Will Oil Prices Collapse Once Again?

Description

After collapsing sharply toward the end of 2018 on fears of a building global supply glut, oil has rebounded substantially to see the North American benchmark West Texas Intermediate (WTI) trading at almost US$60 per barrel. While optimism surrounding the outlook for crude is improving at a marked clip, there are signs that prices could fall sharply once again during 2019.

If oil experienced another price collapse, it would weigh heavily on Canada's energy patch, especially companies that struggling to be profitable when WTI was trading at US$50 a barrel. That certainly wouldn't be good news for **Cenovus Energy** (TSX:CVE)(NYSE:CVE), which is one of the oil sands producers most vulnerable to lower crude.

Why has oil rallied?

The latest rally was triggered by a combination of OPEC production cuts, news that the Saudi Arabia is considering extending those cuts beyond June 2019, unforeseen inventory draws, and expectations that a trade war between China and the U.S. will be avoided. These factors, however, may only be enough to support prices for the short term and another price collapse could be on the way.

A fundamental issue is that OPEC can't keep cutting production forever. Not only is crude a crucial economic driver and source of fiscal revenue for cartel members, but for many it is the only major economic resource that they possess. This all-important source of wealth is under considerable threat, not only from weaker prices but diminishing demand because of the rapid rise of renewable sources of energy and electric vehicles. This is ratcheting up the pressure for those nations to extract as much oil as possible to maximize the economic benefit it provides before it permanently loses value, or worse, becomes a stranded asset.

Those pressures are considerable for cartel members like Venezuela, Iran, Iraq, Libya, and Nigeria because they possess very few, if any other, economic resources. Petroleum's accelerating loss of value combined with reduced production is preventing them from generating the required capital to invest in critical economic, social, and physical infrastructure required to develop their economies.

The threat this poses to those nations’ development can’t be downplayed. Even Saudi Arabia has recognised this, investing heavily in a range of alternative industries in recent years to pivot its economy away from a dependence on petroleum.

Growing U.S. oil production

Then there is the shale oil boom doing what was thought impossible only a few decades ago, causing U.S. oil production to surpass Russia and Saudi Arabia, seeing it become the world’s largest oil producer. During December 2018, the U.S. produced, on average, 11.8 million barrels daily, which, while marginally lower than a month earlier, was a whopping 18% higher year over year.

This rapid production growth is placing further strain on OPEC by sharply reducing the cartel’s political capital and further weighing on its ability to control prices. As the cartel’s ability to control prices declines, its leverage wanes, and members are unable to fully benefit from their massive petroleum reserves as well as fund vital social programs, which help to ease internal dissent. That is being exacerbated by the willingness of the Trump administration to use crude as a political and economic weapon, which is illustrated by U.S. sanctions being imposed on the petro-economies of Iran and Venezuela.

For these reasons, it doesn’t make sense for many cartel members to keep capping or cutting their oil output, particularly when the looming threat of peak oil is considered.

Cenovus is vulnerable

If oil prices collapse once again, it will have sharp impact on many oil sands operators like Cenovus because of their high breakeven costs.

The company, which completed the $17.7 billion acquisition of **ConocoPhillips’s** Canadian oil sands and natural gas assets in 2017, has been estimated to have a breakeven price of around US$40 per barrel of oil equivalent produced. That is higher than many of its peers, which, along with its considerable exposure to wider price differentials for bitumen and weak balance sheet in comparison to its major oil sands peers, leaves it vulnerable to another oil price collapse.

Cenovus finished 2018 with $8.5 billion in long-term debt, which is a very worrying six times trailing 12-month adjusted EBITDA. This — along with many near-term debt maturities with $1.7 billion maturing before the end of 2021 — is weighing on Cenovus’s outlook, because another sharp decline in oil will place pressure on a balance sheet already under considerable strain.

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