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THE IRANIAN DILEMMA: ENERGY AND SECURITY IMPLICATIONS

INTRODUCTION

With the occupation of the U.S. Embassy in Tehran on November 4, 1979, and taking of 62 American hostages, militant followers of the Ayatollah Khomeini have added a new and perilous dimension to the political and economic environment in the Middle East. The embassy was seized by a group of students demanding the extradition of Shah Mohammed Reza Pahlevi to Iran to stand trial as a "war criminal." They also are demanding that the U.S. government seize the deposed monarch's assets and turn them over to the Iranian government.

While it is not known whether the takeover was directly instigated by the Khomeini government, there is no doubt that the Islamic regime has capitalized on the act to shore up its deteriorating position. It is somewhat ironic that only a few weeks prior to the incident, other Iranian students were demonstrating in the streets of Tehran against the ayatollah.

In Iran, members of the Iranian Air Force and the Iranian Army have come to the embassy to demonstrate their support for the occupiers. The Carter Administration has announced a boycott of Iranian oil shipments to the U.S., which was followed within hours by an announcement by Iran of an embargo on shipments to the U.S. Similarly, an announcement by Iran that it was going to withdraw assets held in the U.S. was followed within hours by an announcement from the White House that President Carter has ordered these funds frozen.

President Carter's November 12th ban of Iranian oil was a pre-emptive neutralization of Iranian oil leverage over the U.S. designed to weaken the Iranian bargaining position vis-a-vis the American hostages held in Tehran and, by extension, its leverage vis-a-vis the status of the Shah. Since Iran will have no problem

selling its oil elsewhere, and indeed may make more money doing so, the cutoff is not really a sanction as such, but an aggressive defensive move aimed at depriving Iran of a potential sanction. Given the fact that Iran was on the verge of declaring an embargo on oil exports to the U.S. (the Iranians make the self-serving claim that they had already made the decision to embargo oil exports to the U.S. when President Carter announced the American boycott of their oil) the U.S. had little to lose and much to gain.

The U.S. boycott of Iranian oil has improved the U.S. bargaining position in the short run and sets a precedent that may deter other petrocoercive pressure in the long run.

To emphasize this show of American independence, officials have stressed that the U.S. is not asking oil-producing nations to boost output to offset the shortfall in U.S. oil imports, nor is it asking allies to cut imports to divert oil to the U.S. The expectation is that since oil is an extremely fungible commodity, the international oil industry can reroute oil traffic through swap agreements that will allow the U.S. to find alternative oil supplies made available by the release of Iranian oil formerly funneled into the U.S. However, the Iranians may attempt to overcome the flexibility of the international oil distribution network by resorting to a production cutback, much as Arab oil producers did in 1973.

Sadegh Ghotbzadeh, a prominent member of the Revolutionary Council, confirmed on November 13 that there would be a drop in production levels, at least in the short-term, "for fifteen days to three weeks" while the oil company makes the necessary marketing adjustments for the loss of U.S. orders. The size and duration of the proposed production cutbacks is yet unknown. In any event, the international oil market resembles a giant sponge and it will be impossible for the Iranians to focus the resulting shortages on the U.S. market since they do not control the oil distribution network. All they can do is lower the oil content of the sponge as a whole. The Iranian oil weapon is therefore untargetable and would inflict collateral damage in an indiscriminate manner on a broad array of oil-importing states who were in effect innocent bystanders. Such a policy will win few friends for Khomeini, who may soon need all he can get given the deterioration of Iran's relations with Iraq, the growing strength of radical leftists and continuing restiveness of several ethnic minority groups seeking greater autonomy, if not independence. (These groups would welcome support from Iran's neighbors -Iraq, Afghanistan and the Soviet Union.)

THE WORLD OIL OUTLOOK

At present, world oil production is in the neighborhood of 49.2 million barrels per day (mbd). Of that figure, Iranian production is estimated at around 7.1 percent, or roughly 3.5

mbd. In terms of U.S. imports, Iran represents a relatively small share. Prior to the imposition of the boycott and embargo, the United States was importing between 700,000 and 800,000 barrels of oil and refined products per day from Iran. This was a sharp reduction in absolute terms from the level of Iranian imports under the Shah, which was in excess of 1 million b/d. Direct imports to the U.S. are actually only 501,000 b/d, with the balance going to the Virgin Islands and Puerto Rico. As a percentage of imports, Iranian oil accounted for 6.5 percent of all imports, and imports accounted for around 47.9 percent of all consumption. Therefore, Iranian production amounted to only about 3 percent of total U.S. oil requirements. Other nations are in less enviable positions.

