



PolicyWatch 2362

A Nuclear Deal with Iran: The Impact on Oil and Natural Gas Trends

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Also available in

January 27, 2015

Most immediately, lifted sanctions on Iran's oil and gas industry could spur tensions with other energy producers, such as Russia, Saudi Arabia, and Qatar.

In last week's State of the Union Address, President Obama threatened to veto new legislation affecting five issues, four of them in the domestic policy arena and just one covering foreign policy. The foreign policy issue in question involved the prospect of new sanctions legislation targeting Iran. Correspondingly, the administration has recently ramped up efforts to conclude a nuclear deal with Iran.

Should the United States and its partners in the P5+1 -- Britain, China, France, Russia, and Germany -- strike a deal with Iran, the global oil and gas markets would no doubt be affected. Indeed, several leading oil and gas companies are already preparing for a return to business in Iran in the event sanctions are lifted. Such jockeying would only intensify once the Iranian oil and gas sector became fully available to international markets.

Oil

In mid-2012, sanctions were imposed against Iran's oil exports, precipitating a drop from 2.5 million exported barrels a day to close to 1.4 million a day. If sanctions were lifted now, Iran might need a full year to bring its production to pre-sanctions levels. Moreover, given current market conditions, only limited international investment will likely be available to help restart its production. For one thing, Iran has not offered particularly attractive terms to investors, and at today's oil prices, investors are cutting back everywhere. Such realities cast major doubt on Iranian oil minister Bijan Zanganeh's recent claim that if sanctions were to end, "Iran will double its oil exports within two months."

However, the announcement alone of an agreement with Iran that removes international sanctions would accelerate the current steady downward trend of the global oil price. Thus, the oil price would be affected even before increased physical supplies of Iranian oil reached the market. And more oil would gradually return to the market, helping keep global oil prices low and perhaps depressing them even further. Burdened by sanctions, Tehran has offered discounts to regular buyers such as China, India, Japan, South Korea, and Turkey. The end of sanctions would most likely mean that such consumers would pay a price more in line with global prices. Accordingly, this could create an opportunity for Saudi Arabia and other Gulf producers to increase their market share.

Natural Gas

Since the Russia-Ukraine crisis erupted last year, Tehran has tried to position itself as a reliable alternative to Russia as a gas supplier to Europe. Indeed, Iran is the only state close to Europe's borders that possesses enough natural gas to rival Russia's dominance in most European gas markets. Iranian president Hassan Rouhani even stated recently that "Iran can be a secure energy center for Europe." And Iran's deputy oil minister, Ali Majedi, boasted in official Iranian media that "Iranian natural gas is Russia's only competitor for Europe." He continued that European countries could import Iran's gas through three separate routes: Turkey, Iraq, or a pipeline running through Armenia and Georgia, and then under the Black Sea.

The notion of Iran as a future alternative gas supplier for Europe is acknowledged by European officials as part of their recent drive to lessen dependence on Russian imports. In April, the EU's foreign policy arm -- the Directorate-General for External Policies -- published a study of the EU's natural gas import options in light of the Ukraine crisis and concluded that "Iran is a credible alternative to Russia."

However credible an option Iran might be for supplying Europe, two main obstacles would slow Iran's entry into Europe's gas markets: one, the need to produce more gas and, two, the need to build infrastructure to get it to Europe. To be sure, Iran is a significant natural gas producer, generating 160 billion cubic meters a year, third globally behind just Russia and the United States. Its output constitutes about 35 percent of annual EU gas consumption. Iran also has vast reserves. Yet interestingly, Iran is a net gas importer, with the country consuming a larger proportion of natural gas than any other country in the world. Iran's high natural gas consumption rate is due in part to its very low domestic gas prices and thus low energy efficiency. Iran imports gas from Turkmenistan and Azerbaijan, while it exports a bit less to Turkey and Armenia.

In Turkey, energy industry sources have reported that Ankara is preparing its pipeline infrastructure to enable transit of Iranian gas to Europe once sanctions are removed. However, natural gas production requires much larger investments than oil production, and concluding a supply contract generally takes a number of years. In addition, either long-distance pipelines or liquefied natural gas (LNG) facilities cost billions of dollars, with these costs recovered only over many years. Such investments are therefore not undertaken lightly. Accordingly, after sanctions are removed, it will probably take at least five years, and possibly much longer, until meaningful volumes of Iranian gas hit European markets. Europe will also compete with Asia for Iran's gas exports, since LNG exports into lucrative Asian markets may be more attractive to Tehran than European markets. If Iran seeks to sell LNG to Asia, U.S. LNG exports to the region could find themselves challenged by a new competitor. However, this would take close to a decade to play out.

Geopolitical Impact

A lifting of sanctions on the Iranian oil and gas industry would have a number of geopolitical ramifications. Regarding the export of oil in particular, the strongest effect would undoubtedly be heightened tensions with Saudi Arabia, including on OPEC policy. Recently, Iranian president Rouhani explicitly criticized Saudi Arabia for what he views as Riyadh's intentional policy to keep oil prices low and threatened that "[the Saudis] will suffer."

On gas, Russia would take steps to block Tehran's entry into European markets, as it has done in the past. In 2007, when Tehran inaugurated gas supplies to neighboring Armenia, Russia's Gazprom immediately bought up the pipeline project within Armenia and built it with a small circumference to preempt its future use for transiting gas to European markets.

Moscow and Tehran could also find themselves competing for gas market share in neighboring Turkey. Already Russia's second largest gas export market, Turkey's role in Russia's gas export strategy has recently grown with Russia's proposed route change of the South Stream export pipeline from Bulgaria to Turkey.

Overall, cooperation between Russia and Iran rests on a rocky basis, and once Iran is released from sanctions and its conflict with the West, many issues of strategic competition between Tehran and Moscow will resurface, including in the sphere of gas markets.

Another potential conflict that may emerge once sanctions are removed and Iran's natural gas industry revives is with Qatar over the delimitation of their shared South Pars/North Dome field. This natural gas field is one of the world's largest and the main source of Qatar's massive LNG exports as well as the main area where Iran has been investing in new gas and oil capacity. Conflict between Doha and Tehran over delimitation has been forestalled somewhat by sanctions and the corresponding lack of investment in Iranian production in the contested field.

Conclusion

If the United States and its partners can reach a deal with Iran, all players must understand the potential consequences of Iran's reentry into the global oil and regional gas market. Most immediately, tensions could surge with other energy producers, such as Russia, Saudi Arabia, and Qatar. The downward spiral of global oil prices would also be reinforced. Tehran, it must be noted, could face serious difficulties finding markets for expanded output and attracting the needed investment in production and gas transit facilities. But in the long term, expanded Iranian output could create more supply options for European and Asian gas markets.

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