



Oil, Gas & Shipping

magazine

OFFICIAL
MEDIA
SUPPORTER
ONS 2016

ISSUE 89 www.ogsmag.com

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ISRAELI NATURAL GAS INDUSTRY: WHERE DO WE GO NOW?



After years of deliberations, negotiations and amendments, the Israeli government recently adopted its final framework for the regulation of the burgeoning natural gas sector. This exciting development is a reflection of the country's vibrant democracy, strong rule of law, and climate of regulatory certainty; it will hopefully foster geopolitical stability in the eastern Mediterranean basin, and will potentially promote economic co-development projects and unprecedented investment opportunities in the region.

Israeli law firm partners Shiri Shaham and Simon Weintraub share their analysis of the natural gas industry in Israel and its potential for direct foreign investment.

The Israeli Gas Framework

Background and process

Israel has historically been a natural resource-poor country and is more widely known for its innovation and high tech industry. Over the course of the last seven years, however, several major natural gas reservoirs have been discovered in the country's Exclusive Economic Zone ("EEZ") placing Israel on the map for the first time with respect to natural resource opportunities. Israel's four largest natural gas fields have largely been held by two parties – Noble Energy and the Delek Group, while the exploration efforts of other rights holders have mostly proved unsuccessful. As of June 2016, Delek and Noble together control 85% of the Leviathan field, 67.25% of the Tamar field, and 100% of both the Karish and Tanin fields. The Tamar field, estimated at containing 10 trillion cubic feet (tcf) of gas, was first discovered in 2009 and became operational in April 2013. It now generates

more than half of Israel's domestic electricity production. The Leviathan field (estimated at 22 tcf) was discovered in 2010 and production has not yet commenced. Tanin and Karish are much smaller fields which similarly have not yet been developed to production stage.

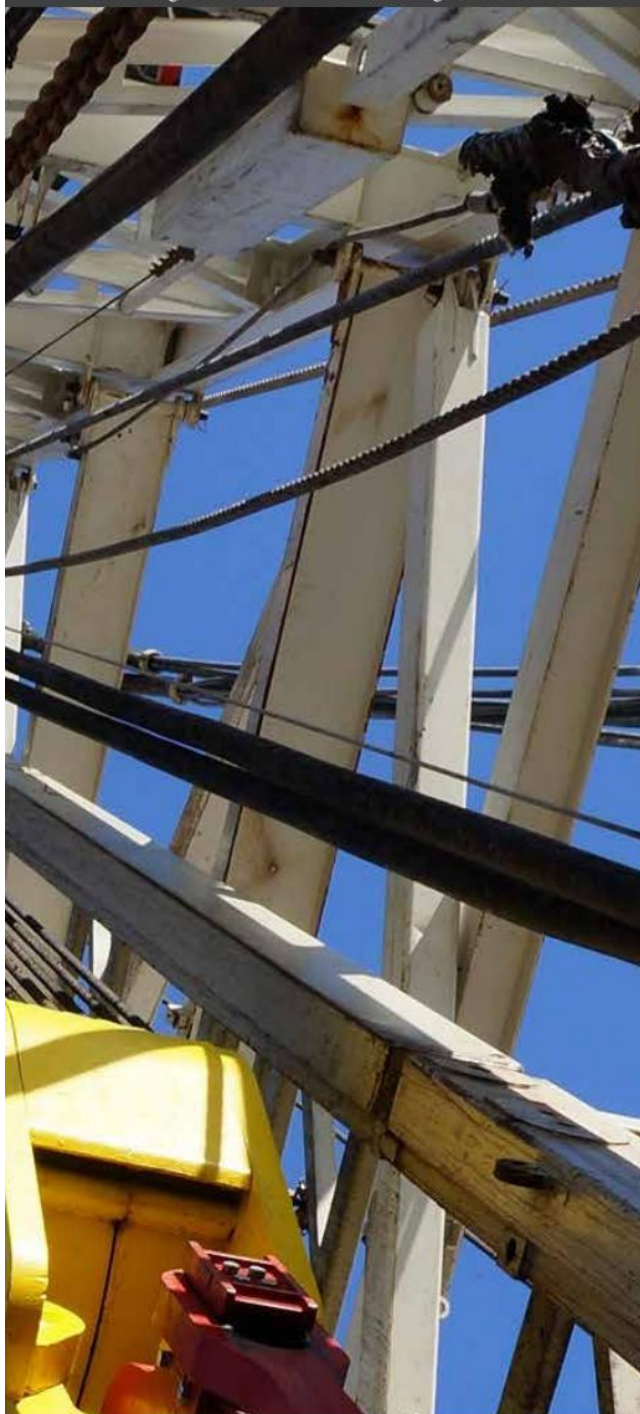
In December 2014, Israel's then Antitrust Commissioner

