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Feature

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OPECalypse Now and the World Economy



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Since 2014, the price of crude oil has suffered a major drop of approximately 60 percent from its peak of \$111.80 and currently hovers around \$60. This has created a financial crisis for most Organization of the Petroleum Exporting Countries (OPEC) members and other oil-producing countries. The OPEC struggle can potentially impact the world economy.

All but two OPEC member nations are on a collision course with financial ruin. Budget deficits as a percentage of GDP are generally double-digit, levels that are clearly unsustainable. Cash and investment reserves are being depleted, and sovereign debt is being incurred to delay the day of reckoning. The total sovereign debt of OPEC is approaching the level of subprime mortgage debt that rocked the world on its economic axis in 2008.

The current crude futures curve strongly suggests that crude prices will not increase to a level that will allow Saudi Arabia and others to balance their budgets. Most major energy executives now accept that “peak demand” is a reality and that that inflection point will be reached in the next decade, confirming that the shape of the crude futures curve is well-founded. For a variety of reasons, including peak demand and increasing concerns about hydrocarbon emissions, the sun is beginning to set on crude’s domination of the world’s energy supplies. This ultimate financial demise of OPEC has the potential to significantly impact the world’s economy.

World’s Reliance on OPEC Oil

To analyze the impact of the oil industry on the world’s economy, one must first review the supply-

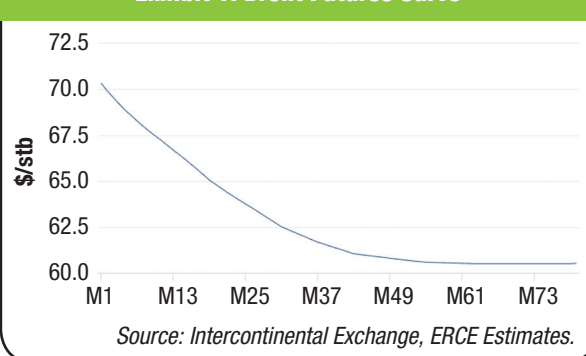
and-demand metrics of oil and the role that OPEC plays in this arena. OPEC’s oil production accounts for approximately 44 percent of the oil production of the world.

Theoretically, one would assume that OPEC should then have the ability to dictate oil prices by thoughtfully controlling the supply of oil, which has largely been true in the past. Events of the last decade have shown that this assumption is no longer viable. Output cuts have been extended a number of times, but the impact of these cuts has been minimal as oil prices are continuing to hover in the \$60 range, dipping as low as \$35.64 in 2016. There are several reasons for this:

- Over the last decade, the U.S. has nearly doubled its domestic production of crude by exploiting the development of shale oil. The increase of U.S. crude production over the last 10 years totals more than 6.7 million barrels per day² and is more than the total daily production for Iran. U.S. shale production is projected to increase in the future as technological advances and economies of scale continue to lower the cost of pro-

² “U.S. Field Production of Crude Oil,” U.S. Energy Information Administration, available at eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=MCRFUS2&f=M (unless otherwise specified, all links in this article were last visited on April 25, 2019).

Exhibit 1: Brent Futures Curve



¹ Research assistance was provided by Jeffrey A. Nerland, Wen Tan and Arsalan Kayhanfar of GlassRatner. Editorial assistance was provided by Adam B. Connors, a managing director with Northland Capital Markets.

duction.³ The U.S. is now a net exporter of crude for the first time in 75 years.⁴

- Slowing economic growth in developing countries such as China further limits the demand for oil.⁵
- It is now well accepted that the world is approaching a point of peak demand, after which demand for crude will begin to decline into the foreseeable future.⁶
- Major efforts by governments around the world to promote electric or hybrid vehicles has also limited the demand growth for oil,⁷ further flattening the demand curve. Parties to various production-curtailment agreements have both the motivation and the ability to circumvent those agreements, potentially leading to additional supply.

The crude future curve shows that oil prices are projected to gradually decrease over the next 73 months, bottoming at around \$60 (see Exhibit 1).

