



State Policies of Georgia in the Energy Sector: Tariffs on Electricity and Gas

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Short overview

Tariffs on electricity and natural gas in Georgia are the highest in the region and throughout the post-soviet area. One probable reason for this is that the country's natural gas supply is completely imported. The situation in the area of electricity, however, is different: 70-75% of electricity is produced by hydroelectric power stations.

During the work on this report it was not possible to determine whether the current tariffs in Georgia are accurately calculated or fair. However, while conducting research it became clear that the Georgian National Energy Regulatory Commission (GNERC), the entity responsible for establishing tariffs, is under substantial pressure from governmental circles. It also became clear that the government of Georgia is trying to control both the state (which is under its control anyway) and private segments of the energy sector.¹

The role and authority of the GNERC is established by the Georgian Law on Electricity and Natural Gas (adopted in 1997), the Georgian Law on the Independent National Regulator (adopted on October 15, 2002), and the Resolution of the Parliament Concerning the Main Course of State Energy Policy of June 2006.

In January 2006 amendments to the Law on Electricity and Natural Gas entered into force. These changes curtailed the authority of the GNERC and expanded the authority of the Ministry of Energy. Specifically, the Ministry of Energy was made responsible for determining the annual energy balance and establishing market rules, which had previously been the task of the GNERC.

Furthermore, the government of Georgia directly interferes in the work of the GNERC to determine independently the tariffs on electricity and gas. In the agreement signed with Energo-Pro Georgia and the memorandum signed with Rao-Telasi, the government has taken the obligation to force the GNERC to make specific decisions about determining and indexing tariffs as well as about the use of common energy meters. Consequently, the current tariffs are not based on the GNERC's cost-benefit analysis methodology but in accordance with the agreements between the government and private companies. These agreements were to ensure a continuous supply of electricity and gas by the energy companies in return for receiving high tariffs, which are not connected with their real expenses.

If the government intends to either limit the authority of the GNERC or completely abolish it, it must be made clear who will assume the responsibility for ensuring the economic stability of the energy sector and protecting consumers from monopolistic prices, as GNERC currently performs the these two important functions.

¹ The project of the World Bank: Recommendations Regarding the Legislative Basis for the Energy and Natural Gas Sector. The project was implemented by the Econ One Consortium, p. 12

The functions of the independent regulator according to Georgian legislation

In 1996-1997, the Georgian government decided to create the Georgian National Energy Regulatory Commission (GNERC) in order to regulate the energy sector. In some developed countries, regulatory commissions have played a role in the protection of consumer interests and positively influenced the long-term development of the energy sector. Thus, the government's decision to establish an independent energy regulator was considered a strategic decision made in accordance with "best practice."

The GNERC was assigned the responsibility of regulating the spheres of electricity and gas. It was created as an independent body not founded on state property, which must act within the framework of the corresponding rules and delineated authority. In addition, the GNERC was granted financial independence and is to be financed by the income from regulatory fees and other taxes as allowed by Georgian legislation.

The Parliament issued a law concerning the independent regulator on October 15, 2002. According to the law:

- Interference in the activity of the independent regulator, control of its activities, and requesting reports related to it are impermissible except in cases determined by the law;
- The GNERC is accountable only to the President and the Parliament of Georgia;
- The GNERC is authorized to establish and regulate tariffs in the area of electricity and gas (interference in the tariff policy or control of its authority is impermissible);²
- The GNERC must act in compliance with the main course of state energy, security, and environmental policies and administrative and legislative normative acts;³
- GNERC's activity is based on the Constitution of Georgia, international treaties and agreements, the Georgian Law on Electricity and Gas, the GNERC's statutes, and other legislative acts.⁴

The law stipulates that the GNERC establishes electricity and gas tariffs on the basis of its own methodology. According to the present methodology, the tariff should reflect the expenditures of the license holder, importer, or supplier, which must include: (a) economically justified costs of the purchased oil, (b) expenses on exploitation, (c) expenses on current and capital repairs, (d) a significant part of the loans taken in the form of circulating capital, and (e) interest rates. It must also take into account the reasonable and fair level of profits from capital investments, which ought to be sufficient for attracting investments for the purpose of rehabilitating and developing the field.⁵ Throughout the process of establishing tariffs, the GNERC must also protect consumers from monopolistic prices.

