Chapter 3

Iran’s Energy Policy: An Overview

The predominance of oil provided Iran a new strength in defense. This is the result of its relationship with oil consumer countries and also its role in the global oil market. But at the same time oil makes it vulnerable too. This is so because Iran’s economy depends on oil revenue. Currently, some 80 per cent of the state’s hard currency income comes from crude oil exports. In fact, oil prices and specially its high price in recent years have increased government income.

Thus, while one of the priorities of the state has been using high oil revenues to promote the broader growth of the economy, larger oil income also has largely entailed increased current spending by the government and a lesser sense of urgency about the need to diversify its sources of income by promoting other industries (Ibid). It has to be considered that although the state has sought to promote the development of non-oil industries to diversify its sources of income and also reduce the shocks to the economy from oil price fluctuations but it has not been successful till now. Thus Iran’s economy depends on oil revenue and due to this fact, it is known as a rentier economy.

For understanding the role of oil in Iranian state and the resultant energy policy decision making process in Iran, review of historical background is done in this chapter. For that, Iran’s energy policy will be reviewed in two parts: 1) Iran's oil policy since discovery of oil until Islamic revolution (1901-1979) and 2) Iran's oil policy under Islamic government.

3.1. Iran's Oil Policy since Discovery of Oil until Islamic Revolution (1901-1979)

Historically, state’s interference in the Iran’s economy has started from the Pahlavi dynasty. Thus, background of state’s role in economy is not more than 80 years. Before that the economy of Iran was included two sectors: agricultural and ranch. It was also due to lack of political power and financial poverty of the state that prevented its function in economic sector. In this situation state’s role was limited in foreign trade.
This function was including granting some concession to foreign companies for exploring and exploiting some resources in Iran territory. Oil was one of these resources (Ghaninejad 2006).

3.1.1. Discovery and Concession of Oil

It was on May 28th, 1901 that Mozafar'od - Din Shah (of Qajar) granted the British subject William K. D'Arcy a 60-year oil concession on all areas of the country except the five Northern provinces bordering Russia. The concession provided its holder the exclusive privilege to explore, exploit and export petroleum. The concession granted the holder the sole right of transportation of oil the area of the concession. Only according to Article 10 of agreement stipulated a royalty of 16 per cent of the net profits on all operations to the Iranian Government.

Thus, according to this agreement, D'Arcy started to work and oil was discovered in commercial quantities in the southwest of the country in late May 1908. Following discovery of oil the Anglo-Persian Oil Company (APOC) was formed in London in April 1909. It was formed with an initial capital of 2 million pounds to assume all the D'Arcy's rights and responsibilities. On 20 May 1914, an agreement was signed between the British government and the APOC by which the British government became the major shareholder of APOC owning 51 per cent of the shares.

The agreement gave the British government the right to appoint two directors on the Board who would have the power of veto on any questions relating to British national interests. Also on the same day, a contract was signed between APOC and the British Admiralty by which APOC guaranteed the supply of oil to the Admiralty for 30 years at fixed prices (Malek 2007).

It was expected that discovery of oil will change the character of Iran's economy, but it did not happen and Iran's economy remained based on agriculture and ranch. It was result of, the British control which gave Iran a little share from oil revenue, and the major part of this share was going to the royalty budget. Therefore the oil revenue did not have any clear impact on the economy of Iran which in turn did not make it a factor in the Iran's state. It was the time for foreign countries to interfere in Iran's internal politics.
And finally, due to lack of power in Qajar government and foreign interference, the Pahlavi dynasty replaced the Qajar dynasty in late 1925.

Table 1: Oil Revenue and Oil Exports, 1919-1926

<table>
<thead>
<tr>
<th>Year</th>
<th>Oil Rev. (£.M.)</th>
<th>Value of exported (£ m.)</th>
<th>Rev. a % of exports values</th>
<th>Vol. of exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>1919</td>
<td>0.47</td>
<td>7.24</td>
<td>6.49</td>
<td>1106</td>
</tr>
<tr>
<td>1920</td>
<td>0.59</td>
<td>6.88</td>
<td>5.57</td>
<td>1385</td>
</tr>
<tr>
<td>1921</td>
<td>0.59</td>
<td>6.54</td>
<td>9.02</td>
<td>1743</td>
</tr>
<tr>
<td>1922</td>
<td>0.53</td>
<td>7.73</td>
<td>6.85</td>
<td>2327</td>
</tr>
<tr>
<td>1923</td>
<td>0.41</td>
<td>8.11</td>
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<td>2959</td>
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<tr>
<td>1924</td>
<td>0.83</td>
<td>12.30</td>
<td>6.75</td>
<td>3714</td>
</tr>
<tr>
<td>1925</td>
<td>1.05</td>
<td>12.53</td>
<td>8.10</td>
<td>4334</td>
</tr>
<tr>
<td>1926</td>
<td>1.40</td>
<td>13.43</td>
<td>10.42</td>
<td>4556</td>
</tr>
</tbody>
</table>

Volume of oil exports refers to long ton figures
Source: J. Bharier, Economic Development in Iran, (Katouzian 1971).

Reza Shah ended regionalism and tribalism and established a nation-state for the first time in Iranian history. It was also time of state interference in the economy. He initiated Iran's first industrialization program and dramatically improved Iran's infrastructure by building numerous roads, bridges and state-owned factories. He built the Trans-Iranian Railway and started branch lines toward the principal cities (1927-38). He took control of the country's finances and communications, which up to then had been virtually in foreign hands.

In 1928 Reza Shah put an end to the one-sided agreements and treaties with foreign countries and companies, abolishing all special privileges. D'Arcy concession or APOC was including those agreements. Then, Shah of Iran started talks on the revision of the oil concession in London in late July 1928 (W. Stocking 1971: 27). Tehran was
under extreme financial pressure in March 1931 and the inflation rate had risen to nearly 45 per cent and the Shah needed a huge sum to go further with his railway and the army.

Therefore, he considered oil revenue as basic source of state budget. Due to this issue, he continued his struggle with APOC. On November 26th 1932, the Shah cancelled the D'Arcy concession. But in its cancellation announcement, Tehran did not close the door to APOC as it stated that it would not “refuse to grant a new concession to that Company” (Malek 2007).

Two meeting were held in the Shah’s Palace on April 24th and 26th, 1933, and the Shah agreed with a new 60-year concession in return for the following:

- “A minimum guaranteed payment (of 750.000 pounds annually) plus a royalty of 4s (gold) per ton of oil produced.
- 4 per cent as tax to Iran (with a minimum guaranteed tax of 230.000 pounds annually).
- Iran’s representation on the board.
- Payment of one million pounds (by APOC) as settlement of all past claims.
- Investment by APOC on Iranians so that this would minimize dependency on skilled foreign employees.
- Reduction of the area to 100.000 square miles.
- Full cancellation of the exclusive right of transportation of oil.
- 20 per cent of the share to Iran.
- Cheaper oil for Iranians” (Malek 2007).

Thus, for the first time oil revenue increased and government wanted to use it as financial source for the economy. Economy depends to oil revenue has been started from this time.

Although, the new oil agreement extended concession for 60 years but there was opportunity for Iran. It was the reduction of the area and the cancellations of the exclusive right of transportation that provide the opportunity for the Shah to develop possible oilfields out of the southwest in the hands of non-British. Germany and U.S. were interested to invest in Iran’s oil sector. Germany showed interest in acquiring an oil concession and Iran also suggested some concession to U.S. for 60-year on 100.000 square miles in the east leaving a huge buffer zone between them and the British (Ibid).
They were also granted the right to build a pipeline to the Sea of Oman. Although, this concession was similar to that of the 1933 concession for the British, but no progress was made until July 1938 when Americans notified that they had lost interest on their concession. They had acquired more beneficial concessions in the Arab countries, which meant for easier transportation to the Persian Gulf (Ibid).

Result of British and U.S policy towards Iran, Reza Shah looked to Germany as third power in the world, but with the outbreak of W.W. II (1941), Reza Shah, wanting to remain neutral, refused to side with the Allies. The Allies protested his rapprochement with the Germans, and in 1941 British and Russian forces invaded and occupied Iran. Forced to abdicate in favor of his son, Mohammad Reza Shah, died in exile in Johannesburg of South Africa in 1944. Mohammad Reza Shah replaced his father and continued the reform policies of his father, but a contest for control of the government soon erupted between the Shah and an older professional politician, the nationalistic Mohammad Mossadegh.