Importance of the Oil Sector to OPEC Members

It is evident that many OPEC members are increasingly dependent on revenues from their oil industries. This is evidenced by the large percentage of gross domestic product (GDP) contributed from their oil sectors. The oil segment accounts for 43 percent of Saudi Arabia's

GDP.⁸ The obvious conclusion is that these countries' economic well-being is directly tied to the price of oil (see Exhibit 2).

Budget Deficits and Surplus

Beginning in the early 2000s, OPEC enjoyed a decade of unprecedented prosperity resulting from the oil price surge from around \$30 to almost \$100.⁹ This increase allowed many OPEC countries to create massive social programs for its citizens. The obvious risk is the assumption that pricing will remain at a level that supports those expenditures, which is a now-clear falsity for a volatile commodity.

A few OPEC members, particularly Saudi Arabia, have belatedly realized that an investment in diversifying their economy is the only way out of this economic trap. The question is whether Saudi Arabia has the financial resources and the time to accomplish this repositioning of their economy before disaster strikes.

When the price of crude collapsed in 2014, many OPEC countries began to run unsustainable budget deficits. According to the latest report,¹⁰ all OPEC members are currently running a budget deficit, and five are running a budget deficit of more than 10 percent of the GDP. To put it into prospective, Greece was running a budget deficit of 15.4 percent in 2009 when many people considered it a hopelessly insolvent state.¹¹ Any budget deficit that significantly exceeds the GDP growth rate is unsustainable in the long run. There is little question about the financial outcome if oil prices remain stable at current levels. The only uncertainty is the actual timing (see Exhibit 3).

In 2012, the average oil price was \$86.46, which declined to \$42.81 in 2016. The budget balance for major OPEC countries followed a similar pattern. Saudi Arabia's

3 David Blackmon, "Technology and Efficiency Gains Create a 'New Normal' for U.S. Shale," *Forbes* (Sept. 18, 2018), available at forbes.com/sites/davidblackmon/2018/09/18/technology-and-efficiency-gains-create-a-new-normal-for-u-s-shale/#7c6b1f9e6591.

4 Javier Blas, "The U.S. Just Became a Net Oil Exporter for the First Time in 75 Years," *Bloomberg* (Dec. 6, 2018), available at bloomberg.com/news/articles/2018-12-06/u-s-becomes-a-net-oil-exporter-for-the-first-time-in-75-years.

5 Noah Browning, "Oil Drops More Than 1 Percent as China Slowdown Bites," *Reuters* (Jan. 22, 2019), available at cnbc.com/2019/01/22/reuters-america-update-4-oil-drops-more-than-1-pct-as-china-slowdown-bites.html.

6 Adam Vaughan, "Global Demand for Fossil Fuels Will Peak in 2023, Says Thinktank," *The Guardian* (Sept. 11, 2018), available at theguardian.com/business/2018/sep/11/global-energy-demand-fossil-fuels-oil-gas-wind-solar-carbon-tracker.

7 Marianne Kah, "Electric Vehicles and Their Impact on Oil Demand: Why Forecasts Differ," Columbia I SIPA Center on Global Energy Policy (July 2018), available at energypolicy.columbia.edu/sites/default/files/pictures/CGEP_Electric%20Vehicles%20and%20Their%20Impact%20on%20Oil%20Demand-Why%20Forecasts%20Differ.pdf.

