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Israel Natural Gas Lines Ltd.

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Lines Ltd. – Financial
Audit and Various
Aspects of the
Company's Activities**



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Background

Israel Natural Gas Lines Ltd. (INGL or the Company) was incorporated in 2003 as a government company wholly owned by the State of Israel (Government Resolution 649). In 2004, it was granted a license (which was extended in 2005 until 2034) to establish and operate a natural gas transmission system¹ under the Natural Gas Sector Law 2002, and it began operating in 2004. The Company is a natural monopoly in the gas transmission sector in Israel. INGL is subject to two regulators: The natural gas regulator is the Ministry of Energy and Infrastructure, which operates through the Natural Gas Authority; and the Government Companies Authority, which regulates all government companies. In 2022, the Company employed about 150 workers. The transmission system established by the Company includes four main components: (a) Three stations receiving the gas from the offshore gas suppliers; (b) Onshore and offshore pipelines; (c) PRMS² stations; (d) Block valve stations³. According to the license, the Company is responsible for the system's operation and ongoing maintenance. The natural gas transmission system extends from the Tziporit Local Authority in the north to Sedom in the south. The length of the gas transmission pipeline is about 830 km (as of 2021). The Company transfers natural gas to 41 customers, including customers exporting gas to Egypt and Jordan, and to 50 PRMS stations, connecting customers to the transmission system.

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- 1 Natural gas, like oil and coal, is a source of energy originating from fossil fuel and is found in reservoirs in the bowels of the earth. The main component of natural gas is methane (CH₄) which is a flammable gas. This, compared to LPG ("cooking gas"), which is a product of oil refining.
 - 2 PRMS facility – a facility for pressure reduction and measurement of natural gas (Pressure Reduction & Metering Station).
 - 3 Block Valve Station – a station used to operate the system and control it and to isolate sections in an emergency.



Key Figures

**NIS
1,005
million**

INGL's revenues in 2021, 64% from the Israel market, 23% from exports to Egypt, and 13% from exports to Jordan

**52.5%;
25.1%**

the operating profit and net profit rate in 2021. The long-term average net profit rate of the Company (16%) is high compared to other monopolistic infrastructure companies (Energy Infrastructures Ltd. – 15%; Mekorot – 4%; Average of foreign companies – 6%)

NIS 0

the dividend that has been transferred to the government since INGL's establishment in 2004–2022. In 2022, the Company announced the transfer of NIS 80 million as dividend to the state for the first time since its establishment. Still, the funds have not yet been transferred

**about
NIS 200
million**

the loss to the state due to reduced corporate tax in 2018–2022, due to accelerated depreciation of NIS 863 million required as a result of non-extension of the operating license

**about
14 years**

have passed since the decision of the Minister of Energy and Infrastructure, at the time (2009) to formulate a master plan for the development of the energy sector; however, the master plan was not yet formulated

**NIS 346
million**

INGL's share (43%) in financing the Ashdod-Ashkelon offshore pipeline (out of NIS 796 million)

**NIS 60
million**


the budget increase for the Ashdod-Ashkelon offshore pipeline project will be made after the tenders are concluded. The pipeline completion date has been postponed from April 2023 to January 2024 (not final)

17%

the reduction rate in the Company's tariff set by the Gas Council as of 2022. Including a decrease of about 7% in the tariff for the Company's customers and the remaining 10% being transferred to a systemic tariff for the management of the Natural Gas Authority





Audit Actions

 From August 2022 to January 2023, the State Comptroller's Office audited the Company's financial issues. The audit focused on presenting the financial statements for 2019–2021; The financial and economic ratios, material items from the balance sheet, and the profit and loss statement; the auditing accountant's work, and corporate governance. The audit was conducted at Israel Natural Gas Lines Ltd., the Natural Gas Authority, the Ministry of Energy and Infrastructure, and the Government Companies Authority. Completion examinations were conducted at the Israel Electric Company (IEC) and Noga – Israel Independent System Operator Ltd.