3.1.2. Nationalization of Oil

The departure of foreign troops after the Second World War brought a new era of tumult to the southern oil fields. In 1945, several thousand Iranian employees of the AIOC demonstrated for better working conditions, housing benefits, and higher wages. The British government responded by sending the first of a series of official missions to study existing conditions and make appropriate recommendations. In 1946, several major strikes, one of which turned into a riot, crippled the company’s operations.

With the active involvement of the Iranian government, company officials made partial accommodations to the workers’ demands and offered them additional payments. The Iranian government further pressured the AIOC for adjustments in the 1933 agreement in order to increase the Iranian technical and managerial staff and provide a more equitable distribution of profits. The government’s position was buttressed by a 1947 Majlis act urging it to take appropriate measures to restore Iranian rights in the southern oil fields.

After a year and half of negotiations, the Gass-Golshayan agreement was reached on 17 July 1949; it increased Iran’s royalty from four to six shillings per ton and made
other adjustments more favorable than the terms of the 1933 concession (Makki 1981). Opposition to the Gass-Golshayan agreement delayed a vote on the final measure in the fifteenth session of the Majlis.

During the elections for the sixteenth session, many candidates, especially the National Front nominees led by Dr. Mohammad Mosaddegh, made the new oil agreement a major campaign issue, and when the new Prime Minister, General Ali Razmara, reintroduced the agreement to the newly elected Majlis in 1950, Mosaddegh and his allies led a successful fight against it (Ibid). Razmara tried to pressure the AIOC into making a more favorable proposal, while the news of the Aramco’s fifty-fifty profit-sharing agreement with Saudi Arabia bolstered Iranian opposition to existing AIOC arrangements.

The company expressed its willingness to renegotiate, but this was not communicated to the Majlis or the public at the time. Meanwhile Mosaddegh and his supporters proceeded to draw up a bill to nationalize the oil industry; demonstrations in Tehran and many other urban centers indicated extensive public support for Mosaddegh and oil nationalization. In November 1950, the (Parliament) Majles Committee concerned with oil matters, headed by Dr. Mohammad Mossadegh, rejected a draft agreement in which the AIOC had offered the government slightly improved terms.

These terms did not include the fifty-fifty profit-sharing provision that was part of other new Persian Gulf oil concessions. Subsequent negotiations with the AIOC were unsuccessful, partly because General Ali Razmara, who became prime minister in June 1950, failed to persuade the oil company of the strength of nationalist feeling in the country and in the Majles. When the AIOC finally offered fifty-fifty profit-sharing in February 1951, sentiment for nationalization of the oil industry had become widespread. Razmara advised against nationalization on technical grounds and was assassinated in March 1951 (Mahdavi 1972: 73-75).

On 7 March 1951 Razmara was assassinated, and within several days a bill to nationalize the oil industry was passed. The news of nationalization was followed by anti-British demonstrations in Tehran and strikes in the southern oil fields. The new Prime Minister, Hussein Ala, soon discovered that he could not continue in office in the highly emotional atmosphere; with the fall of Ala’s government, Mosaddegh became prime
minister on 28 April 1951; a nine-point law incorporating his view on the dispossession of the AIOC was passed immediately (Makki 1981: pp. 217-39).

Under this law the National Iranian Oil Company was created and in June 1951 its management established itself in Korramshahr by evicting the management of the Anglo-Iranian Oil (Ministry of Oil 2003). Oil production came to a virtual standstill as British technicians left the country, and Britain imposed a worldwide embargo on the purchase of Iranian oil. Only Japan and Italy resist the pressure to join the embargo and continue to purchase Iranian oil. British also continued its policy towards Iran. As an example in September 1951, Britain froze Iran's sterling assets and banned export of goods to Iran. And finally Britain took its case against Iran to United Nations (UN) Security Council in New York and the International Court of Justice at The Hague in the Netherlands. In The Hague, Mossadegh defends Iran's action in both forums. Ultimately, Britain's legal assault fails when the Court of Justice upholds Iran's argument that the oil dispute is outside its jurisdiction and cannot be heard. It has to be considered that Mossadegh also was supported by U.S.

However, in another reaction, the British took the dispute for mediation to the American government, the World court, and later to UN security. But, Mossadegh did not accept any mediations and followed nationalization of oil. Even the World Bank tried to mediate (in early 1952) by a proposal to hold proceeds from the sale of Iranian oil until a final settlement was reached. This proposal also was rejected by Mossadegh. Some scholars argue that rejection of this proposal was the greatest mistake of Mossadegh (Amirahmadi 1995: 188).

During this time U.S was supporting Mossadegh but gradually turned its back on the nationalist Mossadegh due to British pressure that was trying to accuse Mossadegh as the precursor of a possible communist takeover in Iran. Also after Dwight Eisenhower

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1 Thus the British company, first as Anglo-Persian, then as Anglo-Iranian Oil, operated in Iran for forty-two years, during thirty-nine of which it was the most important oil producer, refiner and exporter in the Persian Gulf area. During those thirty-nine years (1912-51) it exported a total of 338 million tons of oil from Iran for which it paid Iran £118,000,000 representing an average of about 7 shillings per ton. According to an estimate made by the author of Persian Oil the Anglo-Iranian's total investment in Iran amounted to £21,656,252 of which £5,000,000 was provided by the British government. In return for this investment the company's stockholders received £115,000,000 in dividends, of which £49,000,000 went to the British government apart from the sum of £175,000,000 which was paid to it as tax (Ruhani 1973).
took over the presidency in the United States, the Dulles brothers, Allen and John Foster, convinced the President that Iran under Mossadegh was on the verge of joining the Soviet camp. A book on the 1953 coup in Iran – All the Shah's Men by Stephen Kinzer – based on declassified CIA documents graphically describes how the CIA, aided by the U.K.’s Secret Intelligence Service (MI6), executed the plan codenamed “Ajax” to overthrow the Mossadegh government (Kinzer 2003).

In planning the operation, the CIA organized a guerrilla force in case the communist Tudeh Party seized power as a result of any chaos created by Operation Ajax. According to formerly “Top Secret” documents released by the National Security Archive, Undersecretary of State Walter Bedell Smith reported that the CIA had reached an agreement with Qashqai tribal leaders in southern Iran to establish a clandestine safe haven from which U.S.-funded guerrillas and intelligence agents could operate. The leader of Operation Ajax was Kermit Roosevelt, Jr., a senior CIA officer, and grandson of the former President Theodore Roosevelt. While formal leadership was vested in Kermit Roosevelt, the project was designed and executed by Donald Wilber, a career CIA agent (Meyssan 2009).

The operation centered around having the increasingly Shah dismiss the powerful Prime Minister Mossadegh and replace him with General Fazlollah Zahedi, a choice agreed on by the British and Americans after careful examination for his likeness to be anti-Soviet (Frontline 2007). Despite the high-level coordination and planning, the coup d'état briefly faltered, and the Shah fled Iran. After a short exile in Italy, however, the Shah was brought back again, this time through follow-up operations, which were successful. Zahedi was installed to succeed Prime Minister Mossadegh (Ibid).

The deposed Mossadegh was arrested, given what some have alleged to have been a show trial, and condemned to death. The Shah gracefully commuted this sentence to solitary confinement for three years in a military prison, followed by house arrest for life. The Oil Companies continued to pressure the new government until Zahedi negotiated on 9 April 1954, a Consortium Oil Agreement with the cartel. The fact, that Iran had to deal with a group of Companies, rather than just one, made things tough for Iran. In fact, the government of coup d'état signed the Consortium Agreement in 1954. According to this
agreement, the Anglo-Iranian Oil Company, which had then become British Petroleum, had 40 per cent of shares, and 40% was owned by American oil companies. Of the remaining 20%, 14% of shares went to ‘Royal Dutch-Shell’, and 6% to the French ‘CFP’ (Zoghi1997).

Financially, this agreement did not differ much from the other agreement in the West Asia, because Iran’s revenues would not move beyond the 50% which was the basis in all of them. In addition to 10 million Pounds Sterling with given by Iran, as compensation for Kermanshah refinery and domestic distribution facilities (Ibid).

