The International Energy Agency Responds to the Libyan Crisis (ARI)

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**Theme:** On 23 June, the International Energy Agency (IEA) announced the release of 60 million barrels of its members’ strategic petroleum reserves in July. In justifying the move, the IEA cited the need to mitigate the effects of the Libyan crisis, but it has been interpreted as a call for the Organization of the Petroleum Exporting Countries (OPEC) to boost production and not jeopardize the economic recovery, as well as giving Saudi Arabia time to make the announced production increase materialize.

**Summary:** The announcement alone of the release of reserves had an immediate and significant effect on markets, although, as evidenced by the return of prices to pre-announcement levels, the effect was short-lived. While possibly ridding the market of some speculative operations, it is questionable whether it will change the dynamics of some markets whose broad underlying trends hinge on the fundamentals underpinning supply and demand, and the different projections suggest that in the next few quarters the oil shortage could continue. In this connection, the measure is not a sustained energy policy able to alter those market fundamentals over time, but it does imply that the members of the International Energy Agency (IEA) have decided to take the initiative with the measures implemented so far to pressure the Organization of the Petroleum Exporting Countries (OPEC), and show Saudi Arabia that they are waiting for the production increase it promised.

**Analysis:** The release of strategic reserves announced in June has only two precedents: the Gulf War in 1991 and Hurricane Katrina in 2005, and its scale is much greater than both. The decision came two weeks after the meeting of the Organization of the Petroleum Exporting Countries (OPEC) on 8 June in Vienna, when, despite the efforts of Saudi Arabia and other members of the Gulf Cooperation Council (GCC), the cartel failed to hammer out an agreement on a production hike. Those two dates were landmarks in the recent relations between oil-producing and oil-consuming countries, raising important issues regarding the role of strategic reserves and their ability to influence prices, the future of talks between producers and consumers, the waning solidarity within OPEC itself, and the cross-alliances between some members of the International Energy Agency (IEA) and producers belonging to the cartel. Underlying the issue are two fundamental questions, one economic and the other geopolitical: the final impact of the measure on oil prices, which are threatening the global economic recovery; and the influence of the decision on the struggle between Saudi Arabia and Iran, on the one hand, and on strategic relations between the US and Saudi Arabia, on the other.

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Chronicle of a Decision Foretold

On 23 June, the IEA announced the release of 60 million barrels of its members' strategic petroleum reserves over a period of 30 days, without specifying either the type of products or the planned sequence of release. Of these 60 million barrels, 30 million correspond to the US (approximately 4% of its strategic reserves and the equivalent of a day-and-a-half's consumption by that country), which has already announced that it has received a large number of offers, even exceeding supply and posing storage headaches. 30% was assigned to European countries, and a 3.8% quota was earmarked for Spain. At the end of June, CORES (the government corporation responsible for managing Spain's oil strategic oil stocks) began to release 2.3 million barrels of petroleum products (some 75,800 barrels per day for 30 days), the equivalent of 2.3 days of national consumption. The barrel of Brent, which on 23 June was trading at around $112, tumbled to $105 in just two days, but it then picked up again to near $114 on 5 July. These price oscillations came on the back of the announcement alone, since at the time of writing the barrels of reserves have not yet started reaching the market.

On 25 June, Iran complained that the IEA's decision was politically motivated and that its effect on crude oil prices would be limited, and other OPEC countries aligned with Iran's preference for high prices agreed. The first part of Iran's warning is evident: OPEC's decision of 8 June not to increase production, imposed by the organization's hawks, was followed by the no-less political move by the IEA, which groups together the major OECD consumer countries. But the IEA can argue that it was OPEC's incapacity to replace the 132 million barrels lost due to the Libyan conflict, close to 1.5 million barrels per day, that explains its response.

The apparent stagnation of the Libya situation and the realization that the country will not recover its output level for years has withdrawn from the market a supplier close to Europe of high quality light crude oil, very widely used in European refineries because of its low sulphur content, compliant with the EU regulations in this regard.1 As the disruption to Libyan oil supplies persists, its impact has become more difficult to manage, especially in light of the seasonal increase in demand in the US and Europe during the summer (so-called 'driving season'). Libyan crude oil has been replaced mainly by Western African crude oil, which has similar characteristics, but the pressure on vehicle fuel (petrol and diesel) prices has continued in the United States and Europe. The gap of almost 1.5mn b/d left by Libya has only been partially filled, and only since May (with an estimated increase in production of some 200,000 barrels in May and close to 300,000 barrels per day in June, mainly from Saudi Arabia). In any event, the 2mn b/d to be released by members of the IEA over 30 days amply offsets the roughly 1.5mn b/d of lost Libyan output.

