Middle East escalation pushes energy prices higher

Oil and gas prices have moved higher following an Iranian missile attack on Israel. Markets are waiting to see how Israel responds. Escalation in the region is putting energy supply at greater risk

Bushehr nuclear power plant in Iran

The impact of losing Iranian oil supply

Oil prices briefly broke above $80/bbl as the market waits to see how Israel responds to Iran's latest missile attack. Clearly, growing tensions have seen the market price in a greater war risk premium. However, where prices go from here will depend on how Israel responds. A similar response to Iran's April attack would likely see the risk premium eventually start to erode, with fundamentals once again coming to the forefront. And with the global market set to be in surplus through 2025, this means that oil prices will likely weaken. We are forecasting that ICE Brent will average $72/bbl over 2025.

However, Israel may decide on a more aggressive response. There have been suggestions that Israel could target Iranian energy infrastructure. The key question would then be whether Israel hits downstream assets or mid/upstream assets. Hitting downstream oil assets, such as refiners, would likely increase oil supply for the global market as Iran would be unable to process this oil and so would have a larger exportable surplus. In theory, this should be bearish for prices.

However, given it would be seen as an escalation, oil prices would still likely move higher, at least initially. A more serious impact for the global oil market would be if Israel targeted mid and upstream oil assets, which would affect Iran's ability to export crude oil. This would put as much as 1.7m b/d of supply at risk, which could see oil prices trading above $90/bbl in 2025.

This kind of response would only escalate the situation further and take the market a step closer to a more extreme scenario, which for now we still think is unlikely. There is the potential in a worst-case scenario that Iran attempts to disrupt Persian Gulf oil flows through the Strait of Hormuz. Almost a third of global oil flows through the Strait of Hormuz and any significant disruption to these flows could very well see oil trading to new record highs, exceeding the record price of almost $150/bbl in 2008. Unfortunately, given that the bulk of OPEC capacity sits in the Persian Gulf, this spare capacity would be of little help if Iran was successful in significantly disrupting oil flows through the strait.

Persian Gulf LNG flows disrupted under worst-case scenario

European natural gas prices have also rallied on the back of Middle East developments. TTF once again broke briefly above EUR40/MWh. While the European market is well supplied with storage close to 95% full and likely to be close to 100% full ahead of the 2024/25 heating season, it is still vulnerable to supply disruptions.

We believe that European natural gas prices should fall through 2025. However, much will depend on how the weather develops over the winter. Europe has had two mild winters and we cannot assume a third. Even assuming a normal winter, as well as the loss of Russian pipeline flows through Ukraine from 1 January 2025 following the expiry of Gazprom's transit deal with Ukraine, we still expect Europe to exit the 2024/25 heating season with storage more than 40% full. The starting and ramping up of several US LNG export facilities should help to offset potential Russian supply losses via Ukraine.

However, a growing concern for gas markets related to Middle East escalation is the potential for disruption to Persian Gulf LNG supplies moving through the Strait of Hormuz. While it is an extreme scenario, the potential impact of these supplies being disrupted is significant. Qatar exports a little more than 100bcm of LNG annually and makes up around 20% of global LNG trade. Losing a large share of this trade would leave the global LNG market in deficit, pushing up prices. The ramping up of new LNG export capacity elsewhere will take time, so any potential disruptions to flows from the Persian Gulf would be difficult to offset through the 2024/25 winter.

Author

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com