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# Iran in the European Gas Market: a Russian Point of View

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**Igor Tomberg**

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IFRI  
27 RUE DE LA PROCESSION  
75740 PARIS CEDEX 15  
PH. : +33 (0)1 40 61 60 00  
Email : ifri@ifri.org

IFRI-BRUXELLES  
RUE MARIE-THÉRÈSE, 21  
1000 - BRUXELLES, BELGIQUE  
PH. : +32 (0)2 238 51 10  
Email : info.bruxelles@ifri.org

SITE INTERNET : *Ifri.org*

# Contents

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<b>POLITICAL CONTEXT .....</b>	<b>2</b>
<b>THE ENERGY CONSTITUENT OF THE “IRANIAN QUESTION” .....</b>	<b>5</b>
<b>A DIFFICULT CHOICE: PIPELINE OR LNG .....</b>	<b>9</b>
<b>EUROPEAN COMPANIES EXPAND CONTACT WITH IRAN.....</b>	<b>12</b>
<b>NABUCCO: A BONE OF CONTENTION IN THE ANTI-IRANIAN COALITION?.....</b>	<b>15</b>
<b>AZERBAIJAN ALONE WILL NOT SAVE NABUCCO .....</b>	<b>18</b>
<b>CENTRAL ASIA IS BIDDING ITS TIME.....</b>	<b>20</b>
<b>INCREASED WAR RISKS OF GAS TRANSPORTATION.....</b>	<b>22</b>
<b>PARTNER OR COMPETITOR? .....</b>	<b>24</b>
<b>INTERESTING PROSPECTS FOR GAZPROM.....</b>	<b>28</b>
<b>MARKET SHARING IS POSSIBLE.....</b>	<b>30</b>

## Political context

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Behind Iranian diplomacy lies the continuing hope for an easing of tensions between America and Iran, with its consequences, which have not yet been worked out satisfactorily, both for Russian interests in the sphere of energy and from the point of view of preserving the fully-formed configuration of Eurasia's gas market.

It is possible to talk about Iran as a potentially significant participant in the Eurasian gas market, but only with one major concession: no military development may take place in the conflict with the global community on the problem of uranium treatment. As it turns out, such a concession is entirely justified, since an increasing number of signs are appearing that the potential for military confrontation between the West and Iran on nuclear issues is decreasing.

Western participants of Iran Six hope to convince Moscow and Beijing to introduce new sanctions against Tehran, such as restrictions for Iran sales of gas and oil and refined products import. This directly affects the interests of Russia and China, which do not follow the restrictions of the American "Iran and Libya Sanctions Act" of 2006 concerning Iran which has been extended for a further 5 years. It allows for sanctions in relation to foreign companies investing more than \$20 million per year in the energy sector in these countries. The "Iran Freedom and Support Act" passed not long ago also strengthens the extent of the sanctions, having extended them not only to foreign oil companies but also to "private and state" creditors, underwriters and financial backers taking part in oil projects in Iran.

In spite of the violent controversy within the USA surrounding the effectiveness both of the mechanism of these sanctions and the aforementioned legislation in particular, Western European companies are extremely guarded in their attitude towards investments, and towards cooperation with Iran in general. Similarly,

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*Igor R. Tomberg (PhD in Economics) is a director of the Centre for Energy and Transport in the Institute of Oriental Studies at Russian Academy of Sciences. At the moment also in a position of the professor in Moscow State Institute of International Relations (MGIMO) within the Ministry of Foreign Affairs of RF and a senior research fellow in the Centre for Energy Studies in the Institute of World Economy and International Relations (IMEMO) at the Russian Academy of Sciences.*

a decision on the Iranian question remains essentially frozen, for no less than six months. First, the new administration in the White House is still learning the ropes.

Many experts, including Americans, had high hopes, which have not materialized, that the staunch conservative Mahmoud Ahmadinejad would be succeeded by a reformer, with whom more constructive dialogue can be held than with Iran's current leadership.

President for the United States, Barack Obama, is openly in favor of establishing a dialogue between Washington and Teheran, while the former Republican administration already maintained an office for American interests in the Iranian capital. The idea to send American diplomats to the Iranian capital after relations had been suspended for almost three decades received support from both sides. At the same time, the process of restoring a legal US presence in Iran continues, both at a private level and in the shade of major political events, so to speak. At the end of September 2008, the American-based non-governmental organization The American-Iranian Council (AIC) was given the green flag to open its office in Teheran. The AIC is not the first American NGO in the Islamic Republic, but it will be the "only one dealing with questions of peace and security", according to the organization's official website. Here, it is important for any American presence in Teheran to become an automatic guarantee of security. This significantly reduces the likelihood of military strikes such as on the part of the USA.

Finding ways of reconciliation with Tehran is one of the strategic directions of Barrack Obama's foreign policy. But so far the Iranians actually ignores all the initiatives in Washington to begin a dialogue. Moreover, Tehran refuses on principle to minimize or at least preserve its missile and nuclear programs.

For its part, Teheran, sensing the weakening threat of military confrontation with America, is starting to strengthen its own position as a dominant regional power. Thus, in March 2008, Iran announced that it was filing an official application to join the Shanghai Cooperation Organization (SCO). This was communicated by Iran's Foreign Minister, Manouchehr Mottaki during a visit to Tajikistan. As the Iranian minister emphasized, Tajikistan "supports" Iran on this issue. This is not the first time in which Iran has aspired to join the SCO, where, alongside India, Mongolia and Pakistan, it is still seen as more of an onlooker. At the same time, Iran now appears to be one of the key economic players in the zone of the SCO's natural interests – in the so-called Big Central Asia region, and, judging by its economic activity and purposefulness, Iran has all the groundwork it needs to become a full member of this organization. Formally speaking, it is a procedural matter, but in practice Iran's nuclear dossier prevents the country's immediate accession to the SCO, however the official reaction to Iran's application by the member states at the upcoming SCO summit in late summer this year in Dushanbe can hardly be predicted today.

Furthermore, Teheran has noticeably stepped up its political onslaught not only in the direction of Eastern Europe, but also to the West, actively playing its trump card in the sphere of energy as an enticement, primarily for Europeans who are over-anxious about their own energy security.

At the same time, the U.S. believe that now is not the time to make deals with Iran to use its gas in any of the projects aimed at gas supply of the Europe. This was the statement of the special U.S. envoy for Eurasian energy issues Richard Morningstar in the end of May this year.

