Past Imperfect, Future Tense: Iran’s Oil Industry Post-Sanctions

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The Arab Gulf States Institute in Washington (AGSIW), established in 2014, is an independent, non-profit institution dedicated to increasing the understanding and appreciation of the social, economic, and political diversity of the Arab Gulf states. Through expert research, analysis, exchanges, and public discussion, the institute seeks to encourage thoughtful debate and inform decision makers shaping U.S. policy regarding this critical geo-strategic region.
About the Author

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Executive Summary

Iran is navigating a myriad of challenges in its efforts to restore oil production to pre-sanctions levels and attract foreign investment amid the worst downturn in oil markets in more than a decade. Iranian crude oil production has steadily increased since sanctions were lifted in mid-January, to 3.5 million barrels per day (mb/d) in April, up by 500,000 b/d since the start of the year.¹ Plans to raise production to 4 mb/d by the end of the Iranian calendar year in March 2017 appear ambitious and even modest growth of a further 600,000 b/d by 2021, to 4.6 mb/d, may be out of reach given political, legal, and investment challenges.

President Hassan Rouhani, under fire from conservative politicians who argue the Joint Comprehensive Plan of Action (JCPOA) nuclear deal has failed to deliver the economic benefits promised, is banking on the proposed Iran Petroleum Contract (IPC) that will govern new joint ventures with international oil companies (IOCs) to secure tens of billions of dollars from foreign investment in the country’s oil and gas sector.

Political opposition from hard-line conservative politicians to foreign investment has repeatedly delayed the release of the much-anticipated revised model IPC for IOCs, which is now set for this summer. Industry executives are reserving judgment until more details on the contract emerge and remain cautious about entering into new business deals in Iran given significant political, financial, and legal risks.

Indeed, the initial enthusiasm over Iran’s return to the global community following the signing of the historic nuclear agreement on January 16 has given way to a more pragmatic assessment of complex commercial opportunities in Iran. Tehran’s escalating war of words over what it perceives as U.S. obstacles to achieving economic benefits from the deal is also causing concern among foreign oil companies. Iranian officials argue existing U.S. sanctions that prohibit financial transactions in U.S. dollars, among other restrictions, are blocking European and Asian banks from handling new business ventures with the country.² In response, U.S. Secretary of State John Kerry, EU foreign policy chief Federica Mogherini, and their European counterparts have undertaken a series of extraordinary meetings with banks and the broader business communities to clarify that remaining primary U.S. sanctions, outside the scope of the JCPOA, are not a barrier to doing business with Iran.³ However, reassurances from high-level U.S. and European government officials have so far failed to dampen the criticism leveled by Iran.

Moreover, companies say primary U.S. sanctions are just one obstacle that is limiting their engagement with Iran and that other serious risks remain. Iran’s well-documented history of money laundering and financing terrorist activities has made it subject to derogatory reports from the Financial Action Task Force. That, in addition to Iran’s opaque financial industry, makes it a high-risk country with which to conduct business.⁴ Rouhani is taking some measures to address the country’s substandard banking industry and implementing economic reforms.

¹ “Iran Crude Oil Output Crosses 3.5 mb/d,” Shana, April 16, 2016.
² “EU foreign policy chief admits Iran deal difficulties,” The National, April 17, 2016.
but it will be a long, arduous process.

While the nuclear agreement appears to be fraying at the edges, the architects of the hard-won deal, both in the West and Tehran, are committed to staying the course. Rouhani has the unenviable task of managing overinflated economic expectations at home and at the same time delivering a meaningful financial dividend in the coming year. European and U.S. officials, mindful that Rouhani needs an economic windfall to maintain support for the deal, continue to encourage companies, outside the United States, to invest in Iran and explore options that will ease the process.

The successful launch this summer of the new petroleum contract for foreign oil company investment could provide a much-needed boost to Rouhani's reformist government. Indeed, the political and financial imperative to increase oil production and revenue may lead the government to pursue a more commercial and investment friendly approach than in the past. Equally, continued political interference with the contracts may further dampen IOCs' interest. Finalizing new oil contracts for foreign participation would likely not take place until 2017 but announcements of new contracts worth billions of dollars could provide a valuable political dividend in the short term.

