Iran's Nuclear Ambitions: A Looming Crisis For the Oil Market

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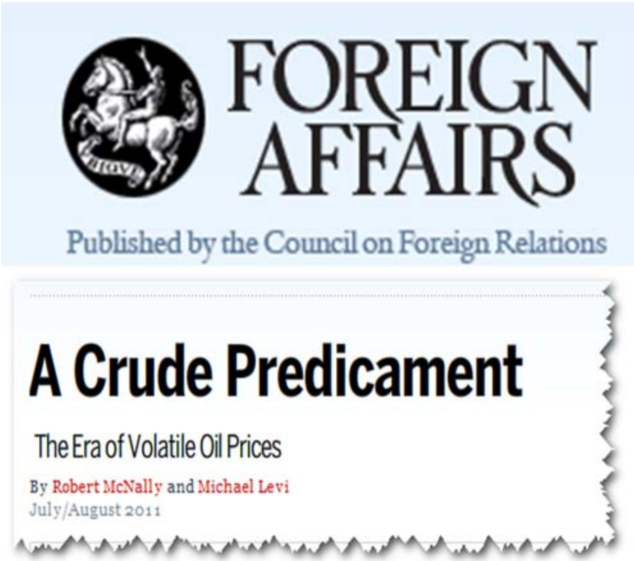
Robert McNally

President
The Rapidan Group

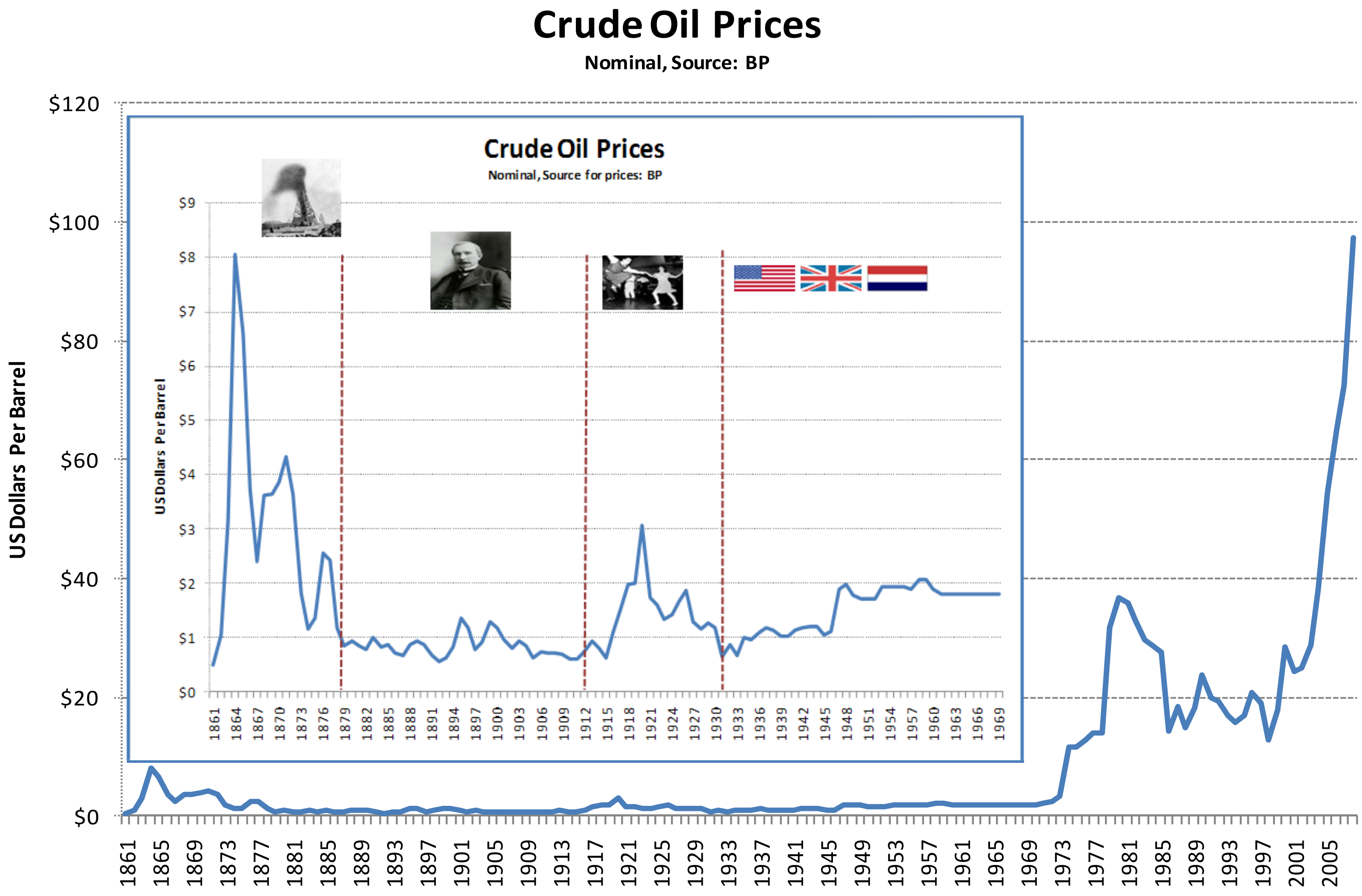
Bob.McNally@RapidanGroup.com
www.rapidangroup.com
t. +1 301.656.4480

