Canada dictates the pace of economic activity throughout the industry's total supply chain.

A sharp drop in the world price of crude oil in 2015 and 2016 hurt the profitability of upstream oil and gas companies in both Canada and the US. However, while economic activity in the US upstream segment increased substantially with a modest recovery in crude oil prices in 2017 and 2018, investment in Canada's upstream segment as a share of total capital expenditures in Canada declined consistently from 2014 through 2018. While total capital expenditures in Canada declined post-2014, the decline in capital expenditures for oil and gas extraction was even more pronounced. Thus, while capital expenditures for oil and gas extraction accounted for approximately 28 percent of total Canadian industrial capital expenditures in 2014, oil and gas extraction accounted for only 14 percent in 2018.

Investment analysts and portfolio managers have recently warned that investment in the oil and gas sector is moving increasingly to the US and away from Canada, and that they are reluctant to invest their clients' savings in Canadian oil and gas companies. An unfavourable business environment for oil and gas exploration and production in Canada is cited as the reason, particularly compared to the business environment in the US. A number of Canadian oil and gas companies have also reallocated their exploration budgets away from Western Canada to the more profitable shale oil producing regions of the United States.

In the absence of changes to Canadian government policies affecting the sector, relatively low prices for Western Canada crude oil as well as depressed profitability of Canadian oil and gas companies are likely to continue. As a consequence, the ongoing shift in the location preferences of North American oil and gas companies towards the US might well intensify with drastic consequences for the fiscal health of the Alberta and Saskatchewan governments.

While limited pipeline capacity is the major factor depressing the price of Canadian heavy crude oil, more favourable tax and regulatory environments in the US compared to Canada are also contributing to the diversion of upstream oil and gas investments from Canada to the US. By way of illustration, whereas capital expenditures in the upstream segment were around 41 percent higher for the US when comparing 2018 to 2016, they were only about 15 percent higher in Canada. An investment manager in the United Kingdom recently wrote a letter to Prime Minister Trudeau saying that it was hard for her to watch a vibrant Canadian oil and gas industry being strangled by regulation, carbon taxes, and the inability of producers to get their products to world markets. Recent investment patterns in the North American oil and gas sector support this sentiment.



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Oil Prices ($US per barrel) for West Texas Intermediate and Western Canada Select, and the Difference