

EXECUTIVE SUMMARY

Brief project description and Interim Report Objective

The overall objective of the project focuses on the assessment of all possible scenarios/options regarding the future structure and ownership regime of the EAC. The restructuring process could involve up to three stages depending on the preferred option that is eventually chosen: (a) the **unbundling of EAC's operations** and the potential establishment of the legal entities (b) where applicable, the **appropriate corporatization of EAC activities or entities** and (c) the potential **subsequent privatization** of the company (-ies). In this sense, the restructuring of EAC will be designed and prepared taking into account, as well, the potential subsequent corporatization and privatization processes. This implies that the potential unbundled legal entities should be possible to be legally corporatized in full alignment with the Cyprus and EU legislation. Furthermore, the potential legally and functionally unbundled entities should be attractive for investors in order to maximize the benefits of privatizations in fiscal and strategic terms and enhance the competition in the energy market aiming at electricity cost reduction.

The present document comprises the Executive Summary of the Interim Report submitted on September 26, 2015, presenting the results of the completed Tasks 1, 2 and 3 and the intimal work carried out for Tasks 4, 5 and 6, as those are described in the Terms of Reference. More specifically, the **Interim Report** presents the scenarios formulated for the restructuring of EAC in line with Key Government Objectives and the conclusion on the most preferred scenarios. The proposed preferred scenarios will be subject to further assessment and refining from financial, privatization and legal/regulatory points of view through the work for Tasks 4 to 9.

Methodology and approach

The evaluation and prioritization of Key Government Objectives (KGOs) and their prioritization proposed by MECIT was the first step of the work. The proposed prioritization was considered, in general, as reasonable, however the Consultant proposed slight modifications, on the basis of his own assessment, which reduced the ranking levels, without however reversing the overall prioritisation order. The Consultant assessed and defined, as well, the main drivers towards the fulfilment of this KGO, which

are related to key features of and/or market characteristics emerging from the restructuring options for EAC.

In parallel, a series of scenarios have been formulated taking into account the requests of the ToR, reasonable assumptions for their feasibility and the need for adaptation to the Cyprus and EU legislative and energy framework, as well as to the agreements adopted by the GoC. Finally, 12 scenarios covering all reasonable evolutions of AEC restructuring were formulated and assessed further from the point of view of their anticipated contribution to the KGOs.

The Consultant adopted a Multi-Criteria Assessment (MCA) methodology for the assessment of the 12 scenarios and the selection of the preferable ones. To this end, a Significance Coefficient (SC) has been assigned to each KGO in line with its prioritisation order. On the other hand, each scenario was assigned a Score Mark reflecting its contribution in achieving each Key Government Objectives in comparison to the rest of the scenarios, taking into account, in qualitative terms, their effect of the aforementioned drivers for each KGO.

Two groups of scenarios were distinguished from this exercise: one group including scenarios based on the restructuring model of Vertically Integrated Utility and Independent System Operator (VIU/ISO) and one including scenarios which are based on the restructuring model of Ownership Unbundling (OU). Further to that one mostly preferred scenario for each group was concluded considering international best practice, market attractiveness and effectiveness and efficiency criteria.

Identification of drivers influencing the KGOs

In the context of the analysis of the Key Government Objectives, the Consultant has identified certain key drivers contributing to them which include:

- **Competition in the generation/supply segments.** The enhancement of competition in the generation and supply businesses contributes to enhancing security of supply by triggering new investments, minimizing the cost of electricity and contributing to reducing the environmental footprint of the electricity sector by investing in more efficient generation.
- **Capital availability.** The availability of capital ensures the realization of investments in the generation and transmission/distribution grids. Further, it is an essential aspect of security of supply and promotion of competition.
- **Facilitation of entrance of new investors.** The entrance of new actors in the electricity market is a prerequisite for the efficient functioning of the market, facilitates the introduction of natural gas in the electricity mix and eventually drives down electricity costs.
- **Effective unbundling of regulated activities.** The effective unbundling of networks activities in the electricity sector shall facilitate CERA towards securing transparency in the operation and the costs of the regulated activities. It is also

expected to influence favourably potential new investors as it enhances trust of investors in non-discriminatory operation, thus facilitating new investments, and competitive operation of the electricity market.

