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## Strategic Issues of Structuring in LNG Chain and Legal Review of LNG in Iran

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**Abstract:** *The social and economic development of every country and its industrial growth requires three factors which are work force, investment and energy. However, it is not easy to determine the importance degree of these factors, but for a country such as Iran which is rich in energy, the role that is related to the energy, is more important so that it is the development engine. The present article tries to have a comprehensive review of the LNG chain and the legal issues regarding LNG in Iran. The research shows that structuring of the LNG project will not be effective unless the project companies consider several multi-faceted factors. This role becomes even harder in Iran because the economical, political and legal system of Iran is far from the basic stages to develop and attract LNG investors so that the foreign investors should take these risks into account when making decision to invest in Iran.*

**Keywords:** *LNG chain, Financing, Project Company, Risks and Obstacles.*

### INTRODUCTION

As it is known most of the world's natural gas fields are in the countries that there is not enough domestic demand to monetise this interest, so the gas holding country tries to commercialize these reserves in several ways, expanding from transporting the gas to neighbor countries, to involving in different petrochemical, power-generation, or LNG export projects. Nowadays LNG trade covers ~27.8% of NG market, so if it is focused on, it will progress the NG market to a more global and oligopolistic rather than a local, monopolized one (The Global Liquefied N. G. Market, 2003). Because of its geostrategic position, Iran is one of the best countries to invest. Commercialization of energy specially supplying LNG in Iran is one of the main fields of interest in the international community. Despite the importance of this issue, there is not still a meaningful support of foreign investor to invest in LNG industry in Iran and also there are several prohibiting Acts in IRI constitution that even make the issue more complicated. These Acts including Article 81 that directly forbids granting franchise to foreign nationals to establish companies in different economical fields challenges foreign investment in Iran. Also, Article 139 regarding the reconcile in claims that one of the parties is a foreign national concerns the investors as well. It should also be noted that recently some Acts like the Act of Foreign Investment Promotion and Protection has solved most of the ambiguities in this regards. This is a library research and the result of this study not only introduces us the interesting theoretical discussions of multiple LNG structure and their profit and losses, also it provides us risks and obstacles of investment in Iran.

### The LNG Chain

Energy companies should invest in different highly-connected fields to make the LNG ready to be used. Aside from pipeline operations between stages, usually the LNG value chain includes the following levels:

A) Exploration: The first step is the search for the natural gas in the earth crust, natural gas is usually discovered in the oil search fields and then is processed to be delivered to the users.

B) Liquefaction: In order to transport the gas by the ship, it should be converted into a liquid state.

C) There should be special-purpose vessels to ship the LNG.

D) The last step is the storage and regasification in which the liquefied gas that was stored in the tanks should be converted into its gaseous state to be delivered by the gas pipeline system to the final destination.

The range of the end users for the LNG is very wide and can range from commercial and industrial users to the domestic applications for heating and cooking (Turbervill-geoffrey P., 2009).

### **The Structure of LNG projects**

One of the basic issues regarding developing an LNG infrastructure is the structure of the project. It can directly affect the project financing and its ease and also the risks that maybe included. Usually the project sponsors consider many factors like contractual relationships, local law and tax regimes to select the final structure. Generally, there are two important models for project structures namely project company and tolling company.

In the first model, the company that own the LNG facility (project.Co) acts somehow independent and is not interested in the upstream assets. It owns the projects plants, so project Co. has the task of buying the natural gas as feedstock for the plant, processing it into LNG on the basis of FOB, CIF or DAP contracts to one or more buyers.

The project company model can come into various forms. In some variations, the owners of project Co. are the same as the upstream facilities owners. But sometimes this unity of interests does not exist along the LNG chain. for example, in some project structures, the natural gas suppliers are not project Co. owners but most of them in upstream natural gas suppliers are also LNG liquefaction facility owners.

Also, there maybe cases that the Project Co. is owned by a governmental entity directly or through the State-Owned National Oil Company but the facilities are operated by a company owned by an upstream PSC contractor.