Key Themes



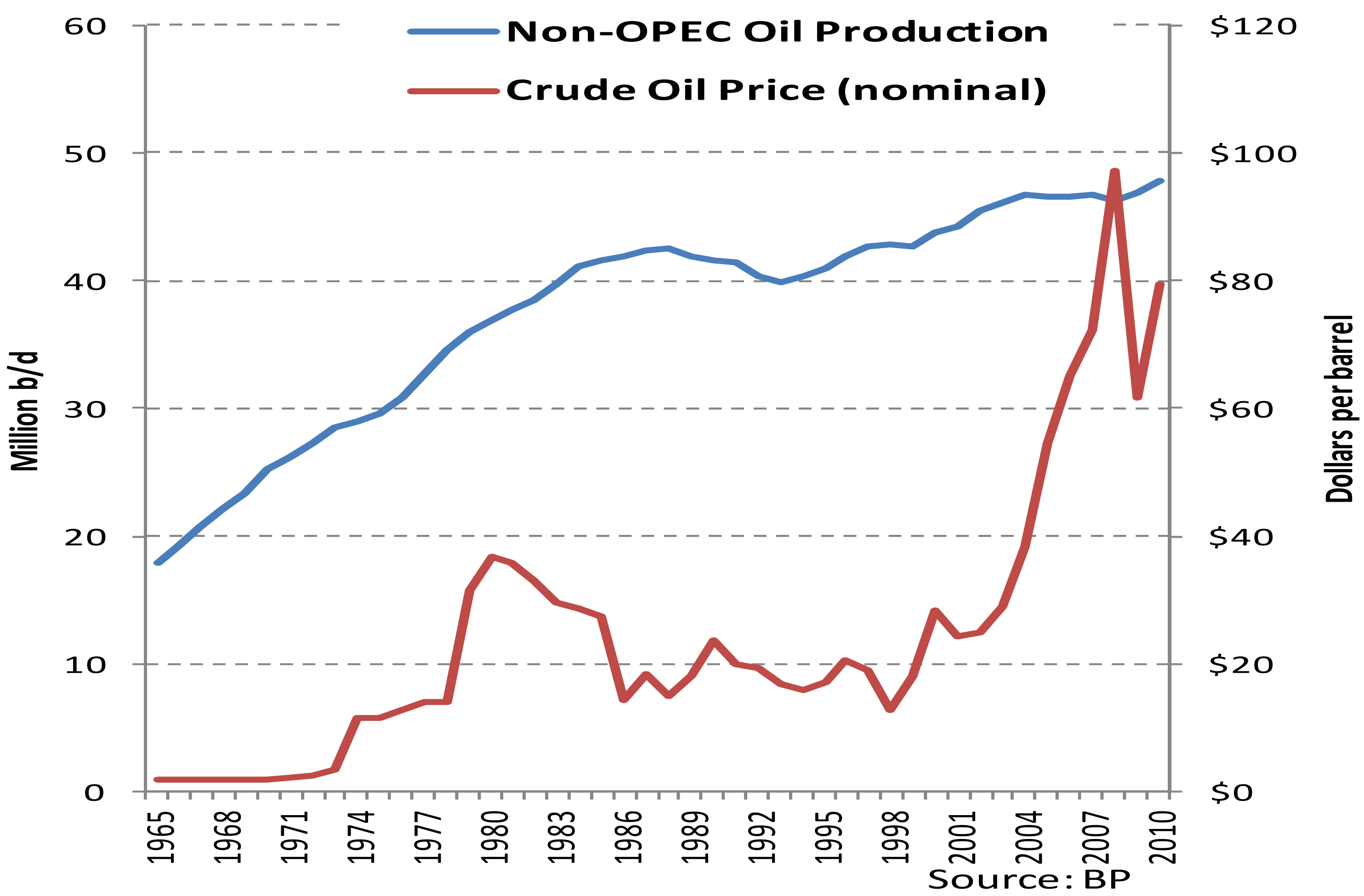
- The oil market has entered a prolonged period of fundamental tightness, geopolitical risk, and oil price volatility
- OPEC (Saudi) spare capacity is and will likely remain low
- Therefore, market sensitivity to geopolitical disruptions is very high
- Iran's nuclear crisis may come to a head this year and oil market participants are starting to price in conflict risk – LNG exports are also a concern
- Scenarios: (1) Iran concedes; (2) Iran prevails; and (3) conflict
- Iran's pursuit of a nuclear weapons capability will lead to oil and LNG market turbulence, one way or the other

Absent Supply Control, Oil Prices are Prone to Booms and Busts



1861-1944 US Average.
1945-1983 Arabian Light posted at Ras Tanura.
1984-2008 Brent dated.

"The Cure for High Oil Prices Is High Oil Prices"…?



