

**REVIEW OF GOVERNMENT OF PAKISTAN'S
PETROLEUM RIGHTS AGREEMENTS
UNDER SHARI'AH LAW**

by

Shafqat Mahmood Khan

T03098

A thesis submitted in partial fulfillment
of the requirement for the degree of
MASTER OF LAWS
(Faculty of Shari'ah and Law)
in The International Islamic University
1427/2006

Master's (LL.M.) Committee:

Dr. Sohaib Qadar
Muhammad Munir
Muhammad Arif

13,08,200

MS.
343.0805491
SHR

1. Petroleum - Law and Legislation - Pakistan.

John
md.

D.E.
to
7.12.10

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

FINAL APPROVAL

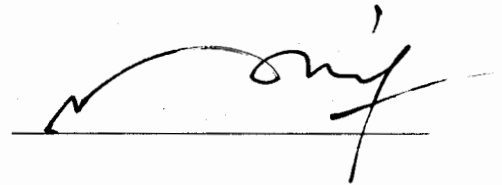
Date: July 8, 2006

It is certified that we have read the thesis submitted by **Shafqat Mahmood Khan** and it is our judgment that this thesis is of sufficient standard for warrant its acceptance by International Islamic University, Islamabad for Master Degree in Law.

COMMITTEE

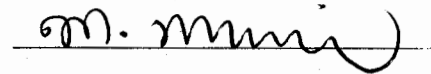
External Examiner

Mr. Muhammad Arif
Manager Legal & Commercial
Orient Petroleum Inc.
Hayat Hall, Diplomatic Enclave
Sector G-5, P.O. Box 1325
Islamabad



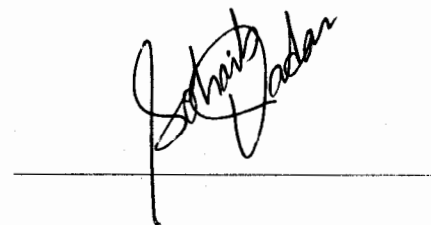
Internal Examiner

Muhammad Munir
Assistant Professor
Acting Dean
Faculty of Shariah & Law
International Islamic University
Islamabad



Dr. Sohaib Qadar (*Supervisor*)

Attorney-at-Law (Ohio S. Ct., USA)
& Advocate (Lahore H. Ct., Pakistan)
Law Office of Sohaib Qadar
177 A, Gomal Road
Sector E-7
Islamabad



Shafqat Mahmood Khan
© ----- 2006
All rights reserved

TABLE OF CONTENTS

LIST OF TABLES.....	vi
LIST OF FIGURES.....	vii
LIST OF ABBREVIATIONS.....	viii
DEDICATION.....	ix
ACKNOWLEDGMENTS.....	x
ABSTRACT.....	xi
I. COMMERCIAL CONTRACTS UNDER SHARI'AH LAW.....	1
A. INTRODUCTION.....	1
B. SHARIA'H APPRAISAL OF COMMERCIAL CONTRACTS.....	3
1. <i>Free Mutual Consent</i>	5
2. <i>Prohibition of Gharar (Uncertainty)</i>	6
3. <i>Prohibition of Riba (Interest)</i>	6
4. <i>Prohibition of Qimar (Gambling) and Maysir (Games of Chance)</i>	7
5. <i>Prohibition of Khilabah and Ghishsh (Fraud and Deception)</i>	9
6. <i>Prohibition of Two Mutually Inconsistent Contracts or Contingent Contracts</i>	10
7. <i>Prohibition of Contracts against the Maqasid al-Shari'ah (Objectives of Shari'ah)</i> ...	10
8. <i>Principle of Liability for Loss and Entitlement to Profit</i>	11
9. <i>Permissibility as a General Rule</i>	12
C. OWNERSHIP, CONCESSIONS AND PRODUCTION SHARING OF PETROLEUM UNDER SHARI'AH LAW.....	13
1. <i>Ownership of Petroleum under Shari'ah Law</i>	14
(a) <i>Classification of Minerals by Muslim Fuqaha (Jurists)</i>	16
(b) <i>Ownership of Petroleum under Four Schools of Thoughts (Aima Arba'a)</i>	17
(i) <i>Hanafi School</i>	17
(ii) <i>Shafi School</i>	17
(iii) <i>Hanbali School</i>	18
(iv) <i>Maliki School</i>	18
2. <i>Concessions of Petroleum under Shari'ah Law</i>	19
3. <i>Production Sharing of Petroleum under Shari'ah Law</i>	23
II. MODERN PETROLEUM RIGHTS AGREEMENTS: PETROLEUM CONCESSION AND PRODUCTION SHARING AGREEMENTS.....	25

A. PETROLEUM CONCESSION AGREEMENT (PCA).....	25
1. <i>Historical Background of PCA</i>	27
2. <i>Characteristics of PCA</i>	30
(a) Legal Nature of PCA.....	30
(b) Main Features of PCA.....	32
(i) <i>Exclusive Right to Explore</i>	32
(ii) <i>Ownership of Production</i>	33
(iii) <i>Payment of Surface Rentals</i>	33
(iv) <i>Payment of Royalty</i>	33
(v) <i>Payment of Taxes</i>	33
(vi) <i>Ownership of Equipment and Installations</i>	34
(c) Conclusion.....	34
B. PRODUCTION SHARING AGREEMENT (PSA).....	36
1. <i>Historical Background of PSA</i>	38
2. <i>Characteristics of PSA</i>	40
(a) Legal Nature of PSA.....	40
(b) Main Features of PSA.....	42
(i) <i>The Subject of PSA</i>	43
(ii) <i>Appointment of IOC</i>	44
(iii) <i>The State as a Party to PSA</i>	44
(iv) <i>The provision of Equipment and Technology and Bearing the Sole Risk and Cost of Operations</i>	45
(v) <i>Ownership of Production</i>	45
(vi) <i>Payment of Royalty and Recovery of Cost of Operations</i>	46
(vii) <i>Remuneration of IOC</i>	46
(viii) <i>Payment of Taxes</i>	46
(ix) <i>Reverting the Equipment and Installations to the HC</i>	48
(x) <i>Establishment of Joint Committee</i>	48
(xi) <i>Characteristics Distinguishing a PSA from other Forms of Subsoil Use</i>	48
(c) Conclusion.....	49
III. REVIEW OF GOVERNMENT OF PAKISTAN'S PETROLEUM CONCESSION AGREEMENT (PCA) UNDER SHARI'AH LAW.....	51
A. HISTORICAL BACKGROUND OF PCA.....	51
B. LEGISLATION SUPPORTING PCA.....	53
C. REVIEW OF PCA UNDER SHARI'AH LAW.....	54

1. Ownership of Petroleum and Right of Royalty.....	56
2. Payment Mechanism and Project Financing.....	58
(a) Payment Mechanism.....	58
(i) Commercial Exploitations.....	59
(ii) Sheer Injustice.....	59
(iii) Earning of Money through Unfair Trading Practices.....	59
(vi) Enrichment of One Person (or a Company or State) at the Cost of Others.....	60
(b) Project Financing.....	61
(i) Shari'ah Appraisal of Conventional Project Financing.....	62
(ii) Shari'ah Alternatives for Financing.....	62
• Mudarabah (Prophet Sharing).....	63
• Murabaha (Cost-Plus/Mark-Up Financing).....	64
• Musharakah (Partnership/Profit-Sharing Financing).....	64
• Ijarah (Leasing).....	66
• Bay'al-Salam (Markup-Base Financing).....	67
• Istisna'a (Commissioned Manufacture).....	67
3. Insurance and Indemnification.....	70
(a) General Concept of Insurance and its Validity under Shari'ah Law.....	70
(b) Shari'ah Appraisal of Conventional Insurance.....	71
(c) Shari'ah Alternative for Insurance.....	72
(d) Difference between Conventional Insurance and Islamic Insurance.....	73
4. Shari'ah Compliance of Events for the Frustration of Contract (Force Majeure).....	76
(a) Unforeseeability of the Events.....	79
(b) The Inability to Perform Must Involve an Exorbitant Loss.....	80
(c) The Event Must Be of a General Nature.....	81
(d) The Event Must Make the Performance Impossible.....	81
(e) The Event Must Put an Excessive Burden.....	82
 D. SUMMARY ANALYSIS OF PCA UNDER SHARI'AH LAW.....	 84
 IV. REVIEW OF GOVERNMENT OF PAKISTAN'S PRODUCTION SHARING AGREEMENT (PSA) UNDER SHARI'AH LAW.....	 86
A. HISTORICAL BACKGROUND OF PSA.....	86
B. LEGISLATION SUPPORTING PSA.....	87
C. REVIEW OF PSA UNDER SHARI'AH LAW.....	89
1. Introduction.....	89

2. <i>Shari'ah Prohibition of Contracts Containing Gharar (Risk, Uncertainty and Speculation)</i>	90
(a) Definitions of <i>Gharar</i>	92
(b) Prohibition of <i>Gharar</i> (Risk, Uncertainty and Speculation) under <i>Shari'ah</i> Law.....	93
(c) Philosophy behind Prohibition of <i>Gharar</i> (Uncertainty, Speculation and Risk) under <i>Shari'ah</i> Law.....	95
D. SUMMARY ANALYSIS OF PSA UNDER SHARI'AH LAW.....	96
CONCLUSIONS AND FUTURE PROSPECTS.....	98
GLOSSARY.....	102
BIBLIOGRAPHY.....	104

LIST OF TABLES

1.1	Classification of Minerals by Muslim Fuqaha.....	16
3.1	Ownership of Petroleum Resource: Main Schools of Jurisprudence.....	57
3.2:	Summary of Main Features of <i>Shari'ah</i> Modes of Financing.....	68
3.3:	Conventional and Islamic Modes of Insurance.....	74
3.4:	Summary Analysis of PCA under <i>Shari'ah</i> Law.....	84
4.1:	Summary Analysis of PSA under <i>Shari'ah</i> Law.....	96

LIST OF FIGURES

2.1	Basic form of PCA.....	32
2.2	Basic form of PSA.....	42

LIST OF ABBREVIATIONS

GoP	Government of Pakistan
HC	Host Country
IOC	International Oil Company
JOA	Joint Operating Agreement
PCA	Petroleum Concession Agreement
PSA	Production Sharing Agreement
RAT	Raziallah Taala Unhu (May Allah Almighty be pleased with him)
SAW	Sallalla ho Alaihe Wassallam (Peace be upon him)

DEDICATION

I dedicate this thesis to my loving parents, whole family and specially my elder brother Safdar Mahmood Khan Mastoi whose loving company since my childhood and guidance made me able to walk, to speak, to read and attain the respectable status in the society.

ACKNOWLEDGMENTS

I wish to express sincere appreciation to many people who have in one way or other made this thesis possible. My first, and most earnest, acknowledgment must go to my supervisor Dr. Sohaib Qadar for his patient guidance, encouragement, invaluable advice and many fruitful discussions throughout this study. His critical eye, and enlightened thoughts were instrumental and inspiring. Many thanks also to my committee members Muhammad Arif and Muhammad Munir for their time and effort in reviewing this work with beneficial comments. I am deeply indebted to partners at Amhurst Brown, especially Javaid Akhtar, for his constant cooperation, support and understanding. Without his help, this work would not have been possible. I am also grateful to the members of the Law Office of Sohaib Qadar for their support and comradeship; especially to Syed Khalil-ur-Rehman Shah and Umar Bashir. Again special thanks to my teacher at the Faculty of Shari'ah and Law, Muhammad Munir, for his unremitting moral and academic support and encouragement throughout my research project. At the end I would like to thank all the teachers at Faculty of Shari'ah and Law particularly, Dr Mahmood Ahmad Ghazi, Aurangzeb Mahmood, Ahmad Mukhtar, Shehzad Akbar Mirza, Usman Karim Khan, Jamshed Hameed, Muhammad Arif, Muhammad Aslam Hayat, Dr Tahir Mansoori and Ahmad Khan whose unflinching support made my LL.M possible and enjoyable for me.

ABSTRACT

REVIEW OF GOVERNMENT OF PAKISTAN'S PETROLEUM RIGHTS AGREEMENTS UNDER SHARI'AH LAW

by

Shafqat Mahmood Khan

"All praise is due to Allah, so we praise Him, and seek His pardon and we turn to Him. We seek refuge with Allah from the evils of ourselves and from the evil consequences of our deeds..." [Khutbat-ul-Hajjattul Wida]

Shari'ah seeks to build a society based on justice and equity. The nature of relations between the individual members of the society stipulated by *Shari'ah* is rooted in mutual care, brotherhood and sympathetic cooperation. The main purpose of *Shari'ah*, while regulating the commercial activities among the people is also to promote the universal principles of equity, fairness and justice. Where *Shari'ah* asks for the rights, it also stresses on the fulfillments of the obligations. By applying the above principles in today's worldly commercial dealings, *Shari'ah* allows those commercial activities where both the contracting parties practice the *Shari'ah* teachings in their economic life and observe *halal* and *haram* in all their commercial actions.

The basic purpose of this thesis is to review Government of Pakistan's petroleum concession agreement and production sharing agreement under *Shari'ah* law to know whether there is any clause which directly or indirectly effects the rights of the other parties or there is any

provision in these agreements which is contrary to the *Shari'ah* principles like is there any chance of *riba*, undue influence, *gharar* and like that activities or there is any violation of general masses rights living in that Muslim state when the underground resources are explored and whether the ultimate results of such exploration are the economic development, prosperity and well being of the people of that state or it just makes the companies more affluent and the state treasury more packed.

This thesis begins with the introduction of *Shari'ah* principles regulating the commercial activities among the contracting parties including the brief description of parties' mutual rights and obligations. This is followed with the *Shari'ah* appraisal of commercial activities by exploring the concepts of ownership, concessions and production sharing of petroleum under *Shari'ah* law. The next chapter deals with the issue of modern petroleum rights agreements while giving their brief history, legal nature and basic features. Similarly, in third chapter, Government of Pakistan's petroleum concession agreement is reviewed under *Shari'ah* law. The next chapter deals with the review of Government of Pakistan's production sharing agreement under *Shari'ah* law. Then the thesis ends with the conclusion and future prospects.

Chapter 1

COMMERCIAL CONTRACTS UNDER SHARI'AH LAW

CHAPTER 1

COMMERCIAL CONTRACTS UNDER SHARI'AH LAW

A. INTRODUCTION

Islamic law is a religious law based on the texts of the Holy Quran and the *Sunnah* of the Holy Prophet (s.a.w.).¹ Some research scholars of the history of Islamic law prefer to use the expression "*al-Shari'ah al-Islamiyyah*" and define the *Shari'ah* as the commands given by Allah Almighty to His servants through any of the prophets. So the Islamic *Shari'ah*, according to this definition, is a body of laws which Allah Almighty prescribed for His servants through our Holy Prophet (s.a.w.)². It has also been defined as:

Shari'ah means the commands given by God to His servants, which have been brought by any of the prophets. It is all the same whether they relate to the manner of action and this is known as subsidiary and applied law to which the science of *Fiqh* was developed; or they relate to the manner of belief, and this is known as the essentials and dogmatics for which the science of *Kalam* (scholastic theology) was developed.³

The *Shari'ah* rules which form the Islamic law are divided into two major divisions. One into religious observations (*ibadat*) and second into transactions (*muamalat*). *Ibadat* are the

¹ Nyazee, Imran Ahsan Khan, *Islamic Jurisprudence* (Islamabad: Islamic Research Institute, 2000), 45.

² Hassan, Dr. Hussain Hamid, *An Introduction to the Study of Islamic Law* (Islamabad: Leaf Publications, 1997), 3.

³ Thanawi, Muhammad Ala, *Kashshaf Istilahat al-Funun* (Calcutta: Asiatic Society of Bengal, 1862, 1759), quoted in Ahmad Hassan, *Principles of Islamic Jurisprudence*, Vol. 1 (Islamabad: Islamic Research Institute, 1993), 1.

rules of the *Shari'ah* which regulate the relation of man with his Creator. So, it makes clear what is obligatory on him towards his Creator with regard to showing obedience to Him and omitting the acts forbidden by Him, such as observing prayer and fasting, and abandoning the eating of the prohibited things like carrion and flesh of swine. While *muamalat* are the rules of *Shari'ah* which govern the relation between the people. These regulate the relation of the individual with the individual, or his relation with the Islamic State, or the relation of the Islamic State with other States. The purpose of these rules is to protect the mutual rights of the people and to force them to fulfil their obligations.⁴

The methodology of *Shari'ah* in dealing with *ibadat* and *muamalat* is somewhat different in character. A thorough study of the Holy Quran and the *Sunnah* of the Holy Prophet (s.a.w.) on this subject reveals that *ibadat* have been dealt with in detail, while *muamalat* have been discussed in general terms. The wisdom appears to be that *ibadat* are held to be universal truths that are unaffected by the time and space. They are not subject to modification or change by means of *ijtihad* or otherwise. As these fixed commandments were necessary, they have been provided for. The *muamalat* are matters pertaining to individuals interacting amongst themselves. The variety of this interaction is neither foreseeable nor capable of being complied with by a regime of fixed rules. They are also changeable in different periods of time within various geographical entities.⁵

⁴ Hassan, pp. 9-10.

⁵ Mansoori, Dr. Muhammad Tahir, *Islamic Law of Contracts and Business Transactions* (Islamabad: Shariah Academy, 2005), 3.

While handling the issue of *muamalat*, the focus of *Shari'ah* is on the principles of justice, fairness and equity. More specifying *muamalat* into commercial activities of the people like contractual rights and obligations, the concept of *Shari'ah* in commercial dealings is different from other systems of the world as it mostly stresses on the elimination of economic and commercial injustices prevailing in the society.

The main purpose of the study in this chapter is to know to what extent *Shari'ah* principles relating to contractual matters are different from principles of other legal systems and why it is claimed by the Muslim jurists that *Shari'ah* supersedes the other legal systems in bringing the concept of Islamic social and welfare state where every body is given equal status in commercial activities of life whether he is a Muslim or non-Muslim, King or a common man and it mostly stresses on the elimination of economic and commercial injustices and social and business upheavals in the society.

B. SHARI'AH APPRAISAL OF COMMERCIAL CONTRACTS

Before going into detail as how *Shari'ah* appraises commercial contracts, first we see how literally the word contract is defined by *Shari'ah*. Various terms are used in *Shari'ah* for contracts like *mithaq* (a contract that signifies earnestness and firm determination on the part of parties to fulfill the contractual obligations), *ahd* (a unilateral promise or undertaking although it also includes a bilateral obligation) and *aqd* (it is synonymous with the word

“contract” found in modern law and it implies obligation arising out of a mutual agreement).

In Holy Quran at many places this word is used.

“God will not call you to account for what is futile in your oaths, but He will call you to account for your deliberate oaths.”⁶

“O ye who believe! Fulfill (all) your obligations (contracts).”⁷

While commenting on the above second verse, Abdullah Yusuf Ali writes;

“The general principles established are: (1) take no futile oaths; (2) use not God’s name, literally or in intention, to fetter yourself against doing a lawful or good act; (3) keep to your solemn oaths to the utmost of your ability; (4) where you are unable to do so, expiate your failure by feeding of clothing or clothing the poor, or obtaining someone’s freedom, or if you have not the means, by fasting. This is from a spiritual aspect. If any party suffers damage from your failure, compensation will be due to him, but that would be a question of law or equity.”⁸

Now coming to the *Shari'ah* appraisal of commercial contracts, the general principles about contracts under *Shari'ah* is that all contracts in particular those involving monetary obligations should be;

- preferably recorded as writing removes the possibility of any uncertainty and distrust;
- without any ambiguity;
- witnessed by at least two witnesses as the matter pertains to the commercial activities;
- witnessed by witnesses agreeable to both parties;
- scribed by the faithful and honest scribe;
- no fabrication of the documents nor any suppression of facts and
- faithfully discharged.

⁶ Holy Quran, 5:89.

⁷ Holy Quran, 5:1.

⁸ Ali, Abdullah Yusuf, *The Holy Quran: Translation and Commentary* (Islamabad: Dawah Academy), 206.

The Holy Quran and the *Sunnah* of the Holy Prophet (s.a.w.) repeatedly accentuate that the terms of the agreements and contracts should be faithfully and sincerely honoured. This accentuation is applicable not only to mutual contracts but also international contracts and commitments. Business contracts without free consent are void.⁹ In more detail, the *Shari'ah* principles governing commercial contracts are described as:

1. Free Mutual Consent

A prerequisite under *Shari'ah* for the validity of a contract is the free mutual consent of the contracting parties. This is the cause that brings into being the obligations arising from the contract. A consent that is obtained through coercion, fraud, misrepresentation or some other illegal means renders a contract invalid under the *Shari'ah*.¹⁰

Allah (s.a.w.) says;

“Oh ye who believe! Eat not up your property among yourselves in vanities: But let there be amongst you traffic and trade by mutual good-will.”¹¹

The Holy Prophet (s.a.w.) has said:

“The contract of sale is valid only by mutual consent.”¹²

⁹ Hassanuz Zaman, S.M, *Islamization of Knowledge-21: Economic Guidelines in the Quran* (Islamabad: The Institute of Islamic Thought, 1999), 159.

¹⁰ Mansoori, p.4.

¹¹ Holy Quran, 4:29.

¹² Muhammad ibn Yazid ibn Majah, *Sunan, Kitab al-tijarat Bab al-Bayyi ani ma lam yaftariqa*, Beirut: Dar al-Fikr, *Hadith* no. 2185 quoted in Mansoori, p. 5.