In this context, the consumer countries on the one hand and the GCC producers, led by Saudi Arabia, on the other, had been trying for some time to secure agreement on an increase in production at the June OPEC meeting. The Agency had already warned in May that it might otherwise release its reserves, but the talks regarding this measure date from at least as early as April and had been conveniently leaked. In the weeks leading up to the Vienna meeting, discussions emerged between the US and Saudi Arabia on a plan to swap light, sweet crude oil stored in the US strategic reserves for an equivalent amount of heavy, sour Saudi crude oil. This would have enabled part of this high-quality oil to be

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exported to Europe to supply its refineries with oil similar to the Libyan product. Although the swap got no further than the informal proposal stage, it was the first sign that the US was willing to start using its strategic reserves to intervene in the market, and that Saudi Arabia was seeking ways to cooperate with consumer countries.

This set the stage for the OPEC meeting in Vienna, which the Saudi oil minister Ali bin Ibrahim Al-Naimi called ‘one of the worst meetings we have ever had’, at which those attending failed to offer a coordinated response to the tensions which have emerged in the oil market since the Arab Spring began and, in particular, since the Libyan oil supply was cut off. Like all OPEC meetings, it was shaped by political considerations and two opposing views of the market outlook. Starting with the latter, the view of the Gulf monarchies, especially Saudi Arabia, was to boost production to supply the increase in demand for OPEC crude oil, which OPEC itself estimates will be 2mn b/d in the third quarter. The Gulf producers, which have vast reserves and want to continue exporting for many years, fear that high prices will crush demand, damage the economic recovery and provide incentives to develop alternative resources.

The traditional hawks, led by Iran and Algeria, argued that the economic crisis and the end of the effects of the US Fed’s quantitative easing programme would affect demand and that the call for OPEC crude all would be even less than the 1mn b/d projected by the IEA. In this scenario, the risk would be of a sharp decline in prices like that of 2009. However, underlying both views is the structural difference in preferences between the Gulf monarchies, the only producers with the capacity to increase production, and the rest, which cannot do so and which would lose market share in favour of the former.

From the political standpoint, the meeting represented the intensification of the traditional rivalry between Iran, which holds the rotating presidency of OPEC, but whose production is stagnant at 3.6mn b/d, and Saudi Arabia, which, in addition to producing some 9mn b/d, holds the bulk of the market's spare capacity (more than 3mn b/d) and is the only producer with a decisive influence on the market. Indeed, after the humiliation in Vienna, Saudi Arabia announced that it would gradually step up production to 10mn b/d outside the discipline of OPEC. This would mean exceeding its 2008 quota of 8mn b/d by almost 2mn barrels, providing markets with the additional 1mn barrels which IEA estimates suggest that the global market needs for the third quarter. As we have already pointed out, Saudi Arabia ramped up its production considerably in May and June, and the Agency’s decision was supposedly taken on the basis of a tacit commitment from Saudi Arabia to the US.

The Role of Strategic Reserves and their Capacity to Impact on Prices
Although the IEA’s decision has not caused great controversy in Spain, in other European countries and in the United States it has unleashed a lively debate on how appropriate it is. The members' positions have not been made public, but it has been so difficult to reach the consensus required by IEA procedures that it has raised the question of whether this consensus will ever be reached again. The discussion on whether strategic reserves should be used to influence prices may be broken down into two separate issues. Firstly, whether strategic reserves should be used at all other than for the purpose for which they were designed, namely to ensure supply in the event of disruptions. Secondly, whether they are efficient as an instrument to keep prices lower over time.

With regard to the first question, the Agency has based the intervention on the effects of the Libya crisis (which we have already mentioned), although the scale of released reserves might appear to be disproportionate, as various OPEC members have complained. The drawdown criteria have evolved over time in line with global market circumstances, with the emergence of new players outside the IEA, like China and India. Quantitative criteria (a stoppage of no less than 7%) have been replaced by a looser definition referring to ‘significant supply disruption or an imminent threat thereof’. But the debate focuses not so much on the essential concept of strategic reserves as on the practical implications of tapping into them in light of the recent events in oil markets, whether geopolitical or technical. The uncertainty in the Middle East and North Africa are among the issues cited by those defending a pure use of stockpiles. Nevertheless, this aspect has not triggered much controversy, since on aggregate IEA members have a level of reserves higher than that required by the Agency: 146 days of net imports, compared with the 90 days required.

