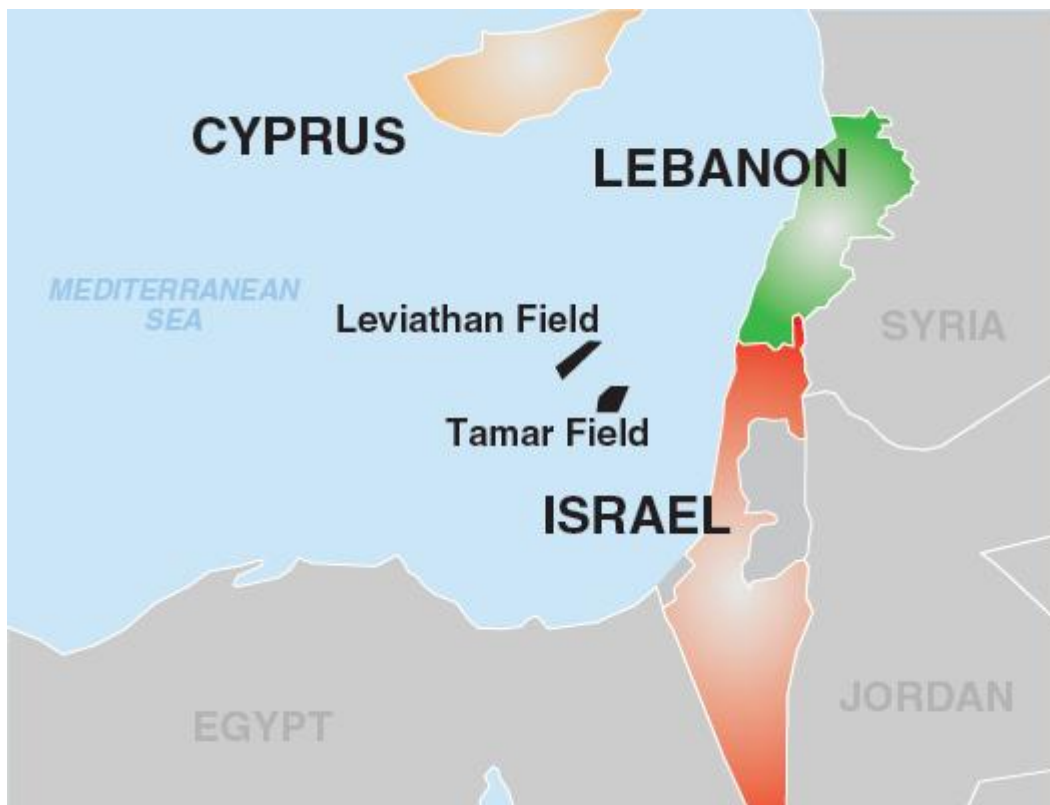
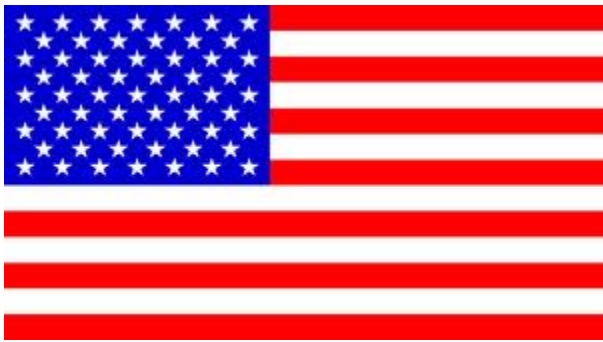


# LEGAL ASPECTS OF NATURAL GAS EXPLORATION, PRODUCTION AND DISTRIBUTION IN ISRAEL



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## **I. INTRODUCTION & OVERVIEW**

Israel's energy sector is undergoing seismic changes. Discoveries of significant natural gas fields in the Mediterranean Sea just off Israeli shores have generated hope of energy independence for the first time in history. Additional recent discoveries raise the prospect of Israel becoming a net energy exporter.

