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Iranian Oil Sanctions: Winners & Losers

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I have been asked to discuss U.S.-Iran relations from the viewpoint of the oil industry. I will therefore address myself only to this aspect of the U.S.-Iranian issue and not discuss the U.S. rationale and justification for imposing these sanctions.

Let me start with a few facts: Iran has been a major player in the world oil market since the beginning of this century. At its current production level of 3.65 million B/D, it is the world's fourth largest producer and at its export level of about 2.6 million B/D, it is the second largest exporter (after Saudi Arabia). Iranian oil is needed in world oil trade. If, for any reason, Iranian oil exports became unavailable, world oil prices would soar instantly, especially if this occurred while Iraqi oil exports are still limited by the UN Security Council.

First Winners and Losers: Total and Conoco

Current U.S. policy is not designed to block ongoing Iranian oil exports, although in 1995 this was advocated by many prominent U.S. legislators. The goal of the current U.S. oil policy is to curb Iranian oil and gas production gradually, progressively reducing the country's earnings from its principal export commodity. The first and, so far, principal impact of this policy on the oil industry was to force a major U.S. oil company, Conoco, to back out of an agreement with Iran to develop one of its major offshore oil fields. Conoco had been awarded the Sirri A and E project in a competitive bid with other international companies. Iranian officials, and also some independent observers, have said the award to Conoco was made not only because of its high professional qualification but also as political gesture towards the U.S.

After Conoco was forced out, the French company Total eventually took the Sirri project which is now well on its way towards commercial production and is expected to reach its 150 thousand B/D target on schedule.

Who were the winners, who were the losers in this U.S. government-imposed withdrawal of Conoco? The winner obviously was the French company, the loser the U.S. company which had spent several years and some $15 million to prepare the project. Regarding Iran, the U.S. government's target for punishment, it remained largely unaffected by the change except for a delay of several months in switching from one foreign company to another.

Next Losers: U.S. Oil and Equipment Companies

Shortly after Conoco's withdrawal, the President issued an Executive Order prohibiting U.S. companies from engaging in any business transaction in or with Iran, which meant, among other things, that they could not purchase any Iranian oil. There had been a prohibition on importing Iranian oil into the U.S. since 1987. But until mid-1995 U.S. companies could trade in Iranian oil abroad or use it in their foreign refineries. The U.S. Administration expressed the hope that other industrial countries would follow suit, just as it had hoped they would in 1987. As we know, no country joined the U.S. import embargo on Iranian oil either in 1987 nor in 1995. Thus, the U.S. is now the only country barring all trade in Iranian oil.

Who gained, who lost by this action? Here again, U.S. companies lost because their flexibility in trading, exchanging and refining oil has been somewhat curtailed, relative to their foreign competitors. Iran, on the other hand, was unaffected by the U.S. restriction (except for a brief transition period). It now exports about as much oil as it can, given its rising domestic demand and recent flat production level.

U.S. oil service and equipment companies also lost out under the Executive Order of 1995. Their actual and potential business loss as a result of the Executive Order has been estimated at some $600 million. Of course, their prospective losses -- i.e. foregone earnings -- will continue while the Executive Order is on. Thus, the Administration's attempt to curtail or reduce Iran's oil income through a sanctions policy has been an object lesson of the well-known theorem that unilateral sanctions in international trade generally do not work. The U.S. Congress, which was more eager to punish Iran for its support of terrorism than the White House, recognized this limitation and passed the Iran and Libya Sanctions Act of 1996 requiring the President to impose a variety of sanctions on foreign companies investing more than $40 million annually in the oil and gas sector of Iran,* and also Libya (tagged on to the bill on Iran just before the vote without any hearings). The Act became law on August 5th, 1996.

I won't go into the details of the Act since it has already been discussed here. But, again, the question is, who was hurt by it and is it achieving its intended purpose? The Sanctions Act exempted Total's Sirri project from any U.S. penalty under its "grandfather" clause. But it did have some effect on new foreign investment in Iran. The chief executives of two major foreign oil companies, Royal Dutch/Shell and British Petroleum, have publicly stated that they cannot ignore the U.S. Sanctions Act because of their companies' large investments and commercial interests in the U.S. market. ARCO had also been interested in one of the offshore projects but pulled out when the U.S. sanctions policy was announced.

* The annual threshold amount will be reduced to $20 million from August 1997 on.

Will Iran be a Big Loser?

Despite these setbacks, production from the Iranian offshore, the only area where Iran is seeking foreign participation, has increased in both 1995 and 1996 and is expected to do so again this year. At year-end 1996 the offshore area produced 550 thousand B/D, an increase of 200 thousand B/D in the last two years. The *Middle East Economic Survey* (MEES) commented last December that "the fact that NIOC [National Iranian Oil Company] Offshore has been able to increase production so substantially in the face of the U.S. sanctions regime is indeed impressive." Most independent forecasts agree with the projection of a 1 million B/D offshore production by 2000.

