Iranian Nuclear Negotiations: As Talks Extend, Oil Markets Tilt the Balance in Favor of the P5+1

SUMMARY

- Last week, Iran and the P5+1 negotiators announced that they would again extend talks aimed at halting Iran’s nuclear weapons program, with a proposed final framework due by March 1, 2015, and a final deal due by July 1.
- Since the previous 2014 extension, oil markets have experienced a significant shift. With global oil demand growth proceeding at a manageable pace, non-OPEC oil production surging, and Libyan output back online, the market is extremely well supplied. Prices have dropped by $40/bbl since June as a result.
- These developments could play an important role in the negotiations going forward. If current market dynamics persist, Iranian oil export revenue will decline by 25 percent year-over-year in 2015 to roughly $40 billion—the lowest level since 2004 and well short of a projected budget requirement in excess of $60 billion. While most of Iran’s oil revenues are captured in escrow accounts abroad, this drop in earnings should increase Iran’s desire for a deal.
- Yet, Iran is in a catch-22: Revenues are falling and sanctions are stressing its economy, but any incremental barrels it brings to the market will simply add to the glut, further depressing prices and offsetting any revenue gains.
- Meanwhile, a more flexible global oil market should make the P5+1 more willing to maintain current sanctions levels, which are now essentially cost-free. Moreover, our analysis suggests that oil market conditions throughout 2015 will make it possible for the P5+1 to credibly threaten to strengthen sanctions if needed without risking economically-destructive oil price volatility.

INTRODUCTION

On November 24, Iran and the P5+1—the United States, Russia, the United Kingdom, France, and China, plus Germany—agreed once again to continue negotiations focused on halting Iran’s pursuit of nuclear weapons capabilities, with a final deal due by March 1, 2015 and a fully negotiated settlement due by July 1, 2015. This marks the second extension of the negotiating framework, the Joint Plan of Action (JPA), under which the two sides initially agreed to a series of short-term conciliatory steps in pursuit of a longer-term agreement intended to bring Iran into compliance with the nuclear Non-Proliferation Treaty and end nearly a decade of punitive economic and financial sanctions.
After more than a year of negotiating within the JPA framework, it is not clear whether the two sides are any closer to a final deal than they were at the start. While there have been occasional positive signals emanating from Tehran throughout 2014, and important components of Iran’s enrichment program have been suspended for more than a year, it is also clear that there remains considerable distance between Iran and the P5+1 on issues such as the number of centrifuges that will remain in place under a final agreement, the schedule for phasing out sanctions, the rigor of future inspections, and the treatment of Iran’s stockpile of enriched uranium.

As policymakers, analysts, and other observers begin to assess the range of potential outcomes that could arise from the next negotiating deadline in March, it is important to consider the evolving nature of key incentives for both Iran and the P5+1. Specifically, there have been considerable developments in global oil markets over the past twelve months that, in our view, have already impacted the negotiations and are likely to continue to do so.

This report highlights key changes in global oil market dynamics between 2013 and 2014, including the 30 percent drop in crude oil prices between June and November 2014. We argue that this sharp decline—and the structural, but temporary, factors that drove it—has altered the playing field in the Iranian nuclear negotiations. In essence, oil markets served to exacerbate the negative effects of the existing sanctions on Iran, cutting projected government revenue in 2015 by more than $10 billion year-over-year, even if export volumes remain at the levels observed in the first half of 2014. In principle, these conditions should increase the pressure on Iran to negotiate a final settlement, all things being equal.

However, current oil market dynamics have placed Iran in a difficult bind. The key catalyst for the steep decline in oil prices in 2014 was a general condition of excess oil supply during a period of decelerated global oil demand growth. In our view these conditions are likely to persist well into 2015 and possibly beyond, suggesting that any additional Iranian oil exports in this timeframe would simply exacerbate the short term—market imbalance, driving oil prices lower and heavily offsetting any potential revenue gains of increased exports. While Saudi Arabia and other Arab OPEC members would have the technical capacity to rebalance markets, it is not clear that they would act to the degree necessary given the broader strategic considerations in play vis-à-vis Iran. Over time, lower prices should result in a rebalancing of oil markets as investment in higher-cost non-OPEC supply is deferred, but the time horizons over which this would occur remain highly uncertain. To some degree, these dynamics undermine Iran’s incentive to settle for anything less than a deal it perceives to be solidly in its favor.

