Structural Changes in NOCs: A Proposal in the Case of NIOC

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In spite of some efforts to separate the functions and roles of Iran's Ministry of Petroleum and the National Iranian Oil Company (NIOC) the situation is still full of ambiguity. A regulatory body is still lacking. Although operating companies have restructured themselves and are trying to do their business based on a "Business Units Model", a lack of meritocracy, professionalism and efficiency incentives, are among the dominant factors hindering performance. Establishing an effective fiscal regime will increase incentives for NIOC to resolve its problems. In fact, transparency leads to a clear-cut distinction between policy-making and operation in the oil industry. This paper suggests a framework, which includes a royalty for the government and recognizes NIOC as an operating company. The paper concludes that applying such a fiscal regime will help NIOC to commercialize its activities.

Introduction

The international oil industry has undertaken a number of measures to increase efficiency. These include restructuring, downsizing, commercializing, portfolio restructuring, diversification of activities, mergers, acquisitions, and so on.

Contrary to the international oil companies (IOCs), the national oil companies (NOCs) are not concerned about their survival in the markets. Therefore, they have paid less attention to restructuring and commercializing their activities. However, the growing size of the public sector, soaring state expendituers, high population growth rates, management incompetence, and other factors have caused governments to pursue policies leading toward subsidy elimination, increasing profitability and reducing government interference.

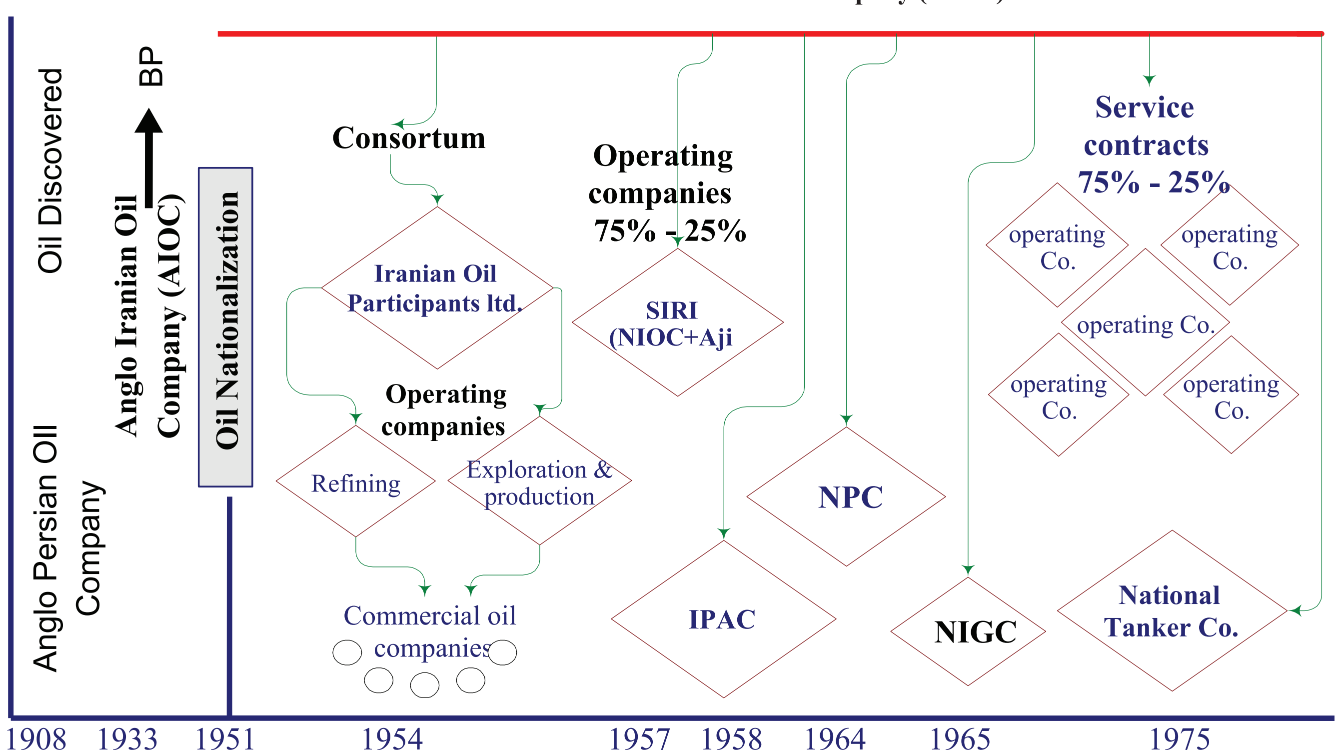
Structural Changes in the Iranian Oil Industry

In 1908 oil was discovered and the Anglo Persian Oil Company was formed. In 1914 the UK government purchased a considerable part of the company with 50 percent voting rights.