## The energy constituent of the “Iranian question”

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In analyzing the political context of the situation surrounding Iran, it is extremely important to take into account the fact that in addition to the political and military, Teheran also has another resource for international positioning – one that is entirely familiar and comprehensible to us: energy.

In terms of the size of its petroleum reserves, Iran is fourth in the world after Saudi Arabia, Iraq and Kuwait. In the list of major global producers of “black gold”, the Islamic Republic is also in fourth place, once again behind Saudi Arabia as well as the USA and Russia. The majority of petroleum produced in Iran is exported. In February 2008, petroleum extraction in the country reached its highest level in 30 years – 4,184 million barrels per day.

In terms of natural gas supplies, Iran is in second place in the world after Russia, and is able to dispatch these raw materials to the global market. Gas yields in the country grow by 10% every year, and reached 112 billion cubic meters in 2007.<sup>1</sup> That year Iran ceased to be gas netto-importer and the volume of production was equal to the volume of gas consumption.

Iran possesses extensive gas fields, among which the “South Pars” stands out as the largest single reserve in the world with reserves of 13.1 trillion cubic meters of gas and 19 million barrels of condensate. Eight deposit lines are currently in operation, each of which produces 25 million cubic meters of gas per day. The annual yield from all eight lines is 73 billion cubic meters.

Deposits of natural gas are mainly located across several kilometers of sea coastline, in particular the shallow Persian Gulf. This is easy to access and exploit at relatively low cost.

A significant amount of the gas extracted from subsurface resources (raw output), is pumped into oil fields in order to increase well production capacities. Wastage connected with combustion in flares of associated gases is also high. At the current time, around

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<sup>1</sup> *BP Statistical Review of World Energy*, June 2008.

Figure 1. Iran's hydrocarbon infrastructure



Source: mineral.ru.

30 billion cubic meters of produced gas (associated and non-associated) are repeatedly injected in situ in Iran, while around 12.6 billion cubic meters per year are burned up in flares or released into the atmosphere.

When the produced gas is processed, it is cleaned to remove associated components (such as sulphur) and extract beneficial hydrocarbon components (liquefied petroleum gases – LPG); the dry gas obtained as a result and utilisable for energy-related purposes differs sufficiently in terms of quantity from commercial gas. Approximately 22 billion cubic meters of natural gas are currently lost per year during the treatment process.

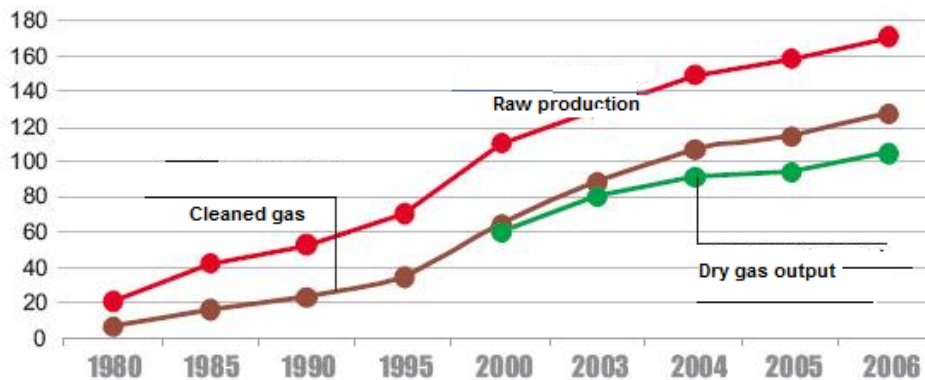
The country's leaders have set the task of increasing Iran's share in the world gas market. The projected program for the next 20 years of Iran's socio economic development envisages growth in Iran's market share of up to 10%.

The main element of the overall plan seems to be to create favorable internal conditions for increasing the export volume of Iran's natural gas. The extraordinarily high growth rate of domestic consumption of natural gas in Iran is evidence that the low gas tariffs in place are encouraging wasteful gas consumption by the population, the development of power-consuming industries and construction of



energy-intensive turbines in thermal power plants. Under these conditions, the country's gas production industry is only working in the interests of its domestic consumers, and exports cannot even be considered. Currently, the share of gas in Iran's energy basket has reached 62%.<sup>2</sup>

**Figure 2. Gas production history in Iran from 1980-2006,  
in billion cubic metres**



Source: mineral.ru.

In connection with this, new, higher gas tariffs are to be introduced in the country, which will lead to reasonable gas consumption. A decrease in domestic gas consumption should, if all goes to plan, provide conditions for gas exports. But in the meantime, Iran will be not only an exporter, but also an importer of gas.

In recent years, sanctions, technical and political difficulties surrounding natural gas production in Iran have seriously interfered with development of this sector. But equally important as American sanctions, and an impediment to development of the oil and gas sector is the prohibition enshrined in the constitution of the Islamic Republic of Iran preventing foreign companies owning mineral resources. In the energy sector, foreigners are not permitted to own property in any form; they are also excluded from the option of production sharing. Only in 1995, foreign companies were granted the right to enter into service contracts, dubbed "buy-back", in which the contractor finances all work in field development or the execution of reconnoitering work in exchange for a specified rate of remuneration. This remuneration, as a rule, covers the initial investment (plus bank charges) and ensures a profit over the course of several years after the initial production or project completion. This contract system is not satisfactory to either side. In particular, international oil companies are dissatisfied with the rates of return, which they consider too low,

<sup>2</sup> *Iran News*, 17 June 2009.

as well as the over-elaborate and constantly-revised conditions under which contracts are concluded.

The advantageous geographical location of the gigantic reservoirs of natural gas will allow Iran to implement a permanent and dependable gas supply to satisfy demand around the world for some considerable time. According to Iranian gas workers, there are different options for expansion on the global gas market. Hedayat Omidvar, who is responsible for strategic research in the department of research and technology at the National Iranian Gas Company, believes the main directions for exports are as follows:

- Gas exports in the form of LNG to countries in the Pacific region
- Exports to Europe in the form of LNG or by way of pipelines
- Gas exports to Pakistan and other neighboring countries by way of pipelines
- Gas exports to India and/or China in the form of LNG or by way of pipelines
- LNG exports to other Far East countries, such as Japan and South Korea.<sup>3</sup>

Taking into account the potential of Iran's resources and the possibilities for realizing major projects in the sphere of exploration of gas fields and attracting resources from foreign investors, the country's highest powers decided to develop the gas sector at a fast pace with a view to becoming one of the world's leading exporters of natural gas and an important supplier of energy products over the coming decades.

