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Oil, Gas Contracts And Islamic Principles

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ABSTRACT

A great amount of the reserves of crude oil and natural gas resources are located within the territories of the countries the majority of the population of which are Muslims. There is a growing concern among the population of these countries that the deeds and the actions of their states should be in accordance with the Islamic principles. The development and conclusion of oil and gas contracts in accordance with the sources of Islamic law such as Qur'an, Sunnah, Ijma and Qiyas is of particular importance. The concepts of land ownership, licencing, taxation of minerals are analysed separately in order to reach an inductive outlook. In this respect, Buy Back Contracts are formalised. Buy Back Contracts are regarded to have significant resemblances with risk service contracts. As a form of oil and gas contracts that are formalised in accordance with the Islamic principles, Buy Back Contracts, still, need upgrades in order to be in full conformity with Islamic considerations.

Key Words: Crude Oil, Natural Gas, Islamic Principles, Iqta, Buy Back Contracts

The supply chains of the international oil and gas industry have a unique structure in that the principle actors, who are the host countries that own the hydrocarbon resources and the contractor companies that invest in extracting these sources, have differing objectives. Generally, the host countries cannot explore, develop or extract their hydrocarbon sources on their own. Rather, they have to make use of the financial strength, and administrative and technical know-how of international contractor companies. These companies then apply this power in cooperation with the host countries to exploit the oil and gas reserves.

Because the two sides have different motivations and objectives, perceptions on each side of the negotiation table may contradict each other. Within this complicated framework, host countries try to make lucrative offers to attract investment from international contractor companies. However, in doing so, they do not want to lose control over their reserves out of sovereignty and nationalistic considerations. Meanwhile, international contractor companies try to maximize their control of the overall exploration, development and production operations of the reserves under consideration. The companies are primarily motivated by financial gain so they aim to make as much profit as they can from exploiting the fields they invest in, using their economic funding, managerial expertise and technical know-how.

This study focuses on the financial and contractual aspects of petroleum and gas exploration, especially in the Middle East, and the development of the contract negotiations in relation to Islamic principles. There is a growing demand coming from the public in the Middle East that their states' actions should follow Islamic principles, or at least should not contradict them. In this regard, the objective of this study is to explore the philosophy of oil and gas contracting, particularly Buy-Back Contracts.

This article has three main inter-related parts. The first section deals with the formation of energy contracts, including the classification of contractual based systems and royalty tax systems. The second section investigates energy sources from an Islamic perspective, specifically questions regarding ownership of mineral sources, state participation in mineral extraction, the nature and kinds of mineral agreements, and the amount of taxation to be applied to these sources. The third part explains buy back contracts, which apply Islamic norms and principles to energy agreements.

The Formation of Energy Contracts

There are two main bases within the practices of the international oil industry regarding the cooperation of international energy companies and host governments. These two main families of fiscal systems are concessionary systems, also known as royalty/tax systems, and contractually-based systems, including production-sharing and service contracts. This classification is important in determining the foundations of the relationship and cooperation between the two sides since their interests, priorities and calculations tend to differ when negotiating about how to cooperate over energy sources. There are elastic terms to deal with carefully on the negotiation table between the host countries and contractor companies.[1]

The concept of title to the mineral resources is paramount in classifying fiscal regimes governing oil and gas contracts. It is important to note that royalty/tax systems allow title to hydrocarbons to be transferred at the well head during production Contractually-based systems differ according to whether reimbursement or remuneration of contractors is in cash, which is the general case for service contracts, or kind, which is the general case for production-sharing contracts.[2]

There are differences between contractually-based systems, classified as service contracts and production-sharing contracts. Production-sharing contracts were introduced by Indonesia, stemming from the principle of cooperating to produce agricultural corps in the case where the farm owner lacks the capacity or intention to cultivate it but another person has the intention and capacity to farm but lacks the land. Their joint effort makes it possible and viable to use the land and the capability for investment.[3] The outcome, production, is divided in kind among the parties based on agreed criteria. This logic has since been transferred and restructured to fit with the practices and norms of the international oil and gas industry.

For production-sharing contracts, the title to the hydrocarbons is transferred at the point of export point. A joint venture is formed between the host government's national oil company and international contractor companies. Payment (reimbursement, remuneration) is made in kind to the contractor companies in return for their economic and engineering activities. There are three main types of production-sharing contracts: Peruvian, Indonesian Type and Egyptian. In the Peruvian type contracts, gross production is divided whereas profit is divided among the parties under the Indonesian type. In the Egyptian type, unused cost oil, labelled 'ullage', is

[1] Xu Zhao and others, "Modelling Optimal Production Rate with Contract Effects for International Oil Development Projects", *Energy*, Vol. 45, 2012, p. 662.

[2] Daniel Johnston, *International Petroleum Fiscal Systems and Production Sharing Contracts Course Workbook*, Daniel Johnston & Co., Inc, 2004.

