Will the Latest Oil Production Cuts Save Canada’s Energy Patch?

Description

Canada’s energy patch is under considerable pressure after the latest oil price collapse. For the first time in history, the North American West Texas Intermediate (WTI) benchmark price plunged into negative territory last month. It has since bounced back to be trading at US$34 a barrel, while the international Brent price is at US$36.

Why did oil prices collapse?

The latest price collapse can be blamed on a price war between Saudi Arabia and Russia occurring at the same time a demand shock emerged because of the coronavirus pandemic. The recovery in oil prices can be attributed to Moscow and Riyadh electing to end their price war and OPEC as well as its allies committing to new production cuts.

The latest round of cuts include non-cartel members, aside from key allies such as Russia, including prominent petroleum producers like the U.S. and Canada. The goal of the latest round of production reductions is to shave somewhere around 20 million barrels daily off global oil output, or roughly a fifth of total global output. OPEC and its allies, including Russia, have committed to 9.7 million barrels, with the remainder coming from other global oil producers

Oil demand is falling

It isn’t only unfavourable conditions on the supply side that are impacting oil prices. The coronavirus pandemic and related government measures aimed at curtailing the spread of the virus sparked a dramatic demand shock. Oil consumption has fallen dramatically. Analysts estimate that it is up to 20% lower than at the end of 2019, equating to a reduction of around 20 million barrels daily.

There are signs that oil demand will fall further. The global economy is facing its worst headwinds since the Great Depression because of the fallout from the coronavirus pandemic. Late last month, the IMF slashed its earlier optimistic 2020 GDP growth forecast of 3.3%. It believes that global GDP willcontract this year by 3% but return to growth in 2021.

Poor outlook for oil prices

Such a sharp economic contraction bodes poorly for oil prices, indicating that they will remain lower for longer than many industry pundits predicted. It is for these reasons that WTI is trading in a band at around US$30 per barrel regardless of the latest production cuts.

More worrying is the spat earlier this year between Riyadh and Moscow. It highlights the considerable risks associated with betting on higher oil prices in a world where a mammoth supply glut has weighed on prices since 2015. The latest OPEC plus agreement only occurred because of the economic damage inflicted on Saudi Arabia's and Russia's petro-economies.

The only glimmer of hope for oil prices is the litany of production cuts in North America's energy patch and expected flood of bankruptcies. This will see the U.S. lose its mantle of being the world's largest oil producer, handing it back to Saudi Arabia.

Canada's oil patch is in trouble

Weaker oil prices have sharply impacted Canada's oil patch. This is especially apparent when it is considered that the Canadian heavy oil benchmark price Western Canadian Select (WCS) trades at a deep discount to WTI, which is currently around US$8 per barrel.

The considerable apathy surrounding bitumen prices and Canada's oil sands has forced the closure of the **Canadian Crude Oil Index ETF**. This was the only exchange tradable fund for investors seeking exposure to Canadian heavy oil prices.

Oil sands unpopularity coupled with a sharply weaker price will weigh on major bitumen producers like **Cenovus** (TSX:CVE)(NYSE:CVE). Oil sands typically have higher breakeven prices than forms of conventional and shale oil production. During the last oil price collapse, Cenovus was essentially pumping crude at a loss.

For the first quarter 2020, oil sands were responsible for 80% of Cenovus's production. On a worrying note, Cenovus's operating netback, a key measure of profitability, for its heavy oil assets was $1.93-$3.06 per barrel sold. A decline in oil prices, as witnessed during the second quarter, and/or an increase in blending and transportation costs would see Cenovus pumping heavy crude at a loss.

These headwinds saw Cenovus report a $1.8 billion first-quarter net loss compared to a $69 million profit a year earlier. For these reasons, Canada's third-largest oil sands operator is a stock to avoid.

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