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<sup>3</sup> *Mirovaya Energetika*, No. 03 (51), March 2008.

## A difficult choice: pipeline or LNG

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In early July 2008, three phases of development of the “South Pars” gas field, geared towards the production of LNG, turned out to be vacant: in the spring Shell and Repsol refused to invest in phases 13-14, now Total has made a similar decision.

Teheran was ready for such a turn of events: negotiations had been underway since the spring with potential applicants to replace the Europeans: Russia's Gazprom, India's ONGC and Turkey's TPAO.

On 13th July, Gazprom took a significant step towards rapprochement with Iran. The Russian oligopoly and NIOC signed a memorandum of understanding in the area of cooperation in the oil and gas sphere. This memorandum presupposes the formation of sides for work in the joint venture, including in third countries, the participation of Gazprom in exploration of the South Pars and North Azadegan, as well as swap operations with gas.

Although no specific, detailed agreements have been signed for each project and it does not make sense to overestimate the result to date, attention is drawn to the fact that not one of Gazprom's competitors has reached a similar arrangement.

Let us remember that the development project for “South Pars” is divided into 24 phases. Alongside proper exploration of specific sections of the gas field, the framework of each phase allows for corresponding infrastructure to be created, depending on how the gas is to be used. To date, investors and development schemes have been defined for 18 phases of the project. Five of the first phases, put into operation between 2003 and 2005, are already providing gas, which supplies Iran's domestic market.

In the fourth phase — 11-14 (12 in part) — gas is planned to be exported in the form of LNG. For this, two LNG facilities will be built in the country — Persian LNG and Pars LNG. Gas in the remaining phases, 15-18, is destined for use within the country, the demand for which in “blue-sky fuel”, according to five-year development plans, will reach 120 billion cubic metres per year by 2011. Some of this gas will also be exported to Turkey, Europe, Pakistan, India and possibly China. Specific details regarding the export direction of pipeline gas have yet to be finalised.

Exploitation of the “South Pars” is encountering the same problems that have been experienced by other major oil and gas projects: cost escalation and time displacement. In Iran, aside from global factors, the situation is exacerbated by political troubles.

So, over the past year, US pension funds, which had invested significant amounts in shares in Shell (to the tune of \$700 million) and other oil and gas companies, have asked to withdraw from work in Iran or significantly reduce their presence in this country, since participation in the projects underway there goes against the sanctions introduced against Iran by the USA. The authorities in Washington have put pressure on the funds accordingly, demanding that they withdraw from cooperation with companies that invest in Iran. Parallel to this, the scandal at Total has gained momentum in France – the chairman of the oil company having been accused of corruption and financial irregularities in Iran. These cases aside, in 2007 it became clear that projects involving European companies were continuing: in particular, the implementation of phase 11 – almost twofold. Significant changes in the course of projects bear witness to the problems encountered in their development. Investors have been forced if not to withdraw from work in Iran, then as a minimum to defer the start of any major investments or curtail their volume. As a result, Teheran will not be able to implement its stated plans either to begin exports of LNG or by means of pipeline supply.

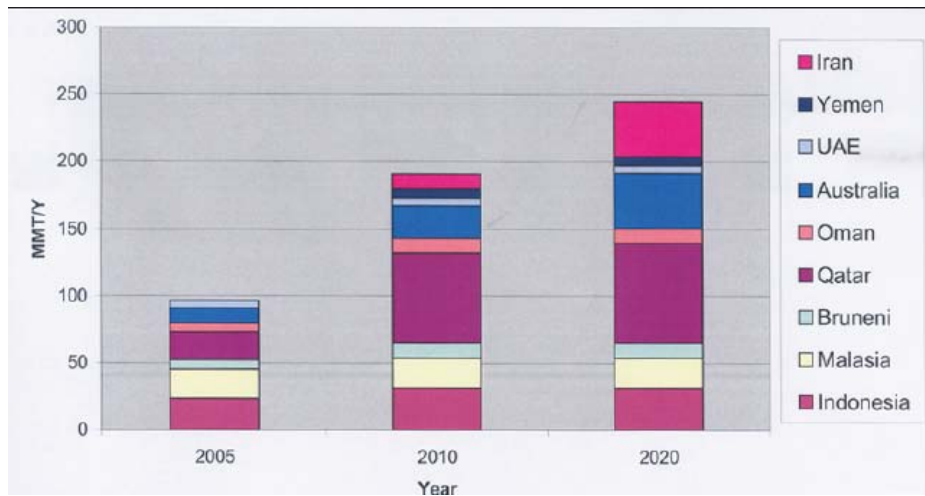
Under the influence of these vicissitudes, Teheran has pondered whether to send all gas intended for liquefaction via the export pipeline.

Tehran intends to use the LNG to expand markets for its hydrocarbons. In particular, the country has plans to build four gas liquefaction plants in the Persian Gulf ports of Tombak, Assaliya and Kangal near the South Pars field. The production capacity of each project is 9.6 million tons of LNG per year. Exports will start in the next decade, and will focus on markets in Europe, South and East Asia.

Teheran also plans to export LNG on the conditions of substitution (swap deals). The demand for gas in the northern provinces of the country the Iranian side plans to meet by the supplies from neighboring countries, mainly from Turkmenistan. In return, Iran will transfer an equivalent amount of LNG for sale in the Asia-Pacific region.

On 8th February, 2008, Iran and the People’s Republic of China signed costs of \$16 billion. According to the plan, gas will be liquefied and 10 million tons of LNG released into the atmosphere every year, within the framework of this gas project. It is true in the spring, the proposal was mooted in Beijing to join the Iranian/Pakistani/Indian gas pipeline project, replacing India. Although significant progress seemed to have been made in negotiations on this gas pipeline a year ago, no final contracts on the sale and transportation of gas have yet been signed.

