Limited oil and gas investment could be shoring up tightness in the future

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As oil has traded over US$70/barrel since April 2018, US production has continued to expand and the Organization of Petroleum Exporting Countries (OPEC) has dialled back it production curbs. The threat of undersupply in the near future is small in our opinion. However, looking further into the future, we believe that the lack of investment in oil and gas exploration and production could give rise to tightness in supply.

Brent oil prices crashed from over US$110/barrel in 2014 to under US$30/barrel in 2016 as OPEC embarked on a programme to expand production. Between 2014 and 2016 upstream oil and gas investment declined in excess of 40%. After inflicting a lot of self-harm, OPEC changed strategy once again in 2017 to cut back on production and assign individual country quotas. It was largely successful and pushed the price of oil back to over US$80/barrel in June 2018. A relaxation of OPEC curbs in June 2018 has taken oil a little lower, but prices have consistently remained above US$70/barrel since. As prices have made a recovery, investment in oil and gas exploration has increased. In 2017 investment rose by 4% to US$450bn and in 2018 investment is forecast to rise by 5% to US$472bn. But by no means has the industry recovered lost ground.

Figure 1: Global investment in upstream oil and gas sector

Source: International Energy Agency, WisdomTree, data available as of close 01 August 2018.

Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties

Focus on short cycles

Most of the growth in investment is from shale and tight oil, almost by definition focused on shorter cycles (approximately 80% of the output comes in the first two years of production). Having been burnt by sharp price volatility between 2014-2016, international oil companies have been hesitant to commit to longer investment projects. The small growth in onshore conventional is mainly from brownfield investments from national oil companies in the Middle East and Russia. Offshore conventional which has the longest lead times has been in decline.

Figure 2: Share of global investment in upstream oil and gas by type

Source: International Energy Agency, WisdomTree, data available as of close 09 August 2018.

Historical performance is not an indication of future performance and any investments may go down in value.

While investment is expected to grow in Europe and the Middle East, the sharpest gains in investment will likely come from the US in shale oil projects, which have aggressive production decline rates and thus short cycles. Already producing (brownfield) assets have tended to be prioritised in the Middle East.

Figure 3: Change in upstream investment by selected regions 2017-2018 forecasts

Source: International Energy Agency, WisdomTree, data available as of close 01 August 2018.

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Balance likely to remain for now

The International Energy Agency (IEA) forecast that global oil demand will rise to 101.5mn barrels per day in Q4 2019, up 2.7mn barrels per day from an estimated 98.8mn barrels per day in Q2 2018. US shale is likely to meet most of that gain in demand, while spare capacity from Saudi Arabi and Russia can meet most of the remainder.

However, beyond this horizon, if investments in long-term projects have been low, we could start to see problems in meeting oil demand (should oil demand maintain strong growth rates).

We are unlikely to see any expansion of oil from Iran, as US sanctions on the country are likely to completely stall investments. Venezuela, likewise in economic turmoil is unlikely to continue to see supply decline. Meanwhile supplies from Libya are likely to remain volatile.

Very few discoveries likely to constrain future supply

The collapse in investment in recent years has been felt mostly in exploration. With that has come a dearth of new discoveries. So, although projects being sanctioned are on the rise, with discoveries having declined supply constraints could be in the pipeline.

Figure 4: Global discovered conventional resources and share of exploration in total upstream investment

Source: Bloomberg, WisdomTree, data available as of close 01 August 2018.

Historical performance is not an indication of future performance and any investments may go down in value.

Conclusion

With the exception of US shale, investment in oil exploration has been woefully low since the oil price crash in 2014. While not an immediate concern, supply is likely to tighten in future.

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