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The Iranian Buy-Back Approach
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Abstract

This article first outlines buy-back contracts (BBC) for development of Iran’s oil and gas fields. Then it examines the main features of the mechanism. Third, it discusses the criticism of the buy-back agreement from a contractor’s and from the Iranian perspective. Furthermore, this paper outlines new developments of the enhanced buy-back contract and reviews the new buyback model proposed by NIOC to address these challenges. Finally, it looks into the possibilities of PSAs in Iran and also briefly looks into the new Foreign Investment Law for buy-back contracts.

This paper represents an abstract from a comprehensive investment guide "*Iran's Energy Report - From a Business and Legal Perspective*", which will be published in Summer 2009 by PennWell Corporation, USA within its *Oil & Gas Journal Executive Reports*.

I. Background of the Buy-back Concept

To prevent foreign control over its resources, which is prohibited by law, Iran introduced the so called buy-back concept, within the mandate of the legislation. The Constitution of the Islamic Republic, which is derived directly from the interpretation of the Holy Islamic Law, declares first that only God is sovereign and has the right to legislate. Likewise, the constitution sates under Article 4, that all civil, penal, financial, economic, administrative, cultural, military, political and other laws and regulations must be based on Islamic criteria.

1. Constitutional restrictions

The constitution restricts participation in economic activities by the private sector in general, and by foreign investors in particular. Article 81 denied foreign persons the right to establish a company in Iran, and granting any concession to foreign persons was also banned. Furthermore, the employment of foreign experts is restricted by article 82, and epically control over natural resources by foreign persons was prohibited by article 153. [1, 2]

In general the Iranian constitution, the Petroleum Law of 1974 and the Petroleum Act of 1987, aim at securing State sovereignty over its resources and in maintaining government control by prohibiting the direct ownership of Iran's mineral wealth by foreigners.

The legal and constitutional restrictions and the interpretation of the Islamic republic's constitution therefore is interpreted to deny the granting of foreign ownership, concessionary basis or direct equity stake or any production sharing agreement (PSA). As a result concessions and PSAs, as found in other oil rich countries not only in the Middle East, are practically impossible to negotiate. However, the 1987 Petroleum Law permits the establishment of contracts between the Ministry of Petroleum, state companies and "*local and foreign national persons and legal entities.*" The bar on foreign ownership of minerals in the Islamic Republic has been interpreted to mean a bar on the foreign control of reserves.

Hence, the concept of 'buy-backs' contracts (BBC) which are essentially risk service contracts was introduced. This interpretation consequently dictates that this is the only form of direct investment in the oil gas industry in Iran allowed by foreign persons or companies is via buy-back contracts (BBCs), under which foreign companies can also act as engineering, procurement and/or construction contractors. The law defines buy-back contracts (BBC) as: *'An agreement concluded between two real or legal persons under which one party 'the exporter' agrees to produce and deliver a certain quantity of a specific commodity or commodities for export within an agreed period of time, against the commitment of the other party to the* *exporter, to place materials, tools, machinery, parts or required services at the disposal of the other party for carrying out its commitments'.[2]*

2. Concept of the BBC

Due to the mentioned legal/constitutional restrictions and Iran's suspicions of foreign investors in the oil and gas sector, the concept of 'buy backs' or risk service contracts was introduced as a controlled and workable vehicle for foreign direct investment. The principle of such agreements was established in the Law which accompanied the first Iranian five year development plan, for years 1989-94, and was further developed in the second five year plan, which assumed legal status in 1995. At this time, the use of BBC for the development of oil and gas fields is an established mechanism in Iran and the current legislation authorizes the National Iranian Oil Company (NIOC) to use BBC for both exploration and development.

Fundamentally, BBC are fixed price/fixed return service contracts, where the contractor does not take any ownership of the oil or gas field and in which an Iranian entity (i.e. NIOC) subcontracts certain aspects of its responsibilities to a foreign party. Therefore buy-back contracts (BBC) are based upon a defined scope of work, a capital cost ceiling, a fixed remuneration fee and an agreed cost recovery period. It allows foreign companies to invest in projects and manage them in the development phase, and recoup their cost and earn a fixed rate of return (ROR) during the operating phase.