Next Major Bullish Driver To Come On The Demand Side

Consensus may be lowballing oil intensity of EM GDP growth

- Historical experience of oil demand responding to price hikes **not** likely to repeat
- Consensus forecasts (DOE/EIA, IEA) assume an **unlikely** decline in per capita energy consumption
- But if per capita energy use increases, demand will be much higher (as much as 30% compared with consensus forecasts by 2030)

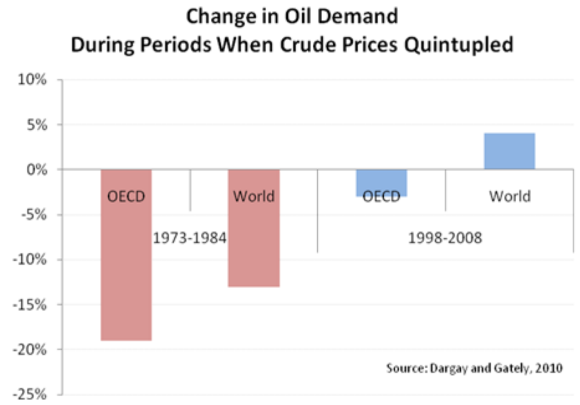
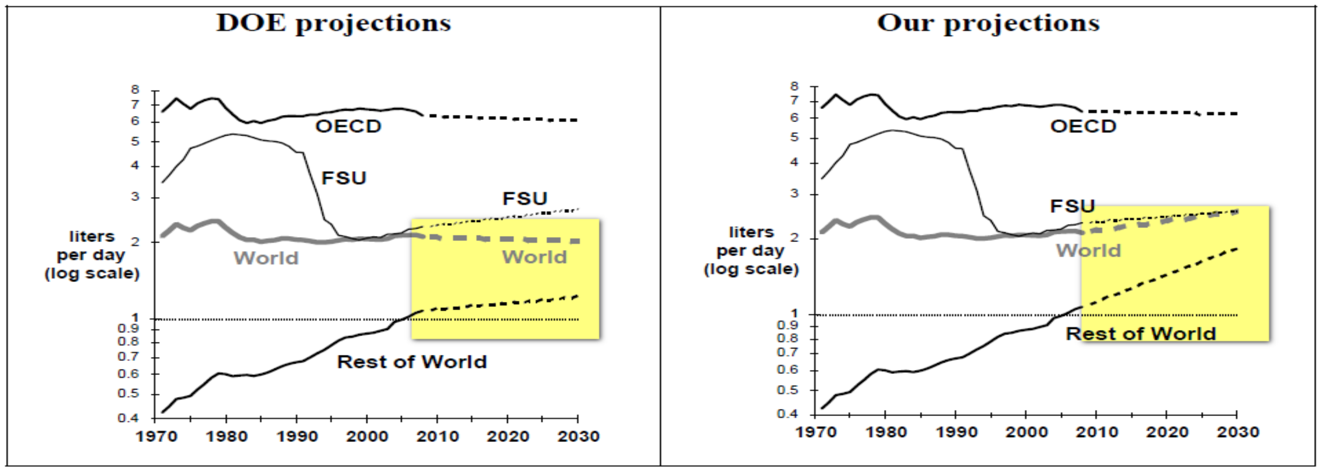


Figure 15. Per-capita oil demand 1971-2008, and projections to 2030 using DOE Reference Case assumptions for crude oil prices and income growth: DOE projections and Our Projections

