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A Critical Analysis of Iranian Buy-Back Transactions in the Context of International Petroleum Contractual Systems

Mohammad Mehdi Hedayati Kakhki

A thesis submitted for the degree of Doctor of Philosophy in the Institute for Middle Eastern & Islamic Studies (IMEIS), School of Government and International Affairs, University of Durham.

1 5 MAY 2008

April 2008

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List of Abbreviation

APOC Anglo-Persian Oil Company

AIOC Renamed from the APOC to the Anglo-Iranian Oil Company in 1935

bl Barrel

b/d barrels per day

BOT Build-Operate-Transfer

BOOT build-own-operate-transfer

CIS Community of Independent Nations

CKD Knock-down Components

EIA Energy Information Administration

FDI Foreign Direct Investment

FIPPA Foreign Investment Promotion and Protection Act

GCC Gulf Co-operation Council

IEF Iran Energy Focus

ILSA Iran-Libya Sanctions Act

IOC International Oil Company

LAPFI Law for the Attraction and Protection of Foreign Investment

MEC Majlis Energy Commission

NIGC National Iranian Gas Company

NIOC National Iranian Oil Company

NPCC National Petroleum Construction Co

NSQ Naft Sazeh Qeshm

O.I.E.T.A.I Organisation for Investment, Economic and Technical Assistance of Iran

OPEC Organisation of Petroleum Exporting Countries

PSA Production Sharing Agreement

SKD Semi-knock down Components

SOE state-owned enterprise

WEC World Energy Council

WTO World Trade Organisation

Declaration

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person nor material which to a substantial extent has been accepted for the award of any other degree or diploma of the university or other institute of higher learning, except where due acknowledgment has been made in the text.

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Abstract

This research critically examines the Iranian petroleum contractual system from its birth to the present, and considers its future evolution. Initially, it reviews the development of oil contracts, from the early concessions until the annulment of all obligations as the result of two major events; the Nationalisation Movement and the Islamic Revolution of 1979. The constant policy struggle between the need for foreign funding and technology in the oil industry on one hand and the desire to avoid foreign exploitation on the other is analysed in terms of its impact on the current stance towards foreign investment and the formation of the present contractual model.

The embodiment of this complex struggle is the buy-back contractual model that has found widespread use in Iranian petroleum transactions since 1989. This scheme is best described as a short term risk service agreement, whereby the foreign investor provides the funds for petroleum Exploration and Exploitation in exchange for a pre-defined, volume-based quantum of remuneration in case of successful production that serves to both compensate and reward the contractor. The adoption of this system is a compromise solution between the need for foreign capital, expertise and services on one hand and wariness of foreign involvement in natural resources on the other, as evident from the Constitutional limitations discussed later in this study. A crucial element of this arrangement is the transfer of the field's operation back to the National Iranian Oil Company following conclusion of the contract; a legal step which distinguishes buy-back contracts from alternative systems that may be contrary to the Constitution.

Both the structure and the comparative advantages of the buy-back have been discussed at length, with particular attention to the enabling laws and their flaws. Detailed analysis is devoted to the other major international contractual models, including a comparative evaluation of these

alternative systems and their suitability for the Iranian oil industry, given the limitations of the Constitution.

The buy-back system is scrutinised from both the foreign and the domestic perspective and the issue of whether revision of its terms or an alternative model would be more appropriate considering the grievances of all the participants. The extent to which the Iranian oil industry was and will be affected by increasing international pressure, particularly as the result of US Sanctions, was considered extensively. It appears that Iran is not yielding to such pressure but rather orienting itself towards alternative allies and continuing to sign contracts based on the buy-back. Particularly stringent examination of specific terms and conditions of buy-back has been conducted through a review of various oil fields so as to determine if the model's perceived flaws manifest themselves in reality.

The finding of the analysis described above is that the buy-back contract as implemented in Iran is flawed on basis of the limiting nature of its provisions rather than by virtue of the model itself. A number of provisions, such as maximum contract length and method of remuneration, which are needlessly restrictive, are highlighted and the importance of modernising them in light of the current economic environment is noted. Based on the facts and findings throughout the study, the conclusion arises that evolutionary rather than revolutionary reforms are both required and viable, without undermining the current legal framework. Lastly, the study yields a practical recommendation as to the reforms most crucial to the preservation of Iran's attractiveness to investors, in light of the current economic, political and legal environment.

Part One: Origin and Background of the Iranian Petroleum Contractual System

Introduction

The Iranian oil industry is currently preparing to celebrate its second century of life.[1] Iran's oil industry holds a prominent position in the region, as Iran was the first country in the Middle East to discover oil, granted the first oil concession to a foreign country[2] and to nationalise its oil sector. Iran occupies the position of a leader in the oil industry, with the second-greatest oil output within the OPEC.[3] Iran's oil production relative to the world in general occupies the fourth place, outputting 132.4 billion barrels,[4] and containing 11 percent of the world's proven oil reserves.

The oil industry has been a vital part of Iran's economic life since the early years of the 20th century and this has had a significant impact on the social and political development of the country. The oil revenues provide between eighty and ninety percent of Iran's annual income in foreign currencies and forms up to fifty percent of the government's budget.[5] This data illustrates the crucial role of the Iranian oil industry for its economy, as well as its prominent position in the global energy community.

---

[1] Oil was discovered by the British as early as 1908 and Iran would celebrate its 100th birthday in 2008/9

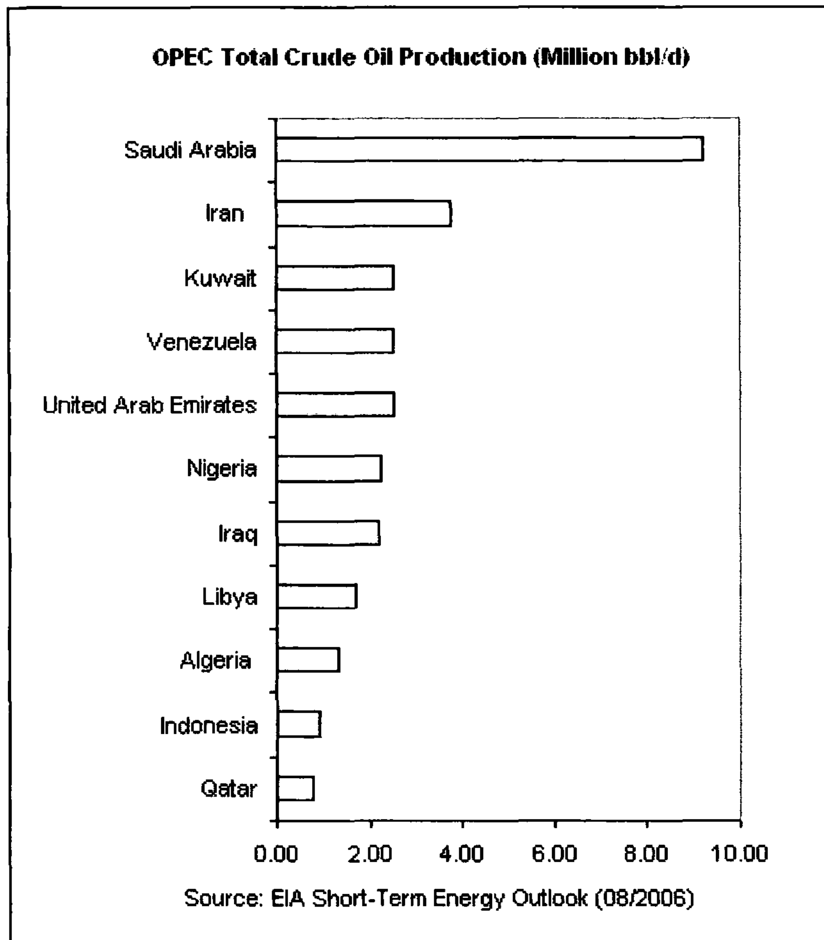
[2] The first Concession in the Middle East was granted in 1901 to the British engineer William D'Arcy. A Concession is the grant of access to specified areas for a period of time during which certain rights to hydrocarbons that are discovered will be transferred from the host country to an enterprise. The rights transferred will usually be for the exploration, development, production and sale of the hydrocarbons. The rights are typically granted in return for taxes, fees and/or royalties on profits earned from the exploitation of the rights.

[3] The Organisation of the Petroleum Exporting Countries (OPEC) is a prominent organisation, agreed upon at the Baghdad Conference on September 10–14, 1960, by Iran, Iraq, Kuwait, Saudi Arabia and Venezuela. The Founding states were later joined by eight other Members. OPEC's goal is to provide common petroleum policies among Member Countries so as to ensure stable prices for producers; an efficient, dependable supply of petroleum to consuming nations; and a decent return on capital to those investing in the industry.

[4] In July 2004, Iran's oil minister announced that the country's proven oil reserves have increased to 132 billion barrels following discoveries in the Kushk and Hosseineih fields of Khuzestan province.

[5] Energy Information Administration's Iran Country Analysis Brief, August 2006 [www.eai.doe.gov]

Table 1: Iran's Relative Oil Production in OPEC



As mentioned above, the method commonly utilised for the development of Iran's oil and gas resources is the buy-back. The attractiveness of this model for the domestic party stems from the distribution of risk, which is squarely placed on the contractors' shoulders, as they are obligated to fund all technical, exploration, engineering and personnel costs in exchange for the prospect of compensation and even profit where a commercially viable resource is discovered and exploited. Rather than the percentage-based remuneration prevalent in other contractual systems, buy-back contracts prescribe a specific amount of remuneration in-kind, in terms of volume rather than production share.

Even though other systems also use a Rate of Return to calculate remuneration, the payment takes place in monetary value rather than in product itself. It is notable that buy-back contracts are not widely used by petroleum producers around the world and, therefore, have not been the subject of extensive analysis that this study offers. Consequently, the aim of this study is to fill the vacuum of comprehensive analysis of buy-back contracts that is evident in academic and commercial literature, by deploying a multi-disciplinary approach in order to assess the economic, political and legal issues affecting this contractual scheme.

Although the issue of buy-back contracts is principally a legal one, this study recognises that laws and regulations do not exist independently of society, history and the economy, particularly as the transformation potential of Iran's legal constraints on petroleum is closely linked to the political and economic situation.

In the first part of this work, the history of foreign investment in the Iranian petroleum industry will be elucidated, the historical development of oil contracts in Iran since their inception will be analysed and the industry's expansion will be reviewed. Emphasis will be placed on the key developments in this area, so as to provide historical background for the country's embracing of a new scheme for its oil contracts, known as the buy-back.

There are some important events which act as milestones when discussing the history of the Iranian oil industry. These are the D'Arcy Concession Agreement of 1901, the discovery of oil from the first well drilled at Masjid-e Soleiman in 1908 and the failed attempt to revise the 1933 Concession. Also, one must consider the impact of the two World Wars on the oil industry, eventually leading up to the Nationalisation Movement in 1951 as well as the 1954 Consortium.

The victory of the Islamic Revolution changed the Iranian oil industry in many aspects, as it caused the annulment of all previous rules and regulations and the country had to face a

completely different policy and situation. This situation was further exacerbated by the war with Iraq, beginning just a year after the Revolution and lasting for an exhausting 8 years.

Heavy damage was inflicted on the industry during the war, and so the efforts to repair the oil infrastructure required significant time and financial investment, especially from foreign companies. All of these events had a permanent impact upon the type and terms of the contracts which are currently being agreed between Iran and the foreign parties.

Among the most disruptive challenges for the oil industry at the time was the insufficient number of technical staff for the number of active projects, which had difficulty reaching production targets in the short periods called for, as well as the inadequate funds for the financing of the projects, with the government unable to provide sufficient funds without compromising other areas of the budget. The number of these domestically insurmountable issues was what led Iran to open its oil industry to foreign investment from the early 1990s, through the medium of the buy-back contracts, which was compatible with the prohibitive articles of the Iranian Constitution.[6]

While Iran's legal restrictions on foreign investment may be puzzling in light of the global and unrestrained nature of commerce, they cannot be dismissed out of hand as arbitrary due to the economic and historical background preceding their rise.

Without studying the historical reasons for Iran's adoption of the restrictive current model, it is impossible to fully understand either the current difficulties faced in the course of oil transactions or predict future trends in its development. Consequently, the two Chapters that follow will deal with these historical factors and the means by which they shaped the currently used model of

[6] Takin Manouchehr, Working with Sanctions, Trade Controls &Political Risk 03, *Case Study: Iran,* Centre for Global Energy Studies [www.cges.co.uk/pdf-lib/confpresentationsSanctionsConfNov03Iran.pdf]

buy-back. Such an analysis serves as a representative introduction the wider aims and objectives of this study, namely to provide a realistic rather than a purely academic analysis of both the advisability of buy-back oil contracts as they stand today and propose reforms that are in line with immutable constitutional limitations. In recognition of the subjective nature of Iran's position on oil transactions, the history chapters seeks to provide an understanding of the reasons and gravity of opposition to oil transactions' reform, particularly as such an understanding is necessary for making realistic recommendations on contractual reform. In addition to such a subjective analysis, it is recognised that a comparative analysis of the existing system with both radical international alternatives advocated by buy-back's critics and the international model adds an objective element to the study. A detailed analysis not only of buy-back's basis and legal limitations but also of the procedural implausibility of altering these arrangements provides a realistic viewpoint that is alternative to the uninformed calls for revolutionary and plainly illegal reforms by some critics. The analysis is not grounded solely in theory, as an extensive case study of recent transactions furthers the study's aim of being practically applicable, while the various factors influencing buy-back and compelling reform are highlighted. A further means of improving the realistic applicability of the findings is the consideration of future developments within international oil transactions, with the effect of sanctions and the changing oil-supply situation in the Middle East specifically examined. As any positive reform will have to stem from mutual agreement and understanding by foreign investors and the Iranian government, particularly careful analysis is devoted to outlining their respective positions on this contentious matter while suggesting likely areas of reconciliation. Lastly, the various aspects of the analysis are brought together within the final chapter in order to provide a set of findings and recommendations that incorporate all relevant aspects of the issue, rather than maintaining a narrow viewpoint that is prevalent in other studies into buy-back.

Aim and Objectives

The aim of this thesis is to critically analyse the existing contractual scheme used in Iranian petroleum transactions, so as to determine whether it is the optimal scheme available within the constraints of Iranian law and historical background, as well as to propose remedies for its existing flaws. In order to accomplish the goal of proposing reforms, it is necessary to understand the grievances of the parties involved and this also is a corollary goal of the study, using an extensive examination of influential historical factors to gain such an understanding. As a means of considering various improvements to the status quo, international and domestic buy-back schemes are also comparatively analysed in order to determine whether and where room for improvement exists. A further element of this work which is of crucial importance is the overview and analysis of legal and political constraints placed on any future reform or alteration of the scheme being used; as a merely theoretical conclusion made without consideration to the practical realities and limitations will be of little analytical or practical value.

Review of Literature

Issues related to the energy sector, particularly those of oil production and contracts, are increasingly topical in an economy which places greater reliance on these resources' consumption every year. Despite the growing focus on issues of oil generally, one area has not been sufficiently analysed by academic commentators. This aspect of the oil economy are buy-back transactions, which are becoming increasingly important as extensive petroleum reserves are being discovered in Iran and the structure of its petroleum transactions are continuing to influence both the Iranian and the global energy markets.

In the context of the buy-back's growing importance, an objective and comprehensive assessment of the contracts' nature and legal framework, as well as the advantages, disadvantages and avenues for modernisation in the scheme are needed in order to provide greater foreseeability to foreign investors. Such an analysis would further provide enhanced understanding of such contractual framework in the academic context. One of the direct benefits of this study would therefore be the investors' ability to foresee the future developments in the Iranian petroleum industry, as well as its current state by accessing a single analytical study, in English, rather than the scattered, less detailed resources, available mostly in Farsi. The study also serves the interest of the domestic Iranian oil parties, by providing a comprehensive, analytical overview of the flaws within the current framework and, therefore, enabling reform of certain aspects without infringing on the legal limitations placed by national law.

This study aims to fulfil these goals by approaching the issue with a view of its historical origins as well as predictions of future development, which is not an approach that has been taken in any sufficiently detailed English-language publication or academic work on this issue. The reasoning for the inclusion of a historical analysis of legally significant events that were

formative of Iran's current oil policy is that such an approach permits greater understanding of future development, which is continuously affected by factors from the past. Extensive material is available on the historical background of the Iranian oil industry, but in order to provide sufficient space for analytical material within this study, only those historical events that have significant legal aspects have been highlighted.

This gap in the coverage of the subject results in uncertainty regarding many aspects of buy-back transactions, such as the direction in which the Iranian government's policies are heading and whether an alternative system may be adopted, in the context of Iranian legislation. An illustration of other studies' narrow focus, often concentrating on the immediate state of the system rather than its prospects or origins, can be found in the work by Dr. Ule and Dr. Brexendorff.[7] Despite providing a satisfactory overview of the current state of the buy-back system, in particular with reference to the foreign companies' concerns, it nonetheless fails to provide sufficient historical context to enable an accurate assessment of the present situation within the oil industry as well as its future development, as past events determine both of these aspects.

Furthermore, a careful examination of the authors' analysis of the present system's drawbacks reveals an apparent bias. Whereas the foreign investors' concerns are extensively detailed and supported, mentions of the government's concerns are only provided when such a reference is useful for illustrating the IOC's grievances. In practical terms, whereas the description of government grievances occupies half a page, the contrary perspective occupies three. Such an unequal emphasis is perhaps motivated by the status of the study's authors as legal advisers to oil firms, and the consequent target audience of the study. As any prediction of the government's policy changes regarding buy-back requires an objective assessment of the authorities'

[7] Ule, C. and A. Brexendrorff, Investing in the Oil and Gas Industry. 2005: Mena.

grievances as well as the foreign companies', it is therefore arguable that only an even-handed analysis, such as the one provided within this author's study, will enable accurate prognosis to be made.

Unlike Ule's and Brexendorff's work, this analysis is a product of academic effort and, as the result of not having to cater to either of the interested parties within the dispute over buy-back, is therefore able to provide a more even-handed analysis of the situation.

A further limitation of Ule's and Brexendorff's study is the superficial level of analysis applied to the legal context and limitations of buy-back contracts. Although general information is provided on the subject of Constitutional limitations and the various enabling legislation, insufficient analysis is conducted of these laws' procedural and formative aspects. The failure to thoroughly address the process by which laws are passed in Iran, for instance, prevents the authors from deducing the probability of constitutional or legal reform being enacted to enable alternative contractual frameworks; as the interplay between the various legislative authorities is necessary for such an analysis.

Furthermore, instead of simply stating that an alternative system would be preferable for purposes of commerce, this study recognises and carefully catalogues the various impediments preventing an alternative system from being adopted, such as the restrictive laws and the unfavourable political situation in Iran. Consequently, the perspective presented here is based on the realistic situation rather than a theoretical conclusion regarding the superiority of a different model, which would have no practical utility when the realities of the present legal situation are taken into account, or where such reform attempts have previously been shown to be flawed.

A further area in which Ule's and Brexendorff's study is deficient is its lack of appropriate consideration for the effect of US sanctions on the Iranian economy generally and petroleum contracts in particular. As will be shown later in this study, major oil companies are concerned about the current level of sanctions and several have even stated that if further sanctions are imposed as the result of the current international tension, they will cease their activities within the country. A study on the state of the buy-back scheme and its future development cannot be said to be complete unless this serious influence is considered. This study, on the other hand, extensively examines the past effect of sanctions so as to be able to predict the sanctions' future economic influence on petroleum contracts. In addition, the economic influence on the American economy is analysed in order to predict the likelihood of further sanctions being imposed, considering the already present negative consequences on the US economy. All the information highlighted above subsequently allows the formation of a prediction regarding future effects of sanctions, therefore providing a greater degree of information and, therefore, certainty, for the parties involved in buy-back transactions.

A source offering a different perspective to the one reviewed above is the collection of primary sources, published in Farsi by a collective of writers, edited by Dariush Mobaser, titled "Autopsy of the Oil Contract (Buy-Back)".[8] The book is unique in its publication not only of articles published in academic and popular media regarding buy-back agreements, but also in that it offers the replies provided by the NIOC in reference to the published concerns. The advantage of this book is its holistic approach to analysing oil contracts, as the result of the authors' professional qualifications as lawyers, journalists, politicians and other educated professionals. The book's target audience is not limited to academic circles but rather is aimed at the population

[8] Mobaser, D. Autopsy of the Oil Contract (Buy-Back) collection of articles, 2000

interested in the topical issues of oil in Iran, generally. As a result, the book is accessible and provides sufficient context.

In order to assess the complexity of the perspectives offered within this book, the authors' opinions may be divided into three general categories. The first group of contributors argue that the current levels of productions must be maintained in view of preserving Iranian national heritage, with any expansion of production capability having the irreversible effect of depriving future generations of this strategic national resource. As part of their position, this group reject the formation of buy-back contracts, but such rejection is interpreted by the NIOC as indicating their underlying opposition to any type of contract at all, including production sharing and other types.

The second group of contributors are characterised by a nationalistic outlook on the issue of oil production. While accepting the economic need for expansion of oil production, it is their argument that maximum benefit for Iran is to be extracted through the use of domestic investors, contractors and expertise; therefore keeping all the money involved in oil within the Iranian economy. In response to such arguments, the NIOC points out that insufficient domestic expertise and technology exists at this time to optimise oil production; and the failure to utilise foreign investments, capital, know-how and technology would lead to a decline in production. Reference is particularly made to increased production levels associated with foreign technological and investment input, and emphasis is made on Iran's continuing absorption of technological know-how and expertise, as aided by contractual provisions within buy-back contracts. The argument is further bolstered by the statistical support provided by the NIOC, highlighting that only an insignificant percentage of 1.5% is eventually contributed to the foreign investor in some cases, which is a reasonable figure in comparison to the investment provided by the foreign parties.

The third and last group are proponents of a more balanced approach to oil production, highlighting the need for expansion of oil revenues but also recognising the foreign role in oil production. Commentators in this group do not believe that the buy-back framework is sufficiently attractive to foreign investors and that its replacement with production-sharing or other scheme would ultimately boost Iranian oil revenue. Members of this more liberal subsection of the third group believe that an analysis of foreign concerns is required in order to improve the situation. The NIOC's response to these arguments is a very critical one, with domestic authorities' commentators claiming that the third group acts as lobbyists promoting foreign interests at the expense of Iran. Contrary to this assertion, however, a sub-section of this group believes that buy-back is, in fact, too liberal towards the foreign oil firms and that a harsher scheme should be imposed. The NIOC's reply to such concerns is the emphasis that the world oil market contains other potential investment zones which would attract foreign investment if Iranian terms became overly unfavourable; therefore buy-back must be maintained as the optimal balance between foreign and domestic interests.

An illustrative sample of media outlets and articles where the above perspectives are outlined is included below:

Shoma Weekly, Neshat Newspaper,[9] Ariya Newspaper, Resalat Newspaper, Gozaresh Magazine, Entekhab Newspaper, Global Economy Newspaper (Jahane Eghtesad), Jomhouri Islami Newspaper, Ettella'at Newspaper, Hayate No Newspaper, Iran Newspaper, Magazine of Transportation and Industry, Khorasan Newspaper etc.

It is noteworthy that these media outlets represent the entire media spectrum, including conservative and reformist publications with the corresponding perspectives.

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[9] A reformist newspaper that was subsequently prohibited in Iran in 2000.

Although the compilation of articles does provide a useful starting point of a comparative analysis, as it is aimed at the general public and therefore only limited academic analysis may be extracted. In addition, as the articles are composed by a variety of authors who advocate a wide variety of often radical perspectives, the publications tend to be partisan in tone, which is an unhelpful attribute within the academic context as the authors' bias must be deduced on many instances throughout the book to extract useful meaning. Furthermore, a certain lack of impartiality towards buy-back may be observed in that the NIOC's perspective is given especial prominence in both emphasis and text volume, in comparison to any one of the groups described above. Additionally, the fact that the book's contributors are of Iranian origin means that very little attention is given to the foreign grievances and concerns, outside the context of reform in the interest of economic self-promotion. Such a perspective therefore requires extensive and thorough analysis of the authors' arguments to determine whether they correspond to reality or are merely the result of their bias.

As opposed to the extensive, if slanted, critical analysis within the above sources, several other publications on the topic of Iranian oil contracts fail to provide sufficient analytical content but rather concentrate on summarising of the history and present law regarding buy-back contracts without paying any heed to foreign concerns. Two such books are "A Survey on Iran's Oil Agreements"[10] and "Contract Laws"[11], which are general summaries of the relevant laws and historical background. Although these sources were valuable in providing historical information, such background is not subsequently used to illustrate the present concerns and criticisms of buy-back transactions, therefore providing little analytical value to the material. Such a deficiency is unsurprising as the target audience are law students, rather than academics or other critics of the

[10] Farshadgohar, N., A Survey on Iran's Oil Agreements. 2002, Economic Research Institute, Tehran.
[11] Rabiee, F, Hoghoogh-e-Gharardadha (Contract Laws) 1381, Tehran, Behnami

system. Purely factual and explanatory elements have however proven helpful, in particular a model contract included within and clarification of Iranian statutes on matters of oil.

In addition to written compilations and sources, the author has consulted a number of interviews with prominent decision-makers within the Iranian oil industry in order to obtain a perspective closer to the practical aspects of the formation of buy-back agreements. Among the individuals whose interviews have been consulted is Mehdi Hosseini, the former Deputy Minister for International Affairs better known as the 'Architect of Buy-Back Agreements' or even 'Mr. Buy-Back' for his formative role in initiating the use of such agreements in Iran within the 1990's. The interview offered insights into the NIOC concerns regarding buy-back transactions' benefit to the Iranian side and offered supporting arguments for its continued use. Such arguments are of particular credence as Mr. Hosseini was successful at attracting foreign investment during his direct participation in the program. Within the interview itself, however, Mr. Hosseini was understandably partisan as he was discussing a subject to which he has particular loyalty and therefore little merit was provided to foreign concerns regarding buy-back. As an accurate perception of the competing perspectives may be formed by reviewing pro-buy-back and anti-buy-back in a measured and holistic manner, the interview was nonetheless of clear value.

A further source by an authoritative figure personally involved in the oil industry is by Mr. Hossein Kazempour Ardebili, a former Deputy Oil Minister, who provided historical overview of oil contractual development in Iran. Such a summary was of great value as the Iranian oil authorities' interpretation of previous versions of oil contracts is essential for an understanding of the NIOC's concerns.

The author has also approached an instrumental figure in the study of Iranian oil contracts, senior analyst at the Centre for Global Energy Studies in London, Dr. Manouchehr Takin. This

academic's comments were of extensive use in highlighting the uncertainty in the Iranian oil industry prevalent at the moment, but also the ongoing and potential reform within the industry. This perspective was of especial importance in this thesis, the emphasis of which lies in the need for continuous reform of the contractual provisions; a view apparently shared by Dr. Takin based on his publications.

A further source of information located close to the workings of the oil industry has been provided by Mr. Bijan Khajehpour, the Chairman of the Atieh Bahar Group, within a commercial analysis of the prospects for foreign investment within the Iranian oil industry. The target audience for his study, as specified within its introductory paragraph, is the enhancement of IOC's opportunities within Iran through providing information on its legal, political and economic situation in the context of oil. Although the report provides extensive valuable information, it is limited in its academic value due to the emphasis on commercial information rather than historical background or a comprehensive analysis of the concerns on both sides. Although the information provided is especially valuable in its risk assessment for IOC's, the lack of sufficient evaluative material undermines this source's value in an academic context.

Various industry and general interest journals have been used to provide an up-to-date assessment of the relevant issues. One such journal article utilised pertains to the interaction between foreign and domestic oil interest, and was published within the Journal of Iranian Research and Analysis.[12] The focus of this article was on the nationalisation period of Iranian oil history, with special attention paid to the interaction between the foreign investors and Iranian interest. Through such an analysis, the foreign academic author of this article highlights her opposition to the nationalisation and its legal implications. An additional implication found

[12] Heiss, M. A. National Interests and International Concerns. Journal of Iranian Research and Analysis. Vol. 16, No.2 November 2000.

within this article is the examination of nationalisation's effect on relations between UK and US and Iran, which proved of significant use as a means of assessing the current tense situation. Nonetheless, due to the concentration on the international diplomatic aspects of the situation, insufficient attention is provided to the current balance of oil interests within Iran.

An additional article is from the 2007 edition of the Geopolitical Affairs Magazine,[13] which examines in extensive detail the interplay between American influence and the Iranian oil industry, as well as the future effects of American sanctions on Iran. Although the overview of the situation provided was of value, the perspective taken throughout the article of the examination of oil issue through the lens of continuing availability of Iranian supplies to the world market, with a distinctively political emphasis that ties nuclear issues with those of oil. Consequently, the examination of the relevant issues was not as impartial and measured as could be expected of a purely academic work.

Although an extensive number of sources has been consulted from various perspectives, some desirable materials could not reasonably be accessed due to practical restrictions. Amongst such resources were particular oil contracts with prices and numbers included, which have been requested from the participating oil companies and other sources, but the provision of which was refused due to issues of commercial secrecy. Instead, model oil contracts have been utilised in order to provide a reasonable replacement for the more specific oil contracts.

A further unavailable source was a report regarding the Iranian oil industry by 'Alexander's Gas and Oil Connections', which, despite appearing to be quite complete from its table of contents, was not reasonably accessible due to the 14,000 Euro cost of purchase. Attempts to access this report through academic databases and sources have also been unsuccessful.

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[13] Howard, R., The Politics of Iranian Oil: Posing a Challenge to America. Geopolitical Affairs, 2007. 1(1): p. 216-232.

An analysis of academic work that has been reviewed within this thesis clearly shows that objectivity is lacking within both primary and secondary sources; with the origin of the author often determining their perspective. In several instances, either the NIOC or the IOC concerns are minimised or ignored altogether, which is a fatal flaw for any academic work aiming to propose objective solutions to current issues.

Research Methodology

As the quality of a study's conclusions inevitably correlate with the procedure and method used within the work, a thorough analysis of these procedural factors is required in order to ensure valid conclusions. This is particularly the case in qualitative, social research, where the intent is to create a "decision rule"[14], a systematic means of assessment, in order to analyse the various theories and explanations in an effort to decide which optimally fits the facts at hand. This section aims to clarify the process by which this standard was created and applied to issues of buy-back transactions, as well as to illustrate the extent to which the research method was valid and objective, despite the numerous factors that influence the outcome of social research. The variation of research method used within this study is further elucidated, while also being placed in the context of comparable techniques, and shown to be the maximally compatible means of conducting this analysis when the various influential factors are taken into account.

Commonly Accepted Standards of Research Methods

As alluded above, a set of principles exists amongst those utilising qualitative research, which governs their behaviour and ensures its conformity and ethics. In order to illustrate that this study remained within the boundaries of this Code, it is necessary to outline where these boundaries lie.

One benefit of qualitative research in comparison to more numerically centred studies is its flexibility, particularly when concerning the choice of research tools to be used, as well as procedures involved. As the methods are not firmly set and come in the form of guidelines rather than requirements, they may be changed in the course of the research in response to alterations in circumstances. This study followed this suggestion as no initial, unchangeable hypothesis was

[14] Dooley, D. 'Social Research Methods', Prentice-Hall Inc. Englewood Cliffs, 1984,USA, pg. 9

selected nor was the research methods limited to the types of sources or methods originally outlined.

A further element of the standard research guidelines is the need for openness of the research, which ensures that studies are not limited by rigid hypotheses or requirements which would limit their scope and subsequently, utility as a method of study. This particular research follows these criteria by not attempting to follow the evidence to a specific conclusion but rather examining whichever conclusion the evidence may result in.

An additional recommendation of the Code is that the analysis and subject of the study be reflective in nature, meaning that the impact of context on the subject of study must be examined in detail. Therefore, this guideline suggests that full understanding of the subject matter cannot be attained without a detailed study of the context. This study implemented this recommendation through the inclusion of extensive information on the historical and socioeconomic context of buy-back.

A final guideline is that analysis be conducted in terms of interactions, on the principle that reality is formed as the result of interaction and can be understood through comprehending such interactions. Consequently, the purpose of research is to identify the patterns that form the type of reality being studied and thus be able to predict the outcome of future patterns of behaviour. The study in question abided by this recommendation as buy-back was not studied only in its present form but rather as the sum of events and influences leading up to its current state, with analysis as to the effect of various historical and political influences on the final product.

Consequently, all the essential elements of the Code have been abided by in order to fulfil the guidelines of qualitative research method and maximise the quality of the study.

Overview of Possible Methodologies

As the range of subjects and issues studied through qualitative method, especially in the context of social science, is extensive, the number of methodologies available is similarly large. Although the listing of the various methodologies within the confines of this work would be impractical, it is nonetheless important to outline the general types of research methodologies being used within this field. The counterpart of qualitative research, the study of a phenomenon based on non-numeric elements, is quantitative research, focusing on statistics, data and figures which are then analysed to come to a conclusion. On the other hand, Basic Research is the process of investigating an existing theory in order to either verify or discard it, usually on a more theoretical level. In contrast, Applied Research is of more pragmatic nature as it utilises general theories to solve specific issues, be they policy, social or economic related, usually resulting in the formation of a consistent programme of action.

These methodologies are further subdivided according to the time frame in which they take place, with Longitudinal Research involving extensive time periods between initial and subsequent observations of the subject matter. The level of detail involved in the study is often a distinguishing factor, with Descriptive Research often being used to preliminarily examine a topic in order to determine the viability of a more extensive study.

Types of research most relevant to investigations of petroleum transactions include Comparative Research, a method which compares various units along a similar set of parameters to determine the extent of difference and similarities, especially within a historical, economic or legal context. Elements of this method are utilised within this study when comparing and contrasting Iranian and international buy-back.

The remainder of the study, however, is based around the qualitative method, which must now be examined in greater detail. A concise and encompassing description of this type of research, which shows its relevance to the material being studied within this thesis, is provided by Sarantakos:

> This type of research refers to a number of methodological approaches, based on diverse theoretical principles (phenomenology, hermeneutics and social interactionism) employing methods of data collection and analysis that are non quantitative, and aiming towards exploration of social interactions... for instance 1) exploration, which helps to analyse research objects, identify indicators, and establish classifications and typologies 2) discovery of relationships between variables, enabling comparisons and conclusion to be made about the significance of certain factors for the relationship; 3) establishing integrated constructs and 4) testing hypotheses. [15]

As can be seen from the broad definition of qualitative research stated above, it encompasses a number of approaches. Nonetheless, alternative methodologies are almost always used within an extensive study of a subject as, for instance, comparative analysis is better suited for comparing two sets of phenomena than qualitative analysis is. Therefore, qualitative analysis is utilised throughout the study to determine the causality of various factors, such as historical precedent, political opinions and economic conditions, in reference to the formation of buy-back transactions in their current form. However, the analysis of the comparative strengths and weaknesses of international and domestic contracts, as well as between various types of contractual arrangements, are an issue that is clearly more closely related to the Comparative Research method and therefore it was applied appropriately in the analysis of this extensive and multi-sided issue. The viability of this practice is confirmed by Sarantakos, who states that as

[15] Sarantakos, Sotirios, 'Social Research', the MacMillan Press Ltd, London 1994. p. 6-7

many as four or five methodologies may be used to address a multi-disciplinary issue, an example of such a complex issue may be said to be buy-back.

These types of social research are not mutually exclusive. Researchers usually employ more than one type of research in a project. It is, for instance, possible that descriptive research is used in an investigation together with classification research, theory building research and comparative research. The investigator has to decide about the types and combinations of research forms that, in his or her opinion, best serve the goals of the study. [16] Consequently, although elements of descriptive research are of relevance to the procedure used within this study, such as descriptions of existing oil transactions, such descriptive methods cannot alone constitute an analytical study[17] as further methods aimed at providing explanations are required.

Such a combined approach, utilising descriptive, interpretative and quantitative elements has been described by Bryman as 'the mixed method approach'. [18] He specifically notes that 27% of research papers fail to mention that this is the approach being used and, in order to avoid repeating this mistake, this study is prepared to identify the approach as 'mixed'. As has been mentioned above, while the vast majority of the study utilises the interpretative method, the History sections are descriptive in nature, while quantitative elements are also present throughout. It is submitted, however, that the common mistake of those utilising this mixed method, namely failing to integrate the various elements but instead using them in parallel, is avoided within this study. The rare elements of quantitative analysis are closely interconnected to the analytical/interpretative elements to form a more holistic analysis, while the descriptive History sections are linked strongly to the analysis rather than being included for the sake of comprehensiveness.

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[16] Sarantakos, op.cit.., p.8
[17] Ibid., pg. 9
[18] Dale, A. Mixed Methods Workshop.
[www.ccsr.ac.uk/methods/events/Mixed/documents/mixedmethodssummary.doc] Accessed 18th March 2008

Furthermore, no undue emphasis is placed on the distinction between qualitative and quantitative elements both structurally and in terms of content as, according to Bryman, this creates unnecessary internal barriers within mixed-research. Finally, although a recent Conference[19] on the issue of Mixed Methods did not yield a clear set of criteria for assessing the quality of mixed methods research, it is submitted that as the interpretative and descriptive elements follow the discrete standards for these methodologies and are integrated within the larger work, the general standards of the mixed method are fulfilled within this study.

Interpretative Method: Data Analysis Method

Interpretative method found to be optimal for the subject of buy-back analysis is the interpretative method and, in order to illustrate its appropriateness, it is necessary to address its nature, procedures, advantages and flaws. Interpretive method emphases the complexity of the subject-matter being studied and recognises that an accurate analysis of contentious phenomena is only possible when integrating the various parties' unique social constructions within the context of the issue. Robson particularly highlights that politically and economically complex issues cannot be reduced to quantitative data without losing all sense of meaning, while an examination of only one constituent perspective results in a limited understanding of the issue in question; with such issues rarely being shaped by rational and objective calculation. [20] Considering the diverse nature of the buy-back issues, incorporating not simply various opposing perspectives but also economic, social, historical and political elements, this method has the *prima facie* appearance of appropriateness that merits further investigation.

[19] Ibid.,

[20] Robson, C. Real world research: a resource for social scientists and practitioner-researchers. 2002, .Blackwell Publishing, Oxford. Pg.135

The practical manifestation of such openness to various perspectives is the flexibility prescribed by this method. If new issues are revealed in the course of research or additional scrutiny is required in a specific area, they can be addressed in due course. The practical implications of this method in this particular study is that when initial research revealed the diversity of viewpoints on the issue by the various relevant parties, it was possible to modify the method to place greater reliance on sources, particularly interviews, elucidating the respective stances. Bryman terms such interpretation of the issue through the individual perspectives of the participants 'double interpretation' and considers the successful use of this method to be crucial to a successful interpretative study within the Social Sciences. [21] In particular, the perspectives are predicated upon the social interactions of the participants and a successful study must utilise the full breadth of interpretative methods to holistically assess the situation with regard to all the pertinent elements of which such 'social interactions' are composed, rather than being limited to the core subject (be it economic, political etc.) When applied to this study, it is evident that even though the core issue is the legal viability of buy-back contractual schemes, the study recognises the complexity of the social interactions involved which go beyond simple economic and legal considerations. The study offers an insight into the formation and nature of these social interactions with reference to the political situation as well as through a detailed analysis of historical elements which shaped the nature of such social interactions; illustrating the flexible application of this research method.

The flexibility of interpretative method extends to the data collection methods used, which must, ideally, incorporate interviews, observations and secondary sources. This study fulfils the method's requirement for diversity of data collection methods by using this entire range of sources. Denzin and Lincoln specifically note the importance of interviews when investigating

[21] Bryman, A. Social research methods. Oxford University Press, 2004. pg. 48

topical and contentious issues, as interviews enable participants' direct expression of their points of view—particularly significant where they are significant contributors to the state of affairs being investigated.[22] This study utilises a number of interviews with significant functionaries from the NIOC as well as with individuals involved in the foreign companies' activities, while also evaluating the relative validity of such opinions.

As a consequence of this perspective's recognition of the multitude of factors and perspectives impacting the subject matter, special attention is given to the involvement of the researcher himself with the topic and the effect on both his knowledge and objectivity. Bryman particularly highlights the potential for observer bias, whereby expectations based on personal experiences tend to shape the research findings. [23] However, such general bias can be mitigated through a conscious and deliberate effort to maintain objectivity by recognising the potential sources of bias prior to conducting the research. In this case, the researcher's personal involvement with the topic was limited and the remaining potential sources of bias were addressed by constant awareness of the various sources' subjective leanings, with a correspondingly objective analysis by the researcher himself.

All in all, the methodological framework within which the quality of an interpretive study can be assessed is based on the extent to which various perspectives are incorporated, data collection methods are used, potential problems of trustworthiness and source validity are addressed, as well as a cumulative conclusion is reached despite the diversity of opinions. [24] It is believed that this study fulfils the above criteria by incorporating the divergent perspectives of foreign and domestic parties in oil transactions, based on a number of pertinent sources. The analysis, constantly controlled for observer bias, is based on the entire range of factors studied and a

[22] Denzin, A. and Yvonna, S. Collecting and interpreting qualitative materials. 2003, Sage Publishing, London.
[23] Op.cit. Bryman. pg. 49
[24] ibid.,

definitive conclusion is reached as the result. Consequently, the relevance of interpretative method to the study in question and the fulfilment of this approach's quality standards are evident from the specific efforts to ensure such appropriateness and compliance.

Methodology Chosen and Related Rationale

A study of an economic phenomenon may appear to be more suggestive of a quantitative, statistical-based approach rather than the combination of qualitative method with comparative analysis, hermeneutics and phenomenology used in this thesis. However, such a presumption should be overturned in view of the specialised nature of the subject matter being studied, namely buy-back contracts, as their understanding and analysis is critically dependant on understanding of human elements of the environment such as politics, law and historical influences. Consequently, a number-based study of this phenomenon would yield scant understanding of its nature or its future development as numbers alone would have difficulty providing an understanding of the complex factors affecting the subject. As a result of these considerations, qualitative method was used both in the initial analysis of historical context and in the assessment of purely contractual elements of the issue in the latter parts of the study. Whereas the first part of the work is largely theoretical, the latter part includes more practical and 'hands-on' elements such as case studies of relevant contracts, therefore providing an appropriate balance between theory and practice.

Another important requirement of qualitative research, which also served as the reason for choosing this method is that the scope of the material studied must be narrowly stated so as to allow the making of specific rather than generic conclusions. The importance of this element is emphasised by Silverman:

> For instance, it is important to find causes of social problems like homelessness, but such a problem is beyond the scope of a single researcher with limited time and resources. Moreover, by defining the problem so widely, one is usually unable to say anything in great depth about it... [the aim] should be to say 'a lot about a little (problem)'. [25]

In accordance with this principle, several conscious limitations on the scope of the study have been made so as to maintain the optimal quality of analysis within the length limitations imposed by the format. An example of such intentional narrowing is the decision to narrow the scope of the study of Petroleum Buy-Back to include mostly material related to oil, rather than gas, while addressing gas only as a means of contrasting its status to that of oil. Petroleum, literally "rock oil", is generally defined as geologically extracted hydrocarbons and can be present either in liquid (oil) or gaseous (natural gas) form, mostly found within sedimentary basins, oil shale and tar sands.[26] Clearly, Iran's natural gas deposits, second in the world in size only to Russia's, fall within the definition of petroleum but will not be examined extensively for a number of additional reasons. Firstly, there are far more accessible sources available for Iran's oil buy-back than for its gas counterpart, making the objective study of gas issues specifically extremely difficult due to the absence of sufficient information from both the domestic and foreign perspectives. Secondly, the study of historical influences on the current buy-back position is a vital element of this work but such study is impossible in reference to gas, as the first export agreement of gas occurred only in the 1960s. Thirdly, and most importantly, the terms and conditions pertinent to oil agreements apply almost identically to gas agreements, with only minor differences due to technical details. Consequently, the study of oil also enables an understanding of gas to be

[25] Silverman, David. 'Interpreting Qualitative Data: Methods for Analysing Talk, Text and Interaction'. Sage Publications, London, 1993, p. 1
[26] McMurry, J. Organic Chemistry 5th ed. Brooks/Cole: Thomson Learning 2000. pg.3

gained due to this similarity of terms. Some references to gas agreements are nonetheless included either to show how similar these agreements are or, alternatively, to highlight contrasts between the two, where such differences exist.

Process of Attaining Conclusions

Having discussed the method chosen for this study, it is important to review the structure through which this method will manifest itself, and eventually produce conclusions. Given the initial theoretical question, it is the task of the method to come to a definitive conclusion to this question; but the conclusion arrived at by the study may vary depending on its precise structure. As the subject matter of this work is one which causes great controversy and disagreement between various parties, and is, in turn, shaped by these disagreements, it is appropriate to utilise a structure which illustrates these clashes. Therefore through much of the work, the scheme of providing arguments and counter-arguments from both perspectives was used, with additional adversarial, side-by-side analysis of various contractual frameworks also being provided. As well as displaying the context of the subject matter, this has the additional advantage of providing objectivity as the result of an even-handed examination of both sides of an issue. Such an analysis also allows for the revision of premises and assumptions if one of the sides to this internal dialogue shows the necessity of doing so. This advantage of point-counterpoint structure is highlighted below:

> Theories are conceptual systems, that is, statements of the relationships among concepts... The possibility that concepts are unrelated or are related in unexpected ways reminds us of the most important thing about the theories—they are tentative and preliminary. We are not sure about them, and that is why we call them theories

instead of laws or facts. Theories are preliminary to laws in that they are working models subject to change and improvement. [27]

Dooley further notes that structure is a crucial element of research, as solid theories are only likely to arise out of internally consistent studies that integrated up to date information in a logical manner. Such elements then allow the theory to approach the status of a persuasive argument rather than a "wild guess". [28]

In reference to the order in which the information required for analysis was presented within this work, it must be highlighted that an approach consistent with the emphasis on contextual analysis was used. This approach manifested itself in the decision to place the section on history of Iranian petroleum at the head of the study, so as to provide a context in the light of which the remainder of the work, focusing on the present situation, may be analysed. The inclusion of an initial and extensive historical section also averts the danger of the thesis being overly narrowly focused, by addressing only the present state of buy-back. The remainder of the work is structured in a way which permits general information related to the subject of study to be processed before analysis commences, to ensure that the reader is equipped with all the relevant facts. This logical structure is followed further when the Critical Analysis chapter is located before the comparative section pertaining to International Model Buy-Back, so that flaws of the existing model are pointed out before the alternative, international terms are proposed.

Although chronological sequence is not an emphasis of this study, it is nonetheless appropriate to include the section pertaining to US Sanctions and their potential impact on the Iranian economy before the main conclusion of the work. This adds to the logical nature

[27] Dooley., op.cit, pg. 29
[28] Ibid., pg. 32

of the structure as the work opened with a review of history and a view of the possible developments in the future is relevant after the study of flaws and possible alternatives. Finally, in order to show the practical application of the various historical, economic, legal and political factors affecting buy-back, the Case Study section provides examples of the terms and conditions used in buy-back contracts in proximity to the main conclusion.