[3] Luo Dongkun and Yan Na, "Assessment of Fiscal Terms of International Petroleum Contracts", *Petroleum Exploration and Development,* Vol. 37, No. 6, 2010, p. 757.

treated as a separate category of profit oil when each part (the host country and the contractor company) has its share of the earnings.[4]

Government has to focus carefully on several questions. What type of system is going to be applied to the contract: royalty/tax system, production-sharing contracts or a service agreement base? How will profit be divided among the parties? What mechanisms should be applied for revenue protection? What kind of a cost control mechanisms are needed? How can optimum allocation of the resources and maximum efficient rate objectives be achieved? Who are the companies on the other side of the table? What are their aims? How can conflicts of interests and priorities be harmonised?

It is human nature to feel that the other parties have concluded a better deal or negotiated a windfall for themselves. During the negotiation stage, host government representatives face a lot of pressure because their actions and strategies are scrutinised by other government agencies and bodies, the ruler, who may be a dictator in some cases, the prime minister or energy minister, the president, the public and the press. They keep revenue protection in mind while facing the dilemma of signing a deal with questionable terms and conditions or making no deal the contract's clauses are controversial.

There is also a fear that investor companies are wasting the host country's natural resources of by unnecessary spending and that the companies are most likely cheating the government authorities by claiming more than they have actually spent. By holding audits and imposing legal penalties for fraud or noncompliance with rules and regulations, the government can protect its interests to some extent through authorising expenditure within the project's budget.

Before the 1960s, the concessionary system was mostly used,[5] with investor companies providing a framework in accordance with the government authorities that granted them the right to explore for hydrocarbons. If the company made a significantly profitable discovery, it was given the right to develop the field to produce oil or gas.

Under this system, government control was not strong enough as the contractor was the owner of the hydrocarbons. The contractor was also untaxed since, within each accounting period, its costs were exempted. The royalty paid to the host countries after this exemption were disproportionately low in comparison with the contractors' earnings.

Nationalization movements changed this dominant system as host countries gained political and economic strength due to regional and international political developments. Through renegotiations, they gradually exerted greater control over their own natural wealth,[6] which allowed them increase their earnings and profits under new contractually-based systems.

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[4] Daniel Johnston, *International Petroleum Fiscal Systems and Production Sharing Contracts Course Workbook*, Daniel Johnston & Co., Inc, 2004.

[5] Nasrollahi Shahri and Erfan Nourmohammadi, "An Update on the Status of Petroleum Related Laws and Conractual Frameworks in Iran: A Century of Oil in Persia", *OGEL*, September 2015, p. 5.

[6] Michael Bunter, *An Introduction to the Islamic Law and to Its Effect on the Upstream Petroleum Sector* (CEPMLP: Dundee, 2003), p. 23.

Under contractual systems, host countries had greater participation in negotiations and in the exploration, development and production stages. Joint ventures were formed among the participant companies to extract the hydrocarbon sources, with profits divided between the host country's representative company and the contractors' joint venture. Output was divided into cost oil and profit oil, with the contractors compensated for their expenditures gradually through cost oil in each accounting period based on agreed levels. The remaining amount was divided among the participants as profit oil and the fiscal reports for these activities were submitted to the host's national oil company.[7]

This system clearly increases the government's share, both economically and politically. Once reserves are discovered and production begins, the bargaining power and the relative strength shifts towards the host country as it extracts rent through various taxes, bonuses, profit oil and royalties. However, it is not only rent that favours the government as localization clauses significantly benefit the host's economy by increasing their citizens' employment.

As the host countries have gained more economic and political power within the international system, service agreements have become widely-used. The two main categories are risk service contracts and pure service contracts. Some industry experts regard buy-back contracts designed in relation to Islamic principles as a form of risk service contracts.[8]

In risk service contracts, contractor companies have fewer responsibilities than under older agreements or under pure service contracts as they are no more than an employee of the host's national oil company and cannot gain title to the reserves, unlike in buy-back contracts.[9] Instead, contractor companies are paid to explore for oil or gas, being responsible for the technical aspect of operations. Payment is made through hydrocarbon production considering the company's initial expenditures.

In pure service contracts, the exploration risks are borne by the host countries, with contractors operating on their behalf. Thus, the host country takes on the significant risk of whether exploration is successful or not. If the operations fail then the contractors are still paid, based on an agreed fee.[10]

The international oil and gas industry's practices have experienced tremendous changes since earlier times that now favour host countries economically and politically. Currently, host countries have acquired greater control of their own resources while their citizens and the media have greater power to scrutinize and decide on how these resources are allocated, which allows them to force their governments to conclude deals that comply with their interests and principles.

Energy Sources from an Islamic Perspective

It is important to consider the principle of sovereignty in any activity that a state is involved in as it forms the foundational criteria for its right to rule and operate. If the state is Islamic or the

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[7] Zhuo Feng and others, "On Oil Investment and Production: A Comparison of Production Sharing Contracts and Buy Back Contracts", *Energy Economics*, Vol. 42, 2014, p. 395.

[8] Hossein Jahani, "Evaluating the Concept of Ownership Iranian Oil and Gas Law", *US-China Law Review*, Vol. 12, 2015, p. 210.