Perhaps the most vulnerable nation is Japan which imported 536,000 b/d of Iranian oil last month, amounting to 11 percent of its domestic needs. Japan has virtually no oil reserves of its own, and is not particularly well endowed with other fossil fuels. As a result, the Japanese are totally dependent on imports for their energy requirements in this sector, and are especially sensitive to actions which might upset the delicate balance in the Middle East. There are other nations, though, especially in western Europe, which are also quite vulnerable to severe economic dislocations in the event of a supply interruption from Iran. Among the western European nations, the top users of Iranian oil in 1978 were: the Netherlands with 19.8 percent of its supplies coming from Iran, West Germany with 16.6 percent, Italy with 13.9 percent, Great Britain with 11.4 percent, France with 10.5 percent, Spain with 8.3 percent, and Belgium with 7.4 percent. The British proportion of Iranian oil has changed substantially in the last year due to the development of the North Sea find, and other nations' shares may also have changed due to the reduction of Iranian production; but, on balance, their relative ranks should have remained similar this year. Brazil is also quite vulnerable to an Iranian shutdown, as they receive around 150,000 b/d from that country, and their total consumption is in the range of 1 million b/d.

It should be noted that the real impact of an Iranian shutdown is somewhat hard to assess precisely, due the fact that the current regime has chosen to dedicate a substantial amount of its production to the spot market, where purchases are virtually impossible to trace. Oil sold on the spot market may change hands dozens of times prior to its ultimate resting place. It is this same fact which would lessen the effect of the Iranian boycott/embargo should the Khomeini government choose to continue production at current levels, merely refusing to sell oil directly to the U.S. All that would happen in that case would be a simple reshuffling of customers.

It is important to understand that the current situation differs in many ways from the one which existed as a result of the shutdown of production which occurred in the aftermath of the Shah's downfall, and even more so from the more widespread embargo

which occurred in conjunction with the October War. In both of the other cases, there was an actual interruption of production, whereas there has not yet been such an interruption during the current situation. There is some indication, though, that such an interruption could be forthcoming. A second, critical consideration in the event of an interruption is the inability of other producers to make up any deficit which develops in world oil supplies. During the strikes which crippled oil production from Iran and led to the downfall of the Shah earlier this year, Saudi Arabia, Kuwait, and other OPEC members increased their production to help stabilize world oil markets. Prior to the 1978 shutdown, Saudi Arabia had been producing 8.5 mbd. It increased its production first to 9.5 mbd, and then 10.5 mbd, as world stocks were drawn down. Kuwait increased its output by 500,000 b/d during the same period, and other OPEC members also increased production. In order to help relieve the pressure on oil prices, the Saudis have maintained their production at around 9.5 mbd throughout most of 1979, and are producing at this level at present. This means that they have only half as much shut-in capacity as they did during the last crisis. Further, Kuwait has indicated that it would not be willing to increase production again. Therefore, the cushion which served to soften the impact of the last Iranian supply interruption no longer exists.

Some observers note that there is tremendous potential in Mexico and on the North Slope of Alaska to increase production, and that this capacity might alleviate any long-term interruption of Iranian supplies. Such speculation ignores a number of important facts. First, the Mexican government has indicated that it would impose a ceiling on production from its Reforma find off Yucatan Peninsula to conserve its oil supplies. Secondly, since the Reforma field is relatively shallow, and requires intensive drilling, a massive amount of equipment would have to be put into place before it could reasonably be expected to make up a deficit as large as that which would be experienced in the wake of another Iranian shutdown. Finally, there is great sensitivity in most oil-producing nations to the possibility of creating problems similar to those experienced in Iran through a too rapid development of their mineral resources.

In the case of the North Slope of Alaska, a number of factors inhibit this source from making up an Iranian-caused shortfall. First, there is inadequate refinery capacity available of the right type to process additional amounts of Alaskan crude oil. It is a relatively heavy crude, and requires more extensive processing than lighter crude oil such as that produced in Iran. Secondly, due to the requirements of the Jones Act, the types of shipping available to move Alaskan oil are limited, and thereby constrains the amount which can be produced. Also, as is the case with Mexico, a significant increase in Alaskan production would require the installation of additional equipment, with a very long lead time for installation.

THE DOMESTIC IMPACT

The question on most Americans' minds is the extent to which the boycott/embargo will affect the U.S. gasoline situation. As noted earlier, the answer to this question lies in part in whether or not a production slowdown accompanies the embargo. If such a slowdown does not occur, then the effect in terms of supply will be minimal. It should be noted, though, that supplies of motor gasoline, and especially unleaded motor gasoline, were going to be tight in the spring of 1980 regardless of what has taken place in Iran. The occurrences in that nation will only exacerbate a situation which was developing independently.