Informational Sources and Problematic Areas of the Research

As one of the goals of this study was to assess the controversial issue of buy-back from both the foreign and the domestic perspectives, numerous sources from each side, both in English and in Farsi, have been consulted. As the researcher's native language is Farsi and his experience and education is that of a First Class Attorney, no issues were encountered with analysing the various legal sources in Farsi. In addition to general academic literature on the issue in both languages, additional information was gleaned from sources closer to the buy-back transactions themselves, namely the National Iranian Oil Company's executives and various foreign oil company officials. These sources were further complemented by first-hand material such as Model Contracts released by various organisations and interviews with such functionaries.

Amongst the difficulties encountered in the course of research, the primary one was the veil of secrecy drawn by both parties to oil transactions over the exact details of their contracts. Therefore, it was difficult to procure either first-hand interviews or numeric information pertinent to signed contracts, such as contractual costs, remuneration amounts etc., as the parties involved were worried about commercial secrecy. Nonetheless, the details that were eventually disclosed have been included in the relevant sections.

An additional area of increased sensitivity that must be considered is that of political issues surrounding a study such as this one and the potential influence on the researcher. A great deal of controversy surrounds buy-back contracts in Iran, primarily as the result of historical precedents which are discussed in further detail in the part one of this study devoted to history. Some segments of public opinion view such arrangements as being contrary to the interests of Iran, as the arrangement is balanced in favour of the foreign contractors. Other segments, however, believe that if buy-back was more attractive for foreign investors, the ramifications of the additional profits would be positive for the rest of society and therefore oppose buy-back's restrictive arrangements. As well as the topic being politically charged amidst the general populace, there are also extensive disagreements in the political sphere. Although the buy-back scheme was originally introduced by the Islamic government and given the state's support, following President Ahmadinejad's election, the scheme has been heavily criticised and threatened with cancellation. However, such sentiments appear to have been calmed and the government's approval of buy-back has returned. The political controversy of the topic must be considered when assessing the methodology of this issue as these circumstances affect the material published about it, as well as the stance of the media and the foreign partners. In particular, this tends to radicalise the opinions for both sides when it comes to analysing buy-back, therefore suggesting that an easier compromise between the parties may be achieved if political factors were not considered.

The Relevant Ethical and Moral Issues

This work attempts to critically analyse an essential element of the Iranian economic system which affects all its citizens and deals with issues of the redistribution of wealth amongst domestic and foreign entities. Consequentially, a number of interests may be adversely affected

through alterations to the current contractual system and, therefore, an assessment of the moral and ethical implications in the context of research method is required.

In order to understand the relevance of ethical and moral issues to the study of a subject that is legal to a greater extent than it is social, where such issues would be more clearly discernable, it is important to clarify the scope of these terms as applied to research methods.

Although various attempts have been made to distinguish the characterisations of ethical problems in various types of applied research, such as social experiments, evaluation research, social intervention, and prevention research, consensus appears to be lacking among social researchers as to what actually constitutes an ethical or moral issue in their investigations. A common confusion apparently involves the distinction between 'ethical' problems and 'moral' problems and the point at which either constitutes research 'diversity'. The sheer diversity of ethical problems that one might encounter during the various stages of social research seems to have precluded the emergence of a clear typology or set of classifying characteristics by which to describe and contrast particular studies. [29]

As noted by Kimmel, morality and ethics do not necessarily correspond to 'good' and 'bad' when determining whether a study's benefits outweigh its negative effects, but the guiding principle should rather be whether the method of the study is in conformity to generally accepted principles of conduct. Consequently, a researcher's conduct may be ethical through its conformity to a professional organisation's code of conduct, yet immoral in terms of being disquieting or ambiguous by society's standards, generally.[30] An important element of Kimmel's argument is also that those researchers who are examining a group or phenomenon in relation to

[29] Kimmel, Allan J. Ethics and Values in Applied Social Research, Sage Publications, London p. 26
[30] Ibid., p. 27

which they can be considered 'outsiders', must strive to provide additional supporting basis for their conclusions as they are, by default, less authoritative on the subject.

The classification of this researcher within the framework set out by Kimmel is not entirely clear, as the author of this study is, on one hand, an Iranian citizen who is fluent in Farsi and who has ample legal experience in the capacity of a lawyer, in the contractual negotiating and litigating environment but, on the other, has not been directly involved in petroleum transactions or the relevant industry. Additional factors that shift the scales of the analysis towards greater objectivity and an 'outsider' status is the researcher's additional British citizenship and prolonged experience of life abroad, including research and academic activities.

It is therefore suggested that even though the researcher may be best classified as an 'outsider', as seen from the numerous unsuccessful attempts to procure primary material from those directly involved in Iranian buy-back, he nonetheless is closer to the median of such a scale due to his proximity to the context of Iranian oil. Consequently, following the guidelines set out by Kimmel, the extent of required defensibility of the work is higher than that of an insider but lower than that applicable to complete 'outsiders'.

In reference to the researcher's relative lack of involvement in the subject matter of study, this can be said to minimise the possible effects of bias arising from particular closeness to the material issue. Objectivity and lack thereof are widely interpreted terms which vary from context to context, but it is nonetheless argued that when an analysis of the sources used and their correspondence to the final study is able to show a distortion of their meaning to suit a prejudiced mindset, the criteria for a biased approach would have been met. In the case of this study, the material studied was assessed with the application of the general code of research behaviour, and objectivity through balance of sources from both the domestic and the foreign

sides of the issue was sought. Consequently, statistical and empirical evidence was followed wherever it led, without artificially altering the course of analysis to accommodate pre-set beliefs.

Kimmel further notes that ethical questions are relevant not only in assessing a researcher's methods but also the subject matter itself, the "actual nature of the programs researched". [31] However, as this concern is mainly relevant where the conduct of the study itself may disrupt the natural operations of the subject being studied, this issue is not of significant import in the case of this study. The researcher did not interact with the subject of the study by any means which could directly influence its natural processes, with the exception of interviewing the decision-makers in the area. However, as the questions posed within were of a neutral nature, little influence on their behaviour is to be expected.

[31] Ibid., pg. 32

Organisation of the Thesis

The issue of the Iranian stance on oil contracts is more important than ever at a time when the oil market fluctuates due to instability in some of the world's major producers. Indeed, in its capacity as a leading oil producer, the Islamic Republic of Iran has the power to make or break the global market. This thesis intends to provide a detailed and thorough examination of its oil contracts from both the present and future perspectives. The study focuses on buy-back transactions and consists of nine chapters, analysing all the historical, social and commercial elements affecting the current type of contractual relationship used in the Iranian oil industry. Such a comprehensive analysis of the past and present also allows suggestions to be made as to the means of improving and modernising the current model so as to be in sync with the global contractual framework related to oil.

In order to ensure the comprehensive and objective analysis of this complex issue, a number of sources, from both the domestic and the foreign perspectives have been consulted, as well as a significant quantity of raw data. Among these sources are statistics, as well as other information provided by both the Iranian government and the foreign participants in the oil industry, including statements by the Oil Ministry of Iran, various industry magazines in both Farsi and English and a multitude of other sources. The sources mentioned were referred to accurately in the footnotes, including where direct quotations were involved.

The study is divided into three similarly sized portions, addressing the three most important general areas within which the component issues are grouped. Part One initiates the analysis through reference to historical factors, permitting a more in-depth and contextually aware analysis in the subsequent sections. Part Two of the study addresses, in a critical manner, the general issues of buy-back as a system, as compared to other alternatives, while analysing the relative validity of criticisms levelled by both domestic and foreign parties. Part Three concludes

the analysis by examining, through juxtaposition, the relative potential for advantageous reforms as opposed to the increasing pressure barring Iranian involvement. The chapter by chapter distribution below provides greater detail regarding each of the components.

Chapter one is devoted to the examination of the historical factors which shaped the oil industry as it is today. In particular, the unbalanced contractual terms of the early 19th century concessions are reviewed as a source of public and government discontent with foreign involvement in the oil industry. The cumulative effect of these perceived inequities, along with the British, American and Soviet meddling in internal Iranian affairs during and after World War 2, with the aim of acquiring oil concessions, are shown to be the key causal factors in the 1951 Nationalisation.

Chapter Two concentrates on the consequences of the exploitative 1933 Concession and the failed attempts to renegotiate the deal in order to avoid disruption in the industry. Following these unsuccessful attempts, the consequences of Nationalisation are analysed at length, including the subsequent efforts to prevent further annulments by altering the terms and structure in the agreements, as seen in the 1954 Consortium. Of especial interest are the resulting changes in the legal framework of oil agreements and their effect on the commercial landscape in an attempt to reconcile the opposing interests, particularly as the indispensability of oil to the ambitious economic reforms became clear. The failure to satisfy the grievances of the domestic authorities and the public, resulting in the 1979 Revolution and a complete cancellation of all contracts is reviewed, particularly in the context of the subsequent, destructive Iran-Iraq War and its causal relationship with the increased desire for foreign investment.

Chapter Three, the first section of Part Two, provides a wider context to the buy-back contract by cataloguing and investigating the alternatives to the current model, used globally, such as Production Sharing Agreements and Concessionary Models, as well as Revenue Sharing and

Joint Venture Agreements. Their function and legal bases are examined to determine their compatibility and legality in the light of the Iranian contractual system and the restrictive laws.

Chapter Four involves a thorough overview of the legal basis and nature of buy-back contracts since their inception in the early 1990s, with particular reference to the Constitutional and Statutory restrictions imposed on the formation of oil contracts. The Five Year Development Plans and the new Foreign Investment Law have been examined in terms of their limiting effect on the extent of foreign involvement in the oil industry and the buy-back model itself.

Chapter Five contains the crucial overview of the grievances from both parties involved in oil transactions and highlights the areas where reform and modernisation is required in order to suit the realities of the global market. Several areas of particular concern, such as contract length and lack of improvement incentives, are noted as part of an integration process of elements from alternative models and it is proposed that alterations to the existing model can satisfy the demands for a mutually profitable and legal system without resorting to an anti-constitutional alternative model.

Chapter Six is case study of contemporary Iranian oil transactions, providing practical specifications of buy-back contracts implemented within the industry. Using the specific arrangements for contracts pertaining to major oil fields, the practical application of the buy-back is examined and the persisting foreign involvement, despite the perceived flaws in the current system, is shown.

Chapter Seven, the first section of Part Three, examines in extensive detail both the International and the Iranian buy-back models to determine their comparative advantages and to analyse the extent to which the International scheme was implemented in domestic contracts. The practical

implementation of some controversial provisions is examined in detail to determine the extent to which they undermine or boost the attractiveness of Iranian buy-back schemes.

Chapter Eight reviews the extent of US sanctions on Iranian oil contracts, as well as their effectiveness in deterring foreign involvement. The various complex effects of these trade measures, on a multitude of societal and economic aspects in both the US and Iran, are measured in the context of the US purpose of imposing such sanctions. An overall assessment of the sanctions' success is included as well as a prediction for their future development.

Chapter Nine is the concluding part of the work that summarises the various areas of analysis and suggests a number of modernised improvements that should allay the concerns of the domestic and the foreign participants without crossing the line, drawn by statute and the Constitution, into illegality. The ability to adopt useful elements of alternative models without causing a political and legal crisis is emphasised as there is significant leeway in the precise terms used in the buy-back system.

Chapter 1: Formation of the Iranian Oil Industry in the Pre-Nationalisation Period (1908-1951)

1.1 Introduction

Iran, previously one of the most advanced countries in the region, lost this status by the 19th century. The locations of its cities, once allowing Iran to sit on the world's major trade routes, no longer had that advantage. It was a sparsely populated area, with only 5 million inhabitants, which put it at a disadvantage compared to major world powers.[32] Iran, economically, could not, even remotely, be a competitor in a field where the more developed European countries were involved, particularly as it did not possess any contemporarily valuable upon which it could draw in order to bridge this gap. In the early 19th century, Iran encountered the two great expansionistic powers, Britain and Russia. Only occasionally acting in a concerted manner, these powers were mostly wary of one another. As the result, Iran had been drawn in, against its will, into the struggle for influence in Asia, referred to as 'the Great Game'. Alongside the power struggle, there was a race for economic influence as competition between financiers and businessmen originating from European countries, all attempting to enter the Iranian market while also securing economic benefits from the Iranian government, was increasing in intensity.[33]

A further barrier to Iran's progress was its frail governmental system, particularly when considering its structural flaws, stemming from the country's constant, post-Imperial degradation.

[32] For instance France with 27 million, or Britain with its rapidly expanding population of 8 million.
[33] Muhlberger, Steve, History of Islamic Civilization, Nipissing University 1999 [http://www.nipissingu.ca/department/history/MUHLBERGER/2805/LEADUP.HTM] pg. 1

On a more microscopic level, the leadership of the country was also lacking, with the shahs not willing to attempt modernisation of Iran, particularly in matters of the school system. These vulnerabilities in Iran's policy made it even more susceptible to European pressure. Significant territorial acquisitions,[34] for instance, were made by Russia at Iran's expanse, and were followed by an 1828 treaty legitimising these changes,[35] which also induced Iran into making economic concessions. The extent of the import duty on Russian products was limited to 5 percent, with a prohibition on all internal taxes for such goods. Such concessions resulted in a disadvantage for Iranian merchants when juxtaposed against the situation of the European traders. Just as European countries were beginning the Industrial Revolution, the Iranian domestic market was broken open by these developments.

Furthermore, special immunities were granted to foreigners by treaties such as the Russian-Iranian Treaty of 1828. The rationalisation used to justify these immunities was that the courts of Iran were corrupt and the country itself was an arbitrarily ruled Islamic country which necessitated the utilisation of consular courts when trying Europeans. Iranians employed at embassies and consulates were also granted this privilege, and subsequently the granting of this privilege to any Iranian favoured by foreign representatives became discretionary.[36]

The granting of various concessions was occurring with increasing frequency in the second half of the nineteenth century. Such concessions amounted to the right to develop some form of modern facility, a right that could be purchased from the government for cash or in exchange for other consideration. The initial concession, followed by many others, was the permission to the

[34] Russian ownership was established over the Nakhchivan Khanate, Talysh Khanate and Erivan khanate, making the Aras River the boundary between the two empires.
[35] Persia had little choice in the matter as the Russian government threatened to invade Tehran within five days of a refusal.
[36] The Circle of Ancient Iranian Studies, *"Kanoon-e-Pazhooheshhay-e-Iran-e-Bastan"*, affiliated with the School of Oriental and African Studies. Entry on Turkmanchai Treaty. [http://www.cais-soas.com/CAIS/Iran/torkmanchai.htm]

British for the construction of a telegraph network. They had done so in order to establish a quick link for communication with India. A circumstance that was not given sufficient consideration during the decision-making process pertaining to the above concession, however, was the effective yielding of control over such a technologically advanced area to a foreign entity. [37]

The authority and power of the Iranian government degraded throughout the 19th century, until, at its end, it was merely a formality throughout the country. The government was undergoing financial crises and was in debt, chiefly to Russians and the British. The chaotic state of the government provoked the foreign nations to seize the moment and further expand their demands on Iran for more concessions. The British, in particular, exploited the turmoil and the foreign penetration with great efficiency, leading to the acquisition of a monopoly over the production, sale and export of Iranian natural resources.[38]

Some of the most vital concessions that were granted as the result of Iran's internal weakness pertained to the oil industry. Several notable concessions were made in the 19th century.

1.2 Analysis of Pre-1900 Concessions

The concessions made to foreign powers during this period were characterised by their breadth of scope and were often acquired through the application of direct political pressure[39] from one of the Great Powers with whom Iran could not compete either economically or politically. The terms and conditions of the concessions were weighted heavily in favour of the foreign party and, due to their wide scope, had great potential for unjust exploitation of Iran's national resources. The 19th Century scheme of granting concessions was especially untenable due to the quick refutations of any granted concessions, therefore prohibiting any further commercial

[37] Muhlberger, op.cit., p.2
[38] Farshadgohar, N., "A Survey on Iran's Oil Agreements". 2002, Tehran. P. 20-22
[39] Such pressure was particularly effective as Iran was located in a geographical crossfire between areas controlled by the British Empire and those of Russia

interaction between the parties, while still creating the domestic feeling of resentment at being unjustly exploited as the concessions were granted in the first place. [40]

1.2.1 The Reuter Concession

The Middle East's first petroleum agreement, between the British Baron Julius de Reuter and the Persian Shah Nasr-ed-Din, was signed on the 25th July 1872. Reuter, of German-Jewish origin, had as a result of the power of his agency[41] acquired considerable influence over the government and financial circles throughout Europe, Britain and especially in Iran. He is likely to be remembered by Iranians mostly for his accomplishment of securing a concession which, despite the context of extensively exploitative concessions, was the broadest and most demanding of all.[42] In 1870 the Persian minister in London, Mohsen Khan, met de Reuter and was successful in persuading him to fund ventures in Persia. At this time Naser-ed-Din Shah, was planning a tour of Europe, the first time that a Persian sovereign would have visited a foreign state since Nader Shah invaded India in 1738. Consequently, the appearance in Tehran in 1872 of Baron de Reuter's agent, M. Cotte, with a proposal of cash for a concession, was well timed. In 1872 no doubt the Baron was not thinking particularly of oil; his concession nevertheless was worded broadly enough to cover all possible contingencies. In addition to a monopoly of the construction of railway and tramways, canals and irrigation works, the exploitation of forests and all uncultivated land, and the operation of a bank and public works of every description, the concession handed over the exclusive rights of all Persian mineral resources for a period of seventy years, with the exception of silver, gold and precious stones.[43] According to comments

[40] ibid.
[41] He is better known outside Persia as the founder of the famous news agency.
[42] Elwell-Sutton, L.P, Persian Oil. 1976 ed. 1955, London: Lawrence and Wishart Ltd, p. 11
[43] ibid.

made by Lord Curzon,[44] this concession was the most complete and "extraordinary surrender" [45] by Persia to foreign interests. He stated that "this is the most complete concession which a nation can ever grant, giving up all its possession to foreigners."[46] This concession, however, only existed for 15 month before it was withdrawn due to internal public pressure and Russian objections. Even the British government, scared by the hornet's nest it had allowed to be stirred up, withdrew its support from the Baron, and the Shah soon found an excuse to cancel his rash undertaking,[47] with the effect of confiscation Reuter's deposit of £40,000 by the Persian government, from the Bank of England, where it was being held in trust.[48] This concession, however short-lived, may be seen as the epitome of Iranian fears of foreign exploitation of national resources.[49]

1.2.2 Hotz Concession

One of the earliest concessions granted to foreigners in the 19th century, was given to M. A. Hotz (Albert Hotz), an English company. The Hotz Company was an export and important firm, operating throughout the Persian Gulf, based in Booshehr. The concession granted to it in 1884 gave the company the right to extract oil from Dalky and Qeshm Island. Drilling was commenced by the company, but no oil was found. In 1890, the company transferred their rights pertaining to oil to the Persian Bank Mining Rights Corporation[50] and this corporation, between 1891-1893 drilled for oil but found nothing in the region. In an 1899 announcement, the Persian Government annulled all mining concessions, including the Hotz Concession. The Persian Bank Mining Rights Corporation, to whom the concession was awarded, was dissolved in 1901. No

[44] George Curzon, the eldest son of Baron Curzon, was born on 11th January 1859 in Derbyshire of the UK. He was appointed foreign secretary in 1919 and died on 20th March 1925.
[45] Curzon, George N., Persia and Persian Question, London 1892, Vol 1, p. 480
[46] Rabiee, F., op.cit., p.20
[47] Elwell-Sutton, op.cit., p. 12
[48] Alavi, S. A. History of Oil Industry in Iran, California Institute of Asian Studies, 1978. p.26
[49] Mahdavi, A.H. 'Tarikhe Ravabete Kharejiye Iran,' (History of the Iranian Foreign Relations), Tehran, 1985, p307-314
[50] Fateh, Mostafa, Panjah Sal Naft dar Iran, (50 years Oil in Iran), Tehran, Payam,1358. p.248

major considerations requiring discussion exist in relation to this concession, as no oil was discovered and the concession died away.[51] Dr. Lawrence Lockhart,[52] in an article published in 1938 titled "History of Oil in Iran", commented that Hotz earned the Dalky and Salakh oil concession in Qeshm Island and drilled a number of wells, 270 mitres deep. As they did not find any oil they did not persist with their activities and their consortium was abolished in 1901.[53]

1.2.3 The Imperial Bank of Persia Concession

Following the annulment of the Reuter Concession, for seventeen years the company attempted to breathe new life into their Iranian investment. The British Authorised Minister, Sir Henry Drummondolf, decided in 1889 to use his affable relationship with Amin al Soltan Atabak, the Iranian Chief Minister, in order to enact parts of the Reuter Concession.[54] Following a long negotiation by the parties, the terms of a new concession agreement were agreed on, dictating the establishment of the 'Imperial Bank of Persia'. According to the agreement's terms, Reuter pledged to pay one million Francs, the equivalent of £40,000, at an annual interest of 16%, in the form of a loan to Naser-Aldin-Shah. The Iranian government, for their part, agreed to release the confiscated £40,000 deposit, and the money was used as the starting capital for the Imperial Bank.[55] The Concession consisted of fourteen articles and extended many rights to the foreigners, including the monopoly over minting banknotes. A section was devoted to the exploitation of minerals, including oil.

Under Article 11:

[51] Zoghi Iraj , Masael Eghtesadi va Siyasi Naft Iran, (Economic and Political Issues of Iran's Oil),Tehran, Pazhang 1381, p. 43-44

[52] Laurence Lockhart was born in London, 1890, and worked for the Foreign Office during the First World War and the Anglo-Persian Oil Company in Mexico, 1919-26, and Persia, 1926-30. He returned to the London office of the Anglo-Persian Oil Company during 1935-9 and 1946-8. [http://www.oriental.cam.ac.uk/archive/lockhart.html]

[53] Mousavi, Mir Tayeb, Alireza Amini, Naft Siasat Eghtesad (Oil, Politics, Economy) Tehran, Bahram, 1379, p.30

[54] Specifically Article 20 of the Concession, which dealt with the establishment of a bank, with the hope of preventing the dissolution of the Reuter Company.

[55] Rabiee, op.cit., p.21

Minerals

> 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.[56]

After seventeen years, Reuter resolved its conflict with the Iranian government over the concession, and additionally, obtained a new advantage in relation to oil deposits.[57]

1.3 Overview of Pre-Nationalisation Oil Contracts

This section is devoted to a discussion of the D'Arcy concession of 1901 and other important oil transactions during this period, for example the 1933 Concession. It emphasises the importance and exclusive privileges of these agreements from the perspective of the foreign participants and the attempts to renegotiate these unbalanced contracts due to domestic public pressure.

1.3.1 D'Arcy Concession

Multiple explanations exist as to the means by which D'Arcy acquired his surprising concessions. The most probable cause for this occurrence is that a French archaeologist, by the name of De Morgan, published an article in Les Annales de Mines,[58] in 1892, stating that oil is present in the Qasr-e-Shirin area. This revelation provoked interest among many, including William Knox D'Arcy. He then sent his agent to Persia, to represent him while trying to secure an oil concession. Mozaffar Ed-Din Shah, with the cooperation of the Persian authorities, granted

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[56] Zoghi, op.cit., p.59
[57] Farshadgohar, op.cit., p.39
[58] A French magazine concerned with geology and other natural and earth sciences.

the concession to D'Arcy on 28th May 1901.[59] £50,000 worth of fully-paid shares was granted to the Shah and the other notables. A.K. Khan[60] was given an annual salary of £1,000 and his three sons were recruited with similarly generous pay. The Persian Grand Vazier had also aided D'Arcy, and without him, the acquisition of the concession would have been impossible. Five major Northern Provinces were excluded from the concession (Azerbaijan, Gilan, Mazandaran, Khorasan and Astarabad) in order to recognise the Russian influence. [61] The foundation of the oil industry in Iran, then celebrating its first centennial, was initiated by the signing of this infamous concession.

Several oil extraction concessions were granted in Iran in the second half of the 19th century, when the US oil industry was born in 1859. Several parts of the country were drilled for oil, but no attempts resulted in successful results. Following this pattern, the first phase of the D'Arcy concession's drilling operations in Ghasr-e-shirin and Chah-sorkh also did not bear fruit. The presence of oil was proven through drilling, but the output ratio of the discovered wells was not sufficiently high to warrant further operations in those areas. This finding resulted in the transfer of the drilling rigs further south, to the Shooshtar area. Despite the optimistic prognoses of experts regarding the results of the drilling operations in this region, the inadequacy of D'Arcy's financial support amounted to a critical obstacle. D'Arcy was personally unprepared for the heavier investment required for related projects. A huge sum[62] was spent by 1904, a sum of significant value at the time. A Scottish oil company, which was given a concession in Burma and constructed a refinery in Rangoon, offered D'Arcy funds to aid in resolving his dire financial situation, which he accepted. [63]

[59] Alavi, op.cit., p.29
[60] Acted as the Director General of the Persian Customs agency prior to helping D'arcy and de Morgan secure the concession by means of using his influence with the Shah's government..
[61] ibid., p.30
[62] Over two hundred and twenty thousand pounds.
[63] Finnegan, Sean, "Middle Eastern Oil: An Historical Perspective and Outlook" , [http://blog.lege.net/content/oil/all_about_oil.htm]

In accordance with Articles 4 and 16 of the D'Arcy Concession, the first oil exploitation company was founded in May 1903, with a capital of £600.000 and the price of £1 per share, with the Persian government receiving 20,000 shares.[64] Moreover, due to internal instability and lack of central authority, D'Arcy founded the Bakhtiari Oil Company Ltd., with 400,000 shares at the price of £1 per share, and distributed 3 percent of the shares among the local Bakhtiari Khans, as well as £2,000 annually, in order to ensure the safeguarding of the drilling equipment and supplies, in addition to £1,000 paid for the safeguarding of the pipeline. Subsequently, however, financial difficulties had arisen for the company due to oil exploration, and this occurred before the production of oil in previously discovered fields was sufficiently high. This caused an almost complete exhaustion of D'Arcy's original investment, and a plea for financial assistance. Due to British fears that the concession might end up in American or Dutch oil trusts' hands, the British government asked D'Arcy to delay his negotiations with foreigners, and instead advised Lord Strathcona of the Burma Oil Company to aid D'Arcy.

These events occurred at a time when the British Admiralty made the decision to substitute coal with oil, as the means of fuelling their warships. [65]

The Scottish entity, the Burma Oil Company, was used by the British government to secure the required amount of oil. The company's reserves were not adequate for the task of providing such a long-term commitment, and further expansions of oil procurement operations in the Burmese concessionary area were not recommended by technical experts. The D'Arcy concession was much more suitable for the task of providing these supplies for the British Admiralty, provided that the financial capabilities of the Burma Oil Company were to be diverted to D'Arcy's areas for further investment.[66]

[64] History of Mount Morgan, "Twice a Millionaire" [http://www.mountmorgan.com/dArcy.html]
[65] This project required fifty thousand tons of oil annually.
[66] These funds were needed due to the financial inadequacies of D'Arcy's own financial backing of the project.

Negotiations between the two companies had resulted in the establishment of Concessions Syndicate Ltd.,[67] with headquarters in Glasgow, in May 1905. This syndicate was to continue drilling operations in the Masjid-e-Solaiman area, with the financial backing of the Burma Oil Company. The contract for protection with the Bakhtiari was never affirmed by the Iranian government, as it was negotiated by the British consul, in the absence of government officials, and Reza Shah cancelled it officially in 1924. Drilling operations proceeded in several locations while this was occurring. Two wells, drilled north of Ahwas, did not show promising results; however, wells drilled in Masjid- e –Solaiman struck oil on 26th May 1908. Tests have shown that the find was what the experts have been looking for. Further proof of a huge oil reserve was found when second and third wells were drilled and consequently, Masjid- e –Solaiman became the Middle East's first oilfield.

Such a turn of events was unexpected, since Reynolds, the head of drilling operations, on his way back to Ahwaz, received a letter dated 14th May from the company's headquarters in Scotland, which, written less than two weeks before the Masjid-e–Solaiman success, expressed the company authorities' dissatisfaction with the operations.

Several months after the Masjid-e–Solaiman discovery, the Burma Oil Company, the Concessions Ltd syndicate and Lord Strathcona, the aforementioned British financier, founded the Anglo-Persian Oil Company. All of the concession rights previously held by D'Arcy were transferred to the new company and D'Arcy became a member of its board of directors.[68] Construction operations at the newly discovered oil site began in October 1909.[69] The same year, the company's aeroplane first landed in Iran and the first Iranian cargo of crude oil was lifted for

[67] The Syndicate was to control the shares of the First Exploitation Company and to be under the trusteeship of D'Arcy, with the newly created organisation providing the capital needed for further oil operations.
[68] NIOC, Brief History of Iran's Oil. p.3
[69] These operations involved the hiring of personnel other than the previously employed drillers, as specialists were required to actually exploit the deposits, resulting in total employment of 2500 individuals by 1911.

export a year later, in 1912. Thirty oil wells were drilled in the Masjid-e-Solaiman area by 1914. An agreement was reached between the company and the British government in 1914, whereby the government became the majority shareholder of the company. Following this development, the British government acquired a strong presence in the company's board of directors, numbering two members, who had the special power to veto board decisions which contradicted the British government's interests. Britain's House of Commons approved this arrangement on 17 June 1914, on the eve of the First World War. As per a confidential agreement negotiated with the British Admiralty, the company pledged to satisfy all of the British Navy's fuel needs, at a lowered price.[70]

The land required for the refinery was placed at the company's disposal by Sheikh Khazal, the ruler of Khorramshahr, who had close ties with Britain's diplomat in the Persian Gulf. The agreement dictated that, in addition to an annual lease, the Sheikh would receive a ten thousand pound loan. The Sheikh was also told by the diplomat that the British government would support and protect him and his family. Clearly, the company was using British diplomatic officials' influence to reinforce its position, while ignoring Iran's central government. The arrangements with Bakhtiari tribal heads and Sheikh Khazal were obvious and brazen examples of such undermining behaviour, resulting in Reza Shah's government decision to suppress the sheikhs and the tribal heads, and to take full control.[71]

[70] Such an arrangement was especially fortuitous for the British as, due to the strength of the German navy, naval operations were a significant part of World War 1 and a ready supply of Iranian oil gave it a significant advantage over the blockaded Germans, whose navy was cut off from such supplies.
[71] Zoghi, op.cit., p.68-71

1.3.2 Impact of D'Arcy Concession on Stance towards Foreign Involvement

The aforementioned decision by the Shah's government to reaffirm their control and power over Iran, and to curtail the expansion of foreign influence, can be traced to the harshness of the D'Arcy Concession's provisions, the most controversial of which are highlighted below.

> 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[72] throughout the whole extent of the Persian Empire for a term of sixty years as from the date of the signing.[73]

The width of permitted exploration and exploitation, outlined in Article 1,[74] is striking as it appears to give exploitation rights over a vast area, while noting that the right is exclusive and is effective for an entire 60 years. Moreover, the number of valuable commodities and resources it covers is unprecedented in the context of current oil contracts, which are of significantly smaller geographic and substantive scope.

> Article 7
> 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 pipe-lines, shall enter Persia free of all taxes and Custom House duties.[75]

[72] A naturally occurring mineral wax and paraffin.
[73] ibid., p. 63
[74] Despite being qualified to exclude several provinces in a subsequent Article
[75] The full text of the D'Arcy Concession in the original language, including 18 Articles, can be found in Lesani, Abulfazl, Talaye Ssiyah Ya Balaye Siyah, (Black Gold or Black Disaster), Amir Kabir, Tehran, 1357, p.65-69

The tax-free status given to the Concession's operations is remarkable, especially considering the amount of taxes that could have been injected into the economy from a technologically massive operation such as the exploitation of a new field. This Article appears to be especially surprising and exploitative when taking into account the fairly low[76] share of the Persian government in the profits. One could note, however, that the Persian government was to inherit all the equipment and structures built in the course of the operations; but considering the 60-year length of the concession, it would have been unlikely that the equipment could still be used to find viable oil deposits in the exploited area.

In June 1901, just one month after the original concession was granted, the Shah issued a royal decree to be added to the original concession, further developing the perception that due to foreign pressure, Persia was giving away its natural resources practically for free:

> 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.[77]

From the flattering and ornate language used in the addendum to the Concession, the extent of British influence on the process of decision-making in Persia, especially in regards to concessions, is apparent. It is therefore unsurprising that the Persian government agreed to

[76] 16% as per Article 10
[77] ibid. p.33-34

the vastly inequitable terms of the Concession and the Addendum, considering the amount of pressure to which it was subjected.

1.3.3 Dispute over the D'Arcy Concession and the Resulting Armitage-Smith Agreement

During the First World War, disagreements existed over the wording of the concession. The first dispute concerned Article 10, under which the Company had to pay the Persian government, every year, a sum that was equal to 16 percent of the annual net income of any company or companies.[78] In the interpretation of the Company, this applied only to those companies operating in Persia, while the Persian government claimed it applied to all companies. The second bone of contention stemmed from Article 14, according to which the Persian government had to take all the necessary measures to provide for the safety and to facilitate the activities related to the concession's object. The Company claimed that the government had failed to protect the pipeline and subsequently withheld the royalties to the Persian government. The Persian government claimed that under Article 14, "... it was not liable for loss or damage caused by acts beyond its control, and in accordance with Article 17 it asked for arbitration..."[79] Finally, an agreement was reached on 22nd December 1920 between the Company and the Persian government, known as the Armitage-Smith Agreement.[80] This agreement recognised the Persian government's claim that the profit-sharing provisions in the concession applied to all companies formed by the Anglo-Persian Oil Company (APOC):

"... the Persian government was entitled to receive a 16 percent royalty of all annual net profits arising from the mining, refining and marketing of Persian oil, whether all the stages of the

[78] In additional to initial fees of several thousand pounds.
[79] Moosavi, Amini op.cit., p 48
[80] Considered to be 'interpretive' as it merely clarified previously signed documents and was named after Sydney Armitage-Smith, the British Treasury official serving as the financial adviser to the Iranian government.

above processes were handled by the company itself or through subsidiary companies, whether in Persia or outside...."[81]

However, an exception was noted: "The government was not to receive royalty on the profits arising from the transporting of oil by means of ships..."[82]

In addition, the agreement recognised various deductions for oil and oil products to subsidiary companies refining, distributing or dealing with Persian oil.[83]

It also provided that: "... net profits were to be taken as adjusted for income tax purposes, no deductions were to be made from the net profit for interest or dividends, and interest and dividends received were to be excluded from the profits on which the royalty was payable..." [84]

Finally, the agreement instructed that: "... any dispute regarding royalties should be referred not to arbitrators sitting at Tehran, as provided in Article 17 of the concession, but to a Chartered Accountant in England nominated by the President of the Institute of Chartered Accountants in England, whose decision should be final..."[85]

It is noteworthy that the British claims of these violations were voiced after the British government became the main shareholder in the D'Arcy Concession. As it was the English government that had a vested interest in the Concession, the agreement to allocate the task of arbitration to an English accountancy firm may further confirm the unbalanced nature of the contract, due to the possible lack of objectivity of the English firm.

This new agreement differed extensively from the original D'Arcy Concession, to the detriment of the host country. Also, the motivation behind the policy of linking the payment to the Persian

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[81] Farshad Gohar, N., 'Seyri Dar Gharardadhaye Naftiye Iran',(A Survey On Iran's Oil Agreements) Tehran, 1381, pg 79

[82] Moosavi, Amini , op.cit., p 48

[83] Which were to be made before the calculation of the net profits for the allocation of the 16 percent revenue to the Persian government was carried out

[84] Farshad Gohar, N, op.cit., p 80

[85] Alavi, op.cit., p. 44

government with the trading profit was to ensure that a degree of protection existed for the concession if little or no profit was made during certain years, or even if commercial losses were to occur. This method of payment was attractive to the Persian government, as it was hoped that it would permit a continuous flow of revenue which was needed to resolve its budgetary difficulties.[86]

This method of payment, however, was subject to fluctuations as it depended on the company's profits; a situation which was contrary to the interests of the Persian government. Another aspect of the concession was the amount of royalty payments, which was fixed at 16 percent of the net profit. It conformed to the provisions of the Reuter concession of 1872, "in fact, had it not been for the latter, D'Arcy would have insisted on paying 10 percent."[87]

1.3.4 Cancellation of D'Arcy Concession and the Signing of the New Agreement

In an attempt to renegotiate the Concession, Taimoortash, a powerful court minister, was appointed by the government to negotiate with the Anglo-Persian Oil Company. The government was seeking an arrangement which would give Iran the option of owning 25% of the Company's shares, receiving a two shillings royalty per ton of oil produced. A further condition was having 75% of the concession area returned to Iran, dictating that the payment of tax by the Company was to occur according to Iranian taxation laws and achieving the recognition of Iran's rights in all company operations even after the termination of the terms of concession. If these conditions were accepted, the government was willing to extend the agreement for another 20 years.

Negotiations were ongoing until 1931. During that year, Iran's oil income shrunk dramatically in comparison to the previous fiscal year and the blame for this fall of revenue was attributed to a

[86] Zoghi, op.cit., p.84-86
[87] Alavi op.cit., p.41-45

global recession by the Company. Reza Shah was dissatisfied with the length of the negotiations and the continuous company excuses and issued an order to his ministers to annul the D'Arcy Concession.[88]

The Company was informed immediately and the Shah's decision was confirmed by the Parliament in its 10th session. The British government then issued a strongly-worded memorandum, condemning the annulment. A complaint was filed by Britain in the League of Nations[89] and several warships were sent to the Persian Gulf. A resolution was not passed on the matter by the Security Council; instead, it advised that the disagreeing parties seek a solution through negotiation. Talks were held until the 24th April 1933, both in Tehran and Europe, by Iranian government officials and Company representatives. An agreement was reached on all the decisive points, except on the renewal of the D'Arcy Concession, due to terminate in 1951. Company officials insisted on a 30-year extension, and the Shah eventually intervened, concluding the agreement including such an extension.

1.4 The 1933 Concession

In order to fully understand and evaluate the 1933 Concession, it is imperative that the years and concessions preceding which impacted upon it be first considered. Without the D'Arcy controversy and the politics of the Anglo-Persian Company, the 1933 concession would be impossible to consider.

1.4.1 Criticism of D'Arcy Concession's Integrity and Subsequent Reforms

The Persian government asked a chartered accountant, William McClintock, to examine the financial relationship between the Anglo-Persian Company and the Persian government, in 1921.

[88] It is said that he had lost control due to these difficulties and hurled oil contract paperwork into a fire.
[89] The predecessor of the United Nations, formed during the 1918-1920 Paris Peace Conference and surviving with intermittent success until WWII.

A number of serious irregularities for which the Company was to blame were found, and consequently the government's concern with the oil issue grew, particularly with the Armitage-Smith Agreement. In December 1926, the company was asked by the Persian Oil Commissioner to hand over its financial records from March 1924 to 1927. Sir John Cadman, the Chairman of APOC stated that "...Mr. Armitage-Smith was not instructed or authorised to draw up an agreement effecting changes in the terms of the D'Arcy Concession." [90] In the period between 1926 and 1931, the company employed various methods of averting any changes in the D'Arcy Concession. Once the Depression struck, the Persian government's revenues had decreased just as it needed funds for its development programmes. In 1930, the Anglo-Persian Company claimed that they were exempt from Persian taxation due to the terms of the Concession and refused to pay the taxes. The refusal served as a reminder of the numerous grievances they held against the Company.

The government argued that the D'Arcy Concession was acquired through duress and deceit, and therefore had no legal authority. An example of the company's deceit, cited by the government, was its failure to provide the government access to the Anglo-Persian Company's books, in order for the validity of payments to be checked. The shadiness of the Company's dealings was not just limited to deceits of which the Persian government was aware. For instance, the government has not been informed of the contract signed by the Company and the British Admiralty for the supply of cheap fuel for its war needs and no taxes were paid in relation to the operation of the Company's lucrative tanker fleet. In the view of the government, the Armitage-Smith Agreement of 1920 was not intended to accommodate the present, extensive scale of the company's operations, far larger than what was predicted at the time of the signing. [91] The government also felt that Persian rights were disregarded when the Company made the decision

[90] ibid p.55
[91] Zoghi, op.cit., p.127

to sell oil to the British fleet at a sub-commercial rate. The fact that the Armitage-Smith Agreement was never ratified by the Majlis was also recalled, as well as the rapid decline in royalty payments,[92] the main financial source for Persia's social and industrial development programs,[93] which was further exacerbated by the extreme fluctuations in the price of oil, preventing the government from depending on stable annual revenue. The precariousness of Persia's possession has been described below:

> A careful examination of the D'Arcy Concession gives the answer. The D'Arcy Concession and the Armitage-Smith Agreement rendered the Persian government's revenues more sensitive to a decline in APOC's income, to the extent that the government was to share (at the rate of 16 percent) in the profit of some APOC affiliates after certain deductions were made. Thus during a depression year such as 1931, Persia was left with a very small royalty, mainly as a result of the decline in APOC's profit. However, it is important to emphasise that the decline in the royalties was more than proportional to the decline in APOC's net profit. This was because the Persian government's share of net profits at 16 percent was calculated under the Armitage-Smith Agreement.[94]

Supporting its allegations with action, the government cut the special tax discount given to the Company in relation to its Persia-related activities.

1.4.2 The Formation of the 1933 Concession

Following fruitless discussion between 1929 and 1931, the Persian government declared the original concession to be void on 27th November 1932, but expressed its willingness to negotiate. Initially, the British government refused to accept Persia's cancellation rights and threatened

[92] The amount of payments fell from £1.2 million in 1931 to £300,000 in 1932.
[93] Fesharaki, Fereidun, Development of Iranian Oil Industry, New York 1976 p.11-12
[94] ibid p13

serious consequences in response to this action. The British then brought the matter up before the Council of the League of Nations in 1932. A compromise was reached between the Anglo-Persian Oil Company and the Persian government on the 29th April 1933, before the Council made a decision. The most important provisions of the new concession were as follows:

> The government grants to the company, on the terms of this concession, the exclusive right, within the territory encompassed by the Concession, to look for and extract petroleum as well as to refine or treat in any other way and render suitable for commerce the petroleum obtained through this process. [95]

Additionally, permission to conduct various logistical operations has also been granted.

> ...the company is permitted to procure, without special license, all imports necessary for the exclusive needs of its employees, subject to the payment of the Custom duties and other duties and taxes in force at the time of importation.... [96]

The effect of this contract was an alteration in the business procedure, namely instituting an annual royalty[97] per each ton of petroleum sold, setting a minimum annual total payment to the government[98] and obligating the foreign companies to pay 20% of the dividends earned from distribution.

The 1933 Agreement also provided Iran with the right to investigate the oil company in certain areas,[99] which was part of an effort to ensure that the previous difficulties with ensuring the fair distribution of profits would not reoccur.

[95] Alavi op.cit., p 58
[96] Ibid.,
[97] Four shillings per ton of petroleum sold for utilisation in Persia or export to other countries.
[98] The minimum being seven hundred and fifty thousand pounds.
[99] For instance allowing Persian representatives to be present at board meetings and to receive the same documents and information as the shareholders did.

In case of any disputes arising between the Persian government and APOC, the agreement specified arbitration as the means of resolution with the involvement of the Court of International Justice.

A significant point in relation to arbitration is the ability of one of the sides to default before the 60 year period expired in 1993. Default was permitted to Persia only if the finding of Arbitration Court was not followed by the foreign company, the Company was to be liquidated or at the discretion of the Arbitration Court in cases of terms' breach.[100]

Nonetheless, critics of the concession insisted its conditions were by no means fair to domestic interests. Firstly, it was claimed that the 1933 Concession was granted under duress. Whilst the company retained power to terminate the Concession, the government had no such power, and remained uncompensated for the decreasing value of the pound sterling, in breach of Article 10 (V)(a) of the Concession, attributable to the use of official gold prices rather than market gold prices, as used by the Company, in calculations for the currency. Payments to the government were made after British Income Tax had been deducted, contrary to Article 10(I)(b), and the British government had unjustly limited the share of Iranian distributed profits. Moreover, the sale of petroleum at low prices to the British Navy and British Air Force was seen by many as prejudicial as it lowered the company's distributable profits, shared by Iran. Arguably, the company's abstinence from releasing complete operating data worked against the Iranian government, and aroused suspicion regarding the Company's functions. The Company's practice moreover, in refining crude oil extracted from Iranian fields, outside the country's territory was in breach of Article 21 of the Concession, and limited the government's earning capacity. The Company disrespected its Article 16 duty to progressively substitute foreign employees with Iranian employees, and failed to utilise natural resources at their disposal

[100] ibid p.59-62

appropriately, wasting large amounts of natural gas. Further, the Company often dodged custom duties and charges having equivalent effect on several imported commodities under Article 6 of the Concession. Tax was not levied on the allied forces, as mentioned in Article 19, amounting to losses for the Iranian government of up to $18 million. The conditions of employment of Iranian workers were poor, and unions were banned. For all these reasons, the Iranians felt justified in holding a grudge against the Concession, and the Company, in particular.[101]

The Company, in its defence, claimed that such allegations were unsubstantiated, and that their flexibility of negotiating peacefully had been sufficient at resolving outstanding problems. The Company claimed that the Concession had been granted in good faith, under the supervision of the League of Nations. Further, it was alleged that no pressure had been asserted by the presence of British warships in relation to the drafting of the Concession, that the Iranian government itself had abided by Concession and had reaped its benefits for 18 years.[102] Therefore, it concluded that the Concession was by no means invalid.

The reason for the Persian government's agreement to the new Concession was its desire to find a new method of doing business, which would guarantee a minimum income for the budget. When conditions are favourable, the market is healthy and the oil prices are high, a profit-sharing arrangement is the model of choice. In times of depression and low prices, however, the ton production basis is more desirable.

It was due to these considerations that the principle of tonnage was introduced, to link payments to the volume of oil production with a built-in protection device against change in the value of

[101] The Iranian arguments are presented in various books and reports, eg. H. Makki, 1951.
[102] The British case has been stated in many publications, eg. International Court of Justice

sterling.[103] Following the grant of another extension, with the area limit of 100,000 square miles, opinions were divided whether the Persians or the foreign investors acquired the better deal. In 1951, the Persian government stated that the concession was a disadvantageous one for the country.[104] Other commentators suggested that the concession did not confer a significantly unbalanced advantage to either side.[105]

A steady progress in oil production, royalty payments and refining capacity followed the new concession, as did the opening of new oil fields in the northwest of Iran, in Kermanshah province, and the construction of a pipeline to Kermanshah. In 1936, however, a serious disagreement occurred between the Anglo-Iranian Oil Company (AIOC)[106] and the Persian government, over the technical definition of the word "ton" in the contract. The government argued that by "ton", the concession meant 2,000 pounds, while AIOC claimed that the English term "ton" was used, containing 2,240 pounds. The issues were resolved when the AIOC agreed to accept the government's definition of the term. By 1938, however, the production began to decline, as did the government's revenue, creating yet another problem. The beginning of World War II, in its overwhelming importance, took the attention away from issues of oil in Iran.[107] The next section will examine the process which finally led the nationalisation of the oil industry in Iran.

