

# THE RE-INTEGRATION OF IRAN INTO THE GLOBAL ENERGY MARKETS AND ITS GEOPOLITICAL IMPLICATIONS

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## Background

International sanctions started to hit Iranian economy after the Iranian Revolution of 1979. This year was marked with the first in the series of sanctions after the takeover of the U.S. embassy in Tehran. These sanctions were substantially lifted, but more of them followed in Carter's, Reagan's and Clinton's tenures of presidential office in regard to the Iranian regime's terrorist activities and human rights violation<sup>1</sup>. After International Atomic Energy Agency (IAEA) discovered in 2004 that Iran shifted to the nuclear program which could potentially have a broader reach, UN and EU have also imposed sanctions. Iran refused to cooperate with IAEA on the subject of its uranium enrichment which was allegedly intended for illicit procurement of nuclear weapons. These latter sanctions not only hit oil and gas industries, which were fundamental for the economic stability of the regime, but also included various embargos on banking and trade. In 2012 Iran could not operate its financial services industry anymore, since it was cut off from SWIFT, a world hub for banking services.

As EU companies withdrew from Iranian market, Iranian economy was crippled in many ways. A nuclear program could not be continued at the same scale due to lack of necessary equipment to be produced in Iran. As for energy industries, with limited access to western technologies to increase production efficiency and lack of the same number of customers, energy industries have stopped pumping as much oil and gas as they used to and lost prior competi-

tiveness. Before the sanctions hit, the oil production totaled 4.2 million barrels a day in 2012 and accounts for only 1.3 million now<sup>2</sup>.

It turned out this spring that years of sanctions could be put to an end. Almost two-year negotiations culminated by the nuclear deal struck in Vienna on July 14, which provide for potential removal of sanctions related to Iran's nuclear activities. Though sanctions on rocket and other defense industries are still going to be in place, this will already soothe Iran's dire economic state by opening the gates for international companies to gain from one of the biggest closed economies. With sanctions on key business industries and banking gone, Iranian economy can promptly boost its economic growth. The hydrocarbon industry accounts for just 15% of Iran's gross domestic product, which as of 2013 was the 18th largest in the world measured by purchasing power parity<sup>3</sup>, but both of these indicators might improve as early as next year. Although energy markets are not exactly in the same shape as in 2012, a will of the international community to open this market can contribute to a prompt recovery of Iran's economy. It faced significant inflation of some 50%-70% in 2013, while its GDP plunged by 5%<sup>4</sup> in the same year.

## Impact on global oil and gas markets

**Oil.** At the close of signing a nuclear deal in Vienna, Iranians were already planning some

<sup>1</sup> "Iran Sanctions." *U.S. Department of State*. U.S. Department of State, n.d. Web. 14 Aug. 2015.

<sup>2</sup> IEA Oil Market Report 2015 <https://www.iea.org/oilmarketreport/>

<sup>3</sup> "Investors Eye Iranian Opening - FT.com." *Financial Times*, July 7. <http://www.ft.com/intl/cms/s/3/da428b4c-23d3-11e5-bd83-71cb60e8f08c.html#axzz3iUsDeLvd>

<sup>4</sup> International Monetary Fund data <http://imf.org>

of their strategy. National Iranian Oil Company (NIOC) has been ordered to increase its production at that time<sup>5</sup>. The sanctions are still officially in place, but Iran can boost production by 500,000 barrels a day within three to six months, according to Facts Global Energy, a consultancy bolstering public finances<sup>6</sup>.

According to different estimates, Iran can supply 0.5-1 mln barrels per day next year while the global consumption of oil and other liquid fuels amounted to 93 mln barrels a day (and 95.3 mln barrels supplied as of January 2015)<sup>7</sup>. Since the oil market is not exactly strong these days with already existing glut of oil, any additional supply can drag the price down. This pressure on the price can pull down the price for a barrel of Brent well below \$50 per barrel when the U.S. and U.N. sanctions are going to be lifted – sensitive markets can emotionally allow the price to drop below a threshold of \$40. However, Iran might not be the main factor – OPEC (Iran is a member as well) has been increasing production ever since the prices started to slide. Saudi Arabia, the largest oil producer, has boosted the production to 10.6 mln barrels this June, the highest in its history<sup>8</sup>. The USA has also no plans to cut back on its production.

