Islamic Finance Instruments: Experiences in the Oil and Gas Sector

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Abstract- Islamic finance industry witnessed a remarkable development and increasing growth until the Islamic financial institutions imposed in the global financial environment. Islamic finance has become a reality, an important approach, the added value to the reality of global economic and a bridge of the interdependence between the Islamic world and the Western world. In this context, this paper comes to reveal certain aspects of Islamic finance, that has the means of distinct, diverse renewable and which is not owned by other conventional systems. This study will address: The experiences of Islamic financial instruments in the oil and gas sector and develop a mechanism for development. In regard to how strong role Islamic banks and other financial institutions have had in financing the oil and gas sectors, this study found that, it is possible for Islamic methods of finance to make an effective contribution towards developing oil and gas – quite apart from developing investments in the banks and financial institutions themselves, and thereby helping to bring about the desired development in the Arab and Muslim countries.

Index Terms- Islamic Finance, Internationalization, Investment, Joint Venture, Islamic Banking and Institutions

I. Introduction

The Middle East region - and the Arabian Gulf states in particular - stands in the vanguard of those countries that hold sway over the world energy balance, given that it possesses most of the world's oil reserves – to say nothing of its huge reserves of gas (Hasan et al,. 2010). The oil and gas sector is nothing if not capital-intensive, a fact that requires capital sums to be pumped regularly into this sector in order to fund exploration, drilling, production, development, maintenance and distribution (Dwabh, 2007).

Oil investments in the Middle Eastern countries depend, mainly, on the internal funding resources of the national oil companies, as well as on international capital markets and foreign direct investment. Even though most countries put a ban on foreign capital participating in major oil-industry operations, some states permit arrangements for dividing up production (Richardson, 2007). In the light of most predictions that suggest dependence on Middle East oil and gas resources is set to increase in the coming years (Gohar, 2006), there will need to be a growth in financing in line with a growth in demand for oil and gas, not least because this sector represents the main, underlying source of national revenue in most of the Arab countries, and those of the Gulf in particular (Nienhaus, 1986). This naturally places a burden of responsibility on the banks and Islamic financial institutions to make effective contributions towards meeting the funding needs of the oil and gas sector. For they have adopted as their main goal to have a stake in bringing about social and economic development in Muslim lands; and they in particular are seeing record growth, given that they are thought now to number more than 300 institutions in various parts of the world, with total assets exceeding 300 billion dollars – expected to grow to a trillion dollars by 2014. Their assets have risen at an average rate of 24% p.a. over the past decade, and even on a conservative estimate are expected to maintain that average rate of growth during the next few years (www.asharqalawsat.com).

This, then, is the context in which the present study aims to explore Islamic finance instruments and experiences in the oil and gas sector, and to discover how those instruments and experiences have been strengthened in the age of economic and financial globalization, helping to meet the development needs of the oil and gas sector in Islamic countries, and how they have realized the developmental aims of the Islamic banks and financial institutions and as a consequence brought about ongoing development in the Arab and Islamic countries.

A. ACTUAL FUNDING BY ISLAMIC BANKS AND FINANCIAL INSTITUTIONS IN THE OIL AND GAS SECTOR

Actual funding by Islamic banks and other financial institutions reflects a trend towards financing the oil and gas sector, whether directly or indirectly, since this is viewed as a pivotal sector in the Arab and Islamic countries generally and in the Gulf Cooperation Council (GCC) states in particular. In the light of the information we have we will therefore refer below to a number of test cases of Islamic banks and other financial institutions being involved in this sector, and also to the finance instruments they have used.

1 – Financing Malaysia's PETRONAS Oil Company:

Petronas Trading Corp is a subsidiary of the Malaysian Government oil company PETRONAS. This company entered into a contractual arrangement with the Islamic Development Bank to purchase, on Islamic *murabaha* terms, crude oil worth USD 100 million from member states of the Islamic Conference Organization in order to refine it and then resell it (Dwabh, 2007).