[9] Michael Bunter, "Upstream Petroleum Prospectivity and the Growing ınfluence of the Islamic Law and Its Economic Rules", *OGEL*, Vol. 13, No. 6, 2015, p. 6.

[10] Abbas Ghandi and Cynthia Lin, "Oil and Gas sevice Contracts Around the World: A Review", *Energy Strategy Reviews,* Vol. 3, 2014, p. 64.

majority of the population are Muslims, it may be necessary to apply Islamic principles. Regarding the principle of sovereignty, the Qur'an states that "The right of command is for none but Allah. He hath commended that ye follow none but Him. That is the right way [of life]" (Qur'an, 12: 40) and that "None is a partner in His sovereignty" (Qur'an, 18: 110).

Al-Maududi argues that, in its consideration of sovereignty, the Qur'an's position is that clearly "the Islamic state is a sovereign state in the real sense of this term vis-a-vis the other states of the world, but if it tries to assert its sovereignty vis-a-vis the command of God and his messenger this would amount to the clear negation of its Islamic character".[11] That is, although Islam recognizes private ownership, any natural resources should regarded as state-owned, with qualified people being allowed to exploit them for the common public benefit with the state's permission . The state imposes Zakat and/or taxation based on criteria of fairness and justice.

Apart from the Qur'an and Sunnah as primary sources of instruction, ijma and qiyas also direct Islamic state authorities. It is possible that the Qur'an is silent regarding certain modern issues, with no specific behaviour by the prophet. In this case, the Muslim government's authorities have discretionary power to deal with the issue: "It is, of course, the primary duty of the ruler to safeguard the interests of the state. But in this regard he must always act within the framework [Islamic] law and not outside of it. It is true that the ruler is allowed wide discretionary powers to secure the public interest under the doctrine of siyasa or state policy".[12]

Each Muslim generation has the responsibility to re-read Qur'an, reach a consensus and use reason to enable laws to deal effectively with current circumstances. However, scholars should not compromise their intellect by following any specific school of jurisprudence in all their reasoning but should incorporate other schools of thought into their considerations.[13]

Islamic governments have discretionary powers to enact new laws and regulations to solve problems that the public face since Islamic law can create new norms and regulations to satisfy the needs of the state and the society. Any Muslim ruler, society or individual can follow a school as madhabs in ameli and itikadi terms, such as Hanafi, Jafari, Shafii, Malik or, Hanbalie, on particular issues, while also making use of the assumptions of other schools to develop an answer to any question.

Given this background, it is necessary to analyse through Islamic principles the classification of minerals in terms of ownership, state involvement, the nature and kinds of mineral agreements, and financing and taxation.

In principle, Islam allows private ownership, but not absolutely because that belongs to Allah. A person can only hold the property in trust in that s/he is accountable to Allah. The Qur'an states, "It is not [the case] that to God belongeth whatsoever is in the heavens on earth" (*Qur'an,* 10: 55) and "Ye give them something yourself out of the means which God has given to you" (*Qur'an,* 24: 33).

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[11] Al-Maududi, *Islamic Law and Constitution* (Islamic Publications: Lahore, 1969), p. 249.
[12] N. J. Anderson. "The Muslim Ruler and Contractual Obligations", *New York University Law Review*, Vol. 33, 1958, p. 929.
[13] Walied El-Malik, *Mineral Investment Under the Shari'a Law* (Graham Trotman: London, 1993), p. 31.

In clarifying ownership, Al-Hanbali argues that "the owner of all things is their creator, God. Man possesses only the benefit of them in the manner permitted by the law. He who possesses all benefits is therefore the absolute owner. He who enjoys partial possession has limited ownership and hence is designated by a special name, such as tenant or borrower".[14]

Muslim jurists have defined the term 'maden', referring to two categories of minerals: batin, which means hidden minerals, and zahir, which means visible or surface minerals. The former includes minerals such as iron, copper, gold and silver while the latter includes minerals such as sulphur, naphta and water. Thus, this classification is based on the minerals' nature rather than location. Hence, the Shafie and Hanbali madhabs define zahir minerals as those that can obviously be detected and used when discovered without further processing and effort.[15]

Imam Abu Hanifa teachings indicate that ownership of the minerals follows ownership of land so the surface land owner is entitled to both the surface and the minerals below, and subject to pay zakat as tax for solid minerals. However, the creation of mining rights is left to private agreements as distinct from state contracts. For minerals on state lands, the contractor or investor should have permission to extract or develop the minerals under whatever conditions.[16]

The Jafari School takes a similar approach to the Hanafi School regarding minerals, although it should be noted that ijtihad is still possible in the Jafari School.[17] Ijtihad allowsor makes way for norms to be reinterpreted according to new situations.

According to the Shafie School, mineral ownership on private land depends on their nature. Hidden minerals belong to the owner, who has the exclusive right to work them while being subject to taxation. However, the owner of the land has no exclusive ownership rights over visible minerals, but can only use enough to satisfy his/her own needs.

