Congressional Testimony

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Introduction

Thank you Chairman Chaffetz, Ranking Member Tierney, and members of this distinguished subcommittee for the opportunity to testify. I am honored to appear before you today.

In my testimony, I will examine three ideas to ramp up the pressure on the Iranian regime through tougher sanctions on Iran's oil sales. I will describe an approach that holds the promise of significantly reducing the regime's oil revenues while mitigating the risk that oil markets will perceive these measures in a way that drives up the international price of oil. In my testimony, I will argue that indirect demand-side sanctions on the Islamic Republic could possibly accomplish what an Iranian oil embargo would do -- a severe reduction in Iranian hard currency earnings -- without the diplomatic trauma or a self-defeating oil-market backlash.

The recent report by the International Atomic Energy Agency on Iran's nuclear program has raised legitimate questions about the effectiveness of sanctions to frustrate Tehran's nuclear plans. Sanctions targeting Iran's energy, banking, and shipping sectors have cost the Islamic Republic billions of dollars. These sanctions have led to the slow-motion demise of the Iranian energy industry as Iranian oil production continues to materially decline. However, their medium-to-long term impact is insufficient because Iran will likely cross the nuclear threshold before these sanctions have time to work. There is also no evidence yet to suggest that economic pressure could make the Iranian regime rethink its decision to develop nuclear weapons.

For the West, however, sanctions have to be "targeted." They cannot impose massive economic costs on a country's citizens. They can't inflict too much economic pain on international companies, or rattle voters with higher gasoline prices. Even against this Iranian regime, whose possession of nuclear weapons could lead to a cascade of proliferation resulting in a nuclear-armed Middle East, the diminishment of American power, and a clerical regime even more willing to use terrorism, many in the West resist sanctions that are too "punishing" or "crippling."

So are sanctions against the Iranian regime destined to fail?

I believe sanctions can still work. But they must hit harder at the heart of Iran's oil industry, specifically oil sales, which account for between 50 and 75 percent of the national budget, and 80 percent of hard-currency export earnings, without causing a significant increase in global petroleum prices. Otherwise, Tehran can sell less oil and make more money while roiling global markets. This is a scenario we want to avoid.

The objective of the next round of sanctions should be a reduction in the number of potential buyers of Iranian petroleum without reducing the quantity of oil that Iran puts on the market. With enough Western companies refusing to buy Iranian oil, buyers from China and other countries that fail to enforce sanctions will quickly realize that they have leverage with which to extract discounts from Tehran.

The Chinese are aggressive businessmen with an interest in secure and cheap oil. The right kind of sanctions, although they would enable their questionable policies, would knock down the price of Iranian oil, and in the process deny Tehran tens of billions of dollars in oil revenue. This will make it harder for the Iranians to have the funds to spend on their nuclear program, their terrorist proxies or other malevolent activities. While rewarding China for bad behavior is a less than a satisfactory alternative, when it comes to stopping Iran's nuclear designs, we don't have a choice between good and bad options. Our choice today is between bad and worse ones.

The Partial Success of Existing Energy Sanctions

Since the passage of the *Comprehensive Iran Sanctions, Accountability and Divestment Act* in July 2010, the Iranian energy sector has been under more pressure than it has been in recent memory.

The U.S. Department of State estimates that over $60 billion in foreign investment in Iran's energy sector has been frozen as a result of sanctions.[1] The U.S. Department of Treasury estimates that the regime will lose approximately $14 billion in annual oil revenue or a total of $70 billion over the next five years as a result of a decline in oil production precipitated by a combination of sanctions and energy sector mismanagement.[2] Iran also has been unable to meaningfully develop its enormous natural gas reserves, which are the second largest in the world after Russia, and valued at over $4 trillion. European and U.S. sanctions have significantly curtailed the investment needed to develop Iran's natural gas fields, and, most importantly, cut back on the transfer of liquefaction technology critical to Iran's ability to transport its natural gas by tanker to overseas markets.

In the run-up to the passage of CISADA in July 2010, which included sanctions against Iran's refined petroleum imports, and for some months after, Iran's gasoline imports dropped dramatically. Recent reports indicate that, in the four months between January 2011 and April 2011, Iran received only seven cargoes of refined petroleum, down from a *monthly* average of 10 to 13 cargoes (or approximately 2.7 to 3.5 million barrels per month). Between May and August, the Islamic Republic did not import any gasoline.[3] However, according to a *Reuters* report, imports into Iran increased in October to 63,279 barrels per day from 51,986 bpd in September,[4] or over 1.8 million barrels for the month of October, which puts Iran back at approximately the same level of imports it reached in July 2010 when CISADA was passed (but below the 3.6 million barrels it imported in May 2010).

During the period from May to August of this year, when Iran's imports fell to near zero, it is likely that Iran was able to temporarily reduce its dependence on imports by converting petrochemical facilities for the production of gasoline, utilizing reserve stocks, and reducing demand based on subsidy reductions. Whether or not Iran will rely on foreign imports in the

1 William J. Burns, "Implementing Tougher Sanctions on Iran: A Progress Report," *House Foreign Affairs Committee*, December 1, 2010. (http://www.state.gov/p/us/rm/2010/152222.htm)

2 David Cohen, "Written Testimony of Under Secretary for Terrorism and Financial Intelligence David Cohen Before the House Committee on Foreign Affairs," *House Committee on Foreign Affairs*, October 14, 2011. (http://www.treasury.gov/press-center/press-releases/Pages/tg1327.aspx)

3 "Iran October Gasoline Imports Up 21%," *Reuters*, November 10, 2011. (http://arabnews.com/economy/article531921.ece)

4 "Iran October Gasoline Imports Up 21%," *Reuters*, November 10, 2011. (http://arabnews.com/economy/article531921.ece)

future will depend on how successfully it can sustain lower subsidies in the face of hyperinflation, in part caused by the rapid increase in prices for gasoline and other commodities. It will also depend on how strictly the Obama administration enforces refined petroleum sanctions against Iran's suppliers. Lax enforcement is a message to the trade that it can return to business as usual.