Some of the economic experts believe that the nationalization of oil movement was negative. In particular, it lead to an involuntary explain of oil from the economy. Oil nationalization made an opportunity for government to control oil sector and reduced the role of private sector Musa Ghaninejad believes that oil nationalization was a nationalist movement not a economical solution. He believes that Mossadegh did not pay attention to result of nationalisation of oil for the Iran's economy and oil industry (Ghaninejad 2006).

However, the Iranian movement became a source aspiration and emulation for other oil producers in the region who also began demanding increased control over their oil resources. In 1961 Iran joined with other major oil-exporting countries to form OPEC, whose members acted in concert to increase each country's control over its own production and to maximize its revenues (Oil and Gas Industry 2007).

3.1.3. Iran's Oil Policy and OPEC

Iran took no major initiative in the international oil market until the formation of OPEC on 14 September 1960, which followed the Baghdad Conference on 10 September. The conference, attended by Iran, Iraq, Kuwait, Saudi Arabia, and Venezuela, had initially aimed at defining “a unified stance” by the participants against the major oil companies, which had cut prices in summer 1960 without consulting with the respective governments.

— Although, the First Seven-Year Development Plan (1949 -55) had to be terminated when oil revenue diminished and a promised World Bank loan did not come through. In the absence of oil money, the government partly succeeded in selling a popular bond to the public and shifted focus to small-scale consumer industries with little or no dependency on foreign markets.
The young OPEC, however, could hardly change any thing in an international oil market over which giant oil companies maintained a heavy grip. Significant political difference among the member states were other inhibiting factors. Indeed, in history of oil, the 1960s is known as the decade of OPEC's "resistance" to the "majors", while the 1970s is known as the "decade of OPEC's offensive" (Amirahmadi 1995). Thus until 1970, the change in oil prices was insignificant and most oil producers competed to export higher quantities of crude to increase oil money to implement his grandiose economic and military projects.

In retrospect, this "hit and run" policy succeeded in increasing Iran's oil revenue and the success encouraged the Shah to reestablish the link between oil revenue and economic growth. Oil revenue increased from $10 million in 1954 to $443 million in 1962. In 1958, also the revenue jumped to $291 million from $167 million the previous year (Amirahmadi 1995: 190-191). However, the oil revenue remained insufficient to support at much needed military build up. Thus, between 1954 and 1965, the U.S. gave Iran $612 million in military grants (Ibid.).

Beginning in 1970, the situation gradually changed in favor of oil producers. In November 1970, the Shah convinced the consortium to add nine cents to the price of a barrel of oil and to raise the tax rate on the company's income to 55 per cent (Energy information Administration 2008). In January 1971, Iran took the leadership in negotiating a new price with the majors in Tehran. Jamshid Amuzegar, the Iranian negotiator, charged that crude oil was being sold to Western consumers at $12-$14 per barrel while Persian Gulf producers were getting only $1 per barrel. Later that month, the Shah threatened the majors with unilateral legislative action if they did not negotiate a new price with OPEC (Amirahmadi 1995: 50).

The extraordinary OPEC meeting in Tehran that followed (on 3 February) issued an ultimatum to the oil companies, who agreed to adjust for inflation. The Nixon administration devalued the dollar in August 1971, and again in December 1972, causing substantial reduction oil producers' revenues. After two arduous Geneva negotiations, OPEC was able to get the majors to increase crude prices again by 8.4 per cent in January 1972 and by 10 per cent in June 1973 to compensate for the two-time dollar devaluation.
Iran also initially joined the "participation" movement (state share holding in concessionary companies) that was initiated by the Saudi oil minister Ahmad Zaki Yamani in 1968 (as an alternative nationalisation) (Ibid).

Soon, however, the Shah withdrew from the movement (which was irrelevant to the Iranian case anyway) to negotiate a different deal with the consortium. Shah of Iran announces that the 1954 operating agreement between a consortium of oil companies and Iran will not be renewed when it expires in 1979. Accordingly, on March 22, 1973, the consortium was transformed into a service company paid by the government for its work and in exchange obtained guaranteed delivery of crude oil at the agreed price less 22 cents per barrel.

Although, Iran played important role in OPEC but it did not accept to participate in embargo that was leaded by Arabian country in first oil shock. As matter of fact, in the 1973 oil crisis began on October 17, 1973, when the members of Organization of Arab Petroleum Exporting Countries (OAPEC, consisting of the Arab members of OPEC plus Egypt and Syria) announced, as a result of the ongoing Yom Kippur War, that they would no longer ship petroleum to nations that had supported Israel in its Conflict with Syria and Egypt (the United States, its allies in Western Europe, and Japan (History of OPEC 1998).

Despite the moves taken by the Arab oil producers to reduce world supply, the world market was not as seriously affected as it might have been. The major oil companies made a largely successful effort to reroute supplies from other sources to the embargoed countries. Non-Arab producers such as Iran and Nigeria, and even Arab producer Iraq, increased production to make up some of the shortfall (EIA Analysis: OPEC 2007).

However, price was driven at this time as much by consumer panic as it was by the actual supply-demand situation. Iran held an oil auction in December 73, at which the price of oil was set at $11.65 per barrel [some bids as high as $17.00]. OPEC ministers meeting in January 1974 confirmed this as the official OPEC price (Amirahmadi 1993: 32).
Following the 1973 oil price hike, an intra-OPEC power struggle grew over leadership of the organization. As a consequence, OPEC became increasingly politicized. From the very beginning the two main contestants were Iran and Saudi Arabia. Recognizing the significance of oil for the economy and national security, the Shah adopted a policy which linked oil, regional politics, and economic growth. Oil was used to finance both economic growth and a broad military build-up, which were then used to sustain sizeable oil exports and near-dominant leadership within OPEC and in regional security affairs. Iran's friendship with the United States and accommodation of Oil Companies also contributed to the success of this policy approach.

3.1.4. Oil Revenue and Militarization

The links between oil revenue and arms purchased is well known. This can be seen in Iran specially after increasing of oil revenue that was in same time with cold war. Iran was in a strategic position not only because of its relationship with the Western countries but also because it has a long border with Soviet Union. Therefore, the latter was designed to join the NATO (the North Atlantic Treaty Organization) member chain to the SENTO military treaty. Consequently, Iran by and large, bought its new military equipment after 1964-65.

At this time, not only had its oil revenue increased but it no longer had to pay out about $100 million per year. Thus, Iran could afford new weaponry. Since it was no longer getting new arms under military grants but was paying for them from its oil revenue, Iran could also diversify its sources of supply (Gharehbaghian 1987).

However, military expenditure during this period (1955-1968) was increasing smoothly, but after the oil price hike in 1973, it increased dramatically. Gharehbaghian (1987) describes that “after 1973, Iran's oil revenue amounted to around $20 Billion annually, and created an excess supply of resources that an economy of Iran's size and infrastructure, found difficult to absorb” (Ibid).

The potential alternatives to be used singly or jointly were three (a) to increase the expenditure on development plans, (b) to have investment abroad in whatever from, including real estate and commerce, and to have large-scale military expenditure. In fact all three figured in subsequent attempts by Iran to absorb the revenue from oil...” (Ibid).
It has to be mentioned, Shah’s political aims was to enhance Iran's role in the Persian Gulf. He used oil revenues to expand and equip the Iranian army, air force, and navy. His aim that, in the aftermath of the British withdrawal, Iran would play the primary role in guaranteeing Persian Gulf security coincided with President Richard M. Nixon's hopes for the region (In Memory of Amir Abbas Hoveyda Prime Minister of Iran 1996).

Table 2: Oil Revenue and Military Expenditure during 1955-78
(IN BILLION RIALS/ AT CURRENT PRICE)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil Revenue</td>
<td>4.6</td>
<td>17</td>
<td>311</td>
<td>1.500</td>
</tr>
<tr>
<td>Military Expenditure</td>
<td>4</td>
<td>11.7</td>
<td>134</td>
<td>700</td>
</tr>
<tr>
<td>M.E. as % of oil</td>
<td>87</td>
<td>68.8</td>
<td>43.1</td>
<td>46.6</td>
</tr>
</tbody>
</table>

Source: Collected from various issues of SIPRI and Statistical Yearbook of Iran

The Nixon Doctrine, enunciated in 1969, sought to encourage United States allies to shoulder greater responsibility for regional security. Then, during his 1972 visit to Iran, Nixon took the unprecedented step of allowing the Shah to purchase any conventional weapon in the United States arsenal in the quantities believed necessary for Iran's defense.

