U.S. Policy toward Iran: Will Sanctions Hit Their Mark?

May 2, 1995

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Before the

Subcommittee on International Economic Policy and Trade
Committee on International Relations, U.S. House of Representatives

at its hearing on
U.S. Sanctions Policy on Iran: Can We Be More Effective?

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Introduction

Thank you for inviting me to testify today on U.S. sanctions policy on Iran. My testimony will discuss:

- the impact of current and proposed legislation and Executive Orders on (1) Iranian oil exports and (2) investments in the Iranian oil sector,
- S. 630, which would deny access to the U.S. market to any foreign companies dealing with Iran,
- a hypothetical analysis of the impact on the world market of a successful policy to block Iranian oil exports, and
- the impact of a ban on U.S. company purchases of Iranian oil.

Before starting our analysis I would like to state that we concur with the basic policy intent of H.R. 1033, namely to penalize Iran for its documented continued support of international terrorist activities and its demonstrated consistent record of violations of human rights. We also recognize that economic considerations are not always the paramount consideration in our foreign policy. Any negative impact on the U.S. or its businesses, however, should be acknowledged and weighed by the policy makers.

Impact of H.R. 1033 on Iran: Minimal

Our first point, the impact of H.R. 1033 on the Iranian oil industry, has two aspects: U.S. investments in Iranian oil operations and U.S. purchases of Iranian oil.

Investment Restrictions: Non-U.S. Companies Will Step In

The investment restrictions in the bill, as spelled out in Section 3 (b) (4), have largely been addressed in Executive Order 12957, dated March 15, 1995, which prohibits all forms of U.S. investments in Iran. Issued one day before the Senate Banking Committee hearings on H.R. 1033's twin, S. 277, the Executive Order reflects a newly galvanized and articulated Administration policy, prodded by the Congressional focus on Iran and the proposed billion dollar Conoco oil field development contract with the National Iranian Oil Company. As we know, the contract, accepted and announced in Teheran, was cancelled by Conoco just before the Executive Order was issued by the President.

In the long term, the readiness of non-U.S. companies to invest will become clear. Because foreign companies do not bring to the table Conoco's unique interest in Iranian gas from the Sirri offshore field that can be piped to Dubai to facilitate the company's production there, the Conoco deal, *per se*, is not a matter of a simple transfer from one potential contractor to another. At least two European companies, however, have been reported as negotiating for the play.

Altogether, then, the Congressional initiatives on policy toward Iran, the public attention on the Conoco deal and the related White House Executive Order can be assumed to have some limited negative impact on the Iranian oil sector, both in delaying any non-U.S. contracts and in making the terms less attractive for Iran than the cancelled Conoco contract with its special attractions. The negative impact, however, will be fleeting.

Geologically and economically, Iran is one of the world's most attractive oil investment areas. Iran's current productive capacity (and actual production) is 3.6-3.7 million B/D. In the five years prior to the Iranian revolution in 1979 (and then followed by the Iran-Iraq war of 1980-89), Iran's production averaged 5.5 million B/D. The production decline is not due to a declining resource base but to a combination of neglect, war damage and lack of funds to rebuild its capacity.