After Iran's oil nationalization in 1951, what was then the Anglo-Iranian Oil Company's contract was canceled. Pursuiant to Iranian law, the whole southern oil industry was transferred from the Anglo-Iranian Oil company (AIOC) to the newly-created National Iranian Oil Company (NIOC). A new era dawned for Iran's oil, almost exactly half a century after the granting of D'Arcy's concession.

After protracted negotiations, the Iranian Oil Consortium was formed with an ownership of 40% by AIOC, 14%

Figure 1
Oil Industry Structure Before the Revolution of 1979
Establishment of the National Iranian Oil Company (NIOC)



by Royal Dutch, 40% by five major American oil companies and 6% by French oil company, CFP. This was ratified in 1954 by the Iranian Congress and Senate.

Figure 1 shows the evolution of the structural changes in oil industry in Iran before the revolution. As can be seen,

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See footnotes at end of text.

all oil activities in the upstream were supervised by NIOC and operated through an Iranian based joint company. The contracts were so-called 50%-50% contracts. Since the foreign partner had to pay a 25% tax to the Iranian government, the share to Iran was 75%. Because of this the contracts also were called 25%-75% as well.

The contracts included production sharing and service aggrements.

With the revolution in 1979, the Consortium agreement came to an end. Calm on the oil front ended after a quarter of a century.

After revolution the structure of oil industry was changed. The Ministry of Petroleum was formed and NIOC and other affiliated companies were placed under its authority. The oil industry was managed centrally, fully integrated, and bureaucratically during the next 20 years.

Figure 2 shows the structure governing the oil industry after establishment of the Ministry of Petroleum. As can be seen, all active operating companies in the Iran offshore were merged into one company called the Iranian Offshore Oil Company(IOOC). All oil activities from upstream to downstream came under supervision of Ministry of Petroleum. But all other companies were as sub companies of NIOC in the sense that they had to operate under all NIOC's regulations and procedures. The financial relationship between the companies was not based on market prices and in many cases subsidies were allocated subjectively.

In 1998 the Ministry of Petroleum undertook an extensive restructuring. As can be seen from Figure 2, four parent companies were established. NIOC is an exploration and production (E&P) company, NIGC is responsible for the domestic gas market, NIORDC is the domestic oil refiner and petroleum products distributor. NPC is responsible for investing, producing, supplying and marketing of petrochemical products. All these parent companies have sub companies or business units. For example, within NIOC there are three main oil and gas producing companies, the National Iranian South Company, the National Iranian Central Company and the Iran Offshore Oil Company. All these companies are functionally separated but the old processes remain and a restructuring of financial, commercial, HSE, etc., is needed. Based on the current structure any improvement in efficiency is a far-reaching target.

The structure governing the oil industry should be changed at two levels. One is at the aggregate level and the other is at the level of parent companies their sub companies.

In the next section the necessity of clarifying the financial relation between parent companies and each company with the government is addressed.