Introduction

Iranian President Hassan Rouhani's efforts to deliver an oil revenue dividend from the nuclear accord has been severely undermined by the 60 percent plunge in prices since negotiations for the agreement started in earnest in 2013, making a major effort to increase oil exports all the more urgent. Iran's plan to rapidly restore its pre-sanction export levels could hardly come at a worse time, with an already intense battle for market share being waged by both non-OPEC and OPEC producers in the current oversupplied, lower-priced market. Saudi Arabia, Russia, and Iraq largely replaced Iranian exports while the most stringent sanctions were in place from 2012-15 and, not surprisingly, are unwilling to relinquish their higher market share.

Securing export outlets for higher crude output and attracting foreign investment have been problematic. Untangling the web of primary U.S. sanctions that have remained in effect following the Joint Comprehensive Plan of Action (JCPOA) has created difficulties for European and Asian oil trading companies looking to buy crude from the National Iranian Oil Company (NIOC). Older U.S. sanctions are still in effect that designate Iran as a state sponsor of terrorism and block Iran from access to the U.S. dollar banking system, among other constraints. Iran's inability to process international banking transactions and access its foreign reserves that were frozen under the sanctions led the head of Iran's Central Bank in April to formally complain to U.S. and EU officials, who are now exploring options to improve the process.

The initial euphoria of some professionals in the international oil industry over the prospect

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for new opportunities in Iran's oil sector has been replaced by a more cautious outlook. Iran's oil ministry released a very preliminary draft proposal for the contract in November 2015 but there were few details, and what was included received a mixed reaction. Political opposition to bringing IOCs back into the country has repeatedly delayed finalizing the contract's framework and terms. Resistance to allowing foreign companies back into Iran cuts across both hardliners and more moderate political factions given the oil and gas industry is at the heart of the country's nationalistic pride, but the latter group has quietly accepted foreign investment is needed to deliver a boost to the economy. Crafting the framework for the contract has taken more than a year, with adjustments continually made to address political sensitivities. The formal launch of the new petroleum contract for international oil and gas companies will reportedly take place in late June or July.

Iran's ambitious plans for its upstream oil sector include raising crude oil production capacity to 4.2 mb/d with costs estimated at around $135 billion over the next five years. The country is hoping to attract $30 billion from IOCs with advanced technologies to finance capital-intensive projects aimed at reviving aging oil fields. Development of Iran's oil fields has been severely constrained by the lack of investment and access to advanced technologies such as enhanced oil recovery techniques. Iran's previous contracts were not financially attractive to IOCs and made for severely strained relationships between companies and NIOC. Foreign companies are looking for a significant improvement in investment terms in the new IPC for the projects being offered in the first bidding round this summer. Equally important, a more investor-friendly, commercial operating relationship is expected, especially in the current low oil price environment and era of budget controls.
Weak Links in Fragile Accord Fuels Political Opposition

Iran is facing formidable challenges in reviving its oil industry, not least due to entrenched domestic political opposition to the nuclear accord in Tehran and Washington. Many companies around the world are reluctant to engage with Iran over fears that the agreement could unravel. Concerns include existing U.S. sanctions impeding Iran's return to international markets, Tehran's intransigence over its ballistic missile test programs, and the U.S. presidential election in November.

Of immediate concern are the U.S. sanctions not included in the JCPOA, which are proving to be a weak link in the fragile agreement and are fueling arguments against the landmark deal by Iranian and Washington politicians. The JCPOA removed multilateral economic sanctions on Iran's energy, financial, shipping, and other sectors. However, older U.S. sanctions still in effect that designate Iran as a state sponsor of terrorism block Iran from access to the U.S. dollar banking system, among other constraints. Iran has taken to task EU and U.S. officials over the complex primary U.S. sanctions that remain in place, arguing that they are undermining financial transactions in U.S. dollars, hindering the recovery of Iran's frozen assets, and discouraging European banks and investors from business activities with Iranian counterparts.

Fierce political opposition to the nuclear accord by Iranian hard-line conservatives has been relentless since the process started, but the rhetoric has escalated in recent months due to the delays in completing new investment deals. The fervor against Rouhani and his reformist policies is expected to escalate heading into Iran's presidential elections scheduled for spring 2017.

