A New Era

*James Campbell and Christopher Gunson take a look at the prospects for new investment in Iran’s upstream oil and gas industry.*

The Islamic Republic of Iran has some of the largest oil and gas reserves in the world. Current estimates place Iran’s oil reserves at 150 billion barrels and gas reserves at more than 1,192 trillion cubic feet. Despite these abundant reserves, Iran’s production sharply declined after the Iranian Revolution in 1979, and production today is approximately half of the rate of production during the mid-1970s.

The primary reason for Iran’s low production is the lack of private sector investment in its upstream oil and gas sector. After the Iranian Revolution, Iran sought to exclude any foreign involvement from its upstream oil and gas sector, going so far as to prohibit foreign concessions over natural resources in the provisions of the revolutionary constitution.

In the 1990s, Iran’s Ministry of Oil sought to create an arrangement by which foreign investment could be brought into the upstream sector without violating the constitution through “Buyback Contracts,” a type of risk-based service contract. An outline of the Buyback Contracts is explained below. However, the high risk and low return offered by the Buyback Contracts, combined with increasingly severe international sanctions resulting from Iran’s nuclear program, prevented sustained foreign investment into Iran’s oil and gas sector.

Both of these two problems may soon be resolved. Subject to a final political agreement that has a deadline of June 2015, a preliminary agreement between the P5+1 countries (the United States, the United Kingdom, China, France, Russia, and Germany) and Iran has been reached, and there may soon be a political agreement and the lifting of sanctions. With sanctions lifted, Iran will be able to invite foreign investment and the latest technology to its oil development, and IOCs may finally have to access some of the world's largest oil and gas reserves. Furthermore, the Buyback Contract regime is reported to be replaced with a new Iran Petroleum Contract (IPC). Combined, these two developments create potentially the biggest opportunity for the oil and gas industry and may even be greater than the opening of Iraq’s oil and gas sector to foreign investment in 2009.

The Buyback Contract

Foreign investment in the development of Iran’s oil sparked several political revolutions in the 20th century. The 1979 revolution — which resulted in the establishment of the Islamic Republic — was followed by a new constitution that expressly prohibited the granting of concessions to foreign companies for the development of national resources. Following the revolution and the Iran-Iraq War, Iran’s oil production dropped sharply and never recovered to the levels enjoyed during the 1970s.

Iran’s Oil Ministry recognised the importance of foreign investment in the sector, and yet, due the limitations set out in the Constitution, introduced the Buyback Contract in the 1990s. The first generation Buyback Contract was a short-term risked service contract that allowed contractors to pay for all capital costs involved with oil and gas development. Investment could only be recovered from actual production, and exploration costs that did not result in production meant that capital and operational expenditures could not be recovered. Furthermore, the recovery period was limited to less than ten years, with a fixed remuneration fee set per barrel. All of this combined to create a very unfavorable system that exposed the contractors to the risk of being unable to recover capital expenditures. Contractors were also prohibited from booking reserves. A second generation of Buyback Contract was later introduced that had a longer term and covered exploration activities. Even with these terms, several non-US companies such as Shell, Total, and Inpex — encouraged by the potential of Iran’s upstream oil and gas sector — signed up to Buyback Contracts.

Iranian officials claim that the Buyback Contracts attracted up to US$50 billion in added value to Iran’s oil and gas industry, but the framework did not achieve its goals of increasing oil production. At the time, it was seen as the only politically acceptable method by which to bring IOC investment into the upstream sector, but the high risk and low return, combined with the persistent and increasingly stringent international sanctions on Iran, made it very unpopular with IOCs.

The New Iran Petroleum Contract

In 2009, as new international sanctions continued to be placed on Iran, the National Iranian Oil Company (NIOC) entered into negotiations with several Indian contractors to develop the offshore Farzad B gas field. Negotiations concluded in 2013 with a third generation Buyback Contract being offered to a consortium of ONGC Videsh, Indian Oil Corporation, and Oil India Limited, but it was never signed. Although the terms of that contract have not been disclosed, it is reported that the contracts allow the contractor to recoup their investment expenses quicker than under the first and second generation Buyback Contracts, and to significantly decrease the IOC share of risk.

The2013 contract is a de facto pilot for the new Iran Petroleum Contract (IPC), which was announced in Tehran by the Ministry of Oil in February 2014. The specific terms have not been finalised, but draft terms have apparently been disclosed to some IOCs, although no contract has yet been ratified by the Cabinet. A formal public announcement and a workshop on the IPC has been repeatedly delayed for reasons that appear to be due to the wait surrounding the outcome of a political resolution on sanctions tied to Iran’s nuclear program. A general outline of the terms has been disclosed, and a number of analysts have comments on the anticipated new framework.

First, regardless of the title that is given to the contract, the profit and risk structure will be similar to a production sharing contract, which is the “global standard” for the development of oil and gas resources and more popular with IOCs.

Also, the structure will be a joint venture established with the NIOC or one of its group companies after the exploration stage. This will follow a common strategy of developing countries to bring IOCs into joint ventures to allow the transfer of technology and know-how. This is also part of moving the IPC towards a system that shares both the risk and the profit between Iran and the IOCs, a key element to aligning the interests of both parties over the life of the contract. The contract is now expected to be long-term, with a 20–25 year period having been indicated.

Contractors may paid both in cash and in-kind with crude oil, and may be expected to market some of the share provided to the NIOC joint venture partner.

Contractors may even be able to book reserves under the IPC. The Iranian Constitution provides that natural resources are owned by the state, which is in line with the limitation on granting concessions to foreign contractors. However, the IPC will include provisions allowing transfer of ownership of hydrocarbons to the foreign partner at defined delivery points — similar to the structure used in Abu Dhabi and Kurdistan. This should be enough for most IOCs to conclude that they can book reserves held under the contract (even though Iran will likely assert, and may even say in the IPC, that this is not allowed).

There are expected to be local content requirements and the mandatory use of local contractors. Such requirements are common in the global oil and gas industry. Surprisingly, one of the unintended consequences of sanctions was the improvement in Iran’s domestic oil and gas contractors and machinery manufacturers, and some IOC delegations were impressed to meet domestic companies capable of producing advanced equipment, including drilling platforms currently used in the offshore South Pars Phase 12 development.

Disputes in Buyback Contracts were subject to resolution in Iranian courts. International arbitration in a neutral jurisdiction and in a trusted forum is naturally ideal, and Iran is a party to the New York Convention as of 2001. Iran is not a party to the ICSID Convention, and so foreign investors would have to rely on Iran’s Foreign Investment Promotion and Protection Act which allows foreign investors to petition international tribunals pursuant to bilateral investment treaties, which Iran has signed with a number of countries including many European countries.

Model for the Future

Regardless of the terms of any contracts, Iran will be unlikely to secure any new oil and gas investment from IOCs until it reaches a comprehensive political solution with P5+1 group. For this reason, although a workshop to explain the new IPC was promised on several occasions in 2014, the event has been repeatedly delayed. At this point, no such workshop is expected prior to the June 2015 deadline for the P5+1 agreement.

In anticipation of a successful political agreement, delegations from a number of non-US IOC companies have visited Iran in recent months, and following the preliminary agreement, a number of US IOC representatives also visited Iran. A final agreement with the P5+1 group over Iran’s nuclear program holds the potential to open this market to the world.

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