2 – Financing the Turkish PETROL OFISI Company:

Turkey's Petrol Ofisi made a contractual *murabaha* arrangement to buy oil derivatives worth USD 92.5 million over two years through joint Islamic financing. Those participating in the financing of this deal were Kuwait Finance House (to the tune of 15 million dollars), both Citibank and the Turkish Evkaf

Bank, and three other Islamic banks. Kuwait Finance House and the Turkish Evkaf Bank acted as sponsors and partners in this deal (www.islamicfi.com/arabic/news).

3 – Financing the Bahrain Oil Company (BABCO):

The Bahrain Oil Company (Babco) needed to develop its own oil refinery in order to reach further world markets with products meeting the latest international technical and environmental specifications, and thus to secure greater returns. It therefore set about getting joint financing from Islamic and conventional banks that amounted to about USD 1.011 billion, coming from 9 regional and international banks, so as to complete its tasks in 2007 (www.islamicfi.com/arabic/news).

4 – Financing the UAE's DOLPHIN Energy Company:

Dolphin is a company that invests in energy, and it is partnered by the Mubadala (Exchange) Development Company, owned by the Abu Dhabi Government, and by the French Total and American Occidental Petroleum (www.islamicfi.com/arabic/news). In view of its efforts to extract gas from Qatar's North Field, process it at Ras Laffan and then deliver the dry gas through a pipeline to the UAE, the company depended on funding shared between Islamic and conventional banks in order to achieve its mission by the end of 2006.

The company estimated its funding needs over a 4-year period at USD 3.45 billion, with one billion to come from Islamic financing and the remaining 2.45 billion dollars to come from conventional financing. There were 14 banks participating in the Islamic financing deal. In the lead were 5 major banks: the Dubai Islamic Bank, the Gulf International Bank, ABN Amro, BNP Paribas and City Group. Additionally, there were several other institutions, namely: HSBC Amanah, Barclays Bank, Natixis Banque Populaire, Societe General, West LB, Export Development Canada (EDC), Sao Paulo, AMA China Construction Bank and Commercial Bank of Qatar.

That deal is the largest Islamic finance deal in the oil and gas sector, with the Islamic finance taking two forms: *ijara* (leasing) and *istisna* (manufacturing finance). For the company, acting for the participating financial institutions, sets up various prior-leasing agreements that govern the relationship between the two parties as regards using that financial regime (www.asharqalawsat.com).

5 – Financing the Indonesian PERTAMINA Oil Company:

Indonesia's Pertamina, one of South-East Asia's biggest oil and gas companies, is owned by the Indonesian Government, operates refineries, produces oil derivatives and markets them alongside other commercial activities to do with energy and petrochemicals. Even though Indonesia has large reserves of oil, Pertamina imports substantial quantities of oil from the Middle East, particularly from Kuwait and Saudi Arabia. In order to obtain the oil supplies it needs, the company generally relies on short-term credit facilities.

(www.islamicfi.com/arabic/news) Within this framework the company obtained joint Islamic finance amounting to USD 322 million in order to purchase crude oil under the Islamic *murabaha* system for 6 months from several banks, foremost among these being the Kuwaiti House of Finance, which acted as co-sponsor of the deal, contributing towards it to the tune of USD 40 million, along with a number of other banks including the Dubai Islamic Bank and HSBC.

6 – Financing the EQUATE Petrochemicals Company:

Equate is a Kuwaiti company dealing in petrochemicals. This company managed to obtain credit facilities amounting to USD 600 million for its activities by way of joint financing spread among Islamic and conventional banks. The Kuwaiti House of Finance arranged the Islamic finance tranche of 300 million dollars in accordance with Islamic *ijara* and *murabaha* formulas, with 9 regional and international banks participating in that tranche. Meanwhile the Kuwait National Bank – the second partner to the deal – arranged a tranche, also of 300 million dollars, from those commercial banks that took part in financing the company. Eleven regional and international banks combined forces to provide that conventional tranche of money (www.islamicfi.com/arabic/news).

