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SNAPSHOT **October 26, 2015**

Tehran Tea

Why Oil Might Not Flow Fast from Iran

By Mansour Kashfi

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international oil prices have fallen, and competitors—namely Iraq, Kuwait, and Saudi Arabia—already have footholds in emerging Asian markets.

FIXING A CRUMBLING INFRASTRUCTURE

Iran's once-prosperous petroleum industry has suffered tremendous setbacks since 1979. Tehran's oil production prior to 1979 was over 5.8 million barrels per day with a potential capacity of 6.3 million, making it the world's second-largest oil exporter and the fourth-largest oil producer. The nation had nine well-maintained refineries in operation and two more were near completion, giving Iran the ability to both satisfy domestic needs and generate exports.

Prior to the Iranian Revolution, the National Iranian Oil Company (NIOC) was well run and operated not only in Iran, but also managed international investments and refinery operations in India, South Africa, and South Korea. The NIOC had even reached a tentative agreement to enter U.S. markets to refine and distribute petroleum products, and was in the process of establishing similar ventures in Europe.

In those days, Iran also had nascent plans to produce power from atomic energy. Almost all countries in Europe and North America involved in this business, specifically France, Germany, and the United States, offered Iran their assistance and atomic know-how. In fact, the first Iranian atomic power station was built in 1978 by a German contractor, and the second power station was in the process of being built by a French contractor before the revolution. Since the revolution, Iran's oil and gas industry has suffered massive losses due to corruption, lack of professional and experienced management, technological stagnation, lack of capital, and limited investment in infrastructure.

Not helping matters was the damage inflicted during the 1980–88 Iran-Iraq war, including damage to major portions of the Abadan refinery, which was the largest refinery in the Middle East at the time, as well as several production units and pipelines both on land and offshore in the Persian Gulf.

The damage inflicted during the Iran–Iraq war ravaged Iran's economy, and in an effort to revive the economy and gain more income Iran overproduced, which resulted in geological damage to the reservoirs. To recover from this damage, Iran will need time and substantial capital. And although international sanctions have reduced oil production by one million barrels per day, poor management and chronic corruption was responsible for almost halving oil production prior to the revolution.

CRUDE TALK

Sanctions aside, Iranian oil output has plateaued for some time. Sluggish production has created numerous problems: the pressure in Iran's oil reservoirs has dropped, which slows and reduces production; long periods of technical constraints on operations have resulted in poorly calibrated machinery; and the natural aging of the nation's oil fields means that they will never produce as much as they once did. Deprived of technological advancements, outside investment, and good management, the industry is in a state of advanced decline and requires immediate attention.

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Iranian Oil Minister Bijan Namdar Zanganeh, who surely understands the dire state of the industry, has nevertheless issued bullish promises about the nation's oil discoveries, gas production, petrochemical potential, and new refineries. Zanganeh, who took office in mid-2013, told the OPEC ministerial conference in Vienna in December 2013 that "The revival of Iran's lost share in the oil market is my top priority. Under no circumstances will we reduce our global share even by one barrel and give up our rights on this issue. We will reach four million barrels per day of oil production, even if the crude price falls to 20 dollars a barrel, and we will be able to reach our pre-sanctions level of exports early next year." In March this year, Zanganeh declared that Iran could raise its oil exports by one million barrels a day within two months after sanctions are ended, and pump four million per day in three months. And lastly, during an April meeting in Tehran with Venezuelan Oil Minister Asdrubal Chavez, he said that OPEC has to prepare itself for an increase in Iranian oil production to pre-sanctions levels.

Zaganeh's statements are overly optimistic, however, and the timeframe he proposes is impossible. According to a September U.S. Energy Information Administration (EIA) report, Iran can increase its oil production only by 300,000 barrels per day in the second half of 2016. In fact, the EIA believes that Iran will not significantly increase its oil output for another three to five years. In part that is because, sanctions will be lifted gradually, and only if Iran acts in good faith within the International Atomic Energy Agency (IAEA) procedures. The IAEA verification process, which will determines Iran's compliance to its newfound obligations, may last from six to 12 months. And even if EU and UN sanctions are lifted, U.S. sanctions will likely remain for some time, since they are intertwined with laws, mandates, and Presidential Executive Orders—all of which pose hurdles for Iran's export aspirations.