There are two ways in which the current Iranian actions affect the U.S. situation. The first is in terms of price effects. Regardless of whether or not the U.S. is able to make up the loss of crude from Iran, prices will be adversely affected. If the loss is made up from purchases on the spot market, then the prices at which that oil is purchased will be far in excess of those which would have been in effect under the contracts which were in force prior to the boycott/embargo. At present, spot prices are ranging as high as \$40 per barrel and may go even higher. Should the Iranian oil be replaced at this price, a minimum of 1.7¢ would be added to the price of a gallon of gasoline, assuming a straight pass-through of the increased costs, without taking into consideration other secondary effects such as the increase in petrochemical products, or the additional revenues which might accrue to refiners. Assuming that the total amount of crude and refined products could be replaced through spot marketing purchases, the minimum annual increase to the U.S. consumer would be on the order of \$4.5 billion.

A second, and more serious effect could be an exacerbation of the already tight situation with regard to motor gasoline. Since there is going to be some shortfall in any event, the loss of even an additional 3 percent can be serious. This is especially true as the effects of this loss would make themselves felt at the beginning of the driving season. Needless to say, such a shortfall would only occur if we were unable to replace the Iranian crude with purchases from other suppliers, or if there were a total loss of production in Iran. Ironically, such cut-backs would increase the prices on the spot market even more, and would probably add to the upward pressures on all oil prices. The net effect of such action would, again, be to increase the cost of motor fuels, and other petroleum products to the consumer. One estimate places the minimum increase in the cost of a barrel of oil resulting from the current turmoil in Iran at \$2.50, which would translate into an additional \$14.9 billion annually at current import levels. This would place the overall effect of the current situation at \$19.4 billion, or an additional 7.4¢ per gallon of gasoline. For the average motorist, driving 12,000 miles per year, the additional cost would be \$74.

The current spot price of gasoline in New York (as of November 12, 1979) ranged from \$1.16 for a gallon of leaded regular to \$1.1825 for a gallon of unleaded regular. These, of course, are wholesale prices. They are, however, increasingly seen as leading indicators for each quarter's price rise. This would mean that the retail price of gasoline would rise between \$1.25 and \$1.30 per gallon by the middle of the first quarter of 1980, and if present trends continue, possibly substantially higher by the end of that year.

Similar increases will be felt in diesel fuel and home heating oil prices, with these commodity prices rising to well over \$1 per gallon also.

EFFECTS ON WORLD OIL MARKETS

As long as Iran continues to produce, there will be little effect on the world oil market, except that anxiety among nations with small amounts of domestic oil supplies may lead to panic buying on the spot market. In fact, such buying is already reported to be taking place. Among the nations most active in the spot market appear to be Germany and Japan, with Japan being perhaps the largest purchaser. The surge of prices brought on by this initial spate of panic buying may continue even if there is no curtailment of production.

On balance, most nations are in better shape going into this most recent oil crisis than they were prior to the last Iranian shutdown, and they were in better shape going into that one than they were going into the 1973 embargo. In the U.S., supplies of virtually every category of petroleum product are higher than a year ago at this time and consumption is considerably down. For the four-week period ending October 20, domestic demand for petroleum products was 6.7 percent less than for the same period the previous year. Gasoline demand was down 6.4 percent and distillate demand was down 11.1 percent. Overall, petroleum demand has increased only 0.1 percent from the same period in 1973, and gasoline demand has increased only 4.9 percent from the same period in 1973. Imports of crude oil, however, had increased a staggering 79.7 percent, from 3.65 mbd to 6.56 mbd. Imports of refined products, however, had dropped by 45 percent so that the overall increase in imports was 24.5 percent from 1973.

Of some concern are the effects of a long-term stoppage of the flow of oil from Iran. As evidenced from the figures quoted above, most nations are making progress in curtailing demand, but they can go only so far. At present, the supply/demand equilibrium is in a delicate balance. A total loss of Iranian production at this juncture would upset it, perhaps for years to come. Most of all, however, it would hurt the developing nations.

Unlike the industrialized nations of the West, the developing world does not have a range of energy options open to it.