It is worth pointing out that Spanish legislation establishes minimum security reserve levels of 92 days of consumption of petroleum products. In Spain, before the release these stocks covered 113.7 days of consumption, so after the release they will still be above the 92-day legal requirement. Of those 92 days, only 45 must be covered by strategic reserves held by CORES, while the rest are held by operators under the control and supervision of CORES. These 45 days, which exceed the figure required by the IEA, along with the operators' stocks, appear to offer an ample cushion for the Spanish market. The IEA's requirement refers to imports, which in Spain's case are reduced from 90 to 88 days. In these terms, Spanish reserves total around 97 days, also higher than the level stipulated by the IEA. Furthermore, unlike what has happened in the US, the 2.3mn barrels assigned to Spain have been released by reducing the operators' stocks, affording them ample time to replace them - probably a year. In Spain, it will therefore be the operators who decide the sequence of application (or otherwise) of this reduction in its reserve obligations in accordance with their business strategies. In the US, the reserves released belong to the State and are stored in State-owned caverns; they have been auctioned and the contracts will be signed in the first half of July.

With respect to the impact on oil prices, the IEA announcement alone pushed Brent prices down by almost 7% in barely 2 days, but it remains to be seen whether the effect on markets will last. Indeed, prices rose again on the back of the beginning of the solution to the Greek debt crisis and the euro's ensuing rally, and the barrel of Brent pushed its way back above $110 at the end of June to hover near $114 on 5 July, at the time of the final revision of this work. In principle, since it is a one-off injection that is limited to a single month, it should help ease markets in that period, and after that the IEA will either boost output or release more reserves. However, the real effect will become clear in the next few days, when the drawn down crude and oil products start reaching the markets. Some observers fear that the measure could be used to boost the industry's refining margins, which are currently highly constrained. Although this might absorb part of the drop in prices, it does not seem viable that it could represent a significant percentage thereof.

In fact, the IEA plans to re-assess the situation one month after implementing the initial measure and it could repeat it later when the time is right, otherwise the drop in the ocean of global crude oil consumption it represents might see its efficiency severely eroded. As in a chess game, the threat is sometimes stronger than the deed. Above and beyond the quantitative impact, the IEA has proved to the OPEC hawks that it is willing to take extraordinary measures if the cartel does not respond to global demand for crude oil. The
question is how far this message can convey the necessary consistency to change market expectations and those of the various OPEC members without broader energy policy measures being introduced (at a higher political cost) to replace a measure that is by nature temporary. But in the absence of national energy policy measures the temptation to repeat the move in the next few months is likely to grow or shrink apace with oscillations in crude oil prices.

Total reserves of IEA member countries amount to some 4.1 billion barrels, of which close to 1.6 billion are public strategic reserves maintained solely for emergency purposes in response to the Agency's requirements of holding 30 days' worth of net imports. These are undoubtedly sizeable amounts which allow further action in the future, but not unlimited action: the 60 million barrels recently released almost double the 34 million barrels injected in 1991 during the Gulf War, but barely account for 16 hours' worth of global demand. Indeed, further similar measures would be hard to justify based on supply stoppages (unless new disruptions occur) and they would increase the reluctance of some IEA members to resorting to such measures for reasons other than those originally stipulated. The dilemma of influencing prices while at the same time holding reserves able to reduce physical vulnerability would become even more acute.

The IEA members' calculations might factor in the possibility of restoring reserves in future at more moderate prices, a risky move indeed if, for example, the geopolitical situation in the Middle East and North Africa deteriorates. However, even this might not be necessary: since crude oil consumption is diminishing in many IEA member countries, in future they will need fewer reserves to meet the required ratios, so the operation will likely amount to a net sale of crude acquired probably at lower prices. Based on current oil prices and the fact that stocks were acquired at much lower prices, the revenue from this sale may go some way to alleviating the beleaguered budget balances of OECD countries, but for crude oil markets it is only a stop-gap. In Spain's case, the released reserves belong to operators, so they will have no implications for the budget.