For the first time, Western-led negotiators can work toward the best deal possible without worrying about oil markets.

Of course, the current oil market dynamics cut both ways. Lower oil prices and more deeply entrenched market flexibility have sharply reduced the cost of maintaining the current sanctions for the P5+1, the majority of whom are major oil consumers. For perhaps the first time in the history of efforts to deal with Iran’s uranium enrichment activities, Western-led negotiators can work toward the best deal possible without the added burden of maintaining stability in global oil markets.

Moreover, there is an additional factor to consider—namely, that a slack global oil market has created ample space to remove additional Iranian barrels from the market if needed. This possibility was highlighted in previous work conducted by SAFE and RGE, which suggested that market conditions might allow for further sanctions tightening in 2013. Instead, oil supply disruptions in Libya, Nigeria, and Northern Iraq totaling 1.2 mb/d on average in 2013 combined with other outages to keep markets sufficiently tight such that the supply system could not have afforded to lose additional Iranian barrels without triggering a sharp increase in oil prices.
Today, however, the return of Libyan barrels to the market, the continued surge in non-OPEC oil production, and relatively modest global oil demand growth have made it possible to tighten oil sanctions on Iran if needed. That is, the P5+1 has the ability to credibly threaten to move forward with new punitive sanctions without risking damaging consequences for the global economy. If signaled clearly to Iran that this threat remains on the table, it could arguably be a powerful tool for adding urgency to the negotiations and moving closer to final settlement.

**STATUS OF IRANIAN OIL PRODUCTION AND THE IMPACT OF THE JPA**

During the first seven months of 2012, the United States and several European nations implemented truly punitive oil-related sanctions on Iran as a result of its pursuit of a nuclear weapons capability. These measures included restrictions on financial transactions and shipping insurance associated with the purchase of Iranian oil as well as a complete European embargo on imports from Iran, effective July 1, 2012. Major importers, primarily in Asia, were forced to seek waivers to continue purchasing oil from Iran at reduced levels. The effects were immediate. In 2011, Iranian crude oil production averaged 3.7 million barrels per day (mbd). By December of 2012, production had fallen to 3.0 mbd, its lowest level since 1989. Crude oil exports, the source of 85 percent of Iranian government revenue, fell even more sharply. After averaging 2.5 mbd in 2011, exports fell to 1.5 mbd in 2012 and to just 1.1 mbd in 2013. While estimates may vary, oil export sanctions likely cost the Iranian government more than $50 billion in export earnings in 2013.

**FIGURE 1: IMPORTS OF IRANIAN LIQUID FUELS BY COUNTRY**

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>China</td>
<td>555</td>
<td>438</td>
<td>429</td>
<td>627</td>
<td>46%</td>
</tr>
<tr>
<td>India</td>
<td>312</td>
<td>303</td>
<td>188</td>
<td>275</td>
<td>46%</td>
</tr>
<tr>
<td>Turkey</td>
<td>187</td>
<td>152</td>
<td>106</td>
<td>105</td>
<td>-1%</td>
</tr>
<tr>
<td>Japan</td>
<td>305</td>
<td>185</td>
<td>172</td>
<td>163</td>
<td>-5%</td>
</tr>
<tr>
<td>Korea</td>
<td>230</td>
<td>159</td>
<td>128</td>
<td>124</td>
<td>-3%</td>
</tr>
<tr>
<td>Italy</td>
<td>184</td>
<td>65</td>
<td>6</td>
<td>0</td>
<td>-100%</td>
</tr>
<tr>
<td>France</td>
<td>60</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>Germany</td>
<td>17</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>Spain</td>
<td>151</td>
<td>22</td>
<td>0</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>Other</td>
<td>493</td>
<td>187</td>
<td>74</td>
<td>52</td>
<td>-30%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2,494</td>
<td>1,514</td>
<td>1,102</td>
<td>1,346</td>
<td>22%</td>
</tr>
</tbody>
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Moreover, additional measures that came into effect in early 2013 allocated Iran’s export earnings into escrow accounts held by its trading partners and stipulated that the revenues could only be used to finance goods purchased from those countries or to purchase humanitarian items. Thus, not only did Iran’s earnings fall, but they also lost full access to these earnings, putting them in the position of being a price taker with trading partners.
 Iranian Nuclear Negotiations: Oil Market Impacts