The U.S. Department of State has imposed sanctions on ten companies for violations of CISADA. These include:

- ❖ Naftiran Intertrade Company (Switzerland)[5]
- ❖ Belarusneft (Belarus)[6]
- ❖ Petrochemical Commercial Company International (PCCI) (Jersey/Iran)[7]
- ❖ Royal Oyster Group (UAE)[8]
- ❖ Speedy Ship (UAE/Iran)[9]
- ❖ Tanker Pacific (Singapore)[10]
- ❖ Ofer Brothers Group (Israel)[11] (sanctions have been subsequently lifted)
- ❖ Associated Shipbroking (Monaco)[12]
- ❖ Petroleos de Venezuela (PDVSA) (Venezuela)[13]
- ❖ Tidewater Middle East Company (Iran)[14]

While sanctioning these companies has been an important *initial* step in ratcheting up the pressure on the Iranian regime, many of these companies are small players in Iran's refined petroleum trade or its broader energy sector. Iran's major refined petroleum partners have still continued their trade. Numerous, much larger international companies are in blatant violation of American law by supporting Iran's energy sector and its nuclear and ballistic missile program. In this regard, China stands out as a country of particular concern.

The Limits of Existing Sanctions: The China Problem

Chinese firms are involved in supporting Iran's nuclear and ballistic missile programs. U.S administrations since 1991 have sanctioned Chinese companies over 80 times for providing

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[5] James B. Steinberg, "Briefing On Iran Sanctions Implementation," *U.S. Department of State*, September 30, 2010. (http://www.state.gov/s/d/former/steinberg/remarks/2010/169315.htm)
[6] U.S. Department of State, Media Note, "Iran Sanctions Act Announcement," March 29, 2011. (http://www.state.gov/r/pa/prs/ps/2011/03/159309.htm)
[7] U.S. Department of State, Press Release, "Seven Companies Sanctioned Under the Amended Iran Sanctions Act," May 24, 2011. (http://www.state.gov/r/pa/prs/ps/2011/05/164132.htm)
[8] Ibid
[9] Ibid
[10] Ibid
[11] Ibid. Ofer Brothers Group and Ofer Holdings Group were subsequently removed from the sanctions list though sanctions were retained against Tanker Pacific and two other entities indirectly owned by the Ofer family: http://www.nytimes.com/2011/09/14/world/middleeast/ofer-holdings-of-israel-removed-from-iran-sanctions-blacklist.html
[12] Ibid
[13] Ibid
[14] U.S. Department of State, Press Release, "Joint Statement on Iran Sanctions," June 23, 2011. (http://www.state.gov/r/pa/prs/ps/2011/06/166814.htm)

proliferation-related parts and components to Iran, which has had some impact.[15] While the Chinese military and state-owned companies are now somewhat less active on this front, the supply of critical parts and components for these programs has now shifted to Chinese brokers and middlemen who appear to be acting with the approval of the Chinese government.

Chinese companies also have continued to supply a significant portion of Iran's refined petroleum in violation of U.S. sanctions laws.[16] Zhuhai Zhenrong has been one of the most active traders, along with Emirates National Oil Company, and, in recent months, has been responsible for an increase in gasoline sales to Iran after months of an overall decline in shipments.[17] Its parent company, NORINCO, has been sanctioned several times by the U.S government for supplying Iran with missile technology.[18]

Zhuhai Zhenrong would be a good target for sanctions. Indeed, it may be easier for the Obama administration to sanction a Chinese gasoline trader, which can terminate its ties to Iran in days, and for whom refined petroleum sales is a minor business, than it would be to target China's state-owned energy giants and their billions of dollars of investment in Iran's energy industry. This would send an important shot-across the bow to other gasoline suppliers, and send a message that the administration is serious about the enforcement of CISADA. China should know that it will not get a complete free pass.

Persuading China to stop relying on Iran as a supplier of crude oil will be a more significant challenge. When China looks at Iran's enormous untapped energy reserves, it sees multiple opportunities to develop, extract, and secure energy resources vital to its economic security. Since the 1990s, China's role in global energy markets has increased dramatically. To fuel its double-digit annual growth, China has had to import substantial amounts of energy. By 2006, it was the world's third-largest net importer of oil.[19] In 2008, according to the U.S. Energy Information Administration, China consumed an estimated 7.8 million barrels of oil per day, of which it imported 3.9 million, "making it the second- largest oil consumer in the world behind the United States."[20] In 2010, China's total crude oil imports grew to 4.8 million barrels per day.[21]

China's growth is expected to continue. The International Energy Agency predicts that China

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15 "US Nonproliferation Sanctions Against China-Statements and Developments," *NTI*, accessed November 10, 2011. (http://www.nti.org/db/china/sanctchr.htm)

