



STATE OF ISRAEL

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Executive Summary:

Conclusions by the Committee to Examine the Fiscal Policy on Oil and Gas Resources in Israel, Headed by Prof. Eytan Sheshinski

On April 12, 2010, the minister of finance appointed the Committee to Examine the Fiscal Policy on Oil and Gas Resources in Israel (hereinafter – the Committee). In accordance with the guidelines of the letter of appointment, the Committee members conducted an in-depth examination of the oil and gas exploration market in Israel and around the world, particularly the natural gas market. The Committee members studied the fiscal system in Israel for this industry, along with corresponding fiscal tools and systems around the world. The Committee members also received and studied the positions of the public as submitted to them in August 2010, including economic and legal opinions provided by the entities that requested to present their positions to the Committee. The Committee members worked on a proposal for an up-to-date fiscal system in accordance with the letter of appointment, and conducted in-depth discussions on the application of the proposed changes to the oil and gas exploration industry in Israel.

On November 15, 2010, the Committee published a draft of its main recommendations for public comment. Beginning on that date, the Committee heard comments on its main recommendations from the public, including gas companies and partnerships, small investors, nonprofit associations and organizations. In that framework, the Committee received written opinions on economic, legal and other aspects, as the submitters saw fit to provide, and it enabled the various entities to appear before it over the course of three days. The Committee also appointed a team that held work meetings to gain a better understanding of the financing needs of the



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entrepreneurs in the industry. The Committee reviewed the opinions that were submitted and held a series of discussions on the material presented to it. After examining all the information provided to it, and taking into account the need to ensure the continued development of the natural gas industry at the pace required for the economy's needs, the Committee decided to institute changes in the fiscal system as proposed by it in the published draft of its main recommendations.

The main points of the Committee's final conclusions, including the proposed changes in relation to the published draft of its main recommendations, are presented in brief below:

The objective of the fiscal system

Ensuring the continued development of the gas industry, while receiving appropriate remuneration for the public for exploitation of the state's natural resources, and at the same time giving suitable incentives to those working in the natural gas exploration industry.

Below are the main conclusions:

A. Leaving the existing rate of royalties

The rate of royalties established in the Petroleum Law, 5712-1952 (hereinafter – the Law), which is 12.5%, is common among other countries around the world. It should be noted that in the decisive majority of countries in which a similar rate of royalties is in effect, the royalties constitute a tool that is complementary to other dedicated fiscal tools through which those countries obtain remuneration for exploitation of their oil and gas deposits, and they ensure the state a minimal consideration for the exploitation of its oil and gas deposits from the start of production. The Committee extensively examined the issue of the royalties rate established in the Law, including the question of raising the rate, and it decided that it would be better to implement alternative fiscal tools for the purpose of increasing the state's share. Therefore, given the use of those tools,



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the rate of royalties established in the Law should remain as is, due to the negative impact that changes may have on the development of relatively less profitable gas fields, as well as the impact on the profitability of the deposits under variable market conditions, which could also affect the ability to finance the ventures.

B. Canceling the depletion deduction

The depletion deduction is an anomaly in Israeli legislation and lacks any economic justification, including in the context of expensing. This deduction leads to a considerable reduction in the amount of taxable income. This change is a first and essential component in creating a proper and reasonable fiscal system in the oil and gas exploration industry.

C. Oil and gas profits levy (hereinafter – levy)

Instituting a progressive levy. The rate of the levy will be determined according to the ratio between the cumulative revenues after deduction of the project expenses, royalties and a levy that was paid in previous years, and the overall investment in the exploration and initial development of the deposit. The Committee decided that the levy would not be collected until the stage at which this ratio reaches a rate of 1.5 (repayment of the full investment plus 50%, before tax). The initial rate of the levy will be 20%, and it will rise gradually to 50% according to the amount of the excess profits (a ratio of 2.3).

The proposed formula for the levy is of the R factor type:

$$\mathbf{R\ factor = \frac{\mathbf{Cumulative\ net\ revenues}}{\mathbf{Exploration\ and\ development\ expenses}}}$$

The mechanism will include the following principles:



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- **A special incentive for exploration expenses** – by giving greater weight to the exploration expenses in the integration of the investments in the R factor denominator.
- **Normative recognition of the financing costs during setup** – During the development and setup period, until the commercial production of gas/oil, an annual financing cost will be added to the investment expenses in the R factor denominator, which will be set at a normative rate relative to the investment. This mechanism will lead to a significant reduction in the entrepreneurs' risk if an unanticipated delay occurs during the setup period. The normative interest will be set at the average annual LIBOR rate plus a fixed 3% premium.
- **Deduction of overriding royalties and other expenses paid by the partnership to third parties or any of the partners** – The partnership agreement and other agreements among the various entities connected with the project and/or the partnership establish various payments to be made to the partners and/or third parties which, in effect, constitute the participation of those entities in the profits deriving from production of the gas and the oil. Payments as described above will be charged at the rate of the levy as determined in accordance with the R factor formula for the payment recipient. This charge will be implemented by means of a deduction at source by the payor. The amount to be deducted at source, as stated above, will be deducted from the levy liability of the payor.
- The mechanism will apply to each deposit separately, and it will not be possible to redirect revenues or expenses among the various deposits.

