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Energy

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Cyprus

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Overview

Cyprus is not currently producing any primary sources of energy. It is considered a heavily energy-receiving country, as over 90% of its energy comes from imports. Being an island, it has no electrical or natural gas interconnections with other countries and, therefore, has an isolated energy system.

The country's dominant source of energy in all sectors, including transportation and electricity generation, is imported petroleum products, which contribute over 93% to the country's gross final energy consumption. In relation to electricity generation itself, around 97% of it is produced from imported petroleum products. The European Commission has ranked Cyprus as one of the most vulnerable countries in the EU in terms of energy dependency and security of energy supply. The import of petroleum products accounts for approximately 30% of all the country's imports, which is a heavy burden on its balance of payments and reveals its vulnerability to potential macroeconomic imbalances.

Since petroleum products dominate the country's gross final energy consumption, other sources of energy contribute only marginally to the country's energy mix. In 2011, renewable energy sources ("**RES**") had a share of 6%, and solid fuels (which are only used in cement production) a share of 0.3% to the country's gross final energy consumption. RES, which are now more significant to the country's energy mix than they used to be five or ten years ago, are used as follows:

1. *Solar Energy*: Solar Energy is used by domestic and industrial solar thermal systems. It should be noted that Cyprus ranks first in the world in terms of the use of solar energy for domestic water heating (through solar thermal systems). Photovoltaic grids are also used, and they are either connected to the country's (currently) sole electricity company, or are stand-alone and used in other ways.
2. *Wind Energy*: There are currently five wind farms in operation (and three under construction) and they all generate electricity which they sell in its totality to the country's (currently) sole electricity company. Wind energy is also used through wind turbines for water pumping.
3. *Biomass*: The total capacity of biomass plants is insignificant, generated through manure/organic animal waste and, again, sold to the country's (currently) sole electricity company.

In relation to the electricity market of Cyprus, this is currently dominated by the state-owned Electricity Authority of Cyprus (the "**EAC**"), which generates and provides 100% of the electricity in Cyprus. Around 97% of electricity is produced from imported petroleum products, and only around 3% from the RES that are mentioned above. Natural gas will be a significant source for production of electricity in the next few years, as will be discussed further in this report.

The accession of Cyprus to the EU in 2004 has meant that the monopoly of the EAC in Cyprus should legally come to an end. In 2004, a part of the electricity market was liberalised for certain non-domestic consumers. In 2009 the electricity market was fully opened in relation to all non-domestic consumers, with a view to full liberalisation for all consumers by 2014. Despite the above liberalisation, no electricity company has broken into the market yet, and the EAC remains the sole supplier of electricity. It should be noted that current economic and financial developments in Cyprus may well mean that the government will have to privatise the EAC, or at least sell a significant part of it to an investor, in order to raise finance.

Even if Cyprus does not currently produce any primary sources of energy, this is likely to change soon, as it has discovered large natural gas reserves in its exclusive economic zone ("**EEZ**") in December 2011. This has been the most significant development in the energy history of Cyprus, and its overall energy policy has been changing rapidly over the last 12 to 18 months due to this. The natural gas discoveries have paved the way for the transition of Cyprus from an energy-receiving country to an energy producer, and potentially exporter.

Changes in the energy situation, the legal regime and government policy

<u>Oil & gas exploration – Legal background</u>

In order to be able to outline the developments in the oil and gas sector, one needs to understand the legal regime behind this.

As a full member of the EU since 2004, Cyprus has to fully comply with EU law. As an EU Member State, the Regulation on the Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters is directly applicable to Cyprus. Cyprus is also a member of the New York Convention; it has an excellent network of double tax treaties and bilateral investment treaties, and a very favourable tax system, with corporation tax rate being the lowest in the eurozone (12.5%).

