The privatization of the Oil & Gas Industry in Iran

by Reza Molavi*

Most oil-rich Third World economies have had difficulty in evolving into true economically liberal societies. By owning or controlling revenues generated by oil, the state is able to dominate society, making all classes and groups economically dependent on their 'Black Gold'. Oil tends to centralize state power in the Middle East, as this commodity contributes 90% to 93% of their total foreign exchange revenue. However, with the world rapidly creating new circumstances, this trend is poised for change.

With the political developments within the Middle East in the recent past, it is not hard to accept the notion that by 2013 the entire Middle East region is posed to become a 'Free Trade Zone' (CNN, June 3, 2003). To achieve these aspirations, it has been suggested the countries of the region will have to embrace market economy concepts and agree to move towards transparency and 'privatization', a word often used synonymously with the sale of assets, deregulation and decentralization. Having embarked on the journey towards economic reforms since the end of the war with Iraq (1988), the Islamic Republic of Iran will be part of the new environment. With reforms acquiring a new momentum and with privatization gaining ground, however, a point will be reached when the contentious issue of the privatization of the oil and gas industry in Iran, and the National Iranian Oil Company in particular, can be evaded no longer.

Background

Twenty four years after the victory of the 1979 Islamic Revolution, Iran is on the threshold of ground-breaking economic changes and adjustments. It is no hidden fact, though, that the prevailing situation is in need of an upward push. In 1998, fuel subsidies alone reached $11 billion per year – 73% of the country's development budget. Food subsidies, on basic commodities such as bread, rice and sugar, eat up another $2.2 billion per year. Together, these subsidies use up some 24% of the $54 billion annual budget revenues of the country. The Iranian President Mohammad Khatami has come to accept market reform and advocates attracting foreign investments. The President has skillfully combined cuts to subsidies, the privatization of state firms and changes to labor laws - in short, 'shock therapy' to the market.

President Khatami is fully committed to restructuring the economy. His government has already approved the privatization of 538 state-owned companies through auctions and stock sales, and plans on privatizing another 2,000 (Reuters, March 11, 1999). The Iranian Parliament (Majles) has approved plans to overhaul the oil industry, and boost Iran's sagging oil production from 3.5 million bpd (barrels per day) to 6 million bpd over the next 10 years, according to the U.S. Department of Energy. This will require at least $120 billion in capital, and for this, Iran seeks to facilitate the entry of private investors and foreign sources into its market. The discovery and development of Caspian Sea oil on Iran's northern border is just one of the opportunities for the government to attract international interest and capital after a lengthy hiatus.

Efforts are underway through a strategic development plan, and the implementation of various petrochemical projects, to raise the production level of Iran's petrochemical industry. Begun in 1997, the plan is divided into five phases lasting through 2013. By the end of this period, the total volume of final products is estimated to be 16.8 million metric tons per year. The value of investment will amount to $20.6 billion with total sales topping $11.8 billion (Petrochemical Industries Investment Company, July 1999).

Participation by the private sector, whether in the form of investment or in launching new projects, can have a considerable impact, and for this purpose the Petrochemical Industries Investment Company (PIIC) has been established. As privatization became one of the main policies of the government, it led to the restructuring of the National Petrochemical Company (NPC), with plants with a capacity of less than 100,000 tons subject to transfer to the private sector. The private sector was also allowed to invest in medium-size petrochemical plants. NPC offers bonds for the construction of petrochemical plants, and also supplies raw materials to the private sector at a 30% discount, compared to world prices. These measures could be considered as models for Iran's oil and gas industry.

Yet, doubts remain. The sustainability of macro-economic stability, and progress in the key areas of economic policy reform, are critical for placing Iran on a maintainable growth path. For an improved private sector environment, financial sector and pricing system reforms, Iran must rid itself of the notion that foreign investors are imperialistic. Although the Ministry of Energy has authorized the sale of 14% of the capacity of its state-owned power plants (according to the Utilipoint International Incorporated website), the National

Iranian Oil Company (NIOC), remains off limits. The reluctance on the part of the people and the government of Iran regarding the issue of privatizing the NIOC has complex reasons which can only be understood by looking back at history.

History

In 1951, Iran's Parliament voted to nationalize the oil industry, and legislators backing the law elected its leading advocate, Dr. Mossadegh, as prime minister. Britain responded with threats and sanctions. Dr. Mossadegh refused to back down. In meetings in November and December 1952, British intelligence officials startled their American counterparts with a plan for a joint operation to oust the nettlesome prime minister (Secrets of History, 2000), a plan finally implemented by the CIA in 1953. For nearly five decades, America's role in the military coup that ousted Iran's elected prime minister and returned the Shah to power has been lost to history. After the 1979 Islamic Revolution, much of this grey area of history came to light. These revelations provided reasons for the rulers of Iran to shy away from opening the oil and gas sector to external and internal private investors (Elm, 1994).

Though the term 'privatization' is currently popular in Iran and the rest of the Middle East region, and as mentioned before its implementation begun in the former, the consequences of privatization need to be assessed comprehensively, especially as they relate to standards of services, prices, costs, cross-subsidization, competitiveness, re-allocation of human resources, safety and other components linked to the public interest, as well as to implications for the private sector and existing government organizations.

In 1995, the year the Iranian privatization program began, the value of state sell-offs in the world is reported to have reached a record figure of $73 billion with at least forty five countries in the process of privatizing some industries (The Economist, January 13, 1996, p.5)

The origins, reasons for popularity, requirements, management, social and economic consequences of privatization policies are relatively new to Iran and other countries in the Persian Gulf region. Whilst the answer to the question of why consider privatizing is as old as the subject of economics and management itself, there still exist many ambiguities. In the "Wealth of Nations" (1776) Adam Smith argues that:

'In every great monarchy in Europe the sale of the crown lands would produce a very large sum of money, which, if applied to the payment of the public debts, would deliver from mortgage a much greater revenue than any which those lands have ever afforded to the crown….when the crown lands had become private property, they would, in the course of a few years, become well improved and well cultivated.'

