



## Georgia's State Policy in the Electricity Sector

### Brief History and Ongoing Processes

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#### Brief History: Georgia's Electricity Sector from 1991-2003<sup>1</sup>

The internal political stability and economic development of a country greatly depend on the function of its energy sector. In 1991 immediately after gaining independence, Georgia's energy sector found itself under heavy attack.

The wishes and hopes of the Georgian government to meet the interests of the US and the EU (to receive Caspian gas and oil through Georgia) and become one of the points of the East-West energy chain conflicted with the interests of Russia, the dominant country in the region. Russia wanted to assume the role of the producer, as well as a transporting country for energy resources. Such was the context of a geo-strategic regional controversy between Russia and developed western countries from 1993 to 2002. Georgia, as one of the spheres of alternative transportation of energy resources, found itself in the center of this controversy.

As a result of the recurrences of civil war and controversial geo-strategic interests in the region from 1993 to 2002, Georgia's energy sector gradually collapsed. This collapse was caused by different suspicious incidents (which according to the findings of investigations could be qualified as terrorist acts) and the inability of state institutions to take care of vitally important energy units.

Due to negligence and lack of care, the conditions of generation units, electricity transmission lines, gas pipes, and the units dependant on them gradually deteriorated. Just the Enguri Power Station, which is still being rehabilitated, experienced several accidents, none of which have been fully investigated. The first accident happened in December 1993, two months after the fall of Sukhumi. In 1995 after the attack on the Enguri Power Station, its 500 kilowatt unit was completely destroyed. During the last accident in November 2002, it was again seriously damaged.

Similar unclear incidents happened on Gardabani energy blocks. The first important damage to the gas generation units, specifically the newest ninth and tenth blocks, was caused by a fire in December 1993. In 1998 these blocks were restored with a credit from the German Development Bank and in 1999 were handed over to AES Telasi, the first American company to enter the Georgian energy market in 1998. In December 2001, several months after the announcement about the South Caucasus pipeline by the Shah-Deniz consortium,<sup>2</sup> energy blocks which have already been transferred to the ownership of AES Telasi, suffered another explosion. The ninth block was seriously damaged and the tenth block was entirely destroyed as a result of the explosion.

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<sup>1</sup> The introduction uses the author's research: Liana Jervalidze "Russian Foreign Energy Policy and Implications on Georgia's Energy Security," Global Market Briefs LTD, London, March 2006.

<sup>2</sup> The Shah-Deniz Consortium made a statement about construction of the South Caucasus Gas Pipeline via Georgia in August 2001.





These incidents paralyzed the energy sector, which increased the country's dependence on imported energy supplies from its neighboring countries. In winter Georgia was buying electricity mainly from Russia and Armenia.<sup>3</sup>

With the civil war and economic collapse, the purchasing power of the Georgian population decreased so much that the figure of received payments for consumed electricity collected by AES Telasi in the first year constituted only 10-20%. Such situation provided fertile ground for the emergence of an energy mafia, which was not interested in supplying electricity to a population with low payment capability. As a result, the electricity purchased by the state started to be re-exported to neighboring countries.<sup>4</sup> Meanwhile the Georgian population received a considerably limited amount of electricity.

Agreements concluded in the electricity sector during this period were so loss-making and not transparent that despite several inspections by the Chamber of Control, it is impossible to draw a clear picture of what was happening in this sector during the 1990s. The only verifiable reason is that due to the low rate of payments, it was not profitable to supply electricity to the population and a large part of produced and purchased electricity was used for export or re-export.<sup>5</sup>

From 1995 to 2000 Georgia received 591,770,150 USD in grants and discounted credits to rectify the results of accidents throughout 1993-2000 and to rehabilitate damaged energy units. These credits included a credit from the German Development Bank, which was used to rehabilitate the ninth and tenth grids in Gardabani in 1997-1998. However, later, in December 2001, the result of the credit was negated because of the repeated incident on these blocks. Achieving maximum results through the effective usage of the above-mentioned grants and credits was also hindered by the existing corruption in the sector.

The last sabotage on Georgia's energy units took place after the Rose Revolution in 2003. Namely, from September 15, 2004 to March 2005 Kartli 1 and Kartli 2 lines and the Caucasus high voltage electricity transmission lines were seriously damaged several times. Since then similar incidents have not occurred on Georgia's energy units.

This brief history describing the last fifteen years of Georgia's electricity sector illustrates why the issue of rehabilitation of energy sector units deserves particular attention in the Main Directions of Georgia's Energy Sector Development document, which was adopted by the Parliament of Georgia in 2006 and serves as the basis of this research.