16 Joseph A. Christoff, "Firms Reported in Open Sources to Have Sold Iran Refined Petroleum Products between January 1, 2009, and June 30, 2010," *U.S. Government Accountability Office*, September 3, 2010. (http://www.gao.gov/new.items/d10967r.pdf)

17 Joseph A. Christoff, "Firms Reported in Open Sources to Have Sold Iran Refined Petroleum Products between January 1, 2009, and June 30, 2010," *U.S. Government Accountability Office*, September 3, 2010. (http://www.gao.gov/new.items/d10967r.pdf)

18 Shirley A. Kan, "China and Proliferation of Weapons of Mass Destruction and Missiles: Policy Issues," *Congressional Research Service*, April 5, 2005. (http://fpc.state.gov/documents/organization/47794.pdf)

19 U.S. Energy Information Administration, "China," *Country Analysis Briefs*, July 2009, p. 1. (http://www.eia.doe.gov/cabs/China/pdf.pdf)

20 U.S. Energy Information Administration, "China," *Country Analysis Briefs*, July 2009, p. 1. (http://www.eia.doe.gov/cabs/China/pdf.pdf)

21 Judy Hua and Chen Aizhu, "UPDATE 2-China 2010 Crude Oil Imports Up 17.5 pct to Record High," *Reuters*, January 10, 2011. (http://af.reuters.com/article/energyOilNews/idAFTOE70607320110110)

will overtake the U.S. after 2025 as the world's largest purchaser of imported oil and gas.

To support this growth in long-term energy demand, Beijing has encouraged its national energy companies to invest in upstream projects overseas in an effort to secure long-term resources. Chinese companies, including CNPC, CNOOC, and Sinopec continue to invest heavily in Iran's energy sector and reportedly have signed over $40 billion in new energy deals in recent years.[22] The Obama administration reportedly has assured Congress that Beijing has agreed to not sign new deals, and to "slow-walk" its existing deals.[23] However, it is unclear however whether this commitment covers the deals already in the pipeline and how quickly China is moving ahead in implementing the existing ones.

China is Iran's second largest purchaser of oil after the European Union. It imported 429,000 barrels per day in 2010, according to EIA estimates, which represented about 9% of China's overall crude oil imports and almost 20% of Iran's total daily crude oil exports.[24] At a $100 per barrel average price, if this percentage holds through the end of 2011, Iran will receive roughly $16 billion in oil revenues for the sale of its crude oil to China. This represents about 20% of Iran's total oil revenues, 16% of its hard currency-related export earnings, and approximately 10% to 15% of its total government budget.

This is the real challenge of finding an effective strategy to target Iran's oil exports. The Obama administration must keep up the political and diplomatic pressure on China to curb its role in supporting Iran's nuclear and ballistic missile programs, and sanction Chinese companies involved in Iran's refined petroleum trade. It must hold Beijing accountable for commitments to significantly reduce, or "slow-walk," its investments in Iranian energy production. In return, instead of punishing China for the purchase of Iranian oil, Washington should encourage Chinese firms to continue to buy Iranian crude in whatever quantity they desire and drive ruthlessly for price discounts on every barrel. How that can be done is the subject of the rest of this testimony.

How to Effectively Target Iran's Oil Sales

U.S. sanctions policy has been crafted in a way that reduces Iranian oil *investment*, while giving the market time to adjust to a reduction in Iranian *production*. The down side of this medium-term sanctions strategy is Iran's continued near-term annual oil export revenue of approximately $80 billion. Assuming Treasury's five-year estimates of a $14 billion decrease in annual oil revenues, and a $100 average price per barrel, the regime will still collect approximately $330 billion in total revenue over five years. These funds provide significant resources to buttress the regime against sanctions and its domestic economic difficulties and to fund its nuclear and other nefarious activities.

[22] "China Invests $40b. in Iran Oil and Gas," *The Jerusalem Post*, July 31, 2010. (http://www.jpost.com/IranianThreat/News/Article.aspx?id=183200)
[23] Qasim Nauman and Rebecca Conway, "Iran Plays Down Pressure on China Energy Projects," *Reuters*, September 8, 2011. (http://www.defenddemocracy.org/news-picks/iran-plays-down-pressure-on-china-energy-projects) & Oren Kessler, "In Confronting Iran, Experts Say All Roads Go Through China," *The Jerusalem Post*, November 10, 2011. (http://www.jpost.com/LandedPages/PrintArticle.aspx?id=245027)
[24] U.S. Energy Information Administration, "China," *Country Analysis Briefs*, May 2011. (http://www.eia.gov/countries/cab.cfm?fips=CH)

The challenge is to find a way to squeeze the Iranian regime and, in particular, develop smart measures to target Iran's crude oil sales without encouraging an oil embargo of Iranian crude, which would spook energy markets, drive up the price of oil, enrich Iran, and damage the world economy.

Policymakers are right to target Iran's oil sales: Iran's daily exports of 2.3 million barrels in 2010 provide the regime with over $80 billion in annual revenue (assuming oil at $100 per barrel), and they account for between 50 and 75 percent of the state budget and 80 percent of export earnings.[25] Sanctions can only work – to the extent that they weaken the regime economically and open the door for other more punitive measures to roll back Iran's nuclear program– if they deny the regime this critical source of hard currency.

