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An Embargo on Iranian Crude Oil Exports: How Likely and with What Impact?

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Introduction

The final decision on an EU embargo on oil exports from Iran is expected on 30 January but as yet no details have emerged. This paper considers the possible outcomes of such an embargo, assuming it is imposed.

The initial impact is that the EU countries will have to find alternative supplies to replace their imports of heavy, sour crude from Iran. The exact numbers are uncertain. According to OPEC, in 2010 Iran exported 890,000 barrels per day (b/d) to Europe, while the more detailed figures for 2008 suggest that Italy, Spain, Greece and France imported 500,000 b/d. Also the precise terms of the embargo have not yet been decided and this could be very important in terms of levels of effective compliance. This hunt for alternative supplies will create transitional friction for oil prices. Thus prices for heavy source crude in the Atlantic basin markets would increase and in Asia-Pacific they would decrease as Iran tried to find alternative outlets for the crude originally destined for European markets. In general such transitional friction is more likely to lead to higher than to lower oil prices, at least for a few months. How great this transitional friction will be depends upon how quickly the embargo takes effect and whether there are exceptions. It seems likely that the embargo would have to allow existing contracts to expire. Most such contracts are for at least one month, if not longer. Some EU members will also seek exceptions. For example, Italy has insisted that any embargo should exclude oil being lifted to cover Iran’s $2 billion debt to ENI. Given that Greece depends for over one-third of its imports from Iran on very favourable financial terms, they too will require wriggle room. This hunt for alternative supplies also comes on top of the EU’s existing ban on imports from Syria of

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1 It appears from press reports that the EU has reached an agreement to impose an embargo and EU foreign ministers have set 23 January as a deadline to consider exceptions.

2 Of the total exports of 2.58 million b/d in 2010, 134,000 b/d went to Africa and 1.57 million b/d to Asia-Pacific.

3 For example, would the embargo just be against crude loaded at Kharg Island, given that Iran ships and stores considerable amounts of crude in Egypt? It would also be feasible to send crude to Turkey where it could be refined and the products could then be sent on to Europe where their origin would be obscured. Various other crude swaps could also be used to disguise the origin of the crude. As explained later, it is for these reasons that since 1951, oil embargoes have invariably failed to deliver on their objectives.

4 While the EU agreed an import ban on Syrian oil in September, full implementation was delayed until mid-November as a result of pressure from Italy, which was heavily dependent on Syrian imports. A similar tale is likely to emerge with an Iranian embargo. Also the EU could allow a phasing-in period, following the US lead on financial sanctions, which allowed a six-month period for them to take effect. However, in the absence of greater detail, such possibilities simply add to the uncertainty over prices over the next few weeks.

5 There are already signs in terms of crude price differentials that this transitional friction has begun, as oil importers try to move away from Iranian crude and seek alternative supplies of heavy sour crude.
some 150,000 b/d, imposed in September but not fully implemented until mid-November.

Who might be willing and able to replace Iranian crude?

This period of transitional friction over prices will also depend upon who else is willing to supply. Libya is coming back on-stream much faster than most expected. By early December, the BBC reported that the National Oil Company had claimed production had reached 840,000 b/d and was expected to be back to pre-war levels by the end of 2012, although many regard this as very optimistic. However, Libyan crude is light and sweet while the current Iranian imports to Europe are heavy and sour, and this may create a temporary differentials impact. This will be aggravated by the Syrian embargo that also involved heavy sour crude.

The obvious source of replacement will be the main Gulf Cooperation Council (GCC) countries, which have significant amounts of spare capacity to produce heavy sour crude: at the end of 2011 this amounted to 2.29 million b/d from Saudi Arabia; 220,000 b/d from the UAE and 200,000 b/d from Kuwait. While these states have the ability to replace Iranian crude in Europe, allowing for logistical delays, their willingness may not be all that obvious. officially, Saudi Arabia has publicly stated it will stand ready to replace Iranian crude. However, if it did take some of Iran’s market share, this would be viewed by Tehran as an extremely hostile act. On 12 December, two days before the OPEC meeting in Vienna, Crown Prince Naif (who is also Minister of the Interior responsible for security) and the Iranian Minister of Intelligence and Security, Haydar Moslehi, met in Riyadh. The outcome of this meeting between the effective intelligence chiefs of the two countries is not known. The Saudi Press Agency, reporting the meeting, simply stated that they ‘reviewed a number of issues of common concern’. However, at the OPEC meeting on 14 December, two days later, agreement was reached very quickly and with little acrimony on maintaining OPEC output at 30 million b/d. Observers noted that the Iranian delegation seemed ‘somewhat subdued’. This could imply some sort of back-room deal whereby Saudi Arabia would not rush to fill the gap in return for Iranian support in OPEC. After all, the Al Saud have to live in the region at a time when their attitude to Washington is