Hidden minerals found in dead (ownerless) land cannot be owned by extracting them. Yet, one should note that there are ways of acquiring ownership of dead land, such as being the first to cultivate it. In this case, the first cultivator would be considered the owner and therefore entitled to any hidden minerals.

Visible minerals on state land belong to the whole community. The Shafie School does not recognize private ownership of minerals in this category. Regarding hidden minerals, this school allows discretionary power for the state to grant rights to any contractor or investor who meets the criteria for exploiting the minerals for the betterment of the whole society.

According to Hanbali teachings, visible minerals cannot be owned as they are not regarded as part of the land, whether private, dead or state lands. However, whereas private occupation and ownership of such assets may bring trouble to the public, this is not the case for ownership by the state, which represents society as a whole.[18] The Prophet Mohammad (p.b.u.H.) said that

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[14] Cited in Walied El-Malik, *Mineral Investment Under the Shari'a Law* (Graham Trotman: London, 1993), p. 45.

[15] Hamza Aktan, "Maden", *Türkiye Diyanet Vakfı İslam Ansiklopedisi Cilt 27,* Bekir Topaloğlu and others (ed), (TDV: Ankara, 2003), p. 307.

[16] Vehbe Zuhayli, *İslam Fıkhı Ansiklopedisi Cilt 3*; Translation, Ahmet Efe and others, (Risale Basın Yayım Dağıtım: 1990), p. 285.

[17] Arash Nazhad, "The Link Between Islamic Law and Hydrocarbon Agreements", *Journal of Islamic Law and Culture*, Vol. 10, No. 2, 2008, p. 168.

[18] Hasanuz Zaman, *Economic Functions of an Islamic State* (Islamic Foundation: UK, 1990), p. 33.

"Peoples are partners in three commodities, water, fire and green herbage". Since the term 'fire' in this hadith may refer to either naar or noor, it is possible, according to some scholars, to also interpret it as referring to energy sources.[19]

According to Hanbali teachings, exclusive ownership of hidden minerals in dead land is not achieved merely by extracting the minerals. Any private person, whether investor or contractor, should cultivate the land to bring life to the dead land first before being allowed to exploit the minerals. This right is given by the state.

For the Malik School, ownership of the land does not entail ownership of its minerals because the Muslim community as a whole owns all mineral resources under the direct control of the Imam, the ruler, who acts in accordance with the interest of all the public. State ownership of minerals is allowed by Maliki teachings as[20] private ownership of minerals can lead to improper or unfair exploitation of natural resources and prevent all society's members from benefitting equally from the minerals. Contemporary Islamic opinion on the benefit of mineral wealth tends towards giving it to the state along with the authority to exploit them. Under agreed criteria and conditions, the state may then grant rights to private contractors or investors to extract the minerals.

One should remember that customs are another source of Islamic law. Thus, Islamic principles draw on the concept of private ownership by transforming the pre-Islamic concept of tribal ownership to state ownership. The area that used to be kept as a reserve or sacred territory was called 'hima'. This was reserved for the exclusive use of a tribe.[21] Tribal ownership of hima was transformed into hima for all Muslims. The state then has the power to reserve land for the well-being of all Muslims.

The notion of hima is very similar to the modern concept of mineral reserves, where mining rights and titles can be granted only via state agencies. The state may extract resources itself or can give rights to extract the minerals out to private investors or contractors without granting private ownership.[22]

The Qur'an leaves ownership of minerals to Muslims to decide in accordance with their interests and subject to payment of zakat imposed by the ruler and or Qur'an. The variety of opinions and the principles of different schools or madhabs allows such laws to be flexible. Thus, it is possible to interpret the current situation and adapt laws to deal with the issues arising in new circumstances.

Different madhabs have slight differences in understanding concerning the ownership of natural resources. However, according to the majority, natural resources are owned by the state for the betterment of the whole society. In consideration of a certain payment, the state can grant rights to private investors or contractors to exploit these natural resources.

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[19] Hamza Aktan, *İslamda Madenlerin Hukuki Statüsü* (Atatürk Üniversitesi Basımevi: Erzurum, 1986), p. 18.
[20] Abdurrahman Ceziri, *Dört Mezhebe Göre İslam Fıkhı*; Translation: Mehmet Keskin (Çağrı Yayınları: İstanbul, 1990), 9. 877.
[21] Ali Abd Al-Kader, "Land Property and Land Tenure in Islam", *Islamic Quarterly*, Vol. 5, 1959, p.4.
[22] Thomas Walde, "Methods of Mineral Investment Promotion", *Technical Paper, No. MRB/001 NRED/DTCD,* 1990, p.9.

This principle of state ownership of minerals has been reflected in the constitutions of various countries with majority Islamic populations and where the public demands that state actions should follow Islamic principles. Thus, the 1965 Constitution of Iraq declares that "Natural wealth together with its resources and energies shall be the property of the state, which shall properly dispose of them". This principle was preserved in the new constitution drafted after 2003. Similarly, Article 21 of the 1961 Kuwaiti Constitution provides that "All of the natural wealth and resources are the property of the state. The state shall preserve and properly exploit these resources needful of its own security and requisite to the national economy." Article 11 of 1964 constitution of Egypt states that "the natural wealth, whether subterranean or within the territorial waters, as well as all its resources and energy, are the property of the state which guarantees their proper exploitation."[23] Other Islamic states in the Middle East follow more or less the same pattern concerning the ownership of minerals.

