Special Bulletin

A Japanese Perspective on the International Energy Landscape (80) March 16, 2012

Growing U.S.-Iran Tensions and International Oil Market

Ken Koyama, PhD
Chief Economist, Managing Director
The Institute of Energy Economics, Japan

Harsh comments on Iran's nuclear development program have come from the United States. In a joint press conference with British Prime Minister David Cameron on March 14, U.S. President Barack Obama stated, "I think they (Iranians) should understand that because the international community has applied so many sanctions, because we have employed so many of the options that are available to us to persuade Iran to take a different course, that the window for solving this issue diplomatically is shrinking." The remark could be interpreted as a warning to Iran.

In an interview published on March 2, President Obama stated that, with regard to Iran, he is maintaining a military option and did not "bluff." In a speech on March 4, the president said that he would not "hesitate to use force" to defend the United States and its interests. Following these remarks, the March 14 message might have been designed to give a strong warning to Iran and to urge Tehran to review its nuclear development program and seriously take part in negotiations. As a matter of course, the United States might have not yet lost hope for a diplomatic solution.

Because Iran's diplomatic efforts were strongly criticized for a tendency "to delay, to stall, to do a lot of talking but not actually move the ball forward," as noted by Obama, however, the president might have indicated declining chances for Iran to diplomatically solve the issue by stating that "the window" for solving this issue diplomatically was shrinking. Russian paper Kommersant on March 14 reported that U.S. Secretary of State Hillary Clinton asked Russian Foreign Minister Sergei Lavrov to tell Tehran that the expected talks next month with the five permanent U.N. Security Council members and Germany, known as P5+1 would be the last chance for Iran to avoid military action to the country. The U.S. attitude toward Iran has apparently grown tougher. Behind such tougher attitude is the special factor of the U.S. presidential elections this year. While a possible preemptive attack by Israel on Iran is suggested frequently, the U.S. administration is plagued with complicated problems including Israel's influence on U.S. politics, how to avoid criticisms of weak-kneed diplomacy, and how to prevent crude oil price hikes from affecting the U.S. economy.

Under growing pressures, Iran for its part has maintained the policy of promoting its nuclear development program for what it argues are peaceful purposes. But it has agreed to resume talks with the P5+1 group, indicating its willingness to accept diplomatic talks. Seemingly, Iran has taken a carrot-and-stick policy. The nation's talks with the P5+1 group, which are expected to take place in Turkey in April, can be seen as a new development to fill the absence of such talks over more than one year since January 2011. Iran has also offered to accept access to the Parchin military facility in suburban Tehran for IAEA review. When the International Atomic Energy Agency sent inspectors to Iran in January and February, Iran refused to grant access to them to the facility. In such situation, Iran's talks with the P5+1 group in April and their results will attract global attention.

While the April talks are attracting attention, remarks and other information on the risk of military attacks have had no direct impact on crude oil prices. The risk premium might have been factored into the present high crude oil price levels to some extent. Therefore, future crude oil price changes may depend heavily on future developments in the Iranian situation (or the presence or absence of any new significant developments). If without new developments or any major moves affecting the situation, crude oil prices may be more susceptible to oil supply/demand fundamentals and financial markets (money factors) than to the Iranian issue.

As a matter of course, the Iranian situation itself may greatly affect supply/demand factors. This point is worthy of attention. In an emergency (as with the use of force), large-scale oil supply disruptions could emerge, greatly affecting the oil supply/demand environment. In addition, the impacts of economic sanctions and an Iranian oil embargo cannot be ignored. In its monthly oil market report on March 14, the International Energy Agency made an analysis that Iranian crude oil exports could be cut by 0.8-1.0 million barrels per day from the middle of the year. This analysis is based on an assumption that the European Union will impose an Iranian oil embargo with such major Asian countries as China, India, South Korea and Japan reducing oil imports from Iran to some extent. Actual reductions are uncertain. If 1 million bpd in Iranian crude oil is lost from the market, however, extra supply to cover the loss may be required. Specifically, those among the Organization of Petroleum Exporting Countries with surplus production capacity, including Saudi Arabia and other Persian Gulf countries, may be urged to increase production. In February, the 12 OPEC members' surplus production capacity totaled 3.6 million bpd (including 130,000 bpd for Iran). If the OPEC members excluding Iran expand oil output by 1 million bpd, the effective surplus production capacity may be lowered to 2.5 million bpd. How will the market respond to such a surplus capacity fall? The response may depend on the international situation and the oil supply/demand environment. If geopolitical risks are high, the market's vulnerability may be strongly recognized.

Regarding Iranian crude oil delivery, we may have to take note of the insurance problem and its trend as well in the future. The EU's sanctions on Iran have led leading European insurance companies to announce that they would exempt Iranian crude oil delivery from marine insurances (including reinsurances for ship owners' oil pollution compensation, hull and cargo insurances). The action has emerged as a major constraint on Iranian oil delivery for Japanese and other companies. As far as insurance is concerned, we may have to be prepared to see not only the abovementioned effect on the Iranian crude oil delivery but also hull and cargo insurance premium hikes and coverage changes in an emergency for overall shipment to and from the Strait of Hormuz.

Iranian situation developments including Iran's talks with the P5+1 group in April and the Iranian oil embargo are unpredictable. Based on the world economy and oil supply/demand fundamentals, such complicated factors as the responses of other oil-producing countries including

Saudi Arabia, the U.S. domestic situation toward the presidential elections and Israeli moves may be combined to affect the oil market. Oil accounts for 45% of Japan's energy supply, meaning that crude oil prices have great influences on Japan's overall energy import prices. The Iran problem is likely to become a major disturbing factor for the oil market. Accurate situation analyses and responses based on such analyses are important.

Contact: report@tky.ieej.or.jp

The back issues are available at the following URL
http://eneken.ieej.or.jp/en/whatsnew/JPOIEL.html