Report of the State Comptroller of Israel | November 2022

Energy Infrastructures Ltd.

Energy Infrastructures Ltd. – Financial Audit

Energy Infrastructures Ltd. – Financial Audit

Background

Fuel products are essential for the regular operation of the entire economy, and they currently play a central role in the development of the economy and its financial growth. Energy Infrastructures Ltd. (EI or the Company)[1] is a government company wholly owned by the state providing fuel for industry needs, including storage, flow, and supply of fuel products. EI subsidiary is Oil Products Pipeline Ltd. (the OPP Company), founded in 1959 and received the rights and assets of the Iraqi Oil Company. The Iraqi Oil Company received a 70-year concession from the British mandate, and the State of Israel recognized this concession. The concession expired at the beginning of 2001 and from then until June 2022, the state and the Company did not sign an operating agreement defining the assets that will remain in the Company, the assets that will be returned to the state, the taxation arrangements, the royalty payment arrangements (User Fees), the land ownership arrangements and other issues essential for the continuation of the Company's activities.

1 This name was adopted in 2021. The Company's previous name – Energy and Oil Infrastructures (EOI).

Key Figures

800 km	**NIS 1.37 billion**	**NIS 0**	**15%**
the length of the pipe for the flow of crude fuel and fuel distillates	the distributable surplus balance and funds of the Company's as of December 31, 2020	the dividends the Company transferred to the state in 2017–2021	the net profit rate on average in 2018–2020 compared to a net profit of 2% on average in those years in international companies in the industry in which the Company operates

NIS 350 million	**NIS 316 million**	**NIS 216–659 million**	**20 years**
raised through the issuance of bonds from the institutional bodies to finance the functional continuity plan in 2020	EI's annual turnover in 2020	estimate of the harm to the economy from the failure to sign an operating agreement	since the Company's concession expired, however, the Company and the state have yet to sign an operating agreement

Audit Actions

From August 2021 to January 2022, the State Comptroller's Office examined the Company's financial situation. The audit focused on the Company's financial statements for 2018–2020; the operating segments; the financial and economic ratios; material items from the balance sheet and the profit and loss statement; the auditing accountant work; and corporate governance issues. The audit was carried out at EI, the Ministry of Energy, and the Government Companies Authority. Supplementary examinations were carried out at the Haifa Municipality, the Shipping and Ports Authority at the Ministry of Transportation and Road Safety, the Israel Lands Authority (ILA), the Ministry of Environmental Protection, the Accountant General's Division at the Ministry of Finance and the Planning Administration at the Ministry of the Interior.

Key Findings

- **Net Profit and Return on Assets According to Operating Segments** – it was raised that the gross profit in the storage and distribution of distillates segment increased in 2020 by 35% compared to the three years preceding it. In contrast, the gross profit in the piping, port services, and crude oil storage segments decreased in 2020 by 62% compared to the three years preceding it. Moreover, the rate of return on assets in the crude oil storage segment was on a downward trend – from 18% in 2017 to 8% in 2021. And the rate of return on assets in the port segment (5% on average) was lower than in the other segments (10% on average) in these years.

- **Operating Agreement with the State** – since the Company's concession ended in January 2001, over 20 years ago, the Company and the state have not signed an operating agreement. This affects the Company's future operations planning and the state's income from the Company. Had an operating agreement been signed according to the agreements from 2003, it would have significantly impacted several key items in the financial statements, such as the state user fees from the Company's active assets, the rental of income-generating assets, and the tax assessment. By the State Comptroller's Office estimate, the lack of an operating agreement resulted in an economic loss (losses to the state and the Company) of NIS 216–659 million.

- **Return of Assets to the State** – upon the end of the concession, the Company did not return to the state the assets that are not at the core of its activity, including half of a commercial building in Tirat Ha'Carmel, storage areas in the Atarot industrial area in Jerusalem and an area of 24 thousand sqm. in Shemen Beach in Haifa Bay. At the audit completion, the Company owned and operated these assets, and in 2020 they generated an annual income of NIS 1.6 million. It was raised that there are areas in the non-operating assets that were not rented and did not generate income, for example, the Company's land in Shemen Beach. Failure to transfer the state land assets not at the core of the Company's activity, as stipulated in the memorandum of understanding[2], caused a loss of income to the state and the Company due to the non-exhaustion of the revenue from those assets.

