

**LEGAL PROTECTION OF FOREIGN  
DIRECT INVESTMENT  
IN SAUDI ARABIA**

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# ABSTRACT

Developing countries are converging in their Foreign Direct Investment (FDI) policies. This reflects not just the external pressure to liberalise economic policies but also the growing realisation that Multi National Corporations (MNCs) have played and will continue to play a leading role in transnational investment. This is particularly so when it comes to the exploration for and development of oil and gas resources. The role of MNCs in the explorations and development of petroleum resources in Saudi Arabia since the 1930s has indeed been significant. Saudi Arabia has been seeking economic diversification since the 1970s. It decided to change its development strategy so as to become less dependent on oil revenues. The Kingdom thus embarked upon various legal and policy reforms to improve the investment climate in the country. This subject is highly important to foreign investors in Saudi Arabia because of the potential returns offered by what is becoming a more attractive investment environment.

A key issue for foreign investors is the availability of an adequate legal framework for foreign investment which facilitates the establishment and operation of their business in Saudi Arabia and provides them with adequate protection for their investments. However, there are concerns which have arisen amongst foreign investors. These concerns mainly stem from a sense of legal uncertainty and unpredictability of the laws and dispute settlement systems relating to FDI in Saudi Arabia, including where relevant Shari'a which is fundamental to the Saudi legal system.

This study is therefore concerned with the identification and analysis of these legal problems – both existing and perceived – in the laws of Saudi Arabia as well as the stability of investment agreements under Shari'a which is necessary for conducting business there.

As the title of this study indicates, its primary objective is to examine the legal security and protection of FDI in Saudi Arabia. The examination of this topic will be conducted in the light of the rules relating to FDI which are designed to provide effective protection for foreign investment. Since Shari'a is the main source of law within the Saudi legal system, the relevant Shari'a principles will also be addressed in this study. The study also examines the mechanisms available for the settlement of foreign investments disputes in Saudi and asks whether or not these mechanisms provide independent and impartial bodies capable of settling such disputes. The study is intended to make an original contribution to current and prospective foreign investors' understanding as well as to inform proposals for action on the part of the Saudi government.

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***To my parents***

# ABBREVIATIONS

ARAMCO	Arabian American Oil Company
BG	Board of Grievances
BITs	Bilateral Investment Treaties
BP	British Petroleum
CDSC	Commercial Dispute Settlement Committee
CEPMLP	Centre for Energy Petroleum and Mineral Law and Policy
CERDS	Charter of Economic Rights and Duties of States
ECT	Energy Charter Treaty
FCIC	Foreign Capital Investment Code
FDI	Foreign Direct Investment
FIA	Foreign Investment Act
GATT	General Agreement on Tariffs and Trade
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
IAIGC	Inter-Arab Investment Guarantee Corporation
ICA	International Commercial Arbitration
ICC	International Chamber of Commerce
ICSID	International Centre for the Settlement of Investment Disputes
IMF	International Monetary Fund
IOC	International Oil Company
KSA	Kingdom of Saudi Arabia
MAI	Multilateral Agreement on Investment
MIGA	Multilateral Investment Guarantee Agency

MITs	Multilateral Investment Treaties
MNCs	Multi National Corporations
NOCs	National Oil Companies
NYC	New York Convention
OAPEC	Organization of Arab Petroleum Exporting Countries
OGEL	Oil, Gas and Energy Law Intelligence
OPEC	Organisation of Petroleum Exporting Countries
PBUH	Peace be Upon Him
PSC	Production Sharing Contract
PSO NR	Permanent Sovereignty Over Natural Resources
SAGIA	Saudi Arabian General Investment Authority
SAMA	Saudi Arabian Monetary Agency
SCER	Saudi Commerce and Economic Review
SEC	Supreme Economic Council
SIDF	Saudi Industrial Development Fund
SJC	Supreme Judicial Council
SGI	Saudi Gas initiative
SPMC	Supreme Petroleum and Mineral Council
UAE	United Arab Emirate
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNGA	United Nations General Assembly
WB	World Bank
WTO	World Trade Organisation

# INTRODUCTION

Saudi Arabia is the largest country in the Arabian Peninsula and about 65% of its landmass is comprised of deserts. The Empty Quarter represents a great part of this desert which is one of the most oil-rich regions of the world.<sup>1</sup> The country is rich in petroleum resources, which account for much of the nation's prosperity. Petroleum thus dominates the economy of Saudi Arabia.<sup>2</sup> Oil was first discovered in the country at the beginning of the 1930s, but commercial production only started in 1938. During the 1960s Saudi's oil wealth contributed to rapid economic development, a process which accelerated in the 1970s.<sup>3</sup> Today, oil still plays an important role in the economy as it accounts for more than 90% of the country's exports and nearly 75% of government revenues; the proven reserves are estimated to be 260 billion barrels, which amounts to about one-quarter of world oil reserves.<sup>4</sup> Today, more than 95% of all Saudi oil is produced by Saudi ARAMCO (Arabian American Oil Company) on behalf of the Saudi Government.<sup>5</sup>

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<sup>1</sup> The country comprises about 80 percent of the Arabian peninsula bordered by Jordan and Kuwait to the north, the Red Sea and Yemen to the west and south, Oman to the south, and the United Arab Emirates and the Gulf Coast to the east. For more discussion on background and development of Saudi Arabia see generally, Al-Farsy, F., *Modernity and Tradition: The Saudi Equation*, Channel Islands: Knight Communications Ltd, (2003).

<sup>2</sup> The importance of Saudi oil to the development of an international industry and the success of the major oil companies has been recognised since the introduction of the first concession in 1933 to California Arabian Standard Oil Company (CASOC) who later changed their name to Arabian American Oil Company (ARAMCO). For an historical account of the beginnings of the oil industry, its growth and importance throughout the world, the Middle East and in Saudi Arabia, see the ARAMCO Handbook, *Oil and the Middle East*, Arabian American Oil Company, Dhahran, Saudi Arabia, (1968). See also Obaid, N., *The Oil Kingdom at 100*, Washington, DC. The Washington Institute for Near East Policy, (2000).

<sup>3</sup> For an in depth history of the oil industry of Saudi Arabia, see Yergin, D., *The Prize*, New York: Free Press, (2003), pp. 283-292. The Prize is widely known as the definitive work on the subject of oil and the major contribution to history and politics of oil. See also Twitchell, K., *Saudi Arabia with an Account of the Development of Its Natural Resources*, New Jersey: Princeton University Press, (1953).

<sup>4</sup> Saudi Embassy Washington, *ARAMCO CEO's lecture on energy at Rice University, Texas*, available at: <http://www.saudiembassy.net/archive/2005/speeches/page14.aspx>.

<sup>5</sup> For information on the current status and technical details on oil and gas activities in the country, see the website of Saudi ARAMCO at: <http://www.saudiaramco.com/bvsm/JSP/home.jsp> (23/12/06). For in depth discussion of the role of ARAMCO and its evolution see Chapter 4 *infra*.

The contribution of the oil industry has made Saudi one of the richest countries in the world and an attractive environment for investment. In the aftermath of the 1973-4 rise in oil prices, as the largest oil exporter of the OPEC (Organisation of Petroleum Exporting Countries) group, Saudi Arabia accumulated enormous financial surpluses and subsequently increased its international economic power. However, despite being one of the major oil exporting countries with an overwhelming dependence on the export of crude oil, it also became a major capital importing country with an increasing reliance on foreign investment in the oil sector. With that over-dependence on oil wealth there is also a realisation that oil reserves may be depleted in the future. At the same time other factors are also becoming important for the Saudi government to deal with, such as growing pressure on the Saudi national budget, the problem of international debt, the development of other sectors such as agriculture along with the importance of water to economic survival and an increasing dependence on foreign labour. Thus, the country is now facing the daunting task of transforming its economy into a diversified industrial economy.<sup>6</sup> Many commentators<sup>7</sup> suggest that the Saudi economic reform programme should at least address six distinct elements that would reduce government expenditure, increase its revenues and stimulate investment. Those elements are decreasing defence spending, reducing government subsidies, expanding privatisation, stimulating foreign investment, reducing dependence on foreign workers and encouraging natural gas development.<sup>8</sup>

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<sup>6</sup> See Cordesman, A., *Saudi Arabia, Guarding the Desert Kingdom*, Westview Press, (1997), pp. 47- 76 for an explanation of economic and social issues in Saudi Arabia.

<sup>7</sup> Such as Champion, D., *The Kingdom of Saudi Arabia: Elements of Instability within Stability*, Middle East Review of International Affairs, VOL 3, No.4 – (December, 1999).

<sup>8</sup> For an in depth discussion of each of these elements, see Enav, P., *The Saudi Oil Dilemma*, London: Financial Times Energy, (2000), pp.91-102.

The government has introduced recent changes to its policy, legislative and regulatory framework to attract foreign private investment into the country.<sup>9</sup> Such efforts to increase private participation generally may well spill over into the oil and gas industry and thereby increase the rate of private participation therein. On 5 June 2000, a foreign investment act entitled the "Foreign Investment Law" came into force in Saudi Arabia.<sup>10</sup> The purpose of this act was to promote foreign investment in Saudi Arabia and to ensure that licensed foreign investment projects would enjoy the same benefits, incentives, and guarantees enjoyed under Saudi Arabian law by wholly Saudi-owned companies. The Foreign Investment Law provides for the Saudi Arabian General Investment Authority (SAGIA) to issue licenses for foreign capital investment in any investment activity in Saudi Arabia.<sup>11</sup> Further government action to promote foreign investment includes the adoption of regulations and formal incentives.<sup>12</sup> In June 2005, King Abdullah, who chairs the Supreme Economic Council (SEC) in charge of economic reforms, approved the implementation of seventeen agreements<sup>13</sup> to encourage

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<sup>9</sup> See SAGIA, *The Legal Background to Foreign Investment in Saudi Arabia*, Saudi Arabia General Investment Authority (SAGIA), (2003).

<sup>10</sup> Foreign Investment Law (as enacted by Royal Decree No. M/1 dated 5/1/1421 H / 10 April 2000). See copy of the text at: <http://www.sagia.gov.sa/innerpage.asp?ContentID=85&Lang=en> (07/07/05).

<sup>11</sup> See Article 2. Article 5 provides that foreign investments licensed under the provisions of this Act, may be in either of the following forms: facilities owned by a national and a foreign investor; and facilities wholly owned by a foreign investor. The legal form of the facility shall be determined according to regulations and directives. The Act also states that investments related to the foreign investor shall not be confiscated wholly or partially without a court order and that it may not be subject to expropriation wholly or partially except for public interest against an equitable compensation according to Regulations and Directives.

<sup>12</sup> The Original Regulations were enacted by the Board of Directors of the General Investment Authority Resolution No. 2 dated 15/5/1421 H / 15 August 2000 (the "Original Regulations") and were subsequently revised by Board of Directors of the General Investment Authority Resolution No. 1/20 dated 13/4/1423 H / 24 June 2002 (the "New Regulations").

<sup>13</sup> The agreements were made between the Saudi Arabian General Investment Authority (SAGIA) and relevant government departments to make Saudi Arabia more investment-friendly. The intention of the agreements is to encourage the private sector to set up specialised universities and colleges in conjunction with renowned world universities, foster industrial projects by giving exemptions on customs tariffs, and granting facilities such as entry visas to foreign investors. Further measures aim to streamline the judicial procedures to resolve trade disputes, strengthen guarantees for investors, promote women's input in investment and speed up the process of collecting imports from entry ports. Other measures include special incentives to locals and foreigners who invest in less developed areas of the vast Kingdom or who add to the operational capacity of Saudi ports. For more details see supra note 4, *Political, Economic and Social Initiatives the Kingdom of Saudi Arabia*, available at: [http://www.saudiembassy.net/files/PDF/Reports/2008Reports/Reform\\_Report\\_May08.pdf](http://www.saudiembassy.net/files/PDF/Reports/2008Reports/Reform_Report_May08.pdf).

foreign investment.<sup>14</sup> It is generally accepted that these government activities in respect of foreign investment are conducive to allowing non-Saudi nationals to invest in the economic activities of the country.<sup>15</sup>

This section, which introduces the pertinent issues concerning the role of foreign investment in the Saudi economy, will serve as the basic foundation for a subsequent and fuller analysis in the following chapters of the roles of government and the private sector in the economy. This analysis will also involve an examination of the position of international law relating to foreign investment and an examination of the national legal framework in Saudi Arabia.<sup>16</sup>

### ***Conceptual Definition of Foreign Investment***

Various definitions of “Foreign Investment” have been developed by different scholars, governments and organisations. They range from the simple ‘investment made by a foreigner’<sup>17</sup> to more complex explanations that foreign investment is usually defined in terms of the scope of investment agreements through key terms, such as ‘investment’ and ‘investor’

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<sup>14</sup> Ibid. The mechanisms to improve the Kingdom’s investment climate were prepared with the support of a number of government agencies. They are: Ministry of Defence and Aviation, Ministry of Municipal and Rural Affairs, Ministry of Interior, Ministry of Foreign Affairs, Ministry of Planning and Economy, Ministry of Finance, Ministry of Justice, Ministry of Higher Education, Ministry of Commerce and Industry, Ministry of Labour, Ministry of Transportation, Ministry of Health, Ministry of Water and Electricity as well as the Communication and IT Agency, the Court of Grievances, King Abdul Aziz City of Science and Technology and an Experts Committee at Cabinet.

<sup>15</sup> Bahgat G., *Foreign Investment In Saudi Arabia’s Energy Sector*, , Middle East Economic Survey, VOL. XLVII, No. 34, (23-August-2004).

<sup>16</sup> The Basic Law allows for international treaties (which Saudi has signed) to supersede domestic rules including Shari’a mandatory rules. Thus, domestic courts are allowed to disregard stringent domestic rules and interpret international treaty provisions in harmony with international trends. Hence, international arbitration agreements entered into by the State or one of its agencies would subordinate the Saudi legal system to the rules of the arbitral tribunals. The two Constitutional articles, according to *Hanbali* school of thought - see chapter 1 of thesis - are in harmony with the spirit of Shari’a on the grounds of the rationale behind the existence of Shari’a, which is the welfare and protection of the vital interests of people. See also Al-Shareef, *Enforcement of Foreign Arbitral Awards in Saudi Arabia: Grounds for Refusal Under Article (V) of the New York Convention of 1958*, PhD Thesis, University of Dundee, ( 2000), p. 65

<sup>17</sup> See Eshiekh, F., *The Legal Regime of Foreign Private Investment in Sudan and Saudi Arabia*, Cambridge University Press, (2003), p26.

and the assets and nature of the obligations of the parties involved.<sup>18</sup> The Saudi Foreign Investment Law of 2000 Article 1 defines foreign investment as ‘investment of foreign capital in an activity licensed by this Law’. We will explore this definition in our examination of the national legal framework of Saudi Arabia. For the purposes of the thesis, we will adopt the most commonly acceptable definition of foreign investment namely that suggested by Sornarajah who states that foreign investment involves ‘the transfer of tangible or intangible assets from one country into another for the purpose of use in that country to generate wealth under the total or partial control of the owner of the assets’.<sup>19</sup> In other words, foreign investment involves a transfer of funds or materials from the capital exporting country to the host country in return for a direct or indirect participation in the earnings of that enterprise.<sup>20</sup> A specific definition of direct investment can be obtained from the International Monetary Fund where foreign investment is defined as ‘investment that is made to acquire a lasting interest in an enterprise operating in any economy other than that of an investor, the investor’s purpose being to have an effective choice in the management of the enterprise’.<sup>21</sup> All these definitions involve three basic elements namely the *capital exporting country* from which the investment comes, the *foreign investor* who is a national of the capital exporting country and the *capital importing country* as the location for the investment.

In most cases, however, it is large International Oil Companies<sup>22</sup> (hereafter referred to as “IOCs”) that undertake foreign direct investment (FDI) in developing countries.

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<sup>18</sup> See UNCTAD Series on issues of international investment agreements, *Scope and Definition*, New York: United Nations Publication, UNCTAD/ITE/IIT/11 (Vol. II), (1999).

<sup>19</sup> Sornarajah, M., *The International Law on Foreign Investment*, Cambridge University Press, (2004), p.4.

<sup>20</sup> Ibid.

<sup>21</sup> IMF, *Balance of Payments Manual*, (1980), para.408 cited in Sornarajah, Ibid.

<sup>22</sup> FDI is also defined as “an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate)”; see UNCTAD, *World Investment Report 2007: Transnational Corporations, Extractive Industries and Development*, United Nations Publication, (2007), p. 245. This general definition of FDI is based on OECD,

Attracting FDI from these large IOCs is a priority in economic policy for most countries with emerging economies. Therefore, it is important for these developing countries to identify factors and policies that can influence the IOCs in choosing specific locations. These factors range from market size, to taxes, red-tape alleviation, regulations, laws, infrastructure, political stability, and investment promotion. The debate is still open on what combination of factors is the most effective for attracting FDI, especially in small developing countries who have become more dependent on foreign aid and who wish to reduce their dependency on it.<sup>23</sup> In order to exert their control over their investments, IOCs increasingly demand that their investments are adequately protected by the host country. IOCs claim that this need for protection is necessary in order to provide them with some certainty as regards the safety and integrity of their capital investment and projected return on it so that they are able to make a meaningful contribution to the economy of the host country.<sup>24</sup>

## **A- Objective of the thesis:**

This study endeavours to identify and analyse the legal guarantees and dispute resolution mechanisms needed for the protection of FDI in Saudi Arabia. It addresses the security of foreign investments under Saudi law (including the relevant principles of Islamic law), bilateral and international investment agreements to which Saudi Arabia is a party and investment contracts between foreign investors and their Saudi partners. The guarantees of foreign investment in Saudi Arabia against non-commercial risks<sup>25</sup> as well as the appropriate methods of dispute settlements are also addressed in this thesis. Reviewing such issues is

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Detailed Benchmark Definition of Foreign Direct Investment, 3rd Ed., OECD, (1996) and International Monetary Fund, Balance of Payments Manual, 5th Ed., IMF, (1993).

<sup>23</sup> See Estrin and Meyer (eds.), *Investment Strategies in Emerging Markets*, Cheltenham: Edward Elgar Publishing Limited, (2004).

<sup>24</sup> For more discussion see chapter 5 *infra*.

<sup>25</sup> Non-commercial risks refer to risks other than commercial factors such as war, internal turbulence and governmental interference as well as political risks. For more discussion on these issues see Moosa, I., *Foreign Direct Investment: Theory, Evidence and Practice*, New York: Palgrave Macmillan, (2002), PP. 131-160.

crucial in clarifying the correct balance between safeguarding and controlling the national wealth of the host state on the one hand, and recognising the need for foreign investors by providing them with the stability and security needed on the other. The purpose of such review is to demonstrate the need for stability and the types of risks that foreign investors are exposed to. Understanding such risks is important in assessing the legal effectiveness and techniques used to avoid those risks.

## **B- Statement of the problem:**

A foreign investor needs to be confident that there is a legal regime in place that secures his investment. What comes immediately to the mind of a foreign investor<sup>26</sup> is whether the legal regime addresses his concerns in relation to the potential conflict of laws between Shari'a (Islamic Law) which forms the basis of the Saudi legal system and judicial system on the one hand, and the conventional common law system which is the usual law chosen by parties to govern their FDI contracts. Similarly, a foreign investor will want to know what importance the Saudi legal system attaches to the rule of law and how and whether the traditional law doctrine of *pacta sunt servanda*,<sup>27</sup> the contractual *umbrella clause*<sup>28</sup> is recognised, understood and applied in Saudi Arabia. Finally, he will want to know whether Saudi Arabia will agree to submit investment disputes to an independent international dispute resolution mechanism.

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<sup>26</sup> This may be because of the great threat that arises from subjecting the agreement to the domestic law of the host state. Therefore, IOCs, for example which invest in developing countries have never been comfortable with the idea that the domestic law of the host state should apply to their contracts with host states or state entities. See Delaume, G., *The Myth of the Lex Mercatoria and State Contracts*, in Carbonneau, T., (ed), *Lex Mercatoria and Arbitration: A Discussion of the New Law Merchant*, Boston, Mass: Kluwer Law International, (1998), pp. 111-116.

<sup>27</sup> A traditional International Law doctrine translated as "Every Treaty in force is binding upon the parties to it and must be performed by them in good faith". See Article 26 of the Vienna Convention on the Law of Treaties 1969 <http://www.un.org/law/ilc/texts/treatfra.htm>

<sup>28</sup> The so-called "umbrella clause" a provision found in many BITs that imposes a requirement on each Contracting State to observe all investment obligations entered into with investors from the other Contracting State. See generally Salacuse, J & P. Sullivan, *Do BITs Really Work?: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain*, 46 *HARV. INT'L L. J.* 67, 67 (2005).

## **C- Significance of the thesis:**

Analysis of the protection of FDI in Saudi Arabia is crucial, not only to academics, capital exporting countries, foreign investors, and international organisations with an interest in Saudi, but also to the Saudi government itself and those individuals that may have an influence in shaping the future direction of foreign investment in the country. It will contribute to clearer understanding of the cultural and legal framework for the conduct of business by non-Saudi investors within Saudi Arabia and to a better appreciation of where the actual difficulties lie. It is important both to the Saudi Government and to the international investor to know whether or not a legal framework exists which provides some degree of protection for investment in the country and whether or not such a framework is enforced vigorously and effectively.

## **D- Methods of the thesis:**

This study is both analytical and comparative. It combines an examination of the issues of international law on foreign investment and national law, and applies these to the situation in Saudi Arabia. The thesis will investigate and examine the relevant international treaties concerning foreign investment which apply to Saudi Arabia. The methodology further adopts an analytical approach to investigate the status and protection of foreign investment in Saudi Arabia under national and international law. It also examines the applicable rules (national and international) to foreign investment and investigates whether they are effective, and if not why they are not. It goes on to analyse what could be done to ensure that these rules are adhered to by the authorities to ensure that investment is adequately protected.

Saudi government policy regarding FDI will be analysed to examine issues relating to the security of FDI. This examination will also highlight the rules applicable in Saudi and directly question and contribute to an ongoing debate that promotes greater transparency in Saudi's investment climate. Another limited comparative approach is pursued in some parts of this study without any intention to have a full and detailed comparative study. This is necessary to cover the shortage in Saudi materials and to support certain ideas. Research material and data will be gathered from primary sources of Shari'a, statutes, official regulations, texts of international treaties, text books and online articles and journals. In addition to an examination and review of published literature, the researcher made use of qualitative research methods whereby interviews were conducted, though without following any specific format or system. This method of empirical work and data collection was conducted over a period of three months (October, November and December 2005) at SAGIA in Riyadh. The idea of this empirical method was to sample the opinions of those holding influential positions in the Saudi government whose activities are related to the issue of foreign investment which intended only to serve as background to the thesis. For instance, questions were put concerning the effect of government laws and policies on foreign investors, the effect of the Kingdom's Islamic system on foreign investment, administrative policy of foreign investment, visas, incentives policies, labour policy, financial policy and the resolution of investment disputes. The answers to such questions helped the researcher to further his understanding of the issues, an understanding which has, in turn, informed the recommendations made at the end of this thesis.

## **E- Thesis gap:**

The motive behind carrying out this research stems from the absence of a recent and comprehensive work that addresses the subject. There are very few legal studies on foreign

investment in Saudi Arabia. Most research conducted hitherto has been on the oil industry, and what is published is mainly descriptive. Moreover, these studies do not take into account the non-oil sector. However, there are two studies concerning foreign investment in Saudi Arabia.<sup>29</sup> Although these two studies are relevant to the current study they do not cover major developments which have taken place since. In other words, these studies were completed prior to the implementation of the Foreign Investment Law in 2000 which itself replaced the 1979 Foreign Capital Investment Code (FCIC) which was the major applicable legal instrument in this area. This thesis is thus intended to fill the gap left by these two studies which were confined to the oil and gas industry. In contrast this thesis has a wider scope. Furthermore, it is hoped that this work will provide the legal community interested in foreign investment in Saudi with an overall legal perspective on foreign investment, which may help to solve investment disputes in the future. Undoubtedly, legal problems do exist in several areas of foreign investment in Saudi and it is also hoped that the study will contribute to the development of more effective regulations related to foreign investment in the Kingdom in order to provide better solutions for these problems. It should be made clear that in many areas of foreign investment in Saudi the problem is more of a misunderstanding or misconception than a reality and that a tool, such as this work, in giving greater insight into the subject, may help allay apprehension felt by foreign investors wishing to invest in the country.

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<sup>29</sup> 1- Al-Samaan Y., *The Legal Security of Foreign Investment in the Kingdom of Saudi Arabia*, PhD thesis, (unpublished), University of Dundee, CEPMLP, (1993).

2- Al-Saleh M., *A Study of the Foreign Investment regulation in the Kingdom of Saudi Arabia: Law and Policy*, Phd thesis, (unpublished), University of Warwick, (1994).

## **F- Structure of the thesis:**

The study consists of seven chapters. The objectives of the study, its significance, scope and methodology have already been delineated here in the introduction. Chapter 1 examines the Saudi legal system, looking particularly at the aspects of the legal system relevant to regulation and protection of foreign investment. This examination includes the elucidation of the principal sources of the basic law of the country, the jurisdiction of Saudi courts including the Shari'a courts and the Board of Grievances which plays a major role in settling foreign investment disputes.

The security and sanctity, under law, of investment agreements signed by the Saudi government is the topic examined in chapter 2. Chapter 3 investigates the dispute settlement system and applicable law in the Kingdom and how international dispute resolution measures are applied. The purpose of this chapter is to elucidate the available mechanisms for the settlement of investment disputes including litigation, arbitration and the provisions of international instruments. It also explores arbitration under Islamic law and the attitude of the Saudi government towards arbitration.

Chapter 4 introduces the evolution of the contractual relationship between Saudi Arabia and ARAMCO. The aim of this chapter is twofold: First, it demonstrates the commitment of the Saudi government to its agreements with ARAMCO by showing that the Saudi Government avoided resorting to unilateral action such as nationalisation. This is crucial evidence of the general policy of the Saudi Government towards the protection of foreign investment in Saudi Arabia. The second aim of the chapter is to introduce the government's general policy on privatisation of the economy in order to provide foreign investors with an attractive investment environment.

Chapter 5 investigates the issue of protection of foreign investment under Saudi law, Islamic law and international law. This investigation looks at the state's right to regulate foreign investment within its territorial boundaries. This includes the two positions of host state regulation and home state control over foreign investors. The purpose of this chapter is to demonstrate the treatment of foreign investors, particularly the "minimum standard" of treatment put forward by the developed world and the "national treatment" standard argued for by developing countries.

Chapter 6 discusses the licensing of foreign investment and the legal incentives offered to foreign investors in the Kingdom. Efforts are made here to show whether or not the incentives offered to foreign investors are suitable in the light of limited comparison with incentives offered by other host countries. Finally, chapter 7 formulates general conclusions and suggested legal reforms.

# (1) THE LEGAL SYSTEM AND FOREIGN INVESTMENT IN SAUDI ARABIA

## Introduction

This chapter sets out the general framework of Islamic or Shari'a Law and looks at the ways in which it addresses the important analytical issues relating to Islamic law, foreign investment and state participation and ownership over the oil and gas resources in Saudi Arabia. It will also briefly highlight the importance of international law in relation to the treatment of foreign investment in a country like Saudi Arabia. Islamic Law forms the basic foundation for the law systems of all the Arab countries, thus creating a lot of similarities in the approaches of these countries to foreign investment and the oil industry. The oil and gas resources are of profound importance in Islam. Like water they are considered a blessing from God.<sup>1</sup> However, it is not the purpose of this chapter to explore theological issues in any detail but rather to refer to the main principles that are derived from the Islamic legal framework pertaining to oil and gas issues and to discuss how Saudi Arabia, as a country with an Islamic constitution, can abide by these principles whilst encouraging foreign investment in the oil and gas industry. The chapter will therefore analyse two models of law. The first is the set of theologically based Islamic law principles as they pertain to legal aspects of oil and gas. Having established these principles, it will then examine the

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<sup>1</sup> The *Quran* is the primary source for Islamic values. Muslims believe that it is the exact word of Allah revealed to the Prophet Muhammad (pbuh) through the Angel Gabriel. While the *Quran* does contain some specific prescriptions that rank as legal, primarily it establishes a general set of moral guidelines - a compass for Muslims to use in following an Islamic way of life. The *Quran* says of itself that "Here is a plain statement to men, a guidance and instruction to those who fear Allah." (Chapter 3: Verse 138).

application of Islamic law in Saudi Arabia in order to examine the specific Saudi model of law that is derived from the larger umbrella of Islamic law.<sup>2</sup> This chapter provides the context for the thesis, since it is necessary to understand the scope of the implementation and adaptation of Islamic law by the Saudi Government. From that point it will be a more straightforward task to differentiate between the Saudi Law system and Islamic Law. Hence, whenever any comparison is made with any other legal system(s), there should be no confusion between these two related but different systems of law. The important distinction being that although Saudi law is derived from Islamic law and its principles, it is a distinct system in its own right,<sup>3</sup> and it is *this* Saudi system that is of concern in terms of arriving at a framework for dealing with foreign investment in the oil and gas industry.

## ***1.1 The legal system of Saudi Arabia***

Saudi Arabia is a monarchy with the King as the religious leader, 'Imam' and the source of political power in the country.<sup>4</sup> His power and duties are defined in Islamic law, according to which he must serve for the good of the people, and he has been given full authority to issue or approve any law provided that it does not contradict Islamic law.<sup>5</sup>

Article 1 of the Basic Law<sup>6</sup> states that "The Kingdom of Saudi Arabia is a sovereign Arab Islamic state with Islam as its religion; God's Book and the *Sunnah* of His Prophet, God's

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<sup>2</sup> See Saudi information at <http://www.saudinf.com/> (12/12/06).

<sup>3</sup> Ibid.

<sup>4</sup> Some of the important laws of the Saudi Government are the Constitution or Basic Law of Government (1993), the Consultative Council Establishment Act (1993), the Consultative Council Statute (1993), the Consultative Council Membership Statute (1993), the Consultative Council Sanctions Statute (1993), the Consultative Council Finances Statute (1993), the Council of Ministers Statute (1993) and the Regional Authorities Establishment Act (1993). The texts of these legislative instruments can be seen at [http://www.oefre.unibe.ch/law/icl/sa\\_indx.html](http://www.oefre.unibe.ch/law/icl/sa_indx.html) (12 Dec 2005).

<sup>5</sup> It is narrated that the prophet Muhammad (pbuh) said: "It is necessary upon a Muslim to listen to and obey the ruler, as long as one is not ordered to carry out a sin." (Sahih al-Bukhari, no 2796). See also Al-Saleh, M., *Foreign Investment Regulation in the Kingdom of Saudi Arabia: Law and Policy*, PhD Thesis, (unpublished), University of Warwick, (1994) p.3.

<sup>6</sup> The Basic Law (Constitution) of the Kingdom of Saudi Arabia, 1993 was officially adopted by Royal decree of King Fahd, Oct 1993. See text at: [http://www.oefre.unibe.ch/law/icl/sa00000\\_.html](http://www.oefre.unibe.ch/law/icl/sa00000_.html) (10 Dec. 2007).

prayers and peace be upon him, are its constitution, Arabic is its language and Riyadh is its capital.”

Saudi Arabia is one of the most traditionalist Islamic legal systems in the world today. Constitutionally, Islamic law is the law of the land, and the general jurisdiction is exercised by judges trained in Shari’a jurisprudence. In common with other theologically based jurisprudential system, different philosophical and legal schools developed during Islam’s history. In Saudi Arabia, the judges primarily apply the Shari’a according to the teaching of the *Hanbali*<sup>7</sup> Juristic School. Western laws and legal concepts are frequently applied in day-to-day commercial practice and practical solutions provided by Shari’a are often similar or even identical to those known to Western jurisdictions.<sup>8</sup>

Saudi Arabian society underwent a significant number of changes due to the oil boom of the 1970s, and these changes in the wider economic, social and political cultures have affected the legal system. As a result, Saudi Arabia has created legal institutions that appear modern and similar to many that exist in the West. In particular the promulgation of numerous regulations and decree laws, as well as the creation of a number of judicial and quasi-judicial bodies to deal with issues arising under the new “legislation”, marked a transformation of the Saudi legal system. The Saudi legal system is a legal system *sui generis*, in that it resembles the system of neither civil law nor common law countries. This is due to the fact that Saudi law is based on the principles of the Shari’a, mainly in accordance with the teaching of the *Hanbali* School, and not on a codification of laws as in civil law jurisdictions or case law in common law jurisdictions.

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<sup>7</sup> An explanation of the four Juristic Schools will be dealt with later on in this chapter.

<sup>8</sup> For more discussion, see chapter 2.

The legal system of Saudi Arabia is based on two types of law, 'Shari'a' or Islamic Law on the one hand and Decree Law on the other hand. Shari'a is based on the *Quran* and the sayings of the Prophet Mohammed. Decree laws are issued to regulate industrial and commercial affairs, such as company law, the mining code, foreign treaties, oil and mineral concessions and foreign capital investment regulations. The Decree laws require the King's approval to be promulgated as Royal Decrees<sup>9</sup>, such as the main law that regulates foreign investment, namely the 1979 Foreign Capital Investment Code (FCIC), which will be examined below in the chapter.

According to some scholars, Islamic law is the 'law that governs adherents of the Muslim religion' in that it 'provides rules to cover all aspects of a person's life, within a complete moral and ethical code of conduct'.<sup>10</sup> As far as foreign investment is concerned, Islamic law provides the necessary protection to foreign investors in that the taking of private property by the state is not allowed except in the case of a contractual breach by the investor.<sup>11</sup> Additionally the 'state has the right of intervention and unilateral cancellation if the investor uses the property to the detriment of the state'.<sup>12</sup> We will highlight practical examples of such cases relating to the oil and gas industry in a chapter on dispute resolution.

The word "Shari'a" is the name given to the totality of God's commandments, which are constituted of the principles in the holy book *Quran* and the sayings and doings of the prophet. Shari'a consists of four sources: first and foremost is *Quran*, then *Sunnah*, Consensus (*Ijma'a*) and Analogy (*Quiyas*). *Quran* is the holy book of Islam. It consists of 6237 verses and constitutes God's ordinances to the people, which the prophet Muhammad

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<sup>9</sup> See Saudi Consulting House, *Basic facts about the Kingdom the Country and its People*, 7<sup>th</sup> ed. in *A Guide to Industrial Investment*, Riyadh, (1986), pp.3-17.

<sup>10</sup> See El-Malik, W., *Minerals Investment under the Sharia Law*, London: Graham & Tortman, (1993) p.3.

<sup>11</sup> Article 11 of Foreign Investment Law of 2000.

<sup>12</sup> *Ibid.*

received from God over a period of twenty three years. However, this is not to say that *Quran* addresses every aspect or situation which may arise at any future point in history in specific terms, but it offers general guidance which is interpreted in the light of other sources. *Quran* means, in Arabic, “reading” and it is considered by Muslims to be the ultimate authority in legal and religious matters.

## ***1.2 A closer look at Islamic Law***

An important starting point is to look at the opinions of the scholars that shaped the Islamic legal tradition about 1300 years ago for their opinions on what Islamic law is all about. According to Malik,<sup>13</sup> Islamic law is the ‘law that governs adherents of the Muslim’s religion in that it provides rules to cover all aspects of a person’s life, within a complete moral and ethical code of conduct’.<sup>14</sup> Hence morality is equal to legality or, to put it another way, whenever immorality arises there is also illegality. The *Quran* remains the word of God and the basic foundation of the Islamic religion, as it contains the general principles of Islamic law. These principles include the principle of sovereignty and of economic fundamentals, as well as political principles and the establishment of the Consultative Council (*Shurah*). The Council of Ministers is the main decision-making and governing body of the state.<sup>15</sup> The presentation of the Islamic perspective on foreign investment in the oil and

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<sup>13</sup> Imam *Malik* is one of the greatest scholars in the Islamic History. He lived in *Maddinah* and was known as the leader and the founder of school of *Haddith* (prophet speech), which means that he has the strongest knowledge of the Islamic legal system as he directly took the *haddith* from the followers of the prophet’s companions. Therefore his statements are still highly influential in Saudi Arabia.

<sup>14</sup> See Vogel, F., *Islamic law and Legal System: Studies of Saudi Arabia*, Leiden, Brill, (2000), p. 3. See also El-Malik, W., supra note 10, p.3. Islamic Law does deal with temporal life as well as the hereafter. Therefore, whatever action we take in this life will have an effect on the afterlife.

<sup>15</sup> *Shurah* is refers to the assembly of a group of representative people who decide the policy and decisions of the government, which can now be called Parliament, it should be noted, however, that members of the council are appointed by the king, see Consultative Council Membership Statute (1993) Article 1. See also Zaidan, A., *Alwajiz fi Usul Al-Fiqh*\_(Summery in the Islamic Jurisprudents), Beirut: Muassasatu Ar-Risalah, (1996), pp. 378-385.

gas industry or any other issue must be based upon these sources.<sup>16</sup> The reason is that they are considered as the main sources of Sharia, inviolable for Muslims and they contain the economic and sovereignty principles for the government to use.

Both *Quran* and *Sunnah* are known as the basis of religion and Islamic Law, and originally, no other sources of Islam were accepted. However, after the death of the prophet in 632 A.D., the second stage of Islam began under the guidance of the followers of the prophet. They continued to decide cases in accordance with the primary source, *Quran* and *Sunnah*. However, if these sources made no specific reference to the matter in question, the companions reached a consensus or resorted to analogy. Consensus means the agreement of Muslim jurists, in any particular age, on a rule of law. Consensus and analogy are the third and fourth sources which were not used until the second *Hijrah*<sup>17</sup> century.

The following section highlights both the *Quran* and *Sunnah* as the main sources of Saudi law which are relevant to our main research area of foreign investment in the oil industry of Saudi Arabia.

### 1.2.1 *Quran* and *Sunnah* as the main sources

While the *Quran* is the main source and guide for Muslims, containing the revelation of Allah, the *Sunnah*<sup>18</sup> reflects what the Prophet said, did, or tacitly approved. In Islam, following the example of the Prophet is given great importance because the *Quran* instructs

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<sup>16</sup> Therefore, to be consistent with all legitimate discussions of Islam, quotes from both the *Quran* and the *Sunnah* are included in this chapter wherever appropriate.

<sup>17</sup> The *Hijrah* refers to the Prophet's migration from Mecca to *Madinah*. This journey took place in the twelfth year of his mission (622 C.E). It is the beginning of the Muslim calendar. The word *hijrah* means to leave a place to seek sanctuary or freedom from persecution or freedom of religion or any other purpose. *Hijrah* can also mean to leave a bad way of life for a good or more righteous way.

<sup>18</sup> 'Sunnah means the way, custom and habit of life and also the utterances of the prophet, *Haddith*. The principle based on the '*Sunnah*' includes the authentic sayings and deeds of the prophet Mohammed as it is stated in the *Quran*, 'Who so obeys the messenger, obeys Allah. (4:80).

Muslims to follow him: “*O ye who believe! Obey Allah and obey the Apostle.*”<sup>19</sup> For Muslims, the Prophet is the perfect human role model and leader and the society he built around him is the model for a caring, equitable society. The degree of importance attached to the Prophet in Islam is unparalleled in any other religion. If the *Quran* is a compass for Muslims, the *Sunnah* – the sayings and doings of the prophet Muhammad or those things which were allowed by the prophet (*pbuh*) to be done by his companions in his time – is a more detailed map for the human journey on earth. It includes the silence of the Prophet (*pbuh*) on some matters which happened or some actions done in front of him. Moreover, as far as the *Hadith* – the oral traditions relating to the sayings and deeds of the Prophet (*pbuh*) – nature is concerned, some of them are binding on Muslims while some are only factors to take into account.

For example, the prophet did not approve the sale of water except for its supply and for distribution services. For water allocation and equal distribution, the Prophet (*pbuh*) insisted on equal water distribution among the companions. The *Sunnah* is the second source of Islamic Law/Shari’a. What is the most important here is that those incidents, their natures and occurrences at different times, have led Muslim Scholars to find different opinions about water distribution itself and how to develop them in our lifetime. The reasoning behind this is that the actions of the Prophet (*pbuh*) and those who lived with him are followed for as long as they are suitable for our time. This is what the Islamic jurisprudence says about it i.e. we pursue the actions which are the most suitable for our lifetime, but at the same time we will base our actions on the general principles and guidelines that the Prophet provided for us. So, as current conditions are different from those prevalent in the Prophet’s time, we have our own problems which are different from those of that time. Therefore we address our

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<sup>19</sup> The Holy Quran (4:59)

problems and changes through a combination of the Prophet's guidelines and our own current issues. It explains the Quran and interprets its general provisions. The *Quran* is the text and the *hadith* are its commentaries.<sup>20</sup>

### 1.2.2 The inviolability of *Quran* and *Sunnah*.

The *Quran* and *Sunnah* are presented to us protected and unaltered. Some of the *Sahaba*, or companions of the Prophet, memorised and wrote down what the Prophet said or did. These documented narrations are called *hadith*, and they were later checked for authenticity based upon such factors as independent confirmation, soundness of the chain of narration, credibility of narrators in the chain, and consistency with other *hadith* and the *Quran*.<sup>21</sup> In specific cases, known as *hadith qudsi*, Muslims believe that the Prophet's sayings are the revelation of Allah, expressed in the Prophet's own words, but only in relation to the matters of laws and regulations to the community. Otherwise, Muslims consider the Prophet as a normal human being.

There are six sources, which are considered to be the most accurate and reliable, those of Imam Al-Bukhari,<sup>22</sup> Imam Muslim, Imam Al-Tirmidhi,<sup>23</sup> Imam Malik,<sup>24</sup> Imam Abu-Dawood,<sup>25</sup> and Imam Ibn Majah.<sup>26</sup> Importantly, in addition to the *Quran* and the *Sunnah*, *Ijtihad* can be used to make rulings that address new questions related to changing conditions.

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<sup>20</sup> The above two sources are primary sources, whereas the second category is composed of auxiliary sources called the *Ijma* (consensus) and *Qiyas* (analogy). For more discussion see Vogel, F., supra note 14 pp. 36, 40 & 56. See also Lombardini, M., *The international Islamic Court of Justice: Towards an International Islamic Legal System?* Leiden *Journal of International Law*, V. 14 (2001), P. 675.

<sup>21</sup> See Zaidan, A., Supra, note 14, p. 382.

<sup>22</sup> Born in 194 H, and died in 256 H. See Islam web for details, <http://www.islamweb.net/ver2/archive/readArt.php?lang=A&id=16729> (14/12/06).

<sup>23</sup> Born in 207H, died in 279H. See *ibid*.

<sup>24</sup> Born in 93H, died in 179H. See *ibid*.

<sup>25</sup> Died in 275H. See <http://www.islamweb.net/ver2/Fatwa/ShowFatwa.php> (15/12/06).

<sup>26</sup> Died in 273. See *ibid*.

Essentially, *Ijtihad* is the development of Shari'a from its sources i.e. the *Quran* and the *sunnah*. The five tools used to carry out *Ijtihad* are *Quiyas* (analogy), *Ijma* (unanimous agreement of jurists), *Istihsan* (juristic preference), *Maslaha* or *Istislah* (public interest or human welfare), and *Istishab* (continuity or permanence).<sup>27</sup> Although some forms of inquiry are indeed prohibited in Islam, such as questioning key articles of Islamic faith (for example, the oneness of God) – there is an increasing need for multidisciplinary<sup>28</sup> creative inquiry into new problems and questions arising in today's society, following the guidelines already established by the *Quran* and *Sunnah*.<sup>29</sup>

### 1.2.3 Economic and sovereignty principles in *Quran* and *Sunnah*

The Islamic interpretation of the principle of sovereignty is that God is the only true sovereign. God delegates to mankind the power to rule the Earth and the issues of sovereignty therefore pass to the government, whose duty is to administer to the people in the way that is prescribed by the *Quran* and *Sunnah*. As far as the Muslim community (*Ummah*) is concerned, they should use this power, delegated from God, to conduct the worldly affairs of their nations, and should not abuse this position.<sup>30</sup> Thus, the importance of these principles of sovereignty is that Muslims obey their system of law as something of divine origin, and not merely the will of the majority of the leaders of the country.<sup>31</sup> At the same time, there is always some scope left to make decisions and to change the nature of the rules and regulations when the times demand it, so as to have an updated and modernised system of

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<sup>27</sup> For more in-depth analysis see Vogel, F., supra note 14, chapter 1, "*Ijtihad as Law*", pp. 3-32. See also Faruqi, N. and Al-Jayyousi, O., *Water Management in Islam*, United Nations University Press, (2001).

<sup>28</sup> For more details supported by examples, see chapter two in stability of investment agreements under Shari'a.

<sup>29</sup> See Zaidan, A., Supra note 17 p. 382.

<sup>30</sup> This principle of sovereignty is explained by *Al-Maududi* "no doubt the Islamic state is a sovereign state in the real sense of his term vis-à-vis the other states of the world, but if it tries to assert its sovereignty vis-à-vis the command of God and his messenger this would amount to the clear negation of its Islamic character" *Al-Maududi, Islamic Law and Constitution*, Lahore: Islamic Publications, (1960) p. 249, also see El-Malik, W., supra note 10, p.10.

<sup>31</sup> *Ibid*

law. Meanwhile, political powers under the principles of sovereignty include the rule that consultation - *Shurah* - is the basis of government in particular issues and legislation. The *Shurah* is a forum for discussion with a view to reaching a decision based on agreement and general support. The *Quran* refers to “those who harked to their lord, and establish regular prayers, who conduct their affairs by mutual consultation”.<sup>32</sup>

For the purposes of our examination of foreign investment in the oil industry, it would also be useful to outline some of the economic principles found under Islamic law. These principles dictate that Islam is broadly opposed to the intervention of the state in economic activities, with the right of private property being guaranteed. Thus, there is no provision for the taking of private property unless that property is being used contrary to the teachings of Islam,<sup>33</sup> or if the owner of the property fails to fulfil his obligations under a specified contract.<sup>34</sup> Obviously, these related principles are important with regard to the treatment of foreign investment in Saudi’s oil and gas industry. On the one hand, Islamic Law would seem to suggest that it is the government’s role – under the principle of sovereignty – to administer this and other economic sectors in the best interests of the people.<sup>35</sup> However, it might also be argued that public interest would be best served by the introduction of private investment in a

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<sup>32</sup> Quran: (42:38).

<sup>33</sup> The inviolability of property has been also asserted in the teachings of the jurists of schools of Islamic jurisprudence. However, Shari’a prohibits investments in activities which are contrary to it such as illicit drugs, alcohol and gambling. All these matters have direct connection to Islamic jurisprudence on public policy, and public interests. Also the principles of the necessity (*Darura*) under the Islamic legal maxim are always applied. In other words, if the right of ownership comes into conflict with the public interest, the latter prevails. See Coulson, N., *The State and the Individual In Islamic Law*, International & Comparative Law Quarterly, Vol. 6, Issue 1, Jan. 1957, pp. 49-60.

<sup>34</sup> The obligations are that the companies and the private sector should act faithfully as should the public sector. Accordingly, the expropriation of private property is also justified against the payment of just compensation and the execution of a judgement against a debtor’s property. This is to promote good life quality for the people. It should be noted in this context that compensation for lost potential profits and the obligation to pay interests on overdue payments are prohibited under Shari’a. See Al-Samman, Y., *The Legal Protection Of Foreign Investment In The Kingdom Of Saudi Arabia*, Dar Al Andalus for Pub. & Dist. Hail, Saudi Arabia, (2000), pp. 58-59.

<sup>35</sup> El-Malik, W., *State Ownership of Minerals Under Islamic Law*, Journal of Energy and Natural Resources Law, Vol.14 No. 3, (1996), p. 316.

particular sector. Under the economic principles of Islamic law, which are broadly opposed to government intervention, foreign investment would appear to be justified so long as it continues to serve the interests of the public. Furthermore, Islamic teaching would appear to accept investment in the oil industry even if it comes from outside the country, with the *Quran* stating that “there is no compulsion in religion”<sup>36</sup> meaning that it is the duty of Muslims to allow non-Muslims to live according to their respective laws, within the limitations of public morality and security. After all, all human beings are regarded as equal and should be treated as such.<sup>37</sup> Additionally, the political view of government to foreign investment is based on Islamic law which includes the rule of consultation (*Shurah*) as the basis of government (i.e. ‘discussion with a view to reaching a decision based on agreement and general support’).<sup>38</sup>

The above are some of the important principles on which the Saudi legal system is based, and they are referred to again in the following section and chapters on foreign investment in the oil and gas industry of Saudi Arabia. Up to this point, then, we have examined the general background of the *Quran* and *Sunnah* as the main sources for Islamic Law, and have explored matters within these sources related specifically to economic and political sovereignty under Islamic Law. The above background sets the context for the next section, which concentrates on the approach of the Saudi Courts to foreign investment.

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<sup>36</sup> See Verse (2:256) which states that all humans are the stewards of common resources that belong to the community.

<sup>37</sup> See also *Quran* verse 17:70 which states that ‘we have made the children of Adam respectable’ and also 49:13.

<sup>38</sup> The *Quran* (42:38) refers to “those who harked to their lord, and establish regular prayers, who conduct their affairs by mutual consultation”.

### *1.3 Jurisdiction of the Saudi Courts concerning foreign investment*

According to Saudi Constitutional law, the authorities of the state consist of the judiciary, executive and the regulatory authority.<sup>39</sup> These authorities cooperate with each other in the performance of their duties, in accordance with this and other laws. The King is the head of all these authorities.<sup>40</sup> The Saudi judicial system consists of both general courts and specialised tribunals.<sup>41</sup> The courts, which are of general jurisdiction in Saudi Arabia are Shari'a courts administered by the Ministry of Justice according to the Judicial Code of 1975.<sup>42</sup> Shari'a Courts have general jurisdiction over all disputes except those excluded from their jurisdiction by special codes.<sup>43</sup> In particular, they have exclusive jurisdiction over civil, criminal cases and matters of personal status.<sup>44</sup>

The legal basis for the courts in Saudi is the Basic Law and the Holy Quran.<sup>45</sup> The judiciary is an independent authority and there is no political control over judges in the dispensation of their judgments except in the case of the Islamic Shari'a.<sup>46</sup> The Constitution further provides for the right to litigation, which is guaranteed to all citizens and residents of the Kingdom on an equal basis.<sup>47</sup> These issues are important to the subsequent discussion

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<sup>39</sup>See Chapter 6 The Authorities of the State, Article 44 of the Basic Law.

<sup>40</sup> Ibid.

<sup>41</sup> The courts and tribunals may consist of a combination of judges and non-judges. Decisions may be given quickly or may take some time and in some cases, decisions may be appealed. See Info-Prod Research (Middle East), Saudi Arabia, <http://www.infoprod.co.il/country/saudiaza.htm> and <http://www.infoprod.co.il/article/24> (5/7/06).

<sup>42</sup> Royal Decree No. M/64 dated 14/7/1395 H. (July 23, 1975), as amended by Royal Decree No. M/76 dated 14/10/1395 H. (19/10/ 1975); Royal Decree No. M/4 dated 1/3/1401 H. ( 6/01/1981)

<sup>43</sup> Article 9 & 25 of the Law of the Judiciary. See also Al-Samaan, Y., *supra* note 33, p220.

<sup>44</sup> Royal Decree No. M/76 of 1975. Shari'a Courts consist of Summary Courts, Ordinary Courts and Courts of Appeal.

<sup>45</sup> Article 45 of the Constitution states that the sources of the deliverance of fatwa in the Kingdom of Saudi Arabia are God's Book (Holy *Quran*) and the *Sunnah* of His Messenger. In turn, this law defines the composition of the senior *ulema* body, the administration of scientific research, deliverance of *fatwa* and its (body of senior *ulema's*) functions.

<sup>46</sup> Article 46.

<sup>47</sup> Article 47. In terms of Article 48, the courts are under an obligation to apply the rules of the Islamic Shari'a in all the cases that are brought before them. The judgments are carried out in accordance with what is indicated in the *Quran* and the *Sunnah*, and regulations decreed by the Ruler which do not contradict the *Quran* or the

which highlights the treatment of foreign investment in the oil industry and also some of the examples of dispute resolution in chapter three.

The King appoints judges on the recommendation of the Supreme Judicial Council (SJC), which is composed of 11 senior jurists also appointed by the King. Judges, including those who sit on the SJC, are appointed for life. Although appointed by the king, judges are subject only to the provisions of Shari'a and the law.<sup>48</sup> Article 1 of the 1975 code provides: "Judges are independent and not subject to any authority in rendering judgment except as that provided in Shari'a and applicable regulations. No person shall have the right to interfere in the judicial process. Accordingly, judges are required to conduct their functions independently and impartially".<sup>49</sup> Under Article 58, Judges are prohibited from engaging in commercial activities and from performing any other work incompatible with the dignity of judicial office and the principle of judicial independence.

To maintain independence, disciplinary matters concerning members of the judiciary are handled by a special committee of the Ministry of Justice. The SJC appoints members of this special committee. The members are chosen from the ranks of jurists of the Court of Appeals and general courts. The 1975 Judicial Law provides for disciplinary trials to be held in public, unless the special committee decides otherwise.<sup>50</sup>

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Sunnah. Another function of the courts is to arbitrate in all disputes and crimes. Finally the King or his deputy is responsible for the implementation of judicial rulings (Article 50).

<sup>48</sup> See Article 45 of the Constitution.

<sup>49</sup> Article 1 of the Law of the Judiciary. See also Al-Samaan, Y., *The Legal Security of Private Foreign Investment in the Kingdom of Saudi Arabia*, Unpublished PhD Thesis, CEPMLP., University of Dundee, (1993), p 249.

<sup>50</sup> Article 33 of the Law of the Judiciary. See also Lerrick, A. & Mian, J., *Saudi Business and Labour Law*, Graham & Trotman, (1987), p. 200.

An understanding of the roles and functions of the different courts is important in our examination of the legal system of Saudi Arabia, which will also shed light on matters concerning the treatment of foreign investment in the oil and gas sector mentioned in the next chapter. The following section therefore provides a necessary overview of the different types of courts and other judicial bodies in Saudi Arabia.

### 1.3.1 Shari'a Court

The Shari'a Courts form the largest court system in Saudi Arabia<sup>51</sup>. As a general rule, the Shari'a courts have jurisdiction over all matters except where a special committee has expressly granted exclusive jurisdiction to another judicial authority.<sup>52</sup> Whilst the Shari'a courts try cases involving civil, criminal, family, personal injury and personal property matters, they do not hear commercial cases.<sup>53</sup> The Shari'a courts apply only Islamic Law.<sup>54</sup>

Expediency is an important feature of the Shari'a Courts. The time between hearings is usually no more than a few weeks, and a final judgement is typically rendered within a few months. Until recently, most judgements rendered by Shari'a courts were not published, but a new decision regarding the publication of judicial decisions was issued by the Council of Ministers in 2003.<sup>55</sup>

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<sup>51</sup> Different types of courts are established under the Constitution of the country (see the Royal Decree No. M/76 of 1975). In October 2007 Shari'a Courts were reorganised into several categories: Courts of the First Instance (Summary and General Courts), Courts of Appeal and the Supreme Court. See Saudi embassy website in Washington at: [http://www.saudiembassy.net/about/country-information/government/legal\\_and\\_judicial\\_structure.aspx](http://www.saudiembassy.net/about/country-information/government/legal_and_judicial_structure.aspx). 13/11/09. See also Article 9 of the Law of the Judiciary.

<sup>52</sup> Al-Samaan, Y., supra note 33, p. 220.

<sup>53</sup> Commercial courts will oversee disputes that had previously been addressed by special Ministry of Commerce and Industry committees, see Saudi Embassy website at: <http://www.saudiembassy.net/archive/2007/news/page152.aspx>. Accessed on 13/11/09.

<sup>54</sup> Royal Decree No. M/76 of 1975.

<sup>55</sup> Article 21 of the Law of the Board of Grievances.

The judicial system of the Shari'a Courts consists of four tiers. The first level consists of Summary Courts, empowered to hear civil and criminal cases. Summary court jurisdiction in civil cases is limited to claims of up to SR 20,000, excluding property matters. Criminal jurisdiction extends to all offences not reserved for General Court review, which may be referred to as petty offences. In the second level are the General Courts, which are the courts of first instance in matters beyond the jurisdiction of the Summary Courts. The General Courts also include the Grand Shari'a courts that sit in major cities. The jurisdiction of the General Courts extends over matters concerning amounts in dispute in excess of SR 20,000 and serious criminal offences. The Court of Appeal, located in Riyadh, is the third level of court. Appeals are usually on issues of law, with a great deal of discretion given to the court of first instance on issues of fact. For most matters, the Court of Appeal is the final court of appeal. The SJC, the supreme instance in the land, is not truly a court, but a body which issues opinions at the request of the King or the Minister of Justice. The SJC does, however, have final jurisdiction over capital cases, in which the King is the final point of appeal, with power to grant pardons.

### **1.3.2 Board of Grievances**

Since 22 June 1987, the Board of Grievances has become the competent judicial body to adjudicate on commercial disputes involving the government or any of its agencies with investors.<sup>56</sup> To meet the growing needs of government administration, the government of Saudi Arabia has adopted the concept of *Mazalim* to resolve disputes to which the government, or any of its agencies, is a party. Thus, Article 19 of the Council of Ministers Code of 1954 provides for the establishment of the Board of Grievances (*Diwan al-*

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<sup>56</sup> The concept of grievances has its roots in the early Islamic period and was practiced by the prophet and later by the caliphs who appointed judges to hear grievances and resolve them using their knowledge of the Islamic Shari'a.

*Mazalim*)<sup>57</sup> as an institution attached to the Council of Ministers.<sup>58</sup> The Board was re-organised in 1955 and became an independent institution headed by a president who was directly responsible to the King.<sup>59</sup> The Board is the exclusive forum for disputes between the Saudi government and private contractors. The Board of Grievances also has jurisdiction over distributorship, commercial agency and maritime disputes, and those involving company regulation and all other purely commercial matters, except for those related to banking which are dealt with by the Commercial Paper Committee.<sup>60</sup>

The Board of Grievances is divided into three circuits, corresponding to the field of administrative law, commercial law and criminal cases mostly related to commercial dealings,<sup>61</sup> which is the third circuit. Each circuit has two levels, the circuit level (Court of first instance) and the appellate panel, which renders final decisions on appeal.<sup>62</sup> In relation to the former, the lack of satisfactory definition of what constitutes a commercial dispute is a source of uncertainty. A major problem stems from the separation between the Board and the Shari'a courts because there is a grey area around the definition of "commercial disputes", the term that determines the conflict and, therefore, the competent court involved for resolving the dispute. In general, foreign investors prefer cases to be heard before the Board

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<sup>57</sup> The term "Grievances" in Arabic *Mazalim* means to exceed the defined limits, as well as injustice and oppression. *Diwan* is the place where grievances are dealt with. See Ulian, S., *Qada Al-Mazalim fi Al-Islam*, (The Grievances' Rule in Islam), 2<sup>nd</sup> ed. Riyadh: Dar Al-Rasheed for Publications & Distributions, 1980), p. 49, (in Arabic).