The Mari B field was first discovered between 1999 and 2000 off the coast of Israel.<sup>1</sup> Five years later, in 2004, natural gas was made available for consumption.<sup>2</sup> From 2004 to 2009, natural gas consumption increased *two hundred and seventy five (275)* percent.<sup>3</sup> Natural gas creates electricity for most major industrial sectors in Israel that previously relied exclusively upon electricity from Egypt under the Camp David Accords.<sup>4</sup> The anticipated construction of gas distribution networks in the next few years will allow for a mass conversion to natural gas throughout Israel.<sup>5</sup> Indeed, natural gas consumption will likely quadruple over the next twenty years and become Israel's primary energy source.<sup>6</sup>

The 2009 and 2010 discoveries of the Tamar, Dalit and Leviathan natural gas fields are expected to supply Israel with

sufficient natural gas to satisfy its own private energy needs for decades. These discoveries have also sparked substantial interest from investors around the world and could ultimately propel Israel into the forefront of natural gas exportation to Europe and other surrounding areas.

Early indications suggest that the first of these fields, the Tamar, could begin producing natural gas as early as 2012.<sup>7</sup> As a result, Israel has been furiously enacting and amending numerous pieces of legislation in order to liberalize its largely state-owned energy sector, and to establish an appropriate regulatory regime to control its substantial energy reserves.

This paper provides a brief overview of Israel's governmental structure, trade regime and the various laws and regulations governing the exploration, production, distribution, and transmission of natural gas in Israel.

## **II. ISRAEL'S GOVERNMENT AND TRADE REGIME**

### ***Israel's Government & Legal Structure***

Israel has no formal constitution. Israel maintains several constitution-like laws that are formulated in various "basic laws" that lay down the foundations of its parliamentary democracy and the fundamental rights of its citizens. Legislative authority rests in the Knesset (a unicameral parliament) with 120 members. The President (head of state) is elected by the Knesset for a non-renewable term of seven (7) years. Executive power is vested in the

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<sup>1</sup> State of Israel, Ministry of Natural Infrastructures - Natural Gas Authority, *Brief Overview of the Natural Gas Sector in Israel*, p.1 (2009).

<sup>2</sup> *Id.*

<sup>3</sup> Bergman Naveh, Rona, *Israel Infrastructure and Natural Gas Industry – Recent Highlights*, (2011).

<sup>4</sup> Minister of National Infrastructures, *Natural Gas Practical Guide*, p. 6 (2011).

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at p. 14.

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<sup>7</sup> Michael Ratner, Congressional Research Service, *Israel's Offshore Natural Gas Discoveries Enhance Its Economic and Energy Outlook*, p. 1 (2011).

government through the Prime Minister (head of government).

Israel's legal system includes aspects of Ottoman Law, British Mandate laws, English common law, and Jewish religious law. The judicial branch is divided into general law courts and tribunals, composed of the Supreme Court, District Courts, Magistrate Courts, Religious Courts, and other specialized lower courts. Israel's judiciary is highly independent and Israel is a party to both the International Center for Settlement of Investment Disputes and the New York Convention on the Enforcement of Arbitral Awards.

Israel's Ministry of Industry, Trade & Labor is charged with encouraging exports and economic cooperation, establishing relationships between Israel and foreign countries and multinational companies, as well as maintaining and improving foreign trade agreements. This Ministry is composed of two branches: the International Branch and the Export Promotion Branch. The International Branch is charged with negotiating agreements with trade partners and implementing decisions of the World Trade Organization. The Export Promotion Branch maintains representatives in various locations throughout the world to encourage and promote relations between Israeli exporters and foreign importers.

#### ***Israel's WTO and International Trade Commitments***

Israel maintains a small, innovation-based economy. International trade accounts for 90% of Israel's GDP and its economic growth is primarily export led. Israel ranks first worldwide in terms of the ratio of research and investment to

GDP, second in the quality of education and third in terms of entrepreneurship.<sup>8</sup>

Israel maintains a very open trade sector to support its international economy. Investment incentives and benefits, including grants, tax incentives, research and development support, wage financing, and training support are available to both local and foreign investors.<sup>9</sup> Israel's average applied Most Favored Nation tariff rate in 2005 was 8.9%. Israel's public procurement regulations provide price preferences to local suppliers, with the exception of purchases subject to the WTO Agreement on Government Procurement. Those purchases are subject to non-discriminatory measures allowing equal competition to local and foreign providers.