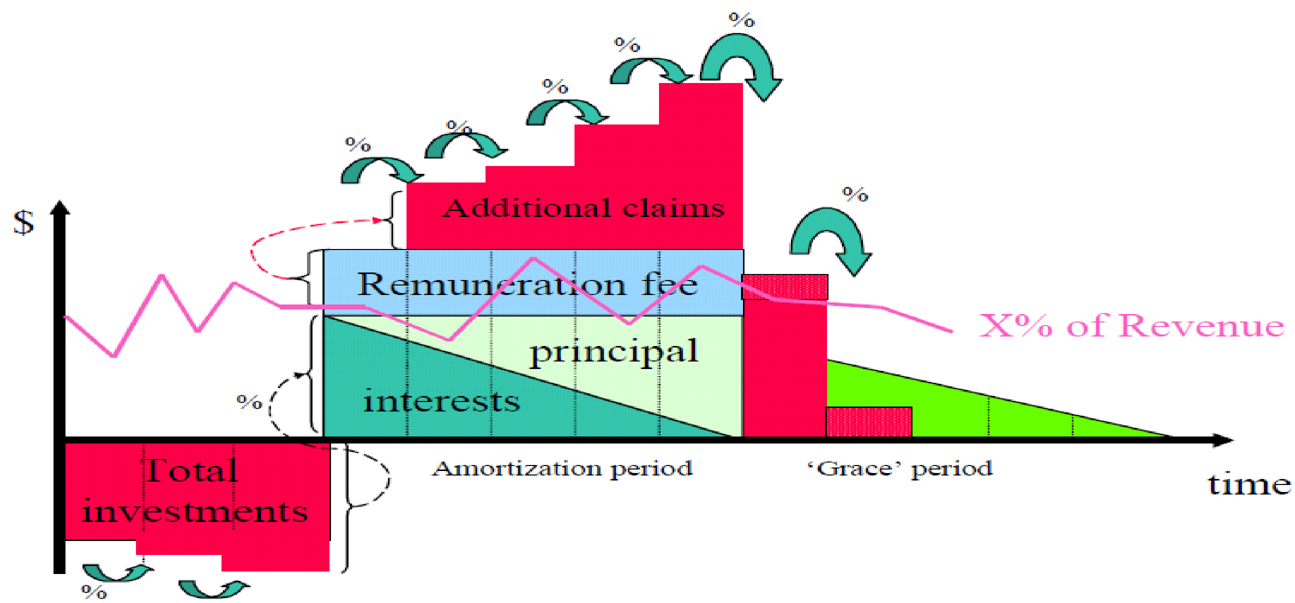
The contractor is the designated operator for design, construction, commissioning and start up of all facilities and this responsibility passes to NIOC immediately after start up. The foreign partner provides all the capital for the project and acts as a total contractor, organizing the development of the oil/gas field, including the construction of a turnkey process plant which is to be operated by NOIC. In the BBC regime, the investments are converted to a loan (annuity), which is to be paid back to the contractor by their outlay and an agreed level of profit of the revenue generated from the product.

3. Remuneration mechanism

In order to achieve an investment return reflecting the risks involved, a so-called Remuneration Fee (RF) is added to the annuity. Typically the government takes a percentage of the oil produced in priority to the cost and remuneration fee recovery by the contractor. This is commonly in the range 30-40%. However, the size of the RF is typically an item to be negotiated, not only because it will directly influence the return on investment for the oil company, but also the cost efficiency, a measure used by NIOC to evaluate proposals from foreign oil companies or contractors. Cost efficiency is defined as the total cost divided by production capacity. If the oil or gas produced in a given period is not sufficient to generate revenue that will cover the annuity and the RF, a corresponding claim is transferred to the subsequent period, adjusted with the interest London Inter Bank Offer Rate (LIBOR). The contractor is compensated for all capital and operating costs and bank charges incurred in fulfilling the specifications of the Master Development Plan. Interest on capital employed shall be accrued at a rate of LIBOR plus an agreed percentage, generally in the range 0.50-0.75%.

A claim remaining at the end of the amortization period is likewise transferred to a so-called Grace period, as shown in **Figure 1**. Whenever a claim is moved to a subsequent period, profitability is reduced because transferred claims are only adjusted by the LIBOR rate. The oil company therefore has a strong incentive to deliver a low cost and efficient facility. [3]

Figure 1: Cash-flow dynamics of the Buy-back contract



Source: [4]

Basically BBC service contract can be separate into two major parts - the sample exploration service contract, which covers the development phase of a field, and the volume-based long-term export product sales agreement, which regulates the reimbursement of costs and a return in the form of minerals.

The IOC contractor provides certain Exploration & Production (E&P) services in return for which the contractor's costs, and a reward, are reimbursed out of a share of project revenue. Generally, there is no cash return under a buy-back service contract. While the contractor develops the field, the NOIC repays the costs that comprise capital expenditure, operating expenditure and accrued bank charges. Additionally, the contractor receives a pre-agreed remuneration fee, normally by way of an entitlement to an amount of produced hydrocarbon. At the same time as the international oil companies (IOC) gains lifting rights to a portion of crude, a contractual right to equity oil is also gained. This results in a positive effect to the corporate balance sheet.

The remuneration itself is based on an agreed contractor rate of return, which has to date reflected nominal rates of return to the contractors in the range 13-21%. The gross remuneration fee is usually in the region of 30% to 70% of the capital cost of the project. The exact percentage will vary from project to project depending on the time frames for cost recovery and remuneration.

The cost and profit elements need not be amortized over identical periods. Several contracts have been signed in which the profit element is paid over a shorter period than cost recovery. [5, 6]

4. Challenges in calculation and kind of return

The key feature of the Iranian style of so called buy-back contract (BBC), which distinguishes them from both concessions and PSAs is that usually international oil companies (IOCs) are remunerated in crude oil or natural gas rather than in cash. Furthermore under BBC, costs and remuneration fee are paid in the form of crude oil, out of a fixed proportion (generally ca. 60-70%) of the new or additional production generated by the project under long-term export oil sale agreement (LTEOSA) and will be effected by archiving the successful completion of development activities, the acceptance of facilities by NIOC and the achievement of agreed production levels. The LTEOSA continues until the contractor has fully offset its petroleum costs and the remuneration. In exceptional cases (e.g. South Pars 2 and 3), costs and remuneration can be recovered from production from other projects operated under buy back contracts.

