Debt-Driven Dividends & Asset Fire Sales

Key Findings

- For years, major oil and gas companies have attracted investors by paying them steady dividends. But the practice has masked the industry's financial frailty and inherent instability.
- Following a decade of declining profits exacerbated by the COVID-19 pandemic, some oil majors, such as Shell, have slashed dividends, while others, including ExxonMobil and BP, are racking up debt to maintain their shareholder payments and sustain their image as sound investments.
- Oil and gas companies are also writing-down and selling off their assets at heavily discounted prices, in a move that reflects a desperate need for cash and growing skepticism about the future value of fossil fuels.
- Petrochemicals and the plastic they produce do not offer oil and gas companies a way out of their economic troubles. Dovetailing trends of lowered plastic resin prices, increased plastic regulation, and decreased capital spending threaten the fundamentals of the petrochemical industry, on which many oil and gas companies have staked their future growth.
- Dwindling dividends, deepening debt, and decreasing assets are just the latest evidence that the oil and gas industry is in an endgame that began well before COVID-19. Fiduciaries have a duty to re-evaluate the soundness of continued investments in a sector in long-term decline, and policymakers have a duty not to pour public funds into companies that are both economically unstable and environmentally destructive.
- The longer pension funds stay invested in fossil fuels despite stark warning signs about financial precarity and climate exposure, the more fiduciary risks accrue.

This briefing note follows on from CIEL's April 2020 report, *Pandemic Crisis, Systemic Decline: Why Exploiting the COVID-19 Crisis Will Not Save the Oil, Gas, and Plastic Industries*, which argued that the converging public health, economic, and human rights crises triggered by the pandemic have magnified long-term structural weaknesses in the oil, gas, and petrochemical sectors and accelerated the industry's collapse. Through a closer look at post-crisis trends with respect to dividends, debt, and asset sales in the oil and gas sector, this note highlights the latest signs of the industry's underlying unsustainability and the related risks of investing private or public funds in a sector in decline.

One of the main ways major oil and gas companies have attracted investors over the years has been by paying steady dividends to shareholders. This practice has masked their financial frailty and the industry's inherent instability. For at least a decade, those payouts have been propped up not by strong earnings, but by a precarious combination of debt and asset sales. A report from the Institute for Energy Economics and Financial Analysis (IEEFA) reveals that the five oil majors — ExxonMobil, Chevron, Shell, BP, and Total — have distributed more in dividends and share buybacks since 2010 than they earned in free cash flow.[1] This discrepancy should have been cause for concern among investors, especially as the ongoing distributions did little to buoy stock prices. (Energy has been the worst-performing sector of the S&P 500 since 2010.[2]) The COVID-19 crisis has forced the industry to reckon with the fundamental unsustainability of oil and gas company finances and exposed the steady decline behind the industry's steady dividends.

Oil and gas companies continue to lose value as demand for their products remains depressed amidst the COVID-19 pandemic and ensuing global recession. Fuel consumption is down, as is the demand for petrochemicals, which are derivatives of oil and gas production used to make things like plastic*, pesticides, and fertilizers. The petrochemical boom on which the oil and gas industry was staking its future looks increasingly like a bust, and certainly not the economic salvation fossil fuel producers sought.[3] The market meltdown has forced some of the major integrated oil and gas companies to make unprecedented cuts to their dividends, while others accumulate debt and spin off assets to fund continued payouts to shareholders. The former appears to be an overdue admission of financial strain; the latter, a further hit to the balance sheets of companies whose revenues are plummeting. Both approaches should alert investment managers and policymakers who are accountable to beneficiaries and taxpayers, respectively, to the perils of funneling more cash into oil and gas companies. Dwindling dividends, deepening debt, and decreasing assets are just the latest evidence that the industry is in its endgame.

Slashed Shareholder Payouts

On April 23, 2020, Norway's Equinor became the first international oil company to cut its dividend. The company reduced shareholder payouts by two-thirds, on top of suspending share buybacks and issuing bonds for $5 billion.[4]

A week later, on April 30, Shell announced it too was suspending share buybacks and would cut its dividend by nearly two-thirds.[5] Shell was the first of the oil majors to reduce payments to shareholders, marking the first time the company cut its dividends since World War II. Shell is also planning to cut capital expenditure in 2020 by at least 20% (from $25 billion to no more than $20 billion), and reduce operating expenses by an additional $3-4 billion.[6]

With the largest and best performing companies in the sector in such dire financial straits, it's no surprise that smaller cash-strapped oil and gas producers are likewise ditching their dividends and digging themselves further into debt. US producer Occidental Petroleum Corporation has cut its dividends twice in 2020, first to 11 cents a share[7] and then to one penny a share in late May, representing a 91% drop and the largest reduction since the 1970s.[8]

