Are Higher Oil Prices Doomed?

Description

In a surprise move, OPEC recently announced that it estimates that oil production from non-OPEC producers will climb at a greater rate than it had initially expected. This is despite signs that compliance among members for the production caps that were initially established in late 2016 is at its highest level ever. Much of this is being driven by a marked increase in U.S. oil output driven by the shale oil industry.

The latest announcements from the U.S. Energy Information Administration (EIA) aren't helping the situation, indicating that global energy markets have a long way to go before rebalancing. This has led to fears that not only will oil plummet once again, but the production caps established by OPEC could fall apart at any time.

Now what?

For the week ending March 9, 2018, the EIA reported a massive commercial inventory build of five million barrels from the previous week. It is projected that global oil supplies pushed by swelling U.S. production will exceed global demand growth, despite the global economic upswing spurring greater demand for crude.

You see, U.S. oil production is growing at a rapid clip, surging to 10,381,000 barrels at the end of last week, which is its highest point since the agency's reporting began.

The U.S. rig count also continues to expand, reaching 981 active rigs, which is its highest point since August 2015, as shale oil companies ramp up drilling to boost their oil output to cash in on higher prices.

Drilled uncompleted wells (DUCs), which essentially means they haven't been fracked, continue to grow. This has given the major U.S. shale basins, notably the Permian, considerable spare productive capacity, which has been rated by industry analysts as being second only to Saudi Arabia.

For these reasons, the EIA predicts that by April 2018, U.S. shale oil output will reach seven million barrels daily. With shale oil companies moving to boost their spending on exploration and drilling activities, there is no sign of U.S. production growth easing any time soon.

This is placing considerable pressure on oil prices and causing many OPEC members to question the rationale for continuing with the production caps, especially because of growing U.S. oil exports to the key Asian market. That could cause the deal to fall apart, as members like Iran, Iraq, and Nigeria remain determined to boost production. If this occurred, it would spell the death knell of US$60 oil and cause it to slide to $50 per barrel.

So what?

This is extremely bad news for Canada's energy; many producers are already suffering because of the sharp discount of Canadian crude blends, notably heavy crude to the North American benchmark West Texas Intermediate (WTI). Canadian heavy crude blend Western Canada Select is trading at a US$25, or 42%, discount to WTI, meaning that in many cases, heavy oil producers aren't breaking even.

That bodes poorly for upstream producers such as **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) and **Pengrowth Energy Corp.** (TSX:PGF)(NYSE:PGH), which desperately need WTI to stay above US$55 per barrel to generate sufficient cash flow to reduce their burdensome debt. Both companies need WTI to be greater than US$55 per barrel to generate sufficient cash flow to meet debt payments, maintain investment in their operations, and expand production to offset natural decline rates.

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