Key Findings



 **Financial Ratios** – INGL is a natural monopoly in Israel's gas transmission market. Excessively high-profit rates of a monopoly may come at the expense of the consumer [excess profits of a monopoly that reflect a situation in which consumers paid too high a price for the service] and make it difficult for him to cope with the cost of living. INGL's average net profit rate for 2019–2021 (16%) was four-fold higher than that of Mekorot (4%) and 2.67-fold the average of comparable foreign companies⁴ (6%). It was similar to the net profit rate of Energy Infrastructures Ltd. (15%). The rate of INGL's operating profit increased from 36% in 2019 to 52% in 2021. It was significantly higher than the operating profit rate of the other two government infrastructure monopolistic companies – Energy Infrastructures Ltd and Mekorot in each of the years 2019–2021 (20% on average in 2021), and in comparison, to 14% in the foreign comparison companies. The EBITDA index rate from INGL's revenues in 2019–2021 averaged 88%, a rate three-fold higher than the comparison companies (27%), among other things, due to INGL's failure to revise its tariffs downward by the end of 2021. INGL's EBITDA is expected to decline in 2022 due to the Natural Gas Authority's decision to lower the tariffs by about 17%, including a decrease of about 7% in the tariff for the Company's customers, and the balance of 10% being transferred to a systemic tariff for the management of the Natural Gas Authority.

 **Non-Extension of INGL's License by 15 Years** – in 2017, a summary report was published on the strengthening of INGL's equity ("Capital Strengthening Outline") designed to increase the ratio of equity to balance sheet from 14% in 2016 to 20% in

⁴ Enbridge, Plains All American Pipeline, Kinder Morgan, Enlink, Pembina Pipeline Corp, Oneok.



2022, thus ensuring future capital raisings and the continuation of the Company's development plan. To achieve the leverage goal, it was recommended, among other things, to extend INGL's license for establishing and operating a natural gas transmission system by 15 years until 2049. The audit found that the extension of INGL's license by 15 years until 2049 was not carried out. Although the Capital Strengthening Outline was signed in 2017, only in 2020 did the Natural Gas Authority prepare a bill to amend the Natural Gas Economy Law, which was not submitted for the Knesset's approval due to the change of governments.

Failure to renew the license caused and may result in the following:

- In 2018–2022, the postponement of payment of INGL's taxes to the state treasury due to the decrease in corporate tax by about NIS 200 million and the reduction in the Company's reported profits by about NIS 863 million as a result of the recording of expenses as accelerated depreciation.
- According to the Company's assessment, the non-renewal of the license (assuming a net profit of about 7.5% from operations) in 2024–2049, based on operating expenses of about NIS 120 million per year, will result in a loss of profitability for the Company of about NIS 9 million each year and of about NIS 135 million until 2049.
- The tariff formula gives INGL a full refund of the principal repayment amount. Thus, the principal repayment increases in the remaining years until the license expires in 2034, which may increase the tariff for the Company's customers, and the Company can meet its obligations. This will affect, among other things, the prices of natural gas transmission and, by implication, the cost of living.
- Towards the license expiration date, INGL is expected to make only necessary investments in the system, which may adversely affect the Company's growth and operation.



Conflict of Interests of the INGL Regulators and its Effect on Dividend Transfer

– since INGL's establishment in 2004 until the audit end, INGL did not transfer a dividend to the state. It was raised that each regulator has different goals, so their actions to achieve their various goals may lead them to opposing actions. While the Government Companies Authority works to maximize the return on capital through the transfer of dividends at an adequate level, the Ministry of Energy and Infrastructure, which sets the tariff affecting the possibility of dividend transfer (return on capital), does not consider dividend transfer by INGL as possible, even not in the long run. This resulted in a dispute between the Government Companies Authority and the Natural Gas Authority regarding the decision of the Company's board of directors to transfer a dividend of NIS 80 million in 2022. At the audit end, the Government Companies Authority had not yet approved



the dividend transfer since the Minister of Finance then, the minister in charge of the Government Companies Authority instructed the Authority to suspend the transfer of dividends to the state until the formulation of their policy on this matter.

📌 Priorities in the Supply of Natural Gas – at the audit end, the gas supply derives from three gas reservoirs: Tamar, Leviathan, and Karish. Among other things, gas supply depends on the diameter of the pipeline carrying the gas to consumers and on the quantity of gas supplied by the gas suppliers. The gas produced at Tamar and Karish is mainly intended for the domestic market, while the gas produced from Leviathan is designed chiefly for export. INGL's agreement with its customers does not allow it to prioritize domestic customers over export customers; therefore, there is a concern that the interruption of gas supply from Tamar due to maintenance or another event could create a gas shortage in the domestic market and disrupt the market activity, including the production of electricity – both daily and at the hourly level (peaks and slumps in electricity production). The result is the operation of coal-fired power plants or the use of diesel, which costs the market more than gas and causes more environmental harm.