The legislative regime of Cyprus in relation to hydrocarbons is based on the country's obligations derived under both EU and international law. Cyprus is a party to the United Nations Convention on the Law of the Sea ("**UNCLOS**") which, amongst others, outlines the rights and responsibilities of states in their use of the world's oceans, establishing guidelines for businesses and regulating the territorial waters, contiguous zones and exclusive economic zones of states. Cyprus has ratified UNCLOS in 1988, and it has passed a law defining and regulating its EEZ in 2004. Part of the EEZ of Cyprus is an exploration area of 51,000 square kilometres in the south of the island, which is divided into 13 offshore exploration blocks. The jurisdiction of Cyprus within its EEZ relates to: the exploration, utilisation and management of all natural resources; the waters, the seabed and the soil under the seabed; the production of energy; the utilisation of man-made islands, installations and structures; scientific research; and the protection of the environment.

Agreements on the delimitation of the EEZ of Cyprus exist between Cyprus and respectively Egypt, Lebanon and Israel in relation to the south and south-east of the country. The agreement with Egypt has been ratified and is in force; the agreement with Lebanon has yet to be ratified; and the agreement with Israel has been ratified and is in force (although disputed by Lebanon in relation to the involvement of Israel).

The hydrocarbon exploration and exploitation activities in Cyprus are subject to the Hydrocarbons Law (of 2007) and Regulations (of 2007 and 2009) which were enacted to transpose the EU Directive on the Conditions for Granting and Using Authorisations for the Exploration and Production of Hydrocarbons into national law. Relevant sections of the Hydrocarbons Law stipulate that the ownership of hydrocarbons wherever they are found in Cyprus, including the territorial waters, the continental shelf and the EEZ of the Republic of Cyprus, shall be deemed to be and always to have been vested in the Republic. The powers to determine, within the territory of the Republic and the relevant offshore zones, the areas to be made available for prospecting, exploring for and exploiting hydrocarbons, and to grant authorisations for the prospection and/or exploration and/or exploitation of hydrocarbons in a geographical area, after due process set out in the Hydrocarbons Law, rest with the Council of Ministers.

The Hydrocarbons Law and Regulations set out the criteria for the valuation of the licence applications and provide for three types of licence/authorisation. A prospecting licence is valid for a maximum of one year, and involves evaluation of potential by identifying geophysical techniques and evaluation of offshore potential by carrying out geophysical surveys such as 2D/3D seismic surveys. Prospecting licences do not allow drilling. An exploration licence is granted initially for up to three years, and can be renewed twice for a period of two years for each renewal, providing for a maximum of a seven-year licence. Upon each renewal, 25% of the initial licence area is relinquished. The licensee is permitted to carry out gravity and magnetic surveys, as well as 2D/3D seismic surveys and exploratory drilling. In case of a discovery, the holder has the right to be granted an exploitation licence for that discovery.

An exploitation licence is granted for an initial period of up to 25 years, with the ability for one renewal of up to ten years. Conditions and requirements contained in the authorisation for exploration or exploitation are stated explicitly in a production-sharing contract ("**PSC**") between the state and the licence holder. An applicant for an exploration licence must carry out an environmental impact assessment, and has a number of environmental obligations under international and local law upon being granted a licence.

What is notable in relation to the Hydrocarbons Law is its transfer and change of control provisions in relation to rights granted under, or deriving from, a licence. In accordance with section 27 of the Hydrocarbons Law, no holder of an authorisation (meaning any type of licence) may transfer an authorisation or assign the rights arising from an authorisation to another entity, except with the consent of the Council of Ministers. The Council of Ministers may grant such consent: (i) if the transfer or assignment does not endanger national security; (ii) if the entity to whom the authorisation is to be transferred, or the rights arising from an authorisation are to be assigned, has sufficient technical knowledge, experience and financial resources to secure the proper exercise of the activities of prospecting, exploring for and exploiting hydrocarbons; and (iii) if such entity undertakes to comply with such other conditions and requirements as the Council of Ministers may deem proper to impose. In accordance with section 28 of the Hydrocarbons Law, no entity may, after the grant of an authorisation thereto, come under the direct or indirect control of a third country, or a national of a third country, without the prior approval of the Council of Ministers.

