

**THE MERITS OF THE IRANIAN PETROLEUM CONTRACT MODEL TO MEET  
THE DEVELOPMENT NEEDS OF IRAN'S OIL RESOURCES SECTOR**

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## **ABSTRACT**

This research provides an examination of the Iranian Petroleum Contract (IPC) system from inception to the present day. First, the thesis analyses the expansion of petroleum contracts from the initial Concession Agreements to the termination of all obligations following the Islamic Revolution of 1979 and the Nationalisation Movement. Second, the thesis examines the ongoing policy tension between the Iranian oil industry's need to access foreign funding and technology and its aim to avert foreign exploitation of its natural resources. Focus is given to the impact of this tension on Iran's current position regarding foreign investment and the development of the current contractual model. In this context, the thesis compares the Buy Back Contract as a model for access to Iranian petroleum in the period since 1989 with the IPC model, noting that the latter is fundamentally characterised by the provision of funds by foreign investors for the development of oil fields. The thesis argues that the IPC model, where rights are granted to successful foreign investor companies to access their capital, technology, and know-how in exchange for remuneration and the potential reward for successful production, is essentially a compromise approach that addresses the twin national priorities of (1) accessing international funds, expertise and services while (2) constraining the exploitation of natural resources by foreign parties. The thesis provides an extensive analysis of the IPC structure and relative advantages via a comparative analysis with the Buy Back Contract model. The thesis also analyses other major contractual models in the international arena and assesses their suitability for the oil industry in Iran.

The thesis analyses IPCs from the perspectives of both Iran and the foreign oil companies. As such, it provides a platform from which to determine whether all participants may be better served by revising the terms of IPCs or by substituting IPCs altogether with an alternative model. A relevant factor in this regard is the degree to which the petroleum industry in Iran was and may continue to be impacted by pressure from international actors, particularly the United States (US). The thesis considers the extent to which Iran resists international pressure and positions itself towards other countries who are willing to continue to sign Buy Back contracts. The thesis entails a close study of IPC's terms and conditions through a review of several petroleum fields in order to ascertain whether perceived issues with the model emerge in reality.

The thesis concludes that notwithstanding the demonstrable flaws in the IPC model, its revised terms and conditions regarding key elements related to contract length, risks borne by investor companies, and the mechanism for remuneration approach make it the best contract structure to meet the development needs of Iran's oil and gas sectors. Based on this conclusion, the thesis recommends that in the current economic, political and legal climate, the IPC model provides a framework for Iran to initiate reforms to its resources sector while at the same time preserving Iran as an attractive option to foreign investors.

## STATEMENT OF AUTHENTICATION

The work presented in this thesis is, to the best of my knowledge and belief, original except as acknowledged in the text. I hereby declare that I have not submitted this material, either in full or in part, for a degree at this or any other institution.

Signature: Pegah Pornou

Date: 08/09/2021



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## CONTENTS

ABSTRACT	I
STATEMENT OF AUTHENTICATION	III
ACKNOWLEDGEMENTS	IV
LIST OF TABLES	VIII
LIST OF FIGURES	VIII
LIST OF SELECTED ACRONYMS	X
DEFINITIONS OF KEY TERMS	XI
1 INTRODUCTION	1
1.1 Snap-Shot of the Iranian Petroleum Industry	2
1.2 Foreign Investment in Iran's Petroleum Industry	6
1.2.1 Buy Back Contracts	6
1.2.2 Iranian Petroleum Contracts	8
1.3 Scope of the Thesis	9
1.4 Research Questions	10
1.5 Methodology	12
1.6 Organisation of this Thesis	15
2 IRAN'S PETROLEUM INDUSTRY: INFLUENCE OF PRE-NATIONALISATION (1908-1951) CONCESSIONS, NATIONALISATION AND SANCTIONS ON MODERN PRETROLEUM CONTRACTS	18
2.1 Introduction	18
2.2 The Global Upstream Oil and Gas Sector	18
2.2.1 Iran's place within the global upstream oil and gas sector	20
2.3 Pre-1900 Oil Concessions	22
2.3.1 The de Reuter Concession	24
2.3.2 Hotz Concession	25
2.3.3 Imperial Bank of Persia Concession	25
2.4 Twentieth Century Pre-Nationalisation Oil Concessions	26
2.4.1 D'Arcy Concession and foreign involvement	27
2.4.2 D'Arcy Concession dispute and the Armitage-Smith Agreement	29
2.4.3 D'Arcy Concession: Cancellation and the new agreement	30
2.4.4 1933 Concession	31
2.5 World War Two and Politics in Iran	32
2.5.1 Soviet Union influence on oil concessions	33
2.6 Overview of Pre-Nationalisation Era	34
2.6.1 Concession issues and their renegotiation	35
2.6.2 Rejecting the compromise agreement	35
2.7 Nationalisation of the Oil Industry and its Consequences	36

2.7.1	The 1953 Coup D' Etat and its implications for foreign investment	37
2.7.2	The 1954 Consortium	38
2.7.3	The National Iranian Oil Company and the International Consortium	39
2.7.4	Reforming the petroleum agreements	40
2.8	Contractual and Commercial Changes between 1960 and 1979	41
2.8.1	Petroleum transactions and the Iranian economic development plans	41
2.8.2	The 1965 agreements	42
2.9	The Islamic Revolution and its Impact on Petroleum Contracts	42
2.10	Iran-Iraq wars	43
2.11	Conclusion	44
3	REGULATORY FRAMEWORKS	44
3.1	Introduction	44
3.1.1	Single article non-voiding the contracts	44
3.1.2	Bill to establish the Ministry of Petroleum, 1941	46
3.1.3	Petroleum Law 1947	48
3.2	Additional Regulations following the Islamic Revolution	49
3.2.1	Annual Budget Law	50
3.2.2	Annual budget laws and the five-year development plan	51
3.2.3	Legal support for foreign investment law	52
3.3	Conclusion	52
4	MODERN CONTRACTUAL FORMS: THE EMERGENCE OF BUY BACK TRANSACTIONS	55
4.1	Introduction	55
4.2	International Petroleum Agreements	55
4.3	Addressing the Imbalance	58
4.4	Contractual Systems	61
4.4.1	Production Sharing Agreements	62
4.4.2	Revenue sharing contracts	66
4.4.3	Joint Venture Agreements	66
4.4.4	Service Contracts	67
4.5	Buy Back Contracts	69
4.5.1	International Buy Back Contracts	71
4.5.2	Limitations of Buy Back Contracts	72
4.6	Conclusion	73
5	IRANIAN PETROLEUM CONTRACT – AS A RESPONSE TO THE PROBLEMS WITH BUY BACKS CONTRACTS	75
5.1	Energy Sector in Iran	75
5.1.1	Competition in Iran’s oil fields	77

5.2	Attracting Foreign Direct Investment into Iran’s Energy Sector	79
5.2.1	Foreign direct investment and the Iranian Petroleum Contract	83
5.3	Iranian Petroleum Contract and Iran’s Constitution	85
5.3.1	Redesigning the contracts	87
5.3.2	Iranian Petroleum Contract fiscal parameters	89
5.3.3	Investment, technology and exploration benefits	92
5.3.4	Foreign interest in Iranian Petroleum Contracts	95
5.4	United States Sanctions	99
5.5	Comparing Buy Back Contracts to Iranian Petroleum Contracts	102
5.5.1	Pros and cons of the Buy Back Contract	107
5.6	Summary of Iranian Petroleum Contracts	113
5.7	Critical Analysis of the Iranian Petroleum Contract	115
5.7.1	Perceived weaknesses and ambiguities	115
5.7.2	Iranian law	117
5.7.3	Joint Venture Agreements and credit risk for international oil companies	118
5.8	Pros and cons of the Iranian Petroleum Contract	119
5.8.1	Unconstitutional?	120
5.8.2	Undermines Iran’s sovereignty over its natural resources	121
5.8.3	Lack of clarity around role of domestic entity	121
5.8.4	More risks for Iran related to international oil company remuneration payments	122
5.8.5	Recovery of costs	122
5.8.6	Take advantage of foreign technologies and expertise	123
5.8.7	Increase optimisation of natural resources	123
5.8.8	Favourable dispute resolution mechanism	124
5.8.9	International oil company concerns with the Iranian Petroleum Contract	125
5.9	Implications of the analysis of the Iranian Petroleum Contracts pros and cons	127
5.9.1	Political landscape	129
5.9.2	Cost recovery	130
5.9.3	Fee structure	131
5.9.4	Joint Venture Agreements and management structures	133
5.9.5	Time extensions	134
5.9.6	Timing	137
5.9.7	Lack of access to technology	138
5.10	Recommendations	140
6	CONCLUSION	144
6.1	Strengths and Weaknesses of the Iran Petroleum Contract in regard to the International Petroleum Trade (RQ1)	145



6.1.1	The long duration of the IPC and the impact on its efficacy in the context of article 81 of the Iranian Constitution	148
6.1.2	Establishing stable and predictable contractual relationships: The role of stabilisation clauses	150
6.1.3	Meeting legal, economic, and social objectives	153
6.2	Impact of the Buy Back Contract Model on Iran’s Participation in the International Petroleum Trade	154
6.2.1	Buy Back Contract model’s limited fiscal system	155
6.2.2	Technology and knowledge transfer	156
6.3	The Extent to which the Iran Petroleum Contract Addresses the Current and Potential Needs of the Oil Resources Industry in Iran (RQ3)	157
7	BIBLIOGRAPHY	160
7.1	Books	160
7.2	Journal Articles	163
7.3	Iran	169
7.4	Government Publications (outside of Iran)	170
7.5	Industry Publications	170
7.6	Online News Publications / Newspapers	173
7.7	Working Papers	175
7.8	Conferences	175
7.9	Interviews	176
7.10	Dictionaries	176

## **LIST OF TABLES**

Table 4.1	Non-Concessionary Contracts	57
Table 5.1	IOCs with certification to bid at Iran’s oil and natural gas tenders, 2017	97
Table 5.2	Comparison of the Buy Back Contract and IPC models	105
Table 5.3	Pros and cons of Buy Back Contracts for the oil and gas sectors in Iran	107
Table 5.4	IPC Highlights	114
Table 5.5	Pros and cons of the IPC for the oil and gas sectors in Iran	119

## **LIST OF FIGURES**

Figure 1.1	OPEC share of world crude oil reserves 2018	3
Figure 1.2	Monthly Iran crude oil and lease condensate exports in 2018	5
Figure 1.3	Crude and condensate exports from Iran to Asia, Turkey and Europe, November 2017 to April 2018	6



## LIST OF SELECTED ACRONYMS

AIOC	Anglo-Iranian Oil Company
APOC	Anglo-Persian Oil Company
BOT	Build, Operate and Transfer
BP	British Petroleum
BPD	Barrels Per Day
BBC	Buy Back Contract
CAPEX	Capital Expenditures
CoM	Cost of Money
CSI	Cost Saving Index
DCC	Direct Capital Costs
EPC	Engineering, Procurement and Construction contract
EPD	Engineering, Procurement and Drilling contract
EEA	European Economic Area
FIPPA	Foreign Investment Promotion and Protection Act
FDI	Foreign Direct Investment
ICJ	International Court of Justice
IDC	Indirect Costs
IEA	International Energy Agency
IOC	International Oil Company
IPAC	Iran Pan American Corporation
IPC	Iranian Petroleum Contract
JCPOA	Joint Comprehensive Plan of Action
JOA	Joint Operation Agreement
JVA	Joint Venture Agreement
LPG	Liquefied Petroleum Gas
LIBOR	London Interbank Offered Rate
NIOC	National Iran Oil Company
OPEC	Organization of Petroleum Exporting Countries
PSA	Production Sharing Agreement
R&D	Research and Development
ROR	Rate Of Return
UK	United Kingdom
US	United States

## DEFINITIONS OF KEY TERMS

*Agreement*: Agreed understanding by two or more parties about their respective rights and duties concerning past or future performances; a demonstration of mutual agreement by two or more parties.<sup>1</sup>

*Buy Back Contract*: A financing deal whereby the host nation sells a property to a foreign investor on the condition it buys back the production output via long-term sales contract.<sup>2</sup>

*Concession Contract*: Grants rights to juridical persons or International Oil Company to explore and exploit oil and gas in exchange for the payment of costs and taxes related to the operations.<sup>3</sup>

*Contract*: An agreement among two or more parties producing obligations and responsibilities that are enforceable by law.<sup>4</sup>

*Exploration license*: An investor is granted permission to survey and drill shallow wells to access petroleum.

*Joint Venture Agreement*: A contract form involving a business undertaking by two or more parties to deliver project outcomes.<sup>5</sup>

*License*: An investor is granted the right to exploit a specified area for a fee and/or royalty payment.<sup>6</sup>

*New Concession Contract*: Includes the basic legal format of the Concession Contract, but with modifications to its financial terms and features.<sup>7</sup>

*Production License*: An investor is granted the exclusive right to search for and bore petroleum.

*Production Sharing Agreement*: A contract between an international company and a host government whereby the company provides investment capital in exchange for control over an oil and gas field and access to revenues from sales.<sup>8</sup>

*Reservoir*: A subsurface, porous, permeable rock formation containing oil and gas.<sup>9</sup>

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<sup>1</sup> *Black's Law Dictionary* (4<sup>th</sup> ed, 1951) 89.

<sup>2</sup> Willem JH van Groenendaal and Mohammad Mazraati, 'A Critical Review of Iran's Buyback Contracts' (2006) 34(18) *Energy Policy* 3709, 3709.

<sup>3</sup> Keith Blinn et al, *Exploration & Exploitation Agreements, Legal, Economic, and Policy Aspects* (Euromoney, 1986) 47.

<sup>4</sup> *Macquarie Dictionary* (3<sup>rd</sup> ed, 1997) 241.

<sup>5</sup> *Black's Law Dictionary* (n 1) 973.

<sup>6</sup> Mohammad Alramahi, *Oil and Gas Law in the UK* (Bloomsbury, 2012) 5.

<sup>7</sup> Albert T Chandler, 'Thailand Petroleum Concessions' (Research Discussion Paper Chandler & Thong-ek Law Offices, 14 December 2015) 2.

<sup>8</sup> *Ibid* 3.

<sup>9</sup> Anthony Jennings, *Oil and Gas Exploration Contracts* (Sweet & Maxwell, 2002) 56.

*Royalty payments:* Payments made by the licensee in cash or in kind as a percentage of the volume of the petroleum produced.<sup>10</sup>

*Service Contract:* An agreement by the host nation to grant an international company a contractual (not proprietary) right to conduct exploration and production of natural resources while retaining control over the operations.<sup>11</sup>

*Upstream oil and gas industry:* Points in production that commence early in the process including exploration, drilling, and extraction.<sup>12</sup>

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<sup>10</sup> Daniel Johnston, *International Petroleum Fiscal Systems and Production Sharing Contracts* (Pennwell, 1994) 3.

<sup>11</sup> Alramahi (n 6) 6.

<sup>12</sup> Paolo Mecini and Ezio Mesini, 'The Petroleum Upstream Industry: Hydrocarbons Exploration and Production' (*Encyclopaedia of Life Support System*, 2011) 2.

## 1 INTRODUCTION

The Iran Petroleum Contract (IPC) is currently used as the contractual model for petroleum transactions in Iran. This thesis seeks to shine a light on the suitability of the IPC scheme for meeting Iran's resources management strategy as well as proposing solutions on how the nation might improve the contract scheme to strengthen relations with foreign investors.

Recent political and legal developments in petroleum producing countries within the Middle East particularly has seen continued progress towards reinforcing the laws of the host country, in alignment with *lex petrolea*,<sup>13</sup> in the terms and conditions of the new petroleum contracts.<sup>14</sup> In Iran specifically, the *Oil Regulation 1974*, the *Oil Regulation 1987*, the *Oil Law Reform Act 2011*, and relevant regulations in the Fourth and Fifth Development Plans, were each confirmed as compliant with Iranian laws as an obligatory order.<sup>15</sup>

As a starting point, it is important to clarify the definitions of the key terms applied in this thesis referring to natural resources and petroleum in particular. Although the standard Iranian contract and the relevant regulations refers to 'petroleum' rather than 'oil', the focus of this thesis is on concessions applied to the crude oil resources of Iran. Petroleum, meaning 'rock oil', is defined as geologically extracted hydrocarbons embedded mostly in sedimentary basins, oil shale and tar sands, which may be liquid (oil) or gaseous (natural gas) in form.<sup>16</sup> The focus of this thesis is limited to oil contracts. It does not separately consider gas or refined condensates. It is also important to briefly note that although there is little difference in lexical terms between a contract and an agreement, an agreement may or may not be formalised as a contract. Lastly, although Iranian legislation is based on the Islamic (lunar) calendar, for the purpose of this thesis, all legislation is dated according to the Gregorian calendar.

The rationale for the focus of this thesis emerged from the ongoing tension in Iran between the petroleum industry's need to access foreign funding and technology and its aim to avert exploitation of its natural resources by foreign entities. This tension continues to have an impact on Iran's current position regarding foreign investment and the development of the

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<sup>13</sup> *Lex Petrolea* was introduced into the legal lexicon of the international oil and gas industry in an international arbitration case in 1982. It refers to the customary law comprising the legal rules for the nature and specificities of international petroleum industry disputes. Thomas C Childs, 'Update on Lex Petrolea: The Continuing Development of Customary Law Relating to International Oil and Gas Exploration and Production' (2011) 4(3) *Journal of World Energy Law and Business* 214, 214.

<sup>14</sup> Ahmad Heidari, 'The Governing Law of International Oil Contracts in Iran Legislations' (2015) 36(4) *Fen Bilimleri Dergisi (CFD)* 1756, 1756.

<sup>15</sup> *Ibid.*

<sup>16</sup> John E McMurry, *Organic Chemistry with Biological Applications* (Cengage Learning, 2014) 3.

current contractual model. Indeed, this tension was originally manifest in the Buy Back Contact model used in transactions with foreign oil companies for access to Iranian petroleum since 1989 (this is discussed in detail in Chapter 4). The Buy Back Contract model was fundamentally a short-term risk service contract characterised by the provision of funds by foreign investors for oil exploration and exploitation of petroleum in exchange for a set remuneration return for successful production. As such, it presented essentially as a compromise approach to both access international funds, expertise and services while constraining the exploitation of natural resources by foreign parties. A key factor in this approach is that when the oil field goes into full production, its operation is taken over by the National Iranian Oil Company (NIOC). It is this legal element which differentiates the Buy Back Contact model and the IPC. Other contract models exist in the international arena which are briefly referred to in sections throughout Chapter 4.

A comprehensive analysis of the terms and conditions of the Iranian IPC helps to ascertain whether the perceived issues with the contract model can be the subject of reform to improve outcomes for all stakeholders. As such, this study adopts a qualitative interpretive methodology to examine the current implementation of IPCs in Iran to attract international oil companies (IOCs) to invest in the exploitation of the nation's petroleum reserves. Specifically, industry and research literature such as journal articles, industry publications, government reports, media reports, and the like are analysed to draw conclusions about the merits of the different contract forms in relation to their stated legal, economic and social objectives (see Section 1.5 for further details).

## **1.1 Snap-Shot of the Iranian Petroleum Industry**

The petroleum industry in Iran is more than 100 years old.<sup>17</sup> Indeed, Iran was the first Middle Eastern nation to discover oil, grant a foreign country an oil concession,<sup>18</sup> and to nationalise its oil sector. Iran is a leader in the global petroleum industry, accounting for the second-largest petroleum output within the Organisation of the Petroleum Exporting Countries (OPEC).<sup>19</sup> Figure 1.1 compares the share of world crude oil reserves between

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<sup>17</sup> The British discovered oil in Iran in 1908, with Iran celebrating 100 years of oil production in 2008/09.

<sup>18</sup> The first Concession was granted to William D'Arcy in 1901. The Concession gave D'Arcy access rights to designated areas over a stated time period to explore for hydrocarbons (which included crude oil and gas) and, if discovered, for their transfer from the host nation (Iran) to the enterprise. The exploration, production, sale rights etc. were granted in exchange for tax and royalty payments on profits.

<sup>19</sup> OPEC was established at the Baghdad Conference on September 10–14, 1960. The founding states included Iran, Iraq, Kuwait, Saudi Arabia and Venezuela. Eight other countries have subsequently gained OPEC membership. The goal of OPEC is to formulate and implement petroleum policies to deliver stability in oil prices for producers and to establish an efficient and reliable supply of petroleum to the market.

OPEC and non-OPEC nations in 2018. It shows that Iran’s petroleum production is the fourth-largest globally, with 155.6 billion barrels produced at the end of 2018, equating to 13.1 percent of the global oil reserves.

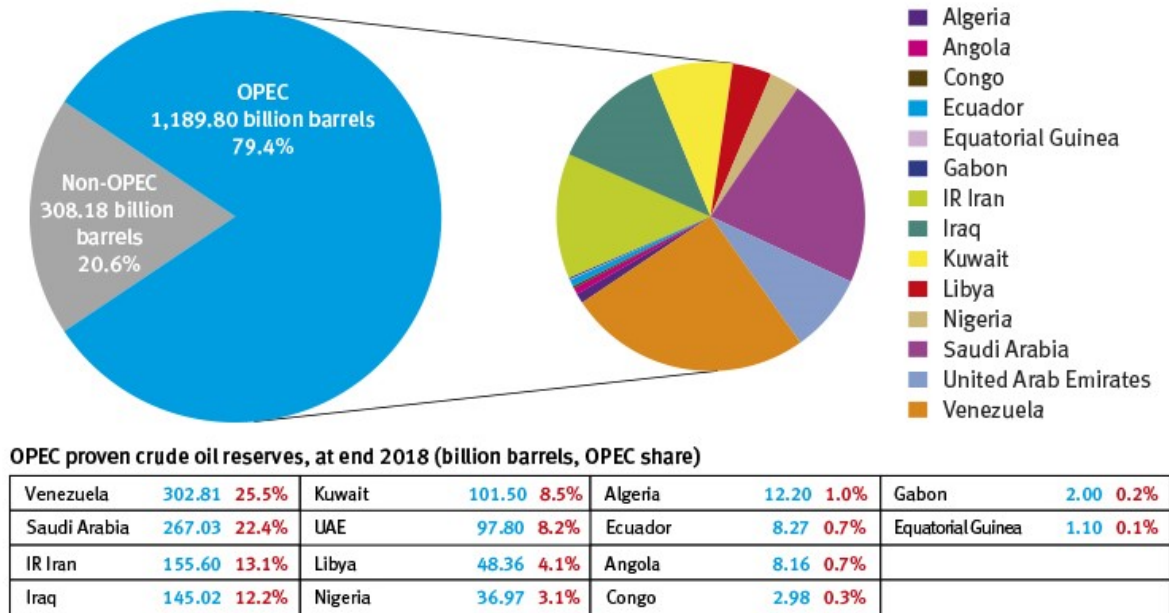


Figure 1.1 OPEC share of world crude oil reserves 2018<sup>20</sup>

The petroleum industry in Iran is thus crucial to the national economy and thus has a substantial impact on social development and domestic politics. An estimated 80-90 percent of Iran’s annual income comes from petroleum revenues, making it significant to the spending capacity of the government.<sup>21</sup>

Arguably the most significant domestic event to impact the petroleum industry in Iran was Islamic Revolution in 1979. This changed the national petroleum industry irrevocably as it led to the annulment of all national rules and regulations in the industry. The 8-year war with Iraq (1980-1988) shortly after exacerbated this upheaval due to the heavy damage to petroleum industry infrastructures and the considerable time and investment required, particularly from foreign companies, to finance the repairs. As will be seen in Chapter 2 at Section 2.9, these events affected the contract types and contract terms agreed to by Iran with

<sup>20</sup> OPEC ‘Annual Statistical Bulletin 2019’, <[https://www.opec.org/opec\\_web/en/data\\_graphs/330.htm](https://www.opec.org/opec_web/en/data_graphs/330.htm)> (accessed 9 November 2019).

<sup>21</sup> Energy Information Administration, ‘Iran: Country Analysis Brief August 2006’ <[www.eia.doe.gov](http://www.eia.doe.gov)> (accessed 4 July 2019).



foreign investor companies. Lack of technical staff needed for petroleum production in Iran was especially disruptive to its petroleum industry as it increased the difficulty in achieving production targets.<sup>22</sup> Moreover, lack of government funds to finance the exploration and production of oil and gas added to the difficulties.<sup>23</sup> These domestic issues prompted Iran to open up the petroleum industry to foreign investors through the Buy Back Contract scheme<sup>24</sup> with the first contract issued on 6 March 1995. As elaborated upon throughout this thesis, more recent disruptions to the petroleum industry in Iran have included the 2018 trade sanctions imposed on Iran by the US government (specifically, the Trump Administration). The sanctions include a ban on petroleum sales to the West which has led to a significant reduction in the number of direct crude oil buyers in the Iranian petroleum trade.<sup>25</sup> As with the sanctions of the 1980s and 1990s, the recent tough sanctions have been imposed against Iran with the primary objective to stop or to reduce the development of the country's nuclear program.<sup>26</sup> Some exemptions were initially granted by the Trump Administration to eight countries who were among Iran's biggest petroleum consumers; namely, China, India, Turkey, South Korea, Japan, Taiwan, Greece and Italy.<sup>27</sup> Figure 1.2 sets out Iran's petroleum exports to these countries during 2018.

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<sup>22</sup> Edward Chow, Cyrus Ashayeri and Andrew J Stanley, 'The Future of Iran's Oil and Gas Industry' (USAAE Working Paper No. 18-364, 2018) 5.

<sup>23</sup> van Groenendaal and Mazraati (n 2) 3709.

<sup>24</sup> Maryam Shafiei Khah and Ali Amiri, 'Petroleum Contracts in Iran' (2014) 3(3) *European Online Journal of Natural and Social Sciences* 375, 376.

<sup>25</sup> Benoit Faucon, 'Amid Tensions, Iran's Crude Buyers Jump Ship' (27 May, 2019) *The Wall Street Journal* <<https://www.wsj.com/articles/amid-tensions-irans-crude-buyers-jump-ship-11558964215>> (accessed 21 June 2019).

<sup>26</sup> Farzam Ardalan, Nejad Ali Almasi, Mansour Atasheneh, 'Effects of Contractor and Employer's Obligations in Buy Back Contracts: Case Study of Oil Exporting Country' (2017) 5(2) *Entrepreneurship and Sustainability Issues, Entrepreneurship and Sustainability Center* 345, 346.

<sup>27</sup> Reuters, *US is Reportedly Granting 8 Countries Iran Sanctions Waivers* <<https://www.cnbc.com/2018/11/02/us-is-reportedly-granting-8-countries-iran-sanctions-waivers.html>> (accessed 19 June 2019).

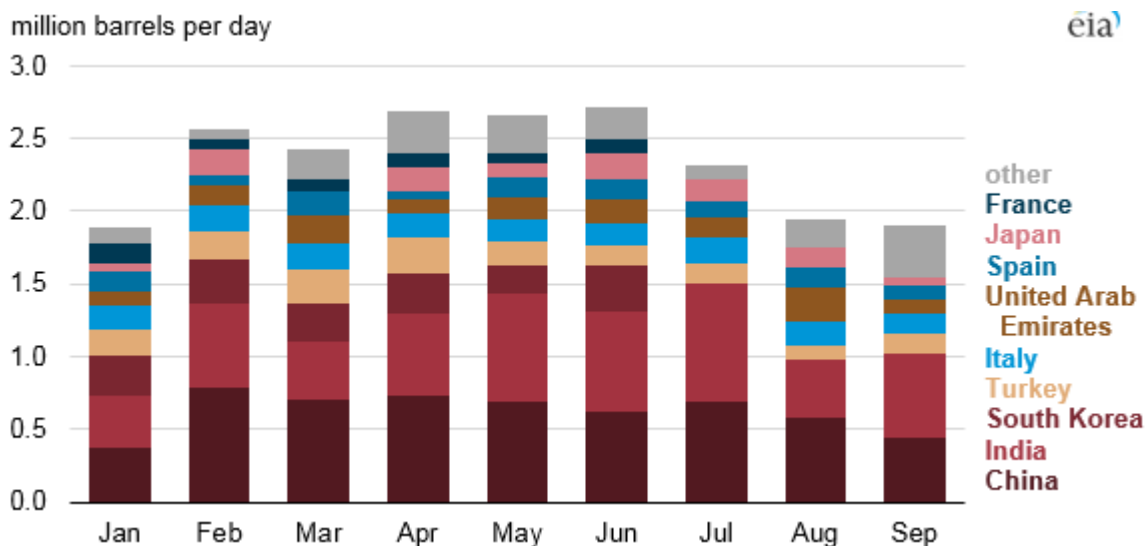


Figure 1.2 Monthly Iran crude oil and lease condensate exports in 2018<sup>28</sup>

However, these exemptions were ended by the US in April 2019 including in relation to China (Iran's biggest customer), leaving the United Arab Emirates (UAE), Egypt and potentially Russia<sup>29</sup> as the main 'customers' in the Iranian petroleum trade. Figure 1.3 presents further details of the crude and condensate<sup>30</sup> exports from Iran to Asia, Turkey and Europe.

<sup>28</sup> United States Energy Information Administration (2018) <<https://www.flickr.com/photos/eiagov/43699512980>> (accessed 21 June 2019).

<sup>29</sup> Ibid.

<sup>30</sup> A gas condensate is a hydrocarbon liquid stream separated from natural gas comprising higher-molecular-weight hydrocarbons which are found in the reservoir as elements of natural gas. They are extracted as liquids in separators or processing plants, in James G Speight, *Handbook of Offshore Oil and Gas Operations* (Elsevier, 2014) 19.

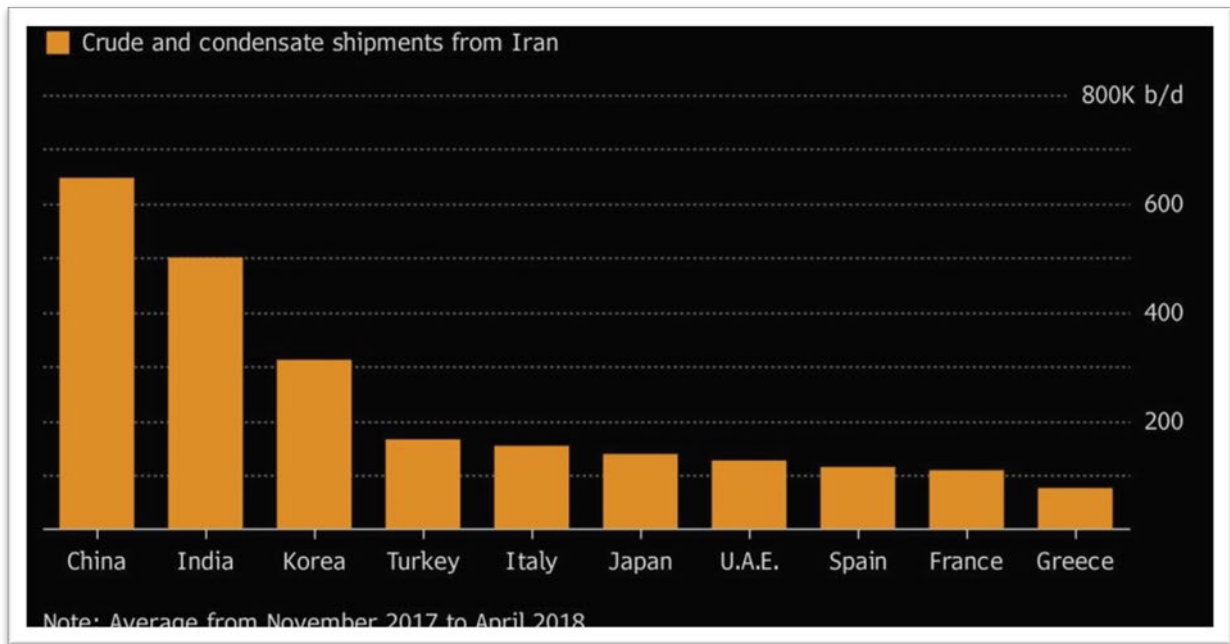


Figure 1.3 Crude and condensate exports from Iran to Asia, Turkey and Europe, November 2017 to April 2018<sup>31</sup>

## 1.2 Foreign Investment in Iran’s Petroleum Industry

The history of foreign investment in Iran’s petroleum industry is complex. The development of petroleum contracts in Iran along with the expansion of the petroleum industry over time is marked by key developments. Collectively, they establish the context for the eventual introduction of the Buy Back Contract model until its replacement with the IPC in 2016. Milestone events such as the D’Arcy Concession Agreement in 1901, the first discovery of oil at Masjid-e Soleiman in 1908, and the attempt and failure to revise the 1933 Concession are all of importance. Moreover, both World War One and World War Two had a significant impact on the petroleum industry in Iran and on the 1951 Nationalisation Movement and 1954 Consortium (see Chapter 2, Section 2.6 for further details).

### 1.2.1 Buy Back Contracts

Broadly speaking, the Buy Back Contract is a concession agreement in which the foreign company foregoes any claim to the profits made following receipt of an agreed remuneration payment. The foreign company also commits to handing over management and operations of the petroleum resources to the NIOC (or a representative) following the finalisation of oil

<sup>31</sup> ‘Bloomberg Tanker Tracking’ in Brandon Kochkodin and Grant Smith, ‘Iran Ships Most of Its Oil to Asia, Turkey and Europe’ *Bloomberg* <<https://www.bloomberg.com/news/articles/2018-05-08/iran-ships-most-of-its-oil-to-asia-turkey-and-europe-chart>> (accessed 30 June 2019).

extraction and commencement of oil production.<sup>32</sup> Van Groenendaal and Mazraati describe the four core elements to an Iranian Buy Back Contracts as follows:<sup>33</sup>

1. The contract stipulates the yearly capital expenditures during the investment period to establish the total investment by the foreign oil company to be repaid after the stated year. The duties paid on imports by the foreign oil company are reimbursed following the handover of the project to the NIOC.
2. The payment of bank charges on the amount invested. The London Inter Bank Offer Rate (LIBOR), in addition to a premium of up to 1%, is the interest rate used for calculating the Buy Back Contract bank charges.
3. Remuneration for the resource development activities undertaken by the foreign oil company. The remuneration is paid within an agreed time period, typically between 7 and 12 years. Total remuneration to the foreign oil company may include a reward for the financing of engineering, procurement and project construction services as well as for the transfer of technology.
4. A negotiated internal rate of return for the foreign oil company, typically between 12% and 15%. This return rate is based on the agreed investment and production schedule.

When first introduced by the Islamic government in Iran, Buy Back Contracts had the support of the state. Nonetheless, what was particularly problematic was achieving a satisfactory balance between ensuring the contract form generated sufficient revenue for Iran to meet the economic, social, political and resources sector interests of the nation while remaining attractive to foreign entities.<sup>34</sup>

These issues surrounding the Buy Back Contract arrangements were not limited to the academic and public arenas with disagreements over their structure and use also subjected to ‘the intrusion of politics’.<sup>35</sup> These disagreements came to a head following the election of President Ahmadinejad in 2009 when the scheme came under heavy criticism from his rivals within the Iranian parliament about the over-involvement of politics in commercial matters. This was in response to what the critics argued was the President tightening ‘his grip over the oil sector’ in addition to the increase in quasi-state players and domestic contractors with ties

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<sup>32</sup> van Groenendaal and Mazraati (n 2) 3709.

<sup>33</sup> Ibid 3711–3712.

<sup>34</sup> Nima Mersadi Tabari, *Lex Petrolea and International Investment Law: Law and Practice in the Persian Gulf* (Routledge, 2016) 152.

<sup>35</sup> William Yong, ‘NIOC and the State–Commercialization, Contestation and Consolidation in the Islamic Republic of Iran’ (Oxford Institute for Energy Studies, 2013) 11.

to the Islamic Revolutionary Guard Corps (IRGC).<sup>36</sup> The constant shifting ground in relation to political support for Buy Back Contract transactions in Iran highlights the importance of the broader political context in Iran to its approach to contracting with foreign entities for the development of its petroleum sector. This is because the political conditions inevitably impacted upon the scheme itself, the stance taken by the media towards the scheme, and the views of foreign entities who entered into partnerships with the Iranian government when signing the contracts.<sup>37</sup> In response to changing sentiment towards the Buy Back Contract in Iran, the government ultimately shifted its position to endorse the IPC.

### **1.2.2 Iranian Petroleum Contracts**

The IPC was introduced into Iran in 2016 as a new form of contract. It is essentially a type of service contract whereby a foreign oil company agrees to be paid in sale revenues for extracting an oil or gas resource. The IPC is used in Iran to develop its oil and gas resources. This model is attractive to the government because the risk is carried by the contractors who are required to fund all costs (i.e. technical, exploration, engineering and labour). In exchange, they receive compensation or profit from the discovery and exploitation of a commercially viable resource. The IPC thus emerged as an attempt by the government to reverse the country's reliance on local companies to develop oil and natural gas fields in the face of sanctions imposed by the US. However, as of mid-2018, only two IPCs had been finalised - a July 2017 agreement with French Total and the China National Petroleum Corporation (CNPC) and a 2018 agreement with Russian state-controlled Zarubezhneft.<sup>38</sup> Of significance to an understanding of the current IPC are the alternatives advocated by international critics of the model. In particular, the foundational elements and legal limitations of the IPCs, along with the procedural challenges associated with such alternatives, are important for assessing their impact. The theoretical frameworks to explain recent IPC transactions also provide insights into the factors shaping the current IPCs and those driving reform. There has also been extensive consideration in recent years to future developments in the international petroleum contract arena in the context of current sanctions imposed on Iran by the US, as well as the changes surrounding the nature of oil-supply in the Middle East. Arguably for any reform initiative to be successful it must emerge from a

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<sup>36</sup> Ibid 14.

<sup>37</sup> Ibid 4.

<sup>38</sup> United States Energy Information Administration, 'Background Reference: Iran' (2019) <[https://www.eia.gov/beta/international/analysis\\_includes/countries\\_long/Iran/pdf/iran\\_bkgd.pdf](https://www.eia.gov/beta/international/analysis_includes/countries_long/Iran/pdf/iran_bkgd.pdf)> (accessed 7 November 2019).

position of mutual agreement and understanding between the Iranian government and the foreign investors. This points to the importance of analysing the respective positions and exploring the potential areas of agreement. The key findings from such an analysis may then be used as a springboard to providing recommendations on how to move forward to address the salient issues around the IPC (see Chapter 5).

Notably, IOCs do not generally enter into IPCs and, as a result, this type of contract remains a relatively under-researched area. This thesis contributes to closing the gap with a comprehensive analysis of the academic and industry literature relating to IPCs. It adopts a multi-disciplinary approach that canvasses the economic, political and legal issues relevant to IPCs. The rationale for analysing IPCs from the economic and political perspectives (in addition to the legal perspective) emerges from the interconnections between the laws and regulations and the broader society and economy. There is significant potential for the constraints placed around Iran's laws on petroleum to transform the nation's political and economic outcomes.

Iran's legal restrictions around foreign investment in its natural resources sector are important in order to understand the current challenges related to petroleum transactions and to predict future trends in development. Indeed, the history of Iran's contract concessions, the Buy Back Contract scheme, the effect of the nationalisation of the resources industries, and now the IPC, all form important elements in the narrative of Iran's effort to control the exploitation of its petroleum resources. They are all a part of the historical development of the contract regime and it is necessary to carefully analyse the elements of the Buy Back Contracts in order to identify which parts have been incorporated into the new IPC and the potential effect.

### **1.3 Scope of the Thesis**

This study aims to critically analyse the current contractual model applied to petroleum transactions in Iran, namely, IPCs. The overarching objective of the analysis is to assess the suitability of IPCs and to propose remedies to the flaws in the contracts that remain aligned with the Constitutional constraints. To propose realistic reforms, it is first necessary to explore and understand the historical factors underpinning the grievances of foreign investors and the Iranian Government in relation to the IPC contract. Chapter Four (see section 4.2) examines International contract schemes and compares them with the IPC in order to understand the status quo and to determine how improvement may be achieved. In order to provide recommendations, this thesis analyses possible legal and political constraints around

future reforms to the IPC, taking into consideration the relevant theoretical and practical context.

Another important objective of this research is to ensure that the scope of the material being studied is sufficiently narrow to support the provision of targeted findings and specific rather than generic research conclusions.<sup>39</sup> To support this principle and to optimise the quality of analysis, the scope of this study has been narrowed to petroleum related IPCs; that is, petroleum contracts rather than gas contracts. Gas contracts are discussed at times however only to establish a point of contrast to their oil counterparts.

Although Iran's natural gas deposits, second only in size to Russia's gas deposits, are included in the definition of petroleum, they are not examined for three reasons. First, there are fewer sources available for an analysis of Iran's gas contracts than for IPCs. Second, gas exports from Iran commenced as recently as the 1960s and, as a result, there is not the historical influences and aspects for analysis as is the case for IPCs. Third, and most importantly, gas contracts in Iran have almost identical terms and conditions to those included in petroleum contracts, with only minor technical details comprising the points of difference. Hence, focusing on petroleum contracts (including greater access to data sources) also permits a developing understanding of gas contracts in Iran, with references to the latter providing a useful platform to demonstrate points of similarity and difference.

#### **1.4 Research Questions**

To achieve these aims and to respond to the present gap in the research literature, the thesis addresses the following research questions:

1. What are the strengths and weaknesses of the Iran Petroleum Contract in regard to the international petroleum trade?
2. How did the Buy Back Contract model impact Iran's participation in the international petroleum trade?
3. To what extent does the Iran Petroleum Contract best address the current and potential needs of the oil resources industry in Iran?

All three research questions are relevant to Iran's operations within the international petroleum trade, which is generally defined as the trading of crude oil among supplier and

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<sup>39</sup> David Silverman, *Interpreting Qualitative Data: Methods for Analysing Talk, Text and Interaction* (Sage Publications, 1993) 1.

user nations at designated oil prices. Research question 1 (RQ1) focuses on the IPC within the international petroleum trade framework and is important given that crude oil and petroleum products remain vital for the development of countries all around the world. Indeed, petroleum represents the largest primary commodity of international trade for both volume and value, with the international community dependant to a significant degree on access to affordable oil within the international marketplace.<sup>40</sup> By focusing on the strengths and weaknesses of the IPC within the context of the international trading market place, insights can be gained in relation to its capacity to achieve its stated objectives (as determined by the Iranian Government) and for informing decision making on how the contract option may be improved more generally.

Regarding research question 2 (RQ2), an effective way to better understand the strengths and weaknesses of the IPC as a contract option for Iran is to compare it to its predecessor; that is, the Buy Back Contract. In this way, RQ2 is important because it introduces the concept of obsolescing bargains into the discussion in this thesis of regarding the motivations and objectives of Iran for transitioning to the IPC. To explain, obsolescing bargains in the petroleum trade are those contract or other forms of interaction models that exist between the IOC and host country (i.e. Iranian Government).<sup>41</sup> Such ‘bargains’ initially favour the IOC but, over time, the bargaining power shifts more towards the host government as the fixed assets of the IOC in the host country increase over time.<sup>42</sup> It is anticipated that investigating how the Buy Back Contract model impacted Iran’s participation in the international petroleum trade in the context of its pathway towards obsolescence will provide important insights into the political processes and efforts towards the control of Iran’s energy resources by the Iranian Government laid the foundation for the introduction of the IPC.

Then, research question 3 (RQ3) ensures that explicit focus is given in this research investigation to the extent to which the IPC may be considered as success. As implied in the question, success will be evaluated in broad terms according to the extent to which it emerges that the IPC meets the needs (actual or perceived) of the oil resources industry in Iran.

However, given the design complexities of the different petroleum contract models combined with the competing needs of all stakeholders in the contract, the success of the IPC model

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<sup>40</sup> Zhijie Zhang, Huiqing Lan, and Wanli Xing, ‘Global Trade Pattern of Crude Oil and Petroleum Products: Analysis Based on Complex Network’ (2018) 153(2) *IOP Conference Series: Earth and Environmental Science* 1.

<sup>41</sup> Abdelrehim Neveen and Steven Toms, ‘The Obsolescing Bargain Model and Oil: The Anglo-Iranian Oil Company 1933–1951’, (2017) 59(4) *Business History* 555, 555.

<sup>42</sup> *Ibid.*



must also be evaluated against several other outcomes. The principal outcomes among them for consideration in this thesis include the extent to which the IPC appeals to IOCs (in terms of investment risk and return) and therefore encourages uptake, the degree to which it strikes the right balance regarding compliance with Iran's Constitution and other legal frameworks around control and ownership of domestic natural resources, and how well it achieves its primary objectives to inject revenue, technology, and know-how into Iran's energy sector. It is anticipated that the combination of providing detailed answers to these three questions will provide a string platform for assessing the merits of the IPC model in relation to the specific needs of Iran's oil resources sector.

## 1.5 Methodology

The research in this thesis is a systematic inquiry into the questions outlined above.<sup>43</sup> The overarching purpose of the research is to address these questions and to provide meaningful explanations for the proposed conclusions.<sup>44</sup> The particular methodological design of this study was adopted to permit conclusions to unfold in a logical, useful, and effective way.<sup>45</sup> In turn, this study adopted a qualitative interpretive methodology to examine the IPCs currently being implemented in Iran to engage foreign investors in the exploitation of the nation's petroleum reserves.<sup>46</sup> Barkhuizen and Ellis remind us that 'there is no one way of doing qualitative research'<sup>47</sup> and this thesis relies on a document analysis approach primarily, with some minor doctrinal research. The adoption of qualitative interpretive methodology is justified for two reasons. First, the interpretivist principles underlying qualitative research establish a robust platform for an examination of the IPC models for their capacity to benefit the energy sectors in Iran. Applying qualitative paradigms to the analysis of primary and secondary documents thus permits an interpretative understanding of the nature of IPCs and their potential benefits using inductive discovery processes.<sup>48</sup> Second, qualitative research allows for an insider's perspective of the topic to be formulated.<sup>49</sup>

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<sup>43</sup> John W Creswell, *Qualitative Inquiry and Research Design: Choosing Among Five Approaches* (Sage, 2012) 24.

<sup>44</sup> Ibid.

<sup>45</sup> Louis Cohen, Lawrence Manion and Keith Morrison, *Research Methods in Education* (Routledge, 7<sup>th</sup> ed, 2007) 33.

<sup>46</sup> Ted Benton *Philosophical Foundations of the Three Sociologies (RLE Social Theory)* (Routledge, 2014). 23.

<sup>47</sup> Gary Barkhuizen and Rod Ellis, *Analysing Learner Language* (Oxford University Press, 2005) 254.

<sup>48</sup> Benton (n 46) 23.

<sup>49</sup> Robert E Burns, *Introduction to Research Methods* (Longman, 4<sup>th</sup> ed, 2000) 11.

