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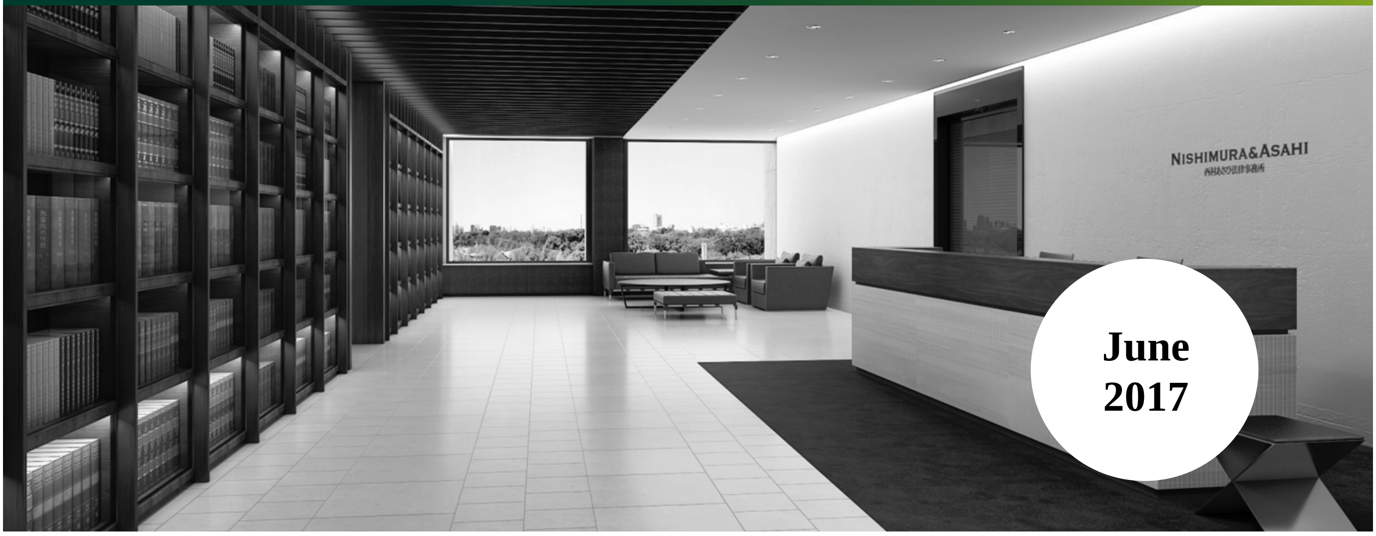

New Iranian Petroleum Contract

Mark Tudor

Overview

Iran has the world's fourth-largest proved reserves of crude oil and the second-largest natural gas reserves but due to international sanctions the Iranian energy sector has not been able to fully develop and exploit these reserves. However, pursuant to the 2015 Joint Comprehensive Plan of Action ("**JCPOA**") (under which sanctions can be suspended where Iran meets nuclear-related obligations under the JCPOA), the US and the EU have lifted nuclear-related sanctions (although sanctions could be reinstated if Iran subsequently fails to comply with its JCPOA obligations). The lifting of sanctions creates the potential for international oil and gas companies to invest in Iran.

The terms of the existing "buyback" regime for exploration and production of petroleum have also discouraged foreign investors and the new Iranian Petroleum Contract ("**IPC**") is an attempt by the Iranian Government to attract foreign investment into the Iranian oil and gas sectors by improving some of the terms on which foreign companies can participate. The IPC was announced in 2015 and the general terms and structure of which were ratified by the Iranian Parliament in September 2016 but the specific wording of the IPC contract has not yet been publicly released as it remains subject to political discussion within Iran. Although the general terms and structure of the IPC have been announced the full risk picture will not be known until the political discussions are finalised and the final wording is published.

Criticisms of the Buy Back Regime

The buyback contract is a short-term risk service contract under which the oil company takes the risk of recovering its sunk costs and being paid a fixed remuneration fee from sales of petroleum from a field – with the field being operated by the National Iranian Oil Company ("**NIOC**") during the production phase.

Major criticisms of the buyback regime from international oil companies ("**Contractors**") are that the Contractor is being asked to bear too much risk, including:

- Operational Risk: The Contractor does not have control over production as the field is handed over to and operated by NIOC during production, however, the Contractor bears the risk of NIOC's operation of the field;

- Payment Risk: A few aspects of the buyback regime combine to increase this risk:

  1. The short duration of the buyback contracts (typically 5 to 7 years);

  2. Payments to the Contractor are limited to a maximum of 50% of the revenue from the field over the term of the contract;

  3. Sunk costs and the remuneration fee can only be recovered from the production from the field and there is no ability to recover unpaid costs and any remuneration fee that is outstanding at the end of the term.

