TRUMP AND THE END OF THE IRAN DEAL: OIL MARKET IMPLICATIONS

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In a little more than three months, the United States could withdraw from the Joint Comprehensive Plan of Action (JCPOA) with Iran. Donald Trump has indicated that unless the US Congress and US partners in Europe "fix" the JCPOA, he will refuse to authorize the extension of sanctions waivers that permit the JCPOA to function. Absent these waivers, Iran would likely restart its nuclear program and has in fact already threatened to do so even if the JCPOA remains functionally in place due to the chilling effect the Trump Administration has already had on sanctions relief.

This paper is intended to focus on the immediate effects of a decision to rescind the waivers, which would initially target Iranian oil sales. It is these waivers that are up for renewal in May 2018, and if Trump is to be believed, it is these waivers that are directly threatened by the ultimatum issued on January 12.

The paper then offers an assessment of what would likely happen if waivers were permitted to expire, how sanctions reimposition might work, and how foreign partners and oil markets might respond. It is not an endorsement of this decision—far from it. Rather, a decision to walk away from the JCPOA absent direct evidence of Iranian cheating would be catastrophically unwise. It would set the United States on a path of confrontation with not only Iran but also our partners in Europe and East Asia. It would likely prompt an Iranian nuclear restart, with the Iranian nuclear program once more closing on an ability to produce a nuclear weapon within weeks of a decision to make one by Iran's supreme leader. And it would do so at a time when attention is needed on a variety of other critical foreign and domestic policy matters, such as the resolution of the Syrian civil war, the ongoing crisis with North Korea's nuclear program, and the need to address Russia's continued revisionist impulses in Eastern Europe. Simply put, a decision to walk away from the JCPOA would be a reckless, unnecessary, and counterproductive act. But the author's view of the sense in taking this step does not obviate the need to understand what would result should the U.S. rescind the waivers. It is this potential situation along that this paper will focus on.

What Are the Oil Sanctions?

Before we discuss what would happen, it is necessary to recall the nature of the law and how it operates.

The sanctions law in question is found in Section 1245 of the FY 2012 National Defense Authorization Act (NDAA), as amended by the relevant sections of FY 2013 NDAA (also known as the Iran Freedom and Counterproliferation Act, or IFCA). This law required the secretary of the Treasury to impose sanctions on those foreign financial institutions that conduct business with the Central Bank of Iran or other designated Iranian financial institutions unless the country holding jurisdiction over those foreign financial institutions had reduced their purchases of Iranian crude oil to a significant degree. The definition of significant reduction as well as crude oil was left to the Executive Branch; under President Obama, the United States generally considered reductions of 20 percent by volume of crude oil (which did not include condensates) to be sufficient. For those countries that had reduced their purchases significantly, exceptions from the imposition of sanctions could be offered by the secretary of state. The period of evaluation was set at 180 days, and generally speaking, the United States simply compared the per-day volume purchased of one 180-day period against the previous 180-day period. The law also afforded the president the ability to switch off the sanctions altogether if he determined there to be insufficient oil in the market to make up for any Iranian shortfall. Thus far, the president has determined since 2012 that the oil market can address at least some amount of lost Iranian exports.

This simplified description of the law and its requirements obscures the tremendous complexity inherent in its execution.

First, the law hinged on the ability of the United States to accurately and fairly estimate purchases and exports. Contracts and commitments from foreign governments or companies were useful pointers for what was intended, but the United States needed to verify that the amount of oil to be sold matched what was sold. This required an intensive information and intelligence assessment process, consuming many personnel hours in study, evaluation, and consideration.

Second, the period of US evaluation was highly arbitrary and did not fit with normal contract periods or even measurement. Contracts were already in place when the law went into effect in 2012, limiting partner compliance in some cases and making it complicated in others. This—taken in combination with the definitional issues around “crude oil” (more specifically, the fact that condensates were not judged to be “crude oil” in 2012) as well as the accepted measurement methodology—created frequent confusion both within the US government (including with Congress) and with negotiating partners as to what was needed and by when.

Third, there was consistently far more noise in the international community about oil sales and transactions than there was signal. Press stories about illicit shipments, some of which were accurate and others not, could result in days of lost productivity as US officials sought to investigate problems and allegations of misconduct.

Fourth, the very nature of the law created obligations on some parties and risks for others, but in a disjointed and confused way, distorting incentives and risks. For example, to avoid sanctions, foreign countries had to undertake a collective response to US sanctions demands. The United States essentially created a requirement for governments to intervene directly into their oil markets. In some cases, this was achievable because of the structure of national oil companies and their relationship with the government. In other cases, superseding laws—

as with the EU's own sanctions—made it relatively easy to implement sanctions and verify compliance. But in other cases, governments had little to no control over the actions of their companies. Indeed, though the United States would often demand a high level of performance from foreign governments, it is notable that as a result of our own legal structure, had the United States such a need to reduce company purchases of a foreign country's oil (rather than curtail them altogether), it would struggle to do so. Imagine, for example, a requirement from the US government that all US-based oil companies reduce their purchases of a foreign country's oil by 20 percent. Level-setting initial conditions, let alone enforcing implementation, would take a considerable amount of effort and likely result in many errors.

