The Reform in the Israeli Electricity Sector

June 2018

The electricity sector in Israel is almost entirely controlled by the Israel Electric Corporation Ltd. (the "**IEC**" or the "**Company**"), which constitutes a vertical monopoly that operates throughout all of the sector's segments - generation, transmission, distribution, supply and system management. Although in recent years there has been a process of opening the generation and supply segments up to competition by granting licenses to Independent Private Producers, *de facto*, the Company still produces approximately 70% of the electricity and provides consumers with approximately 85% of the electricity in Israel.

After more than 20 years of negotiations for a large-scale structural change in the IEC, aimed at bringing about reform throughout the electricity sector, on May 17, 2018, the Minister of Energy signed the "*Document of Principles for Structural Changes in the Electricity Sector and the Israel Electric Corporation*" (the "**Reform**"). A Letter of Undertaking from the IEC was attached to the principles document, in which the IEC undertook to comply with the principles specified, subject to satisfaction of certain conditions.
On June 3, 2018, the Israeli Government passed a decision approving the details of the Reform, in accordance with the principles document (the "**Government Resolution**").

This recently agreed Reform heralds great opportunities for new players and investors in the energy market in Israel and is expected to have a significant impact on the electricity sector and the economy in general.

The principal objective of the Reform is to increase competition in the electricity sector, with this objective being achieved through the following actions:

- reducing the Company's share of the generation segment through sale of power stations;
- separating the system management activity and transferring it to a separate government-owned company;
- opening the supply segment to competition;
- focusing and increasing the Company's activity in the transmission and distribution segments;
- improving the financial strength of the Company and adopting an efficiency model in the Company, primarily by reducing the number of employees; and
- reducing the use of coal-fired power stations by the Company.

It is important to note that the implementation of the Reform is still conditional upon legislation, *inter alia*, through the amendment of the Electricity Sector Law 5756-1996 (the "**Electricity Law**"), promulgation of secondary legislation and updated regulations of the Electricity Authority (the "**Electricity Authority**") and entry into force of the collective agreement with the Company's employees. We note that the Memorandum for Amendment of the Electricity Law in accordance with the Reform, has already been published for public hearing.
The steps that will be implemented in the framework of the Reform over the next eight years are as follows:

1. *The Generation Segment*

The Company will reduce its activity in the generation segment through the sale of existing power station sites, as detailed below. On the other hand, the Company will be permitted to construct two generation units, subject to certain conditions.

(a) Sale of existing power station sites

Over a period of five years, the Company is required to sell about half of its natural gas fired power stations, with a total capacity of 4,500 megawatts, including infrastructure and connected land, by way of tender, as follows:

Name of site	Last date for delivery of possession*
Alon Tavor 600MW	18 months from the Government Resolution Date**
Ramat Hovav 1,137MW	30 months from the Government Resolution Date
Reading 428MW	36 months from the Government Resolution Date
Hagit (the part of the site that contains an E-type combined cycle area), approx. 697MW	48 months from the Government Resolution Date
Eshkol 1,693MW	60 months from the Government Resolution Date

* These dates will remain in effect as long as the legislation required in connection with the Reform has been passed by November 30, 2018.

** Government Resolution Date – 3.6.2018

It was further determined that the principle elements of the new regulations that will enable the sale of the said production sites in an efficient and competitive manner will be published within 3 months from the Government Resolution Date.

Once the Reform has been implemented, IEC's market share of installed capacity in the generation segment will decline from about 80% in 2017 to about 45% in 2026 and approximately 33% several years later.

The consideration: pursuant to the Electricity Authority's decision[1], the Company's consideration for the sale of the sites included in the Reform, will be at fair value, and in any event not less than the value of the sale plus the value of the land, as determined by an expert. For this matter, the value is the "tariff value of the site", plus any additional cost recognized by the Authority, deriving directly from the sale process, including any expense due to removing the Company's infrastructures. The consideration for the sale of the site will be paid to the Company in cash, at the time of delivery of possession of the site.

Gas purchase agreement: the Electricity Authority further decided[2] that the IEC's existing gas purchase agreement with the Tamar leaseholders would not be assigned to the new power station owners and these would be free to purchase gas independently. The Electricity Authority will recognize the Company's gas costs deriving from the minimum gas purchase obligation (take or pay) under the Company's agreement with the owners of Tamar, as long as the Company acts in accordance with the Authority's instructions.

(b) Establishment of new generation units by the IEC

The Reform allows for the IEC to be granted generation licenses for two new natural gas combined cycle generation CCGT units, with a total installed capacity of approximately 1,200 megawatts, in the Hadera site (where the existing coal-fired units are situated). The first CCGT is to be completed by no later than June 2022, whereas the construction of the second CCGT will take place after the sale of Alon Tavor and the publication of a tender for the sale of the Ramat Hovav site. The licenses for the new units should be granted to a wholly-owned subsidiary of the IEC.

