Canadian Energy Update: Alberta Cuts Oil Production to Raise its Discounted Crude Oil Prices

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Alberta Cuts Oil Production

The Government of Alberta (GOA) announced its mandatory curtailment of crude oil production plan on Sunday, December 2, 2018.[1] The plan is a short-term measure to raise the price of Alberta's crude oil, currently selling at a discount at $10 per barrel, in order to compete with the global price of $50 per barrel. Production of crude oil in Alberta will be cut by 325,000 barrels (8.7 per cent) per day across the board by January 1, 2019. The plan is expected to last up to a year (December 31, 2019) and will be implemented through regulations, ministerial orders and directives of the Alberta Energy Regulator (AER). The new production rate will be monthly reviewed and revised as needed. Reduction levels will be set at the operator level (rather than individual well or project basis) and will be based off its highest six months of production over the past 12 months. The first 10,000 barrels produced by each operator are exempt. Companies that have already undertaken reductions on a voluntary basis will be taken into account.>

The AER will administer this reduction in production on behalf of the GOA and will establish a process to address company-specific concerns and make policy recommendations back to the government.

There Will be Winners and Losers

There is no industry consensus of opinion on Alberta's plan and even the major producers are divided. Those who own upgraders, refineries and gas stations disagree with the curtailment plan, as they benefit from lower feedstock prices. Others see the curtailment plan as an inevitable option. The smaller producers already hurting from the cost of production, also fear inequity in the allocation of the new rates. The GOA recognizes these diversity of interests in the industry and promises to ensure that smaller producers are treated fairly under the curtailment plan.

Why Production Cuts Now?

The GOA states that the price differential threatens Alberta's economic recovery and blames the situation on the federal government's inaction in building pipelines to take production to market. While oil sands production is gradually increasing, pipeline capacity has decreased. Currently, 35 million barrels of Alberta crude oil sit in storage.

What Can be Done to Fix the Problem?

The GOA further states that, as the owner of the resources, it has a duty to act when the markets are not working in order to protect jobs, the economy and the public interest. The GOA's medium-term plan is to buy 7,000 rail cars and about 80 locomotives, proposed to be operational by next year, that will transport Alberta produced oil to market. In the long-term, the GOA will continue its efforts to build new pipelines and encourage upgrading and refining products in Alberta.

Risks and Unintended Consequences

While the results of Alberta's curtailment plan are uncertain, the risks and unintended consequences are significant. Among the potential immediate impacts are the loss of proposed winter drilling projects, restricted volumes combined with the barrels in storage means more production off the market, and restricted volumes with already significantly high production cost. Potential challenges of implementing the curtailment plan include, among others, apportionment of the production cuts among producers including in multiple ownership contexts. The effect of the first 10,000 barrels exemption on the smaller producers is yet to be tested.

Impact on Pipeline Air Barrels Dispute

Also an issue at this stage is the impact of the new production rate on the ongoing pipeline air barrels dispute. The level of curtailment for each company under the plan will be based off its six months of highest level of production over the past 12 months. The Enbridge Mainline pipeline system, a common carrier interjurisdictional pipeline regulated by the National Energy Board (NEB), has the capacity to transport about 2.75 million barrels of heavy and light oil per day to the United States. However, in 2018 the pipeline was calculated to be operating 125,000 barrels a day below capacity (4.5 per cent) because of over-nomination by producers of more pipeline capacity than needed, to ensure protection if capacity allocations are reduced by the pipeline, known as "air barrels". Air barrels are said to inflate the demand for pipeline capacity and pipeline apportionment, negatively impact the ability of producers to access pipeline capacity to sell their monthly oil production, and force producers to remarket production at a significant discount to the monthly index price.

On June 6, 2018, BP Products North America Inc. (BP) filed a complaint at the NEB pursuant to Part IV of the *National Energy Board Act* in respect of Enbridge's implementation and subsequent reversal of a new supply verification procedure (SVP). A majority of the parties and the NEB[2] subsequently agreed that no further NEB process was required provided Enbridge adhered to its commitments which are to not reinstate the SVP or a similar procedure without NEB approval and to consult with all interested stakeholders to develop a solution to the over-nomination and apportionment issue. The NEB directed that any substantive changes to the verification procedures should be clearly set out in Enbridge's tariff to be approved by the NEB.

Impact of the Trans Mountain Pipeline Review and the Keystone XL Pipeline Review on Alberta's Curtailment Plan

The GOA hopes that the cutbacks will increase the price of oil but declined to speculate as to its next line of action should the curtailment plan fail to restore Alberta's crude prices. The long-term plan of building new pipelines appears longer given the recent turn of events in respect of a couple of the pipelines hoped to alleviate Alberta's market access challenges.

While the Government of Canada purchased the Trans Mountain Pipeline system and the related expansion project in August 2018, the Federal Court of Appeal's August 30, 2018 decision quashed the Order in Council that had approved the Trans Mountain Expansion project, and nullified the Certificate issued by the NEB for the project. The grounds were inadequate consideration of project-related marine shipping and Indigenous consultations. In September 2018, the Government of Canada issued a new Order in Council and referred these aspects related to the application of the *Canadian Environmental Assessment Act, 2012*[3] and the *Species at Risk Act*[4] back to the NEB for reconsideration within 155 days (February 22, 2019). A public hearing for the NEB reconsideration of the Trans Mountain Expansion Project is ongoing. It remains uncertain whether there will be further court challenges after the NEB reconsideration of the project.

