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SEE ENERGY BRIEF

Monthly Analysis

The Hamas-Israel War and Its Impact on Energy Prices

Introduction

The Middle East, where the Hamas-Israel conflict is centred, holds a significant portion of the world's proven oil reserves, while it plays a crucial role in global energy markets as a major exporter of oil and natural gas. Based on Energy Institute's data **(1)**, the Middle East accounted for 33% of global oil production and 18% of gas production in 2022.

In the wake of bloody attack by Hamas in Israel on October 7 and in the immediate post event period, European natural gas and global oil futures shot up by 14% and 4% respectively **(2)**, reflecting wider uncertainty and fears of an intensifying conflict. Oil shot up because there are worries, again, that Iran might close the Strait of Hormuz, the chokepoint for nearly a third of seaborne oil. Natural gas prices went up firstly because Israel shut down a big offshore production platform in missile range of Gaza, and secondly because a pipeline in the Baltic mysteriously developed a hole, which Estonian officials attributed to "external" actors.

Even if Israel's ground invasion into Gaza leads to an extended conflict, the impact on energy prices and the resultant OPEC response would depend on the scale and reach that the conflict takes. If it remains localised without affecting major oil producers or transit routes, prices may see limited immediate change, prompting OPEC to maintain current production levels.

Implications for the Global Oil Market

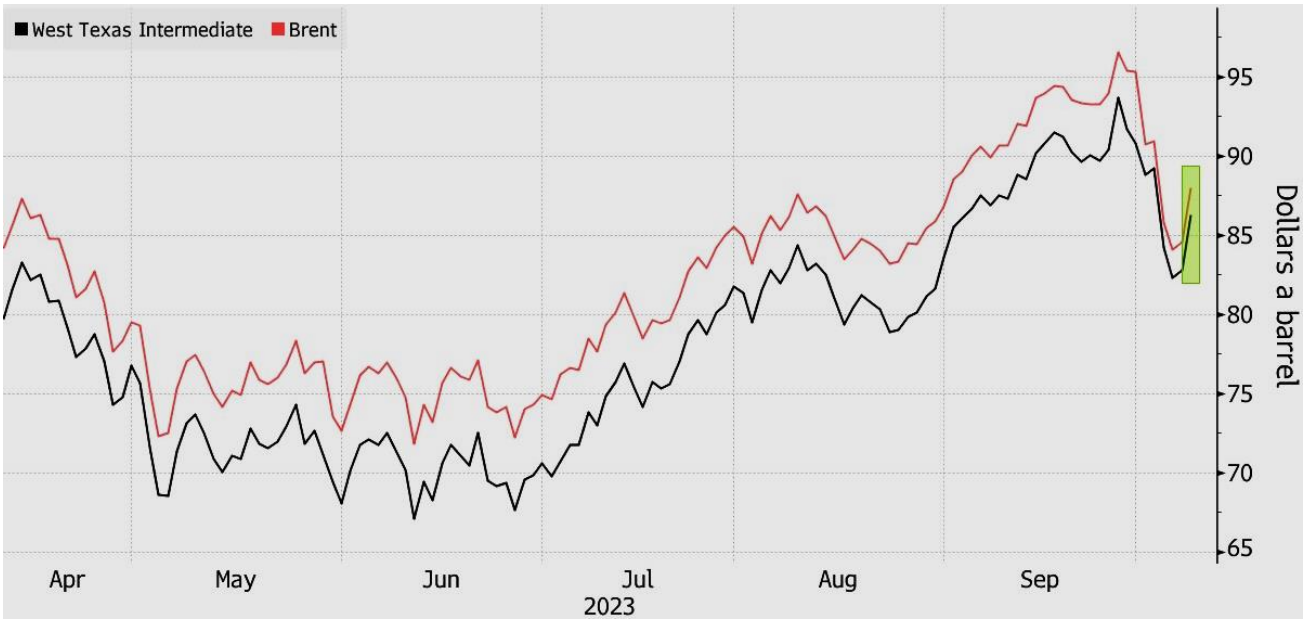
Though Israel is not an oil producing country and no major international oil infrastructure runs close to the Gaza Strip or southern Israel, the outbreak of serious conflict in the area nevertheless has implications for the stability of the global oil market. There are two reasons for this. First, global energy markets do not like turmoil in the Middle East, as the region contributes about a third of global oil production. Second, global energy markets worry about the potential role of Iran in the conflict.