The contract further stipulates (in a development project) that the contractor should attempt to produce at a defined *'Maximum Efficient Rate'* and use best efforts to produce the forecast volumes according to the annual work programme. Typically the IOC is committed to a development period of 2-3 years and a 5-10 years remuneration/operation period, from the date of first or additional production from the project.[7]. Any costs, which cannot be recovered in any given period, are carried forward and recovered with interest in subsequent periods.

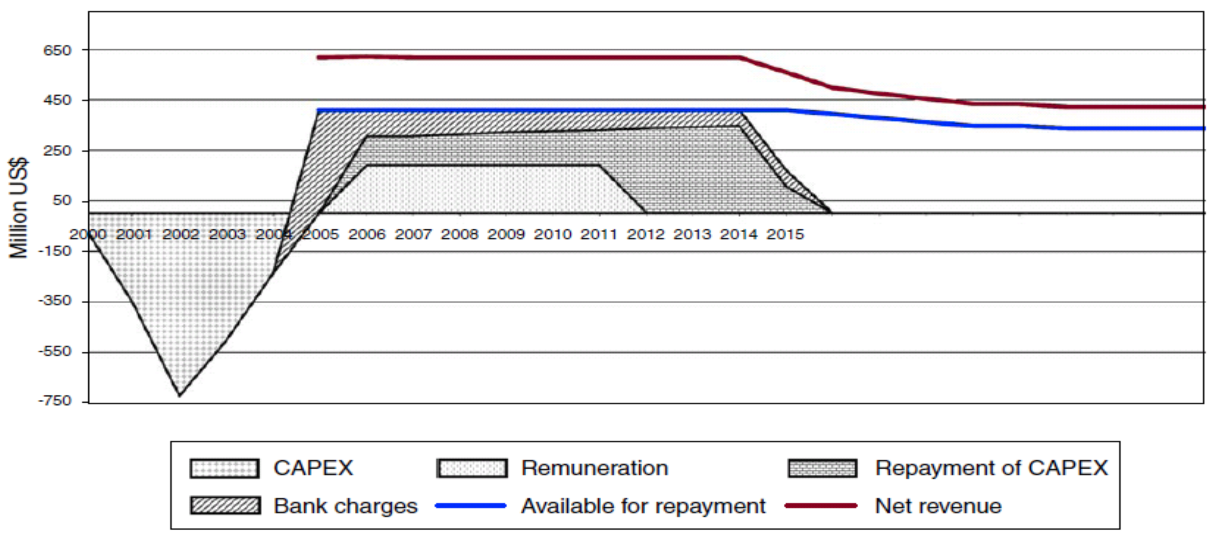
If the actual field costs are greater than anticipated then the extra cost is borne solely by the contractor and the additional costs are not eligible for cost recovery. But, if the actual costs incurred are less than that stipulated in the contract then the remuneration fee (which is based on the original cost estimate) is not reduced. Amortizations payments are based on the lower capital spend.

This shows the fundamental differences between BBC and PSA, where the IOC normally operates the field and receives a share of future profits (either in money or in kind).[8] The BBC itself, as Shiravi and Ebrahimi stated, consists of four major costs:

- Capital cost (capex)
- Non-capital costs (non-capex)
- Operating costs (opex),
- And Bank charges

The distribution of the revenues and the breakdown of cost under a buy-back contract, e.g. CAPEX, Non-Capex, OPEX, Bank charges, net revenues and Available repayment rates, can be found in the following **Figure 2**.

Figure 2: General distribution of revenues in a BBC



Source: [8]

As classified in an accounting procedure annexed to the BBC, CAPEX refer to all costs that relate directly to carrying out development operations. Non-capex refers to those costs that are difficult to ascertain at the time of contracting, being mainly moneys paid to Iranian authorities in respect of development operations: taxes, social security charges, customs duties, and any other levies required in Iran. OPEX are on-going cost for running a production and refer to expenses directly, necessarily and exclusively incurred and paid for production before the project is completed and handed over to NIOC. As production operations are to be conducted by NIOC when the project is completed, OPEX are mainly relevant when the production target is planned to be achieved in two or three phases, and the IOC authorized to operate the field developed in the first or second phase. Bank charges refer to costs of financing, which are calculated according to the London Interbank Offered Rate (LIBOR), plus a defined percentage, generally in the range 0.50-0.75% [1]

The Iranian BBC is defined by four major elements, which van Groenendaal and M. Mazraati define as followed:

First, the contract will stipulate the annual capital expenditures during the investment period. The contract stipulates the maximum allowable cost (in US$) to fulfill the Master Development Plan and the number of years over which such expenditure will be made. Any costs incurred in excess of this figure will be wholly borne by the contractor. The capital cost allowance figure has generally been set in the contract and is only changed if there is a major change in the scope of work from what was originally anticipated and detailed in the Master Development Plan. The figure could only be changed by amendment of the Master Development plan and with agreement from NIOC.

Second, bank charges on the amount investment have to be paid based on the London Inter Bank Offer Rate (LIBOR) plus a premium of 0,5%-1%. Still this percentage is rather low given the risk involved in oil and gas projects.

Third, a BBC will contain remuneration for the IOC's effort. These payments will take place during an agreed upon time period. Within this period also, the repayment of the investment and the bank charges will be settled, which is usually between 7 and 12 years. The total remuneration is the amount paid to the IOC as a reward for its service, which include engineering, procurement, and construction of the project, the financing thereof, and the transfer of the agreed upon technology. The payment actually starts after the development is completed and the products (oil, gas, condensate, LPG, ethane, and sulphur) become available for marketing. Total remuneration is normally about 50-60% of the amount invested.