Years of deprivation from western technology have had a toll on Iranian abilities to produce and supply immediately and for this reason some experts say that Iranian oil is going to return to the markets only in the medium-term perspective. Other sources seem to have a similar stand on Iran's capabilities to return to the market. Société Générale, a French bank, says "Iranian crude will not become a major issue for the oil markets until 2016"<sup>9</sup>. Iran still has an estimated stored capacity of 30 million barrels that could have not been supplied anywhere else due to the sanctions and letting out this amount of oil in the global market might be

acid for the oil price, though this is deemed an unlikely scenario.

Since sanctions are going to be lifted in intervals when Iran proves its compliance after IAEA investigations – possibly first sanctions could be lifted by the end of this year.

According to Amir Zamaninia, a senior deputy oil minister, Iran's energy sector requires investments of \$185 billion by 2020<sup>10</sup>. Likes of Shell, Total, BP, Lukoil and Eni openly acknowledge negotiations about the new contracts in Iran. Though the companies are attracted to low capital expenditure for production per barrel – \$10-15<sup>11</sup>, their managers are looking for improved terms in agreements due to losses they suffered after the EU introduced their sanctions in 2011 and the risk of Iran's non-compliance with the nuclear deal. Most notably, the companies hope to bear fruit of integrated petroleum contracts which suggest longer timeframe and scope of cooperation. Despite prior objections to these steps, Iran might be willing to introduce joint ventures up to 20-25 years with western partners where they may even partly own the oil for production in exchange for transfer of technologies<sup>12</sup>. This measure is undertaken by Iranian government in order to incentivize multinationals for a higher risk they have to bear by also lulling them into a long-term cooperation, which can lead to a sustainable growth.

**Natural gas.** Iran has second largest natural gas reserves in the world, with 34 trillion cubic meters in reserves<sup>13</sup> and there are multiple countries willing to receive energy from Iran once the sanctions are lifted. India, China and European Union could be competing for natural gas flowing from Iran. The question is, however, that most infrastructure is not built to any of these territories and the investment in any of

<sup>5</sup> «Иранская НАОС получила задание увеличить нефтедобычу» *Technoblog.ru*, July 15. <http://teknoblog.ru/2015/07/15/42764>

<sup>6</sup> "Investors Eye Iranian Opening - FT.com." *Financial Times*, July 7.

<sup>7</sup> IEA Oil Market Report 2015 <https://www.iea.org/oilmarketreport/>

<sup>8</sup> OPEC Monthly Oil Market Report. July, 2015. <http://www.opec.org>

<sup>9</sup> "How Iranian Nuclear Deal Would Affect Oil Markets." WSJ, April, 2. <http://www.wsj.com/>

<sup>10</sup> "Iran Holds Out Improved Oil-Contract Terms." WSJ, June 18. <http://www.wsj.com/>

<sup>11</sup> Data according to Turquoise, consultancy specializing on investments in Iran <http://www.turquoisepartners.com/iraninvestment/>

<sup>12</sup> "Iran Holds Out Improved Oil-Contract Terms." WSJ, June 18. <http://www.wsj.com/>

<sup>13</sup> Natural gas reserves, data from BP website <http://www.bp.com/en/global/corporate/about-bp/energy-economics/statistical-review-of-world-energy/review-by-energy-type/natural-gas/natural-gas-reserves.html>

those projects depends on its cost, the gas price negotiated with Iran and the situation on oil and gas market.

The European Commission, pre-occupied with an idea of energy security and diversification of natural gas supply, might certainly welcome an idea of another large partner coming to the market. Multiple projects such as Nabucco, Iran-Iraq-Syria pipeline and TANAP/TAP discussed for a long time leave many people perplexed which route exactly will be chosen in the end, but the latter is actually preferred by the European Commission. Iranian officials reassured that they could implement Azeri and Turkmen gas in a single pipeline running to the EU<sup>14</sup>, though it is not exactly in its interests. Notably there is no existing pipeline from Azerbaijan to Iran and it might take years to build one. Shah Deniz, a gas field located in Azerbaijan, can potentially produce as much as 25 billion cubic meters and European looked positively at the prospect of Azeri gas to flow in Europe as well. Gazprom, facing legal challenges in a number of countries in Europe in 2012-2013 and on-going uncertainty about its "Turkish Stream" project, might have to budge on their prices even more when Iranian gas will start flowing to Europe. The Russian natural gas typhoon has a considerable cushion of time before Iranian gas flows in Europe thanks to a dilapidated production infrastructure and lack of actual pipelines from Iran to the EU.

