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BIG OIL'S NEW PROBLEM ISN'T LACK OF DEMAND, IT'S LACK OF SUPPLY

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The oil market is rapidly shifting from a period of over-supply during the height of the pandemic to one of potential shortage. Producers who managed the slump now need to be diligent in managing the recovery.

The oil producing countries in the OPEC group — led by Saudi Arabia and Russia — have done an amazing job at managing oil supplies as demand has crawled its way back from the biggest collapse in history.

Sure, they got off to a shaky start. Instead of slashing supply as demand cratered in April 2020, they boosted it in a production free-for-all after their previous cooperation fell apart. The deal that emerged when they eventually got together took days to form and almost foundered on the unwillingness of Mexico to play its part.

But after some vague pledge from President Donald Trump that the U.S. would make up the cuts that Mexico refused, the producer group announced a record output reduction of almost 10 million barrels a day. And, for the most part, it has stuck by what it promised.

As always, there are those who haven't done all they pledged. Some, most notably Russia, have been given a free pass. Others, like Iraq, Nigeria and most visibly the United Arab Emirates, have been called out and persuaded to compensate with even deeper cuts. Saudi Arabia twice made additional unilateral reductions to its production to speed up the process of market rebalancing.

Demand is now well on the road to recovery — literally. Highway traffic is back at, or even above, pre-pandemic levels in the U.S., China and large parts of Europe. Domestic and regional aviation is also picking up. The number of passengers passing through security at U.S. airports surpassed 2 million a day for the first time since March 2020, while European air traffic has risen by one-third in the past month. The remaining weak spot is long-haul flying, which is still constrained by restrictions on incoming passengers in many parts of the world.

As the story has switched from collapsing demand to recovery, however, it's now supply that is lagging. That's partly because the OPEC producers want to keep draining stockpiles, deliberately pumping less than their customers are using to whittle away the excess inventory built up during their slow response to the onset of the pandemic. But it's also because oil companies aren't investing in new production. That's not yet a serious problem, but it could become one.

Some of the companies' reluctance is due to pressure from shareholders, who are either pushing for more environmentally conscious business models or seeking better returns on their investments. Some is simply due to oil incomes getting hit hard in 2020, which forced companies to slash budgets.

The OPEC countries have the capacity to raise output quickly, although maybe not by as much as we've been led to believe. Spare capacity is concentrated in just a few of the 23 countries, and the two biggest probably have less of it than the numbers used in the production cut deal indicate.

One reason for this is that the reference production levels used for the two biggest producers, Saudi Arabia and Russia, were arbitrarily set at 11 million barrels a day when the deal was first struck in April 2020. That allowed Russia to claim a bigger cut than it actually made and is more than it can pump. It is also more than Saudi Arabia has produced at any time except during its April 2020 production surge. Other countries, most notably Angola, have seen production capacity slump as investment has stalled.

The true production uplift available is probably closer to 4.5 million barrels a day, rather than the 5.8 million barrels suggested by the numbers in the deal.

The U.S. shale patch isn't yet responding to higher prices with increased activity, at least not on a scale that's big enough to do more than offset declines from already operating wells. Production has been stuck at around 11 million barrels a day for a year, even though the number of rigs drilling for oil has doubled since August.

While the OPEC countries have been raising output in the past couple of months, they currently have no plans to do so after July until their current deal expires next May.

That will have to change. The group is due to meet on July 1, and to continue meeting monthly thereafter. It will need to act to prevent oil prices from rising high enough to choke off the recovery.

Saudi Energy Minister Prince Abdulaziz Bin Salman said last week that it is his job, along with others, to ensure that a new super cycle in global oil prices doesn't happen. To do that he's going to have to manage the return of OPEC production just as carefully as he's managed its reduction — and perhaps ease up on the caution for which he's now known.

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