Even when there exists a unity of interests in the LNG supply chain, it is preferred to structure the Project Co. as a separate company. One reason can be the tax considerations that requires a distinct company with separate profit (or loss) from its operations. Another case is when the local law requires that there should be governmental ownership for the LNG facilities.

Another fact that affects the structure of a Project Co. is the commercial issues. Sometimes upstream owners are unable or unwilling to invest on liquefaction facilities, so there should be a separate project company to do this. Also when the plant owners are not interested in the upstream supplies, the integrated project model does not seem to be suitable.

One of the commercial aspects a sponsor should consider while selecting a project Co. model is the fiscal regime in the project country which defines the time when the first hydrocarbon sale occurs.

The project company model may impose some risks on Project Co. besides its usefulness in commercial and legal aspects. One of the most important risks imposed is the commodity pricing risks that occurs in purchasing natural gas and selling LNG. Project Co. as a separate entity from the party that produced the natural gas should purchase the natural gas from the upstream producers according to a gas supply agreement and then can sale the LNG.

As upstream supplier who is not the project Co. owner can impose undesirable market risks on project Co. because of the pricing mechanisms in the gas sales agreement. For example, those agreements may include a

netback price based upon the sale price of the LNG from the project Co. or a participating economic interest in the revenues of the Project Co.

A project Co. model which uses a uniform sale pattern has both advantages and disadvantages. We can refer to the simplicity of the management and capacity allocation to the LNG plant as advantages and reduction of the flexibility of each equity holder with regard to natural gas production and LNG disposition as disadvantages. Usually LNG Sale agreements are different and the project Co. takes the upside and downside commodity risks related to the buying of the natural gas and marketing LNG by Long term LNG sale and purchase agreements (SPA) (Holmberg TE., 2012).

Another project structure model is the Tolling Model in which the LNG liquefaction facility owner company (Toll Co.) receives a fee to process the natural gas which is owned by an LNG producer or purchaser and the company does not take title to the processed natural gas. Usually the natural gas owners sell the LNG to a downstream buyer at the LNG plant under tolling structure. There are different variations to the tolling model. Sometimes the toll Co. which receives the tolling fee for processing the natural gas, takes title to the LNG and sales it on a FOB-based contract (Hosseini SE., et al., 2015). This way the tolling Co. takes away the company from price risk by receiving the tolling fee and at the same time sharing in upside pricing. This is a kind of hybrid management and is called "quasi-tolling" (Holmberg TE., 2012).

A tolling structure usually benefits from a two-part fee payment which minimizes the market risks to the toll Co. The first part fee payment is the amount called a " reservation charge " and is the fee paid to ensure that LNG plant has the necessary capacity to liquefy natural gas on a regular basis (e.g. monthly). This charge enables the toll Co. to recover the fixed costs and also a return on capital because whether the natural gas is liquefied or not, the reservation fee should be paid.

Commodity charge should be paid in the second part of fee payment. This fee is associated with natural gas processing costs. This kind of payment structure under tolling Co. model keeps the tolling Co. away from the market risks because by the way the reservation charge should be paid whether any LNG has been produced or sold by the LNG owner to the downstream users (Router M.).

In cases where there is uncertainty of natural gas supply or of downstream markets or where the sponsors wish to attract outside investors to the project, the tolling structure seems to be favorable because the upstream suppliers may wish to face the risk by commodity to the tolling fee in change for toll Co.'s investment in the project (Holmberg TE., 2012).

In addition to the above-mentioned, there are two kinds of joint venture structures namely unincorporated joint venture and incorporated joint venture which differ mainly in creating a separate legal entity in incorporated joint venture that does not exist in unincorporated joint venture. In UJV the parties manage their relationship by stating terms and conditions in their UJV agreement.

The common promises in UJV include the following:

The UJV itself makes no profits, it means that each party is liable for operating costs proportionate to their interests and after the production each party markets its share to make profit, so, there maybe some competition between the two parties in this regard.

