



Regional Supply Issues for Both Crude Production and Finished Products were the Primary Factors behind Rising Prices in the Second Quarter of 2016.

Product supply issues in Western Canada, stemming primarily from the Alberta wildfires, limited the production and transportation of crude, putting some upward pressure on crude prices. Coupled with finished product supply issues from refinery outages in the Central and Western regions, Canadian retail prices reached their highest levels to date in 2016.

Crude supply issues were widespread both abroad and domestically over the last quarter. Supplies were constrained by lower shale production and issues related to the wildfires in Alberta. This led to a dip in inventories, and triggered higher crude prices throughout the last few months.

Seasonally high North American gasoline demand, strong refined product exports, and the approaching summer driving season meant refinery inputs rose despite a reduction in operable capacity related to a number of refinery issues. This also led to a drawdown of refined product inventories and a sharp rise in wholesale product prices for most of the quarter – predominantly in the Midwest, which saw product shortages in the wake of refinery issues in Alberta. This was in sharp contrast to the eastern regions of Canada which were largely unaffected by these issues, and so their wholesale prices were much more stable over the period.

Diesel refining margins, which typically fall over the summer months, began to rise late in the quarter. This was driven by supply tightness, largely the result of strong overseas demand and refinery strikes in France. **Figures 1&2** show the historical movement of retail gasoline and diesel prices in Canada along with their component prices.

WTI and Brent, key North American and international crude benchmarks respectively, moved in lockstep throughout the quarter, feeling upward pressure from global supply constraints. WTI rose to a high of 51.23 \$US/BBL in mid-June before ending the month at 48.30 \$US/BBL; 28.3 percent above the end of last quarter. Brent crude rose to 51.03 \$US/BBL in mid-June before ending the quarter at 48.23 \$US/BBL, 27.8 percent higher than it ended the previous quarter, while remaining at parity with WTI.

Similarly, Western Canadian Select (WCS) ended June up 37.5 percent from the end of last quarter. In April, a portion of the Keystone pipeline that moves roughly 590,000 barrels per day from Canada into Cushing was shut down for a week, widening the WCS to WTI discount to 14.97 \$US/BBL. As Canadian oil sands production came offline in response

Figure 1: Canadian Average Regular Gasoline and Component Prices

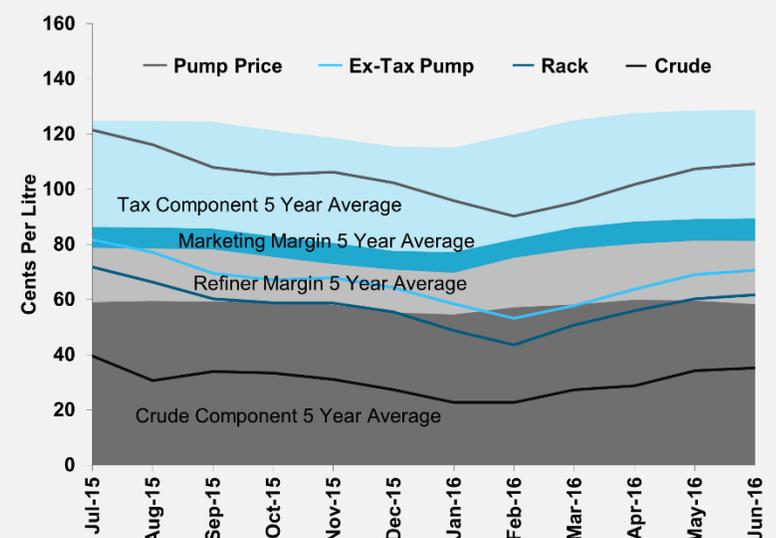
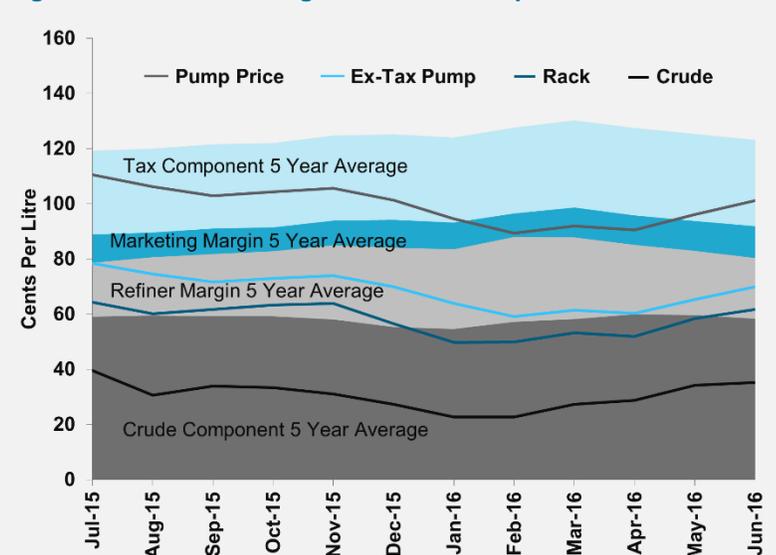


