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A SURVEY OF CURRENT ISSUES IN THE EUROPEAN ENERGY SECTOR

THE EUROPEAN
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THIRD ENERGY PACKAGE

Throughout this publication, we refer to the two Directives and three Regulations adopted by the European Council and the Parliament on 13 July 2009 as the "Third Energy Package". For ease of reference, the Directives and Regulations adopted as part of the Third Energy Package: EU Directives 2009/72/EC, 2009/73/EC and Regulations (EC) No 713/2009, No 714/2009 and No 715/2009 are referred to as the "Third Electricity Directive", the "Third Gas Directive", the "ACER Regulation", the "New Electricity Regulation" and the "New Gas Regulation", respectively. Where the context so requires, we refer collectively to the two Directives as the "Third Electricity and Gas Directives" and to the Regulations as the "New Electricity and Gas Regulations", as appropriate.

CLIMATE CHANGE PACKAGE

We refer to the four Directives, one Regulation and one Decision adopted by the European Parliament on 17 December 2008 and the European Council on 6 April 2009 as the "Climate Change Package". For ease of reference, throughout this publication, we refer to EU Directives 2009/29/EC, 2009/28/EC, 2009/31/EC and 2009/30/EC as the "New EU ETS Directive", the "Renewable Energy Directive", the "CCS Directive" and the "Biofuel Directive" respectively. Further, we refer to EU Decision No 406/2009/EC and Regulation (EC) No 443/2009 as the "GHG Reduction Decision" and the "Emissions Standards Regulation", respectively.

Where required, we have referred to the previous internal energy market directives 1996/92/EC and 1998/30/EC as the "First Electricity Directive" and the "First Gas Directive", respectively and to Directives 2003/54/EC and 2003/55/EC as the "Second Electricity Directive" and the "Second Gas Directive", respectively.

Throughout the publication, we refer to Transmission System Operators as "TSO" and to Distribution System Operators as "DSO".

We use the following abbreviations for the various unbundling models:

FOU: Full Ownership Unbundling;
ITO: Independent Transport Operator;
ISO: Independent System Operator

LEGAL ADVICE

Please note that the content of this publication does not constitute legal advice and should not be relied upon as such. Specific legal advice should be sought for your specific circumstances.

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INTRODUCTION

I am delighted to introduce the 2015 edition of "The European Energy Handbook" which provides an in-depth survey of current issues in the energy sector in 42 European jurisdictions.

This year's edition focuses on recent legal and commercial developments in each jurisdiction and covers issues as diverse as the design of electricity markets, the reform of the support schemes for renewable electricity, new cross-border interconnections, new state aid guidelines, taxation issues for the upstream sector and significant commercial transactions and privatisations in the energy sector.

In addition to contributions for the European Union, Belgium, France, Germany, Spain, Russia and the United Kingdom from our own offices, this year we have contributions from Schönherr (Albania, Austria, Bulgaria, Croatia, Czech Republic, Hungary, Montenegro, Romania, Serbia, Slovakia and Slovenia), Peterka & Partners (Belarus), Karanovic-Nikolic (Bosnia and Herzegovina and the Former Yugoslav Republic of Macedonia), S. A. Evangelou & Co LLC (Cyprus), Kromann Reumert (Denmark), Raidia Leijns & Norcoux (Estonia, Latvia and Lithuania), Roschier (Finland), Kyriakides Georgopoulos & Daniolos Issaias (Greece), Arthur Cox (Ireland), Studio Legale Legance (Italy), Signum (Kazakhstan), Arendt & Medernach (Luxembourg), Buttigieg, Refalo & Zammit Pace Advocates (Malta), Nauta Dutilh (the Netherlands), Arntzen de Besche Advokatfirma AS (Norway), WKB Wierciński, Kwieciński, Baehr (Poland), Esquivel Advogados (Portugal), Mannheimer Swartling (Sweden), Homburger (Switzerland), Kolcuoğlu Demirkan (Turkey), BBA//Legal (Iceland) and Sayenko Kharenko (Ukraine).

Whilst 2014 was supposed to be the year in which the internal market for energy would be completed, not all Member States have transposed the Third Energy Package into national law and the European Commission has referred a number of Member States to the European Court of Justice for either partial or complete failure to implement the same.

2015 will see intensified efforts to integrate the European energy market and is set to be an important year for the electricity market as the EU Target Model for electricity market integration is expected to be fully implemented this year.

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The gas markets are likewise anticipating further changes: In January, ACER published its updated Gas Target Model, which covers matters such as security of supply, the future of wholesale markets, the role of gas in complementing power generation from renewables, and new development along the gas value chain.

The security of gas supply is another topic which is likely to receive a lot of attention in 2015 as the European Commission has, in January 2015, opened a new consultation seeking views on EU rules to guarantee the security of gas supplies, in a bid to further improve Europe's resilience to gas supply disruptions. This follows stress tests carried out in October last year which showed that better cooperation and coordination between EU Member States was desirable.

In short, 2015 will be another busy year for the European energy sector.

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ENERGY LAW IN CYPRUS

Recent developments in the Cypriot energy market

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INTRODUCTION

In 2014, a series of developments took place in the energy industry in Cyprus. These developments relate to the growing utilisation of Renewable Energy Sources ("RES"), the further exploration and appraisals of hydrocarbons in the Cyprus Exclusive Economic Zone ("EEZ") and the progress of a cross-border electricity grid.

In the past, energy consumption in Cyprus was broadly dominated by oil and petroleum products.¹ However, with the island's 2020 RES target indicator at 13%, the energy mix has seen a firm increase in energy diversification.² Going forward, Cyprus aims to reduce energy dependence whilst improving efficiency and making effective arrangements for energy security.

Cyprus also aims to provide attractive fiscal regimes³ in order to incentivise investors, and despite its recent financial turmoil, the energy industry is experiencing a substantial influx of international investment.

The recent discoveries of natural gas in the Cyprus EEZ have shown promising prospects of development of the hydrocarbons industry, which is still in its infancy and is currently undergoing commercial and legislative developments. Parallel to the upstream oil and gas activities currently taking place in the Cyprus EEZ, the government also announced invitations of interest for proposals of participation in the joint venture that will be responsible for the development, financing, construction and operation of gas storage facilities and a Natural gas Liquefaction Plant.

In all energy-related activities the Ministry of Energy, Commerce, Industry and Tourism ("MCIT") and the Cyprus Energy Regulatory Authority ("CERA") have purported to provide, for the protection of the environment, the facilitation of healthy competition and encouraging the development of RES. The Ministry has also devised a policy regarding the objective of contributing to the European Strategic Oil Stock Scheme.⁴ CERA has undertaken to fully align Cyprus policy with the European Directives and Regulations of the Third Energy Package on natural gas and electricity markets by the end of 2015 as well as targeting relatively low Greenhouse Gas emissions ("GHG") by 2020.

With the country going through a financial crisis, the prospect of reducing the amount of energy required for either the provision of products and services, or for private use, is attractive for both businesses and customers who are looking to make savings where they can. Strategic energy efficiency constitutes a top priority for Cyprus as an effective energy efficiency plan may result in reducing Cyprus' reliance on oil imports for power generation.