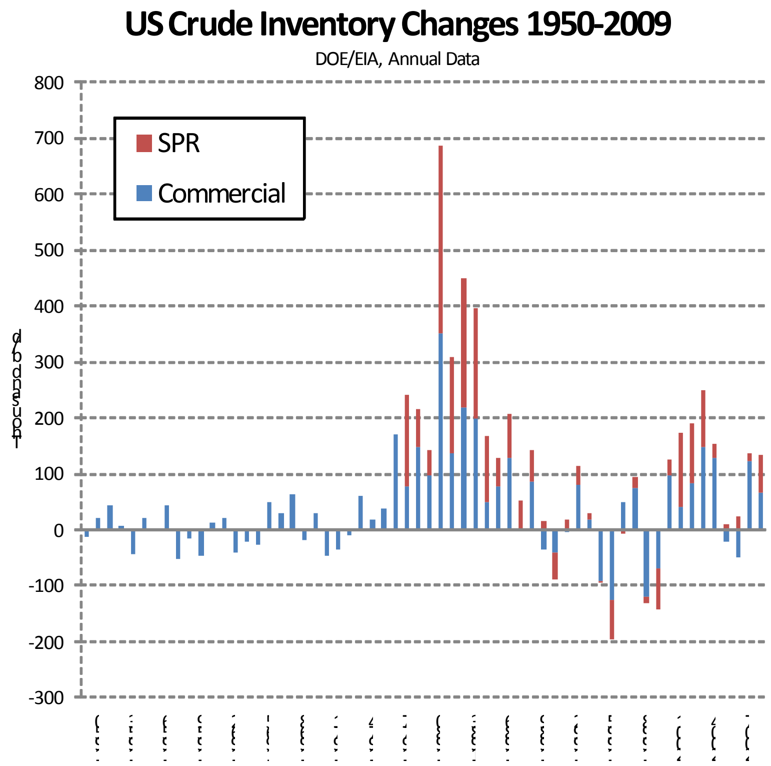


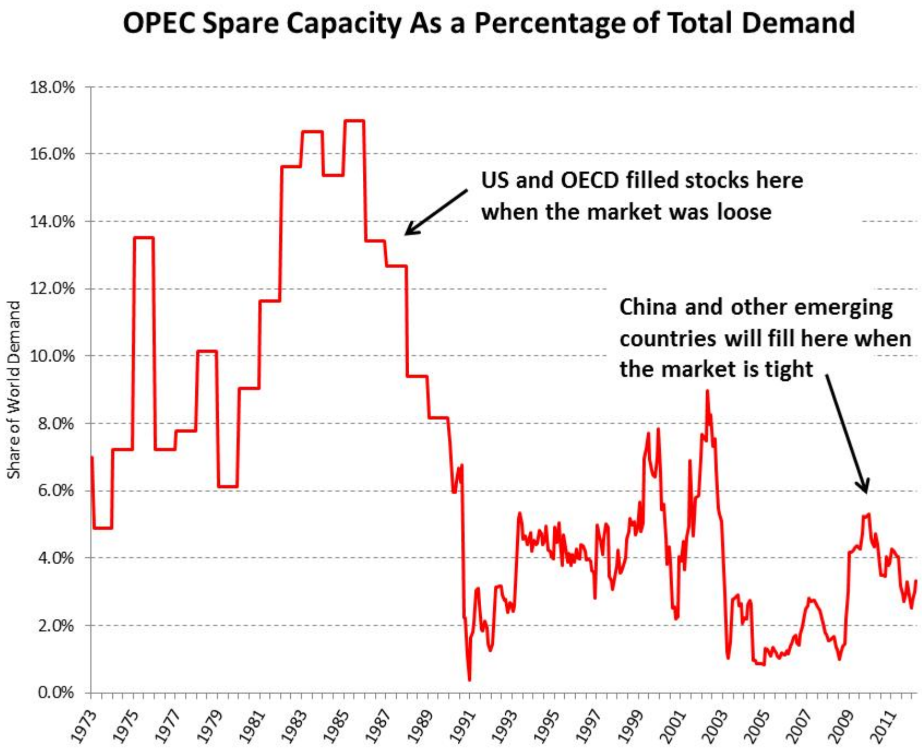
World oil demand's shift toward faster growing and less price-responsive products and regions, by Joyce M. Dargay and Dermot Gately, February 2010

http://www.econ.nyu.edu/dept/courses/gately/OilDemandDargayGatelyFeb2010.pdf

China Is Scrambling to Build Stocks In a Tight Market

The US was lucky to fill stocks with oil freed up by demand-switching, recessions and non-OPEC supply surges