- **Dividend Distribution to the State** – according to the Company's audited financial statements, at the end of 2020, from an accounting point of view, over NIS 1 billion were eligible for distribution as a dividend (from the balance of the accumulated profits and the funds). The Company's equity ratio of the total balance sheet at the end of 2020 was 64%. However, it increased because the Company did not regularly distribute dividends

2 The company and the government signed a memorandum of understanding in 2003 but never signed a formal operating agreement.

to the state. For example, from profits of NIS 214 million accumulated in 2017–2020, the Company did not transfer any dividends to the state, even though the Government Companies Authority decided in January 2019 that it must distribute dividends (50% of the net profit). The undistributed dividends for 2017–2020 were NIS 107 million.

Net Profit Rate – the Company's average net profit rate in 2017–2020 (15%) was considerably higher than the profit rate of four leading companies in the same sector in the United States (2%) and is similar to the profit rate of the Israel Natural Gas Lines Company. The external capital rate of the Company (36% in 2020) is low and conservative compared to the other government companies sampled (average of 75%) and compared to the target set by the Government Companies Authority for 2021 (45%).

Administrative and General Expenses – the rate of administrative and general expenses from the Company's revenues in 2018–2020 (13%) was over the rate set by the Price Committee – Energy (about 9%). It should be noted that the Company's expenditure (NIS 45 million) is about NIS 17 million more than the expenditure calculated by the norm set by the Price Committee – Energy (NIS 28 million, which is 9% of the revenues of NIS 316 million).

The Company's Assets and the Assets it Operates

- **The Kiryat Haim Tank Farm ("The Terminal")** – in April 2022, the Kiryat Haim Tank Farm had 42 fuel tanks. 22 of them (about half), a third of the total storage capacity at the site, were unusable. Therefore, the use of the tank farm premises is only partial. The fuel storage infrastructure is old, and in 2017–2021, the Company invested about NIS 187 million in the maintenance of the tanks.

- **Land Owned by the Company in Haifa Bay – The Northern Lands** – for decades, an area of 1,147 thousand sqm. owned by the Company in Haifa Bay (the northern lands) has not been generating any value for the state and the Company; The financial statements have no information on the value of the lands and the state's share in these lands.

- **The Fuel Port in Haifa** – the fuel port in Haifa is outdated and does not meet modern construction standards. However, disagreements between the decision makers affix the situation of the continued operation of the old fuel port, and the plan to renovate it has not been implemented.

- **Registration of Land Rights** – by data provided by ILA and the Company to the State Comptroller's Office, the use of 8 out of 12 properties at the core of the Company's activity is not regulated by ILA.

The Company's Tariff – to calculate the Company's tariff, the Price Control Committee considers the Company's weighted return (WACC). The components that must be considered are the risk-free interest rate for determining equity; the risk-free interest rate for foreign capital; the market interest rate; and the sector adjustment coefficient rate (beta). The only updated variable during the annual price update was the risk-free interest rate for determining equity. It was found that the calculation resulted in setting the return at 4.59%. On the other hand, if the Committee had considered all of EI's components in calculating the weighted cost of capital, the return would have been at a rate of 3.93%. Given the equity in the balance sheet of NIS 1,371 million as of December 31, 2020, this would have affected the tariff and would have reduced the Company's revenues by about NIS 9 million, i.e., a price drop of about 2.5% of its revenues in 2019 (the last reported year without the effects of Covid-19 pandemic).

The Term of Office of the Auditor – as of the audit completion date, January 2022, the Ministers of Finance and Justice and the Government Companies Authority did not appoint the committee members for appointing accountants. As a result, the Company's auditor has been serving for about 18 years, 12 years over the period stipulated in the rules of the Government Companies Authority.

The Board of Directors of the Company and the Subsidiary (OPP):

- **Adequate Representation** – it was raised that in December 2021, six of the eight directors in office in EI were men.
- **OPP's Board of Directors** – it was raised that in 2017–2020 there was no legal quorum for the OPP board of directors, and at the audit completion – January 2022, there was only one director.

The Company's Rating – in February 2020, the Company was given an initial conditional rating by the "Midroog" credit rating company, the highest possible rating – Aaa. il. In March 2022, a follow-up report was published, and the rating horizon of bonds issued by the Company that year was determined to be stable.

