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News Flash – Flashpoint Iran

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3 JANUARY 2012: Iran's drive to join the world's most elite club (nations possessing nuclear capabilities) presents the developed world and energy markets with a highly complex problem. The region, which is already struggling to regain its equilibrium after withstanding uprisings in Algeria, Libya, Egypt, Tunisia, Yemen, Syria and Bahrain as well as the winding down of the Iraq War, would undoubtedly be thrown into tumult should Iran acquire nuclear capability. A nuclear Iran would pose a serious and potentially fatal threat to one of America's closest allies in the region – Israel. Clearly it is in the interest of the international community at large to halt Iran's nuclear program without engaging in direct military conflict which would risk igniting the entire region. Stopping Iran's nuclear program will not be an easy task and most likely will unsettle the global energy markets.

Iran is already the subject of numerous international sanctions as a result of its willingness to sponsor terrorism and as a result, its economy and its people have suffered. Prior to the Islamic Revolution, the Iran-Iraq War and the introduction of international sanctions, Iran produced approximately 5.5 million barrels of oil per day. Sanctions, as well as a lack of investment, have reduced Iran's output to approximately 4.0 million barrels per day - 2.2 million of which is exported. Today, oil exports provide approximately half of Iran's government revenues and represent 80 percent of Iran's total exports. Despite these challenges, Iran remains the world's 4th largest producer of oil and the world's 3rd largest oil exporter.

For the international community, the only remaining lever to dissuade Iran from realizing its nuclear ambitions is to limit its ability to export crude to the international markets thereby restricting its primary source of export revenue – this revenue is the very oxygen keeping both Iran and its nuclear program alive. This treatment, however, is not easily prescribed due to seriousness of potential side effects – i.e., the unsettling of the oil markets, the alienation of allies currently relying on Iranian oil, and the risk of military retaliation by Iran. Nonetheless this is the very prescription that both the EU and the US are considering.

The US, which already has sanctions in place restricting US banks and corporations from doing business with Iran, has been poised to expand these sanctions to include any foreign financial institution or corporation entering into transaction with the Iranian Central Bank. The Iranian Central Bank is a clearinghouse for the bulk of Iran's oil exports and, consequently, applying sanctions to foreign banks or corporations entering into transactions with the Iranian Central Bank will have a chilling effect on oil exports. On 31 December 2011, President Obama signed these new tough sanctions into law as part of the 2012 National Defense Authorization Act. Some sanctions will take effect within 60 days, including purchases not related to petroleum, and the sale of petroleum products to Iran through private banks. The toughest measure will not take full effect for at least six months, including transactions by governments purchasing Iranian oil and selling petroleum production. The law provides the President some discretion in its application, allowing Obama to grant waivers based on the price of alternatives to Iranian oil or if he determines a waiver is "vital to the national security of the United States."

In addition, the EU is considering joining the existing US embargo on the importation of Iranian oil. The EU intends to review and finalize this decision in late January.

These two strategic initiatives focused on halting Iran's nuclear program by restricting its access to the global oil markets have, as expected, prompted a vigorous Iranian response. Last month, the British Embassy in Tehran was attacked and ransacked by hundreds of protesting students. Moreover, the Iranian military recently concluded 10 days of military exercises in the Persian Gulf and the Strait of Hormuz. Finally, Iran test-fired a shore-to-sea and a surface-to-surface missile, called Qader (Capable) and Nour (Light) soon after President Obama signed into law the new expanded sanctions.

To a certain extent the recent actions taken by both sides seem a bit pointless. Further US sanctions and a potential embargo by the EU will succeed only if all other nations agree to follow along. Since oil is a fungible commodity any importing nation breaking ranks with the US and EU will create an outlet for Iran's oil – albeit at potentially reduced prices. In our view, the likelihood of all major importing nations falling in line with the US and EU is small. Iran's principal export partners (as shown by the accompanying chart produced by the EIA) are China, the EU, Japan, India, South Korea and Turkey. New US and EU sanctions in all probability will halt the flow of Iranian oil into the EU (although it will be challenge for both Italy and Spain – both major importers of Iranian oil, to arrange for substitute supply), Japan and possibly South Korea. It is highly unlikely that both China and India will fall in line. The more likely outcome is that some or all of these nations will use the new US and EU sanctions as an opportunity to import greater quantities of Iranian oil and as a basis to drive a harder bargain with Iran with regard to price. Although Iran's oil revenues will be impacted it will not be as dramatic as expected because this situation will most likely have the effect of driving global oil prices higher. In the end, Iran will continue to have access to the international oil markets.

