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BACKGROUNDER

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IRANIAN EFFORTS TO BYPASS OIL SANCTIONS

International sanctions have made it more difficult for Iran to export oil, which is the major source of funding for the Iranian regime, but the sanctions have not significantly reduced exports. This backgrounder addresses some of the ways Iran is bypassing sanctions—specifically, how and to whom Iran can still sell its oil, alternative methods for processing payments for oil, and how it can transport oil to its customers. A future backgrounder will address specific policy recommendations for increasing the effectiveness of sanctions.

WHAT ARE THE SANCTIONS AND HOW DO THEY WORK?

Sanctions against the Iranian regime cover imports and exports of military equipment, material and supplies that could be used in the Iranian nuclear program, business dealings with the Iranian Revolutionary Guard Corps, and other Iranian entities. These sanctions originate from various multinational organizations, including the United Nations and the European Union, as well as individual nations. This backgrounder focuses primarily on U.S. sanctions against the trade in Iranian oil, specifically, the Iranian Transactions Regulations as defined by the U.S. Department of the Treasury's Office of Foreign Assets Control.[1] These sanctions are intended to reduce funding to the Iranian nuclear program, and while they are unilaterally imposed by the U.S. government, they represent the foundation of the international sanctions against the Iranian oil trade, primarily because the vast majority of the international oil trade is denominated in U.S. dollars.[2] Because the majority of international oil trade is denominated in dollars, the U.S. government can unilaterally impose sanctions that restrict the use of the dollar in trading Iranian oil. Whether an individual country such as India wants to comply with the sanctions against Iranian oil is irrelevant when it comes to completing the purchase of Iranian oil using dollars. The U.S. government regulations make it virtually impossible for India, or any other country, to use dollars to purchase Iranian oil.[3]

The U.S. Department of Treasury's Office of Foreign Assets Control administers the American sanctions against Iran; this agency has implemented a wide array of sanctions over the last few decades. The U.S. has had some version of economic sanctions against the Iranian regime continuously in effect since President Jimmy Carter signed Executive Order 12170 in November of 1979.[4] The current set of sanctions against the Iranian oil trade has gradually increased in intensity since December of 2011 with full implementation scheduled for July of 2012.[5] For all practical purposes, most international financial institutions are already in full compliance to ensure they do not run any risk of being identified by the Department of Treasury as being in non-compliance.

HOW DID IRANIAN OIL GET TO MARKET BEFORE THE SANCTIONS?

Prior to sanctions taking effect, international oil markets treated Iranian crude oil production in a similar manner to other crude oil production coming out of the Persian Gulf. Customers either contracted in advance for a specific amount of crude or bought it on the spot market; international shipping companies contracted with customers to carry the crude from origin to destination; and maritime insurance agencies wrote coverage for both the ships and the cargo.[6]

Although several Iranian ports can handle import and export of both crude and refined petroleum products, the primary port for Iranian oil exports is Kharg Island, located approximately twenty miles off the Iranian shoreline in the northwest Persian Gulf. Kharg Island offers multiple advantages making it an ideal export facility: it is located in relatively deep water; the approach and departure corridors are well marked and don't require any crossing traffic separation schemes; and multiple ships, including the largest supertankers, can dock simultaneously. As a result, Iranian oil exports have consolidated at Kharg Island, which now processes 98 percent of Iranian oil exports.[7]

According to the National Iranian Oil Company (NIOC), an increase in storage capacity at Kharg Island was completed in March 2012. Following the expansion, the NIOC facilities at Kharg Island can now store twenty-two million barrels of oil, which represents about ten days' worth of Iranian oil production, with a planned future expansion to thirty days' worth of Iranian oil production. In accordance with Iran's strategic approach to military and industrial self-sufficiency, the financing and construction of the expansion was completed using domestic financing, construction companies, and labor.[8]

From a perspective of technical and economic efficiency, having one large and consolidated petroleum export complex at Kharg Island is advantageous to the Iranian regime. From a strategic perspective, it leaves the Iranian oil industry dependent on a single point of failure approach to exporting oil. Since Kharg Island is inside the Persian Gulf and all oil exported through Kharg Island goes through the Straits of Hormuz, any effort Iran makes to close the Straits of Hormuz would also shut off its oil exports and revenues.

WHERE WAS IRANIAN OIL GOING BEFORE THE SANCTIONS?

