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SPECIAL FEATURE

Bridging the Gulf

Iran powers up for project finance

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Iran expects over USD 15bn worth of oil project finance deals before the end of its calendar year on 20 March 2018 – a bullish view for a country that has long languished under international isolation and sanctions. But recent tenders and deals suggest that Iranian project finance is finally on the table once again for foreign companies, following isolated forays out of Italy and France last year.

Hawkish rhetoric from the US government's dealings with Tehran since the election of President Donald Trump, has not yet derailed an increasing interest among international companies to assume Iranian project financing risk. This is despite the clear and present danger that any regression by the Trump administration to a sanctions regime on Iran could nullify investors' ability to retrieve their money.

"*There is no guarantee of debt repayment from the Iranian government in the case of sanctions snapback,*" said William Breeze, partner at law firm Herbert Smith Freehills in London. "*This is because giving a guarantee for the repayment of external financing, and thus giving sanctions protection, would mean that the government is implicitly endorsing US foreign policy – and that would be unacceptable to Iran.*"

Most recently, Total's Chief Executive Patrick Pouyanne said on June 20 that the French oil company will proceed with development of phase 11 of the South Pars gas field in southern Iran this summer. He said that despite the risk of sanctions snapback, Total would make an initial USD 1bn investment in the field, according to state media. On 3 July, Total and the National Iranian Oil Company (NIOC) signed the contract for the project. The contract has a 20-year duration and is the first Iranian Petroleum Contract (IPC) and is based on the agreement from November 2016. Total will be the operator with a 50.1% stake alongside the Chinese state-owned oil and gas company CNPC (30%), and Petropars (19.9%), a wholly owned subsidiary of NIOC.

In May, Iran, which is looking to boost its crude production, launched a tender to develop the Azadegan oil field, the country's largest, amounting to as much as 37bn barrels of oil. Total, Petronas and Inpex are among international companies to submit technical surveys so far. On 20 June the managing director of the NIOC, Ali Kardor, told local media that the project could be delayed for three or four months to allow companies more time to conduct due diligence.

On 19 June, Italian oil company Eni signed two memorandum of understandings (MoUs) with NIOC, according to local media. Under these agreements, Eni will conduct development studies on the phase 3 of Darkhovin oil field in southwest Iran as well as Kish gas field, Tasnim news agency reported. After six months, ENI will propose a master development plan to the NIOC.

"When the JCPOA came into effect on Implementation Day in January 2016, there was significant optimism..."

This is a revival of a project from August 2011, when NIOC and a consortium of Iranian companies signed a USD 1.6bn deal to develop the third phase of the Darkhovin oilfield. This has an estimated in-place oil reserve of five billion barrels. Crippling western sanctions on Iran subsequently stalled progress, but the project has an estimated production of 71,000 barrels of crude oil per day.

The development plan for the Kish gas field began in 2007. The field holds around 66tn cubic feet of in situ gas and 514m barrels of condensate.

On 12 June, the Iranian government secured a EUR 1bn (USD 1.2bn) credit line from Austrian lender Oberbank to finance investment projects in Iran, according to the Financial Tribune.

These big breakthroughs for international re-engagement follow a development deal in November led by French firm Total, estimated at around USD 5bn. And, in April last year, FI Cassa Depositi e Prestiti, mostly owned by the Italian government, agreed a EUR 4bn (USD 4.5bn) credit line to Iranian public entities to fund infrastructure projects. It also provided EUR 800m to support Italian SMEs doing business in Iran.

Washington-Tehran relations remain a challenge for would-be investors into Iran, but the Islamic Republic is no longer entirely out of bounds even for US companies. On 10 June, Boeing announced that it had signed an agreement for Iran Aseman Airlines to buy up to 60 737 MAX commercial passenger airplanes. The deal includes firm orders for 30 737 MAXs, valued at USD 3bn at list prices, and purchase rights for an additional 30 737 MAXs.