📌 Master Plan for the Energy Sector and the Natural Gas Sector – at the audit end, the Natural Gas Authority does not have a master plan for the natural gas sector. Thus, among other things, the Authority has no vision, goals, or objectives regarding the natural gas sector and INGL. The lack of such a plan could harm, among other things, the analysis of the needs of the fuel sector, the development of fuel infrastructures, and the reliable supply of fuels to essential consumers in an emergency, as well as these aspects in the natural gas sector. The lack of a master plan also adversely affects the ability of the planning bodies (such as the Planning Administration, local authorities, and the Ministry of Environmental Protection) to make decisions that balance the needs of the natural gas industry with the needs of other infrastructures and industries, environmental needs, the needs of the population and urban needs.

📌 The Ashdod-Ashkelon Offshore Pipeline: Adoption of the Gas Commission Resolutions – in 2021, INGL engaged with Chevron Mediterranean Ltd. to supply transmission services for the flow of natural gas from the Leviathan reservoir and the Tamar reservoir in Ashdod to the EMG receiving station in Ashkelon⁵ for export to Egypt. The Commission's minutes regarding the decision to establish the Ashdod-Ashkelon offshore do not include the Commission's deliberations. It was also found that Commission Resolution 3/2020 fully adopted the recommendation of the Natural Gas Authority's engineering opinion regarding the financing of the construction of the offshore segment and decided on the distribution of the funding (costs) between INGL (43.5%) and the exporter (56.5%); hence, a decision was made to finance the construction of the pipeline at about NIS 400 million from INGL's funds. These costs will be included in the tariff calculation, which may make INGL's tariff more expensive.


⁵ In the past, the EMG company operated a natural gas import line from Egypt to Israel. Today the infrastructures in Ashkelon are used for the export of natural gas from Israel to Egypt.




Furthermore, the meeting minutes do not include mention or discussion of simulations, scenarios, or data presented by INGL. It was also found that at the time Resolution 3/2020 was adopted, the Commission was short on members since, contrary to the law requirements of five members, including two public representatives, only three members served in it, none of them a public representative: The Director of the Natural Gas Authority, a representative of the Minister of Energy and Infrastructure, and a representative of the Minister of Finance.

-  **The Ashdod-Ashkelon Offshore Pipeline: Timetables and Budget for the Implementation of the Project Starting in November 2021** – the delay in the execution of the Ashdod-Ashkelon offshore pipeline project was caused by numerous delays in the work with the EAPC (Europe Asia Pipeline Co. Ltd.) and due to an operational malfunction in the Seminole sea vessel responsible for laying the pipeline. After the completion of the tenders, the project budget increased by about NIS 60 million, and its end date has been postponed from April 2023 to January 2024 (not final).
-  **Preparedness for Earthquakes and Emergencies** – it was found that until the audit end, the Geological Institute's update report on the effect of earthquake scenarios on the gas transmission network, commissioned in 2020 (564 km of pipeline) was not completed and that the last report was prepared in 2012 (length of 168 km of pipeline). The Geological Institute stated in November 2022 that the Institute ran earthquake scenarios on the sites and the location of transmission lines for gas and oil, as stated by the Ministry of Energy and Infrastructure. Still, the Ministry did not define which specific earthquake scenarios it intended to examine and did not provide the Institute with information regarding the fragility curves of the pipeline (graph which describes the durability of the pipeline as a function of ground motion). Therefore, as of November 2022, the Institute stopped updating the report.
-  **Onshore Gas Storage** – it was raised that from 2012 until the audit end, the Gas Authority directed INGL several times to conduct an economic examination of alternatives for onshore storage of natural gas, which were examined by it. Furthermore, the Gas Authority instructed INGL in 2022 to promote the 'Rosh Zohar' (Zohar Head) experiment. However, the Gas Authority did not decide on the matter, among other things, due to the high costs, it did not finish preparing a detailed document of principles for formulating a policy for the onshore storage of natural gas. The Gas Authority did not have policy documents and principles for onshore natural gas storage at the end of the audit.
-  **The Auditor's Term of Office** – INGL is subject to the Government Companies (Appointment of Auditors and their Salary) Rules, 1994, which stipulate that an auditor's cumulative term in office shall be no more than six consecutive years. However, the Company's auditor has been in office for over 18 years since he was appointed in 2004.



