Securing America's Future Energy

Intelligence Report

October 11, 2011 – Vol. 4 Issue 11

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Libyan Revolution Lessons for Oil (and Gas) Security

SUMMARY

- Libya has substantial challenges ahead, and the rebels' victory is only the end of the beginning. Much more needs to be done to build a stable, democratic state.

- Libyan oil production is unlikely to recover until 2013, requiring the global oil market make up the losses for at least another year. If handled properly, Libya's offshore sovereign wealth is sufficient to enable reconstruction.

- Saudi Arabia fed the Libyan shortfall through a complex swap arrangement sending heavy Saudi crude to Asian refineries and light crude slates to primitive European refiners. But ad hoc arrangements aren't the answer. Policymakers should be asking tough questions about what international institutions can do to better coordinate outages.

- The Libyan revolution has implications for the wider region. The US should welcome Qatar as an emerging regional leader while taking care to avoid potential problems in Libya, which faces many of the same domestic challenges as Iraq.

ANALYSIS

With fighting in Libya now near an end, some observers may say that since the Arab spring has sprung three new North African democracies (Egypt, Tunisia and Libya) upon the world, we can all get back to business as usual. This reaction ignores some important points.

First, the transition is far from over in these countries. All three are ruled by some form of transitional council and major steps ranging from holding elections, to forming a permanent government, and dealing with former regime loyalists have yet to be taken. Second, the Arab spring refigured the Middle East, creating new risks and opportunities for Western diplomacy. Finally, the Libyan revolution has shown serious problems with the global system of energy security. Although the world managed the crisis as well as could be expected, the global community couldn't keep oil prices from spiking $30 a barrel after Libyan exports were cut to nearly zero. The high oil prices have helped, along with the European debt crisis, to push the world to the brink of a renewed recession, showing once again how important oil prices and volatility are to economic growth.

What's next for Libya?

For the moment, all three countries aspire to be democracies, but are a fair distance from the goal. Both Egypt and Tunisia plan to hold their first democratic elections this fall, eight and nine months, respectively, after their authoritarian presidents resigned. Egypt's generals are aiming to have presidential elections by the end of 2012, nearly two years after Mubarak was removed from power. The situation in Libya is more fluid and complex. In both Tunisia and Egypt, the time between the first protests to the Presidents' resignation was less than a month. In both countries the main institutions of state simply shifted their loyalties and remained intact. This dramatically simplified the transition because the countries saw a change of government without the need to build a new state from the ground up. In this sense, the revolutions in Tunisia and Egypt are comparable to the overthrow of communism in Eastern Europe in 1989: an unpopular leadership deposed while the technocratic institutions of the state remained.

The situation in Libya is more like Iraq. Before the crisis, Libya's institutions, both its state and financial system, were less robust and more politicized than those of Tunisia and Egypt. As a result, Libya now must integrate the remnants of Gaddafi's state with the National Transitional Council (NTC) while not alienating supporters of the old regime. At the same time, Libya must reintegrate about one million refugees (out of a total population of six million) who fled Libya during the fighting. Integrating the NTC's forces with quasi-independent militias that fought Gaddafi in eastern Libya and what remains of Libya's armed forces and police will be particularly challenging. Despite the best will in the world, it will take time for the new Libyan state to live up to its motto of "Freedom, Justice, Democracy."

Turning back to oil and gas, Nuri Berruien, the newly appointed chairman of the Libyan national oil company, told the *Financial Times* that "initial oil output will be measured in the 10,000s of barrels a day (bbl/d) rather than in the 100,000s of bbl/d.... In 15 months we can reach the pre-war level of 1.6m bbl/d. That is the optimistic forecast ... But I think there is reason for optimism." Fortunately, the NTC has made clear that companies operating under Gaddafi are welcome to return to Libya, which should help output. Last month Italian and French oil majors restarted production, but a bigger challenge will be rebuilding Libya's refineries and export terminals, most of which were seriously damaged in the fighting. The international community needs to continue its coordination of sufficient light crude to the market while waiting for Libya to restore exports.

If Libya is unable to fully restore production until 2013, as seems likely, then the NTC will need other means to fund government salaries, social services and reconstruction. Libya's offshore sovereign wealth, estimated at around $160 billion, is more than sufficient to do so, but the assets must be unfrozen. The largest part of Libya's sovereign wealth is held in the $65bn Libyan Investment Authority (LIA), Libya's poorly-managed sovereign wealth fund, which KPMG, its auditor, described as lacking "operational robustness to effectively manage investments of this complexity." Libya needs substantial help simply taking the measure of its sovereign wealth. The new government will need to establish a robust and transparent set of institutions to manage Libya's sovereign wealth.

Implications for North Africa and the Wider Middle East

While the challenges of restarting Libyan oil production and rebuilding the Libyan state are large, they are neither insurmountable nor unexpected. However, it is important to recognize that the repercussions of the Libyan revolution extend beyond its borders. Most notably, the positions of Qatar and Algeria have changed dramatically.

The Libyan revolution has cemented Qatar's position as a regional leader. Qatar moved early to support the Libyan opposition through funding, supplying fuel, and marketing what oil it was able to produce. Moreover, the contribution of the Qatari air force to coalition operations and Qatar's early recognition of the NTC as the legitimate government of Libya helped to justify intervention and boost support for the NTC in the Arab world.