In addition, Boeing also signed an agreement in December to supply Iran Air with 80 planes by 2018. The deal is under review by the US Treasury Department.

But despite these signs of progress, lawyers, bankers and other market practitioners have yet to see a flurry of deals in Iran.

"*When the JCPOA [Joint Comprehensive Plan of Action] came into effect on Implementation Day in January 2016, there was significant optimism,*" said William Breeze in London. "*However, a number of challenges, culminating with Donald Trump being in office, have meant a measure [of caution] about Iran from international investors. The lifting of European primary and US secondary sanctions under the JCPOA is only the first step towards doing business in Iran.*"

Iran turns a corner

In July 2015, Iran and world powers (via the P5+1) agreed the JCPOA, which aims to ensure that Iran's nuclear programme is peaceful and to deter Tehran from developing a nuclear weapon.

In exchange, various countries lifted multilateral sanctions related to Iran's nuclear programme, including an oil embargo in January 2016. SWIFT relinked Iranian banks to its payments system and Iranian banks entered into corresponding banking relationships with small and medium non-US banks in order to reduce financial transaction costs and ease cross-border trade barriers. Iran's access to foreign exchange reserves improved by around USD 30bn in previously blocked or frozen assets and oil receipts.

Meanwhile, the Iranian government continues to take steps to improve the business environment.

"*In recent years, the government has been making efforts in the legal infrastructure to attract international investment,*" *said Shahrzad Atai, head of the Middle East desk at law firm Child & Child in London. "A foreign party can now own 100% of a company in Iran, either as a branch company or an Iranian limited company. Further banking laws have been legislated to address anti-money laundering and anti-terrorism financing to improve the standard of banking laws for the purpose of business environment.*"

The World Bank notes that Iran is the second largest economy in the region after Saudi Arabia and has the second largest population after Egypt. The Bank says Iran has a well -diversified economy compared to its regional peers, as well as holding the second highest natural gas reserves in the world and fourth highest proven crude oil reserves. It forecasts that the economy grew by around 6.4% in 2016, in contrast to a nearly 2% contraction in 2015.

Iran's financing needs

Since the fall of oil prices, from USD 90-120 to a USD 40-50 range, the Iranian government revenue has struggled to cover general and administrative expenses, according to an investment banker based in Tehran.

"Iran needs USD 200bn of investment to revive its obsolete energy sector over the next five years"

"*Wages and retirement benefits are weighing heavily on the budget and after passing those obligations, there are no resources left for infrastructure expenditures,*" he said. "*Therefore, lots of infrastructure projects are waiting for financial resources to kick off.*"

Energy priorities of the past few years have been oil and gas exploration and production, said the banker. In the industrial sector, capital goods, aerospace, defence and transportation industry are top of the agenda, he added.

In particular, the railway industry is a focus, with "*lots of predefined projects ready for financing*", he said.

"*Iran needs USD 200bn of investment to revive its obsolete energy sector over the next five years, according to the US Energy Information Administration,*" said Florence Eid-Oakden, chief economist at Arabia Monitor.

Iran plans to attract USD 50bn in foreign investment for the mining sector by 2022 within the framework of its Sixth Five-Year Development Plan (2017-22) and has approved around USD 3bn worth of foreign investment in its renewable energy sector, Eid-Oakden noted.

"*Furthermore, Iran intends to launch a large-scale project to construct renewable energy power plants under the Sixth Five-Year Development Plan to generate 5 GW of energy,*" she said.

Other than infrastructure projects, many companies have feasible expansion or development plans, but due to high interest rates inside Iran, are reluctant to finance their projects internally, said the investment banker in Tehran. They are eager to have the opportunity to refinance their business expansion from external creditors, he said.

Challenges remain

Despite optimism from those polled by Debtwire post-JCPOA and opportunities in Iran, a number of political and economic challenges remain for international banks looking to finance projects inside Iran.

