What Does 2016 Hold for the Energy Patch?

Description

If you thought 2015 was a tough year for Canada's energy patch then think again, because the outlook for 2016 appears far worse. Not only are there signs that crude will fall further, but many energy companies' hedging positions are unwinding, exposing them to the full fury of market forces.

Canadian oil producers are already struggling to cover their operational costs as some Canadian crude blends are selling below the breakeven price for many oil companies. This will only fuel a further round of consolidation, while potentially pushing many smaller, heavily indebted oil producers to the wall.

Now what?

OPEC recently confirmed that it will adhere to its policy of maintaining output in order to bolster market share; it set a 30 million barrel per day production ceiling at its December meeting. Despite this ceiling, there are signs that OPEC's output continues to grow.

In November alone, OPEC's oil output grew by 130,000 barrels per day month over month, and with the Saudi's investing heavily in developing their oil assets, this growth can only continue.

If this wasn't enough to keep oil prices weak, you then have Iran, which in 2016 is expected to boost its oil output by up to one million barrels per day once trade sanctions are lifted.

Russia has also indicated that it won't crimp production, despite weak oil prices; its November oil output came in at record levels.

On top this, despite the U.S. rig count now being at it lowest level in over a decade, U.S. output remains close to its highest level ever recorded, and there are no signs it will fall anytime soon.

Global oil inventories have also swelled to their highest level on record with oil stocks in developed countries standing at three billion barrels.

All of these factors will place considerable pressure on the price of crude and could easily push itsprice below US$30 per barrel.

Investors also should consider that Canadian crude blends trade at substantial discounts to the North American benchmark price, West Texas Intermediate, or WTI.

Canadian heavy crude, which is primarily produced from oil sands, is now trading at under $30 per barrel, despite WTI trading at US$35 per barrel. As a result, if the price of WTI falls further, the impact on the oil sands will be magnified by this discount, creating havoc among companies that are already producing crude at an operational loss.

This bodes poorly for heavily levered companies with high breakeven costs, such as **Pengrowth Energy Corp.** (TSX:PGF)(NYSE:PGH), that have invested heavily in boosting their oil sands operations.

However, larger integrated energy majors such as **Suncor Energy Inc.** (TSX:SU)(NYSE:SU), which has deep pockets and low breakeven costs along with the ability to boost margins from its refining businesses as the price of crude falls, will easily survive.

Oil investors also need to consider the moves by the Alberta government to restrict greenhouse emissions through increased carbon levies, which will increase costs for oil sands companies. When this is coupled with the Paris climate agreement, which aims to eliminate fossil fuels from the world energy mix, the outlook for oil stocks is bleak.

So what?

Clearly, the energy patch is under siege and there are signs that sharply weaker oil prices are here to stay for at least foreseeable future. This makes oil stocks, particularly those like **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) and **Pacific Exploration and Production Corp.** (TSX:PRE), which are cash flow negative and have heavily levered balance sheets, unattractive investments.

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