TURKEY & IRAN: ENERGY, ECONOMY, AND POLITICS IN THE FACE OF SANCTIONS

While Turkey and Iran have long been geopolitical antagonists, the two countries have a history of prioritizing their bilateral economic relations. One of the main driving forces for cooperation between Turkey and Iran is trade in the energy sector; Turkey buys large amounts of oil and gas from Iran despite political, military, and diplomatic divergences. Particularly, in recent years, Iran's strong economic links with Turkey have played a crucial role in reducing the economic pressure of Western sanctions. Against the backdrop of increasing tension in the Turkey-US relationship, Turkey and Iran's geographic proximity and currency issues could mean that the two are able to forge a lucrative energy trade isolated from US sanctions.

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TURKISH POLICY QUARTERLY
Fall 2018

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Turkey and Iran have had a long history of political rivalry that dates back to the Ottoman and Safavid Empires. However, economic opportunities have, even back then, superseded political animosity, allowing for mutually beneficial trade to flourish.[1] When it comes to the contemporary energy trade, Turkey has prioritized its relationship with Iran because it benefits economically from purchasing oil and gas from Iran.

Turkey has a history of prioritizing energy relationships that benefit its economy over its political relationships with neighbors. This can be seen today in its ongoing relationship with the Kurdistan Regional Government (KRG) in Iraq. Turkey has long sought to counter the KRG's attempts at autonomy because of the political threat it poses to Turkey. However, despite the central Iraqi government's desires, Turkey has allowed the KRG to export oil from Kirkuk through Turkey. This energy trade has proved lucrative for both Turkey and the KRG. Even though facilitating the KRG's oil trade has helped the KRG's bid for an independent Kurdistan, Turkey has continued to maintain trade and profit from it.[2]

Turkey's energy trade with Iran has traced a similar path, in which Turkey ignored politics and favored the economic benefits of a robust energy trade with Iran even when Iran was considered a pariah country for its support of terrorism and its nuclear weapons ambitions. It was only when Turkey faced economic sanctions that it withdrew its energy trade with Iran.

Turkey presents a particular problem to the Trump administration's efforts to isolate Iran and enforce economic sanctions. The US' relationship with Turkey has become strained in recent years over such issues as the conflict in Syria and Russian involvement in the Middle East. These relations have grown increasingly antagonistic over the past several months. To illustrate, in August 2018, the Trump administration authorized tariffs on Turkish steel and aluminum. The US is Turkey's largest customer for steel and aluminum and the move caused the Turkish Lira to fall against the dollar.[3] The Trump administration also imposed targeted sanctions over Turkey's detention of American Pastor Andrew Brunson on charges of espionage and terrorism relating to the 2016 failed coup in Turkey.[4] Brunson was held for two years after being released on 12 October 2018.

[1] Andras Riedlmayer, "Ottoman-Safavid Relations and the Anatolian Trade Routes: 1603-1618," *Turkish Studies Association Bulletin,* Vol. 5, No. 1 (March, 1981), pp. 7-10.

[2] Ellen R. Wald, "Kirkuk's Oil Chessboard," *The Cairo Review*, 2018 https://www.thecairoreview.com/essays/kirkuks-oil-chessboard/

[3] Krishnadev Calamur, "'U.S. Relations With Turkey Are Not Good at this Time,'" *The Atlantic*, 11 August 2018, https://www.theatlantic.com/international/archive/2018/08/trump-turkey/567248/

[4] Adam Goldman and Gardiner Harris, "US Imposes Sanctions on Turkish Officials Over Detained American Pastor," *New York Times,* 1 August 2018, https://www.nytimes.com/2018/08/01/world/europe/us-sanctions-turkey-pastor.html

Even though the United States and Turkey are NATO allies, President Trump took the extraordinary step on 1 August of imposing economic sanctions on two ministers in the Turkish government who were directly responsible for Brunson's detention.[5] The sanctions were authorized under the Global Magnitsky Act, a law that enables the executive branch to issue sanctions on individuals for human rights abuses.[6]

The severity of the campaign for Brunson's release and the new tariffs on Turkish steel and aluminum imports to the United States have rapidly caused a rift between the two countries. Turkish President Erdoğan's rhetoric towards the has grown increasingly hostile. For example, Erdoğan has threated to retaliate against US sanctions with boycotts of American products such as the iPhone. In particular, Erdoğan has targeted the dollar, calling on the Turkish public to "stand decisively against the dollar."[7] The timing of the Trump administration's campaign against Turkey may prove particularly disadvantageous to US policy aims regarding Iran and may incentivize Turkey to take a stand against the United States by disregarding US sanctions and continuing to purchase oil and gas from Iran.