Figure 3. LNG trade prospects



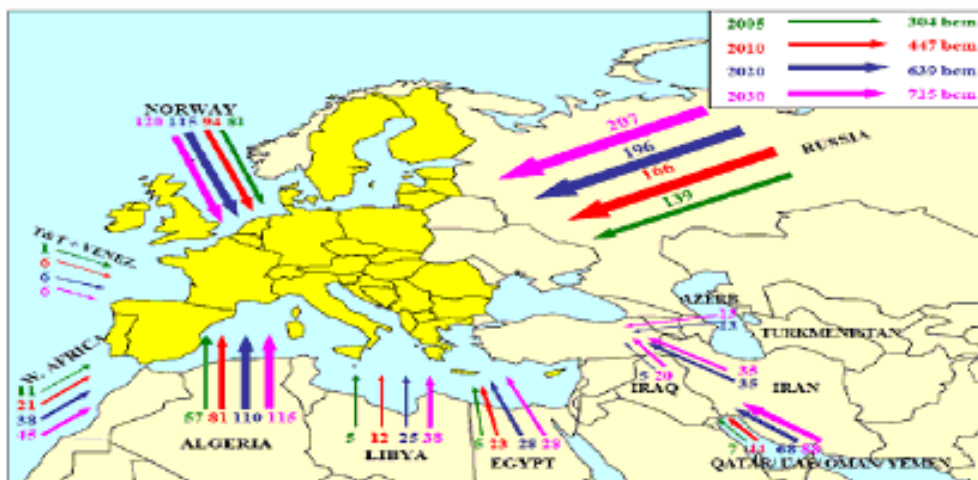
Source : Iran Ministry of Oil.

Consequently, the demand for Iranian gas does exist, and moreover in various parts of the world, but the gas itself, at least in a form ready for export shipping, does not. The regions in which demand for this gas will be satisfied in the first instance most certainly depend on the way in which companies will help Iran tap the South Pars.

## European companies expand contact with Iran

At that the same time, judging by the price increase for energy products, interest from foreign companies in Iranian gas reserves is growing. And under the threat of stricter international sanctions, which will certainly be substituted for a military decision on the Iranian problem, Teheran is boosting its energy diplomacy in EU countries, doing its best to emphasize its willingness to cooperate actively with the European Union in the sphere of energy. Europeans, for their part, seized by the need to diversify their sources of gas supply, are trying to separate politics from energy and are beginning to make contact with Teheran.

Figure 4. EU prospective gas supply routes



Source: OME, 1st Trans-European Energy Networks information day, 30 March 2007, available on Ec.Europe.eu.

The Portuguese have been in discussion with Teheran regarding energy for some time. Negotiations have been held between Iranian oil companies and the Portuguese state-owned company "Galp" behind closed doors since 2006. If they are concluded successfully, Teheran will become one of the suppliers of liquefied gas to Portugal, and Galp will be granted the right to a participatory interest in the extraction of natural gas in Iran.

Apart from this, it has been reported that Iran is holding negotiations with the Italian company Edison on the issue of supplying natural gas to Italy. According to information given in December last year by Iran's minister for the oil industry, Gholamhossein Nozari, the preliminary supply at the end of 2008 was 1.5 billion cubic feet with a subsequent increase up to 4.5 billion cubic feet (42.5 and 127.4 million cubic meters respectively).

In mid-March, a contract was signed for gas supply from Iran by the Swiss Elektrizitaets-Gesellschaft Laufenburg Group (EGL), a company registered in Switzerland that has shares in various European countries and trades electrical energy in these countries. It contributes to the capital of several Swiss power plants (through the group Axpo) and owns the LEP network, by means of which electrical energy can be exported to neighboring countries.

In Italy, EGL owns the station Calenia Energia, which was started in 2007 and has an output of 760 MW (working on gas), in joint stock of which 85% belongs to the company. In addition, EGL is running a further 5 projects to construct power stations in the Apennines.

As the EGL stations are commissioned, the company will require large volumes of gas in all of them. In order to guarantee supply to these stations and possibly start new business, EGL is participating in the construction of a trans-Adriatic gas pipeline (TAP). In February 2008, EGL and Statoil came to an agreement to set up, and in April did set up, a joint venture for funding the construction of this pipeline. In June, the companies presented documents to the Greek regulators for the energy market, from whom they are awaiting permission to construct the TAP. The contract with the National Iran Gas Export Company (NIGEC) valued at \$20 billion was signed for a period of 25 years. From 2009, Switzerland will buy up to 5.5 billion cubic meters of gas every year. The volume of exports is expected to grow after 2012, when the new Trans-Adriatic Pipeline (TAP, from Greece to southern Italy across Albania and the bed of the Adriatic Sea) is commissioned.

Subsequent to the Swiss agreement to supply Iranian gas, Austria also signed a contract. The Austrian EconGas GmbH intends to begin purchasing natural gas in Iran from 2013. This information was given to journalists recently by the head of the company, Michael Peisser. By all appearances, Michael Peisser's announcement was the result of an agreement between EconGas, OMV (owns 50% of EconGas) and NIGEC that was made as early as 2004. At that point, the company signed a memorandum of understanding in which they declared their intention to develop long-term cooperation in the area of geologic exploration, natural gas supply and participation of Iranian companies in the gas pipeline project Nabucco.

The point of view of those who support closer contact with Iran in the area of gas was recently voiced by the former executive director of the International Energy Agency (IEA), Claude Mandil, who



declared in an interview with the Russian agency Interfax that it would only be possible to implement Nabucco with the participation of Gazprom. Although this would not release Europe from its dependence on Russia, in the long term it prepares for the emergence of Iranian gas in this pipeline. “We suggest that France endeavours to persuade its partners throughout the European Union to move forward in this direction” – hopes Mandil, speaking with the authority of an independent expert providing consulting services to the French Government.<sup>4</sup>

In October 2008 it was announced that Turkey intends to undertake an agreement regarding gas imports from Iran. According to Turkey’s Minister of Energy, Hilmi Güler, the definitive text of the agreement has already been agreed upon and there were no impediments to it being signed in 2008. Under the conditions of the agreement, the Turkish state-owned oil and gas company TPAO will perform its own exploration work on the Iranian South Pars oil field, and the gas extracted will be sent to Turkey via pipeline. There, it will both be used to meet domestic demand and re-exported to Europe.

