Iran's Energy Sector and Economy:
An Overview of the Role Played by Companies Developing Iran's Energy Resources and their Impact on the Country's Economy

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Mr. Chairman, thank you for the privilege of appearing today on Iran's oil and gas industries and the rather unique perspective through which my company views corporations from around the world that are financing and developing the energy-related projects that generate Iran's primary source of revenue.

By way of introduction, I am Vice President of Conflict Securities Advisory Group, a Washington, DC-based research and risk management firm that was founded five years ago to service a growing demand from institutional and individual investors – as well as policy practitioners – for data on those U.S. and foreign companies that maintain business ties to U.S. State Department-designated terrorist-sponsoring states. Our firm performs this research to help investors and corporations better understand their exposure to so-called global security risk, defined as the often-asymmetric financial risk to a company's share value and reputation that can accompany these business ties.

I would like to speak, first, about the broad role that Iran's oil and gas industries play in supporting virtually all facets of the Iranian government and then address the company-specific dimensions of that equation. I will also touch on the impact of U.S. policy on corporate decision-making regarding the pursuit of these business opportunities.

Iran's Oil Industry: Three Interlocking Pressures

In our view, three central issues define Iran's oil industry today.

1) Iran's oil exports play the central role in financially underwriting the country's government. As oil prices increase, Tehran experiences economic windfalls that have a direct impact on the government's discretionary spending across the board. Iran has obviously benefited enormously from the recent rise in global oil prices. It is important to remember, however, that we have in the past seen periods where the opposite has been true. In the 1990s, for example, relatively low oil prices had Iran on the verge of defaulting on its international debt obligations. Had it not been for the intervention of the country's various

creditors, in part through the actions of specific foreign companies, Iran would have faced a considerably more severe financial crisis.

Of course, Iran's is not the only economy that lives and dies on oil prices. The Soviet Union in the 1980s is perhaps the best case study of a government experiencing the highs and lows of relying too heavily on oil prices.

2) Despite the lucrative nature of Iran's oil exports, its energy industry as a whole has distinct weaknesses that, since the revolution in 1979, have prevented it from reaching its full potential. Iran's oil industry is state-controlled, old, inefficient and in need of significant upgrades that only foreign companies, with their access to large-scale capital and advanced equipment and technology, are capable of carrying out. These upgrades are essential for Iran to cushion the impact of increasing domestic oil consumption and aging oil fields that are currently putting downward pressure on the country's oil exports.

   In order to reach the country's stated goal of increasing daily oil production from 4 million to 5 million barrels per day by 2008 and to 8 million barrels per day by 2010, Iran will need to upgrade significantly its existing fields and begin producing from new ones. Tehran's challenge is to attract foreign investment in sufficient quantity to reach these goals, despite unpopular contract terms and intense international security concerns. As I will address in a few minutes, although companies are starting to change the way they do business in Iran due to security risk factors, in our view, security concerns are not stemming the tide of companies interested in doing business there. The real inhibitor to foreign investment seems to lie more in bureaucratic obstacles within the country.

3) The country's gasoline-related expenditures have put added strain on Iran's budget. Despite booming revenues, Iran's lack of refining capacity has forced the country to spend billions of dollars importing gasoline. Moreover, the decision by Iran's parliament to lock domestic gas prices at 2003 levels could cause even more pronounced problems for Iran, as billions of dollars in state subsidies, which could increase under the new President, lead to increased consumption. Increased consumption leaves less oil for export and, combined with decreasing production, could eventually have a material impact on export-related revenues.

Over the coming years, the intersection of these three important energy industry pressures will put the Iranian government and the companies that do business in the country at a crossroads. With Iran almost completely dependent on its energy exports for revenues and in desperate need of foreign investment to keep these revenues flowing, foreign companies will become even more important to the prosperity of Tehran.

<u>Iran's Oil Industry and Prospects for the Future</u>

The summary statistics regarding the role of oil in the Iranian economy tell the story: Iran holds an estimated 10 percent of the world's proven oil reserves; its oil exports generate 80 to 90 percent of the country's total export earnings and 40 to 50 percent of its total government budget.

Although the state-owned National Iranian Oil Company largely runs the Iranian oil industry, we understand that oil export revenues are effectively funneled straight to the country's central bank, also known as Bank Markazi. Accordingly, as might be expected, oil export revenues quite literally equate to discretionary funds for Tehran. Although Iran's military and nuclear spending is largely unknown – at least through public sources – it can be reasonably expected that both, in addition to most other government programs, are benefiting directly from recent oil windfalls.

To maintain these higher revenue flows, however, not only will oil prices need to remain high, but Iran will need to invest heavily in its existing and prospective energy projects. Aging oil fields require upgrades and new fields require development. Most would agree that the success of both requires billions of dollars in foreign investment, capital and technology in the coming years.

