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US Sanctions Policy – Iran & Iraq

A Presentation by

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US sanctions policy on Iran and Iraq has been officially pronounced as a "dual containment" policy in May 1993 by its two originators Martin Indyk (then the National Security Council Middle East Officer) and Anthony Lake (then Special Assistant to the President on National Security). The dual containment policy which is still in effect, although modified, reflects both the reality that after the end of the Cold War neither country could turn to Russia for protection against US policy and the judgement that both countries governments' are hostile to essential US interests in the Middle East, that both support terrorism and are seeking to acquire or produce weapons of mass destruction (WMD). Thus, the US has adopted a policy of separate economic and strategic containment of Iran and Iraq, designed to change their policies on these issues or to change their regimes.

Actually the term "dual" in our Iran/Iraq containment policy has always been somewhat irrelevant, perhaps even misleading, since our containment policies towards the two countries differ fundamentally from each other in cause as well as in implementation and intended goal. As we shall discuss, our current dual containment policy is moving, or creeping, towards a coexistence policy with Iran and a regime-change policy in Iraq.

Given these evolving structural differences, let us briefly look separately at our two sanctions policies, as they affect each country's oil sector.

Iran: Unilateral Sanctions

The most important aspect of US oil sanctions policy on Iran, within the framework of our "dual containment" discussion, was, and is, its *unilateral* character. No other country has joined the US in its sanctions on Iranian oil exports or investments. The first US embargo on oil imports from Iran was imposed in November 1979 in response to the 444-day hostage taking of US diplomats in Teheran. The embargo had no impact on Iranian oil exports, which had declined by some 2 MMB/D for domestic reasons i.e. the Iranian revolution. Similarly, when the hostages were released in January 1981 and US sanctions were lifted it had no impact on Iranian oil exports, which were largely suspended in the first year of the Iraq-Iran war.

The next sanctions measure was imposed in 1987 by President Reagan as an executive order in response to Iran's attack on tanker traffic in the Gulf. It prohibited all Iranian imports into the US but put no restriction on foreign transactions of Iranian oil by US companies or their investments in Iran. Both the Bush Administration and the Clinton Administration actively tried to get some European countries to follow the US lead in barring Iranian oil imports but failed to get even serious consideration.

Next came the big actions of 1995 and 1996. President Clinton, aware that Congress was about to pass legislation prohibiting US oil companies from any activity involving Iranian oil and gas because of suspected acts of terrorism in the Middle East and attempts to obtain nuclear weapons, decided to move ahead and passed two comprehensive Presidential Executive Orders in 1995, prohibiting US involvement with any petroleum transaction and development in Iran, thereby forcing Conoco to abandon a major oil/gas project it had been awarded by the Iranian government, probably as a message that US oil investments were now welcome in Iran. The project was picked up very quickly by Total of France and Petronas of Malaysia.

In recognition of the reality that foreign firms would not follow US policy and thus might benefit from the self-imposed sanctions on US business in Iran, Congress passed the famous, or infamous, Iran-Libyan Sanctions Act (ILSA) in August 1996, which adds to the restrictions on *US* companies secondary boycott type sanctions on *foreign* companies investing in the Iranian (and Libyan) oil and gas sector above $20 million annually. At first ILSA did cause some foreign companies with investments in the US to withdraw from some post-ILSA oil/gas projects in Iran, possibly keeping Iranian oil exports slightly lower than they would have been otherwise. However, given the high world oil prices in1996 and 1997, the Iranian economy did not feel any pain from these very limited reductions. In 1998 Iran, like all producers, did feel the pain of low prices. But by then most US-imposed constraints on non-US investment in Iran had been disregarded and foreign oil companies are entering Iran on a potentially multi-billion-dollar scale.

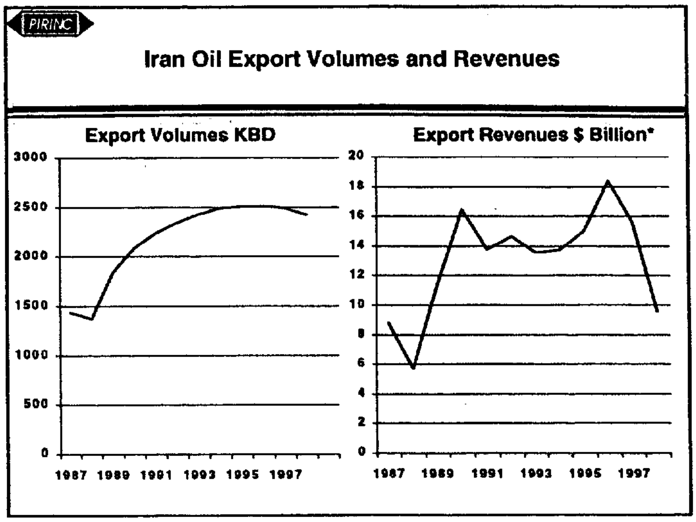
The US Administration has recognized that it has absolutely no support or even consent from other industrial nations for its Iranian sanctions policy and has decided to take no action against any of these foreign companies. Thus, as widely predicted, the principal victims of our Iranian sanctions policy are US oil companies and ancillary businesses.

