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Introduction

Mr. Chairman, distinguished Committee members, I am pleased to be here today to testify on “Energy and the Iranian Economy.”

Iran is an important country from a number of perspectives, and has a particularly significant place in the international oil and gas domain. But Iran is also a country whose policies and actions have long been cause for deep concern. Given its pursuit of weapons of mass destruction and missile delivery systems, its place as the leading state-sponsor of terrorism, its support for violent opposition to Middle East peace, its unhelpful role in Iraq, its oppression of its own citizens and abysmal human rights record, Iran poses, as Under Secretary Burns recently said, a profound threat to US interests.

Iran’s concerted effort to develop a nuclear weapons capability has become the focus of particular concern, not only for the US but for the international community, as reflected in the resolution adopted in February by the International Atomic Energy Agency (IAEA) Board of Governors, and in the March statement by the United Nations Security Council (UNSC). On June 6, the governments of the US, UK, France, Russia, China, and Germany –referred to as the P5+1-- offered Iran a set of far-reaching proposals that presented Iran with a clear choice between two paths: One path leads to important benefits for the Iranian people, if Iran suspends all enrichment-related and reprocessing activities and enters into negotiations on the basis of the P5+1 offer. The Secretary has made clear that the United States would be willing to join the negotiations if Iran fully and verifiably suspends its enrichment program.

If Iran chooses the other path and continues on its current course, it will face greater international isolation and strong UN Security Council action. Iran has failed to take the steps needed to allow negotiations to begin, specifically the suspension of all enrichment-related and reprocessing

activities. Absent such a positive, concrete response from the Iranian government, we and our international partners have no other choice than to return to the UN Security Council to adopt a resolution which would make suspension mandatory.

The Importance of Energy

Let me turn to energy matters. Iran is the world's second largest holder of natural gas reserves (after Russia), with an estimated 940 trillion cubic feet of gas available, and it ranks second or third (the Iranians claim 132 billion barrels) in conventional oil reserves. (While there is no doubt that Iran's oil and gas reserves are substantial, the opaque nature of the Iranian energy sector makes it difficult if not impossible to independently verify the figures it claims.) With a capacity of just over 4 million barrels per day (bpd), Iran is OPEC's second largest oil producer and second largest exporter (about 2.6 million bpd).

What is striking, however, is the fact that Iran is not as prominent a player on the international oil and gas scene as its geological potential would suggest. Despite its huge gas reserves, Iran is actually a gas importer (from Turkmenistan). At present, it exports gas only to Turkey and to the small Azerbaijani exclave of Nakhichevan, with imports and exports roughly balancing. A project for a gas pipeline to Pakistan and India has long been a subject of study and discussion, but thus far of little concrete action. Notwithstanding its central location, Iran has not developed into a hub for international oil or gas pipeline development.

LNG has also been a focus of discussion and negotiation, but at present, no LNG facilities exist and none are under construction. This contrasts with the situation in Qatar, Iran's small neighbor on the other side of the Gulf, whose North Field shares a reservoir with Iran's South Pars field. Qatar's liberal investment regime, secure political climate, and strong relationship with the US have attracted massive foreign investment and enabled Qatar to leap far ahead of Iran in developing LNG and other gas projects. At just above 4 million bpd, current oil output in Iran is significantly less than the approximately 6 million bpd Iran produced prior to the 1979 revolution; production has increased in recent years, but not by a great deal (it was about 3.8 million bpd in the mid-90s). New production has been largely offset by the natural decline (estimated at 8 to 13% per

year) in the output of older fields, while rising consumption squeezes exports.

Energy Policy

Iran has expressed its intention to expand its production of both oil and gas. Plans have been announced to increase oil production to 5 million bpd in 2010 and 8 million bpd in 2015. But Iran's efforts to attract foreign investment through "buy-back" deals, initiated in 1995 in a reversal of post-Revolution policy, have met with only limited success. Foreign investment in this sector appears to be slowing, due in part to a strong perception of heightened political and financial risk in dealing with Iran. In addition to the discouraging impact of Iran's problematic policies, including its pursuit of nuclear weapons which has raised the possibility of international sanctions, international companies have found it increasingly difficult to reach agreement with Iranian negotiators on project terms that are economically attractive. US measures and policies, including ILSA (the Iran and Libya Sanctions Act), have also contributed to the negative business and investment climate that prevails today for Iran. Foreign involvement in the oil and gas sector also remains a politically charged issue in Iran. Most current oil production in Iran comes from fields developed and operated by Iranian entities;

Iranian refining capacity is inadequate to meet the demand for most petroleum products, particularly gasoline, and the Energy Information Administration (EIA) estimates that Iran will spend more than \$4 billion on product imports this year. Prices are fixed well below international market levels (gasoline costs about 9 cents per liter), which inevitably spurs demand and makes smuggling to other countries profitable. Price increases have proven politically unacceptable, and proposals for rationing are meeting opposition.

