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## Iranian Game: Multiple Layers

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Iran is back, and with a vengeance. Despite temporal excitement from the Arab Awakening, the structural realities of Iranian nuclear ambitions were never going to go away. It's not crunch time yet, but regional and external policy makers in the Middle East need to pose a very serious and very fundamental policy question: are they ultimately happy to live with a nuclear armed Iran or not? Depending on how you answer that question will have massive implications for global energy supplies, Middle East (in)stability, global economics and global politics *writ large* over the next few years. Yet the most important short term answers will not be found in the West, but how an emerging Asia (most notably China) interacts with long established Gulf States – this is where the most telling hydrocarbon pressures will or won't tell on Tehran if we have any hope of keeping things on an even keel.

## Strategic strife

Gradations do of course enter the equation, but the working assumption without compelling evidence to the contrary, is that Iran is rational (and some would argue sensible) to try and develop nuclear weapons beyond civilian power capabilities. Unsavoury regimes without nuclear arsenals haven't exactly come out well of late – think Saddam for one, Ghaddafi for two, compared to the benevolent benefits the 'Great Leader' Kim Jong Il wangled out of international leaders, as example three. Nukes work, at least as far as political testosterone and security protection is concerned. Iran firmly buys into this logic not as a party political point, but as a veritable 'article of faith' on the Persian street.

The real question is therefore under what timeframe and what conditions Iran wants to reach its nuclear end goal. Assuming Tehran wants to gain the strongest possible hand from its nuclear posturing, a slow-boat to nuclear capabilities is the most likely approach. Get the timing right, balancing ambition with long term credibility, and Iran could potentially gain far greater political concessions from external powers compared to a dash for nukes strategy. 'Sporadic' (i.e. carefully timed) IAEA inspections will be put into the mix as a sign of 'good will' and 'good intent' along the way.

What makes the timing issue more fraught is sabre rattling on all sides of the fence. This is where the greatest scope for miscalculation and escalation rests – any rash moves towards a nuclear fast track from Iran could result in radical responses from Washington, and indeed those considerably closer to Tehran's home. Israel is making things increasingly clear that it won't let the nuclear clock tick down to zero without taking assertive action – a move many Republican presidential hopefuls are more than happy to echo. Whether Washington can, or even wants to control Israel is an open ended question, but should things get that far, sparks will obviously fly. The list of downside risks this presents for regional instability and the global economy are as long as they would be cataclysmic. Armageddon here we come.

Given the stakes involved, the strategic outlook clearly requires urgent attention, but the question is what should that be? Putting aside any drastic pre-emptive strikes for now, Western policy makers need to be remarkably careful to differentiate long term Iranian intent from short term bluster to avoid making a bad situation exponentially worse. The Ayatollah's theocratic regime is just as vulnerable as its monarchical Gulf neighbours and Arab nationalist republics to populist political pressures; external threats inevitably translate into domestic political capital for Iranian political elites to cash in. If external actions are to be taken, they must *at least* be effective to have any strategic merit to avoid becoming outright counterproductive. Getting dragged into games of Persian political chicken without a serious strategy will merely result in Western laid eggs for the Supreme Leader to hatch at times of 'theocratic choosing'. This is exactly where Western policy currently stands in relation to

poorly aligned sanctions. Political manna from heaven might be going a bit far, but relatively feeble Western pressures will be used for pending March parliamentary elections, not to mention Presidential elections in June 2013.

The unfortunate upshot is that we are currently on a path of escalation dressed up as nuclear containment, albeit without any serious economic bite. That's a shame, precisely because oil is the only credible key to brokering some kind of agreement that all sides can live with without resorting to doomsday scenarios. Iran needs oil exports for 80% of hard currency and 65% of government revenues. Assuming the West wants to apply serious hydrocarbon pressures as its policy option of choice, it's going to have to play a far smarter oil game. Forget Iran, forget Israel and focus on Saudi Arabia and China. Sounds odd at first, but this is where hydrocarbon fundamentals point towards if the Iranian nuclear clock is to be synchronised with international expectations.