Corporate Governance – the State Comptroller's Office commends the Company for compliance with the ISO 37001 standard for the anti-bribery system, developing and implementing a code of ethics, and operating an effective risk assessment system.

Key Recommendations

The Ministry of Finance, under the leadership of the Accountant General, the Government Companies Authority, the Ministry of Energy, ILA, and the Tax Authority, should complete the formulation of an agreed operating agreement with the Company. This is to regulate the payments of the land use fees, the income tax assessment, the transfer of the dividends and assets to the state, and to enable regulation of the Company's activities and its development in the long term with a renewed license. This need for agreement intensifies as the Company intends to raise additional funds from the public through the issuance of bonds.

- It is appropriate that the Government Companies Authority and the Ministry of Finance regulate the payments to the state for the use of active assets, including the settlement of past debts. ILA and the Company should arrange valid lease agreements regarding all of the Company's assets to ensure certainty of rights and obligations towards the state regarding the land and that the state receives lease fees and use fees for the land.

- The Company should implement the board of directors' resolution from June 2021 to distribute dividends to the state at the rate set by the Government Companies Authority (50% of the net profit). It is recommended that the Government Companies Authority verify the Company's compliance with the dividend distribution targets set by the Government Companies Authority in an ongoing manner as part of the control over the Company's compliance with all of its goals.

- The State Comptroller's Office recommends that the Company's board of directors and the Government Companies Authority examine the high rate of the Company's net profit over the years. It is further recommended that the Price Committee – Energy analyze the rates approved for the Company as a key player or monopoly in its core activity, affecting its revenues and profitability in its financial statements.

- It is recommended that the Minister of Energy, the Minister of Finance, and the Government Companies Authority ensure adequate representation of women on the Company's board of directors. It is also recommended that the Minister of Energy and the Minister of Finance appoint directors to the OPP company so that it can duly adopt decisions.

The Company's Areas of Operation (Segments) in 2020 (in NIS Thousands)

	Storage and Distribution of Distillates	Piping	Port Services	Storage crude oil	Total
Revenues	147,913	81,991	52,246	33,476	315,626
The segment's share in the total revenues	47%	26%	17%	11%	100%
Total expenditure	97,422	62,190	47,498	26,719	233,830
The expenses rate from the revenues	66%	76%	91%	80%	74%
Gross profit	50,490	19,801	4,748	6,757	81,796
The gross profit rate from the revenues	34%	24%	9%	20%	26%
The segment's assets	124,458	566,656	5,454	-	696,568
Mixed operating assets	222,104	117,269	198,145	169,567	707,085
Total assets attributed to the segment	346,562	683,925	203,599	169,567	1,403,653
The rate of profit from the segment's assets	15%	3%	2%	5%	6%
Assets not attributed to the segment					133,126
Total assets					1,536,779

Source: EI.

Summary

EI is a significant factor in the fuel industry in Israel in routine and in emergency and is a monopoly or a key player in most of its operating segments. The Company's facilities and pipelines are spread across the length and breadth of the country. The Company's net profit rate over the years is relatively high (10%–20%) and sound. However, its long-term financial situation is unclear since, in March 2022, the government decided to close down the petrochemical segment in the Haifa region. Such a decision has wide-ranging effects on the Company, including the relocation of infrastructure and the potential to affect its scope of activity. In addition, the Minister and the Ministry of Energy did not validate the Company's strategic plan.

The audit raised that the Company has been operating for more than 20 years without an operating agreement between it and the state regulating the relationship between them and the ownership of the assets that the Company maintains and operates. As a result, among other things, there was an economic loss (to the state and the Company) during this period estimated at hundreds of millions of NIS (from NIS 216 to 659 million). In addition, a dispute between the Company and the Tax Authority over tens of millions of NIS of the Company's tax liability regarding land assets that are supposed to be transferred to the state is being heard in court. It was also found that the Company has a surplus balance eligible for distribution as a dividend to the state of more than NIS 1 billion and that in 2017–2020 the Company did not distribute dividends to the state.

The Ministry of Finance, under the leadership of the Accountant General, the Ministry of Energy, the Government Companies Authority, the Tax Authority, and the ILA, with the assistance of the Attorney General, should formulate an agreed operating agreement with the Company. The Government Companies Authority should cooperate with the Company's board of directors to distribute dividends to the state.