² Georgian Law on Independent National Regulatory Bodies, October 15, 2002

³ Georgian Law on Electricity and Gas, 1997.

⁴ Georgian Law on Electricity and Gas, 1997, paragraph 4, status and functions

⁵ Georgian Law on Electricity and Gas, 1997, paragraph 43, the principles for establishing tariffs

Regardless of the fact that the Parliament's resolution on the main political course of the Georgian state in the energy sector passed in June 2006 reads that the GNERC should be independent from government influence, on January 1, 2006 amendments to the Law Concerning Electricity and Gas entered into force. The experts of the project Recommendations Regarding the Legislative Basis for the Energy and Natural Gas Sector implemented by the Econ One Consortium and funded by the World Bank came to the conclusion that those amendments hint at restriction of the GNERC's rights and obligations. Particularly, they pointed out that the distribution of powers between the GNERC and the Ministry became ambiguous. According to the amendments, the authority to establish the balance between electricity (capacity) and natural gas and determine the market rules in electricity and gas sectors was transferred to the Ministry of Energy. This complicated the division between the Ministry as the body determining the policy and the GNERC as the body regulating the sector.

The experts of the Econ One Consortium have also outlined that the government influence has limited the GNERC's ability to use the authority conferred on it by law. In this situation, progress is impossible through mere legislative amendments. The existence of the political will to allow the GNERC to make independent decisions within the framework of its authority defined by the law is necessary to solve this problem.

In addition, the experts commented on the policy of privatizing energy units. According to their explanation, "The government must know that ensuring a transparent legislative basis is a crucial precondition for potential legitimate investors. An independent body that functions according to law and whose activities are predictable is certainly a guarantee for such a transparent legislative basis. If privatization is a part of government policy the process of dividing the functions of strategy formation and that of regulation must become more vigorous."

The experts of the Econ One Consortium suggested to the government to review the issue of privatization of strategic units. They indicated that the existing legislative and regulatory principles will hinder the Georgian government's ability to attract investors in the process of privatization. "Negotiations, at best, will result in 'side deals,' approximately as happened in the case of the acquisition of Telasi by AES. The above mentioned deal still hampers the transparent regulation and function of Georgia's electricity sector."⁶

Such were the recommendations of the international experts in February 2006. The empirical material regarding how these recommendations have been reflected in the energy policy of the country and what is the current role of the independent regulator is discussed in the following subchapters.

The debut of the GNERC in the establishment of tariffs on electricity in the period of acquisition of Telasi by AES⁷

In 1996-1997, when the GNERC was created, its chairman was also a member of the privatization commission.⁸ The first privatization, in which the head of the GNERC participated, was the acquisition of Telasi by the AES (this privatization was executed in December 1998).

⁶ The project of the World Bank: Recommendations Regarding the Legislative Basis for the Energy and Natural Gas Sector. The project was executed by the Econ One Consortium, p. 22.

⁷ The following information based upon interview with Elizbar Eristavi, the chairman of the GNERC in 1997-2003. Interview was conducted on February 7, 2008.

According to the explanation of the then-chairman of the GNERC, Elizbar Eristavi, initially, the AES requested very high tariffs (approximately 17 tetri per kilowatt/hour of electricity in Tbilisi). In order to verify the fairness of AES's tariff declarations by the authority conferred on it by law, the GNERC hired a highly regarded independent international auditor (Deloitte & Touche), an independent Georgian auditing company, and two accountants. After the verification of investment and other expenses by the experts, the GNERC set tariffs at 8 tetris per kilowatt/hour of electricity, which according to the exchange rate of the time was approximately 3 cents.

Government interference in the functions of the independent regulator – the memorandum signed on June 1, 2007 with Rao-Telasi and Inter-Rao-UES

The memorandum signed on June 1, 2007 with Inter-Rao-UES is an obvious example of government interference in the function of the GNERC. The fact that from the Georgian side the memorandum was signed by Prime Minister Zurab Noghaideli was inappropriate.

