FLAG DAY: A demonstrator during a ceremony to mark the 33rd anniversary of the Islamic Revolution, in Tehran's Azadi square February 11, 2012. **REUTERS/CAREN FIROUZ**

As U.S. and European diplomats imposed tougher sanctions on Iran, they feared triggering an oil price spike

Behind the sanctions on Iran

BY ARSHAD MOHAMMED, JUSTYNA PAWLAK AND WARREN STROBEL

WASHINGTON, DECEMBER 28, 2012

In his first week as U.S. president, Barack Obama told Iran's leaders he would extend a hand if they would "unclench their fist" and persuade the West they weren't trying to build a nuclear bomb.

So far, they have not. In response, the United States and the European Union this year took a step they had long resisted, imposing trade sanctions to choke off Iran's life blood: oil revenue.

It was financial warfare, and it carried grave risks. Until recently, Iran was the world's fourth largest exporter of oil, providing just under three percent of internationally traded supply. The campaign to take that oil off the market risked driving up world oil prices, disrupting the international payments system and

stifling a fragile global economic recovery.

In interviews, senior U.S. and European officials described the intense diplomatic maneuvering they undertook to enact the sanctions without causing an oil shock.

Obama warned allies that oil sanctions were the only way to avert a new war between Israel and Iran. U.S. envoys pressed Iraqi, Libyan and, above all, Saudi officials to pump up their own crude supplies. Washington and its allies massaged skittish oil markets with carefully calibrated messages. U.S. diplomats journeyed to southern Iraq to inspect plans for new oil terminals that could help blunt the loss of Iranian shipments.

The challenge, American officials said, was to clamp down on Iran's oil exports while mitigating the risks of an oil crisis.

"That is the needle we were trying to thread," said a senior Obama administration official. "It was always a roll of the dice because we didn't know what the reaction was going to be."

In one sense, the calculated gamble paid off. Iran is losing billions of dollars in revenue every month and its currency has been crippled by both the sanctions and its own mismanagement. Its oil exports have fallen by 55 percent this year, according to the U.S. Treasury. Other producers have offset losses and the global oil price has actually fallen.

But there's no evidence yet the pressure has had its desired effect: to convince Iran to stop spinning the centrifuges to enrich uranium that could be used in a nuclear bomb.

DECADES OF BAD BLOOD

U.S. sanctions on Iran are as old as the 33-year-long enmity between the two governments.

Tehran insists that its nuclear program is peaceful and that sanctions are unjustified. But in 2007, as questions about Iran's nuclear program grew, the Treasury Department under President George W. Bush deployed a new strategy: blacklisting Iranian banks one by one, forcing foreign banks to decide whether to do business with Iran or the vastly larger U.S. economy.

DIFFICULT BALANCE: Obama with Deputy National Security Advisor for Strategic Communication Ben Rhodes (center) and then Senior Advisor David Axelrod (right) in the White House in May 2010.
REUTERS/PETE SOUZA/THE WHITE HOUSE

> "Now what we are talking about is full-blown economic warfare
>
> **Mark Dubowitz**
> Foundation for Defense of Democracies

The Treasury had used the maneuver to freeze North Korean assets in Macao's Banco Delta Asia in 2005, effectively making it radioactive to other banks.

"There was a very conscious decision: let's see if we can replicate this in the case of Iran," said Daniel Glaser, Assistant Secretary of the Treasury for Terrorist Financing.

Treasury officials traveled the globe, carrying reams of financial intelligence. They spoke "the language of risk" to bankers and governments, Glaser said, seeking to persuade them to make Iran a financial pariah.

Iran has found ways around some of the measures. Reuters has documented how Iran obtained millions of dollars' worth of embargoed U.S. tech components for its telecommunications industry via Chinese, Middle Eastern and Iranian firms; how it changes the names and flags on its ships to get around other embargoes; and how it has masked oil sales.

Neverthless, sanctions are hurting – and this year has been crucial.

The final straw that made oil sanctions possible was a January 2011 diplomatic blow-up in Turkey.

Top envoys from the world's five most powerful nations and Germany gathered in Istanbul to meet an Iranian delegation. They wanted to know if Iran might take a fresh look at a 15-month-old proposal: Iran would ship out much of its enriched uranium in exchange for fuel for the U.S.-supplied Tehran Research Reactor that produces medical isotopes.

