COLUMBIA | SIPA
Center on Global Energy Policy

The U.S. Drive to End Iranian Oil Exports: Expectations, Risks and Outcomes

By Richard Nephew
April 23, 2019

***

INTRODUCTION

- Until we know whether and how the Trump Administration intends to implement their decision to drive Iranian oil exports to zero, it will be difficult to gauge how the oil market and those countries affected will respond.
- That said, there are myriad implementation and policy challenges beyond this immediate question, not least being how to respond in the face of a refusal to cooperate by Iran's current customers.
- Iran itself will have a vote in how the situation evolves and probably will seek opportunities to escalate tensions, create risk for the United States (especially in the nuclear arena), and retaliate against regional adversaries who it sees as spurring the Trump Administration forward.

The Trump Administration's decision to insist that Iran's current oil customers cut their purchases to zero was seen by many as a surprise. It should not have been due to the ample indications that this was under serious consideration. Since the May 2018 decision to withdraw from the Joint Comprehensive Plan of Action (JCPOA) and reimpose sanctions suspended pursuit to it, the Trump Administration has signaled impatience and a desire to bring matters to a head with Iran as quickly as possible. As early as June 2018, staff at the State Department were saying that Iran would be forced to zero exports by November 2018. This comment was walked back immediately by more senior officials within the Administration, but the threat remained: achieving zero exports as swiftly as possible was the objective of U.S. policy. The real questions were: by when and at what cost?

Over the course of the first few months of 2019, it has been apparent that the Trump Administration has been disappointed by the relative stability of the Iranian government. In 2018, there was widespread and senior U.S. government commentary to the effect that Iran was only a few months and a few sharp shoves away from collapse. Protests continue in the country, as does economic turbulence, but there are no reasonable indications of exceptional unrest. Politically, the regime appears reasonably solid, and security forces show no signs of defecting. At the same time, the pressure campaign itself has not had deal with too much in the way of impediments. European sanctions resistance has been paltry and even sanctions opponents in China and Russia have failed to offer Iran much alternative economic succor. Altogether, the problem appears not to be with the implementation of sanctions but rather with the difficulty of their assigned objective: undermining the Iranian regime's internal cohesion such that it either 1) makes sweeping policy concessions and/or 2) collapses.

As I suggested in November 2018, Iran's stubborn refusal to surrender or disintegrate has created a "strong incentive on the part of the Trump administration to escalate matters with Iran in 2019." The early April decision to name Iran's Revolutionary Guard Corps (IRGC) as a Foreign Terrorist Organization may have some substantive merit but should be properly seen as an aggressive bid to increase the pressure on the Iranian regime. The oil export decision is another indication that the confidence with which some U.S. officials judged the likelihood of Iranian regime change in the fall of 2018 is flagging; they hope this will recreate a sense of momentum behind the policy.

In this commentary, I first outline what the law requires, what happens next and possible scenarios that the Trump Administration might pursue. I identify the issues and problems that will emerge in implementation, and Iran's likely response.

WHAT THE LAW REQUIRES

Under Section 1245 of the Fiscal Year 2012 National Defense Authorization Act, as amended (NDAA) stipulates, significant non-U.S. transactions with the Central Bank of Iran (CBI) are sanctionable. U.S. transactions with the CBI are, of course, criminally liable, unless conducted under a license.

This is a pretty significant issue because, according to Iranian law (and stemming from the post-revolution constitution), oil and related products are the property of the Iranian nation. Consequently, the CBI is the designated recipient of all oil – and natural gas – payments made.

The only way a foreign financial institution could conduct these transactions without being subject to U.S. sanctions would if the country in which it is based is operating under either a national security waiver (as was the case under the JCPOA) or a significant reduction exception (SRE). The law provides for specific terms for use of either instrument, but – simply put – the waiver is a broader authority and the SRE is far more narrow. To obtain an SRE, a country has to be found to have reduced significantly its purchases of Iranian crude oil. The period of evaluation is – usually – the last 180 day period and SREs are renewable every 180 days. The law does not define an SRE but, in practice, the United States has evaluated countries based on oil imports by volume. In the Obama

Administration, the United States considered a 20 percent reduction to be appropriate; the Trump Administration has given no specific guideline.

Companies can also be subject to sanctions for their purchasing behavior under an amendment made to the NDAA by President Obama via Executive Order 13622 that was reimposed via Executive Order 13846. These provisions are discretionary.

It is also worth noting that, under the 2013 amendment to the NDAA, all payments made to the CBI have to be held in escrow in the receiving country and only used for either 1) bilateral trade of non-sanctioned goods; or, 2) humanitarian trade.

Without an SRE, any significant transaction with the CBI would be sanctionable immediately. Oil purchases would undoubtedly qualify as "significant," though there is some discretion in assessing "significance."

NOW WHAT?

The Trump Administration's announcement was short, succinct, and to the point: as of May 2nd, the United States will no longer provide exceptions to those countries that reduce their purchases of Iranian crude oil significantly. All other things being equal and consistent with this statement, any transactions in furtherance of buying Iranian crude oil conducted on 3 May and thereafter are potentially sanctionable. So too are any other transactions that involve the Central Bank of Iran.