According to the memorandum, the government of Georgia undertook the obligation to compel the GNERC (a) to make a decision before September 1, 2007 concerning the establishment of fixed tariffs on electricity in Tbilisi for an extended period (until 2015)⁹ and (b) to allow the existence of combined electricity meters (one on each floor) for compactly settled IDPs in Tbilisi.¹⁰ The parties agreed that if the annual rate of inflation exceeded the simple indices or if the lari-dollar exchange rate changed by 10% or more, the GNERC would revise Rao-Telasi's distribution tariffs.¹¹ Formally, the regulation of these issues was in the GNERC's competence.

On its part, JSC Telasi undertook the obligation not to request a tariff increase or modification (except the predetermined cases) after GNERC has determined the tariffs until 2015. In addition, Telasi promised that it would not raise controversial issues, such as: reimbursement of losses resulting from the decision of the Constitutional Court of Georgia on reduction of tariffs and reimbursement of investments made but not recovered by Silk Road Holding BV.¹²

Putting the question of the reimbursement of investments made but not recovered by Silk Road Holding BV on the agenda through this memorandum raises the issue of Rao-Nordic's acquisition of Telasi from AES. AES Corporation purchased 75% of Telasi shares for 23 million USD in 1998. In addition to Georgia, this American company possessed assets in the energy sectors of Ukraine, Kazakhstan, and Kyrgyzstan. During five years, AES Corporation invested 400 million USD in Telasi, which included 56 million USD provided by the EBRD. The company attracted the rest of the sum from its headquarters. By 2002, Telasi had completed the installation of energy meters and reimbursement for consumed electricity had reached 86%. At that time, the company's annual income was second only to the state budget.¹³

⁸ His idea with regard to privatization of energy units inevitably had to be taken into consideration.

⁹ Memorandum between the government of Georgia and the Director-General of Inter-Rao, paragraph 1.5, June 20, 2007

¹⁰ Memorandum between the government of Georgia and the General Director of Inter-Rao, paragraph 4, June 20, 2007

¹¹ Memorandum between the government of Georgia and the General Director of Inter-Rao, paragraph 1.4, June 20, 2007

¹² Memorandum between the government of Georgia and the General Director of Inter-Rao, paragraph 1.6, June 20, 2007

¹³ Research conducted on account of the order of the World Bank "Revisiting Reforms – Lessons from Georgia." The research was published on September 14, 2004. It confirms the fact of the reimbursement of 86% of the value for the used electricity.

Many experts, including energy experts of the Sector Economy and Economic Policy Parliamentary Committee, supposed that AES-Telasi consciously exaggerated the amount of its expenses and that it was impossible that the installation of energy meters for 400,000 subscribers in Tbilisi would cost so much. Since 2002, AES Corporation has experienced considerable losses in California and the countries of Latin America, where it owned substantial assets. At the same time, it faced problems in Georgia as well. It experienced severe political pressure from political groups, which lobbied for Russia's state-owned company Rao-UES.

In 2003, AES Corporation annulled the debt (210 million USD) of AES Telasi to the head office and sold Telasi (clear of debts¹⁴), Mtkvari Energy, and the right of management for hydroelectric stations Khramhesi 1 and Khramhesi 2 to Rao Nordic for 25 years for 23 million USD. Rao-Telasi continued its activity through tariffs established for AES Telasi, which, at that time, already equaled 12.7 tetris (approximately 5.3 US cents according to the exchange rate of the time).

The consumer rights defender in the energy sector, Davit Ebralidze, who has examined the question of selling Telasi to Rao-Nordic, explained that AES Corporation annulled Telasi's debt (210 million USD) in 2003.¹⁵ Consequently, Rao-Telasi had no right to make use of the tariffs established for its predecessor, especially in light of the fact that it made no investments at that time. In autumn 2003 and summer 2004, during his visits to Georgia, General Director of Rao-UES, Anatolii Chubais, also expressed readiness to reduce Telasi's tariffs. Nevertheless, after 2005, all discussions concerning tariff reduction have been ceased.

In order to ascertain the authenticity of the research conducted by Davit Ebralidze, the chairman of the GNERC, G. Tavadze, addressed the director of Silk Road Holding BV (by means of which AES Corporation possessed shares of Telasi), A. Fedotov. In response, Fedotov wrote that after Rao-Nordic purchased Silk Road Holding BV and Telasi from AES, it had received the right to request reimbursement of investments from the purchaser.¹⁶

Fedotov's response to Tavadze's letter would have been convincing if any of the purchasing contracts were available to the public. However, if there are some experts familiar with the contract of Silk Road Holding BV on the purchase of Telasi, the contract of the purchase of Silk Road Holding BV and Telasi by Rao-Nordic has not been available even for the GNERC.¹⁷ Until these contracts and, especially, the last contract, are made publicly available, doubts regarding the properness and suitability of the use of the existing tariffs by Rao-Telasi will remain.

