

Iran Nuclear Deal: Scenarios for the Global Oil Market

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A Product Of



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SUMMARY

- With the July 20 deadline for the P5+1 nuclear talks with Iran fast approaching, Securing America's Future Energy (SAFE) and Roubini Global Economics (RGE) have assessed three potential oil market and geopolitical scenarios based on differing outcomes from the negotiations: a temporary deal (70 percent probability); a final settlement (20 percent probability); and a failure to reach agreement (10 percent probability).
- A **Temporary Deal** could lead to modest increases in Iranian exports from the H1 2014 average of 1.4 million barrels per day (mbd) to 1.6 mbd by the end of 2014 and as much as 2 mbd by mid-2015 if rollovers become the norm. However, extensions will become unsustainable, raising the probability of settlement or failure later in 2014 into 2015.
- **Final Settlement** would eventually lead to higher levels of output. Yet, even if sanctions are lifted, Iran's oil output is expected to remain below the 2011 level of 4.2 mbd through end-2015 (exports rising to 2.5 mbd and production to 3.6 to 3.8 mbd). Despite the technocratic leadership of key Iranian ministries, Iran's bureaucracy and tough business environment will remain hurdles for foreign partners.
- If there is **Failure to Reach Agreement**, sanctions can be expected to tighten somewhat, pressuring Iranian exports back toward their 2013 average of 1.0 to 1.1 mbd by the end of 2014. However, we note that reinstituting sanctions is likely to be exceedingly difficult, especially at a time of oil market tightness. The negotiating partner countries cannot afford an oil price spike, and the U.S. will not want Iran to play a destabilizing role in Iraq.
- We would expect oil prices to ease slightly under either of the first two scenarios (\$110 and \$105/bbl Brent, respectively, by the end of 2014), in the absence of other changes in the global market, but likely rise under the failure scenario, which brings with it a higher chance of military conflict and regional destabilization (\$120+/bbl).

INTRODUCTION

In November 2013, Iran and the P5+1 negotiators—the United States, Russia, United Kingdom, France, China, and Germany—reached an initial agreement that essentially halted the development of certain components of Iran's nuclear program in exchange for limited sanctions relief. This Joint Plan of Action (JPA) specified that negotiations toward a long-term, comprehensive settlement would be extended but expire on July 20, 2014. In the lead-up

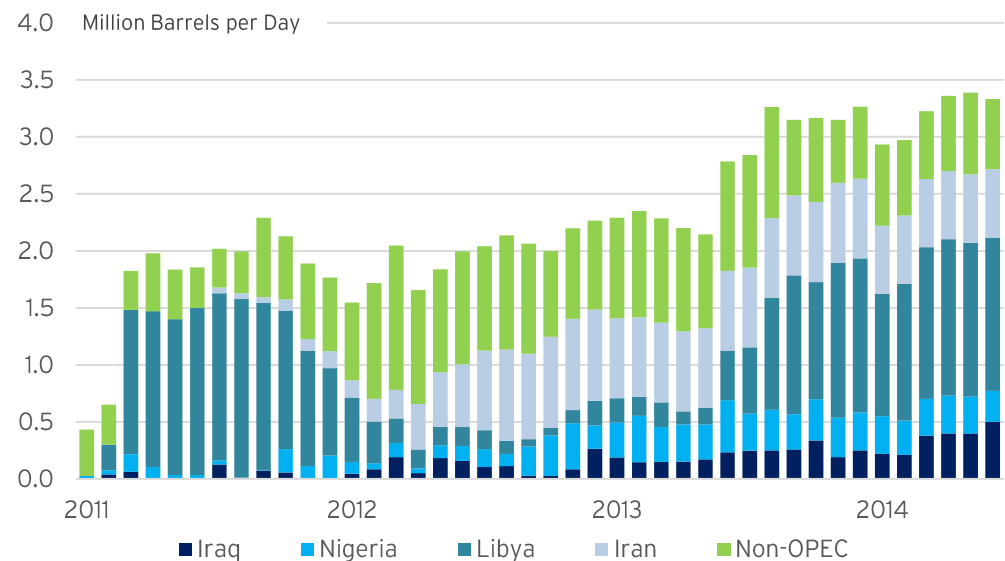
to the expiration, this Intelligence Report assesses the impact that various outcomes might have on global oil markets in the near and medium term.

The report presents three potential scenarios through the end of 2015, including a “Temporary Deal,” or continuation of status quo negotiations, a “Final Settlement” scenario that creates a pathway to normalization for Western relations with Iran, and a “Failure to Reach Agreement” scenario that halts or reverses recent sanctions relief. Under the first two scenarios, oil output would increase, albeit modestly in the case of a Temporary Deal. Under the third scenario, however, oil output would reverse its recent gains as sanctions are reinstated.

Oil markets have tightened sharply since early 2013 due to a surge in global supply outages and robust demand growth.