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6 There is a further complication. If Saudi crude replaces Iranian crude and Iran cannot export all it wishes because the embargo actually works, this would reduce the amount of spare crude producing capacity in the system. Given other threats to supply (see footnote 8) this would make the markets extremely nervous, almost certainly putting an increasing premium on the oil price.
tinged with deep suspicion following the United States’ ditching of Mubarak with what was seen in Riyadh as indecent haste.\(^7\)

In the meantime, Iran must find alternative buyers for the crude displaced from Europe. Oil exports account for over 80 per cent of hard currency earnings and over 50 per cent of central government revenues. Iran’s obvious choice would be to sell in Asia although it would mean offering more favourable terms. This would compound the ‘transitional friction’ for oil prices arising from the EU embargo. Again the impact and duration of this friction would depend upon what other measures might be taken by the United States and the EU. For example, given the current situation in North Korea, both South Korea (imports from Iran 230,000 b/d) and Japan (520,000 b/d) are extremely vulnerable to American pressure to join any embargo against Iranian crude. Japan has recently been actively seeking ways to reduce imports from Iran.

Looking further afield, the prospect of a UN-wide embargo is extremely unlikely.\(^8\) The other two major importers – China (430,000 b/d in 2008) and India (410,000 b/d in 2008) are less likely to halt Iranian imports. Given they are both on the UN Security Council, any UN resolution to embargo Iranian oil would almost certainly fail. Russia has also indicated on a number of occasions since 7 December that it would oppose any UN ban on the grounds that it would be driven by ‘political motivations and these should not be used in the context of energy exports’. This is an important political point for Russia, which is seeking to improve its reputation as an energy supplier. However, there are signs that Asian importers are looking less favourably on Iran. This January it appears China has reduced its lifting of Iranian crude by almost 50 per cent – largely, it appears, because of disputes over pricing.\(^9\) This suggests that Iran will have to offer significant discounts on its crude, which will reduce revenues. However, while the price remains above $100 per barrel, this is unlikely to be a serious financial problem for Iran.\(^10\)

\(^7\) The Saudi press announced on 9 January that the Saudi Council of Ministers reviewed global oil market developments and reiterated Saudi Arabia’s commitment to ensure international market stability in terms of balancing demand and supply and prices. The cabinet, chaired by King Abdullah, said the kingdom viewed oil embargoes imposed by certain countries (on Iran) as their internal matters. It also stressed that the kingdom’s oil sales are done purely on a commercial basis through deals reached by Saudi oil companies and foreign firms that purchase Saudi oil. The implication is that Saudi Arabia may not come to the rescue of countries looking to replace Iranian crude.

\(^8\) A UN-wide embargo would have raised the possibility of a blockade against Iranian crude via the Strait of Hormuz, as opposed to an embargo, although this would almost certainly provoke an attempt by Iran to block exports by other Gulf states.

\(^9\) However, it is quite likely that China is in fact repositioning itself over anticipated discount negotiations with Iran in the event of a UN embargo.

