Iran: sanctions cast a long shadow

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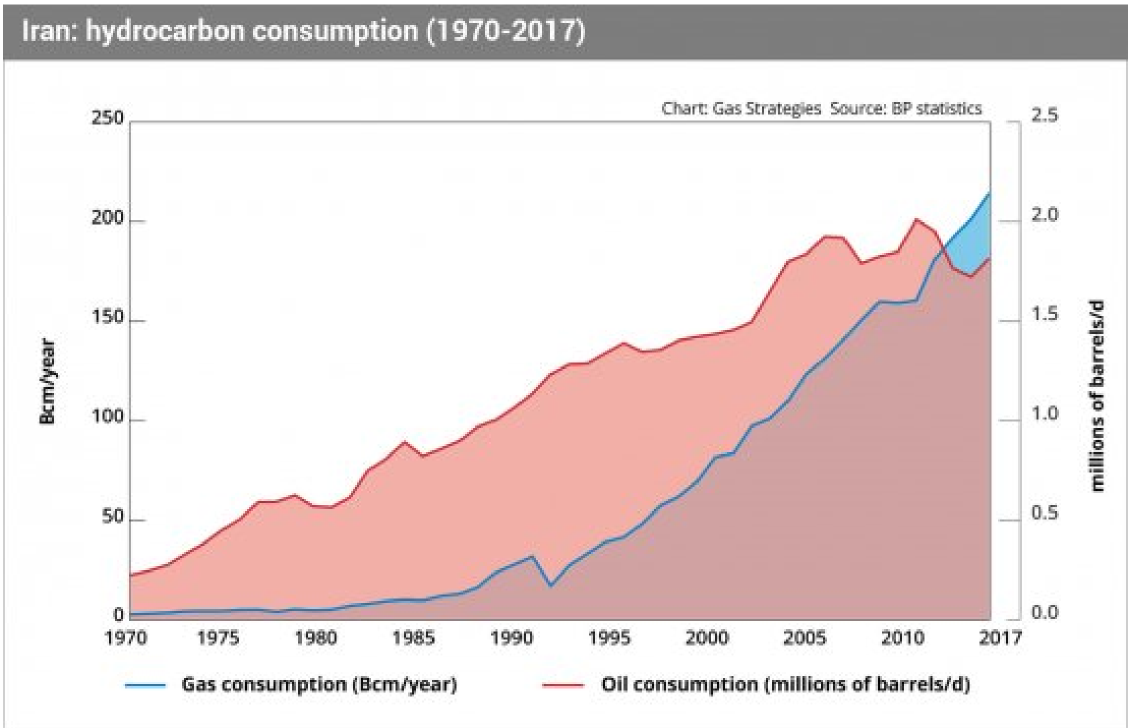
Iran has the second-largest gas reserves in the world after Russia, but with investor sentiment already low and the threat of renewed US sanctions, big questions remain over how the country will attract the foreign investment it needs to achieve its upstream ambitions.

The US is piling on the pressure on companies active in Iran. The White House appears to be prohibiting firms and Iranian banks from using the greenback, which could mean that outsiders spending substantial sums in the country will be unable to repatriate profits. So far, high-profile investor Total has halted involvement in the country's flagship field, South Pars, and has just two months to secure a waiver from the US to avoid these measures. In light of this, Iran's goal of attracting USD 200 billion in investment and ramping up gas and oil production to around 500 Bcm/year and 6 million barrels/d by 2021 seems further away than ever. But there may be more to this story.

Sanctions and new pricing structures

Prior to Hassan Rouhani's rise to president in 2013, the Iranian hydrocarbons industry was languishing after decades of isolation. With outgoing president Mahmoud Ahmadinejad gone, Rouhani prioritised the revitalization of the sector, rehiring many of the specialists previously expelled from the country under the his predecessor. As a result, the Iranian energy sector is currently the best qualified it has been in years, but a lack of investment has left the country's oil recovery rate dwindling at around 20%, well below the global average of 35%. To make matters worse, a significant volume of gas is still flared.



