



Has Oil Peaked?

Description

Oil's latest rally came to an abrupt halt after Saudi Arabia and Russia announced they are considering [opening the spigots](#) to bolster production. While this has come as a surprise to some analysts, both nations had intimated that such an event could occur, as oil raced ever higher with the international benchmark Brent breaking through the US\$80-per-barrel mark.

As a result, crude has pulled back sharply; the North American benchmark West Texas Intermediate (WTI) fell to well under US\$70 a barrel, and Brent slipped to US\$76 per barrel. There is every sign that this weakness could continue, as OPEC members jostle to boost government revenues, and the tempo of activity in the U.S. shale oil patch builds at a frenetic rate.

Now what?

This is bad news for Canada's oil patch, which has had to weather sharply weaker prices for almost the last four years. What makes it worse is that many heavy oil producers are already labouring under the pressure of the significant discount applied to Canadian heavy crude known as Western Canadian Select (WCS). The latest developments could be a significant blow for struggling oil sands companies such as **Athabasca Oil Corp.** (TSX:ATH), **BlackPearl Resources Inc.** (TSX:PXX), and **Pengrowth Energy Corp.** (TSX:PGF)(NYSE:PGH).

One of the key threats to higher oil prices, especially if OPEC and Russia move to unwind production caps, is the surge in activity in the U.S. energy patch and rapidly rising shale oil production. The U.S. rig count, a key indicator of drilling activity south of the border, surged to 1,059 active rigs last week — the highest number since early 2015.

Meanwhile, drilled but uncompleted wells known as DUCs, which are essentially drilled wells that have not been fracked, for April 2018 rose to a staggering 7,677 wells with the majority located in the prolific Permian Basin. That is the highest level of DUCs since the U.S. Energy Information Administration (EIA) started reporting that data in December 2013.

What makes the growing inventory of DUCs particularly worrying is that it gives shale oil companies considerable spare capacity that can be brought online at relatively short notice. If WTI rallies to over

US\$70 a barrel once again, it is not difficult to foresee shale oil producers ramping up drilling and completing their considerable inventory of DUCs. Their concentration in the Permian has led to speculation that the basin has up to one million barrels daily of idle production capacity, making its spare capacity second only to Saudi Arabia.

There is every sign that for as long as WTI remains at over US\$60 per barrel that the U.S. shale oil industry will continue ramping up activity. This is because the majority of shale oil plays have breakeven prices of less than US\$50 a barrel, and 2017 company results indicated that US\$55 a barrel is the magic number for the majority of shale oil drillers.

It shouldn't be forgotten that President Trump has voiced his opposition to higher oil, because it has the potential to curtail economic growth, preventing the controversial president from successfully meeting his campaign promises. In April 2018, he'd tweeted that OPEC was keeping prices artificially high, and this could certainly have been considered by Saudi Arabia when they discussed easing production caps and put more crude back on the market.

So what?

This is bad news for heavy oil producers, because a combination of transportation bottlenecks and constraints have caused WCS to trade at a significant discount to WTI. That discount has widened to 25%, meaning that companies such as Athabasca, BlackPearl, and Pengrowth are selling their crude at significantly less than the spot price for WTI. While there is very little danger posed to those companies should WTI continue trading at over US\$65 per barrel, there is considerable risk if it slips under US\$60 for a prolonged period.

Fortunately for Pengrowth, it has [mitigated that risk](#) by establishing a hedging program, while its Lindbergh thermal project is one of the lowest bitumen assets operating in Canada. This means Pengrowth is capable of resisting any significant decline in oil.

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