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# The Russian Iranian Energy Relationship.

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Are Russia and Iran, with 20% and nearly 50% of the globe's proven oil and gas reserves, likely to develop a policy of coordination of production and exports, potentially influencing global prices and/or supply, to the detriment of energy consumers? In a world where energy importing countries are newly concerned about security of global supply, this has become a legitimate question.

This author would argue that if one examines past history, current Russian and Iranian national interests, and the complexities surrounding their modern bilateral relations, it is difficult to envision Russia and Iran being inclined, or even able, to create an alliance to coordinate their oil and gas output and exports.

It is fundamental to remember that Russia and Iran have long been historical rivals. For both the Soviet Union and successor state Russia, Persian-Muslim Iran was neither a client state nor a close ally. The consequences of this competitive historical relationship can still be felt today. And while both countries have, since 1991, forged solid, growing, state-to-state relations, and in some cases relations of mutual dependency, their overall energy relationship is marked by competition, friction, and ambiguity. Further, relations are mainly regionally focused, centered on the Caucasus/Caspian Sea and Middle East areas and include some very divergent market positions. A main feature of Moscow's interactions with Iran have been to further advance Russian interests in these two geographic areas which Iran straddles, the Caspian Sea and Middle East.

## Reserves

The possibility of a coordinated energy policy by both states has been occasioned by growing international awareness of the enormous hydrocarbon reserves of both states, the fact those reserves are firmly under state control, and the willingness of both states to affect energy policy for wider geopolitical purposes.

Russia and Iran control about 20% and 47% of the world's oil and gas reserves. Conservative estimates are that Russia today holds 48 trillion cubic meters (tcm) of natural gas reserves, or nearly 30% of the world's total. This excludes the huge upside gas exploration/development potential of Russia's Northern and Arctic Seas and continental shelf. As regards oil, Russia holds 75bn barrels or approximately 8% of world oil reserves. Again, exclusive of yet-to-be-discovered oil reserves in the vast prospective onshore East Siberia region nor offshore in the north and Far East. Iran holds 27 tcm of gas reserves, or about 17% of the world aggregate and possesses 138bn barrels of oil or 12% of world's total. Given this undeniable reserves base, one may ask what does each state hope to achieve in their energy policies?

## Russian State Interests

As the international affairs maxim goes, nations do not have 'friends,' they have 'interests.' Russia's national interests in the energy sphere, as they relate to Iran, are to:  
Secure export outlets for expanding Russian oil and gas volumes,

including developing a predominant globally-competitive LNG industry;  
Monitor OPEC, of which Iran is a member, to prevent adverse impacts of its decisions on Russian exports and maintain price stability;  
Secure the Turkish and southeast Europe gas market, from Iran among others;  
Persuade Iran to join the Russian position on Caspian Sea demarcation and common access to its surface waters;  
Protect a lucrative export arms and nuclear technology market, including to Iran;  
Ensure Russian firms participate more broadly in Iranian upstream oil/gas plays and other energy ventures;  
Cooperate with Shi'a Iran to halt the flow of Sunni Wahhabi Islamic fundamentalism into Russia;  
Partner with Iran to promote a longer-term Asia-to-Europe trade and transportation corridor to rival the Suez Canal.

#### Iranian State Interests

Iran's State interests, as they relate to Russia and energy, are to:  
Expand its oil and gas production capacity and develop its offshore gasfields, including monetizing the huge South Pars field in the Gulf, so as to not lose market share to Russia and other non-OPEC producers;  
Access foreign capital and advanced (ie US/European, not Russian) upstream oil and gas technology;  
Develop export gas markets regionally and internationally, including developing a new LNG industry;  
Promote new gas pipeline markets such as Turkey, the Balkans and central-east Europe;  
Satisfy domestic energy demand for its mostly young 67mn population living predominantly in northern Iran;  
Secure a larger share of the Caspian Sea oil and gas reserves and counter Russian hegemony of the Caspian surface waters;  
Become a major oil and gas transit route between the Caspian countries of Kazakhstan, Azerbaijan, Turkmenistan and Asia-Pacific consuming nations.

Indeed, the Russian-Iranian energy relationship is evolving into more and more points of competition, overlap and intersection. This trend has been encouraged under the Russian strategically-focused, geopolitically assertive presidency of Vladimir Putin. But it remains ad hoc and self-interested on Moscow's part. Ironically the growing interaction in some areas has also been furthered by the indirect influence of the U.S. sanctions policy towards Iran.

