Saudi Arabia's Cash Reserves Dwindling, Forcing It to Borrow

In an astonishing admission that the Saudis have gambled with a bet that is now going sour, the Saudi Arabia Monetary Agency (the country's central bank) reported:

> It is becoming apparent that non-OPEC producers [in the United States] are not as responsive to low oil prices as had been thought, at least in the short run.
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> The main impact has been [for U.S. producers] to cut back on developmental drilling of new oil wells, rather than slowing the flow of oil from existing wells.
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> This [strategy to break U.S. producers] requires more patience.

But patience will last only as long as their foreign reserves of cash, and Saudi Arabia's reserves (immense though they be) are dwindling rapidly. They peaked at $737 billion in August of 2014. In May of this year, they were down to $672 billion. With the price of oil at less than $50 a barrel, every barrel the Saudis ship costs them $56. Put another way, the Saudis' break-even point needed to fund their lavish welfare state is $106 a barrel.

And so the fact that the government borrowed $4 billion from local banks came as a shock to those who still think the Saudis have wealth beyond counting. Even more astonishing was the news that it would be forced to continue to borrow an estimated $5 billion every month from now on just to slow the shrinkage of its foreign reserves.

The gamble by Saudi Arabia to pump immense amounts of oil to depress oil prices was based on a number of assumptions, each one of which is now being questioned. First, lower prices would force U.S. oil and gas producers to lay down rigs until prices went back up. North American rig counts have dropped — from 1,608 in October to 664 — but production rose: to a 43-year high of 9.6 million barrels per day in June.

Shale gas rigs have dropped even more precipitously, from 1,200 in 2009 to just 209 at present, while output has increased by 30 percent!

Apparently, the Saudis miscalculated when they thought they could shut down the United States' oil business, based on the old model of long lead times and highly expensive drilling. Once shut down, rigs would stay down, forcing prices higher.

It seems they didn't have any idea that 1) fracking was so much less capital intensive, and 2) so much more responsive to market prices. Not to mention how aggressive frackers have been in reducing their costs, which has allowed many/most of them to remain profitable even under the falling price scenario.

What the Saudis didn't count on was American ingenuity. With technological gains, a single surface well in the United States can now drill horizontally in eight or 10 different directions, seeking out favorable formations far below the surface.

Think of traditional oil wells as sitting on a jelly donut, sucking up the good stuff from straight beneath the surface. Think of fracking wells as sitting on a piece of tiramisu, with a single straw descending down miles into the Earth's surface, and then becoming multiple straws turning at right angles to seek out the oil and gas.

Another calculation the Saudis missed: The cost of a new fracking well is a fraction of what it would take to develop a traditional well, which means that a marginal well can be shuttered and then brought back online within days or weeks when prices justify it. Some developers, in fact, have fracking wells that aren't producing until prices rise to justify that production. Consider it as manufacturing "inventory," just waiting for more favorable conditions to bring it to market.

With prices nearing $40 a barrel, producers are working to cut costs even further. Variable costs have already been cut in half this year, with another 30 percent available, according to John Hess, head of the Hess Corporation.

And when a new well is developed, the time from start to production has also been cut in half over just the last year. Scott Sheffield, head of Pioneer Natural Resources, asserted, "We have just drilled an 18,000-foot well [that's nearly three-and-a-half miles] in 16 days in the Permian Basin. Last year it took 30 days."

The other faulty assumptions informing the Saudis' failing gamble were that China would continue to increase its demand for energy, that Iran would continue to suffer under sanctions, and that other members of the OPEC cartel would restrain their own production. None of these have proven to be accurate, causing deficits in Saudi Arabia to run close to 20 percent of the country's total GDP. If oil prices drop further (some are estimating a floor at $30), those deficits will increase.

In February Standard & Poor's lowered its outlook on Saudi Arabia to "negative," explaining, "We view Saudi Arabia's economy as undiversified and vulnerable to a steep and sustained decline in oil prices."

Ambrose Evans-Pritchard, writing in London's *Telegraph*, noted:

> In hindsight, it was a strategic error [for the Saudis] to hold prices so high, for so long, allowing shale frackers … to come of age. The genie cannot be put back in the bottle.

There is no easy way out of this bad bet for the Saudis. If they continue to pump, prices will likely continue to decline, increasing their deficits. If they restrain production, they will lose market share, giving other members of OPEC the advantage and encouraging American producers to bring their rigs back online.

At current rates, those healthy foreign reserves could decline to just $200 billion in three years, leaving the Saudis with few options. The country relies on oil for 90 percent of its budget revenues, and has installed a costly welfare state that was just goosed in January with generous bonuses to public-sector workers by King Salman, who apparently was oblivious to the impending implosion, thanks to his country's bad bet.

The Saudi central bank is right: For the Saudis' strategy to work will require patience. But that patience will expire as its precious foreign currency reserves evaporate, potentially leaving that once-powerful and influential country just as it was before oil was discovered underground: another poor Middle Eastern backwater populated by nomadic tribal societies eking out a marginal existence in an inhospitable desert.

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