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

Background

Oil and gas exploration in the State of Israel began back at the start of the 20th century, but by the end of the century no significant discoveries had been made.

Large-scale natural gas deposits have been discovered in recent years within the economic waters of the State of Israel, which have increased interest in the sea basin to the west of Israel's shores. According to estimates, there are additional gas deposits in the sea that are even greater than those found to date. Currently, most of the area is subject to oil rights that were given to various entrepreneurs.

This natural resource is extremely important for the future of Israeli society and its economy. It is the job of the state to ensure the supply of these limited natural resources in such manner that they will yield the maximum benefit to all citizens of the state, so that the public will receive a proper portion of the profits produced from the sale of the gas deposits. This must all be done while maintaining the efficiency of the economic operations in the industry, providing incentives for investment in the exploration and development of additional deposits, and encouraging competition among gas suppliers in the economy.



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Provisions and arrangements for the oil and natural gas exploration and production operations in the State of Israel, including the principles of the fiscal system, are specified in legislation passed in the 1950s.



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The letter of appointment

1. On April 12, 2010, the Minister of Finance appointed a committee to examine the fiscal policy for the oil and gas resources in Israel (hereinafter – the Committee).
2. The letter appointing the Committee set out the following guidelines for its members:

“In view of the significant discoveries of gas in Israel and in the maritime zone off its coast, there has been a recent awakening in the oil and gas exploration market in Israel, and there is apparently a possibility for significant discoveries in the future. Hence, this matter is likely to have a considerable impact on the Israeli economy and on the government’s operations in the coming years.

Accordingly, an examination of the fiscal system in practice in Israel (a system that encompasses taxation, royalties and fees) should be conducted in everything pertaining to oil and gas exploration, in order to determine whether this system, which was formulated in 1952, is also appropriate today. An examination should also be conducted of how it compares with fiscal systems in other countries in the democratic western world. It is also worth examining, in a timely fashion, the way the Israeli economy will contend with the possible ramifications, in the event that significant oil and gas deposits are discovered in the future, with regard to currency rates and the competitiveness of Israeli exports.

In view of the above, you are appointed members of the Committee to examine the fiscal policy on oil and gas resources in Israel.”



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The Committee's assignments:

- 1. To examine all components of the fiscal system currently in practice in Israel with regard to oil and gas reserves, and to compare it to countries with similar macroeconomic and democratic characteristics, while taking into account the economic and geopolitical conditions unique to Israel.**
- 2. To propose an up-to-date fiscal policy and address the various licensing and discovery phases of the reserve areas, in progress at the time of establishment of this Committee.**
- 3. To examine the possible ramifications of current and future discoveries for the Israeli economy.**

The Committee's work

Pursuant to the Committee's letter of appointment, its 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 and corresponding fiscal tools and systems around the world in this industry, with the assistance of leading international consultants. The Committee members worked on an up-to-date fiscal system proposal in accordance with the letter of appointment, and examined the various aspects entailed in applying this system to the oil and gas exploration industry.

As part of their work, the Committee members received the positions of the public, in detail and in writing, including economic and legal opinions, as provided by the entities that requested to present their positions to the Committee.



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The Committee reviewed the existing fiscal system in the oil and gas exploration industry, which is essentially composed of royalties under the Oil Law, and tax benefits under the income tax regulations for the oil industry. An estimate of the economic value of the tax benefits involved in the royalties led the Committee to the conclusion that the current system does not properly reflect the public's ownership of its natural resources and is actually regressive (the more profitable the project, the smaller the state's share in the profits).

The Committee found that the oil and gas exploration industry was given significant tax benefits that are not consistent with international practice. The main tax benefit is the depletion deduction, which offsets and neutralizes the remuneration demanded by the state by virtue of its ownership of the oil and gas deposits, which, at present, is comprised solely of royalties. Depletion deduction is a tax break that enables holders of oil and gas rights to significantly reduce their taxable income. The depletion deduction was intended to reflect the depletion of the resources in the deposits, and thus a decrease in the value of the asset. However, since no payment for the resource in the deposit was made, and the depleting asset is owned by the state, this cannot be used as a justification for the deduction and, therefore, it is actually a subsidy that is given for operations in the industry by means of a tax benefit.

Moreover, it was found that the tax benefit inherent in the depletion deduction leads to the result that, under reasonable conditions, the amount of the payment to the state that will have to be made by a company that derives its income from the state's natural resources, will be similar to that of a company with a similar cash flow, which produces income without the utilization and depletion of the gas deposits of the State of Israel, which are public resources. In other words, according to the principles of the existing fiscal system, the state and the public receive almost no benefit in the form of remuneration for the public's ownership of the oil and gas.