In complying with its EU obligations under the EU's Energy laws, Cyprus has adopted the European Commission's new Energy Efficiency Directive. For transposing the Directive to national legislation, two laws were amended and secondary legislation was

adopted. The Law for Energy in End-Use and Energy Services and the Law for the Promotion of Combined Heat and Power Generation were adopted in June 2014.

ELECTRICITY

The legal framework surrounding the electricity sector in the Republic of Cyprus is comprised of three interrelated pieces of legislation. The Electricity Law Cap 170, which regulates and governs the generation, transmission and distribution of electricity; the Electricity Development Law Cap 171, which regulates the relationship between the Electricity Authority of Cyprus ("EAC") the state and the consumer; and the Electricity Market Regulation Law⁵, which amended and repealed a number of sections in the aforementioned pieces of legislation and has established significant authorities and procedures to align the internal electricity market of the Republic of Cyprus with EU policy.

The Energy Service of the MCIT is the government authority that oversees and coordinates the energy sector in Cyprus and prepares the requisite legislation and policies. The MCIT is currently in the process of improving its standard of oversight by implementing necessary checks and balances within the sector.

Authority within the electricity sector of Cyprus lies with EAC and CERA. EAC is an independent semi-governmental company established by the Electricity Development Law Cap 171. EAC had a monopoly on the generation and supply of electricity in Cyprus until its succession to the EU in 2004. CERA regulates and serves to protect the security, quality and safety of electricity generation. CERA reserves the right to issue licences for all activities relating to electricity and gas and is responsible for approving tariffs, dispute resolution and securing a reliable electricity system. The Electricity Market Regulation Law provides that CERA is an independent authority not under the control of any ministry.

Another key body within the sector is the Transmission Systems Operator ("TSO"). Pursuant to the Electricity Market Regulation Law the ownership of the transmission system has been unbundled from its operation with the creation of the TSO, although the DSO remains under the EAC's control.

The TSO is deemed to regulate access to the electricity grid, codes for transmission and distribution and the general maintenance or development of the grid. Therefore, the TSO is able to act independently and avoid any conflict of interest.

Cyprus has been classified as a 'small isolated system' under both the Second and Third Energy Packages based on the fact that the island's industry has not integrated with any other neighbouring systems. This status currently grants the island derogation from the application of various Articles of Third Electricity Directive 72/2009/EC including the basic models for Unbundling of Transmission Systems. Cyprus is therefore allowed to maintain its current framework and structure on TSO unbundling.

Liberalisation of the electricity sector began to align with the targets set by the First and Second Electricity Directives concerning the common rules of the internal electricity market. These policies aim to protect consumers from monopolistic market conditions. The Republic of Cyprus was allowed to delay the requirement of 100% liberalisation until 2014. In 2009, the market had been further liberalised to 65% allowing even non-domestic users to select their suppliers. As of January 2014 the market has been fully liberalised. However to date, no private power plants have been built.

A CERA report commissioned to LDK E-Bridge in 2013⁶ which involved a study relating to the remodelling of the electricity market in Cyprus, has provided the regulatory body with three option scenarios as to how the market can be restructured (ie, (i) Gross Pool; (ii) Bilateral Contracts; and (iii) Net Pool). These scenarios involve and take into account the possibility of integrating RES into the market. The report,⁷ published in March 2014, produced an evaluation presenting the 'Net Pool' model as the most appropriate trading arrangement approach for the Cyprus electricity market. The options were evaluated by CERA in terms of efficiency, sustainability and security, alignment with EU Directives and the protection of consumers from undesirable market conditions. In September 2014, CERA published its opinion⁸ and proposed to the MCIT to proceed with the 'Net Pool' approach. In addition, CERA has also sought counsel for the detailed design of this model and is also currently planning for public consultation.

EAC has also introduced net-metering within the industry via the "Solar Energy for All" Scheme, a service which allows electricity consumers (households, local administration buildings and commercial industrial units) who are also electricity producers (via an eligible on-site generating facility delivering to the grid) to offset their generated electricity against the electric energy provided by the utility to that consumer. This scheme aims to incentivise investment in electricity assets and provide for a healthier, more competitive market.

Building a cross-border electricity grid to serve the purpose of linking the island's electricity distribution and transmission system has been a main concern for the MCIT. Though the electricity system in Cyprus operates without cross-border links, on 8 August 2013 the MCIT signed a Memorandum of Understanding ("MoU") with Israel and Greece on cooperation in the fields of energy and water, welcoming joint projects in the energy sector to enhance the security of energy supply, sustainable development and cooperation among the countries in the region. Following the MoU, it has been agreed that parties will co-operate in constructing what is known as the EuroAsia Interconnector. The project is essentially an electrical cable bridge with three arches that will create a network of electrical energy amongst the three states via their established EEZs. This project is aimed at enhancing the pan-European grid network and will be the first energy bridge between Europe and Asia.

GAS MARKET

Currently there is no gas production or trading in Cyprus. The principal legislative instrument governing the domestic gas sector is the Gas Market Law 183(i)/2004 (as amended) (the "Gas Market Law") which has been put in place in anticipation of the arrival and production of gas in Cyprus. Under the Gas Market Law the overall policy responsibility for the gas sector rests with the Council of Ministers. The Council has the authority to appoint a body responsible for the operation of the transportation and storage network as a whole. Furthermore, under the Gas Market

Law, CERA is the national regulatory body that has oversight over the gas market and can issue regulations in relation to issues governed by the Gas Market Law.

As part of the efforts to secure an uninterrupted supply of Natural Gas, the Government has established a 100% government-owned natural gas public company, DEFA, which is responsible for the internal gas market in Cyprus; for the import, storage, distribution and transportation of LNG and the management of the distribution and supply system of LNG in Cyprus. DEFA's role is to ensure that Natural Gas is available in power plants and industrial plants. At the time of writing, efforts towards the import and use of natural gas for power generation are under development. DEFA has invited applicants to place bids for the supply of natural gas for a period of up to ten years. Four proposals were received, however DEFA requested to extend the validity of these bids so as to carefully carry out the commercial examination. Negotiations will soon take place between DEFA and the bidders.

The statutory framework for third party access to the gas transportation system is contained in section 7 and 47(2)(a) of the Gas Market Law. Access is governed by CERA. CERA has the power to approve the tariffs and terms and conditions. Under the Gas Market Law, where an application is received for third party access in respect of construction facilities, supply or import of natural gas, CERA will evaluate the application in an objective and non-discriminatory manner. Regulations issued by CERA provide information on tariffs for transportation and distribution.

Currently there is no LNG terminal in Cyprus. Due to the recent discoveries of natural gas and developments in the hydrocarbons sector, there are plans for the construction and development of a Transmission and Distribution Natural Gas Pipeline Network. This network will consist of three pipelines that will supply the three Power Stations of the Electricity Authority of Cyprus in Vasilikos, Dhekelia and Moni. The initial network will serve as the backbone for the development of the future network which will extend to households, businesses, city buses and other public transport, cogeneration plants and greenhouses. The initial network is estimated to have a total length of about 80km. The project has already secured sponsorship of €10m from EU funds under the European Economic Programme for Recovery.