- **Efficient market operation.** The development of a competitive electricity market shall be a significant driver towards reducing electricity cost, and thus restructuring scenarios which facilitate development of competition shall contribute more towards the objective of reduced prices.
- **Privatisation of EAC/EAC's activities.** The privatisation of EAC/EAC's activities is evidently a pre-requisite for obtaining revenues for the Government.

Formulation of Scenarios and options

Twelve scenarios have been considered that reflect combined options for unbundling corporatization and privatization of EAC. The exercise towards identifying these scenarios was based on the initial scenarios requested by the ToR and the relevant regulatory, legal and economic analyses, which were carried out at this stage of project development. The 6 scenarios of them are based on the VIU/ISO model and the other six on the OU model. Table 1 presents the 12 scenarios, which will be finally assessed with the KGOs.

Table 1 The 12 formulated Scenarios for assessment

Scenario	Scenario Characteristics
Scenario 1-1-1	VIU/ISO, TSOC as today (pseudo ISO), EAC public VIU
Scenario 1-2-1	VIU/ISO, TSOC independent ISO, EAC public VIU
Scenario 1-2-2	VIU/ISO, TSOC independent ISO and separate DISCO, EAC public VIU
Scenario 1-3-1	VIU/ISO, TSOC independent ISO, majority private shareholding of EAC
Scenario 1-3-2	VIU/ISO, TSOC independent ISO, minority private shareholding of EAC
Scenario 1-3-3	VIU/ISO, TSOC independent ISO, minority private shareholding and management of EAC
Scenario 2-1-1	OU, EAC split to Single Network Co and G&S Co, Single Network Co and Generation/Supply Co under public control
Scenario 2-1-2	OU, EAC split to Single Network Co and G&S Co, public Single Network Co and privatization of Generation/Supply Co

Scenario 2-1-3	OU, EAC split to Single Network Co and G&S Co, privatization of Generation/ Supply Co and Single Network Co
Scenario 2-2-1	OU, Separate TRANSCO / DISCO, minority private shareholding and management of DISCO, TRANSCO and full privatization of Generation/Supply Co
Scenario 2-2-2	OU, Separate TRANSCO / DISCO, majority private shareholding of DISCO, TRANSCO and Generation/Supply Co
Scenario 2-2-3	OU, Separate TRANSCO/ DISCO, minority private shareholding of DISCO, TRANSCO and Generation/Supply Co

Each scenario was presented as belonging to scenario category, in which the necessary restructuring actions and the main unbundling, corporatization and privatization characteristics are presented. The approach of transformation of EAC to new entities was considered as the main tool towards unbundling and corporatization.