The United States-Iranian military cooperation deepened when the Shah allowed the United States to establish two listening posts in Iran to monitor Soviet ballistic missile launches and other military activity. Therefore, in 1979, Iran had become the gendarme of the region. While the military never used in any major regional conflict, the Shah used its powerful image to deter his potential enemies and settle regional disputes.

Oil revenue has been a secure income on which the military expenditure has mainly relied. A major part of the oil revenue returned to the industrialized countries through the purchase of arms — a phenomenon which later came to be known as the policy of recycling of petrol-dollars, in the context of the global distribution of U.S
dollars held as stocks (The Iranian Conventional Forces 2005). Though, Iran was regional power but it had faced unstable economy that has known as rentier economy.

### 3.1.5. Iran’s Economic Transformation into Rentier Economy

The theory of the "rentier state" says that countries that receive substantial amounts of oil revenues from the outside world on a regular basis tend to become autonomous from their societies, unaccountable to their citizens, and autocratic (Beblawi and G. Luciani 1987).

According to this theory, rentier economy has four characteristics. First, rent situations must predominate in that there really is no such thing as a pure rentier economy. Second, the rent must come from outside the country. Third, in a rentier state only the few are engaged in the generation of rent, while the majority is involved in its distribution and consumption. Translated, this means that government leaders make the deals and take in the revenue and then allocate to the public, which is not involved in creation of the wealth. Fourth, the government must be the principal recipient of the external rent in the economy (Ibid).

The point here is that external rent liberates the state from the need to extract income from the domestic economy. The government can embark on large public expenditure programs without resorting to taxation. The government becomes an allocation state, which is very different from a production state. A production state relies on taxation of the domestic economy for its income; taxpayers stay involved with government decisions because they are supporting them with onerous taxes. An allocation state, by contrast, does not depend on domestic sources of revenue but rather is the primary source of revenue itself in the domestic economy. The primary goal of the allocation state’s economy is spending.

Mahdavi, the economist who first popularized rentier state theory, believed that the 1951-1956 period represents a landmark in the economic history of the West Asia (Middle East): an historical era when radical nationalizations transformed ex-colonial models of petroleum exploitation into what he termed "fortuitous etatism" (Mahdavi

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3 Etatism is state socialism whose goal is the subordination of the individual unconditionally to the state to mold his or her destiny and to vest all initiative in the government alone.
A massive amount of foreign currency and credit generated by petroleum development flooded into the state coffers and, Mahdavi argues, turned at least some oil-producing countries into rentier states. Kuwait and Qatar are extreme examples of the phenomenon, with limited capabilities for industrialization and few alternatives to rentierism.

The case of Iran was very important to Mahdavi because, given its size and potential, it had alternatives that the extreme cases lacked. He argues that Mossadegh had fought for diversifying Iran’s economy at the same time it nationalized its oil industry but he was not successful. But opposite to his idea, Musa Ghaninejad believes that Mossadegh did not have any economical aims in nationalization of oil struggles; in fact he was following fight with British Companies more that attention to Iran’s economy. He argues, therefore nationalization transferred Iran’s economy to rentiere economy due to it created rentiere state (Ghaninejad 2006).

Ghaninejad argues that during Mossadegh period though the government did not have oil revenue because of AIOC strike, but the nearly two years standoff, Mossadegh was fairly successful in saving of the economic collapse. Some scholars believe “after oil nationalization, oil revenue had become financial source for the government and then the import-substitution industrialization, policies that pursued by the Iranian government during the 1963-79 periods had paradoxical effect of increasing the economy’s dependence on the oil sector” (Brumberg and Ahram 2007).

However, during the 1970s, oil exports remained Iran's main source of foreign exchange. But, it has to be considered that it helped in the development of the country. The country's economic development started with the "first oil shock" which resulted of oil revenue in 1973. This development generated a major economic boom in the year 1973-75. Iranian oil revenue increased substantially to $18.5 billion in 1974, eight times larger than revenue in 1972 (Gillespie and Henry 1995: 199). Participation of foreign capital in Iranian banking, civilian production, and military projects also increased substantially. Most of these investments took the form of joint ventures with the government and or the private sector and were largely financed by the Iranian banking system. Shah's goals were to be achieved by investing in heavy industry and military
technologically advance capital goods, strengthening the administrative and institutional capacity of the state, and maintaining as many external alliances as possible without undermining the sovereignty of his own regime. Without the presence of oil, the Shah would have had little success in implementing his goals, and Iran's relationship with its Persian Gulf neighbors and with the West would have been fundamentally different (Salehi-Isfahani 2000). Hooshang Amirahmadi explains the role of oil in Iran's economy during Shah Period. He explains:

"Recognizing the significance of oil for the economy and national security, the Shah adopted what I have called a linkage policy. Accordingly, his government linked oil, regional politics, and economic growth within a single policy framework. Oil was used to finance both economic growth and military buildup, which in turn used to sustain sizable oil exports and near-dominant leadership within OPEC and in regional security affairs" (Gillespie and Henry 1995: 199).

However, because of dependence on oil revenue, decline of oil price in 1975 and revolutionary movement in 1978 had impact on Iran's economy and it became a major cause of the Shah's death in 1979 (Islamic Revolution). Amirahmadi in his book "Revolution and Economic Transition: The Iranian Experience" (1990) explains that the results of oil decline led to following:

- The GDP growth rate dropped from 17.8 per cent in 1976 to 7.2 per cent in 1977.
- All economic sectors experienced significant decline, but hardest hit were the oil and industrial sectors, and real estate and construction.
- In late 1975, the government already owed its various contractors $3 billion in delayed payments.
- The private debt to the banking system increased to $19 billion, and the banking system had accumulated a deficit of some $3 billion, of which $2.6 billion had been given in loans to the Iranian and foreign capitalists who were fleeing the country even before the revolution was fully under way.
- The value of imports had declined by 36 per cent in 1978, but this was more than offset by a 67.2 per cent decline in exports for the year, leaving a $500 million trade deficit.

However, in 1978, due to over 83 per cent of the government's foreign exchange payments and 60 per cent of its revenue were drawn from this economic crisis (Gillespie
and Henry 1995: 156), Shah's regime could not continue and it collapsed. After that, it was the time of change under the Islamic Republic.

3.2. Iran's Oil Policy under Islamic Government

On January 16, 1979, the Shah left Iran. Ayatollah Khomeini (who lived in exile in Iraq and later in France) returned to Iran on February. On April 1979, after a landslide victory in a national referendum in which only one choice was offered Ayatollah Khomeini declared an Islamic republic with a new Constitution reflecting his ideals of Islamic government and he became supreme spiritual leader (Valy-e-Faqih) of Iran. In addition to the theocratic Islamic state a program that has known as “Islamization” followed by the government.

According to this theory Iran's foreign policy is shaped based on, the export of the revolution, consideration of the West particularly U.S. and its allies including Israel and its Arab conservative as enemy of Islam and Iran. Also, Iran's economic was based on Islamic economic system (Niblock and Wilson 1999). Although new regime suggested Islamic economy but due to lack of program based on this programme, depends on oil revenue not only did not change the Iranian economy but turned it upside down.

At the same time some revolutionary approached and confiscation of property substantially reduced the private sector, while the public sector became rich and was forced to run the country's main businesses. The public sector gradually grew as deprivatization continued and more wealth and power was given to state-supported, clerically-controlled foundations, called “Bonyads”. Bonyads include Bonyad Mostazafan and Bonyad Panzdaheh Khordad. Majority of these revolutionary institutions operate under the supervision of the Supreme Leader and were/are free from tax payment. The economic activities of “Bonyads” account for some 25 per cent of the Iranian GDP (Brumberg and Ahram 2007).

Also, due to privatization and Bonyad oil contractor with the government in the 80's, approximately three thousand companies and businesses, over most of which it monopoly control. The state managers in charge were young revolutionaries with few
managerial skills and little experience. They have run the state enterprises inefficiently, with losses that abused the government budget (Ibid 2000).

