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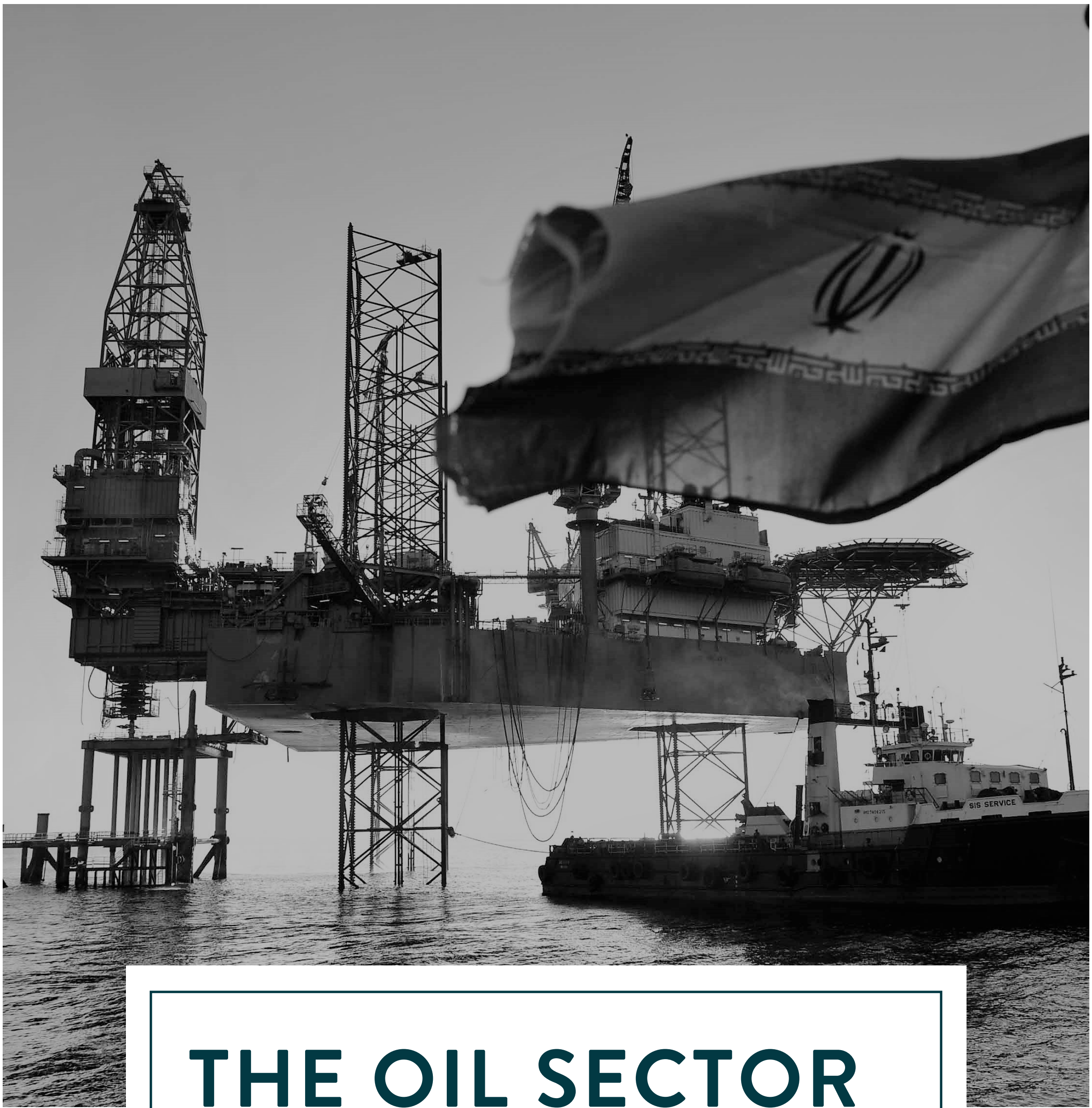

THE OIL SECTOR IN IRAN - US COMPETITION

by Francesca Manenti

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Almost two months after the US withdrawal from the nuclear agreement (Joint Comprehensive Plan of Action - JCPOA), the Iranian government is struggling for assuring the future stability of the pact. Despite the repeated requests to partners in both Europe and Asia to find a solution for ensuring the continued implementation of the JCPOA, no concrete proposal for limiting the effects of the resumption of sanctions by the US has been advanced so far.

Even the last meeting, held among signatory countries in Vienna on 6 July at Foreign Ministers level, led to nothing and thus highlighted the technical difficulties that the negotiators are facing to create a mechanism to safeguard the commitments made with the nuclear deal. Beyond the unanimous stance in favor of the JCPOA and its binding capacity, neither the European representatives nor China and Russia wanted to commit themselves to the actual possibility of limiting the fallout of US decertification.