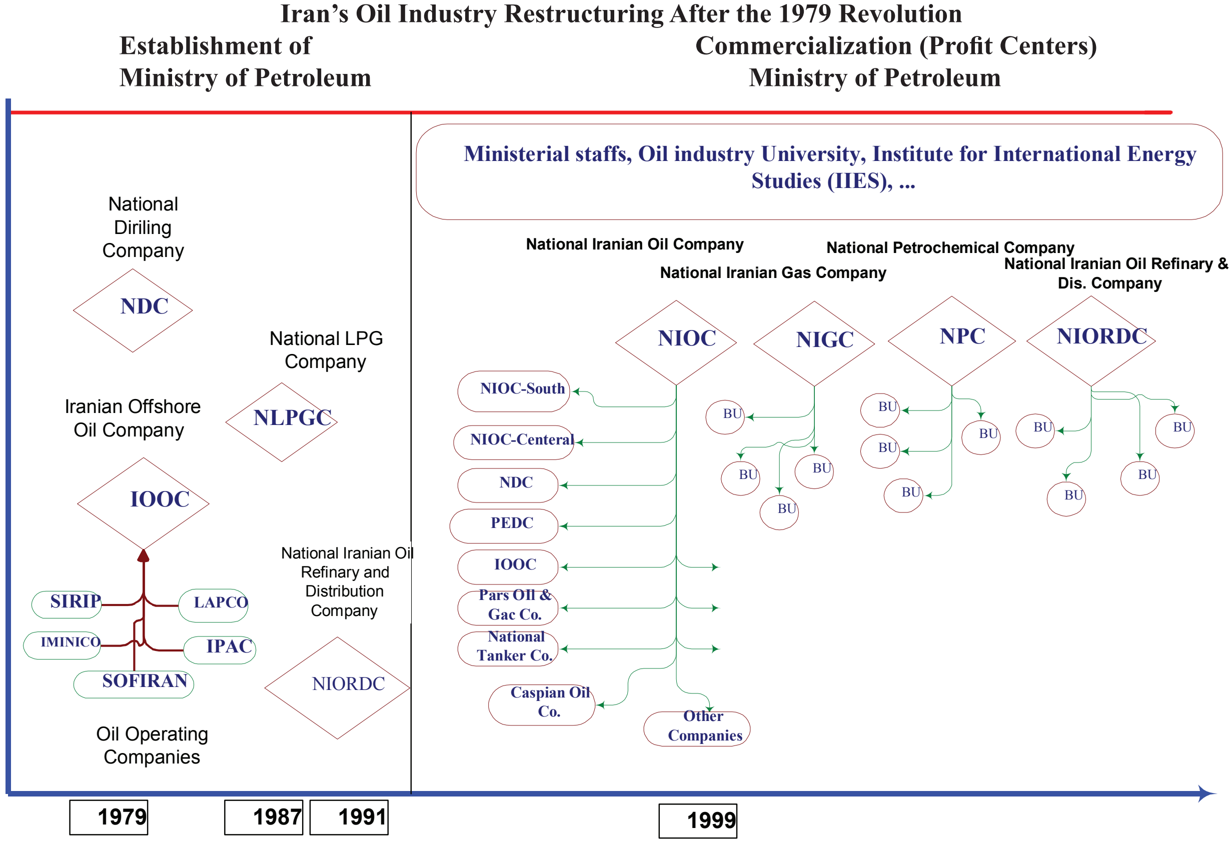
NIOC's Changed Position

As mentioned earlier, before the revolution, NIOC was responsible for all upstream and downstream activities in Iran on behalf of Iranian government. The relationship with international companies was based on a fiscal regime that distributed revenues between the host and the foreign company. In fact, the government's revenue was provided through royalties, corporate taxes, and share interests.

Post revolution, the prevailing fiscal relationship is the

Figure 2

Iran's Oil Industry Restructuring After the 1979 Revolution



government's strict supervision of the oil industry with the aim of capturing oil revenues.[1] Consequently, NIOC was transformed from a government company acting as a business into a mere operational unit providing the government with financial resources. Ever since, NIOC's income has been completely siphoned into the treasury and it has had to bargain over its budget. This situation has offset any motivation by NIOC to optimise its costs and improve efficiency. Its competence has declined dramatically simply because the financial resources were not allocated appropriately to it.

Lack of transparency in this fiscal relationship and some budget commitments caused the government and the parliament to develop other ways to provide financial resources. Revenue from the export of oil products was given to NIOC. In addition, NIOC could take advantage of bank loans, government's public resources, and a share of oil product exports. The procedures of allocating these financial resources have changed on a yearly basis, so evaluating and examining them is practically impossible.

A Restructuring Plan

A restructuring of NIOC will lead to better performance and higher efficiency when it includes a clear and transparent inter and intra-corporate fiscal relationship.