To appreciate the links between an Islamic foreign policy and oil diplomacy, 30 years period can be discussed as follows: (1) 1979 to 1989, when Khomeini was the Supreme Leader; (2) from 1989 to 1997, during the presidency of Rafsanjani; (3) from 1997 to 2005, during the presidency of Khatami; and (4) since Ahmadinejad's presidency began in 2005.


As it has been mentioned above in the first decade of revolution the government controlled all major sectors of the economy and formulated all decisions about their use and about the distribution of income. Iran's constitution also shaped based on government policy due to give legitimacy its control. Therefore according to the Article 44 of the Iranian Constitution, the economy of Iran is to consist of three sectors: State, Cooperative and Private, and is to be based on systematic and sound planning.

The State sector include, all large-scale industries, foreign trade, major minerals, banking, insurance, power generation, dams and large-scale irrigation networks, radio and television, post, telegraph and telephone services, aviation, shipping, roads, railroads and the like; all these will be publicly owned and administered by the State. The cooperative sector include, cooperative companies (and enterprises Bonyad) concerned with production and distribution, in urban and rural areas, in accordance with Islamic criteria. The private sector consists of those activities concerned with construction, agriculture, animal husbandry, industry, trade, and services that supplement the economic activities of the state and cooperative sectors.

Under Ayatollah Khomeini's leadership, the constitution of the Islamic Republic officially enshrined the concept of public ownership and state administration. In this situation oil came under state control, and specifying that mineral wealth "be at the disposal of the Islamic government for it to utilize in accordance with the public interest. In fact, immediately following Iranian Revolution in 1979 and the outbreak of the Iran-Iraq war over 80% of Iran's economy came under the control of the government (Algar 1980).
Thus, in oil sector, the new policy began by terminating the consortiums control of Iranian oil production, exports, and marketing. Oil came under Islamic government and oil ministry was created. Then thought NIOC was established to control oil production and export, but by establish oil ministry the government established a new administration. This affects NIOC deputy because it was/is in parallel with NIOC's duties. This conflict led to the reduction of NIOC's power (Ghorban 2005).

Heshmatzadeh (2001) observes that the government was pursuing these policies in the first decade of Islamic revolution by the following measure:

- Cancellation of all oil agreements with Western States and Oil Companies
- Reduction of oil production
- Attempt to reduce Iran's economic dependence on oil revenue
- Changes in rules about foreign investment and agreement with foreign Countries and Companies.

These aims were according to revolutionary ideology. According to revolutionary government in oil sector also oil agreements were not based on nationalization law and they were based on Western countries and U.S. benefits. Thus, oil agreements with more than 20 oil companies canceled and result of that was 129 complaints against NIOC to international court. Iran also stopped oil exports to Israel and South Africa (Heshmatzadeh 2001: 100). As it has mentioned above in Islamic regime is view production and export oil benefited the West have needed to be come down.

Thus, reducing production can impact West and particularly U.S. situation and they will misuse Iran's oil and wealth. Therefore, Khomeini's government shifted the emphasis by decreeing a policy of oil conservation, with production reduced to a level sufficient to do no more than meeting foreign exchange needs (Global Security 2008). Reducing of oil production and also Iraqi invasion of Iran, stopped oil production of Iran and affected strongly global oil market (see table 3). Result of that was Second Oil Shocked. The shock had a dramatic effect on oil prices and global oil market (Stuart Staniford 2006).

Although Iran oil production declined but high price of oil increased oil revenue. This dramatic increase of oil prices that happened during the first years of 1980s had increased directly the Iranian oil revenues, which lead to big increase in its budget. For
example, while in 1980, the Iranian crude oil revenue was over US$11 billion dollars, three years later the Iranian oil revenue became over US$20 billion in 1983 (Central Bank of Iran 1980-1983).

This big increase of oil income had given radicals groups in the government the money to support their revolutionary mission outside Iran. Some scholars believe that radicals or expansionists “opened camps to give military training to hundreds of young Islamic radicals largely drawn from the states on the western side of the Persian Gulf and the Fertile Crescent, the Arab arc from Iraq to Lebanon. Financed by oil income and staffed by revolutionary Guards, the camps taught recruits the rudiments of small arms, explosives, and simple rocket launchers” (Mackey 1998: 40).

It was short time policy due to Iran-Iraq war. Estimates are that 50 per cent of the capacity of oil production paralyzed during Iran-Iraq war and the result of that was reduced oil production from 6 million barrels per day to 1.662 barrels per day from 1978 to 1981 (Iran Central Bank Statistic). In the other hand, after 1980, oil prices began a six-year decline that culminated with a 46 per cent price drop in 1986. This was due to reduced demand and over-production, which caused OPEC to lose its unity. Oil exporters such as Mexico, Nigeria, and Venezuela expanded production (Brandly 2004).

End of the war Iran faced financial problem and because of that its policy started to change. Iran started to change OPEC policy as one option to increase of oil price. Within OPEC, Iran defended a policy of limiting production and increasing prices. But, it had conflict with some of members especially Saudi Arabia that had tried to increased oil production because of its US alliance and second oil shock (Heshmatzadeh 2000).

Reducing of oil production was also cause of US sanctions. As it has mentioned above since Islamic revolution, Iran has been following ideological approach towards its foreign policy, which is particularly based on anti U.S policy. As a result conflicts erupted between Iran and the US since 1979 onwards. The United States knew that Iran is very sensitive in its economy, and hence they used the weapon of sanctions against Iran. Thus, the United States started using economic sanctions against Iran especially in the oil sector. They first imposed economic sanctions against Iran in response to the hostage crisis of 1979 - 81.
The comprehensive trade and economic sanctions eventually provided a crucial negotiating chip to win the release of American hostages on the day President Ronald Reagan was elected. Therefore, at the end of the war, Iran's economy faced problems. The Iranian government has estimated that the economic cost of the war first five years was $309 billion (Middle East Economic Digest 1986: 13). Thus, declining oil prices in 1986-87 forced the Iranian state to change its foreign policy to revamp its oil sector.

Table 3: Iran Oil Production from 1979 -1988

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<tbody>
<tr>
<td>Total</td>
<td>1622.7</td>
<td>1329.9</td>
<td>586.8</td>
<td>575.0</td>
<td>1041.3</td>
<td>1056.2</td>
<td>940.1</td>
<td>989.0</td>
<td>870.7</td>
<td>982.5</td>
</tr>
<tr>
<td>Crude Oil</td>
<td>1549.3</td>
<td>1259.3</td>
<td>541.2</td>
<td>526.0</td>
<td>979.7</td>
<td>988.8</td>
<td>865.1</td>
<td>914.3</td>
<td>795.7</td>
<td>891.7</td>
</tr>
<tr>
<td>Natural Gas</td>
<td>56.9</td>
<td>54.8</td>
<td>29.3</td>
<td>31.7</td>
<td>43.5</td>
<td>49.7</td>
<td>57.9</td>
<td>57.6</td>
<td>55.1</td>
<td>69.6</td>
</tr>
<tr>
<td>Solid Fuels</td>
<td>3.3</td>
<td>3.8</td>
<td>4.1</td>
<td>4.0</td>
<td>4.5</td>
<td>4.5</td>
<td>4.6</td>
<td>4.9</td>
<td>4.7</td>
<td>4.8</td>
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<tr>
<td>Hydro Power</td>
<td>9.8</td>
<td>8.5</td>
<td>8.8</td>
<td>9.7</td>
<td>10.1</td>
<td>9.7</td>
<td>9.0</td>
<td>8.7</td>
<td>11.7</td>
<td>13.1</td>
</tr>
<tr>
<td>Non Commercial fuels</td>
<td>3.4</td>
<td>3.5</td>
<td>3.4</td>
<td>3.6</td>
<td>3.5</td>
<td>3.5</td>
<td>3.5</td>
<td>3.5</td>
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<tr>
<td>Renewable Energy</td>
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3.2.2. Rafsanjani's Pragmatic Approach and New Oil Policy 1989 - 1997

After Khomeini, Iran's foreign policy moved from Islamisation to more pragmatic considerations based on national interests rather than ideology. Pragmatic and moderate Rafsanjani's policy was based on three considerations: first, Iran cannot change the region's political map; second, Iran must try to adjust to a new balance of power in the region, in which U.S. had played a major role; and third, to build relations with Saudi Arabia because it is a major country in the GCC region.

