News Flash – The Week Ahead

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20 January 2012: It appears that the news cycle is currently focusing on two important developments: Iran and Greece. The first concerns the tug of war currently unfolding between Iran and the West – the West is applying new sanctions in an attempt cut Iranian oil exports and pressure Iran to halt its nuclear program while Iran is responding by threatening the flow of oil through the Strait of Hormuz. The second concerns restructuring of Greece's outstanding debt and the level of private sector involvement (PSI). Next week is shaping up to be a fairly important week with regard to both of these items so we thought we would outline the current status of these issues and their potential impact on the energy markets.

Iranian Sanctions

On 31 December 2011, the US enacted further sanctions designed to pressure both countries and businesses to stop purchasing Iranian oil (or risk being excluded from US financial markets). To date, results have been mixed. Currently Iran produces approximately 4 million b/d of oil and exports approximately 2.2 million b/d. Iran's largest customers are China, the EU, Japan, India, South Korea and Turkey which purchase 550,000, 450,000, 340,000, 325,000, 245,000 and 180,000 b/d respectively.

It appears that the EU will announce an embargo on Iranian oil as early as Monday, 23 January. However, such an embargo will be difficult to implement. The largest importers of Iranian oil in the EU are Italy, Spain and Greece – countries which are suffering from a lack of economic growth as well as austerity and will have difficulty finding alternative supplies at similar credit terms. Accordingly, the EU embargo will include some type of grace period (most likely 6 months or more) to provide these countries with the opportunity to find cost effective alternative supplies.

Over the past weeks, the US has been applying pressure to Iran's Asian customers to fall in line with Washington's efforts. Since Asia is a significant purchaser of Iranian oil, its support is critical to the success of the West's strategy. Recently Treasury Secretary Timothy Geithner visited China, South Korea and Japan to convince these countries to support the sanctions. The reaction to Geithner's visit has been predictably mixed.

Japan, a close ally of the US, has made a commitment to reduce its reliance on Iranian oil imports but has asked for flexibility due to the fragile state of its post-tsunami economy and will seek a waiver from the Obama Administration. Officially South Korea has yet to formulate a response but it appears to be attempting to organize alternative supplies of crude should the US apply further pressure. China, which has officially stated that it opposes any attempts by Iran to develop and possess nuclear weapons, has taken a slightly contradictory position by rejecting any unilateral sanctions being applied against Iran and will continue to import Iranian oil.

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India, another important Iranian customer, has stated that it will only accept sanctions enacted by the UN but not by individual countries and will therefore continue to buy oil from Iran. India recently dispatched a delegation to Tehran to devise ways to continue buying Iranian oil without being impacted by the new sanctions.

At present, Turkey, like South Korea, has not formulated an official position with regard to the US sanctions. However, Turkey looks to be developing plans to reduce its dependence on Iranian imports through one of several avenues including increasing purchases from Saudi Arabia, Russia, Azerbaijan and/or West Africa.

Based on the foregoing, it is clear that the implementation of the new US sanctions has gotten off to a mixed start. Nonetheless, the sanctions appear to be applying pressure to all of Iran's largest customers. Next week we have no doubt that the EU will make headlines with the passage of an embargo but in real terms the likely impact to Iran and the oil markets will be minimal. At present it appears that the most likely consequence of recent US sanctions is the provision of additional leverage to Iran's customers to negotiate deeper discounts in order to continue the relationship.

Greek PSI

In October of last year, after late night negotiations, EU leaders announced their latest plan to address the region's growing debt crisis. A significant portion of that plan involved Greek bondholders "voluntarily" accepting a 50% haircut in return for credit enhancements and a future bond swap. At the time of the announcement we were skeptical of the implementation of this portion of the plan due to the fact that "no details were provided as to the terms, timing or participation relating to such a debt swap – just the concept." We are now in late January and, as predicted, the debate with regard to the write-down of Greek debt held by the private sector has yet to be concluded. Negotiations have been ongoing and as a result of continued deterioration in Greece's economy, the requested level of concessions has increased.

Outside the European Central Bank (ECB), holders of Greek debt vary greatly from banks and insurance companies to pension and hedge funds. In our view, Greece will be hard pressed to avoid a technical default. It seems highly unlikely that the Greek government will be able to negotiate a debt reduction plan which will bring its debt levels (currently at 160 percent), down to a reasonable proportion of GDP and yet gain the necessary percentage of bondholder participation in order to make the transaction "voluntary" and avoid default. On 20 March, Greece is required to make a €14.5 billion bond repayment and to service this requirement, Greece will need money from the ECB Rescue Fund. Access to these funds, however, is preconditioned upon the successful completion of the debt reduction deal. Consequently, these negotiations are currently being undertaken with a certain degree of time pressure as March fast approaches.

As a result of prolonged negotiations concerning Greek PSI, markets have been increasingly pricing in the risk of a hard default in Greece. It is difficult to predict the impact of such an event on the global economy. However, the market has had a significant amount of time to prepare for such an event and thus the overall view appears to be that the impact will be more muted than one would expect. One of the key issues surrounding such an event would be the precedent it sets and its impact on other struggling EU countries. It is not a foregone conclusion that Greece will be unable to strike a deal with its private creditors but with each passing day and a looming prepayment obligation, the likelihood of such an event is growing.

As mentioned above, next week promises to be an interesting week with regard to the global economy and the energy markets. We will be watching events with great care and will advise the direct and indirect impact on the energy markets.

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