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<sup>3</sup> The second block of Russian nuclear power station started working in 1995 after the accidents at the Enguri power station and Gardabani gas generation blocks.

<sup>4</sup> Acts of the Chamber of Control of Georgia, 1994-2001

<sup>5</sup> If the Georgian energy mafia did not directly participate in planning and carrying out attacks against energy units, it was earning large amounts of money thanks to the situation created as a result of these accidents.





## Developments since the Rose Revolution in 2003

The government which came to power after the Rose Revolution in 2003 managed to stabilize the electricity sector. As it was mentioned in the introduction, the last sabotage against the electricity infrastructure took place in the period between September 2004 and March 2005. In 2004-2007 generation units and transmission lines were rehabilitated with budgetary funds and the assistance of foreign donors. The rehabilitation process is still under way. Today the country's electricity system is functioning properly and satisfies the domestic demand on electricity. Currently the task of the Ministry of Energy, the main body defining energy policy, is to develop a strategic plan for meeting the increased demand on energy that accompany the country's economic development.

The Parliament's Resolution on the Main Directions of Georgia's Energy Sector Development, adopted in summer 2006, identifies the transfer of energy units into private ownership as a main component in improving the country's energy sector. According to the same document, privatization of energy units should happen after writing off their debts and in a fully transparent environment; relations between subjects on the energy market will be regulated and rights and obligations defined by the electricity market rules. Further development of the market will be followed with liberalization and full deregulation.

Today the biggest part of electricity distribution (Telasi, Energo-Pro) and part of generation (363 Megawatt hydro power stations owned by Energo-Pro, Kakheti generation units) have been privatized. The issue of private ownership of the Kakheti Distribution Company is not finalized yet. High voltage transmission lines are in the ownership of the Georgian-Russian joint enterprise GruzRosEnergy. Electricity purchase and sale operations are handled by the system's commercial operators, created on the basis of the United Wholesale Market.

The given document discusses to what extent the existing situation in the electricity sector complies with the main provision of the Parliament's Resolution of 2006. These provisions include transparency of privatization, liberalization, and deregulation.

### AES Telasi

Today the Joint Stock Company RAO-Telasi is the electricity distribution company for Georgia's capital. The Russian electricity giant, state company Inter-RAO, owns 75% of its shares and the Tbilisi Municipality owns the remaining 25% of shares. In addition to the distribution in Tbilisi, Inter-RAO, a managing company of foreign shares of RAO-UES, owns the Gardabani ninth and tenth blocks in Georgia (of which only the ninth block is functioning after the accident on December 2001). Inter-RAO also owns two hydro power stations on the River Khrami.

RAO UES entered the Georgian market in 2003, after its sub-company RAO Nordic bought a Dutch company Silk Road BV from AES Corporation for 23 million USD. With the acquisition of Silk Road BV, RAO Nordic became the owner of 75% of Telasi's shares.





AES had originally bought Telasi in 1998 for 22.5 million USD. In 1999 AES acquired the ninth and tenth blocks of Gardabani for 16.5 million USD and also gained the management rights for Khrami 1 and Khrami 2 for 25 years. In 1998, political actors and the general public welcomed the entrance of the American company as a strategic step. Only five years after, due to the financial problems in the head company and pressure coming from the groups close to the Georgian government, AES sold its Telasi shares to the Russian state company RAO Nordic and left Georgia. At that time the Georgian side argued that the exit of AES was only connected to the company's financial problems and that AES Corporation had sold its shares in all post-Soviet countries. In reality, AES Corporation later expanded its activities in Kazakhstan and Ukraine and only several years ago bought shares of the energy sector in Eastern European countries, namely the Czech Republic and later Turkey.

The exit of AES Telasi from Georgia, a company which was a strategic partner five years ago, was unexpected and led to speculation. It was particularly interesting that the company left Georgia after it had significantly rehabilitated Tbilisi's distribution system and raised the payment rate for consumed electricity up to 86%, gained the right to import electricity and transit it to Turkey, and soon would have started making profits.

AES Silk Road<sup>6</sup> entered Telasi for 10 years, with the condition of receiving 20% of capital profits annually. For Telasi rehabilitation the company allocated 210 million USD from its headquarters, and attracted credit resources worth 56 million USD from international financial institutions (EBRD and IFC<sup>7</sup>). According to David Ebralidze, who served as Consumers' Rights Defender with the National Independent Regulatory Commission during that period, by 2003 (five years after acquisition of shares) long-term and short-term liabilities of AES Telasi, including the main capital and interest rates, constituted 825,598,000 GEL (400 million USD according to the exchange rate at that time). In addition this sum had a minimal part of debts towards EBRD and IFC and they were already covered by AES.

