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Testimony of Julia Nanay
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on
"US Policy Options: Iran's Oil and Gas Sector"
before the
U.S. Senate Committee on Foreign Relations
May 18, 2006

Good morning. Senator Lugar and distinguished members of this Committee, it is a pleasure to come before you today to address such an important topic. My name is Julia Nanay and I am a Senior Director at PFC Energy. PFC Energy is a strategic advisory firm, based in Washington, DC. We are advisors to the petroleum industry on oil markets and various aspects of investment risks related to the global petroleum environment.

Iran is a Major Risk Factor Driving Energy Prices Higher

The timing of today's hearing is important as it occurs in an extremely volatile period for oil markets. Here are some of the headlines from the news over the course of just a few days May 3-May 12: Oil hovered near $75 a barrel, within striking distance of record highs, because of mounting tension over Iran's nuclear plans; oil held steady near $70 a barrel after major powers failed to come up with a strategy for containing Iran's nuclear ambitions; oil fell below $70 a barrel on hopes tension over Iran's nuclear ambition will ease after Iran's President made an unprecedented move to contact Washington.

Uncertainty over the ability of the markets to supply the world's oil requirements if Iran's oil supplies were reduced has kept oil markets on edge. The day to day volatility in today's oil markets is driven by the news about Iran. The more that Iran is in the news and the more that the US presses for sanctions and holds out the possibility of military action, the higher that oil prices stay. Any news about the easing of tensions and possible talks between the US and Iran causes the price to drop. Estimates of the Iran premium in today's oil price run as high as $15 a barrel.

Iran's Production and Exports

Iran's oil production capacity today is about 4 million barrels per day. Its oil production is estimated to average 3.8-3.9 million barrels per day. The country's OPEC quota is 4.11 million barrels per day. Iran's oil exports have held steady at 2.4-2.5 million barrels per day, without any significant drops related to tensions over the nuclear problem. Iran's oil export policies have not changed.

Since President Ahmadinejad was elected in June 2005, however, no new contracts for oil or gas development have been signed. Production from Iran's existing old oil fields is being depleted and without significant new investment, oil production declines of at least 200,000 b/d per year are foreseen. Iran has been unable to meet its OPEC quota because of the lag in capacity expansion plans. The Iran Libya Sanctions Act (ILSA) prohibits US investment in Iran's oil and gas sector and has discouraged many western companies from investing.

One solution being promoted by the government of Iran is to dip into the Oil Stabilization Fund to finance oil and gas developments. One idea floated in Iran is to take loans from the Oil Stabilization Fund to spend on oil and gas fields, using future revenues to repay the loans. Information on the actual level of this Fund is difficult to come by since the government has been drawing against it for various purposes. The Oil Stabilization Fund does not show up in Iran's national budget. It is run as an account at the Central Bank by a handful of senior government officials. A better way to look at the Oil Stabilization Fund would be to refer to it as a hard currency reserve account.

The threat of additional sanctions on Iran's oil and gas sector and the rumors about possible military action are keeping foreign investors away from Iran. This could lead to less oil being available from this country over time, depending on how long the current stand off continues. In a period of increasingly tight oil markets, this will keep a floor under oil prices.

Countries That Buy Oil From Iran

The US buys no oil from Iran. According to a report from the Joint Economic Committee of Congress in March 2006, 56% of Iran's oil exports are to Asia and 29% to Europe. The remainder goes to Africa, the Middle East and Latin America. Japan and China together buy over 800,000 b/d of Iran's oil exports or over one-third. Japan is particularly dependent on Iran and the Middle East in general since it imports every barrel it uses and over 90% of its imports come from the Middle East. China purchases less oil from Iran than Japan and its oil import sources are more diversified. Angola and Russia are both large suppliers of oil to China. Japan, therefore, is most vulnerable to any supply interruptions from Iran.

Worries about oil disruptions from Iran are forcing Japanese and Chinese buyers to try to diversify their import sources. Japanese refiners have changed their purchasing patterns to reduce Iranian volumes. Both Japan and China are making overtures to Russia to open up East Siberia to their companies and to allow them to help finance and build new East Siberian export pipelines. This could pose a challenge to western buyers of Russian crude and gas as these resources could be diverted from the west to feed Asian buyers clamoring for non-Middle East supplies. Chinese companies are also becoming increasingly active in Africa. In a recent bidding round in Angola, China's Sinopec offered a signature bonus of $1.1 billion for two deepwater blocks offshore significantly outbidding US companies in a region that in the past was the preserve of the US and European oil industry. US efforts to further isolate Iran are being felt in ways big and small in global petroleum markets as international investors scramble to diversify away from the Middle East.

