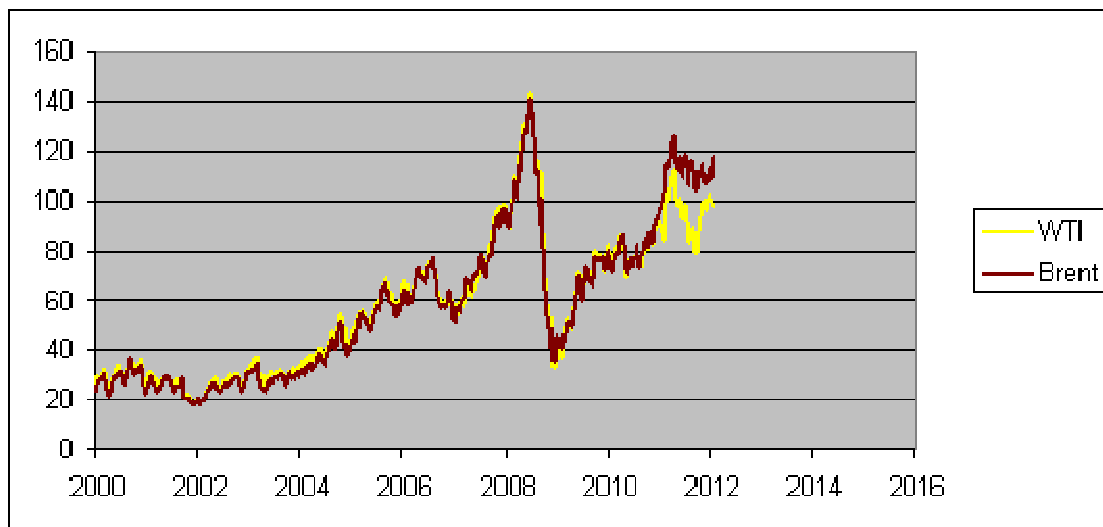


Work-arounds for the politics of Keystone

The [Keystone Gulf Coast Expansion Project](#) is now entering its fourth year of regulatory review, and is currently on [indefinite political hold](#). In the mean time, the market is figuring out other alternatives.

A key demonstration of the need for better oil transportation infrastructure in the United States is the price gap between West Texas Intermediate, a light, sweet crude traded in Cushing, Oklahoma, and Brent, a similar crude from the North Sea. The Law of One Price suggests that these very similar products should sell for a very similar price, and indeed for most of their history, they did exactly that.



Prices (in dollars per barrel) of West Texas Intermediate and Brent, weekly, Jan 7, 2000 to Feb 10, 2012. Data source: [EIA](#).

However, a remarkable spread between Brent and WTI began to develop at the start of last year. New production of crude from North Dakota and Canada, decreased U.S. demand, and pressure on European supplies of light, sweet crude from developments in Libya all changed the relative supply and demand situations in the central U.S. and Europe. Brent began to break away completely from WTI, with the spread last week bumping back up near \$20/barrel. The spread between Brent and North Dakota crude is even more dramatic, with the latter selling at up to a [\\$40 discount to Brent](#).

That price differential is a very loud market signal that we're using available resources extremely inefficiently, and impoverishing ourselves in the process of paying so much to import oil from places like Nigeria, Iraq, Saudi Arabia, and Venezuela. That market signal is also a strong incentive to anybody to try to figure out a way to transport the lower-cost crude now available in the northern and central United States to refiners on the U.S. coasts, who are currently paying inflated prices to obtain oil from overseas.

One logical solution would be [TransCanada corporation's Keystone Gulf Coast Expansion](#) proposal to build a major new pipeline to carry oil all the way from Canada and North Dakota down to refiners on the Gulf of Mexico. As obvious and logical as this is from an economic perspective, it unfortunately became a political symbol for some broader controversies, whose net effect has been to paralyze the Obama Administration from moving forward.



Existing Keystone Pipeline and proposed Keystone Gulf Coast Expansion Project.

But there is more than one way to skin a cat. Enbridge, another Canadian company, has purchased half-interest in the Seaway Pipeline, which historically had been used to carry oil from the Gulf of Mexico to refiners in Oklahoma. Enbridge's plan is to invest in the infrastructure necessary to allow oil to move in the opposite direction through that pipe in order now to bring crude oil from Cushing down to refiners on the Gulf. [Enbridge announced on Friday](#) that this process is well under way:

The initial 150,000 barrels per day (bpd) of capacity on the reversed system could be available by the second quarter 2012. Following pump station

additions and modifications, which are expected to be completed by the first quarter 2013, capacity would increase to 400,000 bpd assuming a mix of light and heavy grades of crude oil.