Scenario assessment

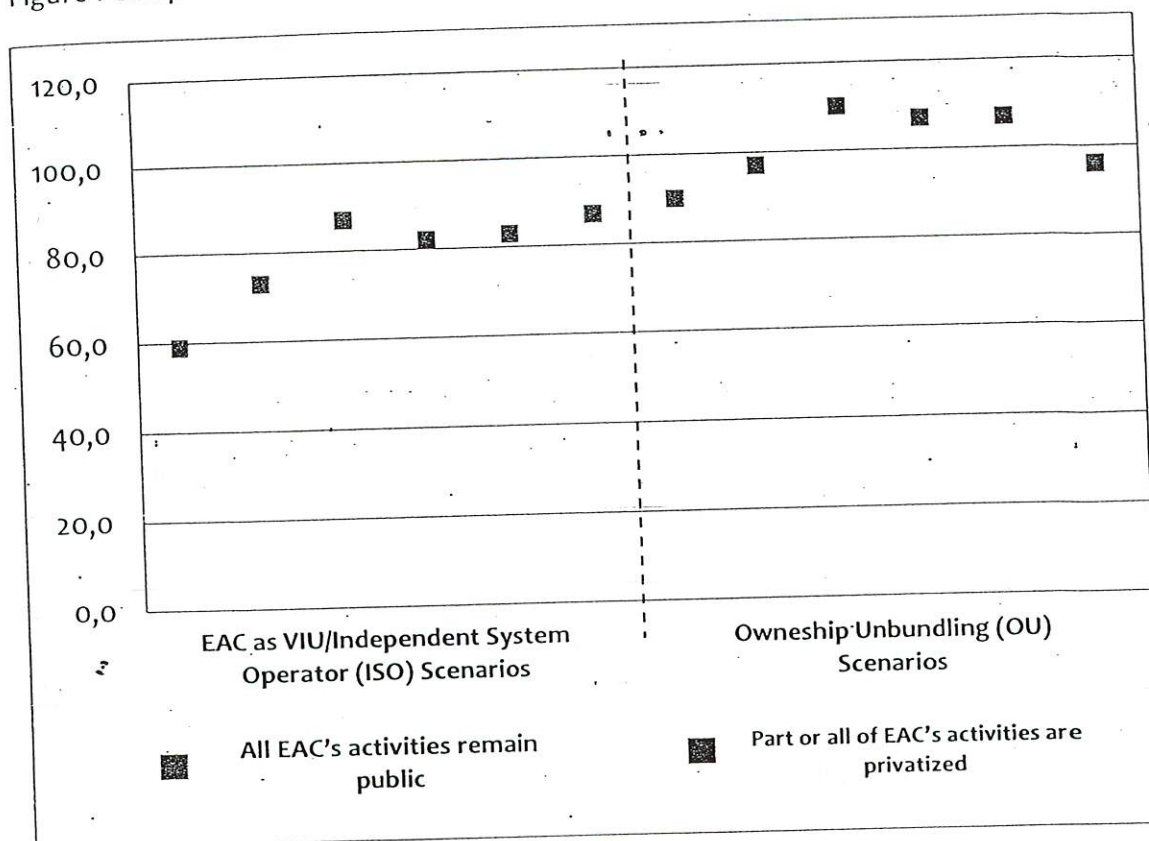
The Consultant assessed the 12 scenarios for compliance with the Key Government Objectives included in the ToR as ranked and analysed on the basis of appropriate drivers. In addition a series of sensitivity exercises took place to examine the robustness of the results achieved through the assessment exercise.

The main results are:

- > Overall, the Ownership Unbundling scenarios rank higher - under all cases - than VIU/ISO scenarios.
- > The group of Scenarios with Ownership Unbundling and privatisation are consistently ranking higher due to better performance in the drivers of competition, facilitation of new investors' entrance, efficient market operation, etc.
- > In the group of Scenarios with EAC remaining as a VIU and an independent ISO two scenarios rank higher than the other, due to the assumption of enhanced independence of DSO.

The ranking of scenarios according to the score achieved in serving the Key Governmental Objectives is presented in Figure 1.

Figure 1 Comparison of the scoring of ISO and OU scenarios



Preferred scenarios and recommendations

The Scenarios included as a first set of options to be examined the retention of the EAC as a Vertically Integrated Utility (VIU), but with appropriate accounting separation and functional unbundling in place for its five current functions, either under state control (Public Entity), or privatized (considering full privatisation, state majority, state majority but private management options). Furthermore, the Consultant examined Ownership Unbundling options for the appropriate and effective EAC restructuring into separate legal entities that may be subsequently privatized. Emphasis was placed that all Scenarios complied with the unbundling rules of the 3rd Energy Package, in particular the Independent System Operator Model (ISO) for the case of the EAC remaining vertically integrated, which is closer to the current structure of the Cyprus electricity sector, and the Ownership Unbundling model.