Although Tehran has not attracted as much foreign assistance as it would like, our research shows that there are a wide variety of corporations currently working in Iran's oil industry. In fact, there seems to be no shortage of corporate interest in Iran's economy. In our view, even considering the outrageous pronouncements of Iran's new president, short of international sanctions, no significant number of companies will forego the country's business opportunities. History has shown time and again that companies will do what the law allows. As long as operating in Iran is legal, the draw of a growing economy and the country's vast oil and gas resources will lure companies in. Of course, companies are aware of the political environment, but, simply put, the risk appears to be worth the reward in the increasingly competitive global energy industry.

There are, however, a few important exceptions. A number of companies have correctly identified a growing sensitivity in the U.S. investor community to business associations with Iran. The prospect of being labeled as "Doing Business with the Enemy" – the title of a *60 Minutes* segment on this issue that aired twice over the past two years – has influenced the behavior of some companies that place more value on their corporate reputation in the U.S. than on their business prospects in Iran. For most other companies, however, this calculation is still in flux.

For at least five prominent U.S. companies, Comptroller William Thompson of New York City made this calculation a good deal easier by registering public shareholder resolutions with the SEC on behalf of the City's fire and police pension funds calling for a Board-level review of their corporate ties to Iran and terrorist-sponsoring states. Specifically, Comptroller Thompson was interested in whether their operations in Iran or these other countries circumvented the spirit, if not the letter, of U.S. sanctions law. He was referring to what some have called a major "loop hole" in U.S. law that allows U.S. companies to do business in sanctioned states via arms-length overseas subsidiaries.

After some wrangling, these companies made adjustments to corporate policy and, in certain cases, renounced any future business ties to Iran whatsoever. The five companies referenced are ConocoPhillips, General Electric, Halliburton Cooper Cameron and Aon.

In my view, two important conclusions relevant to this committee can be drawn from this anecdote. First, companies that discount escalating security concerns in their risk-reward analyses may be less likely to discount the views of leading shareholders. Second, companies most vulnerable to this market-related pressure are those who have more business or reputational exposure in the United States.

For example, let us assume that Company X and Company Y both have business ties to Iran. Company X has a large market presence in the U.S. and therefore has considerably more to lose in U.S. sales than Company Y. Company X would be expected to be more responsive to the concerns of Americans regarding its activities in Iran. In our experience, the same holds true in the capital markets. Let us say that 10% of Company Y's stock is held by U.S. investors, compared to 35% of Company X's. In this case, U.S. investors who care about Iran and, like Comptroller Thompson, act on those concerns would have more leverage with Company X and wield more influence over its corporate governance policies regarding business activities in the country. In today's global economy, market forces such as security-minded shareholder activism can be more effective than regulatory regimes.

The impact of corporate reputational concerns and market forces, however, should not only be measured by whether or not a company chooses to exit completely from Iran. For many companies with large exposure to the country, pulling up stakes is simply not an option. One positive development stimulated by increased investor, government and media attention to this issue has been a new sensitivity by companies to the structure of their corporate ties to Iran. Increasingly, foreign companies are scrutinizing their projects and transactions in Iran to ensure that they do not have the potential to contribute inadvertently to security concerns.

Some non-U.S. companies have begun to self-police their operations in Iran at standards above and beyond the requirements of their national laws to protect their reputations from potential Iran-related harm. While this may be short of what some policy-makers would prefer, it demonstrates an innovative, market-oriented reaction that has a high likelihood of reducing the security risks that these corporate ties can represent.

For example, if a company's business in Iran involves the transfer of dual-use equipment or technology, there is often little the U.S. can do short of extraterritorially sanctioning the company. Were that company, however, in deference to its shareholders or reputation in the U.S. and elsewhere, to undertake additional due diligence, substitute the problematic equipment or seek contractual assurances that it will not be diverted to non-civilian projects, U.S. policy concerns would benefit. No sanctions, no international controversies, no government intervention would be entailed. Rather, in this example, the company is self-policing its business activities in a risky country in response to market forces.

Increasingly, our firm is witnessing corporations – out of concern over their reputation in the United States – insisting on certain contract terms with Iran, rather than vice-versa. In our view, this increased security-consciousness, when it occurs voluntarily, should be viewed as a good thing.

Impact of U.S. Policy

Given recent events and the importance of foreign companies to the Iranian economy, one might ask: what role does U.S. foreign policy play in the considerations of companies abroad operating in Iran. For a long time, the answer, for non-U.S. companies, has been very little. The primary impact of President Clinton's 1995 Executive Order banning U.S. involvement in Iran's energy sector was that it cost Iran access to certain U.S. technology. At the same time, it cost U.S. companies business opportunities in Iran. For foreign companies, however, the Order had little impact and business in the country continued at an even faster rate than before, as Iran was in the midst of opening up to foreign investors.

