What to Expect From Oil for the Remainder of 2018

Description

Since the start of 2018, oil has been incredibly volatile, whipsawing wildly on every piece of news either good or bad, as markets attempt to determine what the future holds for crude. There are growing concerns among a number of industry participants that oil could collapse once again and fall below US$60 a barrel.

Surprise inventory builds, easing infrastructure constraints, and growing international production are all contributing to increasing uncertainty over the outlook for crude.

Now what?

The recent bullishness surrounding oil has received a blow from two notable sources. Firstly, there was the Russian Finance Ministry, which, in a July 2018 statement, claimed that oil was trading well above its equilibrium price and was poised to collapse once again, potentially pulling back to as low as US$50 a barrel.

Now there is **Citigroup Inc.'s** global head of commodities Ed Morse, who predicted the 2014 oil crash; he is claiming that crude will drop back into a band between US$45 and US$60 a barrel. His thesis is based on the belief that supply constraints are nowhere near as severe as perceived and that production will comfortably keep pace with demand.

In fact, Morse asserts that growing capital efficiencies and improved drilling technology are boosting production as well as making it more cost effective. He also believes that decline rates are wildly over blown, and supply won't diminish as rapidly because of declining oil production as some pundits claim.

This is a similar view to that contained in the Russian Finance Ministry report; the author asserted that oil output would continue growing because adequate resources are available for it to continue expanding.

According to the Ministry, because oil's marginal cost of production has fallen to US$50-60 a barrel, there is a considerable incentive for drillers to keep pumping crude.

You only need to look at the latest results from Canada's energy patch to see that cash operating costs are well below those numbers. For the second quarter 2018, **Suncor Energy** (TSX:SU)(NYSE:SU) reported oil sands cash operating costs of $28.65 per barrel, while **Canadian Natural Resources's** (TSX:CNQ)(NYSE:CNQ) were even lower at $20.70 a barrel for its upstream operations. Those low costs reflect the ongoing implementation of operational efficiencies and the low decline rates associated with oil sands assets.

You see, low production declines mean that oil sands operators don't have to invest as much capital to sustain output compared to other forms of oil production, like shale. Because of these low cash costs and higher oil Canadian oil sands, operators are ramping up activity and significantly increasing investment to boost production.

For the second quarter, Suncor's capital expenditure was 5% greater year over year, as it focused on ramping up activity at its recently commissioned Fort Hills property and conducting maintenance at other operations. Fort Hills is expected to achieve 90% of its total production capacity of 194,000 barrels by the end of 2018. Suncor also boosted its total 2018 guidance for capital spending on upstream operations by $450 million to $650 million, which will expand production accordingly.

Renewed spending in Canada's oil patch has seen industry analysts predict that total oil production will expand by up to 33% between now and 2035, adding 1.4 million barrels daily to national oil output. The majority of that will be driven by the oil sands, which are estimated to make up 95% of Canada's oil reserves and just over half of its total oil output.

The fact that Canada's vast oil sands are the world's third-largest oil reserves after Venezuela and Saudi Arabia coupled with such low cash costs, which incentivize investment and production growth, means that there is no shortage of crude on the immediate horizon.

So what?

It is difficult to see oil hitting triple figures any time soon, but a sharp collapse is also unlikely. Fundamentals indicate that oil will remain range with West Texas Intermediate (WTI) trading between US$65 and US$75 a barrel for the remainder of the year.

This is good news for the energy patch, because the majority of upstream producers need WTI to average above US$55 a barrel to be free cash flow positive, while integrated energy majors, such as Suncor and Canadian Natural Resources, should experience a solid lift in earnings.

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