The parties usually own the JV assets as tenants and consequently when dealing with UJV they should appoint an agent or mention the names of all parties in any contracts. Because as it was mentioned above the UJV agreement terms are produced by the parties involved, it seems to be more flexible in structure and operation (Router M.).

### **LNG Finance**

In every LNG project finance ability of the project is the main issue because the sponsors and LNG buyers should make large interdependent capital investment. Many involved factors like political instability, economic

uncertainty and local currency fluctuation should be considered when facing the LNG project financing challenge. In order for an LNG capital to be raised for investments from the wellhead to the end user, besides the sponsors, buyers and lenders, the government of both the importing and exporting countries should also cooperate. Following issues should be considered in financing LNG projects:

- A) The lenders should consider LNG as a fuel to be competitive in cost with other fuels especially in emerging market economy.
- B) The governments of both exporting and importing countries should be committed to the LNG project.
- C) There should be special offers for the lenders to increase credit and to create comfort for them with the cash flow materialization and repayment of the debt (Minyard RJ.).

### **LNG Project Risks**

Two aspects that should be kept in mind in analysing LNG projects risks are: first, the nature of the LNG projects that are geographically far-flung, expensive, political, and technical and the second aspect is that usually there are several different parties involved in the LNG chain that each has different acceptabilities for risks, credit capabilities, negotiating strength and technical expertise. In addition, the parties' legal advisors should identify the involved risks and try to share them in a comprehensive manner.

One of the mainly faced risks in every LNG chain is the force majeure event. It is a broad category and can happen in any stage of the LNG chain and as a result the whole project will face the risk because usually there is not any alternative for the stage in that the force majeure occurred. For example, the force majeure event can happen for the delivery ship or in the liquefaction terminal or in the regasification terminal. In any of these cases, the downstream stages in the LNG production chain will face the problem and can be affected by the delay or damage at upstream levels, because there are usually no alternative for the affected stage and the participants can not effectively compensate for the unexpected events in the upstream and downstream chain.

It should be mentioned that although force majeure events can occur in each LNG link, one of the main examples of these events is LNG shipping classic "perils of the sea" risk.

Since LNG projects are usually owned by several parties or they are structured in such a way that be owned by multiple owners, it becomes crucial for these owners to face the force majeure events as their immediate task and answer these two questions in this regard: If they will face any of the risks of a particular force majeure event itself and to what extent. If they are excused from the effects of a force majeure event on other participants in the chain and to what extent.

Another aspect that usually causes force majeure events is the construction risks involved in LNG projects. As it is clear, expensive, technical facilities should be installed in every LNG project and it surely includes such risks as supply disruption, unavailability of materials or expertise, escalating costs and the costs related to implementation issues.

Considering all these facets in mind, there are just a few limited number of firms worldwide that can perform the projects reliably, so the project owners and their legal counselor should keep this risk in mind that even these experienced firms may fail to execute the construction and commission the liquefaction facility on time. However, the construction contractors cover the delay damages to some extent but no firm is large enough to cover all the delay costs involved and it respectively affects all the downstream stages as well (Thurber M.).

### **Risks and Obstacles of Investment in Iran**

#### **Economic Risk**

The main issue that in the first place foreign investors face in Iran is the unclear policy of the government in different economical sections. The Islamic Republic of Iran has never continued a fixed and determined economical policy and with the change of the governments and empowerment of different political parties. So, most of the time foreign investors are confused about this issue and always face the risk of unstable economy for planning.

Another issue that the foreign investors take into account for investing in Iran is the effect of anti-bourgeois idea existing from the beginning of Islamic Revolution. This issue causes the managers in most sectors to insist on governmental protective policies and require governmental interference at most. We can mention giving subsidy by the government as an example that still exists in some sections. This is not favorable for the foreign investors because this can take the competition power with the subsidy recipient sections from them. However, recent years' realities made the foreign policy makers to revise the issue, but if the parties who follow this kind of arguments get into the power, it is possible that the mentioned trend continue or even to return to the protective policies and subsidy payment.