1.5 Oil in Iran between the Two World Wars

For Iran, the period between the two world wars was influenced heavily by outside interests and global politics. Lying between Russia and Turkey, Iran was an important area to for both the Russians and the Turks during World War One, despite its neutrality. The consequences of its

[103] Moosavi - Amini , op.cit., p.60
[104] Fesharafki op.cit., p. 13
[105] I. Zoghi, op.cit. p. 150
[106] Renamed from the Anglo-Persian Oil Company to the Anglo-Iranian Oil Company in 1935.
[107] Alavi, op.cit., p.63-64

geographical position and its valuable resources were to influence the country for years following the first war.

1.5.1 The Domestic Environment in the Inter-Conflict Period

A key concession in this period was the Khoshtaria agreement, which was granted on 9th March 1916, by the Persian Premier Sepahsalar, in order to utilise petroleum deposits in the north of the country. [108] Despite the date of its formation, the important effects of this concession manifested themselves during the inter-war years and therefore deserve consideration here.

An agreement signed in 1919 by the Iranian government, in which it was stated that Britain was to exercise a controlling influence over Iranian affairs, failed to be ratified by the Majlis. The withdrawal of British forces from the country started two years later. Reza Shah Pahlavi, the commander of Iranian Cossack forces, founded a new, independent government soon after, himself occupying the post of the Minister of War. In 1923, he became the Prime Minister and in two years was elected Shah by the Parliament, which had just ended the reign of the Qajar dynasty by deposing Ahmad Shah, the dynasty's last ruler. During Reza Shah's rule, modernisation in the areas of the judiciary, transportation and communication took place and a course for westernization had been set.[109] The government's next action was the abolition of all feudal titles, and an initiation of an economic modernisation program. In 1936, a friendship and non-aggression treaty was signed with Iraq and Turkey.[110]

1.5.2 Khoshtaria Concession and Other Oil Transactions between the Wars

Iran, despite its neutrality during World War I, served as the battlefield for confrontations between the British and the Russians on one side, and the Turks over the other, both sides

[108]Ghaffari, op.cit., p.45
"The full text of the concessions can be found in *Foreign Relations*, 1920, Vol. III, pp351-352"
[109] A manifestation of this policy, for instance, was the decree ordering Sunni Muslims to wear European-style hats instead of traditional fezzes, which led to some violent protests with a lethal outcome.
[110] Malek, M., History of Iran, Iran Chamber Society. p. 1

attempting to acquire Iran's oil. With the backing of the Russian government, a Georgian by the name of A. F. Khoshtari, acquired a concession over three Northern Provinces, Gilan, Mazandaran and Astarabad in 1916. This concession was very similar to the one given to D'Arcy. APOC was worried about the possibility that the Khoshtaria concession could be given to another foreign company, since the new Soviet government annulled all previous concessions. These fears found confirmation in reality when, for £100,000, Americans purchased the concession and founded the North Persia Oil Co. Ltd. With the intention of taking control of the entire Persian region, APOC began negotiations with the Persian government, with the purpose of acquiring another concession over the two remaining provinces of Azerbaijan and Khorasan.

Following the Russian Revolution, Sepahsalar, with alleged British support, declared the concession invalid.[111] As the result of this declaration, Khoshtaria transferred his rights to APOC on 8th May 1920, for the optimistic price of £100,000. The North Persia Oil Company was subsequently founded, as a subsidiary of APOC, to exploit the concession; endowed with a starting capital of £3m and headed by APOC directors.

Subsequently, an alliance between Persia and Russia was signed on 26th February 1921. This treaty's effect was the official annulment of all treaties and conventions between the Tsarist Government and Persia. It is noteworthy that the concession's Article XIII prescribed that the Persian Government undertook the obligation of not ceding, to a third power or its subjects, the property and concessions returned to Persia through the aforementioned treaty but rather keeping these rights for the Persians.[112]

[111] ibid, p.45. Sir Percy Cox in a letter dated 13th December 1919 stated that "With reference to our recent conversation regarding the Khoshtaria concession...The British government prefer to support the standpoint of the Persia government in that the Khoshtaria concession is invalid. At the same time, the British government hope, in the interests of Persia, that an English company will be preferred".
[112] League of Nations, Treaty Series, 1922, Vol.IX, p. 383-413

Persia's Minister in Washington attempted to persuade American companies to utilise the Northern provinces' oil resources, as a means of countering the British and Russian influences. The Minister further declared that the Standard Oil Company of New Jersey[113] suggested its interest in operating in northern Persia, contingent upon the completion of a satisfactory agreement.[114] Taking into account the extent of Britain's economic and financial influence on the Persian government, due to their ownership of the Khoshtaria concession, the US Secretary of State Colly was wary of the 1919 Anglo-Persian agreement and the possible subsequent difficulty of procuring concessions in northern Persia by US companies. By the end of 1921, the Persian Minister in Washington proffered the granting of concessions to US companies in exchange for a loan from the US, which would allow the Persian government to resist Russian and British pressure. As a result, on 22nd November 1921, the Khoshtaria concession was annulled and a fifty year concession for petroleum utilisation in the Northern provinces was instead given to Standard.[115] Article 5 of the enabling legislation, passed by the Majlis, contained a restrictive obligation that "the Standard Oil Company of New Jersey shall not under any circumstances assign or transfer this concession to any foreign government, company or individual or likewise enter into partnership with other firms or capitalists unless permitted to do so by the Majlis. Non-observance of this article will entail the invalidity of the concession."[116]

This concession lead to an increase in pressure from both the Soviet Union and Britain, with APOC decrying the concession and seeking two agreements; that the Persian government undertake to not use constitutional reasons to annul concessions and that Standard be limited in its method of exporting oil from Persia to using a pipeline to a Persian Gulf port, as APOC owned the exclusive rights of transporting oil throughout Persia, except for the five Northern

[113] Later to transform into the contemporary oil firm Standard
[114] Foreign Relations (FR) 1920, Vol. III, p.353
[115] US Senate, Oil Concession in Foreign Countries, Washington, 1924, p.94
[116] Ghaffari, M., *Political Economy of Oil in Iran*. 2000, London: Institute of Islamic Studies.p.46

provinces and therefore, Standard could not deliver its products to the commercial markets without cooperating with APOC. Due to the increasing tension in the region regarding oil control, especially as the result of the San Remo deal which divided Mesopotamian oil between England and France, excluding the US, the State Department had ample motivation to support Standard's position against APOC.[117]

Nonetheless, the British government maintained a policy of averting direct confrontations between the two companies. As a means of resolving the situation, an agreement was formed between APOC and Standard in February 1921, whereby they would submit a proposal for a joint development of the northern fields.[118] This offer, however, was turned down due to the fact that APOC was one of the parties.[119]

Meanwhile, Sinclair Consolidated Oil Corporation, known for its oil relations with the Soviet Union, itself attempted to gain a concession in northern Persia. The company's relations with the Soviet Union were cordial, resulting in a significant concession on Sakhalin Island in the Far East as well as a contract to sell Russian oil abroad. This relationship led observers to believe that fewer protests would come from the Soviets as the result of Sinclair's concession proposal. The Persian Government required thorough concession proposals to be sent to the Majlis in August 1922 and on 14 June 1923 the Majlis permitted the government to offer the northern concessions to an American company, as long as it can guarantee a $10 million loan to the government. Article 14 of the legislative authorisation proscribed the American company from

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[117]ibid, p.47 "The Russian minister to Persia, Rothstien T., in a note of December 23rd 1921 objected to the granting of the concession to standard on two grounds: 1) Since the Russo-Persian Treaty of February 1921 had not been ratified, all Russian rights in Persia were in full force, 2) even had the treaty been ratified the concession violated Article 13, which forbade the granting of a concession formerly held by a Russian subject to a foreign national. The British minister protested that the concession was an unfriendly act towards Britain."
[118] According to Fatemi, *Diplomatic History of Persia*, 1917-1923, p.304, Standard was given an entry into Iraq and Palestine in return for the arrangement in Persia.
[119] Ghaffari, op.cit., p.48-49

passing on the rights to foreign governments or citizens.[120] The authorisation also noted that the length of the concession is to be 50 years, but within eight years the company had to select no more than 15% of its assigned area and that the net profits had to be at least 16% or alternatively 10%, paid on the gross value of the oil exploited. An additional requirement was to train Persians to fill technical posts as soon as possible.

The Bill's clauses indicate that the government extracted useful guidance from its previous dealings with APOC, namely that the exploitation area was to be limited, involvement of Persians in ownership and control be assured and a higher royalty rate be requested.

The new limitations did not make Standard at all happy, but Sinclair modified its concession proposal so as to satisfy the requirements, resulting in a signing on 20th December 1923.[121] It encompassed four of the five Northern provinces, with the fifth being kept by the government for domestic exploitation; the concession was then confirmed by the Majlis in June 1923. Two hurdles remained for Sinclair, namely the required loan and ensuring Russian permission to move oil through Russian territory.[122] The latter issue was not as challenging as the former, due to the company's standing with the Soviets. The former however proved to be more of a challenge, as in October Sinclair announced its inability to find the loan amount as the Americans had little eagerness for such an investment, even given the favourable conditions of the Standard.[123] Elwell-Sutton argues that this was a clash of conflicting interests, as the Sinclair Group had the reputation as the bad boy of US business. Finally, Sinclair notified the Persian

[120] Foreign Relations, 1923, Vol. II p. 713
[121] Full text of this concession can be found in ibid., p. 721-736
[122] Ghaffari, op.cit., p48-49
[123] ibid., p. 49-50, "The British were first willing to let the American come into north Persia. But, after the AIOC had bought the Khoshtaria concession, the British were determined to keep the Americans out of Persia except on their own terms: the Khoshtaria concession. However, after a visit by Sir John Cadman to the United States and a meeting of representations of standard of New Jersey and of the APOC in London, the American were continued of the soundness of the British agreement, and standard withdraw. The US was no longer fighting for the "Open Door" and it began to see greater merit in the Khoshtaria concession and corporation between the British and American companies for the next decades."

government of its abandonment of Northern concessions due to the Soviet Union's cancellation of the Sakhalin project, the export agreement and the forbiddance of oil transport through Russia.[124]

Overall, despite indications that rich oil deposits were held in northern Persia, attempts to locate them failed due to both the political and physical challenges of moving the oil to the markets. Such movement was contingent on the cooperation of the Soviets, which was uneven at best as the Soviet Union considered Northern Iran as part of its sphere of influence and a strategically vital area in which all foreign power establishments were to be thwarted.

Prior to World War II, Great Britain was especially feared as an old rival and a threat to Persia, although Germany would replace it in this respect later. As the result of this distrust, the Persian government wished American companies to be the ones exploiting the northern deposits, as this would have led to increased income while ensuring the political presence of a geographically distant, powerful country along the border with Russia, so as to balance out the British influence. Nonetheless, the British and the Soviets were not prepared to allow American dominance in a region where they claimed their interests were pre-emptive; they eventually managed to exclude the Americans due to the latter's lack of political will. The State Department in particular yielded to British pressure by not objecting to the Khoshtaria Concession and not fully supporting Sinclair in its conflict with Standard and AIOC. This idea was in accordance with the American wariness of Soviet expansionism into the Balkans and the Middle East. Efforts by the Persian government to give a concession to Sinclair were in vain due to the problems with the Soviet Union as well as Sinclair's domestic problems. The political situation was even further complicated by the rise to power of Reza Shah which changed both the political landscape and the attitude towards the oil industry.

[124] Ibid. p.51

1.5.3 The Effect of New Policies on the Oil Industry (the Rise of Reza Shah)

As the result of internal turmoil in Iran, particularly the Jangli rebellion,[125] the British believed that a strong government was needed to maintain order and protect British interests, even if it must be dictatorial. As the result of such considerations, British influence secured a promotion for a young soldier named Reza Khan to command the Cossack Brigade,[126] with supervision from a British administrative and financial officer, Smyth. However, the British could not secure Ahmad Shah's agreement to Reza Khan's rule and so the latter led his force of three thousand to Tehran in February 1921, with ammunition, money and supplies having been given by the British. The reason for the British support of Reza Khan was the perception that a military dictatorship in Persia would result in the alleviation of British military concerns in Persia, and their description of him as "a strong and fearless man who had his country's good at heart". [127] Smyth instructed Reza Khan "not to take or allow to be taken any violent measures to depose the Shah" but he added "in fact a military dictatorship would solve all our problems and let us get out of the country without any trouble at all".[128] British agents introduced Reza Khan to Seyyed Zia,[129] who was a journalist in close contact with the British Military Mission. In cooperation with the three members of the British mission, he conspired to overthrow the Government with the help of the Cossack Brigade, with Smyth and Reza Khan supporting the plan, as well as the Gendarmerie officers. Consequently, on 20th February 1921, the Cossack forces arrested sixty foremost politicians after marching to Tehran, with Zia replacing the Prime Minister and Reza Khan becoming the Persian Forces Commander.

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[125] Also known as the Constitutionalist Movement of Gilan, this was a rebellion against the monarchist rule of the Qajar central government of Iran, lasting from 1914 to 1921.
[126] The Cossack Brigade was known as the elite unit of the Army.
[127] International Journal of Middle East Studies, Imperial Power and Dictatorship: Britain and the Rise of Reza Shah, 1921-1926, Vol. 24, No. 4 (Nov., 1992), p.639
[128] Ibid, p.663
[129] Seyyed Zia ed-Din Tahatahai, a proponent of English influence and an anti-socialist, who was fully behind the 1919 Anglo-Persian treaty.

In order to demonstrate the independence of the new government, Zia assured the people of land reform, national independence etc. The circumstances of the plot led to the perception that Reza Khan was installed by the British, contributing to his lack of popularity. A chief goal of the revolution, as declared by Zia and Reza Khan, was the freeing of the country of foreign occupation and bringing about national revival, including through the annulment of the 1919 Anglo-Persian Agreement and the signing of a friendship treaty with the Soviets on 26th February 1921. Such a stance against foreign occupation was also clearly relevant to the government's stance regarding national resource exploitation. Zia wished to keep some British involvement through maintaining British advisers in the Finance Ministry and the Army.[130] The British perception of the Zia government was that of a means of maintaining some political influence in the region.

In a statement from 26th February 1921, the Soviets rescinded all Tsarist-era concessions while recognising Persian sovereignty and agreeing to move all troops out of the country, cancel all Persian debts and turn over the Russian Bank, railways, roads and ports. Article VI pertained to the contingency that should a third party intend an armed incursion into Persia so as to use it as a base of operations against Russia, and thus a danger be created to Russia and Persian remedy was not possible, then the Russians "shall have the right to advance its troops into the Persian interior for the purposes of carrying out the military operations necessary for its defence and to withdraw troops after the danger was removed."[131] The effect of the treaty was to make any American or Western European commercial enterprises in northern Iran nearly impossible.

As the result of Zia's unpopularity and perceived bias towards the British, he was replaced as Prime Minister, with the new leader deciding to sever the employment of British foreign

[130] Documents on British Foreign Policy, Vol. XIII, p 13, p. 736-743
[131] Hurenrity, J. C., (ed), "Diplomacy in the Near and Middle East: a Documentary Record 1914-1956, Vol. II", p. 90-94

advisers, kept previously in office by Zia, instead hiring non-neighbouring country advisers such as Americans,[132] in a move against the British and the Soviets. The plan had the Majlis's support, with the additional request of oil concessions in the north to be granted to 'some progressive American companies".[133]

Using his political and military influence, Reza Khan strived to complete his control over the Fifth Majlis elections and succeeded in October 1923, when he took the position of the Prime Minister. By early 1925, he used his influence over a specially convened Constituent Assembly to convince them to depose the Qajar dynasty,[134] while proffering him the imperial position instead. The ascent was not without its opponents, with Dr Mossadegh asking "was it to achieve dictatorship that people bled their lives away in the Constitutional Revolution? ... I do agree that Reza Khan has performed services for the country" during a Majlis debate. Mossadegh feared and warned about that the new leader's power "would lead to a dictatorship, in which foreign and internal policies would be determined without parliamentary consultations."[135] Therefore, Reza Khan's path to the throne involved violence, armed force, terror and military conspiracies, all leading to Iran's changed stance towards foreign influence and, consequently, oil exportation.

Reza Khan's stance on foreign commercial influence was favoured by the Company, especially as his style of governing brought about security and order, which are the ideal conditions for the Company's activity. Furthermore, the government used its power to prevent workers from unionizing or protesting against work conditions and pay. In 1929, the southern oil workers numbering 30,000 attempted to strike due to intolerable living conditions. Six thousand British and Indian government forces were ordered in to suppress the strike, and they succeeded, arresting 200 instigators and agitators. Some of these prisoners were not released until the end of

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[132] Banani Amin, "The Modernisation of Iran, 1921-1941", p. 40-41
[133] Fatemi, "Oil Diplomacy", p.413
[134] A dynasty descending from Iranian Turkmen, spanning the years of 1791 to 1925.
[135] Makki, H., "Dr Mossadegh and his Historical Speeches", p. 46-52

Reza Shah's reign. Such collaboration, both intentional and collateral, was extended further due to his need to procure funds for the strengthening of the military without particular regard as to the source.[136]

1.6 The Consequences of World War II on the Political Environment

World War II quickly delivered proof of the increasing importance of oil. The Allied air forces operating in the Far East, Europe and the Middle East were heavily reliant on Abadan for fuel. Several attempts have been made to form alliances with Iran in the beginning of WWII, including by Germany, Turkey, Great Britain and the USSR, but none were successful. In order to protect oil fields from being occupied by the Germans, however, British and Soviet forces occupied oil-producing areas of Iran in 1941. Following this invasion, all foreigners who were citizens of countries allied with Germany were forced to depart Iran, with the diplomatic mission of such countries being shut and with the Allies being given access and control over the country's communications systems. Reza Shah Pahlavi's connections to Axis interests resulted in his abdication.

The Shah's son, Muhammad Reza Shah Pahlavi, took over his father's position and adopted a pro-Allies policy, as well as going along with the parliament's request for liberal reforms. A treaty promising the observance of Iran's rights to territorial integrity and independence was confirmed by the Soviets and the British in 1942, also promising military aid to fulfil the pledge of protection. According to this agreement, the Allies vowed to discuss with the local government actions pertaining to political, military and economic aspects, which could have an effect on Iran and to provide economic assistance and to withdraw the occupying forces as soon as the Axis threat passed.

[136] Fateh, Mostafa "Panjah Sal Naft Iran" p. 354

As the result of the American military aid and the land-lease system, the USSR and Britain extensively enhanced Iran's transportation facilities by 1943, so as to increase its utility as a corridor through which military supplies can be quickly transferred to the Eastern Front. According to Iran's complaints, however, the USSR cut of all contact between its occupation zone and the rest of Iran. The Soviet excuse for this policy was that it was taking defensive measures to counteract a potential Anglo-American effort to expand their influence in Iran. This dispute was resolved in 1943 at the Allied Conference organised in Tehran,[137] through the issuing of the Declaration on Iran, on December 1st, stating that the three major world powers were, "at one with the government of Iran in their desire for the maintenance of the independence, sovereignty, and territorial integrity of Iran."[138]

The unique advantage of the land route to the USSR through Iran, namely its safety, was lost in early 1945 once the danger for Allied merchant navies passing through the Bosporus and the Dardanelles while delivering war material to the Soviets had decreased. As per the abovementioned agreement, Iran sought to rely on the fact that occupation was no longer necessary and asked the occupying countries to leave Iran. The US agreed to cease the occupation, but the USSR and Britain were adamantly opposed to leaving. Through negotiations, however, an agreement from the Soviets and the British to withdraw from Iran by March 2nd 1946 was procured. The Soviet occupation nonetheless was a cause of grave concern for the Iranian government. Allegedly, Iranian officials were not allowed within the Soviet-occupied Azerbaijan and Kurdistan provinces in order to suppress protests against Iranian government, instigated by groups allied with the Soviets. As the result of Soviet aid, an independence movement was created and grew in Azerbaijan.

[137] Attended by the Allied leaders: President Franklin D. Roosevelt and Prime Minister Winston S. Churchill, as well as Premier Joseph Stalin

[138] Madani, Seyed Jala al Din, Tarikh siyasi moaser Iran, (Modern History of Politics of Iran) p. 289

Table 2: Leading Oil Producers as of 1938[139]

Country Name	Annual Production (million tons)
United States	**161.9**
Venezuela	**27.7**
Iran	**10.2**
Mexico	**5.5**
Iraq	**4.4**

1.6.1 Influence of the Soviet Union on Oil Concessions

Iran became an area of competing interests early on in the Cold War, partly because with the increased consumption and importance of oil,[140] the struggle for its possession and use intensified and the US took a more active role in regards to Middle Eastern oil. Before the outbreak of the war, US companies controlled nearly 16% of Middle Eastern oil production; this must be considered in the context of the fact that in 1940 US domestic production constituted 73% of non-communist output, whereas Middle Eastern production was a mere 6%.[141] Oil, indeed, was to play a critical role in the post-war reconstruction and the subsequent economic boom.

Consequently, ample attention from the American side was directed at Iran's political situation, especially the issue of withdrawal of foreign troops from Iran became a concern. The Anglo-Soviet-Iran Treaty of 1942 included a provision whereby all Allied troops be withdrawn from Iran in six months, but this was not abided by; despite reemphasising it at the Tehran conference between the 'Big Three' of November 28, 1943, where Iran's independence and integrity was

[139] Tugendhat, C. and A. Hamilton, Oil, the Biggest Business. 1975 ed. 1968, London, p. 112
[140] In 1900 oil supplied 3.8% of the world's energy; by 1940 this was 17.9%, representing an increase in oil output by a factor of fifteen.
[141] Eden (et al), "Energy Economics", p77. The US situation was generally more favourable with American companies controlling nearly 40% of 1939's average production as well as a half of foreign deposits. Painter, "Private Power and Public Policy", p14

emphasised.[142] During the occupation of Iran, it was a frequented location for oil concession-hunting, including in 1943 when the Royal Dutch Shell sent representatives to Tehran in order to agree on a concession outside AIOC's area of operation. With the encouragement of Shah Mohammed Reza, some American oil companies were also seeking concessions, while competing with the Russians. Meanwhile in September 1944, Sergei Kavtaradze, the Assistant People's Commissar for Foreign Affairs, visited Tehran to request oil concessions in the northern provinces that neighbour the Soviet Union, but the Iranian government insisted that no concessions be issued until the war ended, so as to avoid the impression that Iran was issuing them under duress. Nonetheless, the domestic Communist Tudeh Party representatives in the Majlis were campaigning for a political balance between the West and Russia. As the British were given oil concessions in the South of Iran, it was argued that the Russians should be granted some in the north; an argument rejected by Mossadegh. The argument he put forward was for 'negative balance'[143] and to prevent favouritism, he passed a bill through the Parliament that prohibited all government employees from discussing concessions with foreigners, with up to a 8 year prison sentence in solitary confinement as a punishment.

During this time, Roosevelt and Churchill were in contact with the Soviet Ambassador, Gromyoko, who characterised the proposed Soviet concession as a means of aiding Iran and helping the friendly relations. He further pleaded for the new petroleum law to be cancelled or altered. This request formed a part of the Soviets' agenda, which included the desire to counter balance US demands for concessions in northern Iran, to establish northern Iran as a security zone and to promote a balanced relationship between the great powers, especially when the Soviets perceived the Western powers combining against them. The fact that the partially

[142] Foreign Relations of the US, Diplomatic Papers. The Conference at Cairo and Tehran 1943, US Government Printing Office, Washington DC, 1961, pp 646-647.

[143] Whereby no privilege are granted to one power that would require the giving of similar benefits to others.

British-owned firm, Shell, was joining US firms in requesting oil concessions probably confirmed this perception. It is in this contest that the Soviet reaction to the US attempt to obtain an oil concession in northern Iran must be understood. As Kennan, the US Ambassador, in Moscow explained, "the oil in northern Iran is important, not as something Russia needs, but as something that it might be dangerous for anyone else to exploit."[144] The British consul in Mashad, Claremont Skrine, summarised the Soviet reaction to the US involvement: "it was ... above all, the efforts of Standard Vacuum and Shell to secure oil prospecting rights that changed the Russians in Persia from hot-war allies into cold-war rivals."[145]

Increasing influence of the Soviets led the Iranian government, represented by Qavam, to order the arrest of right-wing activists while introducing pro-left wing legislation, most importantly disregarding the Majlis law of December, 1944, which prohibited all concessions to foreigners. [146] Two days after his departure for Moscow, he dismissed the pro-British general Arfa from his post as Chief of the General Staff. On February 18, Qavam went to Moscow in an attempt to negotiate a solution. He made three important concessions to the Soviets:

On April 4, 1946 he concluded an agreement establishing a joint Soviet-Iranian company for the exploitation of oil in the north. This concession had certain novel features. The agreement was to be valid for twenty-five years, to be renewable after that period if so desired by both sides. The ownership was to be 51% Soviet and 49% Iranian and after 25 years shares were to be 50/50; profits were to be divided according to the shares held. No mention was made of royalty payments, but profits were to be divided according to the shares held. The borders of the original territory of the company allocated for production and prospecting work were to be that

[144] 'US Charge d'affaires in Moscow to the State Department', 7 November 1944, US Department of State, *Foreign Relations* 1944, Vol. 5, p.470
[145] Skrine C.A., "The World War in Iran", London, Constable, 1962, p.227
[146] As the Prime Minister rejected the law contingent on Majles approval, his covert behaviour earned him the title of 'Old Fox' when the Parliament convened and prevented his law from becoming permanent.

of eastern Azerbaijan situated west of a line running south from the point of intersection of the borders of the USSR, Turkey and Iran, to the eastern shore of Lake Rezaeich (later Uromia), as far as the town of Miyanduab.[147] This treaty could not become law until it had been ratified by the newly-elected Majlis not later than seven months from March 24, 1946. His next move was to organise the elections to the Fifteenth Session of the Majlis, in December 1946-June 1947, which was to decide on the Soviet oil concession. Using the powerful party machine he had built, his party won the majority of seats, while the pro-Soviet Tudeh found it futile to participate in the elections. The elections produced a parliamentary majority for the Prime Minister, in which the Tudeh party, broken and demoralised, refused to take part. Also some twenty-five seats in the Majlis, mostly in Tehran, were won by Mossadegh's National Front coalition.

Meanwhile, the British Government was apprehensive that, if the Iranian Government were to refuse to accept the Soviet demand for the joint development of the oil resources of northern Iran, the forces of nationalism might be tempted to challenge the Anglo-Iranian concession in the south. In the first week of September, the British Ambassador in Iran handed Qavam a memorandum which recommended that the Iranian government should consider the possibility of further discussion. The Government should not reject the demand outright; if they could not accept the draft Soviet treaty, they should allow revised and fairer terms to be presented.[148]

Unlike Britain, the Americans took a direct hand in the matter. On September 11 the American Ambassador made a statement to the Persian-American Cultural Relations Society, in which he defended the right of the Iranian people to choose for themselves how they disposed of their own natural wealth.[149]

[147] Hurenty, op.cit., p.263
[148] New York Times, 13 September 1947, p. 86-87
[149] Sutton, "Persia Oil", p.117.

During this period, the number of members of the Majlis opposed to any concession was growing daily. On September 21st the deputy, E'tebar, attacked both the proposed Soviet oil concession and the existing British one. Qavam on October 5th received a vote of confidence opf 93 to 27 on his general programme, which made no mention of oil. Finally, on 22nd October, after Qavam had given parliament a lengthy account of his negotiations with the Soviet Government, the Majlis rejected the oil agreement.[150] Qavam skilfully used two tactics to diffuse the issue. First, he refused to commit himself outright to the agreement, and thus avoided the danger that rejection of the agreement would be taken as a vote of no confidence in the government. Second, he followed up the rejection by mustering an attack on Britain, thereby salvaging the policy of "positive equilibrium". He obtained parliamentary permission to renegotiate the "unjust" 1933 Agreement with APOC, and he went on the radio to assure the country and the Soviet Union that he would persevere in his course of "positive equilibrium". However, a further law was presented by Dr. Rezezade Shafag, a deputy who later served as Iranian delegate to UNESCO, and who was also to sit on the Majlis oil commission of 1950-51. The bill contained the following:

1) The Premier's negotiations for an oil agreement with the USSR were to be null and void, but he would be exempted from the penalties provided by the law of December 2, 1944 against any minister who tried to negotiate oil concessions with foreigners;

2) Iran would explore her own oil resources during the next five years and exploit them using her own capital. Should it be found necessary to engage foreign experts, they would be drawn entirely from "completely neutral countries";

[150] The vote had the dramatic result of 102 votes to 2. op.cit., Sutton, p. 118

3) If the Iranian enterprise discovered oil, the Government would negotiate its sale to the USSR, provided that the Majlis were kept informed throughout of such negotiations;

4) Iran would not grant concessions to foreign powers, or take foreigners into partnership in any oil company;

5) In all cases where the rights of the Iranian nation had been impaired, particularly in regard to oil in the southern parts of the country, the government would be required to enter into negotiations and take such measures as might be necessary to enter the region to regain national rights, and should inform the Majlis of the results.[151]

The bill, ratified on 22 October 1947, had important implications for the future of AIOC. It not only forbade the granting of oil concessions to foreigners and participation with foreigners in such concessions, but also instructed the government to take all necessary measures to secure Iran's rights to her national resources where such rights had been violated, "with special reference to the southern oil." In response, the Soviet Ambassador sent a note to Qavam stating that in view of the British oil concession the rejection of the Soviet oil agreement was a blatant act of prejudice against the Soviet Union. The Soviets realised that Iran was determined to take control of its natural resources, and that Qavam had skilfully mislead them with the promise of oil so that they would move their forces out of Iran. The British, by contrast, did not take the act seriously.[152]

Generally speaking, the driving force behind the bill was the revival of national feeling in Iran. Now that the days of war and occupation were safely behind them, the people felt that they could once more assert themselves and stand up for their own rights. A further important factor was the

[151] USFR, 1946, Vol. 7, pp 560-561

[152] They assumed that the legislators had made a passing reference to their concession merely to maintain a balance, but with no intentions of changing the status quo.

intensity of the political conflicts between Britain and Russia that were fuelled by oil, causing instability within Iran and being seen as counter-productive. Qavam tried to be the representative of this new national feeling. In a broadcast on December 1, he claimed "I have pursued the case of AIOC concession, and will persist as long as necessary to secure satisfaction for the Persian nation."[153] It was too late. This appeal to nationalist sentiment did not save him; in late 1947, after most of his cabinet had resigned, Qavam called on the Majlis for a vote of confidence and received only 46 votes against 39 with 27 abstentions. He immediately resigned.

1.6.2 The 'Golden Age' of Iranian oil

The golden age of the Anglo-Iranian Oil Company AIOC[154] stemmed from the 1930s-50s, and during the period between 1933-38, production of crude oil doubled, with refinery capacity increasing by three million tons, and facilities such as transportation and market organisation witnessing vast improvements. The construction of the Naft-i-Shah, the new pipeline, the additional eight ships to the company's tanker fleet, and a new refinery built in Kermanshah,[155] all signalled the marked improvement of the company and induced growth. Such growth in term benefited the Government and the company's employees, who soon after drafted a 'general plan' to bring in foreign-skilled workers into the Iranian oil market to boost production further. Such progress was, inevitably set back in 1939, however, by the outbreak of the war. War made the many European and Mediterranean markets inaccessible, and produced shortage of essential materials. Further, loss in shipping capacity coupled with a lack of distributive facilities resulting from war damage aggravated matters. As a result, production fell drastically to half the value by 1941, whereupon the market recovered substantially.

[153] Sutton, "Persian Oil", p119. Also in Survey of the Middle East.
[154] In 1935 the Government of Persia officially announced that the names of 'Iran' and 'Iranian' will be substituted for 'Persia' and 'Persian' respectively. Thus after 1935 the name of the Anglo-Persian Oil Company was changed to Anglo-Iranian Oil Company. During the balance of the discussion of this thesis the names 'Iran' and 'Iranian' will be used in place of 'Persia' and 'Persian'.
[155] In accordance with Article 9 of the 1933 Concession

In retaliation to the problems envisaged during the early years of the war, the Government reached in accord in the August 1940, whereby the company assented in maintaining the level of royalties at a minimum level of 4 million pounds, if ever the actual concession payments fell short of such a threshold at any given year. Such an accord maintained the terms agreed upon under the 1933 Concession. Company progress however increased dramatically, unequalled in history, for the last two years of the war. Such rapid growth[156] was assisted by a striking improvement in the company's shipping capacity, whereby the tanker fleet increased by 800,000 tons since the onset of the war, and of distribution and selling facilities.

Such improvements boosted the Iranian economy, and government royalties rose to £16,031,735 in 1950. Further, employment opportunities increased for both skilled and non-skilled Iranian workers, as did wages and the company was able to amply supply social amenities and educational provisions.

On the political front, matters had been handled diplomatically in relation to the Concession; however, problems emerged in 1947. The 'constitutional democratic' system which replaced the monarchy in the early decades of the 1900s, basing itself on abstract principles enlisted in the Constitution, and detailing the enacting of laws, to be enforced by a cabinet responsible to the people's representatives, was a dramatic change which occurred hastily and failed to allow Iranian culture and society to sufficiently adjust to the shift from the deep-rooted autocratic mentality to that of democracy. Previously, the sovereign's powers and will had been unquestionable, ultimate, and unrestricted. Such unquestionable power to be replaced by a constitution to confer powers was a radical change of conception for the Iranian people. It is argued that such a constitutional framework, and the parliament which replaced the sovereign,

[156] By 1951, in fact, production increased to 31, 750,147 long-tons, and Abadan's oil refinery became the largest in the world, producing 25 million long tons

were inadequate substitutes for the deeply-entrenched system of monarchy; this did not aid the average Iranian in embracing the change of conception, and led to instability, which finally gave away to the emergence of autocracy in 1925, with the election of Reza Khan, whose reign made a substantial impact in changing Iranian society, politically, economically and socially. As oil exploitation is a critical political issue, especially in a country that depends on its national treasures to the extent that Iran does, it is therefore necessary to examine the political variations which led up to the currently used, restrictive model.

The Constitution and Parliament did not take up more than a symbolic presence, under the authority of Reza Shah; members of Parliament were obstructed from taking policy initiatives or formulations, or criticising Cabinet proposals, and were limited to ratifying Government proposals and mundane legislative issues. In light of such a setting, the 1933 Concession was approved without contention[157] or critical utterances. As stated by H. Taqizadeh, the then Minister of Finance and the signer of the 1933 Concession Convention, the endorsement and ratification of the 1933 Concession was merely a formality after Reza Shah's approbation to it.

> We were a few helpless men without authority who did not agree with it (the 1933 concession) and we were exceedingly sorry when it happened (and) I must say that I had nothing whatsoever to do with this matter except that my signature is appended to that paper and whether or not that signature was mine or someone else's it would not have made the slightest difference, and what happened would have happened in any case.[158]

[157] It is interesting to note that the only member of Parliament who publicly opposed the 1933 Concession was Dr. Mohammad Mossadegh who was seized by the police shortly afterwards and promptly dispatched to a provincial jail in Northwestern Iran.
[158] Iranian Embassy, some Documents on the Nationalisation of the Oil Industry in Iran, Washington, D.C.: 1952, p. 15

Any criticisms that were levelled at the 1933 Concession, of which there were many under such a regime, therefore remained unexpressed, nor did they find their expression after Reza Shah's deposition due to concern about war-time problems, such as economic reconstruction.

The government faced a major challenge, and to cope, drafted a Seven-Year Plan, detailing the expenditure of $650 million over a period of seven years for reconstructing and developing the country. A number of American firms were contracted with for the purpose of aiding economic development; foreign exchange required the sum, however, of $217 million,[159] which the Government failed to raise through various means, and therefore focused on increasing the AIOC's annual royalty payments in order to meet the target. In 1948, the Government commenced negotiations with the company on such matters.

In order to illustrate the relationship between external political and military factors and the profitability of oil development, the tables below chart the most essential economic data within the period preceding World War II, the war itself and a portion of the post-war period. It also illustrates the relationship between the net profitability of oil developments and the financial benefits to the parties involved, such as the shareholders and the British and Iranian governments.

[159] Overseas Consultants, Inc., Report on Seven-Year Development Plan for the Plan Organization of the Imperial Government of Iran, New York: 1947, Vol. 5.

Table 3(1): Iran Oil Production, Profit of AIOC, British Tax, Payment to Iran Government and to Shareholders pre-World War II

(1) Year	(2) Yearly Oil Production (Million long tons)	(3) Net Profits (£000)	(4) British Tax (£000)	(5) Payment to Persian Govt. (£000)	(6) Ordinary shares' dividends (%)
1931	5.7	2,319	671	1,339	5.0
1932	6.4	2,380	195	1,525	7.5
1933	7.1	2,654	305	1,812	7.5
1934	7.5	3,183	512	2,190	12.5
1935	7.5	3,519	409	2,221	15.0
1936	8.2	6,123	911	2,580	25+50% scrip bonus
1937	10.2	7,455	1,652	3,545	25.0
1938	10.2	6,109	1,157	3,307	20.0

Valuable observations and inferences on the processes affecting oil development and profitability can be drawn from the above table. As is evident from the above table, pertaining to pre-World War II economic performance, the years of peace has led to a fairly constant growth in profitability both for the British government, through taxes, and to shareholders, based on increased production levels that stability permits.

Table 3(2): Iran Oil Production, Profit of AIOC, British Tax, Payment to Iran Government and to Shareholders during World War II

(1) Year	(2) Yearly Oil Production (Million long tons)	(3) Net Profits (£000)	(4) British Tax (£000)	(5) Payment to Persian Govt. (£000)	(6) Ordinary shares' dividends (%)
1939	9.6	2,986	1,956	4,271	5.0
1940	8.6	2,842	2,975	4,000	5.0
1941	6.6	3,292	2,921	4,000	7.5
1942	9.4	7,790	4,918	4,000	20.0
1943	9.7	5,639	7,663	4,000	20.0
1944	13.3	5,677	10,636	4,464	20.0
1945	16.8	5,792	10,381	5,624	20.0

In contrast, as shown by the above table, during the turmoil of World War II when manpower and technical resources were scarce, a lack of production growth is evident while, even in the last two years of the war when volumes expanded dramatically, profits have not grown in a similar manner.

Table 3(3): Iran Oil Production, Profit of AIOC, British Tax, Payment to Iran Government and to Shareholders after World War II

(1) Year	(2) Yearly Oil Production (Million long tons)	(3) Net Profits (£000)	(4) British Tax (£000)	(5) Payment to Persian Govt. (£000)	(6) Ordinary shares' dividends (%)
1946	19.2	9,625	10,279	7,132	30.0
1947	20.2	18, 565	15,266	7,104	30.0
1948	24.9	24,065	28,310	9,172	30.0
1949	26.8	18,390	22,480	13,489	30.0
1950	31.8	33,103	50,707	16,032	30.0

Lastly, the post-war statistics in the above table show dramatic recovery in production volume along with disproportionate increases in profitability and a uniform level of shareholder dividends, indicating the benefits of stability for production and the positive effects of industrialisation with correspondingly greater demand on oil price. This is particularly evident in the years of 1949 and 1950, when the profits have increased disproportionately to the increase in volume.

1.7 Conclusion

The early to mid 20th century in the life of the Iranian oil industry was marked by diplomatic and political considerations as much as economic factors, as the granting of a concession could lead to conflicts between the various foreign powers which continuously attempted to influence Iranian policy, while securing the largest possible share of Iranian oil to fuel their increasing

consumption. This trend has begun with the early Reuter and Hotz concessions, which were heavily biased in favour of the foreign party, by not guaranteeing sufficient technological exchange and profit for Iran, therefore leading to instability in the industry and the premature cancellation of these oil contracts. In the 20th Century, on the other hand, the Iranian grievances centred increasingly around foreign diplomatic and political involvement, in addition to the acquisition of unbalanced concessions. Prior to the outbreak of World War II, the foreign power especially meddlesome was Great Britain, an old partner as well as a rival. Later the fear of foreign influence was extended to Germany. The Soviet Union, on the other hand, was less afraid of American companies, but suspecting that an American company might be used as a subterfuge for British penetration, it held back co-operation with American concerns, such as with Sinclair in the twenties and Amiranian[160] in the thirties. The Soviets had also become suspicious of the US in the 1940s, and in 1944 blocked both British and American efforts to obtain concessions in northern Iran by demanding the concessions for themselves. After the war, the USSR attempted to fortify its position in the north, through puppet regimes in Azerbaijan and by means of an oil concession in the Northern provinces through joint Iranian-Soviet co-operation. Under pressure from the US through the United Nations, the USSR had to withdraw from Azerbaijan, but it retained the oil concession it received and prevented the Western powers from obtaining concessions. Because of changed international conditions, and Qavam's political abilities – there is no doubt that Qavam had acted with skill and statesmanlike ability as an independent politician – the concession was not activated and was subsequently cancelled. However, the Soviets had succeeded in preventing the establishment of other foreign companies in northern Iran.

[160] Amiranian was an American Oil firm which failed to get a concession in Iran.

It becomes clear from these complicated political interactions that Iran was seen merely as a pawn in the great game of the world's powers; an attitude that could not escape either Iranian politicians nor the people, and consequently can be seen as a major contributing factor to the harsh Iranian attitude on foreign intervention present today.

As an example of attempted manipulation and use of Iran in various global power struggles are the consequences of World War II, namely the development of the policy of containment of Soviet influence in the region while preserving conservative local regimes, regardless of the regimes' methods towards their own people. Iran figured centrally in both these developments.[161] After the war, despite the fact that Britain remained the principle imperialist power in the region, especially in Iran and the Persian Gulf states, the economic and strategic situation there was to be radically transformed by a number of new developments such as the weakened global position of British imperialism and the growing US presence and role in the region, the rise of power of the Soviet Union, the emergence of Arab nationalism, and the establishment of Israel. However the biggest post-war problem that the US faces concerned the attempt to displace British influence in the Middle East, and the competition between the US and Britain for the acquisition of oil concessions in the region.

Meanwhile, under these new circumstances, the Iranians began to realise the inadequacy of the royalties from the AIOC. To be sure, the AIOC had risked capital and it did posses high technical knowledge, but the returns of the company were extremely high – in some years as much as 150% - and the Iranians felt that they should have a much larger share of their own resources. An additional factor in the dissatisfaction with foreign involvement was that influence from the competing powers prevented Iran from closing not what were necessarily the most

[161] Therefore Iran also was affected by the 'Truman Doctrine' whereby instead of passivity, the Soviet Union was to be 'contained' by sponsoring foreign groups opposed to it. This policy is seen to have started the Cold War.

profitable contracts for the Iranian populace, but rather those which encountered the least foreign resistance. Therefore in 1948 negotiations with the AIOC had been opened for the conclusion of a supplemental agreement for a revision of the royalty terms. For the Iranians, the time had come to recover their natural resources and nationalise the oil industry, as we shall see in the next chapter. The elections for the Fourteenth, Fifteenth and Sixteenth Majlis were the most meaningful in Iranian history, until the revolution. The significant features of the results were determined, not by the state, but by the relative strengths, on the one hand, of competing social forces, and on the other, of organised groups, especially political parties, parliamentary factions, and their foreign protectors within the government bureaucracy. Therefore, the country was galvanised by lively but highly complex elections between rival candidates attached to diverse interests, espousing different views and appealing to antagonistic social forces. As for the Shah, when he ascended the throne he was uncertain about his authority, and therefore declared his intention to maintain a constitutional monarchy, thus signalling a shift of power away from the throne to the Majlis. However, later, the weakness of the internal legal institutions, and the rivalry between the allies as well as their influence, encouraged the Shah to regain his power. At this time the Shah's personal political base was in the armed forces, and especially in the army – despite its weakness, the army was still the most powerful force in Iran. As such, its support could make the new Shah an important player in politics. This period also witnessed important changes in both the domestic political scene and the international economy which led to a significant shift in the development path of the Iranian economy and to a restructuring of the world capitalist system which now had access to cheap oil under the US hegemony. After the war, for the first time, drawing on increasing oil revenues, the government introduced an ambitious and extended development plan. This led to an increase in the capacity of the state to intervene in the economy. With such increased capability for economic intervention, it is

therefore unsurprising that the past and current grievances of Iranians in regard to foreign involvement in the oil industry culminated in the introduction of the buy-back contract.

The next stage in the history of Iran's oil contract system which deserves careful consideration in the following chapter, the 1951 Nationalisation, therefore did not occur in a historical vacuum, but rather was the logical progression of the economic and political forces in the 19th and 20th centuries. Such a radical measure would not have been made without the extensive, disappointing experience of attempting to renegotiate contracts perceived by the domestic public and the authorities as being unbalanced, only to be contractually bound as the result of foreign pressure, to further unfair terms. The preceding events, particularly the extensive political meddling of world powers after WW2 with the aim of acquiring Iranian support and oil resources, also had a significant impact on the Nationalisation, as it was not solely an economic rebellion but also a political one. Overall, the events of 1951 cannot be fully understood without considering the interaction with foreign elements that preceded it.

Chapter 2: The Effect of Nationalisation on Oil Transactions

2.1 Introduction

As the result of rising national opposition, due to both economic and political grudges held against foreign companies by the Iranians, a radical transformation had occurred in the 1950s which changed the landscape of the Iranian oil industry. However, in order to fully understand this event as well as its influence on the current oil framework, the preceding events must be examined.

2.2 Contractual Grievances and Renegotiation

The first Development Plan was approved by Parliament in 1949, with a central focus on the oil industry to fund the effort. One change contemplated, during the 1949 elections, to the AIOC, was alterations in the agreement, as the British government received greater profits by taxing the AIOC, than the Iranian government did from royalty payments.

The Iranian Cabinet, every time it imposed higher royalty receipts, found itself being challenged by the Parliament more and more to offer justification for such increases, as signalled by the rider of the 1947 October 22 law, originally designed to guarantee protection against the Soviet Union's acquisition of concession rights in Iranian provinces in the north. The rider runs as:

> In all cases where the rights of the Iranian nation in respect of the country's natural resources, whether underground or otherwise have been impaired, particularly in regard to the southern oil, the government is required to enter into such negotiations

and take such measures as are necessary to regain the natural rights and inform the Majlis of the results.[162]

In place with the Directive issued by the British Government, the AIOC announced that the dividends distribution to stockholders would be limited to 30%, contrary to the interest of the Iranian Government, as it reduced the payments received by the Government, in breach of Article 10(1)(b) of the Concession. Hence, the Government initiated talks to settle the dispute, and negotiations commenced in September 1948, continuing through the year, and dealt with issues such as the ratio of skilled and non-skilled Iranian workers, employment of foreigners in the business, tonnage royalty and minimum payments.