Iran has made a significant comeback to global oil markets over the last year, with production and exports surging. The IEA estimates that in the first eight months of 2023 alone, Iranian crude oil production increased by 600,000 barrels per day – the world's second largest source of incremental supply in 2023 after the United States **(3)**. In August, Iranian output reached 3.14 million barrels per day, the highest since 2018, when the Trump Administration abandoned the Iran nuclear deal – formally known as Joint Comprehensive Plan of Action (JCPA) – and restored US sanctions on Iranian oil. Iran's crude exports have risen to 1.9 million barrels per day, according to Kpler **(4)**, 80% of which goes to China.

At the time Trump's measures had slashed Iranian oil production and exports to a 30-year low. But since 2022, the Biden Administration has turned a blind eye to the US's own sanctions and has backed away from some measures meant to stop Iran's oil shipments. The easing of US pressure was done to facilitate the negotiations that led to the release of five Americans imprisoned in Iran, and most notably to increase the liquidity of the global oil market in the context of the Ukraine war and sanctions on Russian oil.

The potential involvement of Iran in the Hamas attack against Israel could push the United States to strictly enforce again its sanctions against Iran, significantly cutting its oil exports. That could see global oil prices rising to $100/barrel or beyond, pushing inflation higher and further complicating the efforts of central banks to bring it under control. It should be noted, though, that Saudi Arabia and the United Arab Emirates have significant spare capacity and could ramp up their oil production if they wished.

Figure 1: Oil Prices Rise After Israel Attacks



Source: Bloomberg

Global energy markets also fear that the potential involvement of Iran could spark instability around the Strait of Hormuz, the world's most important energy chokepoint. Every day, a fifth of the global oil supply and a quarter of global LNG trade pass through this sea route between Oman and Iran. Should transit be disrupted, even for a few days, the repercussions for global oil and gas prices would be substantial. Equally substantial would be the repercussions of any act of sabotage against oil and gas infrastructure in the Middle East and North Africa region. While not necessarily tangible today, these security risks must be carefully assessed and managed by governments, starting from those in Europe. **(5)**

