IJBPAS, January, 2015, 5(1), Special Issue: 266-277

ISSN: 2277–4998

International Journal of Biology, Pharmacy and Allied Sciences (IJBPAS)

'A Bridge Between Laboratory and Reader'

www.ijbpas.com

EVALUATING THE FINANCIAL SYSTEM OF IRAN'S BUYBACK OIL CONTRACTS

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ABSTRACT

Under buyback contracts, an international company invests in Iran and after the start of production, it divests the oil field to the National Iranian Oil Company (NIOC) or one of its representatives assuming that the produced oil is the agreed amount and the world oil prices are high enough. The foreign company receives the agreed costs and interest resulted from oil and gas interest. According to the Iranian Government, buyback contracts have the necessary incentives for foreign companies' investigation in Iran. In this paper, initially the world energy consumption outlook was discussed and then, buy back contracts were evaluated. In continue, the financial system of these contracts and their consequences were criticized.

INTRODUCTION

The International Energy Agency (IEA) announced the increase in global oil consumption from the level of 84.6 million barrels per day to105.2 million barrels per day in 2030 (1). Exposure to this demand volume in 2030 requires a wide investment in oil production and transportation infrastructure. Most of these investments will take place in the discovered and extractable resources of OPEC member countries. OPEC's share of world oil production will increase from44% to 52% by 2030. Increasing the share of OPEC production will strengthen the importance of production decisions and in simple terms, energy policy of the OPEC countries. Among the OPEC member countries, Iran is the second largest producer and exporter of oil after Saudi Arabia with 137.6 billion barrels of discovered oil reserves. Also, Iran is the second country that has the largest natural gas resources after Russia. Iran's energy policies are determined by the National Iranian Oil Company and the Ministry of Petroleum of Iran[6].Iran's oil and gas industry needs to investigate 15billion dollars in short-time and 70 billion dollars in long-time. Iran seeks to benefit international oil companies through investment in its oil and gas trade. Iran is located in the (MENA-referring to the Middle East and North Africa). All member countries of the MENA region need 100 billion dollars per year to develop their oil fields in 2025. The National Iranian Oil Company consistently uses the buyback contracts as almost the only part of the development of oil and natural gas field of Iran. Buyback contract is an agreement between the National Iranian Oil Company and an international oil company (IOC) and through this, the international oil companies agree to develop an oil or natural gas field and deliver it to the National Iranian Oil company in the beginning stages of production. The international oil company's annual repayment rate is calculated based on a specific percentage of the area of operation plus the agreed rate of return [5].

Types of buy-back contracts:

Oil is a material that has brought political economic developments to communities over the years so that almost in all the countries that have oil resources has been the origin of a lot of changes as a source of economic and political issues. Since 1978 onwards, oil strikes, the occurrence of the Islamic Revolution, weakness of knowledge management, excessive controls cause dysfunction in the executive works. Rent-seeking, contribution seeking eight-year imposed war and etc. led that the natural growth of the activities of the oil industry is faced with a serious problem .The Iranian government needs at least 70 billion dollars in the medium term (15-10 years) just for the upstream oil and gas business development to develop its oil reserves. The mentioned amount includes other required investments in the downstream section of oil and gas industry and other sections of the country. Thus, the Iranian government gravitated to contracts that are so-called buyback contracts to attract foreign investment [2].

A buyback contract is not a separate contractual arrangement in the oil industry's literature but also, the mentioned contract is a kind of service contract with risk that is known as buyback in the literature of Iran's oil industry. Buy-back contracts can be defined as: service contracts are implicated in the various types, in which specific service works and technical help and assistance are assigned to the contractor against fixed or determinable wages [3].

In 1993, with the permission of the first paragraph of Article 29 of the Budget law, the government authorized to conclude contracts with foreign companies up to 3.5 billion dollars in the form of buyback. By beginning of the second five-year development plan in 1995, the investigating establishment way through buyback was pursued in the oil industry. According to this law, administrative apparatuses were allowed to create commitment up to 6.5 billion dollars through buyback method. Article 14 of the Petroleum Act in 2012 acknowledges the development of oil fields buyback [3].

However, due to the economic rules of the fifth development plan and the protecting laws of foreign investment, Iran can assign contracts according to the field condition and aside from buyback contracts which are beyond the scope of this paper.

In the buy-back contracts, contractor undertakes to supply the engineering machinery products, technology, and provide technical knowledge to run a construction project and implement an economic action and in return, it agreed to amortize the costs and profits through buy back the products of the project [4].