The Concession was finally supplemented by the Agreement in May of the following year. The main provisions were as follows;

Clause 3 Part (a) of the Agreement provided for an increase of two shillings in royalty payment to the Government per ton of oil sold in Iran or exported. Under Clause 7 (a) the company agreed to raise its payments with respect to Iranian taxation from nine pence[163] to one shilling per ton of the annual production in excess of the first 600,000 tons.

By Clause 4(a) the company pledged to pay the Government, at the ratification of the Agreement by the Majlis, a sum of £5,090,909 out of the company's general reserves for 1947. It was also made clear that for each year following 1947, the Government would receive 20 per cent of the sums placed annually in the general reserves of the company. The amounts receivable by the government according to this provision were to be increased by such a proportion as would offset the effect of British income tax. [164]

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[162] See clause (a) of the law passed by Iranian Majlis on the 22nd of October, 1947. The English text of this law is presented in: International Court of Justice, op.cit., p. 273.
[163] As was the case under the 1933 Concession.
[164] Zoghi, op.cit., pg. 251-256

All payments to the authorities under Clauses 3(a) and 7(a) were subject to adjustments for fluctuations in the price of gold as was provided for in Article 10(V) of the 1933 Concession.

The company further agreed to discount the basic prices of all its products sold for consumption in Iran by 25 per cent. Furthermore, Clause 4(b) raised the limit of the guaranteed minimum annual payment of £4,000,000.[165]

During the same negotiations a new general plan was evolved under which the company promised 'to reduce within ten years from 1949 the proportion borne by its non-Iranian to its total (salaried) staff from 40 per cent to 33 per cent, and its non-Iranian artisans to its total labour (less unskilled labour) from 3 per cent to 1 per cent.'[166]

The revised provisions, in comparison to concessions granted previously, appeared to provide a fairer and balanced contractual relationship between the parties, with an emphasis on increasing engagement of the Iranian workforce; however the concession was still biased towards the foreign companies and this bias was not ignored by the increasingly nationalist sentiments of the public.

2.2.1 Rejection of the Compromise Agreement

The new Majlis appointed the Mossadegh Committee for examination and recommendation of the supplemental Agreement. In conclusion they found the Agreement dissatisfactory in meeting Iranian interests; before a new proposal could be forwarded however, the significantly more favourable deal between Aramco Oil Company and the Saudi government,[167] making the headlines, ignited public dissatisfaction towards the AIOC in Iran, and demonstrators took to

[165] For the English text of the supplemental Agreement see: Anglo-Iranian Oil Company, Annual Report an dAccounts, 1949, pp. 11 ff.
[166] International Court of Justice, op. cit., p. 215.
[167] With the profits being split 50/50 with the Saudi government.

the streets protesting the 1933 Concession and demanding its cancellation. The AIOC in response proposed an agreement based on 50-50 profit shares, including the payment of 5 million pounds against future royalty payments, in addition to a monthly advance amounting to £2 million until the end of 1951. The proposal was rejected, as the Mossadegh Committee gave its assent for the nationalisation of the oil industry. After the Premier's assassination,[168] due to his efforts at halting the nationalisation of the industry, the proposal was pushed through the Parliament and the Senate, both of which were unanimously in favour of nationalisation. The single-article Bill enacted in 1951, reads as follows:

> 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 to say, all operation of exploration, extraction and exploitation shall be carried out by the government.[169]

Consequently, British technicians abandoned Iran, and Britain declared a worldwide embargo on Iranian oil, dramatically reducing oil production. Iranian assets were frozen in the British currency, and exports prohibited. Britain appeared before the ICJ in relation to the legality of Iran's nationalisation of oil, which was found to be legal. Hostility between the AIOC and the government did not cease however, and Iran's economy suffered.

The political upheaval which followed, leading to the dissolution of Parliament in 1953 under Mossadegh's efforts, had a large impact on the Iranian oil industry.[170]

[168] Prime Minister General Haj-Ali Razmara, elected in June 1950, did not agree with the bill on technical grounds, but was nonetheless killed in 1951 by militant fundamentalists.
[169] Iranian Embassy, op.cit., p.2
[170] Farmanfarmaian, Khodadad, An Analysis of the Role of the Oil Industry in the Economy of Iran,

2.3 Consequences of Nationalisation

The Oil Committee remained in office for two months after the nationalisation law was enacted, introducing the Nationalisation Bill before Parliament, which was approved by the new Premier, Mossadegh and assented to by the Senate and the Shah respectively. Some Articles of the law that require especial consideration are summarised below:

Article 2 is the legal basis of the nationalisation, requiring the Anglo Iranian Oil Company's assets to be disposed and relocated to the control of the Mixed Board.

Article 3 allows the government and the companies' claims to be submitted to the Parliament, under supervision of the Mixed Board.

Article 6 requires the gradual replacement of foreign experts by Iranian experts, including foreign training for domestic experts.

According to Article 7, sales of oil would continue to clients at reasonable international prices, and with the same sales volume as that enjoyed with the Anglo-Iranian Oil Company.[171]

Nationalisation had been secured amidst disapproving attitudes towards the 1933 Concession amongst the Iranian public, based on the unequal financial relationship of the parties and other factors that have been previously described.[172] Fuelled by national outrage at foreign intervention, especially in the context of Iran having been the helpless pawn in the Soviet-American struggle for power, the steps towards nationalisation were as follows.

The Government interpreted the Nationalisation Enabling Act as granting it power to enforce nationalisation without prior authorization from any international tribunal; the Company and

[171] For the English text of this law see: International Court of Justice, op. cit., pp. 279-280.
[172] The chronological account of the nationalisation's unfolding is found in Benjamin Shwadran, 'The Anglo-Iranian Oil Dispute 1948-1953', *Middle Eastern Affairs*, June-July, 1954, pp. 193-230.

the British Government opined however that such an act was unlawful, and appealed to the International Court of Justice, declaring that it would protect British property and assets in Iran. Accordingly, the Iranian Finance Minister issued the statement that all the rights of previous purchasers and customers would be protected, and that further, the Company would be compensated for any damage caused to it by the nationalisation of oil in Iran. The Government-appointed Board of Directors, managing the NIOC was to act in order to respect the existing rules and practices of the Company (AIOC), and continue the employment of the AIOC's former employees.

2.3.1 Arbitration and Negotiation

Despite urges from President Truman, and efforts at reaching a settlement, negotiations ended in failure, and the Company withdrew its tankers from Abadan, followed by evacuation of British citizens from the country. The International Court of Justice issued an order for the protection of both parties' respective rights, to be taken by interim measures.[173] The Iranian Government refused to accept the Court's jurisdiction and order of July 5, and in response the American President urged discussion between the parties, through the medium of the Harriman Commission, to which the Government assented. Lord Privy Seal, Richard Stokes, was to head the British side of the negotiations. The delegation submitted the following proposal:

(a) Transferral of AIOC assets to NIOC.

(b) Formation of the purchasing organisation to oversee the formation of long-term contracts.

(c) An operation organisation would be set up to manage oil operations, to be financed by the purchasing organisation, to be represented by Iranians via a board of directors of the organisation.

[173] For the full text of the order see: International Court of Justice, op. cit., pp.715-716

(d) Terms to which the purchasing organisation would be subjected would in no way be less advantageous to other alternate means of securing the purchase of oil.

(e) Additional sales by the NIOC could be made to the extent that they would not be prejudicial to the purchasing organisation.

(f) The NIOC would be compensated for the transferred assets by the operating costs of the industry, to be retained by the purchasing organization.[174]

The Stokes proposal was duly rejected by the Government on the grounds that it did not conform to its nationalisation policy, and the following proposal was forwarded by the Government:

(1) The NIOC would continue to sell oil to its previous customers, based on a commercial contract.

(2) No discount would be made available to the purchasing organisation.

(3) Sufficient authority would be granted by the Government to foreign companies to guarantee effective functioning of their operations.

(4) The government would only compensate the parties after carefully examining their respective claims.

The Stokes mission ended in failure due to conflicting interests between the negotiating parties, and no settlement was subsequently reached. British staff left the Country, and the British Government instituted proceedings against the Iranian Government in the International Court of Justice. Further economic measures were taken in order to coerce the Government to agree to certain British terms; pound sterling balance payments were frozen, and permits for the exportation of essential materials to the workings of the industry were cancelled. Within the

[174] The summary of the Stokes' proposal presented here is taken from: W. Levy, 'Economic Problems Facing a Settlement of the Iranian Oil Controversy,' *The Middle East Journal*, Winter, 1954, pp. 91-95

United Nations framework, claims were brought by Britain to initiate measures compelling Iran to respect the International Court of Justice's previous order for interim measures, as issued in 1951.

Mossadegh represented Iran himself at the United Nations, arguing that nationalisation of the oil industry, being a purely domestic matter was out of the Court's jurisdiction, or that of any foreign state.[175] The Security Council decided to deal with such a question only after the International Court of Justice had ruled on the matter.

Upon his visit in the United States, Mossadegh was offered a proposal by the International Bank for Reconstruction and Development on the following terms:

> **(a)** The Bank would set up an arrangement, agreed to by both parties, of a temporary management of oil operations. The top positions would be filled by nationals of neutral countries.
>
> **(b)** Oil would be sold, by the Bank, under the terms of a sale of contract to be approved by both parties, to the AIOC, of which the proceeds in escrow would be held by the Bank, until the reaching of a final agreement.
>
> **(c)** Funds for the initial operation of the industry would be provided by the Bank, and repaid from revenue.[176]

The proposal was originally welcomed by the Prime Minister, and the Bank presented it to both governments. However, objectives were placed as to the political situation in Iran, and the Bank's accountability as a public body pertaining to 'Iran's account'.

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[175] The argument was that 'It is a settled principle of international law that in matters of domestic concern, to which this question eminently relates, their (rights) exercise can neither be abridged nor interfered with by any foreign sovereign or international body' Shwadran, op. cit., p. 212

[176] ibid., p. 215

Hearings commenced in 1952 on the International Court of Justice's competence relating to the Iran and United Kingdom dispute, and dealt with the two main issues of the acceptance by Iran of the Court's jurisdiction by the 1932 Declaration, and the 1933 Agreement between the Government and the AIOC. The Court reached the ruling that the Court's jurisdiction was limited to treaties and conventions only, as accepted by Iran after September 1932, and that the 1933 Agreement was a concessionary contract to which the British Government was not party to, and that accordingly, the Court had no jurisdiction to adjudicate on the matter referred to it by the British Government in 1951. The interim measures ordered previously thereby ceased to have effect.

2.3.2 International Involvement in Crisis Resolution

In 1952, the Iranian Government met a financial crisis, due to the pending deficits accumulated throughout the earlier years. The Prime Minister demanded, from the AIOC, a sum of £40 million which he claimed was owed by them. In retaliation, Truman and Churchill proposed a framework for dealing with the problem, stating that the issue was to be submitted to the International Court of Justice, that the United States would advance $10 million in aid,[177] and that the AIOC representatives would arrange for access of Iranian oil into the world market.

This proposal was rejected on the basis that it was inconsistent with nationalisation, and a counter-proposal, as suggested by Mossadegh, which ran as the following, was submitted:

(1) Compensation. The amount of compensation was to be determined by the laws of the country involved, and the agreement or consent of the former oil company.

(2) Basis of Examination of Claims. Claims were to be examined according to the following criteria:

[177] W. Levy, op. cit., p. 95

(a) Claims of the parties up to the date of nationalisation of the oil industry, in consideration of the D'Arcy Agreement and income tax calculations as received by the Government according to Iranian law.

(b) Claims in light of the 1933 Agreement, and the proposed supplemental Agreement (which stopped having effect after nationalisation, in 1951).

(c) Claims in light of concession agreements made by other oil-producing countries, with similar oil producing costs to Iran, within the same period of time.

(3) Determination of Damages. Damages were to be determined on the basis of the direct/indirect activities of the AIOC which may have acted as financial obstacles and resulting in losses, such as delay in fund payments.

(4) Payment in Advance and On Account. Payment in advance and on account of £49 million shown on the former oil company's 1950 balance sheet as increases in royalty, taxes and dividends due to Iran from the reserves. From this amount any part due from royalty and tax, as it was guaranteed on a gold basis, must be paid in sterling convertible to dollars.[178]

The counter-proposal was rejected, and consequently Iran severed relations with the United Kingdom. The US however appeared to be keen in resolving the crisis.

Further consultations followed as a result of which the British transmitted, through the American Ambassador in Tehran, a final offer for the consideration of the Iranian government. It was proposed that (a) the issue of compensation be decided by the International Court of Justice on the basis of loss of the company's business as well as the counter-claims of Iran; (b) an American company be permitted to purchase $133 million worth of oil from Iran with discount, and to pay $50 million in advance. In this connection an international company was to be formed with the AIOC as one of its members which could negotiate an agreement with

[178] As printed in: B. Shwadran, op. cit., p. 220

the Government for the sale of crude and refined oil; (c) before compensation issue is settled, Iran should agree to pay Britain 25 per cent of the gross receipts from the oil. After settlement of compensation Iran was to pay the company 25 per cent in form of oil deliveries or direct payments over a period of twenty years.

Once again and for the last time, Mossadegh refused to accept the new offer on the grounds that the new proposal was in principle no different from the Churchill-Truman joint proposal and as such it conflicted with nationalisation law. Overall, a clear pattern emerges of the strong, populist resistance to foreign involvement in the energy sector resulting in sufficient political pressure for compromises to be rejected, even if they are superior to the originally opposed contract.

On May 28, 1953, Mossadegh wrote a letter to President Eisenhower appealing for financial aid to his Government.[179] In reply the President bluntly dismissed Mossadegh's pleadings stating that "so long as Iran could have access to funds derived from the sale of its oil products if a reasonable agreement were reached' it would be unfair if the money of the American taxpayers were to be spent in Iran.

2.3.3 The 1953 coup d'etat and its effect on foreign investment

The act of closing down the British Embassy in 1952 to stop the intrigues that the government believed were underway there had, in fact, put a stop to covert activities of the British, who were seeking to undermine Mossadegh's government and replace it with one that would be kinder to their oil interests. A full-scale Coup d'Etat was being planned by the British, and they hoped to gain support from the Americans. Representatives from the Foreign Office and from MI6 met with the CIA to discuss plans to overthrow Mossadegh and his supporters. The British had

[179] Madani, S.J., 'Tarikh siyasi moaser Iran' (The Modern Political History of Iran), Vol. 1, Daftare Entesharate Eslami, 1982: 286

already gained support for the coup from various conservative Iranian groups, such as senior police and army officers, mullahs and newspaper editors. It was hoped that the shah and the royal family would also be supportive, and indeed the shah, as well as his mother and twin sister Princess Ashraf, supported the removal of Mossadegh – the women having been 'actively campaigning against him'[180] since he assumed the office of Prime Minister. The shah's growing resentment to Mossadegh's efforts to curtail the involvement of the royal family in politics meant that he agreed to meet with the CIA and he eventually gave his support to the idea of a coup, and to the CIA and MI6 suggestion of replacing Mossadegh with General Zahedi, though he was nervous throughout the coup and worried that the army would not support him.

In February of 1953, as Mossedegh left the Palace, a mob was baying outside and followed him to his home, which was attacked. Mossadegh managed to escape over a wall and hurried to a meeting of the Majlis where he reported what had happened. However, attempts to find and question the rioters were useless due to the involvement of various officials. Mossadegh was now 'acutely conscious both of the loyalty of the security forces and of his own personal safety.'[181] He refused to meet with the shah privately from then on, using only official contacts. That April, a new plan to force Mossadegh to resign was undertaken by the CIA, again with the knowledge and support of the shah. Several key officials sympathetic to Mossadegh's rule were kidnapped in an attempt to throw the country into disarray and turmoil, but the plot was uncovered and those responsible arrested (though not before one captive, the loyal chief of police Afshartus, had been murdered so as to be unable to give witness as to who had kidnapped him). However, after the coup the officials involved were put on trial and quickly cleared of the charges. Mozaffer Baqa'i, a member of the Majlis who had once been a close supporter of Mossadegh, had been directly involved in the kidnapping and was implicated by three of the

[180] Katouzian, H., 'Musaddiq and the Struggle for Power in Iran', I.B. Tauris & Co Ltd, London, 1990: 178
[181] Ibid: 182

retired officers involved, was eventually arrested two days before the final coup but after it had succeeded all charges against him were dropped.

The actual go-ahead for the coup was given by the Americans in late June when President Roosevelt attended a meeting with British officials in London on the 25th of that month. Those planning the coup had, by August, control of four fifths[182] of the media and had distributed mass propaganda in favour of the shah. However, the first attempt at a royalist coup was to fail as Mossadegh learned of the plot and was able to take defensive action. The shah and his queen fled to Baghdad and then Rome and the CIA assumed they had failed.

Amidst the chaos that followed the departure of the Shah on the 17th of August, General Zahedi was able to seize control of the Government. The protests in the streets had continued unabated, and were continuing on the 19th, unaffected by the police despite Mossadegh's attempt to ban demonstrations. The rebels surrounded Mossadegh's house, and put up a white flag, claiming he had resigned. Mossadegh in fact escaped once again over the wall, and was arrested within days. After his trial, he served three years in prison and was then under house arrest until his death in 1967. General Zahedi became Prime Minister and the shah was to rule for another 26 years before the Islamic Revolution in 1979. A year after the coup, General Zahedi's Government concluded an agreement with a consortium of international oil companies which will be referred to as the 1954 Agreement, ending the strong, nationalistic stance on the issue under Mossadegh.

The Coup d'Etat of 1953 was the culmination of a long mission by the British to free themselves from the restraints that the nationalisation of oil had placed on their investment. The Americans, on the other hand, feared that Iran would be the next country to fall under the Iron

[182] Ibid: 188

Curtain, due to its links with the Soviet Union, and the 1953 coup became a blueprint for later operations, including the 1954 coup in Guatemala and the unsuccessful 'Bay of Pigs' attempt at a coup in Cuba in 1961.[183] The Americans were also spurred on by news of the renewed activities of the Tudeh communist party in Iran. However, as is clear from the progression of events up to and after the nationalisation of the oil industry, the issue of Iranian oil was the primary reason for the coup. Thus, it can be argued that the current suspicion regarding the outcome of foreign investment resulting in the strict terms that Iranians insist upon in their oil agreements is understandable. The overthrow of the first democratically elected government has left deep impressions throughout the country, and significantly changed the way that Iran views the western world. The capitulation of the shah to foreign interests sowed the seeds for the Revolution, which it is almost reasonable to assume could have been avoided had the oil interests of the British government, who were exercising an almost colonial rule over Iran, not been the first concern of their Foreign Office. The direct relationship between the oil industry and national security of the country is important to consider when analysing Iranian oil agreements. The removal of the democratically elected government of Mossadegh underlines the importance of the oil industry to all aspects of society and politics, as well as the economic sphere.

The one clear conclusion that emerges from the study of the 1901-1954 period in Iran's oil history is that the major cause of discord has been in one way or another related to the question of the distribution of the direct and indirect economic benefits of the oil industry between its foreign owners and the Iranian economy. Other factors may have also contributed to these controversies but they were not as important as the differences that existed between the parties with respect to the diversion of the benefits resulting from the operation of the oil industry.

[183] Iran Chamber Society op. cit. [http://www.iranchamber.com/history/coup53/coup53p1.php]

Consequently, there exists a mutually responsive relationship between Iranian politics and Iranian oil; a conclusion that remains true today.

2.4 Formation of the 1954 Consortium

A new era in Iran's relations with foreign oil companies dawned when the government changed in the summer of 1953. The incoming government was prepared to negotiate with former AIOC a settlement to the oil dispute, and also to ensure the enlargement of oil exports.[184] The oil companies were equally prepared to sign agreements for refining, marketing and exploration of Iran's oil reserves.

Following the resumption of oil cooperation, Iran and England also resumed their diplomatic relations on December 5th 1953. Prime Minister Zahedi[185] created a special committee to resolve the Anglo-Iranian oil dispute, three days later.

The new government understood that "...the basic issue involved was still to be solved. It was understood in London, and even more so in Washington, that whatever solution was found would somehow to be within the framework of the nationalisation law, even if only formally," and "...could not ignore public sentiment by repudiating that law... Moreover... it would not be possible to bring back the AIOC as exclusive producer, refiner and marketer."[186]

This desire to continue receiving oil profits despite legal restrictions in the source state, and various attempts to circumvent these limits, is very similar to efforts currently undertaken by the Iranian oil authorities and foreign investors.

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[184] Such willingness to conclude contracts was based on the needs of various budget-based large-scale development programs for significant capital, which could only be satisfied through oil revenues.

[185] Later to be exiled from Iran and become an Ambassador to the United Nations.

[186] Alavi, op.cit., p .127-128

2.4.1 NIOC's Cooperation with the International Consortium

Following normalisation of relations between Tehran and Washington, the United States promised direct financial and military support to the new government. And in October 1953, Hoover Jr. arrived in Tehran to help the new government for a solution to the oil disputes.

In the beginning of December 1953, AIOC's president organised a meeting for the Standard Oil of New Jersey, Socony-Vacuum Oil Company, Standard Oil of California, Gulf Oil Company, Texaco, Royal Dutch-Shell and Campagnie Francaise des Petroles in London, with the purpose of studying the best means of bringing Iranian oil into the international market. The companies invited stated that they were ready to "...form a provisional consortium[187] for the solution of the Iranian oil dispute" and that "subsequent discussion between Dennis Wright, the British Charge d'Affairs in Tehran, and the Iranian authorities convinced the Anglo-Iranian Oil Company that a consortium was the best possible answer to the problem."[188]

A plan was then formulated which would solve the Iranian oil problem, or so its drafters Herbert Hoover Jr. and Loy Henderson, the American Ambassador hoped. The British government did not grant its approval to this initiative, in fact "Neither the Anglo-Iranian Co., nor the British Government was quick to seize on Hoover's idea of possible solution... moreover, by December 1953, Sir William Fraser, Chairman of Anglo-Iranian, was persuaded that it would be in the best interest of his company and his country to give the Hoover plan a trial." The United States position was that "... Anglo-Iranian Oil Company's share of the consortium should be limited to 40 percent and the American Companies should together hold a similar share with the remaining 20 percent to be held by the Dutch and the French." The negotiations regarding this issue, involving the British and American governments as well as various oil companies, did not end

[187] Consortium is an economic formation where each participant retains its legal status and the consortium as a body only controls joint issues such as division of profits.

[188] Ibid. p.128

for some months. It was the US's position from the beginning that American oil companies' participation was to be facilitated. An announcement was made on the 20th January "... T.Rieber, former chairman of the Board of the Texas Oil Company and a former official of International Bank for Reconstruction and development has been appointed petroleum advisor to the Iranian Government." Only ten days later, on January 30th, "The U.S Department of Justice grants anti-trust[189] immunity to five big American oil companies which are working out a formula for settlement of the Iranian oil dispute... This frees them to join British, Dutch and French petroleum concerns in forming a consortium to rehabilitate Iran's oil fields and refineries."[190]

A special oil commission, formed as per Prime Minister Zahedi's order on January 31st, "...recommended the creation of a consortium of American, British, and Iranian oil companies to market Iran's oil."[191]

An understanding was, at last, reached on August 15th 1954, between Dr. A. Amini, Iran's Finance Minister and the Vice-President of Standard Oil of New Jersey, Howard Page and an agreement, forming a Consortium, was signed. Following the Majlis's confirmation of the agreement on October 30th 1954, only nine days were needed after the ratification to initiate the flow of Iranian oil into British, Dutch, French and American tankers, and through them, to the world market. The most significant provisions of this agreement were as follows:

> The Consortium of companies will pay the National Iranian Oil Co. for all the equipment and personnel training for export and will sell the crude and products exported... Products for internal consumption will be available to National Iranian practically at the cost that was required to produce them...

[189] 'Anti-trust immunity' permits companies to engage in usually prohibited competitive tactics, such as entirely dominating a market and setting all prices, consequently limiting consumer freedom and choice.
[190] Ibid p.129
[191] ibid p.129

> The agreement is valid for a period of 25 years, with a provision for three five-year extensions... the total direct income to Iran, after the initial three-months period will be: first year, 31 million; second year, 62 million; third year, 67 million... The consortium guarantees to export a minimum of 78 million tons during the first three years... The consortium is to pay Iran, in Sterling, approximately half its net operating revenue in the form of income tax, and to the refinery a commission of two shillings and one-and-a-half pence per cubic meter of crude for exported refined products... The accord provides for the formation of two companies to operate oil... One of the companies to exploration and production, the other for the purpose of refining... Each company is to have seven directors, two to be named by Iran and five by the consortium.[192]

The composition of the Consortium was as follows: The Anglo-Iranian Oil Company (Now British Petroleum Co. Ltd) held 40%; Royal-Dutch-Shell 14%; Standard Oil (New Jersey), Standard Oil Company of Calif., Mobil Oil Company Incorporated, Texas Oil Company and Gulf Oil Corporation each held 8%; and Campagnie Francaise des Petrols held 6%.

The Consortium's formation caused outrage among the smaller oil companies in the US These companies wanted to take part in the Iranian oil operation, resulting in the intervention of the US State Department which compelled the five large United States oil companies (the Consortium members) to grant a small percentage[193] of the Consortium's shares to a group of independent oil companies from the US.[194]

[192] Middle Eastern Affairs, Vol. v, March 1954 P 103

[193] The companies were obligated to grant 1/8 of their interest packages to these smaller companies such as Hancock Oil Company, The Atlantic Refining Company and Pacific Western Oil Corporation (now Getty oil Co.)

[194] Pattinson,R.&Takin, M. 1971,Iranian Oil Operating Companies, 1958, p43

The Consortium members subsequently founded two operating companies[195] whose task it was to produce and refine oil and to receive a fee, as well as to have their operating costs compensated, but not to engage in commerce and

> …received the necessary rights and powers from Iran and the National Iranian Oil Company to be solely responsible for exploration and production in a defined area in south Iran and for the operation of the refinery at Abadan, and they exercise these powers on behalf of Iran and the National Iranian Oil Company to the extent provided in the Agreement. While the National Iranian Oil Company, the shares of which are held by the Iranian Government, is the owner of the fixed assets of the oil industry in Iran, the Operating Companies have unrestricted use of them during the period of the agreement.[196]

The Agreement also specified the role of the National Iranian Oil Company during the effect of the Agreement:

> The agreement provides that petroleum products required by the National Iranian Oil Company for consumption within Iran shall be delivered to it by the appropriate Operating Company. It also provides for the National Iranian Oil Company to take over the responsibility for the provision, maintenance and administration of certain ancillary services required by the Operating Companies, known as "non-basic operations."[197]

[195] The two operating companies were the Iranian Oil Refining Company and the Iranian Oil Exploration and Producing Company.
[196] ibid, p. 335-336
[197] Zoghi, op.cit., p.134

2.5 Legal Basis Reform of Oil Agreements

Three years after the consortium agreement's signing, in 1957, the Majlis passed the first Iranian oil bill, allowing the signing of agreements involving foreign investors outside the consortium's operating area. Major oil companies were disgruntled due to the innovative participation formula. Their opinions shifted, however, once they realised that using the formula was a more stable, appropriate method of securing co-operation from oil producer states. Participation agreements in Iran were based on a 50/50 ratio, where 50 percent of shares were the property of the National Iranian Oil Company while the remaining 50 belonged to one or more foreign oil companies. The Iranian government received half of the foreign partners' shares as tax. In effect, these agreements were 75/25 agreements, and this name stuck. Further updates of tax laws resulted in 85 percent payable tax, in addition to mandatory royalty payments to the National Iranian Oil Company.[198]

2.5.1 Commercial Implementation of New Legislation

Using the 1957 Petroleum Law, miscellaneous contracts were signed by NIOC, usually 75/25 profit sharing agreements "... it was stipulated that half of the profits of the exploitation would go to the NIOC as partner, while the Iranian Government would receive 50 percent of the profit as income tax... this system is an extension of the 50/50... in the sense that tax levied on the foreign company's half of the profit is, as before, 50 percent, but in addition, the Iranian company owns a one half share of the petroleum produced, resulting from the equal partnership with the foreign company."[199]

[198] NIOC, Brief History of Iran's Oil. P7
[199] Alavi , op.cit., p. 142

On August 3rd, 1957, the Societe Irano-Italienne des Petroles (SIRIP) was founded as the result of an agreement between NIOC and Azinde Generale Italiana Petrole (AGIP), an Italian state sector firm. SIRIP, with an equal number of shares belonging to the founding companies, came into possession of 22,900 square kilometres of the shore of Zagros, in the Persian Gulf.

The post-tax profit will be shared equally by AGIP and NIOC, but if commercial quantities of oil are found, then NIOC would provide half the investment capital required for the discovery's further development.

The agreement's period of effect was limited to 25 years, although a provision for renewal was included, giving the option of renewing for either three terms or five years. Drilling had to begin within four years of the agreement's signing, and if half the operating area has not been developed in ten years' time, then the area must be returned.

AGIP was obliged to utilise $22 millions of capital for purposes of exploration.[200] SIRIP was then obliged to compensate AGIP for its expenditures at an annual rate of at least 10 percent per barrel produced. SIRIP would exempt from royalty payments and had to pay solely its profit on its share of the oil.

An agreement was signed in June 1958 between the Pan American Petroleum Corporation, a subsidiary of Standard Oil of India, and NIOC. The result of the agreement was a joint company by the name of the Iranian Pan-American Oil company (IPAC). By virtue of this agreement, 16,000 offshore square kilometres, in the north of the Persian Gulf was given to the Pan American. The same framework was used for this agreement as the one used in relation to GIAP. However, it does differ from the latter in certain respects. Pan American paid NIOC a $25 million dollar cash bonus, procurable in ten annual instalments following the commencement of

[200] 6 million within the first four years and the rest within the next eight.

production.[201] AGIP committed to spending $22 million for exploration, whereas Pan American committed $82 millions of its funds for the same goal. NIOC's obligation came into effect with the beginning of commercial production, and in both cases, the foreign companies were obliged to finance all exploration-related expenses.[202] A further contractual obligation was the payment of half of their net income, stemming from their activities, to the Iranian government. NIOC, in its capacity as a partner in this joint venture, was to acquire 50 percent of post-taxation profits. In the end, Iran's total share of profits amounts to 75 percent.

In a further development in June of 1958, an agreement[203] with the Sapphire Petroleum Company of Canada was signed by NIOC, the subject matter of the agreement being a 10,000 square kilometre offshore area that was previously granted to the Consortium and SIRIP.

The joint agreements between Iran and AGIP, Pan American and other foreign oil companies, did not follow the pattern usually utilised in Middle Eastern concessions, and from the Consortium agreement of 1954. The main commonalities between these agreements were the following:

1. They created a partnership between AIOC and a foreign oil company. Profits were to be taxed at the rate of 50 percent, and the remainder of the profits was to be divided equally between the two parties.

2. Foreign companies were obligated to fund the oil exploration until it was found in commercial quantities.

[201] As required by Article 31.5 of the agreement.

[202] ibid p.144

[203] The terms were identical to those used in the IPAC agreement, with the exception that Sapphire was not obligated to pay a bonus because, instead, it pledged to spend $18 million on exploration.

3. The primary duration was to be 25 years, beginning with the initiation of commercial production and was capable of being renewed for three periods of 5 years each.

4. The employment of foreigners by the operating companies was severely limited and regulated.

5. The nationalities of board members were locked at half Iranian and half foreign.

6. Areas where oil fields have not been developed within a set time period had to be gradually relinquished.

7. Occasionally, a bonus payable to NIOC was made part of the contract, such as in the case of Pan American's agreement.[204]

2.6 Contractual and Commercial Changes between 1960 and 1979

The changes seen in the Iranian oil industry during the period 1960-79 were in large part due to the attempts at modernisation undertaken by the Shah and the desire for increased foreign investment in the field. Economic development was a cornerstone issue of the day and the rapidity with which the modernisation of this system was undertaken had profound effects upon the infrastructure of the country. These changes are discussed in detail below.

2.6.1 Oil Transactions as a Part of the Economic Development Plans and Socioeconomic Context

As a result of a substantial enlargement of oil revenues, which coincided with the centralisation of the Iranian economy, problems of stress within the Iranian society, caused by the imbalance of wealth, have become aggravated. The modernisation campaign, continuing throughout the reign of Mohammad Reza Shah, had a substantial effect on the commercial infrastructure of Iran, but

[204] ibid. p145-148

little effect on the rigid structure of the political system. The gap between these two aspects of Iran's situation was further highlighted due the Shah's adoption of Western industrial policies.

Throughout the 1960s, four main goals were kept in mind when planning the economic programmes. The first was the speedy growth and advancement of various industries through investment and the utilisation of the most modern manufacturing techniques;[205] the other was the hiring of specialists from abroad with the purpose of further developing the industrial sector. The facilitation of significant gains from industry was the third, the fourth being wages management, to be done by moving savings from labour costs to capital investment.

The assumption underpinning this plan was that prosperous industrialists would reinvest their funds in the Iranian economy, consequently vitalising it and encouraging further development. The assumption was false, however, and the large profits acquired by industrialists simply widened the gap between them and the commercial class (or bazaar, the traditional middle class), creating discontent and calls for revolution, which eventually toppled the government.

Mohammad Reza Shah's modernistic reforms and development plans, which he conducted throughout the 1950's, were labelled the "White Revolution" in 1963. The term denoted both the attempt at modernising the economy and stabilising the political environment. The ultimate aim was to increase the pace of national advancement and to improve the government's reputation, painting it to be a protector of public welfare.

Agricultural and industrial reforms were vital parts of the Development Plans, and required 1.5 billion dollars investment into agriculture alone, requiring profits from oil in order to maintain the pace of economic reform. Additionally, a financial expansion had occurred in most economic sectors, following the input of US$1.9 billion into the national budget, which the

[205] Both the huge funds required and modern technology could be acquired through forming and executing oil contracts with more technologically advanced, foreign companies.

government earned through oil revenues. The focus of government activities was on public activities, heavy industries, dam building and the enlargement of the oil and gas production industries. Another beneficiary of the third plan was the private industry, since they had less trouble finding financial backing due to an increase in bank loans.

The fourth plan's effect was an increase in the rate of fiscal development, with its goal being to address problems at the local and national level, through integration into an Iran-wide developmental program. As the result of the plan, GDP growth targets were overshot, with 11.8 annual GDP growth. The biggest strides were made in the petroleum, transportation and communication industries, with industry in general also improving substantially. Among the structures which were being built during the fourth plan were a refining complex,[206] a pipeline leading to the USSR, a steel mill and an aluminium smelter. The prioritisation of industry over agriculture during this plan, however, resulted in the expansion of the gap between the industrial sector and those engaged in farming and crop-production.

The impact of the third and fourth plans on the urban population was particularly noticeable, since high priority was given to expanding the manufacturing of everyday items and increasing the production volumes of oil and gas. Such an area of focus resulted in the construction of numerous industrial installations between 1963 and 1977, mostly in urban areas.

The investment that had been initially devoted to the Fifth Development Plan (1973-1978) was US$36.5 billion, but substantial successes in acquiring greater oil profits during the Plan's duration, expanded the investment size to US$70 billion. The emphasis of this Plan was providing accommodation, mineral and industrial development, natural resources enterprises and

[206] An especial effort was made to decrease Iranian dependence on foreign technology and facilities through building their own refining and oil field developing facilities.

telecommunications, since almost two-thirds of the available funds were channelled into these areas.

Moreover, some of the unexpectedly high petroleum profits were paid for rapidly organised defence and construction projects, as opposed to the Plan's original zones of priority.[207]

During the time of immense petroleum price hikes between 1973 and 1977, the Shah's overly rapid efforts at industrialisation and the creation of a modern, mechanised military resulted in dire consequences. Inflation increased, rural-to-urban migration became more vigorous and corruption plagued all parts of the government. Furthermore, due to the failure to train Iranian specialists for the jobs occupied by foreigners, more and more foreign technical consultants had to be invited to work in Iran. The housing situation in Tehran, already on the brink of overcrowding, was made worse by this importing of labour.[208] As the result of overly rapid economic reform, made possible only through oil money, a radicalisation occurred in the population which eventually led to the Shah's downfall; highlighting oil revenues' power to both aid in construction and to be the cause of national conflict.

2.6.2 Updated Terms of the 1965 Agreements

In an effort to survey the 48,000 square kilometres of the Persian Gulf for the presence of oil, the Iranian government, in early 1964, commissioned such a survey from Western geophysical companies. In the companies' March 1964 report, it was stated that "the world's biggest oil field may be waiting to be tapped beneath 175 feet of Persian Gulf water ... every structure, of course, isn't necessarily oil bearing. And talking its size (twenty seven structures) before actual test

[207] Therefore the oil profits played a significant role in improving the state of the Iranian military prior to the Iran Iraqi war.

[208] The lack of domestically trained specialists clearly showed that the government's efforts to avoid this by imposing limitations on the number of foreign employees as part of oil contracts have failed.

drilling is obviously premature, but there is no doubt that the structures and domes uncovered by the seismic work are tremendously exciting."

As a result of this report, in September 1964 NIOC extended an invitation to all companies who may be interested in taking part in this scheme to submit their business plans to the Iranian government. In January 1965, joint-venture agreements were signed by NIOC with a number of companies.[209]

As per the agreement, each group accepted a 50% partnership with NIOC. Furthermore, a bonus payment must be paid by each group, in Shell's case, 21,075,000 Rials. This amounted to a significant part of the total payment from all contenders, estimated at between 65-70 million Rials.

According to the agreement, the foreign companies would have to pay for exploration costs, but NIOC would join the operations if oil were found. During the first stage of development, the foreign companies will carry the burden of paying the development costs, but half of the development costs paid during this first stage will be reimbursed to them once oil exports have begun, over a stated period. Moreover, both the initial and the production bonus are returned, amortisable at a rate of ten percent of the total sum, each year. The original production period could, at will, be extended by up to three five year extensions. A 50/50 profit split was used for this offshore agreement, with sharing taking place on the basis of the posted prices between the Iranian government, in the role of the taxing authority, and the joint foreign group and NIOC partnership. Consequently, "in virtue of its 50 percent shareholding, NIOC obtains one-half of the profits of the joint company, after taxation by the Iranian Government, and the foreign partner also receives one-half. Total profits are therefore divisible one-half to the Iranian

[209] The companies were united into 5 groups and included Royal Dutch-Shell and Sun Oil Co.

Government and one-quarter each to NIOC and the foreign partner." However, not all groups who wished to participate were permitted to form a contract with NIOC.[210]

2.7 Turmoil Resulting from the Islamic Revolution

Following the Islamic Revolution, led by Ayatollah Khomaini,[211] NIOC annulled all Iranian relation contracts concluded with foreign companies before the Revolution. The NIOC legitimised this decision by noting that it stemmed from a decision made by the Revolutionary Council[212] on 7th January 1979.

As well as having had immediate consequences, the annulment of contracts as the result of the Revolution had effects that were much more far reaching, in the form of costly and prolonged litigation over the cancellation damages.

Three US firms invested in Iranian oil in the form of PSA and joint venture agreements prior to the Revolution, leaving Iran after the Embassy takeover crisis and abandoning their designated oil operations. In order to avoid further interruptions in the flow of oil, Iranian officials took over the fields, as they were sufficiently experienced to conduct such an operation on their own. The companies, members of a consortium in the Persian Gulf region, sued Iran but despite its offer to compensate them the sums owed under the original agreements, they wished to procure a legal verdict against Iran. The disruptive effect of the Revolution can be seen from the potential legal effect of the case, which threatened to undermine the Iranian contractual stance that companies involved in the type of contract in question only had rights to above-ground oil rather than underground deposits. Furthermore, the fiscal dangers of breaching contract due to a radical change of stance on foreign oil involvement are shown by the court's final finding, which

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[210] Movahed, Mohammad Ali "Nafte va Masaele Hoghooghiye an"(Our Oil and its Related Legal Issues) p.61

[211] A Shi'i Muslim religious leader, politician and organiser of the 1979 Iranian revolution.

[212] A group of clerics appointed by Ayatollah Khomeini in 1979 to manage the Revolution of Iran and then legislate for the Interim Government

ordered Iran to pay the companies compensation according to very optimistic predictions of their potential profits.

Furthermore, a further disadvantage of contractual upheaval as seen in the Revolution was highlighted by the ex-NIOC Deputy Managing Director Seyyed Mehdi Hosseini, who noted that oil contracts include various implied provisions which become the subject of debate in judicial arbitration, leading usually to a finding favourable to the foreign investor as the courts are not experts on oil issues and tend to sympathise with the party perceived to have been wronged, therefore making any contractual annulment potentially costly for Iran.[213]

An additional ill effect of the Revolution was that, based on their presence at popular rallies, cross-country strikes and interruptions of oil flow, some Iranian oil industry employees were given the managerial positions in the oil industry, including control over all the relevant operations.[214]

2.8 Iran-Iraq War's Enhancement of International Involvement

After the beginning of the Iran-Iraqi war, on 21st September 1980, oil, petrochemical and gas infrastructure became the target for heavy Iraqi air and ground attacks. These attacks were intended to interrupt Iran's production and export of oil, as well as to undermine Iran's defence capabilities by cutting off fuel transmission to cities, war industries and battle fronts. The Iraqi military made significant gains in this mission, destroying the Abadan refinery and seriously damaging crucial oil industry locations. Oil export terminals were also desirable targets, Khark Island oil terminal, for instance, attracting constant fire barrages. Although damage dealt to oil

213 Exclusive Interview with Mehdi Hosseini, Payvand News, 19th May 2005. [http://www.payvand.com/news/05/may/1146.html]

214 Consequently, the Ministry's leadership was restructured on the basis of political affiliation rather than business talent.

refineries, pipelines, industrial sites and factories decreased the amount of oil produced, it did not substantially decrease the rate of oil export until 1986.

The average production amount, per day, in the period of 1982 to 1986 was 2.3 million barrels. Nonetheless, the compounded impact of decreased oil production and decreasing oil prices caused a deficit of foreign exchange and an economic crisis by 1986. The Abadan refinery's demolishment,[215] the destruction of refining facilities and oil transportation vehicles, as well as the ongoing financial sanctions against Iranian oil instituted by Japan, US and France aggravated the economic trouble. As of November 1987, oil exports were down to an estimated 1 million bpd, from about 1.9 million bpd in the preceding monthly period.[216]

Iraq's strategy of frustrating Iran's oil industry began in February 1984, when Iraqi forces attacked oil tankers making rounds between the Khark and Sirri islands. As the result of a strike on Khark Island, its terminal and cargo handing jetties were damaged and their output decreased from 6.5 million bpd to 2.5 million bpd in the space of just three months. Although this tactic did not stop Iranian oil exports, the diminishing effect it had on the amount exported resulted in financial and funding problems in fiscal years 1985 and 1986.

Due to the decreased efficiency of Khark Island, Iran began to employ the Sirri Island terminal for exporting purposes. Following the beginning of operations there in February 1985, Iraq attempted to disrupt the operations there as well, on August 12th 1986. The first attack caused disarray and disrupted oil exports for a time, but the Iraqi forces' second assault in the autumn of 1986 dealt damage to the terminal from which Iran could not rapidly recover.

Due to the attacks on tankers in 1984, insurance premiums for transporting Iranian oil skyrocketed, forcing Iran to offer special incentives to tanker operators in order to compensate

[215] Which was crucial and produced an average of 628,000 barrels per day.
[216] NIOC, Brief History of Iran's Oil. P.8

them for the risk they incurred. Japan, the largest buyer of Iranian crude, prohibited Japanese transports from travelling the Khark-Sirri route. However, following Iran's decision to provide beneficial terms to its clients, Japan unfroze its oil trade with Iran in July 1984.

The attacks on Sirri Island in August 1986 had the effect of decreasing Iran's oil exports to just a third of their nominal size.[217] An attempt to return the exports to their normal levels was made through an effort to export oil through Larak Islalnd, but monsoon winds, which struck in September 1986, made dispatching shipments from its main oil terminal, Abu al Bukush, temporarily impossible. Iraqi forces then conducted attacks on the terminal in November and December 1986 and succeeded in damaging it. The damage was not such that it permanently prevented it from executing its functions,[218] and by November 1986, Larak Island was repaired and inherited the title of Iran's main export point for oil. Unlike the previously used terminals, Larak Island had not been as vulnerable to attack as it was located far from Iraq's air bases and had a comprehensive anti-aircraft defence system. This allowed it to avoid the fate of other terminals and the oil industry as a whole, attacks on which were gradually eroding Iran's oil export industry. The shuttle fleet was hit the hardest, with 13 damaged tankers in August 1986 alone. The attacks on the oil industry have also necessitated a delay in the unveiling of a major petroleum installation in Bandar-e Khomeini, scheduled to open in 1989, a joint Iranian-Japanese venture. The effect of the war was not solely destructive however, as the serious damage inflicted on the Iranian oil industry necessitated foreign involvement in its reconstruction and set the tone for further contractual cooperation with foreign companies in the 1990s.

[217] From 1.6 million bpd to 600,000 bpd.
[218] Namely exporting an average of 200,000 bpd.

2.9 Conclusion

In order to understand the nature and functioning of modern "buy-back" contracts, it is vital to have an insight into the history of the Iranian oil industry, which has been shaped by wealth, foreign domination and wars. As the industry's history shows, Iran's restrictive stance on foreign ownership and suspicious attitude regarding foreign investments in its oil sector, in view of the excessive power wielded in the past by foreign powers, is neither inconsistent with history nor groundless. If one limits the analysis only to the present, however, such significant understanding of Iran's oil industry will be missed.

One clear trend which emerges from Iran's oil history in the second half of the 20th century is the unfair and unbalanced legal obligations which arise from oil contracts with foreign companies. As part of the pattern, such grievances lead to an escalation of public condemnation which lead to a severe restriction on oil contracts, as was the case in the 1951 Nationalisation and the Islamic Revolution of 1979. Another part of this pattern, however, is the eventual reversal of this radical position once the authorities, be they that of the Shah or the Supreme Leader, once it becomes clear that their ambitious economic reform programmes cannot be sustained without the contribution of oil revenues. The significant contribution of the Iran-Iraq war to this continuous pattern of oil protectionism and attempts at greater commercial cooperation was the simultaneous need for foreign involvement in order to rebuild the oil industry while also maintaining a firmer grasp over national oil reserves due to the distrust generated due to Western support of Iraq in the war. Consequently, these historical events are a vital and indivisible component of an understanding of the buy-back system emerging in the 1990s; combining a willingness to absorb foreign technology and investment while maintaining complete control over Iranian oil. The events of 1953, where a foreign operation ousted Mossadegh's government for the sake of their

oil interests, are enough by themselves to account for a lasting mistrust of any foreign investment in the oil industry.

An examination of the greater economic isolationism that was prevalent during the two most important oil-related events of Iran's history, elucidates the reasons why the contractual system introduced in the 1990s is consistent with Iran's past experience in oil transactions.