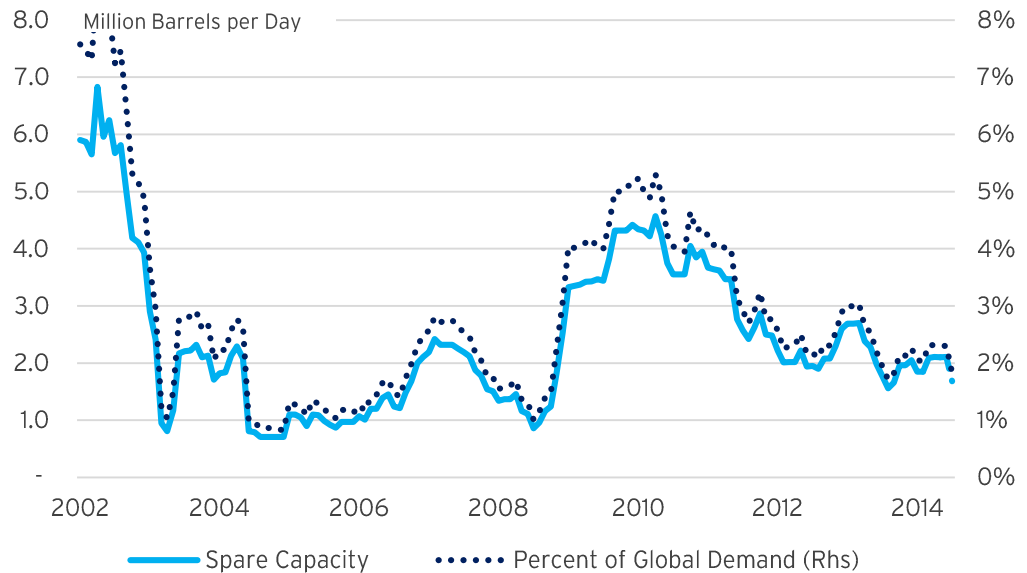
Previous work published by Securing America's Future Energy (SAFE) and Roubini Global Economics (RGE) in [April 2013](#) argued that rising non-OPEC supplies, expanding OPEC production capacity, and moderate global oil demand growth provided an opportunity to strengthen Iran sanctions last year. Since then, oil markets have tightened sharply due to a surge in global oil supply outages (Figure 1), a decline in operable OPEC production capacity, and more robust global demand growth. Based on current projections for global demand and non-OPEC supply growth, consensus estimates suggest that OPEC—principally Saudi Arabia—will need to increase crude production from current levels by up to 0.6 mbd in H2 2014. Such an increase will further erode already thin margins of OPEC spare capacity, which stands at 1.7 mbd (DOE, EIA). Some estimates suggest that OPEC spare capacity could actually be as low as 1.3 mbd, completely held by Saudi Arabia ([WSJ](#), June 23).

Figure 1: Global Oil Supply Outages, 2011– 2014



Source: SAFE analysis based on data from DOE, EIA

Figure 2: OPEC Spare Production Capacity



Whatever the outcome of the P5 +1 negotiations with Iran, it will be significant for oil markets.

In this context, whatever the outcome of the P5+1 negotiations with Iran, it will be significant for oil markets. Though unlikely in our view, Final Settlement could pave the way for Iran to recapture its status as OPEC's second largest producer and exporter and ease global market fundamentals in the near and medium term. Even a Temporary Deal that allows for the return of a limited volume of Iranian crude would ease the supply-demand balance and have a moderating effect on global oil prices in H2 2014, particularly if instability in neighboring Iraq continues to pose a risk. (See SAFE's [recent publication](#) on Iraq for more detailed analysis of the potential oil market implications of further instability in that country).

Alternatively, Failure to Reach an Agreement with Iran has the potential to result in a return to stricter oil and financial sanctions, which have eased substantially in H1 2014 due to suspensions included in the JPA and less extensive enforcement. Even moderate reductions in output would tighten markets further for the remainder of the year unless some combination of Libyan, Iraqi, or Nigerian barrels returns to the market on a sustained basis—unlikely in all cases—or spare capacity is tapped.

U.S. and European policymakers may be limited in their ability to fully reinstate sanctions without risking a price spike.

While the foreign policy objectives with respect to Iran will be the overriding drivers in the negotiations, the impact that oil market conditions could have on the talks should not be discounted. Specifically, U.S. and European policymakers are likely to find themselves limited in their ability to fully reinstate or tighten sanctions without risking a damaging price spike that would affect all major oil consumers and the global economy. In addition, the United States finds itself in the position of seeking to avoid Iran playing a destabilizing role in Iraq, itself central to oil markets. Meanwhile, Iran's largest emerging economy buyers—notably China and India—have already developed new ways of routing payments and insuring their cargos.

STATE OF IRANIAN OIL OUTPUT AND IMPACT OF JOINT PLAN OF ACTION

Annualized data for the first half of 2014 suggest Iranian oil export revenues are on track to hit \$75B this year, up from \$60B in 2013.

