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**The *Sharia'h* Dimension of  
the Persian Gulf's  
Hydrocarbon Resources**

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# The *Sharia*'h Dimension of the Persian Gulf's Hydrocarbon Resources<sup>1</sup>

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Islamic law incorporates general principles governing the economic behavior of the Islamic society and specific instruments regulating classic commercial transactions. Adherence to Islam is the common characteristic of Persian Gulf oil and gas producers and their legal regimes to different extents reflect this common characteristic. This paper addresses the Islamic law of natural resources and the legal frameworks of Islamic finance methods used in upstream projects.

## I. Introduction

The future of peace and prosperity of our world is heavily reliant on our ability to find suitable answers to the problem of energy; and, hydrocarbon resources remain an integral part of any feasible solution. The Persian Gulf region with its uniquely large hydrocarbon reserves, low production costs, established infrastructure, geographical proximity to major markets, access to the international waterways and experienced local work force is still the most important single geographical region capable of a suitable response to our energy demands.

This creates an exceptional opportunity for the region's major producers (Saudi Arabia, Iran, Kuwait, Qatar, Iraq and United Arab Emirates) to capitalize on their historical importance in the international hydrocarbon markets. To achieve this goal, they have adopted different policies and solutions to foreign direct investment in their hydrocarbon resources.

United Arab Emirates, in line with its policy of diversifying revenues thorough creating a free market economy, offers equity rights to international hydrocarbon companies (IHCs). It is highly reliant on foreign workforce and needs to continue large-scale investments in non-oil sectors to compensate the lack of domestic technology and management skills. A uniquely favourable tax regime, free market economy and world-class infrastructure elevate these small emirates to an appealing host for foreign investments.

Qatar is in a similar position and remains a forward-looking, rapidly growing, heavy-weight in the gas market.

On the other end of the spectrum, Iran, the most populated country in the region with the most diversified economy, lacks an atmosphere of competition and a culture of enterprise. It is deeply reliant on the oil and gas sector, which has been severely isolated for the last thirty years. It is failing to reach its OPEC quota, due to decades of under investment, a devastating eight-year war, on-going US sanctions and an unhealthy obsession with self-sufficiency. Iranian economy is heavily dominated by the state, which is to a large extent out of touch with the realities of the international markets. The authorities in charge of the state run economy have shown a high degree of incompetence in creating much needed jobs for a large population of unemployed well-educated young Iranians and the reforms to liberalize and privatize the economy have proved to be superficial and ineffective.

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Kuwait, although not short of capital, welcomes IHCs investments to transfer much needed cutting edge technology to rapidly develop its common reserves with its neighbours and repair the damages its oil sector suffered due to the Iraqi invasion. It is also motivated on another level by the possibility of gaining implied security assurances from home countries of the IHCs.

Thanks to a substantial amount of spare reserves, Saudi Arabia is the only producer, which is believed to still have the ability of balancing the market and controlling the effect of unexpected events on the prices. The House of Saud's policy is to sustain this ability as it continues to be their most valuable bargaining chip in the international stage. Historically Saudi authorities have been confident that Saudi Aramco possesses the expertise and capital to cater for the increase of production by developing new fields, while sustaining the levels of output of the country's currently aging oil fields. However, the need for frontier technologies is pushing them in the direction of a more welcoming stand toward the IHCs.

Iraq is in the unique position of being the only country in the region, and arguably the world, that has the geological potential of rivalling Saudi Arabia. It will however, remain a mere potential contender for the foreseeable future. On one hand, due to several years of devastating sanctions and catastrophic wars it needs investment more than any other country in the region and on the other hand, due to the all out mayhem of the recent years it has by far the highest risk of investment.

The Persian Gulf countries nevertheless share a common historical and cultural perspective, which has been shaped by their shared adherence and contribution to Islam and Islamic civilization.

Islam is the common thread in the social, political and cultural structure of the Middle East and shapes the region's historical experience. The 20<sup>th</sup> century witnessed the rise of revivalist Islamic movements – from the Muslim Brotherhood in Egypt to the Islamic Revolution in Iran – seeking to embrace the modern developments without sacrificing strict adherence to the principles of Islam. In light of the downfall of the traditional Middle East Strongmen and the Arab spring, the public appeal, social clout and more importantly the political influence and the ability to guide policy of Islamic groups and ideologies is only going to grow further.

Today, the legal regimes and business practices of the Middle Eastern hydrocarbon producers reflect this common historical and ideological foundation. Thus, it is of paramount importance to the IHCs and their lawyers to understand the impact of Islamic law on the investment environment of the region, in general, and its hydrocarbon industry, in particular.

Islamic law or *Shari'ah* purports to govern all aspects of the private and public life of the believers, dividing all human actions into objectively good and inherently bad. Its all-embracing character is the constant narrative of Islam as a religion and a civilization.