This pressure almost certainly played a major role in bringing the Iranian government to the negotiating table in November 2013, when Iran and the P5+1 reached an initial agreement that essentially halted certain components of Iran’s nuclear program in exchange for limited sanctions relief. The agreement outlined a series of longer-term reciprocal steps that Iran and the P5+1 could take going forward that would ultimately result in a verifiable, exclusively peaceful Iranian nuclear program and the eventual full lifting of nuclear-related sanctions on Iran. The initial Joint Plan of Action specified that negotiations toward such a long-term, comprehensive settlement would be extended but would expire on July 20, 2014.

The terms of the JPA clearly specified that the initial agreement, or so-called “first step,” would be renewable by mutual consent, and after determining that a comprehensive agreement was unlikely to be reached before July 20, Iran and the P5+1 announced that negotiations in pursuit of a comprehensive settlement had been extended through November 24, 2014. Though no official terms of the extension were released, public statements by U.S. and European officials indicated that the four-month extension would provide Iran with access to an additional $2.8 billion in frozen assets in overseas banks and continue limited sanctions suspension on petrochemicals, gold sales, and imports of automotive parts.

The Joint Plan of Action had a modest but significant impact on Iran’s oil exports and overall economy. Though the agreement referenced only a freezing of further attempts to reduce Iran’s crude oil sales, in practice the agreement and subsequent extension facilitated an increase of more than 0.2 mbd of Iranian crude oil exports year-over-year during the first nine months of 2014 compared to 2013 (See Figure 2). China and India were by far the largest purchasers of the increased exports, with cargoes of Iranian oil during the first half of the year nearly 50 percent higher than the 2013 average (see Figure 1). According to estimates provided by Roubini Global Economics (RGE), the additional revenue from these sales was a major driver in the modest stabilization of the Iranian economy during that period.

FIGURE 2: IRANIAN CRUD OIL EXPORTS, 2000 to PRESENT

Source: IEA

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Iran is faring better than before the JPA, but it will continue to face major fiscal and economic challenges as long as sanctions are in place.

The current extension of the JPA through July 1, 2015, is likely to lead to continued incremental increases in Iran’s exports of crude oil and lease condensate, with commensurate benefits for the government’s fiscal balance and the overall Iranian economy. Nonetheless, recent work published by SAFE and RGE found that Iran will require a global oil price in excess of $120/bbl to balance its central government budget in 2015 based on current production levels—a prospect that seems exceedingly unlikely, with most major forecasters currently projecting 2015 global oil prices (Brent) in the range of $75 to $85/bbl. The terms of the latest JPA extension do provide Iran with access to an additional $5 billion in capital held overseas over the next seven months, but this will only partially alleviate the fiscal pressure of current sanctions. From this perspective, Iran is faring better than before the JPA, but it will continue to face major fiscal and economic challenges as long as the sanctions are in place.

In this context, it is important to examine the potential costs of the sanctions on Iran—both real and perceived. All things being equal, greater economic costs should incentivize Iran to settle more quickly and on terms more favorable to the P5+1. Alternatively, reduced costs—or the perception of reduced costs—should incentivize Iran to hold out for a better deal. In this regard, it is critical to understand recent developments in the global oil market.

NEW CONTEXT: AN EVOLVING OIL MARKET

Over the past six months, global oil prices have plunged by more than $35 per barrel—from their mid-June highs of $115/bbl to approximately $80/bbl on November 24, the day of the most recent extension to the JPA. While a number of factors contributed to the slide, including a strengthening U.S. dollar, there were three fundamental driving factors: (1) Estimates for global oil demand growth were slashed throughout 2014, with the International Energy Agency (IEA) now pegging growth at 0.68 mbd year-over-year compared to estimates of 1.4 mbd earlier this year; (2) non-OPEC oil production has continued to surge, primarily in the United States, where liquids output looks to have increased by an incredible 1.4 mbd year-over-year; and (3) nearly 0.8 mbd of Libyan oil production has returned to the market.

