Why an oil production freeze isn't enough

Bob Ciura

The drop in oil prices has had a catastrophic effect on Big Oil's bottom line. With oil struggling to stay above $30 per barrel in the United States, earnings are falling off a cliff, dividends are being cut or eliminated altogether to save cash, and oil companies are firing thousands of workers. Many economists believe the only way to generate a real, sustainable recovery in the price of oil would be a meaningful supply response from the major oil producing nations.

However, those wishes have so far gone unfulfilled. Until recently, OPEC displayed little to no intention of cutting oil production. The reasoning was simple—major OPEC member Saudi Arabia saw the oil price collapse as a severe blow to both Iran and the United States. It signaled it was content to continue producing aggressively as long as was necessary--but that all may be about to change.

OPEC signals a willingness to come to the table

In a major breakthrough, several media outlets have relayed reports that OPEC may finally be willing to alter its production. On Feb. 17, news broke that Iran could support an agreement between OPEC and non-OPEC oil producing nations to stabilize oil prices. Reports indicated talks had begun between parties regarding a possible agreement to freeze production at January levels. Iran's oil minister was quoted as supporting a possible ceiling on oil production. If such an agreement were made, it would represent the first time in 15 years that OPEC and non-OPEC nations came together on a supply response.

This has caused even more volatility in the price of oil. After plunging to $25 per barrel earlier this month, West Texas Intermediate has rallied to $34 per barrel as of March 1, a 36 percent rally just since these news reports surfaced.

However, hopes have faded in the days since. It appears many of the world's major oil producers including Russia are not willing to freeze production. There is even discord among OPEC nations about supply levels. Iran represents a fairly small portion of OPEC production but does not seem willing to agree to a production freeze and still intends to bring as many as 500,000 barrels per day to market. Granted, this seems rational, since Iran was only recently allowed to bring its oil to market after having Western economic sanctions lifted.

Why a freeze isn't good enough

Investors counting on these talks and the possibility of an output freeze as a catalyst for a sustainable oil recovery are likely to be disappointed. The reason is that from a fundamental level, a simple freeze at January levels is not likely to solve the economic imbalance between supply and demand. The world is currently oversupplied to a significant extent. Current estimates show the world to be oversupplied by about 1 million to 2 million barrels per day of oil, meaning a freeze alone will not bring supply down to a level that can match demand. Both Russia and Saudi Arabia produced in excess of 10 million barrels per day in January, which was a record for both nations.

Adding to the disappointment is that Saudi oil minister, Ali Ibrahim Naimi, gave a speech on Feb. 22 at the IHS CERAWeek conference in Houston, in which he said producers would hopefully meet in March to discuss a freeze—but he effectively ruled out actual cuts to production. Naimi expressed significant doubt that any agreement to cut production would even be kept. He said that even if nations agreed to cut in principal, they would not keep their word, so an agreement itself would be a waste of time.

Russia and Saudi Arabia are the nations that hold the cards when it comes to a real solution to the global supply glut. But on that front, there seems to be little progress. Consequently, investors should not view the output freeze as a reason for a sustained rally from here. Oil has recovered significantly off its 2016 lows, but a further increase beyond the $35 per barrel level does not seem feasible unless one, or ideally multiple, major oil producing nations agree to a significant cut in oil production.

Companies to Watch

Chevron (NYSE: CVX): As one of the world's largest integrated majors, Chevron would be one of the major beneficiaries of a bottom in oil prices. That is because it is aggressively ramping up production at several major oil fields, including the Gulf of Mexico, where its Jack/St. Malo project is key to Chevron's goal to reach 3.1 million barrels per day in total production by 2017. Analysts on average hold a $93.86 target price for Chevron, a bullish rating that suggests approximately 9 percent upside from current levels. A rebound in the price of oil would be the best catalyst for that bullish thesis.

ConocoPhillips (NYSE: COP): Even more so than Chevron, ConocoPhillips desperately needs a higher oil price to restore its fundamentals, which have deteriorated over the past year. ConocoPhillips' net profits are reduced by $85 million-$95 million for every $1 per barrel change in Brent crude, and by $40 million-$45 million for every $1 per barrel fluctuation in West Texas Intermediate crude. As a result, the drop in the price of oil caused ConocoPhillips to lose $3.5 billion in the fourth quarter alone. That amounted to a loss of $2.78 per share for the quarter. Analysts expected a loss of just $0.65 per share.

Occidental Petroleum (NYSE: OXY): Like ConocoPhillips, Occidental would benefit from a bottom in oil because it is an upstream pure-play. Occidental grew its total company production by 16 percent last quarter, year over year, including 72 percent production growth at its core Permian Basin operation. Analysts are bullish on the stock with an average buy rating and $74.50 price target, representing 6 percent upside from the current price.

Sources:

http://www.cnbc.com/2016/02/16/russia-saudi-arabia-output-freeze-helps-oil-price-higher-in-asia.html

http://www.cnbc.com/2016/02/23/al-naimi-we-in-oil-industry-have-more-that-unites-than-divides-us.html