Our Iranian containment policy also affects the participation of US companies in developing the Caspian Sea region's oil and gas resources. Iran is a Caspian Sea littoral country, it is participating in several Caspian Sea projects and it is becoming a transit route for several regional natural gas projects. It also offers the shortest pipeline route to tanker terminals for Caspian oil exports. Currently, US companies are barred from participating in any project in which Iran is a partner or a transit route. This clearly puts them at a competitive disadvantage in this major new oil and gas region.

A potentially positive new development in the political arena has been the election of Mohammed Khatami as President of Iran in 1997. President Khatami has clearly distanced himself from the widely used "Great Satan" label of the US and has denounced state terrorism in a CNN interview and seems ready to embark on a low-key dialogue with the US His presidency is one reason why US containment policy is apparently moving towards a co-existence policy. However the progress is slow.

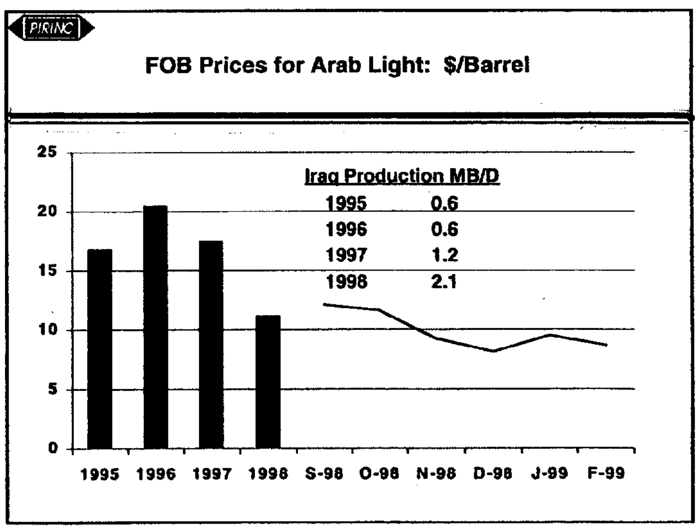
If Iran offers truly attractive buy-back deals, which it has not always done so far, it can get enough offers from foreign firms to do without US companies. On the other hand, if US companies were to return to Iran they would add to the foreign cash inflow, increase competition among foreign bidders for Iranian production, re-open the world's largest oil import market and give Iran access to the services of the world's most advanced exploration technology firms.

The chart on the right shows trends in Iran's oil export volumes and revenues since 1987, the year the US prohibited imports of Iranian oil. Between 1987 and 1993, exports rose by over 1 MMB/D as production recovered from the effects of the war with Iraq. But since 1993, production gains have been modest and export volumes roughly stable at about 2.5 MMB/D. Export revenues moved more or less in line with volumes until oil prices dropped sharply in 1998 when export revenues fell to about $10 billion, from about $16 billion in 1997 and $18 billion in 1996. The depressed level of oil revenues heightens Iran's need for foreign finance, including perhaps the option of funds from international lending institutions. While such pressures may not be decisive in shaping Iranian policy, they do lend support to those pursuing normalization of international relations. Some adjustment of US policy at a time when the government of Iran is taking steps toward normalization could be in order as a means of encouraging the process to go further.



One relatively small but psychologically important step in this direction would be to remove sanctions on US food and medicine sales to Iran. Currently, the US has such restriction on four countries, (Iran, Libya, North Korea and Sudan). Last September Iran requested permission to buy 3 million tons of grain and 400,000 tons of sugar from the US So far, this has not been approved. It is hard to see how these sanctions further US foreign policy interests while it is clear that they harm the US farm sector. Removing these sanctions would be a case of "doing well by doing good."