The contractor is in addition, entitled to a negotiated remuneration fee which remains fixed and unchanged for any decrease in costs incurred by the contractor in carrying out the specifications of the Master Development Plan. This fee is paid to the contractor in equal installments, on a monthly basis, according to the agreed amortization period. Payment commonly begins from the date of first production although, in the case of the Shell Soroosh-Nowruz project, it is payable from the point of full field production through the permanent production facility. In the recent Darquain contract (Eni operator) this target rate has been modified to take the form of a key contractual performance measure, with financial incentives for exceeding the agreed rate and penalties for failing to do so. Any costs and/or remuneration fee that cannot be recovered out of the remaining share of revenues are carried forward and recovered with interest in subsequent periods. The Iranian authorities have indicated that they may adjust the priority oil percentages in the contractor's favor in periods of low oil prices to ensure that they receive an adequate return. Any liabilities on the contractor for Iranian corporate income tax, social security charges or other levies is paid by the contractor which is thereafter compensated for same by NIOC.

Fourth, a buy-back contract will contain an agreed upon internal rate of return for the IOC, which is subject to negotiation but on average somewhere between 12% and 15%. This internal rate of return in based on the agreed upon investment and production schedule and affected by remuneration, bank charges, and repayment of the investment. The scheduling of all elements in a BBC is subject to negotiations between the NIOC and the IOC. The outcome of this process will differ per project and depends to some extend on the NIOC’s and IOC’s risk attitude. This is similar to the wide variation of stipulations in PSA’s or concessions.

Given the number of degrees of freedom in setting, there are many solutions to this problem, so there is ample room for negotiations even after the investment schedule and the rate of return have been set. Note that IOC does not have to pay tax on the remuneration in a BBC. BBC do not allow for payments from financial resources other than the project’s net revenues. Similar to royalty in-kind in a PSA 40% of total gross profits is for the NIOC no matter what.

Hence, buy-back contract is based on build and transfer (BOT), so once production starts, the investment is handed over to the NIOC (or its representative) who will operate and manage it, and the IOC leaves the project. If the technology transferred and the production profile are based on the best practice, and the reservoir is treated according to good reservoir engineering principles, a BBC will bring maximum benefits to the state from a single project point of view, together with a reasonable return for the IOC, which acts as an engineering company. [8]

5. Extra expenses

As for extra expenses under a BBC there is no signature or production bonuses included in buy-back contracts. Also, no area rentals are included and no indirect taxes are payable. Furthermore, no VAT or Sales Tax is applicable under buy-back contract terms. And royalty does not apply in BBC. As well as export duty does not apply and the contractor receives negotiated fees for cost recovery and profit remuneration to guarantee a pre-determined rate of return.

However, the conditions of buy back contracts do provide NIOC with the option to introduce a company to take a minimum 10% share in the buy-back project and recently NIOC has been introducing Iranian entities (generally subsidiaries/affiliates of NIOC) as partners. In recent contracts, Petro Pars has taken a 40% share in South Pars Phases 4 and 5, 80% and operatorship of South Pars 6-8 whilst NICO have taken a 40% holding in the Darquain project.

This introduction of a significant Iranian participation in major development contracts was seen as the preferred model for future agreements and provided the state with a higher degree of control in the projects. Conversely, the Iranian partners have often found it difficult to raise the finance for major projects, which has led to significant delays in the proposed schedules.

II. Criticisms of the Iranian Buy-back Agreements

In taking the legal structure, performance in practice and the earlier mentioned considerations into account, a number of deficiencies in buy-back agreements appear. The deficiencies considered here are the most significant from the perspective of both the contractor and Iranian government.

1. Deficiencies from the contractor's perspective

From the contractor's perspective, there are major risks associated with the buyback contract in terms of the performance guarantees associated with production rates, development cost and project schedule. With the BBC, these risks are not compensated in the same manner as a PSA arrangement through cost oil and profit oil mechanism.
The key shortcomings of the Iranian buy-back contracts are as follows:

- There is a fixed rate of return.
- The lifetime and duration of the contract is too short
- The terms are inflexible and generally not subject to renegotiation
- Transfer of capital and technology
- Transfer of management skills

These major drawbacks of investing in the Iranian petroleum industry through BBC as outlined make it clear that the buy-back schemes do not present a reasonable alternative to the concession and PSA schemes used commonly worldwide. [4]

2. Deficiencies from the Iranian perspective

From the governmental perspective the following deficiencies can be seen in the BBC:

- No price risk for contractor
- Fixed rate of return
- The life of the buy-back project is short
- Transfer of capital and technology

If there is one fundamental criticism of the buy-back concept, it is that is totally inflexible. It locks both parties into a framework that is so rigid that there is no room for modification of the contract in the event of changing circumstances. On the negative side, unforeseen costs, reservoir performance, regional events, sudden changes in capital markets, etc., could place the foreign party under huge financial pressures, which might threaten the very deal in question. At the same time, the foreign party has no incentive to improve reservoir performance following signature of the deal and cannot seek better terms in line with packages that may become available elsewhere in the region and beyond.