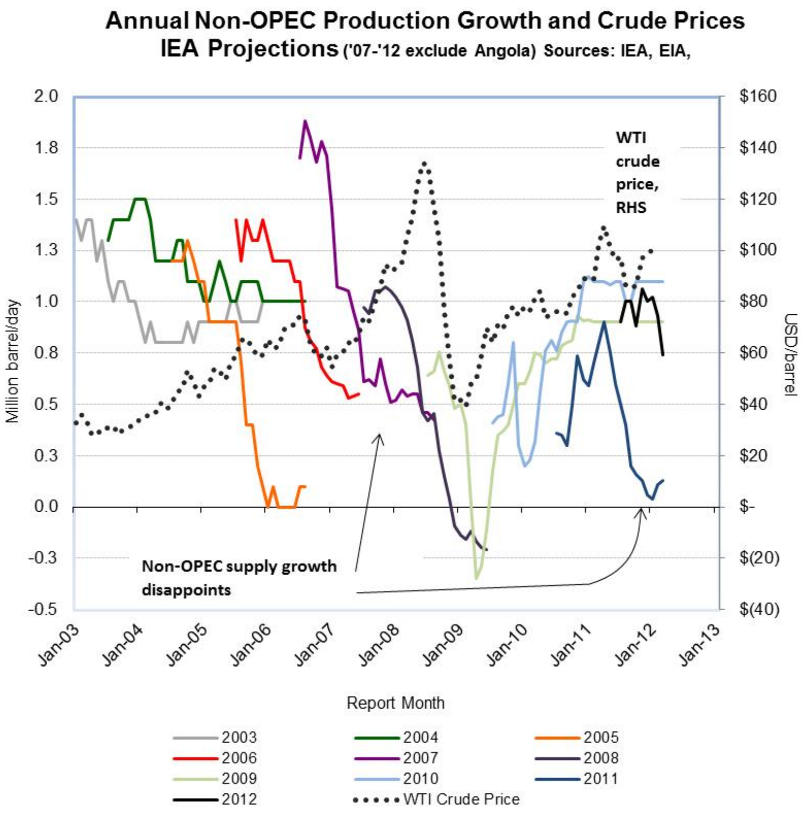




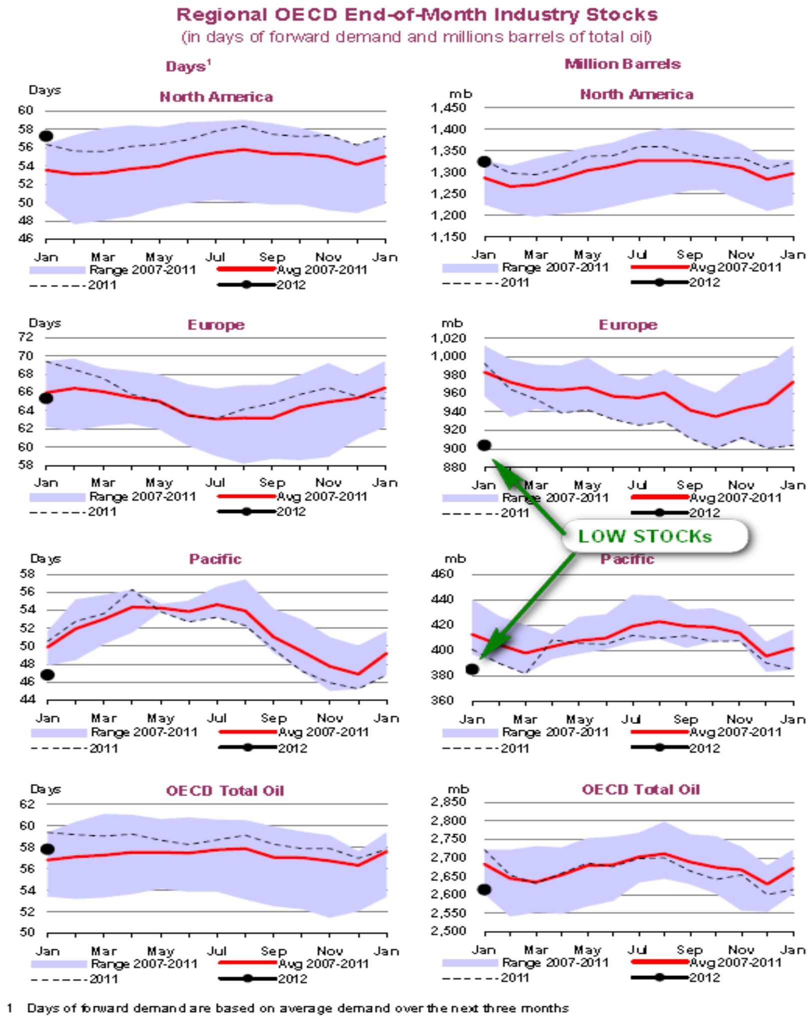
Data: DOE/EIA

Current Status – Oil Market is Tight and Fearful

Non-OPEC supply growth disappoints….