During his August visit to Turkey, the Iranian President Ahmadinejad made attempts to sign such an agreement, however these did not succeed due to opposition from the USA, which was striving to isolate Iran economically. Now that relations between Turkey and the USA have become strained as a result of problems in Northern Kurdistan, along with the rapprochement between Ankara and Moscow which is currently in its teething stage, Turkey is prepared to cooperate with Teheran in the gas sector.

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<sup>4</sup> Interfax, 21 September 2008.



## **Nabucco: a bone of contention in the anti-Iranian coalition?**

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Iranian officials have already repeatedly suggested their country as the foundation for resource provision for this gas pipeline, which in Europe and the USA is considered a primary route to diversifying the gas supply to the EU. For Iran in this situation, according to the accurate definition given by Indian analyst K.M. Bhadrakumar,<sup>5</sup> Nabucco will become Iran's entrance ticket for integration with the EU.<sup>6</sup>

To start with, let us remember that the Nabucco project was initially developed with Iranian gas. In order to flood the pipeline, the Austrian energy group OMV, as stated above, positioned itself to develop Iran's South Pars oil field. This is the largest natural gas field in the world, with gas reserves of 3.5 trillion cubic metres. But then, on account of the flare-up in relations between Teheran and the USA, the gas pipeline was redirected for Azerbaijani gas. However this source of raw materials was clearly insufficient – indeed, Nabucco's minimum profitable output is 30 billion cubic metres per year.

Appearing in early September at the OPEC conference in Vienna, Iran's Oil Minister, Gholamhossein Nozari, took the opportunity to further his country's oil business. In an interview with the newspaper *Wiener Zeitung*, he called upon Austria's largest oil and gas company OMV "to include Iran in the Nabucco gas pipeline project as soon as possible". According to Nozari, Austrians have to hurry to conclude specific contracts for the purchase. "We do not want to wait for OMV indefinitely", he warned. "This year we entered into a large number of contracts for gas supply – more than ever before. Europe needs Iran, and Austria, with whom we have an excellent relationship, must set a good example to Europeans."

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<sup>5</sup> M K Bhadrakumar, "US moves towards engaging Iran", *Asiatimes*, 27 March 2008.

<sup>6</sup> Nabucco will be Iran's passport to integration with Europe.



Figure 5. Nabucco possible routes

Source: Bsdp.org.

This declaration rang out against the background of the latest convulsion of political efforts on the project advancement, the main problem of which was the lack of sufficient guarantees for the gas supply. The pipeline is planned to continue until 2013. It is true that the project initiators do not yet have a single agreement with potential gas suppliers – this is despite the fact that energy input to the gas pipeline, as shown in the graph published recently, is rather modest: in 2013 only 8-10 billion cubic meters are to be pumped, three years later 25-27 billion and only in 2020 will the pipeline reach its designed capacity of 8-10 billion cubic meters. Nabucco’s anticipated cost is estimated at 7.9 billion Euro.

Not receiving any distinct response from the Europeans on their participation in Nabucco, Teheran similarly decided to scare Brussels slightly with its own plans for alternative delivery routes. At the end of September this year, an announcement was made to the effect that Iran intended to build its own pipeline for transporting natural gas to Europe, the agency Bloomberg reports. The operator of the pipeline, under the name Pars, will be a well-known European company. As Iran’s deputy oil minister, Akbar Torkan, proclaimed, Pars will be Teheran’s answer to the Nabucco pipeline and Gazprom’s “Southern Flow”, which are supported by the European Union. According to Akbar Torkan, Iranian authorities are holding negotiations with well-known a European company that may become the operator of the Pars pipeline. However, he was not about to specify which company it was, mentioning only that it is not the Austrian OMV heading the consortium to implement the Nabucco project. Mr. Torkan is sure that the limitations imposed by the USA on foreign investment in Iran will not deter European partners from becoming involved in the project, as nobody has forbidden them from putting up capital inside Iran.

“We are building a pipeline as far as the border, and they will continue to build it further”, said the civil servant. The Pars pipeline will flow out of Iran to Turkey, Greece, Italy and on to Switzerland, Austria and Germany. Teheran plans to transport 37 billion cubic meters of gas through it every year. The cost of just Iranian participation in the gas pipeline as far as the border with Turkey is \$4 billion. However, when Pars will be built has not yet been made public.<sup>7</sup>

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<sup>7</sup> Bloomberg, 25 September 2008.

## Azerbaijan alone will not save Nabucco

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At present, the only more or less tangible supplier of gas for this project is Azerbaijan. It is true that alone, it cannot provide the full load for the pipeline. The proved recoverable reserves of natural gas in Azerbaijan are relatively small and estimated at 1.5 trillion cubic meters. That said, the optimal level of domestic gas use in the entire republic is 12-14 billion cubic meters per year. In 2013, when, according to plans, Nabucco will be put into operation, Azerbaijan is still expected to have a gas reserve of 18-19 billion cubic meters. From this, the state-owned corporation GNKAR plans to obtain 8 billion, a further 8.6 billion cubic meters will be extracted within the framework of the stadium 1 project "Shakh Deniz", and 1.4–2.4 billion cubic meters of associated gas may be produced by the oil project Azeri-Chirag-Gunashli. From the 8.6 billion cubic meters of gas in the Shakh-Deniz project, 6.6 billion will go to Turkey and 0.3-0.8 billion to Georgia. As a result, in the best case scenario, around 12 billion cubic meters will remain in Azerbaijan itself. In other words, the minimum required for the entire republic. Therefore, Nabucco could, of course, obtain gas from Azerbaijan in 2013, but this will be gas already given to Turkey and re-exported to the EU from Ankara. Several experts believe that even taking into account the yield at full capacity from the Shakh-Deniz deposit, Azerbaijan could pump 4 billion cubic meters at the most into a new pipeline.

Besides this, Baku has an attractive alternative: gas supplies along the existing corridor to Greece and the new gas pipeline planned for southern Italy in 2010. The carrying capacity of this route (8-10 billion cubic meters) corresponds more to Azerbaijan's capabilities, since the country is already committed to supplying gas to Turkey at a rate of 6.6 cubic metres per year. A further point is that the head of Gazprom, Aleksei Miller, recently made a proposition to the Azerbaijani President Ilham Aliev regarding the acquisition of all gas at European prices (minus the cost of transportation and the Russian group's premium). Azerbaijani accepted the proposal and agreed to sell Gazprom 0,5 billion cubic meters of gas per year. Such minor quantity shows that the agreement was only a sideshow. Head of the State Oil Company of Azerbaijan Republic (SOCAR) Rovnag Abdullayev, confirmed it, saying: «Politically, we have decided to support the Nabucco, giving it special significance».