2. Prohibition of *Gharar* (Uncertainty)

The second principle for governing all the contracts and commercial transactions is prohibition of *gharar*. The Arabic word *gharar* conveys the meanings of indeterminacy, speculation, hazard and risk. As a technical term it is applied to uncertainty about the ultimate outcome of a contract, which may lead to dispute and litigation. Prohibition of *gharar* has occurred in large number of *Ahadith* such as:

“*Abu Hurayrah* (r.a.t.) narrated that the Holy Prophet (s.a.w.) forbade sale by pebbles and the *gharar* sale i.e. indeterminate and speculative transactions”.¹³

“*Abu Hurayrah* (Allah be pleased with him) reported that Allah's Messenger (may peace be upon him) forbade a transaction determined by throwing stones, and the type which involves some uncertainty”.¹⁴

Section 29 of Pakistani Contract Act, 1872 also declares void those contracts whose meanings are not certain, or capable of being made certain.

3. Prohibition of *Riba* (Interest)

Another principle that governs the contractual activities is the prohibition of *riba* (interest) based transactions. *Riba* is condemned and prohibited in the strongest possible terms (in

¹³ Muslim ibn al-hajjaj Muslim, *Sahih, Kitab al-Buyu, Bab butlan Bay al-Hasat.....*, Beirut: Dar Ihya al-Turath al-Islami, Kitab al-Tijarat, no. 1513, vol. 3, p.1153, quoted in Mansoori, p. 6.

¹⁴ *Sahih Muslim, Kitab Al-Buyu*, Chapter 2: Invalidity of a Transaction by Throwing a Stone, Book 010, Number 3614: Trans.: Abdul Hamid Siddiqui, <http://www.muslimaccess.com/sunnah/hadeeth/muslim/010.html> (accessed June 12, 2006).

detail the issue of *riba* is discussed in Chapter 3). There can be no question about its prohibition as it is declared as an open war against Allah Almighty and His Prophet (s.a.w.).

Allah Almighty says:

“O ye who believe! Fear God, and give up what remains of your demand for usury, if ye are indeed believers. If you do it not, take notice of war from God and His Apostle: but if ye turn back, ye shall have your capital sums: Deal not unjustly, and ye shall not be dealt with unjustly.”¹⁵

A Hadith of Holy Prophet (s.a.w.) on prohibition of *riba* is:

“*Abdullah ibn Mas'ud* narrated: The Apostle of Allah (peace be upon him) cursed the one who accepted usury, the one who paid it, the witness to it, and the one who recorded it.”¹⁶

4. Prohibition of *Qimar* (Gambling) and *Maysir* (Games of Chance)

The fourth general principle is the prohibition of contracts involving *qimar* and *maysir*. Gambling literally means getting something too easily or getting a profit without working for it.¹⁷ Also gambling includes every form of gain or money the acquisition of which depends purely on luck and chance. It also includes any receipt of money, benefit or usufruct that is at the cost of the other party or parties having equal entitlement to that money or benefit.¹⁸

On the other hand, *maysir* means getting something too easily or getting a profit without working for it. The Holy Quran has explicitly prohibited this practice. It is said:

¹⁵ Holy Quran, 2:278-79

¹⁶ *Sunan Abu Dawood, Kitab Al-Buyu*, Book 22, Number 3327: Trans: Prof. Ahmad Hasan, <http://www.muslimaccess.com/sunnah/hadeeth/abudawud/022.html> (accessed June 12, 2006).

¹⁷ Ali, 68.

¹⁸ Ghazi, Mahmood Ahmad, *Mudarabah Financing: an Appraisal*: Paper presented in the Conference on Islamic Corporate Finance: *Shariah based Solutions*, quoted in Mansoori, p. 8.

“O ye believe: Intoxication and gambling, (Dedication of) stones and (divination by) arrows, are an abomination, of Satan's handiwork. Eschew such (abomination), that ye may prosper.”¹⁹

In old Arab history, the form most familiar to the Arabs was gambling by casting lots by means of arrows, on the principle of a lottery. As the arrows were marked and served the same purpose as a modern lottery ticket. Something, e.g. the carcass of a slaughtered animal, was divided into unequal parts. The marked arrows were drawn from a bag. Some were blank and those who drew them got nothing. Others indicated prizes, which were big or small. Whether you got a big share or a small share or nothing, was depending on pure luck, unless there was fraud also on the part of some persons concerned. The principle on which the objection is based for the prohibition of gambling is that, even if there is no fraud, you gain what you have not earned, or lose on a mere chance.²⁰

Similarly, there may be situation in which an act might have certain benefits while it produces corruption and inequity. In such a case the *Shari'ah* would ban that act despite the benefit that it might apparently yield. Gambling might be an effective source of collecting funds for philanthropic objectives; nevertheless, they have to be avoided since the acquisition of benefits is less important from the viewpoint of the *Shari'ah* than the avoidance of corruption. This *Shari'ah* principle can also be explained by this maxim:

“Unlawful things are to be prevented irrespective of benefit”.²¹

¹⁹ Holy Quran, 5:90.

²⁰ Ali, 68.

²¹ Hassanuzzaman, “The Economic Revelance of the Shari'ah Maxims, Al-Qawaid al-Fiqhiya,” http://islamic-world.net/economics/pic/title_03.gif (accessed February 8, 2006).

5. Prohibition of *Khilabah* and *Ghishsh* (Fraud and Deception)

The fifth principle under the Holy Quran and the *Sunnah* of the Holy Prophet (s.a.w.) is strong disapproval of fraud and deception in whatever form they might be. The words *khilabah*, *ghishsh* and *tatfif* have been used in the Holy Quran and the *Sunnah* of the Holy Prophet (s.a.w.) to convey the meanings of fraud, deception and cheating.

Holy Quran says:

“Woe to those that deal in fraud. Those who, when they have to receive by measure from men, exact full measure. But when they have to give by measure or weight to men, give less than due. Do they not think that they will be called to account? On a Mighty Day. A Day when (all) mankind will stand before the Lord of the Worlds?”²²

The Holy Prophet (s.a.w.) is reported to have said:

“*Hakim b. Hazim* (Allah be pleased with him) reported Allah's Messenger (may peace be upon him) as saying: Both parties in a business transaction have the right to annul it so long as they have not separated; and if they speak the truth and make everything clear they will be blessed in their transaction; but if they tell a lie and conceal anything the blessing on their transaction will be blotted out”.²³

“*Abdullah b. Dinar* narrated that he heard Ibn 'Umar (Allah be pleased with them) saying: A man mentioned to the Messenger of Allah (may peace be upon him) that he was deceived in a business transaction, whereupon Allah's Messenger (may peace be upon him) said: When you enter into a transaction, say: There should be no attempt to deceive”.²⁴

While telling about the reward which the honest and truthful people will get on the Day of Judgment, Holy Prophet (s.a.w.) has said:

²² Holy Quran, 83:1-6.

²³ *Sahih Muslim, Kitab al-Buyu*, Chapter 11: Truthfulness in Transaction and Description (of the defect in the commodity), Book 010, Number 3661: Trans.: Abdul Hamid Siddiqui, <http://www.muslimaccess.com/sunnah/hadeeth/muslim/010.html> (accessed June 12, 2006).

²⁴ *Ibid*, Chapter 12: He Who Deceives in Business Transaction, Book 010, Number 3663.

"The honest and truthful merchant will be on the day of resurrection together with Prophets, the faithful ones, the martyrs and the pious people".²⁵

6. Prohibition of Two Mutually Inconsistent Contracts or Contingent Contracts

The sixth principle for governing the commercial contracts is the prohibition of two mutually inconsistent contracts. The Holy Prophet (s.a.w.) has strictly prohibited the two inconsistent mutual contracts. It is reported to have said:

"It is narrated by *Abu Hurayrah* (r.a.t.) that Holy Prophet (s.a.w.) prohibited from two sales in one sale (*bay atan fi bay*).²⁶

7. Prohibition of Contracts against the *Maqasid al-Shari'ah* (Objectives of *Shari'ah*)

The seventh principle is the prohibition of contracts which are against the *Maqasid al-Shari'ah*. Following are the *Maqasid al-Shari'ah*:

- preservation of *Din* (Religion);
- preservation of *Nafs* (Life);
- preservation of *Nasl* (Progeny);
- preservation of *Aql* (Intellect) and
- preservation of *Mal* (Property).

Any transaction or contract that offends or jeopardizes any of these objectives is invalid in the *Shari'ah*. It is pertinent to note here that the *Maqasid al-Shari'ah* are alternately referred to as *huquq Allah* (rights of God).²⁷

²⁵ *Ibn Majah, Kitab al-tijarat, Bab al-hathth 'ala al-makasib*, no. 2139, vol.2, 724, quoted in Mansoori, p. 9.

²⁶ *Abu Dawud, Sunan, Kitab al-Buyu, Bab fi man ba 'a bay'atayni fi bay'atih*, no. 3461, vol.3, p. 274.

The objectives of *Shari'ah* or *huquq Allah* have been emphasized in a large number of texts of the Holy Quran and *Sunnah* of the Holy Prophet (s.a.w.).

Allah Almighty says in the following verses of Holy Quran:

"In the Law of Equality, there is (saving of) Life to you, oh ye men of understanding; that ye may restrain yourselves."²⁸

"Oh ye who believe! Eat not up your property among yourselves in vanities...."²⁹

In a *Hadith*, Holy Prophet (s.a.w.) has said:

"Allah has made the life, and property and honour of each of you unto the other sacred and inviolable like this day of this month in this territory".³⁰

The requirement of the conformity of contract with the objectives of the *Shari'ah* is similar to the requirement of modern law³¹ that an agreement should not be against public policy.³²

8. Principle of Liability for Loss and Entitlement to Profit

Another principle that governs contract and commercial transactions is the principle of liability for loss and entitlement to profit. Holy Prophet (s.a.w.) said: "*Usufruct* devolves with liability".³³

²⁷ Mansoori, pp. 10-11.

²⁸ Holy Quran, 2:179.

²⁹ Holy Quran, 4:29.

³⁰ Bukhari, *Sahih*, *Kitab al-Ilm*, *Bab qawl al-Nabi rubba muballaghin aw'a min sai'n* no. 7447, p. 1562.

³¹ Section 23 of Contract Act, 1872 opposes any consideration or object of a contract which is against public policy (i.e. whatever tends to injustice or oppression, restraint of liberty, commerce and natural or legal right)

³² Mansoori, p. 12.

³³ Abu dawud, *Sunan*, *Kitab al-Buyu*, *Bab Fiman Istra a 'bdan fasta'malahu*...no. 508, vol.3, p. 777.

The principle provides that a person is entitled to profit only when he bears the risk of loss. The principle operates in a number of contracts such as contract of sale, hire or partnership. A businessman is entitled to profits and gains in his business because he is ready to bear loss.

9. Permissibility as a General Rule

In the field of transactions and contracts every thing that is not prohibited is permissible. This rule has been emphasized in a number of verses of the Holy Quran. Allah Almighty says:

“And He has subjected to you, as from Him, all that is in the heavens and on earth: behold, in that are Signs indeed for those who reflect”.³⁴

“Say (O Muhammad): Who hath forbidden the beautiful (gifts) of God, which He hath produced for His servants and the things, clean and pure, which he hath provided for sustenance? Say: they are, in the life of this world, for those who believe, (and) purly for them on the Day of Judgment. Thus do We explain the Signs in detail for those who understand.”³⁵

Holy Prophet (s.a.w.) has said:

“Muslims have to abide by their conditions except those that make the unlawful lawful or the lawful unlawful”.³⁶

This *Hadith* points to the fact that every agreement is basically lawful so long as it does not oppose any explicit text of the Holy Quran and *Sunnah* of the Holy Prophet (s.a.w.).

³⁴ Holy Quran, 45:13.

³⁵ Holy Quran, 7:32.

³⁶ Haythami, *Majma' al-Zawa'id, Kitab al-Ayman wa al-Nudhur, Bab al-Shurut*, vol.4, p.205.

From the above discussion it can be concluded that *Shari'ah* generally does not put any restriction on any type of commercial activity and parties are free to enter into any commercial activities but restriction is put on those commercial transactions where there is a clear violation of the above-discussed *Shari'ah* principles.

C. OWNERSHIP, CONCESSIONS AND PRODUCTION SHARING OF PETROLEUM UNDER SHARI'AH LAW

Shari'ah has laid down certain principles and limits for economic activity of man so that the entire pattern of production, exchange and distribution of wealth may conform to the *Shari'ah* standards of justice and equity. *Shari'ah* does not concern itself with the details of organizational patterns and mechanisms. Such methods are specific to every age and are evolved in accordance with the needs and requirements of the community and the exigencies of the economic situation. The concern of *Shari'ah* is that whatever be the particular form of economic activity in operation, its underlying principles should always be the same.

According to the *Shari'ah* point of view, Allah Almighty has created for mankind the earth and all that it contains. It is, therefore, the birthright of every human being to try to secure his share of the world's wealth and sustenance. *Shari'ah* does not allow a particular person, class, race or group of people to create a monopoly in certain economic activities and equal opportunities for all is its watchword.

Similarly, resources which are provided by nature and which can be used directly by man may be utilized freely, and everyone is entitled to benefit from according to his needs. Water in the rivers and springs, minerals under the surface of the earth and similar other resources cannot be monopolized by anyone nor can restrictions of any sort be imposed on their free use by Allah Almighty's creatures to fulfil their own needs. Of course, people who want to use any of these things for commercial purposes can be required to pay taxes to the State. Or, if there is misuse of the resources, the State may interfere. But there is nothing to prevent individuals availing themselves of Allah Almighty's earth as long as they do not interfere with the rights of others or of the State. It is not right that things created by Allah Almighty for the benefit of mankind should be taken possession of, and then kept idle and useless. One should either benefit from them oneself, or make them available to others.³⁷

By keeping the above golden economic principles of Islam in mind, let's see in detail the concept of ownership, concession and production sharing of petroleum under *Shari'ah* law.

1. Ownership of Petroleum under Shari'ah Law

Ownership constitutes one of the important incentives for engaging in economic activity as the owner has the right to use or dispose of it. Regarding ownership of property in Islam the general law is that everything belongs to Allah Almighty. It is He Who makes all resources

³⁷ Maududi, Syed Abul Aala, "The Economic Principles of Islam," <http://www.jamaat.org>, (accessed March 11, 2006).

function productively according to His plan. Man is only an owner by proxy. Allah Almighty says in the following verses:

"To God belongeth all that is in the heavens and on earth....."³⁸

"...For the earth is God's, to give as a heritage to such of His servants as He pleaseth; and the end is (best) for the righteous."³⁹

"And the earth We have spread out (Like a carpet); set thereon Mountains firm and immovable; and produced therein all kinds of things in due balance."⁴⁰

"Do they not look at the earth--how many noble things of all kinds have we produced therein? Verily, in this is a Sign: but most of them do not believe."⁴¹

When a person owns something; he holds it in trust, acts as a guardian and is responsible to Allah Almighty for its use or misuse. Hence the absolute ownership is with Allah Almighty and the *de facto* or *ad-interim* ownership lies with men.

Generally speaking, as said above *Shari'ah* does not impose any restrictions on the amount of wealth or property an individual can possess. It is for the economic system of *Shari'ah* to regulate or control the means of ownership so that individuals acquire the right to property in a just manner. While so much emphasis is laid on private or individual ownership, there is a concept of community collective ownership as well. The Holy Prophet Muhammad (s.a.w.) has said:

"All Muslims are partners in three things – in water, herbage and fire."⁴²

³⁸ Holy Quran, 2:284.

³⁹ Holy Quran, 7:128.

⁴⁰ Holy Quran, 15:19.

⁴¹ Holy Quran, 26:7-8.

⁴² Al-Haj Maulana Fazlul Karim, ed. and tr., *Al-Hadis: an English Translation and Commentary of Mishkat-ul-Masabih* (Lahore: The Book House, 1939), vol. II, p. 311, no. 8, reported by Ibn Majah and Abu Dawood.

(a) Classification of Minerals by Muslim *Fuqaha* (Jurists)

Fuqaha classify the minerals as follows:

Classification of Minerals	
<i>Zahir</i> (Apparent or visible) mines	<i>Batin</i> (Hidden or invisible) mines
<p><i>Zahir</i> (Apparent or visible) mines are those mines whose products are open and visible and do not require too much manual labor for their exploration and exploitation. Examples of these are salt, antimony, naphtha, sulphur and water.</p> <p><i>Shafi</i> and <i>Hanbali</i> jurists have defined the <i>Zahir</i> minerals as those can be clearly distinguished and used, once found without further processing, e.g. water, salt, naphtha, tar, etc.</p> <p>According to majority of Muslim jurists these mines generally belong to Muslim community and all Muslims have an equal right to benefit from them and, therefore, cannot be granted as domain to individuals. Islamic state will control these mines.</p>	<p><i>Batin</i> (Hidden or invisible) mines are those mines whose products are hidden under the ground and require too much hard work for their exploration and exploitation. Gold, silver, copper, iron, oil and gas etc. are examples.</p> <p>As regards the ownership of these minerals, Muslim jurists do not have a unanimous opinion. Some are of the opinion that these mines cannot be entrusted to individuals and, like the apparent mines these also belong to the Islamic state.⁴³</p> <p>Some other jurists say that these mines can be given to individuals to explore and exploit them.⁴⁴</p>

Table 1.1: Classification of Minerals by Muslim *Fuqaha*

⁴³ Mawardi, *Ahkam-us-Sultania*, Chapter 17, p. 88.

⁴⁴ *Kitab-ul-Amwal*, no. 866, p. 339.

(b) Ownership of Petroleum under Four Schools of Thoughts (*Aima Arba*)

The *Aima Arba'a* (*Hanafi, Shafi, Hanbali and Maliki*) are having divergent opinions about the ownership of petroleum (minerals). According to Muhammad S. Karim,⁴⁵ their opinions are described as;

(i) *Hanafi School*

The ownership of a mine discovered in land that is owned belongs to the surface owner. On the other hand if the discovery is made in land which has not been enclosed, the mine belongs to the surface owner subject to his paying one fifth of the proceeds to the Sovereign who represents the Muslim community. If a mine is found in a public domain, then it belongs to public and cannot be exploited by an individual under a concession unless the concession is rightfully granted by the Imam.

(ii) *Shafi School*

According to *Shafi* School, petroleum belongs to the surface owner subject to his paying the relevant taxes. If petroleum is found in a dead land or public land, it is for the state to grant a concession to an individual for its exploitation.

⁴⁵ Muhammad S. Karim, "Oil, Islamism and International Petroleum Industry: Legal, Economic, Political and Cultural Issues", (LL.M diss., University of Dundee), www.dundee.ac.uk/cepmlp/journal/assets/Karim-Islam-oil2001.doc (accessed January 15, 2006).

(iii) *Hanbali School*

The predominant view is that petroleum belongs to the community as a whole and as such to be managed by the state. The state can confer rights to mine and own these minerals to an appropriate investor. There is another view that recognizes the right of the owner of the land to own the petroleum by analogy to crops and solid minerals.

(iv) *Maliki School*

The *Maliki* view is irrespective of ownership of the land; all minerals whether hidden or unhidden belong to the *Ummah* and therefore are under the direct control of the state.

The divergent views of Muslim scholars on ownership of petroleum can be classified in two groups, i.e. those restricting ownership strictly to the state and those allowing private ownership of petroleum resources. Thus their schools of jurisprudence disallow private ownership and only the State can own the petroleum resource. Broadly speaking the first group restricting ownership strictly to the State can be appropriately referred as the group representing the intellectual opinion of Muslim theologists and scholars in important oil producing countries. This group views the ownership of petroleum as lying with the State. It is up to the state to carry out its exploitation itself in trust to the people. It is also free to grant the rights of exploration and exploitation to an individual or a company subject to appropriate taxation.

2. Concessions of Petroleum under *Shari'ah* Law

Generally, the principles of ownership can be clearly sited in *Shari'ah*, but it is extremely difficult to find out the true guidelines in the primary sources of *Shari'ah* on the issue of petroleum exploitation agreements. However using the Holy Quran and the *Sunnah* of the Holy Prophet (s.a.w.) as the guiding principles one can locate rules that regulate even modern day complex petroleum agreements.

If we look into the starting period of Islam, we find that concessions of an extremely simple form were known to early Islamic communities. There are numerous instances of the Holy Prophet (s.a.w.) in the capacity of the leader of the Muslim community granting concessions to various individuals. While these were mainly concessions to 'vivify' land, some also covered mining of precious metals like gold, silver, iron and copper. Various forms of legal and administrative instruments were used to carry out mining arrangement between the government and the private party; however the early Islamic administrative instrument of *Iqta* seems closest to 20th century concession.⁴⁶

Dr Walied El-Malik in his book "Minerals Investment under the *Islamic* Law" describes the main features of *Iqta* contract as follows:⁴⁷

- a) it covered public, state owned and ownerless lands;

⁴⁶ Karim (2001).

⁴⁷ Walied El-Malik, *Mineral Investment Under the Shari'a Law*, p. 72, quoted in Karim (2001).

- b) it covered defined geographical area;
- c) it is the discretionary power of Imam to decide size of the area according to location or any other reason;
- d) the Imam should fix the initial period;
- e) the grant invests exclusive right for the investor to explore and exploit the minerals;
- f) the Imam can unilaterally revoke the concession after the expiry of initial term if the investor fails to fulfil the work commitment;
- g) the investor should pay a royalty in cash or kind to the government and
- h) the investor can assign/ transfer his rights and obligations to a third party.