Closely analyzing these State interests reveals the complexity of the bilateral relationship.

#### Export Outlets

Russia is the world's largest gas producer and exporter and second largest oil producer. It relies on energy exports for two-thirds of its export revenues. With oil prices up by \$40/B from four years ago, sustained by strong global and Asian energy demand, energy resource holders naturally aim to produce and export to the maximum to win market share and take advantage of high prices. For Russia this is a special priority and challenge given: (a) its massive size within two continents Europe, and Asia, plus the Arctic, (b) the fact that its energy export transportation systems are transitioning from the Soviet/Comecon era to present Russia and newly independent neighbors, (c) recent problems with Russian export transit states, and (d) the fact that its national economy is hugely dependent on export oil and gas revenues making energy outlets all the more important. The Russian goal has become building and increasing the capacity of as many export

outlets, on its territory, as possible.

Such export 'outlets' can encompass export infrastructure such as pipelines, crude and product terminals, LNG liquefaction and regasification plants and LNG tankers, river barges, ice-breaking tankers, etc, as well as swaps since, in the absence of pipelines, swaps can result in increased exports to world markets. For Russia it is vital to have as many export outlets under its control and operating at maximum capacity in order to defend important existing markets such as Europe and create new exports markets in Asia and the US.

It is now a cornerstone of Kremlin energy policy that Russian energy resources must be exported across Russian territory, via Russian ports and terminals, using Russian State-controlled infrastructure such as pipelines, railways, distribution grids, etc. Russia was leaning in this direction but recent pricing and security disputes with transit states Ukraine and Belarus have cemented the policy. Significantly for Caspian producers, Russia does not view Iran as a transit country for the export of Russian oil or gas to the Gulf.

Though for many Western oil firms, this export option would make eminent technical and commercial sense.

Rather, Moscow has given the highest priority to boosting its own export capacity, first doubling, now further expanding, the Baltic Pipeline System throughput, completing the Blue Stream export gas pipeline to Turkey, expanding the Russian Atyrau-Samara pipeline carrying Kazakh crude into and through Russia, promoting the Nord Stream gas pipeline under the Baltic Sea from Russia direct to Germany, and fast-tracking the Eastern Siberian-Pacific Ocean export oil and gas lines to China and Asia markets.

Despite this priority, in the past year Russia has failed to realize new export outlets in its territory leading to a slowdown in its crude production and export growth. The output slowdown may have been due not only to limitations on export capacities, but also depletion of fields currently in production.

Nonetheless, this has occurred while neighboring producers Azerbaijan and Kazakhstan, with the Baku-Tbilisi-Ceyhan (BTC), Shah-Deniz, and Atasu-Alashankou export pipelines, have opened new Caspian export outlets to Europe and Asia.

While Russia will undoubtedly participate in exporting Russian volumes through Atasu-Alashankou, the BTC and Shah-Deniz outlets, bypassing Russia and Iran, represent geopolitical and commercial setbacks for both states.

As regards Russian-Iranian cooperation over Caspian-Gulf oil swaps, this trade, originally pursued by Russian firm Lukoil, which never reached a substantial volume, has now been largely supplanted by Kazakh/Turkmen-Iranian swaps.

Seeking to become an important transit route between the Caspian and Asia Pacific, Iran has recently expanded its oil facilities at its Caspian port of Neka and by October 2006, Kazakh and Turkmen crude shipments through Neka averaged 136,000. The Neka volumes move via pipeline to the Tehran and Tabriz oil refineries in northern Iran, with the Kazakh and Turkmen producers receiving equivalent volumes of Iranian light crude at Kharg Island in the Gulf for onward delivery to Asia-Pacific and Europe.

## OPEC

Both Russia and Iran are major global oil producers and exporters but as regards OPEC, they hold divergent positions. Russian oil production in early 2007 stood at 9.5mn b/d of which about 4mn b/d are exported. Iran hopes to bring its 4mn b/d oil production to a production capacity (if not outright production) of 5mn b/d by 2008.