Israel became a member of the World Trade Organization (WTO) in 1995. In addition to its WTO commitments and obligations, Israel is a party to the US-Israel Free Trade Agreement (FTA) enacted on August 19, 1985. This was the first FTA entered into by the US and with the exception of agricultural products, the FTA eliminates virtually all duties on imports from the respective nations. Additionally, the agreement establishes the US-Israel Joint Committee to supervise and periodically review the functioning of the agreement. On August 26, 2011, the US and Israel announced a renewed process to encourage future trade and investment between the two countries. Efforts to further liberalize trade in agriculture and services are currently underway.

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<sup>8</sup> World Trade Organization, *Trade Policy Review of Israel*, WT/TPR/S/157, at p.1 (22 December 2005).

<sup>9</sup> *Id.* at p.viii.

### **III. MARITIME BOUNDARIES & THE NATURAL GAS FIELDS**

Several disputes have arisen between Israel and its neighbors regarding ownership of the recent natural gas discoveries. Cyprus and Israel have reached agreement on their respective maritime borders and discussed cooperative efforts regarding petroleum activities. Lebanon and Turkey, however, dispute claims to certain parts of the reserves. Specifically, the two countries challenge the validity of Israel's demarcation of its Exclusive Economic Zone ("EEZ"), as well as the legitimacy of the agreement between Cyprus and Turkey.

The 1982 United Nations Convention on the Law of the Sea (UNCLOS) provides coastal States the right to exploit oil and gas reserves on the ocean floor and subsoil up to two hundred (200) miles off its coast. Lebanon is a UNCLOS signatory but Israel and Turkey are not. This has led to conflicts over the proper demarcation of the borders and appropriate method for settling the conflicts.

None of these disputes have risen to the level of impacting foreign direct investment and it is likely that these disputes will be resolved by an international tribunal at some point in the near future.

### **IV. ISRAEL'S ENERGY FRAMEWORK**

Israel has a complex legal framework that governs energy and in particular natural gas. The following is a brief overview of significant rules and regulations that are subject to change as

Israel's energy sector matures and the legal framework adapts to those changes.

The primary laws and regulations governing the petroleum and natural gas industry include the Petroleum Law of 1952, which governs the exploration and production of natural gas, and the Natural Gas Sector Law, which governs the distribution, storage, marketing, and safety of the natural gas industry. The Petroleum Regulations (Principles for Offshore Petroleum Exploration and Production) 2006 also apply to certain offshore petroleum rights.

#### ***Israel's Petroleum Law***

Israel's Petroleum Law (5712-1952) regulates activities associated with the exploration for and production of petroleum, which includes any petroleum fluid such as oil and natural gas.<sup>10</sup> A Petroleum Commissioner is appointed by the Minister of Natural Infrastructures to manage all petroleum affairs. The Commissioner receives advice and counsel from a subordinate Advisory Council.

The Minister of Natural Infrastructures establishes overall policy for natural gas exploration and production. The Minister also has authority to manage certain aspects of the petroleum industry, including setting the minimum monetary investment required to receive a license and authority to open and close Israel lands for exploration and production of natural gas.

The Petroleum Law establishes three primary types of rights:

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<sup>10</sup> The Petroleum Law 5712 – 1952, sec. 1(1). Additional legal citations to the Petroleum Law are omitted for purposes of brevity.

- 1) A *preliminary permit* allowing a party to begin preliminary investigations to evaluate the prospects of a particular area;
- 2) A *license* permitting a party to explore for natural gas and conduct test drilling; and
- 3) A *lease* granting a party an exclusive right to explore for and produce natural gas within the leased area.

No party may explore for petroleum without a permit, license, or lease. Exploration is defined as the drilling of test wells or any other operation in search of petroleum such as geological and geophysical investigations and tests. Furthermore, only a party who has a license or lease may produce petroleum.