Abu Yusuf states in general terms that the Holy Prophet (s.a.w.) granted *iqtas* to certain tribes of Arabs and thereby made reconciliation and won over those tribes for *Islam*. After that the early caliphs also followed this policy in accordance with the welfare of the *Ummah*.

The fundamental aim of granting *Iqta* rights was that grantee should perform his obligations to get the full-fledged production. As Dr Walied El-Malik in his book "Minerals Investment under the *Islamic Law*" and Mr. *Zia-ul-Haque* in his book "Landlord and Peasant in Early Islam" have written respectively. "The investor should pay to the treasury a portion of the proceeds of the minerals. This is now called a royalty."⁴⁸ The basic purpose of granting them was essentially "to bring to life" the "dead" lands in order to develop them for the growing

⁴⁸ Yamani, Ahmed Zaki, *Islamic Law and Contemporary Issues*, 69.

needs of the *Ummah*. It was made contingent upon the fact that the grant in general must not override or harm the interests of the Muslims (*La tadurru bi ahadin min al-Muslimin*).

The Holy Prophet (s.a.w.) gave to *Al-Zubayr* a piece of land called *Jurf*, which contained date palms in the territory of the *Banu nadhir*. Later when Caliph *Umar* (r.a.t.) gave *iqta* comprising the entire *Al-Aqiq*, it encroached on the land belonging to *Urwa* (son of *Al-Zubayr*). At this time Caliph *Umar* (r.a.t.) wanted to give *iqtas* to the Muslims; when *Khawwat Ibn Jubayr* asked for it, Caliph *Umar* (r.a.t.) granted him an *iqta*.

There is another instance of *iqta* when the Holy Prophet (s.a.w.) gave land to *Abu Rafis* people. They did not irrigate and develop it and sold it during *Umar's* (r.a.t.) Caliphate for 8,000 *dinars* or 8, 00,000 *dirhems* and head of Islamic state at that time did not raise any objection about this transaction.⁴⁹

As the Holy Prophet (s.a.w.) and the rightly guided caliphs have granted lands and he who was granted land in this manner by rightly guided rulers was secure in it and none was capable of revoking it.⁵⁰ This proves that *Iqta* was a legal right of the State by virtue of which it could allot land to any one.⁵¹ The grantee is not permitted to keep the land idle for more than three years, according to *Abu-Hanifa*.⁵²

⁴⁹ Abu Yusuf, *Al-Kharaj*, 34-35.

⁵⁰ Ali Abd-ul-Qader, *Land Property and Land Tenure in Islam*, 6-7.

⁵¹ Sayed Sabiq, *Fiqh-us-Sunna*, Dar-ul-Kitab Al-Arabia, Beirut 1985, 172 (text in Arabic).

⁵² *Ibid* 174.

Abu Yusuf draws his inference that the Holy Prophet (s.a.w.) and the early Caliphs granted lands for two purposes: for winning over tribes to *Islam*, and for developing more lands for the *Ummah* in which lay the strength for *Islam*-without these no land would have been given as private estates.⁵³

Imam Shafii considered the capacity for the working of land, not the length of time. He said;

"If the ruler grants a man a piece of land, the ruler is entitled in my opinion to say to him: The Muslims have equal rights over this piece of land, none could prevent any one of them from using it. We have given it to you, to invest it for your benefit and the benefit of the community as a whole. Accordingly, you have to invest it in the proper manner and without delay. If you require a time limit, I will grant it".⁵⁴

Dr. Walied El-Malik is of the opinion that because of their similarity with *Iqta* the early concessions as granted by Saudi Arabian government to Aramco are in line with Islamic law. While there is no doubt that concession agreements of early 20th century have some resemblance with the Islamic contracts of *Iqta*, they seem to miss two fundamental features which have to be present in every Islamic contract. First: At a broad level, the Islamic theory of ownership of natural resources does not allow a private ownership of petroleum. Under the traditional and even modern agreements the title to petroleum lies with the contractor or the oil company and this is not in conformity to the Islamic legal principles. Second: The fundamental idea behind the Islamic theory of contracts is equality of contracting parties meaning that the parties should be placed on an equal footing.⁵⁵

⁵³ *Abu Yusuf, Al-Kharaj*, 35.

⁵⁴ *Abd-ul-Qader, Ali, Land Property and Land Tenure in Islam*, 6-7.

⁵⁵ *Karim (2001)*.

Even M. Bunter writes:

"Nowadays the grant of Concession *sensu strictu* is understood as awarding quite specific Ownership and Proprietary Rights over the object granted which is, in our case the rights over minerals and more specifically petroleum. In the modern world and in many countries the wide-ranging and all-embracing rights granted under the early petroleum concessions have come to be regarded as objectionable, not I suspect through any religious prohibition, but an infringement of national sovereignty".⁵⁶

3. Production Sharing of Petroleum under Shari'ah Law

While discussing the issue of "Pursuit of Wealth", Athar Murtaza writes that "Islam does not prohibit the pursuit of economic wealth, but at the same time it has provided guidelines about its uses, particularly with regard to sharing one's wealth. Such guidelines ensure that one is using permissible means to acquire wealth and is not exploiting others in the course of such pursuits of wealth. Worldly success, such as that explicit in acquiring wealth, is not prohibited by Islam. One of the prayers recited after each of the five daily prayers by Muslims asks Allah Almighty to confer on the supplicant's blessings in this earthly existence and in the after-life.

According to Islamic beliefs, the production of wealth results when the natural resources furnished by Allah Almighty are subjected to the application of knowledge, talents and labor by human beings individually and collectively. Islam enjoins its followers to realize that natural resources having been created and provided by Allah Almighty to humanity in order to facilitate human existence. Such resources are meant for human enjoyment and comfort.

⁵⁶ Bunter, Michael A G, "Petroleum Contracts In Islamic Law: The Concessions (Equity) and Contractor (Production Sharing) Agreements," www.geoconsulting.co.uk (accessed January 15, 2006).

Islam allows private ownership over such resources but not monopolies within limitations. At the same time, three parties, stakeholders, are entitled to share the wealth generated through the development of natural resources: the investors providing the capital, the workers helping in the production, and the community at-large. The pursuit of wealth should not become an end in itself nor should it be earned through exploitation of other human beings. One of the very important tenets of Islam is the prohibition of economic exploitation and misuse of wealth with which Allah Almighty blesses human beings.⁵⁷

By following the above *Shari'ah* principle, in an upstream petroleum arrangement, where the parties like oil companies and the host government enter into a production sharing agreement, the fiscal arrangement should be consistent with Islamic legal principles. As we have discussed earlier that any type of agreement should not contain any element of *riba* (interest) and *gharar* (uncertainty/speculation). Muhammad S. Karim writes in his dissertation that "Muslim law is equally hostile to any commercial operation containing a risk which could possibly amount to a violation of the rule, found in the Holy Quran against gambling and therefore is a cause of disorder. Hence all speculative contracts are against the principles of Islamic legal system".⁵⁸

⁵⁷ Murtaza, Athar, "Islamic Antecedents for Financial Accountability," *International Journal of Islamic Financial Services*, Vol.4, No.1, [http://islamic-finance.net/Journals/journal 13/vol4 no1art 1.pdf](http://islamic-finance.net/Journals/journal%2013/vol4%20no1art%201.pdf) (accessed March 3, 2006).

⁵⁸ Karim (2001).

Chapter 2

MODERN PETROLEUM RIGHTS AGREEMENTS: PETROLEUM CONCESSION AND PRODUCTION SHARING AGREEMENTS

CHAPTER 2

MODERN PETROLEUM RIGHTS AGREEMENTS: PETROLEUM CONCESSION AND PRODUCTION SHARING AGREEMENTS

A. PETROLEUM CONCESSION AGREEMENT (PCA)

All over the world heads of States generally known as Host Countries (HCs) grant to the International Oil Companies (IOCs) the petroleum rights through the petroleum agreements which transfer Equity in petroleum reserves, their ownership after discovery, from the HC to the IOC. Such petroleum agreements are known as Petroleum Concession Agreements (PCAs) but now more often known as Equity Agreements.

The PCA represents one of the two basic categories of agreements for exploration and exploitation of petroleum throughout the world. The other category comprises all kinds of service agreements, including production sharing agreements. However, a PCA has been defined as;

“An agreement between a government and a company that grants the company the right to explore for, develop, produce transport, and market hydrocarbons or minerals within a fixed area for specific amount of time. The concession and production and sale of hydrocarbons from the concession is then subject to rentals, royalties,

bonuses, and taxes. Under a concessionary agreement the company would have the title to the resources that are produced”.¹

Also, according to Walied El-Malik, in his “State ownership of minerals under Islamic Law” quoted by Michael AG Bunter; “the term Concession is a neutral term which applies to any and all formal grants by the State or privileges and rights over public domain”.

Bunter has also defined the PCA in following words;

“...an Agreement, contractually stable in nature, and struck generally between the government of a Host Country (having title to petroleum resources within its domains) and an International Oil Company (IOC). The latter is desirous of exploring, discovering, appraising, developing, producing, refining and marketing for gain the petroleum discovered and its products. The Concession grants to the IOC certain broad proprietary, management and ownership rights in exploration and producing over the resources in a defined area within the Host Country (HC), called commonly the Concession Area or the Contract Area, for a lengthy term. In return the government of the HC and its citizens affected, will demand a substantial payment down, the Lease Bonus, periodic Annual Licence Fees, as well as land rentals and if production takes place other imposts. These will include but are not limited to: Royalties, Taxes on Net Income and Additional Profits Taxes. Title to the petroleum produced shifts from the HC to the IOC at the wellhead on payment of the royalty.”²

Generally in PCA, the host country's revenues are constituted by a royalty paid by the concessionaire³ out of the production and an income tax (and other taxes) collected by the HC. These features are so specific to PCA that sometime this is referred as licence agreement or as a tax and royalty agreement. In the PCA, the concessionaire has the right to sell the

¹ Daniel Johnston, *International Petroleum Fiscal Systems and Production Sharing Contracts*, p.296, quoted in Karim (2001).

² Bunter, www.geoconsulting.co.uk.

³ The private party of the concession agreement.

production minus a portion of the production referred to as royalty. All production belongs to the concessionaire.⁴

A review of World Petroleum contracts by Gordon Barrows found that 76% of the countries surveyed use the PCAs. But the countries that use the PCAs are decreasing in number.⁵

1. Historical Background of PCA

The PCA is the oldest of international agreements. Keith W. Blinn, Claude Duval, Honore' Le Leuch and Andre' Pertuzio in their joint effort, "International Petroleum Exploration & Exploitation Agreements: Legal, Economic, and Policy Aspects", write that "The traditional "concession agreement" originated with the very beginning of the petroleum industry, i.e. the lease issued on December 30, 1857 to Colonel Edwin L. Drake which led to the first discovery of oil in modern times in July 1859 at Titusville, Pennsylvania. The text of that lease is the following:

Pennsylvania Rock Oil Company
To
E.B Bowditch and E.L. Drake

Dated December 30, 1857
Deed Book P, p. 357
\$ in hand.

⁴ Tiny, Kiluange, "The JDZ Model: A Legal Analysis," August 2005, www.juristep.com (accessed January 25, 2006).

⁵ Moerbe, Charles, "International Operations: Contracts with the Government and Basic Concepts of International Operating Agreements," *Lewis Mosburg's Internet Oil & Gas Newsletter*, http://www.mosburgoil-gas.com/html/body_moerbe_11_96_5a.html, (accessed January 18, 2006).

'Demise and let' all the lands owned or held under lease by said company in the Country of Vanango, State of Pennsylvania, 'To bore, dig, mine, search for and obtain oil, salt, water, coal and all materials existing in and upon said lands, and take, remove and sell such, etc., for their own exclusive use and benefit, for the term of 15 years, with the privilege or renewal for same term. Rental, one-eighth of all oil as collected from the springs in barrels furnished or paid for by lessees. Lessees may elect to purchase said one-eighth at 45 cents per gallon, but such election, when made, shall remain fixed. On all other minerals, 10 per cent of the net profits. Lessees agree to prosecute operations as early in the spring of 1858 as the season will permit, or fail to pay rent for more than 60 days, the lease to be null and void.

That lease, brief and superficial though it may be, contains in fact the essence of what still forms the basic contents of petroleum agreements”.

After the grant of above lease an international move began at the turn of the 20th century when William Knox D'Arcy was granted a concession in 1901 by the Persian Ruler which can be considered as classical concession. The period of grant was 60 years to explore, develop, produce, transport and sell hydrocarbon anywhere under Iranian soil. In return he was to pay a modest bonus and the undertaking to fund the exploration and development effort. Thereafter, some Arabian States like Saudi Arabia, Kuwait and Bahrain granted similar arrangements establishing a rather well defined pattern of relationship between the contracting parties. These agreements now confirm a common heritage by having the uniformity of terms, rights and obligations.

Coming to the traditional concession agreements, these were characterized by their simplicity and similarity. They defined the area granted, which was customarily quite large in geographic scope. In some cases, substantially the entire territory of the HC was included.

In a few instances, this consisted of more than 400, 000 square miles. Contrasted with today's practices, the duration of the agreement was very long, frequently extending beyond fifty years.⁶

With the passage of time and political evolution, the provisions of the early concession agreement eventually led to a kind of conflicting stances between the HCs, trying both to assert their sovereignty and to reap more profits from their oil, and the IOCs "sticking" to the sanctity of contracts. The fear of the HC of being unfairly treated, like the perception by the IOC of suffering damages when contractual commitments are broken, emerged without due regard to the contribution made to, or profit derived from the venture.⁷

After second world war, a second generation of concession agreements was developed as a result of the political evolution of the world. They provided for a more active role for the HC and a corresponding decrease in the responsibilities and rights of the IOCs. Such modifications, however, did not alter very legal nature of concession agreement. Only their terms were very different from what they were under the early concession systems with the end result that the features most disadvantageous for the HC were progressively eliminated.⁸

⁶ Keith W. Blinn, Claude Duval, Honore' Le Leuch and Andre' Pertuzio, *International Petroleum Exploration & Exploitation Agreements: Legal, Economic, and Policy Aspects* (116 East 66th Street, New York, N.Y. 10021, Barrons), 43-44.

⁷ I. Shihata, *Arab Oil Policies and the New International Economic Order*, 16 Va. Int'l. L. Rev. 261 (1978), Moran, "The Evolution of Concession Agreements in Underdeveloped Countries and the United States National Interest", 7 Vand. J. Transn'l L. 315, 322, (1974), quoted in Keith W. Blinn, Claude Duval, Honore' Le Leuch and Andre' Pertuzio, *International Petroleum Exploration & Exploitation Agreements: Legal, Economic, and Policy Aspects* (116 East 66th Street, New York, N.Y. 10021, Barrons), 46.

⁸ Keith W. Blinn, Claude Duval, Honore' Le Leuch and Andre' Pertuzio, 60-61.

For near about the last half century the PCAs have been the object of sharp criticism mainly from Third World producing countries. The reason behind that criticism is that in addition to keeping at a minimum the financial rewards available to the HCs, it gave them a very limited direct involvement in managing petroleum operations with a reduced opportunity to enter directly into operations for vital objectives, such as training national personnel and understanding the international energy industry. Furthermore, the large areas conceded, the long term of the agreements, and the type of rights recognized to the IOCs were deemed to deprive the HC of part of its sovereignty. This is the reason that the new contractual systems i.e. the production-sharing agreements, came into being and are more popular among the HCs as compared to the PCAs.

3. Characteristics of PCA

Before describing the characteristics of PCA it would be better to know briefly about its legal nature which will help in better way while characterizing it.

(a) Legal Nature of PCA

Keith W. Blinn, Claude Duval, Honore' Le Leuch and Andre' Pertuzio write that "A concession consists basically in the granting of certain rights called minerals or mining rights to an individual or an entity authorizing him or it, to explore for and, in case of a discovery, to produce and exploit, the mineral(s) object of the concession. Those rights entail the

ownership of the mineral(s) so found and, until recently, the discoverer was the rightful owner of the reserves of said mineral(s). This is still the case in many countries like the United States where oil legislations follow closely traditional mining legislations.

In most countries especially in Europe, the Middle East and other Third World countries the reserves are, however, considered as constituting inalienable natural resources, and the concessionaire acquires the ownership of the production at the well-head. In fact, through a subtle process, the mining rights of the concessionaire have been converted into a mere authorization to explore and produce, the minerals remaining the property of the HC until produced (*jus ad rem versus jus in re*⁹). The counterpart of the rights so granted to the holder of the concession consists in an obligation for the latter to pay to the granting authority i.e., the HC a royalty which is an agreed upon percentage of production".¹⁰

PCAs cover various types of contracts. Sometimes exploration and exploitation are embodied into either a single document or separate documents. Also, whether the terms and conditions governing exploration and exploitation activities are found in a same document or not, the title applying to exploration is sometimes called "permit" while the title issued for exploitation is named "concession" or "lease".

⁹ *Jus ad rem*, is a term of civil law, meaning "a right to a thing;" that is, a right exercisable by one person over a particular article of property in virtue of a contract or obligation incurred by another person in respect to it, and which is enforceable only through such other person. It is thus distinguished from *jus in re*, which is a complete and absolute domain over a thing available against all persons. The disposition of writers is to use the term "*jus ad rem*" as descriptive of a right without possession, and "*jus in re*" as descriptive of a right accompanied by possession (for reference please see Black's Law Dictionary, Sixth Ed., p. 858).

¹⁰ Keith W. Blinn, Claude Duval, Honore' Le Leuch and Andre' Pertuzio, 55.

(b) Main Features of PCA

Following figure shows a very basic form of PCA:

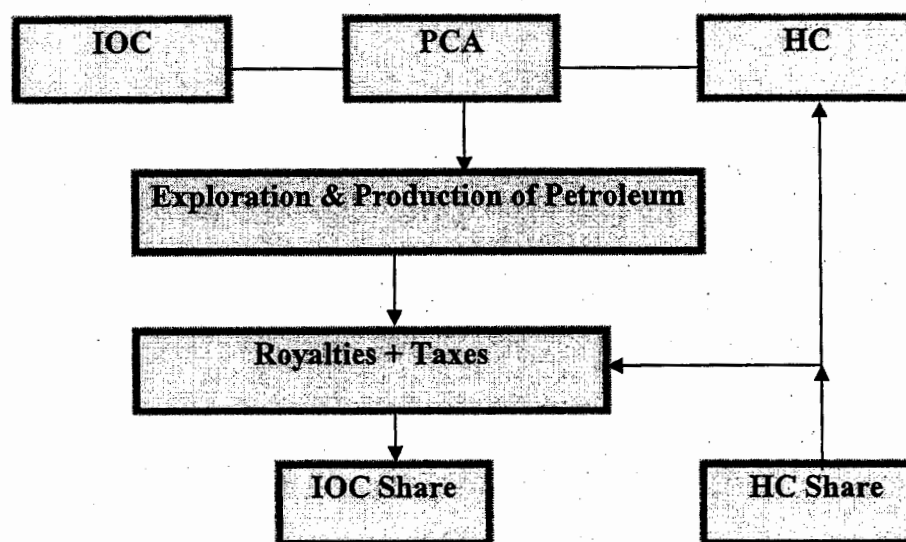


Figure 2.1: Basic form of PCA

In any event, the main features of PCAs are similar, irrespective of the type of agreement concerned; they can be summed up as follows:

(i) *Exclusive Right to Explore*

The main feature of PCA is that under this agreement, the IOC has an exclusive right for the exploration and exploitation of petroleum. The whole activity is performed at its own risk and expense.

(ii) Ownership of Production

The second feature of PCA is that the ownership of production of petroleum rests with the IOC and it can freely dispose of it, subject to the obligation which can be put by the HC to supply to the local market according to the domestic needs. The ownership of petroleum is the big issue under *Shari'ah* as we have discussed in previous chapter and we will conclude this debate in chapter three.

(iii) Payment of Surface Rentals

In PCA arrangement the main source of revenue is surface rentals. During both the exploration and exploitation phases, the IOC pays surface rentals to the HC.

(iv) Payment of Royalty

Another feature of PCA is the obligation of payment of royalty by the IOC to the HC. The IOC can pay royalty to the HC in kind or in cash. The choice of payment is with the HC.

(v) Payment of Taxes

The IOC pays taxes on the profits derived from its exploitation operations.

(vi) Ownership of Equipment and Installations

The equipment and installations used for petroleum operations belong to the IOC.

(c) Conclusion

The above features of PCA can be summarized into following words of Dr Irina Palliashvili, "A concession is a civil agreement under which the state provides on a compensated basis and the investor purchases the exclusive right to the use of a subsoil area for agreed-upon purposes, in particular, for prospecting, exploration and extraction of useful minerals, bears all expenses and risks, as well as makes payments to the HC for the use of the subsoil and for all other taxes and mandatory payments envisioned by law. A concession by its legal nature is a type of a lease agreement.

The licensing system of subsoil use is by its nature administrative-authoritative. Under the licensing system, the IOC also purchases from the HC the exclusive right to use a subsoil area for the extraction of useful minerals. The IOC is also the owner of the extracted raw materials, bears all expenses and risks, makes payments to the HC for the use of the subsoil and all other taxes and fees envisioned by law, but the HC structures its relations with the IOC on an authoritative, administrative-managerial basis. By granting a license, the HC by its authoritative act permits the IOC to use the subsoil on conditions established by the HC

unilaterally. In the same manner, the HC may withdraw its decisions, limit the rights of the IOC or completely withdraw the IOC's rights and revoke the license.