Having reviewed the historical influences that has shaped the perceived need for buy-back as a contractual model in Iran, it is necessary to assess, within Part Two, the other commonly used international oil contracts to determine their relative advantages in terms to the buy-back, as well as to assess their legality in the context of Iranian law, in conjunction with a detailed analysis of the legal basis and function of buy-back within the Iranian system. As the academic discussion on the issue of buy-back takes place between those who believe an alternative system may be used and those who believe in enhancing the existing system, any analysis of the existing framework would be incomplete without determining the viability of utilising a different system in a legally restrictive environment of Iran.

In addition to the emphasis placed on determining alternative systems, the importance of which is highlighted above, the next Part will critically assess the attractiveness of buy-back contracts from the perspectives of both domestic and foreign parties, while identifying areas that may be remedied in order to encourage further investment. Crucially, the analysis is not limited to theoretical considerations but also incorporates an overview of relevant contemporary contracts, in order to illustrate the effect that the foreign companies' misgivings, as well as US sanctions, have on the actual involvement of foreign firms in Iranian oil and gas.

Part Two: Autopsy of the Iranian Buy-Back Transactions

Introduction

Frequent political and economic crises in Iran resulted in recurring disruptions to oil supplies. The greatest disruptions occurred as a result of the Revolution and the Iran-Iraq War. Early on in the war oil production was all but brought to a standstill. This illustrates how any war or tension in the region can cripple the production and transportation of oil. Many buyers who would have traditionally purchased from Iran turned to sources in Saudi Arabia and Kuwait out of fear of losing tankers. This shows the vulnerability of the region's oil supply. The desire of regional leaders to build military power in the region is counter productive to the need to secure a safe supply of oil.

Iran's oil production and export business stabilised in the 1990s but was unable to reach the levels achieved in the 1970s. This is because its oil wells are getting older and shows Iran's need for new wells if it is to retain its production capacity. In order to increase its production it must seek out new oil fields and wells but in order to do this new capital and technology is required. Foreign investors are needed. However, this is not easy due to restrictions on foreign investment placed on Iran by the US. Nevertheless many European and Asian businesses have invested in Iranian oil and gas development. US sanctions have therefore only been a partial success.

The rapid growth of internal energy consumption has become a source of major concern for the Iranian government as it can potentially lower exports and thus the balance of the budget. The government has therefore taken measures to cut down internal demand for oil by raising prices, switching oil for gas while simultaneously increasing oil production. Iran is anxious to increase

its export of energy to various countries but internal political conflict over pipelines has prevented the realisation of this goal.

While service agreements are regarded to create fewer incentives for investors than PSAs, nevertheless Iranian experience with buy-back agreements shows that while IOCs may not like them they will sign them. Simple game theory explains why IOCs will sign these contracts that they claim to dislike. Firstly, they hope that the structure of the contract may change in favour of foreign companies over time. Secondly, there is the fear that if they do not sign another company will and the aforementioned change in contract structure comes to pass leaving the second company in a better position to make a new agreement. It should be remembered that in the mid-1960s large IOCs were reluctant to sign the then new PSAs and yet over time this became one of the most common types of contract.

From a host country's point of view short-term contracts appear to be the sensible option where the foreign investment it needed primarily for building infrastructure and the NOC is considered to be capable of the development and exploration of reserves.[219]

An essential component of a critical analysis of buy-back is the juxtaposition of its basic legal nature to that of other contractual systems, in order to assess the extent to which they are similar and, consequently, interchangeable within the Iranian legal framework. The next Chapter provides such a comparative analysis, as well as outlining the nature, advantages and limitations of alternative frameworks, with particular emphasis placed on their viability within the Iranian context.

[219] Bindemann, Kirsten, Oxford Energy Comment, The Middle East Invites Bids by Foreign Oil Companies, December 1999 [http://www.oxfordenergy.org/comment_prn.php?9912]

Chapter 3: Types and Nature of International Oil Agreements

3.1 Introduction

Oil contracts are strictly regulated and monitored by the host countries'[220] domestic laws, in all aspects, from creating a legal framework for a foreign investment, to exploration, production and setting tax prices. Revenue-sharing regulations are clear and specific, and International Oil Companies (IOCs) should take into account both statutory obligations, and the standard contractual terms of the host country when making any agreement. Those agreements involving the transfer of possession or rights over natural deposits, are undertaken with the involvement of governments or government-assigned companies.[221] The majority of these agreements fall under one of the following regimes:

1. Concessionary Systems
2. Contractual Systems

The concession is the original legal framework for petroleum exploration and production, also being the most common contractual framework when dealing with states.[222] It has the form of an exclusive license to explore for hydrocarbons. Although the state has title to the petroleum *in situ,*[223] once the concessionaire has drilled a well into which petroleum flows title to that

[220] The territorial boundary over which a Host Government has jurisdiction and which a Company has Extractive Industry economic interests.
[221]Total, "Corporate Social Responsibility Report" 2003, [www.total.com/static/en/medias/topic323/Total_2003_CSR_5Ethics_en.pdf]
[222] A 1995 analysis of the oil related legislation of 116 states demonstrated that: Production Sharing Agreements (PSAs) are used in 52 countries, concessions, in 62; In developing countries PSAs are as popular as concessions; Out of 24 major oil producing states (with production levels at least 30 million tons a year) PSAs are used in 13 countries, and licenses in 10, of which in two countries a parallel use of the two subsoil use systems is established by law: in Venezuela (licenses and risk service contracts); and in Russia (licensing system and PSAs). (See: *Barrows. G. "Trends in Petroleum E7P Contracts Worldwide" 7 OGLTR [1992], p 171.*)
[223] In situ is a Latin phrase meaning "in place". In legal context, *in situ* is often used for its literal meaning. For example, in Hong Kong, in situ land exchange involves the Government exchanges the original or expired lease of a piece of land with a new grant or re-grant with the same piece of land or a portion of that. (http://en.wikipedia.org/wiki/In_situ#Law)

petroleum passes to the concessionaire, and the host government[224] take their share by way of income taxes and additional royalties.[225] The concessionaire accepts all operating risks and required investment, and agrees to pay the state.

Under this system, the oil firm is permitted to find, exploit, move and sell the resources in question, usually within a specified territory and within a given time. The sale of the resources thus acquired is then taxed and subject to various other expenses paid to the government.[226]

The concession agreements include a variety of oil contracts; some were signed before the 1950s and granted a wide range of concessions to the foreign companies. Most contracts signed after that decade used the 50/50 share agreement formula.

Under this scheme, the company assumes any risks, expenditures and fees, while being remunerated through a fixed portion of the output, with the deposits themselves not legally changing hands.[227]

Non-concessionary contractual systems are divided into two groups; Production Sharing Agreements (PSAs)[228] and Service Contracts.

PSAs are greater in complexity than concession schemes, as they set out, in extensive detail, the regulations for the relationship between the oil company and the host state. Among the commitments taken on by the foreign company in such a context is the funding of exploration and exploitation while bearing the risk of an unsuccessful development. As remuneration, a share of the output known as "cost oil" is granted for the purpose of refunding the costs incurred, as

[224] Host Government includes local, regional, state and federal representatives of these regimes and institutions and entities that are controlled by these regimes and institutions but excludes National State-Owned Companies.
[225] Dr Christian Ule & Dr Alexander Brexendrorff, "Investing in the oil & gas Industry" Mena, 2005, P 20
[226] EITI, Oil and Gas Reporting Guidelines http://www.eitransparency.org/docs/reportingguidelines.pdf 23rd May 2003, P3
[227] Ibid
[228] Also known as 'Production Sharing Contracts' (PSCs)

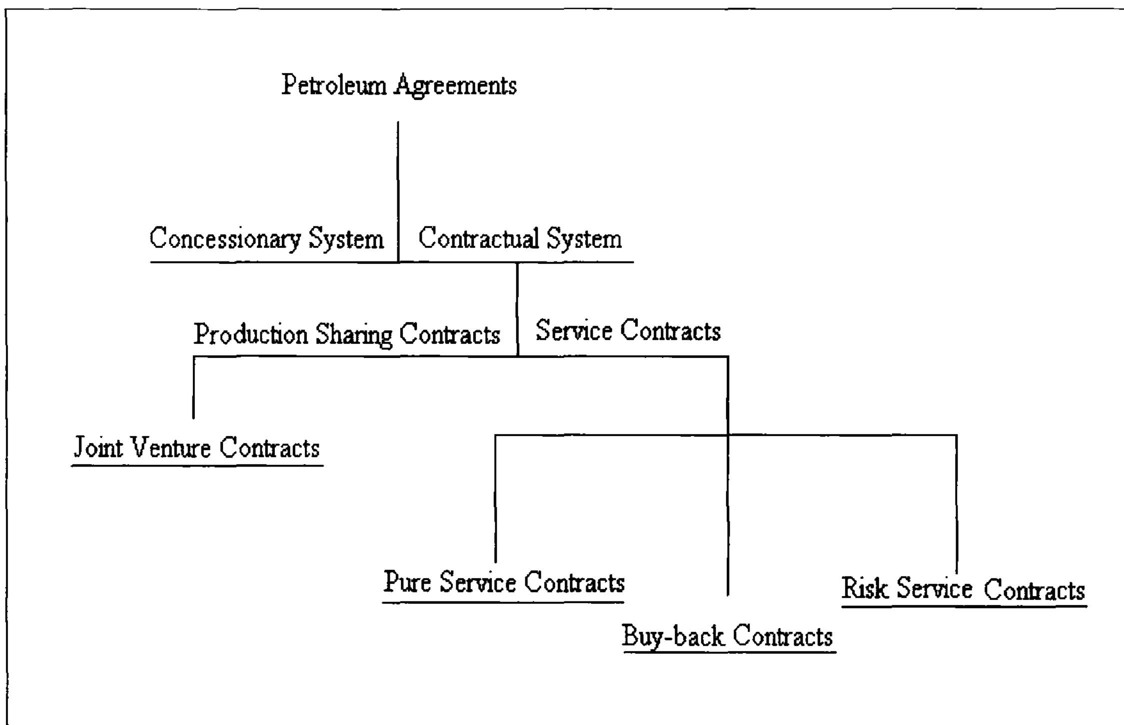
well as any initial funding. Following this refund, the contractual partitioning of the remainder of the output is conducted, with the petroleum being shared at this point referred to as "profit oil".[229]

Some IOCs use Joint Venture Agreements, an upgraded form of Production Sharing Contracts, which will be discussed in depth in the following sections.

The Service Contracts also divide into three groups; Pure Service, Risk Service, and buy-back agreements.[230]

Comparison and analysis of the different possible type of oil contract and their relative strengths and weaknesses is integral to understanding why Iran chose to use the buy-back model.

Figure 1: Break-down of Petroleum Agreements



[229] Total, The Main Types of Oil Production Contract, (see: http://www.total.com)
[230] "Autopsy of the Oil Contract (Buy-Back)" collection of articles by Dariush Mobaser et al, 2000, pg. 21

3.2 Concessionary System in Oil Contracts

The early search for and development of petroleum in the third world was carried out within the context of a legal framework which came to be known as the concessionary system and which favoured, naturally enough, the concession-holding company, endowing it with wide-ranging prerogatives. The host countries were left with only certain formal, symbolic manifestations of supervision as well as a few meagre crumbs of revenue.

With the passage of time and with the growing importance of petroleum as a new source of energy and industrial raw materials, the grave inequalities of the concession regime began gradually to unfold. Some of the host countries, becoming increasingly aware of what was at stake, began to complain, to seek renegotiation of the onerous contractual terms. They demanded equitable new deals. Latin America had the privilege of spear-heading that effort and setting an example for others to follow (Odell, 1968). In the confrontations that challenged the legitimacy of the concession regime, the host countries brandished the sword of equity and *rebus sic standibus* (changed circumstances) and *pacta sunt servanda* (the sanctity of contracts). The duel went on unabated for many years but it was never formally and conclusively adjudicated before a court of law. The deadlock continued until some governments, prompted by sudden, unforeseen events, felt sufficiently confident to act unilaterally. At first the anomaly of the concession regime was to be alleviated gradually by *ad hoc* national legislation which was later followed by either forced state participation or outright nationalisation. The rest of the story is too well known to need any re-telling here.

In the first half of the 20th century a system of long-term concession agreements grew up in the Middle East primarily due to civil law traditions but also because from a handful of common law concepts. These concessions had the nature of a self-contained constitution with their own law

separate from local law although enacted by it. Disputes were generally settled via international arbitration.

The Middle Eastern concessions covered large areas and tended to be of long durations, often for 50 years or more, however, their terms were frequently the subject of negotiation. As circumstances changed they were occasionally amended by mutual consent and in practice they system was not as rigid as some authors would suggest. But the major concessions did place the right to fix both production rates and prices in the hands of the concessionary company giving them the superior bargaining position. This situation was accepted by host states until the late 1960s because it guaranteed a high rate of production and ensured that their product reached the marketplace. Consumer states assured that supplies stayed at stable prices. Hosts were not overly concerned that these prices were low as they had not fronted any money for exploration and development and thus had taken none of the risks while they simultaneously earned large revenues.[231]

Under the concessionary system,[232] any conferral of exploitation rights is preceded by an evaluation by the domestic partner, based on the premise originating in the French Revolution that natural deposits must be operated in accordance to the state's interests.
In contrast, the antiquated system transferred rights without limits for the exploitation of natural deposits, with all decisions being at the company's discretion, including pricing and exploitation speed. Thus, only a small, fixed amount was paid as tax and royalties. However, the deep political revolution after 1950 (such as the nationalisation of the oil industries) led to a change in this arrangement, with discretion over pricing being largely transferred to the host state while previous contracts were reconsidered.

[231] Rees, Judith, The International Oil Industry, London 1987 P 60
[232] Sometimes known as the "Tax and Royalty System"

An example of these changes was the establishment of OPEC in 1960, with its Resolution XVI, passed in 1968, requesting the alteration of previous contractual terms to include gradual increases of state control, of 51% by 1983. As the result of this alteration, by mid-1970's, most member-states were able to partially or fully control development operations.

3.2.1 Typical Concession Agreements Concluded prior to the 1950s

The two following examples demonstrate the typical terms of Middle Eastern concession agreements made before the 1950s.

Under a concessionary contract signed between the King of Saudi Arabia and Standard Oil of California in 1933, the foreign contractor had to pay 50,000[233] pounds of gold to the King in return for a concession covering 500,000sq/km for a 66 year period.[234] The initial agreement prescribed a yearly payment of £5,000 until exploration was successful. Apart from the 50,000 pounds of gold loan to the government, once oil was discovered Aramco was also required to transfer a fee of four shillings per one ton of output, and to build a refinery, providing the government with a free supply of certain quantities of its products. As part of the deal, Saudi Arabian taxes did not apply to the activities of the company. In comparison to other contemporaneous contracts, the terms were fairly generous. This was due to Saudi Arabia's desire to increase foreign investment, and also reflects its bleak prognosis for future exploitation potential.

[233] In 1933 the British Pound was worth about US$4.87; there were twenty shillings to the British pound.
[234] Standard Oil of California passed this concession to an affiliate called California-Arabian Standard Oil Co. (Casoc) in 1936 with the company having no success at locating oil, the Texas Oil Company purchased a 50 % stake of the concession.

This agreement was modified a number of times. The first modifications were made in 1939 after the discovery of oil in 1938.[235] When oil was discovered in 1938, the company's operating territory was boosted while the time scale was extended until 1999, in return for increased fees to the government, as well as an increased donation of fuel to the authorities. [236]

In 1950, the contract was amended to include a split of the fiscal gains down the middle, in the form of taxation on each oil barrel. This change resulted in significant increase in the government's revenues from the concession. Further modifications boosted the state's portion of the profits, particularly after the 1970's. The process continued until the operations area was reduced to just 220,000 square kilometres .[237]

The same type of concession could also be found in the USA up to 1930 with single leases covering all property over a very long period of time. However, by 1930 the standard US contract varied significantly from the Middle East concessions. Leases would expire if no production occurred after a specified number of years. Also incorporated in the new contracts was a clause specifying a production royalty of 8%.

From the 1950s onwards many Middle Eastern contracts were renegotiated. As mentioned, this was initiated by Saudi Arabia and its attempt to change its income from the ARAMCO Concession. The original contract stated that the government should receive 21 cents per barrel at a time when the barrel sold for over US$2. Under the new agreement profits were shared fifty-

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[235] After a long search for oil that lasted around four years without success, the first accomplishment they had was in Dhahran in 1938, a well referred to as *Dammam number 7*. The discovery of this well gave the company the hope to continue and flourish. The company name was changed in 1944 from California-Arabian Standard Oil Company to Arabian American Oil Company (or Aramco). In 1948 Standard Oil of California and the Texas Oil Company were joined as investors by Standard Oil of New Jersey who purchased 30% of the company, and Socony Vacuum who purchased 10% of the company, leaving Standard Oil of California and the Texas Oil Company with equal 30% shares.

[236] In 1973 the Saudi Arabian government acquired a 25% share of Aramco, increased this to 60% by 1974 and finally acquired full control of Aramco by 1980. In November 1988 the company changed its name from Arabian American Oil Company to Saudi Arabian Oil Company (or Saudi Aramco).

[237] Federal Research Division of the Library of U.S Congress/ case of Saudi Arabia
http://www.country-studies.com/saudi-arabia/oil-industry.html

fifty between the parties, and the firm had to pay a royalty. The Iran and Iraq concessions underwent similar changes.

The production of Iranian petroleum had commenced in the very beginning of the 20th century, with the grant to foreigners of exploration and exploitation rights. The most remarkable role was played by the aforementioned D'Arcy, an English businessman credited with finding an oil field in Masjed- Soleyman. This finding allowed the creation, in 1909, of the Anglo-Persian Oil Company, renamed the Anglo-Iranian Oil Company (AIOC) in 1935.

Rows over contractual terms have arisen practically in the beginning of the relationship between the Persian authorities and this firm. In 1920 they reached an interpretative agreement, which temporarily solved their problems. During the Great Depression,[238] however, revenues fell sharply and Iran cancelled the concession. In 1932, Britain appealed to the League of Nations, pressuring the parties into making a weighty alteration into the first agreement between the parties. This amendment was the commitment to pay a fee, per ton of output, in addition to the royalties. The result of these negotiations was that the area covered by the concession was reduced by about 80 percent, and minimum payments to the government were established. In return, the life of the concession was extended by 32 years (until 1993).

However, this was not enough, and disputes continued regarding the contractual provisions. In 1951, the Iranian Parliament chose to nationalise the entire economic area encompassing oil production. In 1954, the authorities changed the AIOC's name into 'Consortium' so as to show its varied ownership between those of different states. [239] The contract granted to this

[238] The Great Depression was an economic slump in North America, Europe, and other industrialised areas of the world that began in 1929 and lasted until about 1939. It was the longest and most severe depression ever experienced by the industrialised Western world.
[239] 40-percent ownership held by British Petroleum, 14 percent by Royal Dutch Shell; 7 percent each by Gulf Oil, Socony-Mobil, Esso (later Exxon), Standard Oil of California, and Texaco; 6 percent by Compagnie Française des Pétroles; and 5 percent by various interests collectively known as the Iricon Agency.

organisation was only to end in 1979, subject to discretionary extensions of 15 years. Nonetheless, in 1973 following a suggestion by the Iranian authorities, the organisation produced an additional entity for the promotion and retail of the country's petroleum output. As compensation, members of the original organisation were entitled to the status of protected purchasers in relation to 20 years worth of oil.

During the Islamic Revolution, in 1978, strikes in the oil fields caused disruption to the Agreement. Petroleum exporting was not resumed until the monarchy departed in 1979. After this, however, the NIOC cancelled the 1973 amended contract, proposing instead a 9-month, special contract for the supply of oil which would be the precursor of them losing their privileged status as purchasers. [240]

After the Islamic revolution, the new constitution put an end to the possibility of concession agreements with Iran. Article 81 declares that:

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

The case of Iran shows that the concession agreements did not serve the needs of the parties adequately, and led them, after a number of re-interpretations and amendments, to conclude their contract in an entirely different manner.

Although the concessionary contracts had, in the past, been more than adequate for the oil companies dealing with Iran, both their desire to maintain the original concession and their willingness to renegotiate can be explained by the following factors.

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[240] ITA, Iran Concession Agreements, data as of December 1987 [http://www.photius.com/countries/iran/economy/iran_economy_concession_agreement~269.html]

Firstly, knowing that the original terms were unreasonably favourable towards themselves, the oil companies were worried that a refusal to negotiate new conditions could result in an increase of hostility and distrust towards foreign firms, potentially resulting in the nationalisation of the industry and the loss of assets.

Second, the terms of the concession were so weighted towards the oil companies that even much less favourable terms would still result in profitable production. Therefore, the consortium was willing to flex to any arrangement, as long is it still allowed to reap the benefits of the vast oil resources in Iran. Because of the strong vertical integration of the oil companies, with access to the reserves they were still able to make profit despite heavy royalties and more unfavourable share agreements.

In conclusion, the typical concessions made in the Middle East, before the 1950s, were characterised by the following features.

- The development rights granted to foreign companies covered vast areas and sometimes even an entire country.
- Contracts were signed for long periods of time.
- The foreign contractor had complete control over schedule and the manner in which mineral reserves were developed. There was no requirement to produce set amounts. Hence, in times of low oil prices the firm could reduce production without incurring penalties. The host government had very limited rights, other than an entitlement to receive a production-based payment.

3.2.2 Typical concession agreements made after the 1950s

Most of the modern concession agreements used today developed from, and are exemplified by, the agreements that were made in Oman (1967) and Abu Dhabi (1974). They granted the foreign contractor exclusive rights to explore, develop, and export petroleum, however at the same time provided for shorter contract periods, work obligations, a relinquishment clause, higher royalties

and bonus payments. It became more common for the state or national oil company to participate actively in the venture. The restructuring of the concession system focused on three key factors:

- The level of control given to the foreign company
- The share of revenue to each party
- Rights and obligations of the foreign companies whilst in the country (e.g. work and investment).[241]

The following table is a brief outline of the most important concession agreements made in the Middle East and neighbouring regions, showing the duration of the contracts and the area covered.

Table 4: Concession Contracts Signed in the Middle East[242] and Neighbouring Regions

Country	Name of Contract	Year of Contract	Duration	Area Covered	Year of Termination
Iran	D'Arcy	1901	70 Years	Whole country less 5 Provinces	1970
Iraq	IPC	1925	75 Years	450 km^2	2000
Saudi Arabia	ARAMCO	1933	66 Years	793 km^2	1999
Kuwait	KOC	1934	75 Years	Whole Country	2009
Qatar	QPC	1953	75 Years	Whole Country	2010
Abu Dhabi	ADPC	1939	75 Years	Whole Country	2014
Dubai	ADMA	1953	65 Years	Whole continental shelf	2018
Sudan	Chevron	1974	18 Years	Southern Sudan	1992
Kazakhstan	Turan	2001	25+Years[243]	22,000 km^2	2026
Chad	Energem	2004	50 Years	8,200 km^2	2054

The rise of OPEC in the 1960s and the growth of smaller 'independent' oil companies changed the situation somewhat. Despite numerous compromises and new arrangements in the late 1960s to early 1970s such as the Tehran agreement on prices, OPEC states acted unilaterally to take

[241] Bindemann, Kirsten, Production-Sharing Agreements, an Economic Analysis, Oxford University, October 1999, http://www.oxfordenergy.org/pdfs/WPM25.pdf
[242] "Autopsy of the Oil Contract (Buy-Back)" collection of articles by Dariush Mobaser et al, 2000, pg. 24
[243] The contract is subject to renewal upon expiration on unspecified terms and for an unspecified duration.

over pricing and as a result the old concessionary regimes came to an end by around 1974. The trend in the Middle East is of state ownership, control and operation.[244]

In the mid 1960s the Indonesian government introduced production-sharing agreements, as a consequence of antipathy to the presently utilised scheme of concessionary agreements. This is discussed in detail in the following section.

3.3 Contractual Systems

In order to assess the competitiveness and attractiveness of buy back contractual framework in the context of the oil market, it is necessary to comprehend and analyse the alternative systems available for such transactions. In this section, the most significant elements of the alternative systems are highlighted, the various frameworks' legal bases considered and their attractiveness and legality relative to buy back is analysed. The results of this analysis is subsequently summarised within the concluding section, along with a conclusion regarding their viability within the context of Iranian law and other factors.

3.3.1 Production Sharing Agreements (PSAs)

Agreements on production sharing are legal instruments regulating the relationship of a government with commercial partners, in the petroleum extraction industry.

Within the production-sharing scheme, the authorities retain the resources' ownership while hiring the IOC for the provision of technological and investment utilities for the various phases of the production process. The government party is ordinarily acting through the proxy of a national petroleum authority. Consequently, the IOC is granted a pre-defined percentage of the petroleum output so as to compensate it for the risks endured and any facilities and services utilised. The remainder of the output is nonetheless owned fully by the government party.

[244] Rees, Judith, The International Oil Industry, London 1987 P 61

Furthermore, the state party is afforded the ability to involve themselves in certain stages of the exploitation and exploration operations, ordinarily with a common governing body to supervise and direct the process.

An assessment of the PSA must begin with a review of its background. The first PSAs were utilised in Bolivia within the early 1950s.[245] Their application was met with gradually increasing support amongst the large petroleum firms, following application in Indonesia a decade later.

In the case of Indonesia, PSAs were introduced in 1966, at a time when nationalist sentiment was resulting in antipathy towards outside companies and the authorities no longer wished to provide concessions. As a response and due to a need for foreign investment and oil profits, the legislature passed laws permitting PSAs as they were seen as ensuring the state's continuing possession of the resources. [246]

Some scepticism was seen from the companies involved in this area of commerce, due to their inability to either legally possess or manage. A further source of anxiety was that an acceptance of such conditions in Indonesia may lead to similar demands for PSAs elsewhere. During this period of hesitation by the large companies, several smaller firms exploited the opportunity to both conclude a profitable arrangement and to wrestle some commercial power from the major companies. In practice, the IOCs usually found that they maintained direct control of the oilfields.

The eventual acceptance of such arrangements led to their propagation throughout the world, other than Western Europe, as only Malta utilises PSAs in its operations there.[247] Productino-

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[245] Irina Paliashvili, Legislation on Production Sharing Agreements, 14th September 1998; http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm
[246] Barnes, 1995
[247] Kirsten Bindemann, Production-Sharing Agreements, an Economic Analysis, Oxford University, October 1999, http://www.oxfordenergy.org/pdfs/WPM25.pdf

sharing is the preferred system within 52 states, including Angola, Libya, Egypt, Malaysia, Peru, Syria, the Philippines as well as many other countries. The Community of Independent Nations (CIS) has, of late, also begun utilising such arrangements.[248]

3.3.2 Description of the key components of a PSA

Within the PSA context, the duties and responsibilities are divided as follows. The legal possessor, in this case, the government, passes down the responsibility for locating and exploiting deposits situated within a certain, pre-defined area and during a pre-defined time span, subject to an eventual compensation payment. In the temporal framework of this arrangement, all risks are borne by the contractor, including any expenditures.

Standards for exploitation of the deposit are prescribed by the state party, particularly pertaining to expenses, nature of the activity and the time span involved. Such an arrangement yields a clearly contractual relationship, as between legally equivalent partners, with penalties agreed for any breaches of this contract.[249]

In the majority of countries in the world, the government has absolute control over any deposits, allowing them to grant access to the contractor to the exclusion of all others. It is noteworthy, however, that the rights transferred to the contractor are not without boundaries, as some bars on their activity do exist.

a) Only the type of operations agreed on within the contract are permitted

b) Only the deposits agreed upon may be extracted

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[248] CIS, Community of Independent Nations, was established by a treaty signed at Minsk, Belarus, on Dec. 8, 1991, by the heads of state of Russia, Belarus, and Ukraine. Between Dec. 8 and Dec. 21, the three original signatories were joined by Armenia, Azerbaijan, (its parliament, however, rejected ratifying its membership until 1993), Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan. When Georgia joined in 1993 all of the former republics of the USSR except the Baltic States had become members of the CIS. Its headquarters are in Minsk.(http://www.bartleby.com/65/co/CommonwelS.html)

[249] Dr. Irina Paliashvili, Legislation on Production Sharing Agreements

c) All other contractual provisions also serve as limiting factors [250]

3.3.3 The role of the state in a PSA

Such contracts are private contractual deals, agreed to by entities of equivalent legal standing with all provisions mutually agreed upon. However, it is important to remember the government participating in the contract does not forfeit its natural powers as a national representative; therefore retaining the obligation to exercise its legal powers for the benefit of the populace. It is possible for these functions to clash, particularly as positions are equivalent only within the agreement's scope while any law may be passed by the state that would affect the agreement. This is important, as whereas the host country has automatic entitlement to any production of petroleum by the investor, the investor may only gain such entitlement through the PSA.[251]

Under a PSA, the investor gains the ability to carry out operations within an area, but no proprietary interest is passed; meaning that the output always belongs to the government. Consequently, as the function of the investor is to act as a contracted/employed legal body on behalf of the government, its payment is composed of the output, emphasising the essence of such contracts, namely the distribution of the output.[252]

It should be noted that all activities envisioned within the PSA are carried out by the investor at their own expense and risk, with the state bearing very little of either. In a scenario where the foreign party injects money into operations related to discovering oil but no such deposits are found, or if the project is not viable commercially, then no refunds are possible for these

[250] Farshadgohar, op.cit., p.. 239
[251] Paliashvili, Irina Legislation on Production Sharing Agreements
[252] 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, September 14,1998 http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm

expenses. It is nonetheless possible to include a clause within the governing contract that would permit the compensation of these expenses.

A system known as the "point of measurement" is utilised with the purpose of calculating the amount of output and to divide it into appropriate shares. This system envisions that a point is chosen within the contract, such as the mine shaft exit, after which a portion of the output no longer belongs to the government but is rather used in order to compensate the investor for their expenditure (cost-recovery product). The remaining output is then split according to the proportions agreed by the PSA (profit product).

The PSA thus allows the state to receive a significant share of the output, without investing its own funds or taking any commercial risk.

The degree of taxation is largely determined by the terms of the contract. If the government receives high royalty payments and a large share of profit oil, common sense would suggest that little room is left for income taxation as this would provide a disincentive to the IOC. As the government's take increases, IOCs' financial stake in the enterprise is decreasing proportionally. As a general rule, if the only financial provision for the government is the payment of royalties, high income taxes will be imposed.[253]

Tax under the PSA is handled in a specific manner. A special regime applying to the investor throughout the duration of the PSA is agreed within the contract, so that general national taxes are substituted with a portion of the output.[254] This does not reflect any special tax privileges or

[253] Bindemann, K. Production-Sharing Agreements, an Economic Analysis, Oxford University, October 1999, http://www.oxfordenergy.org/pdfs/WPM25.pdf

[254] It is an important distinction that tax is levied on the share of 'profit oil', rather than on actual profits.

exemptions[255] granted to the investor, but is simply a replacement of monetary payments with an alternative payment.

Two schemes for substituting tax with alternative output are currently used. The first, used in Libya, is a complete substitution of all taxes by alternative output and involves a sharing of the output according to a 81/19 share. In light of the above, it is therefore clear that production sharing schemes safeguard the investor's wealth in relation to tax law changes, whilst doing the same for the state's interests.[256]

In conclusion, PSAs are attractive both for the state and the investor. The following reasons outline the benefits to states using the PSA:

- The PSA attracts substantial foreign investment into the exploration, extraction and production of oil, increasing the economic stability of the country, and ultimately its national security. In many oil producing countries, the government would not otherwise be able to afford the development of its oil industry.

- PSAs are generally long-term agreements, allowing states to forecast future expansion within the output rate of national deposits, enabling them to accurately plan their future budget.

- Whereas conventional tax is complicated to calculate and difficult to collect, the PSA allows the state to receive a prescribed share of the output, thus simplifying the process.

PSAs are also desirable for investors, as it protects them from fluctuations in the tax regime of a country. Considering that some agreements last many decades, this can make a big difference. The relationship between the foreign partner and the government are nearly exclusively

[255] In 2004, for example, the Russian authorities made public several such tax regulations elucidating the availability of certain tax exemptions under the Production Sharing Agreements scheme, with an emphasis on thorough documentary evidence for such exemptions. Brothers, C. 'Tax Exemptions Under PSA Regime'. *Internationa lFinancial Law Review*. March 2004, accessed 23rd July 2007.
[http://www.iflr.com/?Page=10&PUBID=33&ISS=12029&SID=512264&TYPE=20]
[256] Paliashvili, Irina op.cit.

contractually based (including the tax regime, as shown above). The stability of the legal relationships under the contract are thus of utmost importance to the investor.

3.3.4 Work obligations in Production Sharing Agreements

In continental Europe and in North America, in the early days of the oil industry, a landlord had the right to lease his land, including his ownership rights over the minerals contained in the land. The lessee would then automatically gain rights in petroleum Exploration and Production. The Persian Gulf later adopted this practice.

In exchange for the transfer of the above rights, a consideration was given to the landlord, ordinarily in the form of a significant cash payment, known as a Lease bonus. The landowner's Royalty further included a share of the future production, if the exploitation of the land proved to be successful. Usually, an annual rental fee was also granted to the landowner in exchange for using his land. This system, known as Cash Bidding, can be seen as an economically rigorous one.

This arrangement, also known as the Auction system, was largely discontinued following the Second World War, being replaced by the new Discretionary System of Licensing. In this system, the lessor of the petroleum, at this stage usually the government would give the rights to Exploration and Production to International Oil Companies (IOCs). This would occur subsequent to an evaluation of the competing bids, to be conducted by Ministry officials. The IOCs were obligated to pay a modest sum, in the form of a "signature bonus", and to legally dedicate themselves to conducting geophysical work and drilling one or several exploratory wells within the contractual area. Oftentimes, a further Annual Land Use fee was requested by the government. The term "Exploratory Well" was defined with extensive and precise technical qualifications.

Transaction costs of an oil contract are increased significantly due to the fact that details of the Work Obligation, namely the timing and definition of the Exploratory Well, are some of the most complex issues to be agreed in the course of the negotiations. The Work Obligation is commonly quantified in terms of a Dollar Expenditure Obligation, so that in the case of the IOC failing to fulfil its exploration commitments, the government can request compensation for the work not done, in cash. In such cases, the Work Obligation is valued by the amount of the Expenditure Obligation and consequently, can be considered to be the Consideration to be paid in exchange for the transfer of exclusive Exploration and Production Rights, for the duration agreed, in the appropriate area. English Law prescribes that a binding contract requires a transfer of Consideration and an exchange of offer/acceptance.

In a situation where the foreign oil company does not fulfil its contractual work, the Consideration is considered to not have been completely paid, resulting in the IOC, in its capacity as a Lessee, to be in default. The government can prevent itself taking financial losses in such cases by requesting either an Irrevocable Letter of Credit or a Bank Guarantee, which are easy to enforce. The amount of money the government will procure will depend on the proportion of the IOC's work which has already been conducted, as that amount will be subtracted from the sum acquired by the government. Such arrangements are standard and normal in international practice.

3.3.5 Production Sharing Agreements in Iran

Numerous monumental determinations pertaining to the development of the petroleum sector and cooperation with outside companies are taken by the Majlis Energy Commission (MEC). Dr.

Hossein Afarideh,[257] the MEC Chairman, discussed the official view on key issues about oil production and agreements in Iran.[258]

On the issue of the difference between PSAs and buy-back contracts, Dr. Afarideh said the following:

"[I]n a buy-back scheme the company carries out the project and is reimbursed from the sale of its production, but finance is in fact a sort of loan. You get the loan for development of your field and guarantee that you will pay it."[259]

He continues, saying that "[a]lso, in buy-backs, if the company fails to produce the agreed amount, it will be penalised and the reimbursement will evidently be less than earlier agreements. That is why these contracts are more risky in comparison with finance deals. But I have to say that the buy-back deals we have signed so far have had no risks, because we were all certain about the huge deposits of oil in those areas."[260]

He moved on, commenting on the PSAs that "we all know that there are legal restrictions [in the Iranian Constitution], but still, we are ready to offer PSAs for companies that risk investing in the Sea of Oman or Iran's 13 per cent to 20 per cent share of the Caspian Sea."[261]

On the issue of balancing the needs of Iran with the desires of foreign companies, Dr Afarideh had the following to say:

[257] Dr. Afarideh holds a PhD in nuclear energy and has served in different academic positions, including research directorate of Iran's Atomic Energy Organisation.
[258] 3/5/03 Interview: Iran ready to give Production Sharing Agreements. Source: Menas Associates' Iran Energy Focus, February 2003: http://www.payvand.com/news/03/mar/1026.html
[259] Afarideh, *op cit*
[260] ibid
[261] ibid

"I believe that each of the two parties has its own restrictions here. Foreign companies want to have long-term investment, while buy-backs are short-term agreements by nature. We are therefore changing them to medium-term contracts. Also, these companies want to have an optimal production when they discover a field and take as much oil as possible out of it. We don't disagree, but we want this to be done through buy-backs."[262]

In response to some complaints made by foreign companies that some Iranian development projects, such as the South Pars field, lack attractiveness in the commercial context, Dr. Afarideh said that:

"This is not true. This is their interpretation. We believe it is attractive, but they may want more. You know that more attractiveness means more concessions and it is natural that offers are not as attractive as they used to be in the early days."[263]

On the subject on the issue of whether Iran has the aim of adopting a different system of finance, he stated:

"Why should it? Buy-backs bring us no commitments, so why should we create debts for ourselves?"[264]

When asked about the problematic constitutional restrictions on PSAs in the aforementioned areas, Dr. Afarideh stated that:

"We will find a solution for that. You see, we will not overlook our national interests and will deal with problems when necessary. But for the time being we are not in an emergency, in the way that Iraq is. There are lots of companies working with us in the framework of buy-backs, so

[262] ibid
[263] ibid
[264] ibid

why should we go for PSAs, which have legal constraints and cause us problems? There are lots of companies that are ready to work with us even in the current situation."

As Dr Afarideh discussed, Production Sharing Agreements are restricted under the Iranian Constitution.[265] However, the Iranian Government is prepared to make these agreements with regard to certain areas, as long as the PSA is governed by terms that are compatible with the legal restrictions set out by the Constitution.

However, as I will discuss in chapter 5, the legal restrictions in Iran are such that if a PSA was twisted so as to comply, it would more closely resemble a buy-back agreement, and would have very little similarity with traditional PSAs as discussed in the chapter.

In an interview with IEF, Seyyed Mehdi Hosseini, NIOC deputy managing director made several remarks about the various advantages and disadvantages of PSAs.[266] He said that "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 oil discoveries, such as Iran. Therefore, the rewards can be huge and disproportionate to the risks."[267]

He commented that "from the viewpoint of an oil-producing country, contracts such as PSAs or concessions may be best when the potential for discovering oil is low."[268]

[265] These restrictions are defined in articles 44,45 and 81 of the Constitution
[266] The entire interview by IEF, Exclusive Interview: Mehdi Hosseini, National Iranian Oil Company Deputy Managing Director, Speaks Up (Part One), can be found at: http://www.payvand.com/news/05/may/1146.html, 05/19/2005
[267] ibid
[268] ibid

Given the low risks of exploration in Iran Mr. Hosseini indicates that one of the major advantages of the PSA simply does not exist in Iran. The benefits for the foreign investor for a PSA by far outweigh the benefits gained by an oil rich host country such as Iran where extraction is relatively easy.

3.4 Revenue Sharing Contracts

Revenue Sharing Contracts are very similar to PSAs; however the method of payment (to the investor) is different. Although, as in a PSA, the investor provides the capital and technical expertise required for exploration and development, in Revenue Sharing Contracts they are then paid via a defined share of the revenue rather than a share of the production. If exploration efforts are successful, the investor can recover those costs from the sale revenues.

Therefore, whereas in a PSA the IOC gets a share in the finished product, with a Revenue Sharing Agreement they essentially gain a stake in the oil after it has been discovered, but before production is finished.[269]

Under the current law in Iran, this type of agreement is not possible; and there is no evidence of any Revenue Sharing Contracts being concluded with regard to Iranian oil fields. The Iranian Constitution requires all natural resources to be owned wholly by the state, and no foreign companies are allowed to own any equity stakes:

> **Article 45**
>
> Public wealth and property, such as uncultivated or abandoned land, mineral deposits, seas, lakes, rivers and other public waterways, mountains, valleys, forests, marshlands, natural forests, unenclosed pastures, legacies without heirs, property of undetermined ownership, and

[269] Global unisource Inc, Glossary of Terms, http://www.globalunisource.com/glossary_of_terms_used.htm

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.

3.5 Joint Venture Agreements

In some situations, the state decides to participate as a commercial partner with the IOC, or as part of a consortium. These are known as Joint Venture Agreements, in which the state contributes a percentage share of the capital investment, receiving an equal portion of the "cost oil" and the "profit oil". The IOC's portion is subsequently separated as per the contractually prescribed provisions.

This agreement thus passes some of the risk and potential returns on to the government. Iran has a conservative outlook to Joint Ventures, and although they do not disregard them, they generally prefer to use buy-back agreements. In an interview with 'Iran Today' (a monthly magazine focusing on economics), Seyyed Mohsen Yahyavi, the government's representative in the Majlis and a part of the Oil Commission, compared the two types of agreement:

> On the whole, the foreign investor prefers to own part of the joint venture. In such ventures, for as long as the oil and gas well is productive, the investor will be a partner in the oil well; whereas in the buy -back system, the foreign investor owns no part of the well and once invested capital and interest is received, the investor leaves the premises.[270]

[270] Yahyavi,Seyed Mohsen Elaborates Upon, Iran Today; Economic Magazine (Monthly), 'Iran's Oil Performance, January 1998 [http://www.irvl.net/NET-Iran-OIL.htm]

However, the NIOC has in the past entered into such agreements, for example in 2001 when it signed two joint venture petrochemical deals, one with the Italian oil company ENI, and the other with South Korean LG Engineering and Construction.

Also in 2002, a joint enterprise with Abu Dhabi-based National Petroleum Construction Co (NPCC) and Iran's Naft Sazeh Qeshm (NSQ) was agreed in cooperation with Shell, in order to build the infrastructure required for the exploitation of the Soroosh oil deposit. According to John van den Bergh, General Services Manager at Shell EBV:

> It is the largest contract for surface facilities to be signed to date in the development of the Soroosh/Nowrooz oil fields...

In relation as to why that particular contractor was chosen for the project, he elaborated:

> ... The NPCC-NSQ joint venture was chosen because its bid for the contract was the best in terms of cost, schedule and level of Iranian content. NPCC-NSQ has demonstrated a real commitment towards the development of Iranian industry by researching the capabilities of Iranian suppliers who will be used to help fulfil this contract....[271]

In an interview, Dr Hushang Raissi, a chief executive of Tehran Berkeley, a prominent firm dealing with building services and engineering work, said:

> This is a long-term agreement. Our main aim is to capitalise on NPCC's expertise in offshore fabrications and to create an association between our two organisations to develop the Naft Sazeh Yard in the fabrication and installation of offshore facilities in the Gulf. It will also generate job opportunities and training for Iranians.[272]

[271] 'Shell in the Middle East', News, [http://www.shell-me.com/english/jan2002/news-me1.htm]
[272] Gas and Oil Directory, 18/01/2002 [http://www.gasandoil.com/goc/company/cnm20636.htm]

The above examples show that although Iran does not favour using Joint Ventures, they are willing to enter into them where the circumstances make it prudent to do so.

3.6 Service Contracts

Service Contracts cover agreements for specific work carried out by a contractor for either a flat fee or for a profit share in the final production. These agreements are called, respectively, the Pure Service Contract and the Risk Service Contract.

3.6.1 Pure Service Contracts

In Pure Service Contracts, specific exploration or development work is carried out by a contractor in return for a flat fee; the state takes all of the risk. In the Middle East, countries can often have the required funds, but need outside expertise and technology to develop their natural resources. The agreements usually cover a specific technical service to be carried out over a specific period of time. In most cases, the service company will only have to provide or pay for the equipment, tools, and personnel required to fulfil the contract. Reimbursement is usually fixed by the terms of the contract, and is generally not affected by either project performance or market factors.

The service provider is usually paid on daily or hourly rates, a fixed turnkey rate, or some other specific fee agreed in the contract. Payments are normally paid either on completion of the service, or at specific intervals. In some cases payment is tied to specific performance measures, for example operating cost reductions. In these situations, any risk taken on by the service company is usually limited to non-recoverable cost overruns or contract disputes (such as losses due to breach or default). As payments under Pure Service Contracts are not directly linked to production volume or market price, they do not usually contain reserve payments or agreements.

3.6.2 Risk Service Contracts

In the Risk Service Contract, the service provider also invests capital in the project. In all other respects this agreement is the same as the Pure Service Agreement, however instead of a flat fee, payment is based on the level of initial investment. These agreements almost always contain a reserve agreement that must be met before any payments are made.

Risk Service Contracts are typically used for operations which require not only expertise and technology but also substantial investment to improve.[273]

3.7 Buy-Back Contracts

As mentioned in a previous chapter, and as will be further elaborated upon in subsequent chapters, Iran's favoured type of oil contract is the buy-back. This is a short term contract, where the oil company receives a share of the profit from the government after production starts. Once the contract is over, the company/contractor must transfer all land and facilities to the National Oil Company.[274]

On entering a buy-back agreement, the IOC must provide all investment capital necessary to finance exploration or development of the field. Capital expenditure, interest charges, and the pre-agreed share of production are then repaid through the sale of the produced oil or gas. NIOC has a merely supervisory role. The respective shares for the two parties are calculated by translating gross production into gross revenue and deducting operating costs. Net revenue is then split according to an agreed formula. There are two stages to this process. In the first stage the IOC explores a field, after which the operation is either declared commercial or non-commercial. In the latter case the IOC bears all the risk and costs, and the contract is terminated.

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[273] Farshadgohar, op.cit., p. 239

[274] Mobaser, D., 'Kalbodshekafi Sarmayegozarihaye Sanate Naft, Beyeh Moteghabel, (Autopsy of the Oil Contract "Buy-Back"), collection of articles by et al, 2000, pg. 21

NIOC will declare a commercial discovery if the projected output results in a minimum rate of return after deduction of all capital costs, bank charges, operating costs and fees to the IOC. However, the IOC that conducted the exploration work will not necessarily obtain approval for the development of the field. It has merely the right of first negotiation with NIOC for the development contract. If the negotiations are successful a development contract is awarded, however if they are not then the contract will be tendered. In the second case, the IOC will receive its expenditure plus an agreed fee. Payment is made either directly by NIOC or by the IOC which succeeds in stage two. They in turn are entitled to recoup these costs within the scope of their contract.[275]

Unlike a PSA, at the first stage a buy-back agreement only offers the IOC an exploration contract, which even with a commercial discovery will not necessarily be converted into a development contract. The agreements have a relatively short duration of between five and seven years. The agreements contain ceilings on capital expenditure, which can only be raised for additional work approved by NIOC. The extra expenditure is then added to the initial capital costs and repaid under the amortisation period of the contract. The IOC receives its project expenditure plus a fee. The latter is a percentage of total capital costs excluding bank charges and operating costs.