Often is the issue of Iran's much-disliked buy-back contract raised, which are signed with oil firms looking to invest in Iran. Under the current buy-back system, an IOC pays for the cost of an E&P project up-front. It then recoups its costs and a fixed service fee from the sale of the venture's petroleum output over a five or ten-year period. Effectively, the IOC acts as a contractor and never gains any equity rights over the oil or gas.

Critics argue there is too little incentive for investors to optimize production, as IOCs receive no extra profit for boosting output beyond a certain target. Therefore it is claimed that the buy-back formula must be revised to attract more foreign investment. Also brought up into the discussion is an enhanced formula which should be similar to production-sharing agreements (PSAs). However, a total switch to PSAs is ruled out because of the interpretation of the Islamic republic’s constitution and the mentioned legal restrictions which deny the granting of foreign ownership, concessionary basis or direct equity stake or any production sharing agreements (PSAs).

3. Enhanced buyback contract

Taking into account all these deficiencies of the BBC improvements to the current buyback model for both exploration and development are suggested and underway: the capex ceiling will be calculated and determined when subcontracts are awarded via tendering; an escalation clause could be agreed on to deal with inflation and changes in market prices of materials, equipment and manpower; in place of fixing a fee for rewarding IOCs, a percentage of the production is given to IOCs according to a sliding scale, if the production reaches a level agreed in the contract; instead of allocating a percentage of revenue of the field to IOCs, a percentage of oil produced is allocated to IOCs to enable reserve booking. [1]

NIOC's recent initiative to improve the buyback model in a dialogue with IOCs has been welcomed by the companies (*Petroleum Economist*, 2006). Sinopec of China and the National Iranian Oil Company (NIOC) have finalized a deal for the development of the giant Yadavaran oil field, after three years of tough commercial negotiations.

The field will be developed under the new enhanced Iranian buyback contract, representing a major coup for the new Iranian Oil Minister, Gholamhossein Nozari, who led the review of Iran's fiscal arrangements in 2006. The most significant revision in terms from earlier versions is that the partners will only agree the target capital cost of the development following receipt of construction tender submissions. This should reduce the contractors' exposure to value erosion through cost inflation.

Politics aside, international companies have been unwilling to invest in Iran as the risk-reward profile of the Iranian buyback contract is commonly perceived to be commercially unattractive. Recent enhancements to the contract include:

- A later decision point on project capital costs (after construction tender submissions have been received)
- Longer international company involvement in the project
- Incentives for delivering the project on time and under budget

Most significantly for foreign investors, the enhanced format allows the targeted project capital cost to be agreed at a later stage, believed to be after contract bids have been received. This reduces the partners' exposure to value erosion through capital cost inflation. In any buyback contract, if the actual capital costs are greater than the targeted total then the extra cost is borne solely by the IOC. Such cost overruns have proven seriously detrimental (to already marginal project economics) as they are not eligible for cost recovery. [6]

III. Proposed PSAs for the Caspian?

In recent moth, some influential voices in Iran have been advocating the introduction of PSAs.

The problem is that, up to now, there has been confusion among some senior officials about what production sharing agreements actually means. There has been tendency to confuse PSAs with direct ownership of reserves. The latter is not an absolute necessity or condition for PSAs. As already mentioned, the Iranian constitution prohibits direct ownership of the country's mineral wealth. Nevertheless, Iran has no constitutional ban on PSAs that do not include entitlement to reserves in the ground.

Therefore, the Petroleum Ministry and parliament have been debating proposals to offer production sharing agreements (PSAs) for the Caspian blocks as these are high-risk areas and because they are contested by Iran's neighbors' - Azerbaijan in some blocks and Turkmenistan in others.

The head of investment at Iran's National Iranian Oil Company (NIOC), Hojatollah Ghanimifard, stated that Iran was mulling over a possible move to allow PSAs for the Caspian offshore, in recognition of the high costs that would confront foreign companies. However, in August 2008 Iranian Oil Minister Gholamhossein Nozari disparaged the notion that Iran would allow PSAs for the Caspian, arguing that PSAs were an outmoded contract type that Iran would continue to reject. Nozari insists that Iran's modified buyback contract offers sufficient incentives to investors. In a timely illustration of his stance, over the past few days Nozari has blamed delays in negotiations with Turkey over a $3.5 billion gas export deal on Turkish misconceptions of the buyback contract; Turkish officials have in turn pointed to flaws in the buyback contract itself.

The contradictory statements emanating from NIOC and the Ministry illustrate Iran's internal divisions over fiscal terms. Ghanimifard's position also may not reflect a consensus view within NIOC. While in some quarters there is a clear recognition that foreign companies have shunned the buyback deals, other voices in Iran are highly critical of efforts to amend the contract. Iran's efforts to improve its buy-back model have continued intermittently for more than 10 years, in a cyclical process in which greater incentives for foreign investors have usually prompted a strong domestic backlash.

Any effort to introduce PSAs—which under some regards is seen to contravene a constitutional ban on equity stakes in the oil sector for foreign companies—would face even greater political obstacles.

However, as mentioned already, the constitution leaves room for interpretation and the PSA are adjustable to legal restraints. But, a 2006 proposal of PSAs for oil and gas fields shared with Iran's neighbors did not advance beyond the discussion phase.

At first glance the Caspian would seem to be an obvious candidate for an exception to the buyback contract model. The Caspian has always been slated for more favorable contract terms; the costs of offshore developments are likely to be high, and investment would be far more likely to materialize if investors could book reserves from projects and recover their costs under PSA terms. Moreover, Iran has been left behind while neighboring countries have proceeded with Caspian developments.