As we have seen that PCAs are becoming old fashioned agreements because of their terms not as such much favourable for the HCs. But regardless of the criticisms which have been levelled against the concession system (this criticism on PCA is without prejudice to the criticism under *Shari'ah* law which we will see in next chapter), that system is still widely used throughout the world. It has the advantage of being a tried-and-true system that has proved that it works.

Also this system is flexible enough to accommodate different approaches for its implementation; it can be enacted as a corpus of legislation (as in the United Kingdom, the United States, France, and Australia), or it can be negotiated directly to incorporate the same requirements and achieve the same results (as in the Middle East). The main drawbacks of the concession system, in its traditional form, were that it did not enable the HC to participate in the ownership of the petroleum produced and left the HC with a basically passive role. As this is no longer in consonance with how most countries view the management of their natural resources, it explains why most modern concession agreements provide now for a participation of the HC which is generally exercised through the HC's national oil company (i.e. Government Holding Private Limited in case of Pakistan).¹¹

¹¹Keith W. Blinn, Claude Duval, Honore' Le Leuch and Andre' Pertuzio, and Andre' Pertuzio, 54-55, 68.

B. PRODUCTION SHARING AGREEMENT (PSA)

The oil and gas contractual activities can be carried out under concessions, leases, or contracts granted by the Government. The legal framework of such arrangements are established by the Constitution, the laws and regulations, and in some cases, negotiated in a case-by-case basis following either direct negotiations or competitive bids. One of the most popular contractual modes for such activities is the Production Sharing Agreements (PSAs).

PCAs are among the most common types of contractual arrangements for petroleum exploration and development.¹² Petroleum exploration is a highly risky activity. On average nine out of ten exploration efforts are not successful. Under a PSA, the contractor group led by their operator conduct operations at their own risk and are only paid for their endeavours from a share of the oil and gas produced, if any is discovered and subsequently recovered.¹³

While discussing PSA in more formal way, it is said that a PSA is a contractual arrangement made between an IOC and HC and sometime a designated State enterprise (state party), authorizing the IOC to conduct petroleum exploration and exploitation within a certain area (contract area) in accordance with the rules as agreed by the parties in the agreement through their mutual consent. The authority of the State party is either based on the prevailing petroleum legislation, in which case the area of the agreement coincides with the area of the

¹² "Probably [the] most dominant form of granting access to oil & gas exploration and development to international petroleum companies in developing countries". Thomas W. Walde, *The Indonesian Production Sharing Contract*, book review. 2003. OGEL, quoted in Kiluange Tiny, "The JDZ Model: A Legal Analysis," August 2005, www.juristep.com (accessed 25 January, 2006).

¹³ Tiny, www.juristep.com.

licence, or on a general exclusive authorization (and duty) to undertake petroleum operations covering the whole country without specific obligations attached.¹⁴

In other words PSA can be described as, “a special form of subsoil use relations based on civil-legal contractual principles for relations between a HC and an IOC with respect to prospecting, exploration and extraction of mineral resources”. PSA further can be described as “a contract pursuant to which the HC (owner of the subsoil) entrusts the IOC to conduct prospecting, exploration and extraction of mineral resources within the confines of a defined subsoil area on a compensated basis and for an established time period during which the IOC is obliged to conduct the indicated work at its own expense and own risk”.¹⁵

Broadly speaking, the IOC invests, by invitation of the HC, in the exploitation of the area, and is rewarded, if a development follows, first with the recovery of its costs and then with a share in production, such share being determined by the agreement. The investment by the IOC is the important factor to the HC. It usually funds the whole, or substantially the whole, of the initial cost of exploration in return for tax concessions. These are often the key from the IOC's point of view. Upon production, the HC will seek to compensate itself out of the income ultimately coming to the company for the tax it has forgone and any other revenues, such as royalties, which it would otherwise have received, before eventually taking a share of

¹⁴ David Martyn R. (Edited by), *Upstream Oil and Gas Agreements with Precedents*, London, Sweet & Maxwell, 1996, 44-45.

¹⁵ Palliashvili, Dr Irina, “The Concept of Production Sharing,” A paper presented at the Seminar on the Legislation on Production Sharing Agreements, September 14, 1998, http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm (accessed January 3, 2006).

the profits in a predefined manner.¹⁶ In case where the State party has been given a general authorization, the contract area is the area as specifically described in the PSA. The IOC is responsible for the funding of the exploration and exploitation work, albeit a contract may give the State party an option to contribute to the costs of the development of particular commercial discoveries.

In PSA, all operations are carried out in accordance with annual work programmes and corresponding budgets, which need the approval of a supervisory body, which in most instances is the State party itself. If a discovery is declared commercial, IOC has to prepare a plan for developing such discovery (development plan) and submit this plan to the State party for approval. Development work and production operations are required to be conducted in accordance with the approved plan. The oil and gas production becoming available at the point of delivery is divided between the HC, the State party and IOC.¹⁷

1. Historical Background of PSA

The first concept for the production sharing was used in the beginning of the 50s of the last century.¹⁸ But agreements of production sharing, in their current form are instruments of legal regulation of relations between a HC and an IOC in the sphere of the extraction of useful minerals (in particular oil) were successfully applied in Indonesia between IIAPCO

¹⁶ Jennings Anthony, *Oil and Gas Exploration Contracts*, London, Sweet & Maxwell, 2002, 5.

¹⁷ Keith W. Blinn, Claude Duval, Honore' Le Leuch and Andre' Pertuzio, 60-61.

¹⁸ Palliashvili, http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm.

and Pertamina (Indonesian Oil Company) back in August 1966. Since then, PSAs have been popular in many oil-producing countries, especially in the developing countries with economies in transitions. According to Danial Johnston, a recognized expert on petroleum contracts, in the 1980s and 1990s there was a trend towards the use of PSAs by most oil and gas producing countries.¹⁹

The origin of the concept can be traced back to the Netherlands-Indies Mining Law of 1899, as amended in 1919. In accordance with article 5a of this law, the competent minister could be authorized by special law to enter into contracts with an IOC granting the latter (IOC) the exclusive right to search for and produce petroleum within a certain territory and for a certain number of years. The IOC was obliged to pay a royalty and a proportional part of the gross profit. The proportion was related to the annual capital expenditures. The HC had the right to demand the royalty and profit share be paid in oil, in oil products, provided the oil or oil products so received would be used by the government for its own needs.²⁰

A number of developing countries, when opening up their territory for exploration to foreign oil companies, have opted for adopting the concept of production sharing as the vehicle to engage and co-operate with the latter. For example; Yemen, Myanmar, Vietnam, Ivory Coast, Ghana and Tanzania. Apart from Nigeria, other non-Western major petroleum producing countries, such as Oman (1975) and other Gulf States, similarly experimented

¹⁹ Tiny, www.juristep.com.

²⁰ David, 58.

with the production sharing concept but its application remained restricted to new exploration ventures situated outside their main producing areas. The latter remain state controlled or governed by concessions or licences with majority state operation. Since the 1990s, East European countries, the Russian Federation, Kazakhstan followed their example.²¹

2. Characteristics of PSA

As said above, while characterizing PCA, before describing the characteristics of PCA it would be better to know briefly about its legal nature which will help in better way while characterizing it.

(a) Legal Nature of PSA

There is a controversy surrounding the legal nature of PSAs; some scholars consider them to be international agreements (submitted to the principles of public international law), whilst others considers them to be made under domestic law (which can be amended by the State by the sovereign act). The majority of opinion considers PSAs to be commercial contracts. According to Zhigou Gao, the PSA is a mixture of public and private law,²² encompassing elements subject to the State sovereign privileges and elements of a contractual nature,

²¹ David, 67.

²² Gao, Zhiguo, *International Petroleum Contracts: Current trends and new directions*, Graham & Trotman / Martinus Nijhoff, quoted in Kiluange Tiny, "The JDZ Model: A Legal Analysis," August 2005, 3, www.juristep.com (accessed 25 January, 2006).

governed by the principles of private law, *inter alia*, to the principles of *pacta sunt servanda*²³ and *bona fide*²⁴, unless otherwise expressly provided for, PSAs cannot normally be amended unilaterally by the HC.²⁵

Keith W. Blinn, Claude Duval, Honore' Le Leuch and Andre' Pertuzio write that "legal nature of PSAs does not seem to be always well perceived and the logical consequences therefrom properly drawn. In that respect, it is to be noted that most such agreements limit themselves to the opening statement "This contract is a production-sharing contract" without elaborating much further. For all practical purposes, the impression is sometimes left that the production is a kind of *res nullius*²⁶ which is shared by two parties having a right to it of a same and equal nature.

As a matter of fact, the production is vested exclusively in the party which holds the mining rights, i.e. the HC or its national oil company. Conversely, the IOC's rights are of a purely contractual nature, such as the rights to the reimbursement of costs and to a payment for services rendered. The lack of precision in the definition of the PSA often results in some form of misunderstanding".²⁷

²³ Contracts must be complied.

²⁴ Good faith and fairness.

²⁵ Tiny, www.juristep.com.

²⁶ A thing belonging to no one. In international law, territory not under the sovereignty of any state.

²⁷ Keith W. Blinn, Claude Duval, Honore' Le Leuch and Andre' Pertuzio, p.71.

(b) Main Features of PSA

There are various models and types of PSA varying from country to country, location of exploration areas, and other aspects regarding the prospectivity of a given block. Following figure shows a very basic form of PSA.²⁸

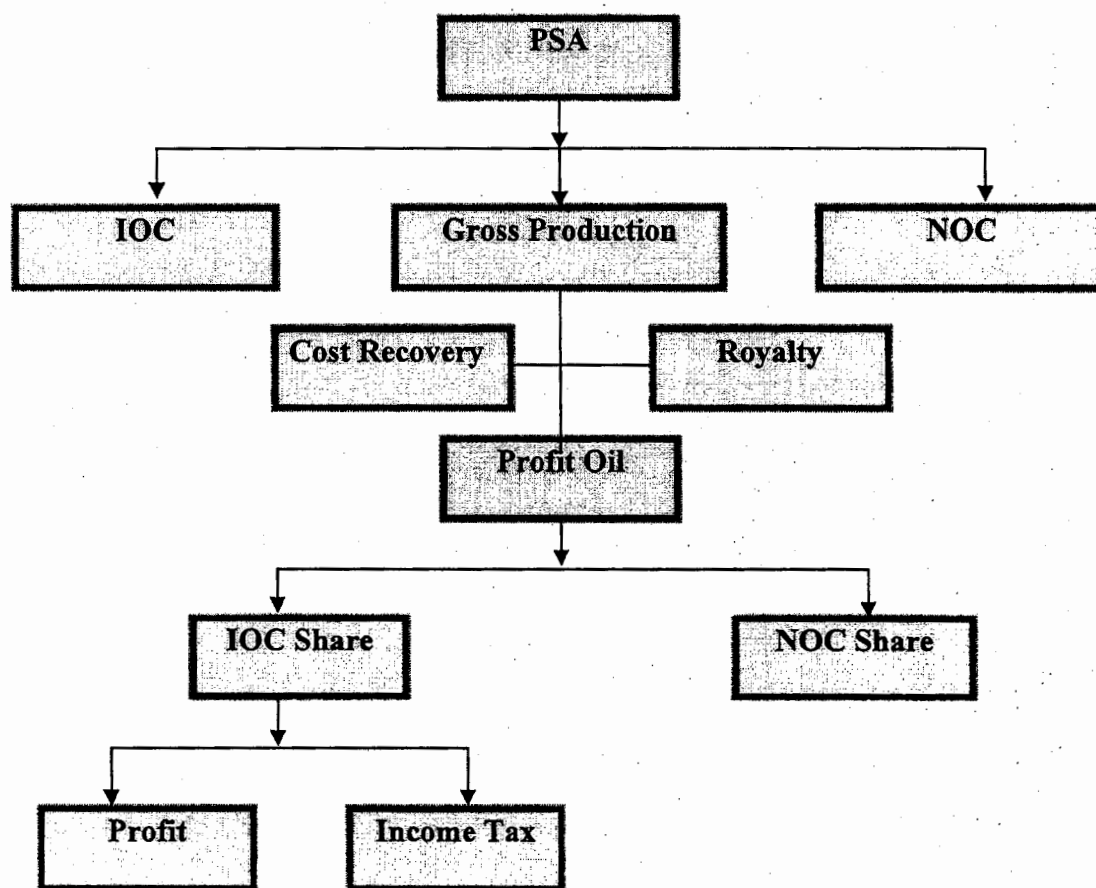


Figure 2.2: Basic form of PSA

²⁸ <http://www.oxfordenergy.org/pdfs/WPM25.pdf>. (accessed March 26, 2006).

However, there are some common characteristics of PSAs, as follows:

(i) *The Subject of PSA*

The subject of PSA is the agreed program of the parties for the extraction of mineral resources which must be fulfilled by the IOC in favour of the HC. Such program includes the type, costs and period of performance. In other words, the HC has hired the IOC as a contractor to perform the work envisioned by the program. As a result, contractual relations arise between two legally equal parties, each having rights and obligations, the violations of which shall entail their legal liability.

The HC hires the IOC as a contractor for the conduct of work connected with the extraction of useful minerals. At the same time, it takes onto itself the obligation to transfer to the IOC for use the subsoil area specified in the agreement. In the majority of countries in the world the subsoil belongs to the HC. The HC has a monopoly over the use of the subsoil and the removal from it of natural resources.

The granting to an IOC of exclusive rights denotes that the HC during the period of PSA's validity, is obligated to abstain on the given subsoil area from activity included in the volume of the transferred rights and not permit such activity on the part of third persons. Only the IOC may conduct activity envisioned by the agreement. But this does not mean that

the investor shall obtain unlimited rights. The exclusive rights being transferred to the IOC are limited by:

- (i) the types of activity envisioned by the agreement,
- (ii) the types of minerals indicated in the agreement, and
- (iii) the terms indicated in the agreement.²⁹

(ii) *Appointment of IOC*

The IOC is appointed by the HC as contractor on a certain area.³⁰

(iii) *The State as a Party to PSA*

Dr Irina Palliashvili writes that, "A PSA as a civil-law agreement; is concluded between legally equal parties: the HC and an investor. All conditions for use of the subsoil and the performance of work is established by the parties by mutual agreement. Nonetheless, one has to take into account that the HC participating in the agreement preserves its state prerogatives. Therefore in relations for subsoil use arising on the basis of a PSA, the HC acts in two roles: on the one hand it fulfills its obligations under the agreement, and on the other hand it preserves its state public-legal functions. These roles may converge or come into conflict with each other. In their delineation, one should be guided by the following

²⁹ Palliashvili, http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm.

³⁰ Keith W. Blinn, Claude Duval, Honore' Le Leuch and Andre' Pertuzio, 69.

principle: within the scope of conditions provided by the agreement, the HC and the IOC are equal partners, outside such scope - the HC makes decisions related to subsoil use on an authoritative, administrative-law basis".³¹

(iv) The Provision of Equipment and Technology and Bearing the Sole Risk and Cost of Operations

The IOC provides all the equipment and technology and bears the cost of operations at its sole risk and expense under the control of the HC.

The IOC carries out the activities envisioned in the agreement (prospecting, search, exploration, extraction and other works) at its own expense and risk. The HC, as the other party to the agreement does not bear any expenses or risks. If the IOC invests funds in the prospecting and exploration but did not discover any minerals, or discovered that their extraction would be economically unprofitable, the expended funds shall not be refunded to the IOC. This is a basic principle of a PSA. The parties, however, may agree otherwise.

(v) Ownership of Production

The HC remains the owner of the petroleum and gas produced; and the ownership of the production only transfers at the export point (usually established as the wellhead). Therefore,

³¹ Palliashvili, http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm.

all extracted minerals or extracted and processed minerals (i.e., the produced product) are the property of the HC. The HC hires the IOC as a contractor to perform work for it, but at the expense and risk of the IOC. The work is carried out on a compensated basis, with the HC paying the IOC not in money, but with a portion of the produced product. This is the so-called production sharing i.e., the sharing of the results of the work carried out by the IOC.³²

(vi) Payment of Royalty and Recovery of Cost of Operations

The IOC pays a royalty, recovers the cost of operations, and then shares the remaining production with the HC on a pre-determined percentage split between the HC and the IOC.

(vii) Remuneration of IOC

Remuneration of the IOC is made in kind, i.e. by the allocation of a “production-share” of the oil produced after the recovery of costs.

(viii) Payment of Taxes

The IOC pays taxes on its share of profit oil. During activities on the basis of a PSA, a special tax regime is used for the IOC. Within the time period of validity of the PSA, the existing HC taxes and other mandatory payments are replaced by a part of the profit product.

³² Palliashvili, http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm.

They are taken into consideration while drafting an agreement to determine the part of the product produced by the IOC which remains in the ownership of the HC. Apparently, no tax privileges are granted to IOCs. The existing tax system is simply replaced by production sharing in the case of the use of a PSA.

Production sharing between the HC and the IOC is carried out on the basis of principles determined in each specific agreement. There are two known systems for replacement of taxation by production sharing:

- (i) complete replacement of taxes by a part of profit product (for example, in Libya, the state divided the produced products between itself and the IOC in the proportion 81:19 without levying any taxes or fees);
- (ii) partial replacement, when simultaneously with production sharing is envisioned the levying of certain taxes (for example, in Russia profit tax and fees for subsoil use are levied, and in Indonesia - income tax and a dividend tax are imposed).

Therefore, the PSA concept, on the one hand, protects the interests of the HC, and on the other - makes the IOC immune from the changing tax policy of the state. Production sharing creates a new procedure for subsoil use, as an alternative to the conventional tax system, in accordance with which individual characteristics of subsoil use are taken into account on a contractual basis in each PSA.³³

³³ Palliashvili, http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm.

(ix) Reverting the Equipment and Installations to the HC

Equipment and installations for the operations revert to the HC after installation, except if leased or rented.

(x) Establishment of Joint Committee

Usually, a joint committee (where both parties are represented) is established to monitor the operations, approve the working programmes and authorize the necessary budgets.

(xi) Characteristics Distinguishing a PSA from Other Forms of Subsoil Use

In the world of practice, the concession and licensing forms of subsoil use are widely used. As discussed earlier, concession is a civil agreement under which the HC provides on a compensated basis and the IOC purchases the exclusive right to the use of a subsoil area for agreed-upon purposes, in particular, for prospecting, exploration and extraction of useful minerals, bears all expenses and risks, as well as makes payments to the state for the use of the subsoil and for all other taxes and mandatory payments envisioned by law.

Under a PSA the relations between the HC and the IOC are contractual, that is formally equal. In the agreement itself, the parties define conditions governing the transfer of subsoil for use. The produced product is the property of the HC, and after production sharing at the

measurement point, a certain part of it is transferred to the ownership of the IOC. A PSA is a type of contract where the right of ownership belongs to the HC, and the IOC receives compensation for the performed work. In this case the tax system envisioned by law is replaced by a special new system of settlements between the parties - production sharing.

(c) Conclusion

PSAs are the result of efforts to modify the nature of the relationships between HCs and IOCs and, above all, to find an alternative to the concession agreement system which would enable the HC to exercise more control over both petroleum operations and ownership of production. If, from a legal standpoint, the difference is indeed fundamental, from an economic point of view that difference lies mainly in the mechanism used to distribute the production and income arising therefrom.³⁴ It follows that in the environment of a transitional economy and changing legislation, subsoil use under PSAs is desirable both for the HC and the IOC. It is desirable for the HC because:

- (i) attracting substantial volumes of investment, including foreign, to the exploration and extraction of useful minerals is important not only for the stable functioning of the economy but also for ensuring the national security of the country by means of reducing dependency on energy imports;

³⁴ Keith W. Blinn, Claude Duval, Honore' Le Leuch and Andre' Pertuzio, 69.

- (ii) exploration and extraction of useful minerals demands less material-financial resources which the HC does not have. The necessary resources are contributed by the IOC;
- (iii) the HC has the opportunity to conclude long-term agreements with IOCs on the basis of which it can calculate future growth in the extraction of oil, gas and other useful minerals, as well as budget income;
- (iv) instead of tax payments, which as practice shows are often difficult to collect, the HC receives a certain fixed part of the extracted product.

It is also desirable for the IOC to invest under a PSA, because it gives such IOC a greater degree of independence from the constantly changing tax system. The relations of the IOC with the HC under a PSA are in large part structured on a civil-legal basis. Of particular importance to the IOC is the stability of legal relations between the HC and itself in the time-period of validity of the agreement.³⁵

³⁵ Palliashvili, http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm.

Chapter 3

REVIEW OF GOVERNMENT OF PAKISTAN'S PETROLEUM CONCESSION AGREEMENT (PCA) UNDER SHARI'AH LAW

CHAPTER 3

REVIEW OF GOVERNMENT OF PAKISTAN'S PETROLEUM CONCESSION AGREEMENT (PCA) UNDER SHARI'AH LAW

A. HISTORICAL BACKGROUND OF PCA

In 1969, the Government of Pakistan (GoP) issued its first PCA. Second PCA was issued in 1982 and third in 1987. However, all these agreements were really a recommended form and therefore it took years for petroleum exploration and production companies to negotiate PCAs with the GoP.

In 1988, GoP held its first bid round, in which forty three exploration blocks were offered to international companies for competitive bidding. Twenty four bids were received for twelve (12) blocks. Nine PCAs were signed as a result of this bid round. Further, with its bid round package which was circulated to petroleum exploration and production companies in 1988, GoP also issued a further revised PCA. Although, this was a significantly improved version, it still was only a recommended form and therefore negotiations still took upto two years.