\(^10\) Given the possible impacts of an embargo on oil prices (see footnote 5), any such discount could be from higher oil prices, ultimately increasing Iranian oil revenues.
Thus the transitional friction over oil prices is unlikely to be significant.\textsuperscript{11} The world oil market is ‘one big pool’ and crude price differentials quickly even themselves out through a process of arbitrage. There are also signs that the market has already discounted a formal announcement of an EU oil embargo and incorporated it into its view of prices.\textsuperscript{12}

**How might Iran react to an EU embargo on oil?**

So far the analysis has assumed that Iran simply accepts the EU embargo without retaliation. This is extremely unlikely and it is necessary to consider what options Iran might have. Recently there has been much speculation, encouraged by some but not all elements in the Iranian power structure that its response would be to inhibit the flow of oil through the Strait of Hormuz. But any attempt to interfere with transit through Hormuz would in its turn provoke a response that would eventually be sufficient to keep the Strait open.\textsuperscript{13} This response, if transit were seriously threatened, would rapidly degenerate into a shooting war between Iran and the United States, the latter supported by many of its allies.\textsuperscript{14}

There are two reasons why a serious attempt by Iran the close the Strait is unlikely. First, any closure would equally damage Iran’s ability to export the oil on which its economy is so dependent. Second, serious and credible attempts to close the Strait are in effect Iran’s ‘big guns’ on the issue of whether or not the United States (or Israel) would launch a military attack on Iran. The threat to close Hormuz does act as a major deterrent against a military strike. This is not necessarily because Iran could close the Strait: a military confrontation with the United States could have only one outcome, which is that the oil would eventually continue to flow.\textsuperscript{15} Limiting the flow of oil through Hormuz would be an existential threat to the global economy and quite simply could

\textsuperscript{11} There are other equally important geo-political issues that will cause price volatility into 2012, including the deteriorating situation in Iraq and Nigeria; all would put upward pressure on prices.

\textsuperscript{12} This discounting of information refers to the announcement of an embargo, not the consequences.

\textsuperscript{13} Physically blocking the Strait of Hormuz (for example by sinking tankers) would be impossible given that it is wider and deeper than the English Channel – the actual operational navigation channels are effectively 8 miles wide. The only closure option would be detonation of an extremely dirty nuclear device there. This would of course block it for users for a very long time.

\textsuperscript{14} If this were to happen in the context of Hormuz, it could well provide an opportunity for the US and/or Israel to attack the Iranian nuclear installations. It is a frightening thought that the West could end up in a major war with Iran by accident or miscalculation.

\textsuperscript{15} The key word here is ‘eventually’. The timeframe would be unknown. However, the IEA has the technical capability to put significant amounts of oil into the market from emergency stocks. Figures being reported in the press (but supplied by the IEA) suggest 14 million b/d could be sustained for at least a month, although this is almost certainly an overstatement. Currently some 17 million b/d pass through Hormuz (roughly 32 per cent of global oil exports) and there is roughly 8 million b/d of pipeline capacity bypassing Hormuz, although the 1.65 million b/d line from Abu Dhabi has now been delayed until later in 2012.
not be allowed. This was clearly demonstrated by the Tanker War after 1984 during the Iraq–Iran war. However, the announcement by Iran of a clear and unequivocal intention to close the Strait, backed up by some form of credible action, would cause the oil price to spike to very high levels.\textsuperscript{16} This would have serious global economic consequences, especially given the current very uncertain prospects for the eurozone and global economic recovery.\textsuperscript{17} As such, this is a very powerful card that Iran is unlikely to play early in the game.\textsuperscript{18}

However, Iran has other retaliation options. It could begin to aggravate upward pressures on oil prices by contributing to the growing instability in Iraq that has emerged since the US completed its troop withdrawal and the Shi’a ruling clique has begun a \textit{de facto} war of attrition against the Sunnis. This could certainly cause problems with Iraqi oil exports. It could also make serious trouble for NATO in Afghanistan. It could also put huge pressure on the GCC exporters to be, at the very least, slow in offering replacements to Europe. At worst it could even threaten GCC export facilities. For example, the Abqaiq processing facility in Saudi Arabia, well within Iranian missile range, processes 5 to 6 million b/d. Some form of retaliatory action against the EU countries of the sort seen when the UK extended its sanctions to financing issues could also be expected.\textsuperscript{19} There could even be a Lockerbie-type response prompted by elements from within Iran.

