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IRANIAN OIL NEGOTIATIONS

The claim of Sheykh Yamani, Saudi Arabia's Minister of Petroleum, that the participation agreement[1] he negotiated is four times "better" than the one reached by the Shah has set off a chain reaction and brought forth demands from Iran that its spring 1972 agreement be revised. This is an example of the leapfrogging effect which has long been of major concern to the companies in their negotiations with various oil producing countries. The consortium companies[2] have presented to Iran calculations that compare revenues to Iran under the spring 1972 agreement and under the Yamani agreement were it to be applied to Iranian production. These calculations appear to indicate that under the Iranian Spring Agreement revenues would exceed those of the Yamani formula through 1985 but would be less from 1986 through 1994. A tenuous consideration in these calculations is the appropriateness of including the new Kharg refinery--see below--as a revenue benefit to Iran, an important

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1. See RECN-31,"OPEC: Participation Agreement," November 2, 1972, (CONFIDENTIAL).

2. Consortium member companies are: British Petroleum (40%), Shell (14%), Exxon, Gulf, Mobil, Standard Oil of California, and Texaco (7% each), Companie Francaise des Petroles (6%), and a mini-consortium of American companies (5% total).

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SUBJECT TO GENERAL DECLASSIFICATION SCHEDULE OF EXECUTIVE ORDER 11652 DECLASSIFIED ON DECEMBER 31, 1978

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component of the Consortium's comparison presentation.[1] The benefits from the new refinery include the higher cost of refinery construction in Iran compared to that in large consuming markets and the higher transport costs of refined product compared to crude. The Iranians remain unconvinced of the validity of the assumptions upon which this part of the presentation is based.

<u>Background</u>

The July 1971 OPEC[2] Conference in Vienna renewed members' demands for host country participation in existing producing operations. Following only slightly veiled threats of nationalization, negotiations began in March 1972 between the companies and Sheykh Zaki Yamani representing Abu Dhabi, Iraq, Qatar, and Saudi Arabia. Iran, as had Algeria, Indonesia, Venezuela, <u>et. al</u>. in the past, decided to pursue its own path toward a restructuring of basic company-government relationships.

In the spring of 1972, talks began at the highest level -- between the Shah of Iran and Exxon's chairman (representing the consortium of Western oil companies operating in Iran). The latter put forward the participation concept which Iran flatly rejected. The negotiations proceeded in an amicable and businesslike atmosphere and ended in late May with an outline of an agreement which would govern the two parties' relationships for the next twenty-odd years. Subsequent lower echelon meetings refined and distilled the outline still further.

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1. The companies' estimate of the benefit of the Kharg refinery to Iran represents about 20 percent of the estimated increased revenues from 1973 to 1994.

2. OPEC (Organization of Petroleum Exporting Countries) members are: Abu Dhabi, Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, and Venezuela.

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By October the significant provisions of the Iranian draft agreement were:

1) The 460,000-B/D capacity Abadan refinery would be turned over immediately to Iran (National Iranian Oil Company - NIOC), although until the consortium had built a new refinery on Kharg Island, the member companies would be able to have their crude processed by NIOC for a fee plus 90 cents per barrel representing incremental profits Iran could have made on these products were it to process and export similar quantities for its own account. Initially, the refinery would serve the Consortium's refined product needs and part of Iran's internal requirements. The balance of the refinery's capacity would be available to NIOC for sale to Consortium member companies or for direct export. As the Kharg Island refinery came into operation with progressively increasing output, the "balance" from the Abadan refinery would in all likelihood grow significantly. Crude to the Abadan refinery would be made available to NIOC at cost.

2) The companies would construct and operate for their own export requirements a new refinery on Kharg Island. Initial start-up capacity (1976) would be 200,000 B/D rising to 500,000 B/D by 1980.

3) NIOC would have made available to it up to 200,000 B/D of so-called "premium" crude oil for export in 1973, escalating by 50,000 B/D per year thereafter to a maximum of 550,000 B/D in 1980. NIOC would purchase "premium" oil from the Consortium at quarter-way price.[1/]

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1. Represents the tax paid cost plus one-quarter of the difference between tax-paid cost and the posted price.

4) The companies would construct and operate for their own export requirements a natural gas liquids plant.

5) Although the 1954 basic agreement expires in 1979, it grants to the companies, at their sole discretion, three five-year renewal options. These would be replaced by an immediate extension of the term of the basic 1954 agreement to 1994.

6) The Consortium would relinquish exclusive operating rights to a portion of the agreement area in the province of Luristan which would be further developed by a Consortium/NIOC 50/50 joint venture. The venture would be operated jointly and capital costs, operating costs, and production output would be shared equally. NIOC would not make any payments to Consortium members for facilities already existing at the time of the joint venture's formation. The companies estimate aggregate production could attain a level of 300,000 B/D.

Current Demands

Resolved to be the first among equals in the Persian Gulf and an innovator in world oil affairs, and with an insatiable appetite for increased revenues (Iranian statements to the contrary notwithstanding), the Shah has offered the Consortium the following options:

1) make substantial changes in the structure of the Spring Agreement so as to increase Iranian revenues, thereby improving revenues in the latter years (after 1985); or

2) terminate the 1954 agreement in 1979 rather than in 1994; or

3) terminate it now in exchange for a long-term crude sales contract.