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Although Turkey and Iran have not often sided with each other politically, the two countries have a long history of prioritizing their economic relations over their political relationship. This is not to say that Turkey's economic relationship with Iran has not been fraught with its share of disagreements and conflicts. However, when it comes to trade, and especially energy, Turkey has sought to engage in advantageous relationships with Iran.

Indeed, Turkey has, at times, prioritized its economic relationship with Iran over its diplomatic relations with the US. Now, as the US seeks to implement new economic sanctions on Iran without the backing of European powers or global institutions,

[5] Defne Arslan, Pınar Dost, and Grady Wilson, "US-Turkey Relations: From Alliance to Crisis," *Energy Source: The Atlantic Council's Global Energy Center*, 7 August 2018, http://www.atlanticcouncil.org/blogs/new-atlanticist/us-turkey-relations-from-alliance-to-crisis

[6] "Executive Order Blocking the Property of Persons Involved in Serious Human Rights Abuse or Corruption," *The White House,* 21 December 2017, https://www.whitehouse.gov/presidential-actions/executive-order-blocking-property-persons-involved-serious-human-rights-abuse-corruption/

[7] Mark Moore, "Turkey's president threatens to boycott iPhone, US electronics in trade tiff with Trump," *New York Post,* 14 August 2018, https://nypost.com/2018/08/14/erdogan-says-turkey-will-boycott-us-electronic-products/

Turkey poses an especially difficult challenge. Turkey's physical proximity to Iran, its energy needs, its financial situation, and its disintegrating relationship with the US all provide incentives for Iran and Turkey to subvert US sanctions in ways that other countries like China and India cannot.

Turkey's Energy Situation

Coal is Turkey's primary energy resource. As of 2014, Turkey generated 30 percent of its total electricity from coal.[8] However, coal is the least environmentally friendly source of energy and efforts are underway worldwide to reduce the use of coal-generated electricity. Turkish electricity producers have increasingly turned to natural gas in recent years, a significantly less dirty fossil fuel. However, Turkey has very little natural gas resources and must import 99 percent of its natural gas supplies. Turkey is most dependent on Russian gas; as of 2015, Russia supplied Turkey with 56 percent of its natural gas needs. Iran and Azerbaijan are Turkey's next largest natural suppliers, accounting for 16 percent and 11 percent of the Turkish market, respectively. Turkey's dependence on natural gas imports will continue to grow as its natural gas demand continues to increase.

In 2015, Turkey consumed an average of 860,000 barrels of liquid fuels per day. This includes crude oil and condensates, which are very light types of oil that are the byproducts of natural gas production. Turkey has little in the way of domestic crude oil resources and imported 90 percent of its crude oil and condensates. Data from the United States Energy Information Agency (EIA) showed that in 2015, Turkey imported 41 percent of its crude oil and condensates supply from Iraq, 20 percent from Iran, 11 percent from Russia and 9 percent from Saudi Arabia. In 2017, however, Iraqi oil imports to Turkey dropped and instead, Turkey began importing more oil from Russia and Iran.[9]

Because Turkey is so reliant on imports to satisfy its natural gas and oil demand, it is especially vulnerable to changes in the global market. It requires a diverse and secure mix of suppliers in order to ensure stable and relatively inexpensive sources of energy. Suddenly eliminating an energy source can have a negative effect on the Turkish economy because Turkish utilities and refineries will face unforeseen costs and possible shortages.

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[8] "Country Analysis Brief: Turkey," *U.S. Energy Information Administration*, 2 February 2017.

[9] Hümeyra Pamuk and Julia Payne, "Turkey's Tupras reduces Iranian crude purchases as U.S. sanctions loom," *Reuters*, 20 July 2018, https://www.reuters.com/article/us-iran-oil-turkey/turkeys-tupras-reduces-iranian-crude-purchases-as-u-s-sanctions-loom-idUSKBN1KA22Y

Turkey and Iran's Energy Relationship

Turkey and Iran have a history of cooperation when it comes to trade. This is especially true in the energy sector. Even though the two countries did not always have positive political and diplomatic relations, trade, and in particular the energy trade, always superseded political, religious, and cultural differences. This is not to say that the energy relationship between Turkey and Iran has always been smooth. The two countries have frequently disagreed on issues related to their oil and gas contracts over the years.

