

THE DAILY STAR

LEBANON

Lebanon faces hard choices on its gas

By Bassam Fattouh

The East Mediterranean has in the recent past experienced what could be described as the beginnings of a small gas revolution. The discovery of large gas deposits in the East Mediterranean since 2009 has spurred a flurry of exploration activity, leading the Financial Times to comment that the discoveries are “potentially so vast that the economic map of the region is already being redrawn.”

Certain geopolitical, regulatory and commercial challenges can undermine the development of resources and the export projects. Assuming that some of these hurdles stand little chance of being overcome in the short term, the region’s combined export potential by 2020 may reach no more than 5 million tons per annum (mtpa), in the form of Cypriot exports and, should Israel decide to move ahead with gas exports, some additional 2-3 mtpa of Israeli (floating) liquid natural gas (LNG). These relatively small export volumes render East Mediterranean gas an unlikely game-changer for international gas markets, though the region remains a potential new source of gas for markets in Europe seeking to diversify their supply sources.

The pace of development of gas reserves will be mainly driven by local political dynamics and energy policies within each of the East Mediterranean countries. While the formation of the Petroleum Authority in Lebanon last year was a welcome development, the underlying political and institutional dynamics that delayed the bidding round are still in full swing.

The assumption that the formation of the Petroleum Authority and the launch of the prequalification round a few weeks ago will speed up the licensing round and the awarding of contracts is rather simplistic. After all, this newly created body is most likely to be subject to the same institutional constraints that have plagued most Lebanese governmental agencies for the last few decades.

The road for Lebanon to become a gas producer is long and it is still early for the government and politicians to start planning how to spend the gas revenues. In the current context of political polarization, the regulatory environment is likely to be highly volatile and key policy decisions (and their implementation) are likely to be subject to constant delays. The Energy Ministry has promised “full transparency in the evaluation process through the bidding round,” but given weak institutions, the lack of a clear governance structure, and the absence of accountability, it is doubtful whether such transparency will ever be achieved, especially in an industry where the size of the rents can be very large and competition for rents fierce. Furthermore, ensuring transparency should not only be limited to the bidding process, but should be extended to the entire supply chain.

In addition to the contractual process, Lebanon will be faced with several strategic decisions, including the pricing of gas, dealing with the electricity sector, and developing an export strategy. A key issue facing Lebanon is whether it should pursue an aggressive export policy to monetize the gas reserves. The balance between the use of gas to meet domestic demand and for export purposes will ultimately determine companies' profitability and their incentive to develop the reserve base.

Meeting domestic demand, especially in the power sector, should assume a top priority in government policy. However, this requires that Lebanon have a clear policy regarding the pricing of gas for the domestic market. This is a contentious issue in the negotiations between the government and the companies.

Furthermore, since gas demand is strongly interlinked with the evolution of electricity demand, it is essential that the government embark on the reform of the power sector and electricity prices. The challenge is grave. Electricite du Liban suffers from huge financial and operating losses, which constitute between 20 percent and 25 percent of the government's primary expenditure. EDL also suffers from chronic underinvestment, which has so far prevented it from modernizing its grid and expanding power generation capacity.

The most likely outcome for Lebanon is the adoption of a balanced approach between meeting domestic demand and allowing companies to export. It is estimated that gas demand will reach 2.6 billion cubic meters (bcm) in 2020, increasing to almost 4 bcm by 2030. If the discoveries are large enough, there will be plenty of gas to meet both domestic requirements and exports by the middle of the next decade.

But this raises another question: Should Lebanon aim at directing its exports toward regional markets by pipelines or should it invest in the more expensive liquefaction facilities? Ultimately, the complex geopolitical landscape will impact Lebanon's choices regarding possible monetization options.

It is important to stress that while there is much hype about Lebanon's gas potential, Lebanon is not expected to produce any natural gas by 2020 and thus it would have to import all of its gas requirements in the short to medium term if it is to achieve its ambitious objective of increasing the share of natural gas in power generation.

Lebanon has little choice but to rely on LNG imports. The question then is: Should the country wait until gas reserves are brought on stream and meanwhile continue to rely on expensive liquids to fuel its power sector or should it pursue the LNG option? While LNG imports are likely to be less costly than liquids especially at the current high international oil prices, the infrastructure cost of switching fuels could be very high as well.

Like other countries, Lebanon will realize sooner rather than later that the key challenges in developing the hydrocarbon reserve base are not underground (in other words technical know-how and infrastructure) but overground (management of gas revenues, the implementation of necessary reforms, the design of the appropriate regulatory and governance structures, and so on). The way Lebanon deals with these overground challenges will determine whether the promised "gas revolution" ever materializes and whether it will be a revolution for the country as a whole or just for the privileged few.

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19/03/2013