DEFA has received four proposals to supply natural gas to the island as an interim solution for power generation by the EAC before its own reserves become available. Based on its initial invitation for proposals, issued in January, DEFA is seeking up to 10 years of natural gas to be supplied, commencing in January 2016. The tender published by DEFA calls for the supply of between 0.7 and 0.95 billion cubic meters of natural gas annually to the Cypriot market through two delivery routes. One route will begin supplying gas in early 2016 and the other no later than the second half of 2017.

In August 2014, DEFA announced that it had finished assessing the bids submitted by interested suppliers of natural gas and would commence direct negotiations with the bidders. The evaluation concerned the application of a set of pass/fail criteria for proposals received. The criteria included:

- the bidder's financial standing;
- creditworthiness;
- experience and technical capability; and
- the technical suitability of the bidder's proposal.

HYDROCARBONS EXPLORATION AND EXPLOITATION

Offshore exploration in Cyprus for oil and gas is ongoing. Cyprus has established its sovereign right to hydrocarbons in the EEZ and in recent years has signed several agreements setting up its EEZ. The discovery of hydrocarbons and their exploitation will minimise Cyprus' dependency on imported energy supplies in the future.

The legal framework applies to the territorial waters, the continental shelf and the EEZ of Cyprus. It comprises the Hydrocarbon (Prospection, Exploration and Exploitation) Law 2007 (No. 4(I)/2007) and the Hydrocarbon (Prospection, Exploration and Exploitation) Regulations 2007 & 2009 (No.51/2007 and No. 113/2009). The laws and regulations implement Directive 94/22/EC concerning the conditions for granting and using authorisations for prospection, exploration and production.

There are three separate authorisations for upstream hydrocarbon activities. These authorisations cover three separate phases in the life cycle of hydrocarbon assets:

- Prospection – this authorisation does not exceed one year;
- Exploration – this authorisation does not exceed three years but can be renewed up to another two terms. On each renewal, 25% of the initial licence area is relinquished. In the event of a commercial discovery the licensee may apply for an exploitation licence; and
- Exploitation – this authorisation does not exceed 25 years but can be renewed for another ten years.

The conditions and requirements for an authorisation for exploration and exploitation are to be set out in an Exploration and Production Sharing Agreement ("EPSA") whilst a prospecting authorisation does not require an EPSA.

In accordance with the SEA Directive 2001/42/EC, MCIT has also carried out a Strategic Environmental Assessment ("SEA") of the area in which the oil fields are located. In this assessment, they have evaluated the likely consequential effects of setting up a hydrocarbon project in that area with regards to the marine life and environment. Further, the SEA also binds licensees to carry out an Environmental Impact Assessment which they are bound to comply with. In doing so they must conduct offshore activities within each licensed area in an environmentally acceptable and safe manner consistent with legislation and good industry practice.

The Exploration and Production Sharing Contract ("ESPC") issued and published by the MCIT sets out all of the terms and conditions of upstream activities agreed between the state and an international oil company. The Hydrocarbons Regulations empower the Minister⁹ to issue a model production sharing contract¹⁰ that a selected applicant enters into with the state. There has been a previous model contract¹¹ issued for the first licensing round of 2007 however, since the second licensing round of 2012, an updated version has been published. The current model agreement sets out fundamental aspects of the project such as minimum work obligations, the development and production plans as well as all upstream fiscal provisions. Such fiscal arrangements include the payments of a signature bonus (payable upon signing of the contract), a production bonus (payable in two tranches upon reaching two distinct target production levels) and the formulae for cost oil recovery and profit oil sharing.

The island's EEZ is divided into 13 blocks. There have been two licensing rounds so far. In the first licensing round in 2007, a

licence was issued to Noble Energy International Ltd (Noble) for the exploration and exploitation of Block 12, the Aphrodite Gas Field where Noble has subsequently discovered natural gas. Appraisal activities are currently taking place to confirm and evaluate the recoverable quantities which is necessary for the planning and development of the infrastructure plans for the Cyprus hydrocarbons market as whole.

Following the second licensing round held between 11 February 2012 – 11 May 2012, 15 bids with a total of 33 applications were made for nine out of twelve; the MCIT awarded licences to the consortium of ENI-KOGAS for blocks 2, 3 and 9 and to Total for blocks 10 and 11. EPSCs licences were signed in January 2013 and February 2013, respectively. ENI-KOGAS carried out their first exploratory well in September 2013 and undertook first appraisal drillings in September 2014. Total are expected to carry out their first exploratory well in the first half of 2015.

The exploratory drillings within the EEZ in 2014 and 2015 will enable Cyprus to obtain a realistic view of what the oil reserves are in the relevant blocks.

Currently the government plans to build an LNG terminal adjacent to the Vasilikos area in Limassol for the liquefaction of natural gas and for the export of LNG by tanker to international markets.

On 26 June 2013 a Memorandum of Understanding was signed by the Republic of Cyprus, Noble and the Delek Group (Delek & Avner). This event was the first of several steps to be taken for the monetisation of Cyprus' offshore resource wealth. The agreement relates to the investment and construction of an LNG terminal to operate in the Vasilikos area. The agreement was expected to set off a series of future agreements with other partners and actors as well. With the aim of further aligning actions for the development of a land LNG Terminal, the Cypriot government and representatives of the ENI-KOGAS joint venture, in August 2014 signed a Memorandum of Understanding (MoU) similar to the one signed in 2013 with Noble. This agreement aims at investigating areas of cooperation related among other matters to the onshore LNG option. The agreement marks the completion of a series of agreements that Cyprus has with the licensees of the Blocks.

However, Noble's findings in themselves do not justify the pursuit of this endeavour. The final investment decision for the construction of the LNG terminal depends on the exploits of ENI-KOGAS, Total and Noble in the Cyprus EEZ, as the LNG terminal requires the discovery of at least 6 trillion cubic feet of gas to be commercially viable. Additional quantities of natural gas will allow a final investment decision for the construction of the LNG terminal. Noble will also be conducting further exploratory work in the EEZ.

If the natural gas quantities commercially justify the construction of an LNG plant, the plant will include facilities for the liquefaction of natural gas and the storage and export of LNG by tanker for transportation to the international markets. The Vasilikos Oil Terminal will also include facilities for the storage of operational oil reserves; facilities for the storage of strategic oil reserves and facilities to operate as an oil trading hub.

As mentioned above DEFA is responsible for the internal gas market in Cyprus and, in addition to that, a National Oil Company has been established. The private company was named KRETYK and has now been renamed to Cyprus National Hydrocarbons Company ("CNHC"). Aiming to increase transparency and establishing appropriate checks and balances a number of

changes have been adopted with regards to the management of CNHC. These changes include the abolition of the previous board of directors and the appointment of a seven-member non-executive board and the authority granted to the Auditor-General to monitor the company's financial results and the actual operation of the company.

RENEWABLE ENERGY SOURCES

Cyprus is almost totally dependent on imported oil for its energy supply, with a small but growing contribution from RES. In accordance with the EU 20-20-20 initiative the government promotes the use of RES mainly through offering financial initiatives. Specifically, over the last few years the government has offered several financial grants to promote solar energy. Cyprus ranks highly at a global level in solar energy use for water heating in households¹² and has generally achieved an improvement in the RES share within the island's energy mix. The RES sector in Cyprus mainly involves wind farms and photovoltaic parks. The sector has set targets to reach 13% of the energy mix by 2020. Currently, the maximum output from RES in Cyprus (on average) reaches 181MW and the National Action Plan ("NAP") has set out to reach a minimum of 584MW by 2020.