Any state, whether Islamic or not, aims to gather foreign exchange by exploiting its natural resources and expects its mineral resources industry to contribute to society, economically and politically. In achieve these aims, the industry and policies should be flexible enough to operate effectively in new environments. Islamic states are therefore responsible for generating policies that conform to the spirit of Islam and Islamic principles when using their discretionary powers to formulate economic and mineral policies.

Islamic countries have two main options regarding mineral investments: state extraction of minerals or private investment. A competent, well-established and well-organized national company is required for efficient state extraction of mineral resources. Its financial capacity and expertize must be enough to operate, extract, develop and produce the natural resources. Islamic countries should also cooperate with private investors in conformity with Islamic principles and Qur'anic directives on condition that the state protects its interests against its counterparts and concludes deal that benefit the public as a whole.

The conditions for investment, land tenure rights, investment and tax provisions, the rights and obligations of host states and investors, and general policies are all codified within mineral and related laws of any state. In Islamic countries, the Imam, the head of the state or the rule-making and governing body or authority is responsible for ensuring that legislation accords with Islamic principles and criteria. Because there may be gaps between the necessities of modern commercial transactions and traditional norms, law codifications should be flexible enough to adapt and deal with such differences, under the authority of the country's government.

The basis for granting mineral rights to contractors or investors in contemporary industry can be traced back to early Islamic practices. Iqta, which can be understood as "the right of the ruler to grant any individual an exclusive right over a certain area of land", was used in early Islam for both agricultural and mineral exploitation. It is widely accepted among Muslim jurists that this earlier iqta understanding can be applied to current mineral industry practices, whereby the head of the state is responsible for taking the option that most benefits the public interest.[24]

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[23] Walied El-Malik, "State Ownership of Minerals Under Islamic Law", *Journal of Energy and Natural Resources Law,* Vol. 14, No. 3, 1996, p. 319.
[24] Ali Şafak, "Kuran'da Maden", *Diyanet Dergisi*, Vol. 17, No. 3, 1978, p. 147.

Iqta for minerals is also recognized by Islamic principles. The Imam, as the head of the Islamic community, or the ruling authority grants somebody permission to explore, develop and exploit the value from a specified piece of land as iqta. The iqta holder is responsible for sharing the wealth gained with the beit-ul mal with the previously determined amount that has been concluded between the iqta holder and the state representatives. The iqta holder should be capable of performing the necessary activities and should pay the state treasury the agreed amount for the production.[25]

This application of a tradition is linked to the actions of the Prophet Mohammad (p.b.u.H.), who granted Bilal Ibn Elharith a piece of land called Al Ziblaya, which also included hills and valleys as iqta to work them. This tradition of giving iqta continued later. Caliphate Omar also granted iqta to people to work specified areas, with the Islamic state benefitting from these activities rather than keeping the area unworked and useless for the welfare of the public.[26]

Host countries expect to benefit from taxation, local spending, reinvestment and employment as benefit from mining activities within their domains. Two different approaches need to be balanced. Contractors should be allowed to gain a fair return on their capital, technological expertise. If host countries are too demanding or impose too much taxation then the investment environment will be undermined, which will reduce potential gains from the mineral resources. While host governments depend on revenues from these non-renewable resources, each barrel of oil produced today represents a loss for future generations. Thus, host governments try to maximize revenue flow by exploiting their natural resources,[27] mainly through taxation.

Zakat is one form of taxation mentioned in the Qur'an, although Islam deals with other types that may derive from pre-Islamic periods before being confirmed by Islam. The Imam, the head of state or the ruling authorities in Islamic states can also impose or enact new taxes for the benefit of the public as a whole. However, these new taxes must be based on justice and equity. Ibn Taimiyah, Imam EbuYousif and Ibn Hazm, along with other prominent Islamic scholars support this by referring to the hadith of the Prophet Mohammad (p.b.u.H.) that "You know better about your mundane affairs, but for your religious matters these are to be referred to me".

According to EbuHanifa, coal, oil and offshore minerals are exempted from tax as only land-based minerals such as gold and silver are taxable. EbuHanifa imposes a 20% tax on contractors, considered as rikaz. EbuYousif also imposes 20% taxation. However, he argues that the tax should be taken from the pure minerals not from the ore, meaning that the costs of obtaining the pure minerals are not taken into consideration. According to Imam Maliki, the tax should be 2.5% (1/40), and imposed on the value or volume of the total output. This view is based on the actions of Caliph Omar Al Khattab, who levied zakat at 2.5% on minerals granted