For Rouhani and his supporters, finding a solution to the problematic U.S. sanctions is critical to delivering the economic benefits promised from the nuclear accord. In a major setback to the ultraconservative political parties, April's runoff elections gave moderates and reformists a working majority in the Iranian Parliament for the first time in more than a decade, which may give Rouhani some breathing space.

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EU Banks Tread Carefully

A post-sanction tour of Europe and China by Rouhani in late January garnered tens of billions of dollars in new investment for electric power infrastructure, steel, automobile, and aircraft industries, among other sectors. In Italy alone, Iranian officials signed $22 billion worth of deals. Iran has also reached a number of bilateral economic accords and investment deals with India and South Korea. However, five months after sanctions were lifted, few deals have been formalized, with Iranian officials complaining U.S. sanctions are limiting companies' ability to operate in the international banking system. Iranian Central Bank head Valiollah Seif formally complained to U.S. officials in April that more steps were needed to facilitate financial transactions, including access to the U.S. banking system. Iranian officials argue that the West is not adhering to the agreement, singling out the United States in particular.

Existing U.S. laws sanction Iran for its role as a state sponsor of terrorism, which includes its support for Hizballah and its destabilizing conduct in Syria, Iraq, and other countries. In addition, U.S. sanctions target Iran's powerful Islamic Revolutionary Guard Corps (IRGC) and individuals and companies associated with it, which by some estimates control around 50 percent of Iran's economy. IRGC companies are run by trust-ownership schemes, which are near impossible for banks to navigate as part of the necessary due diligence process.

European banks are especially wary of running afoul of existing U.S. sanctions after paying a high price for violations in the past. European banks have paid tens of billions of dollars since 2009 for violating U.S. sanctions, with France's BNP Paribas paying out $9 billion in 2015.

In a response to Iranian criticism about U.S. sanctions policy, Secretary of State John Kerry told a press conference in late April that “The United States is not standing in the way and will not stand in the way of business that is permitted with Iran since the JCPOA took effect.” He added, “We've lifted our nuclear-related sanctions as we committed to do and there are now opportunities for foreign banks to do business with Iran. Unfortunately, there seems to be some confusion among foreign banks, and we want to try to clarify that as much as we can.”

Leading a trade delegation to Iran in April, EU foreign policy chief Federica Mogherini, during a press conference with Iranian Foreign Minister Mohammad Javad Zarif, agreed that there have been problems in implementing the accord but downplayed the financial issues, saying they would work with non-U.S. banks to ease the process.

In mid-May, Kerry, along with officials from the U.S. Treasury Department, embarked on yet another round of meetings with European government officials, banks, and companies in

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14 “EU foreign policy chief admits Iran deal difficulties,” The National, April 17, 2016.
15 “European banks remain cautious about Iran, in spite of lifted sanctions,” European CEO, May 2, 2016.
an effort to quell concerns over U.S. primary sanctions and explore other means to support companies resuming normal trade and investment with Iran. Kerry met with Britain’s Foreign Secretary Phillip Hammond and about 10 major European banks in London on May 12 to discuss the issues but the responses were not all positive. Stuart Levey, chief legal officer for HSBC Holdings and a former undersecretary for terrorism and financial intelligence at the Treasury Department, attended the London meeting and afterward wrote in an editorial for The Wall Street Journal, “Our decisions will be driven by the financial-crime risks and the underlying conduct. For these reasons, HSBC has no intention of doing any new business involving Iran. Governments can lift sanctions, but the private sector is still responsible for managing its own risk and no doubt will be held accountable if it falls short.”18

Despite U.S. and EU assurances, banks and companies argue that there are still considerable risks in doing business with Iran. Specifically, Iran's deep-rooted history of money laundering and financing terrorist activities violates international laws, not just U.S. sanctions. The lack of transparency in Iran's financial sector makes it near impossible for companies to track or investigate who they are ultimately transacting business with, especially with the IRGC.

Mirroring the companies’ concerns, on May 17 at a meeting in Tehran an official with the International Monetary Fund – the first high-level IMF official to visit Iran since the 1979 revolution – said that major banking reforms are needed in order for Iran to reintegrate into the international financial system. “The authorities should persevere with strengthening the framework for anti-money laundering and combating the financing of terrorism, which should be critical to facilitate such reintegration,”19 according to David Lipton, first deputy managing director at the IMF.