The 2012–2013 round of economic sanctions took roughly 1.5 mbd of Iranian oil production and exports offline between early 2012 and mid-2013 and sharply reduced Iran's access to the revenues earned from its oil output. Most large buyers in OECD Europe completely eliminated their purchases of Iranian crude after Q2 2012. The five remaining major buyers—Turkey, China, India, South Korea, and Japan—all reduced their purchases to varying degrees, earning waivers that allowed them to continue importing smaller volumes of Iranian crude. Estimates suggest that as a result, Iran's oil export revenues fell by \$25.6 billion between 2011 and 2012, from \$95.4 billion to \$69.8 billion. Revenues are estimated to have dropped to as low as \$60 billion in 2013, but annualized data for the first half of 2014 show that number to now be as high as \$75 billion (assuming oil exports are constant at 1.4 mbd and Brent price of \$110/bbl). These estimates assume that Iran did not discount its oil much—an assumption that may be more difficult going forward as it seeks to increase its market share.

Figure 3: Imports of Iranian Crude

Thousand Barrels per Day	2011	2012	2013	Change 2011-2013
China	555	438	429	-23%
India	312	303	188	-40%
Turkey	187	152	106	-43%
Japan	305	185	172	-44%
South Korea	230	159	128	-44%
Italy	184	65	6	-97%
France	60	2	-	-100%
Germany	17	2	-	-100%
Spain	151	22	-	-100%
Other	493	187	75	-85%
Total	2,494	1,514	1,103	-56%

Source: SAFE analysis based on data from IEA, Reuters, Bloomberg

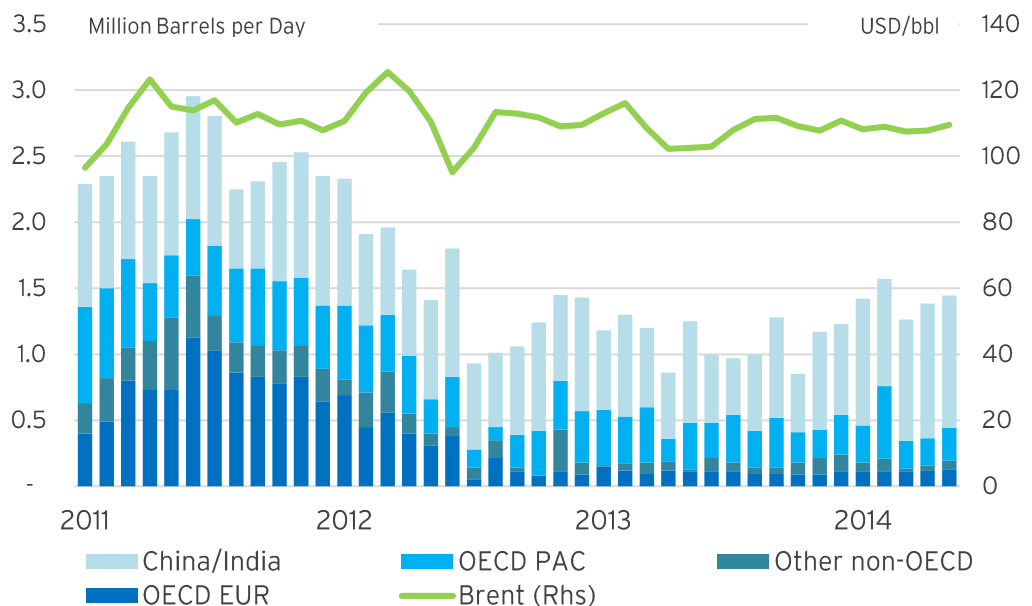
Although broad sanctions efforts—such as the European ban on Iranian imports—have had major economic effects on Iran, the country's exclusion from the global financial system via the Society for Worldwide Interbank Financial Telecommunication (SWIFT) network and its absence from the global insurance market have taken the greatest toll. Lacking both of these channels, buyers of Iranian crude have had to self-insure their cargos which has increased transaction costs. In addition, sanctions have limited Iran's access to foreign assets, which have been locked up in escrow accounts in local currency and can only be utilized to either finance bilateral trade with Iran's five major buyers—China, Korea, Turkey, Japan, and India—or

purchase humanitarian goods. (For more detail, see RGE's [recent analysis](#) with the Foundation for Defense of Democracies.) These developments have kept Iran in the position of being a price taker of key imported goods from China and India, as it has lost the ability to bargain with its suppliers and has been forced into barter arrangements or delayed payments.

Chinese imports of Iranian crude have averaged nearly 650,000 b/d in the first five months of 2014.