[25] Ahmed Zaki Yamani, "Islamic Law and Contemporary Issues", Charles Malik (ed), *God and Man in Contemporary Islamic Thought* (Centennial Publications: Beirut, 1972), p. 69.
[26] Mustafa Demirci, "İkta", *Türkiye Diyanet Vakfı İslam Ansiklopedisi Cilt 22,* Bekir Topaloğlu and others (ed), (TDV: İstanbul, 2000), p. 43.
[27] Rex Bosson and Bension Varon, *The Mining Industry and the Developing Countries* (Oxford University Press: Oxford, 1977), p. 107.

to Bilal Ibn El Harith. Jafari clerics argue that all minerals, whether solid or liquid, are subject to taxation.[28]

Contemporary scholars have very similar views to traditional Muslim jurists. Yousif Al Qaradawi, for example, claims that minerals can be taxed as rikaz 20% or zakat 2.5 % (1/40), dependent on the effort and cost of discovering, developing, extracting and producing the minerals. Qaradawi also allows non-Muslim investors or contractors to carry out investment activities and act with the decided rate in accordance with zakat or taxation laws.[29]

Buy-Back Contracts

As already mentioned, the host country and the international investment company have different objectives regarding mineral contracts. The contractor companies want access to lucrative investment opportunities, control of the cash flow from their activities and bookable reserves. The state, on the other hand, wants to acquire the company's capital and expertise while maintaining its control and the ownership of the reserves and production. The state's concerns over sovereignty is generally more important than cash flow considerations.

Host countries' positions have clearly changed from earlier to current oil and gas contracts. The newer contracts ensure host countries retain greater control of their reserves and enjoy more cash flow than earlier contracts. For example, under the D'Arcy concession signed by Iran in the year 1901, the overall exploration, development and production process was controlled by the foreign investment company, with Iran making only a minor contribution throughout. This led to the nationalization of Iran's oil industry in 1951 under the Mousaddeq government, which was followed by other resource rich countries. They developed a different approach to political developments in the international oil and gas industry. Iran's approach was to allow investor companies to do business in cooperation with a more proactive National Iranian Oil Company, acting to benefit the whole public.[30]

Iran's new Petroleum Law of 1974 limited foreign company participation in oil and gas operations. The Iranian Parliament banned reserve ownership rights of any foreign companies, giving the National Iranian Oil Company exclusive rights of exploration, development and production. Under Article 3, all activities had to be carried out by the national company while great importance was given to the nationalization of mineral reserves.[31] This allowed Iran to gain increasing control of its resources as it acquired more political power.

The implementation and evolution of buy-back contracts should be analysed in accordance with relevant historical and political movements. Iran's 1979 Islamic Revolution created a political atmosphere in which the regulatory system of ownership, control, extraction, development and production of mineral sources to strictly comply with Islamic principles and laws, as reflected in Article 4 of the Constitution, which states that all civil, penal, financial,

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[28] Hamza Aktan, *İslamda Madenlerin Hukuki Statüsü* (Atatürk Üniversitesi Basımevi: Erzurum, 1986), p. 55.

[29] Cited in Walied El-Malik, *Mineral Investment Under the Shari'a Law* (Graham Trotman: London, 1993), p. 82.

[30] N Mohammad, "The New Face of Iranian Buy Back Contract: Any Hop efor Foreign Investment?", *OGEL*, Vol. 7, No. 1, 2009, p. 8.

[31] Maximillian Kuhn and Mohammadjavad Jannatifar, "Foreign Direct Investment Mechanisms and Review of Iran's Buy Back Contracts: How Far Has Iran Gone and How Far May It Go?", *Journal of World Energy Law and Business,* Vol. 5, No. 3, 2012, p. 209.

economic administrative as well as cultural, military, political and other laws and regulations must be based on Islamic criteria.[32]

There were sensitivities to foreign investment in both the revolutionary constitution and 1987 Petroleum Act.[33] Buy-back contracts appeared to be the solution to accommodate the provisions of Iran's laws while also meeting the demands of investor companies by providing attractive contractual terms.

The Ja'fari School, which is dominant in Iran, does not give ownership of minerals to private persons. Instead it places the right of extraction under the domain and responsibility of the state. The logic behind this is that private ownership of the natural resources would lead to corruption, unfair distribution of the wealth of the country and be against the public interest of the whole. Minerals are regarded as the collective property of all Muslims.

The Iranian constitution makes it clear that oil and gas reserves are owned by the state and that the ruling authority should control these public assets itself. Article 43 bans foreign economic domination. Article 45 stipulates that mineral deposits should be solely in the hands of the ruling authority. Article 44 grants ownership of all mother industries to the state. The legal standing and presence of foreign entities is regulated by Article 81, which states that "granting concessions to foreigners for the formation of companies or institutions dealing with commerce, industry, agriculture, services or mineral extraction, is absolutely forbidden." Article 153 bans agreements that would enable foreign domination and control of Iran's natural and economic resources and other strategic sectors.[34] Most criticism and opposition to the buy-back contracts from investor companies arise from this latter notion since these companies cannot gain equity rights or bookable reserves.

