OPEC Agrees to Boost Production: What Does This Mean for Canada's Energy Patch?

Description

In a much-anticipated move, OPEC agreed last Friday to open the spigots and boost oil production by one million barrels daily. Somewhat surprising was the reaction of energy markets. Oil moved higher to see West Texas Intermediate (WTI) gain 4% for the week to close at over US$68 a barrel, while Brent rose by less than one full percentage point to close above US$75 per barrel.

Interestingly, the price differential between WTI and Brent has narrowed sharply in the wake of OPEC's announcement falling from over US$8 per barrel to US$7.12.

Importantly for Canada's energy patch, the price of heavy crude blend, Western Canadian Select (WCS), rose sharply ending Friday at US$44.58 per barrel, or over 7% higher than a day earlier. In a country where almost half of the oil produced is heavy oil benchmarked to WCS, that is a particularly important development, especially when it is considered that Canada is experiencing a heavy oil crisis.

Now what?

The reason for oil moving higher contrary to OPEC and Russia plans to increase production is that much of this decision was already priced in by global energy markets.

You see, OPEC and non-member Russia had been musing over production increases since May 2018 as part of the earlier ground-breaking agreement to cap production. Then there was the pressure applied by Trump since April for OPEC to lift oil output because of fears that crude would move higher and damage economic growth.

Record compliance among OPEC members combined with the catastrophic decline of Venezuela's oil output, Trump's termination of the Iran nuclear deal, and supply outages in Libya all worked to create an ideal opportunity for OPEC to bolster production.

Nonetheless, it is unlikely that production will grow by the one million barrels announced, and it is for this reason that crude rose in value. With the exception of Saudi Arabia and Russia, other OPEC members have little to no spare capacity. This — along with supply outages in Libya and the expected deterioration of Venezuela's oil output — means, according to analysts, that the cartel with the assistance of Russia is only capable of adding approximately another 600,000 barrels daily to global supplies.

This would fail to meet growing demand for crude sparked by stronger global economic growth. Now that the uncertainty of an OPEC production hike or the fear that the cartel and Russia would unwind the production deal is over, oil will move higher in coming weeks.

This — along with firmer WCS — has given the outlook for Canadian oil companies a solid lift.

So what?

Higher oil offers hope for beaten-down oil sands companies **Canadian Natural Resources Ltd.** (TSX:CNQ)(NYSE:CNQ) and **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE), which have plunged by 2% over the last month. Cenovus experienced a sharp decline in first quarter 2018 earnings, reporting a $914 million net loss from continuing operations, despite a massive surge in oil production after the $17.7 billion purchase of **ConocoPhillips's** Canadian oil sands assets. That poor result can be attributed to the deeper discount for WCS and weaker natural gas prices.

Meanwhile, Canadian Natural's first-quarter net earnings more than doubled compared to a year earlier to be $583 million on the back of expanding production, which rose by 28% year over year to 1,123,546 barrels daily. It was the company's dependence on heavy oil production coupled with the wider price differential for WCS compared to WTI that has weighed on its stock performance.

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