According to the U.S. Energy Information Administration (EIA), the statistical and analytical division within the US Department of Energy (DOE), Iranian oil was exported to the following countries in 2011.[9]

COUNTRY	% OF IRANIAN OIL EXPORT
CHINA	22%
EU.	18%
JAPAN	14%
INDIA	13%
SOUTH KOREA	10%
TURKEY	7%
SOUTH AFRICA	4%
SRI LANKA	2%
TAIWAN	1%
OTHERS: PAKISTAN, MALAYSIA, INDONESIA, SINGAPORE	9%

EUROPEAN UNION SANCTIONS AND COMPLIANCE

EU sanctions against Iran are similar to U.S. sanctions in that they make it difficult for any financial institution to process electronic transactions with Iranian banks in support of the oil trade. In the same way that U.S. sanctions have made it difficult to process Iranian oil transactions in dollars, EU sanctions have made it very difficult to process Iranian oil transactions in euros. Additionally, the Belgium-based Society for Worldwide Interbank Financial Telecommunications (SWIFT) announced on March 15, 2012, that it would discontinue all financial messaging and data transaction services to Iranian entities involved in the oil trade.[10] This imposes an additional level of difficulty for institutions that want to process Iranian oil transactions in currencies other than dollars or euros – by doing so, these institutions face the prospect of losing messaging and data transaction services. As a result, most users of SWIFT services have discontinued servicing any transactions related to the Iranian oil trade, regardless of what currency it is denominated in. [11]

While financial institutions in the EU have complied with the sanctions, numerous individual countries have expressed reservations about the sanctions. Pedro Antonio Villena Perez, the Spanish ambassador to Iran, remarked, "Spain is suffering the greatest damage from the embargoes against Iran and has always expressed support for the resumption of talks." [12]

Although it is currently in compliance with the sanctions, Greece has repeatedly advocated for a longer time period to phase in full sanctions and to limit the sanctions overall. Iran has traditionally provided oil to Greece on highly favorable terms, with a sixty-day grace period from delivery of oil to payment being due. With the ongoing Greek financial crisis, this favorable trading scheme has taken on even greater importance.[13]

Finally, Asian shipping companies are lobbying EU officials to provide exemptions to European insurers to allow them to continue insuring tankers heading from Iran to China, Japan, South Korea, and India. These purchasers maintain that since they are buying the Iranian oil anyway using local currencies or barter, and are not using EU financial institutions to process payments, there is no reason the EU-based insurers should be barred from insuring the tankers carrying Iranian cargo.[14]

While it is unlikely that the EU will grant exceptions to the sanctions in the short term, the fact that individual EU member countries and Asian shipping companies are asking for exemptions before the sanctions officially take full effect in July 2012 is indicative of how difficult it will be for these countries and companies to comply with the sanctions in the long term.

It appears that the EU as a whole, while currently enforcing sanctions, is not as committed to the sanctions as the U.S. is. Enforcing sanctions is much more costly for the EU

than for the U.S. Several EU nations have been importing Iranian oil, while the U.S. imports no Iranian oil. Several EU-based insurance companies and shipping firms were profitably participating in the Iranian oil trade, but no companies in the U.S. were. At a minimum, the EU incurs substantial economic costs to comply with the sanctions the U.S. does not. According to the European Commission and International Monetary Fund, commerce between Iran and the EU was thirteen billion euros in non-oil trade alone for 2010.[15]

WHERE WILL IRANIAN OIL GO AFTER SANCTIONS TAKE FULL EFFECT?

Chinese Foreign Ministry spokesman Hong Lei indicated in public statements that Chinese importation of Iranian oil was not in conflict with any United Nations resolutions and that China had no plans to comply with unilateral resolutions from the United States or the European Union.[16] China may yet choose to comply with sanctions or slightly reduce imports of Iranian oil, but for now, it appears to be finding ways to bypass the sanctions.

India has also made it clear that it intends to continue importing Iranian oil, with a variety of creative financing solutions to bypass the ban on dollar-denominated transactions, including processing payments in rupees. India Finance Minister Pranab Mukherjee said he will allow for a tax exemption on rupee payments made to Iranian oil companies.[17] India is also floating the idea of paying for Iranian oil via a barter system that includes commodities such as wheat and soybean meal or consumer electronic goods.[18]

Pakistan recently agreed to export one million tons of wheat to Iran in a barter deal, with a return payment from Iran possibly in iron ore or fertilizer.[19] As the barter market between Iran and Pakistan develops, the barter system could be extended to oil as well.

Turkey agreed to cut its imports of oil from Iran, but only by ten percent and only after the current contracts run out in July.[20] Turkey appears to be resisting pressure to decrease oil imports from Iran any further.

Japan and South Korea have indicated they will reduce their import of Iranian oil, by approximately fifteen percent.[21] This appears to be the minimum amount they could reduce imports and still comply with U.S. sanctions.