There is an important implication of any pipeline running from Iran to the west. With Kurdish and ISIS unrest on the borders between Turkey and Iran, pipelines could be damaged causing a temporary inability to supply gas. For example, the existing pipeline carrying natural gas from Turkey to Iran often came under attack by Kurdish militants since the 1990s and up until 2013, with the new attack happening on July, 28<sup>15</sup>. Due to this geographical neighborhood Iran cannot become a truly reliable partner, since these attacks will persist as long as the Kurdish problem is not resolved.

<sup>14</sup> "Iran Seeking Role In Selling Gas To Europe." RadioFreeEurope/RadioLiberty, February, 22. <http://www.rferl.org/content/russia-iran-gas-supply-europe/26862739.html>

<sup>15</sup> "Attack halts flow in natural gas pipeline from Iran to Turkey." Yahoo, July, 28 <http://news.yahoo.com/>

## Geopolitical outlook

The nuclear deal was generally welcomed by Europeans: eurozone prime-ministers immediately arranged visits to Iran after the accord was struck<sup>16</sup> following many of the European multinationals which visited Tehran to discuss new business opportunities. Switzerland went ahead and lifted its sanctions effectively on August, 13<sup>17</sup> without waiting for the results of IAEA inspections, which is a basis for the rest of European countries to lift their sanctions. Switzerland has traditionally held close ties with the Gulf state, as Iranians reportedly registered sanctioned companies in Switzerland. The companies would be operated for some time under this arrangement to be renamed or re-registered in any other way to circumvent the sanctions. Switzerland is home to some largest oil traders and the country's move to lift the sanctions can help it be in the front accessing the closed market earlier than the rest of European countries.

European businesses are flocking to Iran in the face of the new lucrative deals possible to start as soon as the sanctions are going to be lifted. It is true that EU and UN sanctions are going to be lifted in intervals when Iran proves that it adheres to agreements laid out in Vienna deal, but the prospect of opening this market for European companies hindered by the Ukrainian crisis make European political rhetoric very favorable towards Iran and the nuclear deal. According to World Bank, Iran will grow 5% in 2016 surging from 3% this year<sup>18</sup>. This growth is also reflective of prospective return of European investments in Iranian economy.

However, there is a lot of criticism of the Vienna deal heard throughout the world, with Saudi Arabia and Israel most vocal in the region, and in

<sup>16</sup> "European Companies: Enter The Iranian Market At Your Own Risk". *Forbes*, July, 29. <http://www.forbes.com/>

<sup>17</sup> Federal Department of Foreign Affairs of Switzerland <https://www.eda.admin.ch/eda/en/dfa/representations-and-travel-advice/iran/switzerland-iran.html>

<sup>18</sup> Shanta Devarajan, Lili Mottaghi. 2015 "Economic Implications of Lifting Sanctions on Iran" Middle East and North Africa Quarterly Economic Brief, (July), World Bank, Washington, DC.

the U.S. as well. First, critics note that a nuclear issue is not directly resolved, since the deal only provides for reduction of enriched uranium stockpile and enrichment capabilities. International Atomic Energy Agency representatives will as well receive access to suspicious sites, but Iran can potentially boost his nuclear activities after 10 years of compliance with the nuclear deal when the agreement expires. Second, there is a potential shift in power balance that the removal of the sanctions will cause in the region. Iran can certainly regain its political power when the country gathers economic momentum.