The IMF notes that US primary sanctions remain in place and apply to US financial institutions and companies. These include non-US branches, although not subsidiaries provided they do not deal with US banks. Oliver Martin-

Robinson, consultant at political risk firm Control Risks Middle East said that Iran remains under non-nuclear sanctions by the US and EU, with around 180 entities and individuals still listed.

The presence in the economy of the Islamic Revolutionary Guard Corps (IRGC), a paramilitary organisation established after the 1979 Iranian Revolution, has become an obstacle for foreign investors.

Nazanin Saroush, senior MENA analyst at IHS-Markit, said that the IRGC is under US secondary sanctions and has an extensive, opaque presence in the Iranian economy.

"*They are unable to partner with foreign companies because of aforementioned US sanctions,*" she said. "They also do not want domestic or foreign challenges to their economic influence, and are powerful enough to restrict the inflow of foreign investment that would otherwise benefit their political and economic rivals."

"Local currency and interest rates remain a concern"

As a result, some banks and financial institutional are worried of potential penalties from the US authorities, as well as reputational risk for banks and/or FIs with business in the US or GCC states.

"*The fact of the matter is that any-kind of payment flows from Iran is sensitive for many banks and financial institutions, because they fear actions from the US Treasury,*" said a regional investment banker.

The banker added that the Iranian financial sector itself presents a material hurdle for project finance in the country, given domestic banks' high level of non-performing loans (NPLs) and lack of cushioning liquidity from international markets.

"*Local currency and interest rates remain a concern,*" the banker said. "*The Iranian financial sector remains isolated and closed out of the global financial sector.*"

Hurdles to clear

The regional investment banker noted that US dollar clearing restrictions have not been lifted, which limits dollar financing of projects for large non-US banks and FIs except where there is permission from the US government. According to the IMF, this has restricted Iran's access to corporate trade finance and to reserves, foreign assets, and export earnings particularly from dollar-dominated oil sales.

The regional investment banker said due to restricted dollar financing, lenders would have to use either euros, yen or yuan – meaning that those that typically fund in dollars would bear additional foreign exchange risk. Simultaneously, non-US dollar currencies are less well known in the MENA as many regional currencies are pegged to the US dollar.

In addition to the health of Iranian banks and macro-economic challenges, anti-money laundering and counter-terrorism financing are another issue for Iranian banks and FIs, according to George Bennet, managing partner at OSACO Financial, a firm that helps Iranian banks with compliance and regulatory standards.

"*A lot of Iranian banks and financial institutions face challenges of updating their standards of compliance and regulations as well as anti-money laundering and counter terrorism financing,*" said Bennet. "*The issue of terrorism financing in Iran is a challenge. For example, whilst Iran has laws defining terrorists, they include certain exemptions for 'anti-colonial liberation movements' – thereby covering Hezbollah and Hamas.*"

This is a problem for international organisations such as the FATF (Financial Action Task Force) and by extension, international banks and financial institutions, said Bennet.

Some tail risk around Iranian domestic politics was removed from the equation in May, when the country's incumbent president Hassan Rouhani defeated his hard-line opponent, Ebrhaim Raisi, in presidential elections, to secure a second term.

"*It is my view that the domestic political position has improved the investment climate for international investors,*" said William Breeze. "*The vote in favour of President Rouhani was a clear endorsement of an 'arms-open' approach to international investment.*"

But Saroush at IHS-Markit cautioned against optimism, saying that Rouhani will be constrained at home.

"*Despite winning a strong popular mandate, Rouhani is likely to face stiffer opposition by his rival hard-line revolutionaries in his second term, and therefore to enjoy less political manoeuvrability and influence in his next term,*" said Saroush.

Sanctions busting

As noted by Breeze, the key concern for international banks, FIs and investors is the threatened snapback of sanctions (as negotiated under the JCPOA) should Iran breach its part of the deal. There is legal protection from Iran's 2002 Foreign Investment Promotion and Protection

Act (FIPPA), which aims to afford foreign companies a number of protections.