IRAN CRUDE OIL AND CONDENSATE EXPORTS FOR KEY COUNTRIES
January - June 2011

	Percent of Iran's Exports	Total Volume of Crude Imported from Iran ('000 b/d)	Iran as a Percentage of Total Crude Imported
European Union	**18**	**450**	
Italy	7	183	13
Spain	6	137	13
France	2	49	4
Greece	1	20	14
Germany	1	17	1
UK	0	11	1
Netherlands	1	33	2
Japan	**14**	**341**	**10**
India	**13**	**328**	**11**
South Korea	**10**	**244**	**10**
Turkey	**7**	**182**	**51**
South Africa	**4**	**98**	**25**
Sri Lanka	**2**	**39**	**100**
Taiwan	**1**	**33**	**4**
China	**22**	**543**	**11**

It is clear that Iran has no intention of sitting idle as the US and the EU continue to squeeze its economic interests in an attempt to break its will. Iran knows the international energy markets are deeply concerned about any potential closure of the Strait of Hormuz – i.e., the narrow waterway located between Oman and Iran connecting the Persian Gulf to the Gulf of Oman and the Arabian Sea. This narrow passage is one of the world's most important waterways due to the daily flow of oil that passes through it – approximately 17 million barrels per day or 19 percent of the world's daily consumption. On average, 25 to 30 tankers pass through the Strait on a given day – half laden with crude and the other half empty returning to be loaded. The market is keenly aware that any conflict in the Strait would have a serious impact on supply and price. Although alternative routes do exist – e.g., East-West Pipeline across Saudi Arabia (from Abqaiq to the Red Sea) with a capacity of 4.8 million barrels per day, these alternatives would be insufficient to make up any meaningful stoppage of flow of oil through the Strait. It is clearly in Iran's interest to keep oil markets unsettled by waging a war of words – i.e., threatening to close the Strait, pushing the price of its main export higher and showing the world its discontentment with the new US and EU sanctions. However, Iran also understands that any attempted closure of the Strait would most likely instigate direct military conflict with the US, be extremely costly in terms of men and equipment, deprive itself of oil export revenue and, most likely, be short-lived due to its lack of large naval vessels. It would seem that Iran would only take such an ill-advised step as a desperate last resort.

A simple summary of the situation can be stated as follows. Both the US and the EU wish to turn up the pressure on Iran to halt its nuclear program and the only way to do this is to restrict Iran's ability to export oil to the markets. Iran has no intention (or financial interest) in obliging the demands of the US/EU (claiming that its nuclear program is strictly civilian in nature) and will wage a war of words against the oil markets which Iran views as the West's Achilles heel in an attempt to dissuade the US and EU from implementing their new sanctions. The danger presented by this scenario is that the escalation of tensions will come easily but de-escalation will prove more difficult due to the fact that there appears to be no "pressure release" mechanism available to the parties – i.e., the six party talks having completely failed to date in incenting Iran to comply with the requests of the international community. Ultimately, if the international community (spearheaded by the US and EU) follows through and continues to ratchet up the financial/economic pressure on Iran it could ultimately paint Iran's leadership into a corner where it will have little to lose by initiating a mutually destructive regional war.

As we stated at the outset, the problem posed by Iran's nuclear program is complex due to Iran's importance to the energy markets. It will be difficult for the US and EU to find just the right amount of pressure to apply to Iran's government. Too much will alienate allies dependent upon Iran's oil and could potentially push Iran into an irrational decision of initiating military conflict with the US or others in the region. Too little and Iran will simply continue down its current path and upon achieving nuclear capability upset the delicate balance currently existing in the region. How this situation ultimately plays out is currently unclear. However, it is clear that the situation will not resolve itself quickly and as a consequence markets will be driven largely by headline risk and not fundamentals for the foreseeable future. As a rule, markets driven by headline risk tend to be extremely volatile and we expect energy price volatility to increase significantly in the first half of 2012.

We will be issuing our 2012 energy pricing forecast in the coming weeks. In short, we continue to believe that global economic fundamentals in the US, the EU and China will remain weak and therefore energy fundamentals (i.e., demand) will be, at best, steady. Current global economic activity and oil market fundamentals do not justify today's elevated price levels. There can be no doubt that current price levels include significant premia for the unusually large number of geopolitical risks perceived by the markets. One thing is for sure – energy pricing volatility will be the big issue in 2012 as the markets either revert to underlying fundamentals or are roiled by geopolitical events. In our view it is highly likely that at this time next year prices will either increase or decrease by 15 to 20 percent over current levels – we would be very surprised if markets moved only incrementally – i.e., increase or decrease by 5 or so percent as in 2011.

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