

# The energy policy of Iran towards the EU and China



Iran's huge oil and gas resources make it a strategically important country in the Middle East. Both the EU and China are potentially important economic partners for Iran. The EU can provide foreign direct investment (FDI) and technology and knowledge transfer; and China's national oil and gas companies have signed several import deals and will explore Iranian oil and gas fields to secure its growing oil and gas import dependency. However, domestic and foreign policy factors in Iran seem to be obstacles to large-scale investment by either the EU and China in the country.

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THE OIL INDUSTRY has been Iran's main source of income for the last century. At the end of 2007 Iran had 138.4 billion barrels (bbl) or 11.2% of the world's total proven oil reserves. It ranks second behind Saudi Arabia in proven oil reserves and fourth in oil production behind Saudi Arabia, Russia, and the US.<sup>1</sup> The main countries to which oil is exported are Japan, China, India, South Korea, and Italy.

At the end of 2007 Iran had 981.75 trillion cubic feet (tcf) of proven gas reserves, or 15.7% of the world's total proven gas reserves. This ranks the country second behind Russia in proven gas reserves and fourth in gas production behind Russia, the US, and Canada.<sup>2</sup> About 62% of Iran's proven gas reserves have not been developed yet. But, due to rising domestic demand it has to be expected that gas exports will remain limited in the coming years. The Iranian energy infrastructure has to be modernised extensively and relies on FDI from, for example, the EU to realise this.

#### Iranian oil and gas and EU energy supply security

For the EU, Iran is a potential supplier of oil and gas as well as an important factor for stability in the Middle East and, in turn, its own backyard. The import of oil and gas are vital for the economies of the EU member countries. The EU therefore needs a long-term strategy for the security of supply at reasonable prices. These goals can only be reached if different producers compete on the European market. Momentarily Iran does not play an important role as a supplier of oil and gas to the EU, but it could become an important supplier in the future.

The urge to develop a common energy policy in the EU has been driven by several developments: declining energy production in Europe, concerns about Russia as a reliable energy exporter to Europe, increasing energy prices, and the necessity to fight climate change. The EU Green Papers<sup>3</sup> on security of supply express the concerns that oil and gas supply in the near future will depend on a limited number of oil and gas producing countries, and that import dependence requires an improvement of economic relations with key producer countries. Europe's energy mix is strongly dominated by fossil fuels. Oil accounts for 40% of the total EU energy consumption, gas for 24%.<sup>4</sup> The EU's dependence on fossil fuels is a reflection of what is a general trend in energy usage on the global level. Oil will

remain the main fuel used in the primary energy mix, though there will be a slight decrease of its share in the overall energy usage. At the same time the consumption of gas will grow more rapidly than any other energy source. Currently, about half of the energy consumed in the EU is produced at home, while the other half is imported. The EU becomes increasingly dependent on the import of energy as domestic production capacity is limited. The EU imports its oil from Russia, the Middle East, North Africa and Norway and most of its gas from Russia and Algeria. It is negotiating deals on the import of gas from Libya, Egypt, Qatar, Iran, and Azerbaijan. Furthermore, Iran and European oil companies have concluded several buyback energy contracts in recent years. For Iran, due to the sanctions imposed by the US, Europe is an alternative option to deliver FDI, modern technology, and know-how.

The planned Nabucco pipeline is a recent indication of strengthening energy ties between the EU and the Middle East and Iran in particular. The Nabucco pipeline is planned to transport gas from the Caspian region, Iran, Iraq, and Egypt via Turkey, Bulgaria, Rumania, and Hungary to Austria. It should lower EU dependence on Russian gas. However, the future of the pipeline is no longer clear, since Russia is also following its own pipeline projects that compete with the European pipeline projects, such as the Blue Stream and the South Stream pipelines. The Blue Stream pipeline was inaugurated on 17 November 2005 and is carrying gas from Russia to Turkey via the Black Sea. The planned South Stream pipeline is supposed to carry gas from Russia to Romania, Bulgaria and Greece and from there by a south-western route into southern Italy and on a north-western route into Serbia and Hungary. The diversification of European gas imports is also challenged by other countries competing with the EU for the same resources, above all by China.