Figure 2: Canadian Average Diesel and Component Prices



to the Alberta wildfires in early May, the discount fell to 11.30 \$US/BBL, before rising again as production came back online - ending the quarter at 13.77 \$US/BBL.

Gasoline and Diesel Market Overview

The Canadian average retail gasoline price rose to a ten-month high in June, up 14.1 cents per litre from March, driven by both increased crude prices and refining margins. The onset of the summer driving season and the noted refinery issues caused the average Canadian wholesale price to rise 10.9 cents per litre from March. Retail margins ended the quarter 1.8 cents per litre higher than the previous period.

Regional disparity in wholesale gasoline pricing was prevalent between the West and the rest of Canada, as an unplanned refinery shutdown in Alberta resulted in fuel shortages throughout the region. As stations made efforts to re-supply, retail margins in Alberta, Saskatchewan, and Manitoba rose to end the quarter at an average of 13.2 cents per litre – nearly 8 cents per litre above their March average. However, the largest increase in Canadian retail gasoline prices occurred in Newfoundland and Labrador where the provincial

excise tax jumped 21.5 cents per litre at the beginning of June. This brought the total tax portion of Newfoundland and Labrador pump prices to nearly 58 cents per litre, making their gasoline the most heavily taxed in the country, and pushing their retail prices higher than any other province.

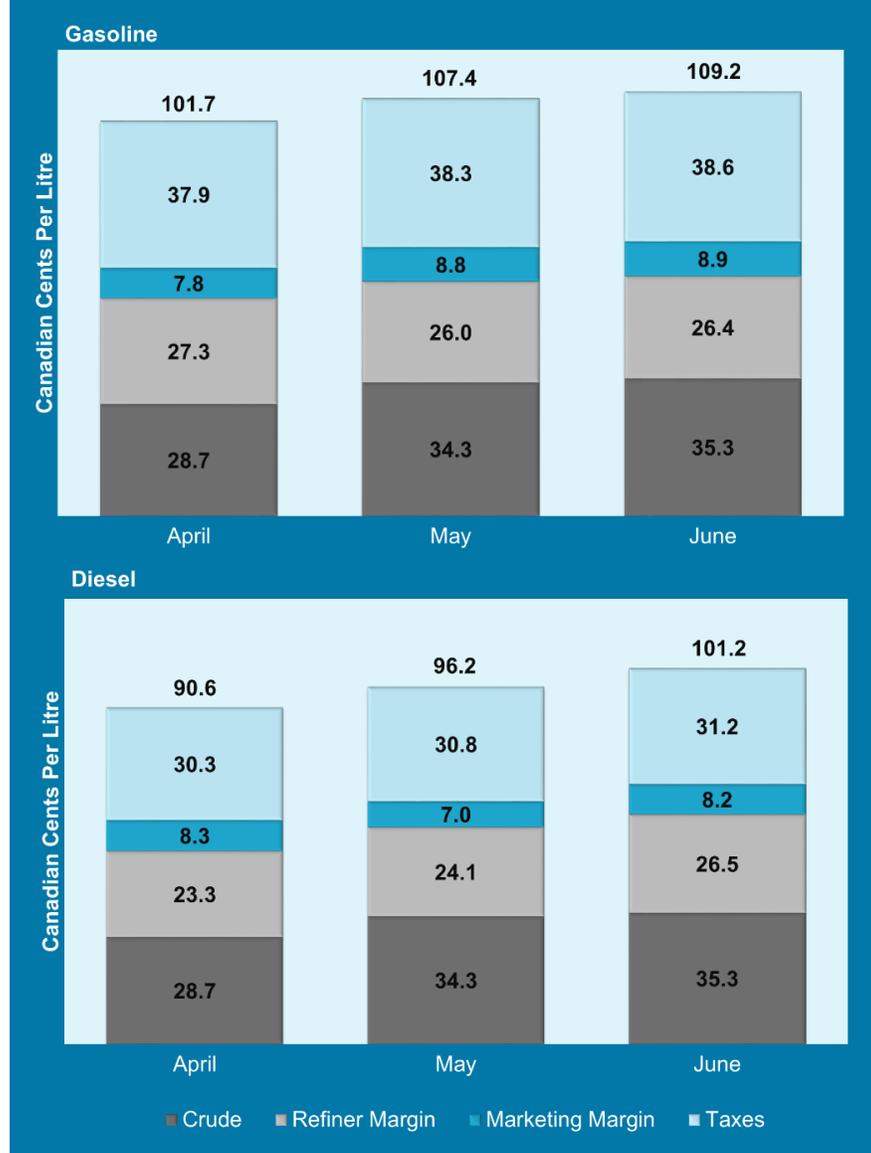
Diesel prices rose 9.3 cents per litre over the second quarter, reaching a six-month high. Refining margins rose in June as demand for distillate increased globally, a result of strong economic growth in developing economies like India. Additionally, supply issues related to refinery strikes in France constrained supply, pushing wholesale prices higher. This runs counter to typical Canadian diesel pricing trends, which are more likely to fall in the summer months. Diesel retail margins remained low, averaging just 7.8 cents per litre for the quarter.