Ghanimifard, the advocate of PSAs, argues that they should be introduced only for the Caspian region, not for South Pars and other offshore projects in the Gulf, or onshore production in southern Iran. However, even if limited only to the Caspian, the PSA introduction would generate a great deal of opposition.

Iran's constitution bars foreign companies from holding concessions or operating projects in the oil sector—a ban that has deep roots in post-Islamic Revolution Iran. Overturning or skirting the constitutional ban would be sure to involve a lengthy political debate, likely requiring the Majles to approve each PSA deal. Conservatives in the Majles and Guardian Council would be sure to object.

The growing influence of allies of President Mahmoud Ahmadinejad in oil sector policymaking positions would also complicate matters—although Ghanimifard is not alone among NIOC officials in supporting greater incentives for Caspian exploration.

Clearly a wholesale shift to PSAs would not be in the offing, but even introducing a PSA that was restricted to the Caspian would essentially be an admission by Iran's government that the buyback contract is not working. After years of tinkering with the contract and making incremental reforms, Iran would be making a substantial change to its governance of the oil sector. In order to justify embarking on the difficult process of securing an exemption from the buyback model, Iran's government would have to demonstrate a sense of urgency on the Caspian. While many in NIOC and the Ministry share growing concerns about declining production and insufficient investment in new source production, it is not clear that all stakeholders view the Caspian as the solution—or are willing to take ownership of the process of vetting PSAs for the Caspian.

A more likely tactic will be to offer new revisions to the buyback contract, perhaps with greater clarity on cost recovery mechanisms and improved rates of return for IOCs. If recent history is any guide, incremental revisions to the buyback contract are unlikely to deliver the desired results. Even if the government takes up the mantle of creating PSAs for the Caspian and securing sufficient political support, revised contracts alone will be unlikely to attract widespread interest.

With a few exceptions—notably the Chinese and Indian NOCs and possibly Russian companies—foreign companies are simply too sensitive to the threat of sanctions, reputational risks and the costs of doing business in Iran to respond to improved terms.

Finally some attention should be paid to the new 'Foreign Investment Promotion and Protection Act' (FIPPA) implications on E&P buy-back contracts. Even thought the FIPPA is an improvement over the previous foreign investor law, although there remain ambiguities concerning the protection of foreign investors in oil & gas buy-back arrangements.

IV. Implications of the New Foreign Investment Law for Buy-back Contracts

The legal consequences for IOCs investing in the Iranian oil & gas sector through buy-back service contracts are still quite complex. Article 3 (b) of FIPPA places foreign investments in all sectors within the framework of "civil participation" and buy-back arrangements under its protection. However, this appears to position buy-back service contracts in the oil & gas industry in direct conflict with the stated provisions of the Iranian Constitution concerning "mother" industries. This arises as oil & gas exploitation, exploration and export are supposed to be strictly state dominated.

However, a closer look at the FIPPA and its Implementing Regulations (I.R.-FIPPA) suggests that up to a certain limit even foreign investment in the E&P oil and gas state dominated industry falls under the protection of the FIPPA.

Article 2 (d) FIPPA provides that the fields in which foreign investments shall be made and the amount of foreign capital to be invested, shall comply with the regulations to be approved by the Council of Ministers. The relevant I.R.-FIPPA, in referring to Article 2 (d) FIPPA, explicitly mentions "Crude oil and natural gas (exploration, extraction and transfer)".

Furthermore, Article 3 (d) FIPPA states that the value of services and commodities resulting from the foreign investments compared to that of the services and commodities supplied to domestic markets in every economic sector and in every field shall proportionally not exceed 25% and 35% respectively. These proportions should be seen in the light of Article 2 (b) and (c) FIPPA, highlighting the main fear of Iranian political and religious influential circles, that foreign investments shall not jeopardize and threaten Iran’s national security and public interest. It makes it clear that foreign investment shall not involve concessions to be granted by the government to foreign investors.

Therefore, exemptions from the above mentioned proportions are provided for foreign investments relating to the production of services and commodities for export purposes, but not explicitly for the crude oil investment.

Oil & gas downstream projects appear to come under FIPPA's protection for their share of the capital. The law protects the contractor's investment, and if the project is nationalized, compensation would be provided and, most importantly, the contractor would be guaranteed to take profits in hard currency.

The situation seems to be entirely different for upstream oil & gas projects. Such projects could be under a constant threat to be in conflict with the "Islamic" provisions of the Iranian Constitution outlined above. Under the present buy-back service contract scheme, the situation remains complex. According to Article 16.2 of the Iranian Model Buy-back Service Contract, the IOC is the operator for the design, construction, installation, commissioning and start-up of all facilities, but only acts on behalf of and in the name of the NIOC(Article 3.1 and 7.1 Model Buy-back Service Contract). After commissioning and start-up the operator ship moves to the NIOC(Article 16.1 Model Buy-back Service Contract).

Provided that the foreign investor or contractor in a buy-back scheme is able to make use of this law, the question of how projects would enjoy such a protection remains. The law specifically refers to deprivation of national assets and property; however, in buy-backs the foreign company does not have the ownership of any property. All that is owned is a right to develop a specific field. Consequently, it is not explicit under FIPPA whether an act by the government that would terminate the buy-back contract prematurely could be deemed as “nationalization" within the definition provided for in FIPPA. Dispute-resolution provisions are provided under FIPPA, but they are still subject to constitutional restrictions.