In terms of our understanding of the merits and deficiencies of IPCs in Iran compared to the previous Buy Bank Contract model, qualitative research permits historical, theoretical and analytical comparisons to be made. In turn, the document analysis research method has been applied to facilitate this comparative analysis. The analysis aims to apply at times relevant legal concepts and principles (i.e. cases, statutes and rules) to examine relevant legislation in a bid to explore their political, economic and social implications around the research topic under investigation.<sup>50</sup> Moreover, a traditional document analysis method has been applied within a two-part process. To clarify, the first part involved identifying and accessing relevant sources of law and the second part involved an interpretation and analysis of the text in terms of the deductive logic and /or inductive reasoning that has been applied within it.<sup>51</sup> To better understand the application and implications of the concepts and legal principles related to the petroleum contracts in Iran, industry and research literature including journal articles, industry publications, government reports, and media reports and the like have been utilised. The primary objective here was to read, analyse and link the industry, government, research and media source information to the relevant body of law to draw conclusions about the merits of the contract forms in relation to their stated legal, economic and social objectives.

As such, qualitative research paradigms are integral to the research methods applied in this study to enable the interpretation and analysis of the context in which the legal principles are being applied.<sup>52</sup> The qualitative component of this research is appropriately described by Hutchinson and Duncan as an analytical reasoning process in which the outcome is contingent upon the experience of the individual.<sup>53</sup> In this thesis the process undertaken was a problem-based research methodology. Hutchinson and Duncan describe this as a seven-step process:<sup>54</sup>

- Gathering relevant facts,
- Identifying the legal issues,
- Analysing the legal issues with the aim to identify relevant law,
- Conducting background research,
- Identifying and accessing primary material (e.g. legislation),

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<sup>50</sup> Terry Hutchinson and Nigel Duncan, 'Defining and Describing What We Do: Doctrinal Legal Research' (2012) 17(1) *Deakin Law Review* 83, 84.

<sup>51</sup> *Ibid* 85.

<sup>52</sup> *Ibid*.

<sup>53</sup> *Ibid* 86.

<sup>54</sup> *Ibid* 106.

- Synthesising all issues in context, and
- Drawing a tentative conclusion.

The analysis and interpretation of industry and institutional documents ‘have been a staple in qualitative research for many years.’<sup>55</sup> The standard approach to document analysis was applied in this research; namely, a systematic review (and evaluation at times) of printed and online documents with the aim to elicit meaning, develop an understanding, and acquire empirical knowledge.<sup>56</sup> While undertaking the interpretation and analysis of the primary and secondary documents, the overarching aim was to ensure a balanced approach was adopted. That is, regard was shown towards the national interests of the Iranian government in relation to the development of the nation’s upstream oil and gas sector as well as to the interests of foreign investors. As such, the primary focus of the analysis in this thesis is on the current legal regimes in Iran governing petroleum contracts (i.e. IPCs and Buy Back Contracts) for the development of Iran’s upstream oil industry.

However, given the political sensitivities around the formulations of these contract schemes and the extremely limited access to primary commercial documents due to confidentiality concerns, it has been necessary in this thesis to rely on secondary resources of the type identified above. More specifically, data for analysis and discussion in relation to the three research questions was primarily drawn from relevant industry and academic publications. Examples of the former include, but are not limited to, publications from the Energy Information Administration, International Monetary Fund, Iran Business News, the Organisation for Economic Cooperation and Development (OECD), Organisation of the Petroleum Exporting Countries, Tavana Energy, the United States Energy Information Administration, and the World Energy Council. Examples of the latter include, but are not limited to, journal publications such as the *Global Trade and Customs Journal*, *Journal of World Energy Law & Business*, *Iranian Studies*, and the *Oil, Gas & Energy Law Journal*. This is in addition to several book publications, Working Papers, Conference Papers and interview transcripts.

The discussion of these publications for their main points and insights is then combined with a discussion of primary sources related to the legal frameworks in Iran relevant to nation’s energy sector and the utilisation of its natural resources. Principal among these is the

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<sup>55</sup> Glenn A Bowen, ‘Document Analysis as a Qualitative Research Method’ (2009) 9(2) *Qualitative Research Journal* 27, 27.

<sup>56</sup> Juliet Corbin and Anselm Strauss, ‘Strategies for Qualitative Data Analysis’ in *Basics of Qualitative Research. Techniques and Procedures for Developing Grounded Theory* (Sage, 4<sup>th</sup> ed, 2014) 85.

Constitution of Iran, however others include, but are not limited to, Iran's Annual Budget Law, and the objectives of the nation's Five-Year Economic, Social and Cultural Development Plans. These primary resources for data collection and discussion are written in Farsi in their original form. Given the Australian context in which this thesis is produced, however, English translations of the documents were utilised and included as referenced material where available. As a person who is proficient at speaking and writing in both Farsi and English, the reliability of the translations of the primary resources was assessed by me prior to their use.

In turn, the comprehensive review of the secondary literature against relevant primary sources, combined with the comparative analysis of the IPC and Buy Back contract models, lays the foundations for the recommendations at the conclusion of this thesis pertaining to the future role of IPCs in the development of Iran's upstream energy sector.

## **1.6 Organisation of this Thesis**

The current position of Iran's petroleum contracts is important given the current context of fluctuating oil markets due to the instabilities or uncertainties surrounding some major petroleum producers around the world. As the world's leading oil producer, Iran arguably has the ability to determine the very nature of the global petroleum market. In this context, this thesis provides a comprehensive examination of Iranian petroleum contracts in relation to the present issues and their prospects in the future. With a focus on IPC transactions, this thesis comprises six chapters, which collectively analyse and report on the historical, social and commercial factors that shape the current contractual relationships undertaken in the petroleum industry in Iran. Chapter 1 has introduced the main points of focus in this thesis along with the rationale for and importance of the research. The research questions underpinning the study were also outlined. This chapter also provided a brief overview of the importance of petroleum contacts and the industry.

Chapter 2 presents an analysis of the historical factors impacting the IPC. The objective for beginning in this way is to lay the foundation for an in-depth analysis of the IPC provided in the subsequent sections. Specifically, Chapter 2 provides a short history of concession contracts in Iran from their introduction to the modern form. It explores the exploitative nature and outcomes of the 1933 Concession, including the unsuccessful attempts by Iran to renegotiate the deal to avert significant disruption to its petroleum industry. The analysis also focuses on the consequences the 1951 Nationalisation of the petroleum industry, including the attempts made to avoid subsequent annulments by altering the contract terms, as per the

1954 Consortium. The subsequent changes to the legal framework underpinning the petroleum contracts and the extent to which they impacted the commercial landscape are explored. The objective in this regard is to better understand the opposing interests and how they may be reconciled given the importance of petroleum industry to Iran's ambitious economic reforms. As such, a review is provided of the failure to address the concerns of the Iranian public and authorities, leading to the 1979 Revolution and the subsequent cancellation of all petroleum contracts. The review also considers the impact of the Iran-Iraq War on Iranian infrastructures and the increasing need for foreign investment and the impact of current sanctions.

Chapter 3 presents a critical analysis of the regulatory framework underpinning the petroleum contract agreements in Iran. It examines the Constitutional provisions relating to petroleum, the standing of the state-owned companies, particularly the NIOC, and the legislative provisions relating to contracts. Focus is given to the 'restrictions' on petroleum contracts in Iran emerging from the Constitution and statutory law. Also examined in this chapter are the Five-Year Development Plans implemented in Iran and the introduction of Foreign Investment Laws and the extent to which they placed constraints around foreign involvement in Iran's petroleum industry along with the IPC scheme.

Chapter 4 then provides a comparison of the contract models utilised in Iran's petroleum sector and the international alternatives. It explores the broader context of petroleum contract by identifying and discussing the alternatives to the contract model applied in the international petroleum industry. The alternatives discussed include, but are not limited to Production Sharing Agreements, Revenue Sharing models and Joint Venture Agreements (JVAs). The examination focuses on their operationalisation and the legal foundations upon which they are based and explores the extent to which they are compatible (legally and operationally) with the current contract system and legislative framework in Iran. The objective underpinning this analysis is to better understand the criticisms made by Iranian and foreign entities in relation to the contract structures and how these criticisms may have contributed to the transition towards the IPC system.

Chapter 5 provides an analysis of the IPC model specifically, using the Buy Back Contract as the model for comparison. The 'pros' and 'cons' of each contract model are identified and discussed. The result of this examination is then used as a springboard to make a recommendation as to the most suitable contract form (from the Buy Back Contract and IPC options) to best meet the interests of the NIOC as a contracting party and the oil and gas sectors in Iran more broadly. Chapter 5 considers whether the IPC is fit for purpose and is

the best for Iran in light of the sanction regime. As such, an evaluation is made as to whether there are other contracts or forms that are better suited for Iran moving forward. In addition, the practical implications of implementing some of the controversial provisions are explored to ascertain whether they strengthen or weaken the integrity and appeal of the IPC model.

The main objective of the comparative analysis is to provide a springboard into an exploration of the potential for reforms to modernise the contract scheme in Iran to align with current global market conditions. As such, a recommendation is also included in this chapter as to which contract model should be pursued in modern-day Iran to best manage and exploit the nation's vast petroleum reserves.

Chapter 6 concludes this thesis. It includes a summary of the main findings from the analyses performed and provides recommendations for the modernisation of Iran's petroleum contracts. The recommendations consider the concerns of both Iran and foreign entities and the current constraints imposed by the Constitution in Iran and its legal framework.

## **2 IRAN'S PETROLEUM INDUSTRY: INFLUENCE OF PRE-NATIONALISATION (1908-1951) CONCESSIONS, NATIONALISATION AND SANCTIONS ON MODERN PRETROLEUM CONTRACTS**

### **2.1 Introduction**

This chapter examines the history of oil and gas Concessions in Iran. This is an important step towards understanding the purpose and form of the recently adopted IPC and for providing a general contextual background to this study. The examination begins with a broader contextual discussion of the global upstream oil and gas sector and Iran's place within that sector. The focus then shifts back to the introduction of the pre-1900 petroleum Concessions in Iran and traces the developments and changes to the petroleum contracts up to the nationalisation of the petroleum industry in Iran in 1951. The chapter then concludes with a discussion of the changes to contractual and commercial agreements in Iran with foreign investor companies following the nationalisation of the industry. This includes focusing on the fundamental changes to the terms and conditions of petroleum contract models in Iran following the Islamic Revolution in 1979 as well as the impact of the Iran-Iraq wars on the design of petroleum contract.

### **2.2 The Global Upstream Oil and Gas Sector**

The oil and gas industry is comprised of three major sectors: [upstream](#), midstream, and downstream.<sup>57</sup> The most capital-intensive and important of the three is the upstream sector because this is where the crude oil and natural gas are produced. All activities relating to crude oil and natural gas exploration and extraction occur in the upstream sector which is done prior to transporting the products to refineries to be processed.<sup>58</sup> Notwithstanding the increase globally in the use of renewables to facilitate electricity generation since the turn of the century (e.g. wind, solar, biofuels, hydro and so forth), several countries maintain a significant level of energy production by burning fossil fuels (e.g. crude oil, coal, natural gas).<sup>59</sup>

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<sup>57</sup> Shafiee, Mahmood, Isaac Animah, Babakalli Alkali and David Baglee, 'Decision Support Methods and Applications in the Upstream Oil and Gas Sector' (2019) 173(1) *Journal of Petroleum Science and Engineering* 1173.

<sup>58</sup> Ibid.

<sup>59</sup> Ibid.

Indeed, oil is still the primary source of fuel globally – at around 33% of all energy consumption – followed by coal at around 29% and natural gas at around 24%.<sup>60</sup> This is largely because upstream oil and gas industries around the world continue to seek new ways to increase volumes of production, achieve cost reductions, enhance safety, improve operational performance, and ensure environmental protections.<sup>61</sup> Such efforts involve complex decision making and the need to consider and address uncertainties and risks in regard to a range of factors including field exploitation, production and maintenance, and life extension and decommissioning.<sup>62</sup>

Notwithstanding the status of oil as the primary source of fuel globally, Bagheri and Di Minin<sup>63</sup> note that IOCs' share of oil and gas reserves has fallen from around 85% in 1970 to less than 10% today. This raises considerable concerns about the business models of IOCs and their sustainability. Added to this is the change in the competitive landscape of the global upstream petroleum industry which has seen IOCs experience significant constraints around access to oil and gas resource bases worldwide.<sup>64</sup> In addition, research evidence shows knowledge retention initiatives and activities in oil and gas companies globally is inconsistent, with little effort being made to mitigate impacts from the knowledge loss from older employees.<sup>65</sup> A range of factors have contributed to this outcome including falls in the price of oil, layoffs, political conditions, and the country locations of the companies.<sup>66</sup> This loss of knowledge is more impactful in the upstream oil and gas sector as it is most affected by falls in oil prices and because knowledge around explorations, drilling, and reservoir management are critical to operations.<sup>67</sup>

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<sup>60</sup> World Energy Council, World Energy Council World Energy Issues Monitor 2017 <[www.worldenergy.org](http://www.worldenergy.org)> 60.

<sup>61</sup> Shafiee (n 57) 1173.

<sup>62</sup> Isaac Animah and Mahmood Shafiee, 'Condition Assessment, Remaining Useful Life Prediction and Life Extension Decision Making for Offshore Oil and Gas Assets' (2018) 53(1) *Journal of Loss Prevention in the Process Industries* 20.

<sup>63</sup> Seyed Kamran Bagheri and Alberto Di Minin, 'The Changing Competitive Landscape of the Global Upstream Petroleum Industry' (2015) 8(1) *The Journal of World Energy Law & Business* 1.

<sup>64</sup> *Ibid.*

<sup>65</sup> Muhammad Saleem Sumbal, Eric Tsui, Eric See-to and Andrew Barendrecht 'Knowledge Retention and Aging Workforce in the Oil and Gas Industry: A Multi Perspective Study' (2017) 21(1) *Journal of Knowledge Management* 180, 180.

<sup>66</sup> *Ibid.*

<sup>67</sup> *Ibid* 181.



### 2.2.1 Iran's place within the global upstream oil and gas sector

Iran remains one of the world's and the Middle East region's main suppliers of energy, gas in particular. In turn, oil and gas resources are important to Iran's energy policy for two main reasons: Iran derives most of its energy from hydrocarbons, and oil and gas provide Iran with a point of connection to the international community along with regional and global energy markets.<sup>68</sup> Revenues from the sale of oil and gas are used by the government of Iran to deliver economic and social transformations such as industrialisation and modernisation as well as to keep the status quo in domestic power dynamic and relations.<sup>69</sup> Hence, Iran is eager to maintain its role in the global oil and gas sector due to the politically influenced nature of the Iranian economy combined with the reality that the economic performance of the nation relies on the effectiveness of its oil and gas sectors.<sup>70</sup>

In terms of Iran's place with the global oil and gas sector, the International Energy Agency reports that global primary energy needs are expected to increase by 55% up to 2030. A key implication of this is that oil and gas industries around the world as the main suppliers of energy will be crucial to support societal advancement and development.<sup>71</sup> Growth in the global oil and gas sector is further evidenced in the increasing demand for both oil and gas fields. Regarding the demand for oil specifically, this increased from 894,283,000 barrels per day in 2012 to 951,151,000 barrels per day in 2016.<sup>72</sup> As a significant contributor to OPEC – with an estimated 158 billion barrels of proved crude oil reserves – Iran remains an appealing target market IOCs including TOTAL, BP and others.<sup>73</sup> Moreover, as a global player, Iran is a primary supplier of fossil energy to China and India – the world's two highest populated countries – with China especially continuing to demonstrate economic growth and a willingness for infrastructure development.

Nonetheless, the volatility of the global export energy market always has the potential to impact Iran's domestic economy as well as its role in the global energy market. This is evident in the revenue received by Iran from its oil and natural gas exports over recent years.

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<sup>68</sup> Tamás Dudlák, 'After the Sanctions: Policy Challenges in Transition to a New Political Economy of the Iranian Oil and Gas Sectors' (2018) 121 *Energy Policy* 464, 465.

<sup>69</sup> Benjamin Smith, *Hard Times in the Lands of Plenty. Oil Politics in Iran and Indonesia*. Cornell University Press, 2007) 23.

<sup>70</sup> Dudlák (n 68) 464.

<sup>71</sup> Sweis, Rateb, [Moarefi, Alireza](#); [Mahmood Hosseini Amiri](#); [Moarefi, Soad](#); [Saleh, Rawan](#). 'Causes of Delay in Iranian Oil and Gas Projects: A Root Cause Analysis' (2019) 13(3) *International Journal of Energy Sector Management* 630, 630.

<sup>72</sup> *Ibid.*

<sup>73</sup> *Ibid.*

Based on figures from the International Monetary Fund,<sup>74</sup> the revenue received by Iran from its oil and natural gas exports fell from US\$55.4 billion in 2014-2015 to US\$33.6 billion in 2015-2016, representing a decrease of almost 40%. The reasons for this significant decrease included the ongoing slump in export volumes combined with a fall in the price of crude oil leading to lower total export revenue. However, it was estimated that revenue from oil and natural gas exports in Iran rose to US\$57.4 billion in 2016-2017 – mostly from crude oil and condensate exports. This was due to a rise in the volume of crude oil exports after the implementation of the JCPOA.<sup>75</sup>

Within the context of this volatility and the competing driving forces, however, the petroleum sector in Iran has been experiencing a decline due to both external sanctions and the lack of investment in the development of new capacities.<sup>76</sup> International sanctions imposed on Iran and the disruptions they have brought to its oil and gas sectors have unquestionably had an influence on Iran's domestic affairs as well as its international status.<sup>77</sup> Given the significant revenue to Iran derived from the sale of its oil and gas, the raw materials form the basis of the national economy.<sup>78</sup> In addition, the raw materials are strategic and political instruments that shape Iran's domestic and foreign policies and are often used in diplomacy by the policy makers. Furthermore, the development of Iran's strategic sectors; namely, its military and energy sectors are concentrated in the hands of Iran's political leadership. Hence, the importance of the interrelationships between politics and hydrocarbon management in the country cannot be over-stated.<sup>79</sup>

Following the partial lifting of the international sanctions during the early twenty-first century, Iran sought to implement significant changes in its energy sector be in a position to provide a new, favourable environment for foreign investments.<sup>80</sup> Despite this intention, however, the relatively limited growth in production combined with a significant increase in domestic consumption continue to shape the future potential of Iran's energy sector

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<sup>74</sup> International Monetary Fund, Article IV Consultation, [Islamic Republic of Iran](#) (IMF Country Report No. 17/62, February 2017) 4.

<sup>75</sup> Ibid.

<sup>76</sup> Bijan Khajehpour. The Future of the Petroleum Sector in Iran, *Global Transitions* (Legatum Institute, 2013), 1.

<sup>77</sup> Ibid.

<sup>78</sup> Ibid.

<sup>79</sup> Ibid.

<sup>80</sup> Ibid.

specifically and its place in the global upstream oil sector more generally.<sup>81</sup> Therefore, of particular importance to Iran's role in the global oil and gas sectors are its ability to maintain oil production capacity in the context of international sanctions, the down turn in the global hydrocarbon energy sector and the shifting landscape of domestic energy consumption as the country undertakes subsidy reforms and pursues better energy efficiency.<sup>82</sup>

There is little doubt that Iran is transitioning away from its reliance on the exporting of crude oil towards a more diversified energy export portfolio including pipeline gas and gas-based industrial products, petroleum products, and electricity.<sup>83</sup> From a regional perspective, Iran would consider itself as a leading energy provider and therefore would likely want to work from the position that energy interdependency is a pathway to mutual cooperation. While the recent international sanctions have slowed down the development of Iran's energy sector, they have arguably compelled the nation to become a significant regional and global player in the production and exporting of energy-related products and services.<sup>84</sup> The pathway towards tension-free relations between Iran the West has many complexities and requires years to achieve, but Iran has the natural and human resources and the geographical positioning to establish itself as a leading player in a regional energy hub. Of course, there is still uncertainty around whether the recent political and economic reform initiated by the Iranian government and the international sanctions and pressure will lay the foundation for a petroleum sector in Iran that is more transparent and accountable. Moreover, disruptions from the sanctions as well as from the domestic mismanagement of the energy sector place pressure on Iran's role in the global oil and gas sector.<sup>85</sup> However, oil and gas resources remain a significant source of revenue for Iran and key stakeholders will naturally be determined to maintain a strong role for Iran in the global supply of energy.

### **2.3 Pre-1900 Oil Concessions**

Concessions or license agreements are a type of "one-sided contract" first introduced during the late 1800s, becoming more widespread during the early 1900s.<sup>86</sup> They describe the

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<sup>81</sup> Ibid.

<sup>82</sup> Ibid 2.

<sup>83</sup> Ibid 6.

<sup>84</sup> Bijan Khajehpour Ibid 6.

<sup>85</sup> Ibid.

<sup>86</sup> R Global, 'Petroleum Contract Models' <<https://irglobal.com/article/petroleum-contract-models-0f76>> (accessed 12 December 2019).

agreement entered into by a State and a company for the latter to explore and develop the natural resources of a designated area over an agreed (fixed) period of time. Oil companies typically competed for the concession by putting forward a bid, generally combined with a signing bonuses to gain the license to the concession rights.<sup>87</sup> As with most mining concessions, the resources (i.e. oil and gas) underground belong to the State and not to the owner of the land. As such, the State - that is, the Government or a designated legal Authority - grants the rights and obligations to a company for to explore a designated 'block' of agreed territory (onshore or offshore) for the potential to develop and produce oil and gas resources.<sup>88</sup> Concessions agreements are generally long-term (e.g. at least 20 years) and based on a two-phase financial structure: exploration and production. Following the granting of a concession license to an IOC or companies, a fee is paid by the licensee to the State per barrel for the right to produce the oil or gas, generally calculated according to market price. All costs and risks are borne by the operating company, but all profits exceeding the agreed fee go to the operating company.<sup>89</sup> Modernised concessions are different to the traditional types in that there is generally a smaller concession area, for a short duration, increased control by the host state, equal profit sharing and updated bonus / tax payments, and a 'far more dynamic and flexible [approach to] accommodating different perspectives and interests of the contracting parties'.<sup>90</sup>

The number of concessions granted to foreign entities increased during the latter half of the 19<sup>th</sup> century. Included in the concessions was the right to undertake the development facilities, a right which could be bought with a cash payment or by negotiating other outcomes.<sup>91</sup> The first of many concessions was granted to a British company to construct a telegraph network. Although the network would provide a quicker communication pathway into India, it effectively handed over control of Iran's technological developments to a foreign power.<sup>92</sup>

Iranian concessions to foreign entities during the 19<sup>th</sup> century were broad in scope and often achieved as a result of political pressure.<sup>93</sup> The government of Iran at this time was

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<sup>87</sup> Keith William Blinn et al. *International Petroleum Exploration and Exploitation Agreements: Legal, Economic and Policy Aspects* (Barrows, 2<sup>nd</sup> ed, 2009) 47.

<sup>88</sup> Mahmoud Fard Kardel, *The Development of Iran's Upstream Oil and Gas Industry: The Potential Role of New Concession Contracts* (Routledge, 2020) 72.

<sup>89</sup> *Ibid* 72-74.

<sup>90</sup> R Global (n 91).

<sup>91</sup> Steve Muhiberger, *History of Islamic Civilization* (Nipissing University, 1999) 2.

<sup>92</sup> *Ibid*.

<sup>93</sup> This pressure was effective because Iran was in a crossfire between regions controlled by the British Empire and regions controlled by Russia.

experiencing fiscal difficulties due to its debts to Russia and the UK.<sup>94</sup> In addition, the chaotic approach to governance in Iran prompted foreign powers to increase their concession demands on Iran. The British, particularly, took advantage of the chaos by establishing a monopoly over the production and sale of the natural resources of Iran.<sup>95</sup> Indeed, with the Concession terms and conditions favouring the foreign entity there was considerable potential for the national resources of Iran to be exploited. As such, the Concessions scheme was particularly unsustainable given the prohibitions placed around additional commercial engagements between the parties, leaving Iran to feel resentful that it was being exploited.<sup>96</sup> The following section provides a brief overview of the major concessions in this period.

### **2.3.1 The de Reuter Concession**

On 25 July 1872 the first petroleum contract was negotiated between Baron Julius de Reuter of Britain and Shah Nasr-ed-Din of Persia. de Reuter had considerable influence in European (including British) financial and political circles at the time<sup>97</sup> and ultimately secured a wide-scoping Concession agreement.<sup>98</sup> de Reuter agreed to finance natural resource ventures in Persia (now Iran) following the visit by de Reuter's agent, Cotte, to Tehran in 1872. During this visit Cotte offered cash to Shah Naser-ed-Din Shah in exchange for a Concession.

Although the Concession did not target oil reserves directly, its terms were sufficiently broad to cover these resources.<sup>99</sup> Included in the Concession was exclusive rights to Persia's mineral reserves excepting gold, silver, precious stones for 70 years, along with the sole right to the construction of rail and tram networks, the building of canals and irrigation systems, access to forests and uncultivated land, and the establishment of a bank and public works of every description.<sup>100</sup>

Lord George Curzon, the eldest son of Baron Curzon and the UK Foreign Secretary in 1919, said at the time that the Concession marked a total and 'extraordinary surrender'<sup>101</sup> by Persia to the interests of foreign entities. Put simply, Lord Curzon described it as 'the most complete concession which a nation can ever grant, giving up all its possession to foreigners'.<sup>102</sup>

However, the Concession was withdrawn after 15 months as a result of both internal (the

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<sup>94</sup> Nasar Farshadgozar, *A Survey on Iran's Oil Agreements (Seyri Dar Gharardadhaye Naftiye Iran)* (Tehran, 1381) 79.

<sup>95</sup> Ibid.

<sup>96</sup> Muriel Atkin, *Russia and Iran, 1780–1828* (University of Minnesota Press, 1980) 147.

<sup>97</sup> He is more well known outside of Persia as the founder of the news agency.

<sup>98</sup> Laurence Paul Elwell-Sutton, 'The Iranian Press, 1941–1947' (1968) 6(1) *Iran* 65, 67.

<sup>99</sup> Ibid.

<sup>100</sup> Ibid.

<sup>101</sup> George N Curzon, *Persia and Persian Question* (Cambridge University Press, 2015), 480.

<sup>102</sup> Rabiei Faranak, *Contracts Law* (Behnami, 2002) 71.

Iranian public) and external (Russia) objections.<sup>103</sup> The British government also withdrew support for de Reuter due to concerns around international tensions leaving the Shah to cancel the Concession<sup>104</sup> and confiscate the £40,000 deposit de Reuter paid to the Persian government.<sup>105</sup> Notwithstanding the short duration of the Concession agreement, it laid the foundation for Iranians to be highly cautious of foreign entities exploiting its national resources.<sup>106</sup>

### **2.3.2 Hotz Concession**

A Concession of note early in the 19<sup>th</sup> century was that granted to the Hotz Company of Britain Operating out of Booshehr in the Persian Gulf. The Hotz Company was granted a Concession in 1884 giving it the right to the extraction of oil from the Dalky and Qeshm Islands.<sup>107</sup> Despite several drilling attempts to discover oil through 1890 to 1893, none was found and after the annulment of all mining concessions by the Persian Government in 1899, the Hotz Concession was voided in 1901.<sup>108</sup>

### **2.3.3 Imperial Bank of Persia Concession**

After the de Reuter Concession was annulled, the company remained committed to making a return on its investment. In 1889, the British Minister, Sir Henry Drummondolf, sought agreement from the Chief Minister of Iran, Amin al Soltan Atabak, for elements of the de Reuter Concession to be enacted.<sup>109</sup> A new concession agreement was eventually agreed on which included the creation of the Imperial Bank of Persia.<sup>110</sup> The terms of the agreement included 14 articles including exclusive rights to mint banknotes, along with the payment of one million Francs (around £40,000) by de Reuter to Naser-Aidin-Shah by way of a loan, at 16% interest per annum. The £40,000 deposit previously ‘confiscated’ by the Persian government was used as capital by the Imperial Bank.<sup>111</sup>

Article 11 stated:<sup>112</sup>

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<sup>103</sup> Elwell-Sutton (n 103) 12

<sup>104</sup> Ibid.

<sup>105</sup> Hamed Alavi, *History of Oil Industry in Iran*, (California Institute of Asian Studies, 1978) 26.

<sup>106</sup> Amir Hossien Mahdavi, *History of the Iranian Foreign Relations (Tarikhe Ravabete Kharejiye Iran)* (Tehran, 1985) 308.

<sup>107</sup> Hooshang Guilak, *Fire Beneath the Ashes: The United States and Iran: a Historic Perspective 1829–1947* (Xlibris Corporation, 2011) 60.

<sup>108</sup> Ibid.

<sup>109</sup> Article 20 of the Concession dealt with the introduction of a bank, hoping to prevent the dissolution of Reuters.

<sup>110</sup> Rabiei (n 107) 21.

<sup>111</sup> Ibid.

<sup>112</sup> Iraj Zoghi, *Economic and Political Issues of Iran's Oil (Masael Eghtesadi va Siyasi Naft Iran)* (Pazhang, 1962), 59.

As the Imperial Bank declares that they are ready to exploit all of the natural minerals, everywhere in the country, immediately, the government will give a concession to this bank to exploit all minerals, including iron, copper, lead, coal, oil, and manganese; provided that the government had not granted this to others in the past. If the bank does not start to exploit any particular resources within ten years from the time that the bank was established, the government would assume that they had abandoned their title to those minerals.

It took almost 17 years for de Reuter to resolve its issues with the Iranian government regarding the concession and ultimately achieve an advantage in terms of oil deposits.<sup>113</sup>

#### **2.4 Twentieth Century Pre-Nationalisation Oil Concessions**

This section discusses the 1901 D'Arcy Concession and other significant oil negotiations during the early 20<sup>th</sup> century such as the 1933 Concession. Focus is given to the privileges the agreements afforded foreign entities and the efforts by Iran to renegotiate the contracts due to pressure from the Iranian public. In sum, the common concession agreements signed in the Middle East prior to the 1950s had the following characteristics:<sup>114</sup>

- The rights granted to foreign petroleum companies to explore for petroleum reserves to develop often covered large expanses of area, sometimes even an entire country.
- The duration of the contracts covered an extensive time period.
- The foreign petroleum company had control over the schedule and manner of the development of the mineral reserves.
- The foreign petroleum companies were not required to produce a set number of barrels per day. As a result, the petroleum companies could reduce or increase petroleum production based on falls or increases in the price of petroleum without incurring a penalty. This left the host nation with limited rights other than the receipt of a payment based on production.

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<sup>113</sup> Farshadgohar (n 99) 39.

<sup>114</sup> Homayoun Mafi, 'Iran's Concession Agreements and the Role of the National Iranian Oil Company: Economic Development and Sovereign Immunity' (2008) 48(1) *Natural Resources Journal* 407, 412-414; Valerie Marcel, *Oil Titans: National Oil Companies in the Middle East* (Brookings Institution Press, 2006) 16-20.

### 2.4.1 D'Arcy Concession and foreign involvement

The signing of the Concession to William Knox D'Arcy in 1901 marked the 100-year anniversary of the foundation of Iran's petroleum industry.<sup>115</sup> With the support of the authorities in Persia, the concession was granted to D'Arcy by Mozaffar Ed-Din Shah on 28th May 1901 in return for £50,000 worth of shares and other payments.<sup>116</sup> In accordance with Article 4 and Article 16 of the D'Arcy Concession, May 1903 saw the first company established for the exploitation of oil.<sup>117</sup> Despite expert opinion being optimistic about the potential of the drilling operations, the lack of financial support from D'Arcy was a major obstacle to success. D'Arcy was not prepared for the significant costs incurred to support related projects. By 1904 he had outlaid more than £220,000, a huge amount of money at that time.<sup>118</sup>

The harsh provisions of the D'Arcy Concessions for Iran laid the foundation for the Shah government's decision to regain control of the oil field for Iran and to limit the increase in foreign influence.<sup>119</sup> The concession provisions regarded as most controversial included:  
Article I

The Government of His Imperial Majesty, the Shah, grants to the concessionaire by these presents a special and exclusive privilege to search for, obtain, exploit, develop, render suitable for trade, carry away and sell natural gas, petroleum, asphalt and ozokerite throughout the whole extent of the Persian Empire for a term of sixty years as from the date of the signing.<sup>120</sup>

The extent to which oil exploration and exploitation was allowed under Article 1<sup>121</sup> is extraordinary given that it appears to grant exclusive rights for the exploitation of oil fields over a significant area of land the subject of the concession for 60 years. Furthermore, the Article covered an unparalleled amount of valued resources and supplies relative to the other petroleum contracts which were much smaller in terms of land area and scope:

Article 7

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<sup>115</sup> Alavi (n 110) 30.

<sup>116</sup> Ibid.

<sup>117</sup> Sundhya Pahuja, Rethinking Iran and International Law: The Anglo-Iranian Oil Company Case Revisited. In James Crawford, Abdul Koroma, Said Mahmoudi, Alain Pellet (eds) *The International Legal Order: Current Needs and Possible Responses: Essays in Honour of Djamchid Momtaz* (Brill 2017) 55.

<sup>118</sup> Ibid.

<sup>119</sup> Zoghi (n 117) 63.

<sup>120</sup> Ibid.

<sup>121</sup> Some provinces were open to exclusion as stipulated in a later Article.



All lands granted by this agreement to the concessionaire, or that may be acquired by him in the manner provided in article 3 and 4 of these agreements, and also all products exported, shall be free of all custom duties and taxes during the term of concession. All material and apparatuses necessary for the exploration, working and development of the deposits, and for the construction and development of the pipelines, shall enter Persia free of all taxes and Custom House duties.<sup>122</sup>

The fact that the Concession operations were exempt from having to pay any tax was extraordinary given the lift to Iran's economy that would have come from an injection of such significant amounts of tax revenue. Moreover, the particularly exploitative nature of Article 7 is evidenced when one considers the relatively low share of the profits from the exploitation assigned to the Persian government.<sup>123</sup> It is true that all of the equipment and other resources were ultimately to be handed over to the Persian government. However, given the terms of the Concessions ran for 60 years, it was doubtful that the equipment from the operations would be useful for locating viable oil deposits in the region.<sup>124</sup> In June 1901, shortly after the granting of the D'Arcy Concession, a Royal Decree from the Shah was to be included as an addition to the Concession which reinforced the view that foreign pressure has again resulted in Persia losing its natural resources for minimal financial return.

Article 10 states:

Pursuant to the concession granted to Mr. William Knox D'Arcy, as a result of the particularly friendly relation which unites powerful Great Britain and Persia, it is accorded and guaranteed to the Engineer William D'Arcy, and to all of his heirs and assigns and friends, full power and unlimited liberty for a period of 60 years, to probe, pierce and drill at their will the depths of Persian soil; in consequence of which, all the subsoil products wrought of him without exception will remain the property of D'Arcy. We declare that all the officials of this blessed Kingdom and our heirs and successors will do their best to help and assist the honourable D'Arcy, who enjoys the favour of our splendid court.<sup>125</sup>

The language of the Concession addendum reveals the extent to which the British government had influence over the decision-making processes in Persia in relation to concessions in particular.

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<sup>122</sup> Zoghi (n 117) 63.

<sup>123</sup> 16% according to art 10.

<sup>124</sup> Zoghi (n 117) 63.

<sup>125</sup> Ibid.

#### 2.4.2 D'Arcy Concession dispute and the Armitage-Smith Agreement

The wording of the Concessions was however disputed during the First World War. Regarding Article 10, for instance, which stated that the Company was required to pay 16 percent of its annual net income to the Persian government,<sup>126</sup> this was interpreted by the Company to apply to companies operating in Persia only.<sup>127</sup> The Persian government, however, interpreted this to mean tax was to be paid from the operations of all companies. In addition, the wording of Article 14 was disputed, which referred to the Persian government's requirement to adopt all necessary measures to ensure the safety of the operators and to facilitate all operations associated with the Concession's object.<sup>128</sup> It was claimed by the Company that the Persian government had not upheld its obligation to protect the pipeline and as a result withheld royalty payments to the government.

On the other hand, the Persian government asserted that according to Article 14, 'it was not liable for loss or damage caused by acts beyond its control'. The government then referred to Article 17 and made a request for arbitration. The two parties eventually signed the Armitage-Smith Agreement in December 1920<sup>129</sup> which recognised the claim from the Persian government that all companies operated by the Anglo-Persian Oil Company (APOC) were subjected to the profit-sharing provisions in the Concession.<sup>130</sup> As a result, the Persian government was eligible to collect a royalty payment of 16 percent of the annual net profits made from mining, refining and marketing oil from Persia, irrespective of whether the processes were undertaken by the APOC or by a subsidiary company, either inside or outside of Persia.<sup>131</sup> There was one exception; a royalty payment was not required to be made to the government on the profits made from the transportation of petroleum by ships.

In addition, the Armitage-Smith Agreement allowed the APOC to deduct the costs incurred by subsidiary companies for the refinement and distribution of Persian petroleum and its products.<sup>132</sup> The Agreement also stated that net profits could be adjusted for income tax reasons and the net profit for interest or dividends were not to be subjected to deductions, and all interest and dividends received were not to be included in the profits for which royalties

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<sup>126</sup> As well as an initial fee of several thousand pounds.

<sup>127</sup> Maximilian Kuhn, *Enabling the Iranian Gas Export Options: The Destiny of Iranian Energy Relations in a Tripolar Struggle over Energy Security and Geopolitics* (Springer Science & Business Media, 2014) 281.

<sup>128</sup> Ibid 282.

<sup>129</sup> This simply clarifies earlier signed documents and is named after the British Treasury official, Sydney Armitage-Smith.

<sup>130</sup> Kuhn (n 132) 282.

<sup>131</sup> Farshadgohar (n 99) 79.

<sup>132</sup> Made prior to the calculation of net profits to allocate 16% revenue to the Persian government.

were payable.<sup>133</sup> Lastly, the Agreement included the provision that all disputes over the payment of royalties should be referred to a Chartered Accountant in England rather than arbitrators from Tehran as stated in Article 17 of the Concession. The Chartered Accountant was to be nominated by the President of the Institute of Chartered Accountants in England and the decision made by the Chartered Accountant was to be final.<sup>134</sup> Notably, the claims by the British that there had been violations of the Concession articles were raised after the British government had become the largest shareholder in the D'Arcy Concession. Given the British government had a significant stake in the D'Arcy Concession, the Armitage-Smith Agreement to assign arbitration responsibilities to an accountancy firm in England may be considered as further evidence of the unbalanced nature of the D'Arcy Concession.<sup>135</sup>

The Armitage-Smith Agreement was significantly different to the D'Arcy Concession in its original form, to the disadvantage of Iran.<sup>136</sup> Furthermore, the intent of the Agreement to link royalty payments to the Persian government along with the profits from trade helped to provide some protection to the Concession if there was minimal or no profit made in some years, or in the event that commercial losses occurred.<sup>137</sup> On the one hand, this payment method appealed to the Persian government because it needed ongoing revenue from the operations to boost its budget bottom line.<sup>138</sup> On the other hand the payment method was subject to fluctuations because it was based on the profits drawn by the APOC. As such, it did not ultimately serve the interests of the Persian government. The royalty payment amount, set at 16 percent of the APOC's net profit, reflected the provisions of the 1872 de Reuter Concession, which was higher than the 10 percent of profits initially argued for by D'Arcy.<sup>139</sup>

### **2.4.3 D'Arcy Concession: Cancellation and the new agreement**

When negotiating with APOC, The Iranian government sought an agreement giving Iran the option to own 25 percent of the company.<sup>140</sup> This was in addition to returning 75 percent of the concession region to Iran, demanding that the tax paid by the Company was calculated

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<sup>133</sup> Stephanie Cronin, 'The Politics of Debt: The Anglo-Persian Oil Company and the Bakhtiyari Khans' (2004) 40(4) *Middle Eastern Studies* 6.

<sup>134</sup> Alavi (n 110) 44.

<sup>135</sup> Ibid.

<sup>136</sup> Kuhn (n 132) 282.

<sup>137</sup> Ibid.

<sup>138</sup> Zoghi (n 117) 84–86.

<sup>139</sup> Gregory Brew, 'In Search of "Equitability": Sir John Cadman, Rezā Shah and the Cancellation of the D'Arcy Concession, 1928–33' (2017) 50(1) *Iranian Studies* 125, 127.

<sup>140</sup> Guilak (n 112) 65.

according to Iran's tax laws and recognising Iran's rights in relation to APOC operations, including after the end of the concession. If APOC agreed to these conditions then the Iranian government would agree to extend the contract for a further 20 years.<sup>141</sup>

However, due to the protracted nature of the concession negotiations and the ongoing excuses by the company regarding its fall in revenue, Reza Shah decided to have the D'Arcy Concession annulled, a decision enacted by the 10th Session of Parliament.<sup>142</sup> Talks were held between Britain and Iran in both Tehran and Europe until 1933, where they agreed on all terms, excepting the renewal of the D'Arcy Concession, which was due to finish in 1951. The Shah eventually agreed to a 30-year extension requested by APOC.<sup>143</sup>

#### **2.4.4 1933 Concession**

After examining its financial relationship with APOC in 1921, the Persian government found a number of irregularities of concern for which the Company was accountable.<sup>144</sup> Then, from 1926 to 1931, APOC used a range of methods to avert changes in the D'Arcy Concession. For instance, in 1930, the Company claimed that it was exempt from having to pay tax according to Persian taxation law.<sup>145</sup> The Company also signed a contract with the British Admiralty to supply cheap fuel that the Persian government was unaware of and subsequently did not pay taxes on the deal.

Overall, the D'Arcy Concession made government revenue more sensitive to a fall in APOC income and during the Great Depression it received only small royalty payments due to the decline in APOC's profit as well as to the calculation for 16 percent of APOC's net profits agreed to under the Armitage-Smith Agreement.<sup>146</sup>

Although the Persian government cancelled the original concession in 1932, it was willing to negotiate new terms. The British government initially would not accept the cancellation and raised the issue with the Council of the League of Nations.<sup>147</sup> A compromise was reached between the parties in 1933 including terms which saw the Persian government grant APOC the exclusive right, to explore for, extract and refine petroleum within the Concession territory.<sup>148</sup> The new contract also stipulated an annual royalty payment per ton of petroleum

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<sup>141</sup> Ibid.

<sup>142</sup> Ibid.

<sup>143</sup> Ibid.

<sup>144</sup> Alavi (n 110) 55.

<sup>145</sup> Ibid.

<sup>146</sup> Fereidun Fesharaki, *Development of Iranian Oil Industry* (New York, 1976) 13.

<sup>147</sup> Alavi (n 110) 58.

<sup>148</sup> Ibid.

sold,<sup>149</sup> providing the Persian government with a minimum total annual payment<sup>150</sup> and requiring foreign companies to pay 20 percent of the dividends made from the distribution of its products. Nonetheless, Iranian critics of the Concession continued to raise concerns that its conditions were not in the best interests of Iran, especially given the Persian government did not have the power to terminate the Concession and received no compensation for any decrease in the value of the pound, as stipulated in Article 10 (V)(a) of the Concession.<sup>151</sup> The rationale underpinning the Persian government's preparedness to agree to the new Concession emerged from its desire to guarantee revenue.<sup>152</sup> A steady increase in oil production, refining capacity, and the payment of royalties followed the new concession agreement, in addition to the opening of new oil fields in Kermanshah province in northwest Iran, and the construction of an oil pipeline to the region.<sup>153</sup> However, by 1938 the oil production fell into decline, along with government revenue, and the onset of World War Two presented its own set of issues.<sup>154</sup> The next section briefly examines the lead up to the nationalisation of the petroleum industry in Iran.

## 2.5 World War Two and Politics in Iran

The increasing importance of petroleum to countries was evidenced during World War II, with several attempts made by foreign countries to form an alliance with Iran including Germany, Turkey, Britain and the USSR.<sup>155</sup> None of these attempts were successful. The British and Soviet forces did however occupy oil-producing regions in Iran in 1941 to protect the oil fields from German occupation.<sup>156</sup> In 1941, due to his links to Axis interests, Reza Shah Pahlavi was forced to abdicate his leadership. His son, Muhammad Reza Shah Pahlavi, succeeded his father and adopted a policy of support for the Allies policy and acknowledged the Iranian parliament's pressure for liberal reforms. Towards this end, treaties were signed with the USSR and Britain in 1942 to observe the territorial rights and independence of Iran.<sup>157</sup> The agreement thus sought an end to the occupation of oil producing areas in Iran,

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<sup>149</sup> Four shillings every ton of petroleum sold.

<sup>150</sup> Minimum amount is 750,000 pounds.

<sup>151</sup> Alavi (n 110) 58.

<sup>152</sup> Mafi (n 119) 411.

<sup>153</sup> Alexander Melamid, 'Petroleum Product Distribution and the Evolution of Economic Regions in Iran' (1975) 65(4) *Geographical Review* 510, 513.

<sup>154</sup> Mafi (n 119) 412.

<sup>155</sup> Guilak (n 112) 183.

<sup>156</sup> *Ibid.*

<sup>157</sup> *Ibid* 129.

and while, unlike the US, both the USSR and Britain were opposed to withdrawing from the regions, a negotiated agreement for their withdraw from Iran was achieved in March 1946.

### **2.5.1 Soviet Union influence on oil concessions**

Iran emerged as a region of competing interests among powerful nations at the start of the Cold War due in part to the global increase in oil consumption and the importance of oil to the growth of national economies.<sup>158</sup> The US adopted a particularly active role in relation to Middle Eastern oil.<sup>159</sup> Given the role that petroleum was to play in the post-war reconstruction period it was not particularly surprising that Iran presented as a country for oil concession hunting. Concessions sought by the Soviets aimed to provide a counter balance to the US requests for petroleum concessions in northern Iran. In return for the Concession, the Soviet Union agreed to protect the security of northern Iran and to encourage a stable relationship between the great powers.<sup>160</sup>

In April 1946, the Prime Minister of Iran, Ahmad Qavam signed an agreement to establish the Soviet-Iranian Oil Company to exploit Iran's oil reserves in the north. This concession was valid for 25 years and included several new features including a 51% (USSR) 49% (Iran) split of ownership, changing to a 50/50 split after a further 25 years; the profits were apportioned according to the number of shares held, with no provision for royalty payments.<sup>161</sup> The British government kept a keen eye on the proceedings, concerned that the forces of nationalism in Iran opposing the Soviet Concession might also challenge the Anglo-Iranian Concession in Iran's south. The US, at least in its rhetoric, defended Iran's right to decide for itself how to dispose of its natural resources.<sup>162</sup>

At this time, the number of Iranian parliamentarians opposed to the granting of any concessions grew daily. This led to their initial rejection of the concession deal with the Soviet Union following lengthy parliamentary negotiations.<sup>163</sup> A Bill was then put before parliament by Dr Rezezade Shafag, who was later to sit on the Majlis Oil Commission of 1950-51, containing the following:

1. The oil agreement with the USSR was to become null and void.
2. Iran uses its own capital and resources to implement a five-year plan to explore and exploit its oil resources.

