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Cyprus

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Overview

Cyprus is not currently producing any primary sources of energy (other than renewables). 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 90% to the country's gross final energy consumption. In relation to electricity generation itself, approximately 91.5% 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. According to the Energy Service of the Ministry of Energy, Commerce Industry and Tourism, in 2013, renewable energy sources ("**RES**") had a share of just over 8% 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 10 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 six wind farms in operation with 153.9 MW installed capacity 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 is the sole generator and supplier of electricity. Around 91.5% of electricity is produced from imported petroleum products, and only around 8.5% from the RES that are mentioned above (according to statistical data provided for the year 2015 by the Cyprus Transmission System Operator). Natural gas will be a significant source for the 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. Since January 2014, the electricity market has been fully liberalised to allow all consumers (both domestic and non-domestic) to choose their electricity supplier. Despite the above liberalisation, no electricity company has broken into the market yet and the EAC remains the sole generator and supplier of electricity, thereby enjoying a *de facto* monopoly. It should be noted that the current economic and financial developments in Cyprus, and its current commitments to its lenders, mean that the government will proceed with the denationalisation of certain profit-making state-owned organisations. Legislation has been passed in March 2014 to allow for this, and the Council of Ministers approved a government plan for the period from 2014 to 2016, dealing, *inter alia*, with the denationalisation of the EAC. Even though the denationalisation of the EAC is likely to have a significant impact on the unbundling of the Cyprus electricity market, this is not expected to occur before the end of 2017. The Cyprus Parliament has recently approved a draft bill by which, in relation to EAC, the entry into force of the denationalisation legislation will be postponed until 31st December 2017.

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 few years 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

Oil & gas exploration – Legal background

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 possibility for one renewal of up to 10 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.

Oil & gas exploration – Developments

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 Leviathan 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, in 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 10 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 in 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, on 11th February 2013, Noble Energy 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 and 35% of its rights in the PSC to BG (now owned by Anglo-Dutch Royal Dutch Shell) in 2016. The rights under the relevant PSC are now held by Noble Energy at 35%, by BG at 35% and by Delek Drilling and Anver Oil at 15% each. The drilling of a second appraisal well in Block 12 was completed in October 2013 in order to further evaluate the findings of the 2011 natural gas discovery. The appraisal work confirmed a mean gross natural gas resource of 4.5 trillion cubic feet. In June 2015, the Ministry of Energy, Commerce, Industry and Tourism announced that Noble Energy, Delek Drilling and Avner Oil, have declared Block 12 to be commercially viable. The commerciality declaration is a significant milestone to the transition of Cyprus from the hydrocarbons exploration phase to that of exploitation. The consortium has also submitted to the Cyprus government a development and production plan in relation to Block 12.

In relation to Block 11, Total has assessed geological and geophysical data but did not identify any drillable prospects. The government has on 18th March 2015 signed an agreement with Total in relation to further exploration works in order for Total to assess further the exploitability of Block 11. A request to extend its exploration licence was also submitted to the government by the ENI and KOGAS consortium in relation to Blocks 2, 3 and 9. The consortium's exploration licence has recently been renewed for two more years, i.e. expiring in 2018.

As far as the remaining blocks are concerned, no licences had been awarded during the second licensing round and the Cyprus government has recently announced the commencement of the third licencing round for offshore exploration of Blocks 6, 8 and 10. Even though Block 10 was previously awarded to Total, the company relinquished the block in 2015 without drilling any wells.

It should be noted that over the years the Cyprus government has signed several agreements in order to facilitate its cooperation with other countries in the field of oil and gas. To name a few recent, in September 2014, it has signed a memorandum of understanding with Jordan which, amongst others, provides for cooperation between the two countries in exchanging information and expertise with respect to energy matters, and also in assessing the possibility of exporting natural gas from Cyprus to Jordan. In February 2015, the Cyprus government further signed a memorandum of understanding with Egypt which, amongst others, authorises the Egyptian Natural Gas Holding Company ("**EGAS**") and CHC (as defined below) to examine technical solutions for natural gas transportation via a direct subsea pipeline from Block 12 to Egypt.