Moreover, by setting the target of sanctions (banks) separate from those engaged in the sanctionable conduct (buying oil), the United States created uneven risks and rewards for those with whom it was conducting its diplomacy. Initially, the United States could only threaten the banks of foreign oil companies, a threat with some sting but far less than what would have been achieved by targeting the foreign oil companies themselves. This was later fixed in July 2012 with Executive Order 13622. In that order, the United States made clear that anyone involved could be sanctioned for purchasing Iranian oil that, by country, was in excess of the significant reductions demanded. This executive order was terminated when the JCPOA went into effect. Consequently, unless the Trump administration refixes the statutory sanctions, this problem of misaligned incentives and risks will reemerge if sanctions are reimposed.

All of these complexities and requirements await the Trump administration, should it restart US sanctions on Iranian oil sales.

The Day After

Were the waivers to expire in May, one of the most critical questions would be, "When will the clock start for evaluating oil purchase reductions?" Under the Obama administration, Iran sanctions snapback was notionally intended to begin 180 days after an announcement that snapback was triggered. This timeline remains in the US Treasury Department's frequently asked questions as guidance, though this guidance is not legally binding and therefore of potentially doubtful utility. Still, this is the most important, immediate threshold question for the Trump administration, and its answer will determine much insofar as oil markets and supplies are concerned.

If the Trump administration decides to delay implementation for 180 days, then it would likely issue one initial waiver to cover the first 120 days of this period and then a further 60-day waiver thereafter. The result would be a clock start in November 2018, with the first evaluation period concluding in May 2019.

On the other hand, if the Trump administration decides to consider the 180-day period of reductions as more than sufficient for companies to wind down their purchases, then it is possible that the first evaluation period will be in November 2018. In this instance, oil purchase reductions would need to begin almost immediately. The reason for this is the massive volumes that would be involved in a normal 20 percent reduction.

Take, for example, a country that is presently purchasing 200,000 barrels per day (bpd). Such a country would be expected to draw down its purchases by 40,000 bpd to a total of 160,000 bpd. If begun immediately, then a 160,000 bpd purchasing habit could be maintained. But if delayed, at some point, a complete halt in any purchases would be necessary in order to make a 20 percent cutoff by volume during the implementation period. For 200,000 bpd as a beginning condition, a country would have to go to zero purchases after 120 days in order to meet a 20 percent reduction if no other reductions took place in the intervening days. For most companies, this would present significant difficulties, especially if there is little warning for implementation.

For this reason, the Trump administration may decide to take a compromise posture, offering a wind-down period less than Obama's 180 days and more than zero.

Regardless, the very next question would be whether the Trump administration was maintaining the previous definition of crude oil as well as of "significant reduction." Either is potentially changeable, with vastly different implications for individual companies and countries. A discussion to exclude condensates would minimize the disruption, as companies would be able to fall back onto older patterns of behavior from 2012–2013. On the other hand, including condensates—much less changing the required reduction—would potentially present major complications to companies that configured their operations after US sanctions were suspended.

Additionally, the Trump administration would have to immediately consult with purchasers to establish the baseline estimate for current purchases and the demand for reductions. Many governments will rush to the State Department to ascertain their position, while others—China, especially—would doubtless refuse those consultations as an unwarranted intrusion into their internal affairs. Yet the State Department has lost almost all of the staff involved in the previous sanctions campaign as well as its organizations for efficient coordination of sanctions policy. This would complicate the immediate need for the United States to get the attention of its partners and communicate Washington's intentions if it is to have any hope in convincing those governments on the fence as to whether to comply to make the desired decision.

Last, the Trump administration would need to decide whether and how to deal with the other US sanctions suspended pursuant to other waivers. Presumably, having decided to terminate the oil purchase waivers, the Trump administration would elect to reimpose all of the remaining sanctions. However, it is possible that the Trump team could elect to leave those waivers in place for another two months as a way of signaling a willingness to back down provided Iran and other countries responded as desired. But if not, then a whole series of other questions would come into play, such as whether the sanctions on oil and gas investment, transportation and shipping, insurance, and financial services were immediately in place or delayed. Given the overlapping effects of some sanctions, particularly with respect to banks, there will be immediate demand for certainty as to what is under sanctions exposure and what is not.

