Déjà vu Oil Over Again

Why this downturn will be just like, and nothing at all like, the last one

In the mid-1980s, the price of crude oil dropped by more than half in a matter of months. By 1986, oil was trading around $10 a barrel, down from a high of $35 a barrel a few years earlier. There were a number of reasons for the collapse in prices.

Slowing economies in the United States, Europe and Japan led to a decrease in demand. But production continued at the same, uninterrupted pace. Oil from non-OPEC countries flooded the market. The OPEC countries failed to curtail production. Indeed, Saudi Arabia actually increased production, partly in response to instability in the Middle East. The United States set out to end its dependence on oil imports. Inventories accumulated. Prices plunged.

The current turmoil in the energy markets looks suspiciously similar. Global demand for oil in industrialized countries, particularly China, has been decreasing for some time. But producers have failed to curtail production. Oil production in the United States skyrocketed with the introduction of shale oil extraction technology. OPEC has once again failed to curtail production. Instability in the Middle East is again a factor. Vehicles in the U.S. have become more fuel efficient, and alternative energy is slowly taking root. Inventories are up, and prices are down by more than 50 percent from their peak.

So how and where will it end? It took the oil industry more than 15 years to recover from the steep price declines of the 1980s. Because of advances in technology and production methods, including the speed at which shale oil can be produced (or not produced, in a down market), no one believes that prices will stay below $50 a barrel for a long time. But no one can say for sure when prices will rebound.

After prices bottomed out in 1986, virtually all companies in the energy industry suffered losses. Especially hard hit were oil field service and production companies. Relatively high operating costs reduced their profit margins substantially. A lot of those companies had borrowed heavily to acquire equipment to meet anticipated demand, and they had to quickly jettison costs to stay afloat. The ripple effect then spread through the supply chain - equipment suppliers, maintenance companies and the like - and then on to entire communities. The Midland-Odessa area in West Texas was particularly affected by the downturn in the industry and the loss of jobs that followed.

Will it be different this time? Many of the causes for the decline in oil prices are the same. But the reaction of the industry may well be different. The companies that survived the downturn of the 1980s and the price depression that followed learned valuable lessons. They learned to keep more cash on hand and avoid excessive leverage. They learned to keep non-variable operating costs to a minimum. Communities that were almost entirely dependent on the oil industry have diversified. Despite all of this, a number of companies will fail; it is inevitable in any economic downturn. But the repercussions should not be as extensive or long-lasting as last time.

The ultimate difference between the last downturn and this one may be interest rates. Rates are much lower today than they have been during the past 30 years. That should make it easier for energy companies to restructure their balance sheets either through new or additional financing, workouts with major creditor constituencies, or Chapter 11 bankruptcy. It also makes it easier for energy companies to merge and consolidate, thereby reducing combined overhead and improving profit margins.

Can companies operate profitably, or restructure their finances to achieve profitability, with oil trading below $50 a barrel? The lowest cost producers certainly can. And the companies with cash reserves that can operate at lower costs stand to benefit the most. They will be able acquire their more inefficient competitors for much less than they could have a few years ago and gain a larger share of the market. Overall, prices should stabilize sooner rather than later, and the most efficient companies will emerge stronger and better positioned to capitalize when prices improve, just like the last downturn in the energy industry.

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