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<sup>158</sup> Oil supported nearly 4% of world's energy in 1900 and nearly 18% in by 1940.

<sup>159</sup> Richard John Eden, Michael Vivian Posner, Richard Bending, Edmund Crouch and Joe Stanislaw, *Energy Economics: Growth, Resources and Policies* (CUP Archive, 1981) 77.

<sup>160</sup> Catherine Skrine, *The World War in Iran* (Constable, 1962) 227.

<sup>161</sup> Ibid.

<sup>162</sup> Lawrence Paul Elwell-Sutton, *Persian Oil: A Study in Power Politics* (Lawrence & Wishard, 1955), 117.

<sup>163</sup> Ibid 118.

3. If oil is discovered, the Iranian government can arrange for its sale to the USSR following informed approval from the Majlis.
4. Iran no longer agrees to grant concessions to foreign entities or to participate in partnerships with foreign oil companies.
5. In cases where Iran's territory and resource rights are breached, particularly in relation to oil exploitation in the south, the government should enter into negotiations to restore its national rights, while informing the Majlis of the outcome.<sup>164</sup>

The Bill, which was ratified in October 1947, indicated Iran's determination to have control over its natural resources. As such, it had significant implications for the sustainability of the AIOC and the oil exploitation operations in the south. The impetus of the Bill was national pride in Iran and the people's desire to stand up for their nation's sovereign rights.<sup>165</sup>

## **2.6 Overview of Pre-Nationalisation Era**

Within Iran, these political interactions created the perception that Iran was being manipulated and exploited by the world's powerful nations. This left a lasting mark in the minds of Iran's politicians and citizens alike, leading to the cautious and untrusting attitude the Iranians have towards foreign intervention today. The inadequacy of the Anglo-Iranian Oil Company (AIOC) in terms of the royalties paid to Iran became an increasing point of contention. Although the AIOC had provided an access point to advanced technical knowledge and the company returns were as high as 150% in some years, there was a developing sense among Iranians that they should have greater control and draw a greater profit from their natural resources.

As a result, the time had come for many Iranians to take action to nationalise the nation's petroleum industry and to recover their natural resources. The elections for the 14<sup>th</sup>, 15<sup>th</sup> and 16<sup>th</sup> Majlis saw important changes in both the domestic politics in Iran and the international economy, which, under the hegemony of the US, now had access to relatively inexpensive petroleum. Therefore, following World War Two the revenue from the sale of petroleum provided a platform for the Iranian government to introduce an ambitious national development plan and to intervene more actively in the economy. This, combined with the

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<sup>164</sup> Ibid.

<sup>165</sup> Ibid 119.

past objections of Iranians to foreign participation in the Iranian petroleum industry, saw the introduction of the Buy Back contract (BBC). Thus, the nationalisation of the petroleum industry in Iran in 1951 emerged from a period of what Iranians saw as manipulative and unfair treatment from foreign powers. In this sense, the Nationalisation initiative was both politically and economically motivated.

### **2.6.1 Concession issues and their renegotiation**

The Iranian government passed the First Development Plan in 1949, to be funded largely by revenue from the petroleum industry. As such, alterations to the agreement with the AIOC were proposed given that the British government made more profit from taxing the AIOC than the government of Iran made from the receipt of royalty payments.

In May 1949, an agreement was reached in which the new provisions were inserted into the clauses of the Concession:

- Clause 3 (a) – royalty payments to the Iran government were to increase by two shillings per ton of exported or sold oil.
- Clause 7 (a) – the AIOC agreed to increase its tax payments from 9 pence to 1 shilling per ton after the first 600,000 tons of production.
- Clause 4 (a) – the AIOC agreed to pay the Iranian government, as ratified by the Majlis, £5,090,909 from the company's general reserves. Additionally, the Government was to receive 20 percent of the annual amount in the AIOC general reserves to offset the impact of the British income tax.<sup>166</sup>

Clause 4 (b) – saw the guaranteed minimum annual payment increase by £4,000,000.

These new provisions appeared to move the contract between the British and Iranian governments towards a fairer and more balanced footing, with greater focus also placed on engaging the Iranian workforce. However, the increasingly nationalistic public sentiment in Iran meant that any remaining bias in the Concession towards the foreign entity could not be ignored.<sup>167</sup>

### **2.6.2 Rejecting the compromise agreement**

The Mossadegh Committee appointed by the new Majlis examined the new Agreement and concluded that it was still not meeting Iranian interests. The sense of exploitation associated with the AIOC deal was compounded by the deal negotiated between Saudi Arabia and the

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<sup>166</sup> Zoghi (n 117) 251–256.

<sup>167</sup> Zoghi (n 117) 256.



Aramco Oil Company.<sup>168</sup> In response, the AIOC agreed to a 50-50 profit sharing deal in addition to a £5 million future royalty payment and a monthly advance of £2 million up to the conclusion of 1951. The Mossadegh Committee passed its decision to nationalise the petroleum industry in Iran and the AIOC proposal was subsequently rejected.<sup>169</sup>

The Bill supporting the nationalisation of the petroleum industry was enacted in 1951 and included the article:

For the happiness and prosperity of the Iranian nation and for the purpose of securing world peace, it is hereby resolved that the oil industry through all parts of the country, without exception, be nationalized; that is, all exploration, extraction and exploitation operations shall be carried out by the government.<sup>170</sup>

The British government responded quickly and broadly, withdrawing all technicians from Iran, declaring an embargo on Iranian petroleum, freezing Iranian assets and prohibiting exports to the nation. This resulted in a dramatic reduction in oil production in Iran and the protracted hostilities between the AIOC and the Iranian government caused the Iranian economy to suffer. In turn, the subsequent political upheaval saw Parliament dissolved in 1953 while the petroleum industry in Iran experienced a significant downturn.<sup>171</sup>

## **2.7 Nationalisation of the Oil Industry and its Consequences**

The law to nationalise the Iranian petroleum industry included several articles which are worthy of attention. For instance, Article 2 formed the legal parameters of the nationalisation process. In turn, to implement nationalisation the AIOC was forced to dispose of its assets and to give control to the Mixed Board of senators and deputies which was established by the Majlis Oil Committee (MOC).<sup>172</sup> In addition, Article 6 formed the basis for the gradual transition from a reliance on foreign expertise to the use of Iranian experts to coordinate the operations. Lastly, Article 7 formed the basis for the sale of oil, which was to continue at the sales volume undertaken by the AIOC.<sup>173</sup>

In response to Britain's concerns about the contractual obligations that Iran had previously agreed to, the newly-appointed Board of the National Iranian Oil Company (NIOC) was

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<sup>168</sup> The profits were split 50/50 with the Saudi Arabian government.

<sup>169</sup> Zoghi (n 117) 256.

<sup>170</sup> Ibid.

<sup>171</sup> Mohammad G Majd, 'The Oil Boom and Agricultural Development: A Reconsideration of Agricultural Policy in Iran' (1989) 15(1) *The Journal of Energy and Development* 125, 127.

<sup>172</sup> Neveen Abdelrehim, Josephine Maltby and Steven Toms, 'Corporate Social Responsibility and Corporate Control: The Anglo-Iranian Oil Company, 1933–1951' (2011) 12(4) *Enterprise & Society* 824, 854.

<sup>173</sup> Ibid.

instructed to comply with the existing practices of the AIOC including the continuance of employment of AIOC employees.<sup>174</sup> The period from 1951 to 1954 proved to be highly unsettled in terms of Iran's capacity to strengthen its nationalised oil sector. The ongoing challenge to Iran's decision to nationalise by the British government in the International Court of Justice (ICJ) resulted in Iran's refusal to accept an interim measures imposed by the Court while trying to resolve the dispute.<sup>175</sup> The attempt by the US government to resolve the international dispute via the establishment of the Harriman Commission to facilitate negotiations between Iran and Britain also failed.<sup>176</sup>

In 1952, the ICJ reached a decision regarding its competence to rule on the Iran and Britain dispute. The decision by the Court was that it did not have jurisdiction to rule on the matter brought by the British Government, and the Court thus called for all interim measures to cease.<sup>177</sup> The subsequent rejection of proposals and counter proposals by both Britain and Iran on how to resolve the dispute, and the ultimate inability of the US government to effectively mediate the dispute, saw Iran strongly defend its position that any outcome must satisfy the requirements of the new nationalisation law. The Iranian government's decision in 1952 to close down the British Embassy was in response to the covert attempts it believed were being initiated by the British government to replace the Mossadegh government with a government friendlier to its oil interests.<sup>178</sup>

### **2.7.1 The 1953 Coup D' Etat and its implications for foreign investment**

With the support of the US, the British government planned a coup d'état to overthrow of the Mossadegh government.<sup>179</sup> On the back of support from some conservative groups in Iran including some mullahs, senior members of the police force, army officers, and members of the media, the Shah and other members of the Royal family also supported the possibility of a coup, with Mossadegh to be replaced with General Zahedi.<sup>180</sup>

The following months saw the home of Mossadegh attacked, and key officials supportive of Mossadegh's rule kidnapped in a bid to destabilise Iran. However, the plan to destabilise Iran was uncovered and the key players in the Iranian government were arrested.<sup>181</sup> By June 1953

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<sup>174</sup> Kuhn (n 132) 286.

<sup>175</sup> Ibid.

<sup>176</sup> Mohsen S Haery, *The Legal Implication of the Dispute Over the Iranian Nationalization of the Oil Industry* (University of California, Berkeley, 1955) 108.

<sup>177</sup> Ibid.

<sup>178</sup> Ibid.

<sup>179</sup> Ibid.

<sup>180</sup> Homa Katouzian, *Musaddiq and the Struggle for Power in Iran* (I.B. Tauris & Co, 1990) 178.

<sup>181</sup> Ibid 182.

however, the US had given its backing for the coup to take place in August. Much of the media was now controlled and giving its support to the Shah.<sup>182</sup> Mossadegh had managed to thwart the first attempt at the coup, and the Shah and his family had been forced to flee Iran to Baghdad and eventually to Rome. However, General Zahedi successfully seized control of the Government and Mossadegh was arrested just days after an attempted escape. Mossadegh was imprisoned for three years and then placed under house arrest where he remained until his death in 1967.<sup>183</sup> Within a year of the successful coup, the Zahedi government had negotiated the 1954 Agreement with a consortium of international oil companies bringing an end to the nationalistic stance adopted by Mossadegh. The coup d'état in 1953 was thus a pivotal element in the efforts of the British to protect their investment interests in Iranian petroleum which were being threatened by the nationalisation of the petroleum industry.<sup>184</sup> Hence, the strict terms and conditions that the Iranian government insisted upon when negotiating petroleum agreements with foreign oil companies is understandable. The West played a role in the overthrow of the nation's first democratically elected government and this, combined with the subsequent capitulation of the Shah to foreign interests, arguably laid the foundation for the 1979 Revolution. This points to the importance of the association between the oil agreement made between Iran and foreign countries and the issues of national security and economic prosperity. During the first half of the twentieth century there emerged serious discord in Iran related to the terms and conditions of oil agreements with foreign entities. Of most concern was the question of how best to ensure the economic benefits of oil agreements were returned to the Iranian economy.<sup>185</sup>

### **2.7.2 The 1954 Consortium**

As such, 1953 saw the emergence of a new era in the relationship between Iran and foreign oil companies.<sup>186</sup> The new government was willing to negotiate with the AIOC to settle the oil dispute as well as to secure an increase in petroleum exports.<sup>187</sup> Moreover, the foreign oil companies indicated their willingness to enter into further contracts to explore, refine, and market Iranian petroleum. However, it was also recognised that the AIOC could no longer have exclusive rights to the production and sale of Iranian petroleum and that all future

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<sup>182</sup> Ibid 188.

<sup>183</sup> Ibid.

<sup>184</sup> Ibid.

<sup>185</sup> Kirsten Bindemann, 'Production-Sharing Agreements: An Economic Analysis' (Oxford Institute for Energy Studies, 1999) 5.

<sup>186</sup> Heidari (n 14) 1758.

<sup>187</sup> The willingness to conclude contracts emerged from the needs of budget-based large-scale development program.

contracts would have to be ‘within the framework of the nationalisation law, even if only formally’.<sup>188</sup>

### **2.7.3 The National Iranian Oil Company and the International Consortium**

As relations between Iran and the US returned to a more normalised state, Washington agreed to provide the new government in Tehran with financial and military support and to assist it to resolve its petroleum disputes. By December 1953, the President of the AIOC met with several foreign oil companies from the US, London, France, Holland to determine how best to bring Iranian petroleum to the international market, with the US arguing that ‘a consortium was the best possible answer to the problem’.<sup>189</sup> However, the US push to establish a provisional consortium did not have the support of the British government or the AIOC. The US adopted the position that the AIOC should have 40 percent share of the consortium, US companies should combine to also have a 40 percent share, with the French and the Dutch oil companies having the remaining 20 percent.<sup>190</sup>

The US at this time was clearly trying to increase the participation of its national oil companies in the production and sale of Iranian petroleum. This is evidenced on 30 January 1954 when the five major oil companies in the US involved in the attempt to settle the Iranian oil dispute were granted antitrust immunity by the US Department of Justice.<sup>191</sup> This meant that they were now free to join with the British, Dutch and French petroleum companies to form a consortium to explore for, refine and sell Iranian petroleum.<sup>192</sup> This move was supported by Prime Minister Zahedi in Iran with the creation of a special petroleum commission to coordinate the establishment of a consortium of primarily US, British, and Iranian oil companies to develop Iranian oil.<sup>193</sup> In August 1954 a consortium agreement was signed and then confirmed by the Majlis in the following October. The consortium composition included the British Petroleum Company (previously the AIOC) 40 percent, five US oil companies (Standard Oil, New Jersey; Standard Oil, California; Mobil, Texas Oil and Gulf Oil) combining to hold 40 percent, Royal-Dutch-Shell 14 percent, and Compagnie Francaise des Petrols 6 percent.<sup>194</sup> Within nine days of the agreement being ratified, Iranian

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<sup>188</sup> Alavi (n 110) 116.

<sup>189</sup> Ibid 128.

<sup>190</sup> Ibid.

<sup>191</sup> 'Anti-trust immunity' allowed companies to carry out typically prohibited competitive tactics including dominating a market and determining all prices, leading consumers to have limited choice.

<sup>192</sup> Alavi (n 110) 129.

<sup>193</sup> Ibid.

<sup>194</sup> Ibid.

petroleum began to flow into US, British, Dutch and French tankers for sale in the world market.

There were several significant provisions in the agreement worthy of consideration:

- The Consortium was to pay the NIOC for all equipment and to train personnel to facilitate the production, export and sale of the crude products.
- Iran would purchase oil for its own consumption at around the cost of production.
- The agreement was for 25 years, with a provision in place for a maximum of three five-year extensions.
- After the initial three-month period, the income to Iran was to increment over the following three years from 31 million in the first year, 62 million in the second year, and 67 million in the third year.
- The Consortium was to guarantee the export of a minimum 78 million tons of oil over first three years.
- The Consortium agreed to pay Iran income tax, in Sterling, at approximately half its net operating revenue.<sup>195</sup>

The Consortium members were subsequently granted by Iran and the NIOC the sole rights to explore and produce petroleum in southern Iran and to operate a refinery at Abadan according to the terms in the Agreement. Although the NIOC, with the Iranian Government as its major shareholder, was owner of all fixed assets in the nation's petroleum industry, the foreign oil companies were granted unrestricted use for the duration of the agreement.<sup>196</sup> The agreement also specified that all petroleum products required for consumption in Iran would be delivered to the NIOC via the appropriate foreign operating company. As such, it was regarded by the Iranian parliament as a way to secure greater participation in the management of the nation's natural resources and to earn higher oil revenues while placing the greater financial burdens and risks onto the foreign oil companies.<sup>197</sup>

#### **2.7.4 Reforming the petroleum agreements**

By 1957, three years after the signing of the Consortium Agreement, the first Iranian Oil Bill was passed by the Majlis allowing for further contracts to be signed with foreign investors for the exploration and production of petroleum outside of the operating area occupied by the

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<sup>195</sup> Mostafa Elm, *Oil, Power, and Principle: Iran's Oil Nationalization and Its Aftermath* (Syracuse University Press, 1994) 310.

<sup>196</sup> The Iranian Oil Refining Company and the Iranian Oil Exploration and Producing Company were involved.

<sup>197</sup> Mafi (n 119) 410 .

consortium.<sup>198</sup> The Consortium Agreement, along with later miscellaneous contracts, were made in accordance with the 1957 Petroleum Law and were defined by 75 percent / 25 percent profit sharing agreements. That is, the NIOC as partner received half of the profits of the exploitation and the Iranian Government would receive 50 percent of the profit as income tax.<sup>199</sup> In some later agreements, the amount of tax payable to the Iranian government increased to 85 percent as changes to tax laws were implemented, along with mandatory royalty payments to the NIOC.<sup>200</sup> Additional agreements were signed by the NIOC and Italian oil company Azinde Generate Italiana Petrole (AGIP) in August 1957; the Pan American Petroleum Corporation (a subsidiary of Standard Oil of India) in June 1958 – forming the Iranian Pan-American Oil Company (IPAC), and the Sapphire Petroleum Company of Canada in June 1958.<sup>201</sup> Notably, these joint agreements had different terms and conditions to the 1954 Consortium Agreement and indeed to those generally agreed to in Middle Eastern oil concessions.

## **2.8 Contractual and Commercial Changes between 1960 and 1979**

The petroleum industry in Iran underwent many changes throughout the 1960s and 1970s due to initiatives led by the Shah to modernise the sector and to increase foreign investment. The sustained development of the economy in Iran was regarded as fundamentally dependent on the rapid modernisation of the sector and its infrastructures as discussed below.<sup>202</sup>

### **2.8.1 Petroleum transactions and the Iranian economic development plans**

Substantial increases in oil revenues coincided with the campaign to modernise Iran under the reign of Mohammad Reza Shah. This included the adoption of Western industrial policies by the Shah during the 1960s to achieve three main outcomes: growth of the industrial sector, the transition to modern manufacturing methods<sup>203</sup> and better wages management.<sup>204</sup> The subsequent reforms and development plans, sometimes referred to as the “White Revolution”, included US\$1.5 billion in investment into the agriculture sector and the allocation of profits from the petroleum sector to build industrial infrastructure. The most substantial progress was

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<sup>198</sup> Alavi (n 110) 142.

<sup>199</sup> Ibid.

<sup>200</sup> Ibid.

<sup>201</sup> Ibid 144.

<sup>202</sup> Alavi (n 110) 145–148.

<sup>203</sup> The significant funds and technology required could be gained by entering into oil contracts with more technologically advanced foreign companies.

<sup>204</sup> Elm (n 200) 42.

made in the petroleum, transport and communication industries; for example, the building of a refinery<sup>205</sup> and an petroleum pipeline into the USSR.<sup>206</sup> However, due to a higher priority being given to the industrial sector over the agricultural sector, there emerged a widening in the capacity of wealth accumulation from the industrial sector compared to farming and crop-growing.<sup>207</sup>

Indeed, the underlying assumption of the modernisation agenda was that industrialists earning robust returns on investments would reinvest in the Iranian economy and thus revitalise it via further development.<sup>208</sup> The reality however was quite the opposite, with much of the profits gained by industrialists contributing to a widening of the gap between the middle and industrial classes and the build-up of social discontent. This was compounded by the jump in the petroleum price from 1973 to 1977, increasing inflationary pressure, corruption among officials, and high levels of migration to urban centres.<sup>209</sup> This highlights the role that petroleum revenues can play in Iran in both national progress and development and national instability and conflict.

### **2.8.2 The 1965 agreements**

In March 1964, a report commissioned by the Iranian government presented its findings from a survey of almost 50,000 square kilometres of the Persian Gulf for the presence of oil. The findings were of a significant amount of oil in the Gulf, prompting the NIOC to invite all interested oil companies to submit to the Iranian government a business plan for the oil extraction and refinement.<sup>210</sup> As a consequence, by the beginning of 1965, a number of JVAs were signed by the NIOC with several oil companies. The contracts were based on the 50 percent partnership arrangement with the NIOC as detailed above.<sup>211</sup>

## **2.9 The Islamic Revolution and its Impact on Petroleum Contracts**

The advent of the Islamic Revolution in Iran in 1979 had a significant impact on the agreements. Following the Revolution, the newly installed Constitution put an end to the Oil Concession Agreements with Iran, with Article 81 stating: “It is absolutely forbidden to give foreigners the right to establish companies or institutions in commercial, industrial, and

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<sup>205</sup> A concerted effort was undertaken to reduce Iran’s dependence on foreign technology by developing their own facilities.

<sup>206</sup> Elm (n 200) 42.

<sup>207</sup> Ibid 40.

<sup>208</sup> Ibid.

<sup>209</sup> Ibid.

<sup>210</sup> Haleh Afshar, *Iran: A Revolution in Turmoil* (Springer, 1985) 103–104.

<sup>211</sup> Ibid.

agricultural fields, as well as in mines and in the service sector”.<sup>212</sup> The NIOC annulled all contractual agreements with foreign oil companies signed prior to the Revolution.<sup>213</sup> The NIOC was acting on the decision by the Revolutionary Council which argued the importance of revising all business agreements with foreign entities. The annulment of the contracts had both immediate and wide-reaching effects to Iran’s economy, including the costly and protracted legal action taken against the Iranian government by the foreign oil companies.<sup>214</sup> Although Iran offered to compensate the consortium members for damages resulting from the cancellation, the aim of the legal action was to achieve a legal verdict against Iran rather than just a payment for damages. Moreover, the withdrawal of foreign oil companies from their operations meant that Iranian officials were forced to manage the fields and try to curb disruptions to the flow of oil.<sup>215</sup>

## 2.10 Iran-Iraq wars

Further disruption to the petroleum sector in Iran emerged as a result of the 1980 Iran-Iraqi war. Oil and gas infrastructures were targeted by air and on the ground with the attacks designed to interrupt both the production and export of petroleum.<sup>216</sup> The Iraqi armed forces enjoyed some success in this campaign, destroying and/or damaging crucial petroleum production, refinery and exporting sites. By 1986 the impact of these disruptions was being acutely felt, with the average barrels of production each day falling from 2.3 million barrels between 1982 to 1986 to almost half that in 1987.<sup>217</sup> Iran’s economic challenges were only made worse by the financial sanctions against Iranian petroleum imposed by the US, Japan, US and France.<sup>218</sup> The damage inflicted on Iran’s petroleum sector as a result of the war with Iraq prompted the need for foreign involvement and investment in the reconstruction of the sector. As such, this established the tone and the parameters for contractual agreements with foreign entity oil companies into the 1990s.<sup>219</sup>

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<sup>212</sup> Constitution of Iran, art 81 <<https://www.wipo.int/edocs/lexdocs/laws/en/ir/ir001en.pdf>> 18.

<sup>213</sup> Paasha Mahdavi, ‘Oil, Monarchy, Revolution and Theocracy: A Study on the National Iranian Oil Company’, in David G. Victor, David R. Hults and Mark C. Thurber (eds), *Oil and Governance: State-Owned Enterprises and the World Energy Supply* (Cambridge University Press, 2012) 243.

<sup>214</sup> Ibid.

<sup>215</sup> Ibid.

<sup>216</sup> Ibid 51–52.

<sup>217</sup> James D Hamilton, ‘Historical Oil Shocks’ (Working Paper No. w16790 National Bureau of Economic Research, 2011) 17.

<sup>218</sup> BBC News, ‘Six Charts That Show How Hard US Sanctions Have Hit Iran’ *BBC* (2019) <<https://www.bbc.com/news/world-middle-east-48119109>> (access 12 January 2020)

<sup>219</sup> Valentina Svalova, *Risk Assessment* (BoD – Books on Demand, 2018) 52–53.



## **2.11 Conclusion**

Examining the historical context of Iran's petroleum industry is vital to gaining a deep understanding of the conditions and functions of modern Iran Petroleum Contract (IPC). The reasons why Iran approaches contractual agreements with foreign entities with caution and some suspicion are readily discernible. History shows that instances of foreign domination, contractual terms and conditions unfavourable to Iran's interests, and growing nationalistic sentiment towards the protection of natural resources against foreign exploitation are key factors shaping the modern petroleum industry in Iran. The petroleum sector in Iran and the sale of exploration rights and revenue gained from the sale of petroleum is critical to an economic reform agenda. In turn, this implies the need for the Iranian government to engage in commercial cooperation with foreign investors to ensure a robust and profitable petroleum sector. The original Buy Back system introduced in the 1990s and the more recent transformation to the IPC demonstrate the need of the Iranian government to effectively balance how it accesses foreign expertise, technology and investment with its internal national priority to maintain complete control over its petroleum resources.

## **3 REGULATORY FRAMEWORKS**

### **3.1 Introduction**

The domestic laws of a country provide the framework for regulating and monitoring the contract terms and conditions for foreign investment, exploration, production and payment of taxes / royalties. This chapter examines the Oil Law and legislation in Iran following the victory of the Islamic Revolution. It provides a detailed discussion on such aspects as the non-voids bale article of approved petroleum contracts of 1940 by the Council of the Islamic Revolution, the complimentary law establishing the Ministry of Petroleum of 1941, the Oil Law approved in 1918, Annual Budget Laws and rules linked to the five-year plan of economic development, laws supporting and encouraging foreign investment of 1962, the Oil Law amendment of 1918 approved in 1971, the duties of the Ministry of Petroleum, and also common conditions, structure and pattern of upstream approved oil and gas in 1975.

#### **3.1.1 Single article non-voiding the contracts**

The Islamic Revolution victory in 1989 changed the rules and regulations governing Iran's petroleum industry. The Revolutionary Council of the Islamic Republic of Iran in August 1940 passed a bill to establish the Ministry of Petroleum for the first time in history. According to Article 1 of the bill, the NIOC, National Petrochemical Company and National

Iranian Gas Company fall under the authority of the Ministry of Petroleum and its affiliates.<sup>220</sup>

It was also at this time that the Guardian Council of the Constitution was first convened. The Council is a 12-member group mandated under the Constitution of Iran to, among other things, ensure the compatibility of the legislation passed by the Islamic Consultative Assembly [i.e. Majlis] with the criteria of Islam and the Constitution.<sup>221</sup> As stated in Article 98 of the Constitution: ‘The interpretation of the constitution is the responsibility of the Guardian Council. This is determined with the approval of three-fourths of its members.’. As such, the economic relations that Iran has with foreign countries may be the subject of constitutional interpretation by the Council, which has the authority to veto laws passed by the Majlis.<sup>222</sup> In addition, the Council supports the influence of the IRGC on the economic and cultural life in Iran.<sup>223</sup> The IRGC was founded by Ayatollah Ruhollah Khomeini after the revolution in Iran as a branch of the Iranian Armed Forces. However, while the Iranian Army is charged with defending Iranian borders and maintaining domestic order according to the constitution, the IRGC is charged with the role of protecting Iran’s Islamic republic political system. This includes providing protection the Islamic political system against interference from foreign countries. Under the President Mahmoud Ahmadinejad's administration, the IRGC has expanded its role in the social, political, military and economic affairs of Iran, leading some analysts in the West to claim that its political power exceeds even that of the Shia clerical system in Iran.<sup>224</sup>

The first year after the Islamic Revolution also saw major changes in the rights of Iranian petroleum in relation to existing contracts. The Revolutionary Council of Islamic Republic of Iran passed a bill for the formation of a special commission on the petroleum contracts to identify all contracts which were inconsistent with the laws underpinning the nationalisation of Iran’s petroleum industry.<sup>225</sup> They were to be placed in the hands of a special commission for the Minister of Petroleum to determine if they were void. The Commission also had the authority to settle disputes arising from such contracts.<sup>226</sup>

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<sup>220</sup> Daniel, Brumberg and Ariel I. Ahram. ‘The National Iranian Oil Company in Iranian Politics’ (Paper Prepared in Conjunction with an Energy Study Sponsored by Japan Petroleum Energy Center and the James A. Baker III Institute for Public Policy, Rice University, 2007) 2.

<sup>221</sup> Constitution of Iran (n 217) art 94 21.

<sup>222</sup> Yasmin Alem, ‘Duality by Design: The Iranian Electoral System’ (IFES, 2011) 21.

<sup>223</sup> Ibid 18–20.

<sup>224</sup> Ibid.

<sup>225</sup> Reza Yeganehshakib, Iran’s New Generation of Oil and Gas Contracts: Historical Mistrust and the Need for Foreign Investment’ (2015) 3(4) *The Journal of Political Risk* 5..

<sup>226</sup> Ibid.

### 3.1.2 Bill to establish the Ministry of Petroleum, 1941

The complementary law to establish the Ministry of Petroleum was approved in March 1941. The aim in establishing the Ministry of Petroleum was to apply national ownership principles to Iran's gas and oil reservoirs; on the oil, gas, and petrochemical installations; and on those related to exploitation and marketing (paragraph 1 of the Act).<sup>227</sup>

The basic tasks of the Ministry of Petroleum include:

- Proper and correct preservation of resources and exploitation of oil and gas resources of the country.
- Maintain oil and gas facilities and the creation of the petrochemical and other associated facilities.
- Efforts to develop technology and relevant industrial knowledge to become more self-sufficient and to be independent of foreigners.
- Supervision of the export of oil and petroleum products; gas petrochemicals and related products, and final approval of contracts and other contracts relating to the above matters.
- Coordinate the activities of different units of oil, gas and petrochemical industries and coordinate with government agencies on the country's energy policy.
- Determine policies and common rules for governing subsidiaries and affiliates.
- Implement and integrate operational plans, financial and commercial subsidiaries, and formulate a comprehensive program within the framework of national programs and the government's economic policies and the executive government.
- Plan major capital projects and the supply of necessary funds.
- Develop existing activities or create new activities.
- Exercise technical, administrative, legal, commercial, financial and administrative supervision and control over the performance of subsidiaries.
- Ensure general subsidiary companies observe the approved principals and follow general policies.
- Monitor the implementation of regulations and general policy assessment and classifications.

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<sup>227</sup> Samad N Ebrahmi and Abdul, Shiroui Khouzani, 'The Contractual Form of Iran's Buy Back Contracts in Comparison with Production Sharing and Service Contracts' (Middle East Oil Show, Society of Petroleum Engineers, 2003) 150.

- Supervise international relations and monitor affairs in the Ministry of Petroleum outside the country.
- Establish and maintain good relations with the legislature and the civil and military authorities.
- Represent Iran in the international oil community.
- Represent the petroleum industry in the Supreme Council for Energy and Economic Council.
- Investigate the conditions necessary for the creation, dissolution, disintegration or integration of subsidiaries and affiliates and legal authorisation from the competent authorities.<sup>228</sup>

The Ministry of Petroleum was given the authority to change the form of existing companies according to the operation necessary for change (analysis, integration, cancelation, or establishment of new companies).<sup>229</sup> In addition, it could undertake the necessary changes after approval by the Committee composed of the Ministry of Petroleum, a supervisor for planning and budget, and the General Secretary for Administrative and Employment Affairs (Article 2).<sup>230</sup>

The statute for the companies listed in Article 2 was provided by Ministry of Petroleum and the changes commenced following approval of the Board and the Ministers (Article 3).<sup>231</sup> However, Article 4 stated that the validity of existing statutes related to the NIOC and national petrochemical industry to approve companies' statutes referenced in Article 3 remains in force.<sup>232</sup> Before approval of new statutes (Article 3), the option to select members to be on the Board of Directors of subsidiary companies was delegated to the Ministry of Petroleum (Article 5).<sup>233</sup> Lastly, this rule stated that to meet the human resource needs the Ministry of Petroleum has the authority to hire workers from subsidiary companies as officers who administer the employment rules (Article 6). They were also to cover all staffing costs from the budget of the subsidiaries and affiliates that hired the workers.<sup>234</sup>

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<sup>228</sup> Ibid.

<sup>229</sup> Ibid.

<sup>230</sup> *Law Amendment Act* art 2.

<sup>231</sup> *Law Amendment Act* art 3.

<sup>232</sup> *Law Amendment Act* art 4.

<sup>233</sup> *Law Amendment Act* art 1 para b established the Ministry of Petroleum on 29.03.1359

<sup>234</sup> Ibid.

### 3.1.3 Petroleum Law 1947

In addition to the provisions of the Constitution after the revolution, in 1947 another Oil Law was ratified by the Iranian parliament. The provision and approval of this rule was likely influenced by the political circumstances and a xenophobic mood to avoid foreign influence in the petroleum industry.<sup>235</sup> In general, the Petroleum Law designates petroleum contracts as private and the NIOC accepts mitigation in accordance with the terms and conditions of the contract. However, the principle that a nation has sovereignty over their natural resources in international law ensures that nations have the right to govern the development of their natural resource while compensating the IOC via the profits they incur.<sup>236</sup>

However, the law does not provide clear regulations about petroleum contract patterns and the mixing of investment and oil installations leads to confusion about how to manage the legal status of such investments.<sup>237</sup> Article 2 of the Oil Law states the country's oil resources are a part of public wealth and according to Article 45 of the Constitution are owned by the Islamic government.<sup>238</sup> All installations, equipment, properties and investments by the Ministry of Petroleum and subsidiaries belong to Iran and are the possession of Islamic government. Acts of sovereignty and ownership of the petroleum interests belong to Islamic government. Based on the regulations and powers prescribed in this Act, it is the responsibility of the Ministry of Petroleum to act according to principles and general plan of the country.<sup>239</sup> This rule repeats Article 45 of Constitution and when comparing the two rules of 1935 and 1947 it is evident that the new rule just addresses the generalities and principles. Thus, when compared to the old rules, the new rules have many shortcomings.

According to Article 12 of the *Oil Law 1947*, the enactment of the Act means any rules against this rule are annulled.<sup>240</sup> It is difficult to say that the rule of 1935 maintained its validity and power. Furthermore, due to Article 6 of the oil rule of 1947, whereby foreign investment in petroleum operation was banned, the legal barriers related to partnership contracts in production continued. Article 6 states that: 'All capital on the basis of budget operation units the Ministry of Petroleum proposed and after approval from the General Assembly will be included in the national budget. Foreign investment in these operations will

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<sup>235</sup> Mohsen Mohebi, *Legal Issues Facing the Oil and Gas in the Light of International Arbitration* (Publication of Knowledge, 1967) 16, 20.

<sup>236</sup> *Ibid* 49.

<sup>237</sup> *Ibid*.

<sup>238</sup> *Law Amendment Act* art 2.

<sup>239</sup> Mohebi (n 240) 20.

<sup>240</sup> *Law Amendment Act* art 12.

not be allowed at all'.<sup>241</sup> After the Islamic Revolution, the selection and use of “reciprocal” type contracts was significantly more common in the petroleum industry (see Chapter 4, section 4.4). This was because of the constraints and requirements of the Constitution and other laws, and the economic sanctions and requirements.<sup>242</sup> Plans to use reciprocal transactions in Iran's petroleum industry go back to the Oil Law, 1935 and the years prior the Islamic Revolution. The legislation imposed significant limitations to the participation of foreign oil companies in oil and gas upstream activities. Article 3 of the Oil Law stipulates that Iran's oil resources and the exploration, development, production and distribution of petroleum throughout the country and continental shelf is exclusively the responsibility of the NIOC directly or through its agents and contractors.<sup>243</sup> In Iran's Reciprocal Transaction Contracts, foreign investment companies undertake all investment funds such as installation of all equipment, start-up, and technology transfer. After setting up the equipment and the production to contract stipulations, return of capital, and costs and benefits, is provided by instalments within a certain time (e.g. seven years). This is in the form of delivery of products produced from these investments and facilities and no other form of reciprocal trading exists.<sup>244</sup> Article 8, Section 3 states the Executive Regulations for the approval of Reciprocal Transaction Contracts of April, 1965 by the state board: ‘If the exploration operation does not lead to the discovery of trading fields in mentioned area, the contract will be terminated and the parties have no right to demand any money’.<sup>245</sup>

### **3.2 Additional Regulations following the Islamic Revolution**

In the First Five-Year Development Plan approved in 1989, it reads: ‘The government can meet part of the needs of the mining industry in matters of production, exports and related investments, and mutual transactions by up to ten billion dollars’.<sup>246</sup> In the Second Five-Year Development Plan, such permission has been granted, and in paragraph ‘a’ of this clause it states:

The relevant executive agencies will be allowed within the validity of the law ... up to six billion and five hundred million dollars using Buy Back Contract methods ... and

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<sup>241</sup> *Law Amendment Act art 6.*

<sup>242</sup> Chow et al (n 22) 4.

<sup>243</sup> *Law Amendment Act art 3.*

<sup>244</sup> Tamara Milenkovic-Kerkovic, ‘Drafting an International Buy Back Agreement’ (2004) 2 *Economic and Organization* 165, 167.

<sup>245</sup> Ebrahimi and Khouzani, (n 232) 8.

<sup>246</sup> *Law of the First Five-Year Economic, Social and Cultural Development Plan 1989*, para (a) cl 29.

up to three billion and five hundred million dollars on the planning and financial obligations.<sup>247</sup>

The Third Five-Year Development Plan implemented by the Iranian parliament from 2000-2004 permits the conclusion of this type of contract.<sup>248</sup> In the Fourth Five-Year Development Plan commended in 2005, the use of Buy Back Contract for the exploitation of oil and gas fields is emphasised. It states in paragraph (b) of Article 14:

The Ministry of Oil is authorised to act for discovery and exploration of more oil and gas fields across the entire country, as well as to the transfer and use of new technologies for exploration operations of onshore and offshore joint fields shared with neighbouring countries in which the relating exploration operations concerns risk-taking by the contracting party and leads to discovery of fields capable of commercial production.<sup>249</sup>

### **3.2.1 Annual Budget Law**

Until 1949, foreign investment in oil and gas existed only in the downstream sector. With the end of the Second world War there was the need to rebuild the destroyed industries, attract foreign investment, and develop a program of economic, social and cultural rights.<sup>250</sup> Iran's Annual Budget Laws and the licenses and guidelines for concluding the necessary contracts are important to this objective. For instance, Iran's 1953 Budget Law after the war saw foreign investment grow substantially leading to tangible outcomes and reflects the priority of the government to undertake Buy Back contracts with foreign companies. Moreover, Budget Law 1966 authorised further investment through the Buy Back Contract.

The Council of Ministers in the *Executive Regulations Promotion and Protection of Foreign Investments Act 1962* provided further incentives and facilities for foreign investment.<sup>251</sup>

However, although the new law encourages investment protection and regulation of the world economy, it is arguable that it does not reduce the scepticism of foreign investors. It is the same scepticism that the authorities have towards foreign companies. To convince foreign investors to invest in Iran's industries, particularly the petroleum industry, requires greater transparency.

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<sup>247</sup> *Law of the Second Five-Year Economic, Social and Cultural Development Plan* para (a).

<sup>248</sup> *Law of the Third Five-Year Economic, Social and Cultural Development Plan* art 85.

<sup>249</sup> *Law of the Fourth Five-Year Economic, Social and Cultural Development Plan* art 14 para (b).

<sup>250</sup> Chow et al (n 22) 4.

<sup>251</sup> *Executive Regulations Promotion and Protection of Foreign Investments Act 1962*, arts 2–3, art 4 para (a, b).

### 3.2.2 Annual budget laws and the five-year development plan

After the Islamic Revolution in Iran other legislation for the petroleum industry was passed. The Annual Budget Laws and the regulations in the Five-Year Economic Development Plans were adopted after the end of the Iran-Iraq War. The laws outline the rules around petroleum contracts and the Annual Budget Law provided the platform to attract foreign capital to restructure the oil and gas industry and to facilitate economic development. Prior to this, only limited economic plans and short-term options were utilised. The laws passed by Parliament in 1950 allowed the government up to 10 billion dollars in bilateral transactions with the central bank guarantee to meet the needs of the mining industry.<sup>252</sup>

The *Annual Budget Law 1953*<sup>253</sup> and *Annual Budget Law 1954*<sup>254</sup> gave the license to use reciprocal contracts to meet the needs of petroleum industry. The Second Five-Year Economic Development Plan (1955)<sup>255</sup> addressed the financial needs of development projects and the needs of industrial and mining projects as defined in the law. Similarly, the Budget Law 1954<sup>256</sup> allowed foreign investment up to the amount of \$3.5 billion in oil and gas projects. In accordance with Clause 22, paragraph (m) of the Second Five-Year Economic Development Plan, the Budget Law of 1957 reaffirms the issue of licenses for contracts with the NIOC. In Budget Law of 1958<sup>257</sup> however, companies were allowed to settle debts and obligations arising from the financing of productive projects and job creation at a rate of \$4.5 billion from the production of the same design. This provision was repeated in the Budget Laws of the following years. The Budget Law 1959<sup>258</sup> also set rules regarding the reimbursement of the cost of the reciprocal transaction.<sup>259</sup>

In reference to obtaining foreign finance for projects mentioned in Article 11 of the Third Economic Law (1960) – including petroleum in the form of budget bills – the Iranian government is permitted to use reciprocal transactions (in general).<sup>260</sup> This is, however, subject to approval by the Economic Council following confirmation of its technical and economic feasibility.

The last notable change in the rules of petroleum contracts after the Islamic Revolution is Article 14 (b) in the Five-Year Development Plan adopted in 1965. The government and the

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<sup>252</sup> *Annual Budget Law* art 29 para (a).

<sup>253</sup> *Annual Budget Law 1953* art 22.

<sup>254</sup> *Annual Budget Law 1954*.

<sup>255</sup> *Ibid* art 22 para (m).

<sup>256</sup> *Ibid* cl 29 para (b).

<sup>257</sup> *Ibid* prov 29 para (L-1)

<sup>258</sup> Sect (L) pr 29.

<sup>259</sup> Mohebi (n 240) 16.

<sup>260</sup> *Third Economic Law* (1960) art 85 para (e).



NIOC use the same permissions in legislation to sign several contracts with foreign companies for oil and gas exploration. Criticisms were also directed towards the necessity of foreign investment, especially in the field of oil and gas exploration. This gradually persuaded the government to reconsider its policy towards exclusive use of reciprocal transaction contracts and open options to use other contract patterns. This included partnership contracts to participate more effectively in the global oil and gas arena while still maintaining national rights over the petroleum. However, the Fourth Economic, Social and Cultural Rights (ratified in 1965)<sup>261</sup> meant the government was permitted to encourage and support international agreements to attract foreign capital and resource use.

### **3.2.3 Legal support for foreign investment law**

In the Regulations Act<sup>262</sup> there is emphasis on the pattern of participation and the foreign investment restrictions (whether direct or indirect) under the provisions of the law. In practice, however, this foreign investment law is not applied in the upstream petroleum industry. In fact, IOCs did not use the law and protection of foreign investment because the contracts did not fit within the framework of the law. In total, there are numerous laws and regulations governing the petroleum industry, the most important of which are the Oil Law 1947 amendments in 1971, the Fifth Five-Year Development Plan, the duties and powers of the Ministry of Petroleum, and the Annual Budget Laws. Also of importance are the general conditions, structure and patterns of upstream oil and gas contracts approved in 1975.

### **3.3 Conclusion**

The historical development of the laws and regulations for petroleum contracts in Iran reveal that the element of sovereignty and ownership of petroleum resources had a significant role in the formulation of laws and petroleum contracts. An examination of the history of the petroleum industry in Iran makes clear that during the Qajar era the nation witnessed the arrival of outside experts to address weaknesses in the fields of finance, information and technology for research, and exploration and exploitation of petroleum resources. Granting concessions is understood historically to be a negative step. The Iranian government and people soon realised the importance of the nation's resources, and to access a greater share of the benefits called for more involvement in the operation. This led to the nationalisation of

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<sup>261</sup> Art 14(b).

<sup>262</sup> Art 1(b) art 4(a-3) art 4 (b).

the petroleum industry in 1911 as certified by Dr Mohammad Mosadegh, Iran's Prime Minister from 1951-1953.<sup>263</sup>

Problems with foreign investors and domestic and international conspiracy against the nationalisation of the petroleum industry resulted in a coup against Dr Mosadegh in 1914. The reinstatement of consortium contracts saw Iran's resources plundered again. In 1918, the approval of partnership contracts attempted to address the role of national interests and sovereignty over national interests and shares in petroleum production. However, Iran's share of interest income from petroleum extraction was only properly addressed in the Oil Law of 1935. This emphasised that property and the sovereignty of the country was paramount and was intended for the bolster the oil and gas industry in Iran.

Service Contracts (reciprocal transaction contracts) emerged after the Islamic Revolution. Legal constraints including Articles 44, 80 and 81 of the Constitution (source privilege and foreign borrowing), Oil Law of 1947, and the limitations of the Annual Budget Law meant that such contracts were the only way Iran could use its upstream projects. One of the main objectives of the contracts was to ensure government sovereignty over oil and gas resources, and to maintain and monitor government operations. This was because Iran had shown special sensitivity when applying the oil rules of 1940 and 1947.

The history of petroleum contracts in Iran over the last century confirms that they challenged the interests of IOCs as well as the interests of the host government. In this sense, the type of contract and its conditions, which are comprised of many important factors, are crucial to the interests of the contracting parties. Petroleum companies and host countries will inevitably have interests in different types of contracts. The petroleum companies are understandably looking to ensure the security of their significant investment.<sup>264</sup> As such, they have an overarching interest in sharing the risks associated with the exploration and development of oil fields with the host nation, and for there to be adequate provisions within the contract to expand operations to exploit opportunities for greater profitability.<sup>265</sup> Conversely, the host country has an overarching interest in securing maximum returns from the foreign company for the exploitation and sale of its natural resources, along with access to advance technology and know-how to develop their natural resources sector.<sup>266</sup> Despite there being little likelihood that either party will have all of their interests meet, Iran considered the benefits of

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<sup>263</sup> Parviz Kambin, *A History of the Iranian Plateau: Rise and Fall of an Empire* (iUniverse, 2011) 85-87.

<sup>264</sup> R Global (n 91).

<sup>265</sup> Ibid.

<sup>266</sup> Ibid.

the existing contracts to be too much in favour of the foreign entities' interests . As a result, changes were introduced into the contract designs to give more consideration to how Iran can better benefit from the exploitation of its petroleum resources.

## **4 MODERN CONTRACTUAL FORMS: THE EMERGENCE OF BUY BACK TRANSACTIONS**

### **4.1 Introduction**

Global petroleum supplies were inevitably disrupted as a result of the frequent political and economic crises in Iran, particularly due to the Islamic Revolution and the Iran-Iraq War. Indeed, the early stages of the Iran-Iraq War brought petroleum production in Iran to a virtual standstill, providing a stark reminder of the sensitivities of petroleum production to tensions in the region.<sup>267</sup> Buyers who ordinarily purchased petroleum from Iran turned now increasingly to Saudi Arabia and Kuwait for their supply, fearful of losing their tankers if they stayed with Iran.