After the issuance of GoP's first Petroleum Policy¹ in 1991 on the eve of the first Government of Pakistan International Petroleum Seminar² which was held in Islamabad on November 22-24, 1991, a further revised form of PCA was issued in 1991. Subsequently, after the issuance of new improved Petroleum Policy in September 1993, a further revised PCA was issued in the same year.

As it is said earlier the PCAs of 1969, 1982, 1987 and 1991 were a recommended form but in March 1994 when the GoP issued its first real Petroleum Policy, it also issued its first real Model PCA in July 1994 reflecting the provisions of the 1994 Petroleum Policy.

In October 1997, the GoP issued the 1997 Petroleum Policy. At about the same time, a revised Model PCA reflecting the provisions of the 1997 Policy was issued by the GoP. Except for few 1997 Petroleum Policy specific provisions, 1997 Model PCA is almost identical to the 1994 Model PCA, which was developed by the Government in consultation with the Pakistani petroleum industry as a follow up of the 1994 Petroleum Policy.³ After the issuance of Petroleum Policy in May 2001, the GoP also issued its Model PCA in 2001 which is currently in use in petroleum industry.

¹ The "policy" is basically statement of Government's objectives and has no binding value like laws, rules and regulations. However, because these policies reflect agenda of the Government, it is important for petroleum exploration and production companies to know them and factor them while making their strategies for Pakistan.

² The theme of this seminar was "New Directions and Strategies for Accelerating Petroleum Exploration and Production in Pakistan".

³ The above historical background of PCA is obtained from Dr Sohaib Qadar's book "Pakistan Upstream Petroleum Laws & Related Legislation: A Guide for Multinational Companies", Barrows Company, New York, 2000, pp. 37-38.

B. LEGISLATION SUPPORTING PCA

Pakistan's Oil and Gas sector has a phenomenal growth since independence in 1947 and in order to remain attractive in highly competitive global exploration and production market the GoP soon after the independence promulgated the law to govern the oil and gas exploration activities and to bring this industry in a stream line. To achieve this goal a primary legislation to regulate the concessions for the petroleum exploration companies is the Regulation of Mines and Oilfield and Mineral Development (Government Control) Act, 1948 (XXIV of 1948).

Generally this Act provides a framework for granting petroleum rights. This Act was first amended in 1955, second in 1964 and third in 1976 pursuant to legislative acts. The relevant provision which gives the power to the Federal Government for the grant of concession is added in the Regulation of Mines and Oil-fields and Mineral Development (Government Control) (Amendment) Ordinance, 1976, which is reproduced here as;

“3B. Concessions to Petroleum exploration companies.- (1) Notwithstanding anything contained in any other law for the time being in force, every company, whether incorporated in Pakistan or outside Pakistan, to whom a licence or a lease to explore, prospect and mine petroleum is granted under this Act, not being a company such as is referred to in sub-section (1) of section 3A, shall be entitled to the concessions specified in the Schedule in addition to any concessions for the time being admissible to it under any other law or the rules made under this Act.

(2) The Federal Government may, by notification in the official Gazette, amend the Schedule so as to add any concessions thereto or to improve any concessions therein”.

The Regulation of Mines and Oilfield and Mineral Development (Government Control) Act, 1948 also contains a schedule of concessions available to holders of a lease or a licence to explore, prospect and mine for petroleum.

This Act of 1948 establishes the power of the Government to make rules regarding licences, concessions, fees, royalties and related matters. While the rules governing the concession are Pakistan Petroleum (Exploration & Production) Rules, 2001 which are promulgated by the GoP on the basis of the powers granted under Section 2 of the above Act of 1948. The relevant provision is reproduced as;

“2. It is hereby declared to be expedient in the public interest that the appropriate Government shall have power to make rules to provide for all or any of the following matters, namely:-

(1) the manner in which, and the authority to whom, application for the grant or renewal of an exploration or prospecting licence, a mining lease or other mining concession shall be made, and the prescribing of the fees to be paid on such application”.

Also to support the above program as said earlier the GoP in May 2001 issued its third Petroleum Policy which is basically a statement of Government's objectives and has no binding value like laws, rules and regulations.

C. REVIEW OF PCA UNDER SHARI'AH LAW

Shari'ah seeks to build a society based on justice and equity. The nature of relations between the individual members of the society stipulated by *Shari'ah* is rooted in mutual care, brotherhood and sympathetic cooperation. Hence, the relationship and the dealing between

the members of the Islamic society, is sympathy and support. *Shari'ah* has prohibited and discouraged all those things that lead to injustice and oppression and has extolled and encouraged all those deeds that inspire people towards mutual care and cooperation⁴ and as such everything departing from justice to oppression, mercy to harshness, welfare to misery and wisdom to folly, runs counter to the tenets of the *Shari'ah*.

The main purpose of *Shari'ah*, while regulating the commercial activities among the people is also to promote the universal principles of equity, fairness and justice. Where *Shari'ah* asks for the rights, it also stresses on the fulfillments of the obligations. Islamic economics is the knowledge and the application of the injunctions and the rules of the *Shari'ah* in regard to acquisition and disposal of the available sources for providing satisfaction to the individuals in order to enable them to perform their obligations to Allah Almighty and the society.⁵

By applying the above principles in today's worldly commercial dealings, *Shari'ah* allows those commercial activities where both the contracting parties practice the teachings of *Shari'ah* in their economic life and observe *halal* and *haram* in all their commercial activities. As we have seen in "Chapter 1", *Shari'ah* prohibits those contracts which involve *gharar* (uncertainty), inducement, usury, *qimar* (gambling), *maysir* (Games of Chance), fraud and deception, inconsistency, non-conformity with objectives of *Shari'ah*, and no principle of liability for loss and entitlement to profit like that. The purpose to review GoP's

⁴ See M. Aslam Khaki v. Muhammad Hashim (PLD 2000 SC 225 at p.528).

⁵ Hassanuzzaman, http://islamic-world/economics/pic/title_03.gif.

PCA is to see whether this agreement is in full compliance with the above mentioned *Shari'ah* principles or not. Whether this agreement contains any element of wrongful acquisition of property (ownership), *riba* (interest), *gharar* (uncertainty) in insurance, risk etc?

While reviewing GoP 's PCA, it comes out that PCA gives the resemblance with the Islamic Contract of *Iqta* (that is discussed in detail in Chapter 1) but on following points, PCA is not fully in conformity with this *Shari'ah* principles. For Example:

1. Ownership of petroleum and right of royalty.
2. Payment mechanism and project-financing.
3. Insurance and Indemnification
4. *Shari'ah* compliance of events for the frustration of contract (force majeure).

Now we discuss all these points in detail.

1. Ownership of Petroleum and Right of Royalty

As we have seen in Chapter 1 that there is a divergence of opinion among *Fuqaha* about the ownership of petroleum. For summary understanding, I reproduce the table made by Muhammad S. Karim.⁶

⁶ Karim (2001).

Ownership of Petroleum Resource : Main Schools of Jurisprudence		
School	Group	Ownership
<i>Hanafi</i>	I	Ownership belongs to the surface owner. Hence mining rights are subject to private agreements.
<i>Shafi</i>	I	Petroleum belongs to surface owners.
<i>Maliki</i>	II	Petroleum belongs to <i>Ummah</i> and hence under the direct control of State.
<i>Hanbali</i>	II	Petroleum belongs to the community as whole. The state can confer rights to private investors for mining.

Table 3.1: Ownership of petroleum resource: Main schools of jurisprudence

Under Article 2.1 of PCA, PRESIDENT of Pakistan is authorized to grant petroleum concession to the private party to explore and produce petroleum.

While in Pakistan , majority of the Muslims are *Hanafi* School followers (although *Hanafi* school is not State declared school and in *Government of N.W.F.P. v. Said Kamal Shah* the Supreme Court has declared that no School of thought is prohibited unless it contradicts with the general principle of Quran and *Sunnah*)⁷ and under above table the right of ownership of petroleum goes with the surface owners and PRESIDENT of Pakistan has no right to grant concession to the company but under the constitution of Pakistan, if the GoP acquires the property on public interest basis it should pay compensation to the private owners (Art. 23,

⁷ See *Government of N.W.F.P. v. Said Kamal Shah* (PLD 1986 SC 360 at p.474).

24 & 173) and if the exploration remains successful it would be the prior right of the government of that province (but in PCA the government means the Federal Government which creates confusion which needs to be clarified) to get the royalty and that major portion of that royalty should be spent on the progress and development of the people of that province as is the situation with Balochistan province. Although there is much exploration of minerals but the development of that province is critical one.

2. Payment Mechanism and Project Financing

(a) Payment Mechanism

The second issue in PCA which needs serious consideration by the concerned authority is the element of *riba* (interest) in the payment mechanism. The relevant clauses in PCA and Joint Operating Agreement (JOA) are 10.6 and 6.5(ii) respectively.

A study of the above clauses shows the presence of elements of *riba*. On the other hand, *Shari'ah* is equally hostile to any commercial operation containing any element of *riba* which could possibly amount to violation of the rule, found in the Holy Quran and the *Sunnah* of the Holy Prophet (s.a.w.) against the interest and therefore is a cause of disorder in the Muslim society. While the general principle for the prohibition of *riba* was given in Chapter 1 but as the issue needs more clarification we now see why *riba* is prohibited under

Shari'ah. Following points present the logic behind the strict prohibition of *riba* under *Shari'ah*.

(i) Commercial Exploitations

The primary objective of *Shari'ah* is to encourage those commercial activities which would not be exploitative as well as becoming an end itself. As *riba* is exploitative in nature *Shari'ah* exhorts its adherents to refrain from *riba*, which translates literally as unlawful or exploitative gains.⁸

(ii) Sheer Injustice

Under *Shari'ah*, *riba* is prohibited because it develops injustice in the society. Not only has this but it given rise a series of injustices the scope of which is widened expanded day by day.

(iii) Earning of Money through Unfair Trading Practices

One of the *Shari'ah's* objectives is to base the financial system on equity, fairness and justice. *Shari'ah* is not against the earning of money. In fact, it prohibits earning of money

⁸ Ibn Qayyim-al-Jawziyya and Muhammad bin Abi Bakar (d. 751/1350). *I'lam al-Muwaqqa'in 'ala Rabba el-Aalamin*, ed. Taha 'Abd al-Rauf Ja'd. (Beirut: Dar al-Jil, 1973) quoted in Frank E. Vogel & Samuel L. Hayes, III, *Islamic Law and Finance, Religion, Risk and Return* (The Hague, London, Boston: Kluwer law international, 1998) 82.

through unfair trading practices and other activities that are socially harmful in one way or another.⁹

Allah Almighty Says:

“Those who devour usury will not stand except as stands one whom the Evil One by his touch hath driven to madness. That is because they say: “Trade is like usury”, but God 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 God (to judge); but those who repeat (the offence) are Companions of Fire: they will abide therein (for ever)”.¹⁰

(vi) *Enrichment of One Person (or a Company or State) at the Cost of Others*

Shari'ah's stress on the prohibition against *riba* seeks not just to forbid loans involving usury but all forms of activities that enrich one individual at the cost of others. The following excerpt from comments made by Umer Chapra to differentiate between various forms of *riba* illustrates the point being made:

“The panel has defined *Riba* as equivalent to interest (First Report, P.1) whereas the *Riba* has been given considerably wider connotations in *Fiqh* literature than what the term interest conveys. Interest refers to what has been termed as *Riba al-nasia'ah* or *Rib al-jali* or *Riba al-duyan* in the *Fiqh* literature. This is the kind of *Riba* that is covered by the Qur'anic ayah. However, the *Sunnah* has also emphasized other aspects of *Riba* generally termed as *Riba al-fadl* or *Riba al-khafi* or *Riba al-buya*. This form of *Riba* covers all forms of economic injustice, exploitation and unearned income (other than that, like inheritance and genuine gifts, allowed by the *Shari'ah*). Ibn Arabi has defined *Riba* as all excess over what is justified by consideration... According to Holy Prophet (s.a.w.) a Muslim could indulge in *Riba* in a number of ways. That is why Caliph felt inspired to say that “you should abstain from *Riba* as well *Ribah* ... *Ribah* is from rayb which literally means doubt and the mind about its

⁹ Hairetdinov, Ravial, “Islamic Financial System,” http://islamic-world.net/economics/financialsystem_02.html. (accessed December 24, 2005).

¹⁰ Holy Quran, 2:275.

rightfulness. It covers all income derived from injunction to, or exploration of, others.”¹¹

So, after describing briefly the reasons for the prohibition of *riba*, it is now incumbent on all Muslims, transacting in petroleum industry to avoid from any type of *riba* based activity and especially the GoP to remove all hurdles which are on the way of having a *riba*-free society and also it is incumbent upon the GoP to amend the above-mentioned PCA's articles and bring them in accordance with the *Shari'ah* principles so, to get the pleasures of Allah Almighty and His mercy and also the pleasure of His Messenger(s.a.w.).

(b) Project Financing

The relevant Article for Project Financing in PCA is Article-XIX. In this Article, the GoP has promoted the conventional project financing which definitely entails *riba*-based financing and such contractual relationships involving *riba* are strictly against the *Shari'ah*. The solution for the GoP is to use *riba* free modes of financing in petroleum industry.

Under the conventional project financing, money lent contains element of *riba*. But as we have discussed earlier that under *Shari'ah* all business practices that involve the use of *riba* are strongly prohibited under the Holy Quran and the *Sunnah* of the Holy Prophet (s.a.w.).

¹¹ Chapra, M.U. “Comments on II Report on Elimination of Interest” in Money and Banking in Islam (Islamabad 1983, PP 212-223), quoted in Murtaza, Athar, “Islamic Antecedents for Financial Accountability,” *International Journal of Islamic Financial Services*, Vol.4, No.1, [http://islamic-finance.net/Journals/journal13/vol4 no1art 1.pdf](http://islamic-finance.net/Journals/journal13/vol4%20no1art1.pdf) (accessed March 3, 2006).

(i) *Shari'ah* Appraisal of Conventional Project Financing

Project financing techniques have become a primary means for financing a broad range of economic units throughout the world. The application of these techniques has been refined in most industrial categories and with respect to most types of assets. For example, they are used for financing of power generation, transmission and distribution assets, for upstream, midstream and downstream assets in oil and gas industries etc.¹²

The conventional financing of infrastructure raises some ethical concerns because the contractual mechanism used to achieve the same should conform to the established principles of *Shari'ah* and be free from *riba*, *gharar*, *maysir*, *dharar*, and like that. Conventional project financing invariably involves conventional financiers and therefore, *riba*-based borrowing and lending. This needless to say, is not permissible in the *Shari'ah* framework.

(ii) *Shari'ah* Alternatives for Financing

There are several methods of *Shari'ah* financing. However, in the world of commercial financing and more particularly, project financing, certain methods are more commonly encountered than others like *mudarabah*, *murabaha*, *musharaka*, *ijarah*, *bay'al-Salam* or *istisna'a*. A summary structure of these is set below:

¹² McMillen, Micael J.T., "Islamic *Shari'ah*-Compliant Project Finance: Collateral Security and Financing Structure Case Studies," p.2, <http://www.kslaw.com/library/pdf/mcmillenislamic2.pdf>. (accessed April 14, 2006).

- ***Mudarabah* (Profit Sharing)**

"*Mudarabah*" is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called "*rabb-ul-mal*", while the management and work is an exclusive responsibility of the other, who is called "*mudarib*"¹³

The main point which is involved in the "*Mudarabah*" mode of financing is that both of the parties will share the profit but in case of fiscal loss, the "*mudarib*" will not suffer with financial losses, but "*rabb-ul-mal*" is under obligation to suffer financial losses as he loses finance, which he used in the *Mudarabah* arrangement.

The concept of "*Mudarabah*" was available in Pre-Islamic era and it was not prohibited after the Dawn of Islam. This mode is entirely based on a non-interest system of finance and in *Mudarabah's* fiscal arrangement in which ideal *Mudarabah* is the instrument and/or product in interest free economic system in which there is no exploitation of skill and talent due to non-availability of funds and finances. The *Mudarabah* is a fiction of Law and Economics, which is to be called as marriage of brain and finance.¹⁴

¹³ Usmani, Maulana Taqi, "Islamic Finance, Musharakah & Mudarabah," <http://www.darululoomkhi.edu.pk/fiqh/islamicfinance/islamicfinance.htm>, (accessed December 2, 2005).

¹⁴ Ansari, Saalim Salam, "Legal Aspects Of Mudarabah In Pakistan," <http://www.pakistanlawsonline.com/lawonline/law/Article.asp> (accessed April 26, 2006).

- ***Murabaha* (Cost-Plus/Mark-Up Financing)**

In Islamic finance, where interest-bearing lines of credit are forbidden, a close substitute to the line of credit is found in the *Murabaha* transaction, which involves the sale of goods with a profit markup built into the price. For example, if a builder needs to finance \$10,000 of raw materials, he can arrange for an Islamic bank or the other investor to purchase the goods on his behalf, add a profit margin, and then resell him the goods for, say, \$11,000.¹⁵

Maulana Taqi Usmani says,

"*Murabaha* is, in fact, a term of Islamic Fiqh and it refers to a particular kind of sale having nothing to do with financing in its original sense. If a seller agrees with his purchaser to provide him a specific commodity on a certain profit added to his cost, it is called a "*murabaha*" transaction. The basic ingredient of "*murabaha*" is that the seller discloses the actual cost he has incurred in acquiring the commodity, and then adds some profit thereon. This profit may be in lump sum or may be based on a percentage. The payment in the case of *murabaha* may be at spot, and may be on a subsequent date agreed upon by the parties. Therefore, *murabaha* does not necessarily imply the concept of deferred payment, as generally believed by some people who are not acquainted with the Islamic jurisprudence and who have heard about *murabaha* only in relation with the banking transactions."¹⁶

- ***Musharakah* (Partnership/Profit Sharing Financing)**

Another *Shari'ah* mode of financing is "*Musharakah*" or profit sharing financing.

Musharakah is an arrangement of business or its financing in which parties contribute their

¹⁵ Frank E. Vogel & Samuel L. Hayes, III, *Islamic Law and Finance, Religion, Risk and Return* (The Hague, London, Boston: Kluwer law international, 1998), 182.

¹⁶ Usmani, <http://www.darululoomkhi.edu.pk/fiqh/islamicfinance/islamicfinance.htm>.

money or skills or a combination of all these components. In this arrangement profits are shared in pre-agreed proportion but loss, if any, is borne by the capital only.¹⁷

Islamic banks provide project finance on the basis of *musharakah*. One or two or more entrepreneurs approach the bank for finance and the bank along with other partners provides complete finance. All the partners, including the bank, have the right to participate in the management of the project. Any one or all of them also have right to waive this right. The profits are distributed according to agreed ratios, which need not be the same as capital proportion but loss has to be shared exactly in the same proportion in which different partners provided finance.

Since the finance in the above mentioned case is provided completely by the bank and its partners, they jointly assume the role of *arbab al-mal* (financers) and the entrepreneurs, the *Mudaribun*. Thus, it is type of *Mudarabah* partnership. But if the investment is provided by the both parties, i.e. the bank and entrepreneurs or the businessmen then it is a *musharaka* arrangement.¹⁸

¹⁷ Siddiqi, Asrar H., *Practice and Law of Banking in Pakistan*, Sixth Ed., (Karachi: Royal Book Company, 1997), 311.

¹⁸ Mansoori, 272-73.

- ***Ijarah* (Leasing)**

The fourth mode of financing is "*Ijarah*" or leasing. "*Ijarah*" is a term of Islamic fiqh. Lexically, it means 'to give something on rent. In the language of law it means lending of some object to somebody in return for some rental against a specified period.¹⁹

In this form the bank (the lessor) purchases a specific property or asset for a specified time. Then the asset is leased to customer (lessee) for a specified rent for the duration of its economic life. The bank (lessor) retains the ownership of the asset and the customer (lessee) has the right to use it as long as it pays the rentals as per agreement. At the end of the specified duration the asset reverts back to the bank (lessor), however, quite often the customer (lessee) is given an option to purchase the asset from the bank (lessor) at a mutually agreed amount.²⁰

Modern Islamic finance often combines leasing with purchase in a single contract called hire-purchase, or *ijarah wa-iqtina*. Under such a contract the lessee pays, in addition to lease, a sum which goes toward buying the leased property. Properly the lessee is given credit for his payments by becoming in ever-increasing degree the owner of the property, with the

¹⁹ Usmani, <http://www.darululoomkhi.edu.pk/fiqh/islamicfinance/islamicfinance.htm>.

²⁰ Siddiqi, 314.

result that the proportion of his payments that goes for rent also continually reduces. The result is not dissimilar to mortgage.²¹

- ***Bay'al-Salam* (Markup-Base Financing)**

Salam is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. Here the price is cash, but the supply of the purchased goods is deferred. The buyer is called "*rabb-us-salam*", the seller is "*muslam ilaih*", the cash price is "*ra's-ul-mal*" and the purchased commodity is termed as "*muslam fih*".

It is basically a mode of financing for small farmers and traders. This mode of financing can be used by the modern banks and financial institutions, especially to finance the agricultural sector.²²

- ***Istisna'a* (Commissioned Manufacture)**

In *istisna'a*, or "commissioned manufacture", one party buys goods that the other party undertakes to manufacture according to specifications given in the contract.²³ As we know the principle of *gharar* prevents one from selling something that one does not own. The

²¹ Frank E. Vogel and Samuel L. Hayes, III, 114.