According to Martin-Robinson, this most relevantly addresses fair compensation in the event of nationalisation, and sets up mechanisms for international arbitration. However, both Martin-Robinson and Bennet stressed that this is yet to be tested.

"*It's worth noting, however, that government contracts in Iran are issued according to a strict tender process that in practice are rarely competitive,*" said Martin-Robinson. "*In that context, and given the relative lack of precedent of dispute resolution between international financial institutions and the Iranian government, it remains to be seen how effective FIPPA would be in protecting investors into Iran.*"

Martin-Robinson also said that, beyond the FIPPA, Iran has bilateral agreements with many countries that afford protections for institutions from those countries in dealing with Iran. Export credit agencies from the investors' home countries can guarantee certain transactions with Iran, depending on the nature of the transaction.

Since the beginning of 2017, the Trump administration has quickly demonstrated the fragile nature of the JCPOA deal with hostile Tweets as well as having levied sanctions against Tehran for test-firing ballistic missiles.

"*Notwithstanding the tensions between Tehran and Washington, the US administration's decision to waive sanctions targeted under the nuclear deal against Iran, just before the elections, seems like a ray of hope for Rouhani's government,*" said Eid-Oakden at Arabia Monitor.

President Trump must review and sign the sanctions relief waiver every 120 days, she noted. Since taking office in January, Trump's first opportunity to roll this back was on 18 May, but the US declared that Iran was in compliance with the agreement. But after the sanction waiver, Trump launched a fierce attack on Iran in Riyadh just a day after Rouhani was re-elected president.

"*In his speech, he [Trump] blamed Iran for funding terrorism and focused on his desire to lessen their influence in the region,*" said Eid-Oakden. "*Therefore, Donald Trump's stance on Iran remains unclear. With the second sanction waiver coming up, his position may become clearer.*"

Cautious outlook

While there is a sense of optimism in light of recent deals and announcements, any desire to finance projects in Iran must be balanced with caution and realism.

"*In the short and medium term I don't see much involvement from foreign banks in Iran,*" said the regional investment banker, adding that it would be better for cooperation to begin at the governmental level and then to gradually allow more banks from the private sector to get involved.

This suggests that, in the near term at least, Iran project finance may continue to be largely the province of firms with a well-established presence in the country. But a new class of investors could emerge over time if Iran continues to move in the right direction.

"*There are two types of investors in Iran,*" said Shahrzad Atai. "*The first are those that had presence in Iran before the sanctions, and know the rewards and profits despite the risks. The second group, are the ones that never had presence in Iran before, but are aware of the opportunities, although they are more cautious or slowly preparing to enter the Iranian market.*"

The recently unveiled USD13bn of South Korean foreign direct investment for Iranian projects points to other encouraging avenues for the Islamic republic. In June, a meeting in Seoul between Iran's Minister of Economic Affairs and Finance Ali Tayyebnia and the president of Korea Export–Import Bank (Kexim) Choi Jong-ku discussed financing of construction and infrastructure projects in energy, petrochemical, oil and health industries, IBENA reported.

"Relatively few UK or European banks are willing to go into Iran because of potential repercussions from the US Treasury"

"*It might be better to get ECAs involved and this could attract investment in terms of risk management,*" said the regional investment banker. "*For example, if the South Korean ECA gets involved then it means you're buying South Korean risk, which is different to Iranian risk.*"

But Breeze suggested that opportunities will remain best-tailored to banks and investors from countries with good political and economic ties with Tehran.

"*Relatively few UK or European banks are willing to go into Iran because of potential repercussions from the US Treasury,*" said Breeze. "*However, there could be some scope for Asian or Middle Eastern banks, from countries such as Oman, Japan and Malaysia that have good political and economic relations with Iran.*"

by Hassan Jivraj

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