Crude oil however is a globally traded commodity, which means demand spikes or supply disruptions *anywhere* in the world affect prices *everywhere* in the world. As a result, U.S. officials seeking to stop Iran's nuclear weapons program are rightly concerned about the impact of an abrupt halt to Iranian crude oil supply on the world economy. Recent unrest in Libya took 1.3 million barrels a day off the market, pushing up U.S. oil prices up by 20 percent.[26]

Iranian crude oil exports represent almost double Libya's, and just over 2.5% over world demand, so a halt to Iranian supply would have an even larger effect.[27] Apart from damaging the world economy, oil price spikes would only enrich the Iranian regime, which could generate $120 billion in annual oil revenue at 2.3 million barrels per day if oil prices reached $150 as they nearly did on July 3, 2008 when they closed at a record $145.29 on NYMEX.[28]

Sanctions must generate good results, not just make us feel good. Sanctions involving a sensitive commodity like oil -- at a time of high oil prices, and economic recession -- must be designed to incrementally and rapidly increase the "hassle factor" in trading in Iranian crude, give the market time to adjust, and minimize the risk of alarmist market reactions. How market participants – particularly financial traders – perceive a new sanctions regime can impact near-term crude prices as much as actual changes in the physical market that the sanctions regime creates.

Moving forward, then, the objective of all these sanctions should be to discourage "white-hatted" companies—European and Asian companies that have no desire to risk their access to the American market—from dealing in Iranian oil. At the same time, these sanctions should actually allow "black-hatted" companies—mainly Chinese firms—to continue to buy whatever quantity of Iranian crude they desire. While this may seem counter-intuitive, our goal is to reduce the number of potential buyers of Iranian petroleum without reducing the quantity of oil on the

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[25] Mark Dubowitz & Reuel Marc Gerecht, "Oil Market Impact of an Iranian-Oil-Free Zone," *Foundation for Defense of Democracies*, October 2011, page 2. FDD confidential report provided to the U.S. government.
[26] Alden, William, "Analyst: Rising Oil Prices 'Primary Threat' To U.S. Economy As Libyan Violence Mounts," *The Huffington Post,* March 21, 2011. (http://www.huffingtonpost.com/2011/03/21/libya-conflict-oil-prices_n_838624.html)
[27] John Deutch, James R. Schlesinger, and David G. Victor, "Consequences of U.S. Oil Dependency," *Council on Foreign Relations,*
[28] Catherine Clifford, "Oil's Record High, One Year Later," *CNN,* July 2, 2009. (http://money.cnn.com/2009/07/02/markets/year_oil/index.htm)

market. With “white-hatted” companies out of the bidding, “black-hatted” buyers would have significant negotiating leverage to extract deep and painful discounts from Tehran.

It is against this backdrop that the Obama administration and Congress should consider a combination of sanctions specifically designed to reduce Iran’s oil revenues and deny the regime the hard currency it needs to operate. This combination includes: sanctioning companies doing business with Islamic Revolutionary Guard Corps (IRGC) entities in the crude oil trade; creating an “Iranian oil-free-zone,” by prohibiting the importation of refined-petroleum products containing Iranian crude into the United States; and targeted sanctions against the Central Bank of Iran as a precursor to a blanket designation of the CBI for its role in supporting proliferation and terrorism and providing financial services for the IRGC.

Exposing Iran’s Islamic Revolutionary Guard Corps in the Sale of Iranian Oil

The Obama administration can greatly intensify the “hassle factor” for buyers of Iranian crude by exposing the role of the Islamic Revolutionary Guard Corps in the crude-oil export supply chain. This can be accomplished by strengthening American, European and other countries’ laws prohibiting commerce with the Guards. This includes sanctions against foreign enterprises involved with the IRGC.

Supreme Leader Ali Khamenei has significantly increased the military and economic power of the Guards in recent years.[29] The Guards are unquestionably the dominant force throughout Iran’s energy sector, including in the sale of Iran’s oil. In the wake of the vicious crackdown on Iran’s democratic opposition following Iran's June 2009 fraudulent election, there is almost universal distaste for the IRGC. This was only compounded after revelations in recent weeks of an assassination plot against the Saudi ambassador to the United States hatched by the Quds Force, the overseas terrorist unit of the IRGC.

In 2008, the Iranian parliament passed legislation to privatize Iran’s state-owned businesses as part of an effort to stimulate growth. On numerous occasions, the IRGC has taken advantage of this process to penetrate the Iranian economy, particularly its oil and gas sector. Using its many subsidiaries, front companies, and “charitable” organizations, the IRGC has burrowed deeply into Iran’s energy sector, making it nearly impossible for international energy firms active in Iran to avoid doing business with them.

The U.S. Treasury Department’s recent decision to sanction Tidewater, which is an IRGC front company involved in managing Iran’s ports, and the subsequent decision by major shipping companies like the Danish company Maersk to suspend its trade with Iran, are good examples of the chilling effect of these types of sanctions.[30] While there is some dispute whether Tidewater is involved in managing ports that involve Iranian crude sales, the Tidewater sanction could be

[29] See: Emanuele Ottolenghi, *The Pasdaran: Inside Iran’s Islamic Revolutionary Guard Corps*. (Washington DC: FDD Press, 2011).

[30] “U.S. Sanctions Iranian Port Operator, Airline,” *Reuters*, June 24, 2011. (http://www.reuters.com/article/2011/06/24/uk-iran-usa-sanctions-idUSLNE75N01W20110624) and Kizzi Nkwocha, “Maersk Cuts Ties With Blacklisted Iranian Ports,” *IFW Website*, July 5, 2011. (http://www.ifw-net.com/freightpubs/ifw/index/maersk-cuts-ties-with-blacklisted-iranian-ports/20017885857.htm)

used as a precedent for designating the IRGC entities that do involve crude, and indeed, sanctioning the ports themselves.