To be sure, false promises and over-optimism are nothing new in Iran's oil industry. In November 2009, former Iranian Oil Minister Rostam Qassemi announced Iran's signing of a contract with China's Sinopec for the construction of five new refineries. At the time, Qassemi said, "Construction of these refineries will increase the country's total oil refining capacity from 1.65 million barrels per day at present to 3.5 million. These refineries will allow our country not only to meet domestic needs, but also to be able to export large volumes of refined products." To date, nothing from this deal has been accomplished. Qassemi, in an interview with *RIA Novosti* in July 2012, said that eight phases of the South Pars gas field, with an anticipated output capacity of 250 million cubic meters a day of natural gas, would be completed by March 21, 2014 to coincide with the Iranian New Year. But again there was no action, just empty promises.

As for NIOC delivering on its promises this time, things don't look good.

TOUGH TIMES

Since Europe stopped importing Iranian crude in mid-2012, NIOC has sold crude at a considerable discount to entice East Asian customers. This practice, however, cannot last forever—especially as global prices continue to fall. Russia and Saudi Arabia are producing vast amounts of oil, while the United States is experiencing a shale oil boom. A slowing economy in East Asia means reduced demand for oil in a formerly hot market for energy. Cheap oil is everywhere, major oil companies are reducing their investments in new ventures, and oil service companies are looking at potential layoffs in the thousands. Oil companies are more selective than ever on where to invest, and Iran might not be at the top of the list, even though Tehran has offered attractive production-sharing agreements, as well as crude oil price cuts.

Iran's Oil Ministry announced during a conference in Vienna this past July that the NIOC has identified numerous potential oil and gas projects that would require $200 billion in investment funds before 2020. In early August, Saeed Ghavampour, NIOC general manager of strategic planning, said that Iran's oil industry needs investment of $100 billion per month for at least five months to be able to reach pre-sanctions production levels. To attract those kinds of investments, Industry Minister Reza Nematzadeh has said that foreign companies can take part in the planned privatization of state-owned Iranian oil companies as soon as sanctions are lifted. This new model would give international producers a bigger share of any profits from the proposed 50 oil and gas projects Tehran will undertake, a change from the less favorable buyback agreements that prohibited oil companies from gaining equity rights. Meanwhile, Iranian officials have said that the country will not impose limitations on foreign investments within its energy industries in its new post-sanctions economy.

Even if Iranian's ministers say that the nation is moving away from state ownership, however, the nation's current constitution says otherwise. Constitutional language still bans foreign ownership of oil and gas, which makes production-sharing contracts impossible, although a share in the output of an oil field could be considered as payment for oil companies' investment. Yet oil companies cannot put speculative amounts of underground Iranian oil on their balance sheets.

Oil companies planning to do business in Iran should be wary of the problems in the country's energy sector. It is chronically corruption and mismanaged. There remains an ever-present risk that the nuclear agreement could collapse and that sanctions would snap back into place. Investments in Iran's oil industry thus remain risky, and they may take a decade or more to bear fruit. Investors know this, and there is little reason to think that they will stampede into the country.

Ending sanctions will possibly boost Iran's economy, but before these effects are seen, the influx of cash to the Iranian economy will provide the government's hardliners and the Islamic Revolutionary Guard Corps with a corpus of cash, with the latter being the number one beneficiary of the end of the sanctions. Contrary to Washington's stance that the lifting of sanctions will boost the Iranian economy, which will soften Iranian officials' positions and promote better behavior within Tehran, boosting the economy will likely increase hardliners' income and their influence over politics and the national economy. Ending sanctions will also strengthen the Revolutionary Guard Corps, resulting in an environment in which proliferation and regional instability becomes all the more likely. Years of stagnation within Iran's oil sector cannot be fixed overnight, just as sanctions cannot be lifted in a day. Both governments and oil companies should be wary of rushing into Iran when much of the heavy lifting is still ahead.

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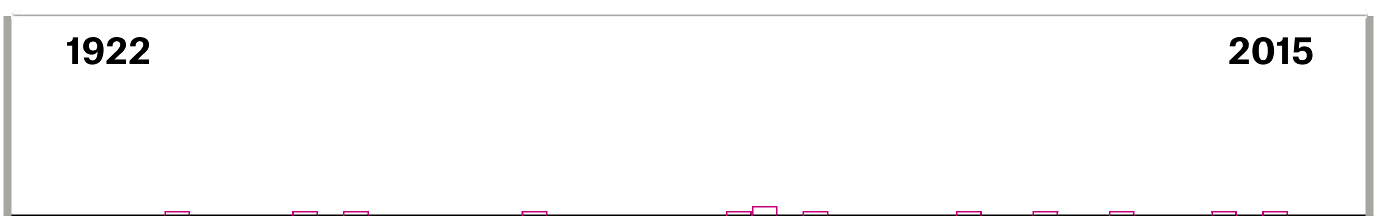

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