Still, unless there are major disruptions caused by some sort of military intervention or sanctions on Iran's oil exports, Iran itself is unlikely to stop or cut back the flow of oil to its customers. For one thing, it would be reluctant to jeopardize its contractual relationships; for another, it would not want to lose the revenues. For every barrel of the 2.4 million barrels a day that Iran exports, it earns over $50 a barrel. Iran's net oil export revenues in 2005 were close to $47 billion and it will earn over $50 billion in 2006.

Iran Imports Gasoline

Despite being OPEC's second largest oil producer, Iran has a deficit in refining capacity to manufacture gasoline. Iran uses about 422,000 b/d of gasoline and imports 170,000 b/d of it, paying upwards of $4 billion in 2006 for these imports. Gasoline is heavily subsidized in Iran, with the price set at under 40 cents per gallon. $2.6 billion was withdrawn from the Oil Stabilization Fund last year to pay for gasoline imports.

Again according to a report from the Joint Economic Committee of Congress in March 2006, an estimated 25 percent of Iran's gasoline imports come from Persian Gulf countries, 15 percent from India, and the remainder from a variety of sources, including France, Turkey, Singapore, the Netherlands and China.

At the same time, volumes equivalent to as much as half of the amount of Iran's gasoline imports are being smuggled abroad. Subsidized prices at home make it lucrative for smugglers to move this product out of the country, with Iraq being a favored market along with Pakistan. Many people in border areas earn a living from smuggling gasoline

Iran is looking into rationing gasoline, so that low prices would apply to a certain level of purchases by each car owner after which the full cost of the gasoline would be paid. This two-tier pricing system is still being discussed but it could be implemented later in 2006.

If gasoline import sanctions were imposed, one affect would be to cut down on smuggling and another, to alleviate the traffic pollution problems in Tehran. Gasoline import sanctions might cast the US in a negative light since unlike other oil and gas sanctions, their impact would fall directly on Iran's people.

US Policy Options in the Oil and Gas Sector

About 60 percent of Iran's export earnings come from the oil and gas sector and 40 to 50 percent of the government's revenues. Investments in Iran's oil and gas sector are already dramatically reduced and timetables delayed due to the sanctions currently in place, as well as weak terms on offer under the buyback contract model. Short of disrupting Iran's oil trade with sanctions on oil exports, which would drive up oil prices and negatively impact the US economy, there is limited impact to be gained for the world community from any other additional sanctions on Iran's oil and gas industry. In a market where companies and countries seek to secure their economic lifelines through access to oil and gas, the idea that you can create a fool-proof sanctions system targeted at any oil and gas producer is a non-starter. There will always be those who violate the sanctions.

Sanctions on gasoline imports would be disruptive and would result in creating dislocations in Iran's economy. However, their impact would be offset to some extent by the likely elimination of the smuggling of gasoline to neighboring countries. Such targeted sanctions will have their own unintended consequences of probably encouraging the smuggling of gasoline from such offshore sources as Dubai from where many products already enter Iran.

The US has to weigh carefully what it wants to gain from such sanctions. The cut off of gasoline imports could just be another item on a list of sanctions already imposed on Iran, which certainly creates problems for the government but then results in adjustments without seriously undermining the government's power or changing its behavior with regard to nuclear enrichment.

Iran-Pakistan-India gas pipeline

Finally, just a few words about the status of this pipeline. This is a project that has been talked about for many years and it is still being discussed. Let's put it in the context of the Baku-Tblisi-Ceyhan oil pipeline which at 1,780 km is 1,000 kms shorter than the 2,775 km Iran-Pakistan-India pipeline. It took almost a decade for BTC to be realized from first project appraisal and this is a pipeline that had private oil company investment and where BP took a strong lead. Constructing and financing such multibillion dollar projects is difficult and expensive and it takes serious commitment from all parties. With an estimated $7 billion price tag, the Iran-Pakistan-India pipeline still has a long way to go before it can be considered a serious project. While the energy is clearly needed by Pakistan and India, there is no agreement in place yet among the three countries to build the pipeline, with the question of who would pay for it not even addressed.