RES initiatives in Cyprus include the EOS project¹³ in Alasa, Limassol which will mainly utilise a Concentrated Solar Thermal (CST) storage system where water will be pumped through coils of stainless steel pipes in steel tanks containing high purity graphite blocks. The result will produce super-heated 'dry' steam which in turn will power a turbine to produce electricity. The main advantage of this particular system is the fact that the system itself is autonomous and can operate around the clock. Production is expected to begin in 2016 at 45% capacity and gradually reach full capacity by 2017. Production will be sold to the EAC at a price which is 40% cheaper compared to current sell prices of the EAC. This technology is also environmentally friendly as the water that evaporates into steam is re-circulated through the system; there are no Greenhouse Gas emissions involved and no chemicals or batteries are needed. The total cost of the EOS project in Cyprus is expected to be around 175m Euros and has received an EU grant which is expected to be between 47 and 60m Euros.

As required by the Renewable Energy Directive, Cyprus has adopted a national renewable energy action plan that has been in effect since 2010. In April 2014, Cyprus adopted and published its 3rd National Energy Efficiency Action Plan in compliance with Directive 2012/27/EU. The plan provides for all measures that are to be taken in order to achieve the mandatory targets, including energy efficiency and energy saving measures.

CLIMATE CHANGE

Cyprus has over the past few years started climate change mitigation initiatives to reduce industry emissions and improve the general protection of the environment. The most important development remains the implementation of the strategy for adapting to climate change which aims to strengthen and increase Cyprus' capacity to respond to climate change and its impacts, as well as identifying the potential opportunities associated with this sector and formulating proposals for specific action in both the short and long term. Operating as a two stage process, the national strategy for climate change adaptation initially focused on the creation of a knowledge base with regards to the implications of climate change, combining policies to maximise successful adaptation. The second phase, which consists of the implementation and monitoring of the strategy, was initiated in 2013. The implementation of the strategy is expected to be a long process, demanding close cooperation of all stakeholders.

In relation to the storage of carbon dioxide, Cyprus has implemented the CCS Directive by Law 71(I)/2012 which sets out the terms governing the application and issuance of storage permits. Despite legislative developments, there are, as yet, no carbon capture and storage projects in Cyprus. The CCS Directive covers the criteria for the sites of storage spaces as well as the obligations of the entity responsible for the storage. The Biofuel Directive was transposed into national law by Law 111(I)/2013.

With regards to the Renewable Energy Directive, Law 66(I)/2005 (as amended) includes the provisions relating to the use of biofuel and other renewable sources for transportation, and Law 33(I)/2003 (as amended) provides for the promotion of renewable energy sources in accordance with the provisions of Directive 2003/30/EC on the Promotion of the use of Biofuels and other Renewable Fuels for Transport.

ENDNOTES

1. These accounted for 96.3% of the island's energy consumption
2. RES energy mix share growth from 2.5% to 4.9% (2006-2010)
3. Revenue generation from energy-related activities
4. 2009/119/EC
5. Law 122(I) of 2003
6. CERA Report on the Restructuring of the Electricity Market in Cyprus http://www.cera.org.cy/main/data/articles/engsummary09_09_2014.pdf
7. Cyprus Energy Regulatory Authority, http://www.cera.org.cy/main/data/articles/engsummary09_09_2014.pdf
8. Cyprus Energy Regulatory Authority http://www.cera.org.cy/main/data/articles/electricitymarket09_09_2014.pdf
9. Minister of Energy, Commerce Industry and Tourism
10. Ministry of Energy, Commerce Industry and Tourism, Exploration and Production Sharing Contract 20 12, hereinafter referred to as EPSC
11. Ministry of Energy, Commerce Industry and Tourism, Production Sharing Contract 2007,
12. EREC, Renewable Energy Policy Review Cyprus, http://www.erec.org/fileadmin/erec_docs/Projcet_Documents/RES2020/CYPRUS_RES_Policy_Review_09_Final.pdf
13. EOS 50 MW CSP

OVERVIEW OF THE LEGAL AND REGULATORY FRAMEWORK IN CYPRUS

A. ELECTRICITY

A.1 Industry structure

National regulatory authorities

The Cyprus Energy Regulation Authority ("CERA") is the independent national regulatory authority for the electricity and gas markets established pursuant to the Electricity Market Regulation Law 122(I) of 2003 (the "Electricity Law") which brought the First Electricity Directive into national law. CERA's role is to ensure proper regulation of the electricity and gas markets, promote competition and to protect all consumers. CERA has exclusive rights to issue licenses for all activities relating to electricity and gas. Its responsibilities include approving tariffs, resolving disputes and securing a reliable electricity system.¹

The Transmission Service Operator ("TSO") was also established by the Electricity Law to harmonise national law with the relevant European Directives for liberalising the electricity market. Its main duties are to operate, synchronise and manage Cyprus' transmission system objectively to ensure the proper maintenance and development of the electricity network. The TSO also arranges the daily trading of electricity while at the same time supporting and promoting electricity generation from renewable energy sources.²

The Energy Service of the Ministry of Energy, Commerce, Industry and Tourism ("MCIT")³ is the government authority that oversees and coordinates the energy sector in Cyprus and prepares the requisite legislation and policies.

Legal framework

The legal framework governing electricity comprises three principal (and interrelated) pieces of legislation: the Electricity Law; the Electricity Development Law; and the Electricity Market Regulation Law 122(I) of 2003, (the "Electricity Market Law") which amended and repealed a number of sections in the aforementioned pieces of legislation.

The nature of the market and the key players

The Electricity Authority of Cyprus ("EAC") is an independent semi-governmental company established by the Electricity Development Law, Cap 171. The EAC had a monopoly on the generation and supply of electricity across Cyprus until its accession to the EU in 2004.

The EAC generates 90% of the electricity in Cyprus, although there are some producers that have entered the generation sector by producing electricity for their own use.⁴ Liberalisation of the Cyprus electricity market began under the provisions of the First Electricity Directive and the Second Electricity Directive concerning the common rules of the internal electricity market. As a result, 65% of the electricity market has been liberalised and opened to competition (with effect from January 2009) including all "non domestic" consumers being able to select their supplier

according to what is in their best interest, thus ending the EAC's monopoly.

Despite liberalisation of the electricity market, the EAC remains the dominant producer of electricity and the owner of both the electricity transmission and distribution systems in Cyprus. The market is due to open to all customers on 1 January 2014.⁵ Any enterprise interested in generating and supplying electricity which fulfils the criteria set in the Electricity Law may submit an application to CERA to obtain the relevant licence. Licensees will have the right to use the existing electricity transmission and distribution network. CERA is authorised to grant exemptions from the licensing procedures for certain generation activities.⁶

Development of TSO and DSO unbundling

Pursuant to the Electricity Law, the ownership of the transmission system has been unbundled from its operation with the creation of the TSO. Even though the function of the DSO remains under the EAC's control, accounts unbundling has been achieved through the publication of separate financial accounts.⁷

The Third Electricity Directive has not yet been implemented in Cyprus and an exemption from article 9 of the directive on the unbundling of transmission systems has been secured.