<u>Oil & gas exploration – Developments</u>

Once Cyprus had defined its EEZ in 2004 and divided the south of the island into 13 offshore exploration blocks, it announced its first licensing round on 5th February 2007. The first licensing round related solely to Block 12, which is located next to the Israeli Tamar gas field. Houston-based Noble Energy was awarded a three-year exploration licence and a PSC was signed in October 2008. Noble Energy started drilling in September 2011 and announced, on 28th December 2011, that it had discovered a natural gas reservoir ranging from five to eight trillion cubic feet.

The Cyprus government approved the launch of a second licensing round consisting of the remaining 12 offshore blocks (covering an average area of approximately 4,000 square kilometres each). The public announcement was made on 11th February 2012 and expired after a three-month bidding period, on 11th May 2012. Fifteen bids were submitted from five companies and ten consortia, for 9 of the 12 blocks. The companies involved came from 15 different countries and revealed some big names in the energy world such as Total, KOGAS, Russian Gasprombank, Malaysian national company Petronas, Italy's ENI and Edison, Marathon Oil of the USA, Australia's Woodside Energy Holdings, Vitol and Premier Oil of the UK. Applicants (in accordance with the Hydrocarbons Regulations) had to disclose detailed information about, amongst other matters: (i) their corporate status and place of business; (ii) the way in which they intend to perform prospecting, exploration or exploitation; (iii) how their obligations will be guaranteed; (iv) their experience in prospecting, exploration or exploitation; (v) their financial structure, and that of their parent company; (vi) detailed financial information and three-year accounts; (vii) the designated area for exploration and a detailed work programme for the exploration area; (viii) the minimum obligations to be undertaken for work and expenditure during the exploration period; (ix) the effects of the exploration on the environment and steps to deal with such effects; and (x) proposals for training and employment of Cypriot nationals and any proposal relating to financing operations.

In accordance with the Hydrocarbons Law, the bids were evaluated by an advisory committee (the "**Advisory Committee**") which was established on 14th November 2011 and comprised the General Secretaries of the Ministries of: (i) Commerce, Industry and Tourism; (ii) Foreign Affairs; (iii) Finance; (iv) Agriculture; (v) the Attorney General; (vi) the Head of the Geological Survey Department; and (vii) the Head of the Department of Energy of the Ministry of Commerce, Industry and Tourism. When evaluating the bids, the Advisory Committee takes into consideration the following criteria: (i) the technical and financial capacity of the applicant; (ii) the means by which the applicant intends to carry out the activities specified in the licence; (iii) the financial terms that the applicant is offering in order to obtain the licence; (iv) whether the applicant demonstrates any lack of efficiency and responsibility under any previous licence or authorisation of any form in any country of the world; and (v) national security and the public interest.

Following its evaluation, the Advisory Committee submitted its recommendations to the Minister of Commerce, Industry and Tourism, who then sought the approval of the Council of Ministers in relation to the recommendations of the Advisory Committee. On 30th October 2012 the government announced that it had reached a decision to award Blocks 2, 3, 9 and 11, which are contiguous blocks (lying north and north-east) to Block 12. Blocks 2 and 3 were to be awarded to a consortium consisting of Italy's ENI (80%) and South Korea's KOGAS (20%). Block 9 was to be awarded to a consortium consisting of France's Total (operator), Novatec Overseas Exploration & Production (of Russia) and GPB Global Resources (again of Russia). Block 11 was to be awarded to Total. Despite the above announcement, negotiations in relation to Block 9 (which is estimated to be the richest block in natural gas) did not proceed as expected. The government announced on 24th January 2013 that three PSCs had been signed with the ENI and KOGAS consortium in relation to Blocks 2, 3 and 9. On 6th February 2013 the government further announced that it had signed two PSCs with Total in relation to Blocks 10 and 11. In relation to the signing of PSCs, it should be noted that the Cyprus government has published a model PSC to form the basis of negotiations with successful bidders for its offshore blocks.