Iran's oil industry has signed and implemented several buyback contracts from 1995. To better understanding the nature of Iran's buyback contracts, a division of the contracts is essential [2].

In this regard ,changes in relation to the contracts between Iran's National Iranian Oil Company were conducted in three seasons that these developments can be expressed by Figure 1 [3].

The first generation pattern

The first buyback contracts of Iran had the following features.

1. In the first buy-back contracts, except for some special cases, reimbursement of the cost of each project must be repaid from the product design site.
2. The cost of each project must not exceed the ceiling approved by the Economic Council.
3. From 2008 onwards, 40 percent of the revenues of each plan must be credited to the public revenue account.
4. A contractor or contractors must transfer his technical knowledge.
5. Manpower training by the employer
6. Approval of the technical and economic feasibility, timing and payment, compliance with environmental conditions and

usage in the domestic economy by the Council.

7. Obligation of the contractor to buy the relevant product
8. Exchanging the agreements with the Management and Planning Organization in connection with any design
9. Obligation of the contractor to use the inside power of the country
10. From 2000 onwards, observing the law of the maximum use of executive and industrial and production technical engineering power of the country in implementing projects and creating facilities in order to export the approved services in 3/2/1997 of the Iranian parliament [3]

The first generation was two types, development contracts and exploration contracts. The contracts' license of the phases two and three of South Pars gas field and the contract to develop the South Pars phase are this kind of the first generation of Iran's buyback contracts [3].

The second generation of buyback contracts

The second pattern of the buyback contracts refers to both exploration and development contracts. In exploration contracts, only contractors can act to develop the field in case of exploring hydrocarbon only with the consent of the National Iranian Oil Company. This issue led to reducing both competition and incentive of the contractors. Thus, in paragraph (f)Article 21 of Iran's Budget Law in 2003 allowed the National Iranian Oil Company to assign a contract with exploration and development in buyback forming areas of the country. The mentioned authorization was extended in a paragraph of Article 21 of the Budget Law in 2004 and paragraph C of the Article 2 of the budget in 2005. In these contracts, 50% of the field products at most are allocated to reimbursement of costs and fees. Commercial computing differences are recognizing the amount in exploration and development contracts compared to the exploration first type contracts in the considered time to produce and sell the product (fifteen years for the first type and twenty years for this type of contracts) and also, the algebraic calculations discount rate (30% in the first paragraph contracts and 30% in the second paragraph contracts). Block contracts of Khorramabad, Kouhdasht, Garmsar, and Saveh are these contracts [3].