D. Accelerated depreciation

Costs that accumulated during the lease stage in the development of the oil and gas assets will be awarded accelerated depreciation at a rate of 10%. The taxpayers will be given the option of choosing one of two alternatives with regard to the amount of the annual deduction:



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1. Depreciation in the amount of the taxable income (before deduction of the accelerated depreciation), but no more than 10%.
2. Depreciation in the amount of the sum deriving from the accelerated depreciation rate (10%).

This mechanism will lead to an increase in the cash flow of the entrepreneurs during the first years of production, facilitating repayment of the debt. The flexibility inherent in this mechanism will enable the partnerships working in this field to take full advantage of the tax shield.

E. Application and transition provisions

The proposed changes will apply to all oil and gas deposits as of the publication of these conclusions. However, the Committee established a gradual track for the transition from the existing fiscal system to the proposed fiscal system, by means of the following transition provisions:

- **Higher rate of accelerated depreciation for investments made by the end of 2013** – Such investments will be given a maximum accelerated depreciation rate of 15%, in accordance with the mechanism specified in section (D) above.
- **Gradual application of the levy rates** –
 - **Deposits in which commercial production began before the establishment of the Committee:**
 - These deposits will enter the bottom of the levy track or below that if their level of profitability is lower than the minimum profitability for implementing the levy, so that the rate of the initial levy applying to them will be, at most, the minimum rate in the first year of payment.
 - The rate of the levy imposed on revenues from the deposits will be reduced by 50%, i.e., multiplied by a factor of 0.5, until the end of production of the gas that is currently in the deposit.
 - **Deposits in which production will begin after the establishment of the Committee, but no later than January 1, 2014:**



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- The levy, at its minimum rate, will apply to these deposits only after their revenues reach double the value of the investment (R factor ratio of 2). The maximum rate of the levy on these deposits will apply only after they reach an R factor ratio of 2.8.

Significance

The proposed system has a relatively low impact on the investment decisions of the entrepreneurs, since the levy will be applied after repayment of the cost of the investment plus a suitable return.

In comparison to the current tax system with its various components, no significant change is anticipated in the scope of the payments to the state during the first years of operation of a deposit. The increase in the state's share in the revenues will come mainly in later years in the life of the deposit, and therefore the impact of the proposed system on the debt repayment ability is minor.

The Committee believes that the combination of the above components will lead to the optimal realization of the system's objectives. The share of the state and the public in the net profit from gas and oil production will increase from one third to 52%-62%. In the proposed model, special attention was given to the high risk entailed in investments in oil and gas exploration. It should be noted that the Committee's conclusions are consistent with the tax systems in practice around the world, also in developed countries, both in terms of the tax mechanisms and in terms of their scope.

The tax rate and the value of the receipts will vary according to the ratio between the level of revenues from the deposit and the scope of the investment that is implemented. The result is the payment of lower receipts to the state by ventures with a low level of profitability, and maximizing governmental remuneration from deposits generating the highest excess profits.



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The proposed system is gradual and suitable for a broad spectrum of global situations, and responds dynamically to changes in price, or in the scope of the gas that is marketed, or to changing investment needs.

The outcome of the fiscal changes proposed above in relation to those that were presented in the draft of the Committee's main recommendations is that even under more stringent assumptions regarding the profitability rates of the deposits, and under the existing structure of the partnerships in the industry, the cash flow of the projects during the debt repayment period will not be impaired, thus there will be no actual impairment in the ability to finance the ventures. Reducing the maximum tax rate reduces the rate of the state's share in the profits from the deposits, with the result that the rate of the state's share in highly profitable deposits will not be higher than the accepted rate in most of the countries in which operations are conducted in this industry.

The transition provisions recommended by the Committee allow for a gradual transition from the current fiscal system to the proposed fiscal system. The purpose of this gradual transition is to ensure the ability to rapidly develop deposits that are close to the development stage, in view of the efforts that have already been invested in their development and the financing arrangements that have been planned for them. Given these provisions, there is no impediment, in terms of financing, to developing the gas deposits that have been discovered to date, within a timetable that is suited to the needs of the economy.