Rafsanjani’s prime objective in pursuing such policies was to recover ground lost during the eight-years Iran-Iraq war, and consequently to reassert Iran's influence in the region (Alam 2000). Rafsanjani tried to restore the country to a position of power in the
region. Thus, after the Iran-Iraq war in 1988, the Iranian government declared its intention to privatize most state industries in an effort to stimulate the ailing economy (Ehteshami 1995).

Rafsanjani advocated a free market economy. With the state's coffers full, he pursued an economic liberalisation policy. Also, he tried to attract Western investment and reduce the government's dominant role in the economy through privatization. In oil sector, with attention to the damage from Iraqi air attacks and limitation of oil exports – officially admitted that oil exports fell to 500,000 bpd during the summer of 1986 – the government could not increase oil production. However average exports for 1986-87 were about 1.3 million bpd, based on output of 2 million bpd (Niblock and Wilson 1999).

However, increasing of oil production needed investment and due to less government income foreign investment was requested. But the Iranian constitution prohibits the granting of petroleum rights on a concessionary basis or direct equity stake. Rafsanjani had tried to changed law to attractive foreign investment especially for oil sector. As a result in 1987 Petroleum Law permits the establishment of contracts between the Ministry of oil, state companies and "local and foreign national persons and legal entities. Buyback contracts\(^4\), for instance, are arrangements in which the contractor funds all investments receives remuneration from NIOC in the form of an allocated, production share, then transfers operation of the field to NIOC after the contract is completed (Stern 2007). The buyback system has drawbacks for both sides: by offering a fixed rate of return (usually around 15-18 per cent), NIOC bears all the risk of low oil prices. If prices drop, NIOC has to sell more oil or Natural Gas to meet the compensation figure.

Finally, companies do not like the short terms of buyback contracts. In response, Iran has considered revisions to buyback terms (e.g., extending the length of contracts, 

\(^4\) As defined by Article 2 of the executive rules approved by the Council of Ministers, a buy-back transaction refers to a deal in which the supplier wholly or partially puts the needed goods and services for the establishment, expansion, reconstruction, improvement or continued production of manufacturing enterprises of the country at the disposal of the producer. The price of the said goods and services, after deducting the mount of down payments plus the related costs disbursed on the basis of the concluded contract, is paid to the supplier or buyer through the delivery of goods or services of the producer and/or through delivery of other industrial and mineral goods and services produced in Iran. The Supplier is any natural person or legal entity that provides the Iranian producer with goods or services in a buy-back transaction. The Buyer refers to any natural person or legal entity that, by receiving goods and services from the Producer or Exporter, pays up the claim of the supplier from the producer. The Exporter refers to any Iranian natural person of legal entity that pays the price of goods and services.
allowing for continued involvement of oil companies after the field is handed over to NIOC), but these have received by the producer, to the supplier by delivery of his goods or services to the supplier or buyer but these have been controversial and generally have not moved forward (Oil and Gas Article 2008).

In early 1990s, Rafsanjani first proposed legislation to loosen the interpretation of Article 44 and allow private investment in previously state controlled sectors but the revolutionary groups could not accept private sector activity due to it the opening of Iran's oil sector began incrementally with foreign investment. In fact, it was first allowed in the less politically sensitive downstream markets of refining and petrochemicals, and only later into upstream markets.

However, increasing of oil production was very important for the government, because some domestic and regional factors such as the conclusion of the Persian Gulf War against Iraq in the beginning of 1991 that changed the Islamic Republic's perception of its security, making it keener to develop both a strong economy and deterrent military force. As Aghazadeh, minister of petroleum, stated in meeting with the ruling clergy in Qum in September 1991; "if the Islamic Republic is to maintain its regional preeminence, it must improve its economy by increasing its oil production" (Gillespie and Henry 1995: 209).

In a subsequent international press conference in Tehran on 16 October 1992, the minister insisted that "we are more concerned with the level of revenue that the number of barrels of oil exported" (Gillespie and Henry 1995: 209). Thus, once again as under the Shah, oil revenue would be used to spur economic growth and military strength

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5 Article 44. The economy of the Islamic Republic of Iran is to consist of three sectors: state, cooperative, and private, and is to be based on systematic and sound planning. The state sector is to include all large-scale and mother industries, foreign trade, major minerals, banking, insurance, power generation, dams and large-scale irrigation networks, radio and television, post, telegraph and telephone services, aviation, shipping, roads, railroads and the like; all these will be publicly owned and administered by the State. The cooperative sector is to include cooperative companies and enterprises concerned with production and distribution, in urban and rural areas, in accordance with Islamic criteria. The private sector consists of those activities concerned with agriculture, animal husbandry, industry, trade, and services that supplement the economic activities of the state and cooperative sectors. Ownership in each of these three sectors is protected by the laws of the Islamic Republic, in so far as this ownership is in conformity with the other articles of this chapter, does not go beyond the bounds of Islamic law, contributes to the economic growth and progress of the country, and does not harm society. The [precise] scope of each of these sectors, as well as the regulations and conditions governing their operation, will be specified by law.
to ensure a prominent role for the Islamic Republic within OPEC and regional security matters.

The second Five-Year Development Plan (1994-98) was even bolder with respect to the contribution of oil, which, along with gas and petrochemicals, has become the axis of the country's future development (Ibid). According to this policy, the oil share the offshore South Pars field the most significant energy development project in Iran started, and, which is estimated to have 450 Tcf of natural gas reserves, or around 47 per cent of Iran’s total natural gas reserves discovered in 1990 (Energy Information Administration 2007).

Table 4: Iran oil production from 1990 - 1997

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<tbody>
<tr>
<td>Production (Total)</td>
<td>1198.2</td>
<td>1361.7</td>
<td>1454.6</td>
<td>1555.9</td>
<td>1655.5</td>
<td>1669.5</td>
<td>1729.2</td>
<td>1614.2</td>
</tr>
<tr>
<td>Crude Oil</td>
<td>1075.1</td>
<td>1192.2</td>
<td>1245.0</td>
<td>1348.0</td>
<td>1426.7</td>
<td>1400.1</td>
<td>1433.4</td>
<td>1321.3</td>
</tr>
<tr>
<td>Natural Gas</td>
<td>104.4</td>
<td>153.1</td>
<td>191.5</td>
<td>186.8</td>
<td>206.7</td>
<td>249.6</td>
<td>275.4</td>
<td>273.4</td>
</tr>
<tr>
<td>Solid Fuels</td>
<td>3.8</td>
<td>3.7</td>
<td>3.8</td>
<td>3.0</td>
<td>3.6</td>
<td>4.7</td>
<td>5.1</td>
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<tr>
<td>Hydro Power</td>
<td>11.7</td>
<td>9.5</td>
<td>11.0</td>
<td>14.6</td>
<td>15.3</td>
<td>11.6</td>
<td>11.4</td>
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<tr>
<td>Non-Commercial fuels</td>
<td>3.2</td>
<td>3.2</td>
<td>3.3</td>
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<td>3.4</td>
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<tr>
<td>Renewable Energy</td>
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Consequently, Iran under President Hashemi Rafsanjani and Oil Minister Gholamreza Agazadeh had reclaimed its place as the world’s second largest exporter of oil after Saudi Arabia, which exports about seven and a half million barrels a day. Iran was producing roughly four million barrels a day and had exported about 75 per cent of this, mainly to Japan and Western Europe (Ibrahim 1992).
3.2.3. Reform and Oil Policy during Khatami Period 1997 - 2005

Mohammad Khatami became Iran’s president in an economically difficult time. While his government was determined to reform the pricing mechanism, expand privatization and increase non-oil exports; it was facing severe difficulties which Rafsanjani also had faced: rampant inflation rates, Iran’s foreign debt crisis and a huge budget deficit. All this culminated in his second year 1998, when oil prices hit their 30 year low (Nourbakhsh 2005). Khatami slogans were “political reforms before economic ones” but he continued economic reform by the third Five-year Economic Development Plan, which was started by Rafsanjani. It was commitment to industrialization (Ibid).

At a macro-economic level, Khatami continued the liberal policies that Rafsanjani had embarked on in the state's first five year economic development plan (1990-1995). On April 10, 2005 Khatami cited economic development, large-scale operations of the private sector in the country's economic arena and the six percent economic growth as among the achievements of his government. He allocated $5 billion to the private sector for promoting the economy, adding that the value of contracts signed in this regard has reached $10 billion (Ibid).

