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## Georgia's Energy Sector

### Are We Prepared to Fulfil the AA Obligations?

#### POLICY BRIEF

#### Executive Summary

The EU-Georgia Association Agreement (AA) signed on 27 June 2014 envisages the implementation of EU energy directives and regulations (energy acquis) by Georgia. The specific timeframes and conditions for this implementation have been defined at the negotiations on Georgia's accession to the Energy Community (EnC). After a delay of two years, it is expected that Georgia will become a member of the EnC in October 2016. However, the full implementation of the EU energy acquis will likely be postponed for several more years. Meanwhile, the existing controversial legislative and contractual system will stay in place and, if the current practices persist, can degrade even further. This situation could create additional barriers to reforms and threaten the entire process of association.

This policy brief calls for the establishment of safeguards against the further deterioration of the legal framework in the energy sector and assurance that the new policies and agreements conform to the EU energy acquis. This should include the creation of internal government procedures, a multi-stakeholder group with the participation of civil society, parliamentary control and consulting with the Energy Community Secretariat to ensure the compliance of the new legal acts with the EU energy acquis. Building the capacity of public servants and CSOs in support of reform will be an important additional result of such a measure.

#### Introduction

By signing the Association Agreement with the EU on 27 June 2014, Georgia has undertaken to reform its energy sector and implement the EU energy acquis, with the terms and conditions to be negotiated under Georgia's Energy Community membership talks. After a long delay, the negotiations on EnC membership are now concluded and it is expected that Georgia will become a full member of the EnC in October 2016. However, it is likely that the crucial part of the reforms will be postponed for

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several years, leaving the existing substandard legislation and agreements essentially in place. If the current practices persist, the existing legal system may deteriorate further thus increasing the already significant threats to Georgia's energy security and economic development, and creating additional barriers to EU association.

## Risk Factors

The governance style in the sector is far from best industrial practices and principles of EU energy acquis. Moreover, it creates a body of problems preventing reform and affecting both the country's and consumers' interests.<sup>1</sup>

The legislative and institutional system regulating the energy sector is plagued by deficiencies, grey areas and inconsistencies allowing free interpretations, that have been created through numerous ad hoc amendments for one time solutions. Concentration of power with the ministry combined with poor legislation, absence of guidance from energy strategy<sup>2</sup> and lack of parliamentary control, allows the high level of arbitrariness in decisions and thus creates an environment prone to mistakes, corruption and/or collusion with external economic and political interest groups.

Indeed: The Georgian Government has already signed many controversial agreements and memoranda with hydropower developers that limit the competition and create financial risks to the country's budget. Even after signing the AA, tens of new MoUs have been signed that may contradict with anticipated reform; The long-term agreements with big utility companies, have resulted in market abuse, underinvestment, low quality of service and excessive spending by consumers. Frequent substandard changes in legislation have diverted strategic investors away from the sector and limited its development; Recent negotiations with Gasprom have raised serious concerns about the strategic direction of the country's energy security policy. Furthermore, the statements of top ministry officials indicate a lack of appreciation and readiness for reforms.<sup>3</sup>

Should this practice continue, reforms may become impossible and the country could drift away from the Association goals. Urgent action is needed to establish safeguards against the further deterioration of institutional and legal environment, to counteract the security, economic and financial risks and to limit the creation of additional obstacles to reforms in energy sector.

## How to avoid further slipping of the energy sector away from EU standards?

Should Georgia successfully join the EnC in October 2016, there will be an intermediate period of several years, when the existing legislation and current governance practices could remain in place. In this intermediate period, there is a danger of signing more memoranda, changing legislation and signing of new international treaties that may further create more barriers to reforms. Eventually the accumulation of these risks may lead to the practical inability of the country to implement the obligations under AA with all associated negative effects for

<sup>1</sup> As discussed on various fora and in publications before (seminars) and formulated in a book "Georgia's Energy Sector in the Context of EU Association" –WEG/ILI-AUNI 2015 Available at [www.weg.ge](http://www.weg.ge)

<sup>2</sup> The current draft being discussed by the ministry with experts is far from perfect and does not specify sufficient principles and criteria for guiding the policies in support of EU association (M.M.).

<sup>3</sup> Meeting of Energy Minister with NGOs of Gasprom negotiations - January 2016.

the country's economic and long-term political interests. The risk of populist and short-term fixes especially increases in the coming pre- and post-election period.

In order to keep Georgia's energy sector on the path of EU association in this intermediate period, the government, parliament, civil society and donor agencies should focus on the following main areas:

### 1. Hydropower development

Government resolution #214 of 2013 defines the procedures for construction of new power plants. It has replaced the previous resolution from 2008, but still allows subjective interpretation and an uneven treatment for different developers. More than 100 memoranda have been signed by the Ministry of Energy (Ministry) for the construction of more than 120 hydropower plants based on these procedures.<sup>4</sup> The conditions of these agreements vary widely, providing: the sales tariffs between 4.3 and 10.5 USC per kWh, the periods of guaranteed purchase by ESCO from 3 to 12 months, and different conditions for access to the export lines, so that the latter can be already overbooked several times.