Through 2012 and 2013, a combination of increased production from the United States, Iraq and the GCC (primarily Saudi Arabia and the UAE) largely offset the loss of Iranian crude, heavily muting the impacts on global oil markets and prices, which stabilized at pre-sanction levels by Q3 2012. Since early 2014, however, enforcement of oil sanctions has been informally relaxed following the November 2013 JPA, and buyers have received their waivers without a need to make meaningful reductions. In fact, the most recent data suggests that Chinese imports of Iranian crude have risen by as much as 50 percent on an annual basis to average nearly 650,000 b/d in the first five months of 2014, and it is anticipated that Indian volumes have also increased. Total Iranian liquids production has stabilized at around 3.4 mbd as Iran (2.85 mbd crude) has skirted loopholes to increase production of condensates, which it claims are not subject to crude oil targets.

Figure 4: Iranian Crude Exports by Region



THREE SCENARIOS FOR IRANIAN OIL OUTPUT THROUGH 2015

This report assesses three scenarios for Iranian oil production and exports through 2015 based on the outcome of the upcoming negotiations. The base-case scenario assumes that a temporary deal is struck, as allowed in the JPA, and is characterized by an extended negotiating period and a continued suspension of the existing sanctions. Conversations with those close to the negotiations suggest that this is the most likely scenario in the coming

A binary pathway to either a more lasting deal or to a failure of negotiations could develop as soon as the end of 2014.

months, but that a binary pathway to either a more lasting deal (the “Final Settlement” scenario) or to a failure of negotiations (the “Failure to Reach Agreement” scenario) will develop as soon as the end of 2014, especially as political cycles in negotiating countries—U.S. mid-term elections, Majlis (legislature) elections, and EU Commission shuffle—intervene. The upside case assumes a final settlement structure is identified, which would lead to a gradual lifting of sanctions via a legal process that will take a matter of months and years beyond the suspended sanctions. The adverse case assumes that negotiations fail, in which case policymakers in the United States and Europe will come under pressure to reinstate sanctions. This is the least likely outcome in the short term as negotiators, particularly in the United States, seek to avoid an outright failure that could exacerbate other sources of instability in the region and elevate oil prices. The three scenarios are summarized in Figure 5.

Figure 5: Scenario Summary

Base Case - 70%	Upside Case - 20%	Adverse Case - 10%
Temporary Deal	Path to a Final Settlement	Failure to Reach Agreement
Assumptions	Assumptions	Assumptions
<ul style="list-style-type: none"> ◦ Rollover of deal facilitates gradual increase in oil exports. ◦ Suspension, not reversal, of existing sanctions tempers investment. 	<ul style="list-style-type: none"> ◦ Pathway to sanctions reversal prompts foreign investment. ◦ Attractive Iranian terms lure IOCs, but only in 2015 though business environment/infrastructure still an obstacle. 	<ul style="list-style-type: none"> ◦ Deal failure revives U.S. implementation of sanctions waivers on oil transactions and some sector specific sanctions. ◦ Increases the risk of military conflict/regional instability. ◦ Global coalition less united than in 2012 tempers implementation (possible Russia side deal).
Oil Output	Oil Output	Oil Output
Oil output gradually rises towards 3 mbd (exports 1.8-2 mbd) in 2015. No new energy sector investment.	Oil output rises towards 3 mbd in 2014, then closer to 3.5 mbd in 2015. Some investment by Asian NOCs and possibly European IOCs.	Oil output trend reverses, falling back toward 2.5 mbd by end 2014 and closer to 2mbd in 2015.
Oil Price (Absent other fundamental changes)	Oil Price (Absent other fundamental changes)	Oil Price (Absent other fundamental changes)
Brent: \$110 at end 2014.	Brent: \$105 end 2014, \$100 end 2015. Saudi Arabia would likely cut production to keep supply in balance.	Brent: \$120+ due to tighter market and increased risk premium due to regional risks.

BASE CASE: TEMPORARY DEAL (70 PERCENT PROBABILITY)

The base-case scenario assumes that negotiators only reach a temporary deal, which mandates continued diplomacy in the fall of 2014. The divides between the United States and EU, on the one hand, and Iran on the other may remain too wide to reach a full resolution before July 20. Key sticking points include the status of important nuclear facilities (Arak and Fordow) and the number of centrifuges in Iran's possession. A temporary deal would likely include modest sanctions relief—in the form of increased access to foreign assets—and continued suspension of specific sanctions, such as oil waivers and petrochemicals. Some of the initial hurdles that limited the benefit of sanctions relief, including the investment

community's caution to do business with Iran, could also gradually recede, modestly reducing the transaction costs for buyers of Iranian crude.

A roll-over deal could see Iranian exports increase from 1.4 mbd to 1.6 mbd by year-end and 2.0 mbd by mid-2015.

In the case of a roll-over deal (with modest sanctions relief/suspension), Iran's oil output could potentially increase from current levels of approximately 2.8 mbd toward 3.0 mbd by year-end 2014 and potentially higher by mid-2015 if roll-overs become the norm. Meanwhile, Iran's oil exports could rise from 1.4 mbd to 1.6 mbd by end 2014 and 2.0 mbd by mid-2015. Exact volumes would depend on Iran's willingness to negotiate on price—which it has been reluctant to do so far—as well as global oil demand, and whether the relaxation of sanctions implementation allows the rerouting of payments. Meaningful investments in the energy sector or other key sectors would not be expected under this scenario, as long-term investors would likely fear a reversal of policy or legal hurdles. Thus, this scenario implies a cap on Iranian production until a comprehensive settlement is reached.