Kerry, Mogherini, and partners from France, Germany, and the United Kingdom held another meeting in Brussels on May 19 to address financial concerns, discussing the possibility of using export credits and project financing to increase trade with Iran. After the meeting the group said it would continue to encourage investment in Iran but, in a nod to banks and other businesses, added that Iran needs to adopt recommendations from the Financial Action Task Force for combating money laundering and terrorist financing.20

The more aggressive posturing by Iran has led some analysts to conclude that Tehran is trying to change the rules of engagement by seeking further sanction concessions from Washington above and beyond the JCPOA. These primary sanctions, however, are not up for negotiation. The United States has ruled out granting Iran access to the U.S. banking system but Treasury Department officials are exploring various mechanisms to grant Iran access to U.S. dollars, including issuing “licenses to offshore dollar clearing houses for specific Iranian financial institutions, an approach that wouldn't require the involvement of American banks,” according to Stuart Levey, “Kerry’s Peculiar Message About Iran for European Banks,” The Wall Street Journal, May 12, 2016.

Despite U.S. and EU assurances, banks and companies argue that there are still considerable risks in doing business with Iran.

19 “Statement by Mr. David Lipton, First Deputy Managing Director of the IMF, at the Conclusion of his Visit to Iran,” IMF, Press Release No. 16/224, May 17, 2016.
to The Wall Street Journal.\textsuperscript{21}

For its part, Iran can explore options that would provide alternative solutions for improving the country's poor investment climate. Restructuring the framework for foreign investment, adopting international standards in its banking sector, and tackling endemic corruption will be an almost insurmountably complex and lengthy process. At the same time, Iran could pursue other options such as new proposals to set up a free financial center in one of the country’s free trade zone, which have been put forward as a means to facilitate increased cash flows now that some sanctions have been lifted. The plan would only be useful if international banking regulations were implemented and the government provided guarantees but starting a new financial center in a free trade zone based on international standards would be far easier than reforming the existing damaged system. Proposals for a financial center in a free trade zone, however, have met with some resistance from finance officials, including at the Central Bank, and would require deft political maneuvering by Rouhani to get such a project off the ground.\textsuperscript{22}

\textbf{Political Hurdles Loom}

The U.S. presidential election in November is also injecting uncertainty about the sanctity of the agreement for oil investors. Front-runner Democratic candidate Hillary Clinton publicly supports the accord but has taken a more hawkish approach than the Obama administration, which raises questions about her willingness to uphold the agreement.\textsuperscript{23} On the same day that sanctions were officially removed in January, Clinton called for new sanctions against Iran: “Iran is still violating UN Security Council resolutions with its ballistic missile program, which should be met with new sanctions designations and firm resolve.” Clinton repeated her argument for new sanctions in March after Iran launched two more test missiles, which the country’s IRGC said were designed to reach Israel.\textsuperscript{24} The United States, France, Britain, and Germany have also asked the U.N. Security Council to respond to Iran’s recent ballistic missile tests, which they say contravene a U.N. resolution that bans testing of missiles capable of carrying a nuclear weapon.\textsuperscript{25}

The presumed Republican presidential candidate Donald Trump has repeatedly said that one of the first things he would do if elected is renegotiate the Iran nuclear accord. “My No.1 priority is to dismantle the disastrous deal with Iran.”\textsuperscript{26}

\begin{itemize}
\item \textsuperscript{21} Jay Solomon, "U.S. Moves to Give Iran Limited Access to Dollars," The Wall Street Journal, April 1, 2016.
\item \textsuperscript{22} Alireza Ramezani, "Will ‘free financial center’ lure foreign banks to Iran?" Al Monitor, May 6, 2016.
\item \textsuperscript{24} Sam Wilkin and Bozorgmehr Sharafedin, "Clinton calls for sanctions on Iran after more missile tests," Reuters, March 9, 2016.
\item \textsuperscript{25} Edith M. Lederer, "US and allies urge UN action against Iran for missile tests," AP News, March 30, 2016.
\item \textsuperscript{26} Steve Chapman, “Why it’s too late to scrap the Iran deal,” Chicago Tribune, April 20, 2016.
\end{itemize}
Meanwhile, U.S. congressional opposition to the nuclear deal is behind a number of bills being put forward that would impose new sanctions primarily targeting the country's ballistic missile program and the IRGC. President Barack Obama has threatened to veto the bills, arguing they break with the spirit of the comprehensive nuclear agreement, but a new administration in 2017 may take a different stance. For IOCs contemplating spending billions of dollars in Iran, the prospect of a “snap back” to full sanctions should Tehran violate the terms of the agreement will increase come November.