²² Usmani, <http://www.darululoomkhi.edu.pk/fiqh/islamicfinance/islamicfinance.htm>.

²³ Frank E. Vogel and Samuel L. Hayes, III, 146.

technique of *Istisna'a* has been developed as an exception to this. As defined by the Islamic Development Bank, *Istisna'a* is 'a contract whereby a party undertakes to produce a specific thing that is possible to be made according to certain agreed specifications at a determined price and for a fixed date of delivery'.

Accordingly, the technique is particularly useful in providing an Islamic element in the construction phase of a project, as it is akin to a fixed price turnkey contracts (A type of construction contract under which the construction firm is obliged to complete a project according to pre-specified criteria for a price that is fixed at the time the contract is signed).²⁴

In Pakistan the example of *Istisna'a* is HUB RIVER financing.

Following table shows the summary of main features of *Shari'ah* modes of financing.

Feature	Modes				
	<i>Mudharabah</i> (profit sharing)	<i>Musharakah</i> (profit sharing)	<i>Ijarah</i> (leasing)	<i>Murabah</i> (mark up-based)	<i>Bay'al-Salam</i> (markup-based)
Nature of financing	Investment based Not obliged to pay back total amount of financing	Investment based Same as in <i>mudharabah</i>	Leasing based Only rent is paid	Combination of trading and debt Obliged to pay back the entire financing	Combination of debt and trading Same as in <i>murabaha</i>
Role of capital provider in management of funds	Nil	Full account	Full control on the use of the finance	Same as in <i>ijarah</i>	Nil
Risk bearing by the capital	i. To the full extent of the capital as well as of the	To the extent of the proportion of capital in the total	Same as in <i>mudharabah</i>	To the full extent of the capital	Same as in <i>mudharabah</i>

²⁴ "Islamic finance: Basic principles and structures, A focus on project financing," (Freshfields Bruckhaus Deringer, January 2006), 4, www.freshfields.com/publications/pdf/2006/13205.pdf, (accessed April 4, 2006).

provider	opportunity cost of capital ii. For the entire period of the contract	investment of the enterprise Same as in <i>murabaha</i>	Until the asset completes its life or is finally disposed of	Only for a short period until the goods are purchased and taken over by the finance user	Even after the expiry of the contract until the goods are finally disposed of
Uncertainty of rate of return	Complete uncertainty	Same as in <i>mudharabah</i>	Same as in <i>mudharabah</i>	Uncertainty only for a short period of the contract	Same as in <i>mudharabah</i>
Cost of capital	Uncertain ex-ante	Same as in <i>mudharabah</i>	Fixed and pre-determined	Same as in <i>ijarah</i>	Same as in <i>mudharabah</i>
Implications on firm's financing choice	Between the two profit-sharing methods, <i>musharakah</i> has the edge over <i>mudharabah</i> as capital owner in the former case has the right to interfere in the management and have some control over problems created by informational asymmetry and moral hazard		Between the two fixed cost of capital modes, <i>ijarah</i> has the edge over <i>murabaha</i> as capital user in the former case is responsible only for the payment of the cost of capital and not responsible for the capital goods themselves		<i>Bay'al-Salam</i> provides the advantage to the seller of receiving cash in advance and the buyer the benefits of lower cost of purchase

Source: Adapted from Islamic Research and Training Institute (1991).

Table 3.2: Summary of main features of *Shari'ah* modes of financing

After having a general idea about *Shari'ah* modes of financing and given the added complexity and uncertainty, it may be asked why non-Muslims would agree to use Islamic finance structures. The principle answer is that Islamic finance provides an opportunity to tap into the significant funds of Islamic investors seeking *Shari'ah* compliant investments and it is also for those who invest in Islamic countries.

3. Insurance and Indemnification

The third issue under PCA is the conventional insurance system. Although in Article-XXIV there is no clear mentioning of insurance system to be followed except the reference of Pakistani laws on insurance which does not clarify the matter because the current Pakistani laws even do not seem to be in conformity with the *Shari'ah* principles. Our main focus like in previous discussion will be to get a general idea about the valid mode of insurance under *Shari'ah* so to get the bounties of Almighty Allah and His Messenger's (s.a.w.) pleasures.

(a) General Concept of Insurance and Its Validity under *Shari'ah* Law

Insurance, in the dictionary sense, is protection against risk, loss, or ruin, by a contract in which an insurer or underwriter guarantees to pay a sum of money to the insured or the beneficiary in the event of some contingency, as death, accident or fire, etc. in return for payment of premiums.²⁵ Some persons mistakenly believe that *tawakkul*, or trust on Allah Almighty means that no effort or activity should be undertaken at all nor should any steps be taken to fulfil present or future needs nor any arrangement be made. This wrong notion is the cause of creation of mis-understanding against *Shari'ah* through such explanations and comments. Trust in Allah Almighty does not at all mean renouncement of means and resources. It, on the contrary, means exploitation of resources to the fullest, leaving the result

²⁵ Council of Islamic Ideology, Government of Pakistan, Islamabad, *Report on Insurance System*, (Islamabad: Council of Islamic Ideology June, 1992), 17.

to Allah Almighty. Also to have such notions is to betray ignorance of the traditions of the Holy Prophet (s.a.w.). Here in our discussion we shall see briefly the *Shari'ah* appraisal of conventional insurance system and what the *Shari'ah* alternatives are in case the conventional insurance system does not comply with the *Shari'ah* principles.

(b) *Shari'ah* Appraisal of Conventional Insurance

A majority of *Shari'ah* scholars find conventional insurance inadmissible in the *Shari'ah* framework. They object that conventional insurance contains elements contradictory to *Shari'ah* like *gharar* (uncertainty), *maysir* (gambling) and *riba* (interest). The insurance contract contains *gharar* due to uncertainty whether the payment will be accepted as promised, the amount to be paid is not known and the time it will occur is not known. Any form of contract which is lopsided in favour of one party at the expense and unjust loss to the other is classified as *gharar*.

When a claim is not made the insurance company may acquire all the profits whilst the participant may not obtain any profit whatsoever. The loss of premiums on cancellation of a life insurance policy by the policyholder, or the "double standard" condition of charging a customary short period in general insurance, whilst only a proportional refund is made if the insurance company terminates the cover is also considered as unjust. In furtherance, conventional insurance involves *maysir* because the participant contributes a small amount of premium in hope to gain a large sum; the participant loses the money paid for the

premium when the insured event does not occur and the company will be in deficit if claims are higher than contributions. When a life insurance policyholder dies after only paying part of the premium his dependants receive a certain some of money which the policyholder has not been informed of and has no knowledge as to how and from where it has been derived.

Apart from the above, conventional insurance involves *riba* because an element of interest exists in conventional life insurance products - as the insured, on his death, is entitled to get much more than he has paid, insurance funds invested in financial instruments such as bonds and stocks contain an element of *riba*.²⁶

(c) *Shari'ah* Alternative for Insurance

As discussed above, conventional insurance is criticized due to *riba*, *gharar* and *maysir* while *Shari'ah* prohibits all the transactions which involve *riba*, *gharar* and *maysir*. To give an alternative to the prohibited conventional insurance, Muslim scholars have introduced the insurance system based on *Shari'ah* principles named *Takaful* insurance.

Takaful is a type of joint guarantee insurance mechanism based on the law of large numbers in which a group of societal members pool their financial resources against certain loss

²⁶ Ashraf, Mohammed, "Takaful Insurance Business", <http://www.accountancy.com.pk/articles.asp?id=157> (accessed April 5, 2006).

exposures.²⁷ *Takaful* is based on the Quranic concept of *taawun* (mutual assistance). Allah Almighty enjoins upon Muslims:

“...help ye one another in righteousness and piety, but help ye not one another in sin and enmity....”²⁸

Takaful fulfils all the conditions of above verse as it is based on the concept of social solidarity, cooperation and mutual indemnification of losses of members. It is a pact among a group of persons who agree to jointly indemnify the loss or damage that may inflict upon any of them, out of the fund they donate collectively. After the *Takaful* benefits are paid, the remaining surplus is paid back to the participants. Thus there is no element of gambling or unjust enrichment in this arrangement. Further, the transaction is clear-cut and transparent and there is no element of uncertainty or *gharar* with respect to the contribution and financial assistance.²⁹

(d) Difference between Conventional Insurance and Islamic Insurance

Mohammad Obaidullah³⁰ enumerates in brief the major points of difference between conventional mode of insurance and the mode which *Shari'ah* has prescribed. Both insurance modes are summarized as under in following table:

²⁷ Maysami, Ramin Cooper and Kwon, W.Jean, “An Analysis of Islamic Takaful Insurances – A Cooperative Insurance Mechanism,” <http://www.icmif.org/2k4takaful/site/documents/analysis> (accessed March 2, 2006).

²⁸ Holy Quran, 5:2.

²⁹ Obaidullah, Mohammad, *Islamic Financial Services*, Part V: Fund Management and Project Finance (Saudi Arabia: Islamic Economics Research Center, King Abdulaziz University) 125, www.islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html-6k (accessed April 6, 2006).

³⁰ *Ibid* at pp.125-126.

Conventional Insurance	Islamic Insurance
<ol style="list-style-type: none"> 1. It is based on profit-motive and aims to maximize returns to shareholders. The business of insurance is, in essence, "owned" by shareholders of the insurer company. 2. In case of conventional insurance insurer's profits include underwriting surplus, which is the difference between total premium received from and total claims and benefits paid to policyholders. Essentially, comprises underwriting surplus plus investment income. The distribution of profits or surplus is a managerial decision taken by the management of the insurer. As a result there is a conflict of interest between shareholders of the insurer company and the policyholders. 3. In case of conventional insurance, the sources of laws and regulations are set by the state and are man-made. A manifestation of this is in the right of insurable interest that is vested in the nominee absolutely in conventional life insurance. 	<ol style="list-style-type: none"> 1. It is based on the motive of community welfare and protection. The business of insurance is, in essence, "owned" by the policyholders and the operator company acts as the agent-manager. 2. In case of Islamic insurance, on the other hand, the operator has no claims in underwriting surplus. Further, it is the <i>takaful</i> contract, not the management of the operator company that specifies in advance how and when profit will be distributed. There is little room for conflict between interests of shareholders of the operator company and the policyholders. 3. In case of Islamic insurance, the laws and regulations are based on divine revelations. The same, however, is determined by Islamic principles of <i>faraid</i> in case of Islamic insurance.

<p>4. Just as in case of the insurer, the insured or policyholders may or may not be governed by the profit motive. For instance, in conventional insurance, the insured or policyholder may decide between original cost or replacement cost as the basis of valuation and claim accordingly – whether or not they chose to rebuild property.</p>	<p>4. In Islamic insurance, however, the insured may not “profit” from insurance and are entitled to compensation only for repair or rebuild or replacement.</p>
<p>5. In conventional insurance the investment of premiums is entirely at the discretion of the insurer with no involvement by the policyholders. As such investment usually involves prohibited elements of <i>riba</i> and <i>maysir</i>.</p>	<p>5. In Islamic insurance, on the other hand, the <i>takaful</i> contract specifies how and where the premiums would be invested. By definition such investment would exclude prohibited areas.</p>
<p>6. In case of dissolution of the former, reserves and excess/surplus belong to the shareholders.</p>	<p>6. In case of dissolution of the latter however, reserves and excess/surplus could be returned to participants, or donated to charity. Most scholars would prefer the latter course of action.</p>
<p>7. The conventional insurance company has not an additional obligation of annual payment of <i>zakat</i>.</p>	<p>7. The Islamic insurance company has an additional obligation of annual payment of <i>zakat</i>.</p>

Table 3.3: Conventional and Islamic modes of insurance

So, from above discussion, it has become clear that the conventional insurance system is not in conformity with the *Shari'ah* principles and it is incumbent upon the GoP to introduce that insurance system in PCA which should not contain any type of *gharar*, *maysir* and *riba* so that we the Muslims should get the compassion, mercy and kindness of Allah Almighty and the pleasures of the Holy Prophet (s.a.w.).

4. *Shari'ah* Compliance of Events for the Frustration of Contract (*Force Majeure*)

In PCA, the relevant Article for the *force majeure* i.e. frustration of contract is Article-XXVII. Apparently this Article is not in contradiction with the *Shari'ah* principles, but to give readers a more elaborative concept of *force majeure* which is general exception to the principle of *pacta sunt servanda*,³¹ I will try to explain in what situations *Shari'ah* allows to escape from the sanctity given to a contract by taking the plea of *force majeure*.

As said above, *force majeure* is an exception to the general principle of *pacta sunt servanda* which also get support from various Quranic verses and Ahadith of the Holy Prophet (s.a.w.).³² Few of them are quoted as:

Allah Almighty says;

“Oh ye who believe! fulfill all your obligations (contracts)”.³³

³¹ Contracts are to be kept/ sanctity should be given to contracts.

³² Schacht, '*Islamic Law in Contemporary States*', American Journal of Comparative Law, 1959, p. 139; Habach, '*Property Right and Contract in Muslim Law*', Columbia Law Review, 1962, p.459 et seq., quoted in Ballantyne, William M, "*The Application of the Islamic Shariah*" a paper published in "*The Shari'a and its relevance to modern transactional transactions*, Arab Comparative & Commercial Law, The International Approach, Vol. 1 (Graham & Trotman, 1987) 12.

Another verse equally implores the Muslims to observe his obligations;

“Nay but (the Chosen of Allah) is he who fulfils his covenant”.³⁴

The Holy Prophet (s.a.w.) also commented on the Quranic injunctions:

“Muslims are bound by their stipulations/agreements (Al-Muslimun ala-shurutihim)”

A great Hanbali Jurist, Ibn Taimiyya, in propounding the theory of the sanctity of contract, opined that transactions not expressly forbidden at the *Shari'ah* are permissible: men shall be permitted, to make all the transactions they need, unless these transactions are forbidden by the Book or by the *Sunnah*”.³⁵ To quote again from the Aramco Award:

“Muslim law does not distinguish between a treaty, a contract of public or administrative law and a contract of civil or commercial law. All these types are viewed by Muslim jurists as agreements or pacts which must be observed, since God is a witness to any contract entered into by individual or collectivities; under Muslim law, any valid contract is obligatory, in accordance with the principles of Islam and the law of God as expressed in the Quran...”³⁶

The principle was further recorded by Professor Rene-Jean Dupuy:

“The observance of contracts, generally speaking, is proclaimed by the Quran (see in particular Sura V, 1), the practice of the Holy Prophet, which is the second source of law in Islam (Bukhari, II, 187).....This principle applies not only to agreements concluded by private persons, but also to agreements entered into by sovereign. Nor any official is exempt as a matter of privilege”.³⁷

³³ Holy Quran, 5:1.

³⁴ Holy Quran, 3:76.

³⁵ Laoust, *Le Traité de Droit Public d'Ibn Taimiyya*, translation of *'Siyaaasa Shar'iyya'*, Beirut 1948, p. 167, quoted in *"The Shari'a and its relevance to modern transactional transactions"*, Arab Comparative & Commercial Law, The International Approach, Vol. 1 (Graham & Trotman, 1987) 12.

³⁶ Laoust, *'Essai sur les Doctrines Sociales et Politiques de Taqi ad-Din Ahmad bin Taimiyya'*, Cairo 1939, p. 445, para. 1; Aramco Arbitral Award as quoted at p. 56, quoted in *"The Shari'a and its relevance to modern transactional transactions"*, Arab Comparative & Commercial Law, The International Approach, Vol.1 (Graham & Trotman, 1987) 12.

³⁷ Libya-Texaco Award, January 19, 1977, quoted in *"The Shari'a and its relevance to modern transactional transactions"*, Arab Comparative & Commercial Law, The International Approach, Vol.1 (Graham & Trotman, 1987) 12.

As we have seen above that generally *Shari'ah* strictly forces the parties to fulfill their commercial commitments (i.e. contracts) but on the other hand *Shari'ah* relaxes this rule if there is happening of any event beyond the control of any party in the contract.

About the rule of relaxation, the Quranic policy can be found in the following verses of the Holy Quran:

“Allah has chosen you, and has imposed no difficulties on you in religion”.³⁸

Certain legal rules (maxims) also cover the above subject, for example;

“Necessity (*dharura*) allows actions which would otherwise be prohibited.”

The above rule broadens the scope of activity there are counter-rules to prevent the misuse of permissibility and relaxation. One such counter-rule, as laid down by some jurists, reads as;

“Permissibility when exceeds will be narrowed down”

This rule, though not discussed generally, has infact been in practice since the earliest days of Islam and provides us with significant policy guidelines.³⁹

It is concluded from the above discussion that the object of relaxation is to overcome the impediments in the smooth economic functioning of the society. But this requires defining

³⁸ Holy Quran, 22:78.

³⁹ The above-mentioned rules have not been systematically codified but may be found scattered throughout general treaties.

the true *Shari'ah* concept of relaxation which plays a very important role in elaborating the above *Shari'ah* principle. The concept not only forms the basis of many subsidiary rules but also lays down the limitations within which the main rule has to operate. Relaxation in the case of society or government becomes obligatory when the community feels that it would suffer an irreparable loss.

By summarizing the above *Shari'ah* principles about the sanctity of contract (*pacta sunt servanda*) and the rule of relaxation (*force majeure* i.e. frustration of contract: rule of excuse: *udhr*) it is obligatory upon the GoP to follow the conditions laid down by *Shari'ah* as interpreted by *Shari'ah* jurists (although this may not be the exhaustive list) while a party in PCA takes the plea of any event of *force majeure* as;

(a) Unforeseeability of the Events

To trigger relief, the supervening events must be unforeseeable. In most contracts, the standard is that of the average man, taking account of external circumstances as opposed to circumstances peculiar to the debtor.⁴⁰ Thus the event must only be "reasonably unforeseeable." A mere vague idea of the occurrence of an event in the future would not keep it from being reasonably unforeseeable. *Sanhoury* an Egyptian Muslim scholar

⁴⁰ Hussain Amer, *La responsabilite civile delictuelle et contractuelle*, Cairo, 1956, 137, pp.360-61, quoted in Rivkin, David W., *Lex Mercatoria and Force Majeure*, http://tldb.uni-koein.de/php/pub_show_document.php?pubdcid=116100 (accessed April 4, 2006).

concurs with this opinion and adds an important observation with regard to the point in time from which unforeseeability must be determined:

“An event is not considered foreseeable simply because similar events occurred in the past. An event which has already occurred may nonetheless remain unenforceable in the future if it is so rare that no particular reason exists to expect that it will occur again. With regard to contractual liability, unforeseeability is determined by reference to the time of the execution of the contract. If a certain event was unforeseeable at that time, the requirement is satisfied even if it becomes foreseeable after the execution of the contract and before its performance is required”.⁴¹

In addition to being unforeseen, the events should not affect the contracting parties alone but should affect a wide range of people. Such events are mainly natural catastrophes such as flood, sudden drought, etc. Thus unforeseen and exceptional events must result in the inability to perform a contractual obligation.⁴²

(b) The Inability to Perform Must Involve an Exorbitant Loss

The second condition is that inability to perform must involve an exorbitant loss. A mere decrease in anticipated profit is excluded. The loss should be disproportionate. Furthermore, it does not have to be assessed on the basis of the personal situation of the contracting parties

⁴¹ Sanhoury, *Traite de Droit Civil* (“al-Wassite”), Vol. 1, 3rd Ed. (Cairo, 1981) 1227-28, quoted in Rivkin, David W., *Lex Mercatoria and Force Majeure*, http://tldb.uni-koein.de/php/pub_show_document.php?pubdcid=116100 (accessed April 4, 2006).

⁴² Saleh, A. Samir, “Some aspects of frustrated performance of contracts under middle eastern law”, *International and Comparative Law Quarterly*, Vol. 33, No. 4 (JSTOR: Oxford University Press, Oct., 1984) 1050.

but on the basis of the objective elements of a particular transaction, regardless of whether the aggrieved party is wealthy or poor, solvent or bankrupt.⁴³

(c) The Event Must be of a General Nature

The third condition is that event must not be specific to the obligor. This requirement has been explained in the following way:

“The event must be of a general nature. It is not enough that the exceptional event, as grave as it might be, affect only the debtor or a small number of people. The debtor could not for example invoke his sickness, the death of his son, or the burning down of his house to obtain a revision of the contract. On the other hand, it is not necessary that the event affect everyone. It suffices that the debtor feels the effects of an event that affects a large number of people. A fire that destroys a city or an entire neighborhood constitutes an exceptional event of a general nature. Likewise, an event which affects a whole category of merchants or industries.”⁴⁴

(d) The Event Must Make the Performance Impossible

The fourth condition generally requires that the contract should become totally impossible to perform. Sanhoury says, “What matters is that impossibility of performance not be due to a failure or a defect peculiar to the obligor, but a cause which cannot be attributed to him”.⁴⁵

⁴³ *Ibid.*

⁴⁴ Abdullah Abdelbaki, *La theorie du contrat* (Cairo, 1948), pp. 547-48, quoted in Rivkin, David W., *Lex Mercatoria and Force Majeure*, http://tldb.uni-koein.de/php/pub_show_document.php?pubdcid=116100 (accessed April 4, 2006).

