BRACEWELL

INSIGHTS

# International Sanctions and the Energy Sector – Part 1: Iran

October 25, 2018

*By: **Robert Meade** and **Joshua C. Zive***

Economic sanctions, in one form or another, have been applied for centuries to effect change in the activities or policies of states, groups or individuals. Sometimes they are perceived as geopolitical economic weaponry, leveraging the intertwined nature of the world's financial systems to inflict maximum economic pressure on their targets. Sanctions are increasingly used and are most prominently imposed, by the United States, European Union and United Nations. However, many nations have recently resorted to sanctions, either in coordination with other states or unilaterally. This leads to a non-harmonized web of compliance hurdles that international business must navigate with care.

International financial sanctions often target the activities of specific companies or individuals, freezing their assets or prohibiting business with them. Since 2012, however, an increase in the use of so-called "sectoral sanctions" has occurred, which target certain sectors of a state economy. The energy sector is often one of the first targeted. Companies operating in the energy sector, therefore need to understand, and keep abreast of, the ever-changing risks to ensure they do not fall foul of the sanctions that are directly or indirectly applicable to them. The penalties for non-compliance can be severe.

## Iran

### JCPOA and Sanctions Relief

International sanctions targeting the Iranian economy have been in place since 1979. The scope of the sanctions gradually increased and, by 2012, there was effectively an embargo on US or EU persons doing business in Iran without a licence. One aspect of those sanctions was a prohibition on the import of Iranian oil, petroleum or petrochemical products.

An unprecedented international agreement between China, France, Russia, the United Kingdom, the United States, Germany, the EU and Iran, known as the Joint Comprehensive Plan of Action ("**JCPOA**"), was concluded in 2015. Widely regarded as a diplomatic triumph and a tangible success in the use of sanctions, the JCPOA provided for Iranian sanctions relief in

exchange for verifiable curtailment of the Iranian nuclear programme. The first tranche of sanctions relief became effective on 16 January 2016 (**"Implementation Day"**).

Implementation Day rolled back the majority of UN and EU sanctions against Iran. The extra-territorial aspects of the US sanctions (the so-called '*secondary sanctions*'), which sought to prevent non-US persons from doing business with Iran, were also relaxed. Non-US persons were therefore able to invest in the Iranian energy sector for the first time in many years without fear of reprisal. The activities of US persons, however, continue to be restricted.

In the JCPOA's wake, Iran was considered by some to be an excellent investment opportunity and various European governments (including the UK) encouraged investment in its economy. However, the reluctance of the international banking system to facilitate such investments, largely due to their real or perceived exposure to the US sanctions still in force, made such investment difficult in practice.

**US Withdrawal From the JCPOA**

On May 8, 2018, the continuation of the JCPOA was thrown into doubt when President Trump announced that the United States would cease its participation in the landmark agreement. This announcement started two concurrent wind-down periods, following which the US sanctions that were lifted on Implementation Day would "*snap-back*" into force. The re-imposition of sanctions was codified in Executive Order 13846 of August 6, 2018.

The first wind-down period of 90 days expired on August 6, 2018. Following that date, a number of activities once again became prohibited by US sanctions including (i) the purchase or acquisition of US dollar banknotes by the Government of Iran; (ii) Iran's trade in gold or precious metals; and (iii) the direct or indirect sale, supply or transfer to or from Iran of graphite, raw or semi-finished metals such as aluminium and steel, and coal.

The second wind-down period of 180 days is likely to be of greater interest to companies operating in the energy sector. It expires on November 4, 2018. Following that date, the full complement of US sanctions against Iran's energy sector will "*snap-back*" into place.