Reclaiming Market Share Faces Headwinds

Iran's efforts to reclaim market share post-sanctions have been complicated by the current supply glut overhanging oil markets. With crude oil prices having fallen 60 percent from a peak of around $110 per barrel (\$/bbl) in mid-June 2014, sellers were aggressively pursuing customers long before Iran started increasing exports in January. After a slow start early in 2016, Iran increased oil exports to 1.6 mb/d in March and near 2 mb/d in April. That compares with an average 1.1 mb/d before sanctions were lifted.

Iranian oil exports averaged 2.5 mb/d and production was around 3.75 mb/d before the United States started tightening sanctions with more restrictions on the banking sector in 2011. The EU adopted more stringent sanctions in mid-2012, halting Iranian sales to Europe, which typically bought roughly 25 percent of the country's crude exports. Asian customers, not part of the sanctions agreement, nonetheless reduced imports from Iran under pressure from the United States and EU countries. Iran's long-term customers China, India, Japan, South Korea, and Turkey, as well as several other smaller importers, lowered imports to a combined 1 mb/d, a level given tacit approval by the U.N.-led partners.

Saudi Arabia, Russia, and Iraq were key beneficiaries of Iran's lost market share under sanctions, supplying all of Iran's European customers as well as some Asian buyers. From 2011-15, the three countries collectively increased production by 2.5 mb/d, more than offsetting the almost 1 mb/d decline in Iranian production.

Iran's efforts to increase exports in an already highly competitive market are being hindered by IOCs and trading companies shying away from the onerous financial controls that need to be navigated post-sanctions for fear of running afoul of U.S. sanctions. European banks are reluctant to issue letters of credit and shipping insurers are unwilling to provide coverage for cargoes.

While oil exports are rising, the deals are complex and almost all crude sales have been done in euros, depriving the government of an increased flow of U.S. dollars. India has been a major buyer of Iranian crude, at 500,000 b/d in April, but is paying 55 percent in euros and 45 percent in rupees, which is far from ideal. Indeed, frustrated by banking constraints, NIOC has told

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28 Jonathon Saul and Parisa Hafezi, "Iran struggles to find enough ships for oil exports," Reuters, April 20, 2016
customers they must pay in euros.\textsuperscript{29} Payments for the crude in euros, however, have been slowed by problems transferring funds to Iranian banks.

The JCPOA allowed Iranian banks to rejoin the Society for Worldwide Interbank Financial Telecommunication (SWIFT) system to conduct financial transactions electronically but so far only a small number have been reinstated. SWIFT regulators have to preform extensive due diligence before certifying a company, made more complicated because Iran is still designated as a risk country by the Financial Action Task Force due to its “failure to address the risk of terrorist financing and the serious threat this poses to the integrity of the international financial system.”\textsuperscript{30} As a result, regulators must follow a stricter due diligence process.\textsuperscript{31}

Iran has made significant progress in raising oil exports to pre-sanction levels but buyers complain that a lack of flexibility on credit terms, strict destination clauses, and pricing may cap volumes going forward. So far, Iran has lined up 700,000 b/d in term contracts out of its 2 mb/d of exports. In the current oversupplied, weak oil market buyers are looking for more flexible terms that enable them to move cargoes around as needed. In a first, even Saudi Arabia has adopted a more flexible marketing approach by selling spot crude barrels to China.