If Tehran agreed, it would give up a type of fuel which, if further refined, could yield fissile material for bombs. In return, the Iranians would get something they wanted – reactor fuel – and, perhaps, a face-saving way to begin wider nuclear negotiations.

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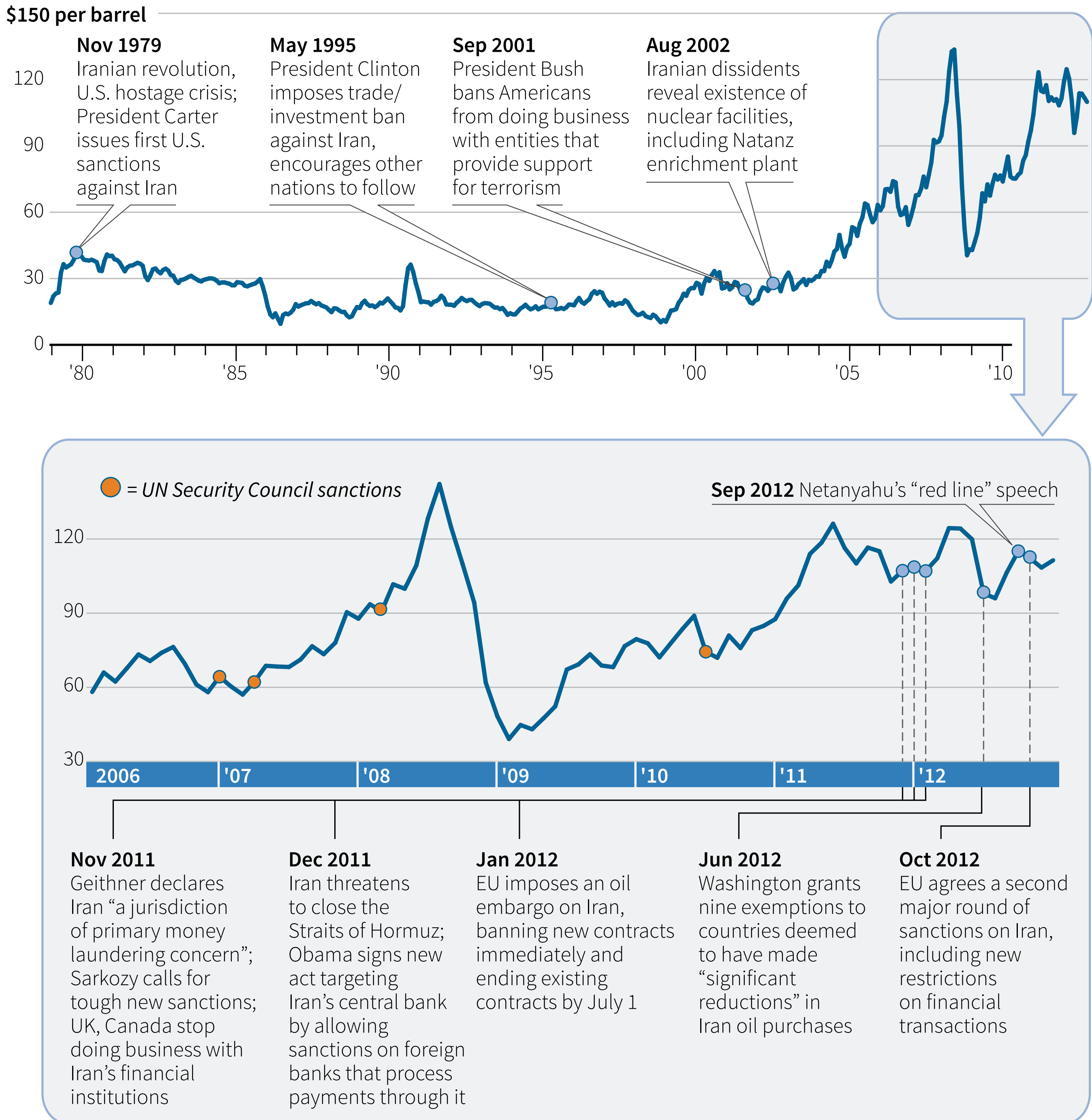
Ratcheting up the pressure

Thirty years of sanctions on Iran plotted against monthly Brent crude prices



Source: Thomson Reuters

But Iranian negotiators at the Istanbul talks struck an uncompromising stance, and what a senior U.S. official described as a "peremptory" tone. The definitive rejection – after two years of Obama's efforts to engage the Iranians – allowed Washington to persuade the EU, Russia and China it was time for tougher sanctions.