By the 1990s, the petroleum production and export industry in Iran had stabilised but it did not reach the output achieved during the 1970s. Contributing factors were that oil wells were old and required upgrading if production capacity were to improve. An increase in production however meant the need for new oil fields and wells. This, in turn, required more capital and new technologies; namely, foreign investors.<sup>268</sup> Thwarting access to further foreign investment was the ban placed on foreign investment in Iran by the US. However, some European and Asian interests invested in the development of the petroleum and gas industry in Iran, thus limiting the success of the US sanctions.<sup>269</sup>

Within Iran, there were also concerns from the government regarding the rapid growth in domestic energy consumption and its potential to reduce petroleum exports and thus affect the budget bottom line.<sup>270</sup> To reduce the demand for petroleum in Iran, the government sought to increase the price of petroleum, to switch from petroleum to gas, and to simultaneously increase petroleum production. Iran at this time was eager to increase its energy exports but internal politics over the construction and maintenance of pipelines presented significant challenges to this outcome.<sup>271</sup>

### **4.2 International Petroleum Agreements**

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<sup>267</sup> Roger Stern, 'The Iranian Petroleum Crisis and United States National Security' (2007) 104(1) *Proceedings of the National Academy of Sciences* 377, 378.

<sup>268</sup> *Ibid* 379.

<sup>269</sup> *Ibid* 378.

<sup>270</sup> Paul Rivlin, 'Iran's Energy Vulnerability' (2006) 10(4) *The Middle East Review of International Affairs* 103, 103.

<sup>271</sup> *Ibid* 103–104.

The domestic laws of host countries typically impose strict regulations and monitoring mechanisms in relation to petroleum contracts.<sup>272</sup> Such regulations cover all aspects of the contracts from the creation of a legal framework to stipulate the nature of foreign investment, to the exploration and production procedures and the setting of taxes. The regulations around revenue-sharing regulations are made explicit, and it is incumbent on International Oil Companies (IOCs) to consider their statutory obligations along with the standard terms of the contract set down by the host country when signing a petroleum agreement. Agreements that include the transfer of rights or ownership over natural deposits involve the government or a government-mandated company and typically fall under one of two regimes: concessionary systems or contractual systems.

As previously established in Chapter 2, the concession system represents the original legal framework established for exploration and production of petroleum and is the most commonly used contractual framework with states.<sup>273</sup> An exclusive license is granted for the exploration of hydrocarbons and although the state has ownership of the petroleum *in situ*, upon drilling a well into the petroleum flow the concessionaire assumes title to that petroleum. In turn, the host nation is to be paid taxes and additional royalties including government representatives at all levels (local, regional, state and federal) and agencies controlled by the governments excluding state-owned companies.<sup>274</sup> The concessionaire accepts all operational and investment risks. As a counterbalance to undertaking these risks, the IOC is permitted to locate, exploit, transport and sell the natural resource, typically within a specified region and over a specified time period. Taxes are then paid to the government upon sale of the resource along with the payment of other agreed expenses.<sup>275</sup> Several types of petroleum contracts are included in concession agreements; with those signed prior to the 1950s including a wide range of concessions to IOCs and those signed after that relying more on a 50-50 share agreement formula. Within these agreements, the IOC assumes the risks and costs of exploration, while receiving remuneration via a fixed portion of the output, meaning the resources do not legally change hands.<sup>276</sup>

Non-concessionary contracts come in two categories: Production Sharing Agreements (PSAs) including JVs<sup>277</sup> and Service Contracts including Buy Back Contracts and IPCs. Service

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<sup>272</sup> The territorial jurisdiction of the host government and where the foreign company has economic interest.

<sup>273</sup> Bindemann (n 190) 1.

<sup>274</sup> Christian Ule and Alexander Brexendorff, *Investing in the Oil & Gas Industry* (Mena, 2005) 20.

<sup>275</sup> van Groenendaal and Mazraati (n 2) 3715.

<sup>276</sup> *Ibid.*

<sup>277</sup> Also referred to as 'Production Sharing Contracts' (PSCs).

Contracts may be further divided into three types; pure service contracts, risk service contracts, and technical assistance contracts.<sup>278</sup> PSAs and Service Contracts are more complex than concession schemes, setting out in extensive detail the regulations underpinning the host nation and IOC relationship. Table 4.1 provides a snap-shot of the main characteristics of each non-concessionary contract.

Table 4.1 Non-Concessionary Contracts

Type	Description
Production Sharing Agreement (PSA)	<p>State retains ownership of the resources</p> <p>Foreign oil company manages and operates petroleum field</p> <p>State and company negotiate a profit-sharing system</p> <p>Oil company accepts most exploration and development risks / costs</p>
Joint Venture Agreements (JVAs)	<p>Stakeholders (foreign oil company / host State) in venture execute business goals jointly</p> <p>Stakeholders share costs and risks of venture</p> <p>JVAs allow host country partner greater control over the venture</p>
Service Contracts	<p>Provide host Governments with the greatest control over the resource exploration and exploitation</p> <p>Foreign oil company performs a specified service and does not typically share in the revenue produced.</p> <p>Host Government maintains control of the resource</p> <p>The three main types of service contracts are:</p> <p>(1) risk service contract – oil company is contracted to provide all risk capital for exploration and production of petroleum. Successful discovery and production of commercial quantities of oil entitles oil company to recoup expenses and remuneration for services. Host Government maintains sovereignty over natural resources at all times.</p> <p>(2) pure service contract – Host Government provides risk capital for exploration and production of petroleum and oil company</p>

<sup>278</sup> Dariush Mobaser et al, *Autopsy of the Oil Contract (Buy Back)* (2000) 21.

	<p>provides states services for an agreed fee irrespective of discovery. Mostly used by countries with very high petroleum deposits.</p> <p>(3) technical assistance contract – mainly for rehabilitation, redevelopment or enhanced petroleum recovery projects. Oil company assumes operations of existing field including existing equipment and personnel to provide capital and technical know-how assistance</p>
Buy Back Contracts	<p>Capital costs are capped and recovered by the contractor as agreed at the commencement of the contract</p> <p>In addition to development costs, contractor receives an agreed rate of return from production revenue</p> <p>Contractor acts as operator during exploration and development phases, with State assuming operatorship at production phase</p>
Iranian Petroleum Contracts	<p>Costs recovery based on annual work programme and budget approved by contracting parties (NIOC has final right of approval in Iran). Contractor reimbursed for petroleum costs and paid a remuneration fee linked to production rates and revenue to costs (i.e. R factor) calculation indexed to market prices</p> <p>Contractor required to be a joint venture partner with State (approved by NIOC in Iran).</p>

Sources: R Global (n 55); Parris, Richard and Louis Skyner 1-4. Clifford Chance LLP.<sup>279</sup>

Comparison and analysis of the different types of petroleum contracts and their relative strengths and weaknesses is integral to understanding why Iran initially chose to use the Buy Back model as well as ultimately adopt the new IPC form.

### 4.3 Addressing the Imbalance

Development of Iran’s petroleum sector and the level of cooperation it has committed to with foreign companies has been driven largely by decisions made by the Majlis Energy Commission (MEC). Over time and with the emergence of petroleum as a new and important energy source, the unsustainable inequalities in the concession system became increasingly

<sup>279</sup>Key comparisons of the new Iran Petroleum Contract and Buy Back’ <<https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2017/01/key-comparisons-of-the-new-iran-petroleum-contract-and-buyback.pdf>> (accessed 1 December 2019).

apparent. Some host nations, being aware of what was at stake, raised their concerns and sought to renegotiate the inequitable terms in the contracts.<sup>280</sup> The host nations challenged the legitimacy of the concession system on the grounds that they lacked balance, demanding *rebus sic stantibus* and *pacta sunt servanda*.<sup>281</sup> To clarify, in international law, the concept of *rebus sic stantibus* (translated as ‘things standing thus’) requires that in the situation of a fundamental change of circumstances, a party is permitted to withdraw from or terminate the contract.<sup>282</sup>

Conversely, the principle of *pacta sunt servanda* (translated as ‘agreements must be kept’) in international law seek to ensure the binding or enforceable nature of international contracts.<sup>283</sup>

Disputes continued for many years (e.g. Aramco Arbitration, 1958; Sapphire Arbitration, 1967; Texaco Arbitration, 1977) with formal adjudication by the Courts including the ICJ and the Permanent Court of International Justice (PCIJ).<sup>284</sup> As such, the governments in some host nations felt the need to act unilaterally by gradually introducing ad hoc national legislation and then by either enforcing state participation or by the nationalisation of the petroleum sector. The concessions thus resembled a type of micro Constitution with its own laws enacted in domestic law and with disputes mostly settled through international arbitration.<sup>285</sup>

As previously mentioned, although concession agreements in the Middle East typically covered large regions for exploration and were generally of long duration (i.e. for more than 50 years), their terms and conditions were sometimes subject to renegotiation or amended by mutual consent in some instances of changing circumstances.<sup>286</sup> The major concessions however gave the concessionary company the right to fix production rates and prices, thus affording them a superior negotiation position.<sup>287</sup> Before the late 1960s, host nations typically accepted these conditions as they were guaranteed high rates of production and that their

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<sup>280</sup> Mafi (n 119) 410.

<sup>281</sup> Piero Bernardini, ‘Stabilization and Adaptation in Oil and Gas Investments’ (2008) 1(1) *Journal of World Energy Law & Business* 98, 98.

<sup>282</sup> Encyclopædia Britannica (online) <<https://www.britannica.com/topic/rebus-sic-stantibus#:~:text=international%20law&text=The%20concept%20of%20rebus%20sic%20relevant%20island%20has%20become%20submerged>>.

<sup>283</sup> Ibid <<https://www.britannica.com/topic/pacta-sunt-servanda#:~:text=known%20by%20the%20Latin%20formula,would%20be%20binding%20or%20enforceable>>

<sup>284</sup> Mafi (n 119) 414, 415, 419.

<sup>285</sup> Ibid 408.

<sup>286</sup> Ibid 430.

<sup>287</sup> Ibid.



product made it to market. Consumer nations maintained stable pricing which, although low, were not of great concern to host nation because they had not incurred costs of exploration and development; that is, had not borne significant risks for their revenue returns.<sup>288</sup>

Within the concessionary system,<sup>289</sup> the transfer of the rights for exploitation followed an evaluation of the agreement by the host nation, based on the desire to ensure the interests of the state were met for conserving and exploiting natural resources. This is compared to the previous system where the rights to exploit the natural deposits were transferred without limits, and with decision making such matters as pricing and the rate of exploitation left to the IOC's discretion.<sup>290</sup> This resulted in the payment of only small and fixed amounts of tax and royalties.<sup>291</sup> The political revolution in Iran during the 1950s and the subsequent nationalisation of the petroleum industry was the catalyst for significant changes to this arrangement, with host nations now having greater say in pricing and with the reconsideration of previous contracts.<sup>292</sup> For example, OPEC was established in 1960, passing Resolution XVI in 1968, calling for all previous terms in the contracts to be altered to include a gradual increase of state control (i.e. to 51%) by 1983. This change resulted in most member-nations acquiring partial or full control over the development operations by the 1970s.<sup>293</sup>

The case of Iran demonstrates how concession agreements did not always adequately serve the interests of the parties and, notwithstanding several attempts at re-interpretation and change, led the government to design their contracts in a completely different way. Even though the concession agreements had previously been more than satisfactory to the foreign petroleum companies with whom Iran was dealing, the desire to keep the original concession and the preparedness to renegotiate their terms was due to several factors. First, the petroleum companies were aware that the terms of the original contracts were particularly favourable to them. As a result, they were concerned that any refusal to renegotiate new terms and conditions may result in hostile action by the Iranian government such as tighter regulations of the petroleum industry or the seizure of assets.<sup>294</sup> Second, given the extent to which the original concession terms favoured the foreign petroleum companies, agreeing to more equitable terms would still lead to the profitable production of petroleum. As a result, the

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<sup>288</sup> Judith Rees, *The International Oil Industry* (London, 1987), 60.

<sup>289</sup> Also referred to as the 'Tax and Royalty System'.

<sup>290</sup> Heidari (n 14) 1758.

<sup>291</sup> Ibid.

<sup>292</sup> Bernardini (n 286) 99.

<sup>293</sup> Ibid.

<sup>294</sup> Rami A Kamal, 'Overview of the Petroleum Industry in the Middle East (1869–1950)' (2005) 24(8) *The Leading Edge* 818, 818.

Consortium was prepared to be enter into new contract arrangements if they could continue to turn a profit from the exploitation of Iran's vast petroleum resources.<sup>295</sup>

Most modern concessions follow the example of the agreements made in Oman in 1967 and Abu Dhabi in 1974.<sup>296</sup> These agreements gave foreign petroleum companies exclusive rights to the exploration, development, and exporting of petroleum, but over much shorter contract periods, clearer production obligations, the inclusion of a relinquishment clause, higher royalty and bonus payment requirements. In addition, the state or national petroleum company took a more active role in the venture. As such, the three areas given particular focus in the restructured concession system were the:

- level of control over operations afforded to foreign petroleum companies,
- share of revenue allocated to each party, and
- rights and obligations applied to foreign oil companies while operating in the country (e.g. production and investment requirements)<sup>297</sup>

The emergence of OPEC during the 1960s combined with an increase in the number of smaller 'independent' operators altered the contractual landscape to some degree. Despite several attempts to agree to new arrangements during the late 1960s and early 1970s (e.g. the Tehran Agreement on petroleum prices), the member states of OPEC undertook unilateral action to control the pricing of petroleum, thus bringing an end to the old concessionary regimes in 1974.<sup>298</sup>

In the Middle East, the trend to maintain state ownership and control over operations continued.<sup>299</sup> By the mid-1960s, Production-Sharing Agreements (PSA) (discussed below) used by the Indonesian government were more commonly utilised in response to the general antipathy towards concessionary agreements. The following section discusses in more detail the various forms of petroleum contract. It also discusses the Buy Back contract as a precursor to the modern petroleum contract, the IPC.

#### **4.4 Contractual Systems**

To evaluate the competitiveness and attractiveness of the new IPC in the global petroleum market, an analysis of the alternative transaction systems is required. This section discusses

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<sup>295</sup> Ibid.

<sup>296</sup> Bindemann (n 190) 10.

<sup>297</sup> Ibid 9–10.

<sup>298</sup> Ibid.

<sup>299</sup> Rees (n 293) 61.

the main elements of the alternative schemes, considers the legal basis for the various frameworks and their suitability for both the foreign petroleum companies and Iran. It leaves the discussion of the most recent form of contract, the IPC to Chapter 5.

#### **4.4.1 Production Sharing Agreements**

Production Sharing Agreements (PSA) are legal instruments to regulate the relationship around petroleum extraction entered into by a government entity and a commercial petroleum company.<sup>300</sup> Within the PSA, the government entity retains ownership of the resource and hires the IOC to provide technological and investment utilities during different phases of the extraction and production processes. The government entity typically acts through a proxy; namely, a national petroleum authority. The IOC is typically granted an agreed percentage of petroleum output as compensation for undertaking the risks of production and for the development of necessary facilities and services. The remaining output remains under the ownership of the government entity.<sup>301</sup>

In addition, the government entity is permitted to be actively involved in certain exploitation and exploration operations, usually under the supervision and direction of a common governing body. In terms of the background to PSAs, they were first introduced into Indonesia in 1966 as unfavourable national sentiment towards foreign companies increased and national authorities were no longer prepared to endorse concessions.<sup>302</sup> The PSA sought to balance national interests against the need for foreign investment in petroleum production and the subsequent revenue. From Indonesia, the passing of legislation took place in “all oil-producing regions with the exception of western Europe” to permit the use of PSAs to ensure state ownership of natural resources.<sup>303</sup> A degree of scepticism remained among foreign petroleum companies with operations in Indonesia based on their inability to legally possess or manage the petroleum reserves.<sup>304</sup> An additional concern was that accepting the terms of PSAs in Indonesia would result in similar demands for the use of PSAs in other countries. As the large petroleum companies hesitated over whether to enter into such agreements, smaller operators took advantage of the opportunity to sign the PSAs and subsequently to wrestle some of the commercial power away from the larger operators.<sup>305</sup> It was fairly common in practice however for the IOCs to maintain direct control over production of the petroleum

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<sup>300</sup> Bindemann (n 190) 1-2.

<sup>301</sup> Ibid.

<sup>302</sup> Ibid 1.

<sup>303</sup> Ibid.

<sup>304</sup> Ibid 67–68.

<sup>305</sup> Ibid 61.

fields. In turn, as acceptance of PSAs became more common in the global petroleum market, they emerged as the preferred system in 52 states including Egypt, Syria, and the Philippines just to name a few.<sup>306</sup>

#### 4.4.1.1 Key mechanisms of a PSA

The PSA operates according to the following process. First, the government as legal owner of the resource hands over the responsibility for locating and exploiting the petroleum reserves within a specified area and over an agreed span of time, with the expectation of an eventual compensation payment. Under this arrangement, the contractor accepts all risks and expenditures. Both parties are equal under the law in a PSA with penalties imposed for any breaches of the contracts terms and conditions,<sup>307</sup> and provision for international arbitration in response to any emergent conflicts.<sup>308</sup> In most countries around the world, the government maintains full control over the natural resource thus allowing it to permit access to the resource to one entity to the exclusion of others. However, there are limitations placed around the exploitation and production rights of the contractor as follows:<sup>309</sup>

- a) Only the types of operations agreed to in the contract are legal
- b) Only the natural resource agreed to in the contract may be extracted
- c) All other provisions of the contract function as limiting elements

#### 4.4.1.2 The PSA and the state

The PSA is a private contractual arrangement in which the government retains power as representative of the nation to exercise all legal mechanisms at its disposal for the benefit of its citizens. This has the potential to create tension within the contractual arrangement because, although both parties are equal within the scope of the agreement, the state may pass laws that impact the agreement. As such, the host nation is automatically entitled to any petroleum produced by the foreign petroleum company, whereas the foreign company is only entitled to the production of petroleum via the PSA.<sup>310</sup>

Although the PSA grants the foreign petroleum company the right to conduct operations within a specified region, there is no proprietary interest attached. As a result, the host government retains ownership of all output. This means that the foreign investor is acting on

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<sup>306</sup> Ibid 48.

<sup>307</sup> Jenik Radon, 'The ABCs of Petroleum Contracts: License-Concession Agreements, Joint Ventures, and Production-Sharing Agreements' in Svetlana Tsalik and Anya Schiffrin, *A Reporter's Guide to Energy and Development of Open Society Institute* (Open Society Institute, 2005) 61–63.

<sup>308</sup> Bindemann (n 190) 30.

<sup>309</sup> Ibid 69.

<sup>310</sup> Ibid 68–69.

behalf of the government and is paid according to the level and distribution of the output.<sup>311</sup> As mentioned earlier, the contractor accepts all expenses and risk, and there are no refund arrangements embedded into the PSA should no deposits be found, or if the project does not achieve commercial viability.

There is however the option to have a clause inserted into the PSA permitting some form of the compensation arrangement for the outlay of expenses.<sup>312</sup> This arrangement allows a point to be determined within the terms of the contract (e.g. at the exit of the mine shaft) where an agreed amount of the output, termed the cost-recovery product, is allocated to the foreign company as compensation for their costs.<sup>313</sup> The remaining output, termed the profit product, is subsequently divided between the host country and foreign entity according to the terms agreed to in the PSA.<sup>314</sup> The PSA therefore allows the host nation to have access to a significant output share without having to invest significant funds or to take on commercial risk.<sup>315</sup> The amount of tax paid to the host government is largely defined in the contract terms. To avoid disincentives for investment, the amount of tax to be paid is typically offset by amount of royalty payments and profit product granted the host nation in the terms of the PSA. As a general rule, the lower the profit product and royalty payments to the government, the higher the level of income taxes paid on the product.<sup>316</sup>

The tax regime applied to the foreign investor under the PSA is unique; that is, general tax payments are replaced by an allocated amount of output and extends for the duration of the contract.<sup>317</sup> This does not equate to the provision of tax exemptions or special privileges to the foreign investor however, but is rather a form of payment in kind.

Such production sharing arrangements thus provide a safety net for foreign company investors against fluctuations in the nation's tax regime of a country or potential changes to tax law whilst also protecting the resource and revenue interests of the state.<sup>318</sup> Given that the PSA may last for decades, this can make a significant difference to the investor.

As such, PSAs emerged as an attractive contract arrangement to both the host nation and the foreign investor. The three main benefits of the PSA to the host nation were:

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<sup>311</sup> Ibid 30.

<sup>312</sup> Bindemann (n 190) 9.

<sup>313</sup> Ibid.

<sup>314</sup> Silvana Tordo, 'Fiscal Systems for Hydrocarbons: Design Issues' (World Bank Working Paper, no. 123, 2007) 44.

<sup>315</sup> Ibid.

<sup>316</sup> Bindemann (n 190) 73.

<sup>317</sup> Ibid 13.

<sup>318</sup> Ibid 69.

1. They attract substantial foreign investment for the petroleum resource related exploration, extraction and production thus contributing to economic stability in the country, and ultimately its national security. It is the case for many petroleum producing nations that the government would otherwise not be able to develop its petroleum industry.
2. They are typically long-term agreements which allow the host nation to forecast future growth in the rate of output to engage in budgetary planning more accurately.
3. They allow the host government to determine the receipt of a fixed share of the output and thus avoid the conventional tax system which can be difficult to calculate on production output and equally difficult to collect.<sup>319</sup>

The contractual relationship between the foreign entity and host government is nearly always exclusive and offer the foreign investor a degree of legal stability within the terms of the contract.

In terms of ensuring that Iran's interests are balanced against the interests of foreign companies, PSAs are restricted under the Constitution of Iran in the sense that all contractual agreements must support the Islamic Principle base on the stated Islamic criteria.<sup>320</sup> However, the Iranian government permits such agreements for exploration of certain areas, if the contract terms are compatible with the legal limitations set down in the Constitution.<sup>321</sup>

According to Seyyed Mehdi Hosseini, Deputy Managing Director of NIOC, the advantages and disadvantages of PSAs are best described as:

The risk the companies accept in PSAs is that of exploration, whereas most of our projects are for development and the exploration costs are not very high compared to development expenses and the revenues gained. This is particularly true in countries with a very high potential for petroleum discoveries, such as Iran. Therefore, the rewards can be huge and disproportionate to the risks. ... From the viewpoint of an oil-producing country, contracts such as PSAs or concessions may be best when the potential for discovering petroleum is low.<sup>322</sup>

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<sup>319</sup>Irina Paliashvili, 'The Concept of Production Sharing', Outlines of the Presentation of Dr. Irina Paliashvili, the President of the Russian-Ukrainian Legal Group, at the Seminar on the Legislation on Production Sharing Agreements, 14 September 1998 <[http://www.rulg.com/documents/The\\_Concept\\_of\\_Production\\_Sharing.htm](http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm)> (accessed 7 January 2020).

<sup>320</sup> Art 4, 'Islamic Criteria'. The restrictions are also provided in art 44, art 45, and art 81 of Iran's Constitution.

<sup>321</sup> Bindemann (n 190) 9.

<sup>322</sup> Mehdi Hosseini, 'National Iranian Oil Company Deputy Managing Director, Speaks Up (Part One)' (May 2005) <[www.payvand.com/news/05/may/1146.html](http://www.payvand.com/news/05/may/1146.html)> (accessed 19 December 2019).

#### 4.4.2 Revenue sharing contracts

Revenue sharing contracts resemble PSAs in several ways, but with a different payment method. Similar to a PSA, the foreign investor ensures the provision of capital and technical expertise to support the exploration and production of the resource.<sup>323</sup> The Revenue Sharing Contract then differs to the PSA in that the investor is paid according to an agreed share of revenue rather than production. The foreign investor thus seeks to recover the costs of a successful exploration via sales revenue. Hence, Revenue Sharing Agreements grant the IOC a stake in the petroleum following its discovery. Current law in Iran does not permit such an agreement.<sup>324</sup> The Constitution of Iran stipulates that the nation's natural resources remain wholly owned by the state. Article 45 Public wealth and property states that such resource locations include uncultivated land, bodies of water (i.e. seas, rivers and lakes, public waterways), natural terrain (e.g. mountains, valleys, forests) unenclosed pastures, properties of unknown ownership, and public property regained from usurpers. All these locations remain available to the Iranian government for use in accordance with national interests.

#### 4.4.3 Joint Venture Agreements

The host nation may at times enter into a commercial partnership agreement with an IOC or become a member of a consortium. These JVAs require the host country to contribute a percentage share of the capital investment to establish the commercial enterprise in return for an equal share of the 'cost oil' and 'profit oil'.<sup>325</sup> Provisions in the JVA typically allow for the IOC's portion to be separated and this results in some of the risk being passed on to the government. Iran adopts a conservative perspective on JVAs and although it does not reject them outright, its preference was to use the Buy Back contract and since 2015 the IPC. In general, IOCs prefer to own part of the joint venture because it will remain a partner in the petroleum well for as long as it remains productive. In contrast, the Buy Back contract and the IPC do not permit the IOC to own any part of the well and once the invested capital and interest has been received, the oil field is vacated.<sup>326</sup>

The NIOC has entered into JVAs in the past,<sup>327</sup> for example, two JVAs related to petrochemical deals were signed with 2001, one with ENI, an oil company in Italy, and one

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<sup>323</sup> Zhuo Feng, Shui-Bo Zhang and Ying Gao, 'On Oil Investment and Production: A Comparison of Production Sharing Contracts and Buyback Contracts' (2014) 42 *Energy Economics* 395, 396.

<sup>324</sup> Ibid.

<sup>325</sup> Abdolhossein Shiravi and Seyed Nasrollah Ebrahimi, 'Exploration and Development of Iran's Oilfields through Buyback' (2006) 30(3), *Natural Resources Forum* 200-201.

<sup>326</sup> Ibid.

<sup>327</sup> Dayarayan, 'Iran at a Glance' <[http://www.parstimes.com/business/iran\\_at\\_a\\_glance.pdf](http://www.parstimes.com/business/iran_at_a_glance.pdf)> (accessed 19 December 2019) 4, 6.

with LG, the Engineering and Construction company in South Korea. In 2002, the National Petroleum Construction Company (NPCC) based in Abu Dhabi and Naft Sazeh Qeshm (NSQ) of Iran entered into a JVA in cooperation with Shell. The aim of the agreement was to build the necessary infrastructure to exploit the petroleum deposits of Soroosh. This was the largest ever contract for surface facilities at the time (i.e. to develop the Soroosh/Nowrooz oil fields) and the NPCC-NSQ joint venture was agreed to because it tendered the best proposal in terms of costs, scheduling and Iranian content. As such, the NPCC-NSQ joint venture was perceived to show real support for the development of Iran's petroleum industry.<sup>328</sup> In addition, it aimed to capitalise on the expertise of NPCC in offshore fabrications to develop the Naft Sazeh Yard as well as to create employment and training opportunities for Iranians.<sup>329</sup>

Thus, notwithstanding that Iran generally prefers not to endorse JVAs, it is willing to enter into such agreements when the circumstances show that it is prudent to do so.

#### **4.4.4 Service Contracts**

Service Contracts are entered into for specific work to be done by a contractor at a fixed price or for an agreed share of the production profit. The three main types are the Pure Service Contract, the Risk Service Contract, and the Technical Assistance Contract.

##### **4.4.4.1 Pure service contracts**

Pure Service Contracts commit the contractor to undertake the exploration or development work at an agreed fixed price.<sup>330</sup> The state adopts all the risk in this contract form. Countries in the Middle East often have the financial resources to develop their natural resources but lack the expertise and technology to do so. Pure Service Contracts are typically agreed to in order to gain access to a specific technical service at a specific point in time. It is generally the case that the service company will provide the equipment and personnel required to complete the work.<sup>331</sup> Payment for service may be a daily rate, fixed turnkey rate, or another specific fee arrangement and is generally not attached to project outcomes or market factors. In cases where payment for service is attached to agreed performance outcomes (e.g. operating cost reductions), the risk adopted by the service company is most often confined to overruns on non-recoverable costs or in relation to contract disputes (e.g. losses due to a contract breach or default).

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<sup>328</sup> Ibid.

<sup>329</sup> *Emirates News Agency*, 'Abu Dhabi-Iran joint venture in Shell deal' (January, 2002) <<http://wam.ac/en/details/1395227046863>> (accessed 9 August 2019).

<sup>330</sup> Feng et al (n 328) 395.

<sup>331</sup> Ibid.



#### 4.4.4.2 Risk service contracts

Risk Service Contracts required the service provider to invest capital into the project. It is mostly similar to the Pure Service Agreement however payment is based on the initial investment amount rather than a flat fee.<sup>332</sup> These contracts typically include a reserve agreement to be satisfied prior to the provision of any payments. Risk Service Contracts are mostly entered into for operations where expertise, technology and substantial investment are required to improve.<sup>333</sup>

#### 4.4.4.3 Technical assistance contracts

This is a modernised version of the pure service contract where the contractor transfers technology to the host country in addition to supporting exploration and production activities.<sup>334</sup> The host country maintains ownership of the resource and equipment and facilities as managed by the national oil company.<sup>335</sup> The IOC then provides the technical services for the project. As such, the IOC performs a defined task for fixed compensation and cannot acquire an interest in the resource.<sup>336</sup>

The first Service Contract in Iran was concluded with the French company, ERAP. The primary advantage of the service contracts was that absolute ownership of the oil deposits could be maintained by the host nation. In this way, it is similar to a PSA in that it favours resource nationalism.<sup>337</sup> Moreover, service contracts allowed the host nation to gain access to the IOC's expertise and capital without having to grant them ownership rights of the field and production.<sup>338</sup> This is a vital consideration for the host nation because maintaining sovereignty over the natural resources increases the potential for proper oversight over the operations of the IOC. That is, they provide the state-owned oil company (e.g. NIOC) with a stronger position in its 'regulatory, supervisory and operatorship roles'.<sup>339</sup> Moreover, it provides a pathway to improving the training provision to local workers through the transfer of technology and technical knowledge. The transfer of technology is considered as a major "externality" of a petroleum contract agreement and as playing an integral role in the eventual level of development of the host country. Externality in this context is defined as the

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<sup>332</sup> Ibid.

<sup>333</sup> Ibid 397.

<sup>334</sup> R Global (n 91).

<sup>335</sup> Ibid.

<sup>336</sup> Ibid.

<sup>337</sup> Ali Zamani, *Challenges in the Development of Iran's Oil Industry* (Desert Publications, 1960) 151-152.

<sup>338</sup> Ghandi Abbas and C-Y. Cynthia Lin, 'Oil and Gas Service Contracts Around the World: A Review' (2014) 3 *Energy Strategy Reviews* 63, 63.

<sup>339</sup> Ibid 66.

unintended or unanticipated benefit to Iran society and to its energy sector more specifically to emerge from the petroleum project itself.<sup>340</sup> The positive transfer of technology within contract arrangements would typically include the requirement for nationals to receive training in operational practices directed by the foreign entity and for the promotion of local research and development initiatives to increase the level of indigenous technology use over time.<sup>341</sup>

Notwithstanding the advantages of service contracts in regard to sovereignty concerns, this contract form was not automatically the preferred choice for the host nation or foreign oil companies. In terms of the host nation, a primary disadvantage of a pure service contract for instance was that the host nation was required to take on substantial operational and financial risks. The pre-determined remuneration to the IOC over the contracts lifetime make it difficult for the state-owned oil companies to facilitate changes to optimal production levels.<sup>342</sup> Regarding the IOC, the main disadvantage in a risk service contract for example, is that it is required to cover all the costs of exploration. Thus, the risks associated with a failure to find oil reserves were significant for the contractor.<sup>343</sup>

#### **4.5 Buy Back Contracts**

Buy Back Contracts are short-term agreements whereby the IOC is entitled to a share of the profit following the commencement of petroleum production. At the completion of the contract in Iran, the company is required to transfer all land and facilities to the NIOC.<sup>344</sup> Under the terms of a Buy Back agreement, the IOC is required to recover the costs to explore for or develop of natural resource field. Repayment for all capital expenditure, interest paid, and the pre-agreed share of production is then facilitated through the sale of the oil or gas produced.<sup>345</sup>

Although Buy Back Contracts included fewer incentives for foreign investors than Production Sharing Agreements (PSAs), the IOCs were nonetheless willing to sign them. Several reasons can account for this. First, IOCs cannot discount the possibility that a favourable change in the contract structure may occur over time. Second, there is the strategic

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<sup>340</sup> Yinka Omorogbe, *The Oil and Gas Industry: Exploration and Production Contracts* (Malthouse Press, 1997) 90.

<sup>341</sup> Kameel Khan, 'The Transfer of Technology and Petroleum Development in Developing Countries: With Special Reference to Trinidad and Tobago' (1986) 4(1) *Journal of Energy & Natural Resources Law* 10, 17.

<sup>342</sup> Ibid.

<sup>343</sup> Zamani (n 342) 152.

<sup>344</sup> Shafiei Khah and Amiri (n 24) 378.

<sup>345</sup> van Groenendaal and Mazraati (n 2) 3709.

concern that not signing a contract presents opportunities for rival companies to do so, which may in turn reap the benefits of any change in the contract structure should it come to pass. During the mid-1960s major IOCs were cautious about signing the new PSAs, but this form of contract was to become the most common.<sup>346</sup> From the point of view of Iran, short-term contracts were the preferred option where foreign investment was needed to build infrastructure; whereas, the NIOC could manage the development and exploration of petroleum reserves.<sup>347</sup>

In Iran, the NIOC has only a supervisory role in a Buy Back Contract. The allocation of shares to each party in the contract is calculated by transferring gross production into gross revenue and then subtracting the costs of operations.<sup>348</sup> The net revenue is then divided between the parties based on an agreed formula. The Buy Back Contract is typically defined according to a two-stage process: exploration of a natural resource field by the IOC; and then a declaration of its commercial or non-commercial viability. If the site is deemed to be non-commercial, the IOC accepts all costs and the contract is subsequently terminated.<sup>349</sup>

The site is regarded to have commercial potential by the NIOC if production output can provide a minimum rate of return following the subtraction of all capital costs, bank fees, operating expenses, and IOC costs.<sup>350</sup> However, although the IOC may have explored and found a commercially viable field, it does not automatically get granted approval to develop the site. Rather, it only has the right to negotiate with the NIOC first to enter into a contract to develop the field.<sup>351</sup> If the negotiation is not successful, the contract goes through a tender process in which the successful IOC agrees to receive costs for its expenditure in addition to an agreed fee.<sup>352</sup>

Buy Back Contracts are of relatively short duration (i.e. between 5-7 years) and include an upper limit on amount of capital expenditure allowed (any increase in the amount must have NIOC approval). In addition, an important condition in the Buy Back Contract is the treatment of price risk.<sup>353</sup> For instance, if there is a fall in revenue to a level that where the monthly entitlement of the IOC cannot be covered, the NIOC may accept a reduction in its share, or the amortisation period may be extended if this remains insufficient to cover the

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<sup>346</sup> Bindemann (n 190) 29.

<sup>347</sup> Ibid 78.

<sup>348</sup> Ibid.

<sup>349</sup> Ibid 131–132.

<sup>350</sup> Bindemann (n 190) 14.

<sup>351</sup> van Groenendaal and Mazraati (n 2) 3709.

<sup>352</sup> Bindemann (n 190) 78.

<sup>353</sup> van Groenendaal and Mazraati (n 2) 3715.

IOC's entitlements.<sup>354</sup> The main distinguishing aspect of this contract is that the contractor does not gain ownership of the petroleum (unless it is bought directly from the host nation). The main differences between a PSA and a Buy Back Contract are what made the latter less attractive to potential investors. For instance, the Buy Back Contracts lacked flexibility and security in terms of tax and investment arrangements given the potential for changes to legislation to be introduced in Iran, and the onus on the contractor to accept all exploration and development risks.

The Buy Back Contract risk is that commercial production is not a right. In this regard, the Fourth Five-Year Development Plan declares: "... If at the end of the exploration phase, commercial areas in any part of the area are undetected, the contract will be terminated, and the parties will not have the right to claim any aspect".<sup>355</sup> Arguably, the main differentiating factors between Buy Back Contracts and PSAs is related to risk. The contractor in a Buy Back scheme is reimbursed for exploration and development costs from the sale of petroleum production.<sup>356</sup> In addition, a contracted company is penalised under the Buy Back scheme if it fails to produce the amount of petroleum agreed as it is subsequently reimbursed to a lesser amount than in earlier agreements. Thus, Buy Back Contracts have increased risk compared to other finance deals.<sup>357</sup>

#### **4.5.1 International Buy Back Contracts**

Within the structure of the Buy Back Contract is the transaction for the use of machinery, equipment, knowledge and technical expertise throughout the construction of the production facilities. Although there are generally only two negotiating parties in a Buy Back Contract, there is the possibility for a three-party or larger transaction to take place. For example, goods or materials may be provided by a third party other than the primary-transaction contractor, who subsequently sells or leases it to the primary-transaction company.<sup>358</sup> In addition, the primary-transaction company may seek to transfer some of its Buy Back obligations; for example, transferring responsibility for the sale of the product to a third party rather than undertake this responsibility itself. In such circumstances, the third party is required to sign

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<sup>354</sup> Bindemann (n 190) 80.

<sup>355</sup> *Law of the Fourth Five-Year Economic, Social and Cultural Development Plan* art 14 para (e).

<sup>356</sup> Dr. Hossein Afarideh, 'Iran Ready to Give Production Sharing Agreement' (Menas Associates' Iran Energy Focus, February 2003) <<http://www.payvand.com/news/03/mar/1026.html>> (accessed 12 June 2019).

<sup>357</sup> Ibid.

<sup>358</sup> United Nations Economic Commission for Europe, 'International Buy Back Contracts' 1 <[http://ierc.bia-bg.com/uploads/vtcontract/files/vtcontract\\_00743d3417d145769033e1b5c06e4113.pdf](http://ierc.bia-bg.com/uploads/vtcontract/files/vtcontract_00743d3417d145769033e1b5c06e4113.pdf)> (accessed 9 December 2019).

its own contract with the host nation.<sup>359</sup> Such third party (International) Buy Back agreements can be very complex and may be as a single contract or be designed as multiple interconnected agreements.<sup>360</sup> A single contract is typically entered into when the product is precisely described and there is no third-party involvement. Notwithstanding the flexibility of the international Buy Back Contract structure, the termination date is typically clearly defined.<sup>361</sup>

Similarities are apparent between Iranian and international Buy Back Contracts in regard to the rights and obligations accepted by the contracting parties including third-party operators supplying technology and equipment. Where they differ, however, is in regard to the special Buy Back provision where the party who establishes operations in a Buy Back Contract is contractually bound to purchase the end petroleum produced through the operation.<sup>362</sup> Any disagreements or disputes to occur as a result of the complex and often onerous nature of the contract obligations are resolved according to the pre-agreed laws governing the agreement. Prior to taking the dispute to Court, however, an attempt to negotiate an acceptable outcome is advised. In the event of a failure to reach a compromise, international arbitration procedures may be used, but the choice of arbiter and arbitration rule must be included in the contract.<sup>363</sup>

#### **4.5.2 Limitations of Buy Back Contracts**

The three main elements underpinning the IPCs relate to collaboration (primarily through its JVA structure), technology transfer and technical know-how, and simplification and consolidation of previous model agreements.<sup>364</sup> These principles emerge from criticisms levelled against the Buy Back Contract model, particularly regarding its limited capacity to meet the national interests of Iran.<sup>365</sup> See Section 5.2 below for a comprehensive discussion of the ‘pros’ and ‘cons’ of the Buy Back Contract model for Iran’s oil and gas sectors and the entities (i.e. NIOC) operating within it. The main criticism of the Buy Back Contract by IOC’s and that which provides this thesis with its answer to RQ2 (see Section 1.4) is related to the capped cost recovery regime. Specifically, the expectation that the IOC would invest in the development of designated areas on the understanding that any costs incurred beyond the

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<sup>359</sup> Ibid 3

<sup>360</sup> Ibid.

<sup>361</sup> Ibid 9.

<sup>362</sup> Ibid 8.

<sup>363</sup> Ibid 3.

<sup>364</sup> James Dallas and Alistair Black, ‘New Model Iranian Petroleum Contract’ *Dentons* (2016)

<<https://www.dentons.com>> (accessed 1 December 2019) 3.

<sup>365</sup> Ardalan et al (n 26) 350.

pre-determined budgets were irrecoverable. This acted as a disincentive to IOCs to invest in projects that carried greater risk or with marginal prospects only of success.<sup>366</sup> In turn, the new IPCs aimed to address this limitation, along with the narrow remuneration structure in place to reward enhanced productivity, by implementing three key changes:

1. full costs recovery amortised over 5-7 years and annual costs recovered and service fee repayments kept to 50 percent of total annual revenues
2. the remuneration of finance and other associated development fees (e.g. income tax and customs duties) incurred throughout the amortisation period
3. replacement of the fixed-cost regime with a standardised yearly work programme and budgeting process<sup>367</sup>

The Buy Back Contract model was also criticised for its remuneration structure, with Contractor fees tied to a fixed percentage of capital costs up to the budgeted cap.<sup>368</sup> This element did not allow for any incremental revenue for exceeding production targets or any upside linked to an increase in the price of petroleum. The new IPC model could offer a volumetric fee structure for the duration of the agreement.<sup>369</sup> In turn, a revised cost-recovery structure combined with a true volumetric tariff (with incentives for incremental production) would incentivise foreign investment in the technology required to optimise green and brownfield reserve production.<sup>370</sup>

#### **4.6 Conclusion**

This Chapter has conducted a broad examination of the petroleum contract schemes in order to establish the context to the IPC by identifying and discussing the precursors to the current model. The Chapter has explored the function and legal basis of PSAs, Concessionary Models, Revenue Sharing, JVs and Buy Back Contracts to assess their compatibility to, and function within, Iranian law. The analysis revealed that Buy Back Contracts are amongst the least profitable options for IOCs, justifying to some degree their dissatisfaction with the scheme.<sup>371</sup> However, the Chapter also demonstrated that other contract options included terms and conditions too favourable to the foreign investor company, thus creating a

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<sup>366</sup> Ibid 351.

<sup>367</sup> United Nations Economic Commission for Europe (n 363) 4.

<sup>368</sup> Ibid 5.

<sup>369</sup> Ibid.

<sup>370</sup> Ibid.

<sup>371</sup> van Groenendaal and Mazraati (n 2) 3711.

reasonable context for Iran to be unwilling to maintain such agreements due to perception of the unfair and exploitative use of the nation's natural reserves.

Moreover, given the potential for some contract schemes to lack alignment with the Constitution of Iran and some of the nation's statutes, particularly in relation to the ownership of resources by foreign entities, it is evident that the IPC emerges as one of the best alternatives. To support a detailed and accurate analysis of the IPC in terms of its strengths and flaws – and subsequent suggestions for improvement – the following Chapter provides a comprehensive explanation of its legal basis, provisions and comparative benefits in relation to alternative international petroleum contracts.

## 5 IRANIAN PETROLEUM CONTRACT – AS A RESPONSE TO THE PROBLEMS WITH BUY BACKS CONTRACTS

### 5.1 Energy Sector in Iran

The energy sector in Iran has been significantly impacted and constrained by the sanctions imposed on the country by the US after the Iranian Revolution in 1979, the UN in 2006, and more recently by the US again in 2018.<sup>372</sup> These sanctions have unquestionably impeded the social and economic development and progress of Iran that was acknowledged as a major player in the global energy sector. The sanctions arguably demonstrate the need for Iran to develop a robust and efficient energy sector that has the capacity to develop and operate its energy assets to the betterment of the nation.<sup>373</sup> However, in order to transition Iran's state-dominated energy sector to a modern and globally competitive industry, it must have the capability to attract significant foreign investment capital.<sup>374</sup>

According to Smousavi, as of 2019, '[b]oth the size of the Iranian energy sector and its influence in the region is expected to grow'.<sup>375</sup> This growth was promoted to some extent through the introduction of the IPC in 2015 and the relaxation of sanctions against the nation in 2016. The easing of sanctions especially provided new opportunities for IOCs to engage with Iran to exploit its energy resources. Conversely, the re-imposition of the sanctions by the US in 2018 has placed serious constraints on both IOCs and the Iran to develop energy sector.<sup>376</sup>

On 14 July 2015, the Guardian Council of the Islamic Republic of Iran signed the Joint Comprehensive Plan of Action (JCPOA), a multilateral nuclear agreement aligned with Iran's constitution and Islamic law more broadly.<sup>377</sup> Following proof of compliance with the plan of action by the UN Security Council on 16 January 2016, the sanctions related to the production of nuclear energy were lifted. Yet, the relief for Iran's energy sector was relatively short lived, with the Trump administration withdrawing from the JCPOA In May 2018, followed by the re-imposition of sanctions on Iran's energy sector on 5 November 2018.<sup>378</sup>

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<sup>372</sup> Shaghayegh Smousavi, 'Iran: The Energy Regulation and Markets Review - Edition 8' (2019) *The Law Reviews* para 1.

<sup>373</sup> *Ibid* para 2.

<sup>374</sup> *Ibid*.

<sup>375</sup> Smousavi (n 377) para 3.

<sup>376</sup> *Ibid*.

<sup>377</sup> Faucon (n 25) para 2.

<sup>378</sup> *Ibid*.



In the context of the current US sanctions regime combined with the desire by the EU and other nations to continue to trade with Iran, it is vital that due diligence is demonstrated by IOCs to assess the extent to which they are exposed to the US sanctions.<sup>379</sup> Moreover, IOCs must assess the risks around Iran potentially violating the terms of the JCPOA and the subsequent need to implement the ‘snapback’ provisions; namely, the reimposition of sanctions on Iran.<sup>380</sup> Furthermore, this is in the broader context of Iran’s low ranking (128<sup>th</sup>) on the ‘Doing Business’ ranking of economies by the World Bank.<sup>381</sup> Implied in this ranking is the need for IOCs to be alert to the risks of bribery and corruption in Iran’s energy sector, and to the challenges presented by Iran’s wider infrastructure development needs.<sup>382</sup>

Notwithstanding the relatively low global oil price as a disincentive for IOCs to invest significant amounts of capital in the development and production of new oil fields, “the costs of production in Iran are estimated to be significantly lower than the international average”.<sup>383</sup> As such, Iran considers this enough incentive for IOCs that it has sought to implement its reforms its energy sector and continue to open it up to foreign investors.<sup>384</sup> As previously mentioned, the IPC endorsed by Iran’s parliament in October 2015 and eventually ratified by the parliament in September 2016 was designed to facilitate such reforms.

Articles 77 and 125 of Iran’s Constitution state that all international agreements have to have the approval of parliament:

Article 77:<sup>385</sup> Treaties, transactions, contracts, and all international agreements must be ratified by the Islamic Consultative Assembly.