On the other hand, the courts of non-Muslim countries, to say the least if only to avoid religious controversy, are reluctant to consider Islamic laws in deciding on transnational disputes. Even in the realm of arbitration and alternative dispute resolution, the tribunals in *Sheikh Abu Dhabi v Petroleum Development Ltd*<sup>3</sup>, *Ruler of Qatar v International Marine Oil Company Ltd*<sup>4</sup> and *Aramco v Government of Saudi Arabia*<sup>5</sup> had refused to apply "Islamic law" as they did not consider it to contain a consistent body of legal principles applicable to modern commercial dealings.

The common view on applicability of Islamic law however is changing rapidly. The growing appeal of arbitration and other modes of alternative dispute resolution alongside the growing scholarship and modern understanding of Islamic law and the international success

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<sup>3</sup> (1952) ICLQ 247.

<sup>4</sup> (1956) 20 Int L Rep 534.

<sup>5</sup> (1963) 27 Int L Rep 117.

of the Islamic finance industry provide new possibilities for application of Islamic law in solving commercial and investment disputes.

## II. Islamic Law

Historically *Shari'ah*, as the structured jurisprudence and formal theology of Islam, was shaped by *Fuqaha* (Islamic scholars) long after the prophet's time. Today there are four Sunni schools of *Fiqh* (Islamic Jurisprudence) and one *Shi'ah* school, all of which are based on the orthodoxy of *Usul al-Fiqh* (sources of jurisprudence).

The *Usul al-Fiqh* or the sources of Islamic law are defined as *Qur'an*, *Hadith* or *Sunnah* (prophet's traditions), *Qiyas* (analogy) and *Ijma* (consensus of the jurists). While the first two are material sources, the third is the rational hermeneutic method which enables the *Fuqaha* to interpret the two revealed sources. The last one, *Ijma*, was designed to serve as a dialectical sanctioning mechanism for the results of *Ijtehad* (juristic efforts) in the material sources by way of analogy.

In other words, in solving each new problem the scholars did not start from a hypothesis which could be proved or disproved. Instead they would reach independently viable conclusions relying on the same divine and quasi-divine sources by using analogy. The independent results then would have to pass the test of a collective dialectical reasoning by the community of scholars comparing each idea against the others. The result would be the organic recognition of a solution based on a consensus reached through constant conversation and dialogue amongst the *Fuqaha*.

During centuries of *Ijtehad*, the body of *Fiqh* was enriched relying on the four sources to become what is now the *Shari'ah*. However, the competing schools are not always of the same opinion, and since their ideas are the result of human efforts, as only *Qur'an* is divine and *Hadith* is quasi-divine<sup>6</sup>, a mechanism of *Ikhtelaf* (disagreement) which provides for "agreeing to disagree" amongst the schools is worked out. Thus, variant opinions of different schools are all considered equally valid.

Another innovation by the *Fuqaha* is the utilization of the doctrine of *Masalaha al-Mursalah* (unrestricted public interests) for issues not previously defined in the body of *Shari'ah* rules. According to this doctrine, the jurist may consider the cost and benefit analysis of an opinion in a macro level within the boundaries of the defined framework of the *Maqasid*<sup>7</sup> (objectives) of *Shari'ah*. In other words, the possible consequences of any opinion and its effects on the Islamic society would be considered and the viability of the opinion will be decided in accordance to the compliance of the possible outcomes with the objectives of *Shari'ah*.

For this purpose the *Maqasid* are agreed by the majority of scholars to include the protection of religion, life, intellect, lineage and property.<sup>8</sup> Here, protection of life includes safeguarding the means of facilitating an honourable life and protection of property not only encompasses the right of ownership but also a right to free trade<sup>9</sup> within the limits of *Shari'ah*.<sup>10</sup>

<sup>6</sup> "Whatsoever the messenger ordains, you should accept, and whatsoever he forbids you should abstain from" *Qur'an* 4:80. It follows that, actions and sayings of the prophet draw the model of good behavior and righteous living although he was a human and his actions were not guided at all times by the divine. Hence, *Hadith* is quasi-divine.

<sup>7</sup> For an introduction on *Maqasid al-Shari'ah* see: S Jackson 'Literalism, Empiricism and Induction: Apprehending and Concretizing Islamic law's *Maqasid al-Sharia'h* in the Modern World' (2006) Michigan State Law Review 1469.

<sup>8</sup> *Ibid.*

<sup>9</sup> "Allah has made trade lawful" *Qur'an* 2:275 ; "Let there be among you traffic and trade by mutual goodwill" *Qur'an* 4:29.

<sup>10</sup> See: Daftar Hamkari Huzah wa Daneshgah *An Introduction to Islamic Law* (Intesharat Samt, 1986).