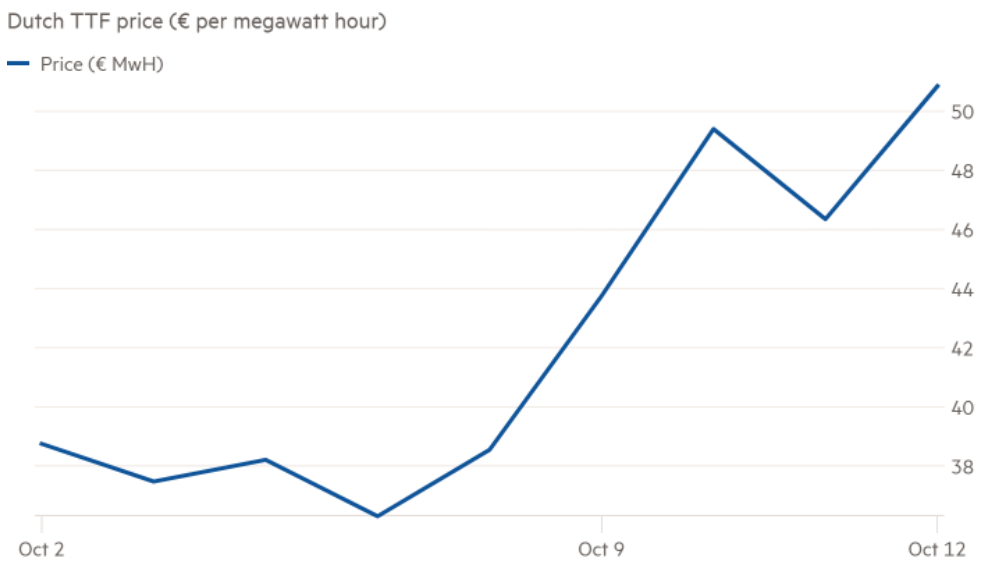
Implications for the Global Gas Market

The Israel-Hamas war is already hitting gas supplies, most notably in Israel. Following the Hamas attacks, on October 9, Israel's Energy Ministry ordered Chevron, the operator of the Tamar platform 25 kilometres northwest of Gaza, which mostly met domestic needs, to temporarily cease production **(6)**. On October 10, Israel's government also instructed Chevron to temporarily halt flows through the most important pipeline connecting Israel and Egypt, the East Mediterranean Gas (EMG) pipeline, which links Ashkelon, an Israeli city 13 km north of Gaza, to Arish in the northern Sinai, Egypt.

Israel's Energy Ministry has also indicated that electricity utilities in Israel should temporarily seek alternative fuel sources to meet their needs. The share of gas in the country's energy mix is about 40%, up from zero in 2000, based on the IEA's data. This rapid expansion has been driven by the electricity generation sector, previously dominated by coal, while gas now provides 70% of Israel's electricity.

The discovery of offshore gas deposits, most notably of the Tamar field in 2009 and the Leviathan field in 2010, has underpinned this major transformation of Israel's energy system, and has also led Israel to become an exporter of gas to Egypt and Jordan. In 2022, Israel produced 21.9 billion cubic metres of gas, 11.4 bcm from Leviathan and 10.2 bcm from Tamar. Of this, 12.7 bcm was consumed domestically, while 5.8 bcm was exported to Egypt and 3.4 bcm to Jordan. Exports were expected to rise further in 2023 supported by the launch of production at the Karish field (initial output of 6.5 bcm). **(7)**

Figure 2: European Gas Futures Rise Since Israel-Hamas Conflict Breaks Out



Source: Bloomberg

It is not the first time the Tamar platform has been shut down over a security threat. It was targeted by rockets in 2021. Increased security risks to the key exporting EMG pipeline, which starts just kilometres from border with Gaza, led to its temporary shut down and impacted Israeli gas exports to Egypt from its biggest gas field, Leviathan. Reduced flows were redirected via an alternative regional pipeline used originally for Egyptian exports and, from 2019, to supply Egypt and Jordan with gas, known as Arab Gas Pipeline.

Figure 3: European Gas Futures in October 2023

Source: ICE

The impact of the current situation on the domestic, regional and international gas balance will ultimately depend on its duration. If protracted, the Tamar and EMG shutdown would reduce more long-lastingly not only supplies to Israel but also exports to Egypt. This would undermine Egypt's ability to satisfy its increasing domestic gas needs, and would also hit its LNG exports to Turkey and several European Union countries – already significantly down this year compared to 2022.

Egypt's LNG exports totalled about 7 million tonnes in 2022, of which 5 million tonnes went to the EU, compared to total EU imports of 96 million tonnes and global trade in LNG of over 400 million tonnes. Nevertheless, in a very tight global LNG market, the prospect of losing the relatively small Egyptian supplies at the beginning of winter has created upward pressure on gas prices across Europe and Asia. Gas prices are already under pressure from other factors, including the alleged sabotage of the Baltic connector between Finland and Estonia, and strikes at some Australian LNG plants.