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According to the EU High Representative, Federica Mogherini, the European Union is about to approve a financial mechanism to protect its companies from any retaliation by the United States, based essentially on two pillars: the update of the EU "Blocking Statute" in order to protect EU Member States' companies; and the update the European Investment Bank's external lending mandate to cover Iran. However, both steps still seem to be in their early stage or to have to go through the intricate Brussels' bureaucracy. This inevitably throws a shadow of uncertainty on both the sustainability and effectiveness of the proposed mechanism and does not allow European diplomacies to offer any guarantees to the Iranian counterpart.

This uncertainty led both Iranian President Hassan Rouhani and Foreign Minister Javad Zarif to try to force the hand for breaking through the situation, warning a possible step back of Tehran from the commitments to JCPOA.

The Iranian government's urgency for tackling the issue finds its raison d'être in the approaching of the re-application of sanctions by the United States, set for August 6th and November 4th. With the first tranche, the US government will re-impose sanctions on:

- The buying and selling of US dollar banknotes by the Government of Iran;
- Iran's trade of gold or other precious metals;
- The direct or indirect sale, supply, or transfer to or from Iran of graphite, raw, or semi-finished metals such as aluminum and steel, coal, and software for integrating industrial process;
- Significant transactions related to the purchase or sale of Iranian rials, or the maintenance of significant funds or accounts in Iranian rial outside the territory of Iran;
- The purchase, subscription to, or facilitation of the issuance of Iranian sovereign debt;
- Iran's automotive sector.

Instead, starting from November 4^{th}, the following sanctions will come back into force against:

- Iran's port operators, shipping and shipbuilding sectors, including the Islamic Republic of Iran Shipping Lines (IRISL), South Shipping Line Iran, or their affiliates;
- Petroleum-related transactions against, among others, the National Iranian Oil Company (NIOC), Naftiran Intertrade Company (NICO), and national Iranian Tanker Company (NITC), including the purchase of petroleum, petroleum products, or petrochemical products from Iran;
- Transactions by foreign financial institutions with the Central Bank of Iran and designated Iranian financial institutions under Section 1245 of the National Defense Authorization Act for Fiscal Year 2012 (NDAA);
- The provision of specialized financial messaging services to the Central Bank of Iran and Iranian financial institutions described in Section 104 of the Comprehensive Iran Sanctions and Divestment Act of 2010 (CISADA);
- The provision of underwriting services, insurance, or reinsurance;
- Iran's energy sector.

At the end of the two windows of opportunity, therefore, the United States will reapply a crackdown on economic relations with the Islamic Republic that seem to be meant not only to have important consequences on bilateral relations, but also to generate wider effects. Indeed, the Iranian government and international partners are particularly concerned for the reintroduction by the Department of the Treasury of the so-called secondary sanctions. These measures apply to any non-US businesses or individuals who maintain relations with Iran and provide for the exclusion from the US economy and financial network, as well as the total or partial freezing of any bank accounts opened inside the US. These retaliations and the costs they would bring to the sanctioned realities, both in terms of loss of business opportunities and penalties, are a precious card in the hands of the United States to ensure the effectiveness of the isolation policy, by forcing countries to comply with measures against Iran. In fact, although the government of a third country does not support the sanctions, the limitations threatened by the secondary sanctions can easily discourage many companies of that same country from carrying on relations with the Iranian counterparts. In this way, the White House can use economic leverage to compensate for the lack of political convergence.

In details, Teheran is particularly concerned about the effect that the resumption of sanctions will have on the energy sector, one of the pillars of national economy. Ranking seventh in the world for reserves of oil and second for natural gas reserves (estimated[1] respectively around 155,6 million barrels and 33,7 million cubic meters), Iran has always considered the development of a structured energy

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[1] OPEC Annual Report 2018

supply chain a matter of strategic interest for strengthening of the State.

The entry into force of the JCPOA in 2016 allowed the Islamic Republic to make significant progress in exploiting its hydrocarbon potential, thanks to both the confluence of foreign investments in exploration and extraction technologies and the resumption of exports. In particular, if the technological gap continues to strongly affect the exploitation and trade in natural gas[2], the oil sector has been much more powered up and, in the last three years, it has become once again crucial for raising internal economy. The increase in hydrocarbon production recorded in 2016 (+ 62%) contributed substantially to the general growth of the domestic economy, which reached + 13.4% that year. In the two-year timeframe 2016 and 2017, in fact, oil exports amounted to 1,9 million and 2 million barrels per day (b/d), worth of 41.123 billion and 52.728 billion dollars respectively, and the oil revenues represented about 5.6% of GDP. In the last year, according to the Iranian Ministry of Oil, the oil export remained well above 2 million b/d, reaching peaks of 2.8 million b/d. Therefore, the restoration of oil sanctions will hit one of the most vivid sectors for the domestic economy. Trump Administration's aim to reduce to zero the hydrocarbon exports of the Islamic Republic fits the will to stop the flow of oil revenues (both crude and condensates), in order to further impoverish the state's coffers and try to endanger the government stability, by

