The Legal Regime for Exploration and Exploitation of Hydrocarbons in Cyprus Waters

Kyriacos Kourtellos

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The international law of the sea

The United Nations Conferences on the Law of the Sea, held at Geneva in 1958 and 1960, concluded that there was a need for a new, generally accepted international convention on the law of the sea. The United Nations Convention on the Law of the Sea (the Convention) was developed in the ensuing years. The Convention established a legal order for all uses of the oceans and their resources on a holistic basis, namely that all problems of ocean space are closely interrelated and need to be addressed as a whole. The Convention was opened for signature on December 10, 1982 and entered into force on November 16, 1994. It is accepted as the global framework for all matters regarding the law of the sea and the base for additional development in specific areas of the law of the sea.

The Convention provides inter alia that coastal states exercise sovereignty over their territorial sea, which they may delineate up to a limit of 12 nautical miles (approximately 22 kilometres) from their coast; over a 200-nautical mile (approximately 370 kilometres) exclusive economic zone (EEZ), with regard to natural resources, certain economic activities (including exploitation of natural resources), marine science research and environmental protection; and over the continental shelf (the underwater landmass which extends from a continent) as regards exploration and exploitation of resources.

The EEZ includes what is known as the contiguous zone, a band of water extending from the outer edge of the territorial sea to up to 24 nautical miles from the coast, within which a state can exert limited control for the purpose of preventing or punishing infringement of its customs, fiscal, immigration or sanitary laws and regulations within its territory or territorial sea.

The physical continental shelf varies enormously in width, from only a few nautical miles up to more than 800 nautical miles. According to the Convention, if the physical continental shelf extends less than 200 nautical miles from the shore, it is deemed to extend that distance. The Convention also provides a framework for states bordering enclosed or semi-enclosed seas to co-operate in managing living resources, environmental and research policies and activities.

However, given that the international law of the sea was adopted over 30 years ago, it may no longer be able to adequately deal with modern issues. This is particularly true in the energy and natural resources sector, where technological advancements have increased substantially and alternative methods of extracting hydrocarbons have been developed, such as so-called fracking or hydraulic fracturing, where rock is fractured by a hydraulically pressurised fluid comprising water, sand and chemicals:

> "The Convention will, however, remain pivotal to the regime in the future and its broad base and detailed coverage of the 'core' of the law of the sea means that it will remain relevant and operative for some decades."[1]

Implementation of the Convention in Cyprus

Cyprus ratified the Convention by the United Nations Convention on the Law of the Sea Law of 1988.

Cyprus's territorial sea is defined by the Territorial Sea Law of 1964 as amended by the Territorial Sea Law of 2014 (together the Territorial Sea Laws), art.3 of which provides that the territorial sea of Cyprus extends to a range of 12 nautical miles from the baselines, which in turn are defined as

> "the lines along the coast of Cyprus, the geographical coordinates of which, as well as the relevant map on which they are shown, were deposited with the General Secretary of the United Nations, on 3 May 1993".

Taking into account the territorial sea's proximity to the coast, it is vital that the Territorial Sea Laws adequately address all relevant issues, especially considering the significant security sensitivity for coastal states such as Cyprus, which is close to several conflict zones and refugee routes. Although foreign flagged vessels may enjoy the right of innocent passage in the territorial sea, matters become more complicated if foreign warships are involved.

The contiguous zone, therefore, developed the security aspect of the territorial sea, by stipulating different relevant powers for the coastal state. The Contiguous Zone Law of 2004 (Contiguous Zone Law), defines the contiguous zone as the area bordering the territorial sea,

> "the inner limit of which is identical with the outer limit of the territorial sea of Cyprus and the outer limit of which shall not extend beyond 24 nautical

[1] D. R. Rothwell and T. Stephens, *The International Law of the Sea* (Oxford: Hart Publishing, 2010), p.28.

> miles from the baselines from which the breath of the territorial sea is measured, in accordance with the Convention".

Article 3(2) provides inter alia that in cases where part of the contiguous zone overlaps with part of the contiguous zone of any other state, whose shores are opposite those of Cyprus, the delimitation of the contiguous zone of the two states should be agreed between them. Also, in the event that an agreement is not put in place,

> "the delimitation of this zone shall not extend beyond the median line or the equidistance line, measured from the respective baselines from which the breadth of the territorial sea is measured".