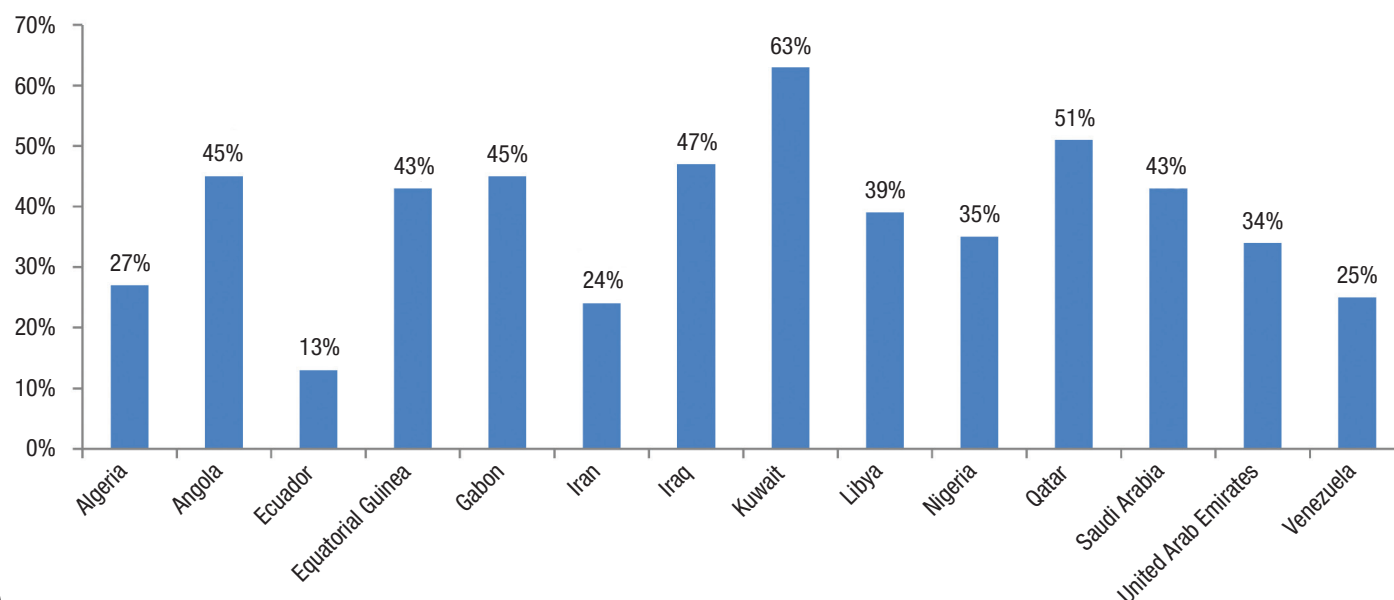
8 "Economic Diversification in Oil-Exporting Arab Countries," Annual Meeting of Arab Ministers of Finance (April 2016), available at imf.org/external/np/pp/eng/2016/042916.pdf.

9 "Crude Oil Prices: 70-Year Historical Chart," *Macrotrends*, available at macrotrends.net/1369/crude-oil-price-history-chart.

10 "The World Factbook," Central Intelligence Agency, available at cia.gov/library/publications/the-world-factbook/rankorder/2222rank.html.

11 David Jolly, "2009 Greek Deficit Revised Higher," *The New York Times* (Nov. 15, 2010), available at nytimes.com/2010/11/16/business/global/16deficit.html.

Exhibit 2: Percent of GDP Attributed to Oil Sector by OPEC Countries



budget balance in 2012 was positive at 12 percent of GDP. In 2016, the budget balance was negative 17 percent of GDP. This further demonstrates the extent to which these OPEC budgets are heavily dependent on oil revenues. It also illustrates the magnitude of the problem posed by low oil prices for OPEC members.

By analyzing each country's financial position, one can calculate the oil price that is required for each country to achieve balanced budgets. For Kuwait and Qatar, which have historically diversified their economies, the budget break-even point is below \$50 per barrel. For other OPEC members, the break-even points all exceed \$60 per barrel. For Saudi Arabia, the break-even point exceeds \$70 per barrel. Saudi Arabia's future is precarious, since the futures curve suggests that the price of oil will average approximately \$60 per barrel for the next five years.

Certain OPEC members are beginning to realize the magnitude and inevitability of the problem and have begun to implement stricter fiscal policies in an attempt to balance their budgets with lower oil revenues. This poses other problems, such as social unrest and the difficulty of achieving economic growth in non-oil sectors.

Strict fiscal policy will spark public outcry from citizens who are accustomed to the enjoyment of significant government benefits. This is especially true for countries with a substantial youth unemployment rate. Saudi Arabia currently has an unemployment rate of 30 percent among youths between the ages of 15-24. Also note that half of Saudi Arabia's current population is composed of youths under the age of 25. Austerity measures will mean an even higher unemployment rate among this age group. *Currently, 70 percent of working people in Saudi Arabia are employed in the public sector.*¹² A disruption of this entitlement will create dissent among its youths and create political instabil-

ity that might pose significant challenges to the country and its royal family.