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[2] Despite the huge reserves, Iran weighs only 1% on global natural gas trading through pipelines and has no adequate infrastructure to manage either imports or exports of liquefied natural gas (LNG).

blowing the fire of popular dissatisfaction. However, the effective feasibility of this choice cannot be taken for granted and thus depends on several variables, closely related both to the dynamics of the oil market and to the changed conditions of the international scenario.
Regarding the oil market, the White House has to balance the political will to continue its anti-Iranian strategy with the need to avoid excessive volatility in the price of hydrocarbons. In the weeks following Trump's decertification of the JCPOA, in fact, the possible exclusion of Iran, which ranks third in OPEC for oil exports, rose uncertainty and negatively impacted the price of the barrel, which reached about 71 dollars. To try to stem the upward shock, the US government has asked Saudi Arabia to increase its production for compensating the Iranian share. This request, however, seems more like an acceleration of the Trump Administration in view of the November 4th deadline, in order not to appear to be primarily responsible for the heavy price increase of crude oil, rather then a precise strategy able to ensure the long-term stability of the market.
First of all because, despite Riyadh’s cautious complacency, it is not certain so far that Saudi Arabia is actually able to compensate for any exclusion of Iran from the group of exporting countries. Regardless the proven reserves, amounting to just over 266 billion barrels, in fact, there are no certain data on the quantity of hydrocarbons still available (as the exploitation of wells in the country has been going on for more than sixty years) and their actual

availability. The Saudi Kingdom would have spare capacity (CPI) to increase the production to 1 million barrels per day, hence insufficient to place on the market those 2 million b/d needed to cover the demand currently met by Iran. With a crude oil production of around 10 million b/d, Riyadh could export no more than 11 million barrels per day. Even considering the data related to the production of condensates, the difficulties would not decrease: in fact, although the CPI related to this type of oil would theoretically allow to reach the highest possible level of production, that is 12 million b/d, reaching the threshold would put under stress the Saudi production system. Furthermore, the intensive exploitation of all Saudi reservoirs would further reduce the ability of hydrocarbon-producing countries to control the stability of the market. Thanks to their capability of flexibly modifying the offer of crude oil, OPEC members has always been able to address, or at least to influence, the international price of the barrel, thus manipulating the dynamics underpinning the stability of the market. However, this is possible only if the producing countries have reserves of resources and the possibility of exploiting them. In this sense, nibbling the Saudi spare capacity could trigger a panic effect, due to the perception that the slow process of depletion of exploitable resources to meet the future demand has started, with direct consequences on the unpredictability of the oil market. The reduction of reserves, from which to draw resources for guaranteeing a constant supply, in fact, would make the whole system much less flexible to sudden

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shocks or to the political risk of some producing countries (such as Libya or Venezuela) and it would have a price increase effect.

Furthermore, it can not be excluded that the rise in crude oil price could jeopardize, or further complicate, the White House's strategy against Iran. Although many big oil companies, especially European ones, have already announced they will stop imports of Iranian oil by November, it is quite likely that some of Teheran's oil-importing partners, such as energy-consuming China, are not willing to join the sanctions imposed by Washington. Therefore, Iran would still have revenues from the sale of oil, thus exporting at the international market price. This would mean that the eventual reduction of exports caused by the sanctions would be offset by an increase in the value of the barrel, as it would let Iranian government to benefit from the oil revenues.

To try to better manage the reactions of the market, the US Administration has considered the possibility of granting waivers for countries which depend on Iranian supplies the most. Third countries' alignment with Washington's requests represents the other big variable for the success of the White House strategy. Only a broader adherence of Iran's trading partners to oil sanctions could significantly affect the energy sector of the Islamic Republic.

In order to assure this compliance, the Trump Administration is counting on the secondary sanctions and on the consequences that the interdiction from the US economic and financial system would have for the industrial sector of

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other countries. Until now, the first accommodating answers have come from those countries that have always been allied with the United States, which have to balance the interest in keeping trade with Iran with the interest of preserving the stability of relations with Washington. Indeed, India, Japan and South Korea, key US allies in the Indian Ocean and the Pacific opened to the possibility of reducing oil imports so far. In particular, the three governments are trying to negotiate with the United States some waivers in exchange for a significant reduction in import quotas from Iran, without having to give up an important partnership for their energy supplies. In fact, for the three Asia markets Teheran is crucial: considering crude oil and condensates, in 2017 New Delhi, Tokyo and Seoul represented respectively 18%, 14% and 5% of the total exports of Iran. Their compliance with the request of the White House derives from two factors: firstly, from the impossibility for their Central Banks to handle payments for oil imports in dollars, for not violating US sanctions and for not facing the economic and financial consequences; secondly, from the desire not to create political fractures in the important relationship with Washington. For this reason, the three governments decided to negotiate with the United States a reshaping of their oil imports from Iran for safeguard their strategic interests without alienating the favor of the ally.

