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Hydrocarbon Transit Revenue Transparency in Georgia



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FOREWORD

Owing to the country's dependence on energy imports, essential aspect of Georgia's energy policies are linked up to the transit of gas and oil and benefits derived from such. In what follows, is a report on the prospects of introduction of the energy transit revenue transparency initiative in Georgia.

Report covers the following: 1) a concise synopsis of the State bodies that are in charge of the Georgian energy sector; 2) Brief analysis of legal regime relevant to oil and gas transportation, distribution and supply; 3) Assessment of Legislation directly or indirectly affecting the realization of the Transit Revenue Transparency Initiative; 4) Examination of rules that are directly applicable to the administrative peculiarities of sector operation.

The underlying objective of this exercise is to identify and assess any stumbling blocks that could hinder Project implementation and set out concrete recommendations for any amendment of the legislation currently in force that may possibly fill in the existing gap.

OVERVIEW OF GEORGIA'S ENERGY SECTOR

Georgia, not an oil and gas producer of significance itself, provides an important part of the land corridor along which major volumes of Caspian oil and gas are transported in transit to European and Mediterranean markets. In respect of the principles of international energy sector governance, Georgia is a member of the Energy Charter Treaty and the World Trade Organization that set important international standards in rule of law and international commerce in the energy sector. The Government of Georgia has introduced a comprehensive energy policy whose main directions, objectives and instruments have been condensed in an important document, which was approved by the Georgian Parliament in June 2007¹. Although this policy document was largely concerned with the power sector², it is also related to achieving self-sufficiency in primary energy, creating the foundation of competitive and investor-friendly national energy market and establishing the country as an important node of energy transit and connecting routes. It is further intended to promote energy efficiency, security of supply (particularly in respect of electricity and gas), market restructuring (including third party access to networks), deregulation and liberalization, implementation of basic market and privatization prerequisites (metering, cost-reflective tariffs, settlement of debts, enforcement of power and gas market rules), facilitation of investment and enhancement of bilateral and regional collaboration in the energy sector. For the purposes of this study it is noteworthy that one of the tenets of the national natural gas strategy has been the construction of new transmission infrastructure for natural gas as well the promotion of arrangement of underground and above ground storage facilities for energy carriers³.

1 Main Directions of the State Energy Policy of Georgia, April 2006, approved by a resolution of the Georgian Parliament on June 7, 2007.

2 In this regard, it has defined the main goal of the entire energy sector as the full coverage of electricity demand, the achievement of “economic independence and stability of the power sector” and the assurance of technical, economical and political security via the best use of the power sector resources and the diversification of imports. All these resulting in revenue generation and state dividend.

3 *ibid.* Article 2.2, item 9. 5 Its activities are governed by the Georgian Constitution, international agreements ratified by Georgia, other standard laws and the “Charter of the Ministry of Energy of Georgia”, which was approved by the Georgian Government in March 17, 2005.

IMPLEMENTATION OF ENERGY POLICY AND REGULATORY SUPERVISION

MINISTRY OF ENERGY OF GEORGIA

The Ministry of Energy of Georgia is the central executive body that carries out the State policy and regulation in the industry and fuel-energy complex. The industry and fuel-energy complex consists of independent state owned entities and individual proprietors that carry out activities in the fields of mining, processing, production, supply and distribution of electric and thermal energy. Following the enactment of the Law on Electricity and Natural Gas of 1999, this Ministry, which operates under the Law on the Structure of the Government of Georgia (11.02.04), has relinquished its ownership, regulatory and operational rights in the natural gas (and electricity) sector and has only certain regulatory functions and rights. Its main remit is to establish the main directions of and awarding of tenders and auctions and the preparation of contracts, negotiations and signing of hydrocarbons exploration and production agreements on behalf of the State. It also issues licenses for oil and gas operations to investors on behalf of the State and as well approves and issues all necessary authorizations, allotments, and permits. It is further responsible for supervising the implementation of licensing terms and conditions and for issuing normative acts required to establish a clear, stable, non-discriminatory, market-oriented and effective legal and regulatory framework for the performance of oil and gas operations. However, nothing related to the transit arrangements or revenues generated thereof except as: “to promote cooperation between licensees, importers and exporters, suppliers and electricity and natural sector entities in foreign countries and to support transit and import/export relations in the electricity and natural gas sectors;”

The Ministry of Energy is tasked with the mission to develop a state policy in the energy sector, to secure its implementation and to create and adopt the legal framework for the whole energy sector⁴. It also makes decisions on energy deregulation based on the approved State energy policy and is responsible for promoting efficient uses of energy and for ensuring the operation of competitive markets. As regards the gas sector, the Ministry is also in charge of tariff policy for internal energy markets (including the retail and wholesale tariff policies for natural gas) and approves, subject to public hearings, the Natural Gas Market Rules that regulate commercial relations for gas trade within Georgia including the transit arrangements. It further issues certain normative-administrative legal acts, which have policy content⁵. For the detailed list of functions and rights, please refer to the Attachment 1.