### **Sanction slips**

So far the Western sanctions debate has merely elevated Iran's underlying hedge (nuclear enrichment vs. oil price spikes) to unmerited attention. For all the headlines around Iranian threats to block the Strait of Hormuz on the back of embargoes, such threats are no more credible than any prospective US-EU sanctions will prove to be effective. Iran would only ever use the Hormuz option as a last ditch attempt to hold onto power or to stop a potential invasion. How long such a blockage could last or how effective it would be, totally misses the point: this is about inelastic consumption vs. price hikes scuppering the global economy, not how many vessels and mines Iran can muster. Any closure of the Strait would instantly secure this in terms of wet vs. paper barrel interaction. 35% of seaborne oil trade is what's at stake: no matter how much Riyadh talks up its East-West export line or UAE options to ship directly to the Indian Ocean, Tehran can hold the global economy to ransom via the Strait.

The beauty for Iran is that it doesn't have to come good on its Hormuz threats anytime soon, whereas the US and EU assuredly have to make energy sanctions stick if credibility is to be maintained. This presents three major problems. The first (and most politically trivial) is the black market. No sooner had EU sanctions been announced for July 1st 2012 than smuggling routes for Iran heavy crudes were being mapped out in Iraq, Turkey, Egypt and indeed Urals grades from Russia. Smugglers and middleman love sanctions; money can be made. Iran will be no exception.

The second is more serious, and it relates to how well any sanctions will stick. The US sanctions bill is clearly going to give the Iranian Central Bank a rough ride as the clearinghouse for all Iranian oil payments (many Iranian traders are already jumping ship to other currencies or gold). But the small print still allows President Obama to grant waivers to countries who

can show that they are taking steps to 'wean themselves of Iranian oil'. Whether the likes of Japan (taking 350,000b/d) of Iranian crude or South Korea (230,000b/d) will bite the Iranian bullet at US behest remains to be seen. The chances are Tokyo and Seoul will still be in the market for Iranian oil by June – at least to some degree.

That's bad, but Europe looks considerably worse. From the 500,000b/d of Iranian crude being slashed, the bulk of European imports go to Italy (180,000b/d), Spain (154,000b/d) and Greece (110,000b/d). The last thing any of these economies need right now is more expensive oil. Iran knows this, so much so that it's likely to instil its own pre-emptive boycott on the likes of Greece (which sources Iranian crude via open credit) long before European sanctions take effect. Snap outages tend to create fungibility problems when supply decks haven't been shuffled and blends concocted to cover gaps. Given the depths of economic woes in Southern Europe, the parlous state of refining margins, and the fact that Italian major Eni, is servicing €2bn of debt on the back of Iranian production, whether European sanctions will stand up to serious scrutiny remains to be seen. At least not without North European economies providing far greater fiscal transfers to ease the economic pain. Bluntly put, don't expect the PIGS (Portugal, Italy, Greece, Spain) to play by Brussels rules on this, just as Turkey will take its own line, balancing private sector interests against governmental instincts.

If Western sanctions don't stand up, the chances of signing up China and India to embargo ranks are close to zero of course, which points us towards the far larger problem here: Asia isn't on board. Glib assumptions that India would cut its 400,000b/d of Iranian supplies on the back of US pressures have failed. Delhi is playing the 'Chindia' game and following China's 550,000b/d Persian lead to source Iranian supplies to bulk up strategic reserves. It's true, both nations have been haggling for major Iranian discounts via Unipet and Zhuhai Zhenrong (China) and ONGC and Essar (India), so much so that Iran has rebalanced its budget to \$85/b price expectations, but the key point is that Iran can still viably shift 2.5mb/d of production towards Asia markets to stay in the black. That's before we even consider re-export prospects from China down the line, or indeed spot sales into Singapore. In this context, sanctions can only ever have limited bite from a Western perspective.

### **Saudi sway**

Actually, the only thing that's been making life more difficult for Iran is the role of Saudi Arabia so far. Riyadh has repeatedly made clear that it is willing to cover any Iranian supply gaps to Europe (and beyond) through its potential 12.5mb/d production. As the only swinger left in town, Riyadh has smoothed market jitters, holding Brent prices to a palatable \$110/b mark. Iran would certainly like to have seen Hormuz threats translating into sharper oil price rises, but Tehran only really has itself to blame on this score. It was Ahmadinejad that tore up OPEC quota systems throughout 2011. The ambiguity created for Saudi Arabia has been sufficient

not to pit Riyadh and Tehran into a full blown OPEC price war just yet, although things could well turn ugly if Saudi starts to take serious Iranian market share.