AES Corporation's 2003 Report shows that AES Corporation wrote off 210 million USD to decrease the value of AES Telasi (to pay off its debts completely) and to put it up for sale.

Experts from the Parliament's Energy Commission believe that AES Telasi was deliberately inflating incurred costs, that it was impossible to make such large investments in such a short period of time (Gardabani blocks had been rehabilitated with the credit of the German Development Bank before AES Telasi bought it in 1999), and that the company carried out works connected only with installing a new metering system.

There was also a third view, which holds that, according to the contract, the company had the right to receive annual 20% of capital costs. In this case, in five years it would have already paid back the

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<sup>6</sup> This company was based in Moscow and was leading negotiations from there on the purchase of energy shares in post-soviet countries. Negotiations on buying Telasi were also held in Moscow.

<sup>7</sup> According to the information on EBRD's website, the bank allocated 30 million USD to AES for rehabilitation of Telasi. The remaining 30 million USD was allocated by the International Finance Corporation.





real investment as well as profits. Because of this reason AES did not submit an appeal to the international arbitration court in London although it had the right to do so according to the contract (despite the fact that it was kicked out of Telasi as a result of pressure). Neither has the US Embassy expressed any protest about the obvious pressure to kick out a U.S. company from Georgia.

In total, AES sold Telasi to RAO Nordic for 23 million USD.<sup>8</sup>

## RAO Telasi

The Memorandum between the Government of Georgia and RAO was concluded in June 2007, in an environment which was not at all transparent. Not a single independent expert or group of experts participated in the development of the Memorandum. The fact of its signing and its substance became known to the public only in November 2007.<sup>9</sup>

One important provision included in this Memorandum is regarding the electricity tariff. From 1998 to 2008 AES consumer tariff included the component of capital costs incurred by AES Telasi, something which was included in the RAO UES tariff after the sale of Telasi. Actually, beginning in the end of 2008, the electricity tariff should decrease<sup>10</sup> for Tbilisi residents; however, the Memorandum does not foresee any tariff cuts.

As a defender of citizens' interests, David Ebraldze in 2003 protested the fact that RAO Nordic, which had received a company freed from debts and did not commit additional investments upon its purchase, maintained the component of capital costs<sup>11</sup> in the consumer tariff. He demanded the withdrawal of this component and cutting the consumer tariff.<sup>12</sup>

In 2003 and 2004 director general of RAO UES during his visit to Georgia talked about the possibility of cutting the tariff; however, it appears that the Government of Georgia did not go deeper into the issue because talks about cutting tariffs were terminated after 2004. In contrast, in 2005 RAO Telasi started a campaign about increasing its own shares in the tariff; a move which was justified by the necessity to cover a credit (170 million USD) taken by AES. In 2005, on the grounds of the lack of sufficient justification,<sup>13</sup> the independent regulator refused to satisfy RAO Telasi's request to increase the tariff. However, before selling distribution and generation units to Energo-Pro in 2006, the same independent regulator decided to raise the electricity marginal tariff and

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<sup>8</sup> According to some reports, after rehabilitation the real value of Tbilisi Electricity Distribution Company equaled 500 million USD. The rate of payments for consumed electricity was 86% and the company's annual income was 70 million USD. Accordingly, AES was second only to the state budget in terms of the amount of its income.

<sup>9</sup> The Memorandum was signed on June 20, 2007.

<sup>10</sup> The deadline for the signed contract with AES and repayment of investments expires in 2008.

<sup>11</sup> Amount of money invested by the company and its interest rate.

<sup>12</sup> Source: Presentation by David Ebraldze, the Public Defender of Consumers' Rights in 2000-2002, on the details of the agreement concluded between AES Telasi and RAO. Presented in summer 2005 at the Soros Foundation.

<sup>13</sup> Later, in the middle of 2006 the independent regulator set the gradual tariff, according to which it shifted the burden of increased tariff to comparably well-off segment of the society.





introduced a gradual tariff. With this decision, the demand of RAO Telasi to raise the tariff was, in fact, indirectly satisfied.

RAO Telasi's commercial director and its deputy<sup>14</sup> justified the tariff, saying that in 2003 (when they bought Telasi) AES Telasi had accumulated 400 million USD in debt. These debts were transferred to their company and this was the reason for maintaining the component of capital costs in the tariff. Although representatives of RAO could not explain how AES could have had so many debts when the headquarters wrote off 210 million USD before its sale. Moreover, they confirmed that AES had already paid off the 56 million USD in credits from EBRD and IFC.

