Why Did Oil Prices Plunge on Wednesday?

Description

After a very brief rally on Tuesday, oil prices plunged once again on Wednesday, spelling bad news for energy producers such as **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG) and **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE).

Interestingly, this latest fall in oil prices came on a day when the U.S. Congress was set to lift the country's oil export ban. Normally, you would think that oil prices should rise in this situation.

So what exactly is going on here?

Lifting the export ban: not a game changer

The United States has banned oil exports for decades with very limited exceptions. The policy was a response to the Arab oil embargo in the 1970s. But as homegrown production has taken off, the ban no longer makes sense.

And the policy was very damaging to local producers. After all, production has been through the roof, and practically all of this oil had to be sold to domestic refiners. Meanwhile, many refiners were set up to handle foreign crude instead. Thus American producers had to offer their product to refiners at a discount. This is why the WTI oil price–which is the price paid for oil at Cushing, Oklahoma–has often trailed the Brent price, which is more of an international benchmark.

But in recent months, the Brent price has actually been falling faster than WTI. The reasons are fairly obvious: supply from countries like Saudi Arabia has remained plentiful, demand from countries like China has been sluggish, and Iran is on the cusp of exporting more crude. Now Brent trades very close to WTI.

So when accounting for transportation costs, exporting oil simply isn't worth it for most North American producers. That could easily change at some point, and this policy shift is certainly a step in the right direction. But the effect is muted in the meantime.

A buildup of inventories

On Wednesday morning, the U.S. Energy Information Administration released its weekly report on crude inventories, showing a rise of 4.8 million barrels overall. This was a very surprising number; analysts on average were expecting a drop of 1.4 million barrels.

There are a few reasons for this surprise. Obviously, supply has held up better than expected, especially given the fall in drilling activity. It’s the same story we’ve heard many times before. In addition, the U.S. is experiencing an unusually warm winter–thanks to an El Niño weather pattern–which is decreasing the demand for heating oil.

Of course, all of these factors will persist well into the new year, which is why **Goldman Sachs** has predicted that oil could fall towards cash costs (about US$20 per barrel). That would mean further pain for investors in Crescent Point and Penn West. You’ve been warned.

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