#### ***THE PRELIMINARY PERMIT***

The preliminary permit allows a party to carry out preliminary investigations, excluding test drilling, to evaluate the prospects of natural gas production. An application must be submitted to the Commissioner who then acts on the permit. In the event an application is denied, the applicant may appeal this decision to the Council.

Provided the applicant complies with certain conditions, such as agreeing to carry out preliminary investigations based upon an agreed upon plan and commits to a certain level of investment for petroleum exploration, the applicant may be granted a priority right for receipt of a permit. This priority right, which can be granted for a maximum of eighteen months, gives the permit holder the exclusive ability to receive a petroleum right (i.e. a license or lease) over the area specified in the preliminary permit. No other party may obtain a license or lease over the specified area.

In addition to the various requirements imposed by the Minister, a permit holder must provide reasonable security or guarantee to compensate for any damage caused during investigation or for failure to restore the area to its original condition once the permit expires.

#### ***THE LICENSE***

In order to proceed further the preliminary permit holder must obtain a license that allows the party to begin drilling explorations such as test drilling. A licensee has permission to engage in petroleum production and the right to obtain a lease after the discovery of petroleum in the licensed area.

To obtain a license, the party must apply to the Commissioner. The application must include 1) a plan of operation for petroleum exploration; 2) the available capital to carry out the plan; 3) a description of the preliminary investigations to determine the sites for test drilling; and 4) the estimated date to begin drilling. The licensee must pay a fee set by the Minister based on various factors such as length of the license, the size of the covered area, and other relevant factors. All licenses are issued by the Commissioner.

A license may also be obtained through a competitive bidding process. This process involves an investigation over a particular area conducted by the Petroleum Exploration Basic Research Company (the "PEBRC"). The PEBRC is permitted to carry out preliminary investigations over open lands. After publishing its findings, those lands which are not burdened by any petroleum rights are open to a competitive bidding process for the grant

of a license. This bid must be submitted to the Council, which issues a recommendation to the Commissioner.

The original license term is three years, which may be extended under certain circumstances. If the licensee has not made a discovery and the Commissioner believes there is good cause to do so, the term may be extended. However, the extension must be granted if no discovery has been made and diligent test drilling is being conducted in accordance with the time table provided in the conditions of the license. The total term of the license cannot exceed seven years from the grant thereof.

In the event discovery has been made, the Commissioner must extend the term of the license to allow that party sufficient time to define the petroleum field. This extension is limited to two years.

The maximum area for a license is four hundred thousand dunams. Further, no person is permitted to hold more than twelve licenses or an aggregate land area exceeding four million dunams, absent prior approval of the Council. The licensee has a duty to explore within four months from the granting of the license, and this duty remains applicable throughout the duration of the license. Moreover, test drilling must be commenced on the date provided in the license and must be within two years of the date on which the license was granted. Test drilling must continue during the term of the license. Finally, after the drilling of one well is completed, drilling of another must be commenced within four months.

The licensee must make reports on petroleum exploration and conduct various tests with results provided to the Commissioner. A final report detailing the exploratory activities must be submitted to the Commissioner when part of the licensed area is surrendered, upon the expiration of the license, or to apply for a lease. If a licensee makes discovery, he must produce the petroleum, define the field, and develop the covered area in the same manner as a lessee. In such a case, the licensee must comply with all the obligations of a licensee and lessee.

#### *THE LEASE*

A lease grants the lessee an exclusive right to explore for and produce petroleum within the specified area. Once petroleum is discovered the licensee is entitled to receive a lease over any area(s) within the licensed area. Area(s) for which the licensee does not seek a lease, revert to the State who may transfer that part of the lease rights to another party.

A leased area cannot exceed two hundred and fifty thousand dunams. Additionally, absent prior approval by the Council, a party cannot hold leases with a total area exceeding three million dunams. Similar to licenses, leases may also be granted through a competitive bidding process.

Lease terms are thirty years but are renewable for an additional twenty years. Generally, the lessee must produce natural gas in commercial quantities within three years of the commencement of the lease. Failure to produce commercial quantities of natural gas can result in expiration of the lease.