Cyprus's EEZ and its continental shelf are defined in the Exclusive Economic Zone and Continental Shelf Law of 2014, which repealed the Continental Shelf Law of 2013 and amended the Exclusive Economic Zone Law of 2004 (EEZ Law).

In accordance with the Convention, the EEZ Law provides for the declaration of the EEZ, to an extent of up to 200 nautical miles from the baselines from which the breadth of the territorial sea is measured. Article 3(2) of the EEZ Law provides that

> "where the coasts of two States are opposite or adjacent to each other, neither of the two States is entitled, failing agreement between them to the contrary, to extend its territorial sea beyond the median line every point of which is equidistant from the nearest points on the baselines from which the breadth of the territorial seas of each of the two States is measured".

The EEZ of Cyprus was delimited by bilateral agreements with Egypt, Lebanon and Israel in 2003, 2007 and 2010 respectively. International differences in the range of jurisdictional rights asserted by coastal states in the EEZ have recently gained worldwide publicity (for example the South China Sea dispute), leading many commentators to the conclusion that in addition to fisheries and environmental protection, the key "unfinished business" of the Convention, and thus national legislation implementing it, is settling the juridicial character of the EEZ as a new maritime zone that is sui generis and sui juris.[2]

Cyprus's energy policy

As a member of the EU, Cyprus has aligned its energy policy with the *acquis communautaire* and transposed all relevant EU Directives into national law. Hydrocarbon exploration and exploitation activities in Cyprus and its EEZ are governed by the Hydrocarbon (Prospection, Exploration and Production) Law (4(I)/2007) (Hydrocarbon Law), which transposed into national law Directive 94/22 on the conditions for using authorisations for the prospection, exploration and production of hydrocarbons. The Hydrocarbon Law and the Hydrocarbon (Prospection, Exploration and Production) Regulations (51/2007 and 113/2009) together set out the licensing framework for prospecting, exploration and extraction activities. Successful applicants for a licence are required to enter into an Exploration and Production Sharing Contract (EPSC), in the form published by the Ministry of Energy, Commerce, Industry and Tourism, which is the regulatory authority.

Oil and gas industry

Cyprus is a relative newcomer to the upstream oil and gas industry. Indications of likely substantial gas deposits in the Levant Basin, in the South-Eastern Mediterranean area, were confirmed by the discovery of the Tamar gas field in Israel's exclusive economic zone in the early 2000s. Interest soon spread to the waters off Cyprus, and the Government took steps to delineate its EEZ and initiate a first licensing round for prospecting and exploration.

The first licence, for Block 12 in the Aphrodite field, was issued in 2008, and in 2012 the licensee announced discovery of a natural gas field with an estimated resource range of between 5 and 8 trillion cubic feet (TCF). The estimate has since been revised to 3.6 to 6 TCF following further exploratory drilling, but even at these lower figures Cyprus will be an important energy source. A second licensing round in 2012 has resulted in the issuing of five further licences to consortia including the world's largest energy companies. Exploratory drilling in these new blocks is scheduled to begin shortly.

The Government's objective is to make Cyprus not only a hydrocarbons producer, but a gas export hub for the region, taking advantage of its location and its geopolitical stability in a volatile region, and negotiations are under way for the development of an LNG compression and export facility costing several billion euro.

Taking into account the surrounding circumstances in the energy and natural resources sector there is scope for further development of the legal regime that focuses specifically on exploration and exploitation activities carried out by international oil companies (IOCs) in Cyprus, either through an amendment to the Hydrocarbon Law or the EPSC. As a relative newcomer to the oil and gas industry Cyprus does not have decades of experience to rely on and will be dependent on overseas precedents. IOCs will no doubt have a role in enabling local suppliers to gear up to international standards, in transferring knowledge and technology, in assisting in building capacity and in delivering leadership training. The Model EPSC currently provides for these to a certain extent, and

[2] Rothwell and Stephens, *The International Law of the Sea* (2010), p.97; I. Shearer, "Oceans Management Challenges for the Law of the Sea in the First Decade of the 21st Century" in A. G. Oude Elferink and D. R. Rothwell (eds), *Oceans Management in the 21st Century: Institutional Frameworks and Responses* (Leiden: Martinus Nijhoff, 2004), p.10.

there is scope to expand the role of IOCs, albeit not on an over-prescriptive basis and considering the input of IOCs at all times.

