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Iran faces a bumpy road back to global energy markets

Simone Tagliapietra, Bruegel Author alerts Feb 09 17:31 Comment

President Hassan Rouhani's attempts to reform the oil sector in Iran are essential for the Iranian economy but are facing steadfast opposition.

On January 30, hardline students gathered outside the oil ministry in Tehran to protest against a proposed new legal framework for the industry. At the end of November, Rouhani's government had proposed extensive changes to the regulation of oil production, seeking to make investment in Iran more attractive to international companies.

The students, along with many in the political opposition, accuse Rouhani of going against the constitution, which strictly prohibits foreign ownership of the country's natural resources.

Iran's constitution, adopted after the Islamic Revolution of 1979, states that "public wealth and property, such as uncultivated or abandoned land, mineral deposits, seas [...], shall be at the disposal of the Islamic government for it to utilise in accordance with the public interest."

On this basis, the constitution also "absolutely" forbids "the granting of concessions to foreigners for the formation of companies or institutions dealing with commerce, industry, agriculture, services or mineral extraction [...]."

The protests are not just a sporadic manifestation of political dissent. They are a sign of a more structural problem that Rouhani and his government are struggling to tackle in their efforts to revive the country's energy sector and consequently the whole economy.

From 1979 to 1998, Iran did not sign any agreements with international oil companies. The government only started to pay attention to the development of the country's oil and gas industry under President Mohammad Khatami, who was in office from 1997 to 2005 .

In order to attract the necessary foreign capital and expertise, the government introduced a new legal framework, the buy-back service contract (BBSC).

Under this scheme, international oil companies can agree to carry out the necessary exploration activities to develop an oil or gas field, but must hand the field over to the National Iranian Oil Company (NIOC) once production starts.

The scheme overcomes the constitutional constraints on oil production. However, the programme is unattractive for foreign oil companies, which are expected to make large investments and then hand the asset back to the Iranian authorities once it becomes profitable, then wait to be repaid.

This has much less appeal than the production sharing agreements (PSAs) commonly used in the international oil industry, which allow companies to own part of a field's oil or gas reserves and share in the costs and profits of its development.

Rouhani and his government carried out a process of structural reform of the legal framework governing the oil industry in parallel to the international negotiations on the nuclear issue. This reflects their recognition that the lifting of international sanctions after the nuclear deal would not be enough on its own to stimulate international investment in the energy sector. The recently proposed Iran Petroleum Contract (IPC) is intended to combine some elements of the BBSC with some elements of a PSA, possibly allowing international companies to gain rights to a certain percentage of Iran's oil and gas reserves for 20-25 years.

The effective implementation of a new legal framework is a prerequisite for the country's return to global energy markets.

Iran's oil ministry had planned to hold a conference in London to present the new legal framework to international investors. But after the January 30 demonstration, the conference was cancelled for the fifth time in two years.

Meanwhile, the Expediency Discernment Council, the powerful Iranian oversight body that reports to the Supreme Leader, has declared that it will review the IPC proposal in detail.

Parliamentary elections will be held on February 26 to elect both the Islamic Consultative Assembly and the Assembly of Experts, so further delays in the reform of the legal framework are likely.

However, reform is vital and urgent. Delays could compromise Iran's return to the global oil and gas markets in the short term. This would have unpredictable results not only for the country's macroeconomic prospects but also for global energy markets.

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