 **Chairman of the Board of Directors and Staffing of the Company's Board of Directors** – for about nine months (from September 2021 to February 2022 and from January 2021 to May 2021), the Company did not have a permanent board of directors' chairman. The Company's articles of association state that the board of directors will consist of 3 to 9 directors, of which two will be external directors. In part of 2020, four directors served on the board; in part of 2021, three. It was further found that there were less than two external directors on the board of directors for about five months (from August 29, 2021, to February 1, 2022).





 **Adequate Representation of Women on the Board of Directors** – except for April to September 2021, in 2019–2022, there was no adequate representation of women on the INGL board of directors according to the Government Companies Law and the Attorney General's instruction. In September 2022, four of the six incumbent directors were men compared to the target of 50% women.



Code of Ethics – as of September 2022, INGL had a code of ethics. After an in-depth examination of the codes of ethics of companies of different types and with other values, the mapping of its core values, and the formation of its vision, the Company prepared a new and updated code of ethics. The new code of ethics represents the Company's normative values by which it operates, based on laws, regulations, and procedures to which it is bound.



Key Recommendations

-  It is recommended that the Government Companies Authority examine the profitability rates of monopolistic government companies, as well as the effect the tariffs set for them also have on the cost of living in Israel, considering the need to maintain the stability of the companies and their compliance with their obligations both in the short and in the long-term. It is further recommended that the Natural Gas Authority and the Government Companies Authority convene to optimize regulation activity, minimize the disputes in the management of the Company, and balance the regulators' interests so the Company will meet its obligations and duties for the development of the gas industry according to the Natural Gas Authority's requirements and the interest in lowering the tariff, and will also transfer dividends to the state as a shareholder, according to what is customary in the market and according to the demands of the Companies Authority, as a return to the owner (the public) for the investment in the development of the Company. In a dispute regarding the dividend transfer, the regulators should turn to the government for approval under the Government Companies Law.
-  The Ministry of Energy and Infrastructure should amend the Natural Gas Sector Law to enable the extension of INGL's license by 15 years until 2049, according to the summary of the Capital Strengthening Committee (whose members were the Ministry of Energy and Infrastructure, the Ministry of Finance, the Government Companies Authority and the Natural Gas Authority). Should the license be extended, it would improve the Company's ability to operate after lowering the tariff (decrease in revenue) by about 17%, help it meet its obligations, and allow it to transfer a dividend to the State of Israel as a return to the owners on the investments in the Company.
-  Natural gas is essential for the economy as well as for gas exporters. It is recommended that the Ministry of Energy and Infrastructure establish priorities between the supply of gas to the domestic market and exporting while coordinating between the various regulators (the Natural Gas Authority, which is in charge of matters of petroleum at the Ministry of Energy and Infrastructure, and the Noga Company, which manages the national power grid) and create an orderly set of rules for different cases. Furthermore, the Ministry of Energy and Infrastructure should prepare a master plan for the energy sector with a vision, goals, and objectives, including a chapter on the natural gas sector.
-  The Natural Gas Authority should examine the feasibility of onshore storage of natural gas and cooperate with the Ministry of Energy and Infrastructure to adopt a decision regarding the establishment of an operational or strategic gas storage reservoir for routine and emergency times, and accordingly establish it, as according to the Natural Gas Authority report in 2022, two uses of the reservoir in times of emergency are sufficient for a return of investment (before current operation costs). It is recommended that the Ministry of