In their recommendations to the government of Georgia (the recommendations were published in February 2006), the experts of the World Bank, which, unlike Georgian experts, were able to access these agreements, declared that "the deal (implying between AES Telasi and Rao-Nordic) still hampers transparent regulation and functioning of the electricity sector of Georgia."¹⁸

¹⁴ In 2002 the debt of 56 million USD to EBRD had already been paid off.

¹⁵ AES Corporation Annual Report 2003

¹⁶ Response of A.I. Fedotov (01.01.2005, 21.01.2005) to the letter of the chairman of the Regulatory Commission, G. Tavadze

¹⁷ This contract must be in possession of the government of Tbilisi, given that it owns 25% of shares of Telasi.

¹⁸ The project of the World Bank: Recommendations Regarding the Legislative Basis for the Energy and Natural Gas Sector. The project was executed by the Econ One Consortium, p. 22

Increase in tariffs and the establishment of step tariffs in May 2006¹⁹

Telasi insisted on increasing its share in consumer tariffs, first in May 2004, although at that time Telasi was content to postpone increasing tariffs until the end of 2006. Telasi justified its request with the heightened tax regime and the necessity to receive reimbursement for past expenses. The declaration was accompanied by the conclusion of the independent auditing company UBS.

The GNERC did not support an increase in tariffs.²⁰ It believed that this would further aggravate the social situation of the society. After the assessment of the declaration of Telasi the GNERC intended to reduce its share in tariffs by 0.3 tetris. Ultimately, the tariff was neither reduced nor increased. The GNERC refused to increase Telasi's share citing a lack of sufficient justification in the declaration.²¹

The January 2006 explosions on the gas pipeline between Russia and Georgia severely strained Russian-Georgian relations. In view of these tensions, Russia demanded 235 USD from Georgia, (instead of 110 USD) for gas per 1000 cubic meter. Naturally, such an increase in prices would be reflected in consumer tariffs on electricity and gas.

The rise in Russian gas prices was given as the basis of the May 15, 2006 resolution²² that established the consumer tariff at 11.424 tetris (excluding value added tax) for kilowatt/hour of electricity. In order to create additional guarantees for social protection and for the promotion of rational consumption of electricity, rigid²³ step tariffs were introduced: for the consumption of up to 100 kilowatt/hour, from 101 up to 300 kilowatt/hour, and more than 301 kilowatt/hour electricity.

Considering that according to the official version, the tariff increase was caused by the rise in prices on Russian gas to 235 USD, the GNERC determined maximum tariffs on production of electricity in thermal power stations by means of this regulation in the following way:²⁴

- Mtkvari Energy (9 blocks of Inter-Rao) – 9.11 tetris for kilowatt/hour
- Tbilisress (blocks 3,4, and 8 in state ownership) – 9.801 tetris
- Gas turbine of Energy-Invest – 13.086 tetris

On November 9, 2007, the government adopted edict #657, which obligated the Georgian Oil and Gas Corporation to sell natural gas for the Georgian lari equivalent of at least 143 USD (excluding the value added tax) per 1,000 cubic meters in accordance with the agreement among the parties. In

¹⁹ By resolution of the GNERC on May 15, 2006.

²⁰ Telasi required increase of its share in tariffs from 7.207 tetris to 11.14 tetris, which would raise the tariff by 4 tetris in the end.

²¹ A letter of the protector of the rights of consumers – Davit Ebraldidze, newspaper 24 Hours, summer 2005

²² By means of this resolution the GNERC also established tariffs of transfer of electricity production and scheduling process.

²³ A rigid tariff means that the customer does not pay tariffs on every next step for the consumption of each further kilowatt/hour of electricity, but pays for entirely consumed electricity. For example, if the customer has consumed 103 kilowatt/hour of electricity during 30 days, s/he pays the cost of 103 kilowatt/hour entirely at the rate of the second step tariff.