The Third Energy Package

As the EAC is the only company generating and supplying electricity, there is no wholesale market in Cyprus and there are no cross-border links. The country has been granted the status of a small isolated system under both the Second and Third Energy Packages. CERA supports the European Commission's proposals for strengthening the power and independence of national regulators, central to achieving harmonisation of the national regulators and the creation of a level playing field. However, the Third Energy Package has not yet been fully implemented.

A.2 Third party access regime

Legislative and commercial framework

The Electricity Law provides a framework for full third party access to the transmission and distribution systems. Whilst the transmission and distribution systems remain the property of the EAC, they are regulated by the TSO which also controls connection to the system. All parties using the transmission and distribution systems, as well as the technical aspects of planning and operating the transmission and distribution system, are governed by the Electricity Law, the transmission and distribution rules and the Trading and Settlement Rules (the "Market Rules").

In accordance with the Market Rules, a prospective electricity provider may submit an application to the TSO to enter into an agreement or protocol to govern the connection to, or use of, the transmission system. An application may also be filed with the

DSO by any person looking to enter into an agreement for the connection to, or use of, the distribution system.⁸

The TSO and the DSO are prohibited from entering into an agreement or protocol where to do so would cause the TSO or DSO to breach the Electricity Law, any regulations that may be issued pursuant to the Electricity Law or any condition of the authorisations granted to the TSO or the DSO.⁹

The charging regime

Persons that have been granted authorisation or an exemption under the Electricity Market Law¹⁰ shall ensure, to the extent that their authorisations or exemptions require, that the tariffs or charges levied for the services provided under the terms of those authorisations or exemptions have been:

- set in accordance with the relevant regulations and the methodology prescribed by CERA, reflecting costs including reasonable profits;
- approved by CERA; and
- publicly notified in accordance with CERA's requirements.

CERA shall ensure that the terms, conditions and procedure for reviewing and approving tariffs and charges is specified in the relevant regulations and the methodology prescribed by CERA. The procedure should include:

- a timetable for consideration by CERA of applications for approval; and
- an opportunity for customers and other persons to comment on such applications.

CERA also has to ensure that licensees or holders of exemptions are permitted to recover all reasonable costs incurred in the operation of their business including, but not limited to, the cost of fuel, wages and salaries, other operating and maintenance costs, provision for capital depreciation, a reasonable return on the capital invested and the costs of Public Service Obligations imposed on the licensee in accordance with the Electricity Market Law or other applicable laws.¹¹

A.3 Market design

Independent power generators and suppliers are required to apply for a licence through CERA,¹² which requires any person interested in engaging in any of the following activities to apply to CERA for a licence:

- construct an electricity production station or produce electricity;
- supply electricity to selected or non-selected consumers;
- undertake any activities reserved for owners of transmission systems by section 46 of the Electricity Law;
- undertake any activities reserved for owners of distributions systems operators by section 52 of the Electricity Law; and
- undertake any activities reserved for transmission system operators by section 59 of the Electricity Law.

An applicant must be an EU citizen or a company established and managed in the EU,¹³ must submit an application in the prescribed form together with the requisite supporting documentation and pay a fee. CERA must objectively consider inter alia the following criteria:

- the safety of the electricity system, the production facilities and the electricity cable lines;

- the protection of the environment; and
- the location of the electricity production facilities and the use of the relevant land.

The prescribed fee currently ranges from €170.86 to €1,708.60 or in the case of a licence for the construction or operation of generating station €0.08543 per KW of generating capacity.¹⁴ The Issue of the Licences Regulations specify the procedure to be followed and list the documents and information that must accompany the application.¹⁵

If CERA rejects an application, it must provide a written notice setting out the reasons for rejection.¹⁶ The decision may be subject to judicial review by the Supreme Court under Article 146 of the Constitution.

A.4 Public service obligations and smart metering

Pursuant to the Electricity Law, the Minister may, by a decision published in the Official Gazette of the Republic, instruct CERA to impose Public Service Obligations ("PSO"). PSO may include obligations in respect of security of supply, regularity, quality and price of electricity supply, environmental protection, energy efficiency and the use of indigenous energy sources.¹⁷ PSO may be issued by regulatory decision or, where deemed necessary, by regulation. To comply with PSO a licensee may be required to ensure that a specified amount of electricity generated using Renewable Energy Sources ("RES") or cogeneration is made available under the licence each year. In such case, CERA will ensure that any additional costs incurred by the licensee will be passed on to consumers.

Currently, there is no legislation imposing mandatory rollout of smart metering in Cyprus. However, current legislation does not restrict the development of a smart metering market. The DSO is ushering out the first phase of smart metering, rolling out a pilot scheme to replace existing damp meters with smart meters, instigating the full transformation from passive to active smart grids. Three-thousand smart meters will be connected to a Meter Data Management System and data will be collected from residential, commercial and industrial customers over the next phase of the project.¹⁸

A.5 Cross-border interconnectors

Though the electricity system in Cyprus operates without cross-border links, on 8 August 2013 the MCIT signed a Memorandum of Understanding ("MoU") with Israel and Greece on cooperation in the fields of energy and water, welcoming joint projects in the energy sector to enhance the security of energy supply, sustainable development and cooperation among the countries in the region.¹⁹ In this respect, the three countries welcome the EuroAsia Interconnector project (a private initiative), which aims to create an electricity interconnector between Israel, Cyprus and Greece. This project would allow for the export of electricity generated in the Eastern Mediterranean to the EU energy market through trans-European electricity networks.²⁰

B. GAS

B.1 Industry structure

Currently there is no gas production or trading in Cyprus. A legislative framework and competent institutions have been put in place in anticipation of the arrival and production of gas in Cyprus. The current legislative framework for the Cyprus gas industry is the Gas Market Law 183(I)/2004 (as amended) (the "Gas Market

Law"), which contains provisions relating to the powers granted to CERA, licensing transport and storage of LNG and the distribution and supply of natural gas.

In accordance with the Gas Market Law, the Council of Ministers is the decision-making body in relation to issues such as the transmission and storage of LNG in Cyprus. The Council has the authority to appoint a body responsible for the operation of the transportation and storage network as a whole.

Under the Gas Market Law, CERA is the national regulatory body with oversight over the gas market as well as the electricity market as explained in A.1 (above). In addition, CERA has authority to issue regulations in relation to issues governed by the Gas Market Law.

The Natural Gas Public Company ("DEFA"), a 100% state owned public company, has a monopoly of gas supply and importation in Cyprus.²¹ DEFA is responsible for the import, storage, distribution and transportation of LNG and the management of the distribution and supply system of LNG in Cyprus. Unlike the electricity market, which was liberalised in 2004, the gas market remains a monopoly. Cyprus will establish its gas industry by granting a supply permit to a single legal entity which will be controlled by DEFA.