7 – ATLAS International's Islamic Energy Portfolio:

ATLAS International structured and put forward a Shari'a-compliant investment portfolio valued at USD 100 million in the domain of energy in a broad sense of the term (www.islamicfi.com/arabic/news). This covers oil and gas, power generation and distribution and water purification. The investment portfolio depends on the periodic distribution of dividends, as well as on the possibility of achieving capital gains through registering and offering energy companies' stocks on the Arab stock markets.

Other Finance Experiences / Instruments Used in the Oil and Gas Sector:

a. GCC Energy Fund

The GCC Energy Fund is the first privately-financed equity fund in the energy sector in the GCC states. The Emirates National Oil Company Ltd (ENOC) (reference 3), with its headquarters in Dubai, is the joint founding sponsor and investor in this Fund. (http://www.ameinfo.com/ar). The aim of the GCC Energy Fund, whose capital amounts to USD 300 million and which enjoys the sponsorship of the Gulf International Bank (GIB) and Standard Bank and is run by GCC Energy fund Managers Ltd, is to accumulate capital, initiate commercial transactions and select investments through acquiring stock in companies and operational projects in a range of energy sector activities. In doing so, it structures, monitors, designs and implements appropriate working strategies for each investment.

b. The Yanbu National Petrochemicals Company (YANSAB)

The Yanbu National Petrochemicals Company (YANSAB) is one of the companies affiliated to the Saudi Arabian Basic Industries Corporation (SABIC). The latter holds 55% of YANSAB's capital, amounting to SAR 5626 billion, while its partners in the Ibn Rushd and Tayef companies own 10%. Around 35% of the company's capital, represented by 39375 million shares valued at SAR 2 billion, has been put to an IPO at a nominal value of SAR 50 per share, with a minimum of 10 and a maximum of 5000 shares.

Through this financing YANSAB is endeavouring to build up its industrial complex at Yanbu Industrial City, scheduled for completion by mid-2008. This is to enable it to enter a phase of annual energy production in excess of 4 million metric tons of petrochemical products, thereby raising the productive and export capacity of Saudi Arabia's petrochemicals industry (www.alriyadh.com).

c. The International Company for Petroleum and Natural Gas Pipelines

The Egyptian-Kuwaiti Holding Company, in partnership with 4 major Egyptian companies operating in the petroleum industries, set up the 'International Company for Petroleum and Natural Gas Pipelines' with a starting capital of USD 400 million and a paid-up capital of USD 200 million, offering 400,000 of the company's shares on the Egyptian stock market at USD 100 per share. The company aims to cover domestic demand for gas pipelines as well as to export the surplus to foreign markets (www.alriyadh.com/net).

d. The Direct Investment Fund in the Egyptian Petroleum Sector

This fund is under study by the Kuwaiti Al-Kharafi Investment Group. It has been allocated a paid-up starting capital of USD 1 billion and is aimed at direct investment in exploration, drilling, extraction and piping of gas and in the petrochemicals industry in regional markets generally. The Kharafi Group's share of the Fund's capital will be somewhere between 50% and 60% of its gross capital, while the Fund's investments will be 40% within Egypt and 60% outside the country (www.alriyadh.net).

e. The Global Investment House (Global) Energy Fund

The Global Investment House (Global) is seeking to offer a new publicly-subscribed investment fund that will specialise in energy, oil and oil derivatives, with capital inputs varying between a minimum of 5 million and a maximum of 100 million Kuwaiti dinars. The Fund's capital is to be invested in energy projects and companies, whether in the State of Kuwait, elsewhere in the GCC region or in North Africa (www.ameinfo.com).

B. BOLSTERING THE ROLE OF BANKS AND ISLAMIC FINANCIAL INSTITUTIONS IN FINANCING THE OIL AND GAS SECTOR

Oil demand forecasts indicate that the world will need 92 million barrels per day (mbpd), after a peak of 93 mbpd in 2010, then rising to 110 mbpd by 2020, as compared with 77 mbpd in 2002.