While Russia and Iran compete in crude exports as discussed above, both agree on the need for stable world oil prices. Iran is a member of OPEC, and Russia is not, nor does it intend to join any time soon. As a non-member observer, Russia has the best of both worlds: unconstrained by oil export quotas, and is the beneficiary of the price stability OPEC quotas provide. At the same time, Russia seeks to maintain good relations with OPEC as the ultimate guarantor of oil price stability. This is as true for gas as it is for oil as gas prices generally lag behind oil prices by about 6 months. And with Russia being the world's largest exporter of natural gas gives it another incentive to support, if not join, OPEC.

As an OPEC member, Iran is bound with adherence to its output quotas, while also facing the imperative need to increase its own production rates not only for urgent economic reasons, but also for technical reasons. Iran is concerned to speed the development of its so-called 'shared' reservoirs or fields, ie oil and gas bearing structures in borderland areas. These include three major fields: South Pars/Northern (Iran/Qatar), Azadegan/Majnoon (Iran/Iraq) and Anaran (Iran/Iraq). Near-term production by contiguous states could harm Iran's eventual output levels from those fields. Further hampering development has been the fact that some fields, ie Azadegan, are strewn with landmines from the 1980-88 Iran-Iraq war.

For Iran and other OPEC producers, Russia is not yet a threat to their strategy. However should Russian crude export volumes substantially increase, this will bring Russia and Iran more and more into competition as the latter struggles to meet domestic demand and pushes back against the loss of export markets to non-OPEC producers like Russia.

As regards the potential for a gas 'opec,' whatever Iran's stated position, it is highly unlikely that Russia, the dominant producer of the two, would agree to such a cartel. For Moscow, state control over export policy is primary; agreeing to cede some of its control, by coordinating output or export policy with another state or states, would appear antithetical to current policy.

## Turkish And Balkan Markets

This is a market where Russia and Iran are in current competition, with Russia defending its position and Iran seeking new markets. Russian gas exports to Turkey are via three pipeline systems: Transbalkan I, Transbalkan II, and Blue Stream. Turkey is demanding price concessions for Russian gas having overestimated its domestic gas demand. Further, the now operational Shah-Deniz gas pipeline from Azerbaijan, traversing Azerbaijan, Georgia and Turkey, is delivering Azeri gas into Turkey. Iran would like to compete with Russia on gas exports not only to Turkey, but also to Bulgaria, Romania and Greece and further west in Europe (see Nabucco below). This is not a market Russia will easily cede to Iran.

The proposed Nabucco gas pipeline project, for which Iran would be a

major gas supplier, has the potential to threaten Russia's hold over export routes from the Caspian and deliveries to southeast Europe. It is being supported by the EU as one means to reduce that bloc's dependence on Russian energy supplies, a most sensitive issue following Russia's January 2006 disruption of European gas deliveries over a dispute with Ukraine and a December 2006 crude supply disruption due to Belarus pricing issues. The 3,300km Nabucco pipeline would bring 25-30 bcm/yr of gas from Azerbaijan and Iran to central Europe, bypassing Russia. The line would run from Iran and the Caspian through Turkey to Bulgaria, Romania, Hungary and Austria. Construction is expected to begin in 2008.

Russia will vigorously oppose this challenge to its control of Caspian export outlets, as well as its dominance of the Turkish, Balkan and east-central Europe gas markets. Russia has signed an agreement with Nabucco-participant Hungary to explore constructing regional transit routes in Hungary for supply to east-central Europe and to consider extending the Bluestream pipeline from Russia to Turkey then to Hungary and onward to Austria and Italy in an effort to provide an alternative to the Nabucco pipeline. The progress in advancing construction of the Burgas-Alexandropolis export oil pipeline from Bulgaria to Greece, with partners Russia (51%), Bulgaria and Greece, is yet another manifestation of Moscow's focus on the Balkan market and control of export outlets.

#### Caspian Ownership/Security

Russia and Iran continue to dispute legal ownership of the Caspian Sea including subsea mineral rights. While Russia has been successful in bringing two other Caspian littorals, Kazakhstan and Azerbaijan, around to its preferred median-line solution, it is finding it difficult to win round Iran and Turkmenistan. Russia has formally ruled the Caspian since 1828 when it gained full control of the inland sea under the Treaty of Turkmenchaisk. After the demise of imperial Russia in 1917, the Soviet Union granted Iran limited control over a small part of the sea (13%) in the Soviet-Iranian Treaties of 1921 and 1940. But with the break-up of the FSU, and the creation of three newly independent Caspian littoral states (Kazakhstan, Azerbaijan, Turkmenistan), Russia has promoted a median-line solution equidistant from each state's coastline, with disputed fields to be developed jointly. As this solution gives Kazakhstan, Azerbaijan and Russia the greatest share of the Caspian, unsurprisingly, they are supporters of this approach.