  Accordingly the Contractor bears the risk of not recovering these amounts if, for example, the reservoir does not behave as expected and the infrastructure put in place is not sufficient to recover sufficient oil to repay the Contractor within the term of the contract (eg enhanced oil recovery mechanisms would need to be added); and

- Cost Escalation Risk: There is a fixed ceiling on capital cost recovery and accordingly the Contractor bears the risk of capital cost overruns in the development.

There are many other commercial areas in which Contractors consider the buyback regime does not sufficiently encourage them to undertake investments (eg the inability to book reserves, significant local content requirements (>51%) with the possibility of termination of the contract for failure to meet the required levels).

IPC Regime

Overall the IPC is a risk service contract similar to the buyback contract structure (which is unsurprising as it is based on the same underlying laws) with some amendments to make it more acceptable to foreign investors.

Based on the information to date, some of the ways in which the IPC differs from the buyback contract are:

- Contractor has some level of participation in operations: The Contractor is required to participate together with an Iranian company approved by NIOC and a joint committee will be formed to make operational decisions and undertake operations. Such decisions will be made on a unanimous basis and will be subject to confirmation by NIOC. The Iranian Government resolutions in relation to the IPC provide that the responsibility for conduct of operations will be with the Contractor, however, this is subject to the terms of the IPC and accordingly the actual level of control of the Contractor is not currently clear;

- A $ per barrel / scf reward system rather than a fixed remuneration fee: NIOC can decide whether to pay the Contractor in cash or in petroleum with a reduction (of up to 50%) in the per barrel /scf fee if the market price falls and an increase (of up to 50%)

if the market price rises. The level of this fee proposed by each bidder will be one of the major factors in determining which company wins the tender;

- No fixed capital cost ceiling: Capital costs under the IPC will be agreed on an annual basis in annual budgets and will take into account field behavior and market conditions;

- A longer contractual term: A term of up to 20 years from the start of development operations with a possibility of up to 25 years for enhanced oil recovery or improved oil recovery operations;

- Risk-reward factors linked to the complexity of development of each field: In order to address one of the criticisms of the buyback system the IPC provides that higher fees may be available for 'high risk' field developments.

A specific area of concern in respect of the IPC relates to the treatment of the "snap-back" provisions of the JCPOA (which effectively allow any JCPOA participant to unilaterally trigger the re-imposition all of the sanctions contained in six UN Security Council resolutions where the JCPOA participant believes Iran has not performed its commitments). From the Iranian perspective there have been statements made that the re-imposition of sanctions under this "snap-back" regime would not be considered a trigger for termination of the IPC by the Contractor and it is unclear whether a "snap-back" will be considered in the IPC drafting as an event which entitles the Contractor to claim force majeure relief.

Comments

Whilst the terms of the IPC detailed so far give an overall framework much of the detail has yet to be filled in and accordingly the exact risks that the Contractor is being asked to bear will not be known until the IPC text is released.

The final wording of the IPC may raise new issues or dilute some of the protections that foreign investors are hoping for based on the principles published by the Iranian government so far. For example, there is a lack of clarity on the level of control that the Contractor will be able to exercise over operations – this is a key issue for Contractors particularly if there are concerns over the technical capability of the Iranian partner company or where the Contractor's internal rules require operations to be carried out to certain standards. There are also key questions regarding whether the Contractor will be able to book the reserves.

Despite the changes made in the IPC there are aspects of the buyback regime that will remain in place as they arise from background Iranian law and will therefore be applicable to the IPC. For example: (a) local content requirements; and (b) the requirement in the Iranian Constitution that the submission to arbitration of any dispute between the state of Iran and foreign nations relating to state property (which would include petroleum) must be approved by both the Board of Ministers and the Iranian Parliament.

As a practical point, based on experience negotiating buyback and related contracts with NIOC and its affiliates, Iranian negotiators may be reluctant to make significant changes to the wording of the final draft of the IPC. Iranian negotiators of buyback contracts had become familiar over many years with the areas of the model forms in which they could make changes (without being in breach of Iranian law), however, with the new IPC and the political scrutiny surrounding it there is a risk of reluctance by the negotiators to make changes or, where changes are requested by a Contractor, the possibility of significant delay in agreeing any changes due to the need for further review by and approval from various stakeholders. Ultimately this could mean that the terms of the IPC are not subject to extensive negotiation.

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Mark Tudor has advised on the negotiation of buyback and related contracts in Iran and has over 18 years' experience advising on energy and natural resources matters (with 10 of those years being in Japan with an international law firm). Most recently he worked for an FPSO and engineering contractor and has experience advising on onshore and offshore FEED, EPC and other engineering and construction contracts and on development of oil, gas and LNG projects.

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