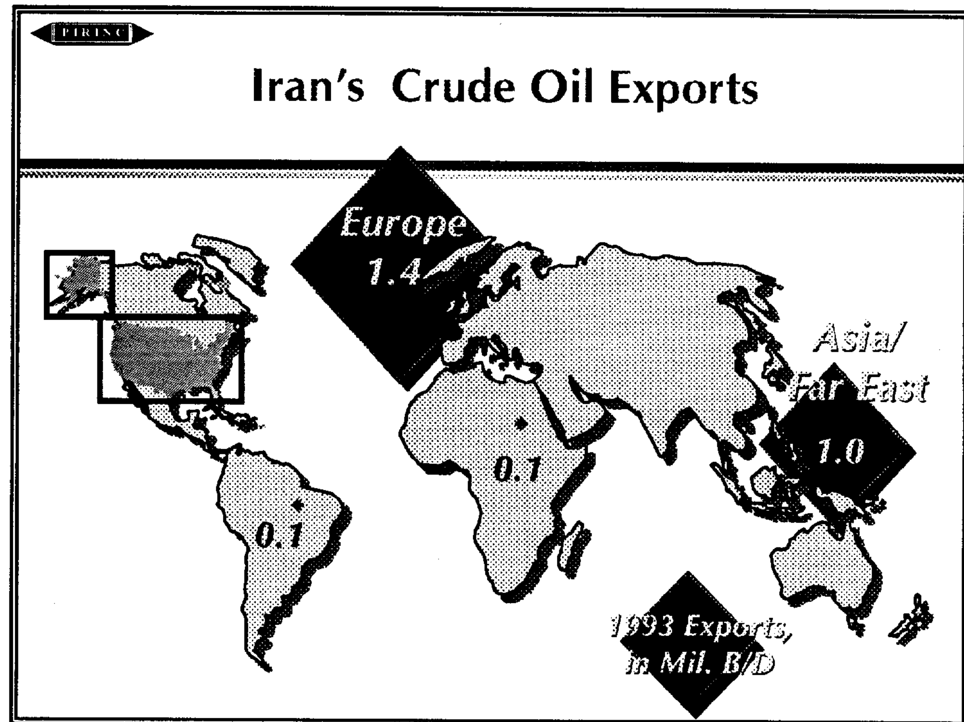
Since virtually all forecasts agree that all Persian Gulf producers must increase their output substantially between now and 2000 and again to 2010 to meet world demand, foreign investment in the Iranian oil sector should be both attractive and necessary. In the absence of U.S. companies, European oil companies can be expected to undertake these investments, regardless of U.S. policy.

Ban on U.S. Companies' Lifting Iranian Oil: Non-U.S. Companies Will Buy It

My next point is the proposed total ban in H.R. 1033 on all Iranian oil lifting by U.S. companies and their foreign affiliates. As you know, of course, since 1987 this ban has only applied to shipments to the U.S. In testimony before the Senate Banking Committee on March 16th on this issue, we made the point that Iran's revenues will be unchanged by a lifting ban such as that in S. 277 because "unilateral embargoes don't reduce exports." Because we discussed this issue in some detail in our March 16th testimony, there have been no changes in the S. 277/H.R. 1033 since then and no new information has come to our attention, we would like to submit an abbreviated version of this section of our March 16 Senate testimony.

Iran exports about 2.6 million barrels per day of oil. As shown in the following figure, Europe takes more than half of the total, with the largest volumes moving to France, Italy and the Netherlands. These countries together account for about 45% of Europe's 1993 Iranian volumes. About 1 million B/D went to Asia and the East

in 1993, with Japan accounting for 35-40% of the total. Small amounts of Iranian oil also went to Canada, Latin America, Africa, and the Mideast. At 1994 prices, the value of Iranian oil exports was approximately $13 billion.



Some 600-650 thousand barrels per day of these exports, worth $3.5 - 4.0 billion, were purchased by a number of U.S. companies for refining, resale or trading outside the U.S.

There have been frequent references to the large sums of money paid by U.S. oil companies to Iran, presumably strengthening the existing regime. There is no doubt that if Iran lost 600 thousand barrels per day of exports its economy would be weakened. However, the implied assumption that if U.S. companies could no longer purchase these volumes (as would be the case under H.R. 1033), Iran's oil export volume and value would decline substantially, is not borne out by the facts, in our view.

The reason is the same that caused Iran very little harm following the reinstatement of the U.S. import embargo in October 1987: no other country joined the U.S. embargo and a *unilateral trade embargo of a globally traded fungible commodity is by definition ineffective*. The U.S. Administration at the time was fully aware of this. Then-Energy Secretary John Herrington was reported to say that the embargo would have little practical effect on stemming Iran's crude oil exports unless there was large-scale cooperation from other countries. As we know, there was none.