Another argument in favour of the move is that it has rid the market of what is seen as a considerable speculative component, a concern for some IEA members which, paradoxically, is one of the most frequent instruments for OPEC members to avoid boosting output at times of high prices. Evidently, holding long positions in crude oil following the release of reserves at the end of June and with the threat of future interventions looming could reduce that speculative component in prices. Some critics say this component had already diminished in the last few weeks, and that the measure was therefore unnecessary, but those who defend the move explain that it was precisely for that reason, because it was done in a market relatively far from highs, that the measure worked: in an overheated market the effect of drawing down reserves would have been negligible. Evidently, this argument was put forward before prices returned to pre-release levels.

In short, those defending the measure see a wealth of benefits and the right timing, while its critics say it will have a limited impact on prices in terms of both scale and duration. A view less indulgent with political posturing is that the measure does not constitute energy policy, if only because a single instrument is being used to attain a range of objectives, and it cannot replace a more sustainable long-term response to the energy challenges facing IEA member countries. In a sense, it is an energy policy by default. But there is some consensus that the effect on prices will be moderate and short-lived, albeit in a context of volatility and a supposed reduction in speculative positions. Only the
performance of prices over the next few weeks will show the extent to which this opinion is right or wrong, and what part of the calculations apparently factored into the IEA's decision were correct and what part will soon be back on the table pending a more solid energy policy.

**IEA Solidarity, OPEC Solidarity and Crossed Alliances**

From the ‘oil diplomacy’ standpoint, the IEA's decision has at least three implications. First, it is a show of solidarity and willingness for collective action by industrialized oil consumers at a time of grave economic strife. A second reading of the measure, according to which it is an exercise of solidarity by the US towards its European allies, more affected by the Libyan intervention, is an extension of this: the move could also be aimed at reducing the price spread between Brent crude oil, which is the benchmark in Europe, and West Texas Intermediate (WTI), which at the time of writing was more than $15. It is worth highlighting that this show of solidarity cannot conceal the internal tensions between member countries regarding the timing and suitability of the measure. Forcing this solidarity, for example with a succession of further interventions, could undermine the very foundational concept of the IEA, which is based on consensus.

Secondly, the Agency's decision weakens OPEC, by evidencing and exploiting on behalf of IEA members the waning solidarity between its members, while underlining the position of countries like Iran and other OPEC hawks. The protests of countries like Algeria, Venezuela and Ecuador show the extent to which these countries see themselves as losers as a result of the decision. Finally, it is a bitter blow for OPEC-IEA dialogue among producers and consumers, consolidating alternative crossed alliances between IEA members and some GCC producers, essentially the US and Saudi Arabia.

Relations between producers and consumers have been doubly affected. On the one hand, OPEC has appeared to be disconcerted by consumers who, for once, have taken the initiative. A number of OPEC members criticized the decision strongly, including some representatives of the Gulf monarchies, who argued that Kuwait and Saudi Arabia had recently ramped up their output and had encountered difficulties in placing it in European refineries. The Secretary General of OPEC, Abdalla Salem El-Badri, was among the harshest critics, although shortly after the release of strategic reserves, in a more conciliatory tone, he declared his willingness to talk to the IEA to prevent ‘this situation [from being] repeated’. However, the damage appears to be done and trust between producers and consumers, historically frayed, appears to be at a low ebb. Having said that, the absence of trust cannot be offset by the non-existence of talks among producers. Indirectly, the release of strategic reserves may undermine Saudi Arabia's position in the cartel, since it reduces its clout in the market, at least in the short term. In this regard, the measure may be regarded ambivalently by Saudi Arabia as a support which is waiting for a response, especially given the complexity of its relations with the United States.

On the other hand, the traditional tacit alliance between Saudi Arabia and consumer countries has become explicit as the almost definitive replacement of relations between the consumer countries and OPEC. This view might be somewhat rash if it entails an escalation of tension between IEA and OPEC countries, although in practice it does little to change the shape of the international oil system. Within OPEC, there are important producers for Spain, for various reasons, like Iran (15% of Spanish crude oil imports), Nigeria (12%), Libya (now off the map but previously accounting for close to 10% of Spain's oil imports), Algeria (Spain's leading gas supplier with prices indexed to crude oil)
and other countries where Spanish companies operate, like Venezuela and Ecuador, as well as Algeria and Libya.

