What Scrapping the Iran Deal Would Mean for Oil Markets

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OPEC Awakens

Members of the Organization of Petroleum Exporting Countries (OPEC) meet November 30 in Vienna and have been negotiating in advance of this meeting in earnest to reach an agreement to curb production and boost oil prices. Saudi Arabia, which showed little interest in managing the market following the initial oil price collapse in late 2014, has changed course, and seems eager to reach a deal. In late September, OPEC nations agreed to reduce output to a collective level of 32.5 to 33 million barrels per day (b/d). At the time, OPEC production was 33.2 million b/d, but has since risen to 33.6 million b/d in October by its own estimate.

Several sticking points to a deal remain. Among the most difficult is Iran's participation. At the meeting in September, it was agreed that Iran would be asked to freeze production, although the level at which it will freeze is under negotiation. Saudi Arabia has said it wants to Iran to freeze at "current production levels", while Iran has been pushing for a level of 4 million b/d or higher. Iran reported to OPEC last week that it produced 3.9 million b/d in October, although secondary sources put the figure at 3.7 million b/d.

The Return of Sanctions?

Complicating the outlook is the election of Donald Trump as President of the United States. Trump has suggested that he opposes the Iran nuclear deal – or Joint Comprehensive Plan of Action (JCPOA) as it is formally known—and intends to renegotiate it. He has argued both for a renegotiation that permits greater U.S. economic access to Iran and for more severe terms for Iran's nuclear program. It is likely, though not certain, that the demand for more stringent terms will be the focus of his agenda, with Iran facing the choice between conceding ever more nuclear activities and rights and losing the sanctions relief conveyed in the JCPOA. As one of us has argued previously, renegotiating the Iran deal will prove far more difficult than Trump may anticipate.

Were the JCPOA to fall apart, it would mean the restart of the U.S. sanctions effort. The Trump Administration would get to decide what sanctions measures to relaunch but would almost certainly reimpose sanctions on the purchase of Iranian oil, a key part of the pre-JCPOA sanctions regime that is still on the books but waived while the JCPOA is in force. The law sets up a simple choice: countries purchasing Iranian oil must reduce their purchases by a significant amount every six months or see their companies and banks associated with the oil trade be denied access to U.S. markets. For major banks and oil companies, such a threat could be the equivalent of a death sentence.

In November 2013, these sanctions were put on hold, with the completion of the initial Joint Plan of Action (JPOA), an agreement between Iran, the United States, and U.S. negotiating partners in the P5+1 (which, in addition to the United States, included China, France, Germany, Russia, and the United Kingdom). When the follow-on JCPOA was implemented in January 2016, these sanctions were reversed, allowing Iran to sell how ever much oil it wished to whomever it wished and to receive the revenues from these sales.

Prior to that, from 2011 to 2013, the United States required buyers of Iranian oil to reduce their purchases by 20 percent every six months. In other words, for countries still purchasing Iranian oil in 2013, they would have had to buy roughly 60% less oil by that point than they did in 2011.

The U.S. sanctions resulted in a reduction of Iranian oil exports from around 2.4 million barrels per day (bpd) in 2011 to just under 1 million bpd in 2013. U.S. sanctions also targeted the shippers of Iranian oil, insurers of Iranian oil, and banks that hold the revenues from Iranian oil. This campaign demonstrated the strength of the U.S. ability to influence foreign economic decisions by leveraging access to the U.S. economy, and was responsible for depriving Iran of access to some $50 billion in oil revenue during that time. Opponents of the nuclear deal – and Trump himself – may believe that they can equal or better the success of this campaign.

Even if the OPEC deal collapses, therefore, it is possible that the reimposition of U.S. sanctions against Iran would still pull large volumes of OPEC oil off the market from Iran, with significant consequences for the oil market.

Realities of sanctions reimposition

The extent to which reimposing sanctions would pull Iranian oil off the market must be considered in the context of today's circumstances. In 2011-2013, the United States had a compelling story to go along with its sanctions, offering to enter into constructive negotiations on a diplomatic outcome to the Iranian nuclear problem. If Trump were to reimpose sanctions, he would do so in an international environment that is deeply skeptical of his presidency and which may be greatly perturbed by his reversal of a nuclear arrangement that most world capitals endorse and support. It is unclear whether foreign governments, much less foreign companies and banks, will cooperate with the U.S. sanctions strategy.