The consequences generated by the reintroduction of secondary sanctions inevitably complicate the position of Europe as well. Indeed, in a difficult moment for transatlantic relations, Brussels has to balance the interest

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in launching a strong political signal to the United States with the need to protect the businesses of European energy companies. As already mentioned, the European Union has not responded concretely to the US' unilateral choice yet and, then, it has not been able to provide European companies with certain ways to be protected from US sanctions. However, any delay in the development of a clear strategy could drastically reduce the effectiveness of Europe's choices on the issue.

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Because of EU uncertainty, European energy companies, which can not risk incurring sanctions because of their exposure to the US system, could take the initiative and withdraw from the Iranian market in advance, thus undermining any political efforts to preserve the JCPOA. It would not only reduce oil supplies, but it would impact also on investments in the hydrocarbon sector, which are important for Iran to improve the quality of exploration or refining technologies and to fully develop its potential. This is the case, for example, of the recent 5 billion dollar agreement signed by the French Total, the Chinese National Petroleum Corporation (CNPC) and the Iranian company Petropars (a subsidiary of the National Iranian Oil Company) for the exploitation of the offshore South Pars gas field. In the next twenty years this multinational cooperation should have led to the exploration of 5 wells, as well as the construction of the infrastructure necessary for the upstream phases, to process up to 2 billion cubic meters of gas per day. Despite the investment already made, the French company has announced its pulling out of the project unless any waivers from US sanctions will be secured.

A backing for Europe in trying to circumvent the problem of sanctions could be provided by China, which signed the nuclear agreement in 2015 and shares with Europe the will to safeguard the future of the pact with Iran. The Asian giant is the main recipient of Iranian oil and accounts for 24% of the Islamic Republic's exports of crude oil and condensates by itself. Although the Chinese government does not seem to have formalized a strategy yet to keep its trade with the Persian partner, China could try to use this opportunity for achieving significant results in the ongoing political and economic competition with the United States.

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First of all, the sanctioning transaction in dollars with Iran could pave the way for the Chinese authorities to propose the yuan as the reference currency, especially for the import-export of energy products. This would allow China not only to save currency conversion costs, but also to take a step forward in the internationalization of renminbi. Last March, the Chinese authorities had already launched yuan-denominated crude futures, traded in the Shanghai International Energy Exchange (Shanghai Stock Exchange), to try to create a new global price benchmark alongside the most famous Brent and WTI (West Texas Intermediate). Besides providing a price indicator for the crude oil qualities used by national refineries (which originate mainly from Iran and the Middle East), with the launch of yuan-denominated futures traded by foreign investors, China tried to carve out a role in determining the crude oil

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international prices. Despite the uncertainties related to the functioning of this market and the regulatory activity of the central authorities, a future stronger China's role in defining global price can't be excluded. The possibility of paying for oil supplies from Iran in renminbi could give an important acceleration in this direction.

This options is becoming more and more interest for the Rouhani government, as it would allow Tehran to preserve the oil trade with the Asian giant and, at the same time, show other partners the possible roads to follow to ensure sustainability of the JCPOA in the near future. At a time when the European Union seems stiffened by its bureaucracy and its decision-making procedures, the Iranian authorities are looking at Beijing as an interlocutor which, by pursuing its own strategic interests, can counterbalance the US political choices and the related international consequences. The recent visit in China of the Iranian Supreme Leader's strategic advisor, Ali Akbar Velayati, just before the twentieth Eu-China Summit, could only be the last example of the Iranian attempt to make the Chinese government take a step forward in this direction. However, although the Iranian issue may become a test for China's strategy of creating a new international order, the success of any effort dedicated to save the JCPOA will be on the EU and on its determination to take decisions that could call into question the traditional political convergence with US. Despite the fact that Europe still considers the alliance with Washington essential, some political choices implemented by the Trump

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Administration (such as tariffs on key sectors for the European economy or the rhetoric used inside NATO) could convince Brussels to adopt a more pragmatic attitude in dossiers of its own interest, like the protection of European businesses within the JCPOA framework. This would ease a real dialogue between the EU and China on how to join efforts for creating alternative instruments to be used in trade with Iran and thus trying to reduce the effects of US secondary sanctions on European and Chinese economic actors.