



MIDDLE EAST E-BRIEFING

THE NEW IRANIAN PETROLEUM CONTRACT – KEY TERMS RELEASED

DECEMBER 2015

MIDDLE EAST

The key terms of the eagerly awaited new Iranian Petroleum Contract (**IPC**) were released officially at the Tehran Summit, a two-day conference held recently in Tehran on 28 and 29 November 2015. During the conference, Iran provided details of around 50 oil and gas projects that it plans to offer to investors with the hope that the projects initially will generate approximately \$25 billion in investments.

RELATED LINKS

[Herbert Smith Freehills](#)

[Iran homepage](#)

[Iran insights](#)

[Middle East insights](#)

[Herbert Smith Freehills insights](#)

The IPC will replace the buyback contract structure, in respect of which both foreign investors and Iranian entities have previously raised a number of concerns.

On the face of it, the IPC may appear to be similar in many respects to the buyback contract. However, some key changes have been made and, although these changes may not be as substantial as some perhaps expected, we anticipate that the new structure will be looked on favourably by both foreign investors and Iranian entities as it (a) addresses many of the previous concerns of foreign investors; and (b) ensures the continued improvement of Iranian capability through Iranian participation and the transfer of technology and know-how. In summary the key considerations are as follows:

- A longer term;
- Ability of the foreign investor to be involved in operating the fields during production;
- No cap on recovery of capital costs;
- A remuneration fee set as a \$/bl or \$/scf amount, linked to production rates and an "R factor", with the ability to adjust the fee against market prices;
- Incentives for higher risk fields, brownfield projects and smaller fields, as well as IOR/EOR projects; and
- Requirements and incentives for the transfer of technology and know-how, as well as participation of Iranian entities in all phases of the project.

Reviewing the full terms of the IPC (which are only expected to be released during the first tender process for available fields – to occur potentially in March 2016) will be fundamental in properly understanding how the changes will be implemented.

Concerns with the buyback structure

The Iranian buyback contract was often characterised by the oil industry as a risk-based service contract in which the foreign investor agreed to develop an oil or gas field and provide all of the required capital in return for earning a lump sum remuneration fee and recovering its costs, which was intended to occur once the field was producing.

Whilst no two buyback contracts are exactly the same, some of the main concerns raised with the generic terms found in a number of buyback contracts are summarised below.

- Operator risk

The foreign investor was only permitted to act as operator during the exploration and development phases of a field. On handover of the project (usually the commencement of commercial production), the National Iranian Oil Company (**NIOC**) took over as operator of the field. The foreign investor was therefore often reliant on the NIOC to operate the field to a sufficient standard to ensure that there would be adequate production to meet the foreign investor's costs and remuneration.

This risk was exacerbated in some buyback contracts which allowed the NIOC to adjust the remuneration fee downwards if the production from the field did not match the estimated production within the field development plan.

- Capital costs ceiling

The buyback contract normally contained a cap on the capital costs that could be recovered by the foreign investor (as determined at the commencement of the contract or within a certain period after commencement) based on the estimated cost of the project. There was often little tolerance built into the cap to take into account additional unforeseen costs (such as those caused by force majeure events or other events outside the control of the foreign investor), and the cap could only be increased for additional works approved by the NIOC.

In many cases, the investor therefore took the risk that the cap would not be sufficient to cover the costs actually incurred by it in developing the field.

- Additional constraints on cost recovery

The term of the contract was generally quite short (and could only be extended with the mutual agreement of the NIOC), and there was generally no ability to recover costs after the end of the term. This, combined with fact that certain costs incurred by the foreign investor were only able to be recovered within a set amortization period, meant that there were potential limitations on whether costs could be recovered fully.

In addition, it was intended that the foreign investor was only entitled to a percentage (up to a maximum of 50%) of the revenues generated from the total production of the field to recover its costs and earn the remuneration fee, and this was often further limited by the term of the sales agreement with the NIOC (under which the foreign investor received its costs and remuneration entitlement), which could only be for a term of no more than 15 years.