(Vickers and Yarrow, 1989)

This positive slant on private ownership and the view of privatization has not gone uncontested by Marxist critique of private ownership, however, in the main, and in many contexts, the basic aims are claimed to be the promotion of competition and the increase of efficiency. To achieve these goals, it was asserted by the Deputy Minister of Economy Dr. Mohammad Khazaee during an Iran Conference in July 2003 at the Royal Institute of International Affairs

(RIIA), replacement of the decision-making of politicians and public servants by market mechanisms, and the injection of a private sector management philosophy and practice into the public sector should ensure maximum efficiency.

The strategy to privatize will require a reduction in the size of the public sector organization, and control and reduction of the level of public sector borrowing to leave room for unfettered private sector borrowing. Privatization is commonly believed by its proponents, to produce transparency of decision-making. Furthermore, because the capital markets are likely to be a surer source of funding than the political capital market, over a period of time privatized companies should be able to raise funds to finance efficiency or expansion in a more flexible manner, to meet their special needs. Financial markets, in turn, bring their own scrutiny by analysts and bankers, a scrutiny and discipline not available in government, as Professor Hashem Pessaran of Cambridge University, told the RIIA seminar on June 30, 2003.

Pros & cons

Criticisms of the concept by Keynesian economists include the argument that the assets of enterprises are undervalued because of government fears that sales will not be finalized. Potential conflict of interest with the appointed consultants in the program is cited as another difficult aspect. The main criticisms of the British privatization program have been in five major spheres: 1) the failure of the government to ensure competition in industries where privatization occurs, thereby appearing to convert public monopolies into private monopolies; 2) the creation of inadequate regulatory frameworks in such monopolistic or oligopolistic industries, especially in relation to the fulfillment of social obligations on the part of privatized industries; 3) failure on the part of the government to adequately safeguard national interests from foreign influences in the privatization drive; 4) selling the 'family silver' - the argument that revenue from sales of public assets should not be apportioned to consolidated revenue but should be earmarked for future generations and future public uses; 5) the standard of services after sale or contracting out (Wiltshire, 1987).

The question arises whether the government of Iran would find the courage to divest itself of the control it now exercises over the National Iranian Oil Company? And can it successfully re-allocate excess human resources when it is down-sized?

Differences in behavior under state and private ownership may be compounded by differences in objectives. In the private sector although profit may not always be rigorously and consistently pursued, there is, nevertheless, a clear bottom line. If losses continue to be made the firm will ultimately fail. In the state sector, however, objectives are vague and tend to change according to the political climate, leading to uncertainty about long term strategy within industries (Martin and Parker, 1997).

In conclusion, it is widely believed that public ownership reduces the incentive to secure profits and removes the threat of bankruptcy. Private ownership would undoubtedly provide a significant spur to managerial efficiency. Capital would be allocated according to market, rather than political, considerations, and intervention would largely cease. To secure such advantages, Mr. Enoch Powell and Professor Milton Friedman have advocated immediate and wholesale denationalization (Littlechild; Veljanovski, Editor, 1989).

Another quotation from Adam Smith also bears on a central theme of this analysis:

The question arises whether the government of Iran would find the courage to divest itself of the control it now exercises over the National Iranian Oil Company? And can it successfully re-allocate excess human resources when it is down-sized?

'Monopoly, besides, is a great enemy to good management, which can never be universally established but in consequence of that free and universal competition which forces everybody to have recourse to it for the sake of self-defense.'

(Vickers and Yarrow, 1989)

Concluding remarks

Despite the pending sorting out of priorities regarding oil and gas, since the announcement of the privatization program in Iran's five year development plan (FYDP) in 2000, significant progress has been made and a new agency set up in the Ministry of Finance. The Majles has promulgated regulations governing privatization. The Privatization Committee, under the supervision of the President, has reviewed 1,039 public sector enterprises for privatization: 217 are to remain public, 87 will be liquidated and 735 are slated for privatization. During the first half of the Iranian year 1380 (2000-01), the Government sold Rls. (Iranian Rials) 2,040 billion (about 0.5% of GDP) of shares in public enterprises on the Tehran Stock Exchange (TSE). It has ceded Rls. 100 billion worth of shares to workers. Rls. 1,800 billion worth of shares are being placed for sale in the current Iranian year. In the oil sector, the Oil Ministry announced that it will cede 23 subsidiary firms to the private sector over the FYDP. These include the National Tanker Company (NITC) and the Liquefied Gas Distribution Centers (World Bank Group country brief, November 2001).

With the above measures and the petrochemical industry setting precedents, the privatization of the oil sector is becoming more acceptable. However, the justifications for such a concept should be widely debated and must be brought to the attention of decision makers. It is anticipated by the Council of Ministers in President Khatami's cabinet that, within the time frame of the FYDP ending in 2010, conditions for the full implementation of a privatization program for the oil industry may well be conceivable.

Clear objectives in economic, social and political spheres should be set by Iran so that any privatization blueprint to be designed, does not compound current problems. Priorities should be meticulously considered. Whilst the Iranian authorities should satisfy themselves by accepting that if they wish to pursue the privatization program, relinquishing 'power' over the NIOC will have to be considered sooner or later, certain intellectuals believe that they should also be satisfied that they are not sacrificing the national interest.

For the Iranian government and the people of Iran, structural economic reforms and the comprehensive privatization of government assets is thought to be essential and a priority for the current government to stimulate recovery and provide stability and transparency, all needed for attracting investors from within and from abroad.

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