However, as with all U.S. sanctions, this simple statement obscures some fairly significant decisions and issues that the Trump Administration will now need to manage.

First, the Administration needs to decide whether it truly intends for all purchasers to discontinue their purchases on 3 May or not. This is not likely the case. First and foremost, though South Korea and Japan are poised to cooperate with a reduction decision, China, India, and Turkey are not. A May 3rd implementation date for this decision would create havoc in their oil sectors, especially with less than two weeks to plan. Some press reports indicate that Iran's buyers expected to be granted exceptions or waivers, meaning that they do not have alternative sources lined up. The announcement that Saudi Arabia and the United Arab Emirates are prepared to make up any shortfalls might be a viable solution to this problem in a few months, but Iran's present export volume remains at nearly 1 million barrels per day (bpd). It will be difficult to replace this oil altogether in two weeks.

More than likely, there will be a wind-down period that will be facilitated with a short-term waiver. This is entirely possible under U.S. sanctions law, and the Administration can elect to choose anything up to 120 days for an implementation period before it would have to issue new waivers. Notably, Secretary Pompeo did not offer any comment on this possibility during his press conference. Assuming this is the decision the Trump Administration reaches, then there will be more time for long-term oil purchase arrangements to be made. Iran will still sell oil in the meantime, but it will do so under existing rules that ensure any such payments go into escrowed accounts that can only be used for bilateral trade or humanitarian purchases.

Second, and even with an implementation period, the Administration will have to negotiate with China, India, and Turkey over the terms of their withdrawal from Iran <u>or</u> be prepared to deal with their noncompliance. Together, these three countries are purchasing nearly 1 million bpd of Iranian oil. They are the main focus of the announcement on April 22nd, and they are the countries that now have decisions to make. It is impossible to state with any certainty what they will choose to do. China, for its part, not only has a practical issue of sourcing nearly 500,000 bpd of crude oil but also the more political issue of having to decide whether to oblige U.S. law. In the last decade of Iran sanctions, the Chinese have only minimally acceded to such U.S. demands, and that was before the ongoing trade war, the arrest of Meng Wanzhou, and the broader geopolitical challenges created by Donald Trump. It is possible that they will cooperate now out of a desire to avoid causing greater harm to their interests in the United States. On the other hand, it is also entirely possible that they will not cooperate, as Chinese officials have already implied. Similar issues will be present for India, given its imminent election in which energy prices may figure, though the Indian Petroleum and Natural Gas Minister Dharmendra Pradhan suggested that India will be able to compensate for the loss of Iranian oil. Turkey too has its own problems, starting with Iran sanctions issues related to previous violations of U.S. financial sanctions and the added complication that <u>17% of its natural gas</u> is imported from Iran. Payments for this gas are also made to the Central Bank of Iran, which, absent a significant reduction exception, may be sanctionable. Turkish officials have, like China, indicated an intention to resist U.S. sanctions.

If the Trump Administration does not reach an amicable solution to these issues with China, India, and Turkey, then it may face the prospect of having to sanction these countries' banks and refiners. The sanctions available under U.S. law are the cutting off of correspondent bank accounts and relationships for financial institutions and a range of penalties, including denial of financing, export/import privileges, and senior official visas to the United States, for companies. In trying to apply penalties and consequences, however, the United States might find a variety of difficulties and challenges. For example:

- Iran's customers could decide to continue their purchases but without changing the modalities of the trade. They could use their existing banking and refining channels uninterrupted. The United States would be able to impose sanctions against them, but would also face the consequences of the denial of trade and business access. Moreover, some of the targets could be significant for the United States in other ways. For example, if the People's Bank of China (PBOC) were to be involved in the trade, then the decision to impose sanctions against PBOC could be deeply prejudicial to other U.S. interests. The result of this challenge is that the United States might also have its threat to impose sanctions called out by these countries, raising the stakes for both enforcement as well as non-enforcement.

- Iran's customers could choose to continue their purchases, but use banks and companies that have no interactions with the U.S. financial system or broader economy. If they did so, then the United States may be able to impose sanctions, but with little chance of steering their purchasing behavior. Iran could sell oil to these customers and the United States would either have to identify new sanctions frameworks or targets to impose the necessary consequences against them.

- The United States could also face the challenge of having imposed sanctions against the entities of these three importers, only to watch them *increase* their purchases of Iranian oil. After all, if the worst sanctions penalties have already come to pass, then there may be little disincentive to double down on the original Iran-friendly bet.

