Investors, Brace Yourselves: $40 Oil Could Be on the Way

Description

Regardless of the optimism about crude at the start of the year and OPEC's May decision to extend its production cuts**,** oil continues to weaken. The North American benchmark oil price West Texas Intermediate is down by almost 15% since the start of 2017, and there are signs that it could continue to weaken**.** Sub-$40 crude is a real possibility.

Now what?

A major factor weighing on oil is the sharp and unexpected increase in U.S. oil production.

Since the start of 2017, production has risen by almost 7%, and there are signs that it will keep growing at a rapid clip. A key indicator of activity in the U.S. energy patch, the rig count, has risen significantly since the start of the year. As of June 23, 2017, there were 941 active rigs, which is an increase of eight over the previous week and 283 higher than at the start of the year.

More startling is that despite crude's recent weakness, the number of active rigs keeps rising.

Weaker oil is having little impact on the U.S. energy patch because the breakeven prices for U.S. oil plays, especially shale oil, continues to fall. Well-head breakeven prices for the major shale plays, the Bakken, Eagle Ford, and Permian, have been estimated at US$29, US$38 and US$39 per barrel, respectively.

In many cases, individual companies operating in those plays have even lower breakeven costs. **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) is drilling in what is considered to be the sweet spot of the Eagle Ford and has a breakeven price of US$30 per barrel for that acreage.

For this reason, a large proportion of the increase in rigs has been in the Eagle Ford and Permian basins.

Such low breakeven costs mean that for many energy companies operating in those shale plays, even with WTI at US$45 per barrel, it is profitable to keep the spigots open and pumping crude.

Another important consideration is that the volume of drilled uncompleted wells, otherwise known as DUCs, has increased significantly in recent months to total almost 6,000 wells, or 12% higher than a year ago. Those DUCs in total are estimated to hold up to an additional 800,000 barrels of daily oil production. They remain popular among energy companies because they can deliver a rapid lift in production along with significant capital efficiencies.

Growing OPEC oil production is another distinct threat to higher prices.

For May, OPEC’s oil output grew by 336,000 barrels daily to just over 32 million barrels, despite the cartel agreeing to extend its production cuts until March 2018. That substantial growth can be attributed to Libya, Nigeria, and Iraq boosting their oil output.

Libya’s production shot up by 178,000 barrels, while Nigeria’s surged by 174,000 barrels, whereas Iraq’s increase was a more modest 44,000 barrels. Both Libya and Nigeria are exempt from the cuts and have made it clear that they aim to grow oil production at a rapid clip to generate much-needed government revenues and boost their economies.

Iraq, which is a signatory and OPEC’s second-largest producer, has made it clear that it intends to grow production regardless of the deal as Baghdad scrambles to invigorate the nation’s battered economy and fund the fight against ISIS.

So what?

There is a very real danger that crude could slip below the psychologically important US$40 per barrier, which would be disastrous for Canada’s energy patch. It would trigger a decline in activity because companies such as Baytex and **Pengrowth Energy Corp.** (TSX:PGF)(NYSE:PGH) would be forced to dial back their drilling and development programs because they based their 2017 budgets on US$55 per barrel. There would also be a surge in asset sales because debt-laden companies would find it difficult to refinance existing debt or access new debt to meet operational costs.

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