Iran and Turkmenistan do not accept the median-line solution. Tehran has consistently held out for an equal share Caspian solution giving every littoral state a 20% sector, regardless of length of coastline. This approach gives Iran a 7% share increase (versus 13%). As Caspian development projects have proceeded, it is clear the northern Caspian basin is more prolific than the southern basin. Thus Iran's only hope of gaining a larger share of Caspian wealth is by extending its sector size. Also developing southern basin reserves offshore Iran will be more costly being located in 600-800ms of water versus 10-50ms in the north Caspian. Tehran continues to insist that all five littoral states must agree demarcation before joint exploration-development projects can proceed.

Paradoxically, while Russia and Iran diverge on how the Caspian Sea should be split, they are united in their opposition to Kazakhstan's plan to build a subsea trans-Caspian pipeline to ship Kazakh, and potentially Turkmen and Uzbek, gas exports, to Europe. Both oppose construction of pipelines across the Caspian seabed until demarcation

of the sea has been agreed among the littorals. They are agreed that in having lost market share due to BTC and Shah-Deniz transport systems, they are not eager to see additional bypass outlets take shape in the Caspian.

Security represents another contentious issue between Russia and Iran in the Caspian Sea, particularly over control of surface waters. This became an especially topical issue in 2006 when the Tengizchevroil joint venture, the Eni-led consortium developing the Kashagan field, and the Kazakh state oil firm, Kazmunaigaz, agreed to create an export system (KCTS - KazakhstanCaspian Transport System) to deliver Kazakh crude from Tengiz and Kashagan to the BTC pipeline in Baku. This system would utilize an oil tanker fleet plying the Caspian waters rather than a trans-Caspian pipeline and would bypass both Russia and Iran (as do BTC and Shah-Deniz).

#### Arms And Nuclear Technology

In nuclear and military assistance, Iran has been a very profitable market for Russia. For Iran, its dependence on Russian arms is growing; it is now Russia's third largest arms buyer. In early 2007, Iran took delivery of sophisticated Russian Tor-M1 anti-aircraft missiles, a sale worth a reported \$1bn-plus, for defense against air attacks, including on Iranian nuclear facilities.

Since 1991 Russia has also sold Iran tanks and armored battle vehicles both critical components for the Iranian army.

Russia plans to undertake a \$5bn project to build five nuclear reactors in Iran. The US opposes those plans claiming the technology involved is dual-purpose, useable for both civilian and military applications. Iran defends its right to acquire 'advanced nuclear technology' for producing nuclear energy and has pledged to cooperate with the IAEA. The Kremlin insists it has been assured by Tehran that it has no plans to develop nuclear weapons and has agreed to sign the IAEA Additional Protocol expanding international inspections of its nuclear program. From Russia's perspective, the IAEA position and Iran's interest in greater transparency in its nuclear program open the way for greater Russian-Iranian nuclear technology cooperation. In the Kremlin's view however, such an important revenue stream with Iran is not going to be sacrificed to US wishes.

#### Iranian Upstream

Russia is not content with the level of Russian firms' involvement in the Iranian oil and gas upstream. Delays in rooting Russian companies in Iran reflect not only Iranian problems implementing the opening of its energy sector to foreign investors, but also the fact that, for Tehran, Russian firms are not the preferred operators. Iranians want to attract the most modern, sophisticated oil and gas field technology available and in many cases that comes from international energy firms.

Russian upstream participation has so far included the Russian gas monopoly Gazprom's participation in the early phases of the huge South Pars gasfield;

Lukoil's interest, with Norsk Hydro, in the 2bn barrels Anaran block in western Iran next to the Iraq border; and Rosneft and Zarubezhneft role in the massive Azadegan oil field near the Iraqi border. In the past, the Russian pipeline construction company, the Gazprom-related Stroitransgaz, had built a major portion of one of Iran's main gas trunk lines between Asaluyeh on the Gulf coast to the Vali Asr gas

processing plant in the interior. Gazprom would also like to build Iran's subsea export gas pipeline to India. New Delhi has stated it will not consider an onshore Iran-India gas pipeline that transits Pakistan, for security reasons.

