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Intensifying Turmoil in Libya and Future Crude Oil Prices

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On February 23, the North Sea Brent crude oil futures price posted a sharp rise of more than $5/barrel from the previous day to $111.25/barrel. On the next day, the price rose further temporarily to $119.79/barrel, nearing the $120 level. The West Texas Intermediate crude oil futures price, whose widening gap with the Brent price had been attracting attention, also soared substantially, hitting the $100/barrel mark temporarily on February 23. It closed the day at $98.10/barrel, rising nearly $12 from February 18.

It may be needless to say that the sharp crude oil price hikes resulted from the extreme intensification of tensions in Libya. Growing antigovernment movements, the military's armed suppression of these movements, the escalation of their clashes, antigovernment forces' control of Benghazi as Libya's second largest city, some senior officials' bolt from the Gaddafi administration, and other developments are marking out growing confusion and indicating a serious political and security situation close to civil war. More important is the fact that these developments have actually affected Libyan oil supply. The Libyan situation indicates that the first serious oil supply problem has emerged with regard to the Middle Eastern and North African domino effect that started with the Tunisian political change followed by the Egyptian crisis and the Libyan upheaval. Amid the Egyptian crisis, fears of oil supply interruptions regarding oil transportation route through the Suez Canal and the other contributed to boosting crude oil prices before Egyptian President Hosni Mubarak's resignation. But no actual supply interruption came on the Egyptian crisis. However, the Libyan upheaval has led to an actual interruption beyond what had been feared.

Libya, as an oil producing country, is more important than Egypt as far as oil supply is concerned. Libya is a major oil producer, boasting the largest oil reserves (at 44.3 billion barrels according to BP Statistics) among African countries. In January 2011, its crude oil production came to 1.58 million bpd. Libya produces mainly high-quality crude oil that is light in API gravity and contains less sulfur. Libyan crude oil has been exported to European countries including Italy, Germany, France and Spain. Libya is a very important crude oil supplier for Europe. It also exports gas to Europe mainly through the Greenstream pipeline linked to Italy. Pipeline gas exports to Europe totaled 9.17 billion cubic meters in 2009. Libya has exported LNG as well. LNG exports came to 0.72 billion cubic meters in 2009. The problem is that crude oil production has been suspended at some oilfields as many international oil companies such as Wintershall, ENI, Total, BP and Repsol have, for security reasons, already withdrawn their staffs from major oilfields and production/export facilities that exist primarily in regions coming under the control of antigovernment forces. Although it is difficult to estimate a production decline amid the confusion, the decline could be considerable. Barclays Capital, for example, has estimated that the decline on the production suspension has reached 1 million bpd and could expand further.

Another problem is that the present Libyan situation is more serious than the Egyptian crisis. Developments are very uncertain and any path to the termination of the confusion is difficult to foresee. The actual civil war situation and security deterioration in Libya could be longer than in Egypt. Colonel Muammar Gaddafi is likely to continue using force to remain in power even under European and American pressures. While Libya has indigenous tribal forces, the military is unlikely to become any stabilizer after firing shots at citizens. Given these conditions, it is very difficult for us to expect the stabilization of the political and security situation and the subsequent normalization of oil production in Libya. This means that a considerable amount of Libyan crude oil could remain lost for several (or more) months in the market. Although the loss might have already been priced into the market, Libyan developments including the continuing and expanding suspension of oil production may basically continue to exert upward pressures on crude oil prices.

To what will the market pay attention next under the circumstances? First, the market will maintain close watch on developments in the Libyan situation. The second key point for attention is responses from OPEC, including Saudi Arabia. Attracting global attention will be when and how much Saudi Arabia, known for giving priority to the stabilization of the oil market, would increase oil production in response to the actual supply interruption lasting for a considerably long time. According to the IEA, OPEC's surplus crude oil production capacity stood at 5.19 million bpd as of January, of which Saudi Arabia accounted for 3.5 million bpd or 67%. The surplus capacity is estimated to sufficiently cover a decline in supply from Libya. But we must pay attention to the fact that the effects of oil producing countries' additional production expansion are uncertain. When will Saudi Arabia and other OPEC members increase oil production? How strong will their signal of commitment to stabilizing the market be? How will the market assess qualitative differences between Libyan and Saudi crude oils and a drop in surplus OPEC production capacity after a production increase? Answers to these questions are uncertain.

The third key point for attention is oil consuming countries' response including market-stabilizing efforts through their release of oil reserves. The IEA, the EU which was affected directly by the Libyan oil supply interruption, the United States which concerned about rising crude oil prices for its impacts on its economy, and other parties might have started discussions on the release of reserves for stabilizing the market and international cooperation. The sharp crude oil price hike on an actual supply interruption is a key point in considering discussions on whether to use oil reserves for stabilizing the market. If oil producing countries' output expansion is the first measure taken to stabilize the market, oil consuming countries may seriously consider their own market-stabilizing measures while watching future market developments and how the Libyan turmoil would spill over to other oil producing countries, as discussed below.

The fourth key point for attention is the Libyan turmoil's potential spillover to other oil producing countries. In this respect, attention may be paid to such countries as Algeria and Iran where antigovernment movements have already been seen. But oil market participants may pay attention to Bahrain and Saudi Arabia. Antigovernment demonstrations and the government's repressive actions in Bahrain occupied media headlines temporarily. But the Bahraini turmoil seems to have been hidden behind the intensifying Libyan turmoil. Nevertheless, Bahrain entails numerous uncertain or opaque factors including the unique Bahraini situation (where the Shiite majority has structural discontent with and is in opposition to the Sunni minority in power), Bahrain's close relations with Saudi Arabia, and the presence of considerable numbers of Shiite citizens close to major Saudi oilfields. The Saudi situation is stable at present and has yet to become any matter of concern. Given its large oil production volume and its great surplus oil production capacity as a market-stabilizing tool, however, Saudi Arabia is far more important than other oil producing nations. Even groundless speculations about Saudi Arabia could become an important market-affecting factor.

Predictions and speculations about future developments play a key role in pricing crude oil. In this sense, information provided to the market is very significant. In the second half of last year and early this year, macroeconomic information including that on U.S. quantitative monetary easing and world economic recovery had been a key factor affecting the market. But geopolitical risks have now become the most important market-affecting factor. For the immediate future, crude oil prices will make unstable moves including further hikes under the presence of geopolitical risks that actually affect oil supply.

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