

Commodities Research

What if Iran's oil returns to the market?

- Momentum seems to be growing in talks over Iran's nuclear programme as negotiations between Iran and the so-called P5+1 continue today.
- Further progress could mean an easing of the sanctions on, among other things, Iran's energy trade.
- An easing of sanctions on Iran would likely have a negative effect on the oil price through increased supply and a lower geopolitical premium.

Iran and P5+1 nuclear talks set to continue

Talks between Iran and the so-called P5+1 (consisting of the US, France, Britain, Russia, China and Germany) resume today two weeks after the two sides failed to reach an agreement over Iran's nuclear programme. The talks are expected to run through Friday.

Markets are likely to keep an eye on the negotiations in Geneva, as momentum seems to be growing. Even though the two sides were not able to strike a deal two weeks ago, the talks have been characterised as the most intensive in many years with high-ranking officials such as US Secretary of State John Kerry participating.

Another reason for optimism could be the fact that on the day after the last round of talks in Geneva ended, Iran signed a deal in Tehran with the International Atomic Energy Agency allowing greater access to some of Iran's nuclear facilities.

Below we take a closer look at the likely consequences of a return of Iran to the global oil market.

Oil embargo weighing on the Iranian economy

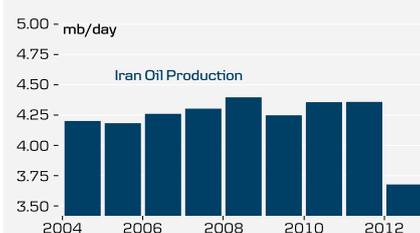
Following the tightening of US sanctions and EU oil embargo which came into effect in July last year, Iran has had limited access to the global oil market. This has had significant consequences for the Iranian economy as it weighs heavily on the fiscal budget.

Oil production has declined steeply and at the current price on oil the fiscal budget is far from balancing. The fiscal breakeven oil price in Iran is estimated to be around USD150/bbl compared with around USD94/bbl in neighbouring Iraq and significantly higher than the current oil price of around USD106/bbl.

Facts on Iran's oil production

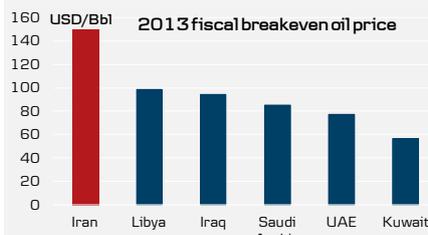
- In 2012, Iran produced 3.7 million barrels per day (sixth-largest producer in the world). It accounted for 4.2% of world production.
- Iran has the fourth-largest proved oil reserves in the world which accounts for 9.4% of total proved world reserves.
- Iran's oil exports were estimated at around 1.5 million barrels per day in 2012 with around half going to China and India.
- The EU and the US tightened sanctions on Iran last year amid worries over Iran's nuclear programme.
- The tightening included freezing the assets of the Iranian central bank and an embargo on Iran's oil.
- Following the tightening of the sanctions on Iran, Iran has seen a sharp drop in oil production and exports.

Sanctions hurting oil production...



Source: BP Statistical Review of World Energy 2013

...and the budget



Source: IMF

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Hence, the Iranian economy is feeling the pressure from the recent tighter sanctions, which raises the possibility of Iran staying at the table and increases the prospect of some sort of deal being struck.

In exchange for a deal with the P5+1 group limiting Iran’s nuclear programme, the sanctions on Iran would probably be eased. This could include unfreezing some of the Iranian assets held in banks overseas and an easing of the sanctions on Iran’s energy trade. Hence, further progress in the talks could have a significant market impact.

EU has cut off oil imports from Iran

Following the tightening of the sanctions on Iran, the country has seen a sharp drop in its oil exports. In 2011, Iran exported around 2.5 mb/day. That number was almost 1 mb/day in 2012.

Following the sanctions, the EU more or less completely closed down its oil imports from Iran. However, Asian countries have found a way to circumvent the sanctions on Iran and subsequently Iran’s exports to this region have not suffered to the same extent.

Data from the Energy Information Agency moreover shows that Iran’s oil exports have suffered further this year and dropped below 1 mb/day.