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Iran's primary energy demand – and gas consumption particularly – has steadily increased in recent years as the population of urban areas like Tehran surged and more citizens connected to the national grid. Primary demand has more than doubled between 2000 and 2017 and natural gas has accounted for the bulk of that consumption. The reinstatement of US sanctions [see box] would have wide-ranging effects on both supply and demand within Iran. On the one hand, Iran may export less oil and gas, which would limit supply entering global markets and help buoy prices. However, sanctions would also complicate any planned investments on the demand side, such as new petrochemical plants.

The EU has hit out against the US measures, but the bloc has limited options given the overwhelming use of the USD as a globally-used hard currency. In theory, the EU could initiate several legal mechanisms to protect itself from the sanctions. European leaders are considering imposing a statute that would simply not recognise the legitimacy of US limitations on European companies. However, the White House might view that as an act of economic warfare, which is not an ideal outcome for either side.

"The US economy is so large that any company dealing with Iran can't afford to lose access to the US banking system and US clearing system," Justin Dargin, Middle East energy expert at the University of Oxford, tells Gas Matters. "The Iranians are quite ingenious at developing solutions when they don't have access to western technology, but some of their problems are just too large."

EU leaders like France's Emmanuel Macron, Germany's Angela Merkel and the UK's Theresa May all publicly denounced the US sanctions, but a top-down renegotiation of the Joint Comprehensive Plan of Action (JCPOA) would be an arduous task for which the UN security council's P5+1 countries – China, France, Russia, the United Kingdom, the United States, plus Germany – will be reluctant to pursue, Dargin said. Aside from this, Iran will want to avoid appearing weak by agreeing to a new set of negotiations on a nuclear deal.

US sanctions on Iran

On 8 May 2018, US president Trump announced intentions to remove the US from the Joint Comprehensive Plan of Action (JCPOA) of 2015 and ordered the US Treasury to re-impose all sanctions eased after that agreement in lots.

Activities subject to sanctions from 7 August 2018:

- Iranian government buying USD banknotes
- Iranian government trading gold, precious metals, graphite, aluminum and steel, coal and software for integrating industrial processes
- Carrying out 'significant' transactions or holding 'significant' funds in Iranian rials outside Iranian territory
- Buying or issuing Iranian sovereign debt
- Importing Iranian carpets and foodstuffs into the US
- US exports of passenger aircraft and related parts to Iran
- Iran's automotive sector

Activities subject to sanctions from 5 November 2018:

- 'Petroleum-related transactions' with the National Iranian Oil Company (NIOC), Naftiran Intertrade Company (NICO) and National Iranian Tanker Company (NITC) – including buying oil, petroleum products or petrochemical products
- Transactions by foreign financial institutions with the Central Bank of Iran and Iranian financial institutions
- Transactions between US-owned or controlled entities and the Iranian government or citizens
- Iran's port operators, shipping and shipbuilding sectors

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US sanctions would prohibit access to the US dollar-clearing system, which would effectively ban Iran from pricing energy contracts in USD, which serves as an industry standard around the world. But that is changing, and some Asian countries like China and Japan are considering offering export contracts in other currencies. Iran, too, has created its economic budget in Euro instead of USD to minimise the impact of sanctions.

However, moving upstream contracts away from USD adds complication as the world's two most main oil benchmarks – Brent and West Texas Intermediate – serve as indices for many long-term contracts for gas, LNG and other commodities.

New investors to the rescue?

If US sanctions do manage to sideline western investors, a slew of alternative players may step into Iran. Companies including heavy-hitters Gazprom from Russia, CNPC from China and ONGC from India have expressed an interest in Iranian gas projects. India is already a big importer of Iranian oil, but these purchases have begun to slow and Indian banks IndusInd and UCO have stated that they will no longer process Iranian currency transfers. Moreover, non-Western companies may lack the expertise needed to effectively work in Iran, one associate at

Gas Strategies notes. Evidencing this, China's CNPC is touted to take over Total's share of South Pars, but so far the Chinese giant is yet to make a concrete move.

