One Worrying Chart That No Oil Investor Wants to See

Description

Since oil prices collapsed back in December last year, there has been carnage in the energy patch, with many companies seeing their share price plunge by 50% or more overnight. Despite claims among some analysts that oil prices are set to rebound over the course of this year, there are growing signs that the carnage will continue for some time.

Now what?

The key triggers for the rout in crude was growing U.S. shale oil production that overtook Saudi Arabia to become the world's largest oil producer last year. This then motivated the Saudi's to pump more oil as they battled to regain market share by keeping crude prices low and forcing high-cost U.S. shale oil producers out of the market.

However, even with those U.S. oil producers savagely slashing capital budgets and shutting down rigs, dropping the U.S. rig count to its lowest level since early 2003, U.S. oil production is at its highest level ever. Even more startling, in the second-last week of May U.S. oil output spiked by 3% to a new production record compared with previous weeks. As the chart shows, all of this is happening despite the declining rig count.

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US Daily Average Oil Production 030615 *Source: U.S. EIA.*

How can this happen? Well, it is quite easy to explain.

While high-cost producers are shuttering rigs, actual output is not falling as rapidly as many had predicted. This is because the first rigs to be shut down were those operating in high-cost and low-volume fields.

Furthermore, oil companies are focused on boosting production from those fields that have low breakeven costs because even in the current harsh operating environment, these fields remain profitable.

Finally, one of the most costly activities in the upstream oil industry is physically drilling the well. This means that once the well is completed and starts to pump crude, costs will continue to fall over its lifetime, compelling its operators to start pumping oil in an effort to regain some of the upfront investment.

So what?

This certainly isn't good news for those bargain hunters who expected oil prices to quickly recover and loaded up on distressed energy companies like **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE). Those companies will struggle to survive if oil production remains high and prices remain stubbornly low. Any sustained period of low crude prices could take companies like Penn West to the wall no matter how many times they renegotiate their financial covenants.

Even **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG), which has over half of its 2015 oil production hedged at $89 barrel and 33% at $84 per barrel, is struggling. For the first quarter of 2015 operating cash flow plunged a massive 31% year over year, while net earnings crashed to earth with a resounding thud, falling by 249%. This can be attributed to the oil crash and these results now have some analysts worried that its monster 10% yield is unsustainable.

Clearly, the storm for oil companies is far from over and energy investors need to remain on their guard.

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