The Middle East enjoys abundant resources and huge reserves of oil and gas. The region has a 69% share of the total of 1050 billion barrels representing proven reserves of crude oil worldwide in 2001; it also has a 31% share of worldwide oil production and around 50% of exports (Bright, 2003).

Furthermore, investment in oil and gas in the Arab Gulf countries has seen continuous growth, amounting to USD 30 billion during 2005, with the value of single contracts going above USD 350 million. This year is expected to set the pace for new contracts (reference 23), making quite clear just how important this region is for both the present and the future state of the world oil and gas market. How important oil is for the GCC states is evident from the fact that it accounts for roughly a third of total GNP and about three quarters of government revenues and of annual exports. These countries, as a group, command a share of about 45% of the world's reserves of oil and 25% of crude oil exports, as well as owning at least 17% of the world's proven reserves of natural gas (Fasano et al,. 2003).

All of the above reflects the promising role of the oil and gas sector – and in particular the fact that it still dominates the communications sector, in which it stands alone in having about 96% of the world energy market allocations. It also accounts for 28% of energy supplies to industry, of which 9% goes to electricity generation Ahmad and Hassan (2007).

As part of the market for primary energy resources as a whole, natural gas has had a constantly growing share. It increased from 18% in 1973 to around 23% in 2001. Several factors have combined to drive this increase: rising oil prices and a big need on the part of energy consuming countries to achieve self-sufficiency; the diversification of energy sources; and the environmental concerns that have been manifested in recent times in connection with global warming and climate change. Natural gas has the lowest carbon density when compared with other fossil fuels, followed by oil and then by coal. The use of natural gas has increased also as a result of the general growth of the petrochemicals industry, being the most important raw material in a sizeable group of different products (Bright, 2003).
Such significant growth in the oil and gas sector has opened up the possibilities for banks and other Islamic financial institutions to bolster their role in assisting development. This is by participating in a way that is much more than just financing this sector, which in general needs the considerable sums of money which these banks and institutions are able to provide. Specifically, it is by joint and mutual financing undertaken between one Islamic bank and another, thanks to the features which distinguish such banks and institutions in their ability to offer financing formulas such as involve risk-spreading and other activities that traditional banks and financial institutions do not offer. Under these formulas the oil and gas sector can be financed as follows, through the various stages of exploration and drilling, extraction, oil refining or gas treatment, and distribution:

1. MURABAHA

By this method banks and Islamic financial institutions can fund the commodity needs of companies in the oil and gas sector against a profit margin on the price for which a commodity was bought. The companies in question pay their dues over a suitable time span, as set out below:

I. Crude oil is purchased and then sold to refineries by *murabaha*.

II. Refined oil is purchased and then sold to oil distributors by *murabaha*.

III. Crude natural gas is purchased and then sold to gas treatment plants by *murabaha*.

IV. Dry or uncontaminated gas is purchased and then sold to gas distributors by *murabaha*.

V. Oil and gas companies' requirements, either in the form of fixed assets (capital financing) or in the form of production and operational equipment (working capital financing), are purchased by *murabaha*, in respect of whatever stage it may be (exploration and drilling, extraction, oil refining or gas treatment, or distribution). In this way *murabaha* provides oil and gas companies with whatever they require in the way of either fixed or moveable assets, thereby developing the Muslim Arab economy, which is in need of people to promote investment and create projects.

2. MUSHARAKA

By this method banks and Islamic financial institutions can fund companies in the oil and gas sector as follows:

I. *Musharaka* ending in transfer of ownership

This way banks and Islamic financial institutions can fund oil and gas companies through partial funding of the company's capital, with the company itself funding the other part. The company can then be entitled to purchase the share of the banks and Islamic financial institutions according to a timetable, taking over ownership as the banks and Islamic financial institutions withdraw and assign ownership in full to the company.

In the *musharaka* contract there is agreement as to both parties' share of the capital, on the term of the *musharaka* and on how the withdrawing company's share is to be paid up, how administration and settlement is to be carried out and how profit and loss is to be distributed. Profit can go in accordance with what has been agreed, while loss is borne in proportion to the capital share. Such an arrangement encourages companies to achieve profits so as to be in a position to withdraw, and thus to have a speedy transfer of ownership, particularly if the *musharaka* contract contains a promise by the banks and Islamic financial institutions to sell their share in full to the company if it has paid off its own share.