Some may go along with the United States and reduce their purchases of Iranian crude. Japan and South Korea, for example, may fear for the future of the U.S. alliance in a Trump Administration that seems decidedly hostile to allies not seen as paying their fair share (a spurious charge, but nonetheless one Trump has made). Europe may also choose to work with the Trump Administration for much the same reason. Other countries could be motivated by the threat of having their companies and banks denied access to the United States, literally the ability to do business with U.S. companies and banks, operate in the United States and use the U.S. dollar.

On the other hand, it's also possible to generate an alternative scenario. For example, Japan, South Korea, and Europe may choose to push back on the Trump Administration, underscoring both their own energy security needs and their refusal to permit the United States to wreck the JCPOA, viewed by these countries as a significant achievement for international security. Europe has, in the past, fought U.S. sanctions legislation, including through threatened suits at the World Trade Organization. Likewise, Japan and South Korea may look to China to see whether it decides to cooperate, which seems unlikely both because China was a recalcitrant sanctions partner previously, and out of frustration for the overall tenor of Trump's approach to trade and economic cooperation with China. Similarly, Turkey and India – other major importers of Iranian oil – could be difficult partners in a renewed sanctions effort.

From an oil market standpoint, sanctions cooperation was made easier previously by the dramatic rise in U.S. oil production that more than offset the loss of Iranian supply. U.S. oil production rose from 6.1 million b/d in January 2012 to a peak of 9.7 million b/d in April 2015. While U.S. production has fallen to 8.7 million b/d, it could rise quickly again if oil prices get a boost from new sanctions against Iranian supply or for other reasons. The Dallas Federal Reserve estimates that the breakeven cost of US shale has fallen from $79 per barrel in 2014 to $53 today. And various projections find that at an oil price of $60 per barrel, U.S. supply could grow between 300,000 and 900,000 b/d annually in the next few years. Additionally, the global market is also currently oversupplied and has very high levels of inventory, making it easier for buyers of Iranian crude to find alternative sources of supply.

At the same time, the oil market is global. If certain countries comply with new sanctions against Iran, but others do not, it would merely shift oil flows, so that Iranian sales are rerouted to countries that choose to ignore new unilateral U.S. sanctions - making it more difficult for those that adhere to sanctions, while providing better access for those that do not. Moreover, Europe previously reduced its purchases of Iranian oil from around 600,000 b/d to zero because it, too, imposed sanctions. This time, it may not do so – obtaining the consensus support of 28 EU members would be difficult at best – and it is instead more likely that individual European companies and countries would gradually reduce purchases to comply with U.S. sanctions, following the path of countries like Korea and Japan, and thus reducing the impact of sanctions on Iranian output this time around. There may also be a large black market in Iran oil purchases, especially if a large consumer like China decides not to comply.

<u>OPEC now</u>

The other question to consider is what the possible reimposition of sanctions against Iran does to Iran's negotiating posture within OPEC. Is Iran more or less inclined to strike a deal and freeze at levels acceptable to Saudi Arabia because the U.S. may soon reimpose sanctions against Iranian oil sales?

On the one hand, Iran may wish to freeze output to shore up support within OPEC and get prices up to earn as much revenue as they can while they still can. Iran may also be less concerned about deterring foreign upstream investment by freezing output if it believes sanctions may soon be reimposed. Most importantly, Iran has likely increased its output as much as it can in the near term, and getting an agreement is in Iran's interest not only to maximize revenue, but also to make markets tighter and thus make buyers of Iranian crude less willing to go along with new U.S. sanctions.

On the other hand, Iran may wish to run up its output if it fears it may soon be isolated, need to find new buyers, and need sell oil to countries that violate U.S. sanctions at a discount.

Conclusion

Even if OPEC can't reach an agreement to cut production, the U.S. may be about to do some of that work for them by sanctioning Iranian oil sales again, and thus pushing up oil prices if other nations again significantly reduce their purchases of Iranian oil in response to diplomacy and the threat of sanctions. But that is far from certain, and there are many more reasons to be skeptical today than in the prior 2011-2013 period that most or all buyers of Iranian crude will comply and thus force a sharp reduction in Iranian oil exports. To the extent pulling Iranian oil off the global market again forces up prices, U.S. shale is also poised to rapidly grow its production, thus acting as a new limit on how far prices can rise in response to production cuts caused by an OPEC agreement, sanctions or any other reason. Beyond the oil market impacts, unraveling the Iran deal would bolster the position of the hardliners in Iran, reinforce the perception that reformists were duped by Americans acting in bad faith, and set back the potential for further political moderation in Iran – as well as any chance of a renewed nuclear deal – for many years.

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