Then, there is the risk of further regional escalation of the conflict. A more extensive conflict between Israel and the Arab states could complicate planned – and in an extreme case, even current – Israeli gas projects with Egypt, Jordan and Lebanon. Such a scenario would make energy cooperation in the Eastern Mediterranean format much harder, if not derail it completely. Cooperation is meant to enable new gas developments, create a major regional hub and to build confidence in the region. More sustained limits on Eastern Mediterranean export capabilities would be a setback, especially for EU countries such as Italy,

which rely on supplies from the region in their strategy to move away from Russian gas imports, and whose companies are investing in production and export infrastructure in the Eastern Mediterranean.

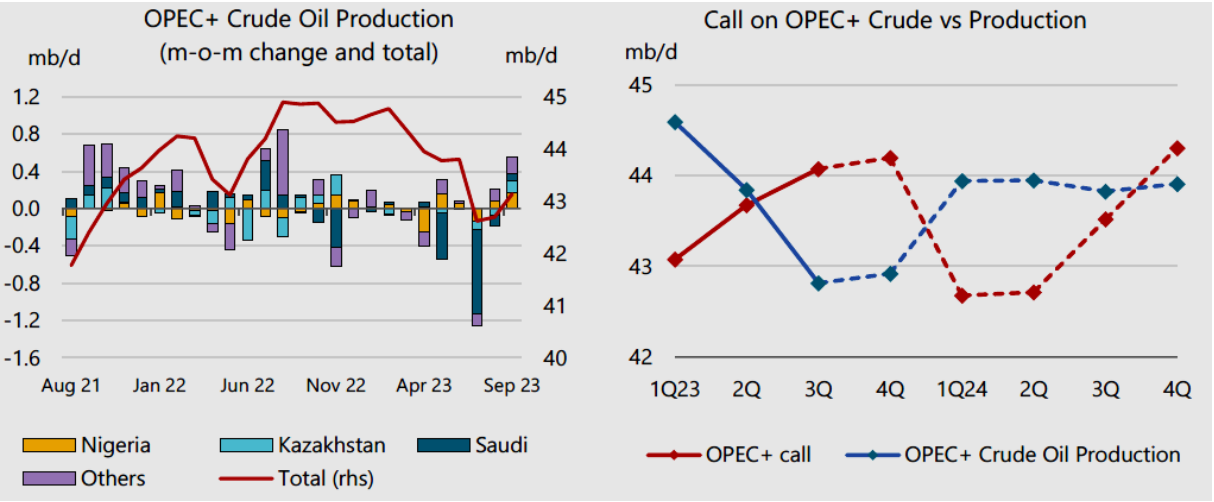
From a broader perspective, similarly to oil markets, if the conflict escalates all eyes will be on potential Iranian involvement. This could have several implications for international gas flows, such as increased security risks for that LNG vessels that pass every day through the Strait of Hormuz, and for international gas pipelines in the region. Wider conflict would also add to concerns about the security of infrastructure connecting North African gas suppliers and Europe, adding uncertainty and volatility to an already tight market. **(8)**

World Watching OPEC

The world is watching out in rapt attention for the responses of the Organization of Petroleum Exporting Countries (OPEC), a pivotal force in the global oil market. Yet, OPEC's actions in the midst of the Israel-Hamas conflict hinge on a number of factors, that would include examining the gravity and duration of the conflict, its ramifications on oil production and logistics, and the global demand for oil in this period.

In the event of a protracted conflict following Israel's incursion into the Gaza Strip and an extended conflict, the impact on energy prices and the resultant OPEC response would depend on the scale and reach that the conflict takes. For instance, if the conflict remains localised without affecting major oil producers or transit routes, prices may see limited immediate change, prompting OPEC to maintain current production levels. However, if regional instability arises without direct impact on major oil sources or routes, there may be speculative shifts in the oil market, leading OPEC to consider production increases for price stability.