Once a lease is granted the lessee must erect boundary marks to demarcate the covered area. Further, the lessee must commence drilling within six months and make efforts to define the petroleum field, develop the area, produce petroleum, and seek markets for the petroleum.

Generally, the lessee must pay royalties of one-eighth the quantity of petroleum produced as well as leasehold fees to the Treasury. Nevertheless, the regulations set a minimum amount payable based on the size of the leased area and the age of the lease. The Commissioner may elect to receive the royalty in the form of petroleum. Petroleum that is used in drilling operations is not subject to royalty payments.

*In order to ensure a sufficient supply of petroleum to Israel, the regulations enable the Minister to require lessees to first distribute, at fair market value, its petroleum to Israel for Israeli domestic consumption. Assuming excess quantities of petroleum remain after satisfying the aforementioned Israeli domestic consumption requirement, the producer may process, transport, export, and trade in petroleum and petroleum products, subject to certain restrictions. In addition, the lessee may construct pipelines and facilities for the transportation of petroleum, subject to the approval of the Commissioner.*

*Under certain circumstances, the holder of a petroleum right may import, free of customs and duties, machinery and equipment necessary to conduct petroleum operations provided that these materials cannot be obtained in Israel. Additionally, the regulations provide*

*other tax benefits and exemptions for certain expenditures.*

In addition to the Petroleum Law, the Petroleum Regulations (5713 – 1953) provide specific information that must be included in an application for a preliminary permit, license, or lease. The Petroleum Law also sets out the applicable fees and royalty payments associated with the petroleum rights, and includes regulations regarding reporting requirements, safety standards, and other general administrative requirements.

### ***Petroleum Regulations of 2006***

The Minister of Natural Infrastructures enacted the Petroleum Regulations in 2006, which provide minimum experience requirements for parties seeking to obtain an offshore petroleum right.<sup>11</sup> *Either the applicant, or his employee or contractor (defined as “an entity who, on behalf of the holder of a Petroleum Right, executes a work program or plans and provides overall supervision for the execution of a work program”), must possess the following experience:*

- 1) To obtain a preliminary permit with priority rights, the applicant must demonstrate execution of offshore seismic mapping;
- 2) To obtain a license in an area with waters of one hundred meters or less, the applicant must show that he has experience in the drilling of at least one offshore well;
- 3) To obtain a license in an area in which water depth exceeds one hundred meters, the applicant must demonstrate that he

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<sup>11</sup> The Petroleum Regulations 5713 – 1953, sec. 1-5D, 6-11B, 18-32. Additional legal citations to the Petroleum Regulations are omitted for purposes of brevity.

has experience in drilling at least one offshore well in waters with depths exceeding one hundred meters;

4) To obtain a lease in an area in which water depth is five hundred meters or less, the applicant must demonstrate that he has produced petroleum in at least one offshore petroleum field;

5) To obtain a lease in an area in which water depth is between five hundred and one thousand meters, the applicant must show that he has produced petroleum at an offshore petroleum field at depths of greater than five hundred feet; and

6) To obtain a lease in an area where water depths exceed one thousand meters, the applicant must demonstrate that he has produced petroleum at an offshore petroleum field in waters exceeding one thousand feet.

An applicant must also demonstrate that he has the financial capacity to cover the estimated cost of the work program as well as half the estimated cost of one drilling well in the approved area. Finally, the maximum area for an offshore preliminary permit is four thousand square kilometers and the maximum area for a license is four hundred square kilometers.

#### ***Recent Petroleum Regulations***

In addition to the above requirements, the Commissioner has issued two additional sets of guidelines imposing more stringent experience requirements.<sup>12</sup> A set of March 2010 regulations require the appointment of an operator with experience managing offshore projects worth at least \$100 million.

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<sup>12</sup> See Noy Dor & Menachem Danishefsky, *A Legal Vacuum Filling Up with Gas: Israel's New Regulatory Environment*, p. 1-2 (2011).