**How might the oil markets react?**

So far the analysis has also assumed that the paper barrel markets behave in a rational manner in the event of an EU embargo being formalized. This is always difficult to predict. The ‘money managers’ who are the key players in the paper markets are notorious for misreading what is happening in the wet barrel market.\textsuperscript{20} It seems likely that they have already discounted the formalization of the embargo expected at the end of January despite recent Iranian sabre-rattling. Therefore much will depend on how they react to any subsequent Iranian response. Provided this response does not involve credible threats to the passage of oil through Hormuz, it is quite possible the

\textsuperscript{16} In one sense the ‘threat’ has already been used but so far at least has not been judged to be serious by the paper markets, hence the need for ‘some form of credible action’.

\textsuperscript{17} In addition to oil, some 83.7 billion cubic metres of liquefied natural gas (LNG) passed through the Strait in 2010 – some 28 per cent of global LNG exports

\textsuperscript{18} Those controlling these events in Iran are both rational and calculating on such matters. Ahmadinejad, who might be expected to be more cavalier, is marginalized on such issues within the Iranian power structure.

\textsuperscript{19} The British embassy in Tehran was sacked and looted and some of the staff were threatened.
market may not respond very much. More subtle responses of the sort discussed above may well go unnoticed.

Conclusions

History has shown that since the Iranian nationalization of 1951 and the events leading to the overthrow of Dr Mossadegh in 1953, oil embargoes simply do not work. The international oil market is too complex, with too many players and too many options, to disguise transactions. History is littered with failed oil embargoes ranging from Cuba, Rhodesia and South Africa to the Arab oil embargo and the embargo against Iraq after 1990.

However, history appears to have passed by the decision-makers of the EU. It is also worth pointing out that an EU oil embargo would greatly strengthen the Ahmadinejad regime at a time when it is under considerable pressure, especially with parliamentary elections looming in March. Unemployment remains very high, as does inflation. The latter has been greatly aggravated by the removal of many price subsidies in the last twelve months. Moreover, in the last few weeks the value of the Iranian rial against the dollar has fallen dramatically (at one point reaching a devaluation of over 30 per cent, before recovering somewhat). This has damaged the credibility of the government and will fairly quickly aggravate the problem of inflation. Given the crucial role of oil in Iran’s deepest political DNA, an EU embargo would put the population solidly behind the current regime.

A more effective means of putting pressure on Iran would be for the United States to persuade the EU to extend sanctions to financial transactions. At the start of 2012, the US passed legislation imposing sanctions against any financial transactions undertaken with the Central Bank of Iran.

Such legislation, despite the fact it has the option to allow waivers, is likely to be more effective in restricting Iranian oil exports than a simple oil export embargo. Financing oil transactions is complex and requires access to credit. Without that access, selling oil in any quantity is extremely difficult, as Iran is already discovering.

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21 Following the nationalization of the Anglo-Iranian Oil Company in 1951, the governments of the UK, United States and France were able to effectively block sales of Iranian crude to third parties under threat of legal action. The legal basis of this threat was very dubious but effectively never tested. However, the oil market of 1951 was very different from the market that developed after the 1960s.
22 It is perhaps worth pointing out that the US oil embargo against Japan imposed in July 1941 was one of the causes of the attack on Pearl Harbor in December of the same year.
23 To some extent the devaluation is probably welcomed by the Iranian authorities, given that a very over-valued rial has been inhibiting non-oil exports.
24 Such legislation, despite the fact it has the option to allow waivers, is likely to be more effective in restricting Iranian oil exports than a simple oil export embargo. Financing oil transactions is complex and requires access to credit. Without that access, selling oil in any quantity is extremely difficult, as Iran is already discovering.
Iranian economy than the US sanctions since the passing of the Iran Libya Sanctions Act (ILSA) in 1996. However, the financial embargo route to restrain oil revenues also presents problems. It is possible that importers of Iranian oil could resort to barter, thereby avoiding using the normal financial instruments. This is clearly an option for China. There are also other financial routes such as using the banks within the UAE to disguise any financial trail. While no route to restricting Iranian oil revenues is perfect, at least financial sanctions will not provoke the same high level of popular backlash from the Iranian public as an embargo, which would be perceived as a direct threat to Iranian oil – although both measures would be seen as an attack on Iran. Despite the problems with financial sanctions, at least they offer some possibility of pressuring Iran in a way that a simple oil embargo cannot. An oil embargo alone cannot succeed.

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