Is Crude on the Cusp of a Long-Awaited Recovery?

Description

The outlook for crude remains bleak. Some analysts have estimated it could fall to as low as US$20 per barrel in coming months as growing inventories and dwindling demand continue to impact its price.

However, there are signs that this pessimism could be overcooked. Financial pressures within OPEC caused by weak oil prices have indicated that relief could be in sight for the energy patch.

Now what?

In recent news, an OPEC insider has stated that Saudi Arabia has proposed implementing a deal to balance the market with non-OPEC assistance.

This news couldn't come sooner for many beleaguered Canadian energy companies such as **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) and **Pacific Exploration and Production Corp.** (TSX:PRE). Both, like many other small- to mid-sized upstream oil producers, are battling negative cash flows and massive debt loads that seem ready to push them into bankruptcy should oil prices remain weak.

Previously, the Saudi's and with their Gulf state allies have remained adamant that they will continue to grow crude output as a means of keeping prices low and pushing higher-cost producers out of the market in order to regain market share.

Meanwhile, the reality is that with oil hovering around US$40 per barrel, many OPEC states are having considerable difficulty balancing their budgets. Then you have the Saudi's and their allies remaining locked in a series of costly Middle East conflicts that are applying further financial pressure.

This latest news appears to be a tremendous back flip by the Saudi's; they said that OPEC will reduce output by one million barrels daily if non-OPEC members commit to joint action.

While many analysts say that Iran will be able to fill the gap because it will be capable of boosting its own oil output by one million barrels per day once sanctions are lifted, this threat is not as credible as it first appears.

You see, in order to achieve such a massive increase in output Iran will require considerable external investment and expertise to bring its aging oil infrastructure up to speed. This will involve a considerable amount of lead time in order to obtain the necessary investments as well as to develop existing and new wells.

Nonetheless, the reality is that the global supply glut of about two million barrels daily clearly exceeds the proffered production cut, plus it is unlikely that non-OPEC members will cooperate. Russia has made it clear that it won't cut output, and with oil being an important driver of economic growth, it may even seize on the opportunity to boost output if OPEC cuts its own output.

Then you have other oil-dependent non-OPEC economies such as Brazil, Mexico, and Kazakhstan who would also more than likely seek to boost production as prices climb.

Along with the North American fracklog of uncompleted wells, which are estimated to have up to an additional 500,000 barrels of daily output, and U.S. crude oil stocks now being close to record levels, these factors mean that there is a considerable amount of oil waiting to enter the market.

So what?

The key takeaway from this is that despite the Saudis expressing a desire to reduce output, there are a wide range of factors that will leave a large supply glut in place. This means that until there is a sharp uptick in global demand for crude, there won't be a recovery any time soon. As a result, dangerously leveraged and cash flow-negative energy companies such as Penn West and Pacific Exploration are unlikely to recover any time soon and in fact may be facing extinction.

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mattdsmith