An Iran nuclear deal would likely bring only moderate relief to the oil market

- The Ukraine crisis has pushed Brent well above USD 100/bbl. Even if energy flows from Russia remain unaffected, the market will continue to price in a sizable geopolitical premium.

- News agencies report that negotiations between western countries and Iran on a new nuclear deal are in advanced stages, and that a deal could be agreed within days, although sticking points remain.

- Given the output constraints faced by several OPEC+ producers, a return to the market of Iranian oil could ease production pressure already in the spring. But the Ukrainian crisis will remain the main driver of Brent prices in the coming weeks.

Brent prices have risen by more than 33% YTD, jumping from USD 78/bbl in early January to around USD 105/bbl at the time of writing. While the inability of OPEC+ to deliver to the market the promised barrels of oil has played a role, the Ukraine crisis is by far the main factor behind the recent price movements given the ramifications for the energy market. While the situation in Ukraine is evolving quickly and in unpredictable ways, so far neither Russia nor the Western allies have leveraged energy as a diplomatic tool to inflict losses on the other side. Europe, but also the US, is dependent on natural gas and oil coming from Russia. And Moscow's public finances rely on oil revenue.

The day after recognizing two breakaway Ukrainian republics, President Vladimir Putin stated that Russia guaranteed the uninterrupted supply of natural gas to the world market. Equally, for the time being, Western sanctions have not targeted any Russian company or bank that is relevant for the energy sector. Germany's decision to suspend administrative approval of the Nord Stream II pipeline will have no material effect on the energy market as the pipeline was not yet in operation – Nord Stream I, on the other hand, which is up and running, has not been sanctioned.

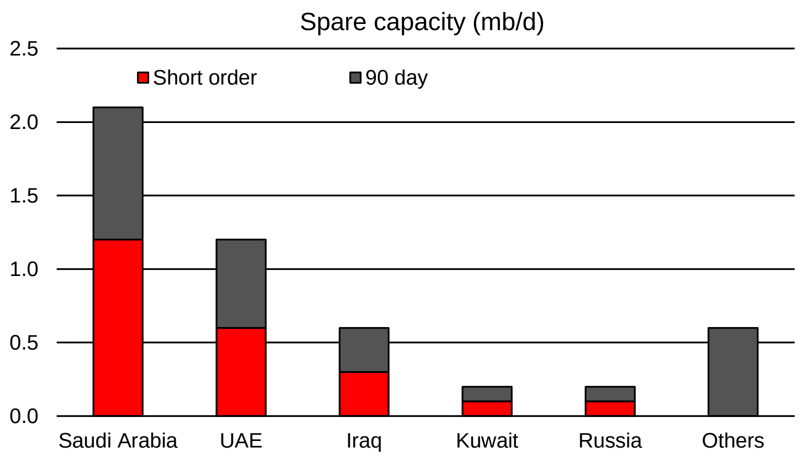
While there is a rising risk that military tensions might damage the natural gas pipelines that run through Ukraine, we are still assuming energy flows from Russia remain unaffected. Therefore, tensions in the region will not impact oil prices via the physical market but rather via market sentiment as Brent will continue to incorporate a sizable and rising geopolitical premium until a resolution of the crisis is achieved. In the meantime, some contained market relief might come from the fading of another geopolitical risk, the stalled negotiations of the Iran nuclear deal. Given the output constraints faced by several OPEC+ producers, a return to the market of Iranian oil could ease production pressures already in the short term but would bring only limited price relief as the Ukraine crisis would remain in focus.

OPEC+ constraints

As we discussed in a recent Chart of the Week, the oil market is tighter than it would be if OPEC+ members were in full compliance with production targets. In December, actual OPEC+ production was 790kb/d below target – the equivalent of two months without increasing production. The missing barrels amount to almost 1% of pre-pandemic global oil production. The two main contributors to the shortfall are Nigeria (450kb/d below target) and Angola (250kb/d below quota). These countries are running out of spare capacity after years of underinvestment (Nigeria's pipelines are leaky and Angola's deep-water fields are in decline) – something that cannot be reversed quickly. Nigeria's December target was 10% above its sustainable capacity (production that can be activated within 90 days and sustained for a prolonged period of time), and Angola's target is almost 18% more than what it can sustainably produce. The situation could also worsen for other countries. By the end of the year, Russia should be producing 11mb/d but its capacity is just 10.6mb/d.