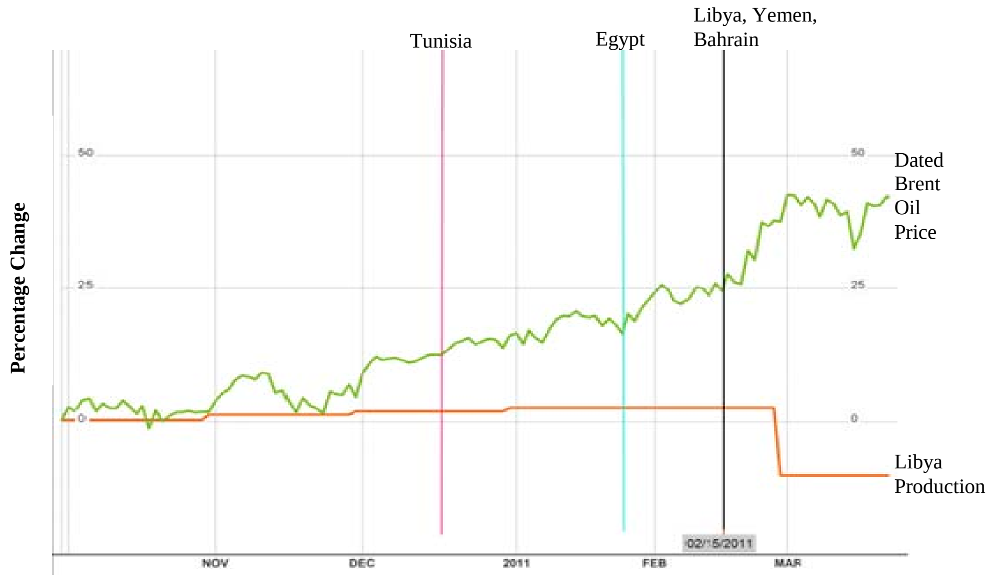
Just as Libya's revolution has boosted Qatar, it has weakened Algeria, the third-largest supplier of natural gas to the European Union after Russia and Norway. Algeria only recognized the NTC earlier last month, and a number of Gaddafi's family members have fled to the country. Of the five countries of North Africa (Morocco, Algeria, Tunisia, Libya and Egypt), three have had revolutions, and Morocco has begun an ambitious reform program to address social tensions.

Meanwhile, joblessness in Algeria grows and the success of the Libyan revolution leaves Algeria with fewer friends in the region. The US must be careful not to alienate Algeria when building its relationship with the new Libyan government and supporting Moroccan reform efforts. Treading carefully will be even more important for Europe given its reliance on Algerian gas imports. Meanwhile, the international community needs to find ways to encourage Algeria to address its economic challenges and avoid further instability in the region. As discussed below, given Algeria's gas exports, it would be far more challenging to replace Algeria's gas production than it has been to replace Libya's oil production.

Lessons for Energy Security

The Libya episode reminds us that energy really matters. As shown in FIGURE 1, oil prices rose during the Arab Spring before any physical crude shipments were disrupted.

FIGURE 1: POLITICAL EVENTS, NOT DISRUPTIONS, DROVE OIL PRICES HIGHER (source: Bloomberg)



As shown in FIGURE 2, although oil markets replaced Libyan crude with other sources, high oil prices persisted throughout the Libyan revolution, contributing along with the European debt crisis to global economic decline, as reflected in global stock market weakness.

FIGURE 2: OIL PRICES HAVE REMAINED HIGH, CONTRIBUTING TO STOCK MARKET DECLINES (source: Bloomberg)

Things could have been much worse for the global oil market if Saudi Arabia had not replaced disrupted Libyan exports. Saudi Arabia did this by facilitating complex barrel swaps with sophisticated refineries in Asia which took heavy Saudi crude instead of previously contracted light crude, allowing primitive refineries in Europe to receive lighter, earlier-to-refine crude slates. Although this coordination was successful, the major global energy institutions -- OPEC and IEA – had no involvement. In fact, many of the Asian countries involved in these swaps are members of neither organization. In order to cope better with future energy security problems, policymakers should consider whether energy security institutions should expand to include China and India and other large consumers currently outside the circle.

Finally, Europe should be glad it was Libya, not Algeria that had the revolution. While the global oil system was just barely able to cope with the disruption, it still pushed the world economy back to the brink of recession and wiped trillions of dollars off global stock markets. As discussed in our last intelligence report on global gas security, it is unlikely the global gas system would be able to cope with a disruption on a similar scale. The gas system has no mechanism for international coordination and there is little effective spare export capacity. If Algerian pipeline exports to Europe are disrupted, Qatar does not have sufficient liquefaction capacity to replace the gas. There is no global gas swing producer to play a coordinating role in the gas markets as Saudi Arabia does for oil, making a global institution for managing the gas market more important. In short, the Libyan revolution is a wake-up call not only for reducing oil dependence, but also for developing a robust global approach to natural gas security.

Additional Reading

Financial Times; The perils, prizes and pitfalls of the Post-Gaddafi era of oil; Daniel Yergin; October 4, 2011: http://www.ft.com/intl/cms/s/0/1b0d3e0c-ee76-11e0-a2ed-00144feab49a.html#axzz1ZuwCpYn9