Article 125:<sup>386</sup> All the treaties, transactions, agreements, and contracts between the government of Iran and other governments as well as all the pacts related to the international unions, after they are approved by the Islamic Consultative Assembly, must be signed by the President of the Republic or his legal representative.

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<sup>379</sup> Hamed Sahebonar, Ali Taheri Fard and Fazel M. Farimani, ‘Economic Analysis of New Iranian Petroleum Contract (IPC): The Case Study of the Caspian Sea Fields’ 1 <<http://www.iaee.org/baku2016/submissions/ExtendedAbs/Sahebhonar.pdf>> (accessed 17 February 2020).

<sup>380</sup> Ibid.

<sup>381</sup> World Bank ‘Ease of Doing Business Rankings’ <<http://www.doingbusiness.org/en/rankings?region=middle-east-and-north-africa>>.

<sup>382</sup> Sahebonar et al (n 423) 1.

<sup>383</sup> Smousavi (n 377) para 15.

<sup>384</sup> Ibid.

<sup>385</sup> Constitution of Iran (n 217) 18.

<sup>386</sup> Ibid 28.

However, as Smousavi points out, the Iranian parliament has also previously accepted that “contracts in which one side is a government entity or company and the other side is a privately owned foreign company are not international agreements subject to Article 77”.<sup>387</sup>

In March 2018, during the period in which the US sanctions were lifted, a trilateral IPC was signed by the NIOC, Zarubezhneft (a Russian state-owned oil company) and Dana Energy Company to develop the Aban and West Paydar oilfields around the border of Iran and Iraq.<sup>388</sup>

A further development in Iran’s petroleum industry at this time was the reintroduction of the Iran Energy Exchange (IRENEX). Initially established in 2012, the IRENEX permitted the Ministry of Petroleum in Iran to sell crude oil and petroleum products in the international market at a competitive price.<sup>389</sup> Operating under the umbrella of the Securities and Exchange Organization, IRENEX aims to organise and supervise the trade of energy carriers. In turn, IRENEX facilitated the purchase of crude oil from Iran during different rounds of the supply.<sup>390</sup>

### **5.1.1 Competition in Iran’s oil fields**

The competitiveness and attractiveness of Iran’s energy sector is determined to some extent by the outcome of the debate between conservatives and moderates in Iran regarding the best utilisation of Iran’s natural resources. With conservatives pushing for an independent and self-sufficient energy sector, and moderates pushing for the energy sector to drive economic and social advancement (through access to foreign capital and expertise), there remains a degree of risk for IOCs around the political and policy uncertainty in the sector.<sup>391</sup> The energy industry in Iran has been in public hands throughout the sanction periods, with the IRGC highly involved in its management.<sup>392</sup> As such, the interests of vested interest groups must be overcome and any attempt to open up the sector may be regarded with suspicion by the IRGC and the domestic energy sector supply chain. This is because the proposed reforms

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<sup>387</sup> Smousavi (n 377) para 20.

<sup>388</sup> Ibid para 22.

<sup>389</sup> Ibid para 23.

<sup>390</sup> Ibid.

<sup>391</sup> Smousavi (n 377) para 44.

<sup>392</sup> Ibid.

fundamentally redefine the role and scope of the NIOC and the reliance on foreign investment and technology.<sup>393</sup>

The introduction of reforms around competition and tariffs in Iran's energy sector has several potential benefits. The primary objective of the reforms is to make sure that the risks around investing in the energy sector are assigned to the entity that is best able to manage them as well as to drive better investment decision making.<sup>394</sup> Competition and the loosening of restrictions aim to shift major performance risks to the private sector, exploit the advantages of competition via the introduction of new technology and international best standards into the sector to the domestic benefits to the economy and citizens.<sup>395</sup>

Given that the Ministry of Energy in Iran is also the regulator of the energy sectors as well as a direct investor in it, there is significant potential for conflicts of interest. In order to implement effective regulation, there are many advantages to be gained from separating key aspects of the State from the sector.<sup>396</sup> However, any reforms to liberalise the sector must be managed carefully so as to make sure that there is not too much upward pressure placed on energy prices during the process which would be difficult to manage, politically.<sup>397</sup> This is because such reforms, particularly around the rejuvenation of aging oil fields, are reliant on the large-scale capital and technology from foreign companies, and will inevitably increase domestic oil consumption <https://www.govinfo.gov/content/pkg/CHRG-109shrg30856/html/CHRG-109shrg30856.htm>

Moreover, the process must be managed carefully to make sure too much pressure is not placed on existing entities to reduce costs and subsequently produce financial problems for the sector.<sup>398</sup> The introduction of stronger competition into the sector also requires the building up of capacity of key institutions that will be managing the skills, resources, and expertise as well as educating the entire supply chain on the processes adopted in Iran.<sup>399</sup>

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<sup>393</sup> Ibid.

<sup>394</sup> Vahid Aryanpur, Mohammad Saeid Atabaki, Mousa Marzband, Pierluigi Siano, and Kiarash Ghayoumi, 'An Overview of Energy Planning in Iran and Transition Pathways Towards Sustainable Electricity Supply Sector' (2019) 112 *Renewable and Sustainable Energy Reviews* 58, 58.

<sup>395</sup> Ibid.

<sup>396</sup> Smousavi (n 377) para 45.

<sup>397</sup> Ibid.

<sup>398</sup> Ibid.

<sup>399</sup> Aryanpur et al (n 399) 59.

## 5.2 Attracting Foreign Direct Investment into Iran’s Energy Sector

Foreign investors and developers seeking to establish operations in Iran’s energy sector must naturally make decisions as to how they want to enter into, and engage with, the Iranian market. As previously established, the IPC provides one such route for entry and engagement via the creation of a JVA with a local entity. It is therefore vital for IOCs seeking to enter the Iranian energy sector to understand the current laws, regulations and industry frameworks in place to manage the sector. Iran’s Constitution dictates that all national laws and regulations are based on “Islamic principles and norms that reflect the heartfelt desire of the Islamic community”.<sup>400</sup> In turn, Iran promotes the participation of foreign entities in its energy sector via the *Foreign Investment Promotion and Protection Act (FIPPA) 2002*.<sup>401</sup> Under the FIPPA, foreign entities can invest in the mining sector and greenfield and brownfield project services upon satisfying of specific criteria. As stated under Article 2 of FIPPA – General Conditions for Admission of Foreign Capital:

Admission of Foreign Investment under this Act and in compliance with other current laws and regulations of the county must be for development and productive activities in the fields of industries, mines, agriculture and services shall be based on the following criteria:

- a. Shall lead to economic growth, promote technology, promote quality of productions, increase employment opportunities and increase exports
- b. Does not jeopardize national security and public interest, harm the environment, disrupt the national economy, or disturb productions dependent on domestic investments
- c. Shall not involve the granting of concession by the government to Foreign Investors; concession means distinctive rights that place foreign investors in an exclusive and monopolistic position
- d. The proportion of the value of goods and services produced by Foreign Investment under this Act in comparison with the value of goods and services supplied in the domestic market at the time of issuance of Investment License, in each economic sector, shall not exceed 25% and in each economic sub-sector shall not exceed 35%.

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<sup>400</sup> Constitution of Iran (n 217) 1.

<sup>401</sup> Yeganehshakib (n 230) 1.

The determination of sub-sectors and amount of investment in each will be pursuant to regulations ratified by the Council of Ministers.<sup>402</sup>

Foreign direct investment (FDI) is permitted in fields where private sector participation is authorised. However, wholly commercial activities are not regarded as foreign investment. Foreign investors can therefore choose either FDI or foreign investment across all sectors within a ‘civil participation’ framework, as stated in Article 3 of the Implementation Regulation of FIPPA:

Admission of Foreign Investment, based on FIPPA and the criteria set forth in these Regulations, may be carried out within the framework of the following methods. The table of investment methods, features and facilities available under FIPPA shall be prepared and published by the Ministry of Economic Affairs and Finance.

- a. Foreign Direct Investment (FDI)
- b. Foreign Investment within the framework of contractual arrangements including various types of “Build-Operate-Transfer” (BOT), “Buy Back”, and “Civil Participation” schemes.<sup>403</sup>

In Iran, the Organization for Investment Economic and Technical Assistance of Iran (OIETAI) is responsible for issuing a foreign investment licence under FIPPA as stated in Article 15 of the Implementation Regulation of FIPPA:

Investors shall submit to the Organization their written application together with the documents specified in the relevant form. After conducting necessary investigations and taking the viewpoints of the ministry responsible for the related sectors, the Organization shall bring the investment application along with its expert advice before the Board within a maximum period of 15 working days. Enquiries remained unanswered by the relevant ministry, after 10 days from the date of receipt of the enquiry shall be considered as agreement of that ministry with the investment concerned. On the basis of the decisions adopted by the Board for which the acceptance of the Foreign Investor has already been obtained, the Investment License shall be drafted and, upon confirmation and signature by the Minister of Economic Affairs and Finance, shall be issued.

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<sup>402</sup> Organization for Investment Economic and Technical Assistance of Iran, ‘Laws and Implementing Regulations Concerning Promotion and Protection of Foreign Investment’ <[http://www.satba.gov.ir/suna\\_content/media/image/2017/02/5236\\_orig.pdf](http://www.satba.gov.ir/suna_content/media/image/2017/02/5236_orig.pdf)> 9-10.

<sup>403</sup> Organization for Investment Economic and Technical Assistance of Iran, 19.

Note: The Investment License shall include the particulars of the investor(s), type and method of investment, the manner for transfer of dividend and profit gained as well as other terms and conditions relating to the approval of every investment project.<sup>404</sup>

The licence treats foreign investment as equal to Iranian investments as stated in Article 8 of FIPPA:

Foreign investments subject to this Act shall enjoy the same rights, protections and facilities available to domestic investments in a non-discriminatory manner.<sup>405</sup>

In addition, it permits the resolution of disputes to take place outside of Iran and has provisions for the repatriation of profits. The OIETAI also provides security against non-commercial risks such as the transfer of currency, as stated in Article 4 of the Implementation Regulation of FIPPA:

Methods of investment referred to in Article (3) of these Regulations, in respect of the procedure for investment and the protection coverage of FIPPA and these Regulations, have the following common or specific features and advantages:

a. Common features and advantages:

1. Foreign Investors enjoy the same treatment as accorded to domestic investors.
2. Import of Foreign Capital, being cash or non-cash (in kind), is only subject to the Investment License and does not require any other license.
3. The volume of Foreign Investment in each individual case shall not be subject to any limitation.
4. Foreign Capital is guaranteed against nationalization and expropriation, and in such cases the Foreign Investor shall be entitled to receive compensation.
5. Transfer of the principal capital, profit and capital gains derived from utilization of capital shall be affected in the form of foreign currency or, as the case may be, in the form of goods, as set out in the Investment License.
6. The freedom to export goods produced by the Investee Firm is guaranteed and, in the event of any prohibition on the export, the goods produced may be sold in the domestic market, and proceeds of sale shall be transferable abroad in the form of foreign currency through the Country's Official Monetary Network.

b. Specific features and advantages:

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<sup>404</sup> Ibid 24-25.

<sup>405</sup> Ibid 12.

1. Foreign Direct Investment (FDI):
  - i. Investment may be made in all areas where the private sector activity is permitted.
  - ii. There is no restriction on the percentage of foreign shareholding.
2. Investment within the framework of contractual arrangements:
  - i. Compensation for losses sustained by the Foreign Investment resulting from prohibition and/or interruption in the execution of financial agreements caused by enactment of law and/or Cabinet decrees, up to a maximum of matured instalments, shall be guaranteed by the Government.
  - ii. In “B.O.T.” and “Civil Participation” schemes where a government agency is the sole purchaser and/or supplier of goods and services at subsidized prices, the purchase of produced goods and services resulting from an investment project by the government agency as a party to the contract, shall be guaranteed in accordance with the relevant regulations.<sup>406</sup>

As for nationalisation and expropriation considerations, Article 9 of FIPPA states:

Foreign Investment shall not be expropriated or nationalized unless for the public interest, through a legal process, in a non-discriminatory manner, and against payment of appropriate compensation based on the real value of that investment immediately before the expropriation.

Note 1: Requests for compensation must be submitted to the Board within a maximum of one year following the expropriation or nationalization.

Note 2: Disputes resulting from expropriation or nationalization will be settled according to Article 19 of the present Act.<sup>407</sup>

Moreover, the regulations around interventions by the government, and government contract breaches are stated in Article 17 of the Implementation Regulation of FIPPA:

The Ministry of Economic Affairs and Finance (State Organization for Tax Affairs, Customs of the Islamic Republic of Iran), the Ministry of Foreign Affairs, the Ministry of Commerce, the Ministry of Labor and Social Affairs, the Ministry of

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<sup>406</sup> Ibid 19-21.

<sup>407</sup> Ibid 12-13.

Industry and Mines, the Ministry of Jihad-e-Agriculture, the Central Bank of the Islamic Republic of Iran, the General Directorate for Registration of Companies and Industrial Property, the Organization for Protection of the Environment, and other executive agencies determined by the Minister of Economic Affairs and Finance shall introduce their fully authorized representatives to the Organization with the signature of the highest executive authority of the agency. The designated representatives, from the standpoint of the employment regulations, shall be considered as the employees of their respective agencies, and, as situation requires and in proportion to the volume of Foreign Investment applications and enquiries by the investors, shall, upon the Organization's request, be present in the Center in order to respond to the enquiries in accordance with the duties assigned to them under this Article.<sup>408</sup>

Regarding the expropriation and nationalisation of the assets of foreign investors, FIPPA acknowledges the foreign entity's right to obtain immediate compensation at fair market value for the assets on the day prior to their expropriation (see Article 9 of FIPPA above).

### **5.2.1 Foreign direct investment and the Iranian Petroleum Contract**

Foreign direct investment (FDI) includes major investments by foreign entities such as in the development of production facilities or via the purchase of ownership stakes in Iranian companies. The benefits of FDI in its energy sector for Iran include the creation of new jobs, an injection of state-of-the-art technologies, and enhanced understanding of management strategies and workplace practices.<sup>409</sup>

As the Organisation for Economic Cooperation and Development (OECD) explains, FDI is arguably a greater catalyst to domestic development than trade and is a vital component in any open and successful international economic system.<sup>410</sup> However, the benefits and advantages of FDI do not accumulate automatically and evenly for different countries and across different sectors. Moreover, a nation's policies and foreign investment architectures play a key role in attracting FDI and in gaining access to the full benefits of FDI.<sup>411</sup> For Iran, the challenges around attracting FDI in its energy sector are associated with ensuring a

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<sup>408</sup> Organization for Investment Economic and Technical Assistance of Iran 25.

<sup>409</sup> Seyed Mohammad Alavinasab, 'Determinants of Foreign Direct Investment in Iran' (2013) 3(2) *International Journal of Academic Research in Business and Social Sciences* 263.

<sup>410</sup> Organisation for Economic Cooperation and Development, 'Foreign Direct Investment for Development, Maximizing Benefits, Maximizing Costs' (OECD, 2002) 3.

<sup>411</sup> Ibid.



transparent, wide-ranging and enabling policy setting for foreign investment that is supported with adequate human and institutional resource capacities.<sup>412</sup>

There are a range of strategies available to a nation to improve its capacity to attract foreign capital into the country. In terms of legal considerations, statutory strategies may be adopted that rely on the legislative power of the parliament. This approach imposes conditions or obligations on the part of the contracting parties and typically reflects the government's economic and social policies.<sup>413</sup> Alternatively, contractual strategies may be deployed by the host nation to attract foreign capital. Such strategies generally include the provision of incentives or specific terms and conditions that entice the foreign entity into the contract and the transfer of capital into the country.<sup>414</sup>

Whatever the strategic approach, the overarching objective is for the host nation to appear as attractive to the foreign investor company. The main points of attraction are generally regarded in terms of the stability of the commercial environment and the capabilities of the host nation to engage in long-term cooperative endeavours to the benefits of both parties.<sup>415</sup> The lifting of sanctions on Iran in 2015 marked the start of a new determination from the Iranian parliament to progress and develop the energy sector on the back of foreign investment.<sup>416</sup> However, the reinstatement of the sanctions by the US in 2018 has clearly had a significant impact on Iran's energy sector and its wider economy.<sup>417</sup>

Iranian Constitutional Law, Article 77, dictates that any international agreements entered into by Iran must be approved, ratified and supervised by Parliament.<sup>418</sup> However, contracts entered into by the Petroleum Ministry or the NIOC with foreign companies or governments are not covered by Article 77 and thus are not monitored by the Iranian Parliament directly.<sup>419</sup> There are however other mechanisms within the regulatory frameworks in Iran for its Parliament to monitor petroleum contracts. For instance, if the petroleum contract is worth more than US\$20 million, the government is required to inform the Planning and Budgeting Commission and Energy Commission of Parliament of the conclusion of the contracts and the

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<sup>412</sup> Alavinasab (n 414) 259.

<sup>413</sup> Sheldon Leader, 'Human Rights, Risks, and New Strategies for Global Investment' (2006) 9(3) *Journal of International Economic Law* 657, 657.

<sup>414</sup> Ibid.

<sup>415</sup> Alavinasab (n 414) 25.

<sup>416</sup> Ibid.

<sup>417</sup> Ibid.

<sup>418</sup> Mahdi Haddadi, 'The Nature of Iranian Petroleum Contracts in Upstream Section' (2014) 44(1) *International Letters of Social and Humanistic Sciences* 45, 50.

<sup>419</sup> Ibid.

processes for its finalization. Additionally, in accordance with Petroleum Law Modification, 1987, classified copies of all petroleum contracts of more than five years' duration should be submitted by the government to Parliament.<sup>420</sup>

The new Petroleum Law passed in 1987 allowed the Petroleum Ministry to conclude petroleum contracts in addition to the NIOC. The model applied by the Ministry was based on the procedures applied prior to 1987.<sup>421</sup> The modifications to the Petroleum Law (1974) passed in 2011 provided the Ministry with the right to govern and own petroleum resources on behalf of the Iranian state.<sup>422</sup> Moreover, Article 16(1) of the modified Petroleum Law (1974) identified the Petroleum Ministry and the NIOC as competent authorities to conclude petroleum contracts in the upstream sector of the petroleum industry.

Operations of IOCs in the upstream sector of the petroleum industry in Iran are undertaken within the terms and conditions of commercial contracts. However, the government maintains ownership of the petroleum resources (as is the case in most countries), can intervene as representative of the Iranian public, and must consider the strategic role of petroleum in domestic economy. As such, there is the potential for the design of such contracts to prioritise public rather than private interests.<sup>423</sup>

In October 2013, the Ministry of Oil in Iran established the Iran Oil Contracts Restructuring Committee (ICCRC), chaired by Seyyed Mehdi Hosseini, former Deputy Oil Minister. Within the scope of the Committee's mandate was to assess the most suitable contract models to apply for the development of the nation's oil and gas fields and to increase the overall production capacity.<sup>424</sup> Accordingly, this included an analysis of Iran's experiences of the Buy Back Contract model during the previous 20 years. The Committee also considered the feasibility of introducing a new contract model that better conforms with Iran's Constitution, social policies, the Petroleum Act and other relevant upstream legislations.<sup>425</sup>

### **5.3 Iranian Petroleum Contract and Iran's Constitution**

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<sup>420</sup> Haddadi (n 423) 50.

<sup>421</sup> Ibid 47.

<sup>422</sup> Law to Modify Petroleum Law (2011) art 2.

<sup>423</sup> Mostafavi Seyed Mostafa and Amani Masoud, 'The Nature of Petroleum International Contracts' (2008) 3(1) *Islamic Research Journal* 22.

<sup>424</sup> Iran Business News, 'Oil Contracts Restructuring Committee (2015) <<https://www.iran-bn.com/tag/oil-contracts-restructuring-committee/>>.

<sup>425</sup> Ardalan et al (n 26) 345.

The competitive nature of the global petroleum and gas sector has forced Iran to reform its petroleum contracts.<sup>426</sup> Of particular concern is the emergence of new petroleum powers over recent decades and the provisions of new petroleum contract models by rival nations in the Middle East (e.g. Iraqi Service Contracts). Moreover, laws such as the FIPPA introduced by the Iranian government as part of the so-called “reconstruction” era (commencing in 1988) to encourage foreign companies to invest in the nation’s oil and gas industries have to date been largely unsuccessful.<sup>427</sup>

Several aspects of Iran’s post-revolution Constitution are related to international contracts and agreements such as the IPC. Principle 77 of the Constitution of Iran states that “International agreements, contracts and deals should be adopted (finalised) in the Parliament”.<sup>428</sup> Given the nature of the IPC and its objective to establish long-term relationships with international players, this principle prompted proponents of the IPC to argue that they should be able to be finalised without having to involve the Iranian Parliament.<sup>429</sup>

Opponents of the contract model refer to Principle 139 of the Constitution and its interpretation by the Guardian Council of the Constitution (see section 3.1.1). According to the Council’s interpretation, any contract in which one party is a government Ministry or institution and the other party is a private foreign company should not be regarded as an international treaty and therefore was not covered by Principle 77 of the Constitution.<sup>430</sup> This interpretation by the Guardian Council is used to argue that allowances for the government of Iran to engage in temporary transactions with foreign companies should not be extended to IPC. This is because the subject of the contract concerns Iran’s national interests and any long-term petroleum contract concerning public assets should have its own specific legal and jurisprudential considerations.<sup>431</sup> The restrictions in the Constitution of Iran related to foreign investment is designed to avoid foreign domination of the Iranian economy. This is emphasised in the Constitutional Principles 43, 81 and 153 as well as in Shia jurisprudence.<sup>432</sup> Accordingly, opponents of the IPC are that the contract model violates the principle of jurisprudence denying the domination of Iranians by foreigners.

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<sup>426</sup> Haddadi (n 423) 50.

<sup>427</sup> Yeganehshakib (n 230) 1.

<sup>428</sup> Ali Reza Mazlumrahni and Mohsen Esmaeli. ‘Legal Analysis and Economic Impact of Iran’s Petroleum New Contracts (IPC)’ (2018) 3(2) *Örgütsel Davranış Araştırmaları Dergisi* 7.

<sup>429</sup> Ibid.

<sup>430</sup> Ibid.

<sup>431</sup> Ibid.

<sup>432</sup> Ibid 8.

The position of Shia law in relation to these kinds of commercial agreement is contained in Article 45 of Iran's Constitution, 'Natural Resources as "Anfal"'. This article identifies the natural resources of Iran as *Anfal* or public wealth and property.<sup>433</sup> The Islamic concept is identified in the Holy Koran where it states:

*Anfal* i.e., Public wealth and property, such as uncultivated or abandoned land, mineral deposits, seas, lakes, rivers and other public water- ways, mountains, valleys, forests, marshlands, natural forests, unenclosed pastureland, legacies without heirs, property of undetermined ownership, and public property recovered from usurpers, shall be at the disposal of the Islamic government for it to utilize in accordance with the public interest. Law will specify detailed procedures for the utilization of each of the foregoing items.<sup>434</sup>

Hence, the Holy Koran asserts that while *Anfal* belongs to God and the Prophet, it is left to the government to utilise it in the pursuit of public interest. Given that Shia Islamic teachings dictate that *Anfal* cannot be transferred or sold to another entity, significant barriers emerge in relation to Iran's scope for negotiating an agreement that may provide title to the oil to a private foreign entity.<sup>435</sup>

### 5.3.1 Redesigning the contracts

Underpinning the examination of the IPC model was its advantages and disadvantages to the petroleum sector in Iran and the potential for a new contract form to better attract foreign capital, technologies and know-how.<sup>436</sup> In turn, the process to assess the current Buy Back Contract model and to develop an improved model saw the ICCRC engage in a number of processes including:

- evaluation of service contracts (partial or in full) from 33 oil producing countries,
- NIOC planning department preparing a report on its operational expectations,
- assessment of extensive research evidence produced both nationally and internationally on the implementation success of service contracts around the world, and

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<sup>433</sup> Nima Nasrollahi Shahri, 'The Petroleum Legal Framework of Iran: History, Trends and the Way Forward' (2010) 8(1) *China & Eurasia Forum Quarterly* 111, 120.

<sup>434</sup> Holy Koran, *Anfal* 001.

<sup>435</sup> Shahri (n 438) 120.

<sup>436</sup> Shana News Agency, 'Who Are Iran's New Oil Managers?' 2019 <<https://en.shana.ir/news/286983/Who-Are-Iran-s-New-Oil-Managers>> (accessed 5 January 2020).

- analysis of the experts' and domestic / foreign companies' point of views regarding the Buy Back Contract form.<sup>437</sup>

Based on these considerations, the 10 core principles of the IPC may be summarised as follows:

1. Iran retains sole and total ownership of the reservoir.
2. Preserve Iran's national interest.
3. Due observance of the laws and regulations.
4. Win-win contract outcome.
5. Alignment in the benefits to both contracting parties.
6. Sustainability.
7. Partnership.
8. Operational efficiency.
9. Technology transfer.
10. Internationalisation.

Some of the 10 principles cited above have been extensively discussed, such as Iran's desire to maintain sole and total ownership of the oil reserves to protect its national interests and the rationale for entering into partnership agreements to improve operational efficiency and technology transfer. Some other principles, however, require further explanation.

Internationalism for instance, refers to the process of regarding "contractual obligations as international obligations".<sup>438</sup> As such, any breach of contract by the State (although not the OIC) is regarded as a breach of international law. Traditionally, all investment contracts are managed according to domestic laws, leaving the investor with little sense of protection and equally little recourse in terms of breaches against it. Internationalism attempts to address these concerns via international law which "recognises the absolute sanctity of the contract".<sup>439</sup> In turn, any breach of contract by the State may be held open to sanction according to international law.

In terms of the principle of sustainability, this no doubt emerged in response to the heavy reliance of Iran on energy-intensive industries for domestic economic production and export.<sup>440</sup> Iran is highly dependent on oil products to meet the nation's primary energy

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<sup>437</sup> Ardalan et al (n 26) 345.

<sup>438</sup> Chin Leng Lim, Jean Ho and Martins Paporinskis, *International Investment Law and Arbitration: Commentary, Awards and other Materials* (Cambridge University Press, 2018) 37.

<sup>439</sup> Ibid 39.

<sup>440</sup> Morteza Sabetghadam, 'Energy and Sustainable Development in Iran' (Helio International, Sustainable Energy Watch, 2005/2006) 1.

demands and to develop its petrochemical and metal industries.<sup>441</sup> Moreover, the slow process to implement energy price reform along with low energy prices and poor energy efficiency combine to present “a serious threat to the economy of Iran”.<sup>442</sup> According to Sabetghadam, this has increased the imperative for Iran to develop ‘coordinated policies and implementation to create a more sustainable energy sector that supports the development and welfare of all Iran’.<sup>443</sup>

The partnership principle is also related to the development of Iran’s energy resources sector via support for and improvement of the capabilities of Iranian domestic entities. Specifically, the IOC is required to gradually transfer the executive management positions to Iranian nationals “in order to facilitate the process and transfer of know-how and managerial skills to the Iranian entity”.<sup>444</sup> With the expectation that under the IPC the Iranian entity will play a larger role in the production activities, the principle of Iran’s right of sovereignty and public ownership of all oil reserves is bolstered. Moreover, the principle related to the transfer of technology and know-how will help to ensure the transfer of such technology in Iran to improve managerial know-how and reservoir engineering skills.<sup>445</sup>

On 3 August 2016, the Council of Ministers in Iran passed a regulation governing the general conditions, structure and terms of upstream oil and gas contracts (the IPC Regulation). This represented a material step in securing approval from the Iranian government to the terms of the IPC and thus a major milestone in the nation’s endeavour to attract foreign investment. Because the IPC is a risk service contract, the IOC carries much of the financial and operational risks related to the petroleum operations. Such costs are recovered by the contractor and a service fee is paid as compensation for carrying the risk only if petroleum operations are successful. Different to PSA, the IPC entitles the IOC to a fixed fee in lieu of a share of production. If there is agreement between the NIOC and IOC, the fixed fee may be paid by way of an allocation of oil produced.

### **5.3.2 Iranian Petroleum Contract fiscal parameters**

There are several fiscal parameters of the IPC such as capital expenditures (CAPEX) including the company's major, long-term expenses (e.g. buildings, equipment,

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<sup>441</sup> Ibid.

<sup>442</sup> Ibid 5.

<sup>443</sup> Ibid 6.

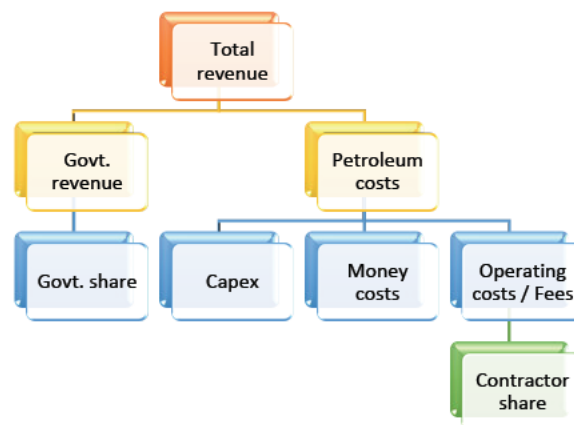
<sup>444</sup> Iran Group, ‘The New Iranian Petroleum Contract – Government Approval’ (*Herbert Smith Freehills*, 2016) <<https://www.herbertsmithfreehills.com/latest-thinking/the-new-iranian-petroleum-contract-%E2%80%93-government-approval>> (accessed 22 June 2020).

<sup>445</sup> Ibid.

machinery), operating expenses (OPEX) including the company's day-to-day expenses (e.g. travel, taxes), Cost of Money (average interest rate for borrowed money), remuneration fees (payment or compensation for services or employment), the amortization period (length of time taken to pay off a loan) and the R-factor or cumulative revenues divided by cumulative costs.<sup>446</sup> Of these, the main fiscal feature of the new contract model for upstream oil and gas production is the introduction of remuneration payments based on a negotiated fee per barrel of production. This provision was modelled on the fiscal model underpinning Iraqi petroleum contracts which had proved attractive to IOCs. As such, it was included by the Iranian authorities as a way to improve the contract framework to better meet the interests of the operator.<sup>447</sup>

The global energy sector can loosely be divided into the domains of supply and demand. The fiscal model underpinning the supply domain arguably has more complexities than its 'demand' counterpart. This is because of the (potentially significant) technical issues that must be managed during the exploration and production of a field, along with the uncertainty around the behaviours of the different suppliers in the market.<sup>448</sup> This is not to mention the uncertainty around the geopolitical relations among nations in the Middle East as well as international tensions due to US sanctions on Iran, reintroduced in November 2018. Not surprisingly, geopolitical tensions and their potential to disturb supply (e.g. the tensions over oil supply between Saudi Arabia and Russia), combined with environmental catastrophes (e.g. the spread of COVID-19 virus) and advances in technology all make petroleum supply modelling and forecasting a complicated endeavour.<sup>449</sup>

The basic cost structure of the IPC is illustrated in Figure 5.1:



<sup>446</sup> Sahebonar et al (n 423) 1.

<sup>447</sup> Ibid.

<sup>448</sup> Sahebonar et al (n 423) 1.

<sup>449</sup> Ibid.

### Figure 5.1 Basic costs structure of IPC

Figure 5.1 of the costs related to the petroleum operation shows a depreciation in costs from allocated revenue to petroleum costs. A fee is paid to the contractor in addition to the remuneration for operation and petroleum costs.<sup>450</sup> All petroleum costs and the remuneration fee are recovered via 50% of revenue from the sale of crude oil from the field. A more targeted description and analysis of the different costs and remuneration fees are provided below:

#### 5.3.2.1 Petroleum costs

In the IPC, the petroleum costs paid by the contractor are divided to four categories:<sup>451</sup>

- Direct Capital Costs (DCC): paid during the exploration and development phases of the project to meet the development and production objectives
- Indirect Costs (IDC): paid during the development phase to Iranian governmental agencies. Such costs include Corporation Income Tax, Value Added Tax, Withholding Tax, customs duties and the like
- Cost of Money (COM): paid to compensate the contractor for costs to finance the project, but contrary to bank charges related to Buy Back Contracts, COM and are applicable to the IDC incurred prior to production and petroleum Costs and remuneration fees in relation to delayed or late payments. They are not related to DCC. The rate used to calculate COM is equal to LIBOR in addition to a premium.
- Operating Costs (OPEX): all costs related to the production phase as detailed in DP apart from COM, Capex and IDC.

#### 5.3.2.2 Remuneration Fee

Remuneration fees are paid to the IOC in consideration of the risks and expenditures it ‘adopts’ during the exploration and development phases, as well as the provision of technology and know-how.<sup>452</sup> The remuneration fees paid to the IOC are based on the magnitude of risk they take on.

#### 5.3.2.3 Cost recovery

In an IPC, cost recovery commences at the first year of production. The DCC and IDC paid by the IOC prior to production date, in addition to the COM as stipulated in the IPC shall

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<sup>450</sup> Elaheh Ghorbani, “Exploration, Development and Production of Iran's Fields and Reservoirs through the Iran Petroleum Contract (IPC)” (2020), *Journal of Energy & Natural Resources Law* 4.

<sup>451</sup> Sahebonar et al (n 423) 5.

<sup>452</sup> van Groenendaal and Mazraati (n 2) 3709.



depreciate over 5-7 years depending on the project demands and characteristics.<sup>453</sup> The 7-year limitation period of the Buy Back Contracts was simply not enough time for the IOCs to procure an adequate return on their investment. This was, of course, remedied via the IPC model with contracts valid for a period of 20 years, with the opportunity to extend it to 25 years upon mutual agreement by the contracting parties.<sup>454</sup> Upon first production, the IDC and OPEX (but not the DCC amortized over 5-7 years) are to be recovered by the IOC at cost without COM.<sup>455</sup> Hence, when the cost structures are considered, the IPC presents as a more favourable contract model to international investors / IOCs compared to the Buy Back Contract.

### 5.3.3 Investment, technology and exploration benefits

The final decision making around the current IPC model was to ensure that it remains “in accordance with the general terms of the most widely used oil and gas production contracts”.<sup>456</sup> Given this context, this thesis sought to answer key questions around the strengths and weaknesses of the IPC (RQ1), the impact of previous contract models (i.e. the Buy Back Contract) on the international petroleum trade (RQ2), and the extent to which the IPC best addresses the development needs of Iran’s oil resources sector (RQ3).

The IPC model designed by the Ministry of Petroleum of the Eleventh Government of Islamic Republic of Iran aimed to make the contracts more attractive to foreign companies.<sup>457</sup> The development of the new model is in response to the Iranian economy’s ongoing dependence on petroleum and the reality that such resources will one day be exhausted. In turn, the model design has the objective at least to support a long term and win-win relationship between the NIOC and the international petroleum companies.<sup>458</sup> The characteristic features of the IPC model are its attempt to optimise Buy Back contracts, transition toward global standards in petroleum contracts, attract foreign investors, and create a better balance between risk and reward.<sup>459</sup>

On 30 September 2015, the Parliament of Iran passed the Iran Petroleum Contract (IPC) Bill whereby greater scope is considered for transferring the production and operation of

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<sup>453</sup> Sahebonar et al (n 423) 4.

<sup>454</sup> Priyanka Prakash, ‘Iran Opens Up: New Goals, New Deals’ (Centre for Air Power Studies, 2017) 1.

<sup>455</sup> Ibid.

<sup>456</sup> Bijan Khajepour, ‘Will Iran Attract International Oil Firms in Post-Sanctions Era?’ (2016a) *al-Monitor* <<https://www.al-monitor.com/pulse/ar/originals/2016/11/iran-petroleum-contract-ipc-total-cnpc-azadegan.amp.html?skipWem=1>> (accessed 5 February 2020).

<sup>457</sup> Mazlumrahni and Esmail (n 433) 1.

<sup>458</sup> Seyed Hassan Mousavi, *A Legal Analysis of Service Contract in Oil and Gas Sector in Iran focusing on IPC* (GanjeDanesh, 2017) 22.

<sup>459</sup> Mazlumrahni and Esmail (n 433) 4.

petroleum reserves to foreign companies. This is contrary to Article 2 of the Constitution of Iran which, as previously established, limits the extraction and production of crude oil and gas to government sector and bans the transfer of operations to private sector companies irrespective of whether they are domestic or foreign. Nonetheless, the rationale for increasing foreign control over production and operations in IPCs is related to the perception in Iran that it is unable to adequately sustain production of petroleum fields due to lack of investment and technology.<sup>460</sup>

#### 5.3.3.1 Investment

Reports from the Iranian Parliament suggest that the NIOC gets 14.5% of the revenue from crude oil and condensate exports.<sup>461</sup> Iran's refining capacity was more than 2 million barrels per day in 2017 on the basis of domestic allocations. In addition, NIOC exports of crude oil and condensate in 2018 were around 2.5 million barrels per day, combined with domestic sales (discounted by 5%) of around 100,000 barrels per day.<sup>462</sup> This calculates to revenue of around \$7.6 billion to the NIOC based on an average oil price of \$55 per barrel throughout 2018. However, throughout 2018 it was expected that the NIOC would have expenses of up to \$29 billion.<sup>463</sup>

According to the *Law of the Sixth Five-Year Law of the First Five-Year Economic, Social and Cultural Development Plan* in Iran, the goal was to have the NIOC produce 4.7 million barrels per day of crude oil and 950,000 barrels per day of condensate by the end of 2020. To achieve such Development Plan goals, NIOC Director of Organisational Planning, Mohammad Delparish announced in 2015 that the NIOC would need in excess of \$65 billion.<sup>464</sup> However, there are several obstacles to attracting foreign investment for the development of the oil and gas fields and to thus achieving such outcomes. They include the perceived unattractiveness of the new IPC by foreign investors, issues around transparency in Iran's banking system, lack of international credit ratings for Iranian companies, currency exchange rate fluctuations, and international sanctions.<sup>465</sup>

#### 5.3.3.2 Technology

The reasons for Iran's need to access advance foreign technology and know-how are several. First and foremost, such technological advancements were benefitting the oil producing

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<sup>460</sup> Ibid 5.

<sup>461</sup> Chow et al (n 22) 4.

<sup>462</sup> Ibid.

<sup>463</sup> Ibid.

<sup>464</sup> Ibid.

<sup>465</sup> Ibid.

neighbouring countries of Iran, as well as the international petroleum industry more broadly.<sup>466</sup> There is little question that the political conviction in Iran to rely on domestic petroleum production capabilities for the management of the oil sector in order to satisfy the Constitution constrained the growth of the sector.<sup>467</sup> It should be acknowledged that the NIOC maintained adequate crude oil production levels although confronted with several challenges and deficiencies.<sup>468</sup> However, the upstream oil sector infrastructures in Iran were more than 40 years old on average towards the end of the 20<sup>th</sup> century, with the national pipeline network more than 35 years old, and most of the oil refineries underperforming as a result of inadequate equipment upgrades.<sup>469</sup> Furthermore, more than 80% of the oil produce in Iran is from a select few mature fields which require significant improvements in their recovery technology. A key issue for the majority of oil fields in Iran is that they have very low recovery rates; rarely above 20-22% for the top five fields.<sup>470</sup> As such, it is reasonable to assert that the constraints and limitations characterising the oil sector in Iran at this time may have been significantly remedied if advanced technologies international practices were harnessed more constructively after the Islamic Revolution. At present, the NISOC and IOOC<sup>471</sup>, two subsidiaries of the NIOC, are responsible for more than 90% of the petroleum production operation in Iran.<sup>472</sup>

#### 5.3.3.3 IPC role in future potential for increased oil production

The NIOC has the potential to increase crude oil production in Iran in two key areas. First, by capitalising on undeveloped and under-developed areas including the West Karun River (Arvandan) and the giant Azadegan field.<sup>473</sup> Second, by accessing the more technically-challenging reservoirs (e.g. the deep-level Bangestan Group of formations in the Khuzestan Province) that demand the use of advanced drilling and stimulation methods to increase the rates of recovery.<sup>474</sup> In terms of the development of the Arvandan Region, the bulk of Iran's untapped oil is situated in a number of giant and supergiant fields located in Khuzestan

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<sup>466</sup> Ghorbani (n 455) 3.

<sup>467</sup> Ibid.

<sup>468</sup> Ibid.

<sup>469</sup> Chow et al (n 22) 5.

<sup>470</sup> Ibid.

<sup>471</sup> National Iranian South Oil Company and Iranian Offshore Oil Company.

<sup>472</sup> Chow et al (n 22) 5.

<sup>473</sup> This supergiant field is the largest untapped oil field in the world

<sup>474</sup> The Ahwaz oil field is one such field. Most wells drilled in this field produce from the shallower Asmari formation, with currently less than 10% of production from the Bangestan formation. Production could potentially increase by 25% (around 220,000 barrels per day extra) by drilling the Bangestan reservoir. Plans to develop the Ahwaz oil field have never come to fruition, however, despite initial interest from BP.

Province, next to the border with Iraq.<sup>475</sup> It is reported that the NIOC has detected 12 oil fields across the region,<sup>476</sup> 5 of which are shared with Iraq. These fields have been identified by the NIOC as being of top priority for development.<sup>477</sup> Moreover, it is estimated by the Arvandan Oil & Gas Company that the shared border oil fields<sup>478</sup> contain more than 64 billion barrels of oil. In turn, the aim of the NIOC is to have production from these fields of 700 thousand barrels per day by 2022. To date, around 260,000 thousand barrels per day have been added to overall NIOC production following the completion of the first development phase in North Azadegan, North Yaran, and Yadavaran added. However, the development of these fields has been subjected to long delays.<sup>479</sup>

For instance, exploratory drilling commenced in 1976 in Azadegan but exploration in the region was halted due to political unrest in 1978, mass demonstrations and strikes by NIOC worker, and the 1979 Islamic revolution. Throughout the 1980s Iran was embroiled in a war with Iraq, with the Azadegan field being the location of a battle ground. Following the conclusion of the Iran-Iraq War, the risk associated with developing the border oil fields remained high as a result of issues around demining and clearing unexploded ordnance from the region.<sup>480</sup> The field in South Azadegan, categorised as a greenfield<sup>481</sup> under the IPC, is estimated to contain around 25 billion barrels of heavy oil. The production target for the South Azadegan field is 600,000 barrels per day with an expected investment requirement of around US\$4 billion. In turn, Memorandums of Understanding (MOU) to explore and develop the supergiant field signed by Shell, Petronas, Total, and Sinopec and accepted by the NIOC have been scuppered by the new round of sanctions imposed on Iran by the US.

### **5.3.4 Foreign interest in Iranian Petroleum Contracts**

Early interest from IOCs in investing in Iran's energy sector via the new IPC model was promising for the nation's ambitions. Following the announcement by Iran that it intended to restructure its energy sector contract framework in 2015, the initial interest from international companies was promising.<sup>482</sup> With more than 28 signed MoUs accepted by the NIOC for joint operations between Iranian domestic companies and IOCs, it appeared that Iran's energy

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<sup>475</sup> Chow et al (n 22) 8.

<sup>476</sup> Azadegan, Darquain, Sohrab, Yadavaran, Yaran, Omid, Band Karkheh, Moshtagh, Khorramshahr, Susangerd, Arvand and Jufeyr.

<sup>477</sup> Chow et al (n 22) 8.

<sup>478</sup> North and South Azadegan, North and South Yaran, and Yadavarn.

<sup>479</sup> Chow et al (n 22) 8.

<sup>480</sup> Mahdavi (n 218) 243.

<sup>481</sup> 50,000 barrels per day produced in 2016.

<sup>482</sup> Prakash (n 459) 1.

sector would have access to the billions of dollars of investment and the transfer of technology and expertise it was seeking.<sup>483</sup>

The only MoU to transition into a contract is the multi-billion-dollar contract agreed to by the NIOC and the consortium comprising French Total (51% share), the China National Petroleum Corporation (CNPC, 30% share) and Iranian Petropars 19% share) in July 2017 to develop South Pars Phase 11.<sup>484</sup> This represents the first significant investment from a foreign investor company in Iran after the JCPOA agreement, with the project cost estimated to total 4.8 billion euros. With the contract signed for 20 years, this deal marks the first return of French Total to Iran since the 1990s.<sup>485</sup>

Notwithstanding extensive exploratory drilling to determine the geologic extent of the Azadegan fields, the full petroleum system in Azadegan remains unclear due to a lack of adequate exploration studies.<sup>486</sup> Although production levels could be maintained at around 400,000 barrels per day for the next two decades with the technology currently available, foreign expertise and technology are needed to support sustained rates of production in newly drilled wells.<sup>487</sup> According to the NIOC, the priority during the first rounds of IPC negotiations with IOCs is to fast-track the development of its shared oil fields.<sup>488</sup> In turn, this is confirmed with the only two contracts with international partners to have been signed by the NIOC to date. What is clearly evident, however, is that Iran has largely failed to attract the foreign investment it needs under the IPC. The Trump Administration's withdrawal from the JCPOA on the Iranian nuclear program and the subsequent reinforcement of sanctions has unquestionably and significantly impacted Iran's capacity to attract foreign investment. However, so too has the unattractiveness of the terms and conditions of the IPC.<sup>489</sup>

The domestic exploration and production companies listed as 'partner options' for IOCs wishing to invest include, but is not limited to, eight firms including the IRGC conglomerate KAA and a subsidiary of the NIOC, the Industrial Development and Renovation Organisation

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<sup>483</sup> Ibid.

<sup>484</sup> National Iranian Oil Company, 'Iran, Frances Total Sign Deal to Develop South Pars Phase 11', June 3, 2017 <<http://www.nioc.ir/portal/Home/ShowPage.aspx?Object=NEWS&ID=c5ae788e-4c87-4e10-a41bf64946f6cc08&LayoutID=dfcdbc2a-d23c-4d84-a9ad5104719e9d10&CategoryID=65c76df2-8d90-4f41-9b18-8b22a277f981>> (accessed 20 March 2020).

<sup>485</sup> Ibid.

<sup>486</sup> Richard Devine and Ida Mokhtassi, 'Iran's Council of Ministers ratifies IPC Terms' (Clyde & Co, 2016) 1.

<sup>487</sup> Ibid.

<sup>488</sup> Iran shares 19 oil and gas fields with neighbours: offshore fields with Saudi Arabia, UAE, Kuwait, Qatar and Oman; and onshore fields with Iraq.