<sup>58</sup> AbdulJawad, M., *Al-Tattawwur al-Tashrye Fi al Mamlaka al-Arabia al-Saudiya*, (Judicial Evolution in the KSA) Egypt: 1397 H. (1977), p. 155 (In Arabic) cited by Al- Samman, Y., supra note 10, p. 222.

<sup>59</sup> Royal Decree No. M/13/8759 dated 17/9/1374 H. (1955).

<sup>60</sup> Commercial Paper Committee will be highlighted shortly in this chapter.

<sup>61</sup> A number of different acts have been passed in which certain crimes and their respective punishments are specified. According to the 1983 Act, the Board may try five types of penal cases, namely, 1) Bribery 2) Forgery 3) Crimes listed in Royal Decree No. 43 of 1956 4) Crimes specified in the Managing Public Finance Act and 5) Crimes defined in different Acts referred to the Board by orders from the President of the Council of Ministers. See Clause 1 (f) of Article 8 of the Board 1983 Act.

<sup>62</sup> It should be noted however, that the legal reforms of 2007 has changed the BG to be solely an administrative court consists of Supreme Administrative Court, Administrative Courts of Appeal, and Administrative Courts. See Article 8 of the Law of the Board of Grievances. See also generally, Law Office of Hassan Mahassni and White & Case LLP, *General Description of the Current Legal System and Dispute Resolution in the Kingdom of Saudi Arabia*, (2000).

rather than the Shari'a court, as the judges in the Board are generally expected to have more knowledge and expertise in commercial law, international law and international commercial arbitration principles.

One special feature of the Board of Grievances is that its judges may consult judicially-appointed legal and technical experts. Thus they are able to consider cases that are more complex in the Shari'a Courts. As with the decisions of other courts, the decisions of the Board of Grievances remain mostly unpublished.<sup>63</sup>

Following the economic boom of 1970s, and the extensive involvement of government agencies in contractual relationships with private parties, the government of Saudi Arabia felt that the Board of Grievance needed to be restructured and accorded greater judicial powers to deal with all types of cases involving the government or any of its agencies, and private foreign and local parties. Consequently, the Board of Grievances was restructured by the 1983 Code.<sup>64</sup>

Although the Board as defined by Article 1 of the Code is an autonomous judicial body which possesses an exclusive jurisdiction over administrative cases, importantly it is under this Article, linked directly to the King. Accordingly, the president of the Board was still directly responsible to the King who had exclusive authority to either approve or reject the Board's findings. This is a matter which would be automatically perceived by foreign investors as a contradiction, due to the fact that its very autonomy is threatened by the superior executive power of King. However, if the Board, by modifying Article 1 of the

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<sup>63</sup> SAGIA, *The Legal Background to Foreign Investment in Saudi Arabia*, Saudi Arabian General Investment Authority, (2003).

<sup>64</sup> The BG. Code, Royal Decree No. M/51 dated 17/7/1402 H. (1983).

Board's Code, separates from direct linkage to the King and enjoys the equitable autonomy of the Shari'a courts, this might allay foreign investor apprehensions and thus restore confidence in the Saudi Arbitration system.

With the growing importance of foreign investment in the country, the government thought of restructuring the Board to give it more judicial authority to deal with all cases where the government is involved with private foreign investors. In 1983 the Board was restructured under a new Code to become a judicial administrative tribunal. According to Article 8, the Board has jurisdiction over claims submitted by government civil servants against the government, and appeals filed by interested parties from administrative decisions on the grounds of formal defects, violations of applicable codes and their implementation rules and abuse of power.<sup>65</sup> The jurisdiction of the Board also includes claims for compensation against the government, disputes concerning agreements between government agencies and private parties; disciplinary cases involving civil servants and criminal cases under the Anti-Bribery Code and Anti-Forgery Code.<sup>66</sup>

It remains a fact, however, that the Board of Grievances has a heavy volume of cases and as a result, the dispute resolution process before it is lengthier than in Shari'a Courts. A case may take between one and two years before a first instance decision, without taking into account any appeal. Although the Board is generally considered to be a fair and independent forum for hearing disputes and has the advantage of being better equipped to hear complex cases, one of the major disadvantages is the length of time it takes to reach a final

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<sup>65</sup> The Board, however, lacks the jurisdiction over appeals against administrative decisions of Special Committees such as that of the Foreign Capital Investment Committee whereby a foreign investor has the right to appeal against a decision of the Committee. See Article 10 of the 1979 Foreign Capital Investment Code (FCIC).

<sup>66</sup> For a detailed examination of the procedures and judgments of the Board, see Al- Samaan, Y., *supra* note 33, pp.227-232.

judgement.<sup>67</sup> Foreign investors also take the view that local courts lack sufficient knowledge and expertise to deal with sophisticated investment transactions. Foreign investors see the publicity attached to local court hearings as an infringement of their confidential investment dealings.<sup>68</sup> It should be stated that, the actual practice of the Board is quite different to what the Rules lay down.<sup>69</sup> However, since as mentioned earlier in this chapter, the decisions of these local courts remain mostly unpublished. There is an absence of officially published and publically-available precedents from the Shari'a courts and the BG. Consequently, there is no means of tracking the results of the judgements for foreign investors, thereby making it difficult to predict in advance the result of a case based on legal precedents. Hence, due to a lack of knowledge of legal precedents, a judge may, for a similar case in another court, issue a completely different judgement. This is likely to fall short of many foreign investors' expectations, particularly for those who are familiar with western legal systems. Foreign investors expect a certain degree of predictability on judicial decisions and the Saudi judicial system has difficulty meeting international standards in this area. Investors also do not trust the impartiality of local courts. It is crucial that judges should perform their duties without any intervention; because it is an aspect of the rule of law. Some investors would therefore prefer arbitration as the means to settle any disputes arising from their investment transaction. This issue is examined in chapter six during the detailed discussion of the settlement of investment disputes through arbitration in Saudi Arabia.

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<sup>67</sup> Shoult, A., *Doing Business with Saudi Arabia*, 3<sup>rd</sup> ed. London: GMB Publishing Ltd, (2006), p. 93.

<sup>68</sup> Al-Samaan, Y., *The Settlement of Foreign Investment Disputes by Means of Domestic Arbitration in Saudi Arabia*, *Arab Law Quarterly*, Vol. 9, No. 3 (1994), pp. 217-237.

<sup>69</sup> Article 15 of the Procedural Rules before the BG 1989 provides that the hearings of the Board must take place in public, subject to one exception. The panel may hear the case in private if the panel concerned believes that to hear it in public would be in breach of the accepted standards of morality and public policy. However, regardless of whether the hearing itself is in public or in private, the pronouncement of the final decision of the panel must be in public. This raises the question as to what constitutes morality and public policy and what does not, because the Rules do not explain what is meant by morality and public policy. Such vague terms may lead to the panel preventing the public (including foreign investors) from attending a hearing beyond what could be justified on these grounds.

### **1.3.3 Limited Jurisdiction Administrative Tribunals and Special Committees**

Numerous ministries and government agencies have been granted limited authority to establish committees to hear specific categories of cases. Although these committees are all formed under the authority of a ministry, the dispute resolution mechanism is tightly regulated to ensure independence. These specialised administrative tribunals have statutes of limitation, and there are limited rights of appeal. However, the judgements made in all these bodies may be appealed to the BG. To enhance our understanding of the government bodies that allow for some settlement of disputes and commercial claims, the following is a general overview of these government bodies.

#### **(i) Commercial Paper Committee**

The Commercial Paper Committee is also known as the Office for the Settlement of Commercial Paper Disputes. This committee has jurisdiction to hear claims concerning bills of exchange, promissory notes and cheques<sup>70</sup>. Its powers come from the Negotiable Instruments Law.<sup>71</sup>

#### **(ii) Agency Conciliation Committee**

The Committee for Conciliation of Commercial Agency Disputes was established within the Chamber of Commerce in 1992. The Committee mediates where foreign companies experience difficulties in changing agents or distributors, due to conflicts with former agents. If Conciliation Committee mediation should fail, the matter is referred to the

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<sup>70</sup> The Negotiable Instruments Office, within the Ministry of Commerce and Industry, includes the Commercial Paper Committee, established by the Law of Negotiable Instruments Law, Royal Decree No. M/37 (1964)

<sup>71</sup> The Law largely reproduces the provisions of the Geneva Conventions Providing a Uniform Bills of Exchange and Promissory Notes of June 7, 1930 and for Cheques of March 9, 1931, even though Saudi Arabia has not become a party to the conventions themselves.

Board of Grievances, but in most cases its decisions will follow recommendations of the Conciliation Committee. There is also a Commission for Labour Disputes and a Committee for Settlement of Banking Disputes for the purpose of settling disputes between banks and their clients arising from contracts and transactions which do not concern commercial papers such as bills of exchange and letter of credits.

### **(iii) Investment Disputes Settlement Committee**

Article 26 of the Rules of Implementation under the Foreign Investment Regulations promulgated in April 2000 provides for the General Investment Authority,<sup>72</sup> to establish a committee comprised of three members, one whom must be a legal advisor. Article 26 requires such a committee to amicably settle differences arising between the parties referred to in Article 26 of the Foreign Investment Regulations. The differences referred to in Article 26 include both differences between the government and foreign investors<sup>73</sup> and the differences between a foreign investor and its Saudi partner, if any. In both cases, the effect of Article 26 is that if any such difference is not settled amicably before the Investment Disputes Settlement Committee, the relevant parties the dispute shall be settled through arbitration according to the Arbitration Act and its executive rules issued by Royal Decree No. (46) Dated 12.7.1403 H.<sup>74</sup> In the case of unresolved differences between the government and a foreign investor, such litigation would be within the jurisdiction of an Administrative Division of the Board of Grievances. Unresolved differences between the foreign investor

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<sup>72</sup> The General Investment Authority reports to the Supreme Economic Council, which was established pursuant to the Supreme Economic Council Regulations promulgated under Royal Decree No. A/111 dated 28/08/1999. The General Investment Authority, was itself established pursuant to the Regulations of the General Investment Authority promulgated under Council of Ministers Resolution N. 2 dated 10/04/2000, administers the Foreign Investment Regulations.

<sup>73</sup> It is not yet clear whether disputes arising out of noncompliance with the terms of an investment license issued under the new Foreign Investment Regulations will be required to be referred to the new committee, before being dealt with by the Board of Grievances.

<sup>74</sup> See Article 26 of the Executive Rules of Foreign Investment Act 2000, available in SAGIA website at: [http://www.sagia.gov.sa/Documents/Foreign\\_Investment\\_Act.pdf](http://www.sagia.gov.sa/Documents/Foreign_Investment_Act.pdf). Accessed on 14/11/2009.

and its Saudi partner would come under the jurisdiction of a Commercial Division of the Board of Grievances.

The application of international law by the Saudi Courts is based on Article 81 of the Constitution that adopts a monist approach<sup>75</sup> to international law. The national courts are therefore allowed to overrule the domestic rules and interpret international treaty provisions, which have been approved by the Saudi government, in harmony with international practice.

This raises the further question of the relationship between the Saudi legal system and that of international law as far as it concerns foreign investment. The following discussion highlights international legal perspective to illustrate the legal effects of international treaties relating to foreign investment in the Saudi domestic legal system. In other words it addresses the question of to what extent international treaties have an influence on the position of foreign investment in Saudi Arabia.

#### ***1.4 Legal effects of international treaties in domestic law***

Saudi Arabia has entered into and ratified many international and regional conventions and protocols. These conventions are sources of international law which are applied by the International Court of Justice. These international conventions are establishing rules expressly recognised by the contesting States.<sup>76</sup> Other sources of international law are *international custom*, as evidence of a general practice accepted as law; and the *general*

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<sup>75</sup> Monism/dualism debate is highlighted later on in this chapter.

<sup>76</sup> Article 38 of the Statute of the International Court of Justice, *supra* note, 8. The Court may also decide a case *ex aequo et bono* (according to what is just and good), if the parties agree thereto. Furthermore, in terms of Article 59, the decision of the Court is only binding between the parties and in respect of that particular case. For the management and peaceful resolution through the ICJ, see Peck C and Lee R (eds.), *Increasing the effectiveness of the international court of justice: Proceedings of the ICJ/UNITAR Colloquium to celebrate the 50<sup>th</sup> Anniversary of the Court*, Martinus Nijhoff Publishers, (1997). See also Singh, N., *The Rule and Record of the International Court of Justice*, Martinus Nijhoff Publishers, (1989), p. 376.

*principles of law* recognised by civilised nations. These are supported by subsidiary sources for the determination of rules of law by highly qualified publicists of the various nations and judicial decisions.<sup>77</sup>

Any discussion of the relationship between international and municipal law involves the controversy that exists between the theories of *monism and dualism*. Monism implies that international law in the form of a treaty may, without legislation, become part of domestic law once such treaty has been concluded in accordance with the constitution and has come into force.<sup>78</sup> Dualism, on the other hand, means that international law is separate from municipal law and that a treaty has no special status in domestic law unless specific legislation is in force to give effect to such treaty.<sup>79</sup> This controversy between the two theories has divided international lawyers over many years. This distinction is most relevant when considering whether a national court should apply a rule of international law. The main issue is whether international law and national law are two separate legal orders, existing independently of one another, and if so, on what basis it be said that either is superior to the other (*dualist view*); or whether they are both part of the same order (*monist view*).<sup>80</sup> Although these systems may in some cases come into conflict, thus giving rise to problems of conflict of law, each country has its own conflict rules whereby it settles such problems

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<sup>77</sup> For an examination of international law and States, international organisations and regimes and individuals see chapter 4 on International Personality in Wallace R, *International Law*, 4<sup>th</sup> ed. London: Sweet & Maxwell, (2002). See also Janis M, *An Introduction to International Law*, 2nd edition, Boston: Little, Brown and Company, (1993). For a recent study of the United Nations Legal Order (UNLO) see Joyner C (ed.), *The United Nation and International Law*, The American Society of International Law (ASIL), Cambridge University Press, (1997).

<sup>78</sup> See Aust A, *Modern Treaty Law in Practice*, Cambridge: Cambridge University Press, (2000), p.143, and his discussion of the group of countries which include France, Germany, The Netherlands, Poland, Russia and Switzerland with a monist approach to international law.

<sup>79</sup> *Ibid*, p. 150 – countries with a dualist approach include the United Kingdom and most commonwealth countries.

<sup>80</sup> Fitzmaurice stated that “the controversy is unreal, artificial and strictly beside the point, because there is no *common field* in which the two legal systems simultaneously have their spheres of activity”. See Harris D, *Cases and Materials on International Law*, 5th edition, Sweet & Maxwell, (1998), p.68. Thus, the general view is that there cannot be conflict between rules belonging to different judicial orders, and consequently, in particular between international and national law.

arising before its own courts. Therefore, there can be no conflict between the two systems in the domestic field, for any conflict will be settled by domestic conflict rules and any conflict between them in the international field, would be resolved by international law, because in that field international law is not only supreme, but in effect the only system there is. Domestic law does not apply in the international field: the supremacy of international law exists because of the field of operation, not because of the inherent supremacy of international law.<sup>81</sup>

The recognition of international law is given in Article 70 of the 1993 Saudi Arabia Constitution, which states that 'International treaties, agreements, regulations and concessions are approved and amended by Royal decree'. Furthermore, this is emphasised in Chapter 9 of the Constitution's General Provisions, where Article 81 states that 'The implementation of law will not prejudice the treaties and agreements signed by the Kingdom of Saudi Arabia with international bodies and organisations'.<sup>82</sup> Saudi therefore adopted a monist approach to the application of international law, which is in line with the general rules of international law that every treaty in force is binding upon the parties to it and must be performed in good faith.<sup>83</sup> Therefore a treaty which has been ratified by the State and which has entered into force internationally automatically becomes part of the law of the State, without any separate act of incorporation or transformation.<sup>84</sup>

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<sup>81</sup> Ibid.

<sup>82</sup> The international treaties and conventions can be seen the right mechanisms to create universal laws which can govern the relation between the different ideologies or legal systems. For more discussion see Maniruzzaman, A., *Choice of Law in International Contracts – Some Fundamental Conflict of Laws Issues*, *Journal of International Arbitration*, (1999) pp.141-172.

<sup>83</sup> The fundamental principle of the law of treaties: *pacta sunt servanda* laid down in Article 26 of the 1969 Vienna Convention on the Law of Treaties. See text in 63 AJIL, (1969), p. 875.

<sup>84</sup> See Brownlie, I., *Principles of Public international law*, Oxford: Oxford University Press, (1998). See also Brownlie, I., *Basic Documents in International Law*, Oxford: Oxford University Press, (1995); Franck, T., *Fairness in International Law and Institutions*, Oxford University Press, (1995). On the examination of international law in Islamic countries see, Shaheen, *Gender and human rights in Islam and international law : equal before Allah, unequal before man?*, Kluwer Law International, (2000).

On the basis of Article 81 international treaties have a direct effect and replace conflicting domestic laws and regulations.<sup>85</sup> In addition, Article 67 states that ‘the regulatory authority (the consultative council) lays down regulations and motions to meet the interests of the State or remove what is bad in its affairs, in accordance with the Islamic Shari’a. On the basis of the above, the domestic courts are allowed to disregard stringent domestic rules and interpret international treaty provisions in harmony with international practice. Thus, according to Al-Shareef, international arbitration agreements entered into by the State or one of its agencies would subordinate the Saudi legal system to the rules of the arbitral tribunals.<sup>86</sup>

## Conclusion

This chapter has examined the main sources of law. We have seen that a Muslim Ruler (*Imam*) can legislate new solutions for new problems from both the principles of Shari’a and considerations of public interests. The chapter also considered the Shari’a courts and their status as courts of general jurisdiction, and that Shari’a law remains the fundamental basis of the legal system. It has been stated that the Board of Grievances, with all its shortcomings, has the exclusive power to decide disputes over Saudi government contracts and also some types of commercial and investment disputes. It may be useful if the Board is encouraged to enhance and develop the use of outside well accredited technical and legal experts to assist in deciding some complex cases where foreign investment is an issue.<sup>87</sup> Saudi Arabia is a party to a number of international conventions and their effects on domestic law has been noted.

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<sup>85</sup> Article 81 of the Basic Law stipulates that “The implementation of this law will not prejudice the treaties and agreements signed by the Kingdom of Saudi Arabia with international bodies and organisations”.

<sup>86</sup> Al-Shareef, *Enforcement of Foreign Arbitral Awards in Saudi Arabia: Grounds for Refusal under Article (V) of the New York Convention of 1958*, PhD Thesis, CEMPLP, University of Dundee, (2000), p. 65.

<sup>87</sup> According to Article 24 of the Procedural Rules, the Board has the power to examine and adjudicate technical and legal issues. In practice, however, the Board refers questions about governmental contracts to the Saudi House for Consultative Services (SHCS). Mahassni argues that international standards of fair trial and due process would suggest that as long as the SHCS is owned and their staff are paid by the government, the Board

In conclusion, it has to be stated that although the legal framework in Saudi Arabia has gone through a series of changes over the ten years (Foreign Investment Law in 2000 and judicial reforms in 2007) which has brought improvements to the legal system, the changes in the Saudi judicial system are not yet complete. From a foreign investor's perspective, the government has not yet gone far enough in its reform efforts. In most cases, although these changes have brought improvements they have also created a greater sense of legal uncertainty for both foreign investors and Saudis alike. Often, there is a long delay between the adoption of a regulation and the implementation of its rules making it difficult for foreign investors to judge how certain commercial disputes would be addressed under Saudi law. In addition, the lack of any published, and easily accessible, system of legal precedent and the great degree of discretion that government officials can frequently exercise in interpreting and applying regulations usually makes it difficult to apply clearly established rules to a particular situation. That is why a clear national legal system and a transparent judicial system are so important for foreign investment. In the absence of clear rules on investment protection, capital-exporting states have found it desirable that they should give as much protection as possible to their investors by insisting on international treaties with a mandatory arbitration clause as protection to their nationals. Thus, the next chapter will examine the efforts of the Saudi government in the protection of foreign investment under Saudi domestic law, relevant international law and through bilateral and multilateral conventions on the promotion and protection of foreign investments in Saudi Arabia.

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should not refer any case to it. Mahassni, H., & Grenley, N., *Public Sector Dispute Resolutions in Saudi Arabia: Procedures and Practices of Saudi Arabia's Administrative Court*, International Lawyer, Vol. 21, (Summer 1987), p. 840.

## (2) THE STABILITY OF INVESTMENT AGREEMENTS UNDER SAUDI LAW

### Introduction

An investment agreement<sup>1</sup> is capable of being an effective instrument for the protection of foreign investment. It provides the eventual basis for the parties' legal status, and therefore offers legal security for their investment. Good governance, transparency, stability and predictability are indispensable foundations for FDI. If these basic political and legal features are lacking, other factors such as abundant natural resources, low taxes, or low labour costs will not be as effective as they could be. Legal instability and inadequate security in a country disrupt most foreign and domestic investments. Stability of key investment conditions is at the heart of investor concerns, and therefore at the centre of negotiations for a specific contractual regime or the proper design of a standard regulatory regime. This is particularly so for natural resources and energy projects where the duration of the investment is particularly long.<sup>2</sup> The neutralisation of the power of the state to change the contract is seen as essential to the stability of foreign investment contracts.<sup>3</sup> The stability of such agreements under Saudi law and under internationally accepted norms governing FDI is thus of great importance to foreign investors.

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<sup>1</sup> The terms "contract" and "agreement" are used in this study interchangeably without distinguishing between them. Contractual practice in the field suggests their interchangeability.

<sup>2</sup> Walde, T., *Stabilising International Investment Commitments: International Law versus Contract Interpretations*, CEPMLP, (1994), p. 5.

<sup>3</sup> Sornarajah, M., *infra* note 88, p. 417.

This chapter is in three parts. The first examines the fundamental principles of Shari'a in the field of contract and international business transactions. The second will explain the differences in theory and practice between Shari'a and western legal systems in order to prove that similarities exist along with the differences. The final part of the chapter will examine the concept of mineral ownership under Shari'a in Saudi Arabia. This is followed by an examination of the Saudi government's legal reforms in respect of title to mineral and investment laws.

The first two parts of this chapter are divided into 4 sections. The first section focuses on the importance of understanding the nature of Shari'a in respect of the contractual relationship and how Islamic contracts developed historically. The various types of Islamic contracts, including the concept of the 'Nominated' and 'Non-nominated' contracts, are highlighted along with the important principle of freedom of contract. Section 2 examines the fundamental principles lying at the root of contractual relations in Shari'a which come from its Islamic historical heritage. These are likely to continue, for the foreseeable future, to influence the attitudes of foreign investors towards commercial partnership with the government of Saudi Arabia. The chapter will also argue that, although the rules of the holy *Quran* are seen by Muslims as eternal and immutable, they can be interpreted to suit new situations, allowing Muslim states to legislate and regulate their worldly affairs in harmony with other states and in harmony with Shari'a. Therefore, it follows that questions should be asked as to the capacity of Shari'a to develop and adapt itself to the exigencies of time and place to meet modern requirements. An analysis of concession agreements and their characteristics with a description of production sharing, service, non-risk and risk service agreements and the combination of production sharing risk service contracts then follows. Section 3 is an overview of the fundamental similarities and differences between Shari'a and

western contract laws. The final section is an examination of the reality of the situation. It seeks to establish whether there remains a problem in Islamic contractual practice, or if the problem is more of a misconception and misunderstanding because conventional businesses think that there are no specific rules or structured laws in Islamic law to regulate modern businesses.

## ***2.1 The Nature of Contract Law***

The law of contract is at the heart of all legal systems including that of Islam.<sup>4</sup> Some knowledge of legal history is vital for a proper understanding of Islamic contract law, as it is for any other legal system. The main focus of this chapter is a survey of the historical and theoretical issues regarding Islamic contract law and its influence on the legal and policy arrangements for foreign investments in Saudi Arabia. Agreements are required for the administration and regulation of international transactions. That confluence of legal systems and concepts in international commercial agreements is an inevitable consequence of globalisation and represents a challenge to Islamic legal systems as they seek to open up for FDI. Therefore, this part of the thesis is concerned with the analysis and examination of the principles of commercial contracts under Shari'a.

Coulson emphasises the fact that international commercial transactions in the Islamic legal system have a long history of remarkable success in part due to the flexibility and validity of Shari'a law.<sup>5</sup> Just as Western systems have some historical links with religion and

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<sup>4</sup> Fox, W., *International Commercial Agreements*, 3<sup>rd</sup> ed., Kluwer Law Intl, (1998), p. 35. See also Coulson, N., *infra* note 5, pp. 17, 27-31.

<sup>5</sup> Coulson, N., *Commercial Law in the Gulf States, the Islamic Legal Tradition*, London: Graham & Tortman, (1984), p. 9. He also stressed that contract in Islamic law is in no sense the precise equivalent of the technical term contract in Western jurisprudence, which involves, certainly at the common law, the two basic essentials of agreement and consideration, p, 18.

religious practices<sup>6</sup>, legal systems in Muslim countries are similar as they are based on Shari'a.<sup>7</sup> However, due to the influence of globalisation, international commercial agreements are becoming increasingly crucial, and these require aspects of law from western legal systems including rules on contracts for the sale of goods or services. Parties to any agreements are free to make any arrangements they choose as regards transportation, risk and other elements of the transaction.

In the West, commercial law is generally described as “that branch of law which is concerned with rights and duties arising from supply of goods and services in the way of trade”.<sup>8</sup> As discussed in Chapter 2, the growth of commerce in countries with legal systems based on Islamic law in recent decades has created a pressing need to develop new codes of law that remain in harmony with the mandatory principles of Shari'a but which at the same time, are more suited to the commercial realities of cross border trade and investment. Shari'a must co-exist with western and secular legal systems.

## ***2.2 The Nature of Contract under Shari'a***

In order to demonstrate the principle of freedom of contract under Shari'a in contemporary commercial contracts, it is necessary to consider firstly its development from the fundamental principles of Islamic contractual law through to the actual practice within commercial life in Islamic countries today. First, we look at the fundamental principles of the meaning of contract in Islam, how it developed into commercial contracts and a survey of the various types of contracts most commonly found in both systems, and their characteristics.

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<sup>6</sup> Fox, W., *supra* note 4, p. 35.

<sup>7</sup> It should be noted, however, that not all predominantly Muslim countries employ strict Shari'a law – e.g. Turkey and some Mediterranean and Central Asian countries – have legal systems which are more secular in character. Saudi Arabia is perhaps the most “purely” Shari'a based but there is a huge range of variety that meant obviously not to contradict with Shari'a. In other words, the Saudi legal system is derived from different sources of law but these sources are all subject and subservient to Shari'a.

<sup>8</sup> Goode, R., *Commercial Law Text, Cases and Materials*, 2<sup>nd</sup> ed. Viking, (1982), pp. 8-9.

The traditional Shari'a rules of contractual obligations were expounded in their definitive formulation in a number of legal manuals composed by jurists during the period of the tenth and eleventh century. One of their early tasks was to define the meaning of contract.

## 2.2.1 Fundamental Principles of Contract under Shari'a

In common law, the essence of contract lies not in the simple fact of agreement but in the 'promise' expressed by the parties in the contract.<sup>9</sup> Generally speaking, a contract in Shari'a is basically a legally recognised undertaking, similar to the meaning in the western legal systems. The Arabic word for contract is 'Aqd'. It comes from the root verb 'Aqada' which means to tie or bind. It denotes the tying of the twin elements of offer and acceptance of contracting parties.<sup>10</sup> The codification of the general principles of contracts under Shari'a took place in 1877 and became known as *Al-Majallah*.<sup>11</sup> It comprised rules from the *Hanafi* School of Islamic Jurisprudence. Contract is defined in Articles 103 and 104 of the *Al-Majallah* as follows:

*"103- What the parties bind themselves and undertake to do with reference to a particular matter. It is composed of the combination of offer and acceptance.*

*104- The conclusion of a contract consists of connecting offer and acceptance together legally in such a manner that the result may be perfectly clear".<sup>12</sup>*

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<sup>9</sup> Zweigert, K. & H. Kotz, *An Introduction to Comparative Law*, 2<sup>nd</sup> ed. Vol. II, Oxford: Clarendon Press, (1987), p. 7. See also footnote 24 infra.

<sup>10</sup> Al-Samman, Y., *The Legal Security of Private Foreign Investment in the Kingdom of Saudi Arabia*, PhD thesis, Dundee University, CEPMLP, (1993), p. 128.

<sup>11</sup> *Al-Majallah* or *Majallat Al-Ahkam Al-Adliyah* (Journal of Justice Rulings) issued in the late nineteenth century by the Ottoman government to standardise the rules operative in courts of law throughout the Ottoman Empire. The 99 rules stated in its preamble explain basic principles of Islamic law. They are expressed in concise form. Placing them in a special subject was very apt. The codification has influenced the later regulations of Islamic countries including Saudi Arabia. See Vogel, F., *Islamic law and Legal System: Studies of Saudi Arabia*, Leiden, Brill, (2000), pp. 284-285.

<sup>12</sup> English text of *Al-Majallah's* rules available at: [http://www.ummah.net/Al\\_adaab/fiqh/majalla/index.html](http://www.ummah.net/Al_adaab/fiqh/majalla/index.html). Accessed on 07/03/09.

Shari'a, however, allows for exceptions to the application of the principle of *pacta sunt servanda*, where the performance of the obligation in the contract becomes impossible or unbearably difficult to one of the parties due to the occurrence of supervening or unforeseen circumstances,<sup>13</sup> or where it declares forbidden that which is allowed or declares allowed that which is forbidden under the law.<sup>14</sup> On the other hand, the traditional position of English common law is that contracts are absolute.<sup>15</sup> However, in English common law, the doctrine of frustration<sup>16</sup> was devised to deal with situations involving impossibility of performance. It can be viewed as an exception to the general principle of *pacta sunt servanda* (agreements should be kept), which is basic to both civil law and common law jurisdictions.<sup>17</sup>

Although in secular law *imprévision* may be an exception to the general rule, the Shari'a takes a rather different view. The late Professor Coulson pointed this out with his usual brilliance:<sup>18</sup>

In English law the sanctity of contract means that the promise endures despite the normal vicissitudes of fortune. It is right that the promise should be kept 'for better or for worse', 'through thick and thin', because this in line with the

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<sup>13</sup> Civil codes of the most GCC countries have incorporated what is referred as the Theory of *imprévision* by which the courts are empowered to intervene in exceptional cases to offer a distressed party to a contract "at least a measure of relief from the rigours of the rule that *pacta sunt servanda*". See generally. Ballantyne, W., *Secular Law and the Shari'a: Pacta Sunt Servanda and the Theory of Imprévision*, in Essays and Addresses on Arab Laws, Surrey: Curzon Press (2000), pp. 236-241.

<sup>14</sup> Hadith, "All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful".

<sup>15</sup> Woolman, S., *Contract*, Edinburgh: Sweet & Maxwell, (1994), p. 195. See also generally Treitel, G., *infra* note 16.

<sup>16</sup> "Among the circumstances which will frustrate a contract are: destruction of the subject matter, supervening illegality, supervening impossibility through government interference, inability to produce a necessary consent of a third party..., and a fundamental change in the basis of the contract". For more discussion on these issues see generally, Atiyah, P., *An Introduction to the Law of Contract*, Oxford: University Press, (2006), pp. 229-244. See also Treitel, G., *Frustration and Force Majeure*, London: Sweet & Maxwell, (2004), Chapter seven.

<sup>17</sup> De Cruz, P., *Comparative Law in a Changing World*, 3<sup>rd</sup> ed. London: Routledge-Cavendish, (2007), p. 326. For more analysis of the issue "frustration of contract, impossibility and supervening events" under civil and common laws, see the same publication at pp. 324-327.

<sup>18</sup> Ballantyne, W., *Construction Contracts in Arab Jurisdictions*, in Essays and Addresses on Arab Laws, Surrey: Curzon Press (2000), p. 274.

popular belief that tenacity of purpose to some degree controls events and that the human will determines the future. The promise must dominate the circumstances. For Islam precisely the converse is true. Circumstances dominate the promise. Future circumstances are neither predictable nor controllable but lie entirely in the hands of the Almighty.... If the tide of affairs turns then the promise naturally floats out with it.<sup>19</sup>

The legal concept of good faith is largely a moral concept comprised of notions of fairness. The moral aspect of good faith necessarily leads to uncertainty regarding the meaning of good faith because moral standards differ based on the people, the context and the circumstances involved.<sup>20</sup> The doctrine of good faith has long been recognised by continental law. Recently, it has been gradually absorbed by a number of common law jurisdictions. English law has hitherto declined to adopt a general principle of good faith but was able to offer specific solutions to a wide range of issues which involve the question of unfairness.<sup>21</sup> Even if it is accepted that good faith provides a more secure conceptual foundation for the rule, it is not an argument in favour of a change in the present substantive law. Rather, it is an argument which relates to the way in which we organise or classify the existing rules. The point of the argument is that the principal reason for the refusal of English law to recognise the doctrine is not to be found in its likely substantive effects. It has more to do with the approach which English law adopts to the recognition of general principles than to the content of the law itself.<sup>22</sup> As for international foreign investment law, among the general

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<sup>19</sup> Coulson, N., *supra* note 4, p. 81. Also cited by *ibid* p. 274.

<sup>20</sup> Barnes, N., *Good Faith under the UNIDROIT Principles of International Commercial Contracts: a Struggle for Meaning*, available at: [http://www.dundee.ac.uk/cepmlp/car/html/CAR9\\_ARTICLE14.pdf](http://www.dundee.ac.uk/cepmlp/car/html/CAR9_ARTICLE14.pdf). Accessed on 15/03/09. It should be noted that good faith is an important feature in Convention contracts such as Vienna Convention, the UNIDROIT Principles and the Principles of European Contract Law (Article 2.301).

<sup>21</sup> Beatson, J., & D., Friedmann, *Good faith and fault in contract law*, Oxford University Press, (1997), pp. 14-15.

<sup>22</sup> McKendrick, E., *Good Faith: A matter of Principle?* in Forte, A., *Good Faith in Contract and Property Law*, Oxford: Hart Publishing, (1999), p.44.

principles with a broad scope of application, the requirement to observe the rule of good faith is especially pertinent to the law of foreign investment, and investment tribunals have had recourse to this principle. In part, this emphasis on good faith reflects the fundamental significance of the concept for the understanding of all obligations in international law.<sup>23</sup>

The above dispensation as exhibited by Shari'a is a reflection of the principle of 'good faith' required of Muslims in all they do, and particularly in matters affecting the rights of others. The *Quran*, in saying, "O ye, who believe, perform all contractual obligations",<sup>24</sup> commands Muslims to perform conscientiously all promises or agreements they make or enter into. Accordingly, Muslims are required to fulfil their promises by performing their agreements and obligations not just as a matter of technicality, but more as a matter of duty required by their belief-system.<sup>25</sup> The equality principle is also of great importance in the theory of Islamic contracts, in that all contracting parties are regarded as equal partners. This was not the case in the early concessions which were weighted heavily towards the foreign oil companies as discussed earlier.<sup>26</sup> The above attempt to balance the imperatives of contractual stability shows the capability of Shari'a in providing rules applicable to modern investment agreements. The above also examines the concept of contracts under Shari'a and other legal systems as well as Shari'a's basic principles relevant to foreign investment agreements which are dealt with in this chapter.

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<sup>23</sup> Dolzer, R., & Schreuer, C., *Principles of International Investment Law*, Oxford: University Press, (2008), p. 5, see particularly note 10 for examples of investment tribunals. See, e.g., Article 31(1) of the Vienna Convention on the Law of Treaties, which states: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose", cited at note 11.

<sup>24</sup> Holy *Quran*, 5:1.

<sup>25</sup> For a discussion of the doctrine of good faith and its requirement under Shari'a especially in commercial transactions, see Majeed, N., *Good Faith and Due Process: Lessons from Shari'a*, *Arbitration International*, Vol. 20, No. 1, (2004), pp. 97-112.

<sup>26</sup> For more discussion see chapter 4 *infra*. See also Cattani, H., *The Law of Oil Concessions in the Middle East and North Africa*, New York: Oceana Publications Inc., (1967), p.126.

## 2.2.2 Development of Commercial Contracts under Shari'a

The purpose of this chapter is to address concerns expressed by foreign investors about the certainty and clarity of rules and decision making under Shari'a in the context of making and securing FDI. Therefore, an explanation of the fundamental principles of Shari'a in the field of agreements and business transactions is necessary. These concerns are due to the fact that foreign investors are naturally more interested in whether or not a contract or an agreement under Shari'a suits and secures their investment activities in Saudi Arabia.

Advocating the significance of the formative elements of a valid contract in their treatment of the conditions of substantive areas of the law, Muslim scholars, through the concept of '*Ijtihad*',<sup>27</sup> have analysed the constituent elements of contracts that formed the basic foundations by which a contract is validly concluded. These elements are called '*Arkan*' (pillars), of which the five most important for any nominate contract<sup>28</sup> are as follows:<sup>29</sup>

### (i) Agreement

An agreement is made between a seller who sells and delivers the product to the buyer who purchases, receives and pays for the product or services on terms and conditions set forth. There must be mutual agreement between the parties with an unambiguous offer – '*Ijab*' – and an unequivocal acceptance – '*Qabul*'. The term 'agreement' has a variety of meanings. However, in this context, it may be used to acknowledge the existence of a legally binding contract<sup>30</sup> that can be enforceable in a court of law.

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<sup>27</sup> For terminology of *Ijtihad* see chapter 1 of the thesis supra, pp. 20-21.

<sup>28</sup> Nominated contracts "*Uqood Musammata*" are contracts that are widely known by specific names – e.g. *Mudarabah*, *Ijarah*, *Murabaha* .. etc – see the foregoing discussion of the chapter.

<sup>29</sup> Rayner, S., *The Theory of Contracts in Islamic Law*, 1<sup>st</sup> ed. Springer, (1991), p.104.

<sup>30</sup> Contrast this with the classic definition of contract in Anglo-American Jurisprudence thus: a contract is any "promise or set of promises made by one party to another for the breach of which the law provides a remedy, or the performance of which the law in some way recognises as a duty". The promise or promises may be

## (ii) Consent and Intention to Contract

Consent has two common meanings. One is a general agreement among the members of a given group or community. The other is as a theory and practice of getting such agreements.<sup>31</sup> There must be a mutual agreement between the parties with an unambiguous offer and an unequivocal acceptance, the *Quran* states:

*“O ye who believe, squander not your wealth among yourselves in vanity, except it be trade by mutual consent”.*<sup>32</sup>

Theoretically, offer and acceptance are expressed and must demonstrate a definite and present intention to contract. The parties to a contract should enter into it of their own free will and must not be subject to coercion or duress. In addition, Shari’a encourages parties to record their agreements in writing which could be considered not only as a proof of the contract but also as an evidence of consent. The *Quran* states:

*“O you who believe whenever you contract a debt,<sup>33</sup> for a stated time period, then do it in writing”.*<sup>34</sup>

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expressed – either written or oral – or may be implied from circumstances. Typically, the remedy for breach of contract is an award of money damages intended to restore the injured party to the economic position the he or she expected to from performance of the promise or promises (known as “expectation measure” of damages). Occasionally, a court will order a party to perform his or her promise (an order of “specific performance” or “quantum meruit”), but this remedy is unusual. In civil law, contracts are considered to be part of the general law of obligation. See Fox, W., *supra* note 4, pp. 48-9.

<sup>31</sup> The process of achieving consensus involves serious treatment of every group member’s considered opinion, and a collective trust in each member’s discretion in follow-up action. In an ideal case, those who wish to take some action want to hear those who oppose it because they count on the fact that the ensuing debate will improve the consensus. In theory, action without resolution of considered opposition will be rare, and done with attention to minimize damage to relationships.

<sup>32</sup> Holy *Quran*, 4:29.

<sup>33</sup> It should be noted that the word “debt” mentioned in the verse includes all types of transactions, including contracts.

<sup>34</sup> Holy *Quran*, 2:282. The *Quran* is one of the four main sources which form the basis of Islam. The second source is the *Sunnah* of the Prophet (the acts and sayings of the Prophet Mohammed “*pbuh*”). What makes the *Quran* different from the *Sunnah* is primarily its form. Unlike the *Sunnah*, the *Quran* is quite literally the Word of Allah, whereas the *Sunnah* was inspired by Allah but the wording and actions are the Prophet’s. The *Quran* has not been expressed using any human’s words. Its wording is litter for litter fixed by no one but Allah. The other two sources are *Ijma’* (consensus of opinion) and *Quiyas* (reasoning by analogy). For more discussion on these sources of Islamic law, see chapter 1 *supra*.

However, Islamic contract law recognises both express contracts as well as what has been described in common law as contract by conduct. It presupposes the making of a contract either orally or by writing or by conduct.<sup>35</sup> Similarly, common law does not require that contracts be in writing. Certain statutory provisions in each jurisdiction, however, require that certain contracts be in writing or that they be evidenced by a written memorandum or note. Where a contract does not comply, it is usually rendered unenforceable, rather than void.<sup>36</sup>

### **(iii) Capacity of Contracting Parties to Agreement**

Generally speaking, under western legal systems of contract laws based on a 'Common Law system' and 'Civil Law system' both parties must have the capacity to understand the terms of the agreement they are entering into, and the consequences of the promises they make. For example, minors and mentally disabled individuals do not have the capacity to form a contract, and any contracts with them will be considered void or voidable.<sup>37</sup> Although corporations are technically legal fictions, they are considered persons under the law, and are fit to engage in contracts. For adults, most jurisdictions have statutes declaring that the capacity of parties to a contract is presumed. This means that anyone who is resisting enforcement of a contract on grounds that a party lacked the capacity to be bound bears the burden of proof on the issue of capacity. The position in Saudi Arabia concerning the above is based on the following extract from the *Quran*:

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<sup>35</sup> Ramadan, H., *infra* note 58, at p. 105.

<sup>36</sup> Gillies, P., *Business Law*, 12<sup>th</sup> ed., Australia: Federation Press, (2004), p. 385.

<sup>37</sup> For example: In common law, a minor is an individual who is under 21 years of age. The common law definition of age has been replaced by statutory definitions in most provinces. The reason for this rule is that minors are presumed to be naïve, inexperienced and easily taken advantage of, so some protection is required. Olivo, M., *Fundamentals of Contract Law*, Emond Montgomery Publication, (2005), p. 46. Another example of Civil law is that under Spanish contract law, parties must have the capacity to enter into contractual relationship, Civil Code, Article. 1263 (1996).

*“Test the orphans [in your charge] until they reach a marriageable age; then, if you find them to be mature of mind, hand over to them their possessions”.*<sup>38</sup>

The two important factors in this regard are majority and prudence which constitute the maturity of mind. In Saudi Arabia, in order to have the capacity to enter into binding contracts an individual must have reached the age of 18 years for legal purposes. In a commercial contracting context ‘prudence’ may be interpreted as sound commercial sense and securing commercial efficacy.

#### **(iv) Object of Sale and Valid Cause**

According to the *Hadith*, “do not sell what is not with you”. It is one of the essential conditions for the validity of a sale contract in Shari’a that the commodity must be in the physical or constructive possession of the seller. This condition has three elements: Firstly, the commodity must be in existence;<sup>39</sup> therefore, a commodity which does not exist at the time of sale cannot be sold. Secondly, the seller should have acquired the ownership of that commodity. Hence, if the commodity exists, but the seller does not own it, he cannot sell it to anybody. Thirdly, full ownership is not enough, it should have come into the possession of the seller, either physically or constructively. If the seller owns a commodity, but he or she has not taken its delivery himself or through an agent, he cannot sell it.<sup>40</sup> However, there is an argument amongst Islamic scholars as to the validity of the contract when the commodity of

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<sup>38</sup> Holy Quran 4:6

<sup>39</sup> The two exceptions of this – when the commodity comes after signing a contract – are the two types of sale which are *Salam* and *Istisna’a* contracts. Those will be discussed shortly.

<sup>40</sup> Usmani, M., *An Introduction to Islamic Finance*, Kluwer Law International, (2002), p. 60.

sale is non-existent i.e. a farmer's crop coming into fruition at a later date.<sup>41</sup> A similar initiative is petroleum products which will be discussed shortly.

As will be discussed below, contract of sale is essentially understood as the unconditional and immediate transfer of ownership of an existing and determined object of legal value. This is for a fixed price which may be payable immediately, or later or even in installments over a fixed period.<sup>42</sup> Therefore, an overwhelming majority of traditional scholars have nullified contracts whose object of sale is non-existent when they are concluded. It was obvious to them that what is non-existent involves necessarily a strong element of uncertainty – '*Gharar*' – for it is uncertain whether the non-existent object would ever materialise, or in what condition and state it would eventually materialise.<sup>43</sup> According to *Ibn Rushd (Averroes)* of the *Maliki* School, *Gharar* is to be found in contracts of sale when the seller suffers disadvantage causing damage, as a result of his ignorance of the price of the article or of the indispensable criteria relating to the contract or to its object.<sup>44</sup>

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<sup>41</sup> Muslim scholars have held different views on their respective perceptions of *gharar*. Whereas *al-Shafi* considered *gharar* (uncertainty) in the sale of absent goods (*bai al-ghaib*) to be excessive, Imam *Malik* viewed it to be negligible. *Abu Hanifah* on the other hand held that there was no issue over *gharar* so long as the buyer was granted the option of viewing (*khiyar al-ruyah*). There is also some difference of opinion over the validity of sale of the non-existent goods (*bai al-madum*). According to Kamali, M., the view that there a general consensus (*ijma*) on the prohibition of this sale among the leading scholars, is incorrect. Many scholars including *Ibn Qayyim al-Jawziyyah*, and *al-Sanhuri*, among others, have departed from the earlier position and maintained that there was no evidence in the sources to proscribe sale of a non-existent object. They are particularly critical of prohibition of that variety of sale of the non-existent in which, although the object of sale was non-existent at the time of contract, it was certain to come into being in the future. Following this approach, the author seems to disagree with the prohibitive judgment of modern scholars on futures trading based on its similarity with sale of non-existent products. As he asserts, "the market realities and the clearinghouse procedures tend to preclude any serious doubt/uncertainty over the existence and delivery prospects of the subject matter of sale". Kamali, M., *Uncertainty and Risk Taking (Gharar) in Islamic Law, Paper presented at the International Conference on Takaful / Islamic Insurance*, (2-3 July 1999).

<sup>42</sup> Coulson, N., *supra* note 5, p. 19-20.

<sup>43</sup> Saleh, N., *Unlawful Gain and Legitimate Profit in Shari'a*, Cambridge University Press, (1986), p. 66.

<sup>44</sup> Comair-Obeid, N., *The Law of Business Contracts in the Arab Middle East*, London: Kluwer Law International, (1996), p. 58.

However, this legal problem prompted *Ibn Qayyim Al-Jawziyya*<sup>45</sup> to denounce the confusion between uncertainty and non-existence. He stated that:

*“There is no mention either in the Quran or in the Sunnah or in the Companions’ tradition of anything to the effect that the sale of what is non-existent is prohibited. What is in the Sunnah is the prohibition of selling certain articles which are non-existent as there is a prohibition of selling other articles which actually exist. The motive behind the prohibition is not the existence or the non-existence but, as in the Sunnah, the sale producing uncertainty and that is what the vendor is not in a position to deliver, whether or not it exists. The vendor’s obligation is to deliver the object of sale; if he is not in a position to do so, this amounts to gharar, risk and gambling... the prohibition of non-existence is not prompted by non-existence itself but by gharar”.*<sup>46</sup>

*Ibn al-Qayyim* argues that the issue is not about the existence or non-existence of the subject matter but about risk, or *Gharar*, and it is impossible to deliver the subject matter whether it is existent or not.<sup>47</sup> Some scholars maintained that “do not sell what is not with you” means not to sell what one does not own at the time of sale.<sup>48</sup> For others it applies only to the sale of specified objects (*al-ayan*) and not to fungible goods. A third group maintained that it means the sale of what is not present and what the seller cannot deliver.<sup>49</sup> Finally, some contemporary scholars take into consideration the changes of the market in the present circumstances compared to the time of the Prophet.<sup>50</sup> It is therefore submitted that the conventional forward contract has great benefits, which are especially obvious in the field of the exploitation and production of commodities such as petroleum with inherent supply and price uncertainties. It can be accommodated in Islamic law either under the general theory of contract and conditions or by analogy to *Salam* and *Istisna* since it does not involve *Riba* or

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<sup>45</sup> He was a well-known Islamist jurist during the 7<sup>th</sup> Century of the Islamic Calendar.

<sup>46</sup> *Ibn Qayyim, Al-Jawziyyah., I’lam Al-Muwaqqi’in*, Vol. I, pp. 357-61. Cited in Comair-Obeid, N., supra note 44.

<sup>47</sup> *Ibn al-Qayyim, I’lam al-Muwaqqi’in*, vol. 1, p. 219.

<sup>48</sup> Muhammad Ibn Isma’il al-San’ani, *Subul al-Salam Sharh Bulugh al-Maram*, 4<sup>th</sup> ed. Cairo: al-Maktabah al-Tijariyyah, vol.3, (1379H), p.17.

<sup>49</sup> al-Baghawi, Abu Muhammad al-Husayn, *Sharh al-Sunnah*, al-Maktab al-Islami, Damascus, Vol. 8, pp. 140-141.

<sup>50</sup> For further details, see Kamali, M., *Islamic Commercial Law, An Analysis of Futures*, The American Journal of Islamic Social Sciences, Vol. 13, No. 2, (Summer, 1996), pp. 205-7.

*Gharar*. It is not included in the prohibited forms of sale of debt and does not oppose the principle “do not sell what is not with you”.

It must also be noted that there are two exceptions to the principle of the existence of the object of sale at the time of concluding the contract. One is ‘*Salam*’ which is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date, in exchange for an advance price fully paid at *consensus ad idem*. The other is ‘*Istisna*’, both will be discussed further later on.

## **(v) Consideration**

Consideration for goods and services in Shari’a is not restricted to a monetary price, but may be in the form of another commodity. Islamic prohibition against uncertainty requires that the price must be in existence and determined at the time of the contract and cannot be fixed at a later date with reference to the market price, nor can it be left subject to determination by a third party.<sup>51</sup> It should be noted that, unlike in English law,<sup>52</sup> the existence and determination of the price cannot be left to be determined later on even through a price determination mechanism that is identified at the time of the contract.

### **2.2.3 The main Characteristics of a Contract in Shari’a Law**

This section discusses the main characteristics of an Islamic contract in order to clarify the position of a foreign investor in such agreement. Firstly, the notion of equality of footing is discussed, followed by general principles found in both *Quran* and *Sunnah*. These principles advocate fulfilment of promises and performance of an obligation followed by a description of the various elements included in government contracts today. It is worth

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<sup>51</sup> Rayner, S., *supra* note 25, p. 141.

<sup>52</sup> SOGA 1979, *Hatmet Ltd v Herbert (t/a LMS Lift Consultants)* [2005] EWHC 3529 (TCC).

mentioning that contracts under Shari'a fall into two major categories: *nominate* contracts which are the contracts mentioned in the treatises of the scholars of the school of Islamic jurisprudence that were known in their time. In contrast, *non-nominate* contracts are those which are not mentioned in the doctrinal writings of the classical Muslim scholars and which emerge from time to time as a result of the growing needs of the community. These later contracts are considered to be a sign of the flexibility and responsiveness of Shari'a. These contracts are also thought to open the doors for all types of contracts as long as they are in harmony with the mandatory rules of Islamic Law. It is worth mentioning that there are in principle no significant distinctions between nominated and non-nominated contracts in Islamic Jurisprudence, as both forms of contracts possess the same degree of sanctity and binding force.<sup>53</sup> Furthermore, no distinction is drawn between treaties, state contracts and private contracts. All these contracts were viewed by the early Muslim jurists equally as agreements that have to be observed in good faith. The contracts were regarded as such by the Arbitration Tribunal in the ARAMCO case which considered the ARAMCO Concession Agreement as a non-nominated contract under Shari'a.<sup>54</sup>

From the perspective of a comparison with most western concepts of contract law, the most difficult Shari'a concepts are those principles which underpin commercial contracts. The fundamental principles of Shari'a in business transactions can be summarised thus: every Islamic contract requires equality of contracting parties, which means that all parties should be placed on an equal footing. Such a provision ensures the equality of treatment of both parties in respect of the economic balance of the contract. This arrangement may not be faced

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<sup>53</sup> Saleh, N., *Origins of the Sanctity of Contracts in Islamic Law*, Arab Law Quarterly, Vol. 13, No. 3 (1998), pp. 252-264.

<sup>54</sup> Saudi Arabia v Aramco, decision of 23 August 1958, reprinted in (1963) 27 ILR 117, p. 165. See also Al-Samaan, Y., *The Evolution of Contractual Relationship between the Government of Saudi Arabia and ARAMCO*, Masters Dissertation, Centre for Petroleum and Mineral Law Studies, University of Dundee, (1990), p. 109. See also chapter 4 *infra*.

with any problems when both contracting parties are on an equal footing, i.e. when an IOC enters into contract with a privatised state enterprise which is detached from the state as a commercial entity with separate legal status. It is advisable that the parties provide in their contract that no economic equilibrium of the contract can be invoked by the party whose act or omission disturbs it.<sup>55</sup> An Islamic contract does not discriminate between different parties or notably against foreigners or non-Muslims. Once a contract is validly concluded, all parties to it occupy the same position.<sup>56</sup> The reason for mentioning this is to counter the misconception that Shari'a discriminates between parties on the basis of religion.

In the *Quran*, justice is a concept which has to be maintained under any circumstances, even towards those who are enemies of Muslims. The *Quran* states: "*O' ye who believe! Show integrity for the sake of Allah, bearing witness with justice. And be not driven by hatred of any people to unjust action, to act justly is closer to piety*".<sup>57</sup> A number of principles in the *Quran* and *Sunnah* caution Muslims to abide by their promises and obligations and extend the protections of the Shari'a to both Muslims and non-Muslims. According to Fox, this *Quranic* principle suggests that an elaborate document freely consented to by the parties will go a long way toward preserving an agreement.<sup>58</sup>

The main issues are that parties must be capable of entering into a contract and must have given their free consent; consent, that is, without any duress, fraud or misrepresentation. Also, as the prohibition of usury – *Riba* is a key and defining concept of Islamic law, any contract which includes a provision as to interest '*Riba*' will render the contract invalid under

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<sup>55</sup> Muniruzzaman, A., *The Pursuit of Stability in International Energy Investment Contracts: A Critical Appraisal of the Emerging Trends*, *Journal of World Energy Law & Business*, Vol. 1, No.2, (June, 2008), pp. 121-157.

<sup>56</sup> Al-Samaan, Y., *The Legal Protection of Foreign Investment in the Kingdom of Saudi Arabia*, Dar Al Andalus for Pub. & Dist. Hail, Saudi Arabia, (2000), p. 118

<sup>57</sup> Holy Quran, 5:11, [Emphasise added].

<sup>58</sup> Fox, W., supra note 4, p. 34.

Shari'a. Finally, the product or subject-matter of the contract must be lawful. Most major contracts in the past have essentially been contracts signed with the government as one of the parties and therefore should embrace the following special elements<sup>59</sup>:

- The contract complies with current laws and decrees.
- The legal obligations provided for in the contract comply with the interests of the state on the grounds of public policy.
- The procedures required to execute the contract are specified in final form in the contract.<sup>60</sup>
- Although contracts which are not in conformity with Shari'a principles are prohibited and declared invalid by Muslim jurists, economic necessity and public interest justified the recognition of certain contracts which would not otherwise be permissible. An example of this is the '*Bai-Al-Wafa*'<sup>61</sup>, which is similar to the concept of mortgage with conditional sale of common law. *Bai-Al-Wafa* is a contract whereby the owner of an estate sells it, with a condition that he will have it back once he returns its price to the buyer. The reason given for this departure is that the contract has been in customary use and there is need for it because of the economic necessity of the state.<sup>62</sup>
- The principle of sanctity of contract under Shari'a is applicable to all types of agreement. Shari'a does not discriminate between types of agreements and the parties

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<sup>59</sup> It has to be stated that some of these elements are requirement of all contracts whether the government is party or not.

<sup>60</sup> Ballantyne, W., *Commercial Law in the Arab Middle East: The Gulf States*, Lloyd's of London Press, (1986), p. 92.

<sup>61</sup> Coulson, N., supra note 5, p. 21. '*Bai-bil-Wafa*', is a sale, apparently originating in the 12<sup>th</sup> century, in which the vendor retains the right of redemption of the property and may repay the purchaser by instalments over a fixed period. It's believed that this institution, when used to create what is in effect the modern type of mortgage for property, provides a method of circumventing the strict prohibition of any interest on a capital loan transaction.

<sup>62</sup> El-Malik, W., *Aspects of Natural Resources, Contract, Investment and Finance at Shari'a and Arab Secular Laws – A Comparative Study*, PhD thesis, CEPMLP, Dundee University, (1997), pp. 185-187.

to them. This will be discussed further below. Shari'a also recognises the principle of sanctity of contract, which is affirmed by the following verses:

*"Successful indeed are the believers who faithfully observe their trust and their covenants".*<sup>63</sup>

*"And fulfil the covenant. Surely the covenant will be asked about (in the hereafter)."*<sup>64</sup>

- A sale contract comprising an illegal object is 'prima facie' void.

These characteristics can be taken as clear evidence of the security and stability of investment agreements under Shari'a and for both foreign investors and their counterparts.

## **2.2.4 The Principle of Freedom of Contract under Shari'a**

As a general rule, the right to conclude contracts is a civil right which is guaranteed under Shari'a. It should be stated that all types of agreements, which are not precisely prohibited by divine law, are permitted. The jurist *Ibn Taimiya* pointed that:

*"All contracts entered into, or conditions attached thereto, are permissible unless prohibited by the religious texts, the Quran and the Sunnah"*<sup>65</sup>.

The freedom of contract in Islamic law cannot be so simply denied due to the fact that the concept of freedom of contract operates as it does in common law. An exception is that autonomy of will is modified by the requirement to comply with limits set by Islam. Within these limits one is free to enter into a contract with whomever one wishes.<sup>66</sup> The main limit is that the subject matter of a contract must not conflict with Shari'a. In this regard the following points should be noted. Firstly, Shari'a permits all types of contracts that are required by the increasing necessities of the society, and which are classified, as already

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<sup>63</sup> Holy Quran, 23:8.

<sup>64</sup> Holy Quran, 17:34.

<sup>65</sup> Ibn Taimiya, *Majmuat Fatawah*, vol.II, (1908), p.326, cited in El-Malik, W., supra note 61.

<sup>66</sup> Ramadan, H., *Understanding Islamic Law*, Rowan Altamira, (2006), p. 103.

mentioned, as non-nominated contracts.<sup>67</sup> Secondly, apart from the prohibition of usury – ‘*Riba*’, Shari’a provides wide scope for the conclusion of various types of contracts.<sup>68</sup> Thirdly, the restriction on some features of contracts is found in almost all legal systems. Contracts, for instance, which violate public order or policy, are void in many legal systems worldwide. In countries such as Saudi Arabia where religious belief shapes public policy, contracts which permit acts that contravene what are believed to be divine commands will therefore be void on public policy grounds.