Petroleum is far more important to their economic survival than it is for industrialized nations. They use it for virtually every essential energy use ranging from electricity generation to fueling industrial boilers. Further, they do not have the export base to manage the increasingly onerous burden petroleum purchases place on their balance of payments. Turkey, for example, may have to commit its total export revenues this year to finance the purchase of oil. Next year, its revenues will not be sufficient. Many other developing nations are in similar straits. The creation of such economic pressures can only add further to the instability already present in the third world, and to the hardships its citizens encounter.

In any case, it is evident that the overall impact of the current situation in Iran will be felt far more severely in nations outside the U.S. than within the U.S. itself. For Americans, it will mean a slight increase in the price of gasoline, home heating oil, and middle distillate fuels, and some deterioration in our balance of payments. At worst, it might mean gas lines in the spring, and some increase in inflation. For nations such as Japan, however, the consequences will be far more serious. At a minimum, it will mean a sharp increase in the cost of petroleum products they purchase, and at its worst, it could mean a loss of as much as 11 percent of their domestic supply.

IRANIAN DOMESTIC POLITICS

The decision to forego Iranian oil imports was a symbolic victory of the U.S. over a radical Islamic regime which has steeped itself in symbolism. Ayatollah Khomeini rose to power as the personification of opposition to the Shah and he has constantly manipulated national symbols such as the chador, the Koran and the Shah himself to paper over significant political, ideological, religious and ethnic cleavages which threaten to shatter the illusory unity of post-Shah Iran. The loose coalition of divergent groups which forced the Shah into exile was broad but shallow, bereft of any real sense of common purpose beyond the ouster of the Shah. To many Iranians, Khomeini was not so much a leader as a source of inspiration. They looked to him to provide a scathing indictment of the Shah based on past traditions, but never fully accepted his prescription for the future.

Once the initial flush of victory wore off, the latent contradictions in the revolutionary camp surfaced and the ad hoc anti-Shah coalition gradually dissolved into three major blocs grouped around the fundamentalist Shi'ite clergy, the moderate secular forces of the National Front, and the radical left. Since political legitimacy is by and large vested in the person of Khomeini, rival factions often invoked his name in support of inconsistent and often conflicting policy goals. Apparently, the Islamic militants who recently seized the American Embassy and took its occupants hostage, did so of their own volition, presenting Khomeini with a fait accompli which he subsequently endorsed.

The embassy takeover is symptomatic of the general proliferation within Iran of a multiplicity of power centers flourishing in the absence of effective centralized control. The collapse of the Bazargan government in the wake of the embassy seizure is likely to accelerate this trend. Already, regional officials such as Admiral Madani, the governor of the strategic oil producing province of Khuzestan, have obtained a large degree of autonomy from Tehran, if not Qom. Madani, in particular, bears watching because he controls self-sufficient navy, air and marine forces which could turn his enclave into a fortress - or a state within a state. Also, he is known to harbor political ambitions.

Although Khomeini made an excellent leader of a mass opposition movement, he has proven to be a poor architect of national unity. In recent months, his delphic pronouncements have increasingly become a source of friction rather than consensus-building. Because he has not created an effective institutionalized framework for policy-making, the ayatollah must continually adjudicate disputes between rival factions and keep a tight rein on the many autonomous political/religious/administrative entities which operate in a piecemeal fashion within the Iranian political landscape. This is a difficult job for anyone, let alone a 79 year-old man. Yet, if he should die, Iran would be plunged into chaos.

In seeking to obtain the release of the hostages, the U.S. is likely to find that it is negotiating not only with Khomeini, but with the Islamic activists at the embassy as well. While Khomeini will probably have the final say, he no longer seems to be fully in control. In general, he increasingly seems to be becoming a reactor responding to events rather than an actor shaping them. Any agreement to free the hostages will probably be difficult, if not impossible, to reach since both sides have staked out non-negotiable positions. Not only is Khomeini intolerant of compromise by temperament, but he stands to reap domestic political dividends in a prolonged stalemate.

Anti-Americanism is one of the few strong binding forces holding the Iranian revolutionary forces together. The three-ring circus at the embassy distracts the fragmented Iranian policy from its festering domestic problems and promotes a spirit of solidarity which strengthens the political position of Khomeini and his inner circle against his growing number of critics. It should be noted that in the week before the seizure of the embassy, unemployed Iranian workers occupied two government ministries in protest over the Khomeini regime's economic policies. If radical student activists had not later invaded the American Embassy, Iranians might now be focusing on a different kind of political symbolism.