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Turkey and Iran developed a close energy relationship after 1979. During the Iran-Iraq War, Turkey increased its imports of Iranian oil such that Iran became Turkey's second largest source of oil imports, after Iraq.[10] In 1996, Turkey and Iran signed a landmark natural gas agreement. Worth 23 billion dollars, the agreement was designed to reduce Turkey's reliance on Russian natural gas by increasing the amount of natural gas supplied by Iran to the eastern and southern parts of Anatolia. In 1996, it was projected that Iran would come to supply Turkey with 10 billion cubic meters of natural gas out of the 27 billion cubic meters of gas that Turkey would need in 2000.[11]

A natural gas pipeline between Turkey and Iran was completed in 2001 but it never reached full capacity. US officials consistently pressured Turkey to cut down on its imports of Iranian gas and switch to natural gas from Turkmenistan instead. In 2002, the flow of gas from Iran to Turkey was interrupted at Turkey's insistence. Turkey complained about the technical specifications of the gas from Iran, but in reality sought to renegotiate its agreement with Iran. In the end, Turkey negotiated a lower price for the Iranian natural gas and several favorable conditions for its utilities.[12] The flow of natural gas was interrupted several more times due to similar disputes in 2004 and 2005. In 2006, Iran halted natural gas shipments to Turkey due to cold weather in Iran, which necessitated redirection of its natural gas to domestic consumers.[13]

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[10] "Turkey and Iran: Limits of a Stable Relationship," *British Journal of Middle Eastern Studies*, Vol. 25, No. 1 (May 1998), p. 78.

[11] British Journal of Middle Eastern Studies (May 1998).

[12] Elin Kinnander, "The Turkish-Iranian Gas Relationship: Politically Successful, Commercially Problematic," *Oxford Institute for Energy Studies* (January 2010), p. 9.

[13] Oxford Institute for Energy Studies (January 2010).

In 2007, Turkey and Iran signed a memorandum of understanding that would include Turkey in an operation to develop natural gas supplies in the South Pars gas field. The agreement also called for a new pipeline to bring natural gas to Turkey and Europe. The Turkish Petroleum Company was hoping to produce 16 billion cubic meters per year from this deal, which it intended to split between domestic use and sale to Europe. At that point, the sanctions situation and the unfavorable environment for foreign investment in Iran were forcing international oil and gas companies to pull out of planned development projects in Iran. Iran employed a system called "buy-back contracts" which are not considered especially lucrative for foreign companies. Essentially, this meant that a foreign company can enter Iran and develop an oil or gas resource for export but once development is complete, ownership would revert to an Iranian national company and the revenues from the project at pre-set levels would be paid back to the foreign company. The system prevents any modicum of "foreign ownership" of Iranian energy resources which is a constitutional imperative in the Islamic Republic of Iran.[14]

Even though other companies were pulling out of Iran in 2008 and 2009, the Turkish Petroleum Company wanted to continue with the project. It did not need international financing and so would have been isolated from some sanctions at the time. The project was supposed to break ground in November 2009, but did not because the Turkish Petroleum Company and the Iranian government could not agree on the terms, particularly the stringent "buy-back" terms that prevented the Turkish Petroleum Company from maintaining any partial ownership in the project after its completion.[15] Although Turkey and Iran were not able to finalize their plans to ensure greater Turkish investment in Iranian natural gas, Turkish imports of Iranian natural gas continued.

Turkey and Iran During the First Sanctions Regime

During the height of the United States and United Nations sanctions regime against Iran, Turkey continued to import natural gas and oil from Iran.[16] Turkish refineries were granted some exemptions from sanctions because they reduced the amount of oil they had been importing from Iran significantly. However, it became difficult for Turkey to compensate Iran for its natural gas as US and EU sanctions banned the use of dollars and euros in any financial transactions with Iran. During this time, Iran accepted Turkish lira as payment for the natural gas it provided Turkey. Iran used

[14] Ellen R. Wald, "The real problem with Iranian oil," *Modern Trader Magazine*, 22 April 2016, http://www.futuresmag.com/2016/04/22/real-problem-iranian-oil?page=1

[15] Elin Kinnander, "The Turkish-Iranian Gas Relationship: Politically Successful, Commercially Problematic," *Oxford Institute for Energy Studies* (January 2010), pp. 13-14.

[16] "Iran a net importer of gas from Mar 2011-Jan 2012-Fars," *Reuters*, 18 January 2012. https://www.reuters.com/article/iran-gas-imports-idAFL6E8CI2NZ20120118

the Turkish lira to buy gold in Turkey and then imported the gold through the United Arab Emirates, Switzerland, the United Kingdom, and India by courier into Iran.[17]

"Because Turkey is so reliant on imports to satisfy its natural gas and oil demand, it is especially vulnerable to changes in the global market."