²⁴ In spring 2006 it had not yet been revealed that the government of Georgia would be able to receive a certain amount of gas from Azerbaijan (1,000 cubic meters for 120 USD). Therefore, the GNERC could not take this into account in its calculations in spring 2006.

addition, it was obligated to sell natural gas to Mtkvari-Energy, JSC Energy-Invest, and JSC Tbilisressi²⁵ – for the Georgian lari equivalent of at least 25 USD (excluding the value added tax) per 1,000 cubic meters.²⁶

The above-mentioned document once more reveals government interference in the competence of the GNERC in violation of Georgian legislation. If the government adopted the November 9th resolution in order to stabilize prices, then the tariff on electricity produced via cheap Azerbaijani gas should have been reduced. In reality, this tariff has not only not been reduced, but also in winter months electricity produced by the gas turbine of Energy-Invest was being sold for 14 tetris, instead of the maximum 13.086 tetris determined by the GNERC.

In fact, the resolution adopted by the GNERC on May 15, 2006 does not reflect the present situation. The GNERC has not adopted a new resolution to modify tariffs so far. The rigid step tariff cannot be considered accurate, given that it does not correspond with the expenses of the generating company, in this case, that of Telasi and Mtkvari-Energy, which is in Telasi ownership. Furthermore, a rigid tariff cannot protect the interests of socially vulnerable groups.

Government interference in the function of the GNERC – Energo-Pro Georgia

According to one opinion, the intention to bring Energo-Pro Georgia to the Georgian market already existed in spring 2006 and the GNERC's May 15, 2006 resolution on increasing tariffs and establishing step tariffs was passed to facilitate Energo-Pro's future activities in the country.

This resolution established tariffs on thermal and hydro generation, distribution in the regions, transmission, and dispatch, in accordance with frequency and with steps of consumption. During 2005-2006, the government funded the installation of communal energy meters by regional distribution companies and the rehabilitation of high and average voltage electricity lines and generation units. These expenditures were reflected in tariffs established through the resolution of the GNERC on May 15, 2006.

In accordance with the agreement between the government and Energo-Pro Georgia, in February 2007 the partially restored (by the government) high, average, and low voltage electricity lines (110, 35-10, and 6-0.4 kilowatts) and the regional distribution system equipped with communal energy meters (excluding the distribution of Kakheti and Tbilisi) along with the determined step tariffs (which reflected expenses of the state and not those of Energo-Pro Georgia) were transferred to Energo-Pro Georgia. According to the information provided by the company, the reimbursement of the costs of consumed electricity by communal energy meters had reached 90% by that time.

According to the agreement, the government undertook the obligation to force the GNERC to make a decision (a) about setting a ten-year time frame for the company to provide the regional population with individual active energy meters²⁷ and (b) about the adoption of the resolution, concerning the realization of the mechanism of tariff indexation.²⁸ The GNERC has not made these

²⁵ Despite the fact that their tariffs had been calculated by GNERC in May 2006 based on Russian gas price \$235 per 1,000 cubic meter.

²⁶ Resolution of the Government of Georgia, #657, November 9, 2007.

²⁷ Agreement between the government of Georgia and the Energy-Pro Georgia concerning the purchase of assets of hydro electric stations and the energy distribution companies, chapter 5, paragraph (f)

²⁸ Agreement between the government of Georgia and the Energy-Pro Georgia concerning the purchase of assets of hydro electric stations and the energy distribution companies, chapter 7, paragraph (n)

decisions so far. Nevertheless, the company will presumably demand the fulfillment of the above mentioned paragraphs after the parliamentary elections in May 2008.

These paragraphs of the agreement between the Georgian government and Energo-Pro Georgia can be considered government interference in the functions of the GNERC and complete disregard of both the essence and specifics of the existing laws on electricity and gas and on the independent regulator. A similar assessment should be made concerning the memorandum signed with Inter-Rao. Furthermore, from a legal and political perspective, these documents have been concluded between unequal partners: on the one hand between the prime minister of Georgia and the chair of the board of Inter-Rao UES and on the other hand between the Ministry of Economic Development and the private company Energo-Pro.