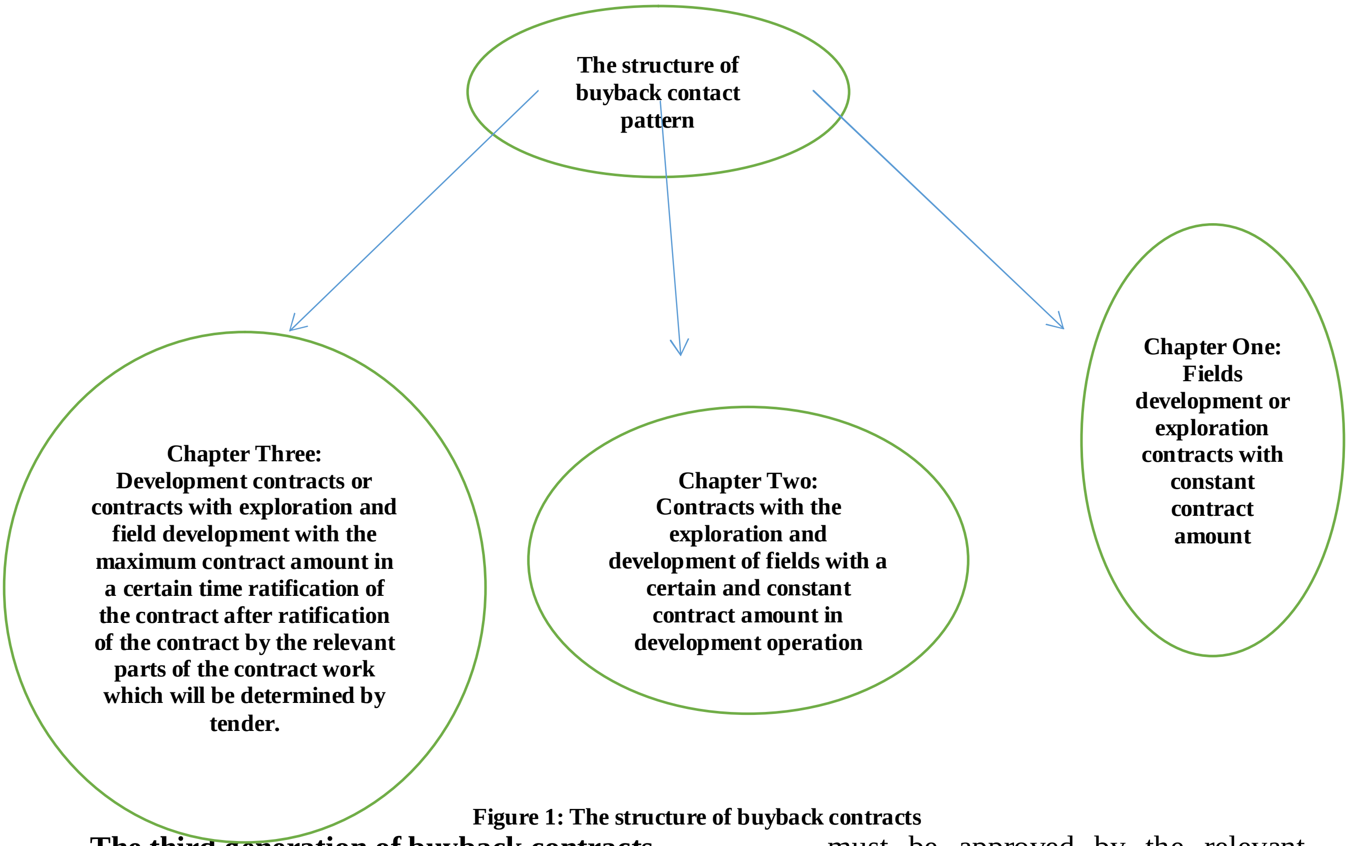

Figure 1: The structure of buyback contracts

The third generation of buyback contracts

In the annual budget laws of 2006 in Iran onwards and the Fifth Development Plan approved 1/5/2011, the obligations to execute the third generation contracts and other issues are presented as follows.

1. Facilities are considered to use the internal power and the contractor must announce his program in this regard. Mechanisms, incentives, and fine are considered in this regard.
2. Master Development Plan which is prepared for the field by experts of National Iranian Oil Company and it must be approved by the relevant authorities by necessity.
3. Plan's capital expenditures limitation is determined after doing tenders to implement the plan by the approval of the National Iranian Oil Company.
4. Contractor fees will be determined according to the Internal Rate of Return in each contract so that it motivates the contractor to use the best relevant methods. The selection criteria of a contractor are the least capital return rate of the suggestion.
5. To ensure the industrial production and enhancing the optimal utilization

of the field, the contractor's fee can be increased or decreased based on the rewards and penalties method in proportion to the actual production with the expected production. The way of applying rewards and penalties in each contract is predicted based on the case.

6. The administrative financial, technical, and etc. operation center will be exclusively in Iran and Iran's external cost will not be refunded.
7. Obligating the contractor to transfer technology and also, training the employer's employees
8. Obligating the contractor to accept the presented experts from the National Iranian Oil Company in its organization chart.
9. Obligating the contractor to provide technical and engineering services in operation period in connection with the technical issues at the request of the National Iranian Oil Company.
10. Delivery and development of relevant plan and verification of the mentioned purposes in the Master Development Plan (MDP) will be based on the delivery methods and procedures. Operators units are obliged to comply with the relevant technical requirements [3].

Financial system in buyback contracts

Buyback contracts one of the service contracts that has unique features and hence, it is discussed as a separate agreement method in some texts. Buyback contracts may be discovered only for field development or they may be used for exploration and development. Since the vast majority of buyback contracts have been signed so far and all the contracts that have been implemented only for field development, financial and tax buyback development model is evaluated here.

Since the signing of the first oil buyback contract in 2005 onwards, no specific contract format is approved by the National Iranian Oil Company or other authorities. In spite of this, from the beginning, the oil company has given the intended format for the contractors and negotiations have been conducted around the format. Since the details of each contract are finalized by negotiation, the buyback contracts are various in terms of provisions and almost, no contracts have a same provision. Many obscure points in the previous contracts are met in the next contracts and gradually, these contracts have been thicker [4].

The most important changes in the buyback contracts in 2007with the approval of the general framework of buyback contracts by the board of directors of National Iranian Oil Company has been updated (third generation) that determining the capital costs limitations was postponed after tenders of sub-contracts instead of performing this at the signing time. In other words, instead of agreeing to the capital costs limitations at the signing time by contracting parties, a method is predicted to determine it during the project. The financial and tax model which is described here is based on this new method.