Taking into consideration the ridiculous amounts of export gas Baku can offer now, even 0,5 billion cubic meters may have negative impact on Nabucco primary resource balance.

## Central Asia is bidding its time

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The situation surrounding Nabucco has been arranged entirely by the central Asian “gas troika” – Turkmenistan, Kazakhstan and Uzbekistan, which is continuing to strengthen its resource and gas solidarity with Russia and in doing so carving out better conditions for itself in trade with Gazprom, gambling on attention from the Europeans.

Turkmenistan, which persistently courts the Europeans and Americans, is not about to give any guarantees yet, apart from general words. The memorandum signed in the spring with the EU commissioner for energy, Andris Piebalgs and the commissioner for international affairs, Benito Ferrero Waldner, which supposedly contained words about Ashhabad’s willingness to sell up to 10 billion cubic metres of gas to Europe, is worth nothing since the country does not even have the gas to supply northern Iran, which has already been contractually agreed.

Quite apart from this, today an agreement is in place between Moscow and Ashhabad, in transit in Kazakhstan and also Uzbekistan regarding additional gas supply to Russia, for which a new Caspian Sea gas pipeline with western Central Asia will be constructed and the pipeline towards Central Asia modernized to enlarge the lines to the south of the region. The implementation of these projects will increase annual Gazprom imports from 42 billion drums in 2008 to 72 billion after 2010 and up to 90-100 million approaching 2020.

At the same time, Iran and recently also Turkey rank among the challengers for the Turkmenian gas that Russia wants to buy. In Ashhabad in early October this year, Turkey’s Prime Minister Recep Erdogan told the President of Turkmenistan, Gurbanguly Berdymukhammedov about his “exclusive” interest in supplies of local natural gas. He referred to the involvement of Turkmenian raw materials in the Nabucco project, on a scale of 30 billion drums per year, for exporting Asian gas to Europe through Turkey.

Simultaneously, Iran declared its wish to acquire gas from the Turkmenian Dovletabad-Donmez deposits, which is currently being imported by Gazprom. Teheran intends to analyze the construction of a Saraks-Jask gas pipeline with a capacity of 18 billion drums per year together with Ashhabad. It should provide a gas supply from southern Turkmenistan to the banks of the Persian Gulf in the waterfront Busher region.

The idea seems fantastical, but huge gas reserves are deposited in this part of Iran, and Teheran cannot yet facilitate the sale of the entirety of these reserves. So Turkmenian gas is de trop there providing that its flow will not in fact be returned by Nabucco towards Meshhed – Neka – Rasht – Terbiz.

## Increased war risks of gas transportation

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The short-lived military conflict in South Ossetia will nevertheless have highly serious and long-term consequences for global politics. One of the areas that immediately appeared to be influenced by the destabilized situation in the Caucasus was the energy industry or, more specifically, its infrastructure constituent. It is currently difficult to predict whether the military operations, which are now over, will lead to fundamental changes on the energy scene in the Caspian and Middle East region, however the speed of the reaction to events in all the fuel produced and transitional states forces us to confront the significant growth in military factors in assessing the prospects not only of separate projects but of the entire region in global energy politics.

Azerbaijan has stopped pumping through Georgian territory. There, oil is directed through the pipeline from Baku to Novorossisk, and in the southern direction towards Iran, which is utterly monstrous from the perspective of the United States. But the gas supply in the Baku-Tbilisi-Erzurum pipeline has also been stopped. So, at the current time, it is not yet appropriate to talk about the United States knocking down new projects. But this is really what Baku-Tbilisi-Erzurum was designed for, having remained practically empty since Azerbaijan hardly has any gas of its own as yet. Everything was with an eye to Turkmenian gas, just as Baku – Tbilisi – Ceyhan was designed for Kazakhstani oil and planned to cover 60% of the general oil circulation. But now, Kazakhstan has stopped its supply through Georgia and re-oriented towards Russia and China.

The post-conflict situation has seriously debased optimism among project initiators, who declared on the eve of the conflict that the Nabucco gas pipeline, through which gas was to be supplied from Central Asia to Western Europe bypassing Russia, would be entirely filled from its very first day in operation. More than 100% of its capacity was already reserved by potential suppliers in accordance with non-binding contracts, said the press relations service for the project operator, Nabucco Gas Pipeline International GmbH (NGPI).

For this project, more important than finding suppliers is finding investors who will build it. It is essential for the international consortium that could construct the gas pipeline from Turkmenistan to Azerbaijan and pump gas through it to Turkey and beyond to somehow close its eyes to the risks in Georgia, doing the bidding of



the American administration. Apart from that it is essential for Azerbaijan and Turkmenistan to resolve their own conflict and talk Russia and Iran into agreement on installation of the pipeline on the bed of the Caspian Sea, which is at risk from earthquakes, and so on.

According to the Deputy Executive Director of the International Energy Agency (IEA), William Ramsay, the crisis in the Caucasus “froze investors somewhat”, and in particular this affected the energy sector. Specifically, the European Nabucco project is suffering, which was called upon to decrease Europe’s dependency on supplies of energy products from Russia. “In the best case scenario, it will slow the implementation of the project”, said Ramsay. However, in his words, this project “was already dead, or almost dead” at the start of the conflict in South Ossetia.

## Partner or competitor?

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After the effective Blitzkrieg in the Balkans by the Russian Presidents and once agreements had been signed regarding the construction of the “Southern Flow” pipeline at the start of 2008, the feeling arose that the geopolitical project Nabucco had been buried for once and for all. Besides the absence of any resource base at the European end of the pipeline, problems of distribution could also emerge. However, the persistence of the project initiators shows that the search for sources of gas supply is not yet over, and one of the directions is Iran.