The Foundation for Defense of Democracies, where I am executive director, has provided a detailed report to the U.S. government mapping out elements of the Iranian crude oil supply chain. Sanctions against these and other IRGC entities, combined with the threat of sanctions against international companies doing business with the IRGC, could greatly encumber Iran's crude oil sales.

Building on the precedent of the Tidewater sanction, the United States should continue to designate IRGC companies that are part of the crude oil supply chain. Highlighted in our study, these companies include:[31]

- Arvandan Institution (Ghorb Karbala Subsidiary)
- Arvandan Oil & Gas Company
- Arvandan Shipbuilding Company (ASC) (IDRO Subsidiary)
- Daryabandar Line Marine and Shipping Services Company (Tidewater Subsidiary)
- Iranian Helicopter Company
- Iranian Oil Pipeline and Telecommunication Company (IOPTC) (NIORDC Subsidiary)
- Iran Shipbuilding & Offshore Industries Complex Company (ISOICO) (IDRO Subsidiary)
- Machine Sazi Pars Co (IDRO Subsidiary)
- National Iranian Tanker Company (NITC)
- National Iranian Oil Products Distribution Company (NIOPDC) (NIORDC Subsidiary)
- National Oil Refining and Distribution Company (NIORDC)
- North Drilling Company
- Paysaz (IDRO Subsidiary)
- Petropars Iran (PPI) (Petropars Subsidiary)
- Petropars Oil & Gas Institute (POGI) (Petropars Subsidiary)
- Petropars Oilfield Services Company (POSCO) (Petropars Subsidiary)
- Petropars Resources Engineering Ltd. (PRE) (Petropars Subsidiary)
- SADRA

In addition to the designations of firms connected to the Islamic Revolutionary Guard Corps, the United States should also consider designating Iran’s state-owned National Iranian Oil Company (NIOC). NIOC is a party to every Iranian oil transaction. Leveraging its position as a state-owned institution, NIOC operates as the ultimate front company in obscuring the role of the IRGC in the oil trade.

In August 2011, IRGC Commander Rostam Qasemi was named as Iran’s oil minister, further increasing the Guards’ position in Iran’s energy sector. Qasemi was designated by the United States and European Union for his role as the commander of IRGC entity Khatam al-Anbiya, which itself has been designated by the United Nations, European Union and United States for its role in supporting proliferation. My colleague Emanuele Ottolenghi, in his recent book on the IRGC, which was published by FDD, notes that the Guards maintain “a loose but fruitful

[31] FDD confidential report provided to the U.S. government.

cooperation with the National Iranian Oil Company."[32] It is a reasonable assumption that Qasemi's appointment will continue to increase this cooperation, making it increasingly difficult for international companies active in Iran's energy sector not to do business with the IRGC.

If the Obama administration rapidly increases its designations of IRGC entities active in the oil supply chain, it is likely that international energy companies, shippers, insurers, traders, refineries, and other market players will begin to look for alternative suppliers. The number of buyers of Iranian oil will shrink. Few respectable international companies would welcome front-page stories about their business ties to an organization increasingly seem as an international outlaw. The remaining buyers will increase their bargaining power to extract discounts on the price of every Iranian barrel of oil.

Establishing the United States as an Iranian-Oil-Free-Zone

There is an additional approach to target Iran's oil exports that leverages the pecuniary motivations of Iran's energy partners. Instead of hoping that penalties alone will be sufficient to persuade oil companies and financial institutions to terminate their ties with Iran, it may be possible to give China, and other buyers of Iranian crude, the incentive to shop ruthlessly when they buy from Tehran.

The key again is to reduce the number of companies willing to do business with Iran and provide the remaining buyers with sufficient leverage to demand a price discount on every barrel of oil.

Washington could accomplish this by declaring the United States an "Iranian-Oil-Free-Zone," an idea FDD developed with a European energy trader with over four decades of industry experience. The idea was first outlined in a *Wall Street Journal* piece I co-authored with FDD's Reuel Marc Gerecht, which ran on May 31, 2011.[33]

Current U.S. sanctions prohibit importing petroleum products directly from Iran, but American consumers still inadvertently purchase Iranian oil indirectly. Indeed, gasoline and diesel imported from Europe is made with Iranian crude. The "Iranian-Oil-Free-Zone" would close this loophole by requiring that all refineries exporting refined petroleum to the United States must certify that their products do not contain Iranian oil and be subject to penalties for false certifications.

Our strong belief, now supported by rigorous research and detailed economic modeling, is that an "Iranian-Oil-Free-Zone" would have a negligible impact on the price of oil and refined petroleum. With the loophole closed, Iranian crude oil supply would not be reduced, it would simply be redirected to different refineries. Refineries, particularly in Europe, would decide that the U.S. market was more important to their business than Iranian oil supplies, and that their Iranian crude imports, most of which are sour (93% is medium sour with the rest evenly split

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[32] Emanuele Ottolenghi, *The Pasdaran: Inside Iran's Islamic Revolutionary Guard Corps*. (Washington, DC: FDD Press, 2011), p. 46.
[33] Mark Dubowitz and Reuel Marc Gerecht, "The Case for an Iranian-Oil-Free Zone," *The Wall Street Journal*, May 31, 2011. (http://online.wsj.com/article/SB10001424052748703730804576321372879366338.html)

between light and heavy)[34] could be easily swapped out in the refinery process for other Middle Eastern crude of similar quality (and, in some scenarios, smaller quantities of Latin American or Russian crude).