On the basis of the abovementioned mechanism and by relying on the sources of Islamic law, the Islamic socioeconomic model was devised. In line with the general principle that, in Islam everything is *Halal* (allowed) unless it has been declared *Haram* (forbidden), the Islamic economic model is based on the freedom of trade and freedom of contract so far as the limits of *Shari'ah* allow.<sup>11</sup> Based on the general rules governing economic activities in *Qur'an* and *Sunnah*, including prohibition of *Riba* (usury), *Gharar* (uncertainty) and *Qimar*<sup>12</sup> (gambling) and encouragement of *Taa'won*<sup>13</sup> (mutual cooperation), the overriding doctrine of fairness in commercial dealings is established.

Reliance on the general doctrine of fairness created an ethical economic model where the forces of the market are protected from unfair manipulation. Thus, inflating the price of commodities by creating artificial shortages (*Ihtekar*), overbidding for the sole purpose of driving the prices up (*Najash*) and concealment of vital information in a transaction from the other party (*Ghish*) are forbidden.

Prohibition of *Riba* requires that any reward or return should be accompanied by undertaking a level of risk and liability. Thus, there can be no reward for time preference alone. Prohibition of *Qimar* forbids gambling and any game of chance which may result in accumulating *Maysir* (unearned income). Thus, uninformed speculation not based on a proper analysis of available information is not allowed.

Prohibition of *Gharar* forbids contracting under conditions of excessive uncertainty and unacceptable levels of risk. Thus, existence of any avoidable uncertainty in a commercial dealing would invalidate it, as it may lead to deceit or unjust enrichment. In practice however, no commercial dealing can ever be completely free of risk and uncertainty. Hence, *Gharar* has always been assumed to mean an unacceptable level of uncertainty, where the level of acceptability is largely defined by the facts of each individual case.

Accordingly, *Jahl* (ignorance) of price or subject matter, of characteristics of price or subject matter,<sup>14</sup> of quantum of the price or quantity of the subject matter and finally of date of performance or delivery would render a contract voidable.

*Gharar* may rise from unacceptable levels of settlement risk, inadequate and/or inaccurate information<sup>15</sup> and complex contracts where multiple transactions are not identifiable with multiple independent contracts.

<sup>11</sup> For a detailed account on Islamist Economics see: M Mutahhari, *Mabani-e-Eqtesad-e-Islami* (Intesharat-e-Hekmat, 1970); also: Imam Musa Sadr *Eqtesad dar Maktab-e Islam* (Ashraf, 1971).

<sup>12</sup> "They ask thee concerning wine and gambling. Say: "In them is great sin, and some profit, for men; but the sin is greater than the profit." They ask thee how much they are to spend; Say: What is beyond your needs. Thus doth Allah Make clear to you His Signs: In order that ye may consider" *Qur'an* 2:219 "O ye who believe! Intoxicants and gambling, (dedication of) stones, and (divination by) arrows, are an abomination, - of Satan's handwork: eschew such (abomination), that ye may prosper." *Qur'an* 5:90 "Satan's plan is (but) to excite enmity and hatred between you, with intoxicants and gambling, and hinder you from the remembrance of Allah, and from prayer: will ye not then abstain?" *Qur'an* 5:91.

<sup>13</sup> The prophet approved of the pre-Islamic practices of cooperation amongst the tribes of the Arabian peninsula and such practices became part of the Islamic tradition and found their way to *Shari'ah* mostly by reliance on the prophets *Sunnah*.

<sup>14</sup> "The Prophet forbade two kinds of sales i.e. Al-Limais and An-Nibadh (the former is a kind of sale in which the deal is completed if the buyer touches a thing, without seeing or checking it properly and the latter is a kind of a sale in which the deal is completed when the seller throws a thing towards the buyer giving him no opportunity to see, touch or check it) and (the Prophet forbade) also Ishtimal-As-Samma' and Al-Ihtiba' in a single garment." *Sahih Bukhari, Volume 1, Book 8, Number 364*. Thus, the purchaser should have opportunity of examining the goods to ascertain the information.

<sup>15</sup> "Both the buyer and the seller give the option of either confirming or cancelling the bargain three times, and if they speak the truth and mention the defects, then their bargain will be blessed, and if they tell lies and conceal the defects, they might gain some financial gain but they will deprive their sale of (Allah's) blessings." *Sahih Bukhari, Volume 3, Book 34, Number 327*.

Any excess to the principal amount of loan, which a creditor is settled to receive from the debtor in return for the time the debt is owed is *Riba* and absolutely *Haram*.<sup>16</sup> Prohibition of *Riba* is designed to avoid any unjust disparity between the exchange objects. Such disparity may constitute a *Riba Alfadhil* (*Riba* of excess) or a *Riba Alnisiyah* (*Riba* of delay).