Admittedly, select official statements from both the United States and Iran could be seen as downplaying the possibility of the six-month extension allowed for in the JPA. Most recently, Iran's Supreme Leader Ayatollah Ali Khamenei, indicated in a speech that Iran requires 190,000 centrifuges, which is well out of line with limits being sought by the P5 +1. However, we see these kinds of statements as a negotiating tactic and believe a roll-over now seems to be the most likely scenario, as the push to reach a deal (the "Final Settlement" scenario) remains high enough that negotiators are unlikely to accept total failure at this point. Failure would carry serious risks for Iran's economy and security. Similarly, the United States and its partners would face risks, including elevated oil prices and a less constructive Iranian approach in Iraq.

It should, however, be noted that the political calendar suggests that a temporary deal is not sustainable indefinitely, and it would lead to a binary choice between complete success and failure as soon as Q4 2014. There are at least three reasons for this. First, President Rouhani will eventually run out of political capital to negotiate with the West as hardliners begin to perceive a deal as impossible. Second, the outcome of U.S. mid-term elections in November could return a Congress to Washington that is increasingly likely to pass further sanctions on Iran. And finally, several key negotiators are set to retire this year, elevating pressure to forge a deal before a new team comes to the table.

UPSIDE CASE: FINAL SETTLEMENT (20 PERCENT PROBABILITY)

In this scenario, negotiators secure a deal that paves the way for a final settlement, with specific non-proliferation steps to be taken by Iran and corresponding sanctions relief over a period of quarters and years. Yet, even under the most optimistic scenario, officially removing sanctions could be slow and take years if the timelines of removing Iraqi and Libyan sanctions prove a guide. This scenario has a relatively low probability in the current round.

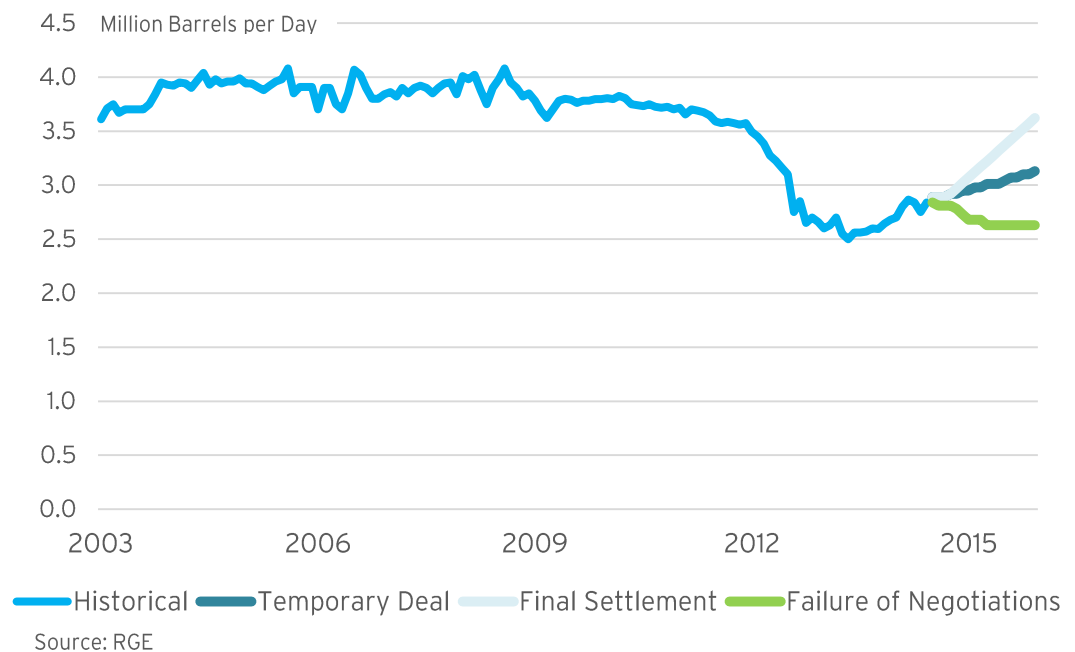
It also appears likely that many of the sanctions would be suspended—not eliminated—until individual national governments take steps to eliminate them legislatively. This could be relatively quick in some European countries if there is consensus within the European Council, which passed the initial sanctions. However, some countries, including the United Kingdom, have sizeable direct sanctions on Iran that would require legislative action to remove. Some legal experts suggest that the close links between European and U.S. sanctions would make it difficult for the removal of Europe's sanctions to have much effect. This suggests that U.S. action would be a key determinant, and that, until such action was taken, U.S.-based companies, including oil services companies and independents, would still find Iran off-limits. In that environment, European producers might remain cautious as well.