If anything, market assumptions (and IEA hype of 14mb/d strategic reserve cover) have been pretty lazy that supplies will inexorably be available in time. That would certainly attenuate any pricing pressures that Iranian outages could inflict, but it also deftly highlights Riyadh's real power play here: the key space to watch isn't how long Saudi Arabia continues to plug Iranian supply gaps under a 'business as usual scenario' to let Western containment strategies play out, but the exact opposite: namely when the Kingdom decides to withhold (or at least threaten to withhold) excess supplies from the market to cover Persian gaps. Oil prices would rapidly rise, international decisions would have to be made; not just in Washington, London and Paris, but Beijing and Delhi to force Iran's nuclear hand and reduce pressures.

### **Turning the screw: multiple reverse twists**

This is precisely why a sanctions strategy isn't just about Western intent, but Gulf State and Asian interests (and actions). It's only combined East-West cohesion that can seriously undermine the Iranian hydrocarbon economy by getting crucial consumers *and* vital producers to turn the screw. Saudi Arabia sits at the supply side heart of this debate, but getting Riyadh to wield such a brutal oil weapon to shoot down Persian nuclear plans, will not be quick or easy given the stakes involved.

The Saudis are well aware of the other (more credible) hedges Iran has up its sleeve beyond Hormuz. Top of the list is stirring Shia schisms in Iraq, Bahrain, Syria, Lebanon and Saudi Arabia itself. The 'Arab Awakening' is still sufficiently fresh in Gulf States minds to keep leaders on edge. Iran has dropped hints that it could have played much tougher with Riyadh over its intervention in Bahrain. The degree to which Iran could pull the strings in Iraq is not a question many Sunni leaders want to test either – nor leaders in Washington DC. Further deterioration in Iraq would hammer US credibility in the Gulf; it would also have a sharp resonance for Allied operations in Afghanistan.

A second option, although massively inflammatory, is for Iran to strike key Saudi oil infrastructure. Tehran's missiles could reach the Abqaiq 5-6mb/d processing plant, or failing that, loading facilities at Ras Tanura. That would be hugely disruptive to Saudi Arabia, but arguably less so to Iran (at least in the very short term) assuming Hormuz remained open. Yet a third ploy could conceivably involve a limited closure of the Strait through a well-planned and clearly communicated Iranian military exercise. Not sufficient for a Western *casus belli*, but enough to spook global oil prices.

Of the three 'options' to hand, Iran will obviously go for the slow Shia burn long before it gets drawn into strategic power plays. These are all considerations that will weigh heavily on Saudi minds, but in the final analysis, they probably remain *secondary* concerns compared to an Iranian nuclear capability. It's this *primary* fear (rather than external posturing) that the West should focus on to get the Saudi's to consider withholding oil from global markets. That's not as a prelude to war - not in any way - but with a view to a far more constructive move: getting China's attention to actually give sanctions a credible chance of working. 'Business as usual' won't do that as long as Riyadh keeps filling the gaps; a threatened Saudi oil 'embargo' undoubtedly would.

At the end of the day, China's key supply relationship in the Middle East is heavily anchored in the Gulf States. Out of China's 5.5mb/d or so of imports in 2011, 2.3mb/d were sourced from Saudi Arabia, Iraq, the UAE and Kuwait, with Iran only accounting for 550,000b/d of supplies. Any way you look at it, China knows that Arab output will always trump Persian production. 'Chirabia' rather than 'Chiran' is the key relationship Beijing needs to get right. China's overriding energy interests are secular stability and steady supplies to fuel the Chinese economy and to keep benchmark prices within a 'stable range'. If China's core suppliers in the Gulf call time on Iranian nuclear ambitions, expect Beijing (and thus India as the junior Chindia partner) to comply accordingly, either to exert serious diplomatic pressure on Iran to change course, or sever all oil ties. Political pieces would then be sufficiently in place to push for UN sanctions if still needed: even the notoriously stubborn Russian veto might falter once the Kremlin saw which way the wind was blowing. It would certainly make a refreshing change from 'Moscow is a very reliable producer' line currently being spun to gain market share on the cheap.