MINISTRY OF FINANCE OF GEORGIA

The Ministry of Finance of Georgia represents a body of executive branch, established in accordance with the Constitution of Georgia and the Law of Georgia “On Georgian Government Structure, Authorities and Activities Guidelines”, which ex-

4 The Ministry “sets” those policies by proposing a state energy policy to the Parliament; if approved, then the Ministry secures the implementation of any such policy.

5 In the natural gas sector context, these are:

- the Natural Gas Balance;
- the Natural Gas Market Rules; and
- the Rules of Installation and Operation of Energy Facilities and other Technical Equipment.

This list goes without explicit mentioning of transit arrangements.

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executes management in the financial-budgetary, tax and customs areas; provides for abidance by tax and customs laws on the territory of Georgia and exercises control over their execution; carries out preventive and operative- preventive, inquiry and preliminary investigation activities in the area of economic crimes. Activities of the Ministry of Finance shall be guided by the Constitution of Georgia, International Treaties and Agreements, the Law of Georgia “On Georgian Government Structure, Authorities and Activities Guidelines”, the Law “On Budget System of Georgia”, Tax and Customs Codes, the Law “On Financial Police”, other legislative acts, Presidential Decrees, Resolutions, Government Resolutions and other legal acts. In carrying out its functions the Ministry represents the State. The Ministry shall be accountable to the Government and executive tasks, provided by the Law and the Prime Minister.

The Tax Department represents one of the state institutional agencies of the Ministry of Finance and is the centralized system, consisting of tax inspectorates; the Excise Taxpayers’ Inspectorate is one of them. It is notable, that Tax department is directly involved and bears an administrative function in relation to the state transit of oil and Gas thru BTC and SCP pipeline correspondingly, however the railway transit and other pipeline transit are either monetized by operator companies and paid in indirect tax payments or are accumulated within the companies and are later released as state designated dividend.

GNERC

On the regulatory front, the Georgian National Energy and Water Supply Regulatory Commission (GNEWSRC) have been entrusted with the function of regulation in the spheres of transportation (transmission), distribution and supply of natural gas. GNEWSRC is tasked with establishing the licensing rules for natural gas supply, transportation and distribution, as well as for the granting, suspension and annulment of licenses; it is also responsible for fixing prices for gas imports and exports, setting transportation, distribution, wholesale and retail tariffs for the gas sector and for resolving disputes among market participants as well as ensuring compliance to the established rules⁶. GNEWSRC has the status of an independent regulatory authority having full financial independence from the government in its decision-making process as well as in the implementation of any legal activity within the bounds of its competences⁷.

NATIONAL AGENCY FOR OIL AND GAS

The National Agency for Oil and Gas (NAOG), which is now part of the Ministry of Energy, is entrusted with the state management of oil and gas operations and oil refining, gas processing or transportation activities. This Agency is assigned a wide variety of functions that are stipulated in the Oil and Gas Law of 1999. These, among other things¹², include the organization, performance and awarding of tenders and auctions and the preparation of contracts, negotiations and signing of hydrocarbons exploration and production agreements on behalf of the State. It also issues licenses for oil and gas

⁶ See Law on Electricity and Natural Gas, Article 4.5.

⁷ See the Law on the National Independent Regulatory Bodies of 2002. See also Articles 5-21 of the Law on Electricity and Natural Gas.

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operations to investors on behalf of the State and as well approves and issues all necessary authorizations, allotments, and permits. It is further responsible for supervising the implementation of licensing terms and conditions and for issuing normative acts required to establish a clear, stable, non-discriminatory, market-oriented and effective legal and regulatory framework for the performance of oil and gas operations. The law also stipulates that NAOG shall oversee the transit related tariff policy; however we don't see such in practice⁸.

GOGC

The State involvement in the domestic energy sector is ensured through the Georgian Oil and Gas Corporation (GOGC), which is the integrated national gas and oil company involved in upstream exploration, development and production, gas transport as well as transit fee management, whose stock is 100% government owned. The company was established in April 2006 by order of the Georgian Minister of Economic Development in the form of a Joint Stock Company following the merger of the Georgian International Gas Corporation (GIGC), the Georgian International Oil Corporation (GIOG) and the Georgian National Oil Company ("Saknavtobi"), each of which earlier performed different tasks and responsibilities on behalf of the Georgian government in the domestic energy sector.

The rationale behind bringing together under the umbrella of the new holding company of GIGC, GIOG and GNOC primarily purported the improvement of the coordination of natural gas supplies to Georgia, since each of these companies has contracts for gas supply from different sources (GIGC from Gazprom, GIOG from the Shakh Deniz field in Azerbaijan, and GNOC from domestic sources where it supervises oil and gas production). In particular, GIGC owned and operated the medium and high pressure gas pipeline network in Georgia, and handled domestic transportation as well as the gas transit to Armenia. The GIOG represented the Government of Georgia in all Caspian oil and gas transportation projects passing through the territory of Georgia. The GNOC represented the State in all production sharing agreements, served as the State's commercial agent in securing receipt of the state's share of oil and gas, monetizing it and transferring the taxes to the state budget; it was also a player in the upstream field and held several exploration and production licenses itself.

