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ISRAEL'S UPSTREAM NATURAL GAS SECTOR AGAINST THE BACKDROP OF THE NEW GAS FRAMEWORK

Introduction

For nearly two years, the Israeli upstream natural gas sector has been in a state of paralysis, with no significant investments or transactions being made in this sector and several deals put on hold or cancelled. This sad state of affairs began with an antitrust issue in an isolated petroleum drilling license, but soon spiraled into a full-blown public debate on the Noble Energy - Delek[1] gas duopoly over the offshore gas discoveries, gas prices in general, gas prices from the Tamar field in particular and export versus "keeping the gas for future generations".

The heated public debate led to an impassioned political debate, several hearings in the Israeli Parliament and its committees, ongoing public demonstrations, the resignation of a minister and the Antitrust Commissioner and petitions to the High Court of Justice.

On the bright side, this situation drove the upstream regulators to collaborate and undertake a concerted effort to organize, modernize and finalize the upstream petroleum framework. These efforts resulted in the New Gas Framework between the Israeli Government and Noble and Delek (the "**New Gas Framework**" or "**NGF**"). The NGF, a comprehensive document and hard-fought compromise covering several topics, including: pricing, export issues and regulatory stability, in addition to the antitrust settlement, should, according to the government, spur competition and reinforce investment stability in Israel's upstream energy sector.

In this newsletter, we will explain how this state of affairs came about and, more importantly, we will summarize the main principles of the NGF which are now applicable to the upstream petroleum sector.

The Status of the Gas Discoveries Pre-NGF

In the decade leading up to the crisis, the natural gas industry had been mutually beneficial and positive for both upstream investors and Israeli consumers. License holders had discovered more than 30 TCF[2] of recoverable reserves and resources of natural gas offshore Israel, including the largest offshore gas discovery worldwide in 2009 (the Tamar field) and in 2010 (the Leviathan field), respectively, and had developed the Yam Tethys and Tamar fields in record time.

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[1] "Noble and Delek" - Noble Energy Mediterranean Ltd, Delek Drilling LP and Avner Oil Exploration LP.

[2] Ministry of National Infrastructures, Energy and Water Resources, "Israeli Gas Opportunities," http://energy.gov.il/Subjects/OilSearch/documents/israeli%20gas%20opportunitties.pdf.

The first gas flowed to power stations in 2004 and reached consumers through a transmission network now over 500 km long. Gas had successfully displaced more pollutant coal and heavy fuel oil, at prices much lower than other liquid fuels. The Tamar field came online in 2013 and has been reliably delivering gas to consumers in Israel. As of 2015, annual gas consumption has reached 8.4 BCM, an increase of 11% from 2014 and currently makes up over 50% of Israel's fuel basket for electricity.

Nevertheless, the cloud hanging over this positive picture was the growing Noble-Delek duopoly over the offshore discoveries. By the end of 2014, Noble and Delek's holdings were as follows:

- ✓ **100%** of the *Ashkelon (*AKA *Mari B)* and *Noa* Leases: Produced 25 BCM since 2004 (depleted fields)
- ✓ **67%** of the *Tamar* Lease: Estimated Reserves 282 BCM (Israel's only producing field)
- ✓ **85%** of the *Leviathan* Leases: Estimated Reserves 470-620 BCM (yet to be developed)
- ✓ **100%** of the *Karish and Tanin* Leases: Estimated Reserves 55 BCM (yet to be developed)
- ✓ **67%** of the *Dalit* Lease: Estimated Reserves 8 BCM (yet to be developed) [3]

To exacerbate the situation, the Egyptian gas flow to Israel, which had begun in 2008, was discontinued by 2012, leaving the Tamar lease holders as the sole gas supplier in Israel.

The Developments Leading up to the NGF

Other than declaring the Tamar lease holders a monopoly in the sale of gas under the Restrictive Trade Practices Law-1988 (the "**Antitrust Law**") and subjecting all gas sales contracts from Tamar to the approval of the Antitrust Commissioner ("the **ATC**"), no restrictions or limitations were imposed on Noble and Delek in their activities offshore Israel, notably, regarding their acquisition of licenses, as evidenced above.