Persistent sanctions and damage to existing infrastructure suggest that Iran would struggle to return to previous highs.

Therefore, it is anticipated that Iranian oil output would gradually increase but fall short of past highs in the near term. A combination of persistent sanctions and damage to existing infrastructure from shut-ins suggests that Iran would struggle to return to the early 2012 output level of 3.5 to 3.7 mbd, let alone the 2008 level above 4 mbd. (Iranian oil output fell during the global financial crisis and never regained its previous levels.) Increasing output beyond 3.8 mbd on a sustained basis would require improved investment terms for international oil companies (IOCs) and would likely materialize only after 2015. Iran's government has approached IOCs with some preferred terms, but there is much uncertainty about these possible contracts and implementation risk. Although the technocratic ministers of Rouhani's government are saying many of the right things, the lower level functionaries may struggle to cope with the cost of operations in a globalized industry, including access to raw materials and rigs, for example. While Iran may be able to make this transition, it will take time.

Iran may also struggle to maintain very attractive terms due to its urgent need for revenue and its domestic content provisions, both of which have been recent issues in Iran's fraught energy partnership with China. Nonetheless, assuming attractive terms from the government in Tehran, both foreign national and international oil companies would be interested in investing in Iran due to relatively low production costs and easy-to-access oil. The Iranian government has dangled attractive offers to IOCs in attempts to supplant Chinese companies, which it believes have underproduced. Furthermore, Iran's leaders have been trying to attract investment through attendance at key conferences and by learning from the experiences of OPEC peers that were reluctant to engage in production-sharing agreements.

Figure 6: Iranian Crude Oil Production in Three Cases



From an economic standpoint, Iran's outlook would improve under a Final Settlement due to a revival of both the oil and non-oil sectors, and purchasing power would pick up via the Iranian rial. Positive sentiment—both domestically and internationally—would increase, resulting in positive feedback loops. However, implementation of policy changes might lag, and one could not expect to see immediate improvements in the business environment. It is highly likely that deals which were attractive at the outset would be renegotiated later in the decade.

ADVERSE CASE: FAILURE TO REACH AGREEMENT (10 PERCENT PROBABILITY)

Under this scenario, negotiations collapse as parties are unwilling to compromise, hardening their positions perhaps because of domestic political pressure. Sanctions suspensions would be notionally reversed, as temporary suspensions that were part of the JPA are turned back and the U.S. Congress pushes for new sanctions. In this situation, Iranian oil exports would fall modestly by the end of 2014 to 1.2 mbd and could fall farther in 2015 to below 1 mbd, with financial sanctions on the Iranian central bank still in place.

The global sanctions coalition may be weaker than it was in 2012, suggesting sanctions could have less of an effect.

It should, however, be noted that the global sanctions coalition may be weaker than it was in 2012, suggesting that sanctions could be less binding. Oil markets are a key reason. Conditions in 2012 were flexible enough to support the loss of 1.0 mbd of Iranian crude without driving oil prices higher (Figure 4). The situation today is much different. EIA estimates current spare capacity to be less than 2 mbd, and several forecasts suggest a tighter market in months to come. Meanwhile, instability in Iraq and Libya continues to pressure oil prices, with both countries looming as potential supply losses throughout 2014. Simply put, many oil consuming nations will be hesitant to add new pressures to the market at a delicate economic moment. Asian buyers of Iranian crude might also be less easily coerced into compliance due to logistics. China and India, for example, have found new ways of self-insuring and rerouting payments.

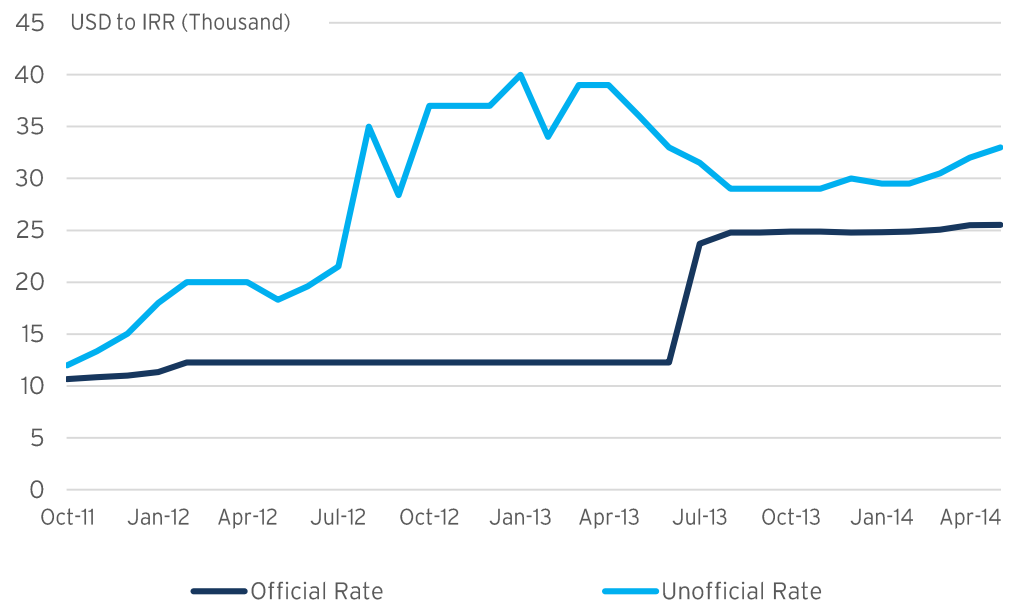
This suggests that this round of sanctions would be less effective than the previous one, and only a modest and gradual decrease in oil export volumes would be expected, first returning to late-2013 levels before moderately decreasing furthering from those levels.