For this reason, Teheran understands only too well its own critical significance in the Nabucco project, and promotes its positioning as an alternative to Russia for gas supply in a southern direction. Consequently, Gholamhossein Nozari, who said straight out that Nabucco “will not work without Iran”, is not far from the truth. “Everyone acknowledges that the project cannot be implemented without participation from the Iranian side”, he said in an interview. “You cannot ignore a country with 16% of the world’s natural gas resources”.<sup>8</sup>

That said, it is true that Iranian officials are extremely anxious about Gazprom’s reaction. During a recent visit to Bulgaria, the head of Iran’s Foreign Ministry, Manouchehr Mottaki called participation in the Nabucco project “one of the possible directions for cooperation between Iran and the EU”. This was said in Sofia, where an agreement had been signed between Bulgaria and Russia the day before regarding the construction of the “Southern Flow” gas pipeline, so the Minister’s words could have been appraised as a challenge to the Russian energy strategy in Southern Europe. For this reason, Mottaki himself hastened to reassure his counterparts that he had not intended to bring Russian and Iranian interests in the gas sector into contact with one another. “My statements in Bulgaria regarding the Nabucco pipeline were interpreted incorrectly. They were not pointed at a third country”.

But how, in fact, were they meant?

Iran’s arrival on the European gas market with a view to seriously exploiting its gas resources may cause considerable damage to the existing balance of interests, and on top of that, could

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<sup>8</sup> *Vremya Novostei*, 15 September 2008.

be subjected to constant doubt by European consumers. The threat to Russia's gas interests can be divided into three groups:

- *Infrastructure.* Iranian gas, together with Iraqi (in the event that the projects for exploiting Iraq's gas deposits that are being actively promoted by the Americans come to fruition) will become the very resource-related groundwork that enables the practical implementation of the Nabucco project to begin. Today, this possibility may seem hypothetical, but even the mere fact of the availability of potential reserves of associated gas for this pipeline signifies the need to activate and accelerate the "Southern Flow" project.

As was mentioned above, the contract for supplying Iranian gas to Switzerland is based on the Trans-Adriatic Pipeline starting up quickly. TAP is a joint project between EGL and the Norwegian StatoilHydro. The planned capacity of the first leg of the pipeline, the construction of which should start in 2010, is 10 billion cubic metres per year. The cost of the pipeline from the Greek city of Salonika to the Italian port Brindisi (186 km through Greek territory, 201 km through the mountains of Albania and 115 km along the bed of the Adriatic Sea) is 1.2 billion Euro. However, no definitive technical or economic groundwork for the project has yet been laid. For this reason, the decision on the full volume of funding will only be taken in the second half of 2009, as noted on the official TAP website.

From this point on, TAP is expected to be connected to the operational pipeline from Iran to Turkey. Teheran and Ankara recently agreed to increase exports of Iranian gas to Europe through Turkish territory. As well as expanding the existing main lines, the two sides plan to construct a second gas pipeline between the two countries. In this way, Iranian gas will immediately join two export arteries opening into Europe – Nabucco and TAP.

- And this implies a *fight for market outlets*. Current opinion favors a certain "immensity" in the European gas market. And indeed, the forecast for the growth in consumption of the blue-sky fuel does boggle the imagination. However, it is also worth paying attention to the colossal effort (together with a no less colossal expense) made by Europeans to level the balance of energy and decrease the proportion of hydrocarbons in that balance, and also to implement energy-efficient technology. It is not impossible that in the space of 10-15 years, they will convert this effort

and expense into a real reduction in gas consumption. In any case, energy consumption in OECD countries has fallen in each recent year.

- Competition for market outlets passes directly into the plane of price competition. This, the third group of risks, had already begun to emerge after the joint announcement by gas workers from Turkmenistan, Kazakhstan and Uzbekistan about the transition to European prices and contracts with Gazprom. Gazprom agreed with the opinion of its Central Asian suppliers, although for the company, this situation will lead to reduced maneuvering space in the event of price competition for market outlets. At the same time, the recent (1st June of this year) proposal by the head of Gazprom, A. Miller, to the President of Azerbaijan I. Aliyev to buy all Azerbaijani exportable gas further signified Gazprom's new price strategy: The Russian group is bartering its profit from the sale of gas on the European market to preserve its own influence in the entire Eurasian gas space. In other words, Gazprom is exchanging profit for control.

Just as Iran is also actively urging the European Union to lower their energy dependency on Russia, it is also encouraging the EU to economize significantly. For instance, the price of a 25-year contract between NIGEC and the Swiss EGL is measured within the range of 10-22 billion Euro, that is, one thousand cubic meters costs between 90 and 200 Euro. Even today, Gazprom's average European price is 240 Euro, possibly growing to 260 Euro for one thousand cubic meters by the end of the year.

At the same time, Gazprom's price policy directly causes a high pricing level to be maintained for European consumers on account of the reduced supplier numbers or their orientation towards a high pricing level predetermined by Gazprom.

Approaching the analysis of the situation objectively, one should not forget a further player in this scheme – Washington. Indications of relations easing do not signify the USA having withdrawn all claims against Iran. There is no basis to talk of freedom of choice for Europeans: the United States of America have already demanded an extensive investigation into contracts for supplies of natural gas from Iran to Switzerland. Washington intends to ascertain whether this document conflicts with the sanctions relating to Teheran in connection with its nuclear program. The

US embassy representative in Switzerland announced a series of checks. Although the Swiss Foreign Ministry declined to comment on this report, the signal has undoubtedly been interpreted in Geneva, as well as in other capitals.

## Interesting prospects for Gazprom

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Still in the same period when Shell and Repsol were considering their position, Teheran began negotiations with companies in India, Turkey and Russia. Out of which, we notice, only one is so far participating in the exploration of the South Pars. This is the Russian company Gazprom, which, together with Total, put phases 2 and 3 into operation at the start of the century. After this, Gazprom attempted to enter into the development plan for phases 4-5 and 15-16, however both times the choice of tenders made was not in its favor. In 2006 Gazprom investments in Iran's oil and gas sector exceeded \$750 million.

In 2008, negotiations between Russia and Iran intensified: different compositions from the two sides met both in the spring and the summer. At the end of April, Gazprom and the National Iranian Oil Company (NIOC) signed a memorandum of understanding and cooperation in the country's oil and gas sector. At that point, Iran's Oil Minister specified "We are holding negotiations with Gazprom regarding this company's development of several oil field lines in South Pars and North Azagedan". In the second ten-day period in July, immediately after Total announced its refusal to invest in the 11th phase, Gazprom and NIOC signed a memorandum concerning work on the South Pars, although no definitive parameters for cooperation were specified. The South Pars and Azagedan were again mentioned in the memorandum as projects for joint development, and swap operations with gas as well as collaboration on the construction of oil and gas transport infrastructure were added to this.