Iranian <u>onshore</u> production, which accounts for 85% of Iran's total, has always been operated and developed entirely by NIOC without any foreign participation in this sector. Thus, practically, most Iranian oil production will not be affected by the U.S. Sanctions Act since Iran is not seeking foreign participation in its onshore sector. Onshore production declined slightly in 1995 and 1996, largely due to delay and neglect of the required substantial gas injections and measures against water encroachment to maintain and increase production of these mature but still giant fields. However, the large increase in Iran's oil revenues last year (March 20, 1996-March 21, 1997) over what had been budgeted at the beginning of the year -- $19 billion actual versus $16 billion projected -- has now brought about some increased investment in these areas and, hence, apparently is beginning to reverse the recent decline in sustainable onshore production. U.S. companies will of course be barred from supplying any of the required equipment and technology for this operation. Foreign companies in contrast face no risk of U.S. sanctions in supplying these requirements since the Sanctions Act only penalizes investment, not trade.

In the Iranian oil industry's <u>offshore</u> sector, the principal source of growth in the country's oil production, substantial foreign investments will be required to expand production from the recent level of 550 thousand B/D to about 1 million B/D by 2000. It is quite likely that U.S. sanctions policy will slow these investments, both by keeping out all U.S. companies and curtailing foreign participation by threatening secondary sanctions. As we have seen, a number of major international companies with substantial U.S. business interests are reluctantly abiding by the U.S. sanctions policy. However, foreign companies with little or no investment or sales in the U.S. market face no such constraint. One example is the Malaysian national oil company Petronas which has recently taken a 30% share in Total's Sirri project. Several European and Canadian companies with no significant exposure in the U.S. have also shown interest in participating in the Iranian offshore projects, such as the Balal Field.

Total Iranian crude production has risen from 2.3 million B/D at the end of the Iranian-Iraqi war in 1988 to about 3.6 million by 1993 without foreign participation. It has remained at the 3.6-3.8 million B/D range since then. The upper end is probably very close to its sustainable productive capacity. With some foreign investments certain in its offshore sector, Iranian production is likely to grow moderately despite U.S. sanctions, though at a slower rate than if there were no sanctions.

Gas Exports to Start

But the country's total energy exports will be boosted significantly further when the first natural gas exports start by 1999. There are several major gas export projects currently under active consideration. The most advanced is a $20 billion, 22-year, Iranian-Turkish project which would start delivery in 1999. It is not clear whether the project would fall under the U.S. Sanctions Act, both because of its initial contract date and the fact that all of Turkey's direct investment in the project would be on Turkish territory. But it is clear that the U.S. does not want Turkey to go though with it and has said so adamantly. Yet, as of now, Turkey seems determined to go ahead. If it does, U.S. firms may well be excluded from participation under current U.S. policy. Thus, here again the project would be built, the gas would be exported, and the only losers under our policy might be U.S. companies.

Another major gas project is the South Pars offshore field in which Iran seeks some international participation. Currently, Total is reported to be the front runner. Here, too, U.S. companies are excluded from any participation, either as suppliers of equipment or as participants in the project. Total may face U.S. secondary sanctions, since unlike the Sirri project, it cannot claim "grandfathering" in the South Pars project.

Major Role in the Caspian Sea

Another important aspect of Iran's oil industry that could affect U.S. companies is its littoral Caspian Sea location. As reported in a recent Energy Information Administration (EIA) analysis, "Iran has backed Russia's claim that... all countries bordering on the Caspian must approve any offshore oil development." The Caspian Sea may contain ultimate oil reserves in the 40-60 billion bls range, according to the EIA as well as other sources. NIOC is actively exploring its Caspian coastal areas and has a 10% stake in one of the international oil consortiums (which includes BP, Statoil and Elf, among others) currently operating there. U.S. companies are not permitted to participate in any project where NIOC has a stake under the existing U.S. Executive Order, hence threatening any U.S. participation in developing the Caspian Sea resources. It could turn U.S. companies into potential liabilities in all Caspian Sea projects, even where there is no current Iranian participation because any future Iranian participation would force the U.S. partner to leave the project. Hence, current U.S. sanction policy could be in conflict with the current U.S. policy of encouraging U.S. participation in the development of Caspian Sea oil and gas resources.

Costs High -- Benefits?

At a recent oil industry conference Deputy Assistant Secretary, William Ramsey, who is in charge of anctions policy at the State Department, pointed out that "the cost of sanctions can be very high" for U.S. business.

This raises the question, do these costs bring commensurate benefits for the U.S.?

In answering, we must recognize that:

- our Iranian/Libyan oil sanctions will remain unilateral, notwithstanding the recent headline-grabbing German court decision;
- the effectiveness of our secondary sanctions policy is quite limited, both because most foreign countries oppose them and may take retaliatory action and because foreign firms with no stake in the U.S. are generally beyond their reach;
- Iran has operated its oil industry without foreign participation since the revolution of 1979 and its current export level is at least being maintained.

Thus, the answer to the question, who gets hurt more by our sanctions policy, the targeted country or the U.S. companies excluded from doing business with it, may not be supportive of our current policy.