The Minister of Energy is required to shortly submit to the government a draft decision regarding procedures for closing units 1-4 of the Hadera site by June 2022.

2. *System Management*

The function of the System Manager is defined in the Electricity Law, *inter alia*, as the entity responsible for the optimization of the electricity sector and the dispatch of power stations, the operation of electricity trading mechanisms, the statutory and engineering planning of the transmission network and long-term planning and forecasts of demand in the electricity market. Within the framework of the Reform, the System Manager will no longer be part of the Company and within 18 months from the date of the Government Resolution, will be transferred to a separate government-owned company - the System Management Company Ltd. This procedure is intended to enable competition in the generation field, while granting independence to the entity that manages the competition between the Company and Independent Private Producers ("**IPPs**").

The Reform also expands the duties of the System Manager so as to include, subject to publication of regulations, the purchase, storage and allocation of the market's fuels (such as liquefied natural gas and diesel).

[1] Resolution 1253 of the Authority dated May 18, 2018.

[2] The Electricity Authority's decision from meeting No. 542 of May 15, 2018, Decision No. 2 (1254).

3. *Transmission Inspection*

The IEC will establish a new "Transmission Inspection Administration" that will operate the transmission system in accordance with the instructions of the System Management Company. IEC has agreed that the System Management Company will be the one performing the connection surveys to the transmission system for IPPs, including determination of schedules.

4. *The Transmission and Distribution Segments*

The IEC will continue to transmit and distribute electricity as a natural monopoly. The Company will operate in the transmission and distribution segments through separate profit centers. In order to maintain the stability and quality of the electricity supply, the Company will develop the transmission network according to the development plan to be approved in accordance with the Electricity Law, by means of the resources that will be invested in the development and expansion of the network and subject to regulatory supervision. Furthermore, the Company's license for the distribution segment will set forth an obligation to enter into agreements with IPPs who use renewable energies and who connect directly to the distribution network.

5. *The Supply Segment*

In order to maintain stability in the supply sector (sale of electricity to the consumer), it was decided, as part of the Reform, to gradually open the supply segment to competition: the supply segment for high-voltage, extra-high-voltage and ultra-high voltage consumers (mainly large business customers) will be fully opened up to competition, while the IEC will be prohibited from competing (it will charge the tariff set by the Electricity Authority) and will remain a default supplier.

Regarding the supply segment for low-voltage consumers (including household consumers) it was determined that this segment will be gradually opened up to competition, so that during the eight years of the Reform period, the Company's market share will not fall below 60%. If the percentage of customers will drop below 60%, the Company will be allowed to compete in the household consumer segment subject to regulation to be determined.
The Company will be considered as the default supplier in the supply segment and will operate through a separate profit center.

6. *The IEC labour and organizational change*

In the framework of the structural change, the Company's workforce will undergo a streamlining process over an eight-year period, in which the number of the Company's tenured employees will be reduced by 25%. Some of the employees will move to the System Management Company or to the new owners of the IEC stations being sold, so that the total number of employees in the IEC will be about 6,400, compared to 9,000 today.

Under the workers' collective agreement, agreed on May 17, 2018, the heads of the Ministries of Finance and Energy, the Histadrut (Israel's national trade union) and the IEC reached agreements regarding: payments to tenured employees and to employees who will retire in the framework of the Reform; transition of employees to the System Management Company and other adjustments to the IEC's labour arrangements. The cost of this agreement is estimated at approximately NIS 6.4 billion.

7. *Financial Strength of the IEC*

(a) Financial objectives
During the eight years of the Reform, a team composed of government entities will be established in order to monitor the IEC's compliance with the financial strength objectives.

(b) Costs of the Reform
The expected costs in connection with the Reform are estimated at approximately NIS 7 billion, which will be spread over a period of ten years from the date of the approval of the Reform (the vast majority of the costs stem from the collective agreement as above). We note that these costs will be fully recognized for the Company, subject to cost control.

8. ***Conclusion***

Twenty two years after the legislation of the Electricity Law which set the groundwork and framework for the structural reform of the IEC, the recently agreed Reform is poised to carry out the structural reform and subsequently bring about significant changes in the Israeli electricity market. This recently agreed Reform heralds great opportunities for new players and investors in the energy market in Israel and is expected to have a significant impact on the electricity sector and the economy in general.
In addition, the Reform places an emphasis on environmental considerations by closing down coal-fired power stations and at the same time defining multi-year goals for promoting and increasing the use of renewable energy.
Although there are still regulatory and legislative steps that need to be completed before the Reform can be fully implemented, we are optimistic that these will be finalized in the very near future.

For any question regarding the above, and for further information on the subject, please contact:

Renelle Joffe, Partner	**Jonathan Finklestone, Partner**
Telephone: 03-6103928	Telephone:03-6103147
Email: renj@meitar.com	Email: jonathanf@meitar.com

It is hereby clarified that the above is general information, it does not relate to specific circumstances and facts, and it should not be considered as a legal opinion and/or legal advice for a concrete matter.