In relation to Block 12, Noble Energy has on 11th February 2013 transferred/assigned 30% of its rights in the PSC to Israel's Delek Drilling and Anver Oil and Gas Exploration, which are both subsidiaries of Delek Energy Systems Ltd. The rights under the relevant PSC are now held by Noble Energy at 70%, and by the other two entities at 15% each. The Cyprus government demanded unlimited parent guarantees to ensure compliance with all obligations under the PSC before granting its consent for the transfer/assignment. Further in relation to Block 12, its appraisal work programme is proceeding, and the drilling of a second appraisal well started in June 2013. It is hoped that the appraisal work programme will finish in the third quarter of 2014.

As far as the not-yet-awarded blocks are concerned, the Council of Ministers has on 16th May 2013 decided to grant an extension for any awards up to 2nd December 2013.

<u>Natural gas and the energy/electricity market</u>

The energy policy of Cyprus is harmonised with the energy policy of the EU. The Cyprus Energy Regulatory Authority ("**CERA**") was established pursuant to the Law on Regulating the Electricity Market of 2003, which was enacted for the purpose of harmonisation of Cyprus law with the relevant EU directive concerning common law rules for the internal market in electricity. CERA was established aiming to open the electricity market (which will be, at least legally, fully opened by 2014), and is the body responsible to ensure that electricity prices determined by (the current monopoly of) the EAC reflect the actual costs of the services offered with a reasonable profit. In addition to the above, by virtue of the Law Regulating the Natural Gas Market of 2004 (which transposes another EU directive into Cyprus law) concerning common rules for the internal market in natural gas, CERA is responsible for regulating the natural gas market. The Transmission System Operator ("**TSO**") was again established pursuant to a decision of the government of the Republic of Cyprus for harmonisation of Cyprus law with another relevant EU directive concerning common rules for the internal electricity market. The main functions and responsibilities of the TSO are to secure the operation of the electricity transmission system, and to manage the electricity market on an objective, non-discriminatory basis in a competitive environment, while at the same time supporting and promoting electricity generation from renewable energy sources. The TSO ensures access to the transmission system of all producers and suppliers of electricity. Both CERA and the TSO have a significant role to play in the energy market of Cyprus, especially in relation to the electricity market, and their role will be even more significant if electricity companies do break into the Cyprus market in the next few years.

Even before the discovery of natural gas in the EEZ of Cyprus, the Council of Ministers decided to import natural gas for the production of (mainly) electricity. Any power station/unit of considerable capacity should be fuelled with natural gas. Despite the natural gas discoveries, if Cyprus is to use any natural gas any time soon, considering that its own natural gas will not be available at least until the third quarter of 2018, it needs to import such natural gas.

It is planned that the supply of natural gas to the Cyprus market will be a clear monopoly for a number of years. The Natural Gas Public Company (the "**NGPC**"), which is fully controlled by the state, was established to become the body responsible for the development of the internal gas market and network. The NGPC is responsible, amongst others, for the import, storage, distribution, transmission, supply and trading of natural gas, as well as the management of the distribution and supply system of natural gas in Cyprus. It will, once Cyprus is able to import natural gas, be the sole importer and distributor of natural gas in Cyprus, i.e. making its position a monopoly. It has to proceed with securing the necessary natural gas quantities, at the most favourable commercial terms, in order to cover the needs of Cyprus for electricity power generation (phase A) and supply industries, hotels and households (phases B and C) with natural gas. It has to develop an efficient gas network, which will initially (phase A) consist of three pipelines, which will themselves be connected to the gas import hub, and to the three existing downstream power stations (all owned and controlled by the EAC). The estimated cost for phase A is approximately €65m, and a €10m grant has been secured from the European Economic Programme for Recovery. Phases B and C, which will connect the receiving terminal to industries, hotels and households, are expected to cost over €500m.