### ***2.3 The Influence of Shari’a Law of Contract on Foreign Investment Agreements***

This section will explain how Shari’a has been adapted to meet the needs of contemporary contracts for foreign investment in Saudi Arabia. To achieve this adaptation, in April 2000, the government approved changes in the law and policy governing foreign investment by granting the same rights to foreign investors as enjoyed by Saudi nationals.<sup>69</sup>

In order to evaluate Shari’a’s ability to meet foreign investors’ needs in an FDI context, the capacity of Shari’a Law of Contract to meet modern contractual requirements will be assessed. The contractual aspects of Shari’a relating to natural resources and legal nature of petroleum exploration will be examined as well as production sharing agreements, along with concession agreements. The main features of Production Sharing Contracts (PSC) will be considered as well as the two main types of service contracts used in the FDI in the oil sector.

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<sup>67</sup> For more analysis see generally Amin, S., *Islamic Law and its Implication for the Modern World*, Glasgow: Rpyston, (1989), p. 41.

<sup>68</sup> Noor, M., *Principles of Islamic Contract Law*, Journal of Law and Religion, Vol. 6, No. 1 (1988), pp. 115-130.

<sup>69</sup> Arab News Newspaper, at [http://www.arab.net/Saudi/sa\\_shariabiz.htm](http://www.arab.net/Saudi/sa_shariabiz.htm), last visited on 07/06/08

This section will end with an examination of the attitude of Shari'a towards these contractual arrangements.

### 2.3.1 Development of the Law

The mercantile nature of international commercial law has, generally encouraged the law to be a responsive subject which facilitates the commercial practices of the business community. As those practices often change and develop to accommodate new technology, the contents of a commercial legal system may change and develop with them. Islamic systems are based on religious concepts, but nevertheless Islamic countries have the power to legislate in harmony with the Islamic Doctrinal base "the law changes for change of circumstances"<sup>70</sup> which Muslims have applied since the demise of the prophet. This is evidence that change and development have occurred. Today, most Islamic countries have adopted a flexible Islamic system that has developed in harmony with both Shari'a and also current commercial realities.<sup>71</sup>

As stated earlier, despite the fact that the rules of the *Quran* are believed by Muslims to be eternal and immutable, the principle of freedom of contracts under Shari'a is distinct. It can be interpreted to regulate current circumstances so Islamic countries have the power to legislate so that internationally agreed standards can be implemented where necessary to

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<sup>70</sup> The doctrine is also known as *tajdid* (renewal or revival). The purpose of *tajdid* is to implement this ideal model in Muslims' lives, wherever and whenever Muslim society exists. This purpose implies that *tajdid* is a continuous effort by Muslims always to explain Islam and make it applicable in continually changing situations without violating its principles. Mawdudi – a very well-known Muslim scholar (1903-1979) – argued that all of the great *Mujaddids* (revivers or reformers) – i.e. the founders of the four Schools of *Sunni* thought, *Al-Gazzali*, *Ibn Taimiyah* and others – were distinguished for their insight into problems before Muslims, for their reform of religious practices, for initiating an intellectual revolution and defending Islam in the political sphere, for establishing the primacy of Shari'a, and for their opposition to the ostensibly orthodox practices of the *ulema* (Muslim scholars). Mawdudi, S., *Islamic Law and Constitution*, Karachi, (1955), pp. 203-204, cited by Nasr, S., *Mawdudi and the making of Islamic revivalism*, Oxford University Press, (1996), p. 136. See also footnote 66 supra and note 73 infra.

<sup>71</sup> Ballantyne, W., *Arab Comparative and Commercial Law. The International Approach*. Vol. 1. The Shari'a and its relevance to modern transnational transactions. The settlement of disputes through arbitration joint ventures. Graham & Trotman. International Bar Association (publisher). First Arab Regional conference, Cairo 15-19 February, (1987), paper 1, the Shari'a and its Relevance to Modern Transnational Transactions, at p. 6.

achieve greater harmony in cross border commercial practice. Further discussion of this issue now follows.

### 2.3.2 The Capacity of Shari'a to meet Modern Contractual Requirements

As stated earlier, it is a general rule in Shari'a that any agreement, regardless of its form or procedure, which is based on justice and equity and free from impediments of constraint, uncertainty, or misrepresentation and deceit is lawful. This is embodied in the Holy Quran: *"And eat up not one another's property unjustly, nor give bribery to the rulers that you may knowingly eat up a part of the property of others sinfully"<sup>72</sup>*.

This is one of the vital principles guiding Islamic trade and commercial systems. With increasing international business activities in the Gulf region, the states face the question of the suitability of Shari'a to govern international commercial agreements. However, before discussing the development of contractual arrangements and the efforts of the Arabian Gulf States and Saudi Arabia in particular, it is noteworthy to reiterate that the option for change and flexibility is crucial. The doctrinal base of "the law changes for change of circumstances"<sup>73</sup> allows for such development.

Concluding commercial contracts between parties from countries with legal systems based on Islamic law was rather an easy matter, due to the awareness of the contracting parties of Shari'a contractual principles. However, it was a different case on an international

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<sup>72</sup> Holy Quran 11:29.

<sup>73</sup> Or "The law must change over the times". Some contemporary Islamic scholars argue that Shari'a should be interpreted in the light of necessity – '*Al-Darurah*' – which should be considered as a source of Islamic jurisprudence in order bring solutions to overcome emerging problems caused by change in time and circumstances. For instance, *Ibrahim Shihata* argued that the prohibition of usury – '*Riba*' – should be restricted to obvious cases of exploitation and unjust enrichment. See Shihata, I., *Some Observations on the Question of Riba and the Challenges Facing Banking*, *CEPMLP Online Journal*, Article 7, available at: <http://www.dundee.ac.uk/cepmlp/journal/html/vol7/article7-7.html>. Accessed on 12/02/2009.

scale. The oil producing countries of the Gulf region had to face economic challenges as a result of the nature of concession agreements that were imposed on them by foreign occupiers unaware of Shari'a, as well as a domestic lack of the capital, expertise and technology needed in the field. This raises the question of whether the implementation of the main types of exploration and production agreements could possibly be recognised under Shari'a. Answering this question will entail firstly analysing the legal nature of Islamic natural resources, followed by a similar close scrutiny of the legal nature of the concession agreements and finally examining their equity.

### 2.3.3 Contractual Aspects of Islamic Law on Natural Resources

Historically, Islamic concession agreements were first applied in the early period of Islam for both agricultural and mineral purposes when the Prophet gave *Iqta* (piece of land) to *Abu-Baker*, one of his companions, in *Madinah* and to the *Abu-Rafis* people.<sup>74</sup> In Shari'a, this share-cropping agreement is based on the precedent of the prophet's actions with the people of *Khyber*. He gave them state-owned lands to work on, in return for which they were to retain half of what it produced and bestow the other half of the crop to the Islamic state<sup>75</sup>. Therefore, *Iqta*, in Shari'a, is defined as "the right of the ruler to grant any individual an exclusive right over a certain area of land."<sup>76</sup>

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<sup>74</sup> El-Malik, W., *supra* note 61, p. 69.

<sup>75</sup> Al-Qaradawi, Y., *The lawful and Prohibited in Islam*, ATP, (1994), p. 279.

<sup>76</sup> Al-Sobaie, M., *Ishtirakiat Al-Islam*, (1960), p. 90, (in Arabic). What has to be stressed is that the exploitation of natural resources, including petroleum, is a matter of public concern all over the world. The public interest element in petroleum contracts sets these contracts apart from ordinary commercial contracts. Under the various families of modern legal systems, the state can, by an exercise of its sovereign legislative power, alter or abrogate its contractual obligations, if this is so required by the public interest accompanied by a fair compensation to the private party when its rights are affected adversely by the state action. Riad, T., *Host Countries and Permanent Sovereignty Over Natural Resources and Protection of Foreign Investors: Some Reflections on the Recent Kuwait/Aminoil Arbitration Case*, 39 *Revue Egyptienne de Droit International*, (1983), pp. 35-99. See generally Kolo, A. & Walde, T., *Renegotiation and Contract Adaptation in International Investment Projects – Applicable Legal Principles and Industry Practices*, 1 *J World Invest. & Trade*, (2000), pp. 5-59. Muniruzzaman, A., *State Contracts with Aliens – The Question of Unilateral Change by the State in Contemporary International Law*, 7 *J. Int. Arb.*, (1992), pp. 141-171.

The Islamic contract of *Iqta* enters into the category of public contracts, and is therefore more accessible to renegotiation and termination by the government than normal commercial contracts. In addition, the Imam (ruler) has the right to terminate agreements entered into with other parties ahead of time if he found that its terms were harmful to the interest of the Islamic community. This is with the provision that an adequate prior notification is sent to the other party informing them of his intention to terminate the agreement. The other party is of course entitled, under Islamic law, to compensation for its loss.<sup>77</sup>

## ***2.4 Legal Nature of Petroleum Exploration and Production Agreements***

Until the 2<sup>nd</sup> World War, many developing countries found themselves in a similar position. They had given total control over their most valuable resources to foreign companies through concessions covering huge areas for very long periods. A wind of change began to blow during and after the 2<sup>nd</sup> World War. The main purpose of these changes was to alter the provision of the old concession agreements into more reasonable and fair arrangements. In order to understand the legal nature of such joint ventures<sup>78</sup> as international petroleum exploration and production agreements, we will analyse their legal nature in order to establish whether they would be acceptable under Shari'a. There are three types of petroleum exploration and production agreements:

- Concession Agreement;

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<sup>77</sup> Al-Qurashi, Z., *Investment Protection under International Petroleum Agreement: An Analysis of the Pertinent Arbitral Jurisprudence*, PhD thesis, CEPMLP, Dundee University, (2004), p. 255.

<sup>78</sup> For more discussion on the historical and definitions of these agreements see chapter 4 of the thesis *infra*. While the objectives of each joint venture are the same, the terms and conditions vary from one agreement to another. In January 2004 the Saudi national oil company, Saudi ARAMCO, announced that it will be partnering with Russian oil company Lukoil to find and develop gas reservoirs, as part of the Kingdom's Gas Initiative. To explore the contract area, Lukoil and ARAMCO will establish an exploration and producing company, with ARAMCO 20% shareholder. The Kingdom concluded a similar deal with the Chinese oil and petrochemical company Sinopec and another deal with a consortium of Italian company ENI and Spanish oil company Repsol. No further information about the deals was announced by the parties. The latter information was obtained from the website of SAGIA at: <http://www.sagia.gov.sa> and ARAMCO's website at: <http://www.saudiaramco.com>.

- Production sharing contracts; and
- Service contracts.

## 2.4.1 Concession Agreement

### (i) Traditional Concession Agreement

The old-style concession system was clearly one-sided. The agreements were granted by sovereign states with sometimes little power to participate in the management of petroleum investment because of foreign political domination.<sup>79</sup> Also, the countries concerned were at that time at a low stage of development, sometimes still nomadic to a large extent, and in no case possessed a legal framework<sup>80</sup> which could govern such things as petroleum operations.<sup>81</sup> A concession agreement in petroleum exploration is described as:

*"An agreement between a company and government that grants the company the right to explore, develop, produce, transport and market hydrocarbons or minerals within fixed area for specific amount of time. The concession and production and sale of hydrocarbons from the concession are then subject to rentals, royalties, bonuses and taxes. Under a concessionary agreement, the company would have the title to resources that are produced".<sup>82</sup>*

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<sup>79</sup> Blinn, K., & others., *International Petroleum Exploration & Exploitation Agreements: Legal, Economic and Policy Aspects*, New York: Barrows Company Inc, (1986), p. 60.

<sup>80</sup> See examples of countries, in particular, the case of Saudi Arabia, more discussion at chapter 4 infra.

<sup>81</sup> Suleiman, A., *The Oil Experience of the United Arab Emirates and its Legal Framework*, 6 *J.E.N.R.L.*, (1984), p. 1-3.

<sup>82</sup> Johnston, D., *International Petroleum Fiscal System and Production Sharing Contracts*, Oklahoma: PennWell Publishing Company Tulsa, (1994), p. 296.

Generally speaking, the old-style concessions were quite simple. They defined the area and the duration of the concession, the payment to be made by the concessionaire and, mostly in general terms, the mutual rights and obligations of the parties. They were then ratified by a law or a decree where the law of the country required such ratification.<sup>83</sup>

## **(ii) The Modern Concession Agreements**

As already indicated, developing countries were dissatisfied with the early form of concession agreements, particularly where the host state was excluded from participating in any decision relating to operations within the concession area. This had the effect of reducing government revenues throughout the duration of the concession. Subsequently the demand from producing countries for a greater share of oil revenues appeared in the early 1940s, and Venezuela was the first state to secure a larger government take.<sup>84</sup> Today, such old style concession agreements are rarely applied. They were replaced with a variety of arrangements including production sharing agreements, participation and service contracts which offer greater fairness and therefore a more sustainable relationship between the parties. Crucially, such contracts allowed the state much greater control of its resources.<sup>85</sup>

### **2.4.1 The Production Sharing Contracts (PSCs)**

PSCs were first introduced in Indonesia in 1966. After independence, nationalist feeling was running high and foreign companies and their concessions became the target of

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<sup>83</sup> Cattani, H., *supra* note 26, (1967), p. 2.

<sup>84</sup> For more details see chapter 4 of the thesis, *infra*. This was the starting point where the host state realised that they were missing out on many areas of revenue collection as well as control of their own affairs, so changes were made resulting in a structure of old concession agreements breaking the link between ownership, control and financial risks and rewards. New forms of concession agreements emerged in addition to production sharing and service contracts.

<sup>85</sup> Saba, A., *The International Commercial Contracts, the Petroleum Contracts*, (1988), p. 32, (in Arabic).

increasing criticism and hostility.<sup>86</sup> PSCs are considered as disguised concession agreements. Some, however, consider it as an agreement which retains the basic legal format of the traditional concession, with significant modifications to the features of its prototype, which nonetheless still worked to the disadvantage of the producing country.<sup>87</sup> However, PSCs are favoured by states because they offered a new model to reject the 'Mineral Concession', which was seen as colonialist. PSCs can be attractive to nationalistic sentiments in producing countries, as they seem to give the symbolic function of ownership and control to the nation.<sup>88</sup>

Under the PSCs the foreign company is granted a contractual right to explore and develop a specified area in exchange for the opportunity to recover its costs and a specified profit. In Shari'a, the Islamic practice of share cropping forms the basis of the PSCs, so it does automatically prima facie lend legitimacy<sup>89</sup> to mineral development.<sup>90</sup> Hence, PSCs are based on the concept that ownership of oil is always with the state and that it alone has the right to its disposal, a reflection of the notion contained in the principle, discussed above, of permanent sovereignty over natural resources.<sup>91</sup> The contemporary pattern of PSCs consists of the issuance of licences by the host government pursuant to a national economic development plan. An outgrowth of this practice has been the promulgation of investment

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<sup>86</sup> Bindermann, K., *Production Sharing Agreements: An Economic Analysis*, Oxford Institute for Energy Studies, (1999), p. 1.

<sup>87</sup> Gao, Z., *International Petroleum Contracts: Current Trends and New Directions*, Graham & Trotman Ltd. (1994), p. 29.

<sup>88</sup> Walde, T., Editorial, *Production-Sharing Contracts*, *OGEL*, Vol. III, Issue, 1, (March, 2005), available at: <http://www.ogel.org/article.asp?key=1723>. accessed on 07/02/2009.

<sup>89</sup> More discussion and analysis will be carried out later on in this chapter.

<sup>90</sup> Al-Sobaie, M., supra note 65, p. 90.

<sup>91</sup> Sornarajah, M., *The International Law on Foreign Investment*, 2<sup>nd</sup> ed. Cambridge: Cambridge University Press, (2004), p. 134.

laws which enable host countries to exercise more effective control over international corporations.<sup>92</sup>

## 2.4.2 Service Contracts

Risk Service contracts and Non-Risk Service Contracts are widely used standard contracts. Service contracts became more widely popular in the late 1960s when Iran and Iraq in particular concluded several such agreements. It was once believed that there was a natural transition from concession over joint venture to service contract.<sup>93</sup> A service contract is a legal relationship between a foreign company and a host country whereby the company is considered to be working as a contractor for the state, not as a partner of the state. The foreign company is not a concession holder, but merely a hired firm. The host state is the sole titular holder of the area under agreement, and all petroleum discovered and produced is the property of the host state.<sup>94</sup> There are two types of service contract which developed under this category of petroleum agreements:

### (i) The Non-Risk Service Contracts

Under this type of agreement, the contractor has no ownership interest in the petroleum resources. The host government involves the contractor on an *ad hoc* basis, usually paying him a flat fee for his service.<sup>95</sup> The contractor's services may include providing equipment and training employees to operate the petroleum facilities. In return, the company will be compensated for the expenses in addition to a fixed fee, which is usually in the form

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<sup>92</sup> Fabrikant, R., *Oil Discovery and Technical Change in Southeast Asia, Legal Aspects of Production Sharing Contracts in the Indonesian Petroleum Industry*, Singapore: Institute of Southeast Asian Studies, (1973), p. 157.

<sup>93</sup> Walde, T., *Investment Policies in the International Petroleum Industry – Responses to the Current Crisis*, in Beredjeck, N., and T. Walde, (eds.), Petroleum Investment Policies in Developing Countries, Graham & Trotman, (1988), p.13.

<sup>94</sup> Zakariyah, H., *New Directions in the Search for and Development of Petroleum Resources in Developing Countries*, 9 Vand. J. Transnat'l. L. (1976), p. 545.

<sup>95</sup> Cameron, P., *Petroleum Licensing, A Comparative Study*, London: Financial Times Business Information Ltd, (1984), p. 12.

of an agreed amount of crude oil. This type of petroleum arrangement is found in Kuwait and Saudi Arabia.<sup>96</sup>

## (ii) The Risk Service Contracts

In these types of agreements, the host state would contract with a foreign company to explore and exploit a specified area and evaluate potential explorations at its own risk. If no discovery is made, the contract ceases to exist.<sup>97</sup> In the event of discovery, the company recovers its expenses for exploration. Despite the high risk associated with this type of contract, and that petroleum exploration is highly speculative, it can also bring large rewards for both parties if successful.<sup>98</sup>

However, it has to be noted that there are several elements of both types of service contracts which do not comply with Shari'a. First, in the Risk Service Contracts, the risks are borne solely by the contractor who provides capital for exploration and if no discovery is made, the contract ceases to exist. In addition, this type of service contracts seems to disregard the principle of equity and that parties should be placed on an equal footing. Second, the contract may contain an element of usury – '*Riba*' – if the state's share of the costs is paid with interests. However, if the parties agreed on a certain percentage of the discovered petroleum's revenues to pay the cost of recovery, then this percentage repays the expenses by sale until after some agreed time. In other words, the parties are sharing the benefits and costs on a percentage basis, and there is no existence of any elements of usury '*Riba*'. In this case, the two types of service contracts would be recognised under Islamic law of Contract.

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<sup>96</sup> Blinn, K., *supra* note 76, p. 97.

<sup>97</sup> Cameron, P., *supra* note 92, p. 13.

<sup>98</sup> *Ibid.*, p. 13.

## ***2.5 Legitimacy of Contractual Arrangements under Shari'a***

The question now arises as to the extent to which Shari'a accommodates the various contractual arrangements. This is addressed in the following subsection.

### **2.5.1 Concession Agreements**

The old concession agreements represent a clear exploitation of public property of the host state, as it places the foreign company in a stronger position than that of the host state. As a result, this obviously contradicts, *inter alia*, the fundamental principle of Islamic contract law, that contracting parties should be placed on an equal footing. Therefore, not surprisingly, Muslim oil producing countries considered concession agreements for exportation of their natural resources as “an encroachment on national sovereignty and an instrument of foreign domination over national economic development”.<sup>99</sup>

Accordingly, such agreements have been gradually terminated by the Saudi government,<sup>100</sup> and many other Islamic countries have done the same, particularly with the increase of the power of OPEC since the early 1960s. There has also been an introduction of national oil companies, usually with technical assistance obtained through a joint venture with foreign oil companies.

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<sup>99</sup> Al-Samaan, Y., *Evolution of the Contractual Relationship Between Saudi Arabia and ARAMCO*, JENRL, Vol. 12, No. 2, (1994), p. 257.

<sup>100</sup> For more discussion on this see chapter 4 of the thesis, *infra*.

## 2.5.2 Production Sharing and Service Contracts

Currently, production sharing agreements are used by a majority of Muslim countries for upstream petroleum arrangements but many Islamic scholars are cautious regarding the fiscal design of PSCs. They may not be consistent with Islamic legal principles in their present form as they not only contain an element of interest/usury but also an element of uncertainty, which is also forbidden under Islamic legal thinking.<sup>101</sup> In fact, legal problems exist in this area of commerce which may render such PSCs untenable under Shari'a law.

However, an Islamic type of contract called *Ijarah*<sup>102</sup> (Hire) could be considered the closest in nature to PSCs in Islamic commercial practice, because of the similarities they share. It should be noted, however, that PSCs could be compatible with Shari'a as long as they adhere to the requirements of the validity of contract under Shari'a principles explained earlier and summarised here:

- The existence of a job which is of permissible nature to be carried out;
- The offer and acceptance with a view to reach consensual agreement;
- The determination of the contract's duration.

On the other hand, in order to find out whether or not PSCs contain elements of usury – '*Riba*', it should be always remembered that most of the Islamic banking and financial institutions are using '*Murabaha*' which is also known as "cost plus financing". *Murabaha* is

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<sup>101</sup> Karim, M., *Oil, Islamism and International Petroleum Industry Legal, Economic, Political and Cultural Issues*, LLM Dissertation, CEPMLP, Dundee University, (2000), available at: <http://www.dundee.ac.uk/cepmlp/journal/html/dev4.html>, last visited 18/06/08.

<sup>102</sup> *Ijarah* means "giving something on rent". In Islamic jurisprudence, the term *Ijarah* is used for two different situations. Firstly, it means to employ the services of a person on wages given to him as a consideration for his hired services. The second type of *Ijarah* relates to the usufruct of assets and properties which means "transferring the usufruct of a particular property to another person in exchange for a rent claimed from him. In this case, the term *Ijarah* is analogous to English term 'Leasing'. A vast majority of Islamic Scholars have settled for *Ijarah* being a binding contract. Both elements of this contract, the usufruct and the rent payment, must be specified precisely, or else uncertainty – '*Gharar*' – renders the contract invalid. See Ballantyne, W., *Islamic Law and Finance: Introduction: Islamic Law and Financial Transactions in Contemporary Perspective*, (CIMEL), SOAS, at: <http://www.soas.ac.uk/cimel/materials/islawfin/islfinintro>, accessed on 12/05/08.

a contract whereby the seller is disclosing his true costs. After discussing the true costs, a profit margin may be agreed either on a percentage of cost basis or as a fixed amount. It is very important to remember that the amount of profit earned in this transaction is not a reward for the use of the financier's money. In other words, a financier cannot take money if he/she does not perform any service other than the use of his/her money for the transaction. Such an occurrence would cause this type of deal to resemble the charging of interest.<sup>103</sup> Similarly, in PSCs the contractor, in the event of commercial production, charges the host country the cost he has incurred plus profits.

To sum up, Saudi law does not include a civil code or any comparable legal code. Therefore, the sources of law for its body of contract law come from the principles of Shari'a, as interpreted by the *Hanbali* School. The moral and ethical precepts instituted by Shari'a underpin the Islamic law of obligations, with the principal object of rejecting unjustified enrichment – *Riba*<sup>104</sup>, speculative transactions (e.g. those dependent on uncertainty), and ensuring that equal bargaining power exists between the contracting parties. A result of this system is that parties are generally free to conclude contracts, on any terms they wish, provided that such terms do not contravene the provisions of Shari'a. As discussed above,

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<sup>103</sup> See Chowdhry, S., *An Overview of the Basics for Businesses Who Want to Conform to Islamic Principles of Financing*, available at: [http://www.dinarstandard.com/finance/finance\\_review100104.htm](http://www.dinarstandard.com/finance/finance_review100104.htm), last visited 21/06/08.

<sup>104</sup> Article 6 of the Negotiable Instruments Regulation, (Royal Decree of 1963), provides that "The stipulation of interest in a bill of exchange is null and void". In a more general manner, Article 6 of the Saudi Arabian Monetary Authority (SAMA) Regulations – now known as Charter of SAMA – states that "SAMA shall not, in its dealings, contravene the traditions of Islam and may neither grant nor receive interest". Available at: <http://www.sama.gov.sa/sites/SAMAEN/RulesRegulation/BankingSystem/Pages/BankingSystemFD01.aspx>. The Banking Control Law of 24/06/1966 does not, however, address the issue of interest. Available at: <http://www.sama.gov.sa/sites/SAMAEN/RulesRegulation/BankingSystem/Pages/BankingSystemFD03.aspx>. It is interesting to note that despite this restriction, commercial business is still transacted in Saudi Arabia where the banks and financial institutions have instituted alternative procedures to replace interest in common financial transactions. Banks in Saudi Arabia grant loans and charge their customers a fee that is comparable to international banks rates on commercial loans. However, this issue is out of the scope of this study and will not be dealt with. For more discussion of this issue see generally, Abdeen, A., & Shook, D., *The Saudi Financial System, in the Context of Western and Islamic Finance*, California: Willy, (1984). See also Saeed, A., *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation*, Published by Brill, (1999). See also Saleh, N., *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar and Islamic Banking*, Cambridge University Press, (1986).

Islamic jurists have established four main conditions regarding the object of the contract, namely that (1) the object of the contract must exist at the time of conclusion of the contract, (2) it must be possible, (3) it must be lawful and (4) its genus, species, quality and value must be clearly determined.

In addition to the discussion above, it is interesting to note that concessions of an extremely simple form were known to early Islamic communities. There are numerous instances of the Prophet (*pbuh*) in the capacity of the leader of the Muslim community granting concessions to various individuals.<sup>105</sup> Although, the principles of ownership can be clearly located in Islamic law, as will be seen below, it is extremely difficult to find any specific guidelines in the major sources of Shari'a on the issue of petroleum exploitation agreements. However, the above discussion shows that using the *Quran* and the *Sunnah* as the guiding principles, one can find rules that regulate even modern day complex petroleum agreements. The next part of the chapter examines the issue of mineral ownership under Shari'a since a key concern of any FDI agreement concluded with regard to exploitation of mineral rights must be establishing the ownership of those rights beyond doubt or legal challenge.

## ***2.6 Mineral Ownership under Shari'a***

### **2.6.1 Title to Minerals under Shari'a and Saudi Law**

Everywhere in the world petroleum excites political sensitivities. It is both a scarce resource and a basic economic necessity. It produces enormous revenues and yet employs relatively few people. In those countries which have petroleum reserves, the reserves are

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<sup>105</sup> Toriguian, S., *Legal Aspects of Oil Concessions in the Middle East*, Beirut: Hamaskaine Press, (1972), p. 99.

regarded as part of the national wealth, and there is suspicion of those who obtain – or wish to obtain – rights to exploit these resources. As a result, it is usual to find a high level of government interest, particularly in the upstream industry where it is found. This can manifest itself in different forms such as state ownership of petroleum resources, establishment of national oil companies and a substantial government take either in money or in kind. The legal title to minerals depends in some countries upon the legal status of the land. Whatever the case may be, it is important to any investor to have knowledge on how to gain access to the land required for mining without excessive procedural delays and cost. With regard to ownership of minerals both solid and liquid, a major conceptual difference exists between Muslim countries such as Saudi Arabia and other legal systems found all over the world and crucial to our study. As Shari'a in Saudi Arabia is most strictly adhered to, the question of the governance of the ownership of minerals is a significant issue. As pointed out in the previous chapters, the law that governs the ownership of minerals in Saudi Arabia is Shari'a.<sup>106</sup>

Islamic Law is based, as previously stated in chapter two, on Shari'a which is divine in origin, revealed to mankind by God (Allah). While the divine rules themselves are regarded as immutable, their understanding and interpretation are permissible and have found their expression in several sources. There are two primary sources, the *Quran*, comprised of the actual words said by God and the *Sunnah* of the Prophet Mohammad (*pbuh*) – i.e. his own words and deeds. They can be interpreted through two secondary sources, the *Ijma* (consensus reached by the jurists) and the *Quiyas* (deductive reasoning applied by a single jurist). In addition, due to the international importance of the subject of ownership over natural

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<sup>106</sup> See, the "Basic Law of Saudi Arabia" (constitution), Article 14 which will be dealt with in this chapter. Available at: [http://www.mideastinfo.com/documents/Saudi\\_Arabia\\_Basic\\_Law.htm](http://www.mideastinfo.com/documents/Saudi_Arabia_Basic_Law.htm).

resources rights, the United Nations played a crucial role in this regard by adopting a number of resolutions through the General Assembly as will be seen in this chapter.<sup>107</sup>

The purpose of this part of the chapter is to examine the concept of mineral ownership under Shari'a in Saudi Arabia. This will be followed by an examination of the Saudi Government's legal reforms regarding title to minerals and investment laws, then a comparison with that of non-Islamic countries in order to examine:

- Whether or not the impact of mineral ownership legislation (Saudi Mining Law) represents a true obstacle to the foreign investors.
- Whether there are similarities or differences between Saudi Mining Law and that of some Western countries.

There are different views of ownership of natural resources based on different interpretations of Islamic Law. This diversity of views may cause some kinds of uncertainty for potential investors, so the importance of the issue of ownership is the focus of the last part of this chapter. In this part of the chapter, the legal problem is demonstrated. We will explore the attitude of Muslim scholars to title to various minerals both above and below the ground, and that the *Hanbali* school of interpretation prevalent in Saudi Arabia makes distinctions between both solid and liquid minerals and where they are found. The issue of the ownership of minerals will also be examined both in Saudi and at an international level.

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<sup>107</sup> These are the United Nations Resolutions relating to the issue of Ownership Applicable to Natural Resources, which include: Resolution No. 626 (VII), 1952 – Right to exploit freely natural wealth and resources; Resolution No. 1803 (XVII), 1962 - permanent sovereignty over natural resources; Resolution No. 3281 (XXIX), 1974 – Charter of Economic Rights and Duties of States. For text of Resolutions, see <http://www.un.org/documents/resga.htm> last accessed 17/10/2008.

## 2.6.2 The legal concept of land ownership practice and title to subsoil minerals in Shari'a and the different views of the four Islamic schools.

This section explains the legal problem of land ownership practice and title to subsoil minerals in Shari'a, taking into account the various views of the four Islamic schools of thought. It discusses the views of Muslim scholars as to Shari'a principles governing ownership rights of minerals both above and below the ground. An understanding of the nature of the ownership rights to minerals in law is needed to fully evaluate and understand the stability of investment agreements in Saudi Arabia. As explained in chapter 2 Saudi Arabia largely follows the teachings of *Hanbali* School of thought. However, from time to time rules from within the other three schools of thought are used in preference to a *Hanbali* rule where this is considered to be in the public interest. So in relation to rights of mineral ownership, the Saudi government follows the *Maliki* view in preference to the *Hanbali* School. This holds that minerals, both subsurface and open, cannot fall into private ownership because of the authority of the Prophet (*pbuh*) expressed in his *Hadith* "People are partners in three commodities, water, fire and green herbage", except in land which has not yet had any state or private ownership. Neither in privately or state-owned land may minerals, subsoil or above the surface, be granted in private ownership because of a fear of monopoly.<sup>108</sup>

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<sup>108</sup> *Ibn Qudamah*, states that: "Minerals are free, he who finds a mineral is entitled to take his need thereof by priority to others, after which he must go away to let others satisfy also their needs, he cannot appropriate the vein or mine of deposit except with and as a result of his appropriation of the grounds where such mines or vein or deposit is found, this appropriation may be through an *Iqta* or grant from the Imam or through occupancy or reclaiming it if it is *Mawat* (dead land), which has no owner". But as to the surface minerals *Ibn Qudamah* said: "According to the prevailing opinion in the *Hanbali* School, apparent minerals are not liable to private appropriation either through discovery and occupancy or through *Iqta* or granted by the ruler (Imam)". Cited by Cattani, H., supra note 26, p. 56. (*Ibn Qudamah* is a follower of the *Hanbali* School. He was born in Naples in 1147 and died in 1223. He is the author of 47 references mostly about principles of *Fiqh*. One of his most important references is *Al-Mughni in Fiqh and Al-Khilaf byna Al-Ulamaa*, (The differences amongst Scholars).

However, there is an exception to these rules in the case of ownerless land where the first-comer may secure rights to subsoil and above the surface minerals only by first discovery.<sup>109</sup>

The *Maliki* view<sup>110</sup> holds that petroleum belongs to the community as a whole and as such should be managed by the state. It seems that the Saudi Government will often apply the rule which best serves its public policy objectives regardless of the originating school. This has the effect of giving the government full control and ownership of petroleum resources. In addition, it is up to the Saudi government 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.

## 2.7 Land Ownership Practice

The issue of property rights is an age-old human problem.<sup>111</sup> The diversity of economic systems can be traced back to the diversity of approaches to the right to property. The issue of whether there should be absolute private ownership, or absolute state ownership,

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<sup>109</sup>Imam Malik bin Anas, *Muwatta'*, English translation by Rahimuddin, M., 2<sup>nd</sup> ed., Kitab Bhavan, New Delhi, India, (2006), p. 325. See also Bunter, M., *An Introduction to the Islamic (Shari'a) Law and its Effects on the Upstream Petroleum Sector*, CEPMLP, University of Dundee, (2003), p. 17.

<sup>110</sup> According to the *Maliki* school view, all minerals are part of the public domain – that is they belong to the Islamic community. Therefore, even if a mineral deposit is situated in *Mulk* land (land that is owned by individual), such a mineral does not belong to the owner of the land but to the community and can only be exploited under a concession granted by the sovereign on behalf the community. In other words, the *Maliki* follow the rule that ownership of minerals does not follow ownership of land. *Maliki's* concept of the ownership of natural resources is based on his theory that private ownership of minerals will ultimately lead to improper exploitation of natural resources and unfair of distribution of such wealth. However, the right of private ownership is limited by the requirements of public necessity in order to prevent public nuisance. Toriguian, S., *Legal Aspects of Oil Concessions in the Middle East*, Beirut: Hamaskain press, (1972), pp. 103-104.

<sup>111</sup> The legal concept of property rights were refined by the Romans, based on the ideas of the ancient Greeks. The Romans produced the longest-running legal system in history which influenced all legal systems of the modern world. One of the most important components of the system is that of private property rights. This was a key part of Roman Private Law with detailed rules for dealing among private individuals. The Roman replaced tribal property with private property and worked out the details about how ownership should be proven and transferred. See generally Finley M., ed., *Studies in Roman Property*, Cambridge: Cambridge University Press, (1976); Clark, E., *History of Roman Private Law*, New York: Biblo and Tannen, (1965), 4 vols. Reprint of 1914 edition; Leage, R. *Roman Private Law Founded in the Institutes of Gaius and Justinian* London: Macmillan, (1924); Kolbert, C. ed., *Justinian, the Digest of Roman Law, Theft, Rapine, Damage and Insult*, London: Penguin, (1979).

or something in between as in a mixed economy, or some altogether different type of ownership, cannot be ignored.<sup>112</sup> In pre-Islamic times, land on the Arabian Peninsula was owned by individuals and by the community. Arabs knew all three forms of ownership at the advent of the Prophet (*pbuh*) where some wealthy *Makkans* possessed land in fertile towns. When the Prophet (*pbuh*) migrated to *Madinah*, many *Madinans* Muslims had their own agricultural lands. The Prophet (*pbuh*) not only confirmed their ownership, but himself set a positive precedent by allocating land to individuals.<sup>113</sup>

Generally the ownership of land is heavily regulated in all GCC countries where the state owns most of the land, and only nationals are allowed to own private property. However, as can be seen from the following examples, most countries are now introducing fundamental changes so that foreigners can be allowed to own property for use in developmental projects. In Kuwait, nationals and GCC nationals can buy property for either self-use or rent/lease. Foreign investors are allowed to rent property only for self-use. However, foreign ownership of land is allowed for companies registered in the GCC States. These companies are treated as Kuwaiti nationals with respect to ownership of real estate in Kuwait for commercial and investment purposes.<sup>114</sup>

Ownership of land in Qatar is only open to nationals and nationals of GCC countries. However, the government has made some provisions for foreign ownership in specific projects. The government has issued a decree that allows non-Qataris to own real estate. The law seeks to allow Qatari and non-Qatari to buy and own real estate of any description in any of the following three projects: the proposed Pearl Island, West Bay Lagoon and *Al-Khor* Resort, for a period of 99 years which is further extendable by another 99 years upon

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<sup>112</sup> Islahi, A., *Economic Concepts of Ibn Taymiyah*, The Islamic Foundation, (1988), p. 107.

<sup>113</sup> Zaman, S., *Economic Functions of an Islamic State*, The Islamic Foundation, (1991), p.119.

<sup>114</sup> Under Decree No. 74 of 1979.

expiration. There is a provision of permanent residency and inheritance in the law for buyers. Regulations with regard to these provisions are expected to be passed by the cabinet. However Qatar has also enacted a law which regulates the ownership of real estate and residential units by non-Qataris, with the aim of opening up the real estate market to wider foreign investment.<sup>115</sup>

In Saudi Arabia, land is owned by the state and nationals are entitled to own their own land and land ownership is protected under the constitution. These rights were, until recently, not available to foreign investors. However, new changes were introduced to encourage major international companies and property developers to enter the Saudi real estate market. A law regulating non-Saudi Ownership of Investment and Real Estate was enacted by the Royal Decree No. M/15 dated 10/07/2000 (Real Estate Law of 2000). It provides for the ownership and investment in real estate by non-Saudi nationals and entitles non-Saudi residents to own real estate for their private residence with the permission of the Interior Ministry and allows ownership of real estate by foreign investors to conduct their business activities and own properties required for staff accommodation etc.<sup>116</sup>

In terms of the law foreign investors should, however, be in possession of a foreign investment licence from SAGIA to own the property necessary for their investment project, including the property necessary to house the investment project's employees. Further conditions include the following: the investment project should be in the nature of property development, the total cost of the project (including land and buildings) must be at least SR 30,000,000 and must be invested within five years from the purchase date of the land.

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<sup>115</sup> For more details about the real estate issue in Qatar, see [www.hejleh.com/countries/qatar.html](http://www.hejleh.com/countries/qatar.html), visited 08.11.2008; and for more information of the legal system, foreign investment and insurance law, see [www.qatarlaw.com/english/articles/qtr.htm](http://www.qatarlaw.com/english/articles/qtr.htm)

<sup>116</sup> For an official version of the investment and real estate laws and overview, see the official website of the Saudi Arabian General Investment Authority (SAGIA) at [www.sagia.gov.sa](http://www.sagia.gov.sa)

Moreover, foreigners may not purchase real property within the municipal limits of the cities of *Makkah* and *Madenah*, although foreign Muslims may lease property in those cities for renewable terms of no more than two years.<sup>117</sup>

## ***2.8 Ownership of subsoil minerals under Shari'a***

Generally, minerals in any country can be owned in one of three different ways. Firstly, it could be that all minerals belong to the state. Secondly, the landowner or occupier of the land owns the minerals founded in his land or thirdly all minerals are *res nullius* – which means that they may be owned by anyone who finds them.<sup>118</sup> In Islam, despite the sovereignty of God, the institution of private property is lawful, sanctioned and specifically protected. To discuss how the law affects the ownership of minerals in the surface or the subsurface, both subsoil and visible, it is necessary to carry out a thorough analytical study to clarify the view of Shari'a on this matter.

Historically, Roman law recognised and adopted the concept of the absolute right of property. Shari'a does not recognise the concept of the absolute right of a person to own property. This is because, in Shari'a, all property belongs to Allah (God) and any Muslim holds property only in trust and is accountable to Allah for the property. Thus, absolute ownership of property by a person is a concept alien to Islam.<sup>119</sup> Claiming absolute

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<sup>117</sup> Ibid.

<sup>118</sup> For detailed examination of the different methods of minerals ownership, see Bastida, A., *Minerals Tenure Regimes in the Context of Evolving Governance Frameworks: a case study of selected Latin American Countries*, PhD Thesis, CEPMLP, University of Dundee, (2004), pp. 30-38.

<sup>119</sup> Siddiqi, M., *Muslim Economic Thinking, a Survey of Contemporary Literature*, International Centre for Research in Islamic Economics, King Abdulaziz University, Jeddah, and Islamic Foundation, UK, (1981), p.7.

ownership as well as rights with one's property is akin to claiming equality of status with the Creator, and this is completely shunned in Islam.<sup>120</sup>

The *Quran* has also emphasised the limitations on the absolute right of ownership by attributing the creation of economic resources to God in these verses.<sup>121</sup>

Several *Quranic* verses suggest that land, among other things, is not the result or end product of anybody's labour but is instead considered to be a precious gift from Allah *s.w.t.* in which every member of the community has equal rights of possession and use. If not put into proper use, it is considered a loss to the community and that must not be tolerated. If any landowner neglects his duty, his land would revert or be repossessed by the state authority. The state authority reserves the right to take or repossess anybody's land if this occurs and give it to another who would use it better and bring benefit to the community at large.<sup>122</sup>

The interpretation and understanding of Shari'a depends on the particular school of legal thought being considered. As will be seen from the brief survey of the main Islamic schools of legal thought below, it appears that the intervention of the state, in one way or another, is almost always required. Under Shari'a, petroleum ventures must therefore be embodied in a licence with the host country.

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<sup>120</sup> See *Quran*, 10:55, "No doubt, surely, all that is in the heavens and on earth belongs to Allah", Al-Hilali, M., & Khan, M., *The Noble Quran – English Translation of the Meanings and Commentary*, King Fahd Complex for the Printing of the Holy *Quran*, (1998).

<sup>121</sup> *Quran*, 24:33. "And give them something (yourselves) out of the wealth of which Allah has bestowed upon you", *Quran*, 14:32-34, "Allah is He who has created the heavens and earth and sends down water (rain) from the sky, and thereby brought forth fruits as provision for you. And he has made ships to be service to you that they may sail through the sea by His command; and hath made rivers also to be of service to you. And He has made the sun and moon, both constantly pursuing their courses, to be of service to you; and He has made the night and day, to be service to you", *Quran*, 67:15, " He is the One who put the Earth at your service. Roam its corners, and eat from His provisions. To Him is the final summoning".

<sup>122</sup> Malinumbay, S., *The Concept of Land Ownership: Islamic Perspective*, Skudai: *Buletin Geoinformasi*, Vol. 2, No.2, pp. 285-304, (Dec. 1998), p. 287. Available at: <http://eprints.utm.my/4950/1/concept.pdf>. Accessed 26/02/2009.

The main principles to be derived from a perusal of the scholars' writings regarding the four different schools of Islamic law in relation to mineral ownership can be summarised as follows:

- According to the *Hanafi*<sup>123</sup> School, mineral ownership follows land ownership.
- According to the *Maliki*<sup>124</sup> School, all kinds of natural resources including minerals are state-owned.
- In the *Shafi*<sup>125</sup> and *Hanbali*<sup>126</sup> Schools, subsoil and surface minerals, with the exceptions mentioned<sup>127</sup>, are not the subject of private ownership.

We have so far dealt with the issue of petroleum resource ownership in the ground under Islamic law. The other important issue that reflects significantly on petroleum agreements is ownership of petroleum on the ground. While this issue might be addressed more specifically in the relevant written laws on petroleum of Muslim countries, it is not clarified in Islamic law owing to its embryonic state with regard to petroleum exploitation. Hence, Islamic law is silent on this important issue. By the use of analogy, it may be argued that laws on ownership of oil on the surface remain the same as oil in the ground.<sup>128</sup>

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<sup>123</sup> The *Hanafi* School is the earliest and the greatest orthodox school in Islam and it has undoubtedly the largest number of followers. This school was founded by Abu *Hanifah*. He was born in Iraq in 699 and died in 769 and was buried in Baghdad in Iraq. In the *Hanafi* School, minerals found on land in private hands belong to the owner of the land. If a mineral deposit is found in a public domain, then the mineral deposit is also a public domain and cannot be exploited by individuals except under a concession. It is up to the state to regulate the exploitation of mines. See Kamali, M., *The Limits of Power in an Islamic State*, *Islamic Studies Quarterly Journal*, Vol. 28, (1989), p. 344. See also Toriguian, S., supra note 107, pp. 101-102.

<sup>124</sup> The founder of the second school is *Malik bin Anas*. He was born in 713 in *Madinah* and died in 795. See supra note 104 for more description. See Imam *Malik* supra note 109, p. 326.

<sup>125</sup> Imam *Mohammad Ibn Edrees Al-Shafi'* was the founder of the third school; he was born in Palestine in 769 and died in Egypt in 819. He was a disciple of *Malik* so became acquainted with the *Maliki* doctrines. Under the *Shafi'* school approach, minerals found in the public domain, be it at the surface or in undeveloped mines, are public property. As to those found in private lands, they are not necessarily private property and, in any event, the authorisation of the state to prospect for, and extract, them is always required. Siddiqi, M., "Islam's Approach to Right of Property," *Some Aspects of the Islamic Economy*, Islamic Publications Ltd., Lahore, (1978), pp. 63-65. See also Blinn, K., supra note 76, p. 28.

<sup>126</sup> *Ahmad Ibn Hanbal* is the founder of the fourth and last school of legal thought. He was born in Baghdad in 780 and died in 855 in Baghdad. See earlier discussion of the previous section. Siddiqi, *Ibid*, p. 74.

<sup>127</sup> See supra notes 105 & 106.

<sup>128</sup> Karim, M., supra note 98, p. 19.

The above discussion shows that the notion of the property can be said to cover both tangible and intangible rights. No serious difficulty arises with regard to the recognition of tangible assets whether movable or immovable. However, as broadly defined above, the Saudi government distinguishes between ownership of the surface of the land and ownership of its subsoil and minerals contained in it. This has been expressed in Articles 1 and 25 of the original ARAMCO Agreement of 1933. These articles were originally stated in the Article of Mining Code enacted by Royal Decree No. 21/M of 20/05/1392 A.H (1972) and extended also to petroleum.<sup>129</sup>

Article 1 of the Mining Regulations clearly stipulates that all natural deposits of minerals, in any form or combination, either in soil or subsoil, belong exclusively to the state. This includes both land and sea territories comprising the continental shelf.<sup>130</sup> Therefore, compensation for expropriation by the state will only be to the extent of the land and not to its content. The reasons for which the government, by virtue of Article 1 of the Mining Code, subjected the minerals to state ownership have been summarised very helpfully by *Walied El-Malik* as follows:

- a) The state is entrusted with the public wealth and is responsible for the preservation of the national income.
- b) Ownership of minerals cannot be made dependant on land surface ownership, because this will result in breaking up the ownership of minerals as a result of the land surface being owned by more than one party.
- c) Private land surface ownership can lead to improper exploitation of minerals and can even make exploitation impossible.

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<sup>129</sup> Al-Samman, Y. A., *The Evolution of Contractual Relationship between the Government of Saudi Arabia and Aramco*, LL.M. Dissertation, University of Dundee, (1990), p. 18.

<sup>130</sup> Saudi Government, *The Mining Code, Article 1*, Al Riyadh Government Press Office, (1964).

- d) Mineral exploitation could simply be left contingent upon the individual owner's wish and will, but proper exploitation of minerals requires the setting up of a general policy to exploit minerals.
- e) If the Saudi government can allow minerals to be considered as wealth without specific ownership, then that would result in weakening the state's ability to supervise and monitor the exploitation of them.
- f) Leaving the minerals without specific ownership would make it possible for anyone who discovers them to claim their ownership regardless of whether or not he has the skill to exploit them and regardless of whether or not he has the necessary financial means to do so.<sup>131</sup>

From the ongoing discussion, it can be easily inferred that although the applicable Islamic school in Saudi Arabia is the *Hanbali* School (by default),<sup>132</sup> the Saudi government has generally adopted the *Maliki* concept of the state ownership of natural resources. What is beyond doubt is that such interpretation of Shari'a has confirmed the sovereign rights of the state to regulate minerals activities within its territory and to direct and utilise them in the interests of the whole community.<sup>133</sup> In the late 1960s and 1970s, oil-exporting host governments such as Saudi Arabia, Iran, Iraq, Venezuela and Kuwait, which had become accustomed to a steady increase in the proceeds of oil sales and a resultant increase in the revenues available to them, worked vigorously to assert sovereignty and control over their

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<sup>131</sup> El-Malik supra note, 61, pp. 55-56.

<sup>132</sup> See Aal Darib, S., *Al-Tanzeem Al-Qadaa'ee fi Al-Mamlakah Al-Arabiyah Al-Saudiyah fi Dua' Al-Sharee'ah Al-Islamiyah wa Nizam Al-Sultah Al-Qada'iyyah*, 1<sup>st</sup> ed., Al-Ma'had Al-Ali le Al-Qadha'- University of Imam Mohammad Ibn Saud, the Ministry of Higher Education, (1983), pp. 313-314, (*in Arabic*). This book categorically states that following Saudi Basic Law (Constitution), political and legal arrangements in the Kingdom should be based upon basic sources of Shari'a, namely the *Quran* and the *Sunnah*, as interpreted by prominent *Hanbali* jurists.

<sup>133</sup> El-Malik, W., *State Ownership of Minerals Under Islamic Law*, Journal of Energy and Natural Resources Law, Vol.14 No. 3, (1996), p. 316.

own national resources.<sup>134</sup> Since petroleum was identified as a mineral, its commercial exploitation is governed by the state rather than any private individual or commercial interest, in both Muslim and non-Muslim states, a thriving and substantial legal practice in the field of oil and gas law has been spawned. This attendant specialist advisory sector exists, inter alia, to identify with whom the foreign investors should be dealing, and on the other hand, to both safeguard the foreign investments made and secure economic development in the host country.<sup>135</sup>

## ***2.9 How Saudi Arabia has implemented the principles discussed above on the ownership of minerals into its domestic law***

In Saudi Arabia all minerals belong to the state. The Saudi Constitution specifically provides in Article 14 that:

“All God’s bestowed wealth, be it under the ground, on the surface or in national territorial waters, in the land or maritime domains under the state’s control, are the property of the state as defined by law. The law defines means of exploiting, protecting, and developing such wealth in the interests of the state, its security and economy”.<sup>136</sup>

In addition to the constitutional provision, the concept of mineral ownership is based on Shari’a and the Saudi Mining Code.<sup>137</sup> According to the Code, all mineral deposits belong to the State. The Code defines the general provisions and conditions for exploration and mining. The Mining Regulations were adopted in 1993 and explain the specific conditions required

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<sup>134</sup> Bunter, M. A. G., *The Promotion and Licensing of Petroleum Prospective Acreage*, Kluwer Law International, (2002), p. 1.

<sup>135</sup> By the 1970s, most of the Arabian Gulf Countries, which by then were independent of British custody, bought major shares in the subsidiary companies that worked within their borders. By the early 1990s, many of these subsidiaries had become completely state-owned entities. They continued to employ Western experts at the highest decision-making levels, but the local government had ultimate responsibilities and profits. Since then, those countries had issued their mining codes and regulations. See Lowell F., *Publication-State-Qatar-August*, (2001). Also see Chapter 4 of this thesis for more discussion of the nationalisation movement in Oil-exporting Countries particularly Saudi Arabia.

<sup>136</sup> The constitution of Saudi Arabia, adopted in March 1992, by Royal Decree of King Fahd, available at: [http://www.mideastinfo.com/documents/Saudi\\_Arabia\\_Basic\\_Law.htm](http://www.mideastinfo.com/documents/Saudi_Arabia_Basic_Law.htm). Accessed 21/02/2009.

<sup>137</sup> See Article 2 of the Mining Code, Royal Decree No. 47/M dated on 18/01/2005. The Code is the revised version based on the version revised on 01/07/1972. The Code and the Regulations can be viewed at [www.dmmr.gov.sa/mining-code.php](http://www.dmmr.gov.sa/mining-code.php) visited on 14/11/2008.

by the Code.<sup>138</sup> The Mining Code and Regulations have become a comprehensive framework that give foreign investors a full image and comprehensive picture of the legal system governing the structuring and treatment of investment in the mining sector.

It is very important to note that the mining code, framed by the Deputy Ministry of Mineral Resources, Ministry of Petroleum and Mineral Resources, Government of Saudi Arabia, contains policy guidelines governing private sector entry into the mining sector. The core of the Code deals with issues of ownership of minerals, documents to be submitted by applicants and the scope of mining rights.<sup>139</sup> The Saudi government position on State ownership of minerals (in line with the above mentioned constitutional provision) is set out in Article 2, which provides that:

“All natural mineral deposits including quarry raw materials of all types, in whatever form or composition whether in the soil or subsoil shall be considered the exclusive property of the state. This shall also include the onshore and offshore territory of the state; its absolute economic area and continental shelf. Title to the minerals shall transfer from the state to the licensee, pursuant to this Code, upon extraction of such minerals from the license area within the duration of the license. Otherwise, the state ownership of the minerals shall be imprescriptible”.

## ***2.10 The concept of mineral ownership in non-Islamic countries***

The purpose of this section is to examine whether there are any fundamental differences between Islamic and non-Islamic countries in the field of mineral ownership. In general, most countries have adopted a similar position to that of Saudi Arabia by adopting the position that all minerals are owned by the State.<sup>140</sup> This position is based, in most cases, on the

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<sup>138</sup> Kingdom of Saudi Arabia, Ministry of Petroleum and Mineral Resources, Deputy Ministry of Mineral Resources, the Mineral Resources Sector.

<sup>139</sup> See [www.ga.gov.au/geojag/jagonly/riydh.html.app](http://www.ga.gov.au/geojag/jagonly/riydh.html.app)

<sup>140</sup> Even countries with minimal activities have adopted this position. An example is Denmark: The first Subsoil Act in Denmark was established as early as 1932. It provides that raw materials in the Danish subsoil belong to the state of Denmark. This principle is preserved in the present Subsoil Act: thus, the state is entitled to decide how and on what conditions these resources are to be developed. The present Act of 10 June 1981 (Act No. 293) which is one of the several aim at the complete reorganisation of resource management in Denmark both

internationally accepted right of the state to exercise sovereignty over all the mineral resources within its national boundaries.<sup>141</sup> As will be seen, this international right of states was adopted by the United Nations in a number of General Assembly Resolutions, notably the principle of permanent of sovereignty over natural resources. This has been included as a statement in most national laws concerning the development of mineral resources. Examples include most African, Latin American, South East Asian countries.<sup>142</sup> However, the South African Mining Law (Mineral and Petroleum Resources Development Act 2002) does not include such a provision and merely states that mineral resources are the common heritage of all the people of South Africa and that the State is the custodian for the benefit of all the people of South Africa, and the Minister of Minerals and Energy may grant licenses for prospecting and mining.<sup>143</sup>

However, there are some exceptions where the mineral belongs to the landowner upon whose land the minerals are found. These include France,<sup>144</sup> Chile<sup>145</sup> and the above example

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onshore and offshore. This Act is concerning the Use of the Danish Underground. It provides that petroleum in place is the property of the Danish State. The central element of the Subsoil Act is the establishment of a licensing system permitting private and state-owned companies to explore for the produce of hydrocarbons. See Ronne, A., & Budtz, M., *The legal Framework for Exploration for and Production of Oil and National Gas in Denmark*, in *JENRL*, Vol. 3. (1985), p. 155; and also see Cameron, P., *North Sea Oil licensing: Comparisons and Contracts*, in 4 *OGLTR*, (1984/85), p. 99.

<sup>141</sup> For more discussion on this international principle see chapter 5 *infra*. Neither state sovereignty nor its right to control foreign property can be questioned. See, section 3 of World Bank Guidelines II provides that the admission of foreign investment is ultimately a matter for each state to decide upon and regulate in the exercise of its sovereignty. See World Bank: Report to the Development Committee and Guidelines on the Treatment of Foreign Direct Investment, 31 *ILM* (1992). Sornarajah, M, *supra* note 80, p. 43. See also, Wallace, C., *The Multinational Enterprise and Legal Control: Host State Sovereignty in an Era of Economic Globalisation*, The Hague: Kluwer Law International, (2002), p. 977.

<sup>142</sup> For detailed discussion of the mining regimes of Australia, Canada, the United States, Latin America, Africa, Asia and South Pacific, the former Soviet Union and the European Union, see Bastida, A., Walde T. and J., Warden-Fernandez (eds.), *International Comparative Mineral Law and Policy: Trends and Prospects*, Kluwer Law International, (2005), pp. 643-1110. This work is comprehensive and informative about the trends and practices of mining activities in most countries. However, the work does not include mining in Muslim countries and thus to that extent is incomplete.

<sup>143</sup> See the Act at: <http://www.info.gov.za/gazette/acts/2002/a28-02.pdf>

<sup>144</sup> The minerals are the property of the landowner as the "accession" system in France means that the subsurface is an accessory of the surface. See for example, Campbell, N., *Principles of Mineral Ownership in Civil Law and Common Law Systems*, Vol. XXXI, *Tulane Law Review*, 304-310, cited in *Ibid*.

of South Africa. For purposes of comparison, the United Kingdom is an example where ownership of minerals is vested in the Crown, but with certain considerations. The following is a brief overview of the UK system.

In the UK, English property rights derive from the Common Law, which dates from the time of the Anglo-Saxon kings and is based on custom and precedent, together with Statute Law, deriving from Acts passed by Parliament and given Royal assent. It stipulates that “to whomever the soil belongs, he owns also to the sky and to the depth”.<sup>146</sup> The basic legislation in the UK is the Petroleum Act 1998, which is based fundamentally on the Petroleum Production Act 1934, which vests all onshore petroleum deposits in the Crown. Its provisions were extended over that part of the continental shelf to which the UK has sovereign rights by the Continental Shelf Act 1964.<sup>147</sup> This exclusive title is contracted out in a statutory licensing system to oil exploration and development companies, which assume the rights subject to, and “without infringing the Crown’s exclusive power to undertake such activities”.<sup>148</sup> Thus, virtually everywhere in the world, the importance of petroleum and gas as a source of energy has resulted in their exploration being declared as a matter of national interest. The end result is that all activities in this field are being increasingly controlled by the state.

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<sup>145</sup> In Chile, the minerals such as non-metallic minerals (basic construction materials such as stone, sand and gravel and quarry materials) are not regarded as minerals and they are regulated by common property law. See Chilean Mining Code Article 13, at: [www.cochilco.cl/anm/articlefiles/198-CDIGOD1.pdf](http://www.cochilco.cl/anm/articlefiles/198-CDIGOD1.pdf)

<sup>146</sup> This follows the common law doctrine *cujus est solum, ejus est usque ad coelum et ad inferos*, Black’s Law Dictionary, 5<sup>th</sup> ed. (1979), p. 341. See also Bunter, M., *supra* note 131, p. 40.

<sup>147</sup> Cameron, P., *supra* note 92, p. 103. See Petroleum Act (PA) 1998, which under section 2(1) states as follows: “Her Majesty has the exclusive right of searching and boring for and getting petroleum to which this section applies”. The PA is Chapter 17 of the Laws of the United Kingdom, available at: [www.hmso.gov.uk/acts/acts1998/98017--b.htm](http://www.hmso.gov.uk/acts/acts1998/98017--b.htm)

<sup>148</sup> See Pitsas, N., *Joint Operating Agreement Considerations in Dealing with a Financially Troubled Operator: Selected Legal Issues Arising out of the Relationship between Participants in a North Sea Petroleum Joint Venture in the Event of the Operator’s Financial Distress and Formal Insolvency and the Effects thereof upon the Operator’s Co-Venturers in the Context of English Law*, PhD Thesis, CEPMLP, University of Dundee, (2005), pp. 422-426. See also, on the concept of ownership of hydrocarbons, Centre for Economic, Research and Management (IFP-School), *Oil and Gas Exploration and Production, Reserves, Costs and Contracts*, Paris: Institut Français du Pétrole, (2004), pp. 171-174.