As Iran's pool of customers shrinks, those that remain would have more leverage in price negotiations. China, for example, could literally put Iran over a barrel when negotiating price on crude imports. This "oligopsony effect" (the buy-side equivalent of an oligopoly effect) would reduce the amount of money Iran makes on its crude oil sales without reducing Iranian oil supply. The magnitude of the discount depends on the number of buyers in the market, their ability and willingness to pay, and Iran's cost of production.

The Foundation for Defense of Democracies has modeled out various scenarios to test this hypothesis. We assessed four broad scenarios: (1) European refineries stop buying Iranian crude but all other countries continue as usual; (2) Europe is joined by Japan and South Korea; (3) China becomes the sole purchaser; (4) Europe, Japan and South Korea stop buying and half of the non-OECD countries (Turkey, India, Malaysia, South Africa, Pakistan, and Sri Lanka) join the effort. We also looked at a scenario in which China and India are the only purchasers of Iranian crude, as well as market differences when refineries within a given country negotiate with Iran separately, or when they collude and negotiate with Iran as a single customer.

According to the analysis, there would be a negligible impact on world crude and refined petroleum prices as a result of the implementation of this idea. Even in the most stringent scenario, where China is the only remaining buyer of Iranian oil, all non-Iranian crude could be redirected to other refineries with no net loss in global supply, and only a minimal impact in transportation costs (less than one cent per barrel when averaged over the global oil pool).

The important takeaway from this scenario: an increase in non-Iranian OPEC production would not be required. Additionally, we expect the financial market to react rationally to the idea as it waited to see the actual physical impacts (which are expected to be negligible) before significantly changing price expectations.

The "Iranian-Oil-Free-Zone" analysis yields a price discount on the sale of Iranian crude that varies considerably across the scenarios explored. The low end, according to our calculations, would yield a 2.7 percent decrease in price which would result in a $2.8 billion reduction in annual Iranian oil revenues, based on a scenario in which only European refineries stop purchasing, but all others continue as usual (and don't collude). At the highest end of the range, the price discount is 41.7 percent – amounting to a $39 billion decrease in Iranian oil revenues - , based on a scenario in which China remains the only buyer and Chinese refineries (all state-owned) collectively negotiate with Iran as a single customer.

Considering that the Treasury Department estimates that *all* current sanctions will cost Iran $14 billion in *annual* oil revenues over the next five years, an additional $2.8 billion reduction in Iran's *annual* oil revenues, based on the lower end of the range (or an additional 20 percent on top of Treasury's estimates), would be significant especially given the negligible impact on oil prices and the minimal risk of supply disruptions or reactionary or alarmist market reaction.

[34] Data from ENI and Energy Intelligence.

The lessons from the modeling exercise are: (1) reactionary or alarmist market reactions that assume Iranian supply will be materially impacted can sharply reduce or entirely negate the intended benefits of the measure; and, (2) buyers of Iranian crude can extract larger discounts on the price of each barrel of Iranian oil when those buyers are few in number, they have more negotiating leverage over Iran, and they can collude and negotiate with Iran as a single customer.

An incremental approach of IRGC designations – implemented rapidly – can reduce the number of "white-hatted" refineries willing to buy oil. These designations, combined with quiet persuasion, and the threat of sanctions against select Iranian crude oil buyers, can reduce the number of buyers, assure markets that physical supply will not be impacted, and reinforce the price discounts extracted by "black hats" as a result of the "Iranian-Oil-Free-Zone"

If past experience with sanctions on investment in Iran's energy sector is any guide, European companies, and possibly select companies from Japan, South Korea, India, will be more responsible and responsive players. They care more about their corporate reputation than Chinese state-owned energy companies or have more U.S. financial or market exposure than, for example, Turkish or South African companies.

While the European Union is the largest single importer of Iranian crude, buying about 20-25 percent of Iran's total crude sales, Iranian crude represents only 5 percent of the Europe's total imports, making it less dependent on Iran.[35] Europe's energy companies however have significant U.S. financial and market exposure making them more susceptible to American pressure.

The other larger importers of Iranian crude in order (with the percent that Iran represents of their crude oil imports in parentheses) are: China (9%), India (15%), Japan (10%), South Korea (9%) Turkey (44%) and South Africa (29%).[36] Japanese and South Korean companies, and to a lesser but still notable extent, Indian companies, have complied with U.S. energy investment sanctions. Some, if not all refineries in those countries, may also reduce or terminate their purchases of Iranian crude if faced with the threat of sanctions for doing business with the IRGC.

A combination of an "Iranian-Oil-Free-Zone" and sanctions against companies buying oil from the IRGC therefore might be enough to persuade Europe (and some individual refineries in Japan, South Korea and India) to stop buying Iranian oil. Indeed, by passing their own energy sanctions or in complying with select U.S. measures, Europe, Japan and South Korea have already demonstrated some willingness to make tough choices in the name of international security.