The method of selecting investors has been quite liberal and real strategic investors are more of an exception rather than the rule. No sanctions have been applied to developers that have failed to develop the projects within the agreed timeframes and they still maintain the rights to develop Georgia's natural resource. This can be attributed partly to the government's desire to show a higher level of activity but also to the willingness to favour less qualified but better connected developers. This wide variety of conditions demonstrates the Ministry's selective approach and can be considered as a hint at collusion and corruption in the sector.<sup>5</sup>

These memoranda limit market competition, shift commercial risks from developers to the State, create a burden on the budget (limiting its future social spendings), and may lead to Georgian citizens paying an unnecessarily high cost for electricity. The government, following the serious concerns expressed by IFIs, has allegedly temporarily halted the issuance of new power purchase agreements. However, formally the process continues and currently there are 57 potential hydropower projects available for expression of interest listed on the Ministry of Energy's website.

If the deal making continues it will create additional groups interested in maintaining the status quo over reforms, and ultimately may lead to the country's practical default on implementation of the AA in the energy sector. The Georgian public may have already witnessed the effect as we saw little progress in the EnC negotiations over the last two years.

### Action needed

- Signing of new memoranda for construction of hydropower plants should be put on hold. The fact that there are already more than 100 such agreements in place

<sup>4</sup> Available at: Website of the Ministry of Energy [www.energy.gov.ge](http://www.energy.gov.ge)

<sup>5</sup> The study by Green Alternative available at: [http://greenalt.org/wp-content/uploads/2014/12/Risky\\_business\\_hydro-power\\_plant\\_constructi\\_on\\_in\\_Georgia.pdf](http://greenalt.org/wp-content/uploads/2014/12/Risky_business_hydro-power_plant_constructi_on_in_Georgia.pdf).

eliminates any urgency for signing any new ones. The opposite may be desirable only for those who want to acquire the right on land and water at favourable conditions for further brokerage, not for interests of public.

- A systematic review of the existing memoranda on HPP construction should be conducted. The positive and negative effects of the current system for the state and for the investors along with its compliance with the EU standards should be examined, and convincing conclusions and recommendations derived for improvement.

- A new system of issuing HPP permits should be established in compliance with international best practices, the EU energy acquis and Georgia's strategic interests.

## 2. Agreements with big utility companies

Since 2006, the long term concessions signed with the energy utility companies (RAO UES, Energo-Pro, SOCAR) operating in Georgia have created a questionable precedent of direct dealing between the government/ministry officials and the big utility companies, versus operating under transparent market conditions. Against good utility practices, the ministry has negotiated the long-term consumer tariffs and investment obligations with the owners of utilities that were subsequently simply rubberstamped by the Regulator. The MoUs with RAO UES and Energo-Pro contradict the principles of a competitive energy market and sound regulation, and according to sector experts, have resulted in a shortage of investment, poor quality of service and excessive payments by consumers.<sup>6</sup>

In 2013 these agreements were renegotiated by the Ministry to comply with the pre-election promises. The residential tariffs were reduced at the expense of investment obligations and have resulted in financial difficulties for the whole sector. This was an example of pursuing short-term political gains to the detriment of long-term interests. Now the MoU with RAO UES is one of the obstacles in the way of implementing the third energy package in accordance with the AA.

In order to prevent the creation of additional barriers to the implementation of the AA, government should refrain from signing any similar MoUs with potential market players, especially in pre-election period and post-election periods.

## Action needed

All new potential agreements should undergo a check for compliance with the EU energy acquis and with the anticipated model of the energy market. Any agreements fixing long-term tariffs, preferential rights and contradicting the principles of unbundling, competition and sound regulation should be avoided.

## 3. Legislative changes

The quality of Georgian energy legislation has been criticised on many occasions and still remains a major problem. One time ad hoc changes resulting from short-

<sup>6</sup> The excess revenue received by JSC Telasi in comparison with the conditions of the initial Telasi investor agreement, from 2006 through 2013 was about 330 million Lari. Available at: <http://weg.ge/wp-content/uploads/2012/12/article-electricity-tariffs-eng.pdf>

term specific needs have become a rule. 16 amendments were introduced in the last three years to the Electricity and Natural Gas Law alone, not to mention the numerous changes to electricity market rules. More often than not, these amendments are superficial quick fixes to concrete problems or needs, not harmonized with the whole logic of energy sector needs. For example, a recent controversial amendment obliged hydropower exporters to pay for the new thermal plant capacity as part of guaranteed capacity requirements and by providing a corresponding surcharge for export virtually blocked it.

The poor quality unstable legislation undermines the operational conditions for investors and thus increases the cost of sector development to the country. Most of these changes drive Georgia's legal system away from the EU energy acquis and make reform more difficult. This practice should be restricted as more questionable amendments may be initiated in the pre- and post-election periods for populist or short-term goals.

### Action needed

Legislative changes and changes in market rules should be scrutinised and brought into conformity with the principles of the third package and anticipated competitive model of the electricity and gas markets. Any agreements fixing long-term tariffs, preferential rights and contradicting the principles of unbundling, competition and sound regulation should be avoided.