GOGC's activities are chiefly centered on the gas (and oil) exploration and production sector where its functions include, inter alia, to partake in the preparation of gas (and oil) contracts (Production Sharing Agreements, etc.)⁹, to take over and deal in the government's share of oil production in such contracts and to set up coordination committees in cooperation with the investors for the purposes of overseeing and administrating commercial and operational issues related to such contracts. It is also in possession of most, if not all, geological, geophysical, production and other information needed to evaluate and manage oil and gas prospects and projects and operates few fields on "grandfathered" terms.

In the gas transportation sector GOGC, through its subsidiary Gas Transportation Company, is in custody of the entire main gas pipeline transmission system and it is also entrusted with its operation, maintenance, rehabilitation as well as the con-

⁸ Refer to the Attachment 2 for detailed list of functions and rights

⁹ Its functions for oil (and gas) exploration and production activities are fully elucidated in Article 9 of the Oil and Gas Law of 2006.

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struction and operation of new infrastructure¹⁰. It also represents the Government of Georgia in the agreements for gas transit from Russia to Armenia via the North South Caucasus Pipeline and gas transit from Azerbaijan to Turkey via the South Caucasus Pipeline. In addition, it is in charge of storing, preparing, refining and recycling oil and gas resources and end-products both within and outside the Georgian territory. Finally, it conducts extensive commercial operations in the gas distribution and retail sectors.

GEORGIAN RAILWAY LLC

The railway assets of Georgia were formed into the new 100% government owned company The Georgian Railway LLC, which operates under the public law of the Enterprise Management Agency, part of the Ministry of Economic Development.

Georgian Railway LLC and its subsidiaries comprise Georgian limited liability companies as defined in the Civil Code of Georgia. The Company was established as a state-owned enterprise in December 1998 by the Decree of President of Georgia # 929 as an entity engaged in the provision of railway transportation services in Georgia. The Group's principal activity is the operation of a nationwide railway system providing freight and passenger transportation services, maintenance and development of railway infrastructure and construction of railway lines within Georgia. The Group is wholly owned by the State of Georgia represented by the State Enterprise Management Agency of the Ministry of Economic Development of Georgia.

COMPANIES INVOLVED IN OIL AND GAS EXPLORATION: TAX REGIME AND RELATED TRANSPARENCY ISSUES

Before any specific transit arrangement is analyzed hereof, it serves illustrative purpose to discuss oil and gas production rather than transportation in relation to the taxable activities and state role in tax administration:

For the companies that operate under PSA¹¹ agreements, typically, taxable income is calculated in accordance with internationally accepted practices in the petroleum industry rather than in accordance with Georgian statutory accounting procedures. Operating losses incurred by an entity investing in hydrocarbon search during the period of preliminary exploration may be carried forward indefinitely and are subject to offset once production starts.

With respect to accounting, financial results of activities under more than one production-sharing agreement may be consolidated and accounts may be kept in US dollars. On the other hand, any activities that are not connected with hydrocarbon business in Georgia and/or relevant contract areas are deemed to be outside the scope of production

¹⁰ The sole exception involves the South Caucasus Pipeline, which is privately operated

¹¹ PSA stands for Production Sharing Agreement. A contract, which assigns to an investor the exclusive right to conduct oil operations in a defined onshore and/or offshore area, on the grounds of compensatory relations within a certain period of time.

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sharing contracts and the related protocol tax regime. In the event that a company is engaged in both hydrocarbon related activities and unrelated activities, separate accounting books in accordance with statutory rules must be maintained to reflect income and loss generated from non-production sharing contract activities.

Generally, foreign subcontractors are exempt from all forms of taxation at the corporate level other than income tax withholding at the source of payment. A production sharing agreement usually stipulates that non-resident subcontractors are subject to no taxes, duties or levies other than a single tax withheld at the employees. The agreements also contain clauses stipulating for protection against future increases in the effective profit tax rate.

As regards to the accounting requirements, foreign subcontractors engaged only in hydrocarbon activities related to a production sharing agreement are not required to maintain statutory books and records. Foreign subcontractors conducting business activity outside of the oil consortia regime are subject to domestic taxation and are required to maintain statutory accounting records and to file all required tax reports in compliance with the statutory tax regime.

The employees of the investing entity and of sub-contractors remain subject to all payroll taxes. Hence, all employees are subject to personal income tax. Foreign employees qualify for relief from income tax under any applicable double tax treaty that is in force.

NATURAL GAS TRANSPORTATION

The transport of natural gas is primarily undertaken through the national main gas pipeline network, which includes the high-pressure trunk lines, the compressor stations, a number of gas metering/regulation stations, and other facilities that operate, or are designed to operate at or above 1.2 MPa pressure¹². The owner of the main transmission system is the Georgian Oil and Gas Corporation (GOGC), which through its subsidiary, Georgian Gas Transportation Company, also is in charge of the system's operations, maintenance and rehabilitation¹³. It is further in charge of constructing, developing and operating any new pipeline infrastructure of the main transmission system. The GOGC also represents the Government of Georgia in the agreements for gas transit via the South Caucasus Pipeline that is privately operated and which transports Azeri gas to Turkey through Georgia in return for an in-kind transit fee¹⁴.