"They had stiffed us on diplomacy at this point," said Dennis Ross, a top White House adviser at the time. "They had completely stiffed us."

'THE NUCLEAR OPTION'

Late last year, U.S. senators crafted legislation meant to take direct aim at Iran's oil revenues. They wanted to give Obama the power to sanction foreign banks, including the central banks of allies, if they dealt with the Central Bank of Iran (CBI) to buy or sell oil.

But Obama's team – including senior officials within the Treasury Department – was divided over whether oil sanctions would hurt Iran or the global economy more.

Targeting a central bank was considered an extreme step by many, not just the Obama White House. If botched, it could disrupt the international payments system managed by the world's central banks. The idea had been debated but set aside by Bush.

"I vividly recall President Bush at numerous meetings beseeching his advisers to provide him new sources of leverage for pressuring Iran, and explicitly raising the idea of going after the CBI," Bush adviser John Hannah wrote in May. "Equally vividly, I recall Treasury Secretary Hank Paulson shooting the idea down, labeling it the 'nuclear option' and direly predicting that it would wreak havoc on global markets and the U.S. economy."

On Nov. 15 last year, a senior Treasury official asked key senators, including New Jersey Democrat Robert Menendez and Illinois Republican Mark Kirk, to hold off introducing legislation.

Within days, the Republicans went ahead anyway, ultimately forcing Senate Democrats – with input from the Treasury, though not its formal blessing – to craft a compromise that would give Obama more flexibility to impose the sanctions.

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> former top White House adviser

The White House still hesitated. On Nov. 29 it sent the number two officials from the State Department, the Treasury and the national security staff to ask senators to go slow on the legislation.

On Dec. 1, Treasury Secretary Timothy Geithner wrote Senator Carl Levin, chair of the Senate Armed Services Committee, to register "strong opposition" to the legislation. He warned it might fracture U.S. allies' solidarity on Iran and fuel Tehran's suspected nuclear ambitions by driving up oil prices and thus Iranian revenue.

The issue came to a head when Treasury Undersecretary David Cohen testified before Congress that day. Menendez, a major proponent of strangling Iran's oil revenues, told Cohen the administration's maneuvers to delay action were "outrageous."

The Senator gave Cohen no chance to respond. "I do not really have any questions for you. I just wanted to set the record straight here after you vitiated my amendment," he said.

The Senate voted for Menendez's amendment by 100 to 0. Obama officials said months later they were only seeking flexibility to minimize the risks in the new strategy.

"The debate at that time was over means, not ends," Cohen said in an interview just under a year later.

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On the last day of 2011, Obama signed the legislation into law.

"Now what we are talking about is full-blown economic warfare," said Mark Dubowitz, head of the Foundation for Defense of Democracies, a conservative-leaning group that is among the most aggressive advocates of Iran sanctions.

FRENCH SPARK, GREEK WORRIES

Europe stood to lose far more than the United States if it throttled trade with Iran. U.S. commerce with Iran barely exists. EU nations did 27 billion euros ($36 billion) in trade last year, roughly 14 billion of that in oil imports.

But in late 2011, pushed by Israel's repeated threat of a military strike on Iran's nuclear facilities, the EU made its own moves toward oil sanctions, and more eagerly than the White House.

"We were scared to death Israel would attack," said a senior European national security official.

There was also no sign of Iran's nuclear program slowing. On Nov. 8, the International Atomic Energy Agency reported that Iran had "carried out activities that are relevant to the development of a nuclear explosive device." Iran, it said, was developing its own nuclear weapon design.

On Nov. 21, French President Nicolas Sarkozy wrote to fellow leaders, urging sanctions on an "unprecedented scale," including an oil embargo and a freeze on central bank assets.

The letter "lit a spark on a gunpowder trail that had been building for a long time," said a senior Obama administration official.

Europe was suffering its worst financial crisis since World War Two, though, and it would take two months of painstaking negotiations to win backing from the entire bloc.