Figure 4: OPEC+ Crude Oil Production (LHS) and Call on OPEC+ Crude vs Production (RHS)



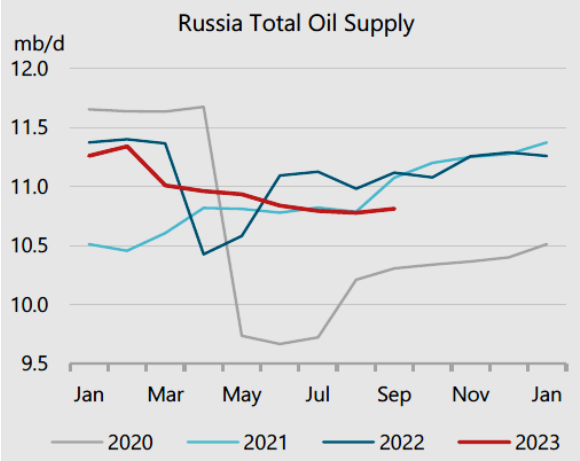
Source: IEA's Oil Market Report (October 2023)

Oil supply could face a significant risk if the conflict spreads to other countries or affects important passages like the Strait of Hormuz. This would require OPEC to increase production and possibly work with non-OPEC oil producers to maintain market stability. If the conflict escalates to involve Hezbollah or Iran, OPEC interventions will become more critical as this could also be accompanied by stricter US sanctions on Iranian oil exports.

The Russia Factor

However, it's uncertain whether a sustained increase in oil prices would prompt Saudi Arabia to alter its plans to unwind its production cuts. During the "Russian energy week" conference on October 11, Saudi Arabia and Russia discussed the oil market situation and prices amidst the Israel-Hamas conflict, with no clear-cut statements on oil production.

Figure 5: Russia's Total Oil Supply



Source: IEA's Oil Market Report (October 2023)

OPEC's response to Israel-Hamas differs from how it had responded to the Russia-Ukraine war. While OPEC purportedly aims for non-political oil strategies alongside collaborating with Russia, the Israel-Hamas conflict isn't seeing involvement of major oil nations or key routes unlike the Russia-Ukraine war. Israel's two refineries producing a total of 300,000 barrels per day and Palestine's absence of oil production contrasts with OPEC's swift adjustment for the Russia-Ukraine war due to Russia's crucial role in oil, which saw OPEC carry out a gradual oil production hike of 400,000 barrels per day for the month of April.

Discussion

The attack on Israel by the militant group Hamas on October 7 has reopened old wounds in the Middle East and created further geopolitical tensions in an increasingly fragile and uncertain world. We recognize that this remains a rapidly evolving situation, fraught with danger, and one that will take several weeks, if not months, to stabilize. Yet, it will inevitably shape relations in the region for many years to come. We see some potential repercussions, both short and longer term, as well as latent risks regionally and globally.

Oil prices remain volatile and we expect upward pressures will remain while tensions in the Middle East persist and the risk of Iran becoming more directly involved in the conflict remains. As analysed in this Monthly Analysis, the price of natural gas is seeing a bigger impact. A key risk in the event of escalation would be the potential for an energy supply shock. While full-scale involvement of Hezbollah, would likely significantly increase risk premiums and volatility in financial markets, any potential oil supply disruption caused by sanctioning Iran and cutting off the exports of Iranian oil, currently about 2 million barrels per day, might be offset by Saudi Arabia given it has sufficient spare production capacity (about 3 million barrels per day). But this is not certain, as Saudi Arabia also wants to see a relatively strong global oil price. **(9)**

The extreme tail risks for energy relate more to the possibility of Iran impeding transit through the Strait of Hormuz, the supply route for about 30% of the world's seaborne oil and one-fifth of global LNG supplies (mostly from Qatar) in a tight market. Yet, Europe also receives one-fifth of Qatar's exports (about 5% of the total European market) and its supply/demand balance has been very tight since Nordstream 1 closed in September 2022. Nevertheless, even in the absence of a material energy supply shock, the evident sensitivity in energy prices to recent events indicate that some inflationary pressures could persist through the Northern Hemisphere winter, particularly if supply disruptions of natural gas and LNG to Europe become more widespread.

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