Another threat for the foreign investors is that the country's economical substructures are not developed enough and it is clear that there should be suitable related economical substructures for the foreign investors to act successfully in Iran, So, if there is no access for the foreign countries to these substructures, they can not have their economical activities. We can point to the weakness in the communication and transportation sections in the country as the example.

Currency fluctuation in domestic market is one of the main economical risks for the foreign investments in the country. Iranian government executed different financial reformations to develop rule and safety in the country's monetary market, one example of them is executing the uniformity policy of dollar rate by the Central Bank of IRI. But still foreign investors face this risks that in the case of severe currency fluctuation especially dollar rate fluctuation, they may face loss at the time of getting the profits or returning the capital asset. This happens when the dollar rate increases suddenly.

### **Political Risk**

Iran's communications with Middle-East contries , especially the peace issue between Palestine and Israel is one of the tension – making issues in foreign policy field. Iran has a complicated condition because of its governmental structure and its relationships with foreign countries . This change in foreign and domestic relationships can easily affect the economical situations and also the foreign investments as well .

Government's ruling of ideal and ideological ideas is another political risk in Iran . Iran's tension – making relations with other countries affects the country's economy and also foreign investments .This issue is so vital that we can see its effects on the rate of foreign investors' activities and requirements with the increase or decrease of the mentioned tensions (Ebtekar newspaper, 2017).

### **Legal Risk**

Article 81 of IRI constitution is one of the main legal problems for direct foreign investment . According to this Article granting the franchise to establish companies and institutions in commercial , industrial , agricultural , mine and service fields to the foreign nationals is forbidden .This Article challenges direct foreign investment attraction. However, in clause "d", Article 2 of foreign investment promotion and protection Act, the share of foreign investment in the economic sectors and other sectors is considered which is about 25% and 35% respectively.

Also, according to the Article 139 of IRI constitution regarding the reconcile in claims of public or governmental assets or referring it to the referee in the cases that one of the parties is a foreign national needs the confirmation of Council of Ministers and Congress causes some concerns for the foreign investor.[9] The Foreign Investment Promotion and Protection Act was approved with the aim of eliminating the deficiencies of the previous law and creating favorable conditions for the activities of foreign investors in 2002. The Act provides a favorable mechanism for the benefit of the owners of foreign capital from the same rights and protection as the domestic investor and provides information on how to participate and operate the private sector, and also the issues regarding expropriation, compensation, currency transfers, and capital withdrawals (Shiravi AH., 2014).

### **Foreign Investment regulations**

It is tried to facilitate the foreign investors' activities in the foreign investment regulations. Although it should be mentioned that the regulation include some limitations for the foreign investments, for example the ownership of immovable assets is prohibited for the foreign investors. According to local and midland regulations in Iran , the ownership of immovable assets is forbidden for foreign deal or legal nationals . In this regard the foreign investors regulations validated this principle and deprived the foreign investors from owning immovable assets in Iran . However, to solve this issue the investment regulation made it possible for foreign investors to register a company in Iran and continue their activities as an Iranian company, so because the company is not foreign any more , they can enjoy the advantage of owning properties and assets in Iran. By the way , it should be noted that the foreign investors can not enjoy the ownership rights with his foreign identity.

### **Legal Reviews of LNG in Iran**

In order to have a better understanding of legal issues relating LNG operations in Iran , we should review the laws and regulations relating to Oil and Gas , foreign investment promotion and protection Act , because there is not any particular regulations passed to regulate LNG operations.

Although the Petroleum Law of 1974 gives NIOC the freedom to have a joint venture with an Iranian or foreign party for the production and refination purposes , LNG projects are not referred to directly and we can just assume that production and refination facility and activities involves LNG as well .It is worth mentioning that in this law the share of NIOC in the joint venture should not be less than 50 percent and the joint venture agreement time should not be more than 20 years . This law allows the Ministry of Petroleum and Affiliated Companies ( e.g. NIOC ) to write agreement with Iranian or foreign companies in order to do the oil and gas projects (Shiravi AH., et al., 2015).