Congress then passed the 1996 Iran Libya Sanctions Act (or ILSA), which sought to punish non-U.S. companies investing more than $20 million annually in Iran's oil and gas industries by restricting their access to the U.S. economy. As a consequence of the controversial "extraterritoriality" of the law and for diplomatic face-saving, ILSA sanctions were never implemented. Soon after the act was passed, several large companies, including France's Total and Russia's Gazprom, violated its provisions and, following an official review, went unpunished. These early precedents cleared the way for other companies to do the same and, today, there are, by our estimates, over 20 companies in technical violation of ILSA.

With U.S. sanctions policy toward Iran remaining fairly consistent since the mid-1990s, one might further ask: what has changed over the past few years causing some corporations to second-guess their operations in Iran and others to enact voluntary, security-oriented governance policies with respect to these higher-risk activities? Surely, the nuclear standoff and President Ahmadinejad's election have complicated the business environment, but the beginning of today's corporate trends vis-à-vis Iran predates, for the most part, both of these developments.

Our findings demonstrate that after September 11, the stigma associated with corporate ties to U.S. State Department-designated terrorist-sponsoring states increased significantly. This stigma reverberated in the local and national press. State and municipal governments began analyzing how their retirement and other public investment funds were invested in companies that collectively form the economic backbones of these irresponsible, dangerous governments. Grassroots attention to these countries as supporters of terrorism and proliferators of weapons of mass destruction and ballistic missiles raised substantially the reputational risk associated with these corporate ties and the potential for corporate activities to be linked by the public to heightened security concerns.

This grassroots movement continues today. For example, the Missouri Investment Trust recently became the first public fund in the country to institute a policy that, after a careful review, screens out certain companies with business in Iran and other terrorist-sponsoring states. A so-called "Terror-Free" mutual fund, the Abacus Bull Moose Growth Fund administered by Roosevelt Investment Group, has likewise been created in response to market demand.

Even though, most of the time, corporate activity in Iran does not represent a significant portion of a company's overall business, the importance of the issue of terrorism in the U.S. has created the potential for such ties to negatively impact corporate share value and reputation and, in some cases, even raise questions of legal liability. Accordingly, some companies are rightfully seeking to safeguard their corporate operations from these types of associations by integrating expanded, security-minded new due diligence into their overall corporate risk management programs. To be clear, this is market-oriented cause-and-effect.

As I noted earlier, most companies are unwilling to forego the Iranian market, especially firms from countries that place huge importance on Iran as a source of energy supplies. Increased vigilance, however, with respect to the security dimensions of their business activities in the country is leading to a new sensitivity to U.S. security concerns on the part of some international companies doing business where U.S. companies cannot.

Corporate Involvement

According to our *Global Security Risk Monitor* online research product that seeks to identify and profile every publicly traded company in the world that has any kind of business tie with terrorist-sponsoring states, over 300 publicly-traded companies have carried out business with Iran during the past three years.

This number does not include those private or state-owned companies that are also doing business in the country. While most companies with the risk appetite to do business in Iran are these larger publicly traded entities, this does not hold true in all cases.

Nevertheless, the point remains the same: there are a large number of companies that are key participants in Iran's economy. These companies are often among the largest in the world and held in most American investor's portfolios, including the Thrift Savings Plan that invests on behalf of members of Congress and many other U.S. public officials. Although most of these firms are involved in the country's energy sector, a number are in other sectors, contributing to Iran's efforts to diversify away from its somewhat one-dimensional economy. These ties range from petrochemical to telecommunications projects to manufacturing plants to power generation projects and so on.

Most of the larger-scale projects, however, are infrastructure-oriented and do not involve the revenue-generating potential for the government that exists in the energy sector. In fact, Iran's diversification efforts seem directed more at infrastructure projects than at launching a new era of market-oriented policies that have the potential to stimulate economic growth and, as a result, generate new streams of government revenues. Although the country may seem more up-to-date as a result, government revenues and stability remain firmly dependent on its export of energy.

The bottom line is that foreign publicly-traded companies play a tremendously important role in Iran's current and future economy.

Conclusion

As stated, short of strong multilateral sanctions, which seem unrealistic barring some kind of serious escalation of the current Iranian nuclear crisis, there will continue to be companies looking to enter the Iranian market or expand the corporate presence. The reach of U.S. policy, therefore, is limited. These new market-oriented concerns, however, are not. In our view, it is ultimately the implications of potential reputational damage that will cause public companies to reconsider their policies and business activities. As this reputational risk increases, so too will corporate self-policing. Should companies choose to remain in Iran, they could be encouraged by shareholders and others to do so in a more security-sensitive mode than ever before. Such new corporate guidelines and due diligence measures will not be lost on the Iranian government and the state-owned companies that will have to learn to be responsive to the reputational burden that they bring to each of their prospective and existing business partners.