

News Flash – Geopolitical Risk Increasing

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6 FEBRUARY 2012: Over the course of the past week we have witnessed a significant deterioration in the stability of the Middle East. Specifically, in Egypt the public has once again taken to the streets - this time not to protest against a corrupt dictator but against a slow moving inept government run by the military. In Syria the Assad government is engaged in a full on battle against anti-government protestors; while the UN Security Council appears to be mired in endless debates due to Russian and Chinese objections to any reference to regime change in a resolution designed to halt the bloodshed. Finally, on the Iranian front, the rhetoric coming from Iran's leadership grew more heated as sanctions have started to bite and Israel upped the ante by discussing the possibility of a unilateral strike against Iran's uranium enrichment sites. It is indisputable that geopolitical risk in the region is increasing and with it the possibility of a disruption in the oil supply from the Persian Gulf.

As we have reported over the past month, new sanctions enacted by the United States at the start of the year targeting governments and businesses transacting with the Iranian central bank and its affiliates were intended to halt the export of oil from Iran, the government's main source of revenue, and pressure Iran into negotiations to halt its nuclear program. US sanctions were followed by the EU which recently banned the importation of Iranian crude. At the request and insistence of Greece and with the firm support of Spain and Italy, all of whom are heavy importers of Iranian crude, the EU ban included a transition period which permitted existing contracts with Iran to be honored until 1 July. The EU ban also included a "review" in April to assess its impact on EU member states and the world oil market.

As expected, Iran did not sit idly by as sanctions were being imposed upon it by the West. Iran responded to the new US sanctions by threatening to close the Strait of Hormuz and held military exercises to show its resolve. When the UK supported the new US sanctions, its embassy in Tehran was attacked by protestors. Finally, after the EU announced its own ban on Iranian oil imports, Iran threatened to pre-emptively cut exports to the EU in advance of the 1 July deadline.

The Iranian economy is starting to feel pressure from the sanctions. The Iranian rial has lost a significant amount of value against the US dollar making consumer goods much more expensive. Also, there have been recent reports that Iran's trading partners have been reducing or stopping shipments into Iran due to problems with payment.

Despite the pressure being applied, Iran remains defiant. In fact, in some ways, the sanctions appear to have galvanized the government, religious leaders and people against the outside world. Iran continues to claim that, like any other nation, it has the right to develop nuclear technology for civilian purposes. Iran

recently met with the IAEA in Tehran to discuss the current situation; the results were, as expected, constructive but inconclusive. Further discussions are scheduled for the end of the month.

It is clear that the new sanctions are beginning to bite and over time stand a good chance of success. The problem is – success will take time. There can be little doubt that the Iranians, in view of the current circumstances, have in all probability accelerated their nuclear program. After the enactment of the new sanctions the Iranians announced that they had begun enriching uranium at their heavily fortified underground Fordo facility. As time passes, Iranian nuclear capabilities will continue to grow. However, at present we have not seen any reports with hard evidence that Iran has actually begun the process of constructing a nuclear weapon. Nonetheless, the fear is that Iran will develop and possess all of the necessary technology and enriched uranium to easily make this last jump should they decide to do so. Iran with the wherewithal to construct a nuclear weapon in the future would destabilize the region.

From a policy standpoint, the US position on Iran was made clear by President Obama in his recent State of the Union address where he said "America is determined to prevent Iran from getting a nuclear weapon, and I will take no options off the table to achieve that goal. But a peaceful resolution of this issue is still possible, and far better, and if Iran changes course and meets its obligations, it can rejoin the community of nations." In short, President Obama wants to wait and give the new sanctions time to work.

It is clear Israel views the situation somewhat differently than President Obama. Israel views Iran's nuclear program as an existential threat. Israel's concern is that Iran appears to be moving elements of its nuclear program into fortified bunkers and underground facilities that will be difficult, if not impossible to destroy, should Iran not be persuaded from its current course. Recently, Ehud Barak, the Israeli defense minister, said that time was not simply running out but "urgently running out." Moreover, Mr. Barak stated that dealing with Iran's nuclear program later "may be too late." Recently, senior US and EU officials have flown to Israel counseling patience and warning that a preemptive strike on Iran's uranium enrichment sites could backfire and strengthen Iran's resolve to develop a nuclear weapon. However, Israel's current state of thinking could be summed up in a statement made by a fellow at the Institute for National Security Studies in Tel Aviv – "everybody agrees on where Iran is in terms of its nuclear programme...the problem is one of threat perception. The Americans are 10,000 miles away from Iran. This does not threaten them as it does Israel." In essence, there are two stopwatches marking time with regard to the Iranian nuclear program – a US and an Israeli one. It is clear from recent comments made by Israel, that its stopwatch is running faster than the US one.

Over the last week, the rhetoric has been heating up between the US, EU, Israel and Iran. On Friday, Iran's supreme leader Ayatollah Ali Khamenei lashed out at the US and Israel. In a defiant speech, the supreme leader admitted that sanctions were painful and crippling but also vowed to retaliate, if necessary, against the new sanctions and threats of war over Iran's nuclear program. In addition, Iran's supreme leader, in an unusually blunt statement said that that Iran would support groups opposing Israel.

Concern seems to be growing that Israel may take unilateral action to degrade Iran's nuclear program. Moreover, there is a fear that Israel may take such actions without first informing the United States. From a purely practical standpoint, the US withdrawal from Iraq provides Israel with the ability to fly over Iraq without having to coordinate a strike with the US military.

The situation with Iran and the wider Middle East is growing more complex and as a result will most likely continue to unsettle energy markets for the foreseeable future. It is our view that the markets will suffer bouts of extreme volatility in the coming weeks being largely driven by news headlines.

Market prices currently reflect a significant risk premia for the potential of a supply disruption from a geopolitical event. However, the amount of risk premia currently included does not fully account for an actual event/supply disruption. If Israel were to strike Iran in an attempt to slow its nuclear program, energy prices would most likely spike in excess of \$150 per barrel. The duration of such a price spike will depend upon the type and extent of any response by Iran and its effect on the flow of oil out of the Persian Gulf.

Determining the likelihood of an Israeli strike is extremely difficult. On the one hand, Israel understands that a unilateral strike would distress its allies and also risk further galvanizing the Iranians in their cause. On the other, Israel views Iran's possession of the technology and enriched uranium necessary to take the next step (i.e., construct a nuclear weapon) as an existential threat that no one nation truly understands except for Israel.

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Prepared by:

Richard D. Soultanian Park Ridge, NJ USA

Lorena A. Weber Park Ridge, NJ USA

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