Another important feature of the buy-back agreement is the treatment of price risk. If the revenue drops to a level not sufficient to cover the IOC's monthly entitlement, NIOC may reduce its share. If this is still not enough to meet the IOC's requirement, the amortisation period will be extended.

[275] Bindemann, Kirsten Production-Sharing Agreements, an Economic Analysis, Oxford University, October 1999, [http://www.oxfordenergy.org/pdfs/WPM25.pdf]

The key distinguishing feature, however, is that at no point does the contractor acquire title over the petroleum (unless they purchase it directly from the state).

Despite some similarities between a PSA and a buy-back contract, there are major differences, which render a buy-back-structure less attractive for potential investors, as will be discussed in detail in the next chapter.

The major criticisms of the buy-back agreement are a lack of flexibility and security concerning tax and investment issues (because of potential legislative changes within Iran), and the fact that all of the risk associated with exploration and development is taken by the contractor.

3.7.1 The Structure and Functioning of International Buy-Back Contracts

International countertrade can be concluded in a number of different forms. One of these structures is the buy-back contract, in which machine, equipment, knowledge or technical services are the subjects of the primary transaction and will then be utilised by the buyer in order to construct production facilities. As recompense for the services rendered above, the purchaser pledges to sell the supplier the end products.

Despite the fact that in its basic form, buy-back only involves two parties, it is possible for three-party and larger transactions to occur. One such instance, when goods in a buy-back come from a party that is not the primary-transaction buyer, is a case when the primary-transaction services are bought or hired by a third party, subsequently selling or leasing it to the producer company.

Buy-back obligations may be transferable, for instance when the original purchaser could either choose to sell the products himself or to transfer this responsibility onto a third party, thus

making them responsible for singing contracts that implement the agreement with the buy-back seller.[276]

As can be seen from the above example, international buy-back transactions may be very complex by nature, and the degree of their complexity determines whether they take the form of a single contract or several interconnected agreements. Such complexity may lead, on occasion, to contracts breaking international and national competition rules, due to the geographic limitations included in the contract, which renders such a contract unenforceable. Each contract must be analysed to determine if it is enforceable, although most buy-backs are less complex, as described below.

When the precise descriptions of the products can be referred to, and no third parties are involved, the form that the contract takes is usually that of a single contract, unless financing reasons prohibit the use of a single contract, in which case agreements collateral to the principal contract may be used.

Despite the flexibility in regard to the structure of the international buy-back, an element that is most often clearly defined within is the final date, which is the date by which all implementing contracts must be discharged.

Similarities exist in terms of the rights and obligations undertaken by the parties in a buy-back transaction and those involved in international sales contracts for technology and equipment. The crucial discrepancy, however, is the special relationship between the contracts in a buy-back, since in the latter, the party who sets up the operation is also contractually obligated to buy the end products of this operation.

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[276] United Nations Economic Commission for Europe, Model Buy-back Countertrade transactions, (http://www.jurisint.org/doc/html/con/en/2000/2000jiconen13.html)

If any disagreements occur due to the obvious complexity of the obligations undertaken by the parties, they will be resolved as per the pre-agreed law which will govern the agreements.

Before the governing law is resorted to, however, it is advisable to attempt to reconcile the clashing interpretations of the contract through negotiation. If a compromise cannot be reached amicably, however, international conciliation and arbitration procedures may be resorted to. The choice of arbitration rule and the arbiter, including the use of customised ad hoc arbitration, must be stated in the contract, along with the relevant procedure to be used.

3.8 Conclusion

The purpose of the wider examination of petroleum contract schemes conducted above is to provide a broader context to the buy-back contract by cataloguing and investigating the alternatives to the current model, used globally, such as Production Sharing Agreements and Concessionary Models, as well as Revenue Sharing and Joint Venture Agreements. Their function and legal bases have been examined to determine their compatibility and legality in the light of the Iranian contractual system and the restrictive laws. An analysis of their relative attractiveness has also shown that buy back schemes are amongst some of the least profitable for foreign companies, therefore, to some extent, justifying the IOC disgruntlement with the system. On the other hand, alternative frameworks have been shown to contain exploitative elements that have, in the past, been used to unfairly take advantage of Iranian natural reserves; thus, in turn, providing a rational context for the domestic authorities' unwillingness to adopt such frameworks.

Oil contracts are strictly regulated and monitored by the host countries' domestic laws, at all levels, from creating a legal framework for a foreign investment, to exploration, production and setting tax levels. Furthermore, a number of features that are integral elements of the various

alternative schemes have been shown to clash with the Iranian Constitution and statutes, particularly where foreign ownership of resources and land is concerned, further contributing to the assessment that, when limited by legal constraints, few alternatives exist to buy-back.

In order to determine the relative attractiveness of the various schemes as well as their viability within the political, economic and legal context of Iran, the major frameworks have been reviewed and analysed.

In the oldest scheme and the most common contractual scheme when dealing with states, the concessionary framework, the company assumes any risks, expenditures and fees, while being remunerated through a fixed portion of the output, with the deposits themselves not legally changing hands. Despite the common use of such setups, it is nonetheless impractical to implement them in Iran as they do not only infringe on the Constitutional limitations imposed specifically to combat them, but also rouse historical resentment over such frameworks' exploitation.

Production Sharing Agreements are greater in complexity than concession schemes, as they set out, in extensive detail, the regulations for the relationship between the oil company and the host state. Among the commitments taken on by the foreign company in such a context is the funding of exploration and exploitation while bearing the risk of an unsuccessful development, in return for compensation of costs and the sharing of the eventual output. Within the production-sharing scheme, the authorities retain the resources' ownership while hiring the IOC for the provision of technological and investment utilities for the various phases of the production process. It should be noted that all activities envisioned within the PSA are carried out by the investor at their own expense and risk, with the state bearing very little of either. In a scenario where the foreign party injects money into operations related to discovering oil but no such deposits are found, or if the project is not viable commercially, then no refunds are possible for these expenses. The high risk

incurred by the company where deposits are far from certain therefore makes this scheme of great attractiveness to a state party, as it exploits the IOC as a means of free exploration. However, within the Iranian context where deposits are ample and fairly certain, the PSA is not as attractive to the government, therefore leading to unwillingness to utilise it as an alternative to buy back. In addition to the practical considerations above, PSA's are contrary to the Constitution and statutes due to certain integral elements of the framework, and if a PSA was twisted so as to comply, it would more closely resemble a buy-back agreement, and would have very little similarity with traditional PSAs as discussed in the chapter. Furthermore, the inevitable proximity to buy back of the legally compatible version of PSA would not aid in the attracting of further investors due to its similarity to the existing scheme, but rather only decrease the legal certainty of transactions.

Following an analysis of alternative contractual frameworks and their relative advantages, as well as the impossibility of the use of several other schemes, and in order to be able to accurately analyse this system's flaws and suggest improvements, it is necessary to provide a comprehensive explanation regarding the legal basis, contractual provisions and comparative evaluation in the context of other international oil schemes.

Chapter 4: Nature and Legal basis of the Iranian Buy-Back Agreements

4.1 Introduction

As mentioned in the previous chapters, during the first half of the 20th century traditional concessions were the only form of Exploration and Production contracts used in oil agreements. A different scheme was introduced, in Venezuela in 1948, when the old concession format was upgraded. Whereas the original concessions only used royalty fees, the upgraded form made use of a more complex fee system. Such concessions continued to develop and be updated quite actively, especially with regard to the fees paid by the concessionaires. In the early 1960s, the first Production Sharing Agreement (PSA) scheme was agreed in Indonesia, a variation on the upgraded concessions that had been developing previously.[277]

In addition to traditional and upgraded concessions, buy-back agreements were established. This third model was introduced in the 1970s and was retained until the mid-1990s. By this time, only a few Latin American countries continued to use buy-back agreements. Before the end of the 1990s such countries had almost entirely replaced buy-back agreements with Concession-Contracts or PSAs. Iran in 1989 and Venezuela in 1993, however, reintroduced buy-back agreements to the world's oil and gas industries. However, following the general nature of the original buy-back, which originated in the 1970s, these agreements had evolved and were presented in a slightly amended form[278] (a more detailed comparative analysis of the original and the amended forms are located in Chapter 8 of this work).

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[277] Konoplyanik, A: "Concessions: from D'Arcy to Kozak", in Oil, Gas and Energy Law Intelligence (OGEL)Newsletter, Volume 1, Issue 01, 2003 (http://www.gasandoil.com/ogel/articles/roundup_06.htm) 3rd July 2006

[278] David. M. R. Hodgshon. S: "Production Sharing Agreements, the Commercial Implication of their Development" in : O.G.L.T.R. 1999 p. 302

Since the late 1980's, the buy-back financing model became the hallmark of petroleum transactions in Iran. The Iranian government sees it as an effective method of ensuring investment from abroad, as well as know-how, while minimising the costs of foreign exchange and expanding their export balance. Since their conception, a number of buy-back contracts have been agreed in relation to the oil and gas industry, and the Iranian government is intending to continue using this type of agreement in their future transactions.

The basic nature of the model being examined is that of a barter transaction,[279] where the necessary components such as machinery, structures, services and technology are supplied by the outside investor in return for the final products, resulting either directly or indirectly from those facilities. In Iran, however, the meaning of such transactions has evolved, as have their terms, therefore making it unique among buy-back agreements worldwide.

Their basic nature is defined in Iranian Law by Article 2 of the Executive Rules, ratified by the Council of Ministers. Such transactions are described within the Article as:

> ... one in which the supplier wholly or partially puts the needed goods and services for the establishment, expansion, reconstruction, improvement or continued production of manufacturing enterprises of the country at the disposal of the producer. The price of the said goods and services, after deducting the amount of down payments plus the related costs disbursed on the basis of the concluded contract, is paid to the supplier or buyer through the delivery of goods or services of

[279] A trade between two countries by which goods and services are exchanged for other goods rather than for hard currency.

the producer and/or through delivery of other industrial and mineral goods and services produced in Iran.[280]

Under a buy-back transaction in the oil industry, the contractor funds all investments, engineering, purchase and installation of major equipment and acquires compensation from the NIOC, as a share of the product, and subsequently returning oil operations to the domestic oil company after the contract expirest. Buy-back agreements, therefore, can be described as "risk-service" based, with the foreign contractor providing the funding while also taking on the risks. The compensation received by the investor, contractually pre agreed at a rate of, usually 15 – 17 %, and is paid in the form of a percentage of the product equivalent to the owed amount. The customary buy-back contracts[281] used in Iran are not the norm in other major producers, where the monetary income is divided instead.

Because of Article 81 of the Iranian Constitution, which prevents the government from granting concessions to foreign companies with the purpose of owning Iranian oil reserves, buy-back transactions take the form of service contracts. The buy-backs entered into by the NIOC thus far largely involve operation of offshore reserves, shared between Iran other Persian Gulf states. [282]

4.2 Definition of the Terms and Conditions

The contents of a standard buy-back contract should include the definition of all the rights and obligations conferred by the contract, particularly:

- Those related to the exchange of services and goods
- Concerning economic relationships
- Method of dispute settlement
- Requirements for performance

[280] Petroleum Iran, Iranian oil information portal (http://www.petroleumiran.com/buy-back.html) 1st September 2006
[281] As described in last section of this chapter
[282] Petroleum Iran, op.cit.

- Means of improving technical capabilities over the contract's duration, and related maintenance needs
- Amount of exportable end product
- A schedule of activities for cases of price, operational expenses and fluctuations of foreign exchange, over an extended time period
- Delivery of the imported/exported goods
- Providing teaching in technical matters to the specialist employees needed, and broadening the qualifications of the currently employed
- Stating a concrete end date of the contract[283]

In order to enhance the understanding of the buy-back contract, and the roles which each contractual party performs in it, the terms and terminology used should be elucidated. They are as follows:

- **The Supplier** is any natural or legal subject, who transfers to the NIOC, the technology, expertise and funds in a buy-back oil contract.
  The Supplier can either be an international or a domestic oil company; the latter must have been registered in Iran.

- **The Buyer** refers to the NIOC, acting under the authority of the Ministry of Oil[284] which, by receiving the abovementioned technology and services, undertakes the obligation of compensating the Supplier, in the form of a share of the end product.

- **Capital Costs**: the capital needed to fund all the direct expenses incurred during the development phase, payable by the investor. This term encompasses the following expense: engineering, purchase and installation of major equipment, service-provider fees, instrumentation, and secondary facilities, as well as buildings and structures. The

[283] Shoja E. Hosseini, Iran Mania Business & Economy, 10th August 2001 (http://www.iranmania.com/news/economy/features/buy-backoil/default.asp) 24th July 2006
[284] Also known as the Ministry of Petroleum

Buyer in a buy-back contract would not be responsible for footing any of the above expenses.[285]

- **Non Capital Costs:** Includes indirect costs accrued while operating the development, which are not covered by the capital costs category, for instance training and providing education to the employees, paying taxes and custom duties.[286]

- **Cost Recovery:** According to a standard buy-back contract, the foreign party is charged with developmental operations, as well as costs for exploration. In exchange, will be reimbursed for the expenditures (both funding and undertaken in course of operations) out of the output. The party in charge of operations is ordinarily compensated in the form of petroleum output and bears the risk of both exploration failure and market fluctuations.

- **Operating Costs:** the equipment required for the conduction of oil operations, including pipes, drilling machinery, storage equipment, drilling platforms and any other standard expenses related to the process of producing oil. This also includes the cost of maintaining the labour force, conducting repairs and supporting the related infrastructure.[287]

- **Petroleum Costs** refers to costs paid out by the foreign party, defined within the contractual document, pertaining to field operations.
- **Development Operations** means operations conducted with the purpose of developing the particular oil field and evaluating the oil deposit's size, which is the subject of the buy-back contract. This could include the following:

[285] Mobaser et al, op.cit., pg. 54
[286] Rabiee, Faranak, 'Hoghoogh-e-Gharardadha', (Contract Law), Tehran 1381, pg 76
[287] Ibid.

I. The development of wells, drilled for the purpose of such development; including any operations intended to enhance the quantity of petroleum being acquired, the means of storage or the method of transporting the final product.

II. The construction and establishment of offshore and onshore drilling platforms and their operation, which encompasses: machinery, implements, utensils and other articles required for purposes of producing and processing oil, as well as delivering it to the end source.

III. Any accommodation or living needs of the personnel, including administrative space, health care facilities and centres for training and education.[288]

- **Exploration Expenditure,** denotes all expenses stemming from exploration of the subject-area in a buy-back contract, including the following items:

  I. The acquisition of machinery and implement required for purposes of oil exploration, including drilling equipment and offshore platforms.

  II. All logistical expenses, including repair, property rent charges, labour and fuel, connected to oil surveys, with the exception of appraisal drilling

  III. The provision of training and education to Iranian citizens, for the purposes of training qualified technical staff, in order to prepare for the eventual return of the field to the Iranian authorities.

  IV. Expenses incurred that relate to maintaining of the original environmental condition, throughout exploration and exploitation of the oil reserves, and the prevention of pollution from resulting due to the operations.[289]

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[288] Farshad Gohar, Naser, 'Seyri Dar Gharardadhaye Naftiye Iran',(A Survey On Iran's Oil Agreements) Tehran, 1381, pg 262

[289] Mobaser, op.cit., pg. 56

V. Customs duty payments relating to the importing of supplies and equipment necessary for the conduction of oil operations (as per the conditions of the particular buy-back contract).

- **Development Phase** indicates the time frame during which the Company exploits the Scheduled Fields.

- **Effective Date** means the date of commencement of the contract, as agreed by the parties in a buy-back contract.

- **Master Development Plan** is the graphical representation of the future operations, including site plans and maps, accurately describing where and how the future operations will be conducted. It also includes contingency plans for emergencies such as earthquakes, requirements for the platforms' structural integrity, the route for the oil pipe network and a detailed time scale for the construction stages.[290]

- **Maximum Efficient Rate**: the highest possible rate of oil exploitation possible without causing physical damage to the field or a loss of oil pressure, as dictated by international practice in this field.[291]

4.2.1 Buy-Back agreements, as defined by the Council of Ministers[292]

In 2001 the Council of Ministers ratified the Regulations for conditions of buy-back contracts. This was based on a joint proposal submitted by the Ministry of Economic Affairs and the Iranian Central Bank, [293] as per Clause V of Article 85 of the Third Development Plan. The

[290] Rabiee, op.cit., pg 76
[291] Mobaser, op.cit., pg. 54
[292] A full translation of the Council of Ministers' Decree, No. H21560T/50991, can be found at: Petroleum Iran, 21/05/2006 [http://www.petroleumiran.com/buy-back.html]
[293] Central Bank of the Islamic Republic of Iran

Council of Ministers subsequently issued a decree, which contained a number of provisions which defined the exact nature of buy-back transactions.[294]

Article Two of the decree outlined the basic nature of the transactions to which it would apply:

> buy-back or counter transactions apply to the transaction methods by virtue of which the Investor undertakes to provide the Investment Receiver all or a part of financial facilities (in cash or kind) for the supply of necessary goods and services. This includes capital or intermediate goods or raw materials or services, for the purpose of establishment, development, reconstruction and improvement of production or services units. The facilities will be repaid including the principal and the resulting costs, through exportation of goods and services produced by the Investment Receiver.

Article Three stated that all profits acquired through buy-back transactions would be regulated by the "Law Concerning Attraction and Protection of Foreign Investment" and that within the framework of this law, guarantees will be granted against confiscation and nationalisation of both property and funds, in addition to the granting of additional protections against sudden changes in export laws.

This is further guaranteed by Article Four, which states that the government will not forbid the export of products or services arising from buy-back activity. If any changes in laws and regulations impede the implementation of contracts on the "export of mutually agreed upon goods and services", and results in the non-fulfilment of the Investment Receiver's[295] commitments, Article Five ensures that:

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[294] The Decree was signed by the First Deputy President Hassan Habibi on 29th January 2001

[295] "Investment Receiver" refers to any Iranian real and legal person who is engaged in establishing, developing, improving or reconstructing production or services units through foreign financial facilities in the form of buy-back

The matured instalments shall be paid to the beneficiary in accordance with the same foreign exchange stated in the pertinent contracts and in compliance with the regulations of the Law Concerning Attraction and Protection of Foreign Investment.[296]

With the purpose of ensuring the fulfilment of commitments to those investing, the Investment Receiver is authorised, under Article Six, to organise the exporting of all output from a single factory, manufacturing organisation/company. [297] The level of repayment (in goods or services exported to the Investor) is specified by the relevant domestic authority.

This is required under Article Seven, which also provides that the Organisation for Investment, Economic and Technical Assistance of Iran is responsible for notifying the Customs, Export Advancement Centre, Central Bank and the managing bank in order that the export of the said goods or services will be facilitated within the framework of all relevant regulations.

The foreign exchange earned by the export of the goods or services carries no obligation to return the earnings to Iran, and is exempted from any duties. These protections are guaranteed under Articles Eight and Nine.

Article Ten states that: "With regard to buy-back contracts, specific mechanisms should be devised for the following matters:

- The manner of fulfilment of the Investment Receiver's commitments to the Investor
- The manner of determining the price of the goods or services within the transaction

contracts for the purpose of importing services, raw materials, intermediate and capital goods in order to implement production and services operations in the country, and shall directly or through any other real or legal person pay for the received goods, services and financial facilities by exporting goods and services and delivering the same to the investor. (As defined in Article One of the Decree)

[296] Petroleum Iran, about Buy-back agreements, (http://www.petroleumiran.com/buy-back.html) 18th May 2006

[297] Plant is the industrial or other installation where products are made.

- Necessary arrangements for settlement of accounts of the contracting parties
- The method of mutually acceptable inspection for quality control of goods or services to be exported
- Appointment of the inspector for examining the quality of equipment, machinery, goods or services."[298]

The decree allows for all contracting foreign investors, and their representatives, to be issued with multiple entry visas (for the purpose of the contract), and Article Twelve requires that the Ministry of Foreign Affairs adopts suitable measures to issue these.

Article Thirteen restricts any changes to the contract which may affect the financial commitments of the parties, and states that:

> Any amendment, alteration or extension of the contract which may cause changes in the financial commitments of the contracting parties, shall be permitted only after the declaration of opinion of the Organisation for Investment, Economic and Technical Assistance of Iran and ratification of the related Ministry and the independent organisation.[299]

4.2.2 Resolution of issues arising under the Decree

For the purpose of accelerating the procedure for buy-back operations governed by the aforementioned regulatory standards and to ease the process of resolving problematic issues, Article Fourteen of the decree requires that a committee board should be formed. This must be comprised of representatives from the Ministries of: Economic Affairs; Commerce; and Foreign Affairs; as well as representatives from the Management and Planning Organisation, the Central

[298] Petroleum Iran, [http://www.petroleumiran.com/buy-back.html] 21st May 2006
[299] Ibid.

Bank, and the Iranian Chamber of Commerce, as well as Industries and Mines. Depending on each case, other pertinent organisations may also have their own representatives.

This board must adopt measures to pursue and obtain reports on the performance of all buy-back projects, and gather and analyse pertinent issues. They are responsible for proposing amendments to resolve any problems or difficulties, either in more general terms or with a view of the specific circumstances of the disagreement. These proposals are then forwarded to the related authorities to enable them to make the appropriate analysis and conduct the necessary actions.

In case a Council of Ministers order is required, due proposals must also be presented to the Council of Ministers' Secretariat, which is situated in the Organisation for Investment, Economic and Technical Assistance.

4.3 The Relevant Iranian Laws with regard to buy-back Transactions

Iranian law is based on the Islamic Shar'ia law, which causes all legal provisions to be derived from the principles of Islam as defined by the Constitution. The lack of separation between church and state means that all regulations have to be approved by religious bodies as being within the principles of Islam. The consequences of this are considered here.

4.3.1 Iranian Constitution

Perceived by many investors as being prohibitive, Iran's laws derive from the Constitution of the Islamic Republic. The Constitution is a direct derivation from the clerics' interpretation of the Holy Islam, which primarily declares that only God is sovereign and has the right to legislate.[300] Under Article 4 of the Constitution, all legal provisions should stem from principles of Islam.

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[300] Ule, Christian& Brexendrorff, Alexander, 'Investing in the oil & gas Industry', Mena, 2005, P 12

> All civil, penal, financial, economic, administrative, cultural, military, political, and other laws and regulations must be based on Islamic criteria. This principle applies absolutely and generally to all Articles of the Constitution as well as to all other laws and regulations, and the fuqaha' of the Guardian Council are judges[301] in this matter.

Due to the Islamic legislative base of Iranian law, all buy-back contracts must be in accordance with Islamic criteria and this is supervised by the Majlis. This indicates that a certain religious factor will be persistently present while forming a contract with the Ministry of Oil. Accordingly, the buy-back model was introduced to negate these constitutional and religious restrictions and therefore provide a degree of certainty to the contractual parties.

When concluding an oil contract, a further notable characteristic of the Iranian political system is the existence of a power structure which is parallel to it, must be considered. For every institution of the state, a corresponding supervisory Islamic shadow exists, an institution which is oftentimes the more powerful of the two.[302]

The effect of this parallel power structure is that there exists a possibility of any contract signed with the Ministry of Oil being reviewed by the Majles. .

Article 43 of the Constitution aims to avert foreign economic domination over the country's commercial life. This Article stems from Iran's previous difficulties related to excessive foreign political power based on the foreigners' control over the natural minerals and the country's

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[301] It is a constitutional authority which reviews Majlis's legislation in order to ensure that the legislation is in accordance to the Sharia law and the Iranian Constitution. Legislation which is deemed to have failed this test is returned to the Majlis for revision. It is composed of 12 members, half of whom are clerics, appointed by the Supreme Leader, and the other are lawyers, who are nominated by the Head of the Judiciary and subsequently approved by the Supreme Leader. Only the clerics are permitted to vote on the compatibility of new legislation to Sharia law. Appointment occurs on a phased basis, so that every three years, half of the members are changed, but the actual term of service is six years. If no consensus is found between the Council of Guardians and the Maijlis, then the Expediency Council makes the final decision on the matter.

[302] Notably, the power of the President is overshadowed by that of the Supreme Leader and the Parliament (Majlis) is subservient to the Council of Guardians, which consists of eminent Islamic jurists.

economy. The following is an extract, relevant to issues of foreign investment, from the Constitution:

> The economy of the Islamic Republic of Iran, with its objectives of achieving the economic independence of the society ... is based on the following criteria:
>
> ...
>
> 5. The prohibition of infliction of harm and loss upon others, monopoly, hoarding, usury, and other illegitimate and evil practices;
>
> ....
>
> 8. Prevention of foreign economic domination over the country's economy;
>
> 9. Emphasis on increase of agricultural, livestock, and industrial production in order to satisfy public needs and to make the country self-sufficient and free from dependence.

Paragraph 2 of Article 44 prescribes that all large-scale and "mother" industries, as well as the mining of Iran's most economically-significant minerals, be encompassed by the state sector of the economy. Oil deposits are obviously included in the above state-controlled industries, and are therefore susceptible to stricter government control, as evidenced by the Article below.

Article 45 grants the Islamic government the authority to manage non-privately owned entities and resources, such as natural deposits, as they see fit.

> Public wealth and property, such as uncultivated or abandoned land, mineral deposits, seas, lakes, rivers ..., 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.

As the above Article makes evident, oil deposits are the property of the public and therefore any ownership or long-term granting of exclusive use of oil fields is in contravention of this Article.

Article 77 declares that "International treaties, protocols, contracts, and agreements must be approved by the Islamic Consultative Assembly."

For this reason, any buy-back contracts would have to be subject to Majlis approval. Generally, this power is delegated to the Ministry of Oil, which will make this decision. However, the Majlis has been known to take particular interest in specific contracts and review them itself, in order to ensure the protection of the public interest.

The most prohibitive Article, and the one which necessitates the use of buy-back as a means of side-stepping the Article's prohibitions, is Article 81 of the Iranian Constitution, which prohibits the legal ownership of oil and gas fields by foreign entities. It prescribes that:

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

This prohibition is absolute, and the government is not granted the power of consent to foreign ownership, subject to the passing of a parliamentary decree (this issue will be addressed below). The private ownership of minerals is illegal, as is their extraction unless these minerals will be subsequently utilised for the purpose of facilitating the state's commerce.

If the subject matter of the agreement is contested by the parties, the provision which is most influential and relevant in governing this process is Article 139 which reads:

> The settlement, of claims relating to public and state property or the referral thereof to arbitration is in every case dependent on the approval of the Council of Ministers, and the Assembly must be informed of these matters.

The same law elaborates on cases where a foreign participant is involved:

> In cases where one party to the dispute is a foreigner, as well as in important cases that are purely domestic, the approval of the Assembly must also be obtained. Law will specify the important cases intended here.[303]

In summary, the Iranian Constitution prohibits the direct ownership of Iran's mineral wealth by foreigners. Consequently, concessions and production-sharing agreements so commonly found in other nations with large oil reserves, including those outside the Middle East, are practically impossible to negotiate.

However, despite this, Iran does not have the requisite funds and technical knowledge to be able to implement all of the necessary projects without external assistance. To solve this problem, the NIOC proposed to establish the buy-back model, and this was confirmed by both the Council of Ministers and the Majlis, through the process described above.[304]

4.3.2 Iranian Petroleum Law

The Petroleum Law of 1987 authorised the government to control all activities related to the exploration and production of oil, outlining the functions and duties of the Ministry of Petroleum. Therefore, the oil industry in Iran is under strict government control. For a foreign

[303] The full translation of the Iranian Constitution, including the texts used in this Chapter, can be found at [http://www.iranonline.com/iran/iran-info/Government/constitution.html]
[304] Atieh Bahar, Oil & Gas Market Overview (http://www.atiehbahar.com/Resources/Oil&Gas.htm)

company to take part in any project, they must not only partner up with an Iranian company (with a maximum foreign shareholding of 49%), but they are also obliged to obtain the approval of Iran's High Economic Authority.

The updated Iranian Petroleum Law of 1997 allows the formation of agreements, by the Petroleum Ministry or publicly owned companies, with "local and foreign natural persons and legal entities". The prohibition of foreign ownership of minerals in the Islamic Republic has been interpreted to bar foreign control of reserves. Consequently, this interpretation dictates that foreign oil companies may only act as contractors to the NIOC, rather than the principals.

Article 2 of the above law reiterates that all petroleum reserves belong exclusively to the Iranian government, and thus its people, and are solely under government control, administered by the Ministry of Oil with Iran's best interests in mind.

> The petroleum resources of the country are part of the public domain (properties and assets) and wealth and according to Article 45 of the Constitution (of the Islamic Republic of Iran) are at the disposal and control of the Government of the Islamic Republic of Iran and all installations, equipment, assets, property and capital investments which have been made or shall be made in future within the country and abroad by the Ministry of Oil and its affiliated companies will belong to the people of Iran and remain at the disposal and control of the government of the Islamic Republic of Iran.

Jurisdictional control over the petroleum industry is granted to the appropriate Ministry, subject to regulations, in the remainder of this Article:

> The authority for exercising sovereignty and ownership rights over the petroleum resources and installations is vested in the government of the Islamic Republic of Iran which on the basis of the regulations, rights and powers prescribed in this Act shall be undertaken and executed by the Ministry of Petroleum in accordance with the general principles and policies of the country.[305]

Under Article 5 of the said law, any important contracts concluded by the Ministry of Oil must be subsequently ratified by the Council of Ministers so as to have effect. The Article proclaims:

> Conclusion of important contracts between the Ministry of Oil or petroleum companies and the local and foreign natural persons and legal entities and determination of the important cases shall governed by the By-Laws to be approved by the Council of Ministers upon the proposal of the Oil Ministry.

The fact that the legal limitations imposed by the Constitutions apply in this context is highlighted in the remainder of this Article:

> The contracts concluded between the Ministry of Oil and other governments shall fully conform to Article 77 of the Constitution of the Islamic Republic of Iran.[306]

4.3.3 Legal Basis for Buy-Back as Outlined in the Five Year Development Plans

The basic legal foundations of the buy-back transactions are found in the legislation of "The Laws of the Five-Year Economic, Social and Cultural Development Plans of the Islamic Republic of Iran", and the yearly Acts of the National Budget. Since 1989, the Development Plans have been renewed and updated every five years, with the fourth Development Plan having

[305] The full translation of the Iranian Petroleum Act can be found at: [www.alaviandassociates.com/documents/petroleum.pdf]
[306] According to Article 77 of the Iran's Constitution " International treaties, protocols, contracts, and agreements must be approved by the Islamic Consultative Assembly.(Majlis)"

been passed in 2005. Each of these plans contains provisions regarding the use of this contractual scheme in order to appeal to outside investors, in a number of sectors, and Iran's Central Bank of issues the regulations required for each particular arrangement. In addition, several annual national budgets[307] contain sections distributing the income from buy-back contracts between the different sectors of the economy.

The First Development Plan[308] contained Article 29, which allows the state party to utilise profits from petroleum contractual schemes, in the form of buy-back, in order to supply the funding for other budget-funded projects, particularly where manufacturing and exporting of goods are concerned, with the set maximum of ten billion dollars' worth of profit. [309]

Under Article 22 of the Second Five-Year Plan, [310] the government was permitted to participate in such arrangements, utilising the national fiscal institutions and banks, so as to boost Iran's output of exports while also providing funding for budgetary projects:

> When concluding contracts with foreign companies and contractors, the government must oblige the selling party to transfer the technical know-how, training and manpower for related activities. With regard to equipment and machinery purchases, utmost use must be made of the available manpower within the country.

[307] Budgets of 1993,1994,1997, 1998, 1999, 2000

[308] The Islamic Republic of Iran's First Five Year Social, Cultural and Economic Development Plan was implemented from the periods of March 1989 to March 1994. The primary objective of the First Plan was to remove the legacy of the economic burdens brought about by the Iraqi invasion of Iran. It was within this context that the First Plan envisaged an annual growth rate of 8%, the creation of some two million new jobs, the rehabilitation and expansion of new industry and greater de-centralization and private sector participation.

[309] Mobaser, D. Moje Dovom, "Second wave", ,2002 Kavir, Tehran, p. 110

[310] The Second Five-Year Social, Cultural and Economic Development Plan (hereinafter the 'Second Plan') was drawn up specifically with the achievements and failures of the First Plan in mind. As a result, following a one year delay so as to incorporate necessary revisions, the Second Plan has envisioned that for the period of March 1995 to March 2000, development and administrative expenditures will total $135.5 billion, greatly outpacing the expenditures accommodated by the First Five-Year Plan. The Second Plan was based on projected oil revenues of $86.5 billion.

In regard to the implementation of buy-back agreements, from the domestic angle, NIOC and its affiliated companies are responsible for putting the contract into force. Consequently, within the context of contractual agreements, the remuneration for imports of materials, equipment and the necessary professional expertise provided, is granted through permission for the final products' sale outside of the country. According to Article 22 to the Second Five-Year Plan Act, the fiscal and insurance institutions involved are obligated to provide any guarantees required to the supplying party, instead of adequate material guarantees of performance (such as the state party's properties, the goods produced or any other guarantees provided). The bank in charge of the arrangement would further contact the outside participant in order to ensure that assurances for the successful export of the output are provided. In turn, the involved bank has to fulfil their obligations to the supplying party, while failure to fulfil the contractual clauses by either party could result in the taking of possession of the guarantees provided.

With regard to government-owned or associated companies, local authorities and other state institutions whose commitments did not require the provision of a guarantee, payments would instead be taken from their funds directly so as to eliminate the possibility of a default. [311]

The Oil Ministry must issue an economic, technological and technical confirmation in order for a bank guarantee to be granted for a buy-back contract. It is also required that the managing bank confirms the agreement, after having considered the relevant fiscal interests and context, as well as the standing policies of Iran's Central Bank. By the term 'managing bank', any bank that is designated as such on the authority of the Central Bank, instructed to handle the arrangement's affairs. This institution is given the choice of either operating on its own or in cooperation with another authorised banks or establishments, capable of providing credit.

[311] Iran Trade Point 26 July 2006, (http://www.irtp.com/howto/Buy-Back/b10.asp)

Note B to Article 85 of the Third Development Plan states that in order to create a foreign currency policy for Iran which balances the need for settling the country's foreign debts with the acquisition of funds for internal investment, the state is authorised to acquire funds from sources settled outside of Iran, within the limitations imposed by the relevant budgetary Act. The outcome of this balance, by the end of the Third Development Plan, must be a difference between investment and debt of less than USD$25 billion. The Islamic Republic of Iran's Central Bank must enforce this policy while giving consideration to the following factors, as outlined in Part 1 of the Article:

> The timing of repayment... shall be made in a way that the annual repayment of such loans and obligations, excluding buy-back obligation, do not exceed thirty percent (30%) of the foreign exchange revenues upon termination of the Third Plan period. Priority shall be given to long term foreign finance.[312]

Moreover, part E of the same Article states that the relevant authorities must provide information on petroleum ventures, at the time of the annual budget presentation, to the Islamic Consultative Assembly (Majlis) and, subject to the latter's approval, execute these projects.

Furthermore, under Article 85, all schemes and plans related to buy-back transactions should be drafted by the relevant Minister and be ratified by the High Economic Council. In order for the above to be ratified, the relevant Minister must make a case for the importance of their role in the national economy.

[312] The full Translation of the Iranian Third Development Plan can be found at: http://www.irtp.com/laws/3socio-economic/11.htm

It is also noteworthy that contracts with a value of over USD$1 million, where a foreigner is one of the parties, must be put to tender, as described in part 3 of Article 85.

Article 14 of the Fourth Development Plan, which is to be in effect until 2010, the utility of the buy-back agreement as a means of formalising oil-related transactions has been reaffirmed once more. The other provisions of the Third Development Plan regarding settlement of foreign debts and the requirement for tenders (of contracts worth more than one million USD) have been included in the most recent Plan.

A further noteworthy element of the above is the instruction to the government to make known, to the Central Bank, any previously-undeclared foreign accounts that are credited as the result of buy-back transactions and their sizes.

The provisions discussed below establish the specific structure of the buy-back transaction from the perspectives of the two parties, as prescribed in the new Foreign Investment law.

4.3.4 The new Foreign Investment Law (FIPPA) and its implications for buy-back contracts

Iran actively encourages foreign investment in most sectors but requires the involvement of a local partner to whom a technology is transferred. Generally, the local partner is expected to have a minimum share of 51% in the project (because of the Constitution's restrictions) The Foreign Investment Act covers foreign investments including Buy-back contracts.[313]

[313] The Canadian Trade Commissioner Service, Sources of project financing, Iran (http://www.infoexport.gc.ca/ie-en/DisplayDocument.jsp?did=38473)

On 24th August 2000 the Majlis approved the initial version of 'Foreign Investment Promotion and Protection Act' (FIPPA), which is a governing act for foreign investment.[314] It was approved by the Expediency Council[315] in May 2002, after months of dispute between the Iranian Parliament and the Guardian Council. This law had evolved from the 1956 Law for the Attraction and Protection of Foreign Investment, which had similar goals of encouraging foreign funding. This law is seen as an improvement over the previous foreign investment law, although there remain ambiguities concerning the protection of foreign investors in oil & gas buy-back arrangements.

According to the 1956 law, the Iranian state encouraged investment by offering support from the authorities, particularly with regard to foreign companies being permitted to take their profits, in the original currency used, out of Iran. It further promised compensation for any instances of nationalisation due to a valid public interest.

FIPPA integrates the majority of clauses found in LAPFI. Nonetheless, its definition of 'investment' goes further, and is inclusive of certain funding setups, including buy-back, which were not represented within LAPFI.

FIPPA, moreover, widens the scope within which the legally protective effect is provided, as under LAPFI, funding of only certain projects from outside Iran were covered:

[314]The full translation of the FIPPA is available in the official website of the Iranian Embassy in London at: http://www.iran-embassy.org.uk/web/page/?jsession=&m=vp&i=58

[315]The Council is an advisory body for the Leader with an ultimate adjudicating power in disputes over legislation between the parliament and the Guardian Council. The Supreme Leader appoints its members, who are prominent religious, social and political figures. In October 2005, the Supreme Leader gave the Expediency Council "supervisory" powers over all branches of government, delegating some of his own authority as is permitted in the constitution. (BBC News, http://news.bbc.co.uk/1/shared/spl/hi/middle_east/03/iran_power/html/expediency_council.stm)

> ... development, productive, industrial, mining, transport or agriculture or for granting credit and financial assistance to Iranian firms engaged in the [aforementioned] activities can enjoy the privileges of this [law].[316]

Consequently, many vital areas were absent, including buy-back agreements, service sector funding, build-operate-transfer (BOT) schemes, and financing of foreign investments, among others.

Under FIPPA, "foreign investors who participate in investment schemes that are also open to the Iranian private sector can enjoy the protection and privileges of this law." It also extends full protection to investments in the areas of finance provision, such as buy-back transactions, project finance, BOT projects, etc. Consequently, the updated legal provisions ensure greater and wider protection for vital sectors of foreign investment.

As the previous law did not cover contracts for the provision of services due to the limited scope of the terms used, no legally protective effect was available in the context of such arrangements. However, the provisions in their updated form allow such an effect on a general basis, rather through the specifying of certain areas, therefore also being inclusive of buy-back arrangements.

Under FIPPA, the following relevant categories are considered foreign investment and afforded a protective effect:

- foreign currency
- Items and Assets of a technological nature
- Knock-down components (CKD) and semi-knock down components (SKD) (e.g. to be used for vehicle production), raw materials, etc.
- Tools and spare parts
- Fiscal gains adduced to the investment capital
- Other areas, subject to discretionary approval

[316] The full translation of this law can be found at: http://www.irvl.net/newforeigninvest.htm

The benefits of being registered as an investor, per FIPPA, are as follows:

- Nationalisation is permitted only where a national interest is being pursued, legal regulations are followed, a non-discriminatory procedure is used and fair compensation is provided, calculated as the real value of the property prior to the occurrence of nationalisation.
- Foreign investors will be affected by regulations just as they affect local participants, including any benefits and exceptions
- General laws of Iran will not be applicable to areas where travel of foreign employees is concerned
- Foreign funds and providers of such funds are entitled to the advantages provided within the law until a more advantageous legal instrument is ratified
- Disputes between investors and the government are to be resolved in a manner agreed by the parties. It follows that the investor may choose the jurisdiction for foreign arbitration, under certain circumstances.
- Pursuant to the approval of a relevant body, those foreigners are allowed to annually remove their earnings (following the payment of necessary taxation and other costs).
- The process of removing such earnings can be carried out in foreign currency or related goods.[317]

4.4 Shortcomings of the new Foreign Investment Law

Although FIPPA permits the funding of a broad range of industries, comparable to the scope available to local investors, there are a number of constitutional restrictions which still affect dealings regulated by this law.

As was already mentioned, Article 44 of the Constitution separates the economic structure into 3 areas: public, cooperative and private. Even though a technical interpretation of this article attributes 90-95% of the economy to the public sector, such a rigid reading does not correspond

[317] Ule, & Brexendrorff, op.cit., p. 14

to reality. Iranian firms have found it relatively easy to enter the many economic spheres not explicitly delineated as being open to non-public investments. Even the banking sector, which had been privatised by the government, is one of such accessible areas.

Where constitutional restrictions are involved, FIPPA does not clearly state if participants from outside Iran acquire protection of the law in such areas, even if, *de facto*, local investors are vigorously operating in such areas.

Under the Iranian Constitution, any participation of a public authority or entity in arbitration has to be confirmed by the Majlis. Therefore, even though the new law sets down dispute-resolution procedures, the foreign participant only has the option of ensuring the effectiveness of the contract's arbitration provisions if a dispute has already occurred, with a subsequent submission to the Majles. This gives significant discretion to the Majlis, resulting in foreign parties' further doubts regarding the security of their investments.

As an alternative to this doubt-filled process, the Guardian Council or another similar authority, could reinterpret the Constitutional provisions causing such difficulties. This tendency is already manifesting itself in some sectors of the economy, with the Guardian Council giving its approval to various laws which are in conflict with Article 44 of the Constitution, for instance the recent April 2000 Act allowing private bank ownership.

Taking into account the above considerations, one possibility is that Iran is already in the process of liberalising the Constitutional restraints so as to allow foreign activity in the traditionally publicly owned and operated areas.[318]

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[318] Iran Insurance Market Report; Insurance and Economic Magazine (Quarterly), Autumn 2000, Vol. 3, No. 1 (http://www.irvl.net/newforeigninvest.htm)

4.4.1 Shortcomings of Article 2 of FIPPA

Article 2(d) dictates that the areas into which foreign capital may be invested and the size of this capital must comply with regulations approved by the Council of Ministers. These pertain to "Crude oil and natural gas (exploration, extraction and transfer)." Exemptions from the abovementioned regulations are provided to foreign investments relating to the production of services and commodities for export purposes, but explicitly not for crude oil investment.[319]

Although 'downstream'[320] oil projects appear to come under FIPPA's protection for their share of the capital (for example, in case of nationalisation), the situation seems to be entirely different for 'upstream'[321] projects. Because such projects involve direct investment into finding and expropriating the oil, there is a constant threat of clashes with the provisions of the Iranian Constitution outlined above.

How buy-back projects would enjoy such protection under FIPPA remains unclear, since the relevant provisions make specific reference to "deprivation of national assets and property" within this context. Nonetheless, as in the contractual scheme being considered, the IOC never gains actual ownership of the oil itself, only the right to develop a specific field. Therefore, it is unclear whether an act of the government, which results in the premature termination of the buy-back contract, might be brought under the scope of the term 'nationalisation' within FIPPA's scope .

Article 2(d) states that the value of services and commodities resulting from foreign investments, compared to that of the services and commodities supplied to domestic markets, in every economic sector and in every field shall, proportionally, not exceed 25% and 35% respectively.

[319] Ule & Brexendrorff, op.cit., p. 32
[320] Downstream, in the context of the oil and gas industry, applies to the refining and marketing sectors of the industry.
[321] Upstream is a term which describes the exploration and production sectors within the oil and gas industry.

These proportions should be seen in light of Article 2 (b) and (c), highlighting the main fear of the influential political and religious circles in Iran, that foreign investments shall undermine Iran's national security and the public interest. The Article makes it clear that foreign investment shall not involve concessions to be granted by the government to foreign investors.[322]

The matters discussed above stem from Article 2 of FIPPA, which, in translation, reads as follows:

> Admission of Foreign Investment shall be made in accordance with the provisions of this Act and with due observance of other prevailing laws and regulations of the country, for the purpose of development and promotion of producing activities in industry, mining, agriculture and services, and is based on the following criteria:
>
> **a)** The investment brings about economic growth, improves technology, enhances the quality of products, increases employment opportunities and raises export amounts;
>
> **b)** It does not pose any threat to national security and public interest, or causes damage to the environment; and does not disrupt the country's economy, or jeopardise production from local investments;
>
> **c)** It does not entail the grant of concessions by the Government to Foreign Investors. 'Concession' stands for special rights, which place the Foreign Investors in a monopolistic position.

One of the most important requirements included is the delineation of the share of profits and commercial transactions for foreign as opposed to local investors:

> **d)** The ratio of the value of the goods and services produced by the Foreign Investments, contemplated in this Act, to the value of the goods and services supplied to the local market, at the time of issuance of the Investment License, shall not exceed

[322] Ule & Brexendrorff, op.cit.,p.32

25 percent in each economic sector and 35 percent in each field (sub-sector). The fields, and the extent of investment in each, shall be determined in the by-law to be approved by the Council of Ministers. Foreign Investment for the production of goods and services for export purposes, other than crude oil, shall be exempted from the aforementioned ratios.

Note to Article: The Law for the Ownership of Immovable Property by Foreign Nationals enacted on June 6, 1921 shall remain in effect. Ownership of land of any type and to any extent in the name of Foreign Investors is not permitted within the framework of this Act.[323]

4.4.2 Shortcomings of Article 3 of FIPPA

Article 3(b) places foreign funding, of any area, into the category of "civil participation", applying also to buy-back transactions in the oil industry within its protection. However, this appears to have the effect of placing buy-backs in direct conflict with the provisions of the Iranian Constitution concerning "mother" industries; oil & gas exploitation, exploration and export are supposed to be strictly state dominated.

However, a careful analysis of both FIPPA, and its Implementing Regulations (I.R.-FIPPA), suggests that up to a certain limit, even direct foreign investment into exploration and production falls under its protection.

