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Lebanon must ready for its oil and gas

By Carole Nakhle

There is a lot of excitement in Lebanon about the country's oil and gas potential. Seismic surveys carried out since the 1990s have indicated the likely presence of offshore hydrocarbon accumulations. Gas discoveries in neighboring countries further strengthen the case. With the appointment of the board of the Petroleum Administration in November 2012, Lebanon seems to be getting one step closer to having its first ever offshore licensing round. This can open a new chapter for the Lebanese economy. However, the journey, just like a typical Lebanese road, is winding, bumpy and risky. The U.S. Geological Survey estimates that the Levant basin (which encompasses approximately 83,000 square kilometers of the eastern-most portion of the Mediterranean area) could be sitting on 1.7 billion barrels and 122 trillion cubic feet of recoverable oil and gas respectively. These are modest estimates, especially when compared with the proven potential of countries like Saudi Arabia (264.5 billion barrels of oil) or Qatar (884.5 trillion cubic feet of gas), for instance. It is also important to distinguish between "resources in place," "technically recoverable" and "commercially recoverable" – the figures tend to become much smaller as we move to the latter category.

Several features distinguish the oil and gas industry from other sectors. These features need to play a role in shaping expectations and development plans of the host country, and they need to be factored into its legislative, regulatory and contractual framework.

Oil and gas projects are by their nature long-term, particularly when they are offshore. There is a significant time lag, often of many years, even decades, from the initial discovery of oil or gas to the time of first production. The exploration and appraisal phases may last.

Meanwhile, a great deal can happen – in particular, economic conditions can change drastically. As a result of the shale revolution, for example, first for gas then for oil, the United States became the largest gas producer in 2009 and is expected to become the largest oil producer in the coming few years – thus putting downward pressure on oil and spot gas prices worldwide.

Realism is perhaps even more important when it comes to the expected results. Exploration is a high-risk activity and it is rare for an exploration well to have a chance of discovery in excess of 45 percent, on average. The odds of making a commercial discovery are even lower, particularly at deep-water locations. Until a hole is actually drilled, the existence of oil or gas remains theoretical.

Lebanon hasn't made a discovery yet. However, various estimates and values of its potential have been given ahead of time, before exploration has started in earnest. The danger is that unrealistic expectations, once they are disappointed, are likely to spell trouble for the host government and its industrial partners. Take the Kashagan field in Kazakhstan, for example. The field was discovered in 2000 and represents one of the largest discoveries of oil during the last 50 years. Twelve years later, it is still “under development.”

Originally scheduled to enter into production in 2005, this date has continually been pushed back because of a series of technical and environmental challenges, while project costs have more than doubled. The Kazakh government originally expected that major tax revenues would flow from the project as early as 2005. But first production is now scheduled for 2013. Facing a major shortfall in expected revenue flows, the Kazakh government demanded in 2008 a fine of $4.5 billion as a penalty for the delay, as well as a large increase in the government’s equity stake. Additionally, tougher fiscal terms were considered.

For a discovery to move into production there has to be enough oil or gas to justify the cost of development, under existing economic conditions, especially at contemporary prices. For an investor, it is a simple equation: The rewards should justify the risks.

Geology, prices and costs are well beyond any government’s control. But host governments can affect the investment climate using a very powerful tool: the legislative, contractual and fiscal framework. A vague law, for instance, increases an investor’s perception of risk while an internationally competitive fiscal regime enhances their appetite.

It is difficult at this stage to comment on the fiscal regime in Lebanon as the information is not in the public domain yet. The Petroleum Law, which was passed in August 2010, does not provide sufficient details to make an informed judgment on the attractiveness of the country from an investor’s perspective. The law, for instance, is mostly focused on oil and remains silent on many aspects related to natural gas, although the data indicates a gas discovery is more likely.

While oil and gas share a number of similarities, the economics of their projects can vary greatly. For instance, investment in an offshore deep-water gas field is typically more capital intensive and expensive than that for oil and its development can take longer as investors need to ensure long-term market access for their gas before committing to expensive infrastructure.

For a small economy with a large public debt like Lebanon, the development of the oil and gas sector – even if not big by international standards – is particularly important. However, getting oil or gas out of the ground often turns out to be easier than managing the revenue flows from oil and gas production. The “resource curse” has been well documented. Many oil and gas rich countries have in fact shown slower economic growth than resource poor countries – and of course this is not because they happen to have hydrocarbon endowment, but because of poor stewardship in making the most of their natural resources. Economists call it the “paradox of plenty” – rich in physical resources, but poor in economic resources.

In Nigeria, for instance, it is clear that the standard of living of the vast majority of the population has not risen over the last 30 years, despite growing oil revenues. Petroleum revenues have also fueled corruption and widened existing divisions. The stakes are high in a post-conflict country like Lebanon.

A robust and clear legislative, contractual and fiscal framework is the main device the government should focus on to ensure a sustainable development of its oil and gas sector. Such a framework should provide investors with certainty and nondiscriminatory treatment. Greater attention should also be given to the specific nature of gas exploration, production and commercialization. The management of petroleum revenues should not be politicized and should be done within a long-term horizon in perspective.

Equally important is development of the administrative capacity to manage that revenue flow and negotiate with experienced international companies, as well as the advancement of local expertise though not by simply relying on the limited training offered by potential investors.

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