Consequently, a decision to let the waivers lapse is not the last decision that would need to be made in this scenario. Rather, it is the first act of a much more complicated operation that would then need to swing into action.

International Reaction

With very few exceptions, the international reaction to a Trump decision to end the oil purchase sanctions waivers would be decidedly negative. Saudi Arabia and Israel would likely welcome the decision, perhaps accompanied by the United Arab Emirates. But by and large, there would be significant disagreement with the act.

Europe, in particular, would likely register its objections with firmly worded statements, a recommitment to the JCPOA, and an expressed intention to provide a more detailed response in the near term. This would permit European leaders to meet and consider how exactly to respond and via what mechanisms. European leaders have thus far ruled out reimposition of their own oil sanctions, in effect from 2012–2016 unless Iran is found to be cheating on its commitments. It is under this decision that European oil and gas companies were precluded legally from buying Iranian oil and withdrew from that market by June 2012. But, taking that option aside, there are a variety of options available to European policymakers, including the following:

1. Retaliation: the EU could decide to relaunch the World Trade Organization (WTO) complaint originally drafted in 1996 and tabled pursuant to an agreement with Secretary of State Albright. It could also state that it would move to add the 2012 NDAA and 2013 NDAA to its list of US laws meriting retaliatory action under the existing blocking statute. (For more information on the blocking statute, see "Decertification of the JCPOA and the Risk of the European Union 'Blocking Statute,'" by Richard Nephew and David Mortlock.) If it did this, then individual EU members would be free to respond as they wish to any imposition of US penalties against their companies. Notably, if the United States not only ended the waivers of oil purchase sanctions but also all of the other JCPOA-suspended measures, the EU has already predelegated authority to retaliate for US sanctions involving oil and gas investment in Iran.

2. Wait and see: the EU could see whether the United States intends to make good on its threat to impose sanctions against EU companies, playing for time and also seeking a negotiated solution to the new crisis. In this option, the EU could potentially negotiate some kind of protection for EU companies in return for a commitment to support US initiatives against Iran more generally.

3. Quietly toe the line: the EU could announce its continued opposition to the reintroduction of US sanctions but acknowledge that it would not block European companies from acquiescing to US demands.

On balance, the EU is most likely to take the wait-and-see approach to see whether something might be salvaged from the crisis. The fact that EU policymaking operates on consensus means that it would be difficult for any single perspective—outright hostility to US actions or sympathy for them—to gain complete support, especially in the early days following a US decision. But just as it would be difficult to convince the EU to reject and retaliate against a US walkout from the JCPOA, it would also be difficult—if not impossible—to convince the EU to join in on the renewed US sanctions campaign. Individual corporate decisions, therefore, would constitute the initial wave of concrete EU responses, as EU oil and gas companies

decide separately whether to cooperate or not with renewed US sanctions pressure. Beyond the overall amount of oil involved (which was a considerable amount of the lost revenues to Iran in the 2012–2013 timeframe), European sanctions also had a significant impact on insurance and tanker movements, which were responsible for some of the earliest Iranian export losses during that period. Losing European support or watching it fracture would naturally diminish the vigor of the sanctions pressure to be applied.

Russia and China can be expected to reject this move altogether. Though Russia would have some economic interest in reduced Iranian oil supplies, the balance of Russian interests with Iran (everything from Syria to Russia's own attempts to build business in the country) would require a negative response to Trump's decision. On a practical level, no Russian energy company would likely be affected by these sanctions and—consequently—there would be little downside in that immediate context. In time, one could even expect Russian firms to seek profit from the situation, particularly if European companies were to withdraw from Iran.

China would oppose this decision vociferously. China was importing over 570,000 bpd from Iran as of December 2017. It could could, in time, seek alternative suppliers but has very little desire to do so. Beijing would possibly weigh the benefits of a de minimis reduction from Iran in order to assuage American concerns and help to manage the situation with North Korea to its advantage, but even this approach would require a significant climb down in policy from China's present one. In fact, given the government's interest in building ties across the new Silk Road it aims to create, China may find that it is to its long-term advantage to test US willingness to impose sanctions against its oil and gas firms. Arguably, China has been doing just that with respect to US threats to impose sanctions against its banks for their involvement with North Korea—to great success as of this writing. Beijing may believe that the US appetite for imposing such sanctions over Iranian oil is less than suggested.

Other countries would decide how to respond depending on their strict national interests. South Korea and Japan, fearful of how the United States may reward recalcitrance on Iran with respect to security assurances vis-à-vis North Korea, may contemplate modest reductions. Already upset with US actions to prosecute Turkish citizens for US sanctions violations, the Turkish government would likely refuse to cooperate (though its companies may do so in any event, as was the case in 2012–2013). By instinct, India would reject US sanctions pressure in this area, as it is seeking to build ties with Iran. On the other hand, given the Trump administration's ongoing rebuke of Pakistan, the Indian government might find it to its broader advantage to let its companies work out separate arrangements with the United States.