Many European governments were "hugely hesitant," in the words of one Western diplomat. Greece had the biggest concern. Run by a caretaker government trying to stop the country tumbling

into default, it enjoyed favorable purchasing terms from Iran, which would accept Greek letters of credit when many exporters apparently would not. Athens argued an emargo would bring deeper financial trouble.

"The Greeks didn't have a government. They could never really tell you what their ultimate political decision was," said one Western diplomat.

Athens wanted assurances that alternative supplies of oil would be secured. On the sidelines of meetings attended by Gulf diplomats, EU foreign policy chief Catherine Ashton urged the Saudis to step in. The Saudis, in turn, sought financial guarantees from the European Commission for selling oil to Greece, but got none. In the end, though, "they delivered," one diplomat said.

In January 2012, EU diplomats met in Brussels to work out final details. Financial sanctions were a hang-up. Many European governments wanted to know how an asset freeze on Iran's central bank would hurt trade in sectors other than oil.

Exemptions were introduced to safeguard legitimate trade. On Jan. 23, the EU announced it would ban member states from importing Iranian oil as of July 1 and freeze

600,000

Estimated barrels of oil per day taken off world markets by European union sanctions

the Central Bank of Iran's assets in the EU. It also barred European firms from transporting and insuring trade in Iranian oil.

MODELING THE MARKET

The European move pulled between 450,000 and 600,000 barrels per day (bpd) off world markets. The new U.S. sanctions added to that, forcing Asian nations and others to wean themselves from Iranian oil.

At the White House, in Brussels, within the French foreign ministry on the Quai d'Orsay, and at Washington think tanks, specialists constructed models of the possible impact. There was a problem: no model could accurately predict how the market would react to the loss of oil or the signal that Iran's petroleum was now in politicians' crosshairs.

Some Obama advisers, Ross said, presented analyses saying there would be a major oil price increase, blunting the U.S. economic recovery. Others countered that an Iran risk premium was already "baked into the market" and that global oil demand would stay depressed for some time.

"Between the two conflicting predictions on what was going to happen, it was hard to know," Ross said.

A joint analysis by Germany, France and Britain distributed to EU members dated Dec. 16, 2011, said the impact of an Iran oil ban was "impossible to fully predict."

There might be only a short, limited price spike, said the analysis, obtained by Reuters and unreported until now.

But if markets saw the embargo as the first in a series of disruptions, "there could be price rises in the range of $10-20 per barrel for a period of approximately 3 months," it said. The EU might have to use its own emergency oil stocks to keep prices down.

'LOOSE TALK OF WAR'

Iran and Israel weren't helping.

On Dec. 28 last year, Iran's navy chief, Habibollah Sayyari, threatened to close the strategic Strait of Hormuz, saying "it will be easier than drinking a glass of water." The Iranians, a U.S. official said, were trying to drive up oil prices to compensate for the loss of exports.

The United States sent a "tough message" to the Iranians that closure of the Strait would not be tolerated, a senior administration official said.

Israeli threats to strike Iran complicated the allies' strategy further.

On March 4, Obama took the stage at the annual gathering of pro-Israel lobby AIPAC in Washington and delivered a headline-grabbing sentence he had inserted into his prepared remarks. "Already," he said, "there is too much loose talk of war." Over the previous few weeks, he said, "such talk has only benefited the Iranian government, by driving up the price of oil."

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TIME BOMB: Israel's Prime Minister Benjamin Netanyahu during a speech at the United Nations in September. Netanyahu said the red line represents the point where the international community should intervene in Iran. **REUTERS/LUCAS JACKSON**

OPEC and Iran

Iran's output has fallen since the latest sanctions took effect, but OPEC has made up for it as Iraq and Libya came back online.