Different variants for the development of operations in the South Pars exist. Experiences from exploration during previous phases shows that Teheran is prepared to attract several international partners to a single project. For this reason it is not impossible that in phases 22-24, Gazprom will work together in partnership with TPAO.

Strategically speaking, this may be a very appealing prospect to Gazprom. It would allow the Russian company to take part in gas disposal, which – once partners have been selected by Turkey – will inevitably go to Europe via Asia Minor – irrespective of which route is used, Nabucco or the "Southern Flow". In the development of this variant it is entirely possible to expect Gazprom and Nabucco to be

consolidated. Moscow has never rated the likelihood of its participation in this project as zero.

Secondly, we believe that once the issue of the refusal of LNG exports in phases 10-14 and the construction of gas pipelines has been discussed, the chances of Gazprom taking part increases. If the question of LNG still remained, the Russian company – not yet having sufficient experience – could be considered for the role of junior partner only. Right now, it would be realistic for Gazprom to be given a leading role in the projects to be developed within this phase.

Apart from this, the prospect of swap operations gives the two countries a very wide margin for cooperation, which, up until the primary export lines are constructed, will allow Iran to increase its hold in Europe, and Russia in Asia.

## Market sharing is possible

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For the time being, the volume of Iranian fuel available for export to European countries cannot be perceived as a serious threat to Gazprom, which meets around 30% of the European demand for gas (approximately 150-160 billion cubic meters per year). With the supply stocks announced (Nabucco – 31 billion cubic meters per year + TAP – from 10 to 20 billion cubic meters) and the project lead time in 2012-2013, neither project is really capable of dramatically altering the market situation, although the factor of time does appear to be crucial. The more so because by this time, Gazprom will have significantly increased its gas supply with new main lines (Nord Stream and Southern Flow) implemented and the Blue Stream extended.

And, nevertheless, the Russian monopolist is actively pushing forward with its own scenario for development of events, which is to its own considerable advantage. By this we mean the redirecting of Iran's abundance of gas to the east – in the direction of China, Pakistan and India. Does it make sense for Iran to wait for the USA for change its position when there are consumers in the east who are ready to ensure a massive demand for energy products and much less inclined to look towards Washington and Europe?

On 28th March this year, India's Oil Minister, Murli Deora, reported that India was still interested in continuing the gas pipeline from Iran and planned to resume negotiations with Pakistan on the issue of a gas pipeline for transporting natural gas out of Iran. Indian specialists are meeting with their Pakistani colleagues next week, after the new government takes office in this country.

Iran recently announced that it was ready to start supplies of natural gas to Pakistan from 2011. Moreover, the gas pipeline under construction has the capacity to deliver 110 million cubic meters of gas per day, so with Pakistan requiring only 50 million cubic meters, the remainder can go to India.

At the end of September 2008, during a behind-the-scenes session of the UN General Assembly, the presidents of Iran and Pakistan reached an agreement that Teheran and Islamabad would complete the work on a project to build a gas pipeline that would connect Iran, Pakistan and India. The two sides agreed to form a company for attracting funding for the construction of the pipeline to transport Iranian gas to Pakistan and India. According to plans, the



gas pipeline, 2,100 km in length, should be complete by the end of 2012.

Up until then, the United States have been regarded as against the implementation of the project, wanting to isolate Iran for its reluctance to stop its nuclear program. However, the Indian minister was not inclined to emphasize this. "The Americans have not told us clearly enough that we may not support or continue this pipeline construction project. And although they are our largest trade partner, this does not mean that they can oppress us in terms of whether to buy or not to buy", said Murli Deora.

It is very likely that, rather than competition between Iran and Russia, mutual coordination of merchandising will prove to be in the interests of the two major gas powers. Since the Iranian President has repeatedly offered his Russian counterpart a similar agreement right up until the division of the market, the possibility an agreement coming into existence cannot be ruled out. Under such an agreement, Russia would remain the main supplier to Europe and Iran would not lay claim to the EU markets with its gas but would look east, having overturned its plans to diversify its sources of energy supply, since this is too dependent on the USA and Europe.

It is no coincidence that Russia immediately expressed its satisfaction at the conclusion in May 2009 an agreement between Tehran and Islamabad to build a gas pipeline from Iran's South Pars field to Pakistan. Gazprom also expressed readiness to join this project, which will divert the free volumes of gas from South Pars of the Nabucco project and send them to the markets of South Asia. A senior manager of state monopoly said that Gazprom could serve as operator of the pipeline, as well as to become the contractor during its construction. The length of the Iranian section of pipe will be about 1.1 thousand km, Pakistanian - more than 1 thousand km. Initially, Iran will export to Pakistan about 11 billion cubic meters a year, then the volume will be doubled. Construction beginning is scheduled for September 2009, completion - from June to September 2014.

In this shape the pipeline is only a part of a larger project, which involves the construction of the Iran-Pakistan-India gas pipeline (« Peace gas pipeline »). In April 2008, President Ahmadinejad during his visits to Pakistan and India managed to convince the two countries support the option of a single pipeline with design capacity of 55 billion cubic meters annually, of which 62.5% would be used for India and the rest - for Pakistan. The Indian section of the pipe is about 600 km, and the project cost was estimated at \$ 7-8 billion.

However, since September last year, India has suspended talks on participation in the project. Officially Delhi referred to the problems in negotiations with Iran and Pakistan on the price of gas and transit. However, as experts note, the real problem was political pressure on India from the United States as well as growing tensions with Pakistan. At the same time we should not forget that India is most likely participant in the project. Expected by 2025 India will need

about 145 billion cubic meters of gas per year. So the gas pipeline from Iran is the country's almost only opportunity to acquire its own permanent source of supply.

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More and more signs are appearing that a gas cartel is forming, which as early as next year could turn into a "gas OPEC" with an organizational structure, as a continuing company in the Forum of Gas Exporting Countries. One of the variants for the charter for new organizations was drawn up in Teheran, the second in Moscow. As soon as the participating countries in the Forum succeed in working out a single charter for new organizations on the basis of the two drafts, which differ in terms of the degree of their radicalism, they can take on the distinct shape and many semiformal agreements typical to cartels, the existence of which can only currently be guessed at.

# European Governance and the Geopolitics of Energy

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