Estimates of Iran’s average oil exports, mb/day

	2011	2012
Japan and Korea	0.55	0.32
China and India	0.88	0.76
Other non-IEA	0.31	0.13
Greece, Italy, Spain, and Turkey	0.63	0.22
Other Europe	0.14	0.02
Total Exports	2.51	1.53

Source: EIA

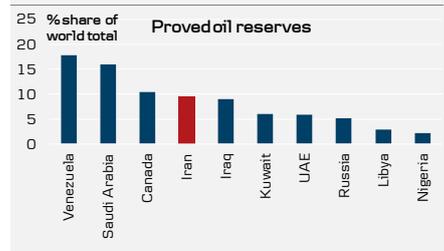
Large drop in Iran’s production

While progress in the talks with P5+1 and an easing of the sanctions on Iran’s energy trade would obviously benefit the Iranian economy, given that Iran holds an important role on the global energy market it would likely also have an effect on the global energy markets.

Iran has one of the world’s largest proved oil reserves. Iran currently holds just below 10% of the proved oil reserves, which puts the country just behind Venezuela, Saudi Arabia and Canada among the countries with the largest oil reserves.

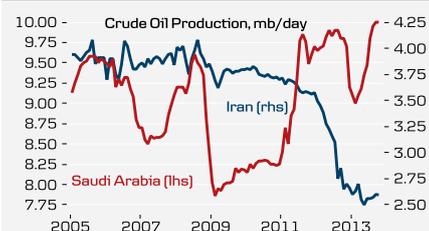
Iran’s oil production dropped sharply last year to 3.7 mb/day amid the sanctions on Iran oil trade – in 2011 Iran produced around 4.4 mb/day. That leaves Iran as the world’s sixth-largest oil producer down from number four in 2011.

Large oil reserves in Iran



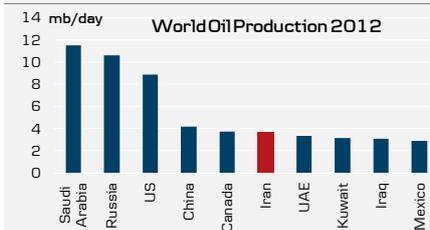
Source: BP Statistical Review of World Energy 2013

Sharp drop in oil production...



Source: Bloomberg

...moves Iran down the list of largest producers



Source: BP Statistical Review of World Energy 2013

This year Iran's oil production has dropped further and Iran is now only producing around 2.6 mb/day – the lowest since the beginning of 1990s. However, increased Saudi Arabian oil production has to some extent mitigated the drop in Iran's oil production. Historically, Saudi Arabia has balanced its production to lesson shocks to the global oil market balance and currently, Saudi Arabia's production, at around 10 mb/day, is at an all-time high.

An Iranian return could send the oil price below 100USD/bbl

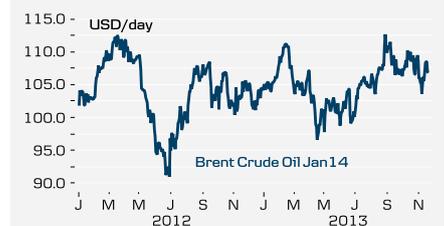
Although momentum surrounding the Iran nuclear talks seems to be at its highest in a long time that does not mean a deal which would remove the sanctions on Iran and let Iran's oil return to the market is imminent.

However, if Iran and the P5+1 reach some sort of agreement which constrains Iran's nuclear programme and eases sanctions on Iran's oil trade, it would likely have an overall negative impact on the oil price. Overall, two effects would weigh on the oil price.

- **A positive supply shock.** The price effect from an increase in the world oil production would be negative as Iran's oil returns to the market. However, it is worth keeping in mind that since Saudi Arabia's production currently is at an all-time high Saudi Arabia would likely balance its production in order to ease the downward pressure on prices.
- **A lower geopolitical premium.** If Iran and the P5+1 strike a deal it would likely mean limitations and increased control with Iran's nuclear programme. That could ease geopolitical tensions in the Middle East, which would reduce the geopolitical premium on the oil price.

If substantial progress is made in the Iran nuclear talks are made and Iranian oil is allowed back on the market there is definitely a risk that the oil price would drop below 100USD/bbl.

Oil price likely to decline if Iran returns



Source: Bloomberg

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