The provision of transportation and transit services requires the granting of a transportation licence, which is issued by the Georgian National Energy and Water Supply Regulatory Commission (GNEWSRC)¹⁵. In particular, under the Law on Electricity and Gas, when there is a need for a new pipeline, the applicants should apply for a

¹² Law on Electricity and Gas, Article 2.(v).

¹³ As mentioned before, Prior to the creation of the GOGC, the main gas pipeline system was operated and maintained by the Gas Transportation Company, which was established in 1999 as an affiliate of the Georgian Gas International Corporation.

¹⁴ The associated gas contracts for this pipeline do not have any destination clauses and re-export restrictions, thereby enabling its operators to act as feeder line for the pipelines linking Turkey and Europe (the Turkey-Greece-Italy line and, perhaps, later Nabucco).

¹⁵ Law on Electricity and Gas, Article 40.1.

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transportation license or, in case such a license already exists, the modification of the existing license. If - after careful consideration of the issue – the GNEWSRC is of the opinion that a new pipeline is necessary, in compliance with State policy and the requirements laid down by the relevant laws, it makes a decision on issuing a new or modified transportation license. The granting of such a license authorizes the successful applicant to construct a new pipeline or other related facility along an approved route and to utilize the lands required for such a construction¹⁶. A transportation license is issued for a designated term during which its holder is subject to certain duties, including the obligation:

- ▶ to fulfill in time a supplier's instructions for natural gas supply, cut off or re-supply;
- ▶ to comply with safety standards and follow safety rules; to keep operational the natural gas system connected to the system of neighboring countries;
- ▶ to design and operate the system in such manner so as to ensure the sustainability of the natural gas distribution system in the event that one or more than one of the facilities are out of operation as a result of natural disaster, sabotage, emergency situation or other circumstances;
- ▶ to safeguard that gas volumes will be distributed fairly according to respective necessity in any case of gas shortages; and
- ▶ to ensure that gas volumes are provided to customers who produce electricity by using natural gas as a fuel.

As regards the access regime to the natural gas transmission network, a regulated access system has been adopted whereby the operator of the network to which a customer requests access is obliged to grant such access on the basis of the general network terms and conditions and tariffs that have been set by the GNEWSRC. The methodology is based on the principle of recovery of reasonable costs for natural gas supply transportation and distribution, but it does not stipulate what the asset base is to apply such tariffs for example whether such tariffs are based on optimized replacement costs or on historical cost.

The general principles for tariff setting as well as the relevant procedures and the terms and conditions relating to the initiation of tariffs are elucidated in Article 43 of the Law on Electricity and Gas. These general principles include:

- ▶ the prevention of monopolistic practices;
- ▶ cost-reflectiveness and assurance of a reasonable rate on return (including the attraction of new investment);
- ▶ the reasonable use of funds by licensees, importers and suppliers for maintenance, management and compliance to the license terms;

¹⁶ Of course, in order to construct and operate a natural gas transportation pipeline, a construction permit must be obtained coupled with relevant authorizations from the Ministry of Environment and Protection of Natural Resources.

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- ▶ the possibility to discontinue service in case of non-payment;
- ▶ price and tariff differentiation by groups of consumers, daily and seasonal variations of demand and other factors;
- ▶ and individual direct consumption tariffs for consumers of this type.

REGULATORY AND INSTITUTIONAL FRAMEWORK FOR REVENUE DISCLOSURE

It is a challenge indeed to consider regulatory and institutional framework pertaining to energy transit activities. In this respect, the approach is to focus on setting out the key legislative areas that need to be considered when establishing the rules that govern the conduct of hydrocarbon transportation related activities. To this effect, three main themes are considered:

- ▶ Existence of the associated infrastructure and means of transportation;
- ▶ Regulation of natural gas and oil transportation as a distinct activity in the energy supply chain; and
- ▶ Transparency concerns related to the rules for operation, contract management and administration.

WAYS TO COVER UP

Some energy companies attempt to funnel profits through offshore accounts and well-known havens for “confidential funds” or to intermediary firms that bring no added value to the venture. Cyprus, Lichtenstein, and other offshore banking centers are favorite locations for intermediary companies engaged in the energy business of the yet to be developed Central Asian, Russian and Caucus regions. Significant number of such offshore “energy ventures” are less likely to bear corporate spirit that adds transparency to business transactions. Even though it is wrong to assume that all of those firms are money-laundering vehicles, many of them do appear to have been established for that reason alone.

In the past 30 years, significant strides have been made in the West toward bringing greater transparency to business transactions, through better accounting and reporting. The Organization for Economic Co-operation and Development (OECD) rules regarding bribing of foreign officials is generally adhered to by member states. Some countries have also adopted tough national laws and enforcement mechanisms to punish firms involved in corrupt business operations. The U.S. Foreign Corrupt Practices Act (FCPA) has forced most American energy firms to adhere to transparent and standardized accounting and business procedures. Although, it has to be mentioned that in the most developing countries The World Bank has attempted, unsuccessfully, to break the link between high energy revenues and governmental corruption¹⁷.

