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Oil price fall brings significant losses for big producers

By Nick Beams

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The initial response of economic "conventional wisdom" to the slide in oil prices over the past 20 months—down from $110 per barrel in June 2014 to levels approaching $30—was that, whatever the impact on oil-exporting countries, it would aid the global economy because it would lift consumption and other spending.

It was argued that the falling oil price could not possibly be the harbinger of a global recession because all the previous downturns over the past 70 years—in particular the recessions of 1974–75 and 1981–82—were preceded by rising oil prices, while the period of growth in the 1990s was characterised by low oil prices.

That soothing scenario has been shattered over the recent period. The International Monetary Fund all but abandoned it last month, saying "the pickup in consumption in oil importers has so far been somewhat weaker than evidence from past episodes of oil price declines would have suggested."

It has become increasingly clear that, far from providing a boost to the world economy, the precipitous drop in the oil price, together with other major industrial commodities, is symptomatic of deep recessionary trends.

The “conventional wisdom” ignored two major changes in the structure of the global economy over the past decade. First, that so-called emerging markets, many of which depend on the export of oil and other industrial commodities, now comprise about 40 percent of global gross domestic product, double their share in 1990, and so any decline in their revenues has a much bigger impact than previously. And, second, that the financial crisis of 2008–2009 was not merely a conjunctural downturn in the business cycle but signified a breakdown in the functioning of the global economy.

The downturn in oil prices is not only contributing to the lack of global demand—Apple pointed to the decline in demand from emerging markets as one reason for the expected first-ever decline in iPhone sales—it is working to create the conditions for a renewed financial crisis if oil-exporting countries default on their debts.

Venezuela could be the first in line. If oil prices continue at their January lows, Venezuela’s export revenues for this year will be $18 billion, compared to debt servicing charges of $10 billion. This leaves just $8 billion to finance imports, which came in at $37 billion last year. The economy contracted 10 percent last year, following a fall of 4 percent in 2014.

Other oil-exporting countries are being caught in the price vortex. World Bank and International Monetary Fund officials are holding talks with Azerbaijan over a $4 billion bailout and Nigeria is seeking a similar loan from the World Bank and the African Development Bank.

The falling oil price is now showing up in the profit and loss reports of the world’s major oil companies as they cut jobs and capital investment plans. Last month, the US producer Chevron, the second-largest US oil group, reported its first quarterly loss since 2002.

Chevron suffered a loss of $588 million in the fourth quarter of last year, compared to a $3.5 billion profit for the same period in 2014. Oil and gas production in the US, where production costs are higher than the company’s international sites, was the weakest division, reporting a loss of $4.1 billion, compared to a profit of $3.3 billion in 2014. Profits from production outside the US came in at $2.1 billion, but this was a drop of 85 percent on the previous year’s results.

ExxonMobil, the world’s largest oil company, recorded a smaller drop in profits than its rivals. Its profits came in at $2.78 billion, a fall of 58 percent compared to 2014. However, the company committed itself to a further 25 percent reduction in capital spending this year, following a 19 percent reduction in 2015.

Shell reported that it will sell off $10 billion worth of assets, following an 87 percent collapse in its annual profits to $1.9 billion. Shell chief executive Ben Van Beurden said the company would make “substantial changes” in the face of the falling oil price. It has eliminated 7,500 jobs and intends to cut the workforce by a further 2,800.

Further “restructuring” could flow from Shell’s takeover of rival BG, a deal valued at £35 billion. The merger is based on calculations that the price for crude will be at least $60 per barrel, compared to the present level of near $30 and predictions that it will remain at these levels for a considerable period.

The worst-placed of the oil majors appears to be BP. It recorded a loss of $5.2 billion for 2015, its worst-ever result, compared to an $8.1 billion profit for 2014. Following write-downs on the value of its North Sea fields, where many of its operations are unprofitable at current prices, it made a loss of $2.2 billion in the fourth quarter alone, compared to a loss of $969 million during the same period in 2014. BP announced that it will axe about 7,000 jobs across its operations over the next two years, amounting to 9 percent of its workforce.

Overall, the energy sector is expected to cut spending to $522 billion this year, following a 22 percent reduction to $595 billion in 2015. This will be the first time since 1986 that the industry has reduced spending two years in a row.

The downturn in oil prices led to a decision by Standard & Poor's to cut the credit ratings of leading US oil and gas companies, including Chevron. The rating agency downgraded three US shale oil and gas producers—Continental Resources, Southwestern Energy and Hunt Oil—from investment grade to "junk" status.

Exxon kept its triple A credit rating but S&P put it on watch for a possible downgrade, saying it will make a decision within the next 90 days. S&P said it will use longer-term projections in determining its credit ratings. The impact of the slump can be seen in those projections. In December 2014, S&P based its calculations on a long-term price for Brent crude of $85 per barrel. That has been cut to $40 for this year, rising only to $50 by 2018.

Apart from lowered credit ratings, the fall in the oil price is impacting on the financial system, especially via US banks, notably smaller regional banks, which have funded shale oil operations. Figures for January reveal that the main contributor to the 5 percent drop in Wall Street's S&P 500 share index was the fall in bank stocks.

The impact of lower prices has yet to be fully felt because oil producers have been able to cover their position by taking out future selling contracts at higher than current market prices. As those contracts expire, however, some shale producers will become unprofitable unless there is a significant upturn in oil prices.