In 2013, the US instituted additional sanctions designed to curb Turkey's gold-for-gas trade with Iran. These sanctions targeted the Turkish bank that had been facilitating the transfers of Turkish lira to gold. Iran was subsequently forced to prove it was buying food, medicine, and necessary industrial products with its funds rather than gold or other precious metals.[18]

Iran and Turkey's Post-Sanctions Energy Trade

After the signing of the Joint Comprehensive Plan of Action (JCPOA), otherwise known as the Iran Nuclear Deal, sanctions were lifted in January 2016 and Turkey's imports of Iranian natural gas and oil increased. In the first six months of 2016, Turkey imported 21 million barrels of oil from Iran. In 2017, that amount increased to 52.8 million barrels.[19] During the first four months of 2018, the share of Iranian oil that Turkey imported increased by 50 percent.[20]

Iran's natural gas exports to Turkey also increased after the sanctions were lifted. Natural gas delivery to Turkey jumped 14 percent in 2017.[21] Between January 2017 and February 2018, Iran exported 8 billion cubic meters of natural gas to Turkey without remuneration.[22] This was in response to a 2016 ruling by the International Court of Arbitration, which awarded Turkey a 1.9 billion dollar settlement in a suit it brought against Iran from 2012. Turkey alleged that Mahmoud Ahmadinejad's government overcharged Turkey for natural gas and won its suit.[23] The payment was

[17] "Turkey says Iran gas not covered by US sanctions," *Reuters*, 4 December 2012, https://www.reuters.com/article/turkey-iran-gas/update-2-turkey-says-iran-gas-not-covered-by-us-sanctions-idUSL5E8N432M20121204

[18] "Turkey-Iran gold trade wiped out by new U.S. sanctions," *Reuters*, 16 February 2013, https://www.reuters.com/article/us-iran-turkey-sanctions-idUSBRE91F01F20130216

[19] "Iran becomes Turkey's biggest crude oil exporter, signals more gas sales," *Hürriyet Daily News*, 4 October 2017, http://www.hurriyetdailynews.com/iran-becomes-turkeys-biggest-crude-oil-exporter-120345

[20] "Iran topping crude oil exporters to Turkey: Turkish media," *Islamic Republic News Agency*, 31 May 2018, http://www.irna.ir/en/News/82931381

[21] "Iran's gas export to Turkey up 14%," *Azernews*, 1 July 2017, https://www.azernews.az/oil_and_gas/115541.html

[22] "Iran fully settled debt to Turkey over natural gas exports," *Iran Daily*, 5 February 2018, http://www.iran-daily.com/News/209491.html

[23] Azernews (2017).

completed at the end of January 2018. Turkey maintains a long-term supply contract with Iran in which Turkey has committed to purchasing 9.5 billion cubic meters of natural gas that continues until 2026.[24]

The Future of Turkey and Iran's Energy Trade

At the beginning of May, US President Donald Trump's administration announced that the US would be reinstating sanctions against Iran. These actions would include secondary sanctions against institutions or individuals who did business with the sanctioned Iranian institutions. The first round of sanctions came into effect in August and included provisions against Iran's financial institutions and automobile industries. The second round of sanctions come into effect on 4 November and included Iran's oil industry.

Initially, analysts forecasted that only about 200,000 to 300,000 barrels per day of Iranian oil would be impacted by these sanctions. However, the Trump administration's approach to these sanctions is significantly more stringent than the Obama administration's approach. Whereas the Obama administration offered waivers to many Asian countries and some European countries to continue importing Iranian oil as long as they decreased their imports somewhat, the Trump administration is not offering waivers with nearly the frequency of its predecessor.

This approach has put Turkey in a difficult position economically because it drastically increased the amount of oil and gas that it imported from Iran after the sanctions were lifted in 2016. During the first round of sanctions, Turkey continued to import some oil from Iran but looked to Iraq to replace the reserves it had stopped purchasing from Iran. It was only with extreme pressure from the US along with additional sanctions on the precious metals trade with Iran that Turkey officially halted its gold for oil and gas scheme with Iran in 2013, although the trade did continue clandestinely until 2015.[25] The political rift between Turkey and the US in 2018 makes it much more unlikely that Turkey will seek to halt its oil and gas purchases from Iran. Turkey does have a tendency to prioritize economic benefit even if its political and strategic enemies also benefit. However, in this case, Turkey may be able to satisfy its anti-American political ambitions and maintain a beneficial economic relationship with Iran.