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![Figure 3: Year-over-Year Change in Oil Supply and Demand, 2012 to 2015](chart.png)

**Figure 3: Year-over-Year Change in Oil Supply and Demand, 2012 to 2015**

- **Global Demand**
- **Non-OPEC Supply**
- **OPEC NGLs**

Source: SAFE analysis based on data from IEA
Taken together, these factors have fundamentally altered short- and medium-term global oil market balances, driving four consecutive quarters of implied oil inventory builds and reducing market fears that it could be difficult or impossible to compensate for a disruption in volatile Iraq. Indeed, non-OPEC oil supply growth has now met or exceeded global demand growth for six consecutive quarters, placing substantial downward pressure on the market’s need for OPEC oil—at a time when more of that oil is flowing due to the return of Libyan barrels. This dynamic is expected to continue in Q4 2014 and throughout all of 2015 (see Figure 3). Meanwhile, in spite of these conditions, Saudi Arabia and other Gulf Cooperation Council (GCC) members of OPEC have indicated that they will not cut back on crude oil production for the time being, a position that was clearly reinforced at the November 27 OPEC meeting.

![Figure 4: Supply growth in the U.S. and Canada has covered global demand growth and offset OPEC production outages since 2011](image)

**FIGURE 4: SUPPLY GROWTH IN THE U.S. AND CANADA HAS COVERED GLOBAL DEMAND GROWTH AND OFFSET OPEC PRODUCTION OUTAGES SINCE 2011**

Forecasts for the next two years suggest that the oil market will remain well supplied, with the call on OPEC crude required to balance the market declining from an average of 29.7 mbd in 2014 to just 29.2 mbd in 2015, its lowest level since the 2007–2009 financial crisis. (The call on OPEC was 30.9 mbd as recently as 2013.) This assessment hinges on assumptions of continued moderate global oil demand growth and a sustained expansion in U.S. shale oil supplies, both of which are anticipated by both IEA and the U.S. Energy Information Administration (EIA), the key forecasters.

In the more medium term, both IEA and EIA are anticipating a rise in OPEC crude production capacity, led by a steady expansion in Iraq. To date, OPEC capacity growth has generally disappointed, perhaps not surprisingly given the continued substantial rise in non-OPEC production and the political situation in countries such as Iraq, Nigeria, Libya, Venezuela, and Iran. Much of the IEA’s forecast capacity growth—2.1 mbd by 2019—is slated to come from
Iranian Nuclear Negotiations: Oil Market Impacts

Spare capacity will rise over the coming year or more, boosting the cushion against global supply outages. Iraq, which remains fraught with challenges. Therefore, we take a more conservative view and include half that level of increase in our projections along with increased capacity in UAE. We see OPEC’s effective crude production capacity rising marginally to average nearly 34 mbd in 2015, up from 33.3 mbd in Q3 2014. Combined with a falling call on OPEC crude, the net result is that the margin of spare capacity is set to rise over the coming year or more, boosting the market’s cushion against possible global supply outages.

IMPLICATIONS FOR THE NEGOTIATIONS

Oil markets and economic considerations are clearly one of a number of factors impacting the relative leverage and negotiating positions of Iran and the members of the P5+1. Ultimately, material national security concerns are at stake for all parties involved, along with matters of national pride, political viability, and strategic influence in one of the world’s most volatile regions. Nonetheless, the evolution of global oil market conditions could have a meaningful effect on discussions between Iran and the P5+1 in 2015—and potentially beyond if the negotiating framework extends farther into the future.

For Iran, structural over-supply and the associated decline in oil prices each present unique challenges. The drop in prices will substantially reduce the revenue Iran can earn from its existing exports under the JPA. This will exacerbate the negative economic effects of the sanctions and should increase the pressure on Iran to negotiate, all things being equal. Meanwhile, structural over-supply in the market will essentially serve to devalue Iran’s future revenue potential from the lifting of sanctions. In a way, this could make Iran less likely to accept anything but a deal it perceives to be strongly in its interest, especially if the government in Tehran believes that oil markets will remain soft for an extended period of time—which we believe is likely.

Alternatively, a well-supplied global oil market sharply enhances the bargaining power of the P5+1 in multiple ways. First, these conditions make it effectively cost-free to maintain the existing sanctions. Oil prices are relatively low, and the market can absorb significant supply losses without seriously raising expectations of damaging oil price volatility. Simply put, the market does not inordinately need Iran’s 1.1 mbd of foregone oil exports to arrive at a price that is conducive for strong global economic growth. This is a notable departure from events in the recent past.