⁴⁵ *Ibid.*

(e) The Event Must Put an Excessive Burden

The fifth condition is that in case of the happening of the event, the party must have a threat of an excessive burden or loss. The loss can be measured in the narrow context of the transaction that gave rise to the contract. It does not matter that the effected party has large resources which would allow him to bear the loss with no great pain. The excessive burden of a debtor's obligation is judged in relation to the sole transaction that is the subject of the contract. If the obligor is menaced with a loss several times as large as an ordinary loss resulting from such a contract, the requirement of an excessive burden is met even if such a burden is not great in relation to the debtor's overall wealth.⁴⁶

Where *Shari'ah* releases the party from the performance of its contractual obligations through the doctrine of *udhr* i.e. *force majeure*, it also put restriction on it through the following *Shariah* rule:

“What is permissible under excuse becomes impermissible after its end”.

The above conditions are equally applicable to individuals (also to companies) and government. Hassanuzzaman, while elaborating this rule takes the example of *bi'l wafa* (buy-back arrangement) and says:

“There was a time when, in some regions scrupulous lenders were not willing to advance loans to traders unless they had an axe to grind. It was on account of this excuse that “Ulama” in those regions legalized *bi'l wafa* (buy-back

⁴⁶ Sanhoury, 877, http://tldb.uni-koein.de/php/pub_show_document.php?pubdcid=116100.

arrangement) so that the traders had not to suffer due to lack of funds. The situation has now changed. The largest and the most organized source of finance are banks which mobilize and allocate most of national savings. Credit policy is controlled and monitored by central bank keeping in view the overall public interest. This has discarded the refusal of scrupulous money lender for not financing the needy producer or trader. The central bank may impose controls to ensure supply of funds to all the priority sectors or neglected sectors on terms and conditions that are in consonance with Islamic principles of finance, on the one hand, and attractive to both the parties on the other. Thus the legality of *bi'l wafa* will no longer remain permissible.”

Further he says;

“On higher level a government has the authority to levy tax for meeting budgetary requirements for public welfare projects only when it is short of public resources. In cases such as compensation for earthquake victims, the justification would cease after rehabilitation work is completed. Special purpose taxes thus need to be spent exclusively for those purposes. Any infringement would amount to breach of trust. As soon as the purpose is achieved, the permissibility of the tax would cease.”⁴⁷

By applying the above examples in our case, when the contract becomes frustrated and it becomes totally impossible to perform, then the doctrine of excuse will apply but in case such cause of frustration does not remain in existence then that party is bound by *Shari'ah* to fulfill its contractual obligations and he cannot take the eternal plea of *force majeure*.

So, this is the strict interpretation of *Shari'ah* of *force majeure*. Any party taking the plea of *force majeure* events must ensure that it complies with all the conditions mentioned and also it is the prime responsibility of GoP to implement *Shari'ah* in all type of commercial activities to promote the universal principles of equity and justice.

⁴⁷ Hassanuzzaman, http://islamic-world/economics/pic/title_03.gif.

D. SUMMARY ANALYSIS OF PCA UNDER SHARI'AH LAW

After having a detail review of PCA under *Shari'ah* law, following table shows the summary analysis of PCA.

Articles	<i>Shari'ah</i> Compliance	Issue for consideration
<i>Article-I: Definitions</i>	Full	
<i>Article-II: Rights and Liabilities</i>	Partial	President's ownership of minerals rights
<i>Article-III: Exploration and Work Programme</i>	Full	
<i>Article-IV: Relinquishment</i>	Full	
<i>Article-V: Working Interest Ownership</i>	Full	
<i>Article-VI: Discovery and Development</i>	Full	
<i>Article-VII: Assignment, Surrender of Areas and Termination of Agreement</i>	Full	
<i>Article-VIII: Wellhead Value</i>	Full	
<i>Article-IX: Royalty</i>	Partial	Federal government's right of royalty
<i>Article-X: Right of Acquisition of Petroleum</i>	Full	
<i>Article-XI: Disposal of Petroleum</i>	Full	
<i>Article-XII: Foreign Exchange</i>	Full	
<i>Article-XIII: Imports and Exports</i>	Full	
<i>Article-XIV: Taxation</i>	Full	

<i>Article-XV: Management and Operations</i>	Full	
<i>Article-XVI: Reports and Information</i>	Full	
<i>Article-XVII: Training and Employment</i>	Full	
<i>Article-XVIII: Contribution to Joint Operations</i>	Full	
<i>Article-XIX: Development Financing</i>	No	<i>Riba</i> based project financing
<i>Article-XX: Refinery, LPG and Natural Gas Processing Plants</i>	Full	
<i>Article-XXI: Other Minerals</i>	Partial	Ownership of minerals
<i>Article-XXII: Audit</i>	Full	
<i>Article-XXIII: Production Bonuses</i>	Full	
<i>Article-XXIV: Insurance and Indemnification</i>	Partial	<i>Riba</i> based conventional mode of insurance
<i>Article-XXV: Parent Company/Bank Guarantee</i>	Full	
<i>Article-XXVI: Effectiveness and Duration</i>	Full	
<i>Article-XXVII: Force Majeure</i>	Partial	Strict interpretation of <i>force majeure</i>
<i>Article-XXVIII: Arbitration</i>	Full	
<i>Article-XXIX: Miscellaneous</i>	Full	
<i>Article-XXX: Notices</i>	Full	

Table 3.4: Summary Analysis of PCA under *Shari'ah* Law

Chapter 4

REVIEW OF GOVERNMENT OF PAKISTAN'S PRODUCTION SHARING AGREEMENT (PSA) UNDER SHARI'AH LAW

CHAPTER 4

REVIEW OF GOVERNMENT OF PAKISTAN'S PRODUCTION SHARING AGREEMENT (PSA) UNDER SHARI'AH LAW

A. HISTORICAL BACKGROUND OF PSA

All over the world, PSAs are the most common types of contractual arrangements for petroleum exploration and development. In Pakistan, PSA is not having a long history as compared to PCA. As discussed in Chapter 3, GoP issued its first PCA in 1969 and till 2001 its petroleum industry has experienced almost seven PCAs. While, on the other hand, GoP's PSA's history can be linked with the long experience of world petroleum industry based on the introduction of first PSA by Indonesian government in 1966, although in that early period IOC's were reluctant to sign PSAs with the HCs as there were no exclusive ownership rights vested with the IOCs under PSAs as compared to the PCAs and their rights were limited to the production which they had to share on the agreed formula after the commercial discovery was made. Similarly the other major reason of introducing PSA was the issue of sovereignty in offshore areas, the latest example being the Caspian offshore oilfields.¹

¹ This short background of PSA is based on the discussion with Mr. H. Mubashar Anwar Rana, Assistant Director Exploration, Ministry of Petroleum & Natural Resources, Government of Pakistan.

Considering the above issue of sovereignty in offshore oilfields and experiencing the successful use of PSAs in all over the world, GoP issued its first Model PSA² in July 2003 which reflects all the commercial incentives offered and transcribed in appropriate language in field.³

B. LEGISLATION SUPPORTING PSA

As discussed in previous chapter, the basic legislation which regulates petroleum exploration and production operations in Pakistan is the Regulations of Mines and Oilfields and Mineral Development (Government Control) Act, 1948 (The Act 1948). The Act 1948 is essentially an enabling law under which the Federal Government is empowered to make rules for the regulation of the activities, *inter alia*, related to the exploration and production of petroleum. The Act 1948 was subsequently amended through an Ordinance titled, the Regulation of Mines and Oilfields and Mineral Development (Government Control) (Amendment) Ordinance, 1976. The provision which empowers the Federal Government to grant the PSA is reproduced here as;

3A. Production sharing agreement.- (1) Notwithstanding anything contained in any other law or rules for the time being in force, the President may enter into an agreement with any company, whether incorporated in Pakistan or outside Pakistan, for the grant of a licence or lease to explore, prospect, and mine petroleum on the basis of a Production Sharing Agreement and on such terms and conditions as may be agreed upon between the Federal Government and the company.

² GoP's Model PSA 2003 also reflects the provisions of Petroleum Policy 2001 like Model PCA 2001.

³ Arif, Muhammad, "Pakistan Production Sharing Agreement: Offshore Fiscal System," *Oil, Gas & Energy Law Intelligence*, Vol.3 – issue 1, March, 2005, www.gasandoil.com/ogel/Issue (accessed December 25, 2005).

(2) Notwithstanding anything contained in the Income Tax Act, 1922 (XI of 1922), a company with which an agreement such as is referred to in sub-section (1) is for the time being in force shall not be liable to pay tax on its income, profits or gains.

The Act of 1948 under its section 2 also empowers the Federal Government to make rules for the exploration and production. The rules providing the legal coverage to the offshore production sharing regime are Pakistan Offshore Petroleum (Exploration and Production) Rules, 2003 (Rules 2003) which were promulgated after extensive consultation with the stakeholders.

Similarly to give more incentives to the IOCs, the GoP announced its petroleum policy in 2001. This 2001 Policy could be termed as one of the most ambitious attempt by the GoP in promoting offshore exploration and production activities in Pakistan by offering maximum fiscal incentives to the exploration and production companies.⁴ The company which signs the PSA also has to follow, among others the Territorial Waters and Maritime Zones Act, 1976, Income Tax Ordinance, 2001 (fifth schedule), Pakistan Environmental Protection Ordinance, 1997 and Mines Act, 1923.

⁴ Arif, www.gasandoil.com/ogel/Issue.

C. REVIEW OF PSA UNDER SHARI'AH LAW

1. Introduction

The sovereignty of an Islamic state is conditional upon compliance with the *Shari'ah* from which it obtains legitimacy. In an Islamic society, the wisdom of people, the validity of their decisions and their power to implement their aspirations is entirely subjected to the will of Allah Almighty as it is expressed in the *Shari'ah*.⁵ To ignore these facts is to ignore our responsibility in life. To lead a life apart from that given by Allah Almighty and His Messenger (s.a.w.) is to invite misery and oppression as individuals and as a nation of believers. Mankind is only truly freed up for progress by living in accordance with Allah Almighty's given instructions, and within a system given by one Creator. To accept otherwise is to invoke the wrath of Allah Almighty. If we examine this aspect of *Shari'ah* in our commercial activities, we will find a long list of practices declared illegal, most of which can and making people millionaires in the capitalist system. For example, the presence of *riba*, *maysir*, *gharar*, *qimar* etc. and no principle of liability for loss and entitlement to profit like that in our daily contractual arrangements. While *Shari'ah* forbids all these elements and allows freedom of earning wealth and doing commercial activities only by those means through which a person renders some real and useful service to the community and thereby entitles himself to fair and just compensation for it. It is not at all objectionable under

⁵ Nomani, Farhad and Rehnema, Ali, *Islamic Economic Systems* (London & New Jersey: Zed Books Ltd., 1994) 2.

Shari'ah if, working with these limits, a man becomes a millionaire; rather, this will constitute a Divine favour. But in the interests of the parties and the community as a whole, *Shari'ah* imposes certain conditions which must be fulfilled and avoiding those will result in nullity of the contractual arrangements.⁶

The main object of this study is to explore those prohibited elements which are made part of PSA. As we have seen while reviewing PCA in previous chapter that certain articles of PCA are partially or fully hostile to *Shari'ah* principles like the issue of ownership of minerals, *riba* based payment mechanism and project financing; *riba* based conventional insurance and indemnification system and the issue of *force majeure*. Similarly, while reviewing PSA it has come out that most of the prohibited elements present in PCA are also part of PSA like the issues referred above. But the distinguishing feature of PSA from PCA is the presence of element of uncertainty (speculation) in production sharing. The relevant article in PSA is Article VI. Now we discuss in detail *Shari'ah* prohibition of contracts containing risk and speculation.

2. Shari'ah Prohibition of Contracts Containing Gharar (Risk, Uncertainty and Speculation)

It has to be fully kept in mind that the injunctions of the *Shari'ah* seek to benefit human beings and eliminate harm. But those benefits and harms are not entirely left to the judgment

⁶ Maududi, <http://www.jamaat.org>.

of man. In a large number of cases those benefits and harms have been specified in the Holy Quran and the *Sunnah* of the Holy Prophet (s.a.w.) and should be made the criteria of judgment. While considering the elements of benefit and harm, the *Shari'ah* prohibits those transactions and activities that involve ignorance, uncertainty, risk and speculation.⁷

Muhammad S. Karim writes that "Muslim law is equally hostile to any commercial operation containing risk which could possibly amount to a violation of the rule, found in the Holy Quran against gambling and therefore is a cause of disorder".⁸

The scriptural foundation of the rule is found in various verses of the Holy Quran. For example, the Holy Quran says;

'O ye who believe! Intoxicants and gambling, (Dedication of) stones and (divination by) arrows, are an abomination,- of Satan's handiwork: Eschew such (abomination), that ye may prosper.⁹

The reason why the transactions involving *gharar* (risk) is prohibited is in order to exclude too much uncertainty and the possibility of speculations and they may also lead to disputes, strife and animosity. One major case of the unlawful transaction regarding risk is often reasoned as one party not sharing risk, and tries to acquire only the gain out of the transaction. Such a prohibition is applied not only to the obvious form as gambling, but also

⁷ Hassanuzzaman, http://islamic-world.net/economics/pic/title_03.gif.

⁸ Karim (2001)

⁹ Holy Quran, 5:90.

to the contract that is conventionally recognized to be useful in society, as insurance. All of these strictness lies on the understandings of *riba*, *gharar* and other principles.¹⁰

(a) Definitions of *Gharar*

Literally *gharar* means risk or hazard. It includes such elements as doubt, suspicion, uncertain conditions, the absolute lack of knowledge about and in determinability of the basic elements of the subject-matter.¹¹ In more elaborative form, Muslim scholars have defined *gharar* as follows;

- According to *Sarakhsi*: *Gharar* takes place where the consequences (of a transaction) remain unknown.¹²
- According to *Ibn-Hazm*¹³: *Gharar* in sales crop up where the purchaser does not know what he has bought and the seller does not know what he has sold.
- Ibn Abidin defines *gharar* in the following words: *Gharar* is uncertainty about the existence of the subject-matter of sale.¹⁴
- *Ibn al-Qayyim* has described *gharar* as being such a subject matter, the vendor is not in position to hand over to the buyer whether the subject matter exists or not.¹⁵

¹⁰ Miki, Haruka, "Risk Management and Humans, - From Social Perspectives," Hitotsubashi University, Tokyo, Japan, Faculty of Social Sciences, <http://members.jcom.home.ne.jp/tekato/05miki.htm> (accessed February 8, 2006).

¹¹ Mansoori, 95.

¹² Sarakhsi, Abu Bakr Muhammad Ibn Ahmad, *al-Mabsut*, vol. 13 (Beirut: Dar al-Ma'arif, 1978)194.

¹³ Ibn Hazm, *al-Muhallah*, vol.8 (Beirut: Dar al-Afaq al-Jadidah) 343-389.

¹⁴ Ibn Abidin, Muhammd Amin, *Radd al-Muhtar*, vol.4 (Quetta: Maktaba Majidiyyah, 1982) 147.

¹⁵ Ibn al-Qayyim al-Jawziyya, *I'lam al-Muqqi'n, an Rabb al Aalamin*, vol.1 (Cairo: Maktaba al-Kulliyah, 1968) 357.

- According to *Ibn Rushd*, *gharar* is to be found in contracts of sale when the seller suffers a disadvantage as a result of his ignorance, with regard to price of the article or the indispensable criteria relating to the contract or its object or quality or time of delivery.¹⁶
- *Sanhoury*, an eminent modern jurist is of the view that lack of knowledge about the material terms of contract is the distinct feature of a *gharar* contract. He says that *gharar* takes place in the following circumstances:
 - (a) when it is not known whether the subject-matter exists;
 - (b) if it exists at all, whether it can be handed over to the buyer;
 - (c) when want of knowledge affects the identification of the genus or species of subject matter;
 - (d) when it affects the quantum, identity or necessary conditions; and
 - (e) when it relates to the date of a future performance.¹⁷

(b) Prohibition of *Gharar* (Risk, Uncertainty and Speculation) under *Shari'ah* Law

Prohibition of *gharar* is another principle that governs all contracts and transactions. A contract is presumed to suffer from *gharar* if it is about:

- an occurrence about which the parties are unaware whether such an event will take place or not;

¹⁶ Ibn Rushd, Muhammad Ibn Ahmad, *Bidayat al-Mujtahid*, vol.2 (Lahore: Maktaba al-Ilmiyyah) 156.

¹⁷ Sanhoury, Abdul Razzaq, *Masadir al-Haqq*, vol.3 (Dar al-Marifah, 1967) 31-41.

- a thing that is not within the knowledge of the parties;
- a thing about which it is not known whether it exists or not;
- a thing whose acquisition is in doubt; and
- a thing whose quantum is unknown.¹⁸

General principles to avoid *gharar* in transactions can be concluded from Traditions, as reported to have been laid down by the Holy Prophet (s.a.w.); a contract must not be doubtful or uncertain as far as the rights and obligations of the parties are concerned. The object of the legal contract (*res in commercio*), must be precisely determined and terms must be clear and known.¹⁹

The following *Ahadiith* are representative of *Sunnah*'s instruction on *gharar*:

Abu Hurayrah (r.a.t.) narrated that the Holy Prophet (s.a.w.) forbade sale by pebbles²⁰ and the *gharar* sale i.e. indeterminate and speculative transactions;²¹

It is narrated by *Anas ibn Malik* that Allah's Messenger forbade the sale of fruits till they were ripe.

Allah's Messenger further said: "If Allah spoiled the fruits what right would one party have to take the money of his brother?"²²

Ali (r.a.t.) reported that the Messenger of Allah forbade forced purchases from a needy person and *gharar* purchase and the purchase of fruit before it reached maturity.²³

¹⁸ Mansoori, 95.

¹⁹ Hassan, Abdullah Alwi Haji, *Sales and Contracts in early Islamic Commercial Law*, (Islamabad: Islamic Research Institute, International Islamic University, 1993) 48.

²⁰ *Hasah*, sale of an object chosen or determined by the throwing of a pebble.

²¹ Muslim ibn al-Hajjaj Muslim, *Sahih, Kitab al-Buyu, Bab butlan Bay al-Hasat*, no. 1513, vol.3 (Beirut: Dar Ihya al-Turath al-Islami, Kitab al-Tijarat) 1153.

²² *Ibid*, *Kitab al-Buyu, Bab wad al-Jawa'ih*, 1190.

²³ Sulayman ibn al-Ashath al-Sijistani Abu Dawud, *Sunan, Kitab al-Buyu, Bab fi bay al-Mudtar*, no.3382, vol.3 (Cairo: Ihya al-Sunnah al-Nabawiyyah, 1975) 676.

Do not buy fish in the sea, for it is *gharar*.²⁴

(c) Philosophy behind Prohibition of *Gharar* (Uncertainty, Speculation and Risk) under *Shari'ah* Law

Shari'ah has not introduced the doctrine of *gharar* to discourage commercial activities, whether in enterprise, venture or speculation in the widest meaning, rather its purpose is to avoid any risk between the parties which is formed in any contract from the beginning. Any risk will result in profit for one party and comparative loss to the other party. This hazard brings about an inequitable or unfair and unjust gain and loss which amounts to gambling and usury. ²⁵I conclude my discussion with the words of Ramin Maysami.

He says;²⁶

“For long, Muslims have managed their lives and Islamic companies have operated businesses under the stringent guidelines of Islamic principles that emphasize, among others, equality in wealth distribution and shared responsibility among participants in business transactions. Muslim individuals, communities and even states have been discouraged from engaging in business activities if one faces uncertain outcomes and yet expects predetermined gains from financial transactions.”

Hence all speculative contracts are against the principles of Islamic legal system.

²⁴ Ibn Hanbal, Ahmad, *Musnad al-Imam Ahmad bin Hanbal*, (Cairo: al-Matba'a al-Yamaniyya, 1985; reprint, Beirut: al-Maktaba al-Islamiyya, 1978).

²⁵ Hassan, Abdullah Alwi Haji, 474.

²⁶ Maysami, Ramin. *An Analysis of Islamic Takaful Insurance- A Cooperative Insurance Mechanism*, International Cooperative and Mutual Insurance Federation, 2004., quoted in Miki, Haruka, “Risk Management and Humans, - From Social Perspectives,” Hitotsubashi University, Tokyo, Japan, Faculty of Social Sciences, <http://members.jcom.home.ne.jp/tekato/05miki.htm> (accessed February 8, 2006).