A separate plan is Enbridge's [Flanagan South Pipeline Project](#), which would lay a second set of pipes twinning its existing system to carry oil from Illinois to Cushing. It would serve a similar function as part of Keystone, adding capacity to get more oil from the north down to Cushing, albeit at greater cost and less efficiently than Keystone. But it's much harder to frighten the public with images of a pipeline that goes right next to one that's already there, and the regulatory obstacles are much more modest. Again from [Enbridge's Friday statements](#):

Enbridge announced that it secured sufficient capacity commitments from shippers to proceed with its Gulf Coast Access initiative offering crude oil transportation from its terminal at Flanagan, Illinois to the United States Gulf Coast. Enbridge also announced that, in response to shipper requests, it would hold a second open season early in the year to provide an opportunity for shippers to subscribe for additional capacity. The Gulf Coast Access initiative will involve construction of an additional line from Flanagan south to Cushing, Oklahoma following Enbridge's existing Spearhead Pipeline right-of-way. This line is expected to be in service by mid 2014 at an estimated capital cost of approximately US\$1.9 billion depending on the final scope of the project. From Cushing, crude oil will move to Houston and Port Arthur, Texas on the Seaway Pipeline system, a joint venture between Enbridge and Enterprise.

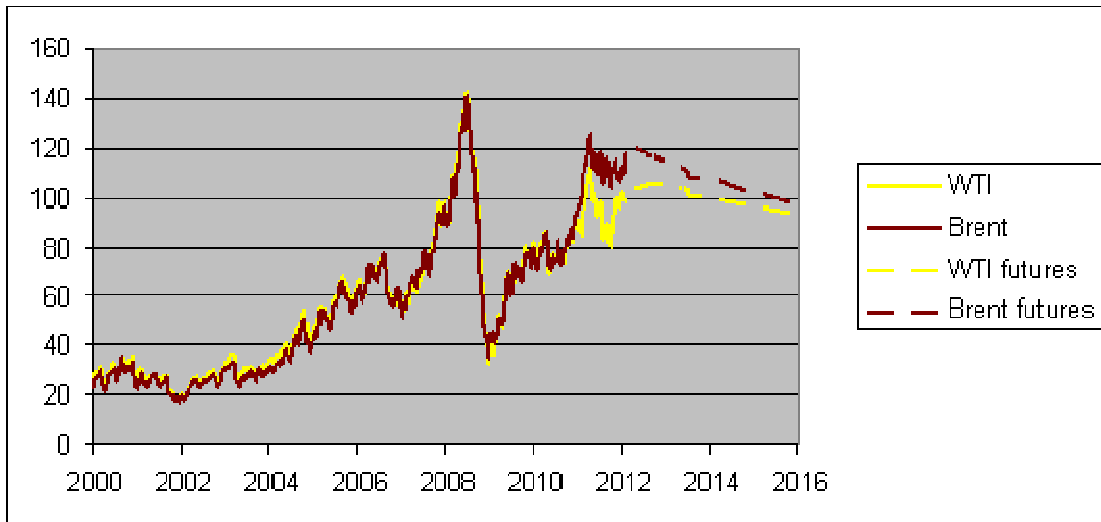


Source: [Enbridge](#).

In yet a third development, TransCanada is recognizing that even if it can't get the full Keystone Gulf Coast Expansion approved, a great deal could still be accomplished with just the segment from Cushing down to the Gulf. TransCanada is reported to be pursuing the possibility of proceeding just with that segment alone even as the broader project still waits for approval ([1], [2]).

As we develop reasonable alternatives to get lower cost oil to refiners on the U.S. coast, the price differential between WTI and Brent has to narrow. The conventional wisdom has been that this would mostly be accomplished by the U.S. price coming up rather than the world price coming down, primarily because the world is a bigger market than just the U.S. But it's interesting

that if you look at futures prices for WTI and Brent, these do indeed show the gap narrowing to \$4/barrel by 2015, but that narrowing comes entirely from Brent falling down below even the present WTI.



Data source: [EIA](#) and [TradingCharts.com](#) [1], [2].