Targeting the Central Bank of Iran

Influential policymakers have characterized the designation of the Central Bank of Iran as the "nuclear option," or a sanction with such overwhelming impact that it should be used only as a

[35] Data is from UN Comtrade, JODI (www.jodidata.org), EIA.
[36] Ibid.

last resort. Indeed, George W. Bush administration officials, notably former Treasury Secretary Henry Paulson, were understood to be strongly opposed to a CBI designation, viewing central banks as a "third rail" of the sanctions track. The view seems to be shared by some Obama administration officials and more widely by policymakers in Europe. The fear is that, with Iran's economy already groaning under the weight of other significant sanctions, such a designation could cause the Iranian economy to effectively implode. The concern is that this would impoverish Iran's citizens and could give the regime a propaganda victory in blaming the economic misery on western sanctions (so far, the regime and not sanctions appear to be the target of blame by Iranians for the country's economic misery). More to the point, analysts fear that the move would have severely deleterious effects on the oil market, sending prices soaring and damaging the fragile world economy.

To the 92 U.S. senators who recently signed a letter calling on the Obama administration to designate the CBI,[37] and to America's jittery allies most concerned about the prospect of Iran armed with an atomic bomb, the real nuclear option involves Iran's spinning centrifuges, uranium enrichment, missile development, and nuclear weaponization. If a CBI designation is strictly implemented, and other central and commercial banks are sanctioned for transacting with the CBI, the impact on Iran could be enormous: It could cut off the Islamic Republic entirely from the global financial system and severely restrict Tehran's ability to engage in any type of meaningful financial or commercial transaction, including the sale of its crude oil.

With the designations of the Libyan and Syrian central banks by the Obama administration this year, a CBI designation is looking more possible. In his testimony before the Senate Banking Committee on October 13, 2011, Treasury Under Secretary David Cohen acknowledged that the Obama administration was looking at a CBI designation, and might move ahead, "if it engenders multilateral support."[38]

As Under Secretary Cohen and his predecessor Stuart Levey have so successfully curtailed the willingness of international banks to settle oil trades with designated Iranian banks, the CBI has become a critical financial lifeline for the Islamic Republic. Oil purchasers -- particularly from China, India, South Korea, and Japan -- have used the CBI, and select banks from Germany, Turkey, and Russia to settle oil trades. With CBI sanctions, these trades could be sharply reduced or frozen.

In recent weeks, however, press reports have suggested that the Obama administration may be backing off from a blanket designation of the CBI because of concerns about the impact on oil markets.[39] The fear may be that a strictly enforced designation against oil companies settling trades with the CBI could make it very difficult for anyone to buy Iranian oil, leading to fears in the oil markets of a disruption of Iranian crude sales.

[37] Anna Fifield, "Senators Call for Iran Central Bank," *Financial Times*, August 10, 2011. (http://www.ft.com/intl/cms/s/0/addf0442-c2b4-11e0-8cc7-00144feabdc0.html#axzz1dVtnQCWA)
[38] David S. Cohen, Written Testimony of Under Secretary David S. Cohen before the Senate Committee on Banking, Housing, and Urban Affairs, October 13, 2011. (http://www.treasury.gov/press-center/press-releases/Pages/tg1323.aspx)
[39] Paul Richter, "U.S. Backs Away From Sanctions on Iran Central Bank," *Los Angeles Times*, November 4, 2011. (http://articles.latimes.com/2011/nov/04/world/la-fg-us-iran-20111104)

In recent decades, five international crises have led to major oil supply disruptions: the Yom Kippur War (1973), the Iranian Revolution (1979), the Iran-Iraq War (1980-1988), the Persian Gulf War (1991), and the Libyan Civil War (2011). These crises led to supply disruptions that lasted anywhere between two and eight months, and increased oil prices ranging from to 20 percent during the first three months of the Libyan Civil War to 67 percent during the first two months of the Persian Gulf War in 1990.[40]

With Iranian crude oil exports representing almost double Libya's, and just over 2.5% of world demand, a halt to Iranian supply could have an even harsher effect on the world economy. Worse still, as noted above, oil price spikes would only enrich the Iranian regime, which could generate $120 billion in annual oil revenue at 2.3 million barrels per day if oil prices reached $150 or higher.

The administration is right to worry that wholesale sanctions against the Iranian central bank could shut down the export of oil and the Iranian economy. But neither the White House nor Congress, where sentiment in favor of central-bank interdictions is rising, needs to *immediately* implement a blanket designation against the CBI. Rather, such a designation could be constructed piecemeal with targeted sanctions against the Central Bank of Iran and its role in facilitating Iran's oil sales involving the IRGC as a precursor to a blanket designation of the CBI.

The administration should designate the CBI in its entirety but provide six months before implementation begins in order to give oil companies time to find alternative suppliers and calm oil markets. Given the pace of development of Iran's nuclear program, this will be a critical six month window during which time it will be necessary to drive as many white-hatted companies out of the market as possible.

To do this, as it builds support for the a blanket CBI designation in Europe and amongst other allies, Washington should immediately and selectively prohibit certain oil transactions, including those where the CBI plays a role in trades involving Revolutionary Guard-affiliated companies and international companies.

Sanctions need not be enforced against Chinese energy firms, for example, buying Iranian oil, using the "Iranian-Oil-Free-Zone" model as a guide. Treasury can selectively enforce sanctions against some buyers and not others based on evidence of IRGC and CBI involvement. Energy traders will quickly sense that the quantity of oil on the market remains unchanged while Iran watches its oil-revenues decline.

The short-term impact, if implemented correctly, would not create panic. Rather, it would create assurances that the West has taken control of the Iran crisis. Smart sanctions, as described here, should ensure that oil prices would react in a rational way as markets appreciate the fact that the physical supply of oil will be unaffected.

