

Escalating military action in the Middle East is raising the likelihood of extended disruptions

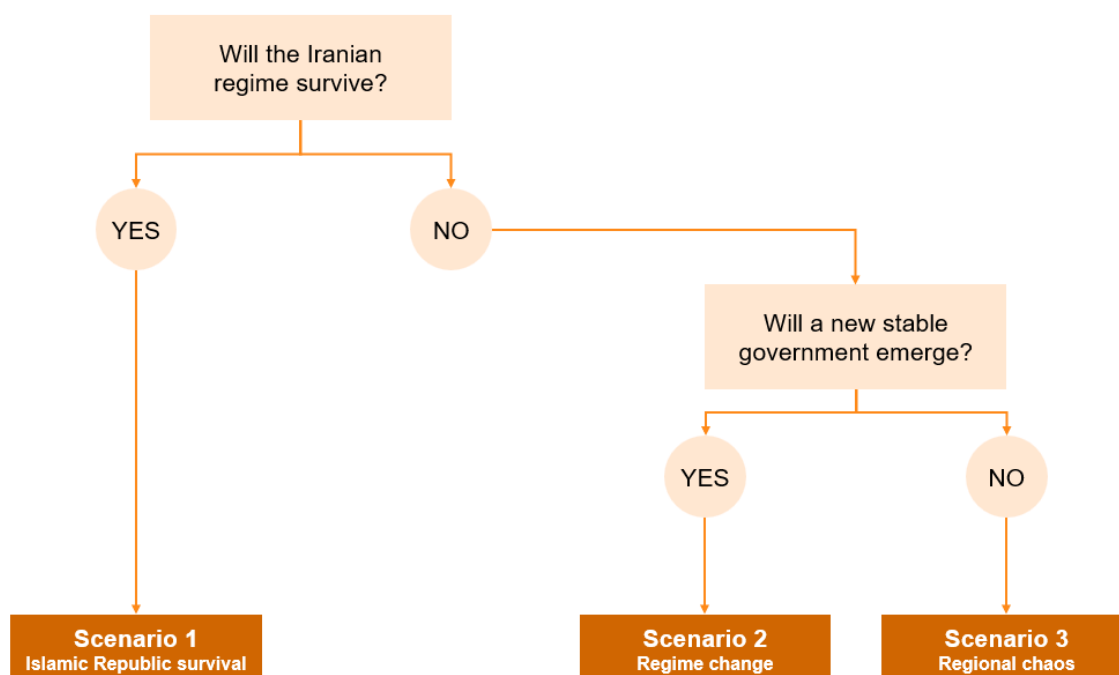
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The large-scale military action initiated on 28th February by the U.S. and Israel against Iran remains in its initial stages. Its duration, long-term evolution and potential outcome therefore remain highly uncertain. This uncertainty is made worse by the apparent absence of a clear set of objectives from the US administration and the wide range of timelines stated by different officials.

Even in just a few days, however, the war has already had profound implications on natural gas markets, with the closure of the Strait of Hormuz and damage to energy infrastructure across the region causing a spike in spot gas prices across the world.

It is therefore essential to examine what the first phases of the war are telling us about its potential evolution and, in turn, what this means for natural gas markets and stakeholders. At its core, the evolution of the conflict and the outlook for the region centers around two key questions:

- Will the Iranian regime survive?
- In the event of regime change, will a new stable government emerge?



Without making any assessment of their relative likelihood, this creates three potential scenarios that capture the theoretically possible range of outcomes:

- Scenario 1: survival of a wounded Islamic Republic, which will remain a source of regional instability and with the high likelihood of a future resumption in military activity with the U.S. and Israel
- Scenario 2: successful regime change, with the achievement of the broadest, and weakly defined, set of objectives set out by the U.S. and Israeli administrations and a permanent change in regional politics. In the long-term, this means the possible rise of Iran as a U.S.-aligned regional power
- Scenario 3: a fall of the Iranian regime without the creation of an alternative centre of power, leading to a prolonged period of chaos within Iran and the region as a whole and with no clear route to a return to stability

All three scenarios clearly will see significant disruptions to LNG trade in the short-term, with highly volatile prices driven not by market fundamentals but by reactions to news and domestic and international political developments. The magnitude of a now increasingly likely global supply crisis will depend on the ultimate duration of the conflict.

However, the most important takeaway of this analysis of the potential outcomes of the war is that only in Scenario 2 are the impacts on global gas markets contained to the period of the conflict or the near aftermath. Both Scenarios 1 and 3 lead to an extended period of uncertainty with further rounds of escalation and uncertainty well beyond the end of this phase of military action.

In our initial analysis, published on 2nd March, we highlighted the following questions as being key in shaping the relative likelihood of different scenarios for the outcome of the war:

1. Any signs of an intensification of anti-regime protests or the formation of a credible alternative with broad support across Iranian society – so far, there has been no evidence of this, including the possible spread of Kurd insurgencies in the north of Iran. The statements by Donald Trump indicating he wishes to pick the next leader of the country are likely to be harmful to the development of such a movement
2. The success of repressive activity by the regime and the compliance of Iranian security forces with efforts by the regime to quell any potential unrest – this appears not to have been required so far
3. The activity of Iranian proxies, which may expand the conflict to other countries and transform this conflict into a full regional war – this appears to have already, at least partially, occurred (i.e. Lebanon)
4. The ability of Iran to sustain its military response to U.S. and Israeli attacks despite suffering significant losses and damage to its military capabilities – while Iranian military capabilities are likely to have been significantly degraded, the ability to wage a protracted hybrid, asymmetric war remains credible

In light of the events of recent days, which have seen a progressive expansion in the scope of the conflict, we have added two more to this list:

5. The activity of nearby affected states, which may drag other regional players into a protracted conflict and take a resolution away from the hands of the U.S. – players

such as Saudi Arabia, the UAE, and Qatar have been openly discussing a direct intervention in the conflict

6. The impact of a disruption to energy trade on the global economy and how successfully the U.S. and other Westerns will be able to limit Iranian efforts to cause such disruptions – this impact is rapidly escalating. Very soon we are likely to see efforts to reopen the Strait of Hormuz as the price paid due to the closure of Hormuz becomes unbearable; the likelihood that this will succeed in bringing a resumption of business-as-usual oil and natural gas trade, though, is very low, at least until the conflict comes to an end

The evolving answers to these questions will continue to shape the relative likelihood of the three scenarios described above. Crucially, though, all signals so far point at a progressive escalation rather than efforts to contain the duration of the conflict.

Importantly, so far, no de-escalation and ramp off strategies have been offered by the U.S., Israel, and Iran. While the first two actors initiated the conflict and appear at a strategic advantage, the second one sees the fight as a war of survival. President Trump's recent statement that the war will only end with Iranian unconditional surrender will reinforce this perception. The Iranian regime has prepared for decades to this scenario and, despite being weakened by economic and social unrests, it remains a significant adversary, especially when considering the possibility of a ground invasion.

This means that, at present, there is no clear route to rapid resolution. With every further escalation, the likelihood of a protracted conflict is increasing. When considering the three theoretical scenarios described above, there appears to be at present no obvious path for the first two scenarios to play out. The absence of signs of a viable alternative to the regime within Iran, especially, make Scenario 2 the least likely at present. The result is that a prolonged period of disruptions to trade of LNG via the Strait of Hormuz is significantly more likely than a week ago.