The oil or gas company will be a trustee of the funds it has at its disposal, and the banks and Islamic financial institutions are entitled to get guarantees against incompetence or negligence. A company does not guarantee the funding provided to it by banks and Islamic financial institutions, and so the *musharaka* venture is all about gains and losses. Thus *musharaka* ending in transfer of ownership is one means by which projects can own their profits, something which whets the appetites of companies to own capital, and thereby to increase production and expand their developmental horizons.

II. Setting up and Taking Shares in Oil and Gas Companies:

This way banks and Islamic financial institutions set up or take shares in companies that invest in the oil and gas sector. Through setting up companies Islamic banks can take a share in part of their capitalization and offer the remaining part to public subscription. This provides significant long-term financial resources to these banks and other institutions which can then be directed towards direct investment in the oil and gas sector in one or more of the stages of production and distribution. Setting up or taking shares in companies furthermore activates the capital markets. Thereby the banks and Islamic financial institutions, through implementing investment projects in that vitally important sector, are contributing towards realizing their developmental goals, the effect of which is to serve the economy of the Arab nation.

3. MUDHARABA

By this method banks and Islamic financial institutions can fund companies in the oil and gas sector as follows:

I. Cash Funding

By this method banks and Islamic financial institutions provide the necessary funding to oil and gas companies in one or more of the stages of production and distribution. Both parties agree on a division of whatever profit may arise from the investment according to shares specified between them, and it is up to the banks and Islamic financial institutions to lay down conditions ensuring that their funding is used properly. If losses occur the banks and Islamic financial institutions are fundamentally obliged to bear them, provided there has been no proven incompetence, negligence or infringement on the part of the company; and in the event of there being losses, the company will get nothing at all in return for its efforts, whatever they may have been. Both sides, then, lose what they have contributed. In this way Islam puts money and labour on an equal footing: they make profits together, or they lose money together, with the capital provider losing his capital and the employer losing his labour.

This is what motivates the capital provider, as represented by the banks and Islamic financial institutions, to be keen to choose viable projects, while also motivating oil or gas companies to want to achieve profits so as to have earnings commensurate with their efforts and to maintain their standing in the marketplace.

II. Oil and Gas Investment Funds

While banks and Islamic financial institutions are setting up investment funds they collect funds from small investors as much as from the big players, and those funds are then invested in the oil and gas sector - in one or more of the stages of production and distribution – either through direct investment (that is, material investment) or through indirect investment (that is, through investing in the shares of that sector).

The funds are issued in return for investors' money in the form of investment documents in accordance with the Shari'a-compliant *mudharaba* regime (Dwabh, 2007). These documents represent a joint share of *mudharaba* capital, and they contain what is the predominant *mudharaba* formula as approved by the Muslim legal experts: this is *mudharaba* with multiple capital providers, so that more than one person provides the money while some single entity provides the labour. This formula, moreover, is inserted under restricted *mudharaba*, since the investment path has to be directed specifically towards oil and gas operations (Izz al-Din, 1993).

4. ISTISNA'

Istisna' means manufacturing items of goods to order using materials to be supplied by the manufacturer, and to particular specifications and at a specified price, the payment of which may be by immediate or deferred lump sum or in instalments.

For three of the schools of Islamic law (the Maliki, Shafe'i and Hanbali schools), *istisna'* is a type of forward buying which is called 'forward buying for industry', while the Hanafi school takes the view that it is a self-contained contract. This difference shows itself in the fact that the Hanafis do not make it a condition that the cost should me met when the contract is agreed, but it may rather be deferred or paid in instalments. With the other three schools, however, all the forward buying conditions have to be applied, the most important one being that the cost must be met at the time of the contract (Omar, 2004).