"Over the course of the last seven years, several major natural gas reservoirs have been discovered in the country's Exclusive Economic Zone (EEZ)"

announced his decision to break up the Noble-Delek dominant position in this sector by cancelling a previous arrangement proposed by the Commissioner that would have allowed such parties to retain their respective stakes in Leviathan and Tamar on the condition that they sell their shares in the smaller Tanin and Karish fields. This decision resulted in an immediate halt in the development of Leviathan and triggered an intense deliberation process by the Israeli government, involving negotiations with Noble and Delek. The aim of such negotiations was to adopt a long term comprehensive arrangement which would enable the development of Israeli gas reservoirs on the one hand, while affording solutions to the natural concerns of exploitation of a monopolistic position. This process took place during the entire year 2015 and involved public and parliamentary hearings and heated debate among the Israeli public. Finally on 17 December 2015, the Israeli Government approved the Natural Gas Framework, which constitutes a comprehensive regulation of this issue (the "Framework").

The main principles of the Framework are:

- **Mandatory sale:** Noble and Delek must sell all their rights in the small fields Tanin and Karish within a specified 14 month timeframe. Delek Group must sell all of its rights in the Tamar field and Noble Energy must sell at least 11% of its rights (limiting its maximum holdings in Tamar to 25%) by December 2021. The buyers of the above mentioned holdings must be unrelated third parties, who shall be approved by the Petroleum Commissioner in consultation with the Antitrust Commissioner.
- **Development and local purchase commitments:** The Leviathan leaseholders must purchase at least US\$1.5 billion in services and equipment for the Leviathan field's





development by the end of 2017 and the Tamar and Leviathan leaseholders must invest at least US\$500 million over eight years in pertinent Israeli goods and services, R&D, personnel and professional training.

- **Protections to customers:** The Antitrust Commissioner conditioned his approval of a series of nine long term agreements for the sale of gas from the Tamar field upon the granting of a two-year "window of opportunity" (anticipated during 2020-22 but subject to change) for customers to reduce the quantities which are committed to be purchased under the current "take or pay" purchase agreements by up to 50%. In addition, with respect to these long term agreements as well as nine additional short term agreements, customers will be permitted to re-sell 15% of their contractually purchased quantity in secondary sales without pricing restrictions. Future purchasers will enjoy additional protections relating to pricing.
- **Export and tax:** The Framework reinstates, with some modifications, a former government resolution regarding export restrictions which determines that a certain predetermined quantity of gas should be reserved for the local market. It also clarifies various points relating to the special taxation regime applicable for the sale of natural resources.
- **Stability clause:** This integral provision requires the government to guarantee regulatory stability for ten years. This clause in its original version in the December 2015 Framework precluded the government from initiating new legislation that would change the main parameters of the Framework and current regulations and required the government to oppose similar private legislation. These undertakings are conditional upon compliance by the leaseholders with their respective Framework commitments.