Considering the fact that the main goal of parent companies is to commercialize their activities, commercialization should be the basis of such relationships. In fact, each company has to offer its services and products to other companies based on its own costs. In this case, transparency in financial performance will make it possible to assess each company which in turn can encourage the companies to improve their management and competence.

When intra-corporate relationships between parent companies are improved, government subsidies become transparent and are internalized in the budget. Then, if the government wants to give subsidies to the society, it has to compensate for the losses undergone by the company, e.g., NIORDC.

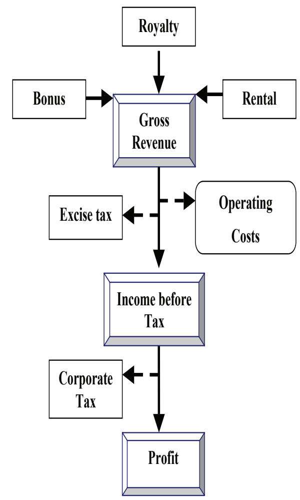
The fiscal relationship between the state and NIOC, NIGC, NIORDC and NPC based upon a corporate tax would be transparent. However, the corresponding relationships in the upstream sector are more complicated. In upstream activities economic rent is generated from such factors as ownership rights, land rent, hydrocarbon resources that are non-renewable, and the availability of lower-cost reserves compared with other regions.

Economic rent is defined as part of the production yield that can be paid by the producer without hindering the process of production. Therefore, governments are seeking some legal levers to take the premium accrued from oil and gas exploration and exploitation activities.

Economists believe that governments can generate revenues by means of levying taxes. This is true particularly in the oil and gas industries where such special tolls as royalties, bonuses, rentals, surtaxes, and special taxes are assumable.

Such being the case, the companies will be able to interact with the government under a fiscal regime with oil contracts formed on such a fiscal basis. As of signing the contracts, companies will be obliged to pay a share of their earnings from oil and gas exploitation as royalty, rentals, special taxes, and corporate taxes to the government. As a result, the relationship between the government and the company becomes clearer. Figure 3 illustrates the interests accrued from exploration and exploitation activities divided between the government and the company.

Figure 3
Suggested Distribution of Revenues Between the Government and NIOC



As mentioned earlier, in this case, financial statements are prepared based on certain standards so that it would be possible to evaluate the company's performance with ease.

Establishing a fiscal regime would enable us to regulate corporate relationships. Such a regime could determine not only minimum and maximum royalty, rental and so on but also oil product taxes as well as excise taxes. Moreover, this could make the system of awarding subsidies more transparent.

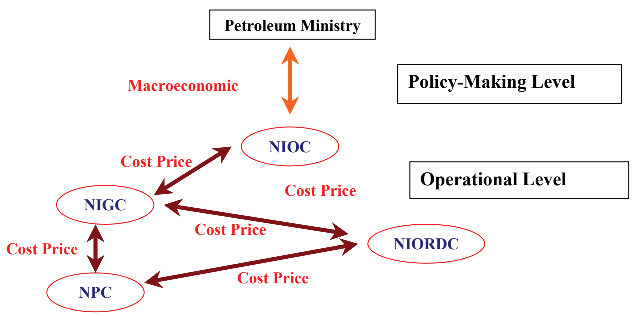
In a fiscal regime, the duties are divided between the government as a policy maker and NIOC as an operating company. And NIOC, aiming to maximize its interests with regard to existing restrictions, will be able to plan within a macroeconomic framework drawn by the government or its deputy, the Ministry of Petroleum.

Figure 4 depicts NIOC's inter- and intra-corporate relationships under this proposal. Due to such relationships, NIOC will be financially independent and budget planning will be logical. Additionally, each company's performance will be more transparent and complications and ambiguities in their financial statements will vanish. In fact, every company will act based on its articles of association and will be obliged to report its financial performance.

Only when the above mentioned conditions are fully realized can we be hopeful that such measures as restructuring and rearranging will lead to improved management and increased efficiency in the Iranian oil industry.

The experiences of Venezuela and Norway indicate that there can be a transparent fiscal relationship between the state and a national oil company[2]. Under such a regime the government is entitled to claim royalty, land rent, corporate taxes and special taxes based on the specifications of the field under contract.