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The main points of Committee's conclusions

The objective of the fiscal system is to ensure the continued development of the gas industry, and to receive appropriate remuneration for the public, while giving suitable incentives to those working in the industry.

The Committee's conclusions were passed unanimously.

Below are the main conclusions:

- **Leaving the existing rate of royalties and some of the tax benefits** – The rate of royalties in the State of Israel is similar to that of other countries around the world. It should be noted that in the decisive majority of countries that collect royalties at that rate, royalties are not the main fiscal tool used by those countries to obtain remuneration for exploitation of their oil and gas deposits, and they are accompanied by complementary collection in the form of fiscal tools that are specific to the industry. The Committee considered whether to raise the rate of royalties, but ultimately believed that the rate of royalties should remain as is, due to the negative impact the process was liable to have on the development of less profitable 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.
- **Canceling the depletion deduction** – The depletion deduction is an anomaly in expensing, and leads to a considerable reduction in the amount of the taxable income recorded for an oil asset. This change is a first and essential component in creating a proper and reasonable fiscal system in the oil and gas exploration industry.
- **Oil and gas profits levy** – Instituting progressive levies on oil and gas profits. The rate of the levy will be determined according to the ratio between the cumulative revenues after deduction of current expenses, royalties and a levy that was paid in previous years, and the overall investment in the exploration and



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initial development of the deposit. The Committee decided that the levy would not be collected until the stage at which this basis reaches a ratio of 1.5 (repayment of the full investment plus 50%, before corporate tax). **The initial rate of the levy will be 20%, and it will rise gradually to 60% according to the amount of the excess profits.**

- The proposed formula is of the R factor type:

$$\mathbf{R\ factor = \frac{Net\ cumulative\ revenues}{Exploration\ and\ development\ expenses}}$$

- The formula will include a special incentive for exploration expenses, by giving greater weight of 1.5 for exploration expenses in the integration of the investments in the factor denominator.
- The formula will be applied to every deposit separately, and no redirection of revenues or expenses between different deposits will be allowed.
- **Financing development of the gas deposits** – The Committee ascribes great importance to developing the gas deposits that have been discovered to date, within a timeframe appropriate to the needs of the economy. Therefore, if it becomes apparent during the hearing of the public positions that there is a financing problem resulting from the Committee's recommendations, during the first years of production from the deposits under development, the Committee will recommend fiscal solutions to resolve the problem.
- **Application** – The proposed changes will apply as of the date of the decision, to all oil and gas deposits, since this involves taxation of future profits.

The proposed model gives special attention to the high risk involved in investments in oil and gas exploration. It should be noted that the Committee's conclusions are consistent with accepted tax systems around the world, in terms of both the tax mechanisms and their scope.



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Significance

Since the proposed levy will be imposed on excess profits, the impairment of the entrepreneurs' incentives to operate in the industry is minimal, and will not result in non-development of existing and new deposits.

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 the 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 impairment of the debt repayment capabilities and of the ability to establish the deposit is minor.

The Committee believes that the combination of these components will lead to the optimal realization of the system's objectives. **The share of the state and the public in the net profit after repayment of the investments from the sale of the gas and oil will increase from one third to about two thirds of the relatively profitable deposits.**

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. The proposed system has a relatively minimal impact on the investment decisions of the entrepreneurs, since the tax will be imposed on excess profits, and after repayment of the cost of the investment plus a suitable return. 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.

In accordance with the format decided upon by the Committee at the start of its work, the Committee is publishing a draft of its main recommendations for the purpose of



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receiving comments from the public. After receiving the public's positions in writing, and, if the Committee should see fit to accept, oral comments as well, the Committee will re-examine the draft of its main recommendations, after which it will submit its final recommendations. The draft of the Committee's main recommendations will be placed on the Ministry of Finance website according to the schedules published by the Committee.

Committee members:

Prof. Eytan Sheshinski – Committee chairman

Prof. Eugene Kandel – head of the National Economic Council

Mr. Shaul Tzemach – director general of the Ministry of National Infrastructures

Dr. Yaakov Mimran – petroleum commissioner, Ministry of National Infrastructures

Mr. Yehuda Nasradishi – director of the Tax Authority

Dr. Udi Nissan – budget director, Ministry of Finance

Observers:

Attorney Avi Licht – assistant attorney general (economic – fiscal)

Dr. Amit Friedman – Bank of Israel