The following is a translation of Article 3 FIPPA, containing the above provisions:

"…. Such investments may be admitted under the following two categories:

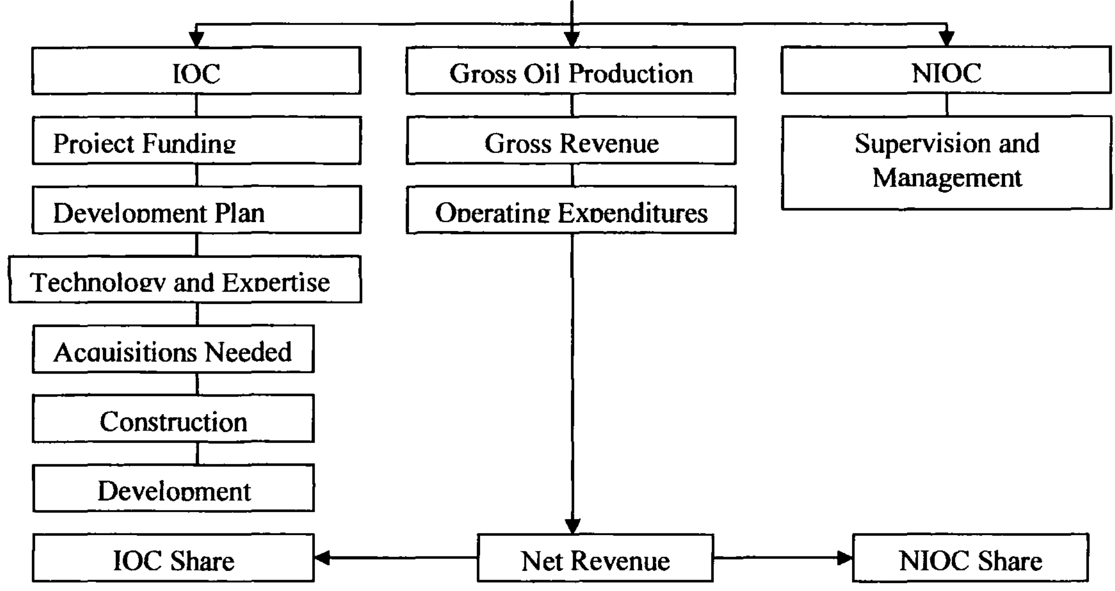
[323] The full translation of this Article is available on the website of the Iranian Embassy in the UK: http://www.iran-embassy.org.uk/web/page/?jsession=&m=vp&i=58

a) Foreign direct investment (FDI) in fields where the activity of the private sector is permitted;

b) Foreign Investments in all sectors within the framework of "Civil Partnership", "buy-back" and "Build-Operate-Transfer" (BOT) schemes where the return of capital and profits accrued is solely emanated from the economic performance of the project in which the investment is made, and such return of capital and profit shall not be dependent upon a guarantee by the Government or government companies and/or banks..."[324]

In conclusion, below is a graphical representation of the rights and obligations of foreign companies in the context of a buy-back agreement.

Figure 2: Legal Framework for Buy-Back Agreements



[324] Ibid.,

4.5 The Contract's Governing Law

The governing law under which the buy-back contract is formed can be of further interest to the parties, since it will regulate the conduct of their affairs. Four Articles within the Iranian Civil Code exist which pertain to this matter. According to Article 966:

> Possession, ownership and other rights exercised over moveable or immovable property follow the laws of the country where the things exist or are situated; nevertheless, the transfer of moveable property from one country to another cannot affect or limit the rights which persons may have acquired over those things in accordance with the laws of the country in which the things were first situated. [325]

Due to the principle stated in this Article, whereby the governing law of a transaction depends on the location of the object, oil, which, in case of buy-back transactions, is located in Iran, therefore, if no conflicting provision is included in the agreement, Iranian law will be used due to the location of the agreement's subject matter and the general principles of the local law. A further critical factor is the location where the buy-back contract was signed, as per Article 968:

> Liabilities arising out of transactions are subject to the laws of the performance of the transaction except in cases where the parties to the transaction are both foreign nationals and have explicitly or impliedly declared the transaction to be subject to the laws of another country.[326]

It can be deduced from the above provisions that the location where the contract is signed is a crucial factor when determining its governing law. Another important rule to consider is the fact that, according to Article 969, the method of formulating an agreement coincides with the law of

[325] Badrian, F. Attorney at Law, The Civil Code of Iran, Daneshvar, p. 269
[326] ibid p. 270

the place where the contract was produced. Consequently, the Iranian law resigns its responsibility over the model upon which the contract is based and the procedure for forming a contract, if the event of the formulation and signing takes places outside Iran. The existence of explicit provisions choosing a different governing law in the contract itself will not have legal effect unless all parties to a contract are foreign nationals. In such a case, an expressly stated choice of governing law will have legal effect.

With regard to a contract dispute, the governing law and court that are responsible for enforcement will be determined as per Article 971:

> Claims and lawsuits follow, in matters of competency of the court and of laws of procedure, the laws of the place where they are instituted. The fact that the same case or claim is already being decided by a foreign court cannot nullify the competency of the Iranian court.[327]

Generally, in the case of the occurrence of a contract dispute between IOC and the NIOC, Iranian law will govern the enforcement of the contract and any claims made in relation to it must be decided upon in the Iranian jurisdiction. However, an exception may occur if a different choice of governing law and jurisdiction is explicitly made in the contract. In such a case, the NIOC will comply with any contractual provisions relating to arbitration or court proceedings outside Iran. Further analysis of this important topic will be conducted within the Arbitration sub-section of Chapter 7.

[327] Ibid p 271

4.5.1 Laws regarding the registration and operation of foreign companies in Iran

The legislation that governs commercial transactions is, primarily, the Commercial Code of Iran.[328] The Code allows the operation of most business models, including companies, collective bodies and partnerships.

A foreign investor, however, will encounter difficulties when attempting to form a legal entity, of any form, in Iran. Such actions are prohibited by Article 81 of the Iranian Constitution, prohibits the registration and operation of non-Iranian companies within the country's jurisdiction:

> The granting of a concession to foreigners for the formation of companies or institutions dealing with commerce, industry, agriculture, services or mineral extraction is absolutely forbidden.[329]

The sole method, for a foreign company, to operate in Iran, is to forego the establishment of a company but rather to create this company outside of Iran and subsequently have a legal representative/branch office registered in the country. This action should receive specific approval from the relevant authorities, as dictated by the Registration of Companies Act 1931. This Act has been frequently amended and is used by the Ministry of Commerce when instructing the foreign companies as to the procedure for the establishment of a local branch. The granting of such approval is limited to those foreign firms that have a contract with the Iranian government or one of its state-controlled institutions. When the Iranian Parliament's approves the company's registration, it would be in the form of a decree, permitting the establishment of a local office of the company, with the sole purpose of fulfilling the contract that has been concluded. Furthermore, foreign ownership of Iranian property is possible as long as it complies

[328] Ghanoon-e-Tejarat

[329] The full translation of the Iranian Constitution is available at: http://www.oefre.unibe.ch/law/icl/ir00t___.html

with the Iranian law's requirements. The following is a description of this matter, suggested by the Iranian Embassy in London:

> Agencies or representatives of a foreign company or foreigners as legal persons or real persons are allowed to buy a property in Iran on the grounds that there is some reciprocal permission between Iran and the origin country of the buyers, but a company registered in Iran, even if all of its shareholders are foreign, can buy and own as much property as it wishes in Iran without any restrictions.[330]

In order to finalise the foundation of a business enterprise in Iran, the company must register either on the general or the commercial register, and the following documents must be included:

- A certificate from a government ministry or public authority, showing the existence of an arrangement with the non-Iranian firm
- A declaration of registration
- An officially approved copy of the company's articles of association.
- An officially approved copy, granting power of attorney rights , to the company's highest ranking executive in Iran
- A letter, instructing an Iranian lawyer to serve as a proxy in cases where he is assigned the procedures for registering the company's branch.
- Any additional company officials entitled to sign contracts or other legal commitments on the company's behalf.[331]

Further legal requirements for the foreign company are the keeping of separate books for the branch in Iran, as well as the appointment of a special company representative to the country.

[330] Embassy of the Islamic Republic of Iran in the UK. (http://www.iran-embassy.org.uk/web/page/?jsession=&m=vp&i=69) 30th November 2002
[331] For further details, see the Islamic Republic of Iran Ministry of Commerce explanation, found at http://www.irtp.com/howto/forgin/b12.asp

To summarise, a foreign oil company wishing to enter a buy-back transaction with the Iranian Ministry of Oil cannot establish itself legally within the country. Instead, it may be created elsewhere and then register a branch in Iran for their local operations, through the process described above. As is evident from the above list of required documents, the process of registration is prohibitively bureaucratic for foreign companies. This point will be further developed in the last chapter of this paper.

4.5.2 Legislation Related to the Taxation of Foreign Enterprises

For a foreign investor who wants to enter a buy-back oil contract in Iran, it is necessary to know about fiscal system enforced in the country. The majority of the taxes are either corporate or personal taxes on income. Investment in certain sectors, such as industry and mining and other production-related enterprises can enjoy tax deductions and other facilities, such as exemptions, with the purpose of encouraging foreign investment. The law which governs the extent and process of taxation for all legal entities, including companies and partnerships, is the Law of Direct Taxation of 1988. Tax is payable on the entire income of companies registered in Iran. Foreign companies' income, on the other hand, is taxable when it was received from Iran or earned in Iran. The government institution in charge of taxing, including customs and excise duties, is the Ministry of Economic Affairs and Finance. The evaluation of the amount of taxes to be paid is carried out by a district tax auditor, mandated by the aforementioned Act, who is a member of the relevant authorities charged with resolving such issues.[332] The basis for the evaluation of the magnitude of tax, to be paid by a local-foreign joint venture, are the book accounts of these companies.

[332] Iran Export, 26 July 2006 (http://www.iran-export.com/invcli/taxation.htm)

Amendments have been made to the Law of Direct Taxation by the Majlis, in 1992 and 2002. The amendments included a cut to the tax payable, a measure intended to promote domestic and foreign investment.

A flat rate of 25% taxing has been established in the amended tax law, deductible from the total income of domestic entities, whether it was earned in Iran or outside it. The foreign entities in Iran are obligated to pay the same flat rate on the income generated by investments in Iran or any other activities that took place there.

Tax cuts do exist for foreign companies contracted to conduct operations according to government contracts. The cuts apply to the expenditures incurred as the result of buying equipment and supplies outside Iran. Such exemptions apply to industrial and mining enterprises, where a six year tax exemption is granted, with the possibility of this period being extended if production is located in an economically deprived area of the country.[333]

4.6 Significant Elements of Iranian Buy-Back Contracts

The Iranian buy-back agreement resembles a variation on the standard risk-service agreement, specifically a short-term version of such an agreement. The agreement will ordinarily be concluded between NIOC and the contractor, composed of an international oil company or a consortium of such companies.

Under the agreement, the foreign contractor is in charge of the provision of Exploration and Production services and is subsequently reimbursed for these expanses, as well as rewarded, once the project begins producing an income.

[333] Iran Yellow Pages. 26 July 2006 (http://www.iranyellowpages.net/en/About_iran/Economy/foreign_investment/foreign_investment1.shtm)

The buy-back agreement is composed of two portions: the contract which pertains to the development stage of the oil field, known as the sample exploration service contract and later, a long-term oil sales agreement (LTEOSA), based on volume, which dictates the distribution of compensation and the amount of oil and/or gas which will compose the contractor's reward.

No cash return occurs in the course of a buy-back contract. The contractor's initial costs for developing the field, such as capital expenses, operating expenditures and accrued bank charges are then compensated by the NIOC, in the form of the final product. Moreover, a previously contractually agreed fee is granted to the contractor, ordinarily in the form of a share of the oil produced. Simultaneously, the contractor acquires procurement rights to a share of the crude, as well as the right to equity oil. The consequence of this arrangement is a positive effect to the corporate balance sheet. The size of the compensation is determined by the value of the rate of return, specified in the contract, which usually is about 15-18%.

The quality and value of the equipment and materials used by the IOCs in their operations are subject of evaluation by a mutually accepted inspection agency. The said agency's evaluation of the quality and value of the materials are binding on the parties and not subject to appeal.

In an effort to cut the bureaucratic and procedural length and expense connected to the implementation of buy-back contracts, a commission was formed of the major economic agencies' and ministries' deputies, tasked with providing supervision over such arrangements. This authority is entitled to make decisions which have legal force, and it is to be informed of ongoing buy-back deals by the banks involved.

In order to facilitate the smooth execution of buy-back contracts, and to alleviate the problems arising from this process, a board has been formed, consisting of deputy ministers of the Ministry of Economic Affairs and Finance, Ministry of Commerce, the Plan and Budget Organization, the

Central Bank of Iran, the Ministry of Oil, a representative of the managing bank and the Iran Chamber of Commerce, Industries and Mines. This board is the highest authority tasked with supervising buy-back transactions and producing decisions which are binding for all natural persons and legal entities. The board is headed by the Deputy Minister of Economic Affairs and Finance who is also in charge of banking and insurance matters. The managing bank must send a copy of all the final buy-back contracts to the board and to report the agreements' progress to them, on a monthly basis.[334]

It is possible to change the terms or renew the buy-back contract if the endorsement of the managing bank is procured and if such an amendment is permitted within the contract.

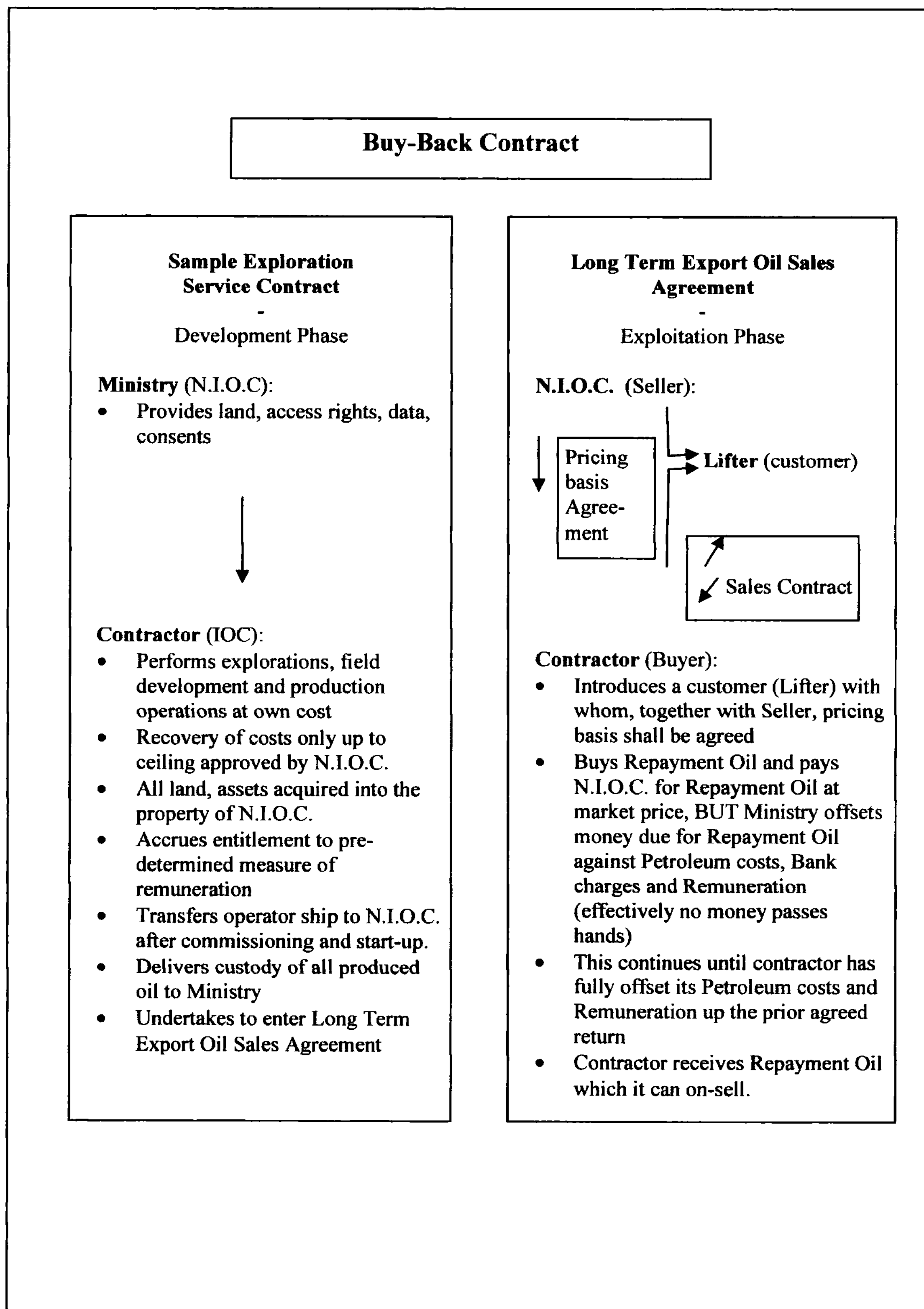
The long-term oil sales agreement will be discharged once the contractor has been fully repaid for its petroleum costs and the contractor has fulfilled all of his contractual obligations.
It is normal practice for the IOC to be obliged to conduct development for two to three years, and further conduct operations for a period of between five and eight years.

In summary, there exist two options for the contractor in an Iranian buy-back agreement. The contractor either concludes the full extent of work required by a full-cycle exploration and production project, or does so only for a development and production project. If the former is to be carried out, and in the process, the contractor discovers a commercially viable source of oil, then the NIOC and the contractor must negotiate the terms of the future development before it can be started. The two types of buy-back contracts, and the responsibilities and obligations which stem from each type are shown below.[335]

[334] - Petroliumiran.com, 'Buy-back', first accessed 05/07/2007 [http://www.petroleumiran.com/buy-back.html]

[335] Ule, & Brexendrorff, op.cit., p. 38

Figure 3: The Basic Structure of a Buy-Back Agreement



4.6.1 Procedure for Formulating a Buy-Back Transaction

The following are the possible outcomes after the development stage had concluded, according to the Model buy-back Exploration Service Contract:

1) If the exploration fails due to the absence of discovered oil or a discovery that is not commercially viable, the Explorations Service Contract is discharged and the exploration contractor receives no compensation.

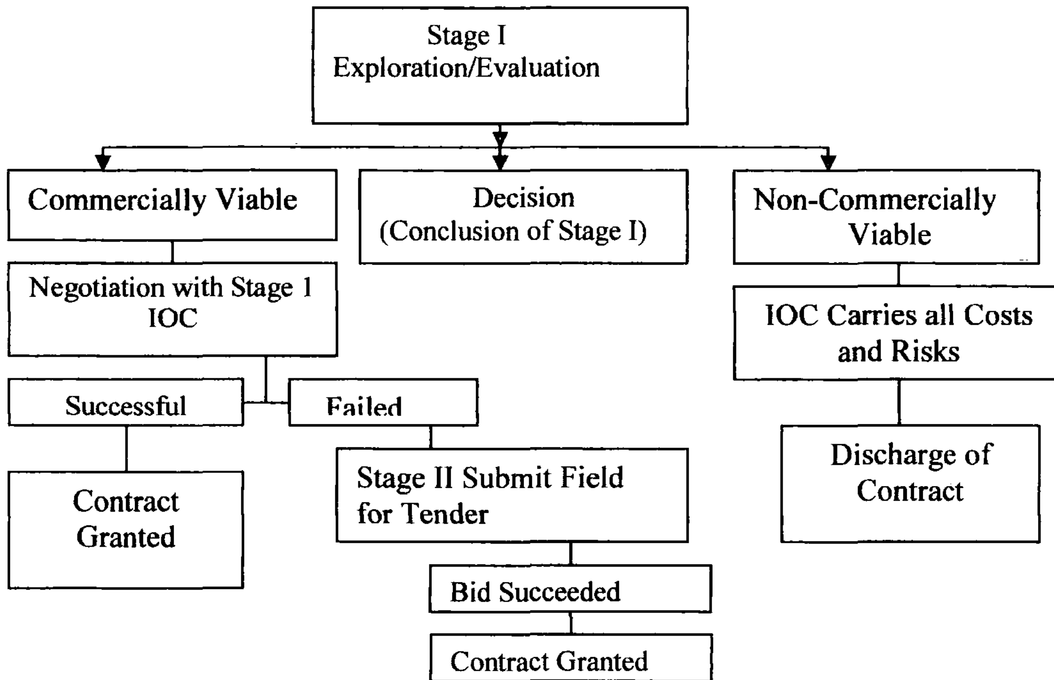
2) If the exploration is a success, then the contractor may negotiate the terms and conditions of the future Development Service Contract (LTEOSA), resulting in two possible outcomes:

a) If a Development Contract is concluded as the result of negotiations, then the contractor acquires the right to the overall negotiated Internal Rate of Return (IRR), as per the Development Services Contract; or

b) In case of failure to conclude a Development Service Contract (because of a breakdown of negotiations or the NIOC's discretionary choice to not carry out the development of the field), according to the most recent buy-back contracts, the NIOC will compensate the contractor, in the amount that was negotiated, encompassing taxes paid, expenses and bank charges incurred, as well as a compensation based on an IRR of about 15%.[336]

[336] Mobaser, D., op.cit., p. 54

Figure 4: Procedure for Securing a Buy-Back Contract



Further possible scenarios for a commercial arrangement, which may occur under a Buy- Back agreement, are as follows.

In the case of the commercial discovery's development by a third party, the original contractor has the right to at least 30% equity in the produced oil, as well as proportional compensation of the exploration expenditures and a contractually agreed reward.

If the exploitation of an existing discovery is involved (or both the appraisal and the discovery), the contractor submits bids, as well as a work plan for the project. If the contractor's bid is successful, he conducts the agreed-upon extent of work and after commissioning, the NIOC operates.[337]

[337] ibid p. 56

From the total duration of the buy-back contract, the amortisation period begins after development of the discovery commences and its commissioning. In the subsequent 5 to 8 years, the contractor must ensure its payback. While the amortisation period is ongoing, the contractor is granted a compensation amount equal to his costs plus interest, as well as a monthly remuneration. If a contractual provision exists for uplift, it will also be provided.

According to the Model buy-back Contract, a fine may be levied against the contractor if the project is not complete by the agreed deadline. No banking interest will be granted for the duration of the delay.

If the compensation fee and the petroleum costs are not completely compensated in the course of the amortisation stage, the contractor will instead receive crude oil/gas made from the field until the required fees have been paid, according to Article 22.4 of the Iranian Model buy-back Contract.

Despite the fact that initially, it may appear as if the contract would be guaranteed to receive the ROR, the previously negotiated duration of the Long Term Sales Contract still plays a limiting role (as per Article 3.3 of the Model buy-back Contract).

It would appear that the contractor is barred from maintaining long-term access to crude oil by the current structure of the buy-back. Theoretically, subject to Article 3.3 of the buy-back Model Contract, the contractor could initiate a series of continuous buy-back agreements, timed in a way which would maximise the return of the previous project, thus creating a stream of investment money which may be channelled into successive projects.

The duration of the agreement is a matter of negotiation, but is likely to be extended for several years. The maximum duration of the exploitation period must not be longer than five years, and

the sales agreement cannot exceed fifteen years, as dictated by Iran's Petroleum Act. Naturally, no guarantee exists that a series of projects will be offered by the NIOC in the above-described manner, nor are there guarantees that the IOC will be allowed to buy a production share.

4.7 Conclusion

As detailed in this chapter, the constitutional bars on foreign investment in Iran's oil sector have led to the conception of the buy-back model contract, as opposed to utilising other methods, such as joint-venture and production-sharing agreements. Since the introduction of the buy-back to the Iranian oil industry, in 1989,[338] numerous such contracts have been concluded and plans to sign further agreements are in the making. The international oil companies are not entirely enthusiastic regarding participation in buy-back agreements, as they consider them to be a "method of finance", as opposed to an oil contract. Nonetheless, several arrangements based on buy-back contracts have been planned between numerous foreign partners and Iran, such as Japan, China, India and Pakistan, as well as with domestic companies. Taking into account Iran's significant role in the international oil tender market and the limited capacity to conduct more business affairs with the global oil industry due to the restrictive nature of the buy-back, it is evident that the current model must be altered and further modernised. The Iranian decision-makers should consider all the criticism and concerns voiced by foreign and domestic participants and respond to it by amending the law. Any amendments made should reflect and address any reasonable concerns expressed by beneficiaries of the oil contracts. Such alterations are not uncommon in the international oil market, as other oil producing states frequently change their laws and policies in order to reflect the demands of the oil market. In the following chapter, the buy-back contracts would be critically analysed, in the light of the criticisms expressed by

[338] If the initiation of the First Development Plan is to be considered as the milestone at which buy-backs began.

both the foreign investors, who believe that the current arrangement is not sufficiently attractive when attempting to bring in foreign capital and technology, and domestic critics. The flaws of buy-back contracts will be further illustrated by case studies based on agreements previously concluded with foreign companies using this model. This precedent-based analysis will be the subject of a different chapter.

Having recognised the Constitutional limitations placed on any oil transaction occurring in Iran, as well as analysing the means by which buy-back contracts circumvent these limitations, it is logical to critically analyse the existing Iranian buy-back in order to determine which aspects of the framework are less attractive to investors than those of the alternative systems. Furthermore, as an oil transaction can only take place with the willingness of both parties, it is therefore also necessary to determine the concerns of the domestic party and suggest an optimal means of reaching a compromise on buy-back terms that would facilitate foreign investment.

Chapter 5: Critical Analysis of Iranian Buy-Back Contracts

5.1 Introduction

As buy-back contracts are a form of contractual relationship which governs transactions of tremendous scope and size, it is unsurprising that they have been the subject of intense critical scrutiny. Such criticism often advocates a diversification in the type of financing contracts that the NIOC employs, arguing that the buy-back model does not sufficiently protect the nation's resource reserves.

The alternatives to the buy-back proffered by its critics include BOT[339] type contracts, whereby private companies are granted franchises from the government to build and operate the resource developments for specified periods for which they are paid fees, with the field's operation being transferred to the public following the period's expiry.[340] A similar scheme, called BOOT[341] also includes an ownership transfer to the company at the beginning of the contract and a return at the end.[342] Another alternative, also aimed at maximally boosting a country's profits, is the use of bonds.

However, others critics propose that buy-back contracts are not perfect, but are nonetheless the optimal financing means, requiring only some alterations in their provisions. Their view is supported by practical and legal considerations, for instance the fact that in one of the world's top oil producers, Iran, Article 81 of the Constitution prohibits granting concessions in any industrial sphere, therefore limiting any changes to the financing schemes to alterations to the existing buy-back model rather than the use of a concession-based, alternative scheme.

[339] Build, Operate and Transfer.
[340] This scheme is used in countries such as Hong-Kong, Malaysia and Japan. [www.eforceglobal.com/ppt/eFORCE_BOT.ppt]
[341] Meaning 'Build, own, operate and transfer'.
[342] Lecture of Prof. Quiggin on BOOTs. [http://www.uq.edu.au/economics/johnquiggin/Conference/BOOT.html]

Nonetheless, it can be noted that even in such legally limiting circumstances, it may be possible to employ, on a case-by-case basis, certain other schemes such as the creation of partnerships with minimal risk.

The necessity for some change, whether revolutionary or evolutionary, is nonetheless evident as both foreign and domestic participants in oil contracts voice their grievances with the current scheme. Consequently, whether to satisfy the perceived need for greater profits for the domestic public as advocated by the domestic parties, or to ease the costs and efforts of oil fields' exploitation, as argued by the foreign companies, alternatives to buy-back contracts must be examined so as to determine their viability. In order to do so, however, it is necessary to evaluate the needs and grievances of domestic and foreign parties.

5.2 Risks of Buy-Back Contracts as Seen by IOCs

The issue of oil fields' developments in OPEC's second largest exporter, Iran, is complicated by the diplomatic and political ramifications of conducting such business in Iran. As the result of the potential for profit from exploiting Iranian oil reserves, political deterrents to oil-related economic activity with Iran, in the form of the 1996 US Iran-Libya Sanctions Act (ILSA) as well as the widespread unpopularity of buy-back with oil firms, have not prevented vigorous pursuing of oil contracts by European and Asian oil companies. As a result, 11.5 billion dollars' worth of oil and gas contract money has been secured since 1997; a necessary sum for the significant task of modernising the energy sector, harmed by both the Iraq-Iran War and the continuing US sanctions.[343]

[343]Payvand, 07/04/2001 [http://www.payvand.com/news/01/jul/1013.html]

Domestic political oversight is another factor limiting the introduction of serious alterations to buy-back contracts, as the Majlis utilises it's 'legal right' of Oil Ministry supervision so as to ensure no overly controversial oil deals are made, which could potentially result in a 'sell-off' of national wealth, while permitting the renewal of earlier buy-back permits and authorising NIOC to sign 7.5 billion dollars' worth of foreign buy-backs.

In order to emphasise the importance of improving the nature and thus the popularity of oil contracts in Iran, special attention must also be given to the increasing competition in the energy sector due to Iraq's reintegration into the world markets. On one hand, if Iraq employs a more investor-friendly scheme than that of buy-back contracts, it is entirely possible that investors may be lured away from Iranian fields. However, such an assertion is subject to the current reality that insufficient stability exists in Iraq for foreign investment to be appealing at present. Moreover, such competition is only realistic in the area of oil as Iran's natural gas reserves are vastly superior. Indeed, some argue that the process of Iraqi reconstruction may in fact boost the Iranian energy sector as this process opens a new market for Iranian products while at the same time offering contracting opportunities for Iranian companies in the course of reconstruction.

The contributing factors to buy-back's lack of support among foreign oil firms are numerous, but the most drastic and potentially damaging is the possibility of an oil field not being exploited, resulting in a lack of compensation to the IOC for both petroleum expenses and remuneration. The Ministry of Oil's discretionary and non-reviewable right to determine the commercial viability of exploitation significantly contributes to this risk, and may serve as a deterrent to business involvement.

A further area in which the domestic party's exercise of discretion may lead to risk for the IOC is the NIOC's freedom to refuse to grant exploitation rights to the IOC which discovered the oil

deposit; therefore permitting the NIOC to largely dictate the contractual conditions due to the power to exercise this discretion.[344]

5.2.1 Risks created through the structure of Buy-Backs

As the result of the domestic party's desire to limit its temporal obligations, the contracts are of a shorter length than the scope of an endeavour such as an exploitation of oil may suggest, only about 7-10 years, with an additional 5 years as a designated 'investment recovery period'. A technique has developed to partially circumvent this limitation, namely through concluding a number of successive contracts to enable the contractor to use the funds from the previous project to finance the next one. However, as contractual simplicity serves to lower both the costs and the time needed to conclude oil contracts, it is clear that this element of the buy-back model is in dire need of alteration.

a) A corollary risk to the duration limitation, especially in view of recent fluctuations in oil prices,[345] is that the agreed upon limit on the amount of oil lifted will be broken prior before the IOC is fully remunerated. One means of resolving this issue is including 'carry over' provisions whereby the IOC is allowed to acquire a larger quantity of oil within a specified time frame if the provisional amount was not sufficient; having the effect of decreasing the amount lifted in the period following the increased production. Arguably it is a deficiency of the model buy-back contract[346] that such a provision is not included, necessitating additional negotiation so as to ensure such provisions' presence in the final contract.

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[344] This is particularly relevant if the NIOC has cash flow problems at the time of discovery, and therefore does not wish to compensate the discoverer.

[345] It should be noted that this circumstance is less relevant at the present time, due to the elevated price of oil. However, it is possible that the prices may decrease once more and therefore exacerbate the risks described above.

[346] A sample contract for Buy-Back transactions issued by the Iranian authorities to standardise oil transactions.

b) The financial structuring of a buy-back contract creates an additional challenge, as per Article 11 of the Model Contract, assets acquired by the contractor will remain NIOC's property, subject to pre-determined purchases of oil and remuneration not being granted until the rescinding of IOC's control.

c) An additional dissuading factor for commercial involvement in oil fields is the possibility that the project costs may be higher than originally estimated, forcing the IOC to pay the difference, resulting in additional risk while the returns decrease. Even factors beyond the IOC's control, such as an unpredictable drop in oil prices,[347] can result in serious difficulty as the foreign company would be obligated to make up for the costs and agreed return by using a limited amount of oil. The buy-back contract fails to account for such commercial contingencies, therefore not allowing for a standardised resolution procedure which would inspire confidence in foreign participants.

d) Due to the nature of buy-back contracts, which require that all expenses and potential returns from the fields be accurately documented in the contract and that estimate is subsequently used as the basis for compensation, an additional source of risk arises as factors such as productivity rates, extent of oil reserves, time required for production and production costs are difficult to accurately predict before the operations have even begun.

5.2.2 Foreign oil companies' stance on buy-back

As well as receiving academic criticism, buy-back has also been the subject of critique by many of the foreign oil companies which had first-hand experience with the scheme. Total's envoy to Iran, for instance, insisted that such contracts are not the correct contractual type for the transfer

[347] Such as the most recent nadir, reached in January 1999, after increased oil production from Iraq coincided with the Asian financial crisis, thus curtailing demand.

of know-how and technology: “In buy-back you develop fields and when it is finished you say goodbye to everything. You don't know how it is produced. And it is exactly the problem”. He further noted the vulnerability of such contracts to changes in domestic politics, as last-minute changes in the contract are often demanded by the domestic authorities[348] and international politics, as he insisted that Total would be unable to operate in Iran if further sanctions were to be imposed. This is not solely Total’s position, as other European oil companies such as Shell, Eni SpA (E) , who have significant operations in Iran, agreed that the system may discourage them from investing in Iranian projects, with the alternative production sharing system being the preferred one. The view may have been accurately summarised by Bill Ramsay, a top executive of the International energy Agency who stated that: “Iran needs to provide a political and business environment in which companies won’t feel they’re going to lose their shirt.” A recent cancellation of an investment in the energy sector by an energy consortium,[349] attributed to negative domestic attitudes towards foreign involvement, shows that the political and business environment is indeed having a detrimental effect on oil commerce.[350]

Such a critical position on the viability of buy-backs as a financing scheme is also shared, to an extent, domestically, for instance by the Chairman of the Parliamentary Energy Commission of Iran Mr. Kamal Daneshyar, who anticipates “total change” in the structure of the oil sector and “fundamental” alterations to buy-back schemes, although unlike Total’s position, his was based on the inefficiency of the system from the government’s perspective. Nonetheless, it is clear that some consensus does exist that at least some modifications to the system are necessary, even if the reasons for such changes differ between the parties.

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[348] - Pfeiffer, D. A., ‘Target Iran’, first accessed 05/07/2007
[http://www.fromthewilderness.com/free/ww3/082404_target_iran.shtml]
[349] Led by Germany’s Linde AG (XET).
[350] Marketwatch, first accessed 05/07/2007
[http://www.marketwatch.com/News/Story/Story.aspx?dist=newsfinder&siteid=google&guid=%7B46

Surprising, a minority of energy sector companies do maintain their satisfaction with the buy-back schemes, for instance the Norwegian company Statoil, saying that "we do not feel there is any obstacle" in relation to Iranian energy operations, while its partner in the South Pars gas field project,[351] the Swedish Finnvik, proclaimed its awareness and general satisfaction with the buy-back scheme, given that "...certain amendments (to the buy-back contract mode) that would help improve future deals"[352] are made.

5.2.3 Issues of legal and fiscal certainty in Buy-Back contracts

It is not surprising that the financing mechanism that is buy-back contracts, which, especially in Iran, arise out of political considerations, are especially vulnerable to political fluctuations, therefore resulting in significantly less legal foreseability than do Production Sharing Agreements.[353] This vulnerability is particularly present in regards to Iranian buy-back contracts, as the government policies, legislation and general attitudes tend to rapidly change, thus resulting in a degrading standard of protection for IOC's fiscal and legal position. Furthermore, the Foreign Investment Promotion and Protection Act (FIPPA) passed by the Majlis in 2002 and regulating foreign investment in Iran does not offer holistic protection of upstream oil and gas buy-back contracts. Any suggestions of instituting major alterations in the buy-back model have been rejected on similar grounds of legal certainty as the senior Iranian diplomat Nejad-Hosseinjan recently stated that "the main existing problems with our buy-backs can be modified by some slight changes without taking much time, given using any new model will lead to delays

[351] One of the most extensive and promising fields in the region, shared between Qatar and Iran.
[352] Iran Daily. [www.irandaily.ir/1384/2274/html/focus.htm]
[353] PSAs are an alternative to the Buy-Back, offering ample protection from risk to the investors and has been used favourably in poorer countries, often with difficult to access deposits.

in contracts under negotiations."[354] Among these changes, the Scandinavian companies wish to see buy-back contracts being extended to over 20 years.[355]

In addition to these concerns, as Iran's legal system is based on Shari'a law, the domestic courts may have jurisdiction over disputes and certain vital commercial transactions, such as the charging of interest through LIBOR,[356] are banned.[357] Due to the power and wide jurisdiction of these courts, it is also possible that in a case of a contract dispute, these courts may deem the entire contract to have been illegal and void based on a violation of some tenet of Islam. The buy-back contract is the only feasible type of agreement permitted within the current Iranian Legal system.

5.2.4 Issues with contract negotiation and bureaucracy

As has been shown above, several provisions necessary for ensuring sufficient protection for the IOC are not included in the default Model Contract, therefore requiring separate negotiation for all aspects to be accounted for. Some of these decisions must be made in a speedy manner, which is inherently inconsistent with the bureaucratic and slow NIOC executive process. There is a consensus among oil companies involved in Iran that "We would obviously prefer things to happen more quickly" but "Iran is a country with a complex social structure, a complex political structure with a lot of checks and balances."[358] Such comments are unsurprising as since the 1979 Revolution, a redundant bureaucratic system has been built around the oil industry, with both the Ministry of Oil and the National Iranian Oil Company duplicating one another's work while lacking accountability and transparency, and therefore complicating the legality and

[354] China Institute. [http://www.uofaweb.ualberta.ca/chinainstitute/nav03.cfm?nav03=44161&nav02=43873&nav01=43092]
[355] Iran Payvand. [http://www.payvand.com/news/06/apr/1186.html]
[356] London Interbank Offered Rate, a daily interest reference rate
[357] Nonetheless, interest is oftentimes charged in business transactions despite the official prohibition on doing so.
[358] According to Alan Stott, Iranian envoy of BG Group, an oil extraction company

efficiency of dealings conducted with these structures. Indeed, Dr. Mina notes that even the structure of these authorities is not clear, as over a hundred companies affiliated with the Oil Ministry and NIOC have been created since the revolution,[359] making dealings with the authorities cryptic and difficult. An additional complicating factor is the lack of a standard regulating law, or a replacement for the repealed Petroleum Act for the functioning of these authorities, as "decisions are made on the spur of the moment, without any consistency or regard for a long term national interest."[360]

5.2.5 Domestic authorities' control over IOC activities and ramification of contract termination

Iranian government authorities have significant and perhaps excessive control over the IOC due to domestic legal provisions. One of such laws is Article 139 of the Constitution which requires the approval of several authorities, including the Council of Ministers and the Parliament, to initiate arbitration of any legal disputes between a foreign party and a domestic party such as the NIOC. The discretionary approval may be of particular relevance where the contract is terminated prematurely, which is one of the contingencies in buy-back Agreements, allowing the NIOC to take ownership of IOC-built facilities. The consequences would include a tremendous financial loss and no compensation, either because the NIOC refuses to cooperate, as it acted as per the contract or due to the difficulty of procuring a permission to arbitrate.

As this discretionary power of approval is placed in the hands of authorities linked by common interest to one of the parties in the planned arbitration, procuring such an approval from the Council of Ministers or the Parliament will be difficult. This is especially true as the current Parliament is known for its hard-line stance and is therefore unlikely to either authorise the

[359] Now employing over 180,000 people in comparison to about 50,000 prior to 1979.
[360] Interview with Dr. Mina. [bayegan.blogspot.com/2005/08/irans-new-oil-disorder-interview-with.html]

formation of new contracts with foreign firms or arbitration of existing ones. As was noted by a source in the Iranian business community, "any attempt by the reformers to base their negotiations with foreign companies on market norms always faces problems because a very conservative section of the government has to be persuaded that it is in the country's benefit[361] and nobody can be accused of having sold the country out." [362]

5.3 Risks and Disadvantages of buy-back contracts from the perspective of the NIOC

The presence of numerous grievances advanced by the foreign companies regarding buy-back contracts does not preclude a similar number of complaints from the domestic authorities. The sharing of such a stance by the government also adds to the political difficulty of instituting any significant reform, particularly a complete change of the contractual framework. Consequently, in order to assess the potential and scope for change within Iranian oil transactions, the grievances of the domestic participants in buy-back must be understood.

5.3.1 Lack of financial incentives for improvement of efficiency and long term development

Contrary to the assertion of the IOC that the viability of its involvement in Iranian oil projects may fluctuate suddenly along with the oil prices, the NIOC maintains that no actual price risk is placed on the IOC, which leads also to no incentive being present to improve the efficiency of the operation. This is due the fixed rate of return[363] and the lack of financial benefit for increasing exploitation effectiveness. NIOC's liability for price decreases may indeed be drastic

[361] The domestic authorities' fear of excessive foreign exports and involvement may be based on the 8% annual decrease in production capacity while the national consumption is increasing by 7%.
[362] BBC News. [http://news.bbc.co.uk/2/hi/business/2512015.stm]
[363] Usually 15-18 percent.

as if such fluctuations occur, NIOC must sell greater quantities of the product in order to fulfil the compensation provision.[364]

However, the argument of the IOC that negative market movements in regards to oil may mean that the quantity of oil permitted to be exploited may not suffice for repaying project expenses and the agreed return rate.

A point on which both domestic and foreign critics agree is the length of the contract, which those concerned with the maximally effective exploitation of Iran's natural reserves claim compels IOC to recover its costs through the sale of oil at the peak stretch of the field's performance, rather than to ensure a longer period of high performance and sell the product during this 'plateau' period. Vitally, no incentive for ensuring high performance exists at all immediately prior to turning the production over to the NIOC at the conclusion of the contract. The need for efficiency-improvement incentives is evident to some foreign companies, for instance Statoil which stated that "some incentives are needed; if you do good job you should be awarded and if you do bad job there should be no more cooperation."[365] Dr. Ghanimifar suggests that the problem of IOC's disinterest in the output of the operation after it has finished selling the product for its own compensation benefit may be resolved by allowing the contractor to play a supervisory role after returning the project to the NIOC, therefore creating an incentive to ensure its continued effectiveness.[366]

[364] Iran Energy Data, Statistics and Analysis - Oil, Gas, Electricity, Coal. [http://www.eia.doe.gov/emeu/cabs/Iran/pdf.pdf]

[365] As stated by Statoil's representative in Iran. [http://www.payvand.com/news/06/apr/1186.html]

[366] Interview with Dr. Ghanimifar [www.petroenergyinfo.net/NewsView.aspx?GroupId=5&MnuId=6&NewsId=26603&Page=1]

5.3.2 Problems with comparing competing project bids and inaccurate project demands

The process of determining the optimal arrangement for oil exploitation and exploration is vital for maximising profits for the NIOC. However, the bidding process is itself mired with problems, namely that of bids not conforming to the stated requirements and therefore not easily comparable. For instance, the recent bidding for the three Bangestan fields, by BP, Shell, Total, FinaElf and Eni resulted in varied, multi-phased bids with 15-20 years duration of project work rather than the requested five-year buy-back contract format. This example is indicative of a secondary problem of bidding; namely the unrealistic requirements of the NIOC which, the companies have decided in this case, were not economically worthwhile or practically possible. Due to this lack of standardisation of bids, extensive negotiations between PEDEC[367] and each participant would instead be required, therefore losing the economic efficiency and speed of a bidding approach.

5.3.3 Drawbacks of the present contractual structure

Iran released two model contracts in 2003: Sample Exploration Service Contract and Sample Service Contract for the Development Operations, the former being a contract to explore for reserves for a specified period with a successful exploration allowing for negotiation of a Development Service Contract and a failed exploration resulting in a negotiated fee and a Remuneration Fee based on the internal rate of return.[368] Meanwhile, the latter contract is of an unspecified duration, with a Joint Management committee overseeing operations while the foreign contractor operates the field development. The contractor is subsequently compensated for the operation expenses and remuneration being made available as a percentage of the net revenues from sale.

[367] Petroleum Engineering and Development Company, a NIOC subsidiary charged with oil buy-back contract negotiation.
[368] Currently constituting 15%.

Despite the recent issuance of the Model Contracts, they nonetheless fail to address the previous problems of buy-back contracts and introduce even greater legal uncertainty as the current separation of contracts into two types makes assessment of required development costs overly difficult. A single, combined contractual framework would permit a more appealing set of obligations, with guaranteed repayment of exploration expenses, regardless of whether it was successful.[369]

5.4 Conclusion

The numerous flaws of the current version of the buy-back system have been exploited by its critics to allege that the model as a whole is not a superior or viable alternative to other schemes, such as PSA or concessions, even taking into account Iran's unique constitutional limitations. The opponents of buy-back believe that the constitutional limitations may be sidestepped through an appropriately altered interpretation of concession or PSA regimes, while resulting in greater efficiency and profit balance than the buy-back currently allows.

Opponents of buy-back contracts also cite statistics which appear to show the buy-back contracts' inability to suit the Iranian market, through the recent decline of the rate of inking new oil contracts.[370] However, it is arguable that the declining popularity of such contracts may be attributed just as easily to the specific grievances with buy-back terms as implemented in Iran rather than with the structure or idea of the buy-back contract in itself.

Among such proposed schemes is a version of PSA suited specifically for the Iranian environment, whereby foreign and Iranian oil companies would form joint ventures which would not contravene the Constitution while essentially acting as a PSA. The Majlis is allegedly

[369] University of Dundee, 08/05/2003 [http://www.dundee.ac.uk/cepmlp/InfoServ/Barrows_Alerts.php]
[370] It is noteworthy that despite this fact, Iran still received 14 billion dollars foreign investment in the years prior to 2005, with 12 billion originating from Buy-Backs.

considering such a proposal at the present time, so as to attract further foreign investment to a country in need of modernisation in the energy sector.

A factor that cannot be ignored when considering the adoption of schemes alternative to the buy-back is the constitutional and political ramifications. Even if such a proposal was not *prima facie* contrary to Article 81 of the Constitution, for instance the 'joint enterprise' proposal described above, it must be noted that the Iranian courts would retain jurisdiction over any contracts signed through this new scheme and, as they are traditionally prejudiced against foreign involvement, would be likely to strike down any such deals due to their perception of them as being exploitative of Iranian national wealth. In view of the escalating conflict of Iran's government with those of Europe and US, where the major oil companies are located, it is therefore unlikely that an adoption of an alternative scheme, even if disguised as a 'joint enterprise' arrangement, would survive such parliamentary or judicial review.

Moreover, other attempts at substantially reforming the buy-back system have not succeeded as resoundingly as critics of buy-back would suggest. For instance, a contract was signed with the Canadian firm Sheer Energy, using ENI-limited risk/reward terms,[371] a substantial alteration to the default buy-back scheme, but a burst of commercial interest in further investment was not forthcoming.