Impact of a Collapse on Debt and Exports

This financial crisis and the foreseeable insolvencies of certain OPEC members might have a significant impact on world financial markets. As previously noted, many OPEC countries (including Saudi Arabia) are depleting foreign reserves at an alarming rate. To slow this decline, they are borrowing internationally and hoping for an oil price rebound. This means that governments and organizations of these countries have accrued a large amount of sovereign debt in the past few years.¹³ External debts from OPEC governments and organizations currently total \$922 billion, and this figure is rising. To put it into perspective, the total subprime mortgage debt in 2007 was \$1.3 trillion.¹⁴

The impact of a default on a portion of the OPEC-related debt has the potential to trigger a similar panic among investors and a downturn in financial markets. This is especially true when signs of a decline in the growth rate of the industrialized nations already exist, a clear bear signal for crude pricing.

Interestingly, a number of OPEC members still enjoy favorable bond ratings with the major rating agencies. Saudi Arabia is currently rated A+ (Fitch), A1 (Moody's) and A- (S&P 500), and has the ability and motivation to borrow from international markets to balance its deficits. Higher sovereign debt further increases the default risk and the potential impact on the world economy (see Exhibits 3 and 4).

One justification for the continued high credit rating, despite the economic data, is Moody's assessment that Saudi Arabia has the capacity to carry more debt. This argument is both circular and unpersuasive. Countries and companies

¹² Suparna Dutt D'Cunha, "Plagued By a 30 Percent Unemployment Rate, Arabian Youth Turn to Startups for a Lifeline," *Forbes* (May 11, 2017), available at forbes.com/sites/suparnadutt/2017/05/11/can-startups-drive-new-job-growth-in-the-mena-region-where-youth-unemployment-rate-is-30/#306434e034f4.

¹³ Elena Holodny, "Saudi Arabia's National Debt Has Exploded Since the Oil Crash," *Business Insider* (Dec. 22, 2016), available at businessinsider.com/saudi-arabia-national-debt-budget-2017-report-2016-12. See also CIA, cia.gov.

¹⁴ Abraham Park, "Why Did Subprime Loans Become Such a Big Deal?," *Graziadio Business Review* (May 5, 2008), available at gbr.pepperdine.edu/blog/2008/05/05/29.

Exhibit 3: 2016 Budget Deficit by OPEC Members

	Deficit/Surplus as Percent of GDP	2016 GDP (\$ Billions)	Deficit/Surplus (\$ Billions)	Budget Break-Even Oil Price (\$ per Barrel)
Algeria	-13.30%	168.30	(22.38)	136.39
Angola	-6.80%	91.90	(6.25)	54.35
Ecuador	-4.00%	99.10	(3.96)	77.40
Gabon	-3.80%	14.60	(0.55)	52.18
Iran	-1.60%	514.06	(8.22)	55.86
Iraq	-14.70%	210.28	(30.91)	72.63
Kuwait	-0.90%	110.50	(0.99)	69.41
Libya	-20.10%	39.40	(7.92)	112.53
Nigeria	-2.40%	415.10	(9.96)	59.62
Qatar	-7.80%	156.60	(12.21)	79.99
Saudi Arabia	-12.80%	637.80	(81.64)	71.29
United Arab Emirates	-3.90%	375.00	(14.63)	59.92
Venezuela	-39.90%	333.70	(133.15)	327.79

Source: CIA (cia.gov).

are increasingly turning to alternative energy sources, and peak demand for crude has now become an accepted working assumption.

It has been clearly demonstrated that as prices move up, additional production capacity can be brought on quickly. The shale oil play in the U.S. alone added more than six million barrels per day to world crude production in only 10 years. The crude futures curve strongly suggests that the consensus view of the world's "smart money" is that prices in the low \$50s to low \$60s are the "new normal" for crude pricing. For Saudi Arabia, whose budget break-even price is \$74 per barrel, borrowing more sovereign debt is only extending the timing of inevitable default.