IRAN VS. IRAQ

Ironically, the Khomeini regime may be irrevocably alienating the United States at a time when it can least afford to do so. In recent months, rising tension between Iraq and Iran have led Baghdad to concentrate its military forces along the border and renew its support of the Arab separatist movement in Iran's oil-rich Khuzestan province (which the Iraqis refer to as "Arabstan"). On October 31, Iraq unilaterally abrogated the 1975 Algiers accord, which ended three years of border hostilities by redefining borders in favor of Iran while mandating pledges from each signatory to end subversion in the other state. At that time, the Shah extracted a high price for ending Iranian support of Kurdish separatists in Iraq: Iraq granted Iran half of the long disputed Shatt-al-Arab estuary. It is believed that Iraq's withdrawal from the 1975 agreement reflects Baghdad's determination to press its relative advantage against Teheran while Iran is weakest, in revenge for the hard bargain which the Shah drove in 1975. Given the sharply deteriorating state of relations between the two countries the outbreak of war is a distinct possibility.

The Iraqis perceive Khomeini's Iran, although it is militarily weaker, to be more of a threat than the Shah's Iran ever was. They are painfully aware that they earned Khomeini's unrelenting hostility when they expelled him from his Iraqi exile in the holy city of Najjaf in the fall of 1978. More importantly, Baghdad fears that Khomeini is bent on exporting his brand of radical Shi'ite activism to other Gulf states. Iraq, like Kuwait and Bahrein, is ruled by a Sunni minority government. While more than half of the Iraqi population is Shi'ite, the ruling Ba'ath party is dominated by Sunni Moslems who fear that Khomeini will purposefully or inadvertently incite Shi'ite unrest which could weaken their grip on the country. Baghdad has already brutally suppressed one spontaneous outbreak of Shi'ite unrest in June, a violent episode which many observers consider to have been a major factor in the ouster of President Ahmed Hassan Bakr by strongman Saddam Hussein the following month. Hussein is known to be much more suspicious of Khomeini's intentions than Bakr and it is believed that Hussein fears that unless Khomeini is checked soon, he will trigger chronic sectarian violence within Iraq for years to come.

In recent months, Hussein's apprehensions have been fueled by the inflammatory rhetoric of radical Shi'ite firebrands within Khomeini's Revolutionary Council. Ayatollah Sadek Rouhani has repeatedly threatened Bahrein with annexation unless Bahrein transforms itself into an Islamic state. Ayatollah Hossein Ali Montazeri, the Imam of Tehran, proclaimed in early October that while Iran had no territorial ambitions in the Gulf, "the Islamic Revolution knows no boundaries, as Islam has no frontiers.... And defending justice and right is not the same as interfering in other countries' internal affairs." The Iraqis have responded by pledging to intervene on Bahrein's behalf if Iran attempts to

annex that island-state and have offered Iraqi troops to both Kuwait and Bahrein as part of a collective Arab Gulf defense plan. The Iraqis have also concluded a bilateral security pact with the Saudis which is believed to define Arab security in Sunni terms.

While Baghdad's insecurities about Shi'ite unrest and the possibility that its 1.8 million Kurds will become inflamed by resurgent Kurdish nationalism within Iran are genuine concerns, there are widespread suspicions that Hussein is playing up the threat of Iran's Shi'ite revolution in order to cloak his own expansionist goals. Iraq has stepped up its direct logistical support for separatist violence mounted by ardent nationalists among Iran's 2 million Arabs in Khuzestan province. Given the Iraqi build-up along the border and the abrogation of the 1975 border accord, Iraqi military intervention, possibly at the request of the Khuzestani Arabs, is a real possibility. Iran's disorganized armed forces would be no match for the 11 Soviet-equipped Iraqi divisions, especially now that the Iranians have provoked the U.S. into suspending shipments of spare parts for the sophisticated American military equipment which Iran purchased under the Shah. The danger is that an Iraqi intervention, even if undertaken on a limited basis, might result in the destruction or lengthy incapacitation of Iran's (or even Iraq's) oil production facilities.

Even if the threat of an Iraqi invasion should not materialize, Iran's oil production could be critically hamstrung by domestic Iranian developments. Arab nationalists have frequently disrupted production by sporadically sabotaging the vulnerable pipeline transportation network which brings Iranian oil to Gulf terminals. Production schedules have also been hampered by wildcat strikes organized by leftists as well as Arab nationalists. Iran's Tudeh communist party is believed to have cultivated a strategic following among the ranks of second-level managers in the oil industry and refinery workers in Abadan. If the Iranian political environment becomes increasingly polarized, a confrontation between leftists and Islamic fundamentalists would almost certainly result in the shutdown of oil production for an indefinite period. Clearly, Iran's oil production will be susceptible to politically-motivated interruptions for months, if not years, to come.

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