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From Oil Glut to Shortage? Some Say It Could Happen

The price rout has caused oil companies to cut deeply into investment

By Georgi Kantchev and Bill Spindle / Dec. 30, 2015 1:16 p.m. ET

With the world awash in crude, the oil industry is contemplating a new problem the oversupply could tee up: an oil shortage.

As the oil glut has sent prices to decade lows, plummeting investment by oil-producing countries such as Venezuela and Russia and oil drillers such as Exxon Mobil Corp. and Royal Dutch Shell PLC means fewer barrels will be produced.

That could leave the world in exactly the opposite situation as now: short of oil and willing to pay more to get it.

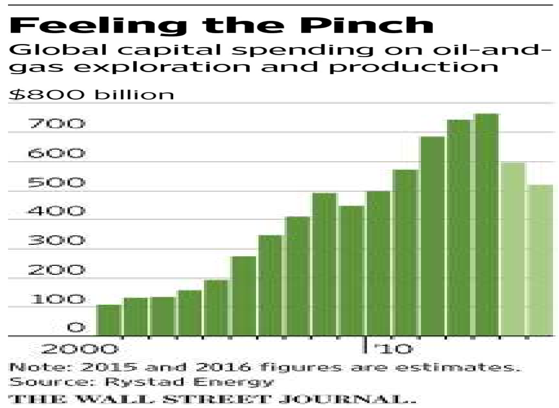
This may herald the beginning of a cycle that other commodities, from gold to copper, find more familiar—a cycle in which a glut leads to lower prices that lead to investment cuts, which chokes supply and prompts the price gains that lead to renewed expansion and future gluts.

“A big gap is forming in oil-industry investment,” Claudio Descalzi, chief executive of Italian energy company Eni SpA, recently told reporters. “That will lead in two to three years to an imbalance between supply and demand that will push prices higher.”

This year, global exploration-and-production investments will fall by $170 billion, or 20%, according to Rystad Energy. If international oil prices average $50 a barrel next year—a level many analysts said appears optimistic—investment could fall by one-fifth in 2016, the Oslo-based energy consulting firm estimates.

That would be the first time the industry has registered two consecutive years of investment declines in 30 years, according to the International Energy Agency, a global industry monitor.

Wednesday in New York, Brent crude futures, the international benchmark, fell 3.5%, to settle at $36.46 a barrel. U.S. crude dropped 3.4%, to $36.60.



Crude has fallen almost 70% since June 2014, while producers are pumping two million more barrels a day than is needed. Producers in Russia, Brazil and Norway pumped more oil in 2015 than forecasters had projected. Moreover, oil-field investments made years ago are set to begin producing, even as exploration-and-drilling projects scheduled to bear fruit in coming decades are being delayed or canceled outright.

The rout in prices has seen oil companies cut deeply into investment budgets.

U.S. oil producers Chevron Corp. and ConocoPhillips Co. will each cut capital spending next year by about one-fourth, the companies said this month. European producers such as BP PLC and Total SA have also announced large spending cuts.

Tudor, Pickering & Holt, an energy-focused investment bank, has tallied 150 projects that have been delayed, resulting in an estimated 13 million barrels a day of oil production deferred indefinitely. That is equal to 15% of total global output.

A chunk of the deferred oil—20%—comes from projects in Canada's oil-sands deposits, where extracting crude is particularly expensive. Arctic production and complicated deep-water projects in the Gulf of Mexico and Africa have also suffered, according to Tudor Pickering.

In countries such as Venezuela, Mexico, Nigeria and Algeria, producers are putting off projects needed to reverse the natural depletion that oil fields experience over time. The industry's average decline rate—the speed that output falls without field maintenance or new drilling—usually runs between 3% and 4% annually. That has nearly doubled this year, estimates Miswin Mahesh, an oil analyst at Barclays PLC.

The oil industry needs to replace 34 billion barrels of crude every year to satisfy expected consumption growth, according to Rystad. Investment decisions for only eight billion barrels were made in 2015, it said.

"The stage is set for a supply crunch down the line," Mr. Mahesh said. "Supply from existing fields will fall, while new projects won't come online to replace them."

Barclays sees Brent reaching $85 a barrel by 2020, while others see the potential for an even steeper rise.

“You could see prices shooting up from $30 to $100 pretty quickly,” said Iain Reid, head of European oil and gas at Macquarie bank. “At some point the chickens will come home to roost.”

Miners have been through this cycle several times. A decline in investment and exploration budgets in the mid- to late 1990s led to a falloff in the supply of many metals in the latter part of the last decade. That contributed to a sharp metal-price run-up at the time, which led in turn to the opening of new mines that would later flood the market with metal once again.

There are, of course, alternative scenarios in which prices continue to languish at low levels. Demand for crude could falter, especially if China’s economy remains sluggish. Weak data in recent months has sparked concern about the health of the world’s second-largest oil consumer.

Also, U.S. output of shale oil could remain resilient. This year, after a peak at 9.6 million barrels a day, U.S. production has stabilized at about 9.1 million barrels in recent months.

The IEA sees prices rising no higher than $80 a barrel by 2020, in part because shale production could fairly quickly meet new demand.

Meanwhile, the U.S. Energy Information Administration said Wednesday that U.S. crude inventories rose more than expected in the week ended last Friday. Oil stored at Cushing, Okla., the delivery point for U.S. stocks, increased by 900,000 barrels, to 63 million barrels, a record, the EIA said in its weekly report.

The oil industry was once notoriously slow to turn the taps back on, given the need for larger pieces of drilling equipment and with rigs in far-flung places, from the Nigerian Delta to the North Sea. But the shale revolution has changed that, bringing technology and oil fields that can be brought online much more quickly. That also differentiates oil from metals, in which mines can take up to eight years to develop.

“The oil market is in the killing zone,” said Michael Hulme, manager of the $460 million Carmignac Commodities Fund. “That’s what killing zones are for—to kill supply and set the scenes for the recovery of prices for the survivors.”

—Eric Sylvers contributed to this article.