**Escalating Saudi-Iranian Tensions**

Iran’s bid to reclaim market share and raise production levels has, as expected, led to strains with some of its fellow OPEC members, especially with its long-time rival Saudi Arabia. The April OPEC and non-OPEC Doha talks to “freeze” production collapsed after Saudi Arabia refused to sign a deal without Iran becoming party to it.\textsuperscript{32} Iran had stated months in advance that it would not participate in a freeze at January production levels, arguing it needs to recapture lost market share and restore production to pre-sanction levels before it participates in an agreement. “If Iran keeps oil output at January levels, it means that there is no impact on the lifting of sanctions,” Iranian Oil Minister Bijan Zanganeh said.\textsuperscript{33}

The intervention by Saudi Arabia’s new power broker, Deputy Crown Prince Mohammed bin Salman (MbS), to kill the deal at the eleventh hour has now cast a cloud of uncertainty over the next OPEC ministerial, scheduled for June 2 in Vienna. OPEC has coped with serious conflicts between its members in the past, including the eight-year war between Iraq and Iran and Iraq’s invasion of Kuwait. However, the latest fracture in relations between heavyweights

\textsuperscript{29} Nidhi Verma, “Iran wants euro payment for new and outstanding oil sales,” Reuters, February 8, 2016.


\textsuperscript{31} “Iran sanctions: It’s complicated,” Deutsche Welle, April 21, 2016.

\textsuperscript{32} Diane Munro, “Sudden Saudi Policy Shift in Doha Injects a New Level of Volatility into Oil Markets,” Arab Gulf States Institute in Washington, April 21, 2016.

\textsuperscript{33} Arash Karami, “Iranian-Saudi rivalry claims another victim,” Al Monitor, April 18, 2016.
Saudi Arabia and Iran has left the group without a clear direction and ignited oil market fears of an all-out war for market share, with Saudi oil policy now seemingly being dictated by MbS. His unexpected move to abandon the Doha “freeze” agreement is widely seen as a more aggressive use of oil policy to attack Saudi Arabia’s nemesis, Iran. Though not unexpected, the replacement of long-serving Oil Minister Ali al-Naimi with Saudi Aramco Chairman Khalid al-Falih on May 7 clearly cemented MbS’ role in setting oil policy. Falih is a widely-respected veteran of the international oil industry and a close advisor to MbS.

Saudi Arabia’s opposition to the Washington-led nuclear talks with Tehran in part reflects its concerns that a sanction-free Iran will use the economic windfall to further fund its political ambitions in the region. MbS, who also serves as defense minister and head of the powerful economic council, has taken a much more confrontational approach against Iranian political machinations in the region, from Yemen to Syria to Lebanon. His stated willingness to increase production by up to 1 mb/d has led to oil market speculation that he is prepared to crash prices in a bid to deprive Iran oil revenue.34

As the lone swing producer in OPEC, Saudi Arabia has long set the group’s policy, but Naimi usually took a more diplomatic approach to the role, in contrast to some blunt public statements from MbS. At a time when OPEC’s smaller, more vulnerable members are starved of oil revenue, comments from MbS that the Saudis do not care about price levels may have struck like a knife to the bone. “But this battle is not my battle. It’s the battle of others who are suffering from low oil prices,” MbS said, adding Saudi Arabia isn’t concerned about price levels because “we have our own programs that don’t need high oil prices.” The brusque comments bode ill for the June meeting, though new energy minister Falih will no doubt soften the tone.35

34 Barbara Kollmeyer, “Saudi prince says country could unleash a million barrels of oil a day,” MarketWatch, April 18, 2016.
Iran may yet step in and offer up a plan to freeze production at its now higher level at the OPEC gathering. There is speculation that Iran is ramping up production to 3.6 mb/d in a bid to set a higher baseline for any new production agreement. Saudi Arabia, however, may no longer be interested in freezing production given the recent oil price gains, now hovering around $45 to $50/bbl compared to $30/bbl when the “freeze” idea was first proposed in January.

Iran's oil industry holds the promise of significant growth potential for the country after more than a decade of sanctions and access to advanced technologies such as enhanced oil recovery techniques. Iran's plans to raise oil production capacity to 4.6 mb/d by 2021 hinge on its ability to attract IOCs with advanced technologies to finance the capital-intensive projects. Iran has projected it will need around $135 billion for the upstream sector in the sixth Five-Year Development Plan that runs from 2016-21. Of that, the country is hoping foreign investment will provide at least $30 billion. Iran's projected production targets appear to have been downgraded by a steep 1 mb/d in the latest five-year plan, from an overly ambitious 5.6 mb/d target mooted in 2015 when expectations for the industry were running high following progress on the nuclear agreement.