Cyprus has brought the Second Gas Directive into national law. In order to bring the Third Gas Directive into domestic law, the latest amendment of the Gas Market Law was approved by parliament in December 2012. Due to its isolated and emergent status, Cyprus has secured a derogation from article 9 on the unbundling of transmission systems and transmission systems operators as well as from other articles of the directive.²² The derogation will expire when Cyprus ceases to be classified as an isolated market by the EU.²³

B.2 Third party access regime to gas transportation networks

There are plans for a gas transportation network in Cyprus but these have not been implemented yet. Conditions for third party access to the network are governed by the Gas Market Law.²⁴ CERA has the power to approve the tariffs and terms and conditions that will be applied in an objective and non-discriminatory manner to all parties.

Any person wishing to construct facilities (ie, storage, transportation, etc.) for supply or import of natural gas requires a licence from CERA. Regulations issued by CERA provide information on tariffs for transportation and distribution.

B.3 LNG and gas storage

Currently there is no LNG terminal in Cyprus. However, given the recent discoveries of natural gas and developments in the sector, plans to construct a natural gas liquefaction plant in the Vasilikos area on the south coast 40km east of Limassol are underway. The plant includes facilities for the liquefaction of natural gas and the storage and export of LNG by tankers for transportation to international markets. It has been widely reported that the US firm Noble Energy, Italy's ENI and France's Total will co-finance the LNG plant. The three companies have drilling concessions on offshore prospects in Cyprus' Exclusive Economic Zone ("EEZ").

Under the Gas Market Law, a network administrator for the transportation network and storage facilities is appointed by the Council of Ministers. Access to storage facilities will be granted on the basis of the regulations issued by CERA after a licence has been granted.²⁵

B.4 Market entry

All market participants, whether owners and/or operators of storage, transportation, distribution or degasification terminals are subject to a licensing regime under the provisions of the Gas Market Law. CERA is the authority designated to examine applications and issue licences (in accordance with regulations issued under the Gas Market Law). The criteria, which include safety of facilities, protection of the environment, efficient use of energy resources and technical specifications, are set out in the Gas Market Law and may be supplemented by directives issued by the Minister of Commerce from time to time.²⁵

The Council of Ministers may assign the importation and supply of gas to a single entity (as is the case with DEFA). In such a case, the provisions applied in relation to licences for new market entrants are suspended.²⁷ It would appear, therefore, that the opportunities for new entrants in the gas supply market are limited unless the Council of Ministers decides otherwise.

B.5 Public service obligations and smart metering

The Minister of Commerce may, via a decision or regulation published in the Official Gazette, instruct CERA to impose PSO.²⁸ These may include obligations in relation to security of supply, quality and price of electricity supply, environmental protection, energy efficiency and the use of indigenous energy sources.

B.6 Cross-border interconnectors

There are currently no cross-border connections in Cyprus.

C. ENERGY TRADING

C.1 Electricity trading

CERA's role, authority and responsibilities concerning the electricity and gas sectors are explained in A.1 (above). A single TSO, unbundled from the system owner, was appointed with exclusive duties to operate, synchronise and control the transmission system using objective, non-discriminatory criteria. Its role is to ensure the property maintenance and development of the electricity network and to arrange for the trading of electricity on a daily basis. The TSO coordinates actions for maintaining a continuity of supply to consumers for an efficient, coordinated, safe, reliable and economically viable transmission system.

Despite the liberalisation of the electricity market, Cyprus' electricity market is still a monopolistic one. EAC is the only generator and supplier of electricity at the moment. Cyprus obtained a derogation regarding article 26(1) of the Second Electricity Directive for further liberalisation of the electricity market and delayed the opening up of the market for all non-domestic consumers until 31 December 2008.

The relevant rules and regulation for electricity trading consists of the Market Rules and the Trading and Settlement Rules. The Trading and Settlement Rules are prepared by the TSO in consultation with Trading and Settlement Rules Committee (made up of all stakeholders) and are approved by CERA and the Minister. These rules enable the TSO to fulfil its obligations and regulate the means by which participants may trade energy.

The Market Rules govern the mechanism prices and other terms and conditions and apply whenever authorisation holders purchase or sell electricity through arrangements operated by the TSO. The Market Rules aim to foster efficiency and competition in the purchase and sale of electricity through arrangements and are

binding on EAC and TSO, who are signatories to the trading and settlement framework agreement. There are no restrictions as to who may apply to the TSO to accede to the trading and settlement framework agreement that is approved by CERA.

Wholesale and balancing market

As prescribed by the Market Rules, bilateral energy contracts are concluded between the TSO and the market participants. A wholesale and a balancing market have been established by the Trading and Settlement Rules. The TSO will enter into appropriate purchase or sale contracts to achieve the required balance whenever there is an imbalance of net supply and demand in the market.

The Trading and Settlement Rules explain the balancing mechanism: the way each participant achieves energy balance and how the TSO will buy or sell energy to achieve minute-by-minute energy balance in the settlement period. Due to the absence of any competition, the wholesale market and balancing market cannot function yet.²⁹

Gate closure

The electricity market is based on bilateral agreements and, according to the Market Rules, the electricity producer has to notify the TSO of their planned production for all settlement periods of the following day. According to the Trading and Settlement Rules, after gate closure no updated bids or offers may be submitted.

C.2 Gas trading

There is currently no gas trading in Cyprus.

C.3 Introduction of EMIR and REMIT

Given the nascent stage of electricity trading and the absence of gas trading in Cyprus, the introduction of EMIR and REMIT is not likely to require any immediate changes to the current regime.

D. CLIMATE CHANGE AND SUSTAINABILITY

D.1 Climate change initiatives

Climate change mitigation initiatives commenced over the past few years include government promotion of hybrid and low emission vehicles and public transportation, construction of dedicated cycling lanes, recycling initiatives and expansion of green areas.

The most important initiative in this area has been the development of the national strategy for adapting to climate change. This strategy aims to strengthen and increase Cyprus' capacity to respond to climate change and its impacts, as well as identify the potential opportunities associated with this sector and formulate proposals for specific action in both the short and long-term.

The development of the national strategy for adaptation to climate change is a two stage process. Phase I (completed at the end of 2012) focused on the creation of a "knowledge base" in relation to the implications of climate change, the adaptation of strategic policy areas, combining policies to maximise successful adaptation and strengthening international cooperation in relation to adaptation.

Following the kick-off conference on climate change adaptation held in November 2011, Cyprus established working groups with the aim of adopting preliminary thematic reports.³⁰ These reports will form the basis of the Cypriot national strategy for adaptation to climate change.

Phase II consists of implementing and monitoring strategy, which began in 2013. The implementation is expected to be a long process, demanding the close cooperation of all parties involved.

Other programmes that have been implemented in Cyprus include CYPADAPT, which is within the framework of the EU Life+ initiative and deals with the development of a national strategy for adaptation to climate change and its implementation.³¹ The total cost of the programme is €1,358,847.00 with 50% of that cost being covered by the contributions of the Life+ initiative. Implementation of the program began in September 2011 and will last for 31 months until the end of March 2014.

EU Climate Change Package

Cyprus has not yet implemented all the components of the EU Climate Change Package (the "Package") which contains four directives, one regulation and one decision.

The Third EU ETS Directive concerning greenhouse gas emission allowances was implemented by Law 110(I) of 2011 (as amended), providing for the establishment of an advisory committee to assist authorities in the examination of applications and issuance of permits for the emission of greenhouse gases (and the terms under which such permits should be granted).

