

Ready, Steady, Drill: The Legislation Governing the Race for Cyprus's Offshore Hydrocarbon Reserves

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On January 11, 2007, the Republic of Cyprus announced the:

“First Hydrocarbon Exploration Licensing Round Offshore Cyprus. This is scheduled to be officially opened on the *15th February 2007* and to be closed on the *16th July 2007* . . . The areas open for bidding will be chosen from 12 offshore blocks. The total area covers approximately 70,000 km² . . .”

The announcement follows the introduction of modern legislation to regulate the oil and gas sectors and to claim the Exclusive Economic Zone of the island in accordance with the United Nations Law of the Sea Convention.

In 2006 Cyprus undertook a seismic survey amounting to approximately 6,770 line-km of new data with the assistance of PGS Geophysical AS, and conducted a further evaluation of the exploration areas with the assistance of Beicip-Franlab. The results of these surveys have been processed into a report that is included in the data package that must be purchased by prospective licence applicants as part of the bid for the first licensing round. It has been reported numerous times that the survey results are “encouraging”.

The Exclusive Economic Zone

The Exclusive Economic Zone Law provides that no person, whether legal or natural, may proceed with the exploration and utilisation of any resources within the exclusive economic zone of the island unless a permit is granted for such purposes.

It is explicitly stated in the law that Cyprus has jurisdiction within its exclusive economic zone over:

- the exploration, utilisation and management of all natural resources, the waters, the sea bed and the soil underneath the sea bed;
- the production of energy;
- the utilisation of manmade islands, installations and structures;
- scientific research;
- the protection of the environment; and
- all rights and duties provided by the UN Convention.

Bilateral agreements

A bilateral agreement between Cyprus and Egypt on the Delimitation of the Exclusive Economic Zone was ratified in 2003. A similar agreement was concluded with Lebanon in January 2007 and awaits ratification.

In May 2006, Cyprus and Egypt signed another agreement on the joint development of hydrocarbon sources straddling the demarcation line which separates the exclusive economic zones of the two countries.

With respect to neighbouring countries, the relevant Cyprus legislation provides that where any areas of the Contiguous Zone or the Exclusive Economic Zone of Cyprus overlap with the respective zones of another state located opposite its shores, the boundaries of these zones are set, in the absence of an agreement, in such manner that they do not extend further from the median line or a line of equal distance from the base lines of each country.

Cyprus is discussing similar bilateral arrangements with other neighbouring countries.

Prospecting, exploration and production

The Hydrocarbons (Prospection, Exploration and Production) Law 4(I) of 2007 is the latest law adopted by Cyprus to transpose EC Directive 94/22 into national law.

Hydrocarbons are defined as “any kind of petroleum in solid, liquid or gas form . . . as well as any kind of minerals or substances that are extracted with them”.

The law sets out the framework criteria as to the assessment of licence applications for the prospecting, exploration and extraction of hydrocarbons in Cyprus's territory including its Exclusive Economic Zone. These criteria may include:

- the technical and financial capacity of the applicant;
- national security and public interest;

- the methods envisaged by the applicant to carry out the activities specified in the licence;
- the economic benefits that the applicant offers in order to acquire the licence; and
- the conduct of the applicant within the framework of any previous licence.

Section 13 provides that licences may be subject to such terms as may be necessary to safeguard:

- (1) the correct undertaking of the activities permitted by the licence;
- (2) the payment of a levy in a currency or as hydrocarbons;
- (3) national security, public health and public safety;
- (4) environmental protection;
- (5) the protection of resources, national treasures and the environment;
- (6) the safety of transport, installations and workers;
- (7) the management of hydrocarbons; and
- (8) the necessity to safeguard the income payable to the Government.

The law expressly provides that the criteria for the granting of licences and the terms applicable to them must be applied in a non-discriminatory manner. Additionally, an environmental impact assessment report must support any application.

Types of licence

By virtue of the Hydrocarbons (Prospection, Exploration and Production) Regulations 51 of 2007, the Government has published detailed rules on the types of licences available and procedural requirements that need to be satisfied by applicants.

Prospecting licences

These will be valid for up to one year. Their purpose is the evaluation of potential by the identification of geological structures. Although drilling is not permitted under this type of licence, they do enable their holders to conduct gravity and magnetic surveys as well as two- or three-dimensional seismic surveys.