OPEC's collapse will shrink revenues for companies that export goods to member countries. The luxury goods market will be severely impacted, and research by Ledbury shows that Saudi Arabia, Qatar and Kuwait are significant purchasers of foreign luxury goods.¹⁵

It is likely that as Saudi Arabia's need for foreign exchange becomes more acute, it (and perhaps other OPEC members) will increase production and drive crude prices even lower. This has the potential to significantly impact other companies in the energy sector around the world. In the U.S., the market cap of energy companies is 5.5 percent of the total market cap of the S&P 500.¹⁶ As a result of the sharp decline in crude prices between the end of 2014 and 2018, 167 producers have filed for bankruptcy¹⁷ and hundreds more have engaged in consensual debt restructuring

with their creditors. U.S. bank regulators have largely "red-lined" exploration and production (E&P) loans and have significantly increased oversight of lenders who are active in this lending segment.

Misconception About Lower Oil Prices

Many experts have seen the oil price decrease as being positive for the U.S. economy. The rationale is that lower gas prices will "put money in consumers'" hands and increase consumer spending.

However, research shows that the net effect of the oil price decline has been close to 0 percent for the U.S. GDP.¹⁸ The increase in consumer spending from lower prices has been offset by a decrease in oil-related investment.

There have been continuing withdrawals by the Saudi Monetary Authority from global-investment firms like BlackRock in the tens of billions of dollars to cover their deficit.¹⁹ The prospect of future loss of investment from OPEC countries can impact economic growth in the U.S. To put this into perspective, Saudi Arabia currently has invested \$250 billion worldwide.

Impact of Oil Prices on U.S. Bankruptcies

Low oil prices have forced companies in the oil and gas industry to cut capital spending by 50 percent in 2015 and 2016, impacting future reserves, operating cash flow and shareholder dividends. Over the next five years, approximately \$590 billion of the industry's debt is maturing.

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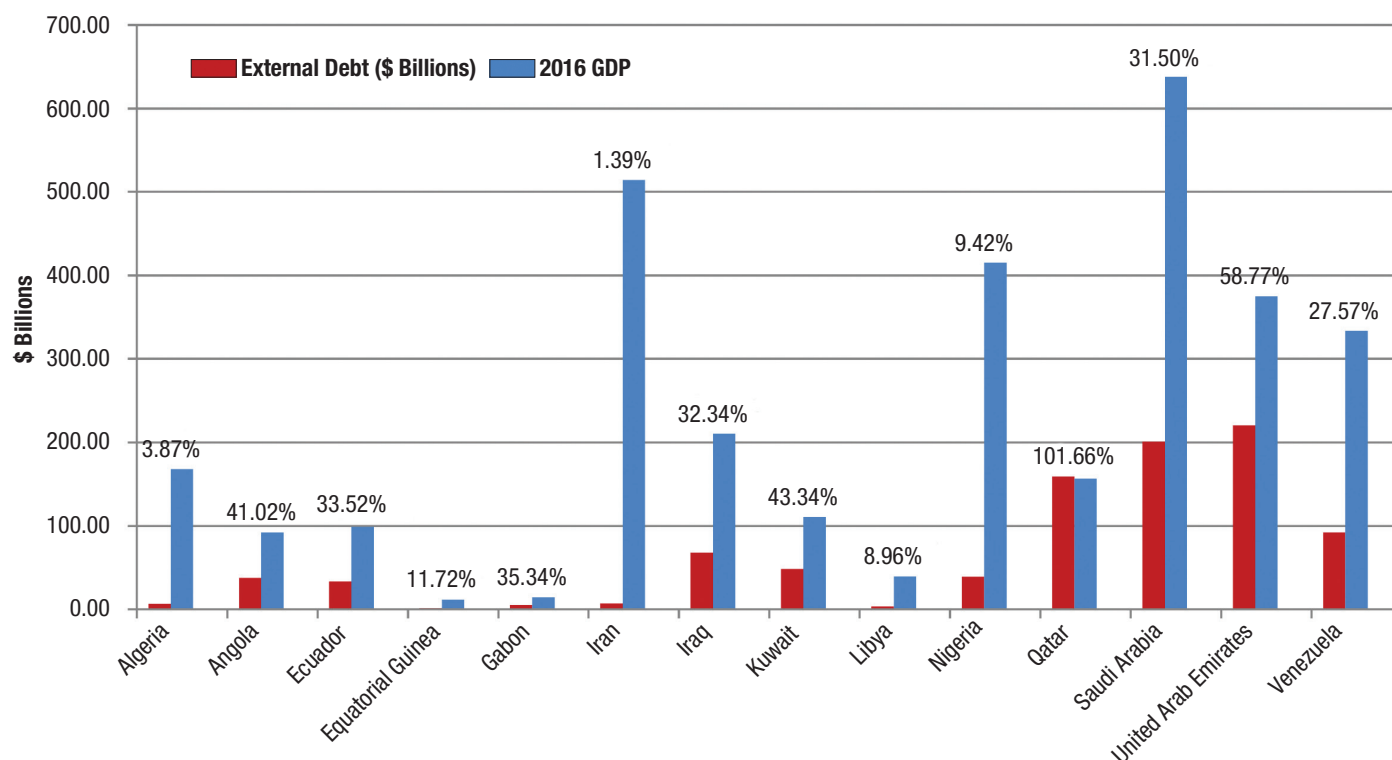
16 "Stock Market Indicators: S&P 500/400/600 Sectors Market Cap and Earnings Shares," Yardeni Research Inc. (April 24, 2019), available at yardeni.com/pub/spxshares.pdf.