New proposed regulations were published in 2011 that seek to restrict the transfer of petroleum rights. The regulations require Commissioner approval before any transfer of interests in petroleum rights or changes of control within the structure of the current holder of petroleum rights. Moreover, any transferee of petroleum rights would have to meet the most recent licensing requirements as opposed to the licensing requirements in effect at the time the license was originally issued.<sup>13</sup>

#### ***The Natural Gas Sector Law***

The Natural Gas Sector Law (5762-2002) was created to establish conditions for the development of natural gas in Israel, regulate and enhance investment in the natural gas sector and ensure the safety of natural gas operations.<sup>14</sup> Unlike the Petroleum Law, this law regulates the midstream and downstream segments of the natural gas industry.

The Gas Law establishes the Natural Gas Authority within the Ministry of Natural Infrastructures. This Authority ensures that licensing conditions are fulfilled, approves tariffs, regulates matters concerning safety in the industry, and sets the criteria for services provided by licensees. The Authority also governs the construction and development of gas installations.

The Gas Law recognizes four main segments of the natural gas supply chain: (1) gas suppliers and sellers; (2) high pressure transmission system; (3) low pressure regional distribution networks; and (4) marketing companies. The sale

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<sup>13</sup> *Id.* at p. 3.

<sup>14</sup> The Natural Gas Sector Law sec. 1(a). Additional legal citations to the Natural Gas Sector Law are omitted for purposes of brevity.

of natural gas does not require a license. However, pipeline construction to transport gas to customers requires a license. A government owned entity, Israel Natural Gas Lines, Ltd. (“INGL”) is constructing a high pressure transmission system (the “INGL Grid”) to facilitate the distribution of natural gas throughout Israel. A number of low pressure distribution licenses have been granted in certain regions. The Gas Law does not require a license to market natural gas; however, the Gas Authority published draft regulations in 2010 that may change the procedure for marketing natural gas

The Gas Law requires a license to engage in any of the following four activities:

- 1) The setting up and operation of a transmission system or part thereof (the transfer of gas through pipelines at high pressure);
- 2) The setting up and operation of a distribution network or part thereof (the transfer of natural gas at low pressure);
- 3) The setting up and operation of a liquefied natural gas (“LNG”) installation (an installation for the unloading, reception, storage, or the conversion to a gaseous state); or
- 4) The setting up and operation of a storage installation either above or below ground.

Different procedures and requirements are in place for granting the various licenses. For example, only a company that is incorporated in Israel under its Companies Law may receive a license. Further, certain persons are restricted from obtaining a license: (1) a

government entity; (2) a petroleum refiner (or one with an interest/control therein); or (3) an electricity supplier (or one with an interest/control therein). In an effort to increase competition throughout the gas sector, the Gas Law limits, in certain instances, the ability of licensees to engage in multiple aspects of this downstream distribution network.

The maximum term for any license is thirty (30) years, with the exception of a distribution license which may be granted without a term. This thirty year term cannot be extended, but the applicant may reapply for a new license upon termination of the term. With respect to a transmission license, the licensee may be granted exclusive rights to engage in transmission over a certain place or region.

The Minister of National Infrastructures has the power to impose conditions on a licensee, require the payment of royalties or fees, cancel or terminate the license for various reasons, and ensure the continuity of operations by various means. Additionally, the Minister must give consent to any transfer of a license and may place conditions on the transfer of control of a license. The Gas Law also creates a Council that is charged with, *inter alia*, establishing service criteria and setting tariffs.

## **V. ENERGY ENVIRONMENTAL REGULATIONS**

In the wake of the BP Deepwater Horizon Disaster in April, 2010 countries around the globe are reviewing their environmental laws and legal framework for dealing with large-scale disasters associated with deepwater energy exploration.

Israel's Petroleum Law of 1952 contains very little coverage of environmental issues. Israel's National Infrastructure Ministry primarily relies upon laws and regulations promulgated by the US Ocean Energy Management Regulations and Enforcement agency, part of the US Department of the Interior. Both of the recent energy discoveries are in deepwater and Israel is in the process of modernizing and strengthening its environmental and legal framework in this area.

## **VI. CONCLUSION**

The discoveries of substantial natural gas reserves off the coast of Israel represent a significant business opportunity for international investors and service providers. While the legal framework governing the natural gas sphere is complex, the opportunity costs for entry into this burgeoning area is very low and the potential benefits significant.