In the buyback contracts oil costs are divided into four groups that their repayment is the function of a particular system. The first group is the capital costs. The capital costs are referred to all costs which are spent to develop the field in accordance with the terms of the contract and they are accounted according to the audit principles provided that they are not recognized under other expenses. The capital costs in turn, are divided into direct costs and project management costs that the project management costs should not be higher than 10% of the direct costs.

One of the features of buyback contracts is the limitation of the refundable capital costs. Limitation for the refundable capital costs means that first, the performed cost must be audited and in case of approving it is refundable. Secondly, if some money be spent less than the maximum limitation for the completion of the project and its goals, the real spent cost is refundable. Thirdly, if some money be spent more than the maximum limitation for the completion of the project and its goals, the contractor must perform it with his own expense but he cannot request its repayment from the oil company.

In the buyback, the capital cost limitation may increase like increasing project objectives under very specific circumstances. Therefore, increasing the costs due to rising prices or due to change in work description does not increase the capital cost limitation. In order to reduce the contractors' risk in 2007, some provisions of buyback contracts have been changed and determining the limitation was postponed to after FEED studies and holding sub-contracts tenders. However, after determining the limitation, any increase in costs and its risks will be assigned to the contractors.

The second group is non-capital costs. On-capital costs refers to the envisaged costs that are paid under the name of taxes and other public rights to the government and public authorities or cannot be determined precisely at the time of conclusion of the contract like the cost of land acquisition or the cost of oil company staff for training. On-capital costs are 10 to 15 percent of capital costs and they do not have limitation and all of it is refundable.

All taxes, dues and other payments that the contractor pays to implement a contract to the competent authorities such as the tax, customs, social security insurance or municipalities organizations such as Contractor's income tax as non-capital costs without considering the limitation is refundable by the National Iranian Oil Company. Thus, all the paid taxes by the contractor are reimbursed to him and all duty taxes that must be recovered by the employer are paid from the oil company resources to the Tax Affairs Organization.

The third group is operating costs. These costs are considered for a project when the operation be the responsibility of the contractor like the early production that the contractor performs the operation related to the exploitation of the wells and the early production facilities or in the time that the project has reached its final production, but not yet delivered to the employer. Operating costs do not have limitation or refundable auditing.

Non-limited operating costs or the fourth group is bank fees or financing or money interest cost. All capital and non-capital costs from the first day until reimbursement time. It includes interest rates. The interest rate is agreed in the contract that is usually higher that the labor rate -London international bank rate- such as 0.75 plus the Libor rate.

If the contractor reaches the production goals, remuneration is awarded to him. Remuneration is calculated based on the rate of return (ROR) specified in the contract and considering the capita; cost limitations, calculating the non-capital costs, cash flow of the project includes reimbursement and investment tables and simultaneous interest rates by determining the capital cost limitation after determining the simultaneous interest rate with determining the capital costs. After determining if the fees calculation assumptions change like the cash flow of the project, the fee cannot be increased but it leads to increase in capital return, the fee decreased up to the return rate limitation.

In buyback contracts, remuneration period of costs including the capital costs and non-capital costs is defined in the contract. On this basis, all costs are divided into the remuneration months and the remuneration allowed limitation is determined for one month in dollars. About the fee, it is also in the same action and all the entitlement fee is divided into payment months. The allowed payment limitation is determined for one month in dollars. Therefore, it is specifiedin each month that how many dollars should be paid to the contractor under the name of cost reimbursement and fee payment [4].

Since, the buyback contracts are along with risk, entitlement amounts of the contractor should be paid from a maximum of 60% of contract revenue or the field product. For this purpose, 60% of the produced oil in the field is calculated daily over a period of three months. If the field produces 20 thousand barrels of oil and the price of oil be 100 dollars; 60 percent of revenues in the period of 90 days (a period of three months) is as follows:

20.000*$100*%60*90=$108.000.000

However, if the contractor's entitlement in period of three months be less than 108 million, the lower amount is paid to the contractor but it be more, more than 60 percent of revenues cannot be paid to the contractor. Therefore, the remainder is transferred to the next three months and this procedure is done during the next three months until the remuneration be paid or the contract period completed. In case of 60 percent shortage of revenue to offset the costs and the fees in over a period of three months, the priority respectively is with operation costs, other costs and fee.