Iraq: Multilateral Sanctions



We are bombing Iraq but there are no US sanctions or restrictions on trade with or investments in Iraq. All such prohibitions were imposed and are enforced by the UN Security Council, following Iraq's invasion of Kuwait in 1990. Under UN Security Council Resolution 986 adopted in April 1995, Iraq's oil exports were subject to a revenue cap of $1 billion every 90 days with revenues going into special escrow accounts. The cap, which has since been altered several times, has recently been raised to $5.25 billion every 6 months. The volumetric limit on oil exports is thus a function of the price of oil, which has moved dramatically since the Resolution was adopted in April 1995. The chart above summarizes the movements since 1995. The price of Arab Light averaged about \$17/B in 1995, rose to about \$20.50 in 1996, declined to \$17.50 in 1997 and then to \$11 in 1998. Current prices are even lower. In February, Arab Light fell to only \$8.70. The limited information available regarding Iraqi crude suggests it currently sells at a significant discount to Arab Light. Iraqi oil production has risen since the passage of Resolution 986 from 0.6 MMB/D in 1995 and 1996, to 1.2 MMB/D in 1997, 2.1 in 1998, and is currently at about 2.6 MMB/D. Export revenues have moved up from \$300 million in 1996, to \$4 billion in 1997 and to about \$6 billion last year.

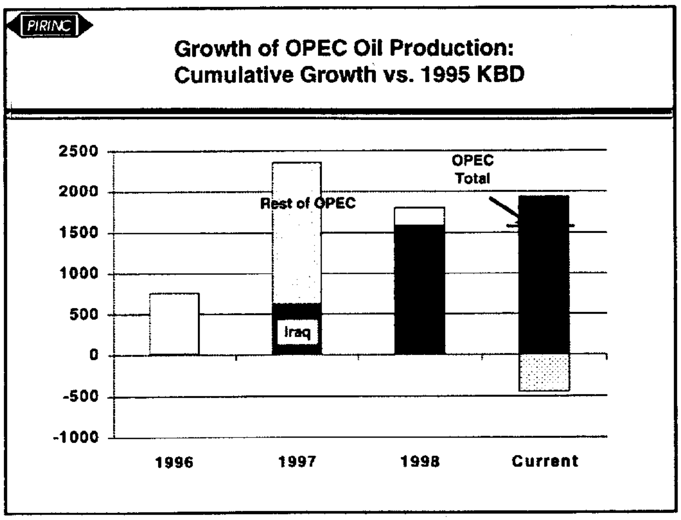
The lower the price, the more oil Iraq can sell within the revenue limit imposed by the Security Council. To put it another way, the lower the price, the higher the volumes Iraq *must* sell to achieve the maximum revenues allowed to finance humanitarian imports. The table on the right shows the relationship between the price received for Iraqi oil and export levels that achieve the allowed \$5.2 billion every six months. At \$20/B, exports of 1.4 MMB/D achieve the target. But at current prices of about \$8/B, about 3.6 MMB/D of exports are required, far above current exports of about 2.1 MMB/D. This level represents an all-out effort and cannot be sustained without significant investments in repair and maintenance of the fields. Although allowed for by the Security Council, the process for importing necessary equipment is moving at a snail's pace of about 300 million every six months. The combination of all-out production and low prices raises issues of how to assure reasonable levels of humanitarian aid and investment to repair and restore oil facilities. In the short term, raising or removing the revenue cap would be ineffective as a means of increasing resources for these purposes. In the longer term it could make a substantial difference, as shall be discussed later.

Exports Permitted at Price of:

$/B	Exports -MMB/D
20	1.4
15	1.9
10	2.9
8	3.6

Current Iraq Exports: 2.1 MMB/D

At the moment, Iraq is producing about 2.5 to 2.6 MMB/D of crude, or about 9% of total OPEC production. Iraq currently ranks 4th among the OPEC producers, coming after Saudi Arabia (8.3 MMB/D), Iran (3.6) and Venezuela (3.1). But these statistics understate the importance of the return of Iraqi oil on world oil markets, especially its contribution to the current low-price environment. The chart on the right looks at Iraqi oil in a different perspective, its share in the cumulative growth of overall OPEC production since 1995. In 1997, OPEC production was 2.3 MMB/D above its 1995 level, with Iraq contributing about 25% of the gain. In 1998, the OPEC countries ex Iraq began to cut production back toward 1995 levels as global demand was collapsing and prices weakening in the face of Asian recession and exceptionally warm winter weather. But Iraqi production moved up 1 MMB/D between 1997 and 1998, offsetting most of the cuts made by the rest of OPEC. In the



latter part of 1998, key members of OPEC (as well as Mexico, Norway, and Russia) reduced production still further. Currently, the rest of OPEC is producing below 1995 levels but further gains in Iraqi production offset most of the latest cuts as well. Obviously other factors are contributing to the ongoing oil price depression. But the growth of Iraqi production is clearly complicating efforts of other producers to adjust supply to reduced global demands.