Exploration licences

This type of licence will be valid for three years with the possibility of two renewals, each of two years. Holders of such licences have the

right to carry out gravity and magnetic surveys, two- and three-dimensional seismic surveys and exploratory drilling. On each renewal, 25 per cent of the initial licence area is relinquished while in the case of a discovery the licensee has the right to be granted an exploitation licence for such discovery.

Exploitation licences

Exploitation licences will be granted for an initial period of up to 25 years with the possibility of one renewal of up to 10 years.

Applications for prospecting licences

Applications for prospecting licences must contain the following general information:

- name, address and citizenship of applicant;
- place of incorporation of the applicant, details of its board of directors, share capital and beneficial ownership;
- details of the proposed financial arrangements if the application is accepted and the nature of the guarantee that the applicant will fulfil its obligations; and
- past experience of the applicant.

In addition to the information submitted with respect to prospecting licences, applications for exploration licences must also contain information as to the nature of the applicant's organisation, including general and financial information on parent and affiliated companies as well as annual reports, balance sheets and any other reports filed by both the applicant and its parent company with the relevant securities and stock exchange authorities during the previous three years.

Additionally, exploration licence applications must include the following information:

- (1) the areas (in order of priority) in respect of which the application is submitted;
- (2) detailed description of the proposed exploration programme;
- (3) minimum undertakings given by the applicant as to the work to be undertaken and the relevant budget for the duration of the licence;
- (4) a brief explanation of the proposed exploration activities, their possible impact on the environment and the measures proposed to minimise such impact;
- (5) proposals on the training and employment of Cypriot citizens;

- (6) proposals in connection with financial arrangements such as the consideration to be paid to the Government;
- (7) any agreement between any entities that relates to the proposed manner of finance of the activities;
- (8) any other information that the Government may request or the applicant may wish to submit.

Any application for the exploitation of hydrocarbon reserves within an area included in the initial exploration licence must be submitted together with a production programme in accordance with the terms of the relevant contract.

Any application for exploration within an area included in an exploration licence must be submitted together with a production programme in accordance with the terms of the relevant contract.

Pursuant to s.27 of the Law and s.12 of the Regulations any licence and the rights deriving from it may be transferred and assigned to another entity with the consent of the Government.

Procedural guidelines as to the first licensing round

The official invitation to interested parties and the evaluation criteria have been published in the Official Gazette of the Republic of Cyprus and the Official Journal of the European Union.

Interested parties were required to submit their applications to the Ministry of Commerce, Industry and Tourism, which will evaluate proposals in association with a special Governmental Consultation Committee.

All licences will be granted on the basis of a model production sharing contract whose specific terms and conditions will be negotiated with the selected parties. On agreement, the contract will be forwarded to the Council of Ministers for approval and for the issuance of the relevant licence.

Model production sharing contract for the first licensing round

It is anticipated that the main terms of the proposed model production sharing contract that will be concluded between each selected licensee and the Republic as to the exploration of the Exclusive Economic Zone and exploitation of the hydrocarbon reserves therein will include, inter alia, provisions as to the following:

- (1) minimum exploration work obligations (i.e. seismic surveys, number of exploration wells, etc.);
- (2) production sharing economic terms (on the basis of crude oil production tiers and crude oil price);
- (3) annual surface fees;
- (4) minimum budget for recruiting and training of EU and Cypriot personnel;
- (5) signature bonus; and
- (6) maximum percentage of cost recovery.

Ancillary merchant shipping legislation

The current policy of the Department of Merchant Shipping as to the registration of vessels under the Cyprus flag is set out in Circular 15/2005 which includes detailed provisions on the conditions for registration of the following.

Mobile offshore drilling units

Mobile offshore drilling units may be registered without any additional conditions if they do not exceed 25 years of age.

If they are over 25 years old, they may be registered provided that:

- (1) an entry inspection is successfully completed; and
- (2) where necessary under legislation, they are operated by a Cypriot or an EU ship management company having its place of business in Cyprus, which is staffed with personnel sufficient in number and qualifications and is ISM compliant and certified.

Furthermore, self-propelled mobile offshore drilling units are required to comply with (and be surveyed and certified in accordance with) the Code for the Construction and Equipment of Mobile Offshore Drilling Units (IMO Resolution A.414(XI) and A.649(16) as amended.