As it was mentioned no reference to the LNG is made in the Petroleum Law and to simplify the method for the foreign investors to have a safe investment , the Foreign Investment Promotion and Protection Act ( FIPPA ) came into force in July 2002 that requires the foreign investors to get an investment licence from Organization of Investment and Economic and Technical Assistance of Iran ( OTETA) according to which they are allowed to have production activities in Iran . When the foreign investors obtain the licence according to the FIPPA they will have the following advantages and protection :

- A) Foreign investors can benefit from the same right, protections , and facilities as the local investors and should be treated similarly.
- B) Except in public interest fields the foreign investment will not be nationalised and if this happens , they will receive a fair compensation by payment of market price of their expropriate investment.
- C) Foreign investors can have safe transfer of profits , payments of financial facilities and royalties and repatriation of capital in the form of foreign currency.
- D) Unlike the law in the past that just 49 percent of a contract share was allowed for a foreign investor, they can now register a company in Iran with up to 100 percent foreign shareholding.

Foreign investment in FIPPA framework can be direct or under contractual agreements. Generally we can say that foreign direct investment is permitted on private sectors according to the Iranian laws and regulations . This direct investment can be by means of foreign investor's participation in capital share of a company or by buying the share of an already existing company in Iran.

The second type of structure covers the public sector economical activities in which the foreign investor usually has an agreement with a state entity in the forms of joint venture , Build – Operate –Transfer ( BOT) or buy back.

Generally , in every LNG project investment in Iran , the technical , commercial and financial viability of the project should be confirmed by the NIOC and then by the Economic Council. Then a committee made up of the Ministry of Economic Affairs and Finance and the head of management and planning organization restricted to award the project.

In order to have a fair and safe tender , the Tender Act was devised in 2005 that clearly explained the tender procedure with the purpose of avoiding corruption , creating similar and equal opportunity for goods and service suppliers to have safe purchases of goods and services with a fair price , and also removing any ambiguity from governmental businesses . Article 11 (c) of the Tender Act emphasizes that open or restricted tendering should be done for any major contracts whose initial estimated value is not less than US\$ 22,200. If the tender is an international one or if the foreign financing is needed, some terms and conditions should be met as follows:

First, according to article 2 (d) of the Tender Act local bidders are preferred over foreign ones and the way for doing this selection is clearly explained in that article . The Economic Council is responsible for decision making where giving priority to the local bidder is not expedient.

Second , according to the law of Maximum Utilization of Technical , Engineering , Production , Industrial and Executive Potential of the country (1997) if there is not a qualified Iranian company among the bidders to execute the project , then there should be a contract of joint-venture or partnership and the contract should be approved by the Economic Council . It should be kept in mind that the necessary condition is that the Iranian party's share should not be less than 51 percent .This conditions also works for the products, works and services of Iranian origin that are preferred in these contracts .If there is any change or modification to this law , the Economic Council should approve it.

So , by reviewing the related regulations and acts , it becomes clear that the LNG project preferably is given to an Iranian company and if there is not a qualified local company , the project shall be executed through a contract of joint venture or partnership with a foreign investor whose share of the contract does not exceed 49 percent.

## Conclusion

The search shows that developers must carefully assess a multitude of factors in order to structure their project in order to form LNG project and different factors should be gathered especially when it is related to country investee. However, in Iran in the field of LNG the basic steps still have not been taken place and there is a huge gap in this respect in comparison to other countries. Although, Iran's foreign Investment Promotion and Protection Act' covers the weaknesses that had already existed in the past but there are still weakness in Iranian legal system to attract foreign investors especially when these laws are related to the LNG chain because there are not special law in this field and it seems that available laws are not sufficient to make LNG project lucrative in Iran .The legal, financial and political risks are among the most important problems that count as obstacles for the growth and development of LNG projects in Iran so that Iran should get a real step towards investors' concerns in these fields.

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