So it is that banks and Islamic financial institutions can draw up an *istisna'* contract between themselves and oil and gas distribution companies (the customer) under which the banks and Islamic financial institutions are obliged to deliver oil derivatives after refining, or gas that has been treated, to distribution companies according to set specifications, on a specified delivery date and at a price agreed upon to be paid in instalments. The banks and Islamic financial institutions then make an independent contract with the oil refining or gas treatment companies requiring the particular company to manufacture or produce the goods in place of the first contract, and to deliver them within a specified time period that takes precedence over the period stated in the first contract, and at a price which is lower than the first price by a margin representing the return to the banks and Islamic financial institutions as per that contract. These banks and Islamic financial institutions pay this price in several payments or as a cash lump sum, after which they take possession of the goods from the refining company (the seller or manufacturer) by the due date for delivery and then consign them to the distribution company (the purchaser or the party that has commissioned the production of the goods). The banks and Islamic financial institutions can also empower anyone they see fit to take delivery of and then forward the goods, although any such procedures must be in the form of real rather than just paper transactions (Ahmad, 2000).

Istisna' thereby manages to create a perfect circle integrating those who have the expertise with those who have the capital. It provides oil refining or gas treatment companies with the capital outlay for their production needs, while they pay off this debt through their products by surrendering whatever goods have been agreed upon to the banks and Islamic financial institutions. The *istisna'* regime furthermore enables the banks and Islamic financial institutions to achieve a dual function and purpose in both funding and broadening the base of beneficiaries by way of financing both the seller and the purchaser: this not only brings in the profits they seek but also helps to achieve economic and social development for the Arab and Muslim countries.

5. TA'JIR TAMWILI (LEASE FINANCING)

Through this method the banks and Islamic financial institutions purchase the capital assets needed by oil and gas companies (Dwabh, 2007) and lend them out to them through a lease funding contract, under which those companies may make use of the leased assets against payment of a fixed rental amount. Such a contract should, however, be linked to one of the following arrangements:

I. An independent deed of gift (*hiba*) in respect of the capital asset leased to the company, this being dependent upon the company's paying the rental amount in full.

II. The promise of a *hiba* in respect of the capital asset leased to the company once the company has paid the rental amount in full.

III. The promise to sell the leased asset to the company, once it has paid the rental amount in full, at a price that has been agreed with it.

IV. Giving the company the option of purchasing the leased asset at market price once the lease period is over, after the company has fully paid all the rental instalments due during that period.

V. Giving the company the right to exercise the option of owning the leased asset at any time it wishes: the leased asset may be sold to the company in due course of time at market price under a new contract, or as may be agreed with the company at the time of the sale.

Thus *ta'jir tamwili* (lease financing) enables oil and gas companies to have their capital asset requirements met at one or more stage of production and distribution without needing to set aside part of their own funds for the purchase and thus to put a burden on their budgets. As a result they have greater liquidity and therefore better chances of using their funds for the most worthwhile of their other activities and, by doing so, securing further good investments.

II. CONCLUSIONS AND RECOMMENDATIONS

What the above study shows, in summary, is that there has been a trend for banks and Islamic financial institutions to finance the oil and gas sector, with a leading part being played by the Kuwait Finance House. These institutions have for this depended on joint financing, in particular with the traditional banks. We have observed, too, that the forms of financing that the banks and Islamic financial institutions have depended on have been *murabaha, ijara* and *istisna'*. *Murabaha* and *ijara* have played the biggest part as financing vehicles, but alongside them there has been indirect investment in the capital markets through investment in the shares of oil and gas companies. All this is in addition to other experiments made by traditional banks and financial institutions depending on traditional financing and on setting up companies and investment funds which invest in the oil and gas sector, whether directly or indirectly. When we consider and review just how strong a role Islamic banks and other financial institutions have had in financing the oil and gas sector, we find that it is possible for Islamic methods of finance to make an effective contribution towards developing oil and gas – quite apart from developing investments in the banks and financial institutions themselves, and thereby helping to bring about the desired development in the Arab and Muslim countries.

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