17 ‘Russia and European energy security: divide and dominate’ By Keith C. Smith

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TECHNICAL AND ORGANIZATIONAL FEASIBILITY

A problem with organizational arrangement exists obviously. It should be stressed that there was a general perspective that the scheme is politically driven by different circles of government and society. Although the principles of direct disclosure and maximum transparency are apparent, some logical processes are still not clear since the general guidance is vague and formal regulations are not in place. Benefits of disclosure of revenues streams from transit undoubtedly contributes to the overall transparency, however the cost of administrating the scheme is a recognized problem.

ACCEPTABILITY – THE CRUCIAL ROLE OF THE ‘REGIONAL APPROACH’

Had a single regional authority with appropriate legal powers existed, and been in a position to approach revenue collection and distribution with fully implemented disclosure procedures, the neighboring local authorities would have had greater direct draw to such practice and would have been less likely to oppose it.

Although the disclosure schemes (their introduction and application to the real life) are usually blocked at their initial stages of introduction or in some better cases are postponed for the days to come, stronger support across the region might well help to build a more effective campaign in favor of the initiative, and ensure wider media and political support.

Though the terms **Transparency and acceptability** are often used in pairs and fittingly with each other, the two concepts are distinct. Transparency relates to how individuals or other agents fair relative to each other. Acceptability concerns approval or disapproval. A revenue tax on identical stakeholders in hydrocarbon transit arrangements may be considered equitably transparent but unacceptable. Conversely, a policy that confers small benefits on most people while concentrating the costs on a few may be considered unacceptable by such due to administrative hassle or simply a cost burden.

Therefore, involvement of general constituency in the induction of a policy is important for implementation of that policy. This is because within a political process that is democratic and representative, only policies that are not opposed by a majority of relevant actors are likely to be implemented. Public demand for such action may well require transparency of the institutional mechanisms of fee setting, allocation of subventions, collection of surplus revenues and spending of revenue, either in case of publicly owned or private players on the hydrocarbon transportation market.

INTRODUCTION OF THE DISCLOSURE REQUIREMENTS FOR TRANSIT AS A DISTINCT ACTIVITY

As already mentioned, the hydrocarbon transportation industry in Georgia is primarily regulated by the Law of the Natural Resources, the Law on Oil and Gas, the Law on Electricity and Gas, several regulations, General Tax Code and International Treaties (when applicable). However, up to now there has not been any particular legislation in the country, specifically dealing with rev-

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venue disclosure requirements. There is only sparse reference in some IGAs¹⁸, which may not be specifically relevant to revenue transparency and disclosure requirements.

Therefore, a comprehensive regulatory and institutional framework for transit revenue transparency needs to be put in place. This framework should provide all information in respect of procedures for granting consents and authorizations to the gas transmission operator¹⁹, access to transportation facilities and other related matters. The setting-up of such a framework should be carefully considered because its establishment will have a profound impact on investment-decision and financing options, not least because it might contribute to mitigating risks regarding strategic transit obligations and risks regarding future revenues from providing transportation services (i.e. price regulation). As such, it must²⁰:

- (a) establish a stable regulatory and market framework capable of attracting investment in gas transit segment of the gas domestic gas sector;
- (b) enhance security of gas supply;
- (c) contribute to the improvement of the environmental situation in relation to the existing gas pipeline networks and related energy efficiency;
- (d) set up harmonized conditions for gas transit in a single regulatory space; and
- (e) eventually fit in the Georgian gas sector model, which envisages step-by-step deregulation and market competition.

It is of course up to the competent authorities of Georgia to decide on how a new transit revenue disclosure regime will be put into place. On a legislative level, though, one route for the implementation of such a regime could be through introduction of a new law specifically dealing with gas transmission in a comprehensive manner, provided that the Georgian authorities are moving towards such a direction. Alternatively, any existing legislation dealing with the gas sector could be modified to provide for revenue disclosure activities. This legislative approach would require amendments to the Law of the Subsoil and Natural Resources, the Law on Oil and Gas and the Law on Electricity and Gas, while specific regulations dealing with certain gas transportation matters, such as the setting-up of tariffs²¹, will be required to be enacted.

18 Intergovernmental Agreements

19 The term “gas transmission operator” is used throughout this report to denote a natural or legal person who carries out the function of gas storage and is responsible for operating a storage facility. On the regulatory front, the GNEWSRC is envisaged to be the competent authority for issuing the gas transmission license as well as for its subsequent modification, suspension and revocation and for establishing the corresponding licensing rules. It shall further be responsible for fixing the license fees and setting the gas transmission tariffs.

20 In accordance with established principles of Energy Community

21 Such tariffs need to be enumerated in full compliance with general principles for tariff setting as well as the relevant procedures and the terms and conditions relating to the initiation of tariffs, which are elucidated in Article 43seq of the Law on Electricity and Gas, so that the tariff rules applicable to each segment of the domestic gas sector will be regulated by consistent and harmonized conditions.