Reduced payouts to shareholders compound significant loss of underlying share value — a phenomenon evident across the oil industry due to a combination of demand destruction, increased climate risk, and mounting debt. Occidental is a

*For the sake of simplicity, when this report refers to plastic, it refers to an array of polymers and products with different chemical compositions.

stark example, as its shares have lost approximately half of their value this year compared to the S&P 500, which has recently recovered its 2020 losses.[9] The company's debt, $23 billion of which is due in the next nine years, exceeded its current market value, estimated at $18.3 billion on June 23, 2020.[10] Similarly, as of that same date, shares of Shell stock were down by more than a third,[11] and shares of Equinor by nearly one-fifth.[12]


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Debt-Backed Dividends

Other oil majors have kept their dividends but only by taking on additional debt, massively reducing planned capital expenditures, or both.

ExxonMobil exemplifies the lengths that oil companies will go to deflect attention from the sector's structural decline and stave off the industry's end. ExxonMobil has so far maintained dividend payments, but at a steep cost. Like some of its peers, ExxonMobil cut spending and raised debt to finance its dividend this year.[13] On April 7, ExxonMobil announced it would reduce capital expenditures by 30% and operating expenses by 15% in 2020, and as of June, was reportedly planning to lay off 5-10% of its US workforce.[14] Despite this massive reduction in outlays, the company added $8.5 billion in debt.[15] As of May 2020, ExxonMobil's payout ratio (the ratio of its dividends to net income) was 130.6%.[16] Given that precarious position, it comes as no surprise that both Moody's and S&P Global downgraded ExxonMobil's credit ratings, with Moody's noting that it does not expect improvement in the company's rating over the medium term.[17]

Paying shareholders more than the company is currently earning is, at best, a short-term fix that masks long-term problems. With a company-wide average breakeven price of $75/barrel and growing debt,[18] there is little prospect of ExxonMobil getting out of the red anytime soon — even if there is a temporary oil price rebound.

BP similarly maintained its dividend, but only by boosting its borrowing because the company's spending cuts of 25% in 2020 were insufficient to cover the shareholder payouts.[19] The company overshot its target debt-to-capital ratio of 30%, hitting 36% as its debt climbed to $51.4 billion.[20] And in June, BP announced that it would cut 10,000 jobs, representing nearly 15% of its global workforce, to rein in spending. Shortly thereafter, the company decided to write off between $13 and $17.5 billion in assets, up to 6% of its holdings.[21] Those massive layoffs and write downs confirm not only how severe the current cash crunch is, but also that the company does not expect to see growth recover anytime soon. Analysts already believe that dividend cuts may be coming as early as next quarter.[22]

The remaining oil majors, Total and Chevron, have kept their dividends for now, but only by prioritizing them over capital spending. Total maintained its dividend,[23] but cut capital expenditures by approximately 20%.[24] Chevron similarly cut its capital spending by $2 billion in April, after already reducing it by $4 billion in March.[25] The $6 billion cut amounts to approximately 30% of the company's planned capital expenditure in 2020.[26]

Taking on more debt is all the riskier when the assets that will be used to pay it back are themselves losing value, as is the case with hydrocarbon reserves.


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Asset Fire Sales

Oil majors are also writing down and selling off their assets in “fire sales,” according to an analysis by Rystad Energy.[27] The massive demand destruction triggered by the pandemic undermines oil and gas revenues, putting downward pressure on dividends and accelerating companies’ efforts to sell off assets for cash. At the same time, depressed oil and gas prices and the uncertain outlook for the future of the market are foiling efforts to monetize hydrocarbon holdings.[28]

Oil and gas majors’ asset fire sales reflect their need for cash today and skepticism about the value of fossil fuels tomorrow.

The spate of write-downs by oil majors in late 2019 and in June 2020, when both BP and Shell reduced the value of their assets by tens of billions of dollars, does little to help the companies fetch a higher price.[29] In part, those write-downs reflect a recognition that climate risks are rapidly becoming a reality, eroding the long-term value prospects of oil and gas assets. Since the bottom fell out of the market, companies have had trouble selling their holdings, effectively leading to asset stranding in real-time.[30]

Plummeting Petrochemical Prospects

The oil majors have been betting on petrochemicals, and plastic production, in particular, to be one of their significant engines of growth in the twenty-first century.[31] But 2020 has revealed the riskiness of this wager. The same market instability and financial uncertainty facing oil and gas production is affecting petrochemicals as well. With an integrated value chain, fossil fuels and plastic rise and fall together.[32]

Declining fossil fuel consumption and the rising costs of extraction have prompted oil majors to look to plastic as an economic crutch. Before the pandemic, the International Energy Agency predicted that, by midcentury, up to half of the growth in oil demand could come from petrochemicals used to produce plastic, fertilizers, and pesticides.[33] Throughout the last decade, over $200 billion has gone into petrochemical infrastructure and plastic plants, much of it in the United States, where it was assumed these facilities would have indefinite access to cheap shale gas.[34] As the market falters under the global supply glut and shale companies fold, however, the economics of the petrochemical expansion are beginning to unravel.