The oil ministry unveiled the framework of the new Iran Petroleum Contract (IPC) at a conference attended by approximately 150 IOCs in November 2015 in Tehran. However, IOCs said the draft contract lacked sufficient detail to assess whether it will be competitive with other opportunities. The IPC replaces the previous unpopular “buy-back” contract, which companies complained was too short term with repayment in oil produced subject to inflexible terms.

Iranian oil officials have had an uphill battle in finalizing a new contract for foreign participation – a process that started long before the sanctions agreement was reached in July 2015. Indeed, the first draft for the IPC was prepared in early 2014. Since then multiple versions have been drafted by a special committee in an effort to satisfy domestic opposition. Iran cancelled a conference scheduled for late February when it planned to release the final new IPC amid political infighting over the draft’s terms. Iranian oil officials recently said they expect to finalize the contract's framework in late June or July, and start negotiations with companies soon after.

As it currently stands, the draft IPC is being sold as a “risk service contract” that reportedly removes all of the problems of the buy-back agreement and includes some aspects of the more typical production-sharing contract. The new contract is longer at 20 to 25 years, which will allow companies a greater return on their investment. Companies will also have increased flexibility for cost recovery. A major improvement in the new contract is that it allows companies to book reserves in their financial reports, even though Iran has exclusive ownership of the oil reserves.

The IPC also stipulates that IOCs partner with Iranian oil companies, which would own a controlling share of not less than 51 percent of the joint venture. Iran has been touting this as a selling point domestically, since the joint venture arrangement boosts local companies and also calls for IOCs to transfer technology to their Iranian counterparts. However, for many foreign companies, entering into a junior partnership role with a local Iranian firm is fraught with problems. While IOCs bear all the project's costs and risks, the Iranian partner as major stakeholder can slow decision making and block key decisions.

Also of concern for IOCs is the legal framework for the IPCs. In the event of a dispute between the joint venture partners, the IPC contract is under the jurisdiction of Iranian courts rather than international arbitration. Other challenges involve navigating Iran's widely reported corrupt business practices. The IRGC plays a significant role in the oil sector and foreign companies also run the risk of violating U.S. sanctions on the powerful military organization.

Iran holds the world's fourth largest oil reserves but development lags behind other major producers due to the Iranian Revolution in 1979, the country's long war with Iraq from 1980-88, and the more than three decades of sanctions. Iran's oil fields have suffered from a lack of access to latest technology, investment to maintain operations and routine field maintenance, and mismanagement over the years.

A New Era at the Oil Ministry and NIOC

The appointment of veteran politician Zanganeh as oil minister in August 2013, a post he held twice under previous administrations, was roundly applauded after the prior eight years when politics overran the oil ministry and the national oil company. Former Iranian President Mahmoud Ahmadinejad's appointment of IRGC General Ghassem Rostami as oil minister in 2005 ushered in an era of mismanagement and the rise of IRGC-run construction conglomerate, Khatam al-Anbiya, which gained a major foothold in Iranian oil and gas projects. The IRGC controls some 800 companies across the country, with deep links to the oil and gas sector, especially the giant South Pars gas development projects. As part of the JCPOA, the EU lifted sanctions on Khatam al-Anbiya, which will technically allow European firms to engage in joint venture partnerships with its subsidiaries. U.S. sanctions on IRGC companies remain in place.

Zanganeh has been cautious in sweeping the broom since he took over, but following the vote of confidence from April's runoff elections, major structural and management changes were made at the oil ministry and NIOC, with veteran oil executives and close allies filling the top posts. Zanganeh immediately appointed Roknoddin Javadi as deputy oil minister and managing director of NIOC when he became oil minister in 2013, and has now expanded the portfolio by appointing four deputy managing directors to support Javadi and implement more management oversight.

The oil ministry and NIOC have identified around 52 upstream oil and gas projects to overhaul

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38 Alex Vatanka, “Hit the Gas in Iran: Oil Minister Bijan Zangeneh’s Big Plans,” Middle East Institute, March 15, 2016.
aging fields and develop some new ones as well as 18 exploration blocks. The list includes 29 onshore and offshore oil fields, with 14 new projects for a targeted producing capacity of just over 1 mb/d. The 15 older projects identified for enhanced oil recovery (EOR) or improved oil recovery (IOR) technologies are aimed at stemming decline rates and improving recovery. Data about decline and recovery rates are not publicly available but outside estimates peg Iran’s recovery rates lower than elsewhere in the region, at an average of 20 percent, compared to higher recovery rates in Saudi Arabia, Kuwait, and Iraq of around 35 to 40 percent.