From this brief<sup>149</sup> comparative study between the legal system as to the title of minerals in the Islamic countries such as Saudi Arabia and those of Western countries, it is very clear that there is no radical difference between Saudi mining law and that of the West as minerals in both of them, as stated above, are regarded as a matter of national interest. The above examples also show that State ownership of minerals is now regarded as an international norm which should be accepted by foreign investors as necessary to safeguard their investment in the mining sector. This clearly means that the Saudi Mining Law helps, rather than hinders, foreign investments in Saudi Arabia.

## ***2.11 United Nations Resolutions on the Ownership Concepts Applicable to Natural Resources***

Due to the importance of petroleum as a natural source of energy and as a matter of national interest, the intervention of the UN General Assembly was important with respect to the ownership of mineral rights. However, there was another main factor that led to the redress of the meaning of ownership of natural resources in developing countries including Saudi Arabia. This was the inequitable<sup>150</sup> situation where seven major international oil companies controlled huge areas under long term concession contracts that only benefited them at the expense of the large nations in which they operated.<sup>151</sup> Consequently, the UN General Assembly took the following action:

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<sup>149</sup> The reason for the comparative study between the law governing the title to minerals in both Islamic and Western countries is so brief is because there are no differences to be analysed or discussed.

<sup>150</sup> For more discussion and analysis see chapter 4 & 5 *infra*.

<sup>151</sup> See Yargin, D., *The Prize: The Epic Quest for Oil, Money and Power*, Free Press, (1991), for an examination of the history of the world oil industry, the founders, the global struggle, war and strategy, the hydrocarbon age, the battle for world mastery including the events that led the creation of OPEC.

On December 21, 1952, the General Assembly adopted Resolution No. 626 (VII)<sup>152</sup> which provides that:

“The right of people freely to use and exploit their natural wealth and resources is inherent in their sovereignty”.<sup>153</sup>

On December 14, 1962, at its Seventeenth Session, the General Assembly adopted Resolution No. 1803 (XVII)<sup>154</sup> entitled Permanent Sovereignty Over Natural Resources which provided that:

“The right of people and nations to permanent sovereignty over their wealth and resources must be exercised in the interest of their national development and of the well-being of the people of the state concerned”.

At the same time, it was declared that:

“Nationalisation, expropriation, or relinquishment shall be based on grounds or reasons of public utility, security or the national interest which are recognised as overriding purely private interests, both domestic and foreign. In such cases, the owner shall be paid appropriate compensation, in accordance with the rules in force in the state taking such measures in exercise of its sovereignty and in accordance with international law”.<sup>155</sup>

The 1962 Resolution was reinforced in 1966 by Resolution No. 2158 (XXI) which was even more explicit on host state rights.<sup>156</sup> Host states were ‘advised’, by exercising their permanent sovereignty, to secure the maximum exploitation of natural resources and to achieve this by the accelerated acquisition by developing countries of full control over production operations, managing and marketing.<sup>157</sup>

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<sup>152</sup> See text of Resolution at UN General Assembly website: [www.un.org/documents/resga.htm](http://www.un.org/documents/resga.htm) 15/11/2008.

<sup>153</sup> For more discussion on the issue of sovereignty, in particular, the issue of the state right to regulate its natural resources see chapter 5 *infra*.

<sup>154</sup> General Assembly website, *supra* note 149.

<sup>155</sup> *Ibid*.

<sup>156</sup> *Ibid*.

<sup>157</sup> See United Nations Centre on Transnational Corporations, *Main Features and Trends in Petroleum and Mining Agreements: A Technical Paper*, New York: United Nations, (1983). See also Steven, P., *infra* note, 172, p. 131 & also for the details of this Resolution, see Blinn, K., *supra* note 76, p. 30.

On December 12, 1974, the General Assembly adopted Resolution No. 3281 (XXIX),<sup>158</sup> entitled “Charter of Economic Rights and Duties of States” which provided that:

a) Every State has and shall freely exercise full permanent sovereignty, including possession, use and disposal, over all of its wealth, natural resources and economic activities...

b) Each state has the right: “to nationalise, expropriate or transfer ownership of foreign property in which case appropriate compensation shall be paid by the state adopting such measures, taking into account any relevant laws and regulations and all circumstances that the state considers pertinent. In any case where the question of compensation gives rise to a controversy, it shall be settled under the domestic law of the nationalising state and by its Tribunals, unless it is freely and mutually agreed by all states concerned that other peaceful means be sought on the basis of the sovereign equality of states and in accordance with principle of free choice of means”.<sup>159</sup>

The remaining crucial issue in the field of title to minerals is whether such minerals can be transferred to a foreign or national corporation. Does the government, while retaining ownership, transfer substantial powers of management (including the power to take critical decisions) to the oil company?

## ***2.12 Petroleum Operations and Ownership Rights of International Oil Companies***

In order to define the ownership rights of the petroleum resources before and after exploration, this section will focus on analysing the ownership of petroleum in the ground (in situ) and the ownership of petroleum at the surface, when produced. This will highlight the position of the rights of both the states on whose territory those resources are found and the oil companies – who undertake petroleum exploration and production in those countries.

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<sup>158</sup> UNGA website, supra note 149.

<sup>159</sup> The above UN General Assembly’s Resolutions of 1952, 1962 and 1974 are cited by Blinn, K., supra note 76, pp. 30-31.

## 2.12.1 Ownership of Petroleum in the Ground

As already explained, most of the world's petroleum resources are owned by the governments on whose territory those resources are found.<sup>160</sup> Under most legal systems (with the exception however of the private land regime in the USA or Canada and in a very few other countries), petroleum below the surface of any land is the property of the state, even if exploration and exploitation rights are granted by it to oil companies. The procedure for disposal and transfer of ownership has to be decided by law. The oil companies which have made such a discovery are usually assured of obtaining from the state the exclusive right of exploitation.<sup>161</sup>

## 2.12.2 Ownership of Petroleum at the Surface

Governments have been compelled to adopt some means of involving private companies in the exploration for and exploitation of their petroleum resources. Obviously, it is one which has to be advantageous to both parties. The choice has usually been some form of licensing arrangement.<sup>162</sup> Although the legal form may simply be called a petroleum licence, it may also be called a concession or a lease. In fact, the differences in terminology conceal a similarity in substance.<sup>163</sup>

When petroleum is produced by an oil company authorised by the state under an Exploration and Production Agreement, there is a transfer of title to petroleum produced at the surface, because any mineral not yet produced and extracted, belongs only to the state.

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<sup>160</sup> Stickley, D., *Natural Gas Negotiations and Contracts*, CEPMLP, (2003), p. 12.

<sup>161</sup> Le Leuch, H., *Petroleum Exploration/Production Agreements and Taxation*, Deventer: Kluwer Law, (2001), p. 4.

<sup>162</sup> Cameron, P., *supra* note 92, p. 5.

<sup>163</sup> *Ibid*, p. 5.

There is then agreement between the state and the producer in conformity with the existing law and agreement entered into between the state and such a producer. The transfer of title and the point of transfer take the following forms:

- Under a production sharing contract (PSC), the transfer concerns only a part of the production and the point of transfer is generally at the outlet of the storage facilities. Management (the power to take critical decisions) is shared between the state and the oil company.

- Under a concession agreement (or a "licence agreement"), the transfer concerns the entirety of the production (except when a royalty is taken in kind by the host state) and is made at the wellhead. A substantial portion of management power is transferred to the oil company.

- Under a service contract generally no transfer of title occurs as the company only receives a monetary compensation without any right to production (unless otherwise provided). No management is transferred to the oil/service company.<sup>164</sup>

In the past, the main concern of producing countries was expansion of oil production in order to maximize their benefits. For this reason, very few concessions embodied provisions for control or curtailment regulations of oil production – except to the extent that special powers were envisaged in times of national emergency.<sup>165</sup> In most countries, especially in Europe, the Middle East and other developing countries, the reserves are, however, considered as constituting inalienable natural resources, and the concessionaire requires 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 authorisation to explore and

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<sup>164</sup> Le Leuch, H., *supra* note, 158, p. 4-6.

<sup>165</sup> Cattani, H., *supra* note 26, p. 104.

produce, while the minerals remain the property of the state until produced (*jus ad rem versus jus in rem*).<sup>166</sup>

An early example is found in Getty's concession in 1949 in the Neutral Zone of Saudi Arabia.<sup>167</sup> Article 42 of the agreement provided that the company should conduct its drilling and production operations according to all reasonable requirements, consistent with good oil field practice. These were as may be imposed upon all other companies conducting oil operations within the Kingdom of Saudi Arabia, for the purpose of conserving the national wealth. The article provided that, if by reason of any curtailment imposed upon production the royalty payable under the agreement in any year shall be less than the minimum royalty fixed by the same agreement and then that such a minimum royalty shall be correspondingly reduced.<sup>168</sup>

In Europe, the first prospecting licenses in England and Scotland under the new Act were granted to the D'Arcy Exploration Co. Ltd., now (British Petroleum - BP), in December 1935 and covered a total of six thousand nine hundred and forty six square miles. Under the 1934 Act, as subsequently amended, the Secretary of State was awarded the power to grant a license which entitles the award holder "to search and bore for and get petroleum". Based on the Permanent Sovereignty Over Natural Resources (PSNR), these licensing powers are permissive rather than mandatory and therefore the government could in fact exploit its own resources without involving private enterprise.<sup>169</sup>

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<sup>166</sup> Blinn, K., supra note 76, p. 55.

<sup>167</sup> The concession for onshore Neutral Zone production was initially secured by legendary oil tycoon J. P. Getty in 1949 and passed to Texaco on its acquisition of Getty Oil in 1984. Chevron became the holder of the lucrative contract following its merger with Texaco in 2001. In 15 July 2008, Chevron's Neutral Zone Concession was extended by the Saudi Cabinet, see Arab News newspaper at: <http://www.arabnews.com/?page=1&section=0&article=111822&d=15&m=7&y=2008>. 30/05/09.

<sup>168</sup> Blinn, K., supra note 76, p. 105.

<sup>169</sup> Bunter, M., supra note 118, p. 41.

### 2.12.3 State participation

As to state participation<sup>170</sup> in the extractive petroleum industry, in practice, it is only made obligatory in the context of an exclusive license granted by the host state. State participation however, is non-obligatory if the state or a state-owned oil company is accepted as a participant in a domestic or foreign petroleum venture by the other participants on a voluntarily basis and for purely commercial reasons.<sup>171</sup>

With regard to the implementation of state participation in the extractive petroleum (oil & gas) industry in Saudi Arabia, in 1965 the government entered into a state participation agreement with respect to acreage situated on its part of the Red Sea continental shelf. The parties were Petromin<sup>172</sup> with a participating share amounting to 40%, and Auxirap<sup>173</sup> with a 60% participating share. Auxirap was responsible for the conduct and financing of the exploration work. As soon as a commercial discovery was made, a joint company would have to be established and run on a commercial basis. The company was liable to pay 50% income calculated on the basis of the price required to be posted by the company. The company had to pay royalty at higher rates than was customary at the time, a rate of 15% increasing to 20% depending on production performance.<sup>174</sup>

In July 1971, the 24<sup>th</sup> OPEC conference passed Resolution, XXIV 135, which called upon all member states to “take immediate steps towards the effective implementation of the

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<sup>170</sup> For more discussion on state participation, see chapter 4 infra and previous part of this chapter.

<sup>171</sup> Tavarne, B., *Co-operative Agreements in the Extractive Petroleum Industry*, London: Kluwer Law International, (1996), p. 101.

<sup>172</sup> Petromin is the Saudi Arabian state oil enterprise, it was not formed until November 1962, its role was intended to be wider than most national oil companies, since it was expected to take part in various industrial and commercial activities connected not only with petroleum, but with minerals in general, for more information see <http://www.saudinf.com/main/d21.htm>

<sup>173</sup> Auxirap is a French company subsidiary of ERAP.

<sup>174</sup> Taverne, B., *Co-operative agreements in the extractive petroleum industry*, Londres: International Energy and Resources Law & Policy Series, (1996).pp. 115-116.

principle of participation". This was followed in September 1971 by Resolution XXV. 139 which called on members to "establish negotiation ... (to achieve) ... effective participation".<sup>175</sup> Generally, under modern participation agreements, the Gulf Countries, including Saudi Arabia, have now a much greater degree of authority and control over petroleum operations. Undoubtedly, the aim of state participation is to strike a fair balance between supervision and control by the government to secure national policy objectives - mainly protecting its natural resources - and the company's freedom to operate so as to secure its corporate objectives.

#### **2.12.4 Petroleum Operations' Information Ownership Rights**

It must be noted that, in the international field of petroleum operation not only is the ownership of natural resources a concern of the state, but also the title to the information and data resulting from petroleum operations are very important. Petroleum Operations involve exploring for, discovering and producing petroleum through drilling, pressure enhancement, pumping or the like and other incidental operations. It includes transportation, storage, handling and sales (whether for export or domestic consumption) of petroleum but does not include transportation for purposes of export or the cost of refining or processing.

A consistent pattern of modern Petroleum International Agreements (PIAs) requires the international oil company to furnish the host state with all available information and data. This is indicated, for example, in a Brazilian PIA providing that "... Any and all plans, maps, drawings, design data, scientific and technical reports or other data and information of any kind or nature whatsoever, relating to the Contractor's operations... be furnished to the

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<sup>175</sup> Stevens, P., *Joint Venture in Middle East Oil 1957-1975*, Beirut: Middle East Economic Consultants (1976), p. 138.

host state's national oil company". The latter one predicts this contract on the concept of ownership of the materials.<sup>176</sup>

Also by reviewing standard Indonesian Production Sharing Contracts<sup>177</sup> (PSCs) which were a new type of petroleum development agreement in 1967, and later adopted by a number of countries in South and South-East Asia and beyond, it is noted that the management framework under a PSC is so designed that work programmes in each phase of operations are drawn up by the contractor, and submitted for approval by the national company. There is also provision for periodic reporting and submission of information.<sup>178</sup> A similar approach to the ownership of material is taken by Equatorial Guinea by declaring, in its standard Petroleum International Agreement (PIA), that the Ministry of Petroleum will have title to all original data resulting from the petroleum operations but permits the contractor to retain copies. The Ministry agrees not to disclose such data to third parties without the contractor's consent during the term of the contract.<sup>179</sup>

It appears that an awareness of the nature of the exploratory process is important in order for a government to adopt a number of measures to safeguard its interests. It is argued that governments should not only require that all exploration data should be furnished to it, but also evaluations made by the companies.

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<sup>176</sup> Le Leuch, H., *International Petroleum Exploration and Exploitation Agreements*, New York: Barrows Co. INC. (1986), p. 158-159.

<sup>177</sup> For more discussion on the PSC see previous part of this chapter.

<sup>178</sup> Hossain, K., *Law and Policy in Petroleum Development*, London: Frances Printer Ltd, 1979, p. 140.

<sup>179</sup> *Ibid*, p. 160.

## Conclusion

In this chapter, it has been found that there are many similarities between Islamic law and western legal systems with regard to commercial contracting. It was also found that many principles similar to those in Shari'a exist or have existed in common law systems despite some differences, such as the doctrines dealing with uncertainty and usury. It has been shown that the principle of freedom of contract conforms to both Shari'a and the exigencies of modern commerce. However, it should be stated that there are certain differences in ethos and practice of different schools of Islamic law as regards principles applicable to petroleum development. These areas have been identified in this chapter. Shari'a emphasises equality of partnership and prohibits unfair profits through usury. This view of Shari'a is utterly different from what is applied in western systems.

Shari'a's attitude towards the old concession agreement was also demonstrated. Traditional concession agreements placed foreign companies in a position significantly greater than the host state in several ways. This unbalanced partnership between foreign oil companies and host states led the latter to act collectively through OPEC to regain control over their natural resources. Saudi Arabia used renegotiation and state participation – at a later stage – as a means of regaining control gradually. It is argued that Saudi Arabia pursuing this policy provides evidence of protection of foreign investment. It should also be mentioned that the old concession agreements have now been replaced by production sharing agreements, state participation and service contracts which reflect a better balance and therefore a more sustainable relationship between both parties.

As far as the stability of investment agreements in Saudi Arabia is concerned, there is a significant conflict between Shari'a's view of certain foreign investment contract types. It has

been shown that they are not in conformity with Shari'a law of contract in several ways, as discussed earlier. Therefore, this could give rise to legal risks for the development of foreign investment projects in the country. However, as has been discussed, the flexibility of Shari'a means that it has the capacity to adapt to changes of circumstances and contractual divergence which will enhance the development of contract law in Saudi Arabia under Shari'a.

The history of private ownership of land has been examined in this chapter as this is of such vital preliminary importance to the economic exploitation of mineral rights through petroleum extraction and production, and to legal issues surrounding foreign investment in such activities. Land ownership was practised before and after Islam. Land was given by the Prophet (*pbuh*) and his successors with the right to use and transfer the title. At times, the absolute right of ownership was taken away by the government, and restrictions on its use were imposed in the interest of the community. Generally under most legal systems such as those highlighted in the chapter, (with the exception of the private land regime in the USA or Canada and a very few other countries), petroleum below the surface of any land is deemed at all times to be the property of the state. The procedure for disposal and transfer of ownership has to be decided by law. The example of the UK was highlighted to show this difference. As for the ownership of petroleum at the surface, when petroleum is produced by persons authorised by the state under an exploration production license, there is a transfer of title of petroleum produced at the surface between the state and the producer in conformity with existing law and the agreement entered into between the state and such producer.

It has been shown that virtually all minerals ownership regimes are based on the jurisprudential theory of state sovereignty. United Nations resolutions relating to the

permanent sovereignty of natural resources have further strengthened the notion that the state owns all the resources found within its boundaries. The sovereign over a defined geographical area has exclusive dominion over the area, and this includes its natural resources. The sovereign can recognise private ownership of these resources, or it can treat them as state-owned minerals whose commercial exploitation shall be managed by a state agency. It may also authorise development by private companies, including foreign companies. Whichever route it chooses it will need foreign expertise, capital and labour. This will only be supplied on competitive terms if a sufficiently certain and clear legal framework for FDI is in existence as well as the availability of effective, independent and impartial mechanisms for the settlement of foreign investment disputes. The next chapter explores the role and suitability of the dispute resolution system to the foreign investor in Saudi Arabia.

# **(3) THE SETTLEMENT OF INVESTMENT DISPUTES**

## **Introduction**

In any commercial agreement, despite the fact that parties to the agreement are bound by its terms, there is still a possibility of a dispute occurring. Thus the infrastructure of, and legal process for, dispute settlement are just as important to an optimal legal framework for FDI as the substantive content of that framework. Parties therefore include provisions in their agreements that cater for such an eventuality. The most important provision is a dispute settlement mechanism for addressing future disputes. Before the method of resolving the dispute can be put into force, the mechanism for determining a dispute and the law that will be used in the method must be determined. Therefore, the need to determine the applicable law is very important.

During the last few decades, it is apparent that International Commercial Arbitration (ICA) has gained worldwide acceptance as the favoured means of resolving international commercial disputes. Around the world domestic laws on arbitration have been mobilised and international agreements on arbitration have been signed with a notable degree of success. The gradual removal of political and trade barriers and the significant progress of globalisation bringing with it an acceleration of economic activities, has made the need for national and international arbitration more evident. Increasing reliance on arbitration in national and international trade is one of the main features of today's world business community. All these developments have created challenges for arbitration institutions in

response to the growth in demand by parties for certainty and predictability, greater speed and flexibility as well as neutrality and efficacy in the settlement of commercial disputes.

This chapter examines how foreign investment is protected in Saudi Arabia by means of dispute settlement methods and infrastructure. It examines the purpose, role and suitability of the dispute resolution system that is in place, including arbitration. It provides a critical overview and evaluation of the international regime and relevant law in Saudi Arabia relating to the settlement of investment disputes. The chapter also examines the concept of arbitration under Islamic law and how it can be used in modern litigation and identifies the main legal obstacles relating to investment agreements. It will also look at the available dispute-settlement mechanisms for the resolution of foreign investment disputes in Saudi Arabia. It is important to have an effective dispute resolution system for the protection of foreign investors. This will pave the way for more economic development in Saudi Arabia and encourage more foreign investors to invest in many different types of industries. This will be achieved in part by foreign investors' awareness of Shari'a, the Saudi legal system and its attitude in respect to methods of disputes resolution. The government and the judiciary of Saudi Arabia are also obliged to fully recognise and adhere to international arbitration agreements and conventions which Saudi has signed and ratified.

The focus in this chapter is therefore the question of how investment disputes in Saudi Arabia are resolved by litigation, domestic and international arbitration. The structure of this chapter is six sections dealing with the following issues:

Section 1 analyses the settlement of investment disputes through litigation in Saudi Arabia. In this section, the structure of the judicial system in Saudi Arabia will be considered followed by the different legal aspects of Shari'a courts and facilities for resolving disputes in the

Board of Grievances.<sup>1</sup> Section 2 summarises the history of dispute settlement methods in both the pre-Islamic period and early days of Islam. The purpose of this section is to see how the Prophet (*pbuh*) resolved disputes in his time and the methods of settlements he applied. Section 3 explores the resolution of disputes arising out of investment agreements through ICA. The discussion in this section will address the influence of the famous ARAMCO award, the Council of Ministers Resolution No 58, the Ministry of Commerce's Circular and the shift in Saudi Arabia's attitude toward ICA.

Section 4 will deal with international treaties/conventions with a discussion of the New York Convention (NYC), summary of the United Nation Commission for International Trade Law (UNCITRAL)<sup>2</sup> and its applicability in Saudi. Section 5 confines itself to the examination of whether Islamic Law represents an obstacle to the application of International Arbitration Law, which will entail discussion of arbitration under the four Islamic Schools and the suitability of ICA in respect of the commercial security and investment stability for both foreign investors and the government of Saudi Arabia. Section 6 examines elements of the domestic Arbitration Law in Saudi Arabia contained in the Arbitration Code of 1983, the arbitration clauses, the autonomy of the arbitration clauses, appointment of arbitrators, number and qualification of arbitrators. It goes on to look at the revocability of arbitrators, procedures of arbitration under Shari'a, arbitration proceedings, place and applicable law of arbitration place, the award and finally the enforcement of foreign arbitral award in Saudi Arabia.

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<sup>1</sup> For more details see Chapter 1 of the thesis.

<sup>2</sup> The UNCITRAL Rules were adopted by the UN General Assembly Resolution No. 31/98 dated December 15, 1976.

### 3.1 Historical view of Dispute Settlement Methods

In general, there is more than one method of dispute resolution arising out of investment agreements. These include methods such as negotiation,<sup>3</sup> mediation<sup>4</sup> and arbitration.<sup>5</sup> In many cases, negotiation and mediation/reconciliation are preferred by commercial parties rather than judicial or arbitral means due to their amicable nature which allows the disputing parties to reach a compromise solution to their disputes. Arbitration and judicial settlement, on the other hand, are employed when there is a requirement for a binding decision, usually on the basis of international law, and hence these are known as legal means of settlement.<sup>6</sup>

Arbitration has a long history as a means used to settle disputes; it pre-dates the state judiciary, or even the state itself.<sup>7</sup> Indeed, some forms of arbitration process may be found even in earliest societies. Peter Stein noted a rudimentary form of arbitration existed in ancient Athens, with commercial arbitration in disputes involving large sums of money, subject to institutional arbitration as early as 403 B.C.<sup>8</sup>

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<sup>3</sup> See Buhring-Uhle, C. *Arbitration & Mediation in International Business*, Kluwer Law International, (1996), p. 222; Negotiation is 'communication directed at achieving a joint decision'.

<sup>4</sup> Mediation is a device for resolving disputes that attempts to defuse a great deal of hostility and anguish between the parties by using a third as a go-between. It has a number of characteristics such as: it is not very time consuming, relatively inexpensive and is normally confidential. Best of all, it is a superior device for preserving the underlying business relationship while permitting the parties to resolve the dispute at hand because it is not nearly as confrontational as litigation. See Fox, W., *International Commercial Agreements*, 3<sup>rd</sup> ed., Kluwer Law Intl., (1998), p. 35.

<sup>5</sup> Arbitration is a device whereby the settlement of a question, which is of interest for two or more persons, is entrusted to one or more other persons-the arbitrator or arbitrators-who derive their power from a private agreement not from the authority of a state, and who are to proceed and decide the case on the basis of such an agreement. Arbitration is an alternative jurisdiction to national courts which are specifically established by the state to apply and uphold the law and determine all forms of dispute. Lew, M., *Comparative International Commercial Arbitration*, Kluwer Law International, (2003), p. 17.

<sup>6</sup> Merrills, J., *International Dispute Settlement*, 3<sup>rd</sup> ed., Cambridge: Cambridge University Press, (1998), p. 88.

<sup>7</sup> Fathy, H., *Arbitration According to Islamic Law*, 1 *Arab Arb. J.* (2000) p.31.

<sup>8</sup> Fox, W., *supra* note 4, p. 286.

### 3.1.1 Pre-Islamic period and early days of Islam

Resort to arbitration (“*Al-Tahkim*”) in the pre-Islamic period in the Arabian Peninsula was optional and left to the free choice of the parties. It relied on tribal justice administered by the chief of the tribe and trustworthy individuals instead of organised judicial justice. Arbitral awards were not legally binding unless the parties had agreed to the contrary.<sup>9</sup> In that period, there were no specific rules to limit the arbitral subjects and the arbitral proceedings were simple and rudimentary.<sup>10</sup> Tribal disputes were settled by arbitration methods, the best example was the dispute which arose between the leaders of *Quraysh*<sup>11</sup> about who should have the honour of lifting and placing the black stone after rebuilding the Holy *Kabba*.<sup>12</sup> The dispute was settled by an agreement to accept the arbitration of the first comer to the place, who happened to be Mohammed *Al-Amin* (the trustworthy) and the decision of the sole arbitrator was accepted and enforced by the parties.<sup>13</sup>

Arbitration in the early days of Islam was recognised as a means of disputes resolution.

The Holy *Quran* indicates its awareness of arbitration in the following verses:

*If you fear a breach between them twain, appoint two arbiters, one from his family and the other from hers; if they wish for peace, Allah will cause their reconciliation; for Allah hath full knowledge and is acquainted with all things.*<sup>14</sup>

The other verse that deals with arbitration is:

*But no, by the Lord, they can have no real faith, until they make thee judge in all disputes between them, and find in their souls no resistance against thy decisions, but accept them with the fullest conviction.*<sup>15</sup>

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<sup>9</sup> Alqurashi, Z., *Arbitration under Islamic Shari'a*, *OGEL*, Vol.1, Issue 2, (March, 2003).

<sup>10</sup> *Ibid*.

<sup>11</sup> Prophet Mohammed's (*pbuh*) tribe.

<sup>12</sup> The first house of God, *Quran*, (3:96).

<sup>13</sup> The prophet said: "Bring me a cloak." When they brought him the cloak he placed the Black Stone on it and said: "Let the elders of each tribe hold on to one edge of the cloak and raise it (to the position of the stone)." They did so and the Prophet (saws) placed the stone in its place. See El-Ahdab, A., *The Muslim Arbitration Law, Arab Comparative & Commercial Law*, Vol. 1, (1987), p.233.

<sup>14</sup> Holy *Quran*, (4:35).

<sup>15</sup> *Ibid* verse 65.

Arbitration was also recognised and practiced by Prophet Mohammed. For instance, he acted as an arbitrator in the feuds of *Al-Aws* and *Al-Khazraj*, the largest tribes in *Al-Madinah* at that time, with three Jewish clans.<sup>16</sup> Prophet Mohammed appointed arbitrators on several occasions to settle many disputes and their decisions were accepted.<sup>17</sup> In fact, arbitration at that time, as stated earlier, relied on tribal justice administered by the head of the tribe and trustworthy individuals instead of organised judicial justice. For this reason, there was no arbitration code and neither was arbitration confined to any particular forum or specialised institution. Arbitrators used their wisdom and the legislative *Quran* verses.

### ***3.2 The Settlement of Investment Disputes through Litigation in Saudi Arabia.***

The settlement of investment disputes through litigation is not regarded as beneficial to foreign investors, due to the fact that the foreign company may have to appear before several tribunals.<sup>18</sup> Furthermore, a foreign investor who lodges a claim against a state in the state's own courts may reasonably or unreasonably fear that the state may act both as judge and party in its own cause.<sup>19</sup> Furthermore, litigation is usually too expensive and time consuming

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<sup>16</sup> Amin., S., *Commercial Arbitration in Islamic & Iranian Law*, Tehran: Vahid & Glasgow: Royston, (1988), p. 50.

<sup>17</sup> Al Samaan, Y., *The Legal Protection of Foreign Investment in Saudi Arabia*, Dar Al Andalus for Pub. & Dist. Hail, Saudi Arabia, (2000), p. 326.

<sup>18</sup> Several tribunals resolve disputes in specialised areas of Saudi law. The Civil Rights Directorate is primarily responsible for enforcing the judgment of a Saudi Arabian court or tribunal. The Negotiable Instruments Committee decides cases involving bills of exchange, promissory notes, and cheques. The SAMA Committee resolves certain disputes between banks and their customers. The Conciliation Committee at the Chamber of Commerce assists in settling problems that arise when a foreign company attempts to change commercial agents. The Preliminary Committee for the Settlement of Labour Disputes hears all matters related to labour and employee relations.

<sup>19</sup> Suleiman, A., *Arbitration in Petroleum Contracts*, 13-14 October, Abu Dhabi, U.A.E, (1998), p. 2.

and court judgements have little international impact<sup>20</sup> because court judgements cannot be easily enforced in other countries.

The importance of domestic courts in the settlement of cross border investment disputes has grown over the years. Judicial systems around the world have grown in confidence in interpreting and implementing rules of international law into their domestic legal systems, and giving effect to them through national enforcement mechanisms. The areas of law that have been developed through local courts and their interpretation of international law rules are mainly in the fields of the environment, human rights and business transactions.

The role of the domestic court in the settlement of an investment dispute is mainly to provide a remedy against home states which have interfered with the rights of foreign investors. It should also provide a remedy to the citizens of the host state that have been affected by the operations of the foreign corporations. Litigation by foreign investors in the domestic courts is a facility which is available in most countries. It can be regarded as a means to promote protection of foreign investment by multinationals through access to the domestic courts of their home states to settle investment disputes arising from contracts made in host states.

However, it is always difficult for the home state to have jurisdiction over contracts entered by its nationals in another country, unless the host state agreed to a forum selection which allows the home state to have such jurisdiction. In most cases, the host state would insist on having jurisdiction to such disputes. But – for example – in the case of the USA, the Foreign Sovereign Immunity Act provides that US courts could have jurisdiction over

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<sup>20</sup> Fox, W., supra note 4, p.2.

commercial acts of foreign sovereigns which produce effects within the USA.<sup>21</sup> Some exceptions to this rule include sovereign immunity and the act of state doctrine. These exceptions are important where it would upset the existing international order based on the equality of the states. This is the reason why no domestic court of one state is competent to exercise jurisdiction over another state.<sup>22</sup>

Examining methods of settlement of disputes arising out of investment agreements through litigation in Saudi Arabia will involve exploring Saudi's legal system. However, as the latter has been discussed earlier in this study,<sup>23</sup> the focus in this section will be exclusively placed on competent judicial bodies (courts & BG) to adjudicate disputes arising out of investment agreements. The Saudi judicial system which is based on Shari'a, is also reflected and incorporated by the various Royal Decrees and decisions of Council of Ministers issued from time to time by the government.<sup>24</sup>

### 3.2.1 The Judicial System in Saudi Arabia

Significant changes are taking place in the Saudi judicial system.<sup>25</sup> One of these changes is the newly established Supreme Court to be set up with specialised courts for labour, commercial and personal disputes. The government emphasises that new commercial courts will meet a pent-up demand by local and foreign investors.<sup>26</sup> It has been assumed that

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<sup>21</sup> See Sornarajah, M., *The International Law on Foreign Investment*, 2<sup>nd</sup> ed. Cambridge: Cambridge University Press, (2004), pp.344-345.

<sup>22</sup> Ibid, pp. 345-357.

<sup>23</sup> For more discussion on the Saudi legal system see chapter 1 supra.

<sup>24</sup> See the forgoing discussion.

<sup>25</sup> Saudi Embassy in Washington at: [http://www.saudiembassy.net/about/country-information/government/legal\\_and\\_judicial\\_structure.aspx](http://www.saudiembassy.net/about/country-information/government/legal_and_judicial_structure.aspx). See also Saudi Judicial System Improving, <http://www.thefreelibrary.com/SAUDI+ARABIA+-+Saudi+Justice+System+Improving-a0170168734>

<sup>26</sup> Ibid, Royal Decree No.(M/78) dated 19/9/1428H (1/10/2007) was issued, approving the Charter of Judiciary system, and the Grievances Bureau Charter, and the implementation work mechanism for both Charters. See SAMA website at: [http://www.sama.gov.sa/sites/SAMAEN/ReportsStatistics/ReportsStatisticsLib/1300\\_R\\_EcoDev\\_En\\_2007\\_12\\_25\\_Q4.pdf](http://www.sama.gov.sa/sites/SAMAEN/ReportsStatistics/ReportsStatisticsLib/1300_R_EcoDev_En_2007_12_25_Q4.pdf). See also Abdulghafour, P., *Kingdom Overhauls Judiciary; Independence of Courts Stressed, Arab*

the previous system of dispute settlement - the BG - will come under the purview of the commercial courts. These changes reflect the Saudi need for regulations that match the requirements of a growing economy that is steadily opening up to foreign investment. Implementation of a more professional system is expected to help clear a backlog of cases. While there is no codification of laws involved, the reformed system is considered likely to make arbitrary judgements less likely than in the past and the system more transparent.<sup>27</sup> These reforms are at too early a stage to evaluate their effect.<sup>28</sup>

## (i) Courts

The judicial system consists of both general courts and specialised commercial courts. Courts and tribunals may consist of a combination of judges and non-judges. Decisions may be given instantly or may take some time. In some cases, decisions may be appealed.<sup>29</sup> The general courts are Shari'a courts administrated by the Ministry of Justice according to Judicial Code of 1975.<sup>30</sup> Shari'a courts have general jurisdiction over all disputes except those excluded from their jurisdiction by special codes.<sup>31</sup> In particular, they have exclusive jurisdiction over civil, criminal cases and matters of personal status.<sup>32</sup> Shari'a courts consist of Summary Courts, Ordinary Courts and Courts of Appeal.<sup>33</sup>

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News Newspaper, (Oct. 2, 2007), available at: <http://www.arabnews.com/?page=1&section=0&article=102007&d=3&m=10&y=2007>.

<sup>27</sup> AME Info., *Saudis move to modernise legal system*, available at: <http://www.ameinfo.com/134904.html>.

<sup>28</sup> The process to bring about structural and procedural changes will take 20 years, said Minister of Justice Sheikh Abdullah Aal Al-Shiekh. See Saudi Gazette at: <http://www.saudigazette.com.sa/index.cfm?method=home.regcon&contentID=2008123125381&archiveissuedate=31/12/2008>.

<sup>29</sup> For more information see *Info-Prod Research (Middle East), Saudi Arabia*, at <http://www.infoprod.co.il/article/24>

<sup>30</sup> Royal Decree No. M/46, dated on 23/07/1975 and amended by Royal Decree No. M/76 dated on 19/10/1975; Royal Decree No. M/4 dated on 06/01/1981.

<sup>31</sup> Al-Samman, Y., supra note 17, p. 220.

<sup>32</sup> Royal Decree No. M/76 of 1975.

<sup>33</sup> Al-Samman, Y., supra note 17, pp. 119-220.

Under the Judicial Code of 1975, Article 53, judges in Shari'a courts are appointed by royal order to execute decisions of the Supreme Judicial Council. Judges must be Saudi nationals of good conduct and possess a degree from the Saudi Islamic Law Faculty or its equivalent. The minimum age is twenty two years or, in the case of appellate judges, forty years.<sup>34</sup>

## **(ii) Board of Grievances (Administrative Court)**

The Board of Grievances (the BG) adjudicate disputes between government agencies and private parties as well as other matters provided for by special codes such as bribery, forgery and trademarks. Most cases are decided on their individual merits, and therefore, legal precedent does not bind judges.<sup>35</sup> The BG usually seeks outside technical experts to decide cases, which are necessary for complex disputes.<sup>36</sup>

This means that the BG is the adjudicative body having subject-matter jurisdiction over cases to which the Saudi government or any of its agencies or instrumentalities is a party. In other words, the BG (*Diwan Al-Mazalim*) is the judicial authority competent to hear investment disputes in Saudi Arabia. Its antecedents are in historical jurisdiction outside the Shari'a court system over grievances against government officials.<sup>37</sup>

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<sup>34</sup> The Law of the Judiciary 1975 available at Saudi Embassy in Washington website: [http://www.saudiembassy.net/about/country-information/laws/Law\\_of\\_the\\_Judiciary.aspx](http://www.saudiembassy.net/about/country-information/laws/Law_of_the_Judiciary.aspx). See also Lerrick A. & Q. Mian., *Saudi Business and Labour Law*, Graham & Trotman, (1987), p. 200.

<sup>35</sup> The legal system of Saudi Arabia does not accept the principle of *stare of decisis* (binding precedent), thus, previous decisions of Saudi courts and other adjudicative bodies –such as (BG) – are not considered as establishing binding precedents for the decision of later cases.

<sup>36</sup> For more discussion in-depth see chapter 1.

<sup>37</sup> Lerrick A. & Q., Mian, supra note 35, pp. 231-232.

### (iii) The Independence of the Board of Grievances

Article 19 of the Council of Ministers Code of 1954 provides for the establishment of the BG as an institution attached to the Council of Ministers. It was reorganised in 1983 and became an independent institution headed by a president, who is directly responsible to the King as Head of State.<sup>38</sup> The BG is defined by Article 1 of the Code of 1983 as an autonomous judicial body which possesses an exclusive jurisdiction over administrative cases. However, as it is linked directly to the King this would be automatically perceived by foreign investors as a contradiction due to the fact that its autonomy is threatened by the superior executive power of the King. Modifying Article 1 of the Board's Code should be considered in order to separate the BG from any linkage whatsoever to the King, and to enjoy the same full independence that is enjoyed by Shari'a courts.<sup>39</sup> Article 3 of the BG's Code stipulates that the appointment and dismissal of the president, vice-president and the judges are made by royal decrees. This may be also perceived by foreign investors to negatively affect the impartiality and independence of the Board's judges. A more impartial approach would be for their appointment and dismissal to be made by the Supreme Judicial Council rather than by the executive body, and this was debated before the 1983 reform.<sup>40</sup> This might eliminate foreign investors' fears and restore confidence in Saudi judicial system.

With the increasing significance of foreign investment in the Kingdom by the 1980s, the government considered restructuring the BG to give it more judicial authority to deal with all the cases mentioned previously. This led in 1983 to restructuring under a new code to

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<sup>38</sup> Royal Decree No. M/13/8759 of 1955. Despite the recent judicial reforms the BG remained linked to the king, Royal Decree No.(M/78) dated 19/9/1428H (1/10/2007). See note 27, *supra*.

<sup>39</sup> Even though the King's extensive power clearly affects the independence of the judiciary, it is very difficult to implement any proposal or reform to limit or reshape the King's authority over the judiciary. This will require constitutional arrangements and acceptance by the King himself. Al-Jarbou, A., *Judicial Independence: Case Study of Saudi Arabia*, 19 *Arab L.Q.*, 52, (2004), pp. 5-54.

<sup>40</sup> Al-Samman, *supra* note 17, p. 224.

become a judicial administrative tribunal. However, the BG is still subject to criticism due to its lack of full independence since the restructuring did not remove entirely the need for the approval of the King.<sup>41</sup> The reforms gave it jurisdiction over claims submitted by government civil servants against the government, and over appeals filed by interested parties from administrative decisions on the grounds of formal defects, violations of applicable codes and their implementation rules and abuse of power. The jurisdiction of the BG also includes compensation claims against the government, disputes relating to agreements between government agencies and private parties, disciplinary cases for civil servants and criminal cases under the Anti-Bribery Code and Anti-Forgery Code.<sup>42</sup>

The BG also adjudicates on foreign investment disputes. Since litigation before the Courts can be a longwinded and protracted process, foreign investors view the local courts as lacking sufficient knowledge to deal with sophisticated investment transactions, and see the publicity accompanied with local court hearings as an infringement of their confidential investment dealings. There is also a lack of trust of the impartiality of local courts. It is therefore assumed that foreign investors prefer arbitration as a means to resolve any disputes arising from their investment activities, and arbitration will be discussed further later.

By virtue of Article 9, the BG is prohibited from entertaining issues pertaining to acts of state, or appeals from individuals against decisions of the courts or judicial bodies in matters within their jurisdiction.<sup>43</sup> The reason for this prohibition is that all these activities, particularly those related to natural resources carried out by public entities; enjoy sovereign immunity because the purpose behind such activities is in the public interest. In addition to

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<sup>41</sup> See generally, Trumbull, C., *Islamic Arbitration: A New Path for Interpreting Islamic Legal Contracts*, Vand. L. Rev., Vol. 59, Issue 2, (Mar. 2006), pp. 609-647.

<sup>42</sup> Article 8, paragraph 1 of the Statutes of the BG, for more discussion see chapter 1 supra.

<sup>43</sup> Royal Decree M/51 of 1983.

the BGs adjudicative jurisdiction, it was in charge of enforcing judgements rendered in states parties to the Arab League agreement regarding the execution of judgements.<sup>44</sup>

Since the transfer of jurisdiction of the Committee on Commercial Disputes<sup>45</sup> to the BG in 1987, its jurisdiction has been broadly expanded to cover all commercial disputes within the territorial domain of Saudi Arabia. This, of course, is of crucial importance to foreign investments in Saudi Arabia. The BG became competent to hear appeals filed by a foreign investor against the decision of the Foreign Capital Investment Committee. It is also responsible for the withdrawal of investment licences or the deprivation of investment of any investment incentives and is also the competent forum for litigating all other disputes arising out of, or in connection with, foreign investments.<sup>46</sup>

### ***3.3 International Commercial Arbitration (ICA)***

In this section the focus will be on the advantages and developments of international commercial arbitration (ICA). The Saudi government's attitude towards ICA before and after the ARAMCO Award will be dealt with.<sup>47</sup> Although already mentioned earlier, it is worth summarising common reasons<sup>48</sup> why the settlement of foreign investment disputes by litigation has always been undesirable to foreign investors. These reasons are:

- Foreign investors lack confidence in the impartiality of national courts of the host countries.
- The long time taken by the court to render a final decision.

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<sup>44</sup> Convention of the Arab League on the Enforcement of Judgements and Arbitral Awards was established on 14/09/1952.

<sup>45</sup> See chapter 1 for more discussion on this committee, *supra*.

<sup>46</sup> Al-Samman, *supra* note 17, p. 226

<sup>47</sup> For more discussion on the ARAMCO Award see chapter 4 *infra*.

<sup>48</sup> See Lew, M., *supra* note 5, pp. 17-19. See also Fox, W., *Supra* note 4, pp. 283-285

- Court proceedings are for most part public and subject to scrutiny. This conflicts with the desire of foreign investors to keep their disputes confidential.
- Settlement of foreign investment disputes by litigation is usually too expensive and court judgements have less international impact.<sup>49</sup>

### 3.3.1 The Development of International Commercial Arbitration (ICA)

As one of the main aims of this thesis is to examine dispute settlement mechanisms in Saudi Arabia from the perspective of their role in the legal framework affecting foreign investment, this section will only discuss briefly the main elements of ICA. Suffice it to say it is a private, effective, widely used and now generally accepted method of resolving international business disputes around the world, including those relating to foreign investment.<sup>50</sup>

Arbitration, especially in international trade disputes, is not merely an attempt at conciliation or restoration of relations. It is in fact, a fundamental method used to settle disputes and national courts are generally referred to in these disputes as a secondary method.<sup>51</sup> The position of international arbitration is not the same as that of national

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<sup>49</sup> While there are only limited arrangements in force for the international recognition and enforcement of judgments in commercial cases, the position is the opposite in the case of international commercial arbitration. This is governed by the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, which has been ratified by no fewer than 137 states. Under that Convention, a party receiving an arbitral award in one state is entitled, on complying with the requisite formalities, to have the award recognised and enforced in another state, provided that state is a party to the Convention. Such recognition and enforcement may be refused only in the restricted circumstances laid down in Article V. See Goode, R., *Litigation or Arbitration? The Influence of the Dispute Resolution Procedure on Substantive Rights*, available at: <http://www.cisg.law.pace.edu/cisg/biblio/goode.html#23> last accessed 08/12/2008.

<sup>50</sup> Redfern, A., & M. Hunter, *Law and Practice of International Commercial Arbitration*, Sweet & Maxwell, (1999), p. 1-12.

<sup>51</sup> El-Ahdap, A., *Arbitration Rules in the International Trade*, *The Lawyers Journal*, (April, 1993), p. 245.

arbitration, perhaps the main difference being that each system of arbitration is concerned with different types of disputes.<sup>52</sup>

A foreign investor, justifiably in many instances, will not have confidence in the impartiality of the local tribunals and courts in settling any disputes that may arise between him and the host state. Arbitration, in a neutral state before a neutral tribunal, has traditionally been seen as the best method of securing impartial justice. Where an international treaty backs up the investor by creating an obligation on the host state to submit to any arbitral proceeding brought against it, a major step could be said to have been taken towards investment protection.<sup>53</sup>

For arbitration to be an effective form of international dispute settlement, agreement between states is needed on the manner in which each state's legal system will accept foreign arbitration.<sup>54</sup> Therefore, a number of international accords and protocols have been prepared regarding international commercial arbitration.<sup>55</sup>

### ***3.4 The Saudi Government's Attitude towards (ICA).***

In order to fully examine the Saudi attitude towards international commercial arbitration, we will focus on the 1958 ARAMCO award. Generally, both before and during the dispute between ARAMCO and the government of Saudi Arabia, the Saudi government

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<sup>52</sup> The term 'international' is used to distinguish the difference between arbitrations which are purely domestic and those which in some way transcend national boundaries and therefore are international or in the terminology adopted by judge Jessup, 'transnational'.

<sup>53</sup> Sornarajah, M., *supra* note 21, p. 266.

<sup>54</sup> Collier, J., & V., Lowe, *The Settlement of Disputes in International Law*, Oxford University Press, (2000). p. 46.

<sup>55</sup> Redfern describes an agreement by the parties to submit to arbitration any disputes or differences between them as 'the foundation stone of modern international commercial arbitration'. If there is to be a valid arbitration, there must be first a valid agreement to arbitrate which is recognised both by national laws and international treaties. *Supra* note 55, p. 21.

had confidence in the system of international commercial arbitration. That is evident both from the government's acceptance of the arbitration clause in the concession agreement and again from the fact that the government was the party that took the initiative in suggesting the referral of the matter to arbitration.<sup>56</sup> It was likewise the first to appoint its arbitrator. However, following the government's defeat in the ARAMCO arbitration, the attitude towards ICA changed dramatically.<sup>57</sup>

On April 1954, Aristotle Onassis signed an agreement with the Saudi government, according to which Onassis was permitted to form a Saudi local company called Satco (Saudi Arabian Tanker Company). Satco was granted a quasi-monopoly for all transport of crude oil from the Kingdom at rates which were very favourable and the agreement was ratified by Royal Decree No. 5737 of 1954. ARAMCO refused to comply with the Onassis agreement, asserting that according to the concession agreement of 1933 between it and the Saudi government, it had the absolute right to choose the means of transport of crude oil. ARAMCO and the Saudi government agreed to submit their dispute to arbitration by *Von Sauser-Hall*.<sup>58</sup> In the award, which dealt with many issues of international public and private law that are undoubtedly of interest to international scholars, the arbitrator held that the theory of vested rights is an essential principle of the national and international law of

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<sup>56</sup> The Saudi government suggested a solution to the disputes by arbitration on October 26, 1954. The proposal to refer the dispute to arbitration was based on the provisions of Article 3 of the ARAMCO Concession Agreement of 1933, which provided for the use of arbitration.

<sup>57</sup> El-Ahdab stated that most of the arbitral awards in Anglo-Arab cases have favoured the European investors against the host state; the applicable law was purportedly the law of the host state, but the law applied in each case was that of a western country. The Arab jurists appointed in the cases resided in the West and did not have any association with the host country and the domination of Western arbitration was apparent in all investment cases. El-Ahdab, A., *Is there an Arbitration Crisis in the Arab World?* in *Strengthening Relations with Arab and Islamic Countries through International Law*, Kluwer Law International, (2001), p. 309.

<sup>58</sup> The arbitral tribunal was held in Geneva in 1958. Professor *Sauser-Hall* observed that: The law in force in Saudi Arabia should be applied to the content of the concession because this state is a party to the agreement, as grantor, and because it is generally admitted, in private international law, that a sovereign state is presumed, unless the contrary is proved, to have subjected its undertakings to its own legal system. This principle was mentioned by the Permanent Court of International Justice in its judgement in the *Serbian Loans Case*. Sornarajah, M., *supra* note 21, p. 418. See also Sayen, G., *Arbitration, Conciliation, and the Islamic Legal Tradition in Saudi Arabia*, 24 *U. PA. J. Int'l Econ. L.*, (2003), pp. 909-910.

“civilised countries”. He further stated that the Saudi government could not take away rights granted to one party in a previous contract by granting them to another party in a later contract. This arbitral decision upset the Saudi government, as it took the view that the decision failed to recognise the shift in public policy towards ownership and control over what was now seen as a sovereign national resource, and subsequently Resolution No. 58 was enacted in 1963.<sup>59</sup>

### **3.4.1 The Influence of the ARAMCO Award on Saudi Attitude towards Arbitration.**

The Saudi government viewed the ARAMCO Award as a great disappointment, not simply because it was made in favour of ARAMCO, but because of the exclusion of Saudi law and the way in which it was excluded, which may be understood as an exclusion of the Shari’a rules, even though it was the applicable law according to the parties’ Arbitration Agreement.<sup>60</sup> Arbitrators in these arbitral tribunals paid no consideration to Islamic values, they further lacked basic knowledge about Shari’a and its fundamental principles applicable to commercial transactions.<sup>61</sup> As a result of the ARAMCO arbitration award, the Saudi government regarded international arbitration as a device used to favour only the interest of Western companies. The direct reaction to the ARAMCO arbitration award as well as other arbitral awards involving some Arab countries and foreign oil companies working within

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<sup>59</sup> ARAMCO v Saudi Arabia August 23, 1958, 27 *International Law Report* (1963), p.117. for more details see Al-Shareef, N., *Enforcement of Foreign Arbitral Awards in Saudi Arabia: Ground for Refusal Under Article (V) of The New York Convention of 1958*, PhD Thesis, CEPMLP, University of Dundee, (2000), pp. 85-88, and Al-Samman, Y., *supra* note 17, pp. 257-258.

<sup>60</sup> Al-Eshiw, M., *Arbitration Regulations in the Gulf Co-Operation Council (GCC) States: A Comparative Study*, PhD Thesis, Exeter: University of Exeter, (1997), p. 232.

<sup>61</sup> Al-Samman Y., *supra* note 17, p. 240.

their territories<sup>62</sup> was that the Saudi Council of Ministers issued Decision No. 58, on June 25, 1963.

Decision No. 58 prohibited the referral of cases to arbitration if the Saudi government or a governmental agency was a party to the arbitration, and the other party was a native person or a private company or establishment. Decision 58 did not distinguish between national and international arbitration. However, it was not an absolute rejection of arbitration, since arbitration was still allowed in two situations: concession contracts of great interest to the state<sup>63</sup>; and technical disputes.<sup>64</sup> Under this Resolution all disputes to which a governmental agency is a party are referred to the BG.<sup>65</sup>

The next major development in consequence of the ARAMCO Award was the establishment of a Ministry of Commerce Circular (an internal circular directed to all branches of the Ministry and all commercial register offices in Riyadh), dated 31/01/1981 under the heading "Agreements Establishing Companies must not contain provisions allowing arbitration to be conducted outside the Kingdom".<sup>66</sup> Consequently, according to this Circular, reference could be made to domestic Saudi arbitration in the articles of association of a joint venture company which is formed by foreign and private local partners for the purpose of carrying out investment operations in the country.

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<sup>62</sup> Such as *Petroleum Development Ltd. V. Sheikh of Abu Dhabi*, [September 1951], *18 International Law Report 1951*, p.144. and *Qatar V. International Marine Oil Company Ltd*, [June 1953], *20 International Law Report 1953*, p. 534.

<sup>63</sup> The state alone determining what constituted such vital interests or a government contract was a technical in nature.

<sup>64</sup> El-Ahdab, A., *Arbitration with the Arab Countries*, Kluwer Law International, (1990), pp. 602-603.

<sup>65</sup> For more details on the Board of Grievances see chapter 1 supra.

<sup>66</sup> After revision of this issue, the Legal Department of the Ministry issued memorandum number 174.k dated 22/02/1399, which was approved by the Minister by letter dated 23/02/1399, stating that arbitration clauses contained in agreements establishing Saudi companies which allow arbitration to be conducted abroad are null and void.

### 3.4.2 The Shift of Saudi's Attitude towards ICA

Saudi Arabia possessed a great economic asset embodied in the form of its oil wealth, and has actively sought a prominent position in international trade. For this reason it was unwise for the Saudi government to continue the rejection of arbitration as a result of the ARAMCO award, since acceptance of referral to arbitration had become an important feature of such international trade. Therefore, as a result of the economic boom<sup>67</sup> of the 1970s and early 1980s which necessitated the involvement of foreign capital and international oil companies in the Saudi economy, the Saudi government sought to soften its attitude towards arbitration of disputes involving it or any of its bodies.<sup>68</sup>

In fact, Saudi Arabia had not only attempted to understand ICA, but also to practice it. The result is that the negative attitude toward arbitration resulting from the outcome of the ARAMCO award has fundamentally changed in favour of arbitration. This is evidenced not only by the fact that Saudi Arabia has now accepted arbitration clauses in its international contracts, but also by having become a party to important international conventions relating to arbitration.<sup>69</sup>

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<sup>67</sup> In the early 1970s, the economic situation changed dramatically. Oil exports expanded substantially, royalty payments and taxes on foreign oil companies increased sharply. Oil-exporting governments, including the kingdom, began setting and raising oil export prices. Saudi Arabia's revenues per barrel of oil (averaged from total production and oil revenues) quadrupled from US\$0.22 in 1948 to US\$0.89 in 1970. By 1973, the price had reached US\$1.56 and soared to US\$10 and higher in 1974 following the Arab oil embargo introduced to pressure Western supporters of Israel during the October 1973 War. In 1982 the average export price per barrel of oil reached well above US\$30. Between 1973 and 1980, government oil revenues jumped from US\$4.3 billion to US\$101.8 billion. At last these higher oil revenues gave Saudi officials the means to make major structural changes in the economy. See Country Studies, *Saudi Arabia: Economic Policy Making*, available at: <http://countrystudies.us/saudi-arabia/36.htm>.

<sup>68</sup> This policy was later reflected in Art. 3 of the Arbitration Regulatory which regulates the restrictions on the use of arbitration as a method for dispute settlement involving Saudi government bodies. Art. 3 provides that "government agencies are not allowed to resort to arbitration for settlement of their disputes with third parties *except* after having obtained the consent of the President of the Council of Ministers".

<sup>69</sup> For more details see chapter 2 on Stability of Investment Agreements. See also the forgoing discussion for example of these conventions and agreements such as NY Convention on enforcement of arbitral awards.

The above discussion leads to one important question, since Saudi Arabia has not only practiced ICA but also has accepted arbitration clauses in its international contracts, why is 'Shari'a' considered to be one of the legal problems associated with the foreign investments in Saudi Arabia?

In fact, the problems can be limited to two main legal problems of international commercial arbitration which arise in cases:

- When an arbitral award provides for the payment of interest (*Riba*) and/or an arbitration clause contains an element of uncertainty (*Gharar*) violating the mandatory rules of Shari'a.<sup>70</sup>
- When an arbitral award contradicts Council of Ministers Resolution N. 58.

In respect of the first problem, when the award provides for payment of interest, the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (NYC) subjects these types of arbitral awards to the domestic law of the country where enforcement is sought. Interest is enforced under NYC if it is customary international practice and recognised by all states. The Shari'a principle of severance allows for the principal amount to be enforced in Saudi Arabia. However, a foreign arbitral award providing for the payment of interest would not be enforced by the competent court (BG), since scholars see this as an infringement of Shari'a law and the public policy that flows from it and as

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<sup>70</sup> An example of *Gharar* judgement is in *NGCC v. Lucent Technologies International, Inc.* In such a case, when a party files a suit in the United States, the law of the forum state governs the interpretation of the contract. Saudi law, and therefore Islamic law, governs the obligations of the parties to the contract. NGCC revolved around a contractual dispute relating to the installation of certain payphone and emergency phone stations in Saudi Arabia. NGCC sued Lucent Technologies for failure to perform, and sought damages not only for the amounts injured, but for lost profits, future loss, and lost opportunity. The Court addressing *Gharar* said: "Future activity is deemed *Gharar* because it is uncertain to anyone except for God. Saudi Arabian courts will not enforce the sale of anything uncertain or unknown. The object of a contract must be certain and defined and in existence". *National Group for Communications and Computers, Ltd. v. Lucent Technologies*, 331 F. Supp. 2d 290 (D.N.J. 2004). Roark, M., *Reading Mohammed in Charleston: Assessing the U.S. Courts Approach to the Convergence of Law, Religion and Commerce*, (February 21, 2007). Available at: <http://law.bepress.com/cgi/viewcontent.cgi?article=4862&context=expresso>. See also Trumbull, C., supra note 46, pp. 635-636.

contradictory to its morality.<sup>71</sup> Arbitration clauses that contains element of uncertainty are dealt with by art. 1 of the Saudi Arbitration Regulatory of 1983 discussed earlier.

The second problem is when the arbitral award contradicts Council of Ministers Resolution No. 58. In this respect Article 3 of the Arbitration Regulations of Saudi Arabia and the rules in Sect. 8 the Implementation Rules of the Saudi Arabian Arbitration Regulations incorporate the prohibition of government entities into arbitration provided in Resolution No. 58 but enlarges the exception provided therein. It provides that:

*“Government agencies may not resort to arbitration to settle their disputes with third parties except after approval of the President of the Council of Ministers. However, these provisions may be amended by resolution of the Council of Ministers”.*<sup>72</sup>

It is also considered that Sect. 8, by referring to disputes “where a government authority is a party with other”, may be intended to permit arbitration where the Saudi government might be the only government sector in a multiparty arbitration. These provisions may also be indicative of the change in the attitude of the Saudi government towards international arbitration. It should also be noted that Council of Ministers Resolution No. 164 Of 04/04.1983, by which the Arbitration Regulations were approved, refers specifically to Council of Ministers Resolution No. 58 without abolishing it.<sup>73</sup>

It could be argued that since arbitration involving Saudi governmental entities must be conducted in Saudi Arabia under Saudi law, that is still a problem. This is still the case even though such arbitrations may be governed by rules of procedure established by international bodies such as the International Chamber of Commerce (ICC) or the United Nations

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<sup>71</sup> Al-Shareef, N., supra note 64, p. 200.