- No incentives for foreign investors

There were little incentives in the buyback structure for foreign investors to develop riskier fields or fields that required more costly procedures (such as brownfield projects or those that required IOR/EOR techniques). Certain contracts contained severe consequences (such as termination) for a failure to meet the minimum requirements for technology and know-how transfer, but there was usually little incentive for foreign investors to exceed such requirements.

This lack of incentives was a cause of concern to many Iranian entities since the development of riskier or more mature fields, together with the transfer of know-how and technology to increase the capability of Iranian entities, is seen as essential for the growth and independence of Iran's oil and gas sector.

- Inability to book reserves

Under Iranian law, foreign ownership of hydrocarbon reserves is strictly prohibited. As foreign investors do not have an ownership interest in reserves and were not entitled to a share of production under the buyback structure, they were not able to book reserves.

Key terms of the IPC

The structure of the IPC is also a risk-based service contract and therefore appears, initially, to be similar to the buyback structure. However, a number of key changes have been made to the contract and these changes address many of the concerns set out above.

Based on the information provided at the Tehran Summit, we have set out below the key terms of the IPC and what this may mean to investors.

<p>Contractor</p>	<p>The contractor is required to be either an incorporated or unincorporated joint venture between, as a minimum, the foreign investor and an Iranian entity. It is unclear whether such entity may be chosen freely by the foreign investor or would have to be selected from a list designated by the NIOC.</p> <p>This means that, prior to bidding for any projects, foreign investors will need to choose an Iranian entity with which to partner. This is intended to support and improve the capability of Iranian entities, one of the key objectives of the Iranian government, but investors will need to be careful to ensure that they carry out adequate due diligence on any prospective partner.</p> <p>Whilst it is not common in the Persian Gulf region to have an incorporated joint venture company as the contractor, we have seen this arrangement in Malaysia. Under this arrangement, the shareholders each provide certain guarantees to the government in respect of the performance of the contractor. One consideration will be whether the shareholders of the contractor will be able to purchase and market the hydrocarbons instead of the contractor. In both cases the foreign investor will need to consider how it ensures that it has sufficient control over decision making.</p>
<p>Term</p>	<p>The term is anticipated to be as follows:</p> <p>Exploration and appraisal (for greenfield projects): 4 years (plus a potential 2 year extension) for exploration and a further 2 years for appraisal.</p> <p>Development and production: 20 years plus a potential 5 year extension for IOR/EOR operations.</p> <p>This longer term should provide foreign investors with greater certainty and increased prospects of recovering costs and earning a return on investment. It should also help benefit Iran as it will provide an incentive for foreign investors to make longer term investments and implement measures to maximise the life of the field.</p>
<p>Ownership of hydrocarbons and booking of reserves</p>	<p>Based on the information provided at the Tehran Summit, it is unclear whether and in what circumstances foreign investors will be able to book reserves. This remains a significant issue for investors and will be essential to review in the full terms of the IPC.</p>
<p>Operatorship</p>	<p>The contractor will act as operator during the exploration and appraisal phases.</p> <p>The contractor is required to establish a joint operating company in Iran to act as operator during the development and production phases, although the contractor will remain liable to the NIOC for the development and production operations.</p> <p>The foreign investor is therefore able to participate in the production phase (in contrast to the position under the buyback contracts) and will not be subject to the same level of operator risk as mentioned above. However, given the participation of an Iranian entity in the operatorship, it will be key for foreign investors to ensure that the Iranian entity has the capability to</p>