Given this context, buy-back contracts are the main contractual framework for foreign cooperation and investment in Iran.[35] The National Iranian Oil Company, acting on behalf of the state for the benefit of the whole public, has been given the right and authority to conclude contracts with international oil and gas companies, with various restrictions and conditions. Equity shares to the energy sources, whether produced or still under the ground, cannot be given to contractor companies. The existing potential of Iran in terms of engineering, construction, design and installation should be maximized. The technology of the contractor investor companies should be transferred through joint ventures between local and foreign companies. The installments of the investors should be paid exclusively from the earnings from the specific project dealing with that reserve. This gives no guarantee of installments if there is a shortfall in production-related activities.

The first buy-back contract in Iran, which aimed to circumvent the prohibition on granting mineral rights to foreign companies, was concluded with the Conoco Oil Company. However, this was cancelled following the Iran-Libya Sanctions Act in the USA. Total then replaced

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[32] Elham Hassanzadeh, *Exports of Iranian Natural Gas to Regional and International Markets a Study of Political, Legal and Economic Barriers*, (Unpublished PhD Thesis, University of Dundee, 2013), p. 120.
[33] Elham Hassanzadeh, *Exports of Iranian Natural Gas to Regional and International Markets a Study of Political, Legal and Economic Barriers*, (Unpublished PhD Thesis, University of Dundee, 2013), p. 123.
[34] Elham Hassanzadeh, *Exports of Iranian Natural Gas to Regional and International Markets a Study of Political, Legal and Economic Barriers*, (Unpublished PhD Thesis, University of Dundee, 2013), p. 121.
[35] Abbas Ghandi and Cythia Lin, "Do Iran's Buy Back Service Contracts Lead to Optimal Production? The Case of Soroosh and Nowrooz", *Energy Policy*, Vol. 42, 2012, p. 181.

Conoco and signed deal with the National Iranian Oil Company for the development of Sirri A and E offshore oil fields.[36]

Buy-back contracts are considered as counter-trade transactions, which are mainly used where direct investment or usual methods of payment are restricted. It is basically a financial application where the developer sells property to a contractor or investor before buying it back in the form of a long-term sales contract.[37] This general understanding is applied particularly to the Iranian mineral sector in that the National Iranian Oil Company and international investment companies conclude a deal in which investor companies shoulder the responsibility to develop an oil or gas field before returning the field to the National Iranian Oil Company after reaching the production phase. The payment to the investor is made according to an agreed rate of return rate based on the production of pre-determined percentages of the field's output.[38]

The National Iranian Oil Company has offered three different forms of buy-back contracts: Exploration Service Contracts, Development Service Contracts, and Exploration and Development Service Contracts.[39] The Exploration Service Contract deal carries high risk because, although the full costs of the contractor companies are recovered if they make a commercially viable discovery, they shoulder all the losses in if the discovery is not viable. In Development Service Contracts, if the exploration stage is successful then the operation continues into development and the contract is concluded for that particular field, which is less risky for the contractor companies.

The Long Term Oil Sales Agreement is formed for the remuneration and cost recovery of the investors' expenditures.[40] The investor or the contractor takes a pre-determined amount of the energy resources produced as repayment. This procedure continues until the investor has been reimbursed for all costs and remuneration is completed.

Buy-back contracts include several terms concerning the features of different stages, including Capital Costs (Capex), Non-Capital Costs (Non-Capex), Operating Costs (Opex) and Bank Charges.[41]

The direct costs of developing operation-related activities fall under Capex. These costs can be recovered up to an agreed level. However, costs within Capex are not reimbursed if they rise above the agreed level. There are indirect costs, too. The funds that are paid by the contractor companies to the host countries as taxes, social security charges and customs duties fall into this category. The contractor companies' expenses during the project operation period prior to handing it over to the national company of the host country fall under Opex. These are recoverable. The costs of financing the project are the bank charges, which are calculated

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[36] Nasrollah Shahri, "Speculations on the Content of the New Iranian Petroleum Contracts: buy Back in Disguise?", *OGEL*, February 2015, p. 4.
[37] Willem Groenendaal and Mohammad Mazraati, "A Critical Review of Iran's buy Back Contracts", *Energy Policy*, Vol. 34, 2006, p. 3709.
[38] Liu Dong, "China's Resource Demand and Market Opportunities in the Middle East: Policies and Operations in Iran and Iraq", *Persectives on Global Development and Technology*, Vol. 13, 2014, p. 573.
[39] Wannis Otman, "The Iranian Petroleum Contracts: Past, Present and Future Perspectives", *OGEL*, Vol 5, No. 2, 2007, p. 12.
[40] Hooman Farnejad, "How Competitive is the Iranian Buy Back Contracts in Comparison to Contractual Production Sharing Fiscal Systems?", *OGEL*, Vol. 7, No. 1, 2009, p. 7.
[41] Michael Bunter, "The Iranian Buy Back agreement", *OGEL*, Vol. 1, No. 2, 2003, p. 4.

according to the London Interbank Offered Rate (LIBOR) in addition to an interest percentage agreed beforehand.[42]

One should remember that the Qur'an does not give permission for any kind of deal including riba, uncertainty, deception, fraud or dishonesty. However, some argue that, although jurists declare such contracts to be invalid for not conforming to Islamic principles, they might be recognised because of the public benefit they bring, or masalihmursalah, or because of economic necessity. Likewise, there is support for the idea that, in some cases, a mining, oil or gas contract that are not in accordance with Islamic principles because it includes some elements of riba and uncertainty can nevertheless proceed on the basis of public benefit or necessity.[43] Such projects are concluded within the context of current international transaction frameworks and definitely provide massive funds for the development and expenditures of the whole society.