#### Iranian oil and gas and China's energy security supply

Historical ties between Iran and China date back as far as 139 BCE when the Hans and the Parthians established diplomatic and trade relations with each other. Trade was carried out on the 'Silk Road' which linked China to Central Asia and the Middle East. When the Mongols conquered both China and the Persian Empire in the 13th century these contacts even increased. Even today Chinese and Iranian leaders refer to these historical relations to legitimise their recent cooperation. Both countries have no history of war and conflicts with each other, which helps the strengthening of their mutual relationship.

With the rise of Deng Xiaoping to power in 1976, the implementation of economic liberalisation policies in China and economic growth, China's demand for additional energy sources has been increasing. Iran's huge oil and gas resources and rising energy import dependency in China has been the most important aspect of the relationship of these two countries. One form of cooperation is the Shanghai Cooperation Organization (SCO), which has developed into an important global political, economic, and security organisation. Established on 14 June 2001,

its six permanent members are China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan. India, Iran, Mongolia, and Pakistan have observer status in the organisation. The inclusion of Iran into the SCO would undermine US dominance in the Persian Gulf and increase SCO influence in the region and the Middle East and Central Eurasia at large. On the part of Iran, SCO membership would expand its international political and economic possibilities. It would grant access to SCO projects and, thus, to technology, investment, trade, and infrastructure development. That means, the sanctions on Iran imposed by the US could be undermined by Iran-SCO cooperation and also by Iran-China cooperation on a bilateral level.

It is expected that China's energy demand will double between 2005 and 2030. That means, by 2010 the country will probably have overtaken the US as the main energy consumer in the world. Today, it is the second largest oil consumer in the world behind the US. Coal will remain the main energy source accounting for 63% of total energy consumption in 2030.<sup>5</sup> Although the country is trying to increase domestic production, oil imports will comprise almost 70% of the country's oil consumption by 2025. Though gas has not been a major energy source in Iran its share in the total energy mix is increasing. According to the Energy Information Administration<sup>6</sup> China's gas consumption almost doubled between 1999 and 2004 to 1.3 tcf, making up about 3% of the total energy consumption in China. Though natural gas production could significantly be increased due to several natural gas discoveries in recent years China is not only orienting itself on domestic production but also considering the construction of transnational pipelines as well as the import of liquefied natural gas (LNG) from, among others, Iran. In 2006 Iran was China's third largest oil supplier behind Saudi Arabia and Angola providing China with 11% of its oil imports. It has to be expected that relations between Iran and China will intensify immensely, primarily because of China's energy needs and Iran's increasing hunger for consumer goods. However, China, which receives around 50% of its oil imports from the Middle East, is also concerned about political instability in the region and the increasing US involvement there. For this reason, China is also searching for alternative energy sources in Africa, especially Angola, Sudan, the Democratic Republic of Congo and Gabon.

#### Prospects

Both for the EU and China Iran could become an important oil and gas supplier in the future. Iran needs the EU to develop its energy industry and the EU and China to export its oil and gas. Increased cooperation in the energy sector with both the EU and China could strengthen Iran's political and economic position in global politics and in the Persian Gulf and Caspian regions. However, to deepen the mutual relationship with both the EU and China several obstacles need to be overcome. The first is the hostile political and economic relationship with the US. Though EU and China's policies towards Iran are not dependent on the Iran-US relationship, a shift from confrontation to dialogue in the mutual relations of the latter two will make Iran-EU cooperation, and to a lesser extent Iran-China cooperation, easier. The second obstacle is an unsafe trade and investment climate both for companies and governments in Iran. These structural problems need to be overcome if Iran's aim is to secure FDI and international trade relations in the long-term. The third obstacle is the nuclear issue, which does not stand by itself but is related to Iran's overall relationship with the rest of the world. A dialogue should be comprehensive and not limited to the nuclear issue. A common approach should include not just the US and the EU, but Russia, China and India as well. With Iran keeping its options open both towards the West and the East, the EU and China should cooperate rather than act as rivals if they are to safeguard long-term access to energy resources from Iran.

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#### Notes

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