The former refers to exchanging unequal (in quantity or quality) units of the same merchandise.<sup>17</sup> The latter, refers to payment of added value, in comparison to a spot sale, in return for delay in payment. It follows that discounting a debt in a commercial relationship unless for benevolent reasons and wholly unrelated to the time of maturity is *Riba* and forbidden.

### **III. Hydrocarbon Resources under Islamic Law**

#### **A. Ownership**

In *Shari'ah*, ownership or *Melk* is defined as the right to benefit, dispose and use *Mal*. *Mal* or property refers to anything that the concept of ownership extends to. This would include the object (*E'in*) and its benefit (*Naf'e*). Property should have monetary value and its exchange should be customary. If property is in possession and its benefit is permitted then it can be subject of a valid transaction. However, if it is not in possession, or is non-determinable, there cannot be a valid transaction.<sup>18</sup>

Hydrocarbon resources before discovery and actual possession cannot be subject to valid transactions. Moreover, minerals in general are “public property” held on trust by the Islamic State for the benefit of the society of Muslims.<sup>19</sup> As such, *Sharia'h* is in sync with the internationally predominant system of mineral rights, which rests the ownership in the sovereign.<sup>20</sup>

#### **B. Exploitation**

Under *Sharia'h*, the Islamic state may grant concessions for exploitation (*Iqta al-Isteglal*) and concessions for possession (*Iqta al-Tamlík*) of minerals and the Prophet himself granted mining concession in the early days of Islam. These concessions granted for exploration and extraction of gold, silver, iron and copper were<sup>21</sup>:

- i. limited geographically to specific boundaries in ownerless or publically owned land,
- ii. granted exclusive rights,
- iii. for specific initial time limits,
- iv. renewable after the conclusion of the initial term, and provided for;
- v. cancelation rights if the work obligation was not fulfilled,

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<sup>16</sup> “O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers” *Qur'an* 2:278.

<sup>17</sup> “The bartering of gold for silver is *Riba*, except if it is from hand to hand and equal in amount, and wheat grain for wheat grain is usury except if it is from hand to hand and equal in amount, and dates for dates is usury except if it is from hand to hand and equal in amount, and barley for barley is usury except if it is from hand to hand and equal in amount” *Sahih Bukhari, Volume 3, Book 34, Number 344*.

<sup>18</sup> M Ja'fari Langrodi, *Maktabhay Hoghoghi dar Hoghogh Islam (Schools of Thought in Islamic Law)*, (Ganj-e-Danesh, Tehran, 1990)1-12, 202-210.

<sup>19</sup> *Ibid*.

<sup>20</sup> T Daintith, *United Kingdom Oil and Gas Law* (Sweet & Maxwell, 1984) 18.

<sup>21</sup> A Obied, *Ketab al-Amwal (the Book of Property)*, (Maktab al-Tigariah, Cairo, 1944) 276- 280; and M Bunter, “The Islamic (Sharia) Law and Petroleum Developments in the Countries of North Africa and the Arab World”, (2003) *OGEL* 1(4).

- vi. right to assign,
- vii. payment of royalties in cash or in kind.

*Iqta al-Tamlík* is not relevant to scope of this paper and the unique nature of oil and gas resources. *Iqta al-Isteglal* however, is the forefather of *Sharia'h* compliant hydrocarbon concessions.

*Iqta al-Isteglal* is an exclusive exploration and extraction license. It offers a right to benefit from the finds and gives permission to conduct all necessary operations in the restricted area. This however, does not offer ownership of the resources found but a proprietary right to the benefits accrued. In other words *Melk* in the *E'in* (the reservoir itself) is not on the table but the *Melk* in the *Naf'e* (benefit) is granted.<sup>22</sup> Thus, the holder of such a concession would acquire ownership rights after extraction and at the wellheads to the extracted oil or gas and not what remains under the ground.

#### **IV. Islamic Finance and Oil and Gas Contracts**

Traditionally the financing of hydrocarbon projects in the region has been a matter for the national hydrocarbon companies (NHCs) and major IHCs. Thus, the deep pockets of the parties involved had always been sufficient to acquire funds and put up capital for such projects.

As such, the relevance of Islamic finance is more because of the need for products in the *Sharia'h*-compliant investment markets than a need for unconventional methods of provision of credit for hydrocarbon projects.

Prohibition of *Riba* in Islamic finance effectively means that under *Shari'ah*, loans are charitable agreements and any loan made in order to make profit is considered to involve *Riba* and thus is prohibited. Prohibition of *Gharar* in Islamic finance means that a transaction involving an unacceptable level of uncertainty would not be valid.