As the NGPC needs to start importing natural gas into Cyprus before the natural gas from the EEZ of Cyprus is available, as part of an interim solution aimed at reducing the cost of electricity production for the period until natural gas from the EEZ of Cyprus is available, the NGPC has, on 27th September 2012, announced the commencement of the procedure for expressions of interest in the short-term supply of natural gas in Cyprus. The expression of interest concerned the potential to supply natural gas for a period of approximately five years, and the target date for the first delivery of natural gas in Cyprus is 1st January 2015. This expression of interest closed on 29th October 2012, and the NGPC received 17 applications from interested parties. Following a preliminary evaluation, 14 participants proceeded to the second stage and on 4th January 2013 the NGPC requested such applicants to submit complete proposals. On 4th February 2013 the NGPC announced the submission of binding proposals by eight interested parties. Following a technical and economic evaluation, three proposals proceeded to the next stage of the process and were required to submit their financial proposals, as well as requested clarifications by 1st March 2013. The final decision of the NGPC has yet to be announced.

Natural Gas – Liquefaction LNG facility/pipeline

The above section, which deals partly with the future of natural gas in Cyprus, does not deal with what will be done with the natural gas discovered in the EEZ of Cyprus. The reserves in the EEZ of Cyprus are estimated to be more than enough to cover the national demand in natural gas for over 20 years; hence natural gas will be exported.

The construction of a natural gas pipeline to the east or west of Cyprus has been proposed, but no such plans are currently in place, mainly due to geopolitical factors. The government's plan is, therefore, to construct an LNG terminal/facility.

On 26th June 2013, Cyprus signed a memorandum of understanding with Noble Energy, Delek Drilling and Anver Oil and Gas Exploration, who are the parties to the PSC for Block 12 since February 2013, regarding the construction of an LNG facility. The proposed facility, which is expected to cost around US$6bn, will be located at the southern coastal industrial site of Vasilikos and will constitute the biggest single investment in the history of Cyprus. It will initially process natural gas from Block 12 into LNG for export and delivery to international markets, but it will also have the ability to expand to accommodate additional natural gas discovered in other blocks in the EEZ of Cyprus, as well as natural gas from neighbouring countries, such as Israel and Lebanon. The final agreement on its construction needs to be signed by 31st December 2013. In accordance with a government announcement, LNG from the facility is hoped to be delivered to the international markets by the end of 2019.

Cyprus National Hydrocarbons Company

In accordance with section 16 of the Hydrocarbons Law, the management of the Republic of Cyprus' participation in the activities of prospecting, exploring for and exploiting hydrocarbons may be assumed by the state itself or by a legal person that the Council of Ministers may prescribe. Pursuant to the Hydrocarbons Law, therefore, the Council of Ministers proceeded with the establishment of the Cyprus National Hydrocarbons Company (the "**CNHC**") in late 2012. The CNHC is a private limited company and has a sole member, namely the Minister of Commerce, Industry and Tourism (on behalf of the state). The CNHC has a seven-member board with a chief executive officer, a first deputy executive officer, a second deputy executive officer, and four non-executive board members. The chief executive officer and the two deputy executive officers are appointed for a five-year term and cannot hold an office for more than two terms (consecutive or not). The first board of the CNHC was appointed in early 2013.

Pursuant to the memorandum of association of the CNHC, the company will have the power to perform the following activities:

1. the commercial exploitation of hydrocarbons that belong to the Republic of Cyprus;
2. the commercial participation in infrastructure which is required for the exploitation of hydrocarbons;
3. the participation in the exploration and/or exploitation, production, processing and transportation of hydrocarbons;
4. the participation in the management and operational control of the energy infrastructure for the exploitation of hydrocarbons on behalf of the Republic of Cyprus;
5. the management and/or supervision regarding the execution of any contracts (in relation to hydrocarbons) that have been in the past, or will be in the future, entered into by the Republic of Cyprus; and
6. the safeguarding of the satisfaction (in priority) of the local natural gas needs out of the reserves that have been or will be discovered in the territory and/or continental shelf and/or EEZ of the Republic of Cyprus.

The CNHC, being a brand new entity in a brand new area of law for Cyprus, is yet to fully start operating. Although its powers are clear from its memorandum of association, some of its functions interfere with those of the NGPC. With the establishment of the CNHC, it is not yet clear what will happen with the NGPC. Developments on this issue are moving very fast and any assumptions made at this point in time in relation to the future of the NGPC or the CNHC may well prove to be very wrong.