Companies dealing in Iran will have to look at the cost benefit of their ventures against losing access to the US, Dargin said. In that sense, smaller 'minnows' less reliant on doing business in USD or that do not repatriate funds through US clearing systems may be best placed to enter the country. To further complicate matters, Iran's business environment is fraught with political and financial risk, so if the government wants to attract investment, it may need to offer especially favourable terms to outsiders, the Gas Strategies associate notes.

"Iran's major natural gas focus is Assaluyeh, where the largest world gas field is located and is joint with neighboring Qatar," Fereydoun Barkeshli, former advisor to National Iranian Oil Company says. "Those fields in Assaluyeh will be developed without the United States and Europe, but at a very slow pace. Of course, China and Russia are interested to invest, but given their low level of technology and expertise, the pace of development will still be slow."

However, even if Iran secures funding to develop Assaluyeh, it remains unclear where gas would be exported. At present, Iran exports around 13.5 Bcm/year, most of which flows to Turkey on a 14 Bcm-capacity pipeline, as well as to smaller volumes to Iraq (around 3 Bcm/year) and Armenia (under 1 Bcm/year). Over the years, various new pipeline projects have been touted without ever materialising.

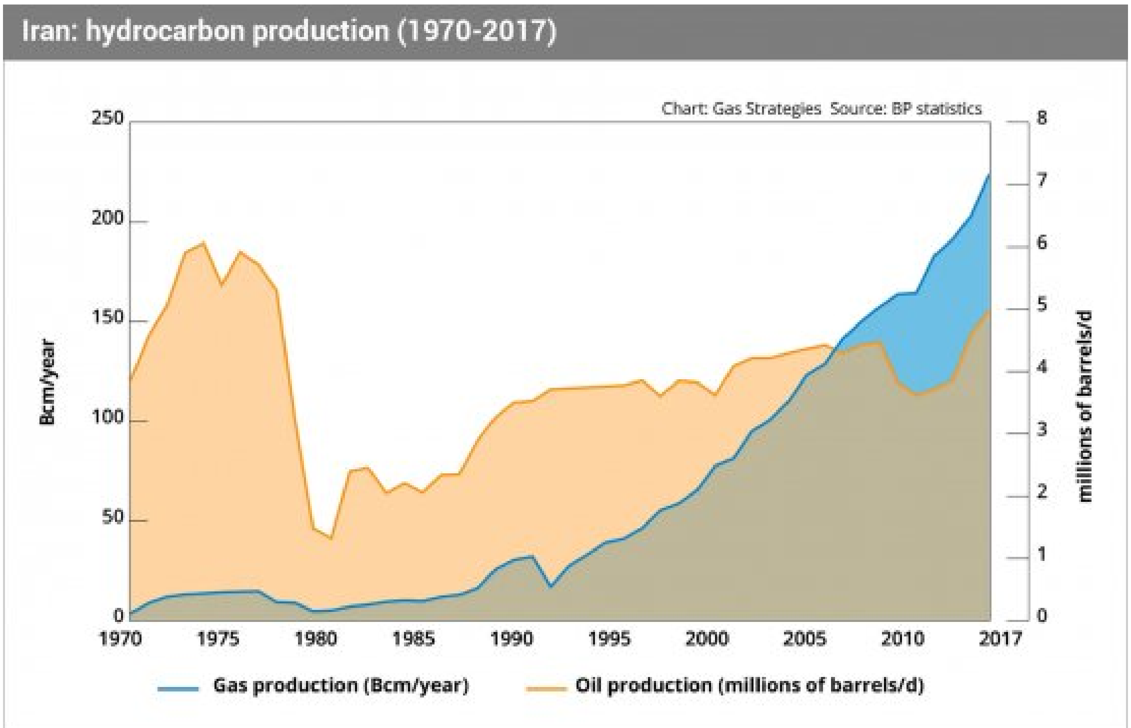
At this point, increasing flows to Turkey appears the least complicated option, since a pipeline already exists and Turkey has sizeable demand, but price remains a sticking point. Until this year, Turkey and Iran had been locked in arbitration because Turkey was paying more for Iranian gas than for gas it was importing from Russia. Turkey eventually won USD 1.9 billion in compensation and a review of the contract. Separately, Iranian exports to Baghdad began in late June after years of delays and there are plans to extend the line to Basra. Flows to Baghdad are planned to run at 2.5 Bcm/year, increasing to nearly 13 Bcm/year under a 25-year contract with National Iranian Gas Company (NIGC).

