What Do the Latest Developments Mean for OPEC and Oil?

Description

Recent announcements by Saudi Arabia and Russia, that they were considering raising production, threw global energy markets into turmoil. Crude has gyrated wildly in recent weeks, as the market digested this news about an unexpected build in U.S. oil inventories, along with stronger than anticipated demand and emerging supply constraints. Higher oil prices and fears of how they will affect global economic growth has put pressure on OPEC to open the spigots and boost production. There are even whispers that the U.S. government has quietly asked Saudi Arabia and other OPEC members to expand production by up to one million barrels daily to bolster global supplies and alleviate supply shortages.

Even the one-time eternally bearish investment bank **Goldman Sachs** has taken a bullish tone and claims that even if an additional one million barrels were added to global oil supplies, inventories would dwindle, and prices would keep rising.

This all sounds very positive for oil and energy stocks, but there are signs that if OPEC increases production, it could depress the price of crude.

Now what?

It has been rumoured that OPEC and Russia are currently considering putting somewhere between 800,000 to one million barrels daily of oil supply back on to the market. The sharp deterioration in Venezuela's oil output, and the curtailing of Iran's plans to significantly grow production after the U.S. pulled out of the controversial nuclear deal have created an opportune time for OPEC to boost production and claim further market share.

It would be quite easy for OPEC to expand production by this amount, because it has been estimated by the U.S. Energy Information Administration that OPEC has almost two million barrels a day of spare capacity. When coupled with recent considerable U.S. production gains and the substantial spare capacity that exists in the Permian Basin, this could cause oil to soften.

For March 2018, U.S. oil production shot up to a record all-time high of 10.47 million barrels daily, and there are signs it will keep growing at a rapid clip.

You see, the volume of drilled but uncompleted wells grew to a record high of 7,677 with the majority located in Permian Basin. The U.S. rig count climbed to 1,060 rigs its highest number since March 2015. It is forecast that the tempo of activity, particularly in shale oil basins, will continue expanding at a solid rate, because West Texas Intermediate (WTI) is trading at well over US$60, which is significantly greater than the estimated breakeven price for the majority of shale oil drillers of US$50 per barrel or less.

Even if OPEC boosts production, it is unlikely that oil will fall as sharply as some analysts have predicted. Firmer demand growth sparked by an improving global economy will underpin prices and prevent oil from plummeting to the lows witnessed in 2016.

So what?

Many oil companies, including **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) and **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG), have reduced costs to the point where they have a breakeven WTI price of US$40 a barrel. That means even if crude slumps to US$60 a barrel, which is plausible in the current environment, they will continue to generate free cash flow and be able to invest in their operations.

What is becoming increasingly clear is that regardless of current developments, oil will, over the long term, rise in value, driving the shares of upstream oil producers higher. While Baytex has gained an impressive 45% since the start of 2018, Crescent Point has substantially lagged behind, only gaining 1%, and that — along with its high-quality assets and solid balance sheet — makes it an attractively valued opportunity for those investors betting on higher oil.

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