

Message of a ‘New Start’

After more than thirty years of working as an international law office, our hope for a paradigm shift in the economic environment of Iran encourages and entices us to experience a new start by providing the public and our selected clients with bi-weekly, bi-monthly and yearly News & Analysis about the legal developments that are taking place in Iran. Our objective is to help our readers to keep themselves abreast of these developments and to remain aware of all the opportunities that are and will become available to them in the Iranian market.

Subjects to be covered

Our office has been active in vast panoply of legal activities during the last 30 years. We will take stock of this experience to share with those who are interested in the rapid developments of the Iranian legal market a steady, comprehensive and expertise-based flow of information covering investment, export-import, banking, insurance, customs, intellectual property, new technologies, transport, and any other subject that may draw attention of firms and companies that are interested in vast natural and human resources of Iran.

Method of presenting the News & Analysis

As professional lawyers, we are interested in explaining the issues of concern to international law firms and multinational enterprises. Our purpose is to provide you, our interested colleague or client, with information in your field of interest to enable you to make an informed decision based on the latest developments in the economic and legal environments of Iran. Our News & Analysis covers the facts as they are, as well as the laws and regulations that may have serious ramifications for your interests in Iran and in its neighboring countries.

Three levels of information sharing

At the first level, an executive summary of our bi-weekly or bi-monthly News & Analysis appears on our webpage. This summary report will be at the public domain. Our selective clients and colleagues will receive the detailed text that will take them to a deeper level of understanding of the Iranian market. Among our clients and colleagues, those who are interested in having more comprehensive reports on their subjects of interest may demand us to provide them with even more detailed and elaborated reports.

Bi-Monthly and Yearly News & Analysis

Every two months, our Bi-Monthly News & Analysis will be shared with a selective group of our colleagues and clients. These bi-monthly reports will focus on more important and more extensive issues including investment, banking, taxation, etc. They will help you to have a more practical understanding of these issues and to keep yourself aware of all the developments that take place in these important fields. Following the same line, at the end of each year we will share with you our Annual News & Analysis that summarizes the main developments of the year and prepares you for the developments that are going to take place during the next year.

IRAN PETROLEUM CONTRACT (IPC)

New developments

The news about Iran indicates that the Iranian government is eagerly looking for a game-changer. The following examples are self-explanatory:

- “Iran’s oil exports have stayed above levels allowed under Western sanctions for a fifth month, according to sources who track tanker movements, in a further sign that a deal to ease some restrictions is helping Tehran sell more crude,” reports Reuters;
- “Iran to pump gas to Baghdad by mid-2014”, reports Iran Payvand News;
- “Iran sees a 'big jump' in gas exports in 2015”, according to Tehran Times; and finally
- “Iran Plans to Offer Better Oil Exploration Terms than Iraq”, Bloomberg reports.

A major change is also taking place in the legal environment. According to Bloomberg: “Iran is postponing by about three months a conference at which it plans to introduce new contract terms to international energy companies, an adviser to Oil Minister Bijan Namdar Zanganeh said.”

“The London event, originally scheduled for early April, will be held instead in late June or early July, Mehdi Hosseini, the head of an Oil Ministry committee that reviews contracts, said today in a phone interview from Tehran.”

The Ministry of Petroleum of Iran has taken all the available measures to draw attention of energy investors to its new contract. One of these measures is to make it clear that the new contract is not an ordinary buy-back agreement. That is why it is called “Iran Petroleum Contract” or IPC.

What are the differences or similarities of IPC with the three previous generations of buy-back contracts? How would it benefit the foreign energy investors to conclude an IPC with the Ministry of Petroleum of Iran? What are the IPC terms that are open to negotiation and what are those that must be accepted as is? This first News & Analysis tries to have a closer look at IPC in order to find tentative responses to these questions. They are tentative because the final version of IPC is yet to be presented in June or July 2014 at the “London event”.

IPC is also called the fourth generation of oil contracts, following its three generations of predecessors. Genealogical study of IPC require that we go through the process of transformation of oil contracts in Iran to see how, why and when they appeared, used, and then replaced by their new versions. In explaining this transformation process, it is indispensable to analyze the legal regime of oil contracts, including the laws adopted, applied, and sometimes repealed by the Parliament and the government of Iran.

Petroleum contracts before 1979

The history of petroleum contracts from 1872 to 1950 can be summarized in one word: concession. The first concession was granted by Nāṣer-al-Din Shah in 1872 to Baron Julius de

Reuter, a British subject of German origin. Then, in 1901 a British speculator, William D’Arcy, received a concession that opened the way for the concession agreement of 1933 that remained valid till 1951, when the oil industry of Iran was nationalized under a law generally known as ‘nine-points law’. This nationalization was based on strong oppositions to the 1933 agreement that was considered as a sell-out of Iranian interests in its oil industry.

After the change of government in 1953, a new legal regime for oil industry was established when the 1954 Consortium Oil Agreement provided for a consortium holding company, Iranian Oil Participants Ltd. (IOP), to establish two companies called ‘Iranian Oil Exploration and Producing Company’ and ‘Iranian Oil Refining Company’. The first company undertook exploration and production while the second one undertook refining activities.