PROPOSED REGULATORY FRAMEWORK

In accordance to the current Georgian regulatory and institutional regime governing the conduct of commercial activities in the domestic gas industry, the Ministry of Energy and Ministry of Finance -in their capacity as the executive authorities of, and the formulator of policy in, the domestic energy sector and revenue administration field - shall be in charge of preparing the drafts for setting the legislative framework for transit revenue disclosure and assume responsibility for the overall supervision of the hydrocarbon transit activities and related revenue operations. It shall also be responsible for approving, subject to public consultation, the specific disclosure rules as well as any rules relating to the hydrocarbon transmission arrangements.

However, from the legislation currently in force it is not entirely clear whether the GNEWSRC or the Department of Revenue Service will be in charge of certain important matters, such as:

- ▶ the making of decisions on applications for exemption from disclosure (in the event that such a system is to be introduced);
- ▶ the resolution of disputes among market participants
- ▶ the supervision of compliance to the established rules.

The above issues need to be specifically clarified in the new legislation so that the rights and responsibilities between these two State bodies are clearly identified and there is no overlap between their competences.

CONDUCT OF DISCLOSURE ACTIVITIES

In order to provide desired transparency and certainty to investors willing to invest in gas transit business in Georgia, it is important that any new (or amended) legislation sets forth detailed action plan and set of instructions on what type of documents the firm will have to submit and what type of qualifications it will need to hold in order to make a satisfactory application; it must further delineate the key principles that the GNEWSRC and the Ministry of Energy or Ministry Of Finance will take into account when processing, judging or publicizing the disclosure documentation. In this regard, the Law and the tax code shall furnish some concrete guidance on how these matters should be tackled.

On this theme, one of the issues that may need to be elaborated is what entity will be tasked with submitting the disclosure documents: namely, the owner of transit or the operator of the transmission network or transportation service (if they are distinct entities). Obviously, the response to this question will be contingent on some other matters impacting on the carrying-out of the Project, such as the particular ownership model to be adopted as well as the form of the business entity conducting the business. For instance, if the facility operator would also be the owner; alternatively, it is possible that the facility operator and the transit contract party are members of the same group and the facility operator's disclosure obligation would require it to secure that the owner would comply with obligations imposed by such requirement (and perhaps undertake directly to the GNEWSRC or the Ministry of Finance to do so). This comes especially

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relevant in case of Railway transit, where Georgian Railway LLP is merely a service provider to the various parties of transit arrangements.

It is proposed, though, that tasking the business responsible for the day-to-day operation of the hydrocarbon transit would be the most appropriate approach; the owner may have some obligations indirectly via the license and disclosure requirements, but it is suggested that the transit operator would be the licensed business, as it would be in charge of the network's (rail's) operation and maintenance. Any such legislation should also set forth the minimum general disclosure requirements to be met by the transit license holder in the performance of its functions.

Moreover, it would be prudent to specifically provide for the accounting separation of the hydrocarbon transport operations of the license holder from any other activities it is involved in the energy supply chain. The advantages of any such arrangement will be two-fold:

- first, it will safeguard that the license holder (in conjunction with any of its relevant affiliate or related undertaking) maintains internal accounting and reporting arrangements, which enable it to prepare separate financial statements for each separate business and to show the financial affairs of each such separate business (correspondingly – the relevant revenue streams generated thereof); and
- Secondly, it will facilitate the avoidance of discrimination or distortion of competition between the energy transit and any other energy activities of the license holder.

Under such scheme, the hydrocarbon transport license holder should operate through a legally distinct and separate entity from any other of its business(es) or venture(s), which is engaged in the production, transportation, distribution or supply of energy resources. As such, the conduct of the transmission operations should be separated from any other licensed activities in energy sector that are carried out by the license holder or any of its affiliates. To further strengthen such separation, it would also be wise that the license holder is obligated to keep proper books of account and records in such a form that the revenues and costs, assets and liabilities of, or reasonably attributable to, each of its distinct activities in the energy sector are separately identifiable in its books. Then, the license holder shall, so far as is reasonably practicable, prepare for each distinct business on a consistent basis from its accounting records in respect of each financial year, disclosure reports comprising:

- (a) a profit and loss account;
- (b) a statement of net assets at the end of the period (with the tax payments and revenue ledgers separately shown);
- (c) a cash flow statement for the period with a reconciliation to the financial statements specified in sub-paragraphs (a) and (b) above; and
- (d) a balance sheet.

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In this regard, it is further important to be specifically provided in the relevant legislation that the relevant competent authority will retain audit rights over the transmission operations of the license holder irrespective of what type of regime for third party access to the transit system is selected to be applicable (such is only relevant to pipeline transport).

DISCLOSURE CONDITIONS

Another important issue that needs to be addressed in the terms of the transit revenue disclosure is the elaboration of the general obligation imposed upon the license holder under the disclosure requirement. For instance, in respect of its obligation to operate, maintain and develop the hydrocarbon transit under conditions of transparent, secure and clear regime, the license holder may be required to maintain at all times its financial affairs in such a way so as not to prejudice the conduct of the whole initiative.