SAUDI ARABIA | IRAQ | IRAN | LIBYA

Output – mln bpd

10
8
6
4
2
0

'10 2011 '12

Pct change vs. OPEC

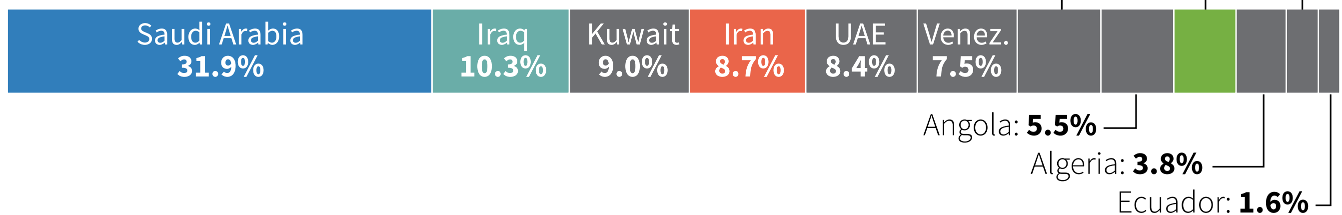
50%
0
-50

+19.7
+6.6
+36.2
-26.0
-7.6

'10 2011 '12

Iran remains the fourth-largest oil producer in the cartel, responsible for 2.7 million bpd, or 8.7 pct of total output.

OPEC output share, Nov 2012



Source: Reuters

Three days earlier, oil prices had peaked at $128.40 per barrel, the highest of his presidency. Republicans were pillorying him for not being tough enough on Iran. The next day, Obama repeated his message in an Oval Office meeting with Israeli Prime Minister Benjamin Netanyahu. "We need to speak to the urgency of dealing with the Iranian nuclear issue without spooking the global energy market in a way that could benefit Iran," Obama said, according to deputy White House national security adviser Ben Rhodes.

Throughout Spring 2012, the White House and European capitals engaged in a rhetorical campaign to calm markets. More than once, Washington publicly signaled it was ready to tap the U.S. Strategic Petroleum Reserve if necessary.

On March 14, Obama met British Prime Minister David Cameron at the White House and asked for his support if an oil drawdown was needed. That night, Cameron sent word to London ordering emergency release procedures to be readied. News of that step knocked $2 off the price of European benchmark Brent crude, taking it under $123 a barrel.

But high prices persisted. White House officials decided that if Brent crude stayed at or above $120 a barrel for any sustained period, they would have to open the strategic reserve, industry sources said.

On May 19, six weeks before the EU oil embargo took effect, G-8 leaders meeting at Camp David issued a terse, three-sentence statement pledging "to ensure that the market is fully and timely supplied."

The message to Netanyahu, the signaling on the strategic reserves and the G-8 statement, "all of those things were essentially letting air out of the balloon of oil prices," Rhodes said.

MIND THE OIL GAP

In January, Obama had set up a special committee to oversee sanctions implementation. The goal was to nudge major

$128

Oil price high, reached in March

EYE IN THE SKY: A 2009 satellite photo of Iran's nuclear fuel facility near Qom. **REUTERS/GEOEYE/IHS JANES ANALYSIS/HANDOUT**

producers to pump more oil and Tehran's major customers, such as China, India, Turkey and Japan, to buy less Iranian crude.

Meeting weekly, the group's members included deputy national security advisers Denis McDonough and Michael Froman – who specializes in international economics – as well as Brian Deese, a White House official who handles domestic economic policy. Treasury's Cohen and Carlos Pascual, the State Department's energy envoy and the point man in talks with oil producers and consumers, were also key players.

Saudi Arabia, which holds most of the world's excess production capacity, had been signaling for months that it would help fill the crude gap.

Riyadh's message was, "give us the customers, we'll produce the oil," said a source familiar with Saudi thinking.

The Saudis cast their action as supporting global economic growth, sticking to a long-held position that they would never use oil as a weapon, even against arch rival Iran, officials and diplomats said.

Saudi Oil Minister Ali al-Naimi redoubled his efforts to convince traders he was serious about keeping prices in check. In late March, six influential oil analysts were called to meet a Naimi adviser in London and told to get on message: high prices weren't justified by market fundamentals.

Riyadh cranked output up to a 30-year high above 10 million bpd in May and kept it high until October. By November, oil prices had dropped $20 a barrel from the March high.

There were other efforts. Opening what may be a new chapter in U.S. energy diplomacy, Pascual and other U.S. diplomats flew to Baghdad and then Basra in November 2011 for a detailed first-hand look at Iraq's plans to boost oil export capacity.