A French proposal in January to the Security Council to remove the $5.25 billion semi-annual ceiling on Iraqi oil exports, and also remove all restrictions on the importation of non-military and non-dual-use goods and services could, over time, raise Iraqi exports well above its current ceiling. The French proposal which is supported by Russia, was quickly followed by a US proposal to remove the ceiling on oil exports. But the US proposal would continue the use of escrow funds to allocate money for the restoration of Iraq oil facilities.

The French proposal, if adopted as submitted, could raise Iraqi exports substantially over time. If we assume that Iraqi export prices in the second half of 2000 will have risen to, say, 12/bbl (approximately in line with the latest EIA short-term price projection), the $5.25 billion ceiling will be reached with an export volume of about 2.4 MMB/D, just slightly above the current volume of 2.1 MMB/D.

Thus, if there is no longer a ceiling on exports and no restriction on commercial imports, foreign companies will be eager to invest in the Iraqi oil sector to bring production at least back to the 3.5 MMB/D immediate pre-war level from existing fields , probably within 18-24 months after the export ceiling is lifted. Under the US proposal to remove the export ceiling, the increase in oil exports would probably be slower, depending on the allocation policy of the UN escrow fund. Foreign companies may be kept out or may not want to come in under this arrangement. Still, without an export ceiling, Iraqi exports can be expected to keep rising as prices increase.

The impact on the market would of course be significant. Thus, the proposals to remove the ceiling on oil exports should be viewed not only from the current position that it is an unreachable target because of the very low price structure, but also from the realistic, though speculative, assumption of a substantial price increase in the course of the year 2000.

The US proposal to remove the $ ceiling on Iraqi oil exports will very likely be criticized by representatives and officials of domestic oil producers at an upcoming Senate hearing on US Sanctions policy on Iraq. The domestic producers and their representatives were already quite critical of the current $5.25 billion ceiling even though it has not been approached. They argue that the rising oil exports under current sanctions policy strengthen Saddam Hussein and weaken US oil producers.

There is some truth to this. The essential goods purchased with the one million B/D increase in Iraqi exports in 1998 have clearly helped Saddam Hussein to survive and have also clearly been a significant factor in last year's oil price collapse. However, providing food and medicine for the people of Iraq is a humanitarian necessity and to have Iraq pay for it through oil exports seems logical and equitable. But it does not justify the removal of the export ceiling.

The Long View

Over the long term, there is a compelling interest in normalizing relations with both countries. Timely development of their resources will play a key role in assuring a moderate, stable, oil market over the next decades. The table on the right below illustrates their significance. The first column shows proven reserves. By this measure, Iraq ranks second only to Saudi Arabia while Iranian reserves are close to those shown for the UAE and Kuwait. Collectively, these 5 Gulf States account for about 65% of the world's proven reserves. The next two columns show 1998 production and the ratio of reserves to production. The R/P ratios are far higher for the Gulf countries, especially Iraq, than for the rest of the world. Thus, Iran and Iraq, along with their Gulf neighbors are holders of much of world's inventory of low-cost, readily accessible reserves that could support expanded output in a relatively short time. In the long run Iran and Iraq are both needed as major supply sources for the growing world oil demand.

	Proven Reserves Billion Barrels	Production Billion Barrels	R/P Ratio
World	1035	24.2	43
Saudi Arabia	263	3.0	86
Iraq	113	0.8	146
Kuwait	97	0.8	128
UAE	96	0.8	119
Iran	90	1.3	68
Subtotal	657	6.7	98
All Other	378	17.5	22

Source: Oil & Gas Journal estimated 1998 production and reserves as of 1/1/99

In the near-term, there is likely to be a continuation of the ongoing military and political confrontation between the US, supported by some allies, and Iraq, all by itself. The confrontation is likely to last as long as Sadam Hussein remains in power. Iraqi oil exports may rise despite this confrontation if it continues into next year.

US-Iranian relations are very slowly moving in the opposite direction of US-Iraqi relations. But no breakthroughs in US sanctions policy is likely in the near future. However, it is important to recall that ILSA self-expires on August 6, 2001 under the exiting law, unless renewed by Congress. As of now, the chances of no renewal of the Iranian part of ILSA, or at least a substantial moderating modification, seem reasonable. This would certainly be a step in the right direction.