The strength of the coalition also depends on the reasons why negotiations fall apart and who global actors perceive to be at fault. Should negotiations fail due to Iranian intransigence, sanctions implementation and buy-in from global actors might be more extensive than if the United States or European Union is seen to be unreasonable. In the latter case, the P5+1 might splinter, with Russia and China forming a 'Plan B' for Iran. Russia and China may also engage in side deals with Iran to maintain their interests. These could include a rumored oil-for-weapons deal under which Russia would provide goods (weapons and/or machinery) to Iran in exchange for oil, supporting Iranian economic output and denting the effect of any other sanctions.

Indeed, with relations between Russia and the West at a post-Cold War nadir, such actions should be assumed as likely. Iranian government leaders view a deal with Russia as less attractive than a broader deal with the United States and Europe—especially because Russian goods are lower quality, Russian companies have less access to state of the art energy extraction techniques, and such a deal would increase Iran's reliance on a single trading partner. Although a Russian deal is not the Iranians' preferred option—as they would prefer to have U.S. and EU oil companies in their country to extract more oil, increase trade in other sectors and develop competition among export partners—conservative groups in Iran may push for a deal with Russia if they feel that president Rouhani's negotiating team is failing to secure the best deal, or if they fear their interests would be negatively affected within Iran by competition.

Under this scenario, Iran would attract very little investment, with the possible exception of Russian and, perhaps, Chinese companies. Even those foreign companies operating in non-sanctioned sectors would be wary of falling foul of U.S. sanctions, which would prevent them from accessing U.S. markets. These sanctions would reinforce the negative effect of Iran's business environment, which remains subject to corruption and weak institutions. In this scenario, renewed pressure on the Iranian rial can be expected, which would weaken from current levels, bringing domestic inflationary pressures and political stress. The price rise and hit to purchasing power would be less than Iran experienced in 2012 given the country's recent adjustment in imports. In this scenario, the Iranian private sector would remain very constrained, without access to credit from the banks, and the Rouhani administration would be gradually discredited.

Figure 7: The Iranian Rial is Already Under Pressure Again

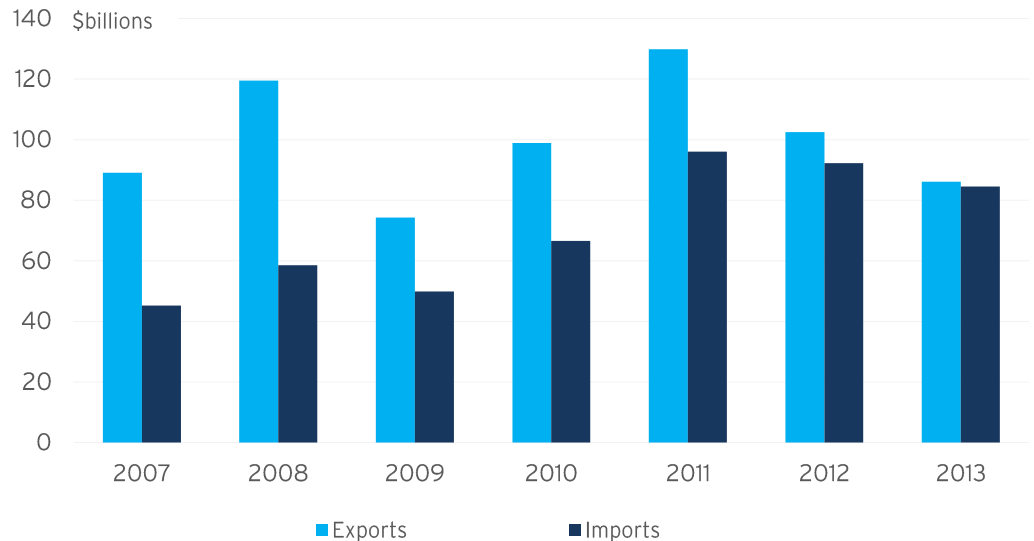


Source: RGE, Haver, Eranico

The failure of negotiations would increase probability of military conflict involving Iran and risk a destabilizing oil price spike.