Second, conditions of oversupply—for as long as they persist—open the door to the potential of additional oil-related sanctions. Admittedly, this is a sensitive topic. There is credible evidence that suggests that the imposition of new sanctions would sacrifice even the modest levels of cooperation the West has received from Iran in 2014, effectively ending the negotiations. However, the potential leverage that could be derived from the credible threat of additional sanctions in the current moment should not be ignored.

The Cost of the Sanctions Burden: the View from Tehran

From Iran’s perspective, the cost of current sanctions has already been significant. Iran’s pre-sanctions export level was 2.5 mbd. With exports estimated at 1.1 mbd in 2013, sanctions removed roughly 1.4 mbd of Iranian oil from the market last year. At an average 2013 oil price of $108/bbl, the foregone exports were valued at more than $55 billion. By way of comparison, public estimates suggest total Iranian government revenue in 2013 was $47.8 billion. Thus, sanctions likely cut the Iranian central government’s revenue in half last year in terms of U.S. dollars. Only cuts to government spending helped narrow the increase in Iran’s fiscal deficit, effectively weakening growth.
Though sanctions have remained in place throughout 2014, the JPA did facilitate a modest increase in Iranian liquid fuel exports this year, totaling more than 0.2 mbd and consisting primarily of lease condensate, but also including limited additional volumes of crude oil. We therefore estimate that, annualized for the full year, Iranian oil export revenue actually increased year-over-year in 2014 by approximately $5.9 billion. This is consistent with estimates from the International Monetary Fund (IMF) that suggest Iran’s oil-related real GDP expanded by 0.5 percent in 2014, which contributed strongly to economy-wide real GDP growth of 1.5 percent, marking the first annual economic expansion in Iran since 2011. In fact RGE’s estimates based on more recent Iranian government data suggest that those numbers are conservative, with total economic growth in 2014 closer to 2 percent and the energy sector accounting for most of the expansion.

Looking to 2015, however, the picture is likely to be substantially different. First, as discussed above, the JPA has facilitated a modest 0.2 mbd increase in Iranian exports to date in 2014 compared to 2013 levels, likely due to Chinese and Indian stockpiling early in the year. However, this is unlikely to be repeated in 2015 given prevailing market conditions. Any potential new Iranian customers will likely be served by other suppliers, unless Iran proves willing to offer sizeable discounts, which it has been unwilling to do of late.

Second, and more importantly, oil prices have dropped considerably, and are now projected to average between $75/bbl and $85/bbl in 2015. Based on current Iranian export levels and using EIA’s most recent Brent oil price forecast of $83/bbl in 2015, Iran’s export revenue will drop to approximately $39.4 billion in 2015, a decline of $10.2 billion from an estimated 2014 level of $49.6 billion. Given the sharp drop in oil prices following the November 27 OPEC meeting, there is almost certainly downside risk to this estimate.
This too is consistent with IMF estimates that suggest Iran’s oil-related GDP will once again contract by 0.3 percent in 2015, while the government’s overall fiscal balance will worsen, reaching –2.2 percent of GDP (compared to –1.4 percent in 2011). More recent estimates from RGE suggest that Iran’s oil-related GDP growth will be flat in 2015, while the deficit will be wider. Holding the deficit to 2 percent of GDP in 2015 would require either: (1) extensive fiscal cuts that would further weaken non-oil output and domestic demand; or (2) a further weakening of the rial that would boost inflationary pressures, also eventually hitting domestic demand. All things being equal, the projected drop in oil revenue should make Iran more interested in reaching a final settlement and bringing an end to sanctions.

However, the scenarios in front of Iran with respect to the future value of its oil exports are much less certain than might initially seem to be the case. In particular, given current oil market balances, the return of any incremental Iranian barrels to the market over the next 12 months is likely to have a counter-productive effect, exerting further downward pressure on oil prices. It is not inconceivable that the value of any increases in Iranian exports could be nearly fully offset by the diminished value of total exports due to an additional drop in oil prices.