There is currently no indication that any oil importing country has any intention to change its position on Iranian oil imports.

Thus, while passage of H.R. 1033 might cause a very short term dislocation for the 25% of Iran's oil exports bought by U.S. companies, the world oil market would quickly redistribute Iranian oil to other markets and/or customers and restore any temporary imbalances. The fact that both Iranian Light and Iranian Heavy crude are mainstream crudes that most refiners can readily process is also a positive factor in redistributing the U.S. companies' share of Iranian exports. If the National Iranian Oil Company cannot find new outlets at suitable prices immediately, it can temporarily put more oil into its storage tanks, a routine procedure in the world oil market.

S. 630: The Cost is Too High

Unacceptable to our Friends

Senator Alfonse D'Amato has recognized the possibility that foreign companies may offset any negative impact on Iran of a global embargo on Iranian oil purchases by U.S. companies and has therefore introduced S. 630. In the Senator's words, "a foreign corporation or person will have to choose between trade with the United States or trade with Iran." S. 630 goes far beyond preventing foreign companies from buying the Iranian oil that U.S. companies would be forced to leave behind under S. 277. It would force foreign companies or individuals who want to do business with the U.S. to cease buying *any* oil or other commodity from Iran. The same would apply to exports to Iran.

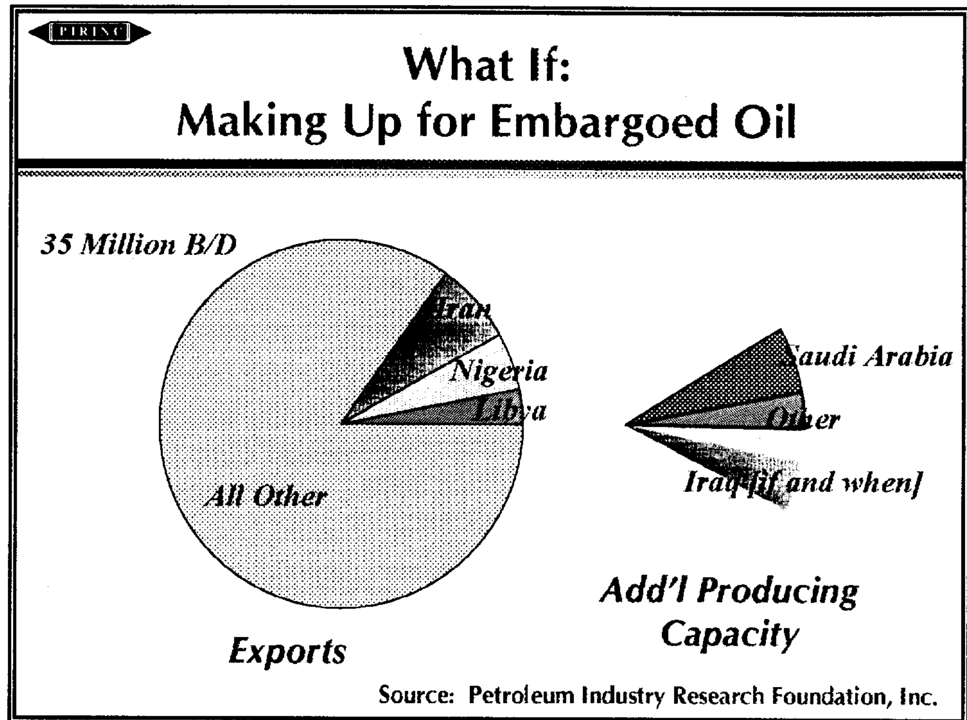
There is virtually no chance that the U.S.'s foreign trading partners would accept this form of secondary trade boycott. They could be expected to protest and then retaliate.

What If the Boycott Works?