The Memorandum concluded between the Government of Georgia and RAO Telasi indicates that in 2008 (after the expiration of the deadline for receiving pay-backs from capital invested by AES Telasi) the electricity tariff will not decrease and instead might possibly increase. According to the Memorandum, the tariff will not increase until 2015 only in the case, if: the inflation rate in the country does not exceed 10%; electricity purchase tariff does not increase more than 10% (in case of increase of gas tariff, Telasi share in tariff will increase to avoid losses for the company); and the existing exchange rate<sup>15</sup> is maintained.

The Memorandum also says that the company does not request that the debts of IDPs densely populated in Tbilisi accumulated before March 1, 2007 be covered. According to the commercial directors, the company will request tax discounts from the government if these debts are written off.

## **Energo-Pro Georgia**

In 2004, after the new government came to power, the belief that the only way to make the energy sector healthy was through privatization of energy units was further reinforced. At that time, all distribution companies, with the exception of Telasi and Adjara Energy Company, were part of the United Distribution Company and were managed by PA consulting, an American consulting company. Generation units, except Kakheti ones, were under the state ownership. Subsequently, they were slated for privatization.

### *The first plan for privatizing the United Distribution Company*

In March 2005 at a conference Georgia's minister of economy, Kakha Bendukidze, presented the first plan to privatize the United Distribution Company. According to this plan, distribution and generation units in Georgia, except the already privatized units, had to be sold in two lots – (1) generation and distribution of the west and (2) generation and distribution of the east. Out of the generation units only Enguri stayed in state ownership. According to the plan, those two buyers would determine generation and distribution costs themselves and would do the optimization of costs as well (without the assistance of an independent regulator). In this way, the function of the

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<sup>14</sup> It has to be noted that these individuals did not work in Telasi during its acquisition by RAO.

<sup>15</sup> The exchange rate of the Georgian Lari with the US Dollar.





independent regulator would have been decreased to the minimum, which meant a step towards its abolishment.

Only transportation and its regulation stayed in state ownership. Although this plan facilitated deregulation of the electricity sector (decreasing state participation in this sector), it limited the possibility of liberalizing the energy market because the generation in the west was tied to the distribution in the west and, as a result, neither producer nor a consumer would have had the possibility to choose the desired consumer or a supplier.

This plan was never implemented and the independent regulatory commission was not abolished.

### *Auctions*

The first auction of the United Distribution Company was held in March 2005. Only one company (Bagebi 2004) expressed interest in participating in it, but the auction failed. One of the (unofficial) reasons for it was that the company was associated with one high government official and this information became public.

On the second auction, the price of the package of the United Distribution Company, Adjara Energy Company, and six hydro power stations was set at 350 million USD. At that time, no company was willing to pay that amount and as a result, the auction was postponed. It is rumored that units were valued at such high prices in order to disinterest competitor companies in participating in the auction.

In the end, after several rounds of failed negotiations, on February 5, 2007 the package was bought by the Czech energy company, Energo-Pro. Both the negotiations and the selling process lacked transparency, in the same way that the purchase of AES Telasi shares by RAO Nordic in 2003 did. The Czech energy company bought shares for 132 million USD instead of 350 million USD. More precisely, Energo-Pro paid 73.5 million USD for the hydro power stations in the west (Lajanurhesi – 113 Megawatts, Rionhesi – 48 Megawatts, Gumathesi – 67 Megawatts, Shaori – 38 Megawatts, Dzevrula – 80 Megawatts, Atsi – 16 Megawatts, in total – 362 Megawatts), 32 million USD for the United Distribution Company, and 14.5 million USD for Adjara Energy Company.

The agreement concluded between Energo-Pro and the Government of Georgia contains some interesting provisions, out of which the following deserve particular attention:

- **Buyer (Energo-Pro) is entitled to free regime of purchase of shares:** Energo-Pro has the right to determine according to its own views the deadlines and conditions for the final purchase (the amount of money to be paid at the given stage). In case of disagreement on this issue between a buyer and the seller (Ministry of Economic Development) the advantage is given to the decision of a buyer. The only pre-condition is that a buyer has to notify the



seller about the readiness to pay.<sup>16</sup> It has to be said that this form of purchase leaves the impression that a company does not bring funds for buying shares but rather tries to cover the costs of purchase with the income received from high tariffs set beforehand.