Natural gas and the energy/electricity market

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 has been, at least legally, fully opened since January 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, according to commentary, natural gas from the EEZ of Cyprus will not be available to the Cyprus market at least until 2020 and exports are not expected to commence before 2024. Cyprus therefore needs to import such natural gas if it is to use any natural gas any time soon.

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, in 2012, announced the commencement of the procedure for expressions of interest in the short-term supply of natural gas in Cyprus. This expression of interest, however, ended with no agreement being reached between the NGPC and any bidder and in January 2014, the NGPC announced the commencement of a new procedure for expression of interest for the supply of natural gas for a period of up to 10 years commencing 1st January 2016. The NGPC received four applications from, amongst others, Vitol of the Netherlands, and M&M of Greece, and on 1st July 2015, Vitol was announced as the successful bidder. The NGPC entered into negotiations with Vitol but has recently announced that it has been unable to reach an agreement and the tender process has, therefore, been concluded without any success.

Natural Gas – Liquefaction LNG facility

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 construction of a floating LNG facility ("**FLNG**") or a compressed natural gas ("**CNG**") plant has also been considered but the government's preferred option has been the construction of an onshore LNG facility.

On 26th June 2013, Cyprus signed a memorandum of understanding with Noble Energy, Delek Drilling and Anver Oil and Gas Exploration, who have been 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. Parties have yet to reach a final agreement on this, so the construction of an LNG facility is not yet definite, and in accordance with news releases, following the appraisal work in Block 12, the Noble, Delek and Anver consortium is considering the FLNG option, as the estimated reserve quantities in Block 12 may not be sufficient to enable the construction of an LNG facility. There is, however, nothing final or official to date on this.

Cyprus 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, which has later changed its name to Cyprus Hydrocarbons Company ("**CHC**"), in late 2012. The CHC is a private limited company and has a sole member, namely the Minister of Commerce, Industry and Tourism (on behalf of the state) and a seven-member board appointed in accordance with the provisions of the Hydrocarbons Law.

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

1. commercial exploitation of hydrocarbons that belong to the Republic of Cyprus;
2. commercial participation in infrastructure which is required for the exploitation of hydrocarbons;
3. participation in the exploration and/or exploitation, production, processing and transportation of hydrocarbons;
4. participation in the management and operational control of the energy infrastructure for the exploitation of hydrocarbons on behalf of the Republic of Cyprus;
5. 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. safeguarding of the satisfaction (in priority) of 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.

Other energy-related developments

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, in February 2013, announced the establishment of the National Energy Council (the "**Council**"). 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 is to 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 CHC; (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 backgrounds.

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 around 8% of the country's gross final energy consumption. The energy policy of Cyprus is, however, aligned with the energy policy of the EU. The three main goals set by Cyprus are: (1) the development of indigenous energy resources; (2) the enhancement of security of energy supply and competitiveness; and (3) the protection of the environment. In this respect, Cyprus has transposed the Renewable Energy Directive 2009/28/EC into Cyprus law by enacting the Law for the Promotion and Encouragement of the Use of Renewable Energy Sources of 2013. The above-mentioned 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 obliged 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 final energy consumption of transport by 2020.

In 2013, the government announced and implemented certain support schemes for the promotion of electricity generation using RES. One of these schemes involved the provision of state grants to vulnerable households for the installation of 2,000 photovoltaic systems of 3kW each and their connection to the grid of the EAC via net metering. The electricity consumption of the household is 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. A second scheme for the installation of a further 3,000 photovoltaic systems of 3kW each (but without a grant) was also announced and implemented in 2013. In 2014, the Ministry of Energy, Commerce, Industry and Tourism announced similar support schemes for the installation of photovoltaic systems of 3kW each by vulnerable households (with a state grant) and by non-vulnerable households and local government authorities (without a state grant). Another support scheme was announced in 2014 for auto-generating photovoltaic systems of 500kW each to be installed on commercial and industrial units.

Major economic events and developments

The March 2013 Eurogroup decisions have resulted in Cyprus going through its worst economic period since the Turkish invasion of 1974. Severe austerity measures have been imposed, the country's banking sector was forced to shrink, and unemployment rates have risen. The discovery of natural gas in the country's EEZ will play a major role in the island's economic recovery.

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