Iran's Potential Oil Bonanza May Still Be Some Way Away

There has been a lot of excitement and comment this past year about Iran's full return to the oil and gas markets as sanctions are lifted and blocked overseas funds released. This is of course is an important event especially considering the fact that Iran currently holds the 4th largest proven oil reserves in the world, however this development is unlikely to see the Iranian government's coffers balloon with fresh revenues in the near term for reasons we discuss below.

Infrastructure

The first hurdle to the country's smooth return to the global energy market is its ailing infrastructure which has suffered from a lack of capital investment for years due to a number of reasons including international sanctions, the war with Iraq (1980-88), bureaucratic inefficiency, a lack of technical expertise and fiscal mismanagement such as wasteful subsidies. In the year before the 1979 revolution Iran produced a record 6 million bpd, this has since fallen to around 3.3 million bpd in 2015. With the recent lifting of sanctions western firms are now lining up to offer their services in rebuilding Iran's oil facilities, however the country's constitution does not currently permit any private or foreign ownership of its natural resources nor does it allow for production sharing agreements. To try and remedy this President Rohuani's cabinet recently unveiled a new oil contract which would facilitate joint-venture projects and allow a share of revenues for up to 25 years, but this contract has already been met with stringent opposition from hardliners within the regime, who plan to challenge its validity, and even sparked protests last week outside the Oil Ministry's offices in Tehran by conservative students who were angered by such a proposal. On top of this many of Iran's oil main oil fields are now mature, and while some new areas have been identified and are starting to be developed with Russian and Chinese assistance, getting these operating to their full capacity will likely still take a number of years and sizeable capital injections.

Domestic Demand

Much of Iran's power production is driven by oil and gas with only a minimal amount generated by hydro or coal fired sources. According to a recent study conducted by E-IR current domestic oil consumption is estimated to be around 1.8 million bpd, which is second only to Saudi Arabia within the Middle East region, and due to strong population growth as well as the government's generous energy subsidies. The demand for cars has also boomed with the automotive sector now the country's second most active industry with an annual vehicle production figure of over one million units (OICA). Meanwhile local refiners have been unable to keep up with the demand for petroleum products and all the major refinery complexes need urgent and comprehensive repairs. Thus Iran has to import around over 40,000-50,000 bpd of gasoline a figure which is expected to continue to rise impacting the country's foreign exchange reserves.

Politics

As mentioned earlier the battle between reformists and hardliners is an ongoing theme in Iran and this will also likely delay any substantial progress on economic reform as well as foreign investment. President Rouhani stated recently that "Sanctions caused 40% of our country's problems; the remaining 60% of our problems are not related to sanctions they are related to our own internal problems." Thus his government is pushing for some (albeit limited) restructuring and opening up of the economy, something that is desperately required because in its current form there is far too much bureaucracy and inefficiencies within the

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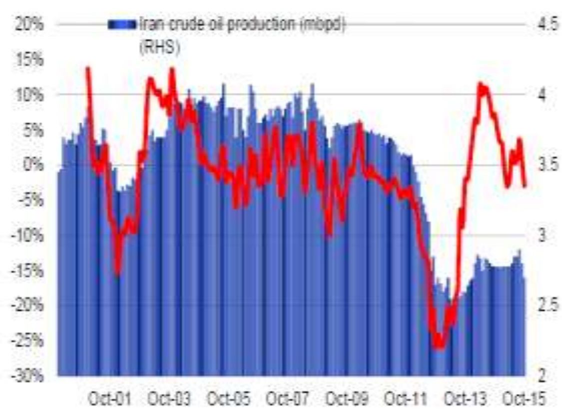
system which even the anticipated inflow of billions of dollars of unfrozen funds can effectively remedy. However he faces strong opposition from conservatives including Ayatollah Khamenei who want the state to maintain in firm control not just of the ideological side of the equation but also of all of the key sectors within Iran's economy especially sensitive areas like energy. This issue was highlighted recently in the rejection by the Guardian Council of 3,000 reformist candidates applying to stand in this month's parliamentary elections. The council which is staunchly conservative is responsible for vetting all political candidates. On the external front Iran's fractious relationship with Saudi Arabia and Tehran's perceived interference in regional affairs will also hold back its full re-integration into the global economy.

Competition

Iran may well be able to bring an extra 500,000 – 800,000 bpd to market this year but it is an amount that appears to be already priced in, and even if the country manages to overcome all of the above hurdles sooner than expected and that production figure becomes sharply larger it still faces an oil market that remains oversupplied and powerful competitors like Saudi Arabia and Russia who will not give up their hard won market-share easily.

Conclusion

The return of Iran to the world's energy markets this year is a significant event , however unless the regime is able to reach an internal consensus that would enable the country to reform both its economy (which remains in deep recession) as well as its political environment the road to prosperity remains a steep one.



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