<sup>489</sup> Chow et al (n 22) 7.

and the SETAD, a government body controlled by the Supreme Leader of Iran mandated to manage these activities.<sup>490</sup>

The list of countries certified to bid for oil and natural gas tenders to be part of a JVA (see Table 5.1) gives an indication of the relationship between the IPCs and the shifting foreign policy position of Iran. The diversity of international oil and gas companies and their countries of origin, along with the marketing expertise they bring with them, were regarded as advantageous by Iran in its aim to build a more resistant and self-reliant economy.<sup>491</sup> Iran had experienced the consequential effects of Western sanctions of its energy industry and appeared reluctant to become too dependent on IOCs operating out of the US and Europe particularly.<sup>492</sup> The introduction of IPCs, combined with the strategy to engage diverse types of IOCs thus reflects Iran’s attempt to re-engage with the international market to strengthen and improve its domestic economy.<sup>493</sup>

Table 5.1 IOCs with certification to bid at Iran’s oil and natural gas tenders, 2017

CNOOC (China)	Korean Gas Corp. (Sth. Korea)	PGNiG (Poland)
CNCP (China)	Lukoil (Russia)	Plus Petrol (Argentina)
CNPW (China)	Maersk (Denmark)	Posco Daewoo (Sth. Korea)
DNO (Norway)	Mitsubishi (Japan)	PTTEP (Thailand)
Eni (Italy)	OMV (Austria)	Schlimberger (Netherlands/US)
Inpex (Japan)	ONGC Videsh (India)	Shell (Netherlands/UK)
ITOCHU (Japan)	Pereneco (France/UK)	Sinopec (China)
Gazprom (Russia)	Pertamina (Indonesia)	TOTAL (France)

Source: David Jalilvand and Friedrich Ebert Foundation<sup>494</sup>

<sup>490</sup> Ibid 21.

<sup>491</sup> Shahdani Mahdi Sadeghi and Mahdi Pakzat Seyed, ‘Oil Futures Contracts, Obligation to Selling or to Daily Settlement?’ (2018) 6(1) *Journal of Asset Management and Finance*, 181.

<sup>492</sup> Ibid.

<sup>493</sup> David Ramin Jalilvand, ‘Iran’s Gas Exports: Can Past Failure become Future Success?’ (The Oxford Institute for Energy Studies, 2013) 7.

<sup>494</sup> David Jalilvand and Friedrich Ebert Foundation, ‘Iranian Energy: A Comeback with Hurdles’ (The Oxford Institute for Energy Studies, 2017) 1 <<https://www.oxfordenergy.org/wpcms/wp-content/uploads/2017/01/Iranian-Energy-a-comeback-with-hurdles.pdf>> (accessed 15 February 2020).

#### 5.3.4.1 Tender model

Of significance is the evaluation criteria applied to determine successful bidders. The fee per barrel is linked to the market and so a primary selection criterion is the IOC's market price percentage "bid" as the base fee per barrel.<sup>495</sup> The "field risk" adjustment factor as part of the overall fee structure is generally pre-determined. Moreover, the production plan is agreed to by both parties within the broader scope of the Development Plan. As such, it remains unclear as to the bases upon which the bidders differentiate themselves. For example, the fee per barrel and production targets are considered critical tender metrics in the Iraqi contract model.<sup>496</sup> It is unlikely that the NIOC applies only technical evaluations when selecting successful tenders, and so other specific commercial criteria must also be bid upon. These criteria may include the flexibility to offer an increase or decrease in the fee adjustments relating to each "R" index step change, or an agreement to finance commitments to "Minimum Obligations" in the exploration stage.<sup>497</sup> The evaluation criteria will naturally differ depending on the prospects of each project (i.e. greenfield or brownfield), but the exact nature of the criteria differences is not explicit in the IPC. It may be that some smaller IPCs do not make their tender public (with the consent of different governing bodies). Furthermore, it is not clearly apparent as to whether there are grandfathering clauses or alternative treatment for those concessions already agreed to under the Buy Back Contract model.<sup>498</sup>

#### 5.3.4.2 Iranian Petroleum Contracts and the Joint Comprehensive Plan of Action

It has been well-established in this thesis that there are many challenges associated with the formulation of petroleum contracts. As such, they are invariably the source of disputes between the negotiating parties irrespective of the prevailing geopolitical tensions in the region. Proponents of the IPC model argue that it can play a vital role in Iran's interactions on the international stage and the development of its resources, despite whatever weaknesses they may perceive the contract model to have.<sup>499</sup> The key element in the JCPOA is the Iranian government's agreement to limit the capacity or close the nuclear facilities in the

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<sup>495</sup> Moslem Alimohammadlou and Abbas Bonyani, 'Iran's Energy Policy After the Nuclear Deal for Cooperation with Foreign Oil and Gas Companies' (2019) 12(2) *International Journal of Procurement Management* 199, 199.

<sup>496</sup> Ibid.

<sup>497</sup> Dallas and Black (n 369) 7.

<sup>498</sup> Ibid.

<sup>499</sup> Amir Ahmadi, 'The Impact of Economic Sanctions and the JCPOA on Energy Sector of Iran' (2018) 13(5) *Global Trade and Customs Journal* 198, 199.

country in return for the lifting of sanctions.<sup>500</sup> In this post-sanction environment, the government of Iran saw an opportunity to attract IOCs back into the country. To do this, however, the Iranian government believed that the petroleum contract model needed to be more attractive to the interests of foreign entities.<sup>501</sup> The IPC model was also seen by the government as a way to build stronger connections between the economy in Iran and the world economy. That is, they could help to establish stronger ties between the banks in Iran and major foreign banks by encouraging the foreign entities to invest in Iran's energy sector.<sup>502</sup>

#### 5.4 United States Sanctions

All of the potential investment, technology and exploration benefits potentially accessed via the IPC must of course be considered in the context of the newly reimposed US sanctions. As alluded to earlier, a key reason why the NIOC was unable to attract significant foreign investment through the IPC upon the implementation of JCPOA was the US sanctions imposed on Iran and the associated risk of sanctions snap back for foreign entities.<sup>503</sup> Certainly, there were several investment opportunities within different section of the petroleum value chain announced by the NIOC. Examples of such projects include oil field development plans, oil exploration blocks, and crude oil storage facilities, pipelines and pump stations.<sup>504</sup> On 8 May 2018, the Trump Administration announced the US withdrawal from the JCPOA, simultaneously announcing the reimposition of all US sanctions either lifted or waived as part of the JCPOA<sup>505</sup>. This included reimposing the:

- *National Defense Authorization Act (NDAA) 2012 s 1245,*
- *sanctions under the Iran Freedom and Counter-proliferation Act (IFCA) 2012,*
- *sanctions under the Iran Sanctions Act (ISA) 1996, and*
- *sanctions under the Iran Threat Reduction and Syria Human Rights Act (ITRSHRA) 2012.*

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<sup>500</sup> Ibid.

<sup>501</sup> Mazlumrahni and Esmail (n 433) 7.

<sup>502</sup> Ibid.

<sup>503</sup> Paul Rivlin, 'Leverage of Economic Sanctions: The Case of US Sanctions Against Iran, 1979–2016' in Mikael Wigell, Sören Scholvin and Mika Aaltola (eds) *Geo-economics and Power Politics in the 21st Century* (Routledge, 2018) 99.

<sup>504</sup> Ibid.

<sup>505</sup> National Security Presidential Memorandum/NSPM-11, <<https://fas.org/irp/offdocs/nspm/nspm-11.pdf>>.



Agencies and departments in the US implemented the sanctions based on 90-day and 180-day wind down periods. Following the designated period, the relevant sanction would be placed back into full effect. For example, at the conclusion of the first 90-day period on 7 August 2018, sanctions were reimposed on:

- Iran's automotive sector,
- undertakings linked to the issuance of sovereign debt,
- Iranian rial-related transactions,
- Iranian gold and precious metals trade,
- graphite, aluminium, steel, coal, and software used in industrial processes, and
- Iranian government US bank note acquisitions.<sup>506</sup>

Around this time the Trump Administration re-stated its intention to reimpose sanctions on:

- Iran's energy, shipping, and shipbuilding sectors along with port operators,
- petroleum-related transactions by Iran, and
- transactions by foreign financial institutions with the Central Bank of Iran.<sup>507</sup>

In terms of snap back, the Trump Administration indicated that it intended to enforce the sanctions fully, warning that any country which did not wind down its trade activities with Iran would risk severe consequences.<sup>508</sup> Regarding the petroleum sector in Iran and the attractiveness of the IPC, the sanction by the US to have had the most significant impact is arguably *NDAA 2012* s 1245. This gives authority to the US Secretary of the Treasury to work with the US Secretary of State to impose sanctions on foreign financial institutions. Specifically, the section prohibits foreign financial institutions from participating in the US financial system if they are found to conduct transactions with the Central Bank of Iran.<sup>509</sup>

There are exemptions for some countries importing crude oil under section 1245 (d)(4)(D) of the Act if the President accepts that the country has "significantly reduced" its purchasing volumes, but exactly what constitutes "significantly reduced" has not been well-clarified by the US State Department.<sup>510</sup> The sanctions can include a prohibition on, or the placement of

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<sup>506</sup> Rivlin (n 508) 101.

<sup>507</sup> United States Treasury, 'Executive Order 13846: Reimposing Certain Sanctions with Respect to Iran' <[https://www.treasury.gov/resourcecenter/sanctions/Programs/Documents/08062018\\_iran\\_eo.pdf](https://www.treasury.gov/resourcecenter/sanctions/Programs/Documents/08062018_iran_eo.pdf)> (accessed 3 May 2020).

<sup>508</sup> Andrea Shalal, 'Pompeo Warns Russia, China Against Ignoring Move to Reimpose U.N. Sanctions on Iran' *Reuters* (August 20, 2020) <https://www.reuters.com/article/us-usa-iran-un-sanctions/pompeo-warns-russia-china-against-ignoring-move-to-reimpose-un-sanctions-on-iran-idUSKCN25F2S4>> (accessed 7 September 2020).

<sup>509</sup> Chow et al (n 22) 11.

<sup>510</sup> *Ibid.*

strict conditions around, companies opening accounts with foreign financial institutions that knowingly conduct or facilitate financial transactions with the Central Bank of Iran or other designated financial institution in Iran.<sup>511</sup> Such sanctions significantly impacted the ability of Iran to export petroleum or petroleum products. Moreover, sanctions may be imposed on foreign financial institutions by the US Secretary of the Treasury if said institution knowingly conducts or supports significant financial transaction with the NIOC.

Section 312 of the *ITRSHRA* had declared the NIOC to be an agent of the IRGC according to Executive Order 13846. When all of these actions by the US are combined they had the effect of placing severe restrictions and constraints arounds Iran's access to foreign investment and technology.<sup>512</sup> Moreover, it put a significant dent in the volume of petroleum exports out of Iran and thus the amount of revenue being injected back into the Iranian economy. Such conditions and outcomes presented significant challenges to the NIOC's capacity to achieve its development goals. It is important to point out however that the most recent round of sanctions placed on Iran by the US have been done so unilaterally and without the support of some US allies (e.g. Germany and France).<sup>513</sup> In terms of the petroleum sector in Iran, the geo-political implication of the reimposition of severe and lasting sanctions on Iran may be a stronger presence of China and Russia in the exploration and development of Iranian petroleum. These countries, who are arguably more prepared to work around the US sanctions if it is in their best interests to do so,<sup>514</sup> will in turn be more likely to be offered lucrative contract terms to attract their interest and involvement should such interest fade from Western companies (e.g. Total).<sup>515</sup> Indeed, 'China is actively creating financial channels for purchasing petroleum from Iran that circumvent the sanctions imposed by the US'.<sup>516</sup> Notwithstanding these movements from some countries, the reality is that the current round of US imposed sanctions presents a major challenge for Iran to get its oil to the international market and hence to inject much needed capital into the oil and gas sectors. Fulfilment of the *Law of the Sixth Five-Year Law of the First Five-Year Economic, Social and Cultural Development Plan* is reliant on a significant increase in revenues from oil and gas sales. In

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<sup>511</sup> *NDAA 2012* s 1245.

<[https://www.treasury.gov/resourcecenter/sanctions/Programs/Documents/ndaa\\_publaw.pdf](https://www.treasury.gov/resourcecenter/sanctions/Programs/Documents/ndaa_publaw.pdf)> (accessed 18 December 2019).

<sup>512</sup> Chow et al (n 22) 9.

<sup>513</sup> *Ibid.*

<sup>514</sup> Shalal (n 513).

<sup>515</sup> *Ibid.*

<sup>516</sup> Chow et al (n 22) 9.

turn, the sanctions have unquestionably presented significant logistical challenges to Iranian petroleum exports, led to a significant reduction in volume, as well as loss of production. Although the US does not import crude oil from Iran, the formidable range of sanctions it has imposed have severely restricted the extent to which countries – both allies and adversaries of the US, conduct business with Iran.<sup>517</sup>

It is worth mentioning that many countries to import oil from Iran are reluctant to participate in sanctioning the nation. Indeed, the European Union, Germany, Canada and other US allies, along with China and Russia, have made clear their intentions to not withdraw from the JCPOA.<sup>518</sup> Hence, Chow et al. have argued that the unilateral decision by the US to reimpose sanctions on Iran “creates the perverse impetus for some countries to come to the aid of Iran” by engaging in initiatives to try to save the JCPOA.<sup>519</sup> Although such initiatives have proved largely to be symbolic, with limited protection provided to the energy resources sector in Iran, they arguably have some positive implications for Iran IPC scheme. To clarify, the sanctions draw the focus of the international community onto Iran’s resources sector and on ways to deal with Iran to potentially create trade opportunities once the sanctions have been lifted.<sup>520</sup> Furthermore, it has arguably strengthened Turkey’s trade relationship with Iran. As a major importer of crude oil from Iran, Turkey has clearly indicated that it intends to keep such trade agreements with Iran in place. In addition, a significant volume of crude oil exports from Iran now go to China and India, which was not the case during the previous round of sanctions.<sup>521</sup> This has the potential to significantly reduce the effect of US sanctions on the Iranian oil and gas sectors as the sanctions arguably rely on the support from China and India for their impact.<sup>522</sup> Nonetheless, the power and the reach of the US Administration to significantly reduce Iran’s capacity to develop its resources sector over the long term should not be underestimated.

## **5.5 Comparing Buy Back Contracts to Iranian Petroleum Contracts**

The central focus of this thesis is the extent to which the IPC presents as a better contract model than the Buy Back model for the NIOC as a contracting party and for the development

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<sup>517</sup> Ibid.

<sup>518</sup> Tatja, Cronberg. ‘No EU, No Iran Deal: The EU's Choice Between Multilateralism and the Transatlantic link’ (2017) 24(3-4) *The Nonproliferation Review* 243, 244.

<sup>519</sup> Chow et al (n 22) 11.

<sup>520</sup> Ghorbani (n 455) 4.

<sup>521</sup> Ibid.

<sup>522</sup> Reuters (n 27).

of Iran's oil and gas sectors more broadly. The primary objective for developing the IPC was to address and improve upon the flaws in the Buy Back Contract form. In total, the Buy Back Contracts underwent three revisions in around 20 years in an attempt to make them more appealing to foreign investors. However, the short-term contract periods combined with the failure of the Constitution in Iran to recognise reserve booking rights for IOCs, thwarted the potential for the success of the Buy Back Contracts.<sup>523</sup> The petroleum projects completed or in operation under the Buy Back scheme contributed total production of 700,000 barrels per day oil.<sup>524</sup>

Comparisons can be made between key elements of the IPC and Buy Back Contract models in relation to the insertion of contractual considerations, the development of contractual risks and how to respond to such risks. In turn, one of the main complaints directed towards the Buy Back Contract model was its lack of flexibility for the IOC.<sup>525</sup> That is, the Buy Back Contract involved the preparation of a Master Development Plan by the contracting parties. The parties also agreed on an investment ceiling, with the cost-recovery period negotiated by the parties along with an agreement on a fixed ROR.<sup>526</sup> The Capex was paid by the IOC who was also responsible for the development of the field. The costs outlaid via Capex was regarded as a 'loan' to the Iranian state, with annuity payments subsequently made from the commencement of production, or when the production target was achieved, until the end of the contract term. These payments were designed to allow the IOC to recover capital expenditures, operating costs and finance charges accumulated during the development phase.<sup>527</sup> Alternatively, the IOC may agree to payment in kind. The development phase of the contract was typically 2-4 years and the production phase was generally around 5-10 years duration. While it is generally regarded that the Buy Back Contract was not the optimal form of technical-service contract, the ROR on investment of around 15-18% on investment was appealing enough to attract numerous IOCs to invest in the development of Iran's oil fields during the 1990s and early 2000s.<sup>528</sup>

Furthermore, the unclear provisions around contract extensions in the Buy Back Contract model left the IOC at greater exposure to risk of not having a request for a time extension

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<sup>523</sup> Chengyuan Li, Mingjun Jiang, Haiming Ge, Zhen Li and Dongkun Luo, 'An Operational Risk Analysis of Iran Buyback Contract and its Policy Implication' (2017) 16 *Energy Strategy Reviews* 43, 43.

<sup>524</sup> Chow et al (n 22) 7.

<sup>525</sup> Li et al (n 528) 43.

<sup>526</sup> Ibid 44.

<sup>527</sup> Ibid.

<sup>528</sup> Ebrahmi and Khouzani (n 232) 150.

granted and thus incurring damages due to delay. This added to the risk for the IOC given the list of events cited as permissible for relieving the IOC from its requirement to complete the operations by the deadline may be limited to such things as failure to provide site possession, undertaking additional or extra activities, and special circumstances beyond the control of the contractor. In contrast, IPCs which include appropriately drafted clauses regarding extension of time provisions can be advantageous to both the IOC and NIOC (or affiliate) in relation to respecting the contracted time to complete works, protecting the rights of the IOC regarding delays caused by the host nation, and preserving the host nation's rights to liquidated damages.<sup>529</sup> Moreover, extension of time provisions in exploration and production contracts can provide IOCs with access to more exploration areas and additional time to produce from the fields.

Hence, the IPC is much more flexible regarding the exploration phase in general and the integration of the exploration and development operations for new fields. Such flexibility is evident in the IPC through its allowance of the IOC to explore nearby fields in the case that the originally agreed-to field is non-productive. Under the terms of the Buy Back Contract, the IOC would be obligated to stay with the development plan already agreed-to.<sup>530</sup> In addition, it offers greater flexibility around oil recovery from brown fields – improved oil recovery (IOR) and enhanced oil recovery (EOR) – and the development of the common fields with neighbouring countries.<sup>531</sup> Lastly, the IPC includes more flexible provisions around the exploration, development and production operations in high risk regions and deep waters, integrated exploration, development and production and IOR/EOR, as well as in the development of green fields.<sup>532</sup> Hence, a key defining feature of the IPC is the integration of exploration, development and production operations. The flexibilities of the IPC compared to the Buy Back Contract are:

1. Flexible Development Plan.
2. Work to annual work program and budget rather than to fixed capped costs.
3. Full cost recovery for IOC.
4. Better balance between risk and reward.
5. Flexible reward structure that considers changes in the price of oil.

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<sup>529</sup> Aline El Sayed, 'Contractors' Right to Clearer Provisions for Time Extension' (2015) <<http://www.qatarconstructionnews.com/contractors-right-clearer-provisions-time-extension/>> (accessed 12 December 2019).

<sup>530</sup> Prakash (n 459) 1.

<sup>531</sup> Sadeghi and Seyed (n 496) 181.

<sup>532</sup> Ibid.

6. Flexible fee structure based on the level of risk for different areas.
7. Cost Saving Index (CSI).
8. More participative decision-making process.
9. Opportunity for further exploration operations in neighbouring fields in case of failure.
10. Flexibility in long-term cooperation in case of EOR.

To provide a comprehensive discussion of the advantages and disadvantages of IPCs compared to Buy Back Contracts from Iran’s perspective, it is necessary to identify their key differences. Table 5.2 presents a comparison of the two contract models including such elements as contract model objective, contract duration, the role and rights of the contractor and others.

Table 5.2 Comparison of the Buy Back Contract and IPC models

<b>Buy Back Contract</b>	<b>IPC</b>
Strategic objective is to preserve the sovereignty of the Iranian government over the nation’s natural resources	Strategic objective is to promote IOCs to use the latest technologies in oil reserve management and petroleum production in order to build capacity of the domestic resources sector
Contractor acts as operator during the exploration and development phases, with operatorship during the production phase assigned to the NIOC.	Favours JVA between Iran (typically NIOC or an affiliate) and the IOC to better access and exploit their technologies.
Positions the Iranian party more as a contractor.	Positions the Iranian party more as a ‘technical’ partner.
Comprises four phases: exploration, development, production and enhanced/improved recovery	Comprises four phases: exploration, development, production and enhanced/improved recovery
Term of contract typically around 5-7 years (2-3-year development period; 4-7-year remuneration).	Term of contract generally between 20-25 years providing foreign investors with more certainty and investment incentive.

Reflects the Iranian Constitution stating ownership of natural resources belongs to the “nation” and cannot be transferred.	Includes provisions for the transfer of ownership of hydrocarbons to foreign partners at specified delivery points. Ownership rights are not however extended to project assets.
Foreign company afforded limited reward for carrying risks. No incentives provided.	Foreign company rewarded for carrying risks as ‘manager’ of the project.
Recoverable capital costs by the contractor are capped (costs are an estimation of project development expenditures). A cap increase for additional works must be approved by the NIOC	Recoverable costs based on an annual work programme and the budget approved by the contracting parties. The NIOC is given final right of approval.
Contractor receives a pre–agreed rate of return from production revenue allocated by the NIOC according to a long–term export sales agreement	Favours the development of ‘joint fields (NIOC and IOC operated) and higher remuneration rates to incentivise investment.
Remuneration fees can be unilaterally reduced by the NIOC if production falls below the level stated in the field development plan.	Field development plan includes a minimum production target approved by the NIOC. However, the consequences of not meeting the targets are not stipulated.
Contracting party disputes to be resolved via escalation, with arbitration as the final method.	Contracting party disputes to also be resolved via escalation, with arbitration as the final method.
No incentives provided to undertake exploration / production of higher risk/ cost fields.	Incentives offered to IOCs for undertaking higher risk fields, and EOR on brownfield projects.
Sanctions and 'snapback' of secondary sanctions not applicable	'Snapback' of US secondary sanctions not recognised as a force majeure event. NIOC <u>not</u> to grant withdrawal rights to contractor in the event of a snapback.

Sources: Creed and Kordvani 2014, 2-3; Kalehsar and Telli, 2017, 165; Parris and Skyner 2017, 1-4.

To sum up, the main issues with the Buy Back Contract are identified as its inflexibility in regard to the scope of the contract, the fixed capital costs and the limited opportunities to



recover cost blow outs.<sup>533</sup> In addition, the contract scheme includes a limited amortization period to recover remaining costs and there is a lack of production operation coverage. Lastly, the Buy Back Contract model does not allow for additional investment in development and IOR/EOR operations, is time-consuming in terms of approval procedures and requires many interventions in decision making.

### 5.5.1 Pros and cons of the Buy Back Contract

The Buy Back Contract scheme in Iran was estimated to attract around US\$50 billion from foreign investor companies between 1995 and 2005.<sup>534</sup> The implementation of sanctions from 2010 to 2014, however, saw a significant down turn in investment as international organisations withdrew their interest to avoid ramifications from the US.<sup>535</sup> The development of the contract model emerged in the context of a lack of modern / advanced technologies across the industries supporting the exploration, development and production of oil and gas fields in Iran.<sup>536</sup> As previously established, it is a type of service contract granting contractor rights to an IOC to explore and develop the nominated oil or gas field.<sup>537</sup> Following NIOC approval, the costs and expenditures of the project for the IOC are to be reimbursed to them from the revenue generated through the sale of the product according to the terms and conditions of the contract.<sup>538</sup> Broadly speaking, because the IOC is required under the terms of the Buy Back Contract to make up-front payments for the costs of exploration and development up-front, at no stage is it in a position to gain equity rights under the agreement.<sup>539</sup> Table 5.3 provides a snap-shot summary of the main pros and cons linked to Buy Back Contracts from the perspective of Iran’s interests.

Table 5.3 Pros and cons of Buy Back Contracts for the oil and gas sectors in Iran

Pros	Cons
Contract model meets Constitutional requirements including the protection of	Project risks heavily carried by IOC, meaning the contract model is broadly

<sup>533</sup> Li et al (n 528) 43–45.

<sup>534</sup> Li et al (n 528) 43.

<sup>535</sup> United States Energy Information Administration (n 38).

<sup>536</sup> M. Me, ‘The Iranian Buyback Model and Its Efficiency in the International Petroleum Market-A Legal View’ (2009) 7(1) *Oil, Gas and Law Intelligence* 22.

<sup>537</sup> Abbas Ghandi and Cynthia Lin Lawell, ‘On the Rate of Return and Risk Factors to International Oil Companies in Iran's Buy Back Service Contracts’ (2017) 103(1) *Energy Policy* 16, 16.

<sup>538</sup> Ibid 18.

<sup>539</sup> Mohammad Reza Moghaddam, ‘Analysis of Buy Back Contracts and Adduction Optimization Model of Contract for Iran (Farsi)’ (2008) 76 *Economy Research Journal* 162, 162.



Iran's sovereignty (ownership) over its natural resources	unattractive to IOCs, thus limiting optimal access by Iran to foreign investment capital
Relatively short contract duration forces IOCs to carry most of the risks around exploration, development and production.	Relatively short contract duration limits incentivisation of IOCs to optimise petroleum production efficiencies and opportunities for transfer of advanced technologies to Iran's oil and gas sectors
Omission of any clause allowing IOCs to renegotiate the contract terms and conditions due to unexpected events means risks related to fluctuations in the price of petroleum and their implications for revenue raising from volume of petroleum produced is carried by the IOC	NIOC capacity to reimburse IOC for exploration and development costs impacted by changes in the market price of crude oil
Iran's legal system and domestic courts have jurisdiction over the settlement of disputes and certain commercial transactions	Complicated bureaucratic administrative processes limit the NIOC's capacity to respond quickly and consistently to decision making on unexpected and unavoidable changes in circumstances.
Fixed ROR provision means risk of not being able to generate sales revenue to cover petroleum production costs of due to falling petroleum prices is carried by the IOC	Fixed ROR does not incentivise IOCs to maximise total production via pursuit of additional reserves and improvements in petroleum recovery and production methods

(Sources: Bunter, 6, 7; Ebrahimi and Shiroui, 2; Kuhn and Jannatifar 15; Me, 22)

#### 5.5.1.1 Restrictive strategic objective

A more comprehensive analysis of the pros and cons of the Buy Back Contract model from the perspective of Iran reveals a range of complexities. For instance, depending upon your adopted political position, the strategic objective of the Buy Back Contract model may be viewed as either a pro or a con. Adopting a politically neutral position, this thesis asserts that the strategic objective of the Buy Back Contract model may be viewed primarily as a 'con' or disadvantage for Iran's oil and gas sectors overall. To explain, it has been established that the objective of the Buy Back Contract is two-fold: to preserve the sovereignty of the Iranian

government over the nation's natural resources; and to preserve the Iranian government's control over the operations of its resource fields.<sup>540</sup> Buy Back Contracts thus provide authorisation to IOCs to conduct petroleum field exploration and development on behalf of the NIOC.<sup>541</sup> Following the exploration and development stages, the production stage commences whereby management of the field operations is transferred to the NIOC or the affiliate organisation. The contract stipulates the annual capital expenditures with the IOC being fully reimbursed following approval from the NIOC.<sup>542</sup> Within all these contract stipulations, the requirement is for strict adherence to Iran's Constitution and Petrol Laws to meet the strategic objective of the Buy Back Contract; namely, the non-negotiable condition that Iran maintain ownership at all times over all resource field developments.

#### 5.5.1.2 Risks carried by IOCs disincentivise field optimisation

An important implication of the strategic objective of the Buy Back Contract model is that it contributes to perceptions of a high level of investment risk by IOCs. This is arguably a negative consequence of the contract model for the NIOC and for the development of Iran's resources in terms of attracting foreign investment into its oils and gas sectors. Of most concern to IOCs is the high level of risk they are required to accept for the rights to explore for and develop a potentially commercial petroleum field.<sup>543</sup> Contributing to their risk perceptions is that all assets acquired by them remain under NIOC ownership, to be offset according to agreed petroleum purchases and remuneration from the NIOC until the control of the assets by the contractor is revoked.<sup>544</sup> This is in addition to the risks carried by the IOC related to higher than estimated and agreed capital expenditures or higher distribution of capital requirements during the construction of the field. In these circumstances, the IOC is obliged to cover any additional costs.<sup>545</sup>

#### 5.5.1.3 Risks for IOC related to costs recovery

Moreover, an unexpected fall in the price of petroleum in the market can add financial pressure to the operations of the IOC. It should also be noted that the terms of the Buy Back Contract are also potentially disadvantageous to the NIOC, given a fall in the price of petroleum increases its liability as remuneration to IOCs is paid in cash from petroleum

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<sup>540</sup> Ebrahimi and Khouzani (n 232) 2.

<sup>541</sup> Ibid.

<sup>542</sup> van Groenendaal and Mazraati (n 2) 3709.

<sup>543</sup> Tavana Energy, 'Iran Petroleum Contract' <<http://tavana-energy.com/iran-petroleum-contract/>> (accessed 17 February 2020).

<sup>544</sup> Ibid.

<sup>545</sup> Ibid.

sales.<sup>546</sup> However, the terms of the Buy Back Contract stipulate that the NIOC can postpone repayments on expenditures and remuneration from sales revenue if the price of petroleum goes below the agreed level. This is a clear detraction of the contract model for the investor company because it is required to cover the shortfall while maintaining the agreed rate of return from production.<sup>547</sup> The risks around having no ownership stake, but still being required to meet rates of production, cover the costs of the exploration and development, and meet the schedule of the project have been raised consistently by IOCs as issues of concern. In essence, the Buy Back Contract does not offer the same level of compensation for these risks compared to alternative contract models.<sup>548</sup> As a result, the detraction for IOCs is that there is little value in developing and/or deploying advanced technologies if the ownership of the technologies is to be transferred to the NIOC at the conclusion of the development phase.<sup>549</sup>

#### 5.5.1.4 Implications of short contract duration

Heightening the level of risk perceived by IOCs is the relatively short life-span of the contract; namely, between 5 to 10 years along with a five-year investment recovery period. The short contract length is considered to reduce incentives for the IOC to implement processes to maximise the production life of the field. Rather, it arguably incentivises the IOC to implement potentially damaging production rates to maximise cost recovery within the contract period.<sup>550</sup> Moreover, the short-term nature of the Buy Back Contract has implications for the IOC's capacity to develop a 'comprehensive' understanding of the field and thus the best strategic approach for its development.<sup>551</sup> This may include revising the investment requirements in response to changes in the extent or 'behaviour' of the field, or how to optimise the extraction of petroleum over the field's full life-cycle. This detraction would often steer IOCs towards alternative contract models including PSAs.<sup>552</sup> The lack of incentivisation of IOCs to optimise petroleum production efficiencies of the field under the terms of the Buy Back Contract thus implies a negative outcome for the

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<sup>546</sup> Tavana Energy (n 548) 162.

<sup>547</sup> Ibid.

<sup>548</sup> Roohollah Kohan Hoosh Nejad, Davood Manzoor and Masoud Amani, 'Economic Evaluation of Fiscal Regime of Buy Back Contracts in Comparison with Production Sharing Contracts (Case Study: Azadegan Oil Field)' (2018) 22(2) *Iranian Economic Review* 579, 579.

<sup>549</sup> Moghaddam (n 544) 161.

<sup>550</sup> Michael AG Bunter, 'The Iranian Buy Back Agreement' (2009) 3(1) *Oil, Gas & Energy Law Intelligence (OGEL)* 6, 7.

<sup>551</sup> Ibid.

<sup>552</sup> Ibid.

development of Iran's oil and gas sectors.<sup>553</sup> The short contract duration in which to exploit the field to its full potential places pressure on the IOC to maximise costs recovery via the sale of petroleum during peak production. This limits the capacity of the IOC to actively seek ways to extend the period of peak performance, and therefore increase petroleum sales, before production is transferred to the NIOC.<sup>554</sup>

#### 5.5.1.5 Risks to the contracting parties related to reimbursement of costs

The reimbursement mechanism in the Buy Back Contract model however presents some disadvantages to both the NIOC and IOCs as contracting parties. To clarify, an initial amortisation period is established (typically 5-8 years) during which time the IOC contractor recovers costs plus interest based on the London Interbank Offered Rate (LIBOR) in addition to a per-month remuneration fee.<sup>555</sup> Along with costs recovery, the terms of the Buy Back Contract include the payment of a fixed amount to the IOC to acknowledge the investment risk it has taken.<sup>556</sup> This remuneration fee is paid upon achievement of the project objectives as set out in the Field Development Plan (FDP)<sup>557</sup> and following the handing over of the project to the NIOC at the commencement of the production stage.<sup>558</sup> In addition, the IOC is granted the right to a discount-rate purchase (typically 5% below market rate) of a percentage of the petroleum produced. As such, the NIOC must bear the risk of a fall in the market price of crude petroleum price and hence its capacity to cover the instalment costs to the IOC.<sup>559</sup> Furthermore, because the IOC does not make a profit from an increase in the level of production beyond what has been agreed, the NIOC also loses out due to the lack of incentive for the IOC to boost output levels.<sup>560</sup>

In terms of the IOC, it is difficult for it to undertake an accurate calculation of costs under the Buy Back Contract model. The contract stipulates that all cost outlays and potential returns from production of the petroleum field are to be detailed accurately in both the FDP and the contract, with the calculation later used to determine compensation.<sup>561</sup> However, the

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<sup>553</sup> Iranian perspective refers to persons known as domestic critics.

<sup>554</sup> Moghaddam (n 544) 162.

<sup>555</sup> Bunter (n 555) 5.

<sup>556</sup> Ibid.

<sup>557</sup> The FDP details the scope of the project activities in addition to the plan to develop the field. Hence, it is integral to the Buy Back Contract model and its objective to facilitate the development of resource field operations in Iran.

<sup>558</sup> Bunter (n 555) 6.

<sup>559</sup> Ibid.

<sup>560</sup> Alexander Brexendorff, Christian Ule and Maximilian Kuhn, 'The Iranian Buy Back Approach' (2009) 7(1) *Oil, Gas & Energy Law Journal (OGEL)* 22, 31.

<sup>561</sup> Richard Parris and Louis Skyner, 'Key Comparisons of the New Iran Petroleum Contract and Buy-Back' (Briefing Note, Clifford Chance, 2017) 1.

calculation to determine compensation is a difficult proposition for the IOC. To clarify, it is difficult to predict with a high level of accuracy the size of the petroleum reserves, how much time is needed for maximum production, and the costs of production more broadly prior to the commencement of operations.<sup>562</sup> Hence, any problems or issues with the processes around the collection of data on the wells may result in incorrect calculations that turn out to be significantly different to the final outcome.<sup>563</sup>

Another notable detraction of the Buy Back Contract model for IOCs is the fixed rate of return (ROR) provision.<sup>564</sup> A fall in petroleum prices increases the risk for the IOC that the volume of petroleum produced from the field will not be enough to generate the sales revenue required to cover the costs of production and the remuneration amount agreed to in the contract. Furthermore, given the uncertainties around fluctuations in the price of petroleum, the actual production potential of field, and the final costs of production and so forth, the Buy Back Contract model is a risky proposition for IOCs because it does not include a provision for renegotiation.

#### 5.5.1.6 No option for IOC to renegotiate

All contracts carry a risk for the contracting parties should the circumstances change in favour of one party over another.<sup>565</sup> The risk can be mitigated to some extent however with the inclusion of a clause allowing for renegotiation of the terms and conditions in light of unexpected events. Because Buy Back Contracts do not offer the IOC – as the party most disadvantaged by a drop in petroleum price or a setback in operations – the option to renegotiate, it must carry a greater share of the overall risk that the NIOC.<sup>566</sup> Nonetheless, the fixed ROR provision in the Buy-Bank Contract is arguably disadvantageous for Iran's oil and gas sectors. This is because it does not incentivise IOCs to maximise total production return via the search for additional reserves and the pursuit of improvements in petroleum recovery and production methods.<sup>567</sup> However, the relatively short Buy Back contract period reduces

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<https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2017/01/key-comparisons-of-the-new-iran-petroleum-contract-and-buyback.pdf> (accessed 1 December 2019).

<sup>562</sup> Ali Emami Meibodi, Atefeh Taklif, Hamidreza Arbab and Hassan Bovairi Monji, 'Investigating the Effects of Contractual Factors and Arrangements on the Optimum Level of Production in Oil and Gas Projects: Evidence from the South Pars Phases 17 & 18' (2020) 24(1) *Iranian Economic Review* 181, 183.

<sup>563</sup> Ibid.

<sup>564</sup> The IOC's agreed ROR (profit) on its investment differs according to the nature of the project but is typically from 15-20%.

<sup>565</sup> Brexendorff et al (n 565) 22.

<sup>566</sup> Maximillian Kuhn and Mohammadjavad Jannatifar, 'Foreign Direct Investment Mechanisms and Review of Iran's Buy Back Contracts: How Far has Iran Gone and How Far may it Go?' (2012) 5(3) *Journal of World Energy Law & Business* 207, 208.

<sup>567</sup> Ibid.

the incentive for the IOC to prioritise the acquisition and/or utilisation of modern or advanced technologies. As a result, this limits opportunities for the transfer of such technologies to Iran's oil and gas sectors.<sup>568</sup>

Foreign investor companies also point to the complicated bureaucratic processes associated with the administration of the petroleum mining project according to the terms of the Buy Back Contract.<sup>569</sup> In particular, they have detailed their concerns that the NIOC was generally unable to respond quickly and consistently to decisions made unexpectedly by the IOC due to unexpected and unavoidable changes in circumstances. At the centre of their concern is that they feel the Buy Back Contracts do not facilitate a cooperative relationship between the IOC and NIOC where the latter acts equally in the interests of both contracting parties.<sup>570</sup> IOCs have also indicated their frustrations with the process of tendering submissions for the rights to explore and develop oil fields. Issues have been raised about the difficulties of conforming to requirements, which some IOCs believe are unrealistic, as well as about the lack of a standardised approach, often rendering the process slow and too costly.<sup>571</sup>

Lastly, an advantage of the Buy Back Contract model to the NIOC is the dispute settlement mechanism. Within Iran's legal system, domestic courts have jurisdiction over the settlement of disputes and certain commercial transactions. In turn, the contract model stipulates in its terms that international arbitration is used to settle any disputes to emerge between the contracting parties in relation to the terms and conditions of the contract and their implementation.<sup>572</sup> For instance, the approach to resolving disputes between contractors and the NIOC in Buy Back Contracts follows an incremental approach where mediation and negotiation are first initiated, and arbitration is left the final stage.<sup>573</sup> The approach to resolving disputes between contractors and the NIOC in IPCs follows a similar incremental approach (i.e. escalation with arbitration as the final stage). However, the parties must first agree to the seat of arbitration and rules and their agreement must subsequently be approved by the Cabinet of Ministers in Iran.<sup>574</sup>

## **5.6 Summary of Iranian Petroleum Contracts**

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<sup>568</sup> Bunter (n 555) 7.

<sup>569</sup> Ibid 16.

<sup>570</sup> Ibid.

<sup>571</sup> Ibid.

<sup>572</sup> Ebrahimi and Khouzani (n 232) 2.

<sup>573</sup> Key comparisons of the new Iran Petroleum Contract and Buy Back' (n 247).

<sup>574</sup> Ibid.

The IPC developed by the NIOC is a hybrid oil contract form containing some of the elements of the Buy Back Contract as well as some of the advantages of the PSA. The contract aims to address many of the perceived shortfalls of the Buy Back Contract, although the lack of ability for IOCs to book reserves remains an issue for IOCs.

In terms of process, at the licensing round for the IPC, the IOCs bid for a stake in different elements of the development plan. For example, contractual work commitment, peak production, fee per barrel, pace of cost recovery and the like. A matrix is used to calculate the ‘score’ of each IOC (bidder). The additional factors given consideration in the licensing process include the level of complexity (e.g. development vs EOR), and the possibility of success (POS) in terms of any geological blocks to exploration. The main strategic objectives of the IPC are technology and know-how transfer (from the IOC to Iran) and the building of domestic capacity.

To achieve these objectives, the IPC is designed to encourage IOCs to utilise the latest technologies in the field of oil reserve management, optimisation and production. In addition, the IPC is structured around a tiered system of remuneration that allows for an increase in the amount paid to the IOC on each produced barrel if the production target is surpassed. Table 5.4 provides a summary of the highlights of the IPC:

Table 5.4 IPC Highlights

Term	25+ years (compared to 5-10 years for Buy Back Contracts).
Signing bonus	None
Reserves	Provision for the transfer of hydrocarbon ownership to foreign entity at a specified delivery point. Reserves bookings are not permitted.
Ownership	Provision for shared ownership of the project’s assets.
JVA	The IOC and domestic partner entity enter into a JVA to develop the field together. The NIOC oversees the planning and operations.
Capex	Capex is no longer pre-set. The JV parties formulate the MDP which includes provisions to permit changes to the Capex if required. An annual budget and work plan is developed and ratified by the JV.
Complexities	Different oil fields have different complexities and therefore different risks and reward attached. High risk fields naturally require higher returns to be paid to IOC compared to low risk fields.
Remuneration	Up to 50% of cost can be recovered by IOCs, in addition to an agreed fee per barrel paid in cash or in-kind.



Asset life cycle	Provision for the contract transition across different reserve stages (i.e. exploration, development, production and EOR/IOR) without having to retender.
Marketing	Provision for the IOC to market products.
Corporate Social Responsibility	IOCs are encouraged to initiate community development projects (e.g. contribution to the building of hospitals) in oil-producing regions.
Transparency	IPCs include provision to ensure better financial transparency to minimise the risk of corruption.
Local content	At least 10% and up to 20% of the local partnership, with priority given to Iranian companies, followed by the Iranian-IOC JVs.

## 5.7 Critical Analysis of the Iranian Petroleum Contract

The introduction of the IPC clearly signals Iran’s objective to formulate a new investor contract that includes more incentives for IOCs than the Buy Back model. From a broad perspective, the main attraction in the framework for foreign investors is arguably that the terms and conditions can be negotiated on a project-by-project basis. This means the contract can be better tailored to the IOC’s needs compared to the uniform contract nature of the Buy Back Contract model. Another point of attraction in the IPC for foreign investor companies is the share of the produced oil they receive which may be sold by the IOC in the global petroleum market. This clearly responds to the disincentivising terms of the Buy Back Contract where companies were paid a fixed fee irrespective of the amount of oil produced. By offering IOC a share of the excess oil they have greater incentive to meet and exceed output targets.

The emergence of IPCs and their aim to generate new foreign investments in the hydrocarbon sector occurred after long consideration of several critical factors including how best to meet the interests of both Iran and IOCs; the contractual conditions required to respond to upstream competitors of Iran, and what type of legal authority was required to best arbitrate or resolve disputes between the parties.<sup>575</sup>

### 5.7.1 Perceived weaknesses and ambiguities

Critics of the IPC claim there are several weaknesses and ambiguities in the design and elements of the contract. Such criticisms follow the concerns raised by supervising

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<sup>575</sup> Paul Stevens, *Prospects for Iran's Oil and Gas Sector* (Chatham House for the Royal Institute of International Affairs, 2015) 20.



institutions such as the Parliament of Iran and the General Inspection Office to the Ministry of Petroleum which prompted several revisions to the original contract.<sup>576</sup> From the outset, questions were raised as to the need for a new contract model (i.e. IPC) to replace the Buy Back Contract. While the Ministry of Petroleum responded to such concerns by pointing to the similarities between the IPC and Buy Back Contract forms, opponents pointed to the similarities the IPC shared with production contracts that inflict more costs on the Iranian economy compared to technical service contracts.<sup>577</sup>

The argument was also made that the primary focus of foreign IOCs was on managing project implementation costs and that this exposed another weakness in the IPC form.<sup>578</sup> In response to these concerns, the Ministry of Petroleum in Iran insisted on the introduction and use of IPCs rather than technical service contracts because foreign companies were demonstrating a preparedness to take a direct role in the different project phases to develop an oil fields.<sup>579</sup> Moreover, some IOCs had entered into negotiations with Iranian officials from the Ministry of Petroleum and National Petroleum Company affiliated companies.

Opponents of the IPC argue that most of the services provided by foreign companies could in fact be performed by domestic companies. In turn, the Ministry of Petroleum was quick to point out that the benefit of the IPC and its JVA component is that domestic companies may still take a significant role in the implementation of the project while in consultation with, and receiving guidance from, the foreign oil companies.<sup>580</sup> That is, domestic companies can learn how to manage issues and weaknesses during project implementation which provide long-term benefits to the sector. Nonetheless, opponents of the IPC argue that allowing domestic companies to undertake project implementation without having to enter into a partnership with a foreign company would result in a suite of executive services related to project implementation being transferred more easily to Iranian companies.<sup>581</sup>

Further to the role of domestic companies in the JVA of the IPC, it is worth pointing out that its role in the negotiations around the contract is secondary to the foreign company.<sup>582</sup> It appears that the terms of the IPC stipulate that all costs incurred by the Iranian company are reimbursed from the sale of petroleum produced from the field, similar to the arrangement for

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<sup>576</sup> Mazlumrahni and Esmacili (n 433) 5.

<sup>577</sup> Ibid.

<sup>578</sup> Ibid.

<sup>579</sup> Sadeghi and Seyed (n 496) 181.

<sup>580</sup> Mazlumrahni and Esmacili (n 433) 6.

<sup>581</sup> Ibid.

<sup>582</sup> Ibid.

the foreign company. This arguably suggests that the motivation, interests and goals of the domestic entity are necessarily similar to those of the foreign entity. This has important implications for the future of Iran's petroleum industry given the assumption that the primary interest of the foreign oil company (and by default, domestic partner companies) is to turn a profit rather than to ensure the long-term sustainability of the petroleum industry in Iran.<sup>583</sup>

### **5.7.2 Iranian law**

The relationship between the IPC and Iranian law is also important for consideration. There is provision for three IPC types with IPC Regulations:

- Exploration Terms – contracts for exploration, development and production,
- Development Terms – contracts to develop existing discoveries, and
- IOR Terms – contracts for improved/enhanced oil recovery at existing fields.

The Development Terms and IOR Terms IPCs focus on increasing the rates of petroleum recovery from the designated field. As such, it is assumed that the service fee is payable only when the IOC achieved agreed production targets. Due to the fixed nature of the upside from exploration compared to the potentially broad downside for the IOC, service contracts are negotiated for brownfield projects mostly, and rarely for exploration projects.

Based on the desire of Iran to increase the level of production from its oil fields as quickly as possible, the NIOC has initially given greater focus to negotiating IPCs with Development Terms and IOR Terms. This is clearly a strategy to attract IOCs given the greater difficulties associated with trying to lock in investment capital for exploration projects in the current market environment.