## 4. International agreements

Georgia is surrounded by strong neighbours pursuing their own interests not necessarily coinciding with the interests of Georgia's Western development. In the absence of a sound energy strategy, analytical support and effective parliamentary control, there is a danger of entering into new international agreements that can create additional obstacles to energy reform and potentially harm the EU association process by changing the energy policy priorities. For example it should be ensured that the discussed North-South energy cooperation between Russia, Georgia, Armenia and Iran will not interfere with the traditional East-West direction involving Turkey, Georgia and Azerbaijan and potentially Turkmenistan. Any new international agreements should be signed with caution and with account of these factors.

Arguably, there is an interest from Gazprom to enter Georgia's gas market. This entry should be handled carefully and in a controllable way that would not become an additional barrier to EU Association.

### Action needed

International treaties and MoUs should be cautiously brought in line with Georgia's energy security interests, EnC membership criteria and the priority of Western

Transit to ensure compliance with EU association goals. To promote informed and rational decision-making, a robust energy strategy should be developed based on a professional process accounting for current realities and providing guidance for decision-making.

### 5. On-going work for sector reform

Along with deficiencies in energy policy there are on-going efforts to improve certain components of the legal and institutional environment. International donors and financial institutions support on-going work to bring the Georgian energy sector closer to international standards and the EU energy acquis. This includes designing the electricity market model (USAID/Deloitte), developing new regulation methods in electricity and natural gas (EU/E-Control) and promoting energy efficiency (EBRD/ECO/VTT) etc. The country's internal sector efforts for planning (Ten Year Network Development Plan<sup>7</sup>) and strategy development (Ministry of Energy – in process) have created a positive precedent that needs to be improved further and brought in line with international standards.

### Action needed

The on-going projects focused on developing the electricity market model as well as new regulations by GNERC and the development of other documents in compliance with the EU energy acquis should be supported with an emphasis on capacity building of government, sector and nongovernment actors. IFIs should be more closely involved in discussing, monitoring and commenting on new legal acts and cases of special interest – e.g. assurance of budget solvency vs new guaranteed PPAs. The support of the Energy Community Secretariat should be sought for sharing the experience of other EnC member states.

### Conclusion

Until recently, the focus of official energy policies has been on building as many HPPs and other infrastructure as possible and addressing short term immediate problems with less regard to economic realities and EU association interests. Within the existing legal framework plagued by grey areas and allowing individual dealings, this process has resulted in excessive state obligations, unwarranted concessions to potential developers and non-competitive agreements now comprising a body of barriers to reform. This was accompanied by the further deterioration of substandard energy legislation and largely failed to attract qualified strategic investors. This environment has allegedly fostered collusion and created interest groups concerned with preserving the status-quo and deferring the reforms.

The situation was made possible by a lack of qualified control and oversight from the high levels of the government, from parliament and the public, whose demands have been focused mostly on short-term gains, unjustified tariff reductions

<sup>7</sup> Available at: [http://www.gse.com.ge/new/wp-content/uploads/2015/05/TYNDP\\_GE\\_2015-2025\\_ENG.pdf](http://www.gse.com.ge/new/wp-content/uploads/2015/05/TYNDP_GE_2015-2025_ENG.pdf)

and superficial reporting of successes in the sector. It was further aggravated by absence of a sound energy sector strategy, insufficient motivation and capacity of policymakers and by influence of interest groups looking for easy gains in the hydropower business or involving Georgia in binding long term international agreements.

This practice is both unsustainable and does not conform with the country's long-term strategic interests or EU association goals. It is necessary to urgently mobilise all stakeholders interested in energy reform and to reverse this trend.

A procedure with the participation of all qualified stakeholders should be established to assure the conformity of energy policies with good industry practices, the EU association goals and the country's long-term strategic interests.

## Recommendations

The following main steps should be undertaken in the short term:

1. The system of compliance with the requirements of EU association should start at the level of the Ministry of Energy, where internal checks and controls for compliance of the potential agreements should be established. A ministerial order should define internal procedure and departments responsible for compliance of policies with the EU energy acquis. The minister or his deputy should be tasked with the oversight of compliance with the EU energy acquis.<sup>8</sup> The regulator should be involved as a guarantor of long-term stability and compliance.
2. The peer reviewing of legislation changes and government agreements by Energy Community should be included as a necessary procedure for submission of the new pieces of legislation to parliament.
3. A multi-stakeholder monitoring group with the participation of the state, non-state actors and international actors should be established for monitoring new potential international agreements and legislation changes. The state minister for European integration and his staff should be involved in organising this group and coordinating its activities.

The above course of action can assure the consistency of policies with the EU Association Agreement in the energy sector, provide necessary capacity building and assure public support for the reforms and the country's development. The most important part is the creation of a monitoring mechanism and dialogue on energy reform through a multi-stakeholder group which is the main recommendation of this paper.

<sup>8</sup> As done in Ukraine, according to personal communication with Ukrainian think-tanks