A year into his first term as president of Iran, Khatami acknowledged Iran's economic challenges, stating that the economy was, “chronically ill ... and it will continue to be so unless there is fundamental restructuring” (Siddiqi 2006). For much of his first term, Khatami saw through the implementation of Iran’s second five-year development plan. On 15 September 1999, Khatami presented a new five-year plan to the Majlis. Aimed at the period from 2000-2004, the plan called for economic reconstruction in a broader context of social and political development. The specific economic reforms included “an ambitious program to privatize several major industries ... the creation of 750,000 new jobs per year, average annual real GDP growth of six percent over the period, reduction in subsidies for basic commodities ... plus a wide range of fiscal and structural reforms” (Ibid). Unemployment remained a major problem, with Khatami’s five-year plan lagging behind in job creation. Only 300,000 new jobs were created in the first year of the plan, well short of the 750,000 that the plan called for. The 2004 World Bank report on Iran concludes that "after 24 years marked by internal post-revolutionary
strife, international isolation, and deep economic volatility, Iran is slowly emerging from a long period of uncertainty and instability” (Siddiqi 2006).

According to statistics published by Central Bank 2001-2004 “real GDP rose from 2.4 percent in 1997 to 5.9 percent in 2000. Unemployment was reduced from 16.2 percent of the labor force to less than 14 percent. The consumer price index fell to less than 13 percent from more than 17 percent” (Central Bank of Iran 2001-2004)

Khatami’s policy was succeeded to attract foreign investment. Both public and private investments increased in the energy sector. However, he had faced same problem about constitution that Rafsanjani had faced but he also had faced U.S. sanction to attract foreign investment for rebuilding oil and gas sectors. In fact oil production was declining and both gas and oil were been sold domestically at highly subsidized rates. At the same time, Iran was neglecting to reinvest in its oil production.

The sanctions prevented Iran from partnering with U.S. LNG plant manufacturers such as Bechtel Group Inc. of San Francisco, which has built 31 per cent of the world's gas liquefaction capacity or Halliburton Co.'s Kellogg Brown & Root, which is constructing similar plants in Nigeria and Mexico. “There has never been an LNG plant built without any U.S. component. With the sanctions, not even a 5-cent washer or bolt could come from the U.S.”, said Ball of Gas Strategies. “This is uncharted territory. It can be done, but nobody has had to do it before.” This means higher end-prices for Natural Gas for Iran (Burmberg and Ahram 2007).

On the other hand, energy sanction by the U.S. also affected the Iran-Europe trade relations, with major engineering and plant manufacturers coming under pressure from the United States to stop trading with Iran. With the presence of all these sanctions foreign financing from European counterparts proved almost impossible to secure production capacity (Ibid).

Khatami was also the beneficiary of a changed mood in the United States about economic sanctions, which had been the principal U.S. instrument to contain Iran. The changed mood had two causes. First and most important was European pressure. European opinion is unsympathetic to sanctions in general; on the theory that trade relations promote positive political change. Europeans were livid about the secondary
boycott provisions of the Iran-Libya Sanctions Act (ILSA), which they regard as unacceptable in principle, irrespective of the purpose to which it is put.

Faced with intense European hostility, in spring 1998 the United States clarified a change in policy that had been in the works since October 1997, namely, the retreat from the threat of a secondary boycott over European investment in Iranian oil and gas projects. This decision had little to do with developments in Iran, being based instead on the desire to avoid an open split in the Western alliance (Clawson, E. K. M 1998).

A secondary factor weakening support for Iran sanctions has been the U.S. business community's lobbying against sanctions as a whole, which is likely to intensify, as U.S. oil firms want the same freedom to invest in Iran that is now available to European firms. That lobbying has changed the mood in Congress. Rather than considering broad sanctions, its 1997-1998 actions on Iran have been more focused.

The Iran Missile-Proliferation Sanctions Act (IMPSA), which passed both houses overwhelmingly in June 1998, targeted only firms that were violating an international arms control agreement – in practice, certain Russian firms. Even so, President Clinton vetoed IMPSA, instead imposing by executive order sanctions on seven Russian firms that Moscow determined had violated Russian technology-export regulations. For Iran, the implication of the new sanctions-wary mood is that U.S. sanctions are not likely to become tougher and may ease (Ibid).

Faced with intense European hostility, in spring 1998 the United States clarified a change in policy that had been at work since October 1997, namely, the retreat from the threat of a secondary boycott over European investment in Iranian oil and gas projects. This decision had little to do with developments in Iran, being based instead on the desire to avoid an open split in the Western alliance (Clawson, E. K. M 1998).

Finally, the result of Khatami's policy was some agreement with oil companies for investment in Iran oil and gas sectors. The first major project under the buyback investment approach became operational in October 1998, when the offshore Sirri A oil field (operated by Total and Malaysia's Petronas) began production at 7,000 bbl/d. The neighboring Sirri E field began production in February 1999, with production at the two fields expected to reach 120,000 bbl/d (Oil and Gas Article 2006).
In March 1999, France's Elf Aquitaine and Italy's Eni/Agip were awarded a $1 billion contract for a secondary recovery program at the offshore, 1.5-billion-Barrel Doroud oil and natural gas field located near Kharg Island. The program is intended to boost production from around 136,000 bbl/d to as high as 205,000 bbl/d. Total is Operator of the project, with a 55 per cent share, while Eni holds the other 45 per cent (Oil and Gas Article 2006). In April 1999, Iran awarded Elf (46.75 per cent share), along with Canada's. Bow Valley Energy (15 per cent share), a buyback contract to develop the offshore Balal field. Eni is also involved, with a 38.25 per cent stake. The field, which contains some 80 million barrels of reserves, started producing at a 20,000-bbl/d rate in early 2003, and reportedly reached 40,000 bbl/d in February 2004 (Cordesman and Al-Rodhan 2006: 125).

The last buy-back contract before the Statoil deal was signed in mid-2001 by ENI of Italy. In that $1 bn agreement, ENI took a 60% share in a joint venture with Naft Iran Inter-Trade Co. (NICO) to prove the reserves of as well as develop the giant onshore oilfield Darkhovin. Lying close to the southern border with Iraq, this field has billion barrels of recoverable oil. Agip, ENI's upstream arm operating the field, in early November 2002 announced a big success in its first appraisal well, producing 20,000 b/d which was more three times the anticipated flow of light crude oil. A second appraisal well, more than half way to its target depth of 4,700 metres, will by early 2003 clarify the extent of Agip's success (World Energy Investment Outlook 2003).

During 2004, Iran produced about 4.1 million bbl/d of oil (of which 3.9 million bbl/d was crude oil), up about 200,000 bbl/d from 2003 (Iran Daily 2004). Iran exported around 2.5 million bbl/d, with major customers including Japan, China, South Korea, Taiwan, and Europe. Iran's main export blends included Iranian Light (34.6° API, 1.4 per cent sulphur); Iranian Heavy (31° API, 1.7 per cent sulphur); Lavan Blend (34°-35° API, 1.8-2 per cent sulphur); and Foroozan Blend/Sirri (29-31° API) (Pars times 2006).

Khatami also tried to increase gas production due to the development of gas sector program started by Rafsanjain. Mainly as a result of the re-evaluation of the size of the massive offshore South Pars gas field, estimates of the size of Iran's reserves have increased by 12 percent since 2000 (Rivlin 2006). The development of the gas sector,
especially the South Pars field, will depend on the availability of foreign technology and capital.