The sanctions to be re-imposed prohibit a number of activities. They include a prohibition on any person knowingly[1] engaging in a significant transaction for the purchase, acquisition, sale, transport or marketing of petroleum or petroleum products or petrochemical products from Iran from November 5, 2018.[2]

OFAC[3] has stated that it will assess whether a transaction is "significant" on a case by case basis, taking into account *inter alia* the size, number, frequency, and nature of the transaction(s) and whether they are a part of a pattern of conduct.[4]

Non-US natural and legal persons who breach this prohibition risk once more becoming the subject of US secondary sanctions and finding themselves effectively cut-off from the US financial system. Energy sector participants engaged in the purchase, acquisition, sale,

transport or marketing of petroleum or petroleum products or petrochemical products should take steps to satisfy themselves that they will not breach the re-imposed sanctions by inadvertently dealing in Iranian origin materials.

However, although the US secondary sanctions will "*snap-back*" into effect, the international position will not simply revert to its 2012 state. The other parties to the JCPOA are not supportive of President Trump's decision, positing that it puts the curtailment of Iran's nuclear programme in jeopardy.

**The EU Blocking Statute**

In an effort to uphold the JCPOA and protect the nationals and companies of its Member States from any US enforcement action, the EU has revitalised the so-called "Blocking Statute."[5]

The Blocking Statute was originally implemented in 1996. The basic principle behind it is that:

*"EU operators shall not comply with the listed extra-territorial legislation, or any decision, ruling or award based thereon, given that the EU does not recognise its applicability to/effects towards EU* operators"[6]

The Blocking Statute sought to protect EU nationals and companies from the extra-territorial effect of sanctions imposed by third countries, such as the US. Originally, it only applied to certain US sanctions against Cuba, Iran and Libya. However, on August 7, 2018, it was updated to capture the more recent US sanctions legislation which re-imposes sanctions on Iran following the withdrawal of the United States from the JCPOA.

The Blocking Statute prohibits EU nationals and companies from complying with any requirement or prohibition based on the specified US sanctions. It also provides EU nationals and companies with a right to recover compensation for loss resulting from the application of the specified US sanctions. It is anticipated that this right to compensation will lead to an increase in civil litigation between contracting parties, in circumstances where one party is suspected of terminating the contract as a result of the specified US sanctions. Proving that this was the reason for termination may be difficult absent express confirmation from the terminating party. EU companies seeking to terminate contracts as a result of the re-imposed US sanctions should therefore tread carefully when asserting their termination reasoning to contractual counterparties.

In appearance at least, the Blocking Statute puts EU companies (which have invested in Iran following the JCPOA) in a difficult position. On the one hand, if they continue their business with Iran in breach of the re-imposed US sanctions, they risk being made the subject of US secondary sanctions. This could result in them being cut off from the US financial system and economy which, in reality, would make it difficult for them to access the international financial system at all. On the other hand, if they decide to exit Iran as a result of the re-imposed US sanctions, they risk breaching the Blocking Statue. It is for the Member States themselves to set the penalties for breach and some, such as the UK, have made non-compliance a criminal offence.[7] Although, to date, there has been little effort by EU Member States to enforce the

Blocking Statute, the political dynamic has changed since it was first enacted in the 1990s and therefore, Member States may develop a greater appetite to invoke its protections in the future.

In addition to updating the Blocking Statute, on 24 September 2018, the EU confirmed that its plans to "*establish a Special Purpose Vehicle, to facilitate payments related to Iran's exports (including oil) and imports, which will assist and reassure economic operators pursuing legitimate business with Iran*."[8] The EU's High Representative, Federica Mogherini has stated that it will be "*a legal entity to facilitate legitimate financial transactions with Iran and this will allow European companies to continue trade with Iran, in accordance with European Union law*."[9] Details on how this "*Special Purpose Vehicle*" is to function in practice have not yet been provided. In any event, absent confirmation from OFAC that transacting through the vehicle will not contravene sections 3(a)(ii) and (iii) of Executive Order 13846 of 6 August 2018 (detailed above), it is difficult to see how EU persons will be able to get comfortable dealing with Iranian petroleum and petrochemical products via the vehicle.

**The Reaction of Energy Companies**

Many energy companies that chose to invest in the Iranian energy sector following Implementation Day foresaw the risk of the JCPOA falling away and sanctions being re-imposed. To cater for that risk, they included so called "*snap-back*" provisions in their contracts. The effectiveness of these provisions is likely to be tested as those companies seek to wind down their Iranian business and withdraw from the country ahead of November 5, 2018.

