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Post-sanctions Iran: Impacts on energy markets

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Introduction

The country of Iran has a key position in energy and general security architecture of the Middle East and the world. The Islamic Republic of Iran preserves one of the biggest energy reservoirs in the world, largely still intact – the country has the second biggest gas reserve and the fourth biggest oil reserve in the world. Its geostrategic location for a major oil and gas exported is ideal as it is located between the oil- and gas-rich Caspian Sea and the globally richest region in terms of energy, the Persian Gulf, where the production cost of oil is the lowest in the world. Still, the country has been isolated since the revolution 37 years ago, and the harsh sanctions targeting the country's energy sector introduced in 2012 have crippled its economy. After years of exclusion from the major developments in the energy markets, Iran is ready to reclaim its role as a major oil and gas producer after the removal of international sanctions in January 2016.

Since the lifting of sanctions, foreign investors have been swooping on Iran to get a lucrative deal in a country hungry for direct foreign investments after years of isolation. Iran is becoming more and more a country to do business with and to invest in, as international companies assess the huge potential of this country with a population of 80 million people. In a first visit to Europe by any Iranian president in sixteen years, Hassan Rouhani visited the Italian and French capitals in January 2016. Moreover, Europe views Iran more and more as its strategic partner, and even companies from a small European Union (EU) country like Croatia seek business opportunities in Iran, evidenced by the Croatian president Kolinda Grabar-Kitarović visiting Iran in May 2016, accompanied by CEOs of major Croatian companies.

Sanctions imposed on Iran lifted after a devastating effect on its economy

With the beginning of 2016, global energy markets are facing a new challenge: how will they cope with the influx of oil and gas from Iran, a country with one of the biggest energy reservoirs in the world? On 16 January 2016, the United States and the EU lifted the sanctions imposed on this country in trading oil, gas and petrochemical products; a move that was anxiously expected after the five permanent members of the United Nations Security Council (China, France, Russia, United Kingdom, and the United States plus Germany – the so called P5+1), the EU and Iran had agreed on a Joint Comprehensive Plan of Action (JCPOA) just six months before, on 14 July 2015.

Complying with the JCPOA conditions, Iran is obliged to dismiss much of its ambitious nuclear program, in return for lifting the sanctions on the oil and gas sector. The lifting of energy sanctions was combined with the lifting of financial sanctions, since from the Iranian revolution in 1979, Iranian assets worth more than 100 billion dollars, excluding the 37 years of interest, had been frozen in Western banks. There is no doubt that this thaw in relations between this Middle Eastern regional power, and the West, namely the world's sole superpower, the United States, is a landmark event that will open Iran to the world and boost the country's influence in a region embroiled in numerous tensions.

Iran preserves the world's second largest proven natural gas reserves and fourth largest crude oil reserves, and the re-emergence of Iran on the oil and gas market will inevitably have an indelible impact on the global energy market and the global economy as a whole. Further to this, Iran needs to invest billions of dollars in its energy infrastructure, since years of international sanctions and isolation have halted investment in the energy sector, crippling its capacity and restraining the country with an obsolete upstream production technology.

Sanctions to Iran were imposed in 2005 when the International Atomic Energy Association (IAEA) under the auspices of the United Nations declared that Iran was developing its uranium-enrichment program in a capacity perceived to have a military use. Due to the long period in which the Iranian oil and gas industry was denied access to the United States and EU markets, many of the country's energy potentials have not been utilized and many upstream projects in the oil and gas sector have been abandoned.

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Because Iran was quite persistent in pursuing its agenda in a uranium-enriching program, the United States and the EU imposed at the end of 2011 and in 2012 sanctions tailored to hit the country at its weakest point, by banning the Iranian crude oil exports, and by

ousting Iran from the European International Group of Protection and Indemnity (P&I) clubs, which insure the vast majority of the world's oil tankers, thus effectively denying Iran an opportunity to ship its oil overseas. How devastating were the effects on Iran of these sanctions imposed by the West is evident in the figures of crude oil exports, which have plummeted from 2.5 million barrels per day (mb/d) in 2012 to just over 1 mb/d in late 2015. In this period, only six big energy importing countries, including China, India and Japan, were allowed to purchase Iranian crude oil.