Cargo vessels (including oil tankers, LNG carriers and LPG carriers) over 1,000 gross tonnes

Cargo vessels of any type exceeding 1,000 gross tonnes not exceeding 15 years of age may be registered. Such vessels over 15 but not exceeding 20 years of age may be registered subject to a satisfactory entry inspection.

Vessels over 20 but not exceeding 23 years of age may be registered subject to a satisfactory entry inspection and provided they are operated by a Cypriot or EU ship management company having its place of business in Cyprus, which is sufficiently staffed with qualified personnel and certified as compliant with the ISM Code.

Cargo vessels over 23 years of age are not accepted for registration other than in exceptional circumstances.

Cargo vessels (including oil tankers, LNG carriers and LPG carriers) with a gross tonnage of less than 1,000 tonnes

Cargo vessels with a gross tonnage of less than 1,000 tonnes no older than 20 years may be registered without any additional conditions. Such vessels of over 20 years of age but not exceeding 23 years of age may be registered provided they undergo a satisfactory entry inspection.

Ocean going tugs

The registration policy for ocean going tugs with a gross tonnage in excess of 500 tonnes is identical to the policy for cargo vessels exceeding 1,000 gross tonnes.

Auxiliary and research vessels

Auxiliary vessels and research ships may be registered without any additional conditions if they do not exceed 25 years of age.

If they are over 25 years old, they may be registered provided that:

- (1) an entry inspection is successfully completed;
- (2) where necessary under legislation, they are operated by a Cypriot or an EU ship management company having its place of business in Cyprus, which is staffed with personnel sufficient in number and qualifications and is ISM compliant and certified.

In addition, offshore supply vessels must comply with the applicable provisions of:

- (1) the Guidelines for the Design and Construction of Offshore Supply Vessels (IMO Resolution A.469(XII));
- (2) the Guidelines for the Transportation and Handling of Limited Amounts of Hazardous

and Noxious Substances in Bulk by Offshore Support Vessels (IMO Resolution A.673(16)); and

- (3) the Code of Safe Practice for the Carriage of Cargoes and Persons by Offshore Supply Vessels (OSV Code—IMO Resolution A.863(20)).

All vessels must comply with the provisions of the merchant shipping legislation and the circulars issued by the Department of Merchant Shipping.

The Government has authorised most of the internationally recognised classification societies to conduct audits and issue certain certificates on its behalf.

EC Regulation 417/2002 on the accelerated phasing-in of double hull oil tankers or equivalent design requirements of the MARPOL 73/78 Convention for single hull oil tankers is in force together with the Merchant Shipping (Double Hull or Equivalent Design Requirements for Single Hull Oil Tankers) Law of 2004.

A law has also been passed to conform to Directive 2003/55 in relation to the regulation of the natural gas market within Cyprus and, more specifically, the storage, transmission, supply and distribution of natural gas. This law does not cover the distribution, transmission and supply from production facilities or the pipelines connecting such facilities with inland gas storage facilities or terminals for the liquefaction of natural gas or re-gasification of LNG.

Investment opportunities and conclusions

Cyprus has both the infrastructure and the tax incentives to become a leading player in the offshore oil and gas industry. It is currently the third-largest ship management centre, has the ninth-largest fleet in the world and has a well-advanced banking sector. Cyprus resident companies active in the energy sector, like all Cyprus resident companies, can benefit from a corporate tax rate of only 10 per cent, while shipping companies can benefit from the extremely favourable tonnage tax system applicable to Cypriot registered vessels by registering their vessels under the Cyprus flag. It should be noted that the Government intends to exempt successful licensees engaged in the exploration and exploitation of the hydrocarbon reserves within the Exclusive Economic Area of Cyprus from corporate income tax on the basis that taxation will be paid in the form of production sharing in accordance with the model production sharing contracts that will be concluded.

Apart from the prospects arising from the exploitation and utilisation of the natural reserves

located in the seabed off Cyprus, significant further investment opportunities will arise as Cyprus shifts to the use of more environmentally friendly fuel such as gas and adjusts to the requirement to maintain minimum stocks of oil

and petroleum products. Overall, Cyprus provides commercial entities with a stable environment for the growth of their business; not only within the EU area and the Middle East region, but worldwide.