In buyback contracts, the possibility to sell oil and gas or gas condensate for reimbursement and entitlement to the contractor is predicted. For this reason, a long-term contract for the sale of oil, gas, and gas condensate is assigned between parties. Selling oil, gas or gas condensate to buyback contractor has an optional aspect for the national oil company and buying it has a mandatory aspect for the contractor. In other words, the national oil company can sell daily price oil to the contractor to compensate the entitlement amount and it can sell the oil with its possession and pay the contractor's money with it.

This point causes that the contractor fails to register the reserves arising from buyback contracts in his offices. However, if the national oil company commits to sell oil equivalent to the entitlement amount to compensate (in some buyback contracts),in this case, the reserves registration in the contractor offices is equal to the contract's entitlement amount.

In summary, the financial and tax system of buyback contracts is complicated and understanding of all aspects of it simply is not possible. These contracts are further like a contract with a specific job description and almost fixed payment in that the contractor does not have any right in oil and he is not shared in benefits from increased production and higher oil prices. This makes the buyback to be used in projects that do not have much risk and its job description can be defined. Buyback was not successful in both exploration and development. Because, first the job description of development cannot be determined at the time if assigning contracts and it must be defined later in case of exploring a commercial field and secondly, the fixed amount of fees are incompatible with paying exploration risks. Oil companies that pay the risk of exploration operations are expected that if they reached a result they receive a worthy reward rather than receive their fees [4].

Cash flow calculations in the buyback service contracture calculated based on the following formula (Van Grondal and Mazraei, 2006):

$$NPV_{IOC} = \sum_{t=0}^{T} \frac{-(Capex)_t}{(1 + r_{IOC})} + \sum_{i=T+1}^{l} \frac{(Bank\ Charges)_i + (Remuneration)_i + (Repayment)_i}{(1 + r_{IOC})^i} = 0$$

In this formula, NPV stands for the net present value. The cash flow is until T period and r stands for the rate of return. Capex stands for capital cost expenditures that in fact, is the total capital cost which occurs during the development period. Bank charges of financing costs represent a monetary benefit that is borrowed from the bank for development and include the combined benefits as well. Remuneration is the extra payment for the services of the international oil company which includes engineering, procurement and construction activities associated with project financing and technology transfer. Repayment is also a part of the debt which is repaid to the National Iranian Oil Company in each period.

Two separate mechanisms are applied in the cash flow of the buyback service contracts that follow two different goals. In the negotiation phase of the first mechanism, repayments, bank charges, capex are specified. The goal is to reach an agreement on the rate of return and reward for an international oil company. Reimbursement calculations are performed based on an agreement on the fixed price of oil and equal to a share of crude oil production for the international oil company [1].

CONCLUSIONS

The National Iranian Oil Company is responsible for developing Iran' soil and gas resources as the world's second largest oil and gas supplier. However, it had not the necessary capacity and financial resources to develop all its energy reserves and it requires cooperation with international oil companies. Currently, Iran uses buyback contracts for cooperation with foreign companies. Although, the foreign companies are not interested in cooperation with Iran and they claim that buyback contract does not meet their business needs. However, the National Iranian Oil Company does not accept the claim and it states that foreign companies will benefit fair return on investment during the buyback contracts without any technical and technological risk (exploration and extraction).

Foreign companies claim that they are faced with risks during the buyback contract. If the price of oil or gas be lower than the agreed level, capital expenditures reimbursement, bank charges, and rewards will be delayed. However, such a price risk is specified when the prices really decreased. The foreign company is faced with other risks such as investment consuming demand or higher than agreed amount or distributing it over the construction period or production profile lower than the expectation level.

All of these cases affect the rate of return of foreign companies. Because, the foreign companies' losses and delays in required payments or expenses (costs) cannot be compensated more than the agreed amount in the contract under the buyback contract.

Also, foreign companies protest such contracts because these contracts are used only to explore or develop until the full production time through this contract. Afterward, the National Iranian Oil Company will accept the responsibility. The role of the foreign companies are declined in providing capital and technology provider (engineering, procurement and construction).Foreign companies state that buyback contracts damage the long-term development of the fields because the knowledge of the National Iranian Oil Company or its representative is not enough for the optimal long-term development of the field. Due to changes in resources' behavior, oil and gas reserves need a new investment during production. For this reason, the expertise and financial resources of foreign companies are needed again. Despite these protests and also, considering the new laws of the Iranian government which expresses that the

National Iranian Oil Company can use any type of contract, any type of contract pattern except buyback has not been on the agenda of the National Iranian Oil Company or Iranian Oil Ministry up to now.

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