Third, there are possible oil market implications for this decision. The United States is apparently confident that there is sufficient global oil supply that losing Iranian supply will not be disruptive to global markets or significantly affect prices. On its face, this argument may be reasonable. The global oil market is reasonably well supplied at present and the Energy Information Administration's April 2019 report on "the availability and price of petroleum and petroleum products produced in countries other than Iran" notes that there may be as much as 2.2 million bpd in available spare capacity. There are important caveats to this point, however:

1) This assumes that there are no other possible disruptions, which seems optimistic given declining Venezuelan production and export and the risk of instability in Libya.
2) This step would reduce current spare capacity by 1 million bpd or roughly half of current levels. While this would leave oil available in an emergency, oil prices may be in part depressed by the abundance of inventory. The loss of Iranian oil would cut into global stocks markedly.
3) Lack of clarity or insight as to what will happen to Chinese, Indian and Turkish refiners may create further uncertainties as to future supply.
4) Iran itself may take actions to address what it perceives as economic warfare against it that could, independently, create supply and price pressures. This is discussed below.
5) This assumes that Saudi Arabia and the UAE are prepared to exceed their OPEC production agreements which, at present, appears not to be the case. Without exceeding these quotas, Saudi Arabia and the UAE may find supplying Iran's old customers more difficult than press statements advertise.

Any of these complications could create pressure on prices which, as Donald Trump has made clear frequently with his tweeting at OPEC, is likewise unacceptable.

In addition, the United States will also have to deal with the geopolitical fall-out of this decision. Europe and other U.S. partners were already concerned about the risk to stability in the Middle East and Iran's remaining compliance with the JCPOA in the face of U.S. sanctions implementation. These concerns will deepen with this decision. This U.S. action may reduce the likelihood of Europe moving forward with sanctions and other measures targeting Iran's missile and non-nuclear activities of concern out of fear for piling on with Iran and creating pressure on the Iranians to withdraw from the JCPOA. But, European reticence to take action against Iran will contribute to an American inclination to "go it alone" and assumption that the rest of the world is ignorant of the challenges presented by Iran. This, in turn, will create escalatory pressures on all sides as well as policy problems for an increasingly isolated Trump team.

IRAN'S RESPONSE

Iran will have to decide whether and when to respond to this decision.

At a minimum, it can be reasonably assumed that Tehran will not back down in the face of U.S. pressure and offer new concessions to buy off the Trump Administration. It is not evident that offering concessions would work in any event but, politically, this seems a remote possibility for the Iranian government at present.

Instead, the Iranians are likely to resist the imposition of U.S. sanctions by threatening their continued compliance with the JCPOA so as to incentivize China to remain an oil purchaser as well as to compel the Europeans and Russians to offer economic relief in short order. The Iranians are also likely to offer discounts and other modifications to their oil sale practices to incentivize China, India, and Turkey to remain customers. Depending on how they respond to U.S. sanctions pressure, this may be sufficient to be worth the risks of challenging U.S. sanctions.

The Iranians will also almost certainly look to create escalation and a sense of threat on their own. This will probably include a nuclear component, including Iran reducing its compliance with the JCPOA by – for example – producing excessive heavy water or low enriched uranium or engaging in new R&D activities with uranium centrifuges. Here, Iran may have unexpected help from the United States in creating a perception of nuclear risk, as there are also reports that the Trump Administration will discontinue the waivers that allow for continued steps to reduce the threat of the Iranian nuclear facilities at Fordow and Arak. Altogether, the Iranians will probably want to communicate that their patience with minimal economic benefit and substantial nuclear concessions is closing. Iran will consider and possibly elect to withdraw from the JCPOA, even if expanding the nuclear program remains of marginal value in combating the real economic problems the country is experiencing. Politically, this may be necessary for President Rouhani to maintain his tenuous position of leadership in the Iranian government and, though Supreme Leader Khamenei will be the main decision-maker in this regard, if Rouhani no longer supports continued JCPOA compliance, no other Iranian official will disagree.

But, Iran will not stop there. The Iranians have made clear that they reserve the right to escalate asymmetrically, especially to undermine the oil exports of their rivals. This could include expanded support for terrorism and militants in the region (including the targeting of naval assets or oil container ships transiting the Red Sea and the Persian Gulf), as well as cyber attacks on U.S., Saudi, Emirati, and other countries.

CONCLUSION

It is possible that this decision will serve as an inflection point in the pressure campaign against Iran. However, the simple act of refusing to offer new significant reduction exceptions to Iran's current purchasers obscures a wealth of complicated problems that will now need to be tackled. In their zeal to unseat Iran's government and willingness to absorb risk, the Trump Administration may be able to finally say that they have gone farther than the Obama Administration in applying pressure on Iran. This may prove a hollow boast, depending on what choices they make next.

ABOUT THE AUTHOR

Richard Nephew joined the Center on Global Energy Policy in February 2015 directly from his role as Principal Deputy Coordinator for Sanctions Policy at the Department of State, a position he held since February 2013. Nephew also served as the lead sanctions expert for the U.S. team negotiating with Iran. From May 2011 to January 2013 Nephew served as the Director for Iran on the National Security Sta where he was responsible for managing a period of intense expansion of U.S. sanctions on Iran.

The views in this commentary represent those of the author.

This work was made possible by support from the Center on Global Energy Policy. More information is available at ***http://energypolicy.columbia.edu/about/mission***.