



Why the President of Goldman Sachs Thinks Oil Is Headed to US\$30

Description

In a recent interview with CNBC, **Goldman Sachs Group Inc.** President Gary Cohn said that oil prices could fall to US\$30 per barrel. This contradicts a recent statement by an OPEC official, who claimed that oil has already reached its bottom.

So what exactly is Mr. Cohn's reasoning? And how should investors react? Below we take a look.

The effect of hedges

First, it's important to make one thing clear: oil companies will only cut output as a last resort. Production cuts send a very bad signal to shareholders, and no management team wants to work for a shrinking company. As one *EnergyWire* reporter put it, "No one likes a quitter." Consequently, what we're seeing is a war of attrition, one in which drillers will maintain production as long as they have the financial flexibility. This is not good news for oil prices.

Furthermore, there's a big reason why so many producers can maintain output for so long: hedging. Numerous producers have hedged a big part of 2015 production at prices of US\$90 per barrel per more. For example, **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG) has half of its 2015 production hedged at this level. Thus the company can afford to keep growing production.

Eternal optimism

There's another factor sustaining prices: optimism. Allow me to explain.

Producing oil requires significant upfront investment, and also requires a time commitment. In other words, it takes time to bring production online. So when making an investment decision, today's oil price doesn't matter as much as *future* prices. And if you believe prices will rise in the future, you're more likely to drill that extra well.

These days, producers are generally optimistic about a recovery. To prove this point, just look at the futures market: producers are still able to lock in a 2015 oil price of US\$57 per barrel. That's almost 25% above the current price!

So ironically, optimism about prices later in 2015 will keep prices depressed early in the year.

Sunk costs are irrelevant

There's another reason that oil prices could fall lower. Many oil projects are already completed, or nearing completion. And even with low prices, it's still worthwhile for producers to bring these assets online. After all, the major costs have already been incurred.

Let's take **Suncor Energy Inc.** ([TSX:SU](#))([NYSE:SU](#)) as an example. The company pegs its oil sands cash costs at \$31.10 (or US\$25.09) per barrel. Why are its costs so low? Because it's already made the major investments necessary to bring its production online! So why would it cut production now?

What should investors make of all this? Well, don't expect an oil price recovery any time soon, at least not in the next six months. Most analysts agree on that. Longer term, there is clearly more optimism. But remember, producers don't like to cut output. It may be a good idea to listen to Mr. Cohn and just stay away.

If you're looking to bet on a turnaround, the free report below reveals a much better option than the energy industry.

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