China, India, Pakistan, and Turkey have all indicated that they will work around the sanctions. Japan and South Korea have indicated they will reduce, but not halt, their import of Iranian oil. Both the U.S. and the EU have taken the approach of gradually intensifying the sanctions over time, with the U.S. leading. As sanctions increase in scope and intensity, China, India, Pakistan, Turkey, Japan, South Korea and other importers of Iranian oil may decrease their purchases further, but this is by no means assured. Given the energy demands of these states, there will be a market for Iranian oil for the foreseeable future, even with the sanctions.

SHORT-TERM IMPACT OF SANCTIONS

In the short term, the most obvious impact of sanctions is that it has become more difficult for the Iranian financial authorities to process oil-related transactions that are denominated in dollars. The alternate methods of accepting payment, either in local currencies, via barter for commodities, or in gold, are less efficient than processing payments electronically via U.S. dollars. Fundamentally, however, the sanctions have not prevented the Iranian regime from exporting oil. The sanctions have made it more difficult and added a layer of transactional complexity and cost, but they have only marginally decreased the volume of Iranian oil exports.

As the various provisions of the Iran Transactions Regulations sanctions have taken effect, Iranian crude exports have been reduced somewhat. According to Geneva-based oil industry consultants Petrologistics, Iranian exports for March 2012 were reduced by about 300,000 barrels per day, or fourteen percent of capacity, as compared to exports for February 2012.[22] Although this does represent a reduction in oil exports, the corresponding rise in oil price over the same time period may have resulted in Iran shipping less oil but at a higher price and without a significant decrease in revenues.

The sanctions have had the greatest impact on the shipping industry, as large Western insurers have started to reduce their coverage on tankers moving Iranian oil. The EU has given insurers until July 2012 to fully comply. Large, established, multinational shipping companies will refuse to accept Iranian crude as insurers stop providing coverage.[23] Thus, the only immediately viable option for shipping Iranian crude will be Iranian state-controlled shipping companies.

In terms of the Iranian domestic economy, the sanctions have had a substantial impact. The official inflation rate has climbed to over twenty-one percent; the value of the Iranian currency, the rial, has fallen to an all-time low as measured against the dollar and the euro, making imported

goods much more expensive, and the standard of living for average Iranian consumers has fallen dramatically.[24] These negative impacts on the domestic Iranian economy, while substantial, appear to have little impact on the ability or willingness of the Iranian regime to continue using revenue from oil exports to finance the Iranian military industrial complex, including the Iranian nuclear program.

NATIONAL IRANIAN TANKER COMPANY (NITC)

NITC is the primary shipping company that transports crude and refined petroleum products and liquefied natural gas to and from Iran. NITC has approximately thirty-nine crude oil tankers ranging in capacity from 98,000 tons to 318,000 tons. Total carrying capacity of the NITC fleet is 9.8 million tons.[25] To put that in context, this represents approximately thirty-two days of total Iranian production capacity.

In response to other sanctions that have been in place since the Iranian revolution of 1979, which restricted Iran's ability to import most weapon systems and military equipment, Iran has sought to become self-sufficient in its military industrial complex. This is a strategic effort which has been underway for decades, and in 2010, Iranian Minister of Defense Ahmad Vahidi declared that Iran was entirely self-sufficient in military equipment and weapons, as well as electronic, radar, and optical projects.[26] In accordance with the Iranian effort to be self-sufficient in its military and industrial capability, the Iranian regime has pursued self-sufficiency in shipping, and the regime has devoted significant resources towards increasing the size of NITC. Like many state-chartered enterprises in Iran, NITC is fully controlled by the state, but the exact terms of ownership are opaque. In 2009, NITC undertook changes to its ownership structure. In its current form, it advertises itself as a private company owned by Iranian pension funds. [27]

While the exact ownership structure of NITC cannot be verified, it is clear that there are close ties between NITC and the Iranian regime. NITC has long been suspected of having ownership ties with the Iranian Revolutionary Guards, and has repeatedly denied the alleged connections.[28] From 1985 until January 2012, NITC was led by an essentially apolitical business executive, Mohammad Souri. Under his leadership, NITC gained a reputation for being a professional and environmentally conscious shipping line. This exceptional performance was recognized in December of 2011 at the Lloyd's List Awards in Dubai where NITC received the Tanker Operator of the Year award. "This is yet further recognition that NITC is dedicated to the carriage of crude oil cargoes for the international community in a safe, efficient and environmentally friendly manner and that will continue to be the measure of our future operations," Souri said. [29]

As evidence of the close connection between the Iranian regime and NITC, Souri was replaced in January 2012 as head of NITC. The new head of NITC is Hamid Behbahani, former transportation minister of Iran and adviser to Iranian President Mahmoud Ahmadinejad.[30]