The IPC Regulation establishes the principles governing the IPC without disclosing the full IPC terms and conditions. Further clarity is therefore required across several areas. In terms of the JVAs, for instance, the IPC Regulation determines that foreign contractors must enter into a joint venture with one or more Iranian entity. The objective of the JVA according to the IPC Regulation is to encourage technology transfer. As shown in Table 5.1, eight domestic companies were pre-qualified by the NIOC to potentially enter into a joint venture partners with IOCs.

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<sup>583</sup> Masoud Derakhshan and Atefeh Taklif, 'The Transfer and Development of Technology in Iranian Upstream Oil Sector: Considerations on the Concepts, Requirements, Challenges and Remedies' (2015) 4(14) *Iranian Energy Economics* 33, 34.

### 5.7.3 Joint Venture Agreements and credit risk for international oil companies

However, there are important considerations in relation to entering into a JVA with an Iranian partner. First, there is a lack of clarity regarding the exact nature of the credit risk assumed by the IOC and how the Iranian partner pays its share of the petroleum operations costs. In addition, it is not clear whether there is a minimum level of interest that the domestic entity must agree to. Second, there are important implications related to fluctuating oil prices for the nature of the alignment between the IOC and the NIOC. The IOC is paid a fixed fee and as such it is arguably protected to some extent from the impacts of the changing oil price. A drop in the price of oil however would potentially result in friction between the NIOC and the IOC as the latter's services would appear to be relatively more expensive. Third, IOCs may reasonably be concerned about the remedies and their effectiveness should a domestic entity partner breach its contract obligations or fail to cover its portion of the petroleum operation costs.

Hence, IOCs must assess the extent to which the IPC aligns the interests of both contracting parties. It is the IOC who must assume all the risks related to the petroleum operations within the terms of the IPC. As such, they must carefully scrutinise the decision-making processes around all major investments. Regarding the terms of exploration particularly, IOCs must develop an understanding of how decisions about the commerciality of discoveries are made and the level of input afforded them in this regard. In addition, the decommissioning and restoration of an oil field is a costly endeavour and it is therefore in the IOC's interest to understand how the costs for such operations are arranged and any liabilities it may have in regard to the decommissioning process specifically.

What is clear from the analysis thus far is that the answers to RQs 1 and 2 particularly must emerge from consideration of the broader geo-political context. According to Dudlák, the Iranian government aimed to use the newly formulated IPC 'to sign 50 contracts with investors concerning exploration and production', including 'Asian companies that helped maintain the Iranian oil and gas production and development during the years of sanctions'.<sup>584</sup> This speaks to the increasing geopolitical competition between the East and West and the focus towards the growing consumer market throughout East Asia rather than just the traditional IOCs operating out of developed nations.<sup>585</sup> Moreover, IOCs operating out of the European Union (e.g. French Total, German Wintershall, and Norwegian DNO) have

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<sup>584</sup> Dudlák, (n 68) 465.

<sup>585</sup> Ibid.

expressed interest in entering Iran’s hydrocarbon sector. However, it remains the case (notwithstanding the recent sanctions imposed on Iran by the Trump Administration) that foreign companies remain cautious about entering into the investment process due to concerns about the uncertainty around the regulatory environment.<sup>586</sup>

## 5.8 Pros and cons of the Iranian Petroleum Contract

Regarding RQ1 (see Section 1.4), although the key terms and condition of the IPC were approved by the Iranian parliament in 2016,<sup>587</sup> there remain several uncertainties and controversies around the structure of the contracts. Of particular focus is the lack of clarity around the terms of ownership of the resource field and the circumstances under which the IOC can reserve a field.<sup>588</sup> Table 5.5 presents a snap-shot summary of the pros and cons of the IPC model from the perspective of Iran to facilitate a more comprehensive analysis below:

Table 5.5 Pros and cons of the IPC for the oil and gas sectors in Iran

Pros	Cons
NIOC shares more of the project risks making the contract model more attractive to IOCs, thus increasing potential to access foreign investment capital	Contract model may undermine integrity of Iran’s sovereignty (ownership) over its natural resources
Provides a new strategic approach to Iran to optimise the development / management of its natural resources	IOCs have a stronger claim a direct economic interest in Iran’s resource fields or the companies operating them
IPCs provide IOCs with stronger incentive to invest and bring new technologies to Iran’s resources sectors	Viewed as diverting focus and effort away from Iran developing a ‘resistance economy’ and taking control and ownership of the development of its oil and gas sectors

<sup>586</sup> David Ramin Jalilvand, *What’s Fueling Opposition to Iran’s New Oil Contracts?* (2016b) *al-Monitor* (<<http://www.al-monitor.com/pulse/originals/2016/05/iran-petroleum-contract-framework-delayed.html#ixzz4Zz768ZpI>> (accessed 5 February 2020).

<sup>587</sup> The terms were approved following the two-day Tehran Summit, on 28-29 November 2015.

<sup>588</sup> Ahmadi (n 504) 200.

Higher foreign investment in Iran's petroleum sector means more domestic jobs and more competitive modes of production	All strategic and operational decisions during the development and production stages are assigned to the contractor via a Joint Steering Committee (JSC)
Dispute resolution mechanism favours NIOC or its affiliated entity as any disputes are initially heard exclusively within the jurisdiction of the Iranian courts rather than international arbitration	Lack of clarity regarding the point at which the domestic company can choose to participate during the development stage and the type of contribution to be made

Sources: Creed and Kordvani, 1-5; Dentons, 3; Mazlumrahni and Esmaeil, 1, 5; Seener, 20.

As with the Buy Back Contract model, whether or not specific elements of the IPC are a 'pro' or 'con' for Iran's oil and gas sectors may depend on the assessor's political position. This is evident in relation to the joint venture structure of the IPC and how one perceives the implications it has for Iran's sovereignty over its nature resources and the demands of the Iranian Constitution.

### 5.8.1 Unconstitutional?

Notwithstanding the 'pros' associated with the new IPC model, opponents of the IPC argue that the joint venture nature of the contract model is unconstitutional and that it weakens Iran's sovereignty over its natural resources. The IPC mandates that successful tendering companies must enter into a JVA with the NIOC or an affiliated domestic company from the energy sector endorsed by Iranian government.<sup>589</sup> The contracting parties must then commit to joint operations to develop the negotiated petroleum reserve, with the IOC 'managing' the operations during the exploration stage.<sup>590</sup> This transitions to a 'joint management' relationship during the development and production stages. However, the IPC terms applied to the management of the contracted oil field are somewhat more complex and variable during the different stages of operation than this initial delineation suggests.<sup>591</sup>

<sup>589</sup> Joanna Addison, 'The New Iranian Petroleum Contract (IPC)' (Herbert Smith Freehills, February 2016) <[file://ad.uws.edu.au/dfshare/HomesPTA\\$/90923458/Downloads/%D0%AD%D0%B4%D0%B4%D0%B8%D1%81%D0%BE%D0%BD %D0%B0%D0%BD%D0%B3%D0%BB%20\(1\).pdf](file://ad.uws.edu.au/dfshare/HomesPTA$/90923458/Downloads/%D0%AD%D0%B4%D0%B4%D0%B8%D1%81%D0%BE%D0%BD %D0%B0%D0%BD%D0%B3%D0%BB%20(1).pdf)> (accessed 17 February 2020).

<sup>590</sup> Ibid.

<sup>591</sup> Haddadi (n 423) 53.

### **5.8.2 Undermines Iran's sovereignty over its natural resources**

Concerns about the implications this has for the sovereignty of Iran over its resources points to such terms of the contract as the requirement to establish a Joint Exploration Committee (JEC) which includes equal representation of the IOC and the NIOC. The JEC assumes management of the exploration operations, with all decisions taken unanimously by the IOC and the NIOC or an affiliated company.<sup>592</sup> The NIOC does however reserve the right of control over critical decisions related to reporting requirements, changes to agreed / proposed targets, and issues around commerciality.<sup>593</sup> Similarly, all strategic and operational decisions implemented during the development and production stages of the petroleum project as assigned to the contractor via a JSC.<sup>594</sup> Like the JEC, the JSC has equal IOC and NIOC representation, with the Chair position alternating between the IOC and NIOC each year. The JSC gives final approval to the Annual Work Plan and Budget (AWPB).<sup>595</sup>

### **5.8.3 Lack of clarity around role of domestic entity**

However, uncertainty exists around the JVA structure regarding the point at which the domestic company can choose to participate during the development stage as well as the type of contribution to be made.<sup>596</sup> Indeed, uncertainty remains around what criteria are to be applied to assess the commerciality of the field.<sup>597</sup> Evidence of the impact of these uncertainties and controversies for example is found in the IPC contract negotiations between the NIOC and major IOCs including France Total and Shell UK. Although Memorandums of Understanding were reached on investment and field production with the major IOCs, they are yet to be cleared by the Iranian parliament.<sup>598</sup> Throughout the operation stage, the petroleum project is managed by the JS. As such, Iran is positioned as a third party which, in principle, does not exact shareholding. However, this is determined according to the unique conditions of each project.<sup>599</sup>

As such, the IPC is viewed as a step backward by commentators such as Ali Reza Mazlumrahni and Mohsen Esmail, who argue that it is diverting focus and effort away from

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<sup>592</sup> Ibid 53.

<sup>593</sup> Ibid.

<sup>594</sup> Dallas and Black (n 369) 3.

<sup>595</sup> Ibid.

<sup>596</sup> Mohammadi Tavakkoli, Mansour Ahmadnejad and Ali Eshaghzade, 'Identification of Factors Affecting the Development of Accounting and Financial Management Procedures for Joint Operating Agreements (JOA) in Iran's Oil and Gas Industry' (2018) 2(1) *Petroleum Business Review* 23, 23.

<sup>597</sup> Ibid.

<sup>598</sup> Jalilvand (n 498) 8.

<sup>599</sup> Shervin Darvish, 'Legal Aspects of Iran's New Oil Contracts' (Natural Gas Europe, 18 July 2016)

<<http://www.naturalgasworld.com/legal-aspects-of-irans-new-oil-contracts-30651>> (accessed 17 January 2020).

addressing the weaknesses in the Iranian petroleum industry (lack of access to advanced technologies to increase production and reduce costs). These critics argue that Iran is relying too much on foreign companies for relief.<sup>600</sup> Moreover, they point out that it is against Article 2 of the Act of Executive Policies of Principle 44 of the Iranian Constitution which restricts the extraction and production of crude oil and gas to the governmental sector.<sup>601</sup> Thus, the transfer of oil and gas field operations to foreign entities using IPCs is to these authors unconstitutional.<sup>602</sup>

#### **5.8.4 More risks for Iran related to international oil company remuneration payments**

In addition, risks exist for Iran around the payment of remuneration to IOCs. Debate continues as to whether the amount should be based on the average yearly petroleum export price in Iran (as is the practice), or whether to base it on the standard pricing formula applied throughout Asia.<sup>603</sup> The investing company is entitled to remuneration proportionate to the level of risk associated with undertaking the exploration, development and production stages. The remuneration amount is variable as it is calculated according to the ratio of cash received to production costs (R factor) and to production rate. Hence, remuneration is based on a fee for every barrel of petroleum produced.<sup>604</sup>

#### **5.8.5 Recovery of costs**

Furthermore, limitations exist around the recovery of some costs outlaid during the development and production stages of the project. There are three main cost associated with the exploration to production phases in the IPC:

1. Direct Capital Costs (DCC)
2. Indirect Costs (IDC)
3. Cost of Money (CoM)

The IPC stipulates that cost recovery occurs 5-7 years after production starts. It includes incentives for decreasing costs via the Costs Saving Index (CSI).

The cost recovery term begins at the initial year of production. The ‘direct capital costs’ and the ‘indirect costs’ paid by the IOC before the start of production are amortised within 5-7 years of the start of production. Following the start of production, the IOC’s direct capital costs are amortised within 5-7 years from the time of outlay. These costs do not include ‘cost

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<sup>600</sup> Mazlumrahni and Esmacil (n 433) 5.

<sup>601</sup> Ibid.

<sup>602</sup> Ibid.

<sup>603</sup> Ahmadi (n 504).

<sup>604</sup> Tavana Energy (n 548).

of money' during the development stage and following the initial date of production.<sup>605</sup> Following the start of production, all additional costs including indirect capital costs are recovered by the IOC or investing entity at cost (i.e. without the cost of money). The amount recovered is based on the invoices submitted by the contractor (every quarter) as approved by the NIOC.<sup>606</sup> In the event that the IOC cannot recover costs during the terms of the contract, the term is extended to provide extra cost recovery time based on approval by the NIOC.<sup>607</sup>

### **5.8.6 Take advantage of foreign technologies and expertise**

Notwithstanding the issues that remain around the capacity of IPCs to meet all national interests of Iran, they at least provide an opportunity to take advantage of the investment and technical services of foreign and advanced countries.<sup>608</sup> The capacity to increase foreign investment in Iran's petroleum sector translates to the creation of jobs, a more competitive mode of production, and the transfer of current knowledge and technologies.<sup>609</sup> This point is also raised by Mohammadi and colleagues<sup>610</sup> who have stated that implementation of the IPC will positively contribute to the acceleration of the movement of petroleum from Iran following the introduction of soft technology and better knowledge transfer mechanisms around petroleum systems and products.

### **5.8.7 Increase optimisation of natural resources**

It is important to note that the IPC were introduced in response to the 'limited easing of sanctions on Iran under the Geneva Joint Comprehensive Plan of Action (JCPOA)'.<sup>611</sup> Notwithstanding the maturity of the Iranian petroleum sector, the international sanctions placed on Iran during the early years of the twenty-first century limited the nation's capacity to attract foreign investment and technology into its oil and gas reserves, decreasing the nation's overall hydrocarbon output.<sup>612</sup> As such, the introduction of IPCs in Iran reflects the country's strategy (and the strategies of other countries around the world also) to adopt a new approach to the optimisation of their natural resources.<sup>613</sup> Such approaches can generally be divided into two forms: initiatives designed to "maintain maximum control, ownership and

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<sup>605</sup> Sahebonar et al (n 423).

<sup>606</sup> Darvish (n 604).

<sup>607</sup> Ibid.

<sup>608</sup> Mazlumrahni and Esmail (n 433) 1

<sup>609</sup> Ibid.

<sup>610</sup> Teymour Mohammadi, Farshad Momeni, Abbas Kazemi Najaf Abadi and Shirkou Bahadori, 'Effect of Petroleum Contracts on Iranian Oil Production Trend' (2016) 12(50) *Quarterly Energy Economics Review* 26.

<sup>611</sup> Adrian Creed and Dr Amir Kordvani, 'Iran's New Integrated Petroleum Contracts' (MENA Legal update, Clyde and Co., 2014) 1.

<sup>612</sup> Ibid.

<sup>613</sup> Ibid.



sovereignty” over the natural resources; or providing IOCs with greater scope to undertake a direct economic interest in the resources fields or in the companies that are operating them.<sup>614</sup> Put more simply, approaches favouring the use of technical services contracts versus production sharing agreements.<sup>615</sup>

The emphasis in IPCs on supporting the acquisition know-how and technologies to develop the Iranian oil fields represents a turning point in how the nation approaches the development of its oil and gas industry. Previously, the main consideration in the Buy Back Contract model was to attract foreign investment without violating the Constitution and related oil and gas legislation in Iran. In turn, while the short-term service nature of the Buy Back Contracts between the NIOC and IOCs served this purpose, the model was largely unpopular with IOCs due to the risks they were obliged to carry.<sup>616</sup> IPCs provide an alternative approach designed to “incentivise international oil and gas companies to invest and bring new technologies to Iran”.<sup>617</sup> Moreover, a key advantage of the IPC to foreign investors is the opportunity to step up the development and optimal exploitation of oil deposits, and to increase the coefficient of oil extraction.<sup>618</sup>

Indeed, Creed and Kordvani assert there are five key objectives underpinning the IPC design:

1. To integrate the exploration and production phases.
2. To help Iran improve capacity, maintenance and reserve recovery.
3. To attract international capital, services, know-how and technology.
4. To establish long-term relationships with international partners.
5. To reduce investment risks via by more flexible investment costs.<sup>619</sup>

### **5.8.8 Favourable dispute resolution mechanism**

Along with the court system, disputes may be settled via other methods including arbitration.<sup>620</sup> International arbitration is undertaken within the framework set up by the Iranian Law on International Commercial Arbitration (1997). In addition, ratification of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958 by Iran furthered the positioning of international arbitration within the legal system of

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<sup>614</sup> Creed and Kordvani (n 616) 1.

<sup>615</sup> Ibid.

<sup>616</sup> Ibid 2.

<sup>617</sup> Ibid.

<sup>618</sup> Fakhime Hadavimoghaddam and Masoud Mostajeran Gortani, ‘Iran Petroleum Contract (IPC) - A New Generation of Oil Contracts’ (2019) 13(4) *Actual Problems of Economics & Law* 1522, 1522.

<sup>619</sup> Ibid.

<sup>620</sup> Smousavi (n 377) para 64.

Iran.<sup>621</sup> The two main arbitration entities in Iran are the Tehran Regional Arbitration Centre and the Arbitration Centre of Iran Chamber. The standard practice in international arbitration is that there is no provision for the right of appeal against an award. However, a party in the dispute may seek to have an adjudication set aside on certain grounds.<sup>622</sup>

Another positive element of the IPC for the NIOC is the dispute resolution mechanism. Arguably, the contract terms in this regard favour the NIOC or its affiliated entity, stating that any disputes regarding the IPC will initially be heard exclusively within the jurisdiction of the Iranian courts rather than international arbitration.<sup>623</sup> However, in cases of an escalation in attempt at dispute resolution between the contracted parties, the IPC includes a provision for arbitration as the final dispute resolution mechanism.<sup>624</sup> Covered in the clause are matters regarding contract breaches, and contract revocation or termination. The terms of condition of arbitration of any disputes are detailed in an annex to the IPC, which generally favour Iran's interests. Central to these conditions is that the IOC (contractor) bears the costs for failure to discover a commercial reservoir, failure to meet the aims of the contract, and when costs cannot be recovered due to an insufficient petroleum reserve.<sup>625</sup>

### **5.8.9 International oil company concerns with the Iranian Petroleum Contract**

The objective underpinning the IPC was to offer petroleum contracts with more appealing terms and conditions for IOCs compared to petroleum contract from Iraq.<sup>626</sup> However, the extensive revisions to the IPC format by the Iranian parliament meant that many IOCs did not necessarily regard the Iranian IPC as superior to the contract previously offered by Iraq. The main issue with the IPC for foreign investor companies is the lack of option to book an oil reserve, which is not permitted according to the Iranian Constitution. Such an option "is important for IOCs in terms of demonstrating their market value".<sup>627</sup> In turn, the lack of success in attracting major IOCs from Europe by the Iranian government under President Rouhani is arguably the reason for the current challenges being experienced by operators in Iran's upstream oil sector.

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<sup>621</sup> Ibid.

<sup>622</sup> Ibid para 65.

<sup>623</sup> Creed and Kordvani (n 616) 2–3.

<sup>624</sup> Mazlumrahni and Esmaeil (n 433) 5.

<sup>625</sup> Ibid.

<sup>626</sup> Tavana Energy (n 548).

<sup>627</sup> Smousavi (n 377) para 21.

In turn, to help to raise capital for exploration and development of Iran's upstream oil sector, the Director of the NIOC, Ali Kardor, announced the 'partnership bond' scheme in 2017. In this scheme, the Ministry of Petroleum in Iran agrees to reimburse Rial investments in foreign currencies such as the Euro or the greenback (US dollars). Reimbursing bond holders has been challenging for NIOC however, with the company having to borrow money from domestic banks to meet its obligations.<sup>628</sup> It may be asserted that part of the problem for the NIOC is the structure of the IPC itself. The mandatory requirement in the IPC for IOCs to enter into joint ventures with Iranian partners (excepting during the exploration phase) is arguably problematic. The general inability of domestic companies to provide any significant financial support means the onus is put on the IOCs to provide most of the investment capital.<sup>629</sup> Another issue for the IPC in relation to attracting international investment capital is that banks in the West are reluctant to enter into transactions with Iran.<sup>630</sup>

Furthermore, the list developed by the NIOC of the public, private and semi-private companies in Iran to qualify to form partnerships with foreign companies was not without its issues. To briefly clarify, the partnership is in the form of a JVA for Development operations and the formation of a Joint Operating Company to oversee production operations.<sup>631</sup> The benefits include the transfer of technology and management skills, fewer interventions in operations, greater financial transparency, more efficient operations, and the internationalisation of operations.<sup>632</sup> An emergent issue however is the lack of clarity around the extent to which the private companies are to operate independently from the government agencies or from political interests.<sup>633</sup> At issue is Article 44 of the Iranian Constitution and the implications it has for the scope of operations afforded privatised companies controlled by the government.<sup>634</sup>

Also, of concern to IOCs is the degree to which the IRGC is involved in some of the domestic companies to qualify for joint ventures. For example, Khatam al-Anbia Headquarters gained qualification from the NIOC and is owned by the IRGC, whereas a, IRGC subsidiary of the IRGC, was considered a private company did not achieve final qualification. Companies considered to have connections to the IRGC are at risk of being

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<sup>628</sup> Chow et al (n 22) 4.

<sup>629</sup> Ghorbani (n 455) 2.

<sup>630</sup> Dudlák (n 68) 28.

<sup>631</sup> Addison (n 594).

<sup>632</sup> Ibid.

<sup>633</sup> Ibid.

<sup>634</sup> Chow et al (n 22) 4.

subjected to sanctions from the US Treasury Department sanctions. However, the situation is made more complex because some of the domestic companies to ‘qualify’ for partnerships with IOCs are sometimes involved in aviation or aerospace industry projects. This is potentially problematic as these companies which may be subjected to US sanctions in relation to Iran’s ballistic missiles program.<sup>635</sup>

## **5.9 Implications of the analysis of the Iranian Petroleum Contracts pros and cons**

To answer RQ3, a thorough assessment of the objective and structure of the IPC must be undertaken to identify the extent to which they are positive for Iran’s oil and gas sectors specifically as well as Iranian society more broadly. The role of OPEC in the global petroleum trade and the fact that the petroleum is exported in crude form by foreign entities means that Iran is trapped in a cycle of ‘exporting crude oil for low prices and importing petroleum products for expensive prices’.<sup>636</sup> Notwithstanding the objective of IPCs to address some of the constraints imposed upon the development of Iran’s oil and gas industries from its protectionist laws, such laws nonetheless still challenge the potential effectiveness of IPCs.<sup>637</sup> It remains the case that the prevailing anti-West/anti-imperialist political and religious sentiment in Iran perpetuates a component of distrust in its relations with the West including Western companies.<sup>638</sup> This distrust is understandably intensified in the context of renewed and more expansive sanctions placed on Iran by the Trump Administration. Such sanctions have impacted Iran’s opportunities to develop its upstream oil and gas industries and also forced foreign investment entities out of Iran which had contracts to develop and renovate resource fields.<sup>639</sup> Moreover, the sanctions place restrictions around the capacity of investors to transfer funds into Iran. Hence, not only do the sanctions make it very difficult for Western foreign entities particularly to do business with Iran in general, they undermine the capacity of IPCs to deliver “advanced and up-to-date technologies, tools, and supplies” to its oil and gas industries.<sup>640</sup>

Indeed, the main point of attraction for IOCs in the design of IPCs is arguably the reduced risk they are obligated to accept to manage the development and production of the oil fields. However, issues of protectionist laws including arbitration of issues within the domestic

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<sup>635</sup> Ibid.

<sup>636</sup> Mazlumrahni and Esmacil (n 433) 1.

<sup>637</sup> Ibid.

<sup>638</sup> Ibid.

<sup>639</sup> Ibid.

<sup>640</sup> Ibid 2.

judicial system and the lack of a “secure environment that guarantees the safety of their investments and profit” must be resolved to enhance the attractiveness of the IPC’s pseudo-sharing production agreements to foreign investors.<sup>641</sup> Furthermore, the response by the Iranian government to the reinstated and more comprehensive sanctions by the West combined with the competition within Iran’s political arena are further causes of concern for investors.<sup>642</sup> Notwithstanding that the re-election of President Rouhani in 2017 in Iran and the general endorsement to his reformist policy that it implies, Iran’s capacity to optimise the potential benefits of the IPCs arguably relies on the normalisation of relations with the West.<sup>643</sup> This is evidenced in the IPCs negotiation immediately after the nuclear agreement was reached with Iran in 2015. For example, the 2016 agreement between French Total and the NIOC saw the Western IOC successfully negotiate a 50.1% stake in development phase 11 of the South Pars gas field, with China’s CNPC (30%) and the Iran’s own Petropars corporation (19.9%) making up the other signatories.<sup>644</sup> This contract, combined with later agreements signed between Norwegian firms and the NIOC to conduct Caspian offshore drillings for example, were described by the media in Iran as the ‘breaking of the petroleum dam’.<sup>645</sup>

The newly imposed sanctions on Iran by the US in 2017-18 however are a significant hindrance to the capacity of IPCs to realise their potential. At first consideration, they would appear to promote the competitiveness of European and Asian IOCs in the Iranian market. However, the legislation in the US to “punishes parallel activities of companies”<sup>646</sup> in the Iranian oil and gas sectors means for many IOCs the decision to enter into investment agreements with Iran carries too significant a risk.<sup>647</sup> Indeed, the US legislation has already resulted in European banks suffering losses of up to USD\$13 billion for conducting business with oil and gas operators in Iran.<sup>648</sup>

In terms of risks for successful IOC investors, it is important to note that the IPC does not recognise the “snapback” from the reinstatement of US secondary sanctions ‘as a force

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<sup>641</sup> Ibid.

<sup>642</sup> Dudlák (n 68) 28.

<sup>643</sup> Diane Munro, ‘Past Imperfect, Future Tense: Iran’s Oil Industry Post-Sanctions’ (The Arab Gulf States Institute in Washington, 2016) 17.

<sup>644</sup> Ibid 30.

<sup>645</sup> Arash Karami, ‘Iran Signs First Energy Contract Since Nuclear Deal’ (2017) *al-Monitor* <<http://www.al-monitor.com/pulse/originals/2017/07/iran-total-france-south-pars-gas-deal-criticism.html>> (accessed 5 February 2020).

<sup>646</sup> Dudlák (n 68) 30.

<sup>647</sup> Ibid.

<sup>648</sup> Jalilvand and Ebert Foundation (n 499).

majeure event'.<sup>649</sup> That is, it does not include a clause which removes liability for natural and unavoidable 'catastrophes' that disrupt the anticipated course of events that restrict the IOC's capacity to fulfil its contractual obligations. Hence, the IOC contractor is not granted any right to withdrawal in the event of such sanction-related snapback. This understandably de-incentivises foreign firms from investing in Iran, prompting foreign firms keen to access Iran's vast oil and gas reserves signing only initial exploratory memorandums of understanding.<sup>650</sup>

### **5.9.1 Political landscape**

The drafting and eventual release of the IPC model must be considered in the context of Iran's political landscape. Although the new model contract was initially announced in Tehran in November 2015, the prospects of its release were clouded due to protests from hard-line political opponents of President Rouhani.<sup>651</sup> They threatened to block its passage through the Majlis. However, the emergence of a "centrists" coalition comprising reformists, moderates and pragmatic conservatives to positions of power in both Iran's parliament and "Assembly of Experts" saw important gains made in relation to controlling hard-line conservatives in Iran.<sup>652</sup> The shift towards more political centrism in Iran was evident in the increased number of moderates in both houses of Iran's parliament. This had the effect of consolidating the hold on power by President Rouhani and strengthening his position re-elected into office for a second term in 2017.<sup>653</sup> This, in fact, was the case, with the new political alignment with President Rouhani in the Iranian parliament leading to several key outcomes: (1) greater consensus on economic policy, (2) the pursuit of foreign investment, (3) JCPOA implementation, and (4) legislative and regulatory reforms to the upstream exploration and production activities of Iran's energy sector, which included the IPC.<sup>654</sup> In turn, the decision making around these structural reforms to acknowledge and respond to the criticisms made of the Buy Back Contracts was crucial to encouraging foreign companies to invest the approximately \$185 billion needed for the modernisation of Iran's ageing energy sector infrastructures.<sup>655</sup> Arguably, the responsiveness of key stakeholders in Iran; namely, the NIOC and legislators to act on the calls for change has been vital. The preparedness of

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<sup>649</sup> Barak Seener, 'Commercial Risks Entering the Iranian Market: Why Sanctions Make Investment in the Islamic Republic of Iran a High-Risk Proposition' (Jerusalem Center for Public Affairs, 2018) 20.

<sup>650</sup> Ibid.

<sup>651</sup> Dallas and Black (n 369) 3.

<sup>652</sup> Ghorbani (n 455) 7.

<sup>653</sup> Ibid.

<sup>654</sup> Dallas and Black (n 369) 3.

<sup>655</sup> Sahebonar et al (n 423) 4.

leadership to draw on the experiences of Iraq (i.e. their technical service contract model) and also seek to be more innovative and flexible with the new contract terms were important signals to investor companies.<sup>656</sup>

### **5.9.2 Cost recovery**

The core elements reflected in the principles of the new contract model are collaboration, technology / know-how transfer, and the simplification / consolidation of previous contract terms. These principles manifest in the use of JVAs (including a revised remuneration scheme that incentivises IOCs to engage in more efficient and enhanced production) and a single contract to cover exploration, development, production and options for enhanced recovery maintenance (including incentives for higher oil recovery).<sup>657</sup>

Indeed, the capped cost recovery condition was unquestionably the target of most criticism levelled at the Buy Back Contract. This is not surprising given the its expectation that IOCs invest in oil field development in the knowledge that any additional costs beyond those stipulated in the pre-determined budgets would not recoverable. Combined with the weaknesses in the remuneration regime that offered no reward for increased productivity, the capped costs recovery did not incentive IOCs to invest in risky projects or those with marginal prospects.<sup>658</sup> By removing these limitations, the IPC model provides greater incentives to IOCs to enhance production in three key ways:<sup>659</sup>

- First, they are offered full costs recovery amortised over 5-7 years (with the possibility of extension if production is insufficient to recover these amounts). In addition, annual repayments for costs recovered and service fees are limited to 50% of all annual revenue raised from the production of oil within the contracted area. The contractor is also reimbursed in full in cases where the contracted area does not yield adequate revenue to recover production costs in full.
- Second, the remuneration of financing costs in the amortisation period (capped at LIBOR+1%), in combination with all indirect fees related to the development phase such as income tax, customs duties and the like add to the internationally competitive nature of the IOC. Financing fees for example are not recoverable in contracts negotiated with Iraq.

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<sup>656</sup> Dallas and Black (n 369) 3.

<sup>657</sup> Ghorbani (n 455) 7.

<sup>658</sup> Dallas and Black (n 369) 4.

<sup>659</sup> Ibid.

- Third, replacing the fixed cost regime in the Buy Back Contract with the standard yearly work programmes and budget process arguably adds more protections around cost for IOC investors.

Implemented via approval from the JSC and NIOC, the use of the committee approach arguably makes the cost control processes more robust. This is important throughout the exploration phase particularly as the set of Minimum Obligations mandated in the IPC differentiate between the technical and operational requirements of this phase. Moreover, by specifying the financial commitment in implementing the Minimum Obligations, there is greater certainty generated around the establishing the budget requirements.<sup>660</sup>

This can place limitations around the degree of flexibility in cost overruns following approval of the figures via the JSC process, with no more than 5% leeway through the production stage, incurring a penalty as part of the production fee structure.<sup>661</sup> Cost overruns are not permitted however through the exploration and development stages, unless there is mutual agreement by the JSC and NIOC due to changes in the project scope or target.

### **5.9.3 Fee structure**

Historical criticisms of the Buy Back Contract were also directed towards its remuneration structure. What emerged as an issue for foreign companies was that the fees they incurred were tied to a fixed percentage of the capital costs up to the cap stipulated in the budget. This structure failed to deliver incremental revenue for going beyond production targets and did not deliver an upside in relation to oil price increases.<sup>662</sup> The fee structure within the new IPC however is based upon the volume of production extending for the duration of the contract agreement. As previously reported, this can be up to 20 years in cases where discoveries have led to production, with the possibility of a tail extension of up to five years to implement enhanced oil recovery (EOR) methods.<sup>663</sup>

The pricing structure of the Iranian IPC is more sophisticated than both the Buy Back Contract and the Iraqi contract model. However, a close analysis reveals there are a number of complexities related to the exact way in which the remuneration is calculated. The main factors to influence the remuneration paid to a contractor are the base fee payable per barrel

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<sup>660</sup> Li et al (n 528) 47.

<sup>661</sup> Ibid.

<sup>662</sup> Dallas and Black (n 369) 5.

<sup>663</sup> Ibid.



of production and the link between the fee and market prices.<sup>664</sup> A percentage of the market price must be determined to represent the base fee and then agreed to by the IOC. In addition, the ‘cap’ mechanism embedded into the IPC to prevent IOCs from accessing mega profits from an unexpected surge in commodity prices.<sup>665</sup> The IPC indicates that the cap applies when rolling average market prices go above the market price at the time of first production by a specified predetermined percentage threshold. Nonetheless, the exact percentage is not specified, and it is not indicated clearly if a ‘collar’ is also applied when the market oil price drops in order to protect the IOC. This is an important consideration given that low market prices draw out the amortisation period for costs recovery.<sup>666</sup>

Base fees in the IPC are subject to further multipliers per barrel to provide an incentive to IOCs to explore high-risk contract areas.<sup>667</sup> Another volumetric base fee multiplier with the aim to reward incremental production is the separate fee multiplier applied to brownfield sites (or to greenfield sites where EOR methods have been used).<sup>668</sup> On close analysis however it is not clear in the IPC structure as to whether or not additional variations are available to the pricing target for fields which producing heavier grades of oil. Moreover, the R-factor adjustment mechanism in the IPC is calibrated so that the fee payable to the IOC may be adjusted according to: (i) the production level of the field, and (ii) the ratio of costs recovered to revenue received.<sup>669</sup> The ratio of costs calculation is made according to the multiple by which the IOCs’ received revenues go beyond total expenditure sustained for the contracted field.<sup>670</sup> There are also additional layers within each band which vary in line with the daily rate of production. Thus, it may be assumed that the fee structure changes in line with the maturity of the contract field as the output and recovery ratio increase. In addition, although cost recovery is permitted if the exploration phase of the field is unsuccessful; namely, the IOC accepts full exploration risk, it is not clear as to whether or not foreign companies are given preferential treatment when adjacent fields are allocated or for future exploration opportunities.<sup>671</sup>

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<sup>664</sup> Roya Derakhshanlavijeh and Jose Manuel Cardoso Teixeira, ‘Cost Overrun in Construction Projects in Developing Countries, Gas-Oil Industry of Iran as a Case Study’ (2017) 23(1) *Journal of Civil Engineering and Management* 125, 125.

<sup>665</sup> Dallas and Black (n 369) 5.

<sup>666</sup> Ibid.

<sup>667</sup> Ghorbani (n 455) 7.

<sup>668</sup> Dallas and Black (n 369) 5.

<sup>669</sup> Parris and Skyner (n 566) 3.

<sup>670</sup> Ibid.

<sup>671</sup> Dallas and Black (n 369) 5.

In turn, because there are few working examples to go by due to the reimposition of US sanctions, there remains a great deal of uncertainty as to how the nature of the relationship between the different adjustment criteria. The IPC states that the fee is payable per barrel produced whether or not the ‘value’ of the hydrocarbons is earmarked for cost recovery (similar to the contract model in Iraq, where the fee is payable per barrel produced). Furthermore, there is a lack of clarity as to the order in which the different fee adjustments are applied.<sup>672</sup> Nonetheless, the more robust cost-recovery structure combined with the implementation of a true volumetric tariff and extra incentives for incremental production may incentivise IOCs to invest in the technology required to maximise oil production in green and brownfield reserves in Iran.

#### **5.9.4 Joint Venture Agreements and management structures**

Arguably, the most significant change to the energy contract structure in Iran was the move to the joint venture model. The primary driver of this move was undoubtedly the objective in Iran to the technology and know-how of IOCs. According to Dallas and Black,<sup>673</sup> the technology and know-how was especially needed in regard to modern EOR methods which were lacking across the energy industry. As stipulated within the IPC, the IOC must partner with the NIOC or a domestic energy company according to an incorporated/unincorporated JVA. Arguably, the rotating management arrangements as a framework for domestic entity participation have the potential to provide much needed benefits to Iran’s energy sector.<sup>674</sup> IPC By-law Article 4(4) for instance endorses the transfer of technology and know-how from the IOC to the joint domestic entity and determines the JOC’s organisation chart during production operations according to the rotated arrangement. Lastly, IPC By-law Article 8(4) and its definition of the “Joint Management Committee” (“JMC”) is arguably of potential benefit to Iran as it provides the NIOC with equal membership on the committees for supervising and monitoring how the petroleum operations are executed. Indeed, the IPC By-laws endorse three types of contracts with foreign entities: (1) exploration and production (E&P) contracts which basically integrates the exploration, appraisal, development and Production Service Contract elements of the project area; (2) development

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<sup>672</sup> Derakhshanalavijeh and Teixeira (n 627) 127.

<sup>673</sup> Dallas and Black (n 369) 6.

<sup>674</sup> Seyed Nasrollah Ebrahimi and Esmat Shahmoradi, ‘A Comparative Analysis of Contractual Considerations in Oil and Gas Contracts with an Emphasis on Iranian Petroleum Contracts’ (2017) 15(3) *Oil, Gas & Energy Law Intelligence* 4, 6.

and production (D&P) contracts; and (3) IOR/EOR contracts designed for the production stage.<sup>675</sup>

IPC By-law Article 1(4) provides the Iranian governments with greater control over the standards of operations by affording the NIOC with the power to specify the key performance indicators (KPIs) to determine the commercialisation of the field.<sup>676</sup> By inserting these KPIs into the contract, combined with regular monitoring and reporting on the petroleum operations, there is enhanced opportunity for the NIOC to identify and address any critical concerns during the operational phases. Moreover, the NIOC may work with the IOC to refine or tweak the agreed KPIs in order to have more control over performance and the achievement of its strategic objectives.<sup>677</sup>

This is because the KPIs allow the main objectives to be quantified and renders the performance of the different teams and departments more 'visible'.<sup>678</sup> This provides the NIOC with a stronger position than the Buy Back contract for making decisions and for taking action to achieve its desired outcomes.<sup>679</sup> KPIs are acknowledged to play a key role in diverse types of business success by improving a company's ability to generate performance data and thus assess the extent to which the performance outcomes align with the short-, mid- and long-term objective.<sup>680</sup> This aspect of the IPC also benefits the NIOC's or affiliated company's role in the development of Iran's energy sector by making more visible the capital 'performance' during operations in regard to costs, risks, resource allocations, returns.

### **5.9.5 Time extensions**

IPC By-law, Article 7 includes the rules governing the execution time of the development and production phase. As previously mentioned, the contract duration is a maximum 20 years from NIOC approval of the Development and Production Plan (DPP). This time frame may be extended by mutual agreement for up to 5 years. The capacity in the IPC for there to be claims for and grants of extensions of time in completing oil projects is also of importance. The time factor adds a degree of volatility to petroleum contracts given the longer the contract term the greater the risk of changes to laws, market conditions, and

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<sup>675</sup> IPC By-law, art 2.

<sup>676</sup> M Soleimani and Newsha Tavakolian, 'Comparative Financial Analysis of IPC, the New Iran's Oil Fields Development and Production Enhancement Framework IPC vs. Buyback Contracts' (SPE Symposium: Production Enhancement and Cost Optimisation, Society of Petroleum Engineers, 2017) 3.

<sup>677</sup> Ebrahimi and Shahmoradi (n 679) 6.

<sup>678</sup> Guy Redden, *Questioning Performance Measurement: Metrics, Organizations and Power* (Sage, 2019) 19.

<sup>679</sup> Ibid.

<sup>680</sup> Ebrahimi and Shahmoradi (n 679) 6.

petroleum prices, all of which reduce contract performability.<sup>681</sup> Conversely, however, it is not feasible to have too much flexibility around time frames embedded into the contract as this increases the risk of misinterpretation and can undermine contract certainty and reliability.<sup>682</sup>

Extending the period of the contract can be a complicated process with significant financial or non-financial implications for the contract parties.<sup>683</sup> Although there can be quite severe consequences to both IOCs and domestic oil companies as a result of delay and disruption to the petroleum project, the commercial advantage of both entities may also be served with time extensions in upstream contracts. The inclusion of clauses in the contract for extensions of time due to unpredicted factors and force majeure can be embedded as rules and principles in an IPC.<sup>684</sup>

The conditions under which extension of time clauses may be enacted include for:<sup>685</sup>

1. an act, omission, breach or default by the NIOC or affiliate,
2. suspension of works initiated by the NIOC or affiliate (but not due to an act or omission of the IOC),
3. a variation imposed by the NIOC or affiliate (but not variation due to an act or omission of the IOC), and
4. force majeure, causing delays in critical pathways identified by the IOC within the specified period.

Standard IPCs include provisions for extension of time entitlements to the IOC due to NIOC forced variations or changes, a suspension of activities, force majeure, and changes to the law. As such, well-considered and drafted extension of time clauses in an IPC can benefit both parties. For instance, it can help with preserving a contractual completion time; maintaining NIOC rights to liquidated damages, and by providing IOCs with relief from strict obligations to finish the works by a stated time in the event of delays due to unanticipated 'neutral' events.<sup>686</sup>

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<sup>681</sup> Ebrahimi and Shahmoradi (n 679) 18.

<sup>682</sup> Ibid.

<sup>683</sup> Soleimani and Tavakolian (n 681) 5.

<sup>684</sup> Seener (n 654) 20.

<sup>685</sup> Ebrahimi and Shahmoradi (n 679) 17.

<sup>686</sup> Peter Godwin et al, 'The Prevention Principle, Time at Large and Extension of Time Clauses' *Construction Dispute Avoidance Newsletter* (2009) <<http://documents.lexology.com/4001b4ac8d7a-4d10-b880-ac10e8f54d2a.pdf>> (accessed 15 August 2019).

However, the exact way in which the ownership interests of each party is determined, and the extent and timing of each party's participation is not clearly stated.<sup>687</sup> That is, the point during field development at which the domestic entity chooses to participate is not clearly determined. Moreover, and it is not clearly apparent as to whether the contribution by the domestic entity is to be primarily technical, financial or a mix of both.<sup>688</sup> It appears that in the IPC the decision-making thresholds are somewhat disaggregated from both the ownership interests of the parties and to the funding regime. For instance, it is expected that the IOC will cover its own costs and the carry of its development partner during exploration, development and production stages.<sup>689</sup>

There are also complexities related to the management structure of the JVAs that are worth consideration. Notably, the management structure varies depending on the exploration or development stage. To explain, the IOC manages the operations and has control over the day-to-day issues during the exploration stage.<sup>690</sup> In terms of control over operational issues, however, this is deferred to the Joint Exploration Committee (JEC) comprising an equal number of NIOC and IOC members. All decisions made by the JEC must be unanimous, however, the NIOC has the final say in decisions on key issues such as the arrangement of final reports and statements, changes to the targets of petroleum projects, and determinations of a field's commerciality. On this last issue, it is noted that the decision is subject to expert referral in circumstances where the IOC and NIOC cannot reach an agreement.<sup>691</sup>

The separation of decision making from ownership and funding responsibilities does not align with the more established PSC models regularly used across the energy sector.<sup>692</sup> Moreover, there is the need for the IPC to be more explicit in terms of the criteria to be applied to determine commerciality. It is in the interests of the IOC to seek to relinquish a non-commercial prospect and there cannot be the expectation that it continues to invest capital into a marginal prospect without fully understanding its overall economic recovery.<sup>693</sup> Notwithstanding that the JVA structure is widely preferred to the risk services model (i.e. Buy Back Contract), the way in which the funding obligations of the IOC are separated from

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<sup>687</sup> Mohammadi Tavakkoli and Ali Eshaghzadeh, 'Developing a Framework for Accounting and Financial Management Procedures of Joint Operating Agreements (JOAs) in Iran's Oil and Gas industry' (2018) 2(1) *Petroleum Business Review* 69.

<sup>688</sup> Ibid.

<sup>689</sup> Ibid.

<sup>690</sup> Dallas and Black (n 369) 6.

<sup>691</sup> Dallas and Black (n 369) 6.

<sup>692</sup> Tavakkoli and Eshaghzadeh (n 692) 70.

<sup>693</sup> Ibid.

the ownership and voting mechanisms has the potential to be problematic. This is particularly the case given that the IOC is obliged to cover all exploration and production costs in addition to the percentage share of carry for the NIOC/local entity during these stages. This presents a range of issues, not least of which is the level of competence (technical) of the domestic entity in the JV, along with any associated sanctions for possible links to the IRGC. Of concern to any IOC is the extent to which it will have to carry its JV partners both financially and in a commercial sense. As such, it is important for the IPC model to make explicit how ownership interests are formulated and the timing and scope of participation by the NIOC/domestic entity in the contracted field.

The clarity of the overall management structure embedded within the IPC is vital to IOCs, particularly throughout the exploration and development stages of the project. This is because it influences which decisions have to be deferred (escalated) to the JEC or JSC and eventually the NIOC. There is some clarity on the conditions to escalate decisions related to the appointment of key personnel or in regard to stipulated decision-making categories. An example is the limited but non-exhaustive list of exploration-phase ‘issues’ requiring escalation to the NIOC for a final decision. This includes determinations of the commerciality of the field.

It may reasonably be argued that IOCs have a legitimate concern that ‘unnecessary’ interventions by the JSC may cause delays to the daily field operations. In addition, they may be concerned that the JV partners will interfere in the development initiatives beyond the formulation of the AWPB and Development Plan. Moreover, IOCs will have concerns about whether the NIOC or domestic entity can ‘direct’ it to undertake an activity that it would not have chosen to perform otherwise (e.g. raising EOR compression). The way in which the Board is composed as well as how the Chairman is appointed would suggest that the only factors mitigating for these risks are the cost recovery mechanism and the ability of the IOC to refer these types of decisions to arbitration.

In terms of the designated domestic entity, whether it enters into a JVA with the IOC directly has implications for decision making. It is noted that in the Iraqi model, the power of the local entity is limited to veto decisions via the introduction of an ‘offshore’ JVA between IOCs in order to align how they vote.

#### **5.9.6 Timing**

It appears that the transition from the Buy Back Contract to the IPC model is the right strategy by Iran, but which has emerged at the wrong time. Iran is endeavouring to re-

establish itself in the global petroleum market in the face of many obstacles. The impacts of the US sanctions on Iran's economy and energy sector more specifically has been well documents in this thesis. When these geopolitical tensions are combined with the intensifying debate around the global response to climate changes, many countries are starting to re-calibrate their energy strategies. International investor companies are naturally cautious of the financial repercussions for doing business with Iran in opposition to US sanctions. Moreover, the energy sectors in countries around the world are simply looking to reduce their reliance on fossil fuels.<sup>694</sup> Countries in the twenty-first century are pursuing greener and cleaner fuels and technologies in an attempt to minimise their carbon footprint. New product entrants into the market such as shale oil are also having their impact as they challenge the status quo of global oil powers. Just how Iran manages these complexities in the coming years will arguably go a long way to revealing whether or not Iran can establish a stronghold in the global petroleum market or continue to see a downward slide market share.