But for the Russians, the South Pars field, with its estimated aggregate cumulative production range of 13 tcm, a stunning one-half of all Iran's recoverable gas reserves, and 17bn barrels of condensate, is the prize. Revenues are estimated to be \$11bn/yr, yielding total revenues of \$700bn over the life of the field. Gazprom has offered to build a pipeline from the project's landfall to an onshore oil field (Agha Jari) for gas reinjection. Later development phases of South Pars are intended as feedstock for producing and exporting LNG for European and Asian markets. Expanding its holdings in the Iranian upstream remains a major priority for Kremlin energy strategists, as well as helping 'shape' the nascent Iranian LNG industry to ensure it does not become a threat to encroach on future Russian LNG markets in Europe and Asia.

#### Muslim Ties

An area where Russia and Iran appear to be in close alignment is the matter of Muslim ties, specifically the question of the export of Islamic fundamentalism from Iran into Russia. Radical Shi'a Islam is not an issue that divides Russia and Iran. Moreover, by strengthening its cooperation with Islamic Iran, Moscow is able to gain protective cover with its own 20mn Russian Sunni Muslims. Russia has a legitimate concern regarding radical Islam fomenting unrest or rebellion in its Volga and Caucasus Muslim regions. However, it does not see Iran as representing such a threat. Iran is Shi'a, and Russia sees the Sunni/Wahhabi form of Islam as more dangerous and threatening. Sunni/Wahhabism emanates from states such as Pakistan and Saudi Arabia, not Iran. There are very few Shi'a Muslims in Russia as the main Shi'a group in the FSU are Azeri Muslims who are of Turkic origin and largely secular.

In this regard at least, Iran's foreign policy has evolved from ideological goals to geopolitical interests best shown by Tehran's policy towards the Chechen conflict. After the October 2002 Moscow theater hostage crisis, the Iranian government's reaction was generally muted and supportive of Russia. This position reflected not only relations with Moscow on Islam as described above, but also Iranian realpolitik, as well as its dependence on Russian military and nuclear development assistance. But perhaps paramount was Iran's concern about the potentially destabilizing effect of ethnic sentiments among its own minority populations.

Iran's respect for Russia's territorial integrity reflects its own problems with its ethnically diverse population. Iranian minorities - Azeris in the northwest, Kurds in the west, Arabs in the south, Baluchis in the southeast, and Turkmen in the northeast - have at different times expressed separatist or autonomous sentiments. Theocrats in Tehran fear that someday Iran, like Russia, may confront a separatist rebellion in one of its provinces. That point of commonality between Moscow and Tehran and its influence on their relations cannot be overestimated.

#### Conclusions

Russian and Iranian energy resources, given their size, both separately and together, are important to future global energy supply. In examining the potential for both coordinating their oil and

gas production and export policies, it is clear the likelihood of that occurring is low, due to the nature of their bilateral relationship, their multiple competing national interests, particularly over new export oil/gas markets, and the ongoing impact of their historic rivalry.

While Iran and Russia do have strong, state-to-state ties across a wide range of important energy-related issues, it is a complicated relationship. Both consider themselves partners and allies in some areas and are clear competitors in others. They appear willing to resolve outstanding issues (Caspian demarcation); exhibit sensitivity towards each other's problems (restive or separatist minorities, territorial integrity); have many points of mutual dependence (stable oil/gas prices and markets, arms and nuclear technology trade, opening new international trade routes); as well as having points of competition (oil and gas exports, sharing Caspian resources, securing regional gas markets; building new LNG industries). Both do not now coordinate their export gas policies because inter alia they are competing for similar markets and are both on the cusp of developing their own LNG industries well beyond their borders and even regions.

One element influencing Russian-Iranian bilateral relations, if inadvertently, is the US sanctions policy towards Iran which appears to be having the consequence of moving Russia and Iran into closer cooperation. Russia and Iran both seek to assert their independent foreign policy as a counter to US policy. At the same time, US dependence on imported gas is growing significantly and is the world's fastest-growing market for LNG. Given Moscow's and Tehran's massive aggregate holdings in oil and gas reserves, and recognizing the complexity and multi-dimensional nature of their bilateral relations, as well as the low likelihood of their aligning export production policies, it would seem prudent for energy importing nations to view them, amongst other issues, in a strategic, long-term, energy supply perspective.

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