Worried About Another Big Drop in Oil? Here's Why Saudi Arabia Won't Allow it

Description

Oil prices recently closed below US$50 again for the first time in over a week due to speculation that Iraq is now joining a group of members who are looking for exemptions from the recently announced OPEC production-cut deal. Iraq is OPEC's second-largest producer, and the market sees this as bad news for the deal that was supposed to cut OPEC production by up to 800,000 barrels per day (bpd).

Libya and Nigeria are already exempt from the deal due to internal conflicts that have damaged their production, but if production were to return from these sources, it would add about one million bpd. Iran is also looking for exemption, and Iran could add another 400,000 bpd if it wanted. With some of OPEC's largest producers (Iran is the third largest) being exempt, the outlook for a deal looks poor.

Fortunately, there is a solution. Saudi Arabia, which produced 10.6 million barrels per day in August 2016, along with its allies in the Gulf Coast, could simply choose to cut much more than originally planned to offset production gains from the exempt countries and allow OPEC to hit their agreed-upon freeze target.

How much cutting would this require? According to a recent *Bloomberg* article, if OPEC targets the high end of target range (33 million bpd down from 33.2 million bpd in August 2016), Saudi Arabia and other Gulf countries would need to cut 1.3 million bpd to reach their target in the best case (where only Nigeria's production returns) and two million bpd in the worst case (where all the exempt countries grow production).

Saudi Arabia would take the brunt of the hit; originally, Saudi Arabia was only expected to cut its production by about 450,000 bpd from August 2016 levels of 10.6 million bpd, but this could grow to 650,000 in *Bloomberg's* best-case scenario and 1.1 million in its worst-case scenario.

Is Saudi Arabia willing to take its production from current record highs to two-year lows?

Saudi Arabia is now serious about market intervention

There has been a major shift of tone within OPEC and particularly within Saudi Arabia. In November 2014, OPEC decided to pursue a market share strategy; it decided to leave its traditional role of cutting production to support falling prices and pump at maximum levels in an attempt to drive out high-cost U.S. shale production.

The strategy saw OPEC production grow from 30.2 million bpd in November 2014 to 33.3 million bpd today, and the recent decision in September to cut production (for the first time in eight years) is a sign that OPEC is now ready to return to market management.

Saudi Arabia in particular may not have much of a choice. They had a huge budget deficit equal to 16% of GDP last year which is expected to be 13% this year. The country is draining its financial reserves quickly, and the IMF thinks they will be drained in five years if the rate doesn't slow.

At the same time, the IMF sees Saudi Arabia's economy growing by only 0.3% this year; it needs oil to be at US$79.50 to balance the budget. Public sector workers have taken also 20% pay cut. On top of this, Saudi Arabia is currently working to diversify itself away from oil, since oil demand is set to fall over the long term.

The key step to doing this is to sell a portion of its Saudi Aramco state-owned oil company. Saudi Arabia expects to receive a $2 trillion valuation, and the proceeds can be used to fund other business investments. Unfortunately, it is estimated that Saudi Arabia will have difficulty getting this valuation, unless oil prices rise significantly (up to $70 per barrel).

The end result is that Saudi Arabia is likely to cut production. Investors can use this opportunity to buy undervalued oil names, and **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG) , is an excellent choice due to the fact it is trading at a discount to its peer group, but it has some of the most economic assets in North America.

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