In fact, the price impact of incremental Iranian exports need not be so substantial in order to present the regime in Tehran with complex choices and tradeoffs. If, for example, the recent extension of the JPA into mid-2015 facilitates an additional 0.2 mb/d in Iranian oil exports, prompting oil prices to soften to $80/bbl on average in 2015, the total value of Iran’s remaining foregone exports would be just $27 billion annualized over 2015—49 percent lower than the estimated foregone oil revenues in 2013.

**The Cost of Sanctions Implementation: The View from the P5+1**

At the same time that the direct economic and fiscal costs of the sanctions burden have increased for Iran, the cost of maintaining the sanctions regime has dropped significantly for the major oil consumers within the P5+1. While this dynamic is more difficult to quantify than the direct effects on Iran, the recent past provides important context on the potential cost of oil market sanctions for major oil consumers and the global economy.

For much of the decade between 2003 and 2013, the global oil market was characterized by three dominant trends: (1) rapidly rising global oil demand driven primarily by emerging market economies; (2) slow or stagnant growth in non-OPEC oil production outside the former Soviet Union; and (3) generally overwhelming increases in OPEC crude oil production capacity. The net result of these trends was the steady erosion of spare oil production capacity within OPEC, especially from 2003 to 2008 and again from 2011 to 2013. Markets are generally comfortable with OPEC spare capacity equal to at least 4 percent of global oil demand. When spare capacity falls below this level, fears rise that the market is susceptible to imbalances from relatively small perturbations in individual countries or regions. In such an environment, disruptions from weather, domestic political instability, or military conflict can generate highly damaging oil price volatility.

The tightness of the global oil market over the past decade meant that any action designed to substantially reduce Iranian oil exports would come with significant price impacts and potentially devastating economic impacts for oil-dependent countries in both the industrialized world and emerging markets. The physical market simply could not afford to lose any meaningful portion of oil exports throughout most of the past decade. Furthermore, the market had a general sense of uncertainty about “where the next barrels would come from” in an era in which conventional resources were believed to be in permanent decline outside of OPEC and any new supplies seemed to be prohibitively expensive. This uncertainty would likely
have extended the duration of any price increase from Iranian oil sanctions, a development that would have been resolved only by demand destruction and global economic recession. More than any other factor, concerns about oil price volatility and economic growth dissuaded serious efforts to sanction Iran’s petroleum industry in the years leading up to 2012.

Today, however, the aforementioned developments in global oil markets have essentially eliminated any costs of maintaining the current sanctions regime against Iran. Though OPEC spare production capacity remains below the robust levels seen prior to 2003 or during the 2007–2009 financial crisis, IEA’s estimate of more than 3 mbd provides a healthy cushion for global oil markets. Even the EIA’s estimate of 2.3 mbd is well above the problematic levels witnessed from late 2004 through 2006, and it is one that is set to grow in the coming months and potentially years.

In other words, based on current and expected trends, the market is more than capable of supporting the existing Iran sanctions regime, and the risk of a significant escalation in oil prices associated with a modest supply disruption is minimal. The market has the flexibility to deal with all but the most catastrophic scenarios. Given these conditions, the P5+1 faces no economic pressure to bring a swift end to negotiations.

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**FIGURE 6: OPEC SPARE CRUDE PRODUCTION CAPACITY, 2002 TO OCTOBER 2014**

Ample global oil supplies and lower prices reduce the incentive for China and other countries to make side deals to purchase Iranian oil. Perhaps most importantly, ample global oil supplies and lower prices reduce the incentive for China and other countries to cheat and make side deals to purchase Iranian oil, making sanctions more durable. This is likely amplified with China in the current environment of weakening economic growth and slowing oil demand, and in which the marginal barrel purchased is being used to build strategic reserves. In fact, initial evidence suggests that
Chinese demand for Iranian oil has softened in H2 2014, averaging 0.43 mbd over the past four months compared to 0.63 mbd during the first six months of the year. If this trend continues, it would add further weight to the notion that a well-supplied market allows the P5+1 to maintain current sanctions with low cost and little risk of capitulation.