Prices for plastic resins were dropping before the COVID-19 crisis,[35] and they have continued to plummet along with oil and gas prices.[36] The plastic market is saturated, and a short-term uptick in demand for personal protective equipment will not change the long-term downward trajectory of plastic use. Moreover, as oil becomes cheaper, the differential in cost between gas-based and oil-based plastic feedstocks has narrowed, cutting into expected margins and undermining the justification for the US gas and natural gas liquid (NGL)-based petrochemical buildout.[37] As noted in a recent Reuters analysis, the combination of a demand shock, increasing regulation of plastic, low resin prices, and decreased capital spending pose a combined significant threat to the petrochemical industry.[38]

Petrochemicals and plastic will not be how the oil and gas industry grows its way out of this crisis or climbs its way out of debt.

The message of the market is clear: plastic and petrochemicals will not save oil and gas — nor should they. Not only are the plastic and petrochemicals sectors unable to compensate for the poor financial fundamentals mentioned earlier, but these sectors are also themselves vulnerable to the same frailties. Investors should not be misled into thinking that plastic will be how the industry grows its way out of this crisis or climbs its way out of debt. Such a strategy is as economically unsound as it is environmentally unsustainable.

Red Flags for Fund Fiduciaries

The inability of so many oil and gas companies to sustain their dividends or to cover the costs of shareholder payouts, despite massive reductions in capital spending, is a red flag that investors should heed. Not only does it bespeak problems for the specific companies highlighted above, but it adds more evidence to the growing case against investing in fossil fuels.

Given the systemic weaknesses across the sector, Shell's historic decision to cut its dividend puts investors on constructive notice that similar cuts are likely coming from others in the industry, and that those companies continuing to pay their shareholders are doing so on borrowed money and time. The other oil majors are not on any more solid financial footing than the Dutch-British giant. According to IEEFA, ExxonMobil's dividends and buybacks between 2010 and 2019 exceeded its free cash flow by $65 billion, and BP's by $50 billion, while Shell's equivalent deficit over the same period was $23 billion.[39]

Debt-backed dividends and cuts to shareholder payouts are just the latest manifestation of deep, structural weaknesses in the oil and gas sector. This new data has direct financial and legal implications for fiduciaries. Investment managers subject to fiduciary obligations, such as trustees of public sector pension funds, owe duties of prudence and loyalty to their beneficiaries. As detailed in CIEL's 2016 report, *Trillion Dollar Transformation,*[40] those obligations include the duty to monitor and re-evaluate prior investment decisions in light of new information to ensure they remain prudent,[41] and the duty to act impartially toward present and future beneficiaries, balancing long-term capital preservation and growth.[42] The latest developments concerning dividend cuts are just the most recent of many clear indications that the sector is in long-term decline, making it a poor investment for those with a long time horizon.

The fossil fuel sector's financial frailty and climate exposure spell fiduciary risk for pension funds.

As evidence continues to mount that the oil, gas, and petrochemical

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sectors are facing financial calamity, fiduciaries have a duty to reevaluate whether continued investment in oil and gas companies is in the best interest of those whose funds they manage. The financial hardships that have been brought into stark relief by the pandemic compound the risks that the climate crisis poses to fund assets in fossil fuels — impact, carbon asset, transition, and litigation risks — further eroding the business rationale for investing in oil and gas. The case for continued fossil fuel investment is especially weak for long-term investors, such as pension funds, that must balance the interests of current generations against future ones. The longer they stay invested in fossil fuels despite stark warning signs about financial precarity and climate exposure, the more fiduciary risks accrue.

Alarm Bells for Public Policymakers

The payment of debt-driven dividends, and the underlying systemic weakness in the sector that those payments mask, should not only discourage private investment in oil and gas companies, but should also disqualify those companies from receiving public subsidies. In the wake of the pandemic, however, the opposite has been true. Oil and gas companies, together with the plastic industry,[43] have sought — and in some cases received — financial,[44] regulatory[45] and legal relief,[46] diverting taxpayer resources from pressing public needs, including investment in the clean-energy transition.

A former member of the Board of Governors of the Federal Reserve echoed this concern in a New York Times op-ed in late May 2020.[47] As she notes, federal support for the long-floundering oil and gas industry sends distortionary market signals, is ripe for abuse without proper restrictions on how taxpayer dollars should be spent, and runs counter to the emerging consensus that recovery should focus on supporting resilient and sustainable industries, not propping up already failing ones. Research published in June 2020 by Influence Map suggests that the Federal Reserve's purchase of corporate bonds of fossil fuel companies, which were in secular decline before the pandemic, may pose untenable and unnecessary risks to US taxpayers.[48]

Investing taxpayer money in the oil and gas industry is a path to public risk, not recovery.