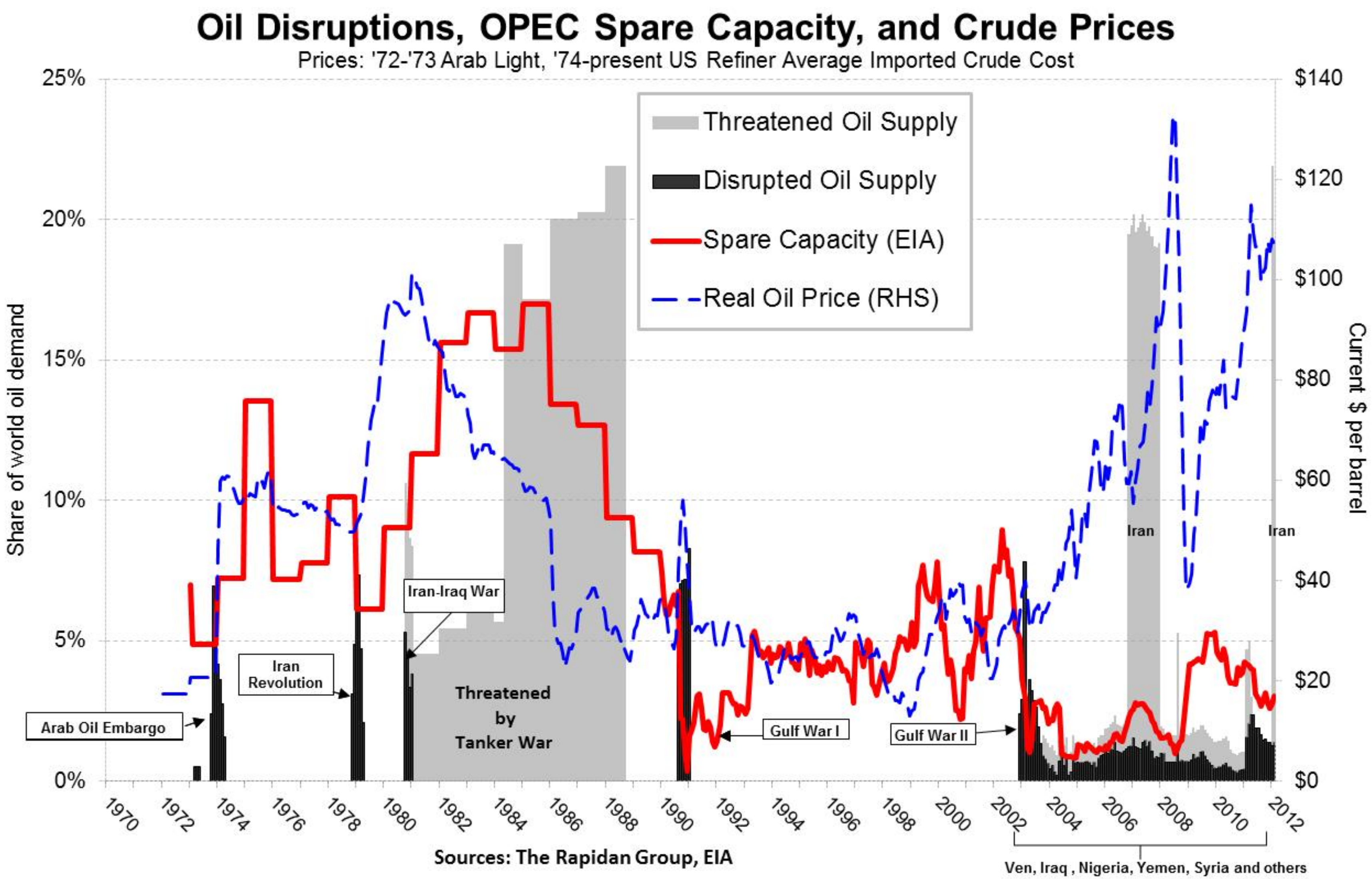


…Inventories are low outside North America.



Sufficient Spare Capacity?

Barely, and Not If Disruption Risk Returns



The Rapidan Group - Geopolitical Event Risk Calendar/Crude Oil – Mar '12 through May '12

Timing is approximate unless noted. Event probability denoted as follows: ^^^ high, ^^moderate, ^low

March | April | May

Crude bullish (rising prices)

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^^Iran: sanctions-related tensions to rise in the Gulf – wild card risk of an overt attack on nuclear program and global reprisals – Fordo, direct and indirect sanctions impacts and Iranian reaction are key risk drivers. Syria playing indirect role.

^^^Mar 30 Pres. Obama's Iran/supply adequacy decision

^^^End-April EIA supply/price adequacy report

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^^ Iraqi civil conflict/instability. Possible repeat of large (0.6-0.7 mb/d) but brief Rumaila bombing disruptions on Oct 7 and Dec 13

^^^Mar 5 IAEA report and board meeting on Iran / PM Netanyahu in DC

^^ Sudan – Ongoing dispute between North and South risks becoming military conflict. ~350 kb/d of South crude production currently disrupted.

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^Mar 2 Iranian parliamentary elections

^^^ April 1 Several Iran term crude contracts expire

^^^End-May EU review of sanctions

^^Libya: Restart of production and exports discounted; now infighting, instability, and downward revisions threaten reported production levels

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^Nigeria: Worsening unrest in north could trigger reprisals in oil-producing south; strike risk low but MEND violence may pick up

^ Syria - EU ban on 150 kb/d of Syrian oil exports in full effect, Assad's descent threatens Tehran

^Kazakhstan: Unrest between labor, oil management and state could raise supply worries for Europe and China

^^^ May 4 West Bank/Gaza elections

^ Egyptian elections have shown Islamist parties consolidating power, with Muslim Brotherhood demanding military cede power

Crude bearish (falling prices)

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^^ P5+1/Iran talks could resume

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^ SPR use likely even absent a major disruption if Brent and/or pump prices continue rising above macro pain threshold levels.

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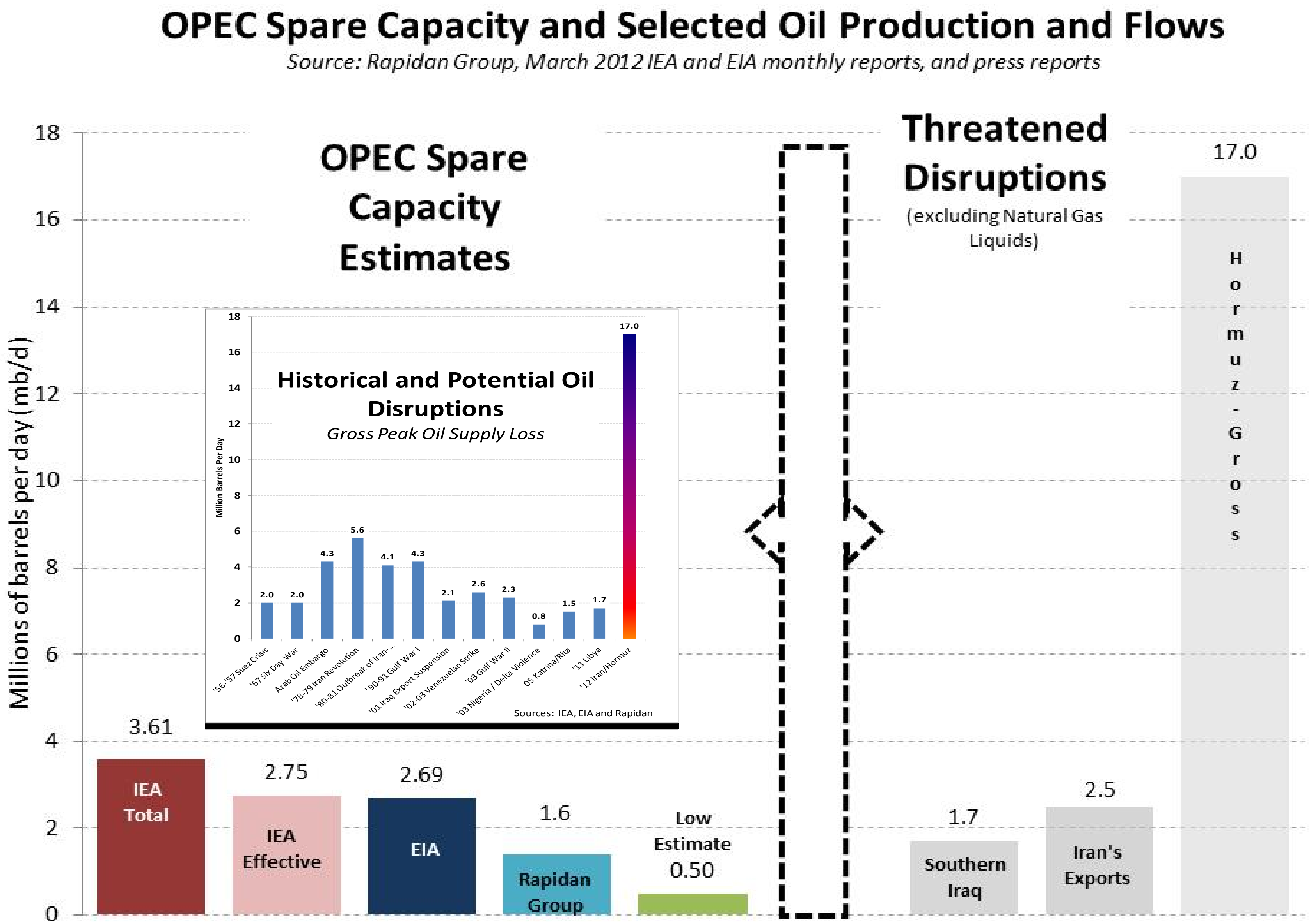
This month's key changes: P5+1 talks restart and possible SPR use new short term bearish drivers.