As a result of these two general prohibitions *Sharia'h* compliant finance would not engage in many of the conventional practices through standard methods. Islamic finance uses an altogether different paradigm of financing, namely asset based financing and profit-loss sharing agreements, and employs the well-defined structure of nominate contracts in Islamic law. The financing methods offered by Islamic finance, relying on defined nominate contracts, tend to share risks between partners in development of projects and aspire to encourage entrepreneurship and trade in productive assets.<sup>23</sup>

So far the exploration and production (E&P) activities worldwide and in the region have predominantly been funded by conventional debt, equity and capital markets financing methods. However, hydrocarbon assets provide an ideal opportunity for *Sharia'h*-compliant financing. E&P operations in principle do not run afoul of the rules against prohibited economic activities; they require long-term commitment and are well suited to some degree of investor share in risk and ownership.

Moreover, as the center of gravity of capital markets shift towards east and south and Muslim investors' financial clout grows, the demand for *Sharia'h*-compliant investment opportunities would also increase. Thus, it is expected that the region will experience a rise in *Sharia'h*-compliant funding for E&P projects.

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<sup>22</sup> *Ibid* and M Ja'fari Langrodi, *Maktabhay Hoghoghi dar Hoghogh Islam (Schools of Thought in Islamic Law)*, (Ganj-e- Danesh , Tehran, 1990)1-12.

<sup>23</sup> See: C Richardson, "Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field" (2006) *Texas International Law Journal* 42, 120-153.

## A. Bai

The simplest nominate contract, which is used as a starting point on many other instruments, is *Bai* (sale). It follows from the general prohibitions on *Gharar* and *Riba*, discussed above, that a sale contract to be valid under *Shari'ah* must be instant and absolute. Thus, a sale attributed to a future date or a sale conditional on a future event is void.

The *Mabi'y* (subject of sale) must be a property of value. For the purpose of *Bai* this is defined as a tangible asset, which is an onerous definition for the utilization of *Bai* in Islamic finance. Thus under the doctrine of *Masalaha al-Mursalaha* the majority of contemporary jurists have ruled that where tangible assets and monetary obligations are combined, for example in sale of a company, if the tangible assets constitute a significant part of the subject matter of the sale then the price is negotiable; if however monetary obligations constitute the significant part then any discounting or pricing of those obligations would result in *Riba*.

The *Mabi'y* should be in existence, in the ownership of the seller and in his/her constructive or actual possession at the time of sale. It should not be forbidden in Islamic law, for example: selling or buying pork is not permissible.

The *Mabi'y* must be specifically known and identified to the buyer. The delivery time must be certain and should not depend on a condition or chance. Finally, the *Thaman* (price) must be certain and determinable.

In principle the premise of “time value for money” where conventional loans operate is a no go area for Islamic finance as it would amount to *Riba*.<sup>24</sup> However, according to *Shari'ah* a seller may charge a purchaser the cost of a merchandise plus an added value. The profit accrued from such a *Bai* contract entered to by the free will of the parties is *Halal* in absent of *Ghish* or *Gharar*.<sup>25</sup>

## B. Murabaha

*Murabaha*, is a variation of *Bai* which is used in international trade as the main part of a hybrid instrument along with a *Bai be Thaman Ajil* (sale with deferred payment), or simply *Bai Mua'jjal* (deferred sale), more than any other method of Islamic finance. Arguably more than 80% of the Islamic finance activity is in trade financing and on the basis of *Murabaha*.<sup>26</sup>

In *Murabaha*, the buyer purchases goods for the price for which it was acquired plus a defined profit. Thus, the distinctive feature of *Murabaha* is that the seller discloses the actual cost incurred and asks for a set amount of profit, which can be demanded as a lump sum or as a percentage of the cost.

For trade finance purposes, the borrower approaches an Islamic lender or investor, instructing it to purchase a certain item at a defined price and offers to buy it back at a marked up price. The lender buys the item and then sells it to the borrower at a marked-up price.

Very rarely, Islamic financial institutions use a simple *Murabaha* transaction, as cost plus profit sale, with the price paid by the borrower immediately and in full. In this case no financing is involved and the lender would only act as a *Simsar* (broker or middle-man). In

<sup>24</sup> It can be argued that an interest may be charged on debts in compliance with *Shari'ah* if its value is pegged to the purchase power of the debt at the time of maturity as defined by a commodity index thus in effect applying a “time value for money” principle to Islamic finance.

<sup>25</sup> “Those who devour usury will not stand except as stand one whom the Evil one by his touch Hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (The offence) are companions of the Fire: They will abide therein (for ever).” *Qur'an* 2:275

<sup>26</sup> I Warde, *Islamic Finance in the Global Economy* (Edinburgh University Press, Edinburgh, 2000) 133.