However, Iran and Iraq have yet to define a clear route for the extension. NIGC has outlined a number of concerns, including the need for security infrastructure along the route from South Pars to Basra and Baghdad to protect against terrorism from Islamic State and other militant groups. "Small-scale criminality and local tribal disputes are the most prevalent security risks in Babil and Qadisiyyah provinces. However, these risks rarely directly impact or threaten infrastructure operation," Niamh McBurney, senior analyst at risk consultancy Verisk Maplecroft says.

Iran is not short of other gas-thirsty neighbours in the Middle East, but its controversial political positions and regional tensions make partnership difficult to forge. Iran inked a memorandum of understanding with LNG exporter Oman in 2013 to develop a roughly 200 km pipeline from Iran to Sohar port in Oman, which despite being a net gas exporter faces depleting onshore reserves. The non-binding deal would also see Muscat receive 10 Bcm/year for 15 years. Total and Shell had initially expressed interest in bidding for a related infrastructure tender, however deadlines for subsea construction have been repeatedly delayed, with the latest set for May 2018 having fallen flat.

Domestic gas industry

When US sanctions were lifted in 2015, Iran's petrochemicals sector attracted global attention from potential investors that viewed the country as a beacon of opportunity. Already Iran accounts for just under 5% of the global petrochemicals supply, and with additional gas, that rate of production could increase. If Iran can provide enough natural gas to feed its petrochemical plants, there is scope for Iran to become a big player in the sector. However, petrochemicals investors face the same as those with pipeline export ambitions: the lack of investment in domestic gas production, and the consequent uncertainty surrounding supply.



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Despite having among the highest domestic natural gas demand in the world, Iran's domestic market still runs at a deficit. Investment in streamlining the country's gas infrastructure, cutting back on waste and extending existing infrastructure to the northern and less well-connected areas could help Iran to take advantage of its large deposits.

"Apart from the investment by foreign companies, it should be noted that Iranian companies are also active in the gas market of Iran and there are projects like Iran's sixth national gas pipeline for export gas to Iraq which has been performed by an Iranian company under [Build-Operate-Transfer] format," Ali Darzi from Iran Foreign Investment Consultants says. NIGC has stated that 95% of Iranian equipment used in the gas industry is provided by Iranian companies, he adds.

Iran has already successfully completed the extension of the IGAT-6 trunkline and Iranian state news agency Shana reported last week (2 July) that the line is ready for gas injection. Small-scale LNG trucking is also being trialed in the north of the country, where there is a large gas deficit and access to the national grid is limited.

Competing markets

Iran's most persistent problem is that the global gas market it has returned to is more supplied than ever. To compete with new and old exporters such as Qatar, Australia and Mauritania, the country will need to offer a favourable business environment and attractive deals to investors, especially non-western ones.

As a potential exporter to Europe, Iran faces fierce competition from Russia and central Asia, as well as burgeoning LNG supply which is being exported from all over the world. Looking ahead, continued stubbornness on the part of Iran to renegotiate its gas export prices could see the country suffer in the face of exporters whose competitive upstream breakeven prices enable their gas sales to remain profitable, while being more flexible and offering lower rates.

Meanwhile, it also faces the difficult task of attracting and maintaining gas expertise. Outside of Russia, non-western developers with the required technical knowledge needed to advance gas plans could be difficult to find, casting doubts that progress in Iran's industry will be made at a decent pace.

Given the various political and financial risks, Iran's gas industry faces significant challenges, but also has much to gain. If domestic gas production can be increased without western help there are large swathes of opportunity for Iran's pipeline gas exports and petrochemicals industry. Potential investors will eagerly watch the progress of majors such as Total or CNPC, and may use the results of those ongoing negotiations as a bellweather of how to proceed. However, ultimately, with the dominance of the US dollar in international business, the severity of US sanctions may seal Iran's fate for the foreseeable future.