It should further be obligated to implement any measures and procedures and take any other steps that the Ministry of Energy, Ministry of Finance, the GNEWSRC and/or the National Agency for Oil and Gas deems requisite or expedient for the purpose of securing compliance by the license holder its obligations. Furthermore, the license holder must be under the duty to furnish to any of the aforementioned authorities - following a relevant request - with accurate information on the business operation that any of these authorities may reasonably require or which may be necessary for ensuring the transmission operator's compliance or for the purpose of performing its corresponding functions.

Moreover, this right to request such information should be in addition to the relevant authority's power to call for information under or pursuant to the Georgian laws and/or any other condition of the transit revenue disclosure requirements. A caveat might perhaps be placed on this disclosure information whereby the license holder will be entitled to disclose information, which the license holder could not be compelled to produce or give in evidence in civil proceedings.

GENERAL RECOMMENDATIONS

The Government and Parliament should consider establishing an independent agency with the authority to monitor (but not approve or disapprove) all major transit arrangements on the territory of Georgia. Such an agency would report to the government and Public regarding the revenue effect of transit agreements. The agency could enforce a minimum level of revenue transparency in international energy contracts that are related to revenue generation based on transit, extending to all companies (domestic and foreign) that do business with or within Georgia.

Besides, governments should be required to notify the agency at the start of negotiations with foreign entities regarding:

- 1) the construction of new energy pipelines (or railway routes),
- 2) the offering of tenders for energy transportation contracts, and
- 3) when conducting talks for the sale of existing energy transmission facilities within their border.

Western energy companies would benefit from a uniform reporting requirement that applies to domestic and foreign firms doing business on the territory of Georgia; one that mandates revenue transparency reporting for their operations at home and abroad. This would weaken the current advantage held by firms with inherently high level of business corruption and an unwillingness or inability to enforce existing contract disclosure requirements.

Firms in Georgia should be barred from including confidentiality clauses that obstruct revenue transparency in contracts with foreign energy companies and/or domestically with each other.

Mechanisms for monitoring and verification by independent external bodies also have to be implemented. The industry representatives as well as other stakeholders should be actively involved in the development, implementation and operation of a hydrocarbon transit disclosure scheme.

MORE SPECIFICALLY, THE FUNCTIONS OF THE MINISTRY OF ENERGY ARE:

- (a) to elaborate programs in the energy sector, including the electricity and natural gas sectors, based on the short-, medium-, and long-term strategy and priorities and to coordinate their implementation;
- (b) to promote short-, medium-, and long-term investments and credit resources and also to implement state investments for rehabilitation and development in the energy sector;
- (c) to promote efficient restructuring and privatization of state owned enterprises in the energy sector, to support competition development in electricity and natural gas sectors and to develop rules and strategy for conservation and liquidation of energy facilities;
- (d) to participate in elaboration and development of legal and regulatory framework and monitor the technical and economic condition of the energy sector;
- (e) to develop and coordinate implementation of uniform State programme targeted to increase efficiency in the areas of electricity generation, transmission, dispatch, distribution, import, export and consumption, as well as in the areas of natural gas supply, import, export, transportation, distribution and consumption;
- (f) to promote development of scientific research, design-construction and education spheres in the energy sector, to promote investment and credit resources and to implement subsidies;
- (g) to promote environmental protection in the energy sector and optimal reflection of environmental aspects in energy programs during their development and implementation;
- (h) to promote cooperation between licensees, importers and exporters, suppliers and electricity and natural sector entities in foreign countries and to support transit and import/export relations in the electricity and natural gas sectors;
- (i) to develop state strategies for energy sector emergencies;
- (j) to determine strategy for the insurance of the security in the energy sector, to elaborate recommendations, to study the emergency situations and technical imperfections and to prepare the conclusions about them; and
- (k) to promote increase of energy resource production, prevalent utilization of the renewable (alternative) energy resources and to support energy efficient measures related to the increase of the effectiveness of such production.

These include the right to:

- (i) Elaborate the legal bases for the functioning, restructuring and developing the energy sector; Coordinate legal relations with the Parliament, President's Administration and other State organizations;

- (ii) Conduct negotiations with investors and donors organizations, prepare and examine the draft agreements and monitor the implementation of the concluded agreements;
- (iii) coordinate the activities of the legal departments of the organizations subordinated to the Ministry;
- (iv) implement the legal relations with the foreign countries, international financial institutions and private investors; in accordance with the Acting Legislation
- (v) ensure representation of the Ministry in Court and Arbitrage in accordance with the rules established by Acting Legislation;
- (vi) prepare the draft legal documents and ensure their compliance with the Acting Legislation;
- (vii) promote the competition in the Georgian energy resources market within the scope of its competences and in compliance with the implementation of the energy sector restructuring and main economic reforms;
- (viii) participate in the elaboration of the State and Budget financing policy in the energy sector and promote its implementation;
- (ix) participate, within its competence, in the negotiations with the donors and investors and financial monitoring of contract implementation;
- (x) within its competence, implement and monitor the procurements made by funds allocated for the energy sector rehabilitation;
- (xi) develop the state indicative programs and forecast plans in the energy sector;
- (xii) monitor and prepare information reflecting the State budget relations and financial statuses of the Legal persons of the public law under the Ministry governance;
- (xiii) coordinate and cooperate with the organizations operating within the energy sector; Monitor over the technical condition of equipment belonging to power generation, transmission/dispatch, distribution enterprises and production enterprises (coal, crude oil, natural gas etc.);
- (xiv) supervise over safe utilization of electric equipment and devices (within its competence);
- (xv) develop the proposals regarding energy sector management, improve technological processes, reduction of energy and thermal losses; develop the projects targeted to modernize technical and technological processes; prepare programs and technical data for rehabilitation of generation, transmission and distribution facilities;
- (xvi) develop the energy balances; forecasts the country's increased demand for energy resources, taking into consideration the household basket and national economic parameters; Monitor over their implementation in order to guarantee reliable operation of the Georgian electric system and energy distribution companies.