17 "Oil Patch Bankruptcy Monitor," Haynes and Boone, LLP (Jan. 7, 2019), available at haynesboone.com/-/media/files/energy_bankruptcy_reports/oil_patch_bankruptcy_monitor.ashx?la=en&hash=D2114D98614039A2D2D5443A61146B13387AA3AE.

18 Christiane Baumeister and Lutz Kilian, "Lower Oil Prices and the U.S. Economy: Is this Time Different?," Brookings (Fall 2016), available at brookings.edu/bpea-articles/lower-oil-prices-and-the-u-s-economy-is-this-time-different.

19 Simeon Kerr, "Saudi Arabia Withdraws Overseas Funds," Financial Times (Sept. 27, 2015), available at ft.com/content/8f2eb94c-62ac-11e5-a28b-50226830d644?mhq5=e3.

Exhibit 4: OPEC External Debt as Percentage of GDP



Maturing debt plus upstream capital-expenditure costs suggests a funding gap of \$2 trillion, assuming an average oil price of \$55 per barrel.²⁰

Smaller and mid-size E&P companies have experienced and will continue to be faced with bankruptcy, debt restructuring, and/or operational downsizing in conjunction with the liquidation of assets. This will put continued pressure on asset values in the segment.

In 2016, the Comptroller of the Currency issued a formal handbook governing the examination of E&P lending, significantly impacting bank lending and industry bankruptcies. The new rules compel a much more rigorous rating methodology for the industry. Bank revenue recognition practices were also altered, making a majority of oil and gas loans unprofitable from a regulatory standpoint.

When the handbook was introduced, a majority of E&P loans were reclassified as “substandard,” requiring *substantial* additional provisions to loan loss reserves. These guidelines resulted in higher pricing, stricter lending underwriting and mandatory hedging, which caused many small- to mid-cap oil and gas bankruptcies. The 167 U.S. industry bankruptcy filings since 2015 have been dealing with debts totaling \$96 billion.²¹

Conclusion

The collapse of OPEC countries resulting from low oil prices would be potentially devastating to the world’s economy. This might lead to a recession similar in magnitude to the 2008 crisis. It is unlikely that oil prices will rebound sufficiently for OPEC countries to balance their budgets and remain solvent. U.S. shale-based operations are becoming increasingly efficient, offsetting OPEC output cuts.

Most OPEC members must implement more responsible fiscal budgets and diversify their economies. It is likely that a number of these countries will run out of time and fail to overhaul their economies into sustainable configurations. The funding gap for U.S. oil and gas companies will result in more bankruptcies for E&P companies and significant financial problems for lenders, suppliers and investors.

A time bomb of considerable proportion is ticking, with no foreseeable solution in sight. The impact of this problem has every likelihood of causing considerable impact to the world’s economy and developed nations. **abi**

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20 “Short of Capital? Risk of Underinvestment While Oil Price Is Lower for Longer,” Deloitte, available at deloitte.com/us/en/pages/energy-and-resources/articles/lower-for-longer-risk-oil-gas-underinvestment.html.

21 Haynes and Boone, *supra* n.17.