The United States portion of the Keystone XL oil pipeline planned to begin construction in February 2019 will now undergo another environmental review (supplemental environmental impact statement) by the U.S. State Department. The review will consider potential effects of the project on greenhouse gas emissions, crude spills, Native American land and cultural resources, and the overall market. The additional review was ordered by the U.S. District Court in Montana in a November 8, 2018 injunction decision preventing physical construction work on the pipeline. It is uncertain what the injunction will mean to the timeline of the Keystone XL pipeline.

BLG is actively monitoring Alberta's new curtailment plan and evaluating its impacts, challenges and potential solutions.

The Central Theme of the Canadian Energy Policy

Indeed this is not the first time Alberta has curtailed production. The diverse economic interests in overcoming pipeline transportation challenges has been a central theme of Canadian energy policy since the 1950s. Some of the federal government energy policies in the 1970s provoked radical provincial actions to control the production, regulation, marketing and pricing of their resources. Alberta created the Alberta Petroleum Marketing Commission in 1974, pursuant to the *Petroleum Marketing Act*,[5] with broad powers over the production, pricing and provincial marketing of oil. Also the 1980 National Energy Program (NEP) triggered more conflict between the province and the federal government. One of the issues was whether domestic oil and gas prices should track global prices. The NEP led Alberta to cut back its oil production, withhold approval of two large oil sand and heavy-oil projects, and challenge the legality of the proposed federal tax on gas exports in *Reference Re Proposed Federal Tax on Exported Natural Gas*.[6] It is interesting that interjurisdictional pipeline issues remain as relevant today as they were over 40 years ago.

At this time, however, Alberta has clear constitutional jurisdiction over energy and natural resources in Alberta pursuant to sections 109 and 92A, among others, of the *Constitution Act, 1867*.[7] Currently, Alberta regulates oil production rates pursuant to the *Oil and Gas Conservation Act* ("*OGCA*"),[8] the *Oil and Gas Conservation Rules*,[9] and the AER's Directives and Orders including Maximum Rate Limitation (MRL) Orders.

Pursuant to the *OGCA*,[10] the AER may by order restrict the amount of oil and gas produced, in association with the oil that may be produced from a pool or pools in Alberta by determining the market demand for a stream or streams of crude oil within a pipeline or pipelines, and by allocating that market demand in a reasonable manner among the wells or group of wells supplying the pipeline or pipelines for the purpose of giving each well owner the opportunity of producing or receiving a just and equitable share of the crude oil in the pool or pools.

While section 34 of the *OGCA* does not apply to crude bitumen, certain natural gas liquids and or synthetic crude oil, the *Oil Sands Conservation Act*, (*OSCA*)[11] defines "wasteful operations" to include "the production of oil sands, crude bitumen, derivatives of crude bitumen or oil sands products in excess of proper storage facilities or transportation and marketing facilities or of market demand for them" and "waste" to include wasteful operations.[12] The *OSCA* also permits the AER to make rules respecting methods of operation to be observed for the prevention of waste, and generally, to conserve oil sands and crude bitumen and to prevent the waste or improvident disposition of oil sands, crude bitumen, derivatives of crude bitumen, declared oil sands or oil sands products.[13] In addition, waste is an offence under the *OSCA* and, notwithstanding a prosecution, the AER may commence and maintain an action to enjoin a person from committing waste.[14]

The AER's authority for the curtailment plan is derived from the *Responsible Energy Development Act* (*REDA*)[15] tying into the existing legislative authority under the relevant energy resource enactment, the *OGCA* and the *OSCA*. Pursuant to the *REDA*, the AER, with the approval of the Lieutenant Governor in Council, may take any action and make any orders and directions that it considers necessary to carry out its mandate and the purposes of the Act or any other enactment that are not otherwise specifically authorized.[16] The AER has the power "to monitor and enforce safe and efficient practices in the exploration for and the recovery, storing, processing and transporting of energy resources" in carrying out its mandate.[17] Further, the Minister may give directions to the AER for the purposes of "ensuring the work of the regulator is consistent with the programs, policies and work of the Government in respect of energy resource development, public land management, environmental management and water management."[18] New rules, ministerial orders, and potential consequential amendments to existing rules, are expected shortly.

1 https://www.alberta.ca/protecting-value-resources.aspx#toc-0

2 https://apps.neb-one.gc.ca/REGDOCS/Item/View/3580523

3 SC 2012, c 19, s 52.

4 SC 2002, c 29.

5 RSA 2000, c P-10.

6 (1982), 136 D.L.R. (3d) 385 (S.C.C.) https://www.canlii.org/en/ca/scc/doc/1982/1982canlii189/1982canlii189.html

7 30 & 31 Vict, c 3.

8 RSA 2000, c O-6.

9 Alta Reg. 151/1971.

10 Section 34 OGCA.

11 RSA 2000, c O-7.

12 Subsections 1(1)(t) and (s) OSCA.

13 Section 20(1)(g) and (u) OSCA.

14 Section 22 OSCA.

15 SA 2012, c R-17.3.

16 Subsection 14(2) REDA.

17 Subsection 2(1) and (2)(f) REDA.

18 Section 67 REDA.

By

Alan Ross

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BLG Offices

Calgary

Centennial Place, East Tower
520 3rd Avenue S.W.
Calgary, AB, Canada
T2P 0R3

T 403.232.9500
F 403.266.1395

Ottawa

World Exchange Plaza
100 Queen Street
Ottawa, ON, Canada
K1P 1J9

T 613.237.5160
F 613.230.8842

Vancouver

1200 Waterfront Centre
200 Burrard Street
Vancouver, BC, Canada
V7X 1T2

T 604.687.5744
F 604.687.1415

Montréal

1000 De La Gauchetière Street West
Suite 900
Montréal, QC, Canada
H3B 5H4

T 514.954.2555
F 514.879.9015

Toronto

Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3

T 416.367.6000
F 416.367.6749

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