D. SUMMARY ANALYSIS OF PSA UNDER SHARI'AH LAW

After having a detail review of PSA under *Shari'ah* law, following table shows the summary analysis of PSA:

Articles	<i>Shari'ah</i> Compliance	Issue for consideration
<i>Article-I: Definitions</i>	Full	
<i>Article-II: Rights and Obligations</i>	Partial	President's ownership of minerals rights
<i>Article-III: Term and Exploration Work Programme</i>	Full	
<i>Article-IV: Relinquishment</i>	Full	
<i>Article-V: Discovery and Development</i>	Full	
<i>Article-VI: Production Sharing</i>	Full	Risk in production
<i>Article-VII: Assignment and Termination of Licence, Lease and Agreement</i>	Full	
<i>Article-VIII: Value for Royalty and Production Sharing Purposes</i>	Full	
<i>Article-IX: Royalty and Rentals</i>	Partial	Federal government's right of royalty
<i>Article-X: Right of Acquisition of Petroleum</i>	Full	
<i>Article-XI: Disposal of Petroleum</i>	Full	
<i>Article-XII: Foreign Exchange</i>	Full	
<i>Article-XIII: Imports and Exports</i>	Full	
<i>Article-XIV: Taxation</i>	Full	

Article-XV: Management Committee	Full	
Article-XVI: Management and Petroleum Operations	Full	
Article-XVII: Information, Data, Confidentiality, Inspection and Security	Full	
Article-XVIII: Titled to Petroleum, Data and Assets	Full	
Article-XIX: Training and Employment	Full	
Article-XX: Development Financing	No	<i>Riba</i> based project financing
Article-XXI: Pipelines, Processing Facilities and Refineries	Full	
Article-XXII: Other Minerals	Partial	Ownership of minerals
Article-XXIII: Accounts and Audits	Full	
Article-XXIV: Production Bonuses	Full	
Article-XXV: Insurance and Indemnification	Partial	<i>Riba</i> based conventional mode of insurance
Article-XXVI: Parent Company and Bank Guarantee	Full	
Article-XXVII: Effectiveness and Duration	Full	
Article-XXVIII: Force Majeure	Partial	Strict interpretation of <i>force majeure</i>
Article-XXIX: Sole Expert & Arbitration	Full	
Article-XXX: Protection of the Environment	Full	
Article-XXXI: Applicable Law and Miscellaneous Matters	Full	
Article-XXX: Notices	Full	

Table 4.1: Summary analysis of PSA under *Shari'ah* Law

CONCLUSIONS AND FUTURE PROSPECTS

CONCLUSIONS AND FUTURE PROSPECTS

Islam is a global phenomenon and its influence on society and economy is ubiquitous. Laws of *Shari'ah* promote the welfare of people by safeguarding their faith, life, intellect, property and their posterity. Allah Almighty nurtures, nourishes, sustains, develops and leads humanity towards perfection. Even though an individual may be making a living because of his efforts, he is not the only one contributing towards that living. There are a number of divine inputs into this effort and therefore, the results of such an effort obviously cannot be construed as entirely proprietary.

Principles of *Shari'ah* are of universal nature. On one side *Shari'ah* grants rights to the people and on the other side it strongly insists for the fulfillment of their obligations. The main focus remains on the maxim *LA DHARAR WA LA DHARAR* i.e. "*Don't wrong and don't be wronged*". Also the principles of justice, fairness and equity are at the top of *Shari'ah's* agenda.

The main objective of the *Shari'ah* is to educate the individual, establish justice and bestow benefits on the people in this world and in the hereafter and as such, everything departing

from justice to oppression, mercy to harshness, welfare to misery and wisdom to folly, runs counter to the tenets of the *Shari'ah*. In daily commercial activities, Muslims are ordered to manage their lives and the companies to operate commercial activities under the stringent guidelines of *Shari'ah* principles that emphasize, among others, equality in wealth distribution and shared responsibility among participants in business transactions. Muslim individuals, communities and even states are discouraged from engaging in business activities if one faces uncertain outcomes and yet expects predetermined gains from financial transactions.

As *Shari'ah* principles are quite different from those prevailing in Western capitalist societies, those who are unfamiliar with these principles may falsely conclude that *Shari'ah* does not promote profit-oriented business transactions. In fact, *Shari'ah* does encourage people to engage in business transactions as long as they do not expect a predetermined return even when the outcome of such transactions is uncertain. Also *Shari'ah* is very liberal in its business policy as long as the players in the business activities do not bring the elements of *riba*, risk, uncertainty, speculation, fraud, undue influence, inducement etc. in their commercial transactions. As we have discussed in detail that anybody who does a commercial activity based on *riba*, he actually starts a war against Allah Almighty and His Messenger and ultimately invites the wrath of Allah Almighty in this world and on the Day of Judgment. Also, any commercial activity involving speculation, risk, uncertainty leads to the nullity of that contractual arrangement.

Pakistan is an Islamic state. Article 2 of its constitution undertakes that *"Islam shall be the State religion of Pakistan"*. So there can be no enactment of any law repugnant to Islamic injunctions and to bring all laws in conformity with such injunctions. In view of declaration of Islam as State religion in Article 2, Pakistan's judiciary is constrained to apply principles of *Shari'ah* which are clearly based on principles of equity, justice and good conscience. Also in view of the objectives and compelling reasons by which our forefathers under the leadership of Quaid-e-Azam Muhammad Ali Jinnah had endeavoured and achieved Pakistan, the contents and declaration of Article 2 is understandable and there cannot be any ambiguity about that.

At an intellectual level, one must keep this thing in mind that *Shari'ah* is the only path which leads to success. Now it is incumbent upon GoP to seriously understand this issue and do the best to eliminate *riba* from every field of life. Holy Prophet (s.a.w.) in his Khutba Hujjat-ul-Wida said;

"All interest and usurious dues accruing from the times of ignorance stand wiped out. And the first amount of interest that I remit is that which Abbas ibn Abd-al Muttalib had to receive. Verily it is remitted entirely".

As we have seen while reviewing PCA and PSA that both the agreements contain the elements of *riba* and uncertainty that are categorically disallowed by the *Shari'ah* principles. Keeping in view the most common use of PSA and also PCA it is likely that modifications may be carried out in the existing structures of PCA and PSA to eliminate the un-Islamic

features to make them more acceptable to *Shari'ah* law. Hence the challenge is enormous and a great amount of work needs to be done in this greatly developing area but let us take the initiative and we hope Allah Almighty's mercy and His Messenger's prayers will make definitely the task easy. INSHAALLAH.....May Allah bless us...AAMEEN.

GLOSSARY

- ad-interim*: In the meantime.
- aima arba*: Four *Shari'ah* schools of thought.
- ahd*: Unilateral promise or undertaking although it also includes a bilateral obligation.
- aqd*: It is synonymous with the word "contract" found in modern law and it implies obligation arising out of a mutual agreement.
- batin*: Hidden or invisible.
- bay'al-Salam*: Markup-base financing.
- bi'l wafa*: Buy-back arrangement.
- concession*: Granting of certain rights called minerals or mining rights to an individual or an entity authorizing him or it, to explore for and, in case of a discovery, to produce and exploit, the mineral(s) object of the concession.
- de facto*: In fact, in deed, actually.
- dharar*: Injury.
- dharura*: Necessity.
- fiqh*: *Fiqh* is Islamic jurisprudence made up of the rulings of Islamic jurists (*Fuqaha*) derived from Holy Qura'n and *Sunnah* of the Holy Prophet (s.a.w.) to direct the lives of Muslims.
- force Majeure*: Frustration of contract.
- fuqaha*: Plural of *faqih* mean *Shari'ah* scholars.
- gharar*: Uncertainty, indeterminacy, speculation, hazard and risk.
- ghishsh*: Deception.
- huquq Allah*: Rights of God.
- ibadat*: Religious observations.
- ijarah*: Leasing.
- ijarah wa-iqtina*: Hire-purchase.
- ijtihad*: A technical term of Islamic law that describes the process of making a legal decision by independent interpretation of the legal sources, the Holy Qur'an and the *Sunnah* of the Holy Prophet (s.a.w.).
- inter alia*: Among other things.
- iqta*: Grant of property right.
- istisna'a*: Commissioned manufacture.
- khilabah*: Fraud.
- khutba hujjat-ul-wida*: Last sermon.
- la dharar wa la dharar*: Do not wrong and do not be wronged.
- muamalat*: Transactions.
- mithaq*: Contract that signifies earnestness and firm determination on the part of parties to fulfill the contractual obligations.
- maqasid al-Shari'ah*: Objectives of *Shari'ah*.
- maysir*: Games of chance.

mudarabah: Profit sharing.
murabaha: Cost-plus/Mark-up financing.
musharaka: Partnership/Profit sharing financing.
muslam fih: Purchased commodity.
muslam ilaih: Seller.
pacta sunt servanda: Contracts must be complied.
production sharing: Special form of subsoil use relations based on civil-legal contractual principles for relations between a Host Country and an International Oil Company with respect to prospecting, exploration and extraction of mineral resources
qimar: Gambling.
riba: Interest.
riba al-fadl: Excess compensation without any consideration resulting from a sale of goods.
rabb-ul-mal: Investor financier.
rabb-us-salam: Buyer.
res nullius: A thing belonging to no one. In international law, territory not under the sovereignty of any state.
shari'ah: The commands given by God to His servants, which have been brought by any of the prophets.
takaful: Joint guarantee insurance mechanism.
taawun: Mutual assistance.
tatfif: Default in duty.
turnkey contracts: construction contract under which the construction firm is obliged to complete a project according to pre-specified criteria for a price that is fixed at the time the contract is signed.
udhr: Excuse.
ummah: World-wide community of Muslims, the nation of Islam.
zahir: Apparent or visible.
zakat: Obligatory alms for Muslims.

BIBLIOGRAPHY

BOOKS

Ali, Abdullah Yusuf, *The Holy Quran: Translation and Commentary* (Islamabad: Dawah Academy), 2006.

Abu Dawood, *Sunan, Kitab Al-Buyu*, Book 22, Number 3327: Trans: Prof. Ahmad Hasan, <http://www.muslimaccess.com/sunnah/hadeeth/abudawud/022.html> (accessed June 12, 2006).

Bukhari, *Sahih, Kitab al-Ilm, Bab qowl al-Nabi rubba muballaghin aw 'a min sai'n*.

Blinn, Keith W.; Duval, Claude; Leuch, Honore' Le; Pertuzio, Andre', *International Petroleum Exploration & Exploitation Agreements: Legal, Economic, and Policy Aspects*, Barrons, 116 East 66th Street, New York, N.Y. 10021.

Black's Law Dictionary, Sixth Ed. West Publishing Company, U.S.A.

Curzon, LB, *Dictionary of Law*, Fourth Ed., International Law Book Services, Kuala Lumpur, 1994.

David Martyn R. (Edited by), *Upstream Oil and Gas Agreements with Precedents*, London, Sweet & Maxwell, 1996.

El-Malik, W., *Mineral Investment Under the Sharia Law*, Graham & Tortman, London, 1993.

Frank E. Vogel and Samuel L Hayes, III, *Islamic Law and Finance, Religion, Risk, and Return*, Kluwer Law International, The Hague, London, Boston, 1998.

Ghazi, Mahmood Ahmad, *Mudarabah Financing: an Appraisal*: Paper presented in the Conference on Islamic Corporate Finance: *Shariah based Solutions*,

Hassan, Ahmad, *Principles of Islamic Jurisprudence*: Islamic Research Institute, International Islamic University Islamabad, 1993.

Hassanuz Zaman, S.M, *Economic Guidelines In The Quran*, The Institute of Islamic Thought, Islamization of Knowledge-21, Islamabad: Islamic Research Institute Press, 1999.

Hassan, Abdullah Alwi Haji, *Sales and Contracts in early Islamic Commercial Law*, Islamic Research Institute, International Islamic University, Islamabad, 1993.

Haythami, *Majma' al-Zawa'id, Kitab al-Ayman wa al-Nudhur, Bab al-Shurut*.

Ibn Rushd, Muhammad Ibn Ahmad, *Bidayat al-Mujtahid*, Maktabah al-Ilmiyyah, Lahore.

Ibn Hanbal, Ahmad, *Musnad al-Imam Ahmad bin Hanbal*, al-Matba'a al-Yamaniyya, Cairo, 1985; reprint, Beirut: al-Maktaba al-Islamiyya, 1978.

Ibn Hazm, *al-Muhallah*, Dar al-Afaq al-Jadidah, Beirut.

Ibn Abidin, Muhammd Amin, *Radd al-Muhtar*, Maktabab Majidiyyah, Quetta, 1982.

Ibn al-Qayyim al-Jawziyyah, *I'lam al-Muqqi'n, an Rabb al Alamin*, Maktabah al-Kulliyah, Cairo, 1968.

Ibn Majah, *Kitab al-tijarat, Bab al-hathth 'ala al-makasib*.

Ibn Qayyim-al-Jawziyya, Muhammad bin Abi Bakar (d. 751/1350), *I'lam al-muwaqqa'in 'ala rabba el-Oalamin*, Edited by Taha ' Abd al-Rauf Ja'd. Beirut: Dar al-Jil, 1973.

Jennings Anthony, *Oil and Gas Exploration Contracts*, London, Sweet & Maxwell, 2002.

Kitab-ul-Amwal, No. 682 quoted from Dr. Yusuf-ud-Din, *Islam ka Muashi Nazariya*.

Kitab-ul-khiraj. Imam Abu Yusuf.

Laoust, *'Le Traite de Droit Publique d'ibn Taimiyya'*, translation of *'Siyaaasa Shar'iya'*, Beirut 1948, quoted from *"The Shari'a and its relevance to modern transactional transactions*, Arab Comparative & Commercial Law, The International Approach, Graham & Trotman, 1987.

Laoust, *'Essai sur les Doctrines Sociales et Politiques de Taqi ad-Din Ahmad bin Taimiyya'*, Cairo 1939, quoted from *"The Shari'a and its relevance to modern transactional transactions*, Arab Comparative & Commercial Law, The International Approach, Graham & Trotman, 1987.

Libya-Texaco Award, January 19, 1977, quoted from "*The Shari'a and its relevance to modern transactional transactions*, Arab Comparative & Commercial Law, The International Approach, Graham & Trotman, 1987.

Mansoori, Dr. Muhammad Tahir, *Islamic Law of Contracts and Business Transactions*, Islamabad: Shari'ah Academy, International Islamic University, 2005.

Muhammad ibn Yazid ibn Majah, *Sunan, Kitab al-tijarat Bab al-Bayyi ani ma lam yaftariqa*, Beirut: Dar al-Fikr.

Muslim, *Sahih Kitab al-Buyu*, Chapter 11: Truthfulness in Transaction and Description (of the defect in the commodity), Book 010, Number 3661: Trans.: Abdul Hamid Siddiqui, <http://www.muslimaccess.com/sunnah/hadeeth/muslim/010.html> (accessed June 12, 2006).

Muhammad ibn Ismail Bukhari, *Sahih*, Beirut: Dar al-Kitab al-Arabi, 1323 A.H., *Kitab al-Buyu, Bab Idha bayyana al-bayyi ani*.

Muslim ibn al-Hajjaj Muslim, *Sahih, Kitab al-Buyu, Bab butlan Bay al-Hasat...* Beirut: Dar Ihya al-Turath al-Islami, Kitab al-Tijarat.

Mawardi, Ahkam-us-Sultania.

Nomani, Farhad and Rehnema, Ali, *Islamic Economic Systems*, Zed Books Ltd, London & New Jersey, 1994.

Obaidullah, Mohammad, *Islamic Financial Services, Part V Fund Management and Project Finance*, Islamic Economics Research Center, King Abdulaziz University, Saudi Arabia, www.islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html-6k. (accessed April 6, 2006).

Qadar, Dr. Sohaib, *Pakistan Upstream Petroleum Laws & Related Legislation: A Guide for Multinational Companies*, Barrows Company, New York, 2000.

Siddiqi, Asrar H., *Practice and Law of Banking in Pakistan*, Sixth Ed., Royal Book Company, Karachi, 1997.

Sarakhsi, Abu Bakr Muhammad Ibn Ahmad, *al-Mabsut*, Dar al-Marif, Beirut, 1978.

Sanhuri, Abdul Razzaq, *Masadir al-Haqq*, Dar al-Marifah.

Sulayman ibn al-Ashath al-Sijistani Abu Dawud, *Sunan, Kitab al-Buyu, Bab fi bay al-Mudtar*, Ihya al-Sunnah al-Nabawiyyah, Cairo, 1975.

Schacht, Joseph, art. "Sharia". *Enc. Of Islam*, Leyden: E.J. Brill, 1934.

Thanawi, Muhammad Ala, *Kashshaf Istilahat al-Funun* Calcutta: Asiatic Society of Bengal, 1862.

Sayed Sabiq, *Fiqh-us-Sunna*, Dar-ul-Kitab Al-Arabia, Beirut 1985.

REPORTS

Chapra, M.U., "*Comments on II Report on Elimination of Interest in Money and Banking in Islam*", Islamabad, 1983.

Report on Insurance System, Council of Islamic Ideology, Government of Pakistan, Islamabad, June, 1992.

ARTICLES

Ansari, Saalim Salam, *Legal Aspects Of Modarabas In Pakistan*,
<http://www.pakistanlawsonline.com/lawonline/law/Article.asp> (accessed April 26, 2006).

Arif, Muhammad, "Pakistan Production Sharing Agreement: Offshore Fiscal System," *Oil, Gas & Energy Law Intelligence*, Vol.3 – issue 1, March, 2005,
www.gasandoil.com/ogel/Issue (accessed December 25, 2005).

Ashraf, Mohammed, *Takaful Insurance Business*,
<http://www.accountancy.com.pk/articles.asp?id=157> (accessed April 5, 2006).

Abdullah Abdelbaki, *La theorie du contrat* (Cairo, 1948), quoted from Rivkin, David W., *Lex Mercatoria and Force Majeure*, http://tldb.uni-koein.de/php/pub_show_document.php?pubdcid=116100 (accessed April 4, 2006).

Bunter, Michael A G, *Petroleum Contracts In Islamic Law: The Concessions (Equity) and Contractor (Production Sharing) Agreements*, Volume 3, Issue #03 - October 2005
<http://www.gasandoil.com/ogel/> (accessed January 15, 2006).

Daniel Johnston, *International Petroleum Fiscal Systems and Production Sharing Contracts*, p.296, quoted in Karim, Muhammad S., *Oil, Islamism and International Petroleum Industry: Legal, Economic, Political and Cultural Issues*,
www.dundee.ac.uk/cepmlp/journal/assets/Karim-Islam-oil2001.doc (accessed January 15, 2006).

Gao, Zhiguo, *International Petroleum Contracts: Current trends and new directions*, Graham & Trotman / Martinus Nijhoff, quoted from Tiny, Kiluange, The JDZ Model: A Legal Analysis, August 2005, www.juristep.com (accessed January 3, 2006).

Hassanuzzaman, *The Economic Revelance of the Shariah Maxims, Al-Qawaid al-Fiqhiya*, http://islamic-world.net/economics/pic/title_03.gif (accessed February 8, 2006).

Hussain Amer, *La responsabilite civile delictuelle et contractuelle*, Cairo, 1956, 137, quoted from Rivkin, David W., *Lex Mercatoria and Force Majeure*, http://tldb.uni-koein.de/php/pub_show_document.php?pubdcid=116100 (accessed April 4, 2006).

Hairetdinov, Ravial, *Islamic Financial System*, http://islamic-world.net/economics/financial-system_02.html (accessed December 24, 2005).

Islamic finance: basic principles and structures, A focus on project financing, Freshfields Bruckhaus Deringer, January 2006, www.freshfields.com/publications/pdf/2006/13205.pdf (accessed April 14, 2006).

Karim, Muhammad S., *Oil, Islamism and International Petroleum Industry: Legal, Economic, Political and Cultural Issues*, A dissertation submitted in partial fulfillment of a LL.M. in Resources Law and Policy to the Centre for Energy, Petroleum and Mineral Law and Policy, University of Dundee. www.dundee.ac.uk/cepmlp/journal/assets/Karim-Islam-oil2001.doc (accessed January 15, 2006).

Maududi, Syed Abul Aala, *The Economic Principles of Islam*, <http://www.jamaat.org> (accessed March 11, 2006).

Murtaza, Athar, *Islamic Antecedents for Financial Accountability*, International Journal of Islamic Financial Services, Vol.4, No.1, http://islamic-finance.net/Journals/journal_13/vol4_no1art1.pdf (accessed March 1, 2006).

Maysami, Ramin Cooper, Kwon, W.Jean, *An Analysis of Islamic Takaful Insurances – A Cooperative Insurance Mechanism*, <http://www.icmif.org/2k4takaful/site/documents/analysis> (accessed March 2, 2006).

McMillen, Micael J.T., *Islamic Shari'ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*, <http://www.kslaw.com/library/pdf/mcmillenislamic2.pdf> (accessed April 14, 2006).

Miki, Haruka, *Risk Management and Humans, - From Social Perspectives*, Hitotsubashi University, Tokyo, Japan, Faculty of Social Sciences, <http://members.jcom.home.ne.jp/tekato/05miki.htm> (accessed February 8, 2006).

Moerbe, Charles, *International Operations: Contracts with the Government and Basic Concepts of International Operating Agreements*, Lewis Mosburg's Internet Oil & Gas Newsletter, http://www.mosburgoil-gas.com/html/body_moerbe_11_96_5a.html (accessed January 18, 2006).

Paliashvili, Dr Irina, *The Concept of Production Sharing*, A paper presented at the Seminar on the Legislation on Production Sharing Agreements, September 14, 1998, http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm (accessed January 3, 2006).

Saleh, A. Samir, "Some aspects of frustrated performance of contracts under middle eastern law", *International and Comparative Law Quarterly*, Vol. 33, No. 4 (Oct., 1984), JSTOR (Oxford University Press), <http://iclj.oxfordjournals.org/cgi/reprint/33/4/1046> (accessed March 15, 2006).

Sanhoury, Traite de Droit Civil ("al-Wassite"), Vol. 1, 3rd Ed., Cairo, 1981, quoted from Rivkin, David W., *Lex Mercatoria and Force Majeure*, http://tldb.uni-koein.de/php/pub_show_document.php?pubdcid=116100 (accessed April 4, 2006).

Tiny, Kiluange, *The JDZ Model: A Legal Analysis*, August 2005, www.juristep.com (accessed January 15, 2006).

Usmani, Maulana Taqi, *Islamic Finance, Musharakah & Mudarabah*, <http://www.darululoomkhi.edu.pk/fiqh/islamicfinance/islamicfinance.htm> (accessed December 2, 2005).