Figure 4
Financial Tranparency Between Parent Companies: Cost Price Approach



According to Venezuelan Hydrocarbon Law, royalty is set at the range of 16.67 to 30 percent of total production. Additionally, the Venezuelan government obliges PDVSA to pay a rental and corporate tax of 67.7 percent of profit. Furthermore, the government as a shareholder of PDVSA receives the corresponding dividends.

In Norway, royalty which varied between 8 to 16 percent of sales was abolished in 1986 and an income tax replaced it thereafter. Norwegian oil companies must pay an area fee and corporate and special taxes have been introduced to absorb the economic rent of oil activities.

In Norway the state takes 28% of companies' profits. But in the oil sector companies must pay 50% of their profit to the government as a special tax. Additionally, another source of the Norwegian government's income is dividends paid by state-owned Statoil. The Venezuela and Norway approach leads to an improvement in the efficiency of their state oil companies.

Therefore, it is recommended that Iran draw up hydrocarbon resource regulations or a fiscal regime that create transparent relationships and financial independence. This should improve the oil industry's performance.

Simulation of government receipts, on the basis of the suggested fiscal regime, indicates that the Iranian government will be able to gain 85 percent of gross oil and gas revenues on average. The suggested fiscal regime consists of the following elemnets:

1. Royalty is set at 30 percent,
2. Iranian government receives 25 percent of NIOC profit,
3. A special tax of 40 percent is levied on NIOC in order to absorb economic rent,
4. Dividends are paid to the government by NIOC

However, in the second phase, the government should set the royalty rate based on the specifications of the field under question and then award it to NIOC under a contract. Under this plan NIOC should be able to improve its performance.

Conclusions

Clarifying the interaction of governments and their national oil companies (NOCs) is a form of structural change within the oil industry. The triangle of policy-making, regulatory authority, and operating companies shows a distinct role for each partner. If all functions are definitely identified and recognized, then few reforms are needed. Otherwise drastic change in the structure would be required. It is believed that the best case is one in which a country has all three of these entities.

As for the Iranian oil industry, these three different functions and roles are intertwined. In spite of the fact that some efforts have been made to separate the functions and roles of the Ministry of Petroleum and the national oil company (NIOC) the situation is still full of ambiguity. Now the Ministry is responsible for the policy delineation and strategies and the parent companies (National Iranian Oil Company, National Iranian Gas Company, National Petrochemical Company and National Iranian Oil Refining and Distributing Company) are responsible for operation. Still a regulatory body is lacking. Although these operating companies have restructured themselves and are trying to do their business based on a "Business Units Model", lack of meritocracy, professionalism and efficiency incentives, are among the dominant factors hindering performance. Lack of responsibility, budgetary autonomy, and discretion to make investment decisions within the affiliated companies have worsened the management of oil activities in Iran.

The reason for all these problems is the ambiguous relationship between the government and NIOC. The lack of an efficient and transparent fiscal regime between the two has caused the above mentioned barriers. Establishing an effective fiscal regime will increase incentives for NIOC to resolve its problems.

Oil-rich governments, aiming to maximize their oil and gas revenues, must try to impose a financial regime on their hydrocarbon resources in such a way that the revenues will be divided proportionately between the government, the NOC and the contractor. In such a regime, levers must be devised to enable the host government to obtain economic rent from upstream activities. These levers may include royalty, corporate taxes, and special taxes.

Transparency in financial relationships between the government and NIOC will enable the government to include the subsidies in its budget and accounts. It will also motivate NIOC to enhance its efficiency. In fact, transparency will lead to a clear-cut distinction between policy-making and administration in the oil industry. This paper suggests a framework which comprises royalty for the government and recognizes NIOC as an operating compony. Applying such a fiscal regime will help NIOC to comercialize its activities.

Footnotes

[1] The enforement of sub-article 38 (1980 Budget Act) caused the revenue of oil and oil products to go directly to the treasury.

[2] Petroleos de Venezuela S.A(PDVSA) and Statoil.

References

1.Brown John, 1999, "Looking to the future BP Amaco's strategic outlook", a presentation to the financial community, London and New York 15/16 July 1999.

2.IIES, 2003, suggesting NIOC-State financial relationship, not published.