Post-sanctions Iranian potential on global oil and gas markets

With sanctions finally lifted in January 2016, Iran will now be able to release its huge oil and gas potential to the market. The country will first release its crude oil stored on oil tankers – notably, the American Energy Information Administration estimated in 2015 that Iranian tankers had some 30 mb of oil floating on vessels in Iranian territorial waters.

With the oil glut present on the global market and with sluggish global demand, factors that are both contributing to oil prices plummeting to the lowest level since the global crisis in 2009 - in January crude oil prices were around 30 dollars per barrel (pb), it is highly unlikely that Iran will over night worsen this oil glut. It is more likely that Iran will be releasing some 100,000 to 200,000 b/d of crude oil during the first six months after 16 January, to gauge the reaction of the energy markets, and to avoid creating dumping oil prices. So, Iran has an opportunity to pump its oil onto the global market, and in the meantime to boost it production to a much higher level than that during the period of 2012–2015, when the sanctions regime was harshest.

There is no doubt that the Islamic Republic will invest much effort to bring the production of oil and gas to the level before the sanctions had been imposed and in the shortest possible period, which has been announced by Iranian officials who claim that this level will be reached by spring 2016. However, it is highly unlikely that this will occur rapidly and it is expected that Iran will need approximately 12 months to upgrade its production level of 1 mb/d of crude oil in 2015 to 2 mb/d. This is due to the fact that many oil wells and reservoirs in Iran have been shut down or abandoned for years, and many fields that are currently in use are mature and face decline of production.

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Whatever the pace, this re-emergence of Iranian oil exports on the global market will surely contribute to the oil glut already present on the global markets. Surging oil and gas imports will allow Iran to be present on the Asian market where other countries from the Persian Gulf, primarily Saudi Arabia on oil markets and Qatar on gas markets, have taken a major share, with Russia, another major global

oil and gas producer, making its way through the Tran-Siberian pipelines to the Asian market too, namely China.

In 2016 and beyond, Iran will also view how to regain its share of the market to the other big energy consumer – Europe. According to the European Commission, Europe imports more than 50% of its energy demand. Before the sanctions, Iran was exporting around one 1 mb/d of crude oil to Europe, and this Iranian export has dropped to just 100,000 b/d of crude oil to Turkey by the time sanctions had been lifted. In European refineries, Iran will face harsh competition, primarily from Russian and Saudi Arabian crude oil.

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Iran's gradual re-emergence as one of the major oil and gas exporters will add an extra pressure on oil and gas prices, which have been declining ever since the summer of 2014 only to reach record low levels in January 2016. The World Bank estimated in 2015 that lifting sanctions to Iranian oil and gas will further increase the high global supplies, thus putting a new pressure on oil prices with an estimated 15% decline. Indeed, from the Brent crude oil price of 38 dollars in mid-December 2015, oil prices fell to around 30 dollars pb in January 2016, just days after sanctions to Iran had been lifted.

It is also uncertain how other OPEC countries will react to the re-emergence of one of its members, especially neighbouring Saudi Arabia and Iraq, major oil producers within OPEC, which currently produces more than 30 mb/d of crude oil. In February 2016, Saudi Arabia and Russia, one of the major oil producers that is not a member of OPEC, struck a deal to decrease global oil production in order to entice a new surge in oil prices, since plummeting oil prices have a devastating effect on both economies. Nonetheless, it is not likely that this Arabian–Russian deal will succeed in decreasing supply and spiking oil prices.

From January 2016, Indonesia has re-joined OPEC, thus contributing to the oil block production with an additional 800,000 b/d. OPEC will have a hard time controlling the supply from its member states, including Iran, so it can be expected that Saudi Arabia will maintain a high level of oil exports, regardless of its deal with Russia, in order to uphold its market share and push shale oil producers from the US out of the market, due to the higher cost of shale production.