Islamic finance *Murabaha* is usually used for providing trade financing in conjunction with *Bai Mua'jjal* which as a form of credit sale permitted in Islamic law.

Thus, the borrower would pay the price later and often in fixed instalments and the lender would receive a set margin of profit in return for the initial spot purchase that it had made on the instruction of the borrower. The profit is *Halal*, as the lender acquires title to assets, even for a very short time, and assumes a risk. The lender thus, is in essence first a buyer in a simple *Bai* and then a seller under a variation of *Bai* and in none of the two stages it assumes the role of a conventional creditor.

The profit is usually defined in reference to an interest rate index such as the LIBOR (London Inter-Bank Offered Rate).<sup>27</sup> This method of determining the profit in a *Murabaha* is a natural outcome of a dual financial system. The profit obtained is not *Riba*, as the market value of assets and the interest rate index are indicative of one another. Hence, the similarity of the outcome to the conventional financing method is a predictable result of the two systems operating in the same global market.

Although this form of finance has little direct application in E&P projects, it is nevertheless an attractive option for financing equipment purchases. In practice, the lender would appoint the expert borrower as its agent to get involved in the actual sales process on its behalf. The hydrocarbon company would be responsible for negotiating all of the commercial terms with the seller of equipments, thus avoiding complexities such as the delivery of nonconforming goods.

### C. Ijarah

An *Ijarah* transaction is the Islamic equivalent of a lease<sup>28</sup> and is defined as a bilateral contract allowing for the transfer of the usufruct. Thus, an *Ijarah* transaction involves the transfer of ownership in *Naf'e* rather than *E'in*. To be valid similar conditions to a *Bai* transaction, albeit with a different terminology, must be satisfied. In an *Ijarah* agreement:<sup>29</sup>

- i. the *Mujir* (lessor) would transfer the usufruct of the property to the *Mustajir* (lessee),
- ii. the ownership in the property remains with the lessor,
- iii. the duration of the lease is determined and certain,
- iv. the *Ujrah* (rent) is determined and is paid on specific dates,
- v. the object should have a use and it cannot be used by the lessee for purposes other than specified in the *Ijarah* agreement.

As an Islamic finance product, similar to the *Murabaha*, the lender buys an asset from a third party. But, rather than selling the asset would lease it to the borrower. The borrower in return makes regular rental payments to the lender while the asset is in use.<sup>30</sup> The rent is calculated using a benchmark such as LIBOR.

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<sup>27</sup> See: T Zaher and M Hasan, 'A Comparative Literature Survey of Islamic Finance and Banking' (2001) *Financial Markets, Institutions and Instruments* 10 (4) 155-199.

<sup>28</sup> "It is permissible to rent the land for cultivation, for *Ibn 'Abbas* said: 'The Prophet did not forbid that, but said: One had better give the land to one's brother gratis rather than charge a certain amount for it.' " *Sahih Bukhari, Volume 3, Book 39, Number 534*; and,

"*Rafi bin Khadij* said: 'My two uncles told me that they (i.e. the companions of the Prophet) used to rent the land in the life-time of the Prophet for the yield on the banks of water streams (rivers) or for a portion of the yield stipulated by the owner of the land. The Prophet forbade it.' I said to *Rafi*: 'What about renting the land for Dinars and Dirhams?' He replied: 'There is no harm in renting for Dinars-Dirhams.' " *Sahih Bukhari, Volume 3, Book 39, Number 537*.

<sup>29</sup> See: M Usmani, *An Introduction to Islamic Finance* (BRILL, 2002) 69-83.

<sup>30</sup> *Ibid*.

*Ijarah* can be used for leveraged lease-financing of E&P projects as a substitute for the conventional leverage lease or sale-leaseback products. The Dolphin Gas Project (Qatar/United Arab Emirates) is a prime example of such use of *Ijarah* in the region.<sup>31</sup>

#### D. Salam

As discussed above, sale of non-existent objects is forbidden in principle as it would result in *Gharar*. However, primarily to accommodate agricultural activities the Prophet approved *Salam*<sup>32</sup> as an exception to the aforementioned general prohibition.<sup>33</sup>

*Salam* is a sale contract where the purchase price is paid in full against the future delivery of a well-defined object in a specified time. As such, in a *Salam* contract, the *Mabi'y* does not have to be in existence at the time of entering into the agreement, and the seller does not need to be in possession. It is most suitable for financing of agriculture or small construction projects.<sup>34</sup>

As an Islamic finance product, *Salam* can be utilized to provide working capital. The lender pays in full for a defined object in advance for supply on a pre-agreed future date. The lender will receive a discount in return for the advance payment. This is calculated by reference to a benchmark, such as LIBOR.

Thus *Salam* is in effect a *Sharia'h*-complaint forward sale, which can be used as a method of providing capital for short-term production increase and/or efficiency improvement projects in operational oil and gas fields.