As for one, Israel was predominantly concerned with the nuclear deal calling it "the biggest mistake"<sup>19</sup> for the security of the Middle East. Saudi Arabia has a similar stance which arises from religious dissimilarities with Iran guiding their foreign policy in many aspects. Netanyahu, Israeli prime minister, is sensitive about the neighborhood with Iran and the long-standing record of hostility of the military elites and the terrorist activity, for which Iran was sanctioned in the past. Israelis fear that once Iran becomes economically stable again, funds can be allocated to fight an Israeli state. Netanyahu also point out at a possibility of developing nuclear bombs that can even reach the USA, since President Obama was one of the initiators of the nuclear deal.

Though the deal is backed by Obama administration, it is not certain whether Congress will accept the terms of the nuclear deal. Multiple Republican congressmen noted uncertainty of the implications of the nuclear deal after its expiration. Their discontent is fueled by Obama's promise to veto any bill blocking implementation of Iran deal.

For some countries in the Middle East the nuclear deal opens additional opportunities. United Arabian Emirates, Iran's neighbor traditionally played a role of a host for many Iranian businesses after the sanctions hit – and accounts for over 10,000 Iranian companies now<sup>20</sup>. Some of them served plainly to overrun

sanctions and maintain banking and other business operations. UAE is a strong banking hub and has a developed aviation industry, both of the areas that Iran might be interested to learn from to grow faster.

To the surprise of many international experts, Russia was also one of the most supportive parties in the Vienna deal. Liberation of Iranian oil and gas is definitely not a win-win situation for Russia: Russia can substantially increase the trade in grain, agriculture, military equipment and projects in atomic energy, but it will face increased competition on European energy markets in the medium term. However, this concession and cooperation with the west over Iran could be strategically important to find a way to resolve the Ukrainian crisis by recognizing Crimea's accession to Russia in one way or another.

<sup>19</sup> "Why Iran Deal is So Deadly: Israel Prime Minister Netanyahu Talks with Steve Forbes". Forbes, July, 16. <http://www.forbes.com>

<sup>20</sup> <http://www.economist.com/news/middle-east-and-africa/21659760-many-firms-looking-do-business-iran-will-go-through-dubai-nuclear-deals>

## Реинтеграция Ирана в глобальные энергетические рынки и ее геополитические последствия

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*Аннотация:* Недавние переговоры, прошедшие в этом году в Швейцарии принесли надежду тому поколению иранцев, чья жизнь претерпела изменения из-за международных санкций, наложенных на страну. Переговоры в Венне также внушили надежду простым иранцам на то, что их жизнь будет улучшена. Достижение соглашения с Ираном также может повлиять на глобальные энергетические рынки, поскольку Иран вполне может стать одним из ключевых поставщиков нефти и газа в Европейский Союз и ряд азиатских стран. Он находится на четвертом месте в мире по объемам нефти, а также обладает существенными запасами газа. В течение десятилетий экономической изоляции Иран не имел доступа к западным технологиям и сейчас необходимы существенные инвестиции в нефтегазовую отрасль, чтобы наладить поставки этих ресурсов в Евразию. При этом в случае экономического роста Иран может восстановить свое политическое влияние на Ближнем Востоке, что станет источником дальнейших разногласий с Израилем и некоторыми арабскими странами.

**Ключевые слова:** ядерная программа Ирана, глобальный энергетический рынок, геополитический баланс сил.

## The Re-Integration of Iran into the Global Energy Markets and its Geopolitical Implications

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*Abstract:* Recent negotiations earlier this year in Switzerland brought hope to the generation of Iranians whose life have been altered by the damaging influence of international sanctions on the country's economy. Recent high-level negotiations in Vienna have a tangible promise of final relief for ordinary people. This nuclear deal has a high potential to influence on global energy markets, since Iran could be a major oil and natural gas supplier to the European Union and a number of Asian countries, since it holds fourth largest reserves of oil and largest reserves of natural gas. Decades of economic isolation from western technologies have had a detrimental effect on the industrial development and the economy needs major investments in order to bring Iranian gas and oil flowing in Eurasia. Iran has some idle capacity of oil waiting to pave its way to the customer once the sanctions are effectively lifted after the accord struck in Vienna on June, 14, and this certainly puts additional pressure on oil and gas prices. Moreover, Iran's economic growth can restore its political influence in the Middle East which has already been source of contention in Israel and some Arabian countries.

**Key words:** Iranian nuclear programme, global energy market, geopolitical balance of power.