GENERAL RECOMMENDATIONS

- (xvii) monitor over production and sale of energy resources, also import/export volumes of energy resources;
- (xviii) prepare the proposals and recommendations on efficient utilization parameters of fuel resources and their effectiveness.
- (xix) forecast energy resource volumes and analysis of current expenditure;
- (xx) elaborate methodological recommendations technical maintenance rules and other Standard Acts on energy producing spheres within the scope of its competence and in accordance with the Acting Legislation
- (xxi) develop the uniform policy and strategy in the energy sector and promote its implementation;
- (xxii) develop short term, medium and long term programs; develop the country's energy security policy and promote its implementation;
- (xxiii) define directions for the utilization of the renewable sources of energy; develop the uniform State policy and strategy in this regard;
- (xxiv) participate in elaboration of the energy sector privatization plans, within the Ministry's competence, and prepare the list of the facilities for privatization*
- (xxv) participate in energy efficiency and energy saving, as well as environmental policy development in energy sector and promotion of their implementation within the scope of its competence.

THE AGENCY'S FUNCTIONS ARE AS FOLLOWS:

- a) the selection of areas to be offered to investors for oil and gas operations, following to consultations with relevant state bodies; the making of decisions regarding form of offering (tender or auction) of areas and form of agreement to be made with an investor;
- b) the preparation of rules and conditions of tenders and auctions for awarding to the winner the areas offered to Investor for oil and gas operations;
- c) the organization, performance and awarding of tenders and auctions in respect of areas offered to an Investor for oil and gas Operations.
- d) the preparation, negotiation and conclusion of all agreements, on behalf of the State. In the process of negotiations and preparation of an agreement, the Agency is entitled to request for, and shall receive, assistance from any governmental body, state organization and enterprise.
- e) the issuance of licenses to investors required for performance of oil and gas operations, on behalf of the State; approval and the issuance or securing the issuance of all other authorizations, allotments, permits, certificates;
- f) the supervision and control of implementation of provisions and activities envisaged in agreements made and licences issued under the Law of Oil and Gas, the provision of conditions required for implementation of oil and gas operations under the relevant agreement and license;
- g) the creation and management of a centralized information bank in respect of all data and information oil and gas resources and oil and gas operations in Georgia (collection, systematization, analysis and storage of information and data);
- h) the issuance of normative acts, required to establish a clear, stable, non-discriminatory and effective legal and regulatory framework for performance of oil and gas operations based on market principles and operating in the national interest.
- i) defining and managing regulation fees that will equal to the marginal amount in accordance with the Georgian legislation with the aim to preparing all necessary permits for an investor to conduct oil and gas operations;
- j) the delegation of all operational or commercial tasks under agreements (except delegation of regulatory functions) to the National Oil and Gas Company, until the State ceases to be its owner or owns more than 75% of its shares; the supervision and control of implementation of all operational and commercial tasks, under agreements, delegated to the National Oil and Gas Company.
- k) In performance of the above functions the Agency shall observe the principle of transparency; including public consideration of auction and tender terms and conditions in the process of preparation and their further approval, publication of annual report on performed activities, etc.

GENERAL RECOMMENDATIONS

More specifically, in the domains of oil refining, gas processing and transportation activities, the functions of the State Agency for Oil and Gas are:

- (i) to issue on behalf of the State licences for oil refining, gas processing and transportation activities and to issue all necessary permits and to approve of funds;
- (ii) to supervise the implementation of any activity licence requirements and to supervise and control oil refining, gas processing and transportation activities and to facilitate the necessary conditions for performance of its obligations by the relevant licence holder;
- (iii) to supervise oil refining and gas processing activities in order to ensure environmental safety and quality of oil and gas products;
- (iv) if deemed necessary, to establish and operate a laboratory in accordance with the relevant Georgian legislation;
- (v) to create and manage a central information bank with all data and information related to oil refining, gas processing and transportation activities (collection, systemization, analysis and storing of information and data);
- (vi) to issue normative acts considering state interests, state policy and market principles for the purposes of efficiency for oil refining, gas processing and transportation activities;
- (vii) to participate in the process of elaboration, amendment and adoption of the crude and oil and gas products standards;
- (viii) to establish crude and oil and gas products' transportation tariffs.

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