Regional wholesale diesel prices showed some disparity in May, particularly along the West Coast, which saw wholesale prices rise 17.7 cents per litre, while Eastern prices rose less than a cent over the same period. (Figure 3)

Market Outlook for the Next Quarter

Although there is always uncertainty around future crude price movement, stable crude prices would likely mean that wholesale gasoline prices fall over the next quarter. Many of the refineries that were offline in the past quarter are back online, finished product markets are well supplied, and inventories are growing. Notwithstanding a major supply issue or shock in crude markets, gasoline prices should soften well into the fall.

Figure 3: Canadian Average Gasoline and Diesel Price Components for 1st Quarter 2016



Diesel prices will likely move with fluctuations in crude markets. Stable crude prices into the next quarter will likely mean diesel prices hold at current levels over the next few months. Towards the end of the next quarter, refiners typically begin building distillate stocks in anticipation of the winter heating season, likely putting some upward pressure on wholesale prices.

What's driving the Recent Rise in the Number of Retail Fuel Sites in Canada?

According to the Kent Group's recently released annual Retail Site Census, the number of retail fuel sites in Canada reached 11,916 in 2015; an increase of over 100 from the previous year. This reversed a 25-year trend that saw the number of retail fuel sites in Canada drop from over 20,000 in 1989 down to 11,811 in 2014. The reversal of this trend actually started a few years ago, with a pronounced deceleration in the rate of decline.

What is driving this shift? Have site closures slowed, or are retailers building more new sites? According to Kent's detailed site data, sourced from over 300 Canadian markets, new-to-industry (NTI) and rebuilt sites have remained fairly stable over the last 10 years, while site closures have decreased by nearly 70% over that time. The result was a change from a net annual decline in the number of sites to a net annual increase over the last few years (Figure 4).

This trend reversal coincided with a near doubling of the average retail margin in Canada between 2006 and 2015 – rising from 5 cents per litre to 9 cents per litre over that time (Figure 5). That increase is likely both cause and effect of a reduction in site closures. High margins may have kept some marginal businesses solvent when they may otherwise have closed, and plateauing site counts can translate to flat or declining site throughputs, ultimately putting upward pressure on margins.

Figure 4: Canadian Net Sites Added/Closed 2005-2015 (Source: Kent-surveyed markets)