According to the latest estimates by the International Energy Agency, in January OPEC+ raised production by only 280kb/d compared with a planned 400kb/d increase. There are essentially two ways to boost production for the cartel. First, countries with higher spare capacity could be allowed higher production quotas. The spare capacity that could be brought online in very short order (which is needed in the current environment of supply shortages), primarily by Saudi Arabia and the UAE, amounts to around 2.2mb/d of 5.1mb/d of total spare capacity (Chart 1). This is enough to address current supply shortages, but such a solution would be a source of inevitable diplomatic and political tensions within the cartel.

CHART 1. CONCENTRATED SPARE CAPACITY

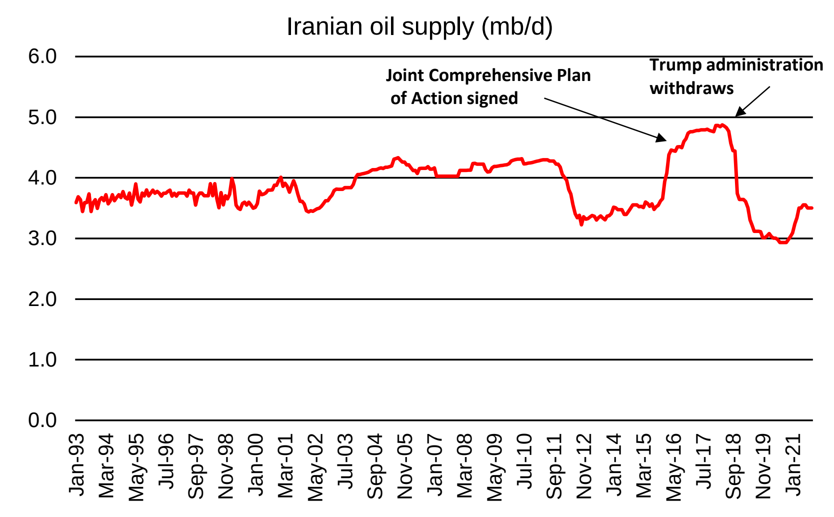


Source: IEA, UniCredit Research

Second, another possible source of relief could come from the signing of a new nuclear deal with Iran – an OPEC+ member that at the moment is exempted from the output cuts. When the Trump administration withdrew from the Joint Comprehensive Plan of Action with Iran in May 2018 and sanctioned Iranian oil exports, Teheran's oil production dropped, almost overnight, from around 5mb/d to 3mb/d (Chart 2). In recent months, production has increased by about 500kb/d thanks to the smuggling of sanctioned Iranian barrels, primarily to China, which is trying to build large inventories in its attempt to mitigate negative spillover from the natural gas crisis. Also Syria and Venezuela continue to import petroleum products from Teheran.

Iran's spare capacity amounts to around 1.5mb/d – roughly 65% more than OPEC+ is currently short of its target. Given how quickly Iranian production responded to the signing of the nuclear deal in 2015, there are expectations of a potentially fast return of Iranian oil exports to the market. According to some estimates, production could increase by about 500kb/d by the end of April and by about 1.3mb/d by the end of the year. From the point of view of OPEC+ members, it would be more acceptable to see Iran normalizing its production after years of sanctions than Saudi Arabia or the UAE boosting their production, when its production quotas were, de facto, well below what any other producers faced even at the peak of the pandemic. Clearly, a return of Iranian oil would require updating the OPEC+ deal and revising quotas, but given how challenging it is for several producers (particularly Nigeria and Russia) to meet their production targets, Teheran's production would contribute to preserving the credibility of the cartel in its attempt to taper production cuts.

CHART 2. IS IRANIAN OIL COMING BACK?



Source: IEA, UniCredit Research

How far are we from a new deal?

When nuclear talks reach a sensitive point, it is difficult to predict if and when a deal will be achieved and, more importantly, what it will look like. Iran has been in negotiations with delegations from the US, China, Russia, France, Germany and the UK for more than ten months. Back in January, US Secretary of State Antony Blinken stated that only “weeks” remained for the Iran talks to reach a “successful conclusion”: The escalation of the Ukraine crisis – and its repercussions for energy prices (and thus inflation and the economic recovery) – creates an incentive to accelerate the negotiations, which could be concluded swiftly according to some media reports.

One of Iran’s pre-conditions for signing any agreement is a pledge from the US that future administrations will honor the deal and will not reimpose sanctions without justification – something that cannot be guaranteed, clearly. The Iranian government has agreed that, in exchange for the lifting of sanctions, it is willing to reinstate extensive international monitoring of its nuclear program and bring uranium enrichment back within defined thresholds. An agreement would support our view that supply will continue strengthening going forward. However, a significant impact on the physical market would not be felt until the end of the year. In the short term an agreement would only partly mitigate the price impact of the Ukrainian crisis, which will remain the main driver of Brent in the coming weeks.

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