<u>Other energy-related developments</u>

National Energy Council

Since the discovery of hydrocarbons has dominated the energy sector in Cyprus over the last couple of years, and no relevant experience exists in Cyprus in relation to many energy matters (e.g. oil and gas exploration and the use of natural gas), the Council of Ministers has, on 5th February 2013, announced the establishment of the National Energy Council (the "**Council**"). Again, being a brand new committee, the Council's role is yet to be seen in practice, but it is meant to be merely advisory. Energy issues/matters are to be discussed with the relevant government departments and with the Parliament, and the Council will advise on the energy policy to be followed (and provide technical support if needed). The Council will be composed of: (i) the Minister of Commerce, Industry & Tourism as the chairman; (ii) three members of Parliament; (iii) the head or a representative of CERA; (iv) the chief executive officer or a representative of the CNHC; (v) the Head or a representative of the Energy Department (of the Ministry of Commerce, Industry & Tourism); (vi) the Head of the Division of Energy, Maritime Policy & Policy Planning of the Ministry of Foreign Affairs; and (vii) three experts/scholars with energy-related background.

Renewable energy sources

Despite the discovery of hydrocarbons dominating the energy sector in Cyprus, there have also been developments in relation to RES. As mentioned in the introduction to this report, RES only have a share of 6% to the country's gross final energy consumption. On 21st March 2013, Cyprus was found by the European Commission to be in breach of its RES obligations under EU law, and was referred to the ECJ for failing to fully transpose the European Renewable Energy Directive into Cyprus law. The abovementioned directive aims at ensuring a 20% share of renewable energy in final energy consumption, and to cut greenhouse gas emissions by 20% as compared to 1990 levels, by 2020 in the EU. Cyprus is bound to achieve a share of 13% of RES in its gross final energy consumption (after adjustment for aviation consumption) and a share of 10% of RES in the final energy consumption of transport by 2020. The directive had to be transposed by the EU Member States by 5th December 2010, and the European Commission proposed for Cyprus a daily penalty of around €11,000. In the event that the ECJ's decision goes against Cyprus, then the daily penalty (which will be decided by the ECJ) will be paid from the date of the judgment until the transposition of the relevant directive into Cyprus law is completed.

A notable RES development is the fact that the government has announced an estimated €5m grant scheme, to be implemented by the end of 2013, in relation to which 2,000 photovoltaic systems of 3kW each will be installed on the roofs of low-income households. The photovoltaic systems will be connected to the grid of the EAC via net metering, and the electricity consumption of the household will be offset by the electricity generated by its photovoltaic system into the grid, with the household being billed for the difference. This is estimated to save each participating household 80% on its electricity bill.

Another important RES development is a proposal considered by the government for the construction of hybrid hydroelectric pump storage systems for the storage of energy produced from wind farms. The production of energy from wind farms does not continuously match the demand, so the ability to store energy produced at times when the demand is low in order to be used at times when the demand is high, makes the use of RES more efficient, and increases the share of RES in the country's gross final energy consumption.

Major economic events and developments

The March 2013 decisions of the Eurogroup in relation to Cyprus almost certainly mean that the country will, in the next few years, go through its worse economic period since the Turkish invasion of 1974. Severe austerity measures have already been imposed, the country's banking sector is (forced) to shrink and unemployment rates keep rising. The discovery of natural gas in the country's EEZ is its only hope for economic recovery.

With the above in mind, the government is rapidly moving towards exploiting the country's natural gas reserves. In order to do so as quickly as possible, it has set out a plan to:

1. sign the project agreement on the LNG terminal with Noble Energy, Delek Drilling and Anver Oil and Gas Exploration in the fourth quarter of 2013;
2. have the appraisal work programme of Noble Energy in relation to Block 12 completed in the third quarter of 2014;
3. have indications as to potential hydrocarbon resources from other blocks in 2014;
4. sign heads of agreements concerning long term contracts for the sale of LNG in the third to fourth quarter of 2014;
5. have the first quantities of natural gas from Block 12 in Cyprus by the third quarter of 2018; and
6. have first exports of LNG from Block 12 by the end of 2019.

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