The effects of this approach would be costly for the CBI since it would face greater rejections of its transactions from responsible institutions unwilling to take a risk with the CBI in this environment and be forced to pay more significant transactions costs for those willing to help

[40] Data is from the EIA and IEA.

them evade sanctions. Increased transactions costs and lower oil revenues would drain the Iranian treasury.

It would also reinforce a central message: The Central Bank of Iran, like the National Iranian Oil Company, and other IRGC entities discussed above -- are critical links in the IRGC-dominated oil supply chain and key enablers of the IRGC's proliferation activities, terrorist operations and human rights abuses. This will help Washington build support for more comprehensive sanctions against the CBI and give markets more time to adjust to the possibility of more severe sanctions. This, in turn, will prompt responsible oil companies and financial institutions to assess carefully the risks of doing business with the CBI for the purchase of oil.

As the number of responsible or "white-hatted" companies decide that these risks are too great, the pool of buyers for Iranian crude will shrink, and the remaining buyers will have enough negotiating power to extract significant discounts from Tehran. All the while, Iran's reserves of hard currency will dwindle, leaving it with less leverage and less room to maneuver.

Conclusion

An effective sanctions strategy must be part of a comprehensive approach that includes a number of coercive measures to thwart—or even stall—Tehran's nuclear designs. Sanctions, even against Iran's oil sales, which are the lifeblood of the regime, are not a "silver bullet" and, to have a chance of working, must include a variety of measures that are dynamic and mutually reinforcing. Tehran is exploiting all loopholes in U.S. law and international sanctions to maintain the critical flow of revenues from its energy sector. Iran has a long history of gaming the international energy and financial markets and Western policymakers must continue to plug loopholes and identify new approaches.

But sanctions need not be a timid response to the Iranian threat. The right sanctions targeting Iran's oil sales, with proper calibration and implementation, can deliver an economic blow to Iran while preserving stability in the global economy. Robust sanctions are a necessary step before moving to more forceful action to stop Iran's nuclear ambitions. Indeed, leveraging sanctions to their fullest against the Iran regime is a strategic and ethical imperative for this administration and this congress. In this way, if sanctions against the regime's oil sales fail, no one can argue that countries threatened by Iran did not exhaust all possible alternatives.

Biography

Mark Dubowitz, Esq.

Mark Dubowitz is executive director of the Foundation for Defense of Democracies. His policy work focuses on Iran and Syria, sanctions, and on the use of technology to encourage democratic change.

Mark is head of FDD's Iran Energy Project, which provides research and analysis on Iran energy sanctions and tracks the role of the Islamic Revolutionary Guard Corps in Iran's energy sector. He directs FDD's Iran Human Rights Project, which provides research on Iranian human rights abuses and on sanctions designed to hold accountable Iranian officials and international companies supporting these abuses. Mark co-leads FDD's work on Syria sanctions against the regime of Bashar al-Assad and is a founding member of the FDD Syria Working Group.

As a former technology executive and venture capitalist, Mark also researches the role of technology in supporting anti-regime democracy movements in the Middle East.

Mark appears frequently on Iran, Syria and technology issues in major media. He is a regular contributor to *Forbes* and *The Huffington Post* (Canada). His writings have appeared in *The Wall Street Journal*, *The Washington Post*, *The Los Angeles Times*, *Foreign Policy*, *Politico*, *Slate*, *The Hill*, *The Weekly Standard*, *National Review*, *The National Post*, and *The Financial Times* (Germany). He is the co-author of *Iran's Energy Partners: Companies Requiring Investigation Under U.S. Sanctions Law* (FDD Press, August 2010) and *Iran's Chinese Energy Partners: Companies Eligible for Investigation Under U.S. Sanctions Law* (FDD Press, September 2010). He is also the co-author of confidential studies provided to the U.S. government on the role of the Islamic Revolutionary Guard Corps in the Iranian energy sector, and on the creation of an "Iranian-Oil-Free Zone" to target the export of Iranian crude oil.

Mark has testified before Congress on Iran sanctions issues and briefed the military, government and counterterrorism officials on a range of national security and terrorism-related concerns.

Mark previously worked in the venture capital industry focused on fundraising for early-stage technology companies. He also worked in software management as Director of International Business Development at Doubleclick (purchased by Google) and as Director of Corporate Development and General Manager, European & Asian Operations, at FloNetwork (purchased by Doubleclick).

Mark has lived in the Middle East, Europe, and Africa and speaks three languages. He graduated with honors with a masters in International Public Policy from Johns Hopkins University's Paul H. Nitze School of Advanced International Studies (SAIS) in Washington, D.C. Mark also has JD and MBA degrees from the University of Toronto.

Committee on Oversight and Government Reform
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)(5)

Name: Mark Dubowitz

1. Please list any federal grants or contracts (including subgrants or subcontracts) you have received since October 1, 2008. Include the source and amount of each grant or contract.

None

2. Please list any entity you are testifying on behalf of and briefly describe your relationship with these entities.

Foundation for Defense of Democracies

3. Please list any federal grants or contracts (including subgrants or subcontracts) received since October 1, 2008, by the entity(ies) you listed above. Include the source and amount of each grant or contract.

CA-167: Democracy Training for Women in the Middle East
Middle East Partnership Initiative
U.S. Department of State
2008 – 4th quarter – $196,365.31
2009 – $1,168,635.76

I certify that the above information is true and correct.
Signature:

Date: November 14, 2011