Effective regulation, legal clarity and comprehensive and coherent policies are essential for the effective and sustainable exploitation of Cyprus's natural resources. The EU and national legislation described earlier, as well as the Convention, provide an effective framework for the management of marine natural resources, and it is essential to flesh out this framework by introduction of the best management practices. The respective laws and regulations should include safeguards that prevent the ineffective use of natural resources, so as to maximise the prospects of success.

Taxation

Most of the new double taxation agreements that Cyprus has concluded over the past two years include an article, based on the OECD Model Convention, regulating taxation of exploration and exploitation activities within the parties' EEZs, intended to ensure that each state's taxation rights in respect of offshore activities are preserved in circumstances where they might otherwise be limited by other provisions of the agreement. Special rules are required because of the short duration of some of these activities. The standard provisions adopted in these agreements are as follows.

An enterprise of one contracting state carrying on offshore exploration or exploitation activities in the other is deemed to be carrying on business through a permanent establishment if the activities are carried out for an aggregate of 30 days or more in any 12 months, rather than the full 12 months of activity that is normally required to constitute a permanent establishment in the case of a building site or the like. Rules are also provided for determining when the 30-day threshold is exceeded where offshore activities are carried out by associated enterprises. This provision overrides the articles regarding permanent establishment and business profits.

Similarly, the normal provisions regarding income from employment are modified so that remuneration derived by a resident of one contracting state employed in offshore activities in the other may be taxed in the second state.

The "standard" article also provides that gains derived by a resident of a contracting state from the alienation of assets (either tangible or intangible) relating to exploration or exploitation activities in the second contracting state or its exclusive economic zone may be taxed in the second state.

Environmental assessment

As a member of the EU, Cyprus's policy in environmental law, as in other areas, is determined by the EU legal framework. What is now the Environmental Impact Assessment Directive 2014/52 as it stood at the time was transposed into Cyprus law by means of the Evaluation of the Consequences on the Environment of Certain Projects Law 140(I) of 2005, which was subsequently amended by Laws 42(I) of 2007, 47(I) of 2008, 80(I) of 2009, 137(I) of 2012 and 51(I) of 2014 (EIA Law). The EIA Law refers to plans and programmes prepared and authorised by a public authority in relation to inter alia agriculture, forests, fishing, energy, industry, transport, waste management, water management, telecommunications, tourism and land use. Such projects and programmes may have a detrimental effect on the environment and must, therefore, be regulated and assessed.

Cyprus's environmental policy has undergone significant change, owing to increasing alignment of national law with the *acquis communautaire*, and in turn this has created momentum towards environmental protection by making it a political priority. Furthermore, in recent years, the relevant authorities have been promoting environmental protection as one of the major goals on their agenda.

There are particular environmental hazards associated with hydrocarbon exploration and exploitation, as was most recently illustrated by the *Deepwater Horizon* oil spill in the Gulf of Mexico, which had a long-term impact on the environment and the livelihoods of those in the nearby communities. In the light of the potential effect on the sensitive marine environment around Cyprus of the development of an LNG compression and export facility and the associated upstream exploration and exploitation projects, a robust and effective means of assessing potential impacts on the environment and preventing any adverse impact is essential.

In parallel, environmental considerations are increasingly important in general developments in Cyprus. Until recently, the issue of potential environmental liabilities had rarely been considered in Cyprus, and there is limited case law on such matters. However, most legal documentation, and facility agreements in particular, now include provisions regarding compliance with best practice in the environmental field.

Concluding remarks

Cyprus has in place the legislation needed to deal with current hydrocarbon exploration and exploitation activities in its seas in line with the cumulative body of both international and EU laws. However, as hydrocarbon related activities increase in scope and in volume, fuller and more specific provisions for the regulation of oil and gas companies within either the model EPSC or relevant legislation might be necessary in due course. Eventually, the manner in which they are implemented, and particularly the approach adopted by the competent authorities, will be a critical factor for the way forward.