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Iran's new Integrated Petroleum Contracts

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Iran hosted an "*Oil Show*" earlier this month in Tehran. According to reports, over 600 foreign companies from 32 countries and over 1,200 Iranian companies attended the event. The foreign participants were mainly from Austria, Belgium, China, France, Russia, the United States, the UK, Japan, South Korea, Malaysia, Spain, the United Arab Emirates, Turkey, India, Germany, and Italy.

The Oil Show was the latest attempt by Iran to attract foreign investment into the country's oil and gas industry. In February 2014, the National Iranian Oil Company (**NIOC**) unveiled the philosophy behind its new generation of Iranian petroleum contracts. This new model form of contract will replace the third generation of "*buy-back*" contracts that were first used in 2009.

According to reports, the new model contract (called "*Integrated Petroleum Contract*"- **IPC**) is expected to be formally inaugurated in London by the end of 2014. The IPC has been introduced in the wake of the limited easing of sanctions on Iran under the Geneva Joint Plan of Action (**JPOA**) agreed by Iran and the P5+1 on 24 November 2013, which came into effect on 20 January 2014 following co-ordinated action by the EU and US.

Background to the IPC

Iran's oil sector is one of the oldest in the world. Production started in 1908 at the Masjid-i-Suleiman oil field. As a result, Iran has one of the world's most mature oil sectors. About 80 percent of its reserves were discovered before 1965. However, over the past decade, international sanctions have meant that Iran has been unable to attract international investment and technology into its oil and gas fields, which has resulted in a decrease in Iranian hydrocarbon output.

Changing global economics and geopolitics has also meant that a number of countries around the world (including Iran) are taking a fresh look at the best way to optimise their natural resources. In the hydrocarbon sector, different approaches have meant that some countries prefer to maintain maximum control, ownership and sovereignty over their natural resources, whilst others are prepared to allow the International Oil Companies (**IOC**s) to effectively take a direct economic interest in certain fields or operating companies. This differing approach is normally manifested by whether a country's model contract is developed as a technical services contract, or as a production sharing agreement. The introduction of the IPC marks a turning point in the way that the oil and gas industry in Iran can acquire the much needed know-how and technologies to develop its oil fields. It also represents a marked change to the previous buy-back model, which was introduced in Iran in the 1990s and early 2000s. At the time, the buy-back model was considered a significant step forward to attract foreign investment in the oil and gas sector without violating, at least in

theory, the provisions in Iran's oil and gas legislation and the Constitution which effectively prohibit private (foreign or domestic) ownership of natural resources.

Essentially, the existing Iranian buy-back contract is a short-term service contract between the NIOC (or one of its subsidiaries), and an IOC under which the latter agrees to develop (effectively as a "*contractor*") an oil or natural gas field. As a contractor to NIOC, the IOC does not gain equity rights in the crude oil or natural gas. The IOC's annual repayment rates are based on a pre-agreed percentage of the production of the field and a pre-agreed rate of return. The field under development should be returned to NIOC's control after the IOC has been paid.

Some of the Iranian oil and gas fields that have been (or were planned to be) developed under buy back contracts include the following:

Oil fields	Gas fields
Siri	South Pars
Salman (oil and gas)	Salman (oil & gas)
Bilal	
Yadavaran	
Farzam	
Nossrat	

Despite some success, the existing buy-back model is generally unpopular with the IOCs for the high risk it presents. The IOCs feel that the buy-back model is prone to huge potential losses because the IOC has very limited options to put a ceiling on its capital costs. Additionally, the way that the contracts are structured means that at the time of signing, long term pre-defined operating targets are set that do not take account of prevailing market conditions, new drilling plans, reserve estimates, financing costs, etc.

Does the introduction of the IPCs herald a new age in the oil and gas industry in Iran?

According to Iranian officials, the IPC has been introduced to incentivise international oil and gas companies to invest and bring new technologies to Iran.

The key objectives of the IPC (as expressed by Iranian officials) clearly point to such desire. Those objectives include:

- integrating the exploration and production phases;
- helping the Iranians achieve enhanced capacity, maintenance and reserve recovery;
- attracting foreign capital, services, know-how and technology;
- establishing long term relationships with foreign partners; and
- reducing the investment risks by offering more flexibility in investment costs.

What makes IPCs different to buy backs?

Under the Iranian Constitution, ownership of the natural resources belongs to the "*nation*" and cannot therefore be transferred. However, the IPC, for the first time, will include provisions allowing transfer of ownership of hydrocarbons to the foreign partner at defined delivery points. This is similar to the tried and tested production sharing agreements used in the UAE and Iraqi Kurdistan. The foreign party, however, will not have any ownership rights over the project assets.

Under the IPC, the NIOC will seek to set up joint ventures between foreign companies and an Iranian party (normally the NOIC or a NIOC affiliate). The aim of the joint venture, as put by Iranian officials, is that "*it is hoped that by using a joint venture structure the Iranian experts will work shoulder-to-shoulder with foreign investment companies in order to become familiar with the latest technologies*".

The IPC is designed to take advantage of foreign companies' marketing expertise and give Iran access to their supply network to find an export market. This is important at this time as the global energy market is expected to face oversupply in the mid-term due mainly to the discovery and harnessing of shale gas in North America. Thus, having the assistance of an international company and its networks around the globe will become an increasingly important resource for Iran.

The term of the IPC will be between 20 to 25 years which is almost double the duration of the old buy-back contracts. This would provide foreign investors with a greater level of certainty and incentive to invest large sums.

The Iranian government wants priority to be given to the development of "*joint fields*" (for example the North Field/South Pars Field shared between Iran and Qatar). To incentivise investment in these joint fields IOCs will be remunerated at higher rates.

Potential problems facing foreign investors

The IPC aims to share risk as the foreign partner will be responsible for all the risks and costs. The Iranian party will act as the "*technical partner*" (rather than a "*contractor*" as is the case under the existing buy-backs). Additionally, the foreign party is rewarded for taking on increased risk by being the "*manager*" of the project. The intension is to minimise the Iranian party's interference in the decision-making and operation of the project.

Under the IPC, a foreign partner will be required to meet the Iranian local content requirement which will be 51% of the contract. This is, however, unlikely to deter too many foreign investors who are used to working in the region.

Another potential sticking point for international oil companies may be the fact that any dispute arising under the IPC will be subject to the exclusive jurisdiction of the Iranian courts. Many international companies may not feel comfortable with this and would probably prefer international arbitration.

Awakening a sleeping lion?

The proposed terms in the new IPC are much more flexible and have greater incentives to foreign investors than buy-back contracts. It is hoped that this will reinvigorate the Iranian oil and gas sector, increase foreign investment and technology and increase Iranian output. BP Plc's Statistical Review published in June 2013 lists Iran as having the world's largest gas reserves, estimated at 1,187 trillion cubic feet, and the fourth-biggest oil deposits, at 157 billion barrels. Assuming that the easing of sanctions continues and now armed with a more commercially viable petroleum contract, Iran could be on the verge of a new "*black gold*" age and will undoubtedly turn the heads of many eager international oil companies looking to tap into these new sources. Iran will use the "*Oil Show*" as a platform to showcase the massive opportunities for investment that are available to those companies when the sanctions are eventually lifted.

Further information

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