



Storm Clouds on the Horizon for Crude Oil Prices

Description

Crude prices react to a range of geopolitical and economic factors, and continue to remain volatile because of uncertainty over the direction of the global economy. A key driver of the outlook for crude prices is economic growth, because higher economic growth signals greater demand for energy, of which crude is a key element. But there are still other global and domestic factors driving crude prices.

Supply interruptions caused by ongoing conflicts in key crude-producing areas such as the Middle East, and the threat of military intervention in this region continue to affect oil prices. So too do the political and economic situations of key oil-producing countries like Venezuela, Canada, and Libya. Growing sources of oil supplies are also influencing oil prices both regional and globally, as technological advances allow oil companies to access oil reserves that were once thought to be not commercially viable.

I've already shown [how crude oil pricing works](#) and explained the two key crude price benchmarks, West Texas Intermediate and Brent. Now, let's take a closer look at the global outlook for crude prices over the short term.

Short-term indicators show crude prices will pull back

Crude is currently trading at its highest levels since October 2013. The emerging markets crisis earlier this year, and fears of an escalation in the conflict in Ukraine and the Crimea were key drivers of this.

However, ongoing instability in the Middle East, a range of conflicts threatening to engulf the region, and civil unrest in Libya and Egypt are set to pull back crude prices over the short term.

Another important contributor to this pullback will be growing U.S. domestic crude production, which in April 2014 alone averaged 8.3 million barrels daily, the highest average monthly production since March 1988. The U.S. Energy Information Administration has forecast that U.S. 2014 average daily crude production will grow 15% compared to 2013, to 8.5 million barrels daily. For 2015, average crude production is expected to hit 9.2 million barrels daily, a 24% increase over 2013.

U.S. crude oil production is expected to continue growing at an exponential rate and the U.S. will

eventually overtake Saudi Arabia in 2020 to become the world's largest oil producer. This has flooded the market with U.S. light sweet crude, known as West Texas Intermediate, causing WTI prices and demand for other light sweet crude blends to soften. If we take a closer look at WTI futures it is possible to see how the market expects prices to react.

Based on these futures, the price of WTI is expected to soften 5% by the end of 2014 and then drop a further 8% by the end of 2015 to around \$90 per barrel. But the pullback in Brent prices is expected to be less severe, with its price dropping 3% by the end of 2014 and 8% by the end of 2015.

This flood of light sweet crude will cause the differential between WTI and Brent prices to widen even further. At this time, Brent trades at a premium of around 7%, but by the end of 2014 it is expected to widen to almost 9% and be around 13% by the end of 2015.

Softer short-term crude prices will hurt the patch

Growing U.S domestic crude production will cause demand for oil imports to wane. The greatest impact will be felt by Canada, with the U.S. accepting around 98% of Canada's total energy exports, or almost 76% of Canada's total crude production. This will see the prices of a variety of Canadian crude blends, particularly Edmonton Par, come under pressure.

In fact, there is already evidence of this, with the price of Edmonton Par for the year to date softening almost 3% and its discount to WTI widening almost 7%. Yet the price of WTI has spiked a healthy 8% over the same period.

What does this mean for investors?

The greatest impact of softening crude prices over the short term will be felt by those players in the patch that predominantly produce light crude benchmarked to the price of WTI. This includes the majority of light oil producers in the patch, including **Crescent Point Energy** (TSX: CPG)(NYSE: CPG), **Lightstream Resources** (TSX: LTS), **Whitecap Resources** ([TSX: WCP](#)), and **Penn West Petroleum** (TSX: PWT)(NYSE: PWE). Any significant drop in the price of Edmonton Par will hurt the revenue of these companies as well as their margins, including operating netback and profitability.

Those Canadian oil companies best positioned to weather this short-term downturn are those able to access offshore energy markets other than the U.S. and obtain Brent pricing.

This includes **Husky Energy** (TSX: HSE), which has a range of offshore projects giving it access to Asian and European energy markets and to Brent pricing for a proportion of its crude production. Another company that stands out is **Vermilion Energy** ([TSX: VET](#))([NYSE: VET](#)), which has a range of globally diversified assets, with around 40% of its crude production indexed to Brent.

It is clear the price of crude will soften over the short term as growing U.S. oil production floods the market with light sweet crude. The greatest impact in the patch will be felt among those operators which produce predominantly light crude benchmarked to WTI and are dependent on exporting to the U.S.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:VET (Vermilion Energy Inc.)
2. TSX:VRN (Veren Inc.)
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