Obstacles to an Iranian infrastructure bonanza

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Energy and infrastructure investors and advisers - particularly those focused on oil and gas projects - were understandably excited by the news of an agreed nuclear deal between Western governments and Iran. The deal could see the lifting of sanctions that has prohibited international investment into the country.

Iran has significant need for new infrastructure investment, and is thought to be sitting on the second-largest gas and fourth-highest oil reserves globally. Once the country starts producing hydrocarbons again, downstream and power projects should follow.

The deal faces several legal hurdles, however, not least ratification by a sceptical US Congress. But even if the deal moves ahead, investors will face further obstacles.

Revised contracts

All oil and gas sector activity in Iran is run by and through state-owned National Iranian Oil Company (NIOC). Before the latest round of sanctions was imposed in 2007, NIOC worked with many international oil majors on the development of its assets. Shell, Total and Inpex have all had contracts in the country previously, and are expected to return if the sanctions are lifted.

But legal restrictions on foreign ownership have always made operating in the country difficult.

Anthony Patten, a partner at Shearman & Sterling in Singapore, explains: “There are no production-sharing contracts or concessions in the Iranian market. Foreign firms are banned from owning oil and gas assets. So in any project, the foreign partner acts almost like a contractor to NIOC under what are known as buy-back contracts.”

These fixed-fee contracts allowed the foreign companies to be paid with oil or gas in kind. They have traditionally disallowed the booking of reserves and do not offer protection against cost overruns, with any increase over the fixed price at the risk of the contractor. Fees paid were also referable to oil prices, which left the investors exposed to price movements.

These terms left foreign firms with a lot of risk and limited reward. The market expects the contract structure to be revised, with an announcement scheduled before year-end. Although details are as yet unconfirmed, it has been suggested that reserves booking may now be allowed and overall returns for oil majors will be enhanced. Direct ownership of gas fields will remain disallowed, however.

Downstream opportunities

Further opportunities exist in midstream and downstream industries, but will require greater levels of investment.

Iran shares a large offshore gas field with Qatar, which the former calls South Pars and the latter North Field. It is expected that Iran will want to develop liquefied natural gas (LNG) units for exports from South Pars as soon as is possible.

“All of the LNG projects undertaken in Qatar in the last few years have taken gas from a field which is shared with Iran. I think Iran will want to be playing serious catch-up with Qatar now," Patten says.

There should also be opportunities for petrochemicals projects further down the line, as well as refineries. Iran imports gasoline and other refined products, which for a country sitting on such large oil reserves is wasteful. Much of these imports come from India.

Although these types of projects make strategic sense, they will have much higher capital expenditure levels than the upstream projects, which will be mainly financed on balance sheet.

International banks will struggle to play in Iran even if the nuclear deal moves ahead, because some sanctions would remain. Local banks were active in oil and gas before the sanctions were first imposed, but the lenders' credit ratings have fallen since. Export credit agencies from Europe and Asia are likely to do much of the heavy lifting if projects get underway.

Immediate outlook

South Pars LNG and a handful of upstream developments are likely to be prioritised, but infrastructure development would be slow.

Before the nuclear deal was agreed, a banker at a major development finance institution told *IJGlobal* that it has a long prospective pipeline of Iranian power projects. Such deals may prove difficult if local constructors are required to be involved.

Some institutions will remain firmly on a sanctions blacklist, even if the nuclear deal is ratified. The Revolutionary Guards are thought to be deeply involved in many local construction companies, and could be a block on deals in the country.

But market observers seem pleased that Roknoddin Javadi is running NIOC. He was previously managing director of NIOC subsidiary National Iranian Gas Export Company, which had been in charge of LNG developments during the regime of former president Mohammad Khatami. It is understood that he is generally well-received by foreign companies.