The Americans, according to officials familiar with the trip, examined the nitty gritty of Iraq's patchwork oil infrastructure: were pumps ready to move the extra flow? Would old pipelines handle the load or burst? Were plans on schedule for construction of offshore terminals, known as single-point mooring mechanisms, that allow huge tankers to lift oil without docking?

"We came back much more optimistic," a State Department official said.

Pascual and Energy Department officials also visited Libya, still recovering from its civil war, to review production trends. Its exports rebounded far quicker than expected.

By September 2012, Iraq was pumping 500,000 more barrels per day than a year earlier, and Libya's daily production had mushroomed from 200,000 barrels to 1.5 million, according to a U.S. Energy Information Administration report.

ENERGY DIPLOMACY

Washington still had to persuade wary allies, and economic competitors such as China, to make the "significant reductions" in Iranian oil purchases that were called for by the new U.S. law or face sanctions.

It was tricky, U.S. officials said: if countries refused en masse, the sanctions would be stillborn.

In one of many meetings with fellow

leaders, Obama and Turkish Prime Minister Tayyip Erdogan grappled with Iran in late March at a Nuclear Security Summit in Seoul.

With the Turks, Chinese and others, Obama deployed a powerful argument for sanctions: the alternative might be another Mideast war.

But Turkey was dependent on energy from Iran.

"If you look at the amount of oil and gas they import from Iran, they can't just turn off the switch. They have an economy to run," Rhodes said. "So this is something that is going to be phased and incremental for them. And we got that."

In negotiations, American diplomats avoided demanding specific reductions in imports of Iranian oil, instead asking countries what they could offer.

"We did not in any of these cases actually go in and say that you need to reduce by 15 percent or 18 percent or 20 percent," a senior State Department official said.

There were talks over alternative oil supplies, and the compatibility of those types of crude with existing refineries – and over price.

One oddity of the discussions was that Washington did not want any capital to reduce imports too quickly – much less stop buying Iranian oil overnight. That would roil markets.

Monthly Iranian crude imports by China and India, Iran's top two customers, fell by just over 30 percent in the third quarter of 2012 compared with the last quarter of 2011, according to figures from the Bipartisan Policy Center, a Washington think tank. Japan, Iran's third-largest importer, cut purchases by 56 percent over the same period. South Korea and Turkey reduced theirs by 82 percent and 19 percent respectively.

AT SEA: Malta-flagged Iranian crude oil supertanker "Delvar" anchored off Singapore in March. In 2012, Iran has used tankers to store oil it could not sell. **REUTERS/TIM CHONG**

TALKS, OR WAR?

As the noose tightened, Iran's rial plunged to an all-time low of 38,000 to the dollar in early October, prompting violent protests around Tehran's Grand Bazaar.

Sanctions played a part. But Iranian mismanagement was also to blame. Iran's decision to launch a new currency-exchange center, for instance, spooked many who saw it as a sign Iran was running out of hard currency.

The size of Iran's foreign reserves, key to its economic resilience, is the subject of guessing games among policymakers and traders.

"Ultimately Iran is running out of cash," said an Iranian currency trader in Dubai, as he navigated his sports car through traffic in October. The late Ayatollah Ruhollah Khomeini "once said that agreeing to a cease-fire in the Iran-Iraq war was like drinking a cup of poison. Sooner or later," the trader said, Supreme Leader Ali Khamanei "will have to drink a cup of poison too."

Many Western officials privately expect a resumption of talks over Iran's nuclear program in early 2013. They won't be easy. Iran resolutely defends its right to enrich uranium for what it says are civilian purposes. Iranian citizens, even those unhappy with their leaders, say they support the program.

But the sanctions, deliberately crafted in years past to avoid widespread harm to the Iranian people, are now causing real pain. New Americans sanctions take effect in February, and U.S. lawmakers are preparing yet more measures. The window for diplomacy is narrowing. At the United Nations in September, Netanyahu gave a rough deadline of summer 2013.

"We've imposed the toughest sanctions in history," Obama told reporters the week after his re-election, saying he would again try to open a dialogue with Iran. "I can't promise that Iran will walk through the door."

Arshad Mohammed and Warren Strobel reported from Washington, Justyna Pawlak from Brussels; Additional reporting by Marcus George in Dubai, and Timothy Gardner, Roberta Rampton and Matt Spetalnick in Washington; Edited by Simon Robinson and Richard Mably

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