However, that changed when the ATC informed Noble and Delek and Ratio Oil Exploration LP of his intent to declare that their purchase of the Leviathan Licenses constitutes an improper Restrictive Arrangement under the Antitrust Law. Subsequent negotiations followed between the ATC and Noble and Delek, culminating in an agreement whereby Noble and Delek would transfer all their rights in the Tanin and Karish fields to a third party by a defined date (the "**ATC Agreement**"), to resolve the antitrust issue. This agreement, reached in March 2014, was incorporated into a draft consent decree in accordance with the Antitrust Law and presented for public comment before its submission for approval by the Antitrust Tribunal. The ATC publicly defended the ATC Agreement in the following months; however on December 23rd 2014, in a sudden and unprecedented move, the ATC notified Noble and Delek of his decision to rescind his consent to the ATC Agreement. The ATC indicated that in his view the ATC Agreement would not succeed in producing truly viable competition against the duopoly.

The rescission of the ATC Agreement, which signified the re-emergence of the antitrust threat, led Noble to declare a freeze on all its investments in Israel, and signaled a general environment of instability that warded off any investments in the upstream sector. Immediately following the ATC's

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[3] Ownership Percentages: Delek's Annual Financial Statements (2014), p. 90. Reserves Estimates: Ministry of National Infrastructures, Energy and Water Resources, *Id.*

announcement, Noble stressed in a press release the need for: "Final resolution of this item, as well as a number of other regulatory matters, … required before we proceed with additional exploration or development investments in our Israel business."[4]

The severity of the situation led to a task force being appointed by the Prime Minister ("**PM**"), with members from the Ministries of Energy, Justice, Finance and the PM's office, in order to try and reach a new and comprehensive arrangement with Noble and Delek. The ATC at the time, Prof. David Gilo participated in meetings until he disagreed with certain principles proposed for such new agreement, and subsequently resigned.

The content of the NGF soon expanded far beyond antitrust issues, due, on the one hand, to Noble's request that all outstanding regulatory issues in the upstream sector be resolved and, on the other hand, to the public debate regarding the price of gas, the duopoly's market share and the linking of the gas discoveries to social issues. The public debate was fueled even more by Prof. Gilo's resignation as ATC.

The NGF was approved by the government in August 2015 as Government Decision 476; however, procedural and political complications related to the attainment of required approvals under the Antitrust Law resulted in many more months of setbacks. Ultimately, the PM, in his capacity as temporary Minister of Economy, granted the required antitrust exemption on December 17, 2015, which signaled the entry into force of the NGF (the "**NGF Approval Date**").

The Principles of the NGF

The NGF is a comprehensive package deal which was the result of significant negotiation and compromise and which relates to multiple issues under different laws.

Below is a summary of the key provisions of the NGF:

A. <u>Development of the Leviathan Field:</u> The NGF includes several measures to ensure the speedy development of the reservoir, including:

- ✓ The commencement date of commercial production from Leviathan and gas supply to the local market (as required under the Leviathan Leases) was extended and set at 48 months after the NGF Approval Date, i.e. year-end 2019.
- ✓ All government entities will take steps to provide all permits, licenses and approvals required for making an investment decision (FID) within reasonable periods of time.
- ✓ By the end of 2017, the Leviathan lease holders will be required to enter into binding purchase agreements for equipment and services for the development of the field in the amount of US $1.5 billion at least, in addition to the sums previously invested.
- ✓ Five years from the NGF Approval Date, the government will be entitled to evaluate its policy regarding the encouragement of foreign investment; however, if by that date either: (i) the Leviathan field produces gas to the local market; or (ii) the Leviathan partners have invested an accumulated sum of US $4 billion and they are in an advanced stage of the development of Leviathan, the policy will not be changed for 10 years from the NGF Approval Date.

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[4]"Noble Energy Provides Update on Regulatory Matters in Israel," Dec. 23, 2014, http://investors.nobleenergyinc.com/releasedetail.cfm?ReleaseID=888877.

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- ✓ The NGF also includes local content obligations and tax provisions which are not discussed in this overview.

B. **Export from the Tamar field**: The NGF relaxes some of the export limitations set out in the Export Decision from 2013, primarily, allowing export from the Tamar field **immediately**, even before Leviathan has come online.