Regardless of its exact ownership structure, NITC is a fully functioning crude oil tanker company equipped with modern ships and controlled by the Iranian government. Given that numerous international shipping companies have abandoned the Iranian oil trade due to sanctions, the question of how much of Iran's oil production NITC can transport is of paramount importance. The London-based shipping information service Lloyd's List reports that in 2011, NITC transported fifty-three million tons of crude oil to market.[31] Using a conversion factor of 7.3 barrels per ton, NITC transported about 387 million barrels of Iranian crude oil to market, or just under half of Iran's current crude oil production.[32]

While NITC cannot currently move all of Iran's oil to market, based on last year's performance, NITC can move about half of Iranian oil production to market. Beyond the thirty-nine oil tankers currently in commission, NITC has an additional twenty-two tankers on order.[33]

As those ships enter the NITC fleet, the ability of the Iranian regime to transport its own oil will increase. Iran is essentially self-sufficient in military equipment and weapons production; the regime appears to have extended that strategy to ship-building as well. In August 2009, Ahmadinejad announced that all Iranian shipping companies and maritime organizations would be required to place future ship purchases through Iranian shipyards. [34]In a related address in 2010, Iranian Minister of Commerce Mehdi Qazanfar stated that Iran is now self-sufficient in building its own vessels, including oil tankers.[35]

Given that Iranian shipbuilder Iran Marine Industrial Company is currently under contract to deliver four Aframax tankers of approximately 125,000 tons each to Venezuela, with the first delivery scheduled for September 2012, Iran's pledge to be self-sufficient in all commercial shipbuilding, including tankers, appears viable. [36]

Aside from NITC's ability to transport Iranian crude, other shippers operating outside of the formal, Western-based financial and insurance systems have indicated a willingness to participate in the transport of Iranian crude. The Indian Oil Company asked the Iranian National Iranian Oil Company (NIOC) to provide insurance to shippers handling Iranian crude bound for India, and NIOC agreed to consider this on a case-by-case basis. If Iran agrees to provide insurance to ships bound for India, independent shippers may be able to bypass the Western maritime insurance industry and insure directly through the Iranian regime.[37]

A number of other options exist to bypass sanctions. Indian companies and the Indian government have invested substantially in expanding the Iranian port of Chah Bahar, located outside of the Straits of Hormuz near the Iranian Pakistani border. This port is now being used for the import and export of dry goods, grains, and raw materials. India has stated long-range plans include building a railway from Chah Bahar to southern Afghanistan to access raw materials there. [38]

While Chah Bahar does not have the oil facilities that Kharg Island does, NITC could self-insure and transport oil from Kharg Island to Chah Bahar, then offload it directly to an Indian tanker for transport to India. While no such activity at Chah Bahar has been observed yet, India is committed both economically and strategically to the success of Chah Bahar as a commercial port. It is certainly feasible for NITC ships to take Iranian crude from Kharg Island to Chah Bahar and offload it there to another ship operating under an Indian or other flag. While this form of lighterage would represent yet another layer of complexity, friction, and cost to the Iranian crude oil trade, it is a technically feasible workaround. The Shipping Corporation of India, a Government of India Enterprise, has a dedicated "lighterage cell" in its tanker division that specializes in ship to ship lighterage operations. This would be well within its technical capacity.[39]

Other workarounds to avoid the sanctions include Chinese shipping companies self-insuring ships and cargo for the Iranian crude trade. A number of Chinese officials have mentioned this as a possibility.[40] Though the sanctions have not fully taken effect, a significant number of customers are already trying to bypass them.

CONCLUSION

The sanctions against the Iranian oil trade will add complexity, friction, and cost to the sale of Iranian oil. As a result, the domestic Iranian economy will suffer, with higher inflation, lower purchasing power for imported goods, and the ongoing devaluation of the Iranian currency. Given that NITC and NIOC can work around the sanctions, self-insuring and transporting a certain baseline amount of Iranian crude production, the Iranian regime itself will continue to receive enough funds to maintain the military industrial complex and armed forces. Considering the size of the NITC fleet and the alternative payment approaches the Iranian regime is accepting, as well as non-traditional shipping methods India and China are considering, it appears for at least the next several months that the sanctions will not significantly diminish Iranian exports of crude oil. Additionally, the recent rise in oil prices means that even if sanctions reduce the amount of oil Iran can get to market, the regime may still get a higher price for it, so the higher price for the oil that does get to market may offset the financial impact of reduced export volume. As of April 2012, the sanctions do not appear to be having a consequential effect on the ability of the Iranian regime to produce and ship oil to its customers.

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NOTES

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