**THE RETURN OF A CREDIBLE SANCTIONS THREAT?**

The critical question is whether the conditions outlined above make it more or less likely that Iran and the P5+1 will reach a final deal in 2015. Given the ongoing pause in critical Iranian enrichment activities, the reduced economic pressure on major oil consumers, and the complex set of incentives facing Iran, it is conceivable that current conditions will not necessarily accelerate the timeline for settlement. With that in mind, we simply note that the P5+1 negotiators do hold additional leverage that could be used if needed. Namely, the oil market could almost certainly support a new round of punitive sanctions designed to remove additional Iranian barrels from the market. Whether or not such sanctions are ultimately implemented, the ability of the P5+1 to credibly threaten to implement them could become critical to breaking the deadlock in the negotiations. From an oil market perspective, the P5+1 has the ability to make such a threat and maintain it through at least 2015.

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**FIGURE 7: CALL ON OPEC CRUDE AND OPEC EFFECTIVE CAPACITY, 2011 to 2015**

In all cases, the call on OPEC is steady or declines over the next two years, while spare capacity rises.

To support this analysis, RGE ran a number of scenarios on its base case oil market outlook, including upside and downside cases for demand (1.5 percent p.a., and 0.7 percent p.a. respectively compared to the base case of 1.1 percent), and a downside scenario for non-OPEC supply growth (0.5 mbd below base case in 2015 to 2017). In all cases with the exception of the highly unlikely high demand and low output scenario, the call on OPEC is steady or declines over
the next two years, and OPEC’s margin of spare capacity rises. Even in the high demand and low output case, OPEC spare capacity only declines slightly in 2015 and rises again in 2016.

Already, OPEC’s effective crude production capacity of 33.3 mbd is in significant excess of the call on OPEC crude, which averaged 30 mbd between July and September of 2014. By the end of 2015, our base estimate of effective OPEC crude production capacity of approximately 34 mbd will be well in excess of IEA’s projected call on OPEC of just 29.7 mbd. If these estimates hold roughly true, the market could support another 1.0 mbd of Iran sanctions in 2015, and possibly more, without risking debilitating oil price impacts.

The economic outlook confronting Iran in the event of new sanctions would be particularly dire. RGE estimates that the implementation of sanctions at levels present before the JPA would mostly erase the economic growth Iran has experienced in the last 12 months. (We estimate an economic expansion of 1.5 to 2.5 percent year-over-year in Iranian fiscal year 2014/2015 versus sharply negative growth in 2012/2013 and a shallower contraction in 2013/2014.) New sanctions such as those pending in Congress would likely lead to a recession, as Iran’s oil output falls, and the government has to make fiscal cuts to balance the budget.

However, it is also clear that the ability of the P5+1 to be successful in such a strategy is highly contingent upon negotiating with one voice, something that appears increasingly difficult going forward. As we noted in previous work on this subject, the coalition might be less unified than in 2012 given the varied interests of its members. In particular, the deterioration of U.S. ties with Russia could increase the likelihood that Russia would strike a side deal with Iran in the event of any new sanctions. We note that the current oil price environment makes it more likely that Chinese interests will remain allied with other members, particularly as the Iranians are reluctant to further increase their reliance on China.

CONCLUSION

For much of the history of the standoff between the West and Iran over its uranium enrichment activities and alleged nuclear weapons program, oil markets have played a limiting role for the United States and its European allies. At critical times when the United States would likely have preferred to engage more assertively with Iran, concerns about oil price volatility and the U.S. economy took priority, constraining America’s ability to act in its longer-term security interest.

This began to shift in 2012, when the first stages of the U.S. oil boom facilitated the implementation of the first truly punitive sanctions on Iran. Yet the implementation of these sanctions was arguably not without costs for the United States. In particular, the loss of more than 1 mbd of Iranian oil exports over the past two years was a principle factor keeping global oil prices elevated above $100 per barrel, which functioned as a persistent drag on growth for the oil-intense U.S. economy. Whether they realize it or not, American and global consumers have helped finance the current Iran policy of the P5+1.

Yet, the evolution in oil markets underway today likely represents a new phase in the dynamics between the P5+1—principally the United States and Europe—and Iran. For the time being, oil markets are unlikely to be a constraint for the United States as it works to negotiate a deal with Iran consistent with its long-term national security objectives. In fact, markets could serve as a key enabler of U.S. objectives in the event that a credible threat of further sanctions becomes valuable or necessary. Our analysis suggests this condition is extremely likely to hold in 2015 and potentially beyond.