<sup>72</sup> A., Lerrick & Q., Mian., supra note 35, p. 154.

<sup>73</sup> Ibid, pp. 10-11

Commission for International Trade Law (UNCITRAL).<sup>74</sup> As a matter of fact, this may no longer be such a major problem. *El-Ahdab's*<sup>75</sup> description of the 1983 Saudi Arbitration Regulatory and the rules promulgated in 1985 under the Regulatory suggest that the arbitration procedures in Saudi Arabia under this new act are not much different, in procedural sense, from those of international bodies. The rules provide for notice of the arbitration, the convening of an arbitral tribunal, the conducting of a hearing in which evidence and argument is received, the construction of the hearing record and the issuing of an award upon close of record. At the same time, there have been a number of construction contract arbitrations carried out in Saudi Arabia using the UNCITRAL rules.<sup>76</sup> Foreign investors have usually preferred settling their disputes through arbitration by inserting a foreign arbitration clause in their contracts. However, such clauses, as previously mentioned, are not allowed in a governmental contract without a decision by the Saudi Council of Ministers.<sup>77</sup>

### **3.4.3 The Suitability of ICA for security for both Foreign Investor and the Government of Saudi Arabia.**

To securely achieve the objectives of foreign investors, the international aspects of such agreements dictate that any disputes or differences between them and host countries should be referred to independent arbitration by an international tribunal.<sup>78</sup> Foreign investors view international commercial arbitration as a safe method that lubricates the wheels of trade and encourages major investors to conclude more contracts with different host countries, regardless of their religion or culture. In respect of Saudi Arabia, a balance has to be struck

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<sup>74</sup> The UNCITRAL Rules were adopted by the UN General Assembly Resolution No. 31/98 dated 05/12/1976.

<sup>75</sup> El-Ahdab, A., supra note 64, p. 430.

<sup>76</sup> Fox, W., supra note 4, p. 370.

<sup>77</sup> Article 3 of Arbitration Regulatory, available in Saudi Embassy in Washington website: [http://www.saudiembassy.net/about/country-information/laws/Arbitration\\_Law.aspx](http://www.saudiembassy.net/about/country-information/laws/Arbitration_Law.aspx).

<sup>78</sup> Ernest, K., *Legal Aspects of Business in Saudi Arabia*, London: Graham and. Trotman, (1979), p.86.

between the national objective of increasing national revenues, and requirements to encourage business activities on the part of foreign investors.<sup>79</sup>

These objectives can be achieved by the acceptance of host countries to refer any disputes that may arise out of foreign investment agreement to an international tribunal. As mentioned earlier, since the 1970s economic boom in Saudi Arabia, and as part of the need for reform of financial instruments in order to advance the natural resources industry, international arbitration has become the accepted method for the resolution of disputes arising out of investment agreements. Therefore, on 19 April 1995 Saudi Arabia acceded<sup>80</sup> to the 1958 New York Convention for the Recognition and Enforcement of Foreign Arbitral Award (NYC) and has become a party to many other international treaties pertaining to international commercial arbitration.<sup>81</sup>

### ***3.5 The Islamic Law (Shari'a) Attitude toward ICA.***

In this section, focus will be placed on whether or not Shari'a, which is the main source of Saudi Law, is really in fact adverse to the enactment of legislation for international arbitration. As mentioned earlier in this chapter, Shari'a recognises and confirms the pre-Islamic method of settling disputes with some modifications. The validity of arbitration is recognised in the two essential sources – *Quran* and *Sunnah*<sup>82</sup> - of Shari'a. As to arbitration, the Holy *Quran* says:

*“Verily, the Believers are but brothers. Therefore set matters right between your brethren and be conscious of ALLAH in order that you may obtain mercy”.*<sup>83</sup>

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<sup>79</sup> Leuch, H., *Petroleum Exploration/Production Agreements & Taxation*, Deventer: Kluwer Law, (2001), p. 2.

<sup>80</sup> See discussion in chapter 5, *infra*.

<sup>81</sup> Barrows, G., *World Petroleum Arrangements*, New York: The Barrows Company Inc, (1991), p.219.

<sup>82</sup> For more discussion see chapter 1, *supra*.

<sup>83</sup> *Quran*. 49:10.

The prophet, in his time used to resolve cases on an *ad-hoc* basis<sup>84</sup> and there was no formal distinction in the first period of Islam between conciliator, arbitrators and judges.<sup>85</sup> The Prophet, explaining the merit of such mediation and the danger of conflict and hostility, said,

*“Shall I not inform you of something far better than fasting, charity and prayers? On receiving reply, ‘Yes’, he said: It is putting things right between people, for to incite people to dispute is like a razor. And I do not mean that it shaves off the hair but that it shears the religion”.*<sup>86</sup>

In brief, arbitration is recognised by Shari’a as a method for settlement of disputes. It has been provided for and recognised by the four sources of Shari’a; the *Quran* and the *Sunnah* (the acts and sayings of the Prophet Mohammed), *Ijma* (consensus of opinion) and *Quiyas* (reasoning by analogy).<sup>87</sup> Arbitration has also been used as a means of resolving disputes by the companions of the Prophet i.e., the arbitration which occurred in 657 A.D between the fourth Caliph *Ali Ibn Abi Talib* and the governor of Al-Sham Province *Muawaiya Ibn Abi Sufian*.<sup>88</sup> The permissibility of arbitration is unquestioned by the main four Islamic Schools; *Maliki*, *Hanbali*, *Hanafi* and *Shafi*’. However, the field of settlement of disputes is one of the richest areas of different opinions across the different School of Islamic Law.<sup>89</sup>

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<sup>84</sup> Where the parties themselves arrange in their arbitration agreement for the appointment of the arbitrators and the arbitral procedure

<sup>85</sup> Angell, N., & G., Feulner, *Arbitration of Disputes in the U.A.E, Arab Comparative & Commercial Law*, Vol. I., (1987) p. 243.

<sup>86</sup> Reported by *Al-Tirmidi* and others, cited by Al-Qaradawi, Y., *The Lawful & Prohibited in Islam*, 15<sup>th</sup> ed., the Islamic Office for Pub. & Dist., (1994), p. 291, (in Arabic).

<sup>87</sup> For more discussion on these sources of Shari’a see chapter 1 supra.

<sup>88</sup> El-Ahdab, A., Supra note 69, p. 602.

<sup>89</sup> Zeyad, Alqurashi., supra note 9.

### 3.5.1 Arbitration under the Four Islamic Schools

As has been stated above, arbitration is recognised by all sources of Shari'a but has received close analysis in the doctrinal writings of the four Islamic Schools. Nevertheless, it is possible to discern what each school provides in relation to arbitration.

The *Hanafi* School emphasises the contractual nature of arbitration, confirmed by the Ottoman *Majallah* (the civil law of the Ottoman Empire which was derived from the *Hanafi* doctrine applied in some of Arab countries).<sup>90</sup> The school holds that arbitration is legally closed to agencies, which means that an arbitrator acts as an agent on behalf of a disputant who had appointed him. They stress a close connection between arbitration and conciliation. To the *Hanafi* School an arbitral award is closer to conciliation than to a court judgement, although it is of lesser force than a court judgement. Nevertheless, under this school the disputing party cannot be relieved from being obligated to be bound by the award, because the agreement to resort to arbitration binds the parties like any other contract.

According to the *Shafi'i* School, arbitration is a legal practice, whether there is a judge in the place where the dispute has arisen or not.<sup>91</sup> However, under this school, the position of arbitrators is inferior to that of judges since the award of arbitrators is liable to be revoked up to the time of the issuance of the award.

According to the *Hanbali* School, an arbitral award decided by the arbitrator has the same binding nature as a court's judgement and an arbitrator must have the same qualification of a judge.<sup>92</sup>

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<sup>90</sup> El-Ahdab, A., *supra* note 13, pp. 23-24.

<sup>91</sup> Saleh, S., *Commercial Arbitration in Arab Middle East, Study in Shari'a and Statute Law*, Graham & Trotman, (1984), p. 22.

<sup>92</sup> Iben Qudamah, *Al-Moghni*, Riyadh: Dar Ehea Atturath Al-Arabi, Vol. 9, (1985), p. 483.

The *Maliki* School holds that one of the disputing parties can be chosen as an arbitrator by the other disputing party. The *Malikies* stress that an arbitrator cannot be revoked after the commencement of the arbitration proceedings.<sup>93</sup>

Shari'a influences all aspects of Arab law, including arbitration, even though most Arab States have now passed codified arbitration acts. These acts were, besides Shari'a, also influenced by other sources such as European legislation. Arab legislation can thus be classified into five groups, according to the influences to which it was exposed.<sup>94</sup>

- Laws influenced by arbitration under Shari'a: Saudi Arabia.
- Laws also influenced by the arbitration system of French origin: Libya, Morocco, Syria (these were influenced by the old French arbitration system) and Algeria and Lebanon (influenced by the modern French system).
- Laws also influenced by the arbitration system of (old) English origin: Iraq, Jordan (a new law inspired by the UNCITRAL model Law is pending in Jordan), and Sudan.
- Laws inspired by the UNCITRAL model Law, with or without modifications: Bahrain, Egypt, Oman and Tunisia.
- Laws which were not inspired by any particular source and are only inspired by the New York Convention: Kuwait, Qatar, United Arab Emirates and Yemen.

Today, there is evidence that arbitration is coming back into favour in Arab countries, and that these countries once again trust arbitration. Most Arab countries have now issued modern arbitration acts and numerous Arab countries have acceded to the New York Convention of 1958 and/or to the Washington Convention of 1965 (the ICSID).<sup>95</sup> From analysis, it can be stated that Islamic Law has never had any objection to the enactment of

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<sup>93</sup> Saleh, S., *supra* note 95, p. 21.

<sup>94</sup> El-Ahdab, A., *supra* note 13, p. 1.

<sup>95</sup> *Ibid.*

legislation for ICA. On the contrary, Islamic law in theory and practice has indeed historically encouraged mutual arbitral settlement of disputes. Although the ARAMCO Award paid no attention to Shari'a values and its basic principles applicable to commercial contracts, Shari'a still recognises ICA as a method of dispute resolution despite its negative attitude towards the ARAMCO Award itself.

### ***3.6 The National Arbitration Law in Saudi Arabia.***

Foreign investors want specific assurances that potential disputes will be resolved impartially, promptly and efficiently. They may prefer to remove their disputes from the jurisdiction of national courts of the host state and to have them settled by arbitration.<sup>96</sup> Therefore, arbitration has become the most effective alternative mechanism for disputes settlement. After all, commercial arbitration has a long history in Arab countries, it predates the existence of organised system of states courts.<sup>97</sup>

One of the main contributing factors for arbitration to be increasingly used in Saudi Arabia as a mean of settlement of commercial disputes on both national and international scale was the economic boom of the 1970s. For these purposes, Saudi Arabia enacted Arbitration Regulations and Implementation Rules by the issuance of Royal Decree M/46.<sup>98</sup> As a result, the arbitration of disputes is no longer uncommon in the kingdom. However, for arbitration to be recognised as an alternative form of disputes settlement, co-existing with the courts, it was necessary that national laws support it.<sup>99</sup> Four significant features of the process

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<sup>96</sup> Al-Samman, *supra* note 17, p. 248.

<sup>97</sup> Collier, J., & V. Lowe, *supra* note 59, p. 45.

<sup>98</sup> This is the Arbitration Code. See the Royal Decree No. M/46 of 25/04/1983. The Arbitration Regulations were published in *Umm Al-Qura*, the official newspaper, on June 3, 1983 and became effective 30 days from that date. The 1985 Arbitration Regulations Implementation Rules, Council of Ministers Resolution No. 7/2021/M on 27/05/1985.

<sup>99</sup> Collier, J., & V. Lowe, *supra* note 59, p. 46.

of international commercial arbitration are briefly mentioned now, although they are the subject of more detailed comments later on. These features<sup>100</sup> are:

- Agreement to arbitrate.
- Choice of arbitrators.
- Decision of the arbitral award.
- Enforcement of the award.

It will now be shown how Saudi laws incorporate these elements.

### 3.6.1 The Arbitration Regulatory of 1983

During the last four decades, arbitration has become of increasing significance in Saudi Arabia as a means of resolving business disputes. It was within this period that the first Arbitration Regulations were adopted in 1983.<sup>101</sup> Like all Saudi laws, the Act and the rules are inspired by Shari'a, which is marked by openness towards the world. The Act draws a distinction between Arbitration Clauses (i.e. agreement referring future disputes to arbitration) and Arbitration Agreements (i.e., agreement referring to an already existing dispute to arbitration) and holds that the former is as valid and binding as the latter.

Before the enactment of Decree M/46, which came into force on July 3, 1983 (30 days after its publication, in English, in the Saudi Official Gazette No. 2963, on June 3, 1983), Shari'a, articles 493-7 of Regulations No. 32 of 15 Muharram, 1350 H, (1971) relating to the statutes of the Saudi Commercial Board ("SRCB arbitration" or "arbitration under SRCB"), and more recently the Chambers' Rules of Implementation, were major sources of Arbitration

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<sup>100</sup> Redfern, A., & M., Hunter, supra note 55, p. 4.

<sup>101</sup> Some important Saudi Government laws are *Constitution or Basic Law of Government*, (1993), *The Consultative Council Establishment Act*, (1993), *The Consultative Council Statute*, (1993), *The Council of Ministers Statute*, (1993) and *The Regional Authorities Establishment Act*, (1993). The text of these laws can be viewed at [http://www.servat.unibe.ch/law/icl/sa\\_indx.html](http://www.servat.unibe.ch/law/icl/sa_indx.html) last visited on 07/03/2008.

Law.<sup>102</sup> The recent enactment of Decree M/46 reduces Shari'a influences as well as fulfilling contractual practice. The Decree expressly repeals the provisions relating to arbitration in Regulations No. 32 (SRCB arbitration) and has enacted what is meant to be a comprehensive piece of legislation regulating arbitration. The regulation Code of 25 April 1983 contains 25 Articles and the Implementation Rules of 27 May 1985 contains 48 sections.<sup>103</sup>

It should be mentioned that in cases where conciliation is not allowed, neither arbitration regulation nor implementation rules are permitted. Therefore, Article 2 of the Arbitration Regulations provides that arbitration shall not be permitted in cases where conciliation is not allowed. This vague definition is clarified by the Implementation Rules which indicate that arbitration is not permissible in criminal matters, which can be interpreted as personal status matters and matters pertaining to public order.

### 3.6.2 Arbitration Agreement and Arbitration Clauses

The four Islamic Schools consider a formal arbitration agreement (submission agreement) whereby parties may agree to submit an existing dispute to arbitration, as the principal basis for conferring upon arbitrators the power to issue binding decisions.<sup>104</sup> However, their doctrinal writings are silent about arbitration clauses (i.e., the agreement referring future disputes to arbitration).<sup>105</sup> Before the enactment of Decree M/46, the effect of arbitration clauses and arbitration agreements made in Saudi Arabia and subject to Saudi Arbitration Law might have been weak. This was as a result of the absence in Saudi domestic

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<sup>102</sup> Saleh, S., *supra* note 95, p. 290.

<sup>103</sup> *Ibid*, p. 292.

<sup>104</sup> Abul-Enien, M., *Liberal Trends in Islamic Law on Peaceful Settlement of Disputes*, 2 *J Arab Arb.* (2000) p. 5.

<sup>105</sup> Saleh, S., *Commercial Arbitration in the Arab Middle East – Shari'a, Lebanon Syria and Egypt*, 2<sup>nd</sup> ed., Oxford: Hart publishing, (2006), p. 16 and 59. The author stated as one of main elements of Arbitration in Shari'a, "{the existence of} a dispute". He also said that: "the contemporary Western practice *ex contractu* agreeing that a future dispute is not determined by reference to arbitration (i.e. an arbitration clause) is not even eluded in Shari'a texts".

law of the concept of arbitration clauses and revocability of the appointment of arbitrators.<sup>106</sup> According to certain commentators<sup>107</sup>, the new law acknowledges that arbitration clauses are binding on parties and recognises arbitration stemming from such clauses without the necessity to enter into a new arbitration agreement (which would then have to be confirmed by the authority originally having jurisdiction). In other words, arguably, there is no official acknowledgement of the validity and binding nature of arbitral clauses in contracts.

Moreover, Article 1 of the Arbitration Code expressly recognises the validity both of the submission agreement and the arbitration clause.<sup>108</sup> This constitutes a significant improvement with respect to the previous Commercial Court Code of 1931, under which the arbitration clause was unenforceable. Therefore, the recognition of the validity of the arbitration clause has removed the uncertainty and made such clauses valid and binding.<sup>109</sup>

Article 1 of the Arbitration Code provides:

*"It may be agreed to refer to arbitration an existing specified dispute; likewise, it may be agreed in advance to refer to arbitration any dispute which may arise as a result of the implementation of a specified contract".*

Therefore, Article 1 of the regulations validates arbitration generally as a means of dispute resolution and does not limit arbitration to commercial matters.<sup>110</sup> According to Article 5, the submission agreement (called the 'arbitration agreement') must be signed by the parties or their authorised attorneys, and by the arbitrators, and must state the details of

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<sup>106</sup> Saleh, S., *supra* note 95, p. 321.

<sup>107</sup> El-Ahdab, A., *Arbitration with the Arab Countries*, 2<sup>nd</sup> ed., Kluwer Law International, (1998), p. 569, cited by Shoult, A., *Doing Business with Saudi Arabia*, 3<sup>rd</sup> ed., Global Market Briefings, (2006), p. 106.

<sup>108</sup> Lerrick, A., & Q., Mian, *supra* note 35, p. 151.

<sup>109</sup> Karam, N., *Business Laws of Saudi Arabia*, Vol. 3, Kluwer Academic Publishers, (1988), p. 342.

<sup>110</sup> So disputes relating to non-commercial property rights, civil debts or financial transactions and the like may be resolved by arbitration

the dispute, the names of the arbitrators and their agreement to hear the dispute.<sup>111</sup> Article 5 also requires that the submission agreement be filed with the Authority originally competent to hear the dispute, together with copies of the documents relating to the disputes. In this particular matter, the most likely Authority will be the Board of Grievances. However, it could be argued that the Regulation is not entirely clear as to whether the Authority originally competent to hear the dispute must also approve the arbitration clause. Article 6 provides that:

*“The Authority originally competent to hear the dispute shall record the application for arbitration submitted to it, and make a decision approving the arbitration instrument”.*

Article 6 of the Arbitration Regulations requires the Authority originally competent to hear the dispute to approve only the arbitration agreement with no mention or indication to the arbitration clause. Therefore, the focal question in this respect is whether arbitration clauses are valid under Shari’a. To analyse this, it could be argued that, despite the silence of the regulation on the arbitration clauses, it does not mean they are prohibited. It could have been ignored due to the fact that they were not in use in the past. The validity of the arbitration clause depends very much on its necessity to the commercial agreement. However, there is a division of opinion amongst Muslim scholars regarding the validity of arbitration clauses under Islamic law. One opinion argues that the validity of arbitration clauses could be challenged on the ground that they provide for the submission of non-existing disputes to arbitration, and obviously this involved uncertainty which is undoubtedly forbidden by Shari’a.<sup>112</sup> Similarly, others view that the silence of Islamic schools on the issue of arbitration

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<sup>111</sup> Nancy, T., supra note 25, p. 6.

<sup>112</sup> For more discussion of uncertainty (*Gharar*) see chapter 2 supra.

clauses does not mean they are prohibited by Shari'a, but only because past prevailing conditions did not require their use.<sup>113</sup> *Al-Sanhury* concludes that:

*"The specific contracts mentioned by scholars are those which were known in their time. If the present civilisation has given rise to new contracts which, contain clauses deemed legal by Figh (Islamic Jurisprudence), these new contracts must be considered as legal"*<sup>114</sup>.

In respect of whether the arbitration clause is prohibited by Shari'a, a notable academic in Arab law Prof. *Ballantyne*<sup>115</sup> took the view that if the embargo upon the submission of a future dispute goes against a basic provision of Shari'a, then why was it permitted in the new Saudi regulation? He said:

*"Let us, recall that the old Constitution of the Hijaz"*<sup>116</sup>*still provides Shari'a as the only source of legislation and indeed, this is the invariable practice in Saudi Arabia. So we must conclude that this dictate of Shari'a was not regarded as presenting a difficulty to the enactment of modern international arbitration legislation, the position must be examined to see whether this is in fact the case"*.

Accordingly, it could be stated that arbitration clauses are valid if:

- They are necessary to the contract, i.e., the delivery of item sold;
- They are appropriate to the contract, i.e., a bond to guarantee payment;

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<sup>113</sup> Arbitration clauses were ignored by early Muslim scholars because the commercial conditions at that time did not require the use of such clauses. It has to be borne in mind that the answers given by Islamic Law to arbitration problems have been given before the commercial and economic evolution had reached today's stage. However, they are not unalterable and do not constitute an exception to the universal rule that *'the law must change over time'*. Indeed, Shari'a is not static and rigid and it is only bound by the *Quran, Sunnah, Idjma'* and *Qiyas* (analogy). See El-Ahdab, A., supra note 69, p. 604.

<sup>114</sup> *Al-Sanhury, Masader Al-Haq*, Vol. 3, Cairo: Dar Al-Nahza Al-Arabiya, (1968), p. 101, cited by A. El-Ahdab, *General Introduction on Arbitration in Arab Countries in International Handbook on Commercial Arbitration*, Suppl. 2, Kluwer Law International, (January 1990), p. 7.

<sup>115</sup> Ballantyne, W., *The Bahrain Euro-Arab Arbitration Conference (1989): a summing up* published with proceedings in *Essays and Addresses on Arab Laws*, Curzon Press, (2000), p. 206.

<sup>116</sup> *Hijaz* is the Western Region of Saudi Arabia where the two Holy cities of *Makkah* and *Madinah* are located.

- They are commonly used in transactions.<sup>117</sup>

Additionally, for an arbitration clause to be valid, the disputed matter must be clear and specific. For the following reasons the arbitration clause is not inadmissible and there is no room for alternative interpretation:

- The legislator does not want the parties to renounce trust in the adjudication's competence in certain matters.
- By specifying the disputed matter, the arbitrator's authority is determined.<sup>118</sup>

### 3.6.3 Arbitration Clause Autonomy (Severability)

One of the main elements of guaranteeing the binding effect of an arbitration clause is to consider it as an agreement independent from the contract in which it is contained. This is known as the principle of autonomy, or severability, of the arbitration clauses. In fact, the question of severability is neither addressed in Saudi Arbitration Regulations nor in the Implementation Rules, nor explicitly enunciated in the rest of the GCC States' laws. However, in this regard *El-Ahdab* suggests that:

*"The solution in our opinion is for the parties to confirm the severability of the arbitration clause from the other provisions of the contract by signing this clause itself so that it becomes an agreement within an agreement".*<sup>119</sup>

In most countries, the arbitration clause is considered as an agreement independent from the contract in which it is incorporated. The main effect of this principle of the severability of the arbitration clause is that invalidity of the main contract, in principle, does not entail the invalidity of the arbitration clause. This prevents a disputing party from avoiding arbitration

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<sup>117</sup> El-Ahdab, supra note 13, p. 7.

<sup>118</sup> El-Eshiw, supra note 65, p. 168.

<sup>119</sup> Ibid, p. 174.

on the grounds that a contract is invalid. The international acceptance of the principle of the autonomy of the arbitration clause relies on the fact that arbitration is essentially a procedural provision without prejudice to the parties' substantive contractual rights and obligations.<sup>120</sup> It may be observed that arbitration clause autonomy is found explicitly in many arbitration rules, for example article 21/2 of the 1976 UNCITRAL Arbitration Rules, Article 41 of the ICISID Convention and Article 8 of ICC Arbitration Rules. Since most disputed matters are related to the annulment of the main contract, the negligence of the separability of the arbitration clause principle might jeopardise the effectiveness of arbitration.<sup>121</sup> As for Saudi Arabia, the separability of the arbitration clause is recognised as valid as long as the clauses are not contrary to public policy; (namely they do not permit what is prohibited by Shari'a).<sup>122</sup>

### 3.6.4 Arbitrators

#### (i) Appointment of Arbitrators

Generally speaking, the regulations for arbitration do not provide procedures for a party's appointment of arbitrators. However, once the disputing parties have agreed to resolve their dispute by arbitration, they are then obliged to reach an agreement on the appointment of arbitrator(s).<sup>123</sup> Article 12 refers to formal notifications to be made by the parties to one another of the arbitrators they have respectively appointed. In this respect, the four schools of

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<sup>120</sup> Schmitthoff, C., *International Commercial Arbitration*, Vol. 1, New York: Oceana Publications, (1980), p. 21.

<sup>121</sup> For more discussion see Redfren, A., & M., Hunter, supra note 55, pp. 17-77.

<sup>122</sup> Al-Samaan, Y., *The Settlement of Foreign Investment Disputes by Means of Domestic Arbitration in Saudi Arabia*, *Arab Law Quarterly*, Vol. 9, No. 3 (1994), pp. 217-237.

<sup>123</sup> Article 10 of the Arbitration Law stipulates that: "If the parties have not appointed the arbitrators, or if either of them fails to appoint his arbitrator(s), or if one or more of the arbitrators is unable or refuses to assume his mission or withdraws, or if he is dismissed, and there is no special agreements between the parties, the authority originally competent to hear the dispute shall appoint the required arbitrators upon request of the party who is interested in expediting the arbitration, in the presence of the other party or in his absence after being summoned to a meeting to be held for his purpose."

Shari'a are silent on the possibility of appointing arbitrators by a third party. Their silence is probably based on the fact that there is nothing under Shari'a which prohibits the appointment of the arbitrators by a third party.

## **(ii) Number of Arbitrators**

According to the four schools of Shari'a, there are no restrictions on the number of arbitrators. The matter is left to the parties involved. However, Article 4 of the Saudi Arbitration Regulation provides that: "in case of multiple arbitrators, they shall be odd in number". The Regulation does not specify the required number of arbitrators in case the parties have not agreed thereon. However, it seems from the current practice in Saudi Arabia that the panel of three arbitrators is the rule.<sup>124</sup> Where the arbitral tribunal consists of three arbitrators, each of the parties will usually have the right to nominate one arbitrator, leaving the third arbitrator to be chosen in some other manner. The advantage to a party of being able to nominate an arbitrator is that it gives the party concerned a feeling of confidence in the arbitral tribunal.<sup>125</sup>

## **(iii) Qualification of Arbitrators**

Saudi Arbitration Law has adopted particular requirements for persons who wish to act as arbitrators. These requirements have been provided for in Article 4 of the Saudi

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<sup>124</sup> The usual tribunal consists of three arbitrators, one arbitrator to be appointed by each party and the third who shall head the tribunal, to be appointed by the two appointed by the parties. Moreover, it can be understood from the ARAMCO Award in 1958 where the tribunal consisted of three arbitrators that this is the case in Saudi. For more discussion on the ARAMCO Award see chapter 4 also see 27*International Law Reports* 117, (1958), p. 168.

<sup>125</sup> Redfren, A., & M., Hunter, *supra* note 55, p. 185.

Arbitration Regulation and section 3 and 4 of the rules for implementation rules.<sup>126</sup> The requirements can be summarised as follow:

- The arbitrator must be a Muslim, whether a national or foreigner.<sup>127</sup>
- The arbitrator must be experienced and of good conduct and behaviour.
- The arbitrator must be of full legal capacity.
- The arbitrator must not have been convicted of a heinous crime.
- The arbitrator must have no interest in the dispute<sup>128</sup>.
- The arbitrator must not have been subject to a disciplinary sanction by which he was debarred from holding public office.
- The arbitrator must not have been bankrupt, unless he has been rehabilitated.
- In the case of more than one arbitrator, the chair of the panel shall have knowledge of Shari'a rules, commercial regulations, customs and traditions applicable in Saudi Arabia.

Except for the additional qualification of 'expertise' and the statutory requirement of 'good conduct and behaviour', it is expected that the rules of Shari'a and Saudi practice prior to Decree M/46 will be maintained.<sup>129</sup> Islamic law is quite different to Western law on the issue of procedural fairness. Generally speaking, impartiality and independence are less important to Shari'a practitioners than expertise. Only the *Maliki* School of Islamic jurisprudence places a high importance on the neutrality of the decision maker.<sup>130</sup>

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<sup>126</sup> Neither the Regulation nor the Implementation Rules state the nature of the required experience, therefore, it seems reasonable to imply that the arbitrator should be an expert in the subject-matter of the arbitration.

<sup>127</sup> Saudi Arabia Regulation on Arbitration, Implementing Rules issued by Council of Ministers Resolution No. 7 of 8/9/1405 A.H. (May 27, 1985). It should be noted that the rules do not require the arbitrator to be Sunni Muslim. Article 3 of the Rules stipulates that: "Arbitrators may be nationals or Muslim foreigners".

<sup>128</sup> Impartiality and independence of arbitrators is laid down in Section 4 of the Implementation Rules.

<sup>129</sup> Saleh, S., supra note 95, p. 299.

<sup>130</sup> Veeder, Q., in Saleh, S., supra note 109, p.17.

#### **(iv) The Revocability of Arbitrators**

Articles 11-12 apply to the disqualification of arbitrators. Article 11 provides that “the parties are permitted to dismiss an arbitrator by mutual consent, and the arbitrator so removed may claim compensation if he had proceeded and if he had not been the cause of such removal. Furthermore, he cannot be removed except for reasons that occur or appear after the filling of the agreement to arbitrate”.

Article 12 provides that “an arbitrator may be challenged on the same ground as judges. The request for removal is made with the authority originally having jurisdiction within five days of the notification of the appointment of the arbitrator to the other party, or as of the date the grounds for a challenge appeared or arose. The request for removal is examined at a hearing with both parties as well as the challenged arbitrators being summoned”.

As to challenges and removal of arbitrators by one of the parties, there are different opinions between the *Maliki* School and the other three Schools. The *Maliki* School prohibits revocation after the procedure has started. On the other hand, the *Hanafi*, *Shafi'*, and *Hanbali* Schools permit the revocation (removal and challenge) of the arbitrators at any time before rendering the award.

In fact, the *Maliki* School's opinion provides that the appointment of an arbitrator is irrevocable after the commencement of the procedure except by mutual agreement of the disputing parties. This is the most appropriate due to its similarities to the requirements of international transactions in the case of resorting to national or international arbitration.

### 3.6.5 Place of Arbitration

Both the Arbitration Regulation and the Implementation Rules are silent on the issue of the arbitration location. Notwithstanding, this silence may be assumed that the following rules apply:

- Within Saudi Arabia it is left to the disputing parties' free choice to designate where the arbitration is to be held. Arbitration inside the country triggers the application of the Saudi Arbitration Law. Arbitration inside the country under the application of foreign arbitration law is not possible. The Council of Ministers Resolution No. 58 dated 25/06/1963 stipulates that:
- It is not permitted for any governmental body to designate any foreign law to govern its relation with any relevant body as the applicable law shall be the Saudi Law, as the law of the place of performance.
- In respect of arbitration outside the country, the Council of Ministers Resolution No. 58 stipulates that disputes with the government or government agencies cannot be submitted to arbitration, whether it is inside or outside Saudi Arabia, unless consent of the President of the Council of Ministers is obtained. Furthermore, as mentioned earlier, the Ministry of Commerce Circular dated 31/01/1981 provides that agreements establishing companies must not contain provisions allowing arbitration to be conducted outside the Kingdom.

Looking at the place of arbitration under the ICC rules to see the difference;

Article 14 provides that:

- a) The place of the arbitration shall be fixed by the court unless agreed upon by the parties.

- b) The arbitral tribunal may, after consultation with the parties, conduct hearings and meetings at any location it considers appropriate unless otherwise agreed by the parties.
- c) The arbitral tribunal may deliberate at any location that it considers appropriate.

As to the place of arbitration under UNCITRAL rules Article 16 provides:

- a) Unless the parties have agreed upon the place where the arbitration is to be held, such place shall be determined by the arbitral tribunal, having regard to the circumstances of the arbitration.
- b) The arbitral tribunal may determine the location of the arbitration within the country agreed upon by the parties. It may hear witnesses and hold meetings for consultation among its members at any place it deems appropriate having regard to the circumstances of the arbitration.
- c) The arbitral tribunal may meet at any place it deems appropriate for the inspection of goods, other property or documents. The parties shall be given sufficient notice to enable them to be present at such inspection.
- d) The award shall be made at the place of arbitration.

Generally speaking, the above discussion indicates that, there are many similarities between UNCITRAL<sup>131</sup> rules and ICC<sup>132</sup> rules. It could be argued that their fundamental differences are due to the fact that the UNCITRAL is ad hoc arbitration, and the other is institutional arbitration. The popularity of the ICC rules means they are used frequently for their institutional characteristics, whereas ad hoc arbitration may be undesirable due to the lack of institutional oversight. As for Saudi Arbitration Rules, the latter are not consistent

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<sup>131</sup> For more information see the UNCITRAL website at: <http://www.uncitral.org/uncitral/en/index.html>

<sup>132</sup> For more information see the ICC website at: <http://www.iccwbo.org/policy/arbitration/id2882/index.html>

with ICC Arbitration Rules. The difference between Saudi law and the ICC is that Saudi law does not codify the practice and outcomes of international arbitration. Saudi law would challenge the jurisdiction of an ICC arbitration tribunal because arbitrators should apply Saudi law as being the law of the place of performance of the contract. A foreign private party should therefore comply with the requirements of Saudi law.<sup>133</sup> It should be advised that to facilitate the arbitration procedures and achieve the best results, the parties should have their arbitration inside Saudi Arabia. This would make it easier for them and for the arbitrators to communicate with the authority originally competent to hear the dispute. On the other hand, in order to overcome the apprehension of foreign investors, the Saudi Arbitration Code should contain specific and liberated rules as to the place of arbitration to give more freedom to the disputing parties.

### ***3.7 Basic Considerations for Arbitration under Shari'a***

As to the contractual aspect, Shari'a treats Muslim and non-Muslim disputants on an equal footing. However, it could be argued that Saudi Arbitration Regulations are not attractive to foreign investors because the arbitrator must be a Muslim and all the documentation and procedure must be in Arabic.<sup>134</sup> However, the main reason for foreign investors' rejection of Saudi Arbitration Regulations and reluctance to accept the national courts in Saudi Arabia could be based on their representatives' lack of knowledge of the Islamic Law or the Saudi Legal System. In fact, there is no fear from the arbitrators being Muslim as they apply Shari'a which:

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<sup>133</sup> Al-Shareef, N., supra note 64, p. 139.

<sup>134</sup> Ballantyne, W., *Islamic Law and Finance: Introduction: Islamic Law and Financial Transactions in Contemporary Prospective*, p. 1, Centre for Islamic and Middle Eastern Law (CIMEL) at SOAS, [www.soas.ac.uk/Centres/IslamicLaw/IsIFinIntro.html](http://www.soas.ac.uk/Centres/IslamicLaw/IsIFinIntro.html)

- Does not discriminate between Muslim and non-Muslim or between a national and foreigner.<sup>135</sup>
- Recognises in full the sanctity of contracts.<sup>136</sup>
- Applies the principle that “the contract is the law of the contractors”, which reflects the basic maxim *pacta sunt servanda* which means that parties who freely and legally enter into a contract are bound to fulfil obligations undertaken through it.<sup>137</sup>
- According to the principle of freedom of contracts under Shari’a, parties are free to include any clause in their contract as long as it does not permit acts against God’s commands, including the incorporation of ‘interest’ (*Riba*) clauses.<sup>138</sup>
- The documentation and procedure must be in Arabic; however, there should be no concern because each party can have his own interpreter.<sup>139</sup>

### 3.8 Applicable Law

The tenets of Islam significantly affect the legal systems, and the systems of commercial arbitration in a number of countries in the Middle East and Africa significant to this study. As mentioned previously, the Saudi Legal System is based on Shari’a, with the *Quran* and *Sunnah* representing the main sources of law. The commercial dispute settlement system in Saudi Arabia is an example of a religiously influenced system. However, this does not mean that this dispute resolution system is unacceptable under Western standards.<sup>140</sup> It is

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<sup>135</sup> “O you who believe! Stand out firmly for justice, as witnesses to Allah, even if it be against yourselves, your parents, and your relatives, or whether it is against the rich or the poor...” (*Quran* 4:135).

<sup>136</sup> “Oh you who believe, observe contracts”, (*Quran* 5:1)

<sup>137</sup> The *Quran* orders Muslims “to fulfil the covenant of God when you have a covenant and break not oaths after their confirmation”, (*Quran*, 16:91).

<sup>138</sup> Al-Qurashi, Z., supra note 9.

<sup>139</sup> Section 5 of the Implementation Rules of the Arbitration Regulations, 1985 stipulates that: “the Arabic language shall be the official language to be used before the arbitration panel, whether in the discussion or in correspondence. The arbitration panel and the parties may not speak other than the Arabic language and any party who does not speak Arabic shall be accompanied by an accredited translator who shall sign with him the minutes of hearing, approving the statements made”.

<sup>140</sup> Fox, W., supra note 4, p. 369. See also note 75 supra.

worth noting that even though the commercial laws of Saudi Arabia are significantly influenced by Western commercial laws. This is despite the Saudi Arabian legal system itself being among the least influenced by Western legal principles.<sup>141</sup> In Saudi Arabia, the laws applied explicitly in commercial matters, such as companies, banking, and commercial paper laws, strongly resemble French and Egyptian laws.<sup>142</sup> The question that may rise here is what is the applicable law that arbitrators must apply regarding the dispute? This is obviously a concern and will be examined more fully below.

Section 39 of the Implementation Rules<sup>143</sup> provides that the award is made by arbitrators who are only bound to comply with the rules of procedure contained in the Arbitration Regulation and its Implementation Rules. In other words, arbitrators, like judges, are bound to apply Saudi Law, whether the dispute relates to a domestic or an international transaction. According to *fiqh* (Islamic jurisprudence) rules, the choice of law does not exist when it comes to the Shari'a.<sup>144</sup> The very concept of a divinely inspired system of laws precludes the choice of any other law by the parties to a dispute.<sup>145</sup> In fact, *Quranic* injunctions urge believers to have their disputes judged "by what God has revealed".<sup>146</sup> This explains why Saudi courts and regulations do not recognise the Western conflict of laws principles and automatically

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<sup>141</sup> Shaaban, H., *Commercial Transactions in the Middle East: What Law Governs?* 31 LAW & POL'Y INT'L BUS. (1999), pp.158-159,169.

<sup>142</sup> Vogel, F. & S., Hayes, *Islamic law and finance: religion, risk, and return*, BRILL, (1998), p. 50. Amin said that the modern commercial practice and international trade has made a significant contribution in the course of the development of the contemporary Saudi Arabian legal system, and that the expert commercial lawyers of the Western world who participate in drafting and negotiating contracts on behalf of their clients have in effect introduced the bulk of modern business law (basically American legal concepts) to the Saudi Arabian legal environment. Amin, S., *Middle East Legal Systems*, Royston Limited, (1985), p. 317.

<sup>143</sup> See section 39 of the Rules for the Implementation of the Arbitration Regulation (1985). For more discussion see generally, El-Ahdab, A., *Arbitration in Saudi Arabia under the new Arbitration Act 1983 and its Implementation Rules of 1985*, J. Int. Arb., (Pts. 1 & 2), Vol. 3, No. 3, 27 (Sep. 1986) & Vol. 3, No. 4, 23 (Dec. 1986).

<sup>144</sup> Sloane, P., *The Status of Islamic Law in the Modern Commercial World*, 22 Int'l Law, (1988), p. 762.

<sup>145</sup> Sayen, G., *supra* note 63, p. 924.

<sup>146</sup> *Quran* 4:60. Another *Quranic* verse says: "judge (you O Mohammad) among them by what God has revealed and follow not their vain desires", *Quran* 5:49.

apply Saudi laws.<sup>147</sup> Accordingly, the award must comply with mandatory principles of Shari'a and the applicable regulations. To meet the ever changing needs of commercial practice and business transactions, Royal and Ministerial Decrees are periodically issued and reviewed. Such Decrees are only valid, however, if they do not conflict with Shari'a mandatory principles. These decrees need to be considered to increase the use of settlement or arbitration for deciding conflicts to become more common in Saudi Arabia.

Saudi officials maintain, however, that they have made tremendous progress in resolving the backlog of commercial disputes, almost to the point of complete elimination.<sup>148</sup> Moreover, the government no longer requires exclusive applicability of Saudi law in the resolution of private commercial disputes. In practice, however, Saudi courts tend to apply Saudi law in commercial disputes litigated in the Kingdom, even when the relevant contract contains a foreign choice of law provision and provides for a foreign forum to have jurisdiction.<sup>149</sup> From the point of view of a foreign investor,<sup>150</sup> this matter represents some risks and problems of unpredictability in the event that a dispute arises that cannot be settled by negotiation or mediation. This is particularly true if the dispute is with a government or an

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<sup>147</sup> David, J., *Islamic Law in Saudi Arabia: What Foreign Attorneys Should Know?* 25 GEO. WASH. J. Int'l. L. & Econ., (1992), p.131.

<sup>148</sup> See Saudi American Bank (SAMBA), *The Saudi Economy at Mid-Year 2005*, Riyadh, (2005).

<sup>149</sup> It is interesting to note that in the field of international commercial arbitration the question of the law applicable is rarely a primary issue. Arbitrators rely on contract interpretation and trade usages. However, this is not the case in state contracts. The question of the law applicable to state contracts is one of the most disputed issues. See Peter, W., *Arbitration and Renegotiation of International Investment Agreements*, London: Kluwer Law International, (1995), pp. 132-157. An example of unpredictability of the BG judgement is a contentious case involving a Saudi company and a Malaysian Subcontractor. The Board of Grievances in Riyadh, in a lengthy opinion based largely on *Hadith* (the Traditions of the Prophet Mohammed), concluded that a Saudi, as a matter of public policy, cannot choose to have his obligations governed by any law other than Shari'a. The Board's judgment was appealed to the Review Panel, which remanded with the observation that a blanket prohibition against enforcing a foreign choice of law itself violated the Shari'a mandate that one fulfils one's legal obligations. Despite this recommendation from above, the Board reaffirmed its refusal to enforce the choice of foreign law in even stronger terms. On the other hand, in a much older decision, the Board of Grievances in Jeddah did not hesitate to enforce the choice of French law in a contract between a French perfume manufacturer and its Saudi agent. Suffice it to say, then, that the issue remains in a state of flux. O'Kane, M., *Securities Regulation in Saudi Arabia*, Riyadh: The Law Firm of Salah Al-Hejailan, (July 5, 2008), available at: <http://www.scribd.com/doc/3827775/Securities-Regulation-in-Saudi-Arabia>.

<sup>150</sup> Afridi & Angell, *An Overview of Legal Structures In The GCC Countries - Issues of Risk and Strength*, Dubai: World Services Group, (Dec. 2006), available at: [http://www.hg.org/articles/article\\_1649.html](http://www.hg.org/articles/article_1649.html).

instrument of the government. Therefore, careful negotiation of the contract to reduce the possibility of disputes and a conciliation or mediation clause, or at least a requirement for a significant “cooling off” period to be used for negotiation, may be the best practical safeguards. In addition, all issues between parties should be expressly regulated in the contract. Particular attention should be paid to ensuring each contractual provision conforms to Shari'a. Business-to-business arbitration assistance, although expensive, is available from local chambers of commerce for some types of disputes.<sup>151</sup>

### ***3.9 Enforcement of Foreign Arbitral Awards in Saudi Arabia***

The purpose of arbitration is to obtain an award, either in the form of an amicable settlement, or in the form of a decision given by the arbitral tribunal. The award is simply the arbitral tribunal's decision or judgement on a dispute referred to it in pursuance of an arbitral clause or arbitration document, but to have effect it must be enforced.<sup>152</sup> This raises the issue of enforcement and the procedures and processes for enforcement which are dealt with below.

Because of the increasing commercial and investment activity of Arab countries and the resulting increase of arbitration proceedings and awards, the enforcement of foreign arbitral awards in the Middle East is ever more decisive. The rules governing the enforcement of foreign arbitral awards vary from country to country in the Middle East.<sup>153</sup>

In Saudi Arabia, Article 20 of the Arbitration Regulation provides that the award of the arbitrators shall be due for execution, when it becomes final, by an order granted by the

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<sup>151</sup> See more info. at <http://www.infoprod.co.il/article/24>

<sup>152</sup> See articles 9, 14, 15, and 17 of the Arbitration Code.

<sup>153</sup> El-Ahdab, A., *supra* note 13, p. 324.

authority originally competent to hear the dispute. The order shall be granted upon the petition of an interested party after the authority has confirmed that “there is nothing to prevent its execution legally”. In other words, the award is fully consistent with the mandatory principles of Shari’a. So the reason of making the enforcement of an arbitral award by means of a judicial decision is to ensure that the award is fully consistent with the mandatory principles of Shari’a. However, although arbitral awards have a judicial character, they are still different from court decisions because the arbitrator cannot enforce the awards without the approval of the courts.

It should be noted that an application for the enforcement of a foreign judgement must include details regarding the plaintiff who requests the enforcement, the defendant against whom the award is to be enforced, the subject of the dispute, and the nature of the award concerned. According to an opinion attributed to Imam *Shafi’i*, as to whether an award is binding is dependent upon the agreement of the parties. Even after the award has been made, the consent of the parties is necessary for its enforcement.<sup>154</sup> It could be argued, therefore, that there is an opportunity for the losing party to prevent the award from being enforced. However, it is argued that as the default position in Saudi Arabia follows the *Hanbali* School (which does not require parties’ consent for a judgment to be enforced),<sup>155</sup> therefore, as provided Article 20 of the Saudi Code, enforcement of an award does not in fact require the consent of the parties.

Once the award is declared enforceable in accordance with Article 20 of the Arbitration Code, the award is considered as having the same status as a judgement made by the

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<sup>154</sup> Ibid, p. 324.

<sup>155</sup> For more discussion see chapter 1 of the thesis.

authority originally competent to hear the dispute.<sup>156</sup> Procedures before the BG allocate the enforcement of a foreign judgement to the Administrative Circuit of the Board. Foreign judgements include foreign arbitral awards issued outside Saudi Arabia since they are not included in Arbitration Law No. M/46. The procedures and requirements for the enforcement of a foreign judgement will apply equally to the enforcement of a foreign arbitration award.<sup>157</sup>

As already mentioned earlier, Saudi Arabia is a party to the International Centre for the Settlement of Investment Disputes (ICSID) Convention. This Convention has established an effective, unprecedented framework for enforcement of awards.<sup>158</sup> The Convention under Articles 53 and 54 requires every contracting state to – including those involved in the arbitration proceedings – recognise the awards rendered by the arbitration tribunals of the Centre, and to enforce the pecuniary obligations imposed in these awards, as if they were final court decisions in that state. Such an award also is not subject to an appeal.<sup>159</sup> This being the case, it will be expected that the BG would give effect to these provisions in respect of foreign awards. However, it should be emphasised that, Saudi's membership of the ICSID convention is subject to the established exceptions particularly that the award must not contradict with the Shari'a principles specially the issue of interest (*Riba*), and public policy. Hence, conditions required for the enforcement of foreign awards are as follows:

- Non-violation of Shari'a, which includes non-violation of public order or policy of the state in which enforcement sought.<sup>160</sup>

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<sup>156</sup> Article 21 of the Arbitration Code.

<sup>157</sup> Nader, M., *Settlement of Disputes through Arbitration*, Proceedings of first Arab Regional Conference, *Arab Comparative and commercial Law*, Vol.1, (1987).

<sup>158</sup> Hirsch, M., *The arbitration Mechanism of the International Centre for the Settlement of Investment Disputes*, Dordrecht: M. Nijhoff, (1993), p. 23.

<sup>159</sup> Ibid, p. 23.

<sup>160</sup> Nader, M., supra note 159, p. 298.

- Reciprocity or mutual treatment. Reciprocity may be applied if the state in which a foreign judgement is issued both accepts enforcement of judgements issued in Saudi Arabia and accepts enforcement procedurally in the same manner as in Saudi Arabia.

It could be suggested that Saudi arbitration would be more attractive for foreign investors if the Kingdom benefited from other countries experience in the field. This would be the case especially for those who consider Shari'a as one of the main sources of law, and have a statute that contains ingredients found in both the UNCITRAL commercial arbitration rules and the new UNCITRAL Model Law on (ICA). It also should recognise arbitration as a legitimate means of dispute settlement, and permit arbitration to take a place outside the country. It has to be stated that the emphasis and concern of Shari'a is only with regard to the dispensation of the case by the tribunal rather than the forum where the case is resolved or other procedural formalities.

## **Conclusion**

This chapter has examined the process of settlement of foreign investment disputes in Saudi Arabia and the efforts of the government to create adequate dispute settlement mechanisms capable of resolving disputes arising out of investment activities. Such efforts resulted in the restructuring of the BG in the early 1980s in order to make the Board competent to hear all disputes to which the government or any of its agencies is a party as well as all commercial disputes including those relating to foreign investments. Unlike Shari'a courts and other Saudi courts, the BG observes a system of precedent which creates predictability and ensures that like cases are treated alike. Furthermore, decisions of the Board may be appealed.

The Saudi government maintains that they have made tremendous progress in settling commercial disputes to the extent that they have achieved a complete elimination of obstacles to dispute settlement. Moreover, the government no longer requires exclusive applicability of domestic law in the settlement of foreign investment disputes. In practice, however, national courts tend to apply domestic law in commercial disputes litigated in the Kingdom, even when the relevant contract contains a clause of a foreign choice of law and provides for a foreign forum to have jurisdiction. As to arbitration in Saudi Arabia, it is available from local chambers of commerce for some types of disputes. Royal Decree No. M/46 has incorporated some Shari'a tenets alongside modern concepts of arbitration, and has generally softened the serious conflict between Shari'a and Western legal concepts which has existed previously in the Saudi arbitration system.

It is apparent that many people doing business in the Middle East are more apprehensive about the method of solving legal disputes than any other aspect of their business.<sup>161</sup> Such apprehension is perhaps justified in isolated instances, but generally speaking there is no need for concern.<sup>162</sup> Saudi Arabia has been following a middle course in its approach towards ICA, hence:

- Based on Shari'a tenets, it up-holds arbitration as a means of resolving disputes arising from investment activities.
- It restricts government bodies from submitting to arbitration whether international or national but with special leave by the Council of Ministers. This is arguably to allow government to exercise its right to national sovereignty over its natural resources as a result of its bitter experience with the ARAMCO Arbitral Award.

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<sup>161</sup> Russell, B., *An Introduction to Business Law in the Middle East*, London: Oyez Publishing, (1975), p. 18.

<sup>162</sup> Ernest, K., *supra* note 73, p. 86.

- Pursuant to its commitments under the relevant conventions, it will permit enforcement of foreign arbitral awards subject to reciprocity, public policy, and Shari'a which also recognises the supremacy of public interests.

In conclusion, there are no particular difficulties in the enforcement of foreign arbitral awards in Saudi Arabia unless they, as stated previously, contain elements of interest, or conflict with the enforcement regulations of the Saudi Arbitration Code of 1983. However, in practice, the Saudi Arbitration Law as it stands could be said to be less favourable to a foreign investor for the following reasons:

- 1- Arbitration involving Saudi Arabian governmental entities must be conducted in Saudi Arabia under Saudi law.<sup>163</sup> This contradicts the equal footing principle.
- 2- The close involvement of the BG.
- 3- The rule that the arbitrator must be a Muslim.
- 4- Arbitration must be engaged in Arabic.
- 5- The uncertainty about enforcement of foreign awards.

Various provisions of the Arbitration Regulations and Implementing Rules make it clear that the arbitrators are to apply Saudi procedural and substantive law to the dispute. This is consistent with the general practise of Saudi courts, which do not recognise the doctrine of conflict of laws, and will not apply non-Saudi law to disputes brought before them even if the disputing parties have chosen a foreign governing law. However, a specific rule derived from a foreign law and incorporated as an express contractual provision should be enforced if not in conflict with any mandatory provision of Saudi law.

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<sup>163</sup> Fox, W., supra note 4, p. 370.

## (4) HISTORICAL BACKGROUND OF FOREIGN INVESTMENT IN SAUDI ARABIA

### Introduction

Saudi Arabia has been the world's leading oil producing and exporting country for many decades. It is a major player in shaping international oil policy, whether through OPEC or outside of it. However, prior to the grant of the first oil concession in 1933, few were convinced that the country possessed the large amounts of oil which was to be discovered subsequently. The history of foreign investment in Saudi Arabia's oil and gas industry is closely linked with the participation of an American oil company in Saudi - Standard Oil Company - and the establishment and evolution of ARAMCO.

Foreign investment in the Kingdom dates back to 1933 when Standard Oil of California signed the first concession agreement with the government of Saudi Arabia. It is widely perceived that the American company took advantage of the inexperienced Saudis throughout the negotiations and drafted the concession in their favour.<sup>1</sup> The concession agreement amounted to a hugely successful commercial bargain to the company. Standard Oil of California was subsequently joined by other American companies to create the Arabian

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<sup>1</sup> Moran, H., *The Evolution of Concession Agreements in Underdeveloped Countries and the United States National Interests*, 7 *Vanderbil J. Transnational Law*, 315-334 (1974). Cited by Al-Samaan, Y., *The Evolution of Contractual Relationship between the Government of Saudi Arabia and ARAMCO*, Masters Dissertation, University of Dundee, Centre for Petroleum and Mineral Law Studies, (1990).

American Oil Company (ARAMCO).<sup>2</sup> The evolution of ARAMCO is therefore very closely linked with the development of the oil industry in Saudi Arabia and therefore plays a major role in the country's national economy.<sup>3</sup> Many commentators are of the opinion that the feeling of unfairness and inequity created by ARAMCO's attitude increased steadily from the time of *The 1933 Concession Agreement* until resorting to *The General Agreement on Participation* in 1972.<sup>4</sup> It was the view of the Saudi government that the country had paid more than enough of its national product to American companies in exchange for their contributions to the development of the national oil industry.<sup>5</sup>

The main aim of this chapter is to outline the historical background of foreign investment in the country. It will analyse – from a legal and historical perspective – the efforts of the Saudi government to nationalise ARAMCO through the method of state participation. For the purposes of understanding the Saudi government's subsequent intention of taking control of the industry, the concept of state participation and some of its pertinent features need to be explained. In addition, it is necessary to trace the development of the original 1933 concession agreement which determined the relationship between the Saudi government and foreign investors, notably through the history of ARAMCO. Later, the chapter will highlight the 1972 *General Agreement on Participation* between the government and international companies (including ARAMCO) to illustrate similar actions in neighbouring countries as regards their relationship with foreign investors in the oil and gas

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<sup>2</sup> For background information on American influence and participation in the Saudi Arabian oil industry see Hamilton, C., *Americans and Oil in the Middle East*, Houston: Gulf Publishing Company, (1962).

<sup>3</sup> From its beginning the Saudi government has been exercising its influence over the historical evolution of ARAMCO. For details of the development of the oil industry, see ARAMCO Handbook, *Oil and the Middle East*, Arabian American Oil Company, Dhahran, Saudi Arabia, (1968).

<sup>4</sup> For a discussion on the terms of the 1933 Concession Agreement, and the initial privileges of ARAMCO, see, Al-Samaan, Y., *supra* note, 1, pp. 28- 33. See generally, Anderson, I., *ARAMCO, the United States and Saudi Arabia: a Study of the Dynamics of Foreign Oil Policy 1933-1950*, New Jersey: Princeton University Press, (1981).

<sup>5</sup> On the shift of the bargaining position of Saudi Arabia and ARAMCO, see Al-Samaan, Y., Chapter II, *Supra* note 1, pp. 55-60.

industry.<sup>6</sup> Finally, it is also necessary to highlight some of the pertinent activities during and after the takeover of ARAMCO in 1980.

#### ***4.1 The meaning of 'State Participation' in the Petroleum Industry***

Generally speaking, state participation<sup>7</sup> in the petroleum industry means the technical and commercial involvement of a state or its designated representatives in the exploration and exploitation of petroleum resources.<sup>8</sup> State participation can be obligatory or non-obligatory. State participation is obligatory when it indicates as a condition the participatory role of the state through its national company as part of the exclusive license granted by the host state. It is non-obligatory when the host state or its national oil company are permitted to participate whether in a domestic or foreign joint venture as a participant on a voluntarily basis for commercial purposes. Usually the foreign investing company will invite the state company to join it in the petroleum activities because of the advantages in having the state's database (including existing technical studies) and knowledge of the resources at its disposal.

In the case where the host state or its national company, as petroleum rights holder and also holder of the licence participate in the joint venture in the form of a joint company, the state usually becomes a shareholder in such company. Usually, the host state does not participate itself, per se, in the petroleum operations but will be represented in the joint venture by the national company.

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<sup>6</sup> The General Agreement on Participation was concluded in December 1972 between Saudi Arabia and Abu Dhabi on one side and the international major companies working within their national jurisdiction on the other. The companies were: Abu Dhabi Marine Areas Limited, Abu Dhabi Petroleum Company Limited and ARAMCO.

<sup>7</sup> For in depth discussion see chapter 2 supra. Some of the facts mentioned in that chapter are also mentioned here for clarity and emphasis. See also Zakariyah, H., *New Directions in the Search for and Development of Petroleum Resources in Developing Countries*, 9 *Vand. J. Transnat'l. L.*, 545-556, (1976).

<sup>8</sup> Taverne, B., *Co-operative agreements in the extractive petroleum industry*, Londres: *International Energy and Resources Law & Policy Series*. 79-100, (1996).

The joint venture is similar to a partnership agreement which forms the basis of the contractual relationship between the host state and the foreign oil company. The partners in the joint venture share the risks and rewards of the petroleum arrangements as the agreement determines the portion of each partner's share of costs, losses, and profits.

Generally, the meaning of 'state participation' in the oil and gas industry can be found in the following type of petroleum arrangements: joint venture, service contract, and production sharing agreement.<sup>9</sup> These three types of agreements on state participation are distinguishable.

#### **4.1.1 Joint venture agreement:**

Generally, a joint venture is where two or more existing businesses agree to co-operate and combine their resources with a view to profit on a specific project for a specific length of time without being bound together indefinitely. In the petroleum industry, under this type of agreement, a foreign oil company and a host government through its national company each contributes a portion of the cost to form a joint venture.<sup>10</sup> This newly-formed company will then, under the authorisation of the licence explore and exploit petrol in the licensed areas. If a commercially viable find is made, then the foreign oil company's exploration cost will be reimbursed by revenues after production of that field. If a commercially viable find is not made, then the foreign oil company loses all its exploration's costs.

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<sup>9</sup> See Johnston, D., *International Petroleum Fiscal Systems and Production Sharing Contracts*, Oklahoma: PennWell Publishing Company Tulsa, (1994), p. 296. On petroleum agreements in general see Maniruzzaman, A., *The New Generations of Energy and Natural Resource Development Agreements*, JENRL, Vol. 2 No. 4, 207-247, (1993).