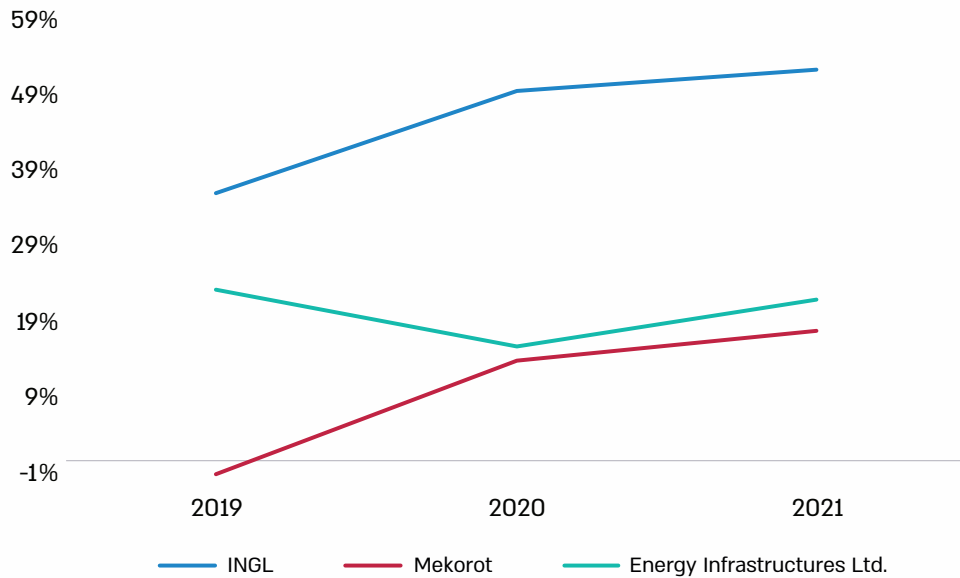
Energy and Infrastructure and the Natural Gas Authority consult with the Noga Company regarding the establishment of the onshore storage reservoir.

💡 It is recommended that the INGL and the Natural Gas Authority remove the barriers and promote the offshore project to complete the laying of the Ashdod-Ashkelon pipeline as soon as possible. A delay in laying the Ashdod-Ashkelon offshore pipeline also delays the potential increase in gas exports for several years. It is expected to harm the Company and the state treasury due to the non-receipt of taxes (corporate tax, levy on oil profits).

💡 The Government Companies Authority, the Minister of Energy and Infrastructure, and the Minister of Finance should appoint directors to INGL before the end of the director's term of office. It is further recommended that the Government Companies Authority carry out professional strategic work, in cooperation with the Ministry of Justice – Consulting and Legislation Department (Public-Administrative Law), so that the ministers in charge of government companies will elect more directors than the number stipulated in the standard for the board of directors and that some of the directors selected over the standard will serve as a reserve for the board of directors. If a director's term expires or a director resigns, it will be possible to appoint one of the replacements as a director in the Company using a shortened procedure. It is further recommended that alternatives be considered to prevent situations in which the positions of chairman of the board of directors and directors whose term of office has expired are not manned and regulated accordingly. Moreover, through the Companies Authority, the Minister of Energy and Infrastructure and the Minister of Finance should ensure adequate representation of women on the Company's board of directors under the Government Companies Law and the Attorney General's instructions. The Minister of Energy and the Minister in charge of the Companies Authority, through the Government Companies Authority, should ensure that at all times, a chairman and external directors, in the number specified by law, serve on the board of directors.



The Operating Profit Rate in INGL and Other Government Infrastructure Companies, 2019–2021 (in percentages)



According to data from Energy Infrastructures Ltd., Mekorot, and INGL, processed by the Office of the State Comptroller.



Summary

INGL is a natural monopoly in Israel's gas transmission sector. The Company built the natural gas transmission pipeline (about 800 km), and it transfers the gas through it to key customers throughout the country. The Company's net profit rate (16%) for years is high compared to infrastructure companies in Israel (Energy Infrastructures Ltd. – 15%; Mekorot – 4% average for foreign companies – 6%), and it is financially sound even though it is more leveraged than companies in the industry.

The audit found that the 15-year extension of INGL's license until 2049 (the recommendation of the Capital Strengthening Outline) was not carried out, negatively affecting INGL and the state. Among other things, this caused (in 2018–2022) the postponement of the payment of taxes to the state treasury due to the reduction of INGL's corporate tax payments by about NIS 200 million, as well as causing, among other things, a decrease in the Company's reported profits by about NIS 863 million, as a result of the recording of accelerated depreciation expenses. It is recommended that the Natural Gas Authority in the Ministry of Energy and Infrastructure, the Ministry of Finance, and the Government Companies Authority extend the Company's license, annually review the Company's tariffs and their effect on the cost of living, and regulate the dividend transfer as a return on the state's investment. It is further recommended that the Ministry of Energy and Infrastructure decide on operational and strategic natural gas storage for routine and emergencies.

According to the government, ministries' plans, and government-adopted resolutions, the use of fossil fuels and natural gas should decrease due to the transition to renewable energies in the coming decades; still, the use of natural gas in the coming decades is strategic for the State of Israel. Therefore, it is recommended that the Ministry of Energy and Infrastructure regulate the Company's future as part of the license extension and formulate a master plan for the energy sector.