Policymakers have a duty to protect workers and communities, not polluters and their shareholders. Governments should recognize that the instability of the oil, gas, and petrochemical sectors predates the current crisis and reject the industry's calls for financial, regulatory, and legal relief. Such subsidies serve only to transfer the risk of underperforming companies from private balance sheets to the public budget and to foist the costs of unabated pollution and avoided cleanup onto local communities and the public at large.

Conclusion

Just as fiduciaries have a duty to the investors whose money they manage, policymakers have a duty to the public whose taxes they spend. Both should heed the warnings and steer clear of funding an industry facing economic decline and fueling environmental disaster.

Endnotes

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44. *See* Lukas Ross, Friends of the Earth, Cashing in on COVID: Tax Breaks, Royalties and Stimulus Loans (2020), https://foe.org/news/new-report-reveals-big-oils-covid-lobby-bonanza/. *See also* Reid Frazier, *Oil and Gas Companies Asked, then Received Changes to Fed Coronavirus Stimulus Program*, StateImpact Pennsylvania (May 11, 2020, 5:38 AM), https://stateimpact.npr.org/pennsylvania/2020/05/11/oil-and-gas-companies-asked-then-received-changes-to-fed-coronavirus-stimulus-program/; Jennifer Dlouhy & Ari Natter, *Fed Changes Open Door for More Drillers to Get Loans*, Bloomberg (Apr. 30, 2020, 2:12 PM), https://www.bloomberg.com/news/articles/2020-04-30/fed-opens-door-for-oil-company-loans-after-lobbying-campaign; Sal Christ, *Occidental's Lobbying Pays Off as it Stands to Benefit From Coronavirus Bailout*, Global Witness (May 13, 2020), https://www.globalwitness.org/en/campaigns/oil-gas-and-mining/occidental-lobbying-pays-off-stands-to-benefit-from-coronavirus-bailout/. For a list of fossil fuel companies eligible for US Federal Reserve bond purchases program, see Rainforest Action Network, Fossil Fuel Companies and Utilities eligible for the Federal Reserve's Coronavirus Bond Purchase Program (2020), https://www.ran.org/wp-content/uploads/2020/05/Fossil-Fuel-Cos-Eligible-for-Fed-Bond-Purchase-Program_May-2020.pdf.

45. *See* Exec. Order No. 13,924, 85 C.F.R. 31,353 (2020), https://www.federalregister.gov/documents/2020/05/22/2020-11301/regulatory-relief-to-support-economic-recovery ("Executive Order on Regulatory Relief to Support Economic Recovery"); Nadja Popovich et al., *The Trump Administration Is Reversing 100 Environmental Rules. Here's the Full List.*, N.Y. Times, https://www.nytimes.com/interactive/2020/climate/trump-environment-rollbacks.html (last updated May 20, 2020); Memorandum from Susan Parker Bodine, Assistant Administrator for Enforcement and Compliance Assurance, U.S. EPA, COVID-19 Implications for EPA's Enforcement and Compliance Assurance Program (Mar. 26, 2020), https://www.epa.gov/sites/production/files/2020-03/documents/oecamemooncovid19implications.pdf.

46. *See* Press Release, U.S. Congressman Jamie Raskin, Raskin Leads 60 Members in Opposing Climate Change "Immunity Grabs" by Fossil Fuel Industry in COVID-19 Legislation (May 5, 2020), https://raskin.house.gov/media/press-releases/raskin-leads-60-members-opposing-climate-change-immunity-grabs-fossil-fuel.

47. *See* Sarah Bloom Raskin, *Why Is the Fed Spending So Much Money on a Dying Industry?*, N.Y. Times (May 28, 2020), https://www.nytimes.com/2020/05/28/opinion/fed-fossil-fuels.html.

48. Influence Map, *Necessary Intervention or Excessive Risk? Corporate Bond Risk Before and After COVID-19 Amid the Fed's Buying Program* (June 2019), https://influencemap.org/report/Necessary-Intervention-or-Moral-Hazard-5e42adc35b315cc44a75c94af4ead29c. For more information about fossil fuel bailouts in the United States, see Bailout Watch, https://bailoutwatch.org (last visited June 23, 2020).

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Debt-Driven Dividends & Asset Fire Sales follows CIEL's April 2020 report, *Pandemic Crisis, Systemic Decline: Why Exploiting the COVID-19 Crisis Will Not Save the Oil, Gas, and Plastic Industries.*

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