<sup>10</sup> See Stevens, P., *Joint Ventures in Middle East Oil 1957- 1975*, Beirut: Middle East Economic Consultants, (1976), p. 17.

Such participation on what is known as a 'carried interest' basis is attractive to host countries because it involves a government in exploration and development in situations in which that government lacks the funds to do so. From the beginning the government is involved as a partner carried by the contractor but without the risks of a financial commitment.<sup>11</sup>

#### **4.1.2 Service contract:**

Under a service contract the private oil company provides on a contractual basis over a pre-arranged period, specific services for the host government. This type of participation is useful, because, it can fill the gaps in the state's experience such as management, technology and know-how. The private firm is considered to be working as a contractor for the state and not as a partner, in carrying out the wishes of the state where it has no interest in the resources themselves. Normally the payment is in cash and not oil which differentiates it from the PSA (Production Sharing Agreement) where the payment is in kind. However, this type of contract is not always attractive to integrated companies who are keen to increase their access to crude oil supplies.<sup>12</sup> The private oil company, in most circumstances, is still viewed as a conventional concessionaire – the foreign company is not a concession holder or partner, but merely a hired agent – as far as the end result is concerned.<sup>13</sup>

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<sup>11</sup> Cameron, P., *The structure of petroleum agreement, Petroleum Investment Policy in Developing Countries*, (1988), p.43.

<sup>12</sup> Cameron, P., *Petroleum Licensing, A Comparative Study*, London: Financial Times Business Information Ltd, (1984) p. 12.

<sup>13</sup> For more discussion on service contracts and its two types of arrangements see chapter 2 *supra*.

### 4.1.3 Production sharing agreement:

This type of arrangement between the State and the private company was first introduced in Indonesia in 1967.<sup>14</sup> Zhiguo Gao defines it as follows:

*“The production-sharing contract is an agreement under which a foreign company, serving as a contractor to the host country/its national oil company, recovers its costs each year from production and is further entitled to receive a certain share of the remaining production as payment in kind for the exploration risks assumed and the development service performed if there is a commercial discovery”.*<sup>15</sup>

This is the most commonly used petroleum agreement and its form was shaped by the law that was promulgated in Indonesia in 1960 (law No. 44).<sup>16</sup> Article 3 provided that the mining of oil and gas could only be undertaken by the state and that mining undertakings of mineral oil and gas were to be exclusively carried out by the state enterprise. Article 6 of the law, however, authorised the Minister of Mines to appoint foreign companies [as contractors for the state enterprises] if they were required to carry out operations which [cannot, or cannot yet be executed by the state enterprises involved].<sup>17</sup>

The production sharing agreement has some elements of both a joint venture agreement and a service contract, in that the underlying basis of a production sharing agreement is the sharing of petroleum production between the parties, rather the revenue produced from the petroleum sale. Under this type of agreement the contractor undertakes the risk of exploration and production. If there is no commercial discovery, the loss is borne by the contractor. But in the case of commercial discovery, the contractor has the right to be reimbursed out of a

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<sup>14</sup> Bindemann, K., *Production-Sharing Agreements: An Economic Analysis*, Oxford Institute for Energy Studies, (1999), p.1.

<sup>15</sup> Zhiguo G., *International Petroleum Contracts, Current Trends and New Directions*, Graham & Trotman Ltd, (1994), p. 72.

<sup>16</sup> Cameron, P., *supra* note 12, p. 14.

<sup>17</sup> Hossain, K., *Law and Policy in Petroleum Development*, (1979), p. 139. The production sharing agreement in Indonesia was introduced and developed to meet the requirements of the Indonesian 1945 constitution, which reaffirmed the sovereignty of the state over its natural resources and to meet the national demand of supervising foreign investment. See generally Fabrikant, R., *Production Sharing Contracts in the Indonesian Petroleum Industry*, 16 *Harv Int. L. J.*, 303, (1975).

percentage of the oil produced; this percentage is considered as cost oil as well as compensation for the efforts done by the oil company. The oil company (Contractor) is entitled to recover the petroleum costs it incurred by taking and freely disposing up to a maximum percentage per year of all crude oil and natural gas produced from the contractual area or such lesser percentage as is necessary to recover the petroleum costs. This amount of oil is referred to as “cost oil”, the ceiling of which varies from PSA to PSA for example, ranging from 40% in the majority of countries to 70% in the Philippines.<sup>18</sup>

## **4.2 The main features of state participation in exploration and exploitation of oil.**

Generally, host countries prefer to have a system of state participation in the oil and gas industry for the following reasons:

### **(i) Increasing government revenues:**

In the past a number of countries entered into concession agreements with foreign oil companies to explore and exploit their natural resources. As already mentioned, these concession agreements were generally one sided, for long periods, and more advantageous to the oil company than to the host country. As a result of the growing dissatisfaction against concession agreements, host countries embarked upon a process to revise these arrangements. This relationship between the international company and the host government came under intense scrutiny in Saudi and other oil producing countries. Saudi's former Oil Minister, Yamani acknowledged this new strategy and urged the major oil companies to “revise their

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<sup>18</sup> See Johnston, D., *supra* note 9, p. 296. See also Blinn, K., Claud, D., H., Le Leuch & Pertuzio, A., *International Petroleum Exploration and Exploitation Agreements: Legal, Economic and Policy Aspects*. New York: Barrows Company Ltd., (1986), p. 242. See also Barrows, H., & Gordon, *Worldwide Concession Contracts & Petroleum Legislation*. PennWell Publishing Co., (1983), for detailed information on the petroleum laws in most countries.

whole system of operation in the producing countries and enter into partnership with the countries.”<sup>19</sup> The type of partnership arrangements envisaged are those mentioned above.

A different strategy adopted by some host countries is the introduction or increase of petroleum taxes. They have realised that they could increase their portion of revenues through the levy of petroleum taxes instead of direct involvement in the petroleum investment. In some cases, international companies are quite happy to be faced with an increase in tax rather than be burdened by the involvement of the state participation.

## **(ii) Control over petroleum resources and over the activities of the concession companies:**

Due to the importance of petroleum as a natural source of energy and as a matter of national interest, the intervention of the UN General Assembly was important with respect to the ownership of mineral rights. However, the main event that led to the revision of the meaning of ownership of natural resources in developing countries including Saudi Arabia was an inequitable situation where the seven major international oil companies controlled huge areas under long term concession contracts that only benefited themselves, at the expense of the host nations in which they operated during the first half of the 20<sup>th</sup> century.<sup>20</sup> Consequently, the UN General Assembly took the following action:

On December 21, 1952, the General Assembly adopted Resolution No. 626 (VII)<sup>21</sup> which provided that:

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<sup>19</sup> Wall Street Journal, 27 June, 1968.

<sup>20</sup> See Yergin, D., *THE PRIZE, The Epic Quest for Oil, Money and Power*, New York: Free Press, (1991) for an examination of the history of the world oil industry, the founders, the global struggle, war and strategy, the hydrocarbon age and the battle for world mastery including the events that led to the creation of OPEC.

<sup>21</sup> See text of Resolutions at UN General Assembly website: <http://www.un.org/documents/resga.htm> (13-06-2005).

*The right of peoples freely to use and exploit their natural wealth and resources is inherent in their sovereignty.*

On December 14, 1962, at its Seventeenth Session, the General Assembly adopted Resolution No. 1803 (XVII)<sup>22</sup> entitled *Permanent Sovereignty Over Natural Resources* which provided that:

*The right of peoples and nations to permanent sovereignty over their wealth and resources must be exercised in the interest of their national development and of the well-being of the people of the State concerned.*

At the same time it was declared that

*Nationalisation, expropriation or relinquishment shall be based on grounds or reasons of public utility, security or the national interest which are recognised as overriding purely private interests, both domestic and foreign. In such cases the owner shall be paid appropriate compensation, in accordance with the rules in force in the State taking such measures in exercise of its sovereignty and in accordance with international law.*<sup>23</sup>

The 1962 Resolution was reinforced in 1966 by Resolution 2158 (XXI) which was even more explicit on host country rights.<sup>24</sup> Host countries were ‘advised’, by exercising their permanent sovereignty, to secure the maximum exploitation of natural resources and to achieve this by the accelerated acquisition by developing nations of full control over production operations, managing and marketing.<sup>25</sup>

On December 12, 1974, the General Assembly adopted Resolution No. 3281 (XXIX)<sup>26</sup>, entitled “Charter of Economic Rights and Duties of States” which provided that:

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<sup>22</sup> Ibid.

<sup>23</sup> Ibid.

<sup>24</sup> Ibid.

<sup>25</sup> See United Nations Centre on Transnational Corporations, *Main Features and Trends in Petroleum and Mining Agreements: A Technical Paper*, New York: United Nations, (1983); Stevens, P., supra note 10, p. 131. For the details of this resolution, see Blinn, K., & others, supra note 18, p. 30.

<sup>26</sup> See text of Resolutions at UNGA website: <http://www.un.org/documents/resga.htm> (12-06-2005).

1. *Every State has and shall freely exercise full permanent sovereignty, including possession, use and disposal, over all of its wealth, natural resources and economic activities...*
2. *Each State has the right:*

*"To nationalise, expropriate or transfer ownership of foreign property in which case appropriate compensation shall be paid by the State adopting such measures, taking into account any relevant laws and regulations and all circumstances that the State considers pertinent. In any case where the question of compensation gives rise to a controversy, it shall be settled under the domestic law of the nationalising State and by its Tribunals, unless it is freely and mutually agreed by all States concerned that other peaceful means be sought on the basis of the sovereign equality of States and in accordance with the principle of free choice of means."*<sup>27</sup>

The issue of control is very important for the host government because of the notion that the resources in the country belong to the state.<sup>28</sup> The state does not want to surrender this right entirely to the foreign company, which subsequently led to these participation arrangements ensuring the right to intervene in petroleum activities. Participation is also regarded as the beginning of full control of petroleum resources by host states, which would give them the opportunity to play a major role in designing the decision-making and other policies of the venture. This control would cover essential issues such as the capacity of production and plans for future explorations. This policy was supported by OPEC's conferences in order to enhance the role of member countries in pricing policy, and the rate of production which was largely dominated by multinational oil companies.

### **(iii) Acquisition of technical and managerial experience:**

In most countries, host governments are not able to undertake exploration and production operations because of inadequate levels of technical and managerial experience.

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<sup>27</sup> The above stated UN General Assembly's resolutions of 1952, 1962 & 1974 are cited by Blinn, K., supra note 18, p. 30-31.

<sup>28</sup> See Schrijver N, *Sovereignty over Natural Resources*, Cambridge University Press, (1997), for a detailed examination of the issue of permanent sovereignty over oil and gas resources.

Hence, participation with an experienced international oil company could be considered the best method to get a better understanding of its resources, to gain the necessary experience and to eventually reduce dependence on foreign oil companies. A policy of state participation would also require that nationals are given opportunities to be involved from the top levels of management to the operational field level.<sup>29</sup>

#### **(iv) Access to the international oil market:**

Host governments usually tend to depend on foreign oil companies to sell their oil in international markets; this may be due to a lack of experience or rather from an absence of links with these markets. However, host countries under a system of state participation, would have the opportunity to acquire the required experience in doing so. The following is a closer examination of the events that led to a change of thinking in Saudi Arabia and neighbouring countries and which in turn led to the desire to increase their participation in the oil industries.

### ***4.3 The General Agreement on Participation***

#### **4.3.1 Background**

Before dealing with the General Agreement on Participation, we need first to outline the attitude of international companies holding a concession in OPEC member countries as well as the dramatic changes which favoured the oil producing countries that happened in the early 1970s.

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<sup>29</sup> See Hossain, K., *supra* note 17, p. 138.

In the late 1960s and the early 1970s, two events took place that would have a major impact on the oil industries of the oil producing countries. Firstly, in September 1969, Col. Gaddafi, the Libyan leader overthrew the former monarchy in Libya through a military coup – known as the ‘Green Revolution’. The new government under Gaddafi dealt swiftly with foreign oil companies operating in the country. The government required increases in the posted prices and threatened that if its requirements were not met, it would nationalise its oil industry.<sup>30</sup> The second important event was the Arab-Israeli War in 1973, which resulted in oil embargoes. Following the armistice in this war, in October 1973, oil ministers of OAPEC<sup>31</sup> held a meeting in Kuwait, which resulted in an embargo on oil shipments to the US and the Netherlands because these countries had supported Israel in the war.<sup>32</sup>

These two events resulted in significant changes in the structure of the relations between the oil companies and host countries, for example, Libya’s success in increasing its oil prices and the rate of income tax encouraged other OPEC countries to demand increases in oil posted prices and tax rates.<sup>33</sup> The oil companies resisted this sudden demand for participation by the host governments because they considered it as a threat to their rights as well as a breach of the concession agreements between them and their host countries. The oil companies argued that they owned the exclusive right to determine the oil price according to the terms of the agreements concerned. Per contra, the host countries argued that they had the sovereign rights to participate in the setting of oil prices because they owned the resources.

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<sup>30</sup> See Cattani, H., *The Law of Oil Concessions in the Middle East and North Africa*, New York: Oceana Publications, Inc., (1967). See also Karim, M., *Oil, Islamism and International Petroleum Industry Legal, Economic, Political and Cultural Issues*, LLM dissertation, University of Dundee, CEPMLP, (2001), Chapter 2.

<sup>31</sup> The Organisation of Arab Petroleum Exporting Countries.

<sup>32</sup> See Yergin, D., supra note 20, p. 606. See also Shihata, I., *The case for the Arab oil embargo: a legal analysis of Arab oil measures with the full text of relevant resolutions and communiqués*, Institute for Palestine Studies, (1975), p. 75.

<sup>33</sup> See Shihata, I., *Destination Embargo of Arab Oil: Its Legality Under International Law*, The American Journal of International Law, Vol. 68, No. 4, 591-627, (Oct., 1974).

In Saudi Arabia, the government insisted on its demand for participation. ARAMCO rejected that at first and suggested an alternative solution by offering 50 per cent government participation in the exploitation of undeveloped proven resources. However Saudi Arabia rejected this offer.<sup>34</sup>

As a result of the above events during 1960s and early 1970s, the OPEC countries were encouraged to participate in their oil industry in order to meet the difficulties which were facing them, such as the decline of oil prices, the domination of foreign oil companies over their petroleum resources and the diminution of their portion of profits. These events led to the oil producing country conference in Caracas, Venezuela in December 1970.<sup>35</sup> The conference passed resolution XXI.120, by which it instructed the member countries to:

- Raise income tax to the rate of 55 per cent.
- Introduce a uniform general increase in posted prices
- Eliminate all remaining discounts allowed to the concession-holders under the royalty regime.

#### **4.3.2 The agreement by the Gulf States to increase government participation**

The actions by the OPEC countries, highlighted in the previous paragraph very much influenced the rest of the Gulf States to change their relationships with the international oil companies. A meeting in Tehran between 13 oil companies and the six Gulf States (Abu Dhabi, Iran, Iraq, Kuwait, Qatar and Saudi Arabia) resulted in an agreement known as

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<sup>34</sup> Al-Samaan, Y., supra note 1, p.137.

<sup>35</sup> The OPEC countries met on 9 December 1970 at Caracas, Venezuela, in December where they agreed to raise the posted prices of Arabian Gulf oil and increase taxes on the oil. See the OPEC website at: <http://www.opec.org>. In 1970, Libya's leader, Gaddafi, used OPEC's influence to put pressure on the other independent Middle Eastern states by cutting its supplies and thus increasing the asking price per barrel. See Adelman M., *Is the Oil Shortage Real? Oil Companies As OPEC Tax-Collectors*, *Foreign Policy*, No. 9 (Winter, 1972-1973), pp. 69-107 (doc:10.2307/1148086).

“Tehran Agreement”. The agreement proposed an increase of the tax rate to 55 per cent and an increase of the posted prices as well as an adjustment mechanism for the period 1971-1975 in order to take into account world inflation. Because of global inflation and the devaluation of the American dollar, the countries of this agreement argued that it needed to be revised. Therefore, the countries started negotiating with oil companies to raise oil prices. However, oil prices rose dramatically as a result of the oil crises of 1973. The increase in oil prices was over 100 per cent in posted prices. From then on, oil prices have been fixed by the producing countries.

### **4.3.3 The positions taken by the Gulf States on participation in their oil industries**

The negotiations for state participation started in May 1972 between the Gulf country governments of Iraq, Iran, Kuwait, Abu Dhabi, Qatar, and Saudi Arabia on one side and the international oil companies (concessionaires) on the other.<sup>36</sup> The negotiations focused on the compensation to be paid by the countries to the oil companies in exchange for the introduction of state participation in the petroleum ventures. At first, the parties could not reach an agreement. During the negotiations and the formalisation of a draft agreement, major differences on the agreement arose between the Gulf countries which resulted in the withdrawal of Iran and Iraq from the negotiations in June 1972. Furthermore, Qatar did not agree with the method of determining the ‘buy-back price’ for government participation and started separate negotiations with its own concessionaires. Although the Kuwaiti Minister of Petroleum signed the agreement on 8<sup>th</sup> January 1973, the Kuwait National Assembly

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<sup>36</sup> See generally, Stevens, P., *National oil companies and international oil companies in the Middle East: Under the shadow of government and the resource nationalism cycle*, Journal of World Energy Law & Business, Vol. 1, No. 1, 5-30, (2008).

(parliament) refused to ratify it.<sup>37</sup> Abu Dhabi and Saudi Arabia on one side, and the oil companies investing in their territories on the other, reached a conclusion by signing the General Agreement on Participation in December 1972. The importance of these two agreements was their objective of the national oil companies of each country acquiring a 51% ownership by 1983. However, it was noted that this agreement included only general principles, which meant that it should be possible for each party to sign separately concluded complementary agreements with oil companies investing on its territory.

### **(i) The contents of the Agreement**

Generally speaking, this agreement was an attempt by the Gulf country governments to re-define the relationship between them and their international investors and to solve continuing controversial issues, which centred around the following:<sup>38</sup>

- ***The rate of participation:***

The countries in this agreement attempted to determine the rate of entitlement on the basis of their ownership over the petroleum resources. For this purpose, it was agreed on an initial 25 per cent which would increase gradually by 5 per cent within 10 years until it reached 51 per cent.

- ***Participation on ownership and management:***

The countries also attempted to obtain definable interests in the production of crude oil through the Agreement. The amount of these interests' was to be equivalent to the country's

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<sup>37</sup> Al-Sabah, Y., *The oil economy of Kuwait*, Routledge, (1980), pp. 20-31. The Kuwaiti Parliament refused to ratify this agreement on the grounds that it aimed at strengthening the position of the concession-holding companies, since it provided for minority and effective participation of 25%. In addition the opposition group in the Parliament argued that the duration of this agreement was excessive as it covered the entire remaining concession period which was due to expire in 2026 and demanded effective and immediate 51% participation. Arab Oil and Gas Magazine, Vol. II, No. 34, 16<sup>th</sup> (Feb., 1973), available at: <http://www.arab-oil-gas.com/index1.htm> visited 16/01/2009.

<sup>38</sup> For a detailed overview of investment in the petroleum sectors of the Gulf countries, see Gulf Organization for Industrial Consulting, Studies Department, *Study on Investment Climate in the GCC Countries for Attracting Direct Investment, Final Report*, (Sep. 2001).

percentage of participation. Additionally, the countries were awarded the right to participate effectively in the management of the operations.

○ *The method of compensation payment:*

It has been stated that the governments and companies did not, in the first instance, reach an agreement on the method of compensation. Later on it was agreed that compensation was due to the companies in return for the transfer of the ownership shares to the host countries.<sup>39</sup>

○ *Offtake Agreement:*

The Agreement obliged the countries to sell certain amounts of their portion of oil to the concessionaires in order to enable them to meet their previous commitments of oil supply. The agreement indicated that the payments should be made at agreed prices within the first three years of the agreement.

## **(ii) The implementation of the Agreement**

The agreement between the Gulf States dealt with conflicting issues and tried to solve them by revising some of the rights and obligations of the two parties under the existing agreements. This agreement obliged the two parties to share the production costs and risks. It also provided for the adherence to any previous agreements between them through Article 9 which states the following terms:

*“Each Gulf state and company or companies presently holding a concession agreement agree that all existing agreements between them in respect of such concession shall remain in full force and effect in accordance with their terms, the terms of this agreement and*

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<sup>39</sup> Ibid., p.182.

*applicable Implementing Agreement. Each state and the company or companies concerned shall cause all steps to be taken to perform their respect of the relevant concession”.*<sup>40</sup>

As already mentioned, the Arab-Israeli War in 1973 and the oil embargoes that followed it led to the unilateral determination of oil prices by OPEC countries and thus speeded up the process of nationalisation in some countries. Subsequently, these events empowered the Gulf countries in their bargaining position with the oil companies. They were able to enforce their control over their petroleum resources and reduce the domination of the oil companies through the imposition of state participation. Another factor that influenced the relationship between Gulf countries and the oil companies is that the latter feared that these states would follow the Mexican example<sup>41</sup> and nationalise the entire oil industry with little hope of compensation. The companies were in a position to choose between contractual modification and complete loss of the concession.<sup>42</sup> Therefore, companies were willing to renegotiate the old concessions and to form participation agreements which led to the eventual takeover of its oil enterprises in their countries and subsequently the collapse of the General Agreement on Participation.

Consequently, all subsequent agreements concluded after the 1973 Middle Eastern wars and the oil embargoes were notably different from the previous concessions and also that of the General Agreement on Participation. Hence, on June 5<sup>th</sup> 1974, Saudi Arabia agreed with ARAMCO to revise the General Agreement on Participation and to raise the State's

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<sup>40</sup> Ibid, p.183.

<sup>41</sup> In 1938 Mexico nationalised the entire oil industry and placed all of the mineral properties in a state-owned oil company, for more examination of the Mexican nationalisation see for example: Kielmas, M., *Oil Investment in Latin America*, in Walde, T., and Ndi, G. (eds.), International Oil and Gas Investment Moving Eastwards, London: Graham & Trotman, (1994), p.133.

<sup>42</sup> Anderson, R., *Fundamentals of the Petroleum Industry*, Norman: University of Oklahoma Press, (1984), p. 47.

participatory interest to 60 per cent.<sup>43</sup> In fact, the evolution of state participation in the Arabian Gulf Countries was that the process of state participation developed gradually from early 1960s towards the main objective of these countries which was the complete takeover of their enterprises from the hands of foreign investors by the end of the 1970s.<sup>44</sup> In Saudi Arabia the history of ARAMCO provides interesting insights into foreign company- host government relations in FDI.

## 4.4 ARAMCO

### 4.4.1 The Role of ARAMCO in the Exploitation of the Oil Resources of Saudi

The American petroleum companies played an important part in the exploitation of the petroleum resources of Saudi Arabia.<sup>45</sup> From these ventures, the Arabian American Oil Company (ARAMCO) was created.<sup>46</sup> However, the contribution of ARAMCO cannot be mentioned in isolation from the impacts of events such as the discovery of petroleum; the concession agreement of 1933; the discontent of government with the agreements; a fifty – fifty profit sharing formula; the shift in the relative bargaining power of the participants; the takeover of ARAMCO through the participation agreement. These will now be outlined in the following paragraphs.

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<sup>43</sup> A Study on Investment Climate in the GCC Countries for Attracting Direct Investment, supra note 38, p. 185.

<sup>44</sup> The initial call for participation among OPEC members was first raised by Saudi Arabia when it approached ARAMCO on the matter in 1963. Later on, Saudi Arabia took the whole subject of participation to OPEC in 1968; the concept of participation was put at the top of the agenda of most of the OPEC subsequent conferences. See Yamani, Z., *The Oil Industry in Transition*, Nat. Resources Law, 391-398 (1975), P. 394. Cited by Al-Samman, Supra note 5, p. 133. See also Zhiguo, G., supra note 15, p. 17.

<sup>45</sup> For a detailed history of ARAMCO see, ARAMCO Handbook, supra note 3. See also Al-Samaan, Y., supra note 1.

<sup>46</sup> For a historical background of ARAMCO in Saudi Arabia, see Wells, D., *ARAMCO: The Evolution of an Oil Concession*, in Mikesell, R., et al, Foreign Investment in the Petroleum and Mineral Industries: Case Studies of Investor-Host Country Relations, Baltimore: John Hopkins Press, (1971), pp.216- 236.

## 4.4.2 The Discovery of Oil in Saudi

Following the successful discoveries of oil in Iran in 1908 and Iraq in 1923 the Saudi government invited foreign investors to invest in the Kingdom's petroleum and mineral resources. At that stage the existence of Saudi's petroleum resources was mainly based on speculation.<sup>47</sup> The first concession was granted in 1923 to the British group Eastern and General Syndicate to explore the eastern province of the territory. The concession area was large and covered approximately 36,000 m<sup>2</sup>. However, no discovery was made and the concession was abandoned in 1927.<sup>48</sup>

The subsequent discovery of oil in Bahrain in 1931 increased the potential for oil discovery in Saudi. Subsequently, in 1933, the Saudi government granted the first concession award to an American Oil Company, namely, Standard Oil of California (SOCAL, now Chevron), to explore and produce oil in an area of 495,900 m<sup>2</sup>.<sup>49</sup> A few months after signing the agreement, there were positive results from the preliminary geological research of oil exploration work which showed encouraging signs of oil in the Jabal adh-Dhahran area.<sup>50</sup>

In 1938, the first oil discovery was made with the Dammam Well No. 7 in an area known as the Arab Formation. A year later in 1939, the first Saudi oil shipment was exported from Ras Tanura Port. Several discoveries followed. By 1999 there were 90 discovered fields (7 of them gas fields; 1 condensates, and the rest oil fields). Eighty-three of these fields are

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<sup>47</sup> See generally, Enav, P., *The Saudi Oil Dilemma*, London: Financial Times Energy, (2000); also Lackner, H., *A House Built on Sand: a political economy of Saudi Arabia*, Ithaca Press, (1978).

<sup>48</sup> The country and its king (Abdul Aziz) were facing many difficulties in generating the necessary funds to meet the country's increasing financial demands, particularly when the country was experiencing a decrease in the pilgrimage tariff after World War I, which was the main financial source for the country.

<sup>49</sup> See ARAMCO Handbook, *supra* note 3.

<sup>50</sup> *Ibid.*

located within the Saudi ARAMCO's concession area, and the remaining are in the Neutral Zone's partitioned area between Saudi Arabia and Kuwait.<sup>51</sup>

#### 4.4.3 The 1933 Concession Agreement

The old style concession agreement, as described above, dominated oil production in the Middle East between 1901 and 1972. The first successful agreement of this type in the area was the concession granted to the British company D'Arcy in 1901 by the Persian Government.<sup>52</sup> Traditional concession agreements worked largely to the advantage of the oil companies of the West and gave them a strong bargaining position to wield power over the host governments of the Middle East. They were in places where governments granted the concessionaires extensive rights, which later came to be regarded as unfair to the oil bearing countries, as these rights were so extensive that some commentators<sup>53</sup> have regarded it as amounting to the transfer of sovereignty.<sup>54</sup>

The concession agreement, whatever form it takes, constitutes the 'charter' or foundation document whereby the state grants to the international oil companies (IOCs) the governmental authority they need in order to conduct their operations in a lawful manner.<sup>55</sup> This was common in the old style concession agreements where managerial freedom was given to the IOCs in the development of their concession area.<sup>56</sup>

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<sup>51</sup> For a detailed overview of the historical background of the oil discoveries in Saudi Arabia, see the website of the Ministry of Petroleum and Mineral Resources at: <http://www.mopm.gov.sa> (October 2006).

<sup>52</sup> Stevens, P., supra note 10, p.1.

<sup>53</sup> See Sornarajah, M., *The Settlement of Foreign Investment Disputes*, London: Kluwer Law International, (2000), P. 44. See also Clove, A., *Oil Economics and Policy*, London: Kluwer Academic Publisher, (2000), p. 59.

<sup>54</sup> Al-Samaan, Y., *The Legal Security of Private Foreign Investment in the Kingdom of Saudi Arabia*, PhD thesis, University of Dundee, CEPMLP, (1993), pp. 11-12.

<sup>55</sup> Miller, P., *The Chain of LNG Project Contracts*, Greenwald, G., (eds), Liquefied Natural Gas, Developing & Financing International Energy Projects, Kluwer Law International, (1998), p. 138.

<sup>56</sup> Stevens, P., supra note 10, p. 4.

The 1933 Concession Agreement is widely regarded as the starting point of the legal regime for the exploitation and development of the petroleum resources of Saudi. The agreement was signed on 29 May 1933 by the Saudi government and the Standard Oil Company of California. The agreement was promulgated by Royal Decree No.1135.<sup>57</sup> The provisions formed the starting point for subsequent agreements. The concession defined the area, the duration of the concession, the payments to be made by the concessionaire to the government and the mutual rights and obligations of the parties.<sup>58</sup>

In 1934, the Standard Oil Company was joined by the Texas Company to form the 'The California Arabian Standard Oil Company'. Oil was discovered in 1938 and subsequently the California Company was compelled to share the concession with other companies which eventually led to a change in the name to the Arabian American Oil Company (ARAMCO).<sup>59</sup> The exclusive rights of ARAMCO under the 1933 Agreement were extended in 1948 when the government granted the Company an Offshore Agreement which covered the whole offshore area of Saudi.<sup>60</sup>

#### **4.4.4 Discontent of the Government with the Concession Agreements**

The weaknesses of the Concession which led to the discontent of the government were mainly the following: the Saudi government was still at an infant stage with large socio-economic demands to provide for its people, to alleviate poverty and to provide for

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<sup>57</sup> See Umm al-Qura, (official gazette in Saudi), 14 & 21 July 1933.

<sup>58</sup> Al-Samaan, Y., *The Legal Protection Of Foreign Investment In The Kingdom Of Saudi Arabia*, Dar Al-Andalus for Pub. & Dist. Hail: Saudi Arabia. (2000), p. 28.

<sup>59</sup> In 1948, the Standard oil Company of California, the Standard Oil accompany of New Jersey and the Texas Company each acquired 30% and Socony Mobil Oil Company 10% of ARAMCO. See Anderson, I., supra note 4, pp. 3-35.

<sup>60</sup> Royal Decree No. 6/5/4/3711 promulgated on the 1st day of Sha'aban, 1368, corresponding to the 28th of May, 1948. See also Al-Samaan, supra note 1, pp. 9-12.

education.<sup>61</sup> Therefore, government was in urgent need to receive the petroleum investment funds.<sup>62</sup> This weakness of the Saudi government was soon realised by the American oil companies, which exploited that position.<sup>63</sup> The government did not have a clear negotiation strategy, there was no legislation for regulating the exploration and development of petroleum resources, and some very important terms and conditions were not included in the agreement. These related to minimum expenditure, government participation interest in the decision making process, company obligations to submit geological data to government, company obligations to reinvest part of the investment returns in the country, determination of crude oil production and price and the observation of conservation of petroleum resources.<sup>64</sup>

Additionally, the company was given absolute discretion over the direction of the exploitation of the petroleum resources.<sup>65</sup> In the terms of the Agreement, the company also enjoyed an exclusive right to be exempted from all taxes; and the exclusive right to explore and exploit the Eastern Province for the duration of 60 years. It also had the exclusive right to export and sell petroleum and their products.<sup>66</sup>

However, this picture was to change with the unfolding of international events. In the 1940s external events contributed to the strengthening of the bargaining power of the developing countries in the international oil industry. These events include the Second World

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<sup>61</sup> See Enay, P., *The Saudi Oil Dilemma*, London: Financial Times Energy, 2000; These problems are still an issue in modern Saudi See also McNulty, C., *An Evaluation of Saudi Arabia's Policies for Economic Diversification*, Unpublished Masters Thesis, University of Durham, (1984) for an examination of the policies for economic diversification which came about because of the first major oil price rise in the early 1970s.

<sup>62</sup> Ibid. See also SAGIA, *The Legal Background to Foreign Investment in Saudi Arabia*, Saudi Arabia General Investment Authority (2003).

<sup>63</sup> Moneys paid to the Saudi government included a bonus of 30000 pounds of gold, that was paid at the signing, an advance payment of 50000 pounds gold and annual surface fees of 5000 pounds gold.

<sup>64</sup> See Al-Samaan, Y., *supra* note 1, p. 7.

<sup>65</sup> Saudi Arabia Information Resource at <http://www.saudinf.com/main/e111.htm> (05/12/06).

<sup>66</sup> See Ministry of Petroleum and Mineral Resources at: <http://www.mopm.gov.sa> (23/12/06).

War, the emergence of the new participants in the industry<sup>67</sup> and importantly the introduction of a 50% income tax on foreign oil companies by the Venezuelan government. Furthermore, the Saudi government was also influenced by the high royalty that was offered by the Getty Oil Company for a concession in the Neutral Zone shared with Kuwait and Iraq. The high profit sharing offered was one eighth of the company's production profits and one quarter of its refinery profits. Consequently, the government perceived that ARAMCO should offer more than that.<sup>68</sup>

In view of these international developments, the discontent of the Saudi government became obvious when they demanded in the early 1950's a 50% share of the profits from ARAMCO, through a new profit sharing formula. This strategy was executed with the introduction of new types of joint venture agreements. The Saudi government demanded firstly a 25% share to participate in the decision making process of the operations of ARAMCO. These events led to a Saudi government demand for ARAMCO to increase its oil revenues and a protest against the high tax imposed by the USA on ARAMCO. On 30 December 1950 the government and ARAMCO concluded the Profit Sharing Agreement whereby it subjected the company to a 50% tax and cancelled the original tax exemption clause of the 1933 Agreement which was imposed unilaterally by the oil company.<sup>69</sup> This profit sharing arrangement was the first step by the government to exert its sovereignty over

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<sup>67</sup> In 1957 a number of small companies known as the "independents" emerged from the USA and some major consuming countries. These companies changed the overall situation so that the "Seven Sisters" bargaining power was in decline as they faced increased competition from the "independents". See Mikesell, R., *Petroleum Company Operations and Agreements in the Developing Countries*, Washington D.C: John Hopkins University Press, (1984), pp. 23-24.

<sup>68</sup> See *ARAMCO v Saudi Arabia [August 23, 1958]*, *International Law Report*, 27 (1963), p.117. For detail see Alsharif N., *Enforcement of Foreign Arbitral Awards in Saudi Arabia: Grounds for Refusal Under Article (V) of the New York Convention of 1958*, University of Dundee, PhD Thesis, (2000), pp. 85-88. See also Al-Saman, Y., *Evolution of the Contractual Relationship between Saudi Arabia and ARAMCO*, *Journal of Energy & Natural Resources Law*, Vol. 12, No. 2, (May 1994), pp. 257-258.

<sup>69</sup> The royalty provisions in the Middle Eastern concessions granted in the 1930s were unfavourable to the governments. The concessions provided for a royalty calculated as a flat rate per ton of oil rather than as a percentage of the value of the sale price of production. For instance, in the concession granted by Saudi Arabia the royalty was set at four shilling per ton. See Blinn, K., Duval, C., Le Leuch, H., and Pertuzio, A., *supra* note 18, p. 57.

the petroleum resources of the country and to redress the balance of the one sided 1933 Concession Agreement.

Article I of this agreement provided that:

*“In no case shall the total of income tax and all other taxes, royalties, rentals and exaction of the government for any year exceed 50 per cent of the company’s gross income after such gross income had been reduced by ARAMCO’s costs of operations, including loss and depreciation, but not reduced by taxes, royalties or exaction”.*<sup>70</sup>

It is widely accepted that despite the improvement of the financial terms of the agreement, the Saudi government was still not in control of its own oil industry and could therefore not direct the much needed investment to the economic and industrial development of the country.<sup>71</sup> During the 1960s, the OPEC member States including Iran, Iraq and Libya restructured their original concessions and gained complete control over their petroleum resources through a campaign of nationalisations. Despite this, Saudi still preferred to participate rather than to nationalise its oil industry because of the realisation that they did not have the technical know-how, and the fear of having to compete with other countries that had by then already nationalised their oil sectors.<sup>72</sup>

In June 1974 the Saudi government agreed with ARAMCO to increase the government’s share to 60% with their intention to fully takeover the company. This was followed by the government’s demand of the acquisition of the remaining 40% of ARAMCO’s producing assets. In 1980 the government acquired 100% ownership of

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<sup>70</sup> Al-Samaan, supra note 7, p.30.

<sup>71</sup> Al-Samaan, supra note 54, p.19.

<sup>72</sup> See Bunter, M., *An Introduction to Islamic (Shari’a) law and to its effect on the upstream petroleum sector*, CEPMLP., (2003), pp. 23-24; see also Al- Samman, Y., supra note 67.

ARAMCO's which resulted from participation agreement mentioned earlier and purchasing almost all of the company's assets. However ARAMCO continued to operate and manage certain phases of the oil operations on behalf of Saudi ARAMCO under a service contract. In 1989, ARAMCO was converted into the national oil company of Saudi Arabia under the name Saudi ARAMCO.<sup>73</sup> Saudi ARAMCO is fully owned by the government, it is regarded as an autonomous legal body, with full financial responsibility.<sup>74</sup> However, the supreme decision making authority is the SPMC under the chairmanship of the President of the Council of Ministers (the King) with ten members appointed by Royal Decree.<sup>75</sup> The Council is responsible for the determination of the general policy of the company, the endorsement of the 5 year business plan, programmes for oil production, exploration and development, and 5 year capital investment plans. The Council is assisted by the Board of Directors, under the chairmanship of the Minister of Petroleum and Minerals resources, with 8 members also appointed by Royal Order for 3 years. The Board is responsible for the day to day management of the company on a purely commercial basis. The Ministry of Petroleum and Mineral Resources is responsible for the supervision of the Company and to ensure that the Company carries out its operations in accordance with government policy, and in line with the regulations on the conservation of petroleum resources in the country.<sup>76</sup>

#### **4.4.5 The Petroleum Policy of Saudi Arabia**

In summary, government petroleum policy is mainly based on the following important aspect: Saudi is the world's largest oil producer, exporter and reserve holder in the world oil

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<sup>73</sup> See ARAMCO Website at [www.Saudiaramco.com](http://www.Saudiaramco.com) and also Ministry of Petroleum and Mineral Resources at: <http://www.mopm.gov.sa> (23/12/06).

<sup>74</sup> Ibid.

<sup>75</sup> The Supreme Petroleum and Mineral Affairs Council (SPMC) was established in January, 2000, by Royal decree by King Abdullah. The new body will be the ultimate decision-maker over future downstream joint ventures with foreign companies - a development the kingdom is eager to pursue. These projects include transforming gas in value-added industries such as power, desalinated water, and petrochemicals, as well as refining technology, lube-oil production. See <http://www.saudinf.com/main/c551.htm> (10/6/05).

<sup>76</sup> See Saudi ARAMCO website at <http://www.saudiaramco.com>.

market. This situation underlines the long-term objectives of the government's oil policy. Furthermore, the oil sector accounts for one third of the gross national product and two thirds of government revenues.<sup>77</sup> Oil policy is geared towards stabilising the revenues from oil over time, for the sustained development of the Saudi economy. Therefore, the cornerstone of Saudi Arabia's oil policy is stability in the international oil market in the interests of the oil producers and consumers and the healthy growth of the world economy. Thus, the Petroleum Policy developed by the Ministry of Petroleum, is based on the following aspects: stability in the international oil market, cooperation with the oil producers and consumers, ensuring continued growth in world oil demand in line with world economic growth, the building of an efficient, integrated and competitive national oil industry and the establishment of channels of communication and dialogue with concerned countries and industries, on energy, environment and technology issues.<sup>78</sup>

## Conclusion

It is beyond question that OPEC member countries played a major role in the process of nationalisation of their oil enterprises during the late sixties and seventies. In this process, like the rest of the OPEC countries, Saudi also played a prominent role, with the ultimate goal of exerting its sovereignty over its natural resources in order to control both the rate of production and prices.

As far as early concession agreements are concerned, they represented an obvious exploitation of public resources of the host state, as they placed the concessionaire on a footing higher than that of the host government. Therefore, Muslim oil producing countries

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<sup>77</sup> For updated information on the national economy see World Bank website at: <http://devdata.worldbank.org/external/CPProfile.asp?CCODE=SAU&PTYPE=CP>. See also the contribution of oil to the national economy of Saudi Arabia at the OPEC website: <http://www.opec.org/aboutus/member%20countries/sArabia.htm> (12/12/06).

<sup>78</sup> See policy on Ministry of Petroleum and Mineral Resources website at: <http://www.mopm.gov.sa/index.htm>

considered concession contracts for the exploitation of their natural resources as “an encroachment on national sovereignty and an instrument of foreign domination over their national economic development.”<sup>79</sup> Accordingly, such agreements have been gradually terminated by the Saudi government and many other Muslim countries, particularly with the rise of the power of OPEC in 1960, and have been replaced by exploitation by state-owned petroleum companies, often with technical assistance from or in a joint venture with international petroleum companies. Saudi Arabia preferred to gradually nationalise ARAMCO through the method of state-participation rather than outright nationalisation as had occurred in Libya. The question arises as to why Saudi Arabia did not nationalise ARAMCO from the start but instead opted for a gradual process through state participation? The following reasons could be offered for this approach:

First, as stated earlier in this chapter, it would conflict with the way of Saudi thinking about their economic and political systems. Secondly, Saudi Arabia tried not to upset its strong relationship with the US and other foreign investors. Thirdly, Saudi Arabia lacked the necessary capital and technical know-how. Fourthly, it was concerned that the concession-holders might increase off take from non-nationalised sources of oil as a retaliatory action against nationalising countries, as these companies did in the case of Iranian nationalisation from 1951-54 and in other instances later on. Finally, Saudi Arabia was concerned that nationalisation might lead to a competitive production race among the producing countries, which could cause the erosion of crude oil prices, which consequently would cause political and financial instability to such country.<sup>80</sup>

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<sup>79</sup> Walde, T., *Methods of Mineral Investment Promotion*, Foreign Investment Law Review (ICSID Review) (1991), p.1. See also Al-Samman Y, supra note 67, p. 257.

<sup>80</sup> See Cordesman, A., *Economics, Energy and the Future Stability of Saudi Arabia*, Strategic Energy Initiative, Washington DC: Centre for Strategic and International Studies, (1999). See also *Aramco v Saudi Arabia* supra note 67, p.117. See also Al-Saman Y., supra note 67.

This chapter has provided a historical account of foreign investment in the oil industry of Saudi Arabia. Before a closer examination of the protection of foreign investment in Saudi, the next chapter will examine the general legal framework in which such protection occurs. It will address some of the pertinent issues relating to Islamic law and foreign investment in Saudi Arabia. It will also briefly highlight the importance of international law in relation to the treatment of foreign investment as well as Saudi Arabia. The next chapter deals with the legal system of Saudi Arabia which is governed by Shari'a and supplemented by a variety of statutes and regulations promulgated by the government.

## **(5) PROTECTION OF FOREIGN INVESTMENT**

### **Introduction**

In order to attract foreign investors, measures have been taken by host countries, particularly developing states, to offer legal guarantees for foreign investments. Most of these countries sought to achieve this objective by unilateral means, i.e. by providing equitable treatment and security for foreign investments in their legal systems and foreign investment laws. However, due to the fact that the host state can unilaterally modify its national laws, there is a view among foreign investors that the guarantees and assurances provided by such instruments are of limited value. Thus a number of developed and developing states sought to offer foreign investors effective legal protection by concluding multilateral and bilateral treaties on the promotion and protection of foreign investment.

The main objective of this chapter is to examine the protection of foreign investment under Saudi national law, Islamic law and international law. Efforts are made to highlight the protection of foreign investments under Saudi domestic law and to demonstrate whether the guarantees provided are sufficient to secure foreign investment. Since Islamic law is the main source of Saudi law its principles concerning the protection of foreign investment will be reviewed first. Later, the discussion will focus on the protection of foreign investment under international law. This chapter will also explore the issue of bilateral and multilateral investment treaties and organisations which are becoming increasingly important mechanisms to impose rights and obligations on both the foreign investors and government.

## ***5.1 The rationale for the protection of foreign investment***

Generally, the host state has the sovereign right to control all aspects of any foreign investment inside the territorial boundaries of the country.<sup>1</sup> It is because of this exclusive right of the host state that foreign investors want more protection against any non-commercial risks. These include nationalisation, restriction on repatriation of profits, and the modification of domestic laws that may interfere with investment which leads to a fundamental increase in financial burdens. Additionally, this could include an increase in taxation or sudden and unplanned development for other onerous regulatory requirements such as new or changed environmental controls.

Despite how attractive the locational advantages offered by a host country might be, an investor will balk at a foreign investment decision if the host country does not offer adequate legal security and stability that for investment. There are however no absolute or universal standards of investment framework adequacy; it is always a question of what will satisfy a particular investor in a particular case. A foreign investor will first evaluate the potential for commercial and financial gain and, after that, weigh up that potential against the risks, including the political risks, prevailing in the host country. If the host country risks include significant elements of legal risk, the foreign investor will be faced with a classical dilemma: either to forego the opportunity or proceed with the investment under legal conditions which are less than adequate. Only the bravest foreign investor will invest in a country with a legal system which offers no constitutional or legislative safeguards for investment.<sup>2</sup>

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<sup>1</sup> For most developing countries, this right of the host state originates from the post-colonial period after the dissolution of the empires. See for example, Sornarajah. M., *The International Law on Foreign Investment*, Cambridge University Press, 2004, pp.22-30.

<sup>2</sup> Flint, D., and others (eds.), *Constitutional and Legislative Safeguards for FDI, Economic Development, Foreign Investment and the Law*, Kluwer Law International, (1996), p. 103.

Foreign investors also demand the provision of adequate and impartial investment dispute settlement provisions and mechanisms in case their rights are infringed by the host state. Consequently, it is now the trend in capital importing countries to adopt measures that would offer some guarantees to the foreign investor. Hence, most developing countries have now, through unilateral means, provided for equitable treatment and protection of foreign investment in their national constitutions, foreign investment laws and government policy instruments. Some of the capital exporting and importing countries have gone further and concluded multilateral and bilateral agreements to promote and protect the foreign investment.

## ***5.2 Protection of Foreign Investment under Saudi Law***

Usually, assurance and guarantees against expropriation, nationalisation and similar measures promised unilaterally by the state to foreign investors are found in constitutional clauses, items of legislation and official policy statements. The purpose of these devices is to confirm the desire of the government to protect foreign investment against arbitrary measures.<sup>3</sup>

The degree of security provided by investment laws is, however, not uniform and there are a number of factors which determine the extent of any guarantee provided by such laws. Among these factors are the degree of requirement for foreign capital, the endowment of certain types of natural resources and the prospective profitability of investment. For instance, if a country is in urgent need of foreign capital, it usually seeks to provide all guarantees required by foreign investors in order to attract them to invest in its territory. In contrast, a country which has sufficient financial resources and whose principal aim in

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<sup>3</sup> El Sheikh, F., *The legal regime of foreign private investment in Sudan and Saudi Arabia*, 2<sup>nd</sup> ed. Cambridge University Press, (2004), pp. 114-115.

attracting foreign investment consists of its desire to obtain foreign technology and expertise usually pays less attention to providing all the guarantees desired by the foreign investors.<sup>4</sup>

In the light of previous discussions, the Foreign Capital Investment Code (FCIC) issued in 1979 is a mechanism that regulates foreign investment in Saudi Arabia. The FCIC has been specially introduced to provide a set of guarantees and incentives for foreign investors wishing to invest in the country. However, the FCIC has been criticised in that it fails to offer foreign investors adequate guarantees against potential arbitrary measures taken by the government, and to assure them their right to freely transfer their investment capitals and earnings to their home countries. The FCIC lacks the provision of a defined standard of treatment of foreign investment and a means of resolving investment related disputes. These issues are regarded as being of the utmost importance by foreign investors.

The FCIC is not yet delivering on previously settled government policy. In 1974, the government adopted the Basic Principles of Industrial Policy whereby foreign investment was encouraged with the transfer of technical know-how, and the government also gave an undertaking not to impose any restrictions on the entry and repatriation of foreign capital.<sup>5</sup>

Consequently, in the year 2000 the government established the Saudi Arabian Government Investment Authority (SAGIA)<sup>6</sup> to provide information and assistance to foreign investors. The Authority operates under the umbrella of the SEC and is headed by a Governor. SAGIA's duties include formulating government policies regarding investment activities; proposing plans and regulations to enhance the investment climate in the country;

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<sup>4</sup> Y. Al Samaan, Y., *The Legal Protection of Foreign Investment in Saudi Arabia*, Hail: Dar Al Andalus for Pub. & Dist., (2000), p 53.

<sup>5</sup> See Saudi Consulting House, *Guide to Industrial Investment*, (1986), pp.53-63.

<sup>6</sup> Royal Decree No. M1 dated 5/1/1421H, (April 10, 2000).

and evaluating and licensing investment proposals. All foreign investment projects must obtain a license from SAGIA before they can operate in the country. Local investors continue to apply to the Ministry of Commerce and the industry's foreign capital investment committee for licenses.<sup>7</sup> In order to encourage foreign investment with a view to strengthening the non-oil sector, the Saudi government began revising its 30 years old FCIC to make the country more attractive to foreign investors and at the same time simplify procedures. With this in mind, recent changes to improve the foreign investment climate in the country include:<sup>8</sup>

- Review of the old Foreign Investment Law to allow for *inter alia* granting to foreign investors the same rights as are offered to Saudi nationals.
- Review of the old Income Tax Law to now impose lower taxes on foreign business profits in gas investment from 45% to 30% in order to provide greater legal incentives.<sup>9</sup>
- Also, Saudi Arabia is undertaking significant efforts to improve its legal environment. New laws such as the Banking Control Law and recent amendments<sup>10</sup> and the insurance regulations<sup>11</sup> are expected to make the investment environment more attractive to foreign capital.<sup>12</sup>

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<sup>7</sup> For more information on SAGIA see: [www.sagia.gov.sa](http://www.sagia.gov.sa) and for overview of the investment climate in Saudi Arabia see: [www.state.gov/e/eb/fdi/2005/43038.htm](http://www.state.gov/e/eb/fdi/2005/43038.htm) 13/03/2008.

<sup>8</sup> For details on the promotion of foreign investment in Saudi Arabia see Saudi Commerce and Economic Review, *Foreign Investors: New Taxation System for Natural Gas, New Business Horizons*, No. 121, (May 2004) pp. 10-12.

<sup>9</sup> Arab news, [www.arab.net/sa\\_shariabiz.htm](http://www.arab.net/sa_shariabiz.htm) 16/03/2008. It is interesting to note that, due to the high revenues that it receives from oil production, the Saudi government is much less dependent than most countries on taxes in order to carry out its functions. For more discussion on tax systems and incentives see chapter 6 infra.

<sup>10</sup> The Banking Control Law, instated in 11<sup>th</sup> June 1966 by Royal Decree No. M/5. The Law established the groundwork of banking regulations; it has been expanded upon a number of times since it was enacted. More information available at: <http://www.sama.gov.sa/en/control/procedure/cofmbldr> accessed on 17/01/2009.

<sup>11</sup> The Law on Supervision of Corporative Insurance Companies, issued on 31<sup>st</sup> July 2003. The Law draft is available at: <http://www.sama.gov.sa/en/control/procedure/Insurance-Law.pdf> accessed on 17/01/2009. It should be noted that the Law allows foreign investors to own up to 49% of insurance companies. However, on April 13,

The changes<sup>13</sup> introduced by new legislation also include the removal of the requirement that foreign investors take local partners, allowing foreigners to own property and to sponsor their foreign employees and to invest in any sector not included in the 'negative list'.<sup>14</sup> Finally, some of the recent incentives introduced by the government include the adoption of a new Corporate Tax Law which lowered the 2003/4 Corporate Tax rate to a flat rate of 20%.<sup>15</sup> A further development to attract more foreign investment is the creation of new Exploration and Development agreements applicable in the development of four contract areas in the Rub Al Khali region.<sup>16</sup>

All investments and businesses pose a degree of risk<sup>17</sup>. Some of the main risks are those which are political in nature, whether caused by a political decision or an indirect action that affects the political situation and subsequently affects the investment. Political risk can result either from government action or a lack of it and can be considered part of a country's risk analysis by foreign investors.<sup>18</sup> In other words, political risks are risks which are unrelated to the nature of petroleum exploration itself, but arise from the possibility of future change in the political and socio-economic conditions in the country where the venture is undertaken.<sup>19</sup> However, some authors see political risks as "random events as in natural catastrophe

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2005, Royal Decree No. 3120/MB allowed foreign insurance companies to operate in Saudi Arabia through direct branches, which are not subject to the requirements of public ownership and cooperative form.

<sup>12</sup> For detailed analysis of the Legal Tax reforms see Mazzanti, M., *Saudi Gas Supplies and Investment Taxation Legislation*, *OGEL*, Vol. 2 – issue 1, (February, 2004), [www.gasoil.com/ogel](http://www.gasoil.com/ogel).

<sup>13</sup> For more discussion see chapter 6 on legal incentives, *infra*.

<sup>14</sup> See Saudi Arabian General Investment Authority (SAGIA) negative list for activities excluded from foreign investment at [www.sagia.gov.sa](http://www.sagia.gov.sa) 17/03/2008

<sup>15</sup> See the new Tax Law at [www.sagia.gov.sa/](http://www.sagia.gov.sa/) 07/03/2008 for an overview of the taxation regime see Saudi Commerce and Economic Review, *supra* note 7, p. 10-12; also see Mazzanti, *supra* note 11.

<sup>16</sup> See Saudi Commerce and Economic Review, *Gas Projects: 1<sup>st</sup> Saudi International Gas Conference*, pp. 24-27; and *Future of Natural Resources in Saudi Arabia*, pp. 28-35.

<sup>17</sup> For more discussion on the distinction between risk and uncertainty see Knight, F., *Risk, Uncertainty and Profit*, Boston: Houghton, (1921).

<sup>18</sup> Vinter, G., *Project Finance*, 2<sup>nd</sup> ed., Sweet & Maxwell. (1997), p. 187.

<sup>19</sup> Zakariya, H., *Political Risk Insurance in Petroleum Investment* in Beredjeck, N., and T. Walde, (eds.), *Petroleum Investment Policies in Developing Countries*, Graham & Trotman, (1988), p.206.

risks”.<sup>20</sup> Following this approach the probability of the host state taking measures to the detriment of the investor cannot be influenced, foreseen, measured or cost for by the host government or the investor. On the contrary, others interpret political risks as the result of an implicit or actual bargaining process between the host government and the investor, and therefore see such measures as policy instruments used by the host state in a rational manner to achieve certain goals.

In relation to the former, governments have a great role in managing political risks and can reduce their effects. These risks can reduce a state’s attractiveness to foreign investment in as much as it can affect the investor’s ability to conduct business there. Political risks can range from a project company not being able to pay interest on its loans or pay dividends because the host government imposes restrictions on the remittance abroad of foreign currency, to the collapse of the host state’s banking system caused by civil war or other hostilities.<sup>21</sup> One of the “nightmare scenarios” is the violent overthrow of the government of the host state and its replacement by another government that does not feel bound by the former government’s commitments.<sup>22</sup> In fact, frequent changes of regimes in developing countries increase these risks.<sup>23</sup> Political risks can also take the form of nationalisation or expropriation or revocation of approval and licenses, or be focused on the performance of foreign counter-guarantees in favour of the institutions. The other is to lengthen the short

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<sup>20</sup> Protopsaltis, P., *Multilateral Investment Guarantee Agency*, Blanpain R., and others, (eds.) *International Encyclopaedia of Law – Intergovernmental Organisation: Supplement 18 Multilateral Investment Guarantee Agency*, (Part 1), Kluwer Law International, (2005) p. 15. See also S. Sinn, *Second Thoughts on MIGA* 21 *Intereconomics*, (1986), p.271.

<sup>21</sup> Saudi Consulting House, *supra* note 5, p 187.

<sup>22</sup> See Hollis S. and Berresford, J. *Structuring Legal relationships in Oil and Gas Exploration and Development in ‘Frontier’ Countries*, in Walde, T., and K. Ndi (eds.), *International Oil and Gas Investment*, Graham & Tortment, (1994), p. 44.

<sup>23</sup> The new Indonesian government sought revision of multi-million dollar contracts concluded by the Suharto regime on grounds of corruption and improper procedure in awarding some of those contracts. See the Economist Magazine, Jan. 8<sup>th</sup> 1997, p. 74.

maturities of commercial loans by guaranteeing later maturity or by way of guaranteeing foreign exchange liquidity.<sup>24</sup>

### 5.2.1 Typical political risks include:

- **Regulatory Risk:** If host government legislation imposes high barriers to entry in terms of initial capital requirements or regulatory costs so that the necessary approvals will not be secured without making huge investment, then it becomes difficult for the project to go ahead. This could be necessitated by an environmental requirement<sup>25</sup> for instance. Similarly, future environmental standards can be increased at the expense of the project, making for increased operating and capital cost.<sup>26</sup>
- **Contract Enforceability:** Host government legislation could be weak or have no provision for enforcing contracts, thereby prejudicing the rights protected in the contracts.<sup>27</sup>
- **Political Violence:** Includes war, civil unrest, terrorism and sabotage. These are risks arising from events which are beyond the control of the parties. These risks also include national disasters, strikes and political insurrection; some of these events are considered *force majeure* risks.<sup>28</sup>
- **Nationalisation/Expropriation:** This involves the requisition and freezing of project company assets by the host government which affects the activities of the project. It can also include discriminatory taxation, also referred to as 'regulatory take' which changes a profitable enterprise into a loss making one. Another aspect could be the

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<sup>24</sup> Greenwald, B., *Liquefied Natural Gas, Developing and Financial International Energy Projects*, The Hague: Kluwer Law International, (1998) pp. 254 & 291.

<sup>25</sup> *Ibid*, p 297.

<sup>26</sup> Stickley, D., *Natural Gas Contracts Negotiation & Management*, CEPMLP, (Sep. 2001), p 20.

<sup>27</sup> Hossain, K., *Law and Policy in Petroleum Development*, London: Frances Printer Ltd, (1979) p. 70.

<sup>28</sup> Teolis, J., *Issues in Project Finance*, in Economic Development, Foreign Investment and the Law, London: Kluwer Law Int., (1996), p. 206.

unjustified cancelation of permits/licences or the refusal to renew them (e.g. import export licences), or even refusing to give consent to start a project.

- **Transfer Risk:** This occurs when the project company is unable to obtain the required amounts of foreign currency and remit them offshore due to the imposition of exchange<sup>29</sup> controls or due to action taken by the host government.<sup>30</sup>

As stated earlier, the management of political risk is mainly the responsibility of the host government. Middle Eastern States more than ever before have become a cause for concern, particularly in the aftermath of the September 11 terrorist attacks, which were linked to the Middle East and made the perception of political risks even higher. It is easy to see how, as a consequence of these activities, Saudi Arabia's risk rating might have been heightened.<sup>31</sup> As will be discussed later in this chapter, Saudi Arabia has done much to minimise the perception of political risk by foreign investors at both international and national level.