	<p>perform its obligations (and meet any funding requirements), and that the foreign investor maintains sufficient control over the operating company.</p> <p>It is clear that the intent of Iran is to develop fully functional stand-alone entities that can operate fields both domestically and internationally.</p>
Minimum production levels	<p>The field development plan will contain production targets and the contractor will be required to meet certain minimum production levels. It is not clear what the consequences will be of failing to meet those production levels, and foreign investors will need to clarify this to ensure that they can protect against this risk.</p>
Cost recovery	<p>In contrast to the general position under the buyback contract, there will be no cap on cost recovery. Instead, costs will be regulated through the annual work programme and budget.</p> <p>There will however be some time constraints on the recovery of certain costs incurred during the development and production phases.</p> <p>Any direct or indirect capital costs incurred prior to first production are to be amortised within 5-7 years of the commencement of first production. After first production, any direct capital costs incurred will be amortised within 5-7 years from the date of expenditure. Indirect capital costs incurred after first production and operating expenses will be recovered on a current basis. Priority will be given to costs recovered on a current basis.</p> <p>If the IOC is unable to recover its costs within the contract term, then, provided that was not due to the contractor, the term may be extended (with the approval of the NIOC) to allow for additional cost recovery.</p> <p>Despite the time constraints this appears to be a more flexible structure than under the buyback contracts, and should provide foreign investors with greater investment certainty.</p>
Remuneration fee	<p>The remuneration fee is anticipated to be a fee per barrel of oil (or per standard cubic feet of gas) produced which will vary depending on the applicable "R factor" (based on the ratio of cash receipts to petroleum costs) and production rates.</p> <p>The contract also contains a mechanism by which the remuneration fee may be adjusted based on market price, subject to a cap on market adjustment. We understand that the mechanism will be based on the average annual export oil price from Iran. However, it is not clear how this will work in practice or whether this will be linked to an international reference such as Platts or a local one such as Iran's Asian standard pricing formula. Obtaining clarity on this issue will be key for foreign investors.</p>
Incentives	<p>The remuneration fee above will also reflect the exploration risk and the field type (i.e. there will be incentives for higher risk fields, brownfield projects and smaller fields). In addition, there will be incentives to undertake IOR/EOR operations. As noted above, this is essential for the growth of Iran's oil and gas sector and is a key driver for the new contract structure.</p> <p>It is also clear that the development of joint fields with other countries will be given priority and supported actively (although the details of this are unclear).</p>
Receipt of cost recovery and remuneration entitlement	<p>We understand that the contractor will have the option to receive its cost recovery and remuneration entitlement in cash or in-kind.</p> <p>As required by Iranian law (and similar to the general position under the buyback structure), the contractor is only entitled to a percentage (up to a maximum of 50%) of the revenues generated from total production from the</p>

	field during the term to receive its entitlement.
Transfer of technology and know-how	The IPC will contain express provisions regarding the transfer of technology and know-how from foreign investors to Iranian entities. The exact requirements are not yet known but it is clear that this is essential to Iran.
Local content requirements	<p>There are local content requirements under Iranian law which require, as a minimum, 51% of the value of the works of a Governmental contract to be awarded to Iranian entities. This requirement was contained in the buyback contract and will be contained in the IPC.</p> <p>It is clear that the Iranian government expects a percentage greater than 51% to be awarded locally, and percentages of around 70-80% for the development stage and 95% and above for the production phase were mentioned during the Tehran Summit.</p>
Dispute resolution	Any disputes between the contractor and the NIOC will be resolved by an escalation dispute resolution clause which provides for arbitration as the final resolution method (which was also the case under the buyback structure). The particulars of the arbitration clause (including the seat of arbitration and the applicable rules) will be agreed by the parties. Investors should be mindful of the Iranian Constitutional provision which requires political approval for submission to arbitration in certain circumstances.
FM and sanctions	<p>Of course wide-ranging international sanctions currently remain in place and investors should consider their impact before conducting any transaction with Iran. In anticipation of the future lifting of most sanctions under the Joint Comprehensive Plan of Action once Iranian compliance has been verified, and in view of the potential for "snapback", or re-imposition, of sanctions, of key importance to investors is that the IPC is anticipated to provide that snapback of sanctions will not be considered as a force majeure event. Given that this matter was dealt with explicitly at the Tehran Summit, we also anticipate that there will be resistance to including any bespoke clauses in the contract providing other protections to investors (e.g. allowing them to withdraw from the contract) if snapback occurs, although such protections should of course be sought so far as is possible.</p> <p>For further information on the current sanctions position, please see our previous e-bulletins on this topic and our Iran Investment Guide here.</p>