Table 5: Iran oil production from 1997-2003

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Production(Total)</td>
<td>1614.2</td>
<td>1635.8</td>
<td>1678.9</td>
<td>1613.7</td>
<td>1784.5</td>
<td>1730.0</td>
<td>1705.7</td>
</tr>
<tr>
<td>Crude Oil</td>
<td>1321.3</td>
<td>1315.1</td>
<td>1341.0</td>
<td>1234.1</td>
<td>1373.0</td>
<td>1303.8</td>
<td>1206.7</td>
</tr>
<tr>
<td>Natural Gas</td>
<td>273.4</td>
<td>301.5</td>
<td>318.7</td>
<td>364.4</td>
<td>398.3</td>
<td>410.0</td>
<td>478.8</td>
</tr>
<tr>
<td>Solid Fuels</td>
<td>3.9</td>
<td>4.0</td>
<td>4.8</td>
<td>4.6</td>
<td>4.8</td>
<td>5.6</td>
<td>5.5</td>
</tr>
<tr>
<td>Hydro Power</td>
<td>11.5</td>
<td>10.8</td>
<td>11.0</td>
<td>7.8</td>
<td>5.7</td>
<td>2.6</td>
<td>2</td>
</tr>
<tr>
<td>Non-Commercial fuels</td>
<td>4.1</td>
<td>4.3</td>
<td>3.5</td>
<td>2.8</td>
<td>2.7</td>
<td>7.9</td>
<td>12.6</td>
</tr>
<tr>
<td>Renewable Energy</td>
<td>0.01</td>
<td>0.01</td>
<td>0.03</td>
<td>0.06</td>
<td>0.05</td>
<td>0.05</td>
<td>0.05</td>
</tr>
</tbody>
</table>


Although gas production has increased rapidly over the last decade, it has not matched domestic demand, and a small deficit – which has been met by imports – has resulted. This is in contrast to the rest of the West Asian countries, where domestic demand has grown more slowly than production, thus permitting exports to grow. Khatami had attempted to diversify Iran’s economy by investing some of its oil revenues in other areas, including petrochemicals. In 2004, non-oil exports rose by a reported nine per cent.

Table 6: Gas Production in Iran, 1995-2005 (billion cubic meters)

<table>
<thead>
<tr>
<th>Year</th>
<th>Production</th>
<th>Consumption</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>35.3</td>
<td>35.2</td>
<td>0.2</td>
</tr>
<tr>
<td>2000</td>
<td>60.2</td>
<td>62.9</td>
<td>-2.7</td>
</tr>
<tr>
<td>2005</td>
<td>87.0</td>
<td>88.5</td>
<td>-1.5</td>
</tr>
</tbody>
</table>

Source: EIA International Petroleum Monthly
Khatamei also was hoping to attract billions of dollars worth of foreign investment to the country by creating a more favorable investment climate (i.e., reduced restrictions and duties on imports, creation of free-trade zones). However, there has not been a great deal of progress in this area, in part due to disagreements between reformers and conservatives (Central Bank of Iran 2004).

3.2.4. Ahmadinejad's Policy on Oil Industry in 2005

Iranian President Mahmoud Ahmadinejad took office in 2005. Since that the country has been led increasingly by fundamentalist, revolutionary leaders and the military (Sariolghalam 2006). Ahmadinejad has restructured the government more extensively than almost any one expected. He has seated new leadership in almost every office and university. Virtually all of the ambassadors who served in the last government were removed. Ahmadinejad has gone so far as to replace sitting undersecretaries, governors and city managers with his loyalists (Kukis 2006). Economically, under Ahmadinejad, spending has increased by 25 per cent, and the state has supported large-scale state subsidies of more than US$40 billion a year for food and gasoline. Domestic consumption, encouraged by low prices and subsidies has increased and become wasteful, resulting in rising petrol imports to meet demand (American Iranian Council 2007). This policy was/is a result of high oil price. Iran's income from exports of crude oil and petroleum by products topped $36 billion in the first eight months of 2007 (which begins in March 21), marking an increase of 15 per cent (Ibid).

Ahmadinejad’s administration also has devised an economic plan which calls for paying subsides for various products directly to people. The plan has been prepared to reduce an excessive waste of the country’s resources especially in using energy, and to ensure that low-income families pay fewer taxes. But, the government’s economic policy has pushed inflation close to 26 per cent by injecting large sums of cash into the economy to fund local infrastructure projects (Tehran Times, August 23, 2008). Ahmadinejad also has supported some organizations belong to conservative groups. For example, the government deficit is further exacerbated by problems of tax collection. Charitable organization called Bonyad make up 30 per cent of the economy, unaccountable to government oversight and exempt from taxes (Samantha 2007).
However, due to high oil prices, Iran's foreign currency reserves held in foreign banks have risen to about $60 billion. At the same time, Iran's foreign debt and obligations has risen to $90 billion dollars (American Iranian Council 2007). The country's Fourth Development Plan (March 2005-March 2010) allows the Government to make commitment for another $30 billion for the oil projects ($10 billion as finance, $7 billion as technical and engineering services, and $13 billion as foreign investment) (Ibid). Despite the enormous amount of money earned through the high oil prices, Ahmadinejad asked parliament for a supplementary budget as his Government was expected to run out of money in the last three months of the year (2007). Surprisingly, the Iranian Government has also withdrawn $12.2 billion from its strategic Oil Stabilization Fund, which serves as a buffer to protect the economy in case of price fluctuations in the cost of oil (Ibid).

Ahmadinejad has come under increasing criticism for distributing un-budgeted cash to provinces where he travels. But he starts to critic's management of oil sector. During his presidential campaign he lambasted the management of this sector and claimed that Iranian oil wealth was controlled by a single powerful family. He said, during the election race: “I will cut the hands of the mafias of power and factions who have a grasp on our oil; I stake my life on this...... People must see their share of oil money in their daily lives” (Bayegan 2005). Ahmadinejad has remarked that “The atmosphere ruling over our deals, production and exports is not clear. We should clarify it” (Ibid). Dr Parviz Mina about Ahmadinejad's policy believes: “Iranian oil being of such a monumental importance for the country's economic and political future, the new president's comments cannot be treated lightly. Moreover, Ahmadinejad would not have made those comments without the backing of the supreme leader, of whom he is a zealous follower, and who has the last word on important issues” (Ibid).

Also, in August 2007, President Mahmoud Ahmadinejad appointed NIOC executive Gholamhossein Nozari to serve as Acting Oil Minister, replacing Vaziri Hamaneh and creating controversy over President Ahmadinejad's role in the energy

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6 Dr Parviz Mina, former Managing Director, National Iranian Oil Company and formerly in charge of the National Iranian Oil Company's international relations, who negotiated and signed many of Iran's continental shelf boundary agreements in the Persian Gulf in late 1960s and early 1970s.
sector (Islamic Republic of Iran News Agency 27 August 2007). However after 3 years, it seems Ahamadinejad was successful to change the management of Iran's state-run oil industry. But it does not mean that he was successful to resolve the problems in Iran's oil industry. He succeed in finish role of reformist groups in oil industry and thus it seems that he was successful in this his aim. Ahamdinejad's policy came under criticizing by scholars. They have believed that his policy has not reduced Iran’s economy dependence on oil revenue. The Iranian senior economist Dr. Masoud Nili of Iran International points to an ever expanding government budget and increasing dependence on the oil revenues as a serious problem for the country. He argues that:

“In 1998, average oil price stood at 10.8 dollars per barrel and oil revenues grew fourfold in about 7 years. Meanwhile, state budget in 1998 was less than 71,000 billion Rials, but Iran's budget for 2006 has been estimated at 600,000 billion Rials; that is, while oil revenues have quadrupled over a 7-year period, state budget has increased eightfold during the same period. Before 2002, government spent an average of 15 billion dollars in foreign exchange. The figure increased to 21 billion dollars in 2003, to 30 billion dollars in 2004, and to 36 billion dollars in 2005. It seems that the figure will reach 45 billion dollars in 2006, which is indicative of serious budgetary dependence on petrodollars. The Third Economic Development Plan aimed at reducing government's dependence on oil revenues to less than 12 billion dollars, but it actually soared to more than 40 billion dollars in 2006. Therefore, the government's budget experienced such a great leap in 14 months from January 2005 to march 2006, when the government was determined to offer Majlis with a budget supplement. Considering this reality, one can conclude that the country witnessed one of its biggest financial developments in the Iranian year, 1385” (Bakhtiar 2007).

Conclusion

From the preceding account, it is clear that oil has played a vital role in the foreign policy behavior of Iran. In the pre Islamic phase, oil revenue was used to bolster Iranian power projection both in the world oil market and regional strategic context. Not to mention that in the domestic system too oil became very vital.

The rentier nature of the Iran’s system did not change after Islamic revolution. The revolutionary government under different presidencies used oil revenue and oil policy started to be based on Iranian domestic and foreign policy. What is clear from the study is that Iran’s oil decision making process has been a principle variable.
Thus understanding of decision making process of Iran's energy policy needs to examine the impact on some important factors like domestic policy and international factors. These factors will be examined in the next chapter.