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<sup>29</sup> Saudi Arabia maintains no exchange restrictions and imposes no trade restrictions for balance-of-payments reasons. The exchange rate policy of the Kingdom has for a long time been geared to maintaining a stable relationship with the U.S. dollar, which is the intervention currency. The exchange rate of the Riyal has been maintained at SAR 3.75 to the dollar since 1986. This created a stable exchange rate environment for the private sector and has also been conducive to foreign investment.

<sup>30</sup> Vinter, G., supra note 17, p. 18.

<sup>31</sup> For more detailed assessments and analysis of the impact and effects of the September 11 terrorist attacks, see Moran, H., (eds.) *International Political Management – The Brave New World*, Washington DC: International Bank for Reconstruction and Development, (2004). For the Saudi stand on September 11 and other terrorism activities, see for example, the report in *Iqtisadyah* (The economist) (Arabic newspaper) from 9 February, 2005 (Issue No. 4136), on the joint efforts Saudi ARAMCO and others Saudi government agencies made in holding public enlightenment programmes and international conferences to prevent and combat terrorism. The campaign was jointly sponsored by the Ministry for Religious Affairs and also involved universities in the country. See also Petroleum Intelligence Weekly Vol. XLIII, No. 19 from 10<sup>th</sup> May, 2004 at: [www.energyintel.com](http://www.energyintel.com), p. 9 where Saudi Foreign Minister Mr. Al Faisal “vowed to strike hard at this deviant group in order to uproot this wicked disease from the body of our nation”. He made the remarks as a result of the terrorist attack in the industrial city of Yanbu that killed five foreign employees of ABB Lummus, a US Engineering arm of Swiss-Swedish firm ABB. ABB were working at the Yanbu petrochemical plant jointly owned by Exxon Mobil and Saudi Sabic. See also a similar report by Energy Compass (Energy Intelligence) Vol. No. 19, May 17, 2004 p.4. This campaign was also backed by the Muslim World League as evidenced by a recent publication by its Secretariat General: *The Muslim World League's Position towards Terrorism* 2005. This publication defined terrorism and condemned in totality all acts of terrorism as perpetrated on September 11, 2001 and disassociated the Saudi Government from all those dastardly acts.

Despite the fact that policy statements are accepted as an expression of good faith which reassures foreign investors, they are, as observed by Nwogugu,<sup>32</sup> merely public statements which are not legally binding. Thus, in order for such policy statements to be of real value in the strict protection of foreign investment, they must be incorporated in municipal law or investment contracts. In this case the host government will consider itself more obligated by such incorporations, and national courts will consider them more readily enforceable than policy statements.

The introduction of the 1992 Basic Law confirmed the protection of private property owned by nationals and foreigners. This included a guarantee of the inviolability of private ownership.<sup>33</sup> Private property cannot be expropriated or nationalised except for public purposes and on the payment of just compensation, and there is to be no public confiscation of private property as a penalty but only after a court judgment.<sup>34</sup> The Basic Law thus provides the foreign investor with a legitimate avenue to challenge, in the national courts, the legality of any government action which adversely affects the investment.<sup>35</sup>

### ***5.3 Protection of Foreign Investment under Islamic Law.***

According to the concept of '*Aman*' (safe passage in the Islamic Shari'a which is given to non-Muslim residents) foreign investors are entitled to the same protection as nationals.<sup>36</sup> The position of Shari'a is of great significance to the protection of property rights. Islamic

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<sup>32</sup> Nwogugu, E., *The legal Problems of Foreign Investment in Developing Countries*, Ocean Publications Inc, (1965), p. 55, cited in Al Samaan Y., supra note 4, p. 56.

<sup>33</sup> Basic Law Article 18 stipulates that: "The State shall guarantee private ownership and its sanctity. No-one shall be deprived of his private property, unless in service of the public interest. In this case, a fair compensation shall be given to him".

<sup>34</sup> Ibid, Article 18 provides that: "General confiscation of assets is prohibited. No confiscation of an individual's assets shall be enforced without a judicial ruling".

<sup>35</sup> Al Samaan, supra note 4 p. 56.

<sup>36</sup> This kind of protection is known as "*Dhimmi*". Literally, this doctrine is a sort of obligation or contract imposed upon a Muslim state to protect and secure its non-Muslim citizens or residents. Prophet Mohammed (pbuh) said: "He who hurts a *dhimmi* hurts me, and he who hurts me annoys Allah", Reported by al-Tabarani.

Shari'a provides for the respect and inviolability of private property.<sup>37</sup> The *Quran* states "O 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"<sup>38</sup> It means that no-one is allowed to take another's property without legal cause. This principle of the inviolability of private property is confirmed in Islamic writings. These writings emphasise the duty of the state to respect private property, and that private property rights are sacred under Shari'a Law. Therefore any infringement is a trespass against the law and a sin against religion.<sup>39</sup> The inviolability of private property has been also asserted in the teaching of jurists in schools of Islamic jurisprudence. For instance, *Ibn Taimyya*, the eminent *Hanbali*<sup>40</sup> jurist, whose teachings have had a great influence on the legal institutions in Saudi Arabia, is reported as saying "the first duty of the state is scrupulously to respect private property".<sup>41</sup>

As mentioned above, the two limits to the right of private ownership are expropriation for public purposes against the payment of a just compensation and the execution of a judgment against a debtor's property. Islamic Shari'a allows for expropriation on the basis of payment of fair compensation. Thus, it can be taken that Saudi has followed this principle on the strict basis as provided in the Islamic Shari'a. The reason for following this principle is because it is regarded as compensation not interest (*Riba*) on overdue payments, which is prohibited in Islamic law. Therefore, foreign investors are usually advised to include in their investment contracts a clause providing for payment of liquidated damages or time penalties in case of delay.<sup>42</sup>

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<sup>37</sup> The notion of property can be said to cover both tangible and intangible assets. For more examinations on property ownership protection under Islamic law Shari'a, see chapter 2, *supra*.

<sup>38</sup> Chapter VI, Verse 29.

<sup>39</sup> See for example, Saba, H., *Property, Right and Contract in Muslim Law*, 62 *Columbia Law Review*, 450 (1962), p.458.

<sup>40</sup> For more elaborating on Shari'a Schools of thought see chapter 1 *supra*.

<sup>41</sup> Ibn Tayymia, *Assiyassah Ashariyah*, (Islamic politics), Almatba'h Alsalafiyah, Cairo, (1386 H), p. 17. See also Al-Samaan, Y., *supra* note 4 pp. 57-58.

<sup>42</sup> *Ibid*, p. 59.

However, contracts relating to the exploitation of natural resources belong to a special category under the Islamic law of contract. Under Islamic law, there seems to be a consensus in current Islamic opinion that ownership of natural resources<sup>43</sup> belongs to the Islamic community (nationals of the Islamic state) and that the Sovereign grants concessions on behalf of the Islamic community in whom the ultimate right of property is vested.<sup>44</sup>

#### ***5.4 Protection of Foreign Investment under International Law***

In international law, any foreign investor has to follow certain duties and rights in order to do business in a particular country. In terms of domestic laws, including treaties and conventions, there is a duty to observe the host state's laws and regulations; and in turn the foreign investor is entitled to the protection of their people and property invested in the host state. It is also notable that capital exporting countries insist on an 'international minimum standard' to protect foreign investors and their property which may be different from the treatment of nationals of the host capital importing country. On the other hand the capital importing countries can argue for the treatment of foreign investors on the same basis as that is given to its nationals ('national treatment').<sup>45</sup>

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<sup>43</sup> For more discussion on the issue of ownership see chapter 2 supra.

<sup>44</sup> El Malik, W., *Mineral Investment under Shari'a Law*, London: Graham & Tortman, (1993) p. 54. This is the view of the *Hanbali* and *Maliki* Schools see Ibn Qudama, *Almughni* ed., by Mohammed Riad (1948) in Arabic, Vol. 5, p. 523-524. Yet there are other Islamic law Schools which disagree with this view. The *Shafi* and *Hanafi* Schools adopt the view that mineral ownership follows land ownership, subject to the payment of (*Zakat*) taxes. This opinion would be similar to that in Anglo-Saxon Common Law, see Bunter. M., *The Islamic Sharia Law and Petroleum Developments in the Countries of North Africa and the Arabian Gulf*, Transnational Dispute Management, (TDM), Vol. 1, Issue 2, May 2004, at [www.transnational-dispute-management.com](http://www.transnational-dispute-management.com).

<sup>45</sup> For an in-depth examination of the international minimum standard, see Sornarajah, M., supra note 1, pp. 328-331.

### **5.4.1 International minimum standard**

Due to the international and cross border nature of foreign investment patterns, these standards offer foreign investors fair and equitable treatment, free access to national courts and respect for their human rights, and in the case of nationalisation or expropriation, the investor/owner is entitled to prompt, adequate and effective compensation. In support of this standard there are two main areas of international law which confer protection on the investor and his property. First are the international rules on state responsibility for injuries to aliens, which provide certain minimum standards for the treatment of aliens and cannot be violated by the host state.<sup>46</sup> Secondly, a recent system of bilateral investment treaties also restricts the sovereign rights of the host state to impose any of its local measures on the investment.<sup>47</sup>

### **5.4.2 National treatment**

As stated above, treatment of foreign investors and aliens on the same basis as that given to host state nationals ('national treatment') is preferred by capital importing developing countries. This standard was laid down by developing countries as a way to protect their own sovereignty against the actions of the powerful multinational corporations from developed countries. There follows a summary of the background to formulation by developing countries of this 'minimum standard' in foreign investment law.

The principle of 'national treatment as a minimum standard' is based on another principle of international law, which has been recognised as the basis of the ownership by

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<sup>46</sup> Even though it does not directly relate to a minimum standard and foreign investment, the General Agreement on Trade and Tariffs (GATT) ensures that local regulations do not violate the principles of free trade. GATT was first signed in 1947 and lasted until 1994, when it was replaced by the World Trade Organisation (WTO). The agreement was designed to provide an international forum that encouraged free trade between member states by regulating and reducing tariffs on traded goods and by providing a common mechanism for resolving trade disputes. WTO membership now includes more than 150 countries. For details on the GATT text, see <http://www.ciesin.org/TG/PI/TRADE/gatt.html> and also <http://www.wto.org/> (10 Jan 2008).

<sup>47</sup> See Sornarajah, M., *supra* note 1, chapter 6, pp. 225-276 for an in-depth analysis of Bilateral Investment Treaties.

states of their natural resources. This is the principle of Permanent Sovereignty Over Natural Resources (PSONR).<sup>48</sup> The creation of this principle was spearheaded mainly by former colonies and developing countries that have gained their independence in order to take control of the exploitation of natural resources in their countries - a privilege that used to be available only to foreign investors, mainly from developed countries.

The main objective of this principle was to underscore the claim of formerly colonised peoples and other developing countries to the right to enjoy the benefits of resource exploitation. It was also necessary to allow 'inequitable' legal arrangements, under which foreign investors had obtained title to exploit resources in the past, to be altered or even to be annulled *ab initio*, because they conflicted with the concept of PSONR. However, industrialised countries opposed this by reference to the principle of *pacta sunt servanda*<sup>49</sup> and respect for their earlier acquired rights.<sup>50</sup>

Initial demands to limit foreign control of national resources were made by Latin American states in terms of the '*Calvo doctrine*'<sup>51</sup> by which foreigners agree not to seek the diplomatic protection of their own state and to submit to the jurisdiction of the host state.<sup>52</sup> These attempts were supported by Eastern European Socialist countries and further demands were made by newly independent states in Asia and Africa, which resulted in a great 'north-

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<sup>48</sup> For the text see Brownlie, I., *Basic Documents in International Law*, Oxford: Oxford University Press (1995), pp.235-239.

<sup>49</sup> The principle means that agreements are binding and are to be observed in good faith.

<sup>50</sup> Schrijver, N., *Sovereignty over natural resources: balancing rights and duties*, Cambridge University Press, (1997), p.1

<sup>51</sup> The inspiration was provided by the writings of Carlos Calvo, an Argentinean diplomat, historian and jurist. In his *Le Droit International* (Vol. 6, 5<sup>th</sup> ed., 1885), he had said: 'Aliens who established themselves in a country are certainly entitled to the same rights of protection as nationals, but they cannot claim any greater measure of protection.' This statement, that aliens are entitled to national treatment only, was adopted in the First International Conference of American States (Washington DC, 1889) and included in the Convention on the Rights and Duties of States adopted at the Seventh International Conference of American States (Montevideo, 1933). Cited in Sornarajah, M., *supra* note 1, p. 21.

<sup>52</sup> See Brownlie, I., *Principles Of Public International Law*, Oxford: Oxford University Press (1998), pp.548-549

south' confrontation over the issue of PSONR.<sup>53</sup> The main factors that shaped this principle into international recognition included the following: concerns about the scarcity and optimum utilisation of natural resources, deteriorating terms of trade in developing countries and a desire for promotion and protection of foreign investment. Other important factors were state succession, nationalisation, cold war rivalry, the demand for economic independence and strengthening of sovereignty and the formulation of greater demands for human rights.<sup>54</sup>

This standard was further developed in the 1962 United Nation General Assembly Resolution (UNGAR) 1803 (XVII) on Permanent Sovereignty of States over their Natural Resources and Economic Activities. The principle, of 'permanent sovereignty' was formulated and debated in the United Nations under the auspices of the Commission on Permanent Sovereignty over Natural Resources<sup>55</sup>, which together with the Economic and Social Council produced the text for the Resolution mentioned which was adopted by the UN General Assembly on 14 December 1962. After its adoption, the principle of 'permanent sovereignty' became linked with efforts to promote the economic development of developing countries and to establish a New International Economic Order (NIEO). The focus of the principle shifted after 1975 to the promotion of exploration and exploitation of natural resources in developing countries, and the role played by international institutions in foreign investment.

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<sup>53</sup> See generally Elian, G., *The Principle of Sovereignty over Natural Resources*, Martinus Nijhoff Publishers, (1979), pp. 141-143.

<sup>54</sup> Shrijver, N., *supra* note 46, pp. 4-6.

<sup>55</sup> The Commission on Permanent Sovereignty over Natural Resources was set up in 1958 by the UN to conduct a full survey with recommendations on the status of permanent sovereignty over 'natural wealth and resources' as a basic constituent of the right to self determination. The Commission was instructed to consider the rights and duties of states under international law and the importance of encouraging international co-operation in the economic development of developing countries. UNGA Resolution 1314 (XIII) of 12 December 1958.

Today permanent sovereignty remains an important concern for the UN in the discussion on sustainable development. The whole debate on permanent sovereignty has been influenced by the rights and duties of developing countries, and their attempt to create a balance between the main interests of all parties (including developed and developing countries) involved in order to promote economic development in the developing countries.<sup>56</sup>

The purpose of the principle is to emphasise the importance of sovereignty over natural resources, and to encourage international cooperation in the development of developing countries. It also emphasises the recognition and respect of the sovereign right of every state to freely dispose of its wealth and its natural resources in accordance with national interests, and respect for the economic independence of states. The principle stipulates a duty on states to exercise their right to permanent sovereignty over their natural wealth and resources in the interest of their national development, and of the wellbeing of the people of the state concerned.<sup>57</sup> Another duty is that the exploration, development and disposition of such resources as well as the import of foreign capital required for these purposes, should be in conformity with any national rules and conditions which authorise, restrict or prohibit such activities.<sup>58</sup>

In addition to the above, some developed countries (mainly the industrialised ones) rejected the adoption of the UNGA Resolution 3281 (XXIX), 12 December 1974 on the Charter of Economic Rights and Duties of States (CERDS). CERDS allowed those states to

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<sup>56</sup> Schrijver, N., *supra* note 46, pp. 33-35.

<sup>57</sup> See Article 1(1).

<sup>58</sup> Article 1(2). In terms of Article 7 the "Violation of the rights of people and nations to sovereignty over their natural wealth and resources is contrary to the spirit and principles of the Charter of the United Nations and hinders the development of international co-operation and the maintenance of peace". See Organisation for Economic Co-Operation and Development, *Investing in Developing Countries*, 4<sup>th</sup> ed., OECD, (1978), pp. 94-97.

regulate foreign investment within their territorial domain in accordance with their own laws and regulations in conformity with national objectives and priorities.<sup>59</sup>

Under CERDS, the host state is not compelled to grant preferential treatment to a foreign investor. It has the right to nationalise or expropriate foreign owned property (upon payment of compensation) and the national courts of the host state must resolve all disputes relating to the investment, under its domestic laws (unless otherwise agreed by the parties). However, this interpretation of CERDS is not without controversy between developed and developing countries. This argument is in line with Article 10 of the Charter of the UN which provides that the General Assembly may make recommendations to the members of the UN on any questions or matters, and that Article does not specify that the resolutions of the General Assembly are binding.<sup>60</sup> The controversy is due to a number of factors. There is an absence of any reference to the applicability of international law to the treatment of foreign investment and also an absence of requirements for the observance of good faith of investment agreements. Finally there is no included mechanism for the settlement of disputes involving foreign private parties.<sup>61</sup>

### 5.4.3 Multilateral Instruments on Foreign Investment

The two most commonly cited multilateral instruments dealing with foreign investment are the United Nations Draft Code of Conduct on Transnational Corporations (UNCTC) and

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<sup>59</sup> Article 2. The developed countries argue that even if a UNGAR should become a custom, it is in any case not binding on dissenting states. The custom can become international law only in the absence of protest. The reservations expressed by these countries to some of these resolutions such as CERDS would have been difficult to ignore as a form of protest to its provisions – in particular those concerning nationalisation – ever becoming a source of international law. See generally, Wolfgang, P., *Arbitration and Renegotiation of International Investment Agreements*, London: Kluwer Law International, (1995), p. 178. Seidl-Hohenveldern, I., *International Economic Law*, London: Kluwer Law International, (1999), pp. 34-39. On the other hand, the majority of the UN countries (namely developing countries) held the view that the draft Charter should be a legal instrument of a binding nature and not merely a declaration of intention. See generally, Brownlie, I., *supra* note 48, pp. 517-519. Wallace, C., *The Multinational Enterprise and Legal Control: Host state Sovereignty in an Era of Economic Globalisation*, London: Kluwer Law International, (2002), p. 990.

<sup>60</sup> El Sheikh, F., *supra* note 3, p. 168. See also references cited therein.

<sup>61</sup> See Al-Samaan, *supra* note 4, p.64.

the 1992 World Bank Guidelines on the Treatment of Foreign Investment and these are considered below.

### **(i) UNCTC Draft Code**

The discontent of the Saudi government with the concession system and their position against foreign company domination was discussed earlier in chapter 1. At the same time, the activities of transnational corporations (TNCs) raised widespread concerns in developing countries. As a result, governments and intergovernmental organisations attempted to regulate the activities of TNCs on an international level. The most notable attempts were initiated in the 1970s, as developing countries began to assert their interests within the United Nations and the growing importance of the principle of permanent sovereignty over natural resources was championed. Various agreements were set up to effectively control the activities of TNCs including the United Nations Draft Code of Conduct on Transnational Corporations.<sup>62</sup> The development of the Code was initiated in 1977 by the United Nations Centre on Transnational Corporations (UNCTC). The Code of Conduct was intended to be voluntary and to forge a positive link between TNCs and the national development goals of developing and developed countries. The Code is one of the main instruments dealing with foreign direct investment in developing countries. Its main objective is to 'maximise the contributions of transnational corporations to economic development and growth and to

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<sup>62</sup> Other international instruments include the International Labour Organisation's Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy, the OECD Guidelines for Multinational Enterprises, and the UNCTAD Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices. A History of Attempts to Regulate the Activities of Transnational Corporations: What Lessons Can Be Learned?, Discussion Paper for Working Group II, Prepared by: Friends of the Earth--England, Wales and Northern Ireland, Washington, DC, November 1998.

minimise the negative effects of the activities of the corporations.’ An important definition in Article 1(a) of the Code is that of transnational corporation, which includes:

‘enterprises, irrespective of their country of origin and their ownership, including private, public or mixed, comprising entities in two or more countries, regardless of the legal form and fields of activity of these entities, which operate under a system of decision-making, permitting coherent policies and a common strategy through one or more decisions-making centres, in which the entities are so linked, by ownership or otherwise, that one or more of them may be able to exercise a significant influence over the activities of the others and in particular, to share knowledge, resources and responsibilities with the others’.

Provisions of the Code include respect for national sovereignty and observance of domestic laws, regulations and administrative practices and adherence to national economic goals and development objectives. It also includes policies and priorities, review and re-negotiation of contracts or agreements between governments and transnational corporations and an acknowledgement that states have the right to nationalize or expropriate the assets of a TNC operating in their territory, but that appropriate compensation is to be paid by the state concerned.<sup>63</sup>

## **(ii) The 1992 Guidelines on the Treatment of Foreign Investment<sup>64</sup>**

Of more recent origin are the non-binding guidelines developed by the World Bank (MIGA and IFC) to emphasise the protection and standards of treatment owed to the foreign investor by the host state. The main areas of the guidelines are admission, standards of treatment, repatriation of capital and returns, expropriation, unilateral alterations, termination of contracts and settlement of disputes.

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<sup>63</sup> See historical collection of the former staff of the UN Centre at <http://www.benchpost.com/unctc/> (8 Jan 2007).

<sup>64</sup> World Bank, *Legal Framework for the Treatment of Foreign Investment* (Vol. II: Guidelines, 1992), Report to the Development Committee and Guidelines on the Treatment of Foreign Investment, the International Bank for Reconstruction and Development/ the World Bank, 1992. See text in ILM 31, 1992, p.1363. See also Shihata, I., *Legal Treatment of Foreign Investment, The World Bank Guidelines*, (1993).

## 5.4.4 Bilateral Investment Treaties

Broadly speaking, there are some major differences to the application and effects of MITs/BITs on foreign investment in the politically risky economies of the developing world.<sup>65</sup> However, there is a considerable degree of acceptance that membership of or participation by an otherwise politically risky country in MITs/BITs though in itself not a guarantee for stability is an element which reduces the foreign investors' perceptions of political risks.<sup>66</sup>

BITs in general are instruments that deal with the protection of foreign investments between two countries. As far back as 1853 the United States concluded such a treaty with Argentina as a Treaty of Friendship, Commerce and Navigation.<sup>67</sup> According to the ICSID the first modern bilateral investment treaty was entered into nearly forty years ago between Germany and Pakistan and there followed an increasing number of European countries that concluded BITs with developing countries.<sup>68</sup> This trend resulted in the universal acceptance of BITs as instruments for the promotion and legal protection of foreign investments.<sup>69</sup> In

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<sup>65</sup> While it has been acknowledged that predictability and transparency of laws and regulations of host countries may be important for attracting foreign investments, doubts have been expressed as to whether multilateral investment rules would be more effective in ensuring predictability and transparency than the existing bilateral and regional investment agreements. The sceptics have also argued that from a development perspective bilateral investment treaties are preferable to multilateral rules in that bilateral treaties can be tailored to the individual needs and priorities of individual countries and typically do not limit the ability of host countries to regulate the admission of foreign investments. See Nieuwenhuys, E., *Multilateral Regulation of Investment*, London: Kluwer Law International, (2001), p. 195.

<sup>66</sup> See generally Walde, T (with Dow, S.), *Treaties and Regulatory Risk in Infrastructure Investment: Effectiveness of International Law Disciplines versus Sanctions by Global Markets in Reducing the Political and Regulatory Risks for Private Infrastructure Investment*, *Journal of World Trade*, 34(2) (2000), pp. 1-61.

<sup>67</sup> See for example the Treaty between US and Argentina, 27 July 1853 at: <http://www.yale.edu/lawweb/avalon/diplomacy/argentina/argen02.htm>. 13/10/2007. For more discussion on BITs see Sornarajah, M., supra note 1, pp. 211-229.

<sup>68</sup> See World Bank Group, ICSID, at <http://www.worldbank.org/icsid/treaties/intro.htm> (9 Jan 2007).

<sup>69</sup> Lists of bilateral investment treaties were published in 1989 and 1992 in the *ICSID Review-Foreign Investment Law Journal*. ICSID. See also Dölzer, R and Stevens, M., *Bilateral Investment Treaties*, Martinus Nijhoff, (1995).

1996 Saudi concluded a BIT with Germany.<sup>70</sup> In view of the growing importance of BITs, it may become inevitable that Saudi will enter into more BITs with future investment partner countries.

As part of its strategy to attract FDI and give more comfort to foreign investors Saudi Arabia has also signed several further BITs<sup>71</sup> in which it agreed to observe the usual modern investment and international economic law disciplines of national treatment and most favoured nation treatment<sup>72</sup> to investments and investors from other contracting parties. This observation is reflected in Saudi efforts to allay such fears by providing various guarantees to foreign investors in the form of national and equitable treatment under domestic law. Article 6 of the Foreign Investment Act in 2000 stipulates:

“A project that has been licensed pursuant to these legislations shall enjoy all rights, incentives and guarantees available in respect of a national project in accordance with the Saudi Law”.<sup>73</sup>

Thus far in this chapter, we have seen an overview of the general framework relating to the protection of Foreign Direct Investment under Saudi law. It has dealt with the international framework for the protection of foreign investment at a multilateral and bilateral level including the discussion of the two main principles of home state control and host state regulation. The following section examines Saudi’s relationship with key multilateral investment treaties and economic institutions.

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<sup>70</sup> See Al-Samaan, *supra* note 4, p. 103. See also *Bilateral Investment Treaties 1959-1999*, UNCTAD Series on issues in international investment agreements, UNCTAD ITE/IIA/2, New York and Geneva: United Nations Publications, (2000), at: <http://www.unctad.org/en/docs/poitciiad2.en.pdf>. Accessed on 24/01/2009.

<sup>71</sup> Saudi Arabia has signed bilateral investment treaties with Belgium, Malaysia, Austria, France and other states. For a list and text of these BITs signed by Saudi Arabia see UNCTAD website at: <http://www.unctadxi.org/templates/DocSearch.aspx?id=779>. Accessed on 07/02/2009.

<sup>72</sup> Both the national treatment and most favoured treatment represent the principle of non-discrimination in international conventional law. The two standards of treatment have a long history and can be found in most trade and investment treaties. See Muchlinski, P., *Multinational Enterprises and the Law*, 2<sup>nd</sup> ed., Oxford: Oxford University Press, (2007), pp. 178 & 238.

<sup>73</sup> See text of Foreign Investment Act 2000 – also known as Foreign Capital Investment Law 2000 – available at: [www.sagia.org.sa](http://www.sagia.org.sa). Also see Appendix in the thesis.

## ***5.5 Saudi's membership of international organisations and MITs pertinent to FDI***

Saudi Arabia is one of the oldest market economies in the world, with a trading history that goes back many centuries. Amongst its Muslim neighbours, Saudi Arabia's economy is fundamentally liberal and open to foreign traders, entrepreneurs and investors. The most favoured nation principle has always been respected by Saudi Arabia, even appearing in a 1933 bilateral agreement with the United States. Saudi Arabia has no foreign exchange and relatively few import restrictions. Applied customs duties and barriers to importation and participation in the Saudi market are low.<sup>74</sup>

Saudi is also a member of an important regional organisation involve in oil and gas called the Organisation of Arab Petroleum Exporting Countries (OAPEC).<sup>75</sup> OAPEC was founded in January 1968 by Saudi Arabia, Libya and Kuwait. It aims for cooperation between its member states in developing the Arab petroleum industry in general and stabilising the oil market. Members of OAPEC increased to thirteen Arab countries in addition to the founding members, as follows: Bahrain, United Arab Emirates, Tunisia, Algeria, Syria, Qatar and Egypt.<sup>76</sup> Other international organisations relevant to the petroleum sector of which Saudi is also a member are the World Energy Council<sup>77</sup> and World Petroleum Congress.<sup>78</sup>

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<sup>74</sup> See Weeks, J., *infra* note 84. See also next chapter.

<sup>75</sup> See OAPEC website at: <http://www.oapecorg.org>.

<sup>76</sup> *Ibid.*

<sup>77</sup> Saudi Arabia became member of WEC in 1991. A national committee consisting of delegates from several entities represents the country at the WEC. The Saudi National Committee to WEC plays an active role and has a prestigious status at the WEC conference held regularly every three years, and is actively involved in the Council's works. See <http://www.worldenergy.org/wec-geis>. 10/06/06.

<sup>78</sup> Saudi Arabia became member of the World Petroleum Congress in 1968. It was elected as a member to the Permanent Council of the Congress in 1971 and to the Executive Council in 1991. The Kingdom contributed in WPC activities through its participation in meetings in Tokyo 1975, London 1983, Houston 1987, Buenos Aires 1991, Stavanger (Norway) 1994, Beijing 1997 and Alberta (2000). For more information see website at <http://www.world-petroleum.org/>

The commitment of Saudi Arabia to the international community was highlighted by H.E. *Ibrahim Al-Assaf*, Minister of Finance and National Economy, at an International Conference on Financing for Development in Monterrey, Mexico on 21 March 2002.<sup>79</sup> He stated<sup>80</sup> that Saudi Arabia endorses goals to eradicate poverty, achieve sustained economic growth and promote sustainable development as we advance to a fully inclusive and equitable global economic system. He also stated that international trade should be seen as an engine for development as the single most important external source of development financing. The Minister elaborated on the obstacles to achieve this international goal, in that policies in industrialised countries erect trade barriers against the exports of developing countries, which are complemented by trade-distorting subsidies and other trade-distorting measures thus denying the developing countries substantial financial resources.<sup>81</sup>

The role of the Saudi government in international development efforts was also highlighted in its contribution, as a developing country, to the financing of international development projects. For example, since the mid seventies, Saudi Arabia's assistance to developing countries, through bilateral and multilateral channels, amounted to more than US \$75 billion.<sup>82</sup>

The case of Saudi Arabia demonstrates recognition of the value and significance of international cooperation and multilateralism through accession to a number of international

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<sup>79</sup>See proceedings of the Conference at the International Monetary Fund (IMF) website at: <http://www.imf.org/external/np/pdr/FfD/2002/> (12/6/06).

<sup>80</sup>See the Statement at UN Economic and Social Development website at: <http://www.un.org/ffd/statements/saE.htm>. 12/06/06.

<sup>81</sup>These words by the Saudi Minister are in line with the IMF's thinking for better globalisation where all the countries have opportunities and integration into the global economy which is good for growth to fight poverty. Horst Köhler, Managing Director of IMF stated that 'The world needs more integration, not less. But it also needs stronger international cooperation, to guide and shape the process of globalisation.' See presentation on 'The Monterrey Consensus and Beyond: Moving from Vision to Action', Introductory Remarks by Horst Köhler, Managing Director, International Monetary Fund at the International Conference on Financing for Development, Monterrey, Mexico, March 21, 2002. <http://www.imf.org/external/np/pdr/FfD/2002/> (12/6/05)

<sup>82</sup> See Saudi Consulting House, *supra* note 5, p. 6.

conventions. By the Council of Ministers Resolution No. 78 dated 15/07/1414 AH (29/12 1993) Saudi Arabia acceded to on 19 April 1994 and ratified the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.<sup>83</sup> Similarly, Saudi is a signatory to the 1964 Convention on the Establishment of the International Centre for the Settlement of Investment Disputes (ICSID) (The Washington Convention), which provides for arbitration as a method of settling investment disputes between member nations.<sup>84</sup> It is also a signatory to the Convention establishing the Multilateral Investment Guarantee Agency (MIGA) of the World Bank. An agreement on legal protection for guaranteed foreign investment between the Multilateral Investment Guarantee Agency (MIGA) and the Kingdom of Saudi Arabia was signed in July 1995.<sup>85</sup> It is also a member of many other international and regional economic cooperation and investment promotion agreements. Of particular and strategic importance is the position and implications of Saudi Arabia's accession to the World Trade Organization (WTO) and its observer status in the Energy Charter Treaty (ECT). While the WTO represents the "trade dimension" of the new international organisations making up the governance of the global economy, the ECT represents mainly "investment" in the energy sector.<sup>86</sup>

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<sup>83</sup> Convention on the Recognition and Enforcement of Foreign Arbitral Awards, done at New York, 10 June 1958; Entered into force, 7 June 1959, 330 U.N.T.S. 38 (1959). For text see: <http://faculty.smu.edu/pwinship/arb-31.htm>. The Convention, among other things imposes a duty on members to recognise and facilitate the enforcement of awards issued by international investment/ commercial arbitral tribunals. Thus, in the event of a dispute adjudicated by arbitration at foreign venue, Saudi Arabia, subject to known exceptions will allow its enforcement against itself or any members to the Convention.

<sup>84</sup> See ICSID Convention and the Regulations at: <http://www.worldbank.org/icsid/basicdoc/basicdoc.htm>. It has to be emphasised however that at the ratification of the ICSID, Saudi Arabia gave notification to the effect that it reserves the right of not submitting all questions pertaining to oil and pertaining to acts of sovereignty to the ICSID whether by way of conciliation or arbitration. See also the notification at <http://www.worldbank.com/icsid/pub/icsid-8d.htm>. Accessed on 04/02/2009.

<sup>85</sup> See MIGA Convention at the website of the Multilateral Investment Guarantee Agency (MIGA) <http://www.miga.org/screens/about/convent/convent.htm> MIGA has its own Arbitration Rules incorporated into its standard Contracts of Guarantee, based on ICSID rules. The MIGA provides a facility for insurance of political risk of member countries. Therefore foreign investors can have their political risks insured and guaranteed by MIGA in Saudi Arabia.

<sup>86</sup> See Walde, T., *Legal and Policy Implications of a Relationship of Two International Treaties in Natural Energy Resources: OPEC and the ECT*, *OGEL*, Issue 5, Vol. 2, (Dec. 2004). For more discussion on ECT see the next section..

There follows a closer examination of the rules of these international treaties in relation to Saudi Arabia.

### 5.5.1 Saudi Arabia's accession to the World Trade Organisation (WTO)

Saudi's bid for accession into the WTO started in 1993 and gained fruition following a landmark BIT signed with the United States on the 9<sup>th</sup> September 2005.<sup>87</sup> Saudi Arabia would soon after become the 149<sup>th</sup> member of the world trade body. The WTO is also a dynamic institution engaging in new negotiations<sup>88</sup> and constantly enlarging its membership.<sup>89</sup> Saudi Arabia's efforts to join the WTO can be seen as an important attempt at reform. Saudi Arabia

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<sup>87</sup> The agreement *inter alia* requires Saudi Arabia to open its markets to imports of more of US farm and manufactured goods as well as service companies in sectors including banking telecommunications, energy, express delivery, transportation and hotel and restaurant management. See Saudi Embassy in Washington website at: <http://www.saudiembassy.net/archive/2005/press/page12.aspx>. See also report by Abdulghafour, P., *The WTO Entry to Boost Foreign Investment*, *Arab News*, (12 September 2004), at: <http://www.arabnews.com>. 12/01/07.

<sup>88</sup> See, Weeks, J. M. (Chairman Of The Global Trade Practice Of APCO Worldwide, and Chairman of the Working Party on the Accession of the Kingdom of Saudi Arabia to the WTO), *The Trading System Of The 21<sup>st</sup> Century And Saudi Accession To The WTO*, (Notes For A Presentation At The Jubail Conference - Saudi Arabia: Major Investment Opportunities In The 21<sup>st</sup> Century, Panel Iii: Economy And Globalisation. The presenter added: The dynamic nature of the WTO is also shown by the negotiations that have taken place since 1995. In 1997 members completed an agreement eliminating duties on information technology products, covering 94% of world trade in these products, or 10% of total world trade. In addition, negotiators completed the negotiations on basic telecommunications services, including commitments from 69 countries. The telecommunications deal included another first, because the regulatory principles to which participants have subscribed are in fact the first WTO provisions addressing domestic competition policy. Renato Ruggiero, the then Director-General of the WTO, pointed out the scope and importance of these two agreements. He noted they covered over one trillion US dollars in annual international business. He added that the value of that trade exceeded the value of world trade in agriculture, textiles and automobiles combined. In December of 1997 members successfully concluded the negotiations on financial services. Earlier in this year the WTO members took up negotiations in agriculture and services, fulfilling the commitment to do so established in the respective Uruguay Round agreements. Despite the failure to launch a full-blown round in Seattle, the WTO has had an active and constructive year. Members are now engaged in considering how best to deal with the range of implementation problems encountered with the Uruguay Round agreements. Furthermore much informal discussion among delegations is about how to move the agenda forward by enlarging the scope of what is being negotiated, and to tackle other issues in a renewed program of work.

<sup>89</sup> *Ibid*, From the Middle East region, Oman became the 139<sup>th</sup> member of the WTO, joining seven other countries in the Middle Eastern region as members: Bahrain, Egypt, Israel, Jordan, Kuwait, Qatar and the United Arab Emirates. Twenty-eight other countries are currently negotiating to join including, of course, Saudi Arabia. In all 12 members have joined the organisation since its inception in 1995. This growth in membership is a kind of positive referendum on the value of the WTO. The WTO is well on its way to becoming a universal organisation.

first applied to join the forerunner of the WTO, the General Agreement on Tariffs and Trade (GATT), in 1993. In November 1999, the late King Fahd stated that "the world is heading for ... globalisation" and that "it is no longer possible for Saudi Arabia to make slow progress".<sup>90</sup>

In recent years, Saudi Arabia sought to join the World Trade Organisation, negotiations focused on the degree to which Saudi Arabia was willing to increase market access to foreign goods and services and the timeframe for becoming fully compliant with World Trade Organisation obligations.<sup>91</sup> The Saudi effort to join the WTO was designed to attract foreign investment (up to \$200 billion over the next 20 years), according to Foreign Minister Prince Saud. This would include over \$100 billion in the power sector alone, plus billions more in petrochemicals and telecommunications. Another goal of Saudi WTO membership is to ensure markets for the country's petrochemical industry, and to create new markets in the future.

There are WTO provisions on trade related investment measures. Members are engaged in a work programme designed to facilitate a decision on whether to enter negotiations to establish multilateral investment rules in the WTO. With new investment laws Saudi Arabia would have a keen interest in these matters. Saudi entry to the WTO, would help increase Saudi Arabia's volume of trade, but it presented several negotiating, cultural-religious and economic problems. Saudi officials tended to blame the WTO for being insensitive to Saudi restrictions on non-Islamic imports, like alcohol, and religious problems in dealing with interest and insurance, while WTO negotiators indicated that the Kingdom has not yet been

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<sup>90</sup> See Cordesman, A., *Study no. VI.: Building True Wealth Versus Over-dependence on Petroleum and the State, Saudi Arabia Enters the 21st Century –Politics, Economics, and Energy*, Washington, DC: Centre for Strategic and International Studies (CSIS), (2002), p. 23, available at: [http://www.csis.org/burke/saudi21/S21\\_06.pdf](http://www.csis.org/burke/saudi21/S21_06.pdf)

<sup>91</sup> The Working Party on the accession of Saudi Arabia to the WTO was established on 21 July 1993. Bilateral market access negotiations on goods and services are underway on the basis of revised offers. Multilateral discussions on the terms of entry are ongoing and the latest revision of the draft Report of the Working Party was circulated in June 2004. The last meeting of the Working Party was held in September 2004. See WTO at: [http://www.wto.org/english/thewto\\_e/acc\\_e/al\\_arabie\\_saoudite\\_e.htm](http://www.wto.org/english/thewto_e/acc_e/al_arabie_saoudite_e.htm) (2/7/06).

willing to show that it will grant the required access to its banking, finance, and upstream oil and gas sectors. The negotiators called for better copyright laws; tribunals to rule on trade disputes; and new legislation on technical trade barriers, customs evaluation, and food health regulations. Additionally, they called for Saudi Arabia to limit tariffs to 15%, and to agree to several sectoral initiatives, including an Information Technology Agreement, chemical harmonisation, a government procurement agreement, and agreements on textiles, pharmaceuticals, medical and construction equipment, and publishing services.<sup>92</sup>

It was also argued that WTO membership might threaten some local businesses. Some Saudi firms are designed to function in a secure environment, protected by high tariffs and monopoly agency agreements. A number of manufacturing enterprises fall under this category, and their managers were deeply worried that having to operate in the WTO environment would put them out of business.<sup>93</sup> Opening up the economy to foreign multinationals and imports would threaten their profit margins and the commercial agencies' monopolies. Some economists on the other hand said that accession to the WTO would encourage foreign investment and increase access to the Kingdom's growing markets. However, despite all these competing arguments, Saudi Arabia finally became a member of the WTO in Dec. 2005.

By Saudi Arabia's accession to the WTO, the government has indicated that it will take a phased approach to:

- Establishing new trademark and intellectual property laws.
- Removing technical barriers to trade by easing travel visa requirements.

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<sup>92</sup> See the working party report on accession to the WTO available on the Saudi Ministry of Commerce and Industry website at: <http://www.commerce.gov.sa/english/moci.aspx?PageObjectId=714>.

<sup>93</sup> Ramady, M., *The impact of Saudi Arabia's WTO accession on selected economic sectors and domestic economic reforms*, *World Review of Entrepreneurship, Management and Sustainable Development*, Vol. 2, No. 3, (2006), pp. 189-199.

- Signing the Information Technology Agreement and phasing in tariff-free trade in information technology equipment.
- Phasing in Basic Telecommunications Agreement to allow competition in telecommunications services.
- Changing competition laws to provide anti-trust and consumer protection in accordance with WTO rules.<sup>94</sup>

The WTO system is essentially a network of contractual rules and commitments capable of being monitored and enforced multilaterally. Its central feature is predictability and certainty in conditions and terms of trade. It guarantees the business community that governments will maintain open and accountable trade regimes. To this end, all WTO members are obliged to have in place legislation and enforcement mechanisms that are needed for them to implement their WTO obligations.

The compliance with this essential WTO requirement should not impose a burden on Saudi Arabia. In most cases the liberal and open practices that lie at the heart of the WTO are already there, for instance in areas like judicial decision-making. What is required, therefore, is that existing liberal practices be codified. What is even more important to remember is that WTO accession and the implementation of WTO-related legislation and enforcement mechanisms is complementary to the domestic economic reform process on which Saudi Arabia has already embarked. Both go hand-in-hand and both are needed to support each other. Indeed, legislation and enforcement - and therefore WTO accession - are essential for underpinning the national reform process and for making it credible to the international community of importers, exporter, producers, consumers and investors.

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<sup>94</sup> *ibid.*

Politically, the issue of Saudi's accession to the WTO brought mixed reactions from Saudi officials and businessmen. Dislike of the WTO has not led to the formulation of clear counter-proposals, whether from the private sector in general or from its sub-sectors. Instead, a general, diffuse fear was spread across parts of the private sector that large multinational enterprises might steamroll over local business.<sup>95</sup> However, it has not been clear in the Saudi debates which sectors were perceived as the most endangered, and might have the highest interest in protection. Somewhat differently from what trade theory would make us expect, clear sector or factor-based interests have not evolved.<sup>96</sup> Saudi local investors in agriculture also view the accession as having potential to negatively affect the Kingdom's industrial and agricultural sectors. "Farmers will not receive most of the incentives they receive now."<sup>97</sup> There is a fear also that Saudi Arabia and other developing countries would become dumping grounds for major producers like the US and European countries. This will threaten the existence of many of Saudi's agricultural projects.<sup>98</sup>

It has been noted earlier that Saudi Arabia is a major petroleum exporter and a member of OPEC. OPEC is an international organisation of 11 petroleum exporting countries and is open to the accession of only those countries "with a substantial net export of crude

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<sup>95</sup> Hertog, S., *Two-level Negotiations in a Fragmented System: Saudi Arabia's WTO Accession*, Review of International Political Economy, 15:4, pp. 650-679. See also Freeman, C., *Saudi Arabia's Accession to the WTO: Is a "Revolution" Brewing?* Middle East Policy Council Capitol Hill Conference Series on US Middle East Policy, 13<sup>th</sup> Jan. 2006, available at: <http://www.saudi-us-relations.org/articles/2006/loi/060122-mepc-freeman.html>.

<sup>96</sup> Ibid.

<sup>97</sup> Ibid.

<sup>98</sup> Some OPEC management staff speaking in their personal capacity agree that Saudi's membership of the WTO will have the effect of opening up of Saudi Arabia's rather close sovereignty in respect of its trade and investment relations to the outside world. Small and medium scale industries may suffer as they will be unable to compete with multinational companies coming into the Kingdom as a result of the WTO accession. However, according to another top OPEC official, the KSA is still guarding its oils and gas sector from "interference," as a result of the accession, though it would be uncertain how far the WTO will give concessions to Saudi Arabia and other energy producing or OPEC members already in the world trade body.

petroleum, which has fundamentally similar interests to those of Member Countries.”<sup>99</sup> OPEC’s aim and goal as enshrined in Article 2 of the OPEC Statute is to safeguard the collective and individual interests of its members and to ensure stabilisation of international oil prices.<sup>100</sup>

Given the strategic position of Saudi Arabia in the energy sector, in this case, petroleum supply and the OPEC’s objectives to control it, one could imagine the rather difficult situation in which Saudi Arabia will be placed after accession to the WTO. Interests will naturally conflict between the demands of OPEC’s petroleum pricing monopoly posture and that of the WTO, which is oriented towards trade liberalisation.<sup>101</sup>

Currently, international investment and to some extent, the trade in energy is regulated more by the Energy Charter Treaty (ECT) and bilateral investment treaties (BITs) than by the WTO. However, the ECT rules on trading make reference, in the main, to the relevant WTO provisions, with formal modifications.<sup>102</sup> In the field of trade, the WTO provides a framework of rules. Essentially, the WTO is a series of agreements among its members, backed up by the most highly developed dispute settlement system yet agreed under international law. However, trading in the petroleum sector is the reserve of OPEC of which Saudi Arabia is a

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<sup>99</sup> Article 7.C of the OPEC Statute. There were five founding members: Iran, Iraq, Kuwait, Saudi Arabia and Venezuela. The current membership includes, in addition to the founders: Algeria, Indonesia, Libya, Nigeria, Qatar, and the United Arab Emirates.

<sup>100</sup> See Article 2(b) of the OPEC Statute. In an effort to reconcile the conflicting interests of stakeholders in the industry (producers, consumers and intermediaries), the Statute provides that OPEC would give due regard to (i) the interests of the producing nations and to the necessity to secure a steady income for them; (ii) an efficient, economic and regular supply of petroleum to consuming nations; and (iii) a fair return on their capital to those investing in the petroleum industry. See Article 2(c) of the OPEC Statute.

<sup>101</sup> This complexity of roles between OPEC and WTO has been analysed in details by Desta, M. *OPEC and the WTO: Petroleum as a Fuel for Cooperation in International Relations*, Middle East Economic Survey, VOL. XLVII, No 10, (08-March-2004).

<sup>102</sup> For an in-depth analysis of the WTO provisions adopted by ECT see Energy Charter Secretariat publication of December 2001: *Trade In Energy: WTO Rules Applying under the Energy Charter Treaty*, OGEL Vol. 2 Issue 5, (December 2004) at [www.gasandoil.com/ogel](http://www.gasandoil.com/ogel)

major member. However, petroleum is the “largest primary commodity of international trade in terms of volume and value.”<sup>103</sup> The WTO essentially implements the General Agreement on Trade and Tariffs (GATT) and generally promotes competition by discouraging governmental impediments to the free flow of trade across borders through, *inter alia*, the prohibition of trade-distorting subsidies, quantitative restrictions on both imports and exports and the encouragement of reciprocal reduction/elimination of import tariffs.<sup>104</sup>

## 5.5.2 Saudi Arabia and the Energy Charter Treaty (ECT)

As stated earlier in the introductory chapter, Saudi Arabia exerts authority as the largest oil producer and exporter in the world. It also has the 2<sup>nd</sup> largest proven gas reserve in the world. It is the biggest and most influential member of the OPEC.<sup>105</sup> Saudi Arabia is therefore a key country in the world in fossil fuel energy supply terms.

The Energy Charter Treaty of 1994<sup>106</sup> is - particularly in view of the demise of the Multilateral Agreement on Investment (MAI) -the major multilateral investment treaty covering over 50 countries plus the EU, Australia, Japan and Central Asian countries.<sup>107</sup> It is an international agreement that aims to create a freer and more competitive energy market among its contracting parties. It has established multilateral disciplines on the regulation of

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<sup>103</sup> See Desta, M., *infra* note, 104, p 1.

<sup>104</sup> See more on this objectives and procedures of the WTO in Permanent Court of Arbitration/Peace Palace Papers, *Strengthening Relations with Arab and Islamic Countries through International Law: E-Commerce, the WTO Dispute Settlement Mechanism and Foreign Investment*, Fourth PCA International Law Seminar, (Oct. 12, 2001), pp 151-157.

<sup>105</sup> *First Saudi Arabian International Gas Conference* held at Chamber of Commerce Building, Dammam, Saudi Arabia, 15-17<sup>th</sup> May, 2004: OGEL Vol. 2, No. 05, (Dec., 2004).

<sup>106</sup> The Energy Charter Treaty (ECT) was signed in December 1994 and entered into legal force in April 1998. The text of the Treaty can be found in [www.encharter.org](http://www.encharter.org). For an examination of the investment regime of the ECT and an analysis of investment dispute resolution mechanism under Article 26 of the ECT, see generally, Happ, R., *Dispute Settlement Under the ECT*, German YB Int'l Law, 45 (2003), cited by Muniruzzaman, A., *Stabilisation in Investment Contracts and Change of Rules in Host Countries: Tools for O & G Investors*, AIPN Research Project, (2005-2006). See Walde, T., *Arbitration in the Oil, Gas and Energy Field: Emerging Energy Charter Treaty Practice*, OGEL, Vol. 1, No. 4, (2003), p. 27. See also Coop, G., *infra* note 107.

<sup>107</sup> Published in 34 ILM 360 (1995) with introduction by Walde, T.

investment transit and trade in the energy sector.<sup>108</sup> It also has “soft-law” obligations on competition law, environment, transfer of technology and access to capital markets.<sup>109</sup>

It is widely recognised that trade, together with foreign direct investment, is a major engine of economic growth. Since the energy sector provides the basic infrastructure for any human activity, the importance of open and competitive energy markets for our societies cannot be underestimated. Transparent, stable and predictable conditions for East-West energy commerce are, no doubt, fundamental for the creation of open energy markets in the Eurasian continent.

One of the major achievements of the Energy Charter process has been the adoption by its member states of the principles and rules of the multilateral trading system. The Energy Charter Treaty now incorporates for the energy sector the major rules of the WTO that govern trade in goods. This significantly contributes to creating a transparent, stable, predictable and non-discriminatory trading environment for East-West energy commerce. Equally important is that by adhering to the treaty’s WTO-based trade rules, ECT signatory countries that are not yet members of the WTO can carry out domestic trade reforms in the energy sector that greatly contribute to the advancement of their accession to the World Trade Organisation.<sup>110</sup>

The main ECT disciplines concern investment protection obligations. These are rules guiding the parties’ conducts in, among other things, expropriation, fair and equitable treatment. That involves the minimum standard treatment, respect for obligations entered

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<sup>108</sup> Desta, M. & Walde, T. , *Legal and Policy Implications of a Relationship of Two International Treaties in Energy Resources: OPEC and the ECT* (annex V), February, 2002 at [www.cepmip.org](http://www.cepmip.org);

<sup>109</sup> Walde, T., *Ibid*: The soft-law obligations are mainly programmatic statements about what governments “should” (“endeavour”) to do.

<sup>110</sup> See World Trade Organization’s website.

(*pacta sunt servanda*), national treatment and repatriation of revenues. Therefore the fundamental aim of the Energy Charter Treaty is to strengthen the rule of law on energy issues, by creating a level playing field of rules to be observed by all participating governments. The Treaty's provisions focus on five broad areas. First is the protection and promotion of foreign energy investments, based on the extension of national treatment, or most-favoured nation treatment (whichever is more favourable). Second is a stable and predictable framework for trade in energy materials, products and energy-related equipment, based on WTO rules. After this comes freedom of energy transit through pipelines and grids; and mechanisms for the resolution of State-to-State and Investor-to-State disputes. And the final area is energy efficiency and related environmental aspects.<sup>111</sup>

Saudi Arabia is currently carrying out internal legal reforms in its investment and tax laws with a view to opening up its market especially for the development of its vast oil and gas resources, and for its mining industry.<sup>112</sup> Now the question is asked as to what is the importance of the relationship between Saudi and the ECT. Saudi holds observer status in the ECT and accession could be seen in the same light as its accession to the WTO. On the hand, accession will serve to demonstrate Saudi's willingness to open up its market to competition. More importantly, accession will prepare it to subject itself to internationally recognised and adopted economic liberalisation disciplines of national treatment and most-favoured nation treatment. Of particular and strategic importance to foreign investors here is that Saudi Arabia will then accept the automatic investor-state dispute resolution mechanism enshrined in the ECT jurisprudence. As mentioned earlier, the Kingdom is already a signatory and has

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<sup>111</sup> For more discussion see generally, Coop, G., *The Energy Charter Treaty: More than a MIT*, Ribeiro, C., Editorial, *Investment Arbitration and the Energy Charter Treaty*, New York: JurisNET, LLC, (2006), pp. 3-22.

<sup>112</sup> See Arab News, [www.arabnews.net/saudi/sa\\_shariabiz.htm](http://www.arabnews.net/saudi/sa_shariabiz.htm); see also US Embassy website: <http://usembassy.state.gov/riyadh> (13/12/2006).

ratified both the ICSID and NY Convention.<sup>113</sup> It will also lend more weight and credence to its internal reforms to encourage inflow of foreign investment. It should also give foreign investors more certainty as to what the general investment climate is like in the Kingdom. Consequently, by signing up to ECT, Saudi Arabia will be seen as offering additional security for any foreign investor against perceptions of political risk.

As Saudi acceded to the WTO, it is hoped that it will soon accede also to the ECT. Accession to ECT by Saudi Arabia<sup>114</sup> and the other Middle Eastern OPEC countries<sup>115</sup> would be strategic and feasible because of the favourable geographical convenience of these countries. Their geographical proximity to the world energy markets provides easy access to export oil and gas to Europe, Asia and Africa. This is in view of energy transit being one of the core objectives of the ECT in addressing issues related to the mitigation of energy investment risks and the right to arbitration. Moreover, the adoption of a number of important international treaties on foreign investment and the recent investment friendly policy of Saudi Arabia, which I have mentioned in this chapter, demonstrates the value and significance of international cooperation and multilateralism.

## Conclusion

This chapter examined the law as it relates to foreign investment in Saudi Arabia as well as the treatment of foreign investment under international law. The effect of these international instruments on Saudi's oil and gas industry is to reassure foreign investors in the

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<sup>113</sup> See UNCITRAL website at: [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html) and ICSID website at: <http://icsid.worldbank.org/ICSID/FrontServlet?requestType=ICSIDDocRH&actionVal=ShowDocument&language=English>

<sup>114</sup> Saudi Arabia still in observer status. See ECT website at: <http://www.encharter.org/index.php?id=43>

<sup>115</sup> Among these countries are the Arabian Gulf Countries – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab emirates – which are members of the Gulf Cooperation Council (GCC). These countries possess roughly 45% of the world's proven oil reserves and 17% of the world's proven natural gas reserves. See Fasano, U & Iqbal, Z., in *the IMF publications* at: <http://www.imf.org/external/pubs/ft/med/2003/eng/fasano/index.htm>. Accessed on 28/01/2009.

oil and gas sector. They show especially that in addition to the abundant investment opportunities presented by immense resources, the multilateral trade and investment climate is equally attractive. With regard to the political instability of host states, this is one of the main problems that investors have to carefully consider and evaluate before embarking upon FDI projects. In particular, a deterioration of the financial situation (currency inconvertibility) of the host state may either be the result of a deterioration of the political situation or, conversely, the cause of it. In this respect guarantees provided by multilateral institutions also serve a dual role, the objective is to reduce or mitigate political risk arising from the roles played by governments either in their sovereign capacity or as contracting parties.

It has been explained here that Saudi Arabia is in the process of reviewing its position as regards these international agencies in order to improve its investment climate. It has signed a number of investment-related conventions to ensure foreign investors' confidence and improve perceptions of its political stability as well as opening its market for both local and foreign investors. Hence, privatisation, foreign investment admission and the legal incentives and changes of investment will be discussed in the following chapter.<sup>116</sup>

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<sup>116</sup> As regards environmental aspects, substantial international efforts have been made in recent years to show the importance of the protection of the environment. In Saudi this environmental obligation can be achieved by adopting environmental laws which lay down some broad policy guidelines for environmental affairs and specific regulations for implementation. Attention should also be given to petroleum agreements which could provide acceptable environmental protection provisions. The importance of the environment is highlighted in numerous international treaties, whose success depends largely on the signatories and ratification of a number of states. The effective implementation of these treaties therefore depends on the joint will of the states and without it these, exercises on the environment are futile and a waste of money. A typical example is the Kyoto Protocol, which could improve the environment if all industrial countries including USA sign and comply with its regulations.

# (6) PRIVATISATION, ADMISSION AND LEGAL INCENTIVES FOR FOREIGN INVESTMENT IN SAUDI ARABIA

## Introduction

As stated earlier in this thesis, Saudi Arabia's oil-based economy has seen strong government control over major economic activities. As is well known, the world is witnessing a diminishing role of the state in economic activities. The trend is to open up through reforms and liberalisation. Governments are assuming a much less interventionist attitude towards their economies than they used to. Instead, deregulation, restructuring and privatisation are the order of the day.<sup>1</sup> There is a general consensus on the positive impact of foreign investment on the welfare of host countries. Foreign investment is considered to be the solution to economic problems and a vehicle for development and prosperity. Due to the advantages of foreign investment, states compete against one another in attracting foreign investors by offering ever more generous incentive packages. They justify their actions with productivity gains that are expected to accrue to domestic producers from the knowledge externalities generated by foreign affiliates. The purpose of this chapter is to explain the economy and its contribution to the development of these main economic activities. Based on

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<sup>1</sup> See generally, Sarcevic, P., *Privatisation in Eastern and Central Europe*, London: Graham & Trotman, (1992), pp. 3-11. However, it should be noted that recent rolling back of state involvement in the economy has a somewhat hollow ring after so much part-nationalisation and state intervention in banking and automotive industries etc worldwide. State intervention is justified on the ground of market failure – e.g. the current global economic crisis – to promote development and correct market imperfections. However, this issue is out of the scope of the present study and will not be discussed. For more discussion on this issue see generally, Taylor, J., *The Financial Crisis and the Policy Response: an Empirical Analysis of What Went Wrong*, available at: <http://www.stanford.edu/~johntayl/FCPR.pdf>. See Crotty, J., *Structural Causes of the Global Financial Crisis: A Critical Assessment of the 'New Financial Architecture'*, available at: [http://www.peri.umass.edu/fileadmin/pdf/working\\_papers/working\\_papers\\_151-200/WP180.pdf](http://www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_151-200/WP180.pdf). See also Bourland, B., *Saudi Arabia and the Global Financial Crisis*, Jadwa Investment, Riyadh, Saudi Arabia, Dec. 2008, available at: <http://www.jadwa.com/Research/store/Monthly%20Bulletin%20December%202008.pdf>.

a country profile approach, this chapter will tackle selected issues of Saudi Arabia's economic and legal environment. The criterion for selection was relevance to foreign engagement in investment activities in Saudi Arabia. The following issues have been dealt with: economic policies between 1960-2009, development prospects, development incentives, the tax system and customs and import regulations. Note should be taken of the successful introduction, albeit incomplete, of private players in the oil industry, which could also be repeated in other sectors. Economic setup should, therefore, be conducive to spearheading this transformation of the remaining sectors towards greater privatisation.