One of the most high-profile withdrawals to date has been Total's exit from the South Pars 11 gas project. The French energy major was unable to obtain a waiver from the US authorities and so elected to exit the project rather than risk the imposition of US secondary sanctions. Total made clear that:

*"it cannot afford to be exposed to any secondary sanction, which might include the loss of financing in dollars by US banks for its worldwide operations (US banks are involved in more than 90% of Total's financing operations), the loss of its US shareholders (US shareholders represent more than 30% of Total's shareholding) or the inability to continue its US operations (US assets represent more than 10 billion dollars of capital employed)."*[10]

Whether the Blocking Statute will be used in respect of Total's or other companies' withdrawal and particularly whether the use of the "*snap-back*" provisions will lead to compensation claims, remains to be seen.

**Looking Forward**

Will the JCPOA be saved? Will the Blocking Statute be effectively policed? Will the United States seek to enforce its extra-territorial sanctions? Will President Trump succeed in negotiating a "better deal" regarding Iran's nuclear program?

These questions are just some of the unknowns surrounding the impact of sanctions on Iran's energy sector. They highlight the risks around doing business with Iran going forward, and

illustrate how quickly the situation can change. The US withdrawal from the JCPOA is likely to have a material impact on Iran's oil production and its economy more generally. Iranian oil production is already falling ahead of the November 5, 2018 "*snap-back*." Recognizing this fact, Iran has commenced proceedings in the International Court of Justice, challenging the US withdrawal from the JCPOA. The ICJ has granted interim relief in Iran's favor pending final resolution of the case. However, the interim relief granted falls far below what Iran requested and is essentially humanitarian and safety related. Even if final relief is awarded in Iran's favor, it is not yet clear whether it can be effectively enforced. Iran is also suspected of deactivating the tracking systems on its tankers in an attempt to conceal the identity of buyers of its oil, a tactic it reportedly used in the past to circumvent the US sanctions.[11]

In September 2018, the International Energy Agency predicted that there would be a tightening of the world oil markets as the re-imposed US sanctions continue to reduce the production and export of Iranian oil and, depending on the reaction of other oil producing nations, this could lead to an increase in oil prices.[12]

EU companies with Iranian investments or interests, or those transacting in Iranian oil, petroleum or petrochemical products (whether directly or indirectly) should be aware that from November 5, 2018 they may find themselves having to choose between the lesser of two evils: either comply with the Blocking Statute or comply with the re-imposed US sanctions.

---

*1* Meaning a person who has actual knowledge or who should have known of the conduct, the circumstance or the result (Section 16(i) of Executive Order 13846 of 6 August 2018).

*2* Section 3(a)(ii) and (iii) of Executive Order 13846 of 6 August 2018.

*3* The US Department of Treasury's Office of Foreign Asset Control, which is responsible for administering and enforcing US sanctions.

*4* OFAC FAQ 289.

*5* Council Regulation (EC) No 2271/96 of 22 November 1996, as amended.

*6* European Commission Guidance Note - Questions and Answers: adoption of updated of the Blocking Statute (2018/C 277 I/03).

*7* Extraterritorial US Legislation (Sanctions against Cuba, Iran and Libya) (Protection of Trading Interests) Order 1996.

*8* EEAS Joint Statement: "Implementation of the Joint Comprehensive Plan of Action: Joint Ministerial Statement" (24 September 2018).

9 ***https://eeas.europa.eu/headquarters/headquarters-homepage/51040/remarks-hrvp-mogherini-following-ministerial-meeting-e3eu-2-and-iran_en***.

10 ***https://www.total.com/en/media/news/press-releases/us-withdrawal-jcpoa-totals-position-related-south-pars-11-project-iran***.

11 ***https://www.ft.com/content/d2c7105e-bcf0-11e8-8274-55b72926558f***.

12 International Energy Agency Oil Market Report, 13 September 2018 ( ***https://www.iea.org/oilmarketreport/omrpublic/***).