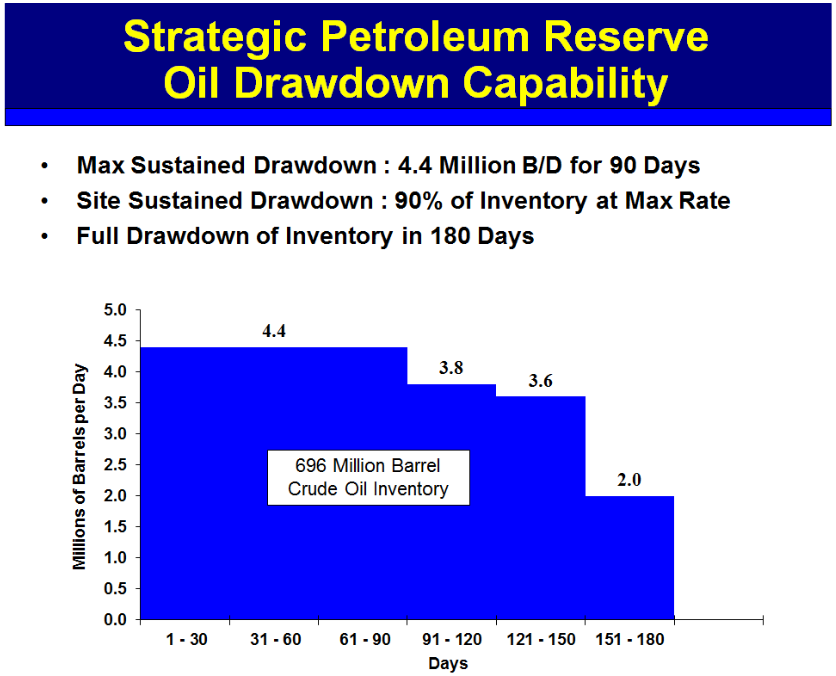
Spare Capacity Not Enough For Peacetime, Much Less Additional Disruptions



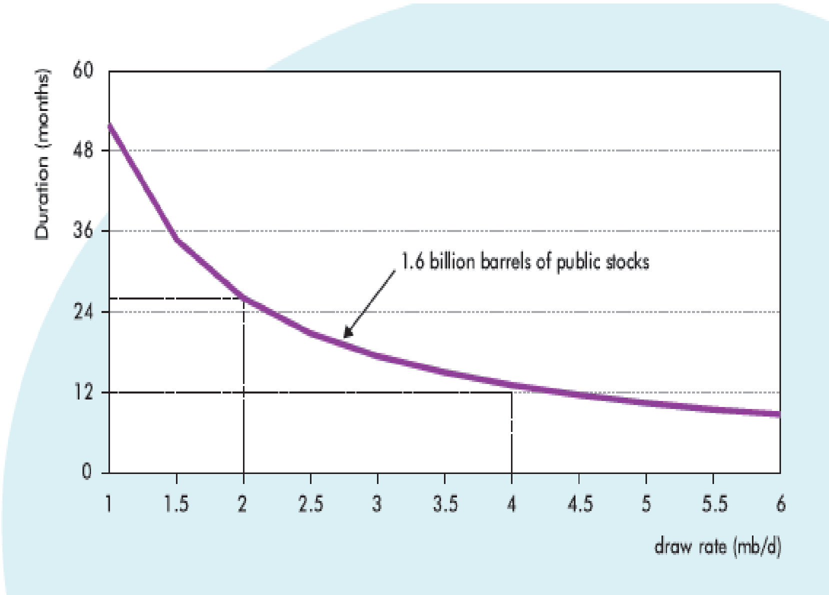
Strategic Stocks Are Available

Recently US SPR drawdown rates have come under scrutiny

US Strategic Stocks



IEA Strategic Stocks



IEA, 2010

Scenarios

1. Iran freezes enrichment to enable negotiations to begin and stop the drift toward conflict – crude oil prices drop by about $5-10 per barrel as risk premium exits.
2. Conflict – Tensions escalate into overt military conflict - (See next page)
3. Iran achieves a hardened breakout capability or nuclear weapon