At this point, none of these documents are legally binding for the GNERC, since, according to Georgian legislation, “The bases of the activity of the GNERC are the Constitution of Georgia, international treaties and agreements (ratified by the parliament), Georgian law on electricity and gas, the statute of the GNERC and other legislative acts.”²⁹ Consequently, in case of the existence of the political will, it is possible to reconsider the above-mentioned documents and make them comply with Georgian legislation, though the final conclusion must be drawn by the appropriate lawyers.

Deregulation of the supply of gas and tariffs on gas

In January 2006, the government of Georgia made a decision concerning the deregulation of the supply of gas. The purpose of this decision was to enable the major consumers of gas – Georgian-Russian and Georgian-Kazakh business groups – to themselves carry on negotiations about the quantity, price, and other important conditions of supply with their partners in Russia and Kazakhstan. This decision ought to have supported releasing the gas market from political influence, nevertheless, later, after successful negotiations with Azerbaijan, the Georgian Oil and Gas Corporation became the main supplier of gas. Given that the import of gas is deregulated, the independent regulator regulates only tariffs on its domestic transportation and distribution. Only the supplier, in this case the Georgian Oil and Gas Corporation, knows the supply price.

During the determination of the gas tariffs, the acquisition price has a crucial importance. Hence, the decision destined for releasing the gas supply from political influence, has become a source of new uncertainties. The Georgian Oil and Gas Corporation considers the gas acquisition price to be a commercial secret, whereas the consumer (which, in this case, is not protected by the GNERC, even theoretically) begins to doubt the accuracy and fairness of the tariff.

The new gas tariff calculated by the GNERC on the basis of Russian gas priced at \$235 per 1,000 cubic meters was introduced in May 2007. This tariff has been in effect throughout 2007, although the Minister of Energy of Georgia managed to purchase about 45% of consumed gas in Azerbaijan (SOCAR and the Shakh Deniz Consortium) at \$120 per 1,000 cubic meters. Neither the price of Azeri gas nor the dollar/GEL exchange rate (depreciation of US) dollar persuaded the government to allow GNERC to recalculate the tariff.³⁰

²⁹ Georgian Law on Electricity and Gas, paragraph 4: status and functions, 1997

³⁰ According to legal experts familiar with the current regulation it is extremely difficult if not impossible for the GNERC to initiate an administrative procedure towards tariff revision. L.J.

Conclusions

- The government of Georgia interferes in the activity of the GNERC, which contradicts the Law on Electricity and Gas and the Law on the Independent Regulator;
- The current tariff on electricity in Georgia does not reflect the expenses of either Rao-Telasi³¹ or Energo-Pro Georgia in the energy sector, which contradicts the Law on Electricity and Gas and the methodology for calculating tariffs on electricity and gas elaborated by the GNERC;
- The memorandum signed by the Georgian government with Inter-Rao and the agreement with Energo-Pro Georgia contradicts the Georgian laws on electricity and gas and on the independent regulator. Moreover, these agreements do not constitute legislative acts having legal force for the GNERC. Accordingly, obligations undertaken by the government on behalf of the GNERC through these agreements are unlawful.
- Deregulation of the supply of gas and the fact that no long-term agreements on gas supply³² exist with Russia and Azerbaijan thus far raises questions among consumers about gas supply prices. This price constitutes the main component of the gas tariff.
- Questions concerning the accuracy of electricity and gas tariffs reveal that the GNERC is unable to protect consumer rights, which, according to the law, is one of its most important functions.
- The Georgian government does not take into account the recommendations of the international (in this case World Bank) experts concerning the distribution of functions between the Ministry of Energy and the GNERC and strengthening the authority of the GNERC in the process of privatization;
- In case the government intends to restrict the authority of the GNERC or to entirely abolish it, it is important to determine what mechanisms will protect the interests of consumers from monopolistic prices and how this decision will affect them and economic processes in general.
- In view of the fact that the existence of precise and fair tariffs on energy carriers has vital importance for the population, as well as for economic actors, independent experts and interest groups specializing in energy and economics have to participate actively in the process of discussion of such modifications.

³¹ Discussions around this question would have ceased, if the agreements (AES-Telasi-Rao, Nordic-Inter-Rao) had been made accessible to the public.

³² Except for the agreement with Shah-Deniz International Consortium, which is valid until 2012.