In 1957, the Petroleum Act of Iran established a solid legal basis for participation agreements. As a result, eight international agreements were signed with American, Dutch and Italian companies till 1964 resulting in establishing joint venture companies out of Iran to manage oil exploration and production activities.

The Petroleum Act of 1974 authorized the oil companies to conclude service agreements for oil exploration, development, and production.

Legal basis of petroleum contracts since 1979 to date

Since 1979 the legal regime of petroleum industry has changed fundamentally. First, under Article 81 of the new Constitution of Iran, granting concessions to foreigners is absolutely forbidden. Further, under a strict interpretation of the same Article, incorporation or even registration of foreign companies dealing with commerce, industry, agriculture, service, or mineral extraction was absolutely forbidden. As a result, Iranian companies could not get into joint venture arrangements with their foreign partners until a more flexible interpretation of Article 81 removed the legal barriers.

The new legal regime of petroleum industry is based on the following Acts:

- *The Petroleum Acts of 1987* and its amendment in 2011,
- *The Fourth and Fifth Economic Development Plans of Iran*, and
- *The Foreign Investment Promotion and Protection Act (FIPPA)*.

It is necessary to look at three legal rules that have serious impacts on oil contracts:

- 1) Under Article 2 of the *Petroleum Act (1987)*, the petroleum resources of the country are part of ‘*anfāl*’ (the public domain in its Islamic sense) and according to Article 45 of the Constitution are at the disposal and control of the Government of the Islamic Republic of Iran.
- 2) Article 3(b) of *FIPPA* regulates foreign investments in all sectors within the frameworks of ‘civil partnership,’ ‘buy-back,’ and ‘build, operate and transfer (BOT)’ where the return of

principal and profit arises solely through the economic activity of the same investment project and does not rely on any guarantee by the government or banks or government companies.

3) Article 14(a) of the Fourth Development Plan provides that the government of Iran is charged with foreseeing of the buy-back projects of the agencies subject of Article 160 of the Fourth Development Plan including all the ministries, government entities, and state-owned corporations especially the National Iranian Oil Company and companies allied with the Ministry of Petroleum and their subsidiaries. The government is also responsible to include the buy-back projects in the annual budgetary bills and to present them to the Islamic Consultative Assembly.

Two caveats about the above rules:

a) Petroleum resources qualified as *anfāl* are subject to the rules that apply to public properties set out in Articles 125 and 126 of the Fifth Economic Development Plan; and b) foreign investment contracts, especially in the field of oil industry, can take innumerable forms, depending on local and international legal and economic contexts.

First generation of buy-back contracts

The following common points are present in the first generation of buy-back contracts signed before the year 1995:

- a. Exploration and development operations were carried out separately;
- b. Contractors were responsible to prepare a comprehensive development plan under which a ceiling was fixed for the development operations;
- c. Contractors were required to establish a representative office in Iran but they were not under a duty to have a managerial basis in the country;
- d. The main purpose of the contracts was to develop the brown fields; as a result green fields were more or less neglected under the first generation of buy-back contracts;
- e. Under the first generation buy-back contracts, Iran's Central Bank guaranteed repayments to international oil companies (OICs); and
- f. If OICs succeeded in their exploration operations, as soon as production phase started, the Iranian side could take over operation of the field.

Second generation of buy-back contracts

During the years 1995-2003, the government of Iran developed the second generation of buy-back contracts that comprised the following elements:

- a. Foreign contractors were authorized to handle both the exploration and the development operations;
- b. They had to establish an operational office in Iran;
- c. Under the second generation buy-back contracts, the foreign party had to transfer its technology to the Iranian side;
- d. Another duty of the foreign party was to respect the Act on Maximum use of Local Technical Power;
- e. Second generation buy-back contracts lacked Iran's Central Bank guarantee on repayments to OICs;

f. If OICs succeeded in their exploration activities, they would have a preemptive right in negotiating their terms with their Iranian counterparts to conclude a contract for development purposes. However, if the parties could not reach to an agreement, the Iranian side, i.e. the National Iranian Oil Company (NIOC), was entitled to start negotiations with other foreign parties on development of the oil field. NIOC was also required to reimburse the contractor for its exploration charges and expenses.

Third generation of buy-back contracts

The current buy-back contracts of Iran have the following characteristics:

