Oil Drifts Lower Despite OPEC’s Decision to Extend Production Cuts

Description

An event that has surprised many pundits is the failure of OPEC’s decision to extend its production cuts through to March 2018 to bolster oil prices.

Instead, crude, or, more specifically, the North American benchmark West Texas Intermediate, has sunk below the psychologically important US$50 mark, while Brent, the international reference price, is hovering at US$50 per barrel.

This has been a blow for the North American energy patch because many companies and industry insiders were predicting that crude could rally as high as US$65 per barrel by the end of 2017. While there are some optimists who believe that is still possible, there are growing signs that sub-US$50 crude is here to stay.

Now what?

One of the major factors weighing on oil prices is bloated international oil inventories. Even after OPEC and key non-OPEC oil producers cut production, global oil stocks remained close to record levels.

While global supplies decreased in April of this year, demand growth slowed, leaving a considerable supply overhang in place. This, rising U.S. production, and Trump’s energy policies are keeping a cap on oil.

U.S. oil production has grown by 6% since the start of 2017 to now be 9.3 million barrels daily — its highest level since August 2015. This growth will continue because the majority of companies operating in the U.S. energy patch have ramped up their tempo of operations and significantly boosted their spending on exploration, well development, and drilling.

The U.S. rig count, which is probably the best measure of activity in the energy patch, has climbed to be more than double where it was a year ago — its highest level since April 2015. That marked increase in activity will cause U.S. oil production to expand further, even if the price of crude remains under US$50 per barrel.

You see, technological improvements coupled with an ongoing industry focus on identifying efficiencies and reducing costs has caused the breakeven prices for shale oil plays to fall sharply. Even if crude remains under US$50 per barrel, it is still profitable for oil companies to keep pumping from those wells. This becomes apparent when perusing the numbers for shale oil producers.

For the first quarter 2017, **Continental Resources, Inc.** (NYSE:CLR) reported net income of US$469,000 for a period where the average realized oil price was US$44.69 per barrel.

Furthermore, cash from operating activities almost doubled compared to the previous quarter and a year earlier.

Even heavily indebted **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) reported first-quarter earnings of $0.05 per share — a solid increase from a loss of $1.66 per share for the previous quarter. That considerable spike in profitability can be attributed to its Eagle Ford shale oil assets, where it has focused the majority of its exploration and development expenditures.

The surprise profitability of shale oil companies even prompted **Goldman Sachs**, which was reasonably bullish on the outlook for oil earlier this year, to state that the long-term oil price is drifting lower.

So what?

While there are a range of contradictory views as to the outlook for crude, what is becoming increasingly clear is that OPEC's production cuts are not enough to lift prices on their own. The resilience of U.S. shale oil, which is supported by technological improvements and falling costs, to weak oil prices means that U.S. oil production will continue to grow. That coupled with burgeoning oil stocks will keep a lid on oil prices for some time.

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Date
2025/08/24
Date Created
2017/06/01
Author
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