A draft bill is under review to incorporate the GHG Reduction Decision into national law.³²

With regards to the Renewable Energy Directive, Law 66(I)/2005 (as amended), which includes provisions relating to the use of biofuel and other renewable sources for transportation (in accordance with the provisions of Directive 2003/30/EC and Law 33(I)/2003 (as amended) provides for the promotion of renewable energy sources.

The CCS Directive was transposed into national law by Law 71(I)/2012, which contains provisions covering criteria used for the selection of storage spaces, the authorities responsible for the issuance of permits for storage and the obligations in relation to the storage of carbon dioxide.

The Biofuel Directive was transposed into national law by amending Law 148(I)/2003 which deals with the specifications of petrol, diesel and other fuels.

D.2 Emission trading

There is no separate emissions trading scheme in Cyprus, only the implementation of the New EU ETS Directive by Law 110(I)/2011 which created a framework for the licensing of 13 installations in Cyprus, responsible for around 58 per cent of Cyprus' emissions. This legislation sets out rules regarding the issue of greenhouse gas emission permits from all or part of the installations that fall within the scope of legislation. The authority which issues the permits is the Minister of Agriculture, Natural Resources and the Environment aided by a consulting committee and the Chief Inspector (as appointed by the Minister). Applications for emission permits may be submitted to the authorities by all interested parties and may be issued (upon such terms as provided by the legislation) by 30 April of each year. From 2013 onwards, 15% of the allowances shall be auctioned and the proceeds shall be used to deal with issues relating to climate change.

D.3 Carbon capture and storage

The CCS Directive was brought into Cyprus law by Law 71(I)/2012, which sets out the terms governing the application and issuance of storage permits. The Minister of Agriculture, Natural Resources and the Environment is responsible for enforcement of the relevant law. Despite developments in legislation, there are, as yet, no carbon capture and storage projects in Cyprus.

D.4 Renewable energy

Cyprus is totally dependent on imported oil for its energy supply, with a small but growing contribution from RES. A new law, for the Promotion of the Use of Energy from Renewable Sources, which came into force in November 2013, repealed the previous law and implemented the Renewable Energy Directive.³³ This law establishes a common framework for the promotion of energy from renewable sources by setting mandatory national targets for the overall share of energy from renewable sources and on transportation issues. It also lays down rules on the transfer of gas between Member States and the Republic of Cyprus and imposes an obligation to respect the sustainability criteria set out in the Petroleum and Fuels Standards Act 148(I)/2003 (as amended).

In accordance with the EU 20-20-20 initiative, the government promotes the use of renewable energy sources mainly by offering financial incentives to encourage their use. Cyprus uses renewable energy sources in the form of solar energy, wind energy, biomass, hydroelectric energy and geothermal energy.

In 2012, RES contributed 7.5% of total energy generation, a percentage that reached half the percentage required by 2015-16.³⁴ In order to meet the EU RES target, Cyprus' RES-generated energy must be 13% of total generation by 2020. Cyprus has already achieved its first (4.92% for 2011-2012) and second (5.93% for 2013-2014) indicative trajectory since the RES generated energy share of the gross final energy consumption was 6.8% in 2011.³⁵

In conforming to the provisions of the Renewable Energy Directive, Cyprus has adopted a new national renewable energy action plan that covers the period 2010-2020. This describes all measures to be taken in order to achieve the mandatory targets, including energy efficiency and energy saving measures. Particular reference should be made to the innovative measure of placing photovoltaic systems on rooftops of households with imputation systems of production-consumption, known as Net Metering, as well as the programme of auto-production using photovoltaic systems on commercial and industrial units for their own use.

To incentivise the use of RES, a special fund has been set up to subsidise or finance certain initiatives intended to promote the use of RES or energy saving, including the co-production of heat and electricity. The fund is managed by a commission that has an obligation to examine applications for the subsidising or financing of such initiatives. As proof of the production of electrical energy from RES, a certificate referred to as a source guarantee is issued on application by the interested producer. The application must be submitted to the authorised issuer in relation to the EAC or the electricity transmission system manager.³⁶

There is no green or white certificate trading system currently in place in Cyprus.

D.5 Biofuel

The Law on the Promotion of the Use of Biofuels and other Renewable Sources for Transport (66(I)/2005) (as amended) authorises the Council of Ministers to set the indicative targets for Cyprus in respect of biofuel and other renewable sources that are used in the market. The Minister of Commerce is responsible for providing suggestions to the Council of Ministers and a Consultation Committee provides assistance to the authorities. There are also provisions relating to the taxation of the import of biofuels and the obligations of producers and importers of biofuels.

The Law 111(I)/2013 has been adopted to implement the Biofuel Directive by amending law 148(I)/2003, the main law on the specifications of petroleum products and fuel. This amendment provides for the reduction of greenhouse gas emissions throughout their life-cycle and sets goals of such reductions. It also provides for a reporting and checking system of implementation of the criteria set by the law for such reductions. It authorises the MCIT to issue decrees in relation to the technical issues and specifications as provided in the legislation and the Council of Ministers to issue regulations that may cover any necessary issue that arises within the context of this legislation.

D.6 Energy efficiency

Cyprus has been quite active in promoting various energy efficiency initiatives in accordance with its second National Action Plan for Energy Efficiency launched in 2011. It has defined the basic categories in which saving energy is essential and these include the industrial sector, where the government encourages the use of equipment for regaining lost energy, the minimisation of loss of energy and the employment of technology in the area of IT systems dealing with energy management. A third National Energy Efficiency Action Plan should be launched before June 2014.

Cyprus' target for 2020 is to achieve an increase of 14.3% in energy savings in the projected primary energy consumption.³⁷ The Regulation of the Energy Performance of Buildings Act of 2006 (N. 2006) has been amended to implement Directive 2010/31/EU aimed at improving the energy efficiency of buildings and setting, inter alia, minimum requirements of energy efficiency of both existing and new buildings and the requirements of regular inspections of the heating systems of existing buildings.³⁸ In the domestic sector there have been initiatives to improve the thermal insulation of houses and the promotion of the use of energy efficient home appliances. A recent example is the proposal "Greece Cyprus 2007-2013" to provide project finance for energy efficient public buildings. The proposal has been approved and will receive €1.6 million for the energy upgrade of four public buildings in Cyprus.

In the transport sector there are initiatives to encourage the use of hybrid, electric and low CO₂ emission vehicles.

Other programmes that have been implemented in Cyprus include the setting up of a special fund for RES (under Law 33(I)/2003) which is used to sponsor funding for energy saving programmes and the set up of solar energy systems, wind energy farms and other renewable energy initiatives.

E. NUCLEAR ENERGY

There are no nuclear energy projects in Cyprus.

F. UPSTREAM

Cyprus is a frontier region and is at the early stages of the hydrocarbon exploration process. Therefore there is no production or exporting of hydrocarbons at this stage. In addition, Cyprus has an isolated energy system relying exclusively on imported petroleum.

The recent discoveries of substantial gas deposits and the ongoing exploration in Cyprus' EEZ show great potential for the future of the hydrocarbons sector in Cyprus, and may mark the transition from being a small importer country to a significant producer and exporter. The latest development is the announcement by the Cypriot government, Noble Energy and its partners Dellek Drilling and Avner Oil of the updated appraisal drilling results of Block 12. The updated figures show that the offshore field holds between 3.6 trillion cubic feet (tcf) to 6tcf of natural gas, proving that there are substantial recoverable quantities of natural gas in the Aphrodite field with important production capabilities. Additional appraisal activities to further refine the ultimate recoverable resources and optimise field development planning are ongoing.

