Has the Next Oil Price Collapse Begun?

Description

After hitting a multi-year high in early October 2018, oil has pulled back in recent weeks to see the North American benchmark West Texas Intermediate (WTI) shed well over US$10 a barrel to trade at around US$63 per barrel. That has caused WTI's gains for the year to date to fall to just under 6%. Much of these recent losses can be blamed on soaring U.S. oil production and growing inventories.

As a result, energy stocks have been hit hard with one of the worst affected being **Baytex Energy** (TSX:BTE)(NYSE:BTE), which has plunged by 33% since the start of 2018. Despite the latest bad news for oil, investment bank **Goldman Sachs** is adamant that the international benchmark Brent will hit US$80 a barrel before the end of the year. If that were to occur, based on the current differential of almost US$10 a barrel, WTI would soar to just over US$70 per barrel.

Nonetheless, there are those market pundits who believe that this is the start of the long-awaited oil price collapse predicted earlier this year by Citibank commodities analyst Ed Morse and the Russian Finance Ministry.

Now what?

The major cause for crude's recent marked pullback was an unexpected surge in U.S. oil production. According to data from the U.S. Energy Information Administration (EIA), August 2018 U.S. oil output was higher than anticipated, reaching 11.3 million barrels daily. This was the first time U.S. oil production exceeded 11 million barrels daily and was 100,000 barrels greater than the Russian Ministry of Energy's estimate of 11.2 billion barrels.

There is every indication that U.S. oil output will keep expanding at a solid clip. The rig count, which is an important indicator of drilling activity, is at close to its highest point since early 2015, and shale oil drillers are ramping up operations at a furious place. Even bottlenecks in the Permian basin, which analysts believe has spare capacity of around one million barrels daily, have failed to put a dent in drilling activity.

The volume of drilled but uncompleted wells (DUC) at the end of September 2018 came to 8,389 wells, which was 192 wells greater than a month earlier. Many of those wells were in the Permian, which also experienced the largest growth in the volume of DUCs, which expanded by 194 wells compared to August 2018.

U.S. oil inventories continue to grow. For the week ending October 26, 2018, commercial reserves, excluding the strategic oil reserves, expanded by 3.2 million barrels compared to a week earlier and were 6% higher than the five-year average.

Each of these fundamental factors indicates that U.S. oil output will keep expanding, which, despite the looming deadline for the reinstatement of sanctions on Iran, will weigh on oil prices.

So what?

Despite these poor fundamentals, many analysts believe that crude is due to rebound, which makes it quite possible that WTI could rise to around US$70 per barrel. At that price, many Canadian drillers will not only break even, but, like Baytex, they will become profitable and free cash flow positive.

With WTI at US$70 a barrel, Baytex expects to generate almost $400 million in free cash flow for 2019 based on production of 95,000-100,000 barrels for the year. Even if WTI averaged US$60 per barrel, the driller expects free cash flow to be over $100 million. This is even after allowing for the wide differentials between Canadian crude blends and WTI.

Such strong free cash flow generation will allow Baytex to further reduce debt and expand its capital spending on exploration and development activities. Many of Baytex's oil hedges unwind at the end of 2018, meaning that going into 2019 it will be well positioned to benefit from higher crude.

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