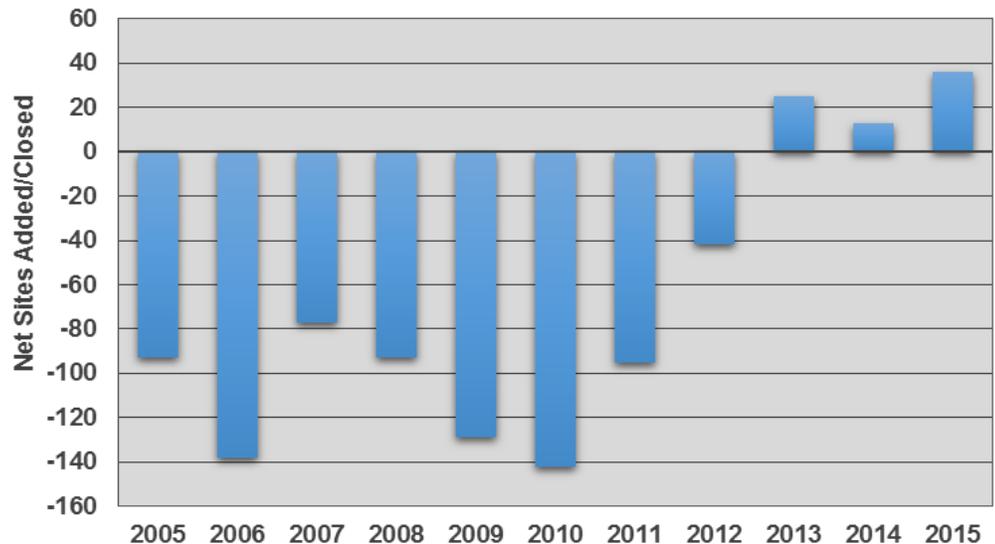
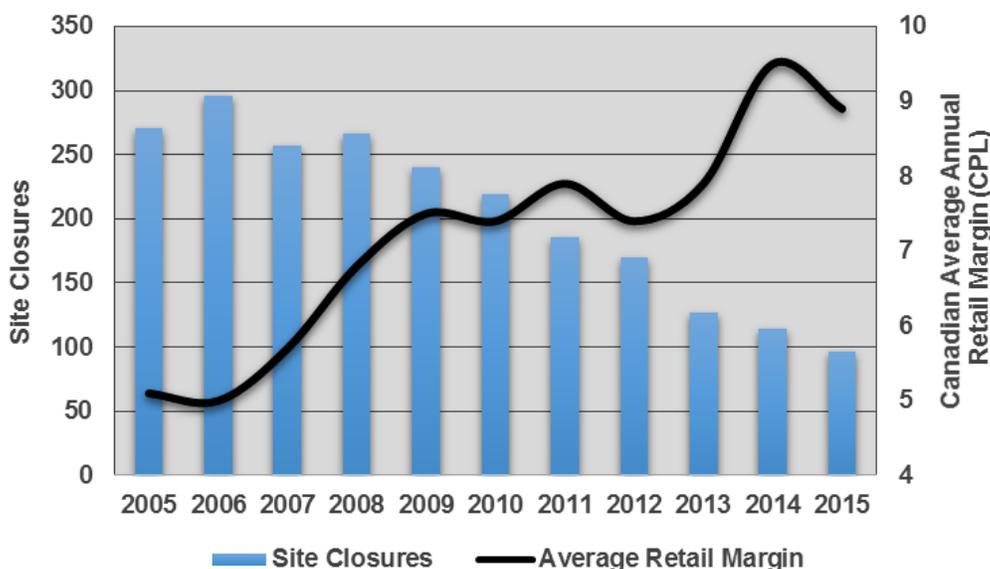


Figure 5: Canadian Site Closures vs. Canadian Average Retail Margin 2005-2015



In addition, there simply may be fewer underperforming sites left in the market after 25 years of consistently high closure rates. Despite the rise in retail margins, the average annualized throughput (volume of fuel sold) at closed sites showed considerable uniformity over the last decade, presenting a consistent profile for sites that are at risk for closure (Figure 6). Further examination of Kent's data from 2006 and 2015 shows that the percentage of sites with volumes below the average annualized throughput of closed sites fell from 15.2 percent in 2006 to just 8.9 percent in 2015, so the reduction in closure rates may simply be a product of a smaller pool of underperforming sites remaining in the market each year.

Certainly there are factors other than margin and throughput influencing site closures, but these two factors remain fundamentally important to site viability. Current market conditions have led to a period of relative stasis in the number of retail sites in Canada; however, this stability is not likely to continue in the long-term. It is unlikely that margins will continue to rise at the same rate they have over the last few years; they are much more likely to follow inflationary trends. Additionally, the demand outlook for retail fuels in Canada is flat, and the throughput from the average NTI site can replace three or four average closed sites. Lastly, despite the abovementioned decline in the number of poorly performing sites, the total number of these sites remaining is still over a thousand. Therefore, the expectation is a continued net decline in the number of sites over the longer-term, albeit at a much slower rate than over the past 25 years.

Figure 6: Canadian Average Annualized Throughput by Site Type, Select Years

