February 9, 2012 New Delhi, India

Iran Sanctions: Can India Walk the Talk?

LexCounsel, Law Offices

C-10, Gulmohar Park
New Delhi 110 049, INDIA.

Tel.:+91.11.4166.2861
Fax:+91.11.4166.2862

Recommended by:

LEGAL 500 · PROFILES · CHAMBERS ASIA

IRAN SANCTIONS: CAN INDIA WALK THE TALK?

Sanctions are not new to Iranians who have defiantly lived through sanctions and asset freezes since 1979 when US President Jimmy Carter froze about $12 billion in Iranian assets, including bank deposits, gold and other properties. Without doubt, the latest spate of sanctions – US sanctions that deny access to the US financial system to any financial institution that conducts business with the Central Bank of Iran for transactions that involve sale of petroleum or petroleum products, and the EU ban on imports of Iranian crude oil and petroleum products – would hurt Iran, but who would hurt more – Iran or purchasers who are heavily dependent on its crude oil? Two of the largest importers of Iran's oil, China and India (together accounting for about 36% of Iran's oil exports) have indicated that they would continue their oil trade with Iran, leaving Iran some elbow room, and mitigating to some extent the impact of US and EU sanctions.

Though China buys twice as much oil from Saudi Arabia, it cannot afford to ignore Iran's oil for its own strategic petroleum reserve programme – a fact evidenced by a 30% increase in China's oil imports from Iran last year. Besides, the level of trade between China and Iran is high and still growing. China has been quick to fill voids created by Western companies pulling out of Iran because of international sanctions. There is substantial cooperation in the energy sector – in the development of oil and fields and refinery projects. A number of Chinese firms do crude oil trades that offset military trade debt with middle eastern countries. Today, China is Iran's most significant trade partner with bilateral exchanges of a value of over $45 billion. Further, the majority of Chinese oil traders are well insulated from US or European pressure and offer no leverage that could be exploited by outside interests – they have no exchange traded stock or US assets. (The US has already imposed sanctions on China's Zhuhai Zhenrong, a large Chinese oil trader for selling refined oil products to Iran, however, the trader does very little, if any, business in the US.) China has been steadily and resolutely forging and strengthening its business interests with Iran in the face of international sanctions without any apologies, and the US, it appears, has no leverage over it.

While confirming that it would continue to buy Iranian oil, India has gone further to state that it would only recognise multilateral sanctions imposed by the UN. In effect, India would not seek a waiver from the US to sidestep sanctions. It appears the landscape is now different from last year when the Reserve Bank of India had, in December 2010, abruptly scrapped the payment clearing union used to make payment for oil supplies to Iran without any visible alternative payment arrangements, triggering rumours that it was a trade off against the lobby for a permanent UN Security Council seat and security of supply of uranium fuel for India's civil nuclear agreement with the US. Why this change of heart?

Unlike China, India's strategic petroleum reserves plans are in the planning stage and storage facilities are still under construction. With India's energy consumption increasingly met by imports, it is highly unlikely that strategic petroleum reserves, when they become operational, would be met by domestic production. India is the fourth largest energy consumer in the world – after the US, China and Russia – with demand still rising. However, with no reserves like the US or China, India is highly vulnerable to volatility in global prices. Squeezing Iran out of the equation can aggravate upward pressure on oil prices. The International Monetary Fund had warned of a 20% to 30% boost in oil price if Iran cuts supplies to the EU (which has banned import, purchase or transport of crude oil from Iran). Also, there is a potential of military strikes against Iran's nuclear facilities. Furthermore, there is instability as far as output is concerned in other major oil producing countries; Iraq, Libya and Nigeria. For net oil importing countries like India, higher prices affect balance of payments and exert downward pressure on exchange rates leading to higher inflation.

In addition, 90% of India's energy consumption requirement is met by crude oil imports, of which 15% is supplied by Iran. Saudi Arabia which supplies more than a quarter of India's oil requirements has indicated that it is willing to raise oil output to fill any shortage due to international sanctions on Iran. However, substantial dependency on Saudi Arabia is a huge challenge for India's energy security. For a country that is almost wholly dependent on overseas suppliers for its energy consumption requirements, India, therefore, understandably cannot afford to ignore a 'sanction troubled' Iran.