It is of further note that no reason exists why the current desire for reform found within the domestic energy authorities cannot be used so as to integrate certain aspects of other financing schemes. Simply because the alternative financing schemes, be they PSAs or concessions, are illegal due to the limiting articles of the Constitution, does not mean that their constituent parts cannot be joined to the current framework of buy-back.

[371] Named after the June 2001 signing of a Buy-Back contract with ENI to develop Darkhovin field, with the significant difference of payment being linked to production capacity.

Despite frequent assertions by the Iranian authorities that buy-back in its current form is a success,[372] the dissatisfaction pertaining to its terms is often shared between domestic and foreign participants. Consequently, reform is called for, especially considering the ambitious targets set out by the current administration for the near future, with the Fourth Five Year Plan (2005-2009) calling for a 5.2 million barrel boost in oil production, which can only be accomplished through extensive foreign investment, with just an addition of one million barrels requiring 12 billion dollars of foreign money. Taking into account the possibility of additional sanctions and the resulting dissuasive effect, the improvement and modification of the current oil contract negotiation scheme appears to be necessary. The beginning of such reforms may be gleaned from the most recent negotiations with Shell and Repsol, which have previously signed energy contracts but were dissatisfied with financial losses due to the unexpectedly rising prices of products and equipment, as well as fluctuating oil prices; all common complaints in relation to buy-back terms. In response, a new version of the contract was offered by the government whereby Iran will have a closer relationship with the foreign companies during the implementation stage of the project, including participation in calculation of expenses. Vitally, the agreement stipulates that in the contingency that the required machinery and equipment is more expensive than predicted contractually, the domestic party will help compensate for the difference. Such reforms, even if limited, nonetheless contribute to the lowering of the much-dreaded risks associated with buy-backs for the IOC, making such contracts with Iran significantly more appealing.

[372] For instance, it was asserted by the Khatami-era Oil Ministry that over 90% of Iranian energy projects have been successfully tendered during his administration.

Indeed, the most recent information pertaining to buy-back reforms[373] suggests that officials are willing to extend the reforms beyond the simple alteration of the existing components of buy-back contracts, such as the duration, but also to more substantive aspects, borrowed from other schemes. One example of such substantive reforms are the proposals to provide contractually agreed upon reward bonuses for foreign contractors whose fields exceed expectations, therefore ensuring the presence of a motivator for enhancing their performance even after they have acquired their core compensation quantity from the output.[374] Such terms are atypical for a buy-back contract and clearly indicate the integrative nature of these reforms. Even more technical alterations may amount to greatly increased incentives for involvement in the Iranian energy market, such as the proposed innovation of determining the capital budget at a later stage of the project than is currently the practice, therefore permitting one of the most presently dangerous aspects of buy-back contracts to be bypassed—inaccurate estimates of costs for which the contractor would then be liable. Indeed, even the traditionally uneven balance of the bargaining and arbitration power within buy-back contracts is about to be altered through the inclusion of 'get out' clauses permitting contract termination in the case of sanctions.

Despite addressing some of the aforementioned IOC concerns, another significant source of criticism remains unresolved, namely the excessively short duration of buy-back contracts; unsatisfactory for both the IOC and the NIOC, albeit for different reasons. Some suggestions that contract length was to be lengthened were heard from the Oil Ministry, namely the former Deputy-Minister Nejad-Hosseinian. Nonetheless, the official position as voiced by the ex-Petroleum Minister Seyed Kazem Vaziri Hamaneh remains that granting of longer term contracts would contravene the Iranian law banning the sharing of natural reserves with other parties.

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[373] Such as the 2007 article in the Economist 'Polishing the Shop Window' [http://www.economist.com/displayStory.cfm?story_id=8657502]

[374] It is noteworthy that this differs from the previous terms as the contractor could be punished for sub-par performance, but never rewarded for exceeding the targets.

Some incremental change may be forthcoming, however, as it has been suggested that companies be permitted to consult during the production processes, so as to gain experience in these processes for future projects. An additional benefit of this reform in the long term is the improvement of field efficiency due to the ability of these consultants to offer proposals to the NIOC with practical experience at hand.[375] Nonetheless it remains to be seen whether such measures will remain purely cosmetic or if they help address the seemingly unchangeable limit on the length of the contracts.

However, it is possible that encouraging greater involvement of the foreign parties with the oil fields, even past the actual duration of the contract, may discourage the tactic of taking vast amounts of oil for compensation at the peak of the production, so as to shorten the capital turnover, but at the risk of damaging the field. Additionally, the ex-Petroleum Minister insists that such tactics are becoming less viable as the relationship between the parties are more structured, with the use of Master Development Plans predicting such actions and the NIOC having the 'final say' on permitting them. An increasing pool of educated Iranian geologists and other related professionals, the ex-Minister claims, will ensure that only carefully devised and fair MDPs will be approved.[376] Collaboration and consultation with foreign companies may have the added advantage of aiding the technology sharing, which is currently a concern for the NIOC as the short contract durations do not permit significant technology to be acquired by the NIOC from the foreign contractor. This problem is especially serious due to the practice of the IOC acquiring its compensation share of the production from the peak period, and subsequently not applying its superior technological resources to enhance production when the field begins to decline, when such technology would be most effective.

[375] The Minister claims that several major companies have already voiced interest in this scheme.
[376] Interview with the Petroleum Minister. [http://www.shana.ir/99264-en.html]

Such less radical, integrative changes, like the January 2004 decision to increase the maximum contract length from 5-7 years to 25 and permit IOC involvement following the hand-off to NIOC, may boost foreign interest more effectively as they partially address some of the investors' main concerns without introducing the legal and commercial chaos that might stem from a rapid and drastic change of the contracts' structure and legal basis. These reforms were confirmed in September 2006 when the NIOC issued 24 international tenders for fields with the proviso of longer contract terms being available so as to increase recovery rates, and as stated by Mahmoud Mohaddes,[377] such changes may legally and profitably balance the need for government control of the fields with the commercial interests of the investors.

In the light of the above factors, it therefore becomes clear that the interests of both parties to energy negotiations, that of utilising national reserves in a maximally efficient manner, and that of maximising profit, may be achieved through continuing and expanding the current reform trend without the need for social and political upheaval that would inevitably result from the adoption of an unconstitutional, non-buy-back model.

Having studied the relative flaws and strengths of the existing model, it is now appropriate to consider the sum of Iranian oil transactions since the introduction of the buy-back in order to understand both the general state and terms of oil contracts and the effect of external factors on foreign investment. The most important and influential projects have been chosen to illustrate these economic trends in the following chapter, as well as to show the practical effects of dissatisfaction with the existing buy-back provisions.

[377] The NIOC director of exploration.

Chapter 6: Case Study on Iranian Buy-Back Transactions

6.1 Introduction

As we have seen, Iran's constitution allows neither direct equity stakes nor the grant of concessionary rights. In the light of this, the Petroleum Act made provisions for the formation of agreements between the Petroleum Ministry and "local and foreign national persons and legal entities."

The early 1990s saw a re-evaluation of this position in the light of the economic imperative to develop Iran's crude oil production; a succession of three Five Year Plans sketched a succession of ambitious plans in this regard, all of which ultimately proved unworkable, the two biggest obstacles being the low domestic levels of both capital and expertise.

It had become clear that Iran could no longer operate in isolation: overseas technical and financial investment was necessary to realise a vibrant oil sector. In 1995, the oil industry approached the Majlis in an attempt to circumvent the entrenched barriers formed by the Constitution; after some debate, it was decided that whilst "investment" would remain forbidden, mere "financing" would not.

This doctrine was to produce the "buy-back" contract. The reality is, however, that the typical role played by the foreign company in such agreements is substantially that of a technical adviser. Essentially the foreign party undertakes the initial investment and is assumed to recoup by exploiting the end product.

It was envisaged that the buy-back contract would maintain Iranian possession of and control over its oil and gas reserves. The aims of the contract are as follows:

- Transfer of technology;
- Short-term contractor presence;
- NIOC's full control and close supervision over the schedule and costs;
- Lower costs compared to other contracts commonly used in the oil industries;
- Maximum use of domestic engineering, technical and executive capabilities in order to promote the quality of domestic sources and prevent the outflow of foreign currency.[378]

In this chapter we will attempt to assess those contracts which are signed under the buy-back scheme, and to see whether the underlying aims and objectives have been achieved.

6.2 A Summary of the Contracts

In 1998 the first major buy-back investment project came on-stream. The offshore Sirri A field (under the operation of Total and Petronus) was now producing 7,000 bp/d. Shortly afterwards the adjacent field of Serri[379] E began production, with an expected combined output of 120,000 bp/d. The 1995 agreement would see NIOC slowly assume control over five years from the start of production, although Total will remain close to the operation until its investments have been fully realised. The March of 1999 saw Total (then the French Elf Aquitaine) and Eni win a $1 billion contract over the Doroud oil and gas field off Kharg island, in a secondary recovery programme intended to boost production of the 1.5-billion-barrel field from 136,000 bp/d to a projected 205,000 bp/d; Eni holds a 45% stake, whilst Total (the operators) hold 55%.[380]

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[378] Oil and Gas article, *Atieh Bahar,* date of access; 4/5/2006 [http://www.atiehbahar.com/Resources/Oil&Gas.htm]
[379] Reuters announced on 9th October 1998 that Total, a major French oil firm, initiated the Sirri deposit's exploitation which was the first collaboration in petroleum with Iran since the Revolution. However, the starting statistics have been lacklustre in relation to other buy-back deals, with onlny Bow Valley and Premier securing deals, as well as the aforementioned Total agreement. K. Bassiti Associates [http://www.bassiti.com/content/pr01.htm]
[380] Oil Gas Articles, *Iran Oil Sector and Foreign Companies Involvement,* 05/3/2006 [http://www.oilgasarticles.com/articles/116/1/Iran-Oil-Sector-and-Foreign-Companies-Involvment/Page1.html]

In April of that year, Elf (46.75% share) Eni (38.25%) and Bow Valley Energy (15%) were awarded a buy-back deal to exploit the Balal field, with it 80 million barrels of reserves. Production began in 2003 at 20,000 bp/d, doubling to 40,000 bp/d by February 2004.[381]

In 2000, the Norwegian Statoil concluded a number of contracts[382] with NIOC to find petroleum in the Strait of Hormuz, [383] and in February 2001, the finding of a large deposit, named Dasht-e Abadan near its port-city namesake, was proclaimed, with the size of the deposit possibly rivalling that of Azadegan.

In January 2001, the Majlis sanctioned the exploitation of Azadegan by participants from outside Iran using the "buy-back" system. Inpex, lacking an in-house upstream experience, involved Total and the commencement of production is anticipated after 2009, rising to 160,000 bbl/d by 2012 and 250,000 bbl/d by 2014/15; the production could therefore form up to 6% of Japan's total crude imports. Thus far, however, the project has failed to advance much: most critically it still lacks a NIOC sanctioned operating agreement.

Disputes have arisen over the minefields (abandoned after the Iran-Iraq war) which still litter the area, as well as the rising cost of steel which have served to make the initial contract less attractive to the Japanese. Iran submitted a protest in 2005, criticising the slow progress and warning that unless a final agreement could be concluded within a year (by September 2006) they would begin development themselves.

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[381] Oil Magazine, a quarterly Magazine published by Ministry of Oil, Kuwait [http://www.moo.gov.kw/magazine/en/index.asp?More=yes&NewsID=354&mode=0&day=13&page=20] Date of access: 14/6/2006

[382] The two firms further collaborate on the building of a processing factory for fields in the south, as well as the Salman deposit.

[383] Flashpoint, *World Conflicts Report on Iran* [http://www.flashpoints.info/countries-conflicts/Iran-web/Iran_briefing.htm]

In 2002, the Petroleum Ministry inked a buy-back agreement in the value of almost $600 million, with PetroIran, whose parent company is the NIOC, in order to exploit the Foroozan reserves, located on the border with Saudi Arabia and expected to produce up to 65,000 bbl/d..

The Cheshmeh-Khosh oil field is located in Dasht-e Abbas, in southern part of Ilam province. Exploitation rights were initially given to the Spanish firm Cepsa for three hundred million USD, but was subsequently given instead to the Central Iranian Oil Fields Company, another state subsidiary.[384]

Canadian Sheer energy was given rights to exploit the Masjed-e-Suleyman deposits in 2002, with the aim of boosting output to 20,000 bbl/d . This firm's commitment was replaced by that of the Chinese company, CNPC, which purchased the subdivision of the Canadian company responsible for the contract, and subsequently initiated its operations in 2005.

In 2004, a group of Japanese companies, headed by Inpex, inked a contract valued at $2 billion, for the exploitation of the huge Azadegan field, known for being the biggest find in Iran for three decades. An onshore field in Khuzestan, Azadegan has proven crude reserves of 26 billion barrels, but the geological complexities of the field are anticipated to render extraction more complex and thus expensive.

Moreover, in March 2005, an agreement to exploit the Bangestan reserves was given to Petro Iran Development Co.,[385] following a number of time-consuming obstacles. The field in question

[384] Addressing the inaugural ceremony, the managing director of the NIOC on July 2006 noted that the project has cost about 73.5 billion Rials and 6.8 million dollars. Alireza Zeighami noted that Iranian specialists have totally designed and built water processing and wastewater treatment plants, which are being built in Iran's upstream industry for the first time. Referring to production capacity of National Iranian Central Oil Company, he stated that the company is currently producing 122,000 barrels per day crude oil. He added that Cheshmeh Khosh plant will increase production capacity of the company to 150,000 barrels per day, but needed pipelines should be constructed. *Shana Oil and Gas Information, 28 July 2006[http://www.shana.ir/86680-en.html]*

[385] Petro Iran Development Company (PEDCO or Petro Iran) was established in October 1998 and is still evolving as a new entity within the oil sector. Petro Iran was initially formed to be the Iranian partner of foreign contractors with a 10% share in each buy-back contract. *Atieh Bahar [http://www.atiehbahar.com/Resources/Oil&Gas.htm]*

is one of Iran's oldest and most effort-intensive, although approximate 6 billion barrels are available for exploitation at a rate of 158,000 bbl/d. The field is experiencing production drop-off issues due to its advanced age, with half its output already lost while another half is expected to disappear due to insufficient gas re-injection.[386]

In the last decade, the state oil agency found several deposits, particularly the Darkhovin field, which was the subject of a recent 2001 deal with Eni, for a five and a half year duration and $1 billion value, with the unusual component of a provision linking the production capacity with the extent of compensation.[387]

A further recent discovery is that of the Anaran deposits, with 2 billion barrels and a capacity of up to 100,000 bbl/d, with Lukoil and Norsk Hydro participating in its exploitation, which is made more difficult by an abundance of mines in the area.

An additional element of Iran's efforts to increase the inking of contracts is the 2006 announcement by the chief executive of the Petroleum Engineering Company that 10 more fields in the south of Iran will be made available to tender, with around $7 billion worth of funds required for their development. [388]

[386] EIA, Energy Information Administration,[http://www.eia.doe.gov/emeu/cabs/Iran/Oil.html]
[387] Oil Magazine, Ministry of Oil, Kuwait, date of access: 14/6/2006
[http://www.moo.gov.kw/magazine/en/index.asp?More=yes&NewsID=354&mode=0&day=13&page=20]

[388] Petro Iran Development Company (PEDCO or Petro Iran) was established in October 1998 and is still evolving as a new entity within the oil sector.

Figure 5: Major Iranian Oil Fields

Source: Joint Economic Committee Research Report, March 2006 [www.house.gov/jec]

According to *Market Research Oil Report 2006*[389], Iran's oil fields (onshore and offshore) are as follows:

1. Abuzar Oilfield
2. Aghajari Oilfield
3. Ahvaz-Bangestan Oilfield
4. Anaran Oilfield
5. Azadegan Oilfield

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[389] Research and Market, Iran's Report 2006 [http://www.researchandmarkets.com/reportinfo.asp?report_id=324341&t=d&cat_id=]

6. Bahregan and Hendijan Oilfield
7. Balal Oilfield
8. Bibi Hakimeh Oilfield
9. Binak and Golkhari Oilfields
10. Caspian Sea Oilfield
11. Cheshmeh Khosh Oilfield
12. Darkhovin Oilfield (Onshore and Offshore)
13. Daroud Oilfield (Onshore and Offshore)
14. Dashte Abadan Oilfield
15. Dehloran Oilfield
16. Farsi Oilfield
17. Forouzan and Esfandyar Oilfields
18. Gachsaran Oilfield
19. Haftgel Oilfield
20. Hengam Oilfield
21. Jofair Oilfield
22. Kabood Oilfield
23. Karanj Oilfield
24. Kharg Oilfield
25. Khesht Oilfield
26. Khorramabad Oilfield
27. Kuhmund Oilfield
28. Lavan A Oilfield
29. Maleh Kooh Oilfield
30. Mansouri Oilfield (Asmari Reservoir)
31. Maroun Oilfield
32. Masjid e Soleiman Oilfield
33. Monir Block
34. Nosrat Oilfield
35. Nosrat Oilfield
36. Paydar Oilfield
37. Pazanan Oilfield
38. Rage Sefid Oilfield
39. Saadatabad Oilfield
40. Salman Oilfield
41. Sarkan Oilfield
42. Sarvestan Oilfield
43. Saveh Block
44. Shadegan Oilfield
45. Sirri A Oilfield
46. Sirri E Oilfield
47. Soroush and Nowruz Oilfields
48. South Pars Oil Layer (South Pars Gas Field)
49. Yadavaran Oilfield
50. Zagheh Oilfield

In order to understand the terms and conditions of buy-back contracts some of the most important of them are analysed in a greater dept in the following paragraph.

6.3 The Most Commercially Influential Oil Projects of Iranian Buy-Back

In order to fully understand the functioning and comparative advantages of buy-back framework, it is necessary to consider, selectively, some of the most important and influential projects in Iran that have utilised buy-back. An analysis of their terms and outcomes allows the gauging of the attractiveness of buy-back as well as its effectiveness.

6.3.1 The Bangestan Oil Field Project

The Bangestan field is located around Ahvaz in Khuzestan province and forms one of the country's largest onshore fields, with production at 150,000-170,000 bbl/d and expected to reach 400,000. On the 18th of March 2005 NIOC concluded a $900 million contract with PIDC[390] which was expected to produce between 70,000 and 120,000 bp/d; unfortunately, the two parties rapidly fell into dispute.

PIDC's managing director, Mostafa Khoi, issued a statement that the contract on the development of Ahvaz Bangestan oil field had not been verified and communicated by NIOC.

In response Ali Akbar Vahidi Alaqa, Managing Director of the Oil Development Engineering Company, as one of the parties to the negotiations with Petro Iran told PIN[391] that it was not right to use the term verification for the Ahvaz Bangestan contract. "The delay in implementation of the Bangestan project has no justification. Even after initial signing of the contract and review of details, it was decided that the maintenance and production plan should be different from what

[390] Petrol Iran Development Company
[391] Petroleum Industry News Agency.

has already been agreed upon. Negotiations are now underway on how to make such changes and with the announcement of results, the contract for implementation of the project will be completed."[392]

a) Buy-back and the incentive for foreign investors

All oil fields, especially the ageing ones, are suffering a drop in production from their reserves every year. Accordingly, the National Iranian Oil Company has concentrated its efforts towards redressing this reduction and increasing the daily production capacity of the oil fields. As we have seen, the issue concerning the activities of the National Southern Oil Rich Regions Company as a firm in charge of developing Ahvaz Bangestan oil field has turned into a bone of contention between the two parties to the contract.

Assessing the competing tenders of overseas investors has become complex, because whilst NIOC has continued to offer five year contracts the companies concerned are reluctant to invest for such short periods; the work does not seem likely to reach completion in so short a time, and to simply invest billions of dollars in another business is far from their standard business practice. The result is that all bids have become non-conforming, which makes them extremely difficult to compare side by side. For example, NIOC is having issues with comparison of the competing submissions by BP, Shell, TotalFinaElf, and Eni. Other than the latter, all the companies have submitted offers for the 3 Bangestans, and unfortunately all the tenders are not in conformance with the requirements, as their structure contains multiple phases, with projected durations of between 15 and 20 years.

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[392] This is as direct a translation as possible from an article, published on the Naft Nevis website at [http://naftnevis.com/?m=200510&page=2 from October 2005

Protracted internal discussion at NIOC has failed to suggest a solution. The next stage would be deliberations by the Petroleum Engineering and Development Company (a state-affiliated company charged with negotiating agreements) with the various candidates. It has been suggested that the most likely outcome will be the evolution of a consortium led by the more politically acceptable companies. The only real point of comparison, therefore, is the proposed additions to production. Overall, 350,000 b/d of increasing output was predicted in relation to these deposits.

Output at the Ahwaz Bangestan operation has decreased to 150,000 bp/d from 250,000, Fesharaki states, and this fall (if unaddressed) is likely to continue to 60,000. Were Iran to invest in gas reinjection, output may be levelled out at 200,000 bp/d, although this is subject to the obvious restrictions of local expertise.

Fesharaki's view (unlike many other experts) is that Iran will be able maintain its present production levels of 3.9 million bp/d; equally, he has called the projections of 5.3 million by 2010 "impossible" in the current "buy-back" investment climate, even without the US sanctions.

b) The effect of the rising price of oil

The sharp escalation in international oil prices following the conclusion of the Ahvaz Bangestan oil field development contract meant NIOC became reluctant to countenance any reduction in production, so as to maximise the national income. In achieving this aim, NIOC had to choose between delegating to either the National South Oil Rich Regions Company or to the Petro Iran Development Company which would necessitate a renegotiation of their contract.

Choosing the first option seems to be more economical and such a decision would mean the start of operation by the National South Oil Rich Regions Company to maintain production level by drilling more wells, along with the development efforts of the Petro Iran Company.

Despite the fact that the output of the Ahvaz Bangestan field will remain high, as will sales (at a time of high oil prices), the impact on the contractor company will actually be negative. Because of the nature of buy-back contracts, PIDC will receive the capital and surrounding expenses from oil sales revenues from these development issues. The company, on the other hand, is denied an opportunity to make money by raising its own production. The lower the share of the company is in raising the crude output of the oil field, the longer it will take to recoup.

If the present production levels remain unchanged, however, there will be no output increase and the company will therefore be unable to repay the expenses of the project, in which case the buy-back project will be threatened. The average production capacity of Ahvaz Bangestan as it stands is at 150,000 – 155,000 bp/d; on the basis of the projections proposed by PIDC when the contract was signed, NIOC should allow the field's natural decline to continue until the PIDC's rejuvenation project is completed. This contract originally allowed PIDC a large margin of error, with only 48,000-50,000 barrels of the 220,000 bp/d to be allocated to aims other than repayment of expenses. However, NIOC's decision to prevent any fall in production at a time of high oil prices has therefore rendered it impossible for PIDC to realise its projected profits.

c) Outcome of the negotiations to be made known in ten days

In an interview the director of NIOC's legal department, Dr. Mostafa Zeineddin said the reason the contract on development of Ahvaz Bangestan oil field has not officially been announced to PIDC was the need for continued assessment of production conditions in the field, with technical discussion over possible solutions to the field output problem being a central area of debate.

He reminded that PIDC, is one of the firms affiliated to the NIOC and therefore negotiations between these two parties should not be viewed as part of a wider crisis over the execution of contracts. Negotiations on terms of the contract will continue for the next week and the outcome is expected to be made known within the next ten days.

Referring to NIOC's fruitless negotiations with several international firms over the past few years on implementation of Ahvaz Bangestan development project, he made it clear that this has been complicated from the beginning.

Talks with foreign companies did not bear any fruit because of the priority given to technical details and optimal production.

d) Previous negotiations on Bangestan

Upon receiving proposals from participants to a tender for development of the Ahvaz Bangestan oil field, new information on drilling of wells in the field was provided to the bidders which envisioned changes to the previously announced terms. This explained why the proposals made by bidders differed from earlier predictions.

British Petroleum (BP) and Total were the last participants in the tender and were engaged in talks with the NIOC until late last year. However, fundamental differences in methods proposed by these two companies for development of the oil field made it very difficult to select a contractor for execution of the project. The tender was ultimately announced null and void. Later on, the Petro Iran Development Company was assigned to increase the daily output of the Ahvaz Bangestan oil field from 100,000-150,000 bp/d to 220,000 bp/d 70 months into its launch at a

total cost of 900 million dollars. It is predicted that the implementation of the project within a period of 25 years will entail an additional crude production of around one billion barrels.[393]

6.3.2 Japanese Investment in the Azadegan Development

Azadegan, located in south-eastern Iran, near the Iraq border, is Iran's largest deposit. An estimated 26 billion barrels of crude oil makes it the world's largest undeveloped oil reserve.

Iran extended favoured rights to develop the oilfield to Japan in 2000. After holding extensive negotiations, Japan pledged to provide a $3-billion credit to Iran over 3 years and the two countries signed a $2-billion agreement in 2004 for development of Azadegan. Inpex[394] holds a 75% stake while NIOC holds the remaining 25% stake.[395]

Total joined National Iranian Oil (NIO) and a consortium of Japanese firms led by Inpex in the development of Azadegan. The news was leaked by an anonymous source to Dow Jones Newswires stating "It's finalized - Total is joining the process with anywhere from a 12% to 15% stake in the project."[396]

Prior to this news there were reports that Iran had been looking to bring in new firms as the final date for inking a contract passed without success. It was reported that Japan was "dragging its feet on the project."[397]

[393] Iran Daily Domestic Economy, 26/09/2006 [http://www.iran-daily.com/1385/2670/html/economy.htm]
[394] Inpex was established in 1966 to promote the development of oil resources in an international context. Inpex is actively engaged as a project operator, conducting successful explorations in Indonesia and Australia.
[395] Rigzone, oil and gas industry website, 4th September 2006 [http://www.rigzone.com/news/article.asp?a_id=35814]
[396] *Ibid*
[397] Iran Daily Economic Focus, 13/09/2006 [http://irandaily.ir/1385/2659/html/focus.htm]

(a) American pressure, Japanese oil requirements and the Inpex deal

The Financial Times (London) claimed that the US was pressuring Japan to cease its petroleum dealings with Iran, over concerns about its nuclear program.[398] However, virtually all of Japan's crude oil is dependant on imports, with, as of 2001, 88.4% of that coming from the Middle East.[399] This reliance on foreign petroleum makes securing deals on this issue a vital matter, and the Japanese government cited this need when Inpex made their deal with NIOC.

Seifollah Jashnsaz, managing director of National Iranian South Oilfields Company, told ISNA that:

"[t]he development of the field is interesting because the Iranian technicians have carried out most of the activities in the field, including exploration studies and research. So far, six wells and a 100-km pipeline have become operational. At the moment, they have the capacity to produce 6,000 bp/d."[400]

He said that NIOC has the capacity to develop the Azadegan oilfield and that Inpex had forecast just a five percent ratio of return on the Azadegan oilfield:

"However, in 40 wells under the direct supervision and control of NISOC, the recovery factor stands at around 16 percent. Therefore, the Inpex projection for Azadegan is totally unacceptable. In addition, Inpex has not considered gas injection into the oilfield to boost its recovery factor, whereas it is necessary to do so."[401]

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[398] Financial Times, 01/07/2003
[http://search.ft.com/ftArticle?queryText=iranian+project+japan&y=0&aje=true&x=0&id=030701002529]
[399] Agency for Natural Resources and Energy: the official website of the government of Japan, 26th June 2007
[http://www.enecho.meti.go.jp/english/policy/oil/fundamental_view.html]
[400] Iran Daily Economic Focus, 13/09/2006 [http://irandaily.ir/1385/2659/html/focus.htm]
[401] Ibid

Jashnsnaz further asserted that Inpex's $3 billion outlay was overestimated and that it was reasonable to exploit the field with only half that funding: "NISOC has the potential to develop Azadegan oilfield on its own and it will be a routine task for its highly skilled technicians, if it gets the authorization. The company has had successful experiences of handling oil development projects in the past, particularly during the 1980-88 Iraq-imposed war. Iran handed over the development of Azadegan to Inpex because of investment shortages."[402]

It is obvious that both Iran as managers and Japan as contractors would have benefited from the Azadegan contract. It would have also allowed domestic Iranian companies an opportunity to display themselves at the international level.

There was also a desire to protect oil reserves for future generations:

"It is vital to produce oil in an efficient manner without wasting a single drop, which can only happen by using modern equipment and the latest methods. However, it is impossible to extract 100 percent of oil from any given reserve."[403]

According to Jashsnaz, while the oilfield has been divided into 16 blocs it is impossible to produce the 5.5 bp/d from all the oilfields by the end of the Fourth National Development Plan (2005-10) due to a lack of funding.

"Some argue that to improve our status and influence in OPEC, we need to produce more oil." Jashsnaz said.[404]

[402] Ibid
[403] NISOC managing director, reported in Iran Daily Economic Focus, 13/09/2006 [http://irandaily.ir/1385/2659/html/focus.htm]
[404] Iran Daily Economic Focus, 13/09/2006 [http://irandaily.ir/1385/2659/html/focus.htm]

b) The effect of international pressure

In October 2006, Inpex agreed with NIOC in principle to cut its concession from 75 percent to ten percent. The Kyodo news agency quoted Mehdi Bazargan, Managing director of Petroleum Engineering & Development Co., as saying:

"If, in the future, Inpex solves its domestic problems, it is possible in the event of an agreement for Inpex to get back its shares or parts of its shares." but "Inpex has not been able to solve its problem with financial institutions, etc., in Japan."

Kyodo further remarked that Iranian Oil Minister Kazem Vaziri Hamaneh had stated that Inpex could regain concession of 75%, subject to further negotiations.

Inpex's CEO Katsujiro Kida said that the firm would give up its share to National Iranian Oil, resulting in the operator's role being transferred to the domestic authorities, with. Inpex instead becoming a collaborator.[405]

Unlike previous buy-back contracts which lasted just 7-8 years the Azadegan contract had a duration of twice that at 16 years.

6.3.3 Sanctions and the South Pars Negotiations

In 2002 an oil layer was found in the South Pars gas field, the world's largest gas field, with shared ownership by Qatar and Iran. An eventual output of 100,000 bp/d[406] of crude oil is expected from the field. The oil layer holds 10 billion barrels. Three wells have been drilled and the drilling of a forth well began in July 2006. Petropars[407] won phases 6-8 of the South Pars

[405] Peyvand Iran's News, 10/09/06 [http://www.payvand.com/news/06/oct/1089.html]
[406] Alexander's Gas and Oil Connections, 31/10/2002 [http://www.gasandoil.com/goc/discover/dix24883.htm]
[407] Petropars received its registration in 1998, as per a decree of the Council for the Economy, in relation to buy-back within the South Pars Field. NICO, a NIOC subsidiary, owns all of Petropars shares.

project and is currently deciding on potential subcontractors. Contracts for South Pars Phases 9-12, and its oil layer, should be signed soon, although in earlier rounds there was a dearth of serious bidders. Mehdi Mir-Moezzi said that Iran will sign deals on the South Pars oil layer by March 2004.

According to Dalton, BP is working with the domestic authorities on its first LNG venture, exporting gas from South Pars to Indian and other foreign. BP also participates in Iran's LNG consortium.

Iran's plan to develop South Pars by means of contracts with large firms, resulted in interest by Total, Russia's Gazprom and Malaysia's Petronas.

In January 2005 the New York Sun reported that Halliburton Products & Services Ltd. won the contract to develop phases 9 and 10 of the south Pars oil and gas field.[408] Owing to an executive order banning substantial investment in the Iranian energy sector, Halliburton later quietly pulled out of the deal.[409]

a) The early effect of US sanctions

Pars Oil & Gas Company (POGC) is in charge of awarding the contracts for the different phases of the South Pars development project. Initially US sanctions appeared to inhibit some foreign investments in Iran's oil and gas sector. In the three years between the re-imposition of US bilateral sanctions in 1995 and the US-E.U. understanding in 1998 about *de facto* exemption of EU companies from US sanctions under ILSA, statements by senior spokesmen for several European, Japanese and Australian energy companies suggest that they were deterred from undertaking development projects in Iran. This was a period of little Iranian success in attracting

[408] The New York Sun, 12/01/2005 [http://www.nysun.com/article/7550]
[409] Alexander's Gas and Oil Connections, 03/05/2005 [http://www.gasandoil.com/GOC/company/cnm52183.htm]

foreign oil and gas investment, but it is impossible to determine the extent to which foreign companies, who continued to negotiate with Iran, were deterred by ILSA or were seeking more favourable terms. The Total-Lukoil-Petronas contract for South Pars development marked a turning point in several respects. It forced a confrontation between the E.U. and US over ILSA in which the US backed down. This set a durable precedent and it was a breakthrough in terms accorded to foreign companies. It also established the buy-back contract framework as Iran's oil and gas development model opening the way for a series of other development contracts.

b) Negotiations after the South Pars agreement

Following the initial South Pars contract, which granted very favourable terms to foreign investors,[410] Iran progressively tightened the terms offered to other developers. As a result new foreign investment commitments had slowed markedly by the end of the decade. This pattern was an indication of the increasing dispute regarding the desirability of foreign gas and oil investment, taking place as a part of the political debate between Iranian "conservatives" and "reformists". The effectiveness of US efforts to impede investment in the Iranian energy sector was considerable diminished while Iran's internal debate over the role of, and terms for, foreign investment became the main impediment.

c) International aversion to economic sanctions

The use and effectiveness of economic sanctions have become increasingly controversial in recent years. The conclusion of many experts at the December 1998 Overseas Development Institute (London) conference on the question of "Can Sanctions Be Smarter?" was that the unilateral sanctions, like the US sanctions placed on Iran, do not work due to the modern

[410] Yielding a reported internal rate of return of 16-18 percent.

economy, which boasts a significant degree of interconnection and integration.[411] The US has therefore faced serious global pressure, especially from Europe, to re-evaluate its sanctions on Tehran.

The split on the issue of sanctions resulted in Iran being able to attract further foreign funding into the petroleum industry. Foreign investors as well as some US companies have chafed at the restrictions of the sanctions.

6.3.4 The Masjed-I-Suleyman Agreement

Sheer Energy and its partner the Naftgaran Engineering Services Company had succeeded in acquiring the rights to exploit the Masjed-I-Suleyman[412] (MIS) deposit. Sheer Energy Ltd. is in charge of the project holding a 49 percent stake with the 51 percent balance held by the Naftgaran Engineering Services Company of Tehran.[413]

The contract provisions detail an updated funding of about $88 million USD [414] over a 4 year period to carry out a thorough observation of the deposit, including the drilling of wells as well as creation of the needed infrastructure, so as to be able to yield 20,000 barrels daily. The work is to be begin immediately.

Sheer Energy will be reimbursed via output sales in the 3 years following the operation's conclusion. Recompense for the funding is calculated on the basis of a pre-determined ROR, with variations based on the extent that production figures were met or exceeded. The total estimated size of the oil pool is 6 billion barrels, although a sixth has already been extracted.

[411] Koenraad Van Brabant, 'Can Sanctions Be Smarter? The Current Debate: Report on a Conference Held in London 16-17 December 1998' (May 1999), first accessed 18/06/2007 [www.odihpn.org/documents/sancconf.pdf]
[412] Discovered in 1908 it was the first to be found in Iran
[413] Sheer Energy was the first non-Iranian firm since Eni's agreement to be granted exploitation rights over Masjed-I-Suleyman.
[414] Alexander's Gas and Oil Connections, 13/03/2001 [http://www.gasandoil.com/goc/contract/cox11491.htm]

a) Sheer's investment and increased oil production

Prior to the Sheer contract production from then NIOC operated pool was around 4,500 barrels of oil per day. NIOC's existing operation was not connected to an existing Service Contract. A consequence of the operation's fulfilment of its goals would be to create a precedent for other fields while also boosting the local economy.[415]

Following the purchase of the Sheer subsidiary by the Chinese company mentioned above, the Joint Venture of CNPCI/NESCO NIOC has signed a Contract with National NIOC to re-develop the Asmari reservoir of MIS Oil Field with the objective of incremental production of 25,000 barrels oil per day.[416]

6.3.5 Recent Success in Jofair negotiations

Mehdi Bazargan, The Managing director of PEDEC, noted that during a recent visit by President Mahmmoud Ahmadinejad to Belarus, the two nations were enthusiastic to continue negotiations on the major development plan (MDP) of the southern Iranian oil field in Jofair region. He added that during the presidents of each country agreed to continue talks on the development plan of the Jofair oil field to finalise the negotiations in a few months.

Upon the finalisation of the technical negotiations of the development plain of the Jofair oil field a draft contract was forwarded to Belarusneft Company and negotiations are underway. The Managing director of PEDEC stated that the contractual negotiations usually take at least three months. Bazargan had already told the Petroenergy Information Network that PEDEC had finalised technical negotiations on developing the Jofair oil field with a Belarusian company.

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[415] Pravda, 29/05/2002 [http://english.pravda.ru/comp/2002/05/29/29456.html]
[416] CNPCI/NESCO MIS Development Project, first accessed 26/06/2007 [http://www.misproject.com/ProjectDefinition.htm]

Mehdi Bazargan added that "the draft agreement intended by the National Iranian Oil Company on development of Jofair oil field has been submitted to Belarusneft Company," stating that the negotiations would lead to a contract signing on 1st July 2007. Continuing, he said that, "[w]e have proposed to Belarusneft Company to finalized [*sic*] negotiations on developing Jofair oil field by the end of June, so that, the contract could be signed at the beginning of July. The company has accepted our proposal and we should wait and see what happens in practice."

The official stated that preliminary sessions on the contract have been held and the Belarusian Company has been studying the text of the contract for the past few weeks.

The official stated that after the Jofair oil field contract is finalized, the company can introduce its partner for joint investment in the field and NIOC can investigate them.

Iran and Belarus signed an early agreement on the development of the Jofair oil field late in the last Iranian calendar year (ended March 20, 2007) and in his recent visit to Minsk the minister of petroleum said, "Belarus is an oil producing [country] and was an energy heartland for the former Union of Soviet Socialist Republics. It seems that the country is capable of developing Iranian oilfields."[417]

Upon completion of development, Jofair oil field is predicted to produce an average of 30,000 bp/d.

6.3.6 The New Yadavaran Oil Field

Yadavaran is an oil field located in Khuzestan, Iran. The field is made up of two former fields, Koushk (discovered in 2000) and Hosseinieh (discovered in 2002). The field was renamed as the Yadavaran Field after researchers discovered that the two fields were actually connected. It is

[417] Belarus News and Analysis, 21/5/2007 [http://www.data.minsk.by/belarusnews/052007]

estimated to have reserves of up to 17 billion barrels (2.7 km^3) of oil, with 3 billion barrels (0.5 km^3) considered to be recoverable.

On January 7, 2004, Iran negotiated a $40 billion deal with ONGC Videsh Ltd (OVL), giving the Indian company a 20% stake in the field. As part of the deal, India agreed to buy 7.5 million metric tons of liquefied natural gas (LNG) from Iran per annum for 25 years.

On October 29, 2004, Iran negotiated a $70 billion deal with Sinopec, giving the Chinese company a 51% stake in the field's development. As part of the deal, China agreed to buy 10 million metric tons of liquefied natural gas (LNG) from Iran per annum for 25 years.

On November 22, 2006, Iran's oil minister said that the agreement with Sinopec is probably going to be concluded within weeks with the only remaining issue being the rate of return Sinopec will get on its investment. The minister would not comment on Iran's offer due to confidentiality.[418] The remaining share (29%) of the oil field is owned by the National Iranian Oil Company. The field is projected to begin production in 2009[419] with China agreeing to buy-back 150,000 bp/d at market price for a period of 25 years after commissioning the field.

6.3.7 Italian Involvement in the Darkhovin Oil Field

Containing 2.5 billion barrels of low sulfur, 39° API crude oil, this onshore field is located in south-western Iran, 45 kilometres northeast of the city of Abadan. Italy's Eni has carried out technical studies on this field. Eni (60%) is working together with Iran's Naftiran Inter-trade Company (NICO) and was the first foreign company to be granted rights to develop an onshore field. The development project for Darkhovin included two phases. The first phase was completed and included the drilling of 8 new wells and the construction of oil treatment and gas

[418] Rigzone, 02/04/2007 [http://www.rigzone.com/news/article.asp?a_id=44623]
[419] Accessed 26/06/2007 [http://www.answers.com/topic/yadavaran-field]

injection plants to increase its production. The second phase which is currently underway[420] is to expand the existing treatment capacity and the construction of new production wells and natural gas re-injection. Darkhovin operations began at 50,000 bpl/d in July 2005, with predicted figures of 160,000 bbl/d in 2007.[421] The project is to last 65 months.

Eni have also become involved in several projects in Iran in addition to their work in Darkhovin and South Pars, among which are the Shiraz and Tabriz Refineries, the Marun-Esfahan oil pipeline and the Marun-Esfahan-Rey oil pipeline pumping system, on behalf of the NIOC. They were also involved in the Iranian Gas Trunkline II project as well as the petrochemical plant of Arak and the Linear Alchyl Benzene plant of Esfahan.

6.4 Conclusion

As we have shown, the constitution of Iran places considerable restrictions on the kind of contracts that can be made for the development of oil fields. This was the initial problem for Iran in attracting foreign investors into their oil fields and one that continues to this day. A combination of the 1987 Petroleum law, permitting formation of agreements with foreign entities, and the creation of the buy-back contract attempted to overcome the constitutional difficulty. The case study indicates some considerable success in this endeavour with numerous foreign companies investing in the Iranian oil fields. However, as we have also demonstrated, there have been a number of problems with regard to the nature of the buy-back contract and internal and external pressure over investment in the Iranian energy industry that has created problems when settling terms.

[420] As of 03/07/2007

[421] Oil Magazine, Ministry of Oil, Kuwait, date of access: 14/6/2006 [http://www.moo.gov.kw/magazine/en/index.asp?More=yes&NewsID=354&mode=0&day=13&page=20]

The United States has been at the forefront of attempts to enforce sanctions that would prevent or at least severely limit investment in the Iranian energy market. In recent years this has been due to misgivings about the Iranian nuclear program and the potential for Iran's development of nuclear weapons. Regarding the Inpex deal for development of the Azadegan oil field we saw a potential 75-percent share in the field drop to a mere 10-percent share due to considerable pressure from the US on the Japanese government who own Inpex. External pressure from the US on outside investors has had some considerable negative consequences for investment in Iranian oil fields. Conflicts over mine-fields in Azadegan left from the Iraq/Iran war have also been obstacles to agreement.

However, one should not overstate the effect US sanctions have had. Post World War Two, America and Japan have had a particularly close relationship and while US interference may have resulted in a reduction of Inpex's share in the field it did not prevent the investment. Given Japan's reliance on foreign imports of oil, especially from the Middle-East, and the sheer size and potential of the Azadegan field the influence of the US was not enough to deter investment from the company.

Indeed, the size and potential of Iranian on-shore oil fields which are unlikely to become exhausted in the near future is a huge incentive for investors on its own.

It is of course difficult to say with certainty what the true effects of US sanctions were. While the US has and continues to put pressure on foreign governments not to invest in Iranian oil fields the fact there was an initial period of reluctance to invest in Iran may be related to a desire for better terms in company's agreements over the oil fields.

Dissatisfaction over economic sanctions came to a head around the same time as the success of the South Pars contract which granted very favourable terms to investors. These events preceded

growth in investment indicating that either one or both may have been responsible for said growth. However, as to precise extent of the effect these events had on the expansion, it is uncertain. Statements by senior spokesmen within oil companies and a correlation between US pressure and initial failure to attract investment suggest that sanctions were having effect. While US sanctions may have initially have had substantial detrimental effects on Iran by inhibiting foreign investment, growing international disapproval with the sanctioning system has led to a drop in the effectiveness of US efforts. The Halliburton affair highlights conflict within industry itself and the policy espoused by Washington. The Total-Lukoil-Petronas contract for the South Pars oil field was important in highlighting this international disapproval between the US and most of the other industrialized nations over sanctions. The conclusion of that deal saw a marked rise in investment within the oil industry leading to foreign contracts for development of the inland oil fields noted above. The profit-making potential in Iranian oil fields seems to outweigh the threat of US disapproval.

The correlation between the progressive tightening of terms to foreign investors and the drop in investment suggests that the external pressures are of limited importance when compared to internal factors. Companies who wish to invest in Iran will do so based primarily on the surplus they achieve from the contract.

Internal conflicts between reformists and conservatives within Iran are part of the reason why it is so difficult to uncover exact terms of the contracts that have been made for the oil fields. NIOC wishes to avoid excessive scrutiny from the Majlis and other public bodies when negotiating and agreeing terms in order to generate investment in the fields. Investors also wish to keep their agreements secret from their competitors in order to prevent them being undercut by a better offer from a rival. There is little incentive and substantial disincentive to publish contract terms.

The case studies show that despite the potential problems of the buy-back contract combined with internal and external pressures, although the external pressures are not as important as one might have initially believed, parties are still willing to invest in Iranian oil fields.

One major point of contention between foreign investors and NIOC is in the duration of development of the sites for the buy-back contract. Those contracts that have been finalised tend to allow for a development period of around five years. The Darkhoven development is expected to last approximately 5 years and 5 months and the Masjed-e-Suleyman development is expected to take 4 years. Contracts between BP, Shell, TotalFinaElf and others fell through because expected duration was between 15 and 20 years and this was considered to be unacceptable.

While the above issues may act as a deterrent for investors, as shown in the Inpex Azadegan deal, nevertheless there is investment in Iran with the majority of problems arising out of unfavourable terms in the contracts. Growth and reduction in investment in Iranian oil is effected by numerous externalities as well as the buy-back contract. However, the buy-back contract is an element of all the agreements. Terms of contracts change as does the political climate in which they are made but the buy-back contract is constant. This shows that despite problems that exist in the buy-back system it does not prevent investment in Iranian oil fields. It may impede investment to a degree by enforcing some unfavourable terms on investors but that will be taken into account in the pricing of the contract. As such, while the buy-back contract is not as efficient for Iran as an alternative system and is an inappropriate model for development of oil contracts it has nevertheless achieved some considerable success despite considerable international and internal pressure along with other difficulties faced.

Considering the extensive and constantly increasing limitations on foreign investments within Iranian petroleum, as well as commercial deterrents stemming from uncertainty due to the

sensitive political situation, linked to international demands regarding its nuclear program, it is necessary to gauge the attractiveness of Iranian buy-back in the context of the international model buy-back. A particular source of such pressure stems from the effect of political and economic measures instituted by the US and international entities, which must be examined prior to reaching the final assessment in this regard.

Such a comparison then permits a more accurate assessment of the influence that increasing international pressure and sanctions would have on Iran's ability to compete within the oil market. The existing effects of such international measures are also reviewed within Part Three, as they serve as a reliable means of predicting the effectiveness of any future sanctions that may be imposed on Iran. As the global oil market consists of interconnected systems, the repercussions for the United States economy and companies stemming from existing and potential sanctions is analysed; as such considerations are likely to affect the viability of any further sanctions.