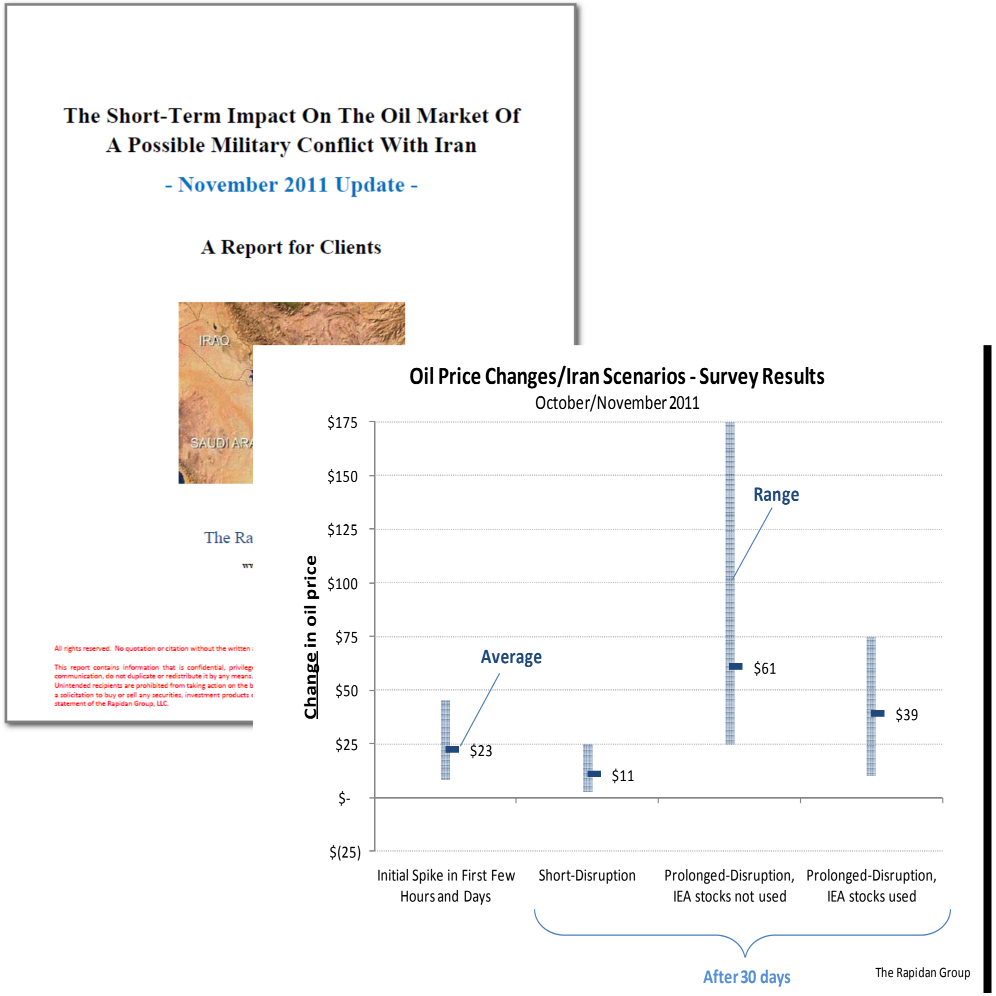
    No major impact on oil prices in 2012 but worst case for oil price stability afterward

    Stable Cold War "Containment" paradigm unlikely to work with Iran and the Persian Gulf Region

    - Cold War was very violent and nearly catastrophic in first decades – in Iran/Israel's case this initially violent/uncertain phase would play out in the confined but energy-critical Middle East.
    - Containment requires credible deterrence, testing/demonstration of capabilities – how will oil and LNG prices respond to Israeli, Iranian, Saudi, and other nuclear tests?
    - Cold War: bilateral; secure, conservative regimes, risk-averse; 70 years of ideological hostility. Iran: Poly-nuclear Middle East; insecure and reckless regimes; religious/ethnic conflict spanning millennia.

Conclusion: Nuclear, hostile Iran + tight oil market = prolonged and high disruption risk and turbulent oil and LNG prices.

Iran-Related Conflict: Short Term Oil Price Impacts



Source: *The Short-Term Impact On The Oil Market Of A Possible Military Conflict With Iran - November 2011 Update, The Rapidan Group*

(We are in the process of updating this study)

Other crude price estimates

- Bank of America – loss of Iran's 2.5 mb/d = $140 WTI crude.
- IMF – loss of 1.5 mb/d Iranian supply = initial price of $120-$130 WTI crude (Brent about $10 higher)

LNG

- 33% of global LNG flows through Strait of Hormuz
- Damage to Qatar's Ras Laffan production complex a risk
- Ras Laffan vulnerable to Iranian missiles; repairs could take years
- Most immediate impact on spot cargoes (19% of supply)
- Impact worst in winter, when gas demand peaks

Contact: report@tky.ieej.or.jp