It is expected that Cyprus will start producing its own gas from offshore Exploration Block 12 by 2019. The government has begun initiatives planning for the establishment of a natural gas liquefaction terminal, for the liquefaction and storage of natural gas and for the export of LNG by tankers to international markets. On 26 June 2013, Cyprus signed a Memorandum of Understanding ("MoU") for the liquefied natural gas ("LNG") plant with the three partners of Block 12, Noble Energy International Ltd, Delek Drilling Limited Partnership and Avner Oil Exploration Limited Partnership. The MoU defines the framework in which the negotiations will be conducted for the conclusion of a comprehensive agreement regarding the project's construction and operation.

On 8 August 2013, Cyprus signed a MoU with Israel and Greece in relation to matters concerning the energy sector, the environment and water resources. The three ministers expressed their support for the "EuroAsia Interconnector" project, connecting the electrical systems of the three countries via a subsea cable that will transfer energy with a total capacity of 2,000MW.

Legal and regulatory framework

The legal framework applies to the territorial waters, the continental shelf and the EEZ of Cyprus.³⁹

Currently Cyprus has the minimum legislation that is required by the EU. Hydrocarbon exploration and exploitation activities are governed by the Hydrocarbon (Prospection, Exploration and Exploitation) Law of 2007 (No.4(I)/2007) and the Hydrocarbon (Prospection, Exploration and Exploitation) Regulations of 2007 and 2009 (No.51/2007 and No.113/2009) reflecting Directive 94/22/EC on the conditions for granting and using authorisations for the prospection, exploration and production of hydrocarbons. These set the framework criteria as to the assessment of licence applications for the prospection, exploration and extraction of hydrocarbons in Cyprus' territory including its EEZ.

Other relevant EU legislation applies to oil and gas activities offshore Cyprus. In addition, Cyprus has ratified UNCLOS '82⁴⁰ and a number of agreements have been signed between Cyprus and its neighboring countries.⁴¹

Environmental protection, health and safety issues are subject to general Cypriot laws and regulations. The Ministry has carried out a Strategic Environmental Assessment ("SEA") in accordance with the EU Directive 2001/42/EC to identify, describe and evaluate the likely

significant effects of implementing hydrocarbon exploration and exploitation activities. The SEA binds the licensees to follow and comply with the results and recommendation of this assessment when conducting compulsory preliminary Environmental Impact Assessment work and study before exploration and exploitation activities.⁴² Every licensee shall ensure that hydrocarbon operations are conducted in an environmentally acceptable and safe manner, consistent with the environmental legislation and good international industry practice.

The Republic of Cyprus, represented by the MCIT, grants Hydrocarbon Exploration and subsequently Exploitation Licenses (upon a commercial hydrocarbon discovery during exploration) to applicants through licensing rounds. Successful applicants enter into an Exploration and Production Sharing Contract ("EPSC")⁴³ with the government, whereas ownership of hydrocarbons remain vested in the Republic.⁴⁴

The EPSC grants exclusive rights to the contractor to conduct hydrocarbons operations in the contract area at its sole risk, cost and expense and in accordance with applicable law and the terms and conditions set out therein⁴⁵. The Director of the Energy Service, representing the Minister, negotiates the terms and conditions of the EPSC.

The following licenses may be granted by the Council of Ministers:⁴⁶

- A Prospection Licence of up to one year, giving permission for prospection to identify geological structures and evaluate the offshore hydrocarbon potential using various geophysical techniques (excluding drilling).
- An Exploration Licence, granting exclusive rights to explore for hydrocarbons in the licensed area, for an initial period of three years with the possibility of renewal for up to two two-year terms (provided that the licensee has fulfilled all their obligations under the exploration term). After each term the licensee must relinquish at least 25% of the initial licensed area.
- An Exploitation Licence, granting authorisation to develop and produce hydrocarbons, as well as the storage and transportation of hydrocarbons to loading installations (excludes refinery), for a period of no more than 25 years. An Exploitation Licence may only be granted after the approval of a Development and Production Plan.

First licensing round

The first licensing round was held in 2007 and resulted in the granting of one hydrocarbon Exploration Licence to Noble Energy International Ltd Block 12 on 24 October 2008. A significant natural gas recovery was announced during exploration drilling and the appraisal process is anticipated to be completed by 2014.

Second licensing round

On 11 February 2012, the MCIT invited applications for the remaining 12 blocks in the EEZ. As a result, five agreements have been signed with ENI/KOGAS for exploration Blocks 2, 3 and 9 and with Total for exploration Blocks 10 and 11.⁴⁷ ENI/KOGAS and Total have entered into an EPSC with Cyprus and are planning to carry out extensive 2D and 3D seismic surveys by the beginning of 2014.⁴⁸ Based on data collected to date it is expected that they will proceed with drilling activities within the next three years.

Main terms of EPSC:

- Minimum exploration work program;⁴⁹
- Cost Oil/Gas recovery (up to a maximum percentage);⁵⁰
- Profit Oil/Gas sharing percentage (for oil according to production tiers and prices; for gas according to production tiers);⁵¹
- Signature and Production Bonus;⁵²
- Minimum Annual Trading Budget;⁵³
- Annual Surface fees;⁵⁴
- Performance guarantee; and
- Zero taxation.⁵⁵

Taxation

Contractors and subcontractors must comply with all applicable tax laws and regulations in force in Cyprus. There is no specific income tax regime for upstream activities in Cyprus under income tax law.⁵⁶

The applicable corporation tax is deemed to be included in Cyprus' share of profit oil and profit gas and therefore the portion of the available hydrocarbons that the operator or contractor is entitled to shall be net of corporation tax.⁵⁷

Cyprus enjoys an extensive network of double taxation treaties and, in combination with EU directives, aims at eliminating double taxation.⁵⁸

Decommissioning

At a national level, the EPSC⁵⁹ deals with any decommissioning issues and provides that the contractor is entirely responsible for proper decommissioning. A decommissioning plan⁶⁰ must be submitted to the MCIT no later than six years prior to the anticipated date of decommissioning. The MCIT may request for amendments to be made before reaching a mutually agreed final plan in accordance with best international petroleum industry practice. To secure these implementations, the government requests a reserve fund in order to approve the Development and Production Plan.⁶¹ Any excess remaining is vested in Cyprus and any excess needed will be borne exclusively by the Contractor.⁶²

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56. Income Tax Law (Law No.118(I)) 2002.
57. Ministry of Energy, Commerce Industry and Tourism, 2nd Licensing Round, The request for Clarifications Period ended on the 17th April 2012 (as per Clause 3.4 of the Guidance Note) 1, <www.mcit.gov.cy/mcit/mcit.nsf/All/696168A6A79E534FC22579B4003E6F10?OpenDocument20> accessed August 2013.
58. ESPC Art 29.
59. ESPC Art. 12.
60. ESPC Art. 12.1.
61. ESPC 12.4.
62. ESPC 12.5.

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