Regardless of the OPEC agenda, the Iranian officials have already announced that they want to increase the oil production of the Islamic Republic to a level of 5 mb/d by 2020. Currently, 5 mb/d is equal to around 5% of the global daily crude oil output. If the Iranians manage to reach this ambitious goal, Iran would become one of the key crude oil producers, along with the United States, Saudi Arabia and Russia. However, in order to achieve this, Iran will need to invest up to 100 billion dollars in updating its obsolete energy infrastructure or in developing new oil fields over the next five years. These efforts to raise

huge assets could be hampered by the currently low oil prices, with a future prospect of any major surge in oil prices looking rather bleak in the coming years.

Nonetheless, Iran's strengths in the competition on global energy markets are to be found in its favourable geostrategic location and geological conditions, which could have a decisive role in placing Iran as the major oil and gas producer and beating its rivals. Iran is the only country in the world that at the same time lies on huge energy reservoirs in the Persian Gulf and the Caspian Sea. The location of the Iranian Islamic Republic lies on the route from central Asian countries to the Arabian Sea, and between Turkey in the West, which will be connected by the TANAP and TAP pipelines to Europe by 2020, and the Indian subcontinent in the East. In Iran, oil and gas are extracted in the Persian Gulf, onshore and offshore, with the energy abundant Caspian Sea basin largely intact.

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The Middle East, including Iran, holds around 50% of the world's oil reserves, and in this region production costs are lowest. NIOC, the National Iranian Oil Company, estimates that crude oil production costs in Iran are between 5 and 10 dollars pb, which is far below deep water and shale oil cost of production in the United States, or Russian production costs where much of crude oil is extracted in the permafrost of Siberia.

These two factors will significantly increase Iran's stakes in beating its competition on the energy markets. This has already been recognized by European companies such as Total, Eni, BP and Shell, which have already expressed their interest to invest in the energy sector of Iran. The Iranian president, Hassan Rouhani, visited Italy and France soon after the sanctions were lifted on 16 January, and European energy majors are lining up to visit Teheran in order to get a contract in the lucrative Iranian oil and gas industry.

Conclusion

World energy markets have witnessed since the second half of 2014 the biggest plunging of oil and gas prices since the global economic recession in 2009. In its *Medium-Term Oil Market Report* (MTOMR) published on 22 February 2016 for the period 2017–2020, the International Energy Agency (IEA) does not predict a significant surge of oil prices, with greatest production gains for the United States among non-OPEC, and for Iran among OPEC member states. Iran can release more than 30 mb/d of crude oil floating on tankers by mid-2016, and it can increase its crude oil production to around 2.2 mb/d by the end of the year, almost reaching the levels of pre-sanctions production levels. Further to this, by 2020 Iranian oil production could surge to 5 mb/d, placing the Islamic Republic among the top global oil producers.

This increase in crude oil production can only be reached with significant investments from Western, primarily European, companies, which have already expressed their high interest to invest in the country's huge energy sector. This interest of the European energy majors is due to Iran's favourable geostrategic location between the Persian Gulf and the Caspian Sea and to its favourable geological conditions, which decrease the crude oil production cost to just 5 to 10 dollars pb. For these reasons, it is expected that Iran will be able to attract the necessary investment into its oil and gas sector and boost its production to the desired level of 5 mb/d by 2020. This will inevitably contribute to the oil glut on the global market, which has already occurred in 2015 due to the slow pace of recovery of the world's economy and harsh competition of OPEC producers, primarily Saudi Arabia, Russia and the United States, which is currently the biggest oil and gas producer in the world, with ambitions to significantly boost its oil and LNG exports to Europe and Asia. This will undoubtedly bring harsh competition to the world energy markets, with continuing pressure to keep the oil prices low, and with Iran emerging as one of the top oil and gas producers by the end of this decade.

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