An Iranian official recently called at the Department of State and at the White House to make a presentation on the sales contract approach. From information available, this appears to take the form of a buyer-seller relationship which would amount to a complete operational take-over of all facilities. Control over crude exploration, production, and refining would be transferred to the Iranians. The companies would take delivery of crude oil and refined products f.o.b. loading terminals.[1] The contract would provide for delivery of specified amounts of crude to the companies at specified base prices over a period of time.

The companies would be indirectly reimbursed for any future capital inputs into exploration and production by discounts from the base price. Presumably, appropriate consideration would also be given to the companies' loss of operating rights under the 1954 agreement, as the Iranians have made it clear that the discounts to the base price would be so fixed as to provide fully for depreciation[2] and profits the companies would have made had the Yamani participation formula been applied to Iranian production. By implication the quantities of oil sold to the companies would be similar to those that would have obtained under the Yamani formula.

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1. At present, title to crude passes at the well-head whence oil is transferred either to the loading terminal for export as crude or to the refinery. In the latter case, refined products are subsequently transferred to a loading terminal.

2. Under the 1954 Consortium Agreement, title to all fixed assets passes to NIOC from the moment of their installation. The companies' rights to these assets are limited to their depreciation and use during the term of the Agreement.

The Iranian emissary argued that this conceptual approach is the one most likely to achieve stability and security of supply at reasonable prices for the international oil market. He said that Iran would seek no new monetary benefits in negotiating such a contract. He asked for U.S. understanding and, by inference, support. New meetings at the highest level between the Consortium and Iran are scheduled for December 10 to 14.

For the Consortium members, the proposal raises the following concerns: a) it may stimulate rather than discourage leapfrogging; b) it may deprive them of tax advantages they now enjoy under American law; and c) it may deprive them of day-to-day control over production and thus give the Iranian Government control over all operations in Iran.

Under the 1954 agreement Iran owns all exploration, producing, and refining facilities, although the Consortium has exclusive use of them. The buyer-seller relationship would place the operation of these facilities exclusively in Iranian hands. Moreover, it would dramatically change the fundamental company-government relationship which has prevailed in essence from time immemorial to the present: day-to-day control by the major international oil companies of the sources of supply of most or all of the oil they require for their downstream operations.

Most major producer nations of the free world would find it politically virtually impossible to resist making similar demands on the companies operating on their territories in order to respond to nationalistic pressures for indigenous control of their natural resources. Economic arguments against such moves based on cash flows, social return on development capital, and increased possibility of price competition between the new national producers would very likely be brushed aside. In fact, were OPEC's present cohesiveness able to withstand the strain of such a major restructuring of relationships, producing nations could well compete with one another in extracting the highest possible sales price from buyers.

The shock waves would very likely be felt in the major consuming countries. Those in favor of direct consumer-producer nation agreements would find their arguments reinforced by the breakdown of the traditional supply system. Competition for available supplies would in all likelihood increase and be reflected in higher prices for petroleum.

Sales contracts usually provide for a sales price inclusive of all taxes, if any, up to the point of delivery, which in this case would be f.o.b. loading terminal. This could mean a loss of U.S. tax credits which the American Consortium members[1/] are now allowed by the Internal Revenue Service to apply against U.S. taxes due on all foreign operations. The actual loss to the U.S. companies would be approximately 52 percent of the tax credit, as the higher crude or product cost would reduce taxable income by the amount of the tax credit under the present agreement. To avoid this problem, sale might take place in Iran to an Iranian subsidiary of the American member company. This subsidiary would then be taxed by the Iranian Government at a level equivalent to present Iranian tax levels, and transaction prices would be adjusted downward accordingly.

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1. British Petroleum may be similarly affected.

In the past the companies' most effective bargaining counter has been their operational control of the sources of supply, as well as their technological know-how, their downstream marketing and distribution networks, and their capital resources. Loss of operational control would deprive them of the power to reduce output levels in a country, a point which has been a major element in their past bargaining strength in sales price negotiations. The threat of seeking other sources of supply may be no longer credible and could be disadvantageous to the companies.

The Iranian presentations in Washington addressed solely the sales contract option and did not mention the other two. The Shah's determination to see Iran develop economically and militarily at the fastest pace possible has stretched available funds to the limit. The Iranians are acutely aware of the replacement costs of the capital that might be required were Iran to finance all investment in oil within the country. These considerations suggest that the sales contract option may well only be a ploy to obtain satisfaction through higher revenues as proposed in option 1.

Option 2 seems to be the least likely of the three demands to be responsive both to the companies' needs and to Iran's desires. It would dispense legally with the three five-year renewal options. However, it would remove an important incentive for the companies to raise current production to a level of 8 million B/D as presently planned, since the companies would be unable to depreciate fully any new investment. Thus, while retaining control, they would not in all likelihood expand production,

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and revenue to Iran would be significantly less than is now projected. Variations to the basic concept of this option could include a sales contract which would be effective at the end of the 1954 agreement period and would provide for a discount to a base price which would permit the companies to depreciate fully all new investment not so depreciated by October 1979.

Option 1, however, would seem to hold the most promise in meeting Iranian objectives. If the terms of the Spring Agreement are revised upward so as to provide net revenues, excluding the benefits of the Kharg refinery, to Iran over the entire period 1973-1994 equal to that which Iran would have obtained under the Yamani participation formula, both Iranian objectives of maximizing revenues and minimizing capital expenditures in oil could be met. The companies, on the other hand, would retain control of the sources of supply which may be worth the higher cost over that of the present Spring Agreement. Additional costs to the companies over the 21-year period could exceed $900 million.

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