The evaluation and ranking of the Scenarios, on the basis of a Multi Criteria Assessment (MCA) with appropriate investigation for the robustness of its results, showed that in the case of the EAC as Vertically Integrated Undertaking the most preferred Scenario comprises:

- Implementing the ISO model for unbundling of the TSO and TSOC having its own personnel;

- › EAC establishing, as a subsidiary company, the Transmission Assets Owner to which it shall transfer the ownership of the transmission assets and the activities and personnel of its current Transmission Business Unit;
- › EAC creating, as well, a second subsidiary company that will perform the functions of its current Distribution Business Unit including the functions of the Distribution Network Operator (DSO).
- › Ownership of the distribution assets shall remain with the parent EAC.
- › Both new companies shall be functionally and accounting-wise unbundled from the competitive, activities (generation and supply) of the EAC in accordance with the respective provisions of the 3rd Energy Package.
- › EAC leasing the distribution network to its Distribution subsidiary and also concluding a protocol with the TSOC for the respective rights and obligations for EAC as owner and TSO as Operator of the transmission system.
- › Regarding ownership, the scenario foresees for the creation of a new EAC Company and transfer all assets and operations of EAC to this company.
- › The state to retain the majority of the EAC Company shares and the private investor to be involved in its management on the basis of an appropriate shareholders agreement.
- › Finally CERA, will certify and continuously monitor the independence of the ISO and the Transmission owner in accordance with the provisions of the EU Directive.

The **Ownership Unbundling preferred Scenario** that includes EAC restructuring not as a Vertically Integrated Undertaking, provides for:

- › Transferring of the Generation and Supply activities of the EAC to a new company, the GS Co;
- › Creation of "EAC Single Network Co", with three Business Units (BUs), the EAC DISCO (for the Distribution assets owner and operator), and EAC TRANSCO (Transmission assets owner and operator) and also a third BU to function as Market Operator and transfer of transmission and distribution assets to the new company.
- › Functional and accounting unbundling between the transmission and distribution activities is established, so the Ownership Unbundling model of the 3rd Energy Package is applied.
- › The preferred option for ownership is for the state to retain majority control in both the GS Co and the EAC Single networks Co and divest minority shares and management to the private sector, because with Government as the majority shareholder investors may view the business risk more favourably and accept a lower prospective return from a Minority Shareholding, particularly if they were given certain protections. In addition a minority shareholding would have a higher proportionate value and would allow Government to retain more of the proceeds.
- › The splitting of GS Co to two or more entities is an option, which might further contribute to electricity market opening.

The assessment of the two Scenarios concluded that while both scenarios ensure Security of Supply, provide revenue to the Government and electricity cost control for the consumers:

- › the **second Scenario is the overall preferred** due to the promotion of effective competition and for attracting investments from new entrants, generators and suppliers to the electricity market,
- › the first Scenario, where EAC remains vertically integrated utility, could be more favourable to investors considering the current privatization conditions.

In addition the second Scenario compared to other potential restructuring Scenarios of EAC presents the following advantages:

- › It implements in the **best possible way the unbundling** of the network activities as Ownership Unbundling is considered the most effective of the unbundling models, for the promotion of competition to the electricity market. It has the clear preference of the European Commission it reduces and simplifies the regulatory burden, as is also recognised by the regulators themselves (EREG)² and the academia.
- › An additional point to the detriment of system reliability under the ISO regime, is that separated transmission system ownership and operation reduces accountability, because responsibility for increasing failure rates, e.g. because of suboptimal investments in grid maintenance, cannot be attributed clearly¹.
- › The synergies and coordination between the TSO and DSO are facilitated, since they both function under the umbrella of the same company.
- › From the aspect of privatisation it offers to the GoC **maximum flexibility to design, organise and proceed with privatisations** in the electricity sector.
- › At the same time the **number of potential interested investors shall increase** in particular in comparison with privatisation of EAC as VIU, as potential investors with a lower budget for investments could be interested, as well as in specific sectors of the electricity industry, for example investors focused on regulated infrastructure as pension funds for the networks privatisation.

As a final remark, in particular considering that the wholesale market arrangements are not yet implemented and their efficiency tested under pragmatic market conditions, and the issue of gas introduction in the energy system of Cyprus, although close, is not finalized, privatizing generation should probably wait until the wholesale market has been established and the terms under which gas shall be sold to generators have been clarified, while **EAC restructuring to separate generation/supply from the networks activities should take place as early as possible.**

¹ Joskow and Tirole, "Competitive Electricity Markets and Sustainability" 2005, p. 259-262.