The Possibility of Higher Oil Fades

Description

Crude keeps edging lower despite OPEC and key non-OPEC oil-producing countries recently agreeing to extend production cuts. The North American benchmark West Texas Intermediate (WTI) is down by 14% over the last year to be just under US$43 per barrel, close to its lowest price over the last 12 months.

There are signs that sub-US$40 crude could very well be on its way once again.

Now what?

The biggest factor working against higher oil prices is the rapid growth of U.S. oil production. Despite the prolonged slump, U.S. oil output has grown by almost 7% for the year to date to be at its highest level since August 2015.

U.S. production will only keep growing.

You see, since oil prices collapsed, heralding the end of the shale oil boom in late 2014, the shale oil industry has focused on slashing costs and driving ever-greater efficiencies from their operations. Coupled with the rapid pace of technological improvements in drilling and rig technology, this has caused operational costs to fall significantly.

As a result, the breakeven costs for the major shale plays have fallen sharply over the last four years to be well under US$40 per barrel for the Permian, Bakken, and Eagle Ford plays. That has triggered a marked uptick in the tempo of operations among shale oil companies every time WTI has moved close to US$50 per barrel.

For as long prices remain above these breakeven costs, U.S. production will keep growing.

A key indicator of activity in the U.S. energy patch that underscores the rapidly rising tempo of operations is the U.S. rig count. The latest data for June 2017 showed that there are 933 active rigs, which is more than double the number during mid-June 2016 and the highest volume since mid-April 2015.

Of even greater concern is the sharp increase in the volume of drilled but uncompleted wells, otherwise known as DUCs.

Data from the U.S. Energy Information Administration (EIA) shows that by the end of May 2017, DUCs had reached their highest level since the EIA started collating data. DUCs stood at 5,946 wells, almost 12% higher than a year earlier. These wells can be brought online rapidly, yet are far cheaper to maintain should prices dip lower, giving U.S. oil producers considerable operational flexibility to respond to movements in the price of crude. It is estimated that if the spigots were opened on all of these wells, they would add another ~300,000 barrels daily to U.S. oil output.

So what?

This certainly bad news for the energy patch. Many upstream producers such as **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) and **Pengrowth Energy Corp.** (TSX:PGF)(NYSE:PGH) based their 2017 budgets on the assumption that crude would average over US$50 per barrel for 2017.

The latest spate of weaker prices means that they will have to cut back on their drilling and development budgets, meaning they will be incapable of growing production. Of even greater concern is that they won't be capable of generating sufficient free cash flow to pay down their considerable piles of debt, leaving them even more vulnerable to further weakness.

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