Iran’s major oil producing fields, located in the Khuzestan region in the west and northwest of the country bordering Iraq and the Gulf, are priority projects for foreign investment and include the country’s four largest onshore fields: Ahwaz, Marun, Gachsaran, and Agha Jari. With Iran’s oil reservoirs suffering from underinvestment and irregular maintenance, these aging fields will require higher capital expenditure for EOR and IOR than more conventional development projects.

Zanganeh has said the priority is also for the development of border fields, which share reservoirs with neighboring countries, including South Azadegan, shared with Iraq. Contracts for development of the offshore Farzad and Foroozan fields, which are shared with Saudi Arabia, are unlikely now given the escalating tensions between Tehran and Riyadh.

Near term, the first tranche of contracts issued by Iran are likely to be aimed at oil service companies for above-ground infrastructure operations such as production units, flow lines, trunk pipelines, and gas compression facilities since smaller service contracts may be easier to finalize than striking the IPCs with international companies.

Iran next plans to invite foreign oil companies to bid on the projects in July once the IPC is finalized. Whatever their misgivings, all the major European and Asian oil companies are expected to beat a path to Tehran to review the new investment contract details. Indeed, preliminary discussions with IOCs over various projects have reportedly already taken place, including Royal Dutch Shell, France’s Total, Italy’s ENI, and Austria’s OMV. BP is reportedly planning to open an office in Iran this summer.41

Conclusion

While political and financial obstacles are tempering IOCs’ enthusiasm, left unsaid publicly is a reluctance by companies to re-engage with Iran given the long history of poor contract terms coupled with the difficult working relationship with the oil ministry and NIOC. An uneasy balance has existed between foreign operators and an oil sector steeped in nationalism and compounded by the politicization of the country’s oil sector since the 1979 revolution. A more pragmatic, commercial approach is likely required now to attract foreign investment against the current low oil price environment and oil companies’ razor sharp focus on the bottom line.

Release of the final IPC this summer will add some clarity on the country’s future oil industry prospects. Given the complexities, formalizing contracts with IOCs will likely not take place until 2017, which makes the country’s production target of 4.6 mb/d by 2021 near impossible given the long lead times of five to seven years needed to bring on new production. Industry experts are forecasting a much more modest increase in Iranian production plateauing at around 3.9 mb/d to 4.0 mb/d by 2021. Iranian officials have readily stated that to boost production much beyond 4.0 mb/d will require foreign oil company expertise.

This timeline, however, is vulnerable to the multitude of obstacles that need to be traversed for the development of the oil sector. Casting a long shadow over foreign investment prospects is Iran’s continued intransigence over its ballistic missile tests, which may lead to additional sanctions from the United States and EU. Fears also loom large that Iran will violate terms of the JCPOA agreement and trigger the so-called “snapback” mechanism, allowing for a resumption of

of bilateral sanctions from P5+1 members (the United States, Russia, Britain, France, China, plus Germany).

Near term, a continuation of Tehran’s war of words over existing U.S. primary sanctions may serve to further erode investor confidence and fuel opposition from the country’s hard liners and disappointment within its population. The high-pitched rhetoric blaming the United States for blocking the much-anticipated economic windfall less than five months after sanctions were lifted appears hyperbolic, especially measured against the more than 10 years of diplomatic efforts to reach the final agreement. No doubt it was necessary for Iranian negotiators to expound on the economic benefits to get the deal finalized, but managing expectations among the voters is critical to retain support for the accord.

European and Asian energy companies will tread carefully due to existing U.S. sanctions, political machinations, and Iran’s opaque financial structure. That said, the global oil industry has always operated in high-risk environments and Iran is no exception. Attractive investment terms in the final petroleum contract may ultimately offset the geopolitical risks for IOCs and deliver the much hoped for economic dividend. However, sustaining the enormous amount of political willpower that was garnered to achieve the landmark nuclear agreement will be challenging but critical for a resurgence of Iran’s oil sector.