- **There will be only one license for exclusive distribution in the distribution space foreseen by the Agreement:** Energo-Pro demands the Georgian National Regulatory Commission not to issue other licenses<sup>17</sup> (except the license of Energo-Pro itself) in its distribution area. This provision limits the possibility of creating a liberal market, as the buyer excludes the emergence of a competitor in its activity area.
- **Buyer has the right of unlimited access:** If Energo-Pro needs to use territory in state or its private ownership to reach units in its ownership, it is free from the obligation to pay compensation, rent, or any other type of payment to the owner of the territory.
- **Buyer receives the assets (identified by annex 6) for a symbolic price set by the legislation in force,** within six months after the completion.<sup>18</sup>
- **Regulator sets rules for communal metering<sup>19</sup> which will be enforced for at least ten years:** Energo-Pro will have at least 10 years of time to complete an individual metering system. There is a question of whether the company, which asks for ten years for completion of individual metering, has the ability to invest 400 million USD as it is indicated in the presentation posted on the website of the Ministry of Energy.
- **The independent regulator will adopt a resolution on the indexation of tariffs in the shortest period, no later than three months after the expiration of the six month period:** indexation of tariffs will happen according to inflation, which will likely result in an increased tariff.<sup>20</sup>

It is important to keep in mind that before selling shares to Energo-Pro, they were entirely free of debts, the electricity consumer tariff increased, and the gradual tariff was introduced. The government justified the tariff increase before the entrance of an investor by making the case that it

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<sup>16</sup> By June 29, 2007 when Energo-Pro received the right of ownership of shares, it had paid only the price of Adjara Energy Company (14.5 million USD) and the United Distribution Company (32.5 million USD). The price of shares of generation units (73 million USD) remains unpaid today. Accordingly, as it turns out, the company is using the rights granted by the agreement to pay the price of shares in a free regime acceptable to it.

<sup>17</sup> The contract guarantees that there will be no other licenses issued by GNRC in its area of activity

<sup>18</sup> According to the contract, the date of completion is the expiration of six months after the signing of the agreement.

<sup>19</sup> Meaning common meters.

<sup>20</sup> Energo-Pro Georgia has already made a preliminary statement requesting a tariff indexation. It addressed the independent regulator with this request in September 2007 and is awaiting a decision at this stage.





wanted to avoid possible negative reaction<sup>21</sup> from the population toward the investor (which would have had to raise the tariff anyway).

The government blamed the raise of the consumer tariff on the increase of the price on Russian gas in January 2006 up to 235 USD per 1,000 cubic meters. According to some Georgian experts, the Russian gas price increase should not have caused such a change in the electricity tariff because the share of gas in electricity generation is only 20-23%. Consequently, an increase in the consumer tariff and, moreover, the introduction of the gradual consumer tariff was considered unjustified. According to some experts, considering the consumer tariff used by Energo-Pro, a state company could have also managed to mobilize sufficient funds for rehabilitation and reinvestment of the system and it would not be necessary to collect shares, so called purchase funds, from the population.

On the background of public protest, the Government of Zurab Noghaideli decided on its own to increase the tariff and the independent regulator agreed, which in reality was an obvious demonstration of undue influence in the work of the independent regulator.

## Conclusion

Obviously the purchasing power of the population today has substantially increased compared to the years of 1993-2000. With the rehabilitation of energy units and individual and group metering of consumers, the rate of payments for consumed electricity also increased (it approached 100% figure). Today's situation in Georgia's energy sector creates the possibility of running a profitable business. Therefore, if in 1993-2000, the sale of electricity on the internal market was not profitable and a substantial part of the existing resources was sold in neighboring countries, currently all resources feed into the twenty four hour supply of the country, which itself is a positive fact. However, according to the materials obtained throughout this study, we can conclude that the priorities declared in the Parliament's Resolution on the Main Directions of Georgia's Energy Sector Development – transparency, movement toward a liberal energy market, and deregulation – are not yet reflected in the state electricity policy.

- **Transparency:** the negotiations with Energo-Pro and their result do not indicate that the new government pays appropriate attention to supporting transparency. Two deals (RAO and Energo-Pro) discussed in this report have one thing in common: in both cases negotiations with private investors were not held in a transparent manner.
- **Movement towards a liberal market:** one important problem of the discussed agreements is that they are not directed towards market liberalization. On the contrary, they leave the impression that monopolistic structures are being formed where they did not exist before.

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<sup>21</sup> It is meant that the investor would have demanded an increase in the tariff to receive back payments for its investments.





For example, Energo-Pro requests in the agreement that another licensee of supply or distribution should not be allowed in the area of its activity<sup>22</sup>.

- **Deregulation:** the contract concluded with Energo-Pro also limits the possibility of deregulation. Tariffs of electricity purchase (even from hydropower stations under the ownership of Energo-Pro), as well as transmission and dispatching were established beforehand by the independent regulator and these tariffs are included in Energo-Pro's contract.

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<sup>22</sup> There were several small distribution licenses in the UEDC area before Energo-Pro entered in 2006.