C. **Transfer of Rights in the Karish and Tanin Reservoirs:** Delek and Noble are required to transfer all their rights in Karish and Tanin within 14 months from the NGF Approval Date and are incentivized to do so within 8 months from such date.

D. **Transfer of Rights in the Tamar Reservoir:** Delek is required to transfer all its rights in Tamar, and Noble is required to dilute its rights in Tamar to 25%, within 6 years from the NGF Approval Date.

E. **Price Mechanism for New GSPAs signed by the Tamar and Leviathan Partners:** For a limited period of time, the Tamar and Leviathan lease holders are required to offer new prospective natural gas purchasers the following four alternatives regarding the natural gas price and its indexation, such alternatives being the sole pricing options, unless prices proposed are lower than those below:

- ✓ "Weighted Average" Mechanism;
- ✓ Best Linkage Formula to Brent;
- ✓ An additional Price Mechanism for Independent Power Producers ("**IPPs**") holding a production license for electricity facilities with an installed capacity of 20 MW or more. The IPP Price Mechanism includes linkage to the Weighted Production Cost Index published by the Electricity Authority and a base price mechanism (for Conventional IPPs – a simple average of prices of the agreements of the three major conventional IPPs in accordance with their linkage and with floor prices as published by the Gas Authority).
- ✓ "Export Price" Mechanism: Lease holders who export gas (from any lease, including Tamar and Leviathan) will be required to offer "New Buyers" the same price formula set in their export GSPAs.

F. **Leviathan Contracts and New Tamar Contracts**: The NGF grants gas buyers flexibility, *inter alia*, to reduce quantities by up to half (Leviathan gas purchasers) or to terminate the agreements unilaterally (Tamar gas purchasers), within a fixed window of time.

G. **The Stability Clause:** The NGF included a comprehensive section with several declarations made by the Israeli Government regarding the creation of a stable regulatory environment with respect to the Tamar and Leviathan Leases for a period of 10 years following approval of the NGF, designed to encourage foreign investment in the oil and gas sector. The clause contained provisions which would prevent the government from initiating changes in its tax and fiscal policy which specifically target the oil and gas sector, and, in the event a private legislative initiative proposing such a change was advanced, the government would be obligated to actively oppose the initiative, including by working to achieve its cancellation if approved. This stability provision proved controversial and was the focus of several petitions submitted to Israel's High Court of Justice ("**HCJ**") opposing the NGF.

Efforts to Oppose the NGF - Ruling of the High Court of Justice

Following the approval of the NGF, several petitions were submitted to the HCJ, with the aim of voiding the NGF or parts thereof. On March 27, 2016, the expanded bench of five Supreme Court justices issued a highly divided decision. The majority decision upheld the validity of the NGF, including its method of approval as detailed above, yet rejected the stability clause, citing the government's lack of authority in approving the clause and insisting that such a significant provision required legislation in parliament. In light of the fact that the stability clause was a crucial component of the NGF, the HCJ held that the NGF would be cancelled if the stability clause is voided, but provided the government one year to resolve the matter.

New Stability Clause

Following the HCJ ruling, the government and Noble and Delek began negotiations regarding the stability clause and on May 22, 2016, the government approved the agreement reached by the parties regarding a revised and much milder stability clause. The main elements of the revised clause include:

- ✓ Any future government will have independent discretion to make policy changes;
- ✓ In the event that there will be a policy change, the government shall positively consider offering different solutions to the gas companies, without committing to any kind of solution in advance; and
- ✓ Authorization of the Minister of Economy and Minister of Energy to extend the deadline for the sale of the Karish and Tanin reservoirs, if necessary, by no more than two additional months.

The government believes that this amended clause now allows for the implementation of the NGF in full and to date, no petitions have been submitted to court against this revised clause.

Israel's Energy Sector Post NGF

Minister of Energy Yuval Steinitz, upon announcing the agreement on the new stability clause, stressed the importance of such a clause in creating a regulatory environment which encourages investment.

Noble reported that the development of the Leviathan gas field will proceed according to the original schedules that were set in the NGF and a few days after the approval of the revised stability clause, the development plan for Leviathan was approved by the regulator.

The New Gas Framework ushered in what will hopefully be a new era for exploration and production of natural gas and oil resources offshore Israel.

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