The Iranian Economy

There are some positive indicators in the Iranian economy: recent IMF estimates for fiscal year 2005 put GDP growth at 6%. Iran's foreign exchange reserves are estimated at \$47 billion, excluding gold—about 10 months worth of imports at the 2005 level. The IMF also estimates a budget surplus for 2005/2006.

But despite the advantage of recent high oil prices, there are also very significant negatives in the economic picture, including high rates of inflation and unemployment. For 2005, official inflation and unemployment rates were both in the double digits at 13% and 11% respectively. Iran's stock market dropped sharply in 2005/06, losing 20 percent of its value (though the stock market is not a major factor in Iran's overall economy). The Iranian economy also remains heavily dependent on the output of a single sector, with petroleum export revenues, estimated at nearly \$45 billion last year accounting for 80 to 90 percent of Iran's foreign exchange earnings and more than 10 % of GDP. According to the EIA's January 2006 report, Iran's major customers for oil are Japan, China, South Korea, Taiwan, and Europe.

Nuclear program.

Iran's formerly secret efforts to develop a complete nuclear fuel cycle included uranium mining and milling, uranium conversion, gas centrifuge enrichment, laser enrichment, construction of a heavy water production plant, a heavy water reactor, and plutonium separation experiments. Iran claims it is seeking an indigenous nuclear fuel cycle, including the capability to make fissile material, for nuclear energy purposes only. Iran has also claimed that its nuclear activities will provide energy security and independence. However, Iran's limited uranium reserves would not give Iran nuclear energy independence and the costs to Iran of manufacturing fuel indigenously would far exceed the price at which fuel could be purchased on the international market. As noted, Iran also has huge reserves of natural gas, which if developed would represent a significant energy resource. If recovered, flared natural gas in Iran would be sufficient to generate over 4000 megawatts of electricity, equal to four Bushehr-capacity power plants.

Bushehr is the only power reactor under construction in Iran. Bushehr, a VVER (from the Russian acronym for water-cooled, water-moderated) 1000, 1000 megawatt light water reactor, is nearing completion. Iran still lacks the know-how and facilities to manufacture the requisite reactor fuel for Bushehr. Russia has agreed to supply fuel for this reactor, and to take back the spent fuel, but has not delivered fuel.

The August 2005 offer from the EU-3 (the UK, France, Germany) – which Iran rejected – included future European assistance to support an

expanded, safe, safeguarded nuclear power program. The June 6, 2006 package of incentives offered by the P5+1 governments includes an offer to cooperate with Iran in the development of a civilian nuclear power program.

The P5+1 package reaffirms Iran's right to nuclear energy for peaceful purposes in conformity with Iran's obligations under the Nuclear Nonproliferation Treaty. The President and the Secretary have made clear that we do not seek to deny peaceful nuclear energy. However, Iran's long history of deception and noncompliance with its NPT (nonproliferation treaty) and IAEA safeguards obligations have created a loss of confidence in Iran's intentions.

As the President has said, civilian nuclear energy "is a legitimate desire. We believe the Iranian people should enjoy the benefits of a truly peaceful program to use nuclear reactors to generate electric power. So America supports the Iranian people's rights to develop nuclear energy peacefully, with proper international safeguards."

Lost opportunities.

With its enormous natural resource endowments and talented people, Iran should be among the most prosperous countries in the world. But counterproductive economic policies, mismanagement, widespread corruption, and misguided goals such as the dangerous quest for nuclear weaponry, have dimmed Iran's economic prospects. Iran's economic problems reflect in some ways its negative political culture, with all the problematic manifestations I outlined earlier. As President Bush recently noted, Americans admire the rich history and vibrant culture of Iran, and its many contributions to civilization. "The people of Iran", the President has said, "like people everywhere, also want and deserve an opportunity to determine their own future, an economy that rewards their intelligence and talents, and a society that allows them to pursue their dreams." Thus far, those dreams have been sadly thwarted.