



Why the Collapse in Crude Is Creating the Next Supply Shock

Description

Oil's sharp collapse has been a wake-up call for North America's energy patch. It forced energy companies that had grown accustomed to excess to rein in excessive capital budgets and operational costs in order to protect their balance sheets and remain sustainable in the harsh operating environment.

While this has certainly ensured the survival of many of those companies, it has also caused oil production and the development of new oil assets to decline, setting the scene for the next supply shock.

Now what?

A key target of these cost-cutting activities has been capital budgets. A number of shale oil companies cut their capital expenditures by 70% or even more. **Continental Resources Inc.**, the largest operator in the Bakken, slashed its 2016 capital budget by 73% in comparison with 2013, whereas **Whiting Petroleum Corp.** cut its budget by 77%, and **Oasis Petroleum Corp.** cut its budget by 72%.

Canadian oil companies have also undertaken a similar exercise. For 2016, **Baytex Energy Corp.** ([TSX:BTE](#))(NYSE:BTE) slashed its capital expenditures by 49% in comparison with 2014. **Crescent Point Energy Corp.'s** (TSX:CPG)(NYSE:CPG) capital expenditures are down by 26% for that period.

The majority of cuts have been made to exploration and development, which has triggered a substantial decline in drilling activity. This has the potential to create a future supply shock because shale oil wells, which now make up the majority of U.S. oil production, have high decline rates and a short production life.

You see, industry analysts' estimate that the decline rate of shale oil wells is up to 10 times higher on average than conventional onshore oil. This means they have a productive life of generally three to five years—about a third of conventional onshore wells.

As a result, there is considerable pressure on shale oil companies to continue exploration and development if they are to sustain production.

However, with investments in the oil industry now estimated by OPEC to be at its lowest level in six years, it is insufficient to sustain future production at the required levels. This pressure will become even greater with OPEC forecasting that global oil demand will grow by 50% between now and 2035.

Then you have a number of companies such as Baytex and **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE) that are focused on shuttering oil production that is uneconomic at current prices. Baytex will turn off the spigot on 7,500 barrels of Canadian heavy crude production, whereas Penn West's 2016 production will be 26% lower than 2015.

The impact of this significant reduction in investment and oil production will be exacerbated by the wave of bankruptcies that are expected to hit the North American energy patch. Consulting firm Deloitte estimated that up to a third of North American energy companies will go bankrupt this year.

So what?

The sharp reduction in investment in oil exploration and development will lead to a significant reduction in the development of new oil assets, causing global oil production to fall and fail to keep pace with growing demand over the long term. This will trigger higher oil prices, which will be boon for companies such as Baytex that are struggling to survive in the harsh operating environment now being witnessed.

Nonetheless, it will take time for this to occur. Higher prices will arrive too late to save companies such as **Pacific Exploration and Development Corp.** (TSX:PRE), which is already on the verge of bankruptcy.

CATEGORY

1. Energy Stocks
2. Investing

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. NYSE:VRN (Veren)
2. TSX:BTE (Baytex Energy Corp.)
3. TSX:FEC (Frontera Energy Corporation)
4. TSX:VRN (Veren Inc.)

Category

1. Energy Stocks
2. Investing

Tags

1. Editor's Choice

Date

2025/09/04

Date Created

2016/04/12

Author

mattdsmith

default watermark

default watermark