Why Weak Oil Prices Are Here to Stay

Description

Recent news from the International Energy Agency (IEA) indicates that the global supply glut for crude continues to grow. The agency has estimated that global oil stockpiles have reached record levels. As alarming as this may be for energy companies and investors alike, there are signs that these stockpiles are set to grow further; this will put considerable pressure on oil prices and the profitability of oil companies.

Now what?

Despite energy companies continuing to shutter production and the U.S. rig count falling to its lowest point in over 13 years, there are signs that low oil prices are here to stay.

The latest data from the IEA shows that U.S. oil production grew over the last four weeks to now be at its highest point since August of this year. This, in conjunction with U.S. commercial oil stocks being at their highest level since April, is applying considerable pressure to the price of crude.

These events have also contributed to global oil stock piles hitting record levels of three billion barrels of crude, and there are signs that they will continue to grow.

There is also the large inventory of completed but unfracked wells in North America, which is estimated to total almost 4,000 wells waiting for completion in the U.S. alone. This equates to daily production of 400,000 barrels of crude still sitting underground. Any marked uptick in the price of oil will see energy companies complete those wells and commence pumping the crude they hold.

Then you have the threat of Iran boosting oil exports by up to 500,000 barrels daily once sanctions are lifted.

These factors are all keeping oil prices under pressure, and with global crude supplies significantly outstripping demand, I expect to see prices remain under US$50 per barrel for at least the foreseeable future.

A sustained period of sharply weak oil prices will apply considerable pressure to those energy companies that have high operating costs and heavily levered balance sheets.

In fact, it could be just enough to push companies such as **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE), **Pacific Exploration and Production Corp.** (TSX:PRE), and **Lightstream Resources Ltd.** (TSX:LTS) to the wall.

All three aggressively loaded up on debt to acquire assets when oil prices were high, many of which were of questionable quality, with a view that the good times would never end. Now, with oil at close to US$40 per barrel, they are struggling to remain financial viable; all three are cash flow negative and continue to bleed red ink.

If oil prices remain significantly weak for a sustained period, it will become increasingly difficult for them to sell assets as a means of raising cash to pay down debt. It also means that with high levels of leverage and declining cash flows they won't be able to obtain additional credit in order to fund operations and capital expenditures.

So what?

The price of crude remains under considerable pressure and, despite some industry insiders expecting oil to rebound, it appears that low crude prices are now the new normal for energy companies. While the integrated energy majors, such as **Suncor Energy Inc.**, **Imperial Oil Limited,** and **Husky Energy Inc.,** will be able to weather the current storm, smaller, heavily levered energy companies are highly vulnerable to a sustained period of weak oil prices.

CATEGORY

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