Sanctions aside, it should be noted that failed negotiations due to Iranian intransigence could bring a higher probability of military conflict involving Iran, which would be destabilizing to the regional and global economy (though likely not as destabilizing as a nuclear Iran). Possible conflict flashpoints could include a potential Israeli strike on Iran, (temporary) blockage in the Strait of Hormuz, or a regional nuclear arms race. While these outcomes are possible under each of the scenarios, they rise significantly under the "Failure to Reach Agreement" scenario and are much lower under the "Final Settlement" scenario. Mapping the potential impact of such shocks using SAFE's [Oil Security 2025](#) scenario analysis, the loss of 1.0 to 3.0 mbd of Iranian exports due to conflict for a period of months could add \$40 to \$60 per barrel to the price of oil depending on the location and duration of the shock and OPEC spare capacity.

Figure 8: Iran's External Surplus is Narrowing



POLICY IMPLICATIONS

All three scenarios have near-term oil market, as well as energy and economic policy, implications. As noted, a temporary deal will see a modest increase in the availability of Iranian barrels in the global oil market, with incremental volumes reaching roughly 200,000 barrels per day by Q4 2014. This would have a beneficial (downward) impact on global oil prices in 2014 and could be supportive of modestly higher economic growth. Similarly, successful negotiations that resulted in a commitment by western governments to eliminate sanctions would not only add incremental Iranian barrels to the market in H2 2014, but they would also have a moderating impact on the risk premium due to de-escalation and signal the imminent return of modest Iranian production growth over the medium term. This too would be supportive of lower Brent prices and stronger global growth in 2014 and 2015.

The failure of negotiations would have immediate repercussions, necessitating concerted action by western governments.

However, the failure of negotiations could have immediate repercussions that would necessitate concerted action by western governments. With current events in Russia and Iraq as context, reinstating suspended sanctions on Iran could involve multiple policy objective tradeoffs and inflict non-negligible pain on the global economy in 2014 and beyond. Moscow's continued support of pro-Russian separatists in Ukraine may soon be met with escalating U.S. sanctions targeting the transfer of U.S. upstream oil and gas equipment and intellectual property to Russian firms in need of investment to support production growth in unconventional resources. While this is unlikely to have an immediate impact on production, it will have a medium-term effect and adds to a climate of uncertainty in the world's second largest oil exporter. Meanwhile, conflict and political instability in Iraq is yet to diminish, threatening to affect oil production in OPEC's second largest oil producer.

In this environment, and given expected market tightness in H2 2014, reinstating suspended Iran sanctions and removing an additional 400,000 to 500,000 barrels per day from the global oil market would have the potential to substantially elevate global oil prices. This would have negative repercussions for global economic growth. It is possible that the return of production in Libya, northern Iraq, or Nigeria could help offset the loss of incremental Iranian barrels, but none of these three are viewed as likely on a sustained basis before the end of the year (although the prospects for the return of Libyan exports does appear to be rising again). Though this set of circumstances may or may not directly affect the negotiating position of the United States and its European counterparts, the Iranian negotiators are almost certainly aware of it and may believe failed negotiations are unlikely as a result.

While Saudi Arabia could add some additional oil supplies to the market, it is almost certain that this would need to be augmented.

In the event that negotiations do fail, the United States, other IEA countries, Saudi Arabia, and possibly China will need to coordinate closely on a short-term oil market strategy. Spare capacity in Saudi Arabia currently stands at a relatively low level below 2.0 mbd. If, as IEA expects, the call on OPEC rises in H2 2014 by 600,000 b/d, this margin could be further eroded. Therefore, while Saudi Arabia could theoretically add some additional oil supplies to the market, it is almost certain that this would need to be augmented with other support.

Key considerations for policymakers include:

1. **Transparency and U.S. and IEA Strategic Stocks:** The United States and other IEA members should make it clear that they are willing to deploy public stocks to keep markets well supplied. Clear communication and close coordination will give markets confidence and moderate price impacts.
2. **Integrating China:** China's crude stockpiles are currently estimated to hold 215 million barrels of crude. While this is somewhat less substantial than the U.S. level of 636 million, it would make sense to involve China in any market action in 2014. At a minimum, western governments will want to call on China to halt aggressive filling of its reserve. Recent analysis from the IEA suggests that China has been building public inventories at a rate of up to 800,000 barrels per day in recent months.
3. **Managing the Geopolitics:** The United States should strive to work with countries such as Russia and China to avoid side deals that they might strike with Iran or other unilateral efforts which could increase Middle East regional instability. Of particular concern for all parties would be a Russian oil-for-goods deal with Iran, as Russia might import Iranian crude to keep it off the market and encourage an "economy of resistance" within Iran that would harden positions on all sides and significantly increase the risk of military conflict with Iran or proxy conflicts in other parts of the Middle East (Iraq, Syria) that destabilize the region. Any regional arms race that prompts further militarization or nuclearization of Middle Eastern states would weaken the resilience of global oil market. Such an arms race or increase in military spending would also increase the fiscal break-even price at which OPEC oil producers are willing to pump more oil.