Special Bulletin

A Japanese Perspective on the International Energy Landscape (228) July 17, 2015

Iranian Nuclear Deal's Implications for International Oil Market

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On July 14, Iran and a group of the five permanent United Nations Security Council members and Germany, known as P5+1, announced that they reached a final agreement on a comprehensive solution to the Iran nuclear development issue after negotiations based on their framework agreement (Lausanne Agreement) in April. Tensions had long continued between Iran and Western countries since the revelation of Iran's suspected nuclear development in 2002 as Western countries had gradually enhanced their sanctions on Iran that had stuck to asserting its right to the development and use of nuclear energy. After their Geneva agreement in November 2013 presented a path to a diplomatic solution to the issue, however, Iran and the P5+1 group continued difficult negotiations before reaching the final agreement. In fact, the deadline for the final agreement was originally set for the end of June. The deadline was extended three times. Even beyond third time extension of the deadline to the July 13, they continued intensive, energetic negotiations. As a result, they coordinated differences over the sanctions on arms exports to Iran and other problems left for the final stage of negotiations, achieving the final agreement at last.

The final agreement features four key points: (1) Iran's uranium enrichment and other related activities will be strictly restricted to limit its nuclear development capacity; (2) the International Atomic Energy Agency will confirm pending matters before the implementation of the agreement; (3) the United Nations and Western countries will lift economic sanctions on Iran as the agreement is implemented; and (4) sanctions will be restored if the agreement is broken. As for the first point, they agreed to cap Iran's nuclear development capacity by banning Iran's production or acquisition of highly enriched uranium over the next 15 years and reducing the number of Iran's centrifuges as well as by other related measures to extend the period of time required for producing nuclear materials for a nuclear bomb from two or three months to more than 12 months.

The final agreement indicates that the P+1 group and Iran have made a major diplomatic achievement to stave off nuclear proliferation in the Middle East by restricting Iran's nuclear development realistically and easing overall tensions. Given the agreement's international impacts including a possible major change in U.S.-Iran tensions since Iran's Islamic revolution and Iran's expanding presence in the Middle East, the latest pact is very significant. Bur close watch may have to be kept on a large number of matters including whether this agreement would actually be implemented, how domestic U.S. and Iranian discussions would develop on the agreement and how U.S. allies Israel and Saudi Arabia would respond to the agreement.

However, the latest Iran nuclear deal will lead to new developments involving Iran. In this respect, one of the future developments that would attract global attention would be Iran's comeback to the international oil market through the termination of the sanctions. The international oil market has seen a substantial price plunge since the second half of 2014 due to a sharp expansion in U.S. shale oil production and the policy of Saudi Arabia or the Organization of the Petroleum Exporting Countries tolerating a price decline. Crude oil prices still remain low, ranging between $50 and $60 per barrel. Recently, the Greek debt crisis and concern about China's economic growth deceleration have exerted further downward pressure on oil prices. Under such situation, the possibility of Iran's comeback or additional supply to the international oil market has emerged as a key matter of concern to oil and energy experts in the world.

In fact, Iran's crude oil exports declined by 1.20 million barrels per day from annual average of 2.61 million bpd in 2011 to 1.41 million bpd in 2014. How fast Iran would come back to the international oil market and how much crude oil Iran would add to the international market will have great impacts on the global oil supply and demand environment and crude oil prices. In this respect, the first clear point at present is that Iranian crude oil would not come back to the international market immediately after the latest Iran nuclear deal. Given that economic sanctions on Iran are to be lifted after the agreement's implementation is verified, Iran may have to wait until the end of IAEA inspections before coming back to the international oil market. Various views exist about how long the IAEA inspections would continue. But the IAEA inspections and report are widely expected to take at least three months, indicating that the sanctions could begin to be lifted late this year at the earliest. So, Iran may begin then to come back to the international oil market.

As well as when Iran would come back to the international oil market, how much Iranian crude oil would be added to the market is a major issue. In fact, experts are widely divided over the issue. While Iran itself has indicated that it would be able to expand oil supply by some 1 million bpd, investment shortages and oilfields' aging under the sanctions have led some observers to expect that the expansion within one year would be limited to 300,000 bpd. The most common projection of the expansion may be 700,000-800,000 bpd for 2016. But there are various uncertainties about the expansion.

But even Iran's additional supply between the lowest forecast of 300,000 bpd and the median forecast of 700,000-800,000 bpd may exert some impact on the market under the present situation. A particularly important point is that it would not be easy for Iran to secure sales outlets for its crude oil at a time when oil demand is weak in Europe and Asia that had been major customers for Iran. Of the abovementioned 1.2 million bpd decline from 2011 in Iran's oil exports, Europe accounted for a half. It may be difficult for Iran to restore that amount under the current European market environment. Furthermore, Saudi Arabia, Iraq and other major oil producing countries have taken a policy of maintaining or expanding supply, making it more difficult for Iran to increase oil exports. As a result, Iran's comeback to the international market could further intensify oil producing countries' race to secure market share.

The price-reducing pressure of Iran's comeback to the international oil market depends largely on how fast Iran would come back and how much crude oil Iran would add to the market, as noted above. It may also depend on the overall supply-demand environment at the time of the comeback. If Iran comes back to the market when the supply-demand balance is loosened due to downside economic risks, an oil price decline may be accelerated. In a reverse case, the impact of the comeback may be minimized. The U.S. Energy Information Administration has forecast that if Iran expands crude oil output by 700,000 bpd in 2016, crude oil prices may fall by $5-15/bbl. Depending on the supply and demand environment at the time of the comeback, however, the decline could be greater. We may have to closely watch the Iran issue's implications for the international energy situation, including Iran's introduction of foreign investment even before the termination of economic sanctions and the fate of medium to long-term oil and gas production expansion.

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