In a way, the IEA has justified its actions as a stop-gap solution until Saudi Arabia and other GCC producers (mainly Kuwait) increase their output. Doubts regarding Saudi Arabia's capacity to raise production in the short term were another factor cited: to give the Saudis time to get the number of barrels it promised into the market. This presupposes that the country has both the capacity and will to increase production significantly, although it is by no means clear that the preferences of IEA member countries and those of Saudi Arabia coincide when it comes to price levels. With regard to the former, Saudi Arabia increased its production in June by almost 300,000 barrels compared with May, but this did not prevent the average OPEC basket crude oil price (calculated based on the prices of twelve different benchmark crudes, one for each member country) from barely altering between May and June, staying close to $110.

In this context, the main effect of the Arab Spring is that the oil prices on which the region's producers based their budgets have soared in 2011. Previously, these prices were estimated to be in the range of $70-$80 per barrel, compatible with the global recovery. With the new Saudi preventive fiscal package (estimated to be worth 22% of the country's GDP) that range may have increased to $85-$100 per barrel, according to various estimates. Saudi Arabia may prefer prices ranges lower than those of, say, Algeria, but for both countries the fiscal needs and expectations have increased on the back of the unrest, and so has the floor of the preferred price ranges.

In contrast, the slowdown in the economic recovery and the fiscal and monetary fatigue in most industrialized countries tends to reduce the crude oil price threshold which their governments can take on. With all the fiscal and monetary alarms sounding, these countries understand that one of the few remaining tools to salvage the recovery is to benefit from a boost on the supply side in the form of lower energy prices. It is difficult to see how such an urgent 'last ditch' approach can amount to a sound economic policy. However, above all it is of doubtful efficiency in the long term and, as the recent price performance shows, even in the short term (although one can always raise the opposite argument of how far prices would have rocketed had the strategic reserves not been released).

Accordingly, the impact of the Arab Spring and the economic crisis limit the possibilities for collective action among producers and consumers. As well as its budget impact, the Arab Spring has underpinned Saudi Arabia's preference for stability and status quo. An analysis of the country's relationship with the US is beyond the scope of this work, but without overlooking its complexity it is fair to say that there have been major tensions over its support for the overthrow of the former presidents of Tunisia and Egypt. Although the oil security alliance between the two countries is irreplaceable for both, it is not necessarily worth any price; and the price Saudi Arabia prefers to charge for its crude oil may have risen in relative terms if it perceives that it is less shielded, for example, against social unrest, although not against Iran.

**Conclusion:** As almost always with oil-related geopolitics, in the final analysis all previous considerations bring us back to the starting point: the rivalry between Iran and Saudi Arabia, which broadly shapes the position of OPEC, the latter's relations with the US (the world's main exporter and consumer, respectively), much of which revolves around
keeping Iran in check. This delicate regional balance has been further complicated by the instability in the region, but the power map has not changed much.

Aside from geopolitical concerns, the release of reserves had an immediate and significant effect on markets, as it did when such moves were made in the past, although this time the effect may be more short-lived in view of the complexity of the situation, as evidenced by the return of prices to pre-announcement levels (but lower than those prior to the rumours and preliminary signs that reserves might be released). Although the move did rid the market of some speculative operations, it is unlikely to change the dynamics of markets whose broad underlying trends hinge on the fundamentals underpinning supply and demand: and according to the various projections, there will be a continued shortage of barrels in the next few quarters. In this connection, the decision is not a sustained energy policy measure, and it does not appear to have much altered the overall situation of supply and demand in the long term. However, the response of markets must be carefully monitored once the released barrels start reaching consumers in the next few weeks before the situation can be analyzed more accurately.

What has changed is that the members of the IEA have decided to take the initiative with hitherto unprecedented measures, and the question is whether this signals a new era for the IEA, and what it might mean. Despite the arguments concerning speculation, the measure is designed to pressure OPEC and show that the industrialized countries expect a hike in output from Saudi Arabia. They have placed the Saudis’ stance at the centre of the discussions and they have sent Saudi Arabia the message that they are waiting, although at the same time they may have reduced their negotiating power with the cartel’s hawks. Now it remains to be seen whether this increase in production will come and on what scale and what impact it will have on the market. The restrictions imposed by OPEC’s position and by the IEA’s decision may limit Saudi Arabia’s manoeuvring room in the short term, but the monarchy’s priority is long-term stability. Consequently, its main constraint is to meet social demands in order to avoid protests such as those of its neighbours, and perhaps it is this change that will be the most significant.

Once again, we will have to wait and see what Saudi Arabia does, but for the first time in a long time, we will have to monitor the IEA’s intentions just as closely.

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