### **Running the Gauntlet: no good options**

This would all come with considerable risks however. Getting China to tighten the Iranian noose via Saudi rope - although economically painful - would raise the geopolitical stakes, and massively so. If Iran could no longer rely on Asia for oil receipts, expect Tehran to get nervous; any one of the scenarios noted above, or a combination thereof could easily play out. Hence the gauntlet of orchestrating a serious sanctions policy is that it could rapidly escalate and denigrate into war if Iran lashes out. Conversely, if Iran dug in deep and decided to sweat it out, eventual pressures of sustained higher oil prices could force a major climb down across consumer states. Not only would consumers be defeated by their own 'embargo', Iran could claim a political victory, picking up its nuclear pieces. Little real progress would be made; even if power changed hands amid the carnage, Tehran's nuclear line would remain largely the same. Regime change is not at the root of the problem, or indeed the solution.

The optimal outcome of course is that economic sanctions encourage Iran to change tack, deciding that the economic and political downsides towards nuclear weaponisation are simply too great. It's pretty clear from the analysis here that's extremely unlikely to happen, but it could at least provide a window of opportunity to use serious economic pressures to open diplomatic channels with Iran towards a negotiated position that all sides could (at least for now) live with. That would entail close controls and inspections of what Iran could do in the nuclear field – albeit without pitching this as any kind of political climb down or humiliation for Tehran. Putting Beijing at the forefront of negotiations would aesthetically help. Gulf States would obviously be wise to start seriously diversify their Hormuz transit options, just as Iran would no doubt get more serious about its own IPI plans. Call it 'Hormuz Plan B'.

Hopelessly romantic, or indeed naïve some might say? But the costs of not going down the sanctions road are actually quite high for China. The further Iran inches towards its nuclear end game, the far more likely it becomes one of the players involved will make a rash move. If we translate that into security terms, Beijing has to become a credible provider, not consummate consumer of geopolitical stability if it wants energy supplies to consistently pan out. It's been too busy keeping its global energy options open under US security cover for far too long. Eventually something has to give; a brutal choice between Saudi and Iranian production could be the *pièce de résistance* case study to focus Chinese minds should Beijing fails to wield any serious nuclear influence with Tehran.

### **Highest game: highest stakes**

To be fair to Beijing, a serious discussion between the US and China would really help as to who should be doing the geopolitically heavy lifting for what (and where) across the 'G2'? Iraq massively reduced US stock in the Middle East, as much as Libya has raised serious question marks over American resolve. Put the US 'energy independence' narrative into the mix that presumably entails a valedictory American departure from the Middle East, and it's abundantly clear that vacuums need to be filled. Instead of fighting China tooth and nail for geopolitical primacy in the Asia-Pacific, America should bring China into the international security fold: a shared division of geopolitical labour in the Middle East would be a good place to start through Beijing's nascent 'String of Pearls' policy. Leaving G2 relations to chance in the Middle East is a risky game for all concerned, particularly as the Saudi-Iran relationship blatantly sits at the heart of US-China relations (at least as currently configured). Should the Iranian situation spiral out of control, the US will act, irrespective of the fiscal damage that's likely to inflict on the US economy. China would see this as last ditch power play by Washington to secure its place in the sand, albeit with the deep (very deep) irony that Beijing will ultimately be bank rolling such an effort through (in)direct financing of American printing presses.

Where all that leaves Europe is a different question. No one expects the EU to be a serious geopolitical actor anytime soon (beyond bilateral forays from London and Paris). But in this high stakes game, Europe needs to be very careful as to how far it stretches its credibility. The core task for now is to make sure its sanctions actually work so that bigger international forces can come into play and give sanctions a serious chance. Even if a broader sanctions policy works out, the prospects for war remain just as likely (if not more so) as they do for a negotiated peace. Bottom line: if the EU can't live with a war scenario, it should discretely pose the nuclear question to all concerned, and do so early doors: living with a nuclear Iran, although unpalatable, still might be a better option than playing Russian roulette with world peace? Depending on what answer that yields in Riyadh and Beijing, Washington and Tel Aviv would at least be wise to consider the response. Someone always has to play the Adlai Stevenson (dove) role; most would expect the EU to do so. The reality is that no good policy options are in play here, it's merely a case of picking the least worse. Whatever decisions are ultimately made, we can only hope they are done so in an orderly manner, on a global basis, and by seriously weighing all the relative costs entailed.