But should we even want to see all or most Iranian oil exports eliminated? From an economic point of view, the answer is clearly ***no*** under current conditions. Iran is exporting about 2.6 million B/D, equal to 7.5% of total world oil exports. If all or most of these exports become unavailable, the price of oil would rise substantially because the world market would have insufficient supplies at current prices.

As shown below, the world's current excess producing capacity amounts to about 3 million B/D, of which 2 million B/D is located in Saudi Arabia. Suppose our policy succeeds in reducing Iranian oil exports by 50% or 1.3 million B/D. Under current conditions, i.e. continuing full U.N. sanctions on Iraqi oil exports, this would reduce

available world oil exports by nearly 4% and result in a price increase of perhaps \$4/Bbl, or the equivalent of 10¢/gallon in product prices.



Source: Petroleum Industry Research Foundation, Inc.

The increase would be substantially lower if Saudi Arabia and the other OPEC countries with spare capacity were to raise their production to offset the loss of Iranian exports. But how likely is such a response? It would clearly be a hostile act towards an OPEC member which actively participates in setting OPEC price and production policy. Since the reduction in Iranian exports would not be based on an official U.N. policy, as the Iraqi sanctions are, OPEC countries with spare capacity would have no reason to cooperate in a policy to hurt one of their members. Obviously, if U.S. policy should succeed in cutting Iranian exports even more than 50%, the price impact would be larger, probably on a disproportionate scale.

The problem compounds as other exporters are targeted. For instance, calls for universal sanctions against purchasing Libyan oil, if implemented, would likewise result in a oil price increase.

Thus, the advocates of imposing global restrictions on oil imports from Iran beyond the elimination of U.S. companies as purchasers of Iranian oil, are faced with a Catch-22 situation. The more they succeed in their endeavor to cut Iranian exports, the more the price of oil will rise with attendant negative impacts on the economies of all importing countries. For the moment, this is the reality of the oil market and, hence, can not be passed over.

Impact on U.S. Companies

Finally, let us examine what the proposed embargo would do to U.S. companies currently engaged in Iranian oil trade. In the broadest sense, it would be a mirror image of the bill's impact on Iran. The affected U.S. companies would have to switch to non-Iranian supply sources for the approximately 600 thousand barrels per day lifted from Iran last year. Over time, they would be able to do so. Since most of their Iranian oil transactions are under term contracts, they would probably have to declare *force majeure* to break their contractual obligations unless the legislation contains a 90-day phase-out period. The phase-out period would also smooth the impact of the embargo on the world oil market.

The U.S. oil companies, however, would not be indifferent to being denied all commercial access to Iran, currently the world's second largest oil exporter (after Saudi Arabia), while their foreign competitors maintain unrestricted access. U.S. oil companies are already handicapped *vis-a-vis* their foreign competitors by the standing, exclusively U.S., prohibition on all trade with Libya, the principal oil supplier in the Mediterranean basin. If Iran were to be added to this restriction, it would further reduce the U.S. companies' international logistical flexibility, would at times prevent them from making optimal trading and transportation arrangements, limit their ability to engage in crude price arbitrage transactions, etc.

All of this would put U.S. firms at some unquantifiable but, at times, significant disadvantage with respect to their non-U.S. competitors. In other words, U.S. companies are likely to be more affected by H.R. 1033 than its intended target, the Iranian economy.

Conclusion

As I said at the beginning of my testimony, there may well be overriding non-economic reasons for the U.S. to prohibit U.S. companies from doing business with Iran. However, as long as other countries do not actively support our policy, the impact of H.R. 1033 on the Iranian economy will be marginal, at best, and short-lived. As I pointed out earlier, while Executive Order 12957, which prohibits U.S. investment in Iran, may have had a negative impact on the Iranian oil sector, that impact is temporary and fleeting. Any dislocations of Iranian volumes from world markets as a result of a ban on U.S. company liftings of Iranian oil would likewise be fleeting. Economically, these sanctions will not hit their mark.