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August 5, 2010

To: The Sheshinski Committee for Review of Petroleum Fiscal Terms

Dear Committee Members,

This letter is in response to the Committee's call for comments on Israel's petroleum fiscal terms.

Pelagic Exploration Company (Pelagic), a Houston based oil company, which I helped found in 2007, currently holds exploration Licenses 370-375 in deepwater offshore Israel. To provide a bit of history, before founding Pelagic, I served as President and COO of Enserch Exploration (Enserch), a \$2 billion NYSE oil and gas company, and later as COO of Reading & Bates Development Corporation (DEVCO), a subsidiary of a NYSE multibillion dollar offshore drilling company. Both companies were active, worldwide, in the exploration, production and marketing of hydrocarbons.

Enserch, whose interests were later pursued by DEVCO, was the first western public company to explore for hydrocarbons offshore Israel in the mid to late 90's. Together with our partners, our pioneering efforts resulted in the first commercial discovery in the MariB well offshore of Ashkelon. So I am very familiar with both the Israel petroleum fiscal environment as well as the 20 year history of most oil and gas fiscal regimes in the world including the United States Gulf of Mexico. In addition as the Director of the Energy Management Program at the University of Houston-Downtown, I taught courses relating to the History of the Petroleum Business, Energy Finance, and Economics which adds to my perspective of the energy business today. I will attempt to draw on those experiences in this letter and relate my experience to the current oil and gas business environment in Israel.

My company, Pelagic, received its exploration Permit and current licenses prior to the major gas discovery at Tamar. At that time, I had the sense that Israel was promoting the industry and taking the necessary steps to bring some legitimate competition into the offshore exploration arena, which at that time was dominated by a consortium led by Noble Energy. It should be noted that Noble was originally introduced to the Israeli offshore in 1998 through the technical presentations of DEVCO's exploration manager Jim Peck (a co-founder of Pelagic). In 2006, Mr. Peck presented his geologic story on the Tamar area to Noble, and his presentation became part of the basis of their decision to farm into the Tamar Prospect.

When it was founded, Pelagic had access to a broad regional grid of 2D seismic, with a replacement cost in excess of \$20 million USD which led us to believe that there was indeed deep potential offshore Israel so we applied for two exploration permits, one of which was granted. In 2008, to compliment our data set, we invested over \$3 million to acquire a 2D seismic program to help delineate our ideas, and recently we executed a \$3mm contract to shoot a high density 2D grid in September 2010 which will enable Pelagic to finalize its first drilling locations on our licenses.

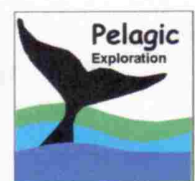
We made these investments with the understanding that we had entered into a contract with the State of Israel through the award of Petroleum Licenses under specific fiscal terms (the Petroleum Law) from the Ministry of National Infrastructure. Although we understand that petroleum fiscal terms can change over time, we felt that Israel was a responsible fiscal regime with a history of honoring the Rule of Law and therefore we were not concerned about changes in the Law being made on a retroactive basis to adversely affect our current Licenses. In fact, as we discussed this concept we were given assurances that Israel would honor its commitments and that there has been no precedent for retroactive change to established law.

We certainly recognize that rates of corporate taxation, import and export restraints, and other monetary policies are subject to modification via overall economic policy changes from time to time, and currently our sense is that Israel has been making policy decisions which encourage foreign investment. The end result being that the economy expands through job creation and Israel benefits from fostering growth through a lower tax environment. But, now we read of the potential for “retroactive” application of new taxes to a specific industry in Israel and I am reminded of the ill conceived ‘Windfall Profits Tax’ implemented in the United States in the 1990s which ultimately brought higher energy costs and localized energy shortages before it was repealed.

The Tamar discovery was definitely a major hydrocarbon find. But since the discovery, very few policy discussions have focused on the overwhelming excess natural gas supply versus the domestic demand and the need for subsequent infrastructure development to help monetize that asset and, hopefully, future discoveries. Instead the focus has centered on what Israel might do to reduce the return to the risk takers, when in fact the exploration companies are still many years away from making any profit from deepwater exploration. Certainly the Tamar well has captured the fantasy of the populous: the media in Israel has broadly described the Leviathan prospect as a “discovery” before it has even been drilled. Noble Energy has stated that the “prospect” has a 50% chance of “geological” success, a very bold prediction. But history has shown us that in many cases geological success (finding hydrocarbons in the structure) does not automatically translate into economic success.

The key to fostering the success of the oil and gas exploration and production sector in Israel lies in providing a friendly and reliable business climate. Israel should continue to promote competition in this business sector by providing incentives which encourage the entrance of oil and gas companies with international experience in finding, producing and marketing petroleum products.

Based on my experience, the geopolitical concerns alone often preclude companies from expanding into Israel. If in addition to those issues, questions relating to the Rule of Law and specifically the retroactive application of adversarial contractual terms becomes a concern, new investments in Israel by foreign firms will most certainly slow to a trickle. In short foreign companies could no longer depend on Israel to honor and enforce its



sovereign contracts thereby making it virtually impossible to rely upon an economic model when evaluating an investment opportunity in Israel.

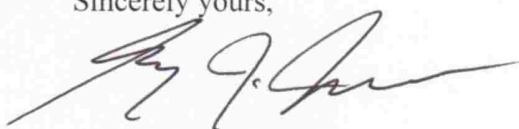
We do, however, think that, based upon the recent exploratory success, there is justification to make fiscal changes for Petroleum Permits and Licenses that will be awarded in the future. However, we believe Israel should follow the model of most western petroleum fiscal regimes, where all the risk is transferred to the investing oil companies. For example, the United States Gulf of Mexico fiscal terms are based on essentially three criteria: a lease bonus, royalty and taxes. Royalty rates in the Gulf of Mexico range from 12.5% to 16.67%, depending on water depth and there is a "lease bonus payment". The MMS (Minerals Management Service – a government agency) issues Tenders on open acreage, and 'qualified' companies bid on this acreage, with the highest bid typically winning the lease award. This system has raised significant funds for the US treasury.

Israel could set up a similar system, requiring companies to "bid" for acreage. If exploratory success continues, then these bids could become significant income for the State of Israel. Additionally, consideration could be given to reducing income tax benefits for the oil industry: for example, decreasing the depletion allowance. Increasing the "tax" burden is preferential to increasing the "royalty" burden, since tax takes into consideration the companies investments and expenses, which are significant in the offshore environment.

There will be continuous release of acreage offshore Israel from existing Permits that have mandatory relinquishments and from Licenses that expire. Also, according to the MNI website, some companies hold more licenses than are allowed by the Petroleum Law and the MNI is reviewing that situation - we assume that some of that acreage will also be relinquished. So there should be significant acreage for the application of new terms. There is a common misconception that all the "good acreage" is already held. However, the history of the oil business reveals that most discoveries occur on acreage that has been relinquished by other companies (the Tamar discovery occurred on acreage forfeited by British Gas). And, as the number of exploration companies involved in the sector increases, new discoveries will increase. We believe that new fiscal policies adopted by the State of Israel should support this goal.

Pelagic looks forward to continuing to explore for commercial hydrocarbons on its acreage offshore and believes that Israel will continue to make sound policy decisions based on the Rule of Law.

Sincerely yours,



Gary J. Junco  
President