[24] "Turkey's physical proximity to Iran, its energy needs and its disintegrating relationship with the United States," *Reuters*, 8 August 2018, https://www.reuters.com/article/us-iran-nuclear-turkey/turkey-to-continue-buying-natural-gas-from-iran-despite-u-s-sanctions-idUSKBN1KT210

[25] Jonathan Schanzer, "The Biggest Sanctions-Evasion Scheme in Recent History," *The Atlantic,* 4 January 2018, https://www.theatlantic.com/international/archive/2018/01/iran-turkey-gold-sanctions-nuclear-zarrab-atilla/549665/

The Problem of Currency

The primary hurdle Turkey faces in continuing to import Iranian oil and gas after November 2018 lies in the financial transactions to pay for the oil and gas. Most of the global oil trade is conducted in dollars. However, any entity that attempts to conduct financial transactions with Iran in dollars, especially with regards to the oil industry, will be sanctioned by the US government. Similarly, if an entity conducts such transactions in another currency, for example, the euro, and also conducts transactions with the US, it will face sanctions. Therefore, the only currency a Turkish refiner can use to pay Iran for oil and gas would be the Turkish lira or Iranian rial. The Iranian rial is a highly unstable currency that has been devalued multiple times in 2018 and thus it is extremely unlikely that a Turkish entity would be in possession of enough Iranian rials to conduct oil and gas transactions in Iranian rials.

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Some countries facing this issue have offered to pay Iran in their own currencies. During the first round of sanctions, China paid for oil in its own currency, through the Bank of Kunlun, which had no exposure to US entities. The US attempted to sanction this bank, but it had no effect because the bank was not exposed to US interests.[26] Following this, Iran found itself with a great deal of Chinese currency, which it could use only to purchase goods from China. Iran did take advantage of this but with limited positive impact on the economy. Revenues from Iran's oil industry are a major component of the Iranian government's budget and the Chinese yuan is of limited use in most respects.

When it comes to Turkey, however, there are more options. Iran can accept Turkish lira in exchange for its oil and gas, and make use of the lira for more than just purchases of Turkish goods. In 2012, Iran and Turkey engaged in an elaborate scheme in which Turkey sold gold to Iran in exchange for various currencies and smuggled the gold into Iran through different countries. After that scheme was discovered, the US placed sanctions on Iran's precious metals trade that effectively halted the scheme. In response, instead of converting lira to gold, Iran could simply decide to use Turkish lira as currency in Iran.

[26] David Mortlock and Ellen Wald, "The Risks of the Trump Administration's Whiplash Policy on Iranian Oil," *Energy Source: The Atlantic Council's Global Energy Center*, 5 July 2018, http://www.atlanticcouncil.org/blogs/energysource/the-risks-of-the-trump-administration-s-whiplash-policy-on-iranian-oil.

Turkey and Iran share a border and this area is largely inhabited by Kurds, an ethnically distinct population that spans several countries in the region. Iran could simply put the Turkish lira to use in the Turkish-Iranian borderland region. This is not an uncommon practice in borderland communities. There are many borderland areas around the globe where multiple currencies are accepted. For example, Canadian currency often mixes with American currency in parts of northern New England and there are several Central American and Caribbean countries that accept American currency.

Turkey's recent currency destabilization also makes this option more attractive from a financial perspective because its utilities and refineries can make purchases of oil and gas without having to use the dollar. Of course, to avoid US sanctions, only Turkish utilities and refineries that are not exposed to American entities would be able to accomplish this. However, given that Turkey purchases very little oil and gas from the US to begin with, cargoes could be rerouted. Certain refineries and utilities can import only Iranian oil and gas while other utilities and refineries use other sources that might expose them to American sanctions. This could pose a distinct problem for the Trump administration as it pursues its objective of reducing Iran's oil and gas exports to zero.

Conclusions

Historically, when it comes to energy, Turkey has put its economic goals above its political considerations. This has included entering into contentious energy deals with its ideological and political adversaries, including Iran and the Kurdistan Regional Government.[27] Economically, it is in Turkey's best interest to continue to import Iranian oil and gas despite US imposed sanctions. Turkey and Iran have long-term contracts that, if broken, would impose great expenses on Turkey.

However, Turkey and Iran are also financially incentivized to work together to avoid US sanctions because both of their currencies have been devalued against the dollar. It behooves them financially to cooperate in avoiding the use of the dollar in energy trade. The development of new hostilities between the United States and Turkey and the depreciation of the Turkish lira against the dollar also incentivizes Turkey to continue to import Iranian oil and gas in contravention of American sanctions. Turkey and Iran's geographic proximity and the shared ethnic connections between their Kurdish populations mean that Iran could potentially use Turkish currency within its own borders, helping it avoid the need for currency conversations that expose Turkish entities to US sanctions.

[27] Ellen R. Wald, "Kirkuk's Oil Chessboard," *The Cairo Review*, https://www.thecairoreview.com/essays/kirkuks-oil-chessboard/