2 Key Numbers Indicating That Weak Crude Prices Are Here to Stay

Description

The outlook for crude remains uncertain as the latest numbers from the U.S. highlight that sharply weak crude prices are not only here to stay, but may even fall further. This would be a tremendous blow to the energy patch because crude already trades well below the cost of production for many oil companies.

As a result, it is not hard to predict that a number of energy companies will struggle to survive in 2016, despite having already slashed operating costs, dividends, and capital expenditures.

Now what?

It appears that weak crude prices are now the "new norm" for the energy patch. Two key numbers indicate that oil prices will remain weak for some time to come.

Firstly, despite the U.S. rig count being at its lowest level in over 15 years, recent data from the U.S. Energy Information Administration shows that U.S. oil production is higher than it was in January 2015.

This highlights that OPEC's strategy of flooding global markets with crude in order to keep the price low and push high-cost U.S. shale oil producers out of production is failing.

There are many reasons for this, but one of the most important is that many U.S. shale oil plays have low breakeven prices.

The Eagle Ford shale formation has an overall breakeven price of US$54 per barrel, while sections of the Bakken and Utica shales have a breakeven price US$47 per barrel. While this may not be particularly impressive in an operating environment where West Texas Intermediate is trading at US$37 per barrel, many companies operating in those shale formations have been able to reduce their breakeven prices even further through aggressive cost cutting.

You only need to look at **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE), which obtains 47% of its oil production from the Eagle Ford, to see this.

It has managed to reduce its breakeven price for the oil it produces in that formation to US$34 per barrel, which is well below the average for the Eagle Ford and means that production remains profitable, even with WTI at US$37 per barrel.

Secondly, U.S. oil stockpiles have hit record levels.

Currently, U.S. commercial oil stocks are at 491 million barrels and, despite growing refinery drawdowns and utilization rates, there are no signs of inventories declining. This is because there is a chronic oversupply of crude that has created a global supply glut in excess of two million barrels daily.

The impact of this global supply glut on oil prices can be seen with Brent, the international benchmark price, now trading below West Texas Intermediate for the first time since August 2010.

Furthermore, low oil prices only create a further incentive for oil producers and traders to store oil until a price rebound to more profitable levels. This, along with OPEC and a number of non-OPEC oil-producing nations such as Russia seeking to boost output, means that global inventories will continue to grow.

So what?

An oil price recovery is a long way off and oil is likely to fall further, so I expect heavily levered energy companies to face extinction in 2016.

Heavily indebted oil producer **Long Run Exploration Ltd.** (TSX:LRE) has already fallen victim; a consortium of Chinese investors have offered to buy all of its assets for $0.52 per share, less than a third of its 52-week high.

Companies such as **Canadian Oil Sands Ltd.** (TSX:COS) and **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE), which are heavily in debt and cash flow negative, are facing a similar fate. For these reasons, the energy patch is shaping up as an unattractive place to invest, at least until crude finds a bottom.

CATEGORY

1. Energy Stocks
2. Investing

TICKERS GLOBAL

1. TSX:BTE (Baytex Energy Corp.)

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