The investor company takes a great risk. Its capital expenditures and operational expenditures are covered. The remuneration fee is also a clause in buy-back contracts as a reward for the activities and risks taken by the contractor company. The remuneration fee is also pre-determined by the parties. If the activities are successful, operations are handed over to the host's national company by the contractor company in return for the remuneration fee payment. A pre-determined amount of the product of the operations, which is generally around fifty to sixty percent, is then recovered by the contractor company.[44]

The nature of buy-back contracts envisages that the contractor company gains no title to the energy sources in the place, at the well head or at the export point. All lands and assets remain the sole property of the national company. Title to the resources remains with the national company acting in the name of the host country. However, the national company has the right to sell the energy resources either to the contractor company or to a third party.

Another feature of buy-back contracts is the importance given to localization clauses. The contractor company has to include least fifty one percent local content, which gives local firms a competitive advantage.

International oil and gas industry projects require long lead times for exploration, development and production before the output of a single field reaches consumers and gains monetary value. However, buy-back contracts are short-term, usually around seven to ten years, which increased from about three years with the possibility of an extension of five years to recover the investment.

Various criticisms are directed towards these contracts. The fact that the investor companies are not allowed equity rights or bookable reserves is the main dissatisfaction of contractor companies. The investors provide capital and expertise, and run the operations. Yet, once the

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[42] M Jannatifar, "Iran in Dilemma: Adherence to buy Back or Transition to Production Sharing Agreements?", *OGEL*, Vol. 8, No. 4, 2010, p. 10.
[43] Walied El-Malik, *Aspects of Natural Resources Contracts, Investnment and Finance at Sharia and Arab Secular Laws: A Comperative Study* (Unpublished PhD Thesis, University of Dundee Centre for Energy Petroleum and Mineral Law and Policy, 1997), p. 177.
[44] Me M. "The Iranian Buy Back model and Its Efficiency in the Interhational Petroleum Market- A Legal View", *OGEL*, Vol. 7, No. 1, 2009, p. 10.

field is mature, they hand it back to the national company so they cannot benefit from the outcome within their portfolio or vertically-integrated structure.

Another dissatisfaction is that the rate of return of buy-back contracts is fixed at about ten to twelve percent rate of return with a pre-determined expenditure ceiling. Thus, investors are not compensated or paid if costs exceed initial estimates. During the operations, additional reserves may be discovered, the projected output may be increased through enhanced recovery techniques or cost-saving measures may be employed. Although this contributes to the total earnings from the fields, these all require additional investment that is not covered under such contracts.[45]

The short duration of buy-back contracts is another source of dissatisfaction because it hinders long-term benefits and reduces profitability. Therefore, some are considering whether to extend the maximum contract length from 5-7 years to a maximum of 25 years[46] since complex projects and large-scale reserves require long-term cooperation to exploit so performance would be better if the duration of contracts is longer.

Another issue of concern is oil price volatility. If energy prices decrease from the pre-agreed level then there is a risk of postponing reimbursement of Capex, bank charges and remuneration for the activities of the contractor companies.[47]

Given these concerns, various studies are being conducted about whether to make buy-back contracts more flexible since this would enable contractors and national companies to cooperate more effectively.[48]

CONCLUSION

Prior to international negotiations on Iran's nuclear activities, a buy-back contract providing better terms for the investor company was concluded between Iran and Sinopec to develop the Yadaravan field. The payback period was reduced to around four years, which is almost half of previous agreements while the rate of return was increased to 14.98 percent from the previous level of 12 percent. To reduce the investment risks, flexibility was included in the cost measurement scheme, which is more realistic and in more accordance with current industry practices.[49]

The evolution of buy-back contracts is certainly not yet ended as academic and technical studies into how to improve them are in progress. For now, it seems likely that the increasing demand from the citizens of Muslim host countries that both the contracts and actions of their states should follow Islamic principles means that more buy-back contracts will be concluded between investor companies and hydrocarbon owner states.

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[47] Hossein Hassantash, "Trend of Crude Oil Prices: Buy Back Contracts vs PDCs", *OGEL*, Vol. 7, No. 1, 2009, p. 4.
[48] Zahra Goudarzi, "The Effects of New Legislations on Iranian Buy Backs", *OGEL*, Vol. 11, No. 5, 2013, p. 2.
[49] Elham Hassanzadeh, *Exports of Iranian Natural Gas to Regional and International Markets a Study of Political, Legal and Economic Barriers*, (Unpublished PhD Thesis, University of Dundee, 2013), p. 134.

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