#### E. Istisna

*Istisna* is a sale contract for future delivery of an object, which is going to be manufactured with predetermined specifications and delivered within a specified time frame.<sup>35</sup> By way of analogy, Islamic scholars have reached from the permissibility of *Salam* to the permissibility of *Istisna*.

Thus, instead of purchasing a nonexistent final product, the buyer is permitted to fund the manufacture, development, assembly, packaging or construction of an object to an agreed specification and in return take delivery on the agreed predetermined completion date.

As an Islamic finance product, the investor pays for the manufacture or construction of the object, often in installments, and in completion will sell or lease it to the manufacturer/borrower. The mark-up constitutes permissible profit under a *Bai* or *Ijarah* contract.

So far, *Istisna* has been successfully utilised in financing large downstream projects such as refineries and petrochemical plants. It is however, an attractive financing option for E&P

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<sup>31</sup> C Richardson, "Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field" (2006) *Texas International Law Journal* 42, 133.

<sup>32</sup> "The Prophet came to Medina and the people used to pay in advance the prices of fruits to be delivered within two to three years. The Prophet said (to them): 'Buy fruits by paying their prices in advance on condition that the fruits are to be delivered to you according to a fixed specified measure within a fixed specified period.'" *Sahih Bukhari, Volume 3, Book 35, Number 455*.

<sup>33</sup> "Allah's Apostle came to Medina and the people used to pay in advance the price of fruits to be delivered within one or two years. (The sub-narrator is in doubt whether it was one to two years or two to three years.) The Prophet said: Whoever pays money in advance for dates (to be delivered later) should pay it for known specified weight and measure (of the dates)." *Sahih Bukhari, Volume 3, Book 35, Number 441*

<sup>34</sup> See: M Usmani, *An Introduction to Islamic Finance* (BRILL, 2002) 83-93.

<sup>35</sup> *Ibid*.

projects and specifically for purchase of deepwater platforms and bespoke drilling equipments.<sup>36</sup>

## F. Musharakah

In *Sharia'h*, equity participation can take the shape of either *Sherkat al-Melk* or *Sherkat al-Aqd*. The former is a partnership based on joint ownership of property and the latter is a partnership based on mutual contract.<sup>37</sup> There are in turn three modes of *Sherkat al-Aqd*:

- i. Where the partners invest capital into a commercial enterprise. (*Sherkat al-Amwal*)
- ii. Where the partners jointly undertake to render services and share the fees. (*Sherkat al-Amal*)
- iii. Where the parties share in the profit accrued from spot sale of commodities jointly purchased on deferred prices. (*Sherkat al-Wujooh*)

*Musharakah* is a term coined by Islamic finance specialists and is usually referring to a *Sherkat al-Amwal* or less commonly to a *Sherkat al-Amal*. It is in essence a partnership between the parties with defined capital contributions to a joint venture. In such a partnership, each party, in addition to providing capital, would have the right to manage the venture. They share in loss, in exact proportion of their capital contribution; and, in profit, according to a predetermined ratio set out in the *Musharakah* agreement.

*Musharakah* is a loss/profit sharing arrangement through equity participation between the parties. As such, it can be used as a framework for E&P joint ventures and/or as a method of acquiring top-up capital by IHCs or NHCs from investors.<sup>38</sup>

## G. Mudharabah

*Mudharabah* is a form of partnership where one party (the investor or *Rab al-Mal*) provides capital and the other (the manager or *Mudharib*) manages the funds provided.<sup>39</sup> Profit share is determined according to a ratio specified in the original contract. Unlike *Musharakah*, where all parties could participate in the management and conduct of business, in *Mudharabah* the investor cannot interfere in the management. As such, *Mudharabah* is often referred to as a trust rather than a partnership.<sup>40</sup>

Unless the manager somehow fails to implement due diligence in the conduct of his duties; any loss is suffered only by the investor who is the sole provider of all of the capital. However, in event of loss the manager does not receive compensation for his efforts. This, more or less, corresponds with venture capital financing in conventional capital markets as the *Rab al-Mal* finances a project and the *Mudharib* only contributes sweat equity by managing the project.<sup>41</sup>

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<sup>36</sup> See: C Richardson, "Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field" (2006) *Texas International Law Journal* 42, 120-153.

<sup>37</sup> See: M Usmani, *An Introduction to Islamic Finance* (Idaratul Ma'arif, Karachi, 1998) 31-92.

<sup>38</sup> C Richardson, "Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field" (2006) *Texas International Law Journal* 42, 130.

<sup>39</sup> K Hassan and M Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing, 2007) 51.