The judicial process

Fueled by heated public discourse questioning the government's policy considerations, a number of interested and political groups challenged the Framework before the Supreme Court of Israel in its capacity as the High Court of Justice. The appeal hinged on the legality of the government's adoption of this type of legislative-like agenda, rather than by primary legislation of the Knesset (Israeli parliament). The five Supreme Court judges methodically reviewed and comprehensively analyzed each issue, with each judge expressing slightly different opinions on the various issues. The majority opinion, issued on 27 March 2016, determined that the Framework in its current form was not adopted properly, primarily on account of the legal status of its Stability Clause. The government was granted one year to resolve this issue.

The revised stability clause

The government promptly addressed the Court's concerns and on 22 May 2016, announced its amended Framework with a more lenient stability clause. While the new clause still refers to a 10-year long regulatory climate in the natural gas sector which is intended to attract investment, it no longer guarantees nor does it mandate that the government will abstain from and oppose the enactment of any material changes.

Rather, the new clause provides that the government will carefully consider future regulatory changes which relate to the "government take" from the leaseholders' profits and other matters dealt with in the Framework when such changes could have a material adverse effect (in the eyes of a reasonable investor) on the leaseholders.

In the event of a material change of this kind, the government will undergo an evaluation process which will explore and form solutions in order to sustain the economic viability of the projects. Such evaluation process must be



concluded during a fixed and relatively short time table and will take into account, inter alia, conformity with OECD and other worldwide standards, amounts already invested in the projects as well as the existence of approved export agreements. As in the previous version of the clause, these governmental undertakings are conditional upon compliance by the leaseholders with the provisions of the Framework. This improved Framework has thus far gone unchallenged although it cannot be ruled out that additional petitions will be submitted to the Court.

Going forward and conclusions

In our opinion recent events in Israel's natural gas sector are an encouraging reality for foreign investment in Israel. The recent deliberations and legal proceedings surrounding the Framework have showcased Israel's vibrant democracy and strong rule of law. The High Court of Justice's opinion outlines a clear separation of powers between Israel's executive and legislative branches, effectuating political, legal and regulatory certainty – imperative for direct foreign investment.

From an investment perspective, it is the hope that the Framework will serve as a stimulus in expediting the development of Israel's natural gas reserves and for promoting trade agreements with neighbouring eastern Mediterranean countries. Such trade agreements can hopefully serve to foster geopolitical stability in the region. By way of example, it was reported that Leviathan partners and British Gas were close to signing a US\$30 billion deal to supply 105 BCM of gas over 15 years to British Gas's liquefaction facility in Idku, Egypt. It has also been reported in the media that Israel and Turkey are coming closer to a gas deal, including the possibility of a pipeline through Turkey. While relations between the two states have been shaky as of late, a trade agreement would advance the rapprochement that interests both sides.

Additionally, in February 2016, it was reported that the Tamar partners signed a letter of intent with private customers in Jordan to supply 1.8 BCM over 10 years. Lastly, in April 2016 it was announced that the Palestinian Investment Fund received a provisional permit and would soon publish tenders for building a US\$600 million power station to be supplied with natural gas from the Leviathan field. The power station is intended to provide 450 megawatts of electricity to West Bank residents.

The Framework is already spawning a boom in discussions on foreign investment and M&A activity in Israel. Under the Framework, the Leviathan field will need to be developed rapidly requiring the infusion of billions of dollars, most of which will likely be funded by sources from outside of Israel. Moreover, it was announced recently by the Israeli government that there will be a new round of exploratory permits (likely in the fall) to be granted by the Israeli government as the country's EEZ continues to prove fertile. For example, this past January, it was reported that the partners in the Daniel gas field off the coast of Ashdod and near the Gaza Strip, have a geological report estimating such field to hold 8.9 trillion cubic feet of natural gas.

We are optimistic that the major regulatory hurdles have now been overcome so that Israel can finally find its place as a global energy provider as well as a home base for safe investment opportunities.

The authors Shiri Shaham and Simon Weintraub are partners in the Israeli law firm of Yigal Arnon & Co. specializing in banking and oil & gas. Most recently, Shiri and Simon represented JP Morgan, CitiGroup and HSBC, as the lead underwriters in the Delek Group \$2 billion bond offering in connection with the development of the Tamar lease.