V. New Foreign Investment Law

Of significant importance for investment in the Iranian oil and gas industry is the new Iranian investment law, the 'Foreign Investment Promotion and Protection Act' (FIPPA). It came into effect in October 2002 after putting in place the related executive regulations (IR-FIPPA) and following the final approval by the Council of Guardians and signature of the President. The new investment law retains most of the provisions of its predecessor, the 1956 Law for the Attraction and Protection of Foreign Investment (LAPFI). However, the FIPPA goes further by extending coverage of "investment" to include some schemes not previously covered under LAPFI.

1. Area of coverage

Since service contracts under LAPFI did not fall within the definition of "investment" because of the Iran Constitution and other legislative restrictions buy-back contracts were not protected.

The legal situation changed under the new investment law, which permits protection of foreign investment in all areas open to private investment (as opposed to specific sectors). FIPPA provides coverage to virtually all activities of foreign investors whether as direct investment or through non-equity participation and also provides coverage for civil partnerships, operate and transfer (BOT) schemes and service contracts such as buy-back agreements (Article 3 (b) FIPPA).

2. Shortcomings

The Iranian initiative in passing the new investment law is in line with the overall trend of creating a more investor-friendly environment, especially with an eye to foreign investors. However, the key problem area remains the strict reading of the Constitution.

The main shortcoming of the new investment law is that it essentially allows foreign firms to invest only in areas where private Iranian companies can invest (Article 3 (a) FIPPA). Therefore, relating to investments in the oil & gas industry, Article 44 and 45 of the Iranian Constitution should be recalled. According to these provisions the state sector has to include all large scale and "mother" industries including major mineral deposits, which are in the property of the Islamic government only. A strictly academic reading of the FIPPA provisions leaves not more than 5 to 10 % of the economy in the hands of the private sector, with the public sector having the lions share.

Even though, such a strict approach has never in fact been applied and Iranian companies have had little problem in entering many areas that are not designated as in the private-sector in the Constitution, foreign investors should be aware that the new bill is not explicit in regards to whether foreign firms can count on legal protection in areas where private Iranian firms are widely and openly involved despite constitutional restrictions.

VI. Conclusions

The research provides the following key obstacles for development of the Iranian energy sector:

A foreign investment unfriendly regarded buy-back contract scheme which leads to lacking advanced technical know-how, combined with economically inefficiency and high subsidies are seen as the main obstacles in the Iranian Energy sector. All these constraints lead to project delays, including the lack of a realistic gas strategy, political interference in decision-making, inflexible contracting policies, and the limitations of the domestic service sector. Most projects are already several years behind their implementation schedules, whilst negotiations for LNG developments with Shell/Repsol and Total/Petronas have stalled, after several years of faltering progress. This results in major incremental economic and financial problems, government dept, aging oil and gas fields, less export and subsequently to additional costs.

The Iranian Energy sector has a pressing need for compulsory investments, advanced technologies and Know-How transfer. It is fundamentally to change the investments climate, set (financial, economical, tax) incentives; change of the Buy-back formula involving a "new method" to attract local and foreign investment. As discussed, there are signs of a growing recognition that Iran needs to do more to attract IOCs, as it is necessary to maintain or even increase current production levels. Some of these changes require legislative changes. Obviously, foreign investments in Iran would be boosted if the country were to offer more flexibility in the buy-back concept and, even better, move towards PSAs that are inherently much more flexible than buy backs. But it is expected that a “new method” of the BBC, now under review and discussion, will be introduced. Given these current circumstances, however, it is unlikely that Iran can deliver on proposals to export incremental gas to Turkey, and new supplies to Bahrain, India, Kuwait, Oman and elsewhere, without exacerbating its domestic supply situation. The Iranian authorities face a series of difficult choices on gas priorities, which require a more realistic appraisal of the many constraints on capacity development. A good first step would be preparation of a national plan that is based on practical expectations rather than politicized over-ambition.

Iran has great upstream potential and a huge domestic market, although it is a nearly closed marked. However, the government intends to open up, and the population of over 60 million people intends to reach out to the globalized world, but there are structural and fundamental obstacles yet to be over-come. These problems range from political jockeying to practical consequences of inexperience in a global market. Despite domestic political volatility and the US embargo, Iran is going to open up and the walls are crumbling over the next 2-3 years. Therefore, significant changes are expected.

The Special Study "***Iran's Energy Report - From a Business and Legal Perspective***" committed for the *Oil & Gas Journal* will try to give some answers to these challenges. The overall results are presented in the conclusion of the final paper.

APPENDIX:

Legal background

Iranian Key Legislation

From an investor’s perspective, Iran has a stable and sound legal structure in place for decades. Even though the Islamic Revolution of 1979, brought some changes, it left most commercial laws untouched. Currently in Iran laws dealing with the protection of foreign investment, contracts, trademarks, patents, property and securities exist, in conjunction with a well-established Napoleonic commercial and civil code which defines various corporations, agencies, pledges, contracts, etc.

Therefore by the given administrative rules and regulations the necessary clarity and transparency for investors is provided in compliance with necessary recommended standards [4]

The Petroleum Act (1974)

The 1974 Petroleum Act sets out the principles and the legal framework for risk service contracts as the basis for discovery, improvement and production of petroleum operations in Iran. According to this Act, any contract, concession or venture that provides ownership rights on reserves and underground and produced oil was prohibited.