Energy Market Reaction

If we assume that the renewed US sanctions only target oil purchases, then the market analysis is somewhat simplified and would depend on how much Iranian oil is actually removed from the market. If the above characterization of government responses were correct, then it would be reasonable to estimate an initial year reduction of perhaps 400,000–500,000 bpd. In other words, Iranian exports would fall from their present value of approximately 2.4 million bpd to 1.9 million bpd within a year of sanctions reimposition.

The basis of this estimate is as follows (and, perhaps unsurprisingly, matches pre-2012 sanctions levels in general terms):

It assumes no change in Chinese or Indian purchases (1,080,000 bpd in aggregate in December 2017).

It assumes no change in Turkish purchases (approximately 250,000 bpd in 2017).

It assumes significant reductions in Korean and Japanese purchases (which were 510,000 bpd in aggregate in December 2017), with 20 percent cuts amounting to approximately 102,000 bpd lost.

It assumes a reduction of approximately 50 percent in European oil purchases from Iran, as some countries and companies exit the market altogether, others reduce marginally, and others remain nominally full purchasers. According to Iran, Europe—in which it includes Turkey—constitutes 38 percent of the market for crude oil. At an annual average of 2.4 million bpd in total Iranian exports, this would amount to approximately 660,000 bpd for Europe, not including Turkey. A reduction of 50 percent for this amount would be approximately 330,000 bpd.

If the Chinese, Indians or Turks agreed to some greater cuts or European cooperation were more significant, it is possible that the amount could be closer to 600,000 bpd in initial year cuts. It is worth noting, though, that the initial sanctions period of 2012 only resulted in around 1 million bpd in cuts, and this included a complete halt in purchases from Europe. Consequently, there is probably a reasonably lower ceiling for how much oil the United States could choke off from Iran. It is also worth noting that a decision by any one country to instead expand its purchases of Iranian oil—for example, if China were to decide to truly test US readiness to impose sanctions—would offset the total effect felt by the Iranians. Likewise, smuggling could be again a potential problem, though recent usage of surveillance tools to detect and prevent North Korean oil smuggling could make this riskier than in years past.

Given current estimates of spare capacity and the possibility of new US shale production coming online, it is possible that a loss of around 500,000 bpd would push oil prices up by a few dollars per barrel, particularly in combination with the increased security premium that might greet a renewed crisis.

If we assume that renewed US sanctions comprise all of the former sanctions measures presently being waived, then the market analysis would become much more complex. For example, if the result was that companies now interested in developing Iranian gas reserves withdrew from those projects, then this could dampen future projections of supply across the board. On the other hand, if—as with oil—some companies withdraw while others invest in Iran, then the result could be more company specific while markets remain largely untouched. Certain big investors—such as Total in the South Pars field—could be damaged by the loss of their present $1 billion investment, only to see their Chinese or Iranian partners (or a substitute) take advantage of the proceeds.

Of course, one difference between the previous experience and today is the degree to which

foreign heads of state and CEOs believe that they can receive carve-outs from sanctions imposition by appealing directly to the president. Under Obama, such an approach was anathema—and it is worth noting that even though Japan was laboring to provide energy for its citizens after the events around the 2011 tsunami and Fukushima nuclear disasters, the United States requested the same level of reduction as being made by other countries. Under Trump, it is plausible that foreign leaders or companies could ask for dispensation from the president and be granted it. In October 2017, it was reported that Trump told European leaders to "take their money; enjoy yourselves" with Iran. The flexibility of this president does not aid cogent analysis in this regard.

Conclusion

Though reimposition of US sanctions has been treated as something that either will or will not happen, there are a variety of scenarios for both how sanctions could be reimposed and what their effects would be. Further analysis will be necessary when the extent of US policy decisions is known, as well as how foreign participants will respond. But unlike in 2012, the international community is largely (and remarkably) unprepared for a US decision to withdraw from the JCPOA. Contacts in industry report skepticism with this being a likely US decision, and even foreign governments seem to treat the concept as a bluff. This is a dangerous notion. Donald Trump may be talking a big game when it comes to his intention to reimpose sanctions, but his wanting to end the JCPOA is far from a bluff. Rather, it is his firmly held desire. He has been restrained from doing so thus far but may not be in the future. Members of Congress and parts of his own administration have noted with alarm the risks inherent in walking away from the JCPOA, not least because Iran's nuclear program could restart quickly. But these officials have also been fighting a losing battle, the decertification decision in October 2017, and the ultimatum in January 2018 demonstrate. For this reason, companies and governments ought to begin planning now for the various contingencies they may face come May 12, 2018.

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The views represented in this commentary represent those of the author.

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