<sup>40</sup> M Usmani, *An Introduction to Islamic Finance* (BRILL, 2002) 14-16; M El-Gamal, "A Basic Guide to Contemporary Islamic Banking" 15-17, available at: <http://www.ruf.rice.edu/~elgamal/files/primer.pdf> accessed 24/04/08.

<sup>41</sup> H Sharawy, "Understanding the Islamic Prohibition of Interest: A Guide to Aid Economic Cooperation Between the Islamic and Western Worlds", (2001) *Georgia Journal of International and Comparative Law* 29,169.

*Mudharabah* can involve multiple investors putting capital in a *Mudharabah* fund and sharing in the risk and benefit of a number of large projects. As such, it is a desirable method to raise funds for upstream projects from passive investors who do not wish to interfere in the day-to-day operations of an E&P project but would appreciate the possibility of binding the IHC to strict covenants and industry standards of best practice and prudent operation.

## H. Sukuk

*Sukuk* are the *Sharia*'h-compliant equivalent of conventional bonds. *Sukuk* is the plural for *sakk*. Each *sakk* or "Islamic bond certificate" represents a proportional ownership in a "subject" which can be tangible assets, a pool of predominantly tangible assets or permissible ventures such as *Mudharabah* or *Musharakah*.

The issuer sells the certificates to the investor with a contractual obligation to buy back the certificate at par value at a future date. The investor/holder acquires ownership benefits alongside the risks associated with such ownership.

The holder then rents back the subject of the certificate to the issuer in return for predetermined payments on basis of an *Ijarah* agreement. The ownership of the subject is proportional but undivided and the payments received as rent correspond to the interest payments to bond holders.<sup>42</sup>

As such, *Sukuk* encompass notable characteristics of both shares and bonds. It should however be distinguished from conventional bonds and conventional equities. It is different from both the former, which represent debt obligations of the issuer, and the latter, which represent ownership interests in the issuer/originator, since:<sup>43</sup>

- i. a *sakk* is a certificate of proportional ownership in a specified subject not the issuer itself;
- ii. the funds raised through the issuance of *Sukuk* can only be applied to investment in that subject and not for general unspecified purposes;
- iii. the payments received by the holder of the certificate must be related directly to the subject and the purpose of the investment made; and,
- iv. the ownership rights are transferred from the issuer to the holder for a fixed period ending with the predetermined maturity date of *Sukuk*.

As an Islamic finance tool, the overall use of *Sukuk* is similar to conventional bonds hence the common use of the inadequate term "Islamic bonds". It is normally combined with other methods of Islamic finance and is in essence a tool to raise money from a wider spectrum of investors rather than an entirely independent method of *Sharia*'h-compliant financing.

Utilization of *Sukuk* is a competitive method of raising funds for E&P projects and has had great success internationally.<sup>44</sup>

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<sup>42</sup> See: N Adam and A Thomas, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk* (Euromoney Books, 2004).

<sup>43</sup> *Ibid*; and see: K Hassan and M Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing, 2007) 53-60.

<sup>44</sup> C Richardson, "Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field" (2006) *Texas International Law Journal* 42, 133; and, M el-Qorchi, 'Islamic Finance Gears Up', (2005) *Finance and Development* 42(4), available at: <http://www.imf.org/external/pubs/ft/fandd/2005/12/qorchi.htm>. accessed: 09/12/2010; and, S Hamdan, 'International Borrowers Take to Islamic Bond Markets' *The New York Times* (28 October 2010), available at: <http://www.nytimes.com/2010/10/28/business/global/28iht-sukuk.html>. accessed: 11/12/2010.

## ***V. Conclusion***

Adherence to Islam is the common characteristic of the Middle Eastern hydrocarbon producers and their legal regimes and business practices to different extents reflect this common characteristic. As such, painting a reliable picture of the legal regimes governing the exploitation of hydrocarbon resources in the region requires consideration of rules of *Sharia'h* with regards to natural resources. Added to this, is the growing role of arbitration and alternative dispute resolution in solving international commercial and investment disputes; which provide the possibility of the utilization of *Sharia'h* as the governing law in E&P related arbitration and alternative dispute resolution proceedings.

Moreover, the accumulation of petrodollars in the hands of the “believers” and the growth of Islamic finance, as a result of the economic resurgence of the Middle East and the rise of political Islam in recent decades, have resulted in the increasing importance of *Sharia'h*-compliant methods of project finance. On this basis any investor looking to enter to or grow its presence in the Middle East would be well advised to consider the risks and opportunities created by the resurgence of “Islamic Law”.

In practice however, so far as international investors and IHCs are concerned, Islamic rules deliver remarkably similar outcomes to the conventional and globally accepted business methods and legal regimes. As such, the relatively painless adaptation of *Sharia'h*-compliant methods would provide for a lucrative and sustainable presence in this prominent hydrocarbon rich region.