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Iranian Nuclear Problem and Energy Market

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In my previous weekly report, titled "Agreement Reached on Framework for Comprehensive Solution to Iran Nuclear Development Problem," I pointed out that the so-called Lausanne agreement will pave the way for the five permanent members of the United Nations Security Council and Germany, known as the P5+1, and Iran to nail down technical details to finally and comprehensively resolve the Iranian nuclear problem toward the deadline of June 30. I also reviewed the history and background of their past negotiations toward the Lausanne agreement, various problems in the future negotiations and complex conditions or environments for major stakeholders (including the United States, Iran, Israel and Saudi Arabia). In this report based on the previous one, I would like to analyze the possible comprehensive resolution of the Iranian nuclear problem and its implications on the energy market.

It may be needless to say that Iran is rich with oil and gas resources. According to BP statistics, Iran's proven recoverable oil reserves totaled 157 billion barrels at the end of 2013, accounting for 9.3% or the fourth largest share of the global total. Its proven recoverable gas reserves aggregated 33.8 trillion cubic meters, capturing 18.2% or the largest share of the world total. In terms of production, Iran boasted of its status as the world fifth largest oil producer and fourth largest gas producer as of 2010 when the economic sanctions against Iran had not full scale impacts on their production. But Iran has the longest history of oil production among Middle Eastern countries, with operating oilfields matured and aged, meaning that Iran must introduce advanced technologies to maintain or expand oil production. Nevertheless, the Islamic revolution, the Iran-Iraq war and other problems have prevented Iran from doing so. Temporarily, Iran had tried to woo foreign investment with the so-called oil buyback deal and other measures. But the buyback deal has turned out unattractive for foreign companies. Iran has thus had no choice but to make domestic efforts to maintain oil production.

As Western countries toughened economic sanctions on Iran over the nuclear problem, however, Iranian crude oil gradually lost markets in Europe and Asia that had been major export destinations. As a result, Iran's oil output declined from 3.62 million barrels per day in 2011 to 2.81 million bpd in 2014. The oil output fall is of course a serious problem for Iran that depends heavily on oil revenue. But oil price hikes in the past years worked to offset the impact of the oil output drop. Nevertheless, the crude oil price plunge since the second half of 2014 has reduced Iran's oil export revenues further, exerting a more serious impact on Iran.

In this situation, the expected lifting of economic sanctions through the comprehensive resolution of the nuclear problem would be of great significance for Iran. Over a short term, the expected lifting of sanctions on Iranian oil exports would help expand exports in volume gradually. Over a medium to long term, oil and gas production capacity would be increased to expand exports through the successful introduction of foreign investment. The medium to long-term expansion of oil production capacity is significant for Iran as Iraq that had competed with Iran for expanding oil output has been steadily increasing oil production. Iran has chosen to win the lifting of economic sanctions even at the cost of some “compromise” regarding the nuclear problem under the recent Lausanne framework agreement apparently because the lifting of sanctions on financial and energy sectors has become an urgent challenge.

But it is uncertain how the comprehensive resolution of the nuclear problem and the lifting of sanctions would make progress. We cannot predict whether the U.S.-led P5+1 group and Iran could compromise on specifics and details of how to limit Iran’s nuclear development and lift the economic sanctions after the Lausanne framework agreement. If any final agreement is made, however, Iran’s oil and gas supply is liekly to expand and influence the international energy market, the degree of which will depend on how fast or how much such supply would increase.

On April 7, the U.S. Energy Information Administration released its latest Short-Term Energy Outlook that if economic sanctions on Iran were lifted through the comprehensive resolution of the Iranian nuclear problem, Iran could expand its crude oil production capacity by at least 700,000 bpd by the end of 2016 and make its existing inventories exceeding 30 million barrels available for sales. Iran’s additional oil supply could work to lower crude oil prices by $5-15/barrel in 2016, according to the outlook. In this way, this outlook assumes that the lifting of the economic sanctions would have little impact on the international energy market in the immediate future and begin around 2016 to exert specific impacts through a gradual export expansion.

Surely, Iran's oil export expansion may be limited in volume and slow even if the comprehensive agreement is reached to pave the way for the economic sanctions to be lifted (procedures to lift the sanctions could take much time). But the key point here is that the market anticipates future developments. When Iran is clearly expected to expand oil supply on the lifting of the sanctions, the market will respond to the expectations, exerting downward pressure on crude oil prices as early as the second half of this year. In contrast, however, if the comprehensive agreement fails to be reached in an unlikely development, the Iranian problem will influence the market as a geopolitical risk.

While a medium to long-term supply expansion is clearly expected to take much time, the lifting of the sanctions is likely to encourage international and state-run oil companies to have growing interests in Iran and activate their relevant business operations. The Iranian side (including those well versed in international business practices) has fully recognized that the abovementioned oil buyback deal in the past is unattractive for foreign companies and is expected to consider and propose new oil deals and start negotiations with foreign companies on their investment in Iran. Though depending on whether new deals are attractive for foreign companies, Iran’s rich with oil resources is likely to become a great matter of interest for foreign companies. Even international oil majors are required to secure oil reserves to maintain and expand their oil and gas output, as indicated by the latest reported attempt by Royal Dutch Shell to purchase BG. If Iran activates operations to woo foreign investment through the lifting of the sanctions, it may stimulate its international competition with Iraq or Mexico for winning foreign investment. In this sense, we may have to pay attention to the likelihood and impact of the lifting of the economic sanctions on Iran.

Japan will have to closely watch conditions and developments regarding the possibility and impact of the comprehensive resolution of the Iranian nuclear problem and the relevant lifting of the economic sanctions. At the same time, Japan is required to timely and appropriately consider responses to the Iranian problem while making strategic decisions.

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