Why American Oil Storage Capacity Is Near a Breaking Point

Description

In Canada, there's a persistent belief that an oil recovery is right around the corner. If you don't believe me, just look at the stock prices of some of Canada's largest oil companies.

Over the past year, a time when oil prices have fallen by more than half, **Suncor Energy Inc.** (TSX:SU)(NYSE:SU) shares have dropped by less than 3%. The same can be said for **Imperial Oil Limited** (TSX:IMO)(NYSE:IMO). If people believed the oil slump will drag on, wouldn't these stock prices have declined further?

There is some reason to believe that oil prices will rebound. Producers are drilling less and demand is starting to pick up. On the other hand, production remains at record levels, and as a result, inventories continue to build.

In fact, new reports suggest that storage capacity is running out! This means producers may soon have to sell all their oil at whatever price can be fetched today. If this were to happen, supply would increase, and prices would plummet even further.

So, why exactly are storage levels so high?]We take a look below.

Production is continuing to increase

According to the most recent data, oil production rose for the fourth consecutive week to 9.3 million barrels per day. Why is this happening if prices are so low?

Well, there are a number of reasons. First, costs have come way down. Second, companies are reluctant to cut production, only to see competitors benefit from higher prices. Making matters worse, some producers are heavily indebted, and have to keep drilling at full capacity just to pay creditors. Finally, producers simply don't want to cut output because it sends a very bad signal to investors.

The general consensus is that production will drop later in the year, but if you're expecting output to drop off a cliff, don't get your hopes too high. The trends mentioned above will still be around.

Refinery shortages

In today's oil price environment, there is simply a lack of refinery capacity, forcing producers to store their crude instead of sell it. There are a couple of big reasons for this. First of all, this is the time of year when many refineries schedule routine maintenance. Second, much of the U.S. refining capacity is designed for heavy crude (the kind that comes from Canada, Mexico and Venezuela), while the production increases have come from lighter oils.

Meanwhile, there is a crude export ban in the United States. So, if the oil can't be refined, it must be stored.

Future prices

Based on today's oil prices, there's an opportunity to make money from storing oil. To be specific, an investor can buy oil today for US$50 per barrel, then enter a contract to sell it for US$59 in December. Even after storage costs, this works out to a nice profit.

Eventually, this opportunity will disappear. In other words, the storage cost will likely increase, or the future price will come down. Neither of these would be good news for the oil market.

So, if you're thinking of buying a company like Suncor or Imperial Oil, you may want to think again. There's a lot of optimism built into these stock prices, not all of which is warranted.

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2. NYSEMKT:IMO (Imperial Oil Limited)
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Date
2025/07/06

Date Created
2015/03/05
Author
bensinclair