Of course, there are other reasons for mutual cooperation. Iran is a key transit route to Afghanistan, which is of strategic military importance for India. India is looking at asserting itself in the Afghanistan region following the withdrawal of US' troops, and in view of Pakistan's increasing coziness with Beijing.

India boldly announced that it will continue buying Iranian oil. Can it walk the talk? The US sanctions target revenues from Iran's oil which the US believe are being used to finance Iran's nuclear programme, and seek to impose penalties on financial institutions dealing with the Central Bank of Iran for transactions that involve sale of petroleum or petroleum products. The EU sanctions have altogether banned imports of Iranian oil. The ambit of the US sanctions has recently been widened to freeze assets linked to the Iranian government.

The latest US sanctions are designed to isolate Iran's central bank and make it difficult, if not impossible, for importers to make payment for oil imports from Iran, thereby effectively choking sales of Iran's oil. To continue buying Iranian oil and not run afoul of US sanctions, India has to walk a tightrope. After scrapping the Asian Clearing Union, India has, for months altogether scurried around to find a payment arrangement for oil imports from Iran that is not violative of US sanctions. It is presently making payments for imports to Iran through Turkey's Halkbank, which is under threat as a result of fresh US sanctions. It is understood that India and Iran have agreed on a trade payment mechanism that would allow payment for upto 45 per cent of India's total crude imports from Iran in Indian Rupees to be paid into Indian bank accounts (which have little or no business in the US) opened by Iran. Iran can access the Indian Rupees to purchase Indian machinery, metals and automobile parts – a move that can boost bilateral non-oil trade. The rest of the payment will be offset against investment in Iran's oil and gas fields and other infrastructure projects.

The US President can grant a waiver for financial institutions in a country that has significantly reduced its dealings with Iran and in situations where a waiver is in US national security interest or necessary for energy market stability, but India has stated that it would not seek a waiver. Though India has taken a stand, US sanctions have already created uncertainty over proposed investments by Indian companies in Iran. Some Indian refineries have announced they would curtail oil supplies from Iran or made alternative arrangements in case supplies are disrupted. Reliance Industries Limited which operates refineries that sell fuel to Iran has already substantially curtailed exports. Essar Energy has also announced that it would curtail oil supplies from Iran. ONGC Videsh Limited ("OVL"), the overseas arm of state-owned Oil and Natural Gas Corporation (ONGC) cannot invest in the development of the Farzad-B gas field it had discovered in Farsi offshore block in view of US sanctions which is against any company investing more than $20 million in Iran's energy sector in any 12-month period. Iran has given OVL one month to execute a contract for the Farzad-B gas field otherwise the award would be cancelled. A lot of Indian businesses in the oil sector have financial dealings with the US and cannot afford to ignore US sanctions against Iran.

While the payment issues appear to have been temporarily resolved, it is apparent that the two countries would not carry on "normal" bilateral trade as long as US sanctions are in effect. While India would continue to import oil from Iran against payment in Indian Rupees and other agreed mechanisms, its investments in Iran's energy sector and infrastructure would likely suffer as a result of US sanctions. While appearing not to recognise the US sanctions, India's trade with Iran would, for the time being, be defined by its energy consumption requirements and informal compliance with US sanctions – a balance not so easily achieved as we would see in the coming months.

By: Alfred Adebare, Of Counsel (aadebare@lexcounsel.in)

Disclaimer : LexCounsel provides this e-newsletter on a complimentary basis solely for informational purposes. It is not intended to constitute, and should not be taken as, legal advice, or a communication intended to solicit or establish any attorney-client relationship between LexCounsel and the reader(s). LexCounsel shall not have any obligations or liabilities towards any acts or omission of any reader(s) consequent to any information contained in this e-newsletter. The readers are advised to consult competent professionals in their own judgment before acting on the basis of any information provided hereby