OPEC Production Deal Implodes: The Next Oil Price Collapse Has Arrived

Description

Coronavirus fears and the economic fallout from slower growth in China has hit oil prices hard. The recent meeting between OPEC and its allies, notably Russia, has revealed gaping holes in the alliance, with the parties failing to reach agreement about making further production cuts.

There are signs that the alliance between the cartel and Russia is over, with Moscow refusing to cut oil production further while indicating that it is considering boosting its oil output. This is applying considerable pressure to oil prices, with the international benchmark, Brent plunging by 50% since the start of 2020 to be trading at around US$45 per barrel at writing.

That has sparked a bloodbath among energy stocks, with the largest industry exchange-traded fund (ETF), the **Energy Select Sector SPDR Fund**, losing a whopping 30% for the year to date.

These latest developments highlight just how precarious it was to bet on higher oil when prices were being supported by production cuts being made by OPEC and its allies amid an operating environment where a large supply glut existed.

There is every indication that the price of crude will fall further as the economic impact of the coronavirus virus ripples around the globe.

Worsening outlook

Some analysts are expecting oil demand growth to fall by up to 50%, which along with signs of a global economic slowdown will weigh further on prices. Saudi Arabia has responded to Russia's unwillingness to agree to further production cuts by launching what appears to be an all-out price war to flood energy markets, causing the price of crude to fall to levels that are unprofitable for U.S. shale oil drillers.

At the end of March, when the latest OPEC production cuts expire, Saudi Arabia can pump as many barrels of crude as it wishes. Industry analysts believe that Saudi Arabia can produce up to 12.5 million barrels daily — nearly 30% more than its current output.

If Riyadh decides to significantly boost its oil output, the price of crude will fall further, with the possibility of Brent falling below US$40 a barrel for the first time since April 2016.

The price differential between the international Brent price and the North American West Texas Intermediate (WTI) benchmark, which stands at around US$4 per barrel, will cause WTI to plunge even further.

This will apply considerable pressure to many North American drillers and have an even sharper impact on Canada's energy patch because of the discounts applied to Canadian light and heavy crude price benchmarks compared to WTI.

If that occurs, it will trigger a bloodbath among energy stocks with many basing their 2020 earnings forecasts on US$55 WTI.

Energy stock to avoid

The most vulnerable are those drillers with debt-laden balance sheets like **Baytex Energy** (TSX:BTE)(NYSE:BTE). Since the start of 2020, Baytex has lost 44% and appears poised to fall further as its tremendous amount of debt totalling $1.8 billion and debt maturities weigh on its outlook.

While Baytex successfully raised capital to push out its first debt maturity of US$400 million to 2024, it will struggle to be profitable if West Texas Intermediate (WTI) falls below US$50 per barrel for a sustained period.

Baytex could even be forced to dial down investment in exploration and well development, thereby impacting its ability to grow production.

If the oil price collapse worsens, Baytex could even be forced to make asset sales further reducing its oil reserves and production at a time when it needs to boost output to bolster cash flow.

Looking ahead

As the global spread of the coronavirus worsens, oil prices will continue to fall because of an increasingly weaker global economic outlook. It is believed that the contagion could reduce China's 2020 GDP growth to less than 5% year over year, indicating that there's worse to come for oil.

The collapse of the OPEC production deal and Saudi Arabia's decision to bolster production in a world facing an economic downturn and oil supply glut will weigh on energy prices boding poorly for debt-laden Canadian drillers like Baytex.

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