Contacts

**Joanna Addison Partner**

Chair of Iran Working Group Corporate and Projects, Doha

T +974 4429 4102
joanna.addison@hsf.com

**James Bremen Partner Construction, London/Doha**

T +974 4429 4002
james.bremen@hsf.com

**Caroline Kehoe Partner Dispute resolution, Dubai**

T +971 4 428 6302
caroline.kehoe@hsf.com

**William Breeze Partner Finance, London**

T +44 20 7466 2263
william.breeze@hsf.com

**Andrew Cannon Partner Dispute resolution, Paris**

T +33 1 5357 6552
andrew.cannon@hsf.com

**Craig Tevendale Partner Dispute resolution, London**

T +44 20 7466 2445
craig.tevendale@hsf.com

If you would like to receive more copies of this briefing, or would like to receive Herbert Smith Freehills briefings from other practice areas, or would like to be taken off the distribution lists for such briefings, please email subscribe@hsf.com.

© Herbert Smith Freehills LLP 2015

The contents of this publication, current at the date of publication set out above, are for reference purposes only. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on the information provided herein.

BANGKOK

Herbert Smith Freehills (Thailand) Ltd
T +66 2657 3888
F +66 2636 0657

BEIJING

Herbert Smith Freehills LLP Beijing
Representative Office (UK)
T +86 10 6535 5000
F +86 10 6535 5055

BELFAST

Herbert Smith Freehills LLP
T +44 28 9025 8200
F +44 28 9025 8201

BERLIN

Herbert Smith Freehills Germany LLP
T +49 30 2215 10400
F +49 30 2215 10499

BRISBANE

Herbert Smith Freehills
T +61 7 3258 6666
F +61 7 3258 6444

BRUSSELS

Herbert Smith Freehills LLP
T +32 2 511 7450
F +32 2 511 7772

DOHA

Herbert Smith Freehills Middle East LLP
T +974 4429 4000
F +974 4429 4001

DUBAI

Herbert Smith Freehills LLP
T +971 4 428 6300
F +971 4 365 3171

FRANKFURT

Herbert Smith Freehills Germany LLP
T +49 69 2222 82400
F +49 69 2222 82499

HONG KONG

Herbert Smith Freehills
T +852 2845 6639
F +852 2845 9099

JAKARTA

Hiswara Bunjamin and Tandjung
Herbert Smith Freehills LLP associated firm
T +62 21 574 4010
F +62 21 574 4670

JOHANNESBURG

Herbert Smith Freehills South Africa LLP
T +27 11 282 0831
F +27 11 282 0866

LONDON

Herbert Smith Freehills LLP
T +44 20 7374 8000
F +44 20 7374 0888

MADRID

Herbert Smith Freehills Spain LLP
T +34 91 423 4000
F +34 91 423 4001

MELBOURNE

Herbert Smith Freehills
T +61 3 9288 1234
F +61 3 9288 1567

MOSCOW

Herbert Smith Freehills CIS LLP
T +7 495 363 6500
F +7 495 363 6501

NEW YORK

Herbert Smith Freehills New York LLP
T +1 917 542 7600
F +1 917 542 7601

PARIS

Herbert Smith Freehills Paris LLP
T +33 1 53 57 70 70
F +33 1 53 57 70 80

PERTH

Herbert Smith Freehills
T +61 8 9211 7777
F +61 8 9211 7878

SEOUL

Herbert Smith Freehills LLP
Foreign Legal Consultant Office
T +82 2 6321 5600
F +82 2 6321 5601

SHANGHAI

Herbert Smith Freehills LLP Shanghai
Representative Office (UK)
T +86 21 2322 2000
F +86 21 2322 2322

SINGAPORE

Herbert Smith Freehills LLP
T +65 6868 8000
F +65 6868 8001

SYDNEY

Herbert Smith Freehills
T +61 2 9225 5000
F +61 2 9322 4000

TOKYO

Herbert Smith Freehills
T +81 3 5412 5412
F +81 3 5412 5413