Approximately 4 million foreign workers play an important role in the Saudi economy, particularly in the service sector.<sup>2</sup> This suggests that there is an existing model for foreign investment in the country which could be of relevance to privatisation. In other words, it has been argued that privatisation might help to strengthen the government's spending power and make up for tax cuts, creating more jobs and providing a better environment for investment.<sup>3</sup> In 1999, the government announced plans to begin privatising the electricity industry, whilst the privatisation of the telecommunications industry has been ongoing since the mid 1990s.<sup>4</sup> The government is expected to continue looking towards private sector growth in order to lessen the Kingdom's dependence on oil and increase employment opportunities for the swelling Saudi population. Economic conditions would seem to suggest that the time is right to give serious consideration to the privatisation of other government-owned sectors. This is especially apparent when these economic conditions are allied to the fact that for the

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<sup>2</sup> See *The Economy of Saudi Arabia*, at <http://countrystudies.us/saudi-arabia/34.htm> (2/2/06)

<sup>3</sup> Calway, S., *Europe Will Stay Hooked to Privatisation*, Asian Finance, (1987), pp.103-104

<sup>4</sup> Privatisation is also promoted by the Saudi Arabia General Investment Authority (SAGIA). SAGIA hosted a workshop on privatisation in Saudi Arabia on December 21, 2003 with the active participation of officials representing Saudi government agencies and the private sector. The purpose of the workshop was to increase awareness about the benefits of privatisation for the Saudi economy. <http://www.sagia.gov.sa/printpage.asp?ContentID=185&Lang=en> (10/6/06).

government of Saudi Arabia, economic interventions have always been driven by pragmatic reasons and have never been ideologically motivated.<sup>5</sup>

As regards the private sector, the government has adopted a 'Privatisation Strategy'<sup>6</sup> to encourage private sector investment and effective participation in the economy based on commercial principles.<sup>7</sup> The strategy aims at expanding the ownership of productive assets by Saudi citizens and encouraging local investments of domestic and foreign capital. It also aims at increasing employment opportunities and optimising the use of the national work force, ensuring the continued equitable increase of individual income, providing services to citizens and investors in a timely and cost-effective manner. It wants to further rationalise public expenditure and reduce the burden on the government budget by giving the private sector opportunities to finance, operate, and maintain certain services that it is able to provide, increasing government revenues from returns on participation in activities to be transferred to the private sector and monies obtained, for example, from granting concessions or the sale of government properties.<sup>8</sup>

So far, however, economic reforms have proceeded cautiously because of deep-rooted political and social conservatism.<sup>9</sup> Nevertheless, private investment is now a major part of the economy of Saudi Arabia. For example, private investors have contributed, over the past two

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<sup>5</sup> El-Naggar, S., *Privatisation and Structural Adjustment in the Arab Countries*, Washington D.C: International Monetary Fund, (1989), p. 2.

<sup>6</sup> Ministry of Planning, *General Objectives and Strategic Bases of the Sixth Development Plan*, Riyadh: Ministry of Planning Press, (1995), p. 17. For a recent release of Ministry of Planning see *Privatisation*, at: <http://www.mep.gov.sa/index.jsp;jsessionid=56AD274FFB9F2682031D2C44979059E0.beta?event=ArticleView&Article.ObjectID=25>.

<sup>7</sup> Examples of these sectors are industry, electricity, gas, water, agriculture, trade, real estate and community and personal services. In addition investments were active in the financial and banking sector as well as in the transport, communications and information technology sectors, as evidenced by the noticeable expansion of these sectors. See Ministry of Economy and Planning, *Plan Achievements (25) 2008, Chapter two: Private Sector Development and Privatisation Policy*, available at: [http://www.mep.gov.sa/home/Home/English/Plan\\_Achievements/25/ch2.htm](http://www.mep.gov.sa/home/Home/English/Plan_Achievements/25/ch2.htm). Accessed on 29/01/2009.

<sup>8</sup> See Privatisation Strategy for Saudi Arabia, at <http://www.maftoum.com/press3/112E15.htm> (29/8/06).

<sup>9</sup> See CIA at <http://www.cia.gov/cia/publications/factbook/geos/sa.html> (23/09/06).

decades, to the enormous growth in the number of industrial plants operating in the Kingdom. In 1975, Saudi Arabia had approximately 470 industrial plants, with overall investment estimated at \$2.7 billion. By March 1999, the total number of factories in the Kingdom had reached 2,557, with a total investment of about \$43.3 billion.<sup>10</sup> With the growth of private and foreign investment in the Saudi economy in mind, the following is a brief overview of the government's economic strategy, which should shed light on the possible role that private investors could play in other sectors under the current regime.

The investment law introduced in April 2000 reversed the previous ownership policy through joint ventures under majority Saudi Arabian ownership which had as their aim the minimisation of foreign interference in the economy. The new investment law permitted one-hundred-per cent foreign ownership in most sectors.<sup>11</sup>

There would seem to have been three major factors responsible for the new investment laws. First and foremost was the Kingdom's bid for membership of the WTO, discussed in the previous chapter, which was being actively pursued by its Ministry of Commerce. It was made clear to the Kingdom's negotiators during meetings in Geneva in April 2000 that liberalisation of foreign investment laws were a prerequisite for membership.<sup>12</sup> The second factor favouring foreign investment was government need for investment and finance, as well as product knowledge and access to foreign markets. The third factor was the liberalisation experience of the other Gulf Cooperation Council (GCC) states. Businessmen in Saudi

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<sup>10</sup> See the Saudi Network at <http://www.the-saudi.net/business-center/economy.htm> (05/03/06).

<sup>11</sup> Saudi Arabian General Investment Authority, *The New Foreign Investment Laws of The Kingdom*, Riyadh: SAGIA, (2000), p. 2. For more discussion on foreign ownership see chapter 1 supra and chapter 2 supra for ownership under Shari'a.

<sup>12</sup> The monopoly control of major export industries by SABIC (The Saudi Arabian Basic Industries Corporation), was not seen as in the interests of fair and transparent international competition. There have been disputes with the European Union over feedstock pricing for petrochemical exports, the position on which could be clarified through benchmarking if alternative foreign-owned industries existed in the kingdom.

Arabia saw the benefits Bahrain and Dubai had obtained from inward investment and wanted to see more similar business generated in Saudi Arabia.<sup>13</sup>

The Supreme Council for Petroleum and Mineral Affairs, established in February 2001, has confirmed that it is not seeking foreign investment in upstream oil-related activities, which will remain the responsibility of ARAMCO. Rather it is in downstream activities that foreign investment is welcomed, as an alternative to more SABIC joint ventures.<sup>14</sup>

## ***6.1 Economic Strategy***

In view of the shape of the Saudi economy detailed previously, and in particular the increasing role played by privatisation and foreign investment, it is important to examine the extent to which the role of private participation is encouraged in the economic strategies of the government. Generally, the government has accepted the argument that it is advantageous to open the economy to private sector involvement. Its application to join<sup>15</sup> the WTO was part and parcel of this new approach.<sup>16</sup> Negotiations focused on the degree to which Saudi Arabia was willing to increase market access to foreign goods and services and the timeframe for becoming fully compliant with WTO obligations.<sup>17</sup> To this end, in April 2000, the government established SAGIA to encourage foreign direct investment in Saudi Arabia. The government maintained a "negative list" of sectors in which foreign investment is prohibited,

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<sup>13</sup> Wilson, R., *Economic Development in Saudi Arabia*, Routledge, (2004), pp. 34-35.

<sup>14</sup> *Ibid*, p. 35.

<sup>15</sup> For more discussion on Saudi's membership to some Multilateral Investment Treaties and Economic institutions, including the WTO see chapter 5 *supra*.

<sup>16</sup> The Working Party on the accession of Saudi Arabia to the WTO was established on 21 July 1993. Bilateral market access negotiations on goods and services are underway on the basis of revised offers. Multilateral discussions on the terms of entry are ongoing and the latest revision of the draft Report of the Working Party was circulated in June 2004. The last meeting of the Working Party was held in September 2004. See WTO at [http://www.wto.org/english/thewto\\_e/acc\\_e/al\\_arabie\\_saoudite\\_e.htm](http://www.wto.org/english/thewto_e/acc_e/al_arabie_saoudite_e.htm) (2/3/06).

<sup>17</sup> Saudi Arabia is now a member of the WTO since Dec. 2005.

but there were plans to open some closed sectors, such as telecommunications, insurance, and power transmission/distribution, over time.<sup>18</sup>

The following is an overview of the developmental plans that were adopted to accelerate economic growth. The plans focused mainly on the distribution of the oil wealth of the country. Private enterprise was encouraged, and foreign investment in the form of joint ventures with Saudi public and private companies was welcomed and the private sector became more important.<sup>19</sup>

The government's 5-year economic development plans sought to allocate petroleum income to transform the relatively undeveloped, oil-based economy into that of a modern industrial state while maintaining the Kingdom's traditional Islamic values and customs.<sup>20</sup> Although economic planners have not achieved all of their goals, the economy has progressed rapidly. Oil wealth has increased the standard of living of most Saudis. However, significant population growth has strained the government's ability to finance further improvements in the country's standard of living. Heavy dependence on petroleum revenue continues, but industry and agriculture now account for a larger share of economic activity. The mismatch between the skills of Saudi graduates and the needs of the private employment market at all levels remain the principal obstacle to economic diversification and development. To compensate for this shortfall, around 4.6 million non-Saudis are employed in the sectors of the economy most in need.<sup>21</sup> It should be noted that, only 15 percent of foreign workers in Saudi Arabia are engaged in skilled labour industries (oil, healthcare, finance, and trading), while the majority are employed in industries with a need for low-skilled labour (agriculture,

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<sup>18</sup> See <http://www.sagia.gov.sa/> (10/6/06).

<sup>19</sup> See Economy of Saudi Arabia at <http://www.saudi-us-relations.org/economy/saudi-economy.html> (14/10/2008).

<sup>20</sup> See Five Year Plans at <http://countrystudies.us/saudi-arabia/37.htm> (3/3/06)

<sup>21</sup> Ibid

cleaning, and domestic service). Expatriates from Europe and North America dominate high-skilled positions; low-skilled workers originate primarily from South and Southeast Asia.<sup>22</sup>

Prior to 1960, there was very little formal planning in Saudi Arabia. However, in the early 1960s the nation began to employ deliberate policies and plans to achieve social and economic development. Initially, planning efforts were not clearly defined, and they were poorly organised. Continued efforts, however, resulted in the nation's first five-year economic development plan, covering the period 1970-1975. By the mid-1980s, Saudi government-business relationships were in a crucial period of transition.<sup>23</sup> Saudi Arabia's first two development plans, covering the 1970s, emphasised the country's infrastructure. The results were impressive, the total length of paved highways tripled, power generation increased by a multiple of 28, and the capacity of seaports grew tenfold.<sup>24</sup> For the third plan, covering the period 1980-1985, the emphasis changed. Spending on education, health, and social services rose markedly, with investment on infrastructure seeing a relative decline.<sup>25</sup> The two industrial cities of Jubail and Yanbu began utilising the country's oil and gas resources to produce steel, petrochemicals, fertilizer, and refined oil products. They experienced large growth in production to the point where they more or less reached their optimum size.

In the fourth plan, covering 1985-1990, the country's basic infrastructure was viewed as largely complete, but education and training remained areas for further investment. Private enterprise was encouraged, and foreign investment in the form of joint ventures with Saudi

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<sup>22</sup> Pakkiasamy, D., *Saudi Arabia's Plan for Changing Its Workforce*, Migration information source, (Nov. 2004) available at: <http://www.migrationinformation.org/feature/display.cfm?ID=264> 16/10/2008

<sup>23</sup> Soufi W., & R. Mayer, *Saudi Arabian Industrial Investment*, Greenwood Publishing Group, (1991), pp. 13-14.

<sup>24</sup> Wilson, R., *supra* note 13, p. 52.

<sup>25</sup> *Ibid*, p. 54.

public and private companies was welcomed. The private sector became more important, rising to 70% of non-oil GDP by 1987.<sup>26</sup> While trade and commerce remained the focus, private investment did increase in industry, agriculture, banking, and construction companies. These private investments were supported by generous government financing and incentive programmes.<sup>27</sup> The objective was for the private sector to have 70% to 80% ownership gained by domestic investors, mostly in the form of joint venture enterprises.

The fifth plan, running from 1990-1995, emphasised consolidation of the country's defences, improved and more efficient government social services, regional development and most importantly the creation of greater private-sector employment opportunities for Saudis. This was to be achieved by reducing the number of foreign workers, a point which might be seen to have negative implications in attracting foreign investment in the country. Its implication seems to be that local Saudi labour might have to be employed by the private companies rather than skilled foreign labour. However, where Saudi workers with the necessary technical proficiency or academic qualifications are not available, the Ministry of Labour may provisionally reduce the percentage<sup>28</sup> of Saudi citizens to be employed by the investment enterprise. But, as skilled workers are scarce in Saudi Arabia, it is usually not necessary to invoke this ministerial discretion and foreign investors are usually compelled to hire not only foreign labourers, but also administrative personnel. However, in view of the policy of the Saudi government to 'Saudize' several jobs, foreign investors will be faced with limited options to hire foreign administrative personnel.<sup>29</sup> In other words, the hiring of foreign labour will be limited to some sectors – e.g. industrial sectors – where there is labour shortage and employment is inevitable.

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<sup>26</sup> See note 2, *supra*.

<sup>27</sup> *Ibid*.

<sup>28</sup> Saudi workers engaged by the employer shall not be fewer than 75% of his total workforce.

<sup>29</sup> El-Sheikh, F., *infra* note, 53, p. 66.

The plan covering 1996-2000 focused on lowering the cost of government services without compromising quality, and also sought to expand educational and training programmes. The plan called for a reduction in the kingdom's dependence on the petroleum sector by diversifying economic activity, particularly in the private sector, with special emphasis on industry and agriculture. It also, as mentioned above, continued efforts to increase the balance of the labour force in favour of Saudi nationals.<sup>30</sup>

The seventh plan, running from 2000-2005, focused more on economic diversification and a greater role for the private sector in the Saudi economy.<sup>31</sup> For the period 2000-2005, the Saudi government targeted an average GDP growth rate of 3.16% per annum, with projected growths of 5.04% for the private sector and 4.01% for the non-oil sector. The government also set a target of creating 817,300 new jobs for Saudi nationals, consolidating the process started in the fifth plan to increase the proportion of Saudi nationals to foreign nationals working in the Saudi economy.<sup>32</sup>

The Eighth Development Plan of 2005-2009 represents a major landmark in the social and economic development path of Saudi Arabia, as it is the first five-year plan prepared in the context of a long term development strategy with definite targets and objectives. This strategy was prepared to provide the framework for the four successive five-year plans until

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<sup>30</sup> Ibid

<sup>31</sup> In terms of water supply, Saudi Arabia will need a capital investment averaging nearly \$2 billion per year for the next 20 years in order to meet projected water demand. This figure assumes a net reduction from 286 litres a day to 250 litres per day consumed per head of population. Loay Al-Mussallam, deputy minister for planning in the Ministry of Water and Electricity (MOWE), gave the figure during a review of Saudi Arabia's efforts to bridge the gap between future supply and demand. He outlined the main objectives of the MOWE as providing access to clean water for all at a reasonable price, connection of sanitary services to all households and safe disposal of wastewater to protect the environment and water resources. Al-Mussallam said that there were considerable challenges to overcome apart from water scarcity. Rapid demographic growth, which he said was at three percent, and a huge investment requirement needed to build a vast infrastructure. Over the next five years, Saudi Arabia will require 4,500 kilometres of new pipeline for freshwater transport and over 22,000 kilometres for wastewater disposal pipes. See [http://www.fact-index.com/e/ec/economy\\_of\\_saudi\\_arabia.html](http://www.fact-index.com/e/ec/economy_of_saudi_arabia.html) (23/2/06).

<sup>32</sup> Ibid.

2024, which together constitute four integrated and combined stages, according to the Ministry of Economy & Planning.<sup>33</sup> Two of the main features of this plan are the establishment of the industrial cities and SAGIA 10x 10 programme.<sup>34</sup>

The Saudi Arabian economy continues to be characterised by a duality between what are referred to as the non-oil sector and oil sectors. However, what is clear is that, as has been stated earlier in this study, despite attempts to diversify and to reduce the economy's dependency upon it, the oil sector is of central importance to the economy of Saudi Arabia.<sup>35</sup>

## ***6.2 Saudi Arabia's Privatisation Programmes.***

The achievement of social and economic development is a standing goal for all the governments of the Middle East region. However, the ways in which these various countries go about achieving this goal differ widely. Some achieve results through central planning; others embark on partnerships with the private sector. Continued social and economic development is essential to meet the challenge of ensuring that the quality of life improves and that disposable incomes for families are increased. With a high rate of population increase in the region, the countries have to achieve ever higher rates of economic growth just to maintain the same standard of living, let alone improve on it. Social and economic development affects the public sector in many ways. It produces the framework for financing

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<sup>33</sup> See Ministry of Economy and Planning, *Saudi Arabia: long-term Strategy 2024*, (2005). The Plan document says: "The methodology of the Eighth Development Plan is different from that of the previous plans, (including the Seventh Development Plan, which included long term strategic directions). It consists of a clearly articulated vision, policies and programmes to achieve this vision, and long term targets to ensure effective follow up and implementation." see Ministry of Economy and Planning, *Saudi Arabia's 8<sup>th</sup> Development Plan 2005-2009*, (2005).

<sup>34</sup> For more details see Saudi Embassy in Washington website at: [http://www.saudiembassy.net/about/country-information/economy\\_global\\_trade/industrial\\_cities.aspx](http://www.saudiembassy.net/about/country-information/economy_global_trade/industrial_cities.aspx). SAGIA 10 x 10 Programme see SAGIA website at: [www.sagia.gov.sa](http://www.sagia.gov.sa).

<sup>35</sup> Oil GDP: 55%, non oil private sector: 28.5%, non oil government 16.5%, see SAMA 42<sup>nd</sup> Annual Report 2006. Non-oil GDP reported a 5.1% growth in 2006, its highest level in 10 years. This growth came mainly as a result of attracting foreign investment and encouraging the private sector, see the National Competitiveness Centre, *The Competitiveness Review*, Vol. 1, Riyadh: SAGIA, (September 2007), p. 59.

resource development, operation and maintenance. Only the oil-enriched countries in the region can afford to finance development projects out of their own treasuries. Other countries need to call upon the contribution of financing agencies and friendly governments to help finance these projects in their public sector.

An equally important consideration of social and economic development is the ability of consumers to meet the real cost of services. So far, none of the countries in the region have managed to impose tariffs suitable for the recovery of the entire costs. Even the oil-enriched countries subsidise their project heavily.<sup>36</sup> Consumers pay only a fraction of the cost of operation and maintenance of services in Saudi Arabia, to give just one example.<sup>37</sup>

The Saudi government has a history of being very innovative in its approach to private sector participation. As stated earlier, In May 1933 the Saudi government contracted out its oil operations to the Standard Oil Company via the formation of ARAMCO. This policy of acquiring technology and foreign expertise by using foreign companies has been pursued since 1973 through the encouragement of joint-ventures in a wide spectrum of sectors, including construction, manufacturing, banking, shipping and petrochemical processes.

For example, by May 1995 there were 287 joint-venture manufacturing projects in the Kingdom involving the public and private sector with foreign capital and expertise. Of those

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<sup>36</sup> In the case of Saudi Arabia, interest-free loans of up to 50% of project costs are provided by the Saudi Industrial Development Fund (SIDF) for industrial projects, see its website at: <http://www.sidf.gov.sa/english/index.htm>. Similar financial support is given for agricultural projects by the Saudi Arabian Agricultural Bank, <http://www.saabserver.com/FrontEnd/Index.aspx>. (Arabic version only), there are also two additional funds, the Saudi Credit Bank, [http://www.mof.gov.sa/en/docs/ests/sub\\_tsleef.htm](http://www.mof.gov.sa/en/docs/ests/sub_tsleef.htm), and the Public Investment Fund, [http://www.mof.gov.sa/en/docs/ests/sub\\_invbox.htm](http://www.mof.gov.sa/en/docs/ests/sub_invbox.htm), which both grant interest-free loans to public or semi-public firms – e.g. Saudi Arabian Basic Industries Corporation (SABIC) – that enter into joint ventures with foreign investors.

<sup>37</sup> See IDRC Books at [http://web.idrc.ca/es/ev-29775-201-1-DO\\_TOPIC.html](http://web.idrc.ca/es/ev-29775-201-1-DO_TOPIC.html) (12/6/06).

projects, 72% of the capital was in the chemicals and plastics sector.<sup>38</sup> The Saudi government had already sold 30% of its shares in SABIC (the Saudi Arabian Basic Industries Corporation) to the public in the early 1980s. It also sold 30% of its share in the Saudi Telecom Company in 2002 after five years of preparation and restructuring. The government has also assigned the maintenance and operation of many government agencies to the private sector. Examples of this include the Port Authority is under the supervision of the Railway Organisation, as well as the operation and maintenance of some hospitals, and the maintenance and construction of roads. The government has also used other methods of privatisation, including liberalisation from legal monopolistic control and permitting the private sector to work and compete in a sector run by the government. Permission for SNAS, DHL and other companies working in fast mail delivery and parcels to compete with the state-owned post enterprise is a clear example of this. The government is concerned with setting up appropriate legal and regulatory structures for the privatisation process in the Saudi economy to ensure competition and to avoid monopolistic tendencies.<sup>39</sup>

The Council of Ministers Decree No. 60 (August 6, 1997) was the starting point to establishing the eight objectives of privatisation in Saudi Arabia and the principles to be taken into account in order to achieve these objectives. The Council of Ministers Decree No. 257 of (February 5, 2001) stated that the SEC would be responsible for supervising the privatisation programme and monitoring its implementation. This was to be in coordination with competent government organisations, and both parties would determine which activities were to be privatised. Decree No. 6/22 issued by the SEC on (August 2, 2001) provided for the reorganisation of the Privatisation Committee within the SEC, under the chairmanship of

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<sup>38</sup> Al-Sarhan, M., & J., Presley, *Privatisation in Saudi Arabia: an attitudinal survey*, Managerial Finance, Vol. 27, Issue 10/11, (2001), pp. 114-122.

<sup>39</sup> Whinney, M. & Co, *Business Structures*, in Shoult, A., (edit.), Doing Business with Saudi Arabia, London: Kogan Page Ltd, (1999), p. 203.

the Council's secretary-general. The new committee consisted of members representing the Ministry of Finance, the Ministry of Industry and Electricity, the Ministry of Commerce, and the Ministry of Planning and National Economy and two members from the Advisory Board for Economic Affairs. SEC No.1/23 dated (4<sup>th</sup>, June, 2002) approved a new privatisation strategy comprising eight basic objectives, each of which required the adoption of a number of policies.<sup>40</sup> The new privatisation strategy was prepared in accordance with the provisions of the Council of Ministers Decision No. 60 dated (6<sup>th</sup>, August 1997) which stated, "expanding the private sector's participation in the national economy and enabling it to undertake its role in investment and financing should be in line with the national development plans, and positive for both the government and private sector".<sup>41</sup>

The privatisation process constitutes an important part of the government's long-term strategy to enhance opportunities for the private sector and to improve the efficiency and competitiveness of the national economy by enhancing the participation of the private sector in economic development. This will be undertaken by adopting the best available methods, including transferring certain types of economic activity to the private sector, and enabling it to accomplish its investment and finance role in accordance with the national development plan. The privatisation strategy defines a number of administrative and implementation procedures related to privatisation, whereby the Economic Council will be responsible for supervising privatisation programmes and monitoring their implementation.<sup>42</sup>

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<sup>40</sup> Draft report on study on business cooperation between the Kingdom of Saudi Arabia and Europe, prepared for SAGIA by IFO Institute and Saudi German Development and Investment Company Ltd (SAGECO), pp. 62-84.

<sup>41</sup> See Saudi Supreme Economic Council (SEC) website at: [http://www.sec.gov.sa/Privatization\\_Strategy/Privatization\\_Objectives\\_and\\_Policies.aspx?lang=en-US](http://www.sec.gov.sa/Privatization_Strategy/Privatization_Objectives_and_Policies.aspx?lang=en-US). See also Ibid, pp. 127-153

<sup>42</sup> Al-Nimir, S., *Attitude of Some Beneficiaries from the Services Given by Some Government Agencies in the Kingdom of Saudi Arabia About Privatising these Services*, *Majalat Al-Edarah Al-ammah*, 34(2), (Sep. 1994), p. 172. (In Arabic).

To carry out the required activities and functions necessary for the discharge by the SEC of its duties and responsibilities with respect to privatisation, the Privatisation Committee is involved in designing the privatisation strategy. Determining and recommending the public enterprises, projects, and services to be privatised, determining the regulatory and implementation procedures for the privatisation process, and monitoring and supervising the implementation of privatisation activities are all within its remit. Although the strategy clarifies the steps that are to be taken, a specific timetable for the process has yet to be established.<sup>43</sup>

The definition of privatisation, as stated in the privatisation strategy, is “the process of transferring the ownership or management of public enterprises, projects and services to the private sector, relying on market mechanisms and competition, through a number of methods, including contracts for managing, operating, leasing, financing, or selling all or part of the governments’ assets to the private sector”. Privatisation has been seen as offering a means of increasing the efficiency with which scarce public resources are used, and of improving the delivery of services to the public. These beneficial results may come about in a variety of ways. For state enterprises which are incurring losses in their operations, a transfer of ownership can end the subsidies or subventions required to avoid those losses.<sup>44</sup>

### **6.2.1 Objectives and Policies for Privatisation.**

On 6<sup>th</sup>, August, 1997, the Council of Ministers Decree No. 60 specified eight objectives for privatisation in Saudi Arabia and determined the principles to be taken into account in order to achieve these objectives. They are as follows:

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<sup>43</sup> Badkook, G., *Is it Time for Privatisation in Saudi Arabia?*, Saudi Cairo Bank Publications, Riyadh: Saudi Arabia, (June, 1992), p. 19.

<sup>44</sup> Pritchard R., & others eds., *Privatisation and Private Provision of Infrastructure*, in R., Pritchard, (Ed.), *Economic Development, Foreign Investment and the Law* 76, (1996), p. 68.

1. Rationalising public expenditure and reducing the burden on the government budget by giving the private sector opportunities to finance, operate, and maintain certain services that it is able to provide.
2. Improving the efficiency of the national economy and enhancing its competitive ability to meet the challenges of regional and international competition.
3. Encouraging private sector investment and effective participation in the national economy, and increasing its share of domestic production to achieve growth in the national economy.
4. Enlarging the ownership of productive assets by Saudi citizens.
5. Encouraging national and foreign capital to invest locally.
6. Increasing employment opportunities, optimising the use of the individual work force, and ensuring the continued equitable increase of individual income.
7. Providing services to citizens and investors in a timely and cost-efficient manner.
8. Increasing government revenues instruments such as the proceeds of participation in activities to be transferred to the private sector, financing compensation accruing from granting concession rights, and revenues generated from privatising part of the government's share.<sup>45</sup>

Generally speaking, the Saudi government plays the predominant role in the economic and social welfare of the country. Government spending, therefore, is not only the major economic engine of the economy, but it represents the source of primary funding for all projects, programmes and services that are essential for national economic development. Although, the government has taken many steps to encourage and enhance private sector participation in the economy, it is only in the last few years that the private sector has been

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<sup>45</sup> SAGIA, *The Legal Guide to Investment in Saudi Arabia*, (2005), p. 22.

strong enough to play a significant role. Therefore, more research should be done to in the area of private sector readiness and capabilities in general. Specifically, the market's ability to finance the privatisation programme is of extreme importance.

## **6.2.2 Methods and Principles governing Privatisation**

In 2002 the SEC issued Resolution No. 1/23 dated 4/6/2002 and confirmed the privatisation strategy. According to this resolution, the methods for privatisation are:

- Management contracts;
- Leasing contracts;
- Finance contracts
- Sale contracts - consisting of direct sales to the private sector through public subscription, or sales to a principal investor.

The privatisation strategy also foresees rules for implementing the privatisation process. First, the process should be transparent and all information relating to the privatisation must be disclosed to the public. Second, excessive delays in the process should be avoided by expeditious implementation, with the aid of timetables. Finally, one of the primary aims of the privatisation process is to bring about changes in the approach and methods of management by improving performance and implementing private sector management practices.<sup>46</sup>

Further steps to be taken under the privatisation strategy include the creation of a regulatory framework for the privatised sector, essentially consisting of the establishment of one or several autonomous regulatory agencies, levying fees for public services provided, as

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<sup>46</sup> SAGIA, *Legal Background for Foreign Investment in Saudi Arabia*, (2003), pp. 20-21.

well as the financial, technical and operational restructuring of the sectors and public enterprises to be privatised.<sup>47</sup> The process of privatisation in Saudi Arabia is currently in its early stages. The government, having taken significant measures, plans to continue the process prudently and systemically, providing even greater opportunities in the future for potential targets for investment in Saudi Arabia.<sup>48</sup>

## ***6.3 Licensing and Legal Incentives and Reforms for Foreign Investment.***

### **6.3.1 Licensing and Admission**

After the commencement of privatisation policies in the 1990s, opening the public sector to the private sector (including national and foreign investors), the Saudi government established SAGIA in 2000 to provide information and assistance to foreign investors. The Authority operates under the umbrella of the SEC and is headed by a Governor. Its duties include formulating government policies regarding investment activities and proposing plans and regulations to enhance the investment climate in the country. It also evaluates and issues licences for investment proposals. All foreign investment projects must obtain a licence from SAGIA before they can operate in the country. Local investors continue to apply to the Ministry of Commerce and Industry's Foreign Capital Investment Committee for licences.<sup>49</sup> It should be noted that SAGIA has removed previous bureaucratic procedures which were considered a significant obstacle to attracting foreign investments. Foreign investors in the past had to experience a long process of application to gain the licence to invest in the Kingdom, which the establishment of SAGIA has removed.

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<sup>47</sup> Ibid, p.21.

<sup>48</sup> See for example, Shoult, A., *Privatisation and Economic Reforms*, in *Doing Business with Saudi Arabia*, 3<sup>rd</sup> ed., London: GMB Publishing Ltd, (2006), pp. 73-84.

<sup>49</sup> For more information on SAGIA see: <http://www.sagia.gov.sa/english/index.php>, accessed 03/07/08.

With regard to admitting investment from outside Saudi Arabia, the first basic requirement is that it must be a 'foreign investment' of the kind that falls within the scope of the policy embodied in investment laws and treaties.<sup>50</sup> Foreign investment ultimately involves three parties: the capital exporting country – of which foreign investors are usually nationals, the foreign investors themselves, and the capital importing country.<sup>51</sup>

### 6.3.2 Legal Incentives and Reforms

This part of the chapter deals with incentives and reform policies in Saudi Arabia, which are relevant to the Kingdom's long term of surplus in finance over the last three decades. This has enabled the country to adopt very generous incentive policies to accommodate foreign capital and attract foreign investments. It should be mentioned that policies work to both offer positive incentives and to reduce negative disincentives. Positive incentives include tax concessions, free custom duties and export zones which are provided by the government. Removal of disincentives to investments means reducing lengthy and bureaucratic systems resulting in delay in issuing visas, travel restrictions and the complexity associated with the licensing and registration of a project or activity. In addition, attempts have been made to reduce the lengthy and complicated procedures associated with settling investment disputes. Saudi Arabia has implemented recent changes to improve the foreign investment climate in the country:<sup>52</sup>

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<sup>50</sup> A foreign investor under Saudi law is a natural or judicial person who has not acquired Saudi nationality in accordance with the nationality laws of the country.

<sup>51</sup> This is the situation in the case of foreign private investment. In the case of foreign public investment, the problem is not so complicated, because the investment transactions involve only two parties, namely the capital-importing and capital-exporting countries thereof. As mentioned previously, this thesis deals only with legal aspects of foreign direct investment in Saudi Arabia.

<sup>52</sup> For more details on the promotion of foreign investment in Saudi Arabia see *Saudi Commerce and Economic Review, Gas Projects: New Business Horizons*, May 2004, No.121, and *Foreign Investors: New Taxation System for the Natural Gas*, pp. 10-12.

- Review of its 48 year old Foreign Investment Law to allow, *inter alia*, granting foreign investors the same rights as are authorised to Saudi nationals. This is referred to as “national treatment” in modern parlance.
- Review of its 48 year old Income Tax Law to impose lower taxes on foreign business profits and provision of greater legal protections for investors.
- A new legal framework was instituted for the banking and insurance sectors to make the investment environment more attractive to foreign capital.<sup>53</sup>

To sum up, the new Foreign Investment Law passed on April 2000, provides for foreign investors:<sup>54</sup>

- 1) The possibility of 100% ownership of projects, giving international companies full ownership of the property required for the project or for housing company personnel, (Article 5);
- 2) Enables them to retain the same incentives given to national companies, (Article 6);
- 3) Permits them to invest in all sectors of the economy, except for specific activities contained in the negative list, (Article 3).

On February 11th 2001 Saudi Arabia’s SEC approved a “negative list”<sup>55</sup> of economic sectors barred to majority-foreign-owned firms, thus clarifying the issue of where in the economy foreigners may invest. The list was published as secondary legislation to the 2000 Foreign Investment Law and earmarked for annual revision. It is also, in the words of the government, to be interpreted “flexibly”. Those sectors not included on the list should be

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<sup>53</sup> Detailed analysis of the Tax reforms see Mazzanti, M., *Saudi Gas Supplies and Investment Taxation Legislation*, OGEI, vol2 – issue 1, (Feb. 2004), p 5, at: [www.gasandoil.com/ogel](http://www.gasandoil.com/ogel)

<sup>54</sup> See generally SAGIA website: [www.sagia.gov.sa](http://www.sagia.gov.sa), accessed: 03/07/08.

<sup>55</sup> It includes oil exploration and production, wholesale and retail trade, printing, transport, fishing, some medical services and real estate in two holy cities Makkah and Madderah.

regarded as legally open to majority-foreign-owned companies. However, few foreign companies are in these sectors because of the poor business environment, which includes regulatory and labour problems.<sup>56</sup>

- 4) Foreign investors are no longer required to have local partners, and may own real property for individual or company business activities, (Article 8).
- 5) They also can transfer money from their enterprises outside of the country and can pay their foreign employees, (Article 7).
- 6) The corporate tax rate for foreign companies with annual profits over SR 100,000 is reduced from 45% to 20%. Companies are also allowed to carry forward corporate losses for an unspecified number of years. Projects that are 100% foreign owned are also eligible for loans from the Saudi Industrial Development Fund (SIDF).
- 7) Similarly, investors are also entitled to hold investment licenses in more than one type of activity (Article 7 of Procedural Rules).

In the same vein, the Saudi Arabian Tax Law is based on Royal Decree No. (M/1) dated 06/03/2004 which lowered the 2003/4<sup>57</sup> corporate tax rate to a flat rate of 20% of the tax base of a resident capital company. A non-Saudi resident who does business in the country, and a non-resident person who does business in the country through a permanent establishment will pay this rate. The tax rate is 30% of the tax base of a taxpayer engaged in natural gas investment activities, and 85% where the taxpayer is engaged in oil and hydrocarbon production. A net operating loss may be carried forward to the tax year

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<sup>56</sup> For more details see: <http://www.zawya.com/marketing.cfm?zp&p=/countries/sa/macrowatch.cfm?eiusection=Investment>

<sup>57</sup> SAGIA, supra note, 36. The Saudi Arabian Tax Law also introduced the Saudi Arabian Income Tax Law (the "Income Tax Law") and by Ministerial Resolution 1535 of the Ministry of Finance (dated 28/07/2004). The Preliminary Tax Appeal Committee (PTAC) and the Appellate Committee for *Zakat* and Tax Appeals (ACZTA) provide rulings and interpretations on questions raised by taxpayers. See also Arab News, [www.arab.net/saudi/sa\\_shariabiz.htm](http://www.arab.net/saudi/sa_shariabiz.htm) visited 04/07/08.

following the year in which the loss is incurred, to be deducted in determining the tax base of future tax years until the cumulative loss is fully offset.<sup>58</sup>

Income tax or *Zakat*, which is a religious wealth tax, is assessed on the taxable income of joint stock companies, limited liability partnerships, foreign branches, partnerships, contractors and professionals. Foreign entities are subject to income tax on their share of profits from business entities, but are not subject to *Zakat*. Saudis and GCC nationals and interests owned by them are subject to *Zakat* (which is applied on a formula basis) but not to income tax. Individuals are not taxed on salaries or wages. Indirect taxes consist of customs duties levied on imported goods. Saudi Arabia does not impose sales tax; value added tax, estate tax or gift tax.<sup>59</sup>

## Conclusion

This chapter, based on a country profile approach, has dealt with selected issues of Saudi Arabia's economic and legal environment. The criterion for selection was their relevance to foreign engagement in investment activities in Saudi Arabia. The following issues have been dealt with: economic policies between 1960 and 2009, development prospects, development incentives, the tax system and customs and import regulations.

With respect to privatisation, the Saudi government has already taken steps by establishing pilot institutions such as SAGIA. It has also ventured into a new system of private-public partnership. These steps cover both the privatisation of public enterprises and the increasing involvement of the private sector which should be intensified in order to

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<sup>58</sup> For taxation regime see *Saudi Commerce and Economic Review Gas Projects: New Business Horizons*, No.121, May 2004, see also [www.the-saudi.net/business-center/regulation-other.htm](http://www.the-saudi.net/business-center/regulation-other.htm) accessed 08/07/08.

<sup>59</sup> Bartlett, S., & W. Murray, *Doing Business with Saudi Arabia*, Business Taxation, (1999), p. 67.

accelerate the restructuring process. This should also be supported by further liberalisation of the capital market.

Economic performance in Saudi Arabia, i.e. the growth of its GDP, has been moderate since the 1990s. Compared with the oil sector, the non-oil sector including petrochemicals gained considerable momentum. There has been tendency, on the one hand, towards diversifying the production structure and on the other towards import substitution and production for export. The most dynamic factor was, and continues to be, an increasing domestic market resulting from a fast growing population. The government is focusing its efforts on the enhancement of the private non-oil sector. The negative list outlines areas which are considered by SEC to be of strategic importance for the protection of the economy and national security against globalisation. However, it is expected that the list will be shortened, especially since joining the WTO. Such restrictive provisions would be considered as interfering with the market forces.

As far as incentives for the private sector are concerned, taxes on company profits have been lowered, capital goods and other industrial inputs are exempted from customs duties, loans are subsidised and foreign ownership is extended to real estate.

Unfortunately, these incentives are neutralised by the obstacle of unnecessary procedural technicalities. These requirements emanate from a deficiency in the existing investment administrative machinery which is characterised by overlapping of jurisdictions between different bodies and bureaucratic red-tape. These problems are addressed by recent investment codes and some improvements have been made, especially with respect to the screening and licensing of projects. All signs are that these procedures are now completed

more quickly than in the past.<sup>60</sup> It is by no means certain, however, that the new investment laws will succeed in the short term in halting Saudi Arabia's decline in relation to other GCC countries. It has to be said that the flow of foreign capital into the Kingdom has increased because of political stability. With regard to legal stability, the next chapter will examine the stability of investment agreements under Saudi law.

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<sup>60</sup> El Sheikh, F., *The Legal Regime of Foreign Private Investment in Sudan and Saudi Arabia*, 2<sup>nd</sup> ed., Cambridge University Press, (2003), pp. 439-440.

## **(7) CONCLUSION and SUGGESTED REFORMS**

The goal of the thesis has been to examine the legal problems associated with foreign investments in Saudi Arabia. Although the focus of the research was mainly on the petroleum resources sector development, the analysis throughout was applicable to other economic sectors generally. The intention was to examine what has been or is being done to improve the Saudi investment climate as viewed by foreign investors. In particular, the study attempted to address in details, the following main issues:

The research investigated legal, legislative and policy issues related to FDI in Saudi Arabia, and what the government has been doing to reduce or diffuse the perception of political risks in these manifestations. We also undertook an exploration of how Shari'a interacts with the conventional system of law in order to facilitate better understanding of the similarities and differences between the two systems. In addition, the research focused on how the status of contracts in Saudi Arabia interferes with the development of relationships with foreign investors. A final area to investigate was to discover how investment and commercial disputes are settled in the Kingdom and how this impacts on foreign investment.

These issues encompassed the key problems that have a direct effect on the development and volume of foreign direct investments in Saudi Arabia. In order to identify the lessons emerging from the issue of legal security of foreign direct investments in Saudi Arabia, each chapter should be revisited to demonstrate what it has offered. Chapter one brought out the substantive legal issues surrounding the topic of FDI. The primary purpose of this chapter was to place foreign investment within the constitutional and legal environment

in which it operates. It has been found that the interpretation of the Shari'a by different judicial bodies may often not be consistent. This is because the main two sources of Shari'a – the *Quran* and the *Sunnah* – do not specifically cover the large variety of commercial transactions which are now in use in Saudi Arabia. Therefore, more attention should be given to the *Ijma* (consensus) among the religious scholars, and to the *Quiyas* (analogy) in order to increase the make use of the flexibility of Shari'a.

Chapter two examined the stability of investment agreements and the status of contracts in Saudi Arabia. The issue of contracts was examined in the light of their status and role where Shari'a does not require a formal written form of contract, but merely stresses the importance of the act of an offer and acceptance to establish a contractual relationship. The aim of this section was to better inform foreign investors of fundamental principles of Shari'a in the field of contracts, which should in turn attract more foreign investment. The second part of the chapter addresses the concept of ownership of minerals under Shari'a. The issue of ownership of minerals was dependent upon many factors. These included land ownership, and whether minerals were above or below the surface of the land. Views of Muslim jurists of the four schools of thought were highlighted. According to the *Hanbali* School, which is the prevailing system, followed by the Saudi Legal system, the state reserves the ownership of the minerals in the sub-soil, and holds title as a trust for the benefit of the society at large. This view was found compatible with most modern concepts of mineral title. This is reflected in the revised Saudi Investment Law of 2000. It was concluded that since Shari'a asserts the sanctity of all types of contracts, and imposes upon Muslims the duty to faithfully observe their contractual obligations, the stability of investment agreements is assured and contracts are deemed to be secured.

Chapter three examined the important issue of dispute settlement and the applicable law in Saudi Arabia. In Saudi Arabia disputes of commercial nature, especially those occurring between the state and foreign investor are resolved by a special judicial body known as the Board of Grievances. However, an issue arises as to the independence of the Board in dispute settlements. This is because the Board is directly linked to the king, which may be considered as a form of government intervention. In addition, the chapter also addressed international requirements under conventions such as the United Nations Commission for International Trade Law (UNCITRAL) and the New York Convention (NYC). In the course of analysis of the issues covered by this research work, as highlighted in the previous section, some challenges were identified. It was concluded that these challenges include the perception that the commercial system in the Kingdom was too regulated and not privatised, and that the dispute settlement mechanism was not open, and needed to be more independent and delocalised. Chapter four highlighted the history and development of contractual relationships between the government and ARAMCO. The main aim of this chapter was to show the observance of the Saudi government of its contractual obligations under the Concession Agreements between 1933 and 1980. The secondary aim was to address the difficulties experienced by the Saudi government through its relations with ARAMOC during its efforts to exercise control over its natural resources. This is the reason that the Kingdom encourages foreign investments only in downstream energy rather than the upstream.

Chapter five examined the protection of foreign investment under Saudi law, international law and through bilateral and multilateral agreements on the promotion and security of foreign investments. The aim of the chapter was to demonstrate whether the guarantees provided under Saudi domestic law are sufficient for the protection of foreign investments or not. The chapter also discussed the protection of foreign investment under

international law and particularly the standards of treatment of foreign investments there under. The role of bilateral and multilateral conventions to which the Kingdom is a party was also dealt with. The purpose of this section was to show Saudi efforts in providing effective guarantees to foreign investment, as well as the basic provisions of these investment agreements. In light of these bilateral and multilateral conventions, it was concluded that bilateral and multilateral treaties and international organisations that Saudi is party to have played a major and important role in providing effective protection to foreign investment in the country.

Chapter six highlighted the privatisation policy of the Saudi government, the admission and the legal incentives of foreign investments in the Kingdom. The aim of this chapter was to study the wave of privatisation and liberalisation in Saudi enacted in order to attract foreign investments. A competitive economy projects a positive image of the private sector which helps to convince foreign investors and even bring back migrating capital investment. The chapter also highlighted the government's attempts to enhance legal incentives and investment licences. It was observed that although privatisation has given the private sector and foreign investors a chance to be a partner in the planning of Saudi Arabia's economic development, the government should speed up the privatisation process as activities that proceed slowly are more susceptible to failure.

It was discovered, that although these challenges were often levelled against the Kingdom, they were in fact also faced in other Muslim countries that have adopted Islamic Law System, but perhaps to a lesser extent. This is because, it was observed, there has been more adaptation of the legal systems of those other countries. The intention there was to attempt a greater accord with international law of investment. The researcher, however,

pointed out that these negative assumptions were not entirely correct, and where they were, they had little or nothing to do with the Shari'a Legal System. In addition to the above and with the introduction of the Foreign Investment Law in 2000, the Kingdom is also exhibiting a marked improvement in conforming with international practice in resolving investment disputes and thereby providing protection to foreign investors in the country. There is a growing practice of dispute settlement between foreign investors and national governments by international commercial arbitration which offers efficient cost and time effective solutions. When contracts are being designed, the factor of international commercial arbitration is now routinely built in.

Following on from this extensive analysis and observation, my conclusions encompass political engagement, a substantive legal framework, economic liberalisation and greater transparency in relation to dispute settlement and the judiciary.

### ***Political and legal engagement:***

Much has been done, and is still being done by the Kingdom to review its laws and policies related to foreign investment. Yet much is still needed to equip the country to partake and play its full role in global trade especially in the energy market. Joining the WTO, for instance was most welcome. It will go a long way towards consolidating Saudi membership of other multilateral conventions and organisations in the field of international trade. WTO membership is seen as a factor which strengthens the harmonisation of investment laws and regulations with regard to international standards. It is also helps to boost world trade and therefore improve conditions for both business cooperation and FDI. Saudi Arabia should go ahead and make its mark in the WTO by moving away from its past history of limitation, restriction and opacity. It needs to transform itself into a more flexible, open and transparent

state. The government should also eliminate the delay between the adoption of new regulations and their implementation rules. It has been stated earlier that old regulations are still being used by some of courts instead of the latest amendments or revisions. This must be done by improving communications between government and judicial staff in order to resolve interpretation problems and uncertainty for both local and foreign investors.

Saudi Arabia faces the challenge of instituting reforms without compromising the principles of its beliefs and traditions of its culture. The country should review policy and legal frameworks concerning mineral development and investment to reflect concepts and methods that could harmoniously be accommodated by both Shari'a and conventional systems. Restrictions on local and foreign ownership and development of commercial and industrial land in Saudi Arabia have eased in recent years, but more work needs to be done to further encourage a responsive land regime in Saudi. The researcher believes that if the rules that form Saudi international public policy were codified<sup>1</sup>, the Saudi legal system would be more transparent and this would eventually increase the flow of FDI to the country. Also, for the sake of transparency, commercial statutes need to be included in a single commercial code, thereby obviating the need for scattered royal decrees, resolutions of the Council of Ministers and relevant statutes and rules.

### ***Economic liberalisation***

The privatisation programme is a great opportunity for large scale investment. Again, it is up to the political decision makers to open up more fields to privatisation and therefore to FDI. Large scale potential foreign investors carefully monitor privatisation programmes all

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<sup>1</sup> Vogel argues that codification would redress many evils: differences and contradictions among *qadis* (judges) and appellate court judgements. See Vogel, F., *Islamic law and Legal System: Studies of Saudi Arabia*, Leiden, Brill, (2000), p. 350.

over the world for feasible opportunities. There may also be an underlying political component in the lack of interest in investing in the country. The Saudi government, however, offers very specific incentives for foreign investors. Among these incentives are low tax and customs rates, and interest-free loans of up to 50% of the project cost provided by SIDF. Other financial support is given for agricultural and housing projects. All these incentives demonstrate an increasing commitment on the part of the government to place the Saudi market on solid legal and economic foundations. Bilateral and multilateral investment agreements with a number of countries to avoid double taxation, and for the promotion and protection of FDI have been signed by the Kingdom.

With regard to labour issues, the government should review dismissal policies to protect all employees. The dismissal policy should be altered to require legitimate reasons for dismissal. It is also necessary to define at least some of those legitimate reasons, without being too rigid. Compensation should also be granted in the case of illegitimate employee dismissal. The Saudisation policy should be made more flexible by creating incentives rather than penalties to encourage companies employ Saudi nationals. This could be implemented by giving tax breaks or special access to public markets to companies with a certain number of Saudi employees. The government should also offer subsidies for the training of Saudi nationals, as well as overhauling the educational system to bring it into line with private sector employment needs.

Given the Kingdom's commitment to opening the economy for FDI, much can be achieved by the liberalising of administrative barriers that currently detract from its appeal as a location for FDI. These barriers include the procedures involved in obtaining visas, work and residency permits, obtaining investment licences, dealing with commercial disputes and

delays in obtaining approval for imports and major delays in appeals related to tax assessment. These areas can all be addressed and improved. The government should further improve administrative procedures by continuing to facilitate the institutional and administrative procedures for licensing foreign projects in the Kingdom as well as providing the necessary support to SAGIA as a one stop shop for other government departments and ministries by implementing investor-friendly reforms at administrative level.

### *Judiciary and dispute settlement*

Even though the law confirms the independence of the judiciary, the relationship between the latter and the executive is open to question. In other words, although the personal independence of judges in Saudi is guaranteed by the constitution of Saudi Arabia<sup>2</sup>, their structural independence needs to be addressed. Therefore, one can suggest that in order to achieve the standard of independence required for adequate dispute settlement, Saudi Arabia should do more to clearly establish the independence of the Board of Grievances in order to allow it to execute its functions as a neutral body, and to ensure transparency in its decision making process.<sup>3</sup> Government involvement in appointment of members and financing should be ended to ensure an effective, transparent and indeed independent body which will undoubtedly attract more foreign investors.

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<sup>2</sup> Article 48 of the Basic Law (Constitution).

<sup>3</sup> It should be noted that the new Law of the Judiciary clearly acknowledges the doctrine of separation of powers. The new law stressed the authority of judges in making decisions independent of outside influence, especially the influence of the "Executive Branch." The most prominent feature of the new law is its practical application of the judicial independence principle, as evidenced by the limiting of the Ministry of Justice's administrative control over the judiciary. Under the new law, the right to supervise all courts and judges was transferred from the Minister of Justice to the Supreme Judicial Council. See the Law of the Judiciary (2007), Articles 6 & 58.

The reforms taking place within the judiciary include the establishment of commercial courts to meet a long standing demand from both national and foreign investors.<sup>4</sup> This demonstrates a potentially remarkable development in the area of law and the administration of justice in the country. This is a major step forward, because these commercial courts will decide on commercial disputes. Until very recently, details of this development have not been available, but the question which must be asked is whether they will have autonomy from the previous position of links with the king. Reforms should also consider the substantial absence of meaningful judicial review of governmental action, and the continuing difficulty of predicting judicial results. It is advisable that all commercial judgements should be in a stored in a depository for future reference.<sup>5</sup> These judgements should then be available for those who are interested. In order to overcome confusing jurisdictions, there is a need to introduce new legislation especially designed for international arbitration. It needs to be compatible with the UNCITRAL Model law to incorporate a doctrine of separability, widen the scope of arbitrability and abrogate legal restrictions to submit to arbitration. The importance of the UNCITRAL Model Law does not only derive from the fact that it would facilitate enforcement of foreign arbitral awards, but that it would also improve the standing of FDI.

The government should also increase training, communication and information so that judges are kept up to date on all new regulations, international agreements and conventions. The next generation of judges and lawyers should acquire such knowledge during law school and in their initial training. This will ensure consistency within the judicial system. Once this occurs, judges will be able to deliver legal decisions in a consistent manner using the same legal framework. Communication needs to be developed within the judiciary in order to

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<sup>4</sup> Saudi Gazette Newspaper April 7<sup>th</sup> 2005.

<sup>5</sup> It should be noted that the Council of Ministers issued a decision No. 162 dated on 17/06/1423H of the formation of a permanent judicial committee for the codification and dissemination of court judgements. So far there are 3 editions of court judgements. For more information see Ministry of Justice website at: [http://www.moj.gov.sa/mdona\\_moj/default.aspx](http://www.moj.gov.sa/mdona_moj/default.aspx). (Arabic version only).

increase the awareness of similar cases in different courts. Seminars, training programmes and user guides to legal procedures should be developed in order to inform the administration, the legal community and the public. Again, this would create consistency with regard to the implementation of rules and regulations. In addition, as soon as a regulation is issued or a treaty or bilateral agreement is ratified, copies should be sent to all jurisdictions.

At the moment, many of these developments are in progress or undergoing amendment so it is not possible to ascertain in detail what the legal situation will be in the future, and some of the current difficulties focussed on in this thesis may be resolved.

To sum up, although Saudi Arabia has achieved tremendous progress in the field of the settlement of investment disputes, it is expected to further improve the legal environment for businesses and to increase its objectivity and transparency. In line with the political stability that exists in Saudi Arabia, there is still need for further improvement in the rule of law in the terms discussed in the thesis. The improvements need to be centred on increasing confidence in legal rules, the effectiveness and predictability of the judiciary and the enforceability of contracts. The globalisation of world trade exerts ever greater demands of competitiveness on energy exporting countries and Saudi Arabia still needs to implement more strategies and reforms to maximise economic development potential for its people by removing remaining obstacles in the way of foreign investors.

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# APPENDIX

## Foreign Investment Law

Royal Decree No M/1

5 *Muharram* 1421 / 10 April 2000

### Article One:

The following terms and expressions shall have the meanings assigned to them, unless the context requires otherwise:

- (a) The Council: The Supreme Economic Council.
- (b) Board of Directors: The Board of Directors of the General Investment Authority.
- (c) The Authority: The General Investment Authority.
- (d) The Governor: The Governor of the General Investment Authority and Chairman of the Board of Directors.
- (e) Foreign Investor: A natural person who is not of Saudi nationality or a corporate person whose partners are not all Saudi.
- (f) Foreign Investment: Investment of foreign capital in an activity licensed by this Law.
- (g) Foreign Capital: For purposes of this Law, foreign capital shall mean, for example, but not limited to, the following assets and rights so long as they are owned by a foreign investor.
  - (1) Cash, securities and negotiable instruments.
  - (2) Foreign investment profits, if invested to increase capital, expand existing projects, or establish new ones.

- (3) Machinery, equipment, furnishings, spare-parts, means of transport and production requirements related to the investment.
- (4) Intangible rights, such as licenses, intellectual property rights, technical know-how, administrative skills and production techniques
- (h) Commodity Firms: Projects for the production of industrial and agricultural goods (crops and livestock).
- (i) Service Firms: Service and contracting projects.
- (j) Law: The Foreign Investment Law.
- (k) Regulations: The implementing regulations of this Law.

**Article Two:**

Without prejudice to the provisions of the laws and agreements, the authority shall issue a license for foreign capital investment in any investment activity in the Kingdom, whether permanent or temporary.

The authority shall act on the investment's application within thirty days of the submission of all the documents required by the regulations. If the specified period lapses without the authority acting on the application, it shall issue the required license to the investor.

If the authority rejects the application within the prescribed period, the decision must be justified, and the party whose application has been rejected shall have the right to appeal such decision according to laws.

**Article Three:**

The council shall have the authority to issue a list of activities excluded from foreign investment.

**Article Four:**

Subject to the provisions of Article 2, the foreign investor may obtain more than one license for different activities, and the regulations shall specify the necessary requirements.

**Article Five:**

Foreign investments licensed under the provisions of this Law may be in either of the following forms:

- (1) Firms jointly owned by a national and foreign investor.
- (2) Firms wholly owned by a foreign investor.

The legal form of the firm shall be determined in accordance with laws and directives.

**Article Six:**

A project licensed under this Law shall enjoy all the benefits, incentives and guarantees extended to a national project, according to laws and directives.

**Article Seven:**

A Foreign Investor may repatriate its share that is derived either from the sale of its equity, the liquidation surplus, or from profits generated by the firm, or to dispose of it in any other lawful manner. The foreign investor may also transfer the amounts required to settle any contractual obligations related to the project.

**Article Eight:**

A foreign firm licensed under this Law may acquire necessary real estate as needed for operating the licensed activity, or for housing all or some of its staff, subject to the provisions governing real estate ownership by non-Saudis.

**Article Nine:**

The foreign investor and its non-Saudi staff shall be sponsored by the licensed firm.

**Article Ten:**

The authority shall make available to all interested investors required information, clarifications and statistics as well as provide them with all services and carry out all procedures to facilitate and complete all investment related transactions.

**Article Eleven:**

The foreign investor's investments may not be confiscated, wholly or partially without a court judgment. Moreover, they may not be subject to expropriation, wholly or partially, except for public interest, against a fair compensation according to laws and directives.

**Article Twelve:**

- (1) The authority shall notify the foreign investor in writing of any violation of the provisions of this Law and its regulations, in order to rectify such violation within the period of time the authority deems appropriate for the rectification of the violation.
- (2) Without prejudice to any harsher penalty, the foreign investor shall be subject to any of the following penalties if the violation persists:
  - (a) Withholding all or some of the incentives and benefits given to the Foreign Investor.
  - (b) Imposing a fine not exceeding 500,000 (Five hundred thousand Saudi riyals).
  - (c) Revoking the foreign investment license.

- (3) The penalties referred to in paragraph (2) above, shall be imposed pursuant to a resolution by the board of directors.
- (4) The resolution issued may be appealed before the Board of Grievances in accordance with its Law.

**Article Thirteen:**

Without prejudice to agreements to which the Kingdom of Saudi Arabia is party:

- (1) Disputes arising between the government and the foreign investor in relation to its investments licensed in accordance with this Law shall, as far as possible, be settled amicably. Failing such settlement, the dispute shall be settled according to the relevant laws.
- (2) Disputes arising between the foreign investor and its Saudi partners in relation to its investments licensed in accordance with this Law shall, as far as possible, be settled amicably. Failing such settlement, the dispute shall be settled according to relevant laws.

**Article Fourteen:**

All foreign investments licensed under this Law shall be treated in accordance with applicable tax provisions and amendments thereto in the Kingdom of Saudi Arabia.

**Article Fifteen:**

The foreign investor shall comply with all laws, regulations and directives in force in the Kingdom of Saudi Arabia, as well as international agreements to which the Kingdom is party.

**Article Sixteen:**

The implementation of this Law shall be without prejudice to acquired rights of the foreign investments, legally existing before this Law comes into force. However, such projects shall be governed by provisions of this Law, as far as conducting their activities, or increasing their capital is concerned.

**Article Seventeen:**

The authority shall issue the regulations and they shall be published in the Official Gazette and shall become effective as of the date of its publication.

**Article Eighteen:**

This Law shall be published in the Official Gazette and shall become effective thirty days after its publication. It shall supersede the Foreign Capital Investment Law, issued by Royal Decree No. (M/4), dated 2/2/1399 H, as well as any provisions inconsistent therewith.