The Oil Act (1987)

The Oil Act of 1987, was approved by the Parliament when Iran was seriously involved in a prolonged war with Iraq (1980 –1988) and there was a mood of pessimism in the country about the engagement of foreign investors in economic activities. The new Act imposed a total ban on any form of foreign investment in the oil and gas industry and all direct foreign investments in the oil industry were terminated. Article (2) of the Act provides that petroleum resources are part of the public domain, which belongs to the Iranian people, and remains at the disposal and control of the Government. According to article (6) of the Act, 'all investments (will be) based on the budget of operational units proposed through the Ministry of Oil and ratified through the country's general budget. Foreign investment in these fields is strictly prohibited.' Article (5) of the Act, however, permits the Ministry of Petroleum and affiliated companies (e.g., NIOC) to enter into contracts with local and foreign individuals or companies for carrying out oil and gas projects. Article 12 further stated that 'with the ratification of this law any previous conflicting law and regulation is nullified.'

Articles 6 and 12 were originally interpreted to mean that any form of foreign investment in upstream oil projects was forbidden. Based on Article 12, it can also be interpreted that even the concept of 'service contract' mentioned in the Petroleum Act of 1974 is prohibited.
However, as a matter of expediency and the need for foreign capital and technology, another interpretation of these articles has been made by the authorities. Under this perspective, only direct foreign investment that calls for the presence of the foreign investor combined with ownership of reserves, installations or equipment is prohibited. Therefore, the concept of 'service contract' has been deemed legal. [1, 6]

Further developments

In the 1990s, Iran adopted several important legislative measures, which provide a foundation for development of the legal infrastructure necessary to advance the attraction of foreign investment. With these laws, a kind of buyback was developed in Iran. Although the concept of buyback was effectively created by the Budget Act of 1993, the terminology of “buyback” as such was first mentioned in the Budget Act of 1994, by which NIOC was authorized to enter into buyback agreements.
By virtue of these legislations, IOCs have been permitted to invest in certain oil and gas projects under buyback schemes. Therefore, article (6) of the Petroleum Act of 1987, which prohibits any foreign investment in oil and gas projects, has been amended by implication. The authorization to conclude buyback was restated in the Second, Third and Fourth five-year economic, social and cultural development plans, of 1995–1999, 2000–2004 and 2005–2009 respectively.
In 1997, Iran's parliament passed the Law of International Commercial Arbitration based on the UNCITRAL model, allowing for modern international arbitration; in 1997, a new law was passed regarding the registration of foreign branch and representative offices; in 1999 an amendment was passed which allows the creation of 100% foreign owned banks and insurance companies in the Free Trade Zones.
A major development in buyback occurred with the Budget Act of 2003, which authorizes NIOC to conclude buyback for both exploration and development of oil and gas fields.
However, the key obstacles to further liberalization of the business environment are (the interpretation of) Articles 44 and 81 of the Iranian Constitution.

Article 44

According to article 44 of the Iranian constitution, the economy is to consist of three sectors: state, co-operative, and private, and is to be based on systematic and sound planning.
The state sector is to include all large-scale and mother industries, foreign trade, major minerals, banking, insurance, power generation, dams and large-scale irrigation networks, radio

and television, post, telegraph and telephone services, aviation, shipping, roads, railroads and the like; all these will be publicly owned and administered by the State.

The co-operative sector is to include co-operative companies and enterprises concerned with production and distribution, in urban and rural areas, in accordance with Islamic criteria.

The private sector consists of those activities concerned with agriculture, animal husbandry, industry, trade, and services that supplement the economic activities of the state and co-operative sectors.

Ownership in each of these three sectors is protected by the laws of the Islamic Republic, in so far as this ownership is in conformity with the other Articles of this chapter, does not go beyond the bounds of Islamic law, contributes to the economic growth and progress of the country, and does not harm society. The precise scope of each of these sectors, as well as the regulations and conditions governing their operation, will be specified by law.

Article 81

The granting of concessions to foreigners for the formation of companies or institutions dealing with commerce, industry, agriculture, services or mineral extraction, is absolutely forbidden.

Fundamental amendments will be needed to clarify the true Constitutional intent of these articles. Such amendments are difficult to achieve and are not expected before President Khatami's second term in power (post August 2001). In the meantime, the Iranian government will continue to pass laws and regulations to evolve the business and legal environment that Iran needs for economic growth and investment. The key developments in this regard are likely to be:

New foreign investment law: the bill for this law is ready and it is expected that it will be passed by the new parliament. The key elements in the new law are guarantees for foreign investment as well as new rules for ownership of Iranian entities by foreign companies;

Reduction of government authority in the economy: the process of decentralization will have positive impacts on the size and authority of the state sector. This in turn will improve the business conditions and the willingness of the private sector to invest in Iran.

Transparency among state institutions: New laws and regulations will ensure state institutions become more transparent and accountable in their behavior in order to create the foundation of fair competition in the Iranian market.

The overall trend in Iran's recent legal developments places emphasis on making Iran more business friendly. The Iranian government realizes the need for intensive (domestic and foreign) private sector activity and appreciates that the required levels of such activity can only be achieved with the necessary legal, political and economic reforms in place.

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- Turan Information Agency
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- US Energy Information Administration
- Wood MacKenzie

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