- a. They require IOCs to pay for oil and natural gas exploration and recover their investment from any production at a pre-arranged rate of return, as reported by Bloomberg News on 22 January 2014.
- b. The specific geographical differences of oil and gas fields, for example in south-west or north of Iran, are not taken into consideration in these contracts.
- c. Two phases of exploration and production are part and parcel of one contract. As a result, the supplier or the contractor who has been involved in exploration phase of a project can undertake the development operations too.
- d. To make the third generation buy-back contracts more appealing to IOCs, mechanism of fixing a ceiling for payments have been put aside. Under the new arrangement, the parties agree on a preliminary estimate of prices that can be increased later, based on the summed up amount of prices proposed by sub-contractors under supervision of NIOC.
- e. NIOC is also responsible to prepare the tentative comprehensive plan of development to be shared with IOC who prepares the final comprehensive plan and submits it to NIOC for approval.
- f. Financial issues are discussed in more detail in third generation buy-back contracts. A major issue that needs special attention is the rate of return (ROR) that comprises cash flow issues including IOC cash out, revenue, and repayment.
- g. A specific annex on transfer of technology outlines detailed guidelines about the time, modality, and requirements of technology transfer under the Iranian laws and regulations. Further, under a condition added to these contracts, Iranian operators must work hand in hand with IOCs to facilitate transfer to technology and know-how, when they take over the operation.
- h. A major concern of IOCs is the high risk present in buy-back agreements resulting from unpredictability of capital cost expenditures (capex). In primary contract of buy-back contracts, contractor is required to develop the oil field in order to increase petroleum production to the level indicated in the contract. As a result, in fixed capex contracts, the parties need to determine the ceiling of capex in advance and include it in their contract. The negative impact of determining the ceiling is that expenses of contractors cannot go beyond the determined amount. But turbulences of the market may always force contractors to pay more than their initial estimations to those who provide them with primary materials. Further, the available information about the estimated amount of oil in each field may prove to be wrong. Therefore, if the actual expenses surpass the amount of capex set out in a buy-back contract, contractors have to pay the balance from their own pocket. This will result in increasing the operational risk

for contractors and will reduce their interest in concluding buyback agreements with NIOC. To avoid this problem, third generation buy-back agreements contain a term under which ceiling of investment expenditures is determined 18 to 24 months after conclusion of buy-back contracts. During this period, the parties get more information about the possible changes in the market and they can also avoid risks resulting from technical uncertainties. Such buy-back contracts are called “open tender” or “open capex” contracts.

Iran Petroleum Contracts (IPCs)

The latest development in the petroleum legal market is called Iran Petroleum Contract. What are the mandatory terms of IPCs? Nobody can respond to this question with certainty because even the Ministry of Petroleum postponed the “London event” from April to June or July to make IPCs more presentable. Despite fuzzy nature of IPCs, certain aspects of these contracts are shared with the public:

- a. Enhanced level of coordination between different phases of exploration, development and production increases the interest of IOCs in IPCs.
- b. IPCs are long-term contracts that cover a period of 15 to 20 years.
- c. Overall management of IPCs shall be accorded initially to IOCs but as soon as local companies acquire the required capacity and capability to manage the projects and IPCs, they will take over management of the projects.
- d. Booking reserve is also included in IPCs but this does not tantamount to transfer of ownership of petroleum fields to IOCs.
- e. Social corporate responsibility is part and parcel of IPCs because under these contracts, IOCs commit themselves to construct hospitals or to establish social service centers in oil-producing regions.
- f. Financial transparency is another trait of IPCs. The Minister of Petroleum in few occasions has criticized the corruption that has tarnished the image of Iranian oil companies. As a corruption-fighting measure, IPCs will enjoy a higher level of transparency to reduce the risk of corruption in their conclusion and application.
- g. Finally, Article 2 of the Act on Maximum Use of Productive and Service Powers to Meet the Country’s Needs (2012) names the juridical persons that are subject to the provisions of the Act including all Ministries, chartered companies and institutions, banks, non-governmental public institutions and establishments, Islamic foundations, industries, factories, etc. Under Article 5 of the Act, these persons are required to demand only competent Iranian companies to provide them with services, construction activities, supply, instruments and products needed for the projects, and so on. Where Iranian companies are not capable to furnish the required services or products, with the approval of the highest executive authority of each entity, joint ventures between Iranian and foreign partners or foreign companies may be required to provide the needed services or products. By mentioning joint ventures before foreign companies, apparently the Act expresses the order of priority that must be respected: If Iranian companies are not capable to provide the needed goods or services the next priority is with the joint ventures. The juridical persons mentioned in Article 2 of the Act may opt for obtaining the goods and services from foreign companies only where joint ventures are incapable of providing the demanded goods and services.

Executive summary

The petroleum contracts in Iran have gone through at least three phases of development. In the first phase, concession agreements are the only form adopted by the Iranian government for more than 65 years. The nationalization of petroleum in 1951 and the agreements concluded for and with an international consortium opened the way for a new legal regime under which joint companies were established for managing oil exploration and production activities. The last phase that started in 1979 witnessed appearance of four generations of buy-back contracts. Each generation tried to propose new incentives to international oil companies (IOCs) in the limits prescribed by the laws and regulations of Iran.

The last step in the 140 year history of Iranian petroleum contract law is called Iran Petroleum Contract (IPC). Iranian lawyers have tried to take stock of their experience, as well as the experience of countries neighboring Iran like Azerbaijan, to draft a legal framework that marries up transparency, transfer of technology, attraction and protection of foreign investment, and optimum development of petroleum resources with appropriate application of Iran's Constitution, Four Year Economic Development Plans and specific petroleum Acts. This marriage may give birth to new legal questions and challenges that may be avoided by taking the required care in drafting, applying and interpreting the IPCs to be concluded in the near future.

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