

Split (Separate) Marketing

Before assessing the applicability of separate marketing, it is necessary to define the terms “separate marketing” and “joint marketing”.

Joint marketing typically describes the practice of the joint venture entering into a sales contract with a buyer(s) on all relevant terms and conditions, including price, quantity, rate, specification and liability.

Separate or split marketing refers to the situation where, pursuant to the existing joint venture agreement, the joint venture parties agree on various parameters for the development of the field, including an optimal depletion plan (i.e. quantities and rates). This plan works to optimize well locations, take points, geologic uncertainty, facilities scaling efficiency, reliability requirements, market offtake reliability, and various economic factors. . Within these constraints, each joint venture party would be free to separately sell its share of gas to a buyer(s) on the basis of independently negotiated terms and conditions.. Another unlikely scenario might be envisaged, where each joint venture party separately sells its share of gas to a buyer(s) on the basis of independently negotiated terms and conditions, including price, quantity, rate, specification and liability and then returns to the others with its own depletion plan and other terms as agreed with its buyer(s). The joint venture parties then agree on the appropriate development to support the sales contracts in place. For split marketing to occur from a jointly developed gas field, all parties in the joint development must be commercially aligned in both the initial investment decision and in the ongoing operating and expansion costs. That means that all parties must know that they can sell all of their proportionate production from the facility or at least the same relative percentage as the other joint venture parties. Otherwise some joint venture parties will not be able to fund the development or will fund the development but will be paying for infrastructure that they are not utilizing and thus *de facto* sponsoring the other joint venture parties.

Generally, in order to implement split marketing, the joint venture parties enter into balancing agreements¹. These agreements establish rules and procedures to encourage all parties of the joint venture to remain in balance on production. They further provide mechanisms to address temporary imbalances, often including cash balancing in the case of extended imbalances. It should be stressed that it is our understanding that balancing agreements do not envision inherent long term imbalances and are structured to address temporary or short term situations where there has been underlifting or overlifting by a particular party(ies) in a joint venture.

To the best of our knowledge, split marketing has only been implemented in gas markets where the gas market demand is materially larger than the size of the contemplated development. This results in all parties of the joint venture being able to contract to sell all of their cumulative production, meaning that all investment decisions are supported by like (or at least not materially different) cash flows for all joint venture parties. This allows timely development of the field and aligned management and expansions of the field. No party is asked to fund work that is less commercially justified to him than it is to the other joint venture parties.

¹ See Article 7.2.1 of the Tzemach Report (<http://energy.gov.il/Subjects/NG/Documents/NGReportSep12.pdf>).

To this regard, it should be noted that the economic analysis of “separate marketing” versus “joint marketing” have been already assessed in several jurisdictions (i.e. Australia, New Zealand).

The Australian Competition and Consumer Commission (“ACCC”) has found that separate marketing in the various relevant Australian markets is not feasible. While it is clear that separate marketing of gas occurs in the USA, the UK and Canada, the gas production markets in those countries are robust and sophisticated. The ACCC has identified a list of market features that are present in overseas gas markets where separate marketing is the norm²:

- a large number of customers creating a diverse gas demand profile,
- a number of competitive suppliers,
- a range of transportation options creating a pipeline grid,
- storage close to demand centers,
- brokers/aggregators providing supply and/or demand aggregation services as well as bundled supply packages,
- gas related financial markets, and
- significant short term and spot markets.

None of these market features currently exist in Israel, nor are they likely to in the foreseeable future and therefore separate marketing seems also infeasible in the current circumstances.

On the other hand, when faced with the same issue in New Zealand, the Commerce Commission recognized that in certain circumstances, joint marketing can provide benefits to the public (such as the fast development of Pohokura) and decided to grant an authorization to OMV, Shell and Todd to jointly market and sell gas produced from Pohokura natural gas field³.

The available domestic gas market in Israel is much smaller than the contemplated size of the development projects. When coupled with the imposition of restrictions on exports, split marketing to the Israeli market would mean that some parties of the joint venture will be successful in marketing their gas while others will wait years or decades before being able to place their gas. This would create irreconcilable business cases within the joint venture that would make development decisions difficult or even impossible to manage and the joint venture parties would be reluctant to design a balancing arrangement on the basis of their ability to make-up deficits from it, nor would they be happy to risk huge sunk investments on it.

For all the reasons developed above, in our view, the most efficient scenario in Israel is joint marketing.

It should be noted that the current situation in Israel is the **artificial** result of the government decision to restrict exports and make a portion of the project captive to the domestic market. If these restrictions were lifted then the total market available to the joint venture parties would exceed the size of the development and split marketing could be responsibly implemented. Again - this would still require balancing agreements to be implemented but they could follow conventions inherent in these types of agreements.

² ACCC (1998), Submission to the Gas Reform Implementation Group on Upstream Issues.

³ Decision 505 dated 1 September 2003 that was later revoked because of material change of circumstances.

If split marketing were to be implemented for domestic Israeli sales as the market is currently managed, the magnitude of imbalances between the joint venture parties would instantly reach levels never seen or contemplated in any balancing agreements we are aware of. In order to restore the necessary commercial balance to allow the timely development of fields, their periodic expansion and their ongoing operation, full monetary balancing between all parties of the joint venture would be required on a regular basis.

While this could indeed be done, it would be very complex solution that would likely delay investment decisions and, ultimately, have all parties in the joint venture sharing in the value of each contract executed by each party. In order to mitigate some of the complexity and create conditions under which split marketing typically occurs, it would be necessary to adopt variations of all or some of the following:

- (1) the lifting of the artificial restrictions on exports;
- (2) an undertaking by the Israeli government to purchase all the production at market prices;
- (3) payment by the Israeli government for the unutilized production capacity; or
- (4) materially reducing the size of the Leviathan development until such time as the growth in the domestic demand justifies an expansion.