### **5.9.7 Lack of access to technology**

In addition to the lack of investment in the Iranian oil and gas sector as a result of the US sanctions is the lack of access to technology for the development of the sector. This thesis has established that development of the energy industry in Iran has been constrained for many decades due to underinvestment and an inability to access technology. Implementation of the JCPOA provided some cause for hope that the IPC would generate a flow of much-needed investment and technology into the resources sector.<sup>695</sup> Foreign investor involvement has not materialised as anticipated however, and this is not likely to change due to the US withdrawal from the JCPOA.

As reported above, Iran has signed several MoUs with IOC and of foreign entities to jointly develop a number of oil reservoirs, yet the finalisation of any contracts has been sent into disarray as a result of companies being unable to get a sanctions waiver from the US.<sup>696</sup> Indeed, efforts by European oil companies to participate in developing and exploiting Iran's petroleum industry have largely come to a standstill due to the renewed US sanctions. Almost all Western IOCs with the capabilities to implement petroleum development and production projects worth billions of dollars have ties to the US financial (banking and insurance) systems.<sup>697</sup> Given that these companies are cautious of snap-back from the secondary

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<sup>694</sup> Prakash (n 459) 1.

<sup>695</sup> Chow et al (n 22) 13.

<sup>696</sup> Reuters (n 27).

<sup>697</sup> Ghorbani (n 455) 5.

sanctions should they enter into business arrangements with Iran, they are reluctant to sign any contracts.<sup>698</sup> This has forced the NIOC to increasingly rely on domestic contractors, know-how and technologies to continue to develop its oil fields, including the most challenging onshore (e.g. Arvandan in the West Karoun region), and offshore (e.g. IOOC) fields.<sup>699</sup> It should be noted that domestic contractors have proven to provide satisfactory support overall to the NIOC in the past. However, it is inevitable that the operational capacity of these domestic operators is significantly reduced as a result of the deteriorating economic landscape for domestic players in Iran due to the new sanctions.<sup>700</sup>

In turn, as a result of the limited positive outcomes of the IPC, the NIOC has undertaken to develop more robust contract models to more actively involve domestic contractors (e.g. Arvandan Oil and Gas Company [AOGC], IOOC and Iran Central Oil Fields Company [ICOFC]) in the development of domestic regions. Several (around 34) field developments, flow pipelines, and above-ground facilities have been earmarked by the NIOC requiring investment of between \$6 to \$7 billion.<sup>701</sup> The projects involve developing new oil wells in numerous onshore and offshore fields and undertaking water injection pressure maintenance assessments. In addition, the NIOC considered the introduction of different contract types; namely, the Engineering, Procurement and Construction (EPC) and the Engineering, Procurement and Drilling (EPD) contracts which include a provision for deferred payment to domestic contractors.<sup>702</sup> Contracts types such as these would provide the platform for the NIOC to continue to develop projects. However, based on the previous discussion, the progress of such projects is significantly impacted by Iran's weakened economic conditions and the lack of technology transfer barriers as a result of US sanctions.<sup>703</sup>

Given the circumstances currently facing Iran's petroleum sector as discussed above, the IPC as a contract form to help develop Iran's oil fields remains in a state of uncertainty. The failure of the contract to thus far attract foreign investment and to promote access to technology has resulted in significant challenges for the upstream petroleum sector and has prevented the NIOC from achieving production growth targets.<sup>704</sup> The increasing presence of Russia in the energy resources landscape in Iran may prove to be an integral element of the

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<sup>698</sup> Seener (n 654) 20.

<sup>699</sup> Chow et al (n 22) 14.

<sup>700</sup> Ibid.

<sup>701</sup> Ibid.

<sup>702</sup> Ibid.

<sup>703</sup> Ibid.

<sup>704</sup> Seener (n 654) 20.



Iranian government is longer-term energy strategy to mitigate the effects of US sanctions.<sup>705</sup> Signs to support such a conclusion were evident in 2017 with the announcement that Rosneft, Russia's largest state-owned oil company, had agreed to a joint venture with the NIOC to work on several 'strategic' projects worth an estimated US\$30 billion.<sup>706</sup> Iran's collaboration with Russia also involves the transfer of technology to develop the nation's refining and petrochemicals operations.<sup>707</sup>

Undoubtedly, the increasing presence of Russia in Iran's energy sector is a by-product of the vacuum created from the lack of Western companies. Both countries have been the target of sanctions by the US and have some common interests in the geo-political dynamics in the Middle East.<sup>708</sup> In turn, although Russia's oil companies may not necessarily offer access to the best technology and are not regarded as top tier options for foreign investment, increasing the oil production rates in shared border fields particularly is a top priority of the IPC. Even though "Iran's investment needs in its energy sector goes well beyond the upstream oil and gas sector",<sup>709</sup> any IPCs signed with Russia and potentially with China to improve the financial and technical outcomes for its upstream petroleum projects would be welcome.

### **5.10 Recommendations**

Notwithstanding the 'grey areas' of the IPC which cause some consternation for IOCs, the key ways in which it improves on the Buy Back Contract model used previously by Iran are welcome. The IPC thus represents a major step in the attempt by Iran to re-open the nation to foreign investment. The transition to IPCs by Iran also reflects "a clear shift from the ideological considerations to a more pragmatic approach in the management of the Iranian economy and its strategic resources".<sup>710</sup> However, it is important to concede that "building trust [with IOCs] is essential" if the IPC model is to realise its potential and provide the anticipated benefits to Iran.<sup>711</sup> In turn, the comparative analysis of the Buy Back Contract and IPC model above has clearly established that the Buy Back Contract has not achieved its strategic objective to improve the capacity and resilience of Iran's oil and gas sectors by attracting foreign technology and expertise. The contract model was initially developed by

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<sup>705</sup> Ghorbani (n 455) 7.

<sup>706</sup> 'Rosneft and National Iranian Oil Company Sign Oil and Gas Strategic Cooperation Agreement' <<https://www.rosneft.com/press/releases/item/188381/>> (accessed 14 September 2019).

<sup>707</sup> Ghorbani (n 455) 7.

<sup>708</sup> Chow et al (n 22) 14.

<sup>709</sup> Ibid 16.

<sup>710</sup> Dudlák (n 68) 35.

<sup>711</sup> Ibid.

the government in Iran as a potential pathway to accessing foreign money, technology and know-how for the development and production of costly and complicated mining projects.<sup>712</sup>

This is because the lack of access to, and utilisation of, such technologies were both hindering the efficiency with which the fields could be developed as well as the capacity of Iran to develop its domestic resource mining capabilities.<sup>713</sup> The Buy Back Contract model has not however provided Iran with the ‘returns’ for which it was designed.

The comparative analysis above indicated that the IPC model is closer to petroleum contract terms and conditions recognised internationally and provides a more attractive balance between risk and rewards for investors. With greater security around their investment and profit potential than the Buy Back model, the IPC is thus more attractive to IOCs, which, in turn, increase the likelihood of gaining access to foreign technologies and know-how.

Another key finding to emerge from the comparative analysis above is that the structure of the Buy Back Contract model did not necessarily incentivise investor companies to maximise petroleum field development and production. The IPC arguably maximises incentives for IOC across low and high risk areas by providing a more robust mechanism for calculating the rate of return based on revenues from petroleum prices.<sup>714</sup> This has the potential to incentivise IOCs to maximise the extraction potential of the field and motivates them to reap the benefits from higher petroleum prices. Moreover, the greater flexibility offered to IOCs on how they transition through the project stages ‘encourages field redevelopment and the use of enhanced petroleum recovery techniques in the process’.<sup>715</sup>

There are two key points for consideration here. First, when negotiating petroleum contracts, IOCs aim to comprehensively understand the key ‘features of contractual elements which serve to respond to the legal, technical and financial challenges involved’.<sup>716</sup> Second, contract managers working for IOCs adopt a comprehensive approach to managing the risks, complexities and uncertainties in international contracts by adopting a dynamic and strategic approach to the identification of risks and the management of the contract lifecycle.<sup>717</sup> IPC By-law Article 3(6) for instance stipulates that the IOC must carry out all operations to achieve the Petroleum Operations objectives while maintaining the well’s Maximum

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<sup>712</sup> Dallas and Black (n 369) 3.

<sup>713</sup> Me (n 501).

<sup>714</sup> A. V. Aliyev. ‘Post-Sanction Iran and its “Game Changer” Effect in Energy Market’ (2018) 49 *The Scientific and Pedagogical News of Odlar Yurdu University* 124, 125.

<sup>715</sup> Ibid 130.

<sup>716</sup> Ebrahimi and Shahmoradi (n 679) 2.

<sup>717</sup> Ibid.

Efficient Rate (MER). Moreover, the flexibility of the IPC is evident around its core principle and objective to facilitate the recovery of petroleum costs. IPC By-law Article 3(3), Petroleum Costs and the Fees, stipulates that all cost are paid to the IOC form the maximum 50% revenue produced from the field following successful petroleum operations. However, IPC By-law Article 3(4) also states that the contract duration can be extended to support cost recovery when the allocated revenues from the field is not adequate for the term of the contract.

The IPC model is also preferable to the Buy Back Contract model because the obligation under the new IPCs for successful IOCs to partner with domestic exploration and production companies benefits domestic entities operating in Iran's resources sectors. Specifically, elements of the IPC favour the partnership (JVA) approach to enhancing project operations and provide greater flexibility around the scope of the project and the management of changes in costs. As such, they arguably provide an acceptable level of protection against claims by the IRGC that a reliance on foreign investor entities 'would damage the country by shutting domestic contractors out of upstream projects and undermining Iran's sovereignty with 20-year contract terms'.<sup>718</sup> A particular concern of the IRGC is that the IPCs undermine the integrity of the resistance economy in Iran by not adequately considering domestic companies and their abilities to successfully manage various aspects of the oil exploration and production projects.<sup>719</sup> Such opposition around the extent to which IOCs are granted 'management rights' and the size of the revenue from sales only serves to illustrate the risks Western companies continue to face regarding the possibility that their assets could be appropriated by the Iranian government "at a political whim".<sup>720</sup> As stated by Seener, '[d]ue to religious and ideological reasons, the risk existed that IRGC would prevent companies entering the Iranian market and competing with it'.<sup>721</sup> However, the more integrated approach by the NIOC (or affiliate) and the IOC on the exploration, development and production operations provides a stronger structure to maximise the alignment of the benefits of the petroleum mining project for both parties. Moreover, it is likely to encourage the development and uses of the best technologies to optimise the outcomes of the operations.

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<sup>718</sup> Seener (n 654) 20.

<sup>719</sup> Ibid.

<sup>720</sup> Ibid.

<sup>721</sup> Ibid.

The IPC thus differs from the Buy Back in terms of greater flexibility around the exploration phase and the integration of the exploration and development operations. In addition, there is greater flexibility around the development of common fields with neighbouring countries as well as the exploration, development and production operation in ‘high risk’ regions and deep waters.<sup>722</sup>

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<sup>722</sup> Seener (n 654) 20.

## 6 CONCLUSION

The aim of this thesis was to critically analyse the current IPC model applied in Iran to petroleum transactions with IOCs. The analysis it presents was framed around three research questions that sought respectively to identify the strengths and weaknesses of the Iran Petroleum Contract in regard to the international petroleum trade (RQ1), how other contract forms (i.e. the Buy Back Contract) adopted by the Iranian Government impact the international petroleum trade (RQ2), and the extent to which the IPC best addresses the current and potential needs of the oil industry in Iran (RQ3). An overarching goal in addressing these questions was then to assess whether the IPC presents as the best contract reform option to Iran to improve outcomes for all stakeholders. Qualitative interpretive methodology was adopted for critical analysis of historical, government, legislative, industry and research literature to draw conclusions about the merits of the IPC in relation to its commercial, economic, and social objectives.

To briefly restate the context of the analysis, IPCs were first conceived in November 2015 as a contract model to replace Buy Back Contracts. The primary objective of the new contract model for Iran, put succinctly by Batmanghelidj,<sup>723</sup> is to attract IOCs to invest and engage in the nation's oil and gas industries so that Iran has access to much needed capital, technology and expertise to optimise the value of its natural resources. On August 3, 2016, the Cabinet of Ministers in Iran passed a resolution permitting the legislation of the terms and structure of the IPC model a risk service contract. As such, the IPC is a combination of a fourth-generation Buy Back Contract and a Production Sharing Contract (PSC) in Iran. According to the contract terms and conditions, contractor entitlements are paid directly from sales revenues (similar to the Buy Back model), however the contractor also receives the benefits of production (similar to the PSC model). As such, the IPC is generally regarded as a service contract and offer IOCs opportunities to invest in upstream oil and gas projects. The stated aim of the Iranian government is to attract upstream capital investment of up to USD\$13 billion by 2020 and up to USD\$200 billion overall.<sup>724</sup>

Analysis of Iran's petroleum contract models in this thesis both identified and discussed the implications of the high investment costs for IOCs seeking to engage in the exploration and development of oil fields in Iran. When this is balanced against the general lack of financial resources and expertise in Iran to support the development of its resources sectors, attention

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<sup>723</sup> Esfandiyar Batmanghelidj, 'Emerging Privatization in Iran's Energy Sector Deserves a Second Look' (2017) *Bourse & Bazaar* <<https://www.bourseandbazaar.com/articles/tag/petropars>> (accessed 15 February 2020).

<sup>724</sup> Seener (n 654) 99.

was drawn to the key points of negotiation between Iran (via the NIOC) and foreign oil companies for resource exploration and production rights. Hence, the main sources of tension between the contracting parties were identified and evaluated in terms of the extent to which the IPC offers either or both of the contracting parties some ‘relief’ from what they perceived as the high risk or burdensome aspects of the Buy Back Contract model specifically. The following section summarises the main findings reported in this thesis in relation to each of the research questions.

### **6.1 Strengths and Weaknesses of the Iran Petroleum Contract in regard to the International Petroleum Trade (RQ1)**

In terms of strengths, this thesis established that IPCs grant Iran the right to maintain sovereignty over its hydrocarbon reserves while agreeing to pay IOCs for all direct and indirect expenses, and financial and operational costs via the allocation of a portion (up to 50%) of products or proceeds based on current market prices.<sup>725</sup> Section 5.3 highlighted that one of the main complaints directed towards the Buy Back Contract model was its lack of flexibility for the IOC.<sup>726</sup> Clearly acknowledged in the literature is that in order for Iran to achieve its strategic objective to develop its energy sector via JV petroleum activities with IOCs, the terms of the contract have to encourage the participation of IOCs.<sup>727</sup> That is, participation in terms of committing to significant cost outlays during exploration and development particularly, as well as to meeting the long-term energy sector interests of Iran. Compared to the Buy Back Contract model, the IPC is arguably more likely to achieve these objectives due to its greater flexibility. It is a reality of petroleum contract negotiations that no company can predict the price of oil during the lifecycle of the contract. Therefore, the mechanisms within the IPC including its renegotiation clauses and the option to adjust some fiscal formulas on agreement, provide a degree of flexibility to the IOC. This encourages the participation by the IOC as it provides a stronger role in their capacity to direct contract outcomes. Moreover, it allows for both contracted parties to cope with unexpected contingencies, as well as for the NIOC to introduce incentives to promote cooperative practices.<sup>728</sup> Lastly, the flexibility embedded into the IPC terms is to the advantage of the NIOC because it provides the space to renegotiate on some contract terms if the IOC fails to

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<sup>725</sup> Ibid.

<sup>726</sup> Li et al (n 528) 43.

<sup>727</sup> Nicky Beredjick, *Petroleum Investment Policies in Developing Countries* (Springer Science & Business Media, 1989) 83.

<sup>728</sup> Ibid.

observe the contractual mechanisms.<sup>729</sup> The greater degree of flexibility in the IPC compared to the Buy Back Contract model also potentially benefits the development of the energy sector in Iran by promoting closer working relationships with foreign entities. Providing scope for renegotiation may facilitate the development of more cooperative and reciprocal relationships as business partners.<sup>730</sup> Of course, it may also be reasonably argued that more rigid contract models (e.g. Buy Back) with minimal flexibility in the contractual elements are efficient when conditions are ‘certain’ and reduce the scope for grievances. However, given the ‘uncertain’ conditions associated with long-term petroleum operations, there is an increased need to ensure a space for compromise and renegotiation between rigidity and flexibility. As demonstrated by the Buy Back Contract model, in conditions of project uncertainty, renegotiations are often requested.<sup>731</sup> For example, the IOC may want to renegotiate when the size of the oil reserves is discovered to be low; whereas, the NIOC may seek to renegotiate terms if the discovered oil quality is very high. As such, there is the view that the flexibility of the IPC will arguably help to reduce renegotiation-related grievances between the contracted parties throughout the duration of the contract.<sup>732</sup>

It has been well-established, including in this thesis, that a leading source of conflict between the host government and the IOC in a petroleum contract is the preoccupation of the IOC with establishing stable and predictable contractual relations. As previously discussed in Section 5.5 of this thesis, the rigidity of the Buy Back Contracts was perceived by many in the Iranian parliament to be highly detrimental to Iran’s interests, and often worked to de-incentivise IOCs to expand production.<sup>733</sup> In turn, although the primary goal of the NIOC and the successful IOC will always be divergent; namely, to promote sector and economic growth and to maximise profits, respectively, the more flexible regime of the IPC provides greater opportunity for both parties to achieve their objectives.

The IPC model also affords the Iranian government with the opportunity to make changes to the contract in response to changing conditions, while not precluding the IOC from negotiating for stabilisation clauses to be included in the contract agreement. IOCs would understandably be opposed to any attempt by the host government to initiate amendments to the contract in an effort to optimise government returns, and thus potentially reducing

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<sup>729</sup> Ibid.

<sup>730</sup> Soleimani and Tavakolian (n 681) 4.

<sup>731</sup> Ibid.

<sup>732</sup> Philippe Aghion and Lucía Quesada, ‘Petroleum Contracts: What does Contract Theory Tell Us?’ (International Workshop on Microeconomics Applied to the Energy Industry, 15 December 2011) 1.

<sup>733</sup> Bindemann (n 190) 73.

estimated company profits. Nonetheless, the naturally changing circumstances over the duration of an IPC means that its new clauses allow the Iranian government to capture more (or a fairer share in the view of many Iranian politicians) of the economic benefits of the petroleum operations without breaching the contract terms or disregarding the IOC calls for stability and predictability.

Moreover, the unwavering determination of the Iranian government to maintain sovereignty and ownership of its natural resources at all times, is counterbalanced to some extent by the Open Capex provision of the IPC.<sup>734</sup> This By-law supports a more flexible approach to capital expenditure based on the field conditions and behaviour as well as the requirement for additional investment.<sup>735</sup> As such, the estimated DCC based on the operational requirements and the performance of the field can be more clearly defined. This helps to protect the rights of the IOC when changes and adjustments are made to the levels of production.<sup>736</sup> Hence, if the NIOC initiates action to limit production due to political or social reasons, the restrictions will not impact the entitlement of the IOC to recover costs and fees. This mechanism, along with other flexibilities around local content requirements and the scope of work in the IPC provide greater ability to the IOC to navigate the different stages and phases of the petroleum operations.

The structure of the IPC has also been found to carry potential advantages to Iran and its participation in the international petroleum trade. The JV component that is embedded in the IPC also encourages participation in the production of oil fields to support national industrial and economic development.<sup>737</sup> This is an upgrade on the Buy Back Contract model where the level of State participation was limited. The service nature of the IPCs allows for greater participation in the exploitation of the fields and thus more control in the management and utilisation of its resources. Moreover, the structure of the IPC allows the parties to the contract to determine commercial, political, and other objectives as the outcome goals of the contracts. As the host nation, the Iranian government can establish specific goals and objectives as the criteria entering into a contract with an IOC. Therefore, the government is in a position to establish criteria that act as fundamental principles to govern the IPCs according to domestic laws including the Constitution.<sup>738</sup> However, contractors are also afforded the

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<sup>734</sup> IPC by-laws art 1(27).

<sup>735</sup> Ibid art 1(28).

<sup>736</sup> Ibid art 3(10).

<sup>737</sup> Ibid.

<sup>738</sup> Soleimani and Tavakolian (n 681) 3.



right to establish certain criteria as an incentive to enter into negotiations. Such objectives generally refer to addressing apparent geological (e.g. exploitability of the reservoir), financial (e.g. ROR), political (e.g. economic sanctions), and social (e.g. Corporate Social Responsibility) risks.<sup>739</sup>

### **6.1.1 The long duration of the IPC and the impact on its efficacy in the context of article 81 of the Iranian Constitution**

Article 81 of the Constitution of Iran sets out that it is “absolutely forbidden” for foreigners to have rights “to establish companies or institutions in commercial, industrial, and agricultural fields, as well as in mines and in the service sector”.<sup>740</sup> As worded, the article forbids completely the concessionary system with the terms “absolutely forbidden” as understood in the context of the Constitution meaning that any such attempt by an IOC cannot be legitimised even if it is approved by the Iranian Parliament.<sup>741</sup> In addition to not letting the government of Iran from agreeing to concessions, it restricts the government from affording foreign entities the right to establish companies or institutions that deal with the extraction of mineral resources.<sup>742</sup> Thus, the government of Iran alone has the authority to legitimately deal with natural resources. It can be then inferred from the Constitution of Iran that concessions contracts, PSAs, JOAs or any other type of contract involving foreign participation and control (see Article 44), ownership (see Article 45), or the establishment of foreign companies (Article 81) are not permitted.<sup>743</sup> It is worth briefly considering, however, the implications of this lack of resource ownership and control rights for IOCs for the overall efficacy of the IPC model.

This thesis has established the different phases of petroleum projects and that the length of the exploration and production phases especially can present significant challenges to the planning and implementation of operational activities. A weakness identified in the Buy Back Contact model was that it included a fixed cap on obligations and that the IOC was required

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<sup>739</sup> Ibid.

<sup>740</sup> Constitution of Iran (n 217) 18.

<sup>741</sup> Shahri (n 438) 121.

<sup>742</sup> Ibid.

<sup>743</sup> Giuseppe Sammarco and Simone Tagliapietra, ‘The Political and Commercial Barriers to the Development of Iran’s Gas Market’, in *Iran after the (Potential) Nuclear Deal: What's Next for the Country's Natural Gas Market?* Fondazione Eni Enrico Mattei (FEEM) 14.

to implement a MDP while simultaneously trying to add flexibility to how they transitioned through the phases (i.e. exploration, development, production, and site abandonment).<sup>744</sup> On the one hand, the IPC is a arguably better option than the Buy Back Contract model because it more clearly defines the phases and stages in which the foreign company conducts its operations. The main activities involved in the life cycle of the petroleum product include upstream exploration and production process, along with midstream and downstream activities carried out via prospecting, drilling, developing, refining, marketing, sales, and the like. Because the JVA in an IPC can help to define more accurately the IOCs involvement, greater clarity can be achieved around the extent to which it participates in exploration and production, or just during the exploration or development phases.<sup>745</sup> On the other hand, given that IPCs are long-term contracts of up to 15 to 20 years, their long-term duration arguably has the potential to undermine its efficacy when considered in the context of Article 81. International oil companies are obliged in the terms and conditions of the IPC to hand over management of the petroleum mining project to domestic companies as soon as the latter has acquired the necessary capacity and capabilities to manage the projects.<sup>746</sup> While the domestic companies on the list as potential partners may be public, private, or semi-private, the extent to which private companies especially “function independently from government agencies or political interests” remains an area of concern for IOC.<sup>747</sup> In addition, although IPCs permit booking reserves by IOCs in some instances this does not equate to the transferring of ownership of the petroleum field to the IOC.<sup>748</sup> These contractual conditions in the context of the long-term duration of the contract may undermine the efficacy of the IPC and potentially constrains the operations of IOCs who would prefer to maintain control over the project for as long as possible.<sup>749</sup> In turn, a number of reasons can be suggested for drawing this conclusion. Domestic companies in Iran are generally unable to contribute meaningful financing to petroleum projects.<sup>750</sup> This forces IOCs to contribute a significant portion of the investment for potentially a longer duration

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<sup>744</sup> Kuhn and Jannatifar (n 571) 15; Me (n 501) 22.

<sup>745</sup> Ebrahimi and Shahmoradi (n 679) 6.

<sup>746</sup> Chow (n 22) 5.

<sup>747</sup> Ibid.

<sup>748</sup> Bi-Weekly News & Analysis, No. 1, International Law Office of Dr. Behrooz Akhlaghi & Associates <<http://intl.law.net/wp-content/uploads/2014/06/Iran-Petroleum-Contract-IPC-1st-Bi-Weekly-N-A-April-07-2014.pdf>> 6.

<sup>749</sup> Ibid.

<sup>750</sup> Chow (n 22) 4.

than in previous contract forms. In addition, the long-term duration of the IPC exposes the IOC “to substantial risk for an extended period”, from the initial outlay of capital to get the exploration project running, to the ongoing appraisal and development costs.<sup>751</sup> These are costs which the IOC naturally aims to recoup from earnings.<sup>752</sup> As a result, it may be the case that IOCs could look to withhold technologies or the transfer of know-how to local companies to defer for as long as possible the development of their capacity and capabilities to assume control of the project. This arguably has the effect to undermine the efficacy of the IPC in terms of its capacity to deliver the best outcomes for Iran’s energy sector in a timely and most cost-effective way.

### **6.1.2 Establishing stable and predictable contractual relationships: The role of stabilisation clauses**

Another important consideration in relation to the efficacy of the IPC to deliver optimal outcomes for Iran’s energy sector is the extent to which all parties can benefit from its flexibility provision. As previously established (see section 5.7.4) the IPC By-laws provide the Iranian government with more control over the operations through additional powers to the NIOC to specify KPIs around the commercialisation of the field.<sup>753</sup> These KPIs increase the capabilities of the NIOC to identify and address operational issues and to promote a more collaborative relationship with the IOC to achieve strategic objectives.<sup>754</sup> The NIOC or its affiliated companies may also benefit from greater visibility of the operational outcomes. Furthermore, it is reasonable to suggest that the inclusion of clauses in the IPC for extensions of time due to unpredicted factors and force majeure provides for a contract mechanism to support the management of apparent financial and operational risks due to delay, disruption, and requests for time extensions. Yet, the reality of the implementation context of IPCs is that ownership of the petroleum remains in the hands of the state, IOCs contribute the required capital and expertise for petroleum exploration and exploitation, and state-owned oil companies have only a minor role.<sup>755</sup> As a result, IOCs and the Iranian Government must reach agreement on the processes for the development of the petroleum resources; that is,

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<sup>751</sup> Margarita Coale, ‘Stabilization Clauses in International Petroleum Transactions’ (2020) 30(2) *Denver Journal of International Law & Policy* 218.

<sup>752</sup> *Ibid.*

<sup>753</sup> Soleimani and Tavakolian (n 681) 3.

<sup>754</sup> Ebrahimi and Shahmoradi (n 679) 6.

<sup>755</sup> Coale (n 756) 218.

they must try to establish stable and predictable contractual relationships.<sup>756</sup> One way for IOCs to try to minimise their investment risks is via contract provisions, with stabilisation clauses specifically aiming to address political risk.<sup>757</sup> Such political risks of concern to IOCs include decisions by the host State to expropriate or nationalise the IOC's operation via legislation directly. Alternatively, more indirect control mechanisms may be enforced such as changes in labour laws, accounting rules leading to increased taxes, or the mandating of domestic service and supply contracts and the like which potentially constrain the IOC's capacity to make a profit.<sup>758</sup>

Stabilisation clauses have the specific objective to “secure the [contract] agreement against future government action or changes in law”.<sup>759</sup> In this way, they specify a contractual commitment by the host State to not alter the contract terms, by legislation, regulation or otherwise, without the consent of the other party or parties to the contract.<sup>760</sup> However, the extent to which such stabilisation clauses permit the Iranian government to benefit from the flexibility embedded into the IPC depends to some degree on how the clauses are treated at arbitration. Stabilisation clauses are “a contractual and domestic law matter” and as such there is inherent uncertainty as to the extent the IOC can successfully rely on the clause should it seek investment treaty arbitration and recourse under international law.<sup>761</sup> As Coale points out, however, stabilisation clauses “are taken seriously by arbitrators” who rely less on the precision of the language used in the clauses and more on the “limitation on sovereignty expressed by such a clause in light of all the circumstances surrounding the transaction”.<sup>762</sup> The flexibility produced through the stabilisation clauses is generally towards IOCs being able to adapt financially to changing pressures and demands and to taxation triggers (i.e. after investment recovery).<sup>763</sup> Arguably, there is a general benefit to the Iranian Government from

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<sup>756</sup> Ibid.

<sup>757</sup> Coale (n 756) 220.

<sup>758</sup> Ibid.

<sup>759</sup> Christopher T. Curtis, ‘The Legal Security of Economic Development Agreements’ (1988) 29(1) *Harvard International Law Journal* 346.

<sup>760</sup> Michelle Flores, ‘A Practical Approach to Allocating Environmental Liability and Stabilizing Foreign Investment in the Energy Sectors of Developing Countries, (2001) 141(1) *Colorado Journal of International Environmental Law and Policy* 159-161.

<sup>761</sup> Andrey V Kuznetsov, ‘The Limits of Contractual Stabilization Clauses for Protecting International Oil and Gas Investments Examined Through the Prism of the Sakhalin-2 Psa: Mandatory Law, The Umbrella Clause, and the Fair and Equitable Treatment Standard’ (2015) 22(2) *Willamette Journal of International Law and Dispute Resolution* 268.

<sup>762</sup> Coale (n 756) 236-237.

<sup>763</sup> Eli Lauterpacht, ‘Issues of Compensation and Nationality in the Taking of Energy Investments’ (1990) 8(1-4) *Journal of Energy and Natural Resources* 243-244.

the inclusion of stabilisation clauses in that the flexibility they imply for the IOC provides the IOC with a greater confidence in the contract and hence commitment to the petroleum project. That is, “stabilisation clauses enhance certainty and predictability which are key ingredients for the success of long-term investment projects”.<sup>764</sup> Regarding petroleum exploitation specifically, given that they are capital intensive, and it takes a long time for the IOC to recoup its investment, the prospect of changes to the laws of the host country can give a degree of economic uncertainty and unpredictability over the project. Stabilisation clauses which constrain the host country’s legislative prerogative to change laws unilaterally help to return a degree of certainty and predictability to the project for the IOC which can, in turn, benefit the host country through better project outcomes.<sup>765</sup>

In terms of perceived or potential ‘limitations on sovereignty’, the Iranian Government may look to ensure two key terms and conditions are in place to also benefit from the flexibility afforded the IOC. First, the economic terms and conditions of the IPC should be structured in such a way as to permit the Iranian Government to start to receive some of the agreed revenue early and which do not grant the IOC unrestricted cost recovery at the expense of Iran’s petroleum resources.<sup>766</sup> Second, there is a benefit to the Iranian Government of having local companies as joint partners with the IOC in the project from its outset. This provides the Government with a voice in the project and helps to ensure that any stabilisation provisions are specific in terms of the types of laws and measures they cover. This gives the Iranian Government the opportunity to ‘test’ the proposed stabilisation provisions during negotiation rather than at a point when significant project costs have accrued.<sup>767</sup>

Hence, by making explicit each party’s obligations regarding the completion of the project, mechanisms can be put in place around the requirements for providing timely notice of any changes in time or financial provisions when things do not go as expected.<sup>768</sup> Such consideration of the possible causes of disruptions or delays to operations and the potential for time extensions when drafting the contract may help to avoid contract disputes. That is, during contract negotiations the terms and conditions for how to define, interpret, and monitor delays and disruptions in accordance with the contract provisions can be established,

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<sup>764</sup> Deloitte, ‘Stabilisation Clauses in International Petroleum Contracts Illusion or safeguard?’ (2014) [https://www2.deloitte.com/content/dam/Deloitte/ug/Documents/tax/tax\\_StabilisationClauses\\_2014.pdf](https://www2.deloitte.com/content/dam/Deloitte/ug/Documents/tax/tax_StabilisationClauses_2014.pdf)> 9.

<sup>765</sup> Ibid.

<sup>766</sup> Kuznetsov (n 766) 268.

<sup>767</sup> Ibid.

<sup>768</sup> Ibid.

along with other key aspects including the ‘extension of time’ entitlements afforded the IOC, penalties, and rescheduling commitments.<sup>769</sup>

There are, however, several issues for the Iranian parliament to consider. It has been demonstrated historically that participation of the State in mining operations reduces the attractiveness of the contract option to foreign entity private investors. Additionally, the involvement of the State increases opportunities for patronage and corruption. This is typically when a domestic entity is imposed upon an IOC aiming to enter into JVs with Iran.<sup>770</sup>

### 6.1.3 Meeting legal, economic, and social objectives

This thesis also reported a number of weaknesses in the IPC model in regard to its capacity to achieve the desired legal, economic and social objectives. Although the Iranian government has legally ratified the tendering process for petroleum projects under the IPC model, the analysis revealed that risks remain for successful IOC investors. Indeed, despite the introduction of IPCs as a new contractual and fiscal framework, oil contracts in Iran remain both complicated and remain a point of intense political debate over the extent to which foreign oil companies should have access to the nation’s energy resources.<sup>771</sup> To attract investors to inject investment into the Iranian energy sector, these outcomes must nonetheless be facilitated by transparency in institutional processes and the ability to forecast new petroleum contracts.<sup>772</sup> Moreover, for Iran to provide itself with the best opportunity to have the IPC address its oil industry and economic needs it is vital for its parliament to administer comprehensive oversight of State-owned entities. This is needed to ensure that they demonstrate the efficient management of the petroleum resources and support the development goals of the nation.<sup>773</sup> The IPC model permits the insertion of provisions to address these concerns. For example, IPC By-law Article 2(7) stipulates that the Contractor must fund and perform the petroleum operations on behalf of the NIOC..

In addition, a key finding to emerge from the comparative analysis of the Buy Back Contract and IPC models is the potentially disruptive role that domestic political pressure, historical

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<sup>769</sup> Ghorbani (n 455) 4.

<sup>770</sup> Ebrahimi and Shahmoradi (n 679) 5.

<sup>771</sup> Jalilvand and Ebert Foundation (n 499) 8.

<sup>772</sup> Omid Shokri Kalehsar and Azime Telli, ‘The Future of Iran-Russia Energy Relations Post-Sanctions’ (2017) 24(3) *Middle East Policy*, 164.

<sup>773</sup> The Natural Resource Governance Institute, ‘State Participation in Oil, Gas and Mining’ (2015), <[http://www.resourcegovernance.org/sites/default/files/nrgi\\_state\\_owned\\_Briefing\\_Eng\\_20150811.pdf](http://www.resourcegovernance.org/sites/default/files/nrgi_state_owned_Briefing_Eng_20150811.pdf)> (accessed 22 January 2020).

grievances held by IOCs, and geo-political tensions (manifest as sanctions against Iran by the US) may impact the negotiations for the contracts. ‘Risks’ and ‘profit potential’ are the main factors guiding the decision making by IOCs as to whether or not to pursue resource mining projects in Iran. As such, the recent re-establishment of sanctions on Iran by the Trump administration presents as a major obstacle to understanding the true extent to which IPCs strike the best balance in meeting the needs of both Iran and foreign investor companies to optimally develop the nation’s petroleum sector.

## **6.2 Impact of the Buy Back Contract Model on Iran’s Participation in the International Petroleum Trade**

The introduction of the IPC is significant for its attempt to address the inadequacies of the Buy Back Contract model to attract international investment in the energy sector.<sup>774</sup> In particular, the legal framework of the IPC defines the interests and commitments of the contracting parties are more explicit and transparent in expressing the objective to protect and increase the interests of Iran, while also meeting the interests of IOCs investing in the sector.<sup>775</sup> Indeed, the Buy Back Contract Model demonstrated the need for flexibility within the mechanisms of long-term petroleum contracts, even beyond clauses that permit renegotiation, in order to limit their rigidity.<sup>776</sup> The Iranian government has initiated the IPC as a form of production sharing agreement to promote more flexibility and adaptability in their relationship with IOCs.<sup>777</sup> That is, IPCs make it easier to adapt the production balance to match the primary petroleum interest of each party as well as to accommodate the local conditions. In this way, greater scope for movement within the conditions of the contract is achieved by adjusting the production share of the IOC. The Buy Back Contracts, as a traditional form of a concession license agreements, did not include the provisions to make such adjustments and thus was not an attractive option for IOCs. As discusses above in Section 2.3.2, the capacity for adjustment was manufactured in the Buy Back Contract via a progressive royalty arrangement that relied on profitability indicators to guide adjustments. In contrast, the provisions in PSAs, including the recent IPC model, to provide greater scope for

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<sup>774</sup> Ibid 165.

<sup>775</sup> Ibid.

<sup>776</sup> Bright Erakpoweri Okogu, ‘The Middle East and North Africa in a Changing Oil Market’ (International Monetary Fund, 2003) 40.

<sup>777</sup> Ebrahimi and Shahmoradi (n 679) 13.

adjustments to changing conditions is achieved via non-linear arrangements to share profit-oil.<sup>778</sup>

### **6.2.1 Buy Back Contract model's limited fiscal system**

The limitations around the fiscal system controlling the Buy Back Contract model also impacted the Iran's participation in the international petroleum trade. The progressive tax schemes embedded into the IPC provide the means to achieve more stable and flexible conditions required for the fair sharing of oil profits between the IOC and the host government. Significant profits can be achieved from petroleum projects and the Buy Back Contract model demonstrated the need for there to be fiscal systems in place that can ensure the profits are divided fairly.<sup>779</sup> It may be argued that the IPC model demonstrates the Iranian governments awareness of the importance of meeting these demands as its design includes a variable fiscal regime whereby the government return is adjusted according to profitability levels. As such, the sliding scale mechanism and profit-oil splits in the IPC provide flexibility to account for the volatility of the global price of crude oil.

Therefore, the Buy Back Contract was found to inadequately meet the demands of IOCs for international contract forms and global practices that permit some flexibility, including the scope for renegotiation, in how outcomes are achieved, and profits divided up. Any contract reform initiative to address these types of demands from foreign investors is arguably beneficial to Iran's energy sector because it can include provisions to revise the terms of the contract in response to changing economic and market conditions not predicted when agreeing to the contract. Moreover, relying on a model with greater flexibility than the Buy Back Contract (i.e. the IPC) to facilitate its participation in the international petroleum trade it arguably benefits the energy sector in Iran because it provides IOCs with stronger investment security. By being able to renegotiate contractual terms the IOC will feel a greater sense of certainty that it can adapt to changing conditions as well as incentivised to increase production capacity.<sup>780</sup>

The 'advantage' of the IPC compared to the Buy Back Contract model is also apparent in the inclusion of By-laws<sup>781</sup> that allow for a review and possible adjustment to the Development Plan. As described in Section 5.3, the development plan in an IPC functions as a type of

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<sup>778</sup> Aghion and Quesada (n 737).

<sup>779</sup> Ebrahimi and Shahmoradi (n 679) 13.

<sup>780</sup> Hadiza TijjaniMato, 'The Role of Stability and Renegotiation in Transnational Petroleum Agreements' (2012) 5(1) *Journal of Politics and Law* 33.

<sup>781</sup> IPC by-laws art 1(14).



predictive plan for the lifecycle of the petroleum operations (e.g. underlying assumptions about the project, strategies to achieve desired outcomes, presumed main activities and the like).

As such, it forms the basis of both the prepared submission on the field development and production activities and any adjustments to be undertaken during the lifecycle of the operations. The capacity to make such adjustments thus reduces the rigidity of the contract model, with the focus during initial contract negotiations on establishing the principles of the contract arrangement.<sup>782</sup> Previous Buy Back Contract models demonstrated the complications to operations and the potential for conflicts between the contract parties when there are unanticipated changes in field development costs. By offering greater fiscal flexibility via fee per barrel of production,<sup>783</sup> the IPC is more accommodating of both parties' needs.

### **6.2.2 Technology and knowledge transfer**

This thesis has discussed at length the Buy Back Contract model and the perceived inefficiencies it engendered across the energy resources sector in Iran due to its lack of flexibility and appropriate mechanisms to incentivise IOCs towards increased production. In turn, to provide greater potential for the development of the sector than what was being provided by the Buy Back Contract model, several articles are contained in the IPC model to improve the efficiency of operations. The requirement in IPC By-law Article 4(2) for potential IOCs to maximise their use of qualified and experienced Iranian workers to conduct the petroleum operations provides the platform for the development of local content in accordance with Iranian law.

In terms of the transfer of technology and know-how into Iran, the Buy Back Contract model afforded the NIOC with a relatively ineffective mechanism for delivering cost-effective and targeted training and development to Iranian employees working on the oil mining industry. In contrast, the provision in the IPC that the NIOC has final approval as to the type and level of training for Iranian employees provides it with a more effective mechanism than Buy Back Contracts for the know-how and technology transfer.<sup>784</sup> As a result, the government in Iran can attempt to coordinate the upgrading of Iranian employee knowledge and skills to perform the responsibilities and tasks needed for successful petroleum operations. IPC By-law Article 4(3) on joint R&D mechanisms further illustrates this point. The IOC is required to

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<sup>782</sup> Ebrahimi and Shahmoradi (n 679) 13.

<sup>783</sup> IPC by-laws art 1(20) and art 6(2).

<sup>784</sup> Ebrahimi and Shahmoradi (n 679) 6.

incorporate R&D proposals into the annual Work Program and Budget of the project. As such, it is reasonable to conclude that this provides the Iranian government with an additional lever to pull to promote the modernization of the energy sector.

### **6.3 The Extent to which the Iran Petroleum Contract Addresses the Current and Potential Needs of the Oil Resources Industry in Iran (RQ3)**

A major concern of Iran as a host nation is with regard to the ownership and sovereignty of its natural resources. These two legal requirements are considered in close relationship with one another and host governments typically aim to achieve most of the advantages from these two factors.<sup>785</sup> A key component within the IPC structure to best address the current and potential needs of the oil resources industry in Iran is the JVA structure. The JVAs under which the IOCs operate include joint operating companies, a Joint Management Committee and related contractual structures. One positive for consideration is the by-law ratified by the President stipulating the basic rules and principles of governance for the IPC.<sup>786</sup>

Iran has the bargaining power in the JVA structure because it has ownership of and sovereignty over the oil reserves and can thus use them in international markets. This is primarily because Contract models based on state participation in upstream and downstream petroleum sectors create a continuum of State control over the oil reserves.<sup>787</sup> Pressure from the upstream network is an important consideration in oil production. Significant investment is made over the life-cycle of an upstream network to preserving network flow. As a result, an upstream oil system is often managed by one operator only to ensure that there is coordination in how the fields are managed. Such a coordinated approach to the operations and management of the fields ensures that the entire network maintains a smooth flow. To achieve this outcome the upstream network must be centrally managed.<sup>788</sup>

Iran's reliance on IOCs working in joint venture with a domestic operators will ensure the national interests are met in terms of access to adequate resources for domestic use, as well as support the growth of the private oil industry sector.<sup>789</sup> Current trends favouring vertical and horizontal integration illustrate the integrated management of joint operation arrangements within supply chains. JVAs have persisted as an operational option within the oil industry in

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<sup>785</sup> Ibid 5.

<sup>786</sup> Ibid 3.

<sup>787</sup> Ebrahimi and Shahmoradi (n 679) 3.

<sup>788</sup> Ibid 3.

<sup>789</sup> Mohammad Maleki, M. Eslami, and M. Rezaei, 'Principles of Arbitration in Oil Contracts' (2018) 5(14) *Revista Publicando* 779, 780.

Iran for one main reason. The significant investment costs tied to upstream exploration, development and production projects means it is difficult for one entity alone to develop and finance the entire project. JVAs are entered into as a way to lower the financial burden and to share the risks.<sup>790</sup> As a result, IPCs help to ensure that there are adequate oil resources for domestic use – arguably the first priority of the Iranian government – as well as provide access to the international market.

Furthermore, IPCs best address the current and potential needs of the oil resources industry in Iran because the level of State participation provided through the JVA structure means the host nation has a fiscal tool at its disposal and a more robust platform from which to promote national development goals.<sup>791</sup> With the NIOC as a party to the IPC and the State representative awarding rights to third parties, there is more direct national involvement in the management and utilisation of the national oil resources.

The affordance of the IPC for greater State participation in key extractive projects via the involvement of State-owned entities is a more positive outcome for Iran than that afforded by the Buy Back Contract. With constructive and considered participation, Iran can generate significant financial returns, encourage capacity building, and develop its capabilities around the monitoring of its oil sector.<sup>792</sup>

As has been established throughout this thesis, the main objective the Iranian government in issuing IPCs are to gain access to project financing and to develop its energy sectors. IPCs provide the government with a new set of fiscal tools including taxes and levies to achieve a satisfactory financial return to achieve its objectives for the sector. Moreover, stipulations in the IPC around the participation of the State endorse local content arrangements thus may help to meet the sector needs in Iran. The IPC By-laws for instance (e.g. Article 4[1]) increases the ability of Iranian companies to participate in oil development and production projects. Furthermore, they gain the experience of operating in regional and international markets and can learn the skills and approaches needed to manage competently the oil fields. In sum, the IPC addresses the two primary (legal) concerns of the Iranian government; namely, ownership and sovereignty over the nation's natural resources, by way of a joint arrangement structure (i.e. JVA of JOCs).<sup>793</sup> Primary consideration is given in IPC By Laws

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<sup>790</sup> Ebrahimi and Shahmoradi (n 679) 3.

<sup>791</sup> Marta Peirano and Johannes Grenzfurthner, *Oil Contracts: How to Read and Understand a Petroleum Contract* (Times Up Press, 2012) 24.

<sup>792</sup> Maleki et al (n 795) 781.

<sup>793</sup> Bindemann (n 190) 73.

to ensuring Iran's petroleum (and other natural) resources remain under the ownership and sovereignty of the government rather than a private entity as stipulated in the Constitution. The participation of the state is facilitated in IPCs using JOA, JOC, JMC mechanisms and rotational management procedures.<sup>794</sup> The IPC aims to attract IOCs to participate in the development of Iran's energy sector through the exploration and production of petroleum products. Lessons learned from the Buy Back Contract era however have highlighted that international companies in possession of the resources and expertise desired by Iran to exploit its energy resources, have strong negotiation positions when determining the terms of the contract. As such, the IPC model includes greater flexibility in its mechanisms to